MINUTES OF THE 2nd MEETING[1] OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on March 30, 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)
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
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 January 2018 Monetary Policy decision, along with the assessment of evolving trends.

2. The YoY CPI inflation eased to 3.8 percent in February FY18 from 4.2 percent a year earlier. The YoY food inflation fell sharply to 2.2 percent in February 2018 as compared to 3.7 percent a year earlier in February FY17, while YoY non-food inflation increased to 4.9 percent in February FY18 from 4.6 percent in February FY17. The lower level of inflation is attributed to a significant out-of-norm decrease in House Rent Index (HRI), which in Q3-FY18 posted the lowest growth levels since FY10, and a decline in food inflation owing to steady supply of perishable item. Nevertheless, the core inflationary measures broadly indicate some underlying inflationary pressure as NFNE inflation on YoY basis held steady at 5.2 percent in February FY18, close to its level of 5.3 percent in February FY17.

3. Under the revised estimates, the average CPI inflation is expected to fall in the range of 3.5 to 4.5 percent for FY18. This lower inflation range is attributed to the following factors. First, food inflation is lower than anticipated. Second, HRI posted growth numbers lower than its historical trend. Indeed, some support for the reduction in HRI comes from the repatriation of Afghan refugees, enforcement action in Islamabad on commercial use of residential properties, and stabilization of previously higher level of house rent in Gwadar and adjoining areas. However, resurgence to the previous level of HRI in the coming months could significantly affect CPI inflation, owing to its 21.8 percent share in the index. Third, the effect of imported-disinflation has played its role in keeping average inflation in check. However, this effect is expected to wane in the coming months given the lagged pass-through impact of multiple exchange rate corrections since December 2017. As for FY19, average inflation is expected to fall close to 6 percent. This forecast 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 movements and potential changes in tariffs.

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

4. Broad Money (M2) registered a relatively lower growth of 2.4 percent during July 01 – Mar 16 FY18, as compared to a growth of 4.6 percent in the corresponding period of the last year. This was the lowest recorded expansion in M2 in the last 9 years and is explained by a substantial contraction of banking system's NFA whereas growth in NDA remained comparable with its level from the same period last year. NFA of the banking system reduced by Rs. 424 billion during Jul 01-Mar 16 FY18, compared to a decrease of Rs. 237 billion in the corresponding period of FY17. Major part of this reduction in NFA is reflected by the decline in SBP foreign exchange reserves in order to finance the current account deficit. Government budgetary borrowing from SBP reached Rs. 1041 billion for the period Jul 01 – Mar 16 FY18 as compared to Rs. 969 billion in the comparable period of the last year. However, NDA of commercial banks reduced to Rs. 189 billion during Jul 01 – Mar 16 FY18 from Rs 420 billion in the comparable period of the last year. On the liability side, the YoY growth in currency in circulation during Jul 01-Mar 16 FY18 was 16.3 percent, which is the same as in the corresponding period of the last year. The change in bank deposits was quite noticeable as their growth declined to 9.5 percent for the period Jul 01-Mar 16 FY18, compared to the growth of 12.4 percent in the corresponding period of the last year. This reduction in deposits growth is highly pronounced in demand deposits, as their cumulative flows recorded a contraction of Rs. 74 billion during July 01- Mar 16 FY18 as compared to an increase of Rs. 393 billion registered in the corresponding period of the last year. Keeping track of these trends, M2 growth is expected to reach 12.5 percent in FY18, which is lower than 13.7 percent growth in FY17.

5. Private sector borrowing increased to Rs. 353.9 billion in Jul-Feb FY18 as compared with Rs. 337.6 billion availed in the corresponding period last year. This credit expansion is attributed to both businesses and individuals. Lending for fixed investments during the period slightly declined to Rs. 148 billion from Rs. 158 billion registered in the comparable period of the last year. Tapering-off of lending for fixed investment can be linked to near completion of major power projects and accomplishment of other capacity enhancement targets in various industries. Gestation of capital investment into the production mode has also started contributing to working capital requirements along with higher demand in the domestic as well as international markets. Despite the delay in the sugar-crushing season, lending for working capital increased to Rs. 197 billion during Jul-Feb FY18 from Rs. 143 billion in the comparable period of the last year. So far in FY18, higher demand for working capital mainly emanated from cement, power, and textile industries, whereas, credit uptake is expected in the sugar sector in the coming months while supply glut in the fertilizer sector is expected to keep its demand for working capital curtailed. Meanwhile, consumer financing increased slightly to Rs. 47.8 billion in Jul-Feb FY18, as compared to Rs. 42 billion in Jul-Feb FY17.

6. The budget deficit decreased to 2.2 percent of GDP in H1-FY18 in comparison to 2.5 percent observed in H1-FY17. This improvement was due to a significant increase in revenue collection, as FBR's tax collection grew by 17.5 percent during H1-FY18, whereas non-tax revenue increased by 43 percent in this period. The deficit for the first half of the year was financed through domestic borrowing of Rs. 412 billion and external borrowing of Rs. 384 billion. Going forward, the fiscal deficit may increase in case of lower than targeted increase in provincial and federal revenues in the second half of FY18.

7. External current account deficit increased to USD 10.8 billion in Jul-Feb FY18 compared to USD 7.2 billion last year. Higher current account deficit was mainly driven by the trade deficit that increased to USD 19.7 billion in Jul-Feb FY18 as compared to USD 16.2 billion in the same period last year. Exports witnessed a broad based improvement to attain growth rate of 12.2 percent in Jul-Feb FY18, as compared to a decline of 0.8 percent during the same period last year. Workers' remittances grew by 3.4 percent during Jul-Feb FY18, compared to a decline of 2.1 percent recorded in the same period last year. Meanwhile, net FDI grew by 19.1 percent with net inflows of

USD 1.9 billion against USD 1.6 billion for the comparable period last year. Improved export performance, positive trend in workers' remittances and FDI, along with official inflows helped contain the balance of payments deficit. Nevertheless, higher current account deficit off-set the aforesaid developments and led to USD 3.8 billion balance of payments deficit. Consequently, SBP's external reserves declined to USD 12.2 billion by Feb 2018 from USD 16.1 billion in Jun 2017. Going forward, the level of SBP's FX reserves in near term would critically depend on the timely realization of projected official flows, as the favourable impact of recent PKR depreciation and other administrative measures would emerge gradually.

8. Real sector activities remained broadly on track and the growth in real GDP is expected to surpass growth rate of 5.3 percent attained in FY17, though it may fell short of the 6.0 percent annual target. LSM grew by 6.7 percent in Jul-Jan FY18, significantly higher than 3.6 percent growth registered in the same period of FY17. This higher level of growth was achieved despite late start of sugarcane crushing season, and issues in fertilizer production, such as low off-take and hitches in gas supply. Agriculture sector is also expected to register healthy growth with sugarcane and rice expected to surpass their targets for FY18, though weak performance of wheat and cotton may keep growth for the sector below the annual target. Lower than target growth in agriculture is also expected to affect services sector. Growth in construction, autos, and consumer goods is expected to remain strong in remaining part of FY18.

9. The staff concluded the presentation by giving an update of the Macro-Stability Index (MSI), which was first presented to the Committee at the meeting of January 2018. It was noted that MSI marginally worsened in net terms primarily due to a marginal reduction in import coverage of forex reserves which was partially offset by the positive impact of moderation in 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. This in turn will mitigate potential risks to the medium-term sustainability of the economic growth momentum.

Financial Markets and Reserve Management

10. An update of the market revealed that the overnight rate has hovered close to the policy rate at 5.98 percent on average; against the policy (target) rate of 6.0 percent, since the monetary policy review in January 2017. The volatility in the overnight weighted average repo rate reduced substantially to 0.12 percent, as compared to 0.22 percent at the time of last monetary policy review meeting. The reduced volatility was observed despite 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. Further, the maturing government securities are not being rolled over, due to higher returns demanded by the market. These trends have reduced the need of SBP's liquidity injection, and going forward, if these trends continue, there could be a need for mop-up operations to implement the SBP's target policy rate.

11. Yield curve has shifted upwards since the last monetary policy review to incorporate the 25 bps increase in policy rate. 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.

12. PKR-USD interest rate differential, despite a 25 bps increase in the policy rate, has reduced further after increase in US policy rates in March 2018. Accordingly, the institutional foreign

exchange borrowings sensitive to PKR-USD interest rate differential may decline significantly. Continuation of this trend will further increase reliance of the balance of payments on official inflows.

Model-Based Assessment

13. MPC was apprised on the latest projections of the Forecasting and Policy Analysis System (FPAS). First of all, 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. Research staff also briefed the MPC about the now-casting of domestic headline, food and core inflation for Q3-FY18, as well as now-casting of output gap consistent with the revised GDP projections for FY18 and fiscal deficit to GDP for H1-FY18 and FY18.

14. After that staff presented the FPAS model projections and policy suggestions. Conditional on the latest data and aforementioned now-casting assumptions, the extended FPAS model suggests a relatively smaller hike in the policy interest rate by Q4-FY18 compared with the interest rate hike suggested in the January 2018 MPC meeting. The policy advice was mainly driven by the unchanged headline inflation for FY19 at around 6 per cent, despite the ease in inflationary pressures observed during Jan-Feb 2018, due to the potential exchange rate pass-through of recent exchange rate adjustments, a positive output gap, the expected fiscal expansion (due to political budget cycles). In addition, the core inflation, although moderated since December 2017, is expected to remain stable at the level (5.2 per cent) for FY19 projected and presented to the MPC in January 2018. This is also manifested by the flat reading of IBA-SBP Consumer Confidence Survey conducted in March 2018. Furthermore, the policy interest rate hike of 25 bps by Federal Reserve in late March has neutralized the impact of the SBP's 25 bps uptick in policy rate of January 2018 on the interest rate differential.

15. In terms of FPAS projections for FY18, owing to the ease in inflationary pressures observed during Jul-Feb, 2018, both average headline and core inflation forecasts have been revised downwards since the last MPC to 4.4 percent and 5.4 from 4.8 percent and 5.6 percent, respectively.

16. Research Staff also apprised the real exchange rate gap again opened up following the adjustment in exchange rate in December 2017 due to a rising relative price differential from the US economy. The most recent adjustment of exchange rate is expected to improve export competitiveness further. This combined with a rising external demand, as shown by upward revisions in the US economy growth in the latest FOMC projections, would reduce the external sector vulnerabilities.

17. At the end, staff presented some alternate scenarios which can impact policy rate to the Committee included: 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

18. 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 increased and expected inflation has not changed on an overall basis, in comparison to the previous survey conducted in

January 2018. It was noted that survey results on CCI and Expected inflation are also being published on the SBP website to enhance disclosure.

Monetary Policy Deliberations and Decision Vote

19. While setting the policy interest rate for the next two months, the Committee pondered at the following points presented by the staff members: (1) the need to maintain macro stability, (2) trends in inflation and growth, (3) external accounts position, and (4) narrowing of PKR's interest rate differential with the rest of the world.

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 increasing the policy rate by 25 bps.

21. Members voting for maintaining status quo were of the view that some time may be allowed so that impact of recent policy developments unfold, while cognizant of the need to maintain stability and support growth at the same time.

22. Members voting for increasing the policy rate by 25 bps were of the view that external account situation and underlying inflationary trends require an increase in the policy rate.

23. In conclusion, the Committee was of the view that some time may be allowed for the impact of recent policy developments to unfold and has therefore decided to keep the policy rate unchanged at 6.0 percent with a majority vote of 6 out of 9 members present, with 3 votes for increasing the rate by 25 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 6.0 percent.*
- *The Monetary Policy Statement – March, 2018 is approved.*