MINUTES OF THE 3rd MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on May 20, 2019

P R E S E N T

Dr. Reza Baqir	Chairman & Governor SBP
Mr. Jameel Ahmed	Deputy Governor (Banking & FMRM)
Dr. Inayat Hussain	Executive Director (FS & BSG)
Dr. Saeed Ahmed	Chief Economist and Executive Director
Mr. Azam Faruque	Director SBP Board
Dr. Naved Hamid	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 March 2019 Monetary Policy decision, along with an assessment of evolving trends.

2. The YoY CPI inflation was 8.8 percent in April 2019, significantly higher than the 3.7 percent recorded in the same month last year, but lower than the peak of 9.4 percent recorded in March 2019. The increasing trend in CPI inflation can be attributed to volatility in the prices of perishable food items, as YoY food inflation increased to 8.6 percent in April 2019, compared to a decline of 0.2 percent in April 2018. Among the core inflation measures, NFNE inflation was recorded at 7.0 percent in April 2019, against a similar increase in the same period last year, but lower than the 8.5 percent recorded in March 2019. The 20 percent trimmed mean measure showed that core inflation increased to 7.2 percent in April 2019 as compared to 5.0 percent in the corresponding month of the last year, but again lower than the 7.9 percent recorded a month ago. 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 a higher level.

3. Keeping in view the inflationary trends and the latest data, the projection of 'end-June' CPI inflation on YoY basis has been revised to around 8.6 percent from 7.2 percent projected in March 2019. This revision takes into account movements in exchange rate, international oil prices, and trends in perishable food prices. The 'average' CPI inflation for FY19 is estimated to be in the range of 6.5 to 7.5 percent, and is likely to be considerably higher in FY20. Alternative scenarios regarding the 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, increase in food prices, growth in money supply and future exchange rate movements. Further, the upside risks to the inflation forecast outweighed the downside risks. Accordingly, pulling inflation back closer to its target at 6.0 percent over the medium-term and anchoring its expectations warrants continued policy measures.

4. Growth in broad money (M2) decelerated to 4.1 percent during 1st Jul-03 May FY19 as compared to a growth of 4.9 percent in the same period last year. The growth in M2 was almost

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

entirely driven by an expansion in NDA on account of increased government borrowings and a rise in the credit to the private sector, while the NFA of both SBP and commercial banks witnessed a contraction. The government borrowed Rs 3.3 trillion from SBP during 1st Jul – 03 May FY19, which was primarily utilized to repay loans worth Rs 2.2 trillion to commercial banks. As a result, reserve money grew by 8.1 percent during 1st Jul- 03 May FY19 as compared to 7.5 percent in the comparable period last year. The NFA of the banking system contracted by Rs 859.1 billion during 1st Jul-03 MayFY19 as compared to a reduction of Rs 508.5 billion in the corresponding period last year. However, some improvement in the country's external accounts is expected to lower the pace of contraction in NFA. On the liability side, currency in circulation witnessed an increase of Rs 427.9 billion during 1st Jul-03 May FY19 as compared to an increase of Rs 355.2 billion in the corresponding period last year. Bank deposits increase by Rs 212.9 billion during the review period as compared to Rs 360 billion in the corresponding period last year, indicating the increasing trend in currency in circulation.

5. Private sector credit increased by Rs 611.5 billion during Jul-Mar FY19 as compared to an expansion of Rs 473.7 billion in the same period last year. This expansion was mainly driven by working capital requirements of the private sector businesses, that expanded by Rs 471.5 billion for Jul-Mar FY19, compared to an increase of Rs 253.1 billion in the same period last year. Higher working capital requirements could be linked to increasing prices of inputs. Meanwhile, fixed investment saw a net increase of Rs 83.1 billion in Jul-Mar FY 19 as compared to a rise of Rs 148.1 billion in the corresponding period last year, reflecting an impact of slowdown in the economy. The demand for fixed investment mainly arose from the power and cement industries.

6. The fiscal deficit for Jul-Mar FY19 is estimated at 4.8 percent of GDP as compared to 4.3 percent in the same period last year. The higher fiscal deficit is driven by both slower growth in revenues and increase in expenditures, led by higher debt servicing and security related expenditures. FBR revenue increased by 2.8 percent in Jul-Mar FY19 as compared to an increase of 15.8 percent in the same period of FY18. The slowdown in revenue growth was witnessed in both FBR taxes and non-tax revenues. The lower tax collection can be attributed to a fall in corporate profits, suspension of tax on cell phone usage, reduction in development expenditure, tax concessions given to the salaried class, reduction in sales tax on petroleum products, and an overall slowdown in economic activity. To finance the deficit, the government had utilized both external and domestic sources. As a result, domestic financing increase significantly to Rs 1,312.8 billion as of Q3-FY19, compared to Rs 956.6 billion in the same period last year. However, external financing is likely to be Rs 516.1 billion as of Q3-FY19, in comparison to the Rs 524.3 billion in the same period last year. Under the prevailing situation, achieving the fiscal deficit target of 4.9 percent for FY19 does not seem possible.

7. The current account deficit (CAD) contracted by more than 29 percent, falling to USD 9.6 billion in Jul-Mar FY2019 from USD 13.6 billion in the corresponding period of the last year. The contraction was mainly driven by the trade deficit that declined to USD 21.3 billion for Jul-Mar FY19 compared to USD 23.1 billion in the same period last year. The lower trade deficit resulted mainly from a contraction in imports that, in absolute terms, declined to USD 39.3 billion in Jul-Mar FY19 from USD 41.3 billion in the same period last year. A relatively higher level of oil prices compared to FY18 masked otherwise a larger contraction in imports. Exports during the period faced stagnation in value terms as they amounted to USD 18.0 billion during Jul-Mar FY19 as compared to USD 18.3 billion during the same period last year, despite increasing in terms of quantum. Further, CAD was also supported by a YoY 41.3 percent decline in the services balance that was mostly driven by a lower travel related outflows. The improvement in CAD can be attributed to exchange rate depreciation, monetary policy tightening, imposition of regulatory duties, and lower import of machinery under CPEC related projects. The CAD also benefited from worker remittances that increased to USD 16.1 billion in Jul-Mar FY19, compared to USD 14.8

billion in the same period last year, registering a YoY growth of 8.7 percent for the period. This increase was due to a significant growth in remittances from United States, Malaysia, United Kingdom, UAE and Saudi Arabia.

8. The surplus in capital and financial accounts increased to USD 11.1 billion during Jul-Mar FY19 as compared to USD 9.7 billion in the same period last year. The foreign direct investment (FDI) stood at USD 1.3 billion in Jul-Mar FY19 as compared to USD 2.6 billion in the same period last year. Foreign portfolio investment (FPI) registered an outflow of USD 276 million in Jul-Mar FY19 as compared to a net inflow of USD 2.3 billion in the same period last year. Support from some friendly countries kept the net official inflows higher at USD 3.8 billion during Jul-Mar FY19, compared to USD 2.4 billion in the same period last year. BOP support from China, Saudi Arabia and United Arab Emirates helped in raising foreign exchange reserves to USD 10.5 billion as of March, 2019, compared to USD 9.8 billion at the beginning of this fiscal year. Going forward, the pass through of PKR depreciation against US dollar, monetary tightening, various administrative measures, and anticipated increase in the official inflows could further narrow the external account deficit.

9. The real GDP growth in FY19 is estimated to have moderated to 3.3 percent, against the 6.2 percent target for the year and 5.5 percent growth achieved in FY18. Lower growth was contributed by weak performance of both agriculture and manufacturing sectors. LSM, taken as proxy for the manufacturing sector, also performed below expectations and is estimated to contract by 2.1 percent in FY19, compared to 5.1 percent achieved last year. Decline in LSM was broad-based and could be linked to a steep reduction in development spending, monetary tightening, and the exchange rate depreciation during FY19 as well as sector specific issues. The lacklustre performance of the agriculture and industrial sectors also affected the services sector. GDP growth is expected to post a slight recovery in FY20 because of some supportive factors on the horizon, including :(i) a possible finalization of IMF program which could boost confidence of investors and businesses; (ii) expected increase in development expenditure in FY20 that could revive construction activities and support allied industries like cement and steel; and (iii) some improvement in the agriculture production as water shortages that mainly hampered sector's growth in FY19 are expected to be overcome to some extent in FY20. The improvement in commodity producing sectors is also expected to support services growth in FY20.

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) higher inflation; (b) lower import coverage of forex reserves; and (c) an elevated fiscal deficit. Given its strong contemporaneous and dynamic correlation with real economic growth, staff underlined the need to put more emphasis on macroeconomic stability through timely and decisive policy measures. The staff also presented the historical trends in the policy rate, the real interest rate that are required to curb aggregate demand, the output gap, and inflation.

Financial Markets and Reserve Management

11. Since the monetary policy review in March, 2019, the interbank overnight repo rate remained at 10.58 percent on average against the policy (target) rate of 10.75 percent. However, the volatility in the repo rate, measured as coefficient of variation, increased significantly to 0.38 percent, as compared to 0.14 percent at the time of the last monetary policy review meeting. The significant increase in volatility could be linked to maturity of T-bills of around Rs. 2 trillion, which the government was unable to rollover due to thin participation from the market in the auction held on 8th May 2019.

12. The government continued to depend on SBP for its domestic borrowing needs. This was also witnessed in the PIBs and MTBs auctions, conducted immediately after the last MPC meeting in April 2019, where the government accepted only small amounts, despite heavy participation by the banks. Accordingly, the market remained liquid and necessitated frequent mop up operations by the SBP for effective implementation of monetary policy stance. Net mop-up of liquidity increased to Rs. 888 billion per day on average during the last two months, compared to Rs. 372 billion in the two months prior to the monetary policy decision of March, 2019.

13. The yield curve of both short and long end shifted upwards to account for the increase of 50 bps in the policy rate in March. A relatively higher spread between the short and long-term yields indicated market's expectations of further increases in the interest rate.

Result of Surveys on Monetary Policy

14. Before discussing the results of surveys on consumer confidence, business confidence and bank lending, the research staff apprised the Committee about the background and the sample size covered for conducting these surveys in detail.

15. While discussing the results of surveys on consumer confidence it was explained that on an overall basis, Consumer Confidence Index (CCI) has witnessed a significant decline in May 2019 as it moved in the negative zone. The perceptions regarding both Current Economic Conditions (CEC) and Expected Economic Conditions (EEC) have moved significantly in to the negative territory. Moreover, the latest survey shows a marked decline in both CEC and EEC in comparison to the survey conducted in March 2019. Overall Inflation expectations in the latest wave of CCS have increased compared to the last wave of March 2019. Furthermore, this increase is broad-based as reflected by expectations of households regarding, food, energy and NFNE inflation. The elevated expectations are probably due to higher food inflation, exchange rate depreciation and uptick in the administered prices of petroleum products.

16. It was noted that the results of the bi-monthly Business Confidence Survey (BCS) conducted in April 2019 were used to compute Current Business Confidence Index (CBCI), Expected Business Confidence Index (EBCI), Business Confidence Index (BCI) and Purchasing Managers' Index (PMI). All of these indices showed a decline in April 2019 as compared to the earlier results of February 2019. BCI for the latest wave conducted in April 2019 moved back to the negative zone compared to the slightly positive level in February 2019. Similarly, CBCI and EBCI have also decreased in comparison to the previous survey results. Sectoral analysis shows that the expected business confidence index for both industrial sector and services sector has worsened, in comparison to the survey conducted in February 2019. It may also be noted that the Purchasing Manager Index (PMI) has moved below the neutral level of 50 into the negative zone for the first time.

17. At the end, the staff 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 conditions. It was highlighted that the respondents of the latest BLS conducted in April 2019 reported that overall demand for bank credit and availability of funds declined during the third quarter of FY19, and is also expected to decline in the last quarter of FY19. The BLS results also show that current and expected cost of borrowing continues to remain at an elevated level.

Model-Based Assessment

18. The staff presented a comparison of the now-casting assumptions of the FPAS used in the March-2019 meeting of the MPC and the actual realization of Q3-FY19 data. After that the MPC was apprised about the main assumptions of the latest FPAS output that included the now-casting of domestic headline and core inflation for Q4-FY19, international oil prices for FY19 and FY20, and the latest FOMC projections for the US Federal-Funds Rate (FFR) path and the US inflation for the next 8 quarters. Other staff assumptions related to the domestic economy included fiscal deficit to GDP ratio of 7.2 percent and 6.9 percent for FY19 and FY20.

19. Conditional on the latest data and aforesaid now casting assumptions, the model suggested a slightly higher increase in the policy rate as compared to its recommendation presented to the MPC in March 2019. The following factors underpinned this policy recommendation.

20. The inflationary trend in food items, upward adjustments in POL prices and increased fiscal deficit have ignited inflationary pressures in the economy. The conditional projection of inflation for FY19 has been revised upwards to 7.4 percent from 7.2 percent for FY19 and have also increased for FY20. The projection for average 4-quarters ahead reveals that inflation going forward is expected to stay elevated, which requires tightening of the policy interest rate. The future inflation path has inched up due to (i) incorporation of actual Q3-FY19 inflation data, (ii) higher estimated fiscal deficits for FY19 and FY20, (iii) depreciated exchange rate path, and (iv) a marginal increase in the output gap.

21. Above factors along with higher inflation expectations, as indicated by the latest wave of IBA-SBP inflation expectation survey, have been contributing to persistent high level of core inflation. Although, core inflation projection for FY19 has been revised downward due to a base effect of House Rents Index for Q4-FY19, the projection of core inflation for FY20 has been revised upwards.

22. Another factor, which explains the relatively larger monetary tightening as suggested by the model, is uncovered interest rate parity viz-a-viz US economy. Federal Reserve, in the latest March 2019 projections, has lowered its inflation projections while showing little appetite for raising it in future. This along with the depreciated PKR exchange rate path means that SBP needs to hike the policy interest rate from an uncovered interest rate parity consideration. This parity is important given the current management of reserves.

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

Monetary Policy Deliberations and Decision Vote

24. 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.

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

26. The Committee unanimously decided to increase the policy rate by 150 bps.

27. The Committee then scripted the Monetary Policy Statement.

28. The MPC decided as follows.

DECISIONS:

- *The policy interest rate is increased by 150 bps to 12.25 percent.*
- *The Monetary Policy Statement - May, 2019 is approved.*