Faysal Asset Management

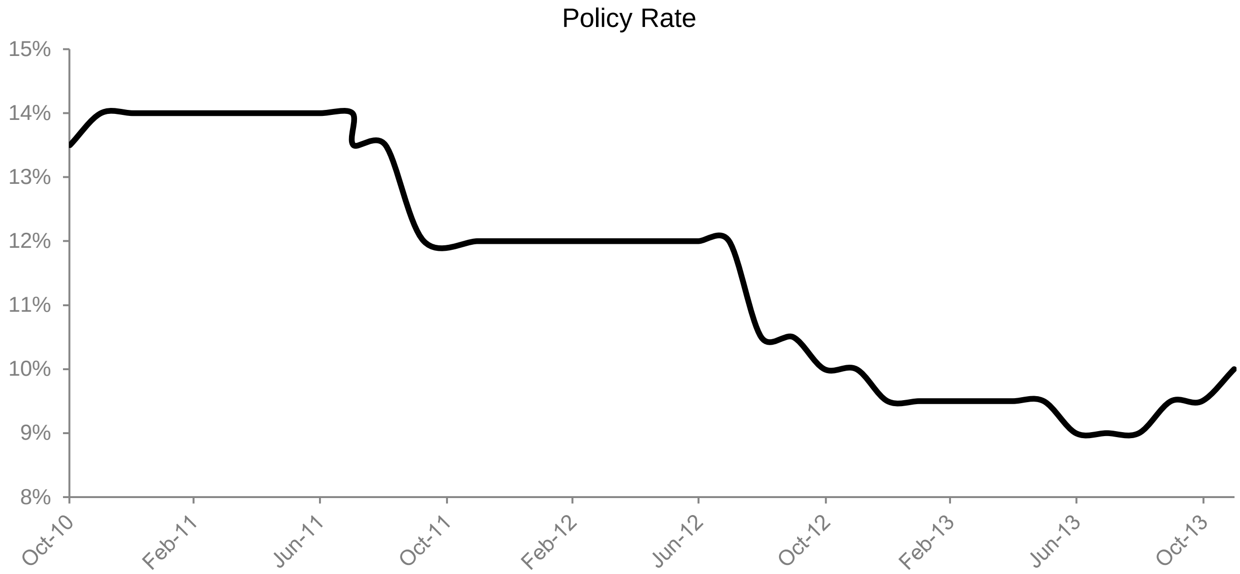
Research Note – Tightening the noose

November 18, 2013

Further tightening of monetary policy

Fiscal year 2014 witnessed the second consecutive hike in key benchmark interest rate when State Bank of Pakistan (SBP) increased the policy rate by 50bps to 10% in its latest Monetary Policy Statement announced on November 13, 2013.

Contrary to the previous monetary policy statement, SBP sounded more optimistic by giving higher weightage to Government's commitment to stay on track with regard to reforms initiated under the IMF Extended Fund Facility (EFF) program. Nevertheless, SBP remained cognizant of the macroeconomic vulnerability mainly underpinned by twin account deficit and structural deficiencies.

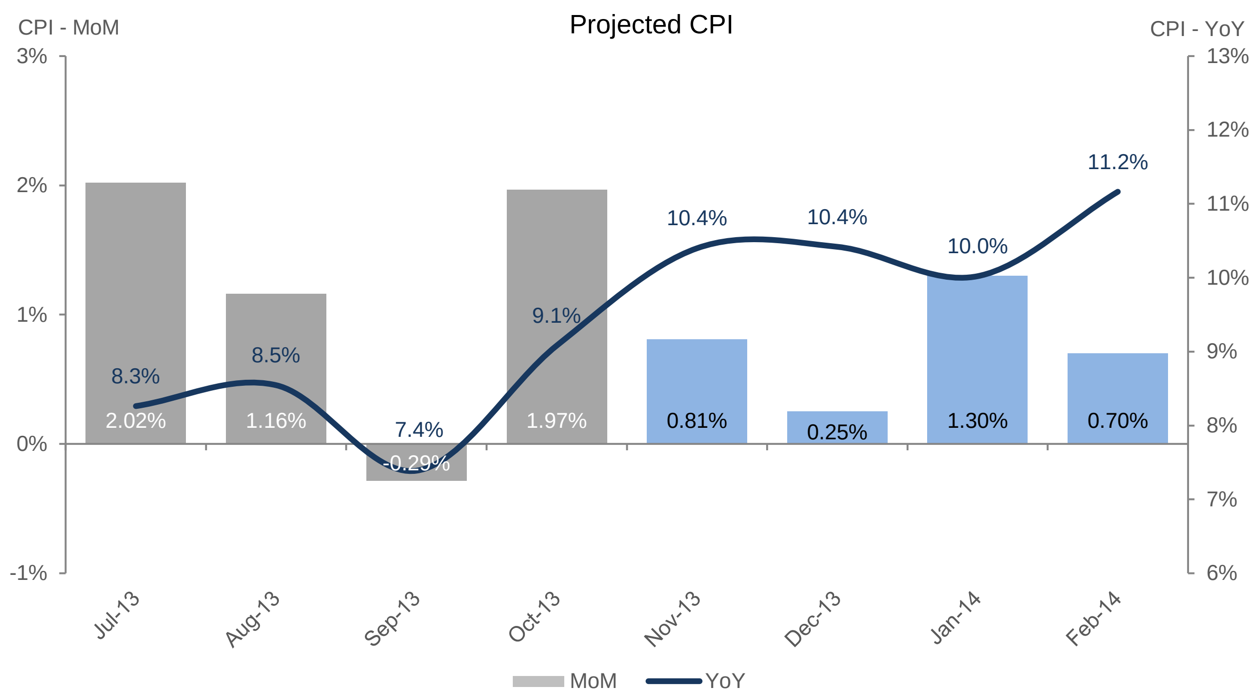


As anticipated earlier, a) deterioration in external account, b) declining foreign reserves, c) exchange rate volatility, d) higher inflationary expectations and e) expected negative real returns were the reasons cited by SBP to further increase the policy rate by 50bps to 10%. However, positivity on the a) resolution of circular debt, b) LSM growth, c) contained fiscal deficit, d) energy tariff rationalization and e) conviction on structural reforms somewhat restricted a more hawkish stance which could have resulted in hike higher than 50bps.

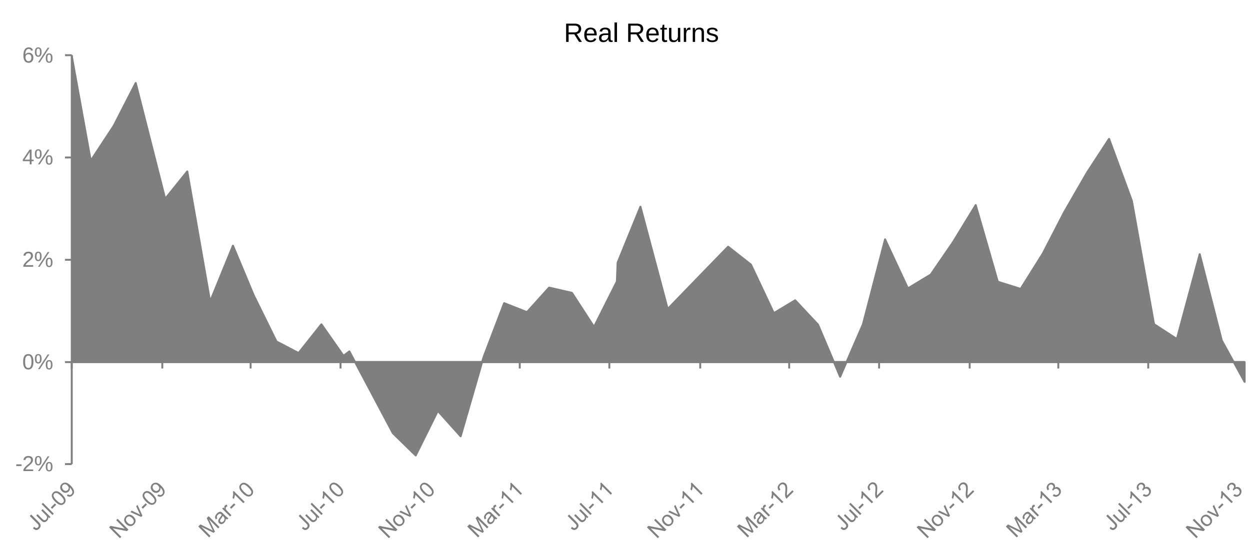
Inflation projection for November 2013

At present, the average Consumer Price Index (CPI) for the 4MFY14 rests at 8.32%. However, SBP in its latest monetary policy statement projects inflation to remain at elevated levels in the range of 10.5% to 11.5% as adjustments in energy prices coupled with higher food prices fuel inflationary expectations.

For the month of November 2013, we anticipate year-on-year headline inflation to exceed double digits for the first time in sixteen months. Underpinned by upsurge in prices of perishable food items and low base effect, year-on-year headline inflation for the month of November is estimated to clock in at 10.39% against the 9.08% last month. Led by colossal hike in prices of tomatoes (+76%), potatoes (+29%), onions (+13%), eggs (+12%), sugar (+7%) and wheat flour (+2%), month-on-month inflation is anticipated to register hike of 0.81%. Although, we expect that prices for perishable food items cannot sustain these elevated levels for long as new supplies are expected to enter the market causing reduction in price levels for these key food items. Even after taking into account these forward projections, inflation for the month of December 2013 is expected to remain in double digits.



Despite the latest 50bps hike in the policy rate, inflation for the month of November will drag real returns into negative territory. Therefore, sustained double digit inflationary expectations coupled with deteriorating SBP FX reserve position may make a case for further monetary tightening in the next policy meeting in January 2014.



Monetary Policy Outlook

In its latest monetary policy announcement, the SBP had room for a 100bps increase in policy rate, yet opted for only a 50bps as the central bank is anchoring its expectations on the ongoing structural reform package and its long term implications for the economy.

In this regard measures like, a) gradually increasing Tax to GDP ratio, b) expanding the base of direct taxation, c) phasing out of subsidies, d) restraining fiscal deficit, e) addressing structural deficiencies and f) permanently increasing foreign direct flows are imperative for the medium to long term prospects of the economy.

Although the central bank is cognizant of the macroeconomic vulnerabilities and foresees a measured recovery in economic indicators vis-à-vis structural reforms, however, in any adverse scenario, the burden of economic management will entirely fall onto the adjustment of monetary and exchange rate policies. Going forward, course of monetary policy will largely hinge upon the successful completion of structural benchmarks under the IMF program and its implications for the economy. Consequently, SBP will be fully vigilant of the developing scenario on fiscal and external front where any adverse movement in key economic indicators will result in more hawkish stance by the central bank and hence we do not rule out further monetary tightening in the next policy to be announced in January 2014.