MINUTES OF THE 1st MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on January 26, 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)
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
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 November 2017 Monetary Policy decision, along with an assessment of evolving trends.

2. The YoY CPI inflation had risen to 4.6 percent in December 2017 from 3.7 percent a year earlier, whereas average headline inflation during H1-FY18 slightly decreased to 3.8 percent as compared to 3.9 percent in H1-FY17. The non-food inflation increased to 5.0 percent, whereas food inflation declined significantly to 2.0 percent during H1-FY18. Indicators of core inflation – non-food non-energy and twenty-percent trimmed mean – increased to 5.5 percent and 4.7 percent respectively in December 2017 from 5.2 percent and 3.7 percent in the corresponding period of last year. The rising trend in inflation can be attributed to an increase in international oil prices that coincided with depreciation of PKR against USD recorded in December 2017. This trend is also attributed to the continuous narrowing of proxies for the output-gap - an indicator for economy's capacity to service demand. In fact, most estimations show that the output gap has now moved in the positive territory albeit marginally.

3. These factors augmented the trend in core inflation, which is indicating higher inflation expectations going forward – a fact also corroborated in the latest reading of the IBA-SBP's Consumer Confidence Survey. Though, forecast for average headline inflation for FY18 is likely to be within the estimated range of 4.5 to 5.5 percent, under the existing trends and policy stance YoY inflation at the end-of-fiscal year is projected to inch towards the annual target of 6 percent.

4. Broad money (M2) showed a lower growth of 1.6 percent during Jul 01-Jan 05, FY18 as compared to a growth of 3.7 percent in the corresponding period of last year. The growth deceleration in M2 was also evident on YoY basis as it grew by 11.4 percent on January 5, 2018 compared with the growth of 14.6 percent at the same point in time last year. This trend in M2 resulted from contraction in NFA and some deceleration in NDA. NFA of SBP contracted significantly, though the decline in NFA of scheduled banks was marginal. As compared to the last

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

year, NDA of both SBP and scheduled banks showed some deceleration for the period Jul 01-Jan 05, FY18. Higher tax collection and proceeds from the issuance of Sukuk and Eurobond worth of USD 2.5 billion have led to lower net budgetary borrowing from banking system which stood at Rs. 353 billion during Jul 01-Jan 05, FY18 as compared to Rs. 487 billion in the corresponding period of the previous year. Deceleration in M2 is also reflected in the liability side, as incremental flows in deposits of banks remained at Rs. 123 billion during Jul 01-Jan 05, FY18 as compared to a rise of Rs. 315 billion in the same period last year. Moreover, currency in circulation increased by Rs. 111 billion during Jul 01-Jan 05, FY18, lower than the increase of Rs. 165 billion observed in the same period last year.

5. Private Sector Credit (PSC) increased by Rs. 296.3 billion between July and December 2017 (or H1-FY18). This statistic is relatively lower than the Rs. 360.7 billion availed during the same period last year. For example, the credit off-take to private sector businesses (PSBs), which accounts for around 75 percent of the total PSC, grew by Rs 252.5 billion in H1-FY18 as compared with Rs. 321.5 billion in H1-FY17. The relatively lower credit off-take during H1-FY18 can be attributed to delays in sugarcane crushing season which restricted the working capital needs of sugar sector. Similarly, driven by relatively lower power sector investment requirements, the credit off-take for fixed investments during H1-FY18 were recorded at Rs. 98.5 billion as compared to Rs 152.5 billion availed in H1-FY17.

6. Fiscal deficit in Q1-FY18 was 1.2 percent of GDP compared to 1.4 percent in the corresponding period of the previous year. The contraction in the fiscal deficit is due to strong revenue generation and was likely supported by curtailed current and development expenditures. Both direct and indirect taxes have contributed to higher revenue. The direct and indirect taxes increased to Rs. 286.9 billion and Rs. 477.9 billion in Q1-FY18 from Rs. 233.7 billion and Rs. 393.1 billion respectively, in the corresponding period of the previous year. Higher revenue generation was supported by increased tax collection by FBR, which posted a growth of 22.0 percent in Q1-FY18 as compared to 4.5 percent in the corresponding period of the previous year. Fiscal deficit for H1-FY18 is expected to remain lower than the last year's level of 2.5 percent during the same period.

7. The external current account deficit was recorded at USD 7.5 billion in H1-FY18 as compared to USD 4.7 billion during the corresponding period of the previous year. Trade deficit increased to USD 14.4 billion for H1-FY18 as compared to USD 11.4 billion during the same period last year, led by increased imports of both oil and non-oil commodities. In particular, the growth of the imports in non-oil and non-machinery is reflective of building demand pressures. Exports increased by 10.8 percent in H1-FY18, the highest growth in the last seven years, as compared to a decline of 1.4 percent during the same period last year. Both textile and non-textile items such as food, petroleum and other manufactured categories contributed in exports growth. The workers' remittances increased by 2.5 percent to reach USD 9.7 billion during H1- FY18 compared to USD 9.5 billion in the same period last year. Country-wise data shows that remittances from all advanced economies witnessed YoY rise during H1-FY18, however, remittances from GCC region continued to be weak. Financing of current account deficit was facilitated by a surplus of USD 5.6 billion in financial accounts during H1-FY18, as compared to USD 4.7 billion in the same period last year. Other than the issuance of Sukuk and Eurobond worth USD 2.5 billion, the surplus in financial account was supported by foreign direct investment that saw a net inflow of USD 1.4 billion during the first six month of the year. As a result, SBP's liquid foreign exchange reserves witnessed a decline of USD 2.6 billion since end June 2017 to reach USD 13.5 billion as of January 19, 2018.

8. Turning to the real economic activities, MPC was apprised that agriculture sector is set to perform better for the second year in a row despite the expectations of a below-target wheat crop

due to a reduction in area under cultivation and an impact on yield of late sowing both due to late sugarcane crushing. Production of all major Kharif crops, except maize, has surpassed the level of FY17. LSM growth for Jul-Nov FY18 remained at 7.2 percent as compared to 3.2 percent growth in the same period last year. Despite some deceleration in LSM growth due to sector specific issues, such as sugar, POL and fertilizer, the overall LSM growth is likely to be strong with an initiation of sugarcane crushing season, uptick in production of petroleum products and signs of revival in fertilizer industry on better availability of natural gas. Benefiting from both infrastructure and CPEC related investments, construction and its allied industries are expected to maintain their higher growth momentum. Taking into account the above development in the commodity-producing sector on the services sector, the real GDP growth is projected to be around 5.8 percent, significantly higher than FY17, but marginally lower than the annual target of 6 percent for FY18.

9. Turing to a reflection of the overall economic outlook, a snapshot exhibiting the relationship between measures of stability and real economic growth was presented. This on-demand analysis showed a strong contemporaneous and dynamic relationship between measures of stability and economic growth implying that stability and economic growth co-move. Keeping that relationship in view, it was discussed that developments in the external sector and fiscal deficit have been affecting the stability and that a continuation of this trend, if not challenged through timely and appropriate policy measures and blend could potentially pose risks to the medium-term sustainability of the economic growth momentum that started last year.

Financial Markets and Reserve Management

10. An update of the market revealed that the overnight rate has hovered close to the policy rate at 5.83 percent on average; against the policy (target) rate of 5.75 percent, since the monetary policy review in November 2017. The volatility in the overnight weighted average repo rate increased slightly to 0.21 percent, as compared to 0.20 percent at the time of last monetary policy review meeting. The volume of outstanding liquidity injection has recently come down to less than Rs. 1 trillion, compared to around Rs. 1.5 trillion in earlier part of the year. Government seems unwilling to borrow long tenors; while the market interest rates have adjusted upwards on account of expected increase in the policy rate in the near term. Consequently, Government is borrowing more from SBP than the scheduled banks, while meeting some of the borrowing needs through external financing. However, this has increased the concentration of short term debt on the books of the Government.

11. Yield curve shifted upwards since the last monetary policy review. Non-issuances of PIBs since July 2017 resulted in a decline of share of this long-term instrument in the overall debt from 60 percent in June 2016 to 45 percent in January 2018, which is raising the rollover risk. Despite the non-issuance, the secondary market remains fairly liquid even for the longer tenor instruments. Institutional foreign exchange borrowings, which are sensitive to PKR-USD interest rate differential, had come down from USD 3,779 million in November 2017 to USD 3,462 million in December 2017. Meanwhile, the FCY deposits have increased from USD 7,233 million in September 2017 to USD 7,367 million in December 2017.

Model-Based Assessment

12. MPC was apprised on the latest projections of the Forecasting and Policy Analysis System (FPAS). The MPC was informed about the main assumptions of the FPAS model output 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 8 quarters, in addition to now-casting of domestic headline, food and core inflation for March 2018, output gap consistent with the revised GDP projections for FY18, fiscal deficit to GDP for H1-FY18 and FY18. The Committee was apprised about the previous forecasts of extended FPAS model along with updates on domestic and external economy since the MPC meeting held in November 2017.

13. Conditional on the latest data and aforementioned now-casting assumptions, the extended FPAS model suggests a moderate hike in the policy interest rate by Q3-FY18. The model has previously suggested small rate cuts based on September and November 2017 data by Q2-FY18 in followed by a small increase in policy rate by Q3-FY18. The policy rate adjustment is mainly driven by an expected increase in inflation and inflation expectations in addition to the opening up of output gap. The inflationary expectation could be attributed to the pass-through of depreciation of PKR, upward adjustments in administered oil prices which prompted federal government to continue with the prudent policy to pass on increases in rupee denominated prices to final consumers by adjusting administered prices upward, while positive output gap could be attributed to building up of demand pressure partially explained by upward revision in the fiscal deficit to 1.2 percent of GDP than the initial estimate of 0.9 percent for Q1-FY18.

14. In terms of FPAS projections, average headline inflation for FY18 has been revised upward to 4.8 percent from 4.7 percent reported in the last MPC meeting. Similarly, headline inflation forecast for FY19 has been revised upward than the projections reported to MPC in November 2017 due to the aforementioned factors. The average core inflation projection for FY18 stays at the same level reported to the MPC in November 2017; however, it has been revised upward for FY19. These projections are also in line with the latest reading of IBA-SBP's Consumer Confidence Survey showing some increase in inflation expectations regarding all the sub-categories compared to the previous survey conducted in November 2017.

15. Alternate scenarios which can impact policy rate were also presented to the Committee include: i) an increase in international oil prices, ii) a further gradual exchange rate depreciation, iii) a relatively higher fiscal deficit due to political budget cycles. In addition, the staff also presented and evaluated the FPAS forecast about inflation and output gap/growth for FY18 and FY19 under different policy scenarios.

Result of Surveys on Monetary Policy

16. Results of surveys on consumer confidence index (CCI), and inflation expectations were also shared with the Committee. MPC was informed that overall CCI was slightly lower and expected inflation was slightly higher regarding all the sub-categories compared to the previous survey conducted in November 2017.

Monetary Policy Deliberations and Decision Vote

17. While setting the policy interest rate for the next two months, the Committee has pondered at the following points presented by the staff members: 1) the twin deficits have begun to adversely impact measures of stability; 2) inflation expectations remained entrenched as evident from surveys; 3) the latest inflation projections for end-of-FY18, and FY19 are expected to be close to the target of 6 percent; 4) output gap proxies are marginally in the positive territory; 5) there is a narrowing of PKR's interest rate differential with the rest of the world; and 6) there is a need to be proactive than reactive given a considerable time lag in the transmission of monetary policy.

18. Following discussions, the MPC voted on the policy rate decision essentially formulating two views: either increasing the policy rate by 25 bps or maintaining status quo.

19. Member voting for maintaining status quo gave more weight to support growth and maintain stability.

20. Members voting for increasing the policy rate by 25 bps were of the view that a timely action is required to address rising trend in inflation and aggregate demand.

21. In conclusion, the Committee decided to increase the policy rate by 25 basis points with a majority vote of 8 out of 9 members present, with 1 vote for maintaining the status quo at 5.75 percent.

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

23. The MPC decided as follows:

DECISIONS:

- *The policy interest rate is increased by 25 bps to 6.00 percent.*
- *The Monetary Policy Statement – January, 2018 is approved.*