

April 20, 2009

Salim Raza announces reduction in SBP policy rate to 14% on positive inflation outlook

Syed Salim Raza, Governor State Bank of Pakistan disclosed today that the central bank has decided to lower its key policy rate by 100 basis points to 14 percent with effect from April 21, 2009.

Addressing a press conference at State Bank of Pakistan, Karachi on the occasion of the release of Monetary Policy Statement for the April-June quarter of the current 2008-09 fiscal year (FY09), Mr Raza said the decision to reduce the key policy rate has been taken on the basis of assessment that inflation will continue to decline.

Mr Raza said the country's economy has made a steady progress on its path towards macroeconomic stability. He pointed out that CPI inflation (Year-on-Year), though still higher than desired, has declined to 19.1 percent in March, 2009 from a high of 25.3 percent in August, 2008. Persistent demand pressures, as depicted in core inflation measures, have also eased, he said and added that the 20-percent trimmed core inflation has come down by about 2.4 percentage points from its peak in October, 2008. Although the projected average CPI inflation for FY09 is around 21 percent, expected inflation of around 14 percent for Q4-FY09 and 8 percent for FY10 illustrates a positive outlook, he maintained.

Mr Raza said that improved fiscal discipline and contraction in the external current account deficit indicate that aggregate demand is showing a downward trend. "This will help narrow the output gap and strengthen the positive outlook for inflation," he added. Referring to recent fiscal developments, he said that fiscal deficit of Rs 251 billion (1.9 percent of projected GDP) for H1-FY09 and the Government's commitment to cap it at Rs 562 billion (4.3 percent of projected GDP) for the entire FY09 is a very significant improvement over last year's 7.4 percent.

Likewise, he pointed out that external current account deficit has narrowed to \$172 million in March, 2009 compared to a deficit of \$2.2 billion in October, 2008, showing much improved trends in the external sector. He said that cumulatively, the

external current account deficit for the first nine months of FY09 stands at \$7.6 billion and is projected to be \$9 billion or 5.5 percent of the full year GDP.

Mr Raza said containment of these twin deficits has reduced demand pressures and helped to align, to some extent, the investment capacity of the economy with the limited availability of foreign and domestic savings. The impact of these adjustments is visible in monetary aggregates. The necessary measure of restricting government borrowing from the SBP has restricted reserve money creation in the system as has the low, albeit gradually improving, foreign exchange reserve position. He said that rise in SBP's foreign exchange reserves of \$4.3 billion between November - April, FY09 and projections that this level will increase to \$9.1 billion by end-June, 2009 is also a key indicator of emerging macroeconomic stability.

SBP Governor said that tight monetary policy, together with the rationalization of fiscal subsidies and expenditure controls, are the key policy actions that have delivered improvement in these deficits. "The efforts of SBP and the Government to achieve macroeconomic stability were also supported by market induced adjustments in the exchange rate, and by fall in the international oil prices," he added.

Mr Raza said that a significant source of M2 slackness has been the fall off in private sector credit demand, for both demand and supply reasons, as we will see later. Total private credit growth for the last 9 months has been only Rs 48 billion, versus Rs 345 billion for this period last year. As a result banks have built up considerable excess liquidity, some Rs 410 billion or about 10% above their reserve requirements. "This has allowed comfortable accommodation of Government rollover of maturing bills, Rs 1475 billion being bid against Rs 700 billion accepted bills," he said. He said last month has seen a little tightness in rates, with 6-month KIBOR and 6-month T Bills both moving up about 66 bps and 108 bps, respectively. "Much of this tightness emanated from the auction coinciding with the substantial tax payments to Government at quarter-end March, and is expected to be temporary," he added.

Talking about challenges that the economy is facing, SBP Governor said that despite positive outlook for inflation, the real challenge here is to improve the business climate. "The difficulty is that not only has the demand for credit by the private sector reduced sharply but that the supply of credit by banks has also remained subdued, and the two issues are difficult to disentangle," he said.

SBP Governor said that slowdown in domestic economic activity exacerbated by power shortages, decline in domestic demand, as well as in external demand due

to the global recession. However, he said that easing of the monetary policy stance to some extent will send a positive signal in this context but may not be sufficient to fully revive the private sector credit and thus the growth prospects, by itself. He said that slowdown in economic activity may lead to slippage in the tax revenues but added: “The government is entirely cognizant of the urgency of enhanced tax revenues and is planning administrative measures, such as tax audits, and evaluating alternatives to broaden the tax base across all sectors of the economy.”

Mr Raza pointed out that despite substantial improvement in the outlook of many important economic indicators; sustainable medium-term recovery remains a challenge. He said that there are structural issues with respect to business conditions that need to be tackled. “As monetary partners in the overall objectives of the economy, we remain committed to playing our role in aiming to provide both the price stability and the essential liquidity that Pakistan’s economy requires for sustainable growth,” SBP Governor asserted.
