# Monetary Policy Statement

January 2018

Pakistan's economic growth is on track to achieve its highest level in the last eleven years. Average headline inflation remains within the forecast range of SBP, but core inflation has continued to increase. Fiscal deficit for H1-FY18 is expected to fall close to the last year's 2.5 percent. There has been visible improvement in export growth and remittances are marginally higher. However, largely due to high level of imports the current account deficit remains under pressure. The exchange rate adjustment in December 2017 is expected to help ease the pressure on the external front.

The progress in the real sector indicates that agriculture sector is set to perform better for the second year in a row. Production of all major Kharif crops, except maize, has surpassed the level of FY17. Similarly, large scale manufacturing (LSM) recorded a healthy broad-based growth of 7.2 percent during Jul-Nov FY18 as compared to 3.2 percent during the same period last year. While there could be some deceleration in LSM growth due to sector specific issues such as sugar, POL and fertilizer, overall industrial activity is likely to remain strong. Benefiting from both infrastructure and CPEC related investments, construction and its allied industries are expected to maintain their higher growth momentum. After incorporating the impact of commodity sector dynamics on the services sector, the real GDP growth is projected to be around 5.8 percent, significantly higher than FY17, but marginally lower than the annual target of 6 percent for FY18. This is largely due to expectations of a below-target wheat crop because of a reduction in area under cultivation.

Average headline inflation for H1-FY18 stands at 3.8 percent. Meanwhile, core inflation (non-food-non-energy) continued to maintain its higher trajectory, and clocked in at 5.5 percent during the first half of the year as compared to 4.9 percent last year. This together with a lagged impact of PKR depreciation and rising international oil prices are likely to increase inflation in the coming months. Taking into account the impact of all these developments, while the average inflation for FY18 is still projected to fall in the range of 4.5 to 5.5 percent, end of fiscal year YoY inflation is likely to inch towards the annual target of 6 percent.

Broad money supply grew marginally by 1.9 percent during 1st Jul-12th Jan FY18.. This is a reflection of the decline in NFA and government efforts to contain expenditures. Higher tax collection and proceeds from the issuance of Sukuk and Eurobond have led to reduction in net budgetary borrowing which stood at Rs. 401.9 billion during 1st Jul-12th Jan FY18 as compared to Rs. 470.4 billion in the corresponding period of the previous year. Moreover, the delay in the sugar crushing season also contributed to a moderation of demand in private sector credit.

On the external front, export receipts posted the highest growth in the last seven years of 10.8 percent in H1-FY18 against a reduction of 1.4 percent in H1-FY17. Worker's remittances also recorded growth (2.5 percent) during the first half of the year as compared to a decline in the same period last year. However, favorable impact of these positives was overshadowed by the continuation of strong growth in imports of goods and services. The current account deficit widened to US$ 7.4 billion during the first half of the year, which was 1.6 times of the deficit during the same period last year. Developments in financial accounts show that one-fifth of this deficit was financed by healthy foreign direct investments inflows, and the rest was managed by the official flows and the country's own resources. As a result, SBP's liquid foreign exchange reserves witnessed a decline of US$ 2.6 billion since end June 2017 to reach US$ 13.5 billion as of 19th January 2018. Going forward, the PKR depreciation in December 2017, the export package, the lagged impact of adjustments in regulatory duties, favorable external environment, and expected increase in workers' remittances, will contribute to a gradual reduction in the country's current account deficit. While increase in international oil prices pose a major risk to this assessment, managing overall balance of payments in near term depends on the realization of official financial flows.

Four key factors of Pakistan's economy have witnessed important changes since November 2017 impinging upon the policy rate decision. Firstly, PKR has depreciated by around 5 percent. Secondly, oil prices are hovering near USD 70 per barrel. Thirdly, a number of central banks have started to adjust their policy rates upwards adversely affecting PKR interest-rate differentials vis-à-vis their currencies. Fourthly, multiple indicators show that the output gap has significantly narrowed indicating a buildup of demand pressures.

Based on these developments, MPC is of the view that in order to preempt overheating of the economy and inflation breaching its target rate, this is the right time to make a policy decision that would balance growth and stability in the medium to long term. Accordingly, the Monetary Policy Committee has decided to raise the policy rate by 25 bps to 6.00 percent.