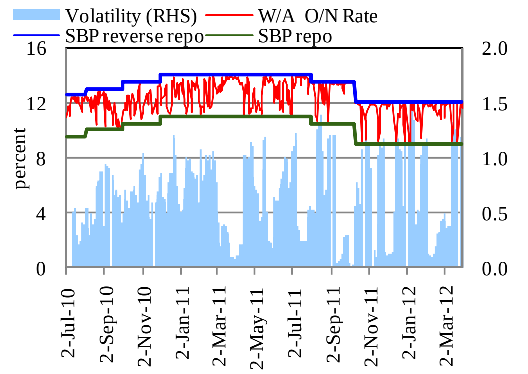
3 Inflation and Monetary Policy

3.1 Overview

The central bank has maintained its policy rate unchanged since the last cut in October 2011, despite pressure on the external account and a surge in government borrowings from the central bank during this period. Early indications that inflation in FY12 will be lower than the target of 12.0 percent provided support to this policy stance. SBP was also hopeful that the government would show some fiscal restraint and the pressures on external account would be manageable, with some flexibility in exchange rate.

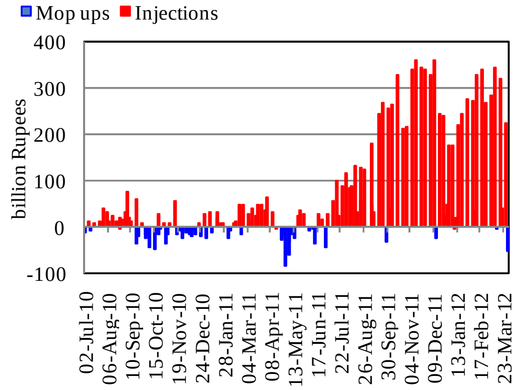
Figure 3.1: Volatility[1] in Overnight Rate



[1] 7 days rolling standard deviation   Source: State Bank of Pakistan

However, monetary management proved quite challenging. While the external deficit led to contraction in domestic liquidity, growing government appetite for funds put an additional squeeze on Rupee liquidity in the market. Despite continuous liquidity injections from SBP through open market operations, the weighted average overnight rate remained volatile during the last two quarters (**Figure 3.1** & **Figure 3.2**).

Figure 3.2: Open Market Operations



Source: State Bank of Pakistan

The fact that SBP liquidity support was needed, despite growth in bank deposits and subdued demand for private sector credit,[56] reflects the sheer volume of government appetite for funds. In net terms, the government borrowed Rs 343.7 billion (adjusted for circular debt settlement) from commercial banks during Jul-Mar FY12 compared to Rs 332.8 billion in the corresponding period of FY11. Not surprisingly, banks had little incentive to finance private sector investments.

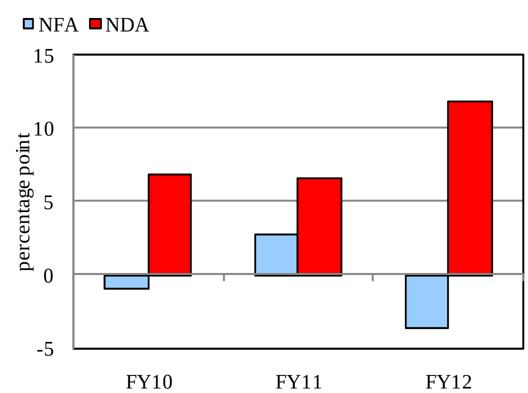
Commercial banks were not the only source of funding; the government also borrowed Rs 199.1 billion from SBP during Jul-Mar FY12. As a result, the government could not adhere to its commitment of zero budgetary borrowing from SBP in the third quarter of FY12, as specified in the amended SBP Act 2012 and repeatedly mentioned in SBP Monetary Policy Announcements.[57]

This acute dependency on bank borrowing was because expected inflows under Coalition Support Fund (CSF), proceeds from the auction of 3G licenses, and arrears from PTCL's privatization, have not materialized so far. In this situation, if SBP had curtailed liquidity support to the market, this would simply have shifted government borrowing from commercial banks to SBP.[58] We need to realize that this state of affairs is a reflection of structural weakness in the fiscal account, which requires a credible strategy to either reduce fiscal deficit or to solicit external financing.

3.2 Monetary Aggregates

The continuing pressure on the external and fiscal accounts also had its bearing for growth in monetary aggregates. Unlike Jul-Mar FY11, when both domestic and foreign assets contributed to growth in money supply, this year M2 growth of 8.1 percent came entirely from domestic sources – foreign assets have

Figure 3.3: Contribution in M2 Growth (Jul-Mar)



Source: State Bank of Pakistan

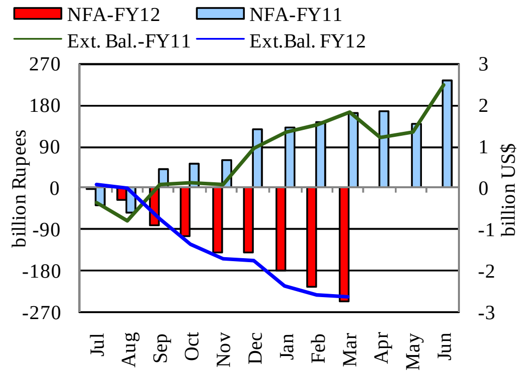
[56] Deposits of the banking sector grew by 7.5 percent during Jul-Mar FY12 compared to 7.2 percent during the same period last year.
[57] For details, see section on **Fiscal Sector**.
[58] It is important to note that temporary liquidity support from SBP for an extended period is like inflationary finance, but by reducing short term liquidity problem, SBP facilitated borrowing from commercial banks. This is clearly visible from increased volume of OMOs in recent months.

continuously drained market liquidity due to the drawing down of foreign exchange reserves (**Figure 3.3**).

Net Foreign Assets (NFA)

Due to rising pressure on the external account, NFA of the banking sector continued to contract during Jul-Mar FY12 (**Figure 3.4**). On a cumulative basis, overall NFA fell by Rs 244.4 billion, against an *expansion* of Rs 162.5 billion during the corresponding period of last year. As shown, the pressure on NFA was higher during Q3-FY12.

Figure 3.4: Overall External Balance and NFA of the Banking System (Cumulative Flows)



Source: State Bank of Pakistan

SBP managed excessive volatility in the exchange rate emanating from developments in the external account.[59] Specifically, SBP provided forex support of US $275 million (in net terms) during Jul-Mar FY12, against net purchases of US$ 2,850 million last year (**Table 3.1**). As a result, SBP's NFA experienced a contraction of Rs 200.1 billion which is in sharp contrast to the expansion of Rs 169.0 billion in the corresponding period of FY11.

Table 3.1: Net Intervention in Forex Market

million US $

	FY11	FY12
Q1	225	600
Q2	1225	-275
Q3	1400	-600
Jul-Mar	2850	-275

Source: State Bank of Pakistan

Net Domestic Assets (NDA)

The NDA of the banking system saw an expansion of 13.4 percent during Jul-Mar FY12, compared to 7.3 percent last year (**Table 3.2**). This acceleration in NDA growth was mainly attributed to budgetary borrowings as well as lower retirement

[59] See Chapter 5 on External Account for more details.

in commodity loans. The major factors affecting NDA of the banking sector are briefly reviewed in the following discussion.

Table 3.2: Changes in Monetary Aggregates
flows in billion Rupees, growth in percent

	FY11			FY12		
	Jul-Dec	**Jan-Mar**	**Jul-Mar**	**Jul-Dec**	**Jan-Mar**	**Jul-Mar**
Broad money (M2)	518.4	24.4	542.8	379.4	166.0	545.4
M2 growth	*9.0*	*0.4*	*9.4*	*5.7*	*2.3*	*8.1*
NFA	126.8	35.7	162.5	-139.9	-104.5	-244.4
NFA growth	*23.2*	*5.3*	*29.8*	*-17.9*	*-16.3*	*-31.3*
SBP	104.2	64.8	169.0	-122.6	-77.4	-200.1
Scheduled banks	22.5	-29.0	-6.5	-17.3	-27.0	-44.3
NDA	391.7	-11.3	380.3	519.3	270.5	789.8
NDA growth	*7.5*	*-0.2*	*7.3*	*8.8*	*4.2*	*13.4*
SBP	130.5	-38.7	91.7	237.6	143.6	381.2
Scheduled banks	261.2	27.4	288.6	281.7	126.9	408.6
of which						
Government borrowing	261.2	-61.0	200.2	691.9	148.7	840.6
For budgetary support	308.5	9.5	318.0	756.0	176.7	932.8
SBP	92.4	-107.2	-14.8	117.3	81.8	199.1
Scheduled banks	216.1	116.7	332.8	638.7	95.0	733.7
Commodity operations	-49.9	-71.7	-121.6	-63.5	-29.4	-92.9
Non government sector	179.9	79.9	259.8	-87.3	144.2	56.8
Credit to private sector	163.4	66.5	229.8	193.5	7.0	200.5
Credit to PSEs	15.7	13.9	29.6	-281.5	137.2	-144.3
Other items net	-49.4	-30.3	-79.7	-85.3	-22.4	-107.7

Source: State Bank of Pakistan

Government borrowing for budgetary support

As mentioned earlier, drying up external flows, in the face of rising fiscal deficit, shifted the burden of financing onto domestic resources. Given the government's limited control over non-bank sources of borrowing, the onus fell squarely on the banking system. As a result, government budgetary borrowing from the banking system reached to record high level of Rs 932.8 billion during the period under review. Within the banking system, although a large part of the borrowing was financed by commercial banks, the government also resorted to inflationary borrowing from SBP (**Table 3.2**).

Realizing the severe consequences of deficit monetization for the overall economy, in March 2012, the legislative councils – both the National Assembly and the Senate – approved limits on government borrowing from the central bank. Specifically, a new section in the SBP Act was introduced, which states that: (1) federal government borrowing from SBP should be brought to zero at the end of each quarter; (2) the outstanding stock of government borrowing as of 30th April 2011 shall be retired within 8 years; and (3) the Finance Minister shall provide a detailed justification to the Parliament if the quarterly limit on federal government borrowing is breached.

These restrictions on government borrowing from SBP are not entirely new. In the past, the government had made commitments with SBP to keep its borrowing within agreed limits, which were often a part of IMF programs (**Figure 3.5a**). This time, the government has made these limits a part of SBP Act itself.

Figure 3.5a: Stock of Net Budgetary Borrowing from SBP

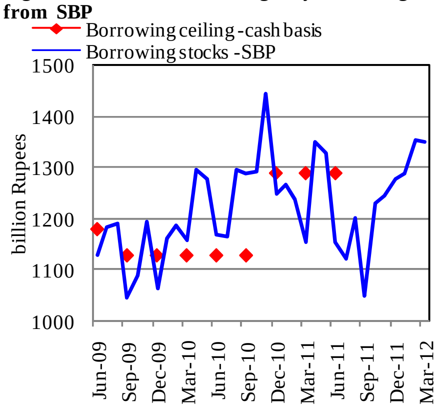
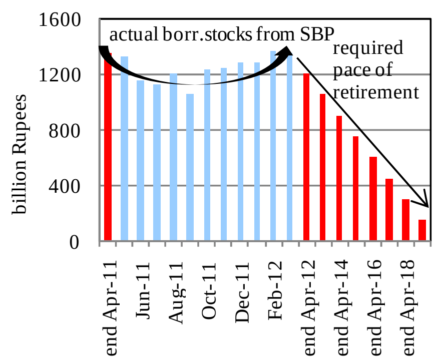


Figure 3.5b : Actual Versus Required Pace of Govt. Borrowing from SBP

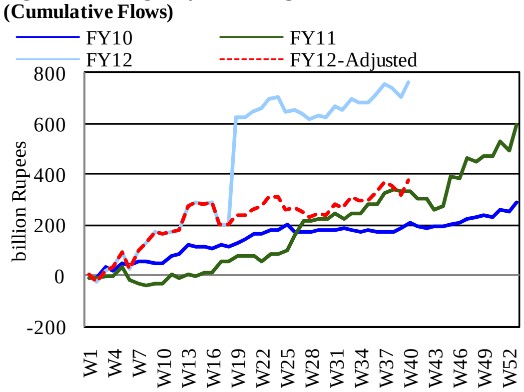


Source: State Bank of Pakistan

Although recent data indicate that the government could not meet its target of zero quarterly borrowing from SBP for the end-March quarter, we expect this situation to improve as the government fulfills its commitment in letter and spirit.

As for retiring outstanding borrowing from SBP, the government has to retire about Rs 150 billion each year to meet its commitment – this also assumes no additional borrowing from SBP during the next eight years (**Figure 3.5b**). It is evident that strict discipline in government spending, and concerted efforts to increase tax revenues would be required to achieve this target.

Figure 3.6: Budgetary Borrowing from Scheduled Banks (Cumulative Flows)



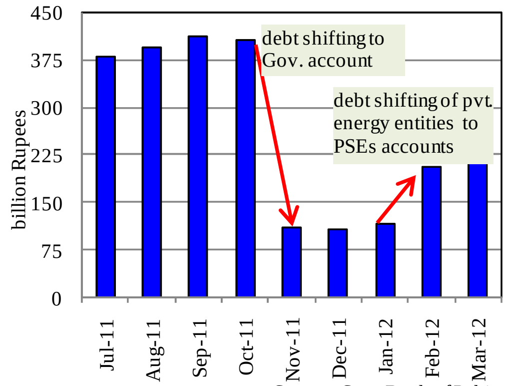
Source: State Bank of Pakistan

Besides SBP, government

borrowing from commercial banks reached Rs 733.7 billion during Jul-Mar FY12, which was more than twice the borrowings of last year. A significant portion of this is attributed to a one-off measure to partially settle the circular debt in Q2-FY12.[60] Adjusting for this one-off settlement, government borrowings from commercial banks turned out to be Rs 343.7 billion; marginally higher when compare with Rs 332.8 billion of last year (**Figure 3.6**).

Credit to public sector enterprises
Partial settlement of the circular debt led to a sharp reduction in outstanding borrowing of PSEs, and created room for more borrowing. Furthermore, the measure also favorably impacted the private sector, as debt liabilities of Rs 93.4 billion were shifted from cash strapped private sector energy entities to PSEs (power holding company) in February 2012. Resultantly, PSEs borrowing reached Rs 137.2 billion in Q3-FY12 (**Figure 3.7**), while the accumulated data for Jul-Mar FY12 still indicate net contraction in PSEs' borrowing by Rs 144.3 billion, compared with an expansion of Rs 29.6 billion during the same period last year.

Figure 3.7: Movement in PSEs Debt Stock



Source: State Bank of Pakistan

Commodity Finance
Commodity loans witnessed net retirement of Rs 92.9 billion during Jul-Mar FY12, compared to a retirement of Rs 121.6 billion last year. The lower repayments under wheat financing, and additional borrowing for the procurement of sugar and fertilizer, reduced the pace of retirement usually seen in the months from July till March of every year.

Moreover, for the upcoming wheat season, the government has not only increased the procurement target, but also revised the support price from Rs 950 to Rs 1,050 per 40 Kg. This would entail an additional borrowing requirerment of Rs 202.1 billion during the on-going prcocurement season (**Table 3.3**). But we expect the

[60] For details, please see Second Quarterly Report for FY12.

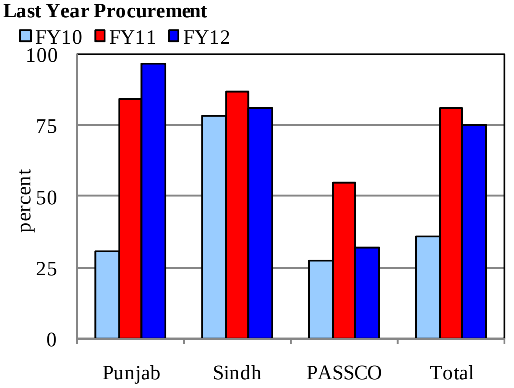
Table 3.3: Participation of Government Agencies in Wheat Procurement Business

Procurement Agencies	Quantitative Targets (million tons)			Financing Requirement* (billion Rs)			Actual Procurement (million tons)		Actual Financing (billion Rs)	
	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY10	FY11
Punjab	4.0	3.5	4.0	95.0	83.1	105.0	3.720	3.2	83.9	68.7
Sindh	1.5	1.3	1.3	35.6	30.9	34.1	1.497	1.4	34.0	31.2
Baluchistan	0.1	0.07	0.1	2.4	1.7	2.6	0.068	0.1	1.0	0.0
KPK	0.3	0.4	0.3	7.1	9.5	7.9	0.300	0.2	7.1	4.5
PASSCO	1.6	1.5	2.0	38.0	35.6	52.5	1.127	1.3	21.7	28.6
Total	**7.5**	**6.8**	**7.7**	**178.1**	**160.8**	**202.1**	**6.7**	**6.2**	**147.8**	**133.0**

*based on support price and available targets
Source: State Bank of Pakistan

actual borrowing requirements to be less as shown by the difference between procurement targets and actuals in FY10 and FY11. [61]

Figure 3.8: Retirement of Wheat Advances as a Percent of Last Year Procurement



Source: State Bank of Pakistan

Agency-level data indiacte that Food Department of Punjab has repaid almost 100 percent of the loans acquired in the last procurement season.[62] On the other hand, Food Ddepartment of Sindh and PASSCO could not retire a sizeable portion of their dues, which may complicate their procurement this season (**Figure 3.8**).

Private Sector Loans

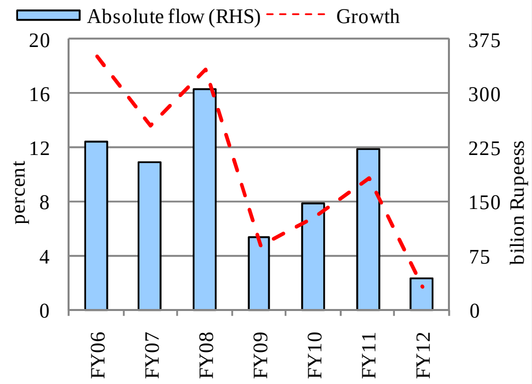
Despite some ease in the weighted average lending rate following the policy rate cut in October 2011, credit expansion to the private sector decelerated to 6.4 percent during Jul-Mar FY12, compared to 7.6 percent last year. Within private sector credit, loans to private businesses increased by only 1.8 percent, which is the lowest growth rate in past 10 years (**Figure 3.9**).

[61] It is pertinent to mention here that the consortium of commercial banks have agreed to provide Rs 175.0 billion for wheat procurement this year.

[62] However, the Food department of Punjab has over 2.0 MT of wheat in stock and Rs 121.0 billion outstanding advances against wheat.

The segment-wise breakup of loans indicate that the deceleration was concentrated in working capital and trade loans, while fixed investment loans staged a recovery in Jul-Mar FY12 (**Table 3.4**).

Figure 3.9: Loans to Business Sector



Source: State Bank of Pakistan

Loans to manufacturing units remained depressed: Loans to the manufacturing sector decelerated sharply in Jul-Mar FY12 over the corresponding period last year. The slowdown was broad-based, as all major industries including textile, sugar, rice, cement, machinery & equipment, were impacted (**Table 3.5**). In the textile sector, substantial retirements of past loans, lower cotton prices, and subdued export performance, contributed to the slowdown in loan demand this year. In the cement sector, a sharp rise in retail prices augmented revenues of the cement sector, which reduced demand for working capital loans.

Table 3.4: Flows in Business Sector Loans
in billion Rs

	Q1		Q2		Q3		Jul-Mar	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Business Sector Loans	-30.4	-95.3	220.6	181.3	31.9	-43.2	222.1	42.9
Working capital	-32.7	-46.2	164.0	145.7	24.9	-62.3	156.2	37.2
Seasonal financing	-34.6	-70.8	107.6	70.1	52.4	22.8	125.4	22.0
Rice	-4.5	-10.7	26.4	22.8	-2.0	-6.4	19.9	5.7
Sugar	-27.4	-35.4	11.5	-4.8	68.9	45.0	53.0	4.8
Cotton	-2.7	-24.7	69.6	52.1	-14.5	-15.8	52.5	11.5
Fixed investment	-4.8	-22.4	12.9	14.0	-7.5	20.6	0.6	12.2
Trade financing	7.1	-26.8	43.7	21.7	14.1	-1.4	64.9	-6.4

Source: State Bank of Pakistan

Government intervention alters working capital needs: During Jul-Mar FY12, the government actively intervened in the fertilizer and sugar sectors, which have affected the credit flows to these sectors. In case of sugar, the seasonal flows of working capital during Dec-Mar FY12 was Rs 51.6 billion, against Rs 83.5 billion during the same period last year. Since sugar mills were not willing to offload their stocks in the market due to a drop in domestic sugar prices, this constrained their ability to borrow this year.

Table 3.5: Source of Deceleration in Manufacturing Loans (Jul-Mar)
in billion Rs

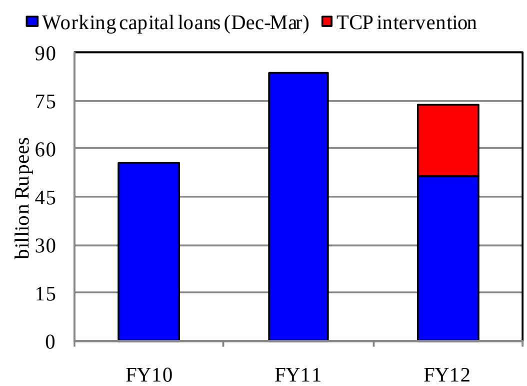
	FY08	FY09	FY10	FY11	FY12
Overall Manufacturing	193.1	88.4	95.0	205.3	65.0
Food products & beverages	23.4	33.5	44.3	82.4	22.8
Rice processing	19.8	13.7	16.5	17.7	7.5
Sugar	4.0	17.2	29.7	62.0	8.8
Textiles	94.2	1.4	32.9	105.5	16.4
Spinning, weaving & finishing of textiles	71.8	2.0	31.1	93.9	16.4
Spinning	41.8	9.1	19.6	52.5	15.8
Weaving	13.6	-5.7	6.7	25.9	-0.3
Finishing	16.5	-1.4	4.7	15.5	0.9
Coke & refined petroleum products	15.6	5.5	2.2	2.0	8.8
Chemicals & chemical products	17.3	26.0	14.3	-2.1	9.7
Fertilizers	7.1	22.2	9.8	-0.9	8.8
Non-metallic mineral products	3.8	10.2	-0.2	4.3	-8.0
Cement	2.3	8.1	-0.3	4.7	-11.0
Basic metals	3.8	-3.3	-2.0	1.0	7.9
Machinery & equipment	3.2	-0.7	1.8	4.0	0.8

Source: State Bank of Pakistan

Furthermore, the sugar crushing season was also delayed. To rectify this situation, the government intervened in the market by purchasing 4.75 million tons of sugar through TCP. This not only stabilized the market price, but also improved the cash flows of the industry (**Figure 3.10**).

In the case of fertilizer, the government's decision to import urea increased the working capital requirements of the industry. The availability of 1.45 million tons of imported urea at a subsidized rate increased supply of urea in the country and fertilizer companies were unable to off-load their domestic products in the market. This in turn created demand for short term loans from fertilizer manufacturers.

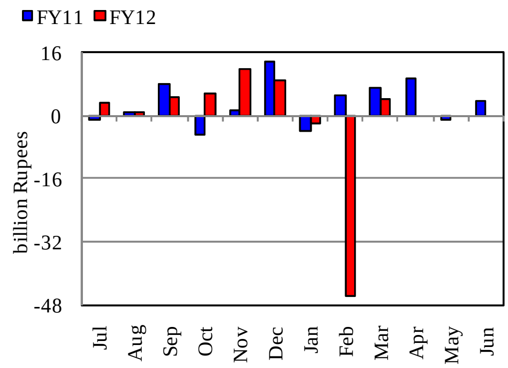
Figure 3.10: Flow of Funds to Sugar Sector



Source: State Bank of Pakistan

Adjustments in loans of private energy entities explain a part of slowdown in working capital requirements: Loans to the energy sector saw a net retirement of Rs 7.8 billion in Jul-Mar FY12, against an expansion of Rs 25.6 billion last year. This retirement is concentrated in the month of February 2012. This is attributable to one-off adjustment of IPPs' receivable mentioned earlier (**Figure 3.11**).

Figure 3.11: Monthly Flows in Working Capital Loans to Energy Sector

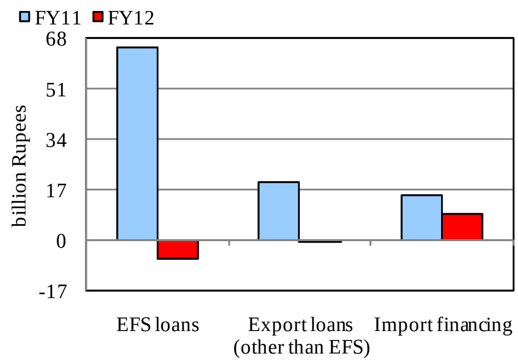


Source: State Bank of Pakistan

Broad based retirements in trade financing loans

The demand for trade financing loans, especially export financing remained subdued during Jul-Mar FY12. Besides slowdown in exports, the rupee depreciation against major currencies made the foreign currency denominated loans costlier, which led to retirement of Rs 33.6 billion of import loans during the same period (**Figure 3.12**).

FIgure 3.12: Flows in Different Divisions of Trade Loans (Jul-Mar)

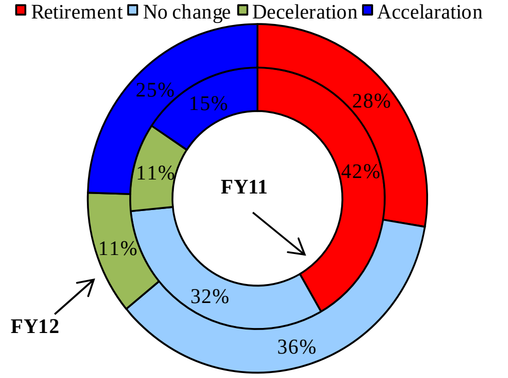


Source: State Bank of Pakistan

Fixed investment loans appear to have bottomed out

Despite an overall deceleration in loans to private businesses, some recovery in fixed investment loans was seen during Jul-Mar FY12. The frequency distribution clearly indicates that the upturn in fixed investment loans is broad-based; not only did the number of sectors experienced retirement fall but more sectors are now also availing long term loans (**Figure 3.13**).[63]

Figure 3.13: Frequency Distribution of Industries Availing Fixed Investment Loans



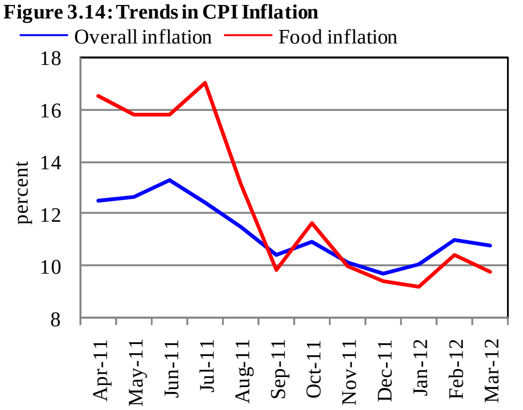
Source: State Bank of Pakistan

3.3 Inflation

Headline inflation remained above 10 percent for Q3-FY12, after briefly receding to below double-digits in December 2011 (**Figure 3.14**). This rebound was largely expected since the fundamentals behind the persistence of inflation have not changed. Energy costs rose with the increase in international oil prices and the revision in gas tariffs; government borrowing from the central bank accelerated during the quarter; and energy shortages in the winter impacted aggregate supply.

As we have highlighted in our earlier reports, the trend in core inflation, as measured by *non-food non-energy* (NFNE) inflation, remained a source of concern. Secondly, the diffusion of inflation across different commodity groups has increased to its highest level since the formulation of the new index (**Figure 3.15**). We believe this reflects the degree to which inflation expectations have become ingrained in the economy.

Figure 3.14: Trends in CPI Inflation



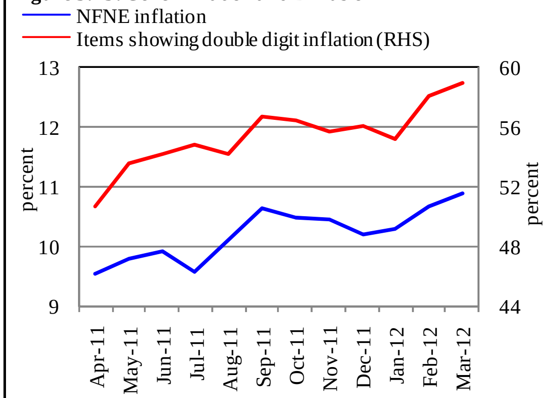
Source: Pakistan Bureau of Statistics

The trend in core inflation is also worrying because of the likely implications if Pakistan experiences another flood later this year. Overall inflation is likely to be

[63] The sectors that showed the renewal demand for fixed investment loans included road transport, iron & steel industries, electric equipments and edible oil & ghee and many others.

higher this time around if NFNE inflation persists around its current level, and food inflation spikes due to yet another disruption in supplies. NFNE inflation was lower than its current level during the last two floods.[64] Secondly, such a supply shock will only add to the persistence in overall inflation, by further reinforcing households' inflationary expectations.

Figure 3.15: Core Inflation and Diffusion



Source: Pakistan Bureau of Statistics

Finally, the increase in government borrowing from the central bank (i.e., the printing of currency notes) may further stoke inflationary expectations. International oil prices and the rupee exchange rate are other factors that will determine the trend in inflation going forward.

[64] NFNE inflation was 8.39 percent in Aug 2010 and 9.57 percent in Jul 2011.