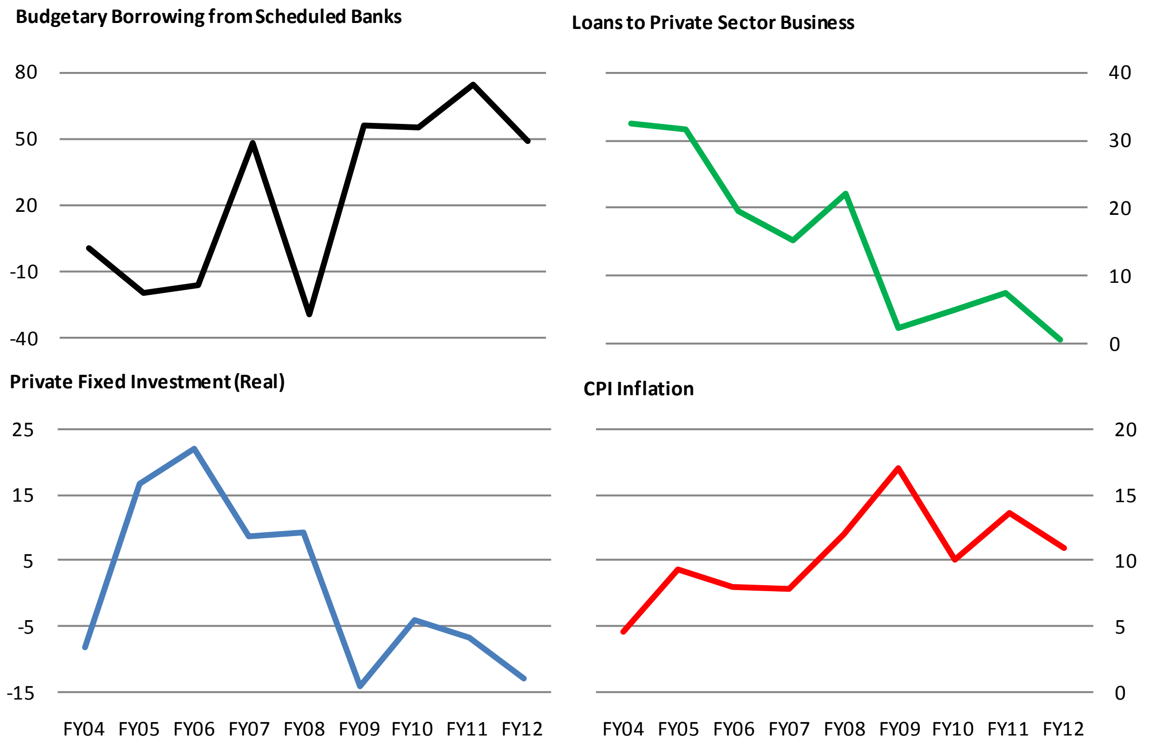
MONETARY POLICY STATEMENT

August 2012



Growth Rates

STATE BANK OF PAKISTAN

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Executive Summary

1. The economy seems to have settled at an unenviable equilibrium of high inflation and low growth. The protracted energy crisis and weak fiscal fundamentals are the main reasons behind this outcome. Similarly, the declining trend in private investment expenditures is continuing while strength of the balance of payment position remains contingent upon foreign financial inflows. The pace of increase in domestic debt is also considerable and uncertain global economic conditions do not inspire much confidence either.

2. In this constrained environment the impact of monetary policy has become limited; whether it is in terms of direct effects of interest rate changes or broad influence on expectations in the economy. Nevertheless, the State Bank of Pakistan will continue to play its required role in nudging the macroeconomic outcomes whenever there is relative ease in some of its core concerns. For instance, there has been some deceleration in inflation, which has improved its outlook. Similalry, the receipt of much delayed Coalition Support Funds has eased, on the margin, the fiscal and external sector constraints.

3. The average CPI inflation for FY12, 11 percent, was well within the target of 12 percent for the year and on the lower side of SBP's earlier projections. The main reason for this moderation in inflation is a collapse in real private investment, indicating a structurally weak economy. However, it continues to persist in double digits for the fifth consecutive year. This persistence is primarily due to entrenched expectations of inflation remaining high. It seems that key drivers for this expectation are continued fiscal borrowings from the SBP despite legal restrictions and feared depreciation of exchange rate even with a modest external current account deficit.

4. More recently, the year-on-year inflation has declined to 9.6 percent in July 2012 from 12.3 percent in May 2012. An unanticipated fall in international oil prices in May and June and a huge reduction of 50 percent in the administered prices of gas in early July 2012 are mainly responsible for this deceleration. The former has already proved to be temporary as the international oil prices have increased since then. The effects of the latter may also only have transitory effects for a few months. Nevertheless, the decline in inflation in July 2012 has created strong market expectations for a downward revision in SBP's policy rate. There has been a

noticeable reduction in yields on the government securities in secondary market and KIBOR.

5. In any case, it would be too early to call it an emerging trend as there are still deep-rooted factors driving inflation. Stickiness in both the core inflation measures points towards the persistence of inflation in low double digits. SBP projects average CPI inflation for FY13 to remain in the range of 10 to 11 percent, which is higher than the announced target of 9.5 percent for FY13. However, much would depend on fiscal restraint on borrowings from SBP, realization of estimated foreign financial inflows, and improvement in energy shortages to increase the utilization of installed capacity.

6. The provisional National Income Accounts estimates show that real GDP growth of 3.7 percent in FY12 was primarily driven by consumption expenditures. Total investment and exports of goods and non-factor services show a significant contraction. The contraction in private investment, for the fourth consecutive year, at 13 percent is particularly of concern. The total investment, as a percentage of GDP, has fallen to 12.5 percent in FY12, which does not bode well for the future productive capacity of the economy.

7. For generating sustainable economic growth in the medium term, it is important to stem further decline in investment. Similarly, given the fragile global economic conditions, an export-led growth also looks less likely to take place. Incorporating these considerations, SBP projects growth in real GDP for FY13 to remain between 3 and 4 percent; well below the target for the year and the country's economic potential. To revive economic growth, the focus must be on an endogenous reform process that focuses on improving infrastructure, productivity, and governance.

8. The utilization of credit by private businesses is one of the important ingredients of investment. However, the net flow of credit to Private Sector Businesses (PSB) was a meager Rs18.3 billion in FY12, which is a drastic decline compared to a net flow of Rs173.2 billion in FY11. Not only the amount disbursed to PSBs was small but the retirements from them were also unusually high. Further, a disaggregated assessment shows that a large part of total credit extended to the private sector was in fact availed by the Non-bank Finance Companies (NBFCs).

9. The main factors that have significantly dampened the demand for credit by private sector businesses are persistent electricity and gas shortages, security conditions, and a challenging political environment. In these circumstances, businesses are avoiding significant commitments in terms of expansion and long term investments. At the same time, scheduled banks continue to prefer government over the private sector. This is despite an improvement in the currency to deposit ratio and a considerable deceleration in growth of Non Performing Loans (NPLs). Given the desired expansion in the private sector credit and the growing need of the public sector to borrow from the banking system, a consistent increase in deposits and improvement in overall financial depth is imperative.

10. The growth in both reserve money and broad money (M2) in FY12 was primarily driven by fiscal borrowings for budgetary support. Of the total expansion of Rs223 billion in reserve money, Rs505 billion was due to direct fiscal borrowings from the SBP. The difference is largely due to a significant contraction of Rs225 billion in the Net Foreign Asset (NFA) of the SBP. Also, the pace of these borrowings increased significantly in H2-FY12, with Rs306 billion borrowed in Q4-FY12 alone. Not surprisingly, the provision of liquidity in the market by the SBP came down considerably in Q4-FY12 as well.

11. These borrowings are despite the commitments announced in the FY12 budget, re-assurances made during the year, and more importantly, explicit requirements of the SBP Act. In particular, the Act states that the fiscal authority not only has to ensure no further accumulation of their debt owed to the SBP but also take steps to retire their borrowings from SBP over the course of next seven years.

12. The fiscal borrowings from the scheduled banks grew by 50 percent in FY12 and contributed 67 percent to the overall increase of 14.1 percent in M2. Apart from crowding out the private sector, these substantial and, at times, unpredictable fiscal borrowings created substantial challenges for monetary management. For instance, short term market interest rates remained volatile and on average on the higher side, imparting inertia to other market interest rates. As a result, the decline in lending rates for the private sector, after a 200 basis point reduction in the policy rate in H1-FY12, has been less than desirable.

13. Given a retirement of Rs198 billion during the first month of FY13, it seems that the fiscal authority is beginning to make efforts to reduce its borrowings from SBP. This was made possible due to considerably higher borrowings from the market

in the two T-bill auctions in July 2012. The injection of liquidity by the SBP has also increased to Rs423 billion by 7th August 2012 as a consequence. However, it should be clear that a prudent approach in consistently implementing the requirements of the SBP Act, without adverse implications for the economy in terms of excessive borrowings from the scheduled banks, would require a consistent decline in the fiscal deficit through comprehensive fiscal reforms.

14. Provisional estimates of the fiscal deficit from the financing side suggest that the fiscal deficit may have reached 6.4 percent of GDP or Rs1328 billion in FY12. This excludes the debt consolidation of power and food sector arrears of 1.9 percent of GDP. This considerable slippage was contributed by shortfalls in tax revenues, non-realization of some non-tax revenues, and overruns in expenditures on account of energy sector circular debt and losses of Public Sector Enterprises (PSEs). The recent receipt of Coalition Support Fund (CSF) will provide some cushion to the FY13 budget. However, concerted efforts to bridge the gap between revenues and expenditures through structural reforms are necessary to bring monetary stability and economic growth on sustainable basis.

15. Unlike fiscal accounts, there were no surprises in the external sector in FY12 relative to SBP's earlier projections. A quantum-led decline of 3.2 percent in export receipts and a price-driven increase of 12.3 percent in import payments pushed the trade deficit to 6.7 percent of GDP or $15.4 billion in FY12. An impressive inflow of $13.2 billion of remittances, however, contributed significantly in limiting the external current account deficit to $4.5 billion or 2 percent of GDP. This is rather small compared to both Pakistan's own history and in comparison with other emerging and developing economies.

16. The net capital and financial flows, required to finance the external current account deficit, on the other hand, remained sparse; $1.5 billion only. More disturbingly, the net private inflows, foreign direct and portfolio investments, have come down to only $590 million in FY12. Consequently, the overall balance of payment position show a deficit, which together with repayment of IMF loans resulted in a decline of $4 billion in SBP's liquid foreign exchange reserves during FY12; from $14.8 billion at end-June 2011 to $10.8 billion at end-June 2012.

17. Given the domestic energy crisis and deteriorating global economic conditions, the trade dedicit for FY13 is not expected to be sigificantly different from the FY12 outcome. However, the recent recepit of $1.12 billion in Coalition Support

Funds and the expected receipt of much delayed auction proceeds of 3G licences could reduce the external current account deficit to $2.5 billion or 1 percent of GDP in FY13. The real focus would need to be on the prospects of financial inflows so that the economy can build foreign exchange reserves to meet the rising debt obligations in the next few years.

18. In conclusion, improvement in key economic indicators would require comprehensive and credible reforms in the energy and fiscal sectors. Adherence to the legal framework(s) of economic policy making – The State Bank of Pakistan Act (1956) and The Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) – is important as well. A drive for economic reform and adherence to laws can go a long way in moving the economy towards a better equilibrium with low and stable inflation and high and sustainable growth.

19. Among all these developments, two factors are particularly important – inflation outlook has improved with a projection of 10.5 percent for FY13 and loans to private sector businesses have sharply decreased. This has led to an increase in real interest rates. In taking the monetary policy decision, the Central Board of Directors of SBP has decided to give a relatively higher weight to the state of private sector credit and investment in the economy, knowing that the projected inflation for FY13 could remain slightly higher than the target. Thus, the policy rate is being lowered by 150 basis points to 10.5 percent with effect from 13th August 2012.

I. Economic Environment during H2-FY12

1. The SBP did not reduce the policy rate further in H2-FY12 after lowering it to 12 percent in H1-FY12. This cautious approach was followed despite expectations of meeting the FY12 inflation target and concerns of declining private investment in the economy. The main reasons were increasing risks to macroeconomic stability due to lack of foreign financial inflows and rising fiscal borrowings from the banking system. Similarly, inflation followed a gradually rising trend, except June 2012, and was expected to remain in early double digits in FY13.

2. The SBP was cognizant of the role of falling private investment in compromising the medium term productive capacity of the economy and thus controlling inflation in future. The 200 basis point reduction in the policy rate during H1-FY12 was, in fact, driven by this consideration. However, in SBP's assessment, continued energy shortage was a major factor behind low demand for private credit for fixed investments. The role of monetary policy was seen as becoming increasingly marginal.

3. Given the varied nature of these challenges, SBP has been trying to strike a difficult balance among concerns such as controlling inflation, ensuring financial stability, preserving foreign exchange reserves, and supporting private investment in the economy. There are bound to be trade-offs involved among these competing considerations. The economy basically needs fundamental reforms, particularly in the fiscal and energy sectors, to engineer a turnaround in economic performance.

4. In the absence of fiscal reforms, the structural gap between revenues and expenditures of the fiscal authority was expected to lead to a higher than expected fiscal deficit. Similarly, realization of planned external budgetary financing was uncertain, which created a disproportionate increase in fiscal borrowings from the banking system including the SBP. Initially, the fiscal authority had been borrowing from the scheduled banks that causing severe liquidity pressures, forcing SBP to inject large amounts of liquidity in the system. In Q4-FY12, the fiscal authority, however, increased their borrowings from the SBP as it ran into difficulties in raising the desired amount from the market at the prevailing interest rates. This unpredictable pattern of fiscal borrowings complicated liquidity management and made it difficult to effectively manage inflation expectations.

5. These large borrowings from SBP were despite the fact that government was required to keep its quarterly borrowings from SBP at zero, under the SBP Act. In SBPs view, the possibility of limiting these borrowings on sustainable basis remains low unless the fiscal deficit is controlled through fiscal reforms, which addresses the structural weaknesses in generating revenues and alignment of expenditures with available resources.

6. The balance of payments position was also not comfortable for macroeconomic stability as the downward pressure on foreign exchange reserves was increasing. Although the external current account deficit was relatively small compared to its historical trends, the capital and financial inflows were inadequate to stem the decline in reserves. Similarly, official inflows such as Coalition Support Fund and proceeds from the auction of 3G licenses did not materialize. External borrowings of the government were also falling short of their planned levels while the prospects of increase in foreign investment remained weak as well.

7. The outlook of the balance of payments was also tainted by the fragile global economic conditions and uncertainties over international oil prices. The euro area crisis continued to hammer the prospects of global economic recovery due to delayed or insufficient policy actions. Moreover, it also increased the financial market stress due to uncertainties over fiscal adjustments and reforms in the affected economies like Greece and Spain and reluctance of other euro zone countries to support them. The growth prospects of the emerging markets were also diffusing due to weak domestic demand and uncertainties over the flow of foreign investments on account of increased risk perceptions. These conditions have further dampened the prospects of tapping resources from the international financial markets for countries like Pakistan.

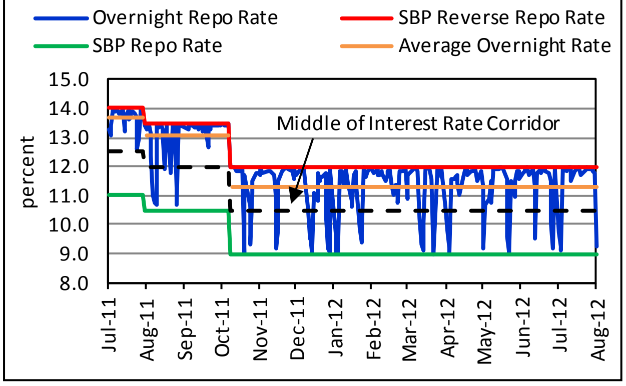
8. While many of the international commodity prices were falling, some of them, such as food and oil prices, had been following uncertain trends. International oil prices had been particularly volatile due to weak prospects of global economic recovery and increasing risks for a decline in global oil supplies on account of sanctions on Iran. Global inflation, in general, had a declining trend. This along with concerns over economic growth prompted some of the developed and developing countries' central banks to decrease their policy rate; however, despite these conditions, many of them had been keeping their policy rates unchanged. Apparently, Pakistan was also facing similar situation; however, the domestic challenges called for a more cautious approach.

II. Recent Economic Developments and Outlook

A. Volatile Short-term Interest Rates: Changing Expectations and Liquidity Flows

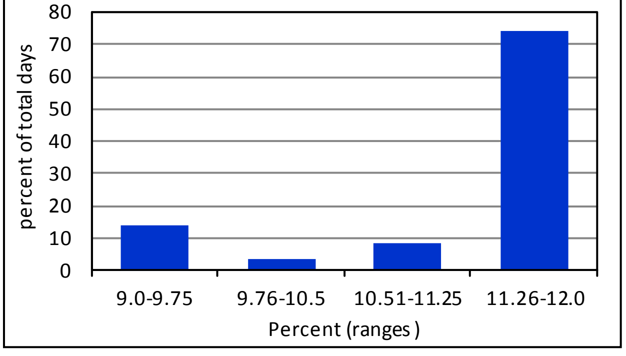
9. Since the decrease in the policy rate by 150 bps in October 2011 the money market overnight repo rate has declined by 174 bps, on average, by 2nd August, 2012. This relatively higher decline, compared to an earlier reduction in the policy rate, has reduced its distance from the middle of the interest rate corridor – SBP's operational target -- which is a movement in the right direction (**Figure 1**).

Figure 1: Movements in SBP's Operational Target



10. However, the average level of money market overnight repo rate is still persisting at a level significantly higher than the middle of the interest rate corridor, 10.5 percent. As shown in **Figure 2**, it has been in the range of 11.26 to 12.0 percent for 75 percent of the time since the decline in policy rate in October 2011. Similarly, its volatility is still high relative to the trends observed in countries that use short term interest rate as the operational target. While the bidding pattern of banks for liquidity in the Open Market Operations (OMOs) explains the persistence of money market repo rate at a higher level, the unpredictable flow of liquidity to and from the market due to fiscal behavior is the main reason for higher volatility.

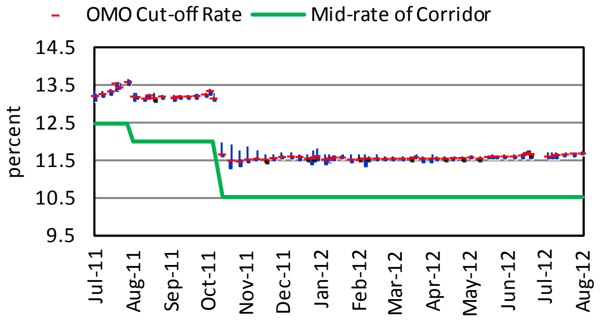
Figure 2: Histogram of Overnight Repo Rate (from 10th October 2011 to 2nd August 2012)



11. Banks typically quote a price higher than the middle of the corridor and close to the prevailing overnight repo rate (**Figure 3**). Such behavior is dictated by their desire to ensure receiving the required liquidity, even if it means paying a higher price in the OMOs. The SBP decides the cut-off rate in the OMOs keeping in view the liquidity requirements of the market. This stickiness in the shortest interest rate in the market at a relatively high level is inhibiting other market interest rates, such as the KIBOR that typically moves in tandem with the overnight repo rate, to decline

further. Bringing money market overnight repo rate close to the middle of the corridor can thus help in bringing other market interest rates down in line with the monetary policy stance.

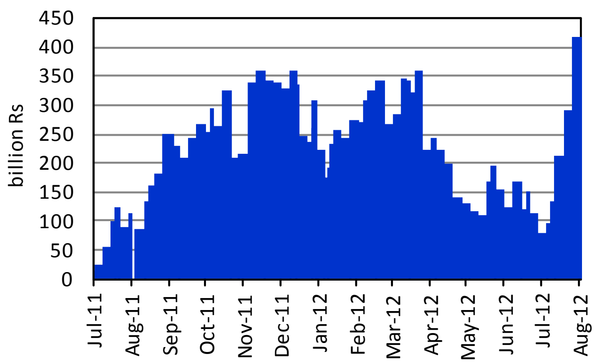
Figure 3: OMO Bid-range and Mid-rate of Corrdior



Note: blue bar in graph shows the gap between low and high bid during OMO auction

12. Once the short term interest rate is determined, provision of liquidity by the SBP is essentially a residual (endogenous) operation conducted to ensure smooth functioning of the payment system and overall financial stability. At times, there is a disconnect between the level of overnight repo rate and amount of liquidity injections by the SBP. For instance, the average money market overnight repo rate was 11.3 percent in Q3-FY12 as well as Q4-FY12. However, the average amount of liquidity injections by the SBP was Rs282 billion in Q3-FY12, with a peak of Rs359 billion in March 2012, and Rs153 billion in Q4-FY12, with a trough of Rs80 billion in June 2012 (**Figure 4**).

Figure 4: Outstanding Open Market Operations (Net Injections)



13. The primary factor influencing market liquidity flows and thus SBP's changing liquidity operations is the unpredictable fiscal borrowing pattern from the SBP and scheduled banks. In Q3-FY12, the fiscal authority raised Rs90 billion (net of maturities) in the fortnightly T-bill auctions (influencing demand for market liquidity) and borrowed Rs82 billion from the SBP (affecting supply of market liquidity) (**Table 1**). In Q4-FY12, however, the fiscal authority was unable to rollover the maturing T-bills in five out of the seven T-bill auctions. As a consequence, it retired Rs81 billion in the T-bill auctions and borrowed Rs306 billion from the SBP to settle its maturing debt with the scheduled banks. This unpredictable borrowing pattern has resulted in excessive volatility in the money market overnight repo rate.

14. A substantial increase in liquidity injections once again by the SBP in Q1-FY13 so far also supports this assessment. The fiscal authority raised Rs204 billion (net of maturities) in the first two T-bill auctions of Q1-FY13, pushing up the demand for liquidity, and retired its borrowings from the SBP by Rs206 billion (cash basis), up till 7th August, 2012 which reduced the supply of liquidity. Consequently, the

outstanding liquidity injection by SBP through OMOs has increased to Rs423 billion by 7th August 2012. Not surprisingly, the volatility of the money market overnight repo rate has remained on the higher side.

15. Thus, unless the government reduces its fiscal deficit substantially and improves its debt management, the market liquidity conditions would remain captive to the fiscal borrowing behavior and conducting a meaningful monetary policy would be difficult. The debt management can be improved by making realistic estimates of external financing, carefully planning and then adhering to domestic borrowing targets through T-bills, PIBs, and Ijara Sukuks, and respecting the SBP Act that requires zero quarterly borrowings from the SBP.

Table 1: Inter-bank Market Liquidity Conditions

billion rupees, unless stated otherwise

	Q3-	Q4-FY12	Q1-FY13[3]
Total deposits[1]	99	386	-248
Currency in circulation	67	16	64
NFA of the banking system	-104	-9	-54
Net budgetary borrowing from SBP	82	306	-188
Private sector credit	7	35	-52
Commodity finance	-29	132	13
T-bill auctions (net of maturities)	90	-81	204
Outstanding OMOs (last week)	223	80	423
Average outstanding OMOs	282	153	255
Average overnight repo rate (%)	11.3	11.3	11.4
Average spread[2] (basis points)	70	71	55

[1] excluding government deposits

[2] spread between policy rate and overnight repo rate

[3] while data for last five indicators is available up to 8th August 2012, the other figures are available up till 27th July 2012 only.

Source: SBP

16. Further, since the scheduled banks know that SBP is the 'liquidity provider of last resort' and that the fiscal authority is a major borrower, they, at times, take an aggressive position while investing in government paper. Specifically, they bid excessive amounts in the auctions of government securities, over and above their actual funding/liquidity position, and then cover this position next day through discounting from the SBP. For instance, on the settlement day of the three T-bills and one PIB auction held in FY13 so far, banks availed on average Rs106 billion. This behavior makes it difficult for SBP to strike an appropriate balance between prudent liquidity operations (including the use of standing facilities) consistent with the objective of anchoring inflation expectations and payment system stability.

17. The other main macroeconomic variable affecting market liquidity is the position of the external sector, which is reflected in changes in the Net Foreign Assets (NFA) of the banking system. The lack of foreign financial inflows coupled with rising trade deficit and debt repayments continued to keep the external position under stress; though the decline in NFA was much lower in Q4-FY12 compared to Q3-FY12. Consequently, the nominal rupee-dollar exchange rate remained under pressure through most of H2-FY12. To counter any excessive volatility in the exchange rate, the SBP did provide calibrated support to the market through foreign

exchange interventions. This contracted the rupee liquidity from the system. Thus, considerations of stability of the foreign exchange market also complicated domestic rupee liquidity management.

18. Forecasting and managing liquidity in H1-FY13 would be challenging since there is considerable uncertainty regarding the behavior of pertinent macroeconomic variables. For instance, the fiscal position is likely to remain weak in FY13 due to structurally low tax revenues and rigid current expenditures. However, the recent thaw in relationships with the USA has resulted in the realization of CSF of $1.12 billion and could lead to more official inflows. Also, the probability of realizing proceeds from the auction of 3G licenses in FY13 is high compared to last year. Taken together, these developments would generate substantial non-tax revenues, easing borrowing requirements and thus pressure on market liquidity to some extent.

19. Further, these official inflows will also have a positive impact on the external current account position, alleviating some of the stress on the balance of payments and thus NFA of the banking system. However, timing of these foreign inflows is difficult to pin down. Moreover, given the expected large size of the fiscal deficit and weak private foreign financial inflows, they might only have a temporary beneficial impact on market liquidity. Thus, SBP expects to remain a net provider of liquidity in the market.

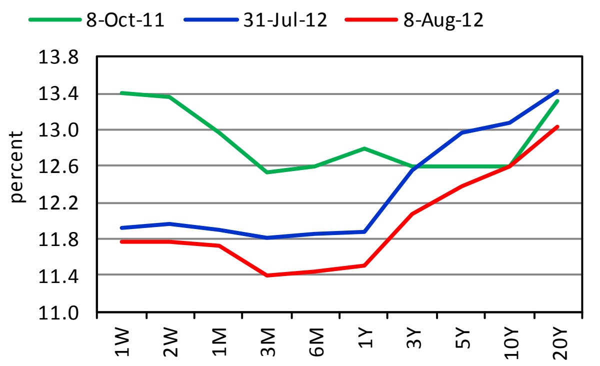
20. The impact of fluctuating market liquidity conditions, in terms of excess volatility, has been limited to overnight repo rate only. Other short term market interest rates have largely remained unchanged until the release of July 2012 inflation figure. For instance, the cut off rates for 3, 6 and 12 month T-bills in the primary auctions increased marginally by 9, 11[1] and 5 bps in H2-FY12 compared to H1-FY12. Similarly, the 6-month KIBOR (benchmark for retail lending to the corporate sector) has closely followed the changes in SBP's policy rate during FY12 without much fluctuation.

21. The long term interest rates, on the other hand, increased as can be seen in the yield curve of 31st July 2012. As a consequence, the spread between 10-year PIB rate and 6-month T-bill rate increased to 121 bps. In SBP's assessment, this increase was more due to a relative increase in supply of long term securities rather than expectations of rising inflation. Nevertheless, the realization of CSF inflows in early

[1] Due to the rejection of 6 month bids during the last auction held in H1-FY12, the difference is calculated from the cut-off rate on 6 month T-bills realized in the first auction of H2-FY12.

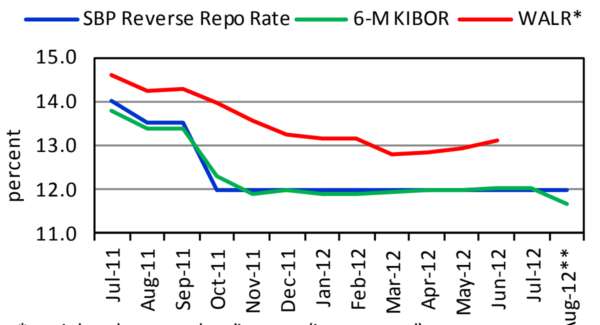
August 2012 and decline in inflation in July 2012 to 9.6 percent has had a positive impact on market expectations. As a result there has been a decline in both short and long term market interest rates which is reflected in the downward shift of the yield curve (**Figure 5**).

Figure 5: PKRV Yield Curves



22. The response of Weighted Average Lending Rate (WALR) is still quite muted despite a considerable reduction in the policy rate introduced during H1-FY12. For instance, it has declined by only 84 bps, to 13.13 percent in June 2012, since October 2011 when a cut of 150 bps in the policy rate was introduced). In fact, WALR has inched up by 30 bps in May and June 2012 (**Figure 6)**. As a result, the spread between WALR and 6-month KIBOR increased to 170bps, indicating room for further decline in lending rates. Given a further decline in KIBOR in August 2012, this spread may have increased further.

Figure 6: Movement in Policy and Market Interest Rates



* weighted average lending rate (incremental)
** data for KIBOR available up till 8thAugust 2012

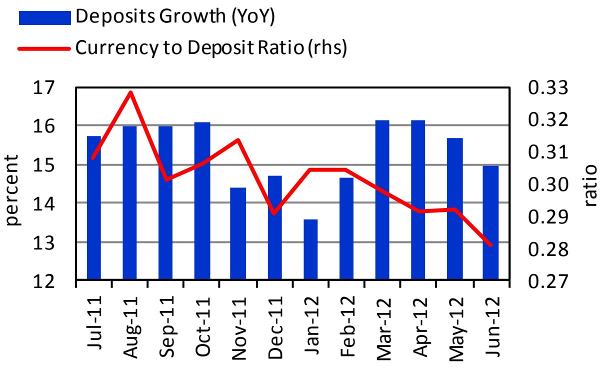
23. On the other hand, Weighted Average Deposit Rate (WADR) has declined by 157 bps, to 6.5 percent, during the same period, leading to a larger negative real WADR. This gradual response in WALR and relatively fuller passthrough to WADR shows that, to protect their profitability, banks are reluctant in passing the decline in the policy rate to the private sector and quick in lowering their funding costs. It is an example of inefficiencies in the banking system that prompted SBP to increase the minimum profit rate on saving products to 6 percent effective 1 May 2012.

B. Monetary Expansion: Deficit Financing a Major Contributor

24. Despite a considerable decline in nominal WADR and persistently negative real WADR, the currency in circulation to total deposit ratio has slightly improved (**Figure 7**). Specifically, it has decreased to 0.28 by end-June 2012, after remaining 0.29 during the last three fiscal years. This improvement was contributed by deceleration in the growth of currency in circulation to 11.5 percent as well as a

reasonable deposit growth of 15 percent. Deceleration in currency in circulation growth is probably explained by substitution of high denomination currency note (Rs5,000) with the high denomination prize bonds (Rs40,000) and relatively moderate food inflation.

Figure 7: Currency to Deposit Ratio



25. A decline in currency to deposit ratio is a positive development as it shows slightly better financial intermediation in the economy. However, when looked in historical perspective, the share of deposits in GDP has been consistently declining for several years, resulting in a fall of broad money (M2) as a percentage of GDP to 37 percent from a peak of 47 percent in FY07. This shows considerable deterioration in overall financial deepening in the economy and points towards a need to improve financial penetration and thus deposit growth.

26. A disaggregated assessment of deposits shows that most of the increase in deposits, mainly in H2-FY12, was due to rise in demand deposits. A relatively higher increase in Resident Foreign Currency Deposits (RFCDs), compared to H2-FY11, and an element of substitution from time to demand deposits can also be observed. Factors like steady inflow of workers' remittances from abroad, relatively higher depreciation of domestic currency, and the usual end-year 'window dressing' largely explain this increase. Within demand deposits, there is a noticeable increase in saving deposits in H2-FY12 compared to the usual increase in current deposits. This increase in saving deposits could be because of an increase of 100 bps, introduced by SBP with effect from 1 May 2012, as the minimum rate of return on saving deposits to 6 percent. However, given the end-year seasonality, it is too early to term it as an emerging trend.

27. Going forward, given the growing need of the public sector to borrow from the banking system and the desired expansion in the private sector credit, a consistent increase in deposits and improvement in overall financial depth is imperative. However, it would be a challenging task given the current structure of deposits and lack of financial literacy among a large segment of the population is not helping the situation either For example, approximately 30 percent of total deposists are current deposits, which represent transactional demand for money and are not

driven by saving considerations These deposits are mostly non-remunerative and do not respond to interest rate changes.

28. Saving deposits, on the other hand, constitute around 40 percent of total deposits and carry a minimum cumpulsory rate of 6 percent, which typically is close to the actual average return as well. Thus, only 30 percent of the remaining deposits can potentially be more sensitive to interest rate changes. Further, it can be argued that significant negative real interest rate on deposits has probably structurally lowered the opportunity cost of current consumption relative to future consumption, resulting into lower national savings.

29. Being cognizant of this challenge that overall deposits cannot be promoted by increasing interest rate alone, SBP has taken various other steps to increase deposits of the banking system. First, to increase financial depth in the economy, SBP has initiated the Financial Inclusion Program (FIP), which aims to provide financial services (such as branchless banking, financial literacy) to an otherwise excluded and marginalized segment of the population, including women and young people. Second, as part of efforts to improve the saving-investment ratio and ensure better return to small depositors, SBP has increased the minimum Profit Rate on saving products to 6.0 percent with effect from 1 May 2012. Third, SBP has been encouraging people to invest in government securities through Investor Portfolio Securities (IPS) accounts. This high yielding avenue of investment is meant to give competition to the banks in raising fresh deposits with better returns.

Table 2: Monetary Aggregates

flow in billion rupees, growth in percent

	FY11	FY12[p]	FY13[1]
NDA: *of which*	683.0	1,200.2	1120.2
Net budgetary support (i+ii)	590.2	1,198.3	
(i) SBP	-8.0	505.3	
(ii) Scheduled banks	598.2	692.9	
Commodity operations	-15.7	38.6	
Private sector credit	121.3	235.2	
Credit to PSEs	36.3	-130.5	
NFA (i+ii)	235.0	-253.6	-118.0
(i) SBP	235.3	-225.4	
(II) Scheduled banks	-0.3	-28.2	
Money supply (M2)	**918.0**	**946.6**	**1002.2**
Reserve money	**286.5**	**223.0**	
Currency in circulation	206.0	172.3	
Total deposits	708.5	775.5	
	Growth (YoY)		
Net budgetary support	29.3	46.1	
SBP	-0.7	42.1	
Scheduled banks	74.5	49.5	
Private sector credit	4.0	7.5	
Money supply (M2)	15.9	14.1	13.1
Reserve money	17.1	11.3	12.7
Currency in circulation	15.9	11.5	
Total deposits	15.8	15.0	

p: Provisional, [1]: Projections

Source: SBP

30. On the asset side of monetary accounts, growth in both the reserve money and broad money (M2) was

overwhelmingly dominated by fiscal borrowings for budgetary support (**Table 2**). Of the total expansion of Rs223 billion in reserve money in FY12, a growth of 11.3 percent, Rs505 billion was due to direct fiscal borrowings from SBP. The difference is largely explained by a significant contraction in the Net Foreign Asset (NFA) of the SBP. The year-on-year growth in fiscal borrowings from SBP was 42 percent, pushing their outstanding stock to Rs1662 billion (on cash basis). The pace of these borrowings increased significantly in H2-FY12, with Rs312 billion borrowed in Q4-FY12 alone. This shows complete fiscal dominance of the balance sheet of SBP and renders any effort by the SBP to bring monetary stability completely futile.

31. These fiscal borrowings from the SBP are despite the commitments announced in the budget for FY12, re-assurances made during the year, and more importantly, explicit requirements of the SBP Act. In particular, the Act states that the fiscal authority not only has to ensure no further accumulation of their debt owed to the SBP (that is, to keep the quarterly flow to zero) but also take steps to retire their borrowings from SBP over the course of next seven years.

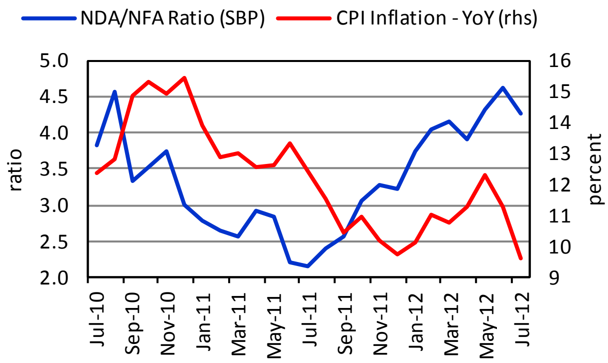
32. Given a retirement of Rs206 billion during 1st July – 7th August, FY13, it seems that the fiscal authority is beginning to make efforts to reduce their borrowings from SBP. However, it should be clear that a prudent approach in consistently implementing the requirements of the SBP Act, without adverse implications for the economy, in terms of excessive borrowings from the scheduled banks, would require a consistent decline in the fiscal deficit through comprehensive fiscal reforms.

33. Similar to reserve money, M2 growth of 14.1 percent was also dominated by fiscal borrowings from the scheduled banks. With a year-on-year growth of 50 percent, these borrowings contributed 67 percent to the overall expansion of money in the economy. However, NFA of the banking system contracted by Rs 254 billion which is a sign of stressed external position. A large trade deficit together with consistently falling foreign financial inflows and rising debt repayments are the main contributing factors in this regard.

34. As a result, NDA to NFA ratio – a summary statistic capturing the fiscal and external sector pressures -- is on the rise again after improving in FY11. For instance, this ratio for SBP's balance sheet (reserve money) more than doubled to 4.6 at end-June 2012 from 2.2 last year. This deterioration indicates expectations of inflation persisting at a high level in the medium term and exchange rate depreciation, with

the latter having a feedback effect as well on inflationary expectation in a high inflation environment (**Figure 8**).

Figure 8: NDA to NFA Ratio and CPI Inflation



35. One of the reasons fiscal authority borrowed heavily from the SBP is that the quarterly targets set to raise funds in the auctions of T-bills were short of its actual requirements. Also, considerable deviations were observed from the announced targets, especially in Q4-FY12 For instance, among the 13 auctions held in H2-FY12, the fiscal authority was unable to meet its target in 7 auctions. In 5 of these auctions the fiscal authority had offers of more than the targeted amounts. This shows that the fiscal authority had the opportunity but it preferred not to meet the target to avoid paying a higher price. Instead, it accessed the SBP to meet its borrowing needs and breached the requirements of the SBP Act to ensurequarterly zero borrowing from SBP. In contrast, in Q1-FY13 so far, the government raised substatially higher amounts in the T-bill and PIB auctions against the targets (**Table 3**).

Table 3: Auction Summary of Government Securities

billion rupees

	Q4-FY12				Q1-FY13		
	Target	Offered	Realized amount		Target	Offered	Realized amount
T-bills							
05-Apr	160	185	152	12-Jul	225	386	308
19-Apr	200	212	165	26-Jul	275	407	365
03-May	180	213	173	09-Aug	300	391	356
17-May	110	179	159	23-Aug	250		
31-May	140	140	118	06-Sep	225		
14-Jun	120	62	69	20-Sep	225		
28-Jun	85	125	100				
	995	**1116**	**935**		**1500**		**1029**
Memorandum items							
	H1-FY12				H2-FY12		
	Target	Offered	Realized amount		Target	Offered	Realized amount
T-bills	1775	2672	1690		1570	2101	1531
PIBs	95	162	103		90	163	118
Ijara Sukuk	50	84	70		100	164	116

Source: SBP

36. On the other hand, in the auctions of PIBs and Ijara Sukuks, it raised substantially higher amounts than the announced targets. While borrowing through long term securities has improved the debt maturity profile and is appreciated, it had costs in terms of a higher price paid by the fiscal authority. In SBP's assessment, the fiscal authority should have been able to raise similar additional amounts at a lower price had they been incorporated in the announced targets. It is understandable that it is difficult to arrive at specific financing needs given the uncertain timing of revenue receipts and expenditures. The fiscal authority can, however, avoid substantial borrowings from SBP by building a buffer through carefully planned raising of funds in auctions of government securities Absence of such planning

creates uncertainty in the market, which makes both monetary and debt management more challenging.

37. Broad money is expected to grow between 13 and 14 percent during FY13. Fiscal deficit financing is likely to remain the major driving force behind monetary expansion in the current year as well. Specifically, out of Rs1120 billion projected increase in Net Domestic Assets (NDA), Rs834 billion is expected to be contributed by government borrowing from banking system. With the heavy government borrowing and structural issues in the economy, private sector credit is likely to remain at the lower level of Rs275 billion. A part of this expansionary impact of NDA on broad money will be offset by projection of continued contraction in Net Foreign Assets (NFA) of the banking system.

38. Substantial government borrowings from the scheduled banks is one of the reasons for muted growth in credit extended to the private sector in FY12. Adverse domestic economic environment such as crippling energy shortages, precarious security conditions and a weak global economy have also significantly dampened the demand for credit by the private sector. The net flow of Private Sector Credit (PSC) in FY12 was Rs235 billion, with a year-on-year growth of 7.5 percent. Moreover, unlike the three previous fiscal years, there was a positive flow of credit in H2-FY12 (**Table 4**).

Table 4: Credit to Private Sector

flows, billion Rs

	H1-FY12	H2-FY12	FY12
Total credit to private sector	193.5	41.9	235.2
1. Loans to private sector businesses	86.0	-67.7	18.3
By type			
Working capital	97.6	-97.7	-0.1
Fixed investment	-12.4	30.9	18.4
By Sectors: *of which*			
Agriculture	8.9	9.1	18.0
Manufacturing: *of which*	53.2	-48.8	4.5
Textiles	30.8	-54.4	-23.7
Food products & beverages	-18.2	33.3	15.1
Electricity, gas and water	29.8	-21.1	8.7
Construction	-3.0	-11.3	-14.2
Commerce and trade	1.6	-5.2	-3.7
Transport, storage & comm.	-6.9	12.0	5.1
Services	-1.8	-2.1	-3.9
2. Personal: *of which*	-8.1	-0.9	-9.0
Consumer financing	-7.3	-5.6	-12.9
3. Investment in securities & shares	11.9	-16.7	-4.8
4. Credit to NBFCs	24.2	96.8	121.0
5. Others	-6.5	98.1	91.4

Source: SBP

39. Although this is the highest net flow of credit to the private sector in a year since FY08, a disaggregated assessment of monthly data presents a completely different and disturbing picture. It shows that a large part of this credit was availed by the Non-bank Finance Companies (NBFCs), Rs121 billion. Credit availed by the Private Sector Businesses (PSBs), on the other hand, was a meager Rs18.3 billion, which is a drastic decline compared to a net flow of Rs173.2 billion in FY11. In fact, not only the amount disbursed to PSBs was small but the retirements from them were also unusually higher. Specifically, PSBs were disbursed Rs205 billion and they

retired Rs187 billion in FY12 compared to a disbursement of Rs268 billion and retirement of Rs95 billion in FY11. If this becomes a trend then the prospects of sustainable medium term economic growth in the economy are very dim.[2]

40. Since most of the NBFCs are channeling their funds to government securities, an understanding of the behavior of credit to PSBs is more relevant to guage the true extent of activity in the private sector. Dissection of the dismal flow of credit to PSBs shows that only Rs98 billion were availed in H1-FY12 which were completely retired in H2-FY12. However, in case of credit for fixed investments, there was a net flow of Rs31 billion in H2-FY12 compared to a decline of Rs12.4 billion in H1-FY12. Further analysis shows that this modest credit uptake was limited to three sector only: agriculture; transport, storage and communications; and food products and beverages.

41. Persistent shortages of electricity and gas are the main reasons for low demand of credit by the PSB. These shortages are adding to the cost of production, making business planning quite difficult, and forcing the productive sectors to operate below capacity. As a result, businesses prefer to avoid significant commitments in terms of expansion and long term fixed investments. Other factors keeping the demand for credit low include: uncertain political environment, high input prices together with exchange rate depreciation, and weak economic conditions in Pakistan’s major export-destination economies.

42. Reasonable overall profitability of the corporate sector also played its part. Sectoral analysis shows that chemicals, cements, energy, and auto industry made good profits while textiles and sugar sectors could not perform well during FY12.[3] The good profitability of firms suppressed their credit demand and induced them to retire outstanding loans while loss making firms failed to tap adequate resources. In FY13, the credit requirement, at least for working capital needs, is likely to increase in the automobile, cement, and power sector due to rising demand. The credit uptake in the textile and fertilizer sector is contingent upon a number of factors including availability of energy, pick up in foreign demand, and improvemnet in overall economic environment.

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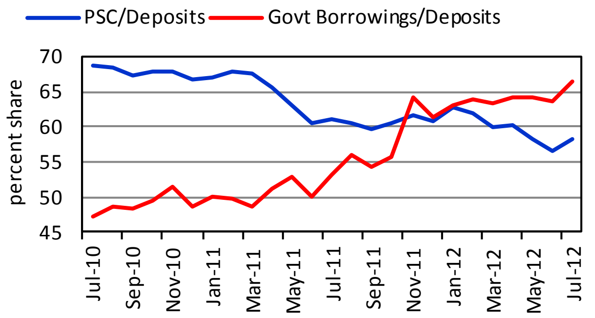
[2] The difference between PSC and PSB has been around Rs30 billion since FY08. However, in FY12, it has increased to a high level of Rs217 billion.

[3] Analysis of financial statement data of 85 listed companies uptill March 2012, which account for 45 percent of the Large Scale Manufacturing (LSM) sector, shows that they posted a year-on-year growth of 16 percent in profits.

Figure 9: Share of PSC and Govt. Borrowing in Total Deposits



Note: sum of the two series may not be equal to 100; the difference is basically a reflection SBP's OMOs

43. Regarding the supply side of credit, additional deposits of Rs776 billion entered the banking system during FY12, showing a 15 percent year-on-year growth. However, the scheduled banks continued to prefer government over the private sector. As a result, the divergence between private sector credit growth and growth in deposits of the banking system continues to persist. Moreover, the share of credit availed by the private sector in total stock of deposits has dropped to 57 percent in June 2012 compared to 67.5 percent in June 2010. Similarly the share of credit to government has increased considerably, especially in FY12 (**Figure 9**). The outstanding stock of government's budgetary borrowings now exceeds the outstanding stock of private sector credit.

44. The government's increasing reliance on scheduled banks has provided banks with an avenue for channeling their loanable funds to risk-free government securities. They continue to adopt a conservative stance towards lending to the private sector although the year-on-year growth in Non Performing Loans (NPLs) has decelerated gradually to 6 percent by end-Q3 FY12 compared to 24 percent at end-Q1-FY12. Moreover, the risk free government securities have given banks an alternative source of investment with embedded advantage on their Capital Adequacy Requirements (CAR).[4] Given these trends, it seems that the government, compared to the private sector, would continue to be the dominant user of banking system funds in FY13.

C. Fiscal Balances: Slippages Remain

45. The consolidated fiscal data for FY12 has not been released yet; nonetheless, provisional estimates from the financing side suggest that the fiscal deficit may have reached 6.4 percent of GDP or Rs 1328 billion. This excludes the debt consolidation of power and food sector arrears of 1.9 percent of GDP (**Table 5**). Thus, the revised fiscal deficit target(s) was breached by a considerable margin.[5] The actual fiscal

[4] Since the risk-weight on government securities is zero, so banks get unlimited advantage on their CAR.

[5] Keeping track of fiscal targets has become increasingly difficult over the last few years. For instance, the fiscal deficit target for FY12 announced with the budget was 4 percent. Later it was revised to 4.7 percent and then again to 5.5 percent of the GDP in the Medium Term Budgetary Statement issued with the budget

deficit during July-March, FY12 had already reached 4.3 percent of GDP. Given the seasonality of fiscal deficit remaining high in the last quarter of a fiscal year, around 2 percent of GDP, the estimated outcome for the year is not surprising.

46. The SBP, in its previous monetary policy statements, has expressed its concerns that the fiscal deficit target is likely to be missed due to structural problems in revenue collection and expenditure outlays. The main underlying reasons for this deficit are low tax to GDP ratio and rigid current expenditures. While exemptions and ineffective taxation of major parts of income generating sectors of the economy are limiting the revenue generation capacity, continued provision of financial support to the loss making public sector enterprises and untargeted subsidies are keeping the current expenditures on the higher side.

Table 5: Summary of Consolidated Fiscal Operations

billion rupees, unless stated otherwise

	FY12^{BE}	Jul-Mar FY12^{P}	FY12^{P}	FY13^{BE}
Total revenue: *of which*	**2870**	**1739**		**3381**
FBR tax revenue	1952	1273		2381
SBP profit	200	154	204	200
CSF money	110	0	0	
Total expenditures	**3721**	**2634**		**4486**
Current: *of which*	3054	2154		3430
Subsidies[1]	180			209
Interest[1]	791	624		926
Development	658	428		1041
Fiscal Balance	**-852**	**-895**		**-1105**
Financing	**852**	**895**	**1328**	**-1105**
External	135	**47**	**80**	135
Domestic	717	847	1248	971
Non- Bank	413	404	535	487
Bank	305	444	712	484
SBP	0	195	508	0
Scheduled banks	305	249	204	484
Memorandum items (as percent of GDP)				
Fiscal balance	-4.0	-4.3	-6.4	-4.7
Impact of PSEs debt settlement		-1.9	-1.9	
Primary balance[2]	-0.3	-1.3		
Revenue balance[3]	-0.9	-2.0		-0.3

P: Provisional; BE: Budget estimates

[1] shows subsidies by federal government only

[2] total revenues minus total expenditures (excluding interest payments)

[3] total revenues minus current expenditures

Source: Ministry of Finance and SBP

47. The provisional estimates of the fiscal deficit for FY12 also show that the shortfall in external financing, compared to the budget estimates, was only Rs55 billion. Thus, the excessive borrowing from the domestic sources compared to budget estimates, in particular from the banking system, of Rs407 billion, was essentially financing the wide gap between revenues and expenditures. This slippage is due to both shortfall in revenues and additional expenditures.

48. For instance, the total tax collection by the Federal Board of Revenue (FBR) during Jul-May 2012 was Rs1608 billion, which is a commendable 22.8 percent, increase over the same period of last year. To meet the targeted amount of Rs 1952 billion, the FBR was required to collect Rs344 billion or approximately 18 percent of

announcement of FY13 . The actual outcome is still higher. Complicating the analysis further, there is an issue of excluding/including one-off debt consolidation figures.

the targeted amount in June 2012. However, average tax collection in the last month of previous five years, excluding FY11 when one-off tax measures were implemented, is 14.6 percent of the total collection. Further, the average year-on-year growth for the month of June is approximately 16 percent, which is substantially lower than the required growth of 38 percent. This suggests that, the FBR has, in all likelihood, missed its target for FY12.

49. Similarly, non-realization of budgeted amount of Rs110 billion from the Coalition Support Fund (CSF) and Rs75 billion from the auction proceeds of 3G licenses significantly contributed to the shortfall in total revenues. It is understandable to plan expenditures on prospective tax and non-tax receipts. However, the fiscal authority should be sufficiently flexible to have contingency plans to adjust expenditures and/or increase revenues in case the likelihood of not meeting the revenue targets is quite high. The burden of adjustment, in Pakistan's case, typically falls on increased domestic borrowings, which creates numerous risks for macroeconomic stability.

50. It is also worth highlighting that a significant part of non-tax revenues, Rs204 billion, was due to an elevated stock of direct fiscal borrowings from the SBP. The ability to borrow any amount at any time from the SBP creates complacency on part of the fiscal authority. Rather than controlling expenditures or stepping up efforts to increase revenues, it finances the fiscal deficit through easily available borrowings from SBP. Specifically, higher borrowings from SBP results in higher SBP profits, which are then transferred back to the government in the shape of non-tax revenues. This creates an impression that total revenues are high enough to meet fiscal expenditures. However, it must be remembered that such revenues are not generated through any productive activity taking place in the economy, thus obscuring deeper structural weaknesses in fiscal accounts and stalling the reform agenda.

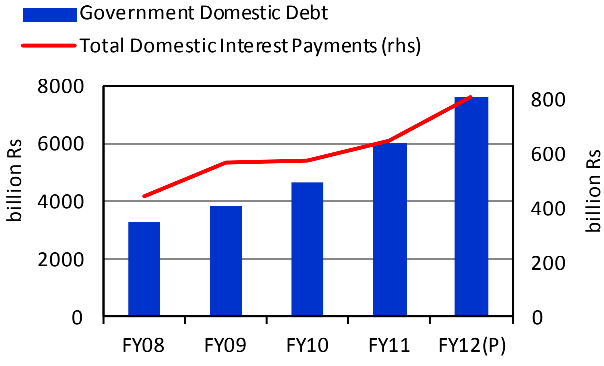
51. Although details on the expenditure side are not available, two main factors explain the likely slippage. First, an overrun in the estimates of interest payments due to continued short term borrowings from the banking system. Second, additional subsidy payments compared to the budget estimates of Rs180 billion. Moreover, due to lack of coordination between provinces and the federal government, the combined fiscal balance of provinces did not manage to post the budgeted surplus of Rs125 billion, contributing towards the high consolidated fiscal deficit.

52. The fiscal deficit for FY13 is targeted at 4.7 percent of GDP, including an assumed Rs80 billion consolidated surplus of provinces. Given a small tax base and rigid current expenditures together with continued delay in introducing comprehensive fiscal reforms, the probability of meeting this target is quite low. For instance, the FBR's target revenue collection of Rs2381 billion assumes a tax buoyancy of 1.7 in FY12, which is rather high when looked in an historical context.[6] Also, compared to the estimated FBR tax to GDP ratio of 9.2 percent for FY12, the targeted FBR tax to GDP ratio is 10.1 percent for FY13. In the current economic environment, a 0.9 percent increase in the FBR tax to GDP ratio in one year is quite ambitious.

53. Further, given persistent borrowings from the banking system through short term government securities, the assumed interest payments of Rs926 billion in the FY13 budget seems underestimated. Similarly, upside risks remain on account of slippages in subsidies with respect to issues related to the energy sector circular debt and PSE losses since these have not been fully resolved yet. Finally, the primary balance has been in a deficit of 1.9 percent on average for the past five years. This indicates entrenchment of structural issues that are making it difficult to bring the overall fiscal deficit below 6 percent of GDP.

54. The impact of persistently high fiscal deficits can also be seen in the rising total public debt of the economy, which has reached Rs12.9 trillion by June 2012. The external debt has increased in FY12 primarily due to exchange rate depreciation; however, it is the growth in domestic debt that accelerated at an unprecedented rate.[7] It has grown at an average rate of 26 percent annually since FY09 and is expected to maintain this trend in the absence of fiscal reforms. Consequently, the share of domestic debt in total public debt has increased from 49 percent in FY09 to 59 percent by June 2012. Within domestic debt, floating debt to GDP ratio has increased to its historically highest

Figure 10: Domestic Debt and Interest Payments



[6] Tax Buoyancy is calculated by dividing FBR tax growth rate by the nominal GDP growth rate. It shows the growth in tax revenues induced by an overall increase in GDP. The average tax buoyancy for the last three fiscal years was 0.8, indicating that a of 1 percent increase in GDP will increase taxes by only 0.8 percent.

[7] External debt in US dollars has decreased due to repayments to the IMF and other multilateral lenders.

levels of 20.1 percent. The accompanying high interest payments are an outcome rather than a cause of current fiscal predicament and essentially manifests a price the fiscal authority is willing to pay to finance its persistent primary deficit (**Figure 10**).

55. The government's fiscal lassitude comes at an immense cost to the economy in terms of risks to macroeconomic and financial stability. The intransigent high fiscal deficit beckons high inflation expectations and a swelling public debt in the coming years. Unless concerted efforts to bridge the gap between revenues and expenses by structural reforms are carried out, SBP's efforts to bring monetary stability in would remain largely ineffective. In this context, it is pertinent to highlight the key requirements of the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005). These stipulate that the fiscal authority should maintain a revenue surplus from FY09 onwards and keep the total public debt below 60 percent of GDP by the end of FY13. The former requirement has not been adhered to in the last four years and the latter is unlikely to be met given recent trends.

D. External Sector: Some Respite in External Current Account

56. The actual outcome of different components of the balance of payments is not much different from SBP's earlier projections for FY12 reported in the February 2012 Monetary Policy Statement. As expected, the external current account balance shows a deficit of $4.5 billion or 2 percent of GDP compared to a surplus of $0.2 billion in FY11. Similarly, net capital and financial flows, required to finance the increasing current account deficit, remained sparse; $1.5 billion only. Consequently, the overall balance of payment position shows a deficit, which together with repayment of IMF loans resulted in a decline of $4 billion in SBP's liquid foreign exchange reserves during FY12 (**Table 6**).

Table 6: Balance of Payment Summary
billion US$

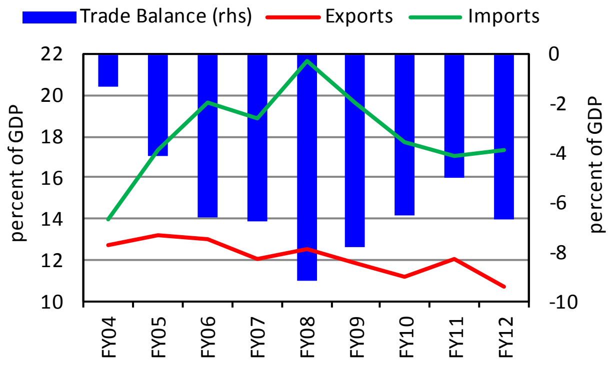
	FY11	FY12	FY13[1]
I. Current account balance	**0.2**	**-4.5**	**-2.5**
Trade balance	-10.5	-15.4	
Exports	25.4	24.7	
Imports	35.9	40.0	
Services balance	-1.9	-3.0	
Income balance	-3.0	-3.4	
Current transfers balance	15.7	17.3	
Remittances	11.2	13.2	
II. Capital and Financial Account	**2.3**	**1.5**	
of which:			
Direct investment	1.6	0.8	
Portfolio investment	0.3	-0.2	
Other official inv. Lib.	0.3	0.9	
III. Errors and omissions	**0.0**	**-0.3**	
Overall balance (I + II + III)	**2.5**	**-3.3**	
Memorandum items:			
Current account as % of GDP	0.1	-2.0	-1.0
Net SBP forex reserves[2]	14.8	10.8	
Exports growth	28.9	-2.8	2.0
Imports growth	14.9	11.6	4.5

[1] SBP Projections based on 3rd August 2012 figures.
[2] Excluding CRR and foreign currency cash holdings
Source: SBP

57. An external current account deficit of 2.0 percent of GDP is rarther small compared to both Pakistan's own history and in comparision with other emerging and developing economies. This is primarily because of an impressive growth of 18 percent in workers remmittances or $13.2 billion in FY12. The trade deficit, $15.4 billion or 6.7 percent of GDP, on the other hand, is on a higher side. Also, the anticipated one-off receipts from the Coalition Support Fund (CSF) and proceeds from the auction of 3G licenses, around $1.6 billion taken together, did not materialize in FY12.

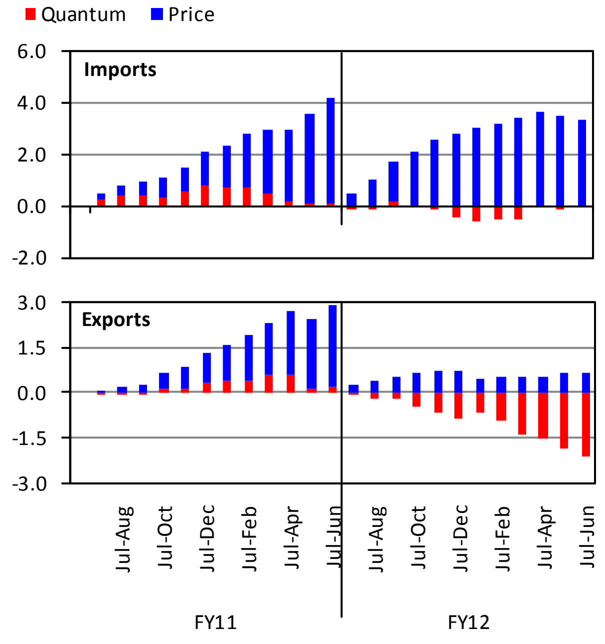
58. It seems that the trade deficit, as a percentage of GDP, has settled in the range of 6.5 to 7.0 percent, both due to gradually declining export to GDP ratio and a high import to GDP ratio (**Figure 11**). The movement in import to GDP ratio, which responds mostly to changes in international commodity prices, especially oil, seem to be driving changes in the trade deficit. The last fiscal year was no exception to this pattern. For instance, export receipts declined by 2.8 percent while import payments grew by 11.6 percent during FY12.

Figure 11: Trade Balance



59. Separating the impact of prices and quantum on the value of exports reveals that the decline in exports was primarily driven by falling quantum of exports (**Figure 12**). The windfall gains to export receipts due to abnormally high cotton prices in FY11 almost entirely disappeared in FY12. In addition to limited diversification of exportable products and markets, severe and continued energy sector bottlenecks continued to hamper production in the export sector and thus the prospects of improving the export to GDP ratio. Unfavorable global

Figure 12: Composition of Changes in Exports and Imports



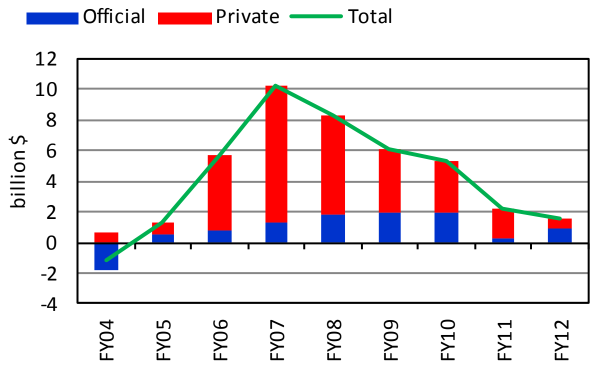
economic conditions, especially in Pakistan's export-destination economies, are only adding to the challenge. In these circumstances and barring any unforeseen development, the export growth for FY13 is projected to be very little; between 1 to 3 percent.

60. Unlike exports, a similar analysis of separating the impact of prices and quantum on the import value reveals that almost all the increase in import payments was due to prices. The negligible contribution of quantum of imports is an indication of depressed domestic economy. Assuming a continuation of this trend, the import growth for FY13 is projected to remain in the range of 3.5 to 5.5 percent. However, there is a lot of uncertainty surrounding these estimates. For instance, volatile political conditions in the Middle East, a stalemate in US-Iran relationships, and weak global economic prospects, are making it quite difficult to project the average oil price for FY13. Since oil payments comprises approximately one-third of total import payments of Pakistan, changes in the assumption of oil prices, currently assumed to be $100 per barrel for FY13, can lead to significant changes in projected import payments

61. The overall external current account balance is expected to get some respite in FY13 due to CSF inflow of $1.12 billion in August 2012. Similarly there is an increased likelihood of receiving $850 million from auction proceeds of 3G licenses in FY13. Incorporating all these factors, the external current account deficit for FY13 is projected to be approximately $2.5 billion or 1.0 percent of GDP. However, the strength of overall balance of payment position would be contingent upon improving the surplus in the capital and financial account.

62. During FY12, the net capital and financial flows of $1.5 billion were not sufficient to finance the external current account deficit of $4.5 billion and avoid depletion in SBP's foreign exchange reserves. More disturbingly, the net private investment inflows continued to show a declining trend for the fifth consecutive year (**Figure 13**). Specifically, the flow of foreign private

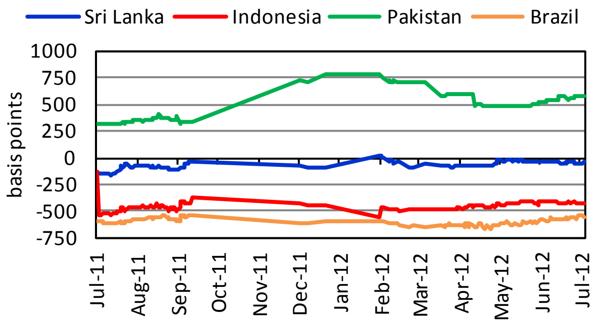
Figure 13: Net Capital and Financial Inflows



investment has declined to $0.7 billion from a peak of $8.4 billion in FY07. The net official inflows of around $900 million, although higher than FY11, were not sufficient to compensate for the declining private inflows.

63. The aversion of foreign private investors towards Pakistan is a reflection of high perceived country risk due to fragile law and order, weak economic, and unstable political conditions in the economy. This aversion can also be seen in higher spreads in international market of Pakistan's bonds compared to other emerging economies (**Figure 14**). The recent downgrade of Pakistan's sovereign bonds by Moody's rating agency to caa1 (along with negative outlook) has made it even more difficult to attract private investors and approach international markets for new issuances of sovereign bonds. However, Standard and Poor's has kept Pakistan's rating unchanged at B-- along with stable outlook.

Figure 14: Sovereign Spread Comparison



Note: spreads are calculted by taking difference of 10-Yr respective bond yields from EMBI yield

64. The impact of declining financial flows and high risk premium together with repayments of IMF loans of $1.1 billion lead to a decline of $4 billion in SBP's liquid foreign exchange reserves during FY12; from $14.8 billion at end-June 2011 to $10.8 billion at end-June 2012. This effect of this continuous drawdown on foreign exchange reserves, on average $1 billion per quarter, on account of a vulnerable balance of payment position also trickled to pressure on the nominal exchange rate. The rupee-dollar exchange rate depreciated by 9.1 percent in FY12 and as on 3rd August 2012 is Rs 94.49 for every one USA dollar**.** Given the scheduled repayments of IMF's loans, amounting to $2.9 billion in FY13, and muted prospects of financial inflows and despite a relatively modest external current account, the management of foreign exchange market would remain challenging.

E. Growth: Investment Decline Continues

65. The provisional National Income Accounts estimates show that real GDP grew by 3.7 percent in FY12, which is higher than last year's revised figure of 3 percent but significantly lower than the target of 4.2 percent for FY12 (**Table 7**). The disaggregated supply side data reveals that this growth largely came from better performance of major crops, improved construction activity, and substantial increase

in the value addition by finance and insurance sector. The growth in agriculture sector in fact surpassed its target despite heavy rains earlier in the year, while severe energy shortages challenging security conditions, and overall low business confidence continued to affect the industrial production, especially the Large-scale Manufacturing (LSM).[8]

Table 7: Supply side of the Economy

percent growth

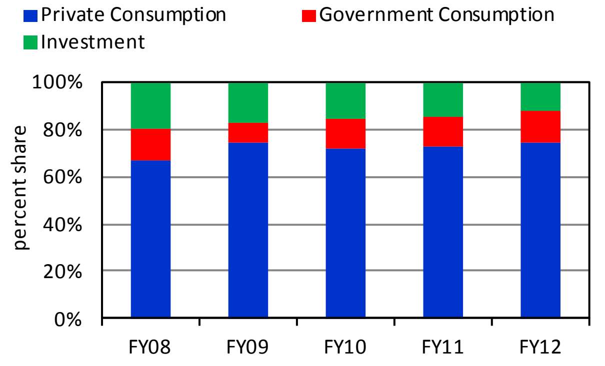
	FY11	FY12^T	FY12^P	FY13^1
Agriculture	2.4	2.2	3.1	
Industry	0.7	4.4	3.4	
LSM	1.1	2	1.3	
Services	4.4	5.0	4.0	
GDP (fc)	3.0	4.2	3.7	3.0 – 4.0

T: Target; P: Provisional; 1 : projections

Source: PBS

66. The data on real GDP measured from the expenditure side reveals that the growth continues to be driven by strong growth in consumption expenditures. The total consumption expenditures, including both private and government, grew by 11.1 percent in FY12 compared to 3.9 percent in FY11 (**Figure 15**). As a result, the share of consumption in real GDP has increased to 88.3 percent in FY12 from 83 percent last year. Moreover, most of this increase in overall consumption was contributed by a sharp increase in private consumption. Increase in rural income on account of better crop prices and steady growth in remittances from abroad for the last few years are the main factors providing momentum to growth in private consumption.

Figure 15: Components of Domestic Demand (% share)



67. The jump in consumption expenditures also indicates that the economy is consuming more now at the expense of future investment. The gross total investment has recorded a decline for the fourth consecutive year in FY12, contracting by 8.6 percent in FY12 compared to a decline of 4.7 percent in FY11 (**Table 8**). The contraction in private investment is even more pronounced at 13 percent in FY12. Consequently, total investment, as a percent of GDP, has fallen to 12.5 percent in FY12. This is an extremely worrisome trend as it essentially means decline in the future productive capacity of the economy. Without stemming the freefall of investment, it would be next to impossible to generate decent and

[8] Estimates given in Economic Survey 2011-12 (pp 195) shows a per year loss of 2 percentage points in real GDP growth (roughly Rs380 billion) due to energy shortage alone.

sustainable real GDP growth in the medium term and contain inflation on more permanent basis.

68. Increase in the share of consumption in GDP also means low domestic savings in the economy. In particular, perpetual fiscal deficits due to structurally low tax to GDP ratio and rigid current expenditures continue to drag down domestic savings. Also, weak economy with fewer employment opportunities, low income levels and high inflation, and limited avenues for savings has kept private savings low as well. Adjusting for net factor income from abroad, the national savings have declined to 10.7 percent of GDP in FY12 from 13.2 percent in FY11 (**Figure 16)**. Thus, despite falling and very low level of investment in the economy, the saving-investment gap, as a percentage of GDP, has remained negative.

Table 8: Components of Aggregate Demand

growth rates

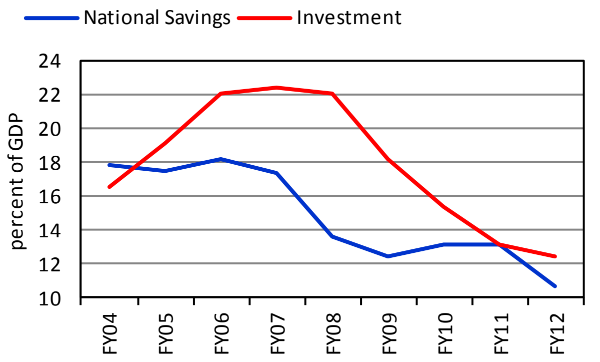
	FY11	FY12[P]
Total consumption	3.9	11.1
Private consumption	3.7	11.6
General government consumption	5.2	8.2
Total investment	-4.7	-8.6
Gross domestic fixed capital formation	-5.6	-10.2
Private sector	-6.7	-13.0
Public sector (incl. gen. govt.)	-1.8	-1.6
Changes in stocks	3.0	4.2
Total domestic demand	2.6	8.2
Exports of goods and non-factor services	2.4	-13.4
Imports of goods and non-factor services	-0.1	10.0
Gross domestic product (MP)	3.0	4.2
Gross domestic product (fc)	3.0	3.7

P: Provisional

Source: Economic Survey 2011-12

69. With an impaired future productive capacity, it seems difficult to revive the economic growth prospects in the medium term based on investment. Even if agriculture sector performs as per historical trends in FY13, revival in industrial performance is not likely since the problem of energy has not been resolved yet. Given that some of the major crops have already shown bumper output last year, it might be difficult for agriculture sector to repeat last year's performance. Incorporating these considerations, growth in real GDP for FY13 is projected to remain between 3 and 4 percent; well below the target for the year and country's economic potential.

Figure 16: Saving - Investment Gap



F. Inflation: Fifth Consecutive Year in Double-digit

Table 9: Average Inflation			
	FY11	**FY12**	**FY13[1]**
CPI Headline	13.7	11.0	10.0-11.0
Food group	18.0	11.0	
Non-food group	10.7	11.0	
Core Measures			
Non-food non-energy	9.4	10.6	
20% Trimmed	12.7	11.5	

[1] Projections

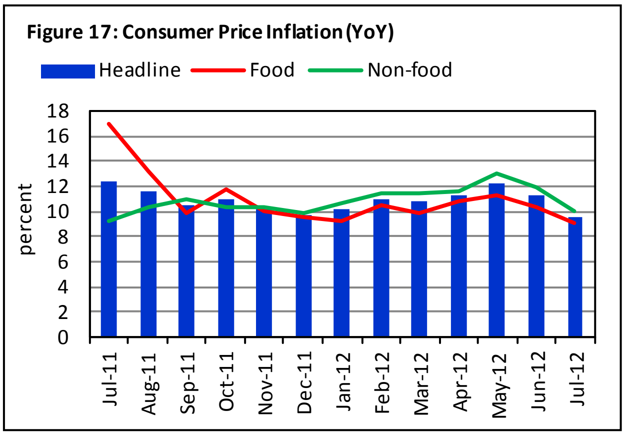
Source: PBS and SBP

70. A significant collapse in real private investment in the economy is the main reason that CPI inflation has moderated somewhat in FY12. The contribution of substantial fiscal borrowings from the banking system, particularly from SBP, is more visible in inflation persistence than its level. Despite a gradual increase in inflation in H2-FY12, the average inflation for FY12, at 11.0 percent, remained below the target of 12.0 percent set for the year and in line with SBP's earlier projections. In terms of its components, this deceleration was mainly due to a sharp decline in food inflation, especially in H1-FY12, as non-food inflation witnessed an uptick in FY12, mostly in H2-FY12 (**Table 9**).

71. However, inflation continues to persist in double digits for the fifth consecutive year in FY12. In broad terms, a combination of strong growth in total consumption expenditures, both public and private, and falling investment explains the stickiness of inflation in early double digits. Other important factor is the entrenchment of expectation that inflation will continue to persist at this level. Key driver for this expectation is the lack of credibility, in public view, of government policies to maintain the purchasing power of domestic currency. A reflection of this can be seen in continued fiscal borrowings from the SBP despite legal restrictions and feared depreciation of exchange rate even with a modest current account deficit. Moreover, structural issues such as disruptive energy sector problems, precarious security conditions, and an uncertain political environment together with high international oil prices are inhibiting the effective utilization of installed productive capacity and thus constraining economy's ability to meet the prevailing domestic demand.

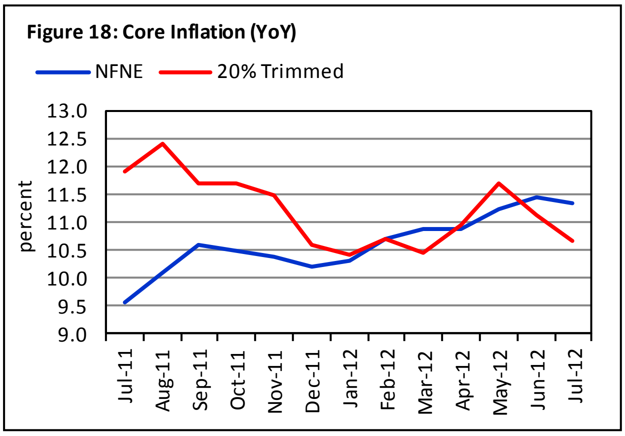
72. The year-on-year CPI inflation, after declining to 9.7 percent in December 2011, mostly maintained an upward trend in H2-FY12 and reached 12.3 percent in May 2012. An unanticipated fall in international oil prices, which was passed-on to the domestic economy, resulted in a decline in inflation in June 2012 to 11.3 percent. However, the effect of oil prices decline on CPI inflation would be transitory given the uncertainty attached to movements in international oil prices. In fact, there has already been an uptick in international oil prices in July 2012, which again has been transferred to the domestic economy. Its effect on inflation will become visible in the

August 2012 inflation figures. Similarly, a huge reduction of 50 percent in the administered prices of gas in early July 2012 has resulted in a further decline in inflation to 9.6 percent in July 2012 (**Figure 17**).

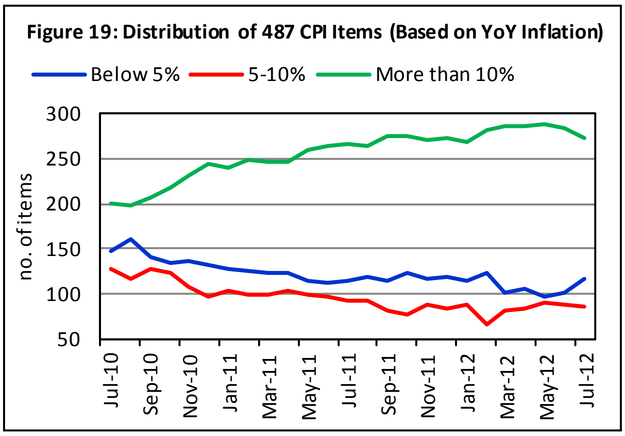


73. Therefore, while year-on-year CPI inflation has declined in the past two months, it is too early to term it as an emerging trend. For instance, the month-on-month growth in July 2012 in the food group and House Rent Index, which have a combined weight of 58 percent in the CPI basket, was still over 1.5 percent. Similarly, the month-on-month inflation in non energy items was also 1.4 percent in July 2012. Thus, there are still deep-rooted factors driving overall CPI inflation.

74. A sustained increase in the Non-food Non-energy (NFNE) measure of core inflation, to 11.3 percent in July 2012 from 9.9 percent in June 2011 also indicates towards the persistence of inflation in early double digits. Similarly, average 20% trimmed measure of core inflation, which excludes items with high volatility, was 11.5 percent during FY12 (**Figure 18**). The persistence of inflation in early double-digits can also be seen in a high and increasing number of CPI items showing more than 10 percent inflation (**Figure 19**).



75. Finally, acknowledging the more recent decline in year-on-year inflation and remaining cognizant of its persistence, SBP projects average CPI inflation for FY13 to remain in the range of 10 to 11 percent. This is higher than the announced target of 9.5 percent for FY13. If these projections turn out to be true, then FY13 is going to be the sixth consecutive year of



double-digit inflation --- the longest spell of high inflation in the history of Pakistan. It seems that the inflationary pressures that started to build in mid 2007 and got exacerbated by the post 2008 balance-of-payments crisis are not showing any concrete signs of abatement despite a protracted slowdown in the economy.

76. Two critical factors can help in lowering inflation on more sustainable basis. First, a durable solution to the energy sector problems. This would help in removing ambiguity regarding unpredictable changes in energy prices thus positively influencing inflation expectations. Resolution of energy problems would also allow the economy to at least operate at the installed capacity to meet the prevailing demand. Second, the importance of abiding by the legal framework(s) of economic policy making should not be underestimated to anchor inflation expectations and infuse credibility. Specifically, the requirement of the SBP Act that fiscal borrowings from the SBP shall be retired by the end of each quarter and the stock be reduced over time should be respected by the fiscal authority. Similarly, the stipulations of the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) to reduce revenue deficit and contain total public debt needs to be implemented.

III. Concluding Remarks

77. Pakistan's economy is locked in a high inflation-low growth nexus for some years now. With falling real private fixed investment in the last four years, GDP growth has not been able to attain an upward trajectory. At the same time, inflation continues to persist at a high level. With the economy operating at a level less than its potential level, this creates a policy dilemma. While a negative output gap does provide room for an accommodating monetary policy stance, persistently high inflation at the back of well entrenched inflationary expectations limits such policy maneuver. Breaking out of this rather complex nexus is therefore the real challenge faced by the Pakistan economy in general and SBP in particular.

78. Amid this situation, SBP's monetary policy is trying to strike an appropriate balance between the competing considerations of inflation and economic growth. While these are the core objectives, SBP is also responsible for maintaining stability in the financial markets through effective supervision and policy intervention. Simultaneous pursuance of these objectives is often quite difficult as they are constantly challenged by developments taking place in both the domestic and global economies. These include, among others, shocks emanating from the behavior of

fiscal authorities, changes in administrative prices, and movements in international commodity prices and financial markets.

79. Further, a protracted energy crisis has severely impaired the future productive capacity of the economy. Without stemming the fall in investment, it would be difficult to generate sustainable economic growth in the medium term. Even if agriculture sector performs as per historical trends in FY13, revival in industrial performance is not likely since the energy crisis is not over yet. Given that some of the major crops have already shown bumper output last year, it might be difficult for agriculture sector to repeat last year's performance. Similarly, given the fragile global economic conditions, an export-led growth also looks less likely. To revive economic growth, the focus must be on an endogenous reform process that focuses on improving infrastructure, productivity, and governance.

80. The average inflation for FY12 was well within the target of 12 percent for the year and on the lower side of SBP's earlier projections. The main reason for this moderation in inflation is a collapse in real private investment, indicating a structurally weak economy. However, it continues to persist in double digits for the fifth consecutive year as there are still deep-rooted factors driving inflation. This persistence is primarily due to entrenched expectations of inflation remaining high. It seems that key drivers for this expectation are continued fiscal borrowings from the SBP despite legal restrictions and feared depreciation of exchange rate even with a modest external current account deficit.

81. The pressure on the external sector has subsided to some extent after the receipt of much delayed Coalition Support Funds. However, unless the structural weaknesses underlying the trade balance and foreign investment are addressed, the strength of the balance of payment position would remain contingent upon temporary flows, which are prone to uncertainties. The trade deficit, which as a percentage of GDP, has settled in a high range, can mainly be brought down with an improvement in exports. In the medium term, vulnerability of the external position to international commodity price movements also needs to be mitigated through a gradual diversification of export products and markets.

82. The structural weaknesses in the fiscal accounts, such as low tax to GDP ratio and rigid current expenditures, continue to cause fiscal slippages. These are increasing fiscal borrowings from the banking system as well as the share of domestic debt in the total debt. Also, the borrowing pattern tends to be unpredictable at

times, which has created substantial challenges for monetary management. For instance, short term market interest rates remained volatile and on average on the higher side, imparting inertia to other market interest rates. As a result, the decline in lending rates for the private sector, after a 200 basis point reduction in the policy rate in H1-FY12, has been less than desirable.

83. Unless the government reduces its fiscal deficit substantially through comprehensive fiscal reforms and improves its debt management, the market liquidity conditions would remain captive to the fiscal borrowing behavior. Conducting a meaningful monetary policy would remain difficult in these circumstances. Debt management can be improved by making realistic estimates of external financing, carefully planning and then adhering to domestic borrowing targets through T-bills, PIBs, and Ijara Sukuks, and respecting the SBP Act that explicitly prohibits direct fiscal borrowings from the SBP.

84. The impact of persistently high fiscal imbalances comes at an immense cost to the economy in terms of risks to macroeconomic and financial stability. High fiscal deficit beckons high inflation expectations and a swelling public debt in the coming years. Therefore, concerted efforts to bridge the gap between revenues and expenditures through structural reforms are necessary to bring monetary stability and economic growth on sustainable basis. In this context, it is pertinent to highlight the key requirements of the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005). These stipulate that the fiscal authority should maintain a revenue surplus from FY09 onwards and keep the total public debt below 60 percent of GDP.

85. Substantial government borrowings from the scheduled banks are one of the reasons for low growth in credit extended to the private sector. The main factors that have significantly dampened the demand for credit by private sector bussinesses, however, are persistent electricity and gas shortages, precarious security conditions, and uncertain political environment. Further, banks' incentives to lend for long term private sector projects are not very strong either; government's growing financing needs are providing them with ample opportunity to invest in risk free government securities. This is curtailing the pool of funds for the private sector at a time when the economy needs it most.

86. Despite this constraining environment, the State Bank of Pakistan will continue to play its required role in nudging the macroeconomic outcomes whenever there is relative ease in some of its core concerns. A relatively improved inflation

outlook and some respite in the external and fiscal accounts due to receipt of CSF has eased, on the margin, the financing constraints faced by the economy. However, a consistent improvement in key economic indicators would require comprehensive and credible reforms in the energy and fiscal sectors. Adherence to the legal framework(s) of economic policy making – The State Bank of Pakistan Act (1956) and The Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) – is important as well. A drive for economic reform and adherence to laws can go a long way in moving the economy towards a better equilibrium with low and stable inflation and high and sustainable growth.

87. Among all these developments, two factors are particularly important – inflation outlook has improved with a projection of 10.5 percent for FY13 and loans to private sector businesses have sharply decreased. This has lead to an increase in real interest rates. In taking the monetary policy decision, the Central Board of Directors of SBP has decided to give a relatively higher weight to the state of private sector credit and investment in the economy, knowing that the projected inflation for FY13 could remain slightly higher than the target. Thus, the policy rate is being lowered by 150 basis points to 10.5 percent with effect from 13th August 2012.