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## **STATE BANK REDUCES POLICY RATE BY 150 BPS TO 12 PERCENT**

The State Bank of Pakistan (SBP) has decided to reduce its policy rate by 150 basis points to 12 percent. This decision was taken at a meeting of the Central Board of Directors of State Bank of Pakistan held under the Chairmanship of Acting Governor, SBP, Mr. Yaseen Anwar in Karachi today.

The SBP will continue to monitor developments in the fiscal sector and those pertaining to foreign financial inflows to gauge risks for macroeconomic stability.

Taking some comfort from declining inflation and high probability of meeting the FY12 inflation target together with a need to support private sector credit and investment growth, the Central Board of Directors of SBP after due deliberations has decided to reduce its policy rate by 150 bps to 12 percent with effect from 10 October 2011, the State Bank said in its Monetary Policy Decision.

Following is the text of Monetary Policy Decision:

‘The main factors contributing in SBP’s decision to reduce its policy rate by 50 basis points in July 2011 continue to show positive progress. There is a decline in CPI inflation and government borrowing from SBP is lower than its end-June level. Led by consistent inflow of workers’ remittances the external current account position is comfortable though there has been some decline in SBP’s foreign exchange reserves. Importantly, concerns regarding weak private sector credit growth and falling real private investment expenditures remain along with a likelihood of rise in real interest rates.

At the same time, risks to macroeconomic stability emanating from fiscal weaknesses and falling foreign financial inflows have not receded. Moreover, severe energy crisis and precarious law and order conditions continue to render domestic economic environment least conducive for productive activities. In addition, the likelihood of falling short of the annual GDP growth target has increased due to damaging impact of recent flood in Sindh. The rapidly deteriorating global economic conditions, especially in Pakistan’s export-destination countries, do not provide much confidence either. In these circumstances, balancing inflation and growth considerations through monetary policy alone is difficult.

The year-on-year inflation in September 2011 has come down to 10.5 percent from 13.3 percent in June 2011 though month-on-month inflation is still more than 1 percent on average. An expected seasonal rise in inflation in the first month of a new fiscal year, the Ramazan seasonality of food prices, and the unexpected effect of flood on inflation have all coincided in the months of Q1-FY12. Thus, isolating temporary changes from underlying inflationary pressures is more demanding at this point in time though the probability of meeting the 12 percent average CPI inflation target for FY12 remains high. There are upside risks, however, in meeting the medium-term inflation targets of 9.5 percent in FY13 and 8 percent in FY14. These risks largely stem from persistence of government borrowing from scheduled banks, exchange rate depreciation, and likely upward adjustments in the administered prices of energy.

Nevertheless, these risks can potentially mitigate if following positive developments and intended policy actions take root. First, continued restraint on government borrowing from SBP. According to the provisional data, the outstanding stock of these borrowings (on cash basis) has

come down to Rs1051 billion as on 30th September 2011. This is considerably lower than the mutually agreed limit of Rs1155 billion for FY12 and is expected to have a beneficial impact on inflation outlook if the trend continues.

Second, the government has decided to consolidate the outstanding inter-agency circular debt of the energy sector and settle the unpaid subsidy claims on account of its commodity operations by issuing government securities of close to Rs400 billion. These measures would alleviate the energy sector's financial difficulties leading to better utilization of installed productive capacity and may release the stuck-up resources of the banking system that can then be channelled to productive activities. Assuming that the efforts to curtail the emergence of incremental debt in these areas will be stepped up, these measures could reduce inflationary pressures by closing the gap between prevailing aggregate demand in the economy and aggregate supply.

Third, led by the 50 bps reduction in the policy rate announced in July 2011, the market interest rates have come down considerably. For instance, 6-month T-bill and 10-year PIB rates in the secondary market have decreased by 114 and 136 bps between 1st August 2011 and 7th October 2011. The effect on corporate lending rates would become more visible in the coming months. This is expected to have a desirable impact on the demand for credit by the private sector over and above their working capital needs. The resulting increase in fixed investment may help the productive capacity of the economy, having a beneficial impact on inflation in the medium term.

Moreover, in continuation of Q4-FY11 trend, the proportion of amount offered by banks in the 12-month tenor during primary auctions of T-bills during Q1-FY12 has increased to 63 percent from 25 percent in Q4-FY11. This noticeable shift in banks' preference for the 12-month T-bill will help in alleviating the pressure on the government to rollover its short term debt and indicate market's expectation of inflation coming down. This may help to some extent in improving the supply of credit to the private sector.

A more enduring expansion in the private sector credit and thus investment in the economy would require fiscal reforms. Especially, in the wake of declining external budgetary support, it is imperative to increase the tax to GDP ratio to scale down the reliance on borrowings from the banking system. Currently, these requirements are substantial and increasing. For instance, compared to an announced T-bill auction target of Rs750 billion for Q1-FY12 the government raised Rs851 billion instead. The announced target for Q2-FY12 is Rs1025 billion, including Rs63 billion incremental requirements, and the possibility that the government may borrow more than this amount cannot be ruled out. Not surprisingly therefore the liquidity position of the market is under stress, in addition to the seasonal factors, as indicated by an outstanding liquidity injection by SBP of Rs292 billion as on 7th October 2011.

Apart from seasonal factors, another source of tight liquidity conditions is a decrease of \$1.1 billion in SBP's foreign exchange reserves during Q1-FY11. The main reasons include a growth of 42 percent in oil import payments and continued decline in foreign financial flows during the first two months of FY12. Consequently, the rupee also experienced a depreciation of 1.7 percent against the US dollar in Q1-FY12. Thus, despite a modest external current account deficit of \$189 million during July-August, FY12, the assessment of overall balance of payment position requires vigilance.'

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