REP-300

Pakistan Economy

Monetary Policy Statement: Unchanged Policy Rate at 7% ; Rates expected to hold in the near term

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Monetary Policy Statement

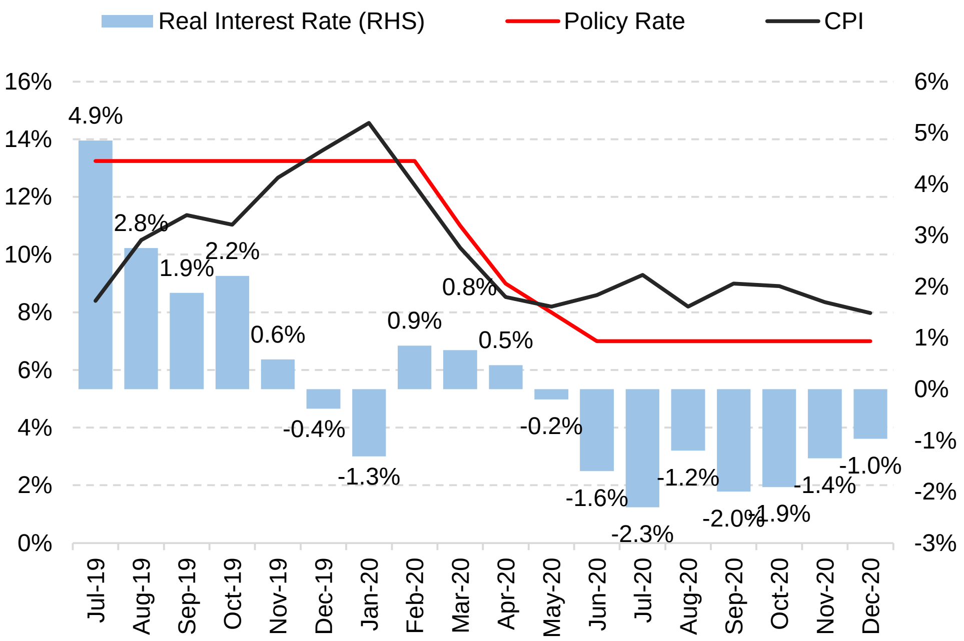
Unchanged Policy Rate at 7%

The State Bank of Pakistan (SBP) decided to keep the benchmark policy rate unchanged at 7% in its Monetary Policy Committee (MPC) meeting today (Jan 22, 2021). The committee noted that since its last meeting in Nov'20, further improvement has been witnessed in the overall domestic recovery, which has aided consumer and business confidence. Pertinently, the SBP observes some upside risks to the previously projected GDP forecast of 2 plus percent for FY21. The Governor also hinted at a very gradual and measured monetary tightening stance when the need arises. In the near term inflationary expectations remain moderate given steadying food inflation following addressal of supply side issues, while excess capacity continues to persist. The inflation outlook appears relatively contained and within the expected 7-9% range for FY21 and slightly lower between 5-7% in the medium term. We do highlight that the particularly cautious stance of the SBP Governor signaled at maintenance of a status quo stance in the benchmark rate for the immediate term. The MPC has shown comfort with the overall economic recovery of the country and current financial conditions do not merit a rate hike at this point in time. We maintain our stance on the monetary policy where we do not expect a rate hike before May'21, when a 25-50 bps hike may be likely.

Key Takeaways from the Monetary Policy Statement

- **Recent inflationary reading appears encouraging**
  - Inflation has witnessed slowdown recently with supply-side pressures from food showing a decline and core-inflation still under control.
  - Whereas any expected hike in utility tariffs may slightly pick up inflation, it will be transitory in nature given excess capacity in the economy and well-anchored inflation expectations.
  - Inflation to hover within the 7-9% range for FY21 and further come down to 5-7% in the medium term.
  - As a result, the prevailing policy rate remains adequate to aid revival of the economy while keeping inflation in-check and maintaining financial stability.

Exhibit: Policy Rate vs. Inflation



Source (s): SBP, PBS, AHL Research

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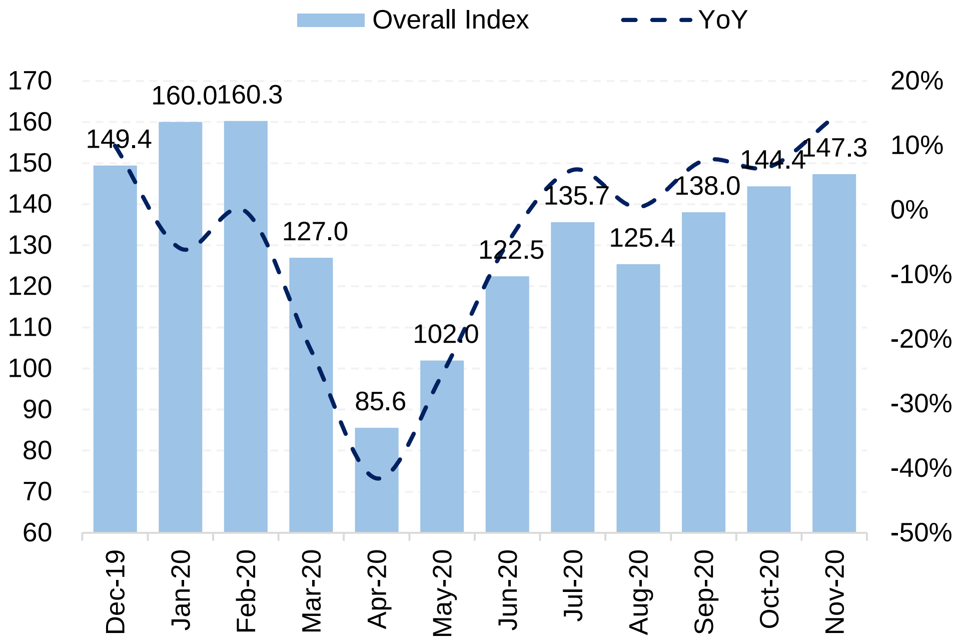
- **Existing MPC stance deemed appropriate**
  - While the ongoing growth and inflation trajectory is deemed favorable, outlook remains ambiguous due to Covid second wave, the MPC noted.
  - Meanwhile it is challenging to project the COVID-19 situation as infection continues to climb globally, with advent of new strains, and roll-out of the vaccination worldwide still uncertain In lieu of such uncertainty, the MPC provided some necessary forward guidance on the monetary policy so as to assist economic decision-making. Pertinently, the committee expects the policy rate to remain unchanged in the near term.
  - Albeit, once the pace of recovery becomes steady and the economy returns to its full potential, necessary adjustments to the monetary policy will be made to achieve slightly positive real interest rates.
- **Economic considerations weighted in**
  - Key economic developments in the real, external and fiscal sectors, as well as their respective forecasts and resulting outlook for monetary conditions and inflation, were taken into consideration.
- **Real sector**
  - Robust Large-scale manufacturing (LSM) growth at 7.4% YoY in Oct’20 and 14.5% in Nov’20 suggests further strengthening of the economy, set in motion since Jul’20.
  - Recovery has also transitioned to other industries and become more broad-based recently: 12 out of 15 subsectors depicted a positive growth in Nov’20 while recovery in employment can also be seen. In FYTD, LSM has shown an uptick of 7.4% YoY against a contraction of 5.3% in SPLY. Albeit, there continues to be spare capacity in the economy as manufacturing activity remains under average levels of FY19.
  - On the demand front, cement sales remain robust given rising construction activity, POL sales have hit a two-year high, automobile sales too continue to impress in both, urban (motorcars) and rural (tractors) markets.

Exhibit: Nov’20: LSMI output up 14.5% YoY



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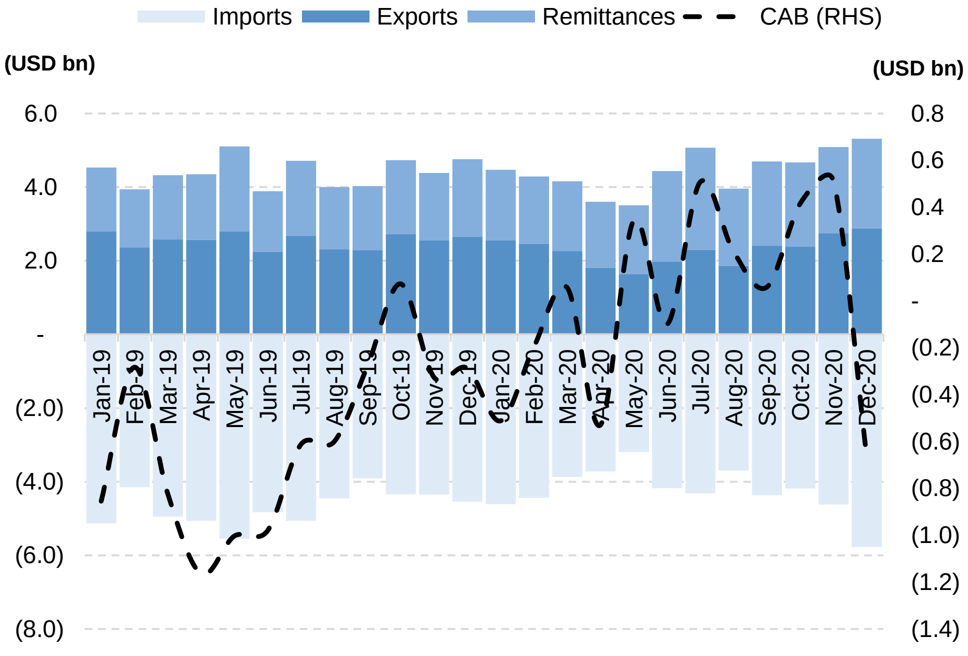
- Although latest production estimates signal at a decline in cotton output in the agriculture segment, this will be cushioned by growth in output of major crops and augmented wheat production. Higher support prices alongside announced subsidies on fertilizers and pesticides for Rabi crops will aid the above.
- Finally, social distancing guidelines are still affecting some service sectors. However, the wholesale, retail trade and transportation segments are expected to benefit from improvements in construction, manufacturing and agriculture segments .

- **External**
  - The C/A balance swung into deficit during Dec'20 (USD 662mn) following five consecutive months of a surplus, taking 1HFY21 surplus to USD 1.1bn. The deficit was primarily led by imports of machinery and industrial raw materials, complementing higher economic activity. Meanwhile, higher wheat and sugar imports curtailed the demand-supply gap in the domestic market. Overall BoP surplus has been supported by strong remittances this fiscal year (+25% YoY during 1HFY21), which were supported by GoP/SBP actions that increased use of formal channels, as well as travel restrictions. Meanwhile the MPC noted that exports have recovered to pre-COVID monthly level of ~USD 2bn. The improving external account helped to slightly appreciate the PKR/USD parity since the last MPS, while external buffers also strengthened (SBP reserves at ~USD 13bn – highest level since Dec'17). The MPC noted the external account outlook has strengthened and expects CAD at under 1% of GDP for FY21.
- **Fiscal**
  - The government has continued to adhere to its commitment of no fresh borrowing from the SBP. Revenue growth has managed to counter higher debt servicing and COVID-related expenditure. Provisional estimates point at net FBR revenue growth of 3% and 8.3% YoY during Nov'20 and Dec'20. FBR revenue during 1HFY21 has grown by 5% YoY (close to targeted levels) supported by rebound in direct taxes and sales tax receipts. Primary surplus settled at 0.5% of GDP during 5MFY21.

Exhibit: Current Account deficit after surplus of five Consecutive Months



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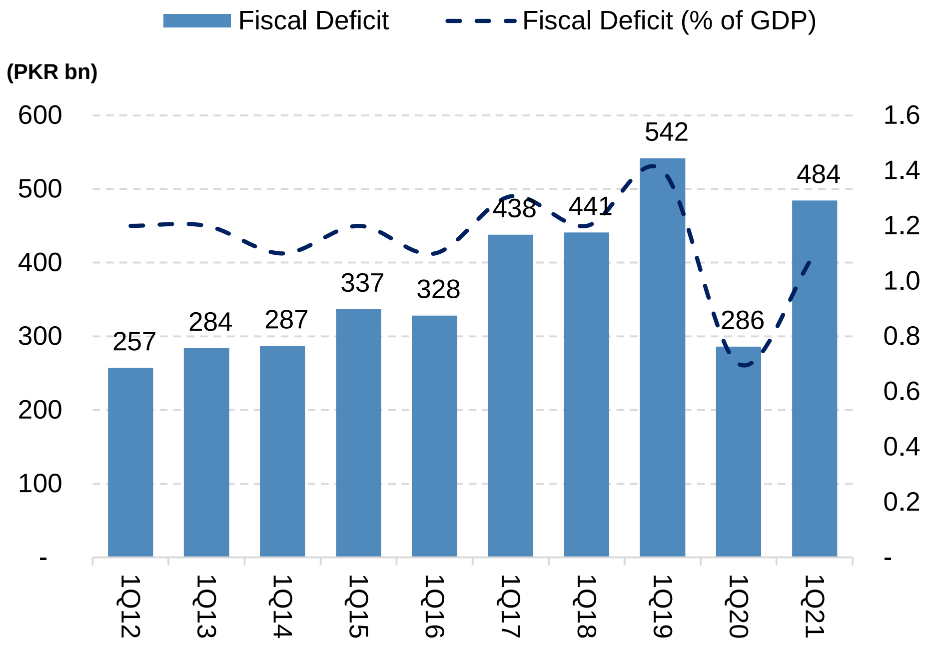
- **Monetary and Inflation Outlook:**
  - MPC described financial conditions as "appropriately accommodative" with real interest rates slightly negative on a forward looking basis. Private sector credit has shown good growth since the last MPS, on the back of rise in consumer and fixed investment loans supported by SBP's refinance facilities. With recovery in demand and fall in inventories in some sectors, working capital loans have also shown growth (albeit lower than last year levels), for the first time since the outbreak of the pandemic.
  - MPC sees inflationary pressure to have eased despite hike in fuel prices. Headline inflation clocked in at 8.3% and 8% in Nov'20 and Dec'20 – the lowest rate since Jun'19, supported by lowering food inflation attributable to supportive weather and supply-side measures taken by the government. Core inflation continues to remain controlled during FY21, in-line with the economy operating under full potential. Inflationary expectations of consumers as well as businesses remain soft and have declined in recent months. The MPC views any supply side shocks from food or utility tariffs to be inadequate to have a prolonged inflationary impact through second-round effects.

Exhibit: Country Posted Budget Deficit of PKR 484bn during 1Q21



Source: MoF, AHL Research

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Arif Habib Limited (AHL) uses three rating categories, depending upon return form current market price, with Target period as Dec 2021 for Target Price. In addition, return excludes all type of taxes. For more details kindly refer the following table;

Rating	Description
BUY	Upside* of subject security(ies) is more than +10% from last closing of market price(s)
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* Upside for Power Generation Companies (Ex. KEL) is upside plus dividend yield.

Equity Valuation Methodology

AHL Research uses the following valuation technique(s) to arrive at the period end target prices;

- Discounted Cash Flow (DCF)
- Dividend Discount Model (DDM)
- Sum of the Parts (SoTP)
- Justified Price to Book (JPTB)
- Reserved Base Valuation (RBV)

Risks

The following risks may potentially impact our valuations of subject security (ies);

- Market risk
- Interest Rate Risk
- Exchange Rate (Currency) Risk