PAKISTAN July 28, 2021

Foundation Alert

Governor SBP meeting takeaways

Event

- Governor of State Bank of Pakistan (SBP) held a meeting with the investment community yesterday to discuss the Monetary Policy Statement. The Governor also shed light on sustainable level of Current Account Deficit along with role of market based exchange rate. Following are the key takeaways of the briefing.

Impact

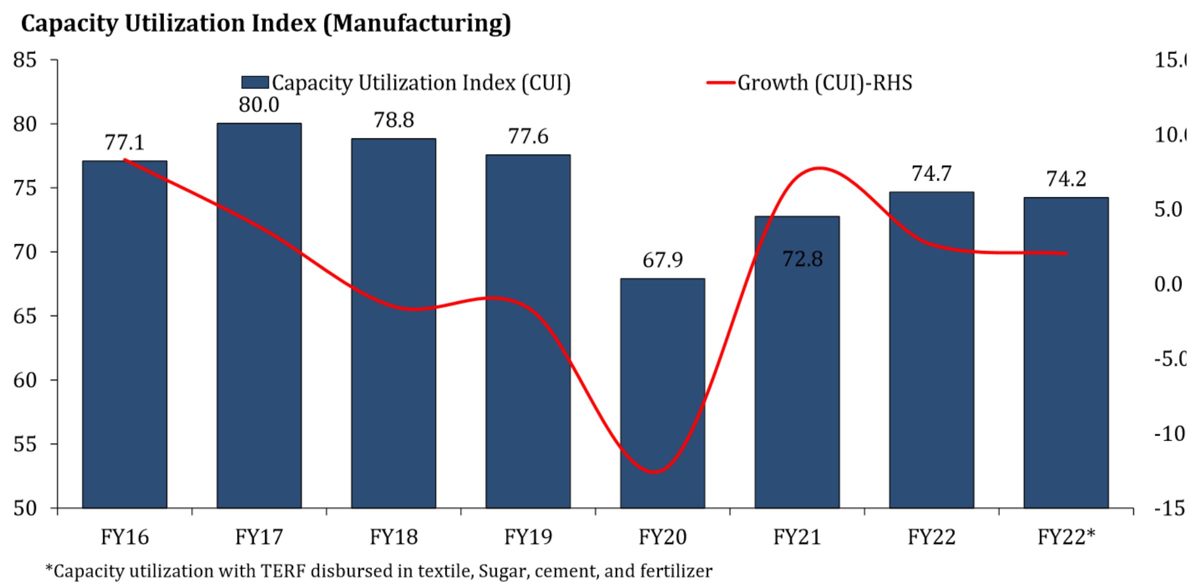
- Monetary Policy Committee (MPC) in its meeting held on Jul 27'2021 decided to keep policy rate unchanged at 7% based on key trends and prospects in the real, external and fiscal sectors, and the resulting outlook for monetary conditions and inflation.
- Governor SBP foresees growth to be in a range of 4-5% in FY22 given growth in high frequency economic indicators, all time-high business confidence, considerable improvement in consumer sentiment and existence of spare capacity along with projection of output gap to remain open. However, deterioration in COVID-19 situation, both domestically and globally could be a downside risk.
- The economic recovery has been benefitted from flexible and well calibrated measures taken by the Central Bank such as reduction in discount rate, extension in loan principal repayments, loan restructuring, introduction of Rozgar Scheme to prevent layoffs, and financing on concessionary rates through refinance facility for hospitals and new industrial investments.
- Inflation is expected to remain in the range of 7-9% in FY22 as Central Bank expects both food and core inflation to remain tame amid inflation neutral budget.
- Moreover, inflation expectations have fallen and real wage growth is still muted, in line with continued slack in the economy further strengthens SBP's conviction on inflation projections. However, increase in global commodity prices, rise in electricity prices and gas tariffs, and slippages in planned fiscal consolidation could inflate these projections.
- The Governor SBP stated that external position is best in last decade and expected to remain strong in FY22. Central Bank opinion is based on FX reserves at 4.5 years high, one-offs in June imports and arrangement of external financing. Moreover, Current Account Deficit is expected to remain in the range of 2-3% of GDP in FY22, much lower than witnessed in FY17 and FY18 as it is supported by flexible market-based exchange rate system, resilience in remittances, improving outlook for exports and appropriate macroeconomic policy setting.
- Capacity Utilization Index (CUI) is expected to reduce by 0.5% in FY22 from 74.7% in FY21, indicating spare capacity exists. This suggests that recovery still has some way to go before demand-side pressures emerge.
- Governor expects FX to rise further by the end of FY22 to reach all-time high due to external financing availability being in excess of requirements. Moreover, Central Bank expects SDR flows of US$2.8bn to come in by end of August.
- Currently, FX reserves are at high of last 4.5 years mainly because of SBP reserves building strategy and only a smaller portion is contributed through net borrowing. Moreover, SBP's forward liabilities have been reduced to US$4.4bn from US$8.0bn and net increase in FX reserves is effectively US$14.1bn since Jun'19.
- However, quicker than expected FED monetary tightening and elevated commodity prices could be a risk to central banks estimation.

- Governor States that flexible exchange rate will remain first line of defense and monetary policy comes in play especially if demand side pressures emerge. Moreover, if there is any adjustment in the policy rate it will be measured and gradual to achieve mildly positive real interest rates.
- On the fiscal side, measures were appropriately more targeted resulting in one of the most favorable outcomes on the public debt compared to other countries where actually debt to GDP reduced by more than 3% in comparison to FY19 for Pakistan.
- Governor SBP expects remittances to grow moderately in FY22 as opening of travel restrictions will allow increase in emigrants. However, risk of shifting of remittances to informal channels would not be material given accommodative measures taken by SBP for facilitation of remittances flows.
- On currency front, SBP states that the PKR has depreciated by 4% since end-May to pre COVID level, broadly in line with depreciation of EM currencies, on FED expectations.

Outlook

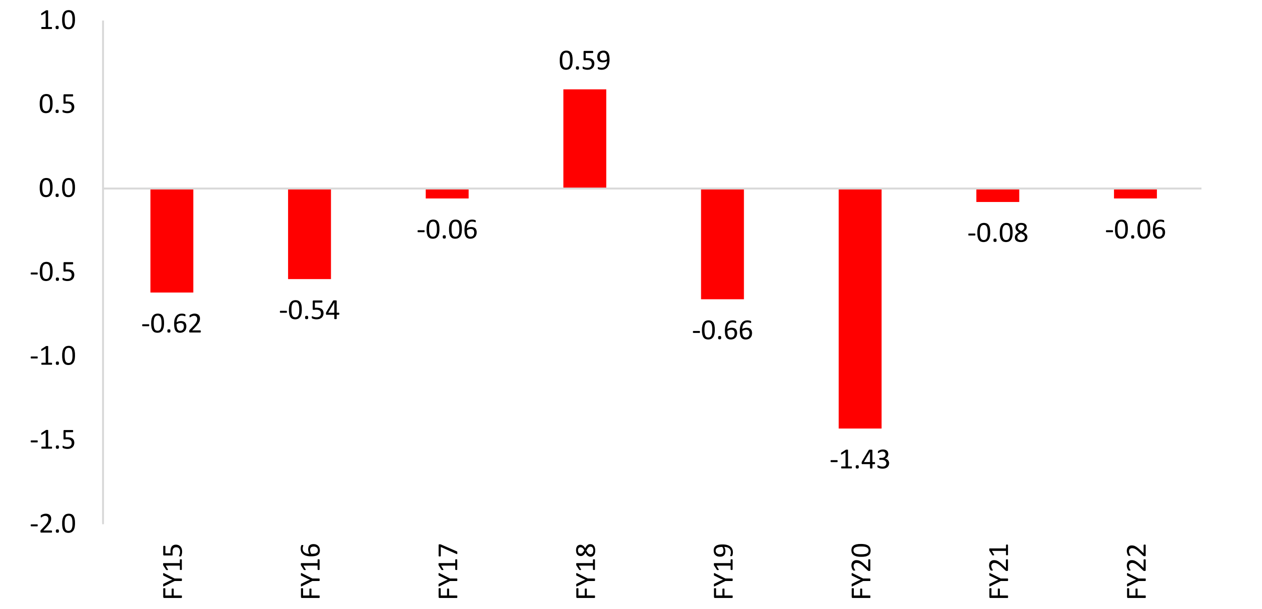
- SBP would facilitate growth in the near term till the demand side pressures emerge and use market based exchange rate regime as a first line of defense, however if the need arises, SBP would act gradually towards achieving mildly positive real interest rates, in our view.

Fig 1: The recovery has more way to go before demand-side pressures emerges



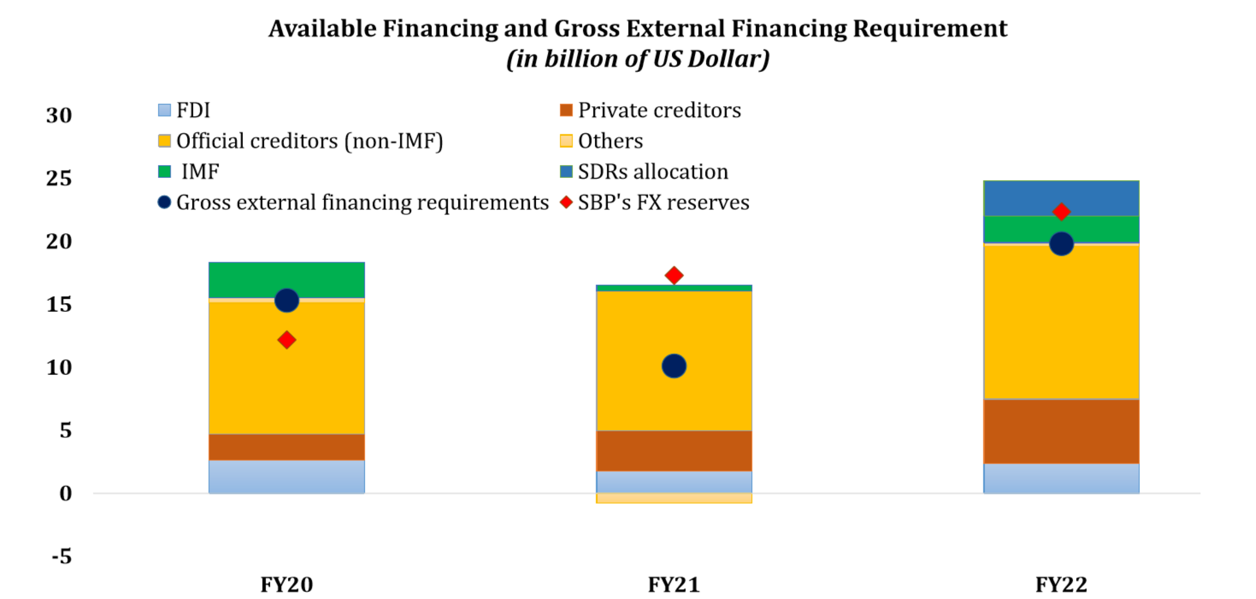
Source: SBP, Foundation Research, July 2021

Fig 2: Output Gap is expected to remain mildly negative given investment on the back of TERF



Source: SBP, Foundation Research, July 2021

Fig 3: External inflows are expected to be more than sufficient to meet external financing requirements



Source: SBP, Foundation Research, July 2021

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If

Expected return >+10%	Outperform.
Expected return from -10% to +10%	Neutral.
Expected return <-10%	Underperform.