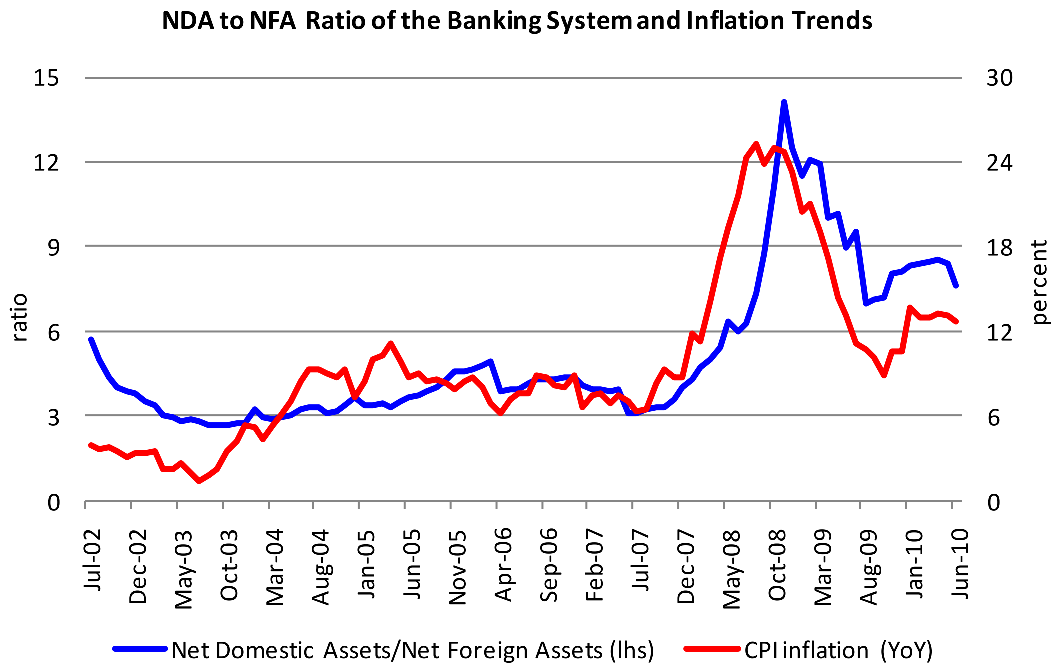
MONETARY POLICY STATEMENT

July 2010



STATE BANK OF PAKISTAN

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Executive Summary

As the new fiscal year begins, concerns of persistence in inflation and fiscal weaknesses are overshadowing the improvement in the external current account deficit and economic recovery. The gap between national savings and investment has narrowed but mainly because of decline in investments. At the same time aggregate domestic demand, led by public sector consumption expenditures, is picking up while prospects of aggregate supply remain weak due to energy shortages and dismal law and order conditions. These developments together with rising total debt are stressing the macroeconomic stability and call for renewed efforts to maintain an upward trajectory in economic growth.

The average CPI inflation of 11.7 percent during FY10 has been 2.7 percentage points higher than the target. Current trends and expected developments indicate risks of inflation pressures continuing in FY11. These include further upward adjustments in electricity prices, increase in General Sales Tax (GST), and revisions in government employees' wages to compensate for the current high inflation. Rising domestic demand relative to weak productive capacity and the recent increase in NDA to NFA ratio along with its strong association with CPI inflation also suggests that inflation is likely to persist in FY11. Incorporating these factors, the average CPI inflation is projected to remain between 11 to 12 percent in FY11, which is higher than the announced target of 9.5 percent.

An increase in the Net Domestic Assets (NDA) of the banking system of Rs488 billion during FY10 can be largely explained by the government's borrowing requirements for budgetary support and commodity operations. The need for continued reliance on the banking system, both from scheduled banks and SBP, to finance the fiscal deficit essentially emanates from low tax revenues, high current expenditures, and shortfalls in projected external financing. While the tax collection by the FBR at Rs1327 billion shows a shortfall of Rs53 billion from the target of Rs1380 billion for the year, only Rs177 billion was received from external sources against the budget estimate of Rs377 billion.

These provisional figures indicate that the revised FY10 fiscal deficit target of 5.1 percent has been missed and could be higher than 6.0 percent. Similarly, the target of government borrowings from SBP has also been breached for the fourth quarter of FY10. The stock of net government borrowings from SBP (on cash basis) was at Rs1171 billion as on 30th June 2010 against the target of Rs1130 billion. Clearly, such fiscal developments are inconsistent with the objectives of

macroeconomic stability. These have contributed towards aggravating expectations of rising inflation and have kept an upward pressure on interest rates. The result is a crowding out of private sector credit and increased stress on debt sustainability.

Containing the fiscal deficit within the announced target of 4 percent of GDP for FY11 already seems challenging. It assumes a 5 percent deficit of the federal government and a combined surplus of 1 percent by the provinces. However, consolidated provincial figures reflect almost a balanced budget. This would suggest that the FY11 fiscal deficit could exceed 5.0 percent of GDP. Moreover, meeting the FBR tax collection target of Rs1667 billion would require a 25.6 percent growth or a 0.8 percentage point improvement in the tax to GDP ratio, which seems unlikely without broadening of the tax base. Low tax revenues of the government have become a serious concern as it has increased reliance on foreign borrowings to meet rising expenditures. Delays or shortfalls in such inflows could put pressure on external accounts sustainability.

The external current account deficit of $3.5 billion or 2 percent of GDP during FY10 was below earlier projections despite steady acceleration in imports in the second half. This outcome was helped by a reasonable recovery in exports, robust growth in workers' remittances, and realization of Coalition Support Fund (CSF). Thus, notwithstanding significantly lower Foreign Direct Investments (FDI) and shortfalls in projected foreign inflows, SBP's foreign exchange reserves increased to $13 billion by end-June 2010 from $9.1 billion at end-June 2009. This includes receipts of $4.6 billion from the IMF; $2.2 billion for balance of payment support, $1.1 billion for temporary bridge financing for the budget, and $1.3 billion through a onetime non-recurring increase in SDR allocations.

Reflecting the improved balance of payment position, the Net Foreign Assets (NFA) of the banking system increased by Rs152 billion during FY10. This, together with increases in total deposits of the banking system, has facilitated the market liquidity conditions and helped in meeting the credit requirements of the economy. SBP's Open Market Operations (OMOs) neutralized the effect of changing liquidity conditions on short term market interest rates and ensured consistency of overnight money market repo rate with the monetary policy stance.

The sustainability of external accounts improvement and build up of NFA, however, faces headwinds in FY11. Consistent with recovery in the domestic economy and forecasts of higher international commodity prices, import growth is projected to increase to 12.0 percent in FY11 as opposed to a decline of 2.3 percent

in FY10. Similarly, despite the uncertainty of economic recovery in Pakistan's export destination countries and an unfavorable domestic business environment, the export growth for FY11 is projected to be around 7.0 percent compared to 2.7 percent recorded in FY10. After assuming a benign outlook for worker's remittances and further CSF inflows, this trade outlook is expected to widen the external current account to 3.7 percent of projected GDP.

Incorporating the projections of the external sector and consolidated fiscal position along with the announced targets of inflation and real GDP growth, the broad money is projected to grow by 13.0 percent in FY11. To assess its relationship with CPI inflation, the developments affecting NDA and NFA will have to be monitored closely. While the former would largely depend on government borrowings from the banking system, the latter would be contingent upon the realization of foreign financial flows matching the expected increase in the external current account deficit.

Evaluating the savings-investment gap is another way of assessing the importance of foreign financial inflows. Data on the expenditure side of the real GDP for FY10 shows that the provisional growth of 4.1 percent in FY10 was mostly due to the increase in total consumption expenditures. It grew by 5.0 percent, led by an increase of 13.4 percent in the government sector consumption expenditures. However, total investment expenditures declined by 1.5 percent due to a decline of 5.1 percent in the private sector investment. The total investment as a percent of GDP has now declined for three consecutive years, reaching 16.6 percent in FY10. Supported by an increase in workers' remittances, national savings on the other hand, improved by 0.5 percentage points to 13.8 percent of GDP in FY10.

Since this reduction of 2.8 percent of GDP in the saving-investment gap is because of a larger fall in investment than increase in savings, it cannot be considered an encouraging development. A decline in investment expenditures means reduced capital per worker and a weakening production infrastructure. Adding to the difficulties are persistent energy shortages and poor law and order conditions. Thus, it seems difficult to consistently increase aggregate supply to meet the rising domestic aggregate demand, which grew by 3.8 percent in FY10 compared to 1.4 percent a year earlier. This partly explains the economy's reliance on foreign borrowings and persistence in inflation.

Thus, renewed committed efforts are required to increase the economy's resource envelope and contain current expenditures. In particular, measures to

increase the tax to GDP ratio and eliminate the revenue deficit of fiscal accounts are urgently required to provide a firm foundation for sustainable economic growth. This would reduce the pressure on government borrowings from SBP and debt payments, create room for development expenditures in critical areas, and soften the adverse impact on the private sector.

To mitigate risks to macroeconomic stability, monetary policy has to take lead for containing aggregate demand pressures emanating mainly from expansionary fiscal position. Therefore, SBP is increasing the policy rate by 50 basis points to 13 percent with effect from 2nd August 2010.

A. Economic Environment and SBP's Policy Response: H2-FY10

Policy rate was kept unchanged anticipating risks to inflation and nascent economic recovery…

1. SBP kept the policy rate unchanged at 12.5 percent during H2-FY10 due to resurgence of inflation and increased pressure on fiscal accounts. Although the rise in inflation was anticipated due to announced increases in electricity tariffs, there was a risk that this increase could spread to other prices. Upward adjustments in domestic petroleum prices and volatility in food prices only added to the uncertainty. Moreover, declining real investment and worsening law and order conditions affected economy's ability to meet prevailing aggregate demand. Taken together, these factors contributed towards entrenchment of expectations of high inflation and adversely affected the inflation outlook.

2. Fiscal management became increasingly challenging as the fiscal year progressed. Low tax revenues and delays in external financing made it difficult to meet rising expenditures despite cuts in development budget and efforts to rationalize subsidies. Consequently, financing of the fiscal deficit tilted more towards domestic sources, including borrowings from SBP. This, together with government borrowings for commodity operations and credit availed by Public Sector Enterprises (PSEs), led to substantial increase in Net Domestic Assets (NDA) of the banking system. Most worryingly, the third and fourth quarter targets of government borrowing from SBP were breached.

3. Clearly, such fiscal developments are inconsistent with the objectives of macroeconomic stability. These have contributed towards aggravating expectations of rising inflation and have kept interest rates under pressure. The result is crowding out of private sector credit and increased stress on debt sustainability.

4. The silver lining was provided by better than expected reduction in the external current account deficit. Not only was the projected Coalition Support Fund (CSF) money realized but growth in remittances and improvement in trade account surpassed earlier projections. Thus, despite shortfalls in official external financing, SBP managed to strengthen its foreign exchange reserve position. Build-up in reserves was further supported by inflows provided by the International Monetary Fund (IMF).

5. At the same time growth in large scale manufacturing sector gathered pace, reflecting recovery in economic activity. Indeed, the provisional real GDP growth figure of 4.1 percent for FY10 is higher than the announced target of 3.3 percent. However, given the severe electricity shortages and deteriorating security situation, this economic recovery seemed fragile and it was deemed prudent not to increase the policy rate in H2-FY10.

Changing global outlook also added to uncertainty over external sector improvement…

6. The uncertain prospects of economic growth are not specific to Pakistan only. A renewed debate is now taking place in international policy circles on the sustainability of initial recovery in the global economic growth witnessed after the recession of 2008-2009. Initially, focus was on providing growth stimulus to minimize a prolonged recession, while also improving the regulatory framework of the financial sector in advanced economies. However, triggered by Greece's sovereign debt crisis of 2010, the fiscal sector issues have taken centre stage in more recent discussions. Opposing views are being voiced on the appropriate monetary and fiscal policy stance in the context of avoiding a relapse in economic activity and managing debt sustainability issues. This uncertain global economic environment has made the task of central bankers and fiscal authorities quite challenging and Pakistan is no exception.

7. One view is that economic recovery, propped-up by historically large fiscal stimulus, remains weak and thus favors continuation of low interest rates and delays in withdrawing the extraordinary fiscal support. Given that the private sector activity in many advanced economies remains weak this seems like a reasonable approach. The risk is that it discounts the likelihood of enormous fiscal pressures having negative implications for financial markets, including the global foreign exchange market. The recent depreciation of euro against the US dollar is an example of that. The impact of this on Pakistan's economy is an appreciation of the Nominal Effective Exchange Rate (NEER) since January 2010. With Pakistan's inflation already high relative to its trading partners, this reduces the competitiveness of our trade sector.

8. Advocates of this view in advanced economies have even recommended revising inflation targets to accommodate the effects of low interest rates on inflation expectations. This challenges the consensus, developed over the past two decades, among most central bankers on monetary policy priorities and strategies.

However, concerns have been expressed regarding the damaging effects on inflation expectations and financial stability because of current and expected low interest rates in most of the advanced economies. Global inflation outlook, including that of international commodity prices, has not been affected yet, but it may be a question of when not why. Countries like Pakistan need to closely monitor and understand such likely developments.

9. The other view is that the size of current fiscal deficits and rapid deterioration in debt indicators of many advanced economies cannot be sustained for long without negative consequences on overall economic stability and growth. Proponents of this view cite examples of Greece and recommend a clearly announced plan of exiting from fiscal stimulus, with a simultaneous but gradual increase in interest rates. Some fiscal austerity measures and reforms have been initiated in many European countries. Also, experiencing faster recovery, resurgence in inflation, and rise in capital flows, some countries like Australia, India, and China have started tightening their monetary policies.

10. Pakistan’s economy is experiencing fiscal difficulties and its debt burden has started to increase. As the global developments reveal, there are strong inter-linkages between fiscal vulnerabilities and financial stability. If not addressed in time they do have a tendency to spillover to other sectors and disrupt real economic activities. Therefore, emphasis on fiscal reforms, including tax collection enhancement measures and rationalization of current expenditure, is imperative to maintain macroeconomic stability in Pakistan.

B. Recent Economic Developments and Outlook

The movement in market interest rates remained in line with the monetary policy stance during H2-FY10...

11. The movement in overnight money market repo rate, which is the operational target of SBP’s monetary policy, remained in line with no change in policy rate during H2-FY10. Developments in macroeconomic conditions, however, did affect market liquidity position causing some fluctuation in the overnight repo rate within the corridor. SBP continued to conduct its Open Market Operations (OMOs) to neutralize their effect on interest rates and ensured smooth functioning of the inter-bank market.

12. Broad macroeconomic factors influencing market liquidity conditions include: movements in total deposits and Net Foreign Assets (NFA) of the banking system and changing credit requirements of different sectors of the economy. For instance, the banking system deposits expanded by Rs311.5 billion during Q4-FY10 compared to contraction of Rs11.3 billion in Q3-FY10 (see **Table 1**). As a result funding base of the banking system improved, easing the potential liquidity pressures. This was helped by sustained increases in remittances and better intermediation by the banking system. An improved currency to deposit ratio, which declined to 28.9 percent in June 2010 from a high of 34.1 percent in November 2009, is an indication of the latter.

Table 1: Inter-bank Market Liquidity Conditions

flows in billion rupees, unless stated otherwise

	Q3-FY10	Q4-FY10
Total deposits[1]	-11.3	311.5
NFA of the banking system	-50.8	92.1
Net budgetary borrowing from SBP	91.7	15.0
Private sector credit	22.6	-34.3
Commodity finance	-58.3	143.3
T-bill auctions (net of maturities)	30.7	80.6
Average outstanding OMO	89.3	9.3
Average overnight money market repo rate (%)	11.7	11.1

[1] Excluding government deposits

Source: SBP

13. Facilitating availability of fresh liquidity, there was expansion in the NFA of the banking system in Q4-FY10 unlike the contraction seen in the preceding quarter. This improvement in the NFA was a reflection of reduction in the external current account deficit and partial realization of projected external official loans towards the end of FY10.

14. These developments have helped in meeting the credit demand of the economy, which largely emanated from the government sector. The contraction of Rs34.3 billion in private sector credit in Q4-FY10 also allowed the banking system to meet the increased borrowing by the government for both budgetary support and commodity operations.

15. Due to seasonal factors, the impact on market liquidity coming from demand for private sector credit and commodity finance is likely to remain muted during the early months of FY11.[1] The expected developments in the NFA of the banking system and government borrowing requirements, however, need to be monitored closely to assess their implication for market liquidity. While the timely realization of foreign inflows would be critical, it is important that the government adheres to the pre-announced T-bill auction target of Rs535 billion for Q1-FY11 to avoid undue pressure on market liquidity.

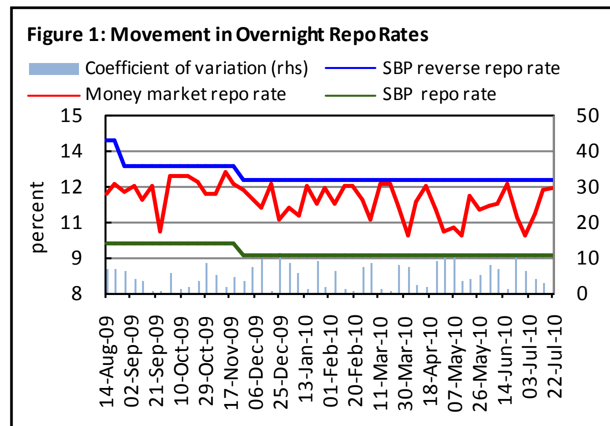
[1] The private sector credit off take typically begins in September and declines in the second half of every year. At the same time, the first few months of each fiscal year usually witness repayment of commodity loans.

16. Interaction of market liquidity and government borrowing from the banking system has two dimensions. While government borrowing from SBP increases liquidity in the system, its borrowings from the schedule banks absorb the available liquidity. Despite advanced announcement of quarterly T-bill auctions targets, the unpredictable borrowings from SBP created unnecessary challenges for monetary management. Not only did it make liquidity management difficult but was also a factor in causing volatility in money market interest rates.

17. Depending on prevailing liquidity conditions, SBP proactively conducted its OMOs during H2-FY10. As the market liquidity gradually improved, the extent of heavy injections was reduced and even some mop-ups were conducted in May and June 2010. To be specific, the average outstanding amount of net OMO injections declined to Rs9.3 billion in Q4-FY10 from Rs89.3 billion in Q3-FY10. This calibrated liquidity management helped in neutralizing the impact of volatile liquidity flows and ensured smooth functioning of the market. At the same time it facilitated consistency of weighted average overnight money market repo rate with the monetary policy stance.

18. Since there was no change in the policy rate in H2-FY10, no significant change was expected in short-term market interest rates, in particular the overnight rate. The overnight rate stayed close to the policy rate initially, but its subsequent movement, within the corridor, broadly matched the changing liquidity conditions (see **Figure 1**). On average, it has been 60 basis points (bps) lower during Q4-FY10 compared to the third quarter average.

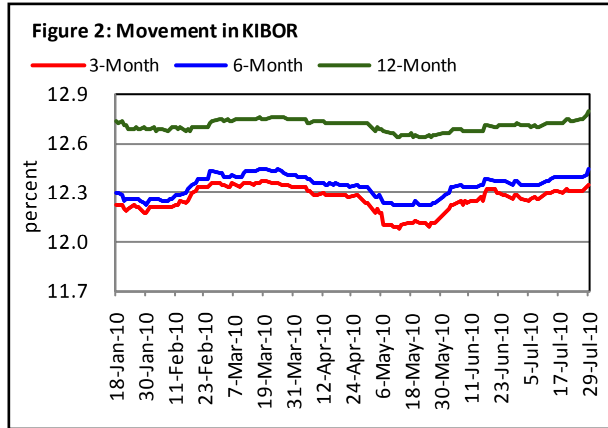
Figure 1: Movement in Overnight Repo Rates



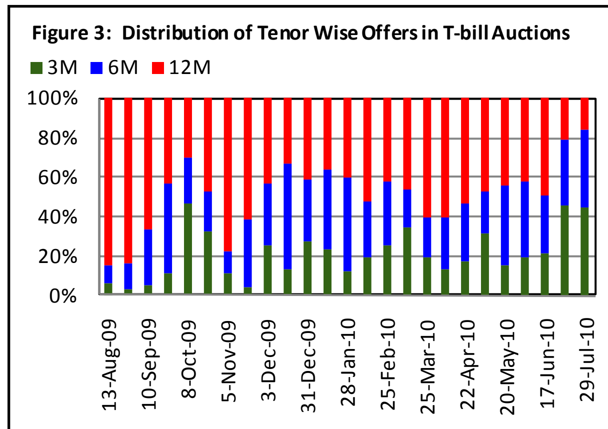
19. However, due to uncertainty regarding the timing of foreign inflows and unpredictability of government borrowings from SBP, volatility of the overnight rate has slightly increased. The coefficient of variation of the overnight rate has increased to 6.2 percent during Q4-FY10, from 4.3 percent during Q3-FY10.

20. Similarly, the KIBOR of different tenors have moved in a narrow range since January 2010 (see **Figure 2**). The recent uptick in the 6-month KIBOR, for example, from 12.2 to 12.4 percent is more a reflection of rising inflation expectations than

liquidity conditions. The bidding pattern of banks in the last three T-bill auctions, and consequent increase in cut-off rates, indicate changing expectations and pressure on interest rates. For instance, the cut-off rate in 6-month T-bills has increased by a cumulative 27 bps in the last two auctions of FY10 and first two auctions of FY11. At the same time, banks seem to be more inclined towards 3 and 6-month T-bills. The proportion of amount offered by banks in the 29th July 2010 auction in these tenors increased to 84 percent compared to 58 percent in the 3rd June 2010 auction (see **Figure 3**).

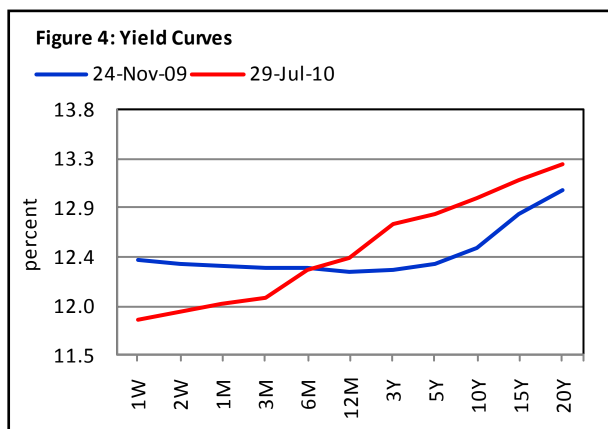


21. Similar change in banks' behavior can be observed in the PIB auction held on 21st July 2010. Although the amount offered, Rs19.9 billion, was close to the target of Rs20 billion, the bid rates increased on average by 40 basis points compared to the last PIB auction. However, the Ministry of finance rejected all the bids.



Steepening of the yield curve reflects renewed inflation expectations...

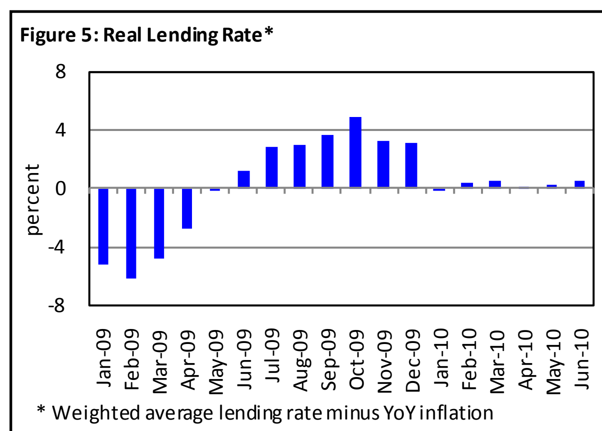
22. Expectation of high inflation can also be gauged by observing an increase in long-term interest rates relative to short-term interest rates in the secondary market. This can be seen in steepening of the yield curve and widening of the yield spread (see **Figure 4**). For example, the difference between the secondary market rates of 10-year and 3-month tenors has increased to 94 bps in July 2010 compared to 19 bps in November 2009 when the last policy rate change was made. This suggests that the market perceives that the current monetary



policy stance is soft in real terms and it may lead to higher future inflation. Further, higher expected inflation implies higher expected nominal GDP and thus demand for money; current higher long-term interest rates are simply a reflection of these expectations.

23. The lagged effect of 50 bps cut in the policy rate in November 2009 is visible in the declining Weighted Average Lending Rates (WALR), on incremental loans. Up to June 2010, the WALR has fallen by 58 bps to 13.2 percent. However, 34 bps of this decline had already taken place during December to February FY10. Since then the pace of further decline in WALR has been limited. Given rising inflation expectations, this implies that the real lending rates may decline in the coming months. Real lending rate, WALR minus YoY CPI inflation, is already showing a declining trend (see **Figure 5**).

Figure 5: Real Lending Rate*



* Weighted average lending rate minus YoY inflation

Private sector credit recovered moderately with improving economic activity …

24. Credit to private sector during FY10, Rs112.9 billion, was lower than what was anticipated earlier given the decline in interest rates and recovery in economic growth (see **Table 2**). To understand this credit behavior, one needs to look into the purpose and period for which the credit was availed. Not only was most of the expansion in private sector credit for working capital purpose (Rs190.2 billion), but it was concentrated in Q2-FY10 (Rs160.2 billion). Importantly, this substantial pick-up in the working capital credit was much higher than the second quarter of FY09 (Rs20.4 billion). This increased credit demand was consistent with gradually improving economic activity, both in the domestic and global economy, and expectation of this trend continuing into H2-FY10.

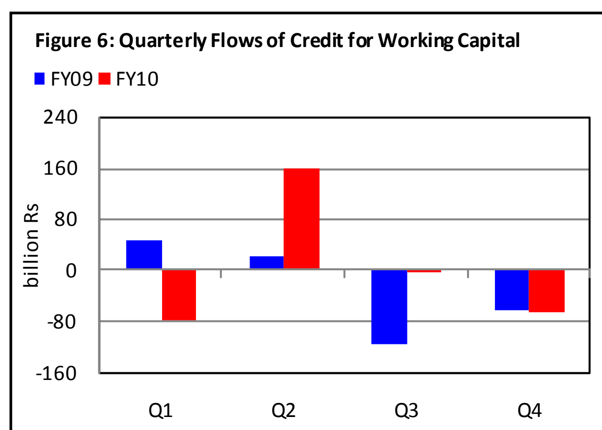
Table 2: Private Sector Credit
flows in billion rupees

	H1-FY10	H2-FY10	FY10
Total credit to private sector	**124.6**	**-11.7**	**112.9**
1. Loans to private sector businesses	**124.7**	**-19.2**	**105.5**
By type:			
Working capital	81.3	-67.3	14.0
Fixed investment	43.4	48.2	91.6
By sectors:			
Agriculture	6.1	0.9	7.0
Manufacturing	85.3	-53.5	31.8
of which: Textiles	*52.2*	*-65.0*	*-12.8*
Electricity, gas and water	27.3	33.8	61.1
Construction	-1.6	-2.3	-3.9
Commerce and trade	5.9	-9.1	-3.1
2. Personal	**-24.3**	**-18.4**	**-42.7**
of which: Consumer financing	*-28.6*	*-20.7*	*-49.3*
3. Investment in security & shares	**2.4**	**29.5**	**31.9**
4. Others	**21.9**	**-3.7**	**18.2**

Source: SBP

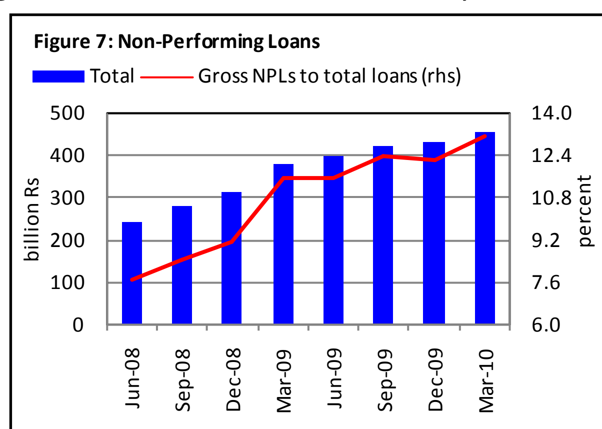
The better growth figures of Large-scale Manufacturing (LSM), exports and imports in H2-FY10 validate these expectations formed earlier and show the contribution of private sector credit to economic growth.

25. The important point, however, is that the retirement of private sector credit in H2-FY10 should not be surprising since the major portion of credit availed earlier was for working capital purpose to begin with (see **Figure 6**). Continued contraction in consumer financing further explains the lower credit utilization by private sector during FY10.



26. In addition, relatively lower credit demand for fixed investment is because no major long term projects have been initiated in FY10. The fixed investment credit of Rs68.3 billion is largely due to projects contracted in the past in the fertilizer and power sectors. Failure to address the electricity shortages and dismal law and order conditions continue to have a dampening effect on the prospects of long term investment projects and higher growth in private sector credit. Lower fixed investment does not augur well for the economy since investment today means ability to produce tomorrow. Lagging investment would constrain future supply and possibly result in an increase in the output gap even if aggregate demand remains unchanged.

27. The outlook and sustainability of private sector credit during FY11 seems uncertain. The main reasons for this assessment are the continued risk averse behavior of the banks, large outstanding stocks of credit for commodity financing and PSEs, and government's increased reliance on scheduled banks for budgetary support.



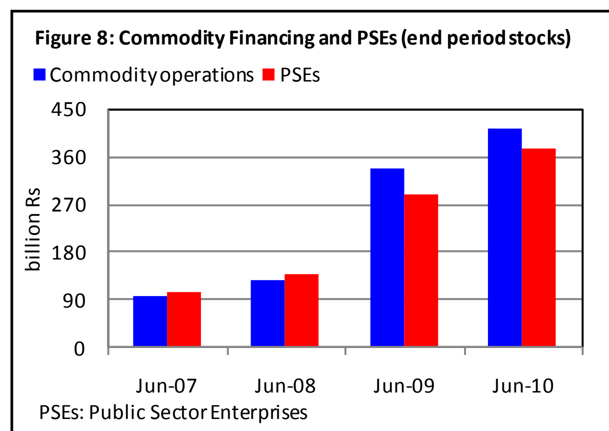
28. Rising stock of Non-performing Loans (NPLs) is one of the key reasons for banks' risk averse behavior and their reluctance in extending credit to the private sector. By the end of March

2010, the stock of NPLs had risen to Rs457 billion, with an incremental increase of Rs25 billion in Q3-FY10. This shows growth of 5.8 percent over Q2-FY10, which is higher by 1.3 percentage points than the average growth of 4.5 percent during previous three quarters (see **Figure 7**). Similarly, the NPLs to loan ratio has increased to 13.1 percent in March 2010 from 11.5 percent in June 2009. Thus, the accumulation in banks' NPLs does not seem to be decelerating and is showing stickiness.

Credit extension for commodity operations and PSEs and rising NPLs is squeezing banks ability to lend to the private sector…

29. The burden on the banking system resources because of the large outstanding stock of credit for commodity financing and PSEs is enormous. The stock of outstanding credit for commodity financing has reached to Rs413.2 billion and that for PSEs was Rs375.0 billion by the end of June 2010 (see **Figure 8**). This includes less than expected retirement in credit taken last year and fresh borrowings in the current fiscal year, particularly for the commodity financing operations of the government. This rising stock of commodity financing, which by nature should be self-liquidating, indicates that another circular debt type of crisis is in the making. The economy is already reeling from the very negative consequences of circular debt related to the energy sector.

Figure 8: Commodity Financing and PSEs (end period stocks)



PSEs: Public Sector Enterprises

30. Not only is the volume of credit availed for commodity operations abnormally large, but the interest rate on these loans, close to 15.1 percent for the 2010 wheat procurement, is also very high. With such a large, relatively risk free, and lucrative avenues for placing funds, banks find little incentive to seek other avenues in the private sector. This has adversely affected the lending rates charged by banks to other relatively more risky corporate borrowers and is keeping pressure on interest rates to remain on the higher side.

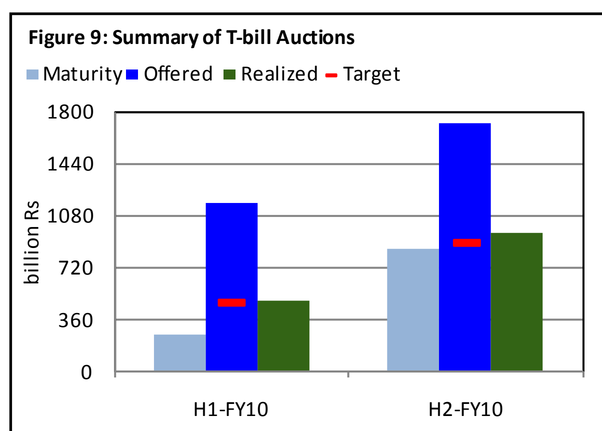
31. Thus, to create space for the private sector, there is an urgent need on the part of the government to revisit the strategy on commodity financing, including reduction in the outstanding stock positions, and to effectively address the circular

debt in the energy sector. This would help in easing pressure on interest rates, revive investment by the private sector, and alleviate constraints impeding the production of electricity. The cost of neglecting these issues would be a lower aggregate supply and persistence of inflation.

Government budgetary borrowing is the major contributor in expansion of net domestic assets and monetary growth…

32. Continued government borrowings from the banking system for budgetary support put further pressure on the banking system resources. Against the pre-announced T-bill auction target of Rs890 billion for H2-FY10, the government realized Rs 961.9 billion, including maturities of Rs850.7 billion (see **Figure 9**).[2] Two points are worth highlighting here. First, banks offered Rs1855.1 billion in these auctions, which is much higher than the announced target. This indicates banks' willingness to continue to subscribe to government paper and reflects their risk averse behavior. Put differently, the current and expected scale of government needs is providing incentives for banks to invest in risk free government T-bills at high interest rates rather than the risky private sector.

Figure 9: Summary of T-bill Auctions



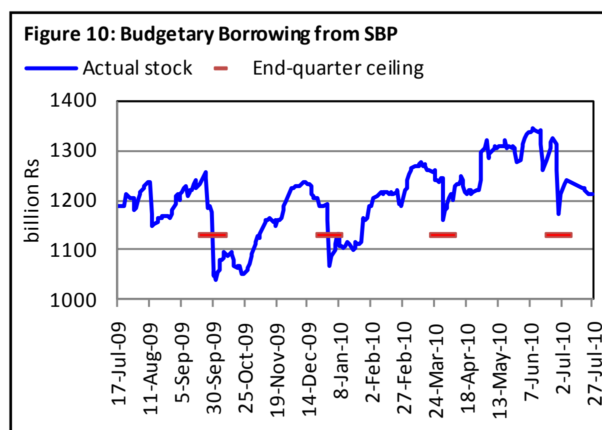
33. Second, given the T-bills already issued in FY10, Rs1347.6 billion will be required just to rollover the maturing amount in FY11. In addition, after including the issuance of T-bills of 3 and 6 month tenor for fresh borrowing requirements in FY11, this amount may increase further. To put this in context, in FY08, the rolling over of maturing T-bills, issued in FY07, amounted to Rs576 billion. Similarly, in FY09, the rolling over of maturing T-bills, issued in FY08, amounted to Rs880.4 billion. Thus, the pressure created from the fiscal position over the last four years will continue to have a bearing in the coming years.

34. Due to uncertainty and delays in external financing of the budget, government also borrowed substantially from SBP. In contrast with H1-FY10, its borrowings increased continuously and remained considerably above the target agreed with SBP

[2] Thid included Rs56 billion realized through non-competitive bids.

in IMF's SBA program throughout H2-FY10 (see **Figure 10**). In fact, both the Q3-FY10 and Q4-FY10 targets were breached. For example, the stock of net government borrowing from SBP increased to Rs1171 billion (on cash basis) as on 30th June 2010 against the target of Rs1130 billion. After taking account of government deposits, the total net government borrowing for budgetary support from the banking system was Rs330.4 billion in FY10, which is 52 percent of the total monetary expansion in FY10.

Figure 10: Budgetary Borrowing from SBP



35. Government borrowing for budgetary support combined with credit extended to the private sector, PSEs, and commodity operations contributed into an overall expansion of Rs487.7 billion in the NDA of the banking system during FY10. Incorporating an expansion of Rs152 billion in the NFA of the banking system, the broad money (M2) grew by 12.5 percent (see **Table 3**). For FY11, with a fall in NFA and strong growth in NDA of the banking system, M2 is projected to grow by 13.0 percent.

Table 3: Monetary Aggregates[1]

flows in billion rupees

	FY09	FY10	FY11[2]
NDA	598.3	487.7	781.7
of which:			
Net budgetary support	316.4	330.4	-
Commodity operations	210.8	77.0	-
Private sector credit	17.1	112.9	-
Credit to PSEs	152.6	85.0	-
NFA	-150.2	152.3	-33.4
Money supply (M2)	448.1	640.0	748.3
YoY growth	*9.6*	*12.5*	*13.0*
Memorandum items:			
Net budgetary support			
from SBP	130.9	44.0	-
from Sch. banks	185.5	286.4	-
Currency in circulation	169.8	143.2	-
Total deposits	277.8	494.8	-
Reserve money	27.5	171.7	-
YoY growth	*1.9*	*11.4*	*12.2*

[1] Currently SDR allocations are treated as equity of SBP. After the finalization of SBP's audited accounts of 30th June 2010, the SDR allocations will be shown as part of the SBPs foreign liability w.e.f. 1st July 2010. This change will result into a lowering of NFA and increasing of NDA of SBP. However, there will be no effect on reserve money and M2.

[2] Projections

Source: SBP

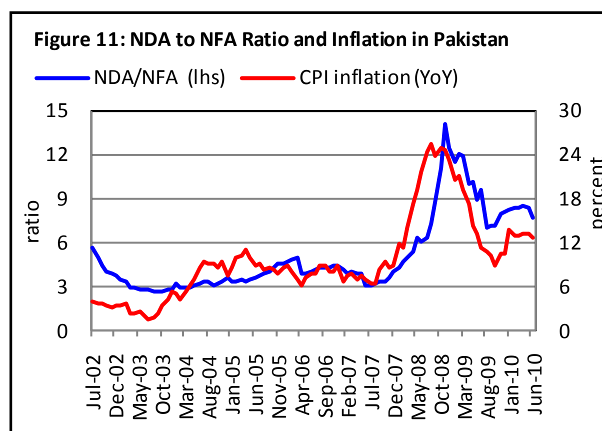
36. Although the growth in M2 in FY10 was lower than earlier projections, the average CPI inflation target for the year was missed by 2.7 percentage points. Even after accounting for the role of cost push shocks and lagged effect of overall money on inflation, useful insights can be gained by looking at the changing composition of monetary aggregates. The overall money growth might remain muted if the NDA expands and NFA contracts. While a rapidly expanding NDA is a reflection of unsustainable total credit growth in the economy, NFA contraction shows vulnerable balance of payment position. The NDA to NFA ratio neatly captures such

developments and has shown strong co-movement with inflation in Pakistan (see **Figure 11**).

As feared, weakening of fiscal position is materializing…

37. Excessive reliance on domestic sources to finance the fiscal deficit shows both the weakening of fiscal position and less than expected realization of projected external financing. Provisional figures indicate that the revised FY10 fiscal deficit target of 5.1 percent of GDP has been breached and could be higher than 6.0 percent of GDP (see **Table 4**).[3] Against the budget estimates of Rs377 billion, only Rs177 billion were received from external sources. This includes around Rs93 billion ($1.1 billion) provided by the IMF as a bridge finance for funds pledged by the Friends of Democratic Pakistan (FoDP).

Figure 11: NDA to NFA Ratio and Inflation in Pakistan



38. Lower revenue generation and higher current expenditures are the underlying reasons for the stressed fiscal position. Despite realization of non-tax revenues such as Rs109 billion CSF and transfer of Rs230 billion SBP profit, the lower than targeted tax collection by the Federal Board of Revenue (FBR) may have caused shortfalls in total revenues. Provisional estimates of tax collection by the FBR at Rs1327 billion shows a shortfall of Rs53 billion (or 0.4 percent of GDP) from the target of Rs1380 billion for the year. FBR tax to GDP ratio has now declined to 9.0 percent, which is the lowest since FY68. Similarly, high growth in current expenditures, 17.3 percent during the first nine

Table 4: Provisional Estimates of Fiscal Sector

billion rupees

	FY10[1]	FY10[2]	FY11[3]
Total Financing	**721.0**	**903.0**	**846.0**
External[4]	**377.0**	**177.1**	**230.0**
Domestic	**344.0**	**725.9**	**616.0**
Non-bank	246.0	421.7	350.0
Bank	97.0	304.1	266.0
Memorandum items:			
FBR tax revenue	1380.0	1327.0	1667.0
Transfer of SBP profit	150.0	230.0	185.0
CSF money	n.a	109.0	129.0
	As percent of GDP		
Total Financing	**4.9**	**6.2**	**5.0**
External	2.6	1.2	1.4
Domestic	2.3	4.9	3.6
FBR tax revenue	**9.3**	**9.0**	**9.8**

[1] Revised budget estimates; [2] Highly provisional estimates; [3] Estimated consolidated position of federal and provincial government's budgets; [4] Including privatization proceeds.
n.a: not available

[3] At the time of the third SBA review, government and IMF agreed to revise fiscal deficit target from 4.9 percent to 5.1 percent of GDP.

months, may have contributed towards likely fiscal slippages despite cuts in development spending.

39. The difference between total revenues and current expenditures, the revenue deficit, has already widened to 1.8 percent of GDP during July-March FY10 against the full year target of 0.7 percent. This deficit may have widened further in Q4-FY10. Revenue deficit, if remains unaddressed, will have strong implications for debt sustainability. Government total debt to GDP ratio has already increased by 0.2 percentage point to 59.0 percent in FY10. Moreover, a relatively higher proportion of this debt is of short-term duration that reflects increased vulnerability to adverse movement in interest rates. Debt sustainability over medium-term requires that the revenue deficit is brought down to zero and preferably a surplus is achieved.

40. For FY11, the target for budget deficit has been set at 4.0 percent of GDP. Given an ambitious FBR tax revenue target, higher requirement of security related expenditures, and a sizeable development budget, reducing the fiscal deficit close to the target level, though imperative, would be quite challenging. Meeting the FBR tax collection target of Rs1667 billion would require 25.6 percent growth or a 0.8 percentage point improvement in the tax to GDP ratio, which seems unlikely. Moreover, the target of 4.0 percent deficit, announced in the budget speech, assumed a 5 percent deficit of the federal government and a combined surplus of 1.0 percent by the provinces. However, consolidated provincial figures reflect almost a balanced budget. This suggests that FY11 fiscal deficit could be around 5.0 percent of GDP.

41. Low tax revenues of the government have become a serious concern. Without increasing the resource envelope it would be difficult to sustain the fiscal deficit at manageable levels and ensure adequate development expenditures. Reliance on cutting development expenditures rather than current expenditures is only going to decrease investment and productive capacity of the economy. Moreover, higher current expenditures will add to the aggregate demand, putting pressure on available supplies and thus inflation. To close the gap, there will be little choice but to rely on foreign borrowings. Delays or shortfalls in such inflows could put pressure on external accounts sustainability.

Despite marked improvements, the sustainability of external accounts faces headwinds…

42. The external current account continued to show improvement in H2-FY10 despite a broad based and steady acceleration in imports. This was supported by a decent recovery in exports, robust growth in workers' remittances, and realization of CSF receipts. As a result external current account deficit, for FY10, narrowed to $3.5 billion (or 2.0 percent of GDP), which is considerably better than earlier projections (see **Table 5**).

Table 5: Balance of Payment Summary

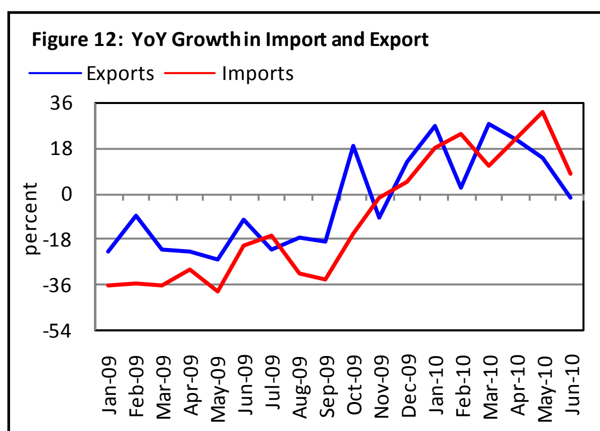
billion US$

	H1-FY10	H2-FY10	FY10	FY11[1]
I. Current account balance	**-2.1**	**-1.4**	**-3.5**	**-6.9**
As % of GDP	*-1.2*	*-0.8*	*-2.0*	*-3.7*
Trade balance	-5.8	-5.6	-11.4	-13.7
Exports	9.3	10.3	19.6	21.0
Imports	15.1	15.9	31.0	34.7
Services balance	-1.5	-0.1	-1.7	-
Income balance	-1.6	-1.7	-3.3	-
Current transfers balance	6.8	6.0	12.8	-
Remittances	4.5	4.4	8.9	
II. Capital and Financial	**3.3**	**1.9**	**5.1**	**7.2**
of which:				
Direct investment	1.0	1.2	2.2	-
Portfolio investment	0.3	-0.3	-0.1	-
Other official inv. Lib.	0.7	0.6	1.4	-
III. Errors and omissions	**0.0**	**-0.3**	**-0.4**	-
Overall balance (I + II + III)	**1.1**	**0.2**	**1.3**	**0.3**
Memorandum items:				
Net SBP forex reserves	11.3	13.0	13.0	14.6
Exports growth	-7.9	14.5	2.7	7.0
Imports growth	-17.6	18.5	-2.3	12.0

[1] Projections
Source: SBP

43. Consistent with recovery in the domestic economy and forecasts of higher international commodity prices,[4] import growth is likely to continue its H2-FY10 trend in FY11 (see **Figure 12**). The import growth is projected to increase to 12.0 percent in FY11 as opposed to a decline of 2.3 percent in FY10. The prospects of sustaining export growth of H2-FY10 in FY11, on the other hand, are relatively weak. The key reasons being uncertain recovery in Pakistan's export destination countries, particularly in Europe, and unfavorable domestic business environment. Despite these factors, the export growth for FY11 is projected to be around 7.0 percent compared to 2.7 percent recorded in FY10.

Figure 12: YoY Growth in Import and Export



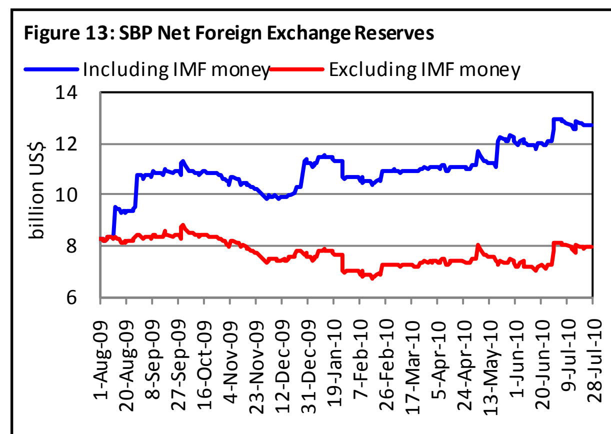
44. The current trends in the terms of trade and real appreciation in the exchange rate do not bode well for the external sector and also suggest a potential widening of the trade deficit in FY11. Even assuming a benign outlook for worker's remittances and further CSF inflows, this trade outlook is expected to widen the external current account deficit to $6.9 billion; or 3.7 percent of projected GDP.

[4] World Economic Outlook, April 2010.

45. The surplus in capital and financial account declined in H2-FY10 compared to H1-FY10. Several factors explain this decline. First, a $600 million repayment of Sukuk bond was due in January 2010. Second, a shortfall in projected official inflows. Third, no further SDR allocations (a onetime non-recurring inflow received in H1-FY10) and lower IMF funds for budgetary support. Other non-debt creating inflows such as Foreign Direct Investment (FDI) remained largely steady during the entire fiscal year, though significantly lower than the previous fiscal year. Had the external current account deficit not improved significantly, overall balance of payment could have turned into deficit in FY10.

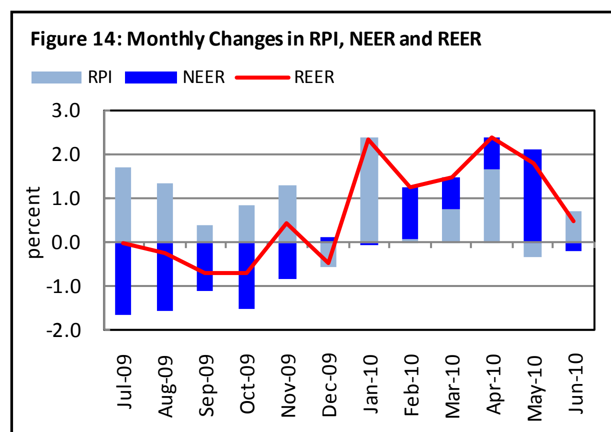
46. With the overall external account surplus of $1.3 billion and $2.2 billion received from IMF for balance of payment support, SBP's net foreign exchange reserves improved from $9.1 billion at end-June 2009 to $13.0 billion at end-June 2010 (see **Figure 13**). However, given the projected rising path of external current account deficit for FY11, improvement in financial and capital inflows is critical to avoid a fall in country's foreign exchange reserves and pressure on exchange rate in FY11. This has become all the more important in the wake of large repayments of IMF loans from beginning in FY12.

Figure 13: SBP Net Foreign Exchange Reserves



47. The foreign exchange market has remained stable during H2-FY10. Despite the transfer of oil payments to the market, since December 2009, rupee witnessed a marginal depreciation of 1.7 percent against US dollar. Importantly, the exchange rate exhibited movements in both directions, which reflects healthy volatility and is consistent with behavior of most international currencies. Also, this flexibility in the exchange rate is consistent with the corridor-based liquidity management framework.

Figure 14: Monthly Changes in RPI, NEER and REER

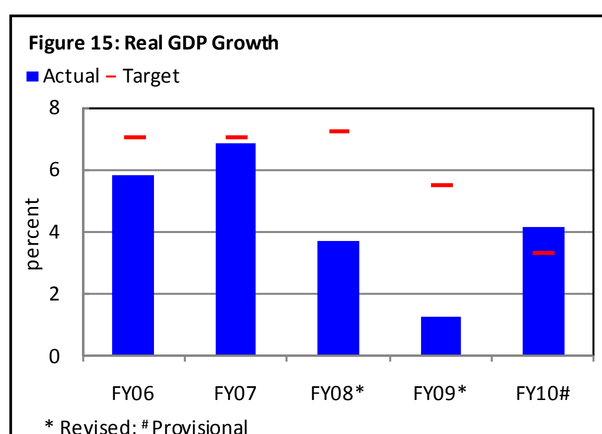


48. However, a relatively smaller depreciation of Pak rupee against the US dollar compared to a larger appreciation of US dollar against other

major international currencies, such as euro, means that Pakistan's Nominal Effective Exchange Rate (NEER) has appreciated by 4.6 percent in H2-FY10. With Pakistan's inflation remaining consistently higher than its trading partners, the Real Effective Exchange Rate (REER) has also appreciated (see **Figure 14**). Given the current and likely developments in Pakistan's balance of payments, this reinforces the need to bring inflation down.

Growth in domestic consumption provided boost to domestic economic activity…

49. Withstanding challenging security conditions and severe energy and water shortages, domestic economic activity rebounded during FY10. The provisional estimates show that the real GDP grew by 4.1 percent against the target of 3.3 percent (see **Figure 15**). This improved GDP growth was led by recovery in the LSM, a reasonable harvest of a few major crops, and above target growth in the services sector.



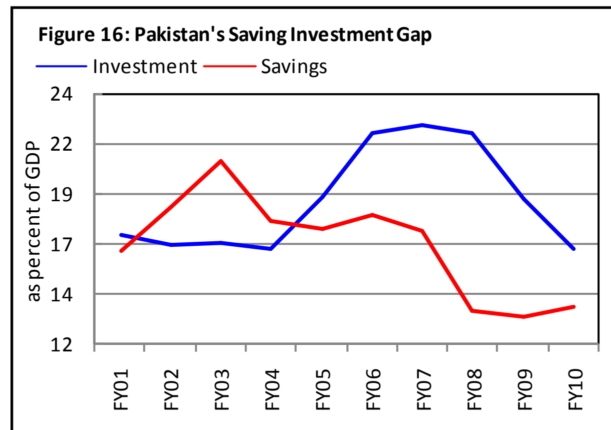
50. Data on expenditure side of the real GDP for FY10 show that this growth was largely due to substantial increase in public sector consumption and investment expenditures. While public consumption grew by 13.4 percent in FY10 against a decline of 31.5 percent last year, public investment increased by 6.5 percent after showing decline in the last year. In contrast, growth in private consumption expenditures moderated to 3.9 percent and investment decreased by 5.1 percent in FY10. Disproportionate increase in total consumption expenditures led to an acceleration in domestic aggregate demand to 3.8 percent in FY10 from 1.4 percent in last year (see **Table 6**).

Table 6: Growth in Expenditures on Real GDP (at constant factor cost of 1999-00)

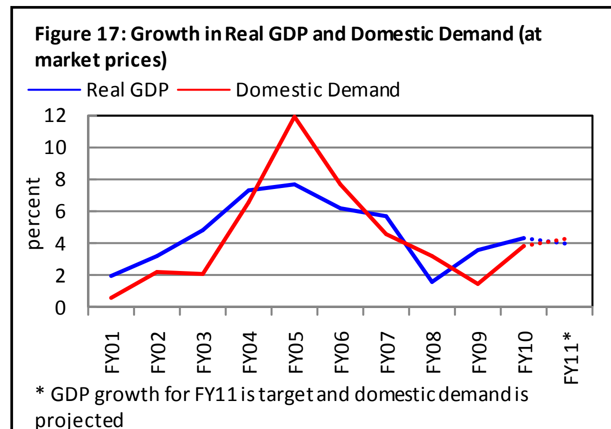
percent

Sectors	FY09[R]	FY10[P]
Total consumption expenditure	4.3	5.0
Private	11.3	3.9
General government	-31.5	13.4
Investment expenditure	-10.1	-1.5
Gross fixed capital formation	-11.3	-2.0
Private	-11.1	-5.1
Public and general government	-11.8	6.5
Changes in stocks	3.6	4.4
Total domestic demand	**1.4**	**3.8**
Export of goods and non-factor services	-3.3	14.1
Import of goods and non-factor services	-15.2	11.2
Gross domestic product (mp)	**3.6**	**4.4**
Gross domestic product (fc)	**1.2**	**4.1**

R: Revised; P: Provisional
Source: Economic Survey, 2009-10



51. Sustaining this largely consumption led growth over the medium term is susceptible to economy's weakening productive capacity due to declining investment. The investment as a percent of GDP continues to decline over the last three years and has now fallen to 16.6 percent. On the other hand, with moderation in private consumption growth and increase in remittances national savings have improved by 0.5 percentage points to 13.8 percent of GDP. This has resulted in a reduction in the saving-investment gap to 2.8 percent of the GDP in FY10 (see **Figure 16**).

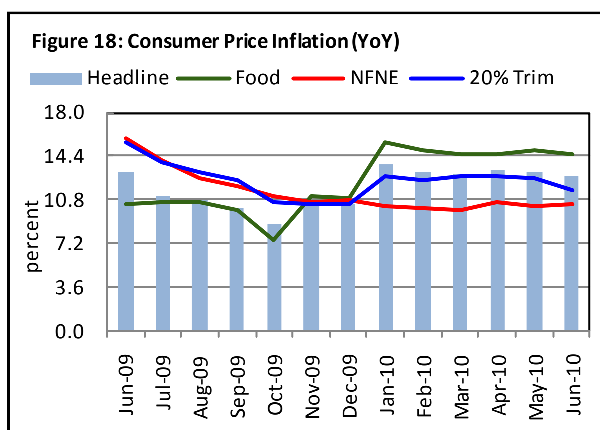


52. Since this reduction in the saving-investment gap is because of a larger fall in investment than increase in savings, it cannot be considered an encouraging development. Decline in investment essentially means reduced capital per worker and thus, labor productivity. The overall decline in investment in critical sectors, particularly LSM and Transport and Communications, shows weakening production infrastructure. Adding to the woes of the economy are persisting energy shortages and dismal law and order conditions. Thus, with aggregate domestic demand expected to remain firm during FY11, it would be difficult to consistently increase aggregate supply to match the rising aggregate demand (see **Figure 17**). This partly explains the economy's reliance on foreign borrowings and persistence in inflation.

Inflation is persisting at high levels…

53. Recovery in domestic aggregate demand, adjustments in administered energy prices and volatile food prices have given a renewed spurt to inflationary pressures in the economy. The year-on-year (YoY) CPI inflation has risen to 12.7 percent in June 2010 from 10.5 percent in December 2009. Moreover, showing persistence, it has remained in a narrow range of 12.7-13.7 percent since January 2010 (see **Figure 18**).

As a result of this increase in YoY CPI inflation and its persistence at high level, the average CPI inflation of 11.7 percent in FY10, was 2.7 percentage points higher than the target (see **Table 7**).



54. Increases in electricity and gas charges and upward revisions in petroleum prices influenced production and transportation costs, causing prices of other CPI items to rise as well. This can be seen in rising number of CPI items showing inflation higher than 10 percent (see **Figure 19**). Similarly, number of items showing higher inflation, than their long-term averages has increased from 133 (with a combined weight of 47.3 percent in the CPI basket), in H1-FY10, to 185 (with a weight of 66.7 percent), in H2-FY10. This indicates entrenchment of expectations of high inflation.

Table 7: Inflation Indicators

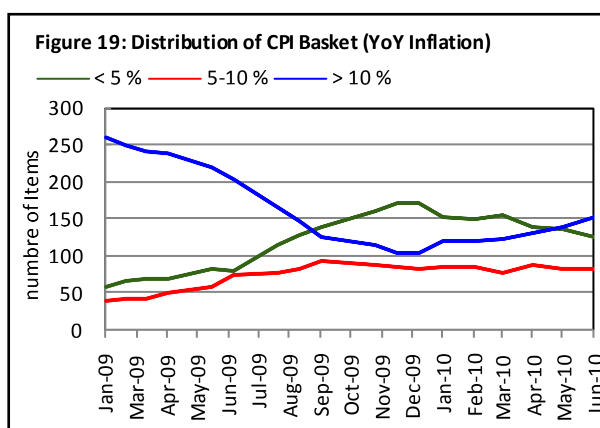
percent

	YoY		Average	
	Jun-09	Jun-10	FY10	FY11[1]
CPI Headline	***13.1***	***12.7***	***11.7***	***11-12***
Food group	10.5	14.5	12.5	-
Non-food group	15.4	11.2	11.1	-
Core Measures				-
Non-food non-energy	15.9	10.4	11.0	-
20% Trimmed	15.5	11.7	11.6	-

[1] Projections

Source: FBS and SBP

55. The impact of these second round effects and rising inflation expectations, together with renewed demand pressures, is reflected in stickiness in core inflation trends (see **Figure 18**). For example, 20-percent trimmed measure of core inflation (YoY) increased from 10.4 percent in December 2009 to 12.7 percent in January 2010 and has remained higher than 12 percent for most of the months since then.



56. Given these inflationary trends and expected developments, inflation in FY11 is likely to persist. Several factors explain risk of inflation remaining high. First, the fiscal consolidation measures, including further upward adjustments in electricity price, increase in General Sales Tax (GST), federal excise and import duties will continue to have upward pressure on inflation. Second, announced increase in

government employees' wages to compensate for high inflation will fuel expectations of rising inflation. Third, rising domestic demand pressures coupled with weak productive capacity may widen the gap between aggregate demand and supply, causing inflation persistence.

57. The impact of uncertain global economic growth outlook on international commodity prices and their transmission to domestic economy remains to be seen. Similarly, contribution of volatile domestic food prices in CPI inflation is difficult to predict. Last but not least, given recent increase in NDA to NFA ratio and its strong association with CPI inflation suggests that inflation is likely to persist in FY11. Incorporating these factors, the average CPI inflation is projected to remain between 11 to 12 percent in FY11, which is higher than the announced target of 9.5 percent.

C. Risks and Challenges

58. Though external sector of the country has shown marked improvement during FY10, there is now need to consolidate these gains by ensuring that current trends of improvement continue. During recent months, however, imports have been rising and external current account deficit is expected to widen. This rise entails more financial inflows which are currently expected to be met mostly through external official borrowings and delayed receipts of privatization receipts. Given the recent track record and developments, these flows are punctuated with a number of ifs and buts. This risks an increase in the vulnerability of external accounts, foreign exchange reserves and the exchange rate. The challenge therefore is to contain trade deficit through both increase in exports and a sustained decline in imports and to ensure that other foreign exchange inflows continue.

59. The timely availability of external official receipts is also important for fiscal accounts which are already prone to several weaknesses. Probability of meeting the tax revenue target for FY11 appears low and current expenditure may turn out higher than budgeted levels due to higher subsidies and security related spending. In the absence of meeting the targeted revenues and availability of external financing there is a risk that the government may resort to a cut in development expenditures or increase its reliance on domestic resources. While high current expenditures lead to consumption led growth in aggregate demand, low development spending hinders growth in the production capacity of the country. In such a scenario inflationary pressures are likely to increase further and outlook of economic growth becomes highly uncertain.

60. Inflation is still at considerably high levels and with little change in the share of those items in the CPI basket where inflation persistence is high, the risks of a rebound in inflation expectations remain strong. In addition, the volatile nature of international commodity prices, especially crude oil poses significant risks to domestic inflation. Moreover, food inflation has remained volatile for quite some time now and any adverse development, such as disruption in supply chain, change in weather conditions, food production in neighboring countries, etc. might put pressure on headline CPI inflation.

61. Structural bottlenecks are still hindering sustained improvement in aggregate supply. Power outages are a critical factor for domestic economic activities and marginalize the prospects of a sustainable recovery. Related to this is the issue of circular debt, which is still unresolved and is preempting financial resources. A substantial amount of subsidies is yet to be transferred which seems increasingly difficult for the government since power tariffs have already been raised substantially causing increase in cost of doing business and inconvenience to the general public.

62. The two year stabilization program followed under the SBA of IMF is coming to an end by December 2010. Unfortunately, the program has witnessed many slippages, which does not bode well for macroeconomic stability. There is a need to continue this stabilization program and accomplish the unachieved targets irrespective assistance is sought from IMF or not, and a permanent mechanism be put in place to ensure that key macroeconomic variables remain within sustainable levels. A key step for this would be a speedy enactment of relevant laws for limiting government's budget deficit and its borrowings from SBP. In this regard, the enactment of Fiscal Responsibility and Debt Limitation (FRDL) law is an important goal that must be pursued with determination.

63. The prospects of a complete recovery in the major global economies have been overshadowed by concerns over recovery in the European economies, which have been hit hard by the Greek debt crisis. European economies are now more concerned over their public debt which has reached to unsustainable levels endangering a prolonged crisis for their economies, particularly the financial sectors. Almost every major G20 countries have already committed to halve their existing deficits within next three years. However, disagreement among these, particularly the US and the European countries, is over the pace of cuts. The US wants more focus on pro growth policies leaving budget consolidation considerations to the

medium term. This division of opinion poses a significant risk to global economic growth prospects since the recent recovery is an outcome of concerted efforts by global economies and any absence of this consensus may result in a muted response. The worst would be the situation where steps pursuing conflicting goals are taken by these economies. In any case, weak recovery in the advanced economies would pose serious challenges for exports recovery in Pakistan. The challenge, therefore, would be to offset the dampening effect through stimulating domestic demand, particularly through investment expenditures with a parallel increase in domestic supply.