STATE BANK OF PAKISTAN

Monetary Policy Decision — 24th November 2009

SBP's policy rate to be cut by 50 bps

A cursory look at key macroeconomic indicators shows substantial improvements on multiple fronts. Inflation (YoY) has fallen to 8.9 percent in October 2009 and is expected to remain in the vicinity of 11 percent by the end of current fiscal year. External current account has improved considerably, positively altering its projected trajectory. With government borrowings from the SBP remaining within the quarterly limits, the broad money (M2) has also remained contained along the projected path. The real sector is also showing signs of improvement as the large scale manufacturing (LSM) stage a recovery after a protracted declining phase. However, a close inspection of these encouraging developments together with a pragmatic assessment of prevailing security situation in the country and fiscal uncertainties invite caution and further analysis.

Recent month-on-month inflation changes in headline and core measures continue to be volatile and on the higher side, oscillating between 0.5 and 1.7 percent in case of the former and remaining stuck at 0.8 percent in case of the later. A reassuring fact is that the number of items in the CPI basket showing higher monthly increases relative to an historical benchmark has come down significantly. However, at the same time, the number of items displaying significant inflation persistence has also increased, which indicates the probable entrenchment of second round effects of inflationary process. The poor administration in the supply chain of some food items is not helpful either in positively altering inflation expectations. A higher than projected fiscal deficit for FY09 has also changed some underlying assumptions for inflation outlook in FY10. In addition, the full impact of electricity and gas price adjustments, a necessary part of fiscal consolidation measures, and recent resurgence of international commodity prices, on the back of early signs of global economic recovery, remains a source of uncertainty for inflation outlook.

Apart from influencing commodity prices, the recovering global economy is expected to revive global trade and flow of liquidity across borders, which bodes well for Pakistan's exports and private financial flows. The recent strong inflow of workers' remittances and a substantially improved external current account deficit of $1.1 billion in the first four months of FY10 may allow Pakistan's economy to absorb the likely swelling of import bill induced by a nascent domestic recovery and higher international oil prices. However, the strength and sustainability of its overall balance of payments crucially depends on resumption of foreign financial flows. Of these, portfolio inflows have picked up, direct investment has fallen, and official inflows, other than IMF, remain lower compared to projections. Looking forward, the magnitude and timing of expected non-IMF foreign inflows remain uncertain and could increase the challenges of SBP's liquidity management and government's budgetary financing.

Public sector's steady borrowing requirements have the potential to raise the Net Domestic Assets (NDA) of the banking system. Though broadly respecting the pre-announced T-bill auction targets, Ministry of Finance (MoF) has realized Rs91 billion for budgetary support against maturities of Rs37 billion in the four auctions held so far in Q2-FY10. Moreover, retirement of earlier borrowings for wheat procurement has been less than expected and to some extent neutralized by fresh borrowings for other commodities like rice, sugar, and fertilizer. Moreover, the credit availed by public sector enterprises continues to increase as well.

Although the cumulative flow of credit to private sector during the first nineteen weeks of FY10 shows retirement of Rs3 billion, it has increased significantly in the past seven weeks (Rs92 billion). This is in consonance with the improved performance of Large Scale Manufacturing (LSM) sector in the first two months of FY10; 0.5 percent growth compared to negative 5.7 percent in the corresponding period of last year. Given the expected improvement in supply of electricity and likely increase in global demand, private sector credit may increase further. Sustained increases in the private sector credit would depend on the extent of risk averseness by banks, scale of public sector's pre-emption of limited funding sources, and fresh injection of liquidity through a gradual build up in NFA of the banking system.

In conclusion, the overall level of risk and uncertainty in the economy has increased considerably given the present law and order situation. As a consequence, the pressure on the fiscal position, especially from the financing side, has escalated and growth in the real economy is limited. Striking a balance between monetary and financial stability and real economic activity has become increasingly difficult. In this perspective, SBP has decided to support the recovering real economic activity while keeping a very close watch on developments concerning the macroeconomic stability in the next two months. Therefore, effective 25th November, 2009, the SBP policy rate will be lowered by 50 bps to 12.5 percent.