MINUTES OF THE 1st MEETING OF
THE MONETARY POLICY COMMITTEE (MPC)
Held on January 30, 2016

P R E S E N T

Mr. Ashraf Mahmood Wathra	Chairman & Governor SBP
Mr. Riaz Riazuddin	Deputy Governor (Policy)
Mr. Khawaja Iqbal Hassan	Director SBP Board
Mr. M. Hidayatullah	Director SBP Board
Mr. Zafar Masud	Director SBP Board
Dr. Qazi Masood Ahmed	External Member
Dr. Asad Zaman	External Member
Mr. Jameel Ahmad	Executive Director (FS & BSG)

Review of Current Economic Conditions and Outlook for FY16

Monetary Policy Department staff presented a review of recent economic developments and an assessment of the evolving trends to MPC. A number of indicators showed a positive outlook of real economic activity. Substantial increase in private sector credit during H1-FY16 indicated improving real economic activity. Total private sector credit increased by Rs 339.8 billion during this period compared to Rs 224.5 billion in the same period of the previous year. This increase was contributed by higher credit for both working capital and fixed investment purposes. The latter in particular is an encouraging development as fixed investment had been stagnant at around 15.0 percent of GDP during the last three years. Moreover, despite the lower commodity prices and raw material costs, increase in credit for working capital indicates that the underlying current economic activity is stronger relative to the previous year.

Large-scale manufacturing (LSM) grew by 4.4 percent during July-November FY16 compared to 3.1 percent in the corresponding period of the previous year. Higher growth in LSM is supported by construction activity, improved energy supply particularly of gas, and a stable and low interest rate environment. Buoyant construction activity is reflected in the 16.0 percent increase in domestic cement sales during H1-FY16 and has largely been led by the Public Sector Development Program.

Though the decision to import LNG is expected to have a favourable impact on the overall industrial sector output, it has particularly resulted in a substantial increase in the production of fertilizer. The low interest rate environment has also facilitated demand for automobiles and consumer durables as an uptick in consumer credit can be seen in the first half of FY16. Similarly, increase in POL consumption by the industry and transport sectors is another factor pointing towards improved real economic activity.

Expected lower contribution from agriculture, largely on account of the decline in cotton and rice production, is a downside risk to real GDP growth in FY16. The upcoming wheat crop, which is expected to surpass the FY16 target given timely sowing and favourable rains, is likely to partly neutralize these losses. In addition, the Kisan package announced by the government in September 2016, which includes cash support for farmers, fertilizer subsidy, soft agriculture loans and tax exemptions, may also help improve the output of wheat and other Rabi crops. Keeping in view these developments, the real GDP is projected to be in the range of 4.0 to 5.0 percent in FY16.

Although average CPI inflation has fallen to 2.1 percent in H1-FY16 compared to 6.1 percent in the same period of the previous year, YoY inflation has been rising for the last three months. After falling to a multi-year low of 1.3 percent in September 2015, the YoY inflation has risen to 3.2 percent in December 2015. The increase in inflation has been broad-based as all major components have contributed to this rise. Moreover, the trend in core inflation has also reversed as both NFNE and trimmed measures of core inflation seem to have bottomed out.

Despite the additional tax measures and increase in gas prices, the headline inflation is expected to remain low in the remaining part of the year mainly due to the decreased international commodity prices, especially of oil, and ample supply of essential food items. Incorporating these factors, SBP projection for average inflation for the year has been revised downward to 3.0 - 4.0 percent from 3.5 – 4.5 percent. Any further fall in global oil prices and difficulties in clearing excess domestic food stocks (wheat, rice and sugar) pose downside risks while fiscal slippages and possible increase in power tariff pose upside risks to this inflation forecast. Volatile prices of perishable food items also add to the uncertainties.

The Balance of payments position has relatively strengthened. The current account deficit was recorded at $1.3 billion for Jul-Dec FY16, almost half of the $2.5 billion deficit seen in the same period of the previous year. This is largely a reflection of the falling global commodity prices, especially oil, which has more than offset the decline in exports. Within imports, some of the benefits from the lower oil price are offset by higher non-oil imports, especially the import of machinery, which is consistent with the increased economic activity. While the current trend in non-oil imports is expected to continue on the back of investment in energy, this is expected to be outweighed by lower oil import payments.

Besides the weak global demand and substantial depreciation of currencies of the trading partners against the US dollar, higher unit value of Pakistan's exports vis-a-vis export prices of regional competitors is the other major factor contributing to the decline in exports. Rationalisation of energy prices and higher input cost, security-related expenditures and low productivity due to power outages could have contributed to the higher costs of the export processing-cum manufacturing firms. Keeping in view the seasonality factor and the slight uptick in cotton prices, exports are expected to improve in H2-FY16 relative to the first half.

Another factor helping to narrow down the current account deficit is workers' remittances, which continued to increase albeit at a slower pace. The continued decline in international oil prices and reduced fiscal space in Gulf economies, however, may have implications for remittances going forward. Nevertheless, the overall external current account deficit in FY16 is expected to remain close to 1.0 percent of GDP.

The improvement in capital and financial accounts continued to be led by higher official inflows. Some improvement in Foreign Direct Investment was overshadowed by the outflows from Portfolio Investment. Relative unrest in financial markets of the emerging economies following devaluation of the Chinese currency and anticipation of a possible Federal Funds Rate hike in the early part of the fiscal year were the key factors behind portfolio outflows. These developments also influenced sentiments in the foreign exchange market which were calmed by the strong fundamentals, especially the sustained increase in country's foreign exchange reserves.

The foreign inflows, going forward, are expected to remain skewed towards loan and grant disbursements from multilateral and bilateral sources. In addition, the planned issuance of the Euro bond and disbursements under EFF would help maintain an upward trajectory in SBP's foreign exchange reserves, which are expected to increase to cover more than 4 months of imports by end-June 2016.

Led by substantial increase in the NFA of the banking system, the broad money (M2) growth had accelerated to 13 percent by 15th January 2016 as compared to 10.7 percent in the same period of the previous year. The impact of lower government borrowing from the banking system, a reflection of lower fiscal deficit and increased external financing, was somewhat offset by the recovery in private sector credit. On the liability side, growth in deposits decelerated to 9.7 percent (against 11 percent in the previous year) and currency in circulation increased by 23.8 percent (against 9.9 percent in the previous year).

The demand for liquidity injections from SBP thus remained strong and resulted in some volatility in the short-term money market interest rates. To be specific, the overnight money market repo rate remained at about 11.5 basis points above the SBP target rate.

Model-based Assessments

Research Department staff presented latest projections of inflation, output-gap and real interest rate gap, using a customized model for Pakistan's economy.

The model-based inflation path indicates that (i) the potential for deflation in Pakistan has disappeared (ii) YoY inflation is well below historical averages and (iii) the YoY inflation projections for FY15 and FY16 are inching up, but are expected to remain well below the target of 6 percent given the current information. This shift in inflation outlook is mainly driven by higher food inflation in December 2015 relative to earlier model prediction. Core inflation inched up slightly but is expected to remain in a narrow band for rest of this fiscal year and the year ahead.

Other independent evidence, not directly captured in the model, such as (i) improving consumer confidence in the economy and (ii) rising administered price inflation can also explain increasing inflation and its expectations.

The above inflation path has important implications for other macroeconomic variables in real terms. Indeed, the real interest rate gap has remained stable and is falling which bodes well for credit growth going forward.

The output gap is actually proxied by large scale manufacturing index (LSM) and is currently below its historical trend. The negative output gap is mainly driven by both the contemporaneous effects of monetary conditions, and the lagged impact of this phenomenon.

In sum, keeping in view the lower inflation expectations the model suggests a downward revision in the policy rate by the end of this quarter. However, the alternative scenario of keeping interest rates where they currently stand shows that there is not much to be gained in terms of the narrowing of the output gap given stability in the foreign exchange market.

MPC Deliberations and Policy Vote

The members discussed and deliberated on the presentations by the Monetary Policy Department and the Research Department before voting for the policy decision, where two views emerged, one for reducing the policy rate by 50 bps and the other to keep the rate unchanged. The arguments presented by the members' are detailed below:

Members voting for a 50 bps reduction in the policy rate observed that economic indicators convey a mixed picture but the benefits of reducing the policy rate appeared to overweigh the demerits. It was noted that three considerations were important in taking the decision i.e. (i) inflation which is expected to remain low despite the recent uptick, mainly due to the subdued outlook of commodities, (ii) private sector credit, where an increasing trend can be seen and going forward government borrowing is expected to grow at a slower pace and (iii) market expectations and model forecast, which also suggest a rate cut.

Members voting for no change in the policy rate observed the need (i) to take a long term view of economic trends and the need to maintain stability in order to encourage prevailing trends to be fully embedded, (ii) the possibility of reversal of oil prices with associated impact on inflation and (iii) foreign exchange market considerations.

These members were of the view that the previous rate cuts have not yet had a full impact in view of the transmission lag, and it was important to maintain stability to facilitate entrenchment of the full impact of the previous policy measures.

It was noted that the era of weak oil prices may not continue for long as the oil producing countries are facing difficulties and may take necessary steps to avert the situation. It was also observed that while the decreasing trend in inflation had reversed, overall inflation is expected to remain below the targeted inflation for the year.

Growth in private sector credit (for both working capital and fixed investment purposes) and LSM were both positive developments which had taken place at the existing policy rate. The implications of a rate cut for the external account and the exchange rate parity were also seen to be factors which required consideration, despite weak historical and empirical linkages. The unrest in international financial markets and associated impact on FPI outflows was also discussed. The inelasticity of deposit growth against changes in the policy rate was also taken into consideration.

In conclusion, the Committee decided to keep the policy rate unchanged with a majority vote of 6 out of 8 votes where 2 members voted for reducing the policy rate by 50 bps.

The Committee decided as follows:

DECISIONS:

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