STATE BANK OF PAKISTAN

MONETARY POLICY DECISION
27th March 2010

Building on initial gains in macroeconomic stability the economy is looking to further its traction for sustainable recovery. Inflationary pressures have dampened but continue to persist, mainly due to alignment of energy sector prices with market factors. Large Scale Manufacturing (LSM) has consistently grown since October 2009 after contraction for almost 20 months but remains fragile. Reduction in the external current account deficit has allowed SBP to rebuild foreign exchange reserves, despite shortfalls in external financial flows. However, uncertainty has increased in some areas, particularly the fiscal sector, with implications for the rest of the economy, including monetary policy.

Although CPI inflation (YoY) has come down to 13.0 percent in February 2010, it is high and exhibits persistence. After a low of 8.9 percent in October 2009, inflation slipped back largely due to increases in electricity tariffs, adjustments in the prices of domestic petroleum products, and administered prices of commodities like wheat. To which extent these factors will influence other prices in the economy and expectations of inflation in the coming months remain difficult to assess. Nonetheless, SBP expects the average CPI inflation for FY10 to remain close to 12 percent.

Despite presence of high inflation, crippling electricity shortages, and challenging security conditions, domestic economic activity has picked up in recent months. A cumulative growth of 2.4 percent during the first seven months of FY10 in the Large Scale Manufacturing (LSM) is encouraging. Sustainability of this trend in LSM and overall economic growth would depend on improvements in the availability of electricity and security situation. In addition, this would need supportive growth in private sector credit, which in turn depends on a reduction in the scale of government and public sector's reliance on bank borrowings.

The balance of payments position has improved considerably. The external current account deficit has come down to $2.6 billion during July – February, FY10 compared to $8 billion in the same period last year. This has allowed SBP to accumulate foreign exchange reserves, $11.1 billion as on 26th March 2010, and has facilitated stability in the foreign exchange market. However, other developments in the external sector, such as Foreign Direct Investments (FDI) and workers' remittances, need to be monitored closely, especially when prospects of foreign official flows remain unclear.

The key source of uncertainty, however, lies in the weak fiscal position. Burdened by significant security related expenditures and shortfalls in revenues, keeping the fiscal deficit for FY10 within target would be challenging. Partial phasing out of subsidies and reduction in development expenditures have helped in containing expenditures but has lead to surge in domestic prices and is hurting crucial public sector investment. Similarly, increased Petroleum Development Levy (PDL) receipts, due to higher oil imports, have cushioned the lower tax revenues to some extent but have contributed towards inertia in domestic inflation. During the remaining months of FY10, uncertainty regarding non-tax revenues on

account of foreign reimbursements and extent of remaining power sector subsidies adds to fiscal complications.

The financing mix of the fiscal deficit also seems uncertain. The external financing for budget, especially the part pledged by the Friends of Democratic Pakistan (FoDP), has mostly been elusive. Of the Rs110 billion net external budget financing received during H1-FY10, Rs93 billion were provided by the IMF. With an understanding that this part of IMF money, provided in lieu of FoDP flows, is for short term, the importance of the timing of external budgetary flows cannot be overemphasized. Not surprisingly, therefore, government borrowing from the SBP has been substantial in Q3-FY10. According to provisional figures the outstanding stock of government borrowing from SBP (on cash basis), as on 25th March 2010, stands at Rs1240 billion, which is Rs110 billion higher than the quarterly ceiling limit.

With less than expected retirement of credit availed by the government for commodity operations and commencement of the 2010 wheat procurement season, pressure will build on the banking system resources. Continued borrowings by the Public Sector Enterprises (PSEs), partly because of the lingering energy sector circular debt, are also straining systemic liquidity. Further, the high infection ratio of credit to Small and Medium Enterprises (SMEs) at 22 percent and Agriculture at 17 percent may lead banks to show reluctance to extend credit to the private sector even when the pace of growth of incremental Non-performing Loans (NPLs) has slowed considerably in the last quarter of 2009.

In this environment, with resources tied up in both commodity and circular debt and risk averse behaviour, banks will tend to negotiate higher rates on risk-free or government guaranteed debt. For instance, the first issuance of the Term Finance Certificate (TFC) in March 2009 was priced at KIBOR plus 1.75 percent, while the second issuance in September 2009 was at KIBOR plus 2 percent. Similarly, the rates for financing commodity operations were around KIBOR plus 2.5 to 2.75 percent. This reflects that banks are building in the cost of ongoing rollover, instead of repayment, of outstanding credit. Thus, the attractively priced government borrowing may lead to stagnation in private sector credit growth.

Government will have to revisit its commodity intervention strategy, sooner than later, so that commodity operation requirements may go back to normal levels. Similarly, a complete resolution of the circular debt would be essential. Apart from releasing banking system resources and easing pressure on market rates, it will alleviate some constraints impeding production of electricity in the country thus paving way for sustainable economic recovery.

Given the uncertainties pertaining to the fiscal and quasi-fiscal sectors, present stance of monetary policy is striking a difficult balance between reducing inflation, ensuring financial stability, and supporting economic recovery. An upward adjustment in SBP's policy rate, at this juncture, runs the risk of impeding the still nascent recovery, while a downward adjustment runs the risk of fuelling an already high inflation. Hence, SBP has decided to keep the policy rate unchanged at 12.5 percent.