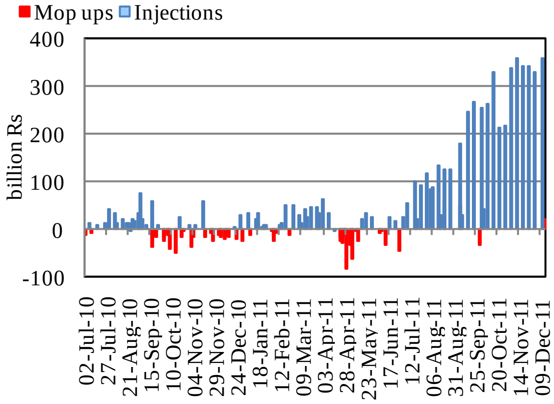
3 Inflation and Monetary Policy

3.1 Monetary Policy

SBP's decision to ease its monetary policy stance in Jul and Oct 2011 was influenced by a combination of gradual decline in headline inflation, comfort in the current account balance, and the government's efforts to contain its inflationary borrowing. SBP's policy rate was reduced by a cumulative 200 bps to 12.0 percent. While this monetary easing was expected to help stimulate economic activities in the economy, risks emerging from external sector were acknowledged; resultantly policy rate was kept on hold in Nov 2011.

A reflection of external sector deterioration is clearly visible from US$ 1.9 billion reduction in SBP's liquid foreign exchange reserves from Jul to Nov 2011. Accordingly, net foreign assets (NFA) of the banking system saw a contraction of Rs 140.5 billion over the same period, against an expansion of Rs 60.8 billion in the previous year **(Table 3.1)**. This, along with heavy reliance of the government on domestic sources for its budgetary finance, has complicated liquidity management. Since the depletion of FX reserves drains domestic liquidity, SBP was forced to inject liquidity through its open market operations, which had reached over Rs 300 billion in recent weeks **(Figure 3.1)**.

Figure 3.1: Open Market Operations of SBP



Source: State Bank of Pakistan

Stepping back, the massive rise of Rs 736.8 billion in net budgetary borrowing over the period of analysis, merits explanation **(Table 3.1)**. Details indicate that 53.1 percent (Rs 391 billion) of the increase in net budgetary borrowing is attributed to the issuance of government securities to settle the circular debt originating in the energy sector and commodity operations. Adjusting for this one-off shift in PSEs' borrowing to the government account, reveals that net budgetary borrowing for this year stood at Rs 345.8 billion, which was slightly higher than the previous year.

Table 3.1:Monetary Aggregates (Jul-Nov)
flows in billion Rupees, growth in percent

	Flows		Growth rates	
	FY11	**FY12**	**FY11**	**FY12**
Broad money (M2)	305.9	154.4	5.3	2.3
NFA	60.8	-140.5	11.2	-18.0
SBP	31.9	-122.5	8.4	-19.9
Scheduled banks	28.9	-18.1	17.4	-10.9
NDA	245.1	295.0	4.7	5.0
SBP	221.6	267.9	22.4	25.8
Scheduled banks	23.5	27.0	0.6	0.6
of which				
Government borrowing	302.4	652.3	12.4	21.6
For budgetary support	336.1	736.8	16.7	28.3
SBP	274.7	71.8	22.7	6.0
Scheduled banks	61.3	665.0	7.6	47.5
Commodity operations	-35.2	-82.6	-8.5	-20.8
Non government sector	42.2	-198.3	1.2	-5.6
Credit to private sector	68.8	78.1	2.3	2.5
Credit to PSEs	-27.3	-276.7	-7.8	-71.4
Other items net	-99.6	-159.1	16.7	24.4

Source: State Bank of Pakistan

Within the banking system, the government relied heavily on borrowing from commercial banks. While this is a welcome development from the inflationary perspective, it may crowd out the private sector. Monthly data up to Nov 2011 indicates that overall credit to private sector witnessed an expansion of 2.5 percent during Jul-Nov FY12 compared to 2.3 percent over the same period previous year. This expansion is primarily driven by increase in banks' investments as loans to private sector businesses saw a contraction of Rs 9.1 billion (during Jul- Nov FY12), in contrast to an expansion of Rs 73.6 billion during the same period last year.[27] Having said this, it is important to note that demand for private sector credit is understandably low due to number of factors including: (a) massive decline in cotton prices compared to previous year; (b) delayed crushing season by sugar mills; and (c) little demand for fixed investment loans as there is excess capacity in the industrial sector.[28] However, provisional weekly data shows that credit to private sector is picking up in recent weeks.

Besides lending to the government, the volume of loanable funds with the banking system is also constrained by slow growth in bank deposits. This is evident from the change in monetary aggregates, as growth in broad money was only 2.3 percent during Jul-Nov FY12, decelerated from 5.3 percent during the same period last year. These developments helped contain inflationary pressures. Year-on year inflation has declined to 9.7 percent in Dec 2011 compared to 13.3 percent in Jun 2011.

[27] One of the largest bank invested Rs 25 billion in non-bank financial institutions.
[28] Moreover, banks are hesitant to lend to the private sector (especially SMEs sector) due to heightened credit risk. This further reduces the supply of credit to the private sector.

Therefore, the end-year average inflation is likely to fall close to 12.0 percent as projected earlier.

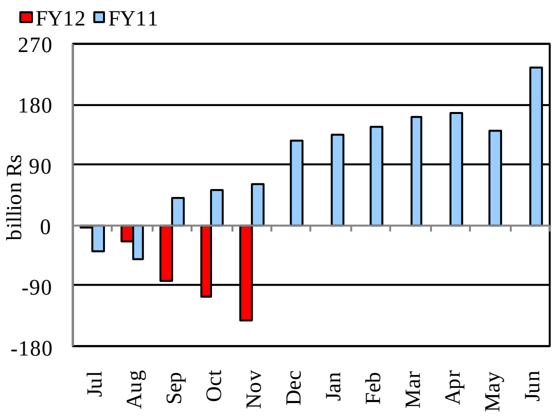
3.2 Developments in Monetary Aggregates

Changes in monetary aggregates during Jul-Nov FY12 are primarily driven by the deteriorating external accounts. Specifically, Net Foreign Assets (NFA) witnessed a contraction of 18.0 percent so far this year, against an expansion of 11.2 percent in the previous year **(Table 3.1)**. This sharp reversal led to deceleration in broad money (M2) growth as the expansion in net demotic assets (NDA) remained almost the same as in the last year.

Net Foreign Assets (NFA)

Composition of NFA reveals that the depletion in foreign assets primarily came from the central bank **(Figure 3.2).** In the absence of external inflows from the IFIs and official grants, SBP had to finance a portion of the current account deficit from its reserves.

Figure 3.2: Cumulative Flows of Overall NFA



Source: State Bank of Pakistan

NFA of scheduled banks also remained under pressure during Jul-Nov FY12. Specifically, in contrast to the expansion of Rs 28.9 billion in the previous year, it saw a contraction of Rs 18.1 billion so far this year. This is largely because of the widening trade deficit coupled with declining private inflows.

Net Domestic Assets (NDA)

NDA of the banking system grew by 5.0 percent during Jul- Nov FY12 compared with 4.7 percent in the corresponding period last year. Two developments in NDA growth remained prominent: (1) shifting of PSEs circular debt to the government account; and (2) continued government reliance on commercial banks for its budgetary financing.

Government Borrowing for Budgetary Support

Realizing the inflationary implications of central bank financing, the government contained its borrowing from SBP. Specifically, the government borrowed only

Rs 71.8 billion from SBP during Jul-Nov FY12, against Rs 274.7 billion in FY11 **(Figure 3.3a)**.

Figure 3.3a: Budgetary Borrowing from the Banking System (Cumulative flows)

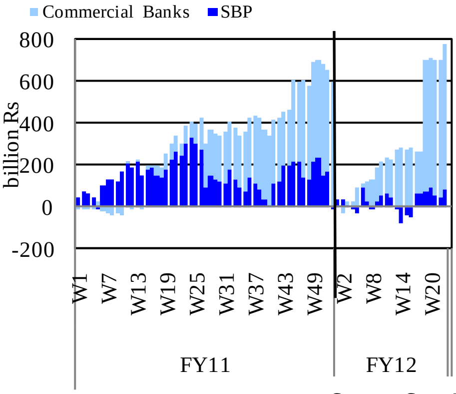
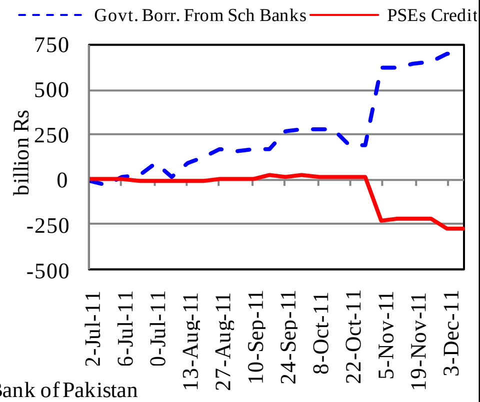


Figure 3.3b: Credit Adjustments in Different Accounts (Cumulative flows)



Source: State Bank of Pakistan

Meanwhile, most of the budgetary needs were met from the commercial banks. The most important development came in the week ended on 4th Nov 2011, when the government borrowed Rs 431.6 billion in one week. As stated earlier, this huge borrowing was made to clean the balance sheet of cash strapped PSEs and public procurement agencies (like TCP, PASSCO); resultantly PSEs retired Rs 251.2 billion and procurement agencies retired Rs 78.7 billion to commercial banks **(Figure 3.3b)**.[29] In other words, this adjustment has little immediate monetary impact. However, now the PSEs have more room to borrow from the commercial banks, which may pick up in coming months.

Table 3.2: Commodity Dues Accrued by the Government (Outstanding Stocks)
billion Rupees

	TCP		PASSCO
	Fertilizer	Sugar	Paddy
As on 31st Oct 2011	52.4	32.5	10.5
As on 25th Nov 2011	7.3	15.0	0.0
Settled amount	-45.1	-17.5	-10.5

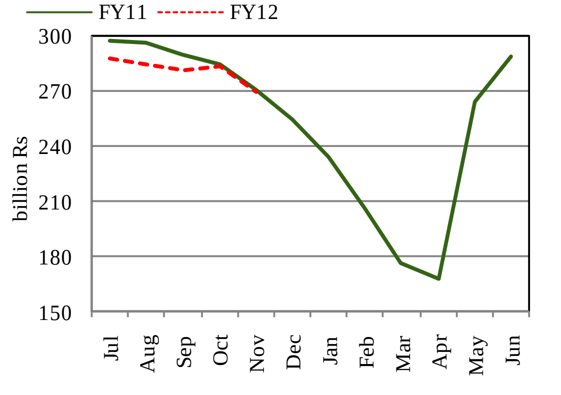
Source: State Bank of Pakistan

Beside these accounting treatments, commercial banks were able to finance the budgetary requirements of Rs 274.0 billion during Jul-Nov FY12. From the non-bank domestic source (NSS), the government borrowed Rs 77.1 billion till Nov 2011 compared to Rs 66.5

[29] The government transferred the debt of state owned energy entities mainly included Power holding company, WAPDA and NTDC.

billion during the same period last year; whereas it faced constraints in securing any significant funding from external sources.

Figure 3.4: Outstanding Stock of Wheat Advances (Excluding TCP- stocks)



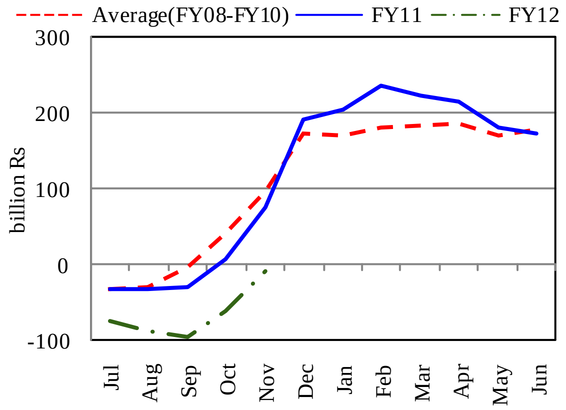
Source: State Bank of Pakistan

Prior to debt settlement, public sector enterprises borrowed Rs 19.4 billion during Jul-Oct FY12, in contrast to a retirement of Rs 26.0 billion in the corresponding period last year. Most of this increase came for working capital loans availed by cash strapped public sector oil and electricity distribution companies.

Commodity Finance

Commodity financing experienced net retirment of Rs 82.6 billion during Jul-Nov FY12, compared to Rs 35.2 billion over the same period last year. The strong retirement in FY12 was largely driven by the release of price differential subsidies to the procurement agencies by the government. Within procurmentment agencies, Trading Corporation of Pakistan (TCP) alone retired Rs 62.6 billion to commercial banks as its receivable on account of subsidies were settled by the government. TCP now owes Rs 45.6 billion to commercial banks compared to its outstanding loans of Rs 97.1 billion as on 30th Jun 2011. The government also settled subsidy of Rs 10.5 billion to PASSCO, accrued earlier for the procurement of the paddy **(Table 3.2)**. Retiring commodity loans facilitates the procurement agencies by creating the financing room for the import of fertilizer and procurement for upcomg wheat season.

Figure 3.5: Private Sector Advances (Cumulative Flows)



Source: State Bank of Pakistan

This shift will also help reduce the financial cost of borrowing, as the government switched over to low cost budgetary financing from more expensive commodity loans.

Table 3.3: The Dynamics of Wheat Advances

billion Rupees

	Stocks (end of Nov)		**Advances Flows (Jul-Nov)**		**Subsidy (Receivable)**		**Amount of Sale Proceed**	
	FY11	FY12	FY11	FY12	Nov-10	Nov-11	Nov-10	Nov-11
PASSCO	53.8	73.4	-4.8	-1.7	1.6	0.0	8.9	12.0
Punjab	179.0	155.0	-12.1	-11.6	39.2	35.5	0.0	0.0
Sindh	34.1	34.3	-7.1	-8.7	0.0	9.6	1.5	2.3
Khyber Pakhtunkhwa	3.8	6.3	-2.8	1.8	0.0	0.0	0.4	0.5
Baluchistan	0.2	0.0	-0.8	0.0	0.0	0.0	0.0	0.3
TCP	12.6	13.6	-14.1	0.9	2.7	0.0	8.7	13.6
Total	283.4	282.7	-41.7	-19.4	43.5	45.1	19.4	28.7

Source: State Bank of Pakistan

A disaggregated analysis however suggests that before this payment of subsidy dues, procurement agencies availed advances of Rs 6.8 billion during Jul-28th Oct 2011, in contrast to the retirement of Rs 24.1 billion in FY11. This was mainly on account of lower repayments under wheat advances, as well as fresh borrowing for the import of fertilizer.

Under wheat advances, the deceleration in retirement is concentrated in TCP on account of borrowing for the import of wheat during FY08-FY09 **(Figure 3.4)**. The retirement pace of other major procurement agencies, such as the food Departments of Punjab and Sindh, is largely on track and they are expected to repay the major portion of their loans before the upcoming wheat procurement season of FY12 **(Table 3.3)**. It is pertinent to note that the government has already raised the support price of wheat by Rs 100/40 Kg, i.e. from Rs 950 to Rs 1050. This elevated support price would result in higher financing requirement if the government decides to procure the same quantity of wheat as targeted in the last year.

Private Sector Loans

Unlike the previous year, growth in loans to private sector businesses remained subdued during Jul-Nov FY12. Specifically, it experienced a net retirement of Rs 9.1 billion in Jul-Nov FY12 compared to an expansion of Rs 73.6 billion in Jul-Nov FY11 **(Figure 3.5)**.

Table 3.4: Advances to Private Sector Businesses during Jul-Nov
billion Rupees

	Trade Finance		Working Capital		Fixed Investment		Total Advances	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Private sector advances	33.2	-15.1	45	27.7	-4.7	-21.9	73.6	-9.1
Manufacturing	30.6	1.2	20	-9.2	-1.4	-7.3	49.2	-15.3
Rice processing	0.3	2.5	8.2	3.5	-1.6	0.1	7.0	6.0
Sugar	-1.3	1.0	-30.5	-46.8	1.3	-1.4	-30.5	-47.2
Textiles	15.6	-10.2	47.5	21.5	3.9	-2.3	66.9	8.9
Spinning	5.1	-2.7	36.7	14.6	-1.3	-4.1	40.5	7.8
Weaving	4.9	-1.2	7.0	-2.6	4.6	2.3	16.6	-1.6
Coke & petroleum products	-0.1	1.1	2.9	3.2	-3.6	-2.7	-0.9	1.6
Fertilizers	0.6	-0.5	-9.9	-5.1	3.5	-1.1	-5.8	-6.6
Cement	6.6	3.9	-1.7	-1.7	-1.7	-1.5	3.2	0.7
Other manufacturing	8.9	3.5	3.6	16.2	-3.1	1.6	9.3	21.3
Production of electricity	-0.8	-2.9	2.9	27.1	4.3	0.7	6.4	24.9
Construction	-0.2	0.2	2.4	-1.4	0.8	-1.1	3.0	-2.3
Commerce and trade	2.9	-4.8	13.2	-2.1	-4.8	-1.2	11.6	-8.1
Exports of finished products	-0.1	-1.0	0.0	-2.6	0.9	0.4	0.9	-3.2
Telecommunications	-0.1	-0.1	-1.9	0.9	0.6	-11.1	-1.4	-10.3
Other sectors	0.8	-8.7	8.4	12.4	-4.2	-1.9	4.8	2.1

Source: State Bank of Pakistan

The contraction in credit was broad based and visible in all three types of loans i.e., working capital, trade financing and fixed investments. Sectoral distribution also reveals that most of the retirement came from sugar, telecom and fertilizer **(Table 3.4)**.

Retirement of Seasonal Financing

It is important to note that Jul-Sep is the retirement season of the credit cycle; credit generally starts picking up from Nov onwards. Sectoral distribution of data shows that sugar, rice and textile sectors availed record working capital credit in the procurement season of FY11. Hence, repayments are more pronounced this year. For example, the textile sector retired Rs 94.6 billion during Mar-Sep 2011, whereas it availed credit of Rs 97.1 billion during Aug-10 to Feb-11.

The sugar sector also retired Rs 68.7 billion of loans during Apr-Nov 2011. However, it still owes commercial banks Rs 14.7 billion from the last crushing season. The lower repayments relative to credit-off take, may hamper fresh loaning in the crushing season of FY12, which has already commenced in the specific regions of Punjab, Sindh and Khyber Pakhtunkhwa (KP). Anecdotal evidence suggests sugar mills were unable to offload their stocks due to depressed sugar price. This affected the repayment capacity of the sugar sector.

Fall in Cotton Prices Reduced Demand for Textile Credit in FY12

Following the massive decline in cotton price in international markets, domestic cotton price in FY12 are hovering around Rs 5500/40 Kg compared to Rs 8700 in the same period last year. This has substantially reduced the credit requirements of the textile sector. This sector is also reluctant to borrow due to the slowdown in global economic activities (i.e. EU and US) and intensifying electricity and gas shortages. Accordingly, the textile sector has availed only Rs 8.9 billion from the banking sector in FY12, against net borrowing of Rs 66.9 billion in FY11.

Demand for Credit in the Energy Sector

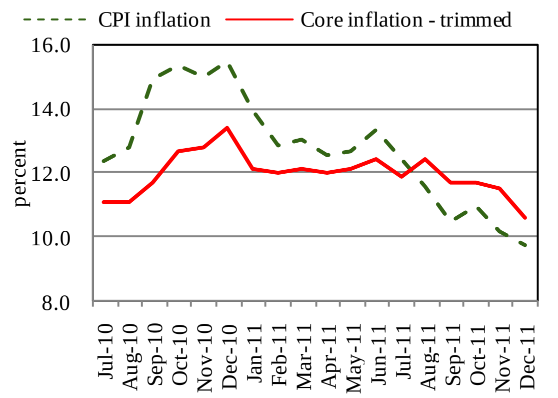
Despite broad based retirement, the power sector borrowed Rs 24.9 billion from the banking sector during Jul-Nov FY12. Hemorrhaging continues to create interagency receivables in the energy sector, which remained a primary reason for the additional borrowing requirements.

Retirement of Consumer Loans Eased

During Jul-Nov FY12, retirement in consumer loans was lower than the previous year. All categories of consumer loans, other than housing and personal loans, witnessed a slowdown in retirements - notably in auto loans.

Loan disbursements indicate that fresh consumer loans comprise of auto and personal loans. In fact, demand for auto loans revived following the change in government policy for the auto sector. Auto sales of both locally manufactured cars and motorcycles, as well as imported one, has witnessed healthy growth in FY12.

Figure 3.6: YoY CPI and Core Inflation

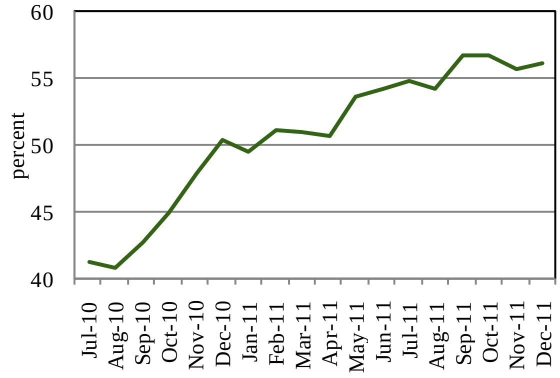


Source: Pakistan Bureau of Statistics

3.3 Inflation

Headline inflation number has been edging down consistently and core inflation, encouragingly, is following suit **(Figure 3.6)**. Food inflation has receded considerably recently and been the major contributor towards the slowdown in inflation. However, commodities displaying double digit inflation have been above 50 percent since Feb 2011– an indication of the broad-based nature of inflation in the country (**Figure 3.7**).

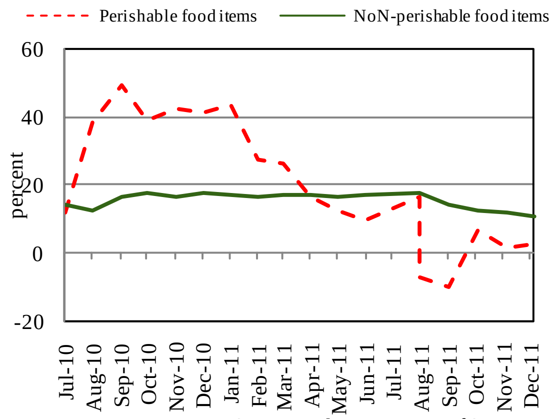
Figure 3.7: Percentage of Items Showing Double Digit Inflation



Source: SBP calculations

Core inflation is likely to recede gradually if there are no supply shocks that reinforce inflationary expectations. The key risk here is the recent deterioration of the external account and the resulting pressures on Rupee, which will increase input costs across the board.[30] Although the prices of most agricultural commodities are expected to decline in the international market, we expect the prices of crude oil and POL products to remain largely stable.

Figure 3.8: A Break up of Food Inflation (YoY)



Source: Pakistan Bureau of Statistics

Therefore, while we expect declining global prices to contribute to slower inflation, the external account position and firm POL prices may put upward pressure on prices. In such a scenario, higher energy prices, which, combined with shortages of natural gas, will lead to a steady rise in overall costs. Consequently, we believe that supply-side pressures on retail prices are unlikely to recede in the short-run.

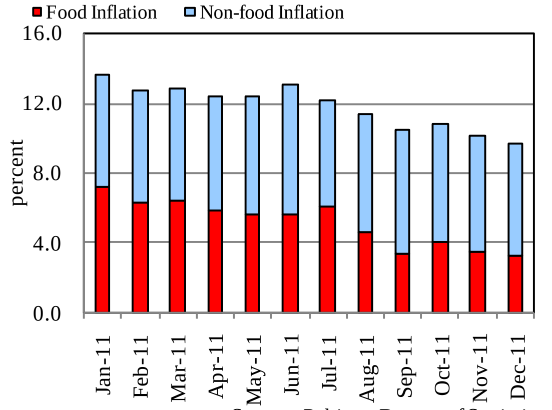
Domestic food prices, however, are expected to remain stable with: (i) a bumper crop of wheat in the offing that will suppress grain prices – despite the increase in the support price – (ii) a surplus of sugar in the market and; (iii) suppressed

[30] Inputs to industry account for roughly 70.0 percent of the country's imports.

international agriculture prices that will reduce exports and smuggling, thus shoring up domestic supply.

Within the food group, prices of perishable food items fell considerably as supply lines were restored following the floods in Sindh **(Figure 3.8)**.[31] The impact of food prices on overall inflation has been falling consistently since Jan 2011 as well **(Figure 3.9)**. Going forward, we expect food prices to remain stable on a monthly basis.

Figure 3.9: Contribution to Overall CPI Inflation



Source: Pakistan Bureau of Statistics

The prices of non-perishable and manufactured food items have been on a steady rise since Jul 2010 due to increases in the cost of production throughout the economy.[32] However, keeping in line with the decrease in the prices of perishable food commodities – which act as inputs for manufactured food items – the pace of price increases has slowed.

Ultimately, given that average CPI inflation for Jul-Dec of this year has been 10.9 percent and with the slowdown in food prices being offset by supply-side pressures and the risks emanating from the external account position, we do not expect either a significant quickening or a rapid slowdown in CPI inflation.

[31] Perishable food commodities account for 4.9 percent of the CPI basket.
[32] Prices of non-perishable food items have increased at an average of 14.1 percent for the first half of FY12 on a yearly basis.