Monetary Policy Statement

July 29, 2024

1. At its meeting today, the Monetary Policy Committee (MPC) decided to cut the policy rate by 100 basis points to 19.5 percent, effective from July 30, 2024. The Committee observed that the June 2024 inflation was slightly better than anticipated. The Committee also assessed that the inflationary impact of the FY25 budgetary measures was broadly in line with earlier expectations. The external account has continued to improve, as reflected by the build-up in SBP's FX reserves despite substantial repayments of debt and other obligations. Considering these developments – along with significantly positive real interest rate – the Committee viewed that there was a room to further reduce the policy rate in a calibrated manner to support economic activity, while keeping inflationary pressures in check.

2. The Committee noted the following key developments since its last meeting. First, the current account deficit narrowed sharply in FY24 and SBP's FX reserves improved significantly from $4.4 billion at end-June 2023 to above $9.0 billion. Second, the country reached a staff level agreement with the IMF for a 37-month EFF program of about $7.0 billion. Third, sentiment surveys conducted in July showed a worsening in inflation expectations and confidence of both consumers and businesses. Fourth, international oil prices have remained volatile in recent weeks, whereas prices of metals and food items have eased. Lastly, with the ease in inflationary pressures and labour market conditions, central banks in advanced economies have also started to cut their policy rates.

3. Taking stock of these developments, the Committee assessed that, despite today's decision, the monetary policy stance remains adequately tight to guide inflation towards the medium-term target of 5 – 7 percent. This assessment is also contingent on achieving the targeted fiscal consolidation, timely realization of planned external inflows and addressing underlying weaknesses in the economy through structural reforms.

Real Sector

4. Latest high-frequency indicators continue to reflect moderate economic activity. Auto and POL (excluding FO) sales and fertilizer offtake increased on m/m basis in June. Large-scale manufacturing also recorded a sharp improvement in May 2024, mainly driven by the apparel sector. The growth in agriculture sector, after showing a strong performance in FY24, is expected to slow down in this fiscal year. Latest satellite images and input conditions for Kharif crops also support this assessment. However, activity in the industry and services sectors is expected to recover, supported by relatively lower interest rates and higher budgeted development spending. Based on this, the MPC assessed FY25 real GDP growth in the range of 2.5 to 3.5 percent as compared to 2.4 percent recorded last year.

External Sector

5. After recording surpluses for three consecutive months, the current account posted a deficit in May and June, in line with the MPC's expectation. These deficits were largely due to higher dividend and profit payments and a seasonal increase in imports, which more than offset a significant increase in exports and workers' remittances. Cumulatively, the current account deficit in FY24 narrowed significantly to 0.2 percent of GDP from 1.0 percent in the preceding year. This, along with the revival of financial inflows, helped build the SBP's FX reserves. Looking ahead, the MPC expects a modest increase in imports, in line with the growth outlook. At the same time, the continued robust growth in workers' remittances, along with an increase in exports, is expected to contain the current account deficit in the range of 0 - 1.0 percent of GDP in FY25.

The Committee assessed that the expected financial inflows, including planned official flows under the IMF program, would help finance this current account deficit and further strengthen the FX buffers.

Fiscal Sector

6. The government's revised estimates indicate improvement in fiscal balances during FY24, as the primary balance turned into a surplus and the overall deficit declined from last year. However, amidst a shortfall in budgeted external and non-bank financing, the government's reliance on the domestic banking system increased significantly. The Committee expressed concern on increasing reliance on banks for deficit financing, which has been squeezing borrowing space for the private sector. For FY25, the government has set the primary surplus target at 2.0 percent of GDP. The MPC emphasized on achieving the envisaged fiscal consolidation and timely realization of planned external inflows to support overall macroeconomic stability, and build fiscal and external buffers for the country to respond to future economic shocks.

Money and Credit

7. The MPC noted that the trends and composition of monetary aggregates during FY24 remained consistent with the tight monetary policy stance. Broad money (M2) and reserve money grew by 16.0 percent and 2.6 percent, respectively, well below the growth in nominal GDP. Almost the entire growth in M2 was led by bank deposits, while currency in circulation remained almost at last year's level. As a result, the currency to deposit ratio improved, as it declined from 41.1 percent at end-June 2023 to 33.6 percent at end-June 2024. At the same time, the improvement in external account increased the contribution of net foreign assets in monetary expansion. Meanwhile, the growth in net domestic assets of the banking system decelerated amidst subdued demand for private sector credit. The Committee viewed these developments as favorable for the inflation outlook.

Inflation Outlook

8. As expected, headline inflation rose to 12.6 percent y/y in June 2024 from 11.8 percent in May. This increase was primarily driven by higher electricity tariffs and Eid-related increase in prices, which were partly offset by the downward adjustments in domestic fuel prices. Core inflation, meanwhile, has steadied around 14 percent over the past two months. The MPC assessed that while the inflationary impact of the FY25 budget is largely in line with expectations, the available information indicates that the full impact of these measures may now take some time to fully reflect in domestic prices. At the same time, the Committee noted risks to the inflation outlook from fiscal slippages and ad-hoc decisions related to energy price adjustments. On balance, after considering these trends – and accounting for the sufficiently tight monetary policy stance and ongoing fiscal consolidation – average inflation is expected to remain in the range of 11.5 – 13.5 percent in FY25, down significantly from 23.4 percent in FY24.