STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

24th May 2010

The economy is recovering but it lacks the necessary infrastructure and sufficient macroeconomic stability to build on the momentum. Stabilization efforts over the last one and a half year have brought dividends in the shape of contraction in the external current account deficit, containment of excessive money growth, and reduction in inflation. However, the worsening power crisis, which has severely hampered economic activity in the economy, and fiscal weaknesses, continue to impede sustainable recovery and comprehensive macroeconomic stability. At the same time, inflation has started to increase gradually. In this scenario, monetary policy, being a stabilization tool, has to remain focused on its ultimate target of monetary and financial stability.

Encouraged by an increase in exports, over $1.8 billion in each of the last two months, supported by steady workers' remittances, and helped by the realization of $656 million from the Coalition Support Fund (CSF) in May 2010, the external current account deficit will be close to 2.5 percent of GDP for FY10. The variables of concern, however, are uncertain official foreign flows and declining Foreign Direct Investments (FDI). Thus, despite a significant contraction in the external current account deficit, $3.1 billion during July-April, FY10, SBP's foreign exchange reserves have largely remained unchanged, around $11.5 billion on average, during the course of the current fiscal year. With an expected export and import to GDP ratios of 10.5 and 17 percent for FY11, keeping SBP's foreign exchange reserves stable in the medium term without a discernable increase in financial inflows would be challenging. Moreover, since the financial inflows are, and expected to remain, heavily skewed in favour of borrowings, sustainability of external debt would require a manageable current account deficit and dependable financial inflows.

A positive implication of the strengthened balance of payment position is a gradual build-up in the Net Foreign Asset (NFA) component of broad money. After experiencing an outflow of Rs150 billion in FY09, NFA now shows an inflow of Rs90 billion during July 1 – May 14, FY10. This has facilitated market liquidity; although most of the increase in NFA took place in Q1-FY10. SBP's Open Market Operations provided the necessary support to adequately manage the market liquidity from September 2009 onwards. More importantly, this 'correction' in the components of M2, in favour of NFA, has helped purchasing power of the rupee in the domestic economy and in the foreign exchange market. For instance, the ratio of outstanding stocks of Net Domestic Assets (NDA) to NFA has come down from a high of 14 in November 2008, when inflation peaked at 25 percent, to around 8.4 by end-April 2010.

The NDA continues to be driven by government's borrowings for budgetary support. In fact, for Q3-FY10, government breached its quarterly borrowing limits from SBP by about Rs30 billion. Since the beginning of Q4-FY10, government borrowing has increased by another Rs150 billion, reaching Rs1310 billion (on cash basis) on 14 May 2010 against the end-June target of Rs1130 billion. Similarly, government borrowing (net of deposits) of Rs206 billion from scheduled banks during July 1 – May 14, FY10 is also substantial. This persistent borrowing from the banking system for budgetary support coupled with expected borrowings for commodity operations in Q4-FY10 is jeopardizing the space for private sector credit, causing inertia in market interest rates, running the risk of excess domestic credit creation, and increasing the debt burden of future generations.

The need for heavy government borrowings for budgetary support from the banking system emanates from the unsustainable equation of revenues and expenditures and uncertain external borrowings of the fiscal authority. The Federal Bureau of Revenue's (FBR) provisional tax collection figures, during the first ten months of the current fiscal year, were Rs1026 billion. This implies that, to meet the yearly target of Rs1380 billion, a collection of another Rs354 billion is required in the next two months. This would be quite challenging given a monthly average of Rs102 billion in the last ten months. Even if the target is met, the FBR tax-GDP ratio is likely to be less than 10 percent, which is one of the lowest in the world. There is a risk that the government may miss the revised fiscal deficit target of 5.1 percent of GDP, which will be inconsistent with the objectives of macroeconomic stability. Moreover, further deterioration of the fiscal account will have consequences for debt sustainability and the external balances.

For medium term fiscal sustainability, necessary for overall macroeconomic stability, it is of utmost importance that effective measures are taken to increase the tax-GDP ratio and reduce the current expenditures of the government. Revenue deficit, the difference between total revenues and current expenditure, must be brought down to zero as stipulated in the Fiscal Responsibility and Debt Limitation (FRDL) Act of 2005. It was 1.5 percent of GDP in FY09 and may cross 2 percent of the expected GDP in FY10. Cutting development expenditures may provide immediate relief but damages the prospects of much needed investment in infrastructure such as electricity generation and human capital. This, in turn, limits the future productive capacity of the economy and adversely affects the inflation outlook as the gap between aggregate demand and aggregate supply widens.

All inflation indicators, whether it is Consumer Price Index (CPI), Wholesale Price Index (WPI), Sensitive Price Index (SPI), or Non-food Non-energy (NFNE) and trimmed measures of core inflation, have shown an upward movement in recent months. The year-on-year CPI inflation, for instance, was recorded at 13.3 percent for the month of April with a month-on-month growth of 1.7 percent. While adjustments in electricity prices, increase in domestic prices of petroleum products, and volatile movements in various food items have given a spurt to inflation, its persistence at a high level indicates that a fall in productivity has played a role as well. This signifies an entrenchment of expectations of double digit inflation, which must be checked to improve the prospects of sustainable economic growth.

The cumulative growth of 4.4 percent in Large Scale Manufacturing (LSM) during July-March, FY10 is encouraging. However, its sustainability would require supportive growth in private sector credit and improvement in the availability of electricity. The former would be difficult to achieve without reduction in the scale of fiscal and public sector borrowings from the banking system and the latter requires forward looking infrastructure investment and resolution of energy sector circular debt.

In these circumstances, with inflation on the rise and the fiscal position not responding to the current monetary policy stance, SBP will closely monitor developments to ensure stability of aggregate prices and support nascent recovery of private economic activity. Therefore, SBP has decided to maintain the policy discount rate at 12.5 percent.