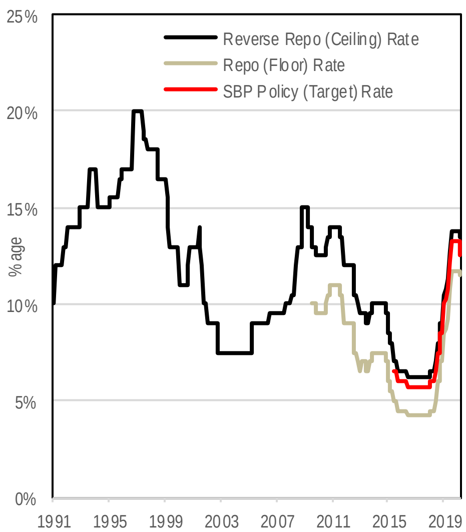
Day Break

Wednesday, 18 March 2020

Economy

Exhibit: Historic Discount rates

Date	Reverse Repo Rate	Repo Rate	Policy Rate	Chg. Bps
23-May-16	6.25%	4.25%	5.75%	
29-Jan-18	6.50%	4.50%	6.00%	25
28-May-18	7.00%	5.00%	6.50%	50
16-Jul-18	8.00%	6.00%	7.50%	100
1-Oct-18	9.00%	7.00%	8.50%	100
3-Dec-18	10.50%	8.50%	10.00%	150
1-Feb-19	10.75%	8.75%	10.25%	25
1-Apr-19	11.25%	9.25%	10.75%	50
21-May-19	12.75%	10.75%	12.25%	150
17-Jul-19	13.75%	11.75%	13.25%	100
29-Jan-20	13.75%	11.75%	13.25%	0
17-Mar-20	13.50%	11.50%	12.50%	-75



Source: Bloomberg, PSX 100 & IGI Research

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Monetary Policy

SBP stays cautious; puts more weight behind the 'unknown' factors

- ✓ In its latest Monetary Policy Committee (MPC) meeting held on 17th March, 2020 the State Bank of Pakistan (SBP) reduced the policy rate by 75bps to 12.5%.
- ✓ Moreover, the SBP also through a separate circular made changes to interest rate corridor (IRC) making it symmetric around the policy rate whereby increasing the ceiling rate by 100bps to 13.5% and by the IRC at 2.0% effectively raised the floor rate to 11.50%.
- ✓ Nevertheless, from a market standpoint reduced interest rates, barring the Islamic banks, conventional banks will face NIMs compression due to changes in IRC. We recommend BAHL, BAFL and HBL as our preferred pick.

Market to less rejoice rate cut; as SBP puts more weight behind the 'unknown' factors that stems from global risks

SBP in its latest monetary policy statement lowered the policy rate by 75bps compared to market consensus of 50-100bps and announced changes in existing IRC to deliver a symmetrical monetary policy mechanism. While monetary easing was long-awaited, the market response however seems less appreciative of SBP's recent decision.

Given the increased volatility in global markets amid outbreak of Coronavirus, SBP decision seems to strike a balance between the 'unknown'; heightened global risks will have detrimental impact on domestic demand and will only subside once the global risk aversion reduces, and the 'known'; reduced global commodities in particularly oil prices which is a positive development in terms of external account and domestic inflation.

''The outbreak has reduced external and domestic demand, while increasing risk aversion and uncertainty about the future.''

– SBP monetary policy statement (March 17th, 2020)

Nevertheless, from a market standpoint reduced interest rates conventional banks will face NIMs compression due to changes in IRC. Whereas for high leveraged companies, rate cut might just come as a slight relief. Moreover, the SBP also through a circular has increased ceiling or the reverse repo rate spread by 100bps to 13.50% and subsequently left corridor spread at 200bps, with floor rate at 11.50%.

SBP lowers policy rate by 75bps to 12.50%

In its latest Monetary Policy Committee (MPC) meeting held on 17th March, 2020 the State Bank of Pakistan (SBP) reduced the policy rate by 75bps to 12.5%. Moreover, the SBP also through a separate circular made changes to interest rate corridor (IRC) making it symmetric around the policy rate whereby increasing the ceiling rate by 100bps from previous 50bps to 13.5% and with the IRC at 2.0% unchanged, effectively reduces the floor rate by 25bps to 11.50% and therefore minimum saving deposit rate (MSDR) for the commercial banks will see a 25bps cut rather than a 75bps.

Exhibit: SBP Monetary Policy Decision and effective rates				
	Current	Rates under previous IRC	Previous	Chg. (bps)
Target Policy Rate	**12.50**	**12.50**	**13.25**	**-0.75**
Discount Rate (Ceiling)	13.50	13.00	13.75	-0.25
Floor Rate	11.50	11.00	11.75	-0.25
Minimum Deposit Rate	11.00	10.50	11.25	-0.25
Corridor	2.00	2.00	2.00	0.00

Striking a balance between the 'Unknown' and 'Known'

Nevertheless, the rate decision came amidst increased volatility seen in global markets due to outbreak of Coronavirus. To counter the impact SBP decision seems to strike a balance between the 'unknown' and the 'known'. The heightened global risks that could potentially have detrimental impact on domestic growth which will only subside once the global risk averts, which at current appears less clear. In aftermath to these risks, global commodity prices have come down substantially in particularly oil prices (Arab Light oil ~39% down since 6th March, 2020), which if continued will bear positive implication on country's external account in terms of reduced import bill and domestic inflation.

Monetary Policy Committee key highlights

Exhibit: Monetary Policy Statement key extracts and outlook			
	Outlook	Segment	Comments
Inflation	**SBP's projection for average inflation remained broadly unchanged at 11-12% for Fy20** and medium-term range of 5-7% may likely be realised earlier than previously forecasted.	Inflation	Headline inflation numbers recorded sizable changes since the last MPC meeting, driven by volatile food prices. The MPC noted that recent weekly outturns in essential food prices reinforced their assessment that the earlier shocks were transitory and that the underlying trend in headline inflation would remain moderate in the remaining part of this fiscal year. Currently, average national CPI stands at 11.7% during the first eight months of FY20.
Interest Rates	**The MPC felt that real interest rates are appropriate** on a forward-looking basis to achieve the 5-7 % medium-term inflation target.	Real-rates	The MPC also decided to make the interest rate corridor symmetric around the policy rate, in line with international best practices.
Real Sector	**GDP growth revised down to 3.0% from 3.5% earlier:** In light of recent domestic and global developments, SBP now projects real GDP growth for FY20 of around 3.0 %, while expecting a modest recovery next year provided that the spill-over impact of the Coronavirus outbreak on global trade and financial markets is moderate and short-lived.	Agricultural	Agricultural growth is likely to be lower than previously forecast. To recall, previous MPC notes on agri-sector highlighted while major crops indicate that all Kharif crops, except cotton, grew in line with expectations. Cotton production has been revised downwards due to adverse supply side shocks.
		Large Scale Manufacturing (LSM)	Large-scale manufacturing (LSM) rebounded strongly in December 2019, moving into positive growth (9.7% y/y) for the first time in the last six months, and indicated strengthening in a growing number of industries, especially export-oriented ones.
		Private Sector Credit	Weak economic activity continues to be a drag on private sector credit, which expanded at 3.6 % during 1st Jul to 6th Mar FY20, less than half the rate seen during the same period last year.
		LTTF and EFS limits enhanced and financings requirements eased	SBP continues to support economic activity through its refinancing facilities, such as its Long-term Financing Facility (LTFF) scheme for export-oriented sectors and its new TERF facility in light of the Coronavirus pandemic. Nearly, 67% and 82% of the ERS and LTTF is availed by textiles, by increasing the financing amount and easing the financing limits will support other sectors to avail the benefit.

External Accounts	**Key Upside Risks:** Benign global growth and inflation impacts of lower global commodity prices, in particularly oil prices. **Key downside risks:** Lower Pakistan export demand, remittance inflows, depressed sentiment among domestic consumers and businesses could have a more material impact on growth.	Current Account Balance	The impact on the current account is expected to be mildly positive as the savings from low oil prices were expected to offset potential weaknesses in net exports and remittances.
		FX Reserve	Notwithstanding recent volatility in foreign exchange markets, the SBP's FX reserves have maintained strong growth, driven by the narrowing current account deficit. Reserves increased from US$ 7.28 billion at end-June 2019 to US$ 12.76 billion as of end-February 2020 – an increase of US$ 5.48 billion.
		Foreign Inflows	The MPC observed that this increase in the net reserve buffers of SBP of US$ 10.68 billion is more than sufficient to cope with any portfolio outflows in an orderly manner.
Fiscal Sector	**Government could face challenges in achieving revenue targets for this year**	Tax Revenues	During Jul-Feb FY20, tax revenues showed a healthy increase of 17.1 % over the same period last year.
		Expenditure	On the expenditure side, increased public spending relative to last year is supporting business activities, especially in construction-allied industries. Moreover, if there are disruptions in economic activity, and may require increased expenditures in health and social sectors to cushion the impacts of the Coronavirus pandemic.

SBP puts more weight behind the 'unknown' factors that stem from global risks

*"**Barring unforeseen shocks,** the inflation momentum is expected to moderate further in coming months. […] With today's reduction in the policy rate, the MPC felt that real interest rates are appropriate on a forward-looking basis. [and] MPC also decided to make the interest rate corridor symmetric around the policy rate, in line with international best practices."*

– SBP monetary policy statement (March 17th, 2020)

At the moment, SBP seems to put more weight behind the 'unknown' factors that stem from global risks, hence the need to make IRC symmetrical seems plausible. While monetary policy operates as a guiding expectation, changes in IRC can dictate a more efficient monetary policy transmission. Henceforth the need for aligning the IRC or having symmetrical policy rate becomes even greater given higher probability of unknown shocks or in our case higher than expected inflation. This could lead to higher negative real rates, which will discourage savings (including foreign portfolio outflows) and may encourage consumption and investments. While negative real rates can encourage investments, this can be achieved through alternative channels, such as adopted along with the recent policy decision.

TERF: Unconventional monetary policy tool

In order to lure long-term investments and keeping up with the domestic growth trend, amid global Coronavirus-led growth slowdown, SBP announced a 'Temporary Economic Refinancing Facility' termed TERF with an aim to provide businesses with a lower refinancing rate.

Under this scheme, the SBP will refinance banks to provide financing at a maximum end-user rate of 7 percent for 10 years for setting up of new industrial units. The total size of the scheme is Rs 100 billion, with a maximum loan size per project of Rs 5 billion. It can be accessed by all manufacturing industries, with the exception of the power sector, where an SBP refinance facility for renewable energy projects already exists. In line with the SBP's other refinancing schemes, the credit risk will be borne by banks and the selection of projects to finance will also be determined by them. This scheme will help counter any possible delays in the setting up of new projects that investors were planning prior to the Coronavirus outbreak. It will be available for one year only, requiring a letter of credit (LC) to be opened by end-March 2021.

Market to less rejoice rate cut; as banks bear the burnt

To recall, the current monetary tightening cycle had begun from Jan-18 taking the policy rate from 6.0% to 13.25%, making it one of the lengthiest (>2.0yrs) monetary tightening cycle, hence the recent cut was a long-awaited one. However, the market response seems less appreciative of SBP's recent decision given market consensus stood at 50-100bps cut with most optimistic viewing a 250-300bps cut.

Nevertheless, from a market standpoint reduced interest rates, barring the Islamic banks, conventional banks will face NIMs compression due to changes in IRC. We recommend BAHL, BAFL and HBL as our preferred pick.

Whereas for high leveraged companies, rate cut might just come as a slight relief. Under construction sector DGKC, MLCF, CHCC, PIOC, ISL and ASTL will stand beneficiary to rate cut. Under fertilizer EFERT, FFC and FFBL in that order stands most impacted due to rate cut and NCL and NML under textiles and PSMC under automobile assemblers.

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