1 Enhancing Effectiveness of Monetary Policy

1.1 Monetary Policy Stance in FY19

Pakistan’s economy witnessed low inflation and healthy GDP growth in FY18 and FY17. However, this growth, primarily consumption led, resulted in a sharp increase in twin deficits i.e. fiscal and current account deficits. Owing to high domestic demand, inflation remained above its target in FY19. Cognizant of the evolving macroeconomic trends, SBP proactively increased its policy rate by a cumulative 575 bps in six bi-monthly meetings for monetary policy decisions. The SBP raised the policy rate by 100 bps to 13.25 percent with effect from July 17, 2019. This was the ninth increase in the policy rate during the current cycle of monetary tightening initiated in January 2018. In aggregate, the policy rate has recorded a cumulative increase of 750 bps during the current cycle of monetary tightening.

The monetary tightening has been supported by greater exchange rate flexibility and administrative measures to contain imports. The government also supported these policy adjustments by increasing regulatory duties on unnecessary consumer and luxury items and arranging external funding to contain deterioration in external buffers (Foreign exchange reserves).

The policy actions have led to a visible improvement in the country’s external accounts and helped in containing domestic demand. Specifically, external conditions continue to improve with a 31.7 percent reduction in the current account deficit (CAD) to USD 13.6 billion in FY19 as compared to a deficit of USD 19.9 billion previous year. The consolidation is likely to gain momentum going forward with CAD to contract further on account of import compression, anticipation of moderate growth in exports and prospects of increase in remittances. In addition, the country’s financial account is going to benefit from the IMF Extended Fund Facility, activation of the Saudi oil facility and other commitments from multilateral and bilateral partners.

The current high frequency indicators point towards a marked slowdown in domestic demand along with overall economic activity. The latest estimates of National Income Accounts indicate that the real GDP grew by 3.3 percent in FY19 as compared to 5.5 percent in FY18. A modest recovery is expected on account of improvement in agriculture sector and its knock-on impact on industry and services sectors and the gradual impact of government incentives for export-oriented industries. Therefore, SBP expects real GDP growth of around 3.5 percent in FY20.

Both the demand and supply side factors pushed the headline inflation to 7.3 percent in FY19, above the medium term target of 6 percent. Year on year CPI inflation increased by 10.3 and 11.6 percent in July and August 2019, respectively. The Monetary Policy Committee expects average headline inflation (old base of 2007-08) for FY20 to remain in the range of 11-12 percent. This notable increase in FY20 inflation is largely stemming from the one-off impact of adjustment in utilities prices, rationalization of taxation structure and the unfolding impact of depreciation of PKR in the last few months. However, the lagged impact of stabilization measures and weakening impact of one-off adjustments would significantly reduce headline inflation in FY21.

1.1.1 IMF Program

The Government of Pakistan (GoP) and the IMF have signed a 39-month Extended Fund Facility arrangement amounting USD 6 billion. The program would help strengthening macroeconomic stability and facilitating the implementation of deep-rooted structural reforms. The GoP in consultation with all stakeholders has developed a well-thought set of economic and financial policies to contain macroeconomic imbalances to manageable levels and to pave the way for sustainable economic growth in the medium to long run.

1.1.2 Strengthening Monetary Policy Formulation

In order to produce high quality analyses for MPC, the relevant departments of SBP continuously seek to improve its macroeconomic forecasting models/ techniques to provide a better/ clearer picture of economy going forward. Improved coordination between Research Department and Monetary Policy Department (MPD) on forecasting front have helped in providing quality reports to MPC.

A number of exercises focused on exploring and strengthening of sectoral interlinkages to facilitate in-depth analyses were undertaken, where multiple findings were converted into research papers and the rest were transformed into Development Projects. MPD completed 16 projects in FY19. Some of the major Development Projects are listed below:

- Roadmap for inflation targeting and prototype inflation report
- Impact of Monetary Policy related communication on money markets
- Estimation of output gap at disaggregate level
- Development of sustainable economic growth path with structural changes
- Interest rate corridor and liquidity management
- Exchange rate undervaluation and economic growth: the Trade-versus-The financial risk channel.

Similarly, sector specific developments are regularly analyzed to keep the MPC updated with latest developments that may affect policy decisions. These are typically covered as box items and made part of the flagship Trends and Development document and final presentation produced by MPD for MPC.

During the year under review, 22 specific developments were covered as box items for the MPC. Some of them are listed below:

- Role of overvalued exchange rate in keeping inflation at lower level
- Sensitivity of SBP inflation forecast to the floods in the country
- Comparison of Pakistan’s exports potential with its existing level (some observations)
- Textile exports to EU: A case of decreasing unit value for textile exporters
- US-China Trade Tensions: Who will benefit
- Impact of Brexit on UK and the EU economies
- A possible shift of government borrowing from SBP to scheduled banks in FY20 and its implications for monetary management
- IMF program and monetary expansion
- Credit uptake and non-financial corporate sector analysis

1.1.3 Progress towards Adoption of Flexible Inflation Targeting

SBP with its commitment towards adoption of Flexible Inflation targeting (FIT) framework by 2020, prepared a draft roadmap document along with key recommendations. In this regard, a seminar was organized in April 2019, to seek comments and suggestions for improvement. The GoP took a significant step towards inflation targeting by announcing its first medium term inflation target at 5-7 percent in the Federal Budget FY20.

1.2 Money and Debt Market

Following initiatives were undertaken during FY19:

1.2.1 Exemption of 'Borrowings from Pakistan Mortgage Refinance Company Limited' from Maintenance of CRR and SLR for Banks / Microfinance Banks

Keeping in view the role of Pakistan Mortgage Refinance Company (PMRC) and to facilitate mobilization of low cost housing finance, SBP revised its instructions on Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR) in March, 2019. Accordingly, borrowings from PMRC have been exempted from maintenance of CRR and SLR. These measures will encourage Banks/ MFBs to finance low cost housing.

1.2.2 Declaration of Pakistan Energy Sukuk as Approved Security for Maintenance of SLR

Considering the scheduled maturities of GoP Ijara Sukuk and limited issuance of sovereign Shariah compliant securities vis-à-vis increasing demand for investment opportunities by Islamic Banking Institutions, SBP supported the eligibility of Pakistan Energy Sukuk issued by Power Holding Private Limited (PHPL) as approved security for maintenance of SLR.

1.2.3 Declaration of Obligations of SBP arising from Bai-Muajjal transactions as Approved Security for Maintenance of SLR

To enhance the available pool of Shariah compliant instruments for Islamic Banking Institutions and to meet the required SLR and help them sustain their growth momentum, SBP supported the declaration of obligations of SBP arising from Bai-Muajjal transactions as approved security for maintenance of SLR.

1.3 Foreign Exchange Reserve Management

The synchronized upswing in global growth and trade that has been the hallmark of recent years gave way to a more uneven growth environment in FY19. While global growth remained positive, most of the major economies seem to be in the intermediary stages of the business cycle. Though the labor market has strengthened in US, the services and manufacturing activity and consumer spending remained muted. Amidst concerns regarding trade tensions and efficacy of fiscal spending, debates regarding Fed policy action have changed from rate hikes to rate cuts. In China, economic growth is also stagnating amidst trade tensions with the US as well as government action against shadow banking practices that have left private debt at worrisome levels. Chinese policymakers are stuck in a balancing act as they face a weaker economy but do not want to risk overstimulation after a decade-long credit boom. Nevertheless, the depreciating Renminbi has partially offset the impact of higher US tariffs. Further monetary and fiscal accommodation may be warranted going forward to prevent any material economic growth slowdown.

European markets also faced slower growth given stalling imports from China as well as uncertainties surrounding 'Brexit'. While central banks of developed economies are prepared to provide stimulus in case of further slowdown in economic activity, markets still need to figure out the ramifications of a slowing global economy.

In line with the SBP guiding principles of safety, liquidity and returns, the SBP reserve management function was proactively aligned with the changing market conditions to earn optimal returns.

In the wake of globally heightened concerns about cyber security, mandatory software upgrade of SWIFT Alliance Access was successfully applied and upgraded in compliance with SWIFT's Customer Security Control Framework. Further, SWIFT Alliance Lifeline was acquired to ensure uninterrupted business continuity in situations where SWIFT infrastructure disrupts or become totally unavailable. In order to strengthen the robustness of the system, Payment Control Service was acquired for maintaining track of legitimate payments and mitigating the threat of cyber frauds.

In pursuance of SBP Vision 2020, a number of policy measures have been initiated during FY19 to improve the efficiency and effectiveness of Foreign Exchange regime of Pakistan (**Box 1.1**).

Box 1.1: Initiatives taken to improve effectiveness of foreign exchange regime during FY19:

- SBP updated Foreign Exchange Manual by incorporating the related Notifications, FE Circulars and Circular Letters issued up to March 14, 2019. Further, Exchange Companies Manual-2018 has also been updated with all FE Circulars and Circular Letters issued till December 31, 2018. Both the manuals have been placed on SBP's website to facilitate access to all stakeholders.

- Keeping in view of the changing dynamics of the foreign exchange market, seven chapters of Foreign Exchange Manual have been revised in consultation with key stakeholders. The revision includes chapters relating to Authorized Dealers, Foreign Currency Loans, Overdrafts and Guarantees, Forward Exchange Facilities, etc.

- SBP restricted advance payment against imports at the beginning of the FY18 to support balance of payment of the country. However, this restriction was removed for certain sectors mentioned as under:

  - Advance payment up to USD 10,000 per invoice has been allowed for essential medicines, aircraft spares, educational lab equipment, books, periodicals, etc. The above limit was further relaxed to USD 50,000 for import of life saving medicines and devices.
  - Advance payment up to USD 10,000 per invoice has been allowed to importers cum exporters for import of raw materials, accessories and spares.

- Similarly, the import on open account basis was confined to manufacturing and industrial users for import of spare parts/ raw materials only. Subsequently, this facility was also extended for import of essential medicines, aircraft spares, educational lab equipment, books, periodicals etc. up to USD 10,000. This limit was further relaxed to USD 50,000 for the import of life saving medicines and devices to improve the health care facilities in the country.

- In order to further strengthen the compliance of AML/ CFT laws and regulations by Exchange Companies, SBP instructed to document all such transactions that require physical movement (transportation) of any currency between their authorized network or with other Exchange Companies and Banks. Besides, it was also advised to use bank accounts for intercity movements of PKR cash.

- SBP issued a detailed guidelines for all types of Exchange Companies on Targeted Financial Sanctions for the prevention of Terrorism and Proliferation Financing, to ensure meticulous compliance of Statutory Regulatory Orders and Notifications of GoP in terms of United Nations (Security Council) Act, 1948 and The Anti-Terrorism Act (ATA), 1997. These instructions, inter alia, require non-provision of services to proscribed persons, development of transaction screening mechanism, strengthening of internal controls and AML/CFT related training of the dealing staff.

- To further improve the operational risk management of all types of Exchange Companies, SBP implemented a standardized policy for the surveillance of every branch by respective Head Office through close circuit television camera arrangement.

1.4 Home Remittances

Notwithstanding the challenges of Gulf Cooperation Council region amidst broad-based fiscal and labor reforms, home remittances rose to USD 21.8 billion during FY19 as compared with USD 19.9 billion in FY18, thereby witnessing a strong growth of 9.7 percent. The rise is mainly attributed to the support extended by the GoP and the efforts made by all stakeholders including SBP, Pakistan Remittance Initiative (PRI) and financial institutions to implement following measures:

1.4.1 Incentive Scheme for Financial Institutions

In order to encourage banks, microfinance banks and exchange companies providing home remittance disbursement services, a performance based incentive scheme has been introduced to enhance their marketing /promotional /awareness efforts for home remittance products and services. The GoP reimburse these expenses to participating institutions through SBP.

1.4.2 Second Pakistan Remittance Summit

The Second “Pakistan Remittance Summit 2019” was held on April 03, 2019 in Dubai, UAE. This Summit was organized by the top five remittance receiving banks in Pakistan under the patronage of SBP and PRI. The summit shed light on the importance of workers remittances for the development and support of Pakistan’s economy and the measures being taken by SBP/ PRI and the banks in Pakistan to increase flow of home remittances through official channels.

1.4.3 Introduction of Technology Based Products

- **Rationalization of M-Wallet Scheme**

In order to further facilitate the banks to promote home remittances through Branchless Banking Operators (BBOs), the incentive of airtime has been increased from Re 1 to Rs 2 against each USD received under home remittances through M-Wallet. Further, the entire amount of incentive to home remittance account holders (HRA) shall be borne by the GoP as against 50 percent sharing of incentive payment by GoP and 50 percent by BBOs earlier.

- **Blockchain Based Remittance Sending Model (From Malaysia To Pakistan)**

Technology has always been a crucial feature to connect overseas Pakistanis with their dependent beneficiaries in remote areas of the country. The banks are continuously guided to introduce better and efficient technology based products. It is with the help of blockchain technology that wallet-to-wallet remittances reach Pakistan from Malaysia instantaneously in the most secured manner. Valyou-Malaysia and Easypaisa - Pakistan brought a cross-border remittance service solution through e-wallet platforms, based on blockchain technology developed by Alipay, a subsidiary of ANT Financial. Pakistan is the first South Asian country that introduced blockchain enabled technology for remittances.

1.4.4 Media/Awareness Campaign to Promote Remittances through Formal Channels

SBP / PRI launched a massive public marketing campaign for the promotion of regulated channels with the following objectives:

- To increase awareness of the general public in rural and urban areas about existing facilities of sending remittances to Pakistan
- To position regulated channels as the industry frontrunner in enabling a reliable and efficient home remittance transactions system through a network of banks, exchange companies and Pakistan Post
- To build public's trust in regulated channels so that more and more people use these channels to remit money from abroad**.**

1.4.5 Increase in Overseas Outreach

As part of continuous efforts, SBP/ PRI have been successful to further increase the overseas outreach of domestic financial institutions by allowing their over 130 agency arrangements with overseas tie-ups during FY19. It includes 10 percent new tie-ups thereby surpassing the total number of agency agreement by 1,000 mark.

1.4.6 Withholding Tax Exemption on Withdrawal of Remittances

On the proposal of SBP/ PRI and other key stakeholders, the GoP through Finance Bill 2019 announced removal of advance tax on cash withdrawal from PKR accounts where deposit in the account is made solely from foreign remittances.

1.5 Research

Research Department has further extended Dynamic Stochastic General Equilibrium (DSGE) and Forecasting and Policy Analysis System (FPAS) models during FY19 by incorporating the dynamics of financial and agriculture sectors, as identified by the MPC. The FPAS-version 3 model has been developed which is being operationalized to provide regular inputs to Monetary Operation Committee (MOC) and MPC for policy formulation.

Like many other central banks, SBP continued to weigh up both the households and firms' perceptions about prevailing and expected economic conditions for monetary policy formulation by conducting Consumer Confidence Survey and Business Confidence Survey after every two months. SBP also continued to conduct quarterly online bank lending survey. Similarly, Banking Services Quality Survey, which assessed the banking services quality through pan Pakistan survey of 4000 bank account holders was conducted. Further, SBP conducted Systemic Risk Survey in collaboration with Financial Stability Department.

The 23rd Zahid Husain Memorial Lecture was organized on April 19, 2019 at SBP Karachi. Former Governor, Peoples Bank of China, Mr. Zhou Xiaochuan delivered the lecture titled, “Lessons from the Role of Peoples Bank of China in their Economic Rise”. In his lecture, Mr. Zhou described the reforms in Peoples Bank of China under his tenure, which reflects China’s gradualist approach towards globalization for sustainable economic development. He emphasized to raise domestic savings in order to address most of the macroeconomic imbalances. He also suggested using regional currencies to facilitate trade in the region. Government officials, financial sector specialists, researchers, heads of commercial banks, diplomats, eminent businesspersons and representatives of academia and the media attended the lecture.

SBP also organized several seminars under Pakistan and World Economy Series during FY19. The most prominent lecture was delivered by Professor Asim Ijaz Khwaja from Harvard Kennedy School. He presented his research paper titled, “Ingredients for growth: Enabling Evidence for Transformation in Pakistan”. Another lecture under the series was delivered by Mr. Hans Timmer, Chief Economist, South Asia region, World Bank. In his lecture, he discussed the role of disruptive technologies and implications on markets.

SBP published five working papers during FY19. These working papers contributed a lot in enhancing the understanding about the working of Pakistan's economy.

1.6 Economic Analyses / Publications

The SBP’s quarterly and annual reports on The State of the Economy provide insights into economic trends, issues and challenges. In FY19, these reports addressed several economic issues and highlighted their importance.

On the industrial front, the impact of global commodity markets on industrial production was analyzed. Additionally, the effect of delayed adjustment of prices on the performance of the pharmaceutical sector was also brought to light. Agriculture sector issues such as crop insurance program, climate smart agriculture, sugarcane pricing and the developing water situation were discussed and analyzed in detail. A section on, “Exploiting Direct Tax Potential in Pakistan” was published in Annual Report 2018. Moreover, SBP provided analytical and data support for relevant sections of the Economic Survey of Pakistan FY19, published by Finance Division.

Regarding the External sector, various topics were covered, both in the main text of the chapter as well as in the form of box items. These included box items on an assessment of FX reserves adequacy based on IMF guidelines and the opportunities and challenges for Pakistan amidst the ongoing Sino – US trade dispute. Further, recent efforts to channelize remittances through official channels were highlighted. The shift in the composition of Pakistan’s energy mix from furnace oil towards LNG and coal was also regularly highlighted.

The Annual Report FY18 featured a special chapter dedicated to the digitization of services in Pakistan. The chapter documented the notable developments taking place across three key domains: e-commerce, Fintech and e-government. It made a compelling case for stakeholders to further facilitate the advancement of digitization, given its potential to trigger investment, financial inclusion, productivity gains and entrepreneurship, all of which could in turn, be a boon for economic growth.

1.7 Data Management System

Pursuing SBP Vision 2020, all major statistics compiled by SBP are in accordance with the international standards. The balance of payments statistics, monetary statistics, flow of funds accounts and debt statistics follow the guidelines provided in the relevant manuals prepared by the international agencies like, IMF, UN, and the World Bank Group. Various stakeholders use the statistics produced by SBP for analysis, research and policy formation within and outside SBP.

During the year, a number of initiatives were taken in the data compilation and dissemination as follows:

- Compilation of Repatriation of Profit and Dividend on Foreign Investment as per International Standard of Industrial Classification of All Economic Activities (ISIC 4).

- Compilation of half-yearly scheduled banks statistics on ISIC 4 together with inclusion of branch-wise data of MFBs and DFIs as a separate chapter in the publication of Statistics on Scheduled Banks in Pakistan.

- Contribution towards implementation of the IMF’s Enhanced General Data Dissemination System (e-GDDS) besides providing data on financial and external sectors for National Summary Data Page of Pakistan, being hosted by Pakistan Bureau of Statistics.

- Survey of importers to update coefficient of CIF margin as 2.7 percent on imports from July, 2018 onward.

- Revision of Foreign Exchange Returns (FERs)-Code Guide for banks to enhance coverage of all banks’ transactions as per recommendations contained in the IMF manual (BPM6).

- Enhancement in the data coverage of weekly Monetary Survey by including data relating to DFIs and MFBs as well as its classification in line with monthly Monetary Survey as per MFSM. SBP will start disseminating weekly Monetary Survey series upon completion of internal and external review process.

- Compilation of quarterly publication of top 100 non-financial companies listed at Pakistan Stock Exchange from the quarter ending September 2018.

- Coordination for the development of a FX dashboard called FX Data Universe. The dashboard aims to provide a consolidated view of foreign exchange data from across various databases used by SBP.

- Coordination for the development of data acquisition and processing modules for monthly reporting of Foreign Currency Deposits & Borrowings (for S&DWD), Turnaround Time Monitoring Portal for SME borrowers (for IH&SMEFD) and data acquisition and compilation module for microfinance banks' Capital Adequacy Ratio (for BPRD).

- Completion of developmental project "Feasibility and Methodology to calculate Divisia Monetary Aggregate Index for Pakistan" meant to introduce a new data series on Divisia Monetary Aggregates to facilitate analysts, researchers and decision makers.