MINUTES OF THE 3rd MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on May 25, 2018

P R E S E N T

Mr. Tariq Bajwa	Chairman & Governor SBP
Mr. Jameel Ahmad	Deputy Governor (Banking & FMRM)
Dr. Inayat Hussain	Executive Director (FS & BSG)
Dr. Saeed Ahmed	Chief Economist / Executive Director (MPRG)
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 the developments in key macroeconomic indicators since the March 2018 Monetary Policy decision, along with the assessment of evolving trends.

2. The YoY CPI inflation eased to 3.7 percent in April FY18 from 4.8 percent a year earlier. The YoY food inflation fell sharply to -0.2 percent in April FY18 as compared to 4.4 percent a year earlier, while YoY non-food inflation increased significantly to 6.4 percent in April FY18 from 5.1 percent in April FY17. The main contributors to higher non-food inflation were clothing & footwear and education where the YoY change in April, FY18 were 7.0 and 13.0 percent respectively. Further, core inflation continued to show an increasing trend as NFNE core inflation increased to 6.9 percent in April FY18 from 5.5 percent a year earlier. To sum, the lower headline inflation can be linked with food inflation, which in itself tends to be volatile. On the other hand, non-food inflation is showing a persistent increasing trend, mainly driven by a swift pass-through of increase in international oil prices and depreciation of PKR against USD, as well as higher domestic demand. Given its role in explaining the future inflation path and its connotation for aggregate demand, core inflation is a number to watch closely in the coming months.

3. Under the current circumstances and data, the average CPI inflation is expected to fall in the range of 3.5 to 4.5 percent for FY18. More importantly, in FY19, average inflation is expected to remain between 5.5 to 6.5 percent with a higher likelihood of it falling closer to upper limit of the range. The forecast range is susceptible to shocks to international oil prices and their pass-through to domestic petroleum prices, changes in food prices, estimates of the output gap, growth in money supply, exchange rate moments, and potential changes in tariffs.

4. Broad Money (M2) registered a relatively lower growth of 4.9 percent during July 01-May 18 FY18 as compared to a growth of 7.3 percent in the corresponding period of the last year. The deceleration in M2 was mainly attributed to a contraction in NFA of banking system, which showed a decline of Rs. 600 billion during July 01- May 18 FY18, compared to a decrease of Rs. 379 billion in the corresponding period of FY17. On the other hand, NDA of banking system increased by Rs. 1,314 billion during July 01-May 18 FY18, almost similar to the increase

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

of Rs. 1,313 billion observed in the same period of last year. Expansion in NDA was led by healthy growth in private sector credit, in addition to Rs 819 billion budgetary borrowing from the banking system during July 01-May18 FY18, which was slightly lower than Rs. 850 billion observed in the same period of FY17. On the liability side, the cumulative growth in currency in circulation during July 01-May 18 FY18 accelerated to 11.9 percent as compared to 10.5 percent in the corresponding period of the last year. The growth in bank deposits on the other hand, decelerated to 2.3 percent for the period July 01-May 18 FY18 as compared to the growth of 6.1 percent in the corresponding period of the last year. While growth in personal deposits and private sector business deposits were broadly in line with the previous year's trend, the deceleration in the overall growth was mainly attributed to the decline in deposits of power sector and other businesses' categories. Based on these developments and taking stock of declining NFA, M2 is expected to grow in the range of 12.0-13.0 percent in FY18, lower than 13.7 percent growth registered in FY17.

5. The credit to private sector maintained its growth momentum and increased by Rs. 532 billion in Jul-Apr FY18 as compared with an uptake of Rs. 503 billion in the corresponding period last year. This credit expansion is primarily driven by relatively higher credit to both businesses and individuals. Increased production activities along with some uptick in input prices led businesses to avail relatively higher credit of Rs. 290 billion for working capital in Jul-Apr FY18 as compared with Rs. 256 billion in the same period last year. The demand for working capital primarily emanated from textile, power, cement, and commerce & trade. The demand from sugar sector, however, remained low during FY18 so far. Turning to fixed investments, the private sector businesses borrowed Rs. 192 billion in Jul-Apr FY18, which is almost equal to the credit being availed in Jul-Apr FY17. Encouragingly, the trends in fixed investments, which earlier observed some moderation has recorded a rebound particularly under the services sectors (commerce & trade, transport, storage & communication, and real estate) on top of buoyant demand from textile, power, and cement sectors. Moreover, personal loans kept an upward momentum as flows during Jul-Apr FY18 increased by Rs. 83 billion as compared with Rs. 54 billion in the same period of the last year.

6. The government has revised upward the fiscal deficit for FY18 from 4.1 percent of GDP to 5.5 percent as compared to the initial target of 4.1 percent. This suggests aggregate demand is much higher than its previous estimates. The increase in the fiscal deficit relative to target was led by both lower than expected growth in tax and non-tax revenue, and higher than expected current expenditures. FBR revenue during the first nine months of FY18 reached 65.4 percent of the budget target against FBR projected target of 68.5 for this period. Similarly, in this period, provinces only collected 48 percent of their budgeted revenue estimates. Furthermore, for FY18, provincial non-tax revenue has been revised down from Rs. 582 billion to Rs. 393 billion. For FY19, the government has set the fiscal deficit at 4.9 percent of GDP.

7. External current account deficit, yet another indicator for the state of aggregate demand, increased to USD 14.0 billion in July-April FY18 compared to USD 9.4 billion last year. Higher current account deficit was mainly driven by a large trade deficit that increased to USD 25.0 billion in Jul-April FY18 as compared to USD 20.8 billion in the same period last year. Exports witnessed a broad-based improvement to attain a growth rate of 13.3 percent in Jul-April FY18, as compared to a marginal decline of 0.03 percent during the same period last year. Workers' remittances grew by 3.9 percent during Jul-April FY18, compared to a decline of 2.5 percent recorded in the same period last year. The rise in remittances is primarily attributed to growing inflows from UK, USA, and EU.

8. Meanwhile, net FDI grew by 6.3 percent during July-April FY18 with net inflows of USD 2.2 billion against USD 2.1 billion for the comparable period last year. Significant part of FDI continued to originate from China as it increased to USD 1.4 billion in July-April FY18 as compared to USD 934.8 million in the comparable period last year. This, along with notably higher official inflows remained insufficient to finance higher current account deficit, which led

to USD 4.6 billion balance of payments deficit. Consequently, SBP's external reserves declined to USD 11.4 billion by end April 2018 from USD 16.1 billion in Jun 2017. Going forward, the level of SBP's FX reserves in the near-term would critically depend on the realization and further mobilization of official flows and the behaviour of international oil prices, as the favourable impact of recent PKR depreciation and other administrative measures would emerge gradually.

9. Real sector activities remained broadly on track as the provisional estimates indicate that real GDP growth reached a 13-year high of 5.8 percent in FY18, surpassing the growth rate of 5.4 percent attained in FY17, though it fell short of the 6.0 percent annual target. Agriculture sector grew by 3.8 percent as compared to the growth target of 3.5 percent, mainly due to better performance of important crops including rice, sugarcane, and cotton, offsetting some decline in the production of maize and wheat. Meanwhile, services sector attained the growth target of 6.4 percent, while the manufacturing sector despite its broad-based improvement fell short of the growth target due to weak performance of sugar and fertilizer. Going forward, the realization of the ambitious growth target of 6.2 percent would critically depend on the policy mix to manage the growing pressures on the country's external account.

10. The staff concluded the presentation by giving an update on the Macro-Stability Index (MSI). It was noted that MSI has marginally worsened in net terms primarily due to (a) a small reduction in import coverage of forex reserves and (b) higher future inflation projections. Given its strong contemporaneous and dynamic correlation with real economic growth, it was re-emphasized to preserve the macro stability through timely and appropriate policy measures.

Financial Markets and Reserve Management

11. An update of the market revealed that the overnight rate has hovered close to the policy rate at 6.03 percent on average; against the policy (target) rate of 6.0 percent, since the monetary policy review in March, 2018. The volatility in the overnight weighted average repo rate increased marginally to 0.15 percent, as compared to 0.12 percent at the time of the last monetary policy review meeting. The low volatility was observed despite the government's deviations from pre-announced auction targets of its securities. The government's preference to borrow more from the SBP, observed since December 2017, continued, and has led to increased liquidity in the market, and incentivized the commercial banks to retire their borrowing from the Central Bank. These trends have reduced the need of SBP's liquidity injection that have come down to about Rs. 300 to 400 billion from around Rs. 1.4 trillion in the initial part of the year. Going forward, if these trends continue, there could be a need for mop-up operations to implement the SBP's target policy rate.

12. Secondary market yields of almost all tenors witnessed a slight decline following the decision of no change in the policy rate in Mar 2018. Non-issuances of PIBs since July 2017 along with market's lack of interest in 12 month MTBs in the past few months has further reduced the share of long-term instruments in the government debt, posing the rollover risk.

13. Reduction in the PKR market interest rates, following the policy review of March, 2018 accompanied with the increase in USD interest rates, resulted in the narrowing of the differential in PKR-USD interest rates. This has discouraged the private sector to borrow in foreign currency; accordingly, external inflows related to private sector saw some reduction, adding pressure to the external reserves. Continuation of these trends will further increase reliance of the balance of payments on official inflows.

Model-Based Assessment

14. MPC was apprised on the latest projections of the Forecasting and Policy Analysis System (FPAS). First of all, a comparison of the now-casting assumptions of the FPAS from the March MPC meeting and the actual realization of data for Q3-FY18 was presented to the Committee. Importantly, food inflation was lower than previously forecasted, which kept the headline inflation below the projected path. MPC was also apprised about the main assumptions of the FPAS model output, including assumptions on international oil prices for the next quarter and FY19, the latest FOMC projections for the US Federal Funds rate path and US inflation for the next 8 quarters. Research staff also briefed the MPC about the now-casting of domestic headline, food and core inflation measures for Q4-FY18, as well as now-casting of output gap consistent with the revised GDP estimates for FY18. Other assumptions related to the domestic economy included fiscal deficit to GDP ratio at 5.9 percent and 5.0 percent for FY18 and FY19, respectively and an increase in uncertainty to reflect a rise in sovereign risk premium on Pakistan's Eurobonds.

15. Conditional on the latest data and aforementioned now-casting assumptions, the FPAS model suggested a relatively larger increase in the policy interest rate by Q4-FY18 than the MPC meeting held in March 2018. This policy change is mainly driven by key factors related to a higher headline and core inflation paths, and rebalancing of the uncovered-interest rate parity (UIP) consideration.

16. On the inflation front, it was explained that headline-inflation is expected to bounce back in the second half of FY19 due to: (i) a lagged impact of the on-going fiscal expansion; (ii) exchange rate adjustments implied by the model to close the RER gap; and (iii) impact of higher inflation expectations as reflected in the core inflation measure, NFNE, and the latest May-2018 reading of IBA-SBP Consumer Confidence Survey.

17. Turning to UIP, the staff explained that US Federal Reserve increased the federal fund rate by 25 bps in March 2018 while left the policy rate unchanged in May. Increase in the US federal fund rate by 25 bps in March 2018, not only neutralized the impact of 25 bps increase in SBP policy rate of January 2018 on the interest rate differential basis but also made domestic debt instruments less attractive. This, in addition to, the PKR depreciation in March requires adjustments in the domestic policy rate in the light of modified uncovered interest rate parity to make our domestic debt instruments more attractive.

18. In terms of FPAS projections for FY18, average headline inflation forecast has been revised downwards from last MPC meeting to 4.5 percent from 5.3 percent, whereas estimate for core inflation is revised upward to 6.6 percent from 5.4 percent. More importantly, assuming the current policy stance and data, headline inflation and core inflation for FY19 are expected to reach 6.1 percent and 7.3 percent, respectively. This situation can be improved upon, assuming no other unknown shocks, by conditioning the model with its implied interest rate path which results in headline inflation and core inflation projections for FY19 of 5.7 percent and 7.0 percent, respectively.

19. The most recent adjustment of exchange rate is expected to improve export competitiveness further by closing the real exchange rate gap. This combined with a rising external demand, as shown by upward revisions in the US economy growth in the latest FOMC projections, would help reducing the external sector vulnerabilities.

20. At the end, alternate scenarios were considered by the Committee which could impact policy rate that included: (i) an increase in international oil prices, (ii) a spike in core inflation by Q4-FY18, and (iii) a relatively higher fiscal deficit for FY18. In addition, the staff also presented and evaluated the FPAS forecast of inflation and output gap/growth for FY18 and FY19 under different policy scenarios.

Result of Surveys on Monetary Policy

21. Research staff presented the results of surveys on consumer confidence index (CCI), and inflation expectations to the Committee. MPC was informed that overall CCI slightly decreased while expected inflation has slightly increased on an overall basis, in comparison to the previous survey conducted in March 2018. Furthermore, it was highlighted to the MPC that expectations for food, energy, NFNE and overall inflation are all currently above the trend of inflation expectations of the last few years.

Monetary Policy Deliberations and Decision Vote

22. While setting the policy interest rate for the next two months, the Committee pondered upon the following points: (1) an overall assessment of aggregate demand relative to aggregate supply; (2) the need to maintain macro stability; (3) trends in future headline and core inflation paths; (4) the sustainability of a higher growth path; (5) the sustainability of external accounts position; and (6) the narrowing of PKR's interest rate differential with the rest of the world.

23. After conclusion of the presentation and the discussion with staff, the MPC voted on the policy rate decision. Deliberations led to unanimous view of increasing the policy rate. However, there were differing views on the magnitude of increase required.

24. Members voting for increasing the policy rate by 50 bps were of the view that a lower increase will not be sufficient to help address increasing trend in core inflation, as well as narrowing of PKR's interest rate differential with the rest of the world.

25. Member voting for increasing the policy rate by 25 bps was to keep the monetary policy supportive of the growth in addressing inflationary trends and issues pertaining to the balance of payments.

26. In conclusion, the Committee decided to increase the policy rate by 50 bps to 6.50 percent, with a majority vote of 8 out of 9 members present, with 1 vote for increasing the rate by 25 bps.

27. Finally, the Committee then scripted the Monetary Policy Statement.

28. The MPC decided as follows:

DECISIONS:

The policy rate is increased to 6.50 percent.
The Monetary Policy Statement – May, 2018 is approved.