Monetary Policy Statement for Jul-Dec 2006

This statement is based on information received up to July 27, 2006

Highlights

- *State Bank and the Government of Pakistan have managed to achieve a fair degree of success in containing inflationary pressures with average increase in consumer price index close to annual FY06 target of 8 percent.*

- *Money supply growth for FY06, while higher than target, remained well contained and much below average broad money (M2) growth of the last few years.*

- *Real GDP growth target of 7 percent for FY07 set by government seems achievable as strong aggregate demand lends confidence that investment and capacity expansion will gain further momentum in the economy.*

- *Balance of risk has tilted towards managing domestic and external imbalances effectively and curbing inflationary pressures.*

- *Though inflation decelerated, the need to reduce volatility and achieve further reduction in inflation rate to 6.5 percent (FY07 target) underscores need for continued effective economic management.*

- *Meeting investment requirements of growing productive sector is assigned high priority by SBP that recently offered special financing incentives for textiles and exports, and has underscored need for diverse sector requirements, while keeping risk exposure tightly within limits.*

- *Most critical will be the need to diversify the source of domestic borrowings to keep central bank financing within manageable limits by, among others, issuing long-term debt which would set a benchmark for catalyzing corporate debt.*

- *Banks have been incentivized through recent change in cash reserve requirement/statutory liquidity requirement (CRR/SLR) to improve returns to depositors, and tighten their internal control systems, while managing their exposures effectively.*

- *SBP is further tightening its monetary policy by raising its policy rate (SBP 3-day Repo Rate) from 9 percent by 50 basis points to 9.5 percent.*

- *These measures coupled with effective consultations between the State Bank and Ministry of Finance on the level and mix of domestic borrowings lends confidence that money supply growth will be contained and aligned to the nominal GDP growth in FY07.*

1. *Executive Summary*

1. The SBP has an explicit dual mandate to ensure price stability and promote growth. Since FY01, with inflation at very low levels, monetary policy had greater bias towards supporting growth. With the inflationary pressures building up, from early-FY05 monetary policy stance has squarely tilted towards inflation containment.

2. Over FY06 and earlier, the firm steps taken to tighten monetary policy along with the Government's administrative measures have helped scale down the inflation rate (YoY) by 3.5 percentage points by June 2006 relative to April 2005. The decline in average inflation rate to 7.9 percent also helped achieve the inflation target with the contribution of monetary policy more evident in decline of the core inflation. Reducing inflation further in too short a period would have substantially hurt growth prospects. Supported by the strong private sector credit growth, the real GDP growth grew by 6.6 percent, which even though slightly below target, captures the growth momentum trend set in.

3. The monetary environment is becoming increasingly challenging. Despite the forecast for a continuation of strong global growth, inflation outlook is uncertain with output gaps closing in many economies and the continued rise in oil and other commodity prices. To stave off incipient inflationary expectations and pressures that could mount as the pass through of oil prices is felt more strongly, monetary policy has been further tightened in several countries. In economies where this has resulted in widening of trade imbalances, the burden to take corrective measures has fallen disproportionately on monetary policy and has often required concurrent adjustments in fiscal imbalances. A major challenge for the monetary authorities in many emerging markets is how to avoid policy mistakes that might put macroeconomic and financial stability at risk.

4. In Pakistan's context, monetary policy must now confront a number of challenges emerging from both domestic and international developments.

- The inflation target for FY07 requires a reduction of 1.5 percentage points over FY06, at a time when the incipient inflationary pressures remain high, particularly non-food inflation among others, because of high aggregate demand pressures as well as the pass-through effects of the oil price rise that looms substantially given the geopolitical situation.

- Provisional figures suggest that broad money supply (M2) grew by 15.0 percent in FY06, while this growth was substantially lower than the past few years trend, it was nevertheless higher than the target. Despite monetary tightening, the robust growth in aggregate demand, in particular private sector credit growth in the last quarter was above expectations. Besides the lingering effect of this, the aggregate demand will be further boosted in FY06 by the fiscal stimulus provided by the government to accelerate the much warranted social and infrastructure spending. An expansionary fiscal policy was unavoidable, given the reconstruction requirements of the earthquake struck areas, and the need to build apace on the country's infrastructure and social indicators, but it does mean that the burden of containing aggregate demand, in order to keep inflation in check, must then necessarily fall on monetary policy.

- These economic compulsions call for the government to reflect further on its domestic borrowing strategy to ensure that budget recourse to central bank is curtailed by enhancing reliance on non-bank financing options. Besides helping to mitigate inflationary consequences, this borrowing strategy would help stretch the maturity of domestic borrowings, while ensuring offering market a bench mark to issue long-term papers.

- Challenges for monetary policy are compounded by rising external pressures as the current account deficit is envisaged to widen beyond FY06 level. In order to contain imports it is important to moderate aggregate demand, while to promote exports it is necessary to achieve price stability and help stabilize their costs to ensure Pakistani exports remain competitive. Achieving both of these objectives requires skillful monetary policy management.

5. Effective monetary management over medium term is critical to avoid recourse to other suboptimal or inefficient options. Other options to deal with the rising external current account deficit range from undesirable drawdown in reserves or increased reliance on external borrowing – both of which would aggravate the aggregate demand pressures and compound complications for monetary management. Given the negative impacts on the long-term economic growth of each of these policy options, it seems desirable to ensure a moderation in the aggregate demand through the continuation of a tight monetary policy.

6. Indeed it is precisely the mix of the still-high inflation in the domestic economy (particularly the resilience in non-food inflation) and the growing industrial and export industry demands that underpinned the recent policy moves by the central bank. These include on the one hand measures to dampen the credit growth by (i) enhancing frequency and intensity of open market operations to manage the banking system liquidity while ensuring monetary stability, and (ii) increasing the reserve ratios in July 2006. On the other hand, SBP has taken special measures for industry by allowing liberal access of concessional long-term financing for export oriented projects (LTF-EOP) and lowering the cost of export refinance.

7. The central bank will continue to focus on both of its performance objectives, i.e. price stability and growth during FY07, though the current balance of risk requires greater focus on containing inflation. Therefore it intends to continue with its tight monetary policy during H1-FY07. In line with its mandate, SBP will continue to monitor the risks to the economy elaborated earlier, and stands ready to modify its policies appropriately in order to protect the long-term growth prospects of the economy.