Faysal AssetManagement

Research Note – Status Quo expected to prevail

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Status Quo expected to prevail

It is increasingly clear that State Bank of Pakistan (SBP) would keep the Policy Rate unchanged in its most eagerly awaited Monetary Policy Statement to be announced on September 13, 2013. With the revelation of Memorandum on Economic and Financial Policies (MEFP) by Ministry of Finance, the state of predicament over the future course of Monetary Policy has ended, at least in the short run.

The Executive Board of the International Monetary Fund (IMF), on September 04, 2013, approved a 3-year arrangement under the Extended Fund Facility (EFF) for Pakistan in an amount equivalent to USD 6.64bn or 425% of Pakistan's quota to support the country's economic reform program to promote inclusive growth. In this regard, MEFP as agreed with IMF provides substantial insight into the course of actions to be pursued by SBP over the program term.

From Policy Rate perspective, following excerpts from MEFP surprised markets and economic pundits which envisages continuation of 'accommodative monetary policy stance' in the first year of EFF despite projected rebound in inflation.

"Inflation reduction will not be a primary focus of the first year of the program so as to mitigate the impact of the envisaged fiscal contraction."

"The negative impact on economic activity will be ameliorated by structural reforms to boost growth and a somewhat more accommodative monetary policy stance early in the program than would normally be required given the inflation outlook."

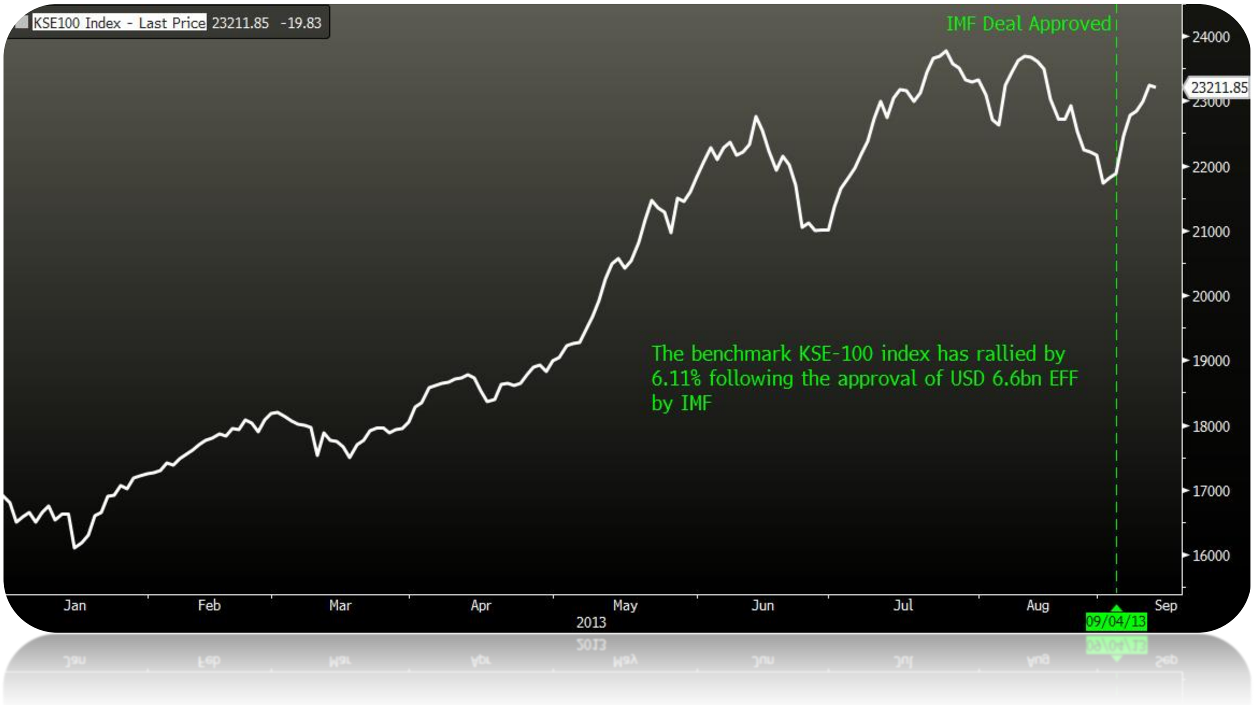
"To ease some of fiscal adjustment effects, the program initially envisages a moderate monetary policy, with policy tightening in years two and three, as exchange rate pressure eases, to bring inflation down to the 6-7 percent range. To reduce inflation, monetary accommodation of fiscal deficits will be scaled back considerably and policy rates will be set prudently to ensure positive real interest rates."

"Monetary policy will likely be tightened in later years to help bring inflation down to the 6-7 percent range by the end of the program period."

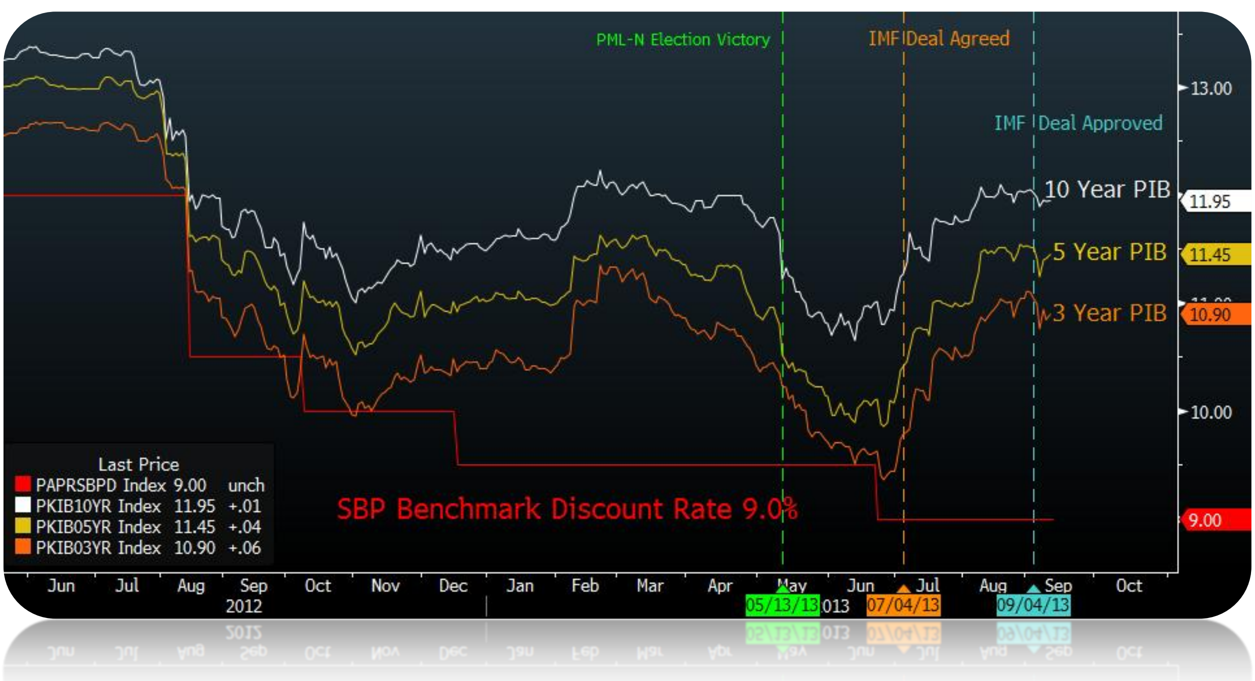
"Beginning in 2014/15, monetary policy will aim to reduce inflation while continuing to rebuild foreign exchange reserves."

Market reaction

Approval of three year program by IMF executives and accompanied set of economic policy measures has changed the dynamics of both equity and money market for the time being.



The Equity bourse has reacted positively to the anticipated continuation in the accommodative monetary policy stance. The KSE-100 index has rebounded almost 6.11% since the IMF loan approval.



Lately, bond yields have been soaring as market increasingly believed preemptive stance by SBP amid sharp falling of real returns. Following emergence of MEFP containing outlook on interest rates, 1-year and 3-year PIB yields have eased by 20bps and 17bps respectively. However, the impact on 10-year PIB yield remains muted as the MEFP clearly envisages policy tightening in second and third year of IMF program.

Inflation and Monetary Policy Outlook

As frequently predicted, inflationary expectations in the economy are gaining momentum mainly on the back of fiscal consolidation and weakening exchange rate. Government officials have also realized that recent trend of suppressed inflationary phase is gradually coming to an end which is depicted by following excerpts from MEFP.

“Headline inflation has recently declined sharply, but it is expected to rebound.”

“Inflation will initially increase, due in part to some weakening of the rupee as reserves are rebuilt.”

“To address declining reserves and a projected rebound in inflation, the SBP will adjust monetary and exchange rate policies.”

The SBP has pursued an accommodative monetary policy to stimulate the economy, in view of sustained weak private investment and declining headline inflation. Over the past two years, the SBP has reduced the policy rate by a cumulative 500bps to 9%.

Proposed series of economic measures to be under-taken over the term of IMF program aims to bring fiscal discipline in the economy at the cost of growth. IMF projects GDP growth of 2.5% during FY14 which is substantially lower than government’s estimation of 4.4%.

To alleviate growth prospects of the economy, we anticipate central bank to adopt accommodative stance on monetary policy front in its decision on September 13, 2013. However, we do not rule out marginal interest rate hikes over the next few policies as real interest rate is anticipated to enter negative zone by the end of current calendar year.

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