STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

30 November 2011

The SBP reduced its policy rate by 200 bps, to 12 percent, in FY12 so far. The objective of adopting this stance is to support revival of private investment in the economy despite a constraining domestic and global economic environment. The primary factors in support of this stance were the expectation of average CPI inflation remaining within the announced target in FY12 and a small projected external current account deficit. In pursuing this stance SBP did acknowledge the risks to macroeconomic stability emanating from fiscal weaknesses and falling foreign financial inflows. These include resurgence of medium term inflationary pressures and challenges SBP is facing in managing market liquidity and preserving foreign exchange reserves.

A reassessment of latest developments and projections indicate that macroeconomic risks have somewhat increased during the last two months. For instance, although the year-on-year CPI inflation stands at 11 percent in October 2011, the month-on-month inflation trends, averaging at around 1.3 percent per month during the first four months of FY12, show existence of inflationary pressures. The sifting of commodity level CPI data reveal that the number of CPI items exhibiting year-on-year inflation of more than 10 percent is consistently increasing and almost all of these items belong to the non-food category. The government has also increased its wheat support price by Rs100 to Rs1050 per 40kg for the next wheat procurement season.

Thus, while the average inflation may settle around the targeted 12 percent for FY12, it is uncertain that inflation will come down to a single digit level in FY13. The main determinants of this inflation behaviour are government borrowing from the banking system and inertial effects of high inflation on its expected path. The severe energy shortages are also holding back the effective utilization of productive capacity and adding to the high inflation-weak growth problem.

On the external front, the earlier comfortable external current account position for FY12, which helped SBP in lowering its policy rate, has become less benign. The actual external current account deficit of $1.6 billion for the first four months of FY12 is now higher than the earlier projected deficit for the year. The main reason for this larger than expected deterioration is the rising trade deficit. In particular, the windfall gains to export receipts due to abnormally high cotton prices in FY11 have dissipated faster than anticipated. This is indicated by slightly less than $2 billion per month export receipts in September and October 2011. At the same time, international oil prices of around $110 per barrel and strong growth in non-oil imports have kept the total import growth at an elevated level of close to $3.4 billion per month. Adding to the challenges faced by the external sector is the precarious global economic outlook.

A relatively larger external current account deficit in FY12 would require higher financial inflows to maintain foreign exchange reserves. However, during July-October, FY12, the total net direct and portfolio inflows were only $207 million while there was a net outflow of $113 million in official loans. As a consequence, SBP's liquid foreign exchange reserves have declined to $13.3 billion at end-October

2011 compared to $14.8 billion at end-June 2011. Given the scheduled increase in repayments of outstanding loans in H2-FY12, realization of substantial foreign flows, especially the proceeds of assumed privatization receipts, euro bond, Coalition Support Fund, and 3G licence fees, becomes important for strengthening the external position.

A reflection of widening external current account deficit and declining financial inflows can be seen in the reduction of Rs115 billion in the Net Foreign Assets (NFA) of SBP's balance sheet during 1 July – 18 November, 2011. This implies that to meet the economy's prevailing demand for money, SBP has to provide substantial liquidity in the system, at least to the extent of compensating for the declining NFA of SBP. As of 28 November 2011, the outstanding amount of liquidity injected by SBP through its Open Market Operations (OMOs) is Rs340 billion. This is significantly higher than normal SBP operations and appears to have developed characteristics of a permanent nature at this point in time.

A dominant source of demand for money and thus liquidity injections by SBP is government borrowings for budgetary support from the banking system. Excluding the issuance of government securities of Rs391 billion to settle the circular debt and commodity loans, the government has borrowed Rs255 billion from scheduled banks and Rs62 billion from SBP during 1 July – 18 November, 2011 to finance its current year's budget deficit. The growth in private sector credit has remained muted so far but may pick up in coming months as the desired effects of a cumulative decrease of 200 bps in the policy rate and reduction in financial constraints of the energy sector gather momentum.

In this context where government is the main user of the system's liquidity and banks remain hesitant to extend credit to the private sector, SBP faces a dilemma. Efforts to scale down liquidity injections could have implications for settlement of payments in the interbank market, which is an important consideration given SBP's mandate of maintaining financial stability. Even if these considerations are addressed, the government may end up settling its obligations by borrowing from SBP. This does not bode well for government's own commitment of keeping such borrowings at zero on quarterly basis. The marginally increasing trend of these injections, on the other hand, also carries inflationary risk, which is not consistent with the objective of achieving and maintaining price stability.

There are three solutions to this predicament of reconciling price and financial stability considerations and supporting private investment in the economy. First, the government needs to ensure that all or major parts of budgeted foreign inflows materialize as soon as possible. This will alleviate pressure on the balance of payments and help inject fresh rupee liquidity in the system. Second, sooner than later the government will have to initiate comprehensive tax reforms that broadens the tax base of the economy. This is of paramount importance to reduce the government's borrowing requirements from the scheduled banks that are currently not consistent with the objective of promoting private sector and economic growth. Third, efforts need to be stepped up to improve financial deepening and increase competition in the banking system.

The last of these solutions is something that SBP has been actively working on. For instance, to promote competition in the banking system and to offer alternative sources of savings to the population, SBP has been encouraging depositors to invest in government securities through Investor's Portfolio Securities (IPS) accounts. The option of maintaining saving deposits or investments in IPS accounts could provide stiff competition to banks forcing them to offer better returns on deposits. This in turn would incentivize savings and help lower the currency in circulation. Moreover, it will improve the transmission of monetary policy changes to market interest rates. Over time this strategy would also diversify the government's funding source, deepen the secondary market of government securities, and facilitate the issuance of corporate debt.

Finally, it must be understood that there are uncertainties involved in realizing the full benefits of these measures. These uncertainties can potentially have adverse effects on SBP's recent efforts to support private sector credit and investment in the economy. Therefore, after giving due consideration to the need to revive growth and emerging risks to macroeconomic stability, the Central Board of Directors of SBP has decided to keep the policy rate unchanged at 12 percent.