MINUTES OF THE 1st MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on January 28, 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
Dr. Aliya Hashmi Khan	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 November 2016 Monetary Policy decision period, along with the assessment of evolving trends.

2. The YoY CPI inflation increased to 3.7 percent in December FY17 from 3.2 percent a year earlier, whereas average inflation during H1-FY17 increased to 3.9 percent as compared to 2.1 percent in H1-FY16. Despite the continuation of its rising trend, inflation has remained lower than its projection so far in FY17. Hence the average inflation forecast for FY17 has been revised downwards by 0.5 percentage points to a range of 4.0 to 5.0 percent. This forecast encompasses the impacts of: i) lower pass-through of the recovery in global oil prices to domestic consumers during H1-FY17, ii) slower than anticipated pick-up in domestic demand, iii) well-anchored inflation expectations (IBA-SBP survey of November 2016 and January 2017), and iv) stable exchange rate. However, there are indications of incipient inflationary pressures due to rising domestic demand from the upward momentum in core inflation. Its Non-Food Non-Energy (NFNE) index increased to 5.2 percent (YoY) in December FY17 from 4.1 percent in December FY16. Similarly, 20 percent trimmed mean inflation increased to 3.7 percent (YoY) in December FY17 from 2.7 percent in December FY16.

3. The underlying inflationary pressure is also partly evident by the credit uptick that has been buoyant, especially led by higher demand from the industry. Private sector borrowed Rs. 375.6 billion in H1-FY17 as compared with Rs. 282.6 billion availed in the same period last year. The uptick in credit for fixed investments gained momentum and was significantly higher at Rs. 134.1 billion in H1-FY17 as compared to Rs. 83.8 billion in the same period last year. It is also significantly higher than the last 5 years' average of Rs. 38.0 billion. Scope of banks' lending for fixed investments has extended further due to demand for credit from cement and CPEC related industry to manufacturing sectors such as textiles, chemicals, and food & beverages. It is also

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

expected that the recent announcement of the export package by the Government might result in another round of uptick in fixed investments especially in the textile industry.

4. On account of improved cash flows of firms and low input prices, volume of working capital loans was relatively lower at Rs. 163.2 billion in H1FY17 as compared to Rs. 179.6 billion in the same period last year. Consumer financing has also seen a noticeable uptick, from Rs. 9.9 billion in H1-FY16 to Rs. 42.8 billion in H1-FY17, indicating rising domestic demand and improving consumer confidence.

5. The uptick in Private Sector Credit is also visible from the expansion of monetary aggregates since broad money registered a cumulative growth of 3.7 percent in the period from July 1 to January 6, FY17 as compared to 2.9 percent cumulative growth in the corresponding period of last year. Also, during this period, government borrowing from SBP was Rs. 860 billion as compared to the retirement of Rs. 415 billion in the corresponding period last year. On the other hand, during July 1 to January 6, FY17 government retired Rs. 380 billion to scheduled banks. Hence, government net budgetary borrowings from the banking system during July 1 to January 6, FY17 was Rs. 480 billion as compared to Rs. 242 billion in the same period last year. Thus the two main sources of acceleration in NDA during H1FY17 are: i) increase in private sector credit, and ii) government borrowing from SBP.

6. It was stated that owing to increasing imports especially those of machinery and capital goods, decelerating remittances and absence of budgeted CSF related inflows of USD 1.1 billion, the current account deficit has deteriorated further. As compared to USD 1,865 million during H1-FY16, it increased to USD 3,527 million in H1-FY17. However, due to the support from financial inflows, the overall balance of payments recorded a surplus of USD 227 million during H1-FY17 as compared to the surplus of about USD 1.5 billion in H1-FY16.

7. It was highlighted that net FDI reached up to USD 1,040 million during H1-FY17 as compared to USD 970 million in the comparative period of last year. Furthermore, due to the launching of the International Sukuk in October FY17, portfolio investment during H1-FY17 reached USD 791 million as compared to USD 203 million in the same period last year. Going forward, keeping stock of realistic trends in external trade, workers' remittances, and realization of CSF proceeds and other financial inflows, SBP projects a balance of payments surplus and upward trajectory in foreign exchange reserves in FY17.

8. Based on the above stated developments, real GDP is expected to grow higher than the growth rate of 4.7 percent achieved in FY16. While sustainably achieving this rising trajectory in real economic growth along with low inflation over the past couple of years is indeed encouraging, going forward, there is the need for prudence given the underlying inflationary pressures, rising imports and stagnancy in workers' remittances which covers the significant part of the trade deficit.

Financial Markets and Reserve Management

9. The staff stated that as far as liquidity operations are concerned, the overnight rate mostly hovered around the policy rate. Liquidity injections have come down from approx. Rs. 2 trillion in June FY16 to Rs. 850-900 billion at present which is owing to the fact that the government has started borrowing from the SBP and to some extent had also retired borrowing from the commercial banks. Since the monetary policy review in November FY17, the overnight repo rate in the interbank market remained at 5.84 percent on average, against the policy (target) rate of 5.75

percent. There has been some volatility in the short term interest rates due to the variance in meeting the auction targets.

10. The position of reserves projected by the IMF was USD 19.1 billion by December FY17 however the actual reserves remained at USD 18.2 billion resulting in a deviation from the forecast.

11. During H1-FY17, the gap in official flows was around USD 1.3 billion which includes inflows expected from the World Bank and CSF. Responding to a query, it was apprised that the projected position of foreign exchange reserves by end FY17 is USD 20.5 billion.

12. It was stated that the longer-tenor interest rates have risen since the monetary policy review in September FY17. The trends in KIBOR and LIBOR reflect that 3-Months KIBOR has been following the SBP policy rate. In the context of the global market, US interest rates have also been increasing and the expectation is that they will go up further, where the differential in PKR-USD interest rates is about 5 percent.

Model-Based Assessment

13. Research Department staff highlighted two emerging factors for FPAS which merit discussion before considering the model forecasts and recommendation for the policy rate: i) the trends in world oil prices and ii) the normalization of U.S. interest rates.

14. The projected price of oil for the remaining period of 2017 is USD 55/barrel while for 2018 it is around USD 56/barrel based on the New York Mercantile Exchange prices and World Economic Outlook. In January 2017, the new OPEC agreement came into force but other countries, such as Nigeria and Libya, are not part of it, so if oil prices rebound in the global markets the agreement will be tested. In addition, oil price dynamics have changed structurally with the availability of shale oil supply which is very price sensitive and has the potential to cap any undesirable price increases aimed by the recent OPEC actions. Therefore, at this stage oil prices are not anticipated to rise in the remaining quarters of the year as high as the level reached in 2008-2010. This last consideration is important for an oil-importing country like Pakistan given its previous experiences with adverse oil price shocks.

15. As far as the US monetary policy normalization is concerned, it was stated that currently the market anticipates at least three hikes in the US interest rates during the calendar year 2017. This anticipated normalization poses few risks for Pakistan economy. One, volatility in international currencies creates a challenging environment for a country with a stable FX market. In such a scenario structural reforms are all the more important. Two, the appreciation of U.S. dollar and its impact on export competitiveness. Three, capital outflows per se. Four, economic policies of the new U.S administration may lead to a higher than projected inflation accelerating normalization. Nonetheless, there is also a possibility of a slower than anticipated normalization of the US interest rates. Indeed, depending on the quality of the measures taken, the economic policies of the new U.S. administration may lead a higher labour force participation in the US, which could in turn moderate the US inflation path.

16. Following this, the MPC was informed about the main assumptions of the FPAS model which include now-casting of the US Federal Funds rate path, US inflation for the next 8 quarters, and higher than expected uptick in YoY growth of LSM index for November FY17. In addition, the market risk premium has been kept at an elevated level to capture heightened uncertainty due to: (i) possible policy changes by the new US government, (ii) lack of respite from other global risk

factors such as the economic fallout of Brexit and upcoming election in the EU and (iii) vulnerabilities of the external sector.

17. Conditional on above assumptions and latest available data, the FPAS recommends a cut in the policy rate by Q3-FY17 and a model-induced interest rate path for FY17 that continues to be lower. The call for moderation in the current policy rate is mainly due to lower inflation and growth projections relative to targets. The magnitude of the cut is significant, but relatively smaller than the moderation suggested in November FY17. Some of the moderation projected in November FY17 is offset by the U.S policy rate path, growing oil prices, the latest LSM growth and potential external sector vulnerabilities.

18. In terms of inflation projections, FY17 forecasts for both seasonally adjusted and non-seasonally adjusted average headline inflation have been revised downward to 4.0 percent from 4.2 percent and 4.9 percent respectively. This downward revision accounts for higher international oil prices.

19. Delving on core inflation, its average YoY measure (non-food and non-oil) is projected to be 5 percent for FY17 owing to a high base-effect. However, other versions of core inflation such as the trimmed measure and relatively stable component of CPI (RSC-CPI) show a modest decline. These projections are further supported by a well anchored and stable consumer confidence and inflation expectations data reflected in the latest IBA- SBP's Consumer Confidence Survey of January-2017.

20. Turning to the real sector, the LSM gap has narrowed in the second quarter. This is explained by an optimistic now-casting of LSM on the basis of YoY growth in November FY17 driven by sugar production and few other sectors such as automobile, iron & steel products and electronics. Factors such as increasing credit to private sector and uptick in CPEC related investments are expected to bode well for this sector and also contribute to this optimism over the longer horizon. However, the medium-term drag in the output gap continues and is determined by channels of the real exchange rate gap i.e. the competitiveness concern of exports, and the real interest rate gap. According to FPAS, softening of the policy rates can help mitigate the output gap over the medium term.

21. In sum, based on downward revision of the projected average headline inflation well below the target for FY17, a persistent output gap, stable consumer confidence and inflation expectations, world economic situation, and after incorporating an uptick in world oil prices the model suggests a downward revision in the policy rate by Q3-FY17 and hence a lower policy rate path.

Monetary Policy Decision Vote

22. 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.

23. Members voting for maintaining status quo gave more weight to: (1) challenges posed by the external account, (2) trends in inflation and (3) the need to maintain stability.

24. 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, reduce unemployment and to

incentivise investment while giving positive signal to the market on continuation of the healthy trends.

25. 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 9 members present, with 3 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 – January, 2017 is approved.*