STATE BANK OF PAKISTAN

MONETARY POLICY DECISION
12th April 2013

In the monetary policy statement of February 2013, the SBP highlighted two main challenges for monetary policy: to manage the balance of payment position and to contain the possible increase in inflation. Since then, SBP's foreign exchange reserves have declined by another $2 billion; from 8.7 billion at end-January 2013 to $6.7 billion as of 5th April 2013, mainly due to debt payments. Contrary to expectations, however, year-on-year inflation has come down by 1.5 percentage points; from 8.1 percent in January 2013 to 6.6 percent in March 2013. These developments pose divergent policy choices for the SBP. While the former calls for caution, the latter indicates a possible resumption of ease in the policy rate.

The balance of payments position continues to be driven by low financial inflows and high debt payments. A cumulative net capital and financial inflow of $34 million during July – February, FY13 is insufficient to finance the external current account deficit of $700 million for the same period. While the external current account deficit is expected to widen further in the remaining months of FY13, the net capital and financial inflows are not likely to increase considerably. It is important to emphasize that it is not the size of the external current account deficit, which is projected to be small and manageable, but the lack of adequate financial inflows that is exerting pressure on the balance of payments.

In addition, the SBP has to retire another $838 million of IMF loans during the remaining period of FY13 after making payments of $2.2 billion during the first three quarters of the current fiscal year. Thus, the pressure on foreign exchange reserves is likely to remain in the coming months. So far the SBP has played an active role in managing the conditions, but only a consistent increase in foreign exchange can ensure sustainable stability in the market. The role of interest rate is also important in this context as it determines the return on rupee denominated assets relative to foreign currency assets. The idea is to discourage speculative demand for dollars by keeping rupee denominated assets sufficiently lucrative.

Real returns on rupee denominated assets have marginally increased due to a substantial decline in inflation. Moreover, led by a depreciation of 5.2 percent in the Nominal Effective Exchange Rate (NEER), the Real Effective Exchange Rate (REER) has also depreciated by 4.2 percent during July – February, FY13. This bodes well for the competitiveness of the external trade sector. However, real cost of borrowing has increased, which may be undesirable in the wake of declining private investment and low growth in the economy.

Despite continued energy shortages and substantial fiscal borrowings from the banking system, credit extended to private businesses has shown some nascent recovery. During July – February, FY13, loans to private businesses have increased by Rs173.3 billion as opposed to Rs56.8 billion during the same period of last year. This has helped in a modest growth of 2.9 percent in the Large Scale Manufacturing (LSM) sector during July – February, FY13 compared to 1.9 percent in the corresponding period of last year.

A cumulative decline of 450 basis points in the policy rate of SBP since the beginning of FY12 has played a role in this uptick. Moreover, an analysis of the balance sheets of the main sectors supports this assessment. Thus, both the decline in inflation and the need to encourage further borrowings by the private sector point towards continuation of current monetary policy stance and a possible reduction in the policy rate. However, the current balance of payments position and a structural imbalance in fiscal accounts suggest vigilance.

The main implication of fiscal imbalance for monetary policy is excessive borrowings from the banking system, including the SBP. During 1st July – 29th March, FY13, the fiscal authority has borrowed Rs853 billion (on cash basis) from the banking system for budgetary support compared with Rs925 billion in the corresponding period of last year and against a full-year estimate of Rs484 billion for FY13. The high level of these borrowings has kept an upward pressure on the system's liquidity and thus market interest rates and is restraining growth in the private sector credit.

The SBP can provide liquidity through short term Open Market Operations (OMOs), which has been the case during most of FY13, as long as inflation expectations remain manageable. However, even if inflation continues to remain within the announced target, this approach cannot be sustained for longer periods since it does not address the source of the problem. The source of the problem is untargeted subsidies and the absence of meaningful tax reforms to increase the tax base. The implications are high borrowings and a rising debt level, which have considerably increased debt servicing expenditures.

One consequence of high level of subsidies is that the government has managed to keep a check on administered prices such as electricity and gas prices and some transportation fares. Apart from financing subsidies, high rate of fiscal borrowing is being used to pay for the already accumulated debt, which does not represent current government demand. Taken together, these two observations largely explain why despite substantial fiscal borrowings and high growth in M2 inflation has come down. In addition, muted private sector investment expenditures are also having a dampening effect on aggregate demand and thus inflation.

Even inflation expectations seem to have moderated, having a broad-based effect on both food and non-food inflation. This is because a major factor in expectation formation is the recent experience of inflation. Thus, not only has year-on-year CPI inflation dropped to 6.6 percent but the 20-percent trimmed measure of core inflation has also declined to 8.4 percent in March 2013; the lowest level since October 2009. The pertinent question, from the point of view of monetary policy, is the sustainability of these subsidies and the overall fiscal position. Any fiscal consolidation effort, which is overdue, can potentially affect the level of subsidies at the expense of partially unhinging expectations of inflation remaining low. A prudent approach would be to gradually reduce the subsidy burden together with a credible and reform oriented medium term fiscal program.

In conclusion, given the risks to the balance of payments position, the Central Board of Directors of SBP has decided to keep the policy rate unchanged at 9.5 percent.