August 15, 2009

SBP Governor's Press Statement

1. We have, in a difficult year, seen steady improvement in key indicators following continued implementation of the macroeconomic stabilization program. CPI inflation continues to fall, government borrowing from the central bank remains within quarterly limits, and SBP's foreign exchange reserves have increased. These positives, in turn, reflect contraction in aggregate demand, much-needed fiscal consolidation, and an improved balance of payments position. Consistent with the gradual strengthening of macro fundamentals, the inter-bank money market is functioning smoothly, the foreign exchange market has been stable within a tight range, and deposit growth in the banking system is picking up.

2. However, these positive developments are not without costs. Exacerbated by electricity shortages and security issues, real GDP growth has fallen to 2.0 percent in FY09, down from 4.1 percent a year earlier. Large-scale manufacturing activity has already seen a record run of eleven consecutive months decline up to May 2009. Further there has been no growth in credit to the private sector. Given the various structural constraints faced by the country in economic and security spheres recovery could be slow and sporadic.

3. While solutions for structural impediments develop in the backdrop, monetary policy will maintain its oversight of inflation and its role in improving macroeconomic imbalances, simultaneously supporting real economic activity. A 7.9 percentage point decline in CPI inflation (YoY), from 19.1 percent in March '09 to 11.2 percent in July, is reassuring and validates the direction of economic policy. The YoY non-food non-energy (NFNE) and 20-percent trimmed measures of core inflation have also declined to 14.0 and 13.9 percent in July. In fact, the pace of decline in inflation increased noticeably in Q4-FY09, compared to the previous quarter, and continued through into the first month of FY10.

4. The external current account deficit contracted to \$8.9 billion (5.3 percent of GDP) and SBP's foreign exchange reserve position strengthened to \$9.1 billion by the end of June '09. As of 13th August, '09 SBP's foreign exchange reserves stand at \$9.4 billion. With continuing global recession and slowdown in domestic economic activity, both exports and imports have declined by 5.9 and 10.5 percent in FY09. Exports may improve slightly if global recovery sets in by the beginning of 2010, as many anticipate. Similarly, imports could pick up also assuming domestic economic recovery. Nevertheless, both are still expected to see a fall from fiscal year '09. As a result, the external current account deficit may come under 5.0 percent of GDP in FY10. Provided projected foreign inflows are realized SBP's foreign exchange reserves could improve further to over \$12 billion in this fiscal year.

5. The ability of the government to control its borrowings from the SBP in cumulative terms and to raise their targeted amounts in T-bill auctions is another mark of success of the stabilization program. Though there has been a slight uptick in the last two auctions, yields on government paper of different tenors have broadly followed a falling trend despite the increased borrowing requirements from banks. This reflects actual retrenchment of the fiscal deficit and transparency in the conduct of borrowing operations from the banking system. At the same

time, it reflects sharp contraction in credit to the private sector, and includes the expectation of further decline in market interest rates amidst decreasing inflation.

6. Although the final consolidated fiscal deficit during first three quarters of FY09 remained within target, higher expenditures related to IDPs and provincial spending in the fourth quarter of FY09 resulted in possible infraction of the deficit. Despite slippages from the budget estimates, the fiscal deficit for FY09 is expected to be well below the 7.6 percent deficit of the previous year.

7. Money supply grew by 9.6 percent. The equilibrium projected money growth for FY10, consistent with projections for the external account and the federal budget announced, is 13 percent versus 15.4 percent for '08 and 19.3 percent in '07. SBP met successfully, the three main end-June IMF performance criteria. Both the stock of budgetary borrowings from the SBP at Rs1130 billion and Net Domestic Assets (NDA) of SBP at Rs1183 billion were below their respective target ceilings of Rs1181 billion and Rs1321 billion. Similarly, the Net Foreign Assets (NFA) of SBP at $3.98 billion were higher than the targeted floor of $2.37 billion.

8. Also corresponding to the reduction in fiscal and external current account deficits, the growth in domestic aggregate demand fell to 0.6 percent in FY09 compared to 3.6 percent in the previous year. Consequently, the saving-investment gap narrowed by 3.1 percent largely owing to the fall in investment expenditures. Although this narrowing gap shows improving macroeconomic imbalances, the fall in investment means lower capital stock and infrastructure per worker, which does not bode well for national production capacity. We recognize that demand contraction has its positives as well as its negatives. The lowered momentum of demand now was necessary to dissipate the monetary overhang accumulated over the past several years.

9. Now, the revival of private sector credit is critical for increased investment and capital formation. Currently, decline in economic growth, power availability problems, and rising Non Performing Loans (NPLs) are hampering private sector credit. The spare capacity created by lack of private loan growth went to finance government, PSEs and commodity operations in a largely falling rate environment. Continuation of fiscal consolidation, further increase in total deposits in line with last quarter of FY09 growth trend, and gradually recovering confidence in the economy could improve the private sector credit growth.

10. Importantly, pick up in the real economic activity will be a key factor in the revival of credit utilization by the private sector in FY10. Resolution of the power sector problems, expected credit requirements and investments by Independent Power Projects (IPPs) and in the fertilizer sector, and government plans for higher development spending could improve the prospects of GDP growth. Impetus to GDP growth may also come from the utilization of spare capacity and re-stocking of inventories in the manufacturing sector. Projected improvement in the global economy towards the beginning of 2010 will also be beneficial in this regard. Taken together, these factors may lead to a GDP growth of 3.3 percent in FY10.

11. Despite considerable progress with respect to macroeconomic stability, it cannot herald sustainable medium term economic recovery by itself. Likely increases in oil and electricity prices and upward revision of public sector wages may lead to renewed inflationary pressures. Similarly, pressures on the fiscal position remain substantial, given higher spending requirements, low economic growth, and some uncertainty in timing of external financing flows.

Also, prospects for sufficient global economic recovery and - thus leading the revival of international investors' sentiments - remain lukewarm.

12. The country faces serious power shortages that have damaged economic growth and productivity limiting the potential output of the economy. Apart from capacity issues, insufficient electricity tariff increases to recover costs and the non-payment of tariff differential subsidies by the government — the circular debt issue — have exacerbated the electricity supply problems. The capacity issue is expected to be substantially addressed through FY10, and circular debt during current year. While the government has shown resolve to address these issues, their likely positive impact may take time. In the interim, the cost of delayed adjustments will be absorbed in the budget with possible repercussions for inflation and thus the monetary policy stance in future.

13. The country's limited resource envelope, reflected in the stagnant tax- GDP ratio, remains under pressure - while the requirements for spending on security-related issues, social and economic infrastructure, and IDPs are on the rise. Reinvigorated efforts on reforming tax policy and administration foresee a medium term solution. Until this gains momentum additional donor support pledged in Tokyo in April 2009 and increased access to IMF resources provides temporary respite to the fiscal position.

14. Part of additional amount of approximately $3.2 billion, approved by the IMF's executive board, will be available to meet domestic spending requirements in FY10. But, in case of significant shortfall in the Tokyo pledges, implications for the economy could be consequential, including the need for substantial additional borrowings from domestic sources and pressure on foreign exchange reserves.

15. At the center of the macroeconomic stabilization program is the BoP. There has been considerable improvement here in the course of the year, and we have referred earlier to the possibility of a further reduction of the current account deficit. Vulnerabilities remain, however, given that our exports and markets are highly concentrated, and slow recovery in those markets will restrain exports. Imports remain vulnerable to price pressures from any rises in oil, commodity and basic raw material prices. Deterioration in the current account will directly affect the foreign exchange reserves position.

Before I proceed to the policy rate announcement, let me inform you about initiatives by the SBP in the area of monetary management.

a) Frequency of Monetary Policy Decisions

The frequency of monetary policy decisions will be increased from four to six times a year. Henceforth, monetary policy decisions will be announced in the last week of September, November, January, March, May, and July. The January and July policy announcements will be accompanied with a detailed monetary policy statement and a press conference. On remaining four occasions monetary policy decisions will be communicated through a brief press release only. High frequency of MPS announcement will provide greater clarity in how changing economic conditions are being addressed.

b) Constitution of an Independent Monetary Policy Committee (MPC)

An independent Monetary Policy Committee (MPC) is being constituted that will have external experts as members in addition to SBP and SBP Board representatives. The inclusion of external members is designed to ensure that SBP benefits from expertise and independent views concerning monetary policy. This step will bring us in line with best international practices by enhancing the transparency and credibility of monetary policy formulation process.

c) Introduction of the Corridor Framework

SBP will introduce a corridor for the money market overnight repo rate, effective 17th August 2009. While the SBP policy rate will serve as a 'ceiling', the repo rate on the new overnight deposit facility, 300 bps below the SBP policy rate, will provide a binding 'floor'. The introduction of this framework will improve liquidity management, enhance effectiveness of market signaling, and foster stability and transparency in the money market operations. It will also improve transmission of monetary policy signals, strengthening its role in fostering price stability.

d) Policy Rate Cut

In recognition of the positive macroeconomic developments and to provide impetus to growth while remaining aware of risks and challenges faced by the economy, **SBP has decided to cut the policy rate by 100 basis points to 13 percent effective August 17th, 2009.**

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