



State Bank of Pakistan

GOVERNOR'S ANNUAL REPORT 2022 - 2023

Governor's Annual Report

2022-2023

December 29, 2023



State Bank of Pakistan

Governor's Annual Report

2022-2023

The analyses presented in this report were prepared on data outturns for fiscal year 2023 (July 2022 - June 2023). These were finalized in November 2023, using data and developments as of then.

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This Report has been prepared in accordance with section 39(1) of the *SBP Act 1956* (as amended up to January 2022), which states that “the Governor shall submit annual report before the Majlis-e-Shoora (Parliament) regarding the achievement of the Bank's objectives, conduct of monetary policy, state of the economy and the financial system.”

Objectives of the State Bank of Pakistan

Objectives	The objectives of the State Bank of Pakistan are set out in section 4B of the <i>SBP Act 1956</i> (as amended up to January 2022), which states: 1. The primary objective of the Bank shall be to achieve and maintain domestic price stability. 2. Without prejudice to the Bank's primary objective, the Bank shall contribute to the stability of the financial system of Pakistan. 3. Subject to sub-sections (1) and (2), the Bank shall support the Government's general economic policies with a view to contributing to fostering the development and fuller utilization of Pakistan's productive resources.
Definition of Price Stability	“Price stability” means the maintenance of low and stable inflation guided by the government's medium-term inflation target. (section 2 (kb) of the <i>SBP Act 1956</i> (as amended up to January 2022))

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Mr. Muhammad Ali Latif	Non-Executive Director SBP Board
Mr. Fawad Anwar	Non-Executive Director SBP Board

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
December 29, 2023

Dear Mr. Chairman,

In terms of Section 39(1) of the State Bank of Pakistan Act, 1956, Governor's Annual Report on the achievement of the Bank's objectives, conduct of monetary policy, state of the economy and the financial system for the year 2022-2023 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament).

With warm regards,

Yours sincerely,



(Jameel Ahmad)
Governor
Chairperson, Board of Directors

Mr. Muhammad Sadiq Sanjrani
Chairman
Senate of Pakistan
Islamabad

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State Bank of Pakistan
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With warm regards

Yours sincerely,



(Jameel Ahmad)
Governor
Chairperson, Board of Directors

Raja Pervez Ashraf
Speaker
National Assembly of Pakistan
Islamabad

Contents

	Governor's Remarks	1
	1 The State of Pakistan's Economy and Financial System	5
	2 Price Stability and the Conduct of Monetary Policy	21
	3 Financial Stability	33
	4 Measures to Support the Government's Economic Policies	43
	Annexure 1: Structure and Regulatory Architecture of Financial System of Pakistan	59
	List of Abbreviations	61

List of Figures

Figure 1.1a	Trends in World Commodities Price Index	6
Figure 1.1b	World Commodities Price Indices	6
Figure 1.2	Key Regulatory and Fiscal Measures	7
Figure 1.3	Total Gross Capital Formation	8
Figure 1.4	Growth in Remittances and Kerb Market Premium	8
Figure 1.5	Export Growth of Selected Economies	8
Figure 1.6	Pakistan's Balance of Payments	9
Figure 1.7a	Currency Volatility: MoM Changes in PKR	10
Figure 1.7b	Currency Volatility over the Years	10
Figure 1.8	Net Loan Disbursement to Private Sector Businesses	12
Figure 1.9a	Trend in Urban Inflation	12
Figure 1.9b	Trend in Rural Inflation	12
Figure 1.10	Trend in Financial Market Stress Index	17
Figure 1.11a	Composition of Retail Banking Transactions: Values	18
Figure 1.11b	Composition of Retail Banking Transactions: Volume	18
Figure 2.1	Inflation Projections and 12-MMA Inflation - FY23	22
Figure 2.2a	Inflation Expectations and Core Inflation	23
Figure 2.2b	Energy Prices and Core Inflation	23
Figure 2.2c	Exchange Rate Depreciation and Core Inflation	23
Figure 2.3	High-frequency Demand Indicators	23
Figure 2.4a	Inflation Started to Decline in H2-FY23	24
Figure 2.4b	Pace of Tightening Slowed Down in H2-FY23	24
Figure 2.5	Economic Policy Uncertainty (EPU) Index	24
Figure 2.6	National CPI Inflation	26
Figure 2.7	ONR Deviation from the Policy Rate	31
Figure 2.8	Interbank Liquidity Indicators in FY23	32
Figure 3.1	Banking Sector Stability Map	33
Figure 3.2	Composition of Banks' and MFBs' Borrowers	34
Figure 3.3	Results of Selected Single Factor Sensitivity Shocks	35
Figure 3.4	Capital Adequacy Ratio – Actual and Projected under Business As Usual and Stressed Conditions	38
Figure 3.5	Frequency Distribution of Credit Ratings	39
Figure 3.6	Key Elements of SBP's Regulatory and Supervisory Frameworks	40

List of Tables

Table 1.1	Actual and Expected Revenue Growth without New Measures - FY23	11
Table 1.2	Assets Composition of the Financial Sector	13
Table 1.3	Key Balance Sheet Variables of Banks, DFIs and MFBs	14
Table 1.4	Performance of Islamic Banking	17
Table 1.5	Movements in Key Variables of Financial Markets	18
Table 1.6	E-Banking Transaction Channels	19
Table 2.1	Inflation in Pakistan	21
Table 2.2	SBP's Macroeconomic Projections and Actual Outcomes for FY23	25
Table 3.1	Key Financial Soundness Indicators of Banks, DFIs and MFBs	34

Governor's Remarks

Heightened uncertainty has been the hallmark of the global economy in recent years. The pandemic, geopolitical tensions, global commodity price super cycle, and climate disasters – the world has been shaken up by these shocks. The fiscal year 2023 also left policymakers with an extraordinarily challenging environment for the fourth consecutive year. With the Russia-Ukraine conflict fuelling post-Covid global commodity price hike, inflation rose to multi-decade high in most of the advanced and emerging economies, and global financial conditions remained under stress. While commodity prices softened by the end of the year, the underlying inflationary pressures remained sticky, despite aggressive policy stances by the world's major central banks and slowing global economic activities.

The impact of these and a host of domestic shocks was particularly pronounced in Pakistan due to the country's longstanding structural weaknesses – such as low tax base, weak productivity and competitiveness, and high public debt – that make the economy less resilient to shocks. The fiscal year 2023 began in the backdrop of strong growth during the previous two years and the lingering effects of fuel and power subsidies in Q4-FY22. The summer floods at the start of FY23 had damaging impact on the economy, which reverberated throughout the year given its devastating effects on lives, livelihoods and infrastructure. The fiscal year 2023 was also marked by political uncertainty that became prominent in the last quarter of FY22 and continued for the most part of FY23. As the year progressed, the negative effects of floods, the persistently elevated global commodity prices in the first half of FY23, and growing pressures on the external account became visible on the exchange rate and inflation outturns.

The scheduled external repayments amid the delay in the completion of the 9th review of the IMF's Extended Fund Facility program and ensuing dearth of external inflows also added to pressures on the external account and the PKR. At the same time, the envisaged fiscal consolidation did not materialize due to less than planned tax revenues amid economic slowdown and lower than targeted reduction in subsidies, despite the reversal of fuel and power subsidies that were announced through the fiscal package in Q4-FY22. While both fiscal and primary balances improved over the previous year, their budgeted targets were missed by a large margin. This was despite notable, albeit delayed, fiscal policy measures in the second half of the year – such as the increase in regulatory duty and GST rates, and some additional tax measures announced through the Finance (Supplementary) Act 2023 – that also added to the already high inflationary pressures.

In this challenging environment, the SBP continued with its contractionary policy throughout the year. Over the course of FY23, the SBP raised the policy rate by a cumulative 825 basis points, taking the total increase to 1,500 basis points since September 2021. In addition, the central bank imposed a variety of measures to contain domestic demand and imports in the wake of growing pressures on PKR and the general prices. These measures, though difficult and painful given their implications for economic activity in the short term, were necessary to meet external debt obligations as per schedule, and contain greater risks to macroeconomic stability over the medium term.

Weighed by the impact of floods, rising cost of production, lower external demand, FX constraints, elevated inflationary pressures, together with policy and administrative measures by the SBP and the government, real GDP growth turned negative 0.2 percent in FY23. Large scale manufacturing contracted by nearly 10 percent after posting double-digit growth in the previous two years, whereas agriculture growth slowed, due to the flood-induced damages mainly to cotton and rice crops. Despite considerable moderation in domestic demand and private sector credit, average national CPI inflation surged to 29.2 percent in FY23, compared to 12.2 percent last year.

The inflation outturn for FY23 was around the upper end of SBP's revised inflation projection of 27 – 29 percent, which is a substantial deviation from the medium term target of 5 – 7 percent. In line with global trends, the mounting inflation was driven by both elevated global commodity prices as well as underlying pressures manifesting as a broad-based increase in prices reflecting the pass-through of costlier fuel and food; exchange rate depreciation; high inflation expectations; and ensuing growth in wages. These were in addition to the impact of floods, the revision in energy prices, and increase in indirect taxes and levies that feeds into market prices of goods and services.

The inflationary pressures and other factors weighing on the economy kept overall domestic macro-financial conditions under stress during FY23. However, the financial sector's soundness remained intact. Despite some moderation in deposit growth, the banking sector remained stable, and even witnessed improvement in liquidity coverage, asset quality and capital adequacy ratios, with the ratio of non-performing loans (NPLs) as percent of total loans remaining steady near last year's level. However, the NPL ratio for microfinance banks (MFBs) increased due to the impact of floods and the slowing economy. The SBP's regulatory and supervisory measures for MFBs, nevertheless, helped them contain the significant increase in NPLs and improve credit availability. The SBP also took a number of initiatives to strengthen its regulatory framework and supervisory effectiveness in line with emerging best practices and changing market dynamics.

In addition to ensuring financial stability, the SBP took several measures as part of its objective to support the government's economic policies with a view to contribute towards the development and fuller utilization of the country's resources. These measures are aligned with the SBP's tertiary objectives given their contribution to financial stability. From the perspective of financial inclusion, these measures included continuation of the National Financial Inclusion Strategy, and the Banking on Equality (BoE) policy. These initiatives helped in improving access to basic financial services, including savings, credit, and payments, and in reducing the gender gap in financial inclusion. The BoE has already started bearing fruits in terms of increase in women owned active accounts, improved ratio of female staff at financial institutions, and the establishment of women's financial services departments/teams for the launch of women centric financial products. In order to support the flood affected agriculture sector, the SBP implemented the PM's Kissan Package and achieved higher agriculture credit target during FY23. Moreover, in view of the national food security requirements, the central bank enhanced the indicative credit limit for wheat and other crops.

The SBP has also taken several measures to enhance the outreach of digital financial services. The Bank launched awareness campaigns, which helped more than double Asaan Mobile Accounts, provided continued support to significantly grow the volume and size of transactions on the instant payment system, RAAST, and issued no objection certificates to five applicants for the establishment of digital retail banks under the Licensing and Regulatory Framework for digital banks. The SBP also took several measures to enhance security of digital banking products and services and to protect customers from unauthorized/illegal digital lending apps. In addition to these, the SBP took various measures to encourage exports of software/IT service companies and freelancers, and to support overseas Pakistanis through various channels aimed at increasing investments and remittance in the country.

In the meanwhile, Islamic banking continues to prosper with total assets and deposits continuing to grow in FY23. The SBP is also taking measures to implement the Federal Shariat Court's judgement on Riba. To this effect, the SBP is actively engaging key stakeholders to develop requisite framework. Accordingly, the Bank's organisational structure has also been changed, where a dedicated Islamic Finance Group has been established with two departments, namely Islamic Finance Policy Department,

and Islamic Finance Development Department, in cognizance of the need for a focused approach to achieve objectives.

These measures are important for long term economic growth and development of the country. Concurrently, the fiscal policy and effective administration are also critical for price and financial stability. These include: strengthening food and energy supply chains, enhancing productivity, reducing the size of the informal economy, and improving tax revenues. Similarly, while the responsibility of price stability rests with the central bank, rationalization of government spending, and increasing revenue collection aimed at public debt sustainability is important to contain price pressures.

The SBP will continue to take decisions to prevent high inflation from becoming entrenched and keep inflation expectations anchored to achieve the medium term target of 5 – 7 percent by the end of FY25. This hinges on the absence of adverse shocks stemming from geo-political tensions, unforeseen climate events, and unfavourable movements in global commodity prices. In the near term, the impact of contractionary monetary policy, improvements in domestic supplies, softer global commodity prices, and the high base effect are expected to moderate average inflation to 20.0 – 22.0 percent in FY24. At the same time, the economic activity is expected to moderately recover, led by improved crop outlook. The data on high-frequency indicators also suggest bottoming out of economic activities from July 2023. The provisional estimates show that the real GDP grew by 2.13 percent in Q1-FY24 compared to 0.96 percent in Q1-FY23, which is in line with the SBP's full-year growth projection of 2.0 – 3.0 percent for FY24. On the other hand, the inflow of US\$ 1.2 billion in July 2023, following the agreement of over US\$ 3.0 billion from the Stand-By Arrangement with the IMF along with the ongoing administrative drive have eased pressures on exchange rate. The expected increase in export earnings amid slight improvement in global and domestic growth is also expected to support foreign exchange reserves. The SBP projects the current account deficit to fall in the range of 0.5 – 1.5 percent of GDP in FY24.

However, in view of the uncertainties over the path of global commodity prices, above-target inflation in most advanced economies and its potential impact on global financial conditions, and Pakistan's susceptibility to shocks, the SBP will continue with its data-dependent approach to calibrate monetary policy decisions to respond to changing near-term inflation outlook. Accordingly, under the fourth Strategic Plan – Vision 2028, the SBP plans to further strengthen its analytical and forecasting capabilities, including deeper understanding of monetary policy transmission and medium term inflation forecasts. Pakistan has navigated difficult situations before, and we stand ready to put inflation on a downward path, ensure financial stability, and work in concert with the government for development and fuller utilisation of the country's resources.

1 The State of Pakistan's Economy and Financial System

The fiscal year 2023 was another challenging year for the economy. Inflation rose to a multi-decade high amid contraction in economic activities in an environment that remained stressful and uncertain due to the emergence of various shocks. At the same time, external account vulnerabilities increased, which kept FX reserves and exchange rate under pressure. These dynamics warranted the continuation of monetary policy tightening that began in September 2021, alongside the implementation of various macro-prudential measures by the SBP. This was done to cool domestic demand and contain imports, even as fiscal consolidation remained less than budgeted. Despite these challenges, the country's financial sector operated smoothly and without any disruption in the provision of credit and financial services. Although the asset base of the financial sector grew at a faster pace compared to the previous year in nominal terms, it fell as a percentage of GDP.

1.1 The State of Pakistan's Economy

Pakistan experienced a highly uncertain macroeconomic environment during FY23. The country's real GDP growth was negative for the first time since FY52 sans the once-in-a-century pandemic-led global contraction in FY20. Average National CPI (NCPI) inflation surged to a multi-decade high. The local currency weakened sharply amid considerable volatility as the external account remained under pressure despite a lower current account deficit (CAD). While these developments indeed reflect longstanding structural weaknesses, a host of unprecedented global and domestic shocks triggered these macroeconomic outcomes.

These shocks started to affect the economy since the second half of FY22, and continued to do so throughout FY23 amid lingering political

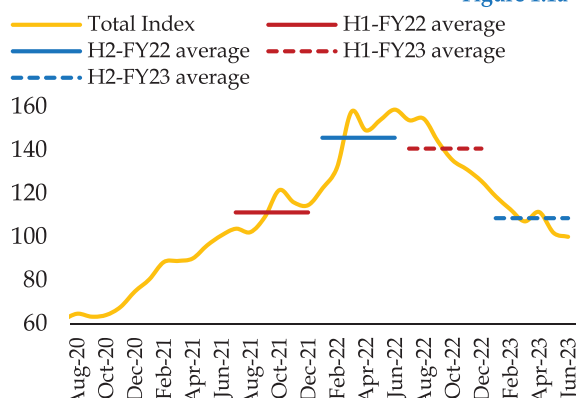
uncertainty, delay in the completion of the 9th review of the IMF's Extended Fund Facility (EFF) program, and tight global financial conditions. In particular, the devastating floods had wide-ranging impact on the economy, including damages to lives, livelihoods, crops, and road infrastructure that disturbed supply chain operations. Moreover, the persistently elevated global commodity prices until the first half of FY23, and the lagged impact of more-than-planned fiscal expansion in Q4-FY22 followed by a less-than-budgeted consolidation in FY23 adversely affected key macroeconomic indicators, especially inflation and external account.

Responding to these challenges, the SBP continued to tighten monetary policy with a cumulative 825 basis points (bps) increase in the policy rate during FY23 aimed at reducing demand pressures and preventing de-anchoring of inflation expectations. With economic conditions becoming more challenging in H2-FY23, owing to a persistent rise in core inflation and growing external account pressures, the SBP increased the policy rate by 600 bps in H2-FY23 compared to 225 bps in the first half. The SBP also introduced various measures to contain domestic demand and reduce imports. While these expectedly contributed to lower availability of imported inputs and raw materials, they were necessary to ease external account pressures and prevent much greater challenges to economic stability, at a time when there was a dearth of external inflows. In addition, the government levied regulatory duties and additional taxes while rationalizing energy tariffs as the year progressed in an effort to improve fiscal balances.

International Developments

Global commodity prices declined on a year-on-year basis by the end of FY23. However, despite a gradual softening, commodity prices remained

Trends in World Commodities Price Index Figure 1.1a



Source: World Bank

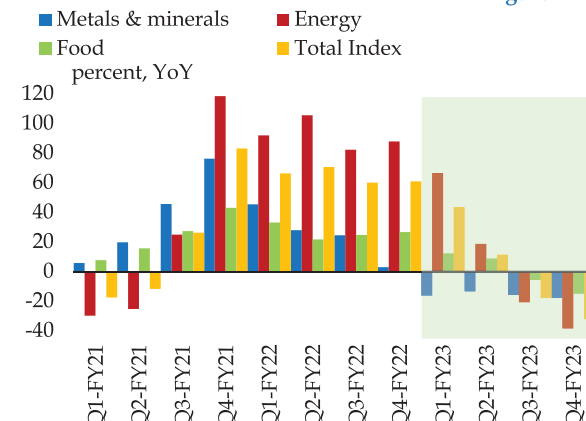
higher at the start of the year, particularly in the first half. By the end of the first quarter, the global commodity price index was higher by more than 40 percent year-on-year, notably because of food and energy prices that reflected heightened uncertainty over the Russia-Ukraine conflict, concerns over tight energy supply, and the pass on of costlier energy onto food and fertilizer prices (**Figure 1.1a & b**). This, along with the appreciation of US dollar against other currencies, and tight labour market conditions that resulted in sticky core inflation, contributed to multi-decade high inflation in many advanced, emerging and developing economies.

Faced with high inflation and geo-economic uncertainties, global central banks acted synchronously and aggressively tightened monetary policies. By the end of the year, headline inflation came down from its peak, as commodity prices tapered off during the second half of FY23. However, core inflation remained persistent, compared to the headline number. The confluence of these factors coupled with US-China trade tensions slowed global economic activities and consumer demand, including in the countries that are Pakistan's key export destinations.

Real Sector

The developments in global markets and economies coupled with domestic uncertainties

World Commodities Price Indices Figure 1.1b

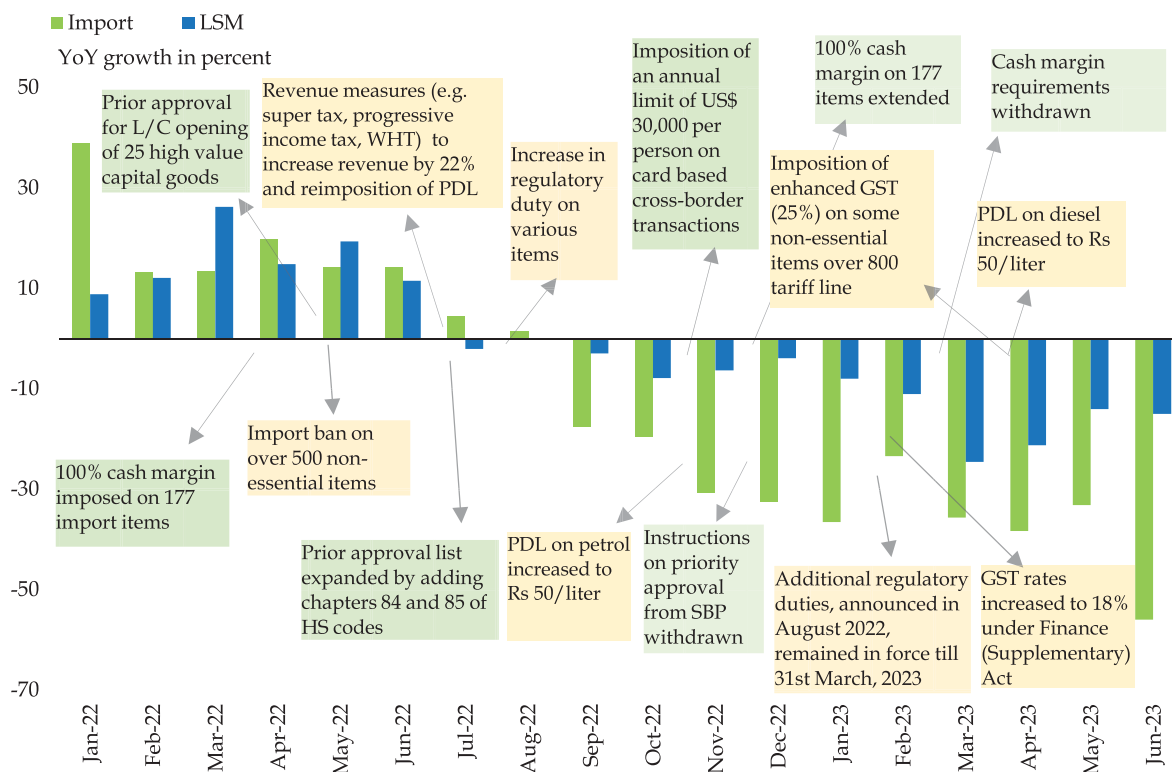


and shocks had a multi-pronged impact on economic activity in Pakistan. First, lower external demand contributed to the decline in domestic production. Second, elevated global commodity prices in the first half of the year together with PKR depreciation and increase in domestic energy tariffs in the second half raised the cost of production. Third, various measures taken by the SBP and the government reduced imports, a trend that was also reinforced by the government's additional fiscal efforts. These measures complemented the contractionary impact of policy rate hikes during FY22 and the cumulative 675 bps increase in FY22. (**Figure 1.2**). Fourth, the FX constraints in the backdrop of lower external demand and uncertainty surrounding the finalization of IMF's 9th review of EFF, and flood-induced supply shortages affected domestic production from the start of the year.

In the agriculture sector, crop output decreased by 1 percent in FY23 against a growth of 8.2 percent last year, mainly due to extreme weather conditions. Drought like conditions had already led to less-than-targeted sowing of cotton at the beginning of the Kharif season. Later, heavy monsoon and the ensuing floods significantly damaged cotton and rice crops. However, a bumper wheat crop and higher sugarcane production partially compensated for the losses, as better water availability after the floods helped improve their yields. From the

Key Regulatory and Fiscal Measures

Figure 1.2



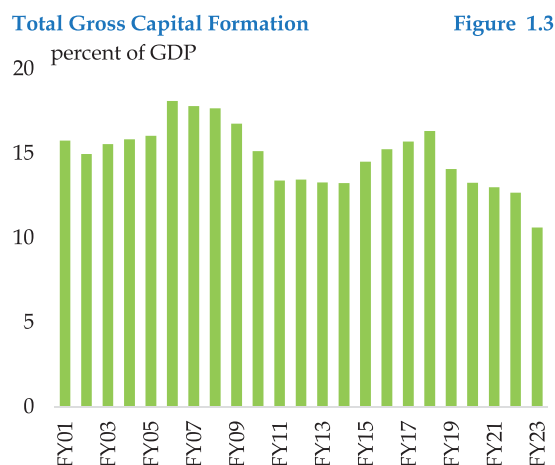
Sources: State Bank of Pakistan, Ministry of Commerce and Federal Board of Revenue

perspective of farm inputs, increased cost of production, particularly due to costlier fertilizer, also impacted crop production despite notable increase in agriculture credit. Nevertheless, due to an estimated inter-census growth in livestock, the agriculture sector still managed to grow by 1.6 percent, albeit much lower compared to 4.3 percent in FY22.

The floods along with the contractionary fiscal and monetary measures amid tight global economic conditions also led to a broad-based contraction of about 10 percent in large scale manufacturing (LSM). While output fell throughout the year, the decline was more pronounced in H2-FY23. With 18 out of 22 sectors reporting a drop in production, output in several key sectors, such as textile, food, pharmaceutical, petroleum refining, automobile, and non-metallic minerals, fell to its lowest level since FY16. In particular, the textile sector was affected by damages to cotton crop due to floods

and weak external demand, indicated by lower export volumes in nearly all its sub-sectors except for wearing apparel. Moreover, a number of textile and automobile firms intermittently suspended production as political uncertainty and challenging economic conditions weighed heavily on business and consumer sentiments.

As a result of contraction in commodity producing sectors and its consequent impact on the services sector, particularly wholesale and retail trade, and finance and insurance, real GDP contracted by 0.2 percent after recording around 6 percent growth in the previous two years. From the expenditure side, consumption accounted for about 94 percent of the GDP while investments continued to falter amid limited fiscal space for public sector development spending (PSDP). The decline in investment is disconcerting given its negative implications for the economy's productive capacity and future



Source: Pakistan Bureau of Statistics

economic growth, external account, and inflation (**Figure 1.3**).

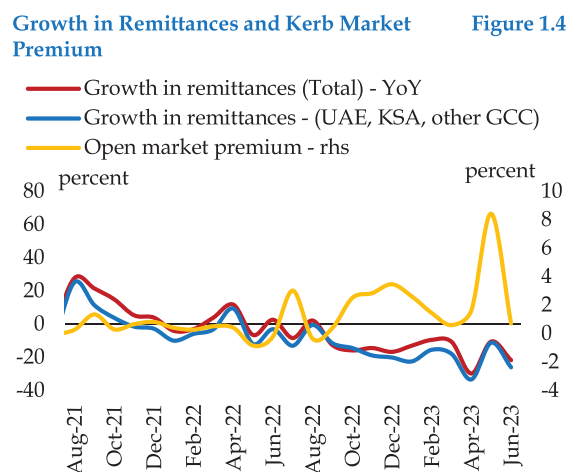
External Sector

The factors underpinning slower growth led to a sharp contraction of 86 percent in the CAD, as the policy-induced sharp decrease in imports offset the decline in workers' remittances and exports. Workers' remittances dropped by 13.6 percent in FY23, recording a decrease for the first time in six years. With the exception of the US, the fall in remittance was broad-based across all major corridors, with the pace of decline increasing in the second half of FY23. While this is attributed to slowing economic activities and increased cost of living in global

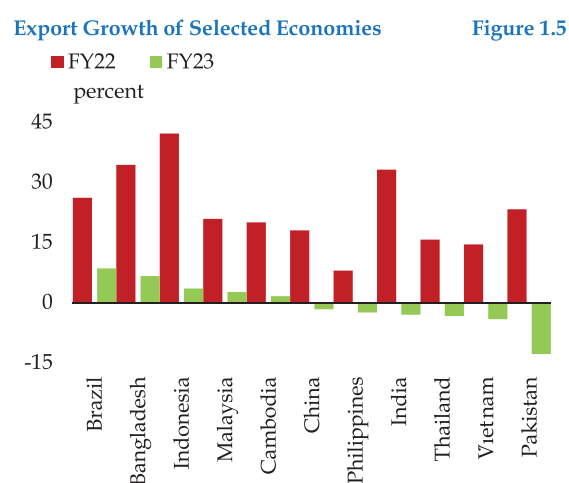
economies, it also reflects the moderation in crude oil prices in H2-FY23 that impacted economic activity in the oil-exporting countries. Heightened domestic uncertainties, increased exchange rate volatility and high kerb premium, particularly in the second half of FY23, also contributed to lower remittance flows through formal channels (**Figure 1.4**).

Export growth in FY23 tapered off for a host of emerging and developing economies due to slowing global demand. However, Pakistan's exports were affected much more than the peer economies due to the combination of domestic and external shocks given the country's structural weakness (**Figure 1.5**). The country's exports fell 14 percent in FY23, with the decline becoming visible from Q2-FY23 in the aftermath of the floods that damaged export-oriented crops like cotton, rice and fruits.

The decrease in exports was broad-based in textile and non-textile categories alike on account of both lower export prices and volumes. The slowdown in traditional export markets led to a nearly 15 percent fall in textile exports, despite a notable increase in the export volume of wearing apparel. Wearing apparel exports benefitted from Covid-led disruptions in Chinese shipments to buyers in the EU and the US, who diverted export orders to alternate suppliers. Among non-textile items, the fall in export of rice and fruits contributed nearly 45



Source: State Bank of Pakistan



Source: Haver Analytics

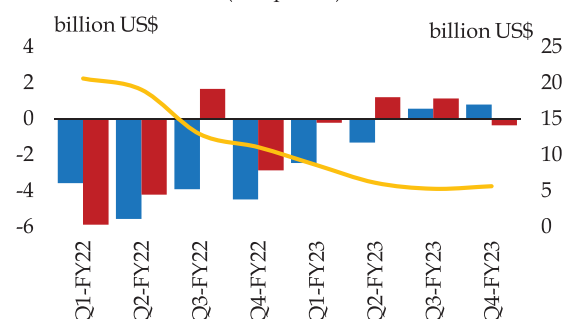
percent of the total US\$ 1.2 billion decline in that category. Despite higher prices, export of non-basmati rice, which constitutes a bulk of rice exports, decreased by nearly 18 percent during FY23.¹

In comparison, imports dropped by about 27 percent in FY23, where the decline in non-energy imports was sharper than that in energy products. The fall in imports was more pronounced in the second half of FY23 in line with slowing domestic demand and economic activity. The fall in imports also reflected the impact of falling global commodity prices and various policy measures taken by the SBP and the government at a time when sharp PKR depreciation started to dampen imports. While energy imports were down by 27 percent in FY23, as global oil prices had remained higher in the first half, non-energy imports declined by nearly 33 percent during the year. Imports of agriculture and chemical goods, machinery segment, particularly mobile phones and power generating machinery, transport, and metal – all posted notable contraction.

Despite the sharp reduction in the CAD, however, the country's external account remained under pressure in FY23 due to reduced financial inflows. The financial account posted net outflow of US\$ 1.8 billion during FY23, in contrast to net inflow of US\$ 11.3 billion during FY22. Total financial inflows, including foreign investment and public and private foreign loans, weakened as the year progressed (**Figure 1.6**). Multilateral and bilateral creditors had withheld their financing owing to uncertainty about the completion of the IMF's EFF program. Its impact was exacerbated by tight global financial conditions at the time when Pakistan's country risk premium and credit ratings started to worsen, making it challenging to borrow from commercial sources. Adding to these pressures were higher-than-last year debt repayments, consisting of long-term multilateral loans,

Pakistan's Balance of Payments
 ■ Current account
 ■ Financial account
 — SBP reserves (end period) - rhs

Figure 1.6



Source: State Bank of Pakistan

maturing Eurobond in December 2022, and commercial borrowings. As a result, the SBP's liquid FX reserves decreased by US\$ 5.3 billion to US\$ 4.5 billion by the end of FY23. These developments, together with an overall appreciation of the US dollar against other currencies, resulted in PKR depreciating of 28.4 percent against the USD during FY23, where H2-FY23 witnessed increased volatility amid heightened economic and political uncertainty (**Figure 1.7a & 1.7b**).

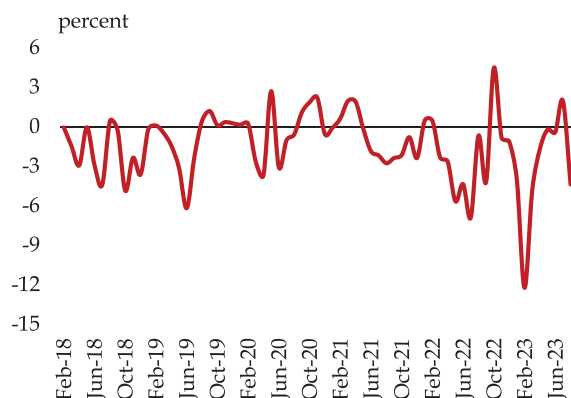
Fiscal Policy and Public Debt

Fiscal and primary balances improved during FY23 as a part of the government's plan for fiscal consolidation. However, the improvement was much lower than the budgeted targets. The fiscal deficit decreased marginally from 7.9 percent of GDP in FY22 to 7.8 percent in FY23, but remained much higher than the target of 4.9 percent. Similarly, while the primary balance improved to a deficit of 0.8 percent from 3.1 percent in FY22, it remained short of the budgeted surplus of 0.2 percent on account of more-than-budgeted subsidies, the unforeseen flood-related relief spending, and less-than-planned revenues. Revenue balance, on the other hand, deteriorated after interest

¹ Headline trade numbers are based on the SBP's BOP (payments) data. However, discussion on item-wise exports and imports are based on customs data on value and volume provided by Pakistan Bureau of Statistics.

Currency Volatility: MoM Changes in PKR

Figure 1.7a



Source: State Bank of Pakistan

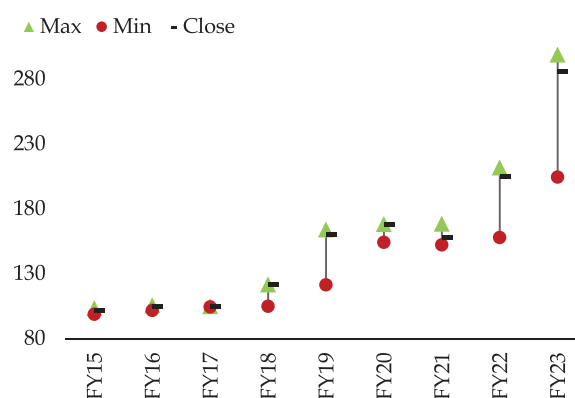
payments soared in the backdrop of rising debt stock and interest rates.

While both interest and non-interest spending exceeded the budget targets in FY23, the major reason for the less-than-envisaged decrease in fiscal deficit was the 83 percent increase in mark-up payments, particularly on domestic debt. This reflected the government's consistently large financing needs and growing reliance on domestic resources to finance its fiscal deficit in rising interest rate environment. In addition, currency depreciation and the expiry of the Debt Service Suspension Initiative (DSSI) last year also contributed to the increase in interest payments, which was equivalent to around 81 percent of federal tax revenues in FY23 compared to 52 percent last year.

The federal non-interest current expenditure declined by about 4.4 percent, albeit less than the budgeted target. This improvement was on the back of 29 percent decline in subsidies, and 14 percent decrease in grants, which fell despite a higher than budgeted spending on social protection to mitigate the impact of floods. However, actual spending on subsidies was still 63 percent higher compared to the budgeted allocation, with the power sector accounting for about 48 percent of the overrun in subsidies, including tariff differential payments to power generation and distribution companies. Federal development spending on the other hand,

Currency Volatility over the Years

Figure 1.7b



increased slightly (as percent of GDP) in FY23, after falling consistently for the past many years.

On the revenue side, the FBR's revenue growth slowed to 16.6 percent against nearly 30 percent previous year. While the FBR's revenues nearly met the revised target, a host of factors contributed to slower growth in the FBR taxes. These include contraction in imports; a significant moderation in domestic demand; the devastating floods; zero GST on diesel and petrol; and ad-hoc exemptions on duties, for instance on imports and supply of relief goods in the wake of floods. With the exception of direct taxes that drove almost the entire increase in overall taxes in FY23, most of the taxes underperformed the expected buoyancy-led growth that typically stems from growth in tax bases (**Table 1.1**). As a result, FBR's tax-to-GDP ratio fell to 8.5 percent from 9.2 percent in FY22.

This underperformance was despite high inflation, exchange rate depreciation, and increase in tax rates in the Finance Act 2022 and Finance (Supplementary) Act 2023, which included increase in income tax rates on salaries; hike in super tax on banks and other sectors; and an increase in GST from 17 to 18 percent. On the other hand, the increase in direct taxes came on the back of growth in indirect collection-mode of direct taxes, i.e., withholding taxes and advance taxes. In an economy, which

Actual and Expected Revenue Growth without New Measures - FY23

Table 1.1

Base	(A) Base Growth ^a (percent)	(B) Buoyancy Metric ^b	Tax Head*	Potential Buoyancy-led Growth (without new measures) (A*B) ^c (percent)	Actual Growth in FBR Taxes (percent)
Nominal GDP	26.2	1.16	Direct Taxes (d)	30.4	49.3
Import (in PKR terms)	-5.35	1.11	Direct Taxes (m)	-5.9	0.8
Nominal LSM	21.2	1.12	Sales Tax (d)	23.7	23.0
Import (in PKR terms)	-5.35	1.1	Sales Tax (m)	-5.9	-7.0
Import (in PKR terms)	-5.35	1.1	Customs Duty	-5.9	-7.5
Nominal LSM	21.2	0.9	FED (d)	19.1	19.4
Import (in PKR terms)	-5.35	0.74	FED (m)	-4.0	-38.5

*(d) domestic; (m) import

Sources: ^a Pakistan Economic Survey FY23; ^b FBR's Evidence-Based Revenue Forecasting FY 2022-23 (Table-9); ^c based on FBR's formula for buoyancy-led growth

has a narrow tax base and high level of informality, indirect collection of direct taxes is inflationary as the taxes are passed on to the final price of goods and services. Compared to tax revenues, federal non-tax revenue grew by nearly 43 percent, mainly due to more than fourfold increase in Petroleum Development Levy (PDL) collections in FY23. Nevertheless, the PDL collection in FY23 was 32 percent lower than the budgeted amount, as the average PDL rate during the year remained much less than the full rate of Rs 50 per litre, particularly on high speed diesel.

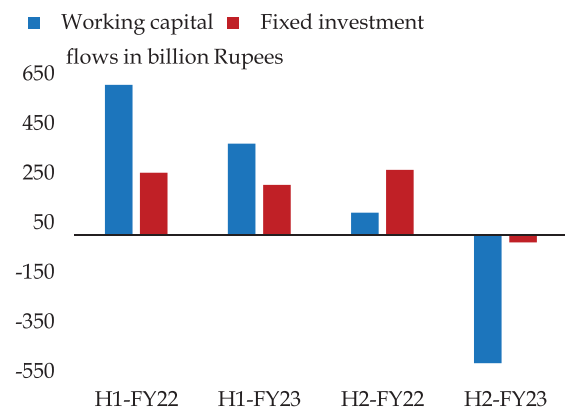
In the wake of less than planned revenue collection and weak external financing, the government mostly relied on domestic sources for deficit financing, which accounted for nearly 57 percent of the expansion in public debt in FY23. While domestic unfunded debt decreased, debt raised through floating-rate PIBs and T-bills rose substantially contributing nearly 90 percent of the increase in domestic debt. The growing reliance on the former exposes the government to increased interest rate risk, whereas the latter has led to both increased roll-over and interest rate risks. On a positive note, unlike yesteryears, most of the growth in domestic debt came from non-bank sources. This trend needs to continue to develop and strengthen the domestic debt market, which will have a positive impact on the government's cost of borrowing going forward. Public external debt on the other hand, rose because of exchange rate

depreciation even as its stock decreased on account of scheduled repayments and insufficient external inflows.

Money and Credit Developments

Owing to increased government borrowing from commercial banks for the financing of large fiscal deficit, Net Domestic Assets (NDA) of the banking system rose sharply during FY23. Moreover, borrowing by public sector enterprises (PSEs), especially power sector PSEs that settled circular debt related payments during the year, also contributed to the higher growth in NDA, as did higher financing under commodity operations due to increase in wheat support price. These developments more than offset the contraction in private sector credit.

The slowdown in economic activity due to the contractionary policies and the impact of floods amid highly uncertain economic environment resulted in a sharp decline in credit flow to the private sector. Compared to an offtake of about Rs 1,215 billion last year, the net increase in credit to private sector businesses was only Rs 31 billion in FY23. Working capital loans saw a net retirement, whereas the offtake in fixed investment loans slowed, as the pace of disbursement under the SBP's concessionary financing schemes tapered-off in the second half of FY23 (**Figure 1.8**). In addition, consumer financing saw a net retirement largely due to decline in demand for automobiles and their financing amid rising interest rates. Lower

Net Loan Disbursement to Private Sector Businesses
Figure 1.8


Source: State Bank of Pakistan

credit demand was also visible in total number of loan applications received by banks, which decreased by 5.1 percent in FY23.

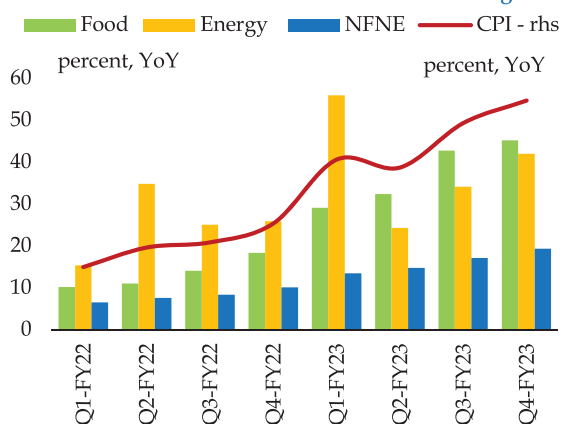
In contrast to the NDA, the Net Foreign Assets (NFA) shrank due to reduced external financial inflows amid delay in the 9th review of the IMF's EFF program and its consequent impact on the flows from other multilaterals. However, nearly 21 percent surge in the NDA more than offset the contraction in the NFA, leading to around 14 percent growth in the M2.

On the liability side, the growth in currency in circulation (CiC) more than doubled to about 21 percent in FY23, with nearly 56 percent of the increase in CiC stemming from cash needs in

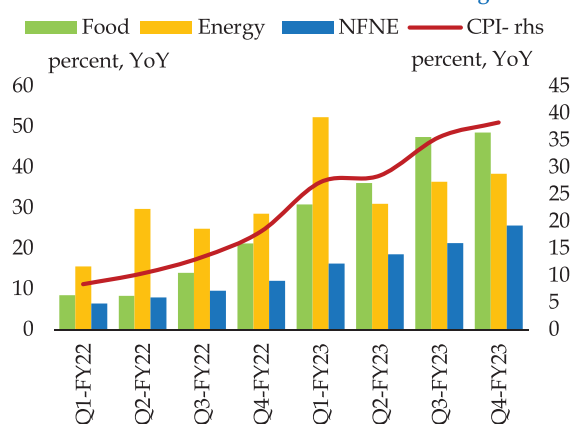
Q4-FY23 that marked the month of Ramazan and the celebration of the two Eids. Conversely, despite high interest rates, growth in deposits remained lower in FY23 due to slow domestic economic activity, rising inflation, domestic uncertainty, and a decline in workers' remittances. The rise in CiC coupled with sizeable government borrowing and net retirement of external debt worth more than Rs 1 trillion, fueled liquidity pressures in the money market, which necessitated a considerable increase in the frequency and volume of longer-tenor open market operations (OMOs) by the SBP during FY23.

Inflation

The NCPI inflation more than doubled to a multi-decade high of 29.2 percent in FY23, despite the contraction in domestic demand in response to continued monetary policy tightening and other demand compression measures. Multiple revisions in energy prices, increase in indirect taxes and indirect mode of direct tax collection, higher PDL, exchange rate depreciation and supply constraints stoked inflationary pressures throughout the year. Flood-induced domestic food shortages and higher global commodity prices in the first half also contributed to higher NCPI inflation. Unlike global trends where inflation started tapering off as the year progressed, inflationary

Trend in Urban Inflation
Figure 1.9a


Source: Pakistan Bureau of Statistics

Trend in Rural Inflation
Figure 1.9b


Source: Pakistan Bureau of Statistics

pressures in Pakistan further increased in H2-FY23 reflecting higher intensity of shocks during the period (**Figure 1.9a & 1.9b**). The upsurge in inflation was broad-based, with food inflation contributing the most, followed by core inflation and then energy.

Within the food inflation that soared to 39 percent, non-perishables were the biggest drivers, where prices of milk and milk products, wheat, edible oil and vegetable ghee rose substantially. Prices of readymade food also rose more than two folds to 37.0 percent and 33.6 percent in FY23, in urban and rural areas respectively. While supply shortages stemming from floods and higher prices of imported goods in rupee terms were among the chief drivers of food prices, the overall rise in cost of production, particularly for readymade food businesses, also added to inflationary pressures.

Despite softening global energy prices in the second half of the year, energy inflation spiked to 38 percent in urban areas and 39 percent in rural areas in FY23. This reflects the increase in administered energy prices on multiple occasions during the year to pass on the impact of high global oil prices in the first half and weaker currency in the second half of the year. Aside from the impact of supply shocks, the administrative and policy issues also contributed to the rise in energy prices. For instance, high distribution losses continued to impact power tariffs. Similarly, increase in electricity tariffs reflected the impact of both costlier fuel on account of large share of thermal power in total generation, and PKR depreciation as tariff components, including guaranteed returns to independent power producers, are indexed to the US dollar. Moreover, the hike in electricity charges in the last quarter of FY23 resulted in high year-on-year inflation during the period because the government had frozen electricity prices in the same period last year.

Core inflation doubled in both urban and rural areas and continued to gather pace throughout the year, culminating into a multi-year high of 16.2 and 20.6 percent respectively. Within the

Assets Composition of the Financial Sector **Table 1.2**

	Jun-21	Jun-22	Jun-23
Assets (billion Rupees)			
MFBs	514	604	721
DFIs	535	807	3,224
NBFIs	1,839	2,171	2,922
Insurance	2,129	2,380	2,740
CDNS	3,942	3,630	3,247
Banks	28,177	34,861	40,797
Total	37,135	44,453	53,650
Asset growth (percent)			
MFBs	28.3	17.6	19.3
DFIs	29.1	50.8	299.5
NBFIs	30.2	18.1	34.6
Insurance	16.5	11.8	15.1
CDNS	-7.4	-7.9	-10.5
Banks	18.9	23.7	17.0
Overall financial sector	16.0	19.7	20.7
Share in total assets (percent)			
MFBs	1.4	1.4	1.3
DFIs	1.4	1.8	6.0
NBFIs	5.0	4.9	5.4
Insurance	5.7	5.4	5.1
CDNS	10.6	8.2	6.1
Banks	75.9	78.4	76.0
Assets as percent of GDP*			
MFBs	0.9	0.9	0.9
DFIs	1.0	1.2	3.8
NBFIs	3.3	3.3	3.5
Insurance	3.8	3.6	3.3
CDNS	7.1	5.4	3.9
Banks	50.5	52.3	48.5
Overall assets	66.5	66.7	63.8

*GDP at market prices (2015-16=100)

Sources: SBP, SECP, CDNS & PBS

core inflation, the pressures were broad-based across both goods and services, largely manifesting the second round effects of shocks to food and energy prices, rising wages, and inflationary expectations that typically track food and energy prices as well as exchange rate movement.

1.2 The State of the Financial System

The country's financial sector grew steadily and continued to meet the needs of credit and financial services in the economy, despite a challenging macroeconomic environment. The

**Key Balance Sheet Variables of Banks,
DFIs and MFBs****Table 1.3**

billion Rupees

	Jun-21	Jun-22	Jun-23
Banks			
Total Assets	28,177	34,861	40,797
Investments (net)	14,162	17,829	21,504
Advances (net)	8,808	10,890	12,060
Deposits	20,441	23,730	26,785
Development Finance Institutions (DFIs)			
Total Assets	535	807	3,224
Investments (net)	368	584	2,944
Advances (net)	117	160	188
Deposits	23	31	36
Microfinance Banks (MFBs)			
Total Assets	514	604	721
Investments (net)	99	133	157
Advances (net)	253	310	360
Deposits	378	447	520

Source: State Bank of Pakistan (unaudited quarterly returns of the institutions)

asset base of the financial sector grew by 20.7 percent to reach about Rs 54 trillion in FY23. However, financial depth — in terms of financial sector assets to GDP ratio — decreased to 63.8 percent from 66.7 percent in FY22 (**Table 1.2**).²

Trends in Key Statistics of the Financial Sector

Total assets of the banking sector, which is the cornerstone of financial sector stability and performs major part of financial intermediation in the economy, grew by 17.0 percent during FY23 compared to 23.7 percent in FY22 (**Table 1.3**).³ The slightly lower growth in assets was due to a moderation in advances, which was in line with the subdued economic activities during the year. Investments, mainly in

government securities, were the major drivers of growth in assets during FY23.

Deposits and borrowings together financed around 84 percent of the increase in assets. The sector's financial performance was driven by significant growth in earning assets and steady flow of non-interest income, though the interest/markup payments to depositors and income tax charges also increased substantially. The after-tax profit of the sector increased by 84.9 percent in FY23 to nearly Rs 495 billion, resulting in improvement of the sector's after tax Return on Assets (ROA) to 1.5 percent in FY23 from 0.8 percent in last year.

In addition to meeting the credit and financial services needs of the economy, the sector contributed substantially to the national exchequer. The aggregate income tax charges provided by the SBP-regulated institutions in their books of accounts amounted to Rs 466 billion in FY23, significantly up from Rs 269 billion in FY22 – the income tax provision was around 6.0 percent of the total tax revenues of FY23. In addition to direct income tax on their earnings, banks also assisted federal and provincial authorities by facilitating tax payers in the payments of taxes and collecting and depositing taxes on various banking transactions.

The asset base of Development Finance Institutions (DFIs) quadrupled to Rs 3,224 billion in FY23. The growth was almost entirely driven by investments in government securities, which were mainly financed by borrowings from financial institutions (FIs). After tax profit of DFIs increased to Rs 21 billion in FY23 from about Rs 11 billion in FY22. Both net-interest

² Financial development indicators of the country are relatively low compared to peer countries due to a host of structural issues. For details on the dynamics and reasons of low financial sector development, see Governor's Annual Report FY2021-22 available at (www.sbp.org.pk/reports/annual/Gov-AR/pdf/2022/Dec/Gov-AR.pdf)

³ Among financial institutions, the SBP regulated entities represent more than 80 percent of the assets of financial sector. As such, the financial performance and standing of these entities is crucial for the financial system and overall economy of the country. Particularly, the banking sector holds key significance in the financial sector due to its large market share as well as the crucial role that it plays in the payment system of the country. See **Annexure 1** on the *Structure and Regulatory Architecture of Financial System of Pakistan*

income and non-interest income contributed significantly in the profitability.

Microfinance Banks (MFBs) increased their asset base by 19.3 percent to Rs 721 billion during FY23. Advances and investments increased by 15.9 percent and 18.4 percent, respectively. Noticeable growth in advances reflects the supportive role of MFBs in providing access to finance for low-income groups of the society, particularly in the times of high stress. The MFBs have been facing strains since the Covid-19 pandemic, which were further compounded by the catastrophic floods during the year. Aggregate losses of the sector increased to Rs 13.5 billion in FY23 from Rs 11.5 billion in FY22. In addition, elevated provisioning expenses, and a surge in operating expenses contributed to these losses.

Non-Bank Financial Institutions (NBFIs) exhibited a significant growth of 34.6 percent in asset base, to reach nearly Rs 2,922 billion by the end of FY23. The fund management segment—holding 87.3 percent share in the NBFIs—contributed more than 90 percent in the expansion of assets during FY23. Within the fund management segment, mutual funds and Real Estate Investment Trusts (REITs) remained principal drivers of growth.⁴

The composition of mutual funds reveals that, money market and income categories witnessed substantial growth in FY23, contributing around 87 percent of the total increase in mutual fund assets. However, equity funds contracted by 27.1 percent on account of lackluster performance of the equity market; resultantly their share in total mutual funds decreased to 8.5 percent. In the wake of government's initiatives to provide them an enabling policy environment, the REITs have emerged as a prominent segment over the last couple of years. The number of the REIT schemes rose to 15 in FY23 from 5 in the previous year and their share in the NBFIs doubled to 9.8 percent during the

year. The asset base of the lending segment of the NBFIs (i.e. investment finance companies, Modarba, leasing companies and non-bank microfinance companies) increased by 15.4 percent to Rs 372 billion; however, its share in the NBFIs' total assets declined to 12.7 percent from 14.8 percent in last year.

The asset base of the insurance sector grew by 15.1 percent in FY23 to reach Rs 2,740 billion by the end of June, 2023. The life insurance segment, which dominates with 84.3 percent share in total assets of the sector, grew by 14.4 percent. The non-life segment posted a growth of 19.2 percent over the same period resulting in a marginal increase in its share to 15.7 percent by the end of June 2023 from 15.1 percent in June 2022.

Trend in Financial Intermediation by SBP-Regulated Institutions

Deposit mobilization and promotion of savings:

Banks, the MFBs, and the DFIs (facilitated a large number of customers through a network of more than 17,500 branches and increasing alternate delivery channels (ADCs) during FY23. With a year-on-year growth of 20.0 percent, the total number of deposit accounts reached 182.5 million by the end of June, 2023.⁵

Total deposits of the SBP's regulated entities grew by 12.9 percent during FY23 to Rs 27,340 billion. Banking sector contributed the most to this growth with its deposit increasing by 12.9 percent to Rs 26,785 billion during the year. The share of current accounts in total deposits rose to 40.5 percent by the end of June 2023 from 38.8 percent, a year earlier. The share of fixed and savings deposits remained almost stable (18.2 percent and 34.0 percent, respectively) in total deposits, while deposits from FIs registered a contraction and their share in total deposits

⁴ Mutual funds and the REITs contributed 52.6 percent and 23.8 percent, respectively, in total rise in the NBFIs assets during FY23.

⁵ www.sbp.org.pk/publications/Quarterly/Jun/Complete.pdf

decreased to 5.4 percent by the end of June 2023 (7.2 percent in June 2022).

Banking sector paid a significantly higher amount of markup and interest income to depositors and fund providers during FY23. Total markup/interest expenses of the banking sector rose to Rs 3,271 billion in FY23 from Rs 1,395 billion in FY22.

Meeting credit needs of the economy:

In the wake of slowdown in economic activities and broad-based decline in output, inflationary pressures and rising cost of borrowing, demand for private sector credit remained low during FY23. However, the public sector's demand for bank credit increased significantly to finance budget deficit, the commodity operations and functioning of the PSEs.

The overall growth in advances of the SBP-regulated institutions decelerated to 11.0 percent (from 23.8 percent growth in FY22) to reach Rs 12,607 billion by the end of FY23. Nonetheless, investments, mainly driven by government securities, increased by 32.7 percent to reach Rs 24,605 billion in FY23, reflecting substantial financing provided by these institutions to the government amid fall in external inflows. With the major increase driven by investments in government securities, banks' credit (advances and investments) to public sector increased to 58.5 percent of their total assets by the end of June 2023 from 54.5 percent in June 2022.

Banks being the major providers of credit among the SBP's regulated entities, financed around 94 percent of the expansion in advances during FY23. The overall domestic advances of the banking sector increased by about Rs 1,310 billion in the reviewed year. Public sector accounted for more than 90 percent of this increase in advances, while growth in private sector advances significantly decelerated. Almost one-third (amounting nearly Rs 374 billion) of the rise in public sector advances came from commodity financing, availed mainly for wheat procurement. Public sector

entities also availed significant financing for working capital and trade financing needs. The domestic private sector, which holds 70.2 percent of the overall domestic advances of the banking sector, availed only around Rs 118 billion during FY23 compared to an offtake of Rs 1,575 billion in FY22. A number of sectors, such as power and sugar, retired their loans, while additional borrowings by textile, chemical and pharmaceutical, and cement sectors, amongst others, remained subdued.

Due to a slowdown in credit growth, the private sector credit to GDP ratio declined to 10.9 percent in FY23 from 13.4 percent in FY22. The advances to deposits ratio slightly fell to 46.1 percent by the end of June, 2023 from 46.9 percent in the same period last year.

Despite the slowdown in overall credit, the combined borrowers of banks and the MFBs rose to 9.6 million by the end of June, 2023 from 8.8 million in June, 2022. This notable increase in borrower base was driven by the MFBs that leveraged technology to offer nano-loans of short maturities to eligible borrowers, through mobile applications. With the surge in the MFBs' clientele, their share (in total borrowers of banks and the MFBs) increased to 58.6 percent by the end of June 2023 from 54.8 percent in the previous year. Given that the major credit portfolio of banks is skewed towards large corporate and commercial borrowers, the higher growth in the MFBs' borrower base would help in improving the access of low income individuals to formal financial services and increasing financial inclusion in the economy.

Within the banking sector, Islamic Banking Institutions (IBIs) performed quite well during the reviewed period. A comparison of key balance sheet variables suggests that IBIs outperformed their conventional counterparts on several fronts, such as financing and investments, which was duly supported by a double-digit growth in deposit mobilization. This trend reflects the increased acceptability of Shariah-compliant banking products and

Performance of Islamic Banking Table 1.4

	IBIs		Conventional Banks	
	FY22	FY23	FY22	FY23
billion Rupees				
Total Assets	6,781	8,118	28,079	32,679
Investments (net)	2,672	3,472	15,158	18,032
Financing (net)	2,961	3,324	7,929	8,736
Deposits	4,856	5,870	18,875	20,915
Growth (percent)				
Total Assets	41.4	19.7	20.1	16.4
Investments (net)	96.1	30.0	18.4	19.0
Financing (net)	39.8	12.3	18.5	10.2
Deposits	27.0	20.9	13.6	10.8
Share in total assets (percent)				
Investments (net)	39.4	42.8	54.0	55.2
Financing (net)	43.7	40.9	28.2	26.7
FDR/ADR (percent)*	61.0	56.6	42.0	41.8

* FDR= Financing to Deposits ratio and ADR=Advances to Deposits ratio

Source: State Bank of Pakistan

services (Table 1.4). The relatively better performance of IBIs increased their share to 19.9 percent and 21.9 percent in total assets and deposits of the banking sector, respectively, by the end of FY23.

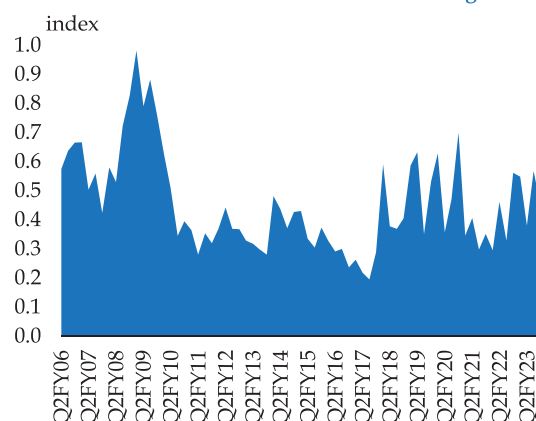
With the complete conversion of a bank during FY23, the number of full-fledged Islamic banks rose to six, while the total Islamic banking institutions remained unchanged at 22. The number of branches rose to 4,534 by the end of June 2023, further facilitating consumer access to Shariah-compliant financial services.

Over the last two decades, the SBP has provided an enabling legal and regulatory framework along with necessary market infrastructure that has facilitated Islamic banking growth. In this regard, with a view to achieve the adoption of Islamic banking in line with the Federal Shariat Court (FSC) judgement on the conversion of conventional banks to Shariah-compliant banks, SBP has initiated a consultation process with relevant stakeholders. Considering the extensive nature of this transformation, the SBP has also modified its internal structure as a priority.⁶

⁶ For details see, Box 3.2: SBP's Strategy to transform the banking sector to Islamic mode – key challenges and opportunities available at (www.sbp.org.pk/FSR/2022/Box-3.2.pdf)

⁷ Average OMOs injection size fell to Rs 569.6 billion in FY23 compared to around Rs 1,356 billion in FY22.

Trend in Financial Market Stress Index Figure 1.10



Source: SBP staff calculations

Financial markets

Domestic financial markets showed a mixed picture during FY23. While the money and equity markets exhibited lower volatility than the previous year, the FX market continued to face increased stress (Figure 1.10). The policy measures taken in FY22 to address the emerging risks helped in narrowing the current account deficit, turning into surplus in the second half of FY23. However, debt repayments and reduced external inflows kept external account under pressure, while inflationary pressures became more intense and persistent. Accordingly, the parity remained under stress and the PKR depreciated by 28.4 percent during FY23 against the USD (Table 1.5). In fact, the exchange rate exhibited highest volatility in FY23 since 2001.

The SBP raised the policy rate by 825 bps in FY23 to arrest rising inflationary pressures. The overnight rate moved up in tandem with the policy rate. Strong demand for bank credit from the government created pressures that necessitated the OMO injections, though the average size of the OMO injections remained low compared to previous year.⁷ However, volatility in the overnight rate on average remained lower in FY23.

Governor's Annual Report 2022-2023

Movements in Key Variables of Financial Markets Table 1.5

		FY21	FY22	FY23
PKR vs. USD	Level (end of period)	157.5	204.8	286.0
	Depreciation (-)/ Appreciation (+) (%)	6.7	-23.1	-28.4
	Volatility*	0.22	0.37	0.96
Weighted Average Overnight Repo rate	Level (end of period)	7.5	13.8	22.5
	Change (bps)	28	631	869
	Volatility*	0.05	0.04	0.03
KSE-100 Index	Level (end of period)	47,356	41,541	41,453
	YoY change (%)	37.6	-12.3	-0.2
	Volatility*	0.95	0.94	0.88

*Volatility is measured using Exponential Weighted Moving Average (EWMA) method

Sources: SBP, PSX and SBP staff estimates

The equity market showed a lackluster performance during FY23, as elevated inflation, a depreciating currency, and uncertainties regarding the political situation and revival of the IMF program weighed negatively on investors' sentiments. Overall, financial markets continued to function smoothly despite some stresses. The financial institutions, nevertheless, exhibited resilience to fluctuations in market conditions and continued to function smoothly.

Payment Systems and Financial Market Infrastructure (FMI)

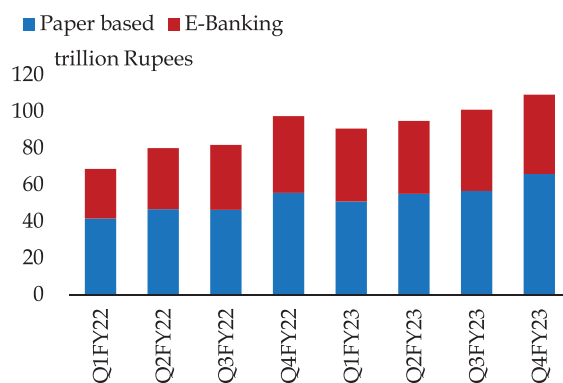
The FMI is a multilateral system among participating institutions that is used for clearing, settling, or recording of payments, securities, derivatives, or other financial transactions. The FMI of Pakistan comprises of: (i) a Large Value Payment System i.e. Pakistan Real-Time Interbank Settlement Mechanism

(PRISM); (ii) a Retail Value Payment System or Instant Payment System i.e. Raast; (iii) an inter-bank switch facilitating various banking services i.e. 1-Link; (iv) a clearing house for paper-based instruments i.e., National Institutional Facilitation Technologies (NIFT); (v) a corporate securities settlement company i.e., National Clearing Company of Pakistan Limited (NCCPL); and (vi) a corporate securities depository, i.e. Central Depository Company (CDC).

These payment systems and institutions are providing systemically essential services for the functioning of the economy and financial markets mainly by facilitating the settlement and clearing of payments and securities. The smooth functioning of the FMI is also crucial for the efficiency and stability of the financial system as well as effective transmission of the monetary policy signals.

The FMI's performance in terms of level of activity remained steady during FY23 as it provided an uninterrupted flow of financial services and demonstrated resilience. The PRISM, which deals with large value payments and offers a mechanism for limiting settlement and systemic risks in the interbank settlement process, by providing settlement on Gross Basis and in Real Time, functioned smoothly during the year. In addition, the PRISM also reduces settlement risk in securities transactions by providing a basis for delivery-versus-payment mechanisms. The PRISM handled 4.9 million

Composition of Retail Banking Transactions: Values



Source: State Bank of Pakistan

Figure 1.11a

Composition of Retail Banking Transactions: Volume

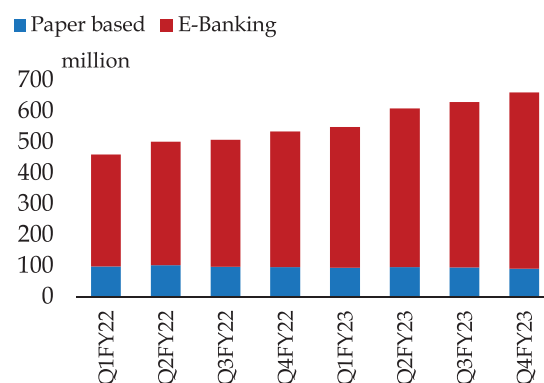


Figure 1.11b

transactions during FY23, compared to 4.4 million transactions in FY22. Nonetheless, in value terms, a decline of 6.0 percent was observed in the reviewed year.

E-banking transactions that have been showing strong growth for the last few years continued its momentum, posting 28.6 percent and 21.4 percent growth in volume and value terms, respectively, during FY23 (**Figure 1.11a & 1.11b**). The volume growth was primarily driven by mobile banking and the ATMs, while mobile banking mainly contributed in value growth followed by and internet banking transactions (**Table 1.6**).

It is important to note that Raast, which was launched by SBP as an instant payment system for retail transactions, got further traction due to the convenience and affordability it offers to the users. The number of transactions processed through Raast jumped to 154.9 million in FY23 from only 8.0 million in FY22. In value terms, Raast handled Rs 3,169 billion worth of transactions in FY23 as compared to Rs 117 billion in FY22.

The development and promotion of an efficient and convenient payment system is among SBP's top priorities, for which it has developed a comprehensive payment strategy and continuously strives to provide an enabling regulatory environment. In this connection, SBP has taken the following measures during the year.

The SBP revised the Regulations for Electronic Money Institutions (EMIs) in June 2023 vis-à-vis increased wallet limits, new use cases like account information and payment initiation, remittances, corporate governance, etc. These revisions were based on international best practices and the local market structure. Since the issuance of these Regulations in 2019, the SBP has received an encouraging response from

E-Banking Transaction Channels**Table 1.6**

transactions volume in million; value in billion Rupees

	FY22		FY23	
	Volume	Value	Volume	Value
RTOB	207	105,309	200	113,942
ATM	692	9,628	810	12,154
POS	138	707	199	1,064
Internet banking	142	10,250	172	16,330
Mobile phone Banking	388	11,851	661	23,758
Call centers/IVR Banking	0.1	7.0	0.1	8
E-Commerce	46	106	32	142
Total	1,612	137,857	2,073	167,398

Note: RTOB: Real-Time Online Branches; ATM: Automated Teller Machine; POS: Point of Sale

Source: State Bank of Pakistan

the market participants and a number of entities have been licensed to provide electronic money (e-money) services. Four EMIs have been granted approval for live operations.⁸ Further, the SBP issued guidelines to improve customer experience, in terms of their use of digital products and to ensure that customers are intimated about scheduled or unforeseen service disruptions in a timely manner. Moreover, in order to facilitate the acceptance of card-based payments in the country, the SBP revised Interchange Reimbursement Fee (IRF) for cards used on domestic POS terminals, and abolished the lower range of Merchant Discount Rate (MDR) of 1.5 percent.

The enhanced use of digital banking channels and integration with mobile banking platforms by un-authorized and un-licensed digital lending apps may raise concerns for consumer protection, potentially causing reputational risk for banks. In this regard, the SBP issued guidelines to banks to help improve their Know Your Customer (KYC) regime. The guidelines aim to regulate the un-authorized/un-licensed digital lending mobile applications from using banking channels, and to perform credit worthiness checks through integration with bank accounts of customers.

⁸ With the approval of another EMI for live operations (on Nov 23, 2023), the total number of live EMIs has increased to five. For details see: www.sbp.org.pk/PS/PDF/List-of-EMIs.pdf

2 Price Stability and the Conduct of Monetary Policy

2.1 Inflation Projections and Outcomes

The average headline National CPI (NCPI) inflation soared to a multi-decade high of 29.2 percent in FY23, around the upper bound of the SBP's revised inflation projection range of 27.0 – 29.0 percent for FY23. A combination of successive global and domestic supply shocks, and less-than-envisaged fiscal consolidation contributed to intense and more persistent-than-expected inflationary pressures throughout the year. The surge in inflation was broad-based, with food prices having a dominant contribution, followed by core and energy group (Table 2.1).

In the aftermath of Russia-Ukraine conflict, the global economy entered into FY23 in a highly uncertain economic environment. In the case of Pakistan, a range of domestic challenges further compounded the impact of global economic uncertainties. As the year progressed, a combination of sequential domestic and global supply shocks including (i) flood-induced supply shortages; (ii) frequent increases in energy prices; (iii) softening but still elevated global commodity prices; (iv) domestic supply disruptions arising from foreign exchange constraints; (v) exchange rate depreciation; (vi) increase in taxes and other levies under the Finance (Supplementary) Act 2023; and (vii) rising domestic uncertainty fueled inflationary pressures almost throughout FY23 (Figure 2.1).

In addition to these supply shocks, the uptrend in inflation during FY23 also reflected the impact of a large and unsustainable fiscal deficit, emanating from a narrow tax base and slow pace of reforms in the Public Sector Enterprises (PSEs). Specifically, energy inflation that contributed about 4.2 percentage points to

Table 2.1

Inflation in Pakistan percent					
	FY19	FY20	FY21	FY22	FY23
National CPI	6.8	10.8	8.9	12.2	29.2
Urban inflation	7.1	10.2	8.1	11.8	26.9
NFNE	7.2	7.5	6.0	8.1	16.2
Food	4.6	13.6	12.4	13.4	37.6
Energy	16.3	12.7	4.1	25.4	38.4
Rural inflation	6.3	11.6	10.0	12.7	32.6
NFNE	6.8	8.7	7.6	9.0	20.6
Food	4.8	15.9	13.1	13.0	41.1
Energy	11.1	6.2	6.6	24.8	39.1

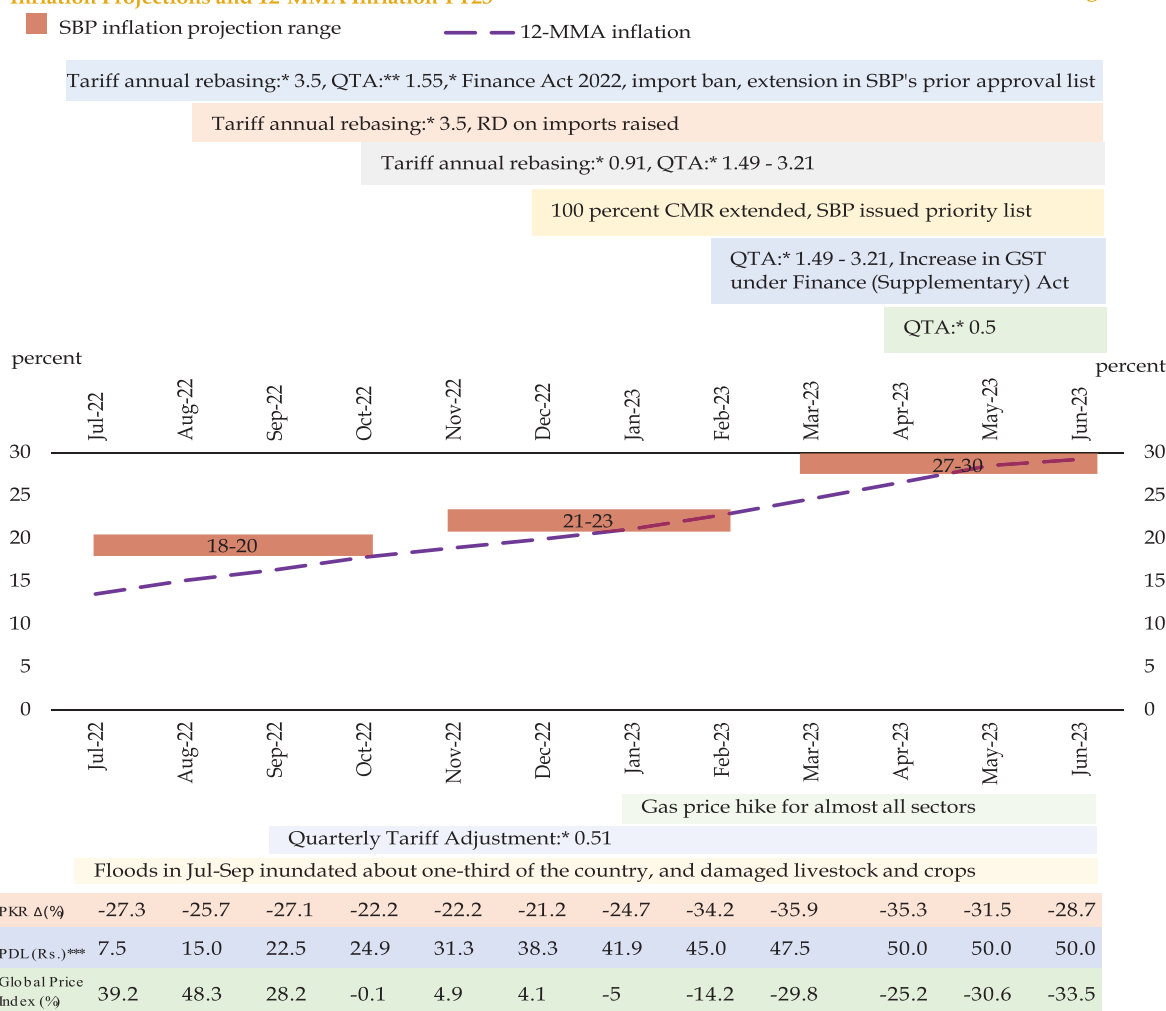
Source: Pakistan Bureau of Statistics

urban inflation during FY23, represented the impact of chronic inefficiencies in the energy sector in the shape of high operational and distribution losses and capacity payments, in addition to elevated global energy prices and the PKR depreciation. These structural deficiencies, together with delayed tariff adjustments and untargeted subsidies not only increased the burden on fiscal accounts, but also resulted in sporadic adjustments in energy prices. Similarly, food inflation also encompassed the effect of wide ranging structural impediments. These include imperfections in the market for food commodities, lack of policy focus on development of food supply chain and low R&D for developing climate change resistant and high yielding crop varieties.

The impact of escalating food and energy inflation and various supply shocks spilled over to general prices, inflation expectations and wages, which pushed core inflation to a multi-year high in FY23, despite a notable contraction in domestic demand (Figure 2.2a, b, c & 2.3). The Monetary Policy Committee (MPC) viewed that these trends if left unaddressed, could have led to de-anchoring of inflation expectations. In this challenging environment, the SBP continued the contractionary policy stance to address emergent risks to price stability, while carefully evaluating financial stability implications and to preserve the medium-term growth prospects.

Inflation Projections and 12-MMA Inflation-FY23

Figure 2.1



Notes: (i) Height of the horizontal bars show the duration of various global and domestic shocks (adjustment in energy tariffs, various import restrictions, changes in tax rates and floods) weighing on NCPI inflation during FY23.

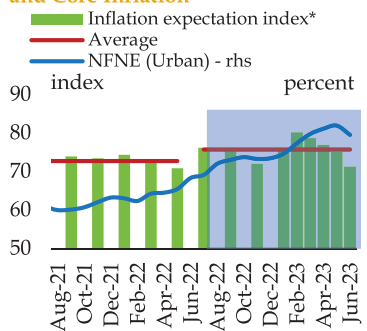
(ii) PKR depreciation (YoY), PDL charges and change in global commodity price index show monthly trends in these variables.

*Rs per KWh, **Quarterly Tariff Adjustment that has an impact for 2 to 4 months from the date of enforcement, *** Rs per litre (average of petrol/diesel)

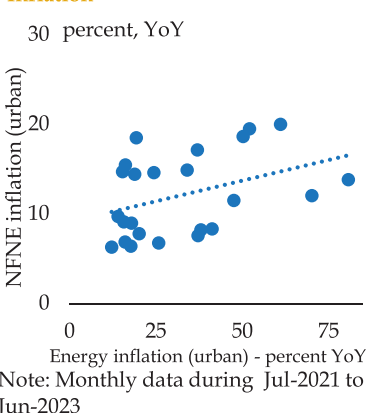
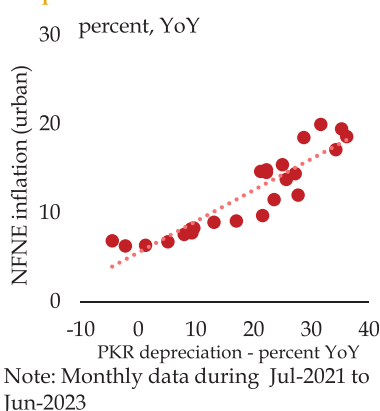
Sources: Pakistan Bureau of Statistics, Planning Commission, SBP projections and calculations, Ministry of Finance, IMF, OGRA, FBR, NEPRA

Given the significant role played by the domestic supply shocks, the inflation path in Pakistan diverged from the experience of many Advanced Economies (AEs) as well as Emerging and Developing Economies (EMDEs) during FY23. Amid softening global demand, alongside some ease in supply bottlenecks, the headline inflation across the AEs and the EMDEs was on a downtrend in FY23, after reaching a peak in mid of 2022. However, core inflation proved to

be more persistent in both the AEs and the EMDEs, because of the second round effects of the earlier surge in food and energy prices. Strengthening inflationary pressures had prompted many central banks to implement aggressive monetary tightening since 2021. However, with falling headline inflation, the pace of monetary tightening somewhat slowed in the second half of FY23 (Figure 2.4a & b).

Inflation Expectations and Core Inflation

*Based on Diffusion Index (DI). DI > 50 implies high inflation views are more than low inflation views

Figure 2.2a**Energy Prices and Core Inflation****Figure 2.2b****Exchange Rate Depreciation and Core Inflation****Figure 2.2c**

Sources: State Bank of Pakistan, Pakistan Bureau of Statistics

Impact of uncertainty about domestic and global economic conditions on the SBP's inflation projections and actual outcomes during FY23

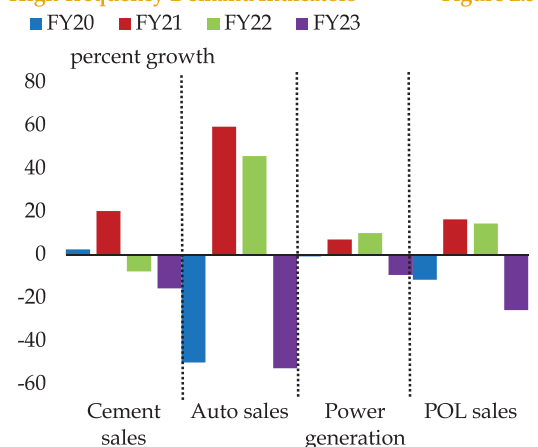
The macroeconomic environment, both at home and abroad, was marked with substantial uncertainty during the year (**Figure 2.5**). Specifically, the unfolding impact of floods, domestic fiscal policy stance, sporadic adjustments in energy prices, exchange rate volatility, the path of global commodity prices, and the state of global economic and financial conditions were the main sources of uncertainty. The persistently uncertain economic environment led the SBP to revise inflation

projections for FY23 twice, first in November 2022 and then in March 2023.

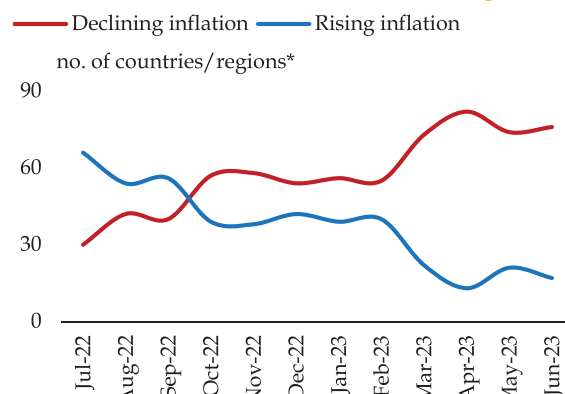
Following the surge in global commodity prices and unwinding of energy subsidies through reversal of fiscal package, inflation had been on a strong uptrend since June 2022. Accounting for these factors, in its July 2022 meeting, the MPC projected the annual headline NCPI inflation for FY23 in the range of 18.0 – 20.0 percent. The MPC expected inflation to peak in the first quarter and then gradually decline through the rest of the year because of the tight policies, normalization of global commodity prices, and a high base effect.

These projections were based on the following assumptions (**Table 2.2**). First, the real GDP growth was expected to moderate in the range of 3.0 – 4.0 percent in FY23 given the unfolding impact of 675 basis points (bps) hike in the policy rate and a range of demand compression measures introduced since FY22. Second, the FY23 budget envisaged a sizable fiscal consolidation with a primary surplus of 0.2 percent of GDP for FY23, compared to a 3.1 percent deficit in the previous year. Lastly, the global commodity prices, which had peaked before the start of FY23, were expected to normalize.

This forecast was, however, subject to significant uncertainty. The upside risks included:

High-frequency Demand Indicators**Figure 2.3**

Sources: APCMA, PAMA, OCAC, NEPRA

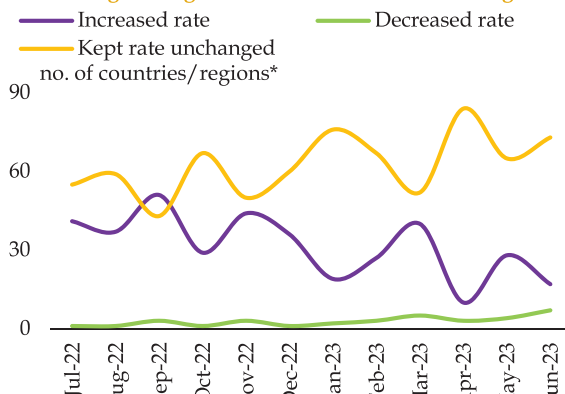
Inflation Started to Decline in H2-FY23 **Figure 2.4a**


*96 EMDEs and AEs, including one region, EU-27

Source: Haver Analytics

(i) continuation of the Russian-Ukraine conflict; and (ii) the upward drift in inflation expectations. Conversely, the downside risks were: (i) an unanticipated contraction in the global demand; and (ii) any new wave of the Covid-19.

Despite a substantial reduction in Fuel Charge Adjustment (FCA) in September 2022 to provide relief to consumers during the floods, the headline NCPI inflation rose to a multi-year peak of 25.1 percent in the first quarter of FY23. Almost half of the surge in inflation came from escalating food prices, which had spiked to 30.0 percent. Particularly, rising operational and transportation costs, concerns about wheat

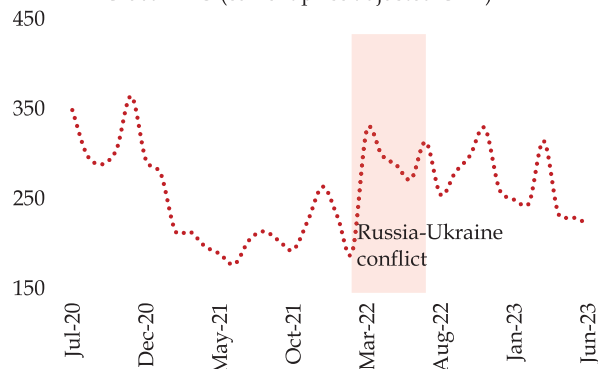
Pace of Tightening Slowed Down in H2-FY23 **Figure 2.4b**


supplies arising from decline in wheat production during FY22, and flood-related food shortages explain most of the surge in food prices during the first quarter of FY23. Other factors included PKR depreciation that spurred imported inflation, earlier hike in energy tariffs, and the second round effects of higher food and energy prices that also triggered increase in wages and upward drift in inflation expectations.

Rising inflation expectations, combined with general increase in cost of production, pushed the core (non-food non-energy) inflation to double digits during Q1-FY23. On the other hand, following an administrative cut in FCA,

Economic Policy Uncertainty (EPU) Index

..... Global EPU (current price adjusted GDP)*



* GDP-weighted average of national EPU indices for 20 countries.

Sources: State Bank of Pakistan and FRED

Figure 2.5


SBP's Macroeconomic Projections and Actual Outcomes for FY23

Table 2.2

SBP Projections for FY23*										Actual Outcome
Jul-22	Aug-22	Oct-22	Nov-22	Jan-23	Mar-23	Apr-23	12 th Jun-23	26 th Jun-23		
Growth rate (percent)										
Real GDP	3.0 - 4.0	3.0 - 4.0	1.5 - 2.5	1.5 - 2.5	1.0 - 2.0	0.0 - 1.0	0.0 - 1.0	--	--	-0.17
Percent of GDP										
CAD	2.5 - 3.5	2.5 - 3.5	2.5 - 3.5	2.5 - 3.5	2.0 - 3.0	1.5 - 2.5	1.0 - 2.0	0.5 - 1.5	0.5 - 1.5	0.7
Fiscal deficit	5.0 - 6.0	5.0 - 6.0	5.5 - 6.5	6.0 - 7.0	6.0 - 7.0	6.5 - 7.5	7.0 - 8.0	7.0 - 8.0	7.0 - 8.0	7.8
US\$/bbl										
Avg. oil prices	94	94	87	91	87	88	88	88	88	87.4

* At the time of MPC meetings

Sources: SBP staff estimates, Pakistan Bureau of Statistics, Ministry of Finance, Bloomberg

energy inflation posted a sharp decline in September 2022, after recording a notable increase during Jul-Aug FY23.

The impact of floods necessitated revisions in macroeconomic projections when the MPC met in October 2022. The monsoon floods that hit the country during July and August 2022, inundated around one-third of the country's land, caused significant losses to lives, infrastructure and property, and gave rise to food shortages, which amplified existing price pressures. Considering the initial assessment about the flood-induced damages to agriculture and its knock-on impact on industry and services, the MPC trimmed the real GDP growth projection for FY23 to around 2 percent in October 2022. Similarly, it was also indicated that the flood-induced shock to food prices could keep headline inflation somewhat above the pre-flood projection range of 18.0 – 20.0 percent in FY23.

These projections were further revised in November 2022, after incorporating the Post-Disaster Needs Assessment of the floods prepared by the government. The SBP indicated increased downside risks to the real GDP growth outlook for FY23, stemming from sizeable production losses of major crops and dampening growth prospects of industry. The projection for CAD was maintained at around 3 percent of GDP for FY23, as softening global commodity prices were expected to offset flood-related increase in imports and any decline in exports.

However, the flood-induced food shortages had further exacerbated inflation outlook in November 2022. On the other hand, after the reversal of an administrative reduction in electricity prices in September 2022, energy inflation also edged up in October 2022. The impact of rising food and energy prices seeped into general prices and inflation expectations that further pushed the core inflation up. In light of these developments, the SBP revised the inflation projection for FY23 upward to 21.0 – 23.0 percent.

The headline inflation maintained an almost consistent uptrend in the rest of the year. Flood-driven supply disruptions exacerbated shortages of various agriculture products causing upward pressure on their prices. In addition, fiscal slippages and external account pressures had a pronounced impact on inflation during FY23. The year had started with some positive developments in the external account. The successful completion of 7th and 8th review of the IMF's EFF program and ensuing disbursement of the US\$ 1.2 billion not only paved the way for unlocking external inflows from other bilateral and multilateral creditors, but also improved market sentiments leading to a notable appreciation in the PKR in August 2022.

The continuation of these positive trends hinged on successful completion of the IMF program. However, the divergence from planned fiscal consolidation path amid floods, and the consequent delay in the completion of the 9th review gave rise to substantial uncertainty about

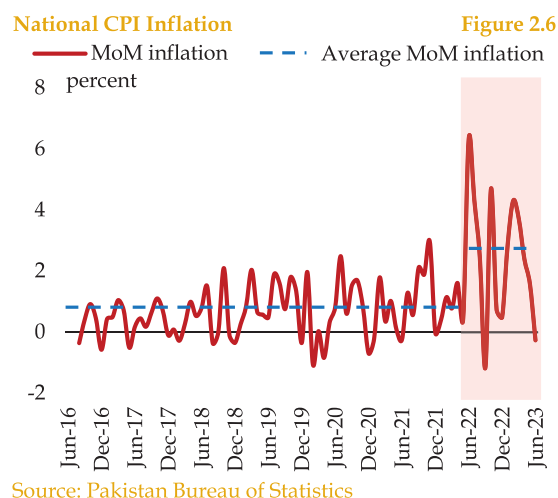
domestic macroeconomic outlook. This, along with increased political instability, affected the confidence of foreign investors and led to downgrade of country's credit ratings in October 2023. The inadequate external inflows gave rise to significant pressures on the balance of payments, as reflected in a drawdown of US\$ 5.3 billion in the SBP reserves and 28.4 percent depreciation in the PKR during FY23. The PKR depreciation partly nullified the gains from ease in global commodity prices.¹

To reduce rising vulnerabilities in the external account, the SBP and the government introduced various measures to slow domestic demand and contain imports during the year. Similarly, to address concerns about fiscal performance, the government increased POL and gas prices and also announced increase in taxes and other levies through the Finance (Supplementary) Act 2023. However, these measures also added to inflationary pressures.

These developments had considerably worsened the near term inflation outlook and caused inflation expectations to further increase. These developments led to a further upward revision in the inflation projection range to 27.0 – 29.0 percent in March 2023.

Overall, the impact of various supply shocks and domestic uncertainties induced greater volatility in month-on-month inflation during FY23. As evident from **Figure 2.6**, the average MoM inflation spiked to 2.2 percent in FY23 compared to an average of 0.8 percent during FY17-22.²

Thus, in response to the rising inflationary pressures and to prevent de-anchoring of inflation expectations, the SBP raised the policy rate more aggressively in the second half by a cumulative 600 bps, following a hike of 225 bps



in the first half of FY23. In line with the aggressive increase in policy rate and moderation in economic activity, the growth in private sector credit slowed to 2.3 percent during FY23, after witnessing a 17.4 percent increase during FY22. With this increase in the policy rate, the MPC viewed that real interest rates had entered in a positive territory, on a forward-looking basis, March 2023 onwards. Hence, barring any unexpected shocks and assuming fiscal consolidation to complement monetary tightening, the MPC considered this stance as appropriate to anchor inflation expectations and bring down inflation towards the medium-term target range of 5.0 – 7.0 percent by end FY25.

To this effect, the SBP has outlined a detailed plan to further strengthen its analytical and forecasting capabilities in its fourth Strategic Plan – Vision 2028 to achieve price stability by maintaining inflation in the medium-term target range. The SBP aims to enhance research and economic modelling capabilities to deepen understanding of inflation dynamics, monetary policy transmission and forecasting medium term inflation. The central bank also aims at

¹ Moody's downgraded its outlook on Pakistan from stable to negative in June 2022, and further downgraded the country's rating from B3 to Caa1 in October 2022, citing external vulnerability risks and higher debt sustainability risks, in the aftermath of devastating floods that hit the country since June 2022. In February 2023, Pakistan was further downgraded to Caa3 on account of country's increasingly fragile liquidity situation. Source: Reuters (www.reuters.com/markets/asia/moodys-slashes-pakistans-rating-amid-payment-crisis-2023-02-28/)

² FY16 marks the start of NCPI on FY15-16 base.

adopting flexible inflation targeting regime by 2028.

2.2 Monetary Policy Stance in FY23

In the challenging and uncertain economic landscape, the SBP's objective to achieve price stability guided the conduct of monetary policy during the year. Following a proactive and data-driven approach, the MPC adapted to rapidly changing macroeconomic conditions and calibrated the monetary policy stance to safeguard price and financial stability, and the medium-term growth prospects.

The MPC continued monetary tightening in all its meetings convened during FY23, with the exception of three reviews, when the committee decided to keep the policy rate unchanged in August and October 2022, and on 12th June 2023. In addition, the SBP also implemented various administrative measures, such as linking of the rates on export finance scheme (EFS) and long term financing facility (LTFF) to the policy rate to strengthen monetary policy transmission and introduction of priority guidance for non-essential imports to reduce pressures on external account.³

Amid increased inflationary pressures and deteriorating external outlook, the MPC raised the policy rate by 125 bps to 15 percent in July 2022

The Russia-Ukraine conflict had markedly increased global economic uncertainty when the MPC met in July 2022. Inflation in most countries had reached multi-decade peaks, prompting central banks to adopt aggressive monetary policy stance. The situation was no different in Pakistan, where the interaction of global economic uncertainties with domestic

challenges further worsened the inflation outlook.

Domestic demand showed robust expansion at the start of FY23, partly on account of unplanned fiscal expansion in the shape of power and fuel subsidies during March-May 2022. Consequently, the LSM and high-frequency demand indicators – sales of cement, automobiles and POL – experienced higher growth since the last MPC meeting in May 2022. Meanwhile, private sector credit also witnessed a broad-based expansion in May 2022 given high input costs and domestic demand.

The strong domestic demand, and a large supply shock in the form of removal of energy subsidies, pushed headline inflation to a 14-year high level of 21.3 percent in June 2022. The increase was broad-based reflecting a notable surge in energy, food and core inflation. Also, the inflation expectations rose markedly in June 2022.

The upsurge in demand also contributed to the spike in imports, which together with a decline in workers' remittances led to a sizeable expansion in the CAD during May 2022. Moreover, lackluster private and official inflows maintained pressures on financial account, and hence the FX reserves and the PKR. In addition to elevated domestic demand, lingering domestic uncertainty, global strengthening of the USD, and unabated increase in international commodity prices, further accentuated pressures on the PKR, since the last MPC meeting in May 2022.

In this backdrop, to ensure a soft landing of the economy, prevent de-anchoring of inflation expectations and provide support to the PKR, the MPC increased the policy rate by 125 bps in July 2022 with a majority vote of five (05) out of six (06). Furthermore, to strengthen the monetary policy transmission, the rates on EFS

³ SBP vide its Circular Letter No. 20 of 2022, dated December 27, 2022, required Authorised Dealers (ADS) to obtain prior permission from the SBP before initiating any import proceedings pertaining to HS code chapter 84, 85 and certain items of chapter 87. (State Bank of Pakistan)

and LTFF loans were linked to the policy rate, though still continuing to incentivize exports by offering a discount of 500 bps relative to the policy rate. The MPC underscored the need to achieve fiscal consolidation envisaged in the budget for FY23, as necessary to complement monetary tightening for achieving the objective of price stability and addressing external vulnerabilities. The committee also suggested to introduce non-traditional measures such as early closure of markets, encouraging work from home and reducing energy intensity of the economy to curtail energy demand for narrowing trade deficit to sustainable level.

MPC kept the policy rate unchanged at 15 percent in August and October 2022 amid floods and moderation in domestic demand

In view of the cumulative 800 bps hike in the policy rate since September 2021, which had started to show the desired results as evidenced from slowdown in high-frequency demand indicators and anticipation of further moderation in economic activity in the aftermath of summer floods, the MPC unanimously decided to keep the policy rate unchanged at 15 percent in both its meetings convened in August and October 2022. This decision also took into account the improvement in external account position after the completion of 7th and 8th reviews under the IMF's EFF program.

Moreover, the economic activity slowed considerably as most demand indicators recorded decline in sales volumes, whereas the LSM posted a contraction in July 2022. The fallout of monsoon floods was expected to further weaken demand-side pressures on inflation and current account. The fiscal performance was also better as seen from a primary surplus in July 2022, compared to a deficit in the same period last year.

However, inflationary pressures intensified in July 2022 with a broad-based surge in energy, food, and core inflation. The MPC viewed this increase in inflation to be in line with

expectations given the reversal of energy subsidies, continued momentum in prices of essential food items and the PKR depreciation in the previous month. Furthermore, a temporary downward revision in the FCA pared the momentum in energy as well as the headline inflation that edged down from 27.3 percent YoY in August 2022 to 23.2 percent in September 2022.

At this point, the global economic situation was marked with substantial uncertainty, with rising risks to global growth prospects that led to softening of international commodity prices. This, together with the demand management measures introduced by the SBP, translated into improvement in the external account. The sharp contraction in energy imports with some moderation in non-energy imports, started to narrow the trade deficit. With these external sector outturns, the CAD witnessed a significant contraction in the first quarter of FY23 and the PKR recovered some of its losses in October 2022.

Stronger and more persistent-than-expected inflation outturns amid global and domestic supply shocks led to 100 bps increase in the policy rate each in November 2022 and January 2023 to 17 percent

The concerns about persistent and pervasive inflationary pressures underpinned further monetary tightening, despite visible slowdown in economic activity and reduction in the CAD at the time of November 2022 and January 2023 MPC meetings. The MPC noted that a combination of domestic and global supply shocks in the form of flood-related domestic food shortages, increase in energy prices, rising global economic uncertainty, and still elevated global commodity prices and their second-round effects to broader prices and wages were feeding into stronger and more persistent-than-expected domestic inflationary pressures. The inflation momentum spiked sharply by 4.7 percent MoM in October 2022, mainly due to the

normalization of the FCA, whereas core inflation continued the past ten months' uptrend in November and December 2022. Reflecting these developments, inflation expectations of both the consumers and businesses increased in January 2023.

The MPC observed that if left unaddressed, inflationary pressures could become entrenched which could be detrimental to the objective of price stability and sustainability of future growth. Therefore, to anchor inflation expectations and to safeguard medium term growth prospects, the MPC raised the policy rate by 100 bps in both November 2022 and January 2023 meetings with a majority vote of seven (07) out of nine (09) and six (06) out of seven (07), respectively. In addition, the MPC stressed the need of introducing administrative measures and timely imports to ease food inflation.

Around the time of the monetary policy reviews in November 2022 and January 2023, the sales volumes continued to plummet, reflecting the unfolding impact of earlier monetary tightening, administrative measures and temporary disruptions caused by floods. On the supply side, the LSM production flattened during Q1-FY23, before witnessing a notable 5.5 percent YoY decline in November 2022.⁴ Emulating these trends, imports also dropped significantly, leading to a contraction in the CAD during H1-FY23. This improvement in the current account came despite an almost consistent decline in workers' remittances during this period, domestic and global uncertainties, rising kerb premium, normalisation of travel and the US\$ appreciation.

Notwithstanding this improvement, the MPC noted that various domestic and global factors increased near-term risks to external sector outlook around the time of November 2022 and January 2023 MPC meetings. Specifically, lower external financing inflows amid ongoing domestic uncertainty, tightened global financial

conditions, and continued external debt repayments resulted in drawdown of the FX reserves. In this regard, the MPC stressed on the importance of completing 9th review of the IMF's EFF program to address uncertainty and ensuring availability of external financing from bilateral and multilateral creditors.

The fiscal performance had also deteriorated with an expansion in overall deficit and a reduction in primary surplus during the first four months of FY23, compared with the same period last year. While acknowledging the challenges posed by floods, the MPC suggested to reprioritise spending towards flood relief efforts and provision of targeted support to vulnerable segments to ensure that magnitude of fiscal slippages remains minimal. The MPC highlighted the need of fiscal policy efforts to complement monetary tightening for achieving the objective of price stability.

Amid deterioration in inflation outlook led by fiscal adjustment and exchange rate depreciation, the policy rate was raised by 300 bps in March 2023 to 20 percent

The materialisation of upside risks to inflation from additional taxes and duties introduced through the Finance (Supplementary) Act 2023, adjustment in energy prices and a large PKR depreciation, led to a significant deterioration in inflation outlook when the MPC met in March 2023. The headline Inflation witnessed a broad-based surge to 31.5 percent in February 2023, with rising prices of essential food items having the largest contribution. After remaining subdued in the past few months, energy inflation picked up in February 2023, with upward adjustment in the POL and gas prices. Incorporating the second round effects of energy price adjustment and elevated inflation expectations, core inflation also escalated in February 2023 across rural and urban areas.

In the external sector, vulnerabilities continued to mount despite sustained contraction in the

⁴ According to revised data released by PBS, the LSM declined by 6.3 percent YoY in November 2022.

CAD. Meagre financial inflows amid tightened global financial conditions and domestic uncertainties alongside scheduled debt repayments, kept the FX reserves and hence the PKR under pressure during Jul-Jan FY23.

In this backdrop, the MPC decided to respond aggressively to anchor inflation expectations and increased the policy rate by 300 bps to 20 percent, in its March 2023 meeting, with a majority vote of seven (07) out of nine (09). Furthermore, the MPC highlighted the importance of maintaining fiscal discipline for economic stability and to achieve the objective of price stability. While assessing the implications of monetary tightening, the MPC viewed that with well capitalized financial institutions, risks to financial stability were likely to remain contained. Although the growth outlook presented a tradeoff, the MPC upheld its earlier view that short-term costs of controlling inflation were lower than the long-term risks of inflation becoming entrenched.

Continued surge in inflation amid persistent challenges to macroeconomic outlook prompted 100 bps increase in policy rate in April 2023 to 21 percent

The macroeconomic outlook had worsened further amid persistent uptrend in inflation, consistent stress on the FX reserves and tightened global liquidity conditions when the MPC met in April 2023. In line with the contractionary policies, economic activity as gauged from the high-frequency indicators and the LSM production had continued to weaken since the last MPC meeting. Despite these developments, a combination of pass-through of taxes and duties introduced via the Finance (Supplementary) Act 2023, further upward adjustment in energy tariffs and its second round effects on input costs, and the PKR depreciation, alongside elevated inflation expectations, pushed the headline NCPI inflation to new highs in March 2023. In the external account, while sustained decline in

domestic demand helped a more-than-expected contraction in the CAD during February 2023, the dearth of FX inflows maintained pressures on the BoP position.

Hence, to anchor inflation expectations around the medium-term target, the MPC raised the policy rate by 100 bps to 21.0 percent in its April 2023 meeting, with a vote of seven (07) out of nine (09). The MPC viewed that this policy stance; with real interest rate in positive territory on a forward looking basis, was appropriate to bring inflation down to the desired range.

Declining inflation momentum and sequentially easing inflation expectations led the MPC to keep the policy rate unchanged in its meeting held on 12th June 2023 at 21.0 percent

Inflation outlook had improved around the time of the MPC meeting on many counts. First, while the headline NCPI inflation maintained the expected broad-based uptrend during April and May 2023, the inflation momentum continued to weaken for the third straight month in May 2023. Encouragingly, this improvement was seen in core inflation as well. Second, inflation expectations of both consumers and businesses continued to ease in May 2023.

Third, the provisional estimates showed substantial slowdown in economic activity in FY23, with the real GDP growth falling to 0.3 percent, from the revised estimate of 6.1 percent in FY22.⁵ Fourth, the CAD posted surpluses for two consecutive months in April and May 2023. Fifth, the FY24 budget envisaged further fiscal consolidation relative to the outgoing year. And lastly, the outlook for global commodity prices and liquidity conditions had improved.

Taking a consolidated view of these developments and the cumulative impact of 1,400 bps increase in the policy rate since September 2021, the MPC decided to maintain the policy rate at 21 percent in its meeting held

⁵ According to the revised estimates published by the PBS in November 2023, real GDP contracted by 0.2 percent in FY23.

on 12th June 2023, with eight (08) out of ten (10) votes. The MPC viewed that domestic uncertainty, continued external account pressures and the impact of monetary tightening were expected to keep domestic demand in check, going forward. Furthermore, inflation was expected to start downtrend from June 2023. The MPC considered this policy stance appropriate to bring down inflation to medium term target in the absence of any unforeseen shocks, if the prevailing domestic uncertainty and external account pressures were addressed effectively.

With emergent risks to inflation outlook, MPC increased the policy rate by 100 bps to 22 percent in its emergency meeting held on 26th June 2023

To ensure completion of the IMF program, some important policy measures were introduced in the last week of June 2023, which posed upside risks to inflation outlook. First, the government increased the PDL rates, and introduced additional taxes and duties in FY24 budget. Second, the SBP withdrew the priority guidance on imports. To review the evolving situation, the MPC convened an emergency meeting on 26th June. The MPC noted that the increase in taxation could have both direct and indirect effects on inflation. Similarly, the ease in import restrictions was likely to create additional

pressures in the FX market, and hence on the PKR, which could further swell inflation.

In order to proactively respond to above-mentioned risks, the MPC increased the policy rate by 100 bps to 22 percent, with a majority vote of eight (08) out of nine (09). The MPC viewed that this decision was required to keep real interest rates firmly in positive territory on a forward looking basis and to keep inflation expectation anchored to achieve the medium-term target of 5.0 – 7.0 percent by the end of FY25, in the absence of sudden shocks. The MPC also highlighted the importance of completing the IMF program and the government's adherence with the primary surplus target for FY24 to address external account vulnerability and to reduce economic uncertainty.

2.3 Monetary Policy Implementation

The implementation of monetary policy mainly focuses on keeping the money market overnight repo rate (ONR) close to the policy (target) rate through the SBP's open market operations (OMOs) and use of standing facilities. Despite increase in interbank liquidity requirements during FY23, the ONR remained 11.0 bps below the policy rate on average. This is in contrast to

ONR Deviation from the Policy Rate

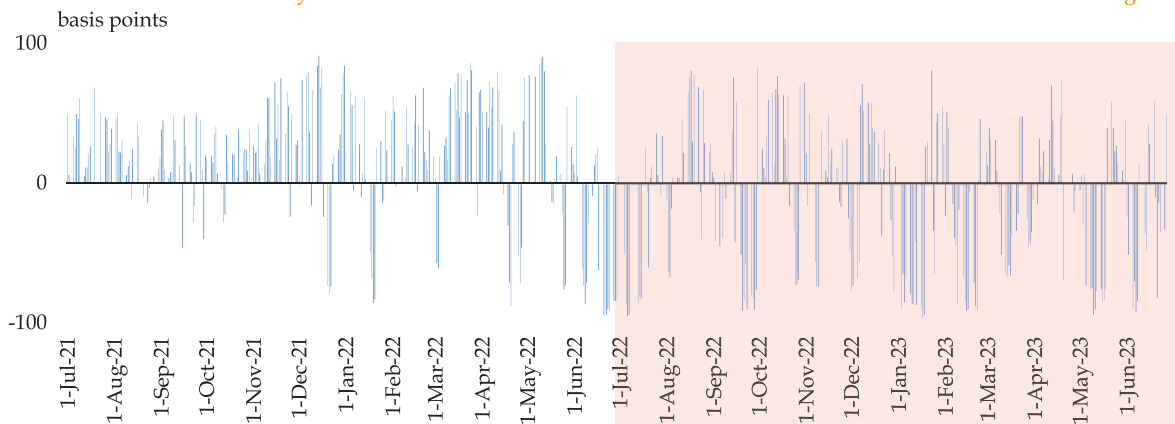
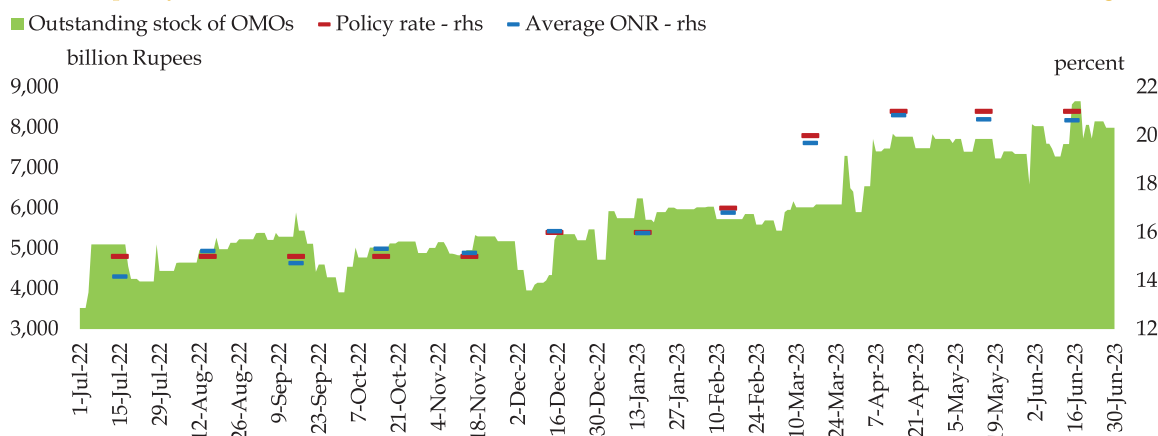


Figure 2.7

Source: State Bank of Pakistan

Interbank Liquidity Indicators in FY23

Figure 2.8



Source: State Bank of Pakistan

FY22 when the ONR remained 17.6 bps above the policy rate on average (Figure 2.7).⁶

Liquidity requirements of the interbank money market significantly increased in FY23 relative to the previous year. A number of factors fueled this increased requirement. These included: a substantial net retirement of the external debt in PKR terms; the government's continued reliance on commercial banks for deficit financing amid unavailability of external financing; restrictions on borrowing from the SBP; and less-than-envisaged fiscal consolidation that undermined monetary policy effectiveness. In addition, elevated macroeconomic uncertainty along with rising inflationary pressures that led to a substantial 20.8 percent expansion in currency in circulation (CiC) in FY23, compared to a 9.6 percent increase in the previous year, and lower growth in deposit mobilization by commercial banks also contributed to higher liquidity requirement.

In this backdrop, the SBP continued to provide liquidity in the interbank money market through regular 7-day and longer-tenor (including 63 and 77 days) OMOs to meet the soaring needs of the interbank market. As a result, the average outstanding stock of OMOs rose to Rs 5,829.2

billion in FY23, from Rs 2,489.8 billion in FY22 (Figure 2.8).

To better manage liquidity, the SBP used relatively longer-tenor OMOs during FY23. Specifically, the SBP cumulatively injected Rs 32.5 trillion through 40 longer-tenor OMOs during FY23 compared to around Rs 5.7 trillion through 9 longer-tenor injections in FY22.⁷ The availability of ample liquidity in the system frequently pushed the ONR below the policy rate during FY23.

Moreover, the market utilized the SBP's floor facility 594 times during FY23 and parked a cumulative amount of Rs 18.3 trillion, compared to Rs 6.7 trillion on 217 occasions in FY22. Therefore, to mop up the excess liquidity from the interbank market, the SBP conducted twenty (20) OMOs in FY23, compared to five (05) in the previous year, whereas the volume of liquidity mopped up nearly doubled in each OMO.

Moreover, to effectively manage the liquidity of Islamic Banking Institutions (IBIs), the SBP injected Rs 4.1 trillion via 70 OMO injections. Thus, the average outstanding stock of these OMOs increased to Rs 539.0 billion during FY23 from Rs 467.3 billion in FY22.

⁶ Excluding weekends and public holidays.

⁷ Total 41 longer tenor OMOs were announced in FY23, of which bids were rejected for one OMO.

3 Financial Stability

The overall macro-financial conditions remained under stress during FY23, as soaring inflation, pressures on external account, tight monetary policy and subdued economic activity posed significant challenges for both the real and financial sectors. However, Pakistan's financial sector maintained soundness; continued to honor its financial obligations; and provided uninterrupted supply of credit and financial services to firms, household, and the government.

As the banking sector holds the biggest share in Pakistan's financial system and plays a pivotal role in the national payments system, its performance and soundness is crucial for the stability of the entire financial system. The banking sector stability map (BSSM),¹ which tracks key financial soundness indicators along various dimensions, shows that the Asset Quality, Earnings, Capital Adequacy, and Interconnectedness witnessed improvements. However, deposit growth showed some moderation vis-à-vis growth in overall asset base (**Figure 3.1**). Nonetheless, aided by the financial cushion and operational capabilities that have been built over the years under a prudent regulatory and supervisory framework, the sector exhibited resilience in the face of adverse macro financial conditions during the year under review.

Asset Quality and Credit Risk

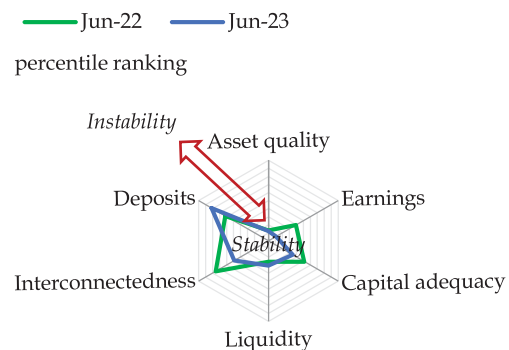
Asset quality profile of banks and the Development Finance Institutions (DFIs) improved further during FY23. The ratio of the banking sector's non-performing loans (NPLs)

to total loans remained almost steady at last year's level; however, it declined in case of the DFIs, on account of decrease in their NPLs during the year. With increased provisioning coverage for loan losses, the net NPLs-to-net loans ratio and capital impairment ratio (net NPLs to capital) further decreased to one of the lowest levels in the last two decades. This suggests a relatively muted residual credit risk to the solvency of banks and the DFIs from their existing delinquent loan portfolio (**Table 3.1**). The results of the latest stress testing exercise (sensitivity analysis) also show that the banking sector has adequate resilience to severe hypothetical shocks to the credit risks factors.

On the other hand, detailed assessment of banks' loan portfolio suggests that it mainly comprises rated firms that prefer to borrow from the banking sector, due to inter alia, limited outreach of the corporate debt market.² Such rated borrowers generally have stronger credit

Banking Sector Stability Map

Figure 3.1



Source: State Bank of Pakistan

¹ BSSM ranks the Financial Soundness Indicators of the current period vis-à-vis their historical level. It is based on percentile rankings (scaled from 1 to 10) of various indicators, and the summary score of these indicators in a particular dimension e.g. asset quality. A ranking close to 10 value on the summary statistic suggests increased risks but not necessarily immediate stability concern. This is because the summary statistic is based on percentile rankings of historical series and the actual indicators for the quarter may still be in comfortable position or above the minimum regulatory requirement. Methodology of BSSM is based on Dattels, P., McCaughrin, R., Miyajima, K., & Puig, J. (2010). "Can you map global financial stability?" *IMF Working Papers*, 1-42

² Loans and financing to rated firms (rated by external rating agencies) constitute 66.6 percent of banking sector's overall commercial and corporate credit portfolio in June-2023 (58.7 percent in June-2022).

Governor's Annual Report 2022-2023

Key Financial Soundness Indicators of Banks, DFIs and MFBs* **Table 3.1**

Description	Jun-21	Jun-22	Jun-23
Asset Quality Indicators			
NPLs to Total Loans			
Banks	8.9	7.5	7.4
DFIs	12.8	8.6	7.2
MFBs	5.4	6.5	7.8
Provision to NPLs			
Banks	88.8	91.6	94.4
DFIs	74.9	86.1	107.3
MFBs	69.3	73.4	89.5
Net NPLs to Net Loans			
Banks	1.1	0.7	0.4
DFIs	3.5	1.3	-0.6
MFBs	1.7	1.8	0.9
Net NPLs to Capital			
Banks	5.1	3.8	2.4
DFIs	3.1	1.5	-0.7
MFBs	7.5	11.0	9.1
Solvency Indicators			
Eligible Capital to Risk Weighted Assets (RWA)[^]			
Banks	18.3	16.1	17.8
DFIs	40.3	36.4	36.0
MFBs	19.1	14.9	9.3
Tier 1 Capital to RWA			
Banks	14.6	13.4	14.8
DFIs	39.1	35.7	35.2
MFBs	15.3	11.4	6.3
Earnings Indicators			
ROA before Tax			
Banks	1.6	1.9	2.9
DFIs	2.8	1.8	1.5
MFBs	-0.6	-2.1	-0.6
ROE before Tax			
Banks	23.5	30.7	50.7
DFIs	10.3	8.2	20.7
MFBs	-5.5	-22.7	-10.9
Liquidity Indicators			
Liquid Assets/Total Assets			
Banks	57.1	58.5	59.9
DFIs	60.0	66.4	89.2
MFBs	31.4	27.8	28.5
Liquid Assets/Total Deposits			
Banks	78.7	86.0	91.2
DFIs	1,396.0	1,745.8	8,098.2
MFBs	42.6	37.6	39.6
Liquid Assets/Short term liabilities			
Banks	114.3	105.2	107.9
DFIs	98.0	99.1	97.2
MFBs	44.6	35.3	38.8

* Share in Total Financial Sector Assets at end June-2023:

Banks=76%, DFIs=6.0% and MFBs=1.3%

[^] Capital Adequacy Ratio (CAR) Requirement: For Banks/DFIs = 11.5 percent; For MFBs = 15 percent

Source: State Bank of Pakistan

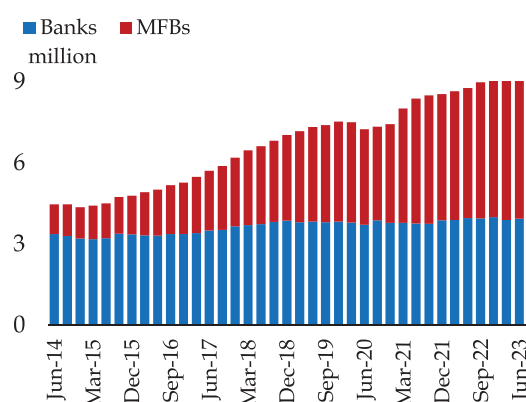
worthiness and an established track record of business and corporate governance.

These factors also underscore the firms' adequate resilience against economic shocks. It is pertinent to mention that the SBP duly recognizes the importance of a developed capital market for financial stability and sustainable economic growth. In this regard, the SBP is co-operating with Securities and Exchange Commission of Pakistan (SECP) for the implementation of Capital Market Development Plan and Road Map.³ It is also promoting corporate governance regime that is essential for firms to access capital market funding in the form of shares, bonds and Sukuks.⁴

While the credit risk of banks and DFIs remained in a comfortable position on an overall basis, the MFBs struggled to recover from the post-pandemic stressed situation and heavy floods of Q1-FY23. In comparison to banks and the DFIs, gross NPLs-to-loans ratio of the MFBs, which have a low share in the overall assets of financial institutions (FIs), showed some deterioration in FY23. This is because around 48 percent of the increase in NPLs during FY23 was in the agriculture portfolio followed by livestock

Composition of Banks' and MFBs' Borrowers

Figure 3.2



Source: State Bank of Pakistan

³ Source: Capital Market Development Plan and Road Map, 2020-2027, SECP

⁴ For instance, as per SBP's prudential regulations, audited financial statements of the borrower is a pre requisite for corporate sector lending by banks/DFIs. Similarly, lending to large unrated borrowers (with total exposure of more than Rs 3 billion) involves higher capital charge for banks/DFIs, thus incentivizing the large borrowers to get themselves rated.

that were affected by the floods of Jul-Aug 2022. In addition to loss of human lives and infrastructure, the floods affected a large crop area in different parts of the country.

The MFBs serve a large clientele base of micro-borrowers who are highly susceptible to economic shocks. Given the MFBs' importance in financial inclusion, the SBP continued its enhanced supervision and facilitated the MFBs in rescheduling/restructuring the loans of flood-affected borrowers for up to one year (**Figure 3.2**). This regulatory support contained the significant increase in the NPLs and helped the

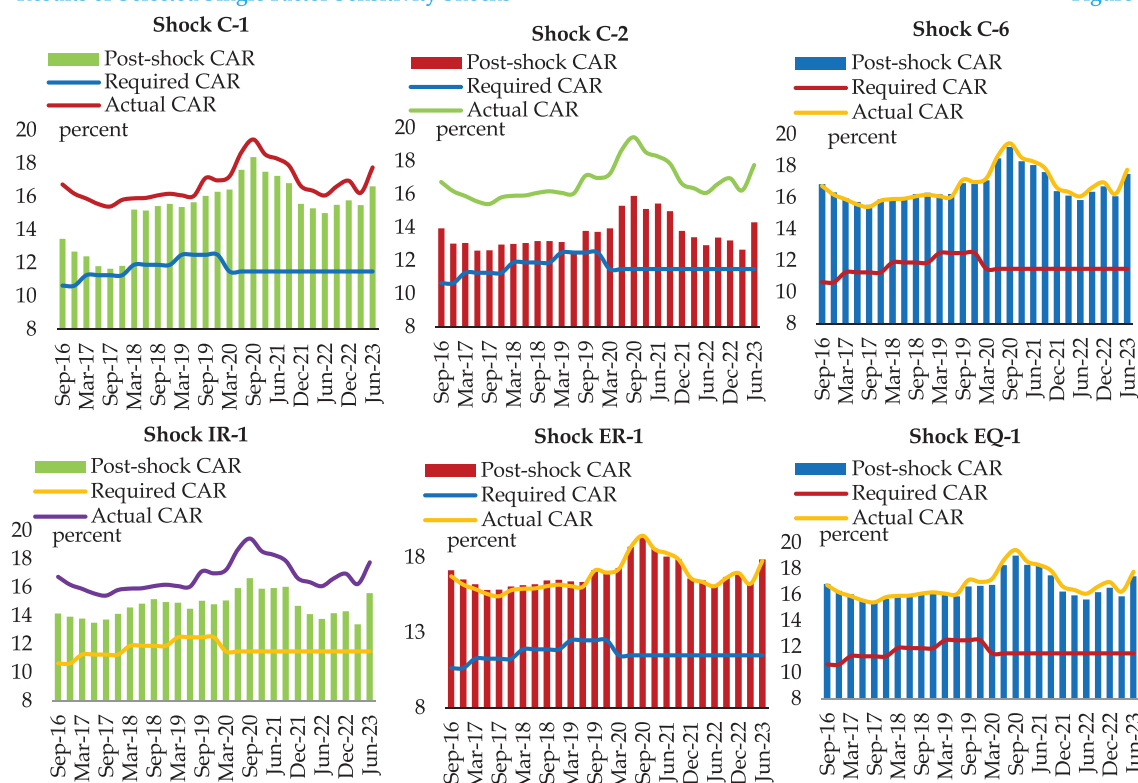
MFBs in not only improving the availability of credit but also weathering the impacts of floods.

Market Risk

Within market risk, interest rate risk is particularly important for banks. Investments in government securities constituted 49.6 percent of the banking sector's asset base at the end of June 2023. Around 89 percent of the government securities were held in Available for Sale (AFS) and Held for Trading (HFT) categories; both these categories are subject to regular mark-to-market adjustment for any changes in interest rates to represent the true

Results of Selected Single Factor Sensitivity Shocks*

Figure 3.3



Shock C-1: 10% of performing loans become non-performing, 50% of substandard loans downgrade to doubtful, 50% of doubtful to loss.

Shock C-2: Default of top 3 private sector borrowers/Groups (fund based) exposures.

Shock C-6: Increase in NPLs to Loan Ratio equivalent to the historical maximum quarterly increase in the ratio of individual banks.

Shock IR-1: Parallel upward shift in the yield curve - increase in interest rates by 300 basis points on all the maturities.

Shock ER-1: Depreciation of Pak Rupee by 30%.

Shock EQ-1: Fall in general equity prices equivalent to maximum decline in KSE-100 index.

* These selected shocks are part of a set of single factor sensitivity analysis that SBP conducts and publishes regularly

Source: State Bank of Pakistan

and fair view of the FIs' economic value of equity and capital cushions. The significant increase of 825 bps in the policy rate during FY23 resulted in revaluation losses on these fixed-income government securities.⁵ However, banks in general were able to sustain the impact, as they had ample capital cushions and their sensitivity to interest rate changes was relatively low, due to shorter maturity/repricing tenors of the investment portfolio. Similarly, the banking sector has limited exposures to FX because of which the sector did not face significant financial strains when the FX market experienced heightened volatility during FY23.

Likewise, given its low exposure to equities, the lackluster performance of equity market in FY23 did not expose banks to equity price risks. The banking sector's contained sensitivity to the FX and equity price movements is partly explained by a prudent regulatory regime, which prescribes conservative limits on banks' exposures. The results of the latest stress testing exercise show that the banking sector in general remained resilient to hypothetical severe shocks related to various market risk factors (**Figure 3.3**).

Similarly, stress testing shocks for the DFIs also suggest that these institutions are resilient to both, a sharp rise in the yield curve (interest rate) as well as a severe fall of up to 36 percent in equity prices. The MFBs, on the other hand, have low exposure to market risk, given their business model; with investments at just 21.8 percent of total assets. Thus, their sensitivity to market risk is relatively low.

Earnings

From financial stability perspective, steady earnings are essential for building capital buffers against unforeseen shocks, and creating incentives for investors to invest in the businesses to improve economies of scale and scope. The after-tax profit of the banking sector

rose by 84.9 percent (Rs 495 billion) in FY23 compared to 10.9 percent (Rs 268 billion) in FY22 – despite a 74.0 percent increase in income tax charges, which amounted to almost half (48.3 percent) of sector's pre-tax profit. Profitability indicators, such as after tax ROE improved to 26.0 percent (12.9 percent in June 2022) and after tax ROA improved to 1.5 percent (0.8 percent in June 2022). The growth in profit mainly came from increase in net interest income due to rising interest rates and growth in asset base, while interest expenses also recorded a sharp growth. On the other hand, operational expenses recorded a noticeable growth of 30.2 percent due to branch expansion and elevated inflation.

The DFIs' after-tax profit almost doubled to Rs 21 billion in FY23 (around Rs 11 billion in FY22). Besides growth in net interest income, the dividend income from associates also supported the profitability. However, the DFIs' earning indicators showed a mixed picture. The sector's after-tax ROA declined to 1.1 percent by the end of FY23 (1.4 percent in FY22) as the growth in earning was mainly driven by higher investments, while its after-tax ROE improved to 15.0 percent (6.3 percent in FY22), as the growth in profits outpaced that in equity.

The MFBs sector, on an aggregate basis, has been incurring losses (before tax) since FY20. This is due to the COVID-19 pandemic and subsequent floods, which affected both the repayment capacity of micro-borrowers, as well as the operations of microfinance banks. The aggregate after-tax loss of the MFB sector rose to Rs 13.5 billion in FY23 (from Rs 11.5 billion in FY22). The slowdown in economic activity and delinquencies in loan portfolios constrained the MFBs' interest income and revenues, while administration and operating expenses increased due to inflationary pressures. As a result, their cost to income ratio remained elevated at 87.3 percent in FY23. Similarly, high provisioning expenses against NPLs fueled

⁵ Revaluation losses on the AFS government securities rose to around Rs 373 billion (1.8 percent of total value government securities) at end-June 2023 compared to Rs 176 billion (1.1 percent of total value of government securities) at end-June 2022.

losses of the sector. Accordingly, profitability indicators such as the ROA and the ROE of the MFBs has remained negative since FY20. However, latest data of Q4-FY23 shows improvement in the MFBs' bottom-line, as it was the first quarter since Q3-FY19 when the MFBs made pre-tax profit on an aggregate basis.⁶

Liquidity

The liquidity profile of the banking sector remained comfortable. With the sector's liquid assets to total assets ratio at 59.9 percent, liquid assets to deposits ratio at 91.2 percent, and liquid assets to short term liabilities ratio at 107.9 percent at the end of June 2023, the banks in general have adequate stock of liquid assets to honor their obligations. The major reason for a strong liquidity profile of banks is the high share of government securities in their asset mix. These instruments have a reasonably developed secondary market that helps banks in managing their liquidity needs.

In addition to the statutory liquidity requirements that are monitored on fortnightly basis for banks, the DFIs and the MFBs, the SBP also requires banks to maintain Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) of at least 100 percent in line with Basel-III standards that cover different aspects of the FI's overall liquidity profile in dynamic manners. Accordingly, the banking sector's compliance with both statutory requirements and Basel standards remained strong. The LCR ratio of the banking sector improved to 244.2 percent in June 2023 from 201.8 percent at the end of June 2022. Similarly, the NSFR improved to 206.4 percent in June 2023 from 160.7 percent at the end of June 2022, suggesting a satisfactory liquidity profile.⁷

The DFIs' liquidity profile - already at satisfactory level - further improved on the back of significant investment in government securities during FY23. The DFIs' liquid assets constituted around 90 percent of the asset base at the end of FY23, as compared to 66.4 percent, a year ago. However, the ratio of liquid assets to short term liabilities slightly contracted to 97.2 percent by the end of June 2023 (99.1 percent in June 2022) as DFIs' repo borrowing rose significantly to fund the growth in assets (mainly government securities), while NSFR of the DFI sector remained steady at 126.4 percent.

Due to higher demand for banks' credit particularly from the government vis-à-vis deposit mobilization, the liquidity conditions in the market came under stress. Therefore, reliance of banks and the DFIs on the SBP's OMOs and standing facility remained elevated. Besides assisting the FIs in managing their liquidity profile, the OMO injections facilitated in keeping the overnight rate close to the policy rate.

Solvency and Capital Adequacy

Solvency indicators of the banking sector improved in FY23. The risk-based capital adequacy ratio (CAR) improved to 17.8 percent by the end of June 2023 from 16.1 percent in June 2022, well above the minimum regulatory capital requirement of 11.5 percent. The improvement in the CAR mainly emanated from higher earnings in FY23. The solvency profile of DFIs also remained strong with an overall CAR of around 36.0 percent at the end of FY23, well above the minimum regulatory of 11.5 percent. The aggregate CAR of the MFBs fell to 9.3 percent by the end of June 2023 from 14.9 percent at the end of June 2022, compared to

⁶ The MFBs recorded Rs 89 million profit (before tax) in Q4-FY23.

⁷ The minimum LCR requirement ensures that banks have high-quality liquid assets to cover all of their liabilities maturing in next 30 days. NSFR, which has long-term perspective, requires that banks have stable funding available to cover at least 100 percent required stable funding needs of their business. Available Stable Funding is the portion of a bank's capital and liabilities that will remain with the institution for more than one year, while Required Stable Funding is the amount of stable funding that it is required to hold given the liquidity characteristics and residual maturities of its assets and the contingent liquidity risk arising from its off-balance sheet exposures. Since NSFR measures liquidity profile over a longer horizon, the ratio is also relevant for the DFIs, which do not raise demand deposits. Details of NSFR is available at: (www.bis.org/fsi/fsisummaries/nsfr.htm)

15.0 percent minimum regulatory capital requirement, as applicable on individual institutions. However, within the MFBs sector, institutions with a combined market share of around 70 percent complied with the minimum regulatory capital requirement.

The MFBs have a low share in the overall asset base of the financial sector (i.e. 1.3 percent at the end of June 2023); however, the sector has a significant role in financial inclusion and provision of financial services to underserved segments of society. The sector is facing challenging operating environment since FY20, when the pandemic severely hit the repayment capacity of its micro-borrowers and disrupted the institution-customer relationship due to mobility restrictions. Moreover, the slowdown in economic activity and flash floods of summer 2022 adversely affected the recovery process. Nonetheless, as part of its regular supervisory process and to improve solvency position, SBP is proactively engaged with the management and sponsors of the respective MFBs to ensure compliance with the minimum regulatory requirements.

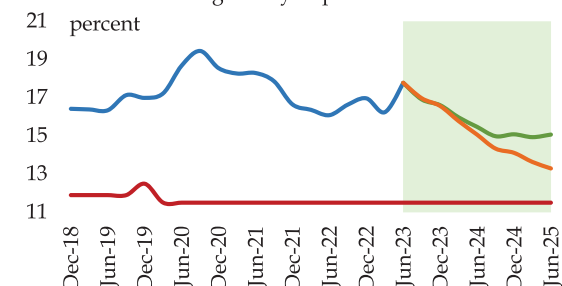
Going forward, the macro environment for the banking sector is expected to witness some improvement in FY24. However, the overall macro-financial conditions may still remain tight and the weak performance of key sectors could put pressures on the repayment capacity of borrowers. Keeping in view that soundness of financial institutions is susceptible to adverse changes in the macroeconomic environment, the SBP regularly conducts sensitivity analysis and macro stress testing (scenario analysis) exercise to assess its regulated institutions' capacity to withstand hypothetical severe macro-financial shocks.⁸ The results of the latest sensitivity analysis suggest that the banking sector, in general, has adequate resilience to withstand severe hypothetical shocks to credit, market, and liquidity risks (Figure 3.3).

Similarly, scenario analysis shows that the CAR of the banking sector is likely to remain above the minimum regulatory requirement under both business-as-usual scenario – that already contains elements of significant strains – and stressed macroeconomic scenario – that adds further hypothetical shocks to the economic conditions – over the projected period of two years (Figure 3.4). Particularly, the large sized banks, which are crucial for overall financial stability in the economy, exhibit relatively greater resilience.

The soundness of individual FIs, especially the larger banks, is the cornerstone of the overall financial stability. The ratings assigned by independent credit rating agencies to regulated FIs also suggest that these financial institutions in general have satisfactory credit worthiness, indicating that they have adequate credit worthiness and the ability to honor their financial obligations (Figure 3.5).

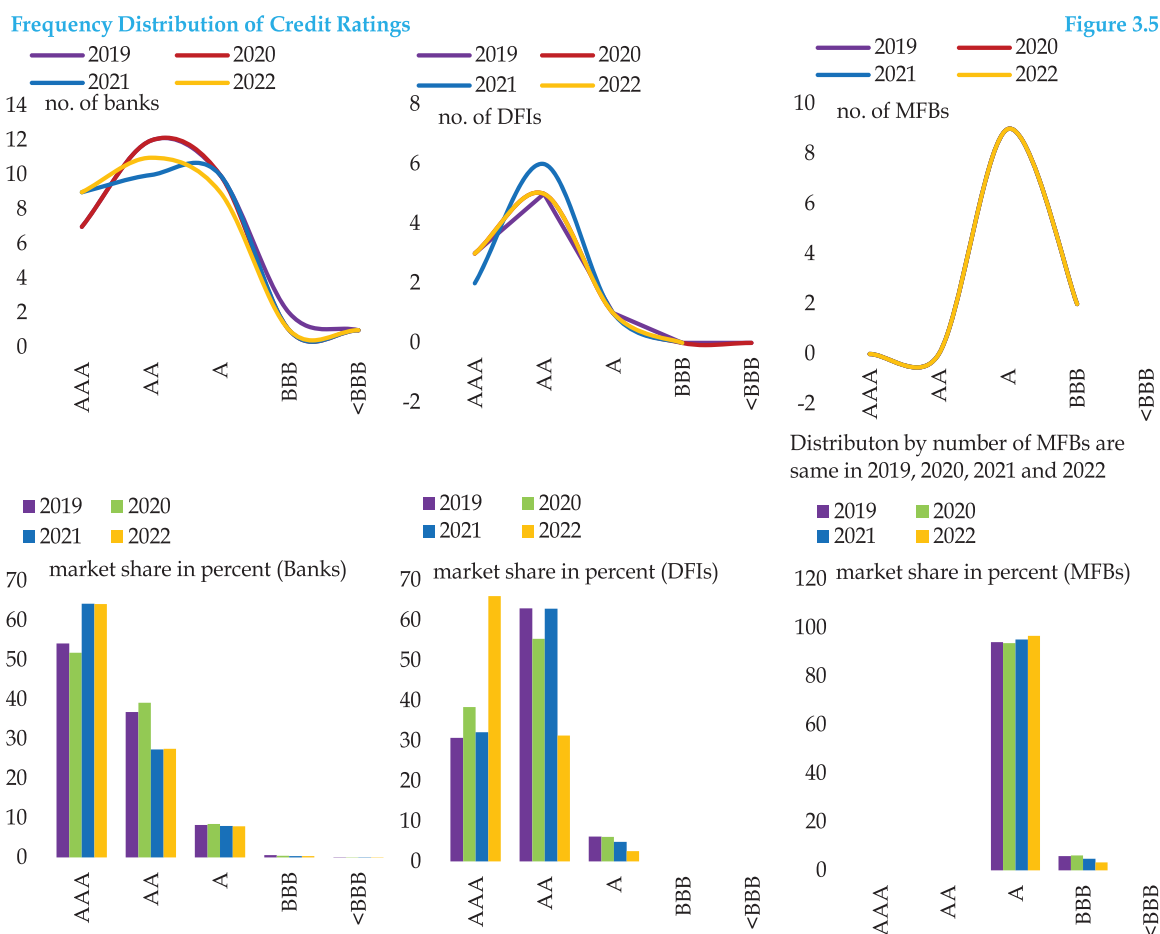
To keep markets abreast of latest dynamics of financial stability, the SBP regularly assesses the financial performance and soundness of the regulated entities and communicates the

Capital Adequacy Ratio - Actual and Projected under Business As Usual and Stressed Conditions Figure 3.4



Source: SBP staff calculations

⁸ As part of its stress testing exercise, SBP conducts sensitivity and scenario analyses on quarterly basis. The summary results of sensitivity analyses are also published in Quarterly Compendium of Banking Statistics and FSIs, and results of scenario analysis are published in Mid-Year Performance Review of Banking Sector.



Source: State Bank of Pakistan

analyses through various publications. In this regard, the Quarterly Compendium on Banking Statistics and Financial Soundness Indicators, Mid-Year Performance Review of Banking Sector (January to June period) and the annual Financial Stability Review are the notable publications.

The SBP also conducts biannual (in January and July) Systemic Risk Survey (SRS) to gauge the views of market participants and independent experts about various existing and emerging risks to the stability of the financial system. The results of these survey are also published in the periodical reviews.

Strengthening Institutional Arrangements on Financial Stability and Current Priorities of the SBP

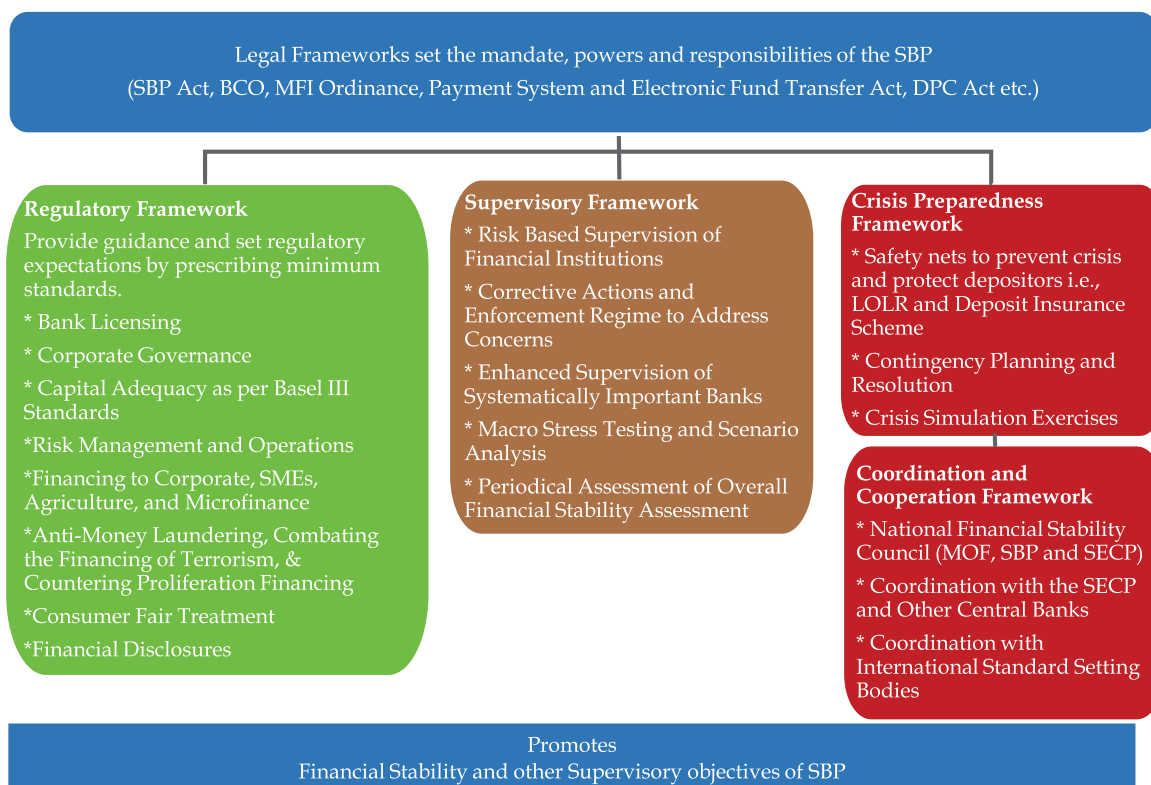
The SBP has a comprehensive regulatory and supervisory framework in place to ensure financial stability and promote other policy objectives. This framework incorporates the key elements that an effective supervisory system is supposed to have as per the internationally accepted standards and principles (Figure 3.6).⁹

The SBP is cognizant of the fact that the macroeconomic environment and technological landscape are quite dynamic and could present novel challenges to financial stability, as well as

⁹ Please refer section 3.2 of the Governor Report FY2022 for further details on the overall structures of SBP's regulatory and supervisory frameworks.

Key Elements of SBP's Regulatory and Supervisory Frameworks

Figure 3.6



Source: State Bank of Pakistan

opportunities for growth and development. Accordingly, the SBP regularly reviews and strengthens its regulatory and supervisory framework, in line with the changing dynamics of the market and emerging best practices over time. In this connection, the leading measures that the SBP undertook during FY23 are briefly discussed below:

Revision in Framework for Domestic Systemically Important Banks

Following the global financial crisis of 2008, regulators realized the need of enhanced supervision of systemically important financial institutions (SIFIs). The SBP, in line with emerging international best practices, had developed a framework for identification and enhanced supervisions of Domestic Systemically

Important Banks (D-SIBs) in 2018. In view of developments over the last few years on the international as well as domestic front, the SBP reviewed this framework; the requirement of Higher Loss Absorbency (HLA) capital surcharge in the form of additional Common Equity Tier 1 (CET1) for designated D-SIBs was amended.¹⁰

Implementation of the IFRS-9

International Accounting Standards Board (IASB) issued International Financial Reporting Standard-9 (IFRS 9) on Financial Instruments (including investments and advances) effective from January 1, 2018. This standard, inter alia, introduces the concept of expected credit loss provisioning, which brought major changes in the way FIs are to assess and provide prospective impairments losses in all of their

¹⁰ BPRD Circular Letter No. 34 of 2022 dated December 12, 2022

financial instruments, including regular loans and investments. In line with international best practices, the SBP finalized and issued Application Instructions on IFRS-9 for ensuring smooth and consistent implementation of the Standard. Keeping in view the prevailing circumstances, the SBP extended the effective implementation date of the standard to January 01, 2024 to give regulated FIs sufficient time to ensure smooth transition, though an early adoption of the standard is encouraged. The SBP also amended the existing format of annual financial statements of banks, the DFIs and microfinance banks (MFBs) in view of the regulatory developments over the last few years, including the implementation of the IFRS-9.^{11,12}

Enhanced Implementation of Regulatory Approval System

The SBP has been capitalizing on technological advancements to improve the efficiency and effectiveness of its regulatory and supervisory processes. Following the implementation of Regulatory Approval System (RAS) for Banking Policy & Regulations Department and Exchange Policy Department in the previous years, the SBP also implemented it for Payment Systems Policy & Oversight Department and rolled it out for industry-wide implementation during the year under review.¹³

Enhancement in scope of Business of Exchange Companies

The SBP amended the regulations prescribing the scope of business of exchange companies (ECs) during FY23 to further strengthen the regulatory regime for the ECs and encourage customers to use banking channels for the purchase of foreign exchange from the ECs. The SBP also undertook various measures to enhance monitoring of the ECs and their currency exchange transactions. These include directing them to conduct their transactions

through their bank accounts, and increasing the frequency of their transactions data reporting.

Review of Shariah-Compliance Assessment Manual

The SBP conducted a holistic review of the Shariah-Compliance Assessment Manual in order to align it with the Risk-Based Supervision (RBS) manual and to incorporate relevant instructions.

Anti-Money Laundering, Combating the Financing of Terrorism & Countering Proliferation Financing (AML/CFT/CPF) Regulations

Pakistan worked under a comprehensive action plan to address the deficiencies in its AML/ CFT regime after being placed under the increased monitoring list by Financial Action Task Force (FATF) in 2018. The SBP was the lead on action points related to the supervision of the FIs and the implementation of Targeted Financial Sanctions in the FIs. As a result of the joint efforts of the SBP and other stakeholders, Pakistan was finally removed from the FATF grey list in October 2022.

Development of a Supervisory Assessment Manual

The SBP developed a Supervisory Assessment Manual (SAM) to enhance supervisory capacity and to understand the critical facets of the IFRS-9. The SAM covers all essential elements of the IFRS-9 including both the qualitative and quantitative elements.

Thematic Assessments

The SBP conducted thematic assessments of various key areas to identify any significant weaknesses and concerns therein, and to ensure healthy practices by the FIs. These areas

¹¹ BPRD Circular Letter No. 07 of 2023 dated April 13, 2023

¹² BPRD Circular No. 02 of 2023 dated February 09, 2023

¹³ PSPOD Circular No 02 of 2022 dated July 06, 2022

included digital frauds and related controls, assessment of digital initiatives, cyber hygiene, fair treatment of customers, agent assisted Branchless Banking operations of the MFBs, assessment of the ML/TF risks and controls on digital banking initiatives.

Development of Business Intelligence Tools

The SBP also developed various business intelligence tools to support its risk- based supervision framework and encourage a data driven supervisory approach. These include Bank Risk Analysis and Monitoring (BRAM) system for regulated entities using key financial indicators and financial information reported by the FIs, automation of the ML/TF related data reported through the Data Acquisition Portal and Credit Risk Analysis and Monitoring (CRAM) system for the credit risk of regulated entities using borrower-level data.

Measures to Further Enhance Cyber Risk Supervision

In order to ensure effective supervision of cyber risk, the SBP has developed a long term Cyber

Risk Supervision Strategy for development and implementation of various tools and measures to enhance cyber risk supervision. Under the same strategy, Cyber Hygiene Assessments of selected regulated FIs were conducted. To further strengthen the off-site assessments, a Cyber Dashboard & Assessment Tool has been developed and operationalized.

Strengthening of Crisis Management Framework through Capacity Building

The SBP has put in place a crisis management framework to deal with adverse conditions in crisis situations. The SBP regularly reviews and improves this framework in the light of emerging international best practices. Effective institutional arrangements and adequate technical and soft skills are essential for regulatory staff to effectively deal with crisis situations. Besides building these skills through training and capacity development, it is essential to conduct simulation exercises to test the effectiveness of institutional arrangements as well as the staff skills. In this regard, the SBP conducted two Crisis Simulation Exercises with the help of the Toronto Center and World Bank.

4 Measures to Support the Government's Economic Policies

4.1 Measures to Promote Financial Inclusion

The fiscal year 2022-23 faced a myriad of challenges emerging from global and domestic fronts that necessitated constant vigilance on part of the central bank in view of its primary and secondary objectives of price stability and financial stability respectively. Concurrently, the central bank took a host of measures and initiatives towards its tertiary objective of supporting the government's general economic policies. In addition to fostering economic development and better utilization of resources, the central bank's measures and initiatives towards its tertiary objectives also contribute to primary and secondary objectives, given their foundational impact on monetary and financial systems in the medium to long term.

Notable among these is the active pursuit of promoting financial inclusion that does not only contribute toward economic development, but also strengthens the transmission mechanism of monetary policy. Similarly, while the digitalization of financial services — another broad category of the SBP's measures — helps develop the state of financial system, it also improves the transmission of monetary policy. Likewise, the SBP has taken a variety of initiatives, including reforms in foreign exchange regulatory framework and facilitation of overseas Pakistanis that support export growth and also mitigate exchange rate pressures, which, in turn, has favorable impact on both general prices and financial stability.

The key measures undertaken during the year under review can be categorized under five major areas: financial inclusion; digitalization of financial services; reforms in the Foreign Exchange (FX) framework; facilitation of overseas Pakistanis; and promotion of sustainable finance.

Financial inclusion is widely recognized as a crucial factor in fostering inclusive economic growth and financial development. Cognizant of this fact, the SBP has been mandated to promote financial inclusion as one of its functions under the SBP Act 1956 (as amended up to January 2022). The policy objective is to improve the access and usage of quality financial services to individuals and firms, with dignity and fairness as being cornerstones of financial services delivery. In this regard, the SBP is implementing the National Financial Inclusion Strategy (NFIS), with a specific headline target of reaching 65 million unique active bank accounts, including 20 million active women-owned accounts, by December 2023. As of June 2023, the number of unique active accounts has increased to 64.7 million from 63.8 million in June 2022, reflecting 1.4 percent growth on a yearly basis. Further, women's active account ownership stood at the same level as last year, i.e., 21.8 million accounts. SBP is now well on course to achieve the NFIS headline target by December 2023.

To achieve the overall financial inclusion targets, the SBP also set out a number of sector and segment specific guidelines and regulations for banks. These are related to: reducing gender disparity across the financial services landscape (from customers to share of women employees working in banks); increasing the share of Islamic banking; making housing finance (especially for low income segments) an important part of banks' lending portfolios; facilitating traditionally underserved business segments, such as SMEs and agriculture; and encouraging exports through traditional (mainly

refinance scheme-based) as well as modern (i.e. digitalization-centric) policy interventions.

(i) Banking on Equality

To reduce the gender gap in financial inclusion and make the banking industry more women-friendly, SBP is successfully implementing the Banking on Equality Policy (BoE). The policy has institutionalized a gender lens within the financial sector through five key pillars: improving institutional readiness; product diversification and development capability; customer acquisition and facilitation of women; robust collection of gender disaggregated data; and prioritizing gender focus in SBP's policies.

The BoE policy, launched on September 17, 2021, is a three-year policy. The progress made against the policy actions and headline targets, as of June 2023, is as follows:

- All SBP-regulated financial institutions (FIs) have developed gender mainstreaming policies with the approval of their Boards that adds an emphasis and focus on BoE implementation across their institutions.
- A total of 5,227 female staff have been added into SBP-regulated FIs work force, which has improved the overall ratio of female staff from 13.1 percent to 14.6 percent.
- A total of 7.4 million active women owned accounts have been added against the baseline total of 20.7 million in December 2021.
- 95 percent of BoE implementing FIs have developed women-centric products and services.
- 34 banks have established dedicated women's financial services departments/teams.
- 56 percent of all FIs staff have been imparted with gender sensitivity trainings.

- Dedicated women champions have been appointed at 51 percent of branches to serve women customers.
- The ratio of women in branchless banking (BB) agents has also increased to 3 percent from the baseline of 1 percent, against the target of 7 percent in CY 2023.

Further, to review the progress of BoE implementation, the SBP developed a scorecard to rank the performance of FIs against their assigned targets and their relative position against the top-performers. The results were shared with the relevant FIs, and this practice will continue on an annual basis.

(ii) Islamic Banking

The Islamic banking industry in Pakistan has been growing at a notable pace over the last few years. This trend continued during FY23 as Islamic banking assets and deposits witnessed year-on-year surge of 19.7 percent and 20.9 percent respectively. As a result of persistent growth, assets of Islamic banking industry crossed eight-trillion mark to reach Rs 8,118 billion by end June 2023. Accordingly, by end June 2023, the market share of Islamic banking assets and deposits in the overall banking industry stood at around 20 percent and 22 percent respectively.

The network of Islamic banking industry comprises 22 Islamic Banking Institutions (IBIs), which includes 6 full-fledged Islamic Banks (IBs) and 16 Conventional Banks with Islamic Banking Branches (IBBs) by the end of June 2023. The branch network of Islamic banking industry stood at 4,534 (spread across 131 districts of the country) by end June 2023 compared to 4,086 branches by end June 2022. The number of Islamic banking windows (i.e. dedicated counters at conventional branches) operated by the IBBs increased by 25 percent to 1,834 in FY23. Moreover, the NRSP Microfinance Bank Limited, MCB Islamic Bank Limited and U Microfinance Bank Limited are also offering Shariah compliant microfinance services in the country.

To further promote Islamic banking, as an important component of SBP's strategic goals, the Bank has taken the following key initiatives during the period under review:

Initiatives to implement the Federal Shariat Court's (FSC) Judgment

The Honorable Federal Shariat Court (FSC) announced its judgement with respect to the 'Riba' case on April 28, 2022. In the judgement, the FSC disposed-off matters relating to Riba/Interest and also gave specific time bound directions for legislative amendments and elimination of Riba from the economy. In order to implement FSC's judgment, Federal Government has constituted a high-level Steering Committee (SC) in December 2022 for providing strategic guidance regarding implementation of the FSC's judgment under the Chairmanship of the Governor, SBP. The SC comprises key stakeholders including the Ministry of Finance, SBP, Securities and Exchange Commission of Pakistan (SECP), Institute of Chartered Accountant of Pakistan (ICAP), Shariah scholars, bankers, a legal expert, and a representative from the business community.

In order to steer the process of conversion under the guidance of the SC, the SBP has established a high-level committee for transformation of conventional banking into Islamic banking. The committee comprises the SBP senior executives and presidents/CEOs of commercial banks. Under this committee, various working groups are engaged in diverse areas such as legal, regulatory and supervisory reforms; creating awareness and capacity building. The working groups also engage in review of conversion plans of banks; fast track adoption of international standards; development of Shariah compliant Sukuk structures, conversion of conventional public debt into Islamic debt and development of an IT ecosystem supporting the conversion to Islamic banking. These working groups are proactively working to provide policy and operational recommendations in

their respective areas to ensure smooth transformation into Shariah compliant banking.

Keeping in view the extensive nature of this transformational task, the SBP has also modified its organizational structure in December 2022 to prioritize and focus on the objectives. For this purpose, a dedicated Islamic Finance Group has been established in the Bank, which includes two departments with distinct mandates: the Islamic Finance Policy Department, and the Islamic Finance Development Department. This organizational change demonstrates the SBP's commitment towards the promotion of Islamic banking in the country.

Strengthening international collaboration

The SBP hosted the 41st meeting of the Islamic Financial Services Board (IFSB) Council for the first time in Islamabad on December 15, 2022. This high-powered council meeting was chaired by the Governor SBP, Mr. Jameel Ahmad, who was also the Chairman of the IFSB council for CY2022. Based in Malaysia, the IFSB is an international standard-setting body of regulatory and supervisory authorities tasked with ensuring soundness and stability of the Islamic financial services industry. The council meeting was attended by governors and senior officials of regulatory and supervisory authorities.

In addition, a number of supplementary events were conducted including, two separate full-day capacity building programs for banking and non-banking sector; IFSB Members' Engagement Session; and 15th IFSB Public Lecture on "Sustainable Development Goals (SDGs) and Islamic Finance Philosophy: The Way Forward". These programs focused on equipping the participants, inter alia, with specialized skills and knowledge relevant to the intricacies of Islamic finance, enhancing their abilities to contribute effectively to the industry. The combination of these side events alongside the main IFSB council meeting provided a comprehensive platform for capacity building, international networking, and public awareness.

SBP adopted four more AAOIFI Shariah Standards

To further strengthen Shariah compliance framework and harmonize the Shariah practices in Islamic banking industry, the SBP has adopted four more Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah standards on i) Salam and Parallel Salam, ii) Istisna'a and Parallel Istisna'a, iii) Combination of Contracts and iv) Irrigation Partnership (Musaqat).

Facilitating conversion of conventional banking businesses into Islamic

The SBP has always actively facilitated and supported the conversion of conventional banking into Islamic. During FY23, Faysal Bank Limited completed its transformation by converting entire conventional operations into Islamic. The transformation of Faysal Bank is not just a first-of-its-kind transformation in the banking history of Pakistan, but it is also one of the largest conversion of a conventional entity into Islamic on a global level (as per the Islamic International Rating Agency). The SBP played a vital part in conversion of the bank and extended all possible regulatory and supervisory support, which resulted in smooth execution of the bank's conversion plan.

Facilitation in issuance of domestic sovereign Sukuk

The SBP has been providing support to Government of Pakistan (GoP) in issuing domestic sovereign Sukuk. During FY23, the GoP issued domestic Sukuk amounting to Rs 872 billion compared to Rs 1,623 billion last year, and SBP extended its facilitation and full support in issuance of these Sukuk.

Awareness and capacity building initiatives

To enhance understanding and dispel misconceptions about Islamic banking and finance, the SBP continued its close collaboration

with the Islamic banking industry and other stakeholders to organize several awareness programs across the country. Furthermore, in order to ensure the supply of skilled human resource from the grassroots level, the SBP also reached out to provincial and federal higher education commissions to incorporate Islamic banking and finance in their respective curricula. During FY23, the SBP with the technical support of National Institute of Banking and Finance (NIBAF) arranged different courses on Islamic banking and finance for academia, the banking industry, the Shariah fraternity and government officials.

(iii) Measures to Promote Agriculture Credit

The agriculture sector plays a key role in the economy of Pakistan with a contribution of 22.9 percent to the GDP, and employs 37.4 percent of the country's workforce. Recognizing its significance, the SBP places great emphasis on provision of adequate financing for agriculture. During FY23, the agriculture sector faced a number of challenges, particularly the devastating floods of 2022 along with rising input costs. In this regard, a number of initiatives were undertaken by the SBP, which facilitated financing to the sector, and enabled better access to credit to small farmers. As a result of these initiatives, agriculture credit disbursement increased by over 25 percent year-on-year to Rs 1,776 billion during FY23. Moreover, the outstanding agriculture credit also recorded a YoY growth of 10 percent, reaching Rs 760 billion by end June 2023. In addition, the agriculture credit scoring model has continued to play a key role in FY23 in terms of performance improvements and achievement of assigned targets.

Prime Minister's Kissan Package

In order to provide relief and rehabilitation in flood-affected areas, the SBP implemented the PM's Kissan Package with the support of the GoP. Under the Kissan Package, the agriculture credit target was enhanced to Rs 1,819 billion for

FY23, which the FIs managed to achieve up to 97.6 percent by end June 2023. Furthermore, the SBP implemented various measures to strengthen the agriculture sector in flood-affected regions, which included waiver of markup on outstanding small loans, where the GoP had reimbursed claims of Rs 1.48 billion to 23 banks, and remaining 50 percent of the markup was waived off by banks. Moreover, two interest-free financing schemes were implemented by the SBP through which Rs 8.1 billion were disbursed to 35,923 subsistence borrowers and Rs 3.9 billion to 30,504 landless farmers.¹

Additionally, a subsidized scheme for the purchase of farm machinery was also introduced to promote mechanization and ensure national food security whereby Rs 2.5 billion were disbursed to 1,233 farmers by end June 2023. These schemes also provided risk coverage for banks. Furthermore, agro-based SMEs were included in the SBP's Refinance Facility for Modernization of SMEs and Prime Minister's Youth Business and Agriculture Loan Scheme, which also provided affordable loans to the agriculture sector.²

Champion Bank Model

SBP introduced a Champion Bank model in FY22, targeted towards the underserved regions of the country and aimed at addressing sustainable agriculture credit demand. In this regard, six banks were designated as Champion banks to lead this initiative. This on-going effort involves Champion banks encouraging other banks to meet the regional targets, develop specialized lending programs, conduct awareness and promotion drives, and address the local challenges faced by farmers.

Besides promising improvement in agriculture financing, the collective efforts of the champion banks, regional field force of banks, SBP and SBP-BSC have also addressed the underlying

issues in the underserved areas particularly revenue related issues in Balochistan and the KPK. Through this initiative, agriculture financing has seen significant uptick in the underserved areas during FY23 with 55 percent growth in Azad Jammu and Kashmir, 53 percent in Balochistan, 46 percent in the KPK, 25 percent in Sindh and 25 percent in the Punjab. However, agriculture financing witnessed a slight decline in Gilgit Baltistan (GB) of around 4 percent during the year. To address the situation in the GB, the institution-wise targets allocated for the region for FY24 have been aligned to strengthen agriculture financing, and explore the untapped potential of the region. Besides other initiatives, various meetings with the regional field force of banks and other stakeholders of the GB have been held under the Champion bank initiative. The initiative is also expected to bring positive structural changes over the medium to long term.

Enhanced agriculture credit limits

Keeping in view the national food security requirements and in the wake of the 2022 floods, the SBP enhanced the indicative credit limit for wheat crop by 67 percent to Rs 100,000 per acre in August 2022, enabling farmers to avail adequate financing from banks to meet their input requirements. Moreover, the indicative credit limits for rest of the crops, orchards, forestry and other financing categories were enhanced on average by 20 percent. These indicative credit limits act as a guideline for provincial governments and banks. The limits assist in estimating and assessing the credit needs of agriculture borrowers while setting targets and sanctioning credit limits, respectively.

Electronic Warehouse Receipt Financing (EWRF)

The SBP formally rolled out the EWRF in February 2022 for maize and rice crops to enable

¹ AC&MFD Circular No. 03 of 2022 dated December 21, 2022

² AC&MFD Circular No. 04 of 2022 dated December 21, 2022

farmers, traders and processors to avail financing from banks against physical commodities stored in accredited warehouses without the need for conventional collateral. Initially, specific targets were assigned to banks for the EWRP for maize and rice crops. Banks continued to finance under the EWRP disbursing Rs 865 million during FY23 compared to Rs 259.3 million by the end of June 2022. Furthermore, the EWRP targets of Rs 1,741 million have been assigned for FY24.

Crop Loan Insurance Scheme (CLIS)

The federal government, by covering the insurance premium cost per crop per season for eligible borrowers, aims to reduce the impact of natural calamities on the farmers' community through this recurring scheme. It is applicable and mandatory for agriculture production loans of Banks/MFBs for wheat, cotton, rice, sugarcane, and maize. Between July 2008 and June 2023, banks have submitted insurance premium claims of Rs 11.1 billion against 7.0 million beneficiaries under the CLIS.

Livestock Insurance Scheme for Borrowers (LISB)

The scheme offers insurance coverage for livestock loss due to diseases, natural occurrences, accidents, and various natural disasters like floods, droughts, windstorms, and heavy rains. The insurance premium cost is covered by the federal government for eligible borrower. This scheme is applicable to loans provided by Banks/MFBs for the purchase of cows, buffalos, and bulls. It is particularly intended for small livestock farmers, allowing them to purchase up to 10 animals. Under the LISB, during the period from July 2014 to June 2023, banks submitted insurance premium claims of Rs 3.20 billion against Rs 0.94 million beneficiaries.

(iv) Financial Literacy Initiatives

The SBP is implementing various financial literacy initiatives, which aim to spread financial

education to promote inclusive economic growth and stability across the country. These initiatives are targeting unbanked/under-banked segments and low-income to middle-income youth, households and professionals to support them in making informed financial decisions. So far, these initiatives have reached more than 3 million youth and adults across Pakistan, out of which more than 50 percent are females.

After the successful conclusion of National Financial Literacy Program (NFLP) in June 2022, SBP-BSC devised a comprehensive self-sustainable plan termed as 'Financial Capability Strategy' (NFLP-II) to enhance outreach and effectiveness of financial literacy, particularly focusing on Digital Financial Literacy. In the first year of implementation, i.e., FY23, the NFLP-II has successfully imparted financial literacy training to 200,000 beneficiaries through class room sessions and street theatres.

The SBP in collaboration with the NIBAF launched the five year "National Financial Literacy Program for Youth" (NFLP-Y) in October 2017 to impart essential financial education to 1.6 million Pakistani youth and school going children to strengthen their money management skills and enhance their understanding of financial matters. In its final year of implementation, i.e. FY23, the NFLP-Y successfully imparted online training to 439,817 beneficiaries and face to face training to 157,000 beneficiaries while surpassing the overall target for the project, reaching to 1,873,000 beneficiaries.

(v) SME Finance

Considering the huge potential of the SME sector in economic growth, employment generation and poverty alleviation, the SBP has taken various measures/initiatives for facilitating the SME's access to finance. In line with National SME Policy 2021, a target of Rs 800 billion of outstanding SME Finance is allocated to banks/DFIs to be achieved by the

end of CY2025. Accordingly, as of December 31, 2022, banks and the DFIs have achieved 93 percent of assigned target i.e. Rs 540 billion to 157,126 SME borrowers. However, at the end of June 2023, outstanding SME finance has been reported as Rs 457 billion, compared to Rs around 485 billion in the corresponding period last year, exhibiting year-on-year decrease of 5.7 percent mainly due to increase in lending rates and a challenging economic environment. The major initiatives are discussed as follows:

Prime Minister's Youth Business and Agriculture Loan Scheme

The GoP, in collaboration with the SBP, rolled out the Prime Minister's Youth Business and Agriculture Loan Scheme (PMYB&ALS) in January 2023. The scheme aims to promote youth entrepreneurship and self-employment opportunities for them. Under the scheme, business and agriculture loans are provided to youth at concessional rates ranging between 0 to 7 percent. The GoP provides markup subsidy for the scheme. To cover for risk regarding financing to youth entrepreneurs, government also provides a partial credit guarantee under the scheme. The SBP allocated Rs 30 billion disbursement target (Rs 15 billion each for SME sector and agriculture sector) to banks for FY23. As of June 30, 2023, banks have achieved this target, disbursing Rs 30 billion to 61,687 borrowers under the PMYB&ALS.

Line of Credit Fund for liquidity support in rain/flood-impacted areas

The GoP has passed on Rs 5.2 billion to the SBP under the Line of Credit scheme for rain/flood impacted areas as designated by National Disaster Management Authority and Provincial Disaster Management Authorities. The fund was provided as credit lines to microfinance providers for onward lending to microfinance borrowers including microenterprises and micro housing. The primary purpose of the facility is to ease the liquidity constraints of microfinance sector and provide access to market-based funds

through a sustainable and market-based credit strategy for revival of livelihoods and economic activities in designated areas.

(vi) SBP Initiatives for Financial Inclusion of Persons with Disabilities (PWDs)

The SBP has issued a comprehensive set of guidelines for banks to follow financial inclusion of all categories of the PWDs, i.e. physically handicapped, visually impaired and people with hearing and speech disabilities. The banks have been advised to ensure the availability of necessary physical and assistive technological infrastructure, prioritized service availability, products and services that cater to the special needs of the PWDs. In this regard, the SBP mandated the banks to develop a policy framework and ensure its implementation through periodic monitoring. The main pillars of banks' policy framework ought to include: i) availability of physical infrastructure to increase accessibility to bank branches; ii) accessibility of banking products and services; iii) accessibility audits of bank premises; iv) capacity building of staff to facilitate the PWDs; v) employment, retention, and career development of the PWDs; vi) capacity building of the PWDs for their financial inclusion; and vii) general guidelines for visually impaired/blind persons.

In this context, the SBP undertook the initiative for establishment of a dedicated network of model branches across the country, including Azad Jammu Kashmir (AJK) and the GB. This resulted in an industry wide plan of establishment of total 389 model branches in 108 districts of the country. These model branches are required to ensure the availability of all necessary physical, technological and facilitative infrastructure and services at one place. By end June 2023, 95 percent of model branches out of the planned 389 branches have been operationalized.

Furthermore, the SBP under a 2-year time-bound action plan covering the CY2021 and CY2022 had advised banks to construct 11,081

ramps at the entrance of their ATM cabins and business places to facilitate the PWDs. Accordingly, around 90 percent of the target has been achieved while for the remaining business places/ATMs, the construction of ramps was not possible due to different reasons, such as local municipal laws, narrow lanes of bazars, proximity to roads, and business places inside shopping malls.

(vii) Housing Finance

Construction and housing has the potential of reviving economic activity, creating jobs and improving living standards. The SBP undertook various initiatives to promote and develop housing finance in Pakistan. These include the issuance of separate prudential regulations for housing finance; ongoing capacity building of stakeholders and implementation of standardized loan documentation. The SBP assigned indicative targets for housing and construction finance, advising banks to increase their housing and construction finance portfolio to 7 percent of their private sector advances by June 30, 2023. However, owing to rising interest rates, and overall tough economic conditions that contributed to sharp deceleration of economic growth, housing finance did not grow substantially during FY23. The outstanding amount of housing and construction finance stood at Rs 456.8 billion by end-June 2023, compared to Rs 450.8 billion as of June 30, 2022.

(viii) Facilitation for Exports

The SBP actively backs industrial growth and export promotion aiming to drive the country's overall economic development. It achieves this objective through various strategies including refinance facilities. Over the years, the SBP has launched special schemes through its refinancing window, ensuring sufficient funding for value-added industries at concessional rates. This facilitates an increase in production capacity and assists in meeting their working capital needs. Key schemes encompass Export

Finance Scheme (EFS) ensuring short-term credit availability for exporters and the Long term Financing Facility (LTFF) for encouraging long-term export-oriented growth.

Export Finance Scheme

The EFS, operational since 1973, is a short-term financing facility for value-added goods with a loan duration of up to 180 days. Additionally, a Shariah compliant alternate of the EFS, Islamic Export Refinance Scheme (IERS), is also available. Further, to incentivize exporters, Rupee-based discounting of export bills/receivables under the EFS was introduced in February 2022. Under this, exporters can obtain financing against their export proceeds by discounting export bills/receivables. The total outstanding amount under the EFS, including the IERS and Rupee-based discounting facility, stood at Rs 745.4 billion as of June 2023, compared to Rs 775.2 billion as of June 2022. In this regard, a new framework has been developed under which the SBP's operational involvement in the two largest refinancing schemes (EFS and LTFF) is set to cease at the end of a 5-year transition period beginning from July 2023.

Long Term Financing Facility for Plant and Machinery

Under the LTFF scheme, financing is offered for export-oriented ventures aiming to procure both imported and locally manufactured new plants and machinery. Each project has a maximum limit of up to Rs 5 billion. A Shariah compliant alternate is also available. The total outstanding amount of the LTFF including Islamic Long Term Financing Facility (ILTFF) as of end June 2023 was Rs 302.6 billion in comparison to Rs 329.0 billion in June 2022. During FY23, the end user rates of the EFS and the LTFF were linked with the policy rate in July 2022 by keeping the gap at 5 percent. Later the gap between end user rates of the EFS/LTFF and the policy rate was reduced to 3 percent.³

³ IH&SMEFD Circular No. 11 of 2022 dated July 07, 2022; SH&SFD Circular No. 13 dated December 29, 2022

4.2 Digitalization of Financial Services

(i) Asaan Mobile Account (AMA) – Mass Media Campaign

To create traction and educate masses on the access and usage of Asaan Mobile Account (AMA), the SBP launched a dedicated mass media campaign on August 11, 2022. The media campaign was launched nationally as well as in regional languages through various mediums including TV, radio, print and digital media. This helped in facilitating easier account opening and usage of formal financial services through the AMA platform. Further, the media campaign created awareness about the (Unique Selling Proposition) USP of the scheme that anyone with a basic feature phone without the need of internet can open and use a bank account simply by dialing *2262#. As a result of the AMA mass media campaign, a total of 3.5 million accounts were opened/linked by the public during FY23, which translates to 83 percent growth over FY22. As of June 30, 2023, total accounts were 7.7 million out of which 38 percent are held by women.

(ii) Regulated Payment System Landscape of the Country

Following the previous years' trend, the regulated digital payment eco-system of Pakistan continued to show growth in FY23. During the year, e-banking transactions processed by banks and the MFBs grew by 28.6 percent by volume and 21.4 percent in value terms. Further, with respect to total bank-based retail transactions processed during the year, the share of e-banking transactions in FY23 was 84.7 percent by volume and 42.3 percent by value, compared to 80.4 percent and 42.0 percent respectively in FY22.

As of June 30, 2023, network of bank branches and ATMs across the country expanded to 17,693 and 17,808 respectively from 17,031 and 17,133 in FY22. Furthermore, the POS machines

deployed by banks also increased by 9.9 percent during the year reaching 115,288 by end June 2023, while the amount of POS transactions increased from Rs 707.2 billion in FY22 to Rs 1,063.6 billion in FY23. Moreover, the number of registered e-commerce merchants accepting payments through cards increased by 41 percent to 6,889 during FY23.

The SBP also took a number of measures to strengthen payment system infrastructure and regulatory framework in the country during the year. By way of these measures, the SBP has brought non-banking entities into the payments' landscape by issuing licenses to Electronic Money Institutions (EMIs). The SBP has so far issued licenses to 4 EMIs for commercial operations, whereas a number of prospective EMIs are operating in either pilot phase or have acquired an in-principal approval. These EMIs have been showing growth in terms of transactions, customer base and payment instruments. A total of 2 million e-wallets have been opened and 2.8 million payment cards have been issued, by these EMIs, to their customers.

(iii) Performance of Payment Infrastructure

In 2021, the SBP embarked on the deployment of Pakistan's Instant Payment System, called Raast. The payment platform is designed to be fast, secure, interoperable and highly accessible for all kinds of payments covering all institutional and individual payments. During the year FY23, Raast experienced continuous growth in both of its use cases, i.e., bulk payments and Person-to-Person (P2P) transactions. As of end FY23, the number of bulk transactions stood at 343,772 with a value of Rs around 84 billion while the number of P2P transactions stood at 154.6 million with a value of Rs 3,085 billion.

The RTGS (also known as PRISM) is Pakistan's only large value payment processing system that enables not only the customers but also the banks to settle their transactions on a real-time basis. During FY23, the PRISM processed an

amount of Rs 1.8 trillion on average per day with the value of total annual transactions equaling about Rs 640.4 trillion. In terms of value processed, the interbank clearing and securities decreased from Rs 614.7 trillion as of FY22 to around Rs 557 trillion in FY23, while customer transfers increased from about 67 trillion as of FY22 to 83 trillion in FY23.

(iv) Guidelines for Digital Payments

Guidelines for Downtime of Digital Channels/Services

The use of digital banking channels such as mobile apps and web portals have started to gain widespread acceptance by the customers. Resultantly, customers expect 24/7 availability of digital channels and services of banks. In order to streamline downtime reporting of digital channels, the SBP issued instructions to its regulated entities for timely communication of planned and unforeseen service disruptions through various channels, such as SMS alerts, emails and social media platforms. This is aimed at facilitating customers to be better informed and anticipate potential inconveniences.

Guidelines to Banks on Digital Payment Services to Unauthorized Digital Lending Apps

Unauthorized and illegal digital lending apps pose a major consumer protection concern due to unethical practices of consumer data collection and harassment and intimidation of citizens. In a major policy intervention to protect consumers from unauthorized / illegal digital lending mobile apps and web platforms, State Bank of Pakistan, on June 6, 2023, issued instructions to its regulated entities barring them from providing digital financial services to such apps. Specifically, the SBP directed all its regulated entities not to provide services, such as deposits or lending products, mobile application integration, payment gateway services, credit scoring and credit worthiness

checks, wallet services, and Application Programming Integration (API) services, to unauthorized/ unlicensed digital lending platforms (individuals or businesses) either directly or indirectly.

The SBP has also advised regulated financial and payment institutions to ensure that the licensing status of digital lending platforms/mobile applications and their authorization to conduct business are duly verified from the relevant regulators (the SECP, SBP) as part of their KYC/CDD process. The SBP has also advised its regulated FIs to review the licensing status as well as the authorization to conduct business of their existing customers that are offering digital lending services.

Improving Payment Card Acceptance Infrastructure in Pakistan

In order to promote digital payments acceptance at low cost for merchants and customers, the SBP issued new instructions to rationalize interchange fee (IRF) on card payments. The new instructions, issued in March 2023, set the interchange at 0.2 percent for debit and prepaid cards, and 0.7 percent for credit cards. By reducing interchange, SBP expects that acquiring banks will be incentivized to aggressively pursue the on-boarding of more merchants across all segments by deploying POS terminals in the country. Similarly, the SBP has also removed the floor of Merchant Discount Rate (MDR). By abolishing lower range of the MDR, the SBP expects that acquiring banks would be able to offer lowest possible rates to merchants, thus incentivizing merchants to deploy the POS at their businesses.

(v) Revision in Regulations for EMIs

Payment instruments in Pakistan were traditionally issued by the banks without the participation of non-banking entities. However, new technological innovations are now enabling non-banking sector to deliver innovative and efficient payment services to consumers at much lower cost. With the objective of removing the

entry barriers for non-banking entities, the SBP issued regulations for EMIs in April 2019 to provide an enabling regulatory framework for the establishment and operations of the EMIs in Pakistan. These regulations also address potential risks relating to consumer protection in line with legal framework of the country while promoting digital payments and financial inclusion.

Since the issuance of these regulations, SBP received an encouraging response from market participants, and a number of entities have been licensed to provide e-money services in the market. SBP's Regulations for EMIs have also received positive response from foreign investors and institutions. In order to increase the uptake of e-money services, SBP encourages current as well as prospective EMIs to come up with new business models, use cases and technological solutions. SBP has revised the Regulations for EMIs in light of the indigenous experiences and international best practices. The revised regulations came into effect from June 21, 2023.

(vi) Issuance of NOCs for establishing Digital Bank

In order to enhance financial inclusion and transform financial ecosystem through technology-based innovations which have been increasingly adopted within the financial sector, the SBP issued Licensing and Regulatory Framework for digital banks in January 2022. Subsequently, in January 2023, the SBP issued no objection certificates (NOCs) to the following five (05) applicants for establishing digital banks:

- Telenor Digital Bank Limited
- HugoBank Limited
- KT Bank Pakistan Limited
- Mashreq Bank Pakistan Limited
- Raqami Digital Bank Limited

(vii) Measures to Enhance Security of Digital Banking Products and Services

The SBP has taken several initiatives to promote digitalization in the financial sector, in recognition of its importance to revolutionize the way financial services are delivered accessed and managed. However, the increased adoption of digital financial services has also led to new forms of fraudulent activities, making it essential to implement adequate controls to mitigate risks. To ensure digital banking products and services are secure, the SBP issued instructions,⁴ which outlines comprehensive measures that the FIs must follow, such as formulation of a digital fraud prevention policy, establishing and strengthening of digital fraud risk management under the oversight of the Board or its designated committee, employment of transactional controls commensurate to the risks identified in the digital banking, and implementation of an Enterprise Fraud Management. By implementing these measures, the FIs can provide secure and reliable digital banking services to customers, thereby building customer confidence and promoting digital adoption in the financial sector.

(viii) Framework on Outsourcing to Cloud Service Providers

Cloud-based services can provide technology for the FIs which enables them to serve the low income segments of society and those residing in remote areas. Without access to financial services, individuals and small businesses are unlikely to achieve prosperity and upward mobility. To reach those who remain unbanked and underserved, financial solutions must be delivered at low cost. This is possible through cloud computing's efficient, scalable and sustainable delivery models.

In order to enable the FIs to design and offer innovative products and services through cloud service providers, the SBP issued Framework on Outsourcing to Cloud Service Providers (CSPs)

⁴ BPRD Circular No. 04 dated April 14, 2023

in January 2023. The framework allows outsourcing of material and non-material workload to domestic as well as international cloud service providers in a safe and secure manner through a risk based approach. However, in case of banks, Microfinance Bank (MFBs), Digital Banks (DBs), Development Finance Institutions (DFIs) and designated Payment System Operators (PSOs)/Payment Service Providers (PSPs), outsourcing of material workloads to offshore/ international CSPs shall be subject to the SBP approval whereby the SBP may grant approval on case to case basis.

4.3 Reforms in Foreign Exchange Regulatory Framework

(i) Measures to Support Balance of Payments

In order to curtail the pressures on the country's Balance of Payments, the SBP imposed 100 percent non-remunerative Cash Margin Requirement (CMR) on imports of additional 177 HS Codes effective from April 7, 2022 until December 31, 2022. However, in view of external account pressures, it was later extended to March 31, 2023. These 177 HS Codes for the CMR were in addition to the existing list of items attracting CMR to rein in rising imports. As per estimates, imports under these 177 HS Codes were worth USD 5.9 billion during Jul-Dec FY22.⁵

Monthly imports of the 177 HS codes started coming down following the imposition of the CMR amid rising commodity prices, weakening rupee and lower domestic demand that also contributed to the decline in imports. Imports fell from US\$ 4.2 million in April 2022 to US\$ 3.9 million in June 2022, and US\$ 2.3 million by August-2022.⁶

With some improvement in the external account

situation, the SBP adopted a two-tiered approach for the CMR. As per the circular, the 100 percent CMR was relaxed for cases where the credit terms of import were more than 90 days. Accordingly, the banks were advised to obtain cash margins (i) 25 percent CMR for items with term of import payment from 91 to 180 days and (ii) 0 percent CMR for items with term of import payment from 181 days and above.⁷

(ii) Support for the IT companies, Freelancers and Exporters' Foreign Currency (FCY) Account

Various regulatory measures have been taken by SBP to encourage software/ I.T service companies and freelancers engaged in the export of I.T/I.T enabled services to earn and repatriate their export proceeds to Pakistan, and retain up to 35 percent of their proceeds in the form of FCY, in exporters' Special Foreign Currency Retention Accounts (SFCAs). Moreover, to facilitate exports of good/services, the SBP has enhanced the scope of utilization of funds available in the exporters' SFCAs covering additional avenues such as, payments for software purchasing, hosting and licensing subscription etc.

(iii) Strengthening the Procedure for Realization of Export Proceeds

In order to encourage the exporters to repatriate export proceeds within the prescribed time period, the relevant instructions have been amended to strengthen the procedure for repatriation of these proceeds. Under the amendment, the Authorised Dealer (AD) shall mark a lien on the amount of export proceeds realized by the exporter and submit a consolidated statement regarding all such liens to Foreign Exchange Operations Department (FEOD). The FEOD shall file a complaint to Foreign Exchange Adjudication Department

⁵BPRD Circular Letter No. 09 of 2022 dated April 7, 2022; BPRD Circular Letter No. 37 of 2022 dated December 30, 2022; BPRD Circular Letter No. 06 of 2023

⁶ BPRD Circular Letter No. 09 of 2022

⁷ BPRD Circular Letter No. 25 of 2022 dated August 05, 2022

(FEAD) with respect to delay in realization of export proceeds for all reported cases. Subsequently, the AD shall deposit the fine with the SBP as ordered by the FEAD.

(iv) Foreign Investment in Real Estate Investment Trust (REIT) Schemes

In order to further facilitate foreign investment in the REIT Schemes, in addition to the existing provisions to invest in the REIT Schemes listed at Stock Exchange and through new Public Offers, the REIT Management Companies (RMC) can now issue their units through private placements and transfer such units, in favor of non-residents.⁸

(v) Cross-Border Transactions through Debit/ Credit Cards

In order to ensure judicious use of cards, including virtual cards, the SBP placed industry wide annual limit on individuals' cards on cross-border transactions. The limit of US\$ 30,000 per individual is still in place. The banks have been advised to allow only those transactions which are commensurate with the risk profiles of their customer and are conducted only for their personal needs.⁹

(vi) Extended Home Remittances channel to Receive Donation/ Charity from abroad

In order to deal with an unprecedented climate catastrophe in Pakistan, an important policy initiative was taken by the SBP during the year. The scope of Pakistan Home Remittances Channel has been extended to accept home remittance inflows received as donation/charity, without any monetary cap.

(vii) Electronic Proceeds Realization Certificate (ePRC) and Statement of PRCs (S-PRC)

For the facilitation of non-resident Pakistanis

and their resident counterparts, the ADs were advised to automate the process of issuance and verification of PRCs, on account of the receipt of remittances from abroad. This initiative has facilitated the beneficiaries of inward remittance in Pakistan as they can now retrieve their ePRC and S-PRC from the Bank's PRC portal with a few clicks.¹⁰

(viii) Purchase of FCY from Exchange Companies (EC) - Use of Banking Channels

To further strengthen the regulatory regime for the ECs, and encourage customers to use banking channels for purchase of foreign exchange, the ECs are required to conduct foreign currency sale transactions of US\$ 2,000/- or above (or equivalent in other currencies) against PKR through bank transfer/cheque from the personal account of the customer.

(ix) Incentivizing ECs for Mobilization of Home Remittance

The ECs have been incentivized to further mobilize the home remittances and surrender the same in the interbank market. As per the scheme, a cash incentive of Rs 1 against surrender of each USD mobilized from inward remittances is being provided to the ECs subject to the condition that they surrender 100 percent foreign exchange received on account of home remittances in the interbank market. Similarly, to expand the domestic disbursement network of home remittances, the ECs have also been allowed to enter into agreements with the ADs to act as their sub-agents for disbursement of home remittances in the PKR to beneficiaries, received by the ADs through their international tie-ups. Moreover, to boost up the flows of home remittances, the ECs have been advised to explore new agency arrangements with foreign entities, as well.

⁸ EPD Circular Letter No. 07 of 2023 dated March 24, 2023

⁹ FE Circular No. 07 of 2022 dated November, 08 2022

¹⁰ FE Circular No. 05 dated August 05, 2022

(x) **Currency Exchange Transactions between the ECs, the ECs of 'B' Category (ECs-B) and franchises of the ECs**

In order to promote documentation and transparency in the foreign exchange transactions, the SBP advised that Pakistan Rupee consideration of currency exchange transactions between the ECs, the ECs of B category and franchises of the ECs shall be conducted through their respective bank accounts.

4.4 Facilitation of Overseas Pakistanis

The SBP has taken number of initiatives for the benefit of Pakistanis living abroad. Previously, the SBP in collaboration with commercial banks facilitated the non-resident Pakistanis (individuals) to open bank accounts remotely. Now, the SBP has issued "Framework for Remote/ Digital Account Opening of Non-resident Legal Entities", which enables Pakistani banks to extend digital account opening services to non-resident Pakistani entities (registered or incorporated abroad) that will help them in strengthening their business alliances in Pakistan, facilitating payments and attract funds from abroad for investment into highly profitable securities in Pakistan. This initiative is another step towards digitalization of country's financial sector.¹¹

(i) **Standards for Minimum Set of Services on Mobile Applications for RDA Customers**

In 2020, the SBP introduced the Roshan Digital Account (RDA) scheme, revolutionizing the banking experience for Non-Resident Pakistanis (NRPs) by allowing them to easily open and manage accounts from anywhere in the world without involving the paperwork. The RDA has been a success story for the country, as more than 156,000 accounts have been opened and

attracted a gross inflow of US\$ 1.6 billion into the accounts during the year. The RDA initiative has been a key stepping stone for the SBP to provide a mechanism for Digital On-boarding of Resident Pakistanis as well, which was later launched in 2022. In addition, the SBP took steps towards facilitating the NRPs by instructing RDA banks to offer a comprehensive range of services through a fully operational mobile application. This inclusive approach transformed the banks' mobile applications into a one-stop solution, empowering the NRPs with streamlined client on-boarding, transactional capabilities, investment services, and financing products.

(ii) **Roshan Pension Plan (RPP)**

The RPP has been another useful addition in the product suite of Roshan Digital Account (RDA). The RPP is an exclusive product for the Non Resident Pakistanis (NRPs) and Pakistani Origin Card (POC) holders to digitally and remotely contribute in Roshan Pension Plan financially securing their post retirement life. The end-to-end digital process and simplified mechanism makes it a convenient and efficient process for the NRPs to contribute in the RPP through their NRP Rupee Value Account (NRVA) at a given frequency with authorized pension fund manager/ Asset Management Company affiliated with the RDA Bank.

(iii) **Roshan Digital Business Account (RDBA)**

The SBP has taken various initiatives for the benefit of not only individual Pakistanis living abroad but also facilitated the companies owned and controlled by the non-resident Pakistanis or non-resident POC holders. The SBP has allowed the RDA banks to introduce Roshan Digital Business Account for legal entities incorporated or registered abroad and owned and controlled by the Non-resident Pakistanis. The RDBA holder entities will enjoy a host of investment and banking facilities in Pakistan. They will be

¹¹ FE Circular No. 03 of 2022 dated August 01, 2022

able to remotely operate their bank account in Pakistan through digital means, inter alia with the facility of online real time convertibility from foreign currency to the PKR.

(iv) Awareness Campaigns for Roshan Digital Accounts

The SBP conducted 240 online webinars in order to enhance awareness, update the Pakistani diaspora regarding the emerging developments relating to the Roshan Digital Accounts and its affiliated products. Through these sessions, the Pakistani diaspora has been engaged in various cities and countries of the world. These webinars helped address the concerns and queries of the overseas Pakistanis and provided feedback to the SBP for taking further measures to ensure facilitation of the NRPs.

4.5 Measures for Promoting Sustainable Finance

Financing for sustainable development has become imperative for Pakistan, given its vulnerability to climate change. To this end, the role of financial industry in facilitating the establishment of a resilient and sustainable economy is highly critical. Recognizing the sensitivity of the issue, the SBP has incorporated climate change as one of the cross-cutting themes in its Strategic Plan for the next five years. This integration reflects the SBP's commitment to enhancing climate risk mitigation and management capabilities, recognizing the urgent need to address the challenges posed by climate change and promote sustainable development.

In this regard, the SBP has undertaken a number of green initiatives to ingrain sustainability considerations in the financial sector, which are aligned with international best practices. These measures mainly include Green Banking Guidelines (2017), the ESRM Implementation Manual (2022) and Financing Scheme for Renewable Energy (2019).

(i) Environmental and Social Risk Management (ESRM) Implementation Manual

To ensure compliance of minimum standards for environmental and social risk management in the financial sector under Green Banking Guidelines (GBGs), the SBP issued the ESRM Implementation Manual in November 2022. The purpose of the manual is to improve and update the GBGs based on international standards, particularly in the "Risk Management" area. The manual provides tools and checklists to facilitate the banking industry in establishing their environmental and social risk management. In addition to environmental risks, the manual also focuses on management of social risks, such as child labor, illegal land acquisition, workers' safety and other related issues that the FIs should consider in lending.

As part of the ESRM Manual, the SBP has also issued a Green Banking Monitoring and Evaluation (M&E) template for quarterly reporting banks/DFIs' GBGs implementation progress (including ESRM activities) to the SBP.

(ii) SBP Financing Scheme for Renewable Energy (RE Scheme)

The objective of the scheme is to finance clean energy projects and meet the growing electricity demand through renewable energy sources in the country. Under the scheme, financing is available for power generation of up to 50 MWs, using alternative / renewable energy sources (i.e. solar, wind, hydro, biogas, bio-fuels, bagasse cogeneration, and geothermal as fuel) at a maximum end-user rate of 6 percent per annum in three categories.

The progress of the scheme has grown over time and has financed more than 2,600 projects, having the cumulative capacity of adding almost 1,726 MWs through renewable energy sources. The total amount outstanding under the RE scheme is Rs around 92 billion as of end June 2023, compared to Rs 88 billion in June 2022.

Governor's Annual Report 2022-2023

During FY23, considering the increase in demand and the importance of renewable energy, the validity period of the RE scheme was extended from June 30, 2022 to June 30, 2024. Additionally, the monitoring mechanism

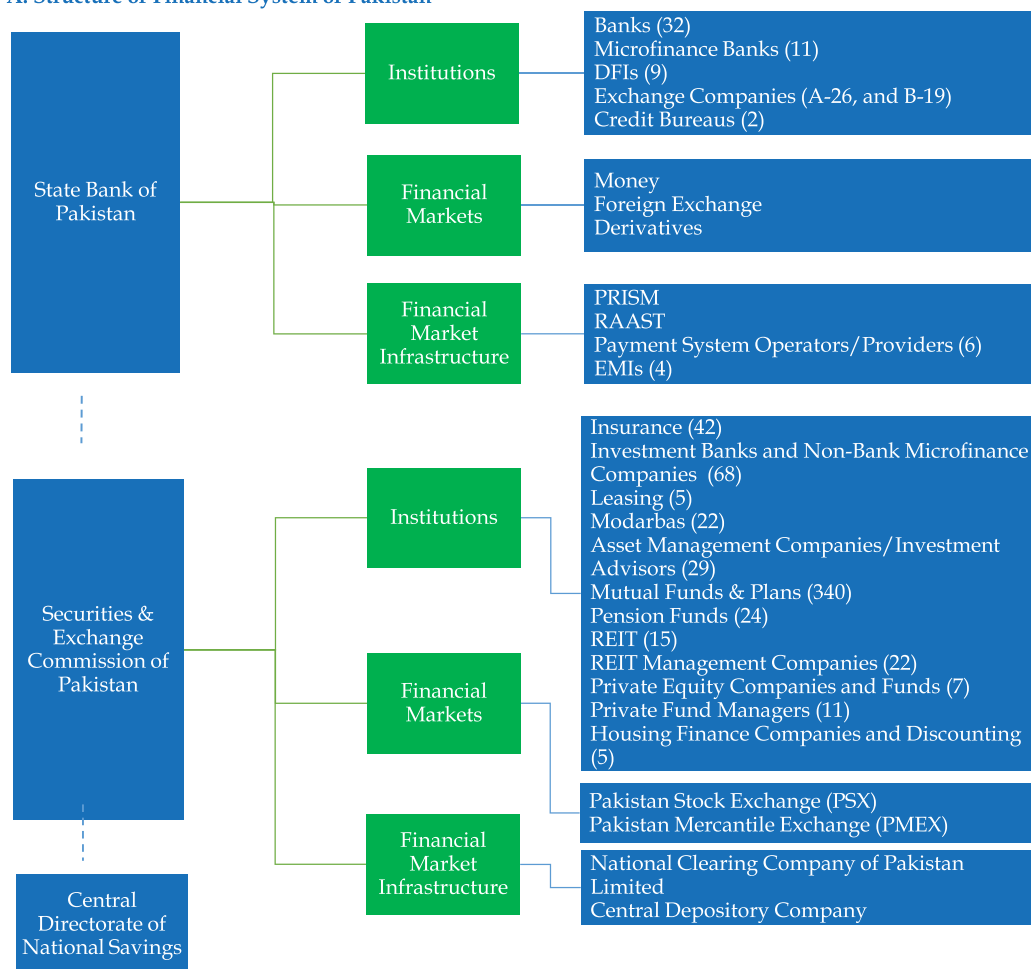
for annual limits allocated to banks/DFIs was changed from disbursement basis to outstanding basis. A Shariah-compliant version of the renewable energy scheme, i.e., Islamic financing facility for renewable energy is also available.

Annexure 1: Structure and Regulatory Architecture of Financial System of Pakistan

In Pakistan, the SBP and Securities and Exchange Commission of Pakistan (SECP) are entrusted to supervise the financial sector. The SBP regulates banks, Development Finance Institutions (DFIs), Microfinance Banks (MFBs), Exchange Companies, Credit Bureaus, Payment Service Operators / Payment System Providers

and Electronic Money Institutions (EMIs). On the other hand, Non-Bank Financial Institutions (NBFIs) and Insurance companies are regulated by the SECP. Moreover, Central Directorate of National Savings (CDNS) mobilizes savings from general public (**Figure A**).

Figure A: Structure of Financial System of Pakistan



Sources: State Bank of Pakistan and Securities and Exchange Commission of Pakistan

List of Abbreviations**A**

AAOIFI	Accounting and Auditing Organization for Islamic Finance Institutions
ADR	Advances-to-Deposit Ratio
ADs	Authorized Dealers
ADCs	Alternate Delivery Channels
AEs	Advanced Economies
AFS	Available for Sale
AJK	Azad Jammu and Kashmir
AMA	Asaan Mobile Account
AML/CFT/ CPF	Anti-Money Laundering / Combating the Financing of Terrorism / Countering Proliferation Financing
APCMA	All Pakistan Cement Manufacturers Association
API	Application Programming Integration
ATM	Automated Teller Machine

B

BB	Branchless Banking
bbl	Barrel
BCO	Banking Companies Ordinance 1962
BoE	Banking on Equality
BoP	Balance of Payments
BRAM	Bank Risk Analysis and Monitoring
BSSM	Banking Sector Stability Map

C

CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CDC	Central Depository Company
CDD	Customer Due Diligence
CDNS	Central Directorate of National Savings
CET1	Common Equity Tier 1
CiC	Currency in Circulation
CLIS	Crop Loan Insurance Scheme
CMR	Cash Margin Requirement
COVID	Coronavirus Disease
CPI	Consumer Price Index
CPF	Countering Proliferation Financing
CRAM	Credit Risk Analysis and Monitoring
CSPs	Cloud Service Providers

D

DBs	Digital Banks
DFIs	Development Finance Institutions

	DPC	Deposit Protection Corporation
	D-SIBs	Domestic Systemically Important Banks
	DSSI	Debt Service Suspension Initiative
	DVP	Delivery-versus-Payment
E		
	ECs	Exchange Companies
	EFF	Extended Fund Facility
	EFS	Export Finance Scheme
	EMDEs	Emerging and Developing economies
	EMIs	Electronic Money Institutions
	EPU	Economic Policy Uncertainty
	ePRC	Electronic Proceeds Realization Certificate
	ESRM	Environmental and Social Risk Management
	EU	European Union
	EWMA	Exponential Weighted Moving Average
	EWRP	Electronic Warehouse Receipt Financing
F		
	FBR	Federal Bureau of Revenue
	FCA	Fuel Charge Adjustment
	FCA	Foreign Currency Account
	FCY	Foreign Currency
	FDR	Financing to Deposits Ratio
	FED	Federal Excise Duty
	FEOD	Foreign Exchange Operations Department
	FIs	Financial Institutions
	FMI	Financial Market Infrastructure
	FRED	Federal Reserve Economic Data
	FSC	Federal Shariat Court
	FATF	Financial Action Task Force
	FX	Foreign Exchange
G		
	GB	Gilgit Baltistan
	GBGs	Green Banking Guidelines
	GCC	Gulf Cooperation Council
	GDP	Gross Domestic Product
	GoP	Government of Pakistan
	GST	General Sales Tax
H		
	HFT	Held for Trading
	HLA	Higher Loss Absorbency
	HS Code	Harmonized System Code

I

IASB	International Accounting Standards Board
IBBs	Islamic Banking Branches
IBIs	Islamic Banking Institutions
ICAP	Institute of Chartered Accountants of Pakistan
IFRS	International Financial Reporting Standards
ILTFF	Islamic Long Term Financing Facility
IMF	International Monetary Fund
IRF	Interchange Reimbursement Fee
IVR	Interactive Voice Response

K

KPK	Khyber Pakhtunkhwa
KYC	Know Your Customer
KSA	Kingdom of Saudi Arabia
KWh	Kilowatt-hour

L

LCR	Liquidity Coverage Ratio
LISB	Livestock Insurance Scheme for Borrowers
LOLR	Lender of Last Resort
LSM	Large Scale Manufacturing
LTFF	Long Term Financing Facility
LVPS	Large Value Payment System

M

MDR	Merchant Discount Rate
MDR	Minimum Deposit Rate
MFBs	Microfinance Banks
MFI	Microfinance Institution
MMA	Monthly Moving Average
MoF	Ministry of Finance
MoM	Month on Month
MPC	Monetary Policy Committee

N

NBFIs	Non-bank Financial Institutions
NCPI	National Consumer Price Index
NCCPL	National Clearing Company of Pakistan Limited
NDA	Net Domestic Assets
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NFIS	National Financial Inclusion Strategy
NFLP	National Financial Literacy Program
NFLP-Y	National Financial Literacy Program for Youth

	NFNE	Non-Food Non-Energy
	NIBAF	National Institute of Banking and Finance
	NIFT	National Institutional Facilitation Technologies
	NOCs	No Objection Certificates
	NPLs	Non-Performing Loans
	NRPs	Non-Resident Pakistanis
	NRSP	National Rural Support Programme
	NRVA	NRP Rupee Value Account
	NSFR	Net Stable Funding Ratio
	NSS	National Savings Scheme
O		
	OCAC	Oil Companies Advisory Council
	OGRA	Oil and Gas Regulatory Authority
	OMOs	Open Market Operations
	ONR	Overnight Rate
P		
	P2P	Person-to-Person
	PAMA	Pakistan Automotive Manufacturers Association
	PBS	Pakistan Bureau of Statistics
	PDL	Petroleum Development Levy
	PKR	Pakistani Rupee
	PMYB&ALS	Prime Minister's Youth Business and Agriculture Loan Scheme
	POC	Pakistan Origin Card
	POL	Petroleum, Oil, and Lubricants
	POS	Point of Sale
	RPP	Roshan Pension Plan
	PRCs	Proceeds Realization Certificates
	PRISM	Pakistan Real-Time Interbank Settlement Mechanism
	PSEs	Public Sector Enterprises
	PSOs	Payment System Operators
	PSPs	Payment Service Providers
	PSX	Pakistan Stock Exchange
	PWDs	Persons with Disabilities
Q		
	QTA	Quarterly Tariff Adjustment
R		
	RAS	Regulatory Approval System
	RBS	Risk-based Supervision
	R&D	Research and Development
	RD	Regulatory Duty
	RDA	Roshan Digital Account

List of Abbreviations

	RDBA	Roshan Digital Business Account
	RE	Renewable Energy
	REITs	Real Estate Investment Trust
	ROA	Return on Assets
	ROE	Return on Equity
	RPP	Roshan Pension Plan
	RTOB	Real-Time Online Branches
	RVPS	Retail Value Payment System
	RWAs	Risk Weighted Assets
S		
	SAM	Supervisory Assessment Manual
	SBP	State Bank of Pakistan
	SBP-BSC	SBP Banking Services Corporation
	SC	Steering Committee
	SDGs	Sustainable Development Goals
	SECP	Security and Exchange Commission of Pakistan
	SFCA	Special Foreign Currency Accounts
	SIFI	Systemically Important Financial Institutions
	SME	Small and Medium Enterprises
	S-PRC	Statement of Electronic Proceeds Realization
	SRS	Systemic Risk Survey
U		
	UAE	United Arab Emirates
	USD	United States Dollar
Y		
	YoY	Year on Year
Z		
	ZTBL	Zarai Taraqiati Bank Limited

