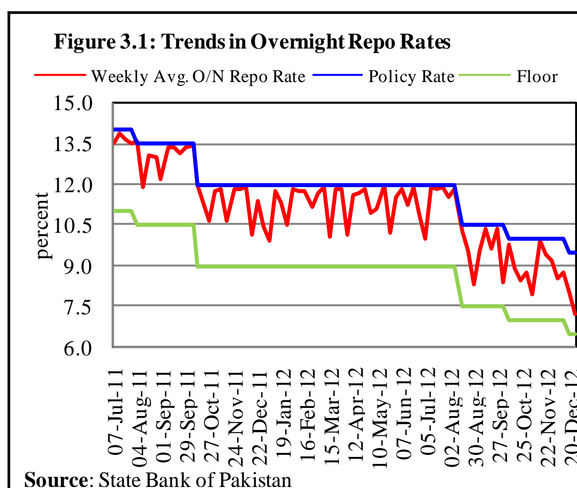
3 Inflation and Monetary Policy

3.1 Overview

The key development in Q1-FY13 was a consistent fall in inflation. After remaining in double-digits for more than two years, headline inflation fell to 9.1 percent in Q1-FY13, compared to 11.5 percent in Q1-FY12. At the same time, SBP's survey of consumer confidence corroborates some softening in inflation expectations.

Figure 3.1: Trends in Overnight Repo Rates



Source: State Bank of Pakistan

The reduction in inflationary pressures, together with some support from the much-delayed Coalition Support Fund (CSF) on the external account, allowed the central bank to cut interest rates.[1] SBP reduced its policy rate by 150 bps to 10.5 percent in August 2012, followed by two more cuts of 50 bps each in October and December 2012 (**Figure 3.1**).

Despite these signals, market liquidity remained tight throughout the first quarter. While the fiscal authorities borrowed extensively from commercial banks, market liquidity was squeezed when the government retired a part of its debt to SBP. To put this in perspective, while the government borrowed a record Rs 564 billion during Q1-FY13 from commercial banks, it retired Rs 412 billion to SBP – effectively absorbing this amount from the banking system.[2]

More importantly, the retirement of SBP debt enabled the government to meet the limit of zero quarterly central bank borrowing, as set under the amended SBP Act of 1956.

[1] The investment to GDP ratio, which has been declining since FY07, reached a low of 12.5 percent in FY12 (see SBP's Annual Report for FY12).

[2] These borrowings are on the basis of *actual cash* realized by the government through debt issuance in the primary auctions. These numbers may not tally with monetary aggregates shown in **Table 3.1** as the latter also includes the impact of any subsequent change in the market value of the government borrowings.

It may be acknowledged that commercial banks assume credit risk while lending to the private sector, whereas lending to government is risk-free and improves the banks' risk-weighted assets. In this situation, a large demand for budgetary finance incentivizes commercial banks to remain indifferent to the private sector. This concern was one of several factors that allowed SBP to further ease its monetary policy in FY13.

However, as the expectation of further cuts in the policy rate took hold, commercial banks started lending more aggressively to the government, particularly investing in 6-12 month T-bills, PIBs and Sukuk. Accordingly, the maturity profile of government borrowing from banks improved slightly during the quarter. Specifically, the share of commercial banks' investment in 3-month T-bills has declined from 26.4 percent of their total T-bills holdings at end-June 2012, to just 7.1 percent as of end-September 2012.[3]

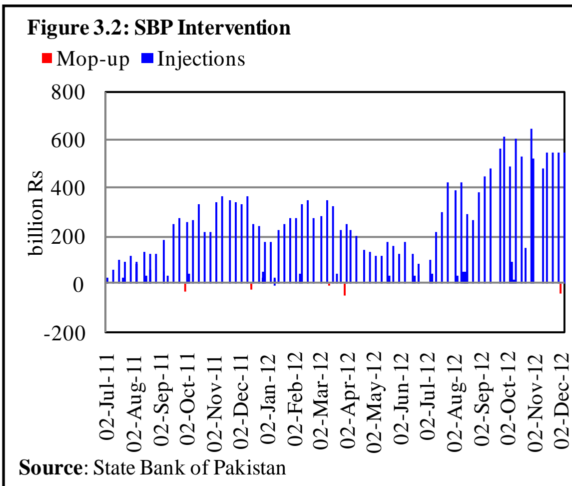
Table 3.1: Monetary Aggregates (Jul-Sep)

flows in billion Rs, growth in percent

	Cumulative Flows		Growth	
	FY12	**FY13**	**FY12**	**FY13**
Broad money (M2)	-21.0	54.0	-0.3	0.7
NFA	-82.7	11.8	-10.6	2.2
SBP	-53.3	-4.3	-8.7	-1.1
Scheduled banks	-29.4	16.0	-17.7	11.6
NDA	61.8	42.2	1.0	0.6
SBP	120.8	101.7	11.6	6.8
Scheduled banks	-59.0	-59.4	-1.2	-1.1
of which				
Government borrowing	179.6	159.0	5.9	3.7
For budgetary support	184.4	152.5	7.1	4.0
SBP	-101.9	-399.4	-8.5	-23.4
Scheduled banks	286.3	551.9	20.4	26.4
Commodity operations	-2.8	9.0	-0.7	2.1
Non government sector	-63.4	-69.4	-1.8	-1.9
Credit to private sector	-88.7	-84.9	-2.8	-2.5
Credit to PSEs	25.2	15.5	6.5	6.0
Other items net	-54.4	-47.4	8.3	5.9
Memorandum Item: Government borrowing on cash basis				
Banking System	160.8	151.5	-	-
SBP	-103.5	-412.1	-	-
Scheduled banks	264.3	563.6	-	-

Source: State Bank of Pakistan

Figure 3.2: SBP Intervention



Source: State Bank of Pakistan

[3] In Q1-FY13, net acceptance of 3-month treasury bills recorded a fall of Rs 447.7 billion, in contrast, 6 months and 12 months T-bills attracted Rs 587.7 billion and Rs 270.5 billion respectively.

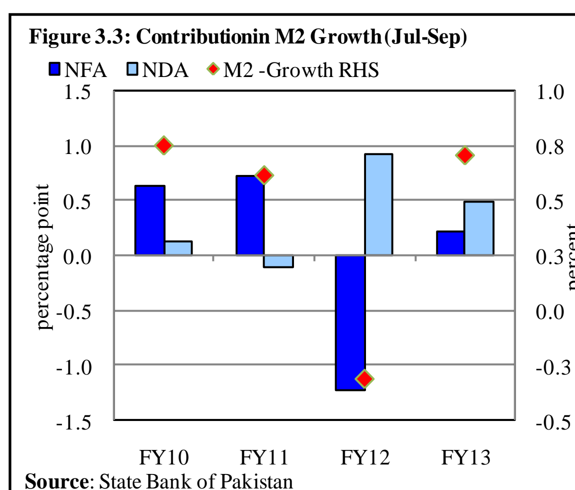
The retirement of SBP debt absorbed market liquidity, and reduced the growth in banks' deposits; furthermore, the drain in SBP's NFA further pressurized interbank liquidity. SBP therefore stepped-in to provide liquidity through open market operations (OMOs) (**Figure 3.2**). This provision of liquidity along with the reduction in policy rate pushed down the 6-month Karachi interbank offer rate (KIBOR) – a benchmark for pricing loans to private sector businesses –which saw a reduction of 256 bps during Jul-Nov FY13. Similarly, the weighted average lending rate (WALR) on fresh loans, has also seen a decline of 222 bps during Jul-Nov FY13.

Although private sector credit remained sluggish in overall terms during the quarter, there are some encouraging signs. Specifically, loans to private sector businesses saw a net retirement of Rs 39.5 billion in Q1-FY13, lower than the net retirement of Rs 95.3 billion witnessed during the corresponding period last year, Most of the current retirement can be traced to working capital loans and trade financing, but fixed investment loans (i.e. loans with a maturity of more than one year) increased by Rs 5.6 billion during the quarter compared to a net contraction of Rs 22.4 in Q1-FY12. The latter appears to support some improvement in the LSM sector.[4]

3.2 Developments in Monetary Aggregates[5]

Broad money supply (M2) grew by 0.7 percent during Q1-FY13 compared to a *contraction* of 0.3 percent during the corresponding quarter of FY12. Both NFA and NDA of the banking system contributed to M2 growth (**Figure 3.3**), whereas in the previous year, the contraction in NFA overshadowed the visible rise in NDA.

Figure 3.3: Contributionin M2 Growth (Jul-Sep)



Source: State Bank of Pakistan

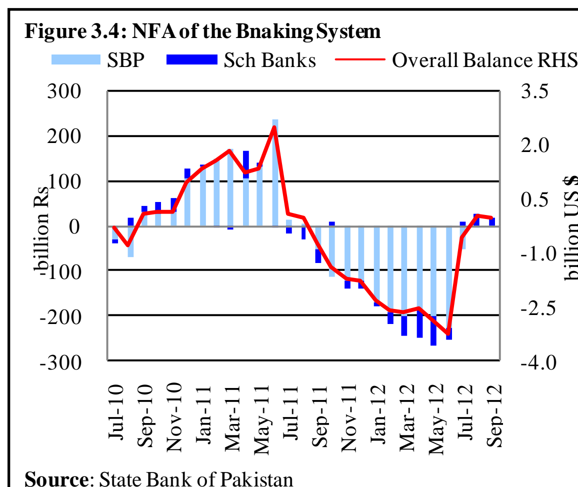
[4] Excluding cars and fertilizer, LSM grew by 3.5 percent during Jul-Sep FY13 compared to 2.9 percent during the same period last year.

[5] Discussion in this section is strictly restricted to the first quarter of the year.

Net Foreign Assets (NFA)

After witnessing a persistent fall in FY12, the banking system's NFA increased during Q1-FY13 (**Figure 3.4**).

Figure 3.4: NFA of the Bnaking System



Source: State Bank of Pakistan

Within the banking system, commercial banks led the expansion in NFA, as the growth in workers' remittances and some increase in portfolio investment, added to their FX holdings.

On the other hand, SBP's NFA contracted by 1.1 percent during the quarter, despite the receipt of US$1.1 billion on account of CSF in August 2012 (**Figure 3.4**).

Net Domestic Assets (NDA)

The growth in NDA of the banking system decelerated to 0.6 percent during Q1-FY13, from 1.0 percent in Q1-FY12 (**Table 3.1**).

Government Borrowing for Budgetary Support

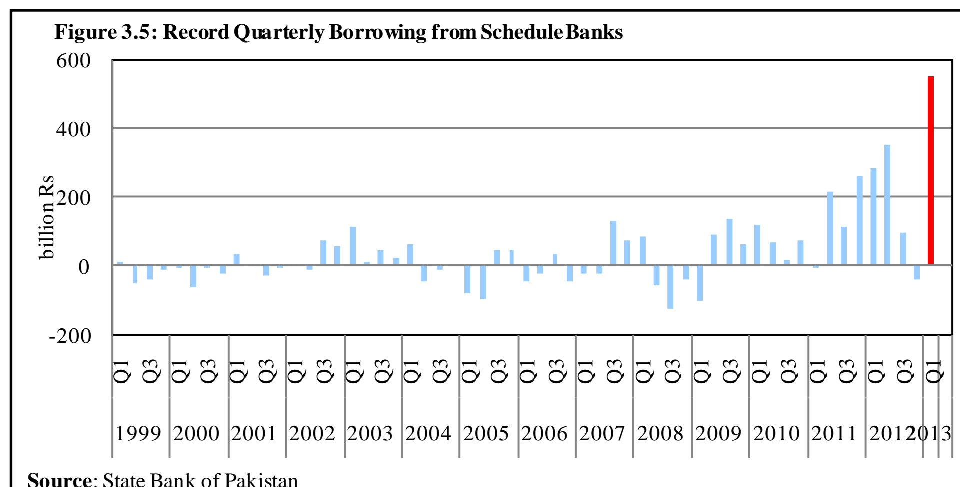
Overall government borrowing for budgetary support was lower in Q1-FY13 relative to the same quarter last year (**Table 3.1**). However, this number masks a major shift in borrowing sources, i.e., the government borrowed heavily from commercial banks during the first quarter to retire its debt with the central bank.

Thus, the government's reliance on commercial banks increased despite CSF money and higher mobilization through non-bank financing (NSS).[6] Specifically, the government borrowed Rs 564 billion (on cash basis) from commercial banks during the quarter – the highest ever for a single quarter (**Figure 3.5**).

Because of this, the government comfortably met the limit of zero quarterly borrowing from the central bank as stipulated under the amended SBP Act. In fact, the government retired Rs 412 billion of its debt held by SBP (**Figure 3.6**).

[6] In net terms, the government received Rs 154.4 billion from national saving schemes during the quarter, which was much higher than Rs 54.3 billion secured in Q1-FY12.

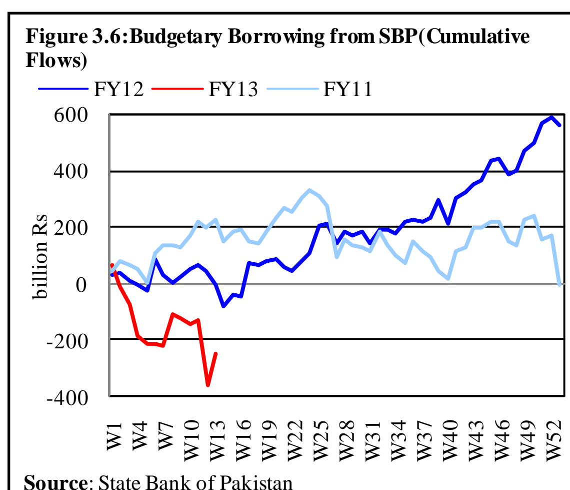
Figure 3.5: Record Quarterly Borrowing from Schedule Banks



Source: State Bank of Pakistan

In order to mobilize more funds from commercial banks, the federal government often accepted larger amounts in the auction than the announced target (**Table 3.2**). Banks were also keen to lend to the government despite a net contraction in their deposits during the quarter.[7] The resulting tightness in the market forced SBP to provide liquidity through OMO injection, so that the money market could function smoothly.

Figure 3.6: Budgetary Borrowing from SBP (Cumulative Flows)



Source: State Bank of Pakistan

Credit expansion to public sector enterprises (PSEs) fell to Rs 15.5 billion during Q1-FY13, compared with Rs 25.2 billion in the corresponding period last year. Almost all of this credit was availed by an oil marketing company and a public sector steel mill.[8]

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[7] Banks' total deposits fell by 0.5 percent in Q1-FY13.

[8] The oil marketing company borrowed Rs 14 billion during Q1-FY13, of which Rs 12 billion was availed to meet the working capital needs. The loan to public sector steel mill was a part of the bailout package approved in Jul 2012 by Economic Cabinet Committee (ECC). It was a term loan

Table 3.2: T-bills Auctions

billion Rs

	FY12			FY13		
	Net Target	**Net Offered**	**Net Accepted**	**Net Target**	**Net Offered**	**Net Accepted**
Jul	88.5	213.1	142.2	3	360.5	228.6
Aug	54	191.7	123.4	-14.6	14.7	-25.1
Sep	12.9	206.7	78.8	24.4	545.4	207.1
Total	**155.4**	**611.5**	**344.4**	**12.8**	**920.6**	**410.6**

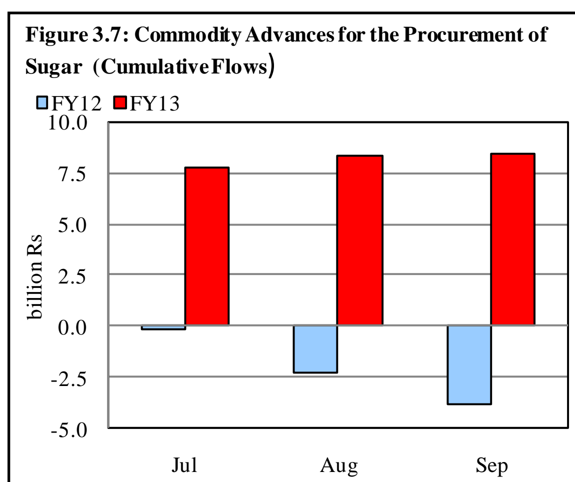
*Net of maturity amounts

Source: State Bank of Pakistan

Commodity Finance

Commodity financing posted an increase of Rs 9.0 billion in Q1-FY13 compared to a net retirement of Rs 2.8 billion in Q1-FY12. This is explained by slower retirement of wheat advances extended during the previous season, and fresh borrowing of Rs 17.6 billion availed by the Trading Corporation of Pakistan (TCP) for the procurement of sugar and fertilizer (**Figure 3.7**).

Figure 3.7: Commodity Advances for the Procurement of Sugar (Cumulative Flows)



The retirement of wheat financing remained subdued because flour mills procured higher stocks directly from farmers instead of buying from the government;[9] the food department of Balochistan could not start procurement on time, and increasing receivables on account of subsidies and sales proceeds to be paid by various government departments. Given the self liquidating nature of commodity loans, the gradual increase in the outstanding amount in recent years, has been pointing towards another circular debt problem.

secured to finance the LC opening for raw material import and to meet current expenditures of the company.

[9] In general, whenever flour mills procure higher stocks directly from farmers, this delays the release of wheat stock from provincial food departments in subsequent months.

Private Sector Credit

Despite the decline in lending cost, growth in credit to the private sector remained sluggish. The structural issues, such as energy shortages, the law and order situation, and some sector-specific constraints, suppressed credit growth. From the banks' perspective, the availability of risk-free government securities, coupled with credit quality concerns, continued to limit the supply of credit to the private sector. This behavior has significantly changed their asset composition. As a result, in August 2012, the outstanding stock of government borrowing exceeded the quantum of private sector loans for the first time (**Figure 3.8b**).

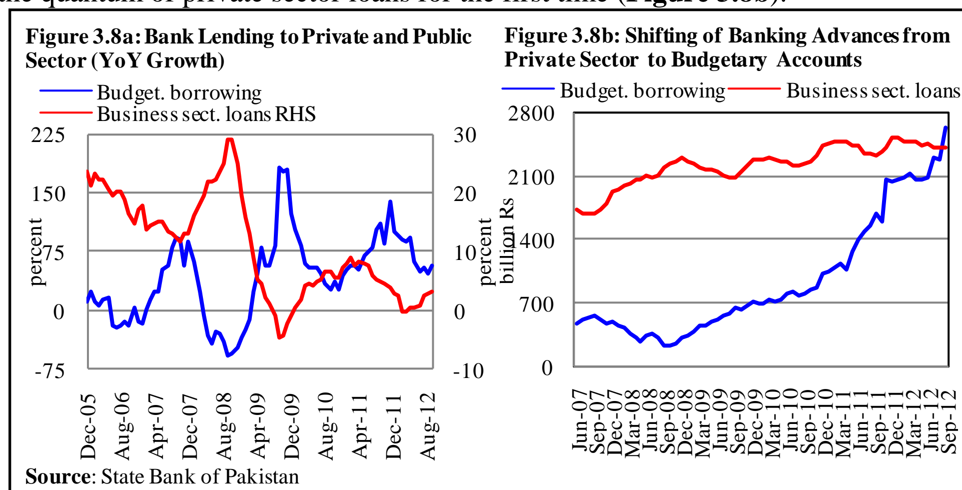


Figure 3.8a: Bank Lending to Private and Public Sector (YoY Growth)

Figure 3.8b: Shifting of Banking Advances from Private Sector to Budgetary Accounts

Source: State Bank of Pakistan

Since the first quarter of the year is a retirement season, private sector credit in Q1-FY13 recorded a net contraction of Rs 84.9 billion – slightly lower than in the corresponding quarter of last year (**Table 3.3**). Within overall credit, loans to private sector businesses saw a lower retirement of Rs 39.5 billion in Q1-FY13, against Rs 95.3 billion in first quarter of previous year. Subdued lending in the preceding season, and some pickup of fresh loans explain the lower repayments in the year.

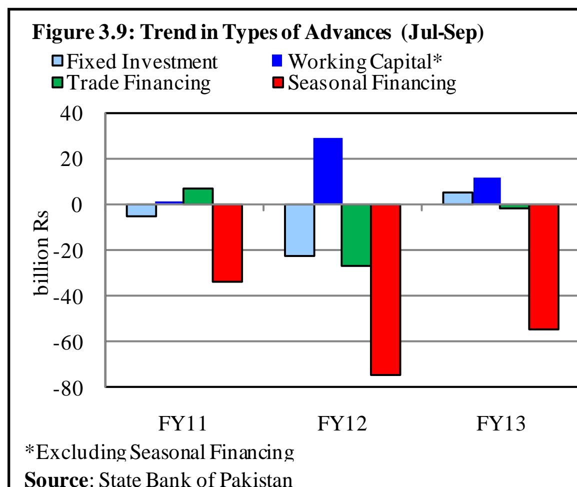


Figure 3.9: Trend in Types of Advances (Jul-Sep)

*Excluding Seasonal Financing

Source: State Bank of Pakistan

Further analysis suggests that most of the retirement came from working capital loans and trade financing. In contrast, the volume of fixed investment loans recorded a modest increase during the period of analysis (**Table 3.3**).

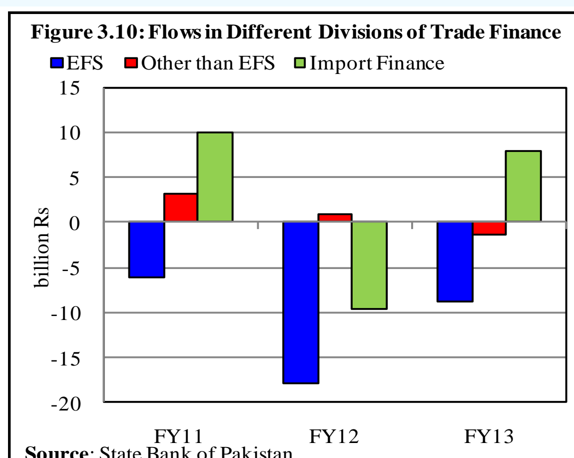
Table 3.3: Private Sector Loans (Jul-Sep)
billion Rs

	Overall Loans		Working Capital		Fixed Investment		Trade Financing	
	FY12	**FY13**	**FY12**	**FY13**	**FY12**	**FY13**	**FY12**	**FY13**
Business Sector Loans	**-95.3**	**-39.6**	**-46.2**	**-43.2**	**-22.4**	**5.6**	**-26.8**	**-2.2**
Agriculture	6.3	6.7	6.5	5.1	0.1	1.7	-0.2	-0.1
Manufacturing	-81.0	-47.4	-61.7	-46.1	-7.1	0.5	-12.2	-1.7
Food and Beverages	-55.0	-42.1	-51.8	-42.6	-2.9	4.5	-0.3	-3.9
Sugar	-36.4	-24.7	-35.4	-28.5	-1.9	2.9	0.9	0.8
Textiles	-44.5	-25.0	-28.7	-16.2	-3.1	-6.1	-12.6	-2.6
Spinning	-31.7	-11.9	-20.6	-12.2	-5.9	-1.1	-5.3	1.3
Weaving	-6.8	-4.4	-7.1	-2.0	3.1	-2.0	-2.8	-0.4
Carpets and Rugs	0.2	5.7	0.0	5.7	-0.1	1.1	0.3	-1.1
Refined Petroleum Products	9.6	0.2	10.5	-2.2	-1.9	2.3	1.0	0.0
Fertilizers	-4.5	7.7	-3.2	10.1	-0.4	-1.3	-0.9	-1.0
Plastics Products	0.0	4.5	0.2	0.2	-0.1	2.2	-0.1	2.2
Cement	0.7	-3.2	-0.6	-0.7	0.6	-0.5	0.8	-1.9
Basic Metals	6.7	3.8	5.4	1.4	0.8	-0.2	0.5	2.6
Electrical Machinery	2.7	0.3	1.6	-0.9	0.3	-0.1	0.8	1.2
Electricity Apparatus	1.8	-1.1	3.5	-0.8	-2.4	-0.2	0.7	-0.1
Ship breaking	-0.8	2.5	-0.2	1.1	0.0	0.0	-0.6	1.4
Electricity Generation	8.0	0.9	10.3	-0.8	-2.1	1.7	-0.2	0.0
Construction	-3.2	-0.6	-1.8	-1.7	-1.6	0.9	0.2	0.1
Commerce and Trade	-5.2	0.6	-1.7	1.7	0.0	2.2	-3.4	-3.3
Retail Trade	-2.7	3.2	-1.7	0.9	0.5	2.0	-1.5	0.4
Trans. Storage and Comm.	-6.7	-1.8	3.7	-1.7	-9.8	0.0	-0.5	-0.1
Telecommunications	-8.6	-2.1	2.7	-1.2	-11.3	-0.8	-0.1	-0.1

Source: State Bank of Pakistan

The seasonal repayment of loans for sugar, rice and cotton explains the bulk of the retirement. The decline in raw material prices and structural issues (i.e., energy and large inventories) partly explain the lower disbursements, especially in the textile sector. Within the sugar sector, which is the second largest sector availing

Figure 3.10: Flows in Different Divisions of Trade Finance



Source: State Bank of Pakistan

Fixed investment loans also showed an increase during Q1-FY12. This expansion however, is concentrated in sectors like agriculture, sugar, petroleum, plastic products and retail trade.

Within trade financing, contraction in export loans overshadowed the expansion in import financing during the quarter (**Figure 3.10**). Demand for import loans largely came from ship breaking, iron & steel, and plastic industry.[10]

Table 3.4: Loans to Consumer Sector (Jul-Sep)
billion Rs

	Cumulative Flows	
	FY12	FY13
Consumer financing	-4.7	-1.7
House building	-1.9	-1.1
Auto loans	-2.3	-0.2
Credit cards	-1	1.3
Personal loans	0.6	-1.7

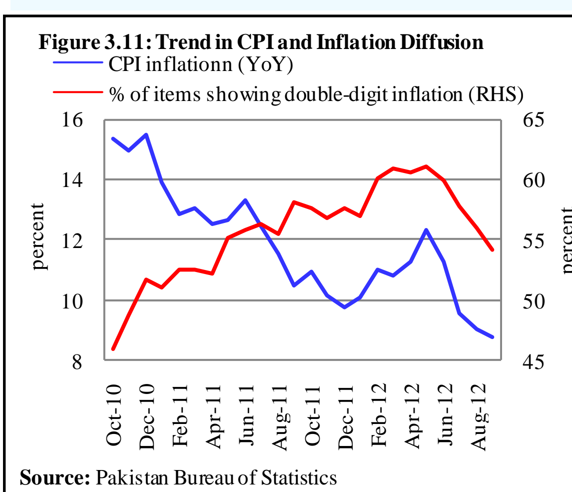
Source: State Bank of Pakistan

In consumer loans, all categories, except personal loans, witnessed a lower net retirement during Q1-FY13. Moreover the loans for credit cards witnessed a net expansion during the period under review (**Table 3.4**).

3.3 Inflation

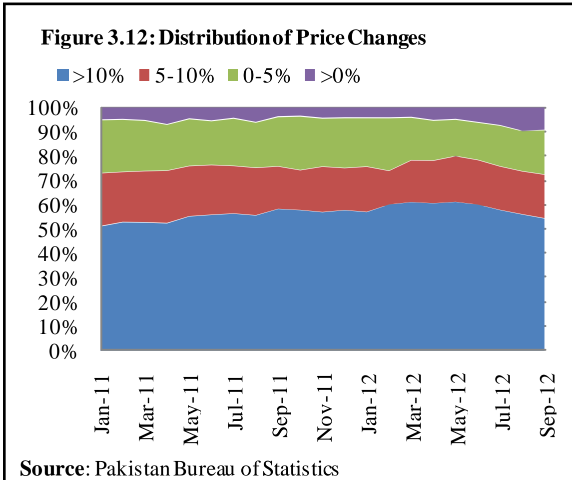
Headline inflation declined sharply in the first month of the quarter, and continued decreasing over the next two months. Average inflation for the quarter was 9.15 percent, compared to 11.48 percent for the same period last year (see **Figure 3.11**). Sharp falls in the prices of a few commodities (e.g. piped gas, pulses, and perishables) pulled down the inflation, but inflationary pressures seem to be easing more broadly (see **Figure 3.12**).

Figure 3.11: Trend in CPI and Inflation Diffusion



Source: Pakistan Bureau of Statistics

Figure 3.12: Distribution of Price Changes

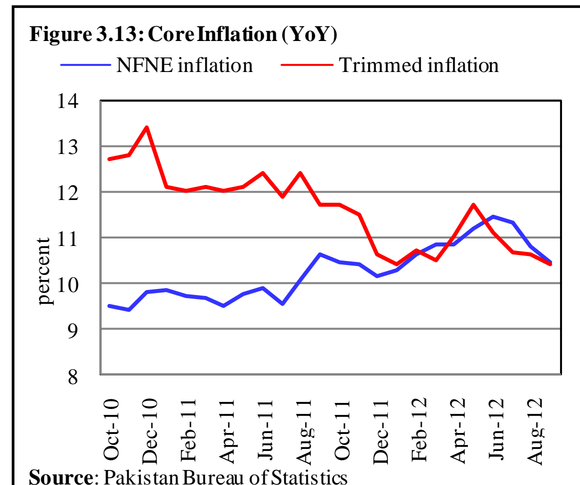


Source: Pakistan Bureau of Statistics

However, both measures of core inflation (non-food non-

[10] The commencement of a polyester film plant created fresh credit demand for all types of financing i.e., running capital, import financing and long-term loans in the plastic industry.

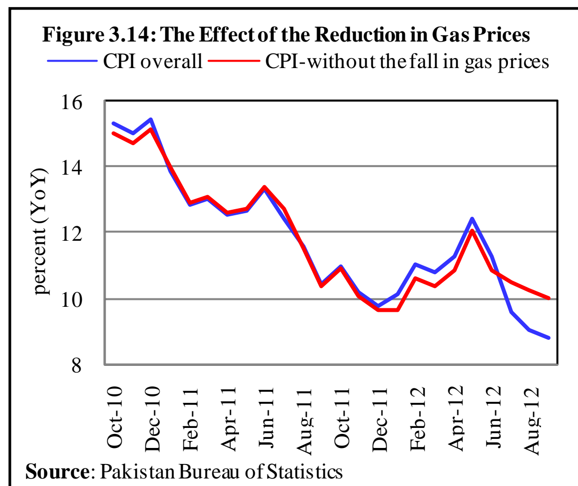
energy inflation and trimmed inflation) have not fallen as sharply as the fall in aggregate inflation (see **Figure 3.13**). Within NFNE inflation, changes in house rents have remained stable at roughly 7 percent, while inflation in other groups has either declined gradually or remained stable. At the same time, SBP's consumer confidence survey has indicated that inflationary expectations have started to ease. The quarter has also been marked by stability in energy prices, which has a strong impact on inflation expectations.



The easing of inflationary expectations may also be attributed to the relative stability in food prices over the past year. The prices of pulses and sugar, in particular, have either declined substantially, or remained stable.

The reduction in gas tariffs

A large part of the decline this quarter can be attributed to the reduction in gas tariffs (see **Figure 3.14**). Although OGRA decreased tariffs for all households, the decrease was greater for higher consumption slabs (see **Figure 3.15**).[11] This meant that the decline in gas prices in the CPI basket was roughly 49 percent on a month-on-month basis. However, a large majority of households consume less than 300 cubic meters of natural gas. Although the calculation is statistically consistent, the 49 percent decline may not be representative of the average urban household. If the government



[11] The index is calculated using a simple average of the five slabs.

were to reverse this decision at some future date, then the increase in inflation may be just as sharp as this decline was, and again not be representative of the average household.

Wheat support prices

The recent trend in wheat prices, however, has been concerning. With the rise in international prices, and the increase in domestic support prices, wheat prices in local retail and wholesale markets have already started inching up.[12]

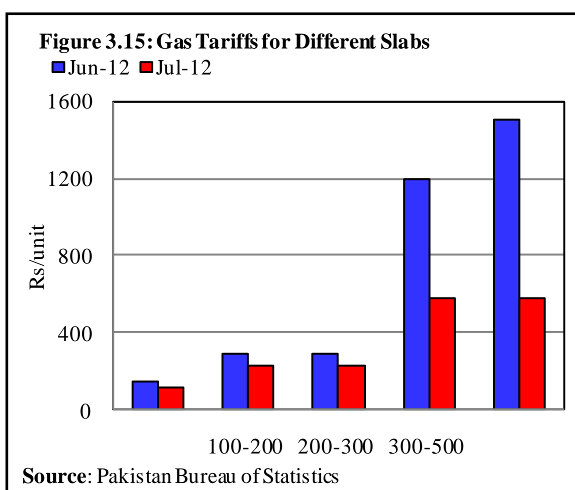


Figure 3.15: Gas Tariffs for Different Slabs

Source: Pakistan Bureau of Statistics

We believe that the increase in the wheat support price will impact food inflation in the near future, given the importance of wheat as part of the staple diet, and as an input for some of the manufactured food items.

The increase in the support price was not a surprise. According to our analysis, changes in the international price of wheat cause changes in the government's support price. Moreover, the wheat support price has been higher than the international wheat price in 12 out of the last 13 years (**Figure 3.16**). International wheat prices have risen sharply in Q1-FY13 due to droughts in Australia and the US. In line with our expectations, the government increased the support price of wheat by Rs150 per 40kg to Rs1200 per 40kg in November 2012. The subsequent increase in retail

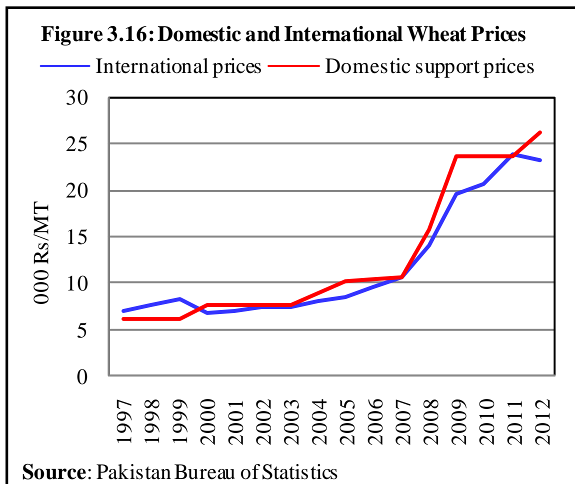


Figure 3.16: Domestic and International Wheat Prices

Source: Pakistan Bureau of Statistics

[12] Wheat prices rose by almost 5 percent on a month-on-month basis in September – the largest monthly increase in two years.

wheat prices and the acceleration in food inflation may pose the greatest risk to managing inflation in the near future.

Outlook

However, the reduction in administered prices for piped gas and CNG, and the stability in house rents, will continue to dampen inflation going forward. Therefore, we expect energy prices to remain largely stable and, due to the increase in the wheat support price, we believe that food inflation will accelerate. The trend in inflation will consequently depend on the trend in administered prices in the near future. The other risks to inflation emanate from the external front, where the impact of the exchange rate on domestic prices will be critical.

Although we expect food inflation to reverse its trend and start increasing in future months, we also expect headline inflation to remain below the government's target of 9.5 percent for the year. That is simply because average inflation for the first half of the year was 8.3 percent, and prices would have to increase much faster than anticipated to breach the 9.5 percent target for the full year.