THE FEDERATION OF PAKISTAN

CHAMBER OF COMMERCE & INDUSTRY (FPCCI)

POLICY ADVISORY BOARD

INPUT FOR THE UPCOMING MONETARY POLICY

September 10, 2021

POLICY BRIEF

Input for the Upcoming Monetary Policy

Acknowledgement & Disclaimer

The Policy Advisory Board – Federation of Pakistan Chamber of Commerce & Industry (FPCCI) expresses its appreciation to industry representatives, economists, financial market participants, and professionals who participated and submitted their responses for the online monetary policy survey.

The conclusions and interpretations expressed do not necessarily reflect the views of the board of directors, associations, business councils, trade organizations, or any associated body which FPCCI represents. Findings and analysis based on the data from Pakistan Bureau of Statistics, International Monetary Fund, and the State Bank of Pakistan are the responsibility of author(s) and do not necessarily reflect the opinion of these agencies. All data and statistics used are correct as of 06th September 2021 and may be subject to change.

For further information or queries regarding this policy brief, please contact

usama.khan@fpcci.org.pk

Chairman – Policy Advisory Board (FPCCI)

Mr. Mohammad Younus Dagha

Team Leader

Dr. Usama Ehsan Khan – Senior Researcher

Researchers

Ms. Uzma Aftab – Junior Researcher

Mr. Asher Raja – Trainee Researcher

Table of Contents

Recommended Policy Direction

Key Highlights

1. Introduction 2
2. Monetary Policy Survey 3
   - *2.1. Policy Rate Direction* 3
   - *2.2. Exchange Rate Expectation* 4
   - *2.3. Inflation Expectation* 5
   - *2.4. Growth Expectation* 6
3. Trend Analysis 8
   - *3.1. Inflation* 8
   - *3.2. Industry* 8
   - *3.3. Trade Statistics* 9
   - *3.4. Exchange Rate* 10
4. Consumer Confidence and Business Confidence Indices 11
5. Policy Rates Comparison – *Pakistan's Position in the Region* 12
6. Correlation Analysis 13

Bibliography

Input for the Upcoming Monetary Policy

Recommended Policy Direction

The Policy Advisory Board - FPCCI proposes that the State Bank of Pakistan should lower the policy rate in the upcoming monetary policy committee to help revive the economy amid pandemic and ongoing episodes of lockdown. Given the moderate economic outlook in the near term along with the low inflationary environment, it is imperative for the State Bank of Pakistan to take an expansionary stance on the monetary policy and reduce the policy rate by 50-100 basis points.

The year-on-year (YoY) general inflation has been declining since April 2021 and reached 8.35 percent in August 2021 which is almost identical to July's 2021 number i.e. 8.4 percent. However, the core inflation lowered to 6.3 percent in August 2021 on YoY basis as compared to 6.9 percent recorded last month. The State Bank of Pakistan has maintained the policy rate at 7.0 percent since May 2020 - the highest in the region, which has its own impact on cost-push inflation. The MPC decision in early COVID days to keep the policy rate lower than inflation had a salutary impact on keeping the economy afloat. Now that the inflation has been falling for the last couple of months and COVID is still relevant, it provides a strong basis for further lowering the policy rate to keep supporting industrial growth.

Key Highlights

- The State Bank of Pakistan slashed the country's policy rate and maintained lower policy rates to support the economy since the pandemic hit the economy. Amid the current moderate economic outlook and fall in inflation during recent months, monetary policy easing will help revive the economic activity.
- The general inflation measured by consumer price inflation on year-on-year (YoY) basis has been declining since April 2021 and reached 8.35 percent in August 2021 from 11.1 percent in April 2021.
- The core inflation on year-on-year basis for July and August 2021 were 6.9 percent and 6.3 percent respectively.
- Monetary policy survey reflects that participants surveyed are of the view that the policy rate should be decreased by 75-100 basis points.
- Imports were increased to USD 6.3 billion in August 2021 from USD 5.3 billion in July 2021, posted a growth of 18.9 percent. The level of monthly exports was however decreased to USD 2.26 billion in August 2021 from USD 2.34 billion in July 2021 exhibited a decline of 3.4 percent.
- Pakistan's current policy rate is 7.0 percent which is well above the regional peers. China, India, and Bangladesh have maintained their policy rates at 2.0 percent, 4.0 percent, and 4.8 percent respectively.

- Despite the overall adverse trend in the quantum index of large-scale manufacturing, volatile consumer and business confidence indices, the policy rate has standstill at 7 percent since May 2020.
- The policy rates were found to be negatively associated with the exchange rate, business confidence index, and loans to the private sector when measured over the period Jan-2020 to July-2021.
- Any increase in inflation in upcoming months will most likely be because of significant depreciation of Rupee against the US dollar. Exchange rate pass-through to inflation must not be managed through monetary policy tightening.

1. Introduction

Monetary policy is one of the key economic policies by which government authorities in a market economy influence to stabilize business cycle fluctuations. Stable and low inflation is generally the primary, if not exclusive, objective of the monetary policies across the world as well as in the case of Pakistan. The State Bank of Pakistan (SBP) Act, 1956 envisages monetary policy objectives as:

'whereas it is necessary to provide for the constitution of the State Bank to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources'

The SBP is mandated to regulate the monetary and financial system of Pakistan in order to foster economic growth in the best interest of the economy. It seeks to control inflation by influencing aggregated demand relative to productive capacity by changing short-term interest rates i.e. policy rates based on the overall economic outlook of the economy. The Monetary Policy Committee (MPC) of the State Bank of Pakistan sets out the policy rate six times a year in order to meet annual and medium-term inflation targets.

Since the last MPC meeting on July 27, 2021; the economic recovery has been moderated along with a continued decline in inflation. Imports were declined in July but increased in August 2021 and reached USD 6.3 billion whereas monthly exports were hovering around USD 2.2 billion in the last couple of months. The rupee lost its value by around 8 percent in the past four months and stretched to USD/PKR 166.3 by the end of August 2021. As opposed to the Pakistan Bureau of Statistics estimates of GDP growth rate i.e. 3.94 percent for the fiscal year 2021-22, the Economist Intelligence Unit (EIU) - The Economist estimated that the real GDP growth rate for Pakistan during the fiscal year 2021-22 was 3.2 percent. Similarly, the International Monetary Fund (IMF), in its World Economic Outlook April 2021 report, forecasted subdued economic growth of 1.5 percent for the year 2021. The World Bank contends that Pakistan's annual per capita growth has averaged by only 2 percent in the last two decades, which is less than half of South Asia's average. The economic growth is constrained by recurrent waves of COVID-19 and fiscal consolidation efforts.

Table 1 below presents some of the key economic indicators. Outstanding loans to the private sector amounted to PKR 6.5 billion in July 2021 showing a decline of 1.34 percent as compared to the previous month. The total liquid forex reserve account indicated a surge of around 10 percent as compared to the previous month with the reserves accumulated to USD 27.78 billion in August 2021. In addition, the trade deficit reached to USD – 4.05 billion in August 2021. National inflation measured by consumer price inflation (CPI) was recorded to 8.35 percent on year-on-year basis in August 2021 as compared to 8.4 percent in the previous month and 9.3 during the corresponding month last year. It must be noted that the YoY rural inflation is higher than that of urban inflation in August 2021.

Table 1:
Key Economic Indicators

Indicator	Aug-20	July-21	Aug-21
Exchange Rate (USD/PKR)	166.42	162.51	166.27
Loans to private sector (Outstanding, PKR Billion)	5,87	6.53	-
Total Forex Reserves (USD Billion)	19.84	24.77	27.22
Trade Deficit (USD Billion)	-1.73	-3.10	-4.05
Consumer Price Inflation - General (YoY, %)	8.2	8.40	8.35
Consumer Price Inflation - Urban (YoY, %)	7.1	8.7	8.3
Consumer Price Inflation - Rural (YoY, %)	9.9	8.0	8.4

Source: State Bank of Pakistan, Pakistan Bureau of Statistics

2. Monetary Policy Survey

The Policy Advisory Board – Federation of Pakistan Chamber of Commerce and Industry (FPCCI) has launched the monetary policy survey that aims to propose the direction to the State Bank of Pakistan for the upcoming monetary policy scheduled to be announced on September 20, 2021. Respondents of the survey include economists, financial market participants, and industry representatives. The questionnaire focuses on policy rate suggestion and expectation, inflation expectation, exchange rate regime, and current economic outlook. Results of the survey are summarized as follows:

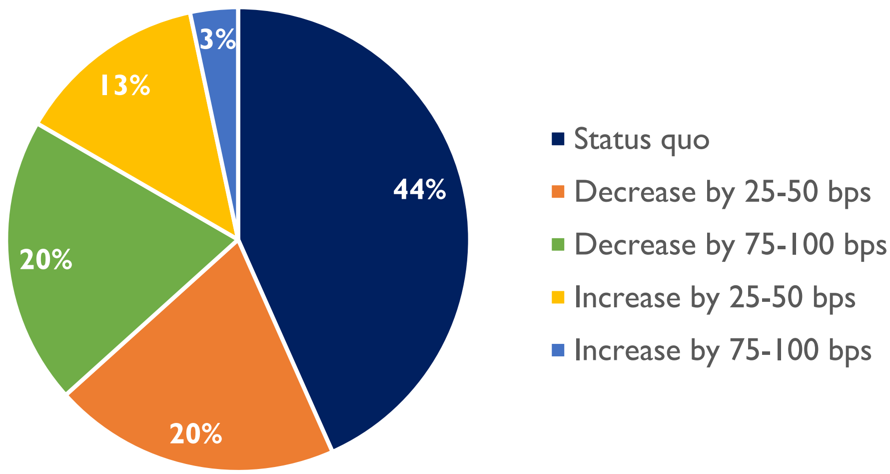
2.1. Policy Rate Direction

For the upcoming monetary policy, 40 percent of the participants surveyed are of the view that the State Bank of Pakistan should cut the policy rate. Decrease by 75-100 basis points is suggested by 20 percent of the participants whereas the same proportion of the respondents proposed 25-50 basis points reduction in policy rates. Around 44 percent of respondents advocated for the status quo in policy rate whereas only 16 percent are of the view to increase the policy rate. It must be noted that 'Status quo' was mainly suggested in line with the core inflation of 6.9 percent, however, it was declined to 6.3 percent in August 2021. Medium-term expectations for the policy rate by December 2021 are mixed. An increase in policy rates was anticipated by 32 percent whereas 29 percent of the participants expect the policy rate to decline. However, the majority believe that the policy rate would not be changed by December 2021.

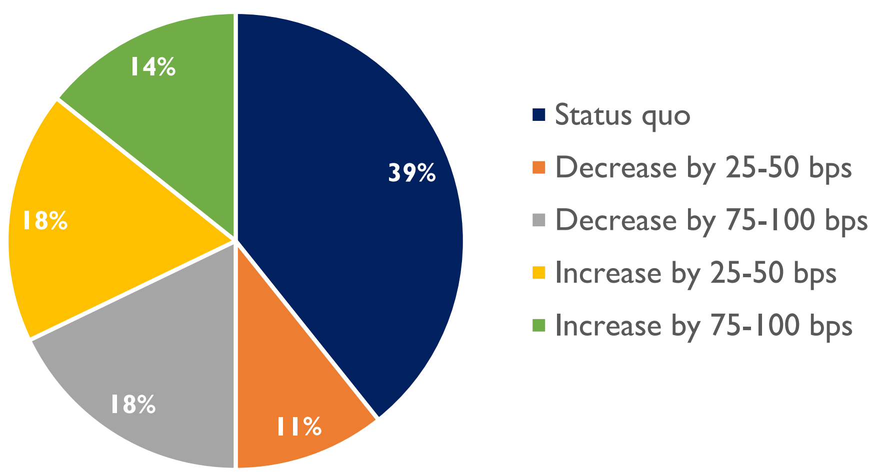
The major reason cited for the suggested cut in policy rate is to help increase economic activity. As COVID-19 is still relevant, funds available at cheaper rates will allow industries to expand.

Although inflation has been declining for the last couple of months however sharp deterioration in the value of the rupee against US dollars is expected to push the exchange rate pass-through to inflation. Any rise in inflation due to exchange rate deterioration must be considered as cost-push rather than demand-pull inflation.

What decision for the policy rate should be made in the upcoming monetary policy?



Where do you expect the policy rate by Dec 2021?

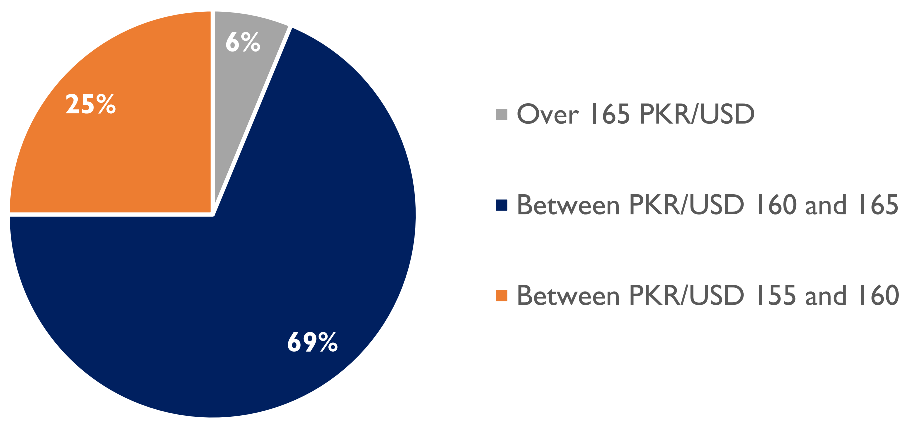


2.2. Exchange Rate Expectation

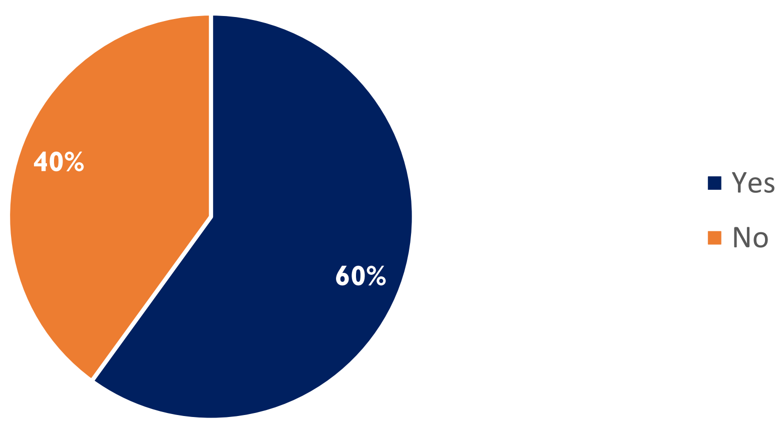
Regarding exchange rate expectation, around 69 percent of the participants surveyed believed that the rupee will remain in the range of 160-165 against US dollars by December 2021. Around 25 percent anticipated that the rupee will maintain its value over 155-160 and only 6 percent of the participants expected the exchange rate to move beyond 165 by December 2021.

The prevailing market-based flexible exchange rate regime was appreciated by the majority of the survey respondents. The advantage of flexible exchange rates is that it automatically removes disequilibrium in the balance of payments and helps prevent the balance of payment crisis. High volatility and instability in prices of imported products can be considered as the major downside of the flexible exchange rate regime.

Where do you expect the exchange rate by Dec 2021?

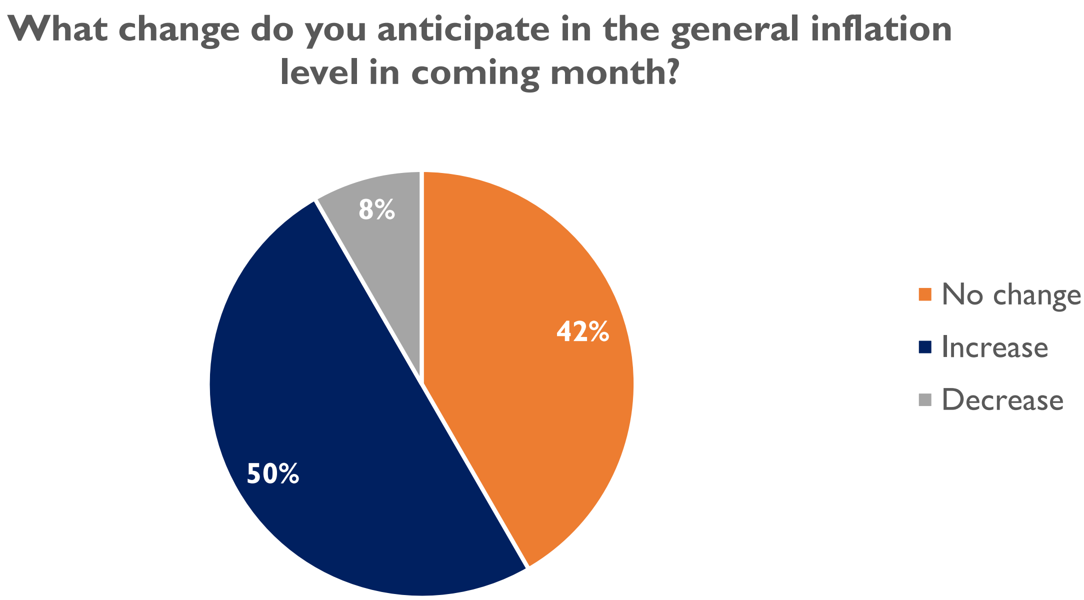


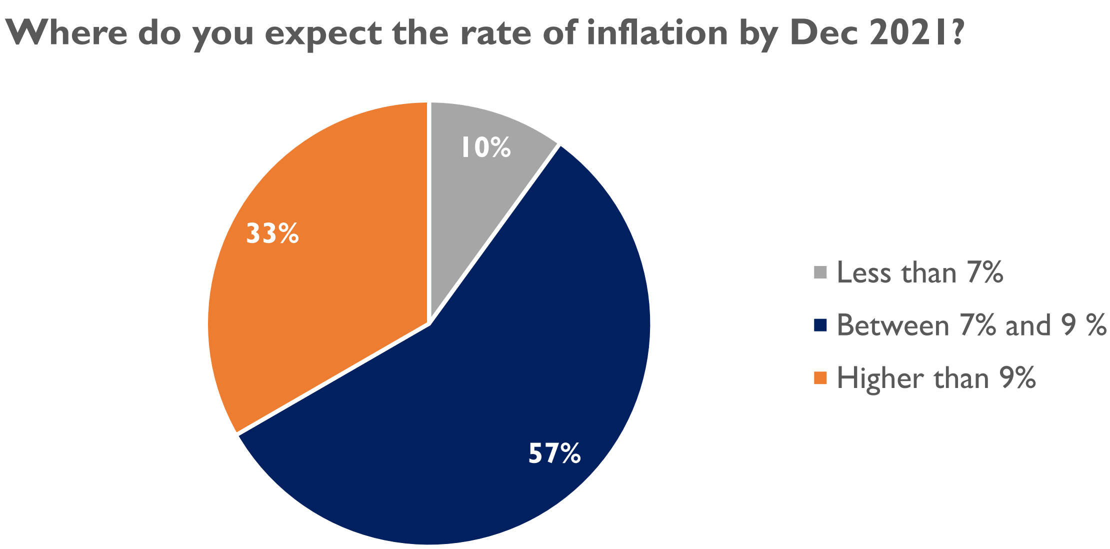
Does the prevailing market-based flexible exchange rate regime is appropriate for businesses?



2.3. Inflation Expectation

The majority of the survey respondents, i.e. 50 percent, were of the view that the level of general inflation is expected to increase in the coming months whereas 42 percent of the participants believed that inflation will sustain at the current level and only 8 percent anticipated decrease in inflation. In addition, around 57 percent of the respondents anticipated general inflation in the range of 7-9 percent whereas 33 percent perceived inflation to go beyond 9 percent and only 10 percent of the respondents conjectured a level of inflation below 7 percent.

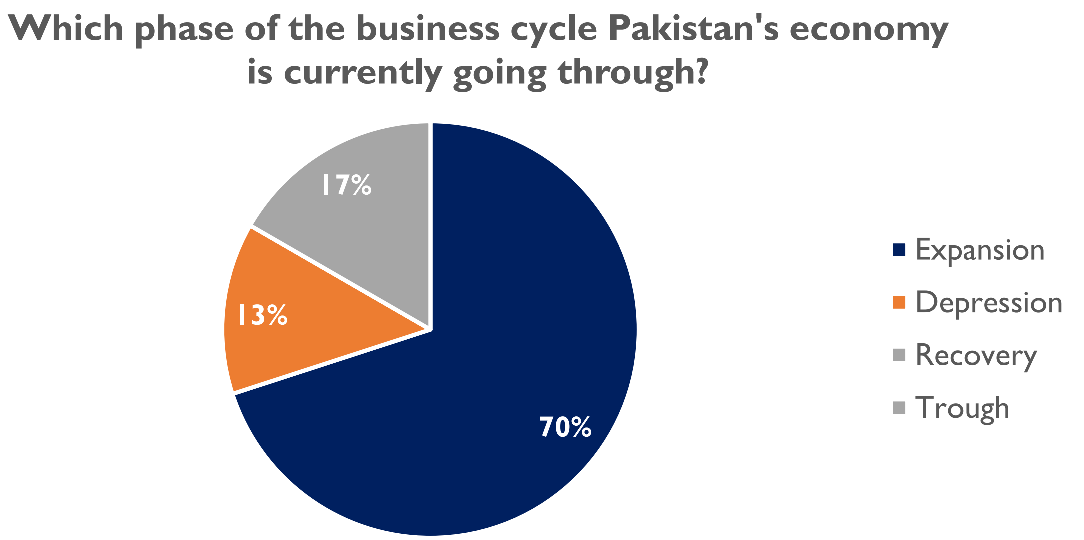


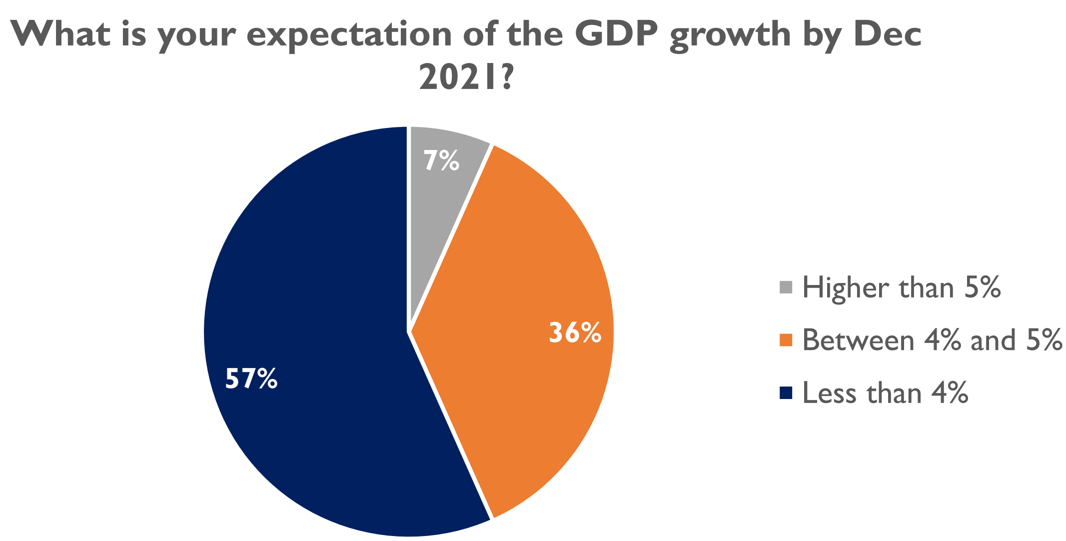


2.4. Growth Expectation

For business cycle positioning, around 70 percent of the survey participants were of the view that the economy is currently going through expansion whereas 17 percent believed that the economy is touching the bottom (trough) and 13 percent highlighted that Pakistan is currently facing economic depression. In terms of GDP growth rate, the majority of the respondents i.e. 57 percent expected that the real GDP growth rate would be less than 4 percent as opposed to the target set by the government i.e. 4-5 percent. The realization of the real GDP growth rate between 4-5 percent was believed by 36 percent of the participants. Only 7 percent of the participants surveyed were optimistic and conjectured that the real GDP growth rate would surpass the government's target of 4-5 percent.

Revival of global economic activities, export competitiveness due to cheap rupee, and fiscal stimulus were among the major reasons cited for expansion and meeting or surpassing the economic growth targets. On the contrary, uncertainties due to COVID-19, inflationary environment, and volatile exchange rate regime were impeding the economic growth as indicated by participants who believe in underperformance of the economy.





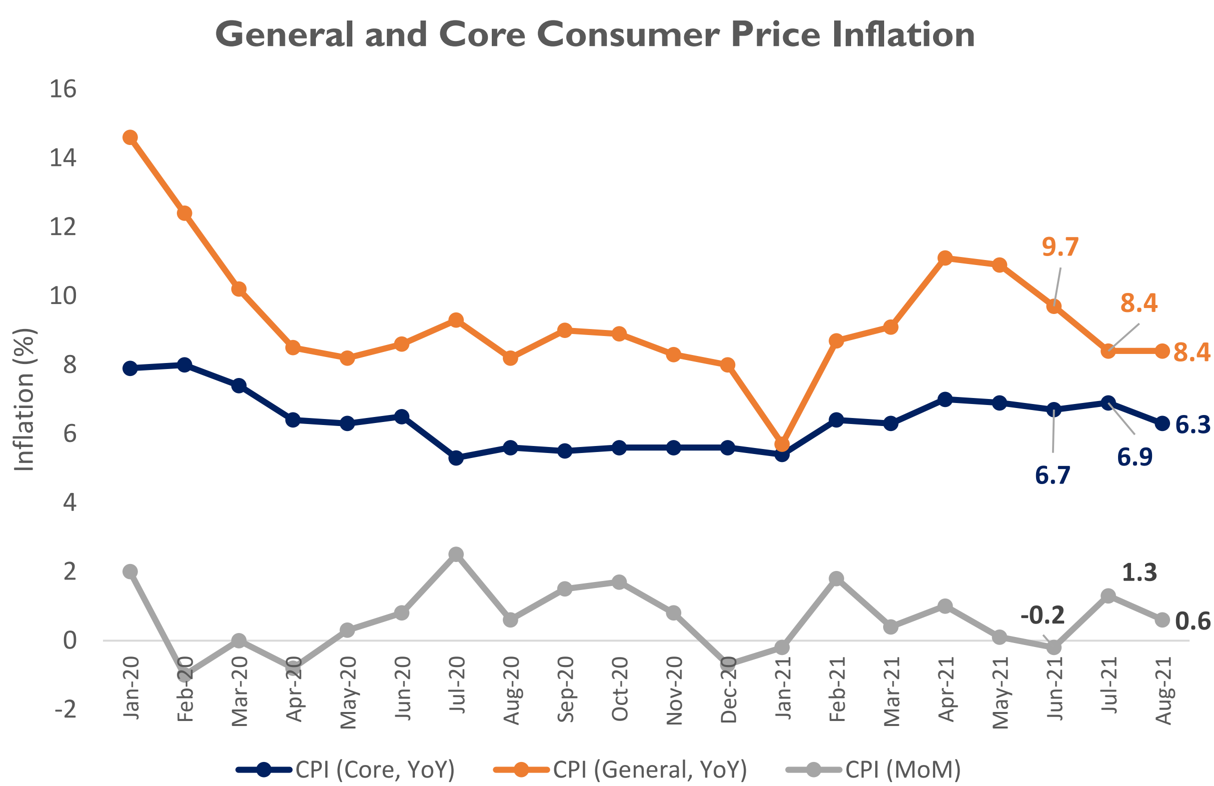
3. Trend Analysis

3.1. Inflation

The year-on-year (YoY) inflation based on Consumer Price Index (CPI) has been declining for the last three months and reached to 8.35 percent in August 2021. On month-on-month (MoM) basis, inflation was reported at 0.6 percent in August 2021. The decomposition of CPI on MoM basis for August 2021 reflected some notable characteristics. It is observed that 42 percent of the inflation was due to Food & Non-alcoholic Beverages. Housing, Water, Electricity, and Gas & Fuels accounted for around 22 percent of the inflation whereas Clothing & Footwear ranked third with its contribution of 10 percent to the inflation measured by CPI for August 2021.

The figure below presents the trend in CPI (general & core) on year-on-year as well as CPI (general) on month-on-month basis over the period January 2020 to July 2021. It is apparent that the general inflation on YoY basis has been declining since April 2021 and touched 8.35 percent in August 2021 – the lowest since January 2021. The CPI (core, YoY) is trending between 6.4 and 7.0 percent and reached to 6.3 percent in August 2021. However, CPI (general, MoM) exhibits a mixed trend with its value at 0.6 percent in August 2021.

Figure 1:
Trend in Inflation



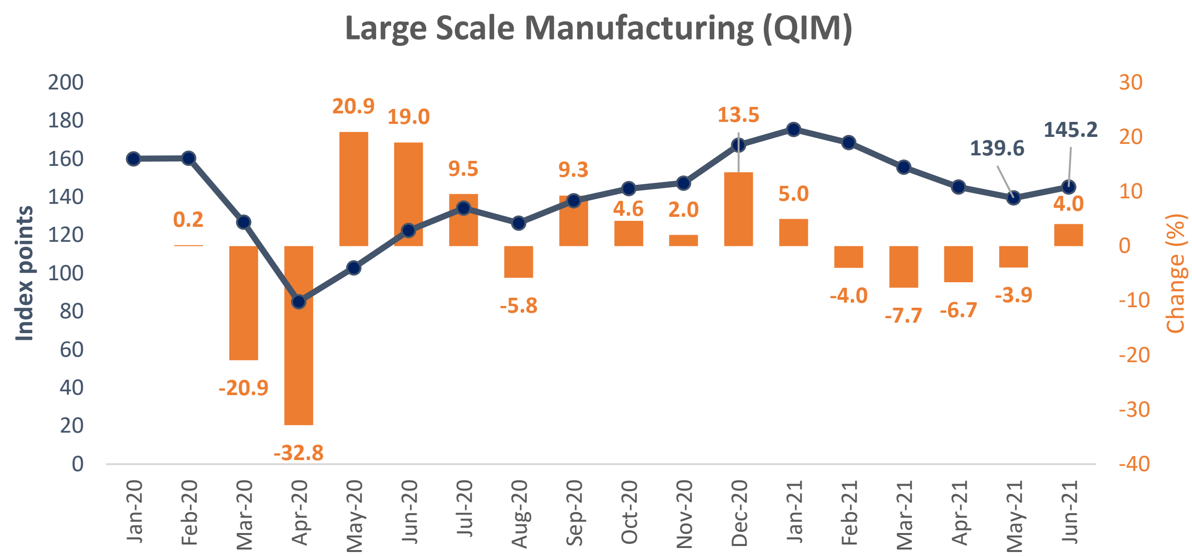
3.2. Industry

The quantum index of Large Scale Manufacturing Industries (LSMI), published by the Pakistan Bureau of Statistics, has been declining since January 2021 before a recent increase in June 2021.

The figure below presents the month-wise trend in QIM between Jan-2020 and June-2021 along with the monthly change.

The large-scale manufacturing contracted significantly during the first wave of COVID-19 with a decline of 32.8 percent in large-scale manufacturing index during April 2020. After a brief period of recovery between May 2020 and January 2021, the declining trend was resumed and continued before a recent increase of 4 percent in June 2021.

Figure 2:
Trend in Large-Scale Manufacturing

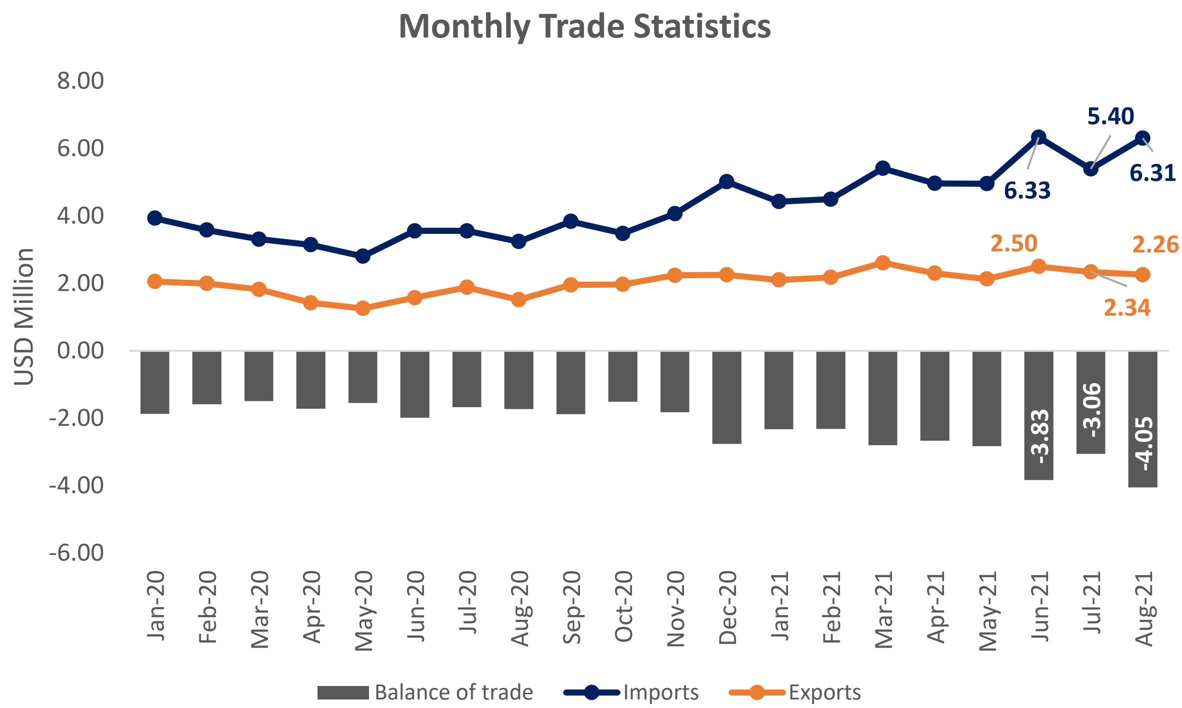


3.3. Trade Statistics

The trade deficit has been widening since the economy resumed recovery. Imports outpaced exports drastically in the last couple of months with the trade deficit stood at USD 4.06 billion in August 2021 which is the highest number in the last two years, the previous high was USD 3.77 billion in June 2018. The pickup in the economic activities combined with rising international commodity prices can be considered as the primary reasons for the huge import bills.

The figure below illustrates the trend in trade statistics. It is observed that monthly imports have been increasing and now reached USD 6.31 billion in August 2021 – the highest in the last two years. Monthly exports however have been hovering around USD 2.0 billion with the value of USD 2.3 billion in August 2021. The highest monthly trade deficit was observed in August 2021 since January 2020 with the deficit recorded USD -4.05 billion.

Figure 3:
Trade Statistics

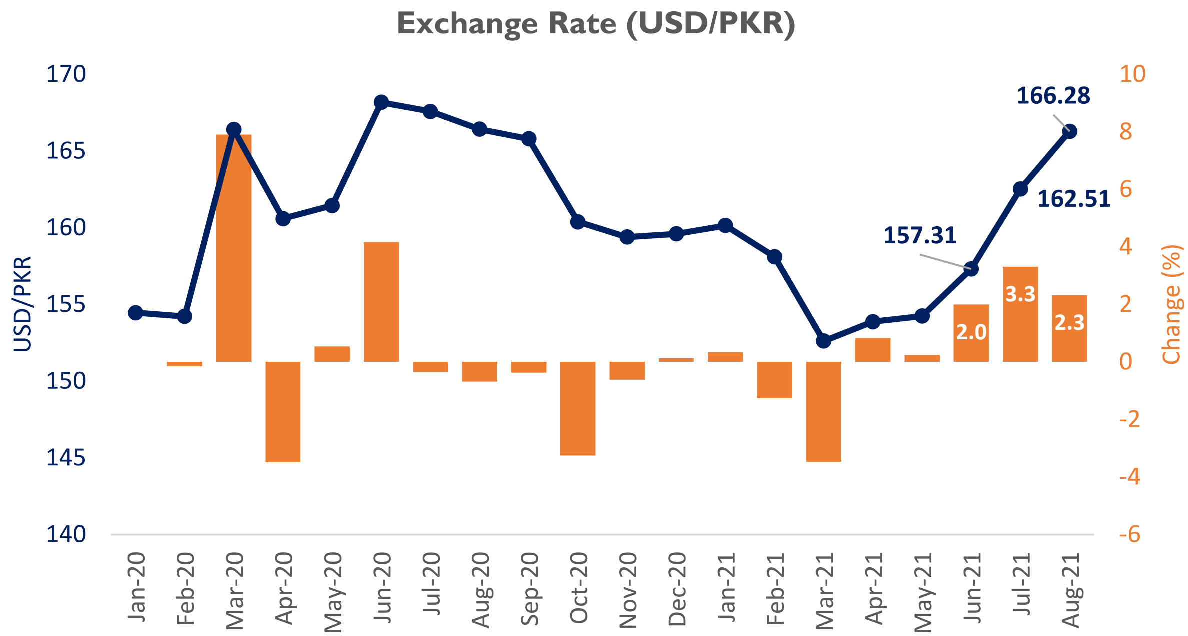


3.4. Exchange Rate

An abnormally fluctuating exchange rate tends to distort domestic market prices. The enormous depreciation of the rupee under the current political regime was followed by a very brief period of relative stability as long as the current account was in surplus. As the current account surplus turned into a deficit and widening of deficit amid mild economic recovery, the rupee started depreciating.

The rupee (PKR) has been losing its value against the US dollar since March 2021 whereas a steep decline was evident in the last three months. The value of PKR against US dollars has touched 166.28 in August 2021 as compared to 152.6 in March 2021 exhibiting a loss in value of around 9 percent.

Figure 4:
Trend in Exchange Rate

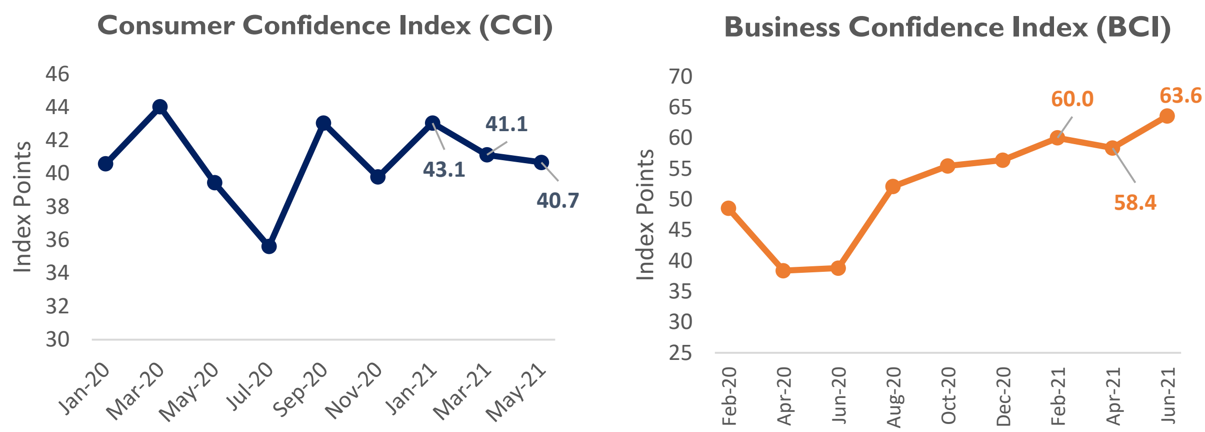


4. Consumer Confidence and Business Confidence Indices

The Consumer Confidence Index (CCI) and Business Confidence Index (BCI) are published by the State Bank of Pakistan at a bi-monthly frequency. The latest survey available for CCI and BCI are for the month of May 2021 and June 2021 respectively.

The panel (a) and (b) of the figure below present trends in consumer and producer confidence indices from January 2020 to June 2021. Consumer confidence has been deteriorating since January 2020 with some improvements in the latest survey held in July 2021. Overall CCI was increased by 8.5 percent in July 2021 with the overall decline in inflation expectation by 1.7 percent as compared to the previous survey held in May 2021. The overall business confidence in Pakistan has been improving since June 2020 and has shifted from negative territory to positive territory, the business confidence has reached the peak in July 2021 since the COVID-19 pandemic.

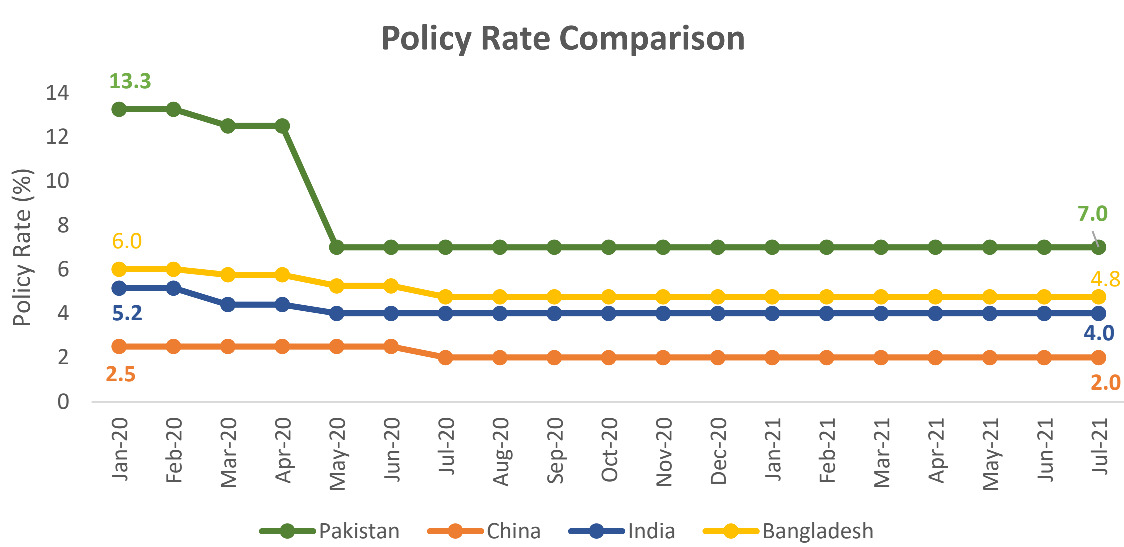
Figure 5:
Consumer and Business Confidence Indices



5. Policy Rates Comparison – *Pakistan's Position in the Region*

The global business landscape has changed substantially in a wake of COVID-19. Governments came forward with expansionary monetary and fiscal policies to mitigate the economic impact of the pandemic. Although the State Bank of Pakistan cut policy rate by 625 basis points from 13.25 percent to 7.00 percent however it is still well above the regional peers. It is shown in the figure below that China, India, and Bangladesh have maintained the policy rate of 2.0, 4.0, and 4.8 respectively till July 2021.

Figure 6:
Regional Comparison of Policy Rates



6. Correlation Analysis

The correlation among policy rate, exchange rate, consumer confidence index, business confidence index, large scale manufacturing index, and loans to the private sector are estimated for the period Jan-2020 to May-2021 and are presented in the correlation matrix below. Key findings of the correlation analysis are as follows:

- Policy rate appeared to be negatively correlated with the exchange rate. It suggests that any rise in policy rate attracts short-term foreign investment inflows (also called hot money inflows) which appreciates the value of the local currency but increases exchange rate volatility especially in the prevailing market-based flexible exchange rate regime.
- Negative association between business confidence index and policy rates suggests that surge in policy rates tends to distort business confidence.
- Loans to the private sector is also negatively correlated with the policy rate which implies that the rise in the policy rate discourages the borrowing for the private sector.

Table 2:
Correlation Matrix

	Policy Rate (%)	*Exchange Rate (PKR/USD)*	*Consumer Confidence Index*	*Business Confidence Index*	*Large Scale Manufacturing Index*	*Loans to Private Sector*
Policy Rate (%)	1.00					
Exchange Rate (USD/PKR)	-0.35	1.00				
Consumer Confidence Index	0.31	-0.26	1.00			
Business Confidence Index	-0.75	-0.15	0.06	1.00		
Large Scale Manufacturing	0.06	-0.26	0.25	0.38	1.00	
Loans to Private Sector	-0.25	-0.66	0.32	0.74	0.31	1.00

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Annexure - I

Table 3:
List of Respondents for the Monetary Policy Survey

S. No.	Name	Designation and Organization
1.	Mr. Mohammad Younus Dagha	Chairman, Policy Advisory Board - FPCCI
2	Dr. Hafiz A. Pasha	Professor Emeritus, Beaconhouse National University
3	Dr. Nadeem-ul-Haque	Vice Chancellor, Pakistan Institute of Development Economics (PIDE)
4	Dr. Shahida Wizarat	Dean, CESD, Institute of Business Management
5	Dr. Idrees Khawaja	Senior Research Economist, PIDE
6	Dr. Javed Iqbal	Professor, Institute of Business Administration
7	Dr. Atiq ur Rehman	Associate Professor, Kashmir Institute of Economics
8	Dr. Adnan Akhter	Chief Investment Strategist, Arch Global Advisors
9	Dr. Muhammad Atif Nawaz	Lecturer, The Islamia University of Bahawalpur Pakistan
10	Dr. Zeeshan Atiq	Assistant Professor, University of Karachi
11	Dr. Aqdas Afzal	Program Director and Assistant Professor, Habib University
12	Mr. Muhammad Sabir	Principal Economist, Social Policy Development Centre
13	Mr. Manzoor Hussain Memon	Head of Research, Manzil Pakistan
14	Mr. Raza Jafri	Head of Equities, Intermarket Securities
15	Mr. Imad Ansari	Head of Risk, Faisal Asset Management Limited
16	Mr. Syed Shabbir Sardar Zaidi, CFA	Head of Equity, UBL Funds
17	Mr. A A H Soomro, CFA, FRM	Managing Director, KASB Securities
18	Mr. Mohammad Yasir Khan	General Manager at Confidential
19	Mr. Shah Khalid	OG-II Officer, National Bank of Pakistan
20	Mr. Yasir Ali Shaikh	Assistant Vice President, Magnus Investments
21	Mr. Frasat Ali	Unit Head Investment Banking, Dubai Islamic Bank
22	Mr. Pir Muhammad Yaqub Chisti	Head of Economics Department
23	Mr. Sayyed Muhammad Bilal	Lecturer, National University of Modern Languages
24	Mr. Syed Monis Jawed	Manager - Risk Analytics and Economic Capital, Soneri Bank
25	All Pakistan Dry Fruits Import & Export Association	Manager, All Pakistan Dry Fruit Imp. & Exp. Association
26	Mr. Mirza Faizan Ahmed	Assistant Professor, NED University of Engineering and Technology
27	Mr. M. Muzzammil Huain	Secretary General - Towel Manufacturers Association of Pakistan
28	Mr. Sateesh Balani, CFA	Head of Research, Providus Capital
29	Mr. Mahmood Nawaz Shah	Member Policy Board - FPCCI
30	Ms. Rafia Riaz	Officer BRC, Rawalpindi Chamber of Commerce and Industry