

State Bank raises Policy Rate to 10 percent

State Bank of Pakistan (SBP) has decided to raise policy rate by 50 basis points to 10 percent. The decision was taken by the Central Board of Directors of SBP at its meeting held under the chairmanship of Governor Mr. Yaseen Anwar in Karachi today.

An increase in inflation while keeping the market interest rates at the current level can increase the incentive for borrowings and discourage savings in the economy. This can potentially increase demand pressure through consumption as well as dampen investment, and thus the productive capacity of the economy. In addition, with fragile external flows, negative real return can encourage outflow of foreign exchange increasing the pressure on exchange rate.

Following is the complete text of the Monetary Policy Decision:

While the challenges for macroeconomic stability in the external sector remain, the fundamentals of the economy going forward in the backdrop of the recent policy and reform measures appear stable. Notwithstanding rising inflation, the prospects of an economic revival inspired by successful political transition and the resolution of energy related circular debt issue are encouraging. To ensure the economy remains on a stable path, further structural reforms are in progress. Although, it is too early to conclude about their impact, there are some indications of a pickup in economic activity. The growth in LSM has accelerated with a year on year increase of 8.4 percent during Q1-FY14. Similarly, exports have also marginally picked up, growing at 1.3 percent in Q1-FY14.

The deterioration in the external accounts has continued in FY14, largely on account of weak financial inflows. The external current account had a deficit of \$1.2 billion in Q1-FY14, similar to that witnessed in the previous quarter. With imports picking up at a relatively higher pace than exports, the widening of the trade deficit mainly explains this. Moreover, the financial account balance had a net outflow of \$68 million. Further, taking into account substantial repayments to the IMF, SBP reserves declined by \$1.3 billion during Q1-FY14. The SBP reserves stand at \$4.2 billion as of 1st November 2013.

Besides these fundamental factors, the speculative sentiments on account of IMF end September 2013 targets resulted in exchange rate volatility. Such sentiments are an attribute of uncertainty over foreign exchange flows, which are expected to be reduced with sustainable improvement in the external accounts. In this regard, the progress on reforms part of the IMF program is likely to play a critical role. For instance, the resolution of the energy related circular debt issue has resulted in improved supply of electricity, which is helpful for the growth in exports.

Successful completion of structural benchmarks under the IMF program will also ensure additional financial inflows from other IFIs. In the absence of such reforms, the burden of adjustment falls disproportionately higher on interest and exchange rates that may perpetuate speculative sentiments in the market.

Carrying out reforms, particularly those related to fiscal consolidation, are critical for the economy. For instance, expanding the base of direct taxes and rationalizing their rates are key for sustainable expansion of revenue collection. These are also superior to all other indirect taxes, which are regressive in nature and require much broader documentation of the economy. While the fiscal authorities have already progressed in this regard by increasing the GST rate, bringing the informal sector in the tax net is an arduous task. Consequently, it is difficult to bring down the fiscal deficit significantly. Keeping fiscal deficit, as evident from the financing side, for Q1-FY14 within the target is plausible; however, the SBP estimates that the fiscal deficit for FY14 would be slightly higher than the budgeted 6.3 percent.

The decline in the estimated FY14 fiscal deficit, compared to 8 percent in FY13, owes much to the realization of non tax revenues such as the CSF. The first installment of CSF (\$322 million) has been realized in October 2013 and the remaining is expected in the current and the forthcoming quarters. Similarly, the realization of the other proceeds is also critical to maintain the deficit within this estimated level. What is more important to consider is the fact that these are either one-off receipts or may not be relied upon on a long term basis. A more permanent solution still lies in the tax reforms.

Similarly, rationalization of expenditures is also important. The revision in power tariffs is expected to contribute in curtailing subsidies and thus creating fiscal space for other expenditures. Such fiscal consolidation measures, however, have their inflationary consequences also. Adjustments in administered prices are directly reflected in higher inflation and raise inflationary expectations, as is evident from the current trends in CPI inflation. After witnessing a significant decline in FY13, inflationary pressures are resurging and could be observed in the sharp increase in inflation during the first four months of FY14. This trend is being contributed by both food and non-food group, however, the reversal in CPI food inflation is relatively sharper. With the continuing of these trends CPI inflation is likely to remain at an elevated level, between 10.5 to 11.5 percent.

An increase in inflation while keeping the market interest rates at the current level can increase the incentive for borrowings and discourage savings in the economy. This can potentially increase demand pressure through consumption as well as dampen investment, and thus the productive capacity of the economy. In addition, with fragile external flows, negative real return can encourage outflow of foreign exchange increasing the pressure on exchange rate.

In light of the above, the Central Board of Directors of the State Bank of Pakistan has decided to increase the policy rate by 50 bps to 10 percent to take effect 18th November, 2013.