MINUTES OF THE MONETARY POLICY COMMITTEE (MPC) MEETING
HELD ON JULY 27, 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 of developments in key macroeconomic indicators since the last Monetary Policy decision in May 2021, along with an assessment of evolving trends.

2. Giving an overview of the real sector, the staff apprised the Committee that high-frequency demand indicators continue to show robust growth since the last MPC meeting, while supply conditions present a mixed picture. The prospects for agriculture to repeat the FY21 performance was affected by 12.8 percent decline in the area under cultivation of cotton, owing to water shortages during the sowing season. The Large-scale Manufacturing (LSM), on the other hand, continued to maintain a strong growth of 14.6 percent in Jul-May FY21 as compared to a decline of 10.2 percent during the same period last year. On a y/y basis, LSM grew by 68.1 percent and 36.8 percent during April and May 2021, respectively. This spike in growth was partly due to a low base effect but also reflective of the ongoing momentum in the economic activity. It was apprised that this LSM recovery is fairly broad-based as reflected by higher production in the textiles, food, beverages & tobacco, petroleum products, pharmaceuticals, automobiles, chemicals, cement, and fertilizers industries during Jul-May FY21. Incorporating the latest trends and keeping in view the recent budget measures, including reduction in import duties on industrial raw materials, higher development spending, and extension in the construction package, the growth projections for FY22 for LSM and construction have been slightly revised upward.

3. Further, it was highlighted that domestic demand continues to remain robust since the last MPC meeting. Sales of Fast Moving Consumer Goods (FMCGs) recorded strong growth in both nominal and real terms. Domestic cement sales recorded an increase of 20.4 percent in FY21 as compared to the last year. Similarly, import and local production of steel has also increased. Further, energy demand also remained strong since the last MPC meeting, reflecting the continued recovery in economic activity. However, automobile sales declined slightly in anticipation of favorable changes in taxes in FY22 budget. It was noted that going forward, automobile sales are expected to resume their increase. On the supply side, the rising number of company registration reflects improved investor confidence amidst the on-going revival of economic activity.

4. Discussing the services sector, it was apprised that this sector is expected to record an encouraging growth during FY22, mainly led by wholesale and retail trade, on the back of the improved outlook for LSM growth. Other factors that would stimulate the services sector include the budgeted higher spending on social sector development, along with an increase in the salaries of the public sector employees by 10-20 percent.

5. In view of these developments, the staff highlighted that economic activity is expected to gain further traction in FY22 and real GDP is projected to grow in the range of 4.0–5.0 percent.

6. Discussing global economic conditions, the staff highlighted that supported by the vaccination drive and latest projections for economic growth by international agencies, economic activity is picking up globally. Highlighting high frequency perception indicators from the global markets, it was apprised that the Bloomberg's global manufacturing Purchasing Manager Index (PMI) for advanced economies is depicting robust improvement, while for emerging economies there are mixed trends due to the spread of the delta variant of Covid-19 and still low vaccination rates in some countries. Supported by the positive sentiment for an economic recovery, prices of almost all major groups of commodities have been rising globally and are above pre-Covid levels at present. Furthermore, the Chicago Board Options Exchange (CBOE) Volatility Index suggested reduction in uncertainty since the last MPC meeting in May 2021; however, it is still above pre-Covid level.

7. Apprising about developments in the balance of payments (BoP), it was noted that the current account deficit fell to a decade low level of 0.6 percent of GDP in FY21. Record high exports and workers' remittances contributed to this improvement. Exports grew by 13.7 percent reaching US$ 25.6 billion. Particularly, higher volumes of hosiery/knitwear exports and favorable international prices of textile products contributed to this growth. Further, it was also noted that export volumes of manufactured items (such as chemicals & pharmaceuticals, medical & surgical goods and engineering products) also saw a notable increase during FY21. Workers' remittances increased by 27.0 percent, reaching US$ 29.4 billion. Factors such as use of formal channels for transfer of money, travel restrictions, improvement in the economic activity in source countries and orderly conditions in the domestic foreign exchange market all contributed to higher remittance inflows during FY21. Meanwhile, imports grew by 23.2 percent to reach US$ 53.8 billion in FY21. The growth in imports was driven by a few categories, including one-offs. These one-offs included import of wheat, sugar and raw cotton, as well as machinery imports under Temporary Economic Refinance Facility (TERF). It was noted that a surge in international oil prices towards the end of FY21 also contributed to higher import growth. Adjusting for one-offs and the increase in international oil prices, the trade deficit of FY21 falls close to the FY20 level. Discussing the Financial Account, the staff highlighted that Foreign Direct Investment (FDI) has been relatively low in FY21, particularly due to Covid-related uncertainties. However, it is anticipated to be higher in FY22 as work on the ongoing CPEC projects is picking up momentum. Resumption of the IMF program, issuance of Euro bonds and the successful launch of the Roshan Digital Accounts (RDAs) for Overseas Pakistanis resulted in a higher surplus in the financial account, which rose by US$ 8.2 billion during FY21. This was instrumental in building the SBP's foreign exchange reserves, which reached US$ 17.3 billion by end-June 2021. In the context of sustainability, it was highlighted that the external sector position looks different from earlier high economic growth episodes given: (i) the flexible exchange rate that continues to act as the first line of defense against balance of payments pressures; (ii) rising FX buffers; (iii) machinery imports in FY21 being higher than in FY17 and more broad-based and better distributed than in FY18; and (iv) as in FY21, expected inflows during FY22 are expected to be more than sufficient to meet gross external financing requirements.

8. Further apprising the MPC on the external sector projections, it was noted that SBP's outlook for exports during FY22 is positive, with major contributions expected from textiles, rice and manufactures. Imports are projected to increase further in line with the trends in domestic investment and economic activity. Specifically, the projections account for the impact of higher international oil prices, import of Covid-19 vaccine, higher transport sector imports due to downward revisions in tax rates on automobiles, and continuation of machinery imports under TERF. Moreover, taking into consideration the impact of incentives announced by the SBP for financial institutions to promote use of formal channels for transfer of funds, better than earlier anticipated global economic growth projection, higher international oil prices and lingering travel restrictions, workers' remittances are projected to marginally rise during FY22 relative to FY21.

However, the low number of workers going abroad, owing to closure of flights, might pose a downward risk to this projection. The financial account is projected to show 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.

9. Presenting fiscal developments, it was apprised that provisional numbers show that the fiscal deficit remained contained at 4.2 percent of GDP in Jul-Apr FY21, as compared to 5.3 percent in the same period last year. The primary balance was in surplus during Jul-Apr FY21, against a deficit in the same period last year. This improvement was mainly due to higher FBR tax collections, which increased by 18.4 percent during Jul-Jun FY21 as compared to the same period last year. Further, it was pointed out that the fiscal deficit in FY21 is expected to fall in the projected range of 6.5 to 7.5 percent of GDP but the primary deficit is expected to be somewhat larger than budgeted (at around 1 percent of GDP instead of 0.5 percent of GDP). Presenting the outlook for FY22, it was apprised that the fiscal deficit is projected to remain in the range of 6.5 to 7.5 percent of GDP with risks skewed towards the upper bound of the range, while the primary deficit is expected to narrow in line with continued fiscal consolidation.

10. Discussing monetary aggregates, it was apprised that on a y/y basis, Broad Money (M2) has expanded at a slower pace due to a deceleration in the growth of Net Domestic Assets (NDA), while Net Foreign Assets (NFA) of the banking system continued to expand on account of multilateral inflows and government commercial borrowings. On the liability side of M2, bank deposits were the primary source of growth of broad money while the contribution of currency in circulation decelerated. Currency in circulation (CiC) has decelerated in FY21 as compared to the previous year.

11. Further, the staff apprised that Private Sector Credit (PSC) rebounded during FY21, with a surge in fixed investment and consumer loans, driven by accommodative monetary policy and SBP refinance facilities. 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.

12. Recent developments indicate that PSC growth in FY21 is expected to remain close to the upper bound of the projected range of 7-9 percent. Moreover, PSC growth is projected to be in double-digits in FY22 (range of 10.5 percent to 12.5 percent), in line with an expected improvement in economic activity as well as budgetary measures favouring business and industry. It was informed that the PSC projection included expected disbursements under TERF in FY22. It was noted that working capital requirements will also increase, attributed to the on-going capacity expansions in some industries and rising input prices. It was highlighted that the actual numbers for PSC may surpass the projected numbers, if there are higher disbursements under the "Kamyab Pakistan" program.

13. The staff then highlighted recent developments with respect to inflation. On a y/y basis, National CPI inflation decelerated in May and June 2021 to 10.9 and 9.7 percent, respectively, after rising to 11.1 percent in April 2021. The deceleration was mainly attributed to imports of wheat and sugar, administrative measures to address food prices, and downward adjustments of the petroleum development levy (PDL). Moreover, exchange rate appreciation for the major part of the year also contained inflationary pressures from imported items.

14. Moreover, the staff apprised that given the capacity enhancement under TERF, the output gap is estimated to remain open through FY22. Consistent with this economic slack, there is still little sign of second-round effects, although real wages in the private sector are expected to pick-up in the backdrop of the recent increase in the minimum wage rate and salaries of the public sector employees announced in FY22 Federal/Provincial budgets.

15. 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 any projection is subject to certain

risks. The primary downside risk here is a resurgence of Covid-19, in the domestic and global market. The upside risks include; (i) higher than expected rise in global commodity prices along with rise in PDL and domestic energy tariffs, (ii) unfavorable exchange rate movement translating into rise in prices of imported items, and (iii) unexpected fiscal expansion.

16. Concluding the presentation, the staff presented inflation projections based on alternative scenarios, including an entrenched fourth wave of Covid-19 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

17. Apprising the Committee on monetary policy implementation, the staff stated that the overnight interbank repo-rate remained around 7.21 percent on average, against the target policy rate of 7 percent. SBP injections through Open Market Operations (OMOs) continued to remain high to keep the short-term interest rates close to the policy rate. The average daily outstanding net injections through OMOs during May 30 – Jul 22, 2021 increased to approximately Rs. 2.1 trillion as compared to Rs. 2.0 trillion during Mar 21 – May 30, 2021. The high level of injections was attributed to: *i) Federal Government borrowing from the banks to build cash buffers, and ii) increase in currency in circulation (CiC).*

18. Strong market participation in 3 and 6 month MTBs and longer tenor securities have enabled the Federal Government to pick the targeted amounts in the auctions. Further, it was noted that the secondary market yields and PIB benchmark interest rates did not change much since the last MPC meeting in May 2021, in line with the forward guidance provided by the MPC.

19. Further, it was highlighted that the foreign exchange market witnessed some volatility and PKR depreciated against USD since the last MPC meeting. It was pointed out that most of the emerging market currencies also followed a similar trend, as on an overall basis, USD appreciated in the international market. Lastly, staff apprised that fiscal year end seasonal payments also partially explained the recent PKR movement against USD.

Model-Based Assessment

20. The staff apprised the Committee on key assumptions of the model. It was explained that the point forecasts of inflation for FY22 has been revised downwards in the latest baseline compared to what was presented in the last MPC meeting in May. This was mainly due to: (i) softening of food prices in the last two months and its lagged effect going forward, and (ii) sluggish pass-through of the increase in the international oil prices to domestic oil prices. Moreover, it was also apprised that there is a moderation of inflation projection path in the medium term in the latest baseline compared to the path presented in the last MPC meeting. It was also informed that recent PKR movement against USD has been taken into account for forecasting. As a result, the model suggests a moderation in the policy rate path increase when compared with the forecast presented in the last MPC meeting. At the same time, the staff reminded the MPC that the model did not fully distinguish between supply and demand-driven inflation.

21. 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 the range medium-term range. It was also noted that uncertainty is still high as we are in the middle of the fourth wave of Covid-19; recognizing this uncertainty implies alternative interest rate paths.

22. As a result, the staff also presented scenarios for including: *(i) a more entrenched fourth wave of Covid-19, which reflects a more protracted episode relative to the third wave, and (ii) an international oil price shock in FY22.*

Result of SBP Surveys for Monetary Policy

23. The staff apprised the Committee that the Consumer Confidence Survey was conducted in the first half of July 2021 and Business Confidence Survey in the second half of June 2021. It was highlighted that consumer confidence has improved in the latest wave of the survey, although, it is still below the threshold level. The Business Confidence Index (BCI) increased significantly since April 2021 and reached an all-time high. The Purchasing Manager Index (PMI), declined slightly but remained well above its threshold level. This shows continuing optimism on the part of businesses despite some challenges due to lockdowns during the fourth wave of Covid-19.

24. The survey results show that both consumer and business inflation expectations have declined, suggesting they remained well-anchored by the MPC narrative.

25. 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 to remain 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 during the current MPC.

Monetary Policy Deliberations and Decision Vote

26. The Committee decided to keep the policy rate unchanged with a majority vote of 8 out of 9 members, with one member voting to increase the policy rate by 50 bps.

DECISIONS:

- *The policy rate is kept unchanged at 7 percent.*
- *The Monetary Policy Statement – July 27, 2021 is approved.*