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SBP's response to Covid-19 challenge

After keeping the policy rate unchanged at 13.25 percent for several months, the Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) has finally decided to reduce it by 75 basis points (bps) to bring it down to 12.50 percent per annum with effect from 18th March, 2020. In addition to the reduction in the policy rate, the MPC has also recognised the negative effects of the spread of COVID-19 in Pakistan and announced two refinance windows to counter the impact of this deadly virus on the economy. Under the first scheme known as "Temporary Economic Refinance Facility (TERF)", SBP will refinance banks to provide financing at a maximum end-user rate of 7 percent for 10 years for setting up new industrial units. The total size of this scheme will be Rs 100 billion, with a maximum loan size of Rs 5 billion. The second facility named as "Refinance Facility for Combating COVID-19 or RFCC" will refinance banks to provide financing at a maximum end-user rate of 3 percent for 5 years for the purchase of equipment to detect, treat and contain coronavirus. The SBP will provide this facility to banks at 0 percent and size of the scheme will be Rs 5 billion, with a maximum financing limit of Rs 200 million.

The following are main reasons given for the cut in the policy rate by the SBP:

There has been a notable deceleration in CPI inflation to 12.4 percent in February, 2020 compared to the surge of 14.6 percent a month earlier. Recent weekly outturns in essential food items show that the earlier price shocks were transitory and there was a strong likelihood that average inflation in FY20 would be in the range of 11-12 percent. A sharp fall in global oil prices and slowdown in external and domestic demand due to coronavirus pandemic are likely to ensure further fall in prices. The MPC felt that the real interest rates were appropriate on a forward-looking-basis to achieve the 5-7 percent medium-term inflation target. The sharp improvement in the external sector during the current fiscal year also called for a reduction in the policy rate. The C/A deficit contracted by as much as 72 percent to 2.65 billion dollars during July-January, 2020, due mainly to a significant reduction in imports and a modest growth in both exports and workers' remittances. Driven mainly by a narrowing C/A deficit, foreign exchange reserves held by the SBP have increased from dollar 7.28 billion at the end of June, 2019 to dollar 12.76 billion at the close of February, 2020, an increase of dollar 5.48 billion within the first eight months of FY20. There has also been a sizeable reduction of dollar 5.20 billion in SBP's forward liabilities in the same period. Obviously, the increase in the net reserve portfolio of SBP by dollar 10.68 billion is sufficient to cope with any portfolio outflows or 'hot' money in an orderly fashion.

The developments on the fiscal front and in the real economy were also not alarming. According to the SBP, fiscal consolidation, with a healthy increase of 17.1 percent in tax revenues, remains on track. However, the government would face challenges in achieving revenue targets for this year if there was disruption in economic activity and health and social sectors required increased expenditures to cushion the impact of coronavirus pandemic. In view of the recent domestic and global developments, SBP now projects the growth rate at around 3.0 percent for FY20 and a modest recovery thereafter, provided the spillover impact of the coronavirus outbreak on global trade and financial markets is moderate and short-lived.

Although the business community in general and perhaps the executive branch of government as well would be somewhat disappointed due to the cut in policy rate lower than expected, the SBP's decision to take a realistic view of the situation and adopt a cautious attitude at this stage is more appropriate to achieve the objective of monetary stability in the medium to long-term. It is of course true that the incumbent Governor of the State Bank had raised the policy rate by a significant margin after he assumed office but it was not advisable to go for a similar or bigger cut in the absence of compelling justification. Yes, the rate of inflation, which is the main determinant of the policy rate, has decelerated somewhat but it is still at a very high level; and the fall in inflation is only visible in the past few weeks. The inflationary pressures could reemerge if there is any disruption in the supplies of essential items due to coronavirus or a rise in prices of POL products due to better understanding between OPEC and non-OPEC countries, particularly between Saudi Arabia and Russia. According to all indications, the rate of growth is still expected to be lower and fiscal deficit during FY20 higher than the original targets which would not allow the inflation rate to settle at a very low level. Although the C/A balance of the country has improved a lot but the deficit has not yet been eliminated completely, forcing the authorities to continue borrowing from foreign sources to enhance the stock of foreign debt. The full extent of negative consequences of coronavirus are also not fully evident as yet. All of this suggests that it is better to take a wait-and-see approach to monetary policymaking before making a major reduction in the policy rate.

The two refinance facilities introduced by the SBP, though unexpected, are, also, in our view, timely and very much in accordance with the evolving situation. The entrepreneurs were not prepared to invest in the country for new projects due to a variety of reasons including overall uncertainty in policies and high rates of interest demanded by commercial banks. As a consequence, weak economic activity continued to be a drag on the growth in private sector credit which expanded by only 3.6 percent during July, 2019-6th March, 2020 or less than half the rate seen during the same period of last year. By establishing TERF at the end-user rate of only 7 percent for 10 years with a total size of Rs 100 billion will enable the entrepreneurs to establish new industries and undertake more projects. This will fuel economic activity, promote growth and increase employment opportunities in the country, which is the need of the hour. The RFCC was also urgently required as our hospitals and other medical facilities are not properly equipped to combat the threat of COVID-19. The extension of RFCC would enable setting up of the much-needed requisite facilities to tackle this pandemic. It seems that this step is somewhat late and should have been taken much earlier when this issue acquired the dimension of pandemic. Well, better late than never.