STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

29th November 2010

The economy's ability to achieve sustainable recovery remains constrained owing to slow progress in the prevailing security and economic conditions. The key economic variables impeding stabilization and thereby growth are high and persistent inflation, continuing fiscal slippages and unresolved power sector issues. Whereas adjustments in administered prices of fuel and energy and the post-flood disruption in the supply chain of food items have contributed to the recent upsurge in inflation, the high level of government borrowing from the SBP is diluting the effectiveness of monetary policy in containing excessive monetary expansion and thus inflation. The need for such borrowing is largely emanating from a seemingly difficult fiscal predicament. While rising security and flood-related expenditures and continued power sector subsidies are one aspect of the problem, a narrow tax base and a declining tax to GDP ratio are bigger issues magnifying the fiscal challenges. The cost to the economy is being paid through erosion in the purchasing power of the rupee, growing total debt, and discouragement of productive private sector activity.

High inflation, at a fundamental level, persists because of money creation in excess of productive activity in the economy. Of the Rs308 billion expansion in reserve money up till 19th November 2010 during the current fiscal year, Rs266 billion is due to government borrowing from the SBP, which has been on an increasing trend since January 2010. Such borrowing has stoked expectations of increasing inflation, resulting in high interest rates. The nature of this fiscal expansion is the fundamental source of high inflation in Pakistan over the last year.

Increases in electricity and domestic petroleum prices and the impact of the catastrophic floods on food prices did play their part in providing impetus to CPI inflation but do not fully explain the persistence in inflation. Further, apprehensions that these supply shocks would dramatically worsen the inflation outlook have thus far not fully materialized. Temporary price hikes in the food category, as seen in a monthly increase of over 5 percent during August and September 2010, have somewhat subsided. As a result, in Oct 2010, CPI inflation posted a marginal decline of 0.4 percent on year-on-year basis, while a 0.6 percent growth on month-on-month basis was well below the last 12 month's average.

On the other hand, the persistent component of inflation, proxied by core trimmed inflation, remains sticky at over 12.5 percent on year-on-year basis since January 2010 and has increased to a 1 percent monthly change in October 2010, with expectations of further increases. An important source of this stickiness is the expectations of a persistent reliance of the government on SBP to finance its deficit. Indeed, the co-movement between persistence of inflation and that of government's financing gap is no coincidence. Therefore, it would be difficult to bring inflation down unless government borrowing from SBP is curtailed substantially and kept under control on a sustained basis.

Government borrowing from SBP at an increasing rate reflects severe fiscal vulnerabilities. Given the delays in the introduction of tax reforms and weak industrial production, the task of achieving close to 27 percent enhancement in tax revenues during FY11 is beginning to look quite ambitious. To increase its capacity to raise revenues and contain inflationary borrowings from SBP within an explicit and clearly defined limit, the government has shown its intention to: i)- widen the tax net through introduction of the Reformed General Sales Tax (RGST) along with other tax measures; ii)- effectively contain the power sector subsidies; and, iii)- amend the SBP Act, including explicit limits on government borrowings from SBP, which is now in the final stage of legislation. Together, these could potentially address the problem in the medium term of stubbornly high inflation expectations, reduce the cost of borrowing, and hence pave the way for long term economic growth. However, it may take some time before the benefits of such important measures, after their implementation, begin to have their impact.

In the mean time, pressing flood-related expenditures and shortfalls in external financing of the budget have increased reliance of the government on domestic sources. The seasonal increase in the working capital credit requirements of the private sector during the second quarter is also higher on the margin due to higher input prices. Consequently, pressure on the banking system and interest rates has increased. With low growth in the banking system Net Foreign Assets (NFA) and deposits, liquidity management has also become challenging. Therefore, to further encourage the private sector, fiscal authorities need to demonstrate greater resolve in implementing their strategy to contain the fiscal deficit through fundamental structural reforms and their commitment to restrict inflationary central bank borrowings. However, the recent rejection of the two PIB auctions in Q1-FY11 and acceptance of Rs50 billion instead of the Rs90 billion offered by the banks in the 16th November 2010 T-bill auction is apparently inconsistent with the stated intentions.

Assuming a real GDP growth of 2.5 percent and that the expected decline in private and public sector investment expenditures would be largely compensated by increases in public sector consumption expenditures, the external current account deficit is likely to be narrower in FY11 than earlier projections of 3.5 percent. Helped by higher cotton prices, the export earnings of $7.1 billion during first four months of the current fiscal year seem fairly encouraging. Similarly, the recent trends in remittances coupled with expectations of realization of Coalition Support Fund (CSF) receipts could prove to be quite helpful in meeting import and other payments. The real test, however, would continue to be in the financing of the external current account deficit. Assuming that the projected external official inflows for FY11 do materialize, a substantial growth in private foreign inflows would be required to maintain and build foreign exchange reserves.

Monetary policy is essentially a short term instrument with which emerging risks and uncertainties are managed. The impact of monetary policy on economic activity and inflation is indirect and operates with a lag, and unlike the case of fiscal policy that tends to be reactive, it has to be proactive. Under the present circumstances, if the expansionary fiscal position is not expected to translate into a high external current account deficit during the current fiscal year then it could be the case that the private sector demand is muted. Therefore, the monetary policy stance could probably remain unchanged. However, inflation is rising and showing persistence because of relentless government borrowing from the SBP. The rising NDA to NFA ratio of SBP balance sheet and its strong association with CPI inflation also suggest that inflation is likely to persist at double digit levels during much of FY11 and possibly in FY12. SBP's efforts to counterbalance the rapid expansion in reserve money and arrest the rising inflation expectations would require an increase in the policy rate. After careful consideration of this trade-off, SBP has decided to increase the policy rate by 50 basis points to 14 percent with effect from 30th November, 2010.

A principled decision has also been taken to strictly implement the revised limits on borrowings of the provinces from SBP, even if it involves stopping payments to the provincial governments. SBP believes that the entire responsibility of tackling macroeconomic problems has been unfairly placed on monetary policy only. SBP also understands that the burden of this monetary tightening is being borne largely by the private sector, as it gets crowded out by the excesses of government borrowing for budgetary purposes and commodity operations, with all its adverse implications for sustainable economic growth.