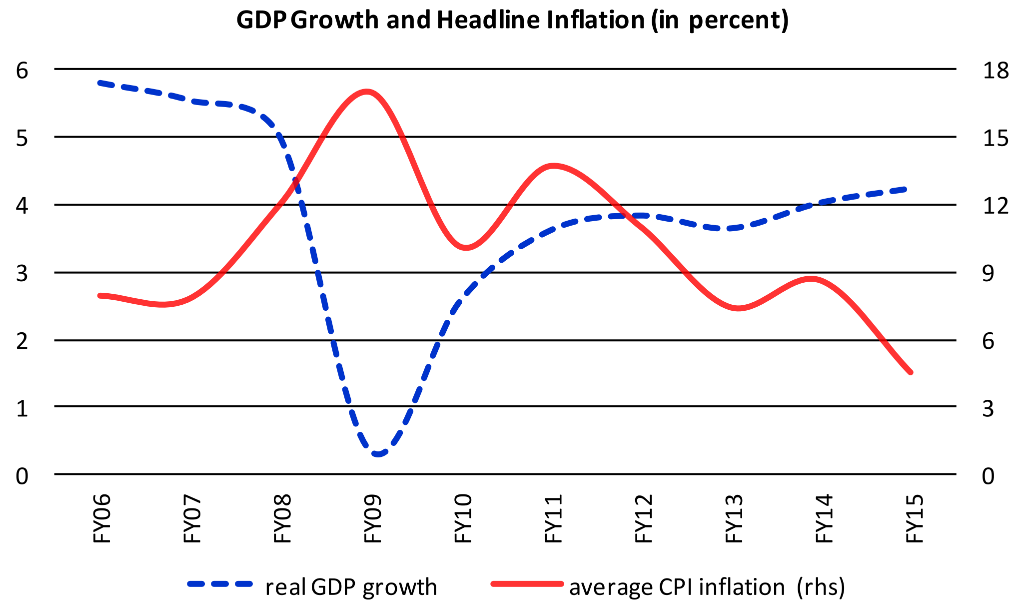
MONETARY POLICY STATEMENT

July 2015



STATE BANK OF PAKISTAN

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Executive Summary

1. Improvements in macroeconomic indicators led SBP to continue with its accommodative monetary policy stance and slash the policy rate by a cumulative 300 bps in FY15. The key factors facilitating the decisions can be pinned down to a sharp decline in CPI inflation, along with its benign outlook, and improvement in external account. In addition to this, narrowing of fiscal deficit and continuation of Extended Fund Facility (EFF) improved the market sentiments. These developments also led to an upgrade of Pakistan's sovereign ratings by international rating agencies in recent months. Macroeconomic stability thus achieved should reflect positively on real economic activity going forward.

2. Following its declining trend in nearly every month of FY15, average CPI inflation came down from 8.6 percent in July FY15 to 4.5 percent in June FY15. Some recent developments such as lagged impact of monetary easing in FY15, expected higher monetary expansion in FY16, bottoming out of inflationary expectations,[1] and the base effect of historically low inflation during the second half of FY15 might suggest slight deviation in the disinflationary trend of FY15 going into FY16. However, there is no major change in SBP's previous inflation forecast.

3. There is a possibility of upward revision in energy tariffs in FY16 and an adverse impact of floods on production of perishable food items going forward that could have an upward pressure on inflation. Meanwhile, projections of high oil production and weak global demand suggest that international oil price might not have bottomed out yet. Given the recent behavior of Pakistani CPI inflation amid falling international oil prices, this could result in keeping inflation on the lower side.

4. While GDP growth in FY15 at 4.2 percent was slightly higher than that of FY14, it remained lower than the target. In particular, industrial sector missed the target due to lower growth in Large-scale Manufacturing (LSM) and electricity generation; however, the activities in construction and mining and quarrying remained buoyant. Agriculture sector despite some losses to major crops from untimely and heavy rains did mange to record some improvement. Noticeable increase in growth, as in the previous few years, came in the services sector.

5. Going forward, expected higher consumption in low interest rate environment, planned increase in development spending, and budgetary incentives

[1] As indicated in IBA-SBP Consumer Confidence Survey of July, 2015.

for construction sector could provide some thrust to growth. Moreover, implementation of infrastructure projects planned under the China-Pakistan Economic Corridor (CPEC) and addressing structural issues especially related to energy and security would create favorable investment environment which is necessary to sustain economic growth over the medium to long term.

6. The balance of payments position continued to improve in the second half of FY15. Reduction in external current account deficit due to decline in import bill and steady growth in workers' remittances are key factors behind the improved external position. Successful completion of reviews under EFF program, issuance of international *Sukuk* and disbursement of program related funding continue to support reserves building besides instilling stability in the foreign exchange market. The net SBP foreign exchange reserves rose from $10.5 billion at end-December 2014 to $13.5 billion as of 30th June 2015.

7. Despite these positive developments, due to structural bottlenecks, sluggish global demand, and lower commodity prices, exports contracted by 3.7 percent in FY15. Moreover, net Foreign Direct Investment (FDI) declined to 0.3 percent of GDP in FY15. More work therefore needs to be done in the coming years to attract investments.

8. In the short-to-medium term, nonetheless, the disbursements of program related funding and planned issuance of Eurobonds are expected to support an upward trajectory in foreign exchange reserves. Therefore, net SBP reserves are projected to increase slightly above 4 months of imports by end-June 2016. Having said this, the need to revive private inflows and exports to sustain this trajectory in foreign exchange reserves remains there.

9. The revised FY15 budget estimates show fiscal deficit of 5.0 percent, lower than the previous year. The estimated reduction in fiscal deficit in FY15 is primarily due to improvement in tax revenues. Total expenditures, on the other hand, are estimated to remain higher than the budget estimates despite reduction in subsidies and lower interest payments. Achieving the FY16 fiscal deficit target of 4.3 percent depends on collection of estimated Rs145 billion from Gas Infrastructure Development Cess and FBR revenue target of Rs3104 billion.

10. The deceleration in broad money (M2) growth from 15.9 percent in FY13 to 12.5 percent in FY14 has slightly reversed in FY15 to 13.2 percent. While Net

Domestic Assets (NDA) led the growth in M2, Net Foreign Assets (NFA) decelerated in FY15. Despite better current account balance, deceleration in NFA of the banking system was a result of lower capital and financial inflows. Government reliance on banking system, specifically on scheduled banks, for its financing needs boosted the NDA of the banking system. Scheduled banks' financing of both commodity operations and PSEs also witnessed higher flow in FY15 against FY14.

11. Private Sector Credit (PSC) increased by Rs 208.7 billion during FY15 as compared to Rs 371.4 billion in FY14. The major drag for PSC remains the structural bottlenecks and low commodity prices. In FY16, construction and real estate sectors show promise as indicated by their continued credit uptake. The lagged impact of easy monetary policy of FY15 is also expected to positively affect the credit growth in the upcoming credit cycle in the first half of FY16. On supply side, possibly making lending slightly more attractive is the spread between WALR and 3-month T-bill rates) that has edged up from 113bps (on average) in FY14 to 131bps (on average) in FY15.

12. The liquidity conditions in the Q3-FY15 remained stressed but later in Q4-FY15 due to net retirement of government borrowing from banking system it eased a bit. Following the easy monetary policy stance other market interest rates also posted decline almost throughout the second half of FY15. However, a change has been observed in the market sentiments since the release of inflation numbers for May 2015.

13. Following the improvements in the Interest Rate Corridor (IRC) framework in May 2015, SBP has ensured that the money market average overnight rate remains close to the newly introduced Target (Policy) Rate at 6.5 percent. This led to an increase in both volume and frequency of open market operations (OMO). As a result, the overnight repo rate remained (on average) 2 bps below the policy rate of 6.5 percent in the post May 2015 monetary policy decision period. Furthermore, there has been less volatility in the overnight rate.

14. Given the above macroeconomic considerations, SBP Board of Directors has decided to keep the SBP Policy Rate unchanged at 6.5 percent.

A. Global Developments

1. Growth prospects for global economy are moderate. IMF projects the global economy to grow by 3.3 percent in 2015, down from its earlier projection of 3.5 percent and less than 3.4 percent increase posted in 2014. While most of the drag is coming from emerging economies, alongwith subdued US performance in the first quarter, advanced economies present a marginally improved outlook. The impulse has mainly come from low commodity (including oil) prices, currency depreciations (excluding the US), and expansionary monetary stance adopted by a number of countries. This outlook is, however, tainted by a number of downside risks which include: increased volatility in currencies, capital outflows from emerging markets, and potential asset price bubbles.

2. The Euro zone posted a 0.4 percent growth[2] over the previous quarter in the first quarter of 2015 as the region's largest economies – Germany, Spain, France and Italy – grew together for the first time in four years. Fears of a prolonged deflation were allayed as the 19-country-bloc posted price increases between Apr-Jun 2015. Unemployment remained steady at 11.1 percent, while Industrial production improved.[3] The key factors contributing to this recovery are low oil prices, depreciation of Euro, and the launch of the Quantitative Easing (QE) by ECB in March 2015. As the economies strengthen, the European Commission has raised its forecast for Euro zone growth for 2015.[4] Moreover, the fears of a negative fallout from crisis in Greece have also receeded in recent days.[5]

3. The US economy contracted in the first quarter of 2015 because of a harsh winter and an appreciating dollar, which boosted imports, discouraged exports, and reduced factory production. The outlook on the economy is, however, still positive as economic performance in the first quarter has tended to be weak in recent years. The Japanese economy expanded by 1 percent[6] during Jan-Mar 2015 over the previous quarter. This was largely helped by the QE initiated last year, which boosted domestic business spending by reducing the relative cost of production and also improved trade balance by encouraging exports.

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[2] EuroStat: Second estimate for the first quarter of 2015 (http://ec.europa.eu/eurostat/documents/2995521/68708 ...)
[3] Eurostat: Industrial production up by 1.1% in euro area (http://ec.europa.eu/eurostat/documents/2995521/67781 ...)
[4]The European Commission is forecasting 1.5 percent growth in 2015, what would be the euro area's best outcome since 2011 when it grew by 1.6 percent.
[5] Greece went into arrears on its $ 1.6 billion loan payment to IMF on June 30, 2015. Later in a referendum, an over whelming Greek majority voted against the terms of its lenders. However, on July 16, 2015 Greece agreed to a bailout package from Eurozone involving tough austerity measures. The deal has greatly allayed fears of a possible Greece's exit from the European Union.
[6] Economic and Social Research Institute Japan/Bloomberg.

4. The growth outlook for emerging markets weakened because of subdued prospects for some large economies such as China, Russia, Mexico, and Brazil.[7] The slowdown in Chinese economy has come about largely as a result of a property slump, decreased investment, and increased capital outflows. Brazil is reeling by the effect of contractionary macroeconomic policies, and a weak private sector sentiment, while the outlook for Russia is affected by lower oil prices and increased geopolitical tensions. However, Indian economy is expected to strengthen because of policy reforms, revival in investment and lower oil prices.

5. The impact of these developments on the international financial and capital markets is varied. Protraction of monetary stimulus programs is causing easy money going into assets such as stocks and property, creating price bubbles. The US, European, and Japanese stock markets stood at multi-year highs, before sliding slightly since end-June 2015 on the risk of contagion from the Greek crisis. The Chinese stock market, in particular, demonstrated the dangers from asset price bubbles, as it soared 150 percent over the previous year and fell 30 percent in a space of 3 weeks. Bond yields have generally risen around the world, while emerging economies are witnessing a reversal in capital flows, as a rate hike in the US is expected sometime this year. Capital flight may lead to depreciation of local currencies, increase in borrowing costs, and to a potential balance of payments difficulties. China, Turkey, Brazil, South Korea, Indonesia, Malaysia, and South Africa are particularly vulnerable to this risk. A decline in foreign exchange reserves of many countries is already being witnessed, as Central banks use these reserves to defend their currencies and repay foreign debt.

6. Furthermore, currencies have witnessed increased volatility in the first half of 2015 due to varying macroeconomic conditions in a number of countries. The prospects of US Dollar changed with an uptick in oil prices,[8] expectations of a delay in the rate hike by the Fed, and a change in sentiment regarding the US economy.[9] Yen continued to depreciate on the strength of the QE program by the Bank of Japan, while euro demonstrated strong performance in Apr-Jun 2015 as it appreciated by

[7] IMF has projected China, Brazil, Russia and India to grow by 6.8 percent, -1.0 percent, -3.8 percent and 7.5 percent in 2015, compared to 7.4 percent, 0.1 percent, 0.6 percent and 7.2 percent growth posted in 2014.

[8] After declining over 60 percent since June, oil prices bottomed out in April 2015 and rebounded to as high as $66.71/bbl in May 2015. Prices rose on the perception that oil production was peaking and narrowing the prevailing oil glut as US production was seen declining up till May 2015. However, in early July 2015, oil prices declined to as low as $55.22/bbl on July 20, 2015 following the expectations of an Iranian nuclear deal.

[9] The US Dollar witnessed an appreciation up till March and declined thereafter to levels similar to what was observed in January.

3.9 percent against the USD on improved prospects in the Euro economy, but it fell following Greece's failure to make a loan payment to IMF on June 30, 2015. The yuan demonstrated stability against the US Dollar in the initial months of 2015 and depreciated slightly in March in the face of pressure from increased capital outflows. Some major currencies that depreciated against the dollar over the last 6 months include the Brazilian real, Turkish lira, Indian rupee, SA rand, Malaysian ringit, and the NZ dollar.

7. The market for commodities has generally remained oversupplied with the slowdown in global economic activity resulting in four consecutive years of price decline. Commodity prices have been further suppressed with the decline in oil prices over the past year and currency depreciation of commodity producers. Specifically, commodity prices in June 2015 stood 33.4 percent below last year's prices. Price decline has been seen in all categories including energy, agricultural produce, and metals. Energy prices have a significant influence on overall commodity prices, as oil is a big component of overall consumption, an essential component in extraction, processing, and transport of all commodities. Therefore, dynamics in overall commodity prices would closely follow the dynamics in oil prices. The nuclear deal with Iran, a major oil producing country, has diminished the prospects of oil price rise and therefore commodity prices are expected to remain subdued.

Table 1: Trade in Emerging Economies

	2014		2015	
	Exports	***Imports***	***Exports***	***Imports***
China	5.4%	0.8%	3.5%	-17.4%
Pakistan	-1.8%	7.0%	-5.9%	-11.2%
Bangladesh	4.5%	14.4%	4.2%	-0.2%
India	2.3%	-0.5%	-14.8%	-12.2%
Sri Lanka	7.3%	7.7%	-0.4%	1.8%
Egypt	-7.5%	0.9%	-25.3%	-13.4%
South Africa	-4.9%	-3.3%	-8.6%	-9.8%
Turkey	3.8%	-3.8%	-5.7%	-9.5%
Indonesia	-3.4%	-4.5%	-11.0%	-17.0%
Malaysia	2.5%	1.4%	-13.1%	-10.9%
Thailand	-0.4%	-9.0%	-4.0%	-6.5%
Vietnam	12.6%	13.6%	7.0%	14.0%

Based on country-wise Import & Export Data from Haver Analytics
2015 Data for all countries is based on Jan-April except that for Egypt (Jan-March)

8. Amidst fluctuating exchange rates, slow recovery of the world economy, and rising geo-political tensions, World Trade Organization has lowered the forecast for growth in global trade from the earlier 4.0 percent to 3.3 percent in 2015.[10] As evident in **Table 1**, this is mainly because of weakening trade performance in emerging and developing economies. The actual data for Jan-Apr 2015 shows faltering trade growth for a number of emerging economies including Pakistan. It is

[10] Trade and Statistics Outlook 2015 (https://www.wto.org/english/news_e/pres15_e/pr739_e.pdf).

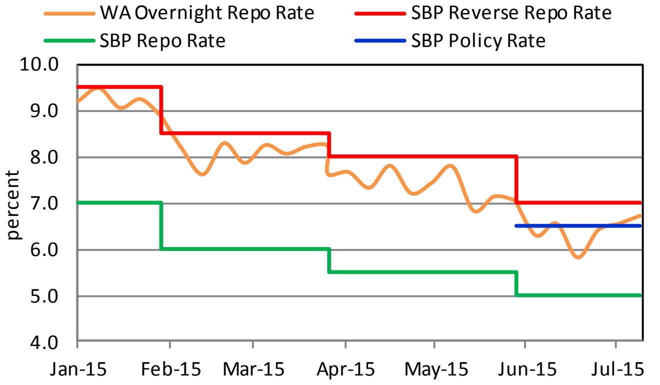
important to mention here that the slowdown in China has especially impacted the demand and hence prices of various commodities provided by emerging markets. Considering the scale of Chinese imports, a 17.4 percent decline in imports is vast and has been one of the major factors in the reduction in emerging market exports.

9. These global economic developments have a special relevance for Pakistan. Although, slowdown in Chinese economy can further decelerate Pakistan's exports, resolution of Greek crisis recently revitalizes hopes of pick up in exports to EU. A possible increase in interest rate by the US Federal Reserve may, however, reverse the trend in capital flows to emerging economies like Pakistan.

B. Domestic Developments and Outlook

I. Interest Rate Structure: Responding to the Revised Interest Rate Corridor (IRC) Framework

Figure 1: Movements in SBP's Operational Target



Source: SBP

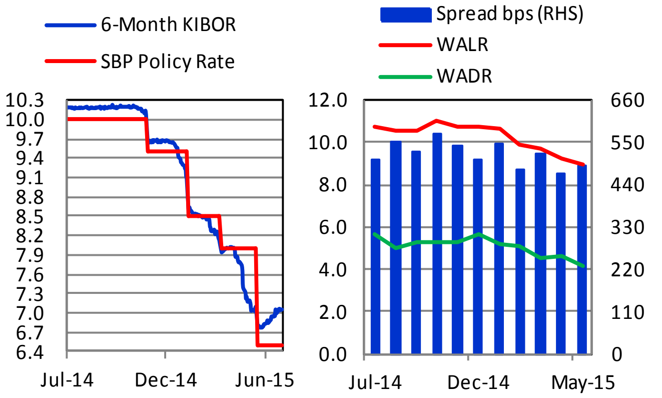
10. With improved macroeconomic indicators and market sentiments in H2-FY15, SBP apart from slashing the policy rate by a cumulative 250 bps also revised the interest rate corridor framework to strengthen the monetary policy transmission mechanism (**Figure 1**). In particular, the idea was to align the SBP's operational target with the proposed policy rate set within the Interest Rate Corridor (IRC). SBP formally announced revision in IRC framework in its May 2015 monetary policy decision and introduced SBP Target Rate (the new Policy Rate) at 6.5 percent; that is, 50 bps below the ceiling of corridor and reduced the corridor width from 250 to 200 bps.[11] The implementation of the required changes called for an increase in both the volume and frequency of Open Market Operations (OMO). Moreover, the spread between the OMO cut-off rate and the ceiling of corridor was

[11] Also, the provisions pertaining to the penal rates in the Clause 4 of DMMD Circular No. 20 dated 5th October 2012 were withdrawn vide DMMD Circular No. 09 dated 23rd May 2015..

kept at 50bps; whereas, the money market overnight repo rate moved closer to the policy rate (**Figure 1**).[12]

11. Following the policy rate, the benchmark rate for corporate lending, KIBOR, also edged down. Unlike H1-FY15 when it showed a positive spread and remained above the policy rate, the 6-month KIBOR hovered below the policy rate till May monetary policy decision. This also led to a consistent fall in weighted average lending and deposit rates (WALR and WADR) (**Figure 2**). While the decline in lending rates is expected to revive private investment going forward, lower deposit rates may discourage deposit growth. To address this issue, SBP responded with a reduction in corridor width by increasing the SBP repo (Floor) rate so as to protect the interest of depositors.

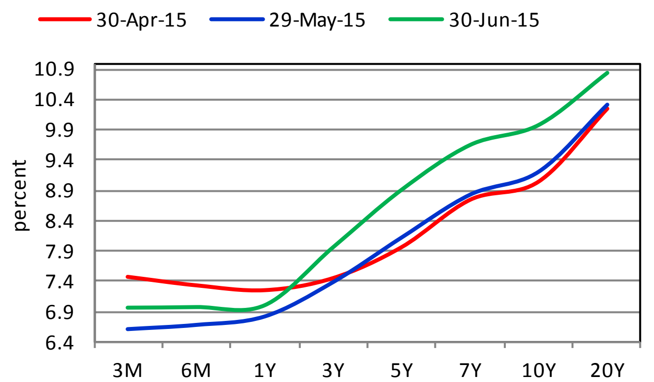
Figure 2: Market and Retail Interest Rates (%)



Source: SBP

12. Furthermore, in line with the monetary policy stance, other market interest rates also continued to decline almost throughout H2-FY15. Against a cumulative cut of 250 bps in the policy rate in H2-FY15, the primary auction yields of MTBs and PIBs fell by 226 and 273 bps on an average, respectively, before moving upward in June 2015. A similar trend can be observed in the secondary market yields **(Figure 3)**.

Figure 3: Secondary Market Yield Curves



Source: SBP, MUFAP

13. Money market sentiments have undergone a shift since the last MPS in May 2015, as the interest rates have started inching up in June 2015. Market is anticipating that interest rates have bottomed out and will not drop further. The bidding pattern in the auction of government securities is also an evidence of

[12] The money market overnight repo rate, on average, remained 51 basis points below the ceiling of corridor in the post March 2015 monetary policy decision compared to 32 basis points in the post January 2015 decision.

market's expectation about the future interest rate changes; shorter tenor instruments have been the most preferred choice of investments in the post May 2015 monetary policy decision.[13] Besides exposing the roll-over risk, this investment pattern is increasing the pressure on short term interest rates.

14. Furthermore, government borrowing from banking system via auction of government securities has been the key driver of market liquidity conditions in H2-FY15. In Q3-FY15, fiscal authorities raised Rs377 billion net of maturities to retire its borrowing from SBP. Owing mainly to the realization of HBL privatization proceeds, the situation slightly eased between late April and May 2015 as there was a brief letup in government borrowing requirements from commercial banks (**Table 2)**. However, after a net retirement of Rs351 billion in Apr-May 2015, government again resorted to borrowing from banking system towards the end of the fiscal year. In the MTB auctions conducted in June 2015, government raised Rs102 billion net of maturities.[14] Moreover, outright sales of government securities of Rs187 billion were also conducted through open market operations on 29th June 2015 which effectively shifted the stock of government borrowing from SBP to scheduled banks to meet the end-June IMF targets.

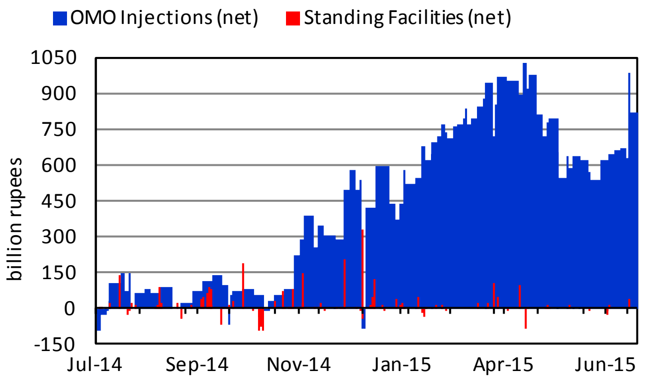
Table 2: MTB and PIB Auctions in H2-FY15
billion Rupees

	Security	Target	Maturity	Realized	Excess/(Short) of Target	Excess/(Short) of Maturity
Q3-FY15	**MTB**	925.0	569.8	1,044.0	119.0	474.2
	PIB	150.0	213.2	200.5	50.4	(12.8)
Total		1,075.0	872.9	1,250.2	175.2	377.2
Apr-15	**MTB**	600.0	601.7	497.9	(102.1)	(103.8)
	PIB	50.0	0.0	44.3	(5.7)	44.3
May-15	**MTB**	175.0	459.0	211.5	36.5	(247.5)
	PIB	50.0	3.6	64.1	14.1	60.5
Jun-15	**MTB**	100.0	65.9	167.5	67.5	101.6
	PIB	50.0	2.1	52.7	2.7	50.6
Total		1,025.0	1,132.3	1,038.0	13.0	(94.3)

Source: SBP

15. Market liquidity conditions remained stressed almost throughout H2-FY15 **(Figure 4)**. SBP injected significant amount of liquidity since the start of Q3-FY15 till mid of April 2015. As on 20th

Figure 4: SBP Liquidity Provisions



Source: SBP

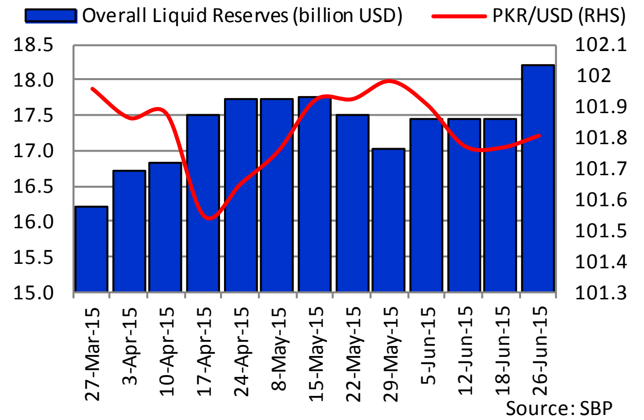
[13] In the MTB auctions for June 2015, 3-month tenor comprised 82 percent of total participation, on average. Prior to this, these accounted for a meager 18 percent of total participation in H2-FY15.
[14] Accordingly, government budgetary borrowing from SBP (on cash basis) increased by Rs426 billion in Apr-May 2015. However, provisional estimates show the same decreased by Rs186 billion in June 2015.

April 2015, the level of outstanding OMO Injections peaked to an all time high of Rs1.03 trillion.[15] Later on in Q4-FY15, the interbank liquidity requirements eased a bit with net retirement of government borrowing from the scheduled banks. Specifically on 30th June 2015, the outstanding level of SBP OMO injections stands at Rs625 billion.

FX Market: Reserve buildup continues amid positive sentiments

16. Market sentiments remained upbeat through most of H2-FY15 because of a number of favorable developments: (i) a surplus in the current account during Dec-Apr FY15; (ii) receipt of CSF in February 2015; (iii) HBL privatization in April 2015; and (iv) continuation of Extended Fund Facility (EFF) program with the IMF, which also facilitated inflows from other creditors. The improvement in the external sector led to stability in PKR, which depreciated by only 1.3 percent in the interbank market during H2-FY15. The situation has, however, changed somewhat since May 2015 with a deficit in the current account.

Figure 5: Forex Reserves



Source: SBP

17. Overall, liquid foreign exchange reserves increased to $18.7 billion as of end-June FY15 showing an increase of $3.5 billion since January 2015 (**Figure 5**). The bulk of this increase was witnessed in SBP liquid reserves, which increased by $3.2 billion mostly on account of CSF inflows in February; IMF tranches after sixth and seventh reviews; loan by the International Development Agency (IDA) in June 2015; and foreign exchange purchases from the interbank market by SBP. Commercial bank Reserves rose by $368.9 million in the same time period, mostly on account of a decline in trade financing against FE-25 deposits. Specifically, import financing posted a sharp decline because of a fall in both price and quantum of oil imports.

[15] This increased volume of SBP Injections also reflects the fact that SBP increased its frequency of OMOs (from a usual practice of one OMO per week to as much as three OMOs per week) in an effort to keep the overnight repo rate close to the target rate.

18. The slump in the international oil prices along with reduced oil import quantum contributed to a current account surplus almost throughout Dec-Apr FY15. Thus, ample FX liquidity in the market, induced stability in the PKR parity.

19. However, the situation changed towards the end of H2-FY15. Trade deficit witnessed a sharp increase in May 2015 both due to falling exports as well as an increase in imports. As a result, current account posted US$ 521 million deficit in May 2015, compared to US$ 275 million surplus in April 2015. This has siphoned off liquidity from the FX market.

II. Monetary Expansion: Growth mainly due to Higher Budgetary Borrowing

20. The deceleration seen in the growth of M2 during FY14 reversed in FY15. To be specific, M2 grew by 13.2 percent during FY15 compared with the growth of 12.5 percent in FY14 (**Table 3**). Nonetheless, the current year's growth is still lower than past 5 year's average growth of 14.2 percent. Viewed in terms of substantially lower inflation in FY15 however, the current year's growth seems to be quite high. This reversal also carries a visible shift in growth composition (**Figure 6**).

21. The main contribution in M2 growth during FY15 came from Net Domestic Assets (NDA) whereas Net Foreign Assets (NFA) contributed lower than FY14. NDA increased by Rs1100 billion during FY15 against an expansion of Rs778 billion observed in FY14. Higher NDA

Table 3: Monetary Aggregates
stock and flow in billion rupees, growth in percent

	June 2014	Flows during	
	Stocks	FY14	FY15[P]
NDA: *of which*	**9367**	**778**	**1100**
Net budgetary support	5549	303	865
SBP	2410	197	-474
Scheduled banks	3140	106	1339
Commodity operations	492	25	72
Private sector credit	3729	371	209
Credit to PSEs	355	67	80
OIN	-799	13	-125
NFA	**601**	**332**	**219**
SBP	490	357	240
Scheduled banks	111	-25	-21
Money supply (M2)	9968	1110	1319
Reserve money	2861	326	282
Currency in circulation	2178	240	377
Total deposits	7777	868	940
Growth (year-on-year)			
Net budgetary support		5.8	15.6
SBP		8.9	-19.7
Scheduled banks		3.5	42.6
Private sector credit		11.1	5.6
NDA		**9.1**	**11.7**
NFA		**123.6**	**36.4**
Money supply (M2)		**12.5**	**13.2**
Reserve money		12.9	9.9
Currency in circulation		12.4	17.3
Total deposits		12.6	12.1

P: Provisional;
Source: SBP

expansion in turn was mainly contributed by higher budgetary borrowing from the banking system; unlike FY14 when pickup in credit to private sector led the growth in NDA (**Figure 6**).

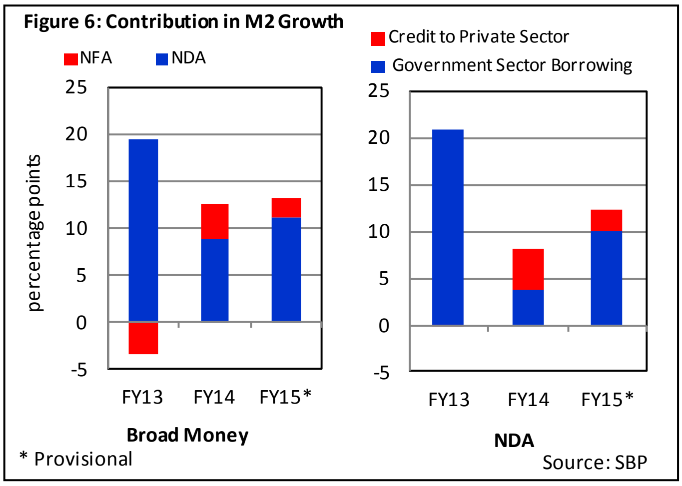


Figure 6: Contribution in M2 Growth
* Provisional
Source: SBP

22. In FY15, government resorted considerably to banking system for its financing needs. This was in contrast to FY14 when availability of foreign inflows made financing of fiscal deficit relatively easier. Also, in a bid to meet IMF-EFF ceiling on its borrowing from SBP, government resorted mainly to scheduled banks, borrowing historically high level of Rs1339 billion and using the funds generated to retire SBP debt (**Figure 7**). With expectations of continued monetary easing prevalent in almost entire H2-FY15, banks' interest in government securities remained strong and hence government had no difficulty in meeting its financing requirements. This behavior by banks helped government in retiring SBP credit which in turn facilitated in meeting both end Q2FY15 and Q3FY15 IMF targets.

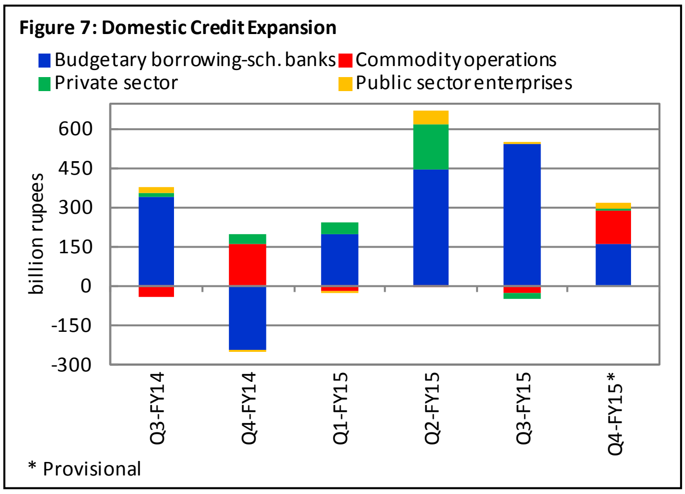


Figure 7: Domestic Credit Expansion
* Provisional

23. The retirement by the government provided space to SBP for meeting ceiling on SBP-NDA in these quarters by considerable margins. Further, SBP also tapped Islamic banks to meet the IMF-EFF target on SBP-NDA. This was done by carrying out purchase of *Sukuk* from Islamic banks on *bai-muajjal* (deferred payment) basis which were later sold on ready basis. As highlighted earlier,[16] this resulted in lowering of SBP-NDA.[17]

24. Scheduled banks' financing of both commodity operations and PSEs increased during FY15 (**Figure 7)**. The higher recourse to bank financing by these sectors during

[16] MPS January 2015.
[17] SBP carried out purchase/sale of *sukuk* worth Rs180 billion during FY15.

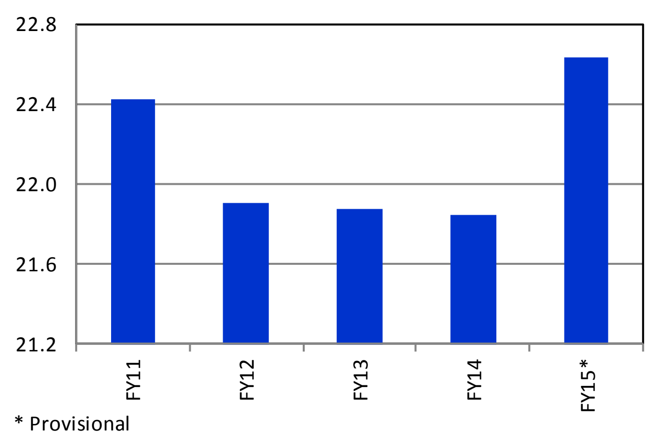
the current year basically indicates cash flow problems of the entities. Particularly, the ones involved in the business of wheat and sugar as they were unable to release their carryover stocks domestically in the wake of higher differential between domestic and international prices incentivizing private sector to import the commodity. However, to address these issues government announced to provide subsidies on wheat and sugar exports. In this context, Economic Coordination Council extended the date of wheat export till July 31, 2015 from the initial deadline of March 2015. If the commodity prices remain depressed, the stock of commodity financing is expected to remain at higher level in FY16 and government would continue to bear the cost.

25. PSEs, particularly the ones that are involved in the oil marketing sector also availed higher bank financing in FY15 than FY14. They availed bank credit of Rs68 billion during FY15 compared with Rs43 billion in FY14. This signifies that the initial breathing space of circular debt settlement and resultant cash flow improvement is gradually waning out.

26. NFA expansion continued in FY15, albeit at a slower pace than FY14. Lower NFA expansion, despite better current account was a result of lower capital and financial inflows.[18] Despite this, NFA of SBP witnessed a sizable surge by Rs240 billion during FY15, while NFA of scheduled banks witnessed slight contraction due to increase in foreign liabilities of local banks (Rs. 21 billion).

27. On the liability side, currency in circulation witnessed substantial growth. The growth in currency in circulation during FY15 was at 17.3 percent compared with 12.4 percent in FY14. Despite lower inflation and subdued growth in GDP in FY15, currency-to-M2 ratio increased to 22.6 on 30th June, 2015 from 21.9 on 30th June, 2014 (**Figure 8**). On the other

Figure 8: Currency-to-M2 Ratio



[18] Current account deficit was recorded at USD 2.0 billion during Jul-May FY15 as compared to USD 3.0 billion during Jul-May FY14. Capital and financial account halved during the period at USD 3.3 billion against USD 6.7 biilion observed in Jul-May FY14.

hand, the growth in deposits at 12.1 percent in FY15 saw slight deceleration than FY14 (from 12.6 percent). The lower growth in deposits increased the currency to deposit ratio to 29.3 in FY15, compared with 28.0 in FY14.

28. Based on (i) projected lower net expansion in NFA of the banking system despite continued inflow of program loans[19] ii) projected acceleration in NDA of the banking system given budgetary borrowing is expected to remain closer to its level in FY15 and iii) credit to private sector to remain subdued both due to supply and demand factors, the growth in money supply in FY16 is projected to remain within the range of 12.5-13.5 percent.

III. Private Sector Credit: Growth Contingent upon Removal of Structural Bottlenecks

29. Compared to FY14, the uptake of Private Sector Credit (PSC) has indeed slowed down in FY15. PSC has increased by Rs194.5 billion during FY15 which is almost half of the amount availed during FY14 **(Table 4)**. Although lower POL prices and monetary easing provided some support to the industry, various other factors such as muted domestic demand as indicated by lower LSM and GDP growth, lackluster export performance, higher real interest rates amid rapidly falling inflation, increased government borrowing from commercial banks, falling commodity prices and continued energy shortages along with buildup of receivables by

Table 4: Credit to Private Sector (Flows)
(billion Rupees)

	FY15	FY14
Total credit to private sector (*as per weekly*)*	208.7	371.4
*Add: Foreign bills purchased***	*-14.2*	*-4.6*
Total credit to private sector	**194.5**	**366.8**
1.Loans to private sector businesses	165.3	293.4
By Type		
Working Capital: *of which*	38.5	222.0
Export Finance	6.3	14.7
Import Finance	24.5	24.5
Fixed Investment	126.9	71.4
LMM	5.8	-6.2
By Sectors		
a) Agriculture: *of which*	32.8	31.2
Livestock	15.0	8.0
Fishing	-0.1	0.5
b) Industrial Sector:	60.5	231.7
Manufacturing: *of which*	58.4	183.6
Food &beverages	15.3	96.8
Sugar	5.4	39.1
Textiles & garments	-20.6	38.4
Coke & Refined Petroleum	15.9	10.5
Chemicals	21.0	20.4
Non-Metallic Mineral Products	19.7	-13.2
Cement	20.1	-14.2
Energy generation & distribution	-11.5	49.2
Construction	13.6	-1.1
c) Services	58.3	37.1
Commerce and Trade	11.1	17.6
Transport , Storage & Communication	29.5	26.8
Telecommunications	18.4	24.9
Real Estate	8.1	-12.6
2. PERSONAL	**44.0**	**31.9**
Consumer Financing	31.1	31.5
3. Equity Investments	**35.5**	**15.3**
4. NBFC	**-35.3**	**-4.2**
5. Others	**-15.0**	**30.4**

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

[19] World bank USD 500 million and ADB of USD 300 million is assumed.

corporates have kept credit growth in check. Nevertheless, if compared with the past three year's average credit uptake of Rs113 billion (excluding exceptional FY14),[20] it would be difficult to term this year's credit uptake as very low.

30. One major highlight of FY15 has been the uptick in credit for long term investment purposes; Rs126.9 billion as opposed to Rs71.4 billion in FY14. This bodes well for future productive capacity and employment generation.

31. Despite weather shocks, agriculture sector has performed reasonably well and its contribution to GDP growth has increased from 0.58 percentage points in FY14 to 0.61 percentage points in FY15[21]. As a result agriculture credit has remained stable. The sector availed net credit of Rs32.8 billion, of which Rs19.4 billion were availed for growing major crops, while Rs15.0 billion were availed for livestock. Going forward, agriculture credit is expected to grow broadly as per its stable trend.

32. The major drag for credit and the economy has been the industry[22]. Dampened domestic and international demand, and falling output prices have been some of the key constraints for major industries such as textiles. Power sector has remained under pressure due to lower utilization of capacity amid build-up of trade debts. As a result, profit margins of these industries have deteriorated **(Table 5).** For textiles, the outlook remains guarded due to expectations of subdued cotton prices in the medium term.[23] For energy,the outlook is dependent on resolution of circular debt and investment in early realization of energy projects under China Pakistan Economic Corridor (CPEC).[24]

Table 5: Corporate Profitability during July- March

Ratios	Textiles		Cement		Power	
	FY15	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**
Cost of Goods Sold to Sales	89.7	87.8	65.2	65.8	91.0	87.0
Gross Profit Margin	10.3	12.2	34.8	34.2	9.0	13.0
Operating Margin	5.5	8.9	32.2	31.1	9.8	14.7
Financial Expenses to Sales	4.1	3.9	2.5	4.0	3.6	5.2
Net Profit Margin	1.8	4.5	22.0	20.8	5.4	8.2
Cash Flow to Sales	24.6	25.0	6.7	10.4	26.7	27.0

Source: Financial Statements of major listed companies in each sector

20 Various factors added to an exceptionally higher credit uptake in FY14 including; a) relative political stability in contrast to prolonged sit-ins during FY15; b) government borrowing from commercial banks at Rs91.3 billion during Jul-May FY14 stood lower than Rs1035.9 billion in Jul-May FY15; c) settlement of circular debt of Rs503 billion in the beginning of FY14 resolved liquidity issues of the energy sector; and d) higher commodity prices kept the demand for working capital higher.

21 Source: Pakistan Economic Survey 2014-15

22 Point contribution of industrial sector to GDP growth dropped down from 0.91 percent in FY14 to 0.74 percent in FY15. Source: Pakistan Economic Survey 2014-15

23 Source: World Economic Outlook, April 2015.

24 Under early harvest projects in CPEC, China will aid Pakistan in producing 20,093 MW energy projects. Source: Ministry of Planning, Development and Reform, Government of Pakistan.

33. On the other hand, amid rising domestic demand, cement sector has posted higher sales volumes and better profit margins. With government's focus on infrastructure projects and incentives announced for construction industry in the recent budget, it is expected that cement sector would perform better in the coming year.

34. As regards funding for credit, private sector deposits during FY15 have recorded Rs898.3 billion inflows against Rs788.3 billion recorded during FY14. This is largely driven by Rs709.2 billion of saving deposits mobilized during the period. The surge in saving deposits can be attributed to households' improved disposable income due to lower energy prices and positive real returns on deposits **(Table 6)**.[25] Going forward we expect real interest rates on deposits to remain positive as long as inflation remains subdued.

Table 6: Private Sector Deposits-Flows (billion Rupees)

Deposit-Type	FY15	FY14
Current	204.3	580.4
Call	(31.5)	89.7
Other	(0.3)	2.3
Saving	709.2	157.6
Time	16.6	(41.7)
Total Private Sector Sector	**898.3**	**788.3**

Source: State Bank of Pakistan

35. As of Q3-FY15, key performance indicators of banking sector present a robust picture. Profitability has enhanced, asset quality is stable and Capital Adequacy Ratio (CAR) at 17 percent is well above the regulatory requirements of 10 percent. One of the key reasons for better performance of the banking sector has been the strategy of the banks to lock in funds at higher rates in risk free government securities in anticipation of falling interest rates amid subdued demand for private sector credit. The shift in risk behavior of banks from risky loans to risk free government securities has also aided in improving their CAR. However, continued risk-averse behavior of banks may create supply constraints leading to lower than expected uptake of credit to the private sector in the future.

36. In the coming months of FY16, several factors might positively influence the growth in private sector credit. Investor confidence, especially of the foreign investors,[26] is high, particularly in the wake of successful IMF reviews, political stability, relative improvements in the law and order situation and, most importantly, the developments in respect of the CPEC. The construction and real estate sectors show buoyancy as indicated by their continued credit uptake. On supply side, risk

[25] Average real returns on fresh deposits during FY15 are 2.37 percent versus negative 1.18 percent during FY14.
[26] The latest survey of April 2015, released by Overseas Investors Chamber of Commerce & Industry (OICCI), shows a surge of 18 percent in business confidence over the previous six months.

premium[27] has edged up from 113bps (on average) in FY14 to 131bps (on average) in FY15 while spreads[28] have fallen only slightly by 33bps from an average of 471bps in FY14 to 438bps in FY15 , possibly making lending slightly more attractive. The current easy monetary policy stance is expected to impact the credit uptake with a lag and credit may pickup in the coming months.

IV. Fiscal Deficit: Lowest in the Last Few Years

37. The revised FY15 budget estimates show the fiscal deficit at 5.0 percent of GDP, slightly higher than the target of 4.9 percent for the year. Provided that actual fiscal deficit, due to substantial increase in budgetary borrowing from the banking system, does not vary significantly from the revised budget estimates, this would be the lowest deficit recorded during the last seven years **(Table 7)**.

Table 7: Summary of Consolidated Fiscal Operations

billion rupees, unless stated otherwise

	FY14[P]	FY15[BE]	FY15[RE]	FY16[BE]
Total revenue: *of which*	**3638**	**4216**	**4227**	**4631**
FBR tax revenue	2266	2810	2605	3104
SBP profit	326	270	399	280
CSF money	108	140	204	154
Total expenditures	**5026**	**5638**	**5610**	**5960**
Current: *of which*	3789	4411	4486	4580
Subsidies[1]	323	203	243	138
Interest	1148	1325	1270	1280
Development	1237	1227	1124	1380
Fiscal balance	**-1388**	**-1422**	**-1383**	**-1328**
Financing	**1388**	**1422**	**1383**	**1328**
External	512	508	358	346
Domestic	877	914	1007	982
Non- Bank	553	686	605	649
Bank	323	228	402	283
Memorandum items (as percent of GDP)				
Overall budget balance	-5.5	-4.9	-5	-4.3
Primary balance[2]	1.0	0.3	0.4	-0.2
Revenue balance[3]	0.6	-0.7	-0.9	0.1

[P] Provisional; [BE] Budget Estimates; [RE] Revised Estimate

[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

38. The reduction in fiscal deficit in FY15 is primarily due to improvement in tax revenues as expenditures witnessed an uptick despite reduction in subsidies and lower interest payments. The tax revenues are estimated to grow by 20.8 percent in FY15 compared to 16.7 percent increase in FY14. This improvement largely reflects estimated recovery of Rs145 billion under Gas Infrastructures development Cess (GIDC). In the absence of any ‘one-off’ revenue items, the non-tax revenues are

[27] Defined as weighted average lending rate (WALR) minus three month treasury bill rate.
[28] Defined WALR minus weighted average deposit rate (WADR) on outstanding loans and deposits, respectively.

estimated to grow by only 4.5 percent in FY15 compared to 38 percent during FY14.[29] Therefore, growth in total revenues is estimated to decelerate to 16.2 percent in FY15 from 22 percent in FY14.

39. The FBR tax collection is estimated to grow by 15 percent in FY15, slightly lower compared to 17.1 percent growth witnessed in FY14 and below the 24 percent growth envisaged in the budget estimates. This shortfall in revenues is despite removal of exemptions and concessions and increase in GST on petroleum products from 17 percent to 27 percent to compensate the revenue shortfall due to decline in international oil prices.[30] The latest available provisional data shows the FBR tax collection approximately at Rs2580 billion, about Rs25 billion less than the revised estimate of Rs2605 billion. This translates into 9.5 percent of GDP, which is significant improvement compared to average of less than 9 percent during the past five years. Maintaining this trend could help in keeping the fiscal deficit at manageable levels besides creating fiscal space for further increase in development spending going forward.

40. Total expenditures are estimated to grow by 11.6 percent in FY15. This translates into 20.4 percent of GDP, which is about 1 percent of GDP higher than the budget estimate. This is despite an estimated decline in development expenditures by 9.2 percent, falling to 4.1 percent of GDP in FY15 from 4.9 percent of GDP in FY14. Like previous few years, the development expenditures largely reflect the shortfall in revenue from its target and increase in current expenditures.

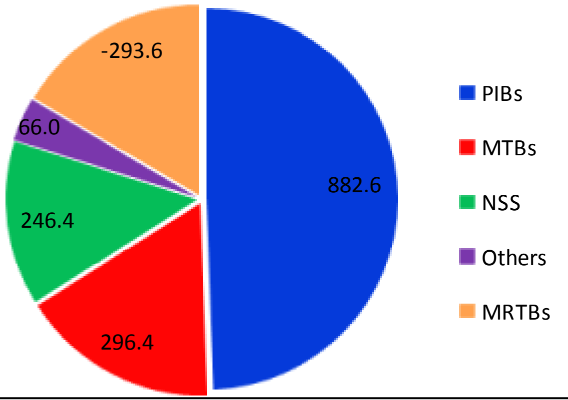
41. Driven by more than budgeted expenditures on defense and general government services, current expenditures are estimated to grow by 18.4 percent in FY15 compared to 3.1 percent increase in FY14. To some extent, the increase in defense and general government services was compensated by reduction in subsidies and lower interest payments. Decline in international oil prices and non-adjustment in electricity tariffs has helped in containing subsidies to Rs243 billion in FY15; though higher than the budgeted amount of Rs203 billion but about 25 percent lower than FY14.

[29] The non-tax revenues contributed by the one-off revenue receipts amounting to Rs313 billion in FY14. These included Rs157 billion received from Pakistan Development Fund (PDF), proceeds of Rs89 billion from the auction of 3G/4G licenses and Rs 67 billion from Universal Service Fund.

[30] The sales tax on High Speed Diesel (HSD) was raised to 22 percent in January, 27 percent in February and then 37 percent in March 2015. However, it was reduced to 32 percent in April 2015 and now it stands at 28 percent in June 2015 (http://download1.fbr.gov.pk/SROs/20156251465339535SRO600OF2015.pdf)

42. On a positive note, interest payments are estimated at Rs1270 billion in FY15; that is, Rs55 billion lower than the budget estimates. Slowdown in domestic debt accumulation, increase in the average term to maturity and reduction in interest rates on domestic debt are the main factors contributing to lower interest payments in FY15. The growth in stock of public debt has slowed down to only 9 percent in FY15 compared to 12 percent growth in FY14. This slowdown in debt accumulation is broad-based as growth in both domestic and external debt decelerated.

Figure 9: Government Domestic Debt (share in change during Jul-May FY15) *(in billion Rs)*



43. During Jul-May FY15, government domestic debt has increased by Rs1198 billion. The bulk of the increase is due to PIBs (Rs883 billion), which has improved the maturity profile of government debt (**Figure 9**). In addition, depreciation of currencies such as JPY, Euro, SDR and other currencies against US dollar has resulted in lower external debt due to the revaluation impact. These trends suggest the interest payments to remain contained in FY16 as well.

44. For FY16, in continuation of government's efforts to consolidate the fiscal position and to bring fiscal deficit at manageable levels, the target for consolidated fiscal deficit is set about 0.7 percent below the revised estimate for FY15 at 4.3 percent of GDP. Underlying this target is the assumption of a provincial surplus of Rs297 billion, FBR tax revenue at Rs3104 billion, and reduction in current expenditure by 1.3 percent of GDP with a substantial reduction in subsidies to Rs138 billion.

45. Like in previous years, the major risk to meet the FY16 fiscal deficit target is from the revenue side. Past trends show a strong tendency of FBR revenues falling short of the target. In the last three years, average gap between actual and target FBR revenue has remained close to Rs286 billion or 1.0 percent of GDP. This, combined with any slippage in current expenditures, could affect development spending, which remains one of the main factors currently contributing to moderate recovery in economic activity.

V. External Sector: Continues to Improve

46. The balance of payments position continued to improve in the second half of FY15 as well. It is particularly reflected in sustained increase in net SBP foreign exchange reserves; rising from $10.5 billion at end-December 2014 to $13.5 billion as of 30th June 2015.[31] Reduction in external current account deficit due to decline in import bill and steady growth in workers' remittances are key factors explaining the improved balance of payments position during FY15. Successful completion of reviews under IMF program and disbursement of program related funding continue to support reserves building besides instilling stability in foreign exchange market. These positive developments have led the international rating agencies to upgrade the country's sovereign credit ratings in recent months.

47. Decline in imports due to sharp decline in oil prices led the external current account to record a surplus of $137 million during H2-FY15. As a result, the overall external current account deficit during FY15 has been contained to $2.3 billion, about 27 percent lower than in FY14 (**Table 8**). Robust growth in workers' remittances and higher CSF inflows are other key factors that explained the lowering of external accounts in FY15 so far.[32] These positive developments have, however, masked the contraction in exports during FY15.

Table 8: Balance of Payments Summary

billion $, unless otherwise indicated

	FY14	FY15	FY16[1]
I. Current account balance	**-3.1**	**-2.3**	
Trade balance	-16.6	-17.0	
Services balance	-2.7	-2.5	
of which: CSF	1.1	1.5	
Income balance	-4.0	-4.5	
Current transfers balance	20.1	21.8	
of which: Remittances	15.8	18.5	
II. Capital and financial account	**7.4**	**4.9**	
Capital account	**1.9**	**0.4**	
Financial account: *of which*	**5.6**	**4.5**	
Direct investment (net)	1.6	0.6	
Portfolio investment (net)	2.8	1.9	
General government (net)	1.6	1.3	
III. Errors and omissions	**-0.4**	**0.0**	
Overall balance (I + II + III)	**3.9**	**2.6**	
Memorandum items:			
Current account as % of GDP	-1.3	-0.8	-0.5 to -1.5
Net SBP forex reserves[2]	9.1	13.5	

[1] SBP Projections; [2] Excludes CRR and foreign currency cash holdings

Source: SBP

48. The decline in oil prices has helped the country to cut its oil import bill by 18.0 percent during FY15. Despite the fact that the oil constitutes almost one-third of total imports, most of its impact on overall imports has been offset by significant

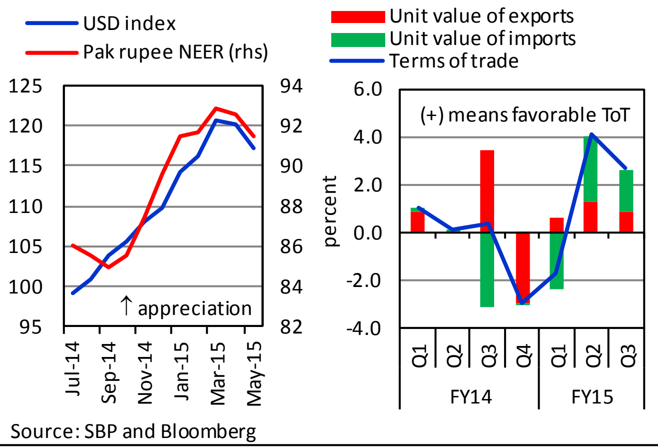
[31] At end-June 2014, net SBP foreign exchange reserves stood at $9.1 billion. Furthermore, SBP's net international reserves (NIR) increased from $2.7 billion at end-June 2014 to $4.3 billion at end-March 2015.

[32] Given the major contribution is coming from GCC countries (around 64 percent of total remittances), whose economies are facing difficulties in wake of lower oil prices, the growth in remittances is quite robust.

increase in non-oil imports. The major among these include imports of metals and machinery.[33] This reflects gradually improving economic activity, particularly under the construction and mining sectors. Given benign international commodity price outlook, stable exchange rate and government's planned investment in infrastructure, the non-oil imports are expected to remain high in FY16 as well. Nevertheless, dominated by price impact, lower oil import bill is expected to keep the overall imports in FY16 close to FY15 level.

49. Contraction in exports, however, is worrisome and has neutralized the gains from the reduction in import bill. Exports declined by 3.8 percent in FY15 that kept the trade deficit slightly higher than the FY14's level. Textile exports, accounting for about 55 percent of total exports, declined by 1.0 percent in FY15. The GSP plus status from European Union continues to show positive impact as high value added textile exports grew by 5.4 percent in FY15. On the other hand, export of low value added textile products declined by 10.0 percent. Besides structural bottlenecks, slowdown in Chinese economy, the major importer for cotton yarn and related products, is the other major reason for decrease in the latter.[34]

Figure 10: Movements in NEER and Terms of Trade



Source: SBP and Bloomberg

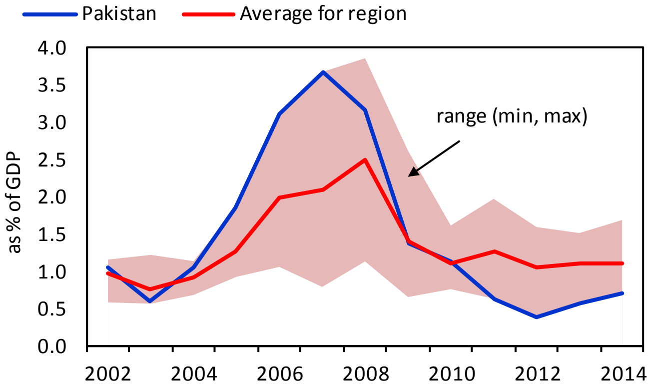
50. The impact of GSP plus status could have been more visible and overall exports might have shown slight improvement had Euro not weakened by 16.0 percent against the Pak rupee in FY15. Despite this, overall terms of trade have turned favorable from Q2-FY15 onwards (**Figure 10**). Indeed, real exchange rate appreciation during FY15 was driven by strengthening of US dollar against basket currencies. Recently, the weakening of US dollar worldwide and lower domestic inflation are expected to arrest some of this real appreciation of Pak rupee in coming months. This might help maintain export competitiveness amid resolution of other important structural

[33] Respectively, metal and machinery imports grew by 20.3 and 11.1 pecent during FY15.
[34] According to latest figures, on average Pakistan exports 65 percent of it cotton yarn and related products to China. During July-May FY15, the value of exported cotton yarn and related products to China has declined by 15.0 percent compared to July-May FY14 figures.

issues. Therefore, keeping in view structural constraints and weak external demand, the exports are projected to recover moderately in FY16.

51. Based on these trends and developments, the external current account deficit in FY16 is projected to remain in the range of 0.5 to 1.5 percent of GDP. This projection also assumes workers' remittances to maintain its current pace and surpass the overall trade deficit in FY16. Nonetheless, as highlighted in previous statements that the financing of even a small external current account deficit can still be challenging due to lack of private financial inflows, particularly the non-debt creating flows.

Figure 11: FDI Inflows to Major South Asian Economies*



* includes India, Pakistan, Sri Lanka and Bangladesh
Source: Haver Analytics

52. In FY15, the capital and financial account posted a surplus of $4.9 billion; mainly on account of $1.0 billion receipts from issuance of international *Sukuk* and $4.1 billion under official disbursements. This surplus is 34 percent lower compared to FY14 and continues to be driven by debt creating flows. Net foreign direct investment (FDI) declined from $1699 million in FY14 to $709 million in FY15 that stands around 0.3 percent of GDP. Although trend in FDI flows to Pakistan is not much different from those in regional countries, Pakistan has fallen in the lowest percentile in recent years (**Figure 11**).

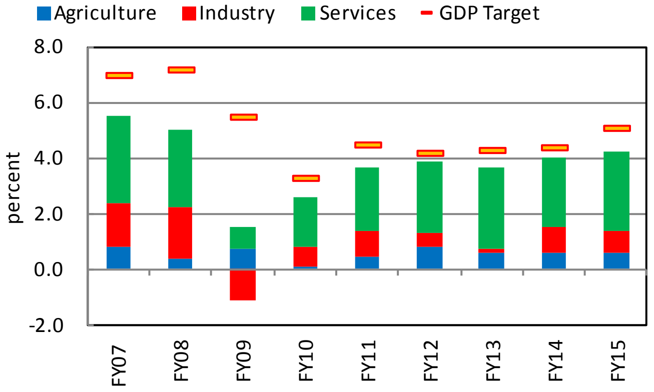
53. This trend in FDI is not encouraging from the perspective of medium to long-term sustainability of the external accounts.[35] In the short to medium-term, however, the disbursement of program related funding and planned issuance of Eurobonds are expected to continue to support an upward trajectory in foreign exchange reserves. Therefore, assuming IMF program remains on track, the net SBP reserves are projected to increase slightly above 4 months of imports by end-June 2016.

[35] Although recent developments related to China-Pakistan Economic Corridor (CPEC) are expected to improve foreign capital flows situation and help in buildup of country's forex reserves; however, its major impact might lie beyond FY16.

VI. Economic Growth: Remains on Recovery Path

54. Supported by robust growth in services and construction sectors, the real GDP growth continues to nudge upwards. Provisional National Income Accounts estimates show that real GDP grew by 4.2 percent in FY15, slightly higher than 4.0 percent in FY14, but lower than the 5.1 percent target for the year (**Figure 12**).

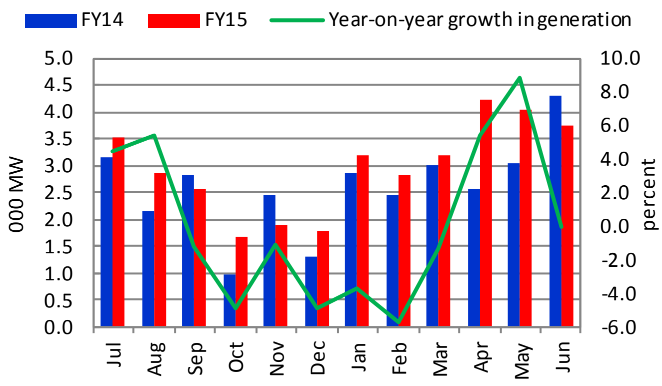
Figure 12: Sectoral Contribution to Real GDP Growth



Source: Economic Survey 2014-15

55. As in the previous few years, major contribution to real GDP growth continues to come from services sector. Supported by general government services and finance and insurance, the services sector grew by 5.0 percent, close to the target of 5.2 percent. The agriculture sector, despite some losses to major crops from untimely and heavy rains, grew by 2.9 percent in FY15 compared to 2.7 percent in FY14 and 3.3 percent target for the year. The growth in industrial sector of 3.6 percent, however, missed the target by a significant margin. It was largely dragged by less than expected growth of large-scale manufacturing (LSM) and electricity generation (**Figure 13**), which also overshadowed an otherwise buoyant construction and mining and quarrying activities.

Figure 13: Electricity Generation - Demand Gap (Average)



Source: NTDC website

56. Despite considerable increase in the production of construction related industries and automobiles, LSM grew by 3.3 percent during Jul-May FY15 compared to 4.4 percent during Jul-May FY14. Persistent energy shortages, shrinking gas supply in particular, continue to affect manufacturing activity on the domestic front. Contraction in exports as well as lower prices of exports have been the discouraging

factors from the external side. These have particularly restrained growth in some of the industries like fertilizer and textile. However, decline in the production of food group was largely due to higher inventories and subdued international commodity prices.

57. On the expenditure side, consumption continue to remain the major contributor to growth, while total investment remained stagnant over the last few years, particularly due to insipid private sector investment (**Table 9**). Driven by 25.1 percent increase in public and government sector investment, total investment increased marginally to 15.1 percent of GDP in FY15 from 15.0 percent in FY14.

Table 9: Growth in Expenditures on Real GDP (at constant factor cost of 2005-06)

percent

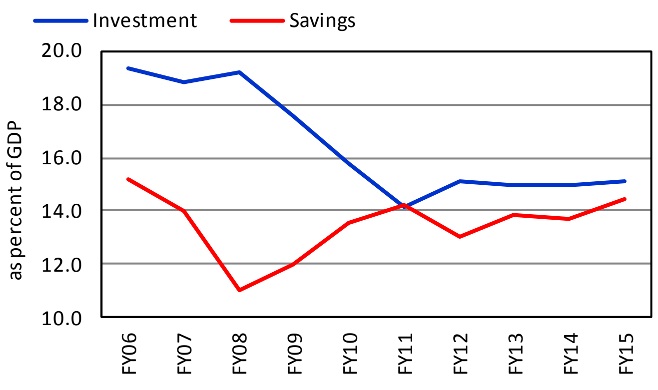
	FY13	FY14	FY15
Total consumption expenditures	**3.0**	**4.9**	**5.1**
Private	2.1	5.4	3.6
General government	10.1	1.5	16.0
Investment expenditures	**2.5**	**4.3**	**8.0**
Gross fixed capital formation	2.6	4.2	8.3
Private	4.3	6.2	3.2
Public and general government	-2.3	-1.9	25.1
Changes in stocks	4.4	4.7	5.5
Total domestic demand	**3.0**	**4.8**	**5.5**
Exports of goods and non-factor services	13.6	-1.6	-2.6
Imports of goods and non-factor services	1.8	0.2	-1.1
Gross domestic product (MP)	**4.4**	**4.7**	**5.5**
Gross domestic product (FC)	**3.7**	**4.0**	**4.2**

Source: Economic Survey 2014-15

58. Nevertheless, investment remains stagnant at almost 15 percent of GDP during the last four year. Similarly, national savings have been hovering around 14 percent of GDP during the last five years (**Figure 14**).

59. Materialization of the planned government investment in energy and infrastructure and gradually improving security conditions and investor confidence are expected to encourage private sector investment going forward.[36] Government's decision to import liquefied natural gas (LNG), besides compensating for dwindling domestic supplies, could also improve the energy mix in electricity generation. The former is expected to directly benefit fertilizer and textile industries.

Figure 14: Saving - Investment Gap



Source: Economic Survey 2014-15

[36] Recent surveys and upgrade by Moodys and Standard & Poors point towards improved investor confidence.

60. In addition, monetary easing in FY15 and inventories built at lower prices in FY14 are expected to encourage manufacturers to increase capacity utilization and scale up production. Automobile and construction related industries are also expected to maintain momentum in FY16. While automobile is expected to benefit from car finance schemes in a lower interest rate environment, planned increase in development spending and incentives for construction sector announced in FY16 budget could continue to support robust construction activity. Further, assuming agriculture growth close to past three years' average, the real GDP is projected to maintain its momentum in FY16 and surpass last year's growth.

61. Nevertheless, the real GDP growth is expected to remain close to its long-term historical average growth. Impetus on implementation of infrastructure projects planned under China-Pakistan economic corridor could help revive investment and push real GDP growth above 5 percent in short term. Addressing structural bottlenecks, especially overcoming energy related issues, and improving security conditions to create favorable investment climate could help sustain or even surpass this growth over the long term.

VII. Declining Inflation: Lowest since FY04

62. The average CPI inflation during FY15 has fallen to 4.5 percent, substantially lower than annual target of 8.0 percent and a year earlier inflation of 8.6 percent. After moderation in first quarter of FY15, decline in inflation gained momentum from October 2014 onwrad mainly due to sharp fall in global oil price and better domestic availability of major food items. The deceleration in inflation had been broadbased as both measures of core inflation, non-food non-energy (NFNE) and 20 percent trimmed, also witnessed decline (**Table 10).** Thus, the faster decline both in actual and projected inflation allowed SBP to cut the policy rate by a cumulative 300 basis points from November 2014 onward.

Table 10: Inflation

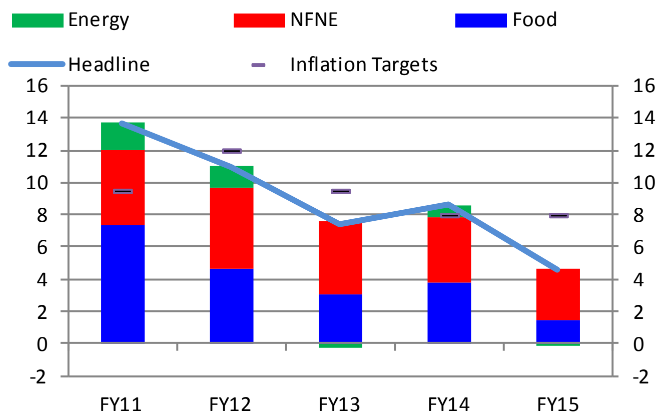
in percent

	year-on-year		Average		
	Jun-14	**June-15**	**FY14**	**FY15**	**FY16[1]**
CPI headline	**8.2**	**3.2**	**8.6**	**4.5**	**4.5-5.5**
Food group	7.4	3.2	9.0	3.5	
Non-food group	8.9	3.2	8.3	5.3	
Core measures					
NFNE*	8.7	4.6	8.3	6.5	
20% trimmed	7.9	3.8	8.5	4.9	

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

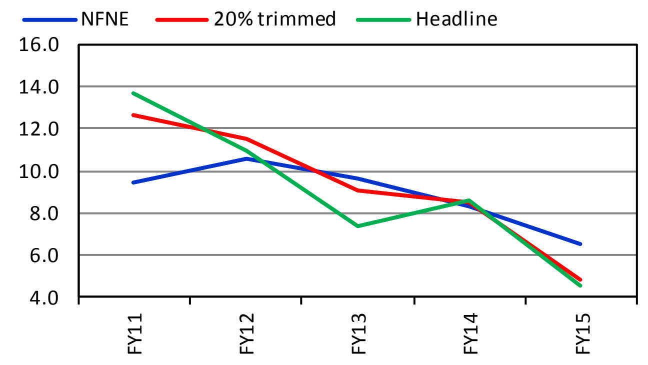
63. Though broadbased, lower energy and food prices were the major contributors to this decline in inflation (**Figure 15**). For instance, sharp fall in global oil prices,[37] which were passed on to public at large, capping of piped-gas tariffs and only a minor increase in electricity tariffs[38] kept the average energy prices low during FY15. In sum, these administered prices have played a key role on the inflation front. Although imperfect, this also had a second round impact through lower transport fares and some reduction in costs of production. Similarly, improved food supply of wheat and rice due to lower exports amid falling export prices and falling import prices of edible oil and tea also contributed to lower food inflation during FY15. Specifically, average inflation of perishable food items fell to 2.5 percent during FY15 from 15.4 percent a year earlier, along with less volatility.

Figure 15: Contribution to Inflation (percentage points)



64. Besides food and energy, both the measures of core inflation continued their gradual softening trend for the fourth consecutive year (**Figure 16**). Apart from lower prices of raw material, particulalry cotton and steel, this is also a reflection of restrained aggregate demand relative to the productive capacity of the economy. The moderation in aggregate demand, in turn, may partly be attributed to the lagged impact of earlier monetary tightening. Thus GDP growth of 4.2 percent in FY15 is still lower than the economy's potential that is exerting downward pressure on core inflation.[39] Likewise, ease in underlying inflationary pressures can also be observed from continuous rise in number of CPI items showing inflation of less than 5.0 percent (**Figure 17**).

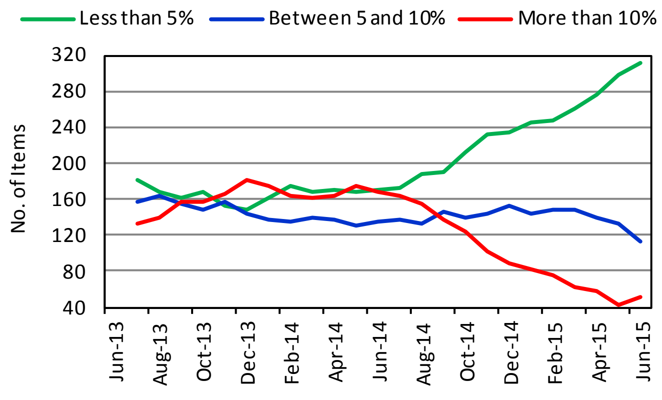
Figure 16: Core and Headline Inflation
(in percent, year-on-year)



Source: PBS

[37] International price of crude oil (Saudi Arabian Light) fell from US$109.7 in June 2014 to US$ 44.5 in February 2015 before recovering to US$ 64.0 in June 2015.
[38] Electricity tariffs were increased by 1.79 percent in November 2014.
[39] Average GDP growth in last 35 years, a proxy for potential GDP, is around 5.0 percent.

Figure 17: Distribution of CPI Basket (YoY Inflation)



Source: PBS

65. In addition, improved fiscal and external accounts[40] also helped in keeping inflation low during FY15. Lower fiscal deficit and its improved financing from external sources favorably affected inflation through contained government borrowing from the banking system. Better external position supported exchange rate stability that eased pressures on domestic prices of imported goods. All this helped in anchoring the inflation expectations at a relatively lower level. This is also supported from the IBA-SBP Consumer Confidence Index (CCI) trend in FY15 that consistently showed lower expected inflation over a six month horizon.

66. However, it is important to recognize the fragility of the inflation outlook since it is the role of temporary factors (i.e. food and global oil prices) that has brought headline inflation below the NFNE measure of core inflation, averaging at 6.5 percent, in FY15 (**Figure 17**). Further, with the weakening of productive capacity of the economy, as indicated by deteriorating investment to GDP ratio, slightly quicker pick up in aggregate demand is enough to pose upside risk to inflation.

67. Going forward, headline inflation would pick up modestly in the second half of FY16 due to the base effect of its lower level in FY15. Firming up of crude oil prices at their current level in the international market also supports this trend. However, possible adverse impact of prevailing low food prices on next year crops production, pick-up in aggregate demand on the back of historic low interest rates, higher remittance growth and weak prospects of increase in productive capacity could result in inflation higher than its projection for FY16. Moreover, any upward adjustment in electricity and gas tariffs also poses upside risks to inflation. Nevertheless, lagged impact of moderate monetary expansion and relatively benign inflationary expectations would affect the inflation outlook favorably. Keeping these developments in view, there is no major change in SBP's previous inflation forecast.

[40] Fiscal dficit as percent of GDP is expected to fall to 5.0 percent during FY15 from 5.8 percent in FY14. Likewise, current account deficit as percent of GDP has fallen to 0.8 percent in Jul-May FY15 from 1.4 percent in Jul-May FY14.

List of Acronyms

ADB	Asian Development Bank
BE	Budget Estimates
bps	Basis Points
CAR	Capital Adequacy Ratio
CCI	Consumer Confidence Index
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CRR	Cash Reserves Requirement
CSF	Coalition Support Fund
DMMD	Domestic Markets and Monetary Management Department
ECB	European Central Bank
ECC	Economic Coordination Committee
EFF	Extended Fund Facility
EU	European Union
FBR	Federal Board of Revenue
FC	Factor Cost
FDI	Foreign Direct Investment
FE	Foreign Exchange
Forex	Foreign Exchange
FX	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructures development Cess
GSP	Generalized System of Preferences
GST	General Sales Tax
H1	First half
H2	Second Half
HBL	Habib Bank Limited
HSD	High Speed Diesel
IBA	Institute of Business Administration
IDA	International Development Authority
IMF	International Monetary Fund
IRC	Interest Rate Corridor
JPY	Japanes Yen
KIBOR	Karachi Interbank Offer Rate
LMM	Locally Manufactured Machinary
LSM	Large-scale Manufacturing
LNG	Liquefied Natural Gas
M2	Broad Money
MP	Market Price
MPS	Monetary Policy Statement
MRTB	Market related Treasury Bills
MTB	Market Treasury Bills
MUFAP	Mutual Funds Association of Pakistan

NBFCs	Non Bank Finance Companies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NIR	Net International Reserves
NSS	National Saving Scheme
NTDC	National Transmission & Despatch Company
NZ	Newzealand
OICCI	Overseas Investors Chamber of Commerce & Industry
OIN	Other Items Net
OMO	Open Market Operations
PBS	Pakistan Bureau of Statistics
PDF	Pakistan Development Fund
PIBs	Pakistan Investment Bonds
PKR	Pakistan Rupee
POL	Petrolium, Oil and Lubricants
PSC	Private Sector Credit
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
SA Rand	South African Rand
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
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
YoY	Year on year
$	United States Dollar
3G	3rd Generation
4G	4th Generation