3 Monetary Policy and Inflation

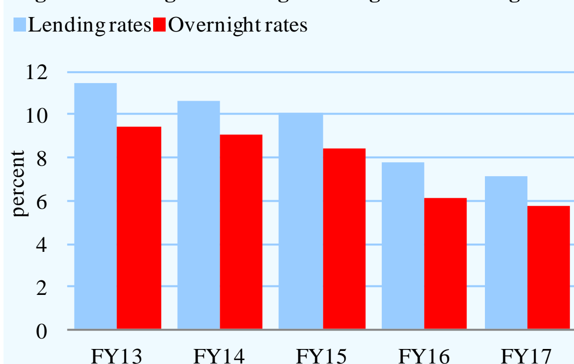
3.1 Policy Review

Monetary policy in FY17 was centered on consolidating the gains from favorable interest rates – set earlier at a historic-low level of 5.75 percent.[1] The objective was to capitalize on the conducive macroeconomic environment and push forward the private investment recovery in the country. While keeping the policy rate unchanged, SBP proactively intervened in the interbank market to ensure sufficient liquidity at banks' disposal, and to keep the overnight rates close to the target rate (**Figure 3.1**). This was facilitated by net retirements to commercial banks by the government, as well as diversion of budgetary borrowing towards SBP; this freed up commercial banks' resources for private lending.[2] Consequently, overnight rates declined further and weighted average lending rates (incremental) remained 57 basis points lower on average during FY17 than the last year, and reached a 12-year low of 7.2 percent.

The continued spell of low interest rates in Pakistan represents a situation that, at least for now, is common across major emerging market (EM) economies – especially in Asia (**Figure 3.2**): at a time when global trade remains sluggish, domestic demand has to take the lead in bringing the output levels close to respective potentials. Therefore, in many EMs including Pakistan, interest rates are currently hovering at record low levels. However, despite subdued inflation and a modest growth outlook, central banks in these countries cannot pursue drastic policy rate cuts. This is because notwithstanding the recent decoupling with Fed rates, EMs' financial markets remain strongly integrated with those in advanced economies; therefore, excessively low rates run the risk of spiking volatility in currency markets.[3]

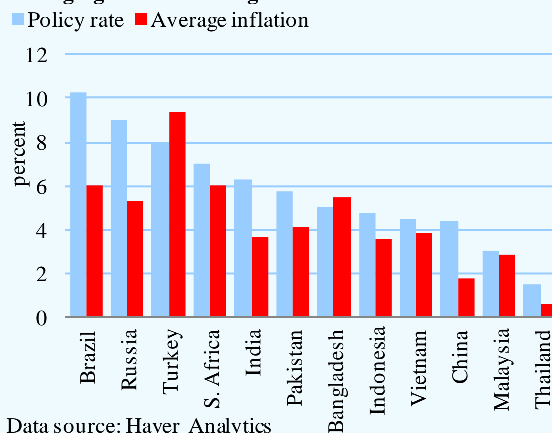
In Pakistan's case, however, the reason for maintaining the current rate is different in nature. The key concern for SBP is the deterioration in the external account, as a strong growth in imports is turning the balance of trade further against Pakistan. In the past, declining comfort on the external front had tended to limit the scope for accommodative monetary policy. In hindsight, FY17 was no exception.

Figure 3.1: Weighted Average Overnight and Lending Rates



Data source: State Bank of Pakistan

Figure 3.2: Policy Rates and Average Inflation in Emerging Markets during FY17



Data source: Haver Analytics

[1] In September 2015 and May 2016, the Monetary Policy Committee (MPC) cut the policy rate by 50 basis points and 25 basis points respectively.

[2] Typically, the borrowing from central bank is considered to have inflationary impact in the economy. However, the growth of reserve money in recent years, does not pose any significant risk for the already low inflation environment in Pakistan.

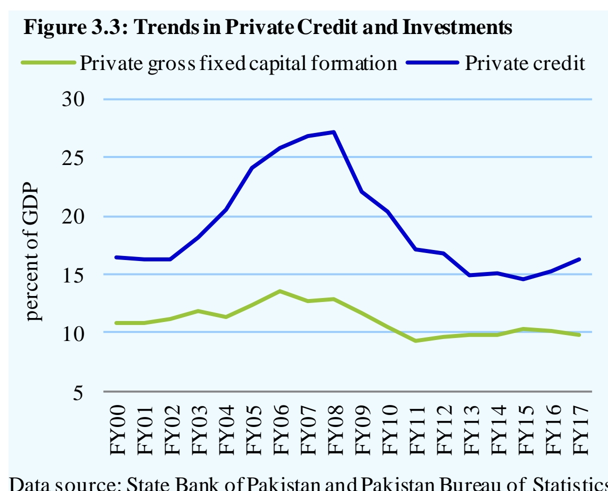
[3] The impact of the taper tantrum episode of 2013 is an obvious case in point, when even the suggestion that the Federal Reserve might gradually roll back monetary expansion in the US sparked capital outflows from emerging markets.

For most of the year, the challenge for monetary policy making was to strike a balance between a below-target economic growth and subdued inflation on the one hand, and widening current account deficit on the other.

The trend in these competing indicators went through significant changes during the course of the year. For instance, in the initial months of FY17, though supply-driven pressures began to emerge on CPI, the overall inflation was benign, especially compared to the target set for the year. Meanwhile, the current account deficit was following an increasing trend but the overall external position remained manageable on the back of official financial inflows. Nonetheless, the MPC exercised caution and refrained from cutting the policy rate further.

By the time the MPC convened for the final meeting of the year, though, conditions in the external sector had become even more challenging. Not only had the current account deficit tripled for the review period compared to a year earlier, capital and financial inflows had also fallen short of expectations (**Chapter 6**).[4] Tellingly, while previous MPC meetings had typically seen members debating one of two possible policy courses (i.e. status quo or cut), the May 2017 decision to maintain the status quo was unanimous.

Figure 3.3: Trends in Private Credit and Investments



Data source: State Bank of Pakistan and Pakistan Bureau of Statistics

Nonetheless, the positive response of businesses to low interest rates was indeed comforting. Private sector credit increased by an unprecedented Rs 747.9 billion during the year, inching up to a 5-year high in terms of GDP. More than a third (40 percent) of the borrowings by private businesses was meant to finance fixed investments. Manufacturing concerns remained the major beneficiaries, taking financing both for fixed investment as well as working capital requirements. In case of working capital, the increasing prices of inputs such as cotton and coal contributed; whereas, in case of fixed investment loans, the enhanced coverage of SBP's refinance schemes factored in. That said, anecdotal evidence suggests that the boost in capital expenditures in manufacturing sector mainly represented investments in balancing, modernization and replacement (BMR), as a visible pick-up in fresh investments still eludes. In the non-manufacturing sectors also, private contractors in construction and power sectors are taking long-term loans primarily for the completion of public projects. Together, these factors help explain, to a certain extent, why private investment has not picked up as yet (**Figure 3.3**).

It is expected that with investor confidence gradually being restored, capital expenditures firming up and imported machinery flowing into the country, the rate of private investment would gather pace soon. A bigger challenge for SBP has been the limited progress on the inclusion front. Commercial banks are still overly devoted to big corporate clients and their exposure on underserved segments such as SMEs and agriculture is quite low in comparison.[5] In this context, microfinance banks hold promise as these institutions are catering to financial needs of a number of microenterprises in the

[4] The current account deficit for Jul-Apr 2017 was US$ 7.2 billion, compared to US$ 2.4 billion deficit in Jul-Apr 2016. This was the latest available data for the May 2017 meeting, as documented in MPC minutes.
[5] Although SME credit posted a recovery in FY17, growing by Rs 78.5 billion over the last year, these comprise only 5.9 percent of total bank advances.

country as well as small-scale agriculture activities. Islamic finance too is taking leaps as supportive regulatory measures have helped broaden the access of Shariah-compliant financial products. In FY17, nearly a third of banks' lending to the private sector was by Islamic banks and Islamic bank branches of conventional banks.

In short, improvements emanating from monetary policy and regulatory measures are being felt at both macro and micro levels, as private sector credit is expanding at a fast pace, and a notable vibrancy is observed in real sector activities. However, from the perspective of private investments and financial access, the progress is too slow for comfort. A sense of urgency stems from the fact that the direction of macroeconomic policies is set only after a careful balancing of often-competing objectives. Specifically, volatility in global commodity prices (especially crude and palm oil) has increased, which has a significant bearing on the outlook of both the country's balance of payments as well as inflation. Furthermore, the impact of domestic demand on headline inflation appears modest so far, but these pressures are steadily firming up, as an exceptional growth in the country's imports and a rise in core inflation would indicate.

These pressures notwithstanding, SBP will continue to monitor the risks to the economy to better guard macroeconomic stability in the country. In the meantime, the large corporate sector must come forward and take charge of capital formation in the country, either by using resources of the banking industry, issuing debt instruments in the capital market, or by deploying its own funds. Side by side, commercial banks must deepen their partnership with marginalized segments of the economy and develop more innovative products and services that address their financial constraints. Without engaging the micro, small and medium entrepreneurs, the objective of a more inclusive and sustainable economic growth will be hard to achieve.

3.2 Developments in Monetary Aggregates

On the surface, broad money (M2) grew at a similar rate during FY17 compared to a year earlier (**Table 3.1**). However, two features of the M2 growth in FY17 are quite peculiar: first, having increased by 13.7 percent during the year, the outstanding stock of M2 has reached to the historic high level as percent of GDP (**Figure 3.4**). And second, its composition presented a great deal of variation. On the liability side, the growth in deposit mobilization remained much higher than last year, whereas currency growth eased to 17.3 percent as compared to a sizable expansion of 30.5 percent in FY16.

Table 3.1: Key Monetary Indicators

	Flows in billion rupees			Growth rate (percent)		
	FY11-15 (Average)	FY16	FY17	FY11-15 (CAGR)	FY16	FY17
Money supply (M2)	1,101.0	1542.7	1,756.2	14.3	13.7	13.7
Currency to deposit ratio	28.5	35.2	36.7	-	-	-
Currency	251.9	779.0	577.4	14.6	30.5	17.3
Total deposits	847.7	758.7	1,174.9	14.3	8.7	12.4
of which						
Non-financial public sector enterprises	32.1	81.0	143.3	8.9	16.9	25.5
Non-bank financial institutions	18.4	90.1	118.1	14.9	47.1	42.0
Private sector (business)	237.6	29.1	341.0	13.7	1.2	13.4
Personal	487.8	470.9	439.3	16.2	10.2	8.6

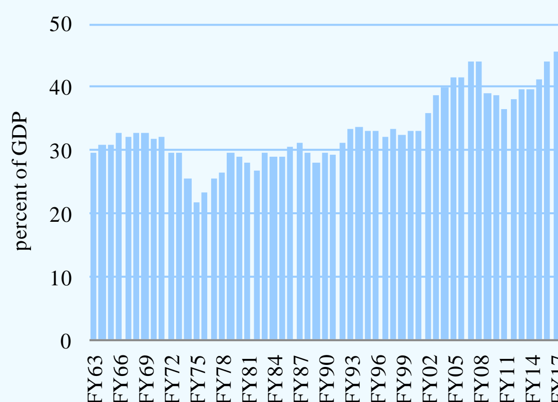
Data source: State Bank of Pakistan

Encouragingly, businesses' deposits that were affected significantly by the imposition of withholding tax last year, showed an impressive recovery in FY17 (**Table 3.1**). However, it appears that the impact of withholding tax is still prevalent on personal deposits. In addition to households, this category also includes bank accounts of unregistered businesses, and the continued deceleration

represents their inclination towards cash-based transactions.[6] In fact, these businesses are switching to alternate modes of payment, e.g., larger denomination prize bonds.[7] As a result, the currency to money supply ratio in Pakistan, which was already quite high compared to other EMs, increased further during the year (**Figure 3.5a & b**).

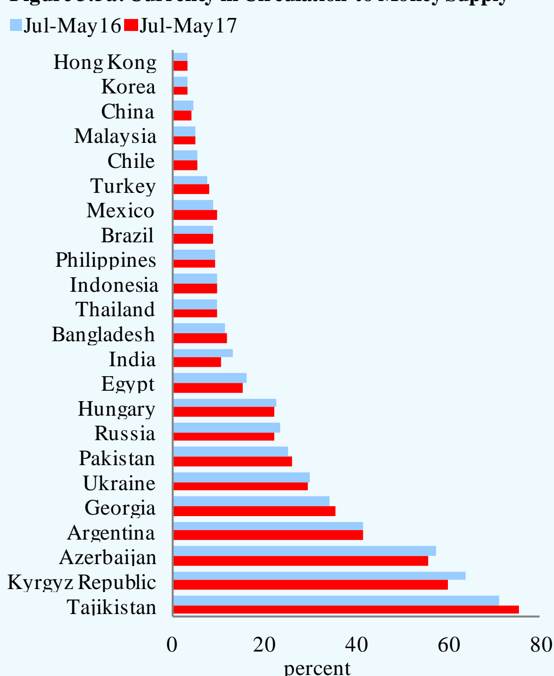
On the asset side also, the composition of M2 went through significant changes; while the contribution of net domestic assets continued to dominate, the net foreign assets of the banking system recorded a trend reversal and posted a contraction of 40.2 percent during the year.

Figure 3.4: Money Supply



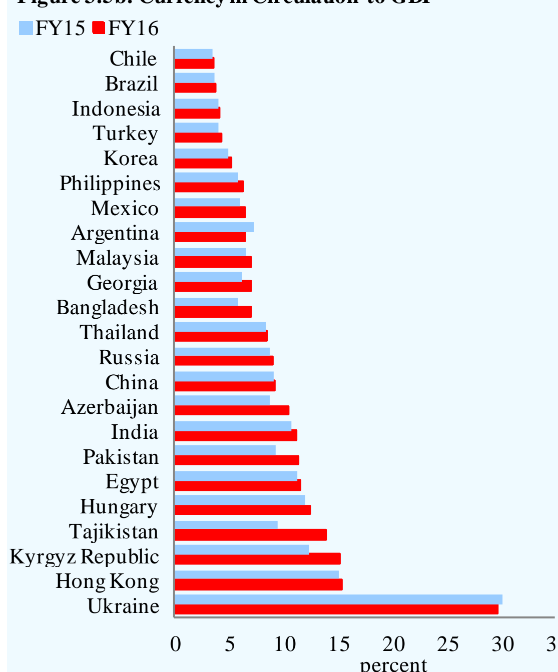
Data source: State Bank of Pakistan and Pakistan Bureau of Statistics

Figure 3.5a: Currency in Circulation to Money Supply



Data source: Haver Analytics

Figure 3.5b: Currency in Circulation to GDP*



*Time period for GDP differs for countries as per their practices. GDP data is not available for many countries for FY17.

Net Foreign Assets

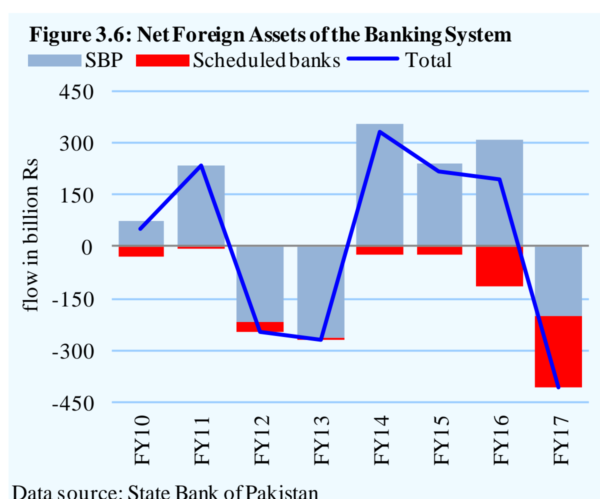
In contrast to last year's expansion, the NFA of the banking system declined considerably during FY17 (**Figure 3.6**). The trend reversal of SBP NFA stood out in particular, which resulted from the external account deficit and corresponding US$ 2 billion drawdown in SBP's foreign exchange

[6] In contrast, a few emerging economies managed to contain this phenomenon. In particular, India's demonetization decision was behind the significant decline in currency to money supply ratio. Likewise, Egypt's currency to money supply slightly improved in favor of a cashless economy; one possible reason may be the increase in opportunity cost for holding cash, since interest rates in Egypt currently stands at historically high level. Furthermore, in case of Russia, the central bank's efforts towards financial inclusion have shown some improvement.

[7] In continuation of trend that emerged in FY16, investments in large-denomination prize bonds increased considerably in FY17 as well. During the year, investments in Rs 40,000 denomination posted an increase of 18.1 percent, whereas the same in Rs 25,000 denomination grew by 26.7 percent over last year.

reserves during the period (**Chapter 6**). This development was compounded by a continuing decline in NFA of scheduled banks, the bulk of which owed to incurrence of higher FX liabilities, such as loans. Consequently, NFA of the banking system made a negative (-3.2 percentage points) contribution to M2 growth, compared to positive contributions in each of the earlier three years.[8]

Figure 3.6: Net Foreign Assets of the Banking System



Data source: State Bank of Pakistan

Net Domestic Assets

The NDA of the banking system expanded significantly during FY17 compared to a year earlier (**Table 3.2**). This expansion was triggered by (a) higher budgetary borrowings from the banking system; (b) an unprecedented flow of credit to the private sector; and (c) sharp increase in credit to PSEs.

Budgetary borrowing shifted gears

With decelerating revenue collection creating fiscal strain, budgetary borrowing from the banking system during FY17 was considerably higher than last year. Moreover, there was a notable shift in its composition: in contrast to FY16 when the government had retired SBP debt and borrowed heavily from commercial banks, the bulk of budgetary funding in FY17 was arranged by SBP (**Figure 3.7**). Consequently, reserve money grew by 22.5 percent during the year, with the substantial rise in NDA of SBP (i.e. more than double the flow compared to last year) overshadowing the drag on reserve money created by declining NFA of the central bank.[9]

Table 3.2: Monetary Aggregates
flow in billion rupees; growth in percent

	Flows		Growth	
	FY16	**FY17^P**	**FY16**	**FY17^P**
Reserve Money	831.6	894.2	26.5	22.5
M2 (A+B)	1,542.7	1,756.2	13.7	13.7
A. NFA	194.9	-405.2	24.0	-40.2
SBP	310.6	-204.1	43.0	-19.8
Scheduled banks	-115.8	-201.1	NA	NA
B. NDA	1,347.9	2,161.5	12.9	18.3
Government borrowing	861.3	1,135.8	12.4	14.5
Budgetary borrowing	791.3	1,087.1	12.4	15.1
SBP	-486.6	907.7	-25.2	62.9
Scheduled banks	1,277.9	179.4	28.6	3.1
Commodity operations	72.1	49.9	12.8	7.8
Non-government borrowing	556.6	1,107.1	12.5	22.1
Private sector	446.5	747.9	11.2	16.8
Private businesses	340.0	625.5	11.3	18.6
PSEs and other financial institutions*	110.1	359.1	24.3	63.8
Other items net	-70.1	-81.4	NA	NA
OMO impact	870.9	-0.3	NA	NA

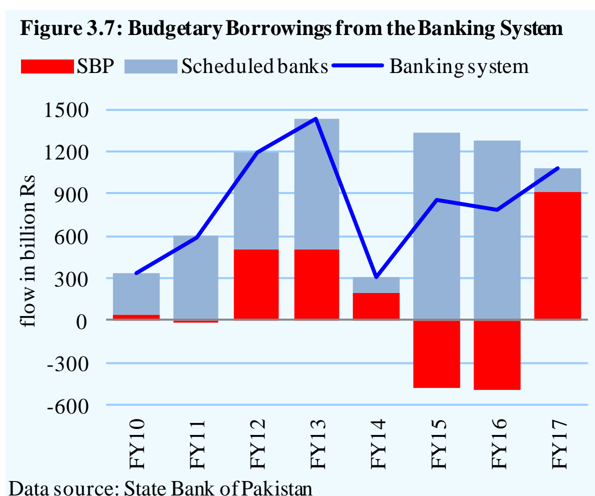
^{P}:Provisional; Monetary statistics will be revised after the finalization of Annual Financial Statement of SBP for the year 2016-17.
*Credit to PSEs includes Rs 100 billion SBP investment in Pakistan Security Printing Corporation during FY17.
NA: not applicable
Data source: State Bank of Pakistan

The government's reliance on scheduled banks was quite modest this year. This phenomenon was more pronounced in H1-FY17, during which, two noteworthy developments occurred in PIB auctions. First, the highest-ever maturity (in a single quarter) of the bonds fell due in Q1-FY17, the bulk of which was not rolled over. And second, the government scrapped all the three auctions of Q2-FY17, as banks were looking forward to higher interest rates and offered volumes lower than Q1-FY17. Therefore, all the budgetary requirements were met through borrowing from SBP during this period.

[8] The contribution of NFA of the banking system to M2 growth was 3.7, 2.2 and 1.7 percentage points in FY14, FY15, and FY16 respectively.
[9] NDA of SBP increased by Rs 1,098.3 billion during FY17, compared to Rs 521 billion a year earlier. Meanwhile, NFA of SBP declined by Rs 204.1 billion during the year, compared to an increase of Rs 310.6 billion during FY16.

In H2-FY17, however, the government altered its approach and reverted to borrowing from scheduled banks. This happened not only because banks increased offered amounts in T-bill and PIB auctions, but also aligned their bid rates with cut-offs in last successful auction. As a result, on aggregate, the government borrowed Rs 649.9 billion from scheduled banks during H2-FY17, and retired Rs 7.5 billion to SBP.

Figure 3.7: Budgetary Borrowings from the Banking System



Data source: State Bank of Pakistan

In terms of instruments, budgetary borrowing from scheduled banks was concentrated in T-bills during FY17, as opposed to the predominance of PIBs last year. This was evident from the amounts accepted (net of maturity) against each class of security, as well as the higher acceptance-to-offered ratio for T-bills during the year (**Table 3.3**). From scheduled banks' perspective, the anticipation that interest rates had bottomed out, coupled with narrower spread between PIBs and T-bill yields, prompted more placements in shorter tenor securities. On the whole though, the year was characterized by a relatively low appetite for government securities on the part of scheduled banks, as indicated by the lower offered-to-target ratios for FY17 compared to a year earlier.

Table 3.3: Auction Profile of Government Papers
billion rupees

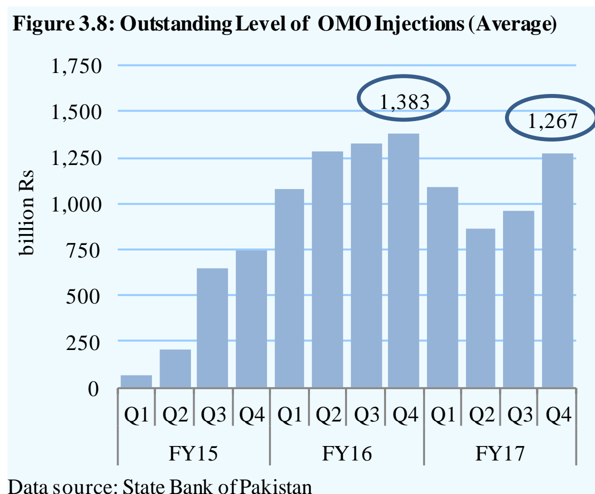
	Target	Maturity*	Total		Net of maturity			Offered/ target	Accepted/ offered
			Offered	Accepted**	Target	Offered	Accepted		
Market treasury bills									
FY16	5,100	4,470	8,975	4,909	630	4,505	439	1.76	0.55
FY17	7,200	6,431	11,351	7,734	769	4,920	1,303	1.58	0.68
Pakistan investment bonds									
FY16	775	197	2,560	964	578	2363	767	3.30	0.38
FY17	800	1,427	1,758	894	-627	331	-533	2.20	0.53

* Maturity excludes PIB coupon payments.
** Only Market Treasury-bills' offered amount does not include non-competitive bids.
Data source: State Bank of Pakistan

OMOs were instrumental

The shifting pattern of budgetary borrowing had implications for the interbank market and SBP liquidity management. In the first half, the heavy retirements made to scheduled banks were almost entirely offset by equivalent reduction in OMO injections. However, during H2-FY17, temporary liquidity pressures could have emerged on account of the government's reversion to borrowing from scheduled banks. To prevent this, SBP duly stepped up its OMO injections – especially during the fourth quarter – with the aim of keeping overnight rates close to the target rate (**Figure 3.8**). As a result, the weighted average overnight rates remained (on average) 7 basis points above the policy rate

Figure 3.8: Outstanding Level of OMO Injections (Average)



Data source: State Bank of Pakistan

during H2-FY17.[10] In addition, commercial banks availed SBP's reverse repo facility on fewer days and availed lower volume of funds from the SBP window during FY17, compared to a year earlier.[11] Moreover, the coefficient of variation of overnight interest rates also declined compared to last year.[12] Taken together, these findings reflect smoother implementation of monetary policy.

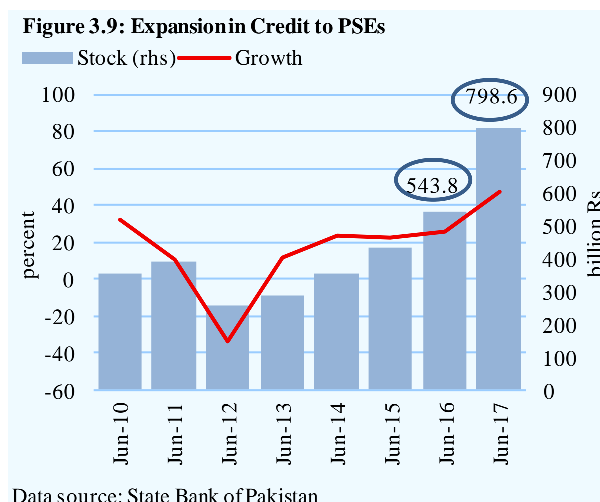
Meanwhile, retail rates declined during FY17 from a year earlier. The weighted average lending rate (WALR) on incremental basis fell to 7.2 percent, from what was already a decade-low 7.8 percent in FY16. This dip – occurring in the absence of a policy rate cut – stemmed from: (a) higher deposit generation; (b) the lower yields on offer from PIBs, which motivated banks to extend loans to creditworthy private borrowers instead; and (c) increased competition among conventional banks and Islamic banks.

PSE borrowings increased sharply

As compared to earlier years, credit to PSEs witnessed rapid expansion during FY17 (**Figure 3.9**);[13] the bulk of the flow is related to energy sector entities. Various public projects have been funded using banks' resources like the development of LNG pipelines, construction of Dasu dam and Neelum-Jhelum power project.

It is also important to highlight that the bulk of PSE borrowing is associated more with their cash flow management than financing their development outlays. Firstly, circular debt issue seems to be a major contributing factor, which led: (a) Power Holding Private Limited to borrow primarily for the settlement of power sector payables to IPPs and fuel suppliers; and (b) PSO to acquire short-term loans to manage its liquidity constraints. Secondly, WAPDA approached banks not just to finance expenditure related to Neelum-Jhelum and Dasu projects, but also to finance payments due to the Punjab government with regard to hydel profits accumulated during the period 2005-16. And thirdly, borrowings by Government Holdings (Pvt.) limited represented its liquidity needs for dividend payments to its shareholders.

Figure 3.9: Expansion in Credit to PSEs



Data source: State Bank of Pakistan

Having said that, it appears that some PSEs could have done without borrowing additional funds from commercial banks. Specifically, these entities are sitting on a large volume of unutilized funds, and their continued borrowing from the banking system is only adding to their financial costs (to the tune of spread they are paying). On aggregate, PSEs deposits amounted to Rs 705.0 billion at end June 2017, which equals 87 percent of their outstanding advances from the banking system. Moreover,

[10] For reference, weighted average overnight rates remained 6 basis points above the policy rate during FY17, compared to 7 basis points a year earlier.

[11] Commercial banks availed SBP's reverse repo facility on only 35 occasions during FY17, compared to 52 visits in FY16. Similarly, the volume of borrowing from the SBP window was also lower, amounting to Rs 935.1 billion during FY17 compared to Rs 2.8 trillion last year.

[12] Specifically, the coefficient of variation of weighted average overnight repo rates declined from 6.8 percent in FY16 to 3.3 percent in FY17.

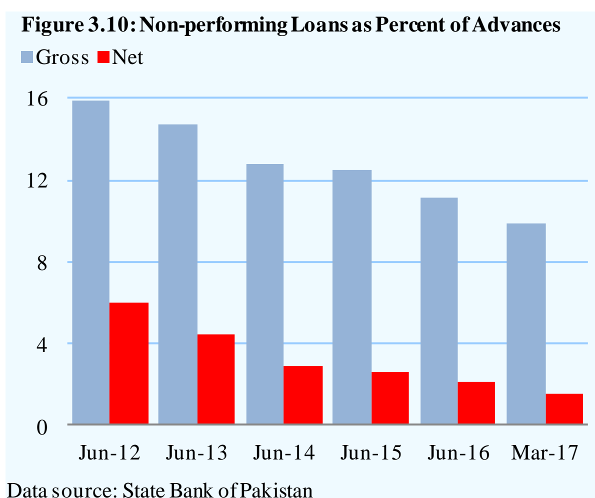
[13] In Figure 3.9, the stock and growth in credit to PSEs excludes the Rs 100 billion SBP investment in Pakistan Security Printing Corporation (PSPC) during FY17. For further details regarding PSPC, see SBP Press Release titled "SBP acquires Pakistan Security Printing Corporation", dated 5 July, 2017.

some PSEs have deposited a large volume of funds in fixed deposits to ensure a regular stream of income. Anecdotal evidence suggests that some institutions seem hesitant in drawing from their deposits to meet operational expenses, in order to avoid penalties associated with premature withdrawals.

3.3 Credit to Private Sector

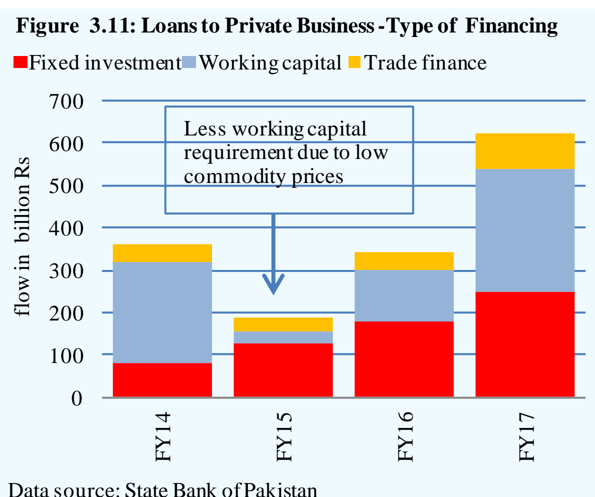
Credit to private sector witnessed a historic expansion of Rs 747.9 billion during FY17. The robust lending is a reflection of favorable supply as well as demand conditions in the economy. On the supply side, the most helpful factor was a healthy deposit growth during the year, which significantly improved liquidity of the banking system. Banks were willing to scale up their exposure on private sector also because of a steady improvement in their perceived credit risk; over the past 5 years, non-performing loans as percent of advances has been declining (**Figure 3.10**). Recent laws and regulatory measures to clean bad loans from the books of banks, higher recovery rates and better economic growth prospects of the economy explain these falling infection ratios.

Figure 3.10: Non-performing Loans as Percent of Advances



Data source: State Bank of Pakistan

Figure 3.11: Loans to Private Business - Type of Financing



Data source: State Bank of Pakistan

On the demand side, low financing costs encouraged private businesses to leverage further; an added impetus came from CPEC-related activity and higher PSDP expenditure, which triggered the demand for fixed investment loans by private businesses. Moreover, a higher capacity utilization and recovery in input prices (specifically cotton and coal) increased working capital requirements of manufacturing firms (**Figure 3.11**).[14]

Businesses dominated as usual

Over 60 percent of the loans to private businesses were availed by manufacturing concerns, within which the most active borrowers were the producers of sugar, grain milling (wheat and rice), dairy, textiles, and cement (**Table 3.4**).

In case of working capital loans, the bulk of the demand came from food manufacturers. Sugar industry stood out in particular as they were to procure an all-time high crop during the year; meanwhile, the presence of unsold sugar stocks also increased their dependence on bank borrowing. Funds' availability at low cost helped sugar mills to raise their capacity utilization and increase production levels by 37.8 percent YoY. In addition to sugar industry, grain millers and dairy firms

[14] Coal prices rose 50.4 in the international market during the period July 2016 to June 2017, compared with fall of 15.9 percent in the corresponding period last year. Coal registered the highest inflation in FY17 in prices of 52 global commodities available from IMF. Domestic cotton (cotton yarn) recorded inflation of 14.7 percent in FY17, compared with fall of 4.1 percent last year. International cotton prices rose 18.5 percent during Jul 2016 to June 2017, compared with fall of 2.9 percent in the same period last year.

too borrowed heavily this year to scale up their production levels in order to cater to the demands of growing clientele.

Table 3.4: Loans to Private Sector Businesses (Flow)
billion rupees

	Total loans		Working capital		Fixed investment		Trade financing	
	FY16	FY17	FY16	FY17	FY16	FY17	FY16	FY17
Total	**321.9**	**624.9**	**110.9**	**286.6**	**171.7**	**253.0**	**39.3**	**85.4**
Of which:								
1. Manufacturing	**210.9**	**384.3**	**132.4**	**177.7**	**31.0**	**132.7**	**47.5**	**74.0**
Food products and beverages	46.7	151.3	26.6	104.6	10.9	35.7	9.2	11.0
i. Sugar	8.6	82.1	6.1	63.6	5.7	14.6	-3.2	3.8
ii. Grain mills products	15.8	25.8	13.2	22.7	-0.7	-0.3	3.4	3.3
iii. Dairy products	-9.3	20.4	-4.0	12.2	-6.3	8.0	1.0	0.3
Textiles	62.7	82.8	33.7	25.2	13.1	36.7	15.9	20.8
Cement	-4.3	21.4	4.4	6.1	-7.8	10.6	-0.9	4.8
Coke, refined petroleum products	9.1	15.6	9.1	12.8	-5.3	1.3	5.3	1.5
Fertilizers	51.7	9.8	42.2	-5.7	9.0	10.8	0.5	4.6
2. Electricity, gas and water supply	**38.0**	**60.1**	**13.5**	**25.2**	**31.1**	**29.6**	**-6.7**	**5.3**
3. Commerce and trade	**28.5**	**42.7**	**20.7**	**36.6**	**8.6**	**3.4**	**-0.1**	**2.8**
4. Construction	**31.6**	**41.0**	**1.2**	**17.8**	**31.2**	**24.3**	**-0.8**	**-1.1**
5. Transport, storage and communications	**35.3**	**29.2**	**0.9**	**0.2**	**34.9**	**28.1**	**-0.5**	**0.8**
6. Real estate, renting & business activities	**16.4**	**18.3**	**8.0**	**2.3**	**3.9**	**11.0**	**4.5**	**5.0**
7. Mining and quarrying	**5.7**	**13.7**	**-1.0**	**-0.4**	**3.8**	**13.8**	**3.0**	**0.4**

Fixed investment includes long terms loans + government self-employment schemes
Working capital includes short term loans + bills purchased and discounted, but excludes foreign bills
Trade financing includes export financing and import financing
Data Source: State Bank of Pakistan

As for the fixed investment loans, earlier changes in SBP's refinance schemes – aimed at reducing the cost and extending their coverage – paid off. SBP had reduced the end-user mark-up rate for Long-term Financing Facility (LTFF) scheme from 7.5 percent to 6 percent for all sectors in July 2015. For textiles, further concessions included: (i) reduction in the end-user mark-up rate for LTFF from 6 percent to only 5 percent in November 2015 – which is even lower than the target rate – and (ii) expanded provision of 100 percent refinancing for the *entire* spinning and ginning sub-sectors (compared to only 50 percent refinancing for 6 eligible spinning processes earlier).[15] These measures proved quite effective in enhancing the credit off-take by textiles, which availed almost 85 percent of loans under the LTFF during FY17.[16] Apart from textiles, fertilizer and sugar sectors also took long-term loans from the banking system, as a number of firms are setting up captive power plants.

Finally, the impact of CPEC related activities was reflected in increased credit off-take by cement, infrastructure, and energy-related entities. Borrowings by energy sector were particularly strong as a number of coal-based power projects began commercial operation. This, together with a steep rise in coal prices in FY17, helps explain a higher off-take of working capital loans by the sector.[17] In

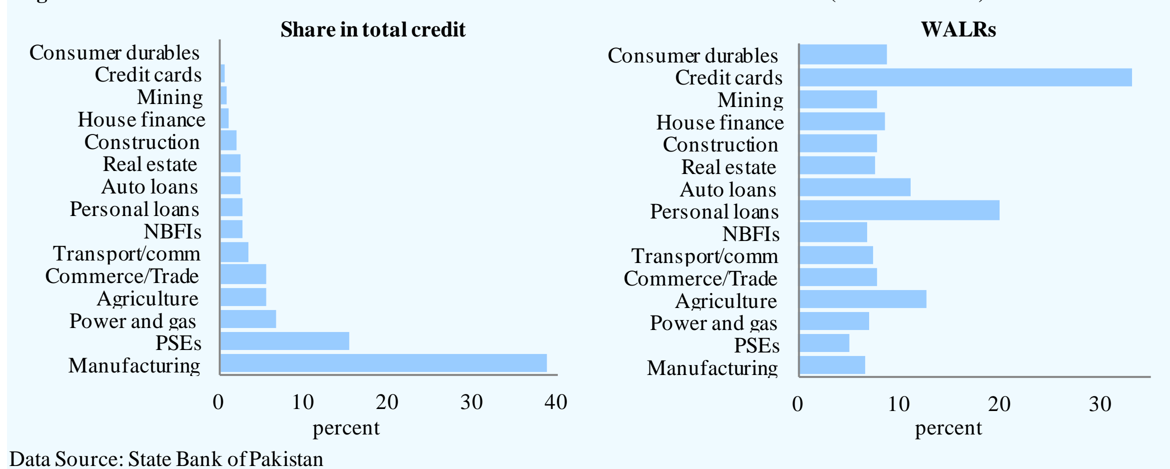
[15] SBP is now refinancing 100 percent of the loans extended by banks/DFIs for imported and locally manufactured new plant/machinery to be used by the export oriented projects of (the entire) spinning and ginning sectors under the LTFF scheme. Earlier, it was refinancing only 50 percent, and that too for only 6 specified processes of spinning sector (for details, see IH&SMEFD Circular No 18 of 2015, dated October 30, 2015).
[16] This subsidized credit scheme helped the textile sector to maintain the increasing momentum of import of textile related machinery whose imports rose by 20.2 percent in FY17, compared to only 2.7 percent a year early. Moreover, the government also provided a number of tax incentives to the textile sector, one of which was an exemption of sales tax on import of machinery.
[17] Generation of electricity from coal rose to 1013 Gw/h in FY17 from only 105 Gw/h in FY16. It is worth to note that few CPEC related power projects started contributing electricity to national grid lately in FY17 as out of the 1013 Gw/h generation from coal in FY17, more than 60 percent was only generated in June 2017 alone.

addition to CPEC, the ongoing infrastructure projects in the public sector and initiation of mega housing schemes in urban areas further supported construction activity in the country. Not only did the credit appetite of cement manufacturers increase, the realtors and private contractors too borrowed actively from banks.

Consumer loans firming up

Given the low interest rate environment during the year, banks strategized to boost their bottom lines by taking exposure in sectors that promise higher returns; consumer financing was an obvious choice (**Figure 3.12**). Consumer loans kept up their momentum and increased by Rs 70.5 billion in FY17 period, compared to Rs 43.7 billion in FY16. This flow mainly emanated from auto financing, which held 54.3 percent share in consumer financing during FY17. In addition to low interest rates, the introduction of new models of passenger cars and increasing popularity of ride-hailing services played a significant role in auto- financing uptick.[18] The rest of the expansion in consumer lending is largely explained by financing in segments like personal and housing loans, which increased by Rs 14.2 billion and Rs 12.5 billion respectively.

Figure 3.12: Sector-wise WALR and their Shares in Total Credit of Scheduled Banks in (December 2016)



Data Source: State Bank of Pakistan

From institutional perspective, the impetus to consumer financing is lately coming from Islamic banking institutions (IBIs), especially in the areas of housing and car financing. In case of car financing, the share of IBIs has increased to 43.1 percent at end FY17. Their penetration in housing finance is even more encouraging and they now dominate this segment with 60.9 percent share in the overall portfolio of the banking industry. The majority of housing finance was taken for outright purchase, followed by construction, and lastly renovation; this pattern was applicable in case of both Islamic and conventional loans.

In case of housing finance, a weak valuation mechanism for real estate and legal glitches faced by commercial banks in exercising their right to collateral has been one of the major restrictive factors in Pakistan. In the absence of a strong non-judicial foreclosure framework in the country, it takes a huge amount of time and money for the banks to take possession of, and sell the collateralized properties upon borrowers' default. To address this, amendments have been made in the Financial Institutions (Recovery of Finances) Ordinance, which ensures collateral foreclosure for banks without recourse to courts. The judicious application of these amendments is expected to bring positive impact on credit expansion to households, especially mortgage loans. Further impetus to domestic mortgage financing

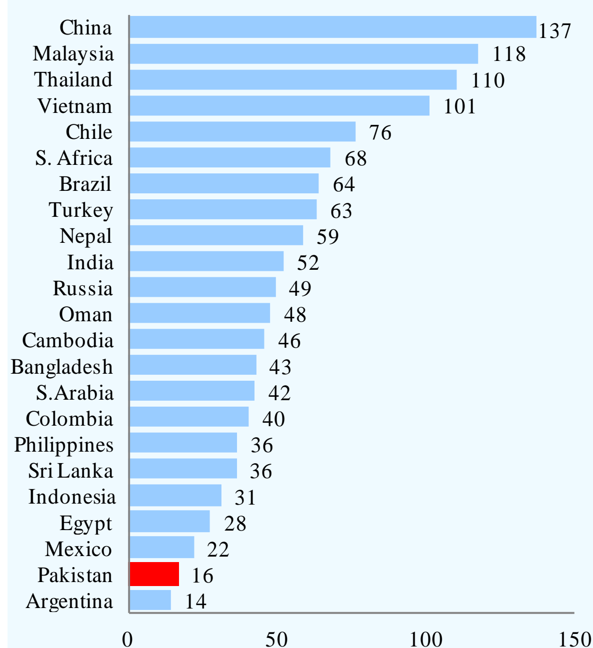
[18] The auto industry has introduced a range of new models in FY17, particularly of Suzuki (Vitara and Ciaz), Toyota (Fortuner and Hilux Revo) and Honda (City, Accord and Civic, BR-V).

would be provided by the Pakistan Mortgage Refinancing Company (PMRC), which is expected to become operational in 2017.[19]

Depth and access is still low

The penetration and depth of private credit in Pakistan is still low relative to comparative countries (**Figure 3.13**).[20] Drawing on such comparisons is useful because it drives home the potential contribution that private credit can make in moving a country rapidly up the development ladder; it is no coincidence that, in general, the economies where credit-to-GDP ratio is higher have shown more robust growth over time.

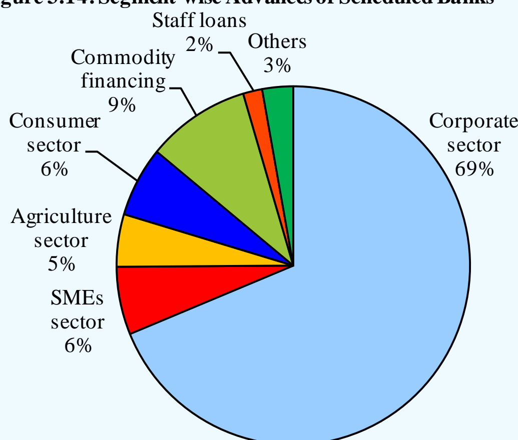
Figure 3.13: Pakistan's Relative Standing in Credit-to-GDP Ratio (2010-16 Average)



Data source: World Development Indicators

That said, there is no single, correct approach to accelerate credit expansion, and referring to the policies and experience of other regional and emerging market economies simply helps develop a sense of what has (and has not) worked in broadly similar economies in recent years. Ultimately, Pakistan needs to continue formulating and tweaking its own customized mix of policies based on the country's distinct comparative advantages and limitations. Moreover, it must be borne in mind that achieving a higher credit-to-GDP ratio is just a means to an end: the prime objective is to expand access to finance so that all deserving entrepreneurs and households can avail credit on equitable terms. This would empower them to expand their businesses and improve their living standards, and simultaneously help the country to make progress against its development agenda.

Figure 3.14: Segment-wise Advances of Scheduled Banks



Data source: State Bank of Pakistan

Therefore, the concept of financial inclusion has appeared in mainstream policy thinking. In Pakistan, the state of inclusion is quite low with only 23 percent of the adult population served by the formal financial sector.[21] Although private credit is expanding rapidly over the last couple of years, it still remains heavily concentrated in corporate sector (**Figure 3.14**). By contrast,

[19] The PMRC was incorporated in 2014 with the objective of promoting mortgage finance. Facilitated by SBP, the PMRC aims to develop the primary mortgage market by: (i) providing financial resources so that primary mortgage lenders can grant more loans to households at fixed/hybrid rates for longer tenure; (ii) reducing the mismatch between house loan maturities and source of funds; and (iii) ensuring loan standardization across primary lending institutions. Simultaneously, it would also help develop capital markets – by providing more private debt securities and asset backed securities to raise funds – and create a benchmark yield curve.

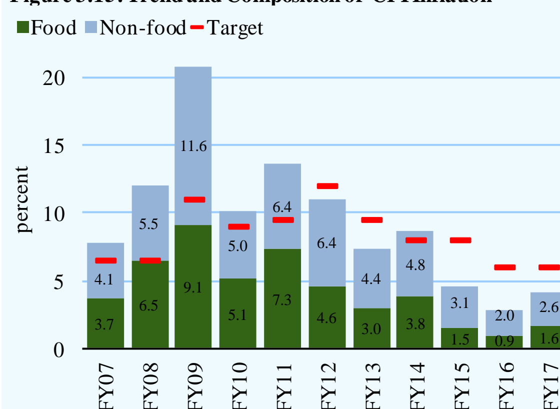
[20] For a detailed discussion, see Khalid, A., and Nadeem, T (2017), Bank Credit to Private Sector: A Critical Review in the Context of Financial Sector Reforms; *SBP Staff Note 03/17;* July 2017.

[21] Source: Access to Finance Survey 2015.

the progress on expanding access to finance for agriculture and SME sector has been mixed during this period. The upside was that, in absolute terms, credit to these segments increased in FY17 compared to a year earlier; however, their share in total bank credit is quite low relative to their needs and contribution to GDP.

There was some expectation that IBIs might take the initiative to cater to previously underserved segments of the economy. Indeed, Islamic financing kept up its growing momentum in FY17 and credit extended by these institutions went up by another 32.9 percent; however, their exposure in SME and agriculture financing remained low. Instead most of their lending went to food manufacturers and textile firms. To be fair though, Islamic banking faces its own unique set of challenges, which may be holding IBIs back from venturing any deeper into SME and agri-financing territory.[22]

Figure 3.15: Trend and Composition of CPI Inflation



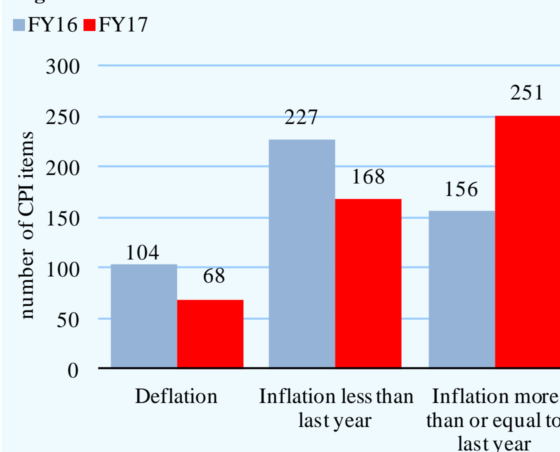
Data source: Pakistan Bureau of Statistics and Planning Commission of Pakistan

3.4 Inflation

FY17 marked the third consecutive year when the headline CPI inflation remained lower than the annual target (**Figure 3.15**). The general trend was nonetheless increasing: after reaching the multi-decade low level at 2.9 percent during FY16, the average CPI inflation inched up to 4.2 percent during FY17.

This trend was spread across a large number of items under the CPI basket.[23] As shown in **Figure 3.16**, over half of the items posted a higher inflation in FY17 compared to last year, and fewer items recorded deflation. This is in sharp contrast to FY16 when nearly 70 percent of the items showed either deflation or a fall in inflation over the preceding year.

Figure 3.16: CPI Prices



Data source: Pakistan Bureau of Statistics

As for the causative factors, domestic demand and supply side factors alike contributed to the increase in inflation during FY17:

(i) The bulk of this increase has stemmed from food items (**Figure 3.17**).[24] In case of food, most of the price pressures were seen in case of perishables; stricter controls for import payments delayed shipments of fresh vegetables and fruits into the country in the initial months of FY17.[25] Meanwhile, crop

[22] For instance, because of limited availability of Shariah-compliant sovereign instruments, it becomes challenging for IBIs to meet SLR requirements. And for the same reason, IBIs operate at a higher financing-to-deposit ratio, which also implies that their risk-weighted assets are higher in proportion to their capital, compared to conventional banks.

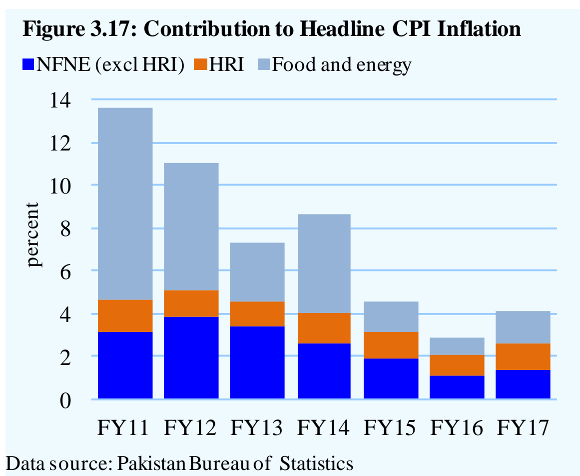
[23] As compared to FY16, the 7 out of 12 sub indices of CPI index showed higher inflation during FY17.

[24] The contribution of energy items in inflation during FY16 and FY17 was negligible.

[25] In order to strengthen payment systems and facilitate stakeholders, the customs authorities and SBP jointly introduced the system of Electronic Import Form (EIF) as an integral part of the goods clearance system (for details, see FE Circular No. 05 of 2016, dated August 09, 2016). In order to import goods into Pakistan, all importers shall be required to submit EIF request through their Web-based-one-customs (WeBOC) User ID to any authorized dealer of their choice in Pakistan. As per new requirements, no consignment without the proper filing of the EIF form will be processed. This move will also help curb informal and illegal transfer of FX across border: since transactions used to get processed manually earlier and it was not possible to keep record of all transactions, there was a possibility of using informal payment modes to their settlement.

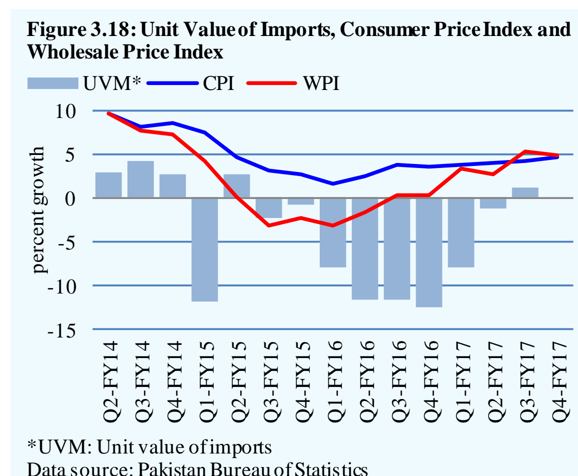
damages emanating from heavy rains in July and August 2016 in India also resulted in fewer supplies of some vegetables in the country. Furthermore, due to security-related measures, cross-border movement of goods was generally limited during the year.

Figure 3.17: Contribution to Headline CPI Inflation



Data source: Pakistan Bureau of Statistics

Figure 3.18: Unit Value of Imports, Consumer Price Index and Wholesale Price Index



*UVM: Unit value of imports
Data source: Pakistan Bureau of Statistics

(ii) A higher inflation in FY17 represents stabilization in prices of some of the heavyweight items. For instance, average prices of potato, rice, cooking oil and ghee had posted a fall in the last year, but posted a nominal increase in FY17. Therefore, the absence of their negative contribution to inflation was prominent in explaining a higher headline number this year. For instance, in case of potato, the bumper crop during FY16 had led to a drastic fall in its price from an average of Rs 43 to Rs 25/kg;[26] in FY17, however, the price posted some recovery and stabilized at Rs 33/kg. Similarly in case of rice, the slump in international prices led to a decline in domestic price of the commodity during FY16. However, during FY17, prices steadily increased resulting in marginal inflation of 2.8 percent on YoY basis, which was in tandem with global trend.

Table 3.5: Average CPI Inflation

percent

		Average inflation		Contribution in inflation	
	Weight	FY16	FY17	FY16	FY17
General	**100**	**2.9**	**4.2**	**2.9**	**4.2**
A. Food	**37.5**	**2.1**	**3.8**	**0.9**	**1.6**
i. Food and beverages	34.8	1.0	3.3	0.4	1.2
ii. Tobacco	1.4	22.0	12.0	0.4	0.3
iii. Restaurant	1.2	5.0	5.1	0.1	0.1
B. Non-Food	**62.5**	**3.4**	**4.4**	**2.0**	**2.6**
i. Clothing	7.6	4.8	4.1	0.4	0.3
ii. Housing group*	29.4	5.1	4.9	1.3	1.3
of which: house rent	21.8	5.6	6.5	1.0	1.2
iii. Household equipment	4.2	4.2	3.0	0.2	0.1
iv. Health	2.2	3.7	10.5	0.1	0.2
v. Transport	7.2	-6.9	-0.8	-0.5	0.0
vi. Communication	3.2	0.4	0.9	0.0	0.0
vii. Recreation	2.0	2.1	1.1	0.0	0.0
viii. Education	3.9	8.5	10.6	0.3	0.4
ix. Misc.	2.8	3.2	5.3	0.1	0.2

*Housing group includes: house rent, construction inputs, construction, wage rate, water supply, electricity, gas, kerosene oil, and firewood.
Data source: Pakistan Bureau of Statistics and State Bank of Pakistan

(iii) A similar phenomenon was seen in prices of imported goods. The deflation in unit values of imports which was evident throughout FY16, fizzled out completely in FY17 (**Figure 3.18**); from Q3-FY17 onwards, there has been a YoY increase in import prices. Most significant impact was seen in transport group, in which the prolonged spell (27 months) of deflation almost ended in FY17. This group, which comprised primarily of motor fuels like petrol and high speed diesel, recorded quite a modest fall in average prices during FY17, compared to 6.9 percent fall during

[26] During FY14 and FY15, potato prices show an abnormal trend because of both lower domestic production and high-cost import of the commodity from China and India during the former year.

FY16. In fact, from December 2016 to April 2017, the government increased the prices of motor fuels in response to an uptick in global oil prices.

(iv) Finally, the increase in core inflation (NFNE) during FY17 was reflected primarily in house rent, education and health (**Table 3.5**). Estimates for house rent are revised every quarter based on surveys in urban areas.[27] Having said this, the gradual increase in NFNE inflation is coming from inflation in education and health related components; their contribution to headline inflation inched up in FY17.

For the next year, the government has set the target for CPI inflation at 6 percent; SBP foresees the average CPI inflation to remain within this target. Main assumptions include expectations of better supply conditions of food items, limited pass-through of international oil prices to domestic market, steady increase in domestic demand, and improving consumer confidence in the economy, as reflected in results of IBA-SBP's Consumer Confidence Survey for July-2017.

[27] For brief explanation of the house rent inflation see SBP’s Third Quarterly Report on The State of Pakistan’s Economy for the year 2016-17.