STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

13 April 2012

As the economy begins the last quarter of current fiscal year, SBP's monetary management continues to play its part in balancing the implications of multiple challenges faced by the economy. The primary consideration remains bringing inflation further down as it has persistently remained in double digits in the last few years. Ensuring smooth functioning of the payment system and financial stability is also important given the current stressed liquidity conditions in the market. Similarly, elevated international oil prices, weak quantum of exports, and insufficient foreign financial flows require careful management of the external position. Last but not least, the consistent decline in private investment is also an important factor in formulating the monetary policy strategy as it impacts both the medium term inflation, growth and employment prospects.

Given limited set of instruments, not all these challenges can be effectively tackled by monetary policy alone. There are bound to be tradeoffs involved among these competing considerations. A supporting fiscal strategy and an active economic reform agenda is critical to deal with some of the structural issues, in particular, low tax to GDP ratio and energy shortages. Most importantly, the economy needs a forward-looking approach to policy making with strict adherence to rules laid out in the legal frameworks, be it the State Bank of Pakistan (Amendment) Act (2012) or Fiscal Responsibility and Debt Limitation (FRDL) Act (2005).

Following this approach is crucial in anchoring inflation expectations around the medium term targets of 9.5 percent for FY13 and 8 percent for FY14 as envisaged in the Medium Term Budgetary Framework (MTBF) of the government. In March 2012 the year-on-year CPI inflation was 10.8 percent and, given the current economic conditions, is projected to remain in double digits during FY13. Consistently growing government borrowing requirement from the banking system is a key variable that is adversely affecting the inflation outlook. Weak private demand, on the other hand, is one reason why inflation is not increasing sharply. Nonetheless, the size of fiscal borrowings and lack of investment is eroding the medium term productive capacity of the economy, contributing towards persistence of inflation in early double digits. Another risk factor that needs to be monitored closely for assessing inflationary pressures is the behaviour of international oil prices.

The current year government borrowings for budgetary support have been Rs373 billion from the scheduled banks and Rs218 billion from the SBP during 1st July – 30th March, FY12. The year-on-year growth in these borrowings turns out to be 56.5 percent and 18.5 percent respectively. The year-on-year growth in the private sector credit, on the other hand, was only 4.2 percent and that in total deposits of the banking system was 17.4 percent during the same period. Thus, despite a decent growth in deposits, the banks continue to prefer financing the fiscal deficit as opposed to searching avenues, taking risk, and building partnerships to facilitate credit to the private sector. The cost to the economy is visible in terms of a decline in investment to GDP ratio to historically low levels and stagnant economic growth that is considerably lower than the economy's potential.

If a revival in private sector credit and growth prospects is to take place, a pertinent question in the current circumstances is: how would the government rollover its maturing short-term debt and raise additional financing while simultaneously retiring its borrowings from the SBP? With shortfalls in

external sources, the most likely avenue will be more borrowings from the SBP. The inflationary implications of this scenario should not be underestimated. However, according to the recent State Bank of Pakistan (Amendment) Act (2012), government borrowing from the SBP is required to be repaid at the end of each quarter and the existing stock is to be retired within eight years. In case of not observing these provisions, the Act also stipulates that the federal government will submit a statement to the Parliament giving detailed justification.

Adherence to this legal requirement, without serious adjustment in the fiscal position, would lead to significant injections of liquidity by the SBP to keep the payment system functioning and financial markets stable. But, SBP is already injecting substantial short term liquidity in the system, Rs200 billion as of 13th April 2012, which is being continuously rolled over. The permanent nature of these injections also potentially carries inflationary risks. Thus, simultaneously meeting the legal requirement of zero quarterly borrowings from SBP, scaling back liquidity injections, effectively anchoring inflation expectations, and creating space for the private sector, could prove to be a much more difficult task than appreciated.

Government borrowing requirements are not the only source of liquidity pressures. With a gradually rising external current account deficit and consistently declining foreign inflows, the SBP's foreign exchange reserves are on a declining path. During the first eight months of FY12, the external current account deficit was $3 billion while the net capital and financial account receipts were only $187 million. Not surprisingly, SBP's liquid foreign exchange reserves have declined to $11.8 billion by end-March 2012 from $14.8 billion at end-June 2011. These external sector developments are exerting downward pressure on rupee liquidity as indicated by a 21.4 percent year-on year decline in Net Foreign Assets (NFA) of the banking system by end-March 2012. Thus, some rupee liquidity injection and increase in reserve money is required to facilitate normal transactions taking place in the economy.

Further, SBP's operational monetary management framework sets the short term interest rate or the price of liquidity based on broad macroeconomic considerations such as likely inflation path relative to the announced target. The requirement of liquidity and thus growth in reserve money is residually determined and provided to ensure smooth functioning of financial markets. The SBP cannot simultaneously set both the interest rates and money growth. The challenge is if the underlying behaviour of a significant user of money does not respond to interest rate signals, then monetary policy would become ineffective in achieving its objectives.

Given substantial external debt payments, declining trend of export quantum, elevated international oil prices, and weak financial inflows, the external position is likely to remain under pressure in the remaining part of FY12 and FY13. Similarly, provisional financing data indicate that the fiscal deficit may have reached 4.3 percent of GDP during the first nine months of FY12. Given the last quarter seasonality, a substantial slippage compared to the revised target of 4.7 of GDP cannot be ruled out. Both these developments would have implications for variables that concern monetary policy such as inflation expectations, liquidity pressures, and private investment. In terms of solutions, the economy needs deep and decisive fiscal and energy sector reforms and an early realization of planned foreign financial inflows to mitigate uncertainty.

Another area of reform is to improve financial deepening and competition in the banking system. In this vein, SBP has already been encouraging depositors to put their savings in government securities through Investor's Portfolio Securities (IPS) accounts. Among other objectives, this is expected to lead to better returns on deposits over time. Moreover, in May 2008, SBP introduced a minimum 5 percent floor on all categories of Savings/PLS Saving Products. Consequently, average deposit rate of all saving related products increased from 2.1 percent to 5.25 percent, with no significant change thereafter. The saving deposits category now account for 38 percent of all bank deposits and 52 percent of total number of deposit accounts.

It was the expectation of SBP that these deposits will respond to market forces and adjust accordingly. The rigidity of the deposit rates, especially for small savers, is adversely impacting the savings-investment ratio of the economy. A more balanced risk-reward incentive structure is warranted in the shape of appropriate deposit rate structure, as the savers, especially the smaller ones, need to be adequately compensated. Therefore, it has been decided that, effective 1st May 2012, all Banks are required to pay a minimum Profit Rate of 6.0 percent on PKR Saving/PLS Saving Products. At the same time, given the overall macroeconomic conditions, the Central Board of Directors has decided to keep the policy rate unchanged at 12 percent.