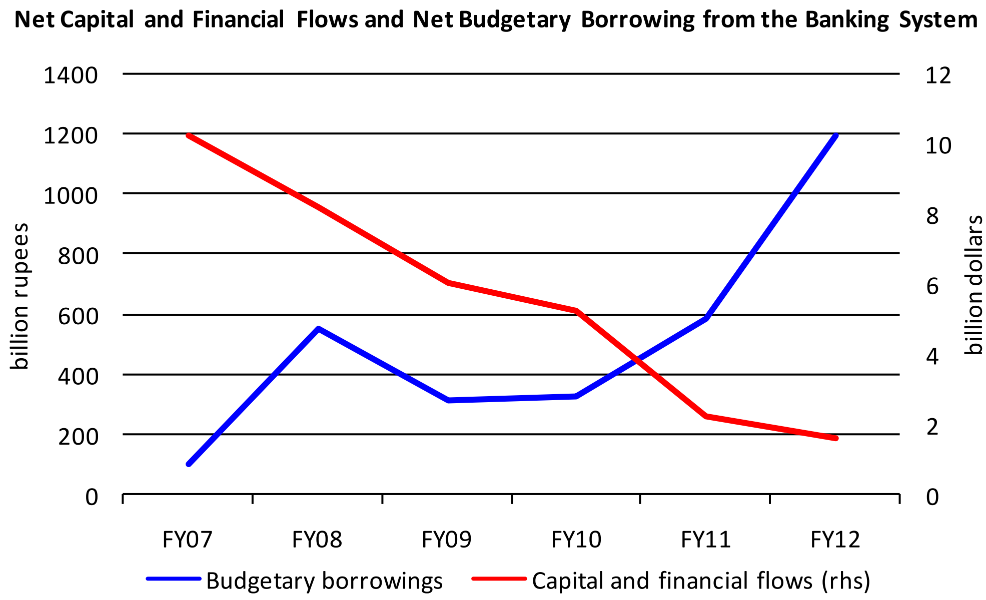
MONETARY POLICY STATEMENT

February 2013



STATE BANK OF PAKISTAN

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Executive Summary

1. The macroeconomic conditions weakened during H1-FY13 despite improvement in some key indicators. The CPI inflation came down quite sharply till November 2012 but has increased since then. The external current account posted a surplus during H1-FY13 but the foreign exchange reserves have declined, predominantly due to IMF repayments. The non tax revenues of the government received a boost after receiving Coalition Support Fund (CSF) of 0.7 percent of GDP during H1-FY13 yet the fiscal deficit is expected to miss the budgeted target by a wide margin.

2. Nonetheless, the SBP did respond to a sharply declining inflation and, assigning a higher weight to contracting private investment, lowered its policy rate by a cumulative 450 basis point over the last 18 months. It has also ensured that both the money and the foreign exchange markets remain stable. Further, the SBP has introduced certain measures to improve the liquidity management and financial intermediation aspects of the banking sector.

3. In the wake of rising risks to macroeconomic stability and in the absence of structural reforms that could have supported price stability and growth in medium term, it may be difficult to continue with the same monetary policy stance. The SBP has to be forward looking and take steps to meet the emerging challenges. The two main challenges, from the point of view of SBP, are managing the balance of payment position and containing the resurgence of inflationary pressures.

4. The fundamental weakness in the balance of payments is the continuous decline in the net capital and financial flows. There has been a net outflow of $539 million in this account during H1-FY13. In addition, the SBP has retired $1.4 billion of IMF loans during the first seven months of FY13. Thus, despite an external current account surplus of $250 million in H1-FY13, the foreign exchange reserves of SBP have declined to $8.7 billion as on 31st January 2013 from $10.8 billion at end-June 2012.

5. The surplus in the external current account during H1-FY13 was primarily due to the receipt of $1.8 billion in the CSF. Marginal improvement in the trade balance and robust growth in workers' remittances have also helped the external current account balance, mitigating the pressure on the balance of payments position. The SBP expects the external current account deficit to remain below 1 percent of GDP

for FY13. This is despite little expectation of receiving proceeds of approximately $850 million from the auction of 3G licence.

6. However, given the declining trend in financial inflows and a very low probability of receiving the budgeted privatization inflows of $800 million in FY13, the challenges on the balance of payments position are unlikely to subside. Further payments of $1.6 billion of IMF loan in the remaining five months of FY13 and $3.2 billion in FY14 do not help the situation either. While the economy has sufficient reserves to meet its debt obligations, the real challenge is to manage the market driven sentiments.

7. Volatility in the foreign exchange market can have implications for the inflation outlook due to potential feedback from exchange rate changes under prevailing conditions. This is why the SBP has intervened in the foreign exchange market in a calibrated manner to ensure its smooth functioning. It is important to remember that only a consistent increase in foreign exchange can ensure stability in the market.

8. Additionally, high growth in monetary aggregates and upward adjustments in administered prices are the major risks to medium term inflation outlook. The recent trend in international oil prices is also on the higher side. The CPI inflation has already risen in the past two months; from 6.9 percent in November 2012 to 8.1 percent in January 2013. The core inflation measures are also inching towards double digit figures again after coming down to single digit.

9. While this reversal in inflationary trend is not surprising and was anticipated by the SBP, the average inflation for FY13 is projected to remain between 8 and 9 percent; well within the target of 9.5 percent. It is the medium term inflation outlook that needs to be assessed carefully. A rising trend in monetary aggregates is a key indicator of medium term inflationary pressures. The SBP expects M2 growth for FY13 to be close to 16 percent. Similarly, due to a weakening external position and rising debt levels in the economy, anchoring expectations of inflation at low levels would be a challenging task.

10. The behavior of monetary aggregates is primarily driven by fiscal borrowings from the banking system. As on 25th January 2013, the year-on-year growth in M2 was 17.3 percent while that in fiscal borrowings from the scheduled banks was 41.3 percent. It is worth highlighting that over the last four years fiscal borrowings from

the scheduled banks for budgetary support have grown by an average of around 60 percent. The average growth in credit to private businesses, on the other hand, has only been 4 percent during the same period. The end result is that the domestic debt has risen by 25.6 percent on average while private fixed investment has contracted by 9.4 percent in the economy.

11. Although the deposits of the banking system show a growth of 17.4 percent, however, given the substantial fiscal requirements, the SBP had to continuously rollover significant amounts of liquidity injections. The average amount of these injections, during 1st July – 7th February FY13 was Rs498 billion and has been the driving force behind a year-on-year growth in reserve money of 15.3 percent. Since inflation had been coming down during H1-FY13, these high level of injections did not pose an immediate risk. A rising inflationary trend, however, would require containment in budgetary financing and a gradual scale back in the size of these injections.

12. While the fiscal authority did manage to retire its borrowing from the SBP in the first quarter of the current fiscal year, it was unsuccessful in the second quarter due to inherent structural weaknesses of the fiscal position. Specifically, it retired Rs399 billion in Q1-FY13 and borrowed Rs183 billion in Q2-FY13 from the SBP. The inability to keep these borrowings at zero within a quarter is a contravention of the SBP Act and an important factor behind an imperfect control over inflation expectations by the SBP.

13. The growth in credit to private businesses, which is a part of overall private sector credit, has been higher during H1-FY13 compared to the corresponding period of last year. In flow terms private businesses availed Rs154 billion during H1-FY13 as opposed to only Rs85 billion during H1-FY12. This could be because of declining interest rates and moderation in accumulation of Non Performing Loans (NPLs). Since the beginning of FY13, the average lending rate has decreased by 204 basis points to 11.3 percent in December 2012. Similarly, the NPLs to advances ratio has declined to 15.5 percent in September 2012 from 16.7 percent in September 2011.

14. However, this increased flow of credit to private businesses is not sufficient to have a sustainable investment led growth in the economy. With contracting private fixed investment expenditures and a fragile global economy, the GDP growth in Pakistan will be essentially consumption-led and is expected to remain just below 4 percent in FY13. The fundamental reasons for this likely outcome are the prolonged

and severe crisis in the energy sector and worsening law and order conditions in the country. These constraints are not only causing substantial under-utilization of the installed productive capacity but also discouraging potential private sector investment.

15. The substantial fiscal borrowing pressures are not providing any breathing space to the private sector either. The main reason for large borrowing requirements from the banking system is the structurally high fiscal deficit, though low external financing is also adding to the problem. The estimates from the financing side of fiscal accounts indicate a deficit of 2.7 percent of GDP during H1-FY13. This is despite receiving 0.7 percent of GDP of non tax revenues in the shape of CSF flows. Given a low growth of 8.8 percent in the tax collection of the FBR during the first five months of the current fiscal year, which is substantially below target, and the continuation of subsidies related to the energy sector, the budgeted fiscal deficit target of 4.7 percent of GDP for FY13 is projected to be missed by a wide margin.

16. The sources of consistently high fiscal deficit are well known – low tax base and evasion together with subsidies to the loss making Public Sector Enterprises (PSEs) and the energy sector. Due to a continuous increase in short term borrowings at a very rapid pace, the share of interest payments in current expenditures has also risen quite sharply in the last few years. Thus, comprehensive initiatives are required to make the fiscal position sustainable and restore macroeconomic stability.

17. In view of macroeconomic conditions discussed above, the Central Board of Directors of SBP has decided to maintain the policy rate at the existing level of 9.5 percent. However, with the objective of improving transmission mechanism by minimizing short-term volatility in interest rates and to bring more transparency, existing width of the interest rate corridor is being reduced from 300bps to 250bps.

I. Economic Environment during H1-FY13

1. A sharper than anticipated decline in CPI inflation and concerns over low level of private investment were the fundamental reasons behind SBP's decision to reduce the policy rate by 250 bps during H1-FY13. The policy rate was initially lowered by 150 bps to 10.5 percent in August 2012 and then by 50 bps each in October 2012 and December 2012 to reach 9.5 percent. While taking these decisions, SBP did incorporate the risks to macroeconomic stability due to continued fiscal weaknesses in the shape of excessive borrowing from the banking system and growing pressures in the external sector due to declining financial inflows and substantial debt payments.

2. At the beginning of FY13, SBP was wary of the high inflation and low economic growth equilibrium in the economy. Although the year-on-year CPI inflation had declined to a single digit, 9.6 percent in July 2012, the stickiness of both measures of core inflation in double digits was indicating persistence in inflation. Nevertheless, the SBP decided to assign a higher weight to growth considerations while taking its monetary policy decisions. Moreover, initially SBP was expecting CPI inflation to remain in the range of 10 to 11 percent for FY13. Later on, however, the likelihood of meeting the 9.5 percent inflation target for FY13 increased due to significant reduction in administered price of gas and decline in food prices. The measures of core inflation also declined, which provided further support to subsequent reductions in the policy rate.

3. Overall economic growth and that in Large Scale Manufacturing sector, in particular, had remained limited to 3.7 percent and 1.2 percent in FY12 respectively. The main reasons were persistent energy shortages, unfavorable law and order conditions and weak global economic performance. These factors did not improve in H1-FY13 and thus the prospects of sustainable economic recovery have remained weak. Of particular concern is the continuous contraction in the private investment for the fourth consecutive year, which has brought the total investment to GDP ratio to as low as 12.5 percent in FY12.

4. Apart from above mentioned structural factors, low utilization of credit by private businesses in the economy is the other main reason for stagnant economic growth. Given the large borrowing needs of the government, scheduled banks preferred investment in government securities over loans to the private sector. This

was despite a significant reduction in interest rates, deceleration in accumulation of Non Performing Loans (NPLs) and an improvement in deposit growth.

5. In these circumstances, impetus through monetary policy had a limited scope. The SBP nonetheless chose to decrease the policy rate to forestall any disincentive created due to higher real interest rates in the wake of falling inflation. SBP was of the view that bringing real interest rates down could potentially increase the demand for private sector credit and kick off economic activities on the margin. In doing so, SBP played its role in facilitating economic growth.

6. The effectiveness of monetary policy, nonetheless, remained contingent upon improvements in the fiscal and the balance of payments position. On the fiscal side, government borrowing from the banking system has continued unabated in H1-FY13 switching between the SBP and the scheduled banks. The government borrowings from the scheduled banks have crowded out the private sector credit and were a primary source of monetary expansion during H1-FY13.

7. These borrowings could have been lower provided that the fiscal authority had introduced reforms to narrow the structural gap between revenues and expenditures. In the absence of fiscal reforms and weak growth in the economy, tax revenues grew at a much slower pace in H1-F13 than required to meet the annual target. Simultaneously, overruns in expenditures due to an increasing proportion of interest payments also contributed to the fiscal gap. The financing gap would have been even higher had the budgeted Coalition Support Fund (CSF) not been fully realized in H1-FY13.

8. The persistent borrowing of the government from scheduled banks was also a major source of liquidity pressures in the market. Consequently, SBP continued to inject large amounts of liquidity into the system to ensure smooth functioning of the market and payment system stability. Such money creation in the banking system was considered a second best strategy since inflation had come down sharply. With weak financial inflows and a contraction in Net Foreign Assets (NFA) of the banking system, SBP had to strike a difficult balance in terms of managing market liquidity while remaining watchful of medium term inflationary pressures.

9. Despite a considerable improvement in the external current account balance, the overall balance of payments position remained under pressure. A higher reduction in import payments compared to export receipts provided some relief to

the trade account, which together with robust growth in workers' remittances and realization of two tranches of CSF in H1-FY13 led to an external current account surplus. However, capital and financial account experienced net outflows due to dwindling private financial inflows and lower than anticipated official inflows. This, together with substantial payments to the IMF, resulted in a drawdown of foreign exchange reserves of SBP. Consequently, pressures have gradually increased on the rupee to depreciate.

10. The impact of uncertainties across global economies in terms of sustainable economic recovery has also been limiting the prospects of an improvement in the balance of payments position of Pakistan. These uncertainties mainly emanate from the slow process of reforms in the euro zone to handle the sovereign debt crisis and the post-election 'fiscal cliff' debate in the USA (a combination of tax hikes and spending cuts).

11. While the solution to the euro zone crisis is slowly taking shape with imminent ECB supervision in European financial markets, political approval for implementing these reforms is expected to take more time. Although an agreement on averting the fiscal cliff in the USA is in place, marginally improving consumer confidence, a new debate on the ballooning federal debt with an end-February 2013 deadline for raising its limit has started. Fiscal uncertainties are still causing low consumer confidence and have rendered quantitative easing programs in US ineffective in boosting growth.

12. Among emerging markets, the weak global economic environment has led to reduced export demand and diminished investment capital. The only silver lining is the positive outlook for China due to acceleration in its infrastructure spending and improvement in manufacturing activities. Overall, the prospects of sustainable global economic recovery remain quite weak. This is reflected in the downward revision in the growth estimates by the IMF for 2013 and 2014.

13. Furthermore, reeling from adverse weather conditions, commodity prices have drifted and fallen in some instances after substantial increases in July and August 2012. Global inflation has eased in recent months, reflecting economic slowdown with continued capacity underutilization and subdued energy prices. The oil market has remained suppressed as a result of weak demand, persistent uncertainty in Europe and the impact of Hurricane Sandy in the USA. Non-OPEC oil supplies resuscitated after seasonal maintenance and end to weather disruptions.

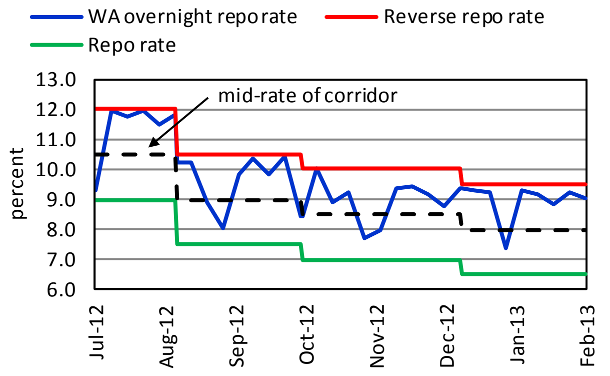
However, OPEC oil production dwindled despite a slight rebound in Iranian crude oil supplies after UN sanctions.

14. In the light of these conditions of marginal global growth prospects and tepid inflation many of the central banks around the world have opted to reduce policy rates, with few developed countries maintaining a status quo. Such global economic growth outlook has negative implications for Pakistan's future trade and capital needs. However, a better global inflation outlook bodes well for the economy in the shape of relatively stable international commodity prices. International oil prices, however, are still susceptible to considerable uncertainty.

II. Recent Economic Developments and Outlook

A. Interest Rates Decline while Liquidity Injections Remain Substantial

Figure 1: Movements in SBP's Operational Target



15. Followed by a decline of 250 bps in the SBP reverse repo rate in H1-FY13, the weekly average money market overnight repo rate has declined by 271 bps till 7th February 2013. This relatively higher decline in the overnight repo rate reflects the strong transmission of SBP's policy actions to market interest rates. In addition, SBP has also introduced some operational changes in its liquidity management framework, which has helped in narrowing the gap between the money market overnight repo rate and the middle of the interest rate corridor targeted by the SBP (see **Figure 1**).

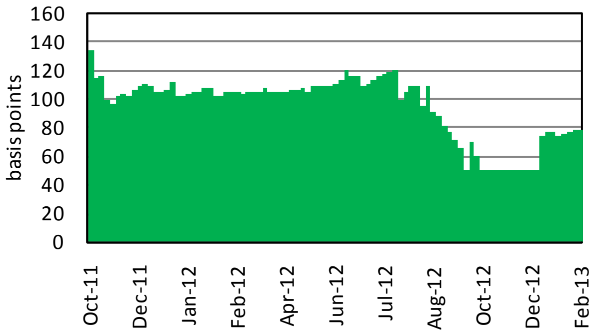
16. Specifically, to dissuade frequent access by banks to the SBP standing facilities, SBP has introduced penal rates for both repo and reverse repo transactions in October 2012. In case an eligible institution accesses either of these facilities more than 7 times during a quarter, a spread of plus/minus 50bps is applied over and above the applicable SBP overnight reverse repo and repo rates for the remainder of the same quarter. Furthermore, in line with the practices of many central banks, SBP has increased the reserve averaging period from one week to two weeks and has reduced the daily minimum Cash Reserve Requirement (CRR) from 4 percent to 3 percent.

17. The objective of these measures is to provide banks sufficient room for managing their reserves so as to reduce their reliance on SBP's overnight lending and deposit facility. The end result is expected to be an improvement in banks' liquidity management and reduction in volatility of the overnight money market repo rate.

18. Analyzing the trends in accessing SBP's standing facilities by banks and DFIs, after the introduction of these measures, a considerable decline in their use can be observed. For instance, the average number of visits by a scheduled bank or DFI during a quarter declined from 9 in Q1-FY13 to 5 in Q2-FY13. This has had a positive impact for the interbank market as it reduced volatility, measured by the coefficient of variation, in the overnight repo rate, which declined to 7.1 percent in Q2-FY13 from 12.2 percent in Q1-FY13.

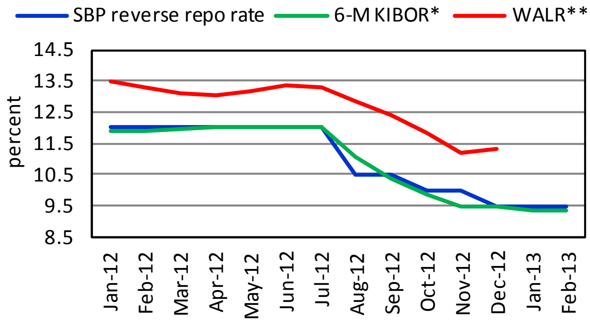
19. The average gap between the overnight money market repo rate and the middle of the interest rate corridor has also declined to 60 bps up till the week ending on 7th February 2013 since the release of monetary policy statement in August, 2012. Earlier, during the period October 2011 to August 2012, this gap was 77 bps on average. The narrowing of this gap is attributed to the improved bidding pattern of banks while participating in the Open Market Operations (OMOs) conducted by the SBP. Specifically, the bid rates have started getting closer to the middle of the interest rate corridor (see **Figure 2**). This is a welcome development since its impact can also be witnessed in other market interest rates; the movement in interest rates is now more closely aligned with changes in the monetary policy stance.

Figure 2: Spread between OMO Injection Rate and Middle of the Interest Rate Corridor



20. The primary and secondary market interest rates have come down across all tenors by a magnitude similar to the decline in the policy rate during H1-FY13. The decline in long term rates, however, has been slightly lower than the short term rates. For instance, in the primary market, the cut-off rate for the 6-month T-bill has

Figure 3: Movement in Policy and Market Interest Rates

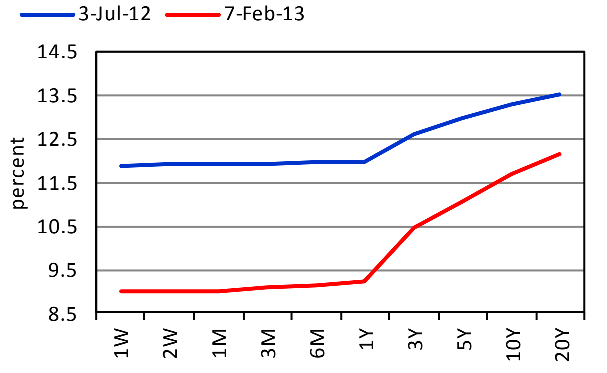


* the data is available up till 7th February 2013
**weighted average lending rate (incremental)

declined by 244 bps while the PIB cut-off rate for the 10 year tenor has come down by 191 bps. Similar declining trends can be observed in the secondary market rates and in the 6-month KIBOR (see **Figure 3**).

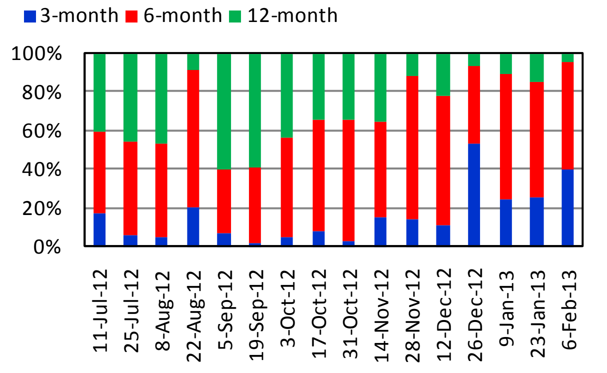
21. A careful inspection of the yield curve and bidding pattern in the fortnightly T-bill auction provide interesting insights. For instance, the spread between the 10-year PIB rate and the 6-month T-bill rate has increased to 256 bps as on 7th February 2013 compared to 133 bps at the beginning of the fiscal year (see **Figure 4**). This steepening of the yield curve indicates that the market expects no further decline in inflation and thus the policy rate. The change in market's expectations can also be observed from the changing pattern of offers in the primary T-bill auctions where the share of 3 and 6 month T-bills combined has increased gradually since the beginning of Q2-FY13 (see **Figure 5**).

Figure 4: Yield Curves



22. Nevertheless, the impact of declining 6-month KIBOR, which is used as a benchmark by banks for corporate lending, can be seen in the weighted average (incremental) lending rate (WALR). WALR has declined by 204 bps from 13.33 percent in June 2012 to 11.29 percent in December 2012. The impact of a decline in the policy and market interest rates on weighted average (incremental) deposit rate (WADR), however, has remained limited to 26 bps only.[1] Partially, this is explained by the floor imposed by the SBP in the form of a minimum deposit rate of 6 percent on saving products, which constitute approximately 40 percent of the total deposit base. With this relatively slower decline in deposit rates, the spread between the WALR and WADR, has come down to 599 bps in December 2012 from a high of 777 bps in June 2012.

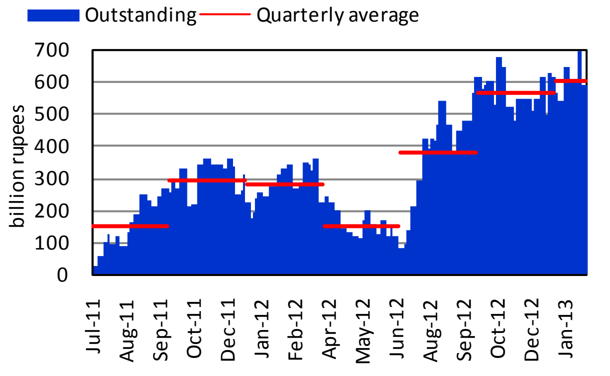
Figure 5: Tenor-wise Offers in T-bill Auctions



[1] The WALR and WADR used here are based on a new series of interest rates prepared by the SBP, which excludes the impact of transactions in the interbank market.

23. Consistent with the monetary policy stance and to meet the rising liquidity deficit in the market, the SBP geared up its liquidity injections in H1-FY13. From a mere Rs80 billion at the end of FY12, the outstanding net injections through the Open Market Operations (OMOs) rose to Rs611 billion by the end of Q1-FY13. Later on, this sizeable level of injections has been more or less consistently rolled-over with the average outstanding injections standing at Rs578 billion as on 7th February, 2013 (see **Figure 6**).

Figure 6: Open Market Operations (Net injections)



24. The size of these injections and their impact on reserve money growth would be manageable provided inflation remains low and stable. However, a gradual and consistent decline in the level of these injections would be required if inflation starts to increase again, as has been the case in the last two months. In this vein, accumulation in the Net Foreign Assets (NFA) of SBP and reduction in fiscal borrowings from the banking system would play important roles. The public's preference for holding currency over deposits also has its negative impact on liquidity conditions. To this end, SBP has been striving to inculcate more competition in the banking sector and improve their outreach to the un-banked segments of the economy.

25. The NFA of SBP witnessed substantial contraction in H1-FY13 due to a stressed balance of payment position on account of weak financial inflows and substantial debt payments. To offset the resulting reduction in reserve money and to ensure smooth functioning of the market and the payment system, SBP therefore had to meet the residual requirement of liquidity. In addition, to avoid any undesirable sentiment driven volatility in the exchange rate, SBP had to resort to calibrated foreign exchange interventions in the market that squeezed rupee

Table 1: Interbank Market Liquidity Conditions

billion rupees, unless stated otherwise

	Q1-FY13	Q2-FY13
Total deposits[1]	-28	478
Currency in circulation	82	79
NFA of SBP	-4	-56
Net budgetary borrowing from SBP	-399	183
Private sector credit	-85	189
Commodity finance	9	-48
T-bill auctions (net of maturities)	276	154
Outstanding OMOs (last week)	612	616
Average outstanding OMOs	385	568
Average overnight repo rate (%)	10.5	9.0
Average spread[2] (basis points)	73	94

[1] excluding government deposits

[2] spread between policy rate and overnight repo rate

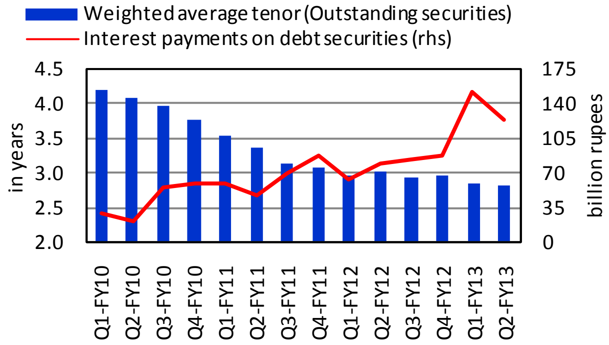
Source: SBP

liquidity from the system (see **Table 1**). Therefore, strengthening the external position and particularly improving the financial inflows are critical from the view point of liquidity management.

26. Similarly, shortfalls in budgeted external financing resulted in increased dependence on domestic borrowings, particularly from the banking system. The share of deficit financing from the banking system has increased from 17 percent in Q1-FY10 to 53 percent in Q1-FY13. Moreover, these borrowings largely consist of T-bills having maturities of one year or less. For instance, at the end of December, 2012 the share of outstanding T-bills in the total securities issued was 66 percent with 58 percent held by the scheduled banks. One consequence of this rise in short term debt is that it has increased the roll over requirement by reducing the average tenor of overall government debt securities.

27. The tenor wise profile of outstanding government debt securities (including T-bills, PIBs, and Ijara Sukuk) shows that the average tenor has declined from 4.2 years at the end of Q1-FY10 to 2.8 years at the end of December 2012 (see **Figure 7**). If the MRTBs issued by the SBP are also included, average maturity declines further to 2.2 years. These high rollover requirements, in turn, have provided incentives to the banks to continue to invest in government securities, creating rigidity in the downward movement of interest rates.

Figure 7: Average Tenor and Interest Payments on Government Debt Securities



28. Further, despite a decline in interest rates, government's overall interest payments on debt securities have been accelerating. In a low interest rate environment, borrowers typically prefer raising long term debt, but the government has instead focused more on short term debt. For instance, in January 2013 the government had an opportunity to raise Rs22 billion by issuing PIBs. However, it decided to reject the entire offered amount. Borrowing through long term securities could have not only helped the government in avoiding high interest payments in the near future but also minimized the rollover requirements, which are keeping the market's liquidity conditions under pressure.

29. In addition to high borrowing requirements, the pattern of government borrowing from the banking system has been rather unpredictable. For instance, the government's recourse to the SBP has moved from retirement in Q1-FY13 to substantial borrowings in Q2-FY13. This behavior has led to uncertainty about liquidity flows in the system and made liquidity management all the more challenging.

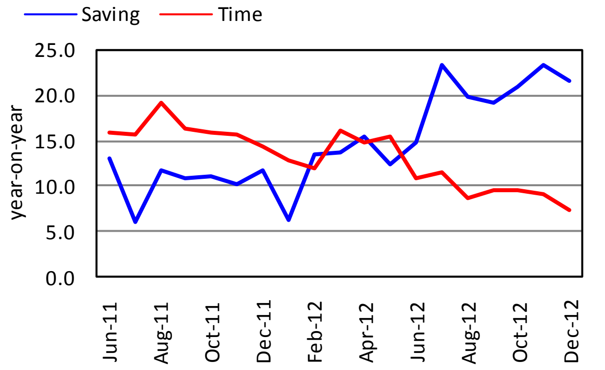
B. Deficit Financing Continues to be the Major Source of Monetary Expansion

30. In a declining interest rate environment together with elevated levels of liquidity injetions it is not surprising to witness a higher growth in reserve and broad money. As on 25th January, 2013 the year-on-year growth in reserve money was 15.3 percent, while M2 grew by 17.3 percent. Of the total expansion of Rs552 billion in M2 during 1st July to 25th January FY13, the contributions of currency in circulation and total deposits with the banks were approximately the same. In year-on-year growth terms, however, currency in circulation has increased quite sharply by 17.0 percent compared to 8.7 percent observed last year.

31. This higher increase in currency in circulation may be attributed to i) higher cash demand triggered by relatively stronger growth in agriculture sector; and ii) higher cash transfers through Benazir Income Support Program (BISP). However, due to a stronger year-on-year increase in deposits, currency to deposit ratio declined slightly to 31.0 on 25th January, 2013 from 31.1 in the same period last year.

32. The year-on-year growth in overall deposits at 17.4 percent was largely due to an increase in demand deposits, which in turn can be attributed to a rise in saving deposits. SBP's policy decision of May 2012 to increase the minimum payable rate on saving deposits from 5.0 to 6.0 percent seems to have played its role in this increase. In addition to better returns on saving deposits, continued increase in workers' remittances and some up-tick in residents' foreign currency deposits amid expectations of exchange rate depreciation have also provided impetus to overall deposit growth.

Figure 8: Growth in Savings and Time Deposits

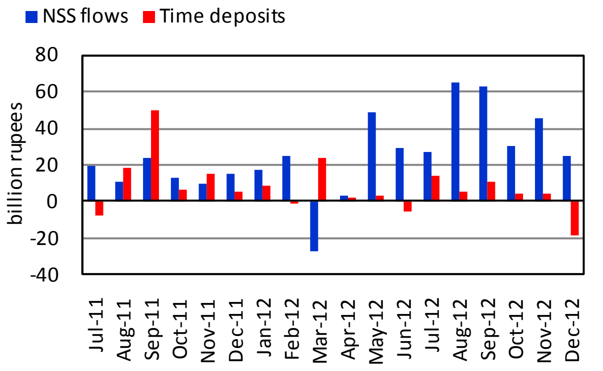


33. Further, some substitution from time to saving deposits can also be observed during H1-FY13 (see **Figure**

8). This substitution may be a reflection of a change in behavior of both banks as well as depositors. On the banks' part, if interest rate is declining and macroeconomic conditions are not conducive for long term lending then mobilization of short term deposits is the preferable mode of raising funds. On the other hand, an increase in the minimum profit rate to 6.0 percent on savings deposit have created incentive for depositors to shift from less liquid to relatively more liquid deposits.

34. Apart from competition from saving deposits, the deceleration in the growth of time deposits is also due to stiff competition from the National Saving Schemes (NSS). Specifically, after allowing institutional investment since April 2012, the NSS has attracted a considerable part of savings in the economy (see **Figure 9**). This may be beneficial for the government in terms of financing its deficit but does not help in increasing the deposit base and developing the financial markets.

Figure 9: NSS and Time Deposits (Monthly flow)



35. Despite a reasonable growth in deposits, currency to deposit ratio, at 31.0 on 25th January, 2013, still show a high degree of cash transactions in the economy. With lower saving to GDP ratio and a stagnant economy, increasing financial market depth and intermediation remain a challenging task. For achieving these objectives, Financial Inclusion Program is one of the long term steps taken by the SBP. However, short term measures like, i) paying depositors on their monthly average balances rather than on minimum balance in a month; and ii) reduction of cash payments for salaries and pensions would help in improving the deposit growth. Lastly, with a continued increase in workers' remittances, banks have the opportunity to retain these funds by introducing migrants' specific financial products.

36. The growth in deposits was not sufficient to meet the credit requirements of the system, particularly of the government, which remained a major user of banking system deposits. As a result, SBP had to meet the residual demand through liquidity injections in the system. This is evident from the fact that in total reserve money expansion of Rs229.1 billion during 1st July to 25th January FY13, Rs467.6 billion was due to SBP's net money market operations. The difference between the two is due to retirement of government borrowing from the SBP and contraction in the SBP's NFA.

37. Specifically, the government has retired its borrowing from SBP by Rs194 billion during 1st July to 25th January FY13. However, almost all of this retirement was concentrated in Q1-FY13. In Q2-FY13 the government borrowed Rs183.2 billion from the SBP. This fresh borrowing is in contravention to the amended SBP Act, which requires the government to keep its borrowing from SBP at zero within a quarter. The continuation of such borrowings is inconsistent with the legal requirements and does not bode well for anchoring inflationary expectations.

38. Similar to the experience of FY12, the NFA of SBP continued to contract during 1st July to 25th January FY13 despite temporary relief provided by the receipt of CSF. This contraction in NFA coupled with an increase in the NDA of SBP due to its liquidity injections has deteriorated the NDA/NFA ratio. Specifically, this ratio has increased to 6.7 as on 25th January, 2013 from 4.6 percent at end- June 2012. This ratio has a strong correlation with inflation and thus indicates medium term risks to inflation.

Table 2: Monetary Aggregates

flow in billion rupees, growth in percent

	June 2012 Stocks	Flow during Jul1-Jan 27 FY12	Flow during Jul1-Jan 25 FY13	FY13[1]
NDA: *of which*	532.1	449.6	578.5	1227.6
Net budgetary support (i+ii)	3799.9	809.1	633.7	
(i) SBP	1706.0	141.7	-193.9	
(ii) Scheduled banks	2093.9	667.4	827.6	
Commodity operations	436.1	-75.0	-54.5	
Private sector credit	3376.4	221.8	94.6	
Credit to PSEs	257.2	-269.5	40.2	
NFA (i+ii)	532.1	-160.3	-26.9	-7.8
(i) SBP	394.1	-157.2	-81.4	
(II) Scheduled banks	138.1	-3.2	54.4	
Money supply (M2)	**7641.8**	**289.3**	**551.6**	**1219.9**
Reserve money	**2188.9**	**131.6**	**229.1**	**365.5**
Currency in circulation	1673.7	152.6	261.0	
Total deposits	5959.1	137.6	289.6	
	Growth (YoY)			
Net budgetary support	46.1	44.0	30.0	
SBP	42.1	1.5	12.6	
Scheduled banks	49.5	97.8	41.3	
Private sector credit	7.5	5.9	3.2	
Money supply (M2)	14.1	12.3	17.3	16.0
Reserve money	11.3	8.6	15.3	16.7
Currency in circulation	11.5	8.7	17.0	
Total deposits	15.0	13.5	17.4	

p: Provisional, [1]: SBP Projections

Source: SBP

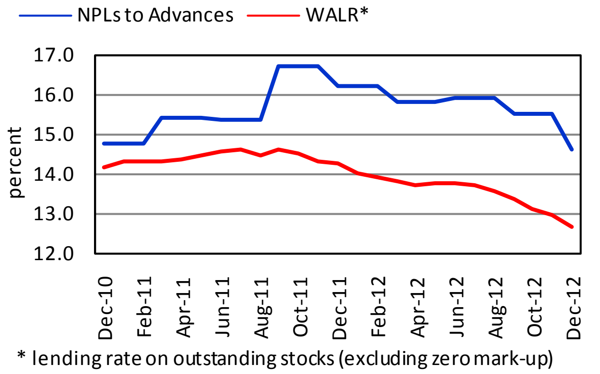
39. The year-on-year growth of 17.3 percent in M2 was primarily driven by the financing requirements of the fiscal deficit. In fact, in flow terms, the government borrowing from the scheduled banks for budgetary support of Rs827.6 billion has outsripped the total monetary expansion of Rs552 billion during 1st July – 25th January, FY13. The year-on-year growth of these borrowings at 41.3 percent is of particular concern since it has been close to 60 percent on average in the last four years (see **Table 2**). This disproportionate burden on scheduled banks is one of the main factors responsible for very low growth in credit extended to the private sector.

40. A further analysis of government borrowings from the banking system yields some further insights. During 1st July to 25th January FY13, scheduled banks have increased their transactions in government securities with the non-bank entities in the money market. These transactions have altered the composition of security holdings between banks and non bank entities. Specifically, the increase in scheduled banks' T-bill stock is considerably higher than the amount raised by the government through T-Bill auctions in the primary market to finance its deficit. This difference is largely explained by scheduled banks' purchase of T-bills from Non-Bank Financial Corporations (NBFC). At the same time, NBFC are substituting their T-bill holdings with either National Saving Certificates or investment in the equity market.

41. Unlike last year, an increase in the NFA of the scheduled banks also contributed towards monetary expansion during 1st July – 25th January, FY13. Specifically, their NFA has expanded by Rs54.4 billion mainly due to an increase in the balances held abroad. This increase partly owes to retirement of loans against FE-25 deposits amid expectation of exchange rate depreciation and falling interest rate on local currency loans. A decrease in the non-resident foreign currency deposits, banks' foreign liability, also contributed to an increase in the NFA of scheduled banks.

42. Given the rising borrowing requirements of the government and an expected considerable fiscal deficit, M2 growth for FY13 is projected to remain in the range of 15.5 to 16.5 percent. This assessment also includes the impact of an increase in the wheat support price by Rs150 per 40kg and the contractionary impact of a weak external position. The contribution of private sector credit in the expected growth in M2 is projected to remain miniscule compared to the contribution of fiscal borrowings from the banking system. Although the aggregate demand pressures in the economy have been fairly contained due to contracting fixed private investmnet, the overall expansionary effect of high government borrowings can not be under-estimated in terms of its impact on medium term inflation.

Figure 10: Declining NPLs and WALR



* lending rate on outstanding stocks (excluding zero mark-up)

43. The lending to the private sector in H1-FY13 has shown some pick up, especially in November and December 2012. In particular, the credit to Private

Sector Businesses (PSB) has increased by Rs153.5 billion during H1-FY13 after contracting by Rs39.6 billion in the first four months of the fiscal year. The overall net lending to the private sector stood at Rs104.5 billion. This increase might have been stimulated by declining market interest rates and the NPLs to advances ratio (see **Figure 10**). However, considering that the second quarter is typically a peak period for the private sector credit demand due to seasonal factors, it is still too early to call it a sustainable recovery.

44. The net credit to private sector needs careful analysis as it includes banks lending to NBFCs as well. Banks lending to these institutions was the main driver of private sector credit (PSC) in FY12. In H1-FY13, however, there has been a net retirement of Rs78.3 billion by the NBFCs. The analysis shows that most of this credit comprised banks' investment through mutual funds, which was incentivized by the tax arbitrage. However, government's decision to gradually eliminate this tax incentive over the next two years has significantly reduced such investments[2].

Table 3: Private Sector Credit
flows; billion rupees

	FY12	H1-FY12	H1-FY13
Total credit to private sector	**235.2**	**193.5**	**104.5**
1.Loans to private sector businesses	**18.3**	**85.2**	**153.5**
By Type			
working capital	-0.1	97.6	127.9
Fixed Investment	18.4	-12.4	25.6
By Sectors: *of which*			
Agriculture	17.9	8.9	12.8
Manufacturing: of which	4.5	52.3	94.0
Textiles	-23.7	30.8	65.2
Chemicals	14.3	7.3	-0.4
Food products & beverages	15.1	-19.1	3.7
Electricity, gas and water	8.7	29.8	16.6
Construction	-14.2	-3.0	1.0
Commerce and trade	-3.6	1.6	12.4
Services	-3.9	-1.8	2.6
2. Personal: of which	-9.0	-8.1	10.1
Consumer Financing	-14.5	-7.9	6.0
3. Investment in securities and shares	-4.8	11.9	11.2
4. NBFC	121.0	24.2	-78.3
5. Others	109.6	80.3	8.1

Source: SBP

45. Most of the expansion in loans to private businesses was to meet the working capital needs, which stood at Rs127.9 billion (see **Table 3**). The disaggregated analysis shows that the textile sector was the main driver of credit uptake. The stable cotton prices and strong demand for textiles in global market increased this sector's credit needs for working capital purposes by Rs61.8 billion during H1-FY13. Nevertheless, structural issues like electricity and gas shortage are still hindering the capacity utilization of this sector, which also affects the industrial output and the overall credit demand.[3]

[2] Currently, banks income is taxed at the rate of 35 percent per annum while their income from mutual funds was taxed at the rate of 10 percent up to FY12. However, as per section 15 (61) of Finance Act 2012, dividend received from Money Market Funds and Income Funds will be taxed at 25 percent in FY13 and 35 percent in FY14 and onwards.

[3] Estimates of APTMA shows that industry incurred a loss of US$3 million per day during complete outage of gas from 20th December, 2012 to 1st January, 2013.

46. The declining interest rates have also helped, to some extent, in the capital formation in the economy, which can be seen in a moderate pickup in credit for fixed investments. The credit availed for this purpose has increased by Rs25.6 billion during H1-FY13. This demand for fixed investment mainly stemmed from the electricity and power (Rs10.7 billion), food and beverages (Rs6.2 billion), the real estate (Rs4.2 billion) and the textiles sector (Rs3.4 billion). If sustained, expansion in these industries could help to generate further credit demand in the upcoming years.

47. The overall expansion in the credit to private businesses is higher than the last 3 year average of Rs133.4 billion and closer to the 5 year average of Rs159 billion for the first six months of a fiscal year. However, this increase is still insufficient to stimulate the economy given the depressed state of investment expenditures in the economy. Moreover, the credit to private businesses as percent of GDP and broad money is also the lowest in the last five years. The fundamental factors behind this lower than desired credit off-take in the private sector include (a) severe energy shortages; (b) unfavorable law and order conditions; and (c) a very high and rising supply of risk free government securities.

C. Addressing the Structural Fiscal Deficit would Require Comprehensive Reforms

48. The fiscal deficit for Q1-FY13 at 1.2 percent of GDP has remained the same as last year's first quarter deficit. However, contrary to last year, this time it was markedly cushioned by one-off non-tax revenues due to the inflow of the CSF of approximately Rs106 billion or 0.4 percent of GDP in August 2012. In addition, primary balance posted a surplus for the first time since Q2-FY09 owing to these flows. This may seem like a positive development, but reliance on temporary flows to prop up the primary balance and in essence underscores the fact that the structural fiscal deficit of the country remains unaddressed.

49. The fiscal data for Q2-FY13 has not been released yet; however, provisional estimates from the financing side indicate that the second quarter deficit would be around 1.5 percent of GDP. Again, considerable support was provided to the revenue side through the receipt of approximately Rs66 billion or 0.3 percent of GDP of CSF in December 2012. Taken together, the fiscal deficit for H1-FY13 is estimated to be close to 2.7 percent of GDP (see **Table 4**).

50. The provisional estimates of the H1-FY13 fiscal deficit also show that, in net terms, the external financing was close to zero, compared to the total budgeted amount of Rs135 billion. The budgeted amount includes Rs75 billion from privatization proceeds. As of end January 2013, there are no signs that these flows will materialize in the remaining five months of the current fiscal year. As a result, substantial borrowings from the banking system are likely to take place in H2-FY13 together with its negative consequences for monetary policy in particular and the economy in general.

Table 4: Summary of Consolidated Fiscal Operations

billion rupees, unless indicated otherwise

	FY13^{BE}	Q1-FY13	Q2-FY13^{P}
Total revenue: *of which*	**3381**	**692**	
FBR tax revenue	2381	400	
SBP profit	200	50	50
CSF money	-	106	66
Total expenditures	**4486**	**976**	
Current: *of which*	3430	812	
Subsidies[1]	209		
Interest	926	313	
Development	1041	75	
Unidentified	-	89	
Budget Deficit	**-1105**	**-284**	**-345**
Financing	**1105**	**284**	**345**
External	135	-1.6	-1
Domestic	971	285	346
Non Bank	487	134	-61
Bank	484	151	406
SBP	0	-412	204
Scheduled Banks	484	564	202
Memorandum items (as percent of GDP)			
Overall fiscal balance	-4.7	-1.2	-1.5
Inc. impact of debt settlement	-		
Primary balance[2]	-	0.1	
Revenue balance[3]	-0.3	-0.9	

P: Provisional; BE: Budget estimates

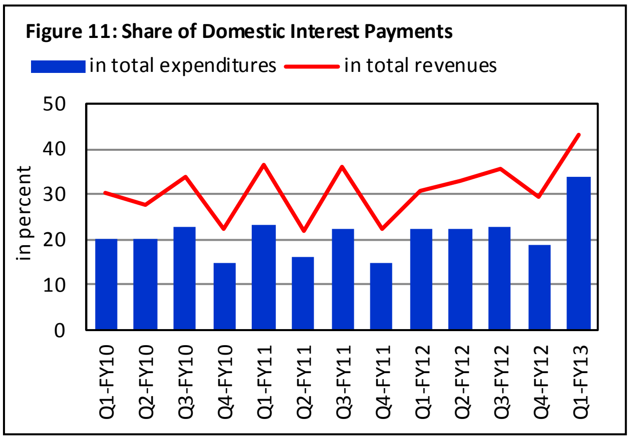
[1] Shows subsidies by federal government only; [2] Total revenues minus total expenditures (excluding interest payments); [3] Total revenues minus current expenditures

Source: Ministry of Finance and SBP

51. The increase in tax collection by the FBR during July - November FY13 has also remained considerably lower than what is required to meet the yearly target of Rs2381 billion. Growing by 8.8 percent, FBR's tax revenues were only Rs695 billion during this period. To meet the revenue target, the FBR would have to achieve 35 percent growth during December - June FY13, which is much higher than the past 10 year average of approximately 17.0 percent for the same period. Lackluster growth in indirect taxes, in particular a decline in the growth of import related sales tax because of a decrease in overall imports, was one of the factors behind this unimpressive performance. Without expanding the tax base and incorporating all income generating sectors of the economy into the tax net, the tax woes of Pakistan's economy are likely continue.

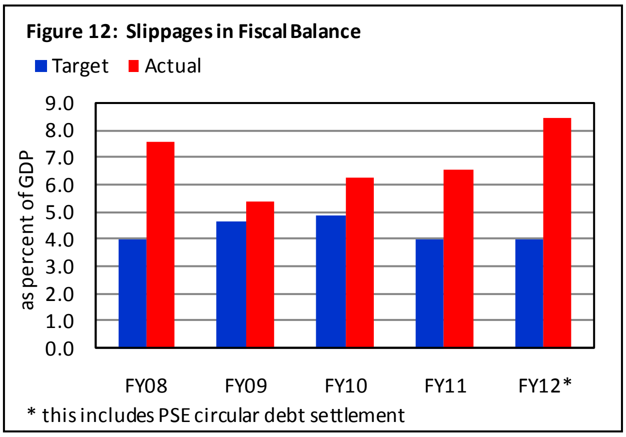
52. Moreover, the volume of interest payments during Q1-FY13 at Rs313 billion is the highest level for a quarter. Consequently, the burden of domestic interest payments, as a percentage of total expenditures and revenues, has increased considerably. This trend could further deteriorate unless serious consideration is given to changing the maturity profile in favor of more long term bonds instead of

short term floating bills, in addition to initiating comprehensive fiscal reforms to reduce the size of the deficit (see **Figure 11**).



53. Given a strong seasonality of the fiscal deficit remaining high in the second half of a fiscal year, the government is likely to experience a considerable deviation from the announced deficit target of 4.7 percent of GDP for yet another year. Apart from substantial expected shortfalls in the tax revenue target, containing the fiscal deficit in H2-FY13 would be difficult because (i) further CSF flows are not expected in this fiscal year; (ii) expenditure excesses in the shape of subsidies continue unabated owing to unresolved power sector issues and Public Sector Enterprises (PSE) losses; (iii) with most of the deficit being financed through short term borrowings, interest payments could turn out to be considerably higher than the budget estimates; and (iv) persistent delays in initiating the auction of 3G licenses has lowered the possibility of raising the budgeted amount before the end of this fiscal year.

54. The consistent gap between the government's budget deficit targets and actual outcomes in the last few years highlight the urgent need to initiate comprehensive fiscal reforms; both to increase tax revenues and curb expenditure excesses. Moreover, it must be remembered that overly optimistic targets without prerequisite foundations reduce the credibility of institutions and therefore do more harm than good. In the past five years, the fiscal authority had committed to keep deficits below 5.0 percent at the beginning of each fiscal year; whereas, the actual outcomes have deviated considerably from these targets (see **Figure 12**).



55. Owing to persistently high fiscal deficits, domestic debt continues to accumulate at a rapid pace. By the end of Q2-FY13, the outstanding stock of government domestic debt and liabilities has increased to Rs8504 billion while its share has increased to 62.7 percent of the total public debt. The average growth in

government debt during FY09 to FY12 has been a staggering 25.6 percent. At this pace, the domestic debt is likely to double in volume terms circa FY15. Moreover, within the domestic debt, floating debt now accounts for 53 percent of the total domestic debt. Without fiscal reforms, this poses a continuous risk in terms of rolling over of maturing debt with borrowings from the SBP.

56. Thus, in the absence of fiscal reforms absent, the prospects of sustainable macroeconomic stability remain weak. The banking system will continue to feed the demand of the government for funds instead of lending to the private sector. The revenue side deficiencies and expenditure excesses cannot be sustained through high levels of borrowings for long. Therefore, structural reforms pertaining to broadening of the tax base and limiting unproductive subsidies are necessary for macroeconomic and financial stability.

D. Declining Financial Inflows Adds Stress to the External Position

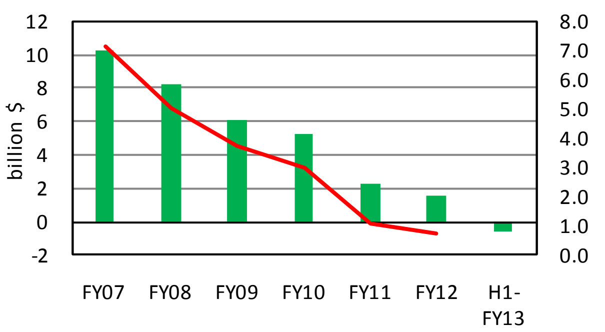
57. The external current account has shown marked improvement during H1-FY13 compared to earlier estimates and the corresponding period of last year. In fact, it recorded a surplus of $250 million during H1-FY13. This improvement in current account is largely due to the receipt of earlier than anticipated CSF flows of $1.8 billion, besides marginal improvement in the trade deficit and robust growth in workers' remittances. Thus, despite little expectation of receiving proceeds of approximately $850 million from the auction of 3G licences, the outlook of external current account has improved. The external current account deficit for FY13 is projected to remain below 1 percent of GDP (see **Table 5**).

Table 5: Balance of Payments Summary
billion US$

	FY12	H1-FY13	H1-FY12	FY13[1]
I. Current account balance	**-4.6**	**0.2**	**-2.4**	
As % of GDP	*-2.0*	*0.1*	*-1.0*	0.0 - 1.0
Trade balance	-15.5	-7.6	-7.9	
Exports	24.7	12.0	12.1	
Imports	40.1	19.6	19.9	
Services balance	-3.0	0.3	-1.3	
Income balance	-3.4	-1.8	-1.6	
Current transfers balance	17.3	9.4	8.4	
Remittances	13.2	7.1	6.3	
II. Capital and Financial	**1.6**	**-0.5**	**0.6**	
of which:				
Direct investment	0.7	0.5	0.5	
Portfolio investment	-0.2	0.2	-0.2	
Other official inv. Lib.	0.8	-0.6	0.3	
III. Errors and omissions	**-0.3**	**-0.3**	**0.0**	
Overall balance (I + II + III)	**-3.3**	**-0.5**	**-1.8**	
Memorandum items:				
Net SBP forex reserves[2]	10.8	9.0	12.9	
Exports growth	-2.8	-0.3	8.5	2.5 - 4.5
Imports growth	11.9	-1.6	18.1	0.0 - 2.0

[1] SBP projections
[2] Excluding CRR and foreign currency cash holdings.
Source: SBP

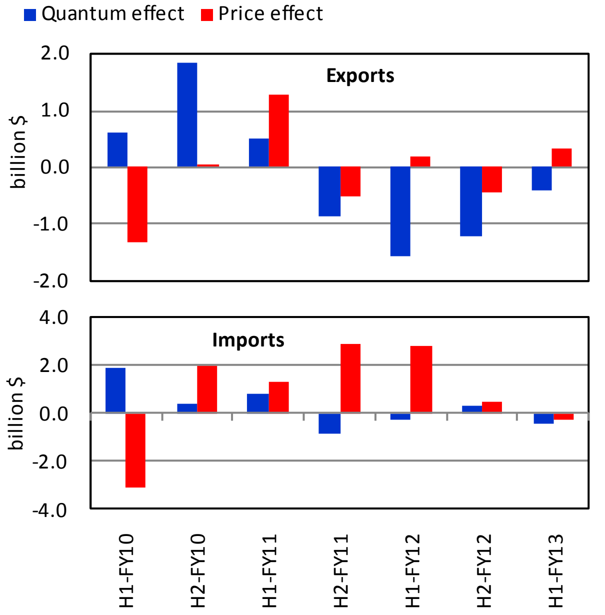
Figure 13: Net Capital and Financial Flows



58. Despite this improvement, the overall BoP position remains stressed. The reason is lack of sufficient financial inflows together with high debt payments. For the first time in the last six years, capital and financial account has experienced a net outflow of $539 million during the first half of a fiscal year (see **Figure 13**). Consequently, the foreign exchange reserves of SBP have declined and pressure on exchange rate has gradually increased.

59. The trade deficit of $7.6 billion during H1-FY13 is slightly smaller than $7.9 billion in the corresponding period of last year. Although exports have declined by 0.3 percent during H1-FY13, the marginal improvement in the trade deficit is due to a relatively sharp contraction in imports that have contracted by 1.6 percent. Other than the overall stagnation in productive activity in the economy the contribution of the depreciation of Pak rupee in containing the trade deficit cannot be ruled out.

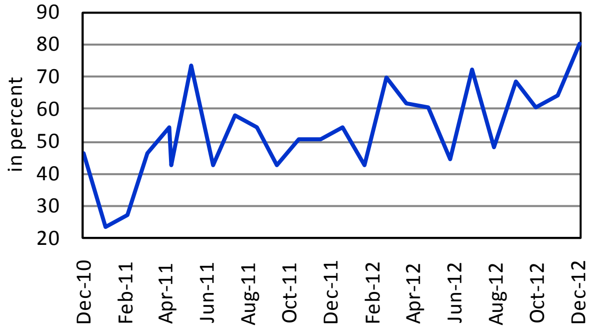
Figure 14: Composition of Changes in Exports and Imports*



* Based on PBS data

60. Separation of the impact of prices and quantum on the value of imports reveals that decline in both these factors have contributed in the slowdown in imports (see **Figure 14**). While the imports of petroleum group have remained roughly the same, the decline mainly stems from food and transport sectors. In particular, import payments in the food and transport groups have contracted by 17.5 and 11.6 percent, respectively. Moreover, prices of major import items such as palm and crude oil have come down by 13.2 and 5.5 percent, respectively during H1-FY13 compared to their levels in the corresponding period of last year. This explains that, unlike last year, imports are coming down due to reduction in the price of imports as well, in addition to a decline in the quantum of imports (see **Figure 15**).

Figure 15: Share of Commodities in Total Imports with Declining Quantum



61. The export performance is mainly driven by quantum increase in low value-added export products, despite decrease in raw cotton prices, and partially due to quantum increase in high value-added textile products. A slight improvement in export prices has also cushioned the export receipts to some extent. The overall declining quantum of exports can be attributed to both external and internal factors such as slowdown in global economies and domestic energy shortages.

62. The marginal contraction in the trade deficit can be interpreted in two ways. First, it can be considered as a positive development in the sense that it helps in improving the external current account balance which, given the weak financial inflows, benefit the overall balance of payments position. Second, it could be taken as an indicator of weakening domestic economy; a growing developing economy typically entails higher imports.

63. Further, the external current account surplus is primarily due to temporary inflows of CSF and not due to structural improvement in the economy. In any case, the projected small external current account deficit is not a source of concern at this point in time, as the country has experienced much higher deficits in the past. The real issue is financing even a small deficit and receiving sufficient financial flows to build foreign exchange reserves.

64. In particular, the private financial inflows need to increase considerably. Although there has been an inflow of $670 million in direct and portfolio investment in H1-FY13, which is slightly higher than $590 million received in FY12, they are considerably lower than historical trends and needs of the economy. The key reasons for the lack of foreign investment in the economy are dismal security and law and order conditions and a volatile political environment. Such conditions do not provide much confidence to the foreign investors to take advantage of the abundant investment opportunities in the economy. Thus, despite relatively high nominal interest rates in Pakistan relative to other countries, the risk premium attached to investment in Pakistan by foreign investors has remained high.

65. The official government inflows are also barely sufficient to meet the amortization of medium and long term loans. The probability of receiving the budgeted privatization inflows of $800 million is also quite low. In addition, the SBP has retired $1.4 billion of IMF loans during the first seven months of FY13. Further scheduled payments of $1.6 billion in the remaining months of FY13 and $3.2 billion in FY14 does not help the situation either (see **Table 6**).

Table 6: IMF Loan Repayments

in millions

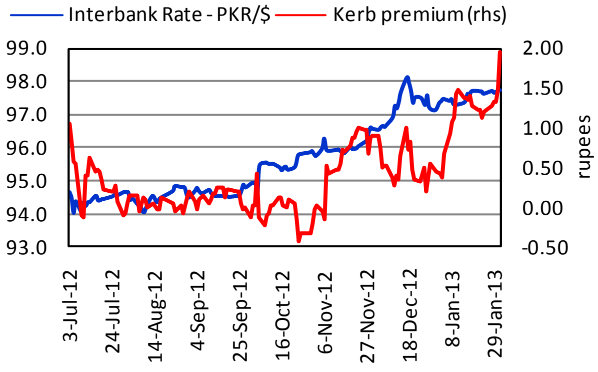
	In SDRs			in US$[1]
Period	**Principal**	**Interest**	**Total**	**Total**
FY12	751.6	108.0	859.6	1,322.6
FY13	1,917.8	65.2	1,983.0	3,044.2
FY14	2,043.2	22.3	2,065.5	3,171.1
FY15	836.6	5.8	842.4	1,293.4
FY16	37.1	0.4	37.5	57.7
Total repayments	**5,586.2**	**201.8**	**5,788.0**	**8,884.9**
Already paid				
FY12	751.6	108.0	859.6	1,322.6
FY13[2]	841.0	55.4	896.4	1,372.0

[1] SDR = US$ 1.534510 as on 6th February 2013
[2] Actual repayments made until 6th February 2013
Source: IMF and SBP

66. Thus, despite an external current account surplus in H1-FY13, the stress on the balance of payments position is unlikely to subside. The foreign exchange reserves of SBP have already declined to $8.7 billion as on 31st January 2013 from $10.8 billion at end-June 2012. While the economy has sufficient reserves to meet its debt obligations, the real challenge is to manage the market driven sentiments.

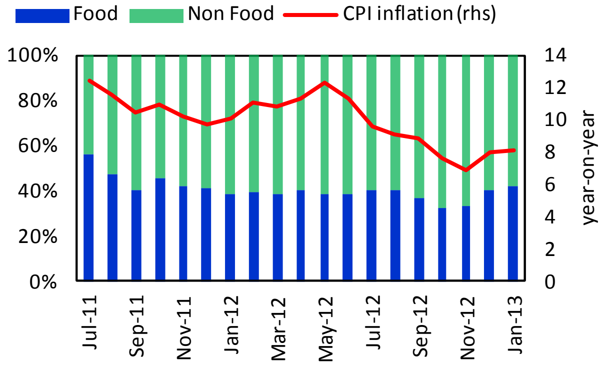
67. Excessive volatility in the foreign exchange market can have implications for the inflation outlook due to potential feedback from exchange rate changes under prevailing conditions. This is why the SBP has intervened in the foreign exchange market in a calibrated manner to ensure its smooth functioning. As a result, the value of rupee viz-a-viz US dollar, which is largely determined by market forces, has depreciated by 3.3 percent during the first seven months of the current fiscal year as compared to the full year depreciation of 9.1 percent in FY12. However, the difference between the interbank and kerb market exchange rate has gradually increased (see **Figure 16**). It is important to remember that only a consistent increase in foreign exchange can ensure stability in the market.

Figure 16: Interbank Exchange Rate and Kerb Market Premium



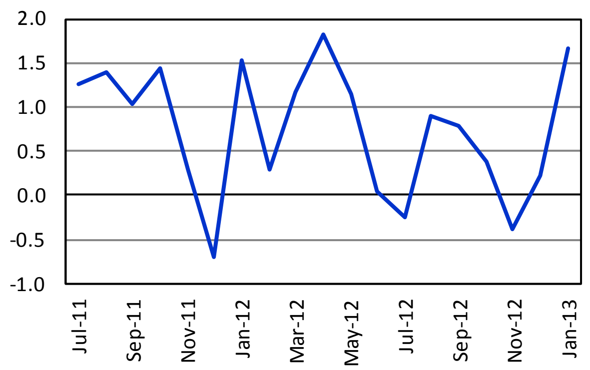
E. Resurgence of Inflationary Pressures after a Sharp Decline

Figure 17: Contribution in CPI Inflation



68. Inflationary pressures have eased considerably over the last seven months though there has been an uptick in December 2012 and January 2013. The year-on-year (YoY) CPI inflation has declined to 8.1 percent in January 2013 from 11.3 percent in June 2012. Although both the food and non-food groups contributed to this deceleration, the share of food group was relatively higher than non-food group (see **Figure 17**). The deceleration is also evident in month-on-month (MoM) changes, where it averaged at 0.5 percent during July - January FY13 compared to the average of around 1.1 percent during the same period of the last three years). However, an uptick of 1.7 percent in January 2013 was fairly significant (see **Figure 18)**.

Figure 18: Month-on-Month Change in CPI Inflation



69. Food inflation declined from 10.3 percent in June 2012 to 5.3 percent in November 2012 before increasing to 8.1 percent in January 2013. The slowdown in food inflation is mainly due to deceleration in perishable food items where it contracted by 6.2 percent (YoY) in January 2013 from 11.7 percent (YoY) growth in June 2012. The reasons for decline in the prices of perishable food items are absence of any adverse supply shock, such as floods in the last two years, and possibly better farm yields.

Table 7: Inflation Indicators (in percent)

	year-on-year		average	
	Jun-12	Jan-13	Jul-Jan FY13	FY13[1]
CPI Headline	11.3	8.1	8.3	8.0-9.0
Food group	10.3	8.1	7.4	
Non-food group	12.0	8.1	8.9	
Core Measures				
Non-food non-energy	11.5	10.0	10.3	
20% Trimmed	11.1	9.9	9.9	

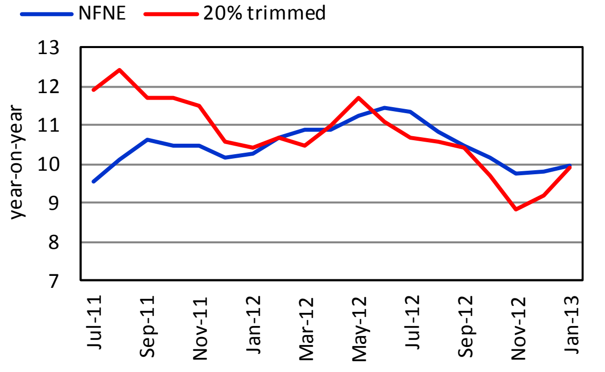
[1] SBP Projections

Source: PBS and SBP

70. Non-food inflation has also declined sharply from 12.0 percent in June 2012 to 8.1 percent in January 2013. Initial decline in non-food inflation was primarily due to downward adjustment of around 49 percent in gas prices during July 2012 (see **Table 7**). Similarly, frequent

changes on weekly basis in fuel prices during the first four months of FY13 have muted the second round impact despite high year-on-year growth in fuel group in January 2013.

Figure 19: Core Inflation



71. Slowdown in inflation seems to be broad-based as reflected in trends of core inflation measures. Non-food non-energy (NFNE) inflation declined from 11.5 percent (YoY) to 10.0 percent in January 2013. Similarly, 20 percent trimmed mean inflation turned into single digit, declining to 8.8 percent in November 2012 before increasing to 9.9 percent in January 2013 (see **Figure 19**). Decline in these measures signify the relative slowdown in demand pressures, though they have inched up in the last two months. The deceleration in inflation to a single digit level is also reflected in the decreasing number of CPI items that show more than 10 percent inflation.

72. At the macroeconomic level, slowdown in overall economy during the last few years is showing its impact on domestic inflation. Real investment has continued to contract and the demand for real imports have also declined. Similarly, fall in real wages during the last four years suggests loss in the purchasing power and deceleration in inflation.

73. Although there is deceleration in headline inflation, the unabated expansionary fiscal position, pressure on exchange rate, and absence of any significant improvement in the long-standing structural bottlenecks, such as energy shortages poses upward risk to inflation. For example, increase in government borrowings, as a consequence of high fiscal deficit, has resulted in acceleration of broad money growth during FY13. Similarly, increased pressure on exchange rate could pass through to CPI inflation. In addition, government has announced increase in wheat support price and an upward adjustment in administered prices, including gas tariffs and motor fuel prices.

74. Indeed, signs of incipient inflationary pressures are already in place. In the last two months of December and January of FY13, month-on-month inflation has been recorded at 0.2 percent and 1.7 percent, respectively. The main thrust to this surge

stems from wheat support, gas, fuel, and house rent prices. While acknowledging this reversal, SBP nonetheless projects average CPI inflation for FY13 to remain in the range of 8 to 9 percent, which is well below the 9.5 percent target for FY13. The actual outcome falling within this range in FY13 would be sobering as inflation would fall to single digit in Pakistan after remaining in double-digits for the previous five consecutive years.

75. However, meeting the FY14 inflation target of 8.5 percent could be rather demanding due to several risks and policy challenges. In particular, upward adjustments in fuel prices and lack of structural reforms addressing energy bottlenecks could add to the inflationary pressures. The rising trend in monetary aggregates also does not bode well for the inflation outlook. Given the mercurial nature of the perishable food items' prices, recent deceleration in food group cannot be relied upon in the medium to long run.

76. More importantly, continuous government borrowing from the banking system and pressures on exchange rate are likely to increase the inflationary expectations and can have a negative influence on medium term inflation outlook. Therefore, fiscal consolidation and attracting capital flows is the key to locking inflation in single digits.

III. Concluding Remarks

77. The SBP has lowered its policy rate by 450 basis points over the last 18 months. The main reason for adopting this stance was a faster than estimated decline in inflation that improved its outlook. This allowed the SBP to place a higher weight to its concerns of contracting private investment expenditures in the economy and thus weak prospects of sustainable economic growth. However, while pursuing this stance, the SBP was fully aware of the limited effectiveness of monetary policy instruments in stimulating growth under the prevailing circumstances.

78. Key examples of this constraining environment include: substantial and rising borrowing requirements of the fiscal authority due to a structural gap in revenues and expenditures, declining foreign exchange reserves due to lack of adequate foreign financial inflows, and persistence of severe energy shortages because of delays in required reforms. In addition, the effective utilization of installed

productive capacity has been severely affected due to dismal law and order conditions and an uncertain political environment.

79. Nevertheless, monetary easing was deemed necessary to try and influence the behavior of private sector businesses to facilitate an increase in the demand for credit and the scheduled banks to step up efforts to improve the supply of credit to the private sector. During H1-FY13, the SBP has also introduced some operational changes in its liquidity management framework. The objective of these measures is to induce an improvement in banks' liquidity management and reduction in market interest rates in line with changes in the policy rate.

80. Indeed, the market interest rates have responded to SBP's policy initiatives and have come down by a magnitude similar to policy rate changes. The decline in long term rates, however, has been lower than the short term rates, which indicates that the market expects no further decline in inflation and thus the policy rate. Moreover, an increase in the minimum payable rate on saving deposits from 5 to 6 percent has lowered the interest rate spread and contributed in a reasonable deposit growth of the banking system.

81. However, despite these marginal gains, the increase in credit to private businesses has been less than desirable. The dominant reason being substantial borrowings of the government from the scheduled banks, which continues to crowd out the private sector. Over the last four years the fiscal borrowings from the scheduled banks for budgetary support have grown by an average of around 60 percent. The average growth in credit to private businesses, on the other hand, have been only 4 percent during the same period. The end result is that the domestic debt has risen by 25.6 percent on average while private fixed investment has contracted by 9.4 percent in the economy.

82. Another implication of substantial borrowing requirements of the government from the scheduled banks is the continuous rollover of significant amounts of liquidity injections in the market. Since inflation had been coming down during H1-FY13, these high levels of injections did not pose an immediate risk. A rising inflationary trend, however, would require containment in budgetary financing and a gradual scale back in the size of these injections. Currently, the growth in reserve money and M2 is considerably high and indicates risks to the medium term inflation outlook.

83. The reason for consistently elevated borrowings from the banking system is the structurally high fiscal deficit, which continues to show considerable deviations from the budget estimates. While factors such as low tax to GDP ratio and underestimation of subsidy payments are well known increase in the share of interest payments in current expenditures, due to a continuous increase in short term borrowings at a very rapid pace, are adding to the fiscal stress. Thus, comprehensive initiatives are required to make the fiscal position sustainable and restore macroeconomic stability.

84. It is understandable to plan expenditures on prospective revenue 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, including those from the SBP. This creates numerous risks for macroeconomic and financial stability. An average annual increase of 25.6 percent in government debt during FY09 to FY12 is one example. At this pace, the domestic debt is likely to double in volume terms circa FY15.

85. On the external front, the overall balance of payments position is stressed. The reason is lack of financial inflows together with high debt payments. While private financial inflows remain weak, the official government inflows are also barely sufficient to meet the amortization of medium and long term loans. In addition, the SBP has retired $1.4 billion of IMF loans during the first seven months of FY13. Further scheduled payments of $1.6 billion in the remaining months of FY13 and $3.2 billion in FY14 does not help the situation either.

86. Thus, despite an external current account surplus in H1-FY13, the challenges on the balance of payment positions are unlikely to subside. The foreign exchange reserves of SBP have already declined to $8.7 billion as on 31st January 2013 from $10.8 billion at end-June 2012. While the economy has sufficient reserves to meet its debt obligations, the real challenge is to manage the market driven sentiments.

87. Excessive volatility in the foreign exchange market can have implications for the inflation outlook due to potential feedback from exchange rate changes under prevailing conditions. This is why the SBP has intervened in the foreign exchange market in a calibrated manner to ensure its smooth functioning. It is important to

remember that only a consistent increase in foreign exchange can ensure stability in the market.

88. Additionally, high growth in monetary aggregates and upward adjustments in administered prices are the major risks to medium term inflation outlook. The recent trend in international oil prices is also on the higher side. The CPI inflation has already risen in the past two months. While this reversal in inflationary trend is not surprising and was anticipated by the SBP, the average inflation for FY13 is projected to remain between 8 and 9 percent; well within the target of 9.5 percent.

89. It is the medium term inflation outlook that needs to be assessed carefully. A rising trend in monetary aggregates is a key indicator of medium term inflationary pressures. The SBP expects M2 growth for FY13 to be close to 16 percent. Similarly, due to a weakening external position and rising debt levels in the economy, anchoring expectations of inflation at low levels would be a challenging task.

90. In view of macroeconomic conditions discussed above, the Central Board of Directors of SBP has decided to maintain the policy rate at the existing level of 9.5 percent. However, with the objective of improving transmission mechanism by minimizing short-term volatility in interest rates and to bring more transparency, existing width of the interest rate corridor is being reduced from 300bps to 250bps.