MINUTES OF THE 6th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on November 30, 2018

P R E S E N T

Mr. Tariq Bajwa	Chairman & Governor 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
Mr. Ardeshir Khursheed Marker	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 FY18

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

2. The YoY CPI inflation continued to rise, reaching 6.8 percent in October 2018, which was higher than the 3.8 percent recorded in the same month a year earlier. The YoY food inflation increased to 2.7 percent in October 2018 as compared to 2.2 percent in October 2017. The higher food inflation largely emanated from an increase in prices of non-perishable food items including wheat, meat, and imported food items. However, persistently low inflation in perishable food items, with a YoY 12.7 percent decline in October 2018, helped keep the lid on headline inflation. More importantly, the YoY core inflation measured by non-food-non-energy components of CPI increased significantly to 8.2 percent in October 2018, from 5.3 percent in the same month last year. Similarly, core inflation measured by twenty percent trimmed mean increased to 6.7 percent in October 2018 as compared to 4.0 percent in the corresponding month of the last year. The significant rise in core inflation was mainly driven by house rent, education fee, transport charges, and construction input prices. The pass-through of depreciation of the rupee and the second round effect of increase in oil prices also contributed to the increasing trend in core inflation. Continuation of this trend is expected as supply side factors like taxes and import duties as well as exchange rate depreciation could keep the core inflation high, despite a marginally lower estimate for output gap of 0.3 percent in November 2018 compared to 0.4 percent in September 2018. Importantly, estimates show that around two-third of core inflation is driven by domestic factors, while imported inflation accounts for one third. Going forward, core inflation and headline inflation excluding perishable goods and administered prices will be important measures to monitor.

3. Keeping in view the inflationary pressures, the projection of 'End-June' CPI inflation is revised upward from 7.2 percent to approximately 8.0 percent. This projection takes into account the ongoing trends in exchange rate movements, and increase in administrative prices of petroleum products and gas tariffs. However, the forecast range of the 'average' CPI inflation for

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

FY19 has been kept unchanged at 6.5-7.5 percent. Alternative scenarios regarding inflation outlook were also presented to the MPC to show that the estimates 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. Pulling inflation back closer to its target at 6% over the medium-term and anchoring its expectations warrants corrective measures given the estimated policy rate pass-through to headline inflation.

4. Broad money (M2) registered a growth of 0.2 percent in Jul 01-Nov 16 FY19 as compared to a contraction of 0.5 percent in the same period last year, despite the ongoing tight monetary policy and relatively lower growth in economic activities. The expansion in broad money can be explained by a significant expansion in NDA, owing to increases in the government and private sector borrowings from the banking system, while the NFA of the banking system continue to contract. In fact, external account pressures kept SBP's NFA on a declining path and its stock turned negative in September 2018, after remaining positive for the last four years. The NFA of SBP recorded a contraction of Rs. 223.2 billion in Jul 01-Nov 16, FY19 as compared to decline of Rs. 262.5 billion in the corresponding period last year. Government's reliance on the Central Bank to meet its budgetary requirements increased NDA of the SBP by Rs. 393.7 billion during Jul 01-Nov 15, FY 19, compared to Rs. 280.6 billion in the corresponding period last year. On the liability side, currency in circulation witnessed an increase of Rs. 222.2 billion in Jul 01-Nov 16 FY19 as compared to increase of Rs. 55.1 billion in the corresponding period last year. On the other hand, bank deposits declined by Rs. 195.1 billion during Jul 01- Nov 16 FY19, compared to a reduction of Rs. 146 billion in the same period last year. The reduction in bank deposits led to a further deterioration in currency to deposit ratio from 37.88 at the end of FY18 to 40.48 as on 16th Nov-2018.

5. The flows of credit to private sector increased by Rs. 198.7 billion during Jul-Oct FY19 as compared to an increase of only Rs. 33.6 billion in the same period last year. Analysis shows that the expansion was mainly driven by the working capital requirements of Private Sector Businesses that increased to Rs. 126.2 billion for Jul-Oct FY19, compared to a decline of Rs 49.2 billion in the same period last year. The higher requirements of credit for working capital can be traced to higher prices of inputs and completion of industrial projects that earlier sourced credits for the fixed investments.

6. The fiscal deficit for the first quarter of FY19 widened slightly to 1.4 percent of GDP against 1.3 percent of GDP in the same period last year. This was largely driven by increase in current expenditures, which surged to 3.9 percent of GDP during Jul-Sep FY 19 as compared to 2.4 percent of GDP in the corresponding period last year. Development spending remained 34 percent lower in Q1-FY19 compared to Q1-FY18. On the revenue side, FBR tax collection increased by 8.8 percent during Jul-Sep FY 19, compared to growth of 22.0 percent in the same period last year. FBR's direct tax collection also witnessed a lower growth of 5.5 percent for Q1-FY19 as compared to 22.8 percent growth observed in Q1-FY18. As a result, budgetary financing, from both domestic and foreign sources stood at Rs. 541.7 billion or at 1.4 percent of GDP. Keeping in view the trend in current and development expenditures, along with lower growth in revenue collection, attaining the fiscal deficit target of 5.1 percent of GDP for FY19 appears to be quite challenging and does not bode well for aggregate demand management.

7. The external current account deficit narrowed to USD 2.1 billion in Sep-Oct FY19 as compared to USD 2.5 billion in the corresponding period last year. Accordingly, the cumulative current account deficit for Jul-Oct-FY19 reduced to USD 4.8 billion from US$ 5.1 billion in the comparable period of the last year. The lower current account deficit mainly resulted from a sharp deceleration in import growth during recent months. In aggregate, growth in imports decelerated to 5.8 percent during Jul-Oct FY19 as compared to 26.3 percent during the same period last year.

The slowdown in imports can be attributed to depreciation of PKR, lagged impact of 275 basis points increase in policy rate since January 2018, in addition to a number of administrative measures by the government. Growth in exports remain fragile, increasing by 4.0 percent in Jul-Oct FY19 to reach USD 8.0 billion as compared to USD 7.6 billion in the same period last year. This increase can be attributed to higher export volumes (especially textile exports to the EU) as unit value witnessed a downward trend. Further, workers' remittances increased to USD 7.4 billion in Jul-Oct, FY19, compared to USD 6.4 billion in the same period last year, depicting YoY growth of 15.1 percent. This increase was due to a significant growth in remittances from Non-GCC countries. The capital and financial accounts posted a surplus of USD 3.0 billion during Jul-Oct 2018, which is equivalent to the level of surplus seen in the same period last year. Projections on the current account front, more specifically the trade deficit, show that the pace of deceleration is slower than anticipated.

8. Meanwhile, net FDI decreased by 46.5 percent on YoY basis to USD 597 million in Jul-Oct FY19 as compared with net inflows of USD 1,116 million for the comparable period last year. This decline is attributed to a fall in net FDI from China (in the power and financial sector) and Malaysia (in the telecommunication sector). Foreign portfolio investment (FPI) showed a decline of 16.3 percent on YoY basis; a net outflow of USD 207 million during Jul-Oct FY 19 as compared to a net outflow of USD178 million during Jul-Oct FY18. The repayments of government external loans during Jul-Oct FY19 was USD 1,572 million, compared to USD 1,427 million in the corresponding period of FY18. As a result, net SBP reserves declined to USD 7.6 billion as of November 2, 2018, as compared to USD 9.8 billion at the beginning of this fiscal year. Going forward, the lagged impact of a notable depreciation of the PKR against US dollar since December 2017, monetary tightening, and expected inflows from friendly countries along with the Saudi oil facility are anticipated to help address the challenges on the financing of the external account.

9. Achieving the GDP growth target of 6.2 percent for FY19, against 5.8 percent growth attained in FY18, seems difficult. The 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 that impacted Kharif crops could persist to impact Rabi crops as well. The industrial sector that achieved 5.8 percent growth in FY18 may not be able to achieve the growth target of 7.6 percent for FY19, indicated by 1.7 percent contraction in LSM output during Q1-FY19, compared to a 10.0 percent growth in the comparable period last year. The decline in LSM growth was noted to be broad-based. Domestic sale of cement witnessed a 0.43 percent decline in the first quarter FY19, compared to 21.9 percent growth in Q1-FY18, showing lower activities in construction. However, exports of cement grew by 39 percent in the first quarter, over the comparable period last year. 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 largely depend on the performance of the agriculture and industrial sectors. Lower spending on PSDP, depreciation in PKR, and the ongoing monetary policy tightening are expected to keep growth supressed in FY19. Latest projections show that real GDP growth is expected to be around 4%.

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 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 decisive policy measures. The staff also presented the historical trends in the policy rate, real interest rate requirement to curb aggregate demand, the output gap and inflation for the last 20 years. The behaviour of these indicators were particularly highlighted in periods of heightened economic stress. The staff also compared for the Committee the strength of current policy stance in real terms relative to similar events Pakistan has seen in the past.

Financial Markets and Reserve Management

11. Overnight rate remained at 8.37 percent on average against the policy (target) rate of 8.5 percent, since the monetary policy review in September 2018. The volatility in the overnight weighted average repo rate decreased to 0.26 percent, as compared to 0.28 percent at the time of the last monetary policy review meeting. Expectations of a further increase in yields on various tenors of Government securities led to preference of banks to hold funds in very short tenors. This kept overnight repo rate well below the target rate, despite daily mop-up operations by the SBP, which swelled to the tune of around Rs 1 trillion.

12. Following the MPC decision of September 2018 to increase the policy rate by 100 bps, the long dated yield curve moved upwards sharply, reflecting market expectations of continued increase in the policy rate going forward. The banks' tendency to avert investment in long dated instruments continued, apparently in anticipation of a further tightening of the monetary policy. The stock of outstanding securities of 6-month and 1-year tenor have now all matured. Further, the stock of PIBs came down from Rs. 4,392 billion in Jun 2017 to Rs. 2,930 billion in Nov 2018. This partly explain the increase in the stock of 3 month MTBs that soared from Rs. 1,383 billion in June 2017 to Rs. 3,381 billion in November 2018. Meanwhile, government borrowings from the SBP have also increased.

13. Increase in market interest rates following the policy review of September 2018 resulted in a wider 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 160 million in September 2018 and USD 203 million in October 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 the overall basis, CCI has significantly decreased in comparison to the surveys conducted in September 2018. The expectations are moving away from positive to negative and neutral zones. The shift in expectations is more pronounced for current economic condition, still showing some expectations of improvements in economic conditions in future. This shift can be partly attributed to the post-election moderation of expectations. Likewise, expectations regarding Current Economic Conditions (CEC) and Expected Economic Conditions (EEC) decreased in the post-election period i.e. in the first week of November 2018. Inflation expectations have increased significantly in the November 2018 wave of Consumer Confidence Survey (CCS) as compared to the September 2018 wave.

15. Research Staff then presented the results of the Business Confidence Survey (BCS), conducted on a 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 both Business Confidence Index(BCI) and PMI have registered a dip in October 2018 in comparison to August 2018. In particular, BCI declined below the neutral level of 50 for the first time since the start of BCS in FY18. In addition, Research Staff also presented the results of the Bank Lending Survey (BLS), a quarterly online survey of senior credit officers of commercial banks regarding current and expected credit market condition. It was highlighted that respondents of latest BLS conducted in October 2018 reported that overall demand for bank credit increased during the first quarter of FY19 and is also expected to increase in the second quarter.

Model-Based Assessment

16. The staff presented a comparison of the now-casting assumptions of the FPAS used in the September-2018 meeting of the MPC and the actual realization of Q1-FY19 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 Q2-FY19, now-casting of international oil prices for Q2-FY19 and FY19, and the latest FOMC projections for the US Federal-Funds Rate (FFR) path along with the projections of US inflation for the next 8 quarters. Other assumptions related to the domestic economy included an increase in uncertainty in line with sovereign risk premium on Pakistan Eurobond(s) in Q2-FY19 as well as latest BCS respondents' remarks, and a now-casting of relatively higher fiscal impulse in line with the recently released fiscal data for Q1-FY19.

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 interest rate changes were mainly driven by upward revisions in inflation projections for FY19, both headline and core, and a larger the USD-PKR interest rate differential.

18. It was explained that headline-inflation is expected to rise in FY19 due to: (i) pass-through of the past, the most recent, and the model implied exchange rate adjustments; (ii) cost pressures due to increased gas-tariffs and administered oil prices; and (iii) higher fiscal deficit than the level envisaged in the supplementary budget for FY19. Conditional on above forecasting assumptions and a model implied interest rate path and other cost pressures, average headline inflation projection for FY19 was revised upward to 7.5 percent from 6.8 percent presented in the September MPC meeting.

19. Moreover, the expected reduction in output gap due to tightening of monetary policy is expected to partially offset the impact of incremental cost pressures on core inflation emanating from the aforementioned factors. Overall, core inflation projection for FY19 has been revised upwards to 8.7% from 8.4% presented to the MPC in September 2018. Assuming no change in the policy interest rate, headline and core inflation for FY19 are expected to be much higher compromising the current policy stance.

20. While explaining the uncovered interest rate parity, the staff explained that USD-PKR interest rate differential has improved due to the hike of 100 bps in policy interest rate by the SBP in the end-September MPC meeting. Keeping in view the model-implied exchange rate path and the future path of the FFR, the interest rate differential is expected to narrow down again. Therefore, adjustments in domestic policy interest rate are also required in the light of the modified uncovered interest rate parity. This parity is important given the current management of reserves.

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: (i) continued inflationary pressure (and rising inflationary expectations) needs to be checked; (ii) real interest rates remain low; (iii) although narrowing, the current account deficit is still high and the fiscal deficit remains elevated; and (iv) unfolding global developments, particularly

the gradual but consistent normalization of monetary policy in the developed economies demands proactive domestic monetary management..

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 on the magnitude of the increase required including front-loading the rate of change on this occasion.

24. Members voting for increasing the policy rate by 150 bps gave more weight to firmly leading the market and reduce uncertainty.

25. Member voting to increase the policy rate by 200 bps were of the view that future inflationary trends need to be contained today, amid a depreciating PKR. They were also of the view that a greater increase in the policy rate will lower the need for large rate increases subsequently.

26. In conclusion, the MPC decided to increase the policy rate by 150 bps to 10 percent with a majority vote of 7 out of 9 members present, with 2 votes for increasing the rate by 200 bps.

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

28. The MPC decided as follows:

DECISIONS:

- *The policy interest rate is increased by 150 bps to 10.00 percent.*
- *The Monetary Policy Statement - November, 2018 is approved.*