# Day Break

Tuesday, 21 September 2021

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## Economy

Monetary Policy Statement

# Rate hiked by 25bps amid deteriorating Current Account Deficit and rising Inflation Outlook

- The State Bank of Pakistan (SBP) in its latest Monetary Policy Statement (MPS) on Monday 20th Sep, 2021, announced a rate hike of 25bps to 7.25% for the next two months.
- Medium term inflation is expected to escalate further with a visible uptick in essential food commodity prices and import driven upward inflationary pressures.
- Growth projections have been enhanced to the upper bound of the forecasted range of 4-5% owing to promising broad based growth indictors.
- For the remainder of FY22, we view monetary policy to remain accommodative to achieve sustainable growth target of 4-5% while keeping C/a deficit manageable. Thus, SBP is likely to gradually increase Policy rates to achieve mildly positive real rates over while monitoring any demand side shocks such as substantial rise in commodity prices.

**A Shift in Policy making: Rate hiked by 25 bps to 7.25%**

The State Bank of Pakistan (SBP) in its latest Monetary Policy Statement (MPS) on Monday 20th Sep, 2021, announced a rate hike of 25bps to 7.25% for the next two months. The SBP decision was backed by demand side inflationary pressures and need to counter slippages in current account deficit while focusing on achieving sustainable growth target.

**Demand side inflationary pressures on the rise**

The press release (link) on monetary policy highlighted increasing Current Account deficit amid a swelling import bill which has contributed to downward pressure on the PKR.

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**Countering slippage in the PKR as the current account deficit balloons**

Current account deficit has swelled to USD 1.5bn in Aug-21 owing to rise in international commodity prices and aggressive domestic demand resulting in overwhelmingly high import volumes.

While SBPs gross FX reserves have posted 3x growth to arrive at USD 20bn with major contributions from overseas Pakistanis, recent inflow of USD 1bn from issuance of international bonds with previous inflow brought in by the same of USD 2.5bn, addition of USD 2.7bn from IMFs SDR collection in Aug-21 and support from moderately stable exports volume, the widening current account deficit remains a key concern which has been so managed by flexible exchange rate regime to absorb pressure on forex reserves. Therefore the SBP deemed it appropriate to divert pressure from the currency by employing monetary tightening policy to contain the trade gap to prevent further slippage of the PKR.

Source: Bloomberg, SBP, MOF, PSX

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## Outlook

For the remainder of FY22, we view monetary policy to remain accommodative to achieve sustainable growth target of 4-5% while keeping C/a deficit manageable. Thus, SBP is likely to gradually increase Policy rates to achieve mildly positive real rates over while monitoring any demand side shocks such as substantial rise in commodity prices.

**Exhibit: Monetary Policy Statement key extracts and outlook**

| | Outlook | Segment | Comments |
|---|---|---|---|
| Inflation | **SBP's projection for average inflation remained broadly unchanged at 7-9%** for FY21 and medium-term range of 5-7%. | | **Headline Inflation remains subdued with expectations of upward trends in 2HFY22 onwards:** Any spike in headline inflation can deemed as transient as it has largely been driven by supply side pressures causing prices of certain food commodities to rise as well as electricity tariff hike in the preceding months. As it is, June onwards food prices have been on a downward trend owing to prudent government measures and timely imports of sugar and wheat while rural and urban CPI trends bear witness to inflation expectation remaining well anchored as well with food and energy prices not having transfused in general prices. |
| | | | **Inflation rate is likely to remain elevated in the coming months** for FY22 close to the upper end of the announced range of 7-9%. |
| | | | **Medium-Term:** In the medium term inflation is expected to fall in 5-7% target range as the February electricity tariff increase drops out of the base. |
| | | | SBP stands vigilant over possible overheating in the economy which will remain affected by i) high international commodity prices ii) subsiding pandemic related uncertainty and iii) administrative decisions surrounding hike in POL prices and electricity rates iv) Overall build up in demand side pressures evident from hefty imports growth. |
| Interest Rates | **SBP hints at tapering rates upwards g**radually in order to achieve positive real rates. | Economic Recovery | **Any further uptick in rates is dependent upon demand side inflationary pressures as well as current Account slippages** A mix of monetary policy remains appropriate in the short term to prevent growth in light of expected demand side pressures. The SBP is seeking to return to normal monetary policy regime as the overall economic growth has attained strength and the positive progress in vaccination rates is expected to keep covid-19 related uncertainty at bay. |
| | | Real-rates | Moreover, assuring the accommodative near-term outlook, SBPs future guidance on rate change is towards achieving **mildly positive real interest rates over time.** |
| Real Sector | **Growth projection calibrated towards upper end of the previously forecasted range of 4-5% amid healthy broad-based growth.** | Industrial Sector | Key high frequency indicators such as automobiles, POL, Cement sales and electricity generation continue to post robust growth on a yearly basis LSM registered a strong growth of 18.5%y/y as it declined to 2.2% with the decline being deemed as seasonal. This remains a reflection of the economic revival gaining firmer footing. |
| | | Agri. Sector | The agriculture sector is expected to make positive contributions despite reduction in area under cultivation of cotton which is to be recompensed by an increase in area for rice, maize and sugarcane. |
| | | Service Sector | The service sector posted a strong rebound as COVID 19 led mobility restrictions abate with activity at public places higher than pre-Covid 19 levels (SBP, Google Community Mobility Reports) |

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| Fiscal Sector | **Fiscal consolidation progresses well** | **Fiscal consolidation bearing fruits:** Strong growth in tax and Petroleum Development Levy (PDL) as well as a significant decline in non-interest expenditures has brought about a decline in the fiscal deficit of 0.5 ppts to 1.4%. In 2MFY22, FBR revenue posted a growth of over 40 percent y/y while Federal PSDP during this period increased by nearly 44 percent of their budgeted amount for the full year. Tax revenue growth remains essential to prevent further expansion of domestic demand and the import alongside fueling of inflationary pressures. |
| IMF | **Shared Goals surrounding Structural reforms** | On matters related to IMF, SBP highlighted that discussions are ongoing and staff level discussions are expected to begin at the end of the month, with a positive outcome expected very soon. |

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