Monetary Policy Statement

SBP raised the policy rate by 125bps to 15% As Expected.

In the latest Monetary Policy Announcement (link) the State Bank of Pakistan (SBP) raised the policy rate by 125bps to 15%; in-line with our expectation (link). Interest corridor now comes at ceiling (Reverse Repo) 16% and floor (repo) rate of 14%. The interest rates on EFS and LTFF loans are also being raised, these rates will be linked to the policy rate and will adjust automatically, while continuing to remain below the policy rate by 500bps in order to incentivize exports.

Key points:

- This further hike in policy rate should help cool economic activity, prevent a de-anchoring of inflation expectations and provide cushion to the Rupee in the wake of multi-year high inflation and historic high imports.
- Since the last meeting, the MPC noted three optimistic developments: reversal of unsustainable energy subsidy and budget centered on fiscal consolidation, thus paving way for successful IMF on-going review; secondly, a $2.3 billion commercial loan from China helped providing support to FX reserves; thirdly, economic activity remains potent, with the impulse of the last two years of slightly below 6 percent growth carrying into the start of FY23. As a consequence, Pakistan faces a moderate trade-off between economic growth and inflation.
- Internationally, inflation is at multi-decade highs in most countries and monetary authorities are reacting aggressively. Domestic headline inflation rose significantly from 13.8% (y/y) in May to 21.3% in June, the highest since 2008. The increase was broad-based—with energy, food and core inflation all rising sharply.
- CAD unexpectedly spiked in May and the trade deficit continued its post-March diverging trend to reach a 7-month high in June, on proliferating energy imports.
- In the interest of social stability, the burden of this adjustment must be shared equitably across the population.
- Since the last MPC meeting, secondary market yields and cut-off rates in the government's auctions have ticked up in the wake of the high inflation reading in June.

Outlook:

- **Inflation:** measures of both short and long-term inflation expectations continue to tick up. Despite the dampening effect of fiscal and monetary tightening on demand-pull inflation, inflation is likely to remain elevated around current levels for much of FY23 due to the large supply shock associated with the necessary reversal of fuel and electricity subsidies. As a consequence, inflation during FY23 is forecast at around 18-20% before declining sharply during FY24.
- **Growth**: most demand indicators suggest strong growth since the last MPC—sales of cement, POL and automobiles increased m/m basis—and growth in LSM remains high. Going forward, growth is expected to moderate to 3-4% in FY23, on the back of monetary tightening and fiscal consolidation
- **Current Account Balance:** without prompt additional measures to curtail energy imports—for instance through early closure of markets, reduced electricity use by residential and commercial customers, and greater encouragement of work from home and car pooling—containing the trade deficit could become challenging. With such measures, the current account deficit is projected to narrow to around 3% of GDP as imports moderate with cooling growth, while exports and remittances remain relatively resilient.
- **External Fund gap**: the expected completion of the on-going IMF review will catalyze important additional funding from external sources that will ensure that Pakistan's external financing needs during FY23 are met.

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