MINUTES OF THE 2nd MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on March 29, 2019

P R E S E N T

Mr. Tariq Bajwa	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
Mr. Atif R. Bokhari	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 the developments in key macroeconomic indicators since the January 2019 Monetary Policy decision, along with an assessment of evolving trends.

2. The YoY CPI inflation increased to 8.2 percent in February 2019 from 6.2 percent in December 2018, and was significantly higher than the 3.8 percent recorded in the same month last year. The increase in CPI inflation was highest since July, 2014 and can be attributed to a sharp increase in the prices of perishable food items, as YoY food inflation increased to 5.0 percent in February 2019, compared to 0.9 percent in December 2018. Among the core inflation measures, NFNE inflation rose by 8.8 percent in February 2019 as compared to a 5.2 percent increase recorded last year in the same period, whereas the twenty percent trimmed mean measure showed that core inflation increased to 7.7 percent in February 2019 as compared to 4.3 percent in the corresponding month of the last year. Apart from the perishable food items, the increasing trend in inflation is more pronounced in the administered prices of gas, petroleum products and electricity, as well as transport. Going forward, the lagged impact of the recent increase in the gas and electricity tariffs is the main contributors in upside risks to the inflation forecasts.

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 7.2 percent from 6.8 percent projected in January 2019. This revision takes into account movement in exchange rates, international oil prices, and increase in perishable food prices. However, the forecast range of the 'average' CPI inflation for FY19 has been kept unchanged at 6.5-7.5 percent. 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. Furthermore, 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 measure.

4. Broad money (M2) registered a significant growth of 3.6 percent during 1st Jul-15th Mar FY19 as compared to a growth of 2.4 percent in the same period last year. The growth in M2 was

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

almost entirely driven by an expansion in NDA on account of increased government borrowings and a rise in the credit to the private sector. The government borrowed Rs. 3.3 trillion from SBP during 1st Jul – 15th Mar FY19, which was primarily utilized to repay loans worth Rs.2.2 trillion to commercial banks. As a result, reserve money grew by 7.5 percent in 1st Jul-15th Mar FY19 as compared to 4.3 percent in the comparable period last year. On the other hand, NFA of the banking system continued to decline on account of increasing foreign liabilities, while foreign exchange reserves continued to remain under stress. The NFA of the banking system contracted by Rs. 880.4 billion in 1st Jul-15th Mar, FY19 as compared to a reduction of Rs. 423.8 billion in the corresponding period last year. However, an improvement in the current account deficit is expected to lower the pace of contraction in the NFA. On the liability side, currency in circulation witnessed an increase of Rs. 416 billion during 1st Jul-15th Mar FY19 as compared to an increase of Rs. 235 billion in the corresponding period last year. Growth in bank deposits was 1.43 percent during 1st Jul-15th Mar FY19, compared to 1.1 percent in the same period last year.

5. Private sector credit increased by Rs.615.9 billion during Jul-Feb FY19 as compared to an increase of Rs. 353.9 billion in the same period last year. This expansion was mainly driven by working capital requirements of the private sector businesses, that increased to Rs. 488.0 billion for Jul-Feb FY19, compared to an increase of Rs 208.6 billion in the same period last year. Higher requirements for working capital financing could be linked to increasing prices of inputs. Meanwhile, fixed investment saw a net increase of Rs. 59.4 billion in Jul-Feb FY 19 as compared to a rise of Rs. 122.2 billion in the corresponding period last year, possibly reflecting an impact of a slowdown in the economy.

6. The fiscal deficit for Jul-Dec FY19 increased to 2.7 percent of GDP as compared to 2.3 percent in the same period last year. The higher fiscal deficit was driven by both, the primary deficit and increased debt servicing. Meanwhile, FBR revenue increased by 2.9 percent in Jul-Feb FY19 as compared to a significant increase of 17.2 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 lower corporate profits, suspension of tax on cell phone usage, reduction in development expenditure, and on overall slowdown in economic activity. To finance this deficit, the government had utilized both external and domestic sources. As a result, domestic financing increased significantly to Rs.812.0 billion in Jul-Dec FY 19, compared to Rs. 412.2 billion in the same period last year. However, external financing was low at Rs. 218.0 billion in H1-FY19, in comparison to the Rs. 384.1 billion raised in H1-FY18. Under the prevailing situation, achieving the revised fiscal deficit target of 5.1 percent for FY19 could be challenging.

7. The current account deficit (CAD) narrowed to USD 8.8 billion in Jul-Feb FY19 registering a contraction of 22.6 percent for the period, as it was USD 11.4 billion in the corresponding period of the last year. The contraction was mainly driven by the trade deficit that declined to USD 19.3 billion for Jul-Feb FY19 compared to USD 19.8 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 35.3 billion in Jul-Feb FY19 from USD 35.8 billion in the same period last year. Exports during the period faced stagnation in value terms as it slightly declined by 0.1 percent during Jul-Feb FY19 while it increased by 12.3 percent over the same period last year, despite increasing in terms of quantum. 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 14.35 billion in Jul-Feb FY19, compared to USD 12.83 billion in the same period last year, registering a YoY growth of 11.8 percent for the period. This increase was due to a significant growth in remittances from United States, Malaysia, United Kingdom and Saudi Arabia.

8. The surplus of the capital and financial accounts declined to USD 7.58 billion during Jul-Feb FY19 as compared to USD 8.595 billion in the same period last year. The foreign direct investment (FDI) stood at USD 1.096 billion in Jul-Feb FY19 as compared to USD 2.42 billion in the same period last year, which can be linked to the deceleration of inflows from China, mainly due to completion of early harvest projects related to CPEC in the power sector. Similarly, foreign portfolio investment (FPI) registered an outflow of USD 402 million in Jul-Feb FY19 as compared to a net inflow of USD 2.3 billion in the same period last year. The net official inflows were also slightly lower during Jul-Feb FY19, mainly due to higher repayments. These were USD 1.52 billion compared to USD 2.48 billion in the corresponding period of FY18. However, BOP support of USD 4.0 billion from Saudi Arabia and United Arab Emirates during Nov-Feb FY19 helped to avoid pressures on foreign exchange reserves, which stood at USD 8.1 billion as of March 8, 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 latest data shows that achieving targeted GDP growth rate of 6.2 percent for FY19 will be quite difficult, even after taking account of the base effect resulting from downward revision of the last year's growth estimates to 5.2 percent from 5.8 percent. Lower growth prospects are resulting from weak performance of both agriculture and manufacturing. Agriculture, despite an upward revision in estimates of rice and sugarcane yields, is expected to perform below the target of 3.8 percent. LSM, taken as proxy for the manufacturing sector, also performed below expectations, as provisional data for Jul-Jan FY19 showed a contraction of 2.3 percent against an expansion of 7.3 percent in the same period last year. Around 0.5 percent increase in cotton yield affected yarn production, delayed start of sugarcane crushing season resulted in 19.1 percent decline in sugar production, and increased preference of power generation units to use LNG instead of furnace oil that contributed to a 5.8 percent contraction in POL products were among the developments that suppressed growth. Lower activity in domestic sales of cement and steel could be linked to almost a 35 percent decline in PSDP spending, which generally increase in the second half of the year. The growth target for the services sector is 6.5 percent for FY19, compared to the actual growth of 5.8 percent in FY18. The lacklustre performance of the agriculture and industrial sectors is expected to adversely affect the services sector. Thus, GDP growth in FY19 is expected to remain weak.

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) increase in 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 January, 2019, the interbank overnight repo rate remained at 10.23 percent on average against the policy (target) rate of 10.25 percent. Moreover, the volatility in the repo rate, measured as coefficient of variation, also decreased significantly to 0.14 percent, as compared to 0.29 percent at the time of the last monetary policy review meeting.

12. As the government shifted its borrowing towards SBP and retire its borrowings from banks, the market remained liquid and necessitated frequent mop up operations by SBP for effective implementation of monetary policy stance. Net mop-up of liquidity increased to Rs. 326 billion per day on average during the last two months, compared to Rs. 231 billion in the two

months prior to the monetary policy decision of Jan 2019. The last auction of T-bills, conducted closer to the monetary policy decision meeting, remained less participative as the banks were anticipating interest rates to go up and the government was not accepting bids at rates above the policy rate. However, the market bid quite actively in the auction of long dated PIB, as the government offered relatively higher interest rates. The yield on 10Y PIB lowered to 13.10 percent in the last week of March, 2019, after witnessing a peak of 13.22 percent in the first week of February 2019.

13. The yield curve of both short and long end shifted upwards to account for the increase of 25 bps in the policy rate in January. A relatively higher spread between the short and long-term yields indicated market's expectation of further increase in the interest rate.

Result of Surveys on Monetary Policy

14. Before discussing the results of surveys on consumer confidence and business confidence, 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 improved in March 2019 as reflected by a movement from neutral to positive zones. Similarly, perceptions regarding Current Economic Conditions (CEC) are starting to move slightly from negative to the neutral zone. Moreover, the latest survey shows an improvement in the Expected Economic Conditions (EEC) in comparison to the survey conducted in January 2019. Overall Inflation expectations are still high, probably owing to higher food inflation 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 February 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 some improvement except PMI. It was explained that PMI is the globally recognized indicator of aggregate demand in an economy and its decline reflects the ongoing slowdown in the economy. BCI for the latest wave conducted in February 2019 moved back to the positive zone compared to almost neutral level of 50 in December 2018. Similarly, CBCI and EBCI have also increased in comparison to the previous survey results. Sectoral analysis shows that the expected business confidence index for both industrial sector and services sector has improved, in comparison to the survey conducted in December 2018.

Model-Based Assessment

17. The staff presented a comparison of the now-casting assumptions of the FPAS used in the January-2019 meeting of the MPC and the actual realization of Q2-FY19 data. After that MPC was apprised about the main assumptions of the latest FPAS output that included the now-casting of domestic headline and core inflation for Q3-FY19, international oil prices for Q3-FY19 and FY19, and the latest FOMC projections for the US Federal-Funds Rate (FFR) path and the US inflation for the next 8 quarters. Other assumptions related to the domestic economy included a now-casting of a relatively higher fiscal impulse, in line with the recently released fiscal deficit data, for Q2-FY19 and FY19.

18. 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 January 2019. The following factors underpin this larger policy recommendation.

19. The inflationary trend in food items, upward adjustments in POL prices and increased fiscal deficit have ignited the inflationary pressures explained by the upward revised gas-tariffs, adjustments in customs duties and the potential pass-through of recent and model-implied exchange rate adjustments trend for the rest of FY19. Incorporating all available information since the last MPC meeting, conditional projection of inflation for FY19 has been revised upwards from 6.2 percent to 7.2 percent. End-June 2019 inflation projection is 9.0 percent, which requires tightening of the policy interest rate.

20. The downward revision of GDP growth for FY18 by the National Accounts Committee means that the output gap used earlier was actually smaller. Nonetheless, the on-going fiscal expansion, and improved export competitiveness driven by model implied under-valued exchange rate are expected to generate positive output gap. The output gap, persistence of inputs cost pressures and a pass-through of model-implied exchange rate path and 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, which is expected to stay at 8.5 percent in FY19.

21. The staff explained that the USD-PKR interest rate differential has improved due to an increase of 175 bps in the policy interest rate by the SBP since November 2018. The US economy has slowed down more than the Federal Reserves (FED) had anticipated due to the tariff-war led economic slowdown in China and the diminishing impact of tax cut implemented in 2017. In the latest March 2019 projections, FED revised downward its inflation projection while holding its policy interest rate constant and signaling little appetite for raising it in future. The FED's latest projections indicate just one increase in 2020 and none in 2021. Keeping in view the model-implied exchange rate path and the future path of the Federal Reserve's fund rate, the interest rate differential is expected to improve in future due to upward adjustments in the domestic policy interest rate. This parity is important given the current management of reserves.

22. At the end, 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

23. While setting the policy interest rate for the next two months, the Committee considered the following points: (i) recent elevation in inflationary pressures as reflected by the latest headline inflation numbers and an uptick in inflation expectations; (ii) increasing trend in core and non-food inflation; (iii) return of food inflation to higher levels consistent with the historical trend and previous staff computations (iv) the level of real interest rate commensurate with ongoing stabilization (v) lagged impact of monetary policy tightening so far; and (vi) the pace of correction in current account deficit and the fiscal deficit.

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

25. In conclusion, the Committee unanimously decided to increase the policy rate by 50 bps.

26. The Committee then scripted the Monetary Policy Statement.

27. The MPC decided as follows.

DECISIONS:

- *The policy interest rate is increased by 50 bps to 10.75 percent.*
- *The Monetary Policy Statement - March, 2019 is approved.*