MONETARY POLICY DECISION

14th December 2012

The changes in fundamental variables influencing the recent monetary policy decisions of SBP continue to support the current stance. The credit extended to private businesses remains muted. The deceleration in CPI inflation is faster than the projected path. And the external current account deficit in October 2012 is small. The overall stress in the external position, however, is increasing given the declining financial inflows and substantial debt repayments. Assigning appropriate weights to these competing considerations is the main challenge currently faced by monetary policy.

Led by direct and portfolio investment flows, the total net capital and financial account inflows are on a declining path for some years now. For instance, these inflows have come down from a peak of 7.2 percent of GDP in FY07 to 0.7 percent of GDP in FY12. This trend is continuing in FY13. During the first four months, there has been a net outflow of $304 million from the capital and financial account. This, together with substantial debt repayments to the IMF, has resulted in a decline in foreign exchange reserves of SBP from $10.8 billion at end-June 2012 to $8.6 billion as on 14 December 2012. Thus, despite an external current account surplus of $258 million during July-October, FY13, there has been some pressure on the rupee to depreciate. Since the beginning of FY13, the rupee, viz-a-viz dollar, has depreciated by 3.3 percent.

This stressed external position has implications for the rest of the economy. For instance, the decline in foreign exchange reserves is causing contraction in rupee liquidity. A depreciating currency is also affecting the size of the outstanding external debt in rupee terms and thus has implications for the fiscal position. Moreover, the magnitude and speed of pass through of exchange rate changes to CPI inflation need to be monitored closely in these circumstances.

Both the level of interest rate set by the SBP and the timely realization of budgeted foreign inflows are critical in managing the balance of payment position. The lower interest rate can potentially affect the credit demand, including that of imports, and return on rupee denominated assets relative to foreign currency assets. The first consideration is not a source of concern at the moment given the weak overall credit conditions and consistent decline in the quantum of imports. The second consideration is important and puts a natural limit on downward adjustments in the interest rate. However, it needs to be weighed against the expected budgeted foreign inflows, which are not linked with the interest rate but can boost much needed financial inflows.

The timely realization of these official inflows is of essence and can alleviate the fiscal pressure on domestic borrowings to some extent. Showing a year-on-year growth of 26.4 percent, these fiscal borrowings from the banking system continue to remain the main source of monetary expansion. During 1 July – 30 November, FY13, the fiscal authority has borrowed Rs586 billion from the scheduled banks and has retired Rs106 billion to the SBP. Consequently, the level of outstanding liquidity injections by the SBP, at Rs615 billion as on 14 December 2012, remains high. The size of these injections would not be a source of concern as long as inflation stays low and stable. However, given the current high year-on-year growth in broad money of 17.8 percent, this approach would require more vigilance in the near future.

It is worth highlighting that almost all of the fiscal borrowings from the scheduled banks and the retirement to the SBP took place during Q1-FY13. In Q2-FY13, the fiscal authority has mostly relied on the SBP to meet its financing requirements while just rolling over the maturing scheduled bank debt. As per the recent amendments in the SBP Act, the fiscal authority is required to ensure at least zero borrowings from the SBP during a quarter. Given that only two weeks remain before the end of Q2-FY13, it seems unlikely that this requirement would be met.

A sustainable reduction in fiscal borrowings from the banking system and thus the scaling down of liquidity injections by the SBP and monetary growth is not possible without comprehensive fiscal reforms. The fiscal deficit of Rs284 billion or 1.2 percent of GDP during Q1-FY13 was entirely financed by borrowings from the domestic sources. Given that almost 91 percent of last year's fiscal deficit was also financed from domestic sources, a year-on-year growth of 62.5 percent in interest payments on domestic debt in Q1-FY13 is not surprising. Thus, without improving the tax collection capability, and given an increasing proportion of expenditures belonging to interest payments, the task of containing the size of the fiscal deficit and thus borrowing requirements would become more and more difficult.

The state of credit to private businesses is not encouraging despite a cumulative 400 basis point reduction in the policy rate over the last 16 months. The detailed disaggregated data show a contraction of Rs39.6 billion in this head during the first four months of FY13, with most of the contraction taking place in the manufacturing sector. While there is some seasonal pick up since mid-October onwards, the outlook for the year is not encouraging. The reason, as highlighted by the SBP earlier as well, is that the expected support to the SBP's initiative in the shape of improvement in the availability of energy and reduction in fiscal borrowing needs has not come through yet. Thus, both the demand for and supply of credit to the private sector remain sub-optimal.

The consistently low level of credit availed by the private sector together with declining foreign investments are the main factors responsible for a stagnant economy. The persistent energy shortages have already decreased the utilization of productive capacity of the economy. Resultantly, the output gap – the difference between aggregate demand and the ability of the economy to meet this demand – is now almost negligible. At the same time, availability of food supplies has been better this year compared to last two years. A sharply decelerating CPI inflation is a reflection of these conditions.

The decline in CPI inflation is considerably faster than earlier estimates. The year-on-year CPI inflation for November 2012 stands at 6.9 percent, with food inflation dropping to 5.3 percent and non-food inflation coming down to 8.1 percent. Even the core inflation measures are in single digits. This broad based deceleration in inflation is now expected to keep the average inflation for FY13 below the 9.5 percent target for the year. Therefore, the Central Board of Directors of SBP has decided to reduce the policy rate by 50 basis points to 9.5 percent with effect from 17 December 2012.