February 8, 2013

State Bank keeps policy rate unchanged at 9.50%: Yaseen Anwar

The State Bank of Pakistan (SBP) has decided to keep the policy rate unchanged at 9.50% but reduced the interest rate corridor by 50 bps. The Governor, State Bank of Pakistan, Mr. Yaseen Anwar while unveiling the Monetary Policy Statement (MPS) at a press conference at SBP Learning Resource Centre, Karachi, said the decision to keep the policy rate unchanged and reduce the interest corridor from 300 bps to 250 bps was taken at a meeting of the Central Board of Directors of SBP held under his chairmanship in Karachi today. The decision to reduce the interest rate corridor was taken with the objective of improving transmission mechanism by minimizing short-term volatility in interest rates and to bring more transparency, he added.

He said the macroeconomic conditions weakened during H1-FY13 despite improvement in some key indicators. The CPI inflation came down quite sharply till November 2012 but has increased since then, he said, adding that the external current account posted a surplus during H1-FY13 but the foreign exchange reserves have declined, predominantly due to IMF repayments. 'The non tax revenues of the government received a boost after receiving Coalition Support Fund (CSF) of 0.7 percent of GDP during H1-FY13, yet the fiscal deficit is expected to miss the budgeted target by a wide margin,' Mr. Anwar added.

Responding to a sharply declining inflation and, assigning a higher weight to contracting private investment, he said the SBP lowered its policy rate by a cumulative 450 basis point over the last 18 months. 'SBP has also ensured that both the money and the foreign exchange markets remain stable. It also introduced certain measures to improve the liquidity management and financial intermediation aspects of the banking sector,' he added.

In the wake of rising risks to macroeconomic stability and in the absence of structural reforms that could have supported price stability and growth in medium term, it may be difficult to continue with the same monetary policy stance, he said, adding that the SBP has to be forward looking and take steps to meet the emerging challenges. 'The two main challenges, from the point of view of SBP, are managing the balance of payment position and containing the resurgence of inflationary pressures,' Mr. Anwar added.

SBP Governor said the fundamental weakness in the balance of payments is the continuous decline in the net capital and financial flows. 'There has been a net outflow of $539 million in this account during H1-FY13. In addition, the SBP has retired $1.4 billion of IMF loans during the first seven months of FY13. Thus, despite an external current account surplus of $250 million in H1-FY13, the foreign exchange reserves of SBP have declined to $8.7 billion as on 31st January 2013 from $10.8 billion at end-June 2012,' he added.

Mr. Anwar said the surplus in the external current account during H1-FY13 was primarily due to the receipt of $1.8 billion in the CSF and added that marginal improvement in the trade balance and robust growth in workers' remittances have also helped the external current account balance, mitigating the pressure on the balance of payments position. 'The SBP expects the external current account deficit to remain below 1 percent of GDP for FY13. This is despite little expectation of receiving proceeds of approximately $850 million from the auction of 3G licence,' he added.

He observed that in view of the declining trend in financial inflows and a very low probability of receiving the budgeted privatization inflows of $800 million in FY13, the challenges on the balance of payments position are unlikely to subside. 'Further payments of $1.6 billion of IMF loan in the remaining five months of FY13 and $3.2

billion in FY14 do not help the situation either. While the economy has sufficient reserves to meet its debt obligations, the real challenge is to manage the market driven sentiments,' he added.

SBP Governor was of the view that volatility in the foreign exchange market can have implications for the inflation outlook due to potential feedback from exchange rate changes under prevailing conditions. 'This is why the SBP has intervened in the foreign exchange market in a calibrated manner to ensure its smooth functioning. It is important to remember that only a consistent increase in foreign exchange can ensure stability in the market,' he added.

Mr. Anwar said the CPI inflation has already risen in the past two months; from 6.9 percent in November 2012 to 8.1 percent in January 2013. The core inflation measures are also inching towards double digit figures again after coming down to single digit. The average inflation for FY13 is projected to remain between 8 and 9 percent; well within the target of 9.5 percent. It is the medium term inflation outlook that needs to be assessed carefully. 'The SBP expects M2 growth for FY13 to be close to 16 percent. Similarly, due to a weakening external position and rising debt levels in the economy, anchoring expectations of inflation at low levels would be a challenging task,' he added.

He said that the year-on-year growth in M2 was 17.3 percent while that in fiscal borrowings from the scheduled banks was 41.3 percent on 25th January 2013. He said that over the last four years fiscal borrowings from the scheduled banks for budgetary support have grown by an average of around 60 percent. The average growth in credit to private businesses, on the other hand, has only been 4 percent during the same period. 'The end result is that the domestic debt has risen by 25.6 percent on average while private fixed investment has contracted by 9.4 percent in the economy,' he added.

SBP Governor said: 'although the deposits of the banking system show a growth of 17.4 percent, however, given the substantial fiscal requirements, the SBP had to continuously rollover significant amounts of liquidity injections. The average amount of these injections, during 1st July – 7th February FY13 was Rs498 billion and has been the driving force behind a year-on-year growth in reserve money of 15.3 percent. Since inflation had been coming down during H1-FY13, these high level of injections did not pose an immediate risk. A rising inflationary trend, however, would require containment in budgetary financing and a gradual scale back in the size of these injections'.

Mr. Anwar said that while the fiscal authority retired Rs399 billion in Q1-FY13 but borrowed Rs183 billion in Q2-FY13 from SBP. 'The inability to keep these borrowings at zero within a quarter is a contravention of the SBP Act and an important factor behind an imperfect control over inflation expectations by the SBP,' he observed.

SBP Governor said the growth in credit to private businesses has been higher during H1-FY13 compared to the corresponding period of last year. Private businesses availed Rs154 billion during H1-FY13 as opposed to only Rs85 billion during H1-FY12, he said, adding that this could be because of declining interest rates and moderation in accumulation of Non Performing Loans (NPLs). 'Since the beginning of FY13, the average lending rate has decreased by 204 basis points to 11.3 percent in December 2012. Similarly, the NPLs to advances ratio has declined to 15.5 percent in September 2012 from 16.7 percent in September 2011,' he said.

He said the GDP growth in Pakistan is expected to remain just below 4 percent in FY13. 'The fundamental reasons for this likely outcome are the prolonged and severe crisis in the energy sector and worsening law and order conditions in the country,' he added.

Mr. Anwar noted the main reason for large borrowing requirements from the banking system is the structurally high fiscal deficit and low level of external financing the estimates from the financing side of fiscal accounts indicate a deficit of 2.7 percent of GDP during H1-FY13. 'Given a low growth of 8.8 percent in the tax collection of the FBR during the first five months of the current fiscal year, which is substantially below target, and the continuation of subsidies related to the energy sector, the budgeted fiscal deficit target of 4.7 percent of GDP for FY13 is projected to be missed by a wide margin,' he added.

SBP Governor said the sources of consistently high fiscal deficit are well known – low tax base and evasion together with subsidies to the loss making Public Sector Enterprises (PSEs) and the energy sector. 'Due to a continuous increase in short term borrowings at a very rapid pace, the share of interest payments in current expenditures has also risen quite sharply in the last few years. Thus, comprehensive initiatives are required to make the fiscal position sustainable and restore macroeconomic stability,' he added.