MINUTES OF THE MONETARY POLICY COMMITTEE (MPC) MEETING
HELD ON JANUARY 22, 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

1. The staff apprised the Committee on developments in key macroeconomic indicators since the monetary policy decision in November 2020, along with an assessment of evolving trends.

2. Giving an overview of the real sector, the staff apprised the Committee that domestic demand continued to gain some further traction since the last MPC meeting. It was highlighted that the second wave of COVID-19 has so far not significantly affected economic activity. Some sectors recorded very strong sales and employment in Large Scale Manufacturing (LSM) industries has also recovered. In agriculture, the area under wheat cultivation posted a 2.0 percent increase in comparison to last year. However, this increase may not offset the impact of the expected decline in cotton production during the current year.

3. In aggregate, LSM posted 7.4 and 14.5 percent Y/Y growth in October and November 2020, respectively. 12 out of 15 LSM subsectors grew in November. Among these twelve subsectors, one of the key contributions came from food, attributed to the early start of sugar production compared to last year. Elaborating further, the staff apprised the MPC that even without taking into account the impact of sugar production, LSM growth for November 2020 is 7.2 percent. However, despite a strong recovery in the last few months, the production volume of key sectors like automobiles and steel has yet to reach the levels observed in FY19, suggesting that the economy has not fully recovered from the COVID -induced contraction.

4. Discussing demand factors, it was appraised that the average sales volume of some industries (e.g. cement and POL) have reached multi-year peaks. In December 2020, automobile sales posted a broad based increase of 24.1 percent, due to an increase in sales of tractors, cars, jeeps and motorcycles. However, according to the industry, it is still operating at approximately 60 to 70 percent of capacity. Domestic cement sales remained strong in the last two months of CY20, with rising demand from both private and public sectors. According to the industry's estimates, the utilization of this sector would reach up to 80 percent by January 2021.

5. Increased economic activity and higher production in LSM contributed to strong POL sales in November and December 2020, with major demand coming from the transport and industrial sectors. Further, it was highlighted that the employment situation in LSM industries has improved in both textile and non-textile sectors. In addition, the results of a PBS survey suggest that after the decline in employment during COVID-19, all industries witnessed a strong rebound and are recovering toward pre-COVID levels of employment.

6. Discussing the Services sector indicators, it was informed that the wholesale and retail trade services have around 17.0 percent share in GDP. The value addition in this sector is primarily based on developments in manufacturing, agriculture and imports. During FY20, imports and LSM witnessed sharp declines, which led to a fall in value addition by wholesale and trade services as well. However, in FY21, SBP projects a recovery in both these sectors, which is in turn expected to revive trade services. Furthermore, a key indicator of the Transport, Storage and Communication Services, i.e., the sale of commercial vehicles, showed a decline throughout FY20. However, FY21 witnessed a recovery in the sales of commercial vehicles, which provides the basis for the projected recovery in the value addition by transport services.

7. Then, the staff apprised the MPC regarding the projections of the real sector. It was highlighted that agriculture growth has been revised down for FY21 due to a decline in cotton production. The growth projections for industry have been revised up mainly because of an upward revision in LSM growth. Moreover, the projection for services was unchanged, taking into account the varying projections for agriculture and industry along with the uncertainty due to the second wave of COVID-19. Consequently, real GDP growth projection for FY21 was revised upward from an earlier projection of 2.1 percent. The supportive factors behind the revision of growth projection include: (i) sustained uptrend in general economic activity (both production and consumption) as seen from high frequency data; (ii) encouraging rebound in exports and remittances; (iii) consistent improvement in business sentiment; and (iv) new fiscal measures, e.g. extension in the construction package. The Committee was informed that the economy is still operating well below its potential and GDP projections are subject to high uncertainty due to various downside risks including: (i) fiscal tightening; (ii) slower than expected domestic roll-out of COVID-19 vaccine; (iii) new strains of COVID-19; (iv) a surge in the price of construction material such as cement and steel; and (v) supply disruptions because of container shortages at ports. The upside risks include: (i) accelerated global roll-out of the COVID-19 vaccine; (ii) sustained increase in remittances; and (iii) a greater than expected increase in exports.

8. Going forward, discussing global economic conditions, the staff highlighted that amid improving global economic prospects, Pakistan’s external sector has recorded further gains. In particular, SBP reserves have reached their highest level since December 2017, rising to around USD 13.4 billion by the end of November 2020. It was noted that despite a deficit of USD 662 million in December 2020, the Current Account Balance (CAB) recorded a cumulative surplus of USD 1.1 billion during H1-FY21. The supporting factors behind this surplus were significantly higher inflows of workers’ remittances, which remained above USD 2.0 billion every month since June 2020, as well as higher ICT services exports (up by about 40 percent Y/Y during H1-FY21) and High Value Added (HVA) textiles exports (up by around 15 percent Y/Y during H1-FY21).

9. Further, it was apprised that net financial inflows remained weak during the first half of FY21, at USD 49.0 million. This was due to lower than expected Foreign Direct Investment (FDI), Foreign Portfolio outflows, as well as banks’ accumulation of assets abroad and higher repayment of their foreign liabilities.

10. Discussing high frequency perception indicators from the global markets, it was apprised that post the first wave of COVID-19, the Bloomberg global manufacturing Purchasing Manager Index (PMI) for both emerging and advanced economies improved. Encouragingly, despite the on-going second wave of the pandemic, this improvement has continued to hold ground. Furthermore, as compared to last year, prices of agriculture commodities and industrial metals have recovered, while energy prices are rising gradually. Also, global equity markets continue to improve.

11. It was highlighted that workers’ remittances remained above USD 2.0 billion for the seventh successive month since June 2020. This trend of workers’ remittances in Pakistan is not very different from that in some peer countries. Moreover, keeping in view the sharp recovery during December 2020 in the number of registered workers heading overseas, specifically to Saudi Arabia, the outlook for workers’ remittances has improved. It is expected that remittances would maintain

the monthly level of around USD 2.0 billion during the remaining months of FY21. This forecast is supported by the enhanced use of official channels for remitting money, orderly exchange rate conditions, and international travel restrictions that are still in place owing to the second wave of COVID -19.

12. Discussing the outlook, the staff apprised that exports based on Pakistan Bureau of Statistics (PBS) data registered Y/Y growth of 5.1 percent in H1-FY20 as compared to 3.1 percent growth recorded in the same period last year. The increase is primarily attributed to better prices and improved volumes in High Value Added (HVA) textile exports. Apart from HVA textiles, there is also a notable improvement in exports of engineering goods, surgical products and pharmaceuticals. On an overall basis, the volume of exports has increased in December 2020 and surpassed the pre-pandemic level. Further, the staff apprised that as per PBS data imports have seen a sharp Y/Y growth of 5.5 percent in H1-FY21 as compared to a decline of 17.0 percent in the corresponding period last year. This was mostly driven by imports of food items such as wheat and sugar. Further, it was highlighted that the overall value of oil imports is still lower despite rising import volumes reflecting lower international oil prices during H1-FY21. Imports of raw materials for capital goods have also begun to increase, which suggests a recovery in domestic economic activity.

13. Further, apprising about the Financial Account, the staff informed that FDI inflows have weakened during H1-FY21 to USD 0.95 billion as compared to USD 1.36 billion in the same period last year. However, anticipating the continuation of work on infrastructure and energy projects under the China Pakistan Economic Corridor (CPEC), FDI is expected to reach around USD 2.0 billion during FY21.

14. Further, the Committee was apprised regarding the external sector projections for FY21. The projected range for exports remained unchanged since the last MPC meeting in November 2020 notwithstanding a rise in the export of HVA textiles, improving external environment and supportive policies of the Government and SBP. However, the projection for imports has been revised upwards due to the expected increase in the import of machinery under the Temporary Economic Relief Facility (TERF), higher than anticipated wheat and sugar imports, rising trend in oil and commodity prices and faster than expected improvement in LSM. Remittances are also expected to grow at a higher rate compared to the projections in November 2020. As a result, the Current Account Deficit (CAD) is expected to improve and fall in the range of 0.0 to 1.0 percent of GDP. It was noted that the improvement in financial inflows would depend on timely realization of multilateral loans and successful issuance of Euro Bonds.

15. Presenting fiscal developments, it was apprised that the overall fiscal balance and primary balance have improved by 0.2 percent and 0.3 percent of GDP, respectively, during the October and November 2020 as compared to the same period last year. This improvement was mainly due to higher tax and non-tax revenues and nearly unchanged PSDP expenditures. In cumulative terms, while the primary surplus increased, the overall fiscal deficit was higher, at 1.8 percent of GDP during Jul-Nov FY21, compared to 1.6 percent of GDP in the same period last year. This increase in the deficit largely came from higher current expenditure, mainly due to higher interest payments. The interest payments recorded an increase of 30.8 percent during Jul-Nov FY21, and stood at Rs. 1,037 billion compared to Rs. 793 billion in the same period last year.

16. Discussing monetary aggregates, it was apprised that Broad Money (M2) expanded by 4.0 percent during 01 Jul-08 Jan FY21, compared to an expansion of 3.3 percent in the same period last year. Until November 2020, the expansion in M2 was largely led by an expansion in the Net Foreign Assets (NFA) of the banking system but NDA has also started to contribute to the growth since the start of December 2020. The expansion in Net Domestic Assets (NDA) of the banking system is mainly attributed to a sharp increase in Private Sector Credit (PSC) and net budgetary borrowings from the banking system. Further, the staff apprised the MPC that since the last meeting, Reserve Money (RM) witnessed a relatively lower expansion due to a substantial decline in Currency in

Circulation (CiC). The decline in CiC along with an increase in deposits have improved the 'currency to deposit ratio' which has resulted in an increase in the money-multiplier.

17. Further, the staff apprised the MPC that since the last meeting in November 2020, the expansion in PSC is mainly driven by working capital loans, which witnessed a notable pickup in November 2020, after recording net retirements during the first four months of FY21. It was highlighted that fixed investment loans and consumer financing were already on the rise since the beginning of FY21.

18. Discussing the PSC in detail, it was apprised that cumulative flows in PSC stood at Rs. 215.5 billion during 01 Jul – 08 Jan FY21 as compared to Rs. 130.2 billion seen in the same period last year. It was noted that low inventory levels revived demand for working capital loans since Oct-Nov FY21, and going forward, due to rise in input prices and steady increase in domestic sales and exports, the demand for working capital loans is expected to rise further. On a cumulative basis during Jul-Nov FY21, fixed investment loans were recorded at Rs. 103 billion, matching the highest growth since FY17. This trend was mainly attributed to a lower cost of borrowing and the impact of SBP financing schemes. Appreciating the SBP schemes, it was apprised that applications for loans aggregating to more than Rs 300 billion loans have been approved under the SBP Temporary Economic Refinance Scheme (TERF), disbursements of which will further contribute to the growth in fixed investment loans.

19. Further, it was apprised that the PSC growth is expected to pick up due to: (i) a notable improvement in LSM output; (ii) continued momentum in housing and construction finance; (iii) lower cost of borrowing along with low and stable risk premium; and (iv) an accelerated disbursement under SBP's TERF scheme.

20. The staff then highlighted recent developments with respect to inflation. On a M/M basis, the national CPI declined by 0.7 percent in December 2020, after rising by 0.8 percent in November. On a Y/Y basis, the national CPI inflation decelerated to 8.0 percent in December 2020, the lowest since June 2019. The Sensitive Price Indicator (SPI) also continued to moderate in the first two weeks of January 2021, with Y/Y growth of 5.8 percent. Moreover, the staff apprised that due to the arrival of fresh crops and lower temperatures across the country, the shelf life of perishable items has improved and their contribution to inflation has dampened. It was also informed that prices of essential items such as sugar, wheat, pulses and rice have declined in the past two months. In addition, core inflation is still at a moderate level in both urban and rural areas.

21. Further, it was apprised that inflationary pressures have eased due to: (i) moderate core inflation due to subdued demand pressures; (ii) improved supply conditions of perishable food items; and (iii) imports and better management in the case of non-perishable food items such as wheat and sugar.

22. Presenting their projections, the staff informed that the inflation for FY21 is still expected to fall in the range of 7.0-9.0 percent, notwithstanding a small increase in the point forecast. It was informed that this projection is conditional upon several assumptions including upward revision of crude oil prices and LSM growth along with an unchanged policy rate. The downside risks to these projections include lower than anticipated growth and normalization of the prices of wheat, sugar and other essential items. The upside risks include supply-side shocks from upward revision in electricity tariffs and unanticipated hikes in food prices, and the rising World Container Index.

23. The staff apprised that excess capacity in the economy together with low farm and non-farm input costs would keep inflation in check in coming months. In particular, the output gap for FY21 is estimated to remain negative even with the revised slightly higher projections of GDP growth.

24. The staff then presented inflation projections based on alternative scenarios for GDP growth and an extended electricity tariff adjustment path. The Committee deliberated on all scenarios and their possible implications for the policy rate.

Financial Markets and Reserve Management

25. Apprising the Committee on monetary policy implementation, the staff stated that the overnight interbank repo rate remained around 7.10 percent, on average, against the policy target rate of 7.0 percent. It was explained that monetary policy implementation was carried out against the backdrop of incremental liquidity injected in the banking systems from two sources; (i) Net Foreign Assets (NFA) of the SBP; and (ii) various refinance schemes of SBP. The average daily outstanding net injection through OMOs stood at Rs. 874 billion during Nov 24 - Jan 14 FY21.

26. It was explained that the secondary market yield inched up across the curve even as the policy rate remained unchanged, possibly in anticipation of an increase in the policy rate. Accordingly, market interest in GOP debt securities is currently mainly concentrated in 3 months T-bills. Discussing the maturity profile of domestic Government debt, it was noted that the concentration in short-term debt securities had ticked up recently.

27. Further, it was apprised that the PKR to USD parity has shown a healthy two-way movement and hovered around Rs. 160.5 per USD. Since, the last monetary policy, it has been in the range of Rs. 160.0-161.0 per USD and liquidity in the foreign exchange market is improving.

Model-Based Assessment

28. The staff apprised the Committee on the assumptions behind the model and highlighted two important developments since the last MPC meeting. Firstly, the “Summary of Economic Projections” released by the US Federal Reserve in mid-December showed an upward revision in growth projection for the US economy in 2021 to 4.2 percent as compared to 4.0 percent projected in September 2020. Secondly, inflation projection for the US economy has also been revised upwards, while the Federal Funds Rate (FFR) is projected to remain unchanged at near zero for foreseeable future. It was informed that these developments and the incorporation of latest data have affected the model-based assessment of Pakistan’s economic outlook.

29. It was further elaborated that the point forecast for inflation in FY21 has been revised upwards in the latest baseline compared to the projection presented in November 2020. Similarly, the inflation projection for FY22 has also been revised slightly upwards. The uptick in the inflation path is mainly due to: (i) recently notified upward adjustments in electricity tariffs; (ii) ongoing and expected increases in international oil prices; and (iii) improved growth outlook for FY21 and FY22. 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 to 7 percent in the medium term.

30. The staff also apprised the committee that there is still considerable uncertainty regarding Pakistan’s growth rate for FY21 due to the knock-on effects of COVID -19 as suggested by the variation in the economic outlook for Pakistan of international financial institutions and rating agencies. Incorporating this uncertainty, the model suggests keeping interest rate unchanged.

31. At the end, the staff presented alternate scenarios for: (i) high GDP growth rate; (ii) extended tariffs adjustment path; and (iii) movement in international oil prices and future exchange rate path.

Result of SBP Surveys for Monetary Policy

32. The staff apprised the Committee that the latest wave of the Consumer Confidence Survey was conducted in January 2021. The results suggested that consumer confidence is still in the negative zone but the pessimism seems to be subsiding slowly. Turning to the Business Confidence Survey results, it was highlighted that business confidence has reached a three-year high level in December 2020. Similarly, the Purchasing Managers Index (PMI) also improved further, reaching the highest level in last two years.

33. It was also reported that inflation expectations for businesses declined in the latest survey, while consumers' inflation expectations remained almost unchanged, suggesting that inflation expectations of both businesses and consumers remained well-anchored.

34. While discussing the Bank Lending Survey (BLS), it was stated that overall credit demand is expected to remain high.

35. The staff then apprised regarding the results of the 'Survey of Other Forecasters'. It was explained that market analysts expect real GDP in FY21 to grow at 1.0-3.0 percent, and their average inflation projection for FY21 has inched up as per the latest wave conducted in January 2021. It was also highlighted that most of the forecasters and experts expect no change in SBP's policy rate.

Monetary Policy Deliberations and Decision Vote

36. Given the outlook for growth and inflation, the Committee viewed the existing stance of monetary policy as appropriate to support the nascent recovery while keeping inflation expectations well-anchored and maintaining financial stability. All members voted to keep the policy rate unchanged.

37. In light of considerable Covid-related uncertainty, all members also favoured providing forward guidance to facilitate policy predictability and decision-making by economic agents. It was highlighted that many advanced economy central banks give forward guidance and many emerging market central banks have also started to follow the same approach during the Covid pandemic. The central banks of emerging markets like Indonesia and Brazil have recently been issuing forward guidance to the market. In discussing the pros and cons of such a commitment, it was highlighted that the main disadvantage is that it would constrain the future course of action. Conversely, the advantage of issuing forward guidance is that it gives confidence to investors and other economic actors in making forward-looking decisions when uncertainty is higher than normal. It was noted that in the current context, the advantages outweighed potential disadvantages as in the near-term, there are no signs of demand-led inflation, unanchored inflation expectations, pressures on the external position or other risks to financial stability. As a result, the MPC issued forward guidance by stating that, in the absence of unforeseen developments, it expects monetary policy settings to remain unchanged in the near term. As the recovery becomes more durable and the economy returns to full capacity, the MPC expects any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates.

38. The Committee then scripted the Monetary Policy Statement.

DECISION:

- *The policy rate is kept unchanged at 7.0 percent.*
- *The Monetary Policy Statement – January 22, 2021 is approved.*