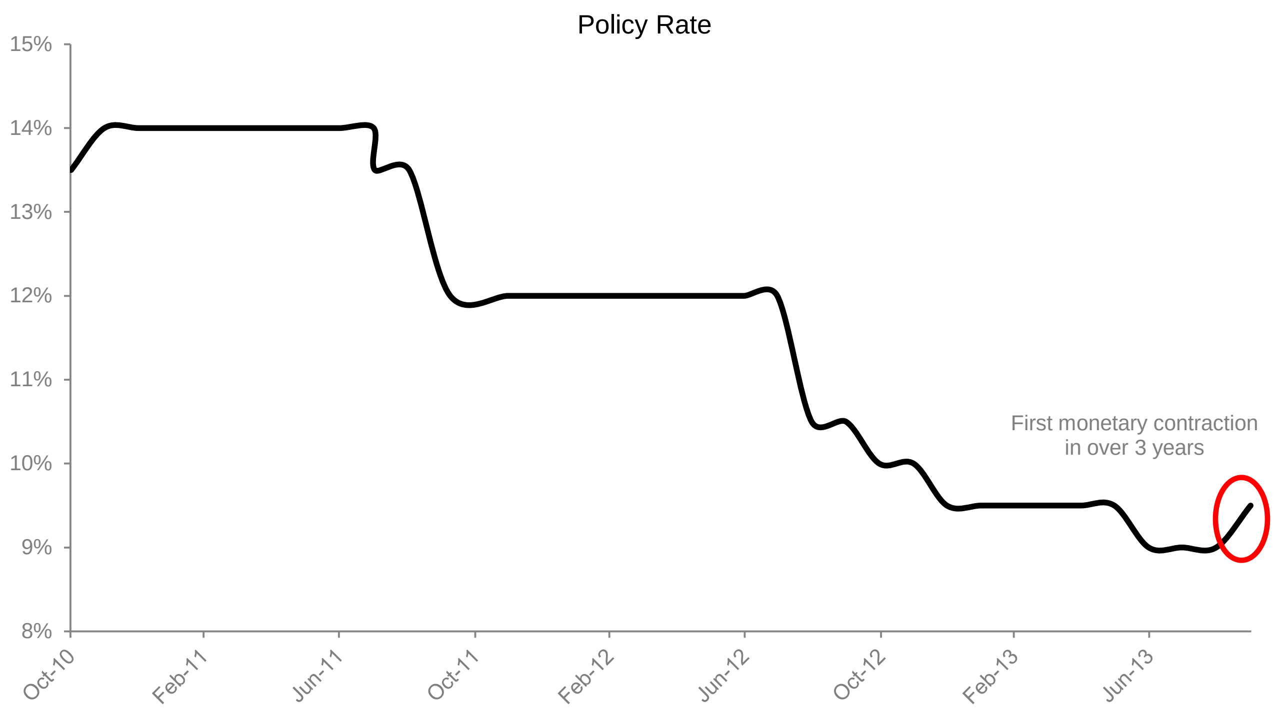
Faysal Asset Management

Research Note – Friday the 13th

September 16, 2013

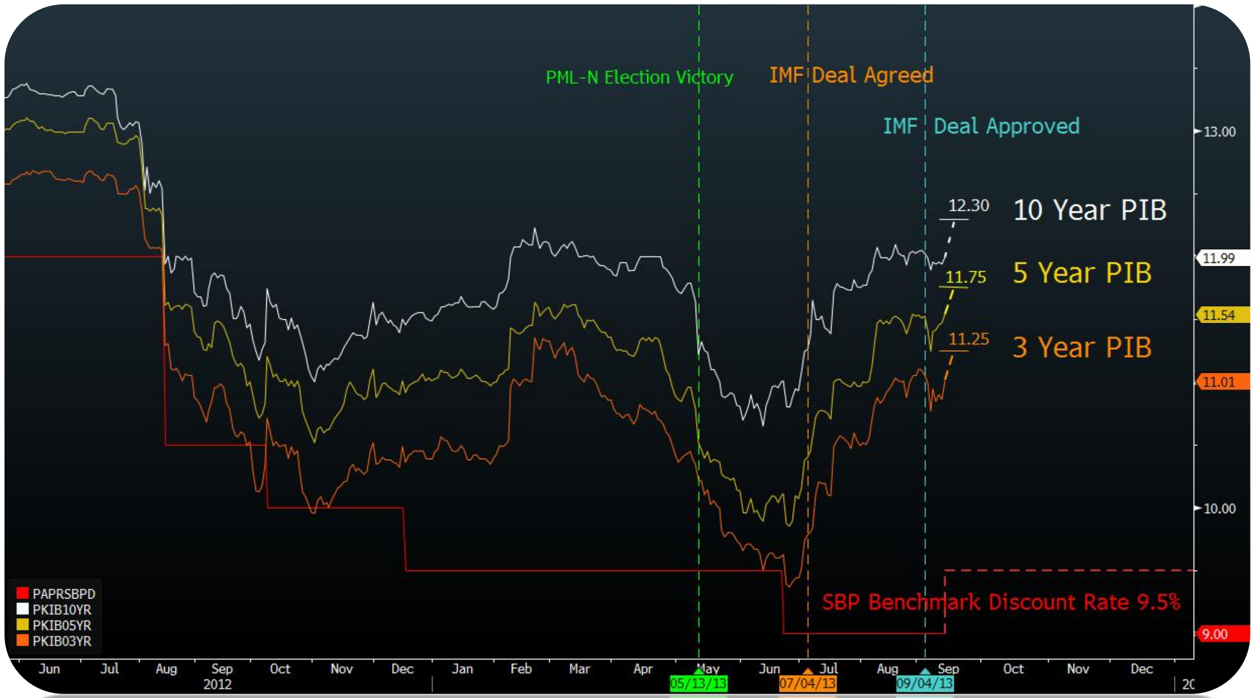
Reversal in Monetary Policy Stance

The Central Board of Directors of State Bank of Pakistan (SBP) released its latest monetary policy statement on September 13, 2013. Citing expected surge in inflation, fiscal slippages and critical external position in the wake of escalating international oil prices, SBP decided to increase the policy rate by 50bps to 9.50% for the next two months.



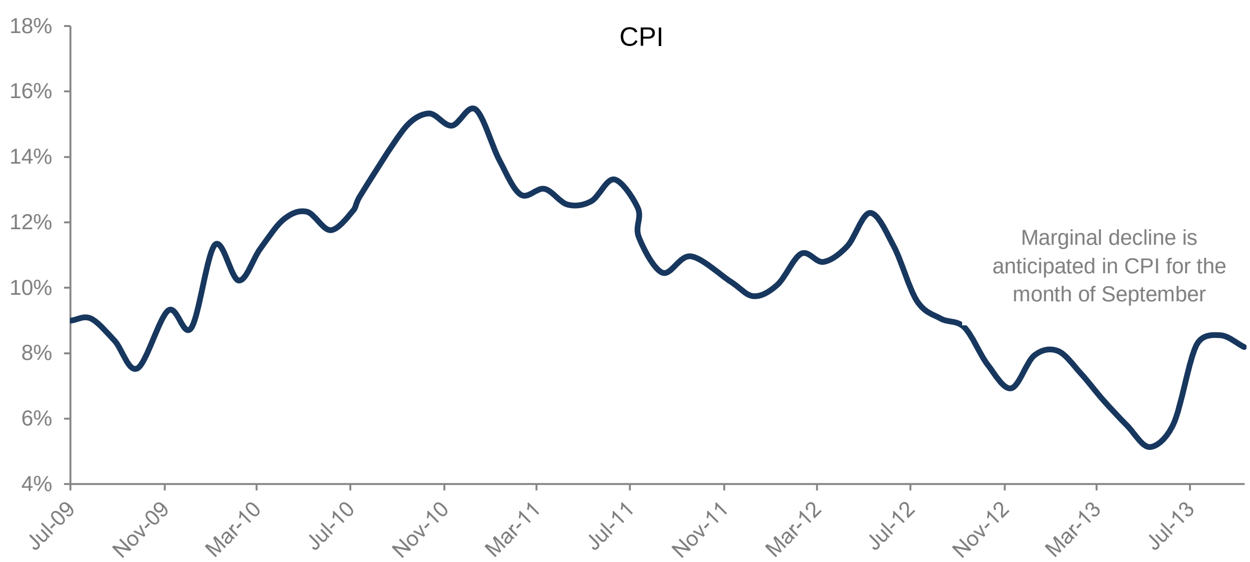
Recall that the Central Bank commenced an accommodative monetary policy back in Augusts 2011 by giving relatively higher significance to decelerating inflation and sustained weak private investments in the economy. This easing stance has been prevalent over the last two years which saw the key interest rate decline from 14% to 9% (cut of 500bps). Latest interest rate hike of 50bps marks the first step towards monetary tightening by SBP in over three years.

As we earlier highlighted in our research notes, inflationary expectations are rising in the economy triggered by fiscal consolidation and weakening exchange rate. The ‘prior actions’ such as fiscal adjustment measures and elimination of tariff differential subsidies undertaken by newly elected government to qualify for the IMF Extended Fund Facility (EFF) has set the stage for Consumer Price Index (CPI) to head towards double digit era. These fiscal measures and tariffs escalations would ultimately find its way into the CPI as companies would ultimately pass on the impact to end consumers. Furthermore, imported inflation will tend to push domestic inflation up on account of recent spikes in global oil prices. The battering of currency exchange rate provides further justifications for the reversal in monetary policy stance.

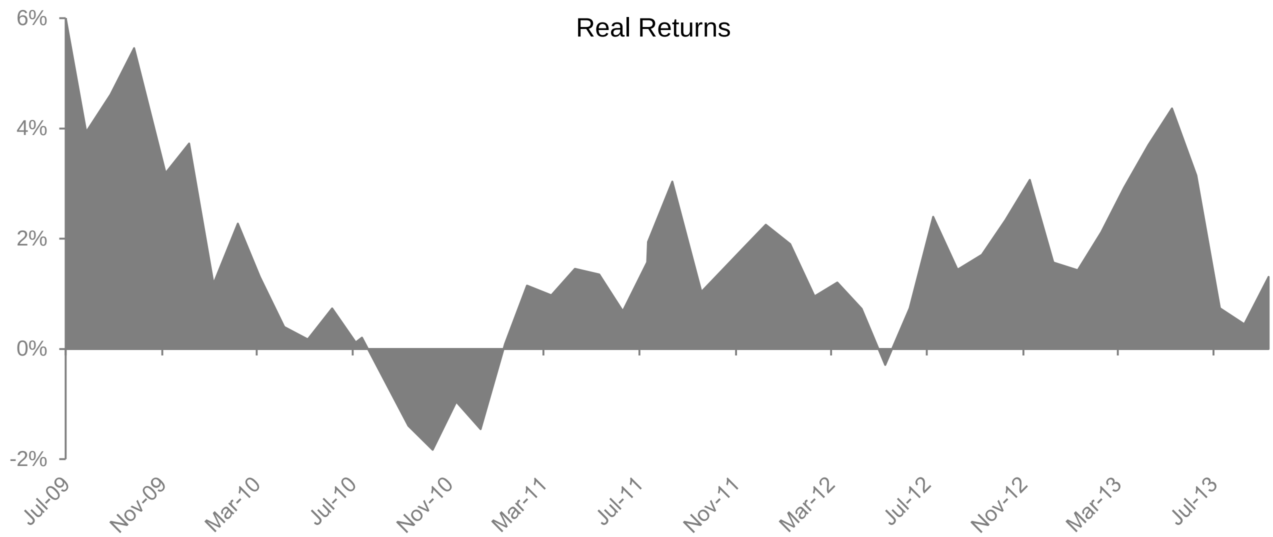


Anticipating continuation in the accommodative monetary policy stance post IMF loan approval, the equity bourse gained more than 6%. With the end of monetary easing cycle, we expect KSE-100 index to react negatively as leveraged companies would be among the first to face the brunt. However, the move would bode well for banking stocks as tightening stance on monetary front would ameliorate banking spreads.

Likewise, we anticipate bond and money market yields to inch up following policy announcement. With +50bps hike, the 3-year bond is expected to inch up to 11.25% (current: 11.01%), while 5-year and 10-year bonds are anticipated to touch 11.75% (current: 11.54%) and 12.30% (current: 11.99%), respectively in the coming weeks.



According to latest Sensitive Price Index (SPI), our preliminary CPI projection for the month of September comes in at 8.19%.



With latest hike in discount rate and anticipated marginal decline in inflation for the month of September, the real interest rate comprehensively rises to 131bps from 45bps.

As agreed in the Memorandum on Economic and Financial Policies (MEFP) with International Monetary Fund (IMF), SBP has addressed the looming concerns such as declining reserves and projected rebound in inflation by realigning the monetary policy accordingly. The preemptive stance of SBP in this regard has put the real interest rates at comprehensive position for the time being. Going ahead, rebuilding of foreign exchange reserves as agreed in MEFP coupled with fiscal consolidation measures are likely to inflate the Consumer Prices Index further where central bank is expected maintain ‘real interest rate’ at comprehensive level.

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