STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

29th September 2009

Macroeconomic considerations and outlook that influence monetary policy decision depict a mix picture. While inflation (YoY) and balance of payment position has improved, fiscal and real sector performance remains tenuous. Domestic financial markets functioned adequately but lending to the private sector has remained subdued. From a forward looking perspective, expected improvement in the external current account and emerging global economic recovery augur well for Pakistan's economy. But, limited progress on electricity shortages and stressed fiscal position dilute some of the optimism. Similarly, inflation outlook is not completely benign yet as depicted by recent monthly trends. Under these circumstances, assessment of balance of risks continues to be somewhat uncertain.

Both CPI and core inflation have declined further in August 2009, with former at 10.7 percent and Non food Non energy (NFNE) measure of the latter at 12.6 percent on year-on-year basis. But, the pace of decline in inflation was less than expected. The monthly increase of over 1.5 percent in CPI inflation in the first two months of FY10 is still quite high and of concern. This monthly increase coupled with administrative issues in the supply chain of food items and projected increases in electricity prices to eliminate subsidies could have a bearing on the behaviour of domestic inflation in the coming months. Increase in international oil prices remains an underlying risk to inflation as well.

However, the likely presence of Ramadan seasonality in the CPI index, especially the food basket, and disproportionate contribution of only a few items calls for caution in interpreting recent monthly inflation indicators. Similarly, the effect of cost push shocks like electricity and oil on inflation may be neutralized by below capacity economic activity and slow aggregate demand. Moreover, expectations of inflation are likely to remain in check while the stabilization program remains on track. While it is likely that inflation will continue its secular decline, as observed in our last communication, there are risks to watch as we go forward.

Tapering aggregate demand pressures in the economy can be clearly seen in persistent and widespread decline in imports. Supported by continued strong inflow of worker's remittances, this fall in import growth has resulted in a modest surplus of $82 million in the external current account for August 2009. Even the cumulative July-August, FY10 external current account deficit of $527 million is much lower than earlier projections.

Similarly, on the back of favourable revisions regarding outlook of Pakistan's economy by international rating agencies, portfolio inflows are now positive; $55 million in the first two months of FY10. This, together with inflows from the IMF, both for budgetary support ($745 million) and allocation of increased Special Drawing Rights (around $1200 million), and adequate, though lower, foreign direct investments substantially improved the external financial account. Resultantly, the SBP's foreign exchange reserves have increased to $10.9 billion as on 28th September, 2009 – an improvement of $1.8 billion since the beginning of FY10 – and is reflected in Rs123.6 billion increase in the Net Foreign

Assets (NFA) during 1st July – 19th September, 2009. This has helped liquidity conditions in the economy and translated into bringing stability to the foreign exchange market.

This improvement in balance of payments is despite a significant shortfall in non-IMF official financial inflows. Non realization or shortfall in these official inflows could pose a potential problem for fiscal management, which faces significant pressure on both the expenditure and revenue side of the budget and has already posted a fiscal deficit of 5.2 percent of GDP for FY09 – 0.9 percentage points higher than the targeted level.

Provisional figure of Rs106.6 billion government borrowing from the SBP during 1st July – 19th September, FY10 also indicate the extent of fiscal position's weakness in the current quarter. This borrowing was despite the fact that Ministry of Finance realized Rs333 billion in the six Q1-FY10 T-bill auctions while adhering to an advance auction target of Rs325 billion for the quarter. However, this financing pressure along with recent uptick in market interest rates and liquidity tightness is largely cyclical and is mostly due to the month of Ramadan and Eid festival. Likely reversal of these phenomena along with the retirement of wheat financing and improvement in external flows is expected to improve the market liquidity in the coming months and flow of credit to the private sector.

Sustainable recovery of real sector of the economy would not be possible without revival of business environment and availability of credit to private sector, which in turn depends on the elimination of electricity shortages among other factors. Moreover, stagnant private sector investment can hurt the potential output of the economy, adversely impacting inflation persistence. However, recent steps taken towards resolution of the circular debt issue could lead to the resumption of private sector credit in the coming months.

In conclusion, there are some risks to inflation while the economy gradually stabilizes. Moreover, uncertainty regarding the outcome of ongoing fiscal consolidation, resolution of electricity problem, and timing of official foreign inflows call for prudence at this point. **Therefore, there will be no change in the SBP's policy rate, which will remain at 13 percent.** These issues are likely to determine SBP's policy trajectory in the coming months.

Progressing further on the formation of the Monetary Policy Committee (MPC), Central Board of Directors of SBP has finalized the composition of this nine member committee. In addition to the Governor of the SBP, Syed Salim Raza, and Deputy Governor, Yaseen Anwar, three SBP executives – Riaz Riazuddin (economic advisor), Asad Qureshi (executive director, financial markets and reserve management), and Hamza Ali Malik (director, monetary policy department) – will be the internal members. Board of Directors of SBP will be represented by Mirza Qamar Beg and Tariq Sayeed Saigol while Hafiz Pasha and Shahid Kardar will join as external members. This committee will start its deliberations in November 2009. To harmonize the constitution of MPC with the legal framework of SBP and make it fully independent, amendments in the SBP Act have already been submitted for the legislative process. Until their enactment, the MPC will seek approval of its recommendations from the Board of Directors of the SBP.