



Comments on the Monetary Policy Statement By SBP for March 2015

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The latest Monetary Policy Statement (MPS) of the SBP was issued on March 21, 2015. It highlights the developments on the economic front in the first seven to eight months of 2014-15. Based on the trends, especially the big fall in the rate of inflation, the State Bank of Pakistan has brought down the policy rate by 50 basis points to 8%.

The MPS generally makes a positive assessment of the economic trends up-to-date in 2014-15. It fails to highlight some of the problem spots that have emerged and are likely to constrain the economic performance in the months to come.

GROWTH

On growth, the MPS says that 'growth is on track to surpass the FY 14 outcome of 4.1%'. It is not clear how this will be the case when in the first seven months the large-scale manufacturing sector has shown a growth rate of less than 2% as compared to over 6% last year. SBP expects that higher growth will come from the major crop sector of agriculture. It seems to have forgotten the floods, especially in Punjab, which affected Kharif crops, albeit less than originally anticipated.

The SBP indicates that the output of cotton and rice is likely to be higher in FY 2015. This is not yet reflected in higher output of cotton yarn or in exports of raw cotton. Total rice exports have, in fact, fallen by 3%, while Basmati rice exports have declined by over 22 percent. Therefore, it will be surprising if the agricultural sector registers a growth rate in 2014-15 significantly more than 3%. Overall, it will be a positive development if the economy can sustain a growth rate of near 4% this year, much below the target of 5.1%.

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INFLATION

The MPS highlights the sharp fall in the rate of inflation from 8.2% in June 2014 to 3.2% in February 2015, on a year-to-year basis. This is partly attributed to prudent monetary and fiscal policies. However, it is generally recognized that this is mostly due to the sharp fall in international commodity prices, especially of oil. Demand pressures remain persistent, as demonstrated by the rate of 'core' inflation, which has fallen by only 2.5 percentage points since June 2014.

The outlook is for the inflation rate to rise somewhat in the next few months. The international price of oil has bottomed out. It has risen by 20% in February. Also, the impact of the higher procurement price of wheat by 8% may start being felt shortly. Further, the prospect of higher gas prices will contribute to more cost-push inflation.

MONEY SUPPLY

The MPS fails to highlight the record level of government borrowings from commercial banks in FY 2015, already in excess of Rs 1 trillion. This has led to a 'crowding out' of credit to the private sector, which has fallen sharply by 48%. The problem for the private sector today is more the access to credit than the cost of credit. A fall in the policy rate will only help if it is accompanied by increased lending by commercial banks to the private sector.

There are also other negative developments. The retirement of commodity financing is much slower at Rs 55 billion, as compared to Rs 133 billion last year. The provinces, especially Punjab, are carrying embarrassingly large stocks of wheat on the eve of harvesting of the next crop. Despite a subsidy, exports have not taken place due to the low international price of wheat.

The four Provincial Governments are expected to generate a large cash surplus of Rs 289 billion so as to attain the consolidated fiscal deficit target of 4.9% of the GDP in 2014-15. As of 6th of March, the cash surplus is Rs 77 billion. It is unlikely that the target will be met in the presence of a large shortfall in transfers from the Federal Government. This will be a factor contributing to a larger fiscal deficit.

FISCAL DEFICIT

The MPS commends the Government for restricting the fiscal deficit to Rs 651 billion, equivalent to 2.2% of the GDP, in first half of 2014-15. This has been achieved despite slower growth in FBR revenues of 14%, as compared to the target growth rate of 24%. The reason is the containment of expenditure. Despite a projected growth rate in cost of debt servicing of 12% this year, payments in the first six months on this account have actually fallen by 4%. Releases for the Federal PSDP projects are only 24% of the annual target in the first six months.

In January and February it is estimated, on the bases of borrowings, that the fiscal deficit in the first eight months has jumped to over 1050 billion equivalent to 3.7% of the GDP. It seems likely that the deficit will exceed 4.9% of the GDP in 2014-15.

The MPS fails to mention the plummeting of FBR revenues in the months of January and February 2015, with a combined growth rate of only 6%. It is clear now that FBR will fall short by almost Rs 200 billion in meeting the annual target. Domestic sales tax, in particular, has stopped growing, because of a stagnant tax base.

BALANCE OF PAYMENTS

The MPS highlights the decline in the current account deficit in the first eight months of 2014-15. This is due not only to the buoyancy of home remittances, fall in imports but also to large CSF and other inflows like the Ijara-Sukuk bond flotation and releases from the IMF. The decline in exports has been more than compensated for by these developments.

But a note of caution is in order here. FDI has stopped growing while the repatriation of profits by multinational companies in Pakistan has increased by as much as 42%. Net external concessional assistance from traditional donors has been only \$372 million, as compared to the target of \$1878 billion for the full year. Also, with the decline recently in the stock market, FPI has turned negative. Therefore, the financial account of the balance of payments has become more vulnerable.

Finally, there is the issue of real appreciation in the value of the rupee. The MPS quantifies this at 8% between July-June FY 2015. For example, in nominal terms, the rupee has risen in value with respect to the Euro by as much as 25% since June 2014. Can Pakistan retain its competitiveness in the EU, despite the presence of GSP+ ? The SBP will need to explain its exchange rate policy.