STATE BANK OF PAKISTAN

MONETARY POLICY DECISION
5th October 2012

A declining inflation together with weak growth in credit to private businesses is the basic context in which SBP reduced its policy rate by 150 bps in August 2012. These indicators point towards muted aggregate demand. In particular, continuous decline in investment as a percentage of GDP is a source of concern as it is hampering prospects of sustainable medium term economic growth. The resumption of monetary easing, in this environment, was deemed necessary to influence the behavior of borrowers in the private sector and scheduled banks to step up efforts to improve their intermediary role.

A host of factors need to be considered for this to be sufficiently effective. Prominent among these are considerable improvement in the availability of energy and reduction in fiscal borrowing needs from the banking system. The former is expected to facilitate an increase in the demand for credit and the latter would help in improving the supply of credit to the private sector. Further support to SBP's initiative can come from realization of expected foreign financial inflows that would alleviate the balance of payment concerns and help in easing the considerable fiscal pressure on domestic borrowings.

A consistent deceleration in inflation since May 2012, to 8.8 percent in September 2012, is more than earlier estimates. Thus, despite an expected uptick in H2-FY13 the overall inflation outlook has improved. In fact, the likelihood of meeting the 9.5 percent inflation target for FY13 has increased. At the macro level, it seems that the effect on inflation of falling private investment demand is becoming more pronounced than the influence of high fiscal borrowings. The disaggregate CPI inflation data also show that this could be a beginning of a broad based trend. The number of commodities with double digit year-on-year inflation has slightly come down in the last few months after a secular increase over the last three years; first in the food group and now in the non food group as well.

The decline in 20 percent trimmed core inflation measure, to 10.4 percent in September 2012, is slower than the fall in CPI inflation. This indicates persistence of inflation expectations due to inertial effect of high inflation experienced in the recent past, overall rising trend in fiscal borrowings from the SBP, and depreciation of exchange rate. The recent fall in inflation together with a retirement of Rs412 billion of fiscal borrowings from SBP during Q1-FY13 could bring down core inflation further by having a beneficial impact on inflation expectations. This would depend, however, on the fiscal authority's resolve to maintain this trend in the coming quarters.

The retirement to SBP was made possible by substantial borrowings from the scheduled banks; Rs437 billion during 1 July – 21 September, FY13. Consequently, the outstanding amount of liquidity injections by the SBP has increased to Rs611.5 billion by the end of Q1-FY13. While this may not be an optimal situation, it is necessary in current circumstances. This is because some base money creation is essential to avoid an economic depression. The creation of money through the other source, accumulation in the Net Foreign Assets (NFA) of the banking system, is difficult due to weak foreign financial inflows. Similarly, the SBP (Amendment) Act (2012) requires at least zero net flow of fiscal borrowings from SBP during a year.

To continue to keep borrowings from SBP under check and avoid the negative consequences of excessive borrowings from the scheduled banks, comprehensive fiscal reforms should not be delayed further. These include, but are not limited to, broadening of the tax base, reduction in wasteful subsidies, and better coordination between federal and provincial governments in terms of keeping the consolidated fiscal position under control.

A reduction in the size of the fiscal deficit and thus need for substantial borrowings would also influence the behavior of scheduled banks. At the moment, scheduled banks are finding it easy to avoid the private sector by lending to the government without any risk. The year-on-year growth in loans to private sector businesses has declined from 22.4 percent in FY08 to 0.7 percent by the end of FY12. A declining interest rate environment should lead towards a rethink of this strategy. The scheduled banks will have to step up efforts to go back to their basic intermediary role and channel loanable funds to the private sector.

The other critical, and probably more fundamental, factor holding back off-take in the private sector credit is the consistent shortage of energy. By reducing the effective utilization of installed productive capacity, it has adversely affected the demand for fresh credit. Despite substantial subsidies given to the energy sector, the re-emergence of the inter-agency circular debt shows that increasing the electricity tariffs alone is not sufficient. An effective overhaul of the governance structure of the energy sector is important for the revival of private credit, investment, and sustainable medium to long term economic growth.

A durable solution to the energy sector can have positive feedback effects on the fiscal position by lowering the subsidy burden. This, in turn, would help in reducing the borrowing requirements and extent of crowding out of the private sector. Resumption of foreign financial inflows, especially the realization of budgeted inflows, can also have a similar impact. Thus, at a broader level, the effectiveness of SBP's current monetary policy stance continues to weigh upon improvement in the fiscal position, better availability of energy, and an increase in foreign financial inflows.

Weak foreign financial inflows are the main challenge faced by the balance of payment position. The external current account balance, on the other hand, is small and shrinking. In fact, during the first two months of FY13, it posted a surplus of $884 million. This is primarily due to robust growth in remittances, $2.5 billion received in July and August 2012, and receipt of $1.12 billion Coalition Support Funds in August 2012. Constrained by energy shortages and weak global economy, the export growth remains subdued. The import growth has also slowed down and most of the incremental increase over the corresponding period of last year is because of price impact.

In conclusion, after giving due consideration to these factors, SBP's Central Board of Directors has decided to reduce the policy rate by 50 basis points to 10 percent with effect from 8th October 2012.

To strengthen the liquidity management framework, SBP has also decided to implement certain measures, details of which are being issued separately.