MINUTES OF THE 5th MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on September 24, 2016

P R E S E N T

Mr. Ashraf Mahmood Wathra	Chairman & Governor SBP
Mr. Saeed Ahmad	Deputy Governor (FM, IB & SI)
Mr. Riaz Riazuddin	Deputy Governor (Policy)
Mr. Jameel Ahmad	Executive Director (FS & BSG)
Khawaja Iqbal Hassan	Director SBP Board
Mr. Ardeshir Khursheed Marker	Director SBP Board
Mr. Mohammad Riaz	Director SBP Board
Dr. Asad Zaman	External Member
Dr. Qazi Masood Ahmed	External Member
Dr. Aliya Hashmi Khan	External Member
Ms. Sahar Z. Babar	Secretary to the Committee/Corporate Secretary

Review of Current Economic Conditions and Outlook for FY17

1. Monetary Policy Department staff apprised the Committee on developments in key macroeconomic variables during the post-July 2016 Monetary Policy decision period, along with the assessment of evolving future trends.

2. The YoY CPI inflation increased to 4.1 percent in July FY17 and 3.6 percent in August FY17, from 1.9 percent and 1.8 percent in the respective months of the previous year. Average CPI inflation during Jul-Aug FY17 increased to 3.8 percent compared to 1.8 percent in Jul-Aug FY16. The 12-month moving average was recorded at 3.2 percent in August FY17 as compared to 3.6 percent in August FY16. Reviewing other measures of inflation, the YoY food inflation increased to 3.4 percent in August FY17 from 0.4 percent a year earlier. YoY non-food inflation increased to 3.7 percent in August FY17 from 2.8 percent in same period of the previous year. Thus, an increasing momentum can be seen in both the food and non-food measures. The pickup in YoY CPI inflation can be attributed to a combination of factors such as relative stability in global commodity prices, moderation in decline in prices of major food items and some increase in domestic demand. Core inflation, based on both NFNE and the 20 percent trimmed mean, increased during the year. Specifically, rising core inflation emanates from increasing house rents, rising prices of health expenses and personal equipment. Further, increase in prices of cotton cloth amid rising cotton prices also contributed to this inflation. However, major risk to this inflation trajectory in FY17 is seen in the uncertain global oil prices.

3. Credit to the private sector recorded seasonal retirement of Rs. 221.8 billion during Jul-Aug FY17 as compared to Rs. 79.4 billion in the previous year. Within credit extended to Private Sector Business (PSBs), the industrial and services sectors retired Rs. 138.0 billion and Rs. 24.7 billion respectively during the year. On the other hand, agriculture sector availed Rs. 4.5 billion during Jul-Aug FY17. The working capital retirement went up to Rs. 174.7 billion during Jul-Aug FY17 as compared to Rs. 76 billion retirement in the comparable period of the previous year. The Industrial sector retirement was Rs. 138.0 billion during Jul-Aug FY17 as compared to Rs. 61.6 billion in the

same period of the previous year. Credit for fixed investment, however, maintained its growth trend, increasing to Rs. 16.5 billion in Jul-Aug FY17 as compared to Rs. 12.7 billion recorded in the previous year. The weighted average deposit rates (WADR) on both outstanding and fresh deposits were also on a 10-year low in FY16.

4. Broad money (M2) followed the seasonal pattern of contraction during the period from July 1 – Sept 9 FY17. The decline in M2 growth was contributed by the contraction in both NDA as well as NFA of the banking system. It was the maturity of Rs. 1.3 trillion PIBs in July FY17 that mainly induced the government to borrow from SBP. Thus, government shifted its borrowing from scheduled banks to SBP. Currency in Circulation was recorded at Rs. 101 billion during the period July 1 – September 9, FY17 as compared to Rs. 262 billion in the comparable period of FY16. During the same period, the decline in Bank deposits of Rs. 237 billion is less than the decline of Rs. 407 billion in the comparable period of FY16.

5. External current account deficit was recorded at USD 1.3 billion during Jul-Aug FY17, compared to USD 686 million during the same period of the previous year. This higher deficit was largely due to the absence of CSF inflows during this period as compared to USD 337 million in the comparable period of the previous year and a USD 422 million higher trade deficit in Jul-Aug FY17 owing to increase in imports and decline in exports. Net FDI flows were recorded at USD 111 million in Jul-Aug FY17 as compared to USD 236 million in the comparable period of the previous year. Foreign Portfolio Investment flows recorded net inflows of USD 99 million in this period as compared to net outflows of USD 82 million in the same period of the previous year. The overall balance of payments posted USD 20 million deficit during the first two months of FY17. On a cumulative basis, SBP's net liquid reserves stood at USD 18.1 billion –sufficient to finance more than four months' of imports. Global economic conditions can readily be identified with uncertainty: subdued growth, elusive oil price, expected Fed interest rate hike, slowdown in Chinese economy, and aftermath of Brexit. All these factors carry repercussions for a small open economy like Pakistan. These uncertainties prevail upon international capital markets and international commodity markets and any adverse development in these markets will impact Pakistan. Although Pakistan has so far achieved macroeconomic stability and high accumulation of foreign exchange reserves, any adverse shock to international oil prices and continued dismal performance of exports can unfavorably impact the balance of payments position.

Financial Markets and Reserve Management

6. Since the last monetary policy review in July FY17, the overnight repo rate in the interbank market remained at 5.86 percent on average, against the policy (target) rate of 5.75 percent, mainly on account of volatility due to Eid-related cash withdrawals. Moreover, SBP's liquidity operations during this period were aimed at striking a balance between competing objectives i.e. achieving the policy rate and meeting the NDA target which resulted in slightly more variation between the overnight rate and the policy rate, as compared in the previous two months.

7. Liquidity injections have come down to Rs. 1.1 trillion from Rs. 2 trillion a few months back and this reduction is mainly attributed to the maturity of PIBs in July FY17. A changing pattern is seen in the first two months of FY17 as the government shifted its borrowings from scheduled banks to SBP. It was the maturity of Rs. 1.3 trillion PIBs in July FY17 that mainly induced the government to borrow from SBP and retire its obligation to the scheduled banks. Net government borrowings from the banking system increased to Rs. 359 billion during the period from July 1-Sept 9, FY17, as compared to Rs. 189 billion in the comparable period of the previous year.

8. Liquidity conditions, both in the money market as well as the foreign exchange market, remained broadly stable in the post July-FY17 monetary policy decision period. Subsequent to the status-quo stance in the July-FY17 decision, interest rates in both primary and secondary markets started to rise initially. This was mainly due to corrections in the yields as well as interest-rate bottoming-out sentiments; but the yields became stable subsequently.

9. Exports have declined by 15.4 percent in Jul-Aug FY17 as compared to the same period of the previous year while imports have increased by nearly 6.3 percent during this time. In view of the upcoming energy-related projects, credit demand from the private sector is expected to increase owing to prevailing low interest rates.

Model-Based Assessment

10. Research Department staff apprised the MPC on the latest projections of the customized version of the Forecasting and Policy Analysis System (FPAS).

11. The staff highlighted the incorporation of actual LSM data for June, 2016 underpinning the latest projections of the FPAS model. The FPAS projections presented to the MPC in July, 2016 used the forecast for LSM for June, 2016 instead of actual data which is only available with a time lag. The lower than expected performance of the LSM sector in June, 2016 led to a larger than anticipated LSM gap that also had an impact on the model-induced interest rate path relative to the path reported in July, 2016.

12. It was explained that even though the uncertainty emanating from some internal factors such as volatility in LSM data and differences in model and survey-based inflation expectations has come down to some extent, however, external sources of uncertainty such as the Brexit vote, mixed global growth signals and structural weaknesses of Pakistan's external sector remain unchanged and thus, to be prudent, the uncertainty related variable in the latest FPAS projections was kept unchanged at the same level as in July, 2016.

13. It was also explained that the model takes a medium-term view of the economy based on the annual targets to be achieved for inflation and economic growth. It was added that it is likely that the inflation projections from the FPAS model going forward may be revised downward on account of lower international crude oil prices, no foreseeable change in administered prices and improving inflation expectations.

14. Conditional on latest data and the now-casting of external and uncertainty variables, the FPAS model-induced interest rate path is lower than the earlier recommendation made in the July, FY17 MPC meeting. The average headline inflation forecast for FY17, with and without seasonal adjustment at 5.0 percent and 5.7 percent respectively, is still below the annual target level of 6 percent.

15. On the real side, lower than expected seasonal decline in the monthly LSM data over the fourth quarter of FY16 had widened the output gap, which is primarily driven by the increasing real exchange rate gap which continues to impact export competitiveness. This conclusion is also supported by some factors outside the FPAS model such as lower foreign investment, slowdown in workers' remittances' and uptick in the long-term yield; all of these factors are weighing down on the real side of the economy in the short-term. Notwithstanding, some leading factors such as: (i) increase in credit to the private sector, (ii) reserve money growth and (iii) uptick in CPEC related investments are expected to mitigate this trend for the sector in the medium to long-term.

16. Even though the real interest rate gap has narrowed due to substantial reduction in the policy rate over the last year and a half, the monetary conditions according to the model are still relatively tight mainly due to the persistent bilateral real exchange rate gap, which is unfavorable for export competitiveness and heightened economic uncertainties.

17. Keeping in view now-casting assumptions, medium term projections, lower than target inflation, increasing output gap, improving consumer confidence and lower inflation expectations, the model suggests a downward revision in the policy rate.

Monetary Policy Deliberations and Decision Vote

18. After the conclusion of the presentation, the staff responded to the queries of the members. Discussing deposit generation, it was apprised that the growth in deposits was 8.7 percent in FY16 as compared to 12 percent in FY15; however, a detailed analysis reflects that the deposits of private sector businesses grew by only 1.2 percent in FY16 which is considerably low as compared to 9.4 percent in FY15. This decline in the deposits of private sector businesses has resulted in the deterioration of the currency in circulation to GDP ratio from 9.3 to 11.3 percent in just one year.

19. It was also noted that last year, currency in circulation expanded by 30.5 percent as compared to 17.3 percent a year before, which reflects that the private businesses are using cash to settle their transactions. Factors contributing to this trend include low rate of return on deposits and imposition of withholding tax on banking transactions.

20. The MPC then voted on the policy rate decision. Deliberations led to formulation of views for maintaining status quo and reducing the policy rate by 25 bps.

21. Members voting for maintaining status quo gave more weight to factors such as: (i) slow growth of deposits and negative real rate of return on deposits, (ii) possible impact on the external sector (iii) the need to maintain stability.

22. Members voting for reducing the policy rate by 25 bps were of the view that there is still room for further reduction as the economy is responding well to monetary easing.

23. In conclusion, the Committee decided to keep the policy rate at the present level of 5.75 percent with a majority vote of 8 out of 10 members present, with 2 votes for reducing the rate by 25 bps.

The MPC decided as follows:

DECISIONS:

- *The policy rate is kept unchanged at 5.75 percent.*
- *The Monetary Policy Statement - September, 2016 is approved.*