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STATE BANK KEEPS POLICY RATE UNCHANGED AT 12 PERCENT

The Central Board of Directors of the State Bank of Pakistan at its meeting held under the Chairmanship of SBP Governor, Mr. Yaseen Anwar in Karachi today has decided to keep the policy rate unchanged at 12 percent after making an assessment of macro economic challenges facing the country's economy.

The economy basically needs fundamental reforms to engineer a turnaround in economic performance. Inflation expectations cannot be effectively anchored around single digit targets without limiting fiscal borrowings from the banking system, particularly the SBP, according to the Monetary Policy Decision issued after the Central Board meeting.

The size of the external current account deficit for FY13 as percent of GDP is projected to be approximately the same as in FY12. 'However, due to anticipated rise in debt payments in FY13, the economy would need substantial external inflows to preserve our foreign exchange reserves. Further, the problems in the euro zone have increased uncertainty in the global economy,' Monetary Policy Decision said and added that being a safe haven for investors, the US dollar has strengthened significantly in the past few weeks against almost all currencies, especially the euro, and Pakistan rupee was no exception.

Following is the complete text of the Monetary Policy Decision:

'While managing the external and fiscal pressures remain more of an immediate concern, the real challenge lies in reviving private investment in the economy. Inflationary pressures have not subsided either despite sluggish GDP growth. At the same time, the scheduled banks continue to avoid extending credit to private businesses, which are already suffering from energy shortages. Fiscal authority, on the other hand, is accumulating short term domestic debt at a rapid pace.

The impact of SBP's monetary policy, in these circumstances, is less effective. The economy basically needs fundamental reforms to engineer a turnaround in economic performance. For instance, inflation expectations cannot be effectively anchored around single digit targets without limiting fiscal borrowings from the banking system, particularly the SBP. Borrowing from the banking system has risen substantially during this fiscal year, Rs 1098 billion (Rs707 billion excluding the Rs391 billion related to the partial settlement of circular debt), from 1st July to 25th May, FY12 with borrowing from SBP (on cash basis) expanding by Rs 414 billion during the same period. In fact, the latter has accelerated during 1st April to 4th June, 2012, increasing by Rs310 billion, pushing the outstanding stock to Rs1660 billion (on cash basis). This behaviour contravenes the SBP (Amendment) Act 2012, which requires not only zero quarterly borrowings but also envisages their retirement in the next seven years.

Not surprisingly, the year-on-year CPI inflation has increased to 12.3 percent in May 2012. A noteworthy aspect of inflation behaviour is its persistence at this high level alongside slack economic

activity. A probable explanation of this persistence is that the expansionary effect of the fiscal position is off-setting the weak private demand, especially investment demand. SBP is not expecting a sharp increase in inflation but its continuation around current levels in FY13. The issue is not just aggregate demand pressures but also people's expectations. Therefore, limiting and retiring budgetary borrowings from the banking system and implementation of consistent and credible policies would help in moving away from this undesirable equilibrium.

The sheer volume of borrowing from the banking system and expectations that this trend will continue, in the absence of fiscal reforms, has made banks complacent. They are simply channelling the economy's incremental deposits, raised at 7 percent on average, to government securities that give an average return of approximately 12 percent across different maturities. Specifically, the scheduled banks perceive the government as a captive borrower and can afford to avoid the private sector without taking a hit on their profits.

The real issue is the structural gap between fiscal revenues and expenditures of the fiscal authority. This gap cannot be narrowed without fiscal reforms. In particular, it would be difficult to reduce the scale of borrowings from the scheduled banks and adhere to the legal requirements of limiting and retiring borrowings from the SBP without generating additional revenues.

Falling private investment to GDP ratio to 12.5 percent in FY12 according to provisional data, also echo's the need for fiscal reforms. Absence of an enabling business environment due to persistent energy shortages and precarious law and order conditions has dampened the demand for fresh private credit. Therefore, urgent energy sector reforms are required to boost business confidence and arrest the declining investment to GDP ratio.

As for the developments in the external sector, the issue is not the size of the external current account deficit but lack of sufficient external inflows to finance it. Cushioned by robust worker remittances of \$10.9 billion, the current account deficit was \$3.4 billion during the first ten months of FY12. After incorporating the estimated deficit for the remaining two months, it is likely to remain around 1.7 percent of GDP for FY12, which is not large for a developing country like Pakistan. The net flows in the capital and financial account, on the other hand, were only \$1.4 billion during the same period. Accounting for repayments of the IMF loans during the year, SBP's net liquid foreign exchange reserves have declined to \$11.3 billion by end-May 2012 compared to \$14.8 billion at end-June 2011.

For FY13, the size of the external current account deficit as percent of GDP is projected to be approximately the same as in FY12. However, due to anticipated rise in debt payments in FY13, the economy would need substantial external inflows to preserve our foreign exchange reserves. Further, the problems in the euro zone have increased uncertainty in the global economy.

Being a safe haven for investors, the US dollar has strengthened significantly in the past few weeks against almost all currencies, especially the euro, and Pakistan rupee was no exception. Appreciation of the US dollar in international markets is probably one explanation why oil prices have eased somewhat, declining from a peak of \$130 per barrel (Saudi Arabian Light) on 3rd April 2012 to \$97 per barrel on 1st June 2012. This, together with expected global slowdown may keep the oil prices

softer compared to earlier projections. Given that almost one third of Pakistan's total import bill is due to oil payments, this would be a positive development. For instance, with the current quantum of petroleum products and crude imports at 21 million metric ton, a decline of \$5 per barrel in international oil prices could save up to \$700 million in import payments in FY13.

After an assessment of the macroeconomic challenges faced by our economy, the Central Board of Directors of SBP has decided to keep its policy rate at 12 percent.'