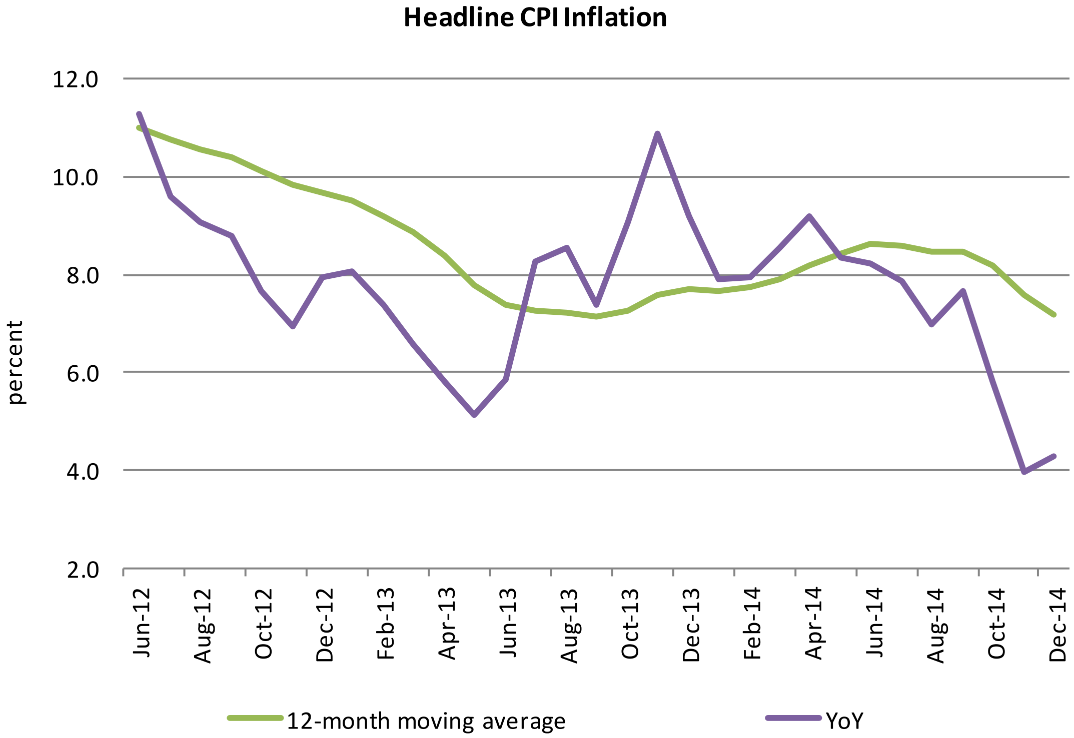
MONETARY POLICY STATEMENT

January 2015



STATE BANK OF PAKISTAN

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Executive Summary

1. The key macroeconomic indicators have improved further since the last monetary policy decision of November 2014. CPI inflation and its expectations continue to follow a downward trajectory. In the last two months of November and December 2014 trade deficit has declined, though it has increased in H1-FY15 when compared to H1-FY14. Moreover, considerable foreign exchange inflows have contributed in maintaining an upward trajectory in foreign exchange reserves. Containment of fiscal deficit thus far is also encouraging and bodes well for the credibility of consistent and coherent policies of the government and for the continuation of official and private capital inflows. With these positive developments, first half of the current fiscal year ended on a better macroeconomic outlook for the remaining months of FY15.

2. While the impact of recent policy rate cut on the economy is subject to a lag, various other factors continued to pull the headline CPI inflation on YoY basis down to 4.3 percent in December 2014. This disinflation is broad based as both food and non-food inflation have been declining. The deceleration in the former is mainly the result of better supply conditions, while the latter is explained by a combination of factors. These include plummeting international oil price as well as decline in other global commodity prices; lagged impact of earlier conservative monetary policy stance and moderating aggregate demand; and stable exchange rate.

3. Similar to YoY CPI inflation dynamics, average CPI inflation during July-December 2014 has also come down to 6.1 percent and both measures of core inflation, NFNE and trim, have decelerated to 6.7 percent and 5.2 percent, respectively. At the same time, given the reduction in domestic oil prices and its second round impact, such as on transport services, inflation is likely to decrease further going forward. Accordingly, SBP has revised downwards its forecast range for average CPI inflation to 4.5 – 5.5 percent for FY15, well below the annual target of 8 percent. Moreover, inflation expectations as per IBA-SBP Consumer Confidence Survey of January 2015 are subdued.

4. It is pertinent to note here that while the recent plunge in international oil price has induced low inflation and improved trade outlook, it is not without some subtle risks to future inflation. The speed and intensity, with which the inflation has come down and continues to recede, can induce expectations of rather low inflation, which may induce additional consumption. There is no doubt about the

redistribution of income from oil producers to oil consumers and since the latter has a higher propensity to consume, there will be some affect on private consumption. Thus, the recent reduction in domestic commodity prices may lead to more spending and as long as additional impact on aggregate demand remains in line with aggregate supply, inflation is likely to remain low.

5. International oil price decrease, through its expected favorable impact on trade balance, contributed in improving the external sector outlook in recent months. In addition to this, successful completion of fourth and fifth review under IMF's EFF and issuance of International Sukuk have also contributed to improvement in overall BoP position. In effect, these developments have been instrumental in improving sentiments in the foreign exchange market and have supported SBP in its reserve building efforts. With IMF program on track and expected proceeds from privatization and official flows, the net SBP reserves are projected to increase further.

6. However, non realization of planned privatization proceeds and lack of private inflows could pose risks in achieving a sustainable BoP position. Note that by the end of FY14, net private direct and portfolio investments were merely 1.8 percent of GDP. Similarly, exports that by the end of FY14 were 10.2 percent of GDP are broadly following a decline in FY15. Policies and reforms to attract foreign direct investment should be the top priority. While securing the GSP plus status is definitely encouraging, to fully exploit its benefits there should be programs and plans for product diversification in exports as well.

7. Fiscal deficit was contained despite substantial increase in interest payments in Q1-FY15 and government borrowing from SBP remained below the agreed targets. As government managed to contain expenditures related to PSEs, it increased the development spending compared to last year. However, growth in FBR revenue collection moderated due to downward adjustment in petroleum prices and slowdown in Large-scale manufacturing. Going forward, overall expenditures could increase due to higher security related expenditures. This along with expected shortfall in FBR revenues may make meeting the fiscal deficit target more challenging.

8. Owing mainly to the reduction in government budgetary borrowing from the SBP, deceleration in broad money (M2) growth which had started in FY14 continued in H1-FY15. In particular, M2's weekly cumulative flow suggests that the slowdown is

visibly lower than its past five years' average flow. While the external inflows helped in boosting NFA, NDA decelerated. The factors that contributed in the deceleration in NDA were lower off-take in private sector credit as well as lending to PSEs. Thus, the growth in M2 is broadly compatible with the inflation and economic growth trends in the economy. Going forward, demand for private sector credit and commodity financing is expected to increase. Therefore, M2 is expected to grow within a range of 11.0 – 12.0 percent in FY15.

9. The credit to private sector uptake during H1-FY15 is lower than the level witnessed during the same period last year. This slowdown in credit growth could be attributed to both demand and supply side issues such as weak corporate profitability of major industries till September 2014, shift in government borrowings away from SBP to commercial banks amid slower deposit growth, challenging security situation, falling commodity prices, and continued energy/gas shortages for the industry. However, the momentum of credit off-take is likely to pick up with the realization of the lagged impact of November 2014 policy rate cut.

10. Considering the requirement of funds by both the government and the private sector, the average year-on-year growth in deposits of 12 percent during H1-FY15, compared to 14.26 percent last year, cannot be termed as adequate. Lower growth in private sector credit could be a possible factor behind low deposit growth. While the inflows in savings and time deposits were positive, current deposits declined substantially. Therefore, keeping return on deposits at adequate levels is of paramount importance for mobilizing resources in the financial sector. Going forward, falling domestic oil prices and inflation may increase the real disposable income of households and reduce the input cost for the industry and reflect positively on deposit growth.

11. The interbank market remained tight almost throughout H1-FY15, despite the cut in policy rate. The market dynamics, however, differed in Q1 and Q2. During Q1-FY15 liquidity conditions remained tight primarily due to FX market considerations. In Q2-FY15, while pressures in FX market eased substantially, government shifted its borrowing from SBP to the commercial banks. The continued decline in inflation retained scheduled banks' appetite for investment in long-term securities in the Q2-FY15 as the expectation of further cut in interest rate strengthened. Going forward, the realization of expected external inflows is likely to reduce the budgetary

borrowing requirements from scheduled banks and improve liquidity conditions in money market.

12. Amid improving macroeconomic conditions, business sentiments are likely to strengthen. Availability of cheap raw material, low input cost, and healthy construction activity, as indicated by higher cement sale and steel production, are expected to benefit commodity producing sector. In addition to this, as a result of recent redistribution of oil price decrease related income from producer to consumer, demand and thus production of consumer durables may increase. On the other hand, with limited impact of floods on rice and sugarcane crops and with incentives for *Rabi* crops in place, the prospects for a better agriculture sector performance in this fiscal year is high. In this backdrop, the real GDP is therefore expected to maintain the growth momentum achieved in the last year into FY15 as well.

13. Given the above macroeconomic developments, the Central Board of Directors has decided to reduce the SBP policy rate by 100 basis points from 9.5 percent to 8.5 percent effective from 26th January 2015.

A. Global Developments and Outlook

14. Global economy, at the moment, shows amixed picture. On the one hand, economies of Russia, China, Japan and Euro zone are faltering. On the other hand, US economy is strengthening. The rapid decline in prices of commodities such as oil and cotton is adding to the uncertainties about global economy. All these developments have important implications for Pakistan's trade deficit going forward. If the oil prices stay at current levels or fall further, the balance of payments position of Pakistan could improve and stabilize the exchange rate even further. Some gains may, however, be eroded because of possible slowdown in exports growth due to expected weak global demand.

15. International oil prices (Saudi Arabian light) have sharply declined by 51 percent during H1-FY15, reaching their lowest level for about six years. This fall is largely associated with sluggish global demand and new shale oil discoveries in North America and a reluctance on part of major oil exporting countries to reduce their supplies in the international market. Cotton prices witnessed decline amid surplus world stocks and low import demand by China. International food prices, on the back of abundant supplies amid fall in demand, experienced significant fall as well. Consequently, IMF's all commodity price index posted a 29.6 percent decline during H1-FY15. The decline is in sharp contrast to a rise of 2.8 percent last year.

16. Russian economy, for the first time in last five years, contracted by 0.5 percent during November 2014. This contraction is a result of economic sanctions and steep fall in oil revenues. The Russian Ruble reacted negatively to oil price plunge and it's depreciation raised fears of a financial crisis because large part of corporate debt of Russia is dollar-denominated. In an effort to strengthen Ruble, the central bank raised its policy rate from 10.5 percent to 17 percent in December 2014. China struggled to regain its growth momentum during H1-FY15 and resorted to quantitative easing measures recently. Japan's economy, despite posting stronger than expected growth in the first quarter of 2014, contracted in the second and third quarter[1], largely in response to rise in the consumption tax.

17. Similarly, economic conditions in the Euro zone remained sluggish. GDP growth of 0.6 percent in the third quarter against the target of 2.0 percent, concerns about deflation, and rising unemployment underline the continued struggle for the

[1] GDP fell at an annualized 1.6 percent from July to September 2014, compared with forecasts of a 2.1 percent rise.

Euro zone. In a bid to kickstart the economies of the Euro zone, European Cental Bank (ECB) has cut the benchmark interest rate to 0.05 percent and has also initiated an asset purchase program. Further quantitative easing (QE) is expected in the next quarter. All these measures may help revive growth in EU—a major trading partner of Pakistan.

18. In contrast, US economic activity upheld increasing momentum in 2014 as it grew by 4.6 percent and 5.0 percent in the second and third quarter, respectively. Strengthening labor market, improving consumer confidence, rising industrial production, and the resultant appreciation of dollar has made the US economic outlook positive. However, it remains to be seen how much can the world's largest economy tug along the global economy.

19. Amidst mixed global growth trends, IMF has recently revised global GDP growth estimate by 0.3 percentage points downard to 3.5 percent and 3.7 percent for 2015 and 2016 respectively, from earlier estimates of October 2014[2]. Weak global demand, partiularly the Chinese import demand, is also reflected in slowdown in world trade. WTO has estimated that world trade growth, in 2014, may fall to 3.1 percent from an earlier estimate of 4.7 percent. Similarly, it has also revised downwards the trade growth estimates of 2015 to 4.0 percent—well below the 20-year average growth of 5.3 percent.

20. These developments in the world economy has affected key global financial markets during 2014 as well. Capital markets of advanced economies registered mixed trend with the US stock market ending up on a positive note in response to positive sentiments. Emerging markets also generated mixed returns and remained modestly low overall. Global Sukuk market, remaining buoyant in H1-FY15[3], may, however, experience tight liquidity in the coming year due to falling oil revenues of Gulf countries—the main drivers of Sukuk market.

B. Domestic Developments and Outlook

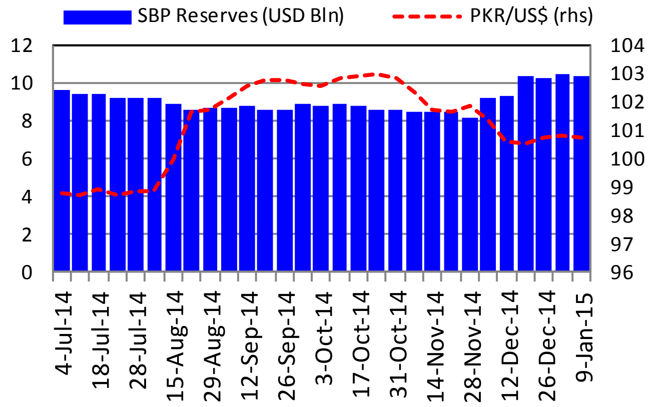
I. Market Interest Rates: Inflation Expectations Shaping Interest Rates Changes

21. While the policy rate was kept unchanged by SBP in its monetary policy decisions of July and September 2014, softening inflationary pressures and

[2] As per *World Economic Outlook Update-January 2015*.
[3] UK, Senegal, Indonesia, Hong Kong, Luxemburg, South Africa, and Pakistan have successfully issued Sukuk during H1-FY15.

improvements in external account facilitated SBP to cut its policy rate by 50bps in the November 2014 Monetary Policy decision.

Figure 1: SBP Reserves Position and Exchange Rate Movements



Source: SBP

22. Market sentiments have been improving since September 2014 because of: (i) receipt of CSF payments in September 2014; (ii) global oil prices slumped to multi-year low in October 2014, auguring well for the country's trade deficit; and (iii) successful completion of government's 4th and 5th Review with the IMF in November 2014 that gave rise to expectations of combined disbursement of two tranches worth US$ 1.1 billion in December 2014. Led by these sentiments, PKR posted a 1.1 percent appreciation in November 2014, despite a US$ 396 million decline in SBP liquid reserves during the month on account of IMF and other debt repayments. Later, however, the IMF disbursement and successful issuance of Sukuk in the international market boosted FX reserves by US$ 2.1 billion in December 2014 (**Figure 1**).

23. Maintaining stability in the FX market with a view to achieve IMF quarterly targets was the key consideration of SBP's liquidity management operations. After remaining stable in H2-FY14, forex market came under pressure in Q1-FY15 as FX reserves posted a US$ 628.0 million decline and PKR depreciated by 3.7 percent.[4] A number of factors were responsible for this, which included, a widening current account deficit in Q1-FY15, uncertainty regarding the successful completion of the IMF's 4th Review meetings in August 2014, and non-realization of planned privatization receipts. The impact of these developments was compounded by political uncertainty in the country especially from August 2014 onwards.

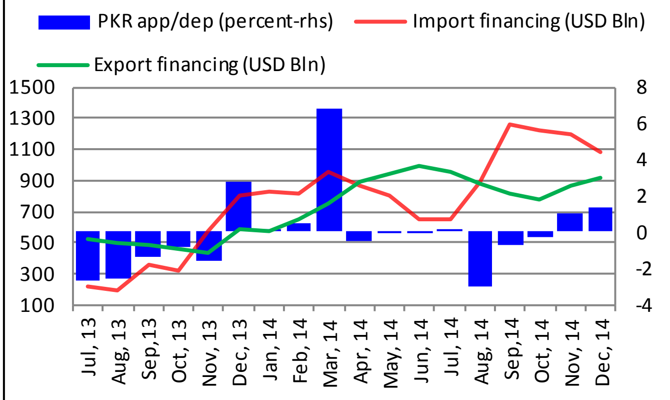
24. Furthermore, due to the non-realization of planned external inflows and to meet the IMF target on government borrowing from the central bank, the governemnt was compelled to rely more on commercial banks for deficit financing. Cognizant of these developments, SBP calibrated its money market operations to ensure stability in the forex market and kept the liquidity conditions tight during Q1-

[4] It is important to note that because of increasing recourse to import financing, commercial bank's reserves posted a more pronounced decline in Q1-FY15.

FY15. However, despite higher inflows in the forex market in Q2-FY15, the liquidity shortages increased in Q2-FY15 primarily due to the pattern of government borrowing from the banking system.

25. Furthermore, the FX reserves held by commercial banks also saw some decline during H1-FY15. This was mainly due to increasing recourse to FX loans by traders, driven by a surge in import financing that peaked in September 2014 (**Figure 2**).

Figure 2: Trade Financing Against FE-25 Deposits



Source: SBP

26. In the absence of financial inflows, the delay in privatization proceeds did not allow SBP to meet the target for Net International Reserves (NIR) for end-September 2014. However, SBP was able to meet the target on its net short swap/forward position with a margin in September 2014. The improvements in Q2-FY15 have helped SBP meet the targets for both NIR and outstanding swap/forward position for end-December 2014.

27. The continued decline in headline CPI inflation in Q2-FY15 further increased banks' appetite for investment in long-term securities. The offer-to-target ratio, for PIB auctions, increased significantly from 1.3 in Q1-FY15 to 5.5 in Q2-FY15. Specifically, the goverment raised Rs372.5 billion through auctions of PIBs in Q2-FY15 (see **Table 1**).[5]

Table 1: Auctions of Government Securities

billion Rupees

	FY14		FY15	
	Q1	Q2	Q1	Q2
PIBs	65.9	105.6	303.7	372.4
T-bills*	-245.7	98.2	10.5	-3.5

Source: SBP

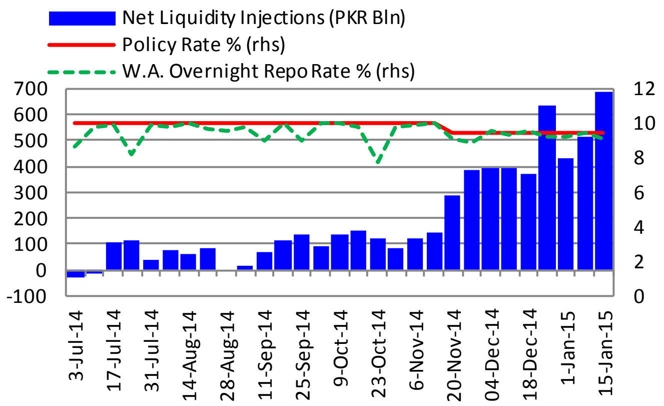
* net of maturity acceptance

28. Moreover, efforts to meet the end quarter target pertaining to government borrowing from SBP further increased liquidity requirements of the interbank. In addition, a 0.7 percent contraction in deposits of the banks in Q2-FY15, also compounded the liquidity shortages in the interbank market. Resultantly, as seen from the volume of injections, liquidity shortages were more pronounced in Q2-FY15 than the preceding quarter. The outstanding volume of net OMO injections peaked to Rs666 billion in December 2014 and the daily average volume of outstanding OMO

[5] GoP raised an almost similar amount of Rs304 billion through PIB auctions in Q1-FY15. However, the very amount appears to be a meager Rs45 billion after adjusting for a hefty interest payments of Rs259 billion during the same period.

injections increased from Rs63 billion in Q1-FY15 to Rs281 billion in Q2-FY15. Furthermore, banks visited SBP discount window with a significant volume in Q2-FY15 as compared to Q1-FY15.[6]

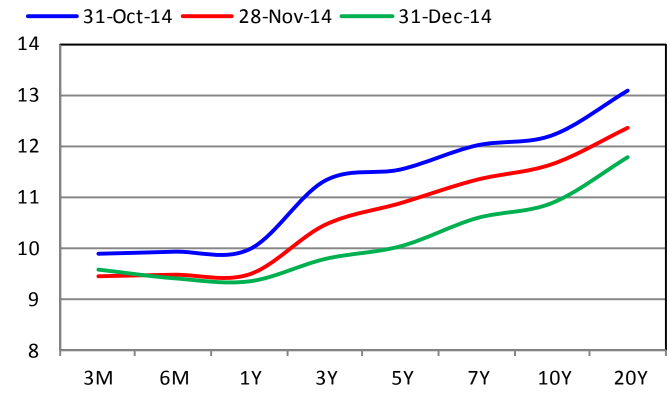
Figure 3: Weekly OMO Injections and Movements in Repo Rate



Source: SBP

29. Despite significant liquidity injections, the weighted average overnight rate remained close to the ceiling of the Interest rate corridor (IRC) almost throughout H1-FY15 (**Figure 3**). The higher interest rates in the money market had flattened the yield curve for MTBs; hence, the return on MTBs appeared to be minimal as compared to PIBs. Furthermore, falling inflations expectations have revived banks' interest in PIBs. Consequently, banks continued to invest in PIBs.[7]

Figure 4: Secondary Market Yield Curves (percent)



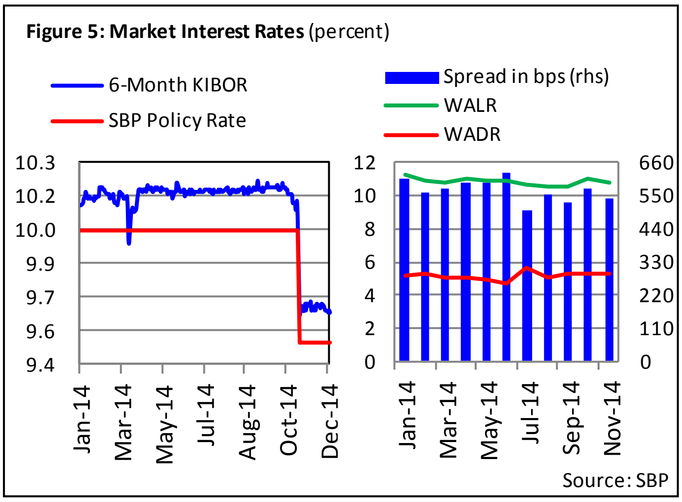
Source: SBP, FMAP

30. The cut in the policy rate has translated to other market interest rates. Against the 50 bps decline in the policy rate in November 2014, the yields of MTBs and PIBs, in the primary market, fell by 49 and 158 bps, respectively. Similarly, secondary market yields are consistently showing a declining trend across all tenors (**Figure 4**).

31. Since, the translation of policy rate to the retail interest rates comes with some lag, it is expected that both WALR and WADR will decline in the coming months. However, the decrease might not be as significant as witnessed in secondary market interest rates for bonds because the retail interest rates follow the trend in

[6] Number of visits on discount window increased from 98 in Q1-FY15 to 118 in Q2-FY15. Also, the volume per visit increased from Rs7 billion in Q1-FY15 to Rs10 billion in Q2-FY15.
[7] Since the start of FY15, the stock of MTBs has increased by a meager Rs81 billion, while the stock of PIBs has increased by Rs668 billion.

benchmark KIBOR, which kept hovering above the policy rate till the first week of January(**Figure 5**).[8]



32. While short term interest rates continue to hover around policy rate, a relatively sharp decline in long term interest rates reveals declining inflation expectations and market anticipation of a further cut in the policy rate in FY15. This can also be observed from the bidding pattern in auction of government securities. Majority of the participation in MTB auctions was skewed towards longer tenor MTBs.[9] This fall in expectations of inflation can also be directly corroborated by IBA-SBP consumer confidence surveys.

33. Furthermore, the decline in global oil prices, the major highlight of H1-FY15, going forward is likely to have a mix effect on the liquidity conditions in the financial markets: (i) the stability in the FX market is expected to continue given that the oil import financing requirement narrows following the oil price slump. This will alleviate additional strain on the overnight money market rates which was seen in Q1-FY15 to reduce excessive pressure on the PKR parity by increasing the cost of rupee liquidity; (ii) lower domestic oil prices may also stimulate business investment because of lowering of cost of production, which may revive the demand for private sector credit; and (iii) lower FBR tax reciepts due to a decline in GST collection on petroleum products may further increase government's borrowing requirements from commercial banks.

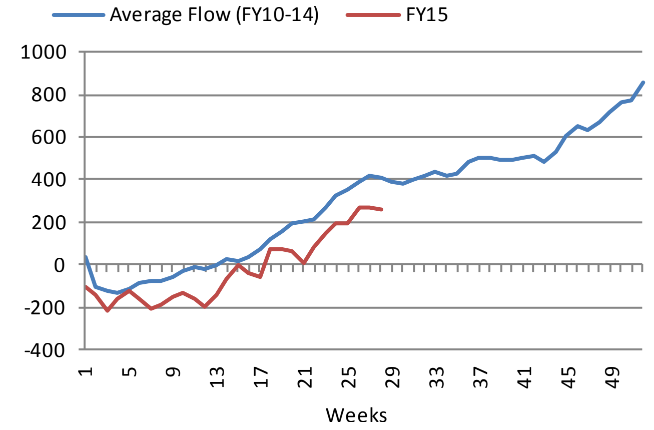
II. Monetary Expansion: Continued Deceleration despite better External Inflows.

34. Unlike earlier assertion that monetary contraction observed in Q1-FY15 is a seasonal phenomenon, recent trends in monetary aggregates suggest that it is

[8] During the calendar year 2014, the 6-month KIBOR has remained 18bps above the policy rate, on average. However, the same has recently dropped by approx. 20bps below the policy rate as on 16 Jan, 2015.
[9] Since the November monetary policy decision, the 6 and 12 month MTBs constitute 94 percent of total participation.

beyond the seasonal factors. This is evident in weekly cumulative flow of broad money, which is visibly lower than its past five years' average growth (**Figure 6**).

Figure 6: Weekly Cumulative Flow of Broad Money (Rs Bln)



35. The YoY growth of broad money as on 9th January, 2014 at 10.0 percent was lower by 3.8 perentage perentage points than the growth observed during the same period last year.[10] This deceleration in growth was largely contributed by Net Domestic Assest (NDA) of the banking system.

36. Government's efforts to improve financing mix of budget deficit and lower its reliance on SBP borrowing mainly led to lower expansion in NDA. Also, subdued credit offtake by the private sector, due to low demand and shift of government budgetary borrowing from SBP to scheduled banks, contributed in slower expansion in NDA (see **Table 2**).

Table 2: Monetary Aggregates

stock and flow in billion Rupees, growth in percent

	June 2014 Stocks	Flows during Jul 01 to 10-Jan-14	9-Jan-15	FY15[1]
NDA: *of which*	9367	663	222	
Net budgetary support	5549	567	255	
SBP	2410	663	-448	
Scheduled banks	3140	-95	703	
Commodity operations	492	-98	-34	
Private sector credit	3729	235	154	
Credit to PSEs	355	58	49	
NFA	601	-218	42	
SBP	490	-227	56	
Scheduled banks	111	10	-14	
Money supply (M2)	**9968**	**445**	**264**	
Increase/Decrease (%)	*12.5*	*5.0*	*2.6*	
Reserve money	2861	307	215	
Currency in circulation	2178	270	244	
Total deposits	7777	175	20	
percent growth (YoY)				
Net budgetary support		32.3	-0.2	
SBP		86.9	-31.8	
Scheduled banks		2.9	30.8	
Money supply (M2)		13.8	10.0	11.0-12.0
Reserve money		13.8	8.2	
Currency in circulation		13.2	9.6	
Total deposits		14.0	10.1	

P:Provisional; [1] Projections
Source: SBP

37. These developments in monetary aggregates largely reflect government's commitments with the IMF under its EFF program. With a resolve to meeting the end quarter quantitative target of budgetary borrowing from SBP, government retired Rs39 billion to SBP in Q1-FY15. However it was unable to meet the end Septmber 2014 target of Rs2070 billion.[11,12] Moreover, the quantivative target for SBP NDA for Q1-FY15 was breached.

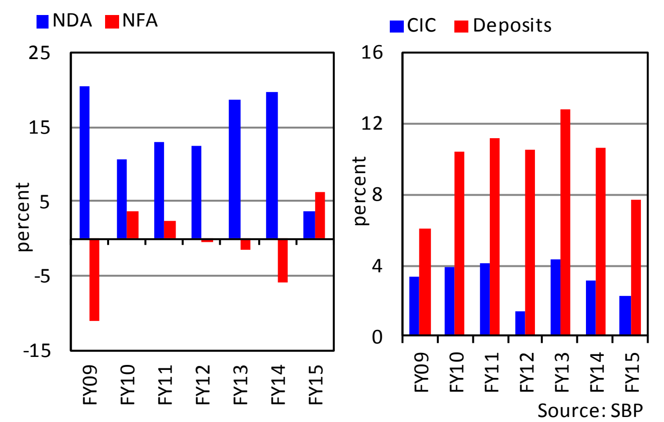
[10] The YoY growth in broad money for the corresponding period last year was 13.8 percent .

38. As government took some corrective measures on its borrowing from SBP, including some prior actions, and SBP's continued efforts to contain NDA, IMF accorded waivers on non-observance of the performance criteria facilitating the successful completion of the fourth and fifth reviews of the EFF leading to the release of USD1.1 billion in December. The retirment pattern continued in Q2FY15, resulting in lowering of government borrowing to well within IMF-EFF target for end December 2014. As a result SBP was also able to keep its NDA below the ceiling agreed under IMF-EFF program. Government has retired Rs447.9 billion (cash basis) to SBP during Jul-Jan 09, 2015, mainly facilitated by higher realization in sale of international sukuk issuance, and receipt of multilateral and bilateral loans and grants besides raising of funds from other domestic sources.

39. Net bugetary borrowings from scheduled banks during Jul-Jan 09, 2014 was Rs703 billion compared with a retirement of Rs95 billion in the same period in FY14. Non bank financing for fiscal deficit also remained considerable at Rs315 billion during Jul-Nov 2014.

40. Recently, SBP has also started conducting OMOs through GOP Ijara Sukkuk (GIS) to manage liqudity of the Islamic Banks. This is expected to improve monetary policy transmission to this emerging component of financial sector besides helping SBP achieve it's NDA target under IMF program.[13] The outright sale of GIS is similar to conventional liquidity mop-ups and reduces SBP's NDA. With substantial Sukuk holding by Islamic Banks, this can help SBP keep its NDA in check.[14]

Figure 7: Contribution in Broad Money Growth (Jul - 9th Jan-FY15)



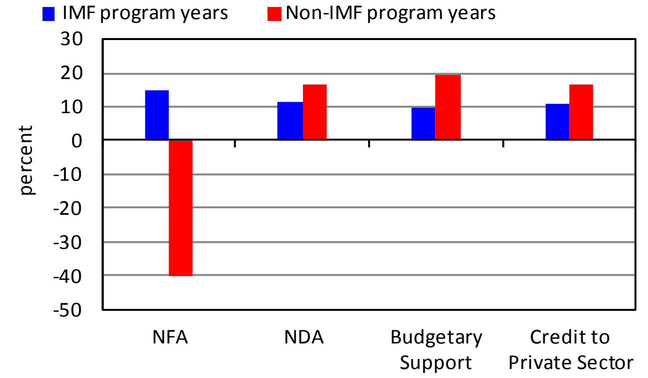
Source: SBP

41. On liability side, both currency in circulation and bank deposits have mirrored the asset side growth pattern in broad money and decelerated visibly for the third year in a row (**Figure 7**).[15] Notably, past IMF programs have also been associated with lower monetary growth with average

[11] The IMF target for government budgetary borrowing is worked out on cash basis. Monetary survey accounts are recorded on accrual basis.
[12] In Q1-FY15, government was successful in keeping flow of budgetary borrowing in negative; which is required at zero under SBP Act.
[13] DMMD Circular No. 17 of 2014 dated October 15,2014.
[14] Total Sukuk holdings stood at Rs. 326.3 billion as of December 31, 2014.
[15] Currency in circulation regsitered YoY growth of of 9.6 percent during Jul- Jan 09, 2014 against 13.2 percent observed in compartive period in FY14. Deposits decelerated to 10.1 percent against 14.0 percent observed in FY14, during the period.

monteray growth of 12.6 percent in IMF program years against 16.2 percent observed in non-program years (**Figure 8**). IMF conditionalities on central bank borrowing and resultantly better availability of external financing alters the deficit financing mix during program years. For FY15, all these factors would contribute towards monetary deceleration besides bringing a shift in sources of money growth which is already visible in actual data. Resultantly, money growth is expected to fall in the range of 11.0 to 12.0 percent for FY15, compared to actual growth of 12.5 percent observed in FY14 and 15.9 percent in FY13.

Figure 8: Average Annual Growth of Monetary Aggregates Components (FY78 to FY14)



Source: SBP

III. Private Sector Credit: Growing at a Slower but Decent Pace

42. Total credit to private sector increased by Rs224.5 billion during H1-FY15; lower than the credit uptake of Rs325.8 billion during the same period last year (see **Table 3**). This slowdown in credit growth could be attributed to both demand and supply side issues such as weak corporate profitability of major industries till September 2014, government borrowings from commercial banks amid slower deposit growth, challenging security situation, falling commodity prices, and continued energy/gas shortages for the industry. Along with the credit growth, the industrial growth in Q1-FY15, as indicated by the LSM index, has also not been as impressive as in the last year.

Table 3: Credit to Private Sector (Flows)

(billion Rupees)	H1-FY15	H1- FY14
Total credit to private sector (*as per weekly*)	222.3	321.3
*Add: Foreign bills purchased**	*2.2*	*4.5*
Total credit to private sector	**224.5**	**325.8**
1.Loans to private sector businesses	**209.8**	**276.3**
By Type		
Working Capital: *of which*	172.9	225.0
Export Finance	44.6	27.6
Import Finance	41.5	27.5
Fixed Investment	36.9	51.3
LMM	6.5	-5.1
By Sectors		
a) Agriculture: *of which*	18.5	17.2
Livestock	9.8	3.7
Fishing	0.2	0.2
b) Industrial Sector:	126.0	199.5
Manufacturing: *of which*	118.6	162.9
Food &beverages	14.9	20.6
Sugar	-30.8	-24.2
Textiles & garments	64.4	98.5
Coke & Refined Petroleum	13.7	11.9
Chemicals	4.2	-3.1
Non-Metallic Mineral Products	5.1	0.7
Cement	4.9	0.4
Energy generation & distribution	-4.4	33.6
Construction	11.8	3.0
c) Services	50.7	50.9
Commerce and Trade	18.3	37.9
Transport , Storage & Communication	10.3	0.3
Telecommunications	10.8	-4.6
Real Estate	14.1	9.5
2. PERSONAL	**17.9**	**18.0**
Consumer Financing	12.3	18.1
3. Equity Investments	**13.3**	**6.5**
4. NBFC	**-13.0**	**-13.3**
5. Others	**-3.5**	**38.3**

* Foreign bills purchased are reported under NFA in Monetary Survey.
Source: State Bank of Pakistan

43. The slowdown in credit growth was mostly led by textiles. Sluggish domestic and international demand, declining cotton and yarn prices and exchange rate fluctuations affected the financial performance of textiles. Consequently, the net profit margins and cash flow of the industry has declined; while costs of goods sold have increased **(**see **Table 4)**. Nonethless, other industries, such as cement and chemicals, showed better financial performance and credit uptake.

Table 4: Corporate Profitability during July- September

	Textiles		Cement		Chemicals	
Ratios	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**
Net Profit Margin	-3.1	3.8	15.2	16.5	25.9	28.6
Financial Expenses to Sales	3.7	3.5	3.1	5.7	3.8	9.1
Cost of Goods Sold to Sales	92.3	86.7	71	67.2	52.3	46.6
Cash Flow to Sales	0.3	6.3	20.6	23	34.5	37.1
Operating Margin	1.5	8.1	24.6	27.6	41.8	50.8

Source: Financial Statements of major listed companies in each sector

44. The agriculture sector, despite recent floods[16], have availed net credit of Rs18.5 billion in H1-FY15 as compared to Rs17.2 billion in H1-FY14. This growth was mostly led by the livestock (Rs9.8 billion) and growing of crops (Rs9.0 billion). The recent announcement of SBP's relief package of Rs10 billion for the farmers in flood affected area with a subsdized mark-up of 8 percent for SMEs and farmers in those regions, may have played some role in sustainability of agriculture credit uptake.

45. On the funding side, banks mobilized deposits of Rs310 billion in H1-FY15 as compared to Rs413 billion in the corresponding period last year (see **Table 5**). The primary sources of these inflows are savings and time deposits. Current deposits, on the contrary, have witnessed a substantial decline. This could probably be due to slowdown in credit to private sector. Falling inflation and the floor on rate of returns on saving deposits have helped achieve a positive real return on saving and time deposits. Ensuring adequate level of returns to depositors will help arrest the falling growth in deposits.

Table 5: Private Sector Deposits- Cumulative Flows (billion Rupees)

Deposit-Type	**H1-FY15**	**H1-FY14**
Current	(145.28)	133.40
Call	(67.53)	(2.83)
Other	5.88	3.49
Saving	350.00	182.42
Time	167.29	96.70
	310.35	**413.18**

46. Apart from slowdown in depoists, heavy government borrowing from commercial banks have constrained their ability to lend to the private sector.[17] Moreover, the risk premium which is defined here as WALR minus three month TBill

[16] As reported by National Disaster Management Authority of Pakistan, the floods have affected 45 districts, damaging farming area of 2.4 million acres and hurting 2.5 million persons of 4,065 villages.

[17] As per Weekly Monetary Survey dated 31st December 2014, government borrowings from commercial banks stood at Rs638 billion as compared to Rs9 billion during the same period last year.

rate, has fallen from an average of 116 bps during H1-FY14 to 95 bps this year. Also, the spread on outstanding loans and deposit rates have fallen by 45 bps from an average of 482 bps during H1-FY14 to 438 bps this year[18]. This indicates that banks have increasingly become risk averse as the gains from taking risk have fallen. Further, November's cut in policy rate of 50bps, has not yet translated into lower real lending rates which may not have favorably impacted the demand for credit.

47. Nonethless, the analysis of the financials of the banking sector, as of Q1-FY15, reveals that the sector remains profitable, capital adequacy is above the minimum regulatory requirements, and there is sizeable growth in investments and advances as compared to Q1-FY14. The outlook of the banking sector is, therefore, stable. If the sector can overcome its decelerating deposits, as is being tried by commercial banks via an intensive national advertisement campaign, it is expected that the slowdown in growth momentum of lending could be arrested, especially in light of the recent cut in policy rate. However, it all depends on a) the pick-up of the aggregate demand b) the performance of industrial sector, c) improvements in law and order d) availability of energy for the industry and e) the behavior of government borrowings from the banking sector in the wake of IMF's cap on the borrowing from the central bank.

48. Moreover, the recenet decline in domestic oil prices and inflation is expected to increase the real disposable income of households and decrease the input cost for the industry. On the one hand, this development may spur deposit and credit growth directly, if economic agents save additional income resulting in banks having more resources to lend. On the other hand, it may indirectly lift credit demand, if households increase their consumption and improved profitability allow businesses to borrow more to meet additional demand.

IV. Fiscal Deficit: Fiscal Consolidation Remains on Track

49. The Q1-FY15 data on fiscal operations show the fiscal deficit at 1.2 percent of GDP compared to 1.1 percent deficit recorded in the corresponding period of last year **(**see **Table 6)**. The slightly higher deficit in Q1-FY15 was mainly due to sharp increase in interest payments and substantial decline in non-tax revenues. Nevertheless, the deficit in Q1-FY15 is in line with the average deficit of 1.2 percent

[18] Additionally, the spread on incremental loans and deposit rates have hardly budged from an average of 360 bps in H1-FY14 to 366bps this year.

during the first quarter of the last three years. The deficit in Q1-FY15 is also well below the IMF target of 1.4 percent of GDP (Rs383 billion) set under EFF.

50. Driven by sharp decline in non-tax revenues, the growth in total revenue significantly decelerated to 1.2 percent in Q1-FY15 compared to 19.9 percent increase in corresponding period of last year. The non-tax revenues, in absence of any one-off revenue items in FY15 so far, declined by 27.3 percent to Rs213 billion in Q1-FY15 compared to Rs293 billion in last year (**Figure 9**).[19] Moreover, growth in FBR revenue collection also moderated to 14.8 percent compared to 17.2 percent increase last year.[20] The latest available data shows FBR tax collection at Rs1162 billion up to December 2014, which suggests that 42 percent growth would be required in H2-FY15 to meet the budget target of Rs2810 billion.

Table6: Summary of Consolidated Fiscal Operations

billion Rupees, unless stated otherwise

	FY15[BE]	Q1-FY14	Q1-FY15[P]
Total revenue: *of which*	**4216**	**830**	**840**
FBR tax revenue	2810	469	538
SBP profit	270	80	68
CSF money	120	0	74
3G license fee	56	0	0
Total expenditures	**5638**	**1117**	**1176**
Current: *of which*	4411	868	1050
Defence	700	146	165
Interest	1325	301	394
Development & Net Lending; *of which*	1347	170	120
Development expenditures[1]	-	87	115
Net lending	120	83	5
Budget balance	**-1422**	**-287**	**-337**
Financing	**1422**	**287**	**337**
External	508	-27	-13
Domestic	914	314	350
Non- Bank	686	116	210
Bank	228	198	140
Memorandum items (as percent of GDP):			
Overall budget balance	-4.9	-1.1	-1.2
Primary balance[2]	-0.3	0.1	0.2
Revenue balance[3]	-0.7	-0.5	-0.8

P: Provisional; BE: Budget Estimates

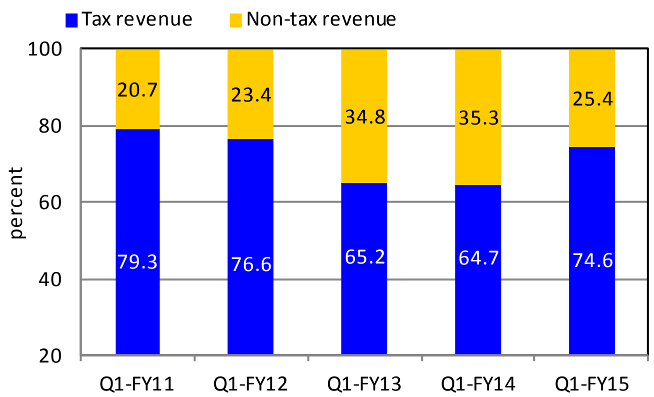
1 Includes PSDP and Other Development expenditures

2 total revenues minus total expenditures (excluding interest payments)

3 total revenues minus current expenditures

Source: Ministry of Finance

Figure 9: Ratio of Tax and Non Tax Revenues in Total Revenues



Source:FBR

51. Lackluster performance of large-scale manufacturing in the first five months of FY15 and fall in international commodity prices, as well as downward adjustment in administered prices, are main factors explaining slower growth in FBR revenue collection. The impact of downward adjustment in petroleum products prices is likely to become

[19] In Q1-FY14, the non-tax revenues were boosted by one-off revenue items that included higher SBP profit of Rs80 billion against normal amount of Rs60 billion, Rs67 billion of the Universal Service Fund and Rs 56.8 billion as mark up from PSEs.

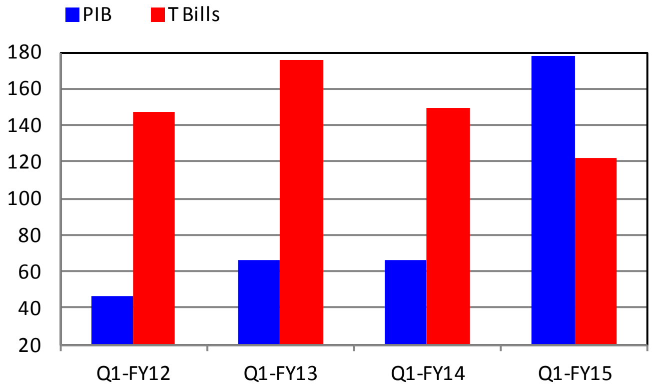
[20] This growth was mainly the outcome of withholding taxation measures introduced in 2014-15 budgets. For details, see First Quarterly Report on State of Pakistan's Economy.

more pronounced in second half of the year in case current trends continue.[21,22] However, this is likely to be partially offset by increase in GST on petroleum products by 5 percent.[23] Thus to achieve the FY15 FBR tax collection target of Rs2810 billion could become challanging.

52. Notwithstanding sharp increase in current expenditures on account of higher interest payments, growth in overall expenditures decelerated to 5.4 percent in Q1-FY15 compared to 14.4 percent in last year. In fact, substantial decline in net lending to PSEs, which was contained to only Rs5 billion in Q1-FY15 compared to Rs83 billion in the corresponding period of last year, more than offset the impact of higher interest payments.[24] The development expenditures, on the other hand, increased sharply (by 32 percent) on the back of higher spending by provinces under PSDP and 'other development expenditures' in Q1-FY15.[25] This is an encouraging sign for investment and real economic activity provided this pace of increase in development spending is maintained in the rest of the fiscal year. However, this seems difficult given expected shortfall in FBR revenue collection.

53. Against sharp decline in overall development and net lending by 29.4 percent, current expenditures increased by 21 percent during Q1-FY15. This growth was mainly driven by sharp increase in interest payments. Though the government has successfully substituted the short term debt (T-bills) with longer term debt (PIBs) in its efforts to improve the maturity profile of domestic debt, it is not without a cost (**Figure 10**). First, government has to raise longer term debt at higher interest rates, and; second, majority of coupon payments are concentrated in two months, July and January.

Figure 10: Interest Payment Trend on PIB & Tbills (Rs Bln)



Source: SBP

[21] Preliminary estimates show that a reduction of Rs20/liter in domestic oil prices of petroleum products is likely to reduce tax collection by 0.07 to 0.1 percent of GDP through reduction in both GST collection and import-related tax.

[22] The domestic petrol price was Rs108 per litre (including GST) in end-June which has been reduced to Rs78.3 per litre by end-December 2014.

[23] As per FBR SRO.1152 (I)/2014 issued on 30th December 2014.

[24] Net lending includes government loans to PSEs for development purposes.

[25] Other development expenditures, outside PSDP, include Benazir Income Support Program (BISP) and Prime ministers schemes.

54. Therefore, government's debt servicing is likely to remain higher during Q1 and Q3 of the current fiscal year. These are, however, likely to be compensated by lower interest payments in Q2 and Q4 of the year. Moreover, reflecting fiscal adjustment continuing in Q1-FY15, the pace of debt accumulation has also slowed down that may further reduce government's debt servicing.

55. The growth in total public debt decelerated to 1.5 percent during Q1-FY15 (from end-June 2014) compared to 7.2 percent during same period last year. Given that government solely relied on domestic sources to finance its deficit in Q1-FY15, the domestic debt grew by 1.7 percent, with a net addition of less than one third of the Rs634 billion accumulated in same period of last year. As discussed above, the domestic debt profile has also improved with increased share of long term debt, mainly 3-year PIBs. Government has also managed to retire its debt to SBP by Rs217 billion through more borrowing from non-bank domestic sources.

56. The expenses related to power sector subsidies are also expected to decline going forward. Reduction in cost of thermal power generation with the decline in oil prices is expected to narrow the tariff differential – the gap between unit cost of electricity generation and average tariff charged – the government has to pay from its coffers. Therefore, power sector subsidies could be contained to create some fiscal space.

57. With this outlook of revenues and expenditures and given strong seasonality of the fiscal deficit remaining high in later quarters, meeting the fiscal deficit target of 4.9 percent for FY15 seems challenging. The major risks to this outlook could emanate from more than expected shortfall in FBR revenue. Increase in security related expenditures and re-emergence of circular debt are other risks to fiscal consolidation.

V. External Sector: Improved Outlook but Risks to Sustainability Remain

58. After showing signs of weakening in the beginning of the fiscal year, mainly due to higher external current account deficit and slow pace in realization of official foreign inflows, the overall balance of payments (BoP) position started to improve from end-November 2014 onwards. Sustained decline in international commodity prices, successful completion of fourth and fifth review under IMF's Extended Fund Facility (EFF), and issuance of International Sukuk are the key factors contributing to

this improvement. As a result, the net SBP reserves have increased to $10.5 billion by end-December 2014 from $9.1 billion at end-June 2014 (see **Table 7**).[26]

59. In fact, the signs of improvement in BoP had started to emerge in the beginning of November 2014 with changing sentiments in foreign exchange market. The positive news about IMF program being on track amid falling international oil prices was instrumental in reducing pressure on exchange rate and reversing of the trends. Earlier, the exchange rate had depreciated sharply by 4.0 percent during July-October 2014 due to political uncertainty, non-completion of fourth review under the IMF's EFF during mid-August 2014, and unsuccessful bid to issue OGDCL GDRs in international market by end-September 2014.[27] The favorable change in foreign exchange market has supported SBP in its reserve building efforts and meeting the end-December 2014 target on Net International Reserves (NIR).[28]

Table 7: Balance of Payments Summary

billion $, unless otherwise indicated

		Jul-Dec	
	FY14	**FY14**	**FY15**
I. Current account balance	**-3.1**	**-2**	**-2.4**
Trade balance	-16.7	-8.7	-9.8
Services balance	-2.5	-1.5	-1.2
of which: CSF	1.1	0.3	0.7
Income balance	-3.9	-2	-2.3
Current transfers balance	20.1	10.2	10.9
of which: Remittances	15.8	7.8	9
II. Capital and financial account	**7.3**	**0.4**	**2.7**
Capital account	**1.9**	**0.2**	**0.3**
Financial account: *of which*	**5.5**	**0.2**	**2.4**
Direct investment (net)	1.5	0.4	0.5
Portfolio investment (net)	2.8	0.1	1.2
General government (net)	1.5	0	0.3
III. Errors and omissions	**-0.4**	**-0.3**	**0.2**
Overall balance (I + II + III)	**3.9**	**-1.9**	**0.5**
Memorandum items:			
Current account as % of GDP	-1.3	-0.8	-0.9
Change in IMF credit and loans	-0.6	-0.5	1.1
Net SBP forex reserves[2]	9.1	3.5	10.5
Exports growth (%)	1.1	2.6	-1.9
Imports growth (%)	3.7	5.3	4.1
Remittances growth (%)	13.8	9.5	15.3
Average exchange rate (PKR/$)	102.9	105	101.3

[1] SBP Projections

[2] Excluding CRR and foreign currency cash holdings

Source: SBP

60. Significant decline in international commodity prices, besides positively influencing the market expectations, are expected to narrow the trade gap, which remained the major contributor to external current account deficit during July-December FY15. With exports declining by 1.9 percent and imports rising by 4.1

[26] Overall country's foreign exchange reserves have increased to $15.3 billion from $14.1 billion at end-June 2014.

[27] Government had planned to raise $850 million by offerining 10 percent share of OGDCL. However, government decided to postpone the transaction due to under valued offers in the face of decline in international oil prices and domestic polictical situation.

[28] SBP missed the end September 2014 NIR target.

percent, the trade deficit widened to $9.8 billion during July-December FY15 from $8.7 billion last year (see **Table 7**). Therefore, despite higher receipts under Coalition Support Fund (CSF) and steady growth in workers' remittances, the external current account deficit increased to $2.4 billion during July-December FY15 compared to a deficit of $2.0 billion in the corresponding period of last year.[29]

61. Decline in exports is worrisome particularly when European Union (EU) has granted GSP plus status to Pakistani exports in January 2014. Falling cotton prices in international markets since June 2014 partially explain contraction in exports.[30] The disaggregated export data shows a 1.1 percent decline in textile exports during July-December FY15. This was largely due to substantial reduction in low value added exports as high value added items, reflecting the impact of GSP plus status, have increased by 21.0 percent despite slowdown in EU. Given the preferential nature of latter under the GSP plus scheme, falling input cost may increase export volumes in coming months.

62. Continued gas shortage is another factor contributing to decline in exports. Moreover, appreciation of Pak rupee in real terms by 3.4 percent during July-November FY15 is not a welcome development from export competitiveness point of view. Nonetheless, government's decision to divert gas to industrial sector and falling input prices could provide some support to exports in coming months.

63. On the other hand, the disaggregated import data suggests that growth in imports during July-December FY15 was broad-based with quantum impact outweighing the price impact. Going forward, however, price impact is likely to become significant as effects of lower international commodity prices would be realized. In particular, oil price (Saudi Arabian light) has declined by 61 percent since end of June 2014.[31] Given that oil imports account for approximately one third of total imports, overall import payments could fall significantly. This would help in narrowing the trade gap and reducing the pressures on exchange rate.

64. Given the likely trends in trade, combined with expectations of workers' remittances maintaining their current trend and realization of remaining CSF, the

[29] Workers' remittances have increased by 15.3 percent during July-December, FY15 compared to last year. Similarly, more than half of the assumed receipts under CSF for FY15 were already realized in first six months.

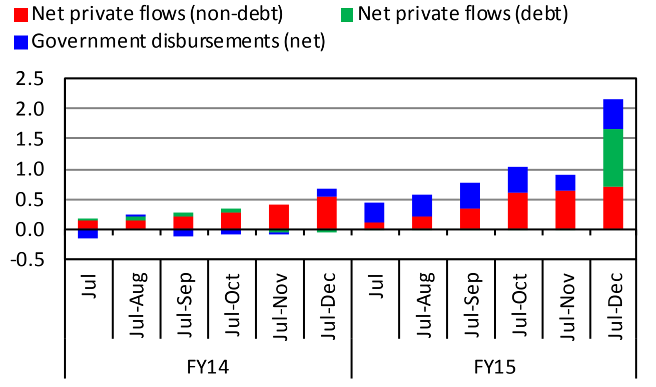
[30] For instance, prices of rice and cotton in international markets, which makes on average 30 percent of Pakistan's total exports, plummeted by an average of 10 and 20 percent on annual basis during July-December 2014.

[31] In the international market, the price of Saudi Arabian light averaged at $85.4 per barrel during FY15 upto 19th January 2015, although end-December 2014 price was $54.7 per barrel. In the same period last year, average price was around $109 per barrel where as end-December 2013 price was $111.4 per barrel.

external current account deficit is projected to remain below the historical levels. Although the projected deficit is still below its recent historical levels, less foreign private inflows than required to finance the current account deficit poses risk in achieving the sustainable BoP position.[32] This risk could increase, in medium term, provided that lower oil prices affect growth in remittances; since a major portion of Pakistani Diaspora works in oil producing countries in the gulf whose economies may adversely be affected by decline in international oil prices.

65. During July-December FY15, though private inflows have shown slight improvement over last year, they still remain insufficient to finance the external current account deficit. Foreign private flows have increased to $1.7 billion in first five months of FY15 compared to $487 million in the corresponding period of last year (**Figure 11**). Together these private flows and official budgeted flows, grants and project loans, have helped the capital and financial account to post a surplus of $2.7 billion during July-December FY15.

Figure 11: Private and Government Official Flows
(Cumulative, Bln $)



Source: SBP

66. In addition to realization of $1.0 billion through issuance of international Sukuk in early December 2014, the expected proceeds from prospective privatization of ABL and HBL and program funding from World Bank and ADB in H2-FY15 are further expected to add to the surplus in financial and capital account.[33] Therefore, the net SBP reserves are projected to increase further.

67. From the perspective of medium-term sustainability of external sector, however, as frequently highlighted in earlier statements, the reliance on debt creating flows is not a sustainable solution. Apart from SBP's efforts, a sustained build-up in SBP's reserves can be achieved through two broad channels. First, there is a need for gradual reduction in trade deficit through increase in exports. Second, in

[32] During the last ten years, the average external current account deficit stands at 2.4 percent of GDP, adjusted for FY08 balance of payments crisis.

[33] Against the budgeted amount of $500 million, government has raised $1.0 billion through the issuance of 5-year dollar denominated Sukuk bonds at a profit rate 6.75 percent. There were total offers of $2.3 billion.

addition to, conducive and investor friendly environment, revival of *non-debt* creating foreign private inflows is essential.

VI. Economic Growth: Maintaining Momentum amid Challenging Environment

68. The latest crop estimates show that impact of heavy rains and floods was not significant except for rice crop. Nevertheless, the production of rice and sugarcane is expected to remain close to last year level while cotton output is estimated to increase by 5.9 percent to 13.5 million bales in FY15.[34] The production of wheat and other crops is also expected to surpass last year's level in the face of better water availability and falling input cost on account of decline in prices of diesel, electricity, and fertilizer. However, depressed prices of cash crops and higher inventories (in case of rice and sugar) could negatively impact agriculture productivity.

69. Availability of cheap raw material and healthy construction activity (as indicated by higher cement sale and steel production), have improved the industrial sector outlook. Though growth in Large-scale Manufacturing (LSM), 2.5 percent during July-November FY15 compared to 5.6 percent in the corresponding period last year, seems subdued, it mainly reflects significant decline in fertilizer production that had increased equally sharply last year. Going forward, expected better electricity supply, stable exchange rate, and lower prices of key raw materials are expected to support higher LSM growth. The services sector is also expected to grow in line with the performance of commodity producing sector. The start of 3G/4G internet service is also expected to enhance value addition by services sector.

70. Incorporating these developments, the real GDP growth is projected in the range of 4 to 5 percent in FY15, below the trend growth rate of 5 percent. Increasing growth close to the historical trend over the short term urgently needs removal of structural bottlenecks related to energy sector. Achieving and sustaining higher growth in the medium to long run, however, requires significant improvement in law and order situation, favorable environment for investment, and increased focus on value added export, particularly textile sector. In addition, the existing system of electricity transmission and distribution desires complete and urgent overhauling to minimize load management.[35]

[34] Estimate by Pakistan Central Cotton Committee as of 1st January 2015.
[35] See, SBP's Annual Report FY14

VII. Declining Inflation: Anchored Expectations amid Declining Oil Price

71. After remaining volatile in FY14, the year-on-year (YoY) CPI inflation has continued its declining trend throughout H1FY15 (see **Table 8**). It declined from 8.2 percent in June 2014 to 4.3 percent in December 2014. Consequently, average CPI inflation during H1FY15 has also moderated to 6.1 percent from 8.9 percent in the corresponding period of last year; much lower than its FY15's target of 8.0 percent. This allowed SBP to cut the policy rate by 50 basis points during November 2014, while miantaining a positive real rate of return.

Table 8: Inflation

percent	year-on-year		period average		
	Jun-14	**Dec-14**	**Jul-Dec-FY14**	**Jul-Dec-FY15**	**FY15[1]**
CPI headline	**8.2**	**4.3**	**8.9**	**6.1**	**4.5-5.5**
Food group	7.4	3.4	9.9	5.1	
Non-food group	8.9	4.9	8.2	6.8	
Core measures					
NFNE*	8.7	6.7	8.4	7.6	
20% trimmed	7.9	5.2	8.3	6.3	

* non-food non-energy; [1] Projections
Source: PBS and SBP

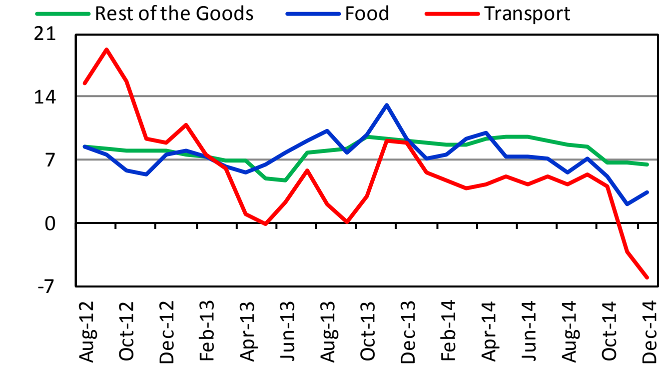
72. Apart from conservative monetary policy stance, this decline in inflation is mainly driven by (i) falling trend in global commodities prices especially that of oil,[36] (ii) lower food inflation, (iii) phasing-out of the impact of major elecricity price hike in October-2013, (iv) lower government borrowing from SBP, and (v) benign inflationary expections for the coming months of FY15[37].

73. Food inflation has come down to 5.1 percent during H1-FY15 from 9.9 percent in the corresponding period of FY14. Improved food supply due to better wheat production in FY14 along with its timely import to meet demand-supply gap, and higher availability of rice due to lower exports amid falling global rice prices are major reasons behind this disinflation. Also, perishable food items exhibited inflation of only 4.4 percent during this period as compared to 20.4 percent[38] in the corresponding period of FY14. As a result, average month-on-month (MoM) inflation for perishable goods has reduced to only 0.10 percent in H1-FY15 as compared to 0.75 percent in H1-FY14. Also, besides directly contributing to decline in inflation, sharp decline in prices of petroleum products had the indirect impact on inflation through lower transport fares in Nov-Dec 2014. Such second round impact is expected to affect inflation in other CPI commodities as well in H2-FY15**(Figure 12)**.

[36] As on January 7, 2014, Saudi Arabian Ligh oil price has fallen to US$ 45.73 per barrel from US$110.70 per barrel at end June 2014.
[37] IBA-SBP Consumer Confidence Survey November 2014
[38] It was due to the delay in potato harvest and slowdown in imports of tomatoes from India.

74. Lower government borrowing from the banking system[39], partly owing to better fiscal consolidation efforts of the government, helped to keep inflation under check in two ways. First, it relatively shrank the money supply impacting inflation directly and secondly, it also anchored future inflationary expectations impacting current inflation in the desired direction. Likewise, improved external financing of the fiscal gap supported exchange rate stability that also contrirbuted in easing pressure on domestic prices of imported goods.

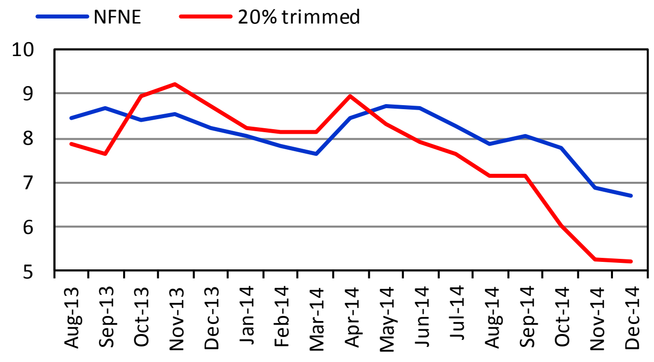
Figure 12: Trend in Composite Group of Headline CPI Inflation
(percent, year-on-year)



Source: PBS

75. Despite LSM growth being low, which is also evident from lower private sector credit uptake,[40] easing inflationary pressure suggests only moderate aggregate demand in the economy. This is reflected in both measures of core inflation **(Figure 13)**. The 20 percent trimmed core inflation and NFNE inflation have been recorded at 6.3 percent and 7.6 percent during H1-FY15 respectively as compared to 8.3 percent and 8.4 percent during the corresponding period in FY14, respectively.

Figure 13: Core Inflation
(percent, year-on-year)



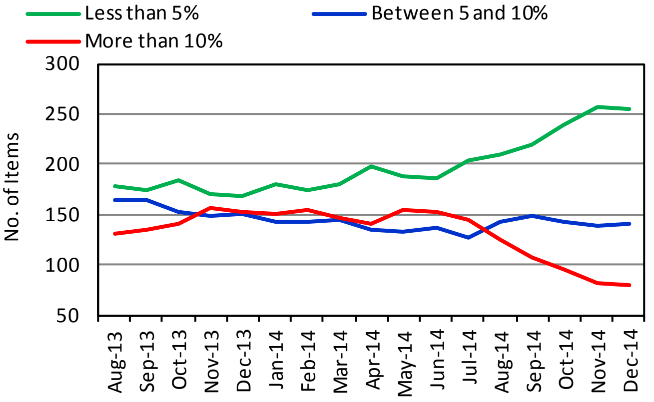
Source: PBS

76. Similarly, broad-based ease in underlying inflationary pressures can be observed from continuous rise in the number of CPI items showing inflation of less than 5.0 percent in FY15 (**Figure 14**). However, the reduction in domestic petroleum prices would generate windfall gains for the households in the economy which, in the short run, can result in some additional spending for consumption.

[39] During 1st Jul-28 Nov 2014 government borrowings from the banking system fell to Rs169.4 billion from Rs419.7 billion in the same period of last year.
[40] See, section on PSC

77. In addition to IBA-SBP Consumer Confidence Survey of January 2015 that shows lower expected inflation for the next six months, inflation expectations, gauged by scheduled banks' increasing interest in the long term government securities also suggest decline; a trend likely to continue in H2 FY15 as well. Furthermore, IBA-SBP Consumer Confidence Inde (CCI) clocked its highest recorded level in January 2015.

Figure 14: Distribution of CPI Basket (YoY Inflation)



Source: PBS

78. Keeping these developments in view, and constrained by the unpredictable global oil price, SBP expects average CPI inflation to remain in the range of 4.5 – 5.5 percent in FY15.

List of Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
BE	Budget Estimates
BoP	Balance of Payments
bps	Basis Points
CCS	Consumer Confidence Survey
CPI	Consumer Price Index
CRR	Cash Reserves Requirement
CSF	Coalition Support Fund
ECB	European Central Bank
EFF	Extended Fund Facility
EU	European Union
FBR	Federal Board of Revenue
FE	Foreign Exchange
FMAP	Financial Markets Association of Pakistan
Forex	Foreign Exchange
FX	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIS	GOP Ijara Sukkuk
GOP	Government of Pakistan
GSP	Generalized System of Preferences
GST	General Sales Tax
H1	First half
H2	Second Half
HBL	Habib Bank Limited
IBA	Institute of Business Administration
IDB	Islamic Development Bank
IMF	International Monetary Fund
IRC	Interest Rate Corridor
KIBOR	Karachi Interbank Offer Rate
LMM	Locally Manufactured Machinary
LSM	Large-scale Manufacturing
M2	Broad Money
MTB	Market Treasury Bills
NBFCs	Non Bank Finance Companies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NIR	Net International Reserves

OGDCL	Oil and Gas Development Company Limited
OMO	Open Market Operations
PBS	Pakistan Bureau of Statistics
PIBs	Pakistan Investment Bonds
PKR	Pakistan Rupee
PSC	Private Sector Credit
PSDP	Public Sector Development Programme
PSEs	Public Sector Enterprises
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
QE	Quantitative Easing
RE	Revised Estimates
rhs	Right Hand Side
Rs	Pakistani Rupees
SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
T-Bills	Treasury Bills
US	United States
USD	United States Dollar
WADR	Weighted Average Deposit Rate
WALR	Weighted Average Lending Rate
WTO	World Trade Organization
YoY	Year on year
$	United States Dollar
3G	3rd Generation
4G	4th Generation