STATE BANK OF PAKISTAN

MONETARY POLICY DECISION
15th March 2014

Almost all major economic indicators have moved in the desired direction over the past few months. Inflation has come down and growth in Large Scale Manufacturing (LSM) has been strong. Similarly, the fiscal deficit has been contained during the first half of the fiscal year while the private sector credit has increased. Moreover, reflecting positive sentiments prevailing in the market, the fiscal authority has been able to borrow long term and rupee has appreciated against the US dollar. Above all, the foreign exchange reserves of SBP, a key source of concern for some time, have increased noticeably.

All-in-all confidence in the economy to rebound seems to have increased. This is visible in a marked improvement in various IBA-SBP survey-based indices capturing consumers' confidence and perceptions of prevailing and expected economic conditions. Despite these positive developments in headline variables, however, the economy still faces many challenges and a pro-active policy effort is required to continue to maintain the momentum.

Increase in SBP's foreign exchange reserves from $3.2 billion at end-January 2014 to $4.6 billion by 7th March 2014 is only a beginning. A substantial and consistent accumulation of reserves is required to reach and maintain an adequate level. Similarly, the net capital and financial flows, $428 million during July – January, FY14, are still considerably lower than the external current account deficit of $2055 million during the same period. A timely materialization of anticipated foreign inflows during Q4-FY14 is likely to improve the overall external position in the coming months. This expected outcome, however, is contingent upon a host of policy actions including an appropriate monetary policy stance.

Concerted structural reforms are required to address the deeper weaknesses in the balance of payments position. Reliance on one-off inflows and foreign loans may provide short-term stability, but share of private financial flows need to increase consistently to achieve long term stability. Similarly, there is a need to reduce trade deficit by improving efficiency and competitiveness of exports and to lower share of imported oil in meeting domestic energy needs. Nevertheless, increase in SBP's foreign exchange reserves has improved market sentiments, dispirited speculators and resulted in an appreciation of rupee viz-a-viz US dollar by 6.0 percent since the last monetary policy announcement on 17th January 2014.

Also playing a role in positively influencing market sentiments is the larger than anticipated decline in CPI inflation. On the back of a month-on-month deceleration in inflation in two of the last three months, the year-on-year inflation has come down to 7.9 percent in February 2014. This is broadly in line with SBP's earlier assessment that pickup in economic activity is more likely to be a reflection of increased utilization of idle productive capacity rather than a marginal increase in aggregate demand. In other words, growth of 6.8 percent in the LSM sector is an indicator of improved aggregate supply, which bodes well for containing inflation. These trends, including exchange rate appreciation, have improved the inflation outlook with a higher likelihood of average inflation remaining within single digits for FY14.

Declining inflation together with rising confidence in the market has helped the fiscal authority in meeting their incremental borrowing needs from the long-term Pakistan Investment Bonds (PIBs) rather than the short-term Treasury Bills (T-bills). However, the stock of fiscal borrowings from SBP (on cash basis), at Rs2669 billion on 7th March 2014, remains at a higher level. Reducing fiscal borrowings from the SBP would also be critical in keeping the growth in Net Domestic Asset (NDA) of SBP within the agreed targets. In this vein, timely materialization of anticipated foreign inflows is an important factor. Not only will it help in the accumulation of foreign exchange reserves but also in keeping key monetary aggregates on a desired path.

Based on these considerations, the SBP's Board of Directors has decided to keep the policy rate unchanged at 10.0 percent.