

State Bank reduces policy rate by 50 bps to 13.5%

The State Bank of Pakistan (SBP) has decided to reduce its policy rate by 50 basis points to 13.5 percent with effect from August 01, 2011. 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.

The key parameter in this assessment is the outlook of inflation that indicates that average inflation in FY12 is expected to remain in line with the announced target, he said, adding that no adjustment in the interest rate would have entailed further tightening of monetary policy in real terms, which is not warranted given the decline in private investment.

Mr. Anwar said that despite fiscal slippages, the government has adhered to restricting the stock of its borrowings from SBP to Rs1155 billion (on cash basis). 'In fact, the government retired these borrowings compared to both the end-June 2010 level as well as the mutually agreed limit of end-September 2010 level,' he added.

He said the government has also expressed its commitment to continue with a stance of zero borrowings from SBP in yearly flow terms in FY12, which bodes well for anchoring inflation expectations. He, however, observed that the developments related to expected financial inflows and pattern of government borrowings from scheduled banks will need to be monitored closely to assess potential risks for macroeconomic stability.

SBP Acting Governor said that a relative decline in average CPI inflation compared to earlier projections and a gradual buildup of foreign exchange reserves provide a modicum of macroeconomic stability as the economy begins a new fiscal year.

Mr. Anwar noted that expectations of inflation are fairly entrenched in the economy. 'Thus, a meaningful reduction in inflation would require consistent and credible implementation of monetary and fiscal policies,' he added.

He observed that acknowledging the persistence of inflation, the government has announced an inflation target of 12 percent for FY12. 'The government has also provided in the Medium Term Budgetary Framework (MTBF) a desired path of inflation of 9.5 percent and 8 percent for the subsequent two years,' he said, adding that conditional upon factors such as adjustments in the administered prices of electricity and oil and a projected broad money (M2) growth of 15 to 16 percent, SBP's forecast of average inflation ranges between 11 and 12 percent during FY12.

'The underlying reasons of growing government borrowings are structural and not specific to FY11 though it must be acknowledged that FY11 was a difficult year given floods and other pressing spending needs. The consolidated fiscal data has not been released, however, provisional estimates from the financing side indicate that the fiscal deficit in FY11 may have reached close to Rs1127 billion or 6.2 percent of GDP. Excluding the one-off payment of Rs120 billion to partially settle the circular debt in the energy sector, the fiscal deficit in FY11 comes down to 5.6 percent of GDP,' he added.

Mr. Anwar underscored the need to accelerate the implementation of fiscal reforms currently being considered by the government. He observed that a path of fiscal deficit in the next three fiscal years has been provided in the Medium Term Budgetary Framework (MTBF), which shows a budget deficit target of 4 percent for FY12. 'Moreover, the government is planning to reduce the revenue deficit to zero in FY12 with a projected surplus in the following two years. This assumes an ambitious increase in tax collection by the Federal Board of Revenue (FBR),' he said, adding that an effective implementation of fiscal reforms, especially those related to broadening of the tax base, and better coordination with the provinces are urgently required to implement this plan.

He said that unlike fiscal accounts, the position of the external current account improved considerably in FY11 and contrary to earlier projections, a surplus of \$542 million has been realized. 'A significant and unexpected growth of 29.4 percent in exports and a robust growth in workers' remittances, which now stand at \$11.2 billion, are the primary factors responsible for this improvement,' he said and added that fragile global economic conditions and dominance of price effect in both exports and imports, which was more pronounced in H2-FY11, has increased exposure of the economy to movements in international commodity prices.

SBP Acting Governor observed that the external current account is expected to show a modest deficit of 0.8 percent of GDP in FY12. 'Given an increase in debt obligations and continued suspension of IMF's Stand-By Arrangement (SBA) financing even a small external current account deficit could pose challenges in terms of maintaining an upward trajectory of SBP's foreign exchange reserves,' he added.

He noted that the main risk in external accounts emanates from the declining capital and financial flows, which have dropped to \$1.8 billion in FY11 from \$5.3 billion in FY10. 'The perceived high country risk, relative to other emerging market economies, is the main factor underlying the reluctance of private foreign investors to invest in the country,' he said, adding that the delays in implementation of economic reforms, on the other hand, resulted in shortfalls in estimated foreign loans. Nonetheless, by end-June 2011, SBP's liquid foreign exchange reserves have increased to \$14.8 billion from \$13.0 billion at end-June 2010.

Mr. Anwar said that the gross fixed capital formation by the private sector contracted by 3.1 percent, leading to a decline in total gross investment to 13.4 percent of GDP; the lowest level since FY74. He, however, observed that due to strong growth in real consumption expenditures, aggregate domestic demand grew by 5.9 percent.

He said that at the same time, national savings have increased to 13.8 percent of GDP, mainly due to net factor income from abroad. 'Consequently, the gap between national savings and investment as a percent of GDP has turned marginally positive,' he added.

'Against this backdrop, SBP has decided to reduce the policy rate by 50 basis points to 13.5 percent effective 1st August 2011,' he concluded.
