**MINUTES OF THE 6th MEETING OF**
**THE MONETARY POLICY COMMITTEE (MPC)**
**Held on November 26, 2016**

**P R E S E N T**

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| Mr. Ashraf Mahmood Wathra | Chairman & Governor SBP |
| Mr. Saeed Ahmad | Deputy Governor (FM, IB & SI) |
| 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 post-September 2016 Monetary Policy decision period, along with the assessment of evolving trends.

2. The YoY CPI inflation increased to 4.2 percent in October FY17 as compared to 3.9 percent in the preceding month and 1.6 percent a year earlier. Average CPI inflation during Jul-Oct FY17 increased to 3.9 percent, as compared to 1.6 percent in Jul-Oct FY16. The 12-month moving average was recorded at 3.6 percent in October FY17 as compared to 2.7 percent in October FY16. The YoY food inflation increased to 4.4 percent in October FY17 from 0.5 percent a year earlier. YoY non-food inflation increased to 4.1 percent in October FY17 from 2.4 percent in the corresponding period of the previous year. Core inflationary measures also indicate inflationary pressures as NFNE inflation on YoY basis increased to 5.1 percent in October FY17 from 3.4 percent in the corresponding month of the previous year, whereas 20 percent trimmed-mean inflation on YoY basis increased to 3.8 percent in October FY17 from 2.8 percent in October FY16. Thus, movement in the NFNE and trimmed mean measures of inflation is showing relatively less steep increase in the underlying inflationary pressures.

3. Broad money (M2) registered a cumulative growth of 1.2 percent during July 01 - November 04, FY17 as compared to growth of 0.3 percent in the comparable period of FY16. M2 increase is mainly led by net government borrowing from SBP which reached Rs. 878 billion in the referred period against retirement of Rs. 225 billion in the comparable period of the previous year. On the other hand, there was retirement of Rs. 482 billion of government borrowing from scheduled banks during this period as compared to borrowing of Rs. 452 billion in the comparable period of the previous year. Consequently, OMO injections declined during this period. Further, growth in NFA of the banking system decelerated due to contraction in NFA of scheduled banks. The significant rise in CIC observed in FY16 is moderating and growth in

deposits can be seen in FY17. However, currency-to-M2 ratio is still high at 26.8 compared to 26.0 last year.

4. Credit to the private sector recorded retirement of Rs. 140.9 billion during Q1-FY17 as compared to retirement of Rs. 39.6 billion in the comparable period of the previous year. Cumulative flows of Q1-FY17 however, understate the credit uptake since the base has become exceptionally high in June 2016 due to various one-off factors. Apart from the unusual trend in June, 2016, the YoY flows for September FY17 show credit uptake of Rs 356.3 billion as compared with Rs 109.8 billion for September FY16. Similarly, YoY flows of consumer financing showed an encouraging uptick as it increased to Rs. 53.7 billion by September FY17, from Rs. 22.6 billion in the comparable period of the previous year.

5. Budget deficit in Q1-FY17 was 1.3 percent of GDP compared to 1.1 percent in the corresponding period of the previous year. The expansion in deficit is explained by lower than targeted revenue collection and increase in public expenditure, which was mainly driven by higher PSDP spending. Non-tax revenues during this period decreased to Rs. 123.1 billion from Rs. 213.5 billion in the corresponding period of the previous year, in addition to absence of any proceeds under CSF in Q1-FY16. FBR taxes posted low growth of 4.1 percent in Q1-FY17 as compared to 11.6 percent in the corresponding period of the previous year.

6. Global growth outlook remained mixed amid uncertainties for financial and commodity markets. External current account deficit was recorded at USD 1.76 billion during Jul-Oct FY17, compared to USD 1.08 billion during the corresponding period of the previous year. Contributing factors in this higher deficit were higher non-oil imports and absence of CSF inflows. Workers' remittances of USD 6.26 billion in Jul-Oct FY17 declined by USD 249 million from the comparable period of the previous year while trade deficit at USD 6.70 billion during the referred period increased by USD 474 million in comparison with the previous year. Lower flow of workers' remittances can be attributed to a tighter AML regime and controls on remittances in United States, depreciation of GBP against USD, decline in number of immigrants from Pakistan and decreasing investment in real estate due to the change in tax rules. Net FDI flows were recorded at USD 279 million in Jul-Oct FY17 as compared to USD 602 million in the comparable period of the previous year. Foreign Portfolio Investment flows recorded net inflows of USD 1,169 million in this period as compared to inflows of USD 333 million in the corresponding period of the previous year. The overall balance of payments posted a surplus of USD 798 million for Jul-Oct FY17 as compared to surplus of USD 839 million in the comparable period of the previous year. On a cumulative basis, SBP's net liquid reserves stood at USD 18.9 billion, providing coverage for more than four months of import payments.

7. Current estimates suggest that real GDP growth is expected to remain close to the target of 5.7 percent for FY17. The initial estimates from the Ministry of National Food Security and Research indicate that some of the major Kharif crops are expected to post healthy growth during the current fiscal year which is expected to help achieve the agriculture growth target of 3.7 percent for FY17. Industry is expected to grow slightly less than the target as LSM remained sluggish in the first three months of FY17, mainly because of cigarettes, POL, Chemicals and Jute, indicating various sector- specific challenges. Services sector is likely to grow at the target level of 5.7 percent.

## Financial Markets and Reserve Management

8. Since the Monetary Policy review in September 2016, liquidity conditions in the interbank market have improved further. The overnight repo rate remained stable, averaging at 5.73 percent, closer to the target rate of 5.75 percent. Consequently, the need for SBP's liquidity injections was reduced and the outstanding stock of OMO injections declined to around Rs. 700 billion. However the yield curve for tenors for 3 months onwards has shifted upward, reflecting market expectations of bottoming out of interest rates. Nevertheless, the current yields of up to one year tenor still showed a reduction by more than 25 bps compared to the level prior to the 25 bps cut in the policy rate in May, 2016. Market expectations that the policy rate will be maintained at its current level have led to higher bids in primary auctions of government securities. On the other hand government has accepted less than the targeted amount in T-bill auctions and also scrapped the recent PIB auction in view of anticipation of continuation of low interest rates amid low inflation. This along with the delay in realization of planned external official inflows led to increased government borrowings from SBP.

## Model-Based Assessment

9. Research Department staff apprised the MPC on the latest projections of the customized version of the Forecasting and Policy Analysis System (FPAS). In addition, the staff also discussed the importance of the FPAS model input for MPC deliberations as an important tool that accounts for interdependent causality between different markets and economic agents. This provides a useful window onto a complex current economic system compared to unidirectional analysis and ad hoc information.

10. Summarizing the main recommendations of the FPAS model for the MPC meeting, the staff explained that sub-optimal LSM activity and lower than projected headline and food inflation, as compared to the model's earlier forecast which in turn lowered the forecasted inflation trajectory for the rest of the fiscal year, necessitates a moderation in the policy rate.

11. The current model output incorporates now-casting of the US Federal Funds rate path and the US inflation for the next 8 quarters based on the Fed's FOMC projections released in September 2016. In addition, the model output also incorporates an optimistic scenario of domestic LSM performance for September 2016 and now-casting of YoY CPI inflation to 3.8 percent for December 2016. Moreover, the risk premium has also been kept unchanged at an elevated level to capture the continued heightened global uncertainty driven by the outcome of the US presidential elections and the continued complexity regarding the economic impact of Brexit.

12. Staff added that the inflationary trend is expected to remain benign as the average headline inflation forecast for both seasonally and non-seasonally adjusted series are at 4.0 percent and 4.8 percent respectively for FY17, well below the target of 6 percent for FY17. In addition, the model suggests a low possibility for average inflation to reach the 6 percent target even in FY18. In fact, given current information, it is highly plausible that year-end inflation projections may have to be revised downwards.

13. To corroborate, even a counterfactual exercise of 8 percent positive shock to the realized headline inflation for FY17 seems unrealistic as it translates to 5.0, 6.3 and 5.6 percent YoY headline inflation for the remaining 3 quarters of FY17, which despite being implausible, averages out to 5.3 percent for the fiscal year.

14. Lower than expected inflation in Q1-FY17 accompanied with no change in the policy rate for the last two meetings has turned the Real Interest Rate Gap positive for the first time in the current fiscal year. This along with the persistent bilateral Real Exchange Rate gap indicates continuously tight monetary conditions which do not bode well for the economy in general and for export competitiveness in particular.

15. LSM YoY growth for Q1-FY17 at 2.2 percent is not only almost half the growth rate recorded in the corresponding period of the previous year but is also lower than the model's forecast of 2.4 percent for the same period. This subdued performance accompanied with an adverse effect of tight monetary conditions has further increased the output gap.

16. Given that LSM is only a proxy for the overall real economic activity, it can be considered as painting a different picture than the ground realities of the economy. However, based on the current available information on real economic activity even other than LSM, it is plausible that growth projections may have to be revised downwards moving forward for FY17, despite an uptick in the CPEC related activities.

17. Staff also explained that the recent upward movement in the yield curve, which incorporates heightened risk perceptions and higher future inflation, is unrealistic and it is desirable to arrest this trend in a timely manner.

18. It was further added that after incorporating various scenarios such as purging of volatile items from the LSM index, muting flexibilities in the Taylor rule and/or assuming higher fiscal slippages-induced inflation, the FPAS remains consistent in its policy recommendation, suggesting a moderation in the policy rate.

**Monetary Policy Decision Vote**

19. 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.

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

21. 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 in view of the macroeconomic developments and the need to provide further stimulus for economic growth.

22. 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 10 members present, with 4 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 - November, 2016 is approved.*