Minutes of Meeting of the Monetary Policy Committee
<u>of the Central Board held at Karachi on 30th January, 2010</u>

Meeting of the Monetary Policy Committee of the Central Board (MPC) was held at State Bank of Pakistan (SBP) Main Building, Karachi on 30th January, 2010 at 9:30 am.

<u>Present</u>:

- Syed Salim Raza — Chairman/Governor, SBP[1]
- Mr. Tariq Sayeed Saigol — Member/Director of the Central Board
- Dr. Hafiz A. Pasha — Member/External Expert
- Mr. Yaseen Anwar — Member/Deputy Governor, SBP
- Mr. Asad Qureshi — Member/Executive Director Financial Markets & Reserve Management, SBP
- Dr. Hamza Ali Malik — Member/Director Monetary Policy Department, SBP

Mr. Aftab Mustafa Khan, Corporate Secretary, SBP attended the meeting as Secretary.

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

Corporate Secretary informed that Mirza Qamar Beg Member MPC/Director Central Board and Mr. Riaz Riazuddin Member MPC/Chief Economic Advisor (MP&R) have requested for leave of absence, which was granted.

Agenda Item No. 2: Confirmation of the minutes of the last MPC meeting

Minutes of the last MPC meeting held on 24th November, 2009 were placed before the Committee for confirmation.

Corporate Secretary drew the attention of the Committee to the minutes of last MPC meeting, for its placement on SBP website, without the names of the members in the deliberations. However, he highlighted that names are being specified in the voting on the recommendation for monetary policy decision. After discussing the pros and cons, the Committee decided that at this stage it is more appropriate that while disseminating minutes of MPC to the public, the number of votes in favour and against the recommendation on monetary policy decision will be given without mentioning names of the members in the deliberations and on voting.

Applauding the high quality of the Monetary Policy Information Compendium (Compendium), one member highlighted its usefulness for the analysis of monetary policy decision and recommended its publishing as attachment to the minutes of the MPC meeting. A member mentioned the earlier decision of the Board which require publishing of the Compendium for general public and stated that he and one other member were of the view that publication of the Compendium needs to be discussed further. One member MPC said that SBP's forecasts may be omitted in final publication of the Compendium as these may unnecessarily influence market. Another member clarified that previous releases of MPS

[1] Attended beginning and conclusion of the session.

have already contained the SBP forecasts and the same may be published with the Compendium, however, he suggested to review these forecasts and the entire contents of the Compendium in the meeting prior to its publication. The Committee agreed with the suggestion.

The Committee confirmed the minutes of the last meeting of MPC and passed the following resolution.

RESOLVED:

That the minutes of the meeting of the Monetary Policy Committee of the Central Board held on 24th November, 2009 be and are hereby confirmed.

Agenda Item No. 3: Monetary Policy Statement (January 2010)

A member briefed the Committee on the overall economic outlook referring to the various sections of the proposed Monetary Policy Statement (MPS) for January 2010. He also mentioned that due to availability of latest information, only a day earlier, some changes in the economic outlook have been incorporated in draft MPS.

One member handed over some articles from newspapers which advocated and reported considerations of slashing budgetary allocation for Public Sector Development Program (PSDP) and showed his concerns over possibility of such developments.

Giving overview of the proposed MPS, one member said that in the first half of FY10, SBP has eased the policy interest rate by a cumulative 150 basis points in addition to bringing reforms to strengthen operating framework for monetary policy. These reforms included introduction of a corridor structure for overnight money market repo rate and re-constitution of Monetary Policy Committee of the Central Board to include external members along with increasing the frequency of monetary policy decisions from four to six a year. He said that corridor structure for the overnight money market repo rate has resulted in anchoring the short-term market rates and these measures together with the quarterly limits on government borrowing from SBP and transfer of oil import payments to the market are expected to further enhance effectiveness and transparency of monetary policy operations to achieve SBP goals.

On effectiveness of SBP measures, a member mentioned that these have helped achieve macroeconomic stability which is evident from considerable decline in average CPI inflation to 10.3 percent from 24.4 percent in the first six months of preceding year. This decline in CPI is fairly broad based as over 205 items showing inflation of over 10 percent in June, 2009 have now reduced to 107, however, expected increase in petroleum products, electricity and government expenditure due to law and order situation, the average CPI inflation for FY10 may be around 11 to 12 percent and uptick in inflation may become visible in a couple of months.

Highlighting the importance of inflation number for a Central Bank, one member referred to the negative base effect which is resulting in high inflation this year. Discussing the components of high CPI, he said that comparison of domestic prices of petrol in January 2009 and January 2010 shows hardly a 25 percent reduction whereas international prices of crude oil at these two points of times have much larger difference. He referred to government levy component in the prices of domestic petroleum products that has resulted in its varying relationship with international crude oil prices and emphasized the need to incorporate domestic petroleum prices in the economic forecasts rather than the international crude oil prices. Another member pointed towards the lag effect due to import mechanism of petroleum products that also alters one to one relationship of domestic petroleum prices with international crude oil prices. One member explained that the present economic forecast model takes into account both the international and domestic prices of petroleum products that may further be refined and enhanced. A member also emphasized on appropriately incorporating the effects of sugar price in overall CPI projections. He commented that if there is a substantial increase in international crude oil price the year-end inflation may exceed 12 percent level and more price shocks may emerge from rise in the prices of sugar, energy and petroleum products which may keep the inflationary expectations high. He asked to further ensure that these components have been incorporated in the CPI forecast. On the price hikes and shortage of electricity, another member said that viability of captive power plants in industry is also withering out due to gas shortages and high cost of generating industrial units' own electricity through furnace oil.

One member pointed towards expectations of growth in Large-scale Manufacturing (LSM) due to better performance of yarn and cotton exports, improved demand of durables and automobiles due to higher farm income and steps towards resolution of circular debt that may bring improvements in the energy sector. One member explained LSM growth forecast has been revised upward to one percent of the GDP based on the positive indications officially received; however, this forecast may be revised when more statistics on the latest developments are received. He further added that changes in LSM growth may affect GDP only to the extent of its share in overall GDP which is about 12 percent. Another member said that recovery in private sector credit may be taken as sign of improvements in LSM that has already registered a growth of 0.6 percent in October; however, liquidity constraints resulting from slow retirement of financing in commodity operations may impair the ability of growth in LSM sector. He said that out of around Rs.316-320 billion outstanding financing in commodity operations, sugar stocks are holding almost Rs.25-30 billion, paddy and rice stocks are holding Rs.21 billion, whereas Rs. 260 billion are being held due to wheat stocks. He said that fresh wheat financing cycle is about to begin in a couple of months with an expected additional need of Rs.50-60 billion for the import of sugar. These requirements may put strain on liquidity of the commercial banks that may result in lower availability of credit for LSM growth. Supporting these views, another member added that previous estimates of net retirement of Rs.80 billion are not expected to materialize and on net basis commodity operations are expected to draw more liquidity from the market.

The Committee discussed real sector growth forecasts in various sectors of the economy and in agriculture sector it was explained that due to water shortages, the wheat crop may not be as good as that of last year. However, overall agriculture sector is showing some improvements such as higher than previous year's cotton crop which is also positively affecting exports of textile sector. Modest but consistent recovery in LSM together with pickup in private sector credit is also encouraging. Better than expected global economic recovery could further support domestic economic activity through increased demand of exports. Similarly, services sector is also expected to maintain growth trend of the previous year. Thus, overall real GDP growth is expected to be 3 to 3.5 percent for FY10, better than 2 percent growth recorded in FY09.

Briefing on the external sector developments, one member said that external current account deficit has declined to $2 billion during first half of FY10 from $7.8 billion compared to same period last year. The sustained flow of workers' remittances (WR) amounting to $4.5 billion till December, 2009 has further contributed towards the reduction of the external current account deficit. However, he underlined that these improvements in balance of payments are despite the delay in foreign reimbursements and shortfall in grants from 'Friends of Democratic Pakistan' (FoDP).

One member mentioned that Federal Bureau of Statistics (FBS) has provisionally reported a 45.6 percent growth in imports for December 2009 when compared with December 2008 that may have implications for balance of payment. He said that the growth trends in workers' remittances (WR) may also be watched more carefully and decline in marginal growth trend may be seen as early warning. He said that other recipient countries of WR from Middle-East, i.e. Philippines, Sri Lanka and Bangladesh etc., have already curtailed their estimates of WR. Explaining the continued growth in WR, it was mentioned that due to punitive actions that have resulting in closure of two to three exchange companies, more remittances is being routed through regulated channels which is keeping sustained uptick in WR even from Middle-East countries. One member added that the decline in WR has been compensated by increased conversion of flows to regulated channel which may tapper off in the long run. Recognizing these developments, a member said the year-end estimate of WR have already been set at $8.6 billion as compared to actual receipt of $7.8 billion in last year depicting modest growth of around 11 percent.

Further discussing the external sector, one member said that in the first five months of the year there was greater degree of adjustments due to liquidity shortages, stable low oil prices, and management of aggregate demand and consequently low private investment and low import of capital goods. However, going forward the situation may change as evident from imports figures reported by FBS and, therefore, room for increase in imports may be incorporated in year-end estimates. Another member explained that imports in terms of growth have already witnessed 18 percent decline in first six months, however, year-end estimates of growth in imports have been worked out to be at -3.2 percent.

On exports, one member highlighted the recent boom in yarn exports and inquired if these were being incorporated in the projections. A member responded that the current export growth estimates of -1.0 percent are showing relative upward trend recovering from -6.4 percent growth of last year. Another member shared that although the export of yarn is picking up but its positive effects are somewhat offset by increased pressure on export prices of value added textile products due to reluctance of foreign buyers to increase their retail prices.

A member briefed on fiscal deficit which is expected to continue at least 0.3 percent owing to slippages occurred in the first quarter. One member referred to the pressures on the fiscal side due to delay in receipts from donor countries which have been partly managed through arrangements with IMF. On the revenue side, one member said that present increased revenue targets of Rs.1396 billion will require about 40 percent growth in the revenue collection in the later part of the year which is extremely ambitious target under the existing circumstances. He said that only the decision of exempting sugar from import duty may have an effect of around Rs.10 billion on government financing. The Committee was of the view that given the significant pressures on expenditures, keeping the full fiscal year deficit at the targeted level seems quite difficult. Another member commented that it may be likely that fiscal pressure may result in cut in spending on PSDP.

Further discussing the pressures on fiscal side, it was mentioned that substantial amount of outstanding credit for commodity operations of the government, i.e. Rs.316 billion as on 23rd January 2010, and the coming wheat financing season are posing risks to adequate availability of liquidity in the market. Continued flow of credit to Public Sector Enterprises (PSEs) and remaining inter-agency circular debt is also adding to the pressures on the available funding sources of the banking system. The additional financing demand may put pressures on the banking sector and if the substantial demand from private sector also emerges; the interest rate may face upward pressure.

MPC then debated various options and scenarios for likely change in policy discount rate. The scenario ranging from no-change in policy interest rate to decreasing it by 50 and increasing it by 50 basis points were discussed. One member said that the Monetary Policy stance of SBP also contributed towards curtailing the aggregated demand and present inflationary pressures are cost pushed, therefore monetary policy decision should not be directed towards reducing demand. Another member said that continued high policy interest rate together with heavy government borrowings may negatively impact savings investment gap in coming years as most of the resources will be applied for debt servicing. A member was of the view that given the fiscal and liquidity scenario, there may not be a case for curtailing the policy interest rate. The Committee came up with the consensus recommendation with all 6 votes for no change in the policy interest rate of SBP.

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

-Sd/-
Chairman
(Syed Salim Raza)
06-02-2010