MINUTES OF THE 4th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on July 22, 2017

PRESENT

Mr. Tariq Bajwa	Chairman / Governor, SBP
Mr. Riaz Riazuddin	Deputy Governor (Policy)
Mr. Jameel Ahmad	Deputy Governor (FM, IB & SI)
Mr. Inayat Hussain	Executive Director (FS & BSG)
Khawaja Iqbal Hassan	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. Mohammad Mansoor Ali	Secretary to the Committee/Corporate Secretary

Review of Current Economic Conditions and Outlook for FY18

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

2. CPI inflation slightly increased to 3.9 percent in June FY17 from 3.2 percent a year earlier on YoY basis, whereas average inflation during FY17 increased to 4.2 percent as compared to 2.9 percent in FY16. Food inflation, on YoY basis, increased to 2.4 percent in June FY17, as compared to 2.3 percent in June FY16, while YoY non-food inflation increased to 5.0 percent in June FY17 from 3.8 percent in June FY16. The increasing trend in inflation, albeit moderate is reaffirmed by similar indications in core inflation measures. YoY NFNE inflation increased to 5.5 percent in June FY17 from 4.6 percent in the corresponding month of the previous year, whereas the 20 percent trimmed-mean inflation on YoY basis increased to 4.2 percent in June FY17 from 3.7 percent in June FY16. These trends could be attributed to an increase in domestic demand supplemented by CPEC related activities and house rent, which has a significant impact on inflation owing to its 21.8 percent share in the CPI basket. Meanwhile, adequate supply of major food items, only partial pass-through of recovery in global oil price to domestic consumers, and un-changed government administered power tariffs contributed to an overall benign inflation environment. Average CPI inflation is projected to be in the range of 4.5 – 5.5 percent in FY18. This projection is explained by lower than anticipated increase in international oil prices, recent behavior of CPI inflation in June 2017, stable administered prices and lower inflationary expectations.

3. Monetary expansion, as of 30th June 2017 Monetary Survey, remained moderate with cumulative growth of 13.7 percent in FY17 which is similar to FY16. Higher than budgeted official inflows could not offset the current account deficit resulting in a NFA contraction in FY17. This contraction was more than counterbalanced by a substantial growth in NDA. Three features explain this NDA growth. First, government budgetary borrowing shifted from scheduled banks to SBP. The borrowing from SBP increased to Rs. 908 billion during FY17 compared to a retirement of Rs.

[1] Meetings are numbered on a calendar year basis.

487 billion in FY16. Second, net lending to public sector enterprises also increased to Rs. 355 billion in FY17 as compared to Rs. 109 billion in FY16. Third, in line with economic growth, private sector credit saw almost a decade high net expansion of Rs. 748 billion in FY17 as compared to an increase of Rs. 446 billion in FY16. The increase in credit during the current year was for both working capital and fixed investment purposes across almost all subsectors surpassing their growth in FY16. To delve further, credit to private sector businesses recorded a significant increase as it stood at Rs. 625 billion for FY17 as compared to Rs. 394 billion in the previous year. Moreover, lending to private sector included a sizable increase for the food products and beverages 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. 70 billion in FY17 as opposed to Rs. 26 billion in FY16.

4. On the liability side, the flow of currency in circulation increased by Rs. 577 billion during FY17 -lower than the flow of Rs. 779 billion in the last year. Moreover, bank deposits mobilization increased significantly to Rs. 1,175 billion in FY17 as compared to flow of Rs. 759 billion in FY16.

5. On the monetary aggregates front, bank deposit mobilization together with historically high credit extension imply improved bank intermediation to the private sector. These trends are likely to persist in FY18.

6. The revised budget deficit decreased to 4.2 percent of GDP for FY17 in comparison with 4.6 percent in FY16. 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.

7. The staff indicated that the global economy is gradually recovering with advanced economies largely maintaining their accommodative monetary policies. Increasing consumer confidence is expected to maintain the pace of recovery in these countries during 2017/18. Prospects of stronger international prices of key commodities such as cotton, wheat and rice are expected to favour Pakistan's balance of trade together with the continuing lower oil prices. On the other hand, higher prices of tea and lower international price of sugar could partially offset some of these gains.

8. External current account deficit increased to USD 12.1 billion in FY17 as compared to deficit of USD 4.9 billion in FY16. Higher current account deficit was mainly driven by deteriorating trade balance in addition to a decline of 3.1 percent in workers' remittances during FY17. Trade deficit for in FY17 increased to the highest level in the last 11 years to USD 26.9 billion, registering 39.5 percent increase over the preceding year, despite the fact that deceleration in exports has reduced to 1.3 percent YoY in FY17 from 8.8 percent in the comparable period of FY16. The large trade deficit was driven by 17.7 percent growth in imports in FY17 as compared to a decline of 0.2 percent in the same period last year. Higher imports were primarily driven by higher import of capital goods, apart from increase in import of petroleum, gas and allied products. On the exports side, there are signs of improvement in export of certain food items and value added textile products. Going forward, despite some increase in exports, the current account deficit is expected to remain a challenge.

9. 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 4.5 percent 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. The performance of services sector also remained robust at 6.0 percent as compared to 5.5 percent in FY16 mainly due to activities in real sector that particularly spurred growth in trade, finance and insurance. The healthy trends in growth are likely to continue to achieve growth target of 6.0 percent for FY18.

Financial Markets and Reserve Management

10. 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 May 2017. Average overnight interbank repo rate for the period was 5.8 percent, despite increased volatility during the same period due to fiscal year end liquidity flows. Average OMO injections increased during the last two months to Rs. 1.4 trillion from Rs. 1.2 trillion. 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 challenges in the external sector and some increase in inflation, which reflects positive market sentiments. The yields in the primary and secondary market remained broadly stable, though there was minor decrease in 10 year securities due to limited supply of the paper.

Model-Based Assessment

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

12. The MPC was informed about the main assumptions of the FPAS model which includes assumptions on oil prices for the next quarter, the latest FOMC projections for the US Federal Funds rate path and US inflation for the next 6 quarters, in addition to now-casting of headline, food and core inflation for the end of first quarter FY18. The staff also informed that latest data for LSM has been incorporated in the model and shared forecasts based on previous and new data. The latest data on LSM was also used to update the 3-month average LSM as a proxy for quarterly GDP in the model.

13. In terms of FPAS projections, average headline inflation for FY18 is expected to be 5.0 percent with core inflation showing an upward trajectory. Despite the increasing trend, YoY inflation for June 2017 turned out to be lower at 3.9 percent against the trend seen in previous months. The lower inflation for June 2017 however can be attributed to relatively more volatile food inflation.

14. On the real sector, a greater than expected improvement in the LSM sector was witnessed during the last few months. The growth in LSM was fairly broad based contrary to earlier trends when this was primarily based on the buoyant performance of a few subsectors. Further, this growth trend in LSM has extended to post March period of this year, contrary to past trend where it usually subsides during the last quarter of a financial year. This continuation of upward trajectory of LSM in the last two months indicates robustness of the growth trend. The uptick in credit to the private sector and CPEC related investments are the main factors for this sustained improvement in LSM.

15. Conditional on above assumptions, now casting and latest available data, the FPAS model-induced interest rate path shows a smaller interest rate cut than the May 2017 recommendation, showing reduced room for further lowering the policy rate.

Monetary Policy Deliberations and Decision Vote

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

17. Discussing the real sector, the Committee briefly discussed sectoral weights where it was noted that PBS is in process of rebasing GDP and the data for the next year is expected to be based on the revised criteria. It was noted that export of a number of items has increased quantitatively but export proceeds are still low due to lower international prices of these items. The need for promoting economic activities focusing on demand in external markets was also underscored as presently output is mostly accommodating domestic demand. It was also explained that an estimated 13 percent increase in cultivation area for cotton crop together with other incentives such as lowering of sales tax and custom duty on agriculture related inputs are expected to raise agriculture output in FY18.

18. After conclusion of the presentation and the discussion with staff, the MPC 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 the need to maintain stability and contain inflation below the target.

20. Member voting for reducing the policy rate by 25 bps were of the view that there is still room for further reduction of the policy rate to support growth and boost investments.

21. In conclusion, the Committee decided to maintain the policy rate at its present level of 5.75 percent with a majority vote of 8 out of 9 members present, with 1 vote for reducing the rate by 25 bps.

22. The Committee then reviewed the draft Monetary Policy Statement and advised some amendments.

23. The MPC decided as follows:

DECISIONS:

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