MINUTES OF THE 2nd MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on March 25, 2017

P R E S E N T

Mr. Ashraf Mahmood Wathra	Chairman & Governor SBP
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
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 indicators since the January 2017 Monetary Policy decision, along with the assessment of evolving trends.

2. The YoY CPI inflation increased to 4.2 percent in February FY17 from 4.0 percent a year earlier, whereas average inflation during Jul-Feb FY17 increased to 3.9 percent as compared to 2.5 percent in the same period of the previous year. The 12-month moving average was recorded at 3.8 percent in February FY17 as compared to 2.6 percent in February FY16. The YoY food inflation remained 3.7 percent in February 2017, same as a year earlier in February 2016 while YoY non-food inflation increased to 4.6 percent in February 2017 from 4.2 percent in February 2016. The lower level of inflation can be attributed to stable food inflation owing to steady supply of perishable items despite some increase in non-food inflation. However, core inflationary measures broadly indicate underlying inflationary pressures as NFNE inflation on YoY basis increased to 5.3 percent in February FY17 from 4.5 percent in the corresponding month of the previous year, whereas 20 percent trimmed-mean inflation on YoY basis increased to 4.1 percent in February FY17 from 3.6 percent in February FY16. These trends could be attributed to increase in real income over the past three years and picking up of momentum in domestic demand. Despite the continuation of the rising trend, the average inflation for FY17 is expected to be within the range forecast of 4.0 to 5.0 percent amid adequate stock of major food items and modest recovery in global commodity prices.

3. Private sector borrowing increased to Rs. 348.8 billion in Jul-Feb FY17 as compared with Rs. 267.5 billion availed in the previous year during the same period. These borrowings included increased level of credit to private sector businesses at Rs. 284.6 billion for Jul-Feb FY17 as compared to Rs. 260.1 billion in the same period of the previous year. Lending to private sector included a sizable increase in fixed investment and slightly lower uptake in working capital mainly due to retirements by the fertilizer industry. Meanwhile, demand for the consumer financing also increased by Rs. 47.3 billion in Jul-Feb FY17, as compared to Rs. 11.4 billion in

Jul-Feb FY16. Demand for private sector credit is expected to stay strong in the remaining period of FY17.

4. Monetary expansion during the year remained moderate with a cumulative growth of 4.2 percent during July 1 to March 3, FY17 compared to a growth of 3.9 percent last year. The YoY growth up till March 3, 2017 was 14 percent as compared to 12.7 percent last year. Higher current account deficit resulted in the contraction of NFA which was offset by higher growth in the NDA of the banking system owing to higher government borrowing and increased off-take of private sector credit. Loans to the PSEs also remained higher in FY17 as compared to the corresponding period of FY16 with an increased flow of Rs. 62 billion during July 1-March 3, FY17. Higher level of currency in circulation saw moderation while there was noticeable growth in bank deposits with inflows of Rs. 347 billion for the period July 1 to March 3, 2017.

5. The budget deficit increased to 2.4 percent of GDP in H1-FY17 in comparison to 1.7 percent in H1-FY16, against a year-end target of 3.8 percent. Higher budget deficit was led by both lower growth in revenues and higher expenditure. The revenue receipts witnessed lower growth of 7.4 percent in H1-FY17 as compared to 17 percent growth in the same period of the previous year. Increased current expenditure contributed to the overall increase in total expenditure that grew by 10.7 percent in H1-FY17 as compared to 5.0 percent in H1-FY16.

6. External current account deficit increased to USD 5.5 billion in Jul-Feb FY17 compared to USD 2.5 billion last year. Higher current account deficit was mainly driven by the trade balance that registered nearly 27percent deterioration in Jul-Feb FY17 as compared to the same period of the previous year. Increased import can be attributed to the surging import of machinery and transport equipment in addition to the increased quantum of oil imports on a relatively higher price compared to last year. Overall balance of payments posted a deficit of USD 1 billion during Jul-Feb FY17 which resulted in net SBP reserves of USD 17 billion by end-February 2017, from USD 18 billion at end-June 2016. Continuation of higher trade gap and relatively lower growth in workers' remittances may increase reliance of the external sector on official inflows.

7. Real sector activities remained mostly on track and the growth in real GDP is expected to increase above the growth rate of 4.7 percent of FY16. This is supported by the preliminary estimates of agriculture production and the current trends in industrial activities. There has been an increase in manufacturing, which is depicted in the key sectors of large scale manufacturing as it grew by 3.5 percent during Jul-Jan 2017. Agriculture sector, with modest growth, is likely to recover from net contraction of 0.2 percent in FY16. Provisional estimates largely based on cultivated area suggest higher than target yield of sugarcane and maize crops in contrast to prospects of lower than target production in rice and cotton while wheat is expected to maintain the production level of last year.

Financial Markets and Reserve Management

8. The staff informed the MPC that as far as liquidity operations are concerned, the overnight rate hovered more closely around the policy rate of 5.75 percent since the monetary policy review in January 2017. Average overnight interbank repo rate for the period was 5.8 percent, showing better implementation of the monetary policy stance. Despite significant deviation from the targets in the primary auction of government securities, stable market conditions were ensured through frequent and higher liquidity injections through Open Market Operations by SBP. However, the yield curve has shifted upward and has steepened since the last monetary policy decision; reflecting market's expectations of higher interest rates going forward.

9. External account situation remained under pressure due to higher current account deficit for Jul-Feb, 2017 that has surpassed the IMF projections of USD 4.7 billion for FY17. At the same time capital and financial inflows, owing primarily to delays in realization of planned official external inflows, fell short of the expectations and proved insufficient to finance the increased current account deficit. As a result, some pressure in the market has been witnessed and foreign exchange reserves have declined. Private sector and banks inflows in the form of loans/borrowings witnessed an increase during FY17. Interest rates in USA have been rising and are expected to increase further.

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. Before presenting the projections of the FPAS model, Research Department staff discussed two key factors: the changing trend of international oil prices and the normalization of the U.S economy, which are incorporated in the model and as such underpin the model forecasts and recommendation for the policy rate.

12. After discussing the two key factors, the MPC was informed about the main assumptions of the FPAS model which includes 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 LSM, international oil prices, headline, food and core inflation for March-2017. In addition, MPC was also informed that the risk premium was kept at an elevated level due to heightened uncertainty in light of: (i) the formal start of the Brexit process, (ii) start of policy changes by the new US administration, and (iii) continued weaknesses in the external sector.

13. In terms of FPAS projections, average headline inflation for FY17 for both Seasonally Adjusted and Not Seasonally Adjusted have been revised downwards to 3.7 percent and 3.8 percent from 4.0 percent for both reported in the last MPC meeting. The softening of international oil prices in the month of March explains the downward revisions in inflation projections to some extent. 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 5.2 percent for FY17; this is slightly higher than 5.0 percent reported earlier. These projections are further corroborated by well anchored and stable consumer confidence and inflation expectations as reflected by the latest IBA- SBP's Consumer Confidence Survey.

14. Turning to the real sector, higher than expected improvement in the LSM sector during November and December 2016, based on the buoyant performance of few sub-sectors, such as sugar, automobile, Iron & Steel Products, Electronics, etc., has reversed the output gap from negative to positive despite the sluggishness of the exporting sector, Textile.

15. Having said that, the Research staff informed the MPC that the underlying growth trend in LSM growth is still not stable as the January 2017 LSM data shows only a Y-o-Y growth of 1.1 percent. In fact, the cumulative LSM growth in FY17 from Jul-Jan is 3.5 percent while it was 4.6 percent during the same period in FY16. In addition, disaggregated analysis of LSM shows that Food, Beverages and Tobacco is the only sub-sector of LSM that has shown higher cumulative growth in the first 7 months of the current fiscal year compared to FY16. This is despite increased credit disbursements to most of the LSM sub-sectors in FY17 compared to FY16.

Given these facts and only one quarter remaining in the current fiscal year the cumulative growth in LSM is likely to remain below the target of 5.9 percent.

16. Turning to the twin policy gaps, Research staff explained that persistent bilateral Real Exchange Rate gap continues to adversely affect the LSM gap through worsening of export competitiveness, going forward. This, accompanied with a moderate increase in the Real Interest Rate gap, has tightened the monetary conditions. According to FPAS, softening of the policy rates can help to soften monetary conditions and in turn bring sustained improvement in the output gap over the medium term.

17. Conditional on above assumptions and latest available data, the FPAS model-induced interest rate path shows a marginally higher interest rate cut than the January 2017 recommendation by Q3-FY17, which is broadly in line with the model recommendations since November 2016 onwards. The call for moderation in the current policy rate is mainly due to: lower average headline inflation and growth projections relative to targets for FY17 and the tightening of monetary conditions relative to January 2017.

Monetary Policy Decision Vote

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: (1) challenges posed by the external account and (2) 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 of the policy rate to support growth.

21. In conclusion, the Committee decided to keep the policy rate at the present level of 5.75 percent with a majority vote of 6 out of 8 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 – March, 2017 is approved.*