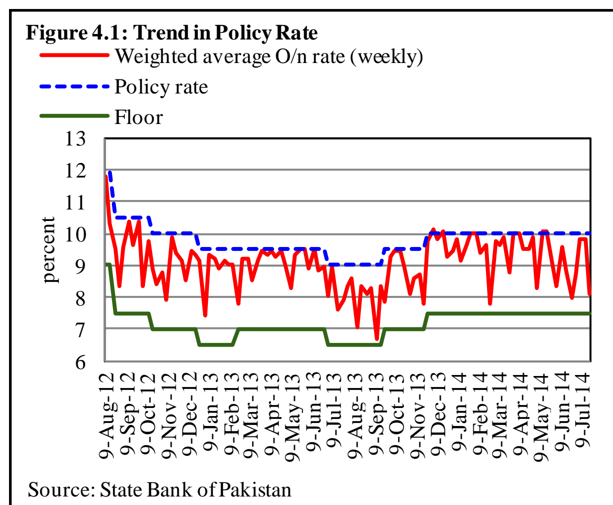
4 Monetary Policy and Inflation

4.1 Overview

Although SBP pursued a cautious monetary tightening throughout FY14, the macroeconomic environment in which monetary policy was operating, can be classified into two distinct phases. The first phase was characterized by severe pressures on the external account; significant upside risks to the inflation outlook; and the government reliance on central bank financing. Hence, not surprisingly, the government decided to re-engage with the IMF in September 2013. In the midst of growing concerns with inflation, SBP increased the policy rate by 50 bps each in its monetary policy decisions of September and November 2013 (**Figure 4.1**). The Monetary Policy Statement of January 2014 (page 1, para1) clearly recognizes two concerns that justified the increase in the policy rate: "one was the continued deterioration in the balance of payments position while the other was worsening of inflation outlook".

Figure 4.1: Trend in Policy Rate



Source: State Bank of Pakistan

During the second phase (H2-FY14), the policy environment improved considerably as: (a) the IMF program helped stem the sharp fall in SBP's foreign exchange reserves (one of the key concerns of policymakers) (**Figure 4.2**); (b) both inflation and inflationary expectations remained lower than SBP's initial projections; (c) fiscal consolidation reduced the domestic financing needs of the government; and (d) together with the resumption of external inflows from IFIs, there was the much needed shift in the financing burden from domestic to external sources and SBP to commercial banks. Despite these positive developments, SBP missed the ceiling on its NDA (as agreed with the IMF) for end March and June 2014.

The government could not contain its borrowing from SBP within the program limits for the second and fourth quarters of FY14. Moreover, although the surge in financial inflows provided much needed comfort to the external sector, the one-off nature of these flows remains a concern. Based on the assessment of these considerations, SBP kept its policy rate unchanged at 10 percent during the second half of the year, and liquidity in the money market was cautiously kept tight to manage any undue pressure on the exchange rate.

The following discussion elaborates the thinking behind SBP's monetary policy decisions during FY14. In this context, the three points are worth noting:

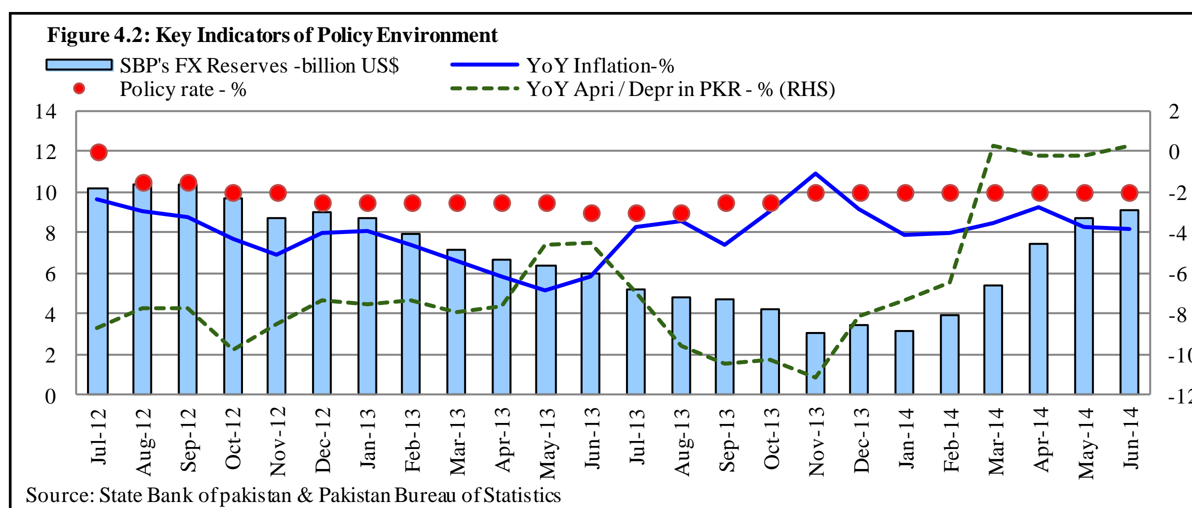
1. Inflation outcome was better than expected:

With hindsight, SBP's initial projection of 11-12 percent for FY14 was much higher than the actual CPI inflation of 8.6 percent for FY14. In fact, SBP assumed the upward adjustment in administered prices and the depreciation of the PKR during initial months of FY14, would persist, which have a critical impact on likely inflation and inflationary expectations.[1] Not surprisingly, therefore, SBP's initial projections exceeded the annual target of 8.0 percent, and the realized inflation of 7.4 percent in

[1] With the IMF program on cards, swift increase in power tariffs was expected to reduce the level of power subsidies.

the previous year. Predictably, headline inflation did pick up and reached 10.9 percent in November 2013, from 5.9 percent in June 2013 (**Figure 4.2**). However, the major contribution came from the unexpected rise in prices of perishable food items and wheat.

Figure 4.2: Key Indicators of Policy Environment



Source: State Bank of pakistan & Pakistan Bureau of Statistics

The second half of FY14 proved more favorable as: (a) the government reduced retail POL prices in November 2013, in response to softening oil prices in the global market; (b) the PKR appreciated after depreciating sharply during Jul-Nov; and (c) the supply of wheat and perishable food items improved, which countered the increase in H1-FY14. These developments, along with the lagged impact of monetary tightening, kept inflation and inflationary expectations in check for rest of the year. The non-food-non-energy (NFNE) inflation declined to 8.3 percent in FY14, from 9.6 percent in the previous year.

2. Risks related to external sector lessened:

The external account also recorded a sharp change during FY14, i.e., from deterioration in Q1-FY14, to a comfortable position in Q4- FY14. Specifically, the current account deficit widened during Q1-FY14, which together with lumpy SBA repayments to the IMF (against smaller inflows), led to a drawdown in SBP's foreign exchange reserves and the depreciation of the PKR.[2] SBP responded by gradual monetary tightening during this period.

However, pressure on the external account eased as bulky re-payments to IMF subsided after November 2013, and current account posted surpluses in December 2013 and February 2014. Further support to the external account came from a sizeable grant under the Pakistan Development Fund, proceeds from the Eurobond, resumption of IFI loans, and the successful outcome of 3G/4G auction. The higher than expected financial inflows not only allowed SBP to build its foreign exchange reserves, but also helped the PKR to regain some of the loss in value earlier in FY14 (**Figure 4.2**).[3] More importantly, this improvement offered SBP room to keep its policy rate unchanged during the second half of the year.

3. A long awaited fall in government borrowing materialized

Despite a reduction in the fiscal deficit in early FY14, the government borrowed Rs 622.1 billion from SBP during Jul-Oct FY14. In fact, commercial banks' reluctance to invest in government securities (they were expecting a hike in the policy rate), and the lack of external financing during this period,

[2] While SBP lost almost half of its foreign exchange reserves during Jul-Nov (to reach at US$ 3.0 billion), the PKR depreciated by 8.2 percent during the same period.

[3] For detail discussion, please see Chapter 7 of the report.

forced the government to rely on SBP funding.[4] This financing mix improved after the increase in policy rate in November 2013, which helped the government to substitute away from SBP. In addition to this, the availability of external funding during the second half of the year reduced the pressure on the banking system.

Broadly speaking, the sharp improvement in external inflows not only pushed up the country's FX reserves, but also eased the government's reliance on domestic sources of funding, especially on the banking system.[5] This, in turn, has strongly impacted monetary aggregates and its causative factors during the year.

At an aggregate level, broad money supply expanded by 12.5 percent during FY14, compared to 15.9 percent in FY13. It is encouraging to note that this deceleration was accompanied with a favorable change in the composition of M2 growth: the net foreign assets of the banking system saw an expansion of Rs 332.0 billion in FY14, against a net contraction of Rs 263.3 billion in FY13; while the increase of Rs 778.2 billion in net domestic assets (NDA) of the banking sector in FY14, was almost half the expansion seen in the previous year (**Table 4.1**). Within NDA, the improvement was entirely a function of lower government borrowing from the banking sector.[6] This, along with healthy growth in bank deposits, improved the supply of loanable funds to the private sector.

Table 4.1: Absolute Changes in Monetary Aggregates

billion Rupee

	FY11	FY12	FY13	FY14*
Broad money (M2)	918.0	946.6	1216.0	1110.2
Net Domestic Assets	683.0	1194.7	1479.3	778.2
SBP	48.7	469.4	448.0	-82.2
Scheduled Banks	634.2	725.4	1031.3	860.5
Net Foreign Assets	235.0	-248.1	-263.3	332.0
SBP	235.3	-219.9	-261.1	356.5
Scheduled Banks	-0.3	-28.2	-2.2	-24.5

*: provisional

Source: State Bank of Pakistan

The demand for private sector credit increased mainly due to relatively better availability of electricity and gas at the beginning of the year (following the settlement of circular debt); the improvement in business confidence; and some sector specific developments. All these factors contributed to a healthy 11.4 percent growth in credit to the private sector, a level last seen in 2008. Moreover, sectoral distribution of credit indicates a recovery in business activity as a number of sectors (textile, food and beverages, telecommunication, energy, electrical appliance, etc.) figured prominently in the credit expansion. Although credit to the private sector recorded positive YoY growth in FY14, a comparison with regional economies indicates that Pakistan is lagging behind its peers as far as credit to GDP is concerned (**Figure 4.3a**). Historical data shows that the credit to GDP is declining in Pakistan, which is a further point of concern (**Figure 4.3b**).

Last but not the least, the recovery in the consumer financing is spreading as an increasing number of banks are positioning themselves to benefit from this segment of the economy.
Being the leading indicators of underlying economic activity, the positive changes in monetary aggregates and its key components, bode well for the outlook of overall economic activity.

[4] It is pertinent to note here that the monetization of deficit entails inflationary concerns.

[5] The impact of financial inflows on the country's foreign exchange reserves and the financing mix of the deficit depends on the nature of financial inflows. For example, BoP support from IMF will increase SBP's foreign exchange reserves, but will have no direct impact on sources of deficit financing.

[6] Within the banking system, a net contraction in SBP's NDA also benefitted from a reduction in refinancing under the export finance scheme (EFS). Specifically, the outstanding loans under EFS stood at Rs 160.5 billion at end FY14, indicating a net reduction Rs 17.3 billion from the last year's level of Rs 177.8 billion.

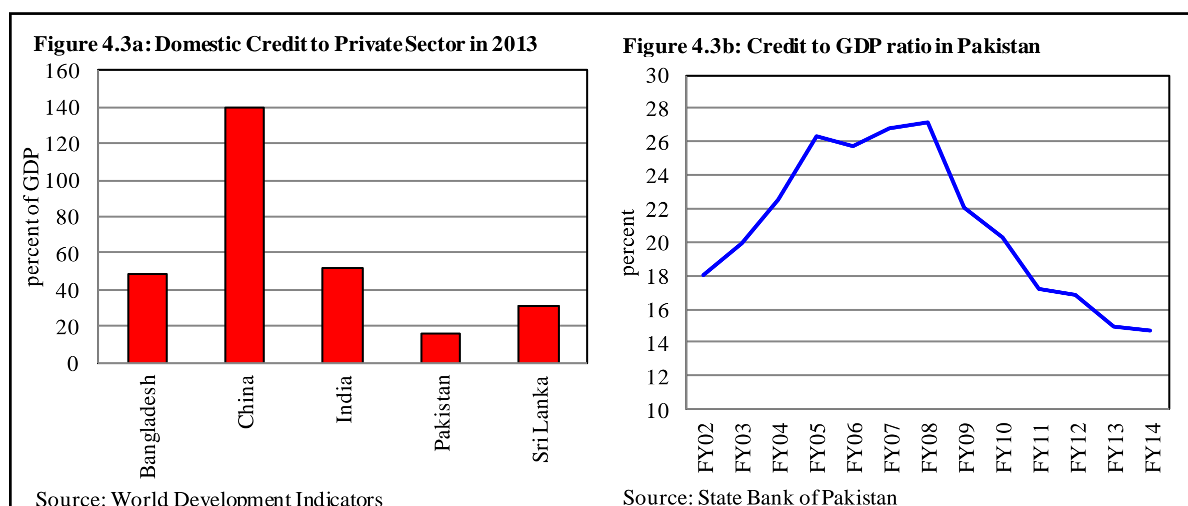


Figure 4.3a: Domestic Credit to Private Sector in 2013

Source: World Development Indicators

Figure 4.3b: Credit to GDP ratio in Pakistan

Source: State Bank of Pakistan

4.2 Liquidity Management

Despite the improvement in the monetary environment, the short term liquidity management remained challenging throughout the year. Like in the policy environment, liquidity conditions in the money market can also be classified into two distinct phases, bifurcated by the monetary policy decision of November 2013. Prior to that decision, the money market had *excess* liquidity: banks were maintaining excess liquidity with SBP; the weighted average overnight rate hovered around the middle of interest rate corridor; SBP was conducting OMOs to drain liquidity from the market; and a large number of banks were utilizing SBP's deposit facility to park their liquidity.[7] The underlying reasons for this comfort in the money market can be traced to banks' reluctance to rollover maturing T-bills in an anticipation of an increase in interest rates, which forced the government to rely on SBP funding. Furthermore, SBP's net FX purchases from the interbank market (to comply with prior actions for the new IMF program), injected liquidity into the market.

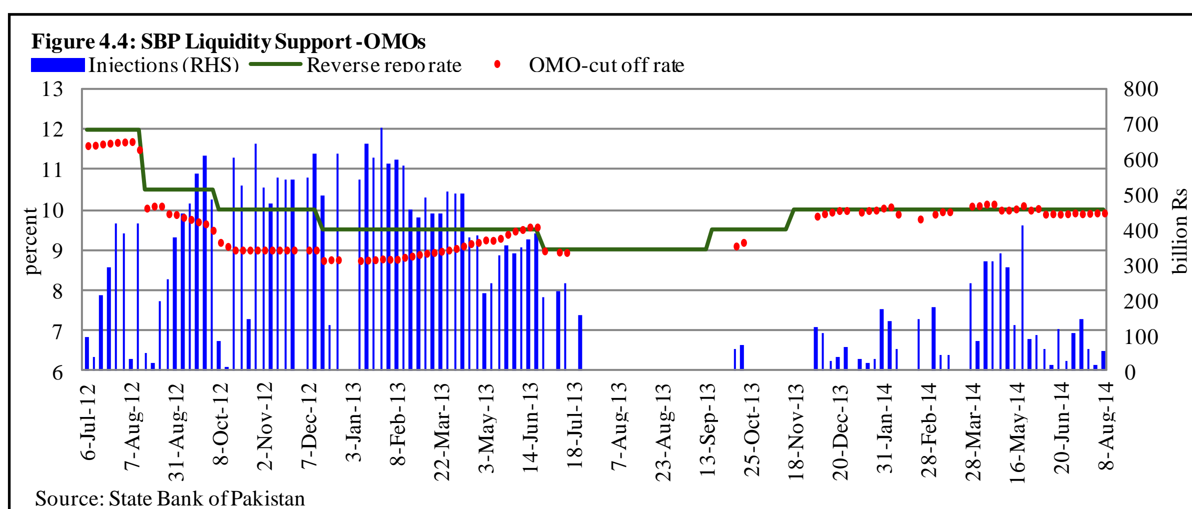
In contrast, the post November phase witnessed severe liquidity shortages in the money market. This abrupt change was largely because of banks' renewed interest in government securities.[8] The government also accepted huge sums in subsequent T-bill auctions to meet the quarterly limit on its borrowing from SBP for end-December 2013. As a result, the cut-off rates on T-bills came very close to the policy rate, creating an almost flat yield curve up to one year maturity (more on this issue in Chapter 6). In the meanwhile, healthy credit off-take further squeezed liquidity in the market. Hence, the overnight money market rate also reached the upper limit of the interest rate corridor.

In this environment, SBP decided to keep the money market rate cautiously elevated to contain expansion in its NDA and any undue pressure in the FX market. Specifically, not only did the overnight money market rate move above the interest rate corridor at times, the OMOs cut-off rate was also higher than the policy rate on several occasions (**Figure 4.4**). In fact, the higher money market rates and limited availability of liquidity through OMOs, forced banks to rely more on SBP's standing facility to meet their liquidity requirements. The banks obtained liquidity from SBP 156 times during the second half of the year, against 76 visits to deposit liquidity with SBP. However, the liquidity conditions improved by end of the year, as higher than expected external inflows not only reduced government borrowing from the banking system, but also shored up the external account.

[7] For details discussion, see SBP's Third Quarterly Report for FY14 on the State of Pakistan's Economy.

[8] Following the change in the policy rate, banks offered Rs 603.8 billion in the first T-bill auction against the pre-auction target of Rs 225.0 billion and the maturity of Rs 151.3 billion.

Figure 4.4: SBP Liquidity Support -OMOs



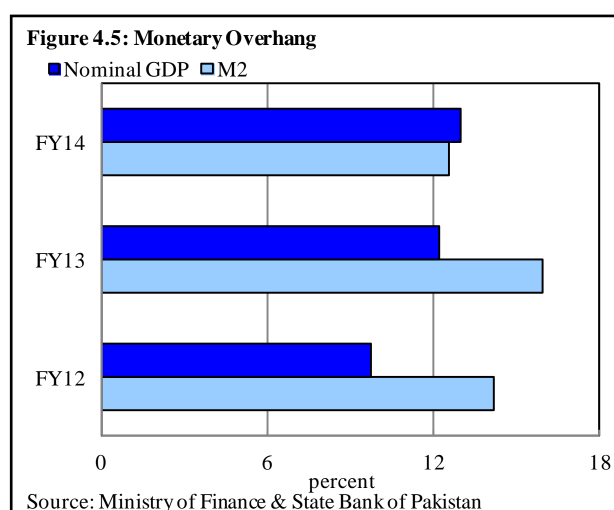
Source: State Bank of Pakistan

4.3 Monetary Aggregate

Changes in monetary aggregates and its causative factors, reflect a number of positives:

(a) The 12.5 percent growth in broad money supply during FY14, was lower than 15.9 percent in the previous year. Reserve money, a narrower monetary aggregate, followed the similar path.[9] The slowdown provides some comfort to the inflation outlook as monetary expansion was lower than the growth in nominal GDP, which would help neutralize the monetary overhang seen in FY12 and FY13 (**Figure 4.5**).

Figure 4.5: Monetary Overhang



Source: Ministry of Finance & State Bank of Pakistan

(b) More importantly, the increase in government borrowing from the banking system (the prime source of monetary expansion in the past few years) fell sharply to only 5.8 percent in FY14, from 38.1 percent the year before.

(c) Encouragingly, credit to private sector saw a healthy growth of 11.4 percent in FY14, against a net contraction of 0.6 percent in FY13. and

(d) NFA of the banking system more than doubled during FY14, in sharp contrast to a 49.5 percent net contraction in FY13.

The subsequent discussion focuses on the underlying reasons for the change in causative factors.

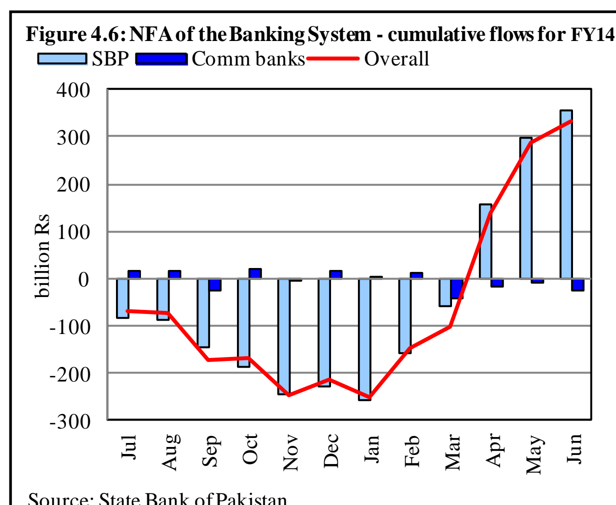
4.3.1 Surge in Net Foreign Assets of the Banking System

In absolute terms, NFA of the banking system saw a sizeable increase of Rs 332.0 billion during FY14, against a net contraction of Rs 263.3 billion in FY13 (Table 4.1). The increase in external inflows included debt (other than IMF loans), grants and privatization proceeds, which were concentrated in fourth quarter of the year (**Figure 4.6**). Given the official nature of these inflows, this expansion was booked in SBP's NFA.

[9] Despite overall deceleration in reserve money, SBP missed the quarterly target on its NDA under the IMF program for two quarters of the year.

On the other hand, NFA of commercial banks witnessed a net contraction of Rs 24.5 billion during the year, which was largely concentrated in Q3-FY14 (**Figure 4.6**). As expectations of PKR appreciation started taking hold during the quarter, this eased the growth in FE-25 deposits, but also encouraged trade financing through FE-25 loans.[10] The latter required banks to reduce their balances abroad, thereby resulting in fall in their NFA.

Figure 4.6: NFA of the Banking System - cumulative flows for FY14



Source: State Bank of Pakistan

4.3.2 Fall in government borrowing[11]

In absolute terms, not only was budget deficit lower in FY14 compared to FY13, there was also a marked shift in the sources of deficit financing. Thus pressure on domestic resources, especially on the banking system, eased significantly. In fact, the budgetary borrowing of Rs 323.7 billion from the banking system, was only 22.2 percent of the amount borrowed a year before (**Table 4.2**). This, in turn, created the room for banks to finance the private sector credit (more on this issue later).

Table 4.2: YoY Absolute Change in Net Budgetary Borrowing

billion Rupee

	FY12	FY13	FY14*
Banking system	1,143.9	1,457.5	323.7
SBP	507.5	505.9	159.8
Scheduled banks	636.4	951.6	163.9

*: Provisional
Source: State Bank of Pakistan

Within the banking system, although budgetary borrowing from both SBP and scheduled banks declined, the government was unable to adhere to the statutory requirement of zero budgetary borrowing from SBP for three quarters in the year. As the key driver of SBP's NDA, these slippages made it extremely difficult for the central bank to contain its NDA within the ceiling agreed upon with IMF for the third and fourth quarters of FY14. As shown in **Table 4.3**, the government also missed the limit on its borrowing from SBP in the second and fourth quarters of the year.[12] In addition to this, monthly data on budgetary borrowing shows that the government faced considerable difficulties in financing its deficit up to third quarter of the year. In this context, the following points are worth noting:

Table 4.3: Quantitative Targets Under IMF Program

billion Rupee

	End-Sep-13		End-Dec-13		End Mar-14		End-Jun-14	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual
Ceiling on NDA of SBP	2,877	2,595	2,968[a]	2,821	2,609[b]	2,650	2,324[c]	2,372
Ceiling on net budgetary borrowing from SBP	2,690	2,521	2,560	2,611	2,390	2,227	2,240	2,328

a: End December 2013 NDA target of Rs 2,901 was adjusted upward by Rs 67 billion to reflect a short fall in multi/bilateral inflows
b: End March 2014 NDA target of Rs 2,627 was adjusted downward by Rs18 billion to reflect an excess in multi/bilateral inflows
c: It may be noted that the end June 2014 NDA target of Rs 2,324 billion, would be adjusted to reflect an excess/shortfall in multi/bilateral inflows compared to the IMF projections.

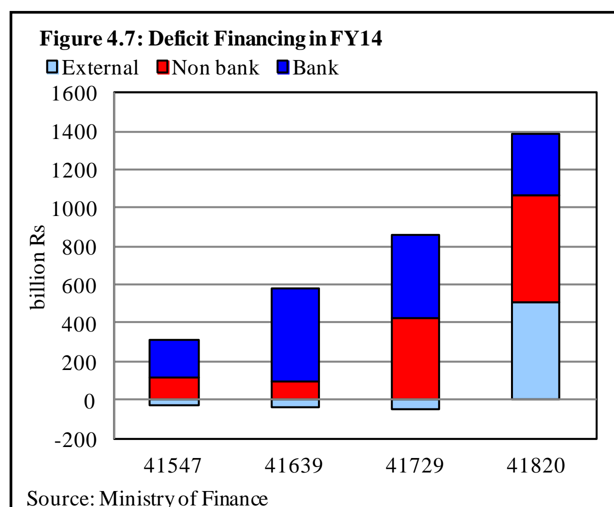
Source: IMF & SBP

[10] This increase in trade financing against FE-25 loans, also contributed to a reduction of Rs 17.3 billion in loans under the Export Finance Scheme during FY14, as a number of traders substituted their Rupee financing with foreign currency loans.
[11] Numbers discussed in this section are on cash basis.
[12] It is interesting to note that the government was able to contain its borrowing from SBP well below the ceiling agreed with IMF for third quarter of the year, yet SBP missed the limit on its NDA with a small margin. This situation primarily emerged from the government decision to keep healthy inflows into Pakistan Development Funds (PDF) intact. While increase in PDF helped government contain its' borrowing from SBP within the limits (as the borrowing from SBP is reported net of government deposits), the government appetite for funding from the banking system remained unchanged during the quarter.

1. The onus of deficit financing fell disproportionately on domestic resources during the first three quarters of the year, as external financing was only available in the fourth quarter (**Figure 4.7**). Within domestic sources, the government was forced to borrow from the banking system during the first half of the year, as net inflows from non-bank sources (especially NSS) remained subdued.[13] Despite these unfavorable conditions, it is encouraging to note that budgetary borrowing from banking sector during H1-FY14 was lower than the corresponding period of FY13.[14]

2. Expecting an increase in the policy rate, commercial banks were not only reluctant to rollover maturing T-bills during the initial months of the year, the offered amounts were concentrated in 3-month T-bills.[15] This forced the government to rely on SBP to meet its funding needs and, at the same time, complicated both liquidity and domestic debt management.

Figure 4.7: Deficit Financing in FY14



Source: Ministry of Finance

3. With the increase in policy rate in November 2013, and a distinct fall in YoY inflation in December 2013 (driven by a sharp dip in food inflation), the market soon came to the view that interest rates have already peaked. Thus, not only did their bid pattern in T-bill auctions shift away from 3-month T-bills, the market's appetite for medium to long term government securities was suddenly revived. This unexpected change helped the government improve the maturity profile of its domestic debt, and also retire some of its inflationary borrowing from SBP.[16]

4. More than expected external inflows during the second half of the year, eased pressure on domestic sources of financing, especially on the banking system. Specifically, budgetary borrowing from the banking system saw a net retirement of Rs 159.7 billion during H2-FY14, against the net borrowing of Rs 483.3 billion during the first half of the year.

Table 4.4: Loans under Commodity Operation

billion Rupee

	FY12	FY13	FY14
Flows	38.6	31.63	22.8
Wheat	52.8	8.5	22.7
Sugar	-7.1	9.6	1.4
Fertilizer	6	13.5	-1.5
Rice	-13.1	0.0	0.1

Source: State Bank of Pakistan

In sum, while the fall in budgetary borrowing from the banking system is a welcome development, it was largely driven by exogenous factors and *one-off* developments (the launch of Euro Bond, the successful 3/4G auction, etc.).

[13] The government has almost no control over inflows from this source.
[14] Net budgetary borrowing from the banking sector during H1-FY14 was Rs 483.3 billion, compared with Rs 557.9 billion in H1-FY13
[15] Specifically, before the change in the policy rate in November 2013, the banks offered Rs 2,573.3 billion in T-bill auctions against the maturity of Rs 2,718.3 billion, and 89.4 percent of the amount was offered in 3-month T-bills alone.
[16] For details, please see Chapter 6 on Domestic and External Debt.

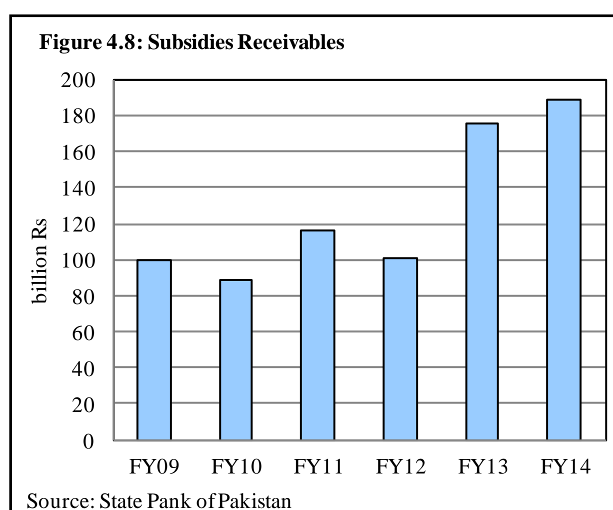
4.3.3 Commodity Operations[17]

Loans for commodity operation, a quasi government borrowing, saw a smaller increase of Rs 22.8 billion during FY14, compared to Rs 31.6 billion seen in FY13. Loans availed for wheat procurement remained dominant, as the Rs 1.4 billion increase in financing of sugar, was completely offset by a decline of Rs 1.5 billion in loans for fertilizer imports (**Table 4.4**).

Despite the relatively lower increase during the course of the year, the outstanding stock of commodity financing has reached an all-time high of Rs 492.4 billion by end FY14. Although a major portion of this amount was disbursed during the year, around 30 percent of this amount was carried forward from the previous years. Given the self-liquidating nature of commodity operations, the outstanding amount carried forward from previous years, is a clear indication of underlying problems in commodity operations.

Another important issue related to commodity financing, is the building up of receivables, which undermines the repayment capacity of the procurement agencies. The receivables on account of subsidies and sale proceeds, reached Rs 282.6 billion by end FY14 (a rise of Rs 27.9 billion in FY14). Furthermore, a large part of these receivables are subsidies due from the government, which saw an increase of Rs 13.3 billion during the year to Rs189.4 billion by end FY14 (**Figure 4.8**). The breakdown indicates that receivables of the TCP and the Food Department of Punjab (from the federal government), account for almost 75 percent of the outstanding amount (**Table 4.5**). Early settlement of such subsidies would help procurement agencies retire their costly borrowing from the banking system.[18] As repeatedly pointed out by SBP, this would be cost effective for the government, as loans for commodity operations are more expensive compared to direct government borrowing for budgetary finance through T-bills.[19]

Figure 4.8: Subsidies Receivables



Source: State Pank of Pakistan

Table 4.5: Receivables of Procurement Agencies (Subsidy Payment)

billion Rupee

	30-Jun-13	30-Jun-14
PASSCO	20.3	22.9
TCP	68.9	63.0
Food Dept of Punjab	68.8	85.4
Food Dept of Sindh	18.1	18.1
Total	176.1	189.4

Source: State Bank of Pakistan

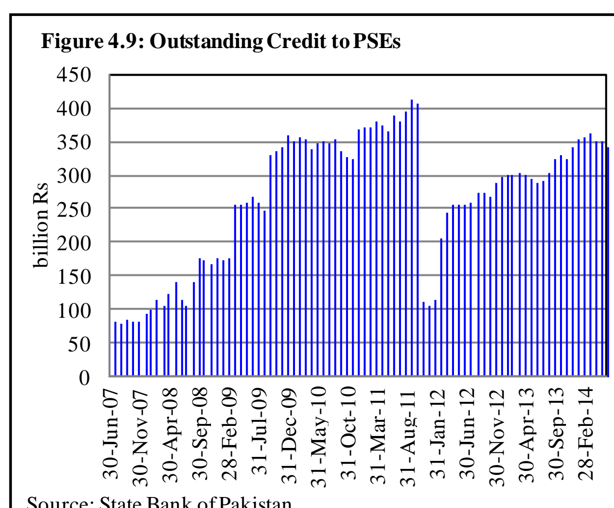
4.3.4 Public Sector Enterprises

PSEs are not only a major drain on scarce fiscal resources, these entities are also actively borrowing from the banking sector to meet their credit needs. In absolute terms, credit to PSEs saw an increase of Rs 54.0 billion during FY14, on top of the Rs 30.9 billion increase seen in FY13. Power sector PSEs, which are facing liquidity problems due to accumulating inter-agency receivables (the circular debt), are the main borrowers. In addition, PIA borrowed Rs 9.9 billion (in net terms) during FY14, on top of Rs 14.7 billion in FY13, while its performance continues to deteriorate.

[17] Numbers discussed in this section pertains to overall commodity finance provided by both banks and development finance institutions.
[18] It is encouraging to note that the risk premium charged by banks has gradually declined in the range of 50 to 85 bps in FY14, compared to 275 bps in FY12.
[19] For details, please see SBP Annual Report on the State of Pakistan's Economy for 2012-13.

Outstanding credit to PSEs has now reached Rs 342.1 billion by end FY14, which is more than three times the level seen in November 2011. To put this in perspective, government efforts to address the circular debt issue, brought down outstanding credit to PSEs from its peak of Rs 412.9 billion (as of end September 2011) to Rs 110.9 billion in November 2011. However, the government's reluctance to take hard steps to deal with the underlying fault lines (especially in the energy sector), is pushing the PSEs debt stock back towards the level seen before the settlement of the circular debt (**Figure 4.9**).[20]

Figure 4.9: Outstanding Credit to PSEs



Source: State Bank of Pakistan

4.4 Credit to Private Sector

Following an extended period of low growth, and recording a net contraction of 0.6 percent in FY13, credit to the private sector registered a healthy growth of 11.4 percent during FY14.[21] This double-digit growth –last seen six years ago – is attributed to a confluence of demand and supply side factors: (a) increased supply (availability) of loanable funds; (b) improvement in business and consumer confidence; (c) better availability of electricity and gas to the industrial sector; and (d) lower effective cost of borrowing.

Table 4.6: Change in Credit to Private Sector

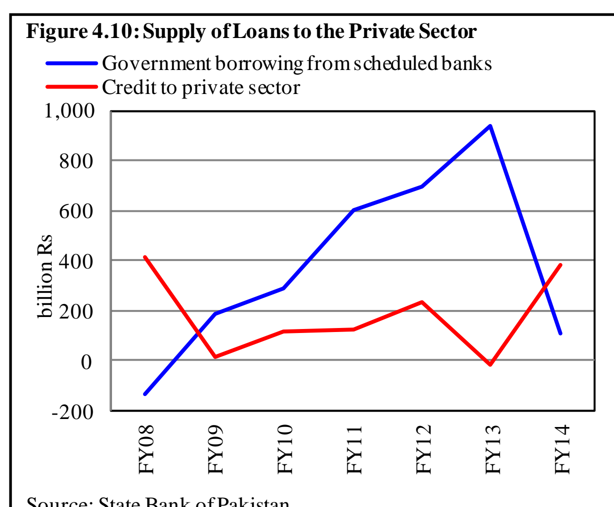
billion Rupee

	FY11	FY12	FY13	FY14
Overall	121.3	235.2	-19.0	384.0
of which				
Loans to private business	173.2	18.3	17.1	298.0
Investments in private stocks	13.0	-4.8	18.9	15.3
Consumer financing	-27.9	-12.9	15.0	31.3
Credit to NBFCs	8.3	121.0	-85.6	-4.2

Source: State Bank of Pakistan

Within private sector credit, the impetus came from loans to private business, which increased by Rs 298.0 billion in FY14, compared to a meager rise of Rs 17.1 billion in FY13 (**Table 4.6**). The distribution of credit by loan types indicates that all three categories, namely working capital, trade finance and fixed investment witnessed a notable improvement during the year.

Figure 4.10: Supply of Loans to the Private Sector



Source: State Bank of Pakistan

The sectoral distribution of loans also indicates a broad-base improvement during the year. In addition to businesses, consumer financing also expanded by Rs 31.3 billion in FY14, more than twice the increase seen in FY13.

Credit to NBFCs, a major source of changes in overall credit during FY12 and FY13, saw a net contraction of Rs 4.2 billion. Around two-thirds of this contraction was attributed to a fall in banks' investment in NBFCs. We believe these changes

[20] As of 5th Sep-14, outstanding credit to PSEs reached Rs 356.4 billion.

[21] Gross disbursements to the private sector also increased by 13.2 percent during FY14 against a fall of 6.5 percent during FY13.

were primarily driven by the government's decision to phase out tax incentives on investments in mutual funds.[22]

Increased Supply of Loanable Funds

As repeatedly highlighted in SBP Annual and Quarterly reports, excessive government borrowing from commercial banks has been crowding out the private sector in recent years (**Figure 4.10**). With government borrowing at its lowest level since FY08, commercial banks were able to increase the supply of loans to the private sector. In addition, healthy growth in bank deposits,[23] and SBP's decision to link the minimum profit rate on savings deposits with the floor of the interest rate corridor,[24] also incentivized banks to shift their focus towards the private sector to shore up their profitability.

Pickup in Demand for loans

At macro level, a modest recovery in economic activity during FY14 was perhaps one of the key drivers behind the higher demand for bank credit during the year. Specifically, the industrial sector, which is the biggest user of private sector credit, grew by 5.8 percent during FY14 – the highest since FY08. In addition, the improvement in consumer sentiments, as indicated by the IBA-SBP Consumer Confidence Survey (CCS), also contributed to the demand for credit. The CCS also showed an optimistic economic outlook throughout the year (**Table 4.7**). As mentioned earlier, the sharp increase in inflation during H1-FY14 reduced the effective cost of borrowing, while the appreciation of PKR led to a visible increase in the foreign currency loans.[25]

Table 4.7: Major Indicators Impacting Credit to Private Sector

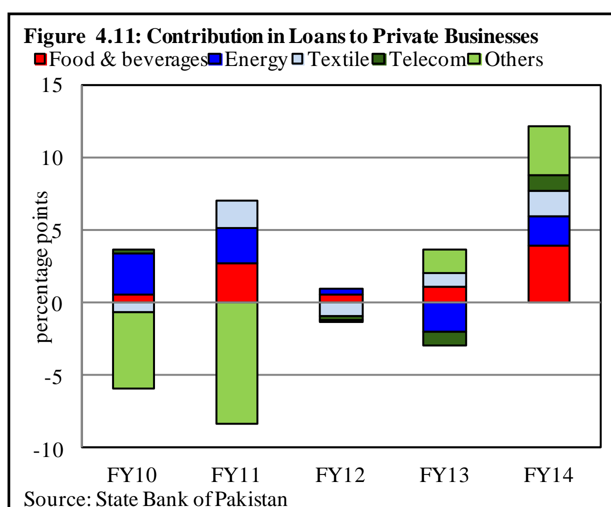
	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Real GDP growth (in percent)[a]	5.0	0.4	2.6	3.6	3.8	3.7	4.1
LSM growth (in percent)[a]	6.1	-6.0	0.4	1.7	1.2	4.0	3.9
Real lending rate (in percent)[b]	-1.0	-2.6	3.5	0.2	2.5	3.8	1.8
Consumer Confidence Index[b]	*N.A*	*N.A*	*N.A*	*N.A*	111.0	128.0	144.0
Expected Economic Conditions Index[b]	*N.A*	*N.A*	*N.A*	*N.A*	109.9	126.0	137.5

Source: a) Pakistan Bureau of Statistics; b) State Bank of Pakistan

Sector-Specific Developments: A positive outcome

Within private businesses, a number of manufacturing firms in food & beverages, energy, textiles and telecom, borrowed heavily during FY14. Together, these four sectors contributed three-quarters of the total increase in loans to private businesses (**Figure 4.11**).

Figure 4.11: Contribution in Loans to Private Businesses



Source: State Bank of Pakistan

Food & Beverages- continued to improve:

Manufacturers of *food products and beverages* borrowed Rs 97.0 billion (in net terms) in FY14, on top of Rs 26.5 billion increase seen in FY13. As a result, the share of this sector in

[22] In the Federal Budget for FY13, government raised the tax rate on dividend income received from Money Market Funds and Income Funds to 25 percent, from 10 percent in FY12.

[23] Banks deposit saw an increase of Rs 868.0 billion in FY14.

[24] With effect from October 1, 2013, SBP explicitly linked the minimum rate of return on savings deposits with the SBP Repo rate (floor of interest rate corridor) vide BPRD Circular No. 07 of 2013 dated September 27, 2013.

[25] For details on foreign currency loans, please see Section 7.5 of Chapter 7.

total loans to private businesses reached 15.0 percent by end FY14, compared with 12.9 percent in FY13, and less than 10 percent in FY10. Pakistan's growing population, increasing use of processed food, and a vibrant livestock sub-sector, are creating opportunities for investment in food and beverages.

Within the food group, a healthy sugarcane crop created strong demand for working capital loans, which saw an expansion of Rs 29.3 billion in FY14, against a net contraction of Rs 0.7 billion in FY13. Fixed investment loans also picked up, as a number of sugar mills are investing to generate electricity from bagasse, and enhance their production capacity. Furthermore, the liquidity problem faced by sugar mills due to excessive carryover stocks, restricted their seasonal retirements during the last quarter of FY14.[26]

Other than sugar, credit demand from *beverages* continued to increase as one of the leading beverage companies expanded its operations and capacities. Foreign direct investment worth US$ 23.0 million also entered this sector during FY14. Anecdotal evidence suggests that the demand of beverages is largely emanating from restaurants and growing international fast food chains operating in the country.

Rising production of *edible oil* and enhanced capacity utilization, also created demand for loans. Higher import of palm and soybean oils, which are used as raw material in the edible oil industry, largely explain the increase in trade finance of Rs 5.7 billion in FY14, against a net retirements of Rs 3.3 billion in the previous year (**Table 4.8**).

Table 4.8: Net Change in Loans to Private Sector Businesses

billion Rupee, share in percent

	Share	Overall Loans		Trade Financing		Working Capital		Fixed Investment	
	End-FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Private. Business	100.0	17.1	298.0	20.2	39.2	4.4	187.4	-7.5	71.4
a) Manufacturing	59.2	58.9	187.2	24.6	30.3	25.2	120.6	9.2	36.3
Of which									
Food & beverages	15.0	26.5	97.5	8.6	7.5	3.5	71.3	14.4	18.7
Of which									
Sugar	6.0	12.5	39.3	4.2	-1.1	-0.7	29.3	9.0	11.1
Beverages	1.0	-2.0	11.2	2.0	1.2	-1.3	9.4	-2.8	0.5
Edible oil	1.6	-9.1	11.0	-3.3	5.7	-6.3	1.8	0.5	3.6
Rice	2.5	-2.0	26.4	0.2	7.0	-2.5	18.9	-0.3	0.6
Textiles	20.2	23.9	43.2	9.7	16.0	9.0	24.2	5.1	3.1
Of which									
Spinning	8.6	-4.1	23.7	-3.6	11.2	0.7	15.4	-1.2	-2.9
Weaving	3.5	4.7	7.5	3.9	0.1	1.1	4.1	-0.2	3.3
Finishing	3.5	7.0	13.2	-1.6	5.9	2.1	5.9	6.5	1.4
Fertilizer	3.6	0.1	1.2	-0.9	-0.3	3.5	10.4	-2.6	-8.9
Appliances	0.6	-1.3	3.5	0.5	-0.4	-0.3	2.9	-1.5	1.0
b) Energy	10.1	-49.2	49.8	0.8	4.8	-27.8	27.9	-22.2	17.0
c) Others*	31.7	7.4	61.0	-5.2	4.1	7.1	38.8	5.5	18.1

*Agriculture, fishing, mining, ship breaking, construction, hotel, transport, real estate, education, health, etc.

Source: State Bank of Pakistan

[26] Compared with seasonal retirements of Rs 27.4 billion during Q4-FY13, the sugar industry retired only Rs 10.4 billion during Q4-FY14.

A bumper *rice crop* not only boosted business activity for rice processors, but also for rice exporters. More specifically, rice production reached 6.7 million tons during FY14, against the target of 6.2 million tons, which increased demand for credit from rice processors to finance their day-to-day operations. In addition, the 11.9 percent growth in rice exports during FY14, increased trade financing, which posted an increase of Rs 7.0 billion during the year, compared with a rise of only Rs 0.2 billion in FY13 (**Table 4.8**).

Finally, although loans for dairy products declined by 3.2 percent in FY14 (a number of firms are retiring their loans), one of the key players increased its borrowing for product diversification and capacity enhancement.[27]

Energy sector - yet to show an improvement: In sharp contrast to a net retirement of Rs 49.2 billion during FY13, loans to the energy sector expanded by Rs 49.8 billion during FY14 (**Table 4.8**).[28] All types of financing, i.e., working capital, fixed investment and trade financing, increased during the period of analysis. In fact, the energy sector not only borrowed for their production activities, but also to invest in capacity expansion/up-gradation and modification to alternate fuels. Fixed investment loans expanded by Rs 17.0 billion in FY14, against a net retirement of Rs 22.2 billion in FY13. The modest increase in trade financing can be traced to the imports of power generating machinery during the year.[29]

The settlement of circular debt in June 2013, helped the liquidity starved energy sector to step up their operations, which c reated demand for working capital during initial months of the year. As the year progressed, re-emergence of receivables, created liquidity problems, which also added to the financing requirements of the energy sector (for details, see **Chapter 3 on Energy**).

Textiles - getting support from GSP Plus: Within private sector businesses, textile is the largest user of bank credit with 20.2 percent share in outstanding loans as of end FY14. In absolute term, loans to the textile sector expanded by Rs 43.2 billion in FY14, which was almost double the Rs 23.9 billion increase in FY13 (**Table 4.8**). A number of factors like the relatively better availability of electricity and gas; the GSP plus status awarded to Pakistan; higher demand for cotton from China (in anticipation of change in import policy); and investment for BMR (balancing, modernization and replacement), contributed to this healthy credit expansion.

It is encouraging to note that loans to all areas of the textile value chain (spinning, weaving and finishing) increased during the year - an indication of broad-based improvement in textiles. Moreover, although a large share of loans is used for working capital and trade financing, net fixed investment loans also expanded by Rs 3.1 billion during the year. Given the excess capacity that exists in the textile sector, the modest increase was primarily for BMR in anticipation of the larger market that comes with attaining the status of GSP plus.

Telecom – renewed interest: Credit to the telecom sector increased by Rs 24.9 billion during FY14 in contrast with a net contraction of Rs 23.0 billion during FY13. Quarterly data reveals the expansion was entirely concentrated in the fourth quarter of the year, as cellular companies heavily borrowed to expand/upgrade their infrastructure to accommodate the 3G/4G spectrums.[30]

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[27] Engro Foods launched a new brand of fresh milk. In addition, it also opened a number of retail outlets in Karachi.
[28] Net retirement in FY13, was attributed to the settlement of circular debt at the end of FY13. Rs 55.5 billion were retired in June 2013.
[29] Imported value of power generating machinery increased to Rs 110.4 billion during FY14 compared with import value of Rs 92.7 billion during FY13.
[30] Distribution of credit by types indicates that fixed investment loans accounted for 71 percent of credit expansion during the year.

Fertilizer- no new investment: Pick up in fertilizer production, created strong demand for working capital loans during the year, which saw an expansion of Rs 10.4 billion, compared to an increase of Rs 3.5 billion in FY13 (**Table 4.8**). However, this increase was largely offset by a net retirement of Rs 8.9 billion in fixed investment loans during the year. It is important to note that the fertilizer sector is currently in a retiring phase, due to major capacity expansion in the recent past (for details, see **Chapter 2**).

Consumer Financing – on an upward trajectory

Consumer financing increased for the second consecutive year, after a long period of net retirements (**Table 4.9**). This recovery, which was confined to personal loans and auto financing in FY13, expanded to other categories, like house building, credit cards and durable goods. However, the outstanding stock of consumer financing is yet to reach the level seen before the financial crisis of 2008.

Table 4.9: Absolute Changes in Consumer Financing

billion Rupee

	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Consumer Financing	**11.0**	**-65.1**	**-49.3**	**-27.9**	**-12.9**	**15.0**	**31.3**
1) For house building	11.9	-5.3	-6.3	-7.3	-6.1	-2.7	0.3
2) Auto financing	-0.4	-26.8	-12.8	-14.2	-5.8	5.4	13.2
3) Credit cards	1.6	-8.9	-6.9	-3.4	-1.7	-1.1	1.0
4) Consumer durables	-0.5	-0.1	-0.2	0.1	0.1	-0.1	0.2
5) Personal loans	-2.1	-24.3	-17.7	-4.4	-0.9	11.1	16.9
6) others	0.6	0.4	-0.2	1.4	1.6	2.4	-0.2

Source: State Bank of Pakistan

Within consumer financing, personal loans were the first to post an improvement, as one of the big five banks revised the limit on its personal loan scheme for government employees in November 2012. Subsequently, a number of other banks also introduced innovative personal loan products, especially designed to cater to the needs of the middle and high income groups.[31]

Auto financing is the second largest component of consumer financing, which saw an increase of Rs 13.2 billion in FY14, compared to an increase of Rs 5.4 billion in the previous year. Like personal loans, auto financing was aggressively marketed by a commercial bank, which accounted for more than 20 percent of total auto financing in FY14.[32] It is encouraging to note that a number of commercial banks have introduced innovative schemes to take advantage of this growing business activity.

Finally, there was an amendment in car financing regulations, which enabled banks to finance cars up to 9 years old.[33] This is likely to create more demand for auto loans.[34] Furthermore, as production numbers are very optimistic, the launch of long awaited new model of Toyota Corolla, will also support demand for auto loans in FY15.

[31] Cash for Gold, Enhanced-Gold Schemes etc. are some of the examples.

[32] The total number of borrowers that availed loans for auto financing increased from 116,474 by the end of June 2013 to 123,005 by the end of June 2014. Out of the total increase of 6531, the share of that commercial bank was 25 percent.

[33] BPRD Circular No. 07 of 2014, dated July 23, 2014.

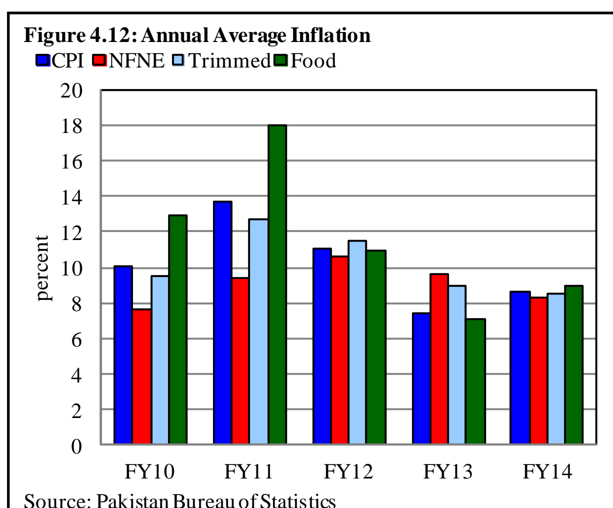
[34] The banks/DFIs desirous of financing the purchase of used cars shall prepare uniform guidelines for determining the value of the used vehicles. In no case the bank/DFI shall finance the cars older than nine years. However, cars older than five years and upto nine year can only be financed subject to the condition that complete repayment of financing is restricted within 12 years of such car age.

4.5 Inflation

While setting the inflation target for FY14, the government was perhaps expecting a reversal in the declining trend of CPI inflation, witnessed during the last two years. Thus, the target of 8.0 percent was higher than the 7.4 percent recorded in FY13. SBP's initial projection for headline inflation was in the range of 11.0 to 12.0 percent, which was based on the expected upward adjustments in administered prices, the depreciation of exchange rate, and the impact of these factors on inflationary expectations.

Inflationary pressures did strengthen in FY14, as average headline inflation reached 8.6 percent in FY14 – a level higher than the target and realized inflation a year before (**Figure 4.12**). Nevertheless, the inflation outcome was far better than SBP's initial expectations: (a) the downward revision in retail POL prices in November 2013, partially offset the impact of the October 2013 increase in utility tariffs; (b) the unanticipated appreciation of the PKR in late March largely compensated for the impact of depreciation during Jul-Nov, and (c) soft oil and palm oil prices coupled with a stable PKR, provided credible anchor that pulled down inflationary expectations and the resulting price-setting behavior of commercial businesses.

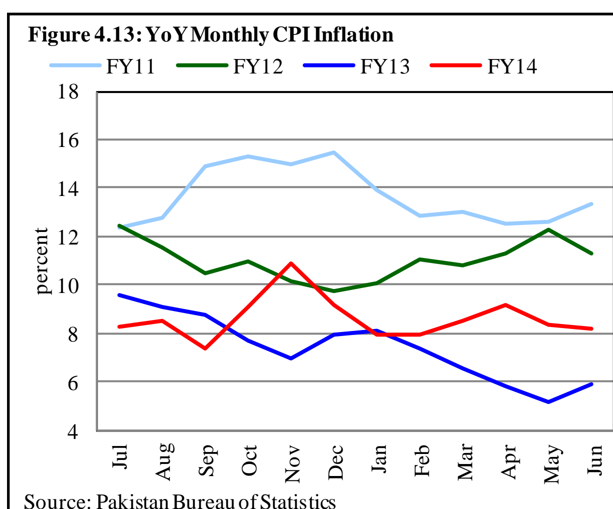
Figure 4.12: Annual Average Inflation



Source: Pakistan Bureau of Statistics

As shown in **Figure 4.13**, YoY inflation generally remained above the corresponding level of last year. Broadly speaking, supply-side factors: the supply constraints in food items, especially of perishable food items; the one percent increase in GST rate; a sharp depreciation of the PKR in H1-FY14; and higher administered prices, explain the higher inflationary outcome. Having said all this, the key message that the market realized was that the outcome on inflation was better than expected, which could explain their expectations of a cut in interest rates, and how this changed their appetite for long-term government bonds so sharply in Q3-FY14.

Figure 4.13: YoY Monthly CPI Inflation



Source: Pakistan Bureau of Statistics

As shown in **Table 4.10**, the "*food and non-alcoholic beverages*" group alone contributed 3.3 percentage points (almost 40 percent) to the overall average annual inflation during FY14.

- The price of wheat and flour remained elevated and hit their peak in February, 2014 largely because of production shortfall in FY13.[35] As a result, the annual average price of wheat and flour increased by 20.3 percent and 19.5 percent, respectively.

[35] Depleted stocks (2.236 million tons as on March 10, 2014, compared to 3.420 million tons a year earlier), and concerns that government would not able to meet the procurement target set for this year's crop. The federal governments have

- Inflation in perishable food items (specifically, potatoes[36], onions[37], tomatoes[38], and fresh vegetables) persisted throughout FY14, as domestic prices reached exceptionally high levels due to lower domestic availability and poor supply management.[39] In addition, fresh vegetables also registered double digit inflation (13.0 percent) in FY14, after remaining stable in the past two years.[40] Since these items are the most frequently purchased by households, this could easily bias upward the perception that inflation is extremely high. This is specifically relevant for lower and middle income households, where the food budget absorb most of the monthly income.

- While the one percentage point rise in GST in FY14 led to an increase in prices across all commodities, the impact of specific budgetary measures on cigarettes and tea was more pronounced.[41] During FY14, the price of cigarettes posted a 17.1 percent increase, while tea price increased by 7.6 percent over last year.

This was followed by "*clothing and footwear*", which increased by 0.7 percentage points in FY14, compared to 0.6 in FY13.[42] The increase in price was broad based, as all the items included in this group, recorded double-digit inflation during FY14.[43]

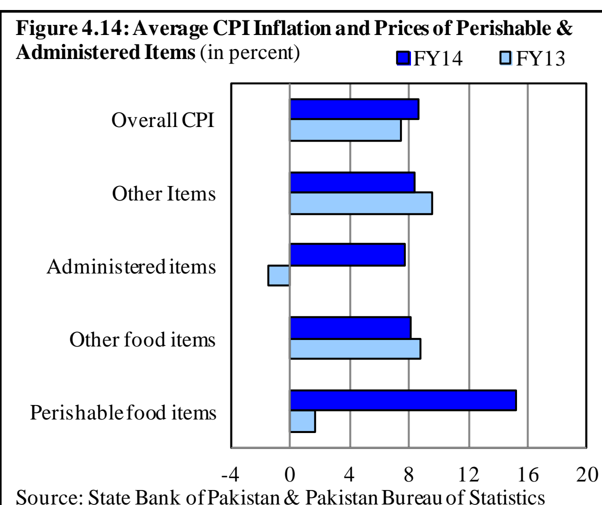
The changes in administrative prices play a significant role in CPI inflation.[44] In the CPI

Table 4.10: Contribution to Average Annual CPI Inflation
percentage points

	FY14	FY13
Food and non-alcoholic beverages	3.3	2.9
Alcohol & beverages	0.1	0.1
Clothing	0.7	0.6
Housing	2.2	1.9
Furnishing	0.4	0.3
Health	0.2	0.1
Transport	0.6	0.6
Communication	0.2	0.2
Recreation	0.2	0.1
Education	0.3	0.3
Restaurants	0.1	0.1
Misc	0.3	0.2
	8.6	**7.4**

Source: Pakistan Bureau of Statistics

Figure 4.14: Average CPI Inflation and Prices of Perishable & Administered Items (in percent)



Source: State Bank of Pakistan & Pakistan Bureau of Statistics

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maintained the Wheat Support Price (WSP) at last year's level of Rs 1,200 per 40 kg., which was well below the prevailing market price of around Rs 1,600 per 40 kg.

[36] The lower stock and the decline in production led to increase in prices of potatoes (see Section on Agriculture for more details).

[37] Damages to onion crop in India and subsequent increase in its prices attracted higher quantities of onion imports from Pakistan. This in turn led to higher onion prices in the domestic market, particularly during the first half of FY14.

[38] The tomato crop in Balochistan and parts of Sindh was damaged due to the bad weather. Although the imports from India partially met the resulting shortfall, the disruption in their exports due to unexpected rainfall in tomato growing areas, kept tomato prices in Pakistan under pressure.

[39] During FY14, retail prices of potatoes, onion and tomatoes remained highly volatile and their average prices increased by 70.2 percent (potatoes), 19.6 percent (onions) and 24.7 percent (tomatoes) over the last year.

[40] Fresh vegetables posted double digit price inflation of 29.8 percent in FY11.

[41] With a view to curb tea smuggling, government in April 2012 slashed the sales tax on tea from 16 percent to only 5 percent. The FY14 Federal Budget revoked this benefit and increased the sales tax to 17 percent. In case of cigarettes, federal excise duty was simplified and re-structured from three slabs based on a composite formula, to two slabs based on a specific rate.

[42] This group includes cotton cloth, woolen cloth, readymade garments, woolen readymade garments, hosiery, dopatta, cleaning & laundering, tailoring and footwear.

[43] All these items showed double digit inflation in FY13 as well.

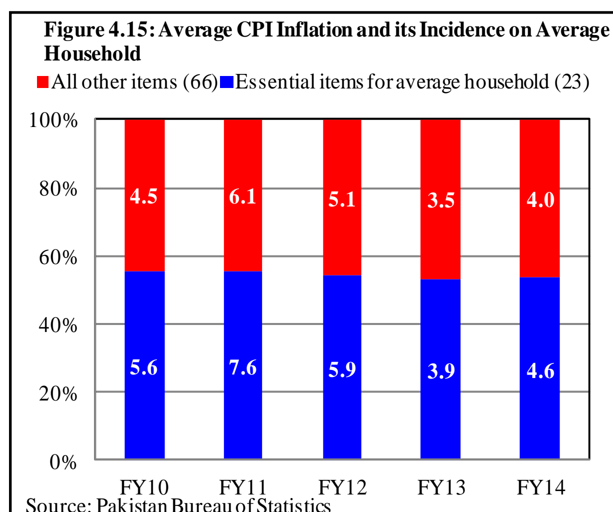
[44] API is a weighted index, compiled by Research Department of SBP on the basis of prices data of PBS. It includes wheat, sugar, electricity, gas, kerosene oil, petrol, HSD, CNG, gas cylinder (LPG), car tax (800 cc – 1300 cc), train fares, platform

basket, items with administrative control on prices, recorded 7.7 percent inflation during FY14, compared to disinflation of 0.5 percent in FY13 (**Figure 4.14**).[45] This higher inflation was expected as the government had revised electricity and gas tariffs upward in FY14, mainly to reduce energy subsidies.[46] According to SBP estimates, an increase in energy prices is largely reflected in output prices within a period of 3 to 9 months.[47]

In addition, the government also enhanced domestic retail prices of petrol and diesel during initial months of FY14. However, softening POL price at international level created room for downward revision in domestic prices, which helped contain inflation in second half of the year. Thus, the average price of *motor fuel* in CPI basket recorded an increase of 5.0 percent during FY14.

Finally, further analysis shows that only 23 commodities, out of a total of 89 in the CPI basket, accounted for more than 50 percent of average inflation in FY14 – a persistent trend observed in the last five years (**Figure 4.15**).[48] The average CPI inflation rate in this sub-group was 9.5 percent in FY14, compared to 5.7 percent last year. Since the pricing in these sub-groups is mostly driven by supply-side factors, or directly controlled by the government, this has serious implications for the effectiveness of monetary policy to control inflation.

Figure 4.15: Average CPI Inflation and its Incidence on Average Household

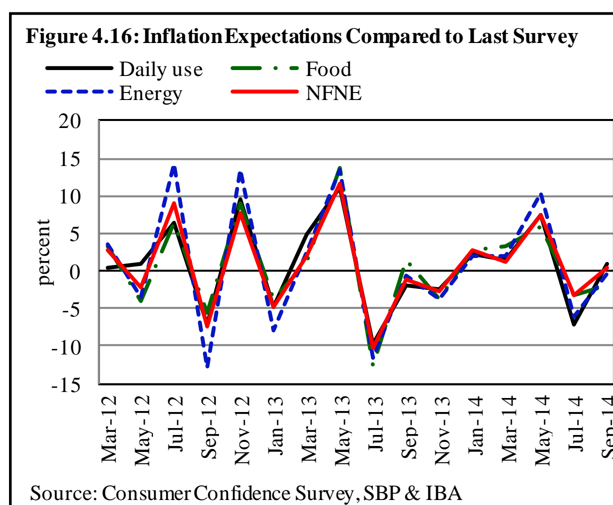


Source: Pakistan Bureau of Statistics

Inflation Outlook: We expect inflation to remain in the range of 6.5 to 7.5 percent during FY15, which is lower than the government's target of 8.0 percent. The stability in international commodity prices (especially oil) should help achieve this target. There are however certain upside risks from perishable food prices, following the recent floods, and a possible upward adjustment in administered prices. More specifically:

- The government has agreed with the IMF to reduce power subsidies by Rs 60 billion in FY15. This would require a 11 percent power tariff hike for all categories of consumers in October 2014.

Figure 4.16: Inflation Expectations Compared to Last Survey



Source: Consumer Confidence Survey, SBP & IBA

tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.

[45] It accounted for 1.1 percent in the overall increase of 8.6 percent in prices during FY14.

[46] Government increased the electricity tariffs for commercial and industrial users by 23.7 percent in August 2013, whereas household tariffs were enhanced from October 2013 in the range of 15.5 to 23.8 percent (for above 200 kWh monthly consumption). Government has also increased gas tariffs by 1.0 percent in June, 2013.

[47] See Choudhary, A., Naeem, S., Faheem, A., Hanif, N., and Pasha, F. (2011), "Formal Sector Price Discoveries: Preliminary Results from a Developing Country," SBP Working Paper No 52. The findings of this paper are based on a price setting survey of formal (manufacturing and services) sector firms by SBP.

[48] This sub-group includes wheat flour, rice, chicken, fresh milk, sugar, tea, potatoes, onion, tomatoes, fresh vegetables, five pluses, cooking oil, water supply, electricity, gas, kerosene oil, cotton cloth, house rent, transport services,

- The FY15 Budget has proposed a collection of Rs 145 billion through Gas Infrastructure Development Cess (GIDC), which is significantly higher than Rs 88 billion collected in FY14. This would require an upward adjustment of 25 percent in piped-gas tariffs in January 2015.

- The recent flooding in Punjab, Sindh and Kashmir, could create supply constraints for perishable food items, which will have a strong, albeit temporary impact on headline CPI. The IBA-SBP's Consumer Confidence Survey (for September 2014) also indicates higher inflationary expectations for the months ahead (**Figure 4.16**).

- While overall commodity prices remain soft in the global market, crude oil prices could become volatile with regional disturbances in the Middle East. However, with the US once again the largest oil producer in the world, oil price forecasts remain soft in FY15.

- Finally, the ongoing political challenges in Pakistan could spark hoarding and price hikes. Although the impact of the political demonstrations is difficult to quantify, it has dampened investor confidence, disrupted normal import / export operations, and created pressures on the PKR, which are likely to impact inflation in FY15.