**MINUTES OF THE 1st MEETING[1] OF**
**THE MONETARY POLICY COMMITTEE (MPC)**
**Held on January 31, 2019**

**P R E S E N T**

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| 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 |
| Hafiz Mohammad Yousuf | Director SBP Board |
| Dr. Aliya Hashmi Khan | 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 November 2018 Monetary Policy decision, along with an assessment of evolving trends.

2. The YoY CPI inflation slightly eased to 6.2 percent in December 2018 from 6.8 percent two months back, but was significantly higher than the 4.6 percent recorded in the same month last year. The slight decline in CPI inflation can be attributed to lower prices of perishable food items as YoY food inflation declined to 0.9 percent in December 2018, compared to 3.8 percent in December 2017. It was highlighted that perishables inflation needs special attention when discussing inflation dynamics because its behaviour is currently statistically not consistent with the five-year trend. Non-food inflation recorded a YoY increase of 9.8 percent in December 2018 as compared to 5.1 percent in December 2017. Among core inflation measures, NFNE inflation rose by 8.4 percent in December 2018 as compared to a 5.5 percent increase recorded last year, whereas the twenty percent trimmed mean measure showed that core inflation increased to 6.9 percent in December 2018 as compared to 4.7 percent in the corresponding month of the last year. Thus, prices of most items in the CPI basket increased, barring perishable food items. This broad based increasing trend in inflation is more pronounced in energy, transport and education. Going forward, the lagged impact of the recent increase in electricity tariffs and volatility in the prices of perishable food items are the main upside risks to inflation.

3. Keeping in view the inflationary trends and the latest data, the projection of 'End-June' CPI inflation has been revised to around 6.8 percent from around 7.4 percent projected in November 2018. This revision takes into account a relatively stable exchange rate, lower international oil prices, and perishable food prices, and below average inflation in education following Supreme Court's decision of December 2018. 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, volatility in food prices (perishables items in particular), growth in money supply and future exchange rate movements. Upon an inquiry of the MPC, the staff prepared a scenario whereby the rest of FY19 was assumed to inherit the behaviour of perishables goods that

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

prevailed in the past five years. It was informed that, in this situation, YoY CPI inflation would easily cross 7 percent in FY19. Therefore, at present, the upside risks to 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 2.2 percent during 1st Jul-18th Jan FY19 as compared to a growth of 1.1 percent in the same period last year. The growth in M2 emanated from a 5-year high expansion in NDA, despite a 5-year high contraction in NFA. Higher expansion in NDA resulted from an increase in government borrowings, predominantly from SBP. The government borrowed Rs. 3.8 trillion from SBP during 1st Jul-18th Jan FY19, which was primarily utilized to repay loans worth Rs. 3.0 trillion to commercial banks. As a result, reserve money grew by 4.5 percent in 1st Jul-18th Jan FY19 as compared to 2.4 percent in the comparable period last year. On the other hand, declining foreign assets and increasing foreign liabilities resulted in a decline in NFA of the banking system, of which NFA of the SBP contracted by Rs. 757.6 billion in 1st Jul-18th Jan, FY19 as compared to a reduction of Rs. 253.5 billion in the corresponding period last year. On the liability side, currency in circulation witnessed an increase of Rs. 306.6 billion in 1st Jul 01-18th Jan FY19 as compared to an increase of Rs. 136.1 billion in the corresponding period last year. Bank deposits witnessed higher flows of Rs. 50.1 billion during 1st Jul-18th Jan FY19, compared to Rs. 26.9 billion in the same period last year. The increase in banking deposits can be attributed to increasing returns and higher private sector credit.

5. Private sector credit increased by Rs. 570.4 billion during Jul-Dec FY19 as compared to an increase of Rs. 296.3 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. 506.7 billion for Jul-Dec FY19, compared to an increase of Rs 271.0 billion in the same period last year. Higher requirements for working capital financing could be linked to increasing trend in WPI (suggesting higher cost of inputs). Meanwhile, fixed investment saw a net increase of Rs. 37.0 billion in Jul-Dec FY 19 as compared to a rise of Rs. 49.0 billion in the corresponding period last year, possibly reflecting an impact of monetary tightening, and is in line with the declining trend in LSM growth.

6. The fiscal deficit for Jul-Dec FY19 is likely to be higher than 2.3 percent of GDP in the same period last year. This is expected to be largely driven by the increase in total expenditures and less than expected growth in revenues. FBR revenue increased by 3.8 percent in Jul-Dec FY19 as compared to a significant increase of 16.5 percent in the same period of FY18. The slowdown in revenue growth was witnessed in both direct and indirect taxes, which seems consistent with an overall slowdown in the economy, a significant reduction in public sector development expenditures, and pressures on profitability of businesses due to the increasing cost of production. To finance this deficit, the government had utilized both external and domestic sources. As a result, domestic financing is projected to increase significantly to Rs. 970.2 billion in H1-FY19, compared to Rs. 412.2 billion in the same period last year. However, external financing was low at Rs. 199.8 billion in H1-FY19, in comparison to the Rs. 384.1 billion raised in H1-FY18, though the latter also included around Rs. 260 billion raised through sukuk bonds. Keeping in view the current scenario, the government's current expenditures are expected to remain high in the remaining part of the year, while development expenditures would likely be further adjusted to keep the overall budget deficit closer to the desirable level.

7. The current account deficit (CAD) narrowed to USD 8.0 billion in Jul-Dec FY19 as compared to USD 8.4 billion in the corresponding period last year. A relatively lower current account deficit resulted mainly from a decline in the services deficit, lower repatriation of profits and dividends, and an increase in worker's remittances. Imports registered a lower growth of 3.0 percent in Jul-Dec, FY18, compared to a significant expansion of 20.8 percent in the same period

last year. The decline in imports can be linked to monetary tightening and exchange rate depreciation, besides a fall in imports of CPEC related machinery. Meanwhile, exports grew by only 0.1 percent during Jul-Dec FY19. This was mainly because of lower export prices as the quantum of export increased considerably during the first half of the year. Further, workers' remittances increased to USD 10.7 billion in Jul-Dec FY19, compared to USD 9.7 billion in the same period last year, registering a YoY growth of 10.0 percent for the period. This increase was due to a significant growth in remittances from United States, Malaysia and United Kingdom.

8. The surplus of the capital and financial accounts declined to USD 5.7 billion during Jul-Dec 2018 as compared to USD 6.9 billion in the same period last year. The foreign direct investment (FDI) stood at USD 1.31 billion in Jul-Dec FY19 as compared to USD 1.63 billion in the same period last year, which can be linked to the completion of early harvest power projects under CPEC. Similarly, foreign portfolio investment (FPI) registered an outflow of USD 308 million in Jul-Dec FY19 as compared to a net inflow of USD 2.2 billion in the same period last year. The net official inflows were also slightly lower during Jul-Dec FY19, mainly due to higher repayments. These were USD 2.5 billion compared to USD 2.1 billion in the corresponding period of FY18. However, BOP support of USD 2.0 billion from Saudi Arabia helped to avoid a sharper decline in reserves, which stood at USD 6.9 billion as of 11th January 2019 compared to USD 9.8 billion at the beginning of this fiscal year. Going forward, the lagged impact of PKR depreciation against US dollar since December 2017, monetary tightening, and administrative measures as well as increase in official inflows are anticipated to further narrow the external account deficit.

9. Under the prevailing circumstances, achieving the GDP growth target of 6.2 percent for FY19 seems increasingly difficult as both, the agriculture and the industrial sectors, are facing headwinds. The growth in the agriculture sector is likely to be constrained, mainly because of serious water shortage in the first half of the year, which led to lower than target area under cultivation for both kharif and rabi crops. Furthermore, the late start of sugarcane crushing may also affect the Rabi crops. LSM, taken as proxy for the industrial sector, also performed below expectations, as provisional data for Jul-Nov FY19 showed a contraction of 0.9 percent against a growth of 7.6 percent in the same period last year. Contraction in LSM was broad-based, but more prominent in steel and POL production, which declined by 6.1 and 4.5 percent against 40.4 and 12.0 percent increase in the same period last year. Domestic sale of cement declined by 1.4 percent in Jul-Dec FY19, however higher exports supported the overall growth of 0.6 percent even this overall growth is significantly low compared to a growth of 11.2 percent in the same period last year. The growth target for the services sector is 6.5 percent for FY19, compared to the actual growth of 6.4 percent in FY18. However, the lacklustre performance of the agriculture and industrial sectors is expected to affect the services sector. Around 40 percent YoY decline in spending on PSDP, depreciation in PKR, and the ongoing monetary policy tightening are expected to constrain growth in the remaining part of FY19.

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 the import coverage of forex reserves; and (b) an elevated fiscal deficit. Given its strong contemporaneous and dynamic correlation with real economic growth, it was re-emphasized to preserve macro stability through timely and decisive policy measures. The staff also presented the historical trends in the policy rate, the real interest rate required to curb aggregate demand, the output gap and inflation for the last 20 years. The behaviour of these indicators were particularly highlighted for periods of heightened economic stress. The staff also compared for the Committee the strength of current policy stance in real terms relative to similar periods of economic stress previously seen in Pakistan.

## Financial Markets and Reserve Management

11. Overnight rate remained at 9.99 percent on average against the policy (target) rate of 10.0 percent, since the monetary policy review in November 2018. The volatility in the overnight weighted average repo rate increased to 0.29 percent, as compared to 0.25 percent at the time of the last monetary policy review meeting. There have been frequent mop up operations, reaching up to Rs. 1.4 trillion, in the last two months to keep the overnight rate close to the policy rate.

12. The excess liquidity in the market resulted from the government's increased reliance on SBP to meet its financing needs, and lower appetite of banks to invest in short dated Treasury Bills in anticipation of further increases in the interest rate. However, comparatively higher returns offered by the government in long dated PIBs, did attract some interest from banks and non-banks in the PIB auction conducted in January, 2019.

13. The yield curve of both short and long-term instruments shifted upward to account for the increase of 150 bps in the policy rate. In view of high spread between the short dated T-bills and long dated PIBs, auctions of PIBs are likely to attract more interest going forward.

14. It was highlighted that the USD/PKR swap premiums have started to increase which depicts a positive shift in market perception, amid recent inflows from UAE and Saudi Arabia.

## Result of Surveys on Monetary Policy

15. Research staff apprised the Committee on the results of surveys on consumer confidence, business confidence and bank lending. On an overall basis, Consumer Confidence Index (CCI) has improved in January 2019 as reflected by a movement from negative 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 November 2018. Overall Inflation expectations are still high, but witnessed some decline, probably owing to lower food inflation and a reduction in the administered prices of petroleum products.

16. It was noted that results of bi-monthly Business Confidence Survey (BCS) conducted in December, 2018 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. BCI has recovered close to its neutral level of 50 in December 2018 in comparison to October 2018. Similarly, EBCI and Overall Business Confidence have increased in comparison to the previous survey results. On the other hand, PMI has slightly declined but remained in the positive zone in December 2018. Sectoral analysis shows that the expected business confidence index for industrial sector slightly declined, while that of the services sector marginally improved, in comparison to the survey conducted in October, 2018.

17. At the end, 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 condition. It was highlighted that respondents of the latest BLS conducted in January 2019 reported that overall demand for bank credit and availability of funds increased during the second quarter of FY19, and is also expected to increase in the third quarter.

**Model-Based Assessment**

18. The staff presented a comparison of the now-casting assumptions of the FPAS used in the November-2018 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 data, for Q2-FY19 and FY19.

19. Conditional on the latest data and aforesaid now casting assumptions, the model suggested a slightly lower increase in the policy rate as compared to its recommendation presented to the MPC in November 2018. The following factors underpin this policy recommendation.

20. The benign inflationary trend in food and the downward adjustments in POL prices have partially offset cost-push inflationary pressures emanating from 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. As a result, conditional projection of inflation for FY19 based on the model-implied exchange rate has been revised downwards from 7.5 percent to 6.2 percent. End-June 2019 inflation projection is 6.8 percent, which is well above the 6 percent inflation target and thus requires some tightening of the policy interest rate.

21. The output gap, despite upward pressures emanating from fiscal deficit, has been narrowing, owing to factors including monetary tightening and a weak external demand. The output gap, persistence of input cost pressures and a pass-through of exchange rate adjustments have been contributing to higher core inflation which is expected to stay at 8.2 percent in FY19.

22. The staff explained that the USD-PKR interest rate differential has improved due to increase of 150 bps in the policy interest rate by the SBP in the end-November MPC meeting. However, keeping in view global developments, FFR is expected to remain in range of 2.25 -2.50 percent by June 2019. Thus, the model-implied exchange rate path and the future path of the FFR shows that 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.

23. 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.

**Monetary Policy Deliberations and Decision Vote**

24. While setting the policy interest rate for the next two months, the Committee considered following points: (i) a relative moderation currently seen in inflationary pressure and inflation expectations, while taking into account the likely upside risk to future inflation dynamics along with possible shocks to inflation; (ii) rising core and non-food inflation; (iii) the level of real interest rate commensurate with the economic cycle; (iv) narrowing yet still positive output gap, amid slowing down of the economy; (v) lagged impact of monetary policy tightening so far; and (vi) the slower pace of correction in current account deficit and the fiscal deficit.

25. Concluding the deliberations, the members voted on the policy rate decision. Deliberations led to formulation of views for maintaining status quo and increasing the policy rate by 25 bps.

26. Members voting for maintaining the status quo were of the view that more time should be given for the impact of recent increases in the policy rate to unfold further.

27. Members voting for increasing the policy rate by 25 bps gave more weight to remaining consistent with the current monetary policy stance in view of the ongoing economic difficulties.

28. In conclusion, the Committee decided to increase the policy rate by 25 bps with a majority vote of 5 out of 8 members[2], with 3 votes for keeping the policy rate unchanged.

29. The Committee then scripted the Monetary Policy Statement.

30. The MPC decided as follows:

**DECISIONS:**

- *The policy interest rate is increased by 25 bps to 10.25 percent.*
- *The Monetary Policy Statement - January, 2019 is approved.*

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[2] In accordance with the Conduct of Meetings Regulations of the MPC, two members conveyed their vote to the Governor prior to the meeting.