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Dr Akhtar unveils Monetary Policy Statement for first half of FY09

Dr Shamshad Akhtar, Governor State Bank of Pakistan has said that considering the risk related to rising external current account and fiscal deficits and worsening inflation outlook, the central bank has decided to raise its policy rate by 100 basis points to 13 percent effective July 30, 2008 to contain further aggregate demand pressures which are contributing to the inflationary pressures.

Fiscal coordination with the monetary policy stance in particular commitment to scale down Government borrowings from the central bank and to contain import growth is critical to achieve the desired impact of monetary tightening, she said at a press conference at SBP, Karachi this afternoon while unveiling the Monetary Policy Statement for the first half of the current fiscal year 2008-09 (FY09).

She further informed that considering the adverse impact of continued borrowing by the Government from SBP on inflation, the SBP Central Board of Directors resolved that the Government should retire Rs 21 billion in each quarter of FY09.

Dr Akhtar said in order to restore macroeconomic stability there was a need for additional corrective policy actions, both at the Government and central bank level. She said assuming the domestic demand continues to grow at last five-year average of 8.1 percent and the real GDP growth target of 5.5 percent for FY09 is achieved, the difference between domestic demand and supply is expected to widen further.

Therefore, it was of utmost importance to curtail aggregate demand pressures through restraining expenditures in the short run; increase the production capacity of the economy by addressing structural constraints; and improving factor productivity, she added.

Dr Akhtar said that these measures are necessary for ensuring price stability and long term growth on sustainable basis. While it is expected that some of the demand pressures will recede in the current fiscal year, but if the supply side issues are not addressed, the ‘gap’ could remain unchanged and the expected favourable impact on inflation will be diluted, she added.

While outlining outlook for the current 2008-09 fiscal year (FY09), Dr Akhtar stressed that FY09 ought to be a year of consolidation as the new democratic Government has entered FY09 with heavy overhang in the economy of the last year’s macroeconomic imbalances. At the same time, the Government carries the responsibility of fulfilling the aspirations and promises to the nation, she added.

“The trade offs are not easy and global economic environment continues to be fraught with uncertainties though some trends are quite clear: global growth has slowed down, international liquidity squeeze remains and Pakistan sovereign rating prevents tapping international markets, and uptrend in international commodity prices continues, in particular in oil," she added.

SBP Governor pointed out that Government's heavy reliance on SBP borrowings has continued unabated with additional new borrowing of Rs149.8 billion during May 25 to June 30, 2008. Budget for fiscal year 2008/09 estimates put it at 7 percent of GDP, while financing data available to SBP for the full FY08 shows this could be around 8.3 percent of GDP. Within two months of May and June 2008, trade and external current account deficits as percent of GDP widened further by 1.5 percentage points each and exchange rate remained under pressure. In the same period, CPI inflation (YoY), on the back of high International commodity prices and high inflationary borrowing, intensified by 4.3 percentage points. Above all, second-round impact of high food inflation has become embedded in the inflation expectations, she added.

Dr Akhtar said recognizing this; the Government and the central bank have taken pre-emptive policy actions together. Budget for FY09 has been rolled back to 4.7 percent of GDP and Government's committed itself to achieve net zero borrowing during the course of the year, while enhancing its reliance on other nonbank sources. To reinforce further, on 10 June 2008 (ahead of the budget for FY09), SBP advised the Government that the Central Board of Directors recommend net retirement of Rs 84 billion for FY09 with quarterly retirement of Rs21 billion.

She said these limits have been worked out keeping in perspective need for consistency with a coherent macroeconomic framework. Adhering to these commitments and targets will be vital to arrest the drift in macroeconomic imbalances, she said and added imposing hard budgetary constraints further requires that the Government amends the *Fiscal Responsibility and Debt Limitation Act, 2005* to include provisions for recognizing the need to phase out the Government's dependence on SBP borrowings over a period. "This involves adherence to limits imposed on SBP borrowings henceforth, while lowering the stock of SBP borrowings," she stressed.

She also pointed out that inflationary pressures in the economy are alarming as on average basis, headline CPI inflation at 12.0 percent in FY08 was 5.5 percentage points above the target for the year and underlying this non-food inflation more than doubled to 13.8 percent since December 2007. In June 2008, the headline CPI inflation (YoY) reached to a 30-year high of 21.5 percent, while food inflation rose to record high of 32 percent. Strong aggregate demand pressures combined with increased pass-through of the persistent rise in imported oil prices contributed to high domestic inflation. On the domestic front, in addition to the demand pressures, a fall in the productive capacity of the economy is also contributing to rising inflation, she added.

Dr Akhtar underscored the need for a dynamic fiscal framework for FY09 that will incorporate necessary adjustments as economic developments evolve. She said early indications are that the budget deficit target for FY09 of 4.7 percent of GDP is already coming under stress. Aside from the changing oil and exchange rate scenario relative to budgetary assumptions, SBP assessment is that budget underestimates spending and overestimates revenues, she said and added containing expenditure growth at 6.5 percent, given a track record of 20.3 percent average increase during the last five years, seems difficult and the subsidy bill is likely to come under strain unless political pressures are muted. Similarly, realizing the estimated growth in tax revenue at 24 percent seems high given the average growth of only 12.8 percent during the last 5 years. "It must be kept in view that past few years benefited from the high and fairly robust GDP growth (7.0 percent on average); while for the coming year a growth of only 5.5 percent is being anticipated," she emphasized.

Dr Akhtar stressed that these optimistic expenditure and revenue assumptions carry the risk of fiscal slippages beyond target again. Even a one percentage point increase in fiscal deficit above the target level would require additional borrowings in the order of over Rs100 billion," she added. "What is worrisome is that there are severe external and domestic constraints which make it difficult for raising the required financing on a timely basis for the projected fiscal deficit for FY09," she said and added generating the same amount domestically from sources other than the central bank would result in crowding out of credit availability to the private sector. Efforts should be launched to raise additional resources otherwise it risks the monetary policy stance. As is evident, during the first twenty five days of current fiscal year the government has already borrowed additional Rs32.9 billion from SBP. This pattern is not in line with SBP's recommendation to the government to retire Rs21 billion during each quarter of FY09, she stressed.

SBP Governor said that the balance of payment scenario for FY09 has warranted further policy action as curtailing further import growth and raising the exports further is critical for narrowing the external current account deficit which is key to the macroeconomic sustainability. She also stressed that additional efforts to mobilize financing to meet the external current account deficit is equally critical as the assumptions underlying balance of payment projections have changed with the rise in international oil prices and exchange rate. At the same time financing mobilization will need to be calibrated to restore foreign exchange reserves to a more comfortable level, she added.

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