



# State Bank of Pakistan's (SBP) Performance in Recent Years By Dr. Hafiz A. Pasha

## DISCLAIMER

This report is prepared by Dr. Hafiz A. Pasha, and opinions, views, estimates and forecasts given in this report, are of Dr. Hafiz A. Pasha. Views, opinions, economic forecasts and future assumptions of Next Capital Research may differ from those that are present in this report. Next Capital therefore, accepts no liability for any of the content of this report. The purpose of this report is to apprise investors of the capital markets of Pakistan, about economic developments and progress of the country through independent views of a well-known and reputed economist, in order to facilitate their top-down investment decision making process. The author is a professor and a former Federal Minister.

# SBP's Performance in recent years

## Pakistan Economy

June 6, 2022

### Pakistan Economy

The State Bank of Pakistan (SBP) is the central bank with the responsibility of conducting monetary policy in the country. According to Section 4B of the SBP Act of 1956 the primary objective of the Bank shall be to achieve and maintain domestic price stability.

The 1956 Act says that without prejudice to the Bank's primary objective, the Bank will contribute to the stability of the financial system of Pakistan. The Bank shall also support the Government's general economic policies so as to foster the development and fuller utilization of Pakistan's productive resources.

According to the Act the key functions shall be to:

- Determine and implement monetary policy.
- Formulate and implement the exchange rate policy.
- Hold and management of international reserves of Pakistan.
- Issue and manage the currency of Pakistan.
- License, regulate and supervise scheduled banks.

In early 2022, the new SBP amendment Act has been promulgated with greater autonomy and exclusive focus on price stability. The objective of this special report is to assess the performance of the SBP since 2018, after the induction of the PTI government.

This special report has the following sections. Section 1 describes the state of the economy in 2017-18 prior to the induction of the PTI Government. Section 2 highlights the financial stabilization policies adopted by the SBP in 2018-19. Section 3 then describes the continuing search for financial stability. Section 4 highlights the positive role played by the SBP in the aftermath of COVID-19 attack. Section 5 quantifies the macroeconomic impact of monetary policy since 2018-19. Section 6 discusses inflation outlook of the Monetary Policy Committee. Finally, Section 7 focuses on the incipient financial crisis that Pakistan faces today, and the role being played by the newly autonomous SBP along with other complementary actions that are required on a priority basis to avert a full-fledged crisis.

### 1. State of the Economy in 2017-18

The key macroeconomic magnitudes in 2017-18 are given below in Table 1, in the year prior to the induction of the PTI Government.

**Table 1: State of the Economy in 2017-18**

<b>1. GDP* Growth Rate (%)</b>	<b>5.5</b>	<b>4. Balance of Payments (\$ billion)</b>	
<b>By Sector</b>		<b>Current Account</b>	<b>-19.2</b>
Agriculture	4.0	Exports of goods	24.8
Industry	4.5	Imports of goods	-55.7
Services	6.3	<b>Trade deficit</b>	<b>-30.9</b>
<b>By expenditure</b>		<b>Financial Account</b>	<b>13.6</b>
Household consumption expenditure	6.2	<b>Others</b>	<b>-1.1</b>
Private Investment	4.4	<b>Balance of Payments</b>	<b>-6.7</b>
Public Investment	28.3	<b>Level of Reserves</b>	<b>9.8</b>
Exports of goods and services	12.6	<b>(Months of import cover)</b>	<b>-1.6</b>
Imports of goods and services	17.7	<b>5. Public Finances (% of GDP)</b>	
<b>2. Rate of Inflation (%)</b>		<b>Revenues</b>	<b>15.2</b>
Consumer Price Index	3.9	Tax Revenues	13.0
'Core' Inflation	5.9	Non-Tax Revenues	2.2
<b>3. Monetary Statistics</b>		<b>Expenditure</b>	<b>21.8</b>
SBP Policy Rate (%) **	6.5	Current Expenditure	17.0
Exchange Rate (Rs/\$) **	118.9	Development Expenditure	4.8
Real Effective Exchange Rate	107.5	<b>Budget deficit</b>	<b>-6.6</b>
(2010 = 100) Index		Primary deficit	-2.0

Source: PES | SBP | MOF

\*With base year of 2005-06 \*\* End of year

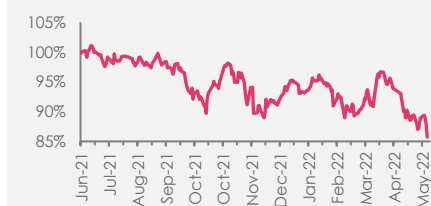
The economy exhibited some strong features in 2017-18. The GDP growth rate had risen to 5.5 percent, the highest after 2006-07. All economic sectors were showing buoyancy. The rate of inflation was very low at 3.9 percent, with food prices rising by only 2.8 percent. Total investment was buoyant, especially public investment due to the peak of investment in power generation.

### Key Data

KSE100 Index	41,315
KSE-All Share Value (PKRmn)	5,989
KSE-All Share Value (USDmn)	30.1
KSE-All Share Volume (Shmn)	225.4
Market Capitalization (PKRtn)	6.9
Market Capitalization (USDmn)	35.0
1 Year High	48,726
1 Year Low	41,315

Source: PSX, Next Research

### 1 Year KSE100 Index Performance



Source: PSX, Next Research

The SBP policy rate was relatively low at 6.5 percent in end-June 2018, close to the core rate of inflation. The exchange rate was Rs 118.90 per dollar, with a depreciation of 13 percent over the year. The currency was overvalued by 7.5 percent according to the real effective exchange rate.

The real concern was the sustainability of the growth process. The current account deficit in the balance of payments had reached the all-time peak level of \$19.2 billion, equivalent to 6.4 percent of the GDP. This was due to a 16 percent growth in imports of goods and services as compared to a 12 percent growth in exports. Foreign exchange reserves which stood at \$17.6 billion at the end of 2016-17, were down to \$9.8 billion, equivalent to under two months of imports.

The state of public finances had also worsened. The budget deficit had reached 6.6 percent of the GDP as compared to 5.8 percent of the GDP in 2016-17, due largely to a rise in current expenditure. The Government debt to GDP ratio had risen to 66.9 percent of the GDP. This represented a major violation of the ceiling on the ratio at 60 percent of the GDP, imposed by the Fiscal Responsibility and Debt Limitation act of 2005.

## 2. SBP Policies for Stabilizing the Balance of Payments

The low reserves position at the end of 2017-18 prompted the SBP to pursue an aggressive monetary policy in 2018-19 to reduce the current account deficit, generate a surplus in the balance of payments and thereby build-up reserves once again.

Table 2 shows the monthly movement in the two instruments of monetary policy, namely the policy rate and the exchange rate, in 2018-19. The cumulative magnitude of the moves was very large. They led to depreciation in the rupee by almost 31 percent and a rise in the SBP policy rate by as much as 575 basis points.

**Table 2: Monthly policy rate and exchange rate, 2018-19 (%)**

POLICY RATE (%)		EXCHANGE RATE (Rs / \$)	
28th May 2018	6.50	Jun-18	118.90
<b>2018-19</b>		<b>2018-19</b>	
16th July 2018	7.50	July	124.35
1st October 2018	8.50	August	123.78
3rd December 2018	10.00	September	124.08
1st February 2019	10.25	October	130.38
1st April 2019	10.75	December	138.47
21st May 2019	12.25	January	138.69
<b>Cumulative Change</b>	<b>5.75</b>	February	138.53
Average	9.12	March	139.17
		April	141.16
		May	145.69
		June	155.24
		<b>Cumulative Change</b>	<b>30.60%</b>

Source: SBP

The basic question is what impact did these moves have on the balance of payments in 2018-19? A comparison is made of 2018-19 figures with 2017-18 in Table 3.

**Table 3: Balance of Payments, 2017-18 and 2018-19 (\$ billion)**

	2017-18	2018-19	Growth Rate (%)
<b>1. Current Account Deficit</b>	<b>-19.2</b>	<b>-13.4</b>	<b>-30.3</b>
Trade Balance	-30.9	-27.6	-10.7
Exports	24.8	24.2	-2.4
Imports	55.7	51.9	-6.8
Remittances	19.9	21.7	9.0
<b>2. Financial Account</b>	<b>13.6</b>	<b>11.7</b>	<b>-13.9</b>
Direct Investment	2.8	1.4	-50.0
Portfolio Investment	2.3	-1.3	-156.5
Government Inflow	4.4	2.2	-50.0
Disbursements	8.5	8.2	-3.5
Amortization	4.1	6.0	46.3
Central Bank Inflow	1.5	5.5	α*
Others	2.6	3.9	50.0
<b>3. Others</b>	<b>-0.5</b>	<b>-1.2</b>	<b>α*</b>
4. Balance of Payments	-6.1	-2.9	-52.5
5. Foreign Exchange Reserves	9.8	7.3	-25.5

\* α means very large

Source: SBP

The outcome was not as positive as was hoped. Despite the big moves, imports fell by less than 7 percent. Overall, the trade balance improved by less than 11 percent because exports declined despite the much better exchange rate offered to exporters.

The big surprise was the significant worsening of inflows into the financial account. The low reserves at the start of 2018-19 plus the big monetary policy moves heightened negative perceptions about Pakistan. There was a big outflow of equity funds from Pakistan and foreign direct investment fell by 50 percent. The inflow also into the Government account was half the level of 2017-18.

The only positive development was large bilateral flows of deposits into the SBP from friendly countries like China, Saudi Arabia and the UAE adding up to \$5.5 billion. However, the overall balance of payments remained in deficit in 2018-19 and reserves fell to the critically low level of \$7.3 billion, enough to provide import cover for only 1.2 months. Pakistan was left with no option but to go to the IMF.

In retrospect, the delay of over a year in going to the IMF for a three-year extended fund facility can be considered as a mistake. If there had been an umbrella of a Fund program in 2018-19 the flows into the financial account would have been larger. Also, the almost draconian increase in the policy rate and big depreciation of the rupee may not have been necessary.

### 3. The Continuing search for financial stability

Pakistan entered a three-year Extended Fund Facility with the IMF in July 2019 of \$6 billion. The macroeconomic projections made at that time in the Program for the period 2019-20 to 2021-22 are given in Table 4.

**Table 4: Macroeconomic Projections in the IMF Program for Pakistan 2019-20 to 2020-21 (Made on July-19)**

	2019-20	Projections 2020-21	2021-22
GDP Growth Rate	2.4	3.0	4.5
Rate of Inflation	13.0	8.3	6.0
<b>Balance of Payments</b>			
<b>Current Account</b>	<b>-6.7</b>	<b>-5.5</b>	<b>-5.3</b>
Financial Account	8.7	7.9	8.6
Others	0.7	0.6	0.6
Balance of Payments	2.7	3.0	3.9
IMF	1.6	0.2	0.6
<b>Change in Reserves</b>	<b>4.3</b>	<b>3.2</b>	<b>4.5</b>
End period Reserves	11.6	14.8	19.3

Source: IMF Staff Report, July 2019

Therefore, the Program projected a gradual acceleration in the GDP growth rate and decline in the rate of inflation. A reduction of 50 percent was targeted for in the current account deficit in 2019-20 with further reductions in the next two years. Consequently, the foreign exchange reserves were expected to rise from \$7.3 billion in 2018-19 to \$11.6 billion in 2019-20 and reach \$19.3 billion by the end of 2021-22.

The SBP was expected to pursue an aggressive monetary policy with, more or less, a market determined exchange rate and use of the policy rate to limit aggregate demand. The focus was on achieving sustained financial stability of the economy.

The actual moves that have taken place since June 2019 up to May 2022 are listed below in Table 5.

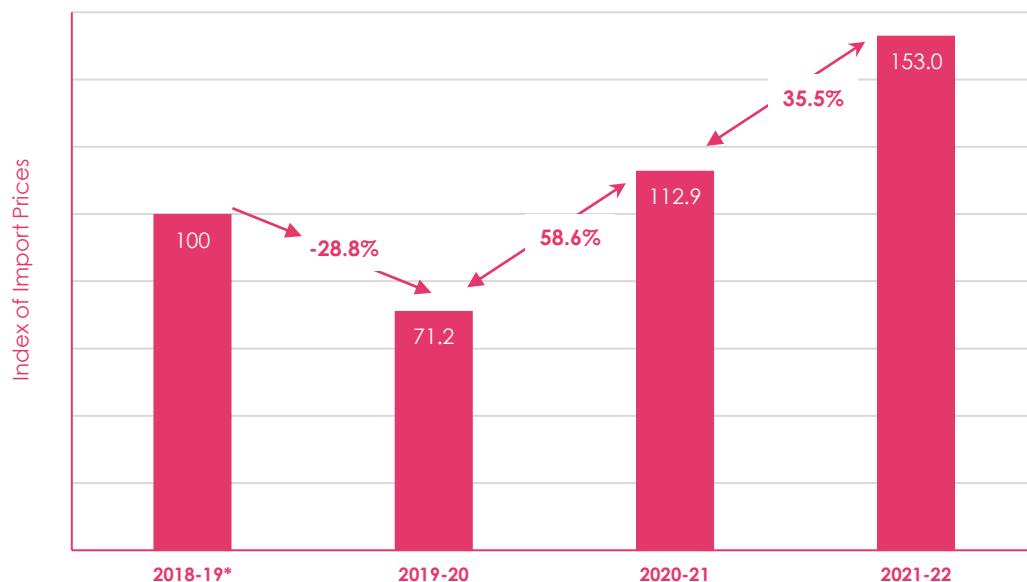
**Table 5: Monthly policy rate and exchange rate June 2019 to May 2022 (%)**

POLICY RATE (%)		EXCHANGE RATE (Rs / \$) (End of month)	
<b>Jun-19</b>	<b>12.25</b>	<b>Jun-19</b>	<b>155.25</b>
17th July 2019	13.25	Jul-19	158.18
18th March 2020	12.50	Sep-19	156.18
25th March 2020	11.00	Dec-19	154.92
17th April 2020	9.00	Mar-20	158.45
18th May 2020	8.00	Jun-20	165.10
26th June 2020	7.00	Sep-20	165.85
21st September 2021	7.25	Dec-20	160.07
22nd November 2021	8.75	Mar-21	156.03
15th December 2021	9.75	Jun-21	156.16
8th April 2022	12.25	Sep-21	168.06
23rd May 2022	13.75	Dec-21	177.17
		Mar-22	184.18
		23rd May 2022	200.93

Source: SBP

The economic environment altered fundamentally in Pakistan after the country was hit by the pandemic, COVID-19, in March 2020. There was a big slowdown in economic activity. The world economy went into deep recession and international commodity prices plummeted. Pakistan's imports became cheaper because of this fall in global prices, as shown in Chart 1.

**Figure 1: Index of Import Prices faced by Pakistan (in \$)**



\*As of June, each year, except in April of 2021-22  
Source: Estimated from PBS imports data.

The overall unit value index of imports in US\$ fell by as much as 28.8 percent in 2019-20.

The balance of payments position improved substantially. Imports fell by 16 percent in 2019-20 and the current account deficit declined by as much as 68 percent from \$13.4 billion in 2018-19 to \$4.4 billion in 2019-20. This was significantly better than the IMF Program target of \$6.7 billion.

Reserves also rose by \$4.6 billion, close to the Program target. However, the inflow into the financial account was smaller than in 2018-19. This was due to the flight of 'hot money' of \$3 billion which had come into Pakistan when interest rates were at their peak, with the policy rate at 13.25 percent. Following COVID-19, the precipitous drop-in interest rates led to the exit of this money.

The IMF program was suspended because of the economic dislocation caused by COVID-19. A special loan was given to Pakistan in June 2020 by the IMF under the Rapid Finance Facility of \$1.4 billion. The program was restored in late 2021 and the sixth review was successfully completed in February 2022. Pakistan also received a special SDR allocation of \$2.8 billion in August 2021.

Despite the rise in import prices in 2020-21, the current account deficit fell to a very low level of \$2.8 billion as shown in Table 6-2. This was achieved by a 14 percent jump in exports and 28 percent rise in home remittances. Reserves rose by the end of the year to the peak level of \$17.3 billion.

**Table 6-1: Current Account and Trade Deficit, 2018-19 to 2021-22, April (\$ billion)**

	2018-19	2019-20	g (%)	2020-21	g (%)	2020-21	July – April 2021-22	g (%)
Current Account Deficit	-13.4	-4.4	-67.8	-2.8	-36.4	-0.5	-13.8	α
Trade Deficit	-27.6	-21.1	-23.6	-28.6	35.5	-22.0	-32.9	49.5
Exports	24.3	22.5	-7.4	25.6	13.8	21.0	26.8	27.6
Imports	51.9	43.6	-16.0	54.2	24.3	43.0	59.8	39.1
Home Remittances	21.7	23.1	6.4	29.5	27.7	24.3	26.1	7.4
Others	-7.5	-6.4	-14.7	-3.7	-42.2	-2.8	-7.0	α

**Table 6-2: Summary of the Balance of Payments (\$ billion)**

	2018-19	2019-20	2020-21	July – April	
				2020-21	2021-22
Current Account	-13.4	-4.4	-2.8	-0.5	-13.8
Financial Account	11.8	9.3	8.8	4.5	8.3
Others	0.1	0.4	-0.5	-0.4	-0.3
Balance of Payments	-1.5	5.3	5.5	3.6	-5.8
IMF	-0.4	-0.7	-1.1	-0.8	-0.8
Change in Reserves	-1.9	4.6	4.4	2.8	-6.6
SBP Reserves* (end of April)	7.3	12.1	17.3	15.6	10.2

Source: IMF Staff Report, July 2019

\* Inclusive of other adjustments and flows by SBP

#### 4. SBPs Role after COVID-19

There is need to fully recognize the extraordinary supporting role played by the SBP in the process of revival of economic activity after the COVID-19 attack.

The first step taken, as shown in Table 5, was a quantum reduction in the policy rate from 13.25 percent, which was set on 17th July 2019, to 7 percent by 26th of June 2020.

A scheme for facilitating new investment was introduced called the **Temporary Economic Finance Facility (TERF)**. This was a concessionary refinance facility. The maximum limit was Rs 5 billion per project, with a 5 percent interest rate, payable in 10 years with a grace period up to 2 years. Between April 20 and March 21, Rs 436 billion was advanced as loans for 628 projects.

The second scheme was the **loan extension and restructuring package**, which was essentially a debt relief scheme. The objective of the scheme was to preserve the solvency of borrowers at a difficult time. Accordingly, payment of the loan principal amount could be deferred for up to twelve months, while continuing servicing of the markup. Over 1.8 million borrowers have benefited from this scheme and the total loan amount deferred is Rs 910 billion, with Rs 121 billion to micro finance borrowers.

The third scheme was the **SBP-Rozgar Scheme**. The objective was to prevent lay-off of workers by financing wages and salaries of employees of private sector units. The scheme was to cover the wage bill for 6 months, with the maximum loan limit of Rs 2 billion. Repayment was to be made in 8 equal quarterly installments. The amount disbursed under this facility is Rs 212 billion.

Pakistan is considered as one of the countries which has managed well the post-COVID-19 economic recovery process. A major contribution to this effort was by the SBP.

There has also been a spate of useful government innovations by the SBP in recent times. These include the Roshan Digital Account to connect overseas Pakistanis with local banks. Almost \$4.2 billion of funds have been raised in this account. Recently the Raast instant and free payment system has been set up and the SBP is in the process of finalizing the *Digital Banking system*.

#### 5. Macroeconomic Impact of Monetary Policy

The primary objective of the monetary policy has been to achieve financial stability especially by the augmentation of foreign exchange reserves and thereby to restrict the depreciation of the exchange rate and limit the rate of inflation.

The BNU Macroeconomic Model has been used to quantify the impact of a 1-percentage point increase in the policy rate and 1 percent depreciation of the rupee respectively on macroeconomic variables like GDP growth and the rate of inflation.

A 1 percentage point increase in the policy rate leading to a corresponding rise in interest rates in the secondary market and on advances and deposits, reduces private investment and promotes savings. It impacts on aggregate demand and reduces the GDP growth rate and the rate of inflation.

However, it also raises the cost of debt servicing on government loans and thereby leads to a larger deficit, which implies higher domestic borrowing and more rapid expansion in money supply and thereby to inflation. As such, the net impact of a hike in the policy rate on the rate of inflation is ambiguous.

A 1 percent depreciation of these exchange rate reduces private investment by raising the cost of imported machinery. On the positive side it reduces somewhat the trade deficit. Clearly, it adds to inflation by raising the price of imported consumer goods. However, it raises import-based tax revenues but increases the cost of servicing external debt.

The magnitudes of the impacts are given in Table 7.

**Table 7: Impact of Changes in the Policy Rate and the Exchange Rate on Macroeconomic Variables Impact \* (% change)**

	Policy Rate up by 1 percentage point	Exchange Rate Depreciation by 1 percent
Rate of Inflation	-0.25	0.17
GDP Growth Rate	-0.31	-0.06
Budget Deficit	4.10	-0.10

\*The impact coefficients have been derived by simulations of the BNU Macroeconomic Model.

Given the actual changes in the policy rate and exchange rate each year from 2018-19 to 2021-22 (projected) and the above coefficients the overall impact of monetary policy has been derived on GDP growth rate and the rate of inflation and the budget deficit in Table 8.

**Table 8: Estimated Impact on Macroeconomic Variables of Monetary Policy 2018-19 to 2021-22 (Combined Impact of Changes in Policy Rate and Exchange Rate) (%)**

	GDP Growth Rate		Rate of Inflation	
	Actual	Impact	Actual	Impact
2018-19	2.1	-2.2	6.8	2.8
2019-20	-0.5	-1.8	10.7	1.9
2020-21	3.9	1.5	8.9	-1.8
2021-22*	4 -4.5**	-1.4	11.0	1.6

\*Up to April 2022 - \*\*Preliminary estimate by IMF/World Bank

It may be observed that the size of the impacts is relatively large. The process of financial stabilization, especially of the external balance of payments, since 2018-19 has implied a significant reduction in the GDP growth rate and a higher rate of inflation. However, the year 2020-21 is an exception, when monetary policy played a major role in helping the economic revival process after COVID-19.

Given that the primary objective of the SBP is to maintain price stability, the BNU Macroeconomic Model has also been used to determine the quantitative contribution of different factors to inflation annually in Pakistan from 2017-18 to 2021-22. The estimates are presented in Table 9.

**Table 9: Magnitude of Contribution of Different Factors to Inflation in Pakistan 2017-18 to 2021-22 (%)**

	Rate of Inflation	Net Monetary Expansion*	Contribution by		Residual	Total
			Imported Inflation**	Inflationary Expectations***		
2017-18	3.9	18.7	46.2	36.3	-1.2	100.0
2018-19	6.8	33.5	37.6	19.3	9.6	100.0
2019-20	10.7	86.9	3.8	21.3	-12.0	100.0
2020-21	8.9	57.4	13.8	40.3	-11.5	100.0
2021-22	11.0	34.5	39.1	26.2	0.2	100.0

\*Net Monetary Expansion = Growth of Money Supply (M2), lagged by one-year minus GDP growth rate

\*\*Imported Inflation = Growth Rate of Import Prices (in \$) + Extent of Depreciation of the Rupee

\*\*\*Inflationary Expectations measured by the rate of inflation lagged by one year.

The results lead to the following conclusions:

- I. Rapid rate of monetary expansion is the largest factor responsible for the upsurge of inflation in 2019-20 and a high rate of inflation in 2020-21. The growth in M2 was as high as 18 percent in 2019-20 and over 16 percent in 2020-21, as compared to an annual average rate of increase from 2015-16 to 2017-18 of less than 13 percent.
- II. The rate of increase in rupee prices of imports, due to jump in dollar prices and devaluation of the rupee, is the largest contributor to inflation in 2017-18, 2018-19 and likely in 2021-22. For example, the import prices in 2021-22 are likely to increase by over 50 percent in 2021-22. However, the contribution is also large in the earlier years.

Therefore, the relatively high rates of inflation in 2019-20 and 2020-21 reflect the inability of the SBP to restrict the growth in money supply.

The above analysis has highlighted the impact of monetary policy on the headline rate of inflation. The question is the impact on the 'core' rate of inflation, which excludes food and fuel prices. The 'core' rate of inflation consists more of goods and of services which are non-tradeable and less vulnerable to imported inflation.

**Table 10: Annual 'Core' Rate of Inflation and Rate of Change in Causative Factors (%)**

	'Core' Rate of Inflation	Food & Energy Inflation	Headline Inflation	Rate of Monetary Expansion	GDP Growth Rate**
2017-18	5.9	3.4	4.7	9.7	5.5
2018-19	7.0	6.6	6.8	11.3	2.1
2019-20	8.2	13.5	10.7	17.5	-0.5
2020-21	7.0	11.0	8.9	16.2	3.9
2021-22 (Up to May)	8.0	15.0	11.3	16.0*	4.5*

\*Projected

Table 10 clearly shows that from 2017-18 to 2018-19 not only was the 'core' rate of inflation significantly lower than the headline rate of inflation but it was also less variable over the years. The variability in the latter rate of inflation is due to the higher rate of inflation generally in food and energy / fuel prices after 2018-19.

The impact of monetary policy on the 'core' inflation rate appears to be transmitted through the rate of expansion in money supply. For example, the highest rate is observed in 2019-20, when there was the fastest expansion in money supply. Also, supply-side factors appear to matter more. The lowest rate of 'core' inflation in 2017-18 coincides with the fastest rate of GDP growth.

A rise in the policy rate raises interest rates on PIBs and MTBs. This increases the cost of domestic bank borrowing by the government and adds more to the money supply. This tends to 'crowd out' the private sector and put pressure on inflation. Consequently, it partly reduces the impact of monetary policy on inflation.

There is rapid transmission of any change in the policy rate on the yield, for example, from treasury bills, as shown in Table 11. However, the secondary market has begun to anticipate future changes in the policy rate. This happened for the first time towards the end of 2021, when the yield on treasury bills jumped to 11.5 percent when the policy rate was 8.75 percent. Currently, the yield on 12-month treasury bills has exceeded 15 percent. This indicates that there is a high likelihood that the policy rate could be raised from 13.75 percent to 15 percent shortly.

**Table 11: The Policy Rate and Yield on Treasury Bills (%)**

	Policy Rate	Treasury Bills		
		3 months	6 months	12 months
Jun-18	6.5	6.76	-	-
Dec-18	10.0	10.3	-	-
Jun-19	12.3	12.74	-	-
Dec-19	13.3	13.45	-	-
Jun-20	7.0	6.84	6.6	6.85
Dec-20	7.0	7.11	7.19	7.29
Jun-21	7.0	7.29	7.56	-
December 2021*	8.75	10.38	11.34	11.48
Jun-22	13.75	14.66	14.95	15.15

\* 1st of December 2021

The best illustration of this is in 2018-19. There was a big upsurge in the policy rate as shown in Table 2. This led a big increase in the budget deficit and the rise in money supply was largely due to domestic bank borrowing by the Government. Therefore, there is a strong tendency for an aggressive monetary policy to be largely neutralized by the fiscal consequences.

**Table 12: Federal Budget Deficit and Domestic Borrowing (adding to M2) (PKR bn)**

	Federal Budget Deficit	Government Domestic Bank Borrowing*	Money Supply (M2)	[ii] as % of [iii]
	[i]	[ii]	[iii]	[iii]
2017-18	2,242	10,199	15,997	
2018-19	3,634	12,366 (2167) *	17,798 -1,801	120
2019-20	3,601	14,547 -2,181	20,908 -3,110	70
2020-21	3,716	16,265 -1,718	24,297 -3,389	51
2021-22 March	3,165	17,375	25,407	100
From 2020-21 March		-1,110	-1,110	

\* Figures in brackets are the changes

Source: SBP, MOF



## 6. Inflation Outlook of the Monetary Policy Committee

The primary focus of the SBP remains on the rate of inflation, which is in line with its primary goal of preserving price stability. This focus has been augmented by the new SBP Act. Consequently, the policy rate is used as the primary instrument by the Monetary Policy Committee (MPC) of the SBP to tackle inflation.

There has been a fundamental transformation in the outlook towards inflation since January 21 in recent MPC statements, from optimism to pessimism, as follows:

Date of MPC	Change in Policy Rate	Outlook on Inflation of MPC	Accuracy of Outlook
January 22, 2021	None, at 7%	Likely decline, due to easing food inflation	Poor. Inflation rises to 11%
July 27, 2021	None, at 7%	Headline inflation should begin to dissipate in second half of year	Poor. Inflation rises to 12.3% by December 21
September 20, 2021	Up by 25 basis points to 7.25%	Depending on the future path of fuel and electricity prices and global commodity prices	-
November 19, 2021	Up by 150 basis points to 8.75%	Upside risks due to global commodity and administered prices	Inflation shows rising trend
December 14, 2021	Up by 100 basis points to 9.75%	Average of 9-11% in 2021-22 as global commodity prices retrench	Poor Average Inflation in 11 months Exceeds 11%
January 24, 2022	None, at 9.75%	Upper end of 9-11% in 2021-22. FY 23 inflation to fall to 5-7%	Poor Average Inflation in 11 months Exceeds 11%
March 8, 2022	None	Upper end of 9-11% in 2021-22. FY 23 inflation to fall to 5-7%	Poor Average Inflation in 11 months Exceeds 11%
April 7, 2022	Up by 250 basis points to 12.25%	Slightly above 11% in FY-22 before moderating in FY-23	Poor Average Inflation in 11 months exceeds 11%
May 23, 2022	Up 150 basis points to 13.75%	Hike in petrol and energy price, inflation to remain elevated in FY-23 and fall to 5-7% in FY-24	

It is surprising how the MPC has frequently changed its own inflation expectations. In early 2021, it expected the rate of inflation to decline and kept the policy rate at 7 percent up to September 2021. The appropriate strategy would have been to gradually raise the policy rate.

Thereafter, the MPC recognized the upside risks due to rising global commodity prices and administered prices, but nevertheless expected the inflation rate to average 9-11 percent in 2021-22. This was biased downwards as the average rate exceeded 11 percent in May 2022.

The MPC on April 7, 2022, raised the policy rate by a large 250 basis points, due particularly to falling reserves. However, it still felt that inflation would moderate in FY-23. Now, in the last MPC of May 23, the outlook is that inflation would remain elevated in FY-23 and only fall to 5-7 percent in FY-24.

Such rapid changes in inflation outlook of the MPC have seldom been observed earlier. However, to be fair to the MPC this is no doubt the result of the high level of uncertainty prevailing both in the global economy and in the domestic economy. Inevitably, this has distorted the timing and intensity of policy actions. It should not come as a surprise if the policy rate is raised further shortly by the MPC.

## 7. The Incipient Financial Crisis

Pakistan is back again in 2021-22 to the situation of an incipient financial crisis of the type we saw at the beginning of 2018-19. Foreign exchange reserves have plummeted by over \$7 billion in the first ten months, especially after February 2022. They stand at \$9.7 billion on the 27th of May, 2022, enough to provide import cover for only 1.5 months. For the first time, net international reserves, after excluding liabilities, are significantly negative.

There are a number of factors which have contributed to the deterioration. First, there is the extraordinary upsurge in dollar prices in imports due to the recovery process in the global economy and more recently because of the supply shortages created by the Russia-Ukraine war.

International prices of petroleum products fell by 53 percent in the immediate aftermath of the COVID-19 attack. They have since recovered and now stand at 44 percent above the base year level. Similarly, food import prices are now 133 percent above the level in 2018-19. Overall, the import prices in dollars faced by Pakistan up to April 2022 are up by over 35 percent in relation to the corresponding period in 2020-21. The value of imports in dollars has increased by over 39 percent as shown in Table 6-1. Exports have also shown growth of 28 percent. However, the trade deficit has gone up massively by 50 percent.

Other factors have also contributed to the balance of payments deficits of \$6.6 billion, as shown in Table 6-2. These include a worsening of the balance of trade in services by 31 percent and larger net outflows in the primary income account by 22 percent. Consequently, the current account deficit has gone up to \$13.8 billion, with the prospect that it could approach \$16 billion by the end of 2021-22, not very far from the record level of \$19 billion reached in 2017-18.

The IMF program remains in a state of suspension due to the lack of completion of the seventh review. Discussions in Doha have just come to an end. The stumbling block is the withdrawal of the big subsidy on petroleum products. The new coalition government has recently raised petroleum prices by Rs 60 per liter. The new autonomous SBP, following the enactment of State Bank Amendment Act of 2022 on the 28th of January 2020, has proceeded aggressively to raise the policy rate to 13.75 percent on May 23, 2022. The latest Monetary Policy Statement has strongly recommended the move to withdraw the subsidy and raise taxes on petroleum products to make the IMF program once again operative and lead to an increased inflow of funds.

However, unlike 2018-19, when there was Government with a fresh five-year mandate, there is uncertainty on the political front and when the next elections will be held. This has added to the economic uncertainty. Consequently, the rupee has plummeted by 9.7 percent since the 1st of April while the KSE Share price index is down by 8 percent. There has been a minor recovery following the partial withdrawal of the fuel subsidy.

## 8. Conclusion

The newly autonomous SBP is now operating in an emergency mode. Over the last five months, there has been a quantum jump in the policy rate of 650 basis points and the rupee has depreciated by 12 percent. the latest position, as of 27th of May 2022, of foreign exchange reserves is \$9723 million.

The SBP has started using more instruments to bring down imports and thereby contain the current account deficit to reduce the pressure on the already low reserves. The import margins have been raised on a number of products, the interest rate on export refinancing has been enhanced and the cost of borrowing in automobile loans has been raised. The SBP has also played a role in the imposition of a temporary import ban on a number of luxury and non-essential imports by the Government.

The increasingly negative perceptions of Pakistan have been further enhanced by the recent downgrading by Moody's of the credit-rating of Pakistan. Apparently, some banks already are refusing to provide foreign exchange for imports of fuel.

In an early move, the MPC may raise the policy rate further to 15 percent. The Federal budget will be contractionary in character with high additional taxation and low development spending. These measures are all necessary for revival of the IMF program, which is essential for increased inflow of funds into Pakistan and improvement in the reserves position. SBP will have to continue playing a very vigilant role.

Fortunately, the economy of Pakistan has always shown resilience in the past and emerged out of financial crises. We hope and pray to God that this will happen once again.