Day Break

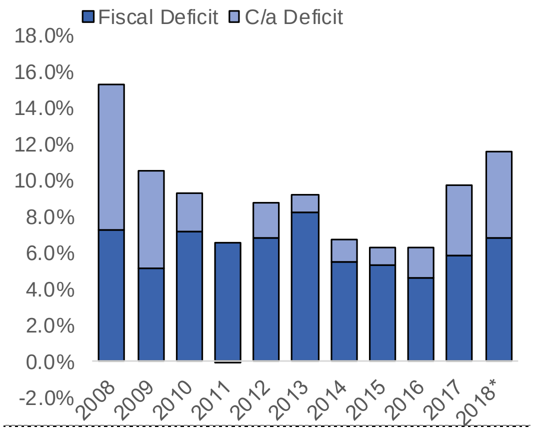
Monday, 16 July 2018

Economy

Exhibit: Historic interest rate

	Reverse Repo	Repo	Target Rate	Chg. (bps)
18-Nov-13	10.00	7.50	-	
17-Nov-14	9.50	7.00	-	
26-Jan-15	8.50	6.00	-	
24-Mar-15	8.00	5.50	-	
25-May-15	7.00	5.00	6.50	-
14-Sep-15	6.50	4.50	6.00	(50)
23-May-16	6.25	4.25	5.75	(25)
29-Jan-18	6.50	4.50	6.00	25
28-May-18	7.00	5.00	6.50	50
14-Jul-18	8.00	6.00	7.50	100

Exhibit: Twin Deficit



Source: Bloomberg, KSE 100, SBP & IGI Research

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Monetary Policy Statement

Monetary tightening and fiscal dominance hints to a challenging start of year FY19

- The State Bank of Pakistan (SBP) delivered its 1st monetary policy statement for the year FY19, on 14th July, 2018 raising the benchmark policy rate by 100bps to 7.5% and subsequently higher discount rate to 8.0% and repo rate at 6.0%.
- The move is in line with ours and market consensus of 100-150bps increase. This is the second rate hike during 2018. Key reasons behind rate hike includes, a) higher inflation target in FY19, b) rising twin deficits and, c) unfavorable trend in international oil prices.
- We view SBP's proactive monetary contraction decision along with additional policies such as reintroduction of import tariffs is likely to herd down multiple of demand pressure in economy, starting from private sector credit growth, cut down non-essential import bill and finally, help recover draining forex exchange reserve position.
- However, rising fiscal deficit is what we think will be crucial in anchoring down overall demand pressure and rising interest rate will come less handy in that situation.
- We expect further rate tightening of 50bps, taking the target rate to 7.5%. On inflation we expect headline inflation to settle slightly higher at 8.0% during FY19 compared to SBP initial target of 6.0-7.0%.

Policy rate hike by 100bps on rising twin deficits

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On the outlook we view SBP's proactive monetary contraction decision along with additional policies such as reintroduction of import tariffs is likely to herd down multiple of demand pressure in economy, starting from private sector credit growth and cut down in non-essential import bill; finally help recover draining forex exchange reserve position. However, rising fiscal deficit is what we think will be crucial in anchoring down overall demand pressure and rising interest rate will come less handy in that situation. From monetary policy statement we sense increasing probability of government approaching IMF post-election 2018. Down the year, we expect further rate tightening of 50bps, taking the target rate to 7.5%. On inflation we expect headline inflation to settle slightly higher at 8.0% during FY19 compared to SBP initial target of 6.0-7.0%.

Inflation expectations continue to de-anchor in 2019 and beyond

On inflation the SBP cited higher underlying pressure as denoted by core inflation which for the outgoing year FY18, recorded a 5.8% growth and in FY19 is expected to record >7.0% growth. As a result, headline inflation is expected to stay downward sticky. Key cost push drivers such as rising oil prices along with sharper exchange rate weakening seems a worrisome factor, seeping into broader inflation basket, with no consolation in sight from food index as water shortage is expected to affect overall agricultural production in coming years (SBP: "food inflation reverting to its normal behavior").

Fiscal dominance; FY18, Fiscal deficit understated by nearly USD 3.5bn

On demand side SBP highlights higher inflation expectations being attributable to lax fiscal policy. For FY18, alone fiscal deficit recorded a 6.8% of GDP, instead of government provisional estimate of 5.5%, that's nearly PKR ~450bn or USD 3.5bn. This means a rise in government borrowing requirement than earlier estimated, with net foreign assets (NFA) trending in opposite direction; the burden on government to borrow more could be larger. Hence this 100bps rate hike and more likely to follow, in the current 'fiscal dominance' nature of inflation, will be less of a tool to anchor down inflation expectations, in fact it will amplify overall aggregate demand.

SBP highlights;

"The multiplier-effect of a strong fiscal expansion during the second half of FY18 is likely to offset the contractionary impact of monetary tightening in the current months of domestic demand."

Despite improvements in remittance and exports combined cover ~80% of total import bill; Government most probable to approach IMF at earliest

While SBP has not yet hinted government reaching out to IMF for BOP support explicitly, but presented the very apparent signs as why country's BOP financing will be necessitated in future. Starting off with sizable current account deficit gap of USD 16bn in (11MFY18) compared to USD 11bn same period last year. Notably both remittances (USD 18.03bn) and exports (USD 22.78bn) have shown improvement rising by +3% and +13.2% respectively but even these both heads combined only manages to cover roughly ~80% of the total imports (USD 50.7bn) last year ~86%. To note, the last time when this ratio dropped below ~80% Pakistan approached IMF for BOP funding, that is in Oct-08 with amount totaling USD 7.6bn.

Deteriorating Fiscal situation to take the center seat as the core inflation problem, rising interest more of 'debt pain' and less of Policy gain

As the inflation scenario keeps deteriorating, there is just so much monetary policy can do. Unless, there is a political solution soon to address rising fiscal deficit, we believe that this problem of fiscal dominance taking over inflation will continue to deteriorate and monetary tightening will be less of a help in this situation, in fact it will bring in more 'debt pain'. In a recently published news article caretaker Finance Minister Dr. Shamshad Akhtar addresses 1% increase in interest rate will lead to PKR 100bn increase in debt servicing cost (to recall, debt serving cost stood at PKR 1.5trn in FY18) and this combined with PKR 1, depreciation leads to a further increase of PKR 8bn in debt servicing cost.

"…if interest rates increased 1%, the debt servicing cost would shoot up Rs100 billion. "A one-rupee depreciation will push external public debt up by Rs70 billion and increase its servicing cost by Rs8 billion," he added. The recent 15% depreciation of the rupee against the US dollar has added Rs1.19 trillion to the public debt. Had there been no depreciation, the debt-to-GDP ratio would have been 68.5% by June 2018, he remarked." [Link]

Banking sector likely to benefit rate hike, however deteriorating macro fundamentals increases potential headwinds

As mentioned sharper interest rate hike was much anticipated. However, recent monetary policy statement attesting the plethora of economic challenges ahead and possible delays in addressing these challenges in wake of ongoing elections will keep market perspective rather jittery in our view. On core side, while rising interest rates will likely benefit financial sectors' interest income it also raises concerns of deteriorating macro fundamental. We view BAHL, MCB and BAFL to benefit most with rate cycle reversal.

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