MINUTES OF THE 1st MEETING[1] OF THE MONETARY POLICY COMMITTEE (MPC)
HELD ON JANUARY 28, 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
Dr. Inayat Hussain	Executive Director (FS&BSG)
Mr. Atif R. Bokhari	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	Secretary to the Committee/Corporate Secretary

Review of Current Economic Conditions and Outlook for FY20

1. The Monetary Policy Department staff apprised the Monetary Policy Committee on the developments in key macroeconomic indicators since the November 2019 Monetary Policy decision, along with an assessment of evolving trends.

2. The staff apprised the committee that the impact of supply shocks in agriculture might lead to lower than expected growth in real GDP. According to the second estimate of Ministry of National Food Security & Research (MNFSR), while the production of rice and maize has remained better than last year, the cotton crop is estimated to decline by 4.2 percent compared to last year. The decline in the cotton crop is expected to impact the real GDP growth for FY20 because of its impact on value addition, cotton ginning, agri-based industries and the services sector.

3. During the first five months of FY20 LSM registered a 5.9 percent decline compared to a marginal 0.5 percent increase in the same period last year. However, it is important to note that the decline in LSM was concentrated in a few sectors and that LSM is a noisy indicator. Specifically, around 60 percent of the entire decline in LSM during Jul-Nov FY20 was contributed by three sub-sectors namely jeeps & cars, electric motors and cigarettes. While sectors like cement, pharmaceuticals, steel, POL are showing improvement in recent months.

4. Encouragingly, a look at the high frequency domestic demand indicators shows signs of a bottoming out of the declining trends. For instance, although the overall automobile sales are showing a large decline, the sales of commercial vehicles which includes buses, trucks and LCVs is showing MoM increase since the past few months. This trend suggests some revival of economic activity, which is also supported by the MoM improvement in freight carried by Pakistan Railways in the recent months. On the same note, POL sales are also showing bottoming out trends with an uptick in demand from the transport sector and industry. Some evidence on industrial employment statistics in Punjab also points out to bottoming out.

5. Another important development was an increase in domestic cement sales since September 2019, which is supported by construction activity in the private and the public sector. Importantly, PSDP releases rose by around 60 percent during Jul-Dec FY20, compared to the same period last year. Furthermore, the analysis of investment trends reveals that machinery imports are showing an improvement since the past few months, which suggests some expansion in

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

economic activity in the coming months. Finally, an assessment of employment conditions in LSM industries reflects that after showing a steep decline during Mar-June 2019, the trend has stabilized and is likely to move up with the expected uptick in manufacturing activity.

6. Turning to inflation, it was stated that YoY National CPI increased by 12.7 and 12.6 percent in November and December 2019, respectively. Similarly, the urban CPI inflation was recorded at 12.0 percent whereas rural CPI inflation was 13.6 percent. Higher inflation in the rural areas is due to the relatively higher weight of food items in the rural CPI basket. This uptick in CPI inflation is mainly due to the surge in the prices of food items along with persistently higher inflation in energy items, whereas core inflation remained relatively stable. Presenting the heat-map of MoM CPI inflation, it was explained that there was a broad-based decrease in inflation during December 2019. The MoM CPI inflation in December 2019 remained at the same level as the seasonal pattern suggests. However, MoM inflation observed in October and November 2019 was higher than three years average of corresponding months, due to shocks in the food prices among other factors. On a YoY basis, food inflation became the major contributor to headline inflation followed by energy and core inflation. It was highlighted that higher prices of both perishable and non-perishable food items contributed to food inflation. The staff also highlighted that there is an early indication that YoY and MoM CPI inflation for January 2020 is projected to be considerably higher as compared to December 2019, primarily due to food items.

7. On the outlook for inflation, staff apprised that the average National CPI inflation is expected to remain within the range of 11-12 percent. It was also highlighted that the level of uncertainty associated with inflation projections has decreased since the last MPS. Furthermore, over the medium term inflation is expected to fall in the 5-7 percent range.

8. The staff apprised the Committee that the monetary expansion was higher during 1st Jul-2019 to 17th Jan-2020, largely owing to an improvement in the country's external accounts. This was reflected in the Net Foreign Assets (NFA) of SBP. It was further apprised that the banking system recorded a contraction in the Net Domestic Assets (NDA) mainly owing to reduction in the Government borrowing. Discussing NDA, it was highlighted that there has been a net retirement of about Rs. 12 billion in the government borrowing from the banking system as compared to a Rs. 735 billion expansion in the same period last year. The composition was in sharp contrast to the last year when Government borrowed excessively from the SBP compared to this year where it has substantially borrowed from scheduled banks. It was also highlighted that due to the change in the borrowing pattern, the Government comfortably met the IMF conditions on the government borrowing from SBP.

9. The overall Private Sector Credit (PSC) witnessed an increase of Rs. 146 billion during 1st Jul-2019 to 17th Jan-2020, which is lower than the expansion of Rs. 507 billion in the corresponding period of FY19. This is largely due to a decrease in credit to LSM, which is generally a major contributor to the growth in PSC. The modest increase in PSC is largely driven by working capital loans, whereas fixed investment loans declined given the economic slowdown and the higher cost of borrowing. Notwithstanding the overall decline in demand for credit, utilization of exports financing (EFS) and Long-term Financing Facility (LTFF) maintained their momentum possibly reflecting business activity of export-oriented industries.

10. Although, SBP has kept its policy rate unchanged in its last two monetary policy meetings, the WALR continues to rise on account of lagged policy rate transmission and rising credit risk premium. As government increased its borrowing from scheduled banks, the spread between risk-free investment and risky lending normalized, which was otherwise declining when government was retiring its borrowing from scheduled banks. With the shift in the pattern of government borrowing from SBP to scheduled banks, the interbank market currently operates in deficit mode (as suggested by SBP OMO injections), hence the banks demand an added premium while lending to the private sector, particularly in times when the repayment risk is high.

11. Discussing demand side indicators of the economy, it was highlighted that the demand side has not been growing significantly and the reasons for weak PSC demand includes higher cost of borrowing as reflected by increase in WALR, persistent slowdown in economic activities (LSM) and the high government borrowing is likely to alter the credit risk premium. Accordingly, the PSC growth projection for FY20 is likely to be revised downwards. Further, it was informed that the M2 growth projections has almost remained unchanged, with only a small increase in M2 due to an improvement in Net Foreign Assets (NFA).

12. While discussing the fiscal deficit, SBP Staff apprised that a strong growth in revenues and restraint over expenditures helped contain the fiscal deficit to 0.7 percent of GDP during Q1-FY20, compared to 1.4 percent in the same period last year. Tax revenue grew by 16 percent during H1-FY20 against a 4.2 percent increase in the comparable period last year. The non-tax revenues are likely to benefit from higher SBP profit and the receipt of renewal fees for 3G licences.

13. On the expenditure side, interest payments are expected to increase by 16.5 percent in H1-FY20. It was informed that development spending has also been increasing at a steady pace. According to the SBP estimates, the fiscal deficit for FY20 is likely to remain close to the annual target for FY20 as shortfall in tax revenue is likely to be offset by higher non-tax revenues. It was highlighted that the Government may not be able to meet the tax revenue target of Rs. 5,238 billion, which has been revised from Rs. 5,503 billion. Responding to a query, it was clarified that the non-tax revenue primarily comes from licensing fees and profits of the SBP. The MPD team further explained that overall projection for fiscal deficit has not changed from the last monetary policy decision.

14. While presenting the global economic conditions, staff informed the Committee that high frequency economic indicators show some signs of recovery since the November 2019 MPS. It was highlighted that the Purchasing Manager Index (manufacturing) has edged above 50 in November and December 2019 after contracting for the last consecutive six months. This is consistent with the World Bank and IMF's projections of global economic growth for 2020. It was highlighted that World Economic Outlook released on January 20, 2020, anticipates global economic growth will pick up to 3.3 percent in CY20 as compared to 2.9 percent in CY19, which was the lowest since global financial crisis. In the same vein, IMF projects a recovery in global trade volumes. This uptick in the economic activity is reflected in the global commodity market as well. Further, it was highlighted that the lower oil prices during FY20 along with increase in prices of cotton and rice would have a positive impact on Pakistan's Balance of Payments (BoP), whereas increase in the prices of the industrial raw material would have a negative impact. It was noted that the recent outbreak of Coronavirus in China could have downside risks to the global economic outlook. Further, better liquidity conditions in the global market are pushing the capital flows to the emerging market economies.

15. While presenting the developments in the Balance of Payment (BoP) position, it was informed that there was a significant improvement since the November 2019 MPC. It was highlighted that the improvement since November 2019 was primarily because of higher foreign inflows while the current account maintained a contractionary trend. The improvement in the current account continued to be driven by a contraction in the trade deficit of goods and services. It was informed that imports maintained their declining trend, whereas a pick-up in exports was witnessed. The Current Account Deficit (CAD) reduced to USD 731 million as compared to USD 3.0 billion in the corresponding period last year. Besides the continued narrowing of the CAD, a substantial increase in foreign inflows, especially portfolio inflows in debt securities, as well as multilateral and bilateral loans led to a jump in SBP's net liquid foreign exchange reserves by USD 3.1 billion during Nov-Dec FY20.

16. SBP staff apprised that there is an expectation that imports would continue to contract and exports would witness some acceleration in the rest of FY20. Exports grew by 4.5 percent

during Jul-Dec FY20 as compared to 0.6 percent increase in the same period last year. The food exports including rice, meat, fish and sugar mainly contributed towards this increase. Further, imports declined by 20.9 percent during Jul-Dec FY20, against a 3.9 percent increase in the corresponding period last year. It was explained that imports of both, oil and non-oil groups, depicted a substantial reduction during Jul-Dec FY20.

17. At the same time, worker's remittances grew by 14.8 percent on YoY basis in the last two months. This increase was attributed to growth in remittances from Saudi Arabia, United States, United Kingdom, United Arab Emirates, and other GCC countries.

18. Further, discussing financial inflows, it was explained that the financial account (net) was in surplus in Jul-Dec FY20 with USD 5.6 billion. The Foreign Direct Investment (FDI) net on YoY basis increased by 62.2 percent to USD 1.28 billion in Jul-Dec FY20, which was mainly attributed to investments in the telecom and power sectors. On portfolio investment, staff apprised that in Jul-Dec FY20, it recorded an inflow of USD 584.0 million as compared to an outflow of USD 308.0 million in same period last year. As a result of these developments, the foreign exchange reserves rose to USD 11.3 billion by the end of December 2019. The staff opined that going forward the current account deficit was expected to remain low.

19. At the end, the staff apprised that the downside risks pertaining to GDP growth in FY20 include: (1) supply shocks in Rabi crops from uncertain weather conditions, (2) increase in energy prices. The upsides risks for GDP growth in FY20 would be: (1) a rebound in agriculture activities, (2) further improvement in export volumes, (3) improving business confidence as instability concerns subside, (4) fiscal stimulus to improve activity in construction and allied industry, and (5) transport activity to improve following completion of road and motorway projects.

Financial Markets and Reserve Management

20. Apprising the committee on monetary policy implementation, the staff stated that overnight repo rate remained very close to the policy rate at 13.27 percent against the policy rate of 13.25 percent with volatility of 0.22 percent. Discussing the developments on the monetary side, it was explained that in the last two months the injections of SBP had decreased suggesting an improvement in market liquidity conditions and NFA. The average outstanding net injection in the last two months (November 25, 2019- January 22, 2020) was Rs. 852 billion, and was currently Rs. 730 billion.

21. It was also apprised that the utilisation of cash deposits (buffers) by the Government, along with an increase in SBP's FX reserves (NFA) improved the market liquidity. It was apprised that decline in the cash buffers held by the Government with SBP indicated better cash and fiscal management by the GoP.

22. While discussing trends in GoP marketable securities, the staff stated that for MTBs, the GoP is adhering to the overall auction targets. However, MoF is showing a preference for shorter tenors and tends to cap the one year MTB yields. Moving onto long-term bonds (PIBs), it was informed that here too, the Government is mostly adhering to the auction target amounts. However, the 5 and 10 year bond yields are being capped. It was informed that participation has declined since the last two months as the low issuances by the MoF is hindering the price discovery process. It was highlighted trends in the residual maturity of GoP securities, stating that the share of maturities with tenor up to 3 months has risen to 25.3 percent after declining to 20.8 percent in November 2019.

23. While presenting data on SBP's liquid foreign exchange reserves and swaps/forward liabilities, it was noted that SBP FX reserves have improved considerably and are now at USD 11.7

billion. It was further informed that SBP FX reserves are projected to close at USD 12.2 billion by end January 2020. The staff also apprised the Committee that SBP's forward book has decreased; showing an overall improvement of USD 8.2 billion in the SBP's FX buffers.

24. Moving forward, the staff shed light on the yield curve, elaborating that it is sharply inverted partly due to expectations of a rate cut and also on account of short supply in long tenors. Furthermore, the staff also presented data on the movement of regional currencies against USD

Result of Surveys on Monetary Policy

25. Starting with the Business Confidence Survey (BCI), it was stated that confidence has been increasing consistently and that overall confidence of the industrial sector has breached the median level. While highlighting the indices, it was apprised that there is an overall increase in the BCI in December 2019 as compared to October 2019. Discussing the four Business Confidence indices, it was highlighted that there is a trend increase in these indices since June 2019. On BCS inflation expectation, it was informed that there is a second consistent decline in this after October 2019, which is a positive sign. Further Purchasing Managers Index also continued to increase for the second consecutive wave.

26. Research staff then presented the results of different surveys to the MPC. It was stated that there is a decline in the Consumer Confidence Index (CCI) in January 2020 as compared to November 2019. However, there is a slight uptick in the Expected Economic Condition (EEC) during the same period. Discussing the indices, it was apprised that there is a further decline in the index of Current Economic Condition (CEC) in January 2020 against November 2019.

27. On consumer inflation expectations, it was informed that there is an increase in the overall inflation expectation index in January 2020 as compared to November 2019, where the current level is above the historical median of inflation expectations. Elaborating further on quantitative measures of the expected price level, it was stated that a decline in expected inflation was observed in January 2020. This figure is a glimmer of hope that inflation-expectation has been well-anchored and that the communications strategy of SBP played an important role in this regard.

28. While discussing the results of the Bank Lending Survey, it was stated that the expected demand of loans increased in Q2-FY20 as compared to Q1-FY20. However, there was a decline in expectations of availability of funds during the same period. Further, expectations on cost of borrowings had a decreasing trend in the first two quarters of FY20.

29. Research staff also shared the results of the 'Survey of other Forecasters', which was initiated in November 2019. It was informed that information for this survey was gathered in the mid of January 2020. The results show that anticipations of real GDP growth in January 2020 are similar to those in November 2019, while there is a marginal increase in the CPI National Inflation. On a query, it was informed that forecasters are from academia and some are market participants. Research staff also shared probability distributions of real GDP growth and inflation forecasts for FY20 and FY21.

Model-Based Assessment

30. The research staff apprised the MPC about the main assumptions of the latest FPAS output that included: (i) the FOMC projections of US policy rate and inflation released in mid-December 2019, (ii) average exchange rate for FY20, (iii) international oil prices around US$65 per barrel for FY20, and (iv) upward adjustments in electricity tariffs.

31. Discussing the baseline assumptions, the staff presented the comparison of actual realization of December 2019 inflation data and the now-casting assumption about the end-quarter inflation used in the MPC meeting held in November 2019. The staff discussed the implications of deviations between numbers for the inflation projections path and the future policy interest rate path. It was added that since there is a higher than expected realization of inflation numbers, this has not only impacted the projected figures of inflation for this year but also changed the trajectory for future inflation moderately despite the positive effects emanating from the exchange rate appreciation.

32. It was elaborated that there are some moderate upward adjustments in the inflation projections for FY20 and FY21, nonetheless, the revised projections for FY20 remain within the inflation projection of 11-12 percent for FY20 and 5-7 percent over the medium term. Hence, the inflation path over the medium term remains broadly similar to that in the previous MPC meeting. The model proposed a fairly moderate adjustment in the policy rate to reflect consistency with the modified uncovered interest rate parity condition and moderate increase in projected headline inflation for FY20

33. At the end, staff presented various projections based on alternative scenarios for: (i) nominal exchange rate, (ii) now-casting inflation for Q3-FY20 at somewhat higher inflation to accommodate recent hike in food inflation and (iii) the calibrated interest rate scenario to hit the inflation target sooner rather than later. The Committee then deliberated on all the scenarios and their possible implications for the policy rate.

Monetary Policy Deliberations and Decision Vote

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

35. The MPC decided to maintain the policy rate at status quo with a majority vote of 7 out of 9 members, with two votes for decreasing the policy rate by 25bps.

36. The Committee then scripted the Monetary Policy Statement.

37. The Committee decided as follows:

DECISION:

- *The policy interest rate is kept unchanged at 13.25 percent.*
- *The Monetary Policy Statement – January 2020 is approved.*