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Policy rate hiked to 10.75 percent

The State Bank of Pakistan (SBP) on Friday hiked the key policy rate by 50 basis points (bps) to 10.75 percent. Rising inflationary pressure on the economy, higher fiscal and current account deficit and massive government borrowing from the SBP are the factors that have compelled the Monetary Policy Committee (MPC) to further tighten the monetary policy stance for the next two months.

Cumulatively, the policy rate has increased by some 425 bps during this fiscal year (FY19) to address the economic challenges. Policy rate was surged by 100 bps to 7.50 percent in July 2018. In September, it was up by 100 bps to 8.50 percent. The committee increased the rate by 150 bps in November 2018 and some 25 bps in January 2018, while on Friday policy rate was further raised by 50 bps to 10.75 percent.

The Monetary Policy Committee (MPC) meeting held on Friday and chaired by Governor SBP Tariq Bajwa noted that sustainable growth and overall macroeconomic stability requires further policy measures due to persisting inflationary pressures, higher fiscal and current account deficit.

According to Monetary Policy Statement, economic data released since the last meeting in January 2019 indicates that the impact of stabilization measures continues to unfold.

In particular, the current account deficit recorded a sizeable contraction during the first two months of 2019, which, together with bi-lateral inflows, helped ease pressures on SBP""s foreign exchange reserves.

These developments on the external front have improved stability in the financial markets, reduced uncertainty and improved businesses confidence, as reflected in various surveys. Nonetheless, despite narrowing, the current account deficit remains high, fiscal consolidation is slower than anticipated, and core inflation continues to rise.

Average headline CPI inflation reached 6.5 percent in Jul-Feb FY19 compared to 3.8 percent recorded in the same period of last year. Meanwhile, YoY CPI inflation has risen considerably to 7.2 percent in January 2019 and further to 8.2 percent in February 2019- the highest YoY increase in inflation since June 2014.

These pressures on headline inflation are explained by adjustments in the administered prices of electricity and gas, significant increase in perishable food prices, and the continued unfolding impact of exchange rate depreciation.

Core inflation maintained its 13-month upward trajectory accelerating to 8.8 percent in February 2019 from 5.2 percent a year earlier.Further, rising input costs on the back of higher energy prices and the lagged impact of exchange rate depreciation are likely to maintain upward pressure on inflation despite a moderation in aggregate demand due to a proactive monetary management. As a result, headline CPI inflation is projected to fall in the range of 6.5 to 7.5 percent for FY19.

Amidst the efforts to curtail inflationary pressures and reduce the otherwise widening macroeconomic imbalances, domestic economic activity experienced the brunt of the stabilization measures implemented thus far.

In particular, Large-scale Manufacturing (LSM) declined by 2.3 percent during Jul-Jan FY19 against 7.2 percent growth recorded in the same period of last year. The latest available estimates of major crops also depict a lackluster performance by the agriculture sector.

According to statement, the slowdown in commodity producing sectors has downside implications for growth in services sector as well. Similarly, a deceleration in consumer demand and capital investments, reflected through a cut in development spending and deceleration in credit for fixed investments, indicates a moderation in domestic demand. In this backdrop, the real GDP growth is projected to be around 3.5 percent in FY19.

Owing to stabilization measures, the current account deficit narrowed to $ 8.8 billion in Jul-Feb FY19 compared to a deficit of $ 11.4 billion during the same period last year - a fall of 22.6 percent. This includes a notable pace of retrenchment of the current account deficit by 59.9 percent during the first two months of 2019 over the same period of last year.

The reduction in the external balance was mainly driven by a 29.7 percent decline in the trade deficit in goods and services as well as a strong growth in remittances. While, the decline in the trade deficit is in large part driven by import compression - this decline would have been even more pronounced if not for a rise in oil prices.

Exports, in dollar value, during this period remained flat, however in terms of quantum there has been a notable improvement. Though still posing a significant challenge in terms of its financing, the narrowing of the current account deficit has translated into some stability in the foreign exchange market.

With an improvement in the external balance as well as an increase in bilateral official inflows, SBP""s foreign exchange reserves gradually recovered to $ 10.7 billion on 25th March 2019.

While the reserves are still below the standard adequacy levels (equal to three months of imports cover), the recent improvement on the external front has nevertheless improved business confidence.

This is captured in the recent wave of IBA-SBP surveys of a large number of firms in industry and services sectors. Having said that, the share of private financial flows needs to increase on sustainable basis to achieve medium-to-long term stability in the country""s external accounts. Similarly, as enunciated in previous statements, concerted structural reforms are required to reduce the trade deficit by improving productivity and competitiveness of the export-oriented sectors.

The fiscal deficit for HI-FY19 was higher at 2.7 percent of GDP when compared with 2.3 percent for the same period of last year. In view of the shortfalls in revenue collections and escalating security-related expenditures it is most likely that the target for the fiscal deficit in FY19 would be breached. So far, a significant portion of the fiscal deficit was financed through borrowings from SBP, which if continued, will not only complicate the transmission of monetary policy but also dilute its impact and prolong the ongoing consolidation efforts.

In absolute terms, the government borrowed Rs3.3 trillion from SBP and retired Rs2.2 trillion of its borrowing from scheduled banks (on cash basis)during 1st Jul-15th Mar, FY19.

The massive government borrowing from SBP facilitated the banks to meet private sector credit demand that increased by 9.2 percent without putting pressures on the market interest rates.

Much of the increase in credit demand was for working capital due to higher input prices and capacity expansions in the power and construction allied industries. Overall, money supply (M2) grew by 3.6 percent during 1st Jul - 15th Mar, FY19 against a 2.4 percent increase in the same period of last year. This growth in M2 was solely driven by expansion in net domestic assets, as net foreign assets declined.

Taking into account the above developments and the evolving macroeconomic situation, the MPC noted that sustainable growth and overall macroeconomic stability requires further policy measures as underlying inflationary pressures continue; the fiscal deficit is elevated, and despite an improvement,the current account deficit is still high.

In this backdrop and after detailed deliberations, the MPC decided to increase the policy rate by 50 bps to 10.75 percent effective from 1st April 2019.

Reuters adds: The move, just days after the central bank cut its 2019 growth forecast to between 3.5 and 4 percent, underlines the pressure cash-strapped Pakistan faces to tighten monetary policy as it seeks a bailout from the International Monetary Fund.

Pakistan""s economy has faced increasing headwinds, with ratings agency Standard and Poor""s cutting its sovereign rating to ""B-"" from ""B"" last month, citing diminished growth prospects as well as external and fiscal stresses.

Pakistani exports have lagged despite a sharp weakening in the value of the rupee, which has lost about a quarter of its value in the past year.

Pakistan""s chronically strained foreign exchange reserves improved somewhat, rising to $10.7 billion as of this week, healped by funds booked from funding agreements with Saudi Arabia and the United Arab Emirates.

However the fiscal deficit, which IMF projections forecast will approach 7 percent of gross domestic product this year, widened further and the central bank said the fiscal defict target for the current year would be breached.

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