Monetary Policy Decision
20th September 2014

The post July monetary policy decision period continued to witness stable macroeconomic conditions. This was most visible in the headline variable of inflation that declined to 7.0 percent YoY in August 2014, which is its lowest level since June 2013. Moreover, after recording an improved 4.1 percent growth rate in FY14, real economic activity is expected to continue in FY15. The other highlight of this stability is the gains on fiscal liberalization: shrinking budget deficits, contained government borrowings, and improved debt profile.

Following on the actual number of 8.6 percent in FY14, the average CPI inflation during Jul-Aug 2014 is recorded at 7.4 percent. This declining trend is broad based since both measures of core inflation, Non-Food Non-Energy (NFNE) and trimmed mean, also decelerated YoY to 7.8 percent and 7.14 percent in August 2014 as compared to 8.7 percent and 7.9 percent in June 2014, respectively. Although actual low inflation might weigh positively on market sentiments, it is the future path of inflation that matters for monetary policy decision. The current outlook of around 8 percent average CPI inflation for FY15 might change adversely if the subsidy to electricity is cut and Gas Infrastructure Development Cess is levied.

After demonstrating low growth since 2008, real economic activity started to show signs of revival in FY14. Continuation of the current growth momentum, however, primarily hinges on agriculture production in FY15. This is because Large Scale Manufacturing (LSM) growth might remain constrained due to continued energy shortages; reduced production capacity of independent power plants; low supply of gas to fertilizer plants; lower domestic and international prices in the sugar sector; and higher inventories and slower exports growth prospects in food and textile sectors, respectively.

Incorporating the latest trends in exports and imports, oil payments in particular, trade deficit is going to dominate the composition of external current account deficit, even with a healthy growth in workers' remittances. Declining private capital inflows, foreign direct investments in particular, would present continued challenges in managing the balance-of-payments position. In this regard, realization of expected privatization receipts and issuance of dollar-denominated Eurobond/Sukuks would be important.

In addition to the risks identified above, ongoing political impasse, delay in the finalization of fourth IMF review, and the current heavy rains and floods, which have engulfed central and southern Punjab, threaten the nascent recovery in economic activity. The former two would weigh more on the private capital inflows. The latter can potentially disrupt the output and supply chain of the perishable food items, which challenges an otherwise benign inflationary outlook. While it is going to take some time before the full extent of damages arrive, initial opinions and past experiences suggest that the current floods would damage some *khariff* crops and may disrupt supply chain temporarily. Besides having implications for economic growth, floods can also create macroeconomic imbalances by putting pressures on fiscal and external sector. Moreover, supply of loanable funds in the credit to private sector market may also be adversely affected, at least initially. Reflecting these apprehensions indeed, there is deterioration in SBP-IBA's Consumer Confidence Survey of September 2014 as well.

Policy vigilance requires balancing the tradeoffs between ensuring the continuation of macroeconomic stability, especially in the external sector, and assuaging the fallout of potential damages due to floods. Therefore, the Board of Directors, State Bank of Pakistan, has decided to keep the policy rate unchanged at 10 percent.