Monetary Policy Statement

March 17, 2020

1. At its meeting on 17th March 2020, the Monetary Policy Committee (MPC) decided to cut the policy rate by 75 bps to 12.50 percent. The decision reflected the MPC's view that the outlook for inflation has improved in light of the recent deceleration in domestic food prices, significant decline in consumer price expectations, sharp fall in global oil prices, and slowdown in external and domestic demand due to the Coronavirus pandemic. Average headline inflation is expected to remain within the SBP's 11-12 percent forecast in FY20, before falling to the medium-term target range of 5-7 somewhat earlier than previously forecast.

2. In addition to its decision on interest rates, the MPC noted that the SBP's new 'Temporary Economic Refinancing Facility (TERF)' for businesses—that provides SBP refinancing for bank lending for plant and machinery for new projects at 7.0 percent fixed for 10 years—should provide important additional support to investment in response to the anticipated slowdown in activity due to the Coronavirus pandemic.

3. The MPC emphasized that it stood ready to take further actions if and when needed as more information becomes available on the outlook for inflation and growth.

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

Key developments since the last MPC meeting

5. The MPC noted that the dominant development since the last meeting on 28th January 2020 has been the outbreak of the Coronavirus, which has taken a significant toll on human life around the world. The outbreak has reduced external and domestic demand, while increasing risk aversion and uncertainty about the future. At the same time global oil prices have plummeted which, if sustained, should help lower domestic inflation and improve the current account. Heightened global risk aversion has recently reduced demand for emerging market assets across the world, and has led to some volatility and depreciation in the domestic foreign exchange market in the past few days, as in other emerging markets. The MPC emphasized that the current market volatility is externally driven and the strengthening in the fundamentals of Pakistan's economy that drove the improvement in Pakistan markets before the Coronavirus outbreak remains intact. As a result, they viewed that the volatility in the domestic markets would likely subside once global risk aversion reduces and country-specific fundamentals regain importance. The MPC also noted that a staff-level agreement with the IMF on the second review under the Extended Fund Facility (EFF) was successfully reached, which will support investor sentiment.

Real sector

6. Recent high-frequency indicators re-affirmed that the decline in most economic sectors was bottoming-out before the Coronavirus outbreak. Large-scale manufacturing (LSM) rebounded strongly in December 2019, moving into positive growth (9.7 percent y/y) for the first time in the last six months, and indicated strengthening in a growing number of industries, especially export-oriented ones. Notwithstanding some improvement relative to last year, agricultural growth is likely to be lower than previously forecast.

7. In light of recent domestic and global developments, SBP now projects real GDP growth for FY20 of around 3.0 percent, while expecting a modest recovery next year provided that the spillover impact of the Coronavirus outbreak on global trade and financial markets is moderate and short-lived. In such a scenario, the export slowdown and market volatility should be contained while the benign growth and inflation impacts of lower global commodity prices would dominate. Under an adverse scenario, a more prolonged and severe phase of weak demand in Pakistan's major export and remittance markets and depressed sentiment among domestic consumers and businesses could have a more material impact on growth. In both these scenarios, the impact on the current account was expected to be mildly positive as the savings from low oil prices were expected to offset potential weaknesses in net exports and remittances.

External sector

8. The external sector continues to improve substantially. The current account deficit contracted by 72 percent to US$2.65 billion during Jul-Jan FY20, driven by a significant reduction in imports and modest growth in both exports and workers' remittances. The MPC noted that Pakistan's exports have performed better in recent months than most of its competitors despite the challenging external environment. This improvement reflected the benefits of a more competitive exchange rate, availability of low-cost funding for export-oriented sectors under the SBP's refinancing facilities, and government efforts to facilitate businesses.

9. Notwithstanding recent volatility in foreign exchange markets, the SBP's FX reserves have maintained strong growth, driven by the narrowing current account deficit. Reserves increased from US$ 7.28 billion at end-June 2019 to US$ 12.76 billion as of end-February 2020 – an increase of US$ 5.48 billion. The actual improvement in the country's external position is much larger, given the sizeable reduction in SBP's forward liabilities of US$ 5.20 billion during the same period. The MPC observed that this increase in the net reserve buffers of SBP of US$ 10.68 billion is more than sufficient to cope with any portfolio outflows in an orderly manner. The MPC noted that the SBP continues to monitor developments carefully and stands ready to respond effectively to address any disorderly market conditions.

Fiscal Sector

10. Fiscal consolidation remains on track, supporting a qualitative improvement in the inflation outlook. During Jul-Feb FY20, tax revenues showed a healthy increase of 17.1 percent over the same period last year. On the expenditure side, increased public spending relative to last year is supporting business activities, especially in construction-allied industries. Going forward, the government could face challenges in achieving revenue targets for this year, especially if there are disruptions in economic activity, and may require increased expenditures in health and social sectors to cushion the impacts of the Coronavirus pandemic.

Monetary and inflation outlook

11. Weak economic activity continues to be a drag on private sector credit, which expanded at 3.6 percent during 1st Jul to 6th Mar FY20, less than half the rate seen during the same period last year. SBP continues to support economic activity through its refinancing facilities, such as its Long-term Financing Facility (LTFF) scheme for export-oriented sectors and its new TERF facility in light of the Coronavirus pandemic.

12. Headline inflation numbers recorded sizable changes since the last MPC meeting, driven by volatile food prices. National CPI inflation surged to 14.6 percent (y/y) in January 2020, before an equally notable deceleration in February 2020 to 12.4 percent. The MPC noted that recent weekly outturns in essential food

prices reinforced their assessment that the earlier shocks were transitory and that the underlying trend in headline inflation, captured in relatively stable core inflation and declining consumer inflation expectations, would remain moderate in the remaining part of this fiscal year. Currently, average national CPI stands at 11.7 percent during the first eight months of FY20.

13. Barring unforeseen shocks, the inflation momentum is expected to moderate further in coming months. There is a high likelihood that average inflation in FY20 will be in the 11-12 percent range forecast by the MPC at the start of the year. With today's reduction in the policy rate, the MPC felt that real interest rates are appropriate on a forward-looking basis to achieve the 5-7 percent medium-term inflation target. The MPC also decided to make the interest rate corridor symmetric around the policy rate, in line with international best practices.