MINUTES OF THE 4th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
HELD ON TUESDAY, JULY 16, 2019

P R E S E N T

Dr. Reza Baqir	Chairman & Governor SBP
Mr. Jameel Ahmed	Deputy Governor (Banking & FMRM)
Mr. Azam Faruque	Director SBP Board
Dr. Naved Hamid	External Member
Dr. Asad Zaman	External Member
Dr. Hanid Mukhtar	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 developments in key macroeconomic indicators since the May 2019 Monetary Policy decision, along with an assessment of evolving trends.

2. The average CPI inflation was recorded at 7.3 percent in FY19 as compared to 3.9 percent last year, breaching the annual target of 6.0 percent after five years. CPI inflation (YoY) stood at 8.9 percent in June 2019, significantly higher than the 5.2 percent in the same period last year. The current uptick in CPI inflation is attributed to food and energy inflation, as YoY food inflation increased to 8.2 percent in June 2019, compared to 3.0 percent last year. The YoY energy inflation was recorded at 23.1 percent as compared to 4.5 percent in the same period last year. Among measures of core inflation, NFNE inflation remained stable at 7.2 percent in June 2019, against a similar increase of 7.1 percent in the same period last year. Apart from perishable food items, the increasing trend in inflation was more pronounced in the administered prices of gas, petroleum products and electricity, as well as transport. Some moderation in core inflation could be linked to the ongoing monetary tightening, although cost-push factors are keeping the overall inflation at an elevated level.

3. The importance of elasticity of demand with respect to inflation was also discussed as a possible consideration in the forecasts. Further, the MPC was apprised about the recent decision by NHA to implement axle load limits on heavy-duty transportation vehicles that would directly affect the freight cost and indirectly the demand, for various commodities. It was suggested to take into account this important development in the forecast for the next MPC.

4. Average inflation in FY20 is projected to be in the range of 11.0 to 12.0 percent, which is higher than the medium-term inflation target of 5.0 - 7.0 percent set by the government. The higher projection for FY20 incorporates the likely impact of budgetary measures and adjustments in utility tariffs. Although of transitory in nature, the budgetary measures and adjustments in utility tariffs will result in a surge in inflation during FY20 and stoke inflationary expectations. However, the impact of earlier adjustments in gas and electricity tariffs will start to dissipate from the second half of FY20. Therefore, the inflation may start falling in the second half of FY20 barring unforeseen domestic or external shocks. Similarly, the impact of adjustments in utility tariffs made in July FY20 will start to fade towards the end of this fiscal year. Moreover, the end to deficit monetization and gradual retirement of outstanding stock of government borrowing from SBP combined with considerable ongoing monetary tightening will counter underlying

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

inflationary pressures and inflation expectations. These favourable developments suggest that headline inflation is likely to fall in FY21.

5. Growth in Broad money (M2) accelerated to 12.2 percent during 1st Jul-28th Jun FY19, compared to a growth of 10.0 percent in the same period last year. The M2 growth was primarily contributed by an unprecedented expansion in net domestic assets (NDA) of the banking system on account of increased government borrowing, especially from SBP, and rise in the credit to public sector enterprises. On the other hand, while net foreign assets (NFA) of the banking system witnessed a contraction, pulling M2 growth down by around 8 percentage points in FY19. The NFA of the banking system contracted by Rs. 1,286 billion during 1st Jul - 28th Jun FY19 as compared to a reduction of Rs. 797 billion in the corresponding period of last year.

6. On the liability side, currency in circulation (CIC) grew by 13.3 percent during 1st Jul - 28th Jun FY19, almost same as in the corresponding period of last year. Nonetheless, bank deposits increased by Rs. 1,366 billion during the review period as compared to Rs. 940 billion in the corresponding period of last year. Most of the increase in deposits during FY19 was witnessed in the last week of June 2019, largely reflecting the impact of an asset declaration scheme and encashment of higher denomination prize bonds.

7. Increased government reliance on SBP borrowing led to acceleration in reserve money growth, which was up by 21.1 percent during 1st Jul - 28th Jun FY19 as compared to 14.2 percent growth in the same period of last year. The government borrowed Rs 3,157 billion from SBP during 1st Jul - 28th Jun FY19 as compared to Rs 1,439 billion in the corresponding period of last year. On the liability side, CIC and scheduled banks' deposits with SBP contributed to higher reserve money growth.

8. Private sector credit, as per monetary survey data, increased by Rs. 683 billion during 1st Jul – 28th Jun FY19 as compared to an expansion of Rs. 769.2 billion in the same period last year. The category-wise data available for the period of Jul-May FY19 reveals that this expansion was mainly driven by working capital requirements of the private sector businesses, which expanded by Rs. 441 billion during 1st Jul – 28th Jun FY19, compared to an increase of Rs. 352.7 billion in the same period last year. Higher input prices have played a key role in inflating working capital requirements. Meanwhile, fixed investment saw a net increase of Rs. 89.3 billion in Jul-May FY19 as compared to a rise of Rs. 176.3 billion in the corresponding period last year, reflecting the impact of a slowdown in the economy. The demand for fixed investment mainly arose from the power sector.

9. Staff then apprised the MPC about the management of government debt held by SBP in light of IMF's guidelines regarding zero flow of SBP's credit to government and re-profiling of the outstanding stock. This development is expected to bring a qualitative change in inflation dynamics in Pakistan.

10. The revised estimates suggest that the fiscal deficit for FY19 stood at 7.2 percent of GDP, as compared to the budget estimates of 4.9 percent. The increase in the fiscal deficit relative to the target was due to both, a slowdown in revenues and a sharp increase in current spending. Further, it was apprised that the high level of current expenditures squeezed the fiscal space and as a result development expenditures witnessed a significant decline of 19.2 percent in FY19 as compared to a moderate decline of 3.5 percent in FY18.

11. Staff apprised that fiscal deficit in FY20 is expected to remain close to the budget estimates. . Although, significant improvement is projected in the tax revenues for FY20, these could help increase the development spending.

12. Current account deficit (CAD) continued to narrow, despite some seasonal variation in Apr-May 2019. This was mainly driven by a noticeable contraction in imports of both goods and services and healthy growth in remittances. Workers' remittances grew by 9.7 percent in FY19 compared with 2.9 percent increase in FY18. Total import of goods contracted by 5.9 percent during Jul-May FY19 as compared to an increase of 18.1 percent in the same period last year. Imports could have declined even more sharply, had oil prices remained at last year's level. The import of services declined by 14.5 percent during Jul-May FY19.

13. In case of exports, despite an increase in the overall quantum of exports by 6.8 percent, the total export value decreased by 1.8 percent during Jul-May FY19 mainly due to a decline in the USD unit value of exports (that is, average price per unit sold). This trend is not limited to Pakistan as almost all emerging market economies – including regional and competitor economies – experienced a decline in unit values of their exports amidst a slowdown in global trade. If this slowdown continues, it may create challenges for exports to show a strong recovery in FY20.

14. Foreign direct investment (FDI) remained low during Apr-May 2019. On a cumulative basis, FDI almost halved to US$ 1.6 billion during Jul-May FY19 from US$ 3.2 billion in the same period of the last year. Moreover, the official inflows were more or less close to the last year. As result, net SBP reserves fell to $7.9 billion by end-May 2019.

15. The current account deficit is projected to narrow further in FY20. More specifically, imports are forecasted to maintain FY19 trends keeping in view the likely impact of exchange rate depreciation, falling domestic demand, and assumed average oil price of $65 per barrel. In addition to gradual improvement in competitiveness, exports are also expected to get a boost from FTA-II with China and preferential trade agreement with Indonesia. Moreover, workers' remittances are expected to maintain last year's momentum in view of better growth prospects in Pakistani diaspora host countries and rising trend in the number of emigrant in recent months. On the other hand, financial inflows are likely to increase with the start of IMF program. Keeping in view the aforementioned factors, SBP reserves are expected to recover in FY20.

16. LSM posted a 3.5 percent decline during Jul-Apr FY19, compared to a 6.8 percent increase in the same period last year. The decline in LSM was broad-based and linked to a reduction in development expenditures, lacklustre performance of the agriculture sector, and marked slowdown in domestic demand owing to stabilisation measures.

17. The projection for real GDP growth in FY20 is lowered to around 3.5 percent mainly due to downward revision in the LSM growth. This revision is based on the change in assumption for average exchange rate, and various fiscal measures announced in the budget for FY20(including an expected increase in development expenditures) compared to May 2019 projections. Further, projections for the agriculture sector remained steady, whereas estimates for the services sector growth in FY20 has been adjusted slightly downwards. The latest estimates show 14.4 percent increase in area under cultivation for the cotton crop against 12.1 percent decline seen in the last season. This constitutes around 93.1 percent of the total target of 2.895 million hectares set for FY20. This increase was mainly helped by a 57.9 percent increase in water availability during the ongoing kharif season, compared to a 40.0 percent decline in the previous season. Specifically, improved water availability is expected to help increase the area under cultivation and yield of major crops during FY20.

18. The downside risks to forecast for GDP growth in FY20 includes: (1) supply shocks in the form of pest attacks and weather related calamities; (2) expected increase in fertilizer prices due to upward adjustment in energy prices and exchange rate depreciation; (3) fiscal constraints regarding budgeted public spending; (4) further increase in input prices i.e. capital, electricity, raw materials etc.; and, (5) uncertainty in macro-environment and political instability. The

upsides for GDP growth in FY20 would be: (1) rebound in agriculture activities; and, (2) development expenditure spending at target level.

19. The staff concluded the presentation by summarizing the key points regarding the real interest rate, inflation forecast for FY20, inflation path till FY21, exchange rate scenarios and the expected fiscal position. Further, the MPC was apprised about the historical and current trends in the real interest rate, the output gap, and a breakdown of explanations (i.e. demand versus cost shocks) for changes in the inflation forecast for FY20. The staff also compared for the MPC, the strength of current policy stance in real terms relative to similar past events in Pakistan.

Financial Markets and Reserve Management

20. While discussing the monetary policy implementation, Executive Director FMRM stated that from July 1, 2019 onwards, Government could not borrow from the SBP, therefore the sole reliance was on the commercial banks to meet the government's borrowing requirement.

21. It was explained that to keep the overnight repo rate closer to the policy rate, SBP has started to inject liquidity in the market since the last MPC meeting in May 2019, in contrast to frequent mop-ups in the previous two quarters. The overnight repo rate remained at 12.27 percent, compared to the policy rate of 12.25 percent with volatility unchanged of 0.38 percent. This significant injection is mainly attributed to a change in the borrowing pattern of the Government and enhanced participation of commercial banks in the auctions of both MTBs and PIBs. This has resulted in average outstanding net injection of Rs. 609 billion since the last MPC meeting. Going forward, it is expected that SBP would have to inject more liquidity in the market, enabling commercial banks to meet their liquidity requirements as the government shifts its reliance on banks for domestic borrowings.

22. Discussing the yield curve, it was explained that the long-term trend in the yield curve depicts the market's expectations of a further increase, in the policy rate. On a query regarding the inverted yield curve, it was explained that since the government is accepting relatively more offers in 3 year and 5 year PIBs on a cut-off rate higher than 10 year PIB, it has resulted in an inverted yield curve in the long end.

Result of Surveys on Monetary Policy

23. The Research staff presented the results of different surveys to MPC. It was apprised that the Consumer Confidence Index (CCI) and Current Economic Conditions Index (CECI) both remained at significantly low levels in July 2019 almost the same as in May 2019. The Expected Economic Conditions Index (EECI) has increased moderately in July 2019 but continued to remain below the neutral level.

24. Discussing the results of overall inflation expectations, it was explained that inflationary expectations continued to remain at significantly high levels although it depicted a marginal decline in July 2019 as compared to the previous last wave of CCS conducted in May 2019. The inflation expectations of households regarding, food, energy and NFNE, all remain elevated. Further, on the suggestion of the MPC, a quantitative measure of inflation expectations was presented at the meeting for the first time. The Committee was also apprised about the exact wording of the question related to this quantitative measure of inflation expectations. While discussing the results of this measure, it was explained that in the next six months, CCS respondents expect a increase in overall inflation. It was also highlighted that these expectations remain high even after adjusting for outliers.

25. The results of Business Confidence Survey (BCS) conducted in June 2019 were then shared with the MPC. It was explained that all indices of business confidence depict a decline in

June 2019 as compared to earlier results of April 2019 wave. The Current Business Confidence Index (CBCI) and Business Confidence Index (BCI) declined significantly in June 2019 and continued to remain in the negative zone. However, Expected Business Confidence Index (EBCI) and Purchasing Managers' Index (PMI) declined marginally in June 2019 compared to the last wave. The EBCI is the only index of business confidence that was above the neutral zone. Discussing trends from FY19, it was highlighted that CBCI has remained in the negative zone since October 2018, while PMI has continued to decline consistently in the same period but moved to the negative zone for the first time in April 2019.

26. While explaining the Business Confidence Index by Sectors, it was apprised that the business confidence indices for the services sector reflected a marginal decline in June 2019 as compare to the results of April 2019 but remained above the neutral level. Whereas, business confidence of industry reflects a significant decline in June 2019 as compared to the last wave and has moved into the negative zone. Further, on the advice of MPC, results regarding various measures of inflation expectations of the BCS respondents was also shared for the first time. The staff highlighted that business's expectations regarding overall inflation, input prices and average selling price are all high. Specifically, the expectations regarding input prices are higher relative to the last six waves of BCS.

27. Further, the results of the Bank Lending Survey (BLS) were shared with the Committee. It was informed that the current and expected demand for loans continued to decline. Whereas, the overall availability of funds has picked up due to increase in bank deposits. However, the expected cost of borrowing continued to remain at a high level.

Model-Based Assessment

28. The staff presented a comparison of the now-casting assumptions of the FPAS used in the May-2019 meeting of the MPC and the actual realization of Q4-FY19 data. MPC was also apprised about the main assumptions of the latest FPAS output that included: (i) the now-casting of domestic headline and core inflation for Q1-FY20, (ii) international oil prices for FY20, and (iii) the latest FOMC projections for the US Federal-Funds Rate (FFR) path and the US inflation for the next 8 quarters. Moreover, it was informed that the Federal Reserve has revised its inflation projection and is likely to cut its policy rate in the upcoming Federal Open Market Committee (FOMC) meeting. Other assumptions related to the domestic economy included fiscal deficit to GDP ratios for FY20 and FY21.

29. Conditional on the latest data and the aforesaid now-casting assumptions, the model suggested a higher increase in the policy rate as compared to its recommendation presented to the MPC in May 2019. The policy advice was based on a revision in the inflation projection, increase in administered prices, the model-implied nominal exchange rate path that significantly closes the bilateral real exchange rate gap by the end of FY20, and a persistently higher fiscal deficit. Accordingly, the conditional projection of inflation for FY20 has been revised upward from the May 2019 projection. Other factors which pushed up the medium-term inflation path include minimum wage rate and second round impact of factors mentioned above. While discussing the interest rate path, it was explained that the Federal Reserve is expected to reduce the policy rate in the upcoming meeting. Nonetheless, the aforementioned PKR exchange rate path implies that SBP needs to hike the policy interest rate from an uncovered interest rate parity consideration.

30. Discussing further, the model's projection for 4-quarters ahead average inflation reveals that inflation is expected to stay at an elevated but will be on a falling trajectory. This forward-looking prognosis is conditioned on a tightening of the monetary policy stance as advised by the model.

31. In addition, the persistence of input cost pressures and a pass-through of exchange rate adjustments have been contributing to higher core inflation. As a result, the core inflation projection in July 2019 has been revised upward as well. This is also in line with the latest reading of IBA-SBP survey indicating higher inflation expectation for next six months.

32. On the positive front, it was explained that despite upward pressures emanating from the fiscal deficit, the model projects a narrowing of the output gap owing to factors including ongoing monetary tightening and a weak external demand.

33. At the end, Research Staff apprised MPC about various projections based on alternative scenarios for: (i) nominal exchange rate, (ii) inflation uncertainty as indicated by fan chart of inflation projections and (iii) oil price shock amidst geo-political risk in Gulf Peninsula. The committee had a detailed deliberation on all the scenarios and their possible implications on the policy rate.

Monetary Policy Deliberations and Decision Vote

34. While setting the policy interest rate for the next two months, the Committee considered the following points: (i) higher recent month-on-month headline and core inflation outturns; (ii) recent exchange rate depreciation; (iii) an elevated fiscal deficit and its increased monetization, and (iv) potential adjustments in utility tariffs.

35. Concluding the deliberations, the members voted on the policy rate decision.

36. In conclusion, the MPC decided to increase the policy rate by 100 bps with a majority vote of 5 out of 8 members, with two votes for increasing the policy rate by 75 bps and one vote for increasing the policy rate by 150 bps.

37. The Committee then scripted the Monetary Policy Statement.

38. The Committee decided as follows:

DECISION:

- *The policy interest rate is increased by 100 bps to 13.25 percent.*
- *The Monetary Policy Statement – July 2019 is approved.*