MINUTES OF THE 3rd MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on May 21, 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. Jameel Ahmad	Executive Director (FS & BSG)
Mr. Zafar Masud	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

Review of Current Economic Conditions and Outlook for FY16

1. Monetary Policy Department staff apprised the Committee on developments in key macroeconomic variables during the post-April 2016 Monetary Policy decision period, along with the assessment of evolving future trends.

2.[1] The latest growth estimates indicate a continuation of moderate recovery in the economy which started in FY14. For FY16, GDP growth is indicated to be at 4.7 percent which exceeds the 4.0 percent growth of FY15 despite still being below current year's target of 5.5 percent. Industry has led this traction in recovery by growing at 6.8 percent as compared to 4.8 percent in FY15, supported by 13.1 and 12.2 percent expansion in Construction, and Electricity and Gas Distribution respectively. Agriculture growth, however, has declined by -0.2 percent with the major drag coming from losses in rice and cotton production along with decline in Cotton Ginning by 21.3 percent against growth of 7.2 percent in FY15. The Services sector has further improved in FY16, recording a growth of 5.7 percent as compared to 4.3 percent in FY15, with major contribution coming from the growth in General Government Services that rose to 11.1 from 4.8 percent in the previous year.

3. Inflation continued its upward trajectory that started in October, 2015 as the Year-on-Year (YoY) headline CPI inflation increased to 4.2 percent in April 2016 from 3.9 percent in the previous month. The 12-month moving average inflation increased to 2.9 percent in April 2016 from 2.7 percent in the preceding month but was substantially lower than the 5.4 percent level observed in April 2015. The average inflation for Jul-April 2016 remained 2.8 percent against 4.2 percent during the same period in the previous year. The Month-on-Month (MoM) inflation increased by 1.5 percent in April 2016 over 0.1 percent increase in March 2016 which could be attributed mostly to seasonal factors.

4. The underlying inflationary tendencies evident from the Non-Food Non-Energy (NFNE) and Trimmed Mean measures of core inflation are leaving behind the declining trend as well. The NFNE

[1] Data in this section is from PBS.

inflation on MoM basis has increased from 1.1 percent in April 2016 from the preceding month while its trend in 12 months moving average is almost flat. The Trimmed Mean inflation has also increased to 0.6 percent in April 2016 as compared to 0.2 percent in March 2016 while a slight uptick is observed in its YoY and 12-months moving average trends.

5. With less than two months left in the current fiscal year and expected monthly average increase of around 0.3 percent in FY16, the average CPI inflation would remain well within the annual target of 6.0 percent average inflation for FY16, even after accounting for the Ramazan impact in the coming month. However, an upward trajectory in inflation is expected to continue owing to bottoming out of oil and commodity prices in the international markets and revival of domestic aggregate demand to some extent.

6. Broad money (M2) increased by 6.6 percent during 01 July - 29 April, FY16, marginally higher than the growth seen during the same period in FY15 although Reserve money during this period exhibited a significant growth rate of 20.2 percent as compared to 10.1 percent in the corresponding period of the previous year. Currency in circulation expanded by 18.5 percent during 01 July - 29 April, 2016 as compared to 11.4 percent in the comparable period of the previous year that explains the lower growth in M2 as compared to increase in Reserve money that resulted in lowering the money multiplier. Credit to private sector during 01 July - 29 April, FY16 increased to Rs. 341 billion with 8.5 percent growth as compared to off-take of Rs. 212 billion in comparable period of the previous year with 5.6 percent growth which is attributed to improved security situation, improvement in power availability and contribution of lower interest rates. Increased credit to private sector includes a higher share of working capital that indicates revival in economic activities.

7. The cumulative deposits of the banking sector increased by Rs. 371 billion during Jul-Mar, FY16 as compared to an inflow of Rs. 461 billion in the same period of the previous year. However, during the same period the inflows under private sector deposits reduced to Rs. 249.8 billion in FY16 from Rs. 400 billion in FY15. A lower growth rate of 1.8 percent for private sector deposits during the first 9 month of FY16 can be linked with the lower rate of return, as well as a possible impact of taxation measures on bank transactions. An almost two-fold increase in near-currency instruments, such as prize bonds, was also noted which could be linked with lower real weighted average rate of return on deposits which reduces further when adjusted for deposits with zero rate of return and inter-bank deposits.

8. External current account deficit for July-April, FY16 at USD 1.5 billion narrowed down by 17 percent when compared with previous year's deficit of USD 1.8 billion, owing to remittances of USD 16 billion along with inflows of USD 937 million under CSF. The financial accounts indicate that multilateral and bilateral official transfers have helped improve the balance of payments but the trend should not be viewed as steady due to the one-off nature of such inflows while more structural improvements are yet to be witnessed. The balance of payments surplus increased the foreign exchange reserves that now cover over 4 months of the import bill as compared to coverage of 3 months in FY15.

Financial Markets and Reserve Management

9. Taking stock of market conditions, it was noted that the revised Interest Rate Corridor (IRC) has helped greatly in improving the transmission of past policy rate cuts to market interest rates and containing money market volatility even more after the policy rate decision of April 9, 2016. Maintaining market rates closer to the policy rate has required liquidity injections with outstanding stock at Rs. 1.3 trillion, with a reduction from the stock of Rs. 1.6 trillion in April, 2016. The relative

decline in the volume of injections can be attributed to lower appetite of the banks for investment in government securities at the prevailing rate.

10. Expectations of higher interest rates going forward could make it harder for the government to meet its financing needs from banks, as reflected by the recent unsuccessful auctions of PIBs and T-bills. The banks have the option to abstain from rolling over the government's maturing debt and repay the liquidity injections of SBP; their own deposit base will not be affected. The expectations of higher interest rates may continue to prevail and pose difficulty in defending a lower policy rate. The government on the other hand has limited options to borrow from SBP under the ongoing program with IMF and recent amendments in the SBP Act, 1956, which require that the government needs to reduce its borrowings from the SBP to zero by each quarter-end, except for what is permitted under the ways and means limit. The policy rate determination should also take into account lower growth rate in deposits and increased level of currency in circulation.

Model-based Assessments

11. Research Department staff apprised the MPC about the latest projections of the customized version of the Forecasting and Policy Analysis System (FPAS). Prior to its presentation, the staff highlighted the importance of growth (5.5 percent for FY16) and inflation (6.0 percent for FY16) targets as the current fiscal year draws to a close, the importance of an interest-rate path for meeting these desired targets and also the importance of integrated, but calibrated adjustments in the economy.

12. Turning to the FPAS model projections, the staff first talked about important data revisions and the new information incorporated in the current set of projections. These revisions pertained to both domestic and external variables that are part of the FPAS model. On domestic side, the significant new data point for current output is the LSM index value for March 2016. On external side, the data revisions in the US output, the US CPI and international commodity prices were incorporated as well. In addition to these actual data revisions, the inputs to the model were also improved in terms of now-casting the current upward trends in food and international oil prices and the medium term assessment of the US Federal Funds Rate.

13. Conditional on the latest data and the now-casting of aforementioned variables, the FPAS model-induced interest rate path is marginally higher compared to the path reported in the April 2016 MPC meeting. However, the broader output of the model still calls for moderation in the policy rate. The average headline inflation forecast is 3.2 percent and 5.0 percent for FY16 and FY17, respectively, both below the inflation target of 6 percent for FY16 and FY17. Average food inflation forecast for FY16 and FY17 is depicting a rising trend capturing the higher readings of CPI-food group in recent months which is expected to sustain over the next two months due to the upcoming month of Ramzan. Nonetheless, core inflation is expected to stay around 4 percent for both FY16 and FY17 and headline inflation is likely to remain below the desired levels (6 percent).

14. On the real side, the LSM gap has narrowed further given the buoyant performance of the sector during the first nine months of the current fiscal year. However, the LSM gap, which is a proxy for the output gap, is projected to widen moving forward despite the narrowing down of real interest rate gap. This projected widening of the LSM gap in the medium term is primarily driven by the real exchange rate gap (stability in the FX market) which is having an impact on export

competitiveness. The current FPAS projections show that going forward the output-gap will remain positive in the medium term. In other words, output growth is currently below the desired levels.

15. Outside the model, the staff also discussed the dominance of government securities on the commercial banks' balance sheet and its linkages with the shape of the yield curve – widely considered to be an important predictor for future economic activity. Such dominance exerts pressure on long-term interest rates thereby influencing the quality of and growth in lending to the private sector.

16. Keeping in view now-casting assumptions, medium term projections and lower inflation than the target and lagging growth, the model suggests a downward revision of the policy rate by Q4-FY16, which is also consistent with the model's recommendation in the previous MPC meeting, however, the magnitude of downward revision is smaller. This moderation in rates may also partially help address the dominance of government securities on certain commercial banks' balance sheets.

Monetary Policy Deliberations and Decision Vote

17. After conclusion of the presentation, the Staff responded to the queries of the members. It was explained that inflation is expected to attain a relatively higher plateau in FY17 but would remain in a lower band. The factors leading to higher inflation forecast include indication of setting oil prices to a higher level and the trend in non-energy commodities, which is on the rise. On a likely increase in oil prices in 2017, the Staff explained that projections of various international agencies vary from USD 43 to 52.

18. On a probable reduction in the policy rate, the Staff explained that it will only affect the yield curve for shorter tenor instruments. It was explained that even with a lower policy rate, the interest rate expectation for the longer tenor instruments may not change as the market is likely to give more weight to the inching up of inflation and increasing international oil prices. It was explained that expectation of higher interest rates will compel banks to refrain from investing in low-yield long term instruments even in the presence of OMOs, which is a short term facility. It was noted that as part of its supervisory role, the SBP monitors that banks do not overly run interest rate mismatch. The Staff also clarified that macroeconomic indicators do not suggest any increase in the policy rate, though unforeseeable shocks, such as sharp increase in oil prices may lead to such a requirement. Options for the government to turndown auctions due to higher bid rates were discussed where it was noted that narrowing margin and interest rate mismatch may restrict the banks from placing lower bids even if the policy rate is reduced. It was noted that market surveys indicate that the markets are not expecting any change in the policy rate.

19. On increase in non-oil based imports, it was explained that the bulk of such items consists of machinery, especially for power generation that may ease energy availability and facilitate economic activities. It was noted that export projections for FY17 are quite promising. In view of the imminent completion of the IMF program, anticipated pressure on worker's remittances from oil-producing countries and uncertainty in CSF flows, it was noted that structural improvements are quite essential to support the balance of payments position. It was noted that present growth in LSM is aimed at fulfilling domestic demand.

20. On queries pertaining to FPAS model, the Staff explained that a large gap under bilateral real effective exchange rate may reduce with the inclusion of other relevant currencies. In view of the limited role of interest rates in increasing exports, it was noted that other policies should play

their role in tandem with the monetary policy. On the alternate scenarios for model projections, it was explained that reducing policy rate by 50 bps may result in lower output gap but the overall results are not exceptionally different, which reinforces the point that the policy rate is not the only factor responsible for reviving the economy. It was however noted that under the current parameters, the model is nevertheless suggesting further reduction in the policy rate.

21. Discussing foreign exchange markets, it was explained that at present the market is self-sustained and hardly requires any intervention, though in case of increase in oil prices and slowing down of workers' remittances, it may witness some pressure. It was also explained that slowing down of official transfers, especially after conclusion of the IMF program in September, 2016, the sustainability of the balance of payments position would need more careful monitoring. Additionally, the impact of the policy rate decision on private sector inflows also needs to be assessed which are typically more interest rate sensitive.

22. At the conclusion of the Staff presentations, the members shared their views and voted on the policy rate decision. Deliberations led to formulation of views for reducing the policy rate by 25 bps and for maintaining status quo.

23. Members voting for reducing the policy rate observed the need to consider: (i) SBP's role in promoting economic growth and full employment and (ii) the positive impact on private sector credit and exports.

24. On the real interest rates moving into the negative zone, it was observed that industrial economies are deliberately maintaining negative interest rates to facilitate economic activities. On the issue of slow growth in bank deposits, it was noted that every policy has negative and positive repercussions and as such bank deposits may undergo some difficulty in maintaining growth but the overall economic benefits should be given more importance. It was reiterated that the policy rate is not the only instrument for promoting growth and other structural impediments also need to be addressed.

25. The member who voted for maintaining status quo did so mainly due to: (i) picking up of inflation, (ii) potential implications for the balance of payments position, (iii) slow growth of bank deposits along with increase in the currency in circulation to deposit ratio from 29.7 to 33.7 percent.

26. In conclusion, the Committee decided to reduce the policy rate by 25 bps with a majority vote of 8 out of 9 members present, with one vote for maintaining status quo.

The MPC decided as follows:

DECISIONS:

- *The policy rate is reduced by 25 bps to 5.75 percent.*
- *The Monetary Policy Statement – May, 2016 is approved.*