STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

26th March 2011

Despite a recent improvement in the external current account, restrained government borrowings from SBP and stable financial markets, the focus must remain on addressing the structural fiscal weaknesses and reducing inflation to provide a sound platform for sustainable economic recovery in FY12. Although some measures have been announced to contain the fiscal deficit of FY11 and inflation has eased somewhat, more work is required to build on these initial efforts by maintaining progress on comprehensive tax reforms, transparent rationalization of subsidies, and the development of a forward-looking debt management strategy. This will require support from across the political divide and from other state and civil society institutions to ensure their smooth implementation. These measures would help check the level of government borrowings from the banking system, creating space for the private sector and lowering their borrowing costs thereby supporting the utilization and expansion of the economy’s productive capacity. Initiation of these reforms has become critical since private and public sector investments are falling while total debt is rising sharply and expectations of high inflation are becoming entrenched.

The decline in year-on-year inflation from 15.5 percent in December 2010 to 12.9 percent in February 2011 can be attributed to three factors. First, a gradual dissipation of the effect of the flood on food prices; second, an incomplete pass-through of high international oil prices to the domestic market and a smaller adjustment in electricity prices than required by the projected size of the power sector subsidy; and, third, a reduction and thereafter containment of the stock of government borrowings from SBP to around Rs1290 billion (on cash basis). The future path of inflation would be contingent upon the policy stance adopted with respect to the last two factors. In addition, the impact of the recent removal of General Sales Tax (GST) exemptions could also influence the inflation outlook.

The SBP is confident that the government will adhere to the mutually agreed borrowing limits from SBP and, in recognition of the high level of inflation, will aim to lower them further. This should facilitate SBP in aligning monetary expansion with the level of productive economic activity while improving its composition in favour of Net Foreign Assets (NFA). By 12th March 2011, the year-on-year growth in reserve money was 15.9 percent, which is slightly lower than the growth rate observed at the time of last monetary policy decision in January 2011, and share of NFA of SBP in reserve money has increased to 27.5 percent compared to 22.5 percent at the beginning of FY11. A continuation of these positive trends can potentially have a beneficial effect on inflation in the next fiscal year.

However, the rise in public debt with a considerable short-term maturity profile combined with reduced availability of bank credit for the private sector at higher interest rates has created challenges for monetary management in terms of striking a balance between containing inflation and promoting economic growth. By end-December 2010, the year-on-year growth in government’s total debt was 14.8 percent, with 45 percent of the tax revenue being absorbed by interest payments. The year-on-year growth in private sector credit, on the other hand, was only 5 percent up till 12th March 2011. Without increasing the private sector’s investment and hence its contribution to economic growth it would become more challenging for the economy to generate sufficient revenues to meet its debt obligations in the future, especially with the terms of trade shifting in favour of sectors with modest contribution to tax revenues.

The recently announced tax measures, estimated to raise approximately Rs53 billion in the remaining months of FY11, together with a cut in planned development expenditures and postponement of some subsidy payments may help in reducing the fiscal deficit for FY11 to some extent. Given the delayed announcement and temporary nature of some of these measures, the improvement in the fiscal position will require these efforts to be consolidated in the forthcoming budget. Thus, implementation of a credible medium term budgetary framework and renewed efforts to abide by the principles of the Fiscal Responsibility and Debt Limitation Act (2005), geared towards reducing the revenue deficit, are required to strengthen the fiscal position on a sustainable basis.

On the financing side, only Rs48 billion were received for external sources to finance the budget during H1-FY11 against the budget estimate of Rs230 billion for the year. If these external flows are not released in a timely manner, there is a risk of further substantial government borrowings from the banking system, which will make liquidity management more challenging. The government has already borrowed substantial amounts, Rs329 billion during 1st July – 12th March, FY11, through various instruments, increasingly in the 3-month Treasury Bills. The incremental requirements of the government for Q4-FY11 and a debt plan that focuses on long term borrowings are awaiting announcement.

There is growing uncertainty in the global economic environment also. The popular uprisings in the Middle East and North Africa (MENA) region and unprecedented damage to the Japanese economy because of an historic earthquake and tsunami have shaken the global economy once again, which has yet to fully recover from the repercussions of the financial and economic crises of advanced economies. One consequence of these uncertain times has been high international commodity prices, especially of oil. So far, the terms of trade shock has been favourable for Pakistan’s economy. More than 90 percent of the incremental increase in export earnings during July – February, FY11 over the corresponding period of last year has been due to high international prices of Pakistan’s exports. The contribution of high import prices, particularly of oil, to the import bill has been relatively low, but is substantial and rising.

The turmoil in the MENA region may also influence the flow of remittances to Pakistan. However, assuming that the inflow of remittances continue its current trend for the remaining months of FY11, there are no immediate risks to the external current account balance. The financial account inflows such as foreign direct and portfolio investments, on the other hand, have remained fairly modest during July – February, FY11; almost half the level of inflows seen in the corresponding period of last year, which was also small compared to historical levels. The overall balance of payments position appears to be strong at the moment with a gradual build-up of foreign exchange reserves and a stable foreign exchange market. However, given the uncertainty with respect to foreign inflows, the developments in the external sector will need to be monitored closely in the coming months.

In conclusion, given a favourable external current account position and relatively disciplined government borrowings from SBP, the immediate risks to macroeconomic stability seem to have subsided, at least for the next two months. Therefore, SBP has decided to keep the policy rate unchanged at 14 percent. However, there is little room for complacency as the risks to the economy may increase if meaningful economic reforms are not initiated to address the structural weaknesses. Inflation persistence still remains high, which is largely formed by recent past levels of inflation and perceptions of economic agents about the credibility and direction of monetary and fiscal policies in controlling inflation and promoting long-term sustainable economic growth. Perceived credibility of monetary policy is also influenced by the behaviour of monetary aggregates. In this respect, while government borrowing from SBP has been contained to end-September 2010 level, growth in public sector borrowing is still very high and that of the private sector low. Further, given the financing requirements of fiscal authorities, budgetary as well as non-budgetary borrowings for the procurement of commodities and addressing the circular debt-related issues, the likelihood of an ease in such borrowings is small. This means that risks to macroeconomic stability could increase in the next fiscal year. The current stability in the financial markets provides valuable time to initiate structural reforms. Not only are urgent measures required to address the energy crisis to increase productive activity but the fiscal position also needs considerable strengthening to cope with rising debt obligations and to ease borrowing pressures on the banking system.