MINUTES OF THE MONETARY POLICY COMMITTEE (MPC) MEETING
HELD ON FRIDAY MARCH 19, 2021

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 FY21

6.1 The Committee was apprised of developments in key macroeconomic indicators since the last Monetary Policy decision in January 2021, along with an assessment of the evolving trends.

6.2 Giving an overview of the real sector, the staff apprised the Committee that domestic demand remained strong since the last MPC meeting with a sustained Y/Y increase in automobiles, POL, cement and Fast Moving Consumer Goods (FMCG) sales. It was explained that growth in automobile sales was attributed to a number of factors including: (i) low interest rates, (ii) higher remittances, and (iii) the provision of subsidy on tractors. The growth in cement sales remained strong, supported by construction activities of both the public and the private sectors. Similarly, sales of FMCG recorded growth in real terms, of around 9.0 percent in Q2-FY21 compared to a 3.5 percent decline in the same period last year. However, the relative slowdown in nominal growth of FMCG sales in Q2-FY21 as compared to Q1-FY21 can be attributed to the impact of the second wave of Covid-19 and may also indicate normalization of demand after the increase in sales in Q1-FY21 due to pent up demand following earlier lockdowns. In line with the overall improvement in economic activity, the demand for energy also expanded in the recent months. The POL sales grew strongly by around 15 percent in January and February 2021. It was highlighted that in January 2021, around two-thirds of the increase in POL sales was contributed by the transport sector, indicating the momentum of economic activity. Similarly, growth in electricity generation also remained positive in the month of January and February 2021.

6.3 Discussing the supply side, it was noted that employment in Large-scale Manufacturing (LSM) industries of Punjab and Sindh was gradually improving since October 2020, with the growth turning positive in the months of November and December 2020. The improvement was seen in textiles and some non-textile sectors. Aggregate employment in H1-FY21 has reached the level seen in FY19 and FY20. Further, it was noted that LSM continued to grow strongly in the months of December 2020 and January 2021. Specifically, the Y/Y increase in January 2021 was contributed by nine out of fifteen sub-sectors with major contributions coming from textiles, automobiles, food and cement. The overall LSM production volume in H1-FY21 exceeded the levels witnessed in the corresponding period of FY19 and FY20. The MPC then discussed capacity utilization in some key LSM sectors such as yarn, cloth, fertilizer, cement, POL and automobiles. It was noted that these sectors have a 56.7 percent share in overall LSM production. Further, it was apprised that capacity utilization during H1-FY21 in cloth, yarn, cement and fertilizers has exceeded the average capacity utilization levels witnessed during the high growth years of FY16-FY18. Similarly, the capacity utilization in POL and automobiles has also improved in H1-FY21, but is still lower than the corresponding averages for FY16-18. It was noted that, in automobiles, the capacity utilization of only *2/3 wheelers* surpassed the average of FY16-FY18, while all other segments are operating well below their average capacity utilization levels during the same period.

6.4 It was informed that the expansion in commodity-producing sectors has also translated into increased activity in the service sector. It was highlighted that POL sales to transport and commercial vehicles remained strong in recent months. Moreover, SBP Business Confidence Survey of February 2021 suggested an improvement in expected employment and business activity for the services sector in the next six months.

6.5 The staff then apprised the MPC of the growth projections for the real sector. On the basis of the improvement in industrial activity, the growth projections for LSM were revised upward in March 2021 from the earlier estimate in January 2021. With the knock-on impact on the services sector, the GDP projection for FY21 has been raised close to the upper limit of the 2.0-3.0 percent range. However, these projections are subject to substantial uncertainties because of the evolving Covid-19 situation. It was highlighted that if LSM production maintains an upward trend then the overall LSM and GDP projections may exceed the baseline projections. However, if a wide-scale lockdown is imposed, as in the previous year, the LSM growth and GDP growth projections may fall below the baseline. These projections were subject to various risks. The upsides were: *(i) greater than anticipated increase in important crops, and (ii) initiation of Covid-19 vaccination which can lead to greater than expected improvement in economic sentiment.* On the other hand, downside risks include: *(i) the emergence of a new wave of Covid-19 that may lead to wide scale lockdowns, and (ii) harsher than expected weather conditions.*

6.6 Discussing global economic conditions, the staff highlighted that prospects have improved, but remained subject to uncertainties. Discussing high frequency perception indicators from global markets, it was apprised that the Bloomberg global manufacturing Purchasing Manager Index (PMI), for both emerging as well as advanced economies, has improved. However, for emerging countries there is a lot of variation due to country-specific factors, suggesting an uneven economic recovery. Countries with more effective vaccination programs recorded an improvement in business sentiment as compared to those where the vaccine drive is slow. Also, as noted by the Chicago Board Options Exchange (COBE) Volatility Index (VIX) of future pricing trends in important stock markets, the overall volatility in the international market remained relatively higher than in the pre-Covid period. Furthermore, the staff explained that since the last MPC meeting, the Bloomberg Composite Monthly Index of the commodities in the global economy has turned positive, which may be attributed to the overall positive business sentiment and the subsequent rise in international commodity prices of all categories.

6.7 In January 2021, the country's Current and Financial Account deficits both remained contained. The Current Account Balance (CAB) recorded a surplus of USD 0.9 billion during Jul-Jan FY21, supported by the continued higher realization of workers' remittance inflows and a moderate growth in exports in recent months. Further, it was apprised that net financial flows remained weak during the first seven months of FY21, recording a net outflow of USD 311 million compared to a net inflow of USD 7.0 billion in same period last year. This net outflow is mainly attributed to higher official debt repayments. Further, the staff informed that Foreign Direct Investment (FDI) during the first eight months of FY21 was USD 1.3 billion as compared to USD 1.9 billion in the same period last year. Most of the FDI inflows were in the power and financial business sectors. Lastly, it was noted that Foreign Portfolio Investment (FPI) recorded an outflow of USD 0.39 billion during July-Feb FY21 on a cumulative basis, however, some inflow has been recorded during Dec-Feb FY21.

6.8 Further, it was highlighted that workers' remittances have remained above USD 2.0 billion each month since June 2020. However, the sustainability of these remittances is uncertain as the uptrend in some peer countries is moderating. On the other hand, but the consistent increase in the registered workers moving abroad visible since October 2020 is a positive indicator. Therefore, remittances are projected to be in the range of USD 26.5-27.5 billion for FY21. The downside risks to this projection include a removal of travel restrictions leading to higher informal movement of remittances and a decline in remittances for family support following the higher expected growth of the domestic economy.

6.9 Discussing further, the staff apprised that in July-Feb FY21, PBS exports have posted a moderate growth of 4.4 percent, driven mostly by High Value Added (HVA) textiles. The HVA textiles export volumes are now above their pre-pandemic levels. It was highlighted that not only has the quantum of HVA textile exports increased but export prices have also been favorable. Further, the staff apprised that a large part of the increase in imports during July-Feb FY21 was driven by one-offs such as the import of wheat, sugar and higher quantity of raw cotton given steep domestic shortfall in its production. As a result, during July-Feb FY21 growth in imports reached 7.8 percent. However, if one-offs are not accounted for, import growth moderated to around 3.0 percent during the first eight months of FY21.

6.10 The Committee was then apprised of the external sector projections for FY21. Owing to better prospects for HVA textile exports, the point estimate for exports was slightly increased from its previous level, while the forecast range of 4.0-6.0 percent remained unchanged since the last MPC meeting in January 2021. The projection for imports has also been revised upwards due to higher oil prices, continuation of higher than anticipated wheat and sugar imports and improving domestic economic activity. Based on these developments, imports are expected to grow in the range of 11-13 percent in FY21. The staff apprised that the forecast for CAB for FY21 remained unchanged, and is expected to be below 1.0 percent of GDP. However, the Financial Account Balance is expected to benefit from realization of official inflows and expected issuance of Euro Bonds. If the projected Financial Account improvement materializes, Foreign Exchange reserves are expected to reach close to three months of import coverage by end FY21. It was highlighted that the position on Net International Reserves (NIR) is improving, which is a better indicator to gauge the health of financial reserves as it nets out liabilities. The Committee noted that despite the pandemic, the position of foreign exchange reserves has improved, with NIR increasing by more than USD 9.0 billion since June 2019.

6.11 Presenting fiscal developments, it was apprised that in Q2-FY21, the fiscal deficit was lower by 0.3 percent of GDP while the primary balance improved by 0.2 percent of GDP as compared with the corresponding period last year. This improvement was mainly due to lower defense and development expenditures during Jul-Dec FY21, along with lower interest payments during the last three months of the period compared to the same months of the previous year. On an overall basis, revenues grew by 7.4 percent in Q2-FY21, with tax revenues coming in at targeted levels and strong contribution also from non-tax revenues. During Jul-Dec FY21, the fiscal deficit stood at 2.5 percent of GDP, slightly higher than in the comparable period last year. Nevertheless, the primary balance recorded a surplus of Rs 337 billion (0.7 percent of GDP), which was higher by Rs 50.8 billion compared to the corresponding period of FY20. Presenting the outlook, it was apprised that the fiscal deficit is projected to fall in the range of 6.0 to 7.0 percent of GDP for FY21 in line with this year's budget and unchanged from the projection in the January 2021 meeting. The downside risks to the fiscal deficit projection include slower than expected economic activity, payments for purchase of Covid-19 vaccines, higher oil prices that could result in lower revenue from petroleum levy and partial payments on the outstanding circular debt. On the other hand, the recovery of unpaid Gas Infrastructure Development Cess (GIDC) could potentially reduce the fiscal deficit by about 0.2 percent of GDP.

6.12 Discussing monetary aggregates, it was apprised that on y/y basis the Broad Money (M2) grew by 16.7 percent as of Mar 05, 2021 as compared to 17.5 percent at the end of FY20. It was noted that up to November 2020, the expansion in M2 was largely led by an improvement in the Net Foreign Assets (NFA) of the banking system but during the last three months, Net Domestic Assets (NDA) has overtaken the contribution by NFA. The expansion in NDA of the banking system is mainly attributed to a sharp increase in Private Sector Credit (PSC) as well as net budgetary borrowings from the banking system.

6.13 Further, the staff apprised that after falling in January 2021, PSC resumed its expansionary trend from February 2021 onwards. The contraction in January was led by a seasonal retirement in working capital loans. However, fixed investment loans and consumer financing continued to grow.

6.14 Going forward, it was informed that PSC is projected to gain further momentum and grow in the range of 7.0 to 9.0 percent for FY21. This projection is supported by expectations of disbursements under TERF and an increase in input prices that could further stimulate credit growth. However, there are downside risks to this projection, such as a slowdown in economic activity due to lockdowns against the backdrop of a recent surge in Covid-19 infections. Discussing the preliminary assessment for FY22, it was highlighted that PSC growth is expected to accelerate subject to: (i) the upcoming government budget, (ii) the level of government borrowing from scheduled banks, and (iii) Covid-19 related developments. Lastly, the MPC noted that M2 growth is projected to lie in the range of 13 - 15 percent for FY21.

6.15 The staff then highlighted recent developments with respect to inflation. On y/y basis, national CPI inflation increased from 5.7 percent in January 2021 to 8.7 percent in February 2021. Out of this 3 percentage point increase, around half was contributed by upward adjustment in electricity charges and sugar and wheat prices. It was noted that the effect of the electricity tariff adjustment on y/y inflation would persist for one year. Moreover, the staff apprised that due to a rise in the prices of perishable food items resulting from reduced shelf life after the end of winter season and the arrival of Ramadan in April-May 2021, more pressure on food inflation may manifest in the remaining months of FY21. Nevertheless, it was noted that core inflation is still at a moderate level, whereas the output gap for FY21 is still expected to be negative notwithstanding the higher growth forecast. Discussing supply-side factors, it was highlighted that Wholesale Price Index (WPI) and S&P Global index have steadily risen since the lifting of lockdowns, again suggesting some upward pressures on inflation.

6.16 Based on these developments, the staff informed that the inflation projection for FY21 has been revised upwards, close to the upper limit of the previous forecast range of 7.0 to 9.0 percent. It was informed that this upward revision in the projection is based on changes in assumptions, including a rise in electricity tariffs, rising global oil prices, and strong LSM growth. The downside risks to these projections include a slowdown in demand due to a third wave of Covid-19, subsidies given on essential food items, and further imports of wheat. The upside risks include an upward adjustment of wheat flour prices, and any unexpected increase in house rents and the cost of other services.

6.17 Concluding the presentation, the staff presented inflation projections based on alternative scenarios featuring assumptions of lower GDP growth and higher global oil prices. The Committee then deliberated on all scenarios and their possible implications for the policy rate.

Financial Markets and Reserve Management

6.18 Apprising the Committee on monetary policy implementation, the staff stated that the overnight interbank repo-rate remained around 6.94 percent on average, against the target policy rate of 7.0 percent. The average daily outstanding net injection through open market operations (OMOs) during Jan 25-Mar 16, 2021 increased to Rs. 1.2 trillion as compared to Rs. 885 billion during Nov 24–Jan 24, 2021. It was noted that previously, various refinance schemes and a rise in the NFA of SBP were contributing to the liquidity in the market but during the last two months SBP had to inject liquidity to meet market needs.

6.19 Further, it was noted that monetary conditions have tightened and secondary market yields of almost all tenors of bills and bonds have increased.

6.20 Participation in the longer tenor securities improved since the last MPC meeting at progressively higher yields. In the recent Pakistan Investment Bonds (PIBs) auctions of February and March 2021, the offered amount remained higher than the target and most of the offered amount came in 5-year bonds. The Government picked mostly the amount offered in the 3-year tenor.

6.21 Further, it was apprised that overall conditions of the external sector have improved and the PKR has appreciated against USD, hovering around Rs. 156 per USD since the last meeting in January 2021. It was pointed out that appreciation of PKR also generally indicated some tightening of monetary conditions.

Model-Based Assessment

6.22 The staff apprised the Committee on a few key assumptions that have been revised for the latest simulations including: (i) the exchange rate, (ii) international oil prices, (iii) fiscal deficits for FY21 and FY22, (iv) electricity tariff adjustments, and (v) estimates for the US Economy and the impact of the US fiscal stimulus.

6.23 The staff then apprised the MPC that the point forecasts of inflation for FY21 and FY22 have been revised upward somewhat due to: (i) a front loading of upward adjustments in electricity tariffs since the last MPC; (ii) higher oil prices, and (iii) a relatively higher growth forecast. Despite the incorporation of fiscal consolidation and a slightly stronger exchange rate path than assumed in the last MPC meeting, the aforementioned factors caused an inching up of the projected inflation trajectory particularly up to the next four quarters. As a result, it was noted that the FPAS model was suggesting a moderate increase in the policy rate in the second half of FY21. The Committee also discussed the medium term inflation forecast relative to the target and the corresponding interest rate path suggested by the model to bring inflation within the range of 5.0 to 7.0 percent in the medium term. However, it was noted that the FPAS model's implied interest rate path did not distinguish between supply and demand side shock contributions to inflation.

6.24 At the end, the staff presented alternate scenarios for; (i) lower GDP growth rate that takes into account potential stronger knock-on effects of the ongoing third wave of Coronavirus on economic growth and slow inoculation of the coronavirus vaccines in Pakistan; and (ii) international oil price shock in FY22. Incorporating the uncertainty regarding economic growth due to third wave, the model suggested keeping the policy rate unchanged; however, in case of an oil price shock in FY22, it suggested raising the policy rate to bring headline inflation back towards the medium term target range.

Result of SBP Surveys for Monetary Policy

6.25 The staff apprised the Committee that the last wave of the Consumer Confidence Survey (CCS) was conducted in March 2021. It was highlighted that, notwithstanding some improvement in previous months, the Consumer Confidence Index (CCI) has been below par for the past two years. In contrast to this, Business Confidence Index (BCI) has been improving continuously for the previous four waves. The latest BCI is significantly higher than its mean value.

6.26 It was also reported that the Purchasing Managers Index (PMI) has also improved. The increase in both BCI and PMI indicates that the businesses are very optimistic since the past 6-8 months. The survey results show that both the Consumer Inflation Expectations and Business Inflation Expectations have ticked up in the latest waves.

6.27 The staff then apprised the MPC of the results of the "Survey of Other Forecasters". It was explained that real GDP growth of 2.0-3.0 percent is expected in FY21 with the highest probability. Similarly, average inflation is thought to be most likely to remain in the range of 9.0-10.0 percent in FY21 according to other forecasters. Lastly, it was highlighted that most of the forecasters and experts expect no change in SBP's policy rate.

Monetary Policy Deliberations and Decision Vote

6.28 The Committee unanimously decided to keep the policy rate unchanged.

6.29 The Committee then scripted the Monetary Policy Statement.

DECISION:

- *The policy rate is kept unchanged at* 7.0 percent.
- *The Monetary Policy Statement – March 19, 2021 is approved.*