MINUTES OF THE 5th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on September 29, 2018

P R E S E N T

Mr. Tariq Bajwa	Chairman & Governor SBP
Mr. Jameel Ahmed	Deputy Governor (Banking & FMRM) SBP
Dr. Inayat Hussain	Executive Director (FS & BSG)
Dr. Saeed Ahmed	Chief Economist and Executive Director
Hafiz Mohammad Yousuf	Director SBP Board
Khawaja Iqbal Hassan,	Director SBP Board
Ardeshir Khursheed Marker	Director SBP Board
Dr. Asad Zaman	External Member
Dr. Qazi Masood Ahmed	External Member
Mr. Mohammad Mansoor Ali	Secretary to the Committee/Corporate Secretary

Review of Current Economic Conditions and Outlook for FY19

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

2. The YoY CPI inflation continued to rise, and reached 5.8 percent in August 2018, which was higher than the 3.4 percent recorded in the same month an year earlier. The YoY food inflation increased to 3.3 percent in August 2018 as compared to 1.2 percent an year before, while YoY non-food inflation increased significantly to 7.6 percent in August 2018 from 5.0 percent in August 2017. The higher food inflation is largely stemming from non-perishable food items such as wheat, meat, fresh milk and imported food items. Further, NFNE inflation increased to 7.7 percent in August 2018 from 5.5 percent during the same month last year. This significant rise in core inflation is mainly attributed to increase in house rents, education fees, transport fares, construction inputs and the pass-through of rising global oil prices to domestic consumers and depreciation of the rupee.

3. In view of the growing inflationary pressures, the forecast range of average CPI inflation for FY19 has been revised upward to 6.5 - 7.5 percent, from the previous range of 6.0 - 7.0 percent presented in the MPC meeting held in July 2018. This upward revision takes into account the trends in exchange rate movements, and increase in administrative prices of petroleum products and gas tariffs. The forecast range indicates FY19 inflation will surpass the annual target of 6 percent for the first time since FY14. However, these projections remain susceptible to shocks to international oil prices and their pass-through to domestic petroleum prices, volatility in food prices, growth in money supply and future exchange rate movements. At present, upside risks to inflation forecast outweigh the downside risks.

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. During 1st Jul-14th Sep FY19, M2 registered a seasonal contraction of 1.2 percent, compared to a contraction of 0.9 percent in the same period last year. Due to substantial bilateral inflows during this period, net foreign assets (NFA) of the banking system posted a small contraction of Rs 27 billion during 1st Jul-14th Sep FY19 in comparison to a significant contraction of Rs. 213 billion during the same period last year.

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

Further, the availability of external financing lowered the government's reliance on domestic borrowing from the banking system, which led to a decline in the NDA of the banking system. Specifically, NDA of the banking system saw a contraction of Rs. 170 billion during 1st Jul-14th Sep FY19 as compared to an increase of Rs. 79 billion during the same period last year. Due to the lower participation of scheduled banks in T-bill auctions in anticipation of monetary tightening, the government borrowed Rs. 1,130 billion from the SBP during 1st Jul–14th Sep FY19, which was substantially higher as compared to Rs. 170 billion borrowed in the comparable period of the last year. Resultantly, government borrowing from scheduled banks saw a net reduction of Rs. 1,219 billion in the aforesaid period, compared to a net borrowing of Rs. 184 billion in the comparable period of the last year. On the liability side, seasonal demand related to Eid-ul-Azha kept currency in circulation at a higher level; it increased by Rs. 131 billion during 1st Jul-14th Sep FY19, compared to increase of Rs.18 billion in the corresponding period last year. In contrast, overall deposits with the scheduled banks declined by Rs. 331 billion during 1st Jul-14th Sep, FY19 compared to reduction of Rs. 153 billion in the comparable period last year.

5. In contrast to the usual seasonal loan retirement phase of the businesses, credit to private sector saw a net expansion of Rs. 16.5 billion during 1st Jul-14th Sep 2018 against a net retirement of Rs. 80.6 billion in the corresponding period of the last year. Similar trends were seen in borrowings for both fixed investment and working capital. Borrowings for fixed investments stood at Rs. 54 billion in Jul-Aug FY19 compared to an increase of Rs. 28 billion in the corresponding period last year. This increase was mainly attributed to activities in cement, sugar and services sector. Similarly, the working capital financing witnessed 50 percent less retirement as it stood at Rs. 47 billion in aforesaid period as compared to Rs. 95 billion in the same period last year. The demand for working capital was mainly driven by petroleum and power sectors. These developments could be interpreted as continuation of the momentum in private sector credit, but also a pre-season credit pick-up, given the expectations of further monetary policy tightening.

6. The fiscal deficit for FY18 widened to 6.6 percent of GDP against the revised estimate of 5.5 percent and the annual target of 4.1 percent of GDP. This was mainly attributed to over spending by the provincial and federal governments in the backdrop of general elections 2018, and substantial shortfall in revenue collections that grew by only 5.9 percent against the targeted growth of 24.9 percent. In absolute terms, the FBR tax collection fell short of target by Rs. 171 billion in FY18. Similarly, non-tax revenues remained below target mainly due to non-realization of Coalition Support Fund (CSF), which was estimated to be Rs. 127 billion. The budget deficit in FY18 was financed through net external borrowing of Rs.785 billion and borrowings of Rs. 1,473 billion from domestic sources. SBP remained the main source of domestic financing for the government despite increasing reliance on external financing that rose from 29.0 percent in FY17 to 34.7 percent in FY18. In sharp contrast to higher fiscal deficit in FY18, a notable fiscal consolidation is envisaged for FY19 as the government's revised fiscal deficit target stands at 5.1 percent of the GDP.

7. In Jul-Aug FY19 external current account posted a deficit of USD 2.7 billion as compared to USD 2.5 billion in the corresponding period last year. The higher current account deficit was mainly driven by a large trade deficit that increased to USD 5.9 billion in Jul-Aug FY19 as compared to USD 5.1 billion in the same period last year. Growth in exports remain fragile, increasing by 4.5 percent in Jul-Aug FY19, as compared to a rise of 16.5 percent in the same period last year. The slowdown in export growth primarily stemmed from non-textile exports, which grew by only 0.5 percent in Jul-Aug FY19. Unfavourable international prices are seen as one of the reasons for lower export proceeds, as PBS data shows a robust growth in export quantum for Jul-Aug FY19. The imports increased by 11.0 percent in Jul-Aug FY19 to reach USD 9,971 million as compared to USD 8,978 million in the same period last year. The worker remittances grew by 13.5 percent in Jul-Aug FY19 to reach USD 4.0 billion as compared to USD 3.5 billion in the corresponding period last year. This increase was attributed to significant growth in remittances

from Non-GCC countries. The financial account posted a surplus of USD 2.8 billion during Jul-Aug 2018 against a surplus of USD 1.4 billion in the same period last year. This surplus largely comprised of bilateral loans from friendly countries in July 2018.

8. Meanwhile, net FDI decreased by 40.1 percent during Jul-Aug FY18 with net inflows of USD 287 million against USD 479 million for the comparable period last year. This decline is attributed to a fall in net FDI from China, which registered a decline of 34.4 percent to USD170.6 million during the first two months of current fiscal year as compared to an inflow of USD 259.9 million in the same period last year. Foreign portfolio investment (FPI) showed a net outflow of USD 124 million during Jul-Aug 2018 as compared to a net outflow of USD146 million during Jul-Aug 2017. The repayments of external loans during Jul-Aug FY19 stand at USD 439 million, compared to USD 544 million in the corresponding period of FY17. Despite these developments, a portion of the current account deficit was financed by using the country's own resources. As a result, net SBP reserves declined to USD 9.0 billion as of September 17, 2018, as compared to USD 9.8 billion at the beginning of this fiscal year. However, a notable depreciation of the PKR against US dollar since December 2017 and initiation of monetary tightening since January 2018 are expected to help address challenges to the country's external accounts.

9. The real sector, after attaining a 13-year high growth of 5.8 percent in FY18, is expected to slow in FY19. Achieving the 6.2 percent target for FY19 seems extremely difficult. Agriculture sector may not achieve the targeted growth of 3.8 percent for FY19 as the latest estimates suggest that cotton production is likely to remain almost 3 million bales below the target of 14.4 million bales. Further, water shortages can also impact production of wheat and sugarcane. The industrial sector, that achieved 5.8 percent growth in FY18 against a target of 6.8 percent, has been targeted to grow at 7.6 percent in FY19. However, growth in this sector could be impinged by a downward revision in funds allocated for PSDP, depreciation in PKR and other 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 agriculture and industrial 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. The staff also presented the historical trends in the policy rate, real interest rate, output gap and inflation for the last 20 years, where behaviour of these indicators were particularly highlighted in periods of heightened economic stress.

Financial Markets and Reserve Management

11. An update of the market revealed that the overnight rate has hovered close to the policy rate at 7.39 percent on average; against the policy (target) rate of 7.5 percent, since the monetary policy review in August, 2018. The volatility in the overnight weighted average repo rate increased to 0.28 percent, as compared to 0.24 percent at the time of the last monetary policy review meeting. The increased volatility resulted due to significant deviation by GOP from the pre-announced auction targets and unpredictable behavior of GOP borrowing from SBP. This borrowing pattern by the government has resulted in a sharp decline in SBP's outstanding liquidity injections to almost negligible levels, which remained around Rs. 1.2 trillion on average in a 2-month period.

12. MPC decision of July 2018 to increase the policy rate by 100 bps has shifted the yield curve upwards, but it got relatively flatter due to a lack of activities in the longer tenor securities.

Apparently, the anticipation of further tightening of monetary policy is keeping the banks away from participating in auction of government securities of longer tenors. This expectation is mainly driven by inflationary trends and pressures on the foreign exchange reserves. Thus, the stock of PIBs has come down significantly from Rs. 4,392 billion in Jun 2017 to Rs. 2,930 billion in Sep 2018. This also partly explained the increase in the stock of 3 month MTBs that soared from Rs. 1,383 billion in June 2017 to Rs. 4,328 billion in September 2018.

13. Increase in market interest rates following the policy review of July 2018 also resulted in a rising 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 283 million in August 2018, as compared to a decline of USD 514 million in June 2018.

Result of Surveys on Monetary Policy

14. 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 has significantly increased in comparison to the surveys conducted in July 2018, which can be interpreted as increased expectations from the new government following the nationwide elections. The team also apprised that a similar pattern was also witnessed after the 2013 election in Pakistan. Moreover, the experience of some other countries also shows that consumers' confidence usually spikes soon after the election as people have positive expectations from the new government. Likewise, expectations regarding Current Economic Conditions and Expected Economic conditions also increased in post-election period i.e. in the first week of September 2018.

15. Research Staff also presented the results of the Business Confidence Survey (BCS), conducted on bi-monthly basis, and covering mostly large scale firms in industrial and services sectors. It was noted that BCS survey results are used to compute Current Business Confidence Index (CBCI), Expected business Confidence Index (EBCI), Business Confidence Index (BCI) and Purchasing Managers' Index (PMI). It was explained that CBCI depicts a slight dip in comparison to a significant increase in EBCI and BCI, whereas PMI remained almost unchanged in August 2018.

Model-Based Assessment

16. First of all, Research Staff presented a recent updates and extensions, like the inclusion of financial block and investment-capital channel, in the Forecasting and Policy Analysis System (FPAS). Moving forward, team explained the comparison of the now-casting assumptions of the FPAS used in the July-2018 meeting of the MPC and the actual realization of Q4-FY18 data. After that MPC was apprised about the main assumptions of the latest FPAS model output that included 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 along with the projections of US inflation for the next 8 quarters. Other assumptions related to the domestic economy included a reduction in uncertainty in line with sovereign risk premium on Pakistan Eurobond(s) in Q1-FY19, and a now-casting of relatively lower fiscal impulse in line with the supplementary budget which envisaged a fiscal deficit to GDP ratio at 5.1 percent relative to the 6.0 percent deficit used for the projections in the last MPC meeting.

17. Conditional on the latest data and aforementioned now-casting assumptions, the FPAS model suggested a relatively higher increase in the policy interest rate by Q2-FY19 followed by another moderate hike in Q3-FY19. The suggested policy change was mainly driven by key factors related to higher inflation projections, both headline and core, and the USD-PKR interest rate differential.

18. It was explained that headline-inflation is expected to rise in FY19 due to: (i) upward revisions in duties in the supplementary budget; (ii) potential pass-through of the past, the most recent, and the model implied exchange rate adjustments; (iii) cost pressures due to increased gas-tariffs and international oil prices; and (iv) a lagged impact of the fiscal expansion recorded during FY18.

19. While explaining the uncovered interest rate parity, the staff explained that USD-PKR interest rate differential has widen since the last 100 bps increase in the policy rate. However, this differential is expected to narrow down again in view of the future path of the Federal-Funds Rate and model-implied exchange rate path. Therefore, a moderate hike in domestic policy interest rate is also required in the light of the modified uncovered interest rate parity.

20. With the fiscal consolidation for FY19 as envisaged in the supplementary budget, the continued monetary tightening, cumulatively 175 bps rise in policy rate so far since January 2018, with another model implied interest rate hike; despite the aforementioned cost pressures, headline inflation projection for FY19 was revised slightly upward to 7.0 percent from 6.9 percent. Core inflation projection for FY19 has been revised upward to 8.5 percent from 8.4 percent in FY19. Assuming no change in the policy interest rate, headline and core inflation for FY19 are expected to be much higher.

21. At the end, Research Staff also briefed the MPC about impact on the economy of various model-embedded simulations of exchange rate and interest rate movements relative to the baseline.

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 low given the unfolding economic picture; (2) an overall assessment of aggregate demand relative to aggregate supply reveals that output gap is expected to remain on the positive side; (3) the overall policy tightening in Pakistan is lagging behind countries finding themselves in a similar situation to Pakistan and since the normalization of world monetary policies, (4) over the near-term, the need to regain macroeconomic stability by bringing the twin deficits closer to their sustainable norms and bolstering the financial account are an overriding priority.

23. After conclusion of the presentation and the discussion with staff, the MPC voted on the policy rate decision. There was a consensus on increasing the policy rate; however, the members discussed various options on the magnitude of the increase required.

24. The members considered the FPAS model's and standalone insights on the future interest-rate path and its impact on output gap and growth, trends in exchange rate parity, and the likely impact of the change in policy rate on financial stability. After deliberations, the members reached

a consensus view to continue with the ongoing economic stabilization exercise and increase the policy rate by 100 bps.

25. In conclusion, the Committee decided to increase the policy rate by 100 basis points as all the 9 members present voted for this option.

26. Finally, the Committee scripted the draft Monetary Policy Statement.

27. The MPC decided as follows:

DECISIONS:

- *The policy interest rate is increased by 100 bps to 8.50 percent.*
- *The Monetary Policy Statement – September, 2018 is approved.*