PAKISTAN ECONOMIC RESEARCH

Economy In Focus

MONETARY POLICY

SBP increases policy rate to 17% as inflationary pressures and external account concerns persist

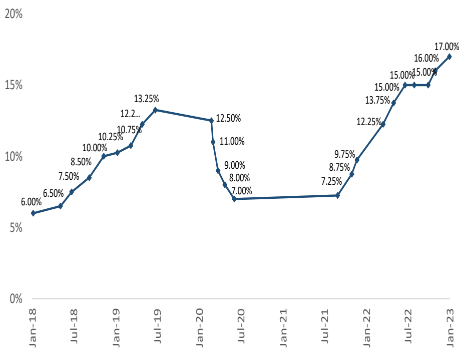
Monday, January 23, 2023

- **In line with market consensus, MPC of the SBP increased policy rate by another 1% to 17% mainly driven by inflationary pressures. The SBP highlighted that the cost of short-term corrective measures seems lower than longer-term implications in case inflation gets out of hand.**
- **Three key areas that supported the MPC's stance included 1) upwelling core inflation that has consistently been on the rise over the past 10 months, 2) limited foreign inflows and consistent external repayments have put the external account under pressure and 3) bleak global economic outlook that has exposed countries like Pakistan to risk of lower remittances and exports.**
- **The SBP also indicated that production decline and supply-side pressures could further hamper the LSM which has already gone down by 3.6% YoY in 5MFY23. Similarly, weaker than expected cotton arrivals are expected to offset the improved performance of sugarcane and wheat and likely keep agri growth in check thereby taking a toll on the overall GDP estimates (2% of GDP expected initially).**
- **CAD has undergone a sizable 60% YoY contraction in 1HFY23 on the back of administrative controls and reduced domestic demand and resultantly the SBP expects to close the year at less than USD 9Bn (previous estimate: USD 10Bn).**
- **The SBP admits that the external account continues to remain under pressure owing to weaker than expected foreign inflows, lumpy debt repayments and political noise escalation. In the current backdrop, earliest resumption of the IMF program is essential to pave the way for materializing related multilateral/ bilateral flows.**
- **Out of the total expected external account requirements of USD 23Bn (excluding CAD), the SBP has thus far settled USD 15Bn (USD 9Bn repayments + USD 6Bn rollover) while the remaining ~USD 8Bn is to be paid over the next 5 months.**
- **Fiscal slippages clocked-in at 1.5% of GDP in 4MFY23 and expected slowdown in economic activity and administrative controls on imports pose likely downside risks to tax collection. Current fiscal policy does not seem to support the MPC stance and fiscal consolidation is needed to keep inflation under control.**
- **In the light of today's development and limited guidance from the SBP regarding the way forward, we expect economic indicators to continue to pose threats to recovery in the index and in the near term, a defensive strategy with focus on high yielding, low-beta and mature sectors should be maintained. Our preferred picks are Banks, E&P's, Fertilizer and Power.**

Taming inflation is of fundamental importance: Risks to inflation readings remain elevated on the back of two primary factors: 1) core inflation has been on the higher side for the past 10 months and 2) adjustments in energy tariffs amid an uncertain global economic outlook which poses threats to prices of major commodities. Core inflation generally tends to be sticky and takes relatively longer to revert to longer-term means and in the last inflation up-cycle (Mar-10 to Oct-14), it topped after 28 months thus signaling at increased risks to overall economic outlook. Furthermore, given the much needed adjustment in energy tariffs, it will likely inch up further while uncertain global outlook poses further upside risks to commodity prices that have backtracked recently.

External account concerns on the rise: Of the USD 23Bn total external payments falling due in FY23, the SBP has thus far only repaid USD 9Bn while USD 6Bn have been rolled over. In the remaining 5 months of the fiscal year, payments of USD 8Bn are due while the SBP is confident of rolling over another USD 3Bn and USD 2.2Bn are expected to be received once again following payment essentially meaning an outflow of only USD 2.8Bn (total repayment of <USD 12Bn). Though this might be a short-term fix, we do not see this to be a solution and will only add to the hefty ~USD 25Bn repayments falling due in the next year. Keeping that in mind, on-boarding the IMF is becoming increasingly important in order to pave the way for other multilateral/bilateral flows otherwise the overhang of sovereign default will continue to hamper the currency, business outlook and market sentiment.

Chart 1: Policy Rate history



Source: SBP, BMA Research

Abdul Rehman Siddiqui
Deputy Head of Research
Tel: 111-262-111 ext. 2056
E-mail: abdul.rehman@bmacapital.com
BMA Capital Management Ltd.

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Buy	>15% expected total return
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*Total stock return = capital gain + dividend yield	

Old rating system

Overweight	Total sector return > expected market return
Marketweight	Expected market return
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