Minutes of the Meeting of the Monetary Policy Committee
<u>of the Central Board held at Karachi on 29th January, 2011</u>

Meeting of the Monetary Policy Committee of the Central Board (MPC) was held at Karachi on 29th January, 2011 at 9:30 am.

Present:

1.	Mr. Shahid H. Kardar	Chairman/Governor, SBP
2.	Mr. Yaseen Anwar	Member/Deputy Governor (Banking), SBP
3.	Mirza Qamar Beg	Member/Director of the Central Board
4.	Mr. Asad Umar	Member/Director of the Central Board
5.	Dr. Ijaz Nabi	Member/External Expert
6.	Mr. Riaz Riazuddin	Member/Chief Economic Advisor, Monetary Policy & Research, SBP (CEA-MP&R)
7.	Mr. Asad Qureshi	Member/Executive Director-Financial Markets & Reserve Management, SBP (ED-FMRM)
8.	Dr. Hamza Ali Malik	Member/Director Monetary Policy Department, SBP (Director-MPD)

Mr. Aftab Mustafa Khan Corporate Secretary, SBP attended the meeting as Secretary whereas Dr. Muhammad Ali Choudhary - Director Research Department was also present through special invitation.

Agenda Item No. 1: Leave of absence to members

Leave of absence was granted to Dr. Hafiz A. Pasha, Member/External Expert on his request.

Agenda Item No. 2: Confirmation of Minutes of last meeting held on 29th November, 2010

The Committee confirmed the minutes of the last meeting of the MPC held on 29th November, 2010 and passed the following resolution:

RESOLVED: That the minutes of the meeting of the Monetary Policy Committee of the Central Board held on 29th November, 2010 is confirmed along with its web version.

Agenda Item No. 3: Monetary Policy Statement - January, 2011

1. A member gave an update on major developments in key areas of the economy.

2. Starting with the positive developments, he briefed the committee that the external current account recorded a surplus during H1-FY11 as a result of the substantially higher exports in comparison with the same period of the previous year, and continued robust growth of workers' remittances. The other positive development was the reduction in the stock of government borrowings from SBP which had come down to Rs.1280 billion from its peak level of around Rs.1500 billion in mid-December 2010. He attributed this improvement to the receipt of USD 634 billion on account of the Coalition Support Fund (CSF), transfer of Rs. 40 billion of SBP profit to the federal government and receipts from issuance of Ijarah sukuk and T-bills.

3. Highlighting the areas of concern, the committee was apprised that inflation was persistently high as evident from the month on month (MoM) increase in core inflation, average inflation of 14.6 percent in the first half of FY11 and year on year (YoY) inflation of 15.5 percent in December 2010. He said that monetary expansion was also on the rise as YoY growth of broad money and reserve money was recorded at 15.1 percent and 16.6 percent respectively uptil 15th January 2011. On the substantial contribution of public sector borrowings in monetary expansion, he informed the committee that almost 80 percent of the total expansion of Rs. 454 billion was for budgetary support. He also mentioned that on the basis of preliminary information, the fiscal deficit was around Rs. 500 billion for the first six months, against the revised target of Rs. 812 billion or 4.7 percent for FY11. On a query from another member regarding the pattern of government borrowings in a given year, he explained that traditionally government borrowings were higher in Q1 and Q4 of each year as compared to the other quarters.

4. On the efforts to reduce the increasing fiscal deficit, another member briefed the committee about the understanding reached with the fiscal authorities. He said that the stock of the highly inflationary government borrowings from SBP would be restricted to the level prevalent at end-September 2010 i.e. Rs. 1290 billion. He explained that any borrowing above this level would entail a cost for the government as it would be offloaded to the commercial banks, thereby reducing the transferable profit of the SBP. On a query from a member regarding the significance of shifting government borrowings from SBP to commercial banks, it was explained that borrowings from commercial banks generally tend to be less inflationary, however the actual impact was difficult to quantify, especially in the long run.

5. A member briefed the committee on the performance and outlook of the key macroeconomic variables in the various sectors of the economy. Beginning with the external sector, he gave details of the improved performance of exports and projections of the external current account. On a query from a member regarding the unexpected increase in exports, he explained that the surge in price of commodities such as rice in December, 2010 was unexpected and even defied international estimates. Another member added that in some cases both the price and the quantum had affected the growth of exports. He added that the decline in the volume of export of cotton yarn reflected a departure from the traditional dependence of exports merely on cotton yarn.

6. One member explained that on analyzing the data on the quantum and prices of export items, which was available for almost 70 percent of exports, it could be concluded that the increase in the volume of exports was driven primarily by higher prices as for most of the commodities, the quantum had declined in relation to the previous year. A member noted that commodity prices in the international markets were likely to be more volatile in general due to the increased interest of global financial players in the commodity markets.

Continuing with his briefing, the member cautioned that despite recording a surplus balance in H1-FY11, the year-end external current account balance was projected to have a deficit of USD 3.0 billion, as some of the receipts in H1-FY11, such as flood related inflows, were a one-off occurrence and would not be available in H2-FY11. Moreover, he added that other inflows into the financial accounts were also expected to remain weak in H2-FY11. In particular, he referred to the nil FDI inflows under privatization proceeds that were previously assumed to be USD 800 million. He added that as a result, the overall balance of payments position was unlikely to be very different from earlier projections.

7. In response to a query from one of the members on flood related external assistance, a member explained that given the urgent nature of relief requirements, the government had requested foreign assistance in cash terms, as the rehabilitation projects generally offered by the donors required implementation over time. One member highlighted the positive aspect of the surplus current account thus recorded, as it helped prevent extra borrowing requirements. On a query from another member, the member briefing the committee responded that out of the Rs. 190 billion private sector credit disbursed in the first six months of FY11, Rs. 106 billion was availed by the textile sector. One member commented that this increase in credit requirement was due to the pricing effect. He also added that the private sector's ability to borrow had been limited by their equity which had not increased over time in line with the increase in working capital requirements due to higher prices.

8. Moving on to the fiscal sector, the member reported that government borrowings (flows) peaked at Rs. 332 billion by mid-September 2010, before declining to Rs. 120 billion by end-Q1 FY11, with further reduction by end-Q2 FY11 as was evident from the net retirement of Rs. 28 billion. On a question from a member on the reasons for decline in government borrowings from SBP, another member explained that the receipt of CSF and shifting of borrowings towards scheduled banks played an important role in this regard. He also apprised the committee that the stock of commodity related financing would further decline in coming months, as the provincial governments were planning to export the surplus stock of wheat on increased international prices.

9. In the context of pressure on government borrowings, the losses of the KESC and other energy-related companies were discussed along with the rationale to recover all associated costs of pilferages, mismanagement and under-efficient power generation plants from the end users. A member mentioned that different initiatives were being discussed to resolve the energy issue on a priority basis, however, the implementation of these solutions might not be possible in February. The Committee also discussed the limited transmission of government subsidies on fuel to the poor as these commodities were not directly consumed by them, especially the CNG which was consumed dominantly in cars.

10. A member then explained the developments in key monetary aggregates, particularly the relationship between reserve money growth and inflation in the recent past, as enquired by another member. On the relationship between fiscal deficit and high inflation, he shared an in-house preliminary research according to which every 1.0 percent fiscal slippage roughly translated into a 0.7 percent increase in inflation in that year, followed by another 1.5-2.0 percent increase in inflation in the following fiscal year. He reiterated that the persistently high inflation and fiscal deficit to the tune of 6.3 percent, as per preliminary estimates, were the main areas of concern.

11. On another related query of a member, he explained that according to some other studies, even in the era of high oil prices in 2008, government borrowings from the banking system were the key contributory factor in the rise of inflation in Pakistan. A member added that in 2008, growth of Net Domestic Assets (NDA) was substantial but due to the steep fall in foreign exchange reserves, the overall growth in reserve money was very low. He added that both these factors explained the high inflation at that time, and now a similar surge in NDA growth was being observed again. Another member also highlighted the results of

another study on persistence of inflation, according to which overall government borrowing from the banking system was a key factor in explaining this persistence.

12. One of the members praised the SBP for its effective communication owing to which the linkages between government borrowings, inflation and interest rate increases were clearer than ever to the general public. He suggested that SBP should build on this achievement by sharing the various research carried out in the Bank to the public domain in the form of brief non-technical articles. Endorsing these views, one member offered his services to make use of the International Growth Center (IGC) platform for this purpose. The Committee was informed that in order to communicate the message of monetary policy to the masses, emphasis was being given on communication in the Urdu language.

13. A member then gave a briefing on the real sector. One member commented that industrial growth of about 2.0 percent might be difficult to achieve as large scale manufacturing (LSM) was facing a decline in production. He also said that given the low credit utilization by the SMEs, growth from the small-scale sector was unlikely to offset the decline in LSM growth to the extent that the overall industrial growth would become positive. While agreeing largely with these observations, it was explained that the demand-side data and the quantum increase in some export items supported the estimates. Another member commented that the low intake of fertilizer by the agriculture sector also suggested otherwise. He was of the view that expected low growth of agricultural sector was also evident from the lower demand for fertilizer as compared to the previous year. He added that contrary to expectations, only nominal shortages of fertilizer had been observed, despite the decline in fertilizer production due to problems in the availability of natural gas.

14. The Committee noted that SBP's continued tight monetary stance had, as expected, led to a reduced demand for private sector credit, which thus quelled inflationary pressures to some extent. A member was of the view that since private sector investment had declined substantially, it might take some time for the economy to recover its trend growth. Another member also expressed his concern for capacity utilization of the industrial sector. At this point, one member added that while capacity utilization was expected to increase once government borrowings had declined, investment might take some time to recover. Another member, however, said that interest rates were unlikely to play any role in this. To a suggestion by him that instead of the interest rate some other instrument could be used to influence the behavior of the government, one of the members said that it could only be done by stopping government borrowings from SBP. Another member appreciated the efforts to restrict the flow of government borrowings from SBP and opined that doing so would be more effective in changing the government's behavior than any particular instrument.

15. The committee also observed that if the interest rate had not been raised, the outcome in terms of higher inflation would be more unfavorable. Highlighting the need to reduce government borrowings which had been the main reason for the tight monetary policy, a member expressed his concern on the escalation in the stock of government debt which, according to the preliminary data, had increased by Rs. 800 billion in the last six months. He further added that the increased amount of debt when expressed in terms of percentage of GDP, appeared to grow at a slower pace due to the nominal expansion in GDP, geared up further by continued high inflation.

16. The Committee then discussed the pros and cons in recommending a change in the policy interest rate. A member opined that while making this recommendation, forthcoming

developments must be kept in mind as a political dialogue was going on to bring reforms in the economy. On a query of another member, he explained that the recommendation of the MPC could be reviewed after two months on the basis of actual developments. Another member recommended the dialogue aspect to be clearly reflected in the monetary policy statement (MPS). One member also recommended some amendments in the draft MPS. Suggesting some minor changes, the committee approved the text of the monetary policy statement.

The members were then invited to give their individual recommendations for the proposed level of the policy interest rate. One member proposed keeping the interest rate unchanged. Another member also endorsed maintaining the interest rate at its current level and further mentioned that he did not see any reason which would lead him to change this view even in the next MPC meeting due in March, as nothing substantial was likely to happen until then. Referring to his earlier briefings, another member proposed an increase of 100 bps in the policy rate. Another member also proposed maintaining status quo on interest rates. He was of the view that the lagged impact of the previous three consecutive increases in the policy rate, along with other positive developments such as the restriction on government borrowing from SBP and improvement in external current account, needed to be observed prior to suggesting any further change. A 50 bps increase in the rate was recommended by a member in view of the unprecedented increase in reserve money which in the preceding seven months was higher than that of the full year growth of 11.4 percent in the previous year. One member proposed to hold the policy rate at the current level and to be watchful of the outcome of the political dialogue. Referring to the expected oil-price shock related to the crisis in Egypt, non-receipt of a number of external flows, limited progress on reforms agreed with donors and persistence of inflation, one of the members was of the view that the central bank should not place weight on political dialogues that historically had been unreliable. He then recommended a 50 bps increase in the rate. He also expressed his apprehension that the market rates could exceed the policy rate in case the increase in interest rate was not implemented timely. One of the members supported status quo in the policy interest rate. Therefore, the decision of the MPC to recommend to the Central Board for its consideration to keep policy interest rate unchanged at 14.0 percent was reached with a majority vote of 5 out of 8, with two votes for a 50 bps increase and one for a 100 bps increase.

The meeting ended with a vote of thanks to the Chair.

Chairman
(Shahid H. Kardar)