MINUTES OF THE MONETARY POLICY COMMITTEE (MPC) MEETING
HELD ON MAY 28, 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 March 2021, along with an assessment of evolving trends.

6.2 Giving an overview of the real sector, the staff apprised the Committee that the provisional data of National Income Accounts confirm the strong recovery in economic activity in FY21, mainly led by the services sector and industry. Pakistan Bureau of Statistics (PBS) estimates show that overall real GDP grew by 3.94 percent in FY21 against SBP's projection of 2.9 percent discussed in the March 2021 MPC meeting. It was noted that SBP's projection had been raised in an appropriately conservative manner in the last MPC meeting, while noting upside risks, notably from strong manufacturing out-turns. Data received since the last meeting confirm that these upsides have materialized. Discussing the real GDP estimates, it was noted that all major crops, except cotton, have performed well. Major crops such as maize and rice have recorded the highest-ever production levels. It was informed that wheat is also expected to see record production and sugar production was also expected to reach near-record highs. As a result, agriculture is expected to grow by 2.8 percent in FY21. Industry is expected to grow by 3.6 percent, with major contributions coming from LSM and construction. LSM maintained its upward momentum since the last MPC meeting, with twelve out of fifteen sub-sectors showing a y/y increase in production in March 2021. LSM is expected to grow by 9.3 percent in FY21. Further, it was highlighted that by end of FY21 when more data will be available, the LSM growth number might improve further. Construction and allied industries have also recorded strong growth in FY21. The cement sector recorded a significant m/m growth of 16.2 percent in March 2021, together with an increase in domestic steel production. Real estate prices are also on the rise, indicating buoyancy in the construction sector. Discussing the services sector, it was apprised that this sector is expected to record a growth of 4.4 percent in FY21, mainly led by wholesale and retail trade, on the back of significant improvements in LSM, agriculture and external trade volumes as compared to last year. In contrast, value addition by electricity and gas distribution has declined by 23 percent, primarily owing to adjustments related to substantial subsidies given by the Government. Nevertheless, electricity generation has increased in the first nine months of FY21. Electricity sales also increased both on m/m and y/y basis in March 2021.

6.3 It was apprised that domestic demand remained strong since the last MPC meeting, with a substantial increase in sales of automobile and Fast Moving Consumer Goods (FMCG). It was explained that the growth in automobile sales was broad-based, with sale volumes of commercial vehicles, personal cars, jeeps and motorcycles all witnessing a substantial recovery since last year. The healthy recovery in automobiles is mainly due to the introduction of new models, lower financing rates and importantly, a recovery in household income. Similarly, sales of FMCGs recorded strong growth in both nominal and real terms. Sales of FMCGs in real terms grew by 14.7 percent in Q3-FY21, compared to a 1.6 percent increase in the corresponding period of last year. Similarly, POL sales grew strongly, with a major contribution from the transport sector.

6.4 Discussing the supply side, it was noted that the registration of new firms with SECP and rise in machinery imports reflected favourable prospects of further expansion in economic activity. The economy has recovered on the back of timely and well calibrated policies. With fiscal measures primarily aimed at reallocation and using resources prudently in the wake of constrained fiscal space, Pakistan witnessed one of the smallest increases in public debt in FY20, creating a conducive macroeconomic environment that buoyed market sentiment and the investment outlook. At the same time, SBP's aggressive stimulus measures of around 5 percent of FY20 GDP helped to cushion the Covid-19 shock and supported the on-going economic recovery. It was noted that the Temporary Economic Refinance Facility (TERF) has encouraged new investments, which is likely stimulate GDP growth and productive capacity in FY22.

6.5 Discussing the outlook, it was apprised that GDP growth in FY22 is expected to improve further, supported by a rebound in cotton production owing to measures taken by the Federal Government, buoyant construction activities and an expected uptick in the Public Sector Development Program (PSDP) spending. The projection is subject to both upside and downside risks. Favourable impacts of higher than expected PSDP spending and pick-up in external demand are likely to offset any negative impact of an expected tightening of credit conditions as growth picks up. However, the unfolding third wave of Covid-19 in Pakistan creates significant uncertainty and remains a major concern.

6.6 Discussing global economic conditions, the staff highlighted that economic activity is generally picking up pace globally, albeit unevenly, supported by the vaccination drive. Highlighting high frequency perception indicators from the global markets, it was apprised that the Bloomberg global manufacturing Purchasing Manager Index (PMI) for emerging economies has remained unchanged while for advanced economies, it has improved further since the March 2021 MPC meeting. Due to positive sentiment regarding the prospects of an economic recovery, prices of almost all major groups of commodities have been rising globally. It was highlighted that energy prices, which were relatively subdued earlier, have also started to pick up in the last few months. Furthermore, a reduction in volatility in the Chicago Board Options Exchange (COBE) Volatility Index (VIX) in the last two months indicated an improvement in global economic uncertainty, while for Pakistan it remained almost unchanged due to the ongoing third wave of Covid-19. Noting that the resurgence of Covid-19 has severely affected two major economies (India and Brazil) and progress on vaccinations has not been uniform across the world, it was pointed out that this could result in uneven paths of economic recovery in the advanced economies compared with emerging markets and developing countries.

6.7 Apprising the MPC about developments in the Balance of Payments (BoP) of Pakistan, it was noted that net financial inflows recorded at USD 3.47 billion during Jul-Apr FY21 as compared to inflows of USD 8.86 billion during the same period in FY20. This was supported mainly by the recent issuance of Euro bonds, disbursement under the IMF-External Fund Facility (EFF) program, foreign investment in government local currency bonds, and investment in Naya Pakistan Certificates through Roshan Digital Accounts (RDA). The Current Account Balance (CAB) recorded a surplus of USD 773 million during Jul-Apr FY21, against a deficit of USD 4.66 billion during the corresponding period last year. During Jul-Apr FY21, FDI reached USD 1.50 billion as compared to USD 2.36 billion in FY20, mainly due to a slowdown in the pace of work on CPEC related projects. The surplus in the CAB and net positive financial inflows further improved SBP's foreign exchange reserves, which were recorded at USD 15.6 billion in April 2021, their highest since June 2017.

6.8 Discussing further, the staff apprised that the data released by PBS shows that in Jul-Apr FY21, exports have posted a growth of 13.6 percent, driven mostly by textiles. During this period, monthly textile exports have remained around USD 1.27 billion as compared to 1.08 billion in the last year. The growth in export values is largely supported by favorable prices as well as higher volumes of hosiery/knitwear exports. At the same time, volumes of major items like readymade garments, cotton fabric and rice generally remained lower than their FY20 levels. The growth in imports has been recorded at 17.9 percent during Jul-Apr FY21. However, after discounting for the impact of one-off imports this year (wheat, sugar and raw cotton being higher than the preceding years) the growth in imports was 13.4 percent. In line with the economic recovery, import volumes of most of the major items (e.g. palm oil, petroleum crude & related products, iron and steel) were higher than last year. Further, it was noted that international oil prices, which were still low on average during FY21 as compared to the last year, have started rising. This could have implications for the import bill going forward.

6.9 Further, it was highlighted that workers' remittance have maintained an upward trend from USD 2.3 billion in February 2021 to USD 2.7 and 2.8 billion in March and April 2021, respectively. The trend for Pakistan is quite similar to that for Bangladesh and, to an extent, to that in Mexico. Although travel restrictions have seen the number of workers going abroad fall in the last few months, the number of returnees is even lower. As a result, there has been a net improvement in the number of new workers to Saudi Arabia, UAE, Oman and Qatar. Along with the uptick in the use of formal channels for transferring money, the outlook for remittances is positive for the coming months.

6.10 The staff also apprised the MPC on insights from the Global Remittance Survey for FY21, conducted in January 2021. With a sample size of 3,589 Pakistani emigrants across the globe, it was asked whether they plan to move back to Pakistan in the next six months, and 90 percent answered in the negative. Further, it was asked whether they would send more remittances in the next six months, to which almost 70 percent responded positively. Summing up the results of the survey, it was highlighted that 73 percent of the remitters are perceived to have switched to formal channels to remit funds to Pakistan; 64 percent of active remitters (those that have sent remittances in 2019 and 2020) have switched to digital modes of funds transfer; and out of those 64 percent, 98 percent are likely to persist with these avenues for funds transfer in future. The survey results are valid until June 2021.

6.11 The Committee was then apprised of the external sector projections for FY21 and FY22. Given the momentum in textile exports, overall export growth is likely to improve. It is now expected to fall in the range of 8-10 percent during FY21 as compared to an earlier projection of 4-6 percent. Owing to the rising trend in international prices amid improving domestic demand and anticipated TERF related imports, the projection for import growth for FY21 has also been revised upwards in the range of 15-17 percent in FY21 as compared to the earlier projection of 11-13 percent. During FY22, growth in both exports and imports is expected to moderate slightly on account of a large base effect. The worker's remittance projection has also been revised upward to around USD 29 billion in FY21 due to net increase in emigrants and much higher than anticipated inflows during first 10 months of the year, while the outlook for FY22 is also positive. The staff apprised that with an improvement in foreign remittances and more a moderate level of deficit in the services trade balance due to restricted international travel, the overall Current Account Deficit (CAD) is expected to be less than USD 1 billion in FY21. In FY22, as travel restrictions are expected to be eased, the CAB is expected to rise but should remain bounded. The Financial Account Balance is expected to improve further in FY22 due to various bilateral and multilateral inflows, as well as inflows under RDA.

6.12 Presenting fiscal developments, it was apprised that the actual data of fiscal operations for the first three quarters suggests the fiscal deficit will remain broadly in line with the FY21 budget estimates. During Jul-Mar FY21, the fiscal deficit was contained at 3.5 percent of GDP, as compared to 4.1 percent of GDP in the same period last year. The primary surplus has increased to 0.9 percent of GDP during Jul-Mar FY21 compared to 0.5 percent of GDP in the same period last year. This improvement was mainly due to an increase in tax revenues, which grew by 11.9 percent during Jul-Mar FY21 over the corresponding period last year. Further, it was pointed out that although there was an increase in current expenditures during Jul-Mar FY21 (attributed to higher interest payments), the growth in overall expenditure remained subdued due to a decline in development expenditures. Presenting the outlook, it was apprised that the fiscal deficit is projected to remain within the range of 6.5 to 7.5 percent of GDP for FY21, unchanged from the last MPC meeting. The fiscal deficit projection is subject to several risks, including: *(i) slight slowdown in revenues collection due to smart lockdowns in the first week of May in number of cities of Punjab; (ii) long Eid-ul-Fitr holidays; (iii) reduction in PDL rate given that domestic oil prices have been kept unchanged despite increase in oil prices in international market; and (iv) increase in non-interest current expenditure, largely coming from increase in subsidies and payments to Independent Power Producers (IPPs).* Lastly, it was apprised that preliminary estimates suggest that the FY22 fiscal deficit is likely to be lower than in FY21, although this will be revisited after the budget.

6.13 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 improved external accounts. The deceleration in NDA growth is largely due to lower net budgetary borrowings from the banking system. The improvement in the currency-to-deposit ratio has reversed in the last two months largely because of an increase in Currency in Circulation (CiC) and deposit withdrawals during Ramzan and Eid, as well as the encashment of Rs. 15,000 and Rs. 7,500 prize bonds.

6.14 Further, the staff apprised that Private Sector Credit (PSC) offtake remains in line with the pattern seen in pre-Covid-19 years of high economic growth (FY17 and FY18). Cumulative weekly credit flows during 01 Jul – 07 May FY21 have been increasing, except for a couple of dips in the last week of April and first week of May due to the Ramzan and Eid holidays. Most of the contribution to the expansion in PSC is coming from fixed investment loans and consumer finance, while improved cash flows of the firms on account of rising demand and higher tax refunds have helped in keeping working capital requirements lower during FY21, so far. 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, notably TERF and LTFF. Going forward, the supply of credit will be supported by disbursements under TERF, as well as the uptick in bank deposits. By May 6, 2021, Rs. 96 billion has been disbursed under TERF and Rs. 55 billion are expected to be disbursed till the end of FY21.

6.15 Recent developments indicate that PSC growth in FY21 is expected to lie in the range of 7 to 9 percent. Moreover, this trend is anticipated to continue in FY22, with PSC growth to improve further. Lastly, the MPC was apprised that M2 growth is projected to remain in the range of 13 to 15 percent in FY21.

6.16 The staff then highlighted recent developments with respect to inflation. In the month of April 2021, national CPI inflation increased to 1 percent on an m/m basis, from 0.4 percent in March 2021, mainly due to the usual seasonal uptick in food prices associated with the Ramzan. On a y/y basis, the rise in April 2021 continues to be mainly driven by supply shocks in the food and energy sectors, with some uptick in the core inflation in urban areas. Since January 2021, electricity charges and a narrow set of food items explained almost 75 percent of the hike in national inflation. In addition, there is still little sign of second-round effects, with real wage growth close to zero.

6.17 Afterwards, the staff informed that the economy is expected to continue to recover further in FY22. As a result, the degree of slack in the economy is likely to narrow, notwithstanding some capacity enhancement due to TERF. As a result, the output gap for FY22 is projected to narrow, suggesting some upward pressure going forward. Discussing supply-side factors, it was highlighted that the Wholesale Price Index (WPI) and S&P Global index are continuously rising, again suggesting likelihood of some upward pressures on inflation in FY22.

6.18 Further, it was apprised that the average national inflation is expected to remain close to the upper bound of the previously announced range of 7-9 percent in FY21. The inflation outlook for FY22 is subject to considerable uncertainty, especially related to the upcoming federal budget. Upside risks include: *(i) removal of GST exemptions; (ii) persistence of domestic supply shortages of sugar and chicken; (iii) more than expected strengthening of global commodity prices; and (iv) any upward revision in administered prices of motor fuel and utilities along with the second round impact of these adjustments in energy prices.* A key downside risk is the third wave of Covid-19.

6.19 Concluding the presentation, the staff presented inflation projections based on alternative scenarios, including a prolonged third 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

6.20 Apprising the Committee on monetary policy implementation, the staff stated that the overnight interbank repo-rate remained around 7.09 percent on average, against the target policy rate of 7 percent. SBP had to inject higher liquidity through Open Market Operations (OMOs) to keep short-term interest rates close to the policy rate. The average daily outstanding net injections through OMOs during Mar 21 – May 19, 2021 increased to approximately Rs. 2 trillion as compared to Rs. 1.2 trillion during Jan 25-Mar 16, 2021. The higher liquidity injections were attributed to: *i) Federal Government borrowing from the banks to build cash buffers, and ii) seasonal increase in currency in circulation (CiC) during the month of Ramzan and Eid.*

6.21 Participation in longer tenor securities improved significantly since the last MPC meeting in March 2021. Further, it was noted that secondary market yields and benchmark interest rates have declined significantly, in line with the forward guidance recently issued by the MPC. This decline was more pronounced in the long-term yields. The decline in yields has enabled the Federal Government to pick higher than the targeted amounts in the PIB auctions at a relatively lower rate.

6.22 Further, it was pointed out that PKR continued to depict two-way movement based on market demand and supply. The staff informed that overall conditions of the external sector continued to improve and the PKR has appreciated slightly against the USD since the last MPC, hovering around Rs. 155 per USD. It was highlighted that most of the regional currencies are also following a similar trend.

Model-Based Assessment

6.23 The staff apprised the Committee on key assumptions of the model. It was explained that the point forecasts of inflation for FY22 and medium-term inflation projection path have been slightly revised upward due to: *(i) a strong recovery in economic activity in FY21 and an expected pickup in FY22; and (ii) higher international commodity prices.* It was also noted that the recent nominal appreciation of the PKR so far helped to absorb some of the rising imported inflation. As a result, the FPAS model was suggesting a moderate increase in the policy rate by Q4-FY21 as compared to its earlier forecast presented in the last MPC meeting. However, it was apprised by the staff that one needs to be cognizant of underlying supply and demand components of inflationary pressures, as the FPAS model does not distinguish between them in determining the implied interest rate path.

6.24 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. It was noted that uncertainty is high keeping in view the third wave of Covid-19.

6.25 The staff also presented alternate scenarios for: *(i) third wave of Covid-19, which* reflects a somewhat less intense but more protracted episode relative to the first wave *; and (ii) international oil price shock in FY22.* The former scenario results in a lower GDP growth rate, opening up the output gap further and leading to moderation of inflationary pressures. Incorporating the uncertainty regarding the third wave of Covid-19, the model suggested keeping the policy rate broadly 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

6.26 The staff apprised the Committee that the Consumer Confidence Survey was conducted in the first half of May 2021 and Business Confidence Survey in second half of April 2021. It was highlighted that consumer confidence continued to remain subdued in the latest wave of the survey. Business confidence, as reflected by the Business Confidence Index (BCI) and Purchasing Manager Index (PMI), also declined slightly but remained well above their threshold levels. This shows continuing optimism on the part of businesses despite some challenges due to lockdowns during the third wave of Covid-19.

6.27 The survey results show that business inflation expectations have ticked up, while consumer inflation expectations remained almost unchanged in the latest wave.

6.28 The staff then apprised the MPC of the results of the "Survey of Other Forecasters" conducted outside SBP. It was explained that real GDP growth of 3-3.9 percent is expected in FY21 with the highest probability. Similarly, average inflation is thought to be most likely to remain in the range of 9-9.9 percent in FY21. The long-run projections of Other Forecasters show that inflation will decline gradually over the years, and real GDP growth will maintain its level around 4.5 percent during the next five years. 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

6.29 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 100 bps. The Committee then scripted the Monetary Policy Statement.

DECISIONS:

- *The policy rate is kept unchanged at 7 percent.*
- *The Monetary Policy Statement – May 28, 2021 is approved.*