3 Inflation and Monetary Policy

The government announcement of *zero* quarterly limits on its borrowing from SBP, projections of a relatively small current account deficit and the likelihood of average CPI inflation to remain close to the 12 percent target for FY12 at the beginning of the year, allowed the central bank to adopt an accommodative monetary policy during H1-FY12. Accordingly, the policy rate was reduced by a cumulative 200 bps to 12.0 percent following the two consecutive monetary policy announcements of July and October 2011. However, SBP kept its policy rate unchanged in November 2011, as comfort on the external accounts' position waned at a much faster pace than earlier expected, and the financing of the fiscal deficit became more challenging due to the lack of external funding.

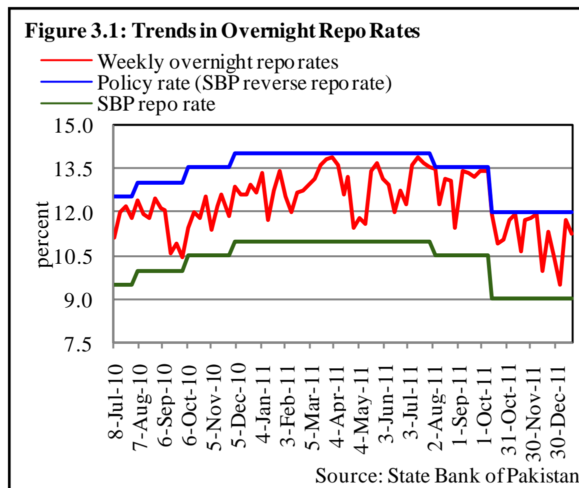


Figure 3.1: Trends in Overnight Repo Rates

Source: State Bank of Pakistan

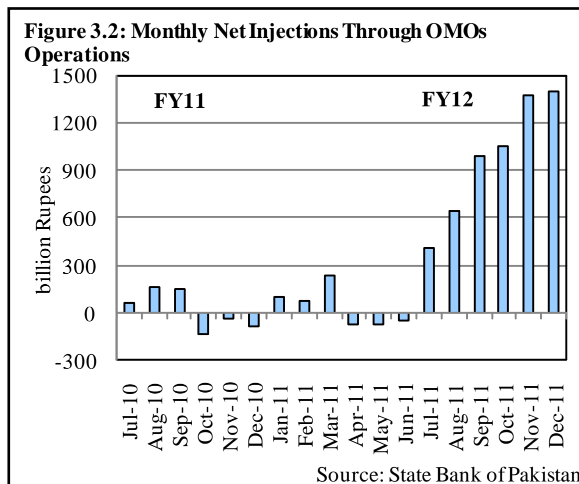


Figure 3.2: Monthly Net Injections Through OMOs Operations

Source: State Bank of Pakistan

Data indicates that inflation has decelerated to single digits (9.7 percent) in December 2011 and period average (H1-FY12) stood at 10.9 percent. In spite of this, underlying inflationary pressures remained strong as more than half of the commodities in CPI basket are still exhibiting double-digit inflation.

Weaknesses in the external account and government borrowing from the banking system complicated market liquidity management, especially during the second quarter of the year. The weighted average overnight money market repo rate remained close to the upper limit of the interest rate corridor, despite substantial liquidity injections through open market operations from September 2011 onwards (**Figure 3.1 & 3.2**).

The impact of these developments is clearly visible from changes in monetary aggregates. Broad money supply saw an expansion of only 5.7 percent during H1-FY12 compared to 9.0 percent during the same period last year. The deceleration in M2 growth is an outcome of the fall in net foreign assets (NFA) of the banking system. In fact, a sizeable portion of the current account deficit during H1-FY12 was financed by drawing down SBP foreign exchange reserves, as capital and financial account inflows declined significantly in Q2-FY12. Resultantly, SBP's NFA contracted by Rs 69.3 billion during the same period. However, overall NFA got some support from commercial banks, which recorded an expansion of Rs 12.1 billion (see **Chapter 5** on **External Sector**).

The drying up of external financing for the fiscal deficit left the government with no choice but to borrow from domestic sources, especially from the banking system. Monetization of the deficit (borrowing from the central bank) reemerged, and reached Rs 219.2 billion in Q2-FY12. In addition to this, the government also relied heavily on commercial banks, which reduced the flow of loan-able funds for the private sector.

3.1 Developments in Monetary Aggregates

Changes in broad money supply and its major components during H1-FY12 were driven primarily by the developments in the external accounts, government borrowing, and a one-off settlement of circular debt. Moreover, quarterly data indicates that the monetary expansion witnessed during H1-FY12 is entirely concentrated in the second quarter of the year due to seasonal credit off-take and a revival in government borrowing from the SBP. In terms of numbers, money supply (M2) saw an expansion of 6.0 percent during Q2-FY12 compared to a fall of 0.3 percent in Q1-FY12. Changes in major components and their causative factors are analyzed in the following discussion.

Net Foreign Assets (NFA)

The NFA of the banking system witnessed a net contraction of Rs 139.9 billion during H1-FY12, in sharp contrast to an expansion of Rs 126.8 billion during the same period last year (**Table 3.1**). This was driven by the developments in external accounts. Specifically, the overall external account recorded a deficit of

US$ 1.8 billion during H1-FY12 compared to surplus of US$ 1.0 billion in H1-FY11.[1]

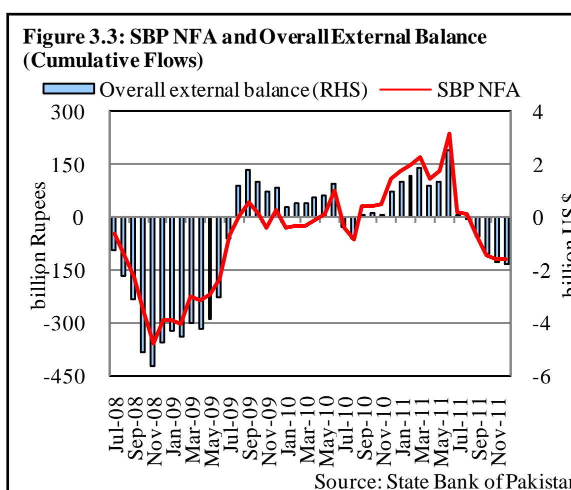
Table 3.1: Monetary Aggregates
flows in billion Rupees

	Flows					
	FY11			FY12		
	Q1	Q2	H1	Q1	Q2	H1
Broad money (M2)	35.5	482.9	518.4	-21.0	400.4	379.4
NFA	41.5	85.2	126.8	-82.7	-57.2	-139.9
SBP	30.5	73.7	104.2	-53.3	-69.3	-122.6
Scheduled banks	11.0	11.6	22.5	-29.4	12.1	-17.3
NDA	-6.0	397.7	391.7	61.7	457.6	519.3
SBP	85.5	45.0	130.5	120.8	116.9	237.6
Scheduled banks	-91.5	352.7	261.2	-59.0	340.7	281.7
of which						
Government borrowing	93.9	167.3	261.2	179.6	512.3	691.9
For budgetary support	120.5	188.0	308.5	184.4	571.7	756.0
SBP	120.5	-28.1	92.4	-101.9	219.2	117.3
Scheduled banks	0.1	216.0	216.1	286.3	352.4	638.7
Commodity operations	-26.0	-23.9	-49.9	-2.8	-60.8	-63.5
Non government sector	-63.3	243.2	179.9	-63.4	-23.9	-87.3
Credit to private sector	-47.7	211.0	163.4	-88.7	282.2	193.5
Credit to PSEs	-15.9	31.6	15.7	25.2	-306.8	-281.5
Other items net	-36.6	-12.8	-49.4	-54.4	-30.8	-85.3

Source: State Bank of Pakistan

Within the banking sector, the major contribution towards the net contraction in NFA came from SBP, which accounted for 87.6 percent of the total contraction, while its share in NFA was 78.7 percent as of end-FY11. This reflects a reduction in SBP's foreign exchange reserves stemming from the widening current account deficit and dwindling capital and financial account surpluses (**Figure 3.3**).

Figure 3.3: SBP NFA and Overall External Balance (Cumulative Flows)

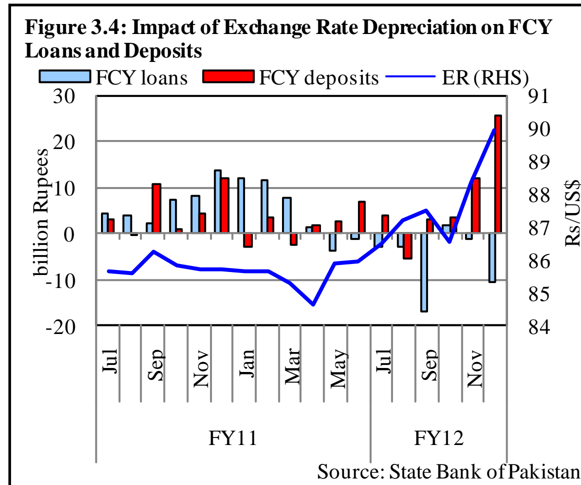


Source: State Bank of Pakistan

[1] For detail discussion on external accounts, see Chapter 5 on External Sector.

Quarterly data shows that changes in NFA of commercial banks followed different patterns during first and second quarters of the year (**Table 3.1**). Specifically, it expanded by Rs 12.1 billion during Q2-FY12 compared to a net contraction of Rs 29.4 billion in the first quarter. This turnaround was largely attributed to depreciation of Pak rupee against major foreign currencies, which led to an increase in FE-25 deposits and a quickening in the retirement of foreign currency loans[2] (**Figure 3.4**). Balances in NOSTRO accounts also expanded sharply by US$ 304.1 million in Q2-FY12 relative to US$ 138.8 million in Q1-FY12.

Figure 3.4: Impact of Exchange Rate Depreciation on FCY Loans and Deposits

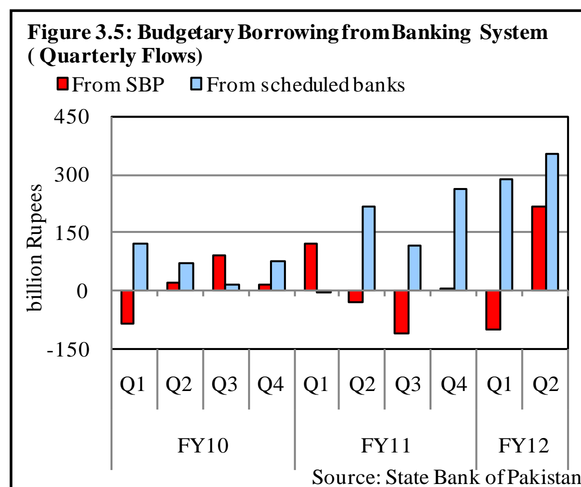


Source: State Bank of Pakistan

Net Domestic Assets (NDA)

The seasonal increase in private sector credit off-take coupled with a sharp rise in government borrowing for budgetary finance led to an acceleration in NDA growth. Specifically, NDA of the banking system experienced a rise of 8.8 percent during H1-FY12 compared to 7.5 percent in same period last year.

Figure 3.5: Budgetary Borrowing from Banking System (Quarterly Flows)



Source: State Bank of Pakistan

Government Borrowing for Budgetary Support

Overall government borrowing for budgetary support more than doubled in H1-FY12 relative to the same period last year (**Table 3.1**). Apart from the shifting of

[2] FE-25 deposits rose by US$327.0 million during Q2-FY12 relative to net withdrawal of US$ 68.0 million in Q1-FY12.

Rs 391.0 billion worth of PSEs' and procurement agencies' loans to the government's account, deficit financing from the banking system alone accounted for Rs 365.0 billion, which was higher than government borrowing of Rs 308.5 billion during first half of FY11. More importantly, the government also resorted to inflationary borrowing from SBP, especially in Q2-FY12. The government breached its quarterly limit of *zero* net budgetary borrowing from the SBP in the second quarter of FY12. This level of borrowing from SBP is the highest in a single quarter during the last 2 years (**Figure 3.5**).[3] This heavy dependence on central bank borrowing was partly attributed to the government's inability to roll-over maturing T-bills in the month of December 2011;[4] a risk regularly highlighted in SBP Annual and Quarterly Reports.

Besides deficit monetization, the government also borrowed Rs 638.7 billion from scheduled banks compared to Rs 216.1 billion last year. However, the monetary impact of this borrowing was limited to Rs 247.7 billion, as the remaining amount was an accounting adjustment due to partial settlement of circular debt. Further details revealed that the government also utilized non-conventional sources of deficit financing, i.e., it borrowed Rs 70.3 billion through Sukuk bonds issued on 20th December 2011. In sum, the burden of financing the deficit during H1-FY12 remained on the banking system, which has strong implications for crowding out

Table 3.2: Banks' Exposure in Different Groups of PSEs (Outstanding Stocks)

billion Rupees

	Jun-10	Dec-10	Jun-11	Dec-11
Transport	31.6	33.2	41.4	46.2
Electricity generation	273.1	291.4	292.1	25.9
Oil & gas	51.5	44.8	41.5	39.5
Engineering sector	19.3	18.9	23.7	23.5
Services sector	0.1	0.1	0.4	0.4
Total exposure in selected sector	375.6	388.4	399.1	135.5

Source: State Bank of Pakistan

the private sector.

Credit to PSEs

Following the government's decision to deleverage the balance sheets of PSEs and procurement agencies, credit to public sector enterprises recorded a net retirement of Rs 281.5 billion during H1-FY12. A disaggregated analysis revealed that credit to PSEs was largely concentrated in electricity generation companies, which

[3] The government borrowed Rs 219.2 billion from SBP during Q2-FY12.

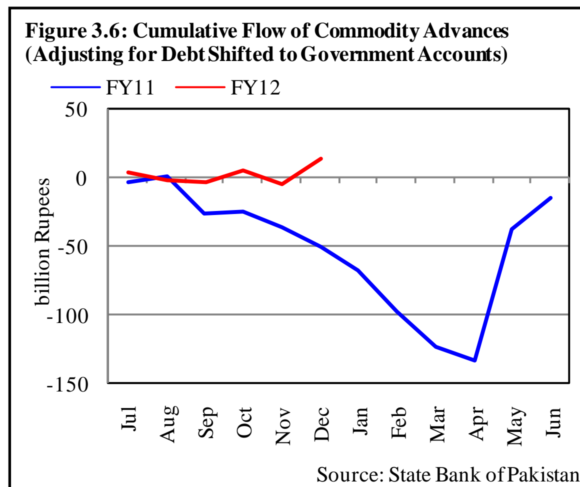
[4] Commercial banks offered Rs 65.7 billion relative to target of Rs 165 billion in last two T-bill auctions of H1-FY12 held on 15th December 2011 and 29th December 2011. This is not surprising as commercial banks tinker with their balance sheet before year end (closing).

accounted for 73.2 percent of PSEs' credit as of end FY11. However, after the settlement of energy related circular debt, banks' exposure to PSEs is more balanced now (**Table 3.2**).

Commodity Finance

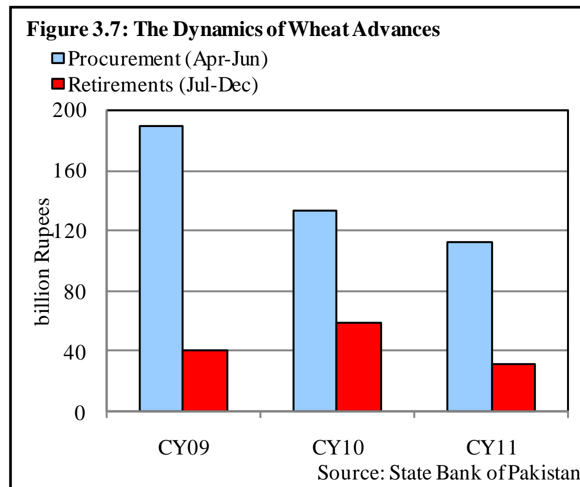
Loans for commodity operations experienced a net retirement of Rs 63.5 billion during H1-FY12 compared to a retirement of Rs 49.9 billion last year. Quartely data indicates that the retirment was primarily concentrated in Q2-FY12 as the government released Rs 78 billion to procurement agencies for the settlement of accumulated subsidies. Adjusting for this one-off payment, the extent of retirement in commodity loans remained low in H1-FY12 (**Figure 3.6**). In fact, TCP borrowing for fertilizer import and lower repayments under wheat advances, were mainly responsible for the slow pace of retirement during the period under review.

Figure 3.6: Cumulative Flow of Commodity Advances (Adjusting for Debt Shifted to Government Accounts)



Source: State Bank of Pakistan

Figure 3.7: The Dynamics of Wheat Advances



Source: State Bank of Pakistan

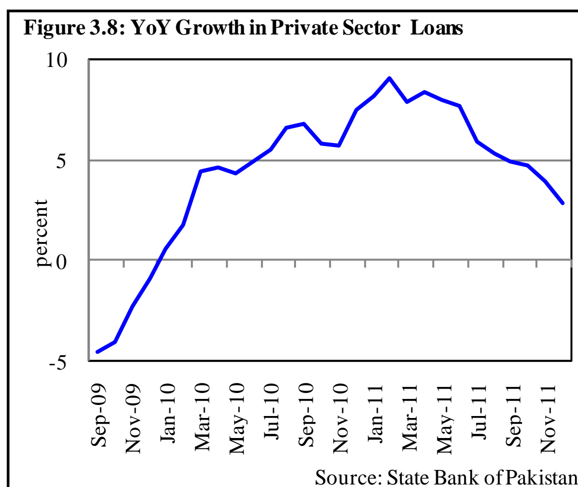
It is pertinent to mention here that speedy retirement of wheat advances in FY11 was largely attributed to the export of surplus wheat. However, export prospects are not very bright this year, which may undermine the repayment capacity of procurement agencies (**Figure 3.7**).

Loans to Private Sector

After reaching a recent peak in February 2011, YoY growth in private sector loans has been continuously declining; it dropped to 2.8 percent in December 2011 from

7.5 percent in December 2010 (**Figure 3.8**). This deceleration is broad-based and visible in all three categories of advances, i.e., working capital, fixed investment and trade financing. Having said this, the composition of advances is shifting from fixed investment loans towards working capital. During the last three years, most of industrial credit demand has been for working capital loans. The hike in raw material prices in global and domestic markets has raised the demand for short-term financing in FY11. In addition, liquidity shortages in POL and energy generation sector have also driven demand for working capital loans.

Figure 3.8: YoY Growth in Private Sector Loans



Source: State Bank of Pakistan

Table 3.3 a: Number of Private Industrial Sub Sectors Availing Bank's Loans (Jul-Dec)

	Loan Expansion			Loan Retirement		
	Working Capital	Fixed Investment	Trade Financing	Working Capital	Fixed Investment	Trade Financing
FY09	33	42	11	24	7	15
FY10	23	19	16	19	15	10
FY11	36	17	22	15	19	5
FY12	35	15	14	18	20	10

*All industries recording the credit flow of Rs 0.5 million or more in Jul–Dec period are included

Table 3.3 b: Expansion and Retirements of Loans taken by Private Sector (Jul-Dec)
billion Rupees

	Loan Expansion			Loan Retirement		
	Working Capital	Fixed Investment	Trade Financing	Working Capital	Fixed Investment	Trade Financing
FY09	126.5	122.0	15.9	-55.0	-7.9	-22.4
FY10	91.5	70.5	25.4	-41.6	-23.4	-10.5
FY11	164.3	39.7	59.0	-42.1	-29.0	-8.2
FY12	147.8	22.2	18.6	-65.5	-35.2	-20.9

*All industries recording the credit flow of Rs 0.5 million or more in Jul–Dec period are included
Source: State Bank of Pakistan

In contrast, industries have reduced their demand for fixed investment loans; only 15 industrial sub-sectors availed fixed investment loans during H1-FY12 compared to 42 in H1-FY09 (**Table 3.3.a & b**). This situation reflects a

significant slowdown of investment activities in the economy. A number of factors explain this slowdown. For instance, structural issues (poor law and order situation and energy shortages) hampered overall industrial activity, resultantly reducing fresh demand for fixed investment loans. Simultaneously, long- term projects in fertilizer, cement and telecom sectors have been completed and these sectors are now retiring loans.

Table 3.4: Loans to Private Sector Businesses

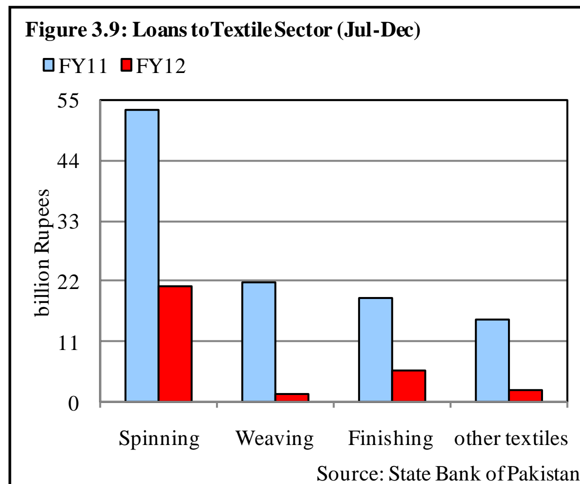
billion Rupees

	Jul-Sep		Oct-Dec		Jul-Dec	
	FY11	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**
Business Sector Advance	-30.4	-95.3	220.6	181.3	190.2	86.1
Working Capital	-32.7	-46.2	164.0	145.7	131.3	99.5
Seasonal Financing	-35.0	-71.0	108.0	70.0	73.0	1.0
Rice	-4.5	-10.7	26.4	22.8	21.9	12.1
Sugar	-27.4	-35.4	11.5	-4.8	-15.9	-40.2
Cotton	-2.7	-24.7	69.6	52.1	67.0	27.3
Fixed Investment	-4.8	-22.4	12.9	14.0	8.1	-8.5
Trade Financing	7.1	-26.8	43.7	21.7	50.8	-5.1
Consumer Financing	-8.8	-4.7	-8.6	-3.2	-17.4	-7.9

Source: State Bank of Pakistan

A recent marked retirement under trade financing, coupled with a deceleration in working capital loans, account for the lower credit off-take in H1-FY12 (**Table 3.4**). Deceleration in working capital loans is attributed to low demand for seasonal financing: fresh disbursements under rice, cotton and sugar sector remained low relative to last year. The slowdown in seasonal working capital loans for the textile sector was attributed to lower raw material prices and reduced global demand. It may be further noted that this slowdown in credit demand was visible in all important segments of textile sector (**Figure 3.9**).

Figure 3.9: Loans to Textile Sector (Jul-Dec)

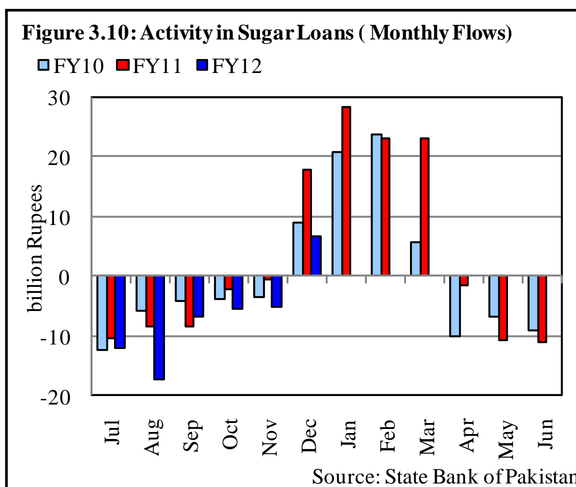


Source: State Bank of Pakistan

Like textile, loans to the sugar sector did not accelerate at the pace shown in the last two years (**Figure 3.10**). In fact, sugar mills could not off-load their inventories before the start of the crushing season, due to the lower domestic price

of sugar. This situation constricted sugar mills' ability to borrow from the banking system. Resultantly, the government intervened in the market and purchased 378,000 tons of sugar through TCP, to alleviate the problems faced by sugar mills. This intervention is expected to not only stabilize the market price but also help sugar mills clear their dues to farmers and to banks.

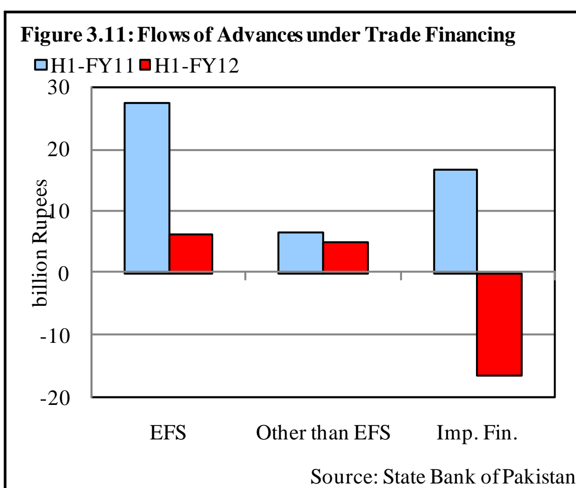
Figure 3.10: Activity in Sugar Loans (Monthly Flows)



Source: State Bank of Pakistan

Demand for working capital loans also came from other sectors including agriculture, refineries, fertilizer, basic metal, electricity equipments, retail trade and power generation. These sectors saw an expansion of Rs 66.0 billion during the first half of the year compared to Rs 26.5 billion in the same period last year. Most of the demand came from the cash- strapped power generation sector, which alone received Rs 35.4 billion in H1-FY12, which is almost twice that of the Rs 17.4 billion availed by the sector in same period last year.

Figure 3.11: Flows of Advances under Trade Financing



Source: State Bank of Pakistan

Meanwhile, the retirement of trade financing came mainly from importers, whereas EFS loans also decelerated sharply during H1-FY12. Within import financing, the retirement was concentrated mainly in foreign currency loans as the depreciation of the local currency during Q2-FY12 increased the cost of borrowing (in foreign currency) for traders. Accordingly, traders retired Rs 28.9 billion of FCY loans during H1-FY12 compared to a net borrowing of Rs 20.8

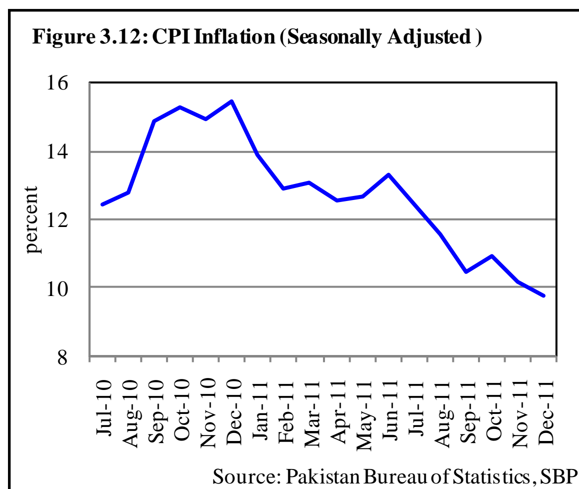
billion in H1-FY11. On the other hand, the deceleration in EFS loans is largely due to the slowdown in textile exports in H1-FY12 (**Figure 3.11**).

Finally, consumer financing showed some signs of improvement during H1-FY12. Loan disbursements under consumer financing reached Rs 75.8 billion in H1-FY12 compared to Rs 64.6 billion last year. Details indicate that auto financing accounted for 45.0 percent of consumer loans disbursed during the period.

3.2 Inflation

Headline inflation fell to single digits in Dec-11 after almost two years (**Figure 3.12**). This was undoubtedly positive news for the economy. However, our analysis indicates that inflation fundamentals have not changed much.

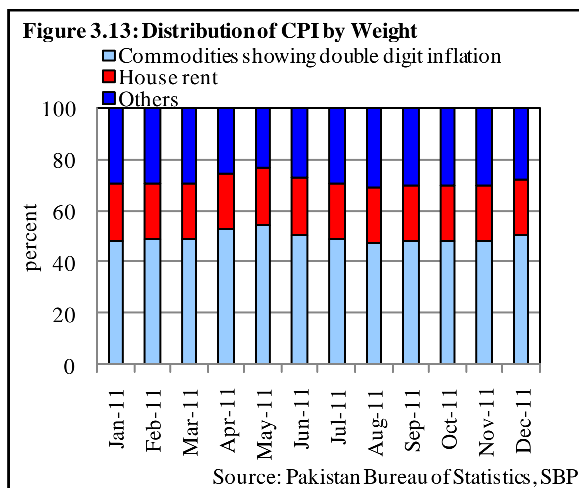
Figure 3.12: CPI Inflation (Seasonally Adjusted)



Source: Pakistan Bureau of Statistics, SBP

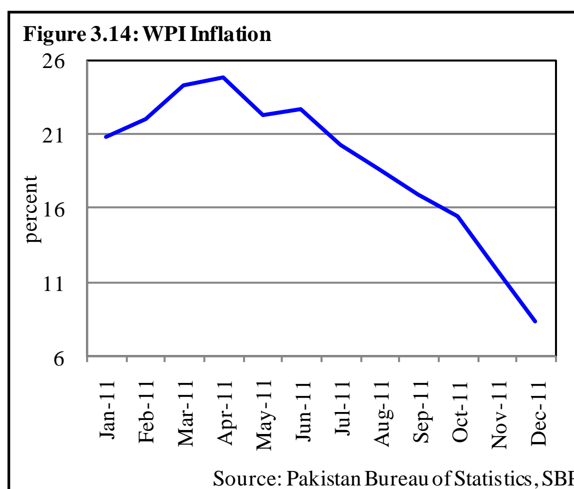
In our previous report, we indicated that more than half of the commodities in the CPI basket are posting double-digit inflation. Significantly, the weight of commodities that are displaying greater-than-10-percent inflation has also hovered around 50 percent for the past year (see **Figure 3.13**). However, inflation in house rents – which constitutes almost 22 percent in the CPI index – has been below 10 percent for the past year. In effect, this implies that the commodities displaying single-digit inflation are a small part of

Figure 3.13: Distribution of CPI by Weight



Source: Pakistan Bureau of Statistics, SBP

the consumption basket, with the exception of house rents. This, in turn, strongly suggests that inflationary pressures are broad-based and have not receded noticeably – despite the decline in headline CPI.



The December decline itself was led by a very sharp decrease in the prices of a few items within the food group. The most notable of these were sugar, onions and potatoes. If these three sub-groups are excluded from the basketYoY inflation comes out to be 11.0 percent, instead of 9.7 percent. The prices of onions and potatoes, like other vegetables, are notoriously volatile, while the price of sugar has declined considerably recently following a good sugarcane harvest. While the price of sugar is expected to stabilize at its current level, the prices of onions and potatoes are tough to predict, and may increase just as sharply as they decreased.

Since only three food items have essentially accounted for the decline in CPI inflation, it is unlikely that the prices of other commodities will experience any substantial slowdown in the near future. However, the price of these three food items – and especially the price of sugar, which is not expected to increase – may continue to help headline inflation in the short run.

In the medium term, given the significant seepage of inflation across commodities, we do not expect a slowdown in overall inflation. The easing of global commodity prices – as reflected by slowdown in WPI inflation – may be offset by the expected effect of the recent depreciation of the Rupee (**Figure 3.14**). POL prices, however, are also expected to increase following this depreciation, the rise in crude oil prices and the standoff between the US and Iran. Gas tariffs were also revised upwards in January 2012 with the imposition of the Gas Infrastructure Development Cess (GIDC). This increase in fuel and energy costs is expected to stoke inflation in the months ahead, both due to their direct impact on price indices and their impact on the overall cost of production.

The deciding factor regarding long-term inflation, however, will be the level of government borrowing from SBP, which is linked to inflationary expectations in the economy. Therefore, the government's inability to retire its stock of borrowing from SBP at the end of this quarter is a matter of concern for SBP.