Faysal AssetManagement

Research Note – The cost of stability

November 13, 2013

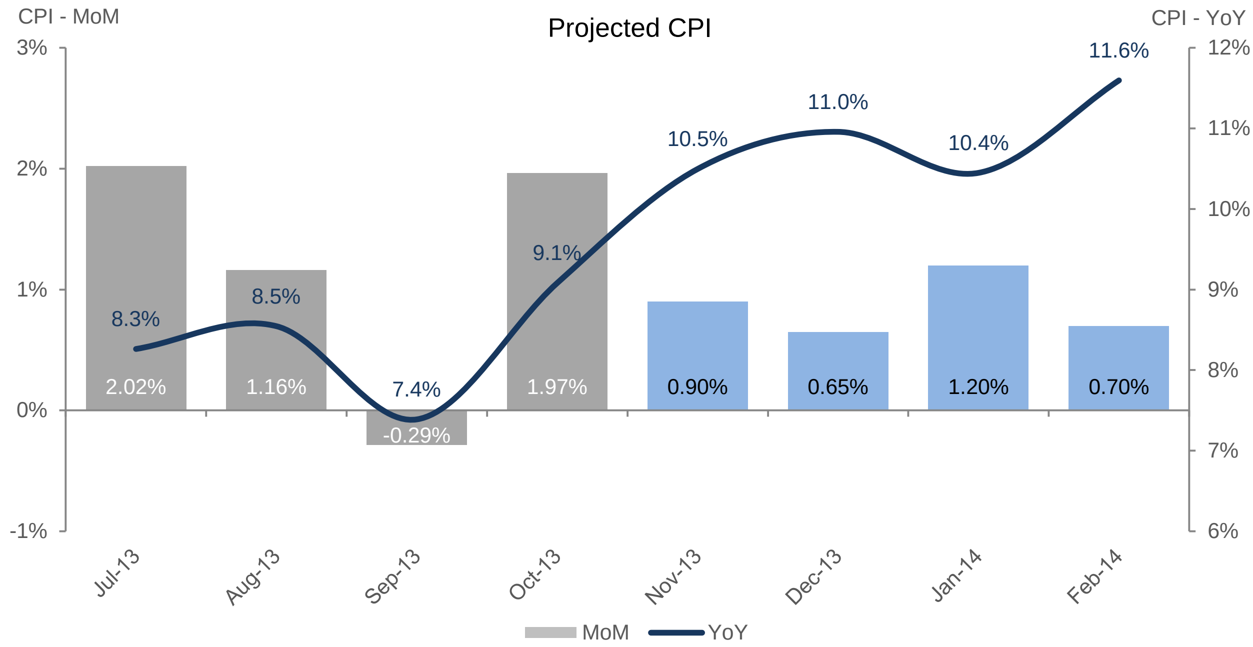
Monetary tightening on the cards

As the newly elected Government started unveiling its economic agenda aimed at long term macroeconomic stabilization, it was quite evident that it would not come without a tradeoff. Implementation of fiscal consolidation measures - by improving revenue collections and gradually phasing out chronic subsidies – are resulting in higher inflationary expectations in the economy. On the external front, mounting pressure on currency exchange rate owing to weak external position poses further challenges for economic policy makers.

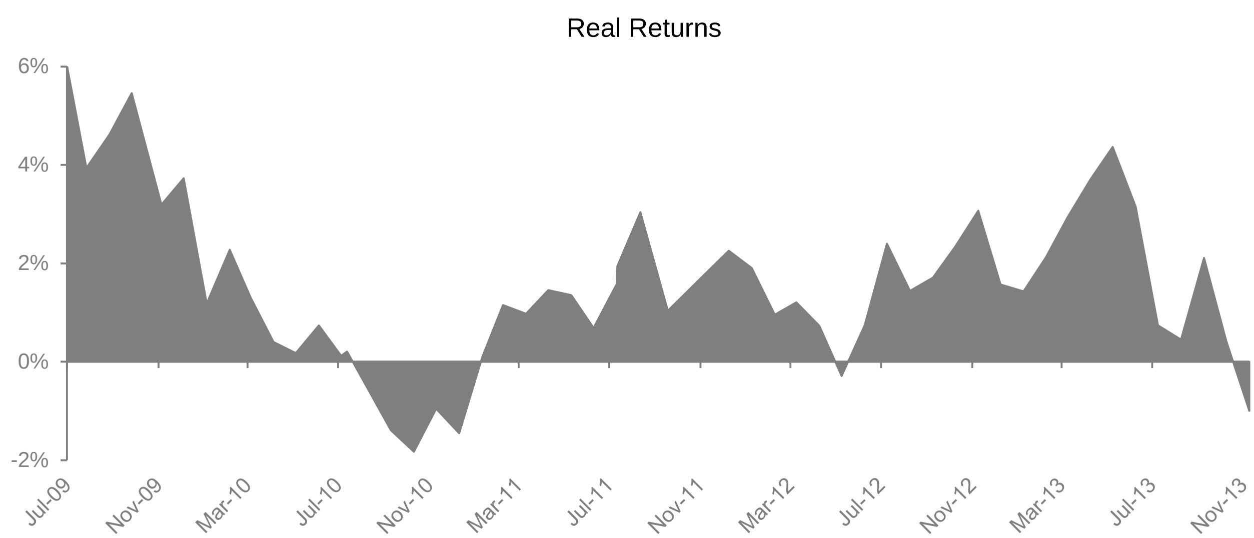
At this critical junction, how would the State Bank of Pakistan (SBP) go about nudging prices downward whilst providing much needed breather to the currency exchange rate? Recall that SBP decided to increase the policy rate by 50bps to 9% in its last Monetary Policy Statement (MPS) citing surge in inflation, fiscal slippages and critical external position. The tighter monetary policy stance then marked the first step towards monetary tightening by SBP in over three years.

MPS Checklist	Jun'13 MPS (-50bps)	Sep'13 MPS (+50bps)	Nov'13 MPS (+100bps expected)	Rate Hike = Yes / NO
Inflation	Below 6.0%	Heading to 9.0%	Heading to double digits	Yes
PKR Exchange Rate	USD 1 = PKR 98.5	USD 1 = PKR 104	USD 1 = PKR 107.5	Yes
Foreign Reserves	USD 11.5bn	USD 9.9bn	USD 9.5bn	Yes
Financial Flows	Dismal	Dismal	Dismal	Yes
NDA / NFA Ratio	24.0	46.0	118.0	Yes
Current Account	Deficit	Surplus	Deficit	Yes

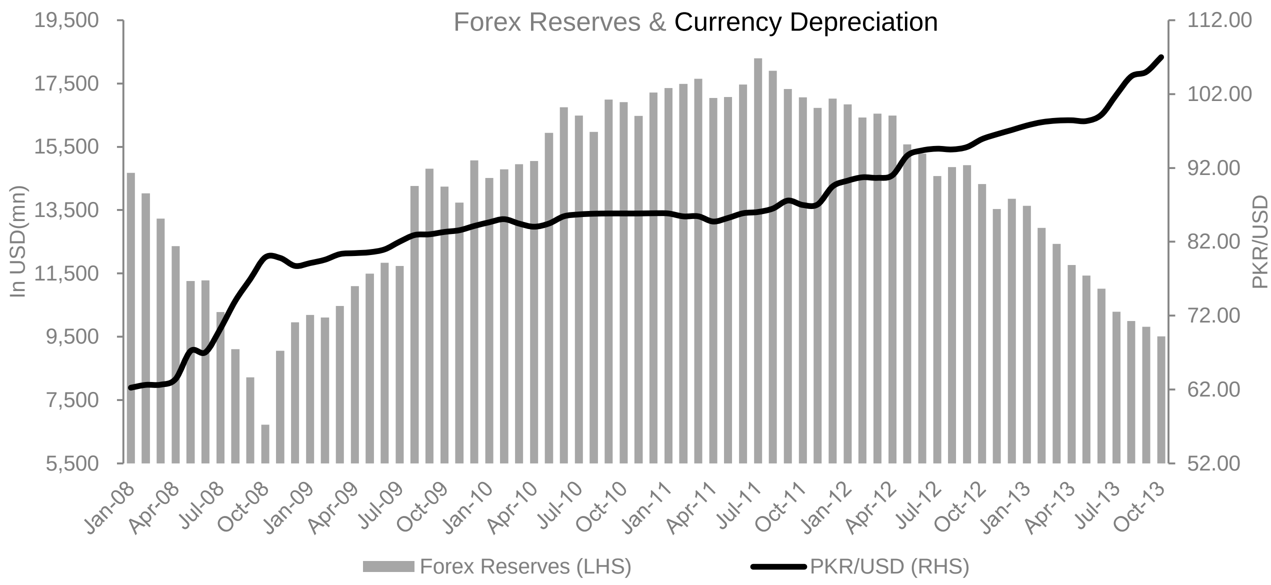
The aforementioned checklist depicts that all the macroeconomic determinants for formulating monetary policy stance have been deteriorating since the last two Monetary Policy Statements warranting further contraction in the monetary policy stance. In this regard, the recently concluded first review of Pakistan's IMF-supported program under the Extended Fund Facility (EFF) provides further insight. Though the IMF's mission expressed overall satisfaction with the implementation of structural reforms, reading between the lines suggest IMF's emphasize on the alignment of monetary and exchange rate policy with the objective of greater exchange rate flexibility and price stability amid persisting concerns on balance of payment position. In this regard, Pakistani authorities have signed an updated Letter of Intent (details yet to emerge) after the IMF mission held discussions with government and central bank officials on the economic performance.



Our preliminary estimates for Consumer Price Index (CPI) after incorporating latest Sensitive Price Index (SPI) readings suggest year-on-year CPI to clock in at ~10.5% for the month of November implying negative real returns of 100bps. In this regard, SPI for the second week of November will further elucidate our projections.



Pakistan has paid USD 148mn to the IMF under the stand-by arrangement (SBA) loan facility during the current month whereas repayments of USD ~540mn are scheduled during the remaining half of November 2013. This implies that Pakistan's foreign reserves with SBP may fall to USD 3,500mn.



Pak Rupee has lost 8% since the start of fiscal year 2014 despite the 50bps hike in interest rate. Given the critical position of foreign reserves, SBP would likely refrain from intervention in the market to ease pressure on the Rupee. Indeed, central bank would likely step in the open market for rebuilding the foreign exchange reserves, inducing further pressure on the currency exchange rate.

Considering the aforementioned key economic variables along with IMF's view on realignment of monetary and exchange rate policy, we anticipate SBP to continue its preemptive stance and increase the policy rate by a further 100bps in the upcoming Monetary Policy Statement.