Monetary Policy Considerations and Outlook

Economy

September 11, 2023

Pakistan Equities
Economy

Key Points

- The Monetary Policy Committee (MPC) of the SBP is scheduled to meet on Sep. 14, 2023 where we expect a 200bps increase in the policy rate to 24% with motives being, expected pressure from the IMF, and anchoring inflation expectations amidst increasing food and energy prices and impacts of weakening domestic currency (despite the recent appreciation).
- Unlike Sri Lanka, where IMF has given specific targets for inflation, although it has not given specific targets for inflation to Pakistan, IMF has highlighted that drastic increase in the size of OMOs and pauses in monetary tightening has led to loose monetary conditions and high inflation expectations.
- Banks being the major source of borrowings for the government for budgetary support, the size of OMOs have drastically increased to around PKR8.9tn currently from PKR3.9tn a year ago.
- Considering the inflationary nature of these OMOs amidst lack of external financing so far, along with overall inflation expectations, we understand that the IMF would be in favour of continuing with a tightening monetary policy while remaining data dependent, particularly inflation readings, for future adjustments.
- Our estimate for FY24 average inflation has now increased to ~25% compared to 21% at the beginning of the year without incorporating a major hike in gas and electricity prices from here onwards.
- Inflation is expected to average above 27% from Sep'23 to Jan'24 (preliminary estimate for Sep'23 inflation is ~31%) before gradually going down to an estimated average of around 20% for Feb-Jun'24.
- Looking at the secondary market yields of government papers especially after the last auction of T-Bills, it appears that the money market is also expecting an increase in policy rate by 150-200bps.

Key Data	
KSE100 Index	46,013
KSE-All Share Value (PKRmn)	5,552
KSE-All Share Value (USDmn)	18.3
KSE-All Share Volume (Shmn)	149.6
Market Capitalization (PKRtn)	6.8
Market Capitalization (USDbn)	22.6
1Year High	49,405
1 Year Low	38,136

Source: PSX, Next Research

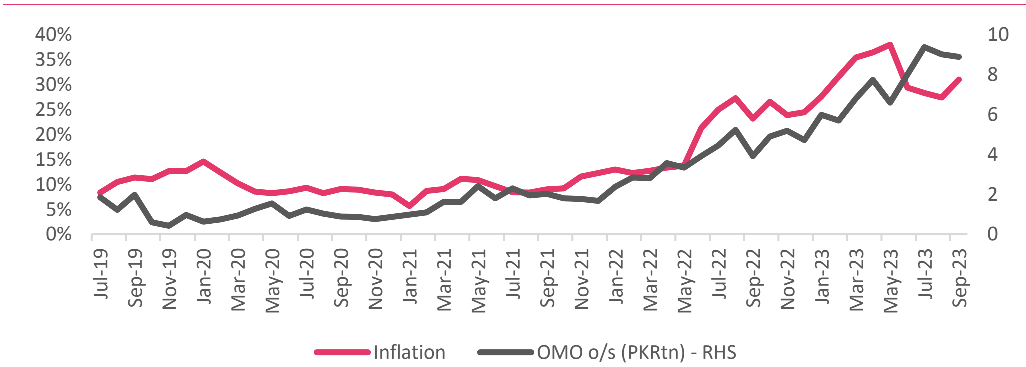
Outlook for the Monetary Policy

The Monetary Policy Committee of the SBP is scheduled to meet on Thursday, September 14th, 2023, to decide on the Monetary Policy of the country till its next scheduled meeting on Monday, October 30th, 2023. While we discuss key consideration points below, we foresee a 200bps increase in the policy rate to 24%, with motives being expected pressure from the IMF, and anchoring inflation expectations amidst increasing food and energy prices and effects of weakening domestic currency (5.7% devaluation in the interbank market since the last MPC meeting including the recent 1.4% appreciation), at the cost of already deteriorated outlook for growth and the fiscal strain due to increasing domestic debt servicing eating up the major revenues.

IMF advocates for a tighter monetary policy

Unlike in the case of Sri Lanka, where IMF has given specific targets for inflation, although it has not given specific targets for inflation to Pakistan, IMF has highlighted that drastic increase in the size of OMOs and pauses in monetary tightening has led to loose monetary conditions and high inflation expectations. IMF emphasized that the SBP needs to continue its tightening cycle to re-anchor expectations given that inflationary pressures are expected to persist due to the impacts of exchange rate corrections. Banks being the major source of borrowings for the government for budgetary support, the size of OMOs have drastically increased to around PKR8.9tn currently from PKR3.9tn a year ago. Considering the inflationary nature of these OMOs amidst lack of external financing having impacts on net international reserves, along with overall inflation expectations, we understand that the IMF would be in favour of continuing with a tightening monetary policy while remaining data dependent, particularly inflation readings, for future adjustments going forward.

Size of OMOs has drastically increased



Source: SBP, Next Research

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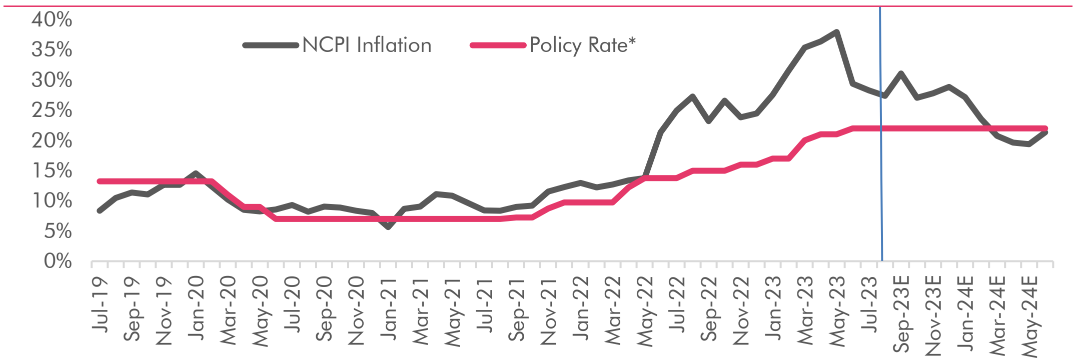
Inflationary pressures persist

NCPI inflation for the month of Aug'23 came in at 27.4%, which is slightly lower than expectations of above 28%. This is primarily due to a 5.7%MoM decline in the price index of perishable food items. However, with Jul'23 inflation exceeding expectations, average 2MFY24 inflation stands at 27.8% compared to 26.1% of the same period last year. Core NFNE inflation for Urban centers remained stable during Aug'23 at 18.4% whereas for Rural centers it increased to 25.9% from 24.6% of the previous month. Weighted average Urban-Rural core NFNE inflation stood at 21.4% compared to 20.9% of the previous month.

Inflation expectations building up

Going forward, spill-over impacts of depreciation of PKR against the USD (although PKR has appreciated 1.4% in the last couple of days), 5-6% increase in prices of MS and HSD already announced and expectations of further increase due to 1) higher international prices, 2) passing on of the exchange rate impact, and gradual increase in OMCs' and dealers' margins as approved by the ECC, and further hikes in electricity and gas prices, are expected to lift inflation expectations further despite the high-base effect from the previous year. At the beginning of the year, our estimate for FY24 average inflation was hovering around 21% (in-line with GoP estimates), which has now gone up to around 25% (getting closer to estimates of IMF, 25.9%) without incorporating a major hike in gas and electricity prices from here onwards. Inflation is expected to average above 27% from Sep'23 to Jan'24 (preliminary estimate for Sep'23 inflation is ~31%) before gradually going down to an estimated average of around 20% for Feb-Jun'24. At current policy rate of 22%, 12-month forward-looking real interest rates are in the negative territory and are expected to remain there in Sep'23 as well if policy rate is not increased. In case our inflation estimates for FY24 hold or does not deteriorate significantly, we expect reversal in monetary policy stance from 3QFY24.

Inflation to start tapering from Feb'24



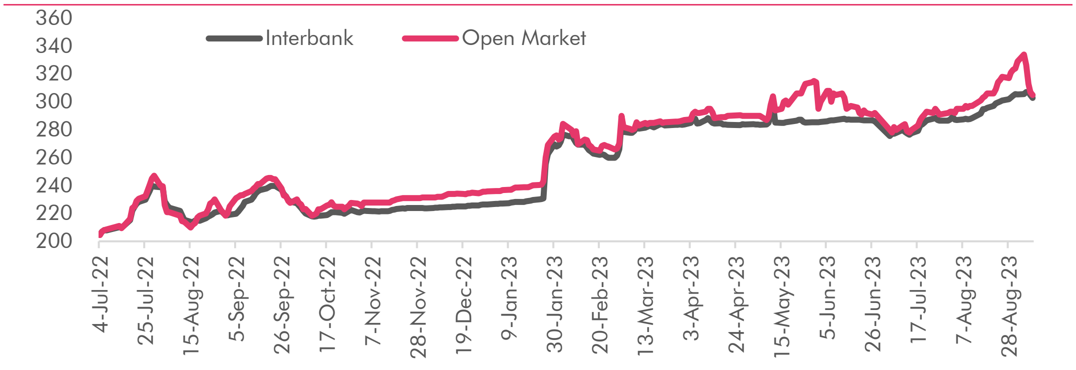
* If policy rate is kept unchanged at 22%

Source: SBP, PBS, Next Research

Positive developments in currency market and outlook for foreign exchange reserves

For the end-Sep'23 quarter review, IMF has set performance criteria of floor on net international reserves of USD-14.5bn. As per the data available at the SBP's website, net international reserves are estimated at around USD-12.4bn at the end of Jul'23 improving from USD-15.4bn of Jun'23 with the inflows coming in from IMF, KSA and UAE. However, considering gradually depleting forex reserves due to resumption of imports leading to current account deficits, no major external inflows materializing, and debt repayment requirements, it would be difficult for the country to meet this requirement of the IMF by the end of this month. To the credit of the caretaker government and SBP for cracking down on malpractices in the currency market, PKR/USD rates have come significantly down by 8.7% to PKR305/USD from PKR334/USD during the previous week in the open market. Similarly, PKR in interbank market has also gained ground by 1.4% in last 3 days of the previous week. Eventually the difference between open market and interbank exchange rate has narrowed to 0.68% well below the IMF's continuous structural benchmark of 1.25%. However, building-up of forex reserves and maintaining this spread while following a market-determined exchange rate policy would be critical for sailing through the next IMF review expected in Nov'23.

Gap between interbank and open market exchange rate has narrowed to <1.25%



Source: SBP, Mettis Global, Next Research

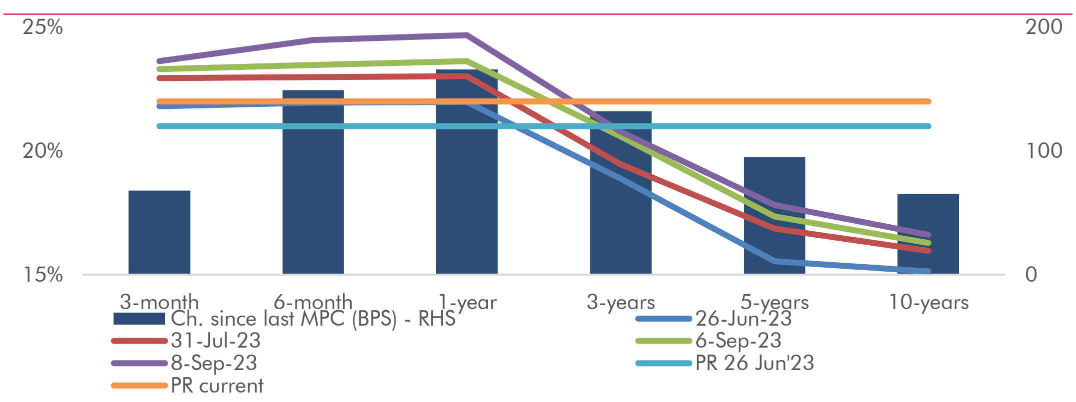
Some improvement in real sector

In its last meeting held on Jul. 31, 2023 (status quo maintained), the MPC expected a real GDP growth of 2-3% for FY24 (our estimate is 2.4%) with a moderate recovery in economic activity supported by increased output of rice and cotton with improved outlook for manufacturing, and construction and allied services after withdrawal of import prioritization guidelines by the SBP (a requirement of the IMF). Accumulated impacts of tightening monetary policy and fiscal consolidation are expected to restrict growth outlook. Looking at high frequency data of sectors; domestic cement dispatches during the first 2 months of FY24 recorded an improvement of 37% with total dispatches including exports for the period improving by 45.2%, auto sales on the other hand continued to decline during Jul'23. Sales of MS and HSD also registered growth of 8% and 11%, respectively during 2MFY24 while sale of FO is reported to have declined by 61%. MoM and YoY uptick in sales of cement, MS, and HSD, may be attributable to low base effect due to last year's country wide floods and heavy rains in north last month, therefore the trend in the coming months is critical for any optimism for growth where credit to private sector has shrunk by over 1%YoY. We therefore understand that considering the performance of the real sector so far, a monetary policy adjustment is not required at this point in time.

Money market operations and expectations

In the recent T-Bills auction held on Sep. 6, 2023, cut-off yields for 3, 6 and 12-months Treasury Bills were increased by 162bps, 204bps and 213bps, respectively to 24.5%, 24.8% and 25.1%, respectively over the previous cut-off yields. In the secondary market, yields have gone up by 68-166bps from the last MPC meeting, where the highest increase was seen in the yields of 1-year T-Bills and the lowest increase was seen in the yields of 3-month T-Bills. We believe that the market has incorporated an increase of 150-200bps in the policy rate in the upcoming MPC meeting.

Yield Curve has shifted upwards



Source: SBP, Mettis Global, Next Research

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