Monetary Policy Decision

September 12, 2015

Year-on-year headline CPI inflation decelerated to 1.7 percent in August 2015 from 7.0 percent in August 2014. Following its declining trend of the past several months, the 12-month moving average CPI inflation came down to 3.6 percent in August 2015 from 8.4 percent in August 2014. Other indicators, such as core inflation measures, have also decreased in August 2015. Major sources of declining inflation are favorable supply shocks and demand management policies. The current deceleration owes much to the smooth supply of the perishable food items and falling international oil price pass-through to consumer prices.

Continuation of current trends along with moderate pick up in aggregate demand would largely determine the path of inflation in FY16. Recent increases in natural and compressed natural gas prices and their likely second round impacts would be offset by lower global oil price that has yet to find the bottom. Thus, there is no change in SBP's forecast of average CPI inflation for FY16 with its range of 4.5-5.5 percent remaining below the annual plan target of 6 percent.

There are, however, two possible upside risks to this forecast. Government plans of paring down of subsidy on electricity along with increase in its tariffs and the possible adverse impact of low food prices on crop production. Downside risks to the forecast include the lesser likelihood of recovery in global commodity prices including that of oil. With current trends and projections, the probability of downside risks appear to be greater than the upside risks. Moreover, the latest IBA-SBP survey of September 2015 has reported lower inflation expectations for the coming months.

The situation in external current account at the beginning of FY16 is not much different from the end of the last fiscal year. While the exports again declined in the month of July 2015, external current account deficit recorded slight improvement due to declining oil import payments and increasing workers' remittances. With favorable trends in these variables, a current account deficit of the size of end-FY15 seems manageable in this fiscal year. This is supported by the expected surplus in the capital and financial account in FY16 on the back of planned Euro/Sukuk bonds inflows, official disbursements, and the remaining IMF funding under the EFF program. Apart from yielding an overall balance of payments surplus, this would help maintain the foreign exchange reserves' upward trajectory of the last two fiscal years.

However, increases in exports and foreign direct investments are imperative for sustainability of external sector. In this regard, recent improvements in law and order situation and continued macroeconomic stability are likely to increase the prospects for long-term foreign capital inflows. Moreover, going forward, much needed boost to Pakistani exports may come through US economic recovery and through further gains in EU's GSP-Plus scheme. However, structural bottlenecks especially in the textile sector and subdued international commodity prices remain the major risk to exports outlook.

The contraction in broad money (M2) during 1st July to 28th August, 2015 was mainly a result of reduction in net domestic assets of the banking system. Increase in government borrowing from scheduled banks was offset by repayment to SBP and Pakistan Investment Bonds (PIBs) maturing during this period. The retirement of working capital in July FY16 by majority of the private sector businesses is as per their normal credit cycle. The off-take of fixed investment loans by energy generation and distribution, chemicals and services sectors signal possible pick-up in their productive activity in the coming months. Therefore, in the coming days, credit off take is expected to strengthen further.

Moreover, monetary conditions, despite easing, still appear to be tight as real lending rates are hovering around 4 percent since December FY15 due to rapidly falling inflation. Overall liquidity situation in financial markets remained stressed in the post July 2015 monetary policy period. Government borrowing from commercial banks, *Eid* related cash withdrawals, and some deposit withdrawal from banks due to seasonal factors increased liquidity shortfall in the money market. Considering liquidity shortages, SBP continued to support the market, keeping the overnight money market rate range bound.

With better law and order situation, investor and consumer confidence is improving. After recording a growth of 3.3 percent, Large-scale Manufacturing is expected to gain further traction at the back of improvement in energy supplies. Implementation of infrastructure development and energy projects under China Pakistan Economic Corridor would further enhance the improving investment environment. Therefore, there is anticipation of higher economic activity in FY16 which is expected to boost credit uptake.

Given the above macroeconomic conditions, the central board of Directors of SBP has decided to reduce the SBP policy rate by 50bps from 6.5 percent to 6.0 percent.