

September 29, 2010

State Bank raises Policy Rate by 50 bps to 13.5 percent from Sept. 30

The State Bank of Pakistan has decided to raise its Policy Rate by 50 basis points to 13.5 percent with effect from September 30, 2010. This decision was taken at a meeting of the Central Board of Directors of the State Bank of Pakistan held under the Chairmanship of SBP Governor, Mr. Shahid H. Kardar in Karachi today.

“The monetary policy stance is formed by the consideration that the impact of continued inflation is substantial and felt by the entire economy. A tightening of the stance is thus called for in full recognition that the difficulty to contain fiscal deficit has resulted in the private sector bearing the full brunt of such an adjustment,” the State Bank explained the rationale behind the increase in policy rate in its Monetary Policy Decision.

It said that the next quarter will be crucial in forming an assessment of the effectiveness of government efforts to contain the fiscal deficit and its inflationary borrowings from the SBP and the banking system.

Following is the complete text of Monetary Policy Decision:

“The recent catastrophic floods have serious implications for macroeconomic stability and growth prospects. However, even before the floods, the macroeconomic conditions and outlook were looking fragile. By the close of FY10, inflation was high and the fiscal deficit had risen to 6.3 percent of GDP. Early assessments indicated that these pressures were unlikely to abate in FY11. Post-flood projections raise legitimate concerns about the worsening of the macroeconomic balances since the initiatives required to address the underlying cause for the primary stimulus to aggregate demand, coming from the fiscal side, have yet to be launched with vigour and coherence. They show that inflation will increase further accompanied by a drop in economic growth, both the trade balance and fiscal accounts will be under stress, and the banking system may witness pressure on account of rise in NPLs of the private sector and borrowings of the government, unless a comprehensive and coordinated response is developed to meet these challenges.

The clarity on the nature and scale of such a package would depend on the complete assessment of losses to the economy expected to be completed in October 2010. Nevertheless, the components of the economic strategy that would need to continue to be in focus despite uncertainty would include implementation of tax reforms to enhance much needed revenues, resolution of the energy sector subsidies and circular debt to restore economic growth, relief measures for those affected by the floods, and containment of government borrowing from SBP to restrict inflation. Committed and credible progress on these fronts will be critical for reviving confidence and stability and stimulating economic growth, otherwise the burden of any adjustment will continue to fall on the engine of growth, the private sector.

Given the scale of the devastation caused by the recent calamity, it is difficult to fully and accurately determine the extent of damage to the economy. Losses in agriculture and infrastructure are more direct and visible while the impact on industry and opportunities for the work force is going to be indirect and nuanced. Highly provisional estimates suggest that economic growth for FY11 could come down to 2.5 percent from an earlier target of 4.5 percent. While aggregate private consumption may decelerate as a result that of the government will most likely increase to meet the urgent needs of the flood victims and their rehabilitation, leading to a sharper deterioration of the fiscal accounts.

The disruption in the supply chain of food items caused the month-on-month (MoM) food inflation to jump to 5.1 percent in August 2010, pushing the M-o-M CPI inflation to 2.5 percent. In SBP's assessment this temporary spike in prices is largely due to floods as it is over and above the average M-o-M growth in food inflation (1.6 percent) and CPI inflation (1.1 percent) during *Ramazan* in the previous five years. It may take two to three months for food inflation to return to normal levels. Slowdown in private demand later in the year will at best have a moderating effect on CPI inflation as it is likely to be neutralized by an expected increase in government spending in general and on reconstruction in the flood affected areas in particular. It is estimated that average CPI inflation for FY11 may fall between 13.5 and 14.5 percent. Further, likely increases in electricity prices, induction of the Reformed GST and continued reliance of the government on borrowings from the SBP only add to the uncertainty surrounding inflation expectations.

In the aftermath of the floods, bringing inflation down to single digits would require a supportive and sustained financial and fiscal effort over the next couple of years. Better management of financial resources including more transparency and timely availability of fiscal figures, broadening of the tax base, controlling discretionary current expenditures and re-prioritizing development expenditures would be imperative for fiscal consolidation. These steps would remove any ambiguity arising from the pre-flood budget for FY11, which initially announced a deficit of 4 percent that shot up to 5.2 percent of GDP after the combined provincial budgets were unveiled. How the fiscal policy response to the floods is incorporated in the revised budget remains to be seen, but it is clear that even attaining the deficit of 5.2 percent of GDP will require considerable adjustment in the key fiscal parameters. The year-on-year growth of 7.5 percent in the Federal Board of Revenue's (FBR) tax revenues during the first two months of FY11 compared to the budget target of 25.6 percent for the full year does not instil much confidence.

To finance the budget deficit the government has increased its reliance on the SBP; it borrowed Rs 220 billion during 1st July – 24th September, FY11 according to provisional figures compared to Rs 126 billion during the corresponding period of last year. This is against the spirit of macroeconomic stabilization, since the elimination of government borrowing from the SBP was one of the main commitments of such a program. Moreover, given the heavy borrowings from the scheduled banks over the last couple of years through short term Treasury Bills (T-bills) there is a significant 'rollover risk' during FY11. Fresh borrowings from the banking system

during FY11 will increase these borrowings even further, especially if the spending requirements increase and there is no commensurate increase in tax revenues.

This entails substantial risks to economic stability in the immediate future and places a considerable pressure in the medium term on the already high debt burden of the country. Rising NPLs and relatively low private sector credit demand may incentivize the already risk shy banks to meet government's borrowing requirements at the cost of private investment in the economy. This could make the task of reviving economic growth and bringing inflation down to single digit level much more difficult.

The dependence on foreign borrowings has also increased due to continuous decline in domestic national savings and private foreign investments in the country. The substantial narrowing of the external current account deficit in FY10 provided some breathing space. After registering a reduction of 2.3 percent in FY10, imports seem all set to grow significantly, especially after the floods, and may post a double digit growth in FY11. Although the growth in exports was also projected to increase in FY11, the recent floods and the resulting disruption in productive activity could act as a dampener if the damage to the cotton crop turns out to be extensive. Thus, the expected increase in the external current account deficit and uncertain foreign inflows could put pressure on SBP's foreign exchange reserves and exchange rate in FY11.

In these circumstances, most of the expansion in broad money in FY11 is expected to be driven by a considerable growth in the Net Domestic Assets (NDA) of the banking system accompanied by a possible decline in the Net Foreign Assets (NFA), which does not bode well for the inflation outlook. Thus, there may be possible liquidity pressures in the market. The SBP stands ready to manage the system wide liquidity and maintain the short term interest rates consistent with its monetary policy stance. However, more is expected from the fiscal authority to articulate and implement a coherent strategy and the market continues to look to government for greater fiscal discipline to allay expectations of rising inflation. The key features of this strategy, as already mentioned above, will have to include broadening of the tax base, adhering to the principles of the Fiscal Responsibility and Debt Limitation Act (2005) in letter and spirit and restriction of government borrowing from the SBP. Failure to do so will only increase the economy's reliance on foreign borrowings with its own complications and risks.

The next quarter will be crucial in forming an assessment of the effectiveness of government efforts to contain the fiscal deficit and its inflationary borrowings from the SBP and the banking system. On its part, the SBP is raising its policy rate by 50 basis points to 13.5 percent with effect from 30th September 2010. The monetary policy stance is formed by the consideration that the impact of continued inflation is substantial and felt by the entire economy. A tightening of the stance is thus called for in full recognition that the difficulty to contain fiscal deficit has resulted in the private sector bearing the full brunt of such an adjustment."
