MINUTES OF THE 3rd MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on May 20, 2017

P R E S E N T

Mr. Riaz Riazuddin	Chairman & Acting Governor SBP
Mr. Inayat Hussain	Executive Director (FS & BSG)
Dr. Saeed Ahmed	Chief Economist
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
Mr. Tariq Jamil Farooqi	Acting Secretary to the Committee

Review of Current Economic Conditions and Outlook for FY17

1. Monetary Policy Department staff apprised the Committee on developments in key macroeconomic indicators since the March, 2017 Monetary Policy decision, along with the assessment of evolving trends.

2. The YoY CPI inflation increased to 4.8 percent in April FY17 from 4.2 percent a year earlier, whereas average inflation during Jul-Apr FY17 increased to 4.1 percent as compared to 2.8 percent in the same period of the previous year. The 12-month moving average was recorded at 3.9 percent in April FY17 as compared to 2.9 percent in April FY16. Food inflation on YoY basis increased by 4.4 percent in April 2017, as compared to 4.7 percent in April 2016, while YoY non-food inflation increased to 5.1 percent in April 2017 from 3.8 percent in April 2016. The increasing trend in inflation is evident from almost all indicators and is broadly reaffirmed by similar indications in core inflation measures as YoY NFNE inflation increased to 5.5 percent in April FY17 from 4.4 percent in the corresponding month of the previous year, whereas the 20 percent trimmed-mean inflation on YoY basis increased to 4.8 percent in April FY17 from 3.8 percent in April FY16. These trends could be attributed to the increase in real income and domestic demand although they are also cost driven, as the House Rent Index which contributes 28.1 percent in the CPI basket, recorded a growth of 6.9 percent in April 2017 as compared to 5.7 percent growth in the same period of the previous year. Increase in the administrative prices of petroleum products and seasonal increase in prices of perishable food items are other factors for the cost push part of the increase in inflation. Despite this increasing trend, headline inflation would still fall below its target of 6 percent in FY17.

3. Private sector borrowing increased to Rs. 438.6 billion in Jul-Mar FY17 as compared with Rs. 323.4 billion availed in the previous year during the same period. The increase in credit during the current year was both for working capital and fixed investment purposes. Credit to private sector businesses also recorded a significant increase as it stood at Rs. 354.8 billion for Jul-Mar FY17 as compared to Rs. 294.8 billion in the same period of the previous year. Lending to private sector included a sizable increase for the sugar sector while lending to the textile sector witnessed moderate growth. Personal credit is another contributor in the increased lending to

the private sector as consumer financing increased by Rs. 63.9 billion in Jul-Mar FY17 as compared to Rs. 19.6 billion during the same period of FY16.

4. Monetary expansion remained moderate with a cumulative growth of 7.0 percent during July 1 to April 28, FY17 compared to a growth of 6.1 percent during the same period of the previous year. The YoY growth until April 28, 2017 was 14.7 percent as compared to 12.7 percent last year. Higher current account deficit and lower than anticipated official inflows resulted in NFA contraction which was offset by substantial growth in NDA to record higher monetary expansion in the current year in comparison with the previous year. Expansion in NDA was led by higher government borrowing from SBP that increased to Rs. 865 billion during July 1 to April 28, FY17 as compared to retirement of Rs. 138 billion in the same period last year, in addition to increased flow of credit to the private sector. Lending to public sector enterprises (PSEs) also increased to Rs. 209 billion in Jul-Apr FY17 as compared to Rs. 32 billion in the same period of FY16. Flow of currency in circulation at Rs. 174 billion during Jul-Apr FY17 was lower than the flow of Rs. 472 billion last year while bank deposits increased significantly with YoY growth of 14.3 percent on Apr 28, FY17 as compared to 9.1 percent growth in the same period of FY16

5. The budget deficit increased to 3.7 percent of GDP in Jul-Mar FY17 in comparison with 3.3 percent in Jul-Mar FY16. Higher budget deficit was led by both lower growth in revenues and higher expenditure. The FBR revenue witnessed growth of 7.5 percent during Jul-Mar FY17 as compared to 18.5 percent growth in the same period of the previous year. Increased current expenditure contributed to the overall increase in total expenditure that grew by 10.4 percent in Jul-Mar FY17 as compared to 6.4 percent in the same period of the previous year.

6. External current account deficit increased to USD 7.2 billion in Jul-Apr FY17 which is even higher than the full year deficit of USD 3.4 billion for FY16. Higher current account deficit was mainly driven by deteriorating trade balance along with almost stagnant growth in workers' remittances. Trade deficit has been driven by 18.7 percent growth in imports for Jul-Mar FY17 as compared to 4.4 percent growth in the same period last year, while exports declined by 3.1 percent in the first nine months of FY17, over and above the 13.0 percent decline recorded in the same period of the previous year. Higher imports included 41.9 percent growth in import of machinery, mostly for power generation, along with 27.5 percent growth in petroleum, gas and allied products. Major decline in exports was registered in food products while growth of value-added textile products showed some signs of improvement.

7. Real sector activities remained mostly buoyant as provisional growth for FY17 has been announced at 5.28 percent, which is well above the growth rate of 4.7 for FY16 and exceeded the growth rate of the last 10 years. Higher growth was possible due to better performance of the agriculture sector which grew by 3.46 percent against growth of 0.27 percent for FY16, in addition to the manufacturing sector which attained 5.27 percent growth against 3.66 percent growth in FY16.

Financial Markets and Reserve Management

8. The staff informed the MPC that the overnight rate hovered close to the policy rate of 5.75 percent since the monetary policy review in March 2017. Average overnight interbank repo rate for the period was 5.81 percent, showing improved implementation of the monetary policy stance. Liquidity injection was around Rs. 1.2 trillion during March 27 – May 17, 2017 in comparison with Rs. 2 trillion in the comparable period of FY16. This trend shows increased

government reliance for raising financing from SBP that consequently provided more room for banks to provide credit to the private sector. The shape of the yield curve since the last monetary policy decision has not changed significantly which shows that market expects interest rates to remain stable despite the balance of payments situation and some increase in inflation, which reflects higher confidence in the economy.

9. External account situation remained under pressure as current account deficit for Jul-Apr, 2017 swelled to USD 7.2 billion against a deficit of USD 2.4 billion for the same period last year. At the same time, capital and financial inflows, owing primarily to delays in realization of planned official external inflows, fell short of expectations and proved insufficient to finance the increased current account deficit that become more pronounced during Jan-Apr 2017. As a result, some pressure in the market has been witnessed and foreign exchange reserves have declined. Increasing trend in LIBOR is continuing which is likely to pose difficulty for local banks to bring in liquidity from overseas.

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 MPC was informed about the main assumptions of the FPAS model which includes assumptions on oil prices, the latest FOMC projections for the US Federal Fund rate path and US inflation for the next 8 quarters, in addition to now-casting of headline, food and core inflation for June-2017. In terms of oil prices, it was stated that they will continue to be range-bound and in terms of normalization of US economy it was informed that increase in US Federal Fund rate is going to be slower than previously anticipated. It was noted that both these factors go in favour of the Pakistan economy. In addition, the MPC was also informed that the risk premium was kept at a moderate level due to uncertainty in light of: (i) UK elections and Brexit process, (ii) start of policy changes by the new US administration, (iii) French elections, and (iv) continued weaknesses in the external sector.

12. In terms of FPAS projections, average headline inflation for FY17 for both Seasonally Adjusted and Not Seasonally Adjusted have been revised upwards to 5.1 percent and 4.3 percent from 3.8 percent for both reported in the last MPC meeting. The pickup in food and core inflation explains this recent uptrend in inflation. However, even after the upward revisions, the projected average headline inflation level continues to remain below the target level of 6 percent for FY17. The average core inflation projection has been revised to 5.3 percent for FY17 which is slightly higher than 5.2 percent reported earlier.

13. Turning to the real sector, higher than expected improvement in the LSM sector during the last few months, based on the buoyant performance of few sub-sectors, such as sugar, automobile, iron & steel products, electronics, etc. resulted in noticeable growth in industrial sector. Encouragingly, textiles and fertilizers have also started to show some signs of improvement. The uptick in the credit to the private sector and CPEC related investments are some of the factors contributing towards this recent better performance in LSM.

14. In order to further elaborate on this trend, a detailed analysis of trends in LSM was presented that included comparison of the ratio of the overall growth in LSM in Jul-Mar FY17 with overall growth in Jul-Mar FY16 for its various sub-sectors. This comparison was also presented in relation to the ratio of cumulative flows of credit to these sub-sectors during Jul-Mar FY17 and

Jul-Mar FY16. On comparing these trends with imports and exports, it was noted that most of the growth in LSM is catering to domestic demand.

15. Conditional on above assumptions and latest available data, the FPAS model-induced interest rate path shows a smaller interest rate cut than the March 2017 recommendation, showing reduced room for further lowering the policy rate. This reduced room for moderation in the current policy rate is mainly due to some increase in average headline inflation and growth projections relative to targets for FY17.

Monetary Policy Decision Vote

16. On the conclusion of the presentation, the staff responded to the queries of the members.

17. Discussing the balance of payment situation, the Committee highlighted the need to examine the utilization of higher import of petroleum products as it may lead to higher output, if consumed for power generation. It was noted that the higher GDP growth is expected to raise the income level and domestic demand which is exerting pressure on inflation. The Committee also advised to seek the impact of remittance originating from e-commerce based exports. It was also advised to submit a brief on bank's profitability for the information of the Committee.

18. Concluding the deliberations, the members voted on the policy rate decision.

19. The MPC was unanimous in its decision to maintain the policy rate at its current level, in view of: (a) external account situation, (b) rising trend in inflation, (c) increase in private sector credit at the prevalent interest rates and (d) the need to maintain stability.

In conclusion, the MPC decided as follows:

DECISIONS:

- *The policy rate is kept unchanged at 5.75 percent.*
- *The Monetary Policy Statement – May, 2017 is approved.*