STATE BANK OF PAKISTAN

MONETARY POLICY DECISION
21st June 2013

There has been a discernible positive change in sentiments post May 2013 elections because of clarity on the political front. The change in the behavior of banks in auctions of government securities and reaction of stock market are two examples. Importantly, there has been a considerable improvement in SBP conducted surveys of consumer confidence, expected economic conditions, and inflation expectations. The absence of foreign financial inflows and high fiscal borrowings from the banking system, however, remain formidable economic challenges, especially for monetary policy. Similarly, power shortages and security conditions continue to be strong impediments to growth.

An almost continuous and broad based deceleration in inflation over the last year has had a favorable impact on inflation outlook – a key variable in monetary policy decisions. In May 2013, the year-on-year CPI inflation was 5.1 percent while trimmed measure of core inflation was 6.7 percent; the lowest levels since October 2009. The average CPI inflation for FY13 is expected to be at least two percentage points below the target of 9.5 percent.

However, in the latest budget the government has announced an increase of 1 percentage point in the General Sales Tax (GST), from 16 percent to 17 percent, and changes in the tax structure for some goods and services. In addition, the government is considering a phase-wise upward adjustment in electricity tariff. The exact magnitude and timing of this adjustment is yet to be decided. Therefore, there is a risk that average inflation for FY14 could exceed the announced target of 8 percent for the year. However, aggregate demand in the economy is expected to remain moderate, which could have a dampening effect on inflation.

A reflection of the current declining trend in inflation can be seen in the muted real economic activity, especially private investment expenditures. Beset by energy shortages and law and order conditions, the GDP growth has struggled to ameliorate in the last few years and this year was no exception. The provisional estimate of GDP growth for FY13 is 3.6 percent, which is lower than the 4.3 percent target for the year. Similarly, private fixed capital formation has decreased by 1.8 percent – the fifth consecutive year of a declining trend. Although there has been an encouraging uptick in the growth of Large Scale Manufacturing (LSM) sector, 4.8 percent in April 2013, it is too early to term it as an emerging trend.

A declining inflation trend and below potential GDP growth make a case for further reduction in the policy rate. The argument is twofold. First, the SBP has been giving a relatively high priority to inflation in its monetary policy decisions over the last few years. Thus, continuing to do so would indicate consistency in the monetary policy stance. Second, without further reduction in the policy rate, the real interest rate – policy rate minus expected inflation – would increase due to declining inflation. High real interest rates are not helpful for supporting private investment in the economy.

However, as indicated in the last monetary policy decision, the current balance of payments position and a structural imbalance in fiscal accounts suggest vigilance. The stress in the balance of payments position was a prime consideration in maintaining the policy rate at 9.5 percent in the last two monetary policy decisions. The basic argument has been that the return on rupee denominated assets needs to be sufficiently attractive to discourage speculative demand for dollars.

There is no significant revision in the assessment of the balance of payments position since the last monetary policy decision. The external current account deficit is expected to remain manageable, around 1 percent of GDP for FY13, signifying very low risk from this source for the external accounts. The real challenge continues to emanate from the lack of financial inflows. Let alone finance the small current account deficit, there has been a cumulative net capital and financial outflow of $143 million during the first eleven months of the current fiscal year. Add to this the on-going payments of IMF loans and it becomes clear that the pressure on foreign exchange reserves has not abated. As of 14th June 2013, SBP's foreign exchange reserves stand at $6.2 billion.

There are two developments, however, that are worth highlighting. First, there has been a noticeable change in sentiments, as highlighted above, that can potentially have a favorable influence on private financial inflows. Other than the overall economic outlook, investment decisions do take into account the relative political certainty that determines the continuation of economic policies for some time in the future. Second, declining inflation has increased the relative real return on rupee denominated assets. This could provide some room for downward adjustment in nominal returns to cater to broad macroeconomic considerations despite external account concerns.

In this context, a lot depends on the fiscal outlook. The fiscal deficit for FY13 has been estimated to reach 8.8 percent of GDP, which is considerably higher than earlier projections. The source of deviation is structural and well known – low tax revenues due to absence of meaningful tax reforms and continuation of untargeted subsidies without comprehensively addressing the energy sector problems. For FY14, the federal government has announced a provisional estimate of 6.3 percent of GDP.

From the monetary policy perspective, it is the financing pressure of the fiscal position that is the source of stress. Due to almost zero net external financing in FY13, the burden of financing the sizeable deficit of 8.8 percent has fallen disproportionately on domestic sources, in particular the banking system. During 1st July – 7th June, FY13, fiscal borrowings from the banking system for budgetary support were Rs1230 billion, including Rs413 billion from the SBP. The high level of these borrowings has kept an upward pressure on the system's liquidity and thus short term market interest rates and is restraining growth in the private sector credit.

If the economy is to reap the benefits of evolving positive sentiments and lure the domestic as well as foreign investors then implementation of a reform oriented and credible medium term fiscal outlook is essential. On its part, the Central Board of Directors of SBP has decided to place a higher weight to declining inflation and low private sector credit relative to risks to the balance of payments position. Therefore, the policy rate is being reduced by 50 basis points, to 9 percent, with effect from 24th June 2013.