MINUTES OF THE 4th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on July 14, 2018

P R E S E N T

Mr. Tariq Bajwa	Chairman & Governor SBP
Dr. Inayat Hussain	Executive Director (FS & BSG)
Mr. Mohammad Riaz	Director SBP Board
Dr. Asad Zaman	External Member
Dr. Qazi Masood Ahmed	External Member
Dr. Aliya Hashmi Khan	External Member
Mr. Mohammad Mansoor Ali	Secretary to the Committee/Corporate Secretary

Review of Current Economic Conditions and Outlook for FY19

1. Monetary Policy Department staff apprised the Committee on the developments in key macroeconomic indicators since the May 2018 Monetary Policy decision, along with the assessment of evolving trends.

2. The YoY CPI inflation increased to 5.2 percent in June FY18 from 3.9 percent a year earlier. The YoY food inflation increased slightly to 3.0 percent in June FY18 as compared to 2.4 percent an year earlier, while YoY non-food inflation increased significantly to 6.7 percent in June FY18 from 5.0 percent in June FY17. Further, core inflation continued to show an increasing trend as NFNE core inflation increased to 7.1 percent in June FY18 from 5.5 percent a year earlier. The higher food inflation is attributed to an increase in prices of imported food items along with seasonal impact of Ramadan on prices of food items. The main contributors to higher non-food inflation were strong domestic demand, pass-through of the rising global oil prices to domestic consumers and depreciation of the exchange rate.

3. In view of the inflationary trends seen by the close of FY18, the range estimate for average CPI inflation for FY19 has been revised upward to 6-7 percent, from the previous range of 5.5-6.5 percent presented in the MPC meeting held in May 2018. The forecast range indicates the anticipation for FY19 inflation to surpass the 6 percent target, mainly due to impact of PKR depreciation and the likely continuation of the twin deficits. External factors, such as higher international prices of commodities also likely to supplement the increasing trend in inflation. The inflation projection remains susceptible to shocks to international oil prices and their pass-through to domestic petroleum prices, volatility in food prices, estimates of the output gap, growth in money supply, future exchange rate movements, and potential changes in tariffs.

4. Broad Money (M2) registered a relatively lower growth of 9.7 percent in FY18, as compared to a growth of 13.7 percent in the last year. This deceleration in M2 growth has resulted from contraction in NFA of the banking system, which showed a larger decline of Rs. 811 billion in FY18, compared to a fall by Rs. 406 billion in FY17. On the other hand, NDA of banking system increased by Rs2,228 billion in FY18 as compared to an increase of Rs2,162 billion in FY17. Expansion in NDA was led by government borrowing from the banking system that increased to Rs. 1,111 billion in FY18 from Rs. 1,087 billion in FY17. Within the banking system, government borrowing remained predominantly from SBP because of banks' relative reluctance to invest in government securities in the rising interest rate scenario, resulting in net retirement to scheduled banks in FY18.

[1] Meetings are numbered on a calendar year basis.

5. Another factor contributing to higher NDA expansion was private sector credit that maintained a healthy growth trend and increased by Rs. 775 billion during FY18 as compared to Rs. 748 billion in FY17. The credit off-take has been positively contributed by the pickup in production activities amid continuing capacity expansion, higher aggregate demand, pick up in input prices and higher demand for consumer financing. With increase in SBP policy rate and lagged impact of exchange rate adjustments, the credit off-take may observe slight moderation in FY19. Credit to public sector slightly decelerated and increased by Rs. 245 billion in FY18 compared to a rise of Rs. 255 billion in FY17. On the liability side, currency in circulation showed deceleration and increased by Rs. 477 billion in FY18 as compared to an increase of Rs. 578 billion in FY17. The increase in bank deposits remained at Rs. 935 billion in FY18, lower than the rise of Rs. 1,175 billion in the corresponding period of last year. The slowdown in bank deposits could be attributed to decline in deposits of NBFIs and private sector businesses' deposits. Keeping in view the ongoing macroeconomic trends, M2 growth is expected to be slightly higher in FY19 as compared to FY18.

6. The fiscal deficit for FY18 stood at 5.5 percent of GDP, as compared to the initial target of 4.1 percent. This indicated much higher than projected aggregate demand in the economy. The increase in the fiscal deficit relative to target was led by both, lower than expected growth in tax and non-tax revenue, and higher than expected current expenditures. FBR revenue during FY18 amounted to 98.1 percent of the annual target, with 17.1 percent YoY increase during the year. Similarly, in this period, provinces only collected 67.5 percent of their budgeted revenue estimates. Furthermore, for FY18, provincial non-tax revenue stood at 40.8 percent of the annual budget estimate. For FY19, the government has set the fiscal deficit at 4.9 percent of GDP.

7. In line with indicators of aggregate demand, the current account deficit, increased to USD 16.2 billion in July-May FY18 compared to USD 11.1 billion during the same period last year. Higher current account deficit was mainly driven by a large trade deficit that increased to USD 28.0 billion in Jul-May FY18 as compared to USD 23.5 billion in the same period last year. Growth in exports remained in the positive zone increasing by 13.1 percent in Jul-May FY18, as compared to a negligible rise of 0.1 percent in the same period last year. Healthy external demand, incentives given to exporters, and depreciation in PKR have helped exports in maintaining the upward growth trend. Imports slightly decelerated to 16.4 percent in Jul-May, 2018, as compared to 17 percent in the same period last year. Workers' remittances grew by 3.0 percent during Jul-May FY18, compared to a decline of 1.9 percent recorded in the same period last year. The rise in remittances is primarily attributed to growing inflows from UK, USA, and the EU.

8. Meanwhile, net FDI grew by 2.2 percent during Jul-May FY18 with net inflows of USD 2.5 billion against USD 2.4 billion for the comparable period last year. Significant part of FDI continued to originate from China as it increased to USD 1.5 billion in Jul-May FY18 as compared to USD 1.1 billion in the comparable period last year. Issuance of USD 2.5 billion Sukuk/Eurobond in Dec 2017 was a major development during the year, that helped increase net foreign portfolio investment (FPI) to USD 2.3 billion during Jul-May FY18, as compared to USD 628 million during the same period an year earlier. This, along with notably higher official inflows remained insufficient to finance the higher current account deficit, forcing the country to tap into its foreign exchange reserves. Consequently, SBP's external reserves declined to USD 9.5 billion by end May 2018 from USD 16.1 billion in Jun 2017. Going forward, the level of SBP's FX reserves in the near-term would critically depend on the realization (and further mobilization) of official flows and the impact of ongoing stabilization measures on the country's current account balance

9. Real sector, after attaining a 13-year high growth of 5.8 percent in FY18, is expected to maintain the healthy growth trend, although achieving the 6.2 percent target for FY19 could be quite challenging. Agriculture sector that grew by 3.8 percent in FY18 is targeted to grow at the same rate, i.e. 3.8 percent in FY19. However, it is set to face some initial difficulties as provisional estimate for cotton crop at 12.1 million bales is below the target of 14.4 million bales. All other

major crops may achieve their target. Industrial sector that achieved 5.8 percent growth in FY18 against a target of 6.8 percent, has been given 7.6 percent target for FY19. However, growth in the sector could be impinged by depreciating PKR and factors including monetary policy tightening etc. Growth target for services sector is 6.5 percent for FY19, compared to the actual growth of 6.4 percent in FY18. Developments in services sector, as usual, will depend on performance of other sectors.

10. The staff concluded the presentation by giving an update on the Macro-Stability Index (MSI). It was noted that since the last meeting, MSI has worsened in net terms due to (a) a reduction in import coverage of forex reserves and (b) higher future inflation projections. Given its strong contemporaneous and dynamic correlation with real economic growth, it was re-emphasized to preserve the macro stability through timely and sizeable policy measures.

Financial Markets and Reserve Management

11. An update of the market revealed that the overnight rate has hovered close to the policy rate at 6.58 percent on average; against the policy (target) rate of 6.5 percent, since the monetary policy review in May, 2018. The volatility in the overnight weighted average repo rate increased to 0.24 percent, as compared to 0.15 percent at the time of the last monetary policy review meeting. The increased volatility resulted from flows related to Eid-ul-Fitar, and year-end tax payments and significant deviation by the government from the pre-announced auction targets of its securities. The SBP continued to address volatility in the money market through OMO operations, where the stock spiked to over Rs. 1.7 trillion during June, 2018, but reduced substantially to Rs. 262.4 billion in the first week of July, in comparison to Rs. 675 billion prior to the last MPC meeting.

12. MPC decision of May, 2018 to increase the policy rate by 50 bps resulted in 43 to 87 bps increase in the secondary market yields of almost all tenors. However, the banks were still unwilling to participate in auction of government securities of longer tenors, which indicates expectations of further hikes in interest rates. This expectation is mainly driven by inflationary trends and pressures on the foreign exchange reserves.

13. Increase in market interest rates following the policy review of May, 2018 resulted in increased spread between PKR and USD interest rates that incentivised the banks to borrow more from the external resources. Thus, net financial inflows of banks increased by USD 350 million in May 2018, as compared to a decline of USD 297 million in April 2018.

Model-Based Assessment

14. First of all, Research Staff presented a comparison of the now-casting assumptions of the Forecasting and Policy Analysis System (FPAS) used in the May-2018 MPC meeting and the actual realization of data for Q4-FY18 to the Committee. After that MPC was apprised about the main assumptions of the latest FPAS model output that includes the now-casting of domestic headline, food and core inflation measures for Q1-FY19, now-casting of international oil prices for Q1-FY19 and FY19 and the latest FOMC projections for the US Federal Funds rate path and US inflation for the next 8 quarters. Other assumptions related to the domestic economy included a heightened uncertainty as manifested by a rise in sovereign risk premium on Pakistan's Eurobonds and a now-casting of relatively higher fiscal impulse as fiscal deficit to GDP ratio increased to 6.8 percent to 5.9 percent for FY18 and 6.0 percent for FY19.

15. Conditional on the latest data and aforementioned now-casting assumptions, the FPAS model suggested a relatively larger increase in the policy interest rate by Q1-FY19 and a relatively

lower increase in Q2-FY19. The suggested policy change was mainly driven by key factors related to higher inflation, projections both headline and core, and narrowing USD-PKR interest rate differential.

16. On the inflation front, it was explained that headline-inflation is expected to rise in FY19 due to: (i) a spillover impact of the on-going fiscal expansion; (ii) potential pass-through of the most recent and the model implied exchange rate adjustments to close the RER gap; and (iii) impact of higher inflation expectations as reflected in the core inflation measure, NFNE, and the latest July-2018 reading of IBA-SBP Consumer Confidence Survey.

17. While explaining the uncovered interest rate parity (UIP), the staff explained that US Federal Reserve increased the interest rate by 175 bps since normalization of interest rates beginning in December 2015. In contrast, the SBP has only hiked its policy rate by 75 bps over the same period. This, in addition to, the recent PKR depreciation requires adjustments in the domestic policy rate in light of the modified UIP condition.

18. In terms of FPAS projections for FY19, average headline inflation forecast conditional upon model implied interest rate path has been revised upward from 5.7 percent in the last MPC meeting to 6.9 percent, whereas estimate for core inflation is revised upward to 8.4 percent from 7.1 percent. Assuming no change in the policy rate, headline inflation and core inflation for FY19 are expected to reach 7.6 percent and 9.1 percent, respectively.

19. At the end, Research Staff also briefed the MPC about an alternative scenario: the June-type adjustments in the exchange rate continuing into FY19. To contain the ensuing inflationary pressures under this alternative scenario, SBP would need to increase the policy rate in the first two quarters of FY19.

Result of Surveys on Monetary Policy

20. Research staff apprised the Committee on the results of surveys on consumer confidence index (CCI) and Inflation expectations (IE). It was highlighted that, on overall basis, CCI have marginally decreased in comparison to the surveys conducted in May 2018, while IE continue to remain at an elevated level indicating sustained high expectations for increase in inflationary trends.

21. Research Staff also presented the results of the newly introduced Business Confidence Survey (BCS). MPC was informed regarding the start of BCS from FY18 and 4 iterations are already conducted before presenting it to the Committee. A brief background of the survey was presented to the Committee before discussing the result of the latest iteration. BCS was conducted with large scale firms in industrial and services sectors to compute current business confidence index (CBCI), expected business confidence index (EBCI), business confidence index (BCI) and Purchasing Managers' Index (PMI). It was pointed out that CBCI, EBCI and BCI depicted a slight dip compared to the wave of BCS conducted in April 2018. Although PMI showed a slight increase compared to the last iteration, overall results of BCS are in line with some moderation in manufacturing activity in the recent months.

Monetary Policy Deliberations and Decision Vote

22. While setting the policy interest rate for the next two months, the Committee considered the following points: (1) trends in future headline and core inflation paths show that the estimated real interest rates are falling, (2) an overall assessment of aggregate demand relative to aggregate supply reveals that output gap has further opened up on the positive side; (3) in a

global context, PK's nominal rates have been stickier than in other countries with similar macroeconomic trends, (4) the more interest-elastic portion of external borrowing is increasing, and (5) in the light of sustainability of the external account position, the need to maintain macro stability is an utmost priority.

23. After conclusion of the presentation and the discussion with staff, the MPC voted on the policy rate decision. Deliberations led to the unanimous view of increasing the policy rate. However, there were differing views on the magnitude of the increase required.

24. Member voting for increasing the policy rate by 150 bps was of the view that a lower increase will not be sufficient to help address the rising trend in core inflation.

25. Members voting for increasing the policy rate by 100 bps were of the view that any sharper increase could be wrongly interpreted by the market as an unusual situation, and could do more harm to the economy than bringing the intended benefits.

26. In conclusion, the Committee decided to increase the policy rate by 100 basis points with a majority vote of 5 out of 6 members present, with one vote for increasing the policy rate by 150 bps.

27. Finally, the Committee then scripted the Monetary Policy Statement.

28. The MPC decided as follows:

DECISIONS:

- *The policy rate is increased to 7.50 percent.*
- *The Monetary Policy Statement - July, 2018 is approved.*