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State Bank keeps policy rate unchanged at 12 percent

The Central Board of Directors of the State Bank of Pakistan (SBP) has decided to keep the policy rate unchanged at 12 percent. This was announced by the Governor, State Bank of Pakistan, Mr. Yaseen Anwar while unveiling the Monetary Policy Statement at a press conference held at SBP, Karachi this afternoon.

Following is the text of SBP Governor's press statement on Monetary Policy:-

'The basic challenge faced by Pakistan's economy is financing its fiscal and external current account deficits. The size of these deficits may not be considered large given the current state of falling private sector investment demand in the economy. A reflection of overall low aggregate demand can be seen in the declining inflation trend, contraction in the real private sector credit, and falling volume of imports. The SBP's monetary policy stance in FY12 so far, a cumulative reduction of 200 basis points, has been largely framed in this context.

The lack of diversified and sustainable financing sources has resulted in substantial borrowings from the banking system by the government and declining foreign exchange reserves. This has squeezed the availability of credit for the private sector and increased the pressure on rupee liquidity. The SBP has been providing substantial liquidity on almost permanent basis, on average Rs230 billion during 1st July – 9th February 2012, to ensure smooth functioning of the payment system and avoid financial instability. The continuation of this trend, however, carries risks for effectively anchoring inflation expectations in the medium term.

The uncertain market liquidity flows have lead to excess volatility in short term interest rates and increased the challenges of monetary management. The main reasons for this uncertainty include: a sharper deterioration in the external current account deficit, a declining trend of foreign inflows, and a higher currency to deposit ratio. However, other market interest rates, such as KIBOR and Weighted Average Lending Rate (WALR), have largely followed the policy rate reductions.

A declining interest rate environment together with a relatively better growth in Large-scale Manufacturing (LSM) is expected to help the pickup in private sector credit. The LSM sector grew by 1.5 percent during July-November, FY12, which is in contrast to an average contraction of 3.1 percent during the same period of last three years. Moreover, credit to the private sector has expanded by Rs238 billion during 1st July – 3rd February, FY12. However, to assess its likely path few points need to be kept in mind.

First, given the continuing energy shortages, unfavorable law and order conditions, and an uncertain political environment, the desired boost in business confidence and thus private sector credit may not take place. Second, profitability of the textile sector, a major user of private sector credit, was better in FY11 due to higher cotton prices. This would facilitate repayments or keep the demand for fresh credit to a minimum in FY12. Third, the utilization of installed industrial capacity is considerably low and continues to decline, which is inhibiting credit demand for fixed investment. Fourth, all of the fresh credit disbursement in H1-FY12 was utilized to meet the working capital requirements, which implies that a significant part of this credit will be retired in H2-FY12.

Thus, the full year expansion in credit to the private sector is expected to remain weak for yet another year in FY12 despite interest rate reductions. Its year-on-year growth is already negative in real terms and indicates depressed private investment demand in the economy. In addition, given substantial government borrowings from the scheduled banks together with rising NPLs, banks are likely to continue to avoid lending to the relatively risky private sector.

According to provisional data, the government has borrowed Rs444 billion from the banking system, during 1st July – 3rd February, FY12 to finance its current year's fiscal deficit. This includes Rs197 billion borrowed from the SBP and show a year-on-year growth of 25.8 percent. Moreover, these borrowings are significantly higher than the yearly financing requirements of Rs293 billion envisaged in the FY12 budget.

The provisional estimate of fiscal deficit for H1-FY12, from the financing side, shows a deficit of Rs532 billion or 2.5 percent of GDP. Given that the fiscal deficit is always higher in the second half of a fiscal year, by at least 0.5 percent of GDP during the last ten years, containing the FY12 fiscal deficit close to the government's revised target of 4.7 percent of GDP would be difficult. Encouragingly, the tax collection by the Federal Board of Revenue during H1-FY12, at Rs840 billion, has shown a strong growth of 27.1 percent. Similarly, the announcement of auction of 3G licenses in the telecommunication sector is a positive development and could help in containing the potential fiscal slippage.

However, based on the seasonal pattern of tax collections, the full year target of Rs1952 billion still seems ambitious. At the same time, there are indications that the issue of circular debt in the energy sector remains and losses of major Public Sector Enterprises (PSEs) continue to increase. Thus, the likelihood of slippages on the expenditure side on account of subsidies, over and above the budgeted amount, cannot be ruled out. The delay in these subsidy payments may have implications for resolving the circular debt issue.

The risks to external position have also increased due to worsening terms of trade, fragile global economic conditions, and continued paucity of financial inflows. In addition, $1.1 billion are scheduled to be repaid to the IMF in H2-FY12. The SBP's foreign exchange reserves have already declined to $12.2 billion as on 9th February 2012 from $14.8 billion at end-June 2011. Similarly, the rupee-dollar exchange rate has depreciated by 5.2 percent in FY12 so far.

Led by 33.7 percent growth in imports of petroleum products on the back of elevated international oil prices, total imports have increased to $19.7 billion in H1-FY12. The volume of imports remained muted, which indicates moderation in domestic demand pressures. Given the rising tensions in the US-Iran relations and political uncertainty in the Middle East region, the oil prices are unlikely to fall significantly in the near future and may even increase. Therefore, despite low volumes, imports are projected to grow in the range of 12.5 to 14.5 percent for FY12.

Similarly, while the falling cotton prices played their part in sharper than expected slowdown in export receipts, $12 billion in H1-FY12, the volume of exports have also declined considerably. Assuming that these trends would continue in H2-FY12 export receipts are projected to show a decline of 3 to 5 percent in FY12. Incorporating a steady flow of workers' remittances, the external current account deficit is expected to remain in the range of $3.5 billion to $5.5 billion or 1.5 to 2.4 percent of GDP. The possibility of limiting the deficit to the lower bound of the range is mainly contingent upon the realization of Coalition Support Fund, $800 million, and the proceeds from the auction of 3G licenses, estimated to be around $850 million.

The real challenge is to finance this projected external current account deficit. The actual net capital and financial inflows during H1-FY12 was only $167 million due to decline in both the direct and portfolio investments and shortfalls in official flows. Assuming that all the official flows contemplated by the government are realized – $500 million from the issuance of euro bonds, $800 million from the privatization proceeds of PTCL, and budgeted loans from international financial institutions – the net capital and financial inflows could increase to $3.8 billion by June 2012.

These fiscal and external developments have resulted in a skewed composition of monetary aggregates. In particular, the increase in the Net Domestic Asset (NDA) component of M2 is disproportionally large while the Net Foreign Assets (NFA) has contracted. Given its strong correlation with inflation, the resulting increase in the NDA to NFA ratio is not a welcome development. The year-on-year growth in M2 for FY12 is projected to be in the range of 12 to 13 percent.

The changing composition of M2 requires a careful interpretation. For instance, the deterioration in the external sector is mostly due to adverse terms of trade developments and uncertain official inflows and may not be a sign of rising aggregate demand. Similarly, the pressure on aggregate demand due to the government borrowings from the banking system is being partly offset by the weak private investment demand.

These conjectures are supported by the decline in year-on-year CPI inflation to 10.1 percent in January 2012. In addition to moderation in aggregate demand, this also reflects improvement in domestic supplies of food items. However, there are indications of underlying inflationary pressures. For instance, the number of CPI items showing year-on-year inflation of more than 10 percent is significant and mostly belong to the non-food category.

The SBP expects the average inflation in FY12 to remain in the range of 11 to 12 percent, which implies an uptick in inflation in H2-FY12. The main reasons for this assessment include: increases in electricity and gas prices, high international oil prices, impact of exchange rate pass-through, increase in support price for the upcoming wheat procurement season, and substantial government borrowings from the banking system.

For inflation to come down further, the implementation of the Medium Term Budgetary Framework (MTBF) is imperative. The MTBF envisages a systematic reduction in the fiscal deficit to 3.0 percent of GDP in FY14 by increasing the tax to GDP ratio and stipulates inflation targets of 9.5 percent for FY13 and 8 percent for FY14. Decisive reforms in the energy sector can also go a long way in achieving the MTBF targets. These reforms not only will reduce the government's reliance on banking system borrowings but also minimize the need to adjust the energy prices in a sporadic and unpredictable manner. Both these factors would help in improving the effectiveness of monetary policy and its contribution in keeping inflation low and stable.

In conclusion, despite moderate aggregate demand, pressure on rupee liquidity is likely to continue due to uncertain foreign inflows and substantial government borrowings to finance the fiscal deficit. Moreover, inflationary pressures have not eased significantly. It must be emphasized that sustainable economic recovery over the medium term would call for a sizeable increase in both the domestic and foreign private investment in the economy. For this to happen, the business confidence needs to be revived by reducing uncertainties due to energy shortages. Against this backdrop, the Central Board of Directors of SBP considers the 200 bps reduction in the policy rate, already introduced in FY12, to be appropriate and has decided to keep the policy rate unchanged at 12 percent'. (The complete text of Monetary Policy Statement is available at SBP website: www.sbp.org.pk)

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