Monetary Policy Going like Clockwork

On December 14, 2012 SBP reached the much awaited single digit Discount rate – levels not witnessed since July 2007. Stressing upon the sluggish growth in credit to private sector despite a cumulative 400bps cut in policy rate in last 16 months and better than expected deceleration in the inflation encouraged the Central Bank to reduce the policy rate by 50bps – thereby closing the calendar year 2012 at a discount rate of 9.5%.

Multiple economic indicators had suggested continuation in expansionary monetary policy with consistently declining inflation giving the loudest cry. CPI inflation for November 2012 clocked in at 6.9%, with food inflation dropping to 5.3% and non-food inflation coming down to 8.1%. Surprisingly, a single digit NFNE index (9.7% in November 2012) further endorsed the economic gurus to envisage at least 50bps cut. The in-house inflationary model suggests that the inflation for FY12-13 will remain comfortably below 9% (with slight hiccups) – keeping the real returns positive throughout the remainder of the fiscal year. Apart from Inflation, devaluation of PKR as well as Pre MPS rally in Stock market had priced in the cut in discount rate well before the MPS.

As per our anticipation, State Bank of Pakistan brought the discount rate to single digit against the backdrop of single digit inflation and non-materialization of foreign inflows. The pressure to meet fiscal expenditure will surmount as the year ends and lower discount rate will somewhat relieve the pressure off the government on repaying the skyrocketing levels of domestic debt. Having said that, improving the tax collection capability and curtailing the expenses (minus payments to IMF and other foreign loans) is crucial for the smooth functioning of the economic wheel.

Going forward, the next MPS scheduled in February 2013 may not hold many surprises for the market since it would be much closer to the elections. However a careful analysis of the trend in inflation (especially the core inflation) and expected currency devaluation will surly impact the final word.

KSE-100 Index Vs. Discount Rate (%)

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