Monetary Policy Statement

January 22, 2021

1. At its meeting on 22nd January 2021, the Monetary Policy Committee (MPC) decided to maintain the policy rate at 7 percent. The MPC noted that since the last meeting in November, the domestic recovery has gained some further traction. Most economic activity data and indicators of consumer and business sentiment have shown continued improvement. As a result, there are upside risks to the current growth projection of slightly above 2 percent in FY21. On the inflation front, recent out-turns are also encouraging, suggesting a waning of supply-side price pressures from food and still-benign core inflation. While utility tariff increases may cause an uptick in inflation, this is likely to be transient given excess capacity in the economy and well-anchored inflation expectations. As a result, inflation is still expected to fall within the previously announced range of 7-9 percent for FY21 and trend toward the 5-7 percent target range over the medium-term. With the inflation outlook relatively benign aside from the possibility of temporary supply-side shocks, the MPC felt that the existing accommodative stance of monetary policy remained appropriate to support the nascent recovery while keeping inflation expectations well-anchored and maintaining financial stability.

2. While noting these favorable growth and inflation developments, the MPC also stressed that considerable uncertainty remains around the outlook. The trajectory of the Covid pandemic is difficult to predict, given still-elevated global cases, the emergence of new strains, and lingering uncertainties about the roll-out of vaccines worldwide. Such external shocks could slow the recovery. In light of such Covid-related uncertainties, the MPC considered it appropriate to provide some forward guidance on monetary policy to facilitate policy predictability and decision-making by economic agents. In the absence of unforeseen developments, the MPC expects monetary policy settings to remain 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.

3. 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

4. The economic recovery underway since July has strengthened in recent months. Large-scale manufacturing (LSM) grew by 7.4 percent (y/y) in October and 14.5 percent (y/y) in November. The manufacturing recovery is also becoming more broad-based, with 12 out of 15 subsectors registering positive growth in November and employment beginning to recover. So far this fiscal year, LSM has grown by 7.4 percent (y/y), against a contraction of 5.3 percent during the same period last year. Nevertheless, the level of manufacturing activity generally remained below average levels in FY19, pointing to continued spare capacity in the economy. On the demand side, cement sales remain strong on the back of rising construction activity, POL sales are at two-year highs, and automobile sales are also rising in both urban (motorcars) and rural (tractors) markets. In agriculture, cotton output is likely to decline more than expected based on latest production estimates. However, this is likely to be offset by improved growth in other major crops and higher wheat production due to the rise in support prices along with announced subsidies on fertilizers and pesticides for Rabi crops. While social distancing is still affecting some service sectors, wholesale, retail trade and transportation are expected to benefit from improvements in construction and manufacturing activity.

External sector

5. Following five consecutive months of surpluses, the current account registered a deficit of $662 million in December. While remittances and exports continued to grow steadily, the trade deficit rose due to a rise in imports of machinery and industrial raw material, in line with the pick-up in economic activity. At the same time, wheat and sugar imports also rose to close demand and supply gaps in the domestic market. Nevertheless, the current account remained in surplus during the first half of FY21, at $1.1 billion compared to a deficit of over $2 billion during the same period last year. This improvement has been mainly driven by workers' remittances, which have remained above $2 billion every month during the current fiscal year due in part to travel restrictions and supportive policy measures taken by the government and SBP that have increased the use of formal channels. Further, the pick-up in workers proceeding abroad in December bodes well for future prospects. Encouragingly, exports have also recovered to their pre-COVID monthly level of around $2 billion since September, with a broad-based recovery in export volumes recorded in almost all categories in December. Persistent improvement in the current account position and improving sentiment led to a mild appreciation in the PKR since the last MPC meeting and further strengthened external buffers. SBP's foreign exchange reserves have risen to $13 billion, their highest level since December 2017. Based upon the data available so far, the outlook for the external sector has improved further and the current account deficit for FY21 is now projected to remain below 1 percent of GDP.

Fiscal sector

6. Fiscal developments have been largely in line with this year's budget and the government has continued to adhere to its commitment of no fresh borrowing from the SBP. Despite higher interest payments and Covid-related spending, healthy growth in revenues has contained the fiscal deficit during the fiscal year so far. Provisional estimates suggest that net FBR revenue grew by 3.0 and 8.3 percent (y/y) in November and December, respectively. Driven by a rebound in direct taxes and the sales tax, FBR revenue during H1-FY21 has grown by 5 percent (y/y) to come in close to the targeted level. Despite higher non-interest current expenditures, the primary balance posted a surplus of 0.5 percent of GDP during July-November, 0.2 percentage points better than the same period last year.

Monetary and inflation outlook

7. The MPC noted that financial conditions remain appropriately accommodative at this early stage of the recovery, with the real policy rate in slightly negative territory on a forward-looking basis. Private sector credit has seen an encouraging uptick since the last MPC meeting, driven by a continued rise in consumer and fixed investment loans on the back of SBP's refinance facilities. As demand recovers and inventories fall in some sectors, working capital loans have also picked up for the first time since the onset of the Covid pandemic, although their level remains lower than last year.

8. Inflation pressures have eased since the last MPC, despite an upward adjustment in fuel prices. After remaining close to 9 percent in the preceding two months, headline inflation fell to 8.3 percent in November and further to 8 percent in December, the lowest rate since June 2019. This decline is mainly attributable to easing food inflation. Owing to conducive weather and various measures taken by the government to address supply-side issues, the price of perishables, wheat, pulses and rice has declined. Moreover, core inflation has

continued to remain relatively soft since the beginning of FY21, in line with the presence of spare capacity in the economy. Inflation expectations of both businesses and consumers remain well-anchored and have declined in recent months. As a result, at this stage of the recovery, any further supply-side shocks from food or utility tariffs are unlikely to have a lasting inflationary impact through second-round effects.