MINUTES OF THE 6th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
HELD ON MONDAY, SEPTEMBER 16, 2019

P R E S E N T

Dr. Reza Baqir	Chairman & Governor SBP
Mr. Jameel Ahmad	Deputy Governor (Banking & FMRM)
Dr. Inayat Hussain	Executive Director (FS&BSG)
Dr. Saeed Ahmed	Chief Economist
Mr. Azam Faruque	Director SBP Board
Mr. Atif R. Bokhari	Director SBP Board
Dr. Tariq Hassan	Director SBP Board
Dr. Asad Zaman	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 July 2019 Monetary Policy decision, along with an assessment of evolving trends.

2. It was informed that PBS has released data of prices on a new base (2015-16) and old base (2007-08) simultaneously. While explaining the difference of new versus old base, it was informed that in new base computations of rural, urban and national indices have been included. Whereas in the old base, there are only indices for urban areas. Further explaining the difference, it was informed that there are changes in computation methodology, weights for cities, number of commodities. It was added that in the new base, a numbers of items for urban and rural indices are overlapping.

3. While discussing the inflation using the old base, it was stated that YoY inflation during August 2019 was 11.6 percent, which was the highest observed since May 2012. This uptick in CPI inflation is due to higher food and energy prices in the last two months. Presenting the heat-map of CPI inflation, it was informed that all the sub-indices are showing double-digit inflation, among which energy is leading with 32.8 percent. While discussing MoM changes in CPI inflation, it was informed that MoM inflation recorded an increase of 2.3 and 1.4 percent in July and August 2019. It was added that the July 2019 inflation was high due to adjustments in utilities tariffs and taxation measures taken in the budget. In August 2019, there was an upward trend in the inflation of food items, because of Eid and border tensions. Discussing the outlook for inflation, staff apprised that the average inflation is expected to remain within the range of 11 to 12 percent. Moreover, the fan charts depicts a decline in uncertainty over inflation projections.

4. The SBP staff apprised that there is a contraction in the SBP's NDA of 3.8 percent (or Rs.293 billion) during Jul 01-Aug 30 FY20 against an expansion of 0.8 percent (Rs.45 billion) during the same period last year, which is mainly due to the restriction on government borrowing from SBP. Similarly, there is an expansion of Rs.229 billion in the SBP's NFA during Jul 01-Aug 30 FY20 as compared to an increase of Rs.66 billion in the corresponding period of FY19, primarily driven by an improvement in the country's external accounts. However, during Jul 01-Aug 30 FY20, broad money (M2) contracted by 0.9 percent as compared to contraction of 0.4 percent in the same period last year. Discussing the government's budgetary borrowing, it was apprised that there is a major shift in the borrowing pattern. Last year, the government borrowed Rs. 1.1 trillion

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

from SBP and retired almost the same amount to scheduled banks. Whereas this year, the government borrowed Rs. 456 billion from scheduled banks and retired Rs. 430 billion to the SBP, which is also a key reason for the decrease in the SBP's NDA.

5. Discussing trends in Monetary Aggregates, it was highlighted that the NDA of the banking system fell by Rs.440 billion as compared to a decline of Rs.106 billion in the last year. Most of the contraction in the NDA was because of net retirement of credit to the private sector and PSEs. During 01 Jul-30 Aug FY20, private sector credit witnessed a net retirement of Rs.85 billion against an expansion of Rs.31 billion in the corresponding period last year. The reason behind the contraction in private sector credit is the unfolding impact of stabilization measures along with slowdown in overall economic activity. It was added that the trends in private sector credit depends on the supply and demand conditions. Considering supply conditions of the banking system, deposits increased significantly in June 2019 due to one-off factors like the Asset Declaration Scheme (ADS) and demonetization of Rs. 40,000 Prize bonds. However, in July 2019, bank deposits saw a seasonal reversal of year-end rise in deposits, and the partial withdrawal of deposits related to demonetization of Prize Bonds and the ADS, 2019. This, along with continued fall in deposits of businesses affected the availability of liquidity. Another reason that may have affected the supply conditions are NPLs, which have increased to Rs.750 billion by end June 2019 from Rs.560 billion last year, and the infection ratio has slightly increased. Therefore, banks might be reluctant in expanding their lending portfolio. Further, an increase in government borrowing from banks may crowd out private sector credit expansion.

6. While discussing the demand conditions in private sector credit, it was informed that WALR has increased by 580 bps since June 2018. This increase in the WALR and higher risk premium have contributed to lower credit demand. Further, discussing the reduction in demand conditions that may be due to firms constraints, it was informed that inventories are rising and sales are decreasing, reducing profits. Lower demand for private sector credit is also visible from the loan applications data.

7. On the outlook of private sector credit, it was informed that the expected growth in private credit for FY20 has been revised downward to incorporate the impact of changes in both demand and supply of loanable funds. However, overall monetary (M2) expansion is projected to remain close to the July 2019 estimates, as the contractionary impact of lower private sector credit is likely to be offset by an improvement in net foreign assets of the banking sector.

8. While discussing the fiscal deficit, it was informed that the budget deficit in FY19 was 8.9 percent of the GDP against revised estimate of 7.2 percent. This was significantly higher than the budget deficit of 6.5 percent in FY18. Explaining the possible reasons, the Committee was apprised that a notable shortfall in the revenue collection largely contributed towards this gap. Excluding the impact of interest payments, the primary deficit in FY19 deteriorated to 3.5 percent of GDP as compared to 2.2 percent in FY18. Discussing the expenditure side, it was apprised that the development expenses declined by 1.5 percent of GDP in FY19, while the current expenses increased by 1.6 percent of GDP against FY18. Discussing the short fall in the revenue collection it was informed that expected revenue from the renewal of 3G and 4G licences in FY19 was not realized. Secondly, there was a drastic decline in the SBP's profit. It was also highlighted that certain assumptions led to an overestimation of revenue projections.

9. Highlighting the fiscal outlook for FY20, it was stated that the budget deficit may remain close to the budget estimates. It was explained that this time there are certain changes in the composition of expenditure and revenue. FBR has assumed a tax collection target of Rs. 5.5 trillion for FY20, which looks quite ambitious. However, shortfall in revenue collections is likely to be largely compensated by favourable developments in the non-tax revenues. The remaining gap could be adjusted by exercising tight control over expenses. Thus, the overall, fiscal deficit may remain close to the target.

10. While presenting the global economic conditions, staff informed the IMF has again revised downward its global growth projections to 3.2 percent. The growth projection of global trade has also been revised downward to 0.9 for FY19and 0.3 percent for FY20. Further, it was highlighted that oil prices dropped by almost 11.0 percent since July 2019. However, the recent attacks on Saudi Arabian oil fields may have some implications on future oil prices, provided oil production remains affected for longer period. Discussing further, staff apprised the committee that since last MPC, the central banks of 33 countries have decreased their policy rates.

11. While presenting the developments in the Balance of Payment (BoP) position since July 2019 MPC, it was informed that there is notable improvement in the current account and financial account. This improvement was mainly driven by a contraction in the trade deficit and an improvement in financial inflows. It was informed that imports maintained their declining trend whereas exports showed a double-digit growth in the first month of FY20. It was further explained that favourable trends in the trade balance show the unfolding impact of stabilisation measures, with major contribution coming from exchange rate depreciation during the last year as well other administrative measures. It was informed that on a YoY basis exports increased by 11.0 percent in July FY20. It was explained that higher textile volumes mainly contributed to an uptick in exports. Discussing the export unit price in dollar terms, the staff informed that the export prices have declined in all the emerging market economies including Pakistan. Further, it was informed that on YoY basis the imports have declined by 25.8 percent in July FY20. It was informed that in general all the import groups have witnessed a decline. On the other hand, worker's remittances recorded a modest increment of 2.9 percent in July FY20. The significant portion of these inflows came from USA, UK, Saudi Arabia and UAE.

12. Further, discussing the financial inflows in July 2019 it was explained that the financial account has improved with disbursement of loan worth US$991.4 million by the IMF. On portfolio investment, staff apprised that in July FY20 it recorded an inflow of US$93.0 million as compared to outflow of US$ 38.0 million in same month last year. This inflow was largely due to investment in debt securities. Highlighting the Foreign Direct Investment (FDI), it was mentioned that in July-FY20 FDI was US$75.0 million as compared to US$178.0 million in July FY19. The sharp decline was due to decrease in investment from China with the completion of most power projects under CPEC. On a query, it was informed that foreign exchange reserves in July 2019 were US$ 7.8 billion. However, SBP's foreign exchange reserves are expected to improve by the year-end.

13. Discussing the real sector, it was informed that based on developments since the last MPC the projected real GDP in September 2019 remains unchanged. This projection is primarily based on a mixed picture of key macroeconomic indicators. Further, it was apprised that based on the latest data received from the PBS, LSM growth witnessed a decline of 3.6 percent in FY19 as compared to significant growth of 6.4 percent in FY18. The decline is mainly attributed to the slowdown in POL, steel, pharma and automobile industries.

14. The staff apprised the committee that LSM growth projections of July 2019 remain unchanged. Elaborating the LSM growth projections, it was highlighted that growth in construction and allied industries are likely to slightly recover because of increase in development budget as compared to the last year. However, prospects of the automobile sector are not very promising. During the first two months of FY20 the sales of automobile industry declined by 21.1 percent, which is mainly attributable to rising prices, increasing cost of consumer finance and decline in real incomes. Similarly, POL refining is projected to suffer in FY20 due to slowdown in economic activities and lower domestic demand for furnace oil because of change in power generation-mix. Further, it was discussed that the textile sector is expected to improve in the backdrop of rising exports. While discussing the domestic demand in FY20, it was highlighted that there is a significant increase in sales tax revenue during first two months of FY20, which reflects a recovery in domestic demand.

15. The downside risks pertaining to forecast for GDP growth in FY20 includes: (1) supply shocks in the form of pest attacks and weather related calamities; (2) increase in input prices in industry; (3) fiscal constraints regarding budgeted public spending. The upsides for GDP growth in FY20 would be: (1) rebound in agriculture activities; and, (2) initiation of work on planned infrastructure projects.

Result of Surveys on Monetary Policy

16. The Research staff presented the results of different surveys to MPC. It was apprised that there is a marginal increase in the Consumer Confidence Index (CCI) in September 2019 as compared to July 2019. The Expected Economic Conditions Index (EECI) increased moderately but was still in negative territory. It was added that recent downtrend in consumer confidence is due to lower confidence of households with regards to current economic conditions. However, their views regarding expected economic conditions are gradually coming back to the mean.

17. Discussing the inflation expectation indices, it was apprised that overall, food and NFNE remained at almost the same level in September 2019. However, energy expectations index showed a marginal decline between the last two waves due to the recent decline in domestic fuel prices. On the quantitative measure of inflation expectations, it was informed that 6-months ahead household inflation expectations have fallen in September 2019 relative to July 2019.

18. Discussing the Business Confidence survey, it was stated that there is a slight improvement in overall business confidence and expected business confidence, but there is a decline in the Purchasing Managers Index (PMI) in August 2019 from the last time. PMI - a globally recognized indicator for the industrial sector performance, is consistently coming down, showing the current conditions in the market. On a query, it was informed that PMI is an index consisting of production, employment, total order books, quantity of raw material purchases and average supplier delivery times in the last six months. It was also informed that inflation expectations indices of businesses have significantly improved between the last two waves in line with households' anticipation of inflation.

19. The team also discussed the prevailing situation of economic policy uncertainty, where it was noted that significant decline in uncertainty has been observed in the last two months.

Model-Based Assessment

20. Research staff apprised the committee about the mechanism of the model for better understanding of newly appointed members. The staff also presented a comparison of the now-casting assumptions of the FPAS used in the July 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, (iii) fiscal deficit for FY20 and FY21, and (iv) the latest FOMC projections for the US policy rate & inflation.

21. Discussing the baseline assumptions, the staff apprised the committee that the now casting of headline inflation for Q1FY20 has been revised downwards in September 2019. This downward revision is mainly attributed to a decline in oil prices, appreciation in nominal exchange rate and lower than expected impact of the electricity prices. Updates on the assumption for FY20 about exchange rate, oil prices and fiscal deficit were also discussed.

22. Given the aforementioned assumptions, the model suggested a moderation in the upward revision of the policy rate by Q1-FY20 compared to the output of July 2019. It was elaborated that the proposed moderate adjustment in the policy rate would reflect (i) consistency with the

modified uncovered interest rate parity condition and (ii) respecting the medium term inflation target of 5-7 percent announced by the Government.

23. Further, the staff apprised that incorporating a revised FY19 fiscal deficit means that model would experience two effects. First, there is initially a lagged effect on aggregate demand in FY20 due to a larger than anticipated fiscal deficit recorded in FY19. Second, from a consolidation point of view this means a bigger contractionary fiscal impulse that will in turn determine the inflation path and hence the policy rate.

24. At the end, Research Staff presented various projections based on alternative scenarios for: (i) nominal exchange rate, (ii) international oil prices, (iii) fiscal deficit, and (iv) output gap. The committee had detailed deliberations on all the scenarios and their possible implications for the policy rate.

Financial Markets and Reserve Management

25. While apprising the committee on monetary policy implementation, ED-FMRM stated that overnight repo rate remained slightly higher at 13.31 percent against the policy rate of 13.25 percent with volatility of 0.49 percent. Discussing the developments on the monetary side, he explained that in recent months the SBP had to inject significantly in the market to keep the overnight repo rate closer to the policy rate. This injection was mainly attributed to aggressive participation of scheduled banks in the government auctions. As a result, the average outstanding injection (net) stood at Rs. 1463.0 billion during Jul 17-Sep 12, 2019.

26. Discussing the residual maturity of the GOP securities, ED-FMRM highlighted significant imbalance between short and long-term maturities of the government debt. He apprised the committee that almost 50.0 percent of the government debt has maturity period less than three months, which depicts government's vulnerability to rely on the bi-weekly MTBs auction. Further, he stated that government is still accepting nominal amount in auctions of long dated PIBs. The committee suggested to provide average auction rates along with amounts offered and accepted.

27. While discussing the yield curve, ED-FMRM stated that yield of 10- year bond has declined sharply to 12.48 percent from 13.86 percent since MPC July 2019. This decline is primarily due to the very limited issuance of 10 and 5 year paper and tilt in the government borrowing pattern to short-term papers. However, it is hoped that MOF will now shift focus to longer tenors in upcoming auctions as long term yields have come down sharply and are below the policy rate. At the end apprising the committee about the shift in market expectations since last MPC, it was explained that market is generally of view that interest rates have peaked and would start to come down in the near future.

Monetary Policy Deliberations and Decision Vote

28 While deciding about the monetary policy stance for the next two months, the Committee considered the following points: (i) aggregate demand and supply situation; (ii) sentiments in foreign exchange market in the post introduction of the market-based exchange rate system; (iii) an elevated fiscal deficit and increased monetization during FY19, and (iv) potential adjustments in utility tariffs (v) higher recent month-on-month headline and core inflation outturns.

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

30 The MPC decided to maintain the policy rate at status quo with a majority vote of 8 out of 9 members, with one vote for decreasing the policy rate by 25 bps.

31 The Committee then scripted the Monetary Policy Statement.

32 The Committee decided as follows:

DECISION:

- *The policy interest rate is kept unchanged at 13.25 percent.*
- *The Monetary Policy Statement –September 2019 is approved.*