Minutes of the Meeting of the Monetary Policy Committee
of the Central Board held at Karachi on 24th November, 2009

Meeting of the Committee of the Central Board on Monetary Policy (MPC) was held at SBP Main Building, Karachi on 24th November, 2009 at 9:30 am.

Present:

- Mr. Yaseen Anwar[1] — Chairman/ Deputy Governor, SBP
- Mr. Tariq Sayeed Saigol — Member/ Director of the Central Board
- Mr. Mirza Qamar Beg — Member/ Director of the Central Board
- Mr. Riaz Riazuddin — Member/ Chief Economic Advisor, Monetary Policy & Research, SBP
- Mr. Asad Qureshi — Member/ Executive Director Financial Markets & Reserve Management, SBP
- Dr. Hamza Ali Malik — Member/Director Monetary Policy, SBP

Mr. Aftab Mustafa Khan, Corporate Secretary, SBP attended the meeting as its Secretary.

Agenda Item No. 1: Leave of absence to members.

Corporate Secretary informed that Dr. Hafeez A. Pasha, External Member has requested leave of absence from MPC, which was granted. On a query, Corporate Secretary informed that the other External Member, Mr. Shahid Kardar requested not to be invited in this meeting of MPC as the matter relating to his being board member of Royal Bank of Scotland has not been resolved as yet.

Agenda Item No. 2: Monetary Policy Decision (December 2009 – January 2010)

Before turning to its monetary policy decision, MPC discussed domestic financial markets, macroeconomic outlook of the country including price stability, real sector developments, balance of payments position and fiscal scenario with emphasis on developments that have emerged since the previous monetary policy decision on 29th September, 2009.

Briefing on domestic financial markets, one member said that foreign exchange reserves position registered a steady growth in the 1st quarter FY10 followed by some depletion in the current quarter. As per earlier decision, interest rate corridor has been implemented successfully which has resulted in less volatile overnight money market rates. Average overnight year-to-date rates remained at 12.19 percent whereas the average overnight rates for September 2009 and current quarter were at 11.9 and 12.1 percent

[1] Chaired the meeting in the absence of the Governor, SBP.

respectively. Through improved liquidity management money market is showing positive signs and the injection requirements have been gradually brought down to Rs.80 billion from around Rs.160 billion in previous quarters which included the increased liquidity requirement due to Eid-ul-Fitr. However, the liquidity injections are again expected to rise to around Rs.150 billion due to extra cash requirement of around Rs.60-70 billion before Eidul-Azha. The extra withdrawals due to Eidul-Azha usually return back in the banking channel in about five to six weeks. He added that healthy trend in money market is also evident from demand for all tenures of T-bills and, on average, bids received were 2.4 times more than the targeted amounts. Moreover, in the current quarter, nominal maturities of T-bills of around Rs.35 billion are due with incremental amount over maturity between Rs.80-90 billion with three more auctions remaining. He informed that last T-bill auction was on 19th November, 2009 and, on average, cut off rates registered a reduction of 24 basis points on auction to auction basis with major shift in the cut-off rates of one year T-bill. He further explained that from Bank's point of view, sanctity of the auction volume is more important whereas bid rates are determined on the basis of current and expected liquidity situation. He added that net foreign assets, net domestic assets, external reserves, government borrowings are all within targets since September, 2009 onwards.

Another member briefed on the macroeconomic outlook of the country. He said that the broad economic picture is showing healthy trend which is evident from low year-on-year inflation of 8.9 percent in October 2009 and the projections for the year end inflation are from 11 to 11.5 percent even after incorporating some affects of forthcoming increase in the electricity price. A reassuring fact is that the number of items in the CPI basket showing higher monthly increases relative to historical benchmark has come down significantly from over 224 to 97. External account has also improved significantly and current account deficit has come down from USD 6.6 billion last year to USD 1.1billion in the comparative four months of the current year leading to reduction of its year end projection from six to below four percent of GDP. On the monetary side, government borrowings from the central bank are within targets and broad money growth is also around the projected 11 percent. Cumulative flow of credit to private sector has increased significantly in the past seven weeks to Rs.92 billion recovering from retirement of Rs.3 billion from the first nineteen weeks of FY10.

The member emphasized that closer examination of these indicators gives a mixed picture inviting caution and further analysis. For example month-on-month changes in headline inflation are consistently more than one percent that projects at 12 percent inflation on annual basis as a rule of thumb. At the same time as the number of commodities having persistent inflationary trends has increased, it raises likelihood of a second round of inflationary process and as a result average annual inflation may be entrenched and sticky at higher level of 12 percent. Fiscal deficit is also expected to be 0.9 percent more than the previous estimate of 4.9 percent and that may change the baseline assumptions of the inflation projections. However, as the official numbers in this regard are yet to be announced, the uncertainty remains. Similarly, availability of electricity together with its already announced increased prices, load management of natural gas etc. may subdue the nascent recovery in LSM output on the back of early signs of global economic recovery. On balance of payments front, there are uncertainties regarding financial accounts. Financing arrangements for even narrowing current account deficit are not certain as the same largely depends on resumption of foreign financial flows of which portfolio inflows have picked up, direct investment has fallen, and official inflows other than IMF remains lower compared to projections. Foreign exchange reserves are already showing decline from USD 11.2 billion in the last quarter to present USD 10.3 billion resulting in decrease in net foreign assets in the current quarter.

The member informed that on monetary side government borrowings are increasing as evident in the four auctions held so far in the current quarter through which government has picked up over Rs.91 billion against the maturity of Rs.37 billion. These borrowings are not only for budgetary support but also being used for the financing needs of public sector enterprises. Financing for commodity operations is not coming down as per past trend and is hovering around Rs.345 billion with emerging financing needs for the procurement of rice, paddy (cotton), and fertilizer. Additionally, private sector credit has also picked up which is a good news but raises challenges for liquidity management from the point of view of the Central Bank. He concluded that the challenge for MPC is to strike a balance between monetary and fiscal stability without adversely affecting the positive developments in the real sector.

Another member apprehended that it was more likely that fiscal deficit may escalate from existing projection of 4.9 percent leading to change in the underlying assumptions for projections of a number of other economic parameters. This expected increase in fiscal deficit is also linked with unplanned government expenditure due to law and order situation of the country. He explained that government's present plans to finance the expected increase in budget deficit are hinged on the magnitude and the timing of expected inflows that are currently uncertain. He added that there is also possibility that significant portion of foreign assistance may be provided in kind instead of cash and thus may be of lesser value in the fiscal context.

One of the members added that incase of heavy government borrowing from banking sector and uncertain external flows, there could be liquidity management issues. He further explained that last year there was 6.7 to 6.8 percent volatility in exchange rate. During the current year, the depreciation in PKR has been around 2.5 percent against USD and with additional 1-2 percent depreciation in case of other major currencies. He further explained that present exchange rate is fairly aligned with the local and foreign market conditions with slight inclination towards exporters which in turn also helps importers with ample availability of export proceeds in the market.

MPC then debated the various options and scenarios for likely change in policy discount rate. The scenario ranging from no-change in policy interest rate to decreasing it by 50, 100, and 200 basis points were discussed. It was understood that in case of no-change in policy interest rate the market interest rate can remain at present level if the expected inflows materialize latest by December 2009. Otherwise, it will be difficult for the market to maintain its present interest rates owing to possibility of liquidity shortage. If more than 100 basis points decrease in the aforesaid interest rate is announced, it will increase the overall demand which can put increased pressure on fiscal, monetary and balance of payments sectors. A decrease of 50 to 100 will cause a slight decrease in market interest rates which the market analysts have already predicted and such reduction will not be perceived as an unexpected decision. However, it was felt that decision taken should be consistent with assessment of forthcoming developments on fiscal side.

One member was of the view that conditions are probably not favorable enough to suggest any cut in policy discount rate owing to fiscal and potential liquidity constraints. He stated that financing for commodity operations stands at Rs.340 billion and retirement of this debt is at a slow pace with emerging need for financing additional procurements. In addition, while Year-on-Year inflation reflects a positive downward trend, Month-on-Month figures are not encouraging going forward. The fiscal deficit is wide and timing of inflows for budgetary support from the Friends of Democratic Pakistan to make up the shortfall is uncertain. Two members endorsed these views and opined that adverse movements on the fiscal side may necessitate reversal i.e. increase in the policy interest rate in the near future.

Two members were of the view that positive sentiments emerging in the market should not be prematurely snubbed on the basis of uncertainty of financial flows. One member emphasized on the dire need for improved management on fiscal side at this point of time in the interest of recovery of economy. One member added that, if necessary, financing of government deficit may be managed by using the allocations for the development programs as a last resort and there are also possibilities of other positive developments to materialize. They asked for likely impact on the market interest rate in case a reduction of 50 basis points in the policy interest rate is proposed and it was responded that the market seems to have already priced in a 50 basis point cut.

The Chairman then invited members to vote for one of the following options:

Recommend to the Central Board to keep policy interest rate unchanged at 13 percent

or

Recommend to the Central Board to reduce policy interest rate by 50 basis points to 12.5 percent

Three members of MPC voted in favour of the recommendation to keep the policy interest rate unchanged whereas other three members voted for the recommendation to reduce the policy interest rate by 50 basis points. The Chairman opted not to exercise his casting vote. The Committee was unable to reach on a majority recommendation for monetary policy decision and agreed to take the analysis for the consideration of the Central Board for further debate and final decision.

The draft of incomplete monetary policy decision statement i.e. without the concluding paragraph, that incorporates the monetary policy decision, was circulated. The Committee reviewed the commentary on the macroeconomic outlook of the country given in the draft of incomplete monetary policy decision statement and advised certain improvements.

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Chairman
(Yaseen Anwar)
17-12-2009