MINUTES OF THE 5th MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on September 29, 2017

P R E S E N T

Mr. Tariq Bajwa	Chairman / Governor, SBP
Mr. Riaz Riazuddin	Deputy Governor (Policy)
Mr. Jameel Ahmad	Deputy Governor (Banking & FMRM)
Mr. Inayat Hussain	Executive Director (FS & BSG)
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. 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 July, 2017 Monetary Policy decision, along with an assessment of evolving trends.

2. CPI on year-on-year (YoY) basis slightly decreased to 3.4 percent in August FY18 from 3.6 percent a year earlier, whereas average inflation in Jul-Aug FY18 decreased to 3.2 percent as compared to 3.8 percent for the same period in FY17. A sharp decline in food inflation is the dominant factor behind the deceleration of inflation in Jul-Aug FY18. An adequate supply of major food items, lower domestic oil prices, and stable exchange rate are major factors behind lower inflation. Food inflation, on a YoY basis, decreased to 1.2 percent in August FY18, as compared to 3.4 percent in August FY17, while YoY non-food inflation increased to 5.0 percent in August FY18 from 3.7 percent in August FY17. On the other hand, YoY NFNE inflation increased to 5.6 percent in Jul-Aug FY18 from 4.6 percent in the corresponding period of the previous year. Higher core inflation can be attributed to higher prices of services including house rent, education and health.

3. Headline Inflation forecast even incorporating various scenarios like increase in energy prices, higher government borrowings and changes in exchange rate was found to be well within the projected range estimates of 4.5-5.5 percent for FY18. Barring these shocks, headline inflation is expected to remain close to the lower bound of its forecasted range in FY18.

4. Credit to private sector for both fixed investment and working capital purposes increased across almost all sub-sectors during Jul-Aug, 2017.Credit for fixed investment maintained its growth trend and increased by 21.8 percent on YoY basis in August 2017 as compared to 16.4 percent growth recorded in the same period of the previous year. Encouragingly, the seasonal retirement in credit to the private sector remained lower at Rs. 72 billion in Jul-Aug FY18 as compared to Rs. 206 billion in the corresponding period last year. Similarly, the retirement of

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

working capital went down to Rs. 93.5 billion during Jul-Aug FY18 as compared to Rs. 170.6 billion retirements in the corresponding period last year. In YoY change, credit to private sector businesses recorded a significant increase as it stood at Rs. 716 billion in August FY18 as compared to Rs.224 billion in the comparable period of previous year. The growth in credit to private sector is expected to carry on with its last year's trend.

5. During Jul 1–Sep 8, FY18 M2 recorded a contraction of 0.9 percent as compared to a contraction of 1.0 percent in the same period of FY17. On YoY basis, M2 exhibited a growth of 13.8 percent as on Sep 8, 2017 compared with a growth of 14.0 percent on Sep 9, 2016. Lower than planned official inflows and widening of current account deficit led to a contraction of NFA of the banking system so far in FY18. This contraction was somewhat offset by a growth in the NDA of the banking system owing mainly to lower retirement of private sector credit. The government borrowing from banking system was Rs. 328 billion in Jul 1-Sep 8 FY18 as compared to Rs. 384 billion in the comparable period last year. However, the composition of government borrowing changed significantly as borrowing from SBP declined to Rs. 91 billion during Jul 1–Sep 8, FY18 from Rs. 879 billion last year. Moreover, the government borrowing from the banking system saw a reversal with a borrowing of Rs. 237 billion during Jul 1–Sep 8, FY18 as compared to a retirement of Rs. 495 billion to scheduled banks in the same period of FY17.

6. The currency in circulation (CIC) increased by Rs. 76 billion (1.9 percent) during Jul 1-Sep 8, FY18, as compared with an expansion of Rs. 101 billion (3.0 percent) recorded in the corresponding period of FY17. The bank deposits witnessed a seasonal contraction of Rs. 208 billion (-1.9 percent) during Jul 1-Sep 8, FY18 as compared with a contraction of Rs. 225 billion (-2.4 percent) in the corresponding period of FY17.

7. External current account deficit was USD 2.6 billion during Jul-Aug FY18, from USD 1.3 billion recorded in the same period last year. The widening of current account deficit was mainly driven by rise in trade deficit to USD 5.0 billion during Jul-Aug FY18 as compared to a deficit of USD 3.7 billion over the same period last year. Financial flows though increased as reflected by a Net FDI flows of USD 456 million during Jul-Aug FY18 as compared to USD 179 million despite the reversal of foreign portfolio investment in the corresponding period last year, were not enough to plug the current account gap. On a cumulative basis, SBP's net liquid reserves stood at USD 14.7 billion by end August 2017. Going forward, the global economic and political developments and the anticipation of changes in both domestic and foreign policies of the US could also impact the global output and trade flows in 2017-18. The global economy continues to demonstrate the broad-based expansion since 2010, which supports expectations of better demand for Pakistani exports going forward.

8. The actual budget deficit increased significantly to 5.8 percent of GDP for FY17 in comparison with government's revised target deficit of 4.2 percent of GDP. This widening of the fiscal deficit was largely attributed to a notable increase in development expenditures, and below-budget tax and non-tax revenues. FBR revenue witnessed growth of 8.0 percent on YoY basis which is significantly less than targeted amount. Encouragingly, the government has successfully contained current expenditures at Rs 5.2 trillion which was within the annual target.

9. Pakistan achieved a ten-year high growth of 5.3 percent in FY17. In FY18, real GDP growth is targeted at 6.0 percent, which is expected to be led by industry and services. The agriculture sector is also expected to continue with the healthy growth trend seen last year and it may even exceed the annual target of 3.5 percent for FY18. The prospects of healthy growth in agriculture are endorsed by a number of factors observed for the Khareef season, where area under cultivation

increased from 6.4 to 6.9 million hector and fertilizer use increased from 2.3 to 2.7 million ton in comparison to the comparable period of last year. The credit disbursement to agricultural was around Rs. 98 billion in the first two months of FY18 as compared to Rs. 71 billion in the corresponding period last year. LSM is also expected to keep up the healthy growth trend, where it attained a 9 year high with growth rate of 5.7 percent in FY17. Based on these real economic activities trends so far in FY18, the target for real GDP growth seems realistic and achievable.

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 September 2017. The overnight weighted average repo rate stayed around 5.80 percent and it's volatility, on average, has reduced to 0.16 percent from 0.2 percent at the time of last MPC decision. During the period, there were substantial government borrowings from the scheduled banks along with a surge in currency in circulation due to Eid-ul-Azha, which resulted in higher demand for liquidity and customary deposit volatility for this time of the year. To mitigate, SBP fulfilled the liquidity needs through injections where the outstanding stock increased to Rs. 1.7 trillion, though it subsequently came down to Rs. 1.5 trillion.

11. The long term yield curve steepened since the last monetary policy decision which clearly indicates market expectations of no further reduction in the interest rates. However, interest rate expectations for the short term are stable as most of the banks are investing in instruments of less than 1 year tenors. Recent auctions of PIB have not been successful and were scrapped due to lackluster response from the participating banks, indicating that the market is waiting for more clarity on the future interest rate path in the midst of pressures on the external account. Sharing results of a market survey, it was informed that market expectations were of no change in the policy rate mostly based on growth/inflation trends although there are concerns on account of weakness of the external account.

Model-Based Assessment

12. Research Department staff apprised the MPC about the latest projections of the Forecasting and Policy Analysis System (FPAS) and explained the addition of fiscal block in the aforesaid Model.

13. The staff informed MPC of the improvements in the model due to incorporation of fiscal block that has led to other changes in the model including revision in Aggregate Demand and the Uncovered Interest Rate Parity equations of the existing FPAS model and adding new equations describing fiscal rule and the accounting of fiscal policy and public debt. MPC was informed that the extended model, the FPAS-Fiscal model, also replaced LSM data with quarterly GDP, which were needed to express fiscal deficit and public debt in terms of GDP.

14. After the brief introduction of the FPAS-Fiscal model, the staff mentioned the major data revisions for the models other than the newly incorporated fiscal data. These included incorporation of actual YoY growth of LSM that was 7.4 percent during Q4-FY17 as compared to the now-casted growth of 10.1 percent, in addition to the now casting of inflation data to accommodate benign food inflation during Jul-Aug, 2017. Revision in external data was informed to be mainly in inflation and quarterly GDP for USA.

15. The MPC was further informed about the main assumptions of the FPAS models which included 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.

16. Conditional on above assumptions, now-casting and latest available data, the existing FPAS model-induced interest rate path shows a smaller interest rate cut than the September 2017 recommendation, implying reduced room for further lowering the policy rate. MPC was also informed that the FPAS-Fiscal model suggests even a lower cut relative to the existing FPAS model.

17. Under the FPAS projections, average headline inflation projections (non-seasonally adjusted) for FY18 have been revised downward to 4.6 percent from 5.0 percent reported in the last MPC meeting (the existing FPAS model). On the real sector, output gaps (both LSM and GDP based) are expected to narrow down in FY18 from the level witnessed in FY17. It was explained that the Textile sector has also showed some signs of improvement in the latter part of FY17 despite the continued loss of competiveness as indicated by persistent bilateral Real Exchange Rate gap.

18. The staff informed MPC that under alternative scenarios like a substantial increase in oil prices, a relatively higher fiscal deficit (which is expected due to political budget cycles) and a simultaneous occurring of the aforesaid shocks, the FPAS models give even a smaller cut in the policy rate.

Result of Surveys on Monetary Policy

19. Results of surveys on consumer confidence index (CCI), inflation expectations and future interest rate direction were also shared with the Committee. MPC was informed that overall CCI has improved as compared to two months ago while there is increased positivity about prevailing and expected economic conditions. Expectations of an increase in inflation and on market interest rates were also informed to the Committee.

Monetary Policy Deliberations and Decision Vote

20. After conclusion of the presentation and the discussion with staff, the MPC voted on the policy rate decision. Deliberations led to formulation of two views, either for maintaining status quo or reducing the policy rate by 15 bps.

21. Members voting for maintaining status quo gave more weight to the need to maintain stability and support growth, while remaining cautious of the weakness in external account.

22. Member voting for reducing the policy rate by 15 bps was of the view that there is still room for further reduction of the policy rate which could also indicate macroeconomic stability and strong prospects of attaining growth target, with below-target inflation.

23. 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, with 1 vote for reducing the rate by 15 bps.

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

25. The MPC decided as follows:

DECISIONS:

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