MINUTES OF THE 2nd MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on April 9, 2016

P R E S E N T

Mr. Ashraf Mahmood Wathra	Chairman & Governor SBP
Mr. Saeed Ahmad	Deputy Governor (FM, IB & SI)
Mr. Riaz Riazuddin	Deputy Governor (Policy)
Mr. Zafar Masud	Director SBP Board
Mr. Mohammad Riaz	Director SBP Board
Mr. Ardeshir Khursheed Marker	Director SBP Board
Dr. Asad Zaman	External Member
Dr. Qazi Masood Ahmed	External Member
Dr. Aliya Hashmi Khan	External Member
Mr. Jameel Ahmad	Executive Director (FS & BSG)

Review of Current Economic Conditions and Outlook for FY16

Monetary Policy Department staff apprised the Committee on developments in key macroeconomic variables during the post January 2016 monetary policy decision period along with the assessment of evolving future trends.

After bottoming out in September 2015, the Year-on-Year (YoY) headline CPI inflation has risen to 3.9 percent in March 2016. Both food and non-food inflation on YoY basis have increased to 3.7 percent and 4.1 percent respectively in March 2016, from 0.5 percent and 3.9 percent in March 2015. Also the measures of core inflation, Non Food-Non Energy (NFNE) and Trimmed Mean have been depicting a rising trend consecutively for five and three months respectively. NFNE inflation increased by 4.7 percent and Trimmed Mean inflation rose by 3.8 percent during March, 2016 in YoY terms. The 12-month moving average CPI inflation declined to 2.7 percent in March, 2016 as compared to 5.9 percent in March 2015; gaining only 0.1 percentage point each in January and February 2016.

The rising trend in inflation, especially in its core measures, indicates pickup in aggregate demand, amid both improved security situation and real incomes. This is reflected in the rising demand for consumer durables, acceleration in construction activities, and expansion in the services sector. Further, uptick in credit to the private sector, mainly owing to lower cost of borrowing, also supports this assertion. At the same time, with improved business sentiments, lower input prices and better energy availability, supply conditions have improved as well. Largely contributed by the automobile, cement, and fertilizer sectors, large-scale manufacturing (LSM) grew by 4.1 percent in Jul-Jan FY16, compared to 2.5 percent growth in Jul-Jan FY15. The improving LSM and industrial growth trends are expected to continue despite sector specific issues in the steel and paper & board sectors, and a sluggish textile sector. Furthermore, excess stock of major food items and the February 2016 pass-on of lower oil prices to domestic consumers are expected to maintain a downward pressure on inflation.

With less than three months left in the current fiscal year, the average CPI inflation during FY16 is expected to remain benign; nonetheless, the possibility of any major change in administrative prices or prices of perishable food items poses some risk.

Amid improved security situation, real incomes, and mainly owing to lower cost of borrowing, private sector availed Rs326 billion net credit during Jul-Feb FY16, as compared to Rs158 billion availed during Jul-Feb FY15. Industrial sector availed net credit of Rs231 billion, with major thrust coming from manufacturing. After remaining sluggish, working capital has also increased. Continuing increase in fixed investments for the fifth quarter remains noteworthy. With positive consumer sentiments and incremental lending rates at considerably lower levels, the uptake in credit to private sector is expected to be at higher level at end FY16 than that at end FY15.

Broad money (M2) increased by 4.8 percent during 01 July - 18 March, FY16, nearly the same growth as seen during the same period in FY15. This monetary expansion is mainly driven by the Net Domestic Assets (NDA) and Net Foreign Assets (NFA) of SBP amidst decline in both for the scheduled banks. Reserve money growth accelerated to 21.9 percent during 01 July - 18 March, FY16, as against the growth of 9.0 percent in the previous year. Currency in circulation growth accelerated to 20.1 percent during 01 July - 18 March, FY16 compared to growth of 13.0 percent in the previous year, a trend which is also aligned with the accommodative monetary policy stance.

The cumulative growth in bank deposits registered an increase of 0.3 percent for the period 01 July - 18 March, FY16. Based on these developments, M2 growth for FY16 is projected to be about the same as in FY15. Despite the welcomed increase in development expenditure, the budget deficit remained manageable in H1-FY16. This improvement came from containment of current expenditures and increase in Federal Government tax revenue by 14.6 percent as compared to only 3.9 percent in FY15. Going forward with current trends, realization of the budget deficit would be close to the target for FY16.

Both money and foreign exchange markets exhibited relative tranquillity in recent months. The cushion provided by the decline in oil prices and inflow of remittances improved sentiments in the foreign exchange market. As a result, in the post January 2016 monetary policy period, PKR remained stable whereas the premium in the kerb market also came down. In the money market, volatility in the overnight repo rate was greatly contained and the repo rate converged to the policy rate. Weighted average overnight repo rate stood at only 3 bps above the policy rate in the post January 2016 monetary policy decision period compared to being 21bps above in the post November 2015 monetary policy decision period. As anticipated, the lagged transmission of the past policy rate cuts and further anchoring of inflation expectations for an extended period of time resulted in further decline in KIBOR and market interest rates in the stabilized environment. Yield differential between the 6 month and 5 year paper has also narrowed from 246bps in March, 2014 to 89bps in March, 2016. Market liquidity requirements are expected to remain high in FY16 on account of the continuing trend in retirement of government debt from SBP through enhanced borrowing from scheduled banks and improving private sector requirements.

External current account deficit narrowed marginally by USD88 million during July-Feb FY16, largely due to lower deficit in the services accounts. Despite the pickup in the quantum of oil imports and higher import of machinery and transport equipment, the trade deficit stood at last year's level of about USD12.0 billion. The continuous decline in exports remains worrisome despite continuing import of machinery and improving domestic conditions, whereas the cushioning growth in foreign remittances is also moderating.

Capital and Financial account remained at last year's level as net foreign direct investment posted an increase of 12.1 percent (USD736 million) and net general government increased by USD1.7 billion. With overall balance of payments posting a surplus of USD1.0 billion, net SBP foreign exchange reserves reached USD15.5 billion. Since the balance of payment position is expected to stay the same in the rest of FY16, medium-term external sector sustainability is still challenged due to the inadequate private capital inflows and structural issues related to exports' growth amid decline in international trade.

On the global front, IMF and OECD see global growth slowing as global trade, investment, and wage growth remain weak and weaker economic activity in China and other economies has been observed. Glut in commodity markets would continue to exert downward pressure on prices. Portfolio outflows from Emerging Market Economies (EMEs) may stabilize on account of boost in monetary stimulus programs of a number of advanced economies and reversal in commodity prices and increased stabilization in emerging economy currencies and financial markets. Consequently, the risk premia for internationally floated emerging market bonds may continue to decline further.

Model-based Assessments

Research Department staff explained the structure and salient features of the customized version of a model known as the Forecasting and Policy Analysis System (FPAS) to the newly constituted MPC. The staff also elaborated on some caveats of the FPAS model and also apprised the Committee about the forthcoming developments on the FPAS.

This was followed by a discussion on the evolution of the international economic scenario over the January-March 2016 period. Staff also observed that international financial markets are much calmer now as compared to the time of the previous MPC meeting as: i) the Federal Reserve is likely to delay its hike in the Federal funds rate. This also implies that the Federal Reserve is prepared to tolerate more inflation than previously thought; (2) the international currency markets' volatility has moderated relative to what was observed at the turn of the year and (3) Capital outflows from China and other EMEs have slowed. From this perspective as well as lower international commodity prices, the balance of risk from the external side has shifted in Pakistan's favor.

Staff then presented the latest projections of the FPAS model. It was observed that the FPAS model-induced interest rate path is relatively lower in the medium-term compared to the model projections reported to MPC in its January meeting. The moderation in the model-induced interest rate path was attributed to: (i) the downward revision in average headline inflation forecast (seasonally adjusted) for FY16 to 2.6 percent from 2.9 percent projected in January 2016; for FY17 the headline inflation is projected at 3.9 percent, (ii) food inflation is also relatively lower in FY16, and (iii) core inflation, though inching up slightly, is expected to move in a narrow band in the medium term. These projections are also corroborated by other independent evidence, not directly captured in the model, such as lower inflation expectations and improving consumer confidence surveys of the economy.

As far as the real sector is concerned, the LSM gap has narrowed considerably given the buoyant performance of the LSM sector during this year. In the medium term, the model projects a negative output gap mainly due to the contemporaneous effects of monetary conditions, the lagged impact of the weak economic growth as well as some losses in competitiveness. The narrowing of the medium-term output gap further would necessitate some softening of the policy rate. It was observed that monetary conditions are tighter than previously thought as especially reflected by an increase in the real interest rate gap. This is unfavorable for domestic investment as well as concerns about competitiveness raised previously.

Keeping in view these projections, tight monetary conditions and lower inflation than the target, the model suggests a downward revision of the policy rate by the end of Q4-FY16. This change may also partially help address the concern that a large proportion of commercial banks' balance sheets is dominated by government securities.

MPC Deliberations and Policy Vote

After the presentation, the Staff responded to the members' queries. It was explained that after a period of high inflation and low growth, the economy is well on track for a reasonable growth rate but further investment and resource mobilization is required given the low tax to GDP ratio. It was noted that 9.8 percent growth in bank deposits so far is weaker than previous year's growth of 11.3 percent in the same period. It was opined that low deposit growth could be linked to the impact of tax measures on bank transactions that may gradually fizzle away.

On the availability of funds for private sector credit, it was explained that the SBP ensures availability of adequate liquidity in the market as evident from the sizable outstanding stock of liquidity injections. Growth in private sector credit also depends on factors other than liquidity such as the risk appetite of banks and constraints like energy availability and security issues. It was noted that the advances to deposit ratio has improved from 46 to 48 percent in the recent past. Also, it was observed that the corporate sector may prefer to use its own liquidity for expansion rather than taking loans from banks, given the improved profitability of private sector companies. The inherent problems in expanding mortgage financing, collateral issues for SMEs and corporate restructuring also came under discussion where it was noted that the SBP has taken several initiatives to strengthen the enabling legal framework.

On a query on the intermediate target of monetary policy, it was explained that the ultimate objective is to maintain the requisite balance between controlling inflation and promoting growth, and that considerations for the monetary policy decision take into account a wider range of economic parameters including inflation, balance of payments, monetary aggregates, interest rates etc. as components of an eclectic system, which is much closer to flexible inflation targeting rather than interest rate targeting. It was added that the weighted average overnight rate is taken as the operational monetary policy target.

Members also discussed the impact of reducing the policy rate on investment. It was noted that empirical evidence is not strong in showing the responsiveness of investment to change in the policy rate though such a relationship exists. It was also noted that lending to SMEs has increased by around Rs. 9 billion in the last 5 months after remaining stagnant for a long period. It was also discussed that the impact of the continued low interest rates has finally started to exert pressure on banks to increase lending to the private sector as the previously held high-yielding government securities are maturing. It was explained that the 400 bps reduction in the policy rate since November 2014 has resulted in lowering the weighted average lending rate by 320 bps in one year (from Jan 2015 to Jan 2016) while lending rates for the agriculture sector by private sector banks have decreased by 200 to 400 bps.

The maturity profile of government securities was also briefly discussed where it was noted that these are well-staggered into different tenors and there is no foreseeable issue in rolling over the upcoming maturities of around Rs 1.6 trillion in July, 2016. It was also discussed that more stable government borrowings would add to the effectiveness of the Monetary Policy decision.

The members then voted on the policy decision. Deliberations led to formulation of views for maintaining stability and keeping the policy rate unchanged while there was also support for reducing the policy rate by 25 bps to give the requisite signal to the financial markets.

Members voting for reducing the policy rate observed the need to consider: (i) expectations for average CPI inflation for FY16 to remain benign and (ii) the need to continue the existing policy stance in view of its positive impact on investment and economic activities.

On the notion of taking the Keynesian approach which suggests increasing the money supply to the extent that it does not impact inflation, it was noted that a significant portion of the increase in money comes from an increase in foreign exchange given that Pakistan is an open economy and any decision on the policy rate should take into account this aspect. It was also discussed that most of the benefits of low oil prices are being off-set by non-oil imports which further necessitates the need for regular and sustainable foreign exchange inflows, particularly when the recent improvements in the balance of payments position are due to one-off sources without any major structural corrections.

Members favoring no change in the policy rate observed that: (i) the real sector is responding well to the existing level of the policy rate (ii) despite the gradual reduction in the policy rate over time, the market rates have not declined correspondingly, indicating the need for more time for the market to fully adjust to the existing level of the policy rate and (iii) the need to be cognizant of the impact of any further reduction in the policy rate on the banking sector where deposits' growth has slowed while at the same time currency in circulation is growing at a faster pace.

These members were of the view that more weight should be given to maintaining stability and also to convey the signal that monetary policy alone cannot propel growth as other policies should also play their role to address structural impediments due to which growth tends to hover below its potential level.

In conclusion, the Committee decided to keep the policy rate unchanged with 5 votes each in favour of the 25 bps reduction in the policy rate and for maintaining status quo. In view of the tie, the Chairman exercised his casting vote in favour of no change in the policy rate.

The MPC decided as follows:

DECISIONS:

- *The policy rate is maintained at the present level of 6 percent.*
- *The Monetary Policy Statement – April, 2016 is approved.*