Day Break

Tuesday, 17 September 2019

Economy

Monetary Policy

Staying Cautious Policy Rate Kept Unchanged for Now; Future Rate Guidance Dependent On Fiscal Perfomance and Oil Prices

- In latest Monetary Policy Committee (MPC) meeting held on 16th Sep, 2019 the MPC left the policy rate unchanged at 13.25%.
- Nevertheless, the motivation behind the current decision is rather precautionary in nature, which comes despite mild improvements witnessed in general economic indicators. In addition to this SBP inflation projections remain relatively unchanged at 11-12% despite rebased and changed methodology in CPI index.
- On inflation outlook we expect it to average close to +10% against SBP target of 11-12% and IMF 13% and are of the view that SBP is likely to keep policy rate unchanged at 13.25% for remainder of 2019 (monetary policy statement announcement due November) and see monetary rate cycle reversal starting Jan-20 onwards

SBP left key policy rate unchanged at 13.25%

In latest Monetary Policy Committee (MPC) meeting held on 16th Sep, 2019 the MPC left the policy rate unchanged at 13.25%. To recall, the current monetary tightening cycle had begun from Jan-18 at 6.0% to 13.25%, making it one of the lengthiest monetary tightening cycle. Nevertheless, the motivation behind the current decision is rather precautionary in nature, which comes despite mild improvements witnessed in general economic indicators. In addition to this SBP inflation projections remain relatively unchanged at 11-12% despite rebased and changed methodology in CPI index. Moreover, future guidance on interest rates remain tilted toward curtailing fiscal deficit and oil prices on the external side.

Inflation outlook remain benign…

As per SBP reading, the new and old CPI index are broadly similar hence the reason there is little or less changes in inflation forecast. Much of the changes in inflation reflects pass-through impact of exchange rate depreciation and administrative energy/power price hikes. Dissipating any adverse development on inflation front, SBP sees headline inflation to rest in the range of 5-7% in the next 2-years.

…however, fiscal and external vulnerabilities still pose a risk

While there has been some improvement witnessed, particularly on external account; such as i) C/a balance (ex-oil) turned to a surplus (USD 409mn in Jul-19), ii) country's import cover have significantly improved starting FY20 and overall REER (Real-effective Exchange Rate) is close to SBP comfort zone, which aid well towards exports growth going forward. Similarly, on fiscal side provisional tax collection data also suggests mild improvements. However, despite these encouraging data flow on economy, SBP is likely to adopt a cautious stance in near future.

When can we see monetary rate cycle reversal?

However, keeping in mind, SBP also highlighted an ill but closely monitor area, the real sector. As per the MPC report, SBP expects no change in growth outlook; 3.5% in FY20 regardless of contracting LSM (Large-Scale Manufacturing) growth – LSM contracted by 3.6% in FY19, as the index does not fully capture

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value-added textile sector exports volume. Moreover, private sector contraction has been limited than initially feared at 1.3% during 2m 2020. However, we note much of the credit disbursement starting FY20 is largely explained by working capital management. Nonetheless, this is one area where we think a faster contraction in aggregate demand could potentially trigger an earlier rate reversal cycle.

On inflation outlook we expect it to average close to +10% against SBP target of 11-12% and IMF 13%. While the newer methodology is expected to somewhat reduce volatility but remains largely in-line with previous CPI trajectory. Based on this, we expect inflation to stay in double at least till the remainder for CY19 averaging +11%, keeping real interest rates in positive territory close to +2.8% (historical average of ~2%). While Feb-20 onwards, inflation is expected to drop down back to single digit, leaving ample of room for authorities to cut key policy rate.

Exhibit: **One of the lengthiest monetary tightening cycle continues**

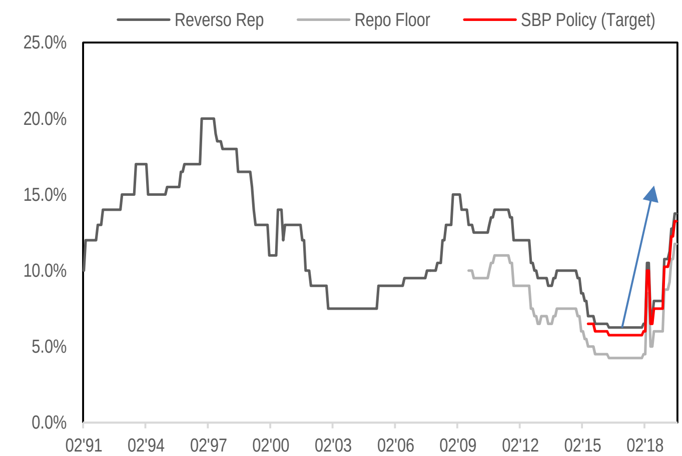


Exhibit: **New versus Old CPI trend; broadly similar**

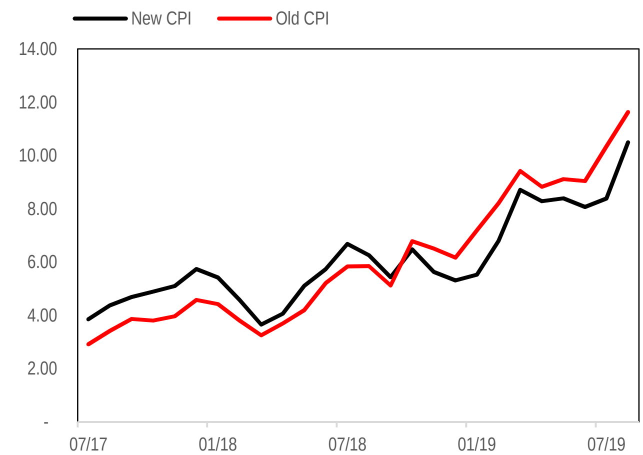


Exhibit: **Both REER and C/a balance improvement**

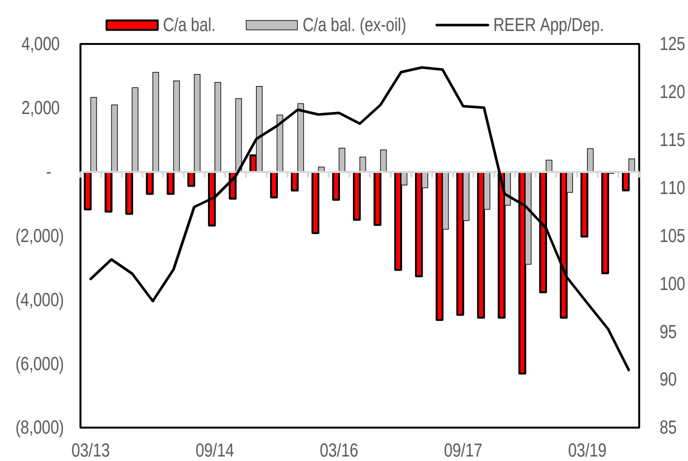
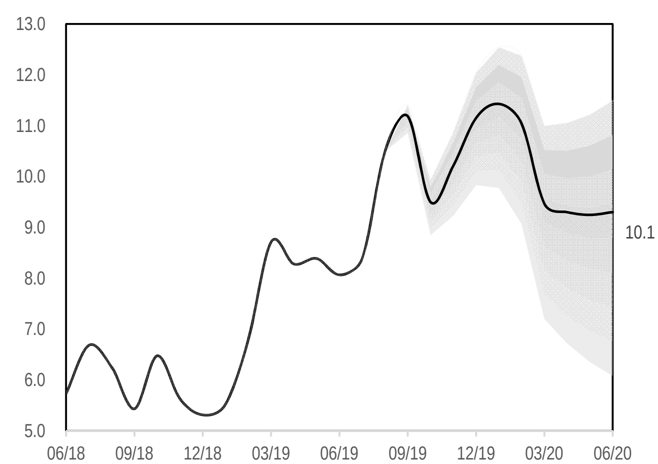


Exhibit: **Inflation expected to average +10% in FY20; compared to SBP target of 11-12%**



Source: PBS, SBP, IGI Research

Outlook: Rate cycle to expected reverse from Jan-20 onwards

Henceforth we are of the view that SBP is likely to keep policy rate unchanged at 13.25% for remainder of 2019 (monetary policy statement announcement due November) and see monetary rate cycle reversal starting Jan-20 onwards.

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