Minutes of the Meeting of the Monetary Policy Committee of the Central Board held at Karachi on 29th September, 2010

Meeting of the Monetary Policy Committee of the Central Board (MPC) was held at Karachi on 29th September, 2010 at 9:00 am.

Present:

1.	Mr. Shahid Hafiz Kardar	Chairman/Governor, SBP
2.	Mr. Yaseen Anwar	Member/Deputy Governor (Banking), SBP
3.	Mirza Qamar Beg	Member/Director of the Central Board
4.	Dr. Hafiz A. Pasha	Member/External Expert
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. Asad Umar, Director Central Board, SBP attended the meeting as an observer.

Mr. Aftab Mustafa Khan Corporate Secretary, SBP attended the meeting as Secretary whereas Dr. Mushtaq A. Khan - Chief Economic Advisor, Policy Development, SBP was also present on special invitation.

Agenda Item No. 1: Leave of absence to members.

All members were present.

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

The Committee confirmed the minutes of the last meeting of the MPC held on 29th July, 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 July, 2010 along with its web-version be and are hereby confirmed.

Agenda Item No. 3: Monetary Policy Decision - September, 2010.

On the post-floods economic scenario, one of the members briefed the Committee that growth rate for FY10 would be between 2 to 3 percent against the target of 4.5 percent. He further mentioned that the inflation which had previously been projected to be in the range of 11 to12 percent would likely to remain between 13.5 to 14.5 percent due to impacts of floods. Highlighting the element of uncertainty in the inflation projections, he explained that the consumption pattern of around 20 million flood affected people would remain at lower levels for a couple of months while the government is expected to disburse substantial amount for relief and rehabilitation. Consumption pattern of those not affected may also display some deceleration in growth for a couple of months. Another member added that the factors resulting in increased projection of inflation also included firming-up of international commodity prices at higher level, expected increase in tariffs on utilities and implementation of improvised GST.

Briefing on the fiscal situation and 6.3 percent annual deficit for FY10, one of the members stated that the key argument for increasing the interest rate in the last MPC was the expected high fiscal deficit to the tune of 6 percent which had turned out to be true. Mentioning fiscal deficit projection for FY11 in the range of 5 to 6 percent, he stated that government was apparently committed to a 4 percent fiscal deficit with an incremental 0.5 – 1.0 percent to cope with the impacts of floods. He stated that achieving such challenging targets seemed to be very difficult as realistic plans have not been unfolded to contain the government expenditures. Endorsing his apprehensions, a member added that the fiscal side had been deteriorating even before floods and assumptions of revenues and high inflows by the fiscal authorities apparently seemed to be optimistic while expenditure estimates appeared to be lower than expectations based on growing commitments. On the current account deficit, he said that it is beginning to worsen and seemed to reflect a surge in demand. A member added that despite the improvement which had been recorded in the current account deficit to 2 percent of GDP last year, imports were growing at a faster rate and might result in the current account deficit to the tune of 3 to 4 percent of GDP with meager support from growth in exports and workers' remittances.

Attributing stagnation in money supply at present to the seasonal phase of loan retirement, a member added that projected growth in money supply for FY11 would remain between 12 to 13 percent. He said that private sector credit demand had remained subdued over a couple of years and overall increase in banking sector credit was largely due to government borrowings. Referring to expected post-flood reconstruction activities, he anticipated pickup in private sector credit which might get some support from a likely credit demand by cotton related industry if the damages to the cotton crop were less than initial estimates. He further said that in his opinion macroeconomic situation seemed to be bleak with the continuation of fiscal imprudence, low growth, high inflation and uncertain inflows to finance the current account deficit.

In the context of post-flood management of economy, one of the members stated that in the absence of data on impacts of floods, the view on monetary policy stance and the policy interest rate had to be taken amid uncertainty. However, he added, that continued fiscal expansion, which was expected to exacerbate further due to flood related expenditure, ruled out any change in monetary policy stance. Emphasizing the need to convey the constraints under which monetary policy decision was to be made, he said that the statement should explicitly mention the underlying cause i.e. continued fiscal expansion, as the rationale for the policy stance, distinguishing it from the temporary uptick in the inflation due to supply shock. He said that the statement should reiterate in its conclusion that the hardship induced by an increase in the policy rate on private sector was an inevitable outcome of the need to contain the effects of fiscal expansion. He also suggested that, to promote transparency, the issue of lack of detailed information on fiscal statistics may be mentioned in the monetary policy decision statement.

Referring to the pre-flood data showing lower growth of 5 percent in the revenue collection, a member highlighted the emerging softness in the revenue collections. He said that the required growth in revenues was expected to be at least twenty five percent even if based on the revised revenue target which was already lower than the benchmark agreed with IMF. Pointing towards the limited avenues of extra revenue generation, he expressed that the slackness in revenue collection might continue in the scenario of low economic growth and lead to increased fiscal deficit beyond six percent. He added that the fiscal deterioration might also emerge from unlikely reduction in commodity and power sector subsidies that could also worsen the issues of financing the budget deficit. Contemplating on the impact of expected substantial net increase in government borrowing, rollover of previous borrowings, and declining trend in non-bank borrowing, he expressed his opinion that the situation necessitated an appropriate move in policy interest rate. He was also of the view that even without upward correction in the policy rate, there would be upward pressures on yields driven by market sentiments due to increased public sector borrowings.

In response to a query regarding the negative impact of the interest rate increase, a member said that in view of unlikely achievement of pre-flood assessment of 4.5 percent growth rate, the increase in the policy interest rate seemed to be inevitable despite its negative impact of the crowding out of private sector borrowings. However, he explained that the interest rate hike would not be expected to cause immediate decline in private sector credit due to seasonal retirement phase at this time. Another member added that to avoid larger adjustments in future, increasing the interest rate at the right time might be a better option, especially when government was borrowing at negative real interest rate and private sector at marginally positive real interest rates. He also pointed out that the crowding out may be limited due to the likely increase in private sector credit on account of increase in weighted average price of cotton.

A member circulated the draft monetary policy decision statement and further explained that the increase in the interest rate seemed to be necessary to reduce the effects of fiscal expansion on macroeconomic stability and also to avoid overshooting of the market interest rate. Another member highlighted the need to further promote economic awareness, particularly the reasons and implications of changes in the policy interest rate. On the market liquidity aspect, one member termed the status as comfortable due to the retirement phase in private sector credit and the quick return of deposits that were withdrawn during Ramzan/Eid-ul-Fitr. However, he highlighted on the need to be mindful of the liquidity condition in November when seasonal borrowing by private sector was expected along side with cash withdrawals due to Eid-ulAzha in mid November. He also emphasized the need to attract foreign investment by taking advantage of international low interest rates and higher domestic interest rate. Responding to a query, he further explained that the recent movement in the foreign exchange rate was due to lumpy payments after the Eid-ul-Fitr holidays.

The Committee discussed options of no change, 25 basis points or 50 basis points hike in the policy interest rate. A member stated that lower consumption by flood affected people, together with subdued consumption behavior of non-affectees, might help in bringing inflation back to around 12 percent next year. He, therefore suggested no change in policy interest rate. He added that increase in the interest rate would not be able to arrest rising inflation in short term due to lagged impact of the change and expected continuation of supply shock for a couple of months. Another member also suggested holding the interest rate hike for the post-flood situation to unfold. However, the majority of the members were of the view that the core cause of inflation, i.e. fiscal expansion was persisting that required upward revision in rate. One of the members was in favour of either no change or an increase of at least 50 basis points in the policy interest rate as a 25 basis points change might not convey the intended message to the economic agents.

The members were then invited to vote for not changing the policy interest rate or to increase the interest rate by 50 basis points. Six members of MPC voted for 50 basis points increase in the policy interest rate whereas two members of the Committee voted for no change in the interest rate. Therefore, the decision on the recommendation of the MPC to increase the policy interest rate by 50 basis points to 13.50 percent was reached with 6/2 votes for further consideration and final decision by the Central Board. The Committee reviewed the draft Monetary Policy Decision Statement and advised certain changes before recommending the same for the consideration of the Central Board.

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

Chairman
19-10-2010