



# STATE BANK OF PAKISTAN

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## Monetary Policy Statement

May 23, 2015

Macroeconomic conditions towards the end of FY15 have further improved compared to the beginning of the fiscal year. Current account deficit has narrowed down; average annual inflation is significantly below the target; there is a marginal uptick in real GDP growth; and foreign exchange reserve buildup continues. All these developments were reflected in the recent upgrades in outlook by international rating agencies that have further improved investor confidence. The current macroeconomic stability achieved through domestic policies and favorable external developments provide an opportunity to focus on reforms that will put the economy on sustainable growth path.

With contraction in imports, led by sharp decline in oil prices, and strong growth in remittances, the external current account deficit at \$1.4 billion during Jul-Apr FY15 is around half of the deficit recorded in the corresponding period of last year. The improvement has overshadowed lower surplus in capital and financial account, especially weak foreign private investment. Overall, this has supported the reserve building efforts with net SBP reserves rising from \$9.1 billion as of 30<sup>th</sup> June 2014 to \$12.5 billion as of 15<sup>th</sup> May 2015. They are expected to increase further due to subdued outlook of international oil prices, successful continuation of IMF program, and realization of expected official foreign inflows. Increase in foreign private inflows can further strengthen this outlook and sustain stability in the foreign exchange market.

The inflation continues with its downward trajectory in this fiscal year. The year-on-year CPI inflation has declined to 2.1 percent in April 2015 from 8.2 percent in June 2014. The decline in inflation during the current fiscal year has been broad based as all the headline and underlying measures of inflation have recorded deceleration. Soft international commodity prices, stability in exchange rate, contained government borrowings from SBP, moderate aggregate demand, and SBP's earlier conservative monetary policy stance have remained the key factors in controlling inflation this year. Going forward, continuation of inflation at lower levels is reflected in the latest IBA-SBP survey of May 2015 that reports subdued inflation expectations. However, uncertainty about international oil prices and possible adjustment in domestic energy prices are the main risks to this inflation outlook.

Credit growth during Jul-Mar FY15 has remained well diversified in terms of coverage and type of finance. All three sectors of the economy – agriculture, manufacturing and services – availed credit both for working capital and for fixed investment purposes. The highlight remains the loans to private sector businesses in fixed investment category that increased to Rs84.4 billion in Jul-Mar FY15 from Rs50.3 billion in the same period of last year. However, owing largely to decrease in commodity prices, loans in the working capital category dropped to Rs90.3 billion



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in Jul-Mar FY15 from Rs223.8 billion in the same period of FY14. Improving investor confidence, buoyant construction activity, continuous stability of the banking system, and the recent monetary easing are expected to positively impact credit uptake in the coming months.

Broad money (M2) has expanded by 7.3 percent during July 01-May 08, FY15 against 7.0 percent during the same period last year. Importantly, the contribution of Net Foreign Assets in the expansion of M2 continues to remain substantial. This has favorably impacted the Net Domestic Assets-to-Net Foreign Assets ratio. The favorable improvement in this ratio is expected to continue with the availability of anticipated external flows. M2 is likely to grow within the safe limits; consistent with the inflationary outlook.

After remaining tight during most of the current fiscal year, liquidity conditions at the back of overall improvement in balance of payments have relatively eased towards the end of FY15. The money market overnight repo rate, on average, remained 49 basis points below the SBP's policy rate in the post March 2015 monetary policy decision compared to 33 basis points in the post January 2015 decision. These developments bode well for the smooth transmission of policy rate changes to other market interest rates in addition to the implementation of the revised interest rate corridor framework. In line with monetary policy stance, market interest rates have fallen since January 2015. With current trends in key macroeconomic variables, money market liquidity is expected to remain at ease in the coming months.

Real GDP is provisionally estimated to have grown by 4.2 percent in FY15, slightly higher than 4.0 percent in FY14. Overcoming energy shortages and improving law and order conditions is expected to provide further impetus in reviving investment and higher production. Gradual realization of planned investment in energy and infrastructure projects will provide additional boost to growth. Consequently, growth is expected to be revived at a relatively faster pace going forward.

Given the above macroeconomic considerations, SBP Board of Directors has taken the following decisions effective from 25<sup>th</sup> May 2015:

1. Ceiling rate of the interest rate corridor is reduced by 100 basis points from 8.0 percent to 7.0 percent.
2. A new "SBP target rate" is set at 50 basis points below the ceiling rate. SBP will ensure that the overnight rate remains close to this target rate. This will be the main Policy Rate of SBP.
3. Width of the interest rate corridor is reduced by 50 basis points from 250 to 200 basis points. Consequently, the floor rate is set at 5.0 percent.