MINUTES OF THE MONETARY POLICY COMMITTEE (MPC) MEETING
HELD ON SEPTEMBER 20, 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 FY22

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

2. Giving an overview of the real sector, the staff apprised the Committee that several demand and supply indicators suggest that economic activity could be higher than anticipated in the last MPC meeting. Despite a decline in the area under cultivation of cotton, the projected growth of the agriculture sector during FY22 remains unchanged at 2.1 percent as discussed in July 2021, owing to an increase in the area under cultivation for other major kharif crops. The Large-scale Manufacturing (LSM) grew by 18.4 percent and 2.3 percent in June and July 2021, respectively, against a decline of 5.1 percent and an increase of 6.2 percent in the corresponding months of 2020. On an overall basis in FY21, LSM grew by 14.8 percent - the highest since FY06. It was noted that a moderation in LSM growth during July 2021 is due to seasonal factors and some mobility restrictions. Discussing the demand indicators, it was elaborated that Auto sales surged in July and August 2021, after slowing down in June 2021, as buyers delayed placing orders in anticipation of budgetary measures. The robust activity in the construction industry is reflected in a rise in the sales of cement, higher production of steel, and a rise in the residential property prices. Further, it was highlighted that overall domestic demand continues to remain robust since the last MPC meeting.

3. The staff highlighted that consistently high energy demand during the last few months also suggests continued recovery in economic activity. Discussing the services sector, it was apprised that key indicators suggest an improved performance. The General Sales Tax (GST) on services grew to record high in Q4-FY21. Further, during July and August 2021, credit to services sector has also picked up. Therefore, projected growth in the services sector for FY22 has been revised upward, mainly led by wholesale and retail trade, on the back of the improved outlook for LSM and strong growth in imports. It was explained that imports are closely associated with consumption - the dominant part of GDP. It was further highlighted that strong growth in tax collection in recent months also reflects underlying strength in economic activity.

4. In view of these developments, the staff highlighted that the real GDP growth is expected to come close to the upper bound of the projected range of 4.0–5.0 percent for FY22. It was highlighted that this upward revision has led the output gap to turn slightly positive this fiscal year in the latest assessment.

5. Discussing global economic conditions, the staff highlighted that due to the spread of the Delta variant of Covid-19, global economic expansion is at a six-month low, especially in emerging

markets. Highlighting high frequency perception indicators, it was apprised that the Bloomberg's global Purchasing Managers' Indices (PMI) for manufacturing as well as services sectors are depicting deceleration in economic expansion, which is more pronounced in emerging economies as compared to advanced countries. Similarly, Morgan Stanley Capital International (MSCI) Index for equity market suggests that the recent wave of the Covid-19 has negatively affected equity markets of emerging economies while those of the advanced countries maintained an uptrend. Furthermore, the Bloomberg Emerging Markets Capital Flow Index is also falling, raising downward risks for emerging economies. On the other hand, with global supply chains still not normalized, international commodity prices remain elevated and inflation is expected to rise in many countries across the globe. Lastly, the Chicago Board Options Exchange (CBOE) Volatility Index suggested a significant reduction in global uncertainty since the peak of the pandemic, although it has continued to be above the pre-Covid-19 level since the beginning of the spread of Delta variant.

6. Apprising about developments in Pakistan's balance of payments (BoP), it was noted that the trade deficit rose to a monthly level of USD 4.2 billion in August 2021 owing to a significant increase in imports led by both, high international prices and a broad-based increase in domestic demand. The Current Account Deficit (CAD) was recorded at USD 0.8 billion in July 2021 and USD 1.5 billion in August 2021. Notwithstanding the rise in the CAD, SBP's FX reserves continued to improve due to healthy financial inflows supported by issuance of Euro bonds, allocation of Special Drawing Rights (SDR) and receipts in Roshan Digital Account (RDA). The financial account recorded a surplus of USD 1.3 billion in July 2021 and USD 3.7 billion in August 2021.

7. Apprising the MPC on the external sector outlook, it was noted that the outlook for exports during FY22 is positive, with major contributions expected from textiles, rice and manufactures. However, despite the availability of an exportable surplus and positive outlook for the upcoming crop, continuing slack in demand for rice in the international market is a major downside risk for its exports. It was also emphasized that an increase in volumes of textile items would be instrumental for growth in exports while their international prices are subject to increased competition as Covid-related restrictions become less stringent amidst the continuing vaccination drive in major competing countries. On the other hand, imports are projected to increase further during FY22 due to: (a) the improvement in domestic economic activity, (b) higher commodity prices, especially the sudden surge in global palm oil and sugar prices, (c) government's efforts to stabilize food prices that are expected to result in higher than earlier anticipated levels of wheat and sugar imports, and (d) continuation of machinery imports under TERF. The MPC was apprised that high workers' remittance inflows and promising trend in ICT related services exports helped finance part of the increase in trade deficit during Jul-Aug FY22. Remittances are expected to maintain the current trends keeping in view the incentives announced by the SBP for financial institutions to promote use of formal channels for transfer of funds and recovery in workers going abroad. The financial account is projected to show a higher surplus during FY22, subject to the timely disbursement of budgeted multilateral and bilateral loan inflows (including from the IMF) and planned issuance of Euro bonds. The risk arising from the situation in Afghanistan was noted as a concern although there is considerable uncertainty, as yet, on the impact on Pakistan's economy.

8. Presenting fiscal developments, it was apprised that fiscal balances improved in FY21 due to strong revenue growth and contained non-interest expenditures. The fiscal deficit fell to 7.1 percent of GDP in FY21 from 8.1 percent in FY20. Similarly, the primary deficit narrowed to 1.4 percent of GDP – 0.4 percentage points lower than the previous year's level. Discussing the latest developments, it was apprised that FBR revenues provisionally grew by around 42 percent during Jul-Aug 2021. It was noted that FBR also exceeded its monthly revenue collection targets of July and August 2021, respectively. Tax collection is expected to maintain the current robust trends but there are downside risks to PDL revenue due to high global oil prices. It was also highlighted that PSPD releases stood significantly higher at 44 percent of the budgeted amount for FY22.

9. Discussing monetary aggregates, it was apprised that Broad Money (M2) witnessed higher contraction during Jul 1 to Sep 3, FY22, mainly due to seasonal retirements in the Private Sector Credit (PSC) and a reduction in net budgetary borrowings. On the other hand, Net Foreign Assets (NFA) of the banking system continued to expand, albeit at a slower pace. On the liability side of M2, higher seasonal withdrawal in bank deposits outweighed an increase in the currency in circulation.

10. Further, the staff apprised that Private Sector Credit (PSC) saw a seasonal retirement, primarily driven by working capital loans. However, SBP's supportive schemes and low interest rates continue to positively influence demand for fixed investments and consumer loans. The uptick in consumer finance is mainly attributed to auto and housing finance, whereas, the acceleration in fixed investment loans is attributed to concessionary SBP schemes.

11. Recent developments indicate that PSC growth in FY22 is expected to be in double-digits, in line with an expected improvement in economic activity as well as budgetary measures favouring businesses and industry. It was highlighted that working capital requirements are also expected to increase, owing to the on-going capacity expansions in some industries and rising input prices. Taking into account the expected growth in PSC and developments in fiscal and external sectors, M2 is projected to grow in line with expectations.

12. The staff then highlighted recent developments with respect to inflation. On a y/y basis, National CPI inflation decelerated in July and August 2021 to 8.4 percent, while on m/m basis it was 1.3 and 0.6 percent, respectively. It was noted that the lagged impact of PKR appreciation, a higher base effect, increase in subsidies and reduced PDL and GST on petroleum products were helping to contain the inflationary pressures.

13. Moreover, the staff apprised that global supply chain disruptions, increased transportation/freight charges and increasing global commodity prices are fueling imported inflation. The contribution of imported inflation in the CPI has increased since January 2021. Further, it was highlighted that the recent exchange rate depreciation, at the time of peak global commodity prices, may add to domestic inflation going forward.

14. Discussing the outlook, it was informed that the average inflation for FY22 is projected to fall in the range of 7-9 percent. However, it was reiterated that the projection is subject to certain risks. The upside risks include; (i) increase in the PDL rates leading to upward revision in administered prices of motor fuel, electricity and second-round impact of these adjustments, (ii) uncertainty due to situation in Afghanistan, and (iii) the exchange rate. The downside risks include; (i) moderation of global commodity prices – especially palm oil, and (ii) further easing of domestic food inflation due to improved supply condition and better governance.

Financial Markets and Reserve Management

15. Apprising the Committee on monetary policy implementation, the staff stated that the overnight interbank repo-rate remained around 7.20 percent on average, against the target policy rate of 7 percent. SBP injections through Open Market Operations (OMOs) kept the short-term interest rates close to the policy rate. The average daily outstanding net injections through OMOs during Jul 27– Sep 17, 2021 increased to approximately Rs. 2.2 trillion as compared to Rs. 2.1 trillion during May 30 – Jul 27, 2021. The high level of injections was attributed to: *i) Federal Government borrowing from the commercial banks, and ii) increase in currency in circulation (CiC).*

16. Strong market participation in 3 and 6 month MTBs and longer tenor securities owing to change in the rules for Primary Dealers, and the forward guidance provided in the MPS, enabled the Federal Government to comfortably meet its borrowing requirements. The government was able to pick higher than targeted amounts in the auctions of Pakistan Investment Bonds (PIBs),

especially the floating rate PIBs. Further, with the exception of last week, the secondary market yields and PIB benchmark interest rates did not change much since the last MPC meeting held in July 2021.

17. Further, it was informed that PKR depreciated by 4.1 percent against USD since the last MPC meeting. This was mainly attributed to the wider trade deficit, higher international commodity prices, and uncertainty linked to Afghanistan. It was also highlighted that the PKR has been less volatile as compared to other major currencies until recent months. Lastly, staff apprised that most of the emerging market currencies also followed a similar trend in the last few months as the US dollar has strengthened, and that PKR has performed better than many other emerging market currencies.

Model-Based Assessment

18. The staff apprised the Committee on key assumptions of the model. It was explained that the point forecast of inflation for FY22 in the baseline scenario has been revised upward primarily because of improved growth prospects for FY22, an upward fuel price adjustment, and the rupee depreciation in recent months. These factors, in addition to expected fiscal impulse in FY22, have also induced an upward revision in the projected inflation path in the medium term in the latest baseline compared to the path presented in the last MPC meeting. As a result, the model suggests an upward revision in the policy rate path when compared with the forecast presented in the last MPC meeting.

19. The Committee also discussed the medium-term conditional inflation forecast relative to the target and the corresponding interest rate path suggested by the model to bring inflation within medium-term range. It was also noted that uncertainty related to the fourth wave of Covid-19 has subsided; but a new source of uncertainty has emerged due to the fallout of Afghanistan situation on Pakistan's economy. The staff also presented scenario analysis incorporating, inter alia, exchange rate movements in FY22 due to continued import demand, and higher GDP growth for FY22.

Result of SBP Surveys for Monetary Policy

20. The staff apprised the Committee that the Consumer Confidence Survey was conducted in the first half of September 2021 and Business Confidence Survey in the second half of August 2021. It was highlighted that consumer confidence has slightly declined in the latest wave of the survey. The Business Confidence Index (BCI) also declined slightly but it continued to remain above the threshold for the past seven waves (since August 2020). Further, it was informed that the Purchasing Managers Index (PMI), declined slightly but remained well above its threshold level, showing continued optimism on the part of businesses.

21. It was noted that both consumers and businesses inflation expectations have increased during latest waves of the respective surveys.

22. The staff then apprised about results of the "Survey of Other Forecasters" from institutions other than the SBP. It was explained that real GDP growth of 4.0-4.9 percent is expected in FY22 with the highest probability. Similarly, average inflation is thought to be most likely in the range of 8.0-8.9 percent in FY22. Lastly, it was highlighted that most of the forecasters and experts expected no change in the SBP's policy rate in the current MPC meeting.

Monetary Policy Deliberations and Decision Vote

23. The Committee unanimously decided to increase the policy rate by 25bps.

DECISIONS:

- *The policy rate is increased by 25bps to 7.25 percent.*
- *The Monetary Policy Statement – September 20, 2021 is approved.*