STATE BANK OF PAKISTAN

MONETARY POLICY DECISION
17th May 2014

Recent gains in confidence in the economy, backed by improvement in key indicators, need to be nurtured to ensure their sustainability. For instance, the average CPI inflation has remained in single digits during FY14 and policy vigilance is required for this trend to continue. Economic activity has improved and further reforms, especially in the energy sector, would help consolidate the momentum. Similarly, improvement in productivity and competitiveness is a must to continue to build foreign exchange reserves in the medium term while meeting external obligations.

The year-on-year CPI inflation has remained volatile during FY14. It increased sharply till November 2013 then declined for few months before increasing again to 9.2 percent in April 2014. The average CPI inflation for July-April, FY14 is 8.7 percent; higher than the year's target of 8 percent. The main reason for this volatility is unexpected movements in food prices and changes in administered prices. The core inflation, however, has remained quite stable at around 8 percent over the past 12 months. Importantly, from the point of view of monetary policy, it is the outlook of inflation that matters.

The SBP expects average CPI inflation to remain around 8 percent during FY15, barring any exogenous shock. Basic factors supporting this assessment are: (i) moderate aggregate demand; (ii) deceleration in broad money growth led by contained government budgetary borrowings from the banking system; (iii) expectations of low inflationary pressures as indicated by SBP-IBA consumer confidence survey; and (iv) stable outlook of international commodity prices.

Indicators of current economic activity are looking better as well. Provisional estimates of real GDP show a growth of 4.1 percent for FY14. Encouragingly, this growth has been led by a 5.8 percent increase in the industrial sector output. Examination of private credit data also points in the direction of improved economic activity. For instance, the flow of net credit to private sector was almost two and a half times more during the first nine months of current fiscal year compared to the corresponding period of last year. Similarly, the monthly average gross credit disbursements, arguably a better gauge of the nexus between credit and production, during the same period are about Rs150 billion higher this year.

These trends show that interest rate is only one factor in affecting economic activity. It is the improvement in sentiments, relatively better availability of energy, and reduction in government borrowing from the banking system that has encouraged the private sector. The continuation of these trends, however, would require a sustained effort to ease impediments to growth through implementation of necessary reforms. In particular, reforms in the energy sector can go a long way in increasing productivity, easing the fiscal burden, and reducing the import bill.

Because of the gap between imports and exports, the trade deficit remains at an elevated level of $12.2 billion during July-March, FY14. Also, the Real Effective Exchange Rate (REER) has appreciated by 8.0 percent in Q3-FY14 and its potential impact on the trade balance needs to be monitored carefully going forward. Nevertheless, mainly due to robust growth in worker's remittances, the external current account deficit, at $2.3 billion, seems quite manageable at this point in time. This is because the capital and financial account net flows have also improved to $2.2 billion, considerably easing the pressure on the balance of payments position. In fact, the SBP was able to meet the IMF's adjusted Net International Reserve (NIR) target for end-March 2014 by a wide margin.

After including the better-than-projected inflows from the issuance of Euro bonds of $2 billion and other inflows from multilateral sources in April and early May 2014, the SBP's foreign exchange reserves have increased to $8.0 billion by 9th May 2014 from $5.4 billion at end-March 2014. This marked improvement in reserves and the consequent stability in the foreign exchange market is the main indicator of improved sentiments in and about the economy. In turn, these sentiments could help in attracting more financial inflows and thus lead to further increases in reserves. The SBP also remains committed to play its role in ensuring further accumulation of reserves to achieve adequate levels in the medium term.

Despite a shortfall in tax collection compared to the budgeted target, the government has been able to contain the fiscal deficit at 3.1 percent during July-March, FY14. Consequently, government borrowing for budgetary support from the banking system has come down to Rs276 billion during 1st July – 2nd May, FY14 compared to Rs1021 billion during the corresponding period of last year. In particular, government borrowing from SBP shows a net retirement of Rs287 billion as compared to an increase of Rs393 billion last year. Moreover, the government was also able to keep its borrowings from SBP below the IMF target for end-March 2014.

Based on a balanced assessment of these considerations, the SBP's Board of Directors has decided to maintain the policy rate at 10 percent.