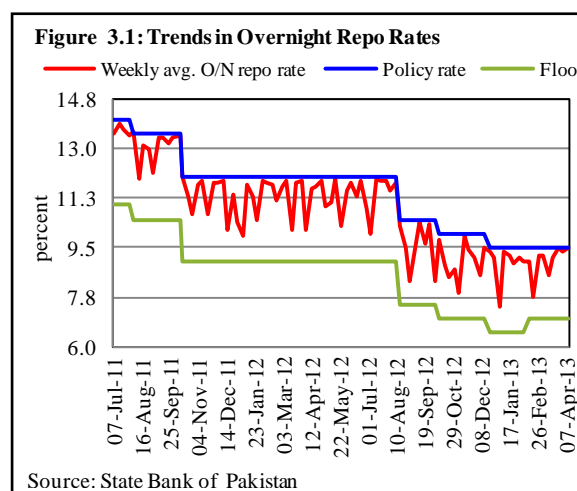


3 Monetary Policy and Inflation

3.1 Overview

Following the 250 bps cut in the policy rate during first half of the year,¹ SBP kept the rate unchanged at 9.5 percent in the last two monetary policy decisions in February and April 2013 (**Figure 3.1**). While inflationary concerns eased to a great extent, a weakening external account posed the real challenge to further monetary easing. Specifically, SBP's liquid foreign exchange reserves declined by US\$ 3.7 billion during Jul-Mar FY13, and the Pak Rupee lost 3.9 percent of its value against the US\$.²

Given the *nature* of the weaknesses in the external account, the interest rate policy is less likely to yield the desirable results as: (a) the absolute size of current account deficit is small;³ (b) increase in interest rates is less likely to attract external financial inflows in the presence of other country-specific risks; and (c) the high cost of borrowing could negatively impact the already low level of private sector investment. Cognizant of these issues, SBP kept the policy rate unchanged in order to keep the opportunity cost of investing in foreign assets high to avoid unnecessary pressure on the local currency. Moreover, the continuation of fiscal weaknesses (as evident from increasing government borrowing from the banking system) also weighted in favor of cautious monetary easing.

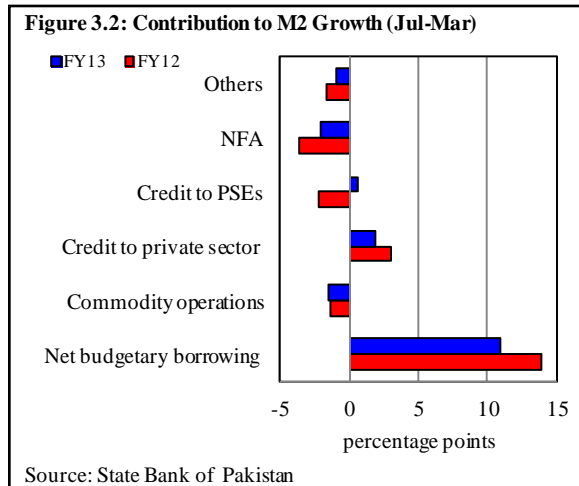


¹ Policy rate was initially lowered by 150 bps to 10.5 percent in August 2012 and then by 50 bps each in October 2012 and December 2012 to reach 9.5 percent.

² For details on external accounts, please see **Chapter 5** on External Sector.

³ Within the current account, imports recorded a YoY decline of 1.9 percent during Jul-Mar FY13.

Stepping back, one of the most notable developments over the period of analysis has been the deceleration in inflation. Headline YoY inflation reached a low of 6.6 percent in March 2013, pulling down the *period* average (Jul-Mar FY13) to 8.0 percent compared to 10.8 percent during the same period last year. This marked decline in inflation was largely attributed to the stability in fuel and food prices, and softening inflationary expectations.

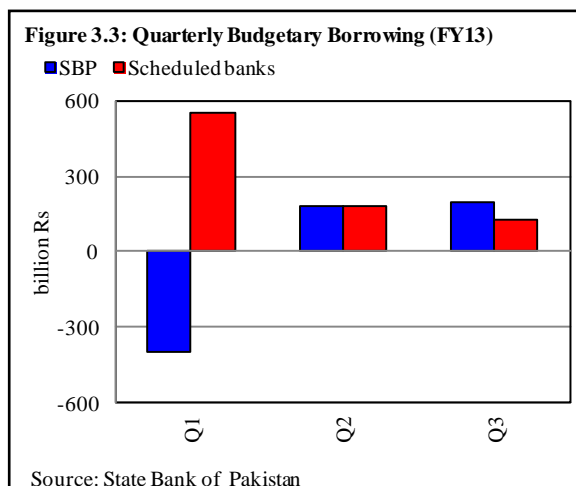


While there is no immediate upside risk to inflation at this point in time, adverse developments on the external front and the government's reliance on bank financing remains the major concerns to inflationary outlook. Currently, developments in both these sectors are complicating the monetary management.

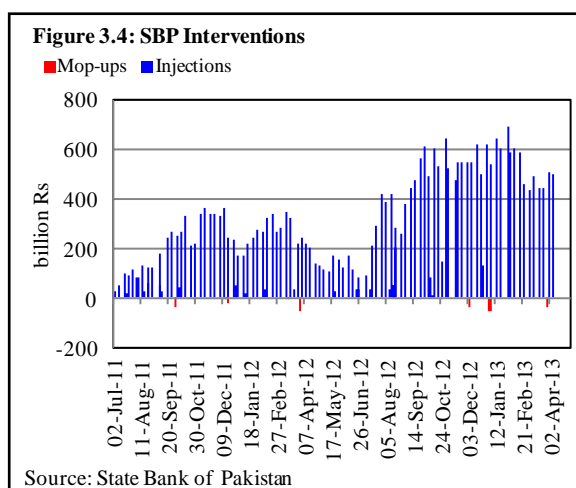
At the aggregate level, broad money supply (M2) grew by 9.0 percent during Jul-Mar FY13, compared to 8.1 percent during the same period last year. However, major source of this monetary expansion has been high government budgetary borrowing from the banking sector (**Figure 3.2**). Specifically, the government borrowed Rs 836.4 billion from the banking sector during Jul-Mar FY13, compared to Rs 932.8 billion during the same period last year.

This small decline in government borrowing in FY13 must be seen in the context of two *one-off* events: lump sum payments (Rs 391.0 billion) on account of the circular debt consolidation in FY12; and the realization of CSF receipts (US\$ 1.8 billion) in H1-FY13, the latter helped contain the government's borrowing needs this period.

Within the banking sector, cumulative flows indicate that the government relied mostly on borrowing from commercial banks, and retired some of its debt from SBP during Jul-Mar FY13. However, quarterly data indicate that the government's reliance on SBP funding increased as the year progressed (**Figure 3.3**).

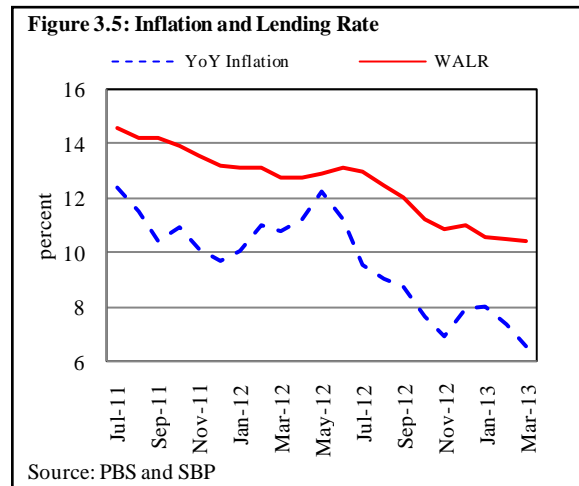


In fact, commercial banks could not mobilize enough deposits to match the government's appetite for funding over the period of analysis.⁴ This, combined with the servicing of external debt (other than IMF) and SBP's foreign exchange interventions, kept rupee liquidity in the market under pressure. Under these circumstances, SBP has been injecting liquidity through Open Market Operations (OMOs) to ensure that the market functions smoothly. As shown in **Figure 3.4**, the volume of OMOs has been hovering around Rs 500 billion since September 2012, which is substantially higher compared to the same period last year.



⁴ Private sector deposits held with commercial banks saw an increase of Rs 482.5 billion during Jul-Mar FY13, while the commercial banks' lent Rs 860.2 billion for budgetary finance.

The provision of liquidity to the system was also necessary to ensure the pass-through of monetary policy decisions – i.e., to ensure that banks reduced the cost of private sector borrowing. Following the cuts in policy rate, the weighted average lending rate (on fresh loans) saw a reduction of 267 bps to 10.5 percent since June 2012. This seems to be one of the key factors contributing to the modest increase in loans to private sector businesses.



However, it is pertinent to note here that the impact of the decline in lending rates was partially diluted, since the *real* cost of borrowing remained almost constant, i.e. inflation adjusted weighted average lending rates (**Figure 3.5**).

In absolute terms, loans to private sector businesses increased by Rs 165.1 billion during Jul-Mar FY13, compared to Rs 42.9 billion in the same period last year.⁵ The volume of all three segments of private sector borrowing (including working capital loans, fixed investment loans, and trade loans) expanded over the first three quarters of the year. Moreover, the distribution of loans across sectors indicates that the expansion was broad-based as well.

Finally, consumer financing also expanded by Rs 8.5 billion during Jul-Mar FY13; this was in contrast to the contractions that had been witnessed in this segment during the last four years (FY09 to FY12). The expansion was largely driven by personal loans, while volumes of other categories of consumer finance (mortgage loans, consumer durable and credit cards) are still declining.

3.2 Developments in Monetary Aggregates

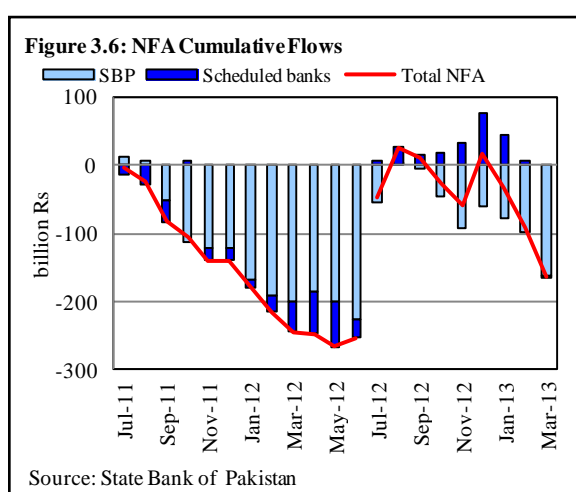
Similar to last year, monetary expansion during Jul-Mar FY13 was driven entirely by net domestic assets (NDA) of the banking sector, while changes in net foreign assets (NFA) partially offset this expansion. However, a net contraction in NFA of Rs 161.2 billion during Jul-Mar FY13 was lower as compared to a decline of Rs

⁵ Compared to 3-year average of Rs 137.6 billion.

244.3 billion in the same period last year: this is a reflection of the relative improvement in the balance of payments position.⁶

The decline in NFA occurred mainly in the *third quarter* of this year (**Figure 3.6**). It is pertinent to mention that two tranches of CSF inflows in H1-FY13 had kept the current account positive during that period. However, the absence of CSF inflows, along with the fall in remittances and an unchanged trade deficit, resulted in the contraction in NFA during Q3-FY13.

Within the banking system, NFA of commercial banks expanded by Rs 1.8 billion during Jul-Mar FY13, which was totally overshadowed by a net contraction of Rs 163.0 billion in NFA of SBP. Although CSF inflows helped contain pressures on the external account, a number of other factors – including external debt obligations (other than IMF), weak financial inflows, and interventions in the FX



market – were driving the net contraction in SBP's NFA. On the other hand, the minor expansion in NFA of commercial banks during Jul-Mar FY13 was attributed to a rise in the balances of banks held abroad, and the decline in non-resident foreign currency deposits.⁷

Net Domestic Assets (NDA)

NDA of the banking system grew by 11.9 percent during Jul-Mar FY13, compared to 13.4 percent during the same period last year. The expansion was largely driven by government borrowing, while credit to private sector and PSEs

⁶ The overall external account balance recorded a deficit of US\$ 1.8 billion during Jul-Mar FY13 compared with a deficit of US\$ 2.7 billion during the same period last year. CSF inflow of US\$ 1.8 billion during Jul-Mar FY13 was the prominent factor.

⁷ Foreign loans for trade financing recorded a retirement of US\$ 431.0 million during Jul-Mar FY13. The balances of banks held abroad also increased by US\$ 224.0 million during this period. Non-resident foreign currency deposits, a foreign liability of the banks, recorded a decline of US\$ 278.0 million during Jul-Mar FY13, which also contributed to an increase in the NFA of scheduled banks.

expanded slightly. Commodity operations, another important component of NDA, recorded net retirements during Jul-Mar FY13.

Government Borrowing for Budgetary Support⁸

Overall government borrowing for budgetary support was slightly lower during Jul-Mar FY13, compared to the same period last year (**Table 3.1**). As discussed earlier, this relative decline was largely because of *one-off* events as fiscal weakness continued to persist. Specifically, government borrowing last year included a one-time adjustment of Rs 391.0 billion on account of circular debt consolidation. Adjusting for this one-off payment indicates that government borrowing this year is much higher than last year. Another important factor is the realization of CSF money during H1-FY13, which helped contain the overall volume of government borrowing.

Table 3.1: Changes in Monetary Aggregates (Jul-Mar)

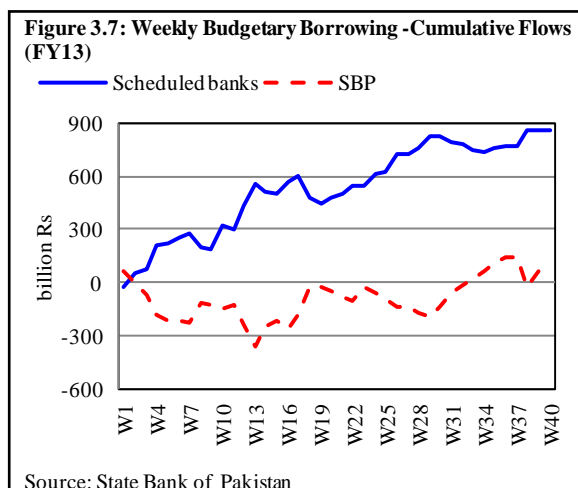
billion Rupees

	FY12				FY13			
	Q1	Q2	Q3	Jul-Mar	Q1	Q2	Q3	Jul-Mar
Broad money (M2)	-21.0	400.4	166.0	545.4	54.0	558.4	74.0	686.4
NFA	-82.7	-57.2	-104.5	-244.3	11.8	5.4	-178.4	-161.2
SBP	-53.3	-69.3	-77.4	-200.0	-4.3	-55.6	-103.1	-163.0
Scheduled banks	-29.4	12.1	-27.0	-44.3	16.0	61.0	-75.3	1.8
NDA	61.7	457.6	270.5	789.8	42.2	553.0	252.3	847.6
SBP	120.8	116.9	143.6	381.2	101.7	170.6	114.7	387.0
Scheduled banks	-59.0	340.7	126.9	408.6	-59.4	382.4	137.6	460.6
Key components of NDA								
Government borrowing	179.6	512.3	148.7	840.6	159.0	319.2	247.0	725.3
For budgetary support	184.4	571.7	176.7	932.8	152.5	365.6	318.3	836.4
SBP	-101.9	219.2	81.8	199.1	-399.4	183.2	192.5	-23.7
Scheduled banks	286.3	352.4	95.0	733.7	551.9	182.4	125.9	860.2
Commodity operations	-2.8	-60.8	-29.4	-92.9	9.0	-47.8	-73.7	-112.5
Non government sector	-63.4	-23.9	144.2	56.8	-69.4	214.3	39.8	184.6
Credit to private sector	-88.7	282.2	7.0	200.5	-84.9	189.5	35.3	139.8
Credit to PSEs	25.2	-306.8	137.2	-144.3	15.5	24.8	4.6	44.9
Memorandum items: Government borrowing on cash basis								
Banking system	160.8	573.6	141.7	876.1	211.5	346.4	298.7	856.7
SBP	-103.5	227.9	70.8	195.2	-247.6	39.8	182.1	-25.7
Scheduled banks	264.3	345.7	70.9	680.9	459.2	306.6	116.6	882.4

Source: State Bank of Pakistan

⁸ See Data Explanatory Note 4(b) at **Annexure A**.

Within the banking system, government borrowing from SBP fell by Rs 23.7 billion during Jul-Mar FY13, while borrowing from commercial banks increased by Rs 860.2 billion (a 41.1 percent increase over the stock of end-FY12) during the same period (**Figure 3.7**). This clearly implies that the government has relied heavily on commercial banks for budgetary financing this year.



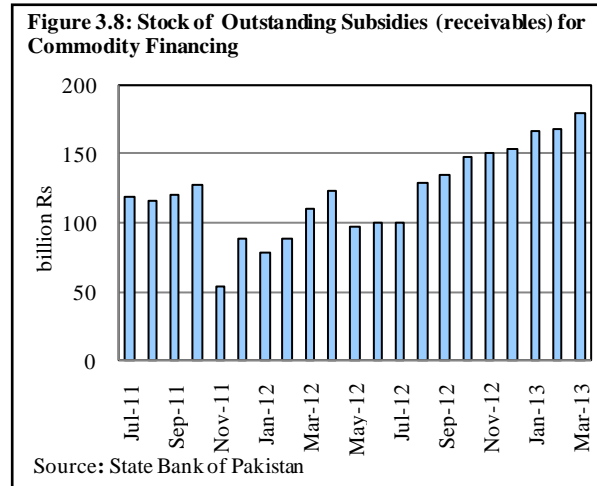
However, these numbers conceal true behavior of government borrowing during FY13. A quarterly analysis of government borrowing indicates that net retirement to SBP was concentrated in the first quarter of FY13, which offset the increase in government borrowing from SBP in subsequent quarters. On the other hand, heavy government borrowing from commercial banks during Q1-FY13, meant that *overall* borrowing from commercial banks during Jul-Mar FY13 remains high despite the substantial decrease in borrowing in subsequent quarters (**Table 3.1**).

Commodity Financing

In addition to budgetary borrowing, the government also borrows from commercial banks for its commodity operations. These loans witnessed a net retirement of Rs 112.5 billion during Jul-Mar FY13, compared to Rs 92.9 billion last year. The retirement was largely driven by repayments of loans taken for wheat procurement last year, before the commencement of the new procurement season.⁹ Specifically, the Punjab Food Department retired Rs 84.4 billion as it offloaded its wheat stocks aggressively after October – the Sindh Food Department also retired Rs 30.3 billion during Jul-Mar FY13. In addition to the usual release of stock, the export of wheat during this period also helped retirement of loans.

⁹ Net retirement of Rs 145.4 billion was recorded by the wheat procurement agencies during the period of analysis.

However, the retirement on account of wheat was partially offset by fresh borrowing for the procurement of sugar and the import of fertilizer.¹⁰ Despite an increase in sugar exports (which should allow for retirement), the outstanding loans for sugar procurement increased by Rs 14.5 billion during Jul-Mar FY13.



It is pertinent to mention here that outstanding subsidies (receivables) for commodity operations (especially for wheat and fertilizer) increased significantly during Jul-Mar FY13. Unlike previous years, when this rising trend of outstanding subsidies peaked in October 2011, the stock of subsidies is still increasing (**Figure 3.8**). This not only impairs the repayment capacity of procurement agencies, but also entails relatively higher financial costs for the government.¹¹

Credit to PSEs

Credit to public sector enterprises (PSEs) increased by Rs 44.9 billion during Jul-Mar FY13 (**Table 3.2**), in sharp contrast to a net retirement of Rs 144.3 billion last year. While last year's net retirement was primarily driven by debt consolidation (especially of energy-related PSEs)¹², this year's borrowing reflects the continuation of the weakened financial position of PSEs.

Table 3.2: Changes in Credit to PSEs (FY13)

billion Rupees				
	Q1	Q2	Q3	Jul-Mar
Credit to PSEs	15.5	24.8	4.6	44.9
PSM	3.3	4.9	3.8	12.0
PSO	13.3	-15.1	8.5	6.6
PIA	-0.2	12.8	1.9	14.5

Source: State Bank of Pakistan

¹⁰ Fresh borrowing by fertilizer sectors increased by Rs 17.9 billion.

¹¹ The outstanding loans for commodity finance saw a YoY increase of 6.3 percent. Commodity finance loans are relatively expensive as compared to the cost of government borrowing from commercial banks for budgetary finance.

¹² The retirement last year was due to the shifting of PSEs' debt on to the government. Adjusting for *one-off* settlement of Rs 312.0 billion reveals that the loans to PSEs indicate an increase of Rs 168.0 billion during Jul-Mar FY12.

Within PSEs, Pakistan Steel Mills, Pakistan State Oil and Pakistan International Airlines were the major borrowers during the period of analysis:

- A bailout package for the revival of Pakistan Steel Mills Limited was approved by the ECC in July 2012;¹³
- Lending to a power sector holding company also recorded a rise during this period;¹⁴ and
- Borrowing by the Pakistan International Airline Company increased to repay some of its external loans.

Credit to Private Sector

Overall credit to the private sector grew by 4.1 percent (Rs 139.8 billion) during Jul-Mar FY13, compared to 6.4 percent (Rs 200.5 billion) during the same period last year (**Table 3.3**).

Table 3.3: Change in Credit to Private Sector

billion Rupees

	FY12				FY13			
	Q1	Q2	Q3	Jul-Mar	Q1	Q2	Q3	Jul-Mar
Overall	-88.7	282.2	7.0	200.5	-84.9	189.5	35.3	139.8
<i>of which</i>								
Loans to private sector businesses	-95.3	181.3	-43.2	42.9	-39.6	186.1	18.6	165.1
Investments in shares & securities	2.9	9.0	-4.4	7.5	-1.1	12.3	4.4	15.6
Consumer financing	-4.5	-2.8	-1.2	-8.5	-1.8	8.4	1.9	8.5
Credit to NBFCs	6.6	18	41.7	65.9	-65.7	-12.6	2.0	-76.3

Source: State Bank of Pakistan

Given the monetary easing during the first half of the year, the fall in credit off-take is confusing at first sight. However, the deceleration stems largely from the decline in banks' investments in Non-Bank Finance Companies (NBFCs), which saw a reduction of Rs 76.3 billion during Jul-Mar FY13 in contrast to an increase of Rs 65.9 billion during the same period last year. This sharp reversal is attributed to the downward revision in tax incentives on investments in mutual

¹³ It was a term loan secured to finance the LC opening for raw material import and to meet current expenditures of the company.

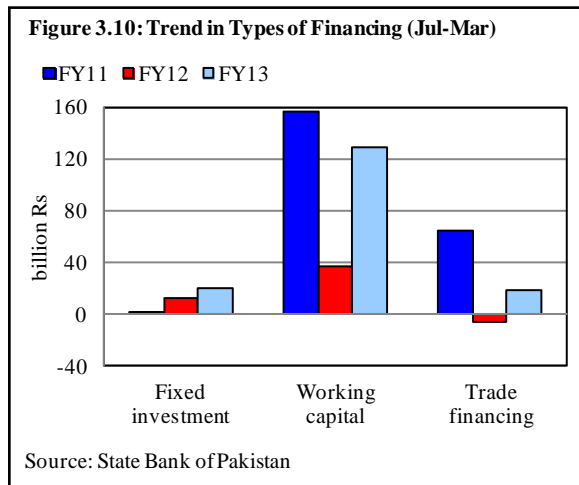
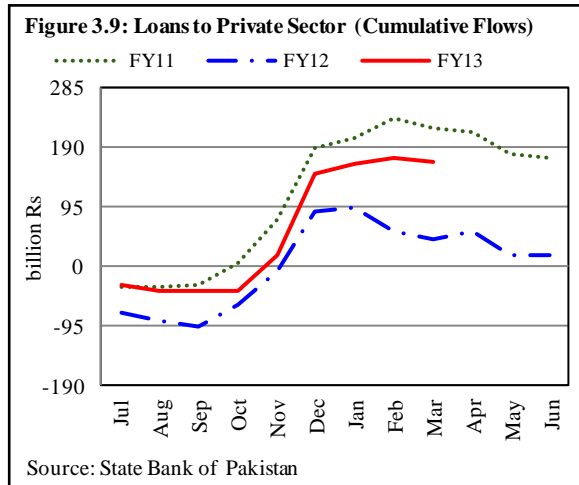
¹⁴ The oil marketing company initially borrowed Rs 13.3 billion during Q1-FY13, of which Rs 12.0 billion was availed to meet the working capital needs. However, by the end of March 2013, total borrowing since June 2012 was Rs 6.6 billion.

funds;¹⁵ and lower returns on government securities following the cut in the policy rate.

Within private sector credit, loans to *private sector businesses*, which account for over 70 percent of credit to the private sector, expanded by 6.7 percent during Jul-Mar FY13, compared to 1.8 percent during the same period last year (**Figure 3.9**).

Apart from the low base effect,¹⁶ the lower cost of borrowing appears to be a contributory factor. A modest expansion is visible in all three segments of credit to private businesses: working capital loans; fixed investment loans; and trade finance. Among these categories, the disbursement of working capital loans was much higher than fixed investment loans and trade finance (**Figure 3.10**).

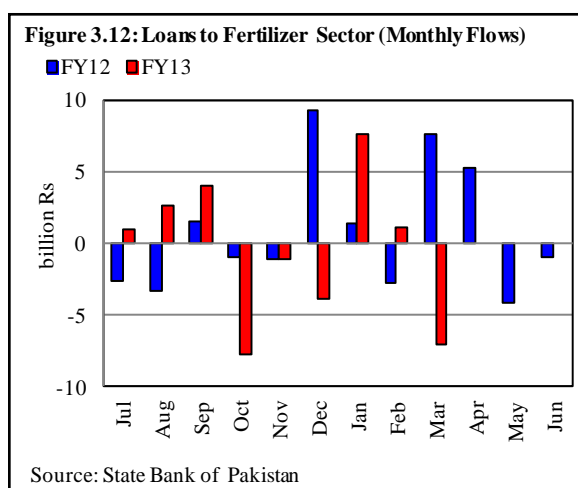
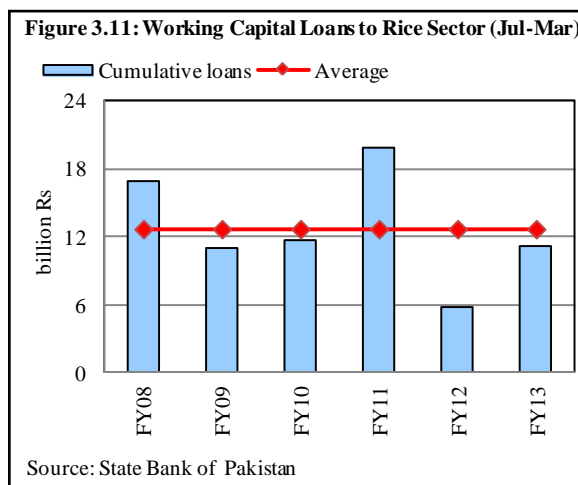
In absolute terms, *working capital loans* expanded by Rs 128.6 billion during Jul-Mar FY13, compared to only Rs 37.2 billion in Jul-Mar FY12. While the increase in working capital loans seems to be broad-based, some sector-specific developments should be highlighted.



¹⁵ Following revision in tax incentives, income (dividend) received from money market funds and income funds will be taxed at 25.0 percent in FY13 and 35.0 percent in FY14 (Finance Act 2012), compared to 10.0 percent up to FY12. Not to surprise, non-bank/corporate investments in government securities have seen a reduction of Rs 140.8 billion during Jul-Mar FY13.

¹⁶ Credit expansion to private sector was unusually low in FY12 on account of shifting loans of private sector to the government sector, and government's intervention in sugar and fertilizer sectors.

- Working capital loans to the *rice processing* industry increased by Rs 11.1 billion during Jul-Mar FY13 as compared to Rs 5.7 billion during the same period last year (**Figure 3.11**). This increase is largely attributed to the unusually low credit off-take last year (base effect),¹⁷ and some increase in rice exports this year.¹⁸
- Working capital loans to the *sugar industry* increased sharply this year. Increased sugar production in FY13;¹⁹ delays in payments by TCP to sugar mills; the export of sugar;²⁰ and a low base effect²¹ are the major reasons for the increase in working capital loans.



¹⁷ Last year's low credit disbursements to rice sector was exceptional as overall credit demand was low due to high interest rates, and banks were reluctant for lending to private sector due to credit quality concerns.

¹⁸ Rice exports reached Rs 135.3 billion during Jul-Mar FY13 compared to Rs 133.7 billion during same period last year.

¹⁹ A sugarcane production in FY12 was 58.0 million tons whereas it is reported to be 62.5 million tons this year.

²⁰ Sugar mills exported 575.4 thousand MT of sugar in Jul-Mar FY13 compared to 4.24 thousand MT for the same period last year.

²¹ The government actively intervened in the sugar sector in FY12. Specifically, the government purchased 4.8 million tons of sugar, which not only stabilized falling sugar prices in the market, but also helped in improving cash flows of the industry.

- There was also a significant rise in working capital loans to the textile sector. This can be explained by the increase in textile exports;²² and seasonal rise, associated with the sale of lawn prints.
- Working capital for the manufacturing of soft drinks and other beverages, also increased significantly. More specifically, one of the leading beverage companies borrowed substantially for the construction of three new bottling plants as a part of its plans to increase capacity.
- Working capital loans to the fertilizer sector decelerated during Jul-Mar FY13, compared to the same period last year. This was largely because of decline in production due to persisting gas shortages (**Figure 3.12**).^{23, 24}
- Electricity and gas companies utilized working capital loans of Rs 11.6 billion during Jul-Mar FY13 compared to a net retirement of Rs 7.8 billion last year (**Table 3.4**). This turnaround can be traced to the partial settlement of circular debt last year, which led to a reduction in the outstanding borrowing of power sector companies.²⁵

Fixed investment loans (loans of more than 1-year maturity) increased modestly during Jul-Mar FY13. This is encouraging as a number of industries are adjusting their business processes to take advantage of growing opportunities. Specifically, manufacturers of dairy products are investing to increase capacity, while one large food producing company has availed financing for increasing its dry milk production. Similarly, some sugar mills availed financing to achieve self sufficiency in power generation, using bagass and biomass for fuel.

In addition to the food sector, there are signs of capacity expansion in a number of industries, including plastic products, paper and board, and electrical machinery. A prominent firm in rubber/plastic sector has invested in a new polyester film

²² Textile exports reached US\$ 9.6 billion during Jul-Mar FY13 compared to US\$ 9.0 billion for the same period last year.

²³ However, there was a major increase in running finance in the month of January FY13. The most likely reason for this was the rise in the NP (nitro-phosphate) fertilizer stocks during that month, which tied up liquidity. NP is a substitute for urea and NP off-take usually rises if there is a shortage of urea. However, urea stocks have been more than adequate this Rabi season.

²⁴ However, following some improvement in gas supplies, fertilizer production has posted some growth since October 2012.

²⁵ Debt liabilities of Rs 93.4 billion were shifted from cash strapped private sector energy entities to PSEs (power holding company) in February FY12.

Table 3.4: Credit Flows (Jul-Mar)

billion Rupees

	Overall Loans		Trade Financing		Working Capital		Fixed Investment	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Business sector loans	42.9	165.2	-6.4	17.3	37.2	128.6	12.2	19.3
Manufacturing	65.0	145.5	-0.9	17.5	52.5	112.5	13.4	15.5
Food and beverages	22.8	60.4	8.0	10.5	10.5	40.1	4.3	9.8
Dairy products	0.4	4.9	0.8	0.5	-2.0	0.8	1.6	3.6
Sugar	8.8	39.9	3.2	2.9	4.8	30.6	0.8	6.5
Rice processing	7.5	15.1	1.7	3.5	5.7	11.1	0.2	0.5
Beverages	-1.4	1.8	-1.6	0.7	0.4	3.7	-0.2	-2.6
Soft drinks & other beverages	-0.5	1.6	-0.9	0.7	0.5	3.8	-0.2	-2.8
Textiles	16.4	74.9	-9.1	10.1	19.6	56.8	6.0	8.1
Spinning	15.8	34.0	-4.0	-2.9	17.5	35.4	2.3	1.5
Weaving	-0.3	10.7	2.1	3.5	-5.0	6.3	2.6	0.9
Finishing	0.9	11.8	-0.5	-0.8	1.1	7.5	0.2	5.1
Made-up textiles	-1.9	6.9	-4.8	2.8	1.9	4.3	1.0	-0.2
Fertilizers	8.8	-3.3	0.1	-2.8	6.2	3.5	2.5	-4.0
Rubber and plastic products	2.6	6.4	0.7	1.6	2.1	3.7	-0.3	1.1
Plastic products	2.8	6.2	0.7	1.7	2.1	3.6	-0.1	0.9
Electrical machinery & apparatus	-0.2	5.6	0.4	1.2	0.1	1.3	-0.7	3.0
Commerce and trade	-4.3	1.8	-2.8	-2.0	-3.5	-4.4	2.0	8.2
Other private business	-1.4	8.7	0.9	-0.2	-2.6	3.6	0.2	5.3

Source: State Bank of Pakistan

plant,²⁶ while the paper and board industry has invested heavily in alternate energy arrangements and capacity enhancement projects;²⁷ and one of the leading companies in electrical machinery is expanding its production capacity. Lastly, a number of textile (especially spinning) firms are enhancing production capacities to take advantage of the growing demand for yarn from China.

Table 3.5: Trade Financing during Jul-Mar (Cumulative Flows)

billion Rupees

	FY11	FY12	FY13
EFS	19.8	-0.1	13.8
Other than EFS	14.9	8.9	5.2
Imp. financing	30.2	-15.2	-1.7
Total	64.9	-6.4	17.3

Source: State Bank of Pakistan

²⁶ PET film is used for food packaging and in LCD/LED TV panels, solar panels and other industrial applications.

²⁷ Such as coal and furnace oil fueled plants.

Trade financing saw an expansion of Rs 17.3 billion during Jul-Mar FY13, in sharp contrast to a net retirement of Rs 6.4 billion during the same period last year. Within trade financing, EFS loans (concessional financing for exporters) increased by 13.8 billion, whereas *loans other than EFS* increased by 5.2 billion (**Table 3.5**).

Table 3.6: Consumer Financing during Jul-Mar (Cumulative Flows)
billion Rupees

	FY11	FY12	FY13
Consumer financing	-19.0	-9.7	8.1
For house building	-5.4	-5.2	-2.4
For transport	-10.6	-5.6	2.3
Credit cards	-3.4	-1.7	-1.9
Consumers durable	0.0	0.1	-0.1
Personal loans	0.4	2.7	10.2

Source: State Bank of Pakistan

The rice, sugar and textile sectors remained the major beneficiary of concessional lending (EFS) during Jul-Mar FY13. The cuts in the EFS rate by 250 bps, during the first half of the year, made EFS loans more attractive during the period under review.

Finally, *consumer financing* showed some signs of improvement during Jul-Mar FY13 (**Table 3.6**). Details indicate that the expansion is largely because of personal loans, since November 2012, due to the upward revision in the loan limit for employees of a large public sector bank.

3.3 Inflation

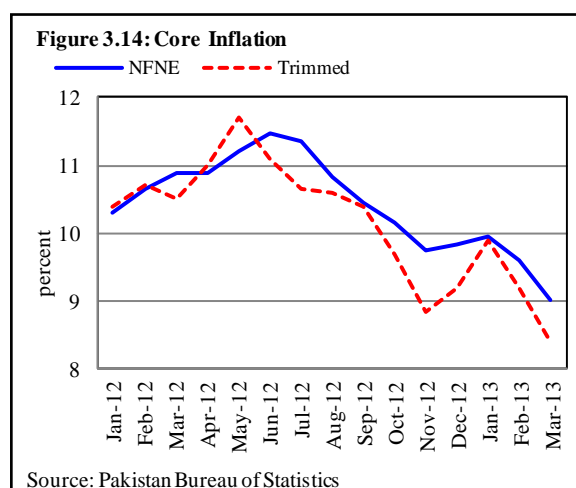
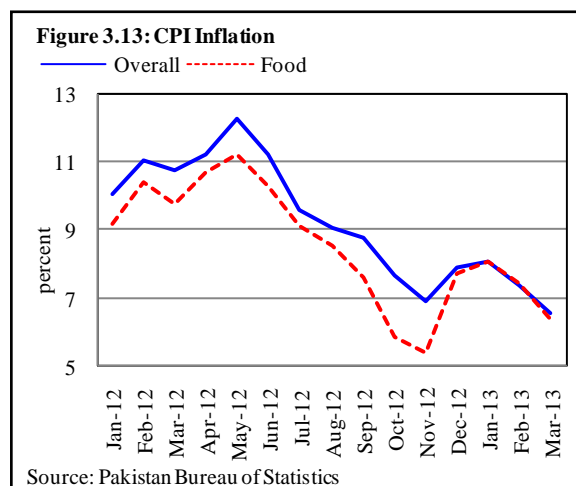
Headline inflation fell to 6.6 percent in March 2013 – the lowest in 45 months, since the new index was first computed (**Figure 3.13**).²⁸ With all measures of inflation, including core inflation (**Figure 3.14**), continuing their downward trend, the short-term outlook for inflation remains subdued.

Furthermore, the decline in inflation has been broad-based, with disinflation across the commodities of the CPI basket (**Figure 3.15**).

The reasons for the decline in inflation over the past two years were covered in the Second Quarterly Report for FY13; this report will focus on the factors that have recently impacted inflation, and the risks going forward.

Food prices

An important reason for the decline in inflation has been the stability in food prices over the last twelve months (**Figure 3.16**).²⁹ The two exceptions to this trend have been the prices of wheat and rice. Although the rise in international wheat prices in Q1-FY13, and the upward revision in wheat support prices in Q2-FY13 did lead to an increase in retail prices of wheat and its products up to the end of the third quarter, retail prices seem to have stabilized since. In fact, there has even been a slight reduction in wheat prices over the course of the third quarter.

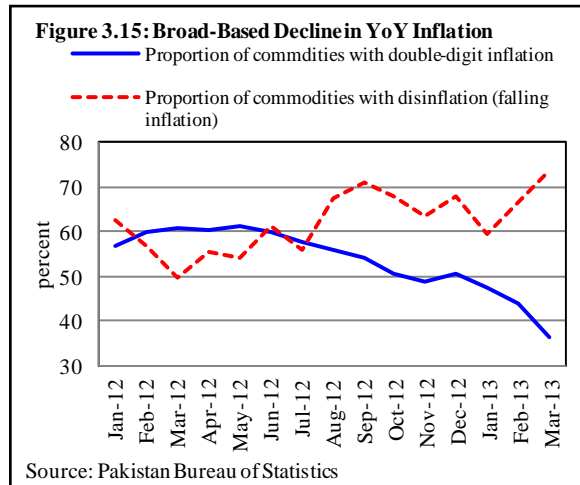


²⁸ The new index is calculated using 2007-08 as its base.

²⁹ Food and its associated subgroups constitute 37.5 percent of the CPI.

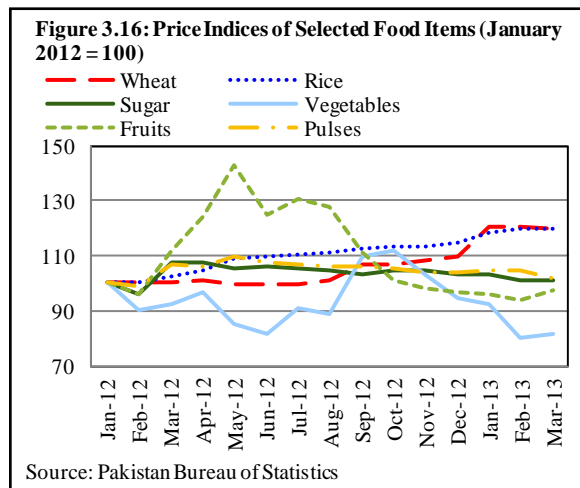
The increase in rice prices, on the other hand, has been largely because of higher prices in the international market, and the decline in domestic production. The price of other important food items have either remained stable or declined.

Since we expect the wheat harvest to more than satisfy domestic demand this year (adding to the current surplus of wheat in the country), wheat prices are expected to either decline or remain stable.³⁰ The only upside risk to food inflation, therefore, remains the price of rice. Overall, however, the outlook for food inflation, in the absence of any adverse supply shocks, is quite stable.



Energy prices

Within the broader domain of administered prices, energy prices have contributed most to the decline in inflation. Electricity tariffs were last revised in May 2012 and have been constant since then (Figure 3.17).³¹ Natural gas tariffs for households were halved in July 2012 and have not been revised upwards thereafter.³² Similarly, while fuel prices have fluctuated, they have hovered within a



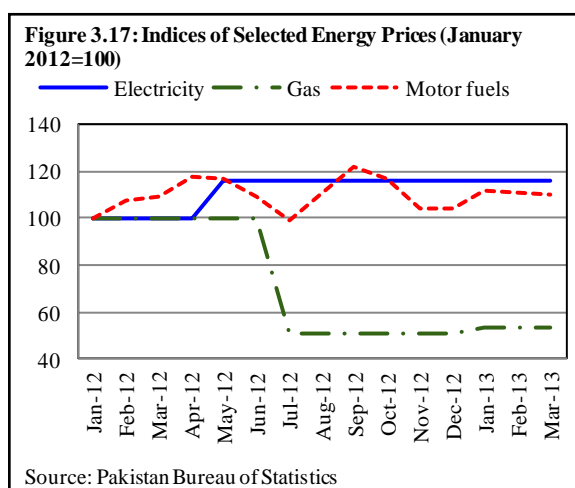
³⁰ Wheat stocks in the country totaled 2.5 million tons as of March 2013.

³¹ Tariffs were increased by 16 percent in May 2012 for households.

³² The price of piped gas to households was slashed by an average of 49 percent in July 2012

certain band in FY13.³³ These factors have capped inflationary pressures, and, in our opinion, also suppressed inflation expectations.

However, an upward revision in electricity tariffs is overdue. Gas prices will also cease to drag down inflation from July 2013 onwards, with a rise in tariffs of roughly 10 percent appearing likely. Fuel prices may also increase if the government chooses to increase the collection of the petroleum development levy – a surcharge imposed on transport fuels – in order to manage its deficit. While energy prices have played a



large part in subduing inflation so far in FY13 (and will do so for the remainder of the year), they are unlikely to continue to dampen inflation going forward.

The external front

The absence of any external shocks in FY13 so far (e.g. a sharp depreciation of the Rupee or a sudden increase in the international price of oil) has also helped contain inflation. The depreciation of the rupee has been gradual so far and global commodity prices have remained stable. The only two commodities, whose prices have been inching upward in the global market in Q3-FY13, have been cotton and rice. The impact of these increases has been transmitted to domestic wholesale and retail prices, but is unlikely to spill over into the rest of the CPI. Given the subdued global economic climate, the outlook for most commodities prices is either stable or pessimistic. Therefore, the risks from any sudden movements in international prices are modest at best. The greater risk to inflation stems from any deterioration in the balance of payments position and the resultant depreciation, and can substantially affect the outlook for inflation.

Outlook

An adverse external shock seems unlikely at this point, and, therefore, the upside risks to inflation for the remainder of FY13 are minimal. Average inflation for the

³³ Petrol and diesel constitute roughly three-fourths of this index, while CNG makes up for almost another quarter.

year will fall comfortably below the government's target of 9.5 percent. However, the revision of energy tariffs is inevitable and poses the greatest risk to inflation beyond FY13. The risk of acceleration in reserve money growth (as a result of greater central banking financing for the fiscal deficit) is another concern for medium-term inflation. However, a return to double-digit headline inflation is also unlikely without a sharp deterioration on the external front, or a sudden disruption in food supplies.

Special Section 3.1: Macroeconomic Dynamics with a Dominant Borrower (Government).³⁴

The State Bank of Pakistan has been grappling with a difficult trade-off in the past several years. With an insatiable government appetite for credit, how does the central bank contain the *quantum* of inflationary finance and yet ensure the private sector is able to secure *adequate* credit from commercial banks?³⁵ This is all the more important as the domestic banking system is the last avenue for government borrowing, and Pakistan has been in this position for the past couple of years.

The policy outcome so far is not heartening: (1) despite a 450 bps cut in the Discount Rate over the past 20 months, net private sector lending remains anemic; (2) spreads in the banking system remain high; (3) SBP financing of the fiscal deficit has increased sharply since Q3-FY13; and (4) the balance sheets of commercial banks continue to skew in favor of government paper.

Choudhary, Pasha, et., al. [2013] have customized a general equilibrium framework (using a Dynamic Stochastic General Equilibrium, DSGE model) that tries to capture the unique set of circumstances that currently exist in Pakistan. The main features they sought to incorporate in their model are:

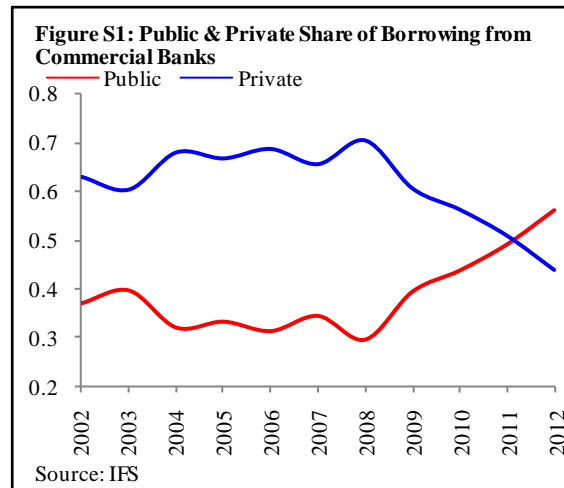
1. A dominant borrower (government) whose appetite for credit is growing as it has limited avenues for raising taxes, which means it would become interest rate insensitive;
2. A central bank that is constrained in how much credit (*money creation*) it can provide to the government;
3. The fact that countries with under-developed financial systems, give the government few alternatives but to borrow from domestic banks (and the central bank); and
4. How endogenously determined banking spreads would behave in such a system.

³⁴ This is an assessment by Dr Mushtaq Khan, of an unpublished manuscript by Choudhary, A., Pasha, F., Khan, etc. [2013] titled: *Dominant Borrower and Endogenous Spreads: The Need to Avoid Corner Solutions*.

³⁵ We dismiss the suggestion that an independent central bank can (and should) impose a hard ceiling on government borrowing to be implemented by bouncing Federal Government cheques (if required). In our view, no central bank may want to take such a course of action, as this would not only seize up the money and FX markets, but could easily trigger a full-blown banking crisis.

Some of these features were empirically tested on various developed and developing countries, using the IMF as the primary source of data. The Financial Development Rankings developed by the World Economic Forum [2012] were also used.³⁶

Figure S1 shows commercial banks increasingly lending to the government (the Dominant Borrower)³⁷, with the *public share* (the fraction of government borrowing in total *commercial bank* lending) in Pakistan rising consistently since 2008.³⁸



The correlation between interest rates spreads and the level of financial development is shown in **Figure S2**.³⁹ This positive correlation is to be expected, as a more developed financial system (a lower ranking) has more players than

³⁶ There are several refinements to this model that are being developed. The most promising is modeling a fiscal shock that necessitates further government borrowing, which creates a fiscal feed-through to subsequent debt servicing, and the stock of domestic debt. This will increase subsequent borrowing by the government, which is made easier as commercial banks become increasingly risk averse in a recessionary environment. In a dynamic setting, the expected equilibrium is likely to be *suboptimal*, in that the system approaches an extreme outcome. In other words, if left alone, this dynamic model (shocked by a fiscal event) shows that banks would eventually only lend to the government and economic growth would fall to levels where private investment is only self-funded. A policy response can also be modeled, whereby the central bank responds to the fiscal shock by increasing interest rates (say in response to the increase in the fiscal deficit or likely inflation). If this happens, the model shows that the adverse outcome would be realized much earlier, while an effort to reduce interest rates would buy the country more time.

³⁷ Public borrowing from commercial banks in **Figure S1**, consists of claims of commercial banks on central, provincial and local governments; public sector enterprises and other FIs. Private borrowing from commercial banks consists of commercial bank claims on the private sector.

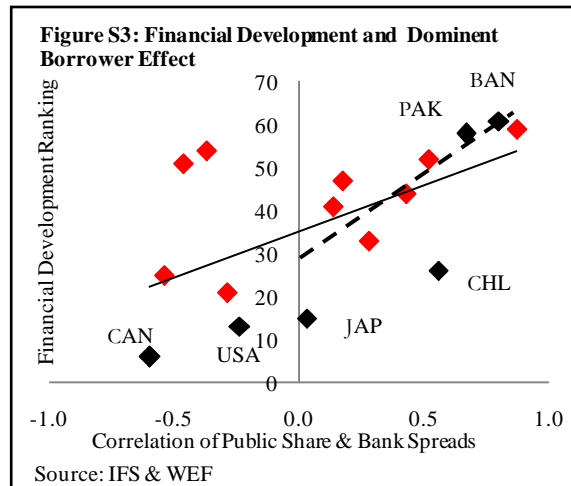
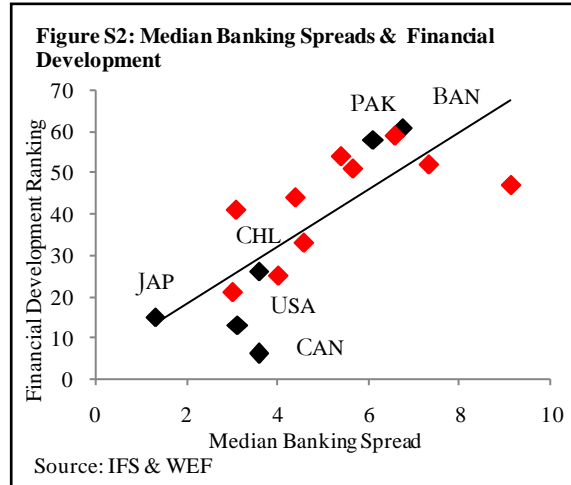
³⁸ However, Pakistan's banking system is not the largest financier to the government: countries like Mexico, Brazil, Japan and even the US have a higher public share compared to Pakistan. This is not just because these governments borrow too much (which they do), but also the fact that commercial banks are not the main source of private sector investment credit and government borrowing.

³⁹ The authors use the universal definition of interest rate spreads, meaning the difference between average lending and deposit rates. The financial development rankings put forward by the World Economic Forum can be found in the following website:
http://www3.weforum.org/docs/WEF_FinancialDevelopmentReport_2012.pdf

commercial banks, which creates a degree of financial competition that keeps spreads low.

In trying to determine whether there is a link between the share of government borrowing and interest rate spreads, Choudhary et. al., computed the correlation between the *public share* and *banking spreads* (Figure S3). The first thing to realize is there is no *causality* or universal correlation between the share of government borrowing and spreads: most developed countries show no correlation, while most developing countries post a positive relationship. The authors interpret this as implying that in developed countries, the efficiency of financial markets is such that spreads are low, and even if their respective governments are large borrowers, they are able to secure financing from *other* sources without putting upward pressure on domestic banking spreads.

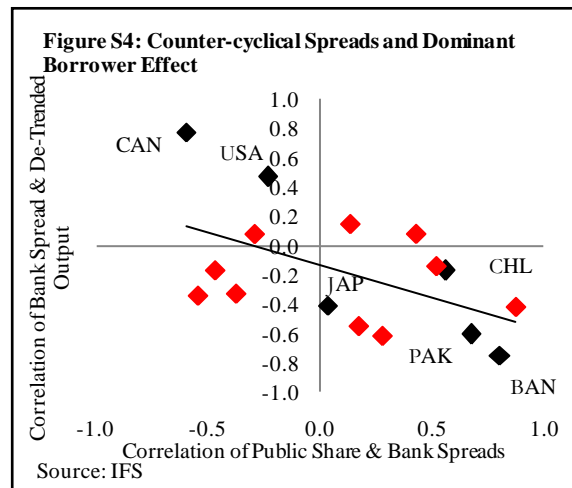
For developing countries, on the other hand, if the government is a big borrower, and the options for alternate financing are severely limited, not only is the correlation between the public share and spreads positive, but the positive slope (Figure S3) suggests correlation becomes stronger when the financial system is under-developed. In



simple terms, the association of a Dominant Borrower and high spreads, is stronger when the financial system is relatively under-developed (this assumes no policy intervention).⁴⁰

Taking this a step further, as interest rate spreads increase (with an increasingly dominant borrower), not only is the government crowding-out the private sector, but by pulling growth below its potential, it increases credit risk in private sector lending, which incentivizes commercial banks to place *even more* credit with the government, creating a vicious spiral. This crowding-out has implications for unemployment; tax collection; documentation; policy effectiveness; private investment; per-capita GDP; and many social welfare indicators.

Figure S4 reveals another insightful dimension of their analysis. The negative slope basically means that in countries with a Dominant Borrower and high banking spreads, the adverse counter-cyclical impact on economic activity is *more* severe. In other words, large banking spreads are more damaging – in terms of keeping GDP growth well below the country’s potential – in those countries with an under-developed financing system and a Dominant Borrower.



Conclusion

As in all academic research that seeks cross-country validation, there are many country-specific details that have not been addressed. Furthermore, it is very important to stress that this analysis highlights *correlation* and not *causation*. One must also realize that interest rate spreads are determined by a host of factors; not just the demand for credit from an interest rate insensitive government.

⁴⁰ It is critical to realize that model dynamics do not reflect reality because of policy interventions. In a country like Pakistan, policy intervention cannot be ruled out, which means the dynamics shown by the model are not reflected in reality. For example, even though GoP has been borrowing quite a lot in the past 18 months, SBP was able to bring down interest rates (during this period) by injecting substantial volumes of liquidity into the system to support its monetary policy stance.

However, the analysis does provide a powerful counterpoint to orthodox economic thinking. It shows that customized analysis is better able to explain why traditional tools of economic management have failed – not just in Pakistan, but also in the OECD. It flags the need to be cautious when dealing with a large borrower, who is increasingly dominating the balance sheet of commercial banks. It also forces us to revisit the twin-mandate of most central banks (price stability and sustainable growth), which could explain why the US Fed; The Bank of England; and the Bank of Japan, have undertaken such an abrupt change in strategy to focus on growth and employment, even at the cost of higher inflation.

Looking specifically at Pakistan, the paper suggests that in an environment where private banks face a Dominant Borrower (who is increasingly attractive), the situation will require some policy intervention to avoid an adverse outcome.⁴¹ This is not just for the overall health of the country's economy, but also to ensure the balance sheets of commercial banks are healthy enough to withstand unanticipated shocks.

⁴¹ Price signals often fail in structurally distorted economies. One must realize that a desperate borrower does not respond to price signals; this is especially the case with addictive goods/services. In other words, while increasing interest rates is sufficient to deter an individual from borrowing more, in the case of a government with a short-term horizon, the rising cost of credit will not deter fresh borrowing, but only increase the government's indebtedness and squeeze the fiscal accounts further (Debt Trap). In this situation, the most effective way to exit the Debt Trap is to impose binding ceiling on the size of the fiscal deficit, and ensure that interest rates are not allowed to increase further.