4 Monetary Policy and Inflation

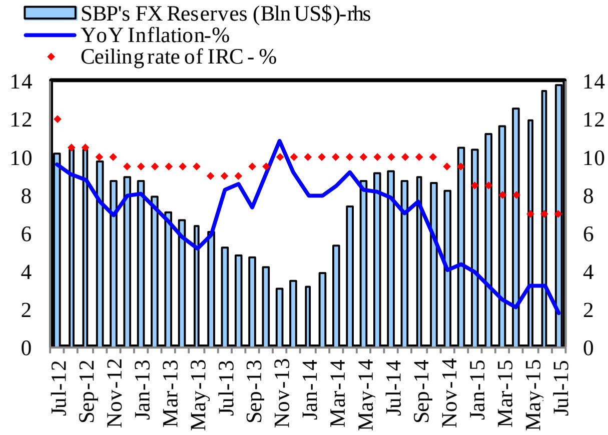
4.1 Overview

Despite several challenges during the initial months of the year, FY15 saw a change in monetary stance from a conservative to a notable easing, especially during the second half of the year.[1] In four consecutive monetary policy decisions from mid-November 2014 to May 2015, SBP cut the ceiling rate of the interest rate corridor (IRC) by a cumulative 300 bps to a multi-decade low of 7.0 percent (**Figure 4.1**).[2] A marked improvement in macroeconomic indicators from October 2014 onwards was the major driving force, which included: (a) a growing ease on external front; (b) a sharp reduction in headline inflation along with subdued inflationary outlook; and (c) contained fiscal deficit along with the government efforts to shift its direct borrowing away from SBP.

Steep fall in international oil prices, robust growth in worker remittances, and strong CSF inflows, helped reduce current account deficit to 1.0 percent of GDP in FY15. This, along with the successful issuance of Sukuk in the international market, higher net disbursements from the IMF, and continued FX purchases from the market, pushed up SBP's liquid FX reserves to more than 3 months of the country's import bill.

This stability in the PKR and the government decision to pass-on the benefit of fall in international oil prices to domestic consumers, helped contain inflation and improve inflationary outlook. Additional support came from lower commodity prices in global markets (edible oil, wheat, steel, etc.), and the lagged impact of conservative monetary policy stance that prevailed during FY14 and in the initial months of FY15. In fact, disinflation prevailed for most of the year (**Figure 4.1**). As a result, average (CPI) inflation declined from 8.6 percent in FY14 to only 4.5 percent in FY15, which was also well below the target of 8.0 percent for the year. The reduction was broad-based. All measures of core inflation (non-food-non-energy; trimmed; and relatively stable component of CPI) recorded noticeable declines during the year.

Figure 4.1: Key Indicators of Policy Environment



Source: State Bank of Pakistan

Inflation expectations, measured by IBA-SBP's Consumer Confidence Survey (CCS) remained at ease for most of the year.[3] The stability in the PKR and a sharp fall in petroleum prices were the key -- the former serves as a nominal anchor for the businesses, while the households focus on the latter to form their inflation expectations. In line with the CCS, a Financial Market measure of inflation expectation based on interest rates on medium to long term government bonds, also improved during FY15.

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[1] In the run up to the political uncertainty in August 2014, the fourth review of the IMF Extended Fund Facility could not be finalized. As a result, the fourth tranche from the IMF was delayed, which created uncertainty in the FX market. In September 2014, heavy rains inundated a large part of the central Punjab that challenged the modest inflation outlook.

[2] Effective from 25th May, 2015, SBP introduced 'target rate' for the overnight money market repo transactions, as a new policy rate. This rate was set 50 bps below the ceiling of the IRC, i.e., at 6.5 percent. Subsequently, this rate was further brought down to 6.0 percent in September 2015 Monetary Policy decision.

[3] Major indices (overall, non-food-non-energy and energy) of inflation expectations, recorded YoY declines in 5 out of 6 surveys conducted during the year.

Uncertainty around inflation expectations was also low in FY15: (a) wholesale price index registered deflation or disinflation throughout the year;[4] and (b) the reserve money decelerated for the third year in a row to 9.9 percent in FY15. While changes in WPI were largely driven by exogenous factors like sharp fall in international commodity prices, the behavior of reserve money was primarily influenced by the policy measures to achieve indicative targets under the IMF program. Specifically, the government was able to contain its borrowing from SBP within the IMF ceiling for the second and the third quarters of the year, while the end-June target was missed by a small margin. This, along with the outright sale of government securities to commercial banks, allowed SBP to meet the IMF ceiling on its net domestic assets for all quarters of the year.

Unlike reserve money, broad money supply grew by 13.2 percent in FY15, compared with 12.5 percent in FY14. This higher expansion was on cards due to aggressive monetary easing during the second half of the year. However, causative factors indicate that the government sector borrowing for budgetary support and commodity operations, which are generally independent of monetary policy stance, played a dominant role.

In absolute term, the government borrowed Rs 888.3 billion (cash basis) for budgetary finance from the banking system in FY15, compared to Rs 323.7 billion in FY14. Within the banking system, the government heavily relied on commercial banks, not only to finance its budgetary deficit, but also to retire some of its borrowing from SBP to meet the IMF targets, as mentioned earlier. Demand for government securities was also high, as commercial banks were eager to lock-in their funds in high yielding assets in a declining interest rate scenario. As a result of demand-supply dynamics, net government borrowing from commercial banks expanded by Rs 1,322.6 billion in FY15 compared with only Rs 163.9 billion in FY14.

Cognizant of its impact on the supply of loanable funds for the private sector, SBP stepped up its liquidity injections through open market operations (OMOs) to ensure adequate supply of credit. The volumes of OMOs increased sharply to near Rs 1.0 trillion, and remained elevated for the rest of the year.[5] Despite provision of adequate liquidity, credit to the private sector expanded by Rs 208.7 billion in FY15 compared with Rs 371.4 billion in the previous year. The slowdown was attributable to a number of factors including: (a) sharp fall in commodity prices, which reduced demand for working capital and trade financing loans during the year; (b) relatively high real cost of borrowing as inflation declined at a much faster pace compared with the lending rates; (c) non-price constraints like power shortages, law & order, and weak external demand; and (d) some sector specific developments like lower production of sugarcane.

However, it is encouraging to note that fixed investment loans (having maturity of more than one year) to private businesses increased by Rs 126.9 billion in FY15, compared with Rs 72.3 billion in FY14. Construction and allied industries are taking the lead, which are likely to help promote economic activity due to strong forward and backward linkages. Going forward, credit to private sector is likely to benefit from: (a) the lagged impact of aggressive monetary easing during the second half of FY15; (b) energy shortages are likely to ease further; (c) law and order situation has improved considerably due to the ongoing campaign against terrorism; and (d) investments under CPEC will have positive spillover effect on domestic businesses.

[4] For discussion on deflation, please see **Special Section 2** on '**Analysis of Deflation**'.
[5] The expansionary impact of these liquidity injections on reserve money was partially offset by the net retirement in government borrowing from SBP.

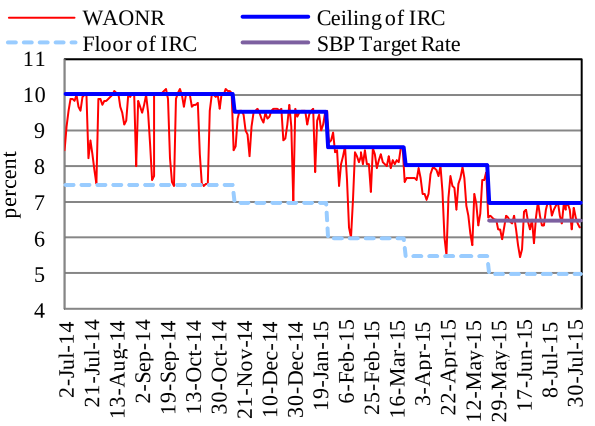
4.2 Liquidity Management and Introduction of SBP Target Rate

Market liquidity and its management witnessed significant changes in FY15. On aggregate, liquidity condition in money market remained tight as the weighted average overnight repo rate remained very close to the ceiling rate of IRC, and SBP continued to inject liquidity through open market operations to keep interest rate at the desired level. The key drivers were: (a) the government's efforts to substitute its borrowing from SBP with commercial banks throughout the year; (b) implementation of monetary easing from November 2014 onwards; (c) developments taking place in FX market; and (d) the announcement and the implementation of a new policy rate as 'SBP target rate'. For a meaningful analysis, discussion of liquidity conditions in FY15 can be divided into three distinct phases: (i) before the implementation of monetary easing in mid-November 2014; (ii) from monetary easing to the announcement of SBP target rate (November 2014 to Feb 2015); and (iii) after the announcement of SBP target rate.

First phase—1st July to mid-November 2014

Market liquidity in this period was cautiously kept tight in line with the conservative stance of monetary policy and considerations under the IMF program. The cut-off rate in OMOs was maintained close to the ceiling rate of IRC, and the acceptance-to-bid ratio averaged at 88.7 percent during the period. As a result, the weighted average overnight repo rate remained elevated, and moved beyond the ceiling rate of IRC at times (**Figure 4.2**). Individual banks also frequently borrowed liquidity from SBP at the ceiling rate. In retrospect, this cautious liquidity management during this period, helped sustain improvement in macroeconomic indicators.

Figure 4.2: IRC and W.A. Overnight Repo Rate

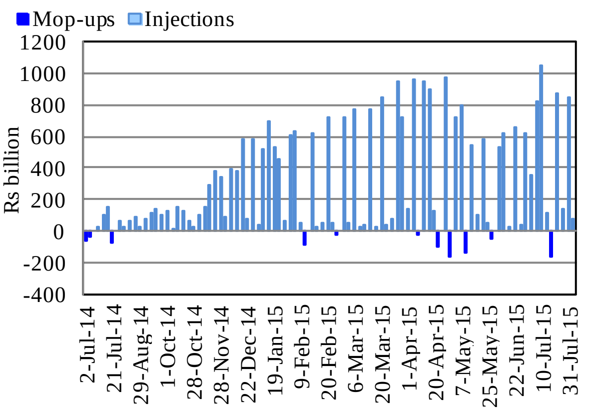


Source: State Bank of Pakistan

Second phase—Mid- November 2014 to mid-February 2015

With the change in monetary policy stance and to ensure smooth supply of credit to the private sector, SBP stepped up liquidity injections through OMOs from mid-November 2014 onwards (**Figure 4.3**). Not only OMO cut-off rates declined in relation to the ceiling rate of IRC, acceptance-to-bid ratio also jumped to over 97.6 percent during this period. Average volume of OMOs for liquidity injections reached Rs 377.9 billion, compared with only Rs 94.2 billion before the change in monetary policy stance. Weighted average overnight repo rate also declined to the desired level.

Figure 4.3: SBP OMOs



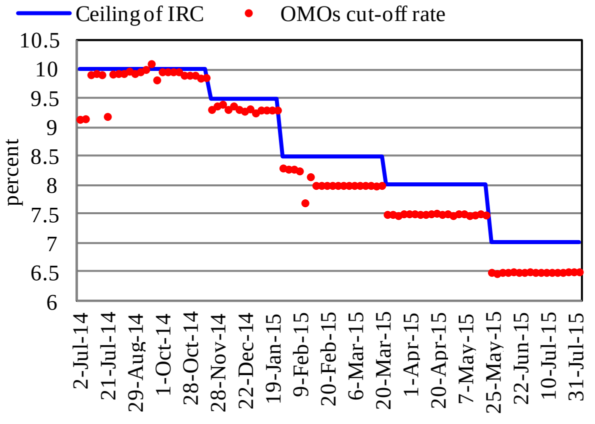
Source: State Bank of Pakistan

Third phase—Introduction of SBP Target Rate

Introduction of 'SBP target rate' as a new policy rate within the existing interest rate corridor framework is the most notable change in SBP's liquidity management. This new rate is basically a 'target rate' for the overnight money market repo transactions, which is set at 50 bps below the ceiling rate of the IRC. Operationally, SBP aims at keeping the money market weighted average overnight rate close to the 'SBP target rate' by using the liquidity management tools, especially the open market operations (OMOs).

For smooth transition to this new framework, SBP unveiled its plan to introduce 'SBP target rate' on February 24, 2015; well before the formal implementation in May 2015. In fact, SBP has implicitly implemented this framework even before the announcement to avoid unnecessary volatility in the money market. Specifically, SBP has gradually reduced the cut-off rate in OMOs to exactly 50 bps below the ceiling rate of IRC a week before the announcement. Consequently, a marked shift in OMO cut-off rates from its past trend is clearly visible from mid-February 2015 onwards (**Figure 4.4**).

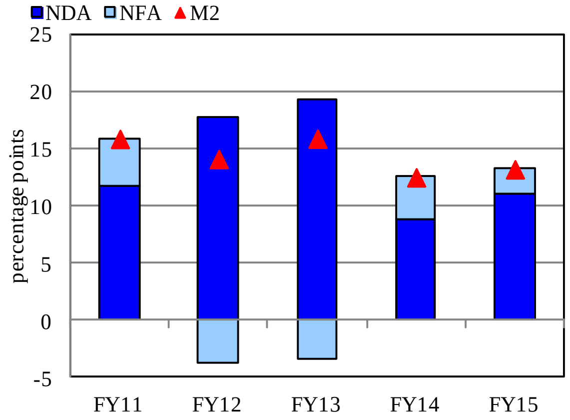
Figure 4.4: OMO Cut-off Rates



Source: State Bank of Pakistan

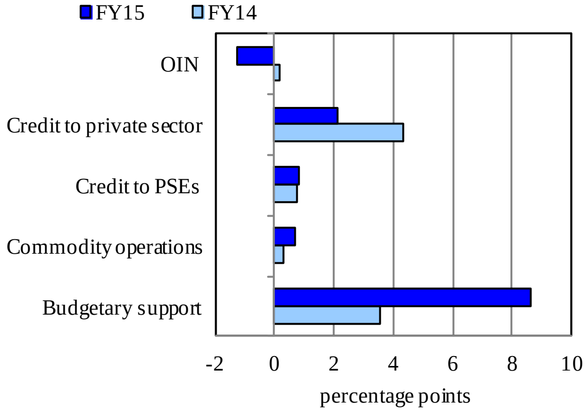
With the formal implementation of the revised IRC framework in May 2015, SBP has completed its transition from money supply (quantity) to interest rate (price) as an operational target of monetary policy. In simple words, SBP would let the money supply adjust according to the interest rate set in the monetary policy decisions. As a result, not only the frequency of OMOs has increased, but acceptance-to-bid ratio has also moved close to 100 percent. Commercial banks, which are adjusting to this revised framework, partially used this liquidity for onward lending to the government (see section on government borrowing for details).

Figure 4.5a: Contribution to broad money growth



Source: State Bank of Pakistan

Figure 4.5b: Contribution to NDA



Source: State Bank of Pakistan

4.3 Developments in Monetary Aggregates

In line with the implementation of monetary easing, growth in broad money increased to 13.2 percent in FY15, compared with 12.5 percent in FY14. Major contribution to this increase came from the NDA of the banking system, which overshadowed the slowdown in the net foreign assets during the year (**Figure 4.5a**). Within NDA, government borrowing for budgetary finance stands out with the contribution of 9.2 percentage points in FY15 (**Figure 4.5b**).[6] In addition to this, loans for

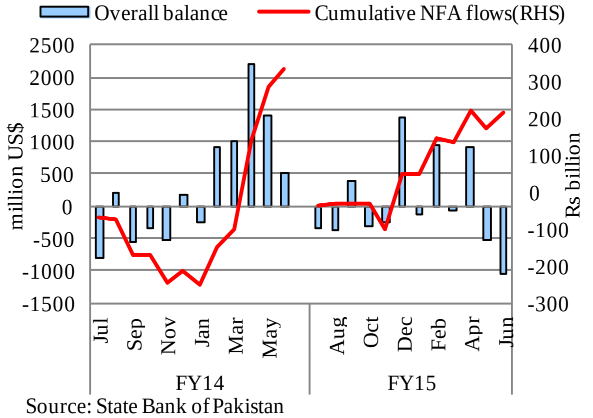
[6] Broad money expanded by Rs 1315.6 billion during FY15, of which Rs 888.3 billion (on cash basis) was used for budgetary financing. In FY14, broad money expanded by Rs 1108.0 billion of which Rs 323.6 billion (on cash basis) was for budgetary financing.

commodity operations and credit to PSEs also contributed to higher growth in NDA of the banking system.

4.3.1 Net foreign assets

Net foreign assets of the banking system grew by 37.0 percent in FY15 on top of an exceptional growth of 125.7 percent in FY14. Although current account balance improved during FY15; the deceleration was attributed to lower capital and financial inflows in FY15.[7] However, it may be recalled that FY14 was an exceptional year, as NFA of the banking system more than doubled during that period (**Figure 4.6**).[8]

Figure 4.6: Net foreign assets of banking system & overall external account balance



Source: State Bank of Pakistan

Within the banking system, the deceleration was entirely concentrated in SBP's NFA: a reflection of lower official inflows during the year. On the other hand, NFA of scheduled banks witnessed a relatively small contraction of Rs 21.0 billion in FY15, compared with the contraction of Rs 24.5 billion during FY14 (**Table 4.1**). In fact, net retirements of foreign currency loans against FE-25 deposits, helped banks increase their balances abroad. This shift in their claims from residents to foreigners led to a relative improvement in their NFA.

Table 4.1: Absolute changes in NFA of the banking system

billion rupees

	FY13	FY14	FY15
NFA	**-263.3**	**332.2**	**218.3**
SBP	-261.1	356.7	239.3
Scheduled banks	-2.2	-24.5	-21.0

Source: State Bank of Pakistan

Table 4.2: Quantitative Targets Under IMF Program

billion rupees

	End-Sep 14		End-Dec 14		End-Mar 15		End-Jun 15[P]	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual
Ceiling on NDA of SBP	2,291.0	2,316.1	2,505.0	2,224.0	2,472.0	2,372.0	2,459.2	2,440.0
Ceiling on net budgetary borrowing from SBP	2,070.0	2,288.7	2,000.0	1,914.0	1,905.0	1,653.3	1,865.0	1,893.4

Source: IMF & SBP

4.3.2 Net domestic assets

NDA of the banking system grew by 11.7 percent in FY15, compared with 9.1 percent in FY14. Though expansion in NDA was on cards due to monetary easing, major contribution came from the government sector, which is relatively less sensitive to the cost of borrowing. With this backdrop, key causative factors of changes in NDA are reviewed in the following sections.

Government borrowings for budgetary support

In absolute term, budgetary borrowings from the banking system (on cash basis) increased by Rs 888.3 billion during FY15, which was almost three times higher than Rs 323.7 billion in the previous year. Besides the higher volume of budgetary deficit in nominal terms, the surge in government

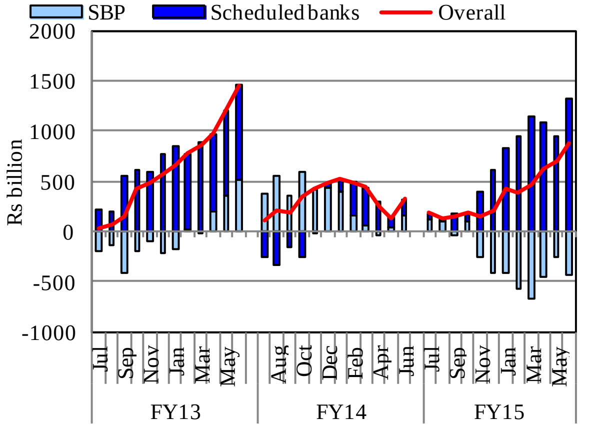
[7] Current account deficit was US$ 2.6 billion in FY15 compared with US$ 3.1 billion in FY14. On the other hand, capital inflows and foreign direct investment recorded a sharp decline.

[8] FY14 was an exceptional year as debt (other than IMF loans) and non-debt inflows (grants and privatization proceeds) had led to a remarkable increase in SBP's NFA. However, the magnitude of such inflows was lower during FY15.

borrowing from the banking system in FY15 was largely attributed to lower availability of external funding. Non-bank financing was also low compared to the last year, as healthy increase in National Saving Schemes (NSS) was eclipsed by small investment in marketable government securities. Consequently, the government was left with no option, but to rely on bank financing.

Another key feature of government borrowing in FY15 was a marked shift in its composition from SBP to commercial banks (**Figure 4.7**). On aggregate, the government retired Rs 434.2 billion to the central bank during FY15, in contrast with the *net borrowing* of Rs 159.8 billion in FY14. These retirements were sufficient to meet the quarterly IMF ceiling on net budgetary borrowing from SBP for the second and the third quarter of the year.[9] Moreover, these retirements also facilitated SBP in meeting the (IMF) ceiling on its NDA (**Table 4.2**).[10]

Figure 4.7: Budgetary borrowing-Cumulative flows



Source: State Bank of Pakistan

Given the overall budgetary deficit, this net retirement to SBP in FY15 was largely financed by government borrowing from commercial banks (**Figure 4.7**). Specifically, the government borrowed Rs 1,322.6 billion from commercial banks in FY15, which was eight times the amount borrowed in the previous year. Both demand and supply side factors facilitated this huge borrowing: while the banks were aggressively participating in primary auctions to lock-in their funds at prevailing higher interest rates, the government was willing to mobilize well above the targets to shift some of its borrowing from SBP to commercial banks.

Auction profile of government securities shows that banks bidding pattern in PIBs and T-bills changed significantly, depending largely on their perception of potential changes in interest rates, inflation, liquidity conditions, and developments taking place on external front . In this context, following points are worth noting:

- At the beginning of the year, the government announced a higher pre-auction target of Rs 300.0 billion for the sale of PIBs in Q1-FY15, to improve maturity profile of its domestic debt. However, commercial banks exercised caution in the wake of challenging economic and political conditions during the initial months of the year. Offered amount in PIBs auctions held in July and August 2014 fell short of the pre-auction targets, and the government was unable to make up for this shortfall from T-bill auctions as well (**Figure 4.8a**). As a result, the government had to rely on SBP funding during this period.

- With the improvement in political situation, commercial banks' appetite for government securities revived in September 2014. Banks focused on high-yielding PIBs, especially on 3-year PIBs due to healthy term premium for this tenor. [11] The PIBs were made more attractive by sharp fall in inflation and subdued inflation expectations. Commercial banks offered huge sums in PIB

[9] IMF targets for the first and fourth quarters of the year were missed by a small margin.
[10] SBP also conducted an OMO for the outright sale of government securities worth Rs 187.0 billion on 29th June 2015, which helped meet end-June IMF targets by shifting government borrowing from SBP to commercial banks.
[11] Specifically, average term premium between 3-year PIBs and 6-month T-bills was 244 bps during Q1-FY15, which reduced to 131 bps during Q2-FY15 and eventually narrowed to 5 bps during Q3-FY15. However, average term premium during Q4-FY15, rose to 53 bps.

auctions, especially during the second quarter of the year.[12] The government responded by accepting well-above the targets up to December 2014. During this period, T-bill auctions remained anemic, as offering amounts were generally lower than the targets.

Figure 4.8a: Auction profile of 3-year PIBs

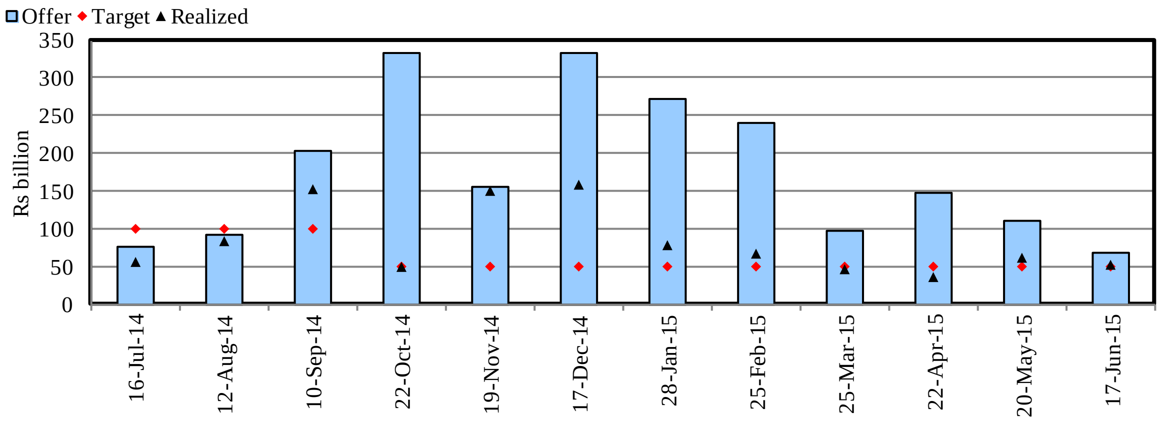
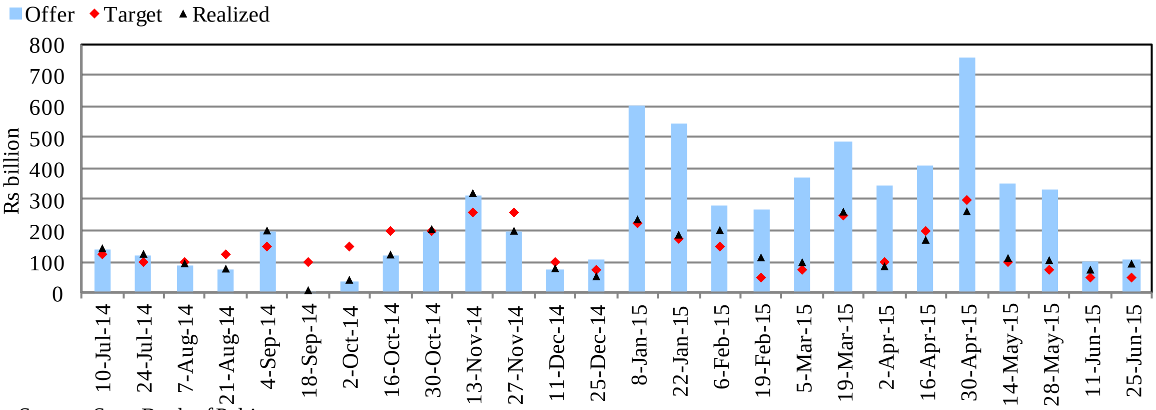


Figure 4.8b: Auction profile of T-bills



Source: State Bank of Pakistan

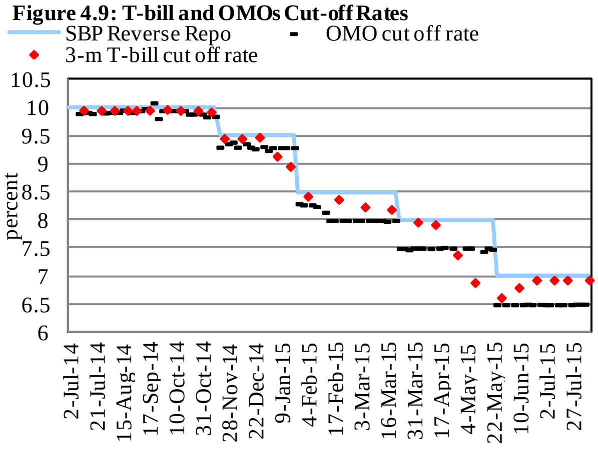
- Following the second cut in the policy rate in January 2015 and fall in term premium between 3-year PIBs and 6-month T-bills, commercial banks followed a balanced approach (investing in both T-bills and PIBs) during the third quarter of the year. Although the realized amount was slightly higher than the pre-auction targets for both PIBs and T-Bills during the third quarter, the government generally adhered to its pre-auction targets (**Figure 4.8a**). Average term-premium between 3-year PIBs and 6-month T-bills declined to only 5 bps during this quarter.

- Commercial banks perception of future interest rates changed following the fourth consecutive cut in the policy rate in May 2015. While the offered amounts in primary auctions indicate the normal (interest rate neutral) conditions, a marked shift towards shorter tenor government securities (3-month T-bills and 3-year PIBs) reflects the market perception that interest rates might have bottomed out. This perception was further strengthened by an increase in T-bills and PIBs cut-off rates in auctions held during June 2015.

[12] Banks offered Rs 828.6 billion in PIB auctions during Q2-FY15 against the cumulative target of only Rs 150.0 billion, and the government realized Rs 354.3 billion from these auctions (more than double the target).

In totality, commercial banks investment in government securities saw an increase of Rs 1.4 trillion to reach an all time high of Rs 5.5 trillion by end-FY15. This huge investment was primarily funded by healthy growth in bank deposits (12.0 percent), and short-term borrowing from SBP (outstanding amount of OMOs stood at Rs 624.8 billion by end June 2015). Given the government appetite for commercial banks funding and T-bill cut-off rates very close to the ceiling rate of IRC, banks utilized short-term liquidity from SBP to finance their investments. The incentive for this maturity transformation was huge, which is amply visible from the gap between T-bill and OMOs cut-off rates in recent months (**Figure 4.9**). Specifically, average secondary market yield for 3-month T-bill in June 2015 was 6.72 percent, compared with 6.31 percent monthly average of overnight repo rate: a spread of 41 bps.[13]

Figure 4.9: T-bill and OMOs Cut-off Rates



Source: State Bank of Pakistan

Commodity Operations

Loans for commodity operations saw a net expansion of Rs 72.0 billion in FY15, which was three times higher the increase seen in FY14 (**Table 4.3**). This was the upshot of lower seasonal retirements during FY15, especially of wheat financing.[14] In fact, procurement agencies were unable to off-load their wheat stocks before the arrival of fresh crop, which did not allow them to retire bank credit during the year (**Figure 4.10**). Further details suggest that the real issue was the higher wheat prices in domestic market as compared to the international market. To take benefit from this price differential, private sector imported 0.7 million tons of wheat during FY15, instead of buying from the procurement agencies at the release price. As a result, procurement agencies were unable to make seasonal retirements before the arrival of fresh wheat crop.

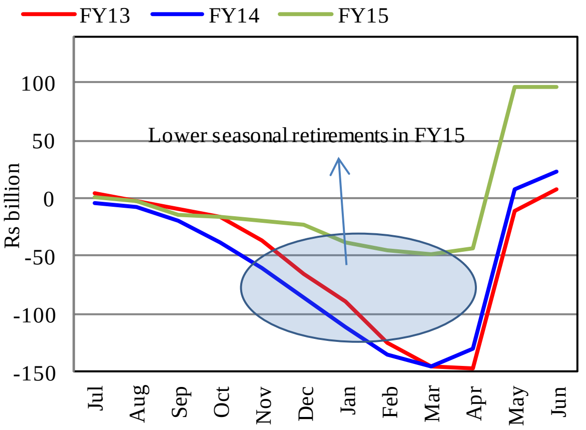
Table 4.3: Absolute changes in Loans for Commodity Operations

billion Rupees

	FY14	FY15
Wheat	22.8	94.4
Sugar	1.4	0.9
Urea	-1.5	-26.1
Rice	0.1	0.1
Cotton	0.0	2.6
Total	22.8	72.0

Source: State Bank of Pakistan

Figure 4.10: Cumulative flows-Wheat financing



Source: State Bank of Pakistan

Lower seasonal retirement together with fresh disbursements for the procurement of wheat at higher support price, pushed the outstanding stock of commodity operations loans to all time high level of Rs 564.5 billion by end June 2015. Given the self liquidating nature of commodity operations, the increasing stock of these loans reflects the underlying problems in commodity

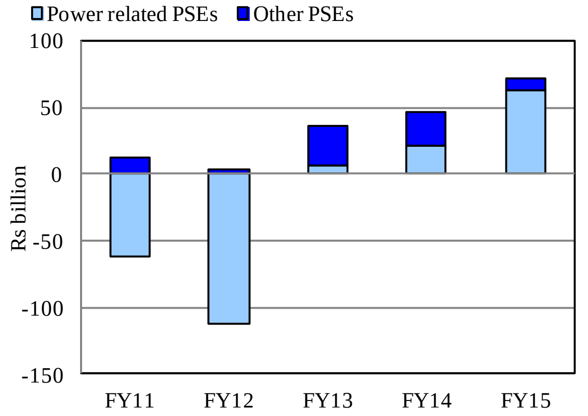
[13] This huge spread cannot entirely be attributed to term premium, as there was a gap of only 4 bps between average secondary market yield of 6 and 3 month T-bills.
[14] Loans for wheat financing have a share of 85.0 percent in overall loans for commodity operations.

operations. As pointed out repeatedly by SBP, receivables (sale proceeds plus subsidies) of procurement agencies constitute 52 percent of their outstanding loans. Furthermore, around two-thrid of these receivables are subsidies. It implies that smooth settlement of these receivables is imperative for containing financial cost of commodity operations and improving fiscal transparency.

Credit to PSEs

Advances to the public sector enterprises (PSEs) increased by Rs 80.0 billion during FY15 on top of 66.6 billion rise in the previous fiscal year. As a result, outstanding loans to PSEs have reached Rs 434.7 billion by end FY15: a level well above the outstanding loans seen before the settlement of receivables in November 2011 and June 2013. Institutional breakup of data indicates that power sector PSEs have availed major chunk of the credit. Share of power related PSEs has been increasing for the last three years, and has reached 62 percent in overall credit to PSEs by end June 2015 (**Figure 4.11**). Despite sharp fall in oil prices, accumulating inter-agency receivables continued to squeeze liquidity of energy related PSEs.

Figure 4.11: Credit to PSEs (flows during the year)



Source: State Bank of Pakistan

4.4 Credit to Private Sector

Despite accommodating monetary policy, overall credit saw a lower expansion of Rs 208.7 billion during FY15, compared with Rs 371.4 billion in FY14.[15] Both supply and demand side factors contributed to this slowdown in credit off take. Banks eagerness to invest in *risk free* government securities reduced supply of loanable funds for the private sector.[16] However, huge liquidity injections by SBP partially mitigated the problem of supply constraints.[17] Supply limitations were also compensated by higher deposit mobilization during FY15. Specifically, private sector deposits recorded a net inflow of Rs 922.9 billion during FY15, compared with an increase of Rs788.3 billion in FY14. In this backdrop, the impact of supply side constraints on private sector credit seems to be well-contained.

Having said this, the need for adequate supply of *bank credit* can hardly be over-emphasized in a country like Pakistan due to the bank-dominated nature of financial sector. Unfortunately, Pakistan has the lowest private sector credit-to- GDP ratio in the region. Moreover, distribution of private sector credit is highly skewed towards manufacturing, and a number of important sectors (like agriculture and SMEs) are underserved (**Special Section 1**). Although SBP has implemented a number of policy initiatives over the years (including issuance of separate set of prudential regulations for SMEs and agriculture sectors; issuance of guidelines to resolve sector specific problems, etc.), there is a need to supplement these initiatives by improving documentation, clear entitlement, property rights, contract enforcement, and overall governance. These steps would go a long way in improving credit to the private sector.

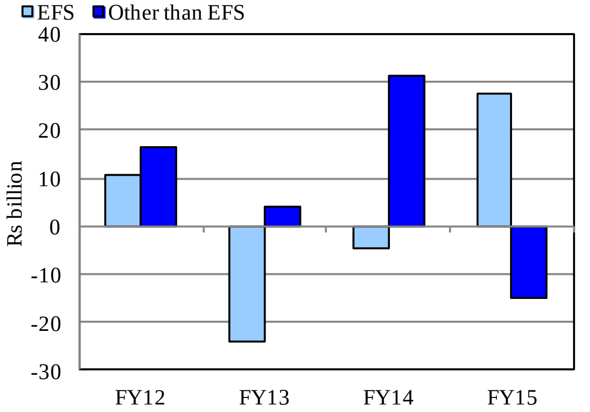
[15] Average monthly gross disbursements during FY15 were Rs 885.0 billion, compared with Rs 979.9 billion during FY14.
[16] Compared with a government borrowing of Rs 163.9 billon from commercial banks during FY14, the government borrowed a huge amount of Rs 1,322.6 billion during FY15, while the government retired Rs 434.2 billion to the central bank during FY15, in contrast with the net borrowing of Rs 159.8 billion in FY14.
[17] Specifically, the average volume of OMOs for liquidity injection stood at Rs 78.4 billion, Rs 217.4 billion Rs 390.3 billion and Rs 501.5 billion during the four quarters of FY15.

In FY15, demand for bank credit specifically from the manufacturing sector was also low, which held back overall credit expansion during the year. Sharp fall in commodity prices had a twofold impact on the credit demand. On the one hand, it reduced the demand for working capital loans especially in the food and textile sectors. On the other hand, sharp fall in inflation, increased the real cost of borrowing.[18] In addition, non-price constraints (e.g., power shortages, law & order, and weak external demand) and sector specific factors, also curtailed the overall credit off-take.

Though it is difficult to disentangle the impact of each factor on credit expansion during the year, price impact could be accounted for by deflating private sector credit with a suitable price index. Loans to private sector businesses, adjusted for the fall in wholesale prices indicates a YoY growth of 8.6 percent in FY15, compared to a growth of 6.5 percent in nominal terms.

Distribution of loans to private sector businesses by types of financing revealed that working capital and trade financing loans saw a slowdown during FY15. Within trade financing, while import financing more or less remained the same, the rise in EFS loans was largely offset by the retirements of export loans in 'other than EFS' category (**Figure 4.12**). In fact, a cumulative reduction of 240 bps in the EFS rate during FY15 incentivized exporters to substitute some of their trade loans with low cost EFS loans. This is also visible from change in trade financing loans against FE-25 deposits, which saw a net retirement of US$ 351 million in FY15, against a rise of US$ 873 million in FY14 (**Table 4.4**).

Figure 4.12: Flows of loans under trade finance



Source: State Bank of Pakistan

In contrast with slowdown in working capital and trade financing, fixed investment loans recorded a YoY growth of 14.0 percent during FY15 compared with 8.6 percent during FY14. Being a leading indicator of investment, this increase bodes well for the economy. Sectoral bifurcation of fixed investment loans indicates that cement and construction sectors borrowed for capacity expansion. This is a welcome development, as construction sector has strong forward and backward linkages in the economy.

Table 4.4: EFS loans versus foreign currency loans

	Foreign currency loans for trade financing (million US$)			EFS loans (billion Rs)
	Total	Imports	Exports	Total
FY14	873	431	442	-14
FY15	-351	-49	-302	27.4

Source: State Bank of Pakistan

Given the discussion on types of loans, sectoral review of credit will be more insightful as it will help understand the role of sector specific developments in low credit growth. Broadly speaking, deceleration in credit off-take by food, textile and electricity, having a combined share of 42 percent in credit to private sector businesses, largely offset the healthy growth in credit to cement, construction and real estate (**Table 4.5**).

[18] The average real cost of borrowing adjusted by subtracting the monthly inflation from the nominal weighted average lending rates was 5.2 percent in FY15 compared with just 1.7 percent during FY14.

Food Products and Beverages:

Net credit expansion to food & beverages sector during FY15 was only 16 percent of the amount seen in FY14 (**Table 4.5**). Soft commodity prices were the driving factor, which significantly reduced the working capital requirements. In this context, three points are worth noting:

Table 4.5: Loans to private sector businesses (Jul-Jun)

Flows in Rs billion

	Total Credit		**Working capital**		**Fixed investment**		**Trade financing**	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Private sector business	298.0	179.5	187.4	21.9	72.3	126.9	38.3	30.8
1) Agriculture	30.7	32.7	20.7	22.3	8.4	10.9	1.6	-0.5
2) Manufacturing	187.2	68.4	120.6	-29.7	36.3	85.0	30.3	13.1
Food & beverages	97.5	15.3	71.3	-5.5	18.7	9.2	7.5	11.6
Rice	26.5	-0.4	18.9	-2.0	0.6	0.0	7.0	1.6
Sugar	39.3	5.2	29.3	-10.1	11.1	11.5	-1.1	3.8
Beverages	11.2	2.9	9.4	0.4	0.5	1.2	1.2	1.2
Textile	43.2	-8.4	24.2	-19.6	3.1	16.6	16.0	-5.5
Cement	-14.2	20.1	-5.6	1.0	-7.9	20.4	-0.7	-1.2
3) Electricity	49.8	-11.4	27.9	-1.0	17.0	-10.7	4.8	0.3
4) Telecom	24.9	18.4	7.1	13.0	17.7	4.9	0.1	0.5
5) Ship breaking	0.1	11.0	-0.1	-0.2	-0.6	-0.1	0.7	11.3
6) Construction	-1.1	13.6	1.6	0.0	-2.5	12.0	-0.1	1.6
7) Real estate	-9.9	8.3	-6.7	5.7	-5.4	3.3	2.2	-0.7
8) Commerce & trade	16.6	13.7	15.7	5.0	-1.8	5.1	2.7	3.6
9) Hotels, restaurants & clubs	0.9	6.0	0.5	0.9	0.4	5.1	0.0	0.0
10) Others*	-1.2	18.9	0.0	5.9	2.9	11.4	-4.1	1.6

*An increase of Rs 12.7 billion was on account of road transport, while minor contributions came from education, mining & quarrying, etc.

Source: State Bank of Pakistan

- ***Rice***: credit to rice sector registered a net retirements of Rs 0.4 billion in FY15, in contrast to a net credit expansion of Rs 26.5 billion during FY14. Though *rice* production surpassed both the last year's level and the annual target, it was the deflation and weak external demand, which suppressed credit expansion for rice during FY15. The impact of falling prices was more pronounced: price of paddy fell from Rs 2400-2500/40kg during FY14 to only Rs 1500-1600/40kg during FY15. External demand was also low: overall export quantum of rice increased by just 1.9 percent during FY15 compared with a rise of 9.1 percent in FY14. This deceleration in export quantum was also visible from lower trade financing (**Table 4.5**).

- ***Beverages***: credit expansion to beverages sector was one-fourth of the increase seen in FY14. Lower demand for working capital loans was a major contributory factor, as trade financing remained unchanged and fixed investment loans recorded only a marginal increase during FY15. It must be recalled that FY14 was an exceptional year, as a number of drinking water and soft drinks manufacturers introduced new products, which led to a phenomenal growth in working capital loans. Although credit expanded further in FY15, the impact was less pronounced due to high base.

- ***Sugar:*** net credit expansion to sugar sector was only Rs 5.2 billion in FY15, compared with Rs 39.3 billion in FY14. This deceleration can be traced to lower sugarcane production, and issues regarding support prices of sugarcane.[19] Initially, this issue delayed the crushing activity and affected the credit cycle within FY15. Later on, it pushed a relatively higher proportion of sugarcane to informal sector for the production of gur and brown sugar, which rarely borrow from the banking sector.[20]

Textile: another drag on private sector credit

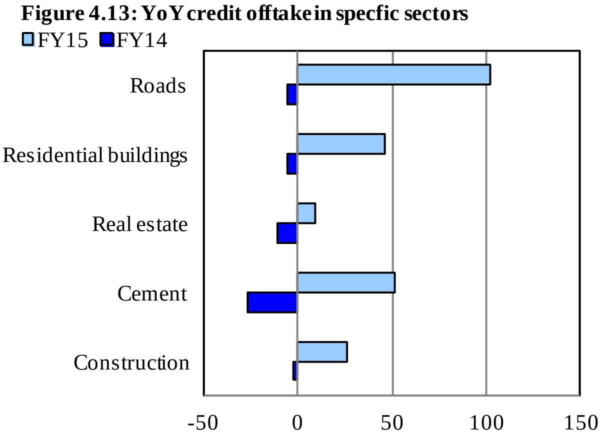
In contrast with a net credit expansion of Rs 43.2 billion in FY14, textile sector recorded a net retirements of Rs 8.4 billion during FY15. Sharp decline in domestic cotton prices, and weak external demand, seems to be major contributory factors. However, the impact of prices was more pronounced as the net retirement was entirely concentrated in working capital loans and trade financing. In addition, lower textile imports (particularly of cotton and cotton yarn) from China and Bangladesh dragged down textile exports of Pakistan, which ultimately reduced demand for credit.

Having said that, it is encouraging to note that a number of large textile firms are expanding and revamping their operations, to benefit from Pakistan's GSP plus status granted by the EU. A notable increase in fixed investment loans (having maturity of more than one year) lends credence to this argument. Specifically, fixed investment loans expanded by Rs 16.6 billion in FY15, compared with only Rs 3.1 billion during FY14.

Power sector

Loans to power sector saw a net contraction of Rs 11.4 billion during FY15 in sharp contrast to a net expansion of Rs 49.8 billion during FY14. Bifurcation of financing shows that working capital loans were suppressed primarily by lower capacity utilization and sharp fall in oil prices. Moreover, FY14 was an exceptional year as the government had settled the circular debt issue at the beginning of the year, which encouraged the energy sector enterprises to enhance their production. As a result, a number of entities reached close to their maximum borrowing limits.

Figure 4.13: YoY credit offtake in specfic sectors



Source: State Bank of Pakistan

It is also pertinent to highlight that loans to power sector grew by 2.4 percent during July-May FY15, compared with 22.0 percent during the same period last year. It implies that net retirement was entirely concentrated in June 2015 as one of the leading power utilities mobilized Rs 22.0 billion by issuing a Sukuk to refinance its existing debt and for future investments. Resultantly, loans to power sector recorded a net retirement of Rs 18.2 billion in June 2015. Had this retirement not been made, the overall credit would have expanded during FY15, though at a slower pace compared to FY14.

Telecommunication

Credit to telecom sector increased by Rs 18.4 billion during FY15, compared with an expansion of Rs 24.9 billion in FY14. This deceleration was expected as cellular companies borrowed heavily in FY14 to pay for 3G/4G spectrum rights, and upgrading their systems accordingly. In FY15, telecom sector borrowing was primarily for operational purposes, which led to Rs 13.0 billion increase in

[19] To be specific, sugarcane production fell by 7.1 percent in FY15, in contrast with a growth of 5.8 percent in FY14.
[20] Subdued increase in prices of both brown sugar and gur also lend credence to this argument. Specifically, price of brown sugar increased by only 1.3 percent in FY15, compared with a rise of 14.2 percent in FY14. On the other hand, the prices of sugar increased by 5.3 percent during FY15 compared with a rise of 0.8 percent in FY14.

working capital loans: almost double the increase seen in FY14. Launch of 4G LTE in December 2014 by one of the cellular companies, and purchases of equipments related to bio-metric verification by all cellular companies, also influenced the credit needs of cellular companies in FY15.

Construction & Allied Industries

Net credit to cement and construction sectors expanded by Rs 33.7 billion in FY15 compared to a net contraction of Rs 15.3 billion in FY14. In fact, construction sector is growing at a healthy pace, which creates demand for credit both directly and indirectly. As a number of residential and infrastructural projects are in the progress, the construction allied industries are positioning to cater to the growing needs of the construction sector. Cement sector is performing well as evident from higher sales volumes, and better profit margins amid falling international prices of coal (a key input). In addition to this, **Figure 4.13** shows that most of the sectors which can be considered as a proxy of infrastructure development, availed net credit during FY15 in contrast with net retirements in FY14.

Loans to Households

Consumer financing saw an expansion for the third successive year (**Table 4.6**). Within consumer loans, the expansion (more than 60 percent) was largely confined to car financing. Launch of a new locally assembled sedan, and change in regulatory requirements allowing banks to finance up to 9 years old cars, were the major contributory factors.

Going forward, credit to private sector is likely to gather pace due to upbeat investors' confidence amid successful IMF reviews, political stability, relative improvement in law & order situation and prospects of CPEC. Aggressive monetary easing during H2-FY15, and marginal improvement in energy supplies, are also likely to improve demand for loans by encouraging investment activity. Cement, construction and real estate sectors have already taken the lead, while other industries are expected to follow.

Table 4.6: Loans to households

flows in Rs billion

	FY12	FY13	FY14	FY15
Consumer financing	-12.9	15.0	31.4	31.2
House building	-6.1	-2.6	0.3	0.9
Car financing	-5.8	5.4	13.2	20.0
Credit cards	-1.7	-1.1	1.0	1.1
Consumer durable	0.1	-0.1	0.2	-0.1
Personal loans	-0.9	11.1	16.9	9.1
Others	1.6	2.4	-0.2	0.2

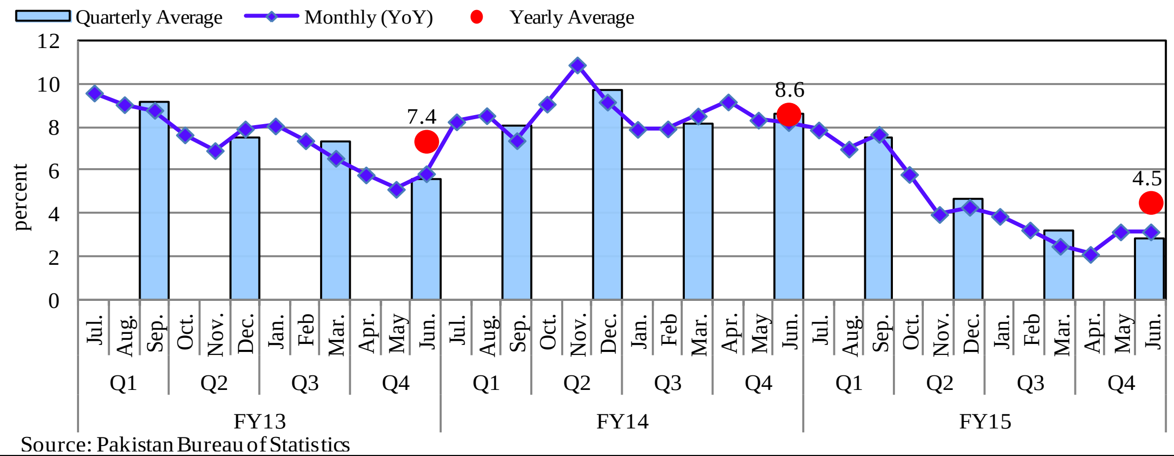
Source: State Bank of Pakistan

4.5 Inflation

FY15 saw a significant ease in inflationary pressures, as average headline inflation came down to 4.5 percent, which was lower than both, the target of 8.0 percent and the realized inflation of 8.6 percent in FY14. This unexpected decline in inflation was mainly driven by a sharp fall in global commodity prices especially POL, wheat, rice, palm oil, etc. In particular, the government decision to pass on the benefit of lower POL prices to domestic consumers not only moderated CPI inflation directly, its spillover effect also contained inflation in other commodities of CPI basket. Further ease in domestic inflation came about due to reduction in the Rupee cost of imports; specifically, the PKR (on average) strengthened by 1.5 percent against the US Dollar during FY15.[21] The inflationary expectation also softened as a result of downward revisions in domestic POL prices and stable exchange rate. Hence, monthly YoY inflation came down sharply during FY15, reaching as low as 2.1 percent in April 2015, the lowest monthly CPI inflation since August, 2003 (**Figure 4.14**).

[21] During the first eight months of FY15, average exchange rate of Pak rupee vis-à-vis US dollar registered a cumulative YoY appreciation of 3.8 percent. Subsequently, it depreciated by 3.0 percent YoY in last four months.

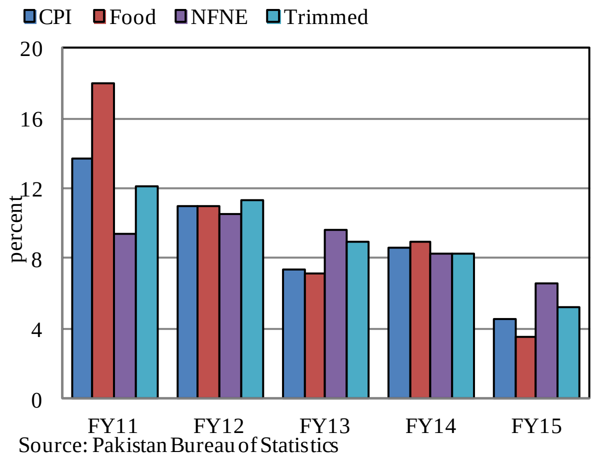
Figure 4.14: CPI Inflation



Source: Pakistan Bureau of Statistics

Broadly speaking, the fall in CPI inflation is broad-based, as 10 out of 12 sub-categories registered a decline in FY15. [22] The impact of lower food and POL prices however remained dominant, as the deflation in just 7 items explains more than 45 percent of ease in inflation during FY15. [23] Thus, not surprisingly, the CPI inflation excluding food and energy (a measure of underlying pressures), shows a decline of only 1.3 percentage points. This is considerably lower than 3.1 percentage points reduction in 'trimmed[24] measure' of core inflation that excludes items showing extreme price changes (**Figure 4.15**).

Figure 4.15: Average Annual CPI Infation YoY



Source: Pakistan Bureau of Statistics

During FY15, food inflation came down sharply to 3.5 percent from 9.0 percent a year ago. As shown in **Table 4.7**, the "*Food Group*", representing 37.5 percent of the CPI basket contributed 1.4 percentage points to the overall average annual inflation during FY15.[25]

- The price of wheat and flour remained depressed almost throughout FY15, due to bumper crop in FY14[26] and a decline in international prices. Specifically, the annual average price of wheat and flour fell by 5.5 percent and 2.5 percent, respectively during FY15.

- Despite concerns after the September 2014 floods, the perishable food items registered a disinflation (2.5 percent) compared to 15.4 percent inflation witnessed last year, reducing their contribution to just 0.1

[22] The exceptions were 'Alcoholic beverages & tobacco' and 'Education'.
[23] These include: wheat, flour, rice, cooking oil, vegetable ghee, Kerosene oil and motor fuel.
[24] Trimmed mean core inflation is computed by excluding items from the CPI basket, showing highest and lowest inflation with cumulative weight of 10 percent. This means, the trimmed CPI basket changes every month.
[25] It includes "Food and non-alcoholic beverages ", "Alcohol & beverages" and "Restaurants" sub groups.
[26] Wheat stocks as on April 2015 stood at 3,351 (000 tonnes) compared to 1,177 (000 tonnes) in April 2014.

percentage points in overall CPI inflation compared to 0.8 percentage points last year.[27] The average price of potatoes came down sharply in the H2-FY15 to Rs 22.7 per Kg from Rs 63 per Kg in H1-FY15.[28] This was accompanied by decline in the price of onion and tomatoes.[29, 30] On the other hand, the average price of fresh fruits and vegetables increased by 10.0 percent and 6.0 percent, respectively during FY15.

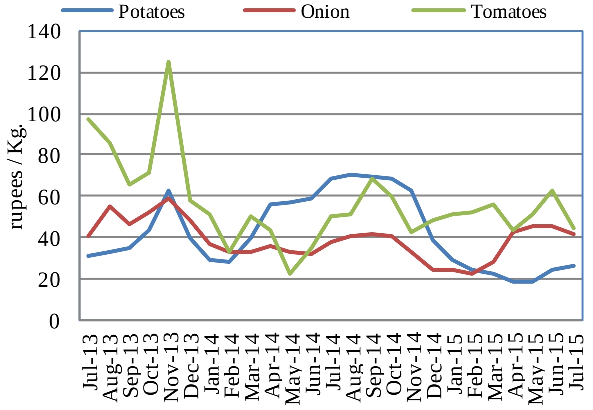
- The changes in federal excise duties on cigarettes in FY15 Federal Budget increased retail prices of cigarettes in the range of 12.2 – 25.6 percent for different brands.[31] This increase alone contributed 0.3 percentage points to overall CPI inflation during FY15 (**Figure 4.16**).

Table 4.7: Contribution to Average Annual CPI Inflation
percentage points

	FY14	FY15
Food Group	3.7	1.4
Clothing	1.0	0.6
Housing	2.2	1.6
Furnishing	0.4	0.3
Health	0.1	0.1
Transport	0.3	-0.3
Communication	0.1	0.0
Recreation	0.2	0.1
Education	0.4	0.5
Misc	0.2	0.2
	8.6	**4.5**

Source: Pakistan Bureau of Statistics

Figure 4.16: Monthly Retail Prices of Potatoes, Onion and Tomatoes



Source: Pakistan Bureau of Statistics

The administered price items included in the CPI basket showed a deflation of 0.3 percent during FY15, compared to 7.8 percent inflationary impact last year.[32, 33] As mentioned earlier, this was mainly led by downwards revision in domestic prices of petroleum products during FY15.[34] Lower domestic fuel prices (having 3.0 percent weight in CPI basket), thus directly caused a reduction of 0.4 percentage points in the overal CPI inflation during FY15. Furthermore, electricity, the single largest item within this category (4.4 percent weight in CPI basket), registered a lower increase of 4.8 percent in prices during FY15, compared to 11.9 percent last year (**Figure 4.17**).[35]

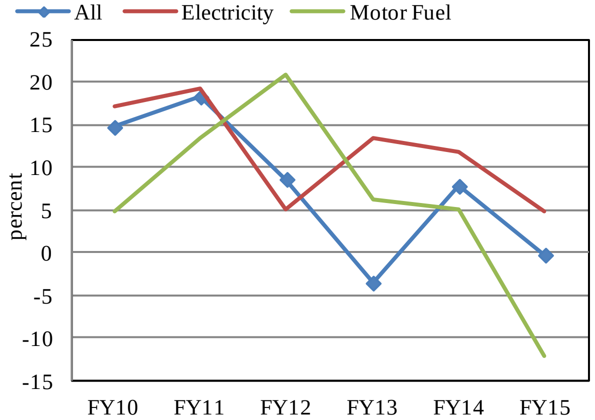
[27] Perishable food items include: fresh fruits, potatoes, onion, tomatoes and fresh vegetables.
[28] The price of potato fell sharply from Rs 70.76 in August, 2014 to Rs 18.29 per Kg in May, 2015, mainly due to better supplies through fresh arrival of the domestic crop and government's decision to allow the import of potatoes. Nonetheless, the average price for FY15 remained at last year's level of Rs 42.8 per Kg.
[29] The average price of onion and tomatoes also decreased by 15.3 percent and 13.4 percent, respectively during FY15 from last year's level
[30] In FY15, the price of onion fluctuated in the range of 22.70 -Rs 45.64 per Kg, markedly lower than Rs. 31.64 -58.78 per Kg recorded during FY14.
[31] The Federal Budget simplified and re-structured federal excise duty on cigarette: instead of three-slabs based on a composite formula, the duty is now levied on two-slabs based on a specific rate.
[32] Contribution of administered prices items in overall CPI inflation, however, became negative (-0.04 percentage points) as against 1.0 percentage points last year.
[33] 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 tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.
[34] During FY15, six successive downward revisions in the domestic prices of petroleum products were announced by the Government, reducing the retail prices of petrol and high speed diesel to Rs. 70.29 and Rs. 80.61 per litre respectively in February, 2015.
[35] The inflationary impact of increase in the electricity tariffs for commercial and industrial users by 23.7 percent in August 2013 and household tariffs from October 2013 in the range of 15.5 to 23.8 percent (for above 200 kWh monthly

Finally, inflation in the items of daily use was much lower as compared to other items.[36] The contribution of essential items of daily use was only 1.1 percentage points in the overall inflation of 4.5 percent in FY15 (**Figure 4.18**).

Inflation Outlook:
The government has set the target of 6.0 percent for CPI inflation in FY16. We expect inflation to remain lower than the target as international commodity prices (especially of crude oil) are still continuing their downtrend. While the likely ease in domestic petroleum prices would further soften inflation expectations of households (as they use POL prices to *anchor* their expectations), a stable PKR against US Dollar positively influence expectation of businesses (since movements in the Dollar-PKR parity directly influence price setting by private sector businesses). The recent IBA-SBP's Consumer Confidence Survey (for September 2015) also indicates lower inflationary expectations for the months ahead (**Figure 4.19**). However, a possible hike in the electricity and gas tariffs by the government may pose up-side risks to inflationary outlook.

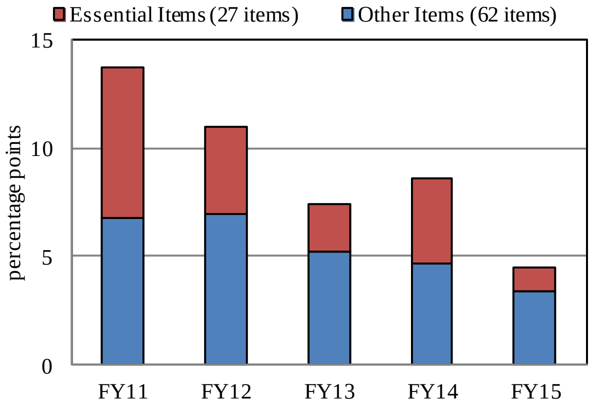
The sharp fall in CPI headline inflation to 1.8 percent in July 2015 from 7.9 percent a year earlier raises concerns about possible seeping of *deflationary* pressure into Pakistan's economy. However, our analysis shows no such risk for Pakistan. A number of developments support this assessment: (a) the recent increase in power tariffs and recovery of Gas Infrastructure Development Cess (GIDC); (b) stable PKR against the major trading partners which lowered the risk of importing low inflation; (c) global oil prices would not fall as sharply as they did last year; and finally, (d) the domestic demand is likely to remain strong given the planned infrastructure spending, monetary easing and improvement in law & order situation.

Figure 4.17: CPI Inflation of Administered Price Items (YoY)



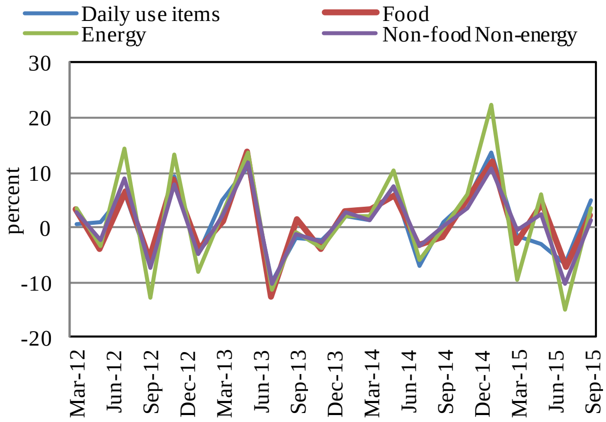
Source: Pakistan Bureau of Statistics

Figure 4.18: Distribution of Inflation



Source: Analyst estimates, PBS

Figure 4.19: Inflation Expectations compared to Last Survey



Source: IBA-SBP

consumption) by the Government continued in Q1-FY15. Government has also imposed 30 paisa per unit equalization surcharge effective from November, 2014.

[36] This sub-group includes wheat flour, rice, chicken, fresh milk, vegetable ghee, sugar, tea, potatoes, onion, tomatoes, fresh vegetables, fresh fruits, five pluses, water supply, electricity, gas, kerosene oil, cotton cloth, utensils, washing soap & detergent, transport services, postal services and text books.

In fact, the data on prices indicate only 14 items out of 89 in the CPI basket registered deflation. Furthermore, items like house rent[37] and education (combined weight of 25.758 percent in the CPI basket) have consistently registered inflation of 6.7 - 8.2 percent and 7.4 - 13.8 percent respectively during last six years. Analysis of the more detailed data (487 items included in the CPI basket) reveals that during the last 5 years, the number of items showing increase/ no change in prices remained between 88 - 94 percent.

[37] House rent index is revised quarterly based on housing survey conducted by the PBS.