STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

21st May 2011

A careful analysis of Pakistan's current economic conditions reveals a mixed situation. Led by strong export earnings and robust growth in remittances, the external current account position has surpassed all earlier projections. This has helped the SBP in building foreign exchange reserves and accumulating Net Foreign Assets (NFA), which contributed in keeping the foreign exchange market stable and provided rupee liquidity in the system. However, key challenges remain in the shape of persistent inflation, weak economic growth and private investment, and a large budget deficit. In such circumstances, SBP is endeavouring to strike a delicate balance to address the multiplicity of considerations in formulating the monetary policy stance such as containing inflation, promoting private productive economic activity, and keeping financial markets stable.

The remarkable improvement in the external current account, a surplus of $748 million during July-April, FY11, has been a major positive development. Given the turmoil in global economic conditions, especially in the export-destination and remittance-generating economies, there were expectations of an external current account deficit. However, a spectacular rise in international cotton prices has boosted exports, which are expected to exceed $25 billion in FY11. This together with consistently rising flow of remittances helped neutralize import and other payments. More importantly, despite falling financial account inflows, $0.5 billion during July-April, FY11 compared to $3.7 billion in the corresponding period of last year, SBP's foreign exchange reserves have increased to $13.7 billion by 18th May 2011 and are expected to increase further by end-June 2011.

Nevertheless, caution needs to be exercised while assessing the outlook of the overall balance of payment position. The main reasons for this prudence include the sharp decline in international cotton prices in the last two months, likely continuation of oil prices at around $100 per barrel, and debt obligations that are due in FY12. Barring any unforeseen developments, these factors together with the continued suspension of IMF's Stand-By Arrangement (SBA), which has implications for other financial inflows, imply that the stellar performance of the external account may be difficult to sustain. Therefore, maintaining the current upward trajectory of SBP's foreign exchange reserves would be a challenging task.

The repercussions of uncertain foreign inflows may not be limited to the external sector. Deviations in the baseline estimates could affect the net external budgetary financing as well as the monetary projections. A similar scenario did play out in this fiscal year with implications for monetary management. For instance, government borrowings from the banking system have increased significantly, partly due to the shortfall in external financing and partly due to the increase in the fiscal deficit on account of security spending, the impact of unprecedented floods and the recent one-off adjustment of Rs120 billion to address the issue of 'old stock' of the circular debt of the power sector. During 1st July – 7th May, FY11 incremental government borrowing from the banking system, including SBP, for budgetary support was Rs614 billion; a year-on-year growth of 28.3 percent. The borrowings from SBP explain almost 80 percent of the expansion in reserve money while total banking system budgetary borrowings explain 95 percent of the expansion in M2.

Demonstrating its commitment the government retired its borrowings from the SBP in Q3-FY11 and by end-March 2011 the stock of these borrowings (on cash basis) had come down to Rs1155 billion. The recent increase in these borrowings is temporary and a reflection of the government's efforts to internalize the growing quasi-fiscal expense related to the circular debt of the energy sector. The SBP has already shifted a portion of this borrowing, Rs61 billion, to the market through an outright Open Market Operation (OMO) and expects that government borrowing will soon converge to the end-September 2010 level, Rs1290 billion, as committed by the government.

The year-on-year growth in both reserve money and M2 remains close to 15.5 percent and may increase further by the end of FY11, which would be higher than SBP's earlier projections. The magnitude of such borrowings poses a challenge for effective liquidity management with implications for inflation in FY12. Though the CPI inflation of 13 percent in April 2011 is lower than the flood-induced peak of 15.7 percent in September 2010, its persistence is a source of concern. The 12-month moving average of 20-percent trimmed measure of core inflation has continued to move between 11.5 and 12.5 percent in the last one year. Nonetheless, the average CPI inflation for FY11 is likely to remain between 14 and 14.5 percent, which is lower than SBP's earlier projections.

Another consequence of government's growing borrowing needs, both current and expected, is that the private sector credit has been squeezed out in terms of banks' allocation of system's deposits. By 7th May 2011, the year-on-year growth in private sector credit, which was mostly due to working capital needs, was 3.2 percent and that of total deposits was 15.3 percent. The basic intermediation function of scheduled banks is being constrained as the fiscal deficit and the commodity operations of the government are financed by deposits at the cost of declining private sector investment. The recently released provisional National Income Accounts reveal that real private investment expenditure registered a decline of 3.1 percent while real private consumption growth was 7 percent, leading to a growth of 5.9 percent in total domestic demand.

These developments highlight a predicament faced by the economy. The rising total debt, Rs11.2 trillion by end-March 2011, and its servicing is demanding an increasing portion of fiscal revenues. At the same time, the GDP growth rate of below 4 percent over the past four years appears to be highly correlated with declining real private investment expenditures and driven by consumption demand. This coupled with severe energy shortages is negatively affecting the utilization and expansion of the economy's productive capacity. This implies that the output gap – the difference between aggregate domestic demand and the supply – is perhaps widening again, making it difficult to bring inflation down. Thus, along with rising debt the economy seems to have settled at a low-growth-high inflation equilibrium.

The solution to these outcomes rests with wide-ranging fiscal reforms that restore the economy back towards the requirements of the Fiscal Responsibility and Debt Limitation Act (2005). In particular, there is an urgent need to address the issue of the falling and single-digit tax to GDP ratio. The Federal Board of Revenue's (FBR) tax collection was Rs1156 billion during July-April, FY11 and it is confident that it will realize additional revenues from the measures announced in March 2011. Plans to consolidate them are being considered along with the announcement of new measures in the forthcoming budget. However, because of the recent adjustment of old dues reflected in the stock of the circular debt of the power sector, the fiscal deficit for FY11 is likely to increase by approximately 0.7 percent of GDP over the revised deficit target of 5.5 percent. The final outcome will depend upon the realization of the targets of FBR revenues and provincial surpluses.

For a sustainable fiscal path revenue-enhancing measures need to be complemented with renewed efforts to stem the leakages in the tax system, bring a wider range of incomes in the tax net, and effective expenditure control measures, especially the removal of untargeted and distortionary subsidies. These initiatives will be critical for reducing the stress on the fiscal position and to encourage entrepreneurship in the economy.

In conclusion, for the economy to grow on sustainable basis, the debt burden to become manageable and inflation to come down to single digits, the private productive activity and investment will have to increase considerably and quickly. This will require government borrowings from the banking system to subside to create space for private sector credit, which in turn would need satisfactory implementation of the aforementioned fiscal reforms. The government is mindful of fiscal pressures and has expressed its resolve to address these issues, especially the containment of the fiscal deficit. The budget for FY12 is expected to reflect this commitment. In this context and after incorporating the improved external position SBP has decided to keep the policy rate unchanged at 14 percent for another two months.