MINUTES OF THE MEETING OF THE
MONETARY POLICY COMMITTEE (MPC)
HELD ON JUNE 25, 2020

P R E S E N T

Dr. Reza Baqir	Chairman & Governor SBP
Mr. Jameel Ahmad	Deputy Governor (Banking & FMRM)
Dr. Murtaza Syed	Deputy Governor (Policy)
Dr. Inayat Hussain	Executive Director (FS&BSG)
Mr. Azam Faruque	Director SBP Board
Dr. Tariq Hassan	Director SBP Board
Dr. Asad Zaman	External Member
Dr. Hanid Mukhtar	External Member
Dr. Naved Hamid	External Member
Mr. Mohammad Mansoor Ali	Corporate Secretary/Director OCS

Review of Current Economic Conditions and Outlook for FY20

1. Recapitulating the decision taken in the MPC meeting held on May 15, 2020, it was recalled that some members had then voted to cut the policy rate by more than 100bps due to the risks pertaining to growth, while a majority took a more cautious stance and voted to reduce the policy rate by 100bps. After reviewing the key factors which led to the reduction of the policy rate in the last MPC meeting, the members were apprised of the reasons for holding the emergency meeting. Key developments prompting this decision included the announcement of Federal budget FY21, update on foreign exchange flows and the opportunity to improve the pass-through of lower policy rates to borrowers due to the repricing of a significant share of loans before early July.

2. It was informed that recently the federal government has announced the budget for FY21 and it is assessed to be non-inflationary, which provides room to revisit the policy rate decision. Further, the MPC was informed that the latest developments on the foreign exchange side suggest that decrease in remittances is so far less than the projections of the World Bank and International Monetary Fund (IMF). However, with the reports of large job losses in key markets for Pakistani expatriates, there is a risk that remittances might come under stress in the near future. On the other hand, it was highlighted that SBP has received fresh disbursements from multilateral agencies including around USD 725 million from World Bank and USD 500 million from ADB. In addition, the Asian Infrastructure Investment Bank (AIIB) is expected to provide USD 500 million while commercial borrowings from Chinese banks of USD 1.3 billion are also expected to be realized by end June 2020. In light of these positive developments, the overall position of the reserves has improved and the outlook is broadly stable. Finally, it was apprised that as per agreements between banks and their customers, loans worth Rs. 3.3 trillion would be repriced at the start of the next quarter based on the policy rate prevailing on June 30, 2020. Therefore, it would be desirable to take action from a monetary policy transmission perspective. In this way, the benefits of interest rate reductions would be passed on to the households and businesses in a timely manner, which is important given the exceptional economic environment created by COVID-19. Later, the staff presented the other developments in key macroeconomic variables since the last Monetary Policy decision, along with an assessment of evolving trends in global and domestic economic conditions in general and in the wake of the COVID-19 pandemic in particular.

3. The staff apprised that the Q/Q (annualized) growth rate of major economies indicates a significant decline in economic activity during the first quarter of CY20. However, Japan has shown some uptick in its growth in Q1-CY20 relative to its growth in Q4-CY19. With the easing of

lockdowns across the globe, the recent data of the manufacturing Purchasing Manager Indices (PMIs) of the advanced and the emerging economies suggested signs of partial recovery after plummeting during the past few months.

4. Afterwards, discussing trends in global capital markets, it was explained that on an overall basis, volatility in global financial markets declined significantly by mid-June CY20 after recording a peak in March CY20. Similarly, it was explained that capital flows to Emerging Market Economies (EMEs) recovered in the last two months after a significant decline in March CY20. However, it was highlighted that a slight uptick in market volatility could be expected in the last week of June along with the capital outflow from EMEs, mainly attributed to concerns of a second wave of the Coronavirus outbreak. The staff apprised the Committee that the 5-year Credit Default Swap (CDS) points have continued to record an improvement since March CY20 but the June CY20 levels are still much worse than in the corresponding period last year. Further, discussing trends in the equity markets, it was explained that the stock markets across the globe rebounded strongly since March CY20. This was also seen at the Pakistan Stock Exchange (PSX). The Committee noted that notwithstanding the significant recovery in the equity market in the last few months, the overall volatility remains relatively high. It was noted that IMF's World Economic Outlook (WEO) update of June 2020 projects that the recovery path looks even slower and more uncertain than anticipated in April CY20, suggesting further downside risks to global growth and inflation. Moreover, the staff highlighted that in case of a second wave of the pandemic in 2021, IMF projects global growth might remain negative for longer.

5. After concluding the discussion on the global economy, the staff presented the 'domestic economic developments and its outlook'. It was apprised that according to the Google's Community Mobility Report for Pakistan (as of June 19, 2020), the population mobility is gradually picking up after easing of the lockdown but it is still significantly below than the pre-pandemic level. Giving an overview of 'sales indicators', it was informed the contraction of sales volume has slowed across most of the industries during May FY20 as compared to April FY20. On a query, the Committee was apprised that sales of the cement sector are expected to recover in June FY20.

6. On the external side, it was explained that the 'current account balance (CAB)' continued to narrow due to a decline in the demand for imported goods/services and particularly due to lower international oil prices. However, the impact of the improved CAB on foreign exchange reserves was partially offset by the slowdown in the financial inflows, as well as outflow of portfolio investment and scheduled debt payments in June FY20. Further, discussing remittances, it was informed that the number of overseas workers has fallen sharply but remittances have so far remained resilient and are expected to remain stable in June CY20. Later, the staff highlighted that the number of workers registered for overseas employment has dropped sharply and it could adversely affect the outlook for remittances in FY21.

7. Presenting the analysis on GDP, it was informed that there is a broad-based decline in the GDP and it is expected to contract in FY20, for the first time since 1952. The staff elaborated the scenario-based assessment GDP growth for FY21. However, it was highlighted that there are downside risks from high level of rains, floods, locusts attack and potentially extended partial lockdowns.

8. Afterwards, the Committee took note of the policy measures taken by other central banks and governments across the globe to counter the economic problems created by the pandemic. It was highlighted that since March FY20, Pakistan has reduced the policy rate by 525bps consistent with the rapid decline in inflation and inflation projections. This reduction in the policy rate is the highest among all the other EMEs except Argentina, which is a special case because of its ongoing sovereign debt crisis. Further, it was informed that in addition to the rate-cut, SBP has also

provided credit relief to households and businesses, relaxed credit requirements for exporters and importers, and introduced refinance schemes to support employment and the health sector.

9. Providing implementation details of these measures, it was apprised that as of June 12, 2020 under the 'employment scheme', 2,227 businesses (headcount of 1.3 million) have applied for the financing. So far, almost 1,500 businesses have been provided with financing of Rs. 107.5 billion and remaining applications are under review. Similarly, under the 'hospital scheme' 39 applications were received to avail financing worth Rs. 7.3 billion. A majority of the applications have been processed and Rs. 5.9 billion has been disbursed. Moreover, the staff highlighted that large numbers of households and small businesses are also benefitting from the credit relief facility. As of June 19, 2020, 950,115 borrowers have availed the facility and principal amount worth Rs. 544 billion has been deferred, while Rs. 94 billion has been restructured.

10. It was highlighted that during July 1-June 12 FY20, the cumulative flow of credit from the banking system to the private sector stood at Rs. 195.2 billion, of which Rs. 187.8 billion is refinanced from SBP, suggesting that SBP refinance schemes remained the key driver of private sector credit in FY20. On aggregate, SBP has provided a much needed stimulus worth Rs. 1.1 trillion to the economy. On a query, it was clarified this amount has already been disbursed and does not include applications under review. It was explained that in addition to the measures taken by SBP, the government has also announced different relief measures worth Rs. 1.24 trillion.

11. The staff then presented the key developments of the recently announced federal budget for FY21. It was informed that the government has substantially revised upward the fiscal deficit (as percentage of GDP) from 7.1 percent to 9.1 percent in FY20. However, for FY21 the government is targeting to bring down the fiscal deficit to 7.0 percent of GDP. Further, it was explained that out of the total proposed expenditures worth Rs. 10.4 trillion, Rs. 1.3 trillion are proposed for development projects, an increase of Rs. 237 billion from last year's revised allocation.

12. Discussing the revenue targets, it was noted that government has not imposed new taxes. It has instead focused on the documentation of the economy to broaden the tax base so as to increase the overall collection of taxes. It was informed that the measures are expected to reduce input costs, improve ease of doing business, encourage growth-inducing imports of intermediate and capital goods, and provide support to domestic industries. Further, the staff apprised that along with the tax measures, the higher allocation for development and social spending is expected to support real economic activity. Going forward, the staff apprised the Committee that the expected impact of budget on average CPI inflation for FY21 is broadly neutral.

13. The staff then apprised the MPC about recent developments in inflation. It was explained that, after peaking in January, inflation has declined substantially in the last few months. On a Y/Y basis the national CPI inflation declined from 14.6 percent in January 2020 to 8.2 percent in May 2020 (i.e. 640bps reduction in 4 months). The sharp decline in inflation is primarily attributed to a significant reduction in international oil prices, slowdown in domestic economic activity (due to COVID-19) and effective administrative measures for price controls. Further, it was informed that headline inflation in both urban and rural areas has declined but the decline was more pronounced in Urban CPI. Giving a comparative analysis, it was highlighted that inflation in Pakistan has decelerated more than for any other EMEs in our sample of around 40 countries since January 2020, which, together with sharply reduced inflation projections, provided the economic justification to substantially reduce the policy rate.

14. It was also explained that M/M inflation increased by only 0.3 percent in May 2020. Similarly, there was M/M increase of only 0.3 percent in both urban and rural CPI during the month of May 2020, mainly due to an overall fall in energy prices. Lastly, it was informed that

there is a broad based decline in inflation except in non-perishable food items, especially of wheat and sugar.

15. Concluding the presentation, the MPD staff presented various projections based on alternative scenarios for: (i) average exchange rate, (ii) GDP growth, (iii) LSM growth, (iv) crude oil prices, (v) broad money growth, and (vi) utility tariffs. In particular, the staff highlighted that the recent waning price momentum is expected to be complemented by the recent cut in domestic petrol and diesel prices.

Model-Based Assessment

16. The staff apprised the MPC regarding assumptions of the model and highlighted two important developments since the last MPC. First, the US Federal Reserve has revised down its inflation projection of CY20 and the next two years. Second, the current Federal Funds Rate (FFR) of 0.1 percent, is projected to remain unchanged for the next two years. It was informed that these two developments have impacted the model based assessment for Pakistan.

17. While discussing this model-based assessment, it was highlighted that FPAS is suggesting a downward revision in the policy rate. The downward revision in the policy rate in mainly due to four factors; (i) downward revision in the inflation path for FY21, (ii) sharp decline in inflation in Q4-FY21, (iii) opening up of output gap, (iv) uncovered interest rate parity. Explaining further, it was informed that as FFR is expected to remain unchanged for the next two years, thus, the interest rate differential against FFR has increased, providing room to further revise down the policy rate.

18. Further, it was explained that the expected downward revision in Q4-FY21 inflation is attributed to three factors: (i) 'base effect' due to higher Q4-FY20 and Q1-FY20 inflation projections; (ii) international oil prices which are projected to only gradually inch up as per the futures data; and (iii) revision in the expected exchange rate path.

19. After discussing the future inflation path, the staff also discussed the projected growth pattern in detail to analyse the potential path of the policy rate.

20. The staff presented various projections based on alternative scenarios of high and low growth for FY21. The Committee then deliberated on all the scenarios and their possible implications for the policy rate. In doing so, the staff also discussed the specification of SBP's reaction function in the FPAS model to explain the role of output-gap and forward-looking inflation underpinning the model-suggested by policy interest rate path.

Monetary Policy Deliberations and Decision Vote

21. Following a discussion, the MPC decided to reduce the policy rate by 100bps with a majority vote of 8 out of 9 members, while one member voted for reducing the policy rate by 50bps.

22. The Committee then scripted the Monetary Policy Statement.

23. The Committee decided as follows:

DECISION:

- *The policy rate is reduced by 100bps to 7.0 percent.*
- *The Monetary Policy Statement – June 25, 2020 is approved.*