Monetary Policy Statement

September 21, 2020

1. At its meeting on 21st September 2020, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 7 percent. The MPC noted that compared to the time of the last meeting in June 2020, business confidence and the outlook for growth have improved. This reflects the decline in Covid-19 cases in Pakistan and the easing of lockdowns, as well as the timely stimulus provided by the Government and SBP. At the same time, the forecast for inflation has risen slightly, primarily due to recent supply side shocks to food prices. Average inflation is now expected to fall within the previously announced range of 7 – 9 percent during FY21, rather than marginally below.

2. The MPC noted that financial conditions continue to be accommodative with real interest rates remaining slightly below zero on a forward-looking basis. In addition, the series of targeted measures undertaken by SBP since the Covid-19 outbreak have injected significant liquidity and further lowered funding costs for many businesses and households. Together, these monetary measures have injected an estimated stimulus of Rs. 1.58 trillion, or about 3.8 percent of GDP, in the cash flow of businesses and households. In addition, the government has undertaken a number of significant measures to support economic activity including the Ehsaas emergency cash program, commodity financing, a risk-sharing facility for SMEs, and acceleration of tax refunds.

3. Taking into account the changes in the outlook for inflation and growth since the last MPC and the impact of the stimulus measures undertaken by the Government and SBP, the MPC was of the view that the stance of monetary policy remained appropriate to provide needed support to the emerging recovery, while keeping inflation expectations well-anchored and maintaining financial stability.

4. In reaching its decision, the MPC considered key trends and prospects in the real, external and fiscal sectors, and the resulting outlook for monetary conditions and inflation.

Real sector

5. Following a deep contraction between March and June, the large-scale manufacturing (LSM) index returned to expansion in July, growing at 5 percent (y/y). High-frequency demand indicators including auto sales, cement dispatches, POL sales, and electricity consumption also reflect an encouraging pick-up in economic activity. Nonetheless, the economic recovery remains uneven across industries, with the hospitality and certain services sectors especially lagging, and the level of activity generally still remains below pre-Corona levels. Going forward, growth is projected to recover to slightly above 2 percent in FY21, after falling to -0.4 percent last year. The recovery is expected to be driven mainly by manufacturing-related activities and construction, which are being supported by various financial policies from SBP including the Temporary Economic Refinance Facility (https://www.sbp.org.pk/smefd/circulars/2020/CL20.htm) and the government's incentives for the housing and construction sectors. The growth outlook is subject to uncertainty. On the downside, risks include a potential second wave of Covid-19 domestic infections, a possible sharp increase in infections in the winter months in Pakistan's major export markets in Europe and the US, and the threat to agriculture from locust attacks. On the upside, a faster global recovery could lift exports higher.

External sector

6. Despite a challenging environment, the external sector has remained resilient since the Coronavirus outbreak. The flexible market-determined exchange rate, introduced in May 2019, has played its valuable role as a shock absorber, as witnessed in orderly two-way movement of the currency. Low global oil prices and subdued domestic demand helped to reduce the current account deficit further during the onset of the Coronavirus. More recently, a gradual recovery is expected in exports and remittances have performed strongly on the back of orderly exchange rate conditions as well as supportive policy steps taken by the Government and SBP under the Pakistan Remittance Initiative. Remittances rose to a record monthly high in July and have topped US$ 2 billion for the last three months. By supporting the current account, which swung into a surplus in July, these developments have helped to restore SBP's foreign exchange reserves to their pre-pandemic level of around US$ 12.8 billion. As a result, Pakistan's reserve adequacy is now back above the important global benchmark of 3 months of import cover. Looking ahead, the current account deficit is expected to remain bounded at around 2 percent of GDP. This, together with expected private and official flows, should continue to keep Pakistan's external position stable in FY21.

Fiscal sector

7. Despite severe pressures from the Coronavirus and contrary to expectations, the fiscal deficit for FY20 ended lower than in FY19 and the increase in public debt was contained to around 1 percent of GDP. This largely reflects the strong steps taken by the government to ensure a primary surplus in the first nine months of FY20, which helped provide fiscal space to respond to the Coronavirus outbreak. During the first two months of FY21, in line with the gradual pick-up in economic activity, tax revenues returned to positive growth, averaging around 1.2 percent (y/y). While far below pre-pandemic growth rates, this recovery in tax collections represents an encouraging turnaround from the double-digit reduction observed during the last quarter of FY20, although risks remain around achieving the revenue target. Federal PSDP-related outlays almost doubled during July-August 2020 compared to the same period last year. Overall, in line with this year's budget, the MPC expects that the pre-pandemic path of fiscal consolidation will resume as economic activity recovers in coming quarters.

Monetary and inflation outlook

8. The MPC noted that, notwithstanding an uptick in headline inflation during June and July, core inflation has been relatively stable and demand-side risks to inflation remain well-contained. Like growth, the inflation outlook is also subject to certain risks. On the upside, risks revolve around food prices, especially in the wake of recent flood-related damages and potential locust attacks. On the downside, the main risk stems from a lower-than-expected pickup in domestic activity. On the global front, the future trajectory of oil prices will also have an important bearing on the domestic inflation outlook.

9. In the wake of heightened risk aversion from banks due to the Coronavirus pandemic, private sector credit has recently been supported to a significant extent by SBP refinance facilities. These facilities, coupled with other supervisory actions related to deferment and restructuring of loans, have ensured the availability of necessary funding to businesses and households, providing important support to growth and employment.

10. Overall, the MPC was of the view that the current monetary policy stance is appropriate to support the emerging recovery while safeguarding inflation expectations and financial stability.