Monetary Policy Statement

March 19, 2021

1. At its meeting on 19th March 2021, the Monetary Policy Committee (MPC) decided to maintain the policy rate at 7 percent. The MPC noted that since the last meeting in January, growth and employment have continued to recover and business sentiment has further improved. While still modest, at around 3 percent, growth in FY21 is now projected to be higher than previously anticipated due to improved prospects for manufacturing and reflecting in part the monetary and fiscal stimulus provided during Covid. Recent inflation out-turns have been volatile, with the lowest reading on headline inflation in more than two years in January 2021 followed by a sharp rise in February. According to SBP estimates, the recent increase in electricity tariffs and sugar and wheat prices accounts for about 1½ percentage points of the 3 percentage point increase in inflation between the January and February out-turns. The recent increase in electricity prices will continue to manifest in headline numbers in coming months, keeping average inflation in FY21 close to the upper end of the previously announced range of 7-9 percent.

2. While noting that the recent increase in inflation is primarily due to supply-side factors, the MPC also highlighted that the output gap is still estimated to be negative, core inflation continues to be relatively subdued, and inflation expectations—while drifting up somewhat due to the recent increase in headline inflation numbers—are still well-anchored. Looking ahead, as the temporary increase in inflation from administered prices wanes, inflation should fall to the 5-7 percent target range over the medium-term. Given this underlying inflation trajectory, the MPC felt that the existing accommodative stance of monetary policy remained appropriate to support the recovery while keeping inflation expectations well-anchored and maintaining financial stability. From a policy mix perspective as well, given that fiscal policy is expected to remain contractionary to reduce public debt, the MPC noted that it was important for monetary policy to be supportive as long as second-round effects of recent increases in administered prices and other one-off supply shocks do not materialize and inflation expectations remain well anchored.

3. In reaching its decision on the policy rate, the MPC also took note of the uncertainty around the inflation and growth outlook. On the growth front, the MPC noted that despite recent momentum, risks remain due to the emergence of a third, more virulent wave of Covid in Pakistan just as the vaccine roll-out is beginning. In terms of the inflation outlook, this summer's wage negotiations and any new tax measures in the next year's budget could add further supply-side shocks. In addition, optimism about a stronger US-led world recovery this year is translating into higher international commodity prices, including both food and oil, which could continue to feed into domestic inflation. These trends in the outlook for inflation and growth will need to be carefully monitored. In the absence of unforeseen developments, the MPC expects monetary policy settings to remain broadly unchanged in the near term. As the recovery becomes more durable and the economy returns to full capacity, the MPC expects any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates.

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. The economic recovery underway since last summer continues, buoyed by appropriately supportive monetary policy, the SBP's temporary refinancing facilities, and targeted fiscal support. Large-scale manufacturing (LSM) grew further by 10.8 percent (y/y) in December 2020 and 9.1 percent (y/y) in January 2021. Through the first seven months of FY21, LSM has grown by 7.9 percent, compared to a contraction of 3.2 percent during the same period last year. Nevertheless, capacity utilization in a number of industries is still lagging and labor market slack remains. A wide range of other high-frequency indicators signal robust growth, including sales of fast-moving consumer goods, automobiles, cement, POL and electricity. In services, transportation is benefiting from the pick-up in manufacturing, while business sentiment indicators foresee further improvements in both activity and employment in coming months. In agriculture, all major Kharif crops except cotton have surpassed production levels in FY20 and targets for FY21, and indicators of input conditions—such as tractor sales, fertilizer usage, water availability, and weather—suggest strong prospects, especially for wheat.

External sector

6. The current account remains in surplus of $0.9 billion through the first seven months of FY21 on the back of record remittances, relatively subdued domestic demand and a nascent recovery in exports. At $230 million, the current account deficit in January was around one-third of its level in December 2020. As the economy recovers, the trade deficit is widening somewhat on the back of imports of capital goods and industrial materials as well as food, together with rising international commodity prices. Nevertheless, the current account deficit in FY21 is still expected to remain below 1 percent of GDP given the out-turn to date, continued strong prospects for remittances—which have remained above $2 billion for the last 9 months—and the on-going pickup in exports, especially high value-added textiles. The recent staff-level agreement on the resumption of the IMF program has further boosted prospects and ensured that external financing needs will be comfortably met. These favorable developments and improving sentiment contributed to an additional 3.4 percent appreciation in the PKR since the last MPC meeting, which now stands close to a one-year high, and helped to keep SBP's foreign exchange reserves around $13 billion, levels last seen three years ago.

Fiscal sector

7. Fiscal developments continue to evolve largely in line with the consolidation envisaged in this year's budget, as the necessary fiscal stimulus imparted in Q4 of FY20 is unwound. During H1 FY21, the fiscal deficit stood at 2.5 percent of GDP, broadly unchanged from the same period last year despite higher interest and Covid-related payments. This mainly reflects healthy growth in revenues, with FBR net tax revenue provisionally growing by 6.0 percent (y/y) through February to surpass target levels despite higher refunds, and non-tax revenue increasing by 16.8 percent (y/y) through December on account of SBP profit transfers and the petroleum levy. Despite higher non-interest current expenditures, the primary balance posted a surplus of 0.7 percent of GDP during H1 FY21.

Monetary and inflation outlook

8. The MPC noted that despite the recent slight uptick in market yields, financial conditions remain appropriately accommodative given continued slack in the economy, on-going fiscal consolidation and well-contained risks to financial stability. Following a seasonal contraction due to retirement of working capital loans in January, private sector credit has resumed its expansionary trend across all major lending categories. Through FY21 so far, private sector credit has surpassed last year's corresponding levels on the back of a sizable expansion in fixed investment loans and consumer financing, primarily due to the lower interest rate environment as well as the SBP's subsidized refinancing schemes, especially LTFF and TERF.

9. While prices of perishable food items have moderated since the last MPC, hikes in administered prices, sugar and wheat led to a significant rise in headline inflation in February 2021, arresting the downward trend observed since September 2020. However, given continued spare capacity in the economy, core inflation remains more subdued and has actually declined in rural areas. Moreover, there is little evidence of de-anchoring of inflation expectations or economy-wide wage pressures. As a result, while headline inflation may continue to remain elevated in coming months due to administered prices and base effects, underlying price pressures from the demand-side or second-round effects should remain contained. Looking further ahead, this year's upcoming round of wage negotiations, next year's budget, and the path of domestic energy prices and international commodity prices may have an important bearing on the inflation trajectory. The MPC will monitor these developments carefully and react to them appropriately when needed.