

3 Monetary Policy and Inflation

3.1 Policy Review

With growing imbalances in the economy, along with a challenging outlook, monetary policy in Pakistan shifted gears in FY18. The Monetary Policy Committee (MPC) increased the policy rate by a cumulative 75 basis points during the year, after keeping it unchanged at historic low levels for around 20 months. The key pressure point was the adequacy level of the country’s foreign exchange reserves (**Table 3.1**), as well as the future inflation path.

Importantly, SBP’s forecasts from January 2018 onwards suggested that persistent domestic demand pressures – evident in rising imports, twin deficits, and elevated level of core inflation – could potentially pose risks to the medium-term sustainability of economic growth. In fact, the forecast of headline inflation for FY19 highlighted the increased likelihood of exceeding the 6.0 percent target primarily due to lagged pass-through of the PKR depreciation and the upward trajectory of global oil prices.

The timing of the policy reversal represents shifting balance of risks during the course of the year. In all the three MPC meetings of H1-FY18, the policy rate was kept unchanged, as inflation remained low and its forecast was within the target. Although global commodity prices had begun to recover, and demand-driven pressures drove up non-food inflation, their combined impact was more than offset by a sharp fall in food inflation. This drop represented the impact of improved supplies of key staples and favorable duty regime for cigarettes – a similar trend persisted through the rest of the year (**Figure 3.1**). Nonetheless, inflation expectations crept up (as indicated by IBA-SBP consumer confidence surveys) due to the imposition of regulatory duties on a number of items and the increase in domestic prices of petrol and other fuels. As for the external sector, although trends were not comfortable throughout the first half of the year, the government’s plans to mobilize funds from the global capital market, lent some support to the outlook.

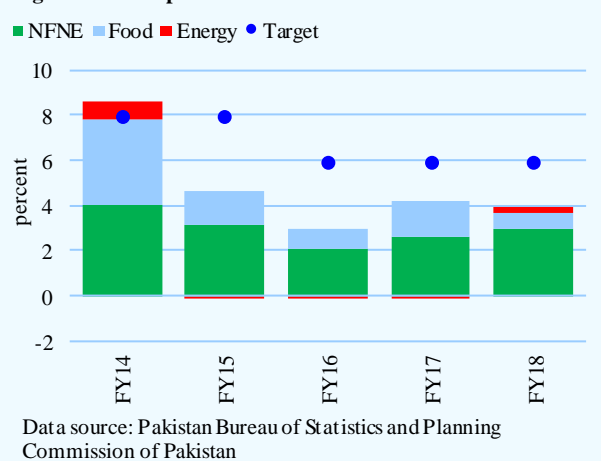
However, the outlook and the policy equation changed completely by the time the MPC met in January 2018. Four factors particularly fed into the decision to raise interest rates: (i) the Pak rupee’s 4.4 percent depreciation in December 2017, which was expected to have a lagged impact on headline inflation; (ii) a steady increase in global oil prices; (iii) narrowing of the interest rate differential between the Pak rupee with the rest of the world; and (iv) estimates of output gap hovering around the

Table 3.1: Major Policy Indicators

	FY16	FY17	FY18			
			Q1	Q2	Q3	Q4
Imports (billion US\$)	44.7	52.9	14.3	14.6	15.6	16.6
Current account/GDP (%)	-1.7	-4.1	-1.1	-1.4	-1.4	-1.9
Fiscal balance/GDP (%)	-4.6	-5.8	-1.3	-1.0	-2.0	-2.3
Import cover (months)	5.8	4.0	3.2	3.2	2.6	2.1
CPI inflation (% period avg.)	2.9	4.2	3.4	4.1	3.8	4.4
Core inflation (% period avg.)	4.2	5.2	5.5	5.4	5.4	7.0
PKR/USD (period avg.)	104.8	104.8	105.4	106.6	111.1	116.8

Data source: PBS; SBP; MoF

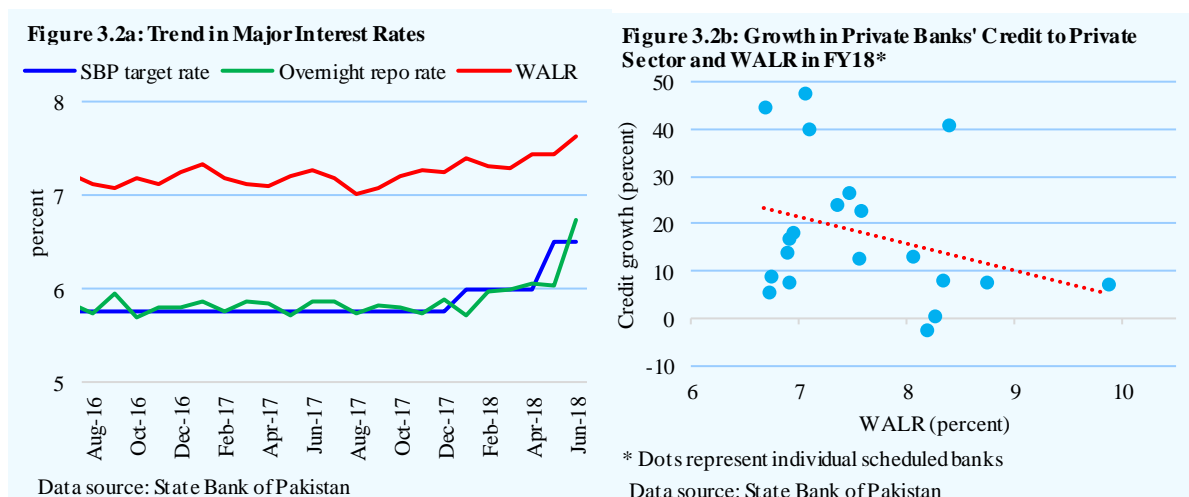
Figure 3.1: Composition of Headline CPI Inflation



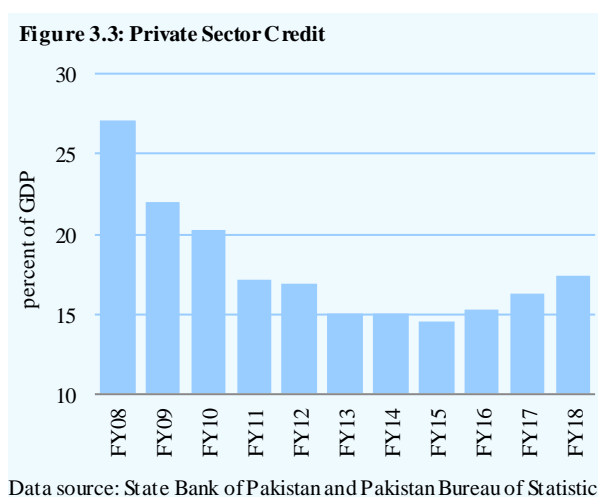
Data source: Pakistan Bureau of Statistics and Planning Commission of Pakistan

positive territory.¹ Therefore, the MPC decided to increase the policy rate by 25 bps in its January 2018 meeting.

In the subsequent review, the policy rate was kept unchanged to allow time for the impact of policy developments to unfold. However, by the time the MPC met again (in May 2018), the twin deficits were presenting a grimmer picture of the economy. First, limited financial inflows, coupled with a sharp increase in global oil prices largely offset the gains from an uptick in exports and a slowdown in non-oil imports. Second, higher-than-expected fiscal expansion was in contrast with the policy adopted by the central bank to counter demand pressures. As a result, a majority of the MPC members voted to raise the policy rate by 50 basis points.



Importantly, the cumulative 75 bps hike during H2-FY18 did not have a significant impact on the weighted average lending rates (WALRs), which inched up by only 39 bps during the same period (Figure 3.2a). Aside from typical lags involved in the pass-through, a modest increase in WALR also represented liquidity available in the interbank market, amid ongoing competition across banks to secure financially sound projects – some negative association has been observed in WALR offered by private banks and the credit expansion they were able to achieve (Figure 3.2b). It is important to reiterate here that low and stable WALR had a major contribution to the country achieving a 13-year high real GDP growth rate of 5.8 percent in FY18, as industries resorted increasingly towards bank borrowings to finance their expenses. This is also evident in the 8-year high level of private sector credit-to-GDP ratio (Figure 3.3).



The momentum in working capital loans was particularly visible in a large number of sectors, including textiles, cement, electrical machinery, iron and steel, edible oil & ghee, basic chemicals and

¹ A number of emerging and advanced economies raised their interest rates during end-2017. Particularly, the US Fed and the Bank of England increased their interest rates by 75 and 25 basis points respectively. Moreover, the Reserve Bank of India also raised the interest rate by 25 basis points in each of its last two monetary policy reviews in June and August 2018.

rice processors (**Section 3.3**). In addition to low interest rates, this growth was attributed primarily to increased production capacities, buoyant industrial activities, and also to input prices that continued to increase in FY18 – albeit at a slower pace compared to last year. As for fixed investment loans, the expansion remained lower than last year. The disaggregated data suggests that the slowdown came primarily from the fertilizer sector, as scheduled retirements of earlier loans fell due. In contrast, capacity expansions/ upgrades in major manufacturing sectors (including textiles, cement, edible oil & ghee and domestic appliances) continued to push up their fixed investment borrowings. SBP’s subsidized financing schemes for export-oriented sectors also played an important role in encouraging capex activities in some sectors, such as textiles. As for the power sector, although fixed investment activity remained dull in H1-FY18, it picked up some pace during the second half of the year as firms tried to expedite project closures in the wake of imposition of ban on new power projects.

On the supply side, banks had sufficient liquidity at their disposal to cater to the demand from the private sector. This liquidity ease was attributed mainly to SBP’s proactive liquidity management in the interbank market; open market operations, which are conducted with an objective to keep the overnight rates close to the policy rate, were particularly helpful. In FY18, these OMOs helped alleviate occasional liquidity pressures that emanated from: (i)

billion rupees		
	FY17	FY18
Q1	-260.2	168.7
Q2	-210.3	147.2
Q3	373.0	-1706.8
Q4	276.9	1238.5

Data source: State Bank of Pakistan

(ii) budgetary borrowings from banks through most of the year (in 3 out of 4 quarters – **Table 3.2**); (ii) FX operations; and (iii) a slowdown in deposit growth. SBP’s liquidity support via open market operations was particularly strong in H1-FY18, when seasonal borrowings from the private sector were in full swing and deposit growth nearly halved compared to last year (**Box 3.1**). Subsequently, the liquidity position in the interbank market eased during the third quarter, amid sizable maturities of T-bills and PIBs, which the commercial banks were not keen to roll over – the government had to borrow Rs 2.2 trillion from SBP. The overall ease in liquidity during FY18 is evident from lower volume of commercial banks’ borrowing from SBP’s reverse repo facility as compared to FY17.

The impact of the overall private sector credit growth on monetary expansion was further reinforced by a sharp rise in public sector borrowings. Not only did the budgetary borrowings continue to grow at a rapid pace, but public sector agencies also borrowed heavily, especially for commodity operations. As a result, the overall net domestic assets grew by 15.9 percent in FY18. However, its impact was partially diluted by a sharp fall in net foreign assets of the country, which represented the growing external account deficit. The overall money supply grew by 9.7 percent, lower than the 13.7 percent growth recorded last year.

Despite this slowdown, the overall M2 as percent of GDP continued with its upward trajectory and crossed the previous high of FY08, by reaching 46.5 percent in FY18. The continuous increase in this ratio over the past few years had been contributing to domestic demand pressures in the economy. Although it is expected that the recent monetary tightening measures will help alleviate these pressures to a certain extent, the effectiveness of this policy change hinges upon coordinated attempts to maintain fiscal discipline.² Specifically, the composition of M2 to GDP shows that the bulk of the increase has come from public borrowings, as the contribution from the private credit has been fairly modest (**Figure 3.4**). This represents the risk that the multiplier effect of a strong and persistent fiscal expansion can potentially offset the contractionary impact of monetary tightening on domestic demand.

² After raising the policy rate by 75 bps in FY18, the MPC announced another rate hike of 100 bps in July 2018.

While posing a major challenge to monetary policy effectiveness, fiscal strains are also not favorable in terms of banking sector development and financial services deepening. In particular, the advances-to-deposit ratio is quite low in Pakistan, as banks typically invest heavily in government papers. Although the ratio has improved over the past couple of years and reached 53.1 percent in FY18, it remains low as compared to 73.9 percent for the Asia Pacific region. This suggests that as long as the government’s appetite for funding continues, banks would not be deploying the bulk of their liquidity in the private sector, especially in the underserved segments. A case in point is the SME sector. Credit offtake by SMEs remained subdued during FY18 over last year, as banks further increased their exposure on big corporates (**Table 3.3**). Not only did the share of SMEs in total advances shrink, the number of SME borrowers also declined. This implies that while private sector credit has grown appreciably over the past 3 years, some cross-sector substitution of banking fund allocation also took place. In other words, increased corporate lending has crowded out SME lending.

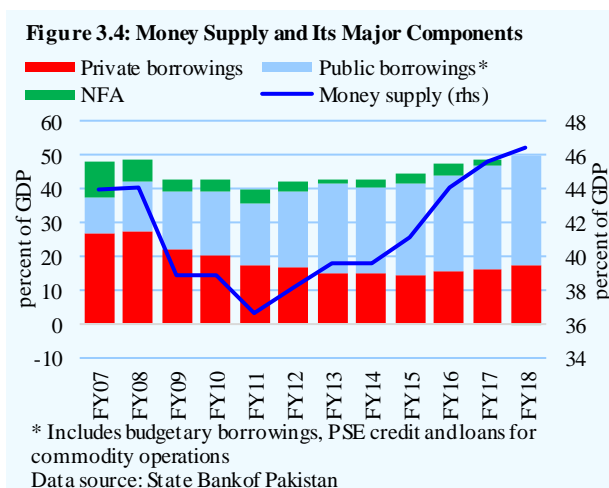


Table 3.3: Major Indicators of SME Financing

	Jun-16	Jun-17	Jun-18
SME finance (yearly flow bln Rs)	30.7	78.5	33.7
Share of SMEs in total advances (%)	5.4	5.9	5.4
SME borrowers (no.)	165,238	177,342	169,768
SMEs’ net NPLs to loan ratio (%)	26.5	20.5	17.8

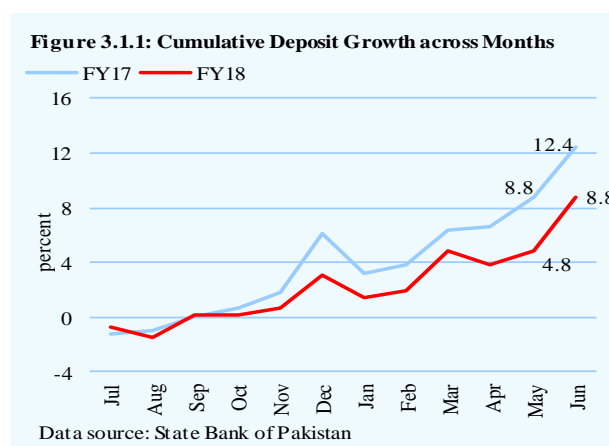
Data source: State Bank of Pakistan

To address this, SBP is undertaking efforts to ensure a more balanced distribution of bank loans across sectors. In FY18, it launched a comprehensive roadmap for the promotion of SME finance. The roadmap comprises 9 key pillars, including improving regulatory framework, upscaling microfinance banks, and simplifying procedures for SME financing. Similarly, SBP has also prepared a draft framework for the promotion of low-cost housing finance (**Box 3.2**). With such measures, the depth and access of private credit in Pakistan is expected to improve considerably. That said, it is also imperative to keep the fiscal policy aligned with the broader objective of ensuring monetary policy effectiveness and simultaneously achieving financial inclusion. Containing demand pressures is getting increasingly important, as cost-push pressures on inflation are expected to get stronger over the medium term. Importantly also, inflation expectations still appear high, as evident from the July 2018 edition of the Consumer Confidence Survey. Thus, SBP will continue to apprise the MPC about emerging risks to the economy, to ensure adoption of appropriate monetary policy stance.

Box 3.1: What has caused a slowdown in deposit mobilization?

Deposit growth slowed down to 8.8 percent in FY18 from 12.4 percent a year earlier. However, it is important to note that over 44.8 percent of the deposit increase during FY18 came in a single month – June; excluding this month, the slowdown in deposit growth is much sharper (see **Figure 3.1.1**). A common explanation is the presence of very low interest rates, which has created a disincentive for depositors to place their funds with banks. Moreover, since overall M2 growth has decelerated, a slowdown in deposits also seems logical.

However, in previous cycles of accommodative monetary policy, the growth in bank deposits had remained intact. Importantly, deposits to M2 ratio at end-June 2018 represents one of the lowest levels since the initiation of reforms in the early 1990s (**Figure 3.1.2**). This indicates



that the newly created money for general public and businesses is not re-entering the banking system. This has several disadvantages, including but not limited to, negative effects on economic growth and lower liquidity with banks to carry out financial intermediation.

Businesses took the major hit

The deposits of the banking system (including government deposits) grew by 13.7 percent in terms of compounded annual growth rate during FY12-FY15; the CAGR then declined to 11.4 percent during FY15-FY18 (see **Table 3.1.1**). Self-employed (i.e., small businesses) and ‘other personal’ deposits (excluding those of salaried persons) have the biggest share in deposits (36.3 percent by June 2018), and the growth in these deposits almost halved during FY15-FY18 as compared to FY12-FY15. With about a quarter share in total deposits, deposit placement by manufacturing, real estate, commerce and trade firms has also been lukewarm.

Withholding tax regime continues to hurt

The foremost reason that triggered the reversal of trend in deposits to M2 ratio a couple of years ago was the imposition of withholding tax on non-cash banking transactions (exceeding Rs 50,000) for non-filers, which went into effect from July 2015 (see **Special Section 1 of SBP’s Annual Report 2017** for details). Though the general perception is that bank deposits subsequently recovered in FY17 and FY18, data shows otherwise. The deposit-to-M2 ratio has continued to slide during FY17 and FY18, which indicates that the impact of withholding tax is still hindering the movement of cash back into the banking system.

Banks’ own strategy to avoid remunerative deposits

Banks’ efforts to mobilize deposits from the private sector have been weak in recent years, especially for remunerative deposits. This behavior can be traced to the imposition of floor on deposit rates that limits banks’ ability to cut their interest expenses. Anecdotal evidence suggests that bankers have been encouraging new customers to open current or savings accounts, instead of fixed/term deposits. A balance sheet review of a selective pool of banks also shows that adjusting deposit portfolios is a common strategy to minimize interest expenses. In fact, many banks have boasted in their annual and quarterly statements of “taper off”, “shed”, or “optimize” their high-cost deposits. Mobilization of low-cost current and savings account (CASA) deposits seems to be rampant amongst banks in hopes of keeping them profitable. Therefore, it is not surprising that the impact on term deposits (21.0 percent share) has been most severe (**Figure 3.1.3**).

Availability of alternative sources of bank liquidity

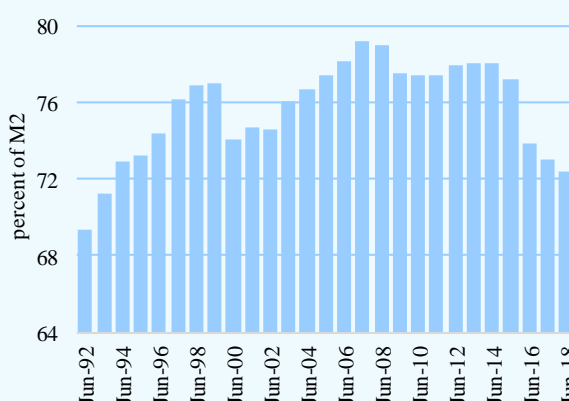
Ample availability of liquidity is another factor that has undermined banks’ deposit-taking efforts in recent years. First, OMO injections by SBP (to keep the overnight rate close to the target rate) have been quite helpful for banks in meeting their liquidity needs. Over the previous 3 years, the average volume of OMO injections has been similar to the increase in banks’ deposit base (**Figure 3.1.4**).

Table 3.1.1: Growth in Sector Wise Deposits

percent	Share in June 18	CAGR	
		FY12-FY15	FY15-FY18
Total	100.0	13.7	11.4
<i>of which:</i>			
I. Government	14.5	14.0	22.9
II. Non-financial PSEs	6.1	4.4	16.8
III. Non-bank FIs (NBFIs)	3.2	16.9	28.5
IV. Private sector business	23.6	15.0	5.9
V. Personal	47.8	15.2	9.3
a. Salaried persons	11.5	17.8	14.2
b. Self employed	21.9	14.3	7.8
c. Other personal	14.4	14.9	8.2
VI. Other	0.5	1.5	-2.6

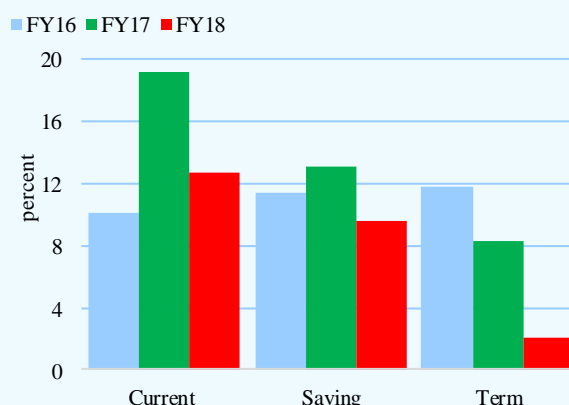
Data source: State Bank of Pakistan

Figure 3.1.2: Trend in Bank Deposits



Data source: State Bank of Pakistan

Figure 3.1.3: Category-wise Annual Growth in Deposits



Data source: State Bank of Pakistan

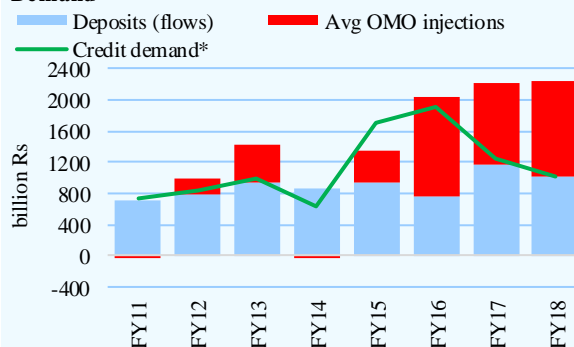
Similarly, SBP’s refinance schemes – that have attracted borrowers due to subsidized mark-ups – have been a source of

liquidity for commercial banks, especially for long-term funding. Over the last 3 years, banks received refinance from SBP against around 12 percent of total business loans.

Last but not least, public sector deposits (government as well as public sector enterprises) have emerged as an important source of bank liquidity. Over the last 3 years, these deposits have contributed, on average, 30 percent of the total increase in bank deposits. In outstanding stock of deposits, the share of the public sector has touched 20 percent by end-FY18, up from 16 percent 3 years earlier. Banks have been relying increasingly on these deposits to meet their operational requirements.

Measures should be taken to encourage savers to place their funds with banks. In this regard, while SBP has repeatedly advised banks to increase their deposits taking efforts and has also put in place floors on deposit rates, it is extremely important to reconsider the taxation regime. The removal of withholding tax on non-cash transactions will be particularly helpful. Importantly also, it is expected that with a reversal in monetary policy stance, liquidity dynamics may change in the interbank and this could induce banks to focus more on expanding the deposit base.

Figure 3.1.4: Major Sources of Banks' Funding and Credit Demand



* including demand from scheduled banks only, such as budgetary borrowings; credit to private sector, PSEs, and for commodity operations

Data source: State Bank of Pakistan

3.2 Monetary Aggregates

Broad money (M2) growth witnessed a slowdown in FY18 from a year earlier (**Table 3.4**), mainly due to a significant decline in SBP's NFA. Furthermore, the growth in NDA was also lower than last year.

Net Foreign Assets

With pressures developing in the external sector, the banking system NFA (stock) turned negative for the first time after FY00. The major drag came from SBP's NFA, which fell by Rs 817.3 billion in FY18 (**Figure 3.5**). By extension, the erosion of SBP's NFA was also behind the lower YoY growth of reserve money during FY18, despite elevated budgetary borrowings from the central bank in the year. As for the commercial banks, their NFA stock had already turned negative in FY16, as banks increasingly resorted to external borrowings to meet rising FX demand in the interbank market.

Budgetary borrowing and money market

In the backdrop of a 5-year high fiscal deficit, budgetary borrowing from the banking system remained elevated during FY18 (**Figure 3.6**). Within the banking system, the reliance on SBP financing became more pronounced during FY18. In Q3-FY18 alone, the government borrowed around Rs 2.2 trillion from SBP, against the limit of zero quarterly borrowing from the central bank prescribed under the SBP Act.

Table 3.4: Monetary Aggregates^P

	billion rupees			
	Abs. change in stocks		Growth rate in percent	
	FY17	FY18	FY17	FY18
M2 (A+B)	1,756.0	1,416.3	13.7	9.7
A. NFA	-405.5	-811.3	-40.2	-134.8*
B. NDA	2,161.6	2,227.6	18.3	15.9
<i>Government borrowing</i>	1,136.1	1,243.7	14.5	13.9
Budgetary borrowing	1,087.3	1,110.5	15.1	13.4
SBP	907.9	1,262.9	62.9	53.7
Scheduled banks	179.4	-152.4	3.1	-2.6
Commodity operations	49.9	133.2	7.8	19.4
<i>Non-government borrowing</i>	998.7	1,022.6	19.9	17.0
Private sector	747.9	775.5	16.8	14.9
PSEs	254.7	245.4	46.8	30.7
Reserve money	894.3	616.7	22.5	12.7

^P: Provisional

*Outstanding stock at end June 2017 was Rs 602.0 billion and at end June 2018 was Rs -209.3 billion.

Data source: State Bank of Pakistan

The government’s increased resort to SBP financing reflects its difficulties in rolling over its borrowings, let alone mobilization of additional financing, from scheduled banks in the perceived rising interest rate scenario. Within T-bills, this trend was particularly visible in case of 6- and 12-month tenor papers, as scheduled banks had a clear preference for the 3-month paper. Specifically, around 92 percent of offers (and acceptances) were concentrated in 3 month T-bills during FY18 (Figure 3.7a). Even the policy rate hikes in January (25 bps) and May 2018 (50 bps) did not prompt any significant change in this pattern, with up to 100 percent of the offers being placed for 3-month T-bills in multiple auctions (Figure 3.7b).

As for PIBs, participation by scheduled banks remained thin on the whole, underscored by lower offered amounts compared to a year earlier (Table 3.5); eight successive auctions were duly scrapped between Aug-Mar FY18. In effect, the government kept on defying market expectations about the trajectory of inflation and interest rates throughout this period, which not only distorted the money/domestic debt market, but also made the overall monetary management challenging. The following consequences are particularly notable: (i) the absence of supply of long-term PIBs led to a suppression of their yields in the secondary market – this made the yield curve less-representative of the market expectations; (ii) the maturity profile of domestic debt was shortened which led to an increase in refinancing risk; and (iii) the government had to fill the financing gap by borrowing increasingly from the central bank.

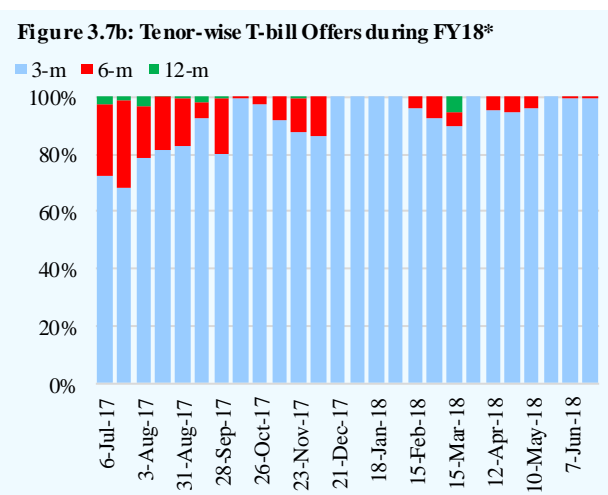
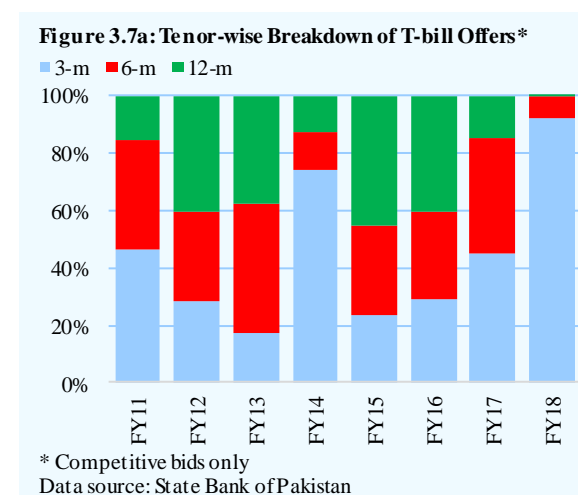
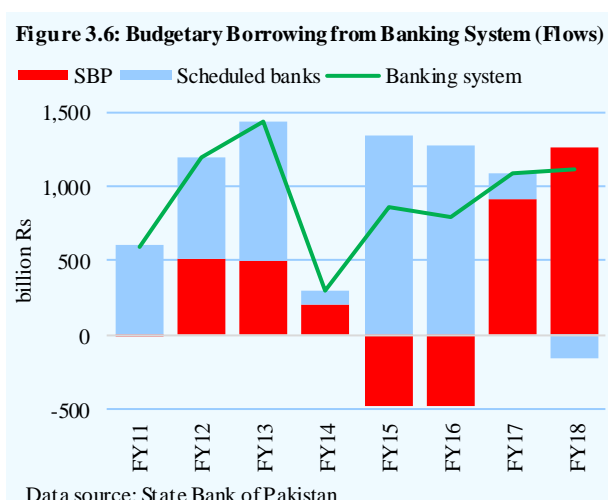
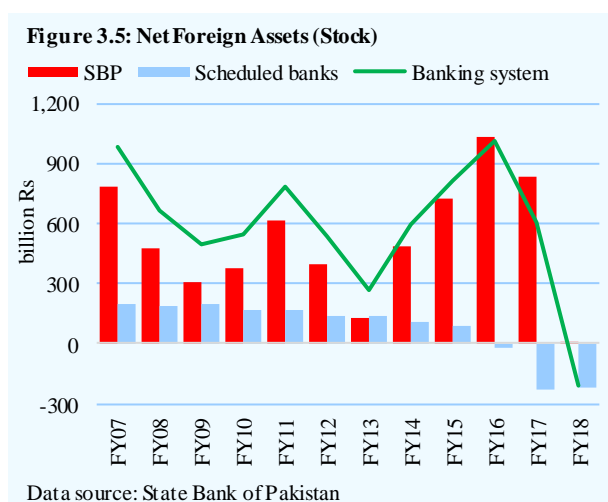


Table 3.5: Government Papers’ Auction Profile (Face value)
billion Rupees

	Target	Maturity*	Total**		Net of maturity			Offered/ Target	Accepted/ Offered
			Offered	Accepted	Target	Offered	Accepted		
Market treasury bills									
FY17	7,200.0	6,430.7	11,350.9	7,733.5	769.3	4,920.2	1,302.9	1.58	0.68
FY18	16,925.0	16,388.0	21,105.2	17,550.6	537.0	4,717.2	1,162.6	1.25	0.83
PIBs - fixed rate									
FY17	800.0	1,427.3	1,757.9	894.0	-627.3	330.6	-533.3	2.20	0.51
FY18	900.0	1,123.4	347.5	101.7	-223.4	-775.9	-1,021.7	0.39	0.29
PIBs - floating rate***									
FY18	100.0	-	296.1	43.1	100.0	296.1	43.1	2.96	0.15

* For PIBs, the maturity column excludes PIB coupon payments.

** Only MTB Offered amount excludes non-competitive bids. For floating rate PIBs, “accepted” column includes non-competitive bids and short selling.

*** Floating rate PIBs were introduced in Q4-FY18, vide DMMD Circular No. 09 of 2018, dated May 7, 2018. Two auctions were duly conducted in May and June 2018 respectively.

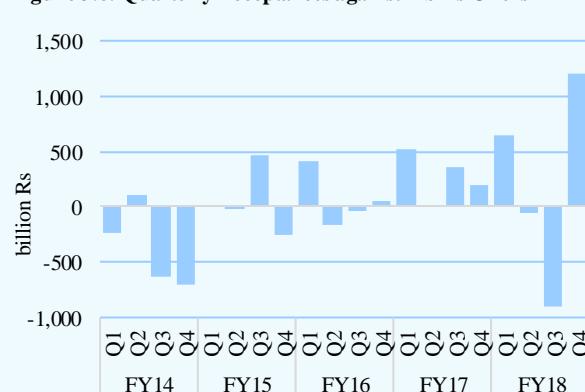
Data source: State Bank of Pakistan

However, the PIB auctions during Q4-FY18 were more eventful, as the government managed to raise Rs 46.1 billion from fixed-rate bonds. Furthermore, Q4-FY18 also marked the launch of 10-year floating rate PIBs, which attracted a considerable degree of interest from market participants. Specifically, in the two floating rate auctions of May and June 2018, offers worth Rs 296.1 billion were received against the combined target of Rs 100 billion. By comparison, the acceptances were low, with the government cumulatively raising Rs 43.1 billion from these securities.

Liquidity Management

The average deviation of weighted average overnight rates from the policy rate fell to 4 bps in FY18, from 6 bps a year earlier. The volume of commercial banks’ borrowing from SBP’s reverse repo facility was also lower as compared to FY17, while the number of occasions on which banks resorted to the SBP window was similar to last year.³ These developments collectively indicated an improvement in liquidity conditions in the interbank and a smoother transmission of monetary policy to the overnight rates.

The average deviation of overnight rates from the policy rate was quite contained throughout the year. As for its direction, the deviation remained positive in 3 out of 4 quarters; it was only the third quarter, when the deviation was a rare negative (3 bps). During this quarter, banks did not roll over a sizable volume of maturing government securities in the rising interest rate scenario (**Figure 3.8**). However, the level of deviation was contained as SBP temporarily unwound its outstanding stock of OMO injections and also conducted calibrated mop-ups.

Figure 3.8: Quarterly Acceptances against T-bills Offers*

* Net of maturity

Data source: State Bank of Pakistan

This dynamic was short-lived though: in the next quarter, T-bill acceptances touched a record high (in both gross and net-of-maturity terms). Specifically, the T-bill auction of 07-Jun-2018 witnessed net-of-maturity acceptance to the tune of nearly Rs 1.2 trillion. Further liquidity pressure in the interbank

³ Commercial banks borrowed Rs 838.9 billion via SBP’s reverse repo facility in FY18, compared to Rs 935.7 billion a year earlier. The banks availed SBP’s reverse repo facility on 37 occasions during FY18, compared to 35 visits during FY17.

emanated from FX interventions, which were particularly pronounced in Q4-FY18. These developments prompted an immediate response from the central bank to keep liquidity pressures at bay (**Figure 3.9**). As a result, the outstanding stock of OMO injections was ultimately hovering around the Rs 1.5 trillion-mark by end-June 2018.

In line with monetary tightening initiated in January 2018, the weighted average lending rates rose during H2-FY18. However, compared to the cumulative 75 bps hike in the policy rate, the rise in retail rates was quite modest (up only 39 bps). This may have come about because banks had ample liquidity at their disposal and were keen to lend to the private sector, given that investment in medium- to long-term government paper was not as lucrative under the circumstances.

Borrowings by Public Entities

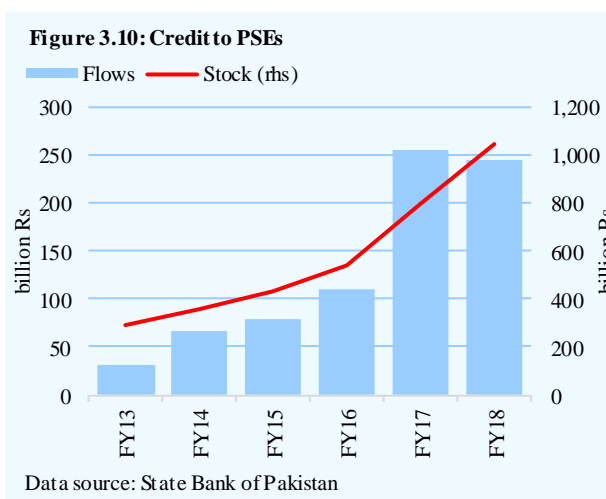
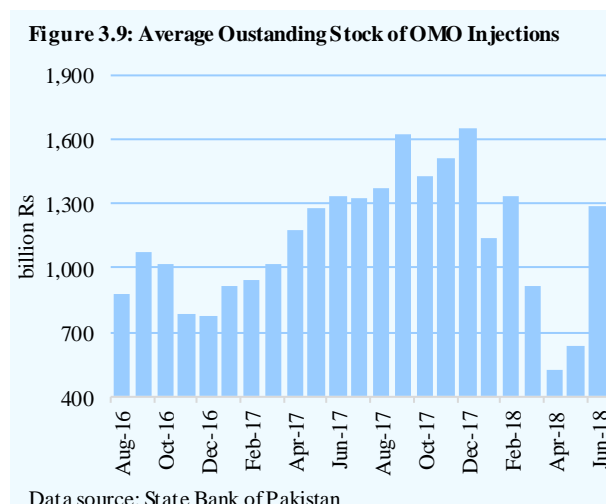
The overall financing under commodity operations grew by Rs 133.2 billion during FY18 compared to only Rs 49.9 billion last year. As far as composition of credit expansion is concerned, majority of the financing went to wheat procurement.

The first three quarters typically represent a season of net retirements, as the period is associated with the consumption cycle of wheat. This year, Rs 58.4 billion worth of net retirements were made during Jul-Mar FY18 as compared to Rs 137.9 billion a year earlier. In the fourth quarter, the overall credit offtake for commodity financing remained slightly higher vis-à-vis Q4-FY17 (**Chapter 2**).

The overall credit offtake by public sector enterprises remained slightly lower during FY18 as compared to a year earlier. During FY18, WAPDA and Power Holding Private Limited (PHPL) turned out to be the largest borrowers and accounted for almost 85 percent of total loans offtake by the segment.⁴ In fact, the bulk (48 percent) of the loans were taken by PHPL to settle circular debt-related payments. It is worth noting that the outstanding loans of PSEs have been growing consistently over the past couple of years, and soared to Rs 1 trillion by end-June 2018 (**Figure 3.10**). Since commercial banks' exposure has already risen significantly to the power sector, energy-related PSEs will have less room to get liquidity support from the banking system going forward.

3.3 Credit to Private Sector

Credit to private sector rose by Rs 775.5 billion in FY18 and surpassed the flow of Rs 747.9 billion for FY17. The overall dynamics of credit market in FY18 were not much different than the previous year. While the vibrancy in economic activities and increased industrial capacities kept the credit



⁴ For further details, refer to SBP's third quarterly report on 'State of Pakistan Economy' for the year 2017-18.

demand strong in general, especially as low financing costs continued to encourage businesses to leverage, supply side also remained favorable as banks continued to look for high yielding assets. What differentiates FY18 from FY17 is the relatively muted impact of input prices. Specifically, higher global commodity prices had a significant role in pushing the credit growth up in FY17, as these inflated the working capital requirements of businesses. However in FY18, the increase in input prices was quite modest and therefore credit growth in major manufacturing sectors was more activity-driven (**Table 3.6**).

Table 3.6: Trend in Major Input Prices

percent change	FY17	FY18
Cotton (domestic*)	23.4	6.8
Cotton (international)	17.2	5.9
Sugar crops (domestic*)	-3.9	-4.7
Coal (international)	50.0	21.7
Palm oil (international)	2.2	-1.5
Iron ore (China)	35.7	-3.1

*Wholesale Price Index

Data source: Pakistan Bureau of Statistics and Bloomberg

As for the supply side, while liquidity conditions remained supportive in general, banks were willing to expand their exposure to the private sector due to subdued credit risk. In particular, banks' non-performing loans as percent of their total loans continued to fall in FY18, as low financial cost and healthy earnings further improved the corporate sector's debt repayment capacity (**Table 3.7**).

Table 3.7: Segment-wise NPLs as Percent of Loans (end-period)

percent	FY15	FY16	FY17	FY18
Corporate	13.4	11.8	9.6	7.9
SMEs	31.6	26.5	20.5	17.8
Agriculture	16.6	15.5	17.9	19.4
Consumer	10.6	9.8	7.3	5.6
Gross NPLs/loans	12.4	11.1	9.3	7.9
Net NPLs/loans	1.6	1.6	1.2	1.1

Data source: State Bank of Pakistan

This improvement in asset quality was broad-based and was shared by nearly all the major sectors. Therefore, banks were more comfortable placing funds in high-yielding private loans than to lock their liquidity in government securities, especially with tenors higher than 3 months.

Increased capacities and activity drove up working capital loans

Private businesses took Rs 471.7 billion working capital loans in FY18, compared to Rs 367.4 billion last year. As usual, manufacturing concerns remained the main beneficiaries. Sectors which drove the higher credit expansion included, textiles, cement, electrical machinery, iron & steel, edible oil & ghee, basic chemicals and rice processors. All these sectors showed buoyancy throughout the year: cement dispatches rose by double digit (13.8 percent) to a historical high of 45.9 million MT in FY18; exports of textiles and rice also rose sharply in FY18.

Power sector was the second biggest user of working capital loans, as it increased its borrowings by Rs 62.1 billion compared to Rs 26.5 billion in FY17. In addition to increased capacity in the sector, three factors mainly explain higher borrowings (i) power generation rose by 12.8 percent in FY18, compared to 5.9 percent last year which increased the fuel needs of the industry; (ii) rise in fuel prices (oil & coal); and (iii) liquidity constraints of few private power producers due to accumulation of circular debt.

Meanwhile, raw material demand of steel manufacturers stimulated borrowing requirements in related businesses.⁵ The case in point was ship breaking industry, which borrowed around Rs 27 billion in FY18, compared to only Rs 0.1 billion last year (**Table 3.8**). Most of this borrowing was used for import financing needs, as the country imported 126 ships for breaking in FY18, compared to 111 ships in FY17 –when the sector retired some of its loans. But in FY18, Pakistan also resumed imports of tanker ships for breaking, as the same category was previously banned due to an explosion and

⁵ Production of steel recorded a double-digit growth of 21.8 percent in FY18, compared to 20.5 percent in the same period last year.

high number of labor casualties during the first half of FY17.

Table 3.8: Loans to Private Sector Businesses

flow in billion rupees

	Total Loans		Working Capital*		Fixed Investment	
	FY17	FY18	FY17	FY18	FY17	FY18
Private Sector Businesses	620.4	699.6	367.4	471.7	253.0	227.9
Manufacturing	384.3	421	251.7	307.2	132.7	113.8
Textiles	82.8	130.1	46.0	90.3	36.7	39.8
Cement	21.4	47.1	10.9	22.4	10.6	24.7
Sugar	82.1	36.5	67.5	25.3	14.6	11.2
Electrical machinery & apparatus	7.7	33.4	4.9	30.4	2.9	3.0
Iron & steel	19.0	30.1	15.9	31.1	3.1	-1.0
Bakery etc.	7.0	28.6	1.5	24.2	5.5	4.4
Edible oil and ghee	7.9	27.5	6.7	21.5	1.2	6.1
Basic chemicals	3.2	19.6	0.8	17.9	2.4	1.7
Rice processing	-0.9	13.4	-1.4	12.6	0.5	0.8
Domestic appliances	4.2	10.1	3.6	5.8	0.6	4.3
Paper	2.1	6.5	5.5	7.1	-3.4	-0.6
Fertilizer	9.8	-43.5	-1.0	-34.0	10.8	-9.4
Electricity, gas and water supply	55.6	87.5	26.0	60.4	29.6	27.1
Prod, trans and dist of electricity	55.0	85.7	26.5	62.1	28.5	23.5
Prod, trans and dist of gas	2.6	1.7	1.4	-1.8	1.1	3.5
Commerce and trade	42.7	68.7	39.4	51.3	3.4	17.4
Real estate & related	18.3	34.9	7.3	18.4	11.0	16.5
Construction	41	27.2	16.7	6.0	24.3	21.2
Ship breaking	0.1	26.8	-0.3	27.4	0.4	-0.7
Transport, storage & commerce	29.2	23.2	1.0	2.8	28.1	20.4
Agriculture	12.4	8.0	11.0	-0.2	1.4	8.2
Mining and quarrying	13.7	2.5	-0.1	-1.7	13.8	4.2

*includes trade financing

Data source: State Bank of Pakistan

Low borrowing appetite in sugar & fertilizer persisted during FY18

Sugar was the major manufacturing sector which borrowed less for working capital during FY18 compared to last year. Sugar production fell by 6.8 percent in FY18, compared to rise of 37.8 percent last year. Meanwhile, fertilizer retired Rs 34.0 billion during FY18, compared to only Rs 1.0 billion net retirement in FY17. Both demand and supply dynamics appeared to be less favorable for the sector during the year. On the one hand, fertilizer offtake fell by 5.0 percent in FY18 compared to rise of 36.4 percent last year, and on the other, the closure of three small plants due to unavailability of cheaper feedstock coupled with temporary disruption of LNG gas to few big firms, affected production. Resultantly, the sector opted to retire its short term borrowings in FY18.

Fixed investment loans continued to increase – albeit at a slower pace

Businesses continued to take long-term positions and borrowed considerably from banks to finance their capital expenditures. Fixed investment loans increased by another Rs 227.9 billion in FY18, as textiles, cement, sugar and power continued to increase/upgrade their capacities. It is important to note that despite a reversal in SBP policy rate, end-user mark-ups for LTFF and EFS were unchanged during the year.⁶ Textiles continued to borrow for its BMR activities at attractive rates on SBP long term refinance schemes such as LTFF, which were offered at 5 percent rate to the sector. In terms of flow, LTFF constituted more than 70 percent of textiles long term borrowing during FY18.

⁶ End-user rate for LTFF was 6 percent (5 percent for textile) while for Export Finance Scheme (EFS) it was 3 percent during FY18.

Cement was the second major manufacturing concern which increasingly borrowed to finance its ongoing capacity expansions in FY18. The sector has planned to increase capacity expansion by a total of 23.4 million MT by FY21. Though regulatory and environmental controls temporarily slowed down the progress on projects for some firms⁷, others were able to add around 3 million MT of capacity in FY18.⁸ The sector borrowed Rs 24.7 billion during FY18, compared to Rs 10.6 billion last year. Likewise, sugar manufacturers have secured long term borrowing for various purposes – BMR, capex on capacity expansion for ethanol, energy plants for self-use, and investment on better technology to reduce cost of production.

Apart from the manufacturing sector, borrowing momentum in the power sector accelerated in the latter part of FY18, when the government imposed ban on new projects in February 2018 and the pace of work on ongoing projects picked up. Resultantly, various entities borrowed to speed up progress on projects based on gas and coal, as well as on renewable sources (wind and solar).

Consumer financing kept on its growing trajectory

Low interest rates continued to positively influence consumer loans, which rose by Rs 86.5 billion in FY18, compared to Rs 70.5 billion last year (**Table 3.9**). This was the sixth consecutive year in a row when consumer financing kept its growing momentum – the current year’s flow was at 12-year high level.

Around a quarter of this increase came from housing finance, as medium-sized conventional banks aggressively took up this business. Like FY17, most of the loans were taken for outright purchases, followed by construction and a small fraction for renovation purposes in FY18. So far, the stock of housing finance has reached Rs 88.2 billion, which is only 0.26 percent of GDP. This ratio is quite low in comparison not just to advanced economies, but also to peer countries

like Bangladesh and India. Importantly, the housing deficit in Pakistan is estimated at 10 million units, which is growing every year not just because of the population bulge, but also due to depleting quality of existing housing stock. SBP has recently prepared and circulated a draft of policy for the promotion of housing finance amongst various stakeholders (**Box 3.2**). This policy aims to achieve the following benchmarks by end-June 2021: (i) increase the outstanding stock of housing finance from existing Rs 88.2 billion to Rs 250 billion; and (ii) increase number of borrowers from existing 62,062 to 200,000.

Table 3.9: Consumer Financing
flow in billion rupees

	FY17	FY18
Total	70.5	86.5
Auto	38.3	43.3
Housing	12.5	22.3
Personal loans	14.2	12.5
Credit cards	4.5	7.4
Consumer durables	0.9	1.1

Data source: State Bank of Pakistan

Box 3.2: Major Initiatives in the Draft Policy for Low-Cost Housing Finance

State Bank of Pakistan has recently formulated a draft of “Policy for Promotion of Low Cost Finance of Housing” and disseminated the same on its website on July 18, 2018 for soliciting public comments. The major highlights of the policy are as follows.

- Definition of low cost housing financing in Pakistan to be adopted as loan amount of up-to Rs 2 million with the property valuing up to Rs 2.5 million. The maximum monthly income of a low cost housing finance borrower should be up to Rs 60,000.

⁷ For details, see **Chapter 3** (Monetary Policy and Inflation) in SBP’s Second Quarterly Report on ‘The State of Pakistan’s Economy’ for the year 2017-18.

⁸ For instance, Attock Cement’s 1.2 million MT per annum plant was commissioned in January 2018. Similarly, Lucky Cement has completed its 1.3 million MT per annum expansion in December 2017. Bestway’s Farooqia Line II having capacity of 6,000 tons per day commenced production in May 2018. Pioneer Cement expanded its cement grinding capacity to 345 tons/hour. Gharibwal Cement’s 250 ton/hour production facility started operation in June 2018.

- SBP to introduce a subsidized financing facility for low cost housing by providing liquidity to the financial institutions at subsidized rate. SBP will provide refinance up to Rs 1 million or 50 percent of loan amount at a rate of 1 percent to banks/DFIs and the end borrower rate will be 5 percent. The remaining 50 percent of the loan / financing amount shall be provided by the banks/DFIs from their own sources at fixed rate of up to 12 percent or variable rate of 1 year KIBOR plus risk premium up to 4 percent. The facility will be provided for both individual house borrowers and housing builders/developers. Similar financing facility will also be provided through the Islamic Financial Institutions.
- Banks to be assigned housing finance targets with instructions to make these targets part of the overall business plan and departmental targets.
- The general reserve requirements against low cost housing finance portfolio of banks/DFIs to be waived.
- Bank/DFI's exposure in low cost housing to be exempted from the exposure limit of 10 percent for real estate sector.
- Microfinance banks to be allowed to increase housing finance amount up to Rs 1 million from Rs 500,000.
- A standardized loan application form is to be issued through PBA to streamline loan processing by banks/DFIs.

Reproduced from: "Draft Policy for Promotion of Low Cost Housing Finance", 2018., pp. i-ii. [sbp.org.pk/smeffd]

However, auto financing was still the dominant segment and accounted for half of the share of increase in consumer portfolio during FY18. This year, car sales hit a record of 216,786 units – reflecting a strong demand for passenger cars, and bank financing played an important role in this.⁹ Factors driving car loans include, low interest rates, introduction of new models by local assemblers in recent years, increasing popularity of small imported cars, growing urbanization and the lack of a reasonable public transportation in most parts of the country.¹⁰ Besides, anecdotal evidence suggests that some consumers are also using their cars for ride-hailing services, as entry and exit to these services are very quick and quite easy.

Within the banking industry, Islamic banking institutions (IBIs) were able to increase their share in auto financing to 46.2 percent by end FY18 from 43.1 percent a year earlier. However, their share remained almost the same in case of housing finance at around 60 percent by end FY18. Besides auto and housing finance, IBIs can design and offer innovative Shariah-compliant products for other consumer segments such as credit cards, personal loans and durables financing – these segments are almost entirely being served by conventional banks at present, with a market share of around 98 percent at end FY18.

3.4 Inflation

Headline CPI inflation stayed below the annual target for the fourth consecutive fiscal year during FY18, and clocked in at its second lowest level since FY03. While non-food inflation increased on the back of higher energy prices and strong domestic demand, a sharp fall in food prices kept the overall inflation low. In terms of dispersion, the majority of sub-indices (59 out of 89 – with about 70 percent share in CPI), showed higher inflation during FY18 compared to FY17.

Food inflation was mainly contained by cigarettes and pulses

Food inflation during FY18 shrank to more than half of its growth from preceding year, due to a sharp fall in cigarette prices (**Table 3.10**). The government changed the FED structure of domestically produced cigarettes by introducing a category with low duty on low price cigarettes, all of which are part of CPI index.¹¹ Excluding this item—that is, had the government not changed the FED structure — the growth in overall CPI index would have been slightly higher during FY18 (4.5 percent), compared to FY17 (4.0 percent).

The second dominant item in dragging the food inflation down was pulses. Due to a decline in local

⁹ Source: Pakistan Automotive Manufacturers Association

¹⁰ Pakistan's economy is typically a market for small cars, as cars up to 1000 cc account for around 52 percent of total sales, (on average during FY16-18).

¹¹ For details, see SBP's First Quarterly Report for FY18 on The State of Pakistan's Economy.

production of pulses, its price had risen during FY16 and part of FY17.¹² However, it has moderated since then due to a record import of the commodity to fill the demand and supply gap. In case of sugar, surplus stocks in the country attributed to record production of sugarcane for the last two consecutive years, as well as a glut-like situation in the global market, continued to depress its domestic prices.

Among other food items, supply factors remained dominant in determination of prices. For instance, chicken prices rose during FY18 due to the imposition of regulatory duty on maize—a key ingredient of poultry feed. Similarly, price of fresh milk drove up as fuel prices increased in the country. Moreover, onion prices too remained elevated through most of the year, due to supply disruptions between August 2017 and March 2018; however, its prices stabilized during Q4-FY18.

Table 3.10: Average CPI Inflation and Contribution

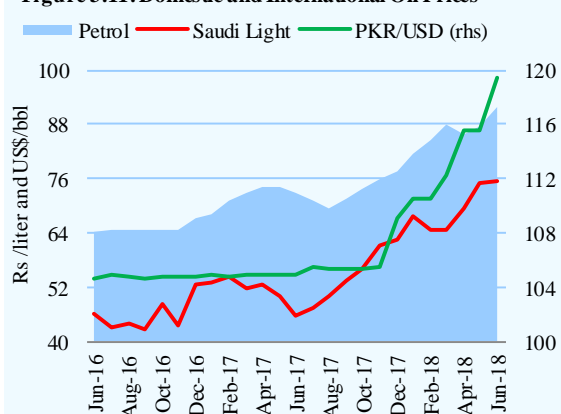
	Wt.	Avg. Inflation		Contribution	
		FY17	FY18	FY17	FY18
General	100	4.2	3.9	4.2	3.9
A. Food	37.5	3.8	1.8	1.6	0.7
Cigarette	1.4	12.1	-17.3	0.3	-0.4
Pulses	1.1	5.6	-16.8	0.1	-0.3
Sugar	1.0	4.3	-16.2	0.0	-0.2
Fresh vegetable	1.7	16.5	-3.9	0.3	-0.1
Meat/chicken	3.8	1.9	8.5	0.1	0.4
Milk fresh	6.7	3.9	3.8	0.3	0.3
Onion	0.5	-33.2	67.6	-0.2	0.3
B. Non-food	62.5	4.4	5.4	2.6	3.2
House rent	21.8	6.5	6.5	1.2	1.2
Education	3.9	10.6	12.4	0.4	0.5
Clothing	7.6	4.1	4.8	0.3	0.4
Health	2.2	10.5	8.1	0.2	0.2
Motor fuel	3.0	-2.1	11.2	0.0	0.2
Construction	0.9	3.7	6.0	0.0	0.1
Core (NFNE)	53.5	5.2	5.8	2.6	3.0

Data source: Pakistan Bureau of Statistics and SBP calculations

Motor fuel prices influenced by international oil prices and exchange rate

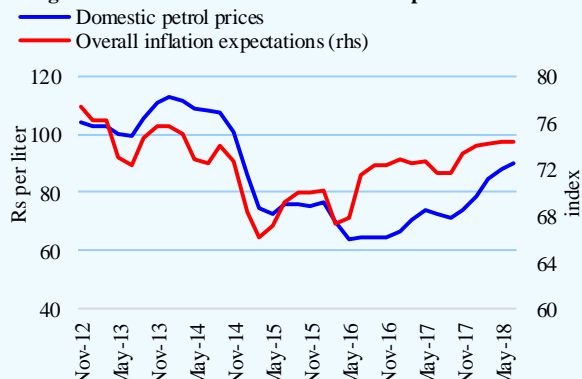
3.1 Motor fuel index that had contributed an average negative 0.3 percentage points during FY15-FY17 to changes in CPI, posted double-digit inflation in FY18. During FY18, prices of petroleum, diesel and LPG showed a double digit growth as international prices soared along with phases of exchange rate depreciations (Figure 3.11). As a result, the government passed on the impact by increasing the petrol prices by a cumulative Rs 24.5 per liter – on 9 separate occasions – during FY18. It must be recalled here that households’ perception of overall future prices are closely associated with retail petrol prices;¹³ this phenomenon is also evident in rising inflation expectation as depicted by IBA-SBP Consumer Confidence Surveys (Figure 3.12).

Figure 3.11: Domestic and International Oil Prices



Data source: Pakistan Bureau of Statistics and Bloomberg

Figure 3.12: Petrol Prices and Inflation Expectations



Data source: IBA-SBP Consumer Confidence Survey and Pakistan Bureau of Statistics

¹² The domestic production has been affected because the yield has been very volatile and low compared to other crops. Farmers have therefore moved on to more profitable crops, such as rice, wheat, maize, cotton and sugarcane (Source: Economic Survey of Pakistan, 2017-18).

¹³ Abbas, H., Beg, S., and Choudhary, M.A. (2015). Inflation Expectations in a Developing Country Setting. Unpublished Manuscript.

Increase in core inflation

The acceleration in non-food non-energy (NFNE) measure of core inflation continued for the second consecutive year in FY18. The declining YoY trend of NFNE had bottomed out in October 2015, after which it remained on an upward trajectory. As compared to FY16, core inflation stabilized at an elevated level during FY17. However, after a slight tapering during the first 8 months of FY18, the index showed a sudden rise during Q4-FY18 on YoY basis (Figure 3.13).

The rise was quite exceptional during April 2018, when the month on month (MoM) growth in NFNE touched 2.4 percent. This increase was far higher compared to other months of the fiscal year, during which the MoM inflation averaged only 0.4 percent (Figure 3.14).

Nearly 75 percent of the commodity groups within NFNE showed MoM inflation of over 1 percent in April 2018, whereas nearly half of the items showed MoM inflation of above 2 percent. The high (YoY) growth during April 2018 was the result of a steep increase in the price indices of clothing, footwear, house rent, furniture, medical tests, transport services, postal services, textbooks, stationery and cosmetic goods.

House rent, health and education contributed persistently

House rent, education, clothing & footwear, health and restaurants are the five indices within CPI, which persisted with their traditional contribution (Figure 3.15). An interesting observation is that the share is broadly unaffected by the overall movement in the index; that is, with headline inflation at 13.7 percent during FY11 and 3.9 percent during FY18, their contribution did not change.

Within education index, prices of 9 out of 16 underlying items had double digit inflation, including fees of both government and private institutions. Similarly, inflation in health index was due to revision in drug prices and doctors' fee, both of which traditionally maintain a consistent uptrend in their price level.

