

1 Enhancing Effectiveness of Monetary Policy

1.1 Monetary Policy Stance in FY18

The Monetary Policy Committee (MPC) regularly met bi-monthly during the year to review and deliberate on SBP's policy stance within the overall macroeconomic conditions and their projections. Trade-offs between conflicting objectives were thoroughly reviewed through empirical as well as technical analyses and forward looking decision making gained further importance.

Within the broader mandate of securing monetary stability, the MPC cautiously pursued an accommodative policy stance in H1-FY18 and maintained a policy rate at 5.75 percent. This policy stance was mainly supported by favorable macroeconomic conditions, particularly below target inflation albeit with some external sector pressures.

However, in H2-FY18, MPC monitored the evolving macroeconomic situation and proactively adjusted the policy rate. External sector pressures such as widening current account deficit, currency depreciation along with upward adjustment of the interest rates by a number of central banks affecting Pak Rupees interest-rate differentials vis-à-vis their currencies as well as overheating of the economy amidst a buildup of demand pressures, raised the need to tighten the policy stance to ensure growth and stability in the medium to long term. Consequently, MPC decided to raise the policy rate by cumulative 75 bps to 6.50 percent by the end of FY18.

Within the interest rate corridor, volatility of the interbank weighted average overnight repo rate remained low. In addition, the pass through of changes in the policy rate in H2-FY18 were transmitted to market interest rates rapidly amidst the rising inflation and depreciation of the exchange rate. However, banks' credit extension to private sector maintained its growth momentum in FY18 in the backdrop of low interest rates and maturity of fixed investments in last few years that added onto the capacity. Credit off-take in FY18 (Rs 775 billion) surpassed the last year's level (Rs 748 billion) which was a historic high.

In order to gauge the effectiveness and credibility of monetary policy communication, research is being carried out to better understand market reactions and behavior on publication of monetary policy statements and minutes, using text-mining approaches.

In realization of the direct impact of their discussion and decisions on market participants, MPC members have appreciated improvements made in the methodology. The SBP staff apprises them of the current macroeconomic situation with an extended forward looking coverage along with relevant scenarios. Seven comprehensive presentations are now being made to the MPC before it deliberates and reaches a decision on monetary policy stance. These presentations include the real sector, inflation, global considerations, balance of payments, monetary aggregates, private sector credit, fiscal sector indicators and numbers, DSGE type FPAS model outcomes, an appraisal of consumer and business confidence surveys and an assessment of the money markets.

1.1.1 Improvement in Forecasting Techniques

On the forecasting front, the quality of inflation outlook was improved by the incorporation of sensitivity analyses of inflation to various shocks such as global oil prices, government borrowings from banking system, exchange rates and others. The use of city level inflation data on important items such as house rents further enriched the analyses. Moreover, in terms of management of

forecasting exercises, Monetary Policy Department (MPD) has improved coordination amongst different departments of SBP in general, and Monetary Policy and Research Group (MPRG) in particular. In the same vein, MPD leads the discussion on oil price projections within the Forecasting Group of MPRG.

Similarly, the external trade outlook was also improved by incorporating comprehensive presentations of both internal and external factors affecting current and future trends. In this context, firm-level analyses were incorporated to enrich the outlook. Importantly, in the presence of increasing vulnerability, the model based medium-term assessments of equilibrium exchange rates were also upgraded using different scenarios of policy shocks.

In order to improve forecasting capabilities with regard to credit extension to the private sector, a model was developed based on frequency domain method (spectral analyses). Scenario analysis based on the shocks emanating from changes in exchange rates and lending rates were developed to improve assessment methodology. In a similar vein, forecasting of the money market liquidity position based on various models was initiated as well.

1.1.2 Adoption of Flexible Inflation Targeting

In order to pursue the goal of price-stable sustainable growth, SBP is committed towards adoption of Flexible Inflation targeting (FIT) framework by 2020. In this regard, a draft roadmap document along with key recommendations was prepared in June 2018. The issues relevant to adoption of FIT in the light of international best practices and empirical analyses are highlighted in the said document. More specifically, the addressed issues include:

- Evaluation of SBP's readiness in terms of its institutional framework to move towards FIT
- The relevant measure of inflation as nominal anchor
- Estimation of medium-term threshold level of inflation
- Transparency and Communication
- Important impediments affecting transmission of monetary policy in Pakistan (i) fiscal considerations, (ii) external sector issues, and (iii) Islamic banking

On the strategic front, MPD is in contact with the Planning Commission of Pakistan in order to apprise the government about its strategic goal of FIT adoption. These consultations are aimed at explaining the concept of FIT to the official stakeholders as well as to generate momentum in collaborative decision-making over medium term national inflation target consistent with sustainable economic growth.

1.2 Money and Debt Market

Following initiatives in this context were undertaken during FY18:

1.2.1 Floating Rate Pakistan Investment Bonds

In May 2018, SBP, as a fiscal agent of Government of Pakistan (GOP), introduced Pakistan Investment Bond (PIB) with Floating Rate Coupon to assist GOP in increasing the maturity profile of public debt and strengthening the suite of available tradable government securities to the market. The Floating Rate PIB is expected to encourage market to invest in longer tenors and enable GOP to mobilize long-term debt in rising interest rate scenario (DMMD Circular No. 09 dated May 07, 2018).

1.2.2 Promotion of Chinese Yuan for Cross-border Trade and Investment with China

In order to further strengthen trade channels in Chinese Yuan (CNY), SBP allowed Bank of China (BOC) Pakistan to establish a local CNY settlement and clearing setup in Pakistan in April 2018. Similarly, Industrial and Commercial Bank of China Limited (ICBC) Pakistan has also been allowed by SBP to offer similar services since 2015. This settlement and clearing mechanism is expected to reduce costs and increase efficiency for the local banking system for transacting in CNY, enhance market liquidity and facilitate settlement of growing trade and investment transactions between China and Pakistan in CNY.

Reciprocally, two new CNY nostro accounts were opened with ICBC, Beijing and Standard Chartered Bank, Shanghai. Further, SBP appointed ICBC as its first ever FX trading agent in Chinese onshore interbank FX market.

SBP in coordination with domestic banks and Financial Markets Association of Pakistan (FMAP), conducted a number of awareness sessions for the business community and investors to promote the use of CNY in cross-border trade and investment with China.

1.2.3 Master Circular on Auction of Government Securities

SBP as a fiscal agent of GOP, conducts auctions of marketable government securities including Market Treasury Bills (MTBs) and PIBs. SBP issued a Master Circular on Auction of government securities in March 2018 to streamline policies for government securities market, update them in light of recent market dynamics and consolidate all previously issued regulations pertaining to auction of government securities. The policy and regulatory changes introduced are expected to increase diversification of investor base of government securities from banks to non-banks and improve operational efficiency in settlement of auctions (DMMD Circular No. 06 dated March 15, 2018).

1.2.4 Master Circulars on Liquidity Management Tools (OMOs, CRR and SLR)

SBP conducts Open Market Operations (OMO) and enforces Cash Reserve requirement (CRR) and Statutory Liquidity Requirement (SLR) to implement its monetary policy stance. In order to improve operational efficiency and risk management, strengthen market policies and regulations in accordance with market developments and consolidate all previously issued instructions on the subject, SBP issued Master Circulars on OMO, CRR and SLR in FY18. The policy and regulatory changes introduced are aimed at bringing operational efficiency in conducting and settling OMOs, strengthening money market policies & regulations, and ensuring their meticulous compliance (DMMD Circular No. 12 dated July 03, 2017 and DMMD Circular No. 04 and 05 dated March 08, 2018).

1.3 Foreign Exchange Reserve Management

The first half of FY18 was characterized by positive euphoria emanating from stable-to-improving economic numbers from the US, Eurozone and China, the remainder of the year has been marked by a substantial rise in market volatility, mainly on account of reciprocal imposition of import tariffs by the US and China, and the continuing differences between UK and Europe, on Brexit-related concessions. Taking a look at the factors for favorable market moves during FY18, US economic growth visibly picked pace this year, touching 4.1 percent for quarter ending June 18, benefiting from substantial cut in corporate tax rates, announced at end December 17. The US showed clear improvement in economic fundamentals this year, and the numbers from the Eurozone have become more stable with GDP trending around 0.7 percent on a quarterly basis, compared to the 0.40 to 0.50 percent range for previous year. Moreover, China's economy has achieved 6.7 percent growth rate, on an annual basis as against expectation of slower growth. While these numbers provided global financial markets

some comfort during H1-FY18, US decision to impose import tariffs on China, prompted China to retaliate with tariffs on US imports. With the world's biggest economies at loggerheads over trade related issues, currency markets have unavoidably entered a phase of heightened volatility. The JP Morgan Index for G7 Currency Volatility, which was trending around 7.6 percent in July 2017, touched a high of 9.1 percent in February 2018. The emerging market (EM) currencies have been specially hit by increasing Sino-US trade frictions, as reflected by JP Morgan's Index for EM Currency Volatility rising to 10.1 percent in June 18, from a low of 7.1 percent in August 2017.

In line with the overall principles of safety, liquidity and return, and cognizant of market developments during the year, SBP increased its funds allocation to short term US treasuries, which proved beneficial as yields improved. SBP also continued with its policy of investment diversification to include higher yielding instruments as well as continuing investment in Islamic Sukuk without increasing the investment risk.

In line with SBP Vision 2020, following initiatives have been taken during FY18 to improve the efficiency and effectiveness of FX regime in the country (**Box 1.1**).

Box 1.1: Initiatives taken to improve effectiveness of Foreign Exchange Regime during FY18

- Foreign Exchange Manual-2018 has been issued by incorporating related Notifications, FE Circulars and Circular Letters issued till June 22, 2018 and placed at SBP's website. This initiative will facilitate the stakeholders, as all foreign exchange related instructions would now be available to them in a single document.
- Updated Exchange Companies Manual-2017 has been issued after incorporating related instructions issued by SBP to Exchange Companies and Exchange Companies of 'B' category through FE Circulars and Circular Letters till December 31, 2017.
- After successful implementation of Electronic Import Form module, the requirement of submission of original shipping documents for making payment against goods imported on open account basis has been dispensed with and an alternate procedure to make payment against goods imported on open account basis has been prescribed. Further, after successful implementation of Electronic Form-E module in WeBOC, exporters have been allowed to directly dispatch shipping documents to consignees or their agents in the country of final destination in case of exports other than against Letter of Credit or advance payment.
- In order to facilitate software exporters, registration requirement for software houses/ companies with respective area office of Foreign Exchange Operations Department, SBP-BSC has been dispensed with. Now, the Authorized Dealers (banks) are required to handle transactions related to export of software independently.
- In order to streamline payment procedure through more efficient electronic payment mechanism, the Exchange Companies and Exchange Companies of 'B' category are required to deposit their fees with SBP in RTGS Clearing Accounts through banks.
- In order to facilitate Exchange Companies and Exchange Companies of 'B' category and to enhance integrity of reporting of data, SBP has implemented an integrated reporting system enabling Exchange Companies and Exchange Companies of 'B' category to submit their transactions data to SBP through Web based online system.
- With a view to further strengthen the AML and CFT regime, Exchange Companies and Exchange Companies of 'B' Category are now required to obtain and retain copies of identification documents. The same includes Computerized National Identity Card/ National Identity Card for Overseas Pakistanis/ Pakistan Origin Card/ Passport having valid visa on it or any other proof of legal stay of a foreigner in Pakistan for all foreign currency buy and sell transactions equivalent to USD 500 or above.
- Implemented sanctions regime for proscribed persons under Fourth Schedule of Anti-Terrorism Act, 1997 in the Exchange Companies sector.

- Conducted detailed training sessions on AML and CFT for senior level employees of Exchange Companies and Exchange Companies of 'B' category at different locations across Pakistan.
- Enhanced coordination with Federal Investigation Agency (FIA) to curb the menace of illegal foreign exchange operators particularly coordinated high-level special campaigns against illegal foreign exchange operators.

1.4 Home Remittances

During FY18, home remittances witnessed a growth of 1.4 percent as against a decline of 2.8 percent in the preceding fiscal year. It is important to mention that based on the trend, home remittances were expected to decline at the start of FY18, however, this moderate increase is encouraging. Despite serious domestic and external challenges including labor and fiscal reforms in most of the GCC countries, de-risking and enhanced due diligence by some large domestic banks, the overall rise in home remittances is mainly attributed to the following factors:

- SBP's support in initiating and implementing various initiatives including increased coordination with regulators in some important corridors; aggressive awareness campaigns on promotion for remittances through mobile wallet scheme etc.
- Holding the 'First Pakistan Remittance Summit' in UAE in December 2017.
- Appreciation of GBP and Euro by around 4 percent.
- Increased outreach in EU as most of the UK based money transfer companies have established their networks in EU region by using UK license as a cost effective solution.

Box 1.2: Initiatives taken for growth of Home Remittances

Promotion of Home Remittances through Branchless Banking/ M-Wallet Scheme: In order to facilitate swift and cost effective flow of home remittances, 'Promotion of Home Remittances through M-Wallet Scheme' was launched in December 2017. The Scheme introduced Branchless Banking Home Remittance Account (BB-HRA) whereby beneficiaries will receive airtime of Rupee 1 against remittance of every USD.

Increase in Domestic and Overseas Outreach: As part of continuous efforts, SBP and Pakistan Remittance Initiative (PRI) have been successful to further increase domestic and overseas outreach during FY18. Domestic financial institutions entered into over 100 new agency arrangements with overseas banks/ money transfer firms during FY18. At the domestic front, the network of Karakoram Bank, a non-scheduled bank, has been included in remittance payment network through agreement with a domestic scheduled bank.

Marketing/ Awareness Campaigns: A key highlight of FY18 was aggressive marketing and awareness campaigns by banks within the country and abroad under the guidance of SBP/ PRI. Some major marketing initiatives taken in this regard are given below:

- One large commercial bank in collaboration with a local media house conducted road shows in 15 cities in Pakistan. The major objective of this campaign was to create awareness regarding the advantages of formal channels and risks of hundi/ hawala.
- With the support of Ministry of Foreign Affairs, most of the Pakistani Missions in GCC region were engaged to create awareness amongst Pakistani Diaspora regarding sending remittances through formal channels. In particular, a documentary drama has also been displayed at Pakistani Missions.
- A large number of marketing campaigns have been conducted in KSA, UAE, Oman, Qatar and UK during FY18 by local financial institutions in collaboration with overseas tie-ups. SBP/PRI also participated in some of these activities.

Pre Departure Briefings: PRI in coordination with the Bureau of Emigration & Overseas Employment and banks conducted a financial training program at the Protectorate of Emigrant Offices. All seven Protectorate Offices throughout Pakistan have been participating in the project to create awareness amongst intended emigrant workers regarding sending remittances through formal channels and opening their own and their family members' accounts.

1.5 Research

Research Department extended SBP's Forecasting and Policy Analyses System (FPAS) during FY18 by augmenting the model with fiscal block. The extended FPAS model was fully operational in September 2017 and its projections are being used for policy inputs by the MPC on bi-monthly basis. Research relating to two extensions of Dynamic Stochastic General Equilibrium (DSGE) and FPAS models, identified by the MPC, was also initiated during the year, in collaboration with Professor Dr. Ehsan Choudhri (Carleton University, Canada). This includes addition of financial sector, which is crucial for understanding the monetary policy transmission mechanism and inclusion of agriculture sector separately in the model to understand its linkages with rest of the economy.

Like many other central banks, SBP continued to weigh up both the public and corporations' perceptions about prevailing and expected economic conditions for monetary policy formulation by conducting Consumer Confidence Survey (CCS) and Business Confidence Survey (BCS) after every two months. Besides conducting regular CCS and BCS surveys, SBP also conducted a number of other surveys during FY18 including banking services quality survey, bank lending conditions survey and systemic risks survey of the financial sector.

As per practice, the 22nd Zahid Husain Memorial Lecture was organized in February 2018. The lecture was delivered by Professor Sir Paul Collier on "The Role of a Central Bank in National Economic Development". Sir Paul Collier is a professor of Economics and Public Policy at the Blavatnik School of Government and a Professorial Fellow of St Antony's College, Oxford University, UK. Government officials, financial sector specialists, researchers, heads of commercial banks, diplomats, eminent business persons and representatives of academia and the media attended the lecture.

The speaker emphasized that it is imperative to create a shared narrative and inculcate such beliefs amongst the main stakeholders, if a country wants to walk on the path of sustained economic development. He appreciated the recent emphasis of SBP on provision of financing to underserved segments of the society including SMEs, low cost housing and agriculture.

SBP also organized two seminars under Pakistan and World Economy Series: one by Associate Professor, Dr. John Steen and the other by Postdoctoral Research Fellow, Dr. Shabbir Ahmad, both from the University of Queensland, Australia.

SBP published eight working papers during FY18, which were contributed by officers of MPRG. These working papers include 'A Model for Forecasting and Policy Analyses in Pakistan: the Role of Government and External Sectors (SBP Working Paper 95)' and 'Threshold inflation in Pakistan (SBP Working Paper 94)' contributed a lot in enhancing the understanding about the working of Pakistan's economy. Further, 13th volume of the SBP Research Bulletin was also released during FY18.

1.6 Economic Analyses/ Publications

The SBP publishes its flagship quarterly and annual reports on the state of Pakistan economy that provide in-depth analyses of economic trends, issues and challenges. During FY18, a wide array of subjects were covered. A special section analyzed and detailed the potential impact of CPEC activities

on industrial sector of Pakistan. Similarly, analyses of the current expansion dynamics of the cement sector and its future prospects was also covered. Further, a discussion highlighting the developments and policy actions necessary to make services sector of Pakistan, export oriented, using historical data analyses and regional policy comparisons was made part of the commentary on real sector.

On the fiscal front, it was empirically shown that withholding tax on financial transactions resulted in heightened disintermediation. Similarly, the impact of depreciation on external debt was evaluated in the form of a box item.

On the external sector front, topics such as an uptick in machinery imports under the umbrella of CPEC, recent initiatives taken to promote home remittances through banking channels, and changing composition of the country's energy imports were covered. Similarly, a section emphasizing on the importance of synthetic textile exports from Pakistan was also included in the review. Moreover, SBP provided analytical and data support for relevant sections of the Economic Survey of Pakistan FY18, published by the Ministry of Finance.

In the Annual Report FY17, a thematic chapter on water sustainability was published with the objective to highlight the challenge of water scarcity faced by Pakistan considering the growing population and adverse climate changes. Issues such as limited storage capacity, trans-boundary disputes (concerning the Indus Water Treaty), outdated water distribution system, pricing issues and depleting groundwater resources were covered. Further, policy recommendations for the way forward were provided.

1.7 Data Management System

In line with SBP Vision 2020, the statistics compiled by SBP largely followed international standards. The Balance of Payments statistics, monetary statistics, flows of fund accounts and debt statistics are compiled in accordance with the guidelines provided in the manuals designed by international agencies such as IMF, UN, and the World Bank Group. Statistics produced by SBP is used for analyses, research and policy formulation, within and outside SBP by various stakeholders.

A number of initiatives in data compilation and dissemination were taken during FY18, which included the following:

- Improvement in data coverage of Pakistan's balance of payments statistics was made by including permissible offshore foreign currency accounts' transactions related to power/energy sectors.
- Implementation of recommendations of IMF Technical Assistance Mission for improvement in the quality of Financial Corporations Survey and Other Financial Corporations Survey. Financial Corporations Survey would be available on SBP website by the end of September 2018.
- Enhancement in the coverage of Banking Statistics by including branch-wise data on deposits, advances, investments and bills of DFIs and MFIs in half-yearly publication "Statistics on Scheduled Banks in Pakistan".
- Adoption of International Standard Industrial Classification (ISIC) Revision 4 for Compilation of Foreign Direct Investment (FDI). FDI data will be disseminated on ISIC (Revision 4) Broad Structure from July 2018 and onwards on SBP website. To facilitate users, its monthly archive will also be available from July 2015.

- Introduction of new data series on “Repatriation of Profit/ Dividend by Country on Ultimate Controlling Parent (UCP) basis”. Data will be disseminated from July 2018 onwards on SBP website. To facilitate users, its monthly archive will also be available from July 2011 on UCP country basis and from July 2007 to June 2011 on immediate country basis.
- Coordination for automation of modules across SBP and SBP-BSC including Financial Sector Supervisory Dashboard for the senior management of banking cluster, data acquisition and processing modules of Credit Guarantee Schemes for SBP-BSC and Quarterly Financial Statement Analyses of non-financial listed companies.
- Development of a data acquisition and processing module for monetary and financial statements of exchange companies, insurance companies and pension funds.
- Compilation and dissemination of new data table “Bank's Foreign Currency Deposits and Borrowings from abroad” including special permission onshore FCA of power/energy sectors and banks borrowing under FE Circular 3 of 2007 from September 2017 onwards.
- Enhancement in the coverage of external sector statistics by acquisition of FE transactions data from Exchange Companies (Category A and B) through DAP on weekly basis.
- The department has initiated a quarterly survey of power companies operating under CPEC to collect data on transactions carried out by such companies through their offshore accounts, as permitted by SBP.