MINUTES OF THE 4th MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on July 30, 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)
Mr. Zafar Masud	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

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-April 2016 Monetary Policy decision period, along with the assessment of evolving future trends.

2. Private sector credit with flow of Rs. 460.6 billion for FY16 was 11.5 percent higher than the preceding year and was over two-fold the 5 year average of Rs. 264.5 billion. Demand by the private sector businesses, as part of private sector credit, was at Rs. 383 billion, with the share of fixed and working capital loans at Rs. 171.7 billion and Rs. 211.6 billion respectively. Fiscal consolidation remained on track as budget deficit for FY16 was expected to meet the 4.3 percent target. Revenue collection efforts improved as the tax collected by FBR registered a growth of 19.9 percent, exceeding the average of 16.6 percent for the last 3 years. Continuation of monetary easing stimulated economic activities by a lowering of market interest rates indicated by KIBOR at around 6 percent.

3. Money supply in FY16 grew by 13.7 percent compared to 13.2 percent in FY15 which can be linked with higher private sector credit and some revival in aggregate demand. Growth in currency in circulation jumped to 30.5 percent in FY16 as compared to 17.3 percent growth in the previous year. Higher level of currency in circulation can be attributed to the imposition of withholding tax on bank transactions and other seasonal factors.

4. Balance of payments posted a surplus of USD 2.6 billion in FY16 that was similar to the one posted in the previous year, whereas the current account deficit decreased slightly to USD 2.5 billion from USD 2.7 billion last year. Despite slow growth in exports, workers' remittances supported the current account deficit. Trends in the external sector are likely to continue in FY17 where only modest recovery in exports is expected, mainly due to weak global economic conditions, though workers' remittances are expected to maintain positive growth despite their dependence on the economic health of Gulf countries. Financial and capital account mostly witnessed multilateral and bilateral inflows and the situation is likely to continue in FY17. Reclassification of Pakistan Stock Exchange in the Emerging Markets index by MSCI has triggered some increase in FPI and the trend is likely to strengthen in FY17. Despite maturing of the Extended Fund Facility by the IMF in

September 2016, inflows from ADB, World Bank and China under CPEC are expected to continue in FY17 which is likely to maintain the surplus in the balance of payments position and the upward trajectory in foreign exchange reserves.

5. The latest growth estimates at 4.7 percent for FY16 makes it the third consecutive year for annual growth to exceed 4 percent. This indicates that the Pakistan economy is out of the stagnation of the prior period. The GDP growth outlook for FY17 is buoyant with continued improvement in the factors responsible for increased growth in FY16.

6. Average CPI inflation declined to a 47 year low of 2.9 percent in FY16, which was also lower than the previous year's level of 4.5 percent and target of 6.0 percent. Core inflation, both NFNE and the 20 percent trimmed mean, also declined during the year. Lower inflation is attributed to low international oil prices and other commodities, stable exchange rate and ample supply of food items. Year on Year (YoY) inflation which had increased to 4.2 percent in April 2016, declined to 3.2 percent in May and June 2016. Upside risks to inflation for FY17 are seen in the likely increase in international oil prices, change in administrative prices of energy and pickup in aggregate demand; whereas, delay in clearance of the domestic food stock poses a downside risk.

Financial Markets and Reserve Management

7. Taking stock of market conditions, it was noted that the last decision of reducing the policy rate by 25 bps had strengthened market expectations of low interest rates to prevail, as evident from the relatively flattened yield curve where yield for the 10-year bond had dropped to 7.5 percent. The reduced policy rate, among other seasonal factors, required SBP to increase its liquidity injections which are now in the tune of Rs. 2 trillion. Despite some volatility due to Eid and close of the financial year in June, the overnight rate remained around 5.62 percent against the policy rate of 5.75 percent. International developments, especially Brexit, have diluted the expectations of any change in international interest rates.

8. Increase in advances for fixed investment and increased economic activity may result in further increase in imports, which has already consumed much of the savings from the lower oil import bill. Higher imports going forward may also be linked with increased government borrowings from the banking system and a higher level of currency in circulation. Foreign exchange reserves, despite being at a comfortable position, still have structural weaknesses as most of the improvements are attributed to inflows of a one-off nature. Prevalent stable exchange rate has distinguished the country from others in its peer group and could play a positive factor in attracting foreign investments.

Model-based Assessments

9. Research Department staff apprised the MPC about the latest projections of the customized version of the Forecasting and Policy Analysis System (FPAS). Prior to its presentation, the staff highlighted the importance of growth (5.5 and 5.7 percent for FY16 and FY17) and inflation (6.0 percent for both FY16 and FY17) targets as the new fiscal year starts, the importance of an interest-rate path for meeting these desired targets and also the importance of integrated, but calibrated, adjustments in the economy.

10. Before turning to the FPAS projections for July 2016, the staff also briefly discussed the evaluation of the policy suggestions from the FPAS model for FY16 in general and for May 2016 in

particular. It was noted that since the last monetary policy decision lower inflation, picking up of private sector credit and economic activities and the flattening of the yield curve for longer duration instruments - a must for long term investment in developing countries - indicates that the monetary policy stance is achieving its objectives.

11. Turning to the FPAS model projections, the staff first talked about the new information incorporated in the current set of projections. It was stated that FOMC projections for the US benchmark Federal Funds Rate and US inflation for 8 quarters has been incorporated in the model to improve now-casting of the external sector. On the domestic front, increased uncertainty was also accounted for by now-casting the relevant variables. Uncertainty increased due to: (i) impact of Brexit - as evidenced by fluctuations in UK Sterling, (ii) fluctuations in LSM growth, (iii) deviation in model-based inflation projections and survey-based consumer confidence, (iv) consumer anxiety reflected by lower consumer confidence index (IBA-SBP Survey) despite continued low inflation and (v) mixed global growth signals.

12. Conditional on the latest data and the now-casting of aforementioned variables, the FPAS model-induced interest rate path is marginally higher as compared to the path reported in the May 2016 MPC meeting. However, the broader output of the model still calls for moderation in the policy rate. Indeed, the average headline inflation forecast with and without seasonal adjustments at 4.9 percent and 5.7 percent respectively, is still below the annual target level of 6 percent. Average food inflation forecast for FY17 is inching up to 7.1 percent mainly reflecting an uptick of 12 percent in the international food index during Q4-FY16. Nonetheless, core inflation is expected to stay at a moderate level of 3.6 percent during FY17.

13. On the real side, the LSM gap remains wide given the mixed performance of the sector during the last three months of the recently concluded fiscal year. However, the LSM gap, which is a proxy for the output gap, is expected to get better in the short term on the back of increased private sector credit and increase in CPEC related investment. The projected widening of the LSM gap in the medium term is primarily driven by the real exchange rate gap which continues to impact export competitiveness.

14. Keeping in view now-casting assumptions, medium term projections, inflation at a level lower than the target, room for improvement in growth and a higher uncertainty pattern, the model suggests a moderate downward revision in the policy rate by Q1-FY17, however, the magnitude of the downward revision is smaller than previous estimates.

Monetary Policy Deliberations and Decision Vote

15. After the conclusion of the presentation, the staff responded to the queries of the members. It was explained that the relation between WPI and CPI can be observed over a longer period and such impact is not reflected in a given year. It was also explained that a direct relationship between inflation, money supply and growth hardly holds owing to structural changes in the banking sector. Discussing the external sector, it was noted that there is ample room for improvement in FDI, which has recently picked up, largely owing to CPEC related projects. The staff also explained that the FPAS model focuses on LSM output which in various studies has proved to be a feasible proxy for projecting GDP growth.

16. It was also discussed that the growth in currency in circulation, growth in reserve money at 26.5 percent and slower growth of bank deposits is driven by several factors besides the policy rate such as higher government borrowings, imposition of withholding tax on bank transactions, etc.

17. It was noted that the monetary easing had finally started to yield results, as evident by the picking up of private sector credit. It was also explained that the lag in monetary policy transmission in Pakistan is around 11 to 12 months.

18. At the conclusion of the staff presentations, the members shared their views and voted on the policy rate decision. Deliberations led to formulation of views for maintaining status quo and reducing the policy rate by 25 bps.

19. Members voting for maintaining status quo gave more weight to factors such as: (i) increase in currency in circulation and growth of broad money, (ii) increasing currency to deposit ratio and (iii) the need to maintain stability.

20. Members voting for reducing the policy rate by 25 bps were of the view that there is still room for further reduction in interest rates as the optimum level of the policy rate may not have been achieved.

21. 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 – July, 2016 is approved.*