The Federation of Pakistan
Chambers of Commerce & Industry

Policy Advisory Board

Assessment of Monetary Policy Effectiveness in Pakistan

POLICY BRIEF - PB03

Acknowledgment and Disclaimer

The Policy Advisory Board – Federation of Pakistan Chambers of Commerce & Industry (FPCCI) expresses its appreciation to industry representatives, economists, financial market participants, and professionals who participated and submitted their responses for the online monetary policy survey. The analytical dashboard on monetary policy survey results can be viewed online on the following link:

https://fpcci.org.pk/pab-dashboard/

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Contents

List of Tables

List of Figures

Assessment of Monetary Policy Effectiveness in Pakistan

Recommended Policy Direction

The Policy Advisory Board - FPCCI proposes that the State Bank of Pakistan should keep the policy rate unchanged in the upcoming monetary policy committee to help revive the economy. In addition, it is recommended to target core inflation rather than general inflation. Given the moderate economic outlook with the decline in real sector and deterioration in business confidence, it is imperative for the State Bank of Pakistan to not control supply shock induced general inflation by raising policy rates.

Pakistan is heading towards stagflation with inflation mounted to 11.5 percent in November whereas visible deterioration in key economic indicators has been evident. The core inflation was recorded at 7.6 percent in November 2021, up by 0.9 percentage points. The State Bank of Pakistan has increased the policy rate by 25 and 150 basis points in the last two monetary policy committee meetings which has raised cut-off yields by 228 basis points for three-month T-bills to 10.78 percent. It is imperative to note here that supply shocks such as a hike in commodity and oil prices provided the impetus for current inflationary pressure. In addition, massive depreciation of the Pakistani rupee against the US dollar along with measures under IMF Program have further triggered inflation.

The State Bank of Pakistan's decisive measures including tightening cash reserve requirements, prudential regulations, and imposition of cash margins are more focused and plausible. However, increase in policy rates tend to have limited or no impact because current inflation is due to abrupt supply shocks rather than expansion in demand. Pakistan's economy is less integrated with the financial sector, for instance, only 7 percent of the industry borrows from formal financial institutions. It renders policy rates counterproductive in controlling inflation.

Following measures are recommended:

- The SBP must target core inflation rather than general inflation as core inflation is a better measure of demand-pull inflation.
- Inflationary pressure due to reforms under the IMF program must not be controlled by raising Policy rates.
- Market-based flexible exchange rate regime should be replaced with managed-float regime in order to avoid importing inflation.
- Government should use prudential regulations to curb demand pulls more effectively.
- Monetary policy measures have differential impacts on different industries and income classes. Impact on the spectrum of industries and income classes must be evaluated before formulating policies.
- Authorities must urge IMF to allow government borrowing from the central bank. Government's alternative reliance on commercial banks would end up borrowing expensive loans along with crowding-out effect on private borrowing.

Key Highlights

- **Recent Monetary Policy Measures.** The State Bank of Pakistan tightened the auto loans and personal loans financing by revising prudential regulations for consumer financing. Similarly, it has increased the average cash reserve requirement from 5 to 6 percent and the minimum requirement from 3 to 4 percent. Such monetary policy measures are more focused and would help arrest demand-induced inflation. Raising interest rates across the board is unlikely to yield the desired results.

- **Positive Relationship between Policy Rates and Inflation.** There exists a strong and positive relation of policy rates with both general and core inflation during Jan-20 to Nov-21, that is, 0.61 and 0.66 respectively. This is in contradiction to the SBP's objective to contain inflation by raising policy rates.

- **Resumption of IMF Program and Inflationary Pressure.** In a bid to resume the Extended Fund Facility (EFF) Program of International Monetary Funds (IMF), the federal government is set to increase the petroleum development levy by Rs. 4.0 per month until it reaches the maximum levy of Rs. 30. In addition, National Electric Power Regulatory Authority (NEPRA) is likely to increase the electricity price up to Rs. 4.75. Both these measures along with others will trigger inflation further and tackling such inflationary pressure by raising policy rates would further aggravate the inflation and push the economy into stagflation.

- **Surge in Imports due to Price Change.** The surge in imports of petroleum and food groups is mainly due to the global market prices. During Jul-Oct 2021, imports of selected food and petroleum products were US$ 2.74 billion for which import value of around US$ 2.66 billion is due to the price change whereas volume change in imports of aforesaid products accounted for US$ 0.08 billion only. Inelastic import demand and inflationary pressure due to these reasons are unlikely to be controlled through raising policy rates.

- **Limited Credit to Private Sector.** According to the World Bank Enterprise Survey, only 7 percent of firms in Pakistan raise finance from formal credit lending institutions. Credit to the private sector (as a % of GDP) for Pakistan was 17.1% in 2020 which is the lowest among the regional peers. Moreover, around 10 percent of outstanding loans to the private sector by the end of October 2021 were covered under SBP's designated fixed rate schemes.

  It reflects a very weak formal credit lending channel exists between industry and financial institutions. Therefore, raising the cost of borrowing to curb demand is very unlikely to yield desired results.

- **General versus Core Inflation.** The general inflation measured by consumer price inflation on a year-on-year (YoY) basis has been increasing since August 2021 and has reached 11.5 percent in November 2021.

  The core inflation on a year-on-year basis for October and November 2021 were 6.7 percent and 7.6 percent respectively. Since the reasons for high inflation are commodity prices and fuel imports, the SBP must target core inflation only.

- **Monetary Policy Survey Results.** Monetary policy survey reveals that around 58 percent of the overall respondents oppose increasing the policy rate further. In addition, the prevailing market-based flexible exchange rate regime is rejected by the majority of the participants i.e. around 58 percent. However, inflation is expected to rise further as anticipated by a significant majority i.e. 83 percent.

- **Pakistan's policy rate in excess of core inflation is higher than India and China.** Pakistan's current policy rate is 8.75 percent which is well above the regional peers. China, India, and Bangladesh have maintained their policy rates at 2.0 percent, 4.0 percent, and 4.8 percent respectively.

- **Business and Consumer Confidence.** A dramatic decline in business and consumer confidence indices since July 2021 indicates poor economic sentiments among industry participants and consumers. Moreover, large-scale manufacturing contracted by 0.7 percent in September 2021.

- **Inflation Expectation.** Measures under the IMF program, exchange rate, global market prices, international commodity prices, and other supply-side distortions are expected to trigger inflation in the near term. However, inflation due to supply-side factors must not be controlled by increasing policy rates.

- **Business Cycle Positioning.** Pakistan is currently undergoing the recessionary phase of the business cycle since 2016 and is expected to continue in recession till FY 2023. Business cycle theories contend that expansionary monetary and fiscal policies should be adopted to boost economic activity. On the contrary, the State Bank of Pakistan raised the policy rate in the last two consequent monetary policy meetings held in September 2021 and November 2021. Unlike other monetary policy tools, raising policy rates fuel cost-push inflation, deteriorate the fiscal equation, and widen the income inequality besides mitigating aggregate demand.

1. Introduction

Central banks around the world conduct monetary policy to anchor inflation. Low inflation provides opportunities for growth and employment generation in the long run. The policy rate is one of the most popular conventional monetary policy tools which is assumed to help central banks in achieving their inflation targets. The State Bank of Pakistan announces the monetary policy every two months with the aim to keep the overall prices, business cycles, and financial markets stable. The State Bank of Pakistan (SBP) Act, 1956 envisages monetary policy objectives as:

> *'whereas it is necessary to provide for the constitution of the State Bank to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources'*

The Monetary Policy Committee (MPC) of SBP has been formed as an independent body under Section 9E of the SBP Act, 1956 which is responsible for formulating monetary policy. During the last two MPC meetings held on September 20 and November 19, 2021; the policy rates were increased by 25 and 150 basis points respectively and the current policy rate touched 8.75 percent. The cut-off yield, as a consequence, increased by 228 basis points for three-month T-bills to 10.78 percent auctioned on December 01, 2021, compared to 8.5 percent in the previous auction held on November 17, 2021. The heightened risks related to inflation and balance of payments stem from global and domestic commodity prices were the major reasons cited by the MPC for increasing policy rates.

Besides a hike in policy rates, the SBP took several other measures to contain monetary expansion. In a major move, the SBP has raised the average **Cash Reserve Requirement Ratio (CRR)** to be maintained for the period of two weeks for the first time in nine years from 5 percent to 6 percent whereas the minimum CRR to be maintained each day has revised upward from 3 percent to 4 percent. In addition, the SBP has also tightened the **Prudential Regulations (PRs)** for consumer financing. The revisions in the PRs effectively prohibit financing for imported vehicles and tighten regulatory requirements for financing of domestically manufactured/assembled vehicles of more than 1000 cc engine capacity and other Consumer Finance facilities like personal loans and credit cards. Another measure on the monetary policy front taken by the SBP in September is to include 525 import items (as opposed to 114 items) under 100 percent **Cash Margin Requirements (CMR)**.

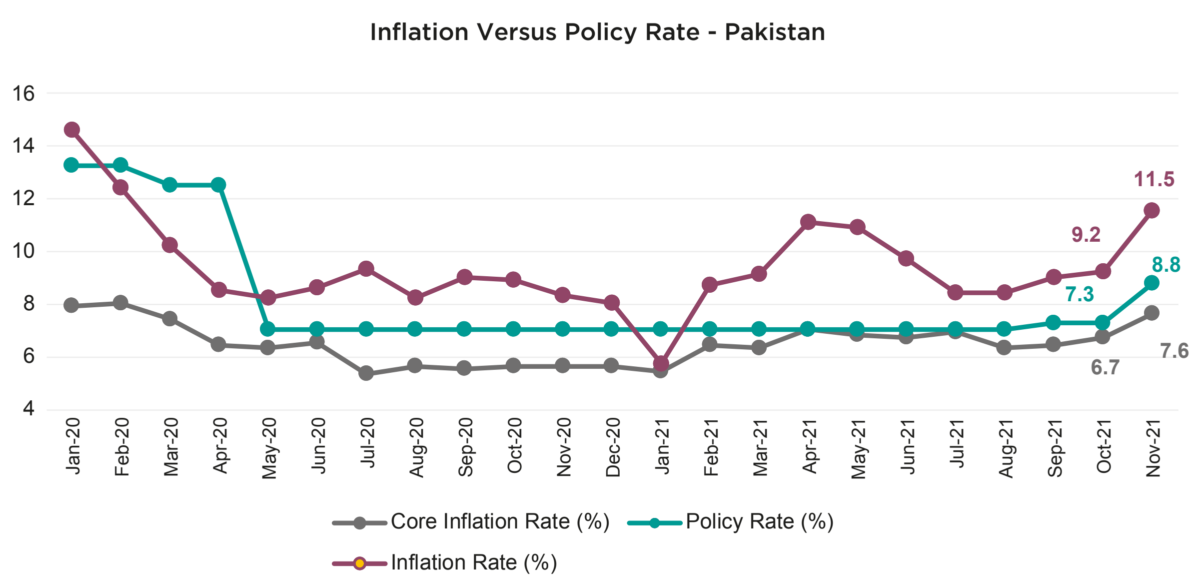
The economy is confronted with pressure on inflation as well as the external sector. The inflation at the beginning of the fiscal year first remained muted at 8.4 percent during both July and August 2021 however it increased to 9.0 percent during September 2021 and further to 11.5 percent recently in November 2021. The trade deficit has been widening and reached US$ -3.9 billion in October 2021 as compared to US$ -1.8 billion in October 2020. Imports although having decreased on a month-on-month basis from USD 6.60 billion in September 2021 to 6.34 billion in October 2021 however level of imports is significantly higher than the level in October 2020. Pakistani rupee continued to follow the declining trajectory with PKR recorded at 175.5 against US$ by the end of November 2021. The International Monetary Fund (IMF) projected Pakistan's economic growth to 3.95 percent for the fiscal year 2021-22. The World Bank contends that Pakistan's annual per capita growth has averaged at 2 percent in the last two decades which is less than half of South Asia's average. The SBP, however, maintained the ambitious growth forecast of 4-5 percent for the fiscal year 2022.

2. Inflation Outlook and Sources of Inflation

As economies and supply chains grow back to life, it is causing a shortage of commodities such as oil and witnessing a massive increase in transportation costs. Inflationary pressure has been magnified in Pakistan due to the ongoing depreciation of the rupee against US dollars. Weak formal lending channels render monetary policy mostly ineffective in Pakistan.

The year-on-year (YoY) inflation based on Consumer Price Index (CPI) has been increasing since August 2021 and has reached 11.5 percent in November 2021. On a month-on-month (MoM) basis, inflation was reported at 2.98 percent in November 2021. Contradictory to the SBP's assumption, the figure below reflects that the general inflation and policy rates are positively correlated. For instance, in a recent scenario, the SBP raised policy rates by 7.25 percent during MPC held in September to contain inflation, however, inflation increased further to 11.5 percent in November 2021.

Figure 1: Trend in Inflation



The correlation among the variables including policy rate, general inflation (year-on-year), core inflation (year-on-year), exchange rate, trade deficit, large scale manufacturing index, consumer, confidence index, business confidence index, and loans to the private sector are estimated for the period of Jan-20 to Nov-21. Key findings of the correlation analysis are as follows:

- In contradiction to the theoretical rationale, the policy rate is positively related to both the general and core inflation on a year-on-year basis. The significant correlation of policy rate with both general and core inflation reflect that increasing policy rates will further increase general and core inflation. Therefore, policy rate as a tool to target inflation appears redundant in the recent scenario.

- Policy rate and exchange rate are negatively associated with each other. Any raise in the policy rate attracts hot money in the short run. The correlation coefficient of -0.21 however reflects that the nexus between the two is weak and would not serve the SBP's secondary objective to strengthen the exchange rate.
- The negative association of policy rates with the Large-Scale Manufacturing Index as well as with the business confidence index reflects the adverse impact of increasing policy rates on the real sector and its role in the deterioration of business sentiments.
- Loans to the private sector and policy rates are also found to be negatively correlated. It suggests that any raise in policy rate tends to restrain businesses from borrowing due to higher costs. However, the weak correlation (i.e. -0.30) is due to the fact that the loans are either covered under the government incentive package for which interest rates are fixed or loans are non-responsive (inelastic) to the change in policy rates.

Table 1: Correlation Matrix

	Policy Rate (%)	*CPI (General, YoY, %)*	*CPI (Core, YoY, %)*	*Exchange Rate (PKR/USD)*	*Trade Deficit*	*Large Scale Manufacturing Index*	*Consumer Confidence Index*	*Business Confidence Index*	*Loans to Private Sector*
Policy Rate (%)	1.00								
CPI (General, YoY, %)	**0.61**	1.00							
CPI (Core, YoY, %)	**0.66**	0.79	1.00						
Exchange Rate (PKR/USD)	-0.21	-0.45	-0.40	1.00					
Trade Deficit	0.35	0.05	-0.12	0.08	1.00				
Large Scale Manufacturing Index	-0.14	0.12	0.03	-0.44	-0.29	1.00			
Consumer Confidence Index	0.21	-0.09	0.25	-0.09	-0.34	0.06	1.00		
Business Confidence Index	-0.38	0.02	0.09	-0.30	-0.73	0.66	0.35	1.00	
Loans to Private Sector	-0.30	-0.12	0.17	-0.07	-0.91	0.29	0.39	0.73	1.00

2.1. Components of Inflation

The upward swing in consumer prices continued with year-on-year CPI (general) recorded to 11.5 percent in November 2021. The general inflation based on consumer price inflation (CPI) surpassed the policy rate in February 2021 with inflation remained in double digits during April and May 2021. The year-on-year (YoY) inflation based on Consumer Price Index (CPI) has been on the rise for the last three months, reaching 11.5 percent in November 2021. It is pertinent to note here that the 'Food & Non-alcoholic Bev.', 'Housing, Water, Electricity, Gas & Fuels' 'Furnishing & Household Equipment Maintenance' and 'Transport' together contributed 74.1 percent (i.e. 8.55 out of 11.5 percent inflation) in the hike in the price level.

Table 2: Heatmap for Inflation

Heat-map of National CPI inflation (YoY)												
	Weight (%)	**Jan-21**	**Feb-21**	**Mar-21**	**Apr-21**	**May-21**	**Jun-21**	**Jul-21**	**Aug-21**	**Sep-21**	**Oct-21**	**Nov-21**
General	100	5.7	8.7	9.1	11.1	10.9	9.7	8.4	8.4	9.0	9.2	11.5
Food & Non-alcoholic Bev.	34.6	6.7	9.7	11.6	15.9	14.8	10.5	8.2	10.0	10.2	8.3	10.5
i. Non-perishable Food Items	*29.6*	*12.6*	*14.7*	*17.0*	*18.4*	*18.2*	*12.9*	*11.6*	*11.1*	*13.8*	*12.3*	*13.6*
ii. Perishable Food Items	*5.0*	*-21.3*	*-17.4*	*-17.3*	*2.7*	*-3.9*	*-3.9*	*-9.1*	*3.4*	*-8.3*	*-10.8*	*-3.6*
Alcoholic Bev. & Tobacco	1.0	5.8	5.7	5.9	4.9	5.0	5.0	3.1	2.1	2.0	1.9	1.8
Clothing & Footwear	8.6	9.5	11.3	10.7	11.9	10.6	10.0	9.5	9.3	9.2	9.3	9.8
Housing, Water, Electricity, Gas & Fuels	23.6	3.4	10.6	8.8	9.7	8.4	9.1	9.2	8.0	9.7	12.0	14.8
Furnishing & Household Equipment Maintenance	4.1	7.6	8.5	8.9	9.5	9.6	9.8	9.8	9.6	9.3	9.2	10.4
Health	2.8	8.5	9.2	8.8	9.0	9.0	9.4	8.6	8.5	8.0	8.0	8.6
Transport	5.9	-2.6	-1.0	2.9	6.5	14.0	16.4	10.5	8.1	9.1	14.4	24.4
Communication	2.2	0.5	0.6	0.6	1.6	1.6	1.6	2.8	2.8	2.8	2.8	2.5
Recreation & Culture	1.6	4.6	4.8	4.6	4.6	4.9	6.2	5.9	6.4	6.9	7.5	7.5
Education	3.8	1.3	1.2	1.0	1.6	1.6	1.8	2.0	2.9	2.6	2.2	2.4
Restaurants & Hotels	6.9	8.9	8.0	8.1	8.2	8.6	8.8	8.5	7.3	7.8	8.3	11.0
Miscellaneous	4.9	11.5	12.2	10.6	10.0	10.7	11.0	9.4	5.9	7.4	8.7	10.0

Inflation in urban areas posted a persistent increase in price levels since February 2021 with urban inflation clocked into 12.0 percent during November 2021 when measured on the year-on-year basis. A break-up in the table below reflects that the substantial hike in price level is mainly due to energy in both urban and rural areas. Energy inflation figures in urban and rural areas were 36.8 percent and 30.7 percent respectively during November 2021.

Food inflation also remained high for both urban and rural areas during November 2021 as it increased to 11.9 percent and 8.6 percent respectively. An enormous increase in international commodity prices such as palm oil, soybean oil, sugar, and others along with the weaker exchange rate were the major drivers of inflation in the domestic market.

Table 3: Heatmap for Inflation - Alternative Breakup

Heat-Map Inflation (YoY)												
		Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21
General Inflation	National	5.7	8.7	9.1	11.1	10.9	9.7	8.4	8.4	9	9.2	""#$!
	Urban	5.0	8.6	8.7	11.0	10.8	9.6	8.7	8.3	9.1	9.6	12.0
	Rural	6.6	8.8	9.5	11.3	10.9	9.7	8.0	8.4	8.8	8.7	10.9
Food Inflation	Urban	7.3	10.3	11.5	15.7	15.3	11	9.4	10.2	10.8	9.4	11.9
	Rural	7.2	9.1	11.1	14.1	12.8	9.8	7.3	9.1	9.1	7.2	8.6
Non-Food Inflation	Urban	3.7	7.6	7.1	8.2	8.3	8.8	8.2	7.2	8.1	9.7	12.0
	Rural	6.1	8.6	8.1	8.9	9.2	9.7	8.7	7.7	8.5	10.0	13.0
Core Inflation	Urban	5.4	6.4	6.3	7	6.8	6.7	6.9	6.3	6.4	6.7	7.6
	Rural	7.8	7.7	7.3	7.7	7.6	7.3	6.9	6.2	6.2	6.7	8.2
Energy Inflation	Urban	-4.5	14.2	11.8	14.9	16.6	21.1	16.1	12.2	17.8	25.9	36.8
	Rural	0.1	12.3	11.1	13.8	16	19.8	15.7	13.8	17.2	23.2	30.7

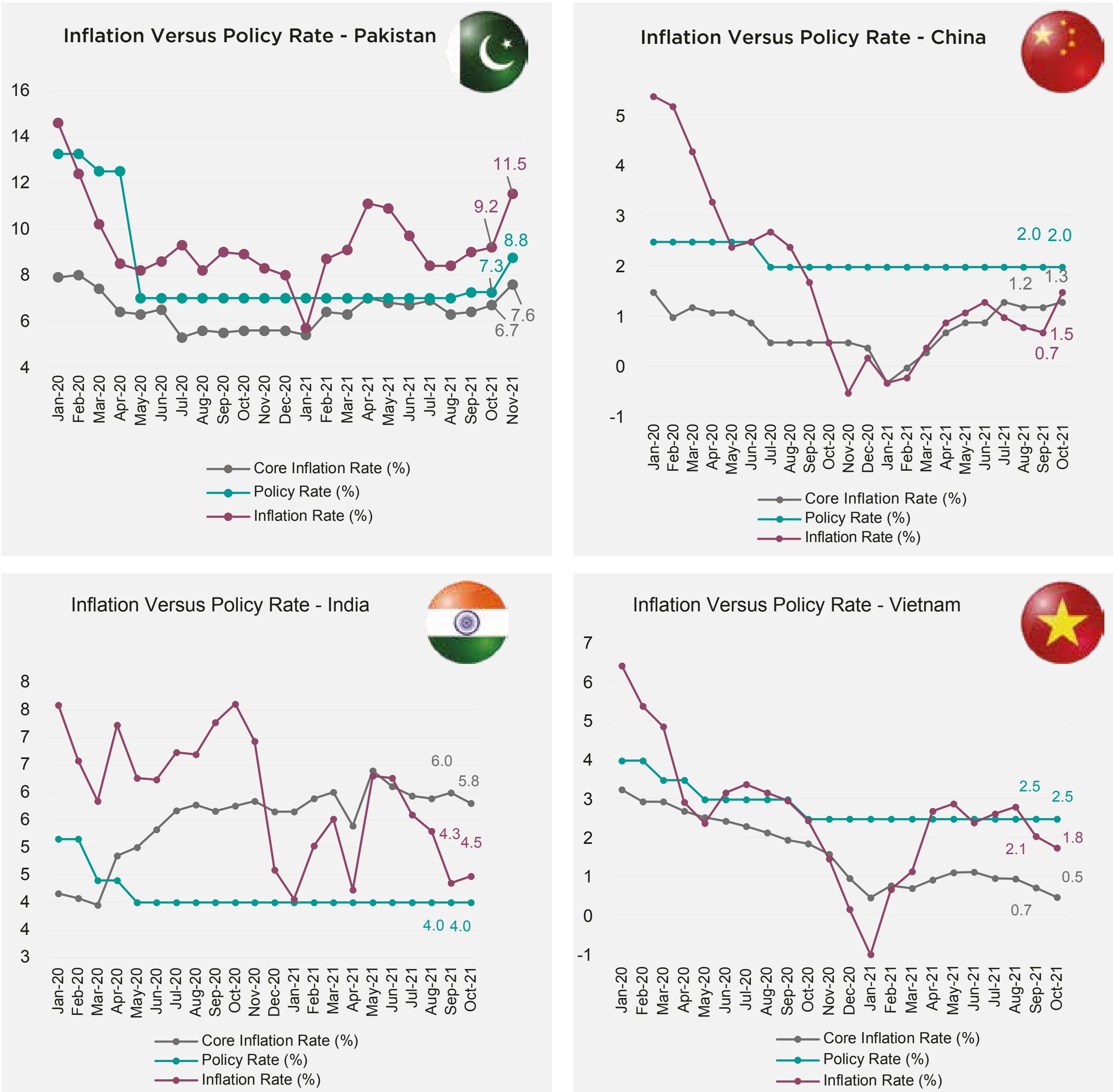
Note: Core and energy inflations are the sub-components of non-food inflation.

2.2. Comparison of Policy Rates and Inflation – A Regional Perspective

Countries around the globe have adopted expansionary monetary policies since the outbreak of COVID. Pakistan also cut the policy rate from 13.25 to 7.0 percent in May 2020, however, it remained higher than the regional peers. In a recent scenario, the State Bank of Pakistan has increased the policy rate first in September by 25 bps and by 150 bps in November with a claim to tame inflation. Peer countries including China, India, and Vietnam however have not changed their stance on monetary policy despite recent upswings in price levels. Inflation stems from a hike in commodity and oil prices are being taken as cost-push inflation by these economies whereas Pakistani authorities have been increasing policy rates to tackle cost-push inflation.

The figure below presents a comparison of policy rates along with inflation in Pakistan as well as in peer economies. Both rate of inflation as well as policy rates in Pakistan are higher than what is prevailing in China, India, and Vietnam. Although the real interest rate is negative in Pakistan, however, the difference between policy rates and core inflation is higher in Pakistan i.e. 1.2 percent as compared to India (-1.8%), China (0.7%). It is pertinent to note here that policy rates and inflation have been increasing simultaneously which indicates that the policy rate itself has its own impact on cost-push inflation. In a highly levered country such as Pakistan, a positive relationship between policy rates and inflation is not surprising as higher interest rates raise the debt servicing and the consequent deficits are covered using fiscal measures such as higher taxes, energy tariff hikes and others.

Figure 2: Regional Comparison of Policy Rates and Inflation



2.3. Primary Drivers of Inflation

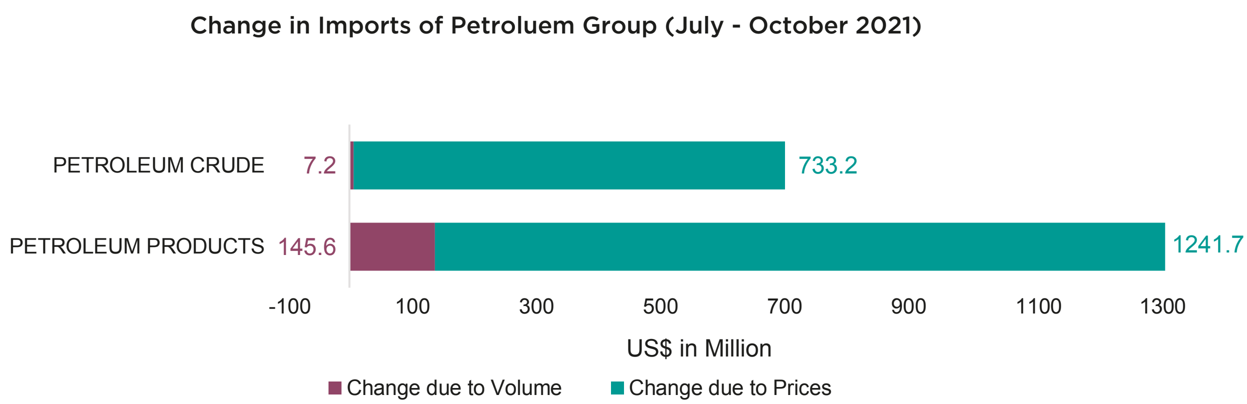
Inflation is stimulated mainly due to supply-side factors especially the rampant depreciation of the Pakistani rupee. The government must target exchange rate policies rather than increasing policy rates to counter inflation. It is imperative to understand the inflation dynamics further. Sub-sections below discuss the major reasons that have triggered inflation:

2.3.1. Surge in International Commodity Prices

The total increase in imports of major food commodities as well as petroleum products & crude in July-October 2021 was US$ 2.74 billion as compared to the same period last year. The increase in imports due to prices was around US$ 2.66 billion which is 97 percent of the total increase in imports of aforesaid products whereas only US$ 0.08 billion were due to volume increase. Controlling imports that are mainly due to global increases in prices is beyond the jurisdiction of national regulatory authorities such as the State Bank of Pakistan.

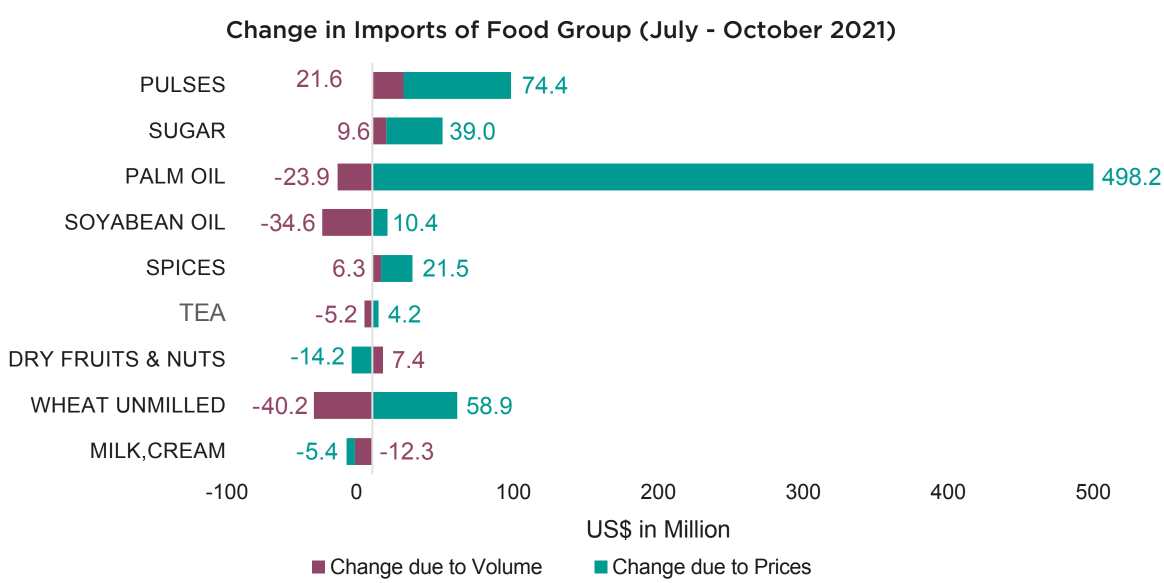
The next two figures below present a further break-up of selected products from food and petroleum groups. It is observed that the total increase in petroleum crude and petroleum products were US$ 2,127.7 million (or 2.13 billion) for which US$ 1,974 million (or 1.97 billion) is due to an increase in prices whereas volume increase only contributed US$ 152.8 million in the surge in import bills of petroleum products and crude.

Figure 3: Breakup for Change in Imports of Petroleum Group



Among the selected food products within the food group, total imports increase due to prices with the value of around US$ 686 million whereas imports volume decreased by the value of US$ 71 million during July-October 2021. The break-up of selected food products are provided in the figure below:

Figure 4: Breakup for Change in Imports of Food Group

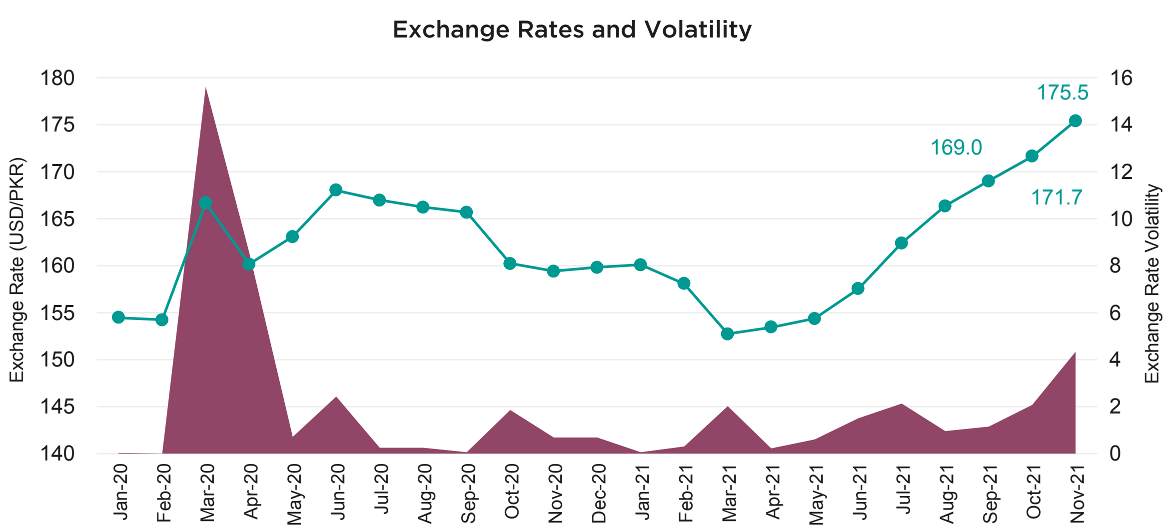


2.3.2. Exchange Rates

An abnormally fluctuating exchange rate tends to distort domestic market prices and fuel inflation substantially especially in import-oriented economies like Pakistan. The Pakistani rupee has been depreciating against US$ since March 2021 whereas a steep decline is visible in the last couple of months. The rupee (PKR) lost its value against the US dollar by around 15 percent since March 2021.

The PKR against US$ was 175.5 by the end of November 2021 as compared to 152.7 in March 2021. Fitch – a global credit rating agency - expects the Pakistani rupee to weaken further and has revised its forecast from the average rate of 165 to 180 against US$ by the end of the fiscal year 2022. In addition, exchange rate volatility[1] describes uncertainty in international transactions both in goods and financial assets. The prevailing market-based flexible exchange rate regime and speculation have increased the volatility in exchange rates. After the highest monthly volatility during Feb-Apr 2020, exchange rate volatility has been picking up since August 2021 as presented in the figure below. Massive depreciation along with increased volatility has induced instability in domestic prices and has been among the major factors that fuel inflation. The figure below presents both the monthly values of exchange rates and the volatility.

Figure 5: Exchange Rates and Volatility

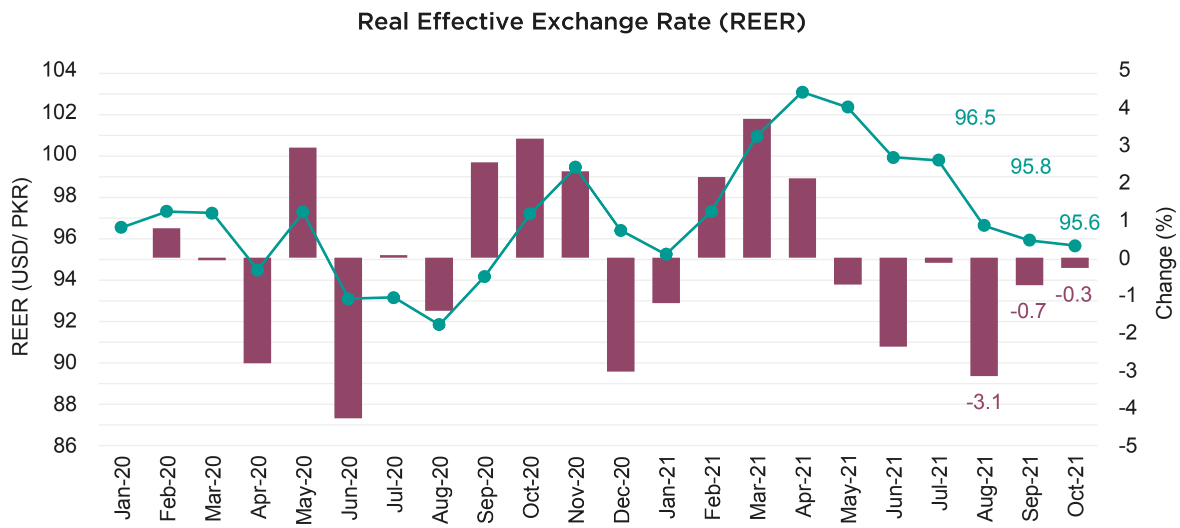


A Real Effective Exchange Rate (REER) is a measure of the value of the currency against a weighted average of several foreign currencies. A REER below 100 means the country's exports are competitive, while imports are expensive. The situation reverses when REER stands above 100 on the index.

Pakistan's REER has been declining since April 2021 reflecting an improvement in export competitiveness. A value below 100 shows that the Pakistani rupee is currently undervalued and likely to appreciate against the US dollar.

[1]Volatility is measured using standard deviation of daily exchange rates for each month.

Figure 6: Trend in Real Effective Exchange Rate (REER)



2.3.3. International Monetary Fund (IMF) Program

Pakistan entered into the $6 billion, 39-month Extended Fund Facility (EFF) of IMF in 2019 to reduce economic vulnerabilities and foster sustainable economic growth. The IMF program requires certain reforms such as the adoption of a market-determined flexible exchange rate regime, revenue mobilization, rebuilding reserves and others. Moreover, the program entails ensuring the autonomy of the State Bank of Pakistan (SBP) and refrain the government for borrowing from the central bank.

Although the magnified impact of global prices has been witnessed due to heavy reliance on imports, IMF's stiff conditions are expected to expand inflation further. The consensus between Pakistani authorities and IMF has been made during the sixth IMF review with a set of prior conditions in November 2021. The government has pledged to enact reforms required by the IMF and mobilize revenues up to Rs. 800 billion by taking measures through a combination of cuts in expenditures and slapping about Rs. 500 billion in taxes. Reforms suggested by IMF tend to foster inflation further, some of them are discussed below:

- **Revision of Tax Targets.** Tax collection target for the fiscal year 2021-22 has been increased to Rs. 6.1 trillion. Pakistan relies more on indirect taxation as 63.5 percent of total revenues were generated through indirect taxes during FY 2020-21. Indirect taxes, such as sales tax, are regressive in nature which increase price level as well as widen income inequality.

- **Increment in Petroleum Development Levy.** The federal government is set to increase the petroleum development levy by Rs. 4.0 per month to take it up to Rs. 30. Increasing petroleum levy at a time when international commodity prices have been skyrocketing would bring a strong wave of high inflation.

- **Increase in Power Tariffs.** Electricity base charges for residential consumers and for all other categories were hiked by Rs. 1.68 and Rs. 1.39 per unit respectively since November 01, 2021. The National Electric Power Regulatory Authority (NEPRA) is likely to increase electricity prices further by Rs. 4.75 to adjust fuel prices. Expensive electricity raises the cost of production which fuels cost-push inflation.

- **Ban on Government Borrowing from SBP.** Refraining government borrowing from the central banks will divert the federal government to the financial institutions to finance the fiscal deficit. As a result, the government will end up be borrowing at a higher rate from banks and financial institutions. Higher costs of borrowing will expand fiscal needs which will eventually be financed through aggressive fiscal measures. As discussed above, higher taxes fuel cost-push inflation.

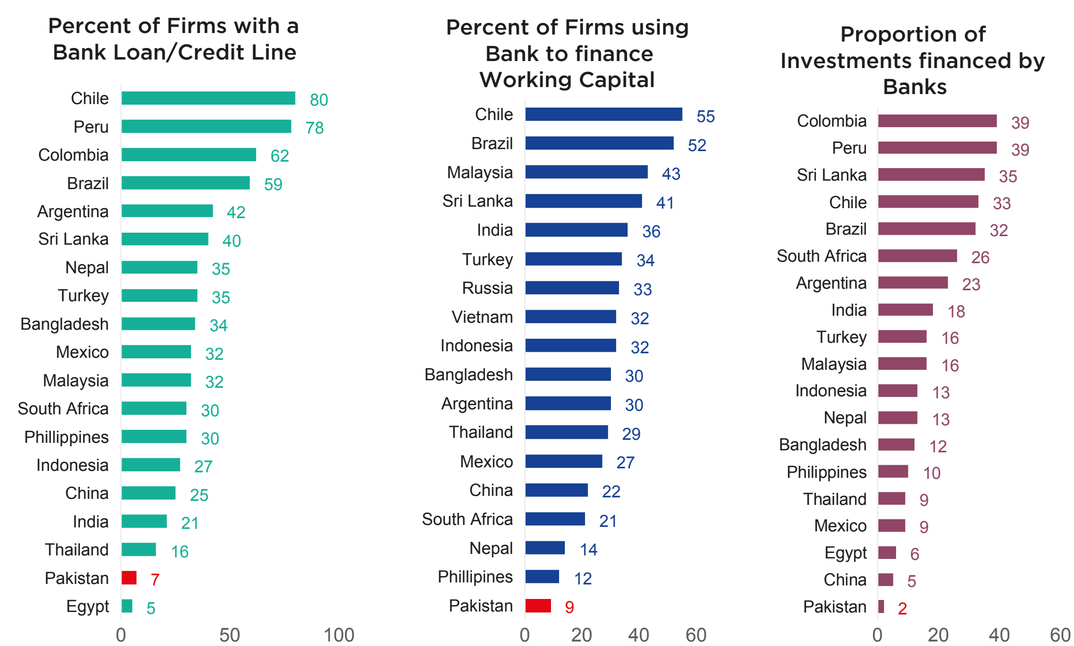
- **Monetary Policy Tightening.** State Bank of Pakistan's forward guidance on monetary policy indicates that the government is likely to move the policy rates above the general inflation. Both general inflation and policy rates are expected to be in double digits in the near term. Contractionary monetary policy has its own impact on cost-push inflation for which the most prominent channel is the surge in debt servicing.

3. Credit to Private Sector

Formal credit to the private sector in Pakistan has reached one of the lowest levels as compared to most of the emerging markets. Low credit to the private sector in a recent scenario is attributed to high-interest rates, crowding out effects due to excessive government borrowing, and economic slowdown amid COVID-19. Rent-seeking behavior of financial institutions to place greater emphasis on serving the well-off and already well-served segments of the society and shy away from lending to low-income individuals and SMEs. As a consequence, credit bureau coverage in Pakistan was 6.7 percent in 2019 which is only marginally better than the minimum threshold of 5.0 percent as defined by the World Bank. Deregulation, liberalization, and aggressive risk management practices of the financial sector since the 1990s have provided them greater autonomy to mobilize their funds. The proportions of credit to the private sector and access to finance in Pakistan are one of the lowest among the developing nations. According to World Bank (2020), the credit to GDP ratio in Pakistan (17.13%) is also lower than other countries such as India (55.25%) and Bangladesh (45.22%). Both low credit to the private sector as well as credit to GDP ratio indicates the poor transmission channel between industries and financial, as a consequence, any changes in the policy rate is highly unlikely to yield the desired results.

The figure below presents the proportion of firms seeking finance from the formal sector. It is evident that 7.0 percent of firms in Pakistan utilize bank loan/credit lines which is significantly low as compared to peer countries including India (21%), China (25%), and Bangladesh (34%). Similarly, only 9.0 percent finance their working capital from banks against 36 percent, 22 percent, and 30 percent respectively for India, China, and Bangladesh. The proportion of investments financed by banks is only 2.0 percent for Pakistan whereas the proportion for India was 18 percent; China, 5 percent; and Bangladesh, 12 percent.

Figure 7: Proportion of Firms using Formal Borrowing Channels

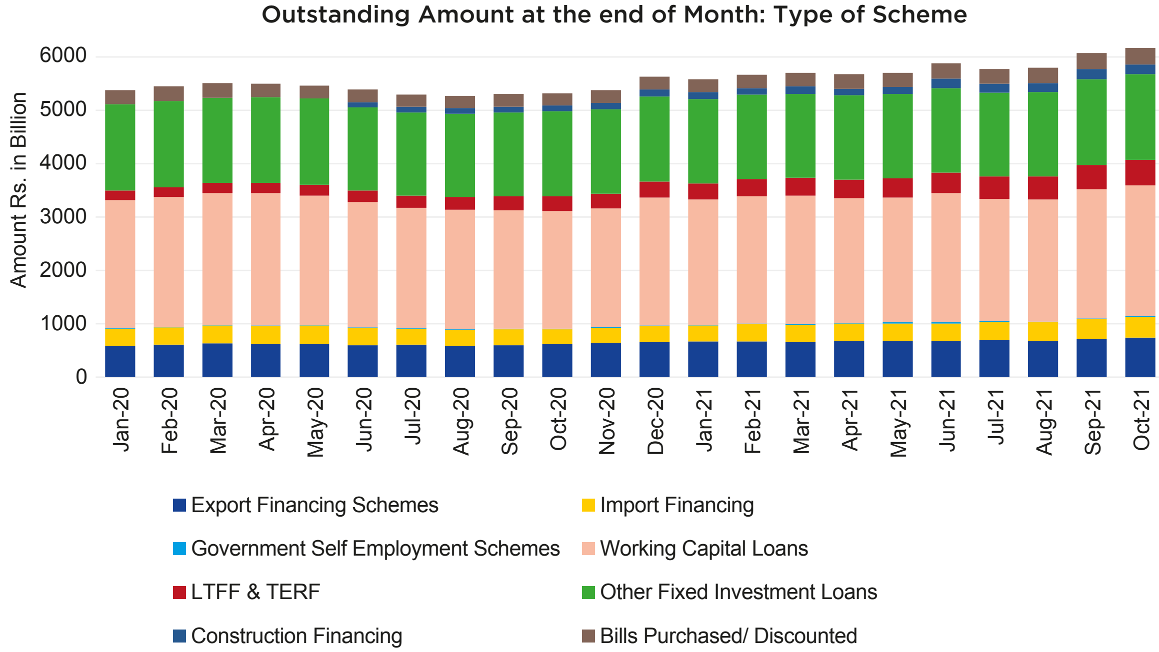


Source: World Enterprise Survey, 2013

3.1. Credit to Private Sector Under Incentive Schemes

The figure below presents the outstanding loans to the private sector at the end of each month. Loans/credit to the private sector faces different credit structures due to coverage under various incentive schemes of the State Bank of Pakistan. Total outstanding loans by the end of October 2021 amounted to 6.1 trillion rupees. Working capital/short-term financing accounted for the highest share of around 40 percent of the outstanding loans which is followed by other fixed investment loans with a share of 26 percent, export financing (12 percent), LTFF & TERF (7.65 percent), import financing (6.2 percent), and others.

Figure 8: Credit Outstanding (by Scheme type)



The table below outlines markup rates under the State Bank of Pakistan's incentive schemes. Outstanding loans for October 2021 were around 6.1 trillion rupees. Around 11 percent of the outstanding loans are covered under SBP's incentive schemes for which mark-up rates are fixed. These schemes include LTFF, TERF, refinance facility for modernization of SMEs, and construction & housing finance facilities.

Table 4: SBP's Incentive Schemes

SBP's Incentive Schemes	Markup Rates
Long Term Financing Facility (For Textile Sector)	5.0%
Long Term Financing Facility (For Non-Textile Sector)	6.0%
Temporary Economic Refinance Facility (TERF)	5.0%
Export Finance Scheme (EFS, For Corporate Borrowers)	SBP Refinance rate + 1.0%
Export Finance Scheme (EFS, For SMEs)	SBP Refinance rate + 2.0%
Import Finance Scheme	Interbank market rate
Refinance Facility for Modernization of SMEs	6.0%
Prime Minister's Youth Loan Program	8.0%
Working Capital Finances	KIBOR + spread
Refinance Scheme for Working Capital Financing of Small Enterprises & Low-End Medium Enterprises	6.0% p.a. for maximum tenor of 1 year
Mera Pakistan Mera Ghar	3.0% for first 5 years, 5% for next 5 years
Construction Finance Facility for Builders and Developers	5.0% (5 Marla Flat/ House) to 7.0 % for (10 Marla)

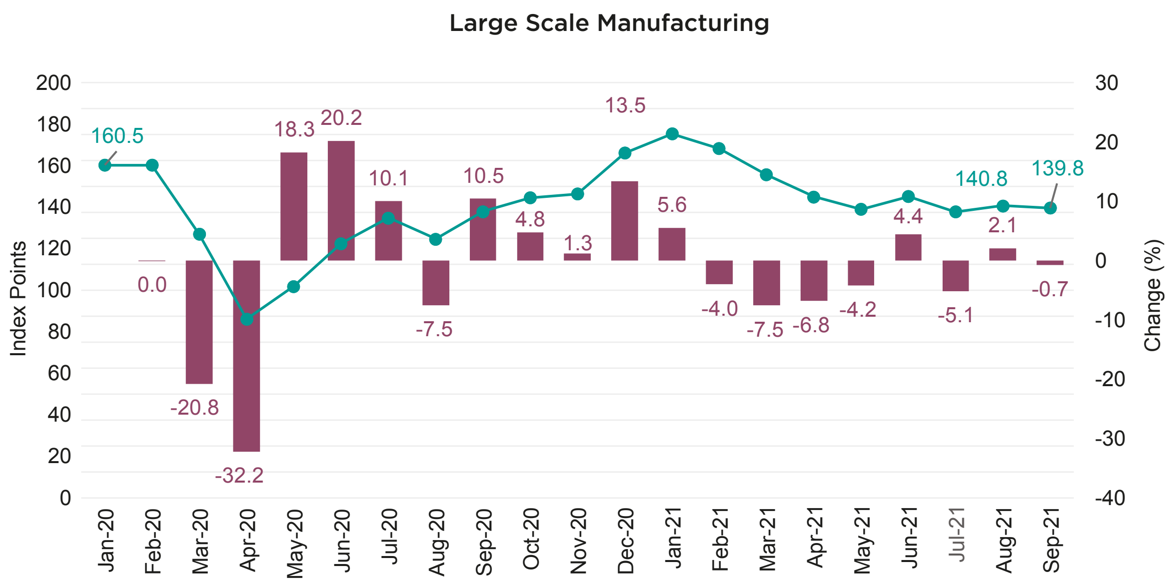
4. Real Sector and Business Perception

4.1. Large Scale Manufacturing

Quantum Index of Manufacturing (QIM) measures the changes in the production of Large-Scale Manufacturing Industries (LSMI) overtime on monthly basis by the Pakistan Bureau of Statistics. The weights presently used for the QIM were derived from the Census of Manufacturing Industries (CMI) 2005-2006.

The QIM exhibits a declining trend since January 2021 with a recent decline of 0.7 percent in September 2021. The index is well below the pre-pandemic level since March 2021. The graph below represents the monthly trend along with the percentage change in the quantum index.

Figure 9: Trend in Large Scale Manufacturing



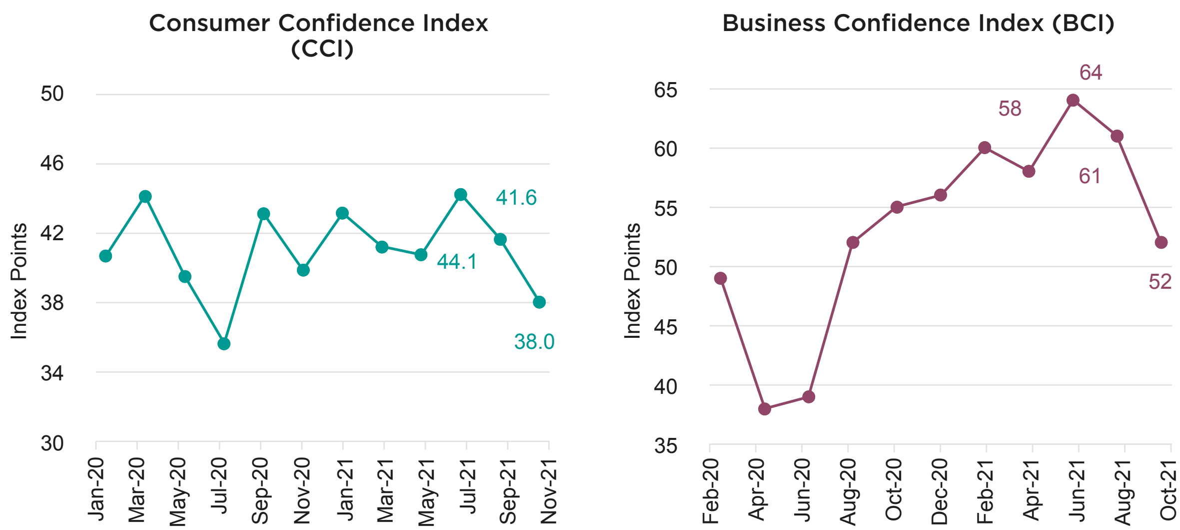
4.2. Consumer Confidence and Business Confidence Indices

Policymakers around the world conduct surveys to gauge their perception. The State Bank of Pakistan publishes both Consumer Confidence Index (CCI) and Business Confidence Index (BCI) after conducting surveys. Consumer confidence and expectations are one of the leading indicators of economic activity having a significant impact on business and economic conditions on an economy. These expectations are based on consumers' perceptions about the current economic conditions. Expectations regarding inflation, interest rate, and employment are important for forward-looking policy formulation which explains why many countries are using consumer surveys for policy-making and research purposes. Indices based on Business Confidence Surveys (BCS) are considered as leading indicators for economic activity as these surveys are particularly suitable for monitoring and forecasting the short-term changes in the economy. Especially, a forward-looking monetary policy requires input on the expectations of different agents (SBP, 2021).

The CCI reflects both the current situation and future economic expectations. CCI values for the month of Sep 2021 declined sharply, reached to 38.0 showing a decline of 8.6 percent from 41.6 in September 2021. This accounts for the deteriorating situation of macroeconomic indicators.

Business Confidence Index underwent an improvement and remained in the positive region (i.e. above 50) for the eight consecutive periods. However, the value showed a decline in the month of October 2021 by nine index points indicating that business expectations are not high from the government compared to previous months.

Figure 10: Consumer and Business Confidence Indices

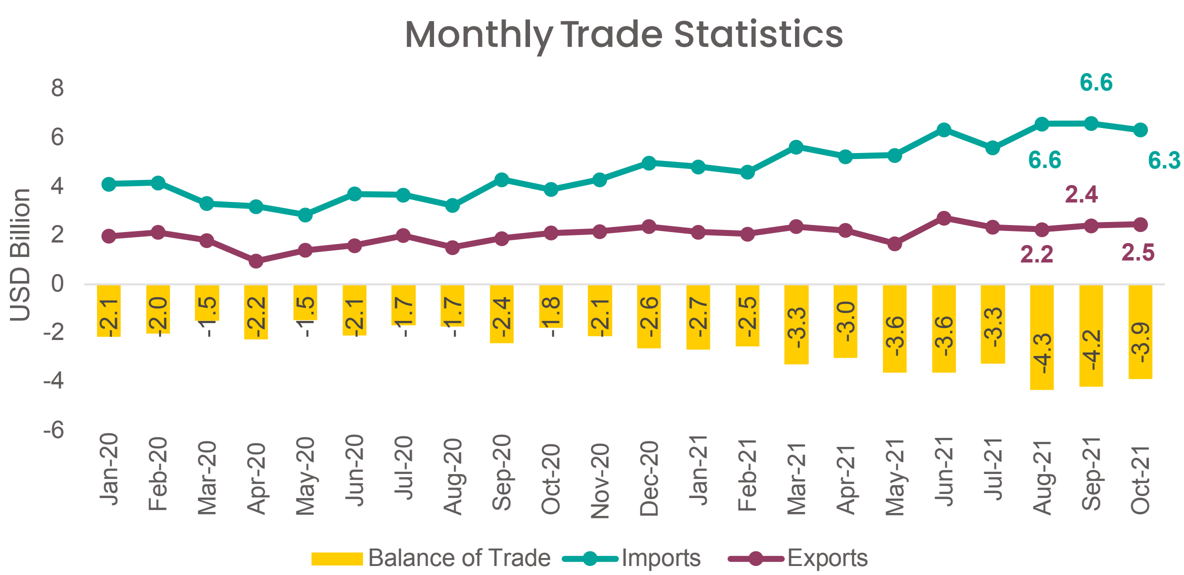


5. External Sector

5.1. International Trade

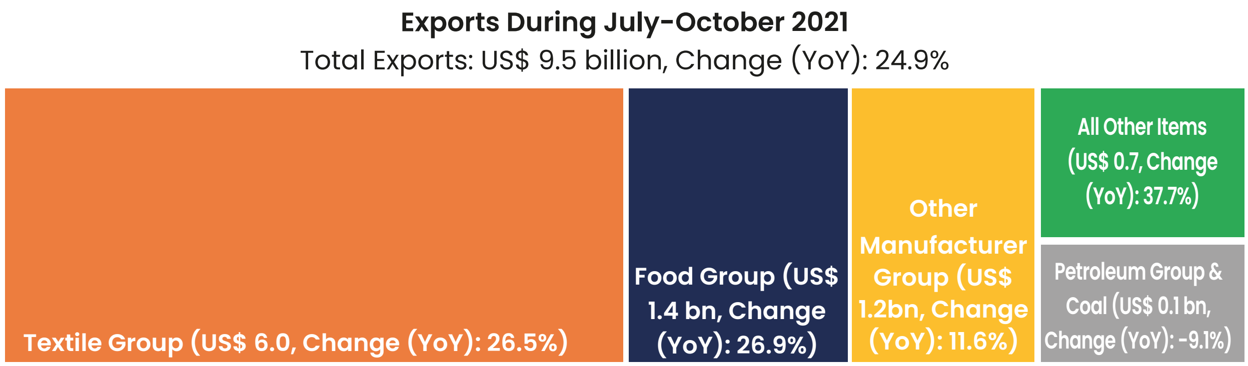
The trade deficit has been widening since November 2020 amid the reopening of borders after the pandemic and touched US$ -4.3 billion in August 2021- the highest since January 2020. It was recorded US$ -3.9 in October 2021 with imports and exports were US$ 6.3 billion and US$ 2.5 billion respectively. The trade deficit widened by around 106 percent during Jul-Oct FY 2022 as compared to same period last year. The comparison on monthly basis reflects that imports have declined to US$ 6.3 billion in Oct-21 as compared to US$ 6.6 billion during Sep-21. According to the Ministry of Commerce (MoC), 40 percent of these imports are comprised of capital goods, raw materials, and intermediaries. Whereas, the major part (60 percent) accounts for fuel (34%), vaccines (11%), food (8%), consumer goods and other goods (7%). Exports on the other hand reflects only a small increase of US$ 0.1 Billion in Oct-21 as compared to Sep-21.

Figure 11: Trend in Trade



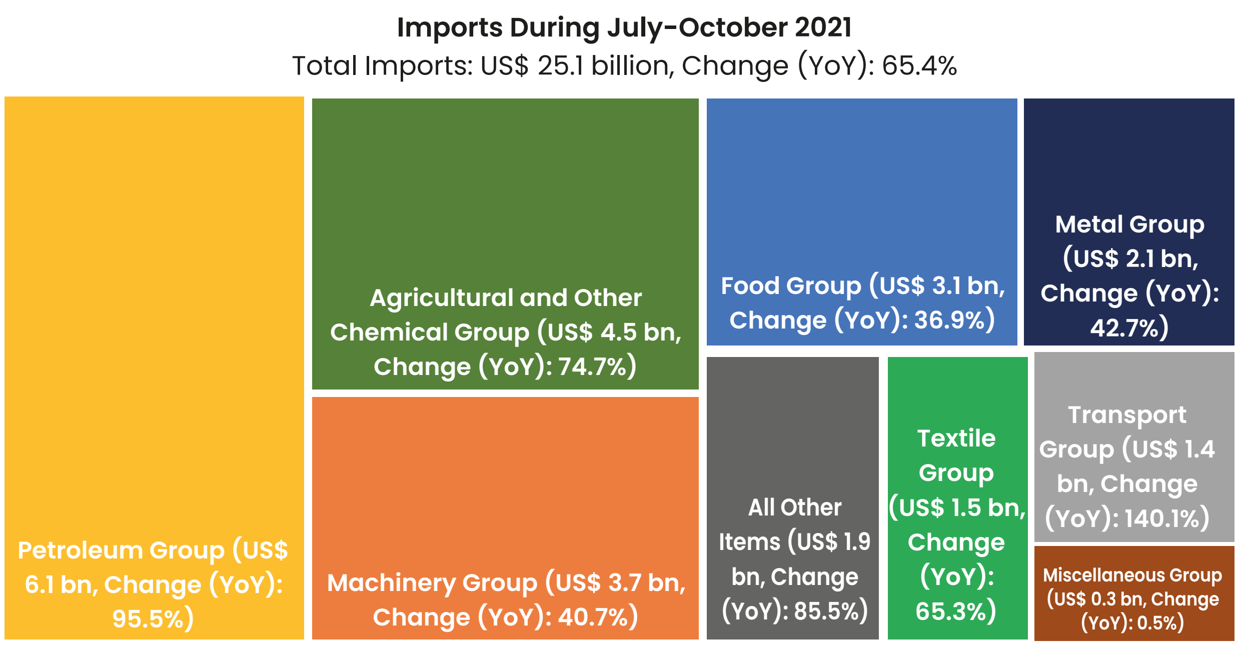
The figure below presents exports and imports during July-October 2021. Exports were US$ 9.5 billion in July-October 2021 showing an year-on-year increase of 24.9 percent. The increase in exports was primarily driven by textile (change: 26.5%) and food (change: 26.9%) during the period mentioned above.

Figure 12: Commodity Group-wise Exports during Jul-Oct 2021



Imports witnessed a robust increase with an import value of US$ 25.1 billion showing an increase of 65.4 percent during July-October 2021 as compared to the same period last year. A surge in imports was attributed to the petroleum group, showing an increase of 95.5 percent.

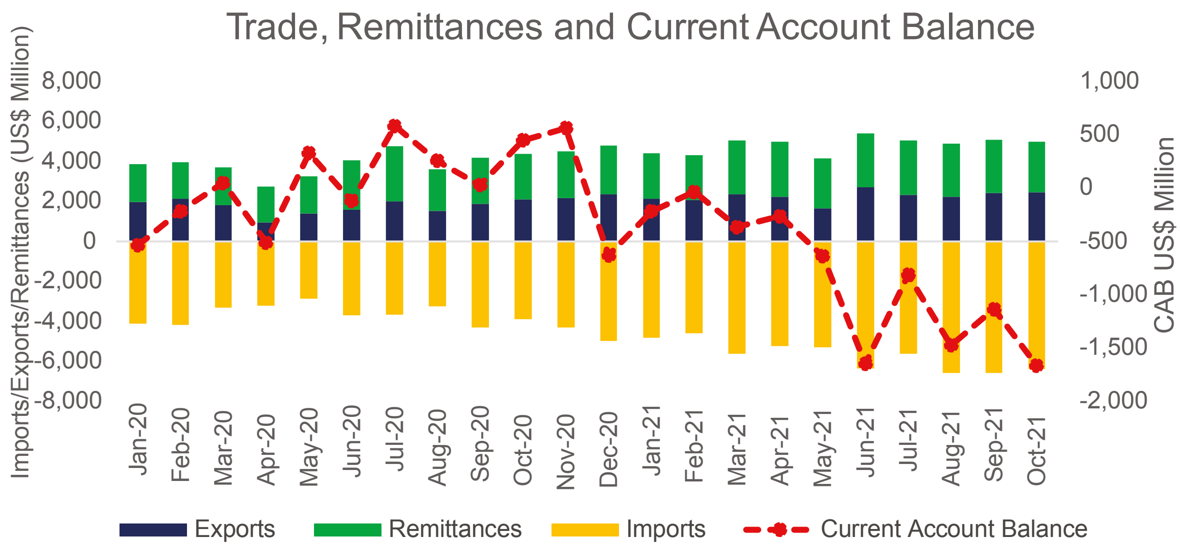
Figure 13: Commodity Group-Wise Imports during Jul-Oct 2021



5.2. Current Account Balance

The monthly current account deficit was US$ 1.1 billion in September 2021 which increased to US$ 1.7 billion in October 2021, up by 46.6 percent on a month-on-month basis. Exports grew by 2.3 percent whereas remittances and imports were declined by -5.8 percent and -2.7 percent respectively.

Figure 14: Trend in Trade, Remittances and Current Account Balances



6. Business Cycle Positioning

Gross Domestic Product (GDP), like other time series, is comprised of three components including long-term trends, business cycles, and short-term shocks. This study uses the Hodrick-Prescott (HP) filter of Hodrick and Prescott (1997) to decompose the real GDP growth rate into its components. The HP filter refers to a data-smoothing technique that removes short-term fluctuations associated with the business cycle. Removal of these short-term fluctuations reveals long-term trends. This can help with economic or other forecasting associated with the business cycle. The time series of real GDP can be decomposed into the following three components:

$$Real\ GDP_t = Y_t + C_t + I_t$$

Where Y_t = *Long-run trend;* C_t = *Cyclical movements; It = Random movements*

The HP filter decomposes the series by following two steps. In the first step, the long-run trend (T_t) component is extracted from the real GDP series. It then filters out cyclical components (C_t) from the rest[2]. The filtering methodology disintegrates the components by minimizing the following objective function:

$$\sum [\text{In } y(t) - \text{In } y^*(t)]^2 - \lambda \sum \{[\text{In } y^*(t+1) - \text{In } y^*(t)] - [\text{In } y^*(t) - \text{In } y^*(t-1)]\}^2$$

Where y* is the long-term trend and λ is the smoothness parameter. Hodrick and Prescott suggested λ = 100 for annual frequency time series. The procedure is repeated to isolate cyclical variation from irregular variations.

The table below summarizes business cycles identified using HP-filter. Pakistan is currently undergoing the fifth business cycle since its inception. The economy entered into a recessionary phase of the 5th business cycle in 2016 which is expected to continue till 2023.

Table 5: Business cycle turning points using HP-filter

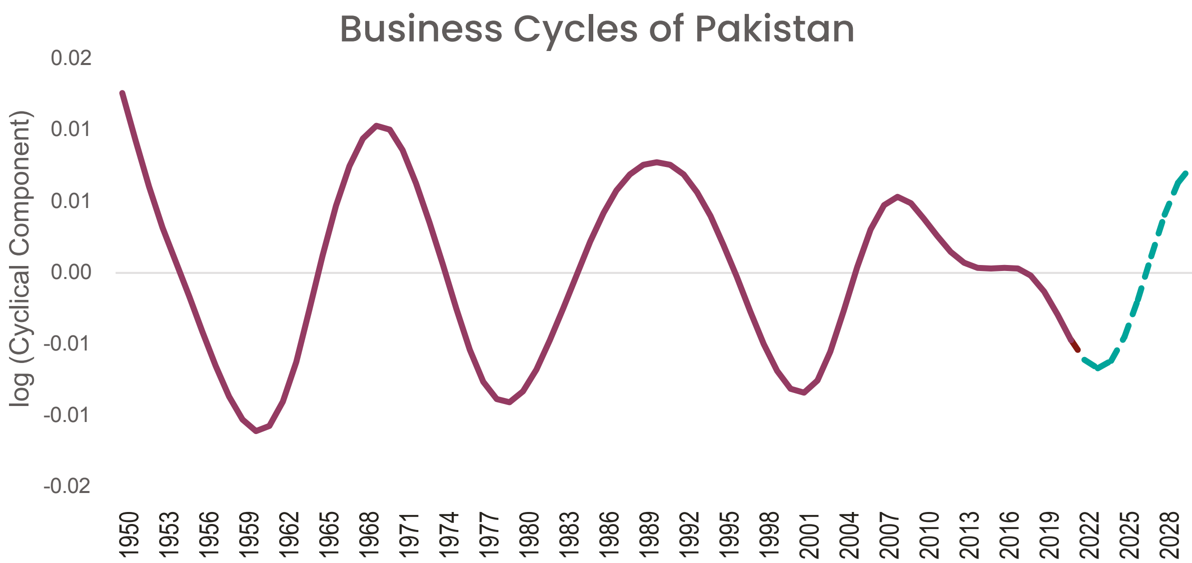
Business Cycles (Fiscal Year)	Duration	Recession	Trough	Recovery	Peak
First cycle	1950 – 1969 (20 years)	1950 – 1960	1960	1960 – 1969	1969
Second cycle	1969 – 1990 (22 years)	1969 – 1979	1979	1979 – 1990	1990
Third cycle	1990 – 2008 (19 years)	1990 – 2001	2001	2001 – 2008	2008
Fourth cycle	2008 – 2016 (09 years)	2008 – 2015	2015	2015 – 2016	2016
Fifth cycle	2016 – to date	2016 – 2023*	2023	2023 –	–

** Denotes forecasted dates*

[2]Details on methodology can be found at SBP Working Paper Series (WP 01)

The figure below presents the business cycles of Pakistan since its inception. Moreover, it forecasts the remaining phases of the fifth business cycle. Economic rebound is expected from the fiscal year 2023-24 which will continue till 2029-30.

Figure 15: Business Cycles in Pakistan



7. Monetary Policy Survey

The Policy Advisory Board- Federation of Pakistan Chambers of Commerce and Industry (FPCCI) has launched Monetary Policy Survey for its Monetary Policy Survey Series which aims to propose policy direction to the State Bank of Pakistan, this monetary policy survey is the second in a series. The survey respondents include industry participants, independent researchers/ economists, and financial markets representatives. The questionnaire designed for the survey covers policy rate suggestions and anticipation, inflation expectation, exchange rate regime, and current economic outlook. Results of the survey are discussed in the following sections[3].

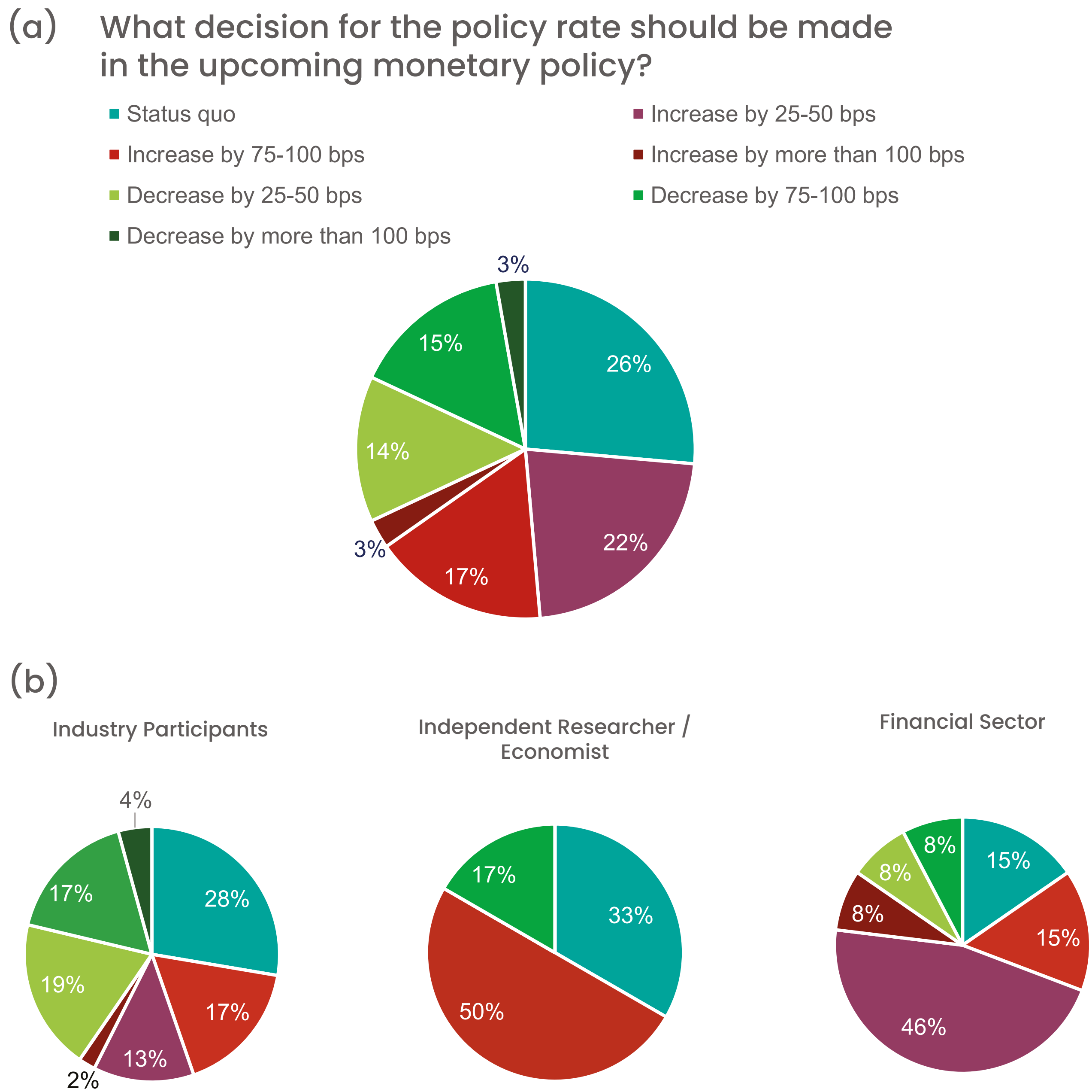
7.1. Policy Rate Direction

Results of the monetary policy survey, as presented in panel (a), reveal that around 58 percent of the total participants oppose the increase in policy rates with 26 percent suggesting to maintain the status quo and 32 percent advocating for a decrease in the policy rate. Among them, 15 percent suggested decreasing policy rates by 75-100 bps, 14 percent proposed a cut of 25-50 bps, and 3 percent advocated to decrease policy rate by more than 100 bps. Besides, 42 percent of the participants were of the opinion that the policy rate should be increased. The major reason cited to increase the policy rate was to keep the inflation and exchange rate stable and bring down imports. It is noteworthy that the decrease in interest rate has been suggested to enhance business activity. The next graph bifurcates the responses from different groups.

The panel (b) of the figure below further classifies the responses among industry participants, independent researchers, and financial market participants. Among industry participants, 68 percent of the participants oppose any increase in policy rates whereas only 32 percent suggested an increase. Independent Researchers/Economists mostly contended (i.e. 50%) to increase in policy rates whereas 69 percent of respondents in the financial sector advocated for the hike in policy rates.

[3]To save space, only results corresponding to policy rate direction was categorized into three group of respondents. Group-wise response on other questions can be viewed online on analytical dashboard link below:
https://fpcci.org.pk/pab-dashboard/

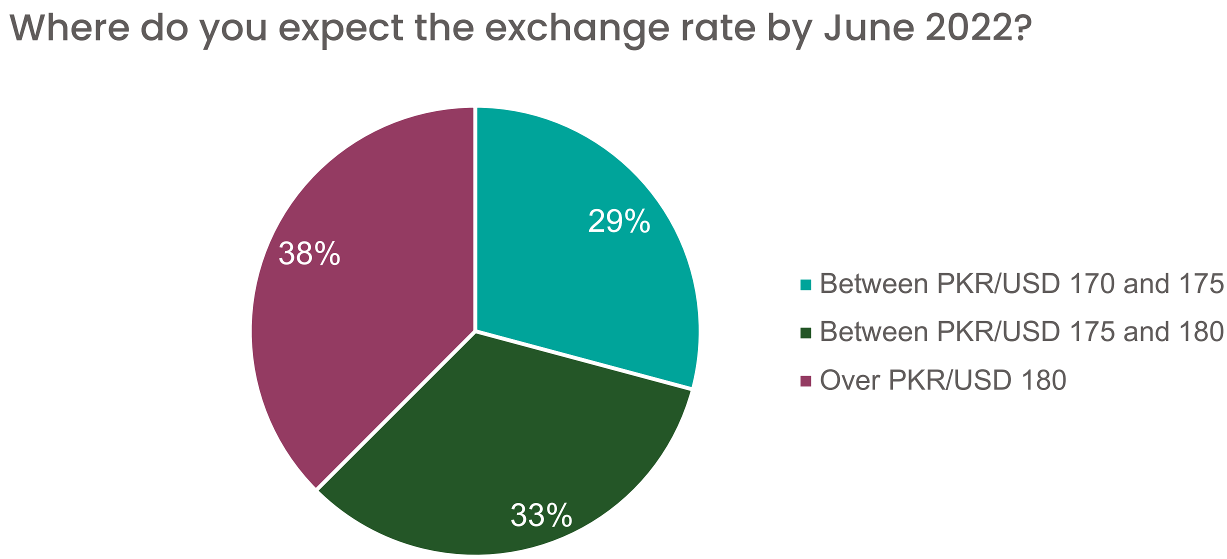
Figure 16: Survey Results for Monetary Policy Direction



7.2. Exchange Rate Expectation

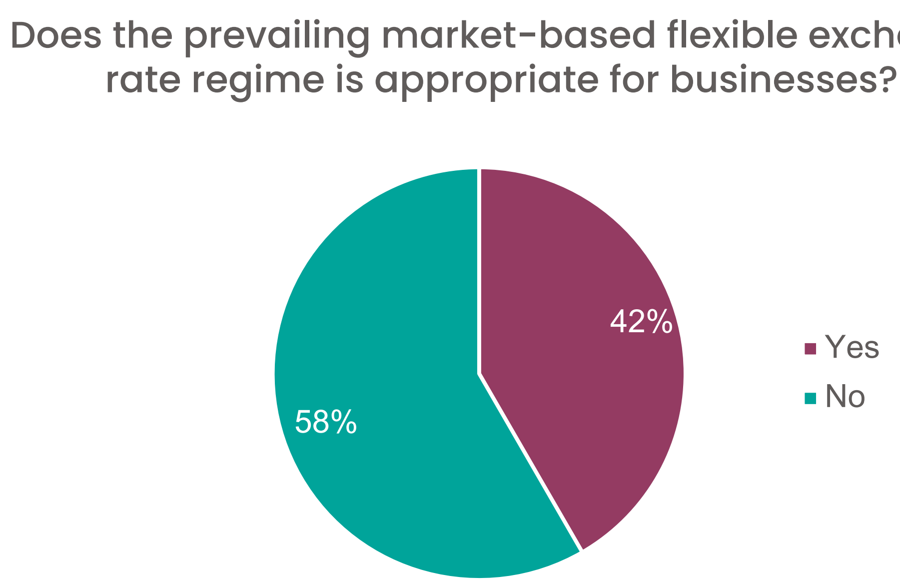
Regarding Exchange rate expectations, around 29 percent anticipated that the rupee value will remain in the range of 170-175 against US dollars by June 2022. Around 33 percent expected that the exchange rate will be between 175-180 whereas the highest percentage of participants i.e. 38 percent believe that the PKR will depreciate further and breach the level of 180 against US dollars.

Figure 17: Survey Results on Exchange Rate Expectation



The prevailing market-based flexible exchange rate regime was appreciated by 42 percent of the participants whereas 58 percent of the participants do not find the flexible exchange rate regime appropriate. This result is in contradiction with that of FPCCI's first monetary policy survey held in September 2021.

Figure 18: Survey Results on Exchange Rate Regime

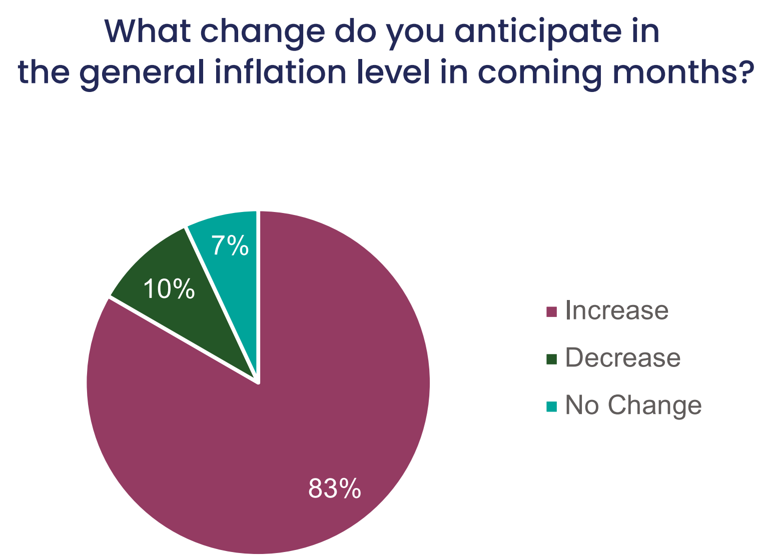


7.3. Inflation Expectations

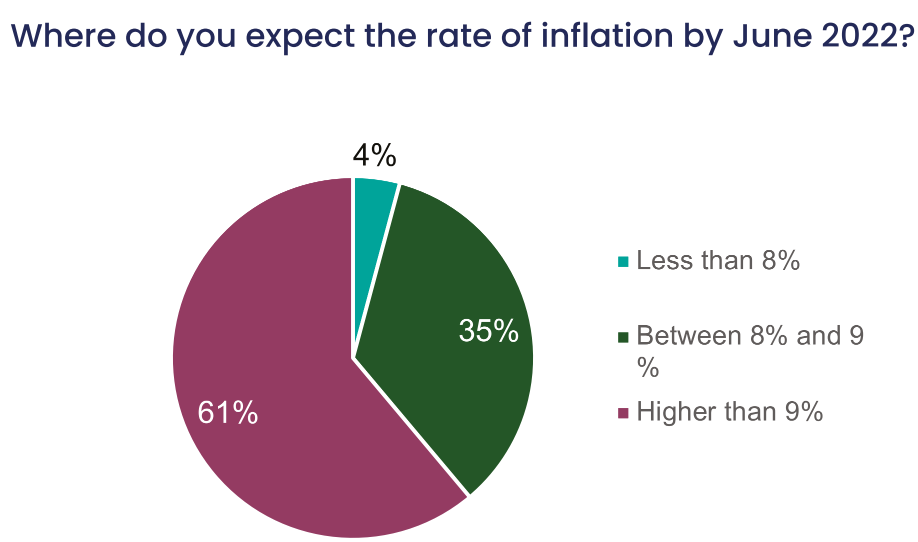
The majority of the survey participants i.e. 83 percent anticipated a further hike in inflation in the coming months whereas 61 percent of the participants believed that inflation will be higher than 9 percent by June 2022. Moreover, around 35 percent of the participants believe that inflation will remain in the range of 8-9 percent by June 2022.

Figure 19: Survey Results on Inflation Expectations

(a)



(b)



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Appendix: List of Respondents

S.No.	Name	Designation and Organization
		Industry and Commerce
1	Fayaz Ahmed	Secretary General, Pakistan Gemstone & Minerals Association
2	Mahmood Nawaz Shah	Member Policy Board- FPCCI
3	Agha Jan Akhtar	Rtd. Civil Servant
4	Zeeshan	Team leader
5	Asif	JAZZ
6	Dr. Usman Mustafa	Team Leader, ME&IE consultant, G3 (JV)
7	Dr Adnan	Chief Investment Strategist, AGA
8	Abdullah Zaman	Trade Manager
9	Ismail Suttar	CEO, Employees Federation of Pakistan
10	Shahid Sattar	Executive Director, APTMA
11	Shahid Anwar Tata	CEO, Tata Textile mills
12	Muhammad Saeed Azhar	CEO, Ranop Solutions Pvt
13	Abdul Jabbar	CFO, CONNECTDOTNET (PVT) LIMITED
14	Zohaib Akhtar	CEO, Sana Traders
15	Zeeshan Mansoor	Akhtar Textile Industries
16	Owais Ahmed Abbasi	SVP-Finance, Tata Pakistan
17	Muhammad Yousuf Munir	Lead Training & Development, Chase Up
18	Adnan	Head of Finance & Accounts, Lucky Textile Mills Limited
19	Shahnawaz Ahmed	Manager HR Admin, Dawood Engineering
20	Hassan Farooq	CEO, Hassan Siddiq Towers
21	Dastageer Shah	Forensics Analyst, Freelancer
22	Muhammad Mohsin	Regional Export Lead
23	Bilal Khalid Khan	Group CFO, Jadeed Feeds Industries (PVT) Ltd
24	Muhammad Haris	Ahmad Hassan Textile Mills
25	Abdus Samad	Proprietor of M/s. Samad Enterprise
26	Ikram ul Haq Chaudhary	Secretary General
27	Shahid Anjum	CFO, Stewart Pakistan Private Limited
28	Maqsood Ahmad	Atlas Energy Limited
29	Dr. Mariam Nouman	President, Women Chamber of Commerce & Industry, Sialkot.
30	Muhammad Ahsan Sultan	Chiesi Pharmaceuticals
31	Waqas Panjwani	CEO, RM SALT Pakistan
32	Shaheed Benazirabad Chamber of Commerce & Industry (SBCCI)	Secretary General, Shaheed Benazirabad Chamber of Commerce and Industry (SBCCI)
33	Murtaza Ali	Chief Executive - ALLIED RENTAL
34	Yousaf Rizvi	ISY PVT LTD
35	Saad Habib	Executive Director/ Jilani Industrial Corporation Pvt. Ltd (Member Flexible Packaging Association of Converters of Pakistan)
36	Mr. Shafiq Ur Rehman	Chairman Departmental Committee on Banking and Finance
37	Farhan Khan	Assistant, Charsadda Chamber of Commerce & Industry

38	Shakeel Muhammad	Secretary General, Mardan CCI
39	Arif ud din	Research and Development, Chamber of Commerce and Industry
40	Kashif Sheikh	Accountant, KP FS&HFA
41	Sardar Fakhre Alam Khan	Secretary General, Nowshera Cahmber of Commerce and Industry
42	Majyd Aziz	President UN Global Compact Network Pakistan
43	Muhammad Shahzeb Khan	Jhelum Chamber of Commerce and Industry
44	Muhammad Salman Khan	Swabi Chamber of Commerce and Industry
45	Muhammad Younus	Pakistan Textile Mills Association
46	Adnan	Director
47	Adeel	
	Independent Researchers/ Economists	
48	Dr. Hafiz A. Pasha	Professor Emeritus BNU
49	Dr. Vaqar Ahmed	SDPI
50	Syed Ghayyur Alam	Senior Assistant Professor
51	Dr. Kashif Imran	Assistant Prof. IOBM, Karachi
52	Dr. Aadil Nakhoda	Institute of Business Administration, Karachi
53	Muhammad Asif Iqbal	MD, Social Policy and Development Centre
54	Mirza Faizan Ahmed	Assistant Professor, Department of Economics and Management Sciences, NED University of Engineering and Technology
55	Dr. Usama Ehsan Khan	Senior Researcher - FPCCI
56	Hammad Ezad	Senior Researcher - FPCCI
57	Amina Qureshi	Senior Researcher - FPCCI
58	Mansoor Muhammad Isani	Junior Researcher- FPCCI
59	Uzma Aftab	Junior Researcher- FPCCI
	Financial Sector	
60	Raheel Qamar	CEO, ORIX Services Pakistan Private Limited
61	Monis	Manager - Soneri Bank
62	Fahad Ullah	Treasury Officer Operation at Zarai Taraqiati Bank Ltd
63	Raheel Qamar Ahmad	ORIX Modaraba (formerly Standard Chartered Modaraba)
64	Ayaz Dawood	CEO, BRR Guardian Modaraba
65	Adil Ghaffar	CEO First Equity Modaraba
66	Muhammad Shoaib Ibrahim	First Habib Modaraba
67	Tipu Saeed Khan	Lead Consultant, Fintax Consulting
68	Noorulain Fatima	Credit Analyst - Meezan Bank Limited
69	Zahra Khurram	Meezan Bank Ltd
70	Mashmooma Z. Majeed	Mutual Funds Association of Pakistan
71	Arsalan Raja	Assistant Vice President BMA Capital Management
72	Muhammad Ahmad, CFA ACMA UK CPA	VP CIB Credit, First Abu Dhabi Bank

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