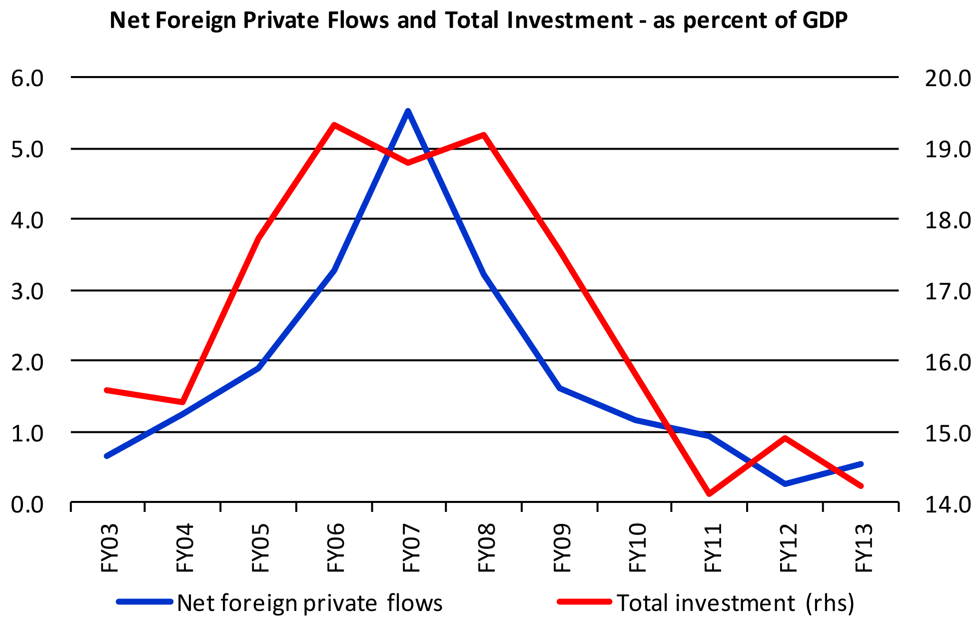
MONETARY POLICY STATEMENT

September 2013



STATE BANK OF PAKISTAN

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Executive Summary

1. Fundamental issues responsible for sluggish long-term economic growth in Pakistan, such as weak economic management and low productivity, have largely remained unaddressed. The economy has experienced bouts of growth and stable inflation but sustainable performance has remained largely elusive. An unprecedented global economic crisis together with escalating energy shortages and worsening security conditions in the domestic economy in recent years has not helped the situation either.

2. One of the implications of these conditions is that the economy has struggled in reducing and financing its domestic and external deficits. A relentless increase in fiscal borrowings and a secular decline in both domestic and foreign investments are only symptoms of structural issues. The role of monetary policy was always going to be limited in this environment; both in terms of keeping inflation low and stable and supporting private investment activity. However, in the wake of considerable deceleration in inflation over the last two years, the SBP did lower its policy rate by 500 basis points.

3. The SBP also intervened in financial markets by imposing a minimum savings deposit rate at 6 percent and containing volatility in the foreign exchange market. It also calibrated its liquidity operations in a manner that balanced financial stability considerations and medium-term inflation risks. As a result of these actions, the weighted average lending rate has declined by 423 basis points by end-July 2013 while deposits of the banking system grew by 15.9 percent and the depreciation of exchange rate was limited to 5.1 percent in FY13.

4. Moreover, a declining interest rate environment did contribute in a marginal pick up in loans to some sectors of private businesses in FY13. Similarly, the Large-scale Manufacturing (LSM) sector grew by 4.3 percent in FY13 compared to an average growth of 0.3 percent in the last five years. However, as has been the case for some years now, most of the loans were used to fulfill the working capital requirements only; loans availed for fixed investments show retirement. Thus, there has been no real broad-based recovery in credit utilization by the private sector. As a result, real private investment expenditures have declined for the fifth consecutive year, reaching 8.7 as percent of GDP in FY13.

5. This shows that higher interest rates were not the major constraining reason for the private sector credit off-take. Two fundamental factors responsible for the lackluster increase in credit demand are: persistence of energy shortages and deterioration in law and order conditions. At the same time, high government borrowing continues to afflict the balance sheet of scheduled banks. For instance, the year-on-year increase in fiscal borrowings from scheduled banks has been around 56 percent on average during the last four years.

6. Moreover, the increase of Rs1446 billion in budgetary borrowings from the banking system during FY13 was almost Rs1 trillion higher than the original target and was even higher than the total expansion in M2. Deviation of this scale has significantly constrained effective monetary management, disrupted financial intermediation in the economy, and has led to a sharp increase in domestic debt. Showing a growth of 24.6 percent in FY13, the stock of government's domestic debt has reached Rs9.5 trillion as of end-June 2013.

7. This could have serious implications for macroeconomic stability. For instance, banks' ability to lend to the private sector for long term, which has already diminished due to frequent and high rollover of government debt, would be constrained further. Similarly, a considerable increase in public debt to revenue ratio reflects weak repayment capacity of the government. Since no government defaults on its domestic debt, this indicates that fiscal borrowings from the SBP could continue, which carries inflation risks in the medium term.

8. The acceleration in fiscal borrowings from the SBP during H2-FY13, Rs714 billion, and Q1-FY14 up till 30th August 2013, Rs547 billion, is particulalrly worrisome. Limiting fiscal borrowing from the SBP is critical for building its credibility, which is of paramount importance for the conduct of an effective monetary policy geared towards anchoring inflation expectations.

9. The inability to raise the tax-GDP ratio is the fundamental source of large fiscal deficits, high borrowings, and rising debt. Although there has been a consistent gap between Federal Board of Revenue's (FBR) budget targets and actual outcomes in the last few years, the gap of Rs445 billion in FY13 was exceptionally high. In fact, this is more than the cumulative shortfall of Rs349 billion during the last five years. Not surprisingly, therefore, the estimated fiscal deficit of 8.0 percent of GDP in FY13 was considerably higher than the budgeted target of 4.7 percent of GDP.

10. The target for consolidated fiscal deficit in FY14 has been set at 6.3 percent of GDP. With swift settlement of the outstanding stock of energy sector circular debt, reduction in electricity tariff related subsidies, and introduction of some taxation measures, the new government has shown intentions to address deeper issues afflicting the fiscal accounts. However, meeting the Rs2475 billion target would require an extraordinary effort by the FBR. Moreover, substantial interest payments, on account of rising stock of domestic debt, are likely to keep the fiscal accounts under stress despite fiscal consolidation efforts of the government.

11. On the external front, stress in the external account has gradually increased with every passing month of 2013 due to shrinking net capital and financial flows and high loan repayments to the IMF. While the former was only $517 million or 0.2 percent of GDP the latter increased to $3 billion in FY13. As a result, despite reduction in the external current account deficit by about half, to $2.3 billion or 1.0 percent of GDP, the SBP’s foreign exchange reserves declined to $6 billion by end-June 2013 from $10.8 billion at the beginning of FY13. These stand at $5.2 billion as on 6th September, 2013 after receiving $544.5 million under the new IMF program.

12. At a broader level, absence of adequate security conditions, and weak fiscal fundamentals have been the major factors responsible for a sustained decline in foreign private inflows. Therefore, despite higher returns on rupee denominated assets vis-à-vis foreign currency assets, private inflows have continued to decline since FY08 – the year Pakistan’s economy experienced a balance of payments crisis. While these factors indicated an increased risk premium associated with investing in Pakistan in the past few years, the current macroeconomic policy scenario has considerably improved the investment outlook.

13. Despite pressures and speculations of a drop in the value of the Pak rupee the foreign exchange market has largely remained stable in FY13. However, since the beginning of FY14 the rupee has depreciated by 5.0 percent as of 12th September 2013. Speculaltive sentiments in the market prior to the new IMF program were a major reason for this accelerated depreciation. The role of volatile conditions in global financial markets, post the announcement of tapering-off of Quantitative Easing (QE) by the Federal Reserve of USA in May 2013, cannot be ruled out either.

14. The likelihood of receiving higher financial flows has increased given that a new IMF program has been approved for Pakistan in September 2013. This would ease pressure in the foreign exchange market. Moreover, clarity on the political front

together with newly-initiated fiscal consolidation efforts of the government could boost offshore investors' confidence and announce Pakistan's return to the international capital markets. With a projected external current account deficit of $3 billion or 1.2 percent of GDP, improvement in financial flows would help in building foreign exchange reserves.

15. As a result, the composition of monetary aggregates is likely to improve in favor of Net Foreign Assets (NFA) of the banking system. At the same time, the growth in the Net Domestic Assets (NDA) is also expected to remain in check due to envisaged reduction in the size of the fiscal deficit and borrowings from the banking system. The SBP projects M2 growth of 14 to 15 percent in FY14, which is more or less in line with the projected GDP growth of around 4 percent and an average CPI inflation remaining between 11 to 12 percent for FY14.

16. Before analyzing the projected inflation path, it would be useful to understand that inflation has been on a declining trend since December 2010. In fact, the deceleration in year-on-year CPI inflation picked up pace in FY13. As a result, the average CPI inflation in FY13 came down to 7.4 percent – a little more than 2 percentage points lower than the target for the year – after remaining in double digits for five consecutive years. Importantly, this decline has mostly been broad based.

17. The main reasons for this broad-based deceleration in inflation are threefold. First, the lagged effect of an overall economic slowdown during the last five years. Second, stable international prices of major imports such as palm oil, petroleum crude and products, and raw cotton together with modest exchange rate depreciation. Third, bank-financed subsidies of the government that kept administered prices under check. The last factor also explains the apparent disconnect between high fiscal-led M2 growth and decelerating inflation. Moreover, with considerable decline in actual inflation the expectations of inflation remaining low gained momentum as well.

18. The sustainability of these subsidies and the overall fiscal position was always questionable and it was just a matter of time before these administered prices had to be adjusted. The government has announced considerable upward adjustments in electricity prices, affecting the inflation outlook. The year-on-year CPI inflation has already jumped to 8.5 percent in August 2013 compared to 5.9 percent in June 2013.

19. Having said that, the impact of upward adjustments in energy prices on inflation outlook cannot be under-estimated. In addition to having a direct effect on CPI inflation, there is a high likelihood of considerable indirect effects as well. Similarly, an increase in the GST together with the removal of certain exemptions could put further pressure on inflation in the coming months. The outlook of oil prices may deteriorate as well given escalating political tensions in the Middle East.

20. Given the various macroeconomic factors and trends described above and the need to contain inflation expectations in the economy, the SBP Central Board of Directors has decided to increase the SBP policy rate by 50 bps to 9.5 percent with effect from 16th September, 2013.

I. Economic Environment during H2-FY13

A. Global Developments

1. Prospects of a sustainable global economic recovery weakened during H2-FY13 in the wake of a likely slowdown in the USA and a protracted recession in the euro area. Even the emerging economies, led by China, Brazil, India and Russia, are expected to experience a relative slowdown. Accordingly, the projections of an increase in global economic growth in 2013 have been revised downwards. The only silver lining for near-term global growth is the relatively higher growth projection for Japan. [1]

2. The economic activity in the USA has been expanding at a moderate pace with improvements in the labor market and increase in household spending and business fixed investment. However, the effects of *sequestration* -- automatic across-the-board spending cuts – are expected to last longer and thus are constraining growth prospects. Similarly, unemployment is still at an elevated level. Given these economic conditions and to ensure that economic recovery strengthens, the Federal Reserve has expressed its commitment to continue accommodative monetary policy stance through asset purchase program, the *quantitative easing* (QE).

3. In May 2013, however, the Federal Reserve indicated tapering its quantitative easing program. This news jolted the global financial markets, causing decline in equity prices and an increase in interest rates in the US markets. This led to capital reversal from emerging markets and resulted in substantial depreciation of their currencies against the US dollar. For instance, India and South Africa have experienced 16 and 17 percent depreciation in their currencies in 2013 so far, with much sharper depreciation since May 2013 onwards.

4. The volatility in currency markets, in the aftermath of these outflows, solicited tightening conditions by monetary authorities to halt capital flight, which has weakened the growth prospects further. Even China, the backbone of emerging economies, brings little respite, as the economy grew at a much slower pace in its first quarter this year than the double-digit growth witnessed earlier.

[1] In July 2013, IMF has revised its projected global economic growth for 2013 to 3.1 percent from its earlier projection of 3.3 percent in April 2013. Among the advanced economies, the GDP growth for USA was revised down to 1.7 percent from 1.9 percent; euro zone to -0.6 percent from -0.3 percent; and the emerging markets to 5 percent from 5.3 percent. For the Japanese economy, the growth projection was revised upwards to 2.0 percent in July 2013 from 1.6 percent in April 2013.

5. In the euro area, economic recession is expected to be deeper due to low demand, depressed confidence, and fragile fiscal and financial conditions. In particular, there are concerns that sovereign stress in the periphery economies and delays in fiscal consolidation is restricting economic recovery. For instance, in Cyprus, the bailout package from the IMF was delayed due to the absence of any progress on the fiscal front. Similarly, in Italy, the government is facing challenges to get its fiscal consolidation plans approved from the parliament due to lack of political consensus.

6. The fiscal austerity measures aimed at reducing debt alongside wage cuts to improve competitiveness appear to be perpetuating a recessionary spiral in the euro zone. It is considered imperative, by the IMF, for euro zone economies to move forward on a fiscal and banking union along with structural reforms that boost growth as well as competitiveness to restore fiscal sustainability. The European Union's plan to salvage its banking system through the *Single Resolution System* also remains shrouded in uncertainty as support from Germany for these reforms is being solicited.

7. In April 2013, with an objective of ending deflation, the Bank of Japan announced a new phase of monetary easing, which aims at doubling the size of its balance sheet in two years. Similarly, the Japanese government has also announced a host of expansionary fiscal measures and promised to undertake structural reforms. With such an aggressive stimulus program, the expectations of revival of Japanese economy have gained momentum. Being the fourth largest economy in the world, growth in Japanese economy is expected to shoulder a revival in global economic growth. So far Japan has witnessed moderate growth driven primarily by a weak yen and a rebound in exports while investment appetite is still low.

8. A weak global economy also has implications for the international commodity prices. Weaker than anticipated growth in Chinese demand has reduced price risks on raw materials, especially metals. Similarly, global food prices have experienced limited volatility in the absence of adverse weather shocks in the first half of 2013. Consequently, global inflation has also eased in recent months. International oil price has also remained stable despite geopolitical tensions in the Middle East on the supply side and dampened growth prospects in the emerging economies on the demand side.

9. These international developments have multiple implications for Pakistan's economy. First, weak global economic outlook does not bode well for Pakistan's

prospects of a possible export-led recovery, especially given the limited product and market diversification of Pakistan's exports. Second, broadly stable international commodity prices are a comforting factor for the external sector and inflation. However, this also suggests that any likely resurgence of inflationary pressures in Pakistan will primarily emanate from domestic sources.

10. Third, volatile international currency markets run the risk of making the US dollar stronger. This could have adverse implications for inflation outlook and external debt and liabilities. Fourth, low risk appetite in global capital markets could make it difficult for Pakistan to access global financial markets even if domestic conditions stabilize. Thus, economic management in Pakistan will have to remain focused on addressing domestic structural vulnerabilities to initiate sustainable economic recovery.

B. Domestic Developments

11. During most of H2-FY13, SBP remained cautious in reducing its policy rate further. In the monetary policy decisions of February and April 2013, it kept the policy rate unchanged at 9.5 percent. In fact, in February 2013, SBP increased the repo rate by 50 bps, narrowing the interest rate corridor for short term market interest rates. In keeping the policy rate unchanged, the key determining factor was the anticipated difficulties in managing the balance of payments position.

12. On the other hand, the real cost of borrowing was gradually increasing as inflation continued to decline. Thus a decrease in the policy rate was always on the cards to support private investment and hence economic growth. It was only in the last monetary policy decision for FY13, in June 2013, that SBP found it conducive to reduce the policy rate further by 50 bps to bring it to 9.0 percent.

13. The risks to the balance of payments position, which continued to increase in H2-FY13, were rooted in a continuous decline in the net capital and financial flows. The external current account deficit was expected to be small and manageable; below 1.0 percent of GDP for FY13. However, with little expectations of realizing budgeted official inflows, weak private inflows and high debt payments, concerns over the sustainability of the balance of payments position were significant.

14. In these circumstances, managing sentiments in the foreign exchange market became quite challenging despite having sufficient foreign exchange reserves to

meet the economy’s debt obligations. The SBP has been cautiously treading a difficult path in allowing the foreign exchange market to move according to economic fundamentals and making calibrated interventions to avoid undue volatility in the exchange rate. The SBP not only had to ensure smooth functioning of the market but also desired to avoid negative implications of disruptive exchange rate volatility for inflation outlook.

15. In this context, the SBP chose to keep the policy rate unchanged to maintain a competitive return on rupee denominated assets relative to foreign currency assets, discouraging speculative demand for the latter. Nevertheless, the SBP was cognizant of the fact that a durable solution to the balance of payments challenges was only a consistent increase in foreign financial inflows.

16. The SBP was also concerned about the likely resurgence of inflationary pressures in the medium term. High growth in monetary aggregates, a likely upward adjustment in administered prices of electricity and gas, and a somewhat up trending international oil prices were the main factors for this assessment. In addition, anchoring inflation expectations in light of external sector vulnerabilities and rising debt levels of the government was also becoming increasingly challenging.

17. The money supply grew rapidly in H2-FY13 on account of substantial increase in fiscal borrowings from the banking system, including the SBP. During the first couple of months of H2-FY13, the outstanding stock of liquidity injections by the SBP was also quite large. These were primarily aimed at filling the residual liquidity gap due to contraction in SBP’s Net Foreign Assets (NFA) and to ensure smooth functioning of the payment system. To reduce the risks to medium-term inflation, SBP significantly lowered its liquidity injections towards the end of FY13. However, the fiscal authority was unable to contain its borrowings.

18. Moreover, these fiscal borrowings from the banking system provided little incentive for banks to lend to the private sector and kept an upward pressure on market interest rates. Nevertheless, due to a significant reduction in the policy rate in H1-FY13, credit to private businesses showed some marginal improvement but was not sufficient to lead an investment-led recovery in the economy. Besides muted economic activities, major impediments for the sustainable revival of private credit were severe energy shortages and poor law and order conditions. These not only held back private investments but also kept the capacity utilization at low levels.

19. A more than anticipated decline in inflation, however, increased the real cost of borrowing, which was deemed undesirable given the consistent decline in private investment expenditures and low credit utilization. The declining inflation also increased the real return on rupee denominated assets relative to foreign currency assets. This provided some room for downward adjustment in nominal returns to cater to broad macroeconomic considerations despite external account concerns. Thus, the SBP lowered its policy rate further by 50 bps, to 9 percent, in June 2013.

20. There were multiple reasons that reinforced the confidence to make this decision. A consistent decline in inflation had improved the medium term inflation outlook and aggregate demand was expected to remain moderate. Moreover, in the post May 2013 elections period there was a noticeable change in sentiments owing to more political clarity. It was expected that these positive sentiments together with increased likelihood of continuation of economic policies could attract foreign private inflows and thus alleviate the major external sector constraint.

II. Recent Economic Developments and Outlook

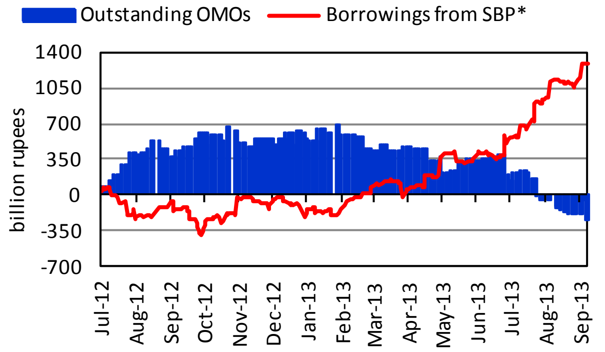
A. Liquidity and Interest Rates: Financial Market Condition Changes

21. To meet the challenges of maintaining stability in the foreign exchange market and controlling high growth in money supply, SBP took two steps in its February 2013 monetary policy decision. First, it narrowed the interest rate corridor from 300 to 250 bps by increasing the floor of the corridor, i.e. the SBP repo rate; and second, it decided to gradually decrease the outstanding amount of liquidity injections.

22. Consequently, interest rates, ranging from cut-off rates in the Open Market Operations (OMOs) to interbank market rates, started inching up. This increased the return on rupee denominated assets relative to foreign currency denominated assets and thus provided some support to the exchange rate. As a result, the depreciation of Pak rupee against the US dollar was limited to 2.5 percent only in H2-FY13 as opposed to speculations of a significant drop in the value of the currency. However, the Pak rupee has depreciated by 5.0 percent in FY14 up till 12th September, 2013.

23. In terms of controlling growth in money supply, however, SBP’s efforts of curtailing liquidity injections did not experience much success. It is because these were offset by an increase in direct fiscal borrowings from the SBP. Specifically, from the outstanding level of Rs691 billion at end-January 2013, the liquidity injections by

Figure 1: Government Borrowings and SBP's Liquidity Injections



* cumulative flow; since end-June 2012

the SBP through OMOs declined to Rs208 billion by end-June 2013. During the same period, the fiscal authority borrowed Rs687 billion from SBP on flow basis (**Figure 1**). The trend has continued in FY14 so far and in fact there is Rs296 billion outstanding in terms of liquidity mop-up as of 13th September, 2013. Similarly, the fiscal authority has borrowed another Rs547 billion during 1st July – 30th August, FY14.

24. The elevated level of borrowings from SBP in H2-FY13 and H1-FY14 so far is a reflection of government's shortfall in raising funds in the pre-announced auctions of government securities. For instance, against the overall target of Rs150 billion through PIB auctions in H2-FY13, the government was able to raise only Rs94 billion. In fact, the government in the PIB auctions held during Q3-FY13 rejected all the bids. Partly because of this unpredictable behavior by the fiscal authority the market only offered Rs55 billion, against a target of Rs100 billion and maturing amount of Rs124 billion during the two PIB auctions held in Q1-FY14 so far.

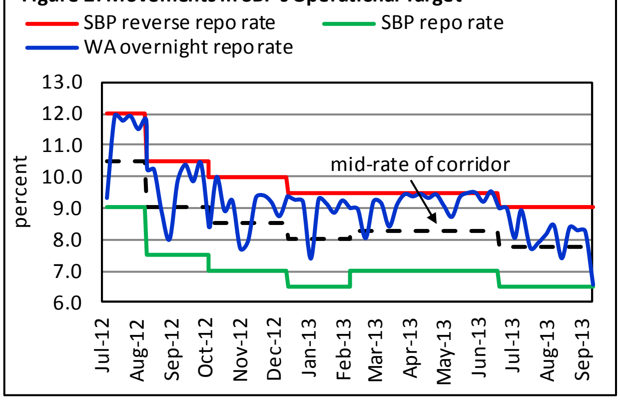
25. Similar pattern can be seen in the fortnightly T-bill auctions where banks' offered amount was lower than both the target and the maturing amount. For instance, in the five T-bill auctions held in Q1-FY14 so far, the government has been able to raise only Rs833 billion against a target of Rs1350 billion and maturing amount of Rs1384 billion. As a result, the average offer-to-target ratio for T-bill auctions has declined to 0.6 in Q1-FY14 so far compared to 1.3 in H2-FY13 and 1.8 in H1-FY13. Other than an unpredictable fiscal behavior, declining interest rate environment together with a floor on saving deposits are other factors for this change in banks' behavior.

26. Furthermore, since the timing of government borrowing from SBP is generally uncertain it created pockets of liquidity shortages in the interbank market. This resulted in frequent recourse to SBP's reverse repo facility by financial institutions, particularly during Q4-FY13. For example, compared to 57 total visits in Q3-FY13, the financial institutions cumulatively accessed the SBP's overnight reverse repo facility 102 times in Q4-FY13.

27. Together with liquidity drain because of macro factors, in particular the foreign exchange reserve depletion, the gradual reduction in SBP's liquidity injections increased its scarcity premium in the interbank market. In an effort to secure funds in the OMOs, the banks started to bid at higher rates, even higher than the SBP reverse repo rate on some occasions.[2] The relatively higher cost of obtaining rupee liquidity through OMOs also created an incentive for banks to maintain their rupee liquidity by rolling over their forward foreign exchange transactions with the SBP. This, in turn, helped in maintaining exchange rate stability.

28. This behavior of banks, in turn, consistently kept the money market overnight repo rate close to the ceiling of SBP's 250 bps interest rate corridor during most of H2-FY13 (**Figure 2**). Specifically, the average gap between money market overnight repo rate and the middle of interest rate corridor stood at 91 bps during the period between two monetary policy decisions of December 2012 and June 2013. The same gap was 49 bps on average in the earlier period of FY13. The upward trend in money market overnight repo rate also kept the other short-term interest rates mostly on a higher side in H2-FY13, including the 6-month KIBOR.[3]

Figure 2: Movements in SBP's Operational Target



29. However, amid positive sentiments emerging after the post 11th May, 2013 elections and following a 50 bps cut in policy rate, effective from 24th June, 2013, both primary and secondary market rates declined till the end of FY13.[4] This market behavior can also be observed in the bidding pattern of T-bill auctions held during the post election period. For instance, the average share of bids for 12-month tenor in total bids increased to 66 percent. The similar share was on average 5 percent in the earlier period of H2-FY13.

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[2] In the three OMO auctions held before the monetary policy decision in June 2013, the banks bid rates moved in the range of 9.45 percent to 9.66 percent. The SBP reverse repo rate was 9.50 percent during this period.

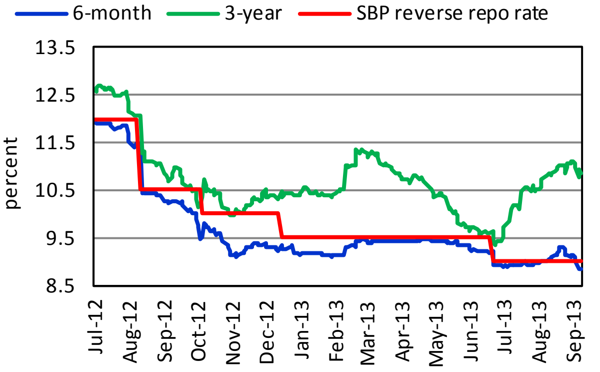
[3] Compared to their levels observed on 6th February 2013, the week before the monetary policy decision, the primary market T-bill rates for 3, 6 and 12 month tenors increased by on average 14, 9, and 2 bps up till the T-bill auction held on 12th June, 2013. Similarly, an increase of average 24 bps can be observed in the secondary market short-term rates (up to 12-month) up till the last monetary policy decision in June 2013.

[4] In the T-bill auctions held during the same period, the 3, 6 and 12 month cut-off rates declined by 50, 48, and 47 bps respectively. Similarly, 35 bps decline can be observed in the secondary market yields for tenors up to 12-month. Further, the long-term rates also declined during the same time frame; for instance, the 3-year secondary market rate declined by 90 bps.

30. Since the beginning of FY14, however, there have been three noticeable developments in financial markets. First, interbank market liquidity conditions have considerably eased primarily due to substantial increase in the pace of government borrowing from the SBP. In fact, the SBP is now mopping-up excessive liquidity. The OMO cut-off rate, on average, has declined by 104 bps since the 21st June, 2013 monetary policy decision. This has helped in bringing down the weighted average money market overnight repo rate though it continued to hover in the upper half of the interest rate corridor during most of the time.

31. Second, the long-term interest rates have inched up, increasing by 113 bps on average during FY14 up till 12th September, 2013. As a result, the spread between 3-year and 6-month secondary market yield has widened by 148 bps compared to the end June 2013 level. As of 12th September, 2013, this spread stands at 201 bps (**Figure 3**). This development was largely a reflection of market's anticipation of higher interest rates in the wake of an IMF program. Lower participation by the market in the auctions for long term securities was a reflection of such expectations. Similarly, in the T-bill auction, held during FY14 so far, 80 percent of the bids were received for the 3-month tenor, on average. Banks typically prefer short-term papers when they anticipate an increase in interest rates down the road.

Figure 3: SBP Policy Rate and Other Secondary Market Rates



32. Third, the depreciating trend in Pak rupee has picked up pace since mid-June 2013. Since the underlying economic fundamentals have not changed much during this period, the depreciation pressure has been mostly speculative. An underlying factor of such sentiments has been the perception that the new IMF program would require build up of foreign exchange reserves by the SBP.

33. The anticipation of interest rate increase and exchange rate depreciation by the market is not completely uncalled for. For instance, resolution of energy sector problems and fiscal consolidation efforts during an IMF program would result in reduction in subsidies and increase in administered prices. Similarly, an IMF program or no IMF program, the need to stem the declining trend in foreign exchange reserves is critical for external sector sustainability.

34. The policy and market developments that emerged just before and during the 2008 IMF program tend to support such conjectures. The market perception of a unidirectional change in the policy rate, however, can be argued against. The past episodes of changes in the policy rate before and during an IMF program show that the policy rate has changed in both directions (**Table 1**). More importantly, it is the economic fundamentals, which drives the policy rate decisions and not the historical precedence.

Table 1: Changes in Policy Rate (PR) and PKR Exchange Rate (ER) before and during IMF Programs

in basis points for PR; in percent for ER - against the US dollar

Date of arrange-ment	Date of expiration or cancella-tion	During 3-month before program		During program	
		ER[1]	PR[2]	ER	PR[4]
16-Sep-93	22-Feb-94	-9.0	200	-1.8	nc[3]
22-Feb-94	13-Dec-95	-1.2	nc	-11.2	-200, 150, 50
13-Dec-95	30-Sep-97	-8.3	50	-15.4	300, -100, -50
20-Oct-97	19-Oct-00	-8.0	-50	-23.3	-50, -150, -100, -150, -100, -200, 100, 100
29-Nov-00	30-Sep-01	-5.7	200	-9.1	100, -100, -100
6-Dec-01	5-Dec-04	5.5	-200	2.1	-100, -150
24-Nov-08	30-Sep-11	-3.9	200	-9.6	-100, -100, -50, 50, 50, 50, -50

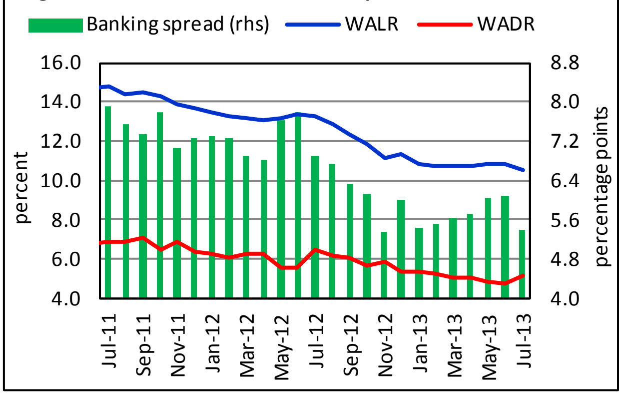
[1] appreciation (+) / depreciation (-); [2] increase (+) / decrease (-); [3] no change; [4] refers to all the changes in PR, including no change

Source: IMF, SBP

35. The 6-month KIBOR that is used as a benchmark for a large part of loans to the corporate sector and the incremental Weighted Average Lending Rate (WALR) have largely followed the trends in changes in the policy rate, though with some lag.[5] After a relatively sharper decline in H1-FY13, the WALR has settled at around 10.8 percent since January 2013 (**Figure 4**). However, given the latest decrease in the policy rate in June 2013, and its immediate impact on 6-month KIBOR, the WALR further decreased by 27 bps in July 2013. Overall, against a cumulative decline of 500 bps in the policy rate since the beginning of FY12, WALR has declined by 423 bps, which indicates a reasonable transmission of an easy monetary policy stance.

36. The Weighted Average Deposit Rate (WADR), on the other hand, has declined by only 172 bps during the same period. This is due to the imposition of a minimum return on savings deposits of 6 percent by the SBP, which was introduced to safeguard the depositors' interest. With a relatively higher decline in

Figure 4: Nominal Interest Rates and Spread

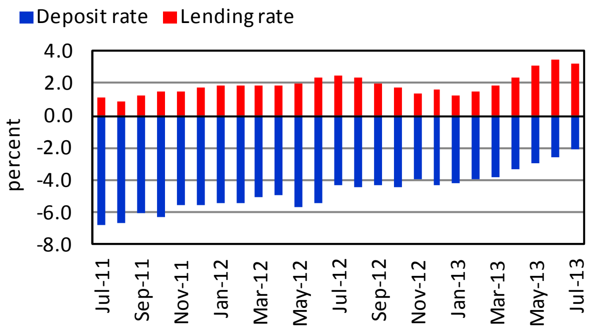


[5] Throughout the monetary policy statement, unless otherwise stated, the weighted average lending and deposit rates used are for gross disbursements and fresh deposits respectively. Further, these rates exclude the interbank transactions, but include disbursements and deposits at zero percent.

WALR, the banking spread has declined significantly from 794 bps in June 2011 to 538 bps in July 2013.[6]

37. In terms of real interest rates, both WALR and WADR have been trending upwards since January 2013 due to a relatively higher decline in inflation (**Figure 5**). A consistently rising real WALR hurts potential borrowers while increase in real WADR favors depositors. Therefore, it is always difficult to define an 'optimal' level of real interest rate in an economy. In the prevailing circumstances of weak economic growth, SBP has been trying to keep real lending rates around zero. With inflation anticipated to gradually increase, the real WALR is expected to decline again.

Figure 5: Weighted Average Real Interest Rates



* calculated as deposit (lending) rate less 12-month moving average headline CPI inflation

B. Monetary Expansion: Mostly Driven by Fiscal Borrowings

38. Successive reductions in the policy rate during the last two years did contribute in a marginal pick up in loans to private sector businesses (PSBs). However, the aggregate flow of loans to PSBs of Rs17.1 billion during FY13 does not reveal an accurate picture. This is because at the end of FY13 the government partially settled the inter-agency circular debt in the energy sector, which was used by the sector to retire outstanding loans. For instance, the electricity, gas, and water sector show a retirement of Rs49.2 billion. Excluding this sector, loans to PSBs increases to Rs66.3 billion in FY13 compared to Rs9.5 billion in FY12 (**Table 2**).[7]

Table 2: Private Sector Credit
flows; billion rupees

	FY12	FY13
Total credit to private sector	235.2	-19.0
1. Loans to private sector businesses	18.2	17.1
By Type		
Working capital	-0.1	31.0
Fixed Investment	18.3	-13.9
By Sectors: *of which*		
Agriculture	17.9	23.5
Manufacturing: *of which*	4.5	58.9
Textiles	-23.7	23.9
Chemicals	14.3	-0.7
Food products & beverages	15.1	26.5
Electricity, gas and water	8.7	-49.2
Construction	-14.2	-0.1
Commerce and trade	-3.6	-3.1
Services	-3.9	-10.8
2. Personal: *of which*	-9.0	20.7
Consumer financing	-14.5	12.6
3. Investment in securities	-4.8	18.9
4. NBFC	121.0	-85.6
5. Others	113.7	9.8

Source: SBP

[6] Banking spread is defined as the gap between WALR and WADR.
[7] In July 2013, the energy sector show a net credit uptake of Rs8.5 billion compared to Rs0.7 billion in July 2012.

39. Inspection of loans availed by other sectors and categories such as *textiles* and *consumer financing* also show some resurgence. Similarly, the net credit disbursement during the second and third quarter – the usual seasonal peak – of FY13, Rs195 billion, was higher than the average of last five years, Rs122 billion. Nevertheless, as has been the case for some years now, most of the loans were used to fulfill the working capital requirements. Loans availed for fixed investments, in fact, show retirement. Thus, there is no real recovery in credit utilization by the private sector despite a cumulative reduction of 500 bps in the policy rate over the last two years.[8]

40. This shows that higher interest rates were not the major constraining reason for the private sector credit off-take. Two key factors responsible for this lackluster performance are: persistence of severe energy shortages and significant deterioration in law and order conditions. Together, they have clouded the economic outlook, increased the risk perception in the economy, and thus discouraged potential borrowers and businesses from taking loans; especially fixed investment loans to expand their productive capacity. In fact, most companies and sectors are operating much below their installed capacity.[9] However, it is expected that private sector credit will start picking up as a result of initial steps taken by the government to resolve circular debt. This will help the industry to increase utilization of existing capacity.

41. What a declining interest rate environment has done is that it has improved the balance sheets of the corporate sector. While relatively better profit margins have positively affected demand

Table 3: Industry Outlook*

In percent

	Textiles		Energy		Sugar		Cement	
	2013	**2012**	**2013**	**2012**	**2013**	**2012**	**2013**	**2012**
Net Profit Margin	6.3	1.4	-0.3	4.4	4.9	5.6	11.4	5.5
Cost of sales/ Revenues	86.5	90.2	78.0	89.2	86.6	84.8	75.8	78.7
Coverage Ratio	34.5	-103.2	14.2	11.6	124.5	43.8	15.7	149.9
Cash flow/Sales	8.4	3.8	4.4	8.2	7.4	8.2	17.3	11.8
Financial Expenses to Cost of Sales	3.2	4.5	16.0	14.7	4.8	5.5	6.2	10.2

* up to March

Source: Financial statements of major listed companies

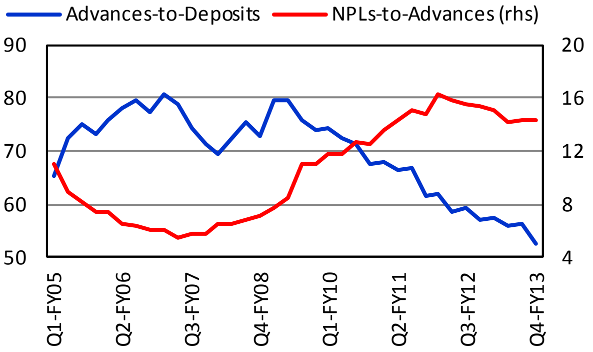
[8] The considerable difference in total credit to private sector between FY13 and FY12 is due to a substantial retirement of Rs85.6 billion by the Non-Bank Financial Corporation (NBFC) in FY13. Lending to NBFCs was the main driver of elevated private sector credit in FY12. Most of the credit under this head comprised banks' investment through their own asset management companies in mutual funds, which was incentivized by the tax arbitrage due to lower taxes on the income of the latter. However, government's decision to gradually eliminate the tax incentive from FY14 has significantly reduced these investments in FY13.

[9] According to survey study by PIDE, energy shortfall has reduced the capacity utilization of the industries by 37-40 percent. (Rehana et. al. 2011, 'The cost of Unserved Energy: Evidence from Selected Industrial Cities of Pakistan,' PIDE Working Paper No. 2011:75).

for credit by some sectors, such as *textiles,* others have opted for deleveraging due to higher net worth and better cash flows, for instance the *cement* sector. Improvement in the balance sheet indicators, a better year-on-year growth of 4.3 percent in the LSM sector in FY13, and the new energy policy can potentially improve the demand for credit and thus its outlook (**Table 3**).

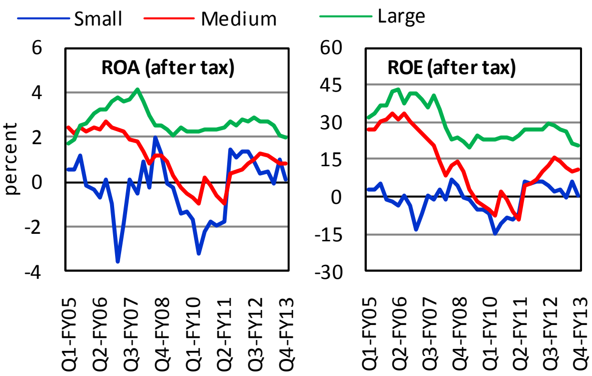
42. However, the higher government borrowing continued to afflict the balance sheet of scheduled banks. The year-on-year increase in fiscal borrowings from scheduled banks has been around 56 percent on average during the last four years. This has severely constrained banks' capacity to lend to the private sector and FY13 was no exception. As a result, the advances to deposit ratio (ADR) has declined from 74 percent in June 2009 to 52.4 percent in June 2013. This has mostly been driven by a considerable slowdown in growth of advances relative to deposits. At the same time the ratio of Non Performing Loans (NPLs) to advances has remained high at around 15 percent, on average since Q4-FY11. This explains the risk-averse behavior of banks towards the private sector (**Figure 6)**.

Figure 6: Lending Behavior of Banks
(in percent)



43. Despite low interest rates, floor on savings deposits, declining ADR and high NPLs, the profitability of the banking sector has remained largely intact, particularly of the large banks. This can be seen from their return on assets (ROA) and return on equity (ROE) ratios (**Figure 7**). For instance, the ROA for large banks, which constitute around 80 percent of total assets and total advances of the banking system, ranges between 2.0 and 2.9 percent over the last four years. For the medium and small banks combined it has moved between -3.2 and 1.5 percent during the same period. Thus, the banking system as a whole has the potential to improve its intermediation of credit to the private sector.

Figure 7: Profitability of Banks



44. These healthy financial outturns have been made possible due to banks' aggressive investment in government securities over the last few years. For instance, the average share of government securities in total assets of the banking sector has increased to 37 percent by end Q4-FY13 compared to 26.5 percent at the end of Q4-FY11. There are numerous advantages for banks in increasing their exposure to government securities. For instance, there is no capital requirement against local currency sovereign debt; these securities are eligible for statutory liquidity requirements and banks are allowed to assign a zero-risk weight to government securities while computing the risk-weighted assets for capital adequacy.

45. However, excessive investment in government securities by banks is not without costs. First, it has reduced financial intermediation by squeezing availability of credit for the private sector. Second, it has negatively affected asset diversification of scheduled banks. Third, the frequent rollover of substantially higher government debt has diminished banks' ability to lend for long term. Fourth, there is a risk of considerable revaluation losses by banks in case of a reversal in the current monetary policy stance.

46. Moreover, given the current low nominal interest rate environment, there are incentives in the market to look for higher returns. This *search for yield* could lead depositors to switch to other (non-banking) sources and could also induce banks to consider relatively high-return private sector lending.[10]

47. The extent of government's excessive reliance on the banking system to finance its fiscal deficit is most noticeable in reserve and broad money expansion (**Table 4**). In fact, the increase in fiscal borrowings from the banking system, including the SBP, during FY13 was even higher than the total expansion in both M2 and reserve

Table 4: Monetary Aggregates

flow in billion rupees, growth in percent

	FY12	FY13[P]	FY14[1]
NDA: *of which*	1,194.7	1,479.3	1,203.0
Net budgetary support (i+ii)	1,198.3	1,446.4	
(i) SBP	505.3	506.8	
(ii) Scheduled banks	692.9	939.6	
Commodity operations	38.6	31.6	
Private sector credit	235.2	-19.0	
Credit to PSEs	-130.5	30.9	
NFA (i+ii)	-248.1	-262.3	67.0
(i) SBP	-219.9	-260.1	
(II) Scheduled banks	-28.2	-2.2	
Money supply (M2)	**946.6**	**1,217.1**	**1,270.0**
Reserve money	**223.0**	**347.4**	**366.0**
Currency in circulation	172.3	265.5	
Total deposits	775.5	949.9	
Growth (year-on-year)			
Net budgetary support	46.1	38.1	
Scheduled banks	49.5	44.9	
Private sector credit	7.5	-0.6	
Money supply (M2)	**14.1**	**15.9**	**14.3**
Reserve money	**11.3**	**15.9**	**14.4**
Currency in circulation	11.5	15.9	
Total deposits	15.0	15.9	

P: provisional, [1] projections

Source: SBP

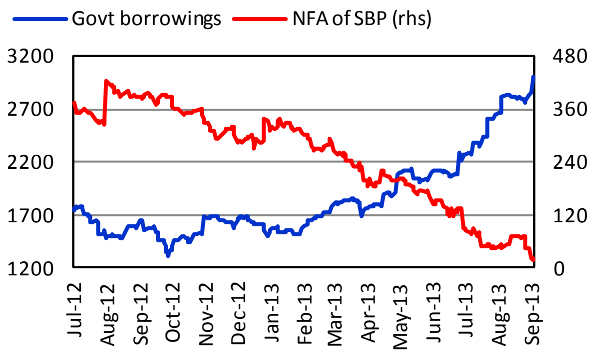
[10] In such situations, problems of moral hazard and adverse selection also arise.

money. For instance, the net fiscal borrowings of Rs1446 billion from the banking system for budgetary support, including Rs506 billion from the SBP, exceeded the total expansion of Rs1217 billion in M2 during FY13. Thus, despite a contraction in Net Foreign Assets (NFA) of the banking system, the 15.9 percent growth in both reserve money and M2 in FY13 is considerably high given the decline in inflation and low real GDP growth.

48. Although the fiscal borrowings might ease slightly in FY14, the projected M2 growth of 14 to 15 percent will still be driven by these borrowings. Also, the foreign financial inflows are expected to improve due to clarity on the political front and under the umbrella of the new IMF program. Thus, the composition of monetary aggregates is likely to improve in favor of NFA of the banking system.

49. The contraction in the NFA of the banking system during FY13 was almost entirely due to SBP's NFA, which decreased by Rs260.1 billion. This is essentially a reflection of declining foreign exchange reserves of SBP and highlights the external sector vulnerabilities. The scheduled banks NFA, on the other hand, increased by Rs77.1 billion in H1-FY13 followed by a contraction of Rs79.2 billion in H2-FY13. The increase in H1-FY13 was largely due to a relatively stronger increase in current transfers and decrease in non-resident foreign currency deposits. The contraction in H2-FY13 owes to a slowdown in current transfers and increase in banks' borrowings from foreign sources.

Figure 8: Stocks of NFA and Government Borrowings from SBP
(in billion rupees)

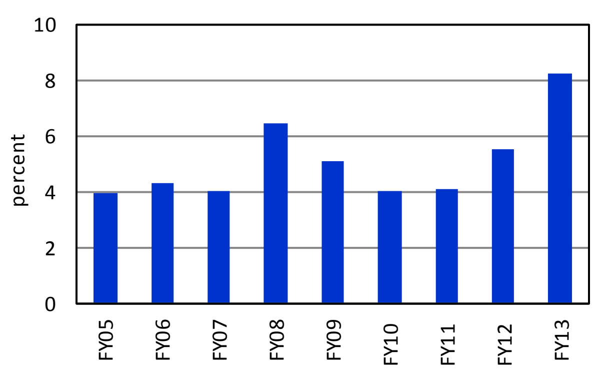


50. The acceleration in fiscal borrowings from the SBP on cash basis during H2-FY13, Rs714 billion, and Q1-FY14 so far, Rs547 billion, is particularly worrisome (**Figure 8**). The stock of fiscal borrowings from the SBP has now reached to an unprecedented level of Rs2715 billion by 30th August, 2013. It is worth highlighting that only a small part of these borrowings is due to a partial settlement of the inter-agency circular debt in the energy sector.[11] Primarily, the persistence of this issue is due to a structurally wide fiscal deficit.

[11] Specifically, out of a settlement of Rs342 billion on 28th June 2013, Rs127 billion (realized value) was settled by issuing Pakistan Investment Bonds (PIBs) directly to the companies, with no impact on monetary aggregates, while the remaining Rs215 billion were paid in cash through borrowings from the SBP. Further, another Rs138 billion were cleared on 22nd July 2013 through book adjustment, without any direct impact on the balance sheet of the banking system. An amount of Rs23

51. In addition to running the risk of having an adverse effect on inflation expectations, the higher monetary expansion together with a rising contribution of domestic assets, particularly fiscal borrowings, compared to foreign assets indicate certain risks to macroeconomic stability. For instance, an increase in the broad money to foreign exchange reserves ratio is considered to reflect risk of substitution of domestic assets with foreign assets by domestic residents. The lower ratio shows greater confidence in the value of money as it is backed by gold and foreign exchange.[12] This ratio has almost doubled in two years; increasing to 8.3 in FY13 (**Figure 9**).

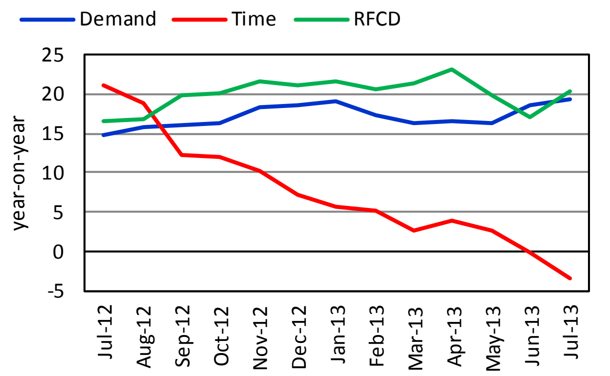
Figure 9: Broad Money to Foreign Exchange Reserves Ratio



52. In the presence of a rigid and high fiscal-driven demand for money, the SBP took certain steps to improve the supply of loanable funds. Specifically, with effect from 1st April 2013, it has asked banks to pay the minimum 6.0 percent rate of profit on monthly *average* balances rather than on *minimum* balances of saving and term deposits. Apart from providing benefit to depositors, the objective of this measure is to put pressure on scheduled banks to step up their efforts to mobilize additional deposits and reduce the currency in circulation.

53. The total deposits of the banking system grew at a reasonable rate of 15.9 percent during FY13. Besides increase in the SBP-imposed minimum return on saving deposits, from 5 to 6 percent in May 2012, better real returns amid falling inflation has also contributed to this growth. However, the compositional change in the growth of deposits is a matter of concern. Specifically, this deposit growth has been largely contributed by increase in demand deposits; the growth of

Figure 10: Category-wise Deposits Growth



billion has been withheld on account of liquidated damages owed by Independent Power Producers (IPPs) to the government. Thus, the total amount of circular debt that was settled in June and July 2013 was Rs503 billion.

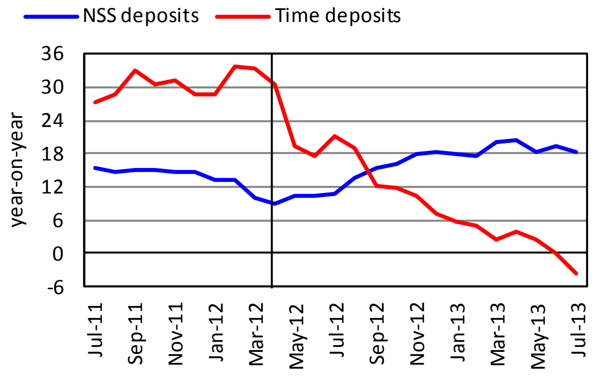
[12] In the academic literature, this ratio is used as an approximate indicator of measuring risks to capital flight as well as of credibility of central bank to defend the exchange rate. For more detail see IMF 2000, 'Debt- and Reserve-Related Indicators of External Vulnerability.'

time deposits has decelerated considerably (**Figure 10**). As a result, the share of time deposits in total deposits has declined to 27.2 percent by end-July 2013 from 31.2 percent a year earlier.

54. Higher growth in demand deposits is partly a result of: (a) mobilization of short term deposit by banks since they are mostly investing in short term government securities and lending to private sector for working capital; and (b) preference of depositors for demand deposits because they are more liquid and are offering a minimum return. Besides substitution to demand deposits, deceleration in growth of time deposits can also be attributed to higher growth in National Saving Scheme (NSS).

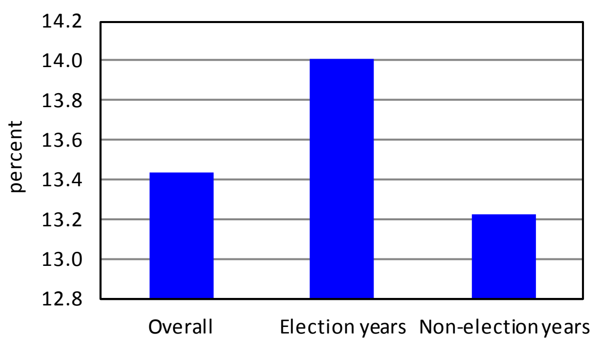
55. While relatively better returns on NSS products compared to time deposits is one reason, allowing institutional investment in NSS since April 2012 has also diverted a considerable part of savings from the banking system to NSS products (**Figure 11**).[13] However, it has adversely affected financial intermediation by the banking system. The falling growth of time deposits is worrisome as it indicates banks' reduced ability for long term lending for investment projects, which is critical for sustainable growth in the economy.

Figure 11: Growth in Time and NSS Deposits



56. One key indicator of financial disintermediation is increase in currency in circulation. It showed a relatively higher growth of 15.9 percent in FY13 compared to 11.5 percent last year. This sharp increase in growth of currency in circulation could be due to a temporary increase in the transactional demand for money, such as additional spending in an election year (**Figure 12**). Moreover, better

Figure 12: Average Annual Growth in Currency in Circulation during FY1988-2013



[13] For example, return on 10-year Defense Saving Certificate was 10.8 percent on 1st January, 2013 compared to 9.9 percent and 8.9 percent return on 5-years and above and 4-years and above but less than 5-years time deposits respectively as of end-December 2012.

rural incomes amid rising prices of livestock and crops have also contributed in an increase in the demand for money as a medium of exchange.[14] A considerable part of transactions in rural economy still takes place in cash.

57. The currency to deposit ratio in FY13 has remained unchanged at the previous year's level of 28.1 percent. However, some budget measures such as increase in the withholding tax on cash withdrawals from 0.2 to 0.3 percent and giving authority to the FBR to access bank account information of individuals might deter savers to hold deposits with the banks. This, in turn, could adversely affect the currency to deposit ratio, which does not bode well for financial intermediation.

C. Fiscal Deficit: Solution Remains in Structural Reforms

58. The consolidated fiscal data for FY13 has recently been released, which shows a fiscal deficit of 8.0 percent of GDP or Rs 1834 billion. This includes the power sector circular debt settlement of Rs342 billion or 1.5 percent of GDP in June 2013 (**Table 5**). This is considerably higher than the budgeted target of 4.7 percent. Also, there are significant deviations in estimates of financing sources. For instance, fiscal borrowings from the banking system are almost Rs1 trillion higher than the original estimates.

Table 5: Summary of Consolidated Fiscal Operations

billion rupees, unless stated otherwise

	FY13[BE]	FY13[P]	FY14[BE]
Total revenue: *of which*	**3381**	**2982**	**3640**
FBR tax revenue	2381	1936	2475
SBP profit	200	220	200
CSF money	-	172	-
3G license fee	-	-	120
Total expenditures	**4486**	**4816**	**5291**
Current: *of which*	3430	3676	3964
Subsidies[1]	209	-	240
Interest	926	991	1154
Development; *of which*	1041	1140	1327
Net lending	-	363	-
Budget balance	**-1105**	**1834**	**-1651**
Financing	**1105**	**1834**	**1651**
External	135	-1.7	169
Domestic	971	1836	1482
Non- Bank	487	378	507
Bank	484	1458	975
Memorandum items (as percent of GDP):			
Overall budget balance	-4.7	-8.0	-6.3
Primary balance[2]	-	-3.7	-1.9
Revenue balance[3]	-0.3	-3.0	-1.2

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

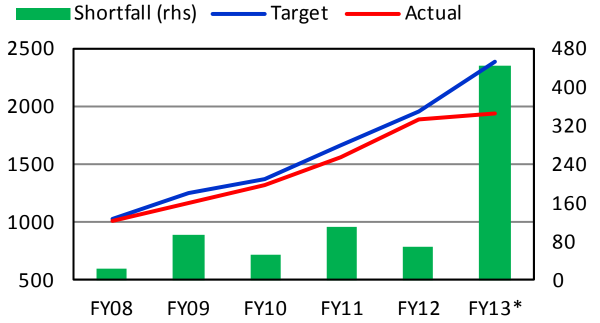
59. As has been the case for some years now, significant shortfall in tax collection estimates of the Federal Board of Revenue (FBR) is the main reason for the large fiscal deficit in FY13. The provisional estimate indicates that the FBR tax collection during FY13 has been only Rs1936 billion – the lowest year-on-year growth of 2.9 percent since FY02.

[14] A large part of increase in currency in circulation was driven by Rs500 and Rs1000 denomination notes suggesting transactional use of money.

This lower tax collection largely stems from a decline in direct and import related taxes.[15] The major reasons, nevertheless, remain structural – narrow tax base and an arcane and inefficient tax structure.

60. Although there has been a consistent gap between FBR's budget targets and actual outcomes in the last few years, but FY13 gap of Rs445 billion is exceptionally high. In fact, this is more than the cumulative shortfall of Rs349 billion during the last five years (**Figure 13**). In this context, weak tax generation capacity is the fundamental economic problem faced by Pakistan. There is an urgent need to initiate and implement comprehensive tax reforms. Inflation tax and lack of credit for the private sector are some examples of failure to undertake such reforms.

Figure 13: Shortfall in FBR Revenues
(in billion rupees)

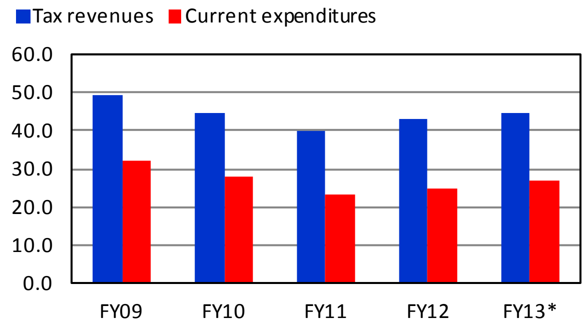


* provisional estimates

61. Higher expenditure on account of subsidies, settlement of circular debt, and interest payments are other main reasons for the large fiscal deficit in FY13. The development expenditures grew by 53.2 percent in FY13 compared to 58.5 percent in FY12. However, this growth includes the circular debt settlement of Rs342 billion and net lending of Rs21 billion to PSEs in Q4-FY13. Excluding this, the growth in development expenditure is only 7.3 percent or just 3.5 percent of GDP. This bias against development expenditures does not bode well for the consistently declining investment to GDP ratio in the economy.

62. The interest payments accounted for 44.4 percent of the tax revenues during FY13; up from 42.8 percent in FY12 (**Figure 14**). Also, these interest expenditures have been higher than the respective budget estimates. There are two main reasons for this outcome. First, significant deviation in the size of the fiscal deficit that resulted in substantially higher borrowing than envisaged at the beginning of the

Figure 14: Interest Payments
(as percent of ...)



* provisional data

[15] While direct taxes grew by only 1.1 percent, the collection of import related sales tax during FY13 declined by 0.2 as compared to the corresponding period of last year.

fiscal year. Second, in the wake of considerable shortfalls in budgeted external financing, most of these borrowings have been short term and from domestic sources that come at a relatively high interest rate.

63. These interest payments have reached close to Rs1 trillion in FY13. Given considerable increase in the stock of government's domestic debt in FY13 and in the absence of a coherent debt management strategy, the interest payments are set to rise further in FY14. The ensuing interest payments, on account of sharply rising accumulated stock of domestic debt, are expected to keep the stress on fiscal accounts in the coming years.

64. Growing by 24.6 percent, the stock of government's domestic debt has reached Rs9.5 trillion while its share in the total public debt has increased to 65.7 percent as of end-June 2013 (**Table 6**). This could have serious implications for debt sustainability and thus macroeconomic and financial stability. For instance, considerably high public debt to revenue ratio reflects weak repayment capacity of the government. Since no government defaults on its domestic debt this indicates the fiscal borrowings from the SBP would continue, which carries inflation risks in the medium term.

Table 6: Debt Sustainability Indicators

in percent

	FY09	FY10	FY11	FY12	FY13
Public debt/GDP	59.4	62.1	60.1	64.3	63.3
Domestic debt /GDP	29.2	31.3	32.9	38.0	41.6
Domestic debt/Public debt	49.3	50.4	54.7	59.1	65.7
Floating debt/ Domestic debt	49.3	51.5	53.8	54.2	54.6
Public debt/Revenues	423.3	444.1	486.2	503.6	486.0

Source: Ministry of Finance and SBP

65. The debt sustainability analysis also suggests that containing the debt to GDP ratio at current level would require the government to reduce its primary deficit to below 2 percent of GDP.[16] Moreover, the rising proportion of short term/floating debt in domestic debt, which now stands at 55 percent, indicates increased sensitivity to movements in interest rates.

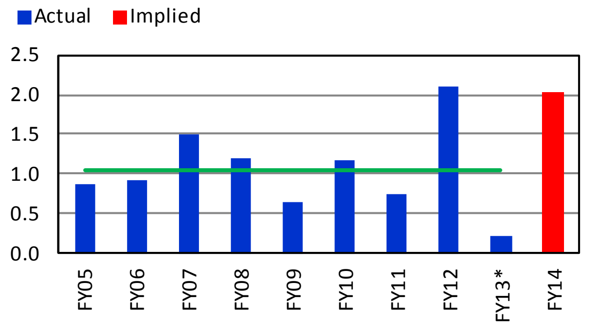
66. The target for consolidated fiscal deficit in FY14 has been set at 6.3 percent of GDP, which is 1.7 percentage points lower than the revised FY13 estimates. Underlying this envisaged reduction in deficit is the ambitious FBR tax collection target of Rs2475 billion and containment of current expenditures to 15.2 percent of GDP mainly through reduction in subsidies. Other than anticipating further receipts from the Coalition Support Fund (CSF), the budget for FY14 also assumes raising Rs120 billion from the auction proceeds of 3G licenses. The government has

[16] This level is estimated using the IMF-World bank debt sustainability framwork (DSA).

struggled in realizing these over the last several years, contributing in fiscal slippages. It is expected that government's privatization efforts will contribute positively to non-tax revenues, besides energizing the state owned enterprises.

67. The major risk of not delivering the announced fiscal deficit target mainly emanates from the revenue side. For instance, achieving the FBR tax collection target would require 27.8 percent growth (or a 1.0 percentage point improvement in the tax to GDP ratio) in FY14. Even though the government has announced an increase in the GST, from 16 to 17 percent, and some related reforms, achieving this seems difficult. This is because the FBR revenues have grown by 14.3 percent, on average, during the last five years with a maximum of 20.9 percent in FY12. Furthermore, required growth in FBR tax collection implies a tax buoyancy of 2 in FY14, which seems rather high when looked in an historical context; the average tax buoyancy for last eight years remains at 1.0 (**Figure 15**).

Figure 15: FBR Tax Revenue Buoyancy



* provisional; Note: Green line shows average buoyancy of FBR revenues during FY05-13

68. The likelihood of keeping the energy sector subsidies within the budgeted amount, however, has increased given that the government has already announced significant increases in electricity tariffs. The need to address inefficiencies associated with electricity transmission and distribution still remains. This would be important to stem the accumulation of circular debt in the energy sector yet again. Other than improving the effective utilization of installed productive capacity in the economy, energy sector reforms can greatly benefit the fiscal position as well.

69. Moreover, non realization of budgeted privatization proceeds and non-tax revenue items like proceeds from the auction of 3G licenses, as has been the case for some years now, carry the risk of escalation in fiscal borrowings from the banking system, with multiple negative implications for the economy. Similarly, due to very high stock of fiscal borrowings from the SBP, the transfer of SBP profits to the government, Rs220 billion in FY13, would remain substantial.

70. Reliance on these profits and one-off measures creates complacency and gives the impression that total revenues are high enough to meet fiscal expenditures. It must be remembered that such revenues are not generated through any productive

activity in the economy and thus obscures structural weaknesses and stalls the reform agenda. With swift settlement of the outstanding stock of energy sector circular debt, reduction in electricity tariff related subsidies, and introduction of some taxation measures the new government has shown its intentions to address the critical issues afflicting fiscal accounts.

D. External Sector: Improved Current Account but Anemic Financial Inflows

71. The stress in the external account gradually increased with every passing month of FY13. The broad indicator of this stress was a consistent decline in SBP's foreign exchange reserves, which came down to $6 billion by end-June 2013 from $10.8 billion at the beginning of FY13. These stands at $5.2 billion as on 6th September 2013 after receiving $544.5 million under the new IMF program. There are two main underlying factors for the low level of reserves: shrinking net capital and financial flows and high loan repayments to the IMF. For instance, the SBP has paid $3.0 billion in FY13 and $729 million in FY14 so far to the IMF from its foreign exchange reserves.

Table 7: Balance of Payments Summary

billion US$

	FY12	FY13	FY14[1]
I. Current account balance	**-4.7**	**-2.3**	**-3.0**
Trade balance	-15.8	-15.1	
Exports	24.7	24.8	
Imports	40.5	39.8	
Services balance: *of which*	-3.2	-1.1	
CSF	0.0	1.8	
Income balance	-3.2	-3.7	
Current transfers balance: *of which*	17.5	17.6	
Remittances	13.2	13.9	
FCA Residents	0.3	0.6	
II. Capital and financial account	**1.5**	**0.5**	
Capital account	0.2	0.2	
Financial account: *of which*	1.3	0.3	
Direct investment (net)	0.7	1.2	
Portfolio investment (net)	-0.1	0.0	
Disbursement of government debt	2.6	2.2	
Amortization of government debt	2.0	2.3	
III. Errors and omissions	**-0.1**	**-0.2**	
Overall balance (I + II + III)	**-3.3**	**-2.0**	
Memorandum items:			
Current a/c as % of GDP	-2.0	-1.0	-1.2
Capital and financial a/c as % of GDP	0.6	0.2	
Change in IMF credit and loans	-1.2	-2.9	
Net SBP forex reserves[2]	10.8	6.0	
Exports growth	-2.6	0.2	6.0
Imports growth	12.8	-1.6	6.0
Remittances growth	17.7	5.6	

[1] SBP projections

[2] excluding CRR and foreign currency cash holdings

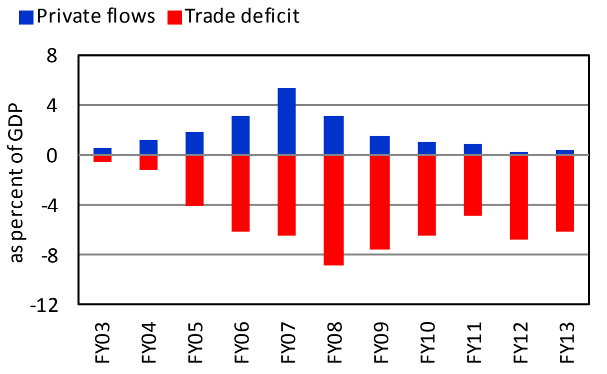
Source: SBP

72. The external current account deficit, on the other hand, narrowed by about half in FY13 compared to FY12; from $4.7 billion or 2 percent of GDP to $2.3 billion or 1.0 percent (**Table 7**). Most of this improvement is due to the receipt of $1.8 billion under the Coalition Support Fund (CSF). With export earnings remain flat and import payments declining slightly, the trade deficit reduced by $700 million, to $15.1 billion. The growth in workers' remittances also tapered off to 5.6

percent though still contributing a significant amount of $13.9 billion[17]. For FY14, the external current account deficit is expected to increase to $3 billion or 1.2 percent of GDP.

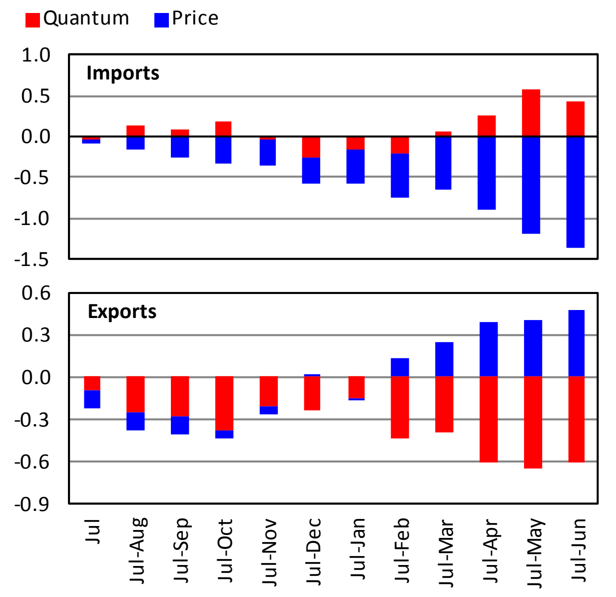
73. Although the trade deficit, as a percentage of GDP, has remained in the range of 6.5 to 7.0 percent during the last two years, the real challenge for the balance of payments position is to attract sufficient private financial inflows to finance it and build foreign exchange reserves (**Figure 16).** This distinction in prioritizing the source of stress is important from the perspective of interest rate and exchange rate policy.

Figure 16: Trade Deficit Financing



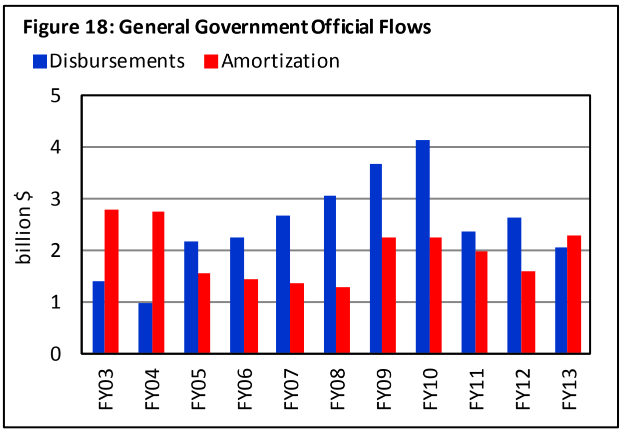
74. An analysis of the disaggregated trade data for FY13 reveals that despite better export prices, especially for rice and cotton cloth, most categories experienced a broad based decline in exports (**Figure 17**). As a result, the export to GDP ratio continued its declining trend and came down further to 10 percent in FY13. Increase in sugar, cement and jewelry exports, however, did contribute in the marginal export growth.

Figure 17: Composition of Changes in Imports and Exports - FY13

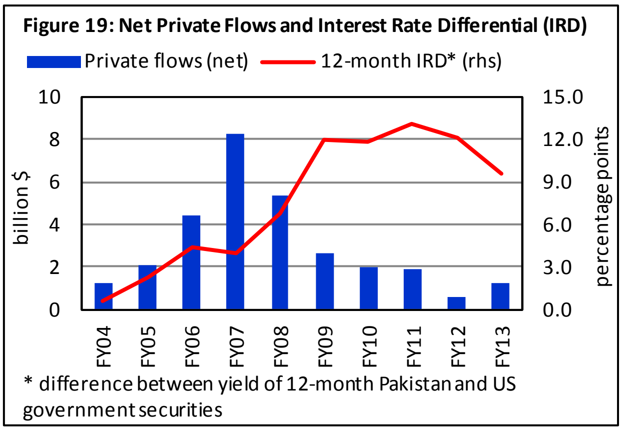


75. On the contrary, the decline in import growth was mostly due to lower import prices, especially of raw cotton, palm oil, and petroleum crude. A positive development is that categories like Metals, Machinery, and Textiles show strong growth, which may be interpreted as an early sign of likely improvement in economic activity, especially in the industrial sector. Incorporating domestic industry specific and global developments, both export receipts and import payments are projected to grow by 6 percent in FY14.

[17] The slowdown is due to a host of factors including: (i) tighter immigration policies by Saudi Arabia and Middle East; (ii) continued weak global growth; and (iii) delayed payment of cash incentive by the government to banks announced under Paksitan Remitance Initiative.



76. While improving productivity and diversification of products and markets is an important medium term consideration for increasing exports, attracting financial inflows is a more urgent requirement. The net capital and financial flows continued their declining trend, reaching 0.2 percent of GDP or $517 million in FY13 compared to $1.5 billion in FY12. The main factor for this drastic decline is lower disbursements and higher amortization of government's official loans (**Figure 18**). The net private direct and portfolio investments in FY13, however, showed an improvement of $666 million over FY12.[18]



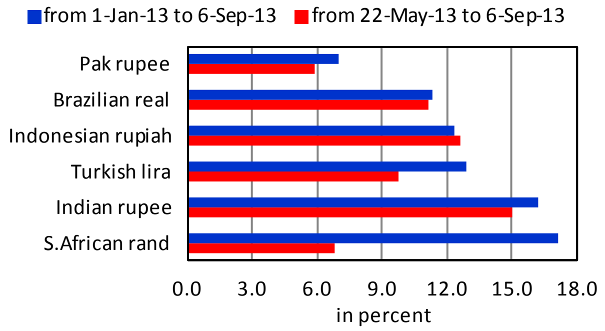
77. At a broader level, absence of adequate security conditions, and weak fiscal fundamentals have been the major factors responsible for a sustained decline in foreign private inflows. Therefore, despite higher returns on rupee denominated assets vis-à-vis foreign currency assets, private inflows have continued to decline since FY08 – the year Pakistan's economy experienced a balance of payments crisis (**Figure 19**). While these factors indicated an increased risk premium associated with investing in Pakistan in the past few years, the current macroeconomic policy scenario has considerably improved the investment outlook.

78. With clarity on the political front together with expectations of an increased focus on reviving investment expenditures in the economy, the foreign private financial inflows could experience a surge in FY14. The newly-initiated fiscal consolidation efforts of the government could also boost offshore investors' confidence and announce Pakistan's return to international capital markets. Moreover, the likelihood of receiving higher financial flows has increased following the initiation of the new IMF program.

[18] Most of this increase, around $400 million, is on account of shares buyback by Unilever. Excluding this, the foreign direct investment comes down to the same level as last year.

79. However, conditions in global financial markets, post the announcement of tapering-off of Quantitative Easing (QE) by the Federal Reserve of USA in May 2013, have become very volatile and indicate a low risk appetite by foreign investors for emerging economies. This may influence the flow of capital to Pakistan as well. For instance, many emerging economies, led by India, have experienced substantial depreciation in the value of their currencies (**Figure 20**). Increased volatility and depreciation in Pak rupee since mid-June 2013 onwards is partly because of these factors.

Figure 20: Depreciation of Selected Currencies against US dollar

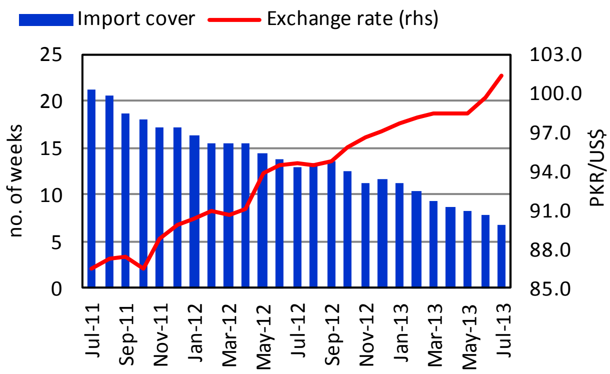


Note: on 22nd May 2013, Fed announced the tapering off its QE program

80. In any case, higher amortization of government debt and repayments to IMF are likely to continue to keep the balance of payments position in stress. Therefore, maintaining exchange rate stability as well as building SBP reserves would remain a challenging task. Nevertheless, despite these pressures and speculations of a significant drop in the value of Pak rupee, the foreign exchange market has largely remained stable. Specifically, the rupee-dollar exchange rate depreciated by 5.1 percent in FY13.

81. With SBP's foreign exchange reserves falling below the adequacy level (in terms of weeks of imports) the rupee has depreciated by 5.0 percent by 12th September, 2013 since the beginning of FY14 (**Figure 21**). In addition to global developments, speculative sentiments in the market in anticipation of the new IMF program are responsible for this accelerated depreciation. After the successful initiation of the program in September 2013 a relieve in pressure in the foreign exchange market can be expected.

Figure 21: Foreign Reserves Adequacy and Exchange Rate



82. On its part, the SBP has made calibrated foreign exchange interventions to ensure smooth functioning of foreign exchange market. It has also used $815 million

in FY13 from the currency swap arrangement with China to shore up its reserves. The basic rationale for these interventions has been to avoid multiple costs to the economy of an abrupt movement in the exchange rate. Examples of these costs include: negative impact on inflation outlook and rise in repayments of existing external debt and liabilities. It must be remembered that interventions by the SBP has its limits. Only a sustained increase in private foreign investment inflows can ease the pressures in the foreign exchange market.

E. Economic Growth: Revival in Investment Remains the Main Challenge

83. The growth in real GDP in FY13 remained anemic for yet another year. According to provisional National Income Accounts estimates, it grew by 3.6 percent against the target of 4.3 percent (**Table 8**). In particular, the services and agriculture sector missed their respective targets by a wide margin. The performance of the agriculture sector was mixed during FY13. While cotton and rice fell short of their respective targets, there were bumper sugarcane and wheat crops.[19]

Table 8: Supply Side of the Economy
percent growth

	FY10	FY11	FY12^R	FY13^T	FY13^P
Agriculture	0.2	2.0	3.5	4.0	3.3
Industry	3.4	4.7	2.7	3.8	3.5
Services	3.2	3.9	5.3	4.6	3.7
GDP (FC)	**2.6**	**3.7**	**4.4**	**4.3**	**3.6**

FC: Factor cost; T: Target; P: Provisional; R: Revised
Source: PBS

84. The industrial sector did show some improvement over the last year despite consistent problems of energy shortages. One underlying reason for this is slightly better utilization of installed productive capacity. The Large-scale Manufacturing (LSM) sector, for example, grew by 4.3 percent in FY13 compared to 1.2 percent in FY12 and only 0.3 percent average growth in the last five years. Similarly, *construction* and *mining & quarrying* sectors grew relatively faster at 5.2 and 7.6 percent respectively. One of the more important industrial sector, the *electricity generation and gas distribution,* however, contracted by 3.2 percent during FY13. This puts a question mark on the sustainability of growth in the industrial sector, and thus the overall economy.

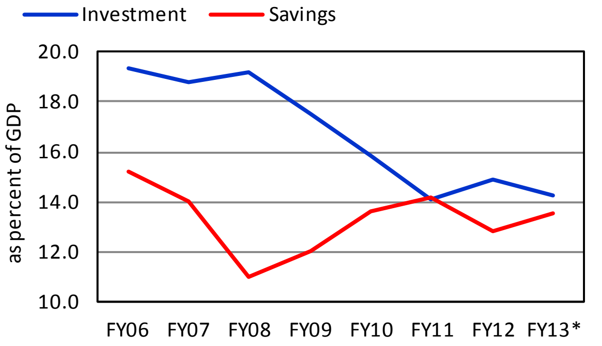
85. At the broader level, the fundamental factors that determine an economy's long-term growth, such as rule of law, better economic governance, and high productivity, largely remained unaddressed. In terms of specifics, the key reason

[19] Cotton and rice production during FY13 was estimated at 13.0 million bales and 5.5 million tons against the target of 14.5 million bales and 6.9 million ton. The wheat and sugarcane crops witnessed growth of 3.2 and 7.0 percent. The sugarcane production actually exceeded the target by a big margin.

responsible for the weak growth performance in FY13 were persistent and severe energy shortages and lack of private sector investment in the economy.[20] Thus, despite ease in the monetary policy stance over the last two years amid declining inflation economic growth has not picked up.

86. An inspection of the demand side of the GDP data confirm that private investment expenditures have declined for the fifth consecutive year in FY13 reaching 8.7 as percent of GDP. As a result, investment expenditures, as percent of GDP, have declined to 14.2 percent (**Figure 22**). This is quite worrisome since the sustainability of macroeconomic stabilization and growth critically hinges upon investment growth.

Figure 22: Saving - Investment Gap



* provisional

87. The growth continues to be driven by consumption expenditures, in particular that of the government. A smaller contribution of investment together with a high share of consumption in GDP growth is not sustainable. Over time, it runs the risk of keeping the need for borrowings, both domestic and foreign, at a high level while the capacity and potential of the economy to meet its aggregate demand deteriorates. Besides domestic issues mentioned above, fragile global economic conditions affecting the risk appetite of foreign investors are also contributing in keeping the investment expenditures suppressed in the economy.

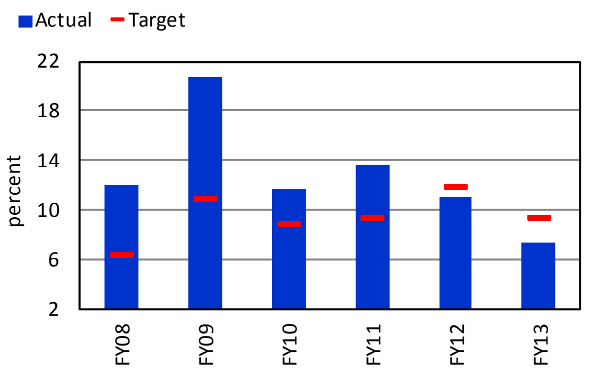
88. Nonetheless, initiation of energy reforms by the new government offers a ray of hope. Also, energy shortages themselves offer investment opportunities in electricity generation and distribution. Since most of the LSM sectors are operating at about fifty percent capacity any improvement in energy supplies alone can help in achieving better industrial-led growth. Assuming that the effects of energy reforms will trickle down and the government manages to invest in the economy by effectively utilizing its development funds, real GDP is expected to grow by 4.1 percent in FY14.

[20] The Planning Commission of Pakistan (*The Causes and Impacts of Power Sector Circular Debt in Pakistan, March 2013*) estimates that around 10 percent GDP was lost in last five years due to energy shortages and the problem is far from being resolved. The energy shortages were around 43 percent in peak hours during FY12 (SBP Annual Report 2011-12). Anecdotal evidence suggests that the situation during FY13 has not changed much.

F. Inflation: Deceleration Seems to be Transient

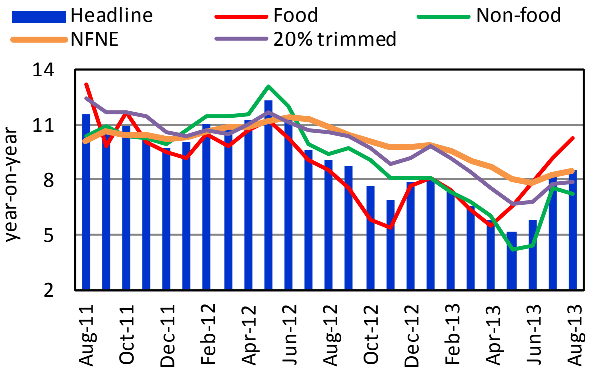
89. The deceleration in year-on-year CPI inflation, which has been on a declining trend since December 2010, picked up pace in FY13. As a result, the average CPI inflation in FY13 came down significantly to 7.4 percent – a little more than 2 percentage points lower than the target for the year – after remaining in double digits for five consecutive years (**Figure 23**). Importantly, this decline has been broad based. Inflation of all categories and measures, such as food, non-food, core, imports, and government-administered, showed a declining trend (**Figure 24**). Similarly, the number of CPI items experiencing an inflation of more than 10 percent almost halved in FY13.

Figure 23: Average Headline CPI Inflation - Actual vs. Target



90. The main reasons for this broad-based deceleration in inflation are threefold. First, an overall economic slowdown generally tends to drag inflation down with a lag. The average GDP growth rate during the last five years was just 2.9 percent compared to the long run average of around 5 percent. More specifically, it is the deceleration in aggregate demand relative to the productive capacity of the economy that helps in bringing inflation down.

Figure 24: Trend in Measures of CPI Inflation



91. Second, international prices of major imports such as palm oil, petroleum crude and products, and raw cotton remained largely stable in FY13. At the same time, due to calibrated interventions by the SBP, the exchange rate also experienced marginal depreciation, contrary to speculations. These factors contributed in containing the impact of import prices and exchange rate depreciation on CPI inflation. Given the vulnerable balance of payments position, however, there is a risk of pass-through of exchange rate changes to inflation.

92. Third, financed by substantial borrowings from the banking system, the government has provided explicit and implicit subsidies to keep the administered prices under check. The Tariff Differential Subsidy (TDS) is a prominent example of an explicit subsidy, which the government uses to keep the price of electricity lower than its cost of production. Implicit subsidies involve costs incurred by the government in regulating the wheat flour and motor fuel prices.

93. This partly explains the apparent disconnect between high fiscal-led M2 growth and decelerating inflation. Further, a significant part of these fiscal borrowings are being used to service the accumulated debt which does not represent current government demand. Deceleration in core measures of inflation support this conjecture that demand pressure in the economy subsided considerably during FY13. Moreover, with considerable decline in actual inflation the expectations of inflation remaining low gained momentum as well.

94. However, the sustainability of these subsidies and the overall fiscal position was always questionable. This is because of numerous negative implications of high level of borrowings and accumulation of circular debt in the energy sector due to delays in price adjustment. It was just a matter of time before these administered prices had to be adjusted and this is what has happened. The government has announced considerable upward adjustments in electricity prices, adversely affecting the inflation outlook.

95. The year-on-year CPI inflation has already jumped to 8.5 percent in August 2013 compared to 5.9 percent in June 2013. Even the monthly increase in CPI inflation in July and August 2013 has been 1.6 percent on average. This sharp increase in inflation, however, was not unexpected.

96. First, it includes the impact of increase in the General Sales Tax (GST) as well as withdrawal of GST exemptions on certain products in the FY14 federal budget in June 2013. Second, inflation typically goes up in Ramadan due to higher demand as well as high profiteering attitude of the market. Third, the monthly inflation in the House Rent Index (HRI), which has a share of 21.8 percent in the CPI basket, was 2.5 percent in July 2013 compared to an average of 1.7 percent in FY13. Fourth, the base effect; that is, due to a reduction in gas tariff by 49 percent in July 2012, increase in inflation in July 2013 has been arithmetically amplified.

Table 9: Average Inflation			
in percent			
	FY12	**FY13**	**FY14[1]**
CPI headline	**11.0**	**7.4**	**11.0 - 12.0**
Food group: *of which*	11.0	7.1	
perishable	*6.7*	*1.5*	
Non-food group: *of which*	11.0	7.5	
energy group	*13.0*	*-2.1*	
Core measures			
Non-food non-energy	10.6	9.6	
20% trimmed	11.5	9.0	

[1] Projections

Source: PBS and SBP

97. Nevertheless, the impact of upward adjustments in electricity prices, already announced for industrial and commercial consumers and expected for household consumers, on inflation outlook cannot be under-estimated. In addition to having a considerable direct effect on CPI inflation, there is a high likelihood of substantial indirect effects as well. Similarly, increase in the GST together with removal of certain exemptions could put further pressure on inflation in the coming months of FY14. Finally, the pace and scale of fiscal borrowings from the banking system is worrisome. There is a risk that inflation may catch up with high growth in fiscal driven monetary expansion. Based on these consideration, the SBP projects average inflation in FY14 to fall between 11 to 12 percent in FY14 (**Table 9**).

III. Concluding Remarks

98. FY13 yet remained another year when the country struggled to manage its fiscal and external deficits. Sharp increase in fiscal borrowings and declining trend in both domestic and foreign investment are a manifestation of structural issues faced by the economy. Moreover, the country has been witnessing bouts of growth and stable inflation for the past several years but a sustainable performance remained elusive. The deep down factors responsible for sluggish long-term economic growth have been the absence of rule of law, weak economic governance, and low productivity.

99. The role of monetary policy was always going to be limited in this environment; both in terms of keeping inflation low and stable and supporting private investment activity. Despite substantial reduction in the policy rate, followed by a decline in market interest rates, there has been no real broad-based recovery in credit utilization by the private sector. As a result, real private investment expenditures have been declining for the fifth consecutive year. Apart from weak credit demand, dominance of fiscal authority as an insatiable borrower continues to afflict the balance sheet of scheduled banks and thus the supply of credit.

100. Despite low interest rates, floor on savings deposits, declining ADR and high NPLs, the profitability of the banking sector has remained largely intact, particularly

of the large banks. These healthy financial outturns have been made possible by banks' aggressive investment in government securities over the last few years. However, excessive investment in government securities by banks is not without cost. It reduces financial intermediation, affects asset diversification negatively, diminishes banks' ability to lend for long term, and creates risks of revaluation losses.

101. There are strong inter-linkages between risks to financial and banking system stability, overall macroeconomic stability, and growth prospects. This has been amply demonstrated in the aftermath of ongoing global financial and economic crisis. Thus, risks to the financial stability need to be analyzed carefully to avoid negative repercussions for the entire economy.

102. Bringing the fiscal deficit down essentially requires increase in tax generation capacity. There is an urgent need to initiate and implement comprehensive tax reforms. Inflation tax and lack of credit for the private sector are some examples of failure to undertake such reforms. The debt sustainability analysis also suggests that containing the debt to GDP ratio at current level would require the government to reduce its primary deficit to below 2 percent of GDP.

103. Admittedly, the fiscal authorities have shown their intention to bring fiscal deficit down by delineating several measures of fiscal consolidation in its FY14 budget. Some of the steps have already been taken and others will be taken in due course of time. This is all appreciated, however, a major risk of not delivering the announced fiscal deficit target emanates from the revenue side. Similarly, the likelihood of keeping the energy sector subsidies within the budgeted amount has increased given the significant increases in electricity tariffs. But, the need to address inefficiencies associated with electricity transmission and distribution still remains. This would be important to stem the accumulation of circular debt in the energy sector yet again.

104. Moreover, non realization of budgeted privatization proceeds and non-tax revenue items like proceeds from the auction of 3G licenses, as has been the case for some years now, carry the risk of escalation in fiscal borrowings from the banking system, with multiple negative implications for the economy.

105. On the external front, while improving productivity and diversification of products and markets is an important medium term consideration for increasing exports, attracting financial inflows is a much more urgent requirement to make the

external sector sustainable. At a broader level, absence of adequate security conditions, an uncertain and volatile political environment, and weak macroeconomic and fiscal fundamentals are the major factors responsible for a sustained decline in foreign private inflows.

106. With clarity on the political front together with expectations of an increased focus on reviving investment expenditures in the economy, the foreign private financial inflows could experience a surge in FY14. However, conditions in global financial markets, post the announcement of tapering-off of Quantitative Easing (QE) by the Federal Reserve of USA in May 2013, have become very volatile and indicate a low risk appetite by foreign investors for emerging economies. This may influence the flow of capital to Pakistan as well.

107. Given the various macroeconomic factors and trends described above and the need to contain inflation expectations in the economy, the SBP Central Board of Directors has decided to increase the SBP policy rate by 50 bps to 9.5 percent with effect from 16th September, 2013.