Monetary Policy Statement

October 10, 2022

1. At today's meeting, the Monetary Policy Committee (MPC) decided to maintain the policy rate at 15 percent. The MPC noted the continued deceleration in economic activity as well as the decline in headline inflation and the current account deficit since the last meeting. It also noted that the recent floods have altered the macroeconomic outlook and a fuller assessment of their impact is underway. Based on currently available information, the MPC was of the view that the existing monetary policy stance strikes an appropriate balance between managing inflation and maintaining growth in the wake of the floods. On the one hand, inflation could be higher and more persistent due to the supply shock to food prices, and it is important to ensure that this additional impetus does not spillover into broader prices in the economy. On the other, growth prospects have weakened, which should reduce demand-side pressures and suppress underlying inflation. In light of these offsetting considerations, the MPC considered it prudent to leave monetary policy settings unchanged at this stage.

2. Since the last meeting, the MPC noted several key developments. First, the desired moderation in economic activity has become more visible and entrenched, signaling that the tightening measures implemented over the last year are gaining traction. With growth likely to slow further in the aftermath of the floods, this tightening will need to be carefully calibrated going forward. Second, after peaking in August as expected, headline inflation fell last month due to an administrative cut in electricity prices. However, core inflation continued to drift upwards in both rural and urban areas. Third, the current account and trade deficits narrowed significantly in August and September, respectively, and the Rupee has recouped some of its losses following the recent depreciation. Fourth, the combined 7th and 8th review under the on-going IMF program was successfully completed on August 29th, releasing a tranche of $1.2 billion.

3. The MPC discussed the post-flood macroeconomic outlook, noting that projections are still preliminary and would become firmer after the flood damage assessment being conducted by the government is finalized. Based on currently available information, GDP growth could fall to around 2 percent in FY23, compared to the previous forecast of 3-4 percent before the floods. Meanwhile, higher food prices could raise average headline inflation in FY23 somewhat above the pre-flood projection of 18-20 percent. The impact on the current account deficit is likely to be muted, with pressures from higher food and cotton imports and lower textile exports largely offset by slower domestic demand and lower global commodity prices. As a result, any deterioration in the current account deficit is expected to be contained, still leaving it in the vicinity of the previously forecast 3 percent of GDP.

Real sector

4. The economy has slowed considerably since the last MPC meeting. Most demand indicators were lower in both July and August than in the same period last year—including sales of cement, POL, and automobiles. On the supply side, electricity generation declined for the third consecutive month in August, falling by 12.6 percent (y/y). In July, LSM declined by 1.4 percent (y/y), its first contraction in two years, largely driven by broad-based deterioration in domestically-oriented sectors. Looking ahead, the recent floods are likely to adversely affect the output of cotton and rice as well as the livestock sector this year.

External sector

5. The current account deficit shrank for the second consecutive month in August to only $0.7 billion, almost half the level in July. In September, PBS data shows that the trade deficit contracted sharply by 19.7 percent (m/m) and 30.6 percent (y/y) to reach $2.9 billion, reflecting a decline in both energy and non-energy imports amid stable exports. During the first quarter of FY23, imports have declined by 12.7 percent (y/y) to $16.3 billion while exports have grown by 1.8 percent (y/y) to $7 billion. Looking ahead, the floods are likely to result in greater need for some agricultural imports such as cotton and a few perishable food items. At the same time, exports of rice and textiles are likely to be negatively affected. However, these adverse impacts could to a large extent be offset by downward pressures on the import bill from lower domestic growth and falling global commodity prices and shipping costs. In addition, as experienced after previous natural disasters in Pakistan, the impact on the current account could be further cushioned by international assistance in the form of current transfers. Given secured external financing and additional commitments in the wake of the floods, FX reserves should improve through the course of the year.

Fiscal sector

6. In July, fiscal outcomes were better than in the same period last year. The fiscal deficit fell to 0.3 percent of GDP while the primary balance recorded a surplus of 0.2 percent of GDP. This improvement was largely due to higher FBR tax revenues as well as a decline in government spending. During the first quarter, FBR tax collection rose to Rs 1.635 trillion, surpassing the target by Rs 27 billion. While the floods could make it challenging to achieve the planned fiscal consolidation this year, the government has so far been able to meet urgent spending needs through re-allocation and re-appropriations of budgeted funds. Looking ahead, additional foreign inflows, including in the form of grants, should help fund any fiscal slippages. Beyond the current year, reconstruction and rehabilitation will necessitate additional spending over the medium-term, with assistance from the international community.

Monetary and inflation outlook

7. In line with slowing economic activity, private sector credit has seen a net retirement of Rs 0.7 billion so far this fiscal year, compared to an expansion of Rs 62.6 billion during the same period last year. This decline in credit mainly reflects a retirement of working capital loans and a sharp fall in consumer finance.

8. After peaking in August, headline inflation fell by more than 4 percentage points in September to 23.2 percent (y/y), driven by a reduction in electricity prices due to an administrative intervention. At the same time, the momentum of inflation also slowed by more than expected, declining by 1.2 percent (m/m). On the other hand, both core and food inflation picked up further. Looking ahead, the supply-shock to food prices from the floods is expected to put additional pressure on headline inflation in the coming months. Nevertheless, headline inflation is still projected to gradually decline through the rest of the fiscal year, particularly in the second half. Thereafter, it should fall towards the upper range of the 5-7 percent medium-term target by the end of FY24. A continuation of prudent monetary policy and orderly movements in the Rupee should help contain core inflation going forward. At the same time, curbing food inflation through administrative measures to resolve supply-chain bottlenecks and any necessary imports should be a high priority. The MPC will continue to carefully monitor developments affecting medium-term prospects for inflation, financial stability, and growth.