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State Bank raises policy rate by 50 bps to 13.0%

The State Bank of Pakistan has decided to raise the policy rate by 50 basis points to 13.0 percent with effect from August 2nd, 2010. This was announced by Mr. Yaseen Anwar, Acting Governor, State Bank of Pakistan, while unveiling the Monetary Policy Statement at a press conference held at SBP, Karachi today.

"This has been done to mitigate risks to macroeconomic stability, monetary policy has to take lead for containing aggregate demand pressures emanating mainly from expansionary fiscal position," Mr. Anwar explained the rationale behind raising the policy rate. He said that renewed committed efforts are required to increase the economy's resource envelope and contain current expenditures. In particular, measures to increase the tax to GDP ratio and eliminate the revenue deficit of fiscal accounts are urgently required to provide a firm foundation for sustainable economic growth. "This would reduce the pressure on government borrowings from SBP and debt payments, create room for development expenditures in critical areas, and soften the adverse impact on the private sector," he added.

He said that the average CPI inflation of 11.7 percent during FY10 has been 2.7 percentage points higher than the target and current trends and expected developments indicate risks of inflation pressures continuing in the current 2010-2011 fiscal year (FY11). These include further upward adjustments in electricity prices, increase in General Sales Tax (GST), and revisions in government employees' wages to compensate for the current high inflation, he said and added that after incorporating these factors, the average CPI inflation is projected to remain between 11 and 12 percent in FY11, which is higher than the announced target of 9.5 percent.

Mr. Anwar said with the start of new fiscal year concerns of persistence in inflation and fiscal weaknesses are overshadowing the improvement in the external current account deficit and economic recovery. He said that the gap between national savings and investment has narrowed but mainly because of decline in investments and at the same time aggregate domestic demand, led by public sector consumption expenditures, is picking up while prospects of aggregate supply remain weak due to energy shortages and dismal law and order conditions. "These developments together with rising total debt are stressing the macroeconomic stability and call for renewed efforts to maintain an upward trajectory in economic growth," he asserted.

He said an increase in the Net Domestic Assets (NDA) of the banking system of Rs 488 billion during FY10 can be largely explained by the government's borrowing requirements for budgetary support and commodity operations. "The need for continued reliance on the banking system, both from scheduled banks and SBP, to finance the fiscal deficit essentially emanates from low tax revenues, high current expenditures, and shortfalls in projected external financing," he said and added that tax collection by the FBR at Rs 1,327 billion shows a shortfall of Rs 53 billion the target of Rs 1,380 billion for the year, while only Rs 177 billion was received from external sources against the budget estimate of Rs377 billion.

The SBP Acting Governor said the provisional figures indicate that the revised FY10 fiscal deficit target of 5.1 percent has been missed and could be higher than 6.0 percent. Similarly, the target of government borrowings from SBP has also been breached for the fourth quarter of FY10 as the stock of net government borrowings from SBP (on cash basis) was at Rs 1,171 billion as on June 30th, 2010 against the target of Rs 1,130 billion. Clearly, such fiscal developments are inconsistent with the objectives of macroeconomic stability, he said and added that these have contributed towards aggravating expectations of rising inflation and have kept an upward pressure on interest rates. The result is a crowding out of private sector credit and increased stress on debt sustainability, he added.

"Containing the fiscal deficit within the announced target of 4 percent of GDP for FY11 already seems challenging," Mr. Anwar said. Moreover, meeting the tax collection target of Rs 1,667 billion would require a 25.6 percent growth or a 0.8 percentage point improvement in the tax to GDP ratio, which seems unlikely without broadening of the tax base, he said and added that low tax revenues of the government have become a serious concern as it has increased reliance on foreign borrowings to meet rising expenditures. "Delays or shortfalls in such inflows could put pressure on external accounts sustainability," he observed.

Talking about external sector, Mr. Anwar said the current account deficit of $3.5 billion or 2 percent of GDP during FY10 was below earlier projections despite steady acceleration in imports in the second half. Notwithstanding significantly lower Foreign

Direct Investments (FDI) and shortfalls in projected foreign inflows, SBP's foreign exchange reserves increased to $13 billion by end-June 2010 from $9.1 billion at end-June 2009, he added. "This includes receipts of $4.6 billion from the IMF; $2.2 billion for balance of payment support, $1.1 billion for temporary bridge financing for the budget, and $1.3 billion through a onetime non-recurring increase in SDR allocations," he added.

Mr. Anwar said that the Net Foreign Assets (NFA) of the banking system increased by Rs152 billion during FY10 due to an improvement in the balance of payment position. "This, together with increases in total deposits of the banking system, has facilitated the market liquidity conditions and helped in meeting the credit requirements of the economy," he added.

He, however, said that the sustainability of external accounts improvement and build up of NFA face headwinds in FY11. "Consistent with recovery in the domestic economy and forecasts of higher international commodity prices, import growth is projected to increase to 12.0 percent in FY11 as opposed to a decline of 2.3 percent in FY10," he said and added that despite the uncertainty of economic recovery in Pakistan's export destination countries and an unfavorable domestic business environment, the export growth for FY11 is projected to be around 7.0 percent compared to 2.7 percent recorded in FY10. "After assuming a benign outlook for worker's remittances and further CSF (Coalition Support Fund) inflows, this trade outlook is expected to widen the external current account to 3.7 percent of projected GDP," he added.

SBP Acting Governor said while incorporating the projections of the external sector and consolidated fiscal position along with the announced targets of inflation and real GDP growth, the broad money is projected to grow by 13.0 percent in FY11. The total investment as a percent of GDP has now declined for three consecutive years, reaching 16.6 percent in FY10, he said. "Supported by an increase in workers' remittances, national savings on the other hand, improved by 0.5 percentage points to 13.8 percent of GDP in FY10," he added.

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