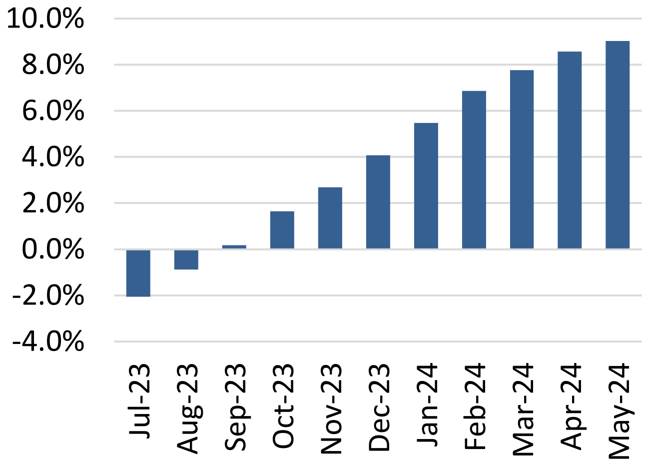
Monetary Policy

Dovish data makes compelling case for Jun rate cut

29 May 2024

- **Rapid fall in inflation.** Six successive weekly SPI declines have accentuated already falling inflation with May-24 NCPI set to fall to more than 2 year low of 12.7% Y/Y, despite persisting overstatement of Nov-23 natural gas tariff hike. Even after building-in rebound in food prices and likely inflationary effects of the upcoming budget, we expect the headline inflation to stay relatively contained, averaging 13% in FY25.
- **GDP remains on a low growth trajectory.** After a contraction of 0.2% in FY23, GDP growth has posted moderate recovery to 2.4% in FY24 helped by robust agriculture sector growth of 6.3%, while non-agriculture growth was timid at 1.2%. Sales of non-essential goods such as cement, steel, automobiles, electrical appliances, etc., remain at multi year lows. Amid tight fiscal and monetary policies and weak investor sentiments, GDP growth is likely to remain in 2-3% band in FY25.
- **Private credit showing signs of stress.** While the stock of banking credit to the private sector has remained stagnant over the past 2 years, loan infection has started to creep up with aggregate gross NPLs of banks/DFIs increasing by 7.5% in CY23. However, with strong corporate balance sheets in general and prolonged risk aversion in the banking sector, NPL formation is likely to remain manageable.
- **External account remains a delicate balancing act.** Tamed by massive erosion in purchasing power, weak domestic demand has been keeping the current A/C in check, posting surpluses in the past 3 months and cumulative deficit of only USD 200 MN during 10MFY24. While current A/C remains manageable, relatively low FX reserves buffer and hefty debt repayments, the external account seems to have become the nominal anchor for monetary policy.

12M Fwd RiR Has Been on a Rising Trend



Source: PBS, Optimus Research

*RiR is Real Interest Rates

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- **Compelling case for lowering the policy rate from its historical peak.** The current macroeconomic indicators present a radically calmer situation when compared with the near meltdown scenario that played out in FY23 when the policy rate was progressively hiked to historically highest level of 22%. The above arguments present sufficient basis for MPC to start with 100-200 bps rate cut in Jun-24.

Inflation Preview – NCPI to fall by 2.4% M/M in May-24

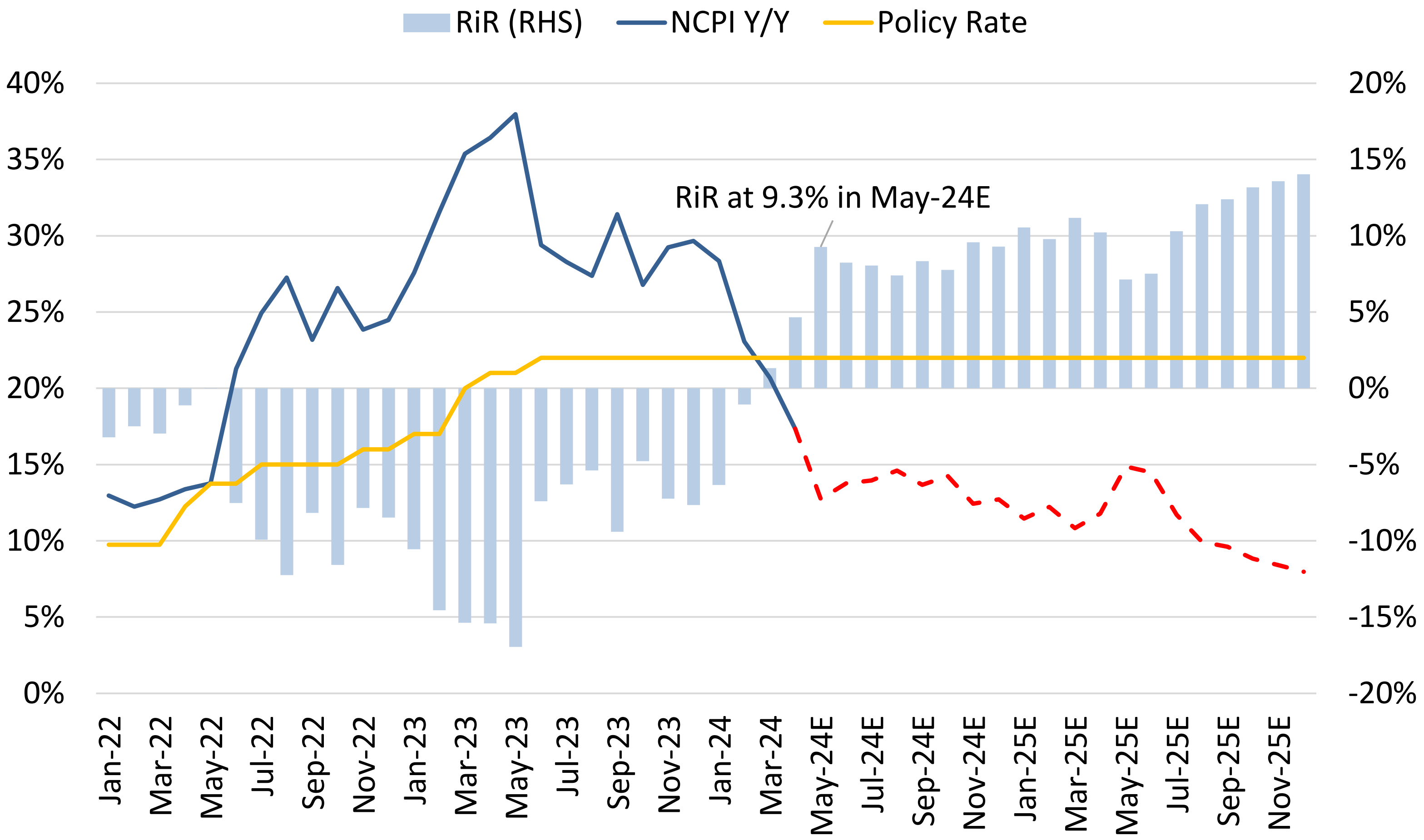
- **May-24 NPCI expected at 12.7% Y/Y.** The NCPI is expected to fall by 2.4% M/M, mainly due to a steep 5.3% M/M fall in food inflation and a 2.5% M/M decline in energy inflation. The headline NCPI is estimated to fall to a 26-month low of 12.7% Y/Y. Similarly, core inflation is expected to drop to 14.6% Y/Y in May-24 (vs. 15.6% in Apr-24).
- **Lowest food inflation at 2.9% Y/Y since Feb-19.** The 20% M/M drop in wheat prices due to a supply glut and the normalization of prices for perishable items, including onions (-48% M/M), tomatoes (-43% M/M), and 28% M/M drop in chicken prices due to bird flue, contributed to a 5.3% M/M decline in the food index. This is likely to lead to a 64-month low in food inflation at 2.9% Y/Y.
- **Energy inflation to ease by 2.5% M/M in May-24.** The decline is anticipated due to a 4.5% M/M decrease in electricity prices and a 10% M/M drop in LPG prices. On a Y/Y basis, energy inflation remains very high at 48% due to sharp increases in gas prices in Nov-23 and the imposition of the Petroleum Development Levy (PDL) as well as the rise in electricity prices in Jul-23.
- **Outlook.** May-24 is expected to mark the end of the steep fall in the headline NCPI witnessed in the past few months. However, despite factoring in all the likely revenue measures, including an 18% GST (or PDL) and the lifting of exemptions on sales tax on various items, and a hike in gas and electricity tariffs, the monthly NCPI is expected to stay sub 15% Y/Y and is projected to average around 13% Y/Y in FY25.

Food & energy key to May-24 NCPI decline

Inflation	Weights	May-24E		11MFY24E
	%	Y/Y	M/M	Y/Y
General	**100.0%**	**12.7%**	**-2.40%**	**24.6%**
Food & non-alcoholic beverages	34.6%	1.3%	-6.44%	23.0%
Alcoholic Beverages & Tobacco	1.0%	3.0%	0.25%	52.1%
Clothing & Footwear	8.6%	18.8%	1.13%	19.7%
Housing, Water, Electricity, Gas & Fuels	23.6%	32.9%	-1.40%	28.8%
Furnishing & Household Equipment	4.1%	14.2%	0.78%	29.6%
Health	2.8%	18.1%	0.50%	21.7%
Transport	5.9%	11.2%	-0.96%	20.4%
Communication	2.2%	14.3%	0.25%	11.4%
Recreation & Culture	1.6%	8.1%	1.49%	36.9%
Education	3.8%	17.2%	2.50%	12.8%
Restaurants & Hotels	6.9%	16.0%	1.24%	27.0%
Miscellaneous	4.9%	15.9%	1.32%	29.0%

Source: PBS, Optimus Research

Inflation to average 13% in FY25 despite anticipated revenue measures



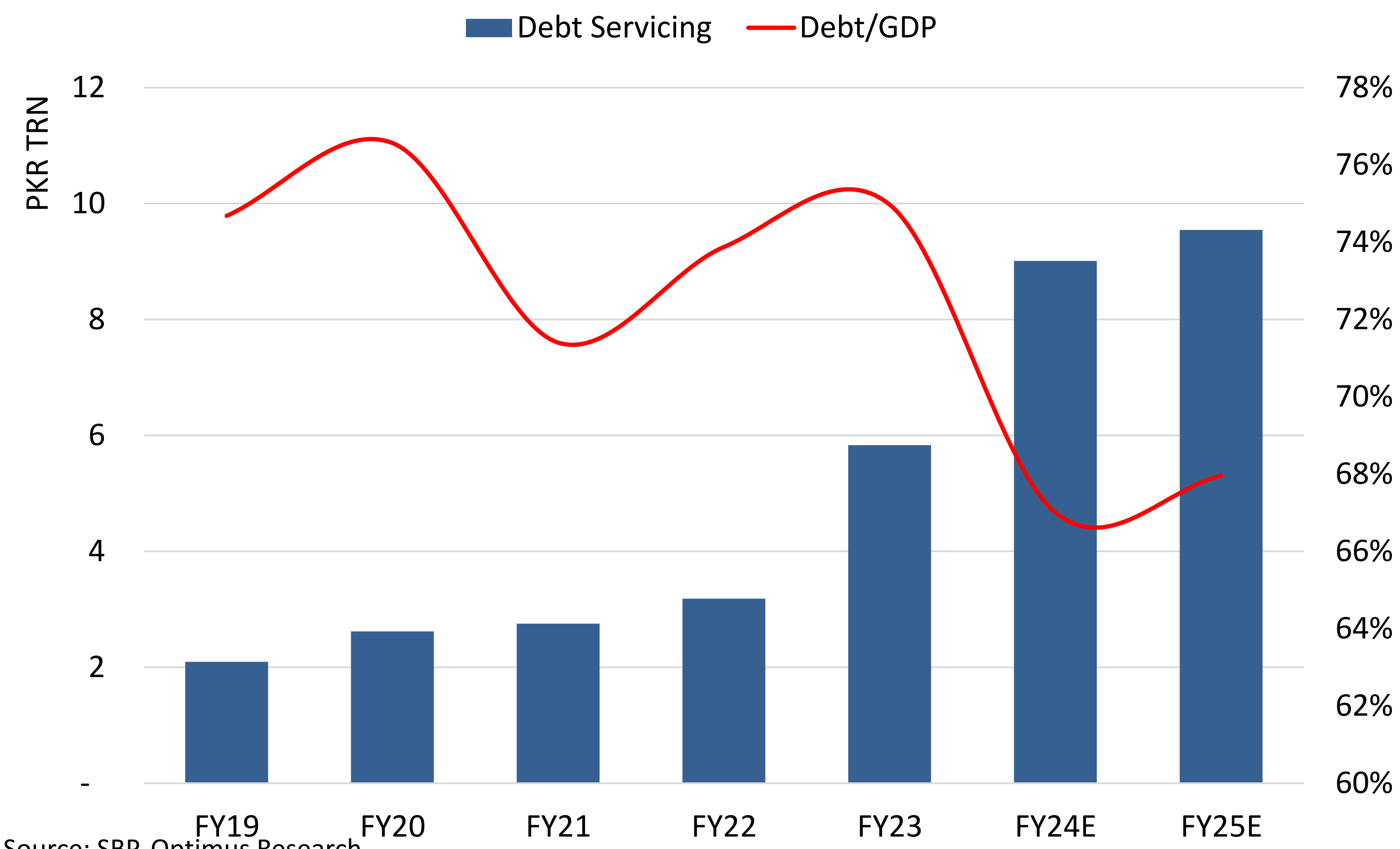
Source: PBS, SBP, Optimus Research

Monthly NCPI Y/Y is expected to stay sub 15% in FY25.

Following are the main assumptions:

- PKR/USD at 310 by Jun-25
- Crude oil at USD 85/BBL.
- 18% GST on MS/HSD in Jul-24
- Removal of sales tax exemption on other heads taken including pharmaceutical sector.
- Rebound in food (wheat & perishable) after sharp decline in recent weeks built in.
- Hike of 20% taken in gas prices in Aug-24.
- Increase of PKR 7/KWh in base tariff assumed in Jul-24.

High real interest rate causes debt to rise faster than GDP



Source: SBP, Optimus Research

Debt Sustainability Equation

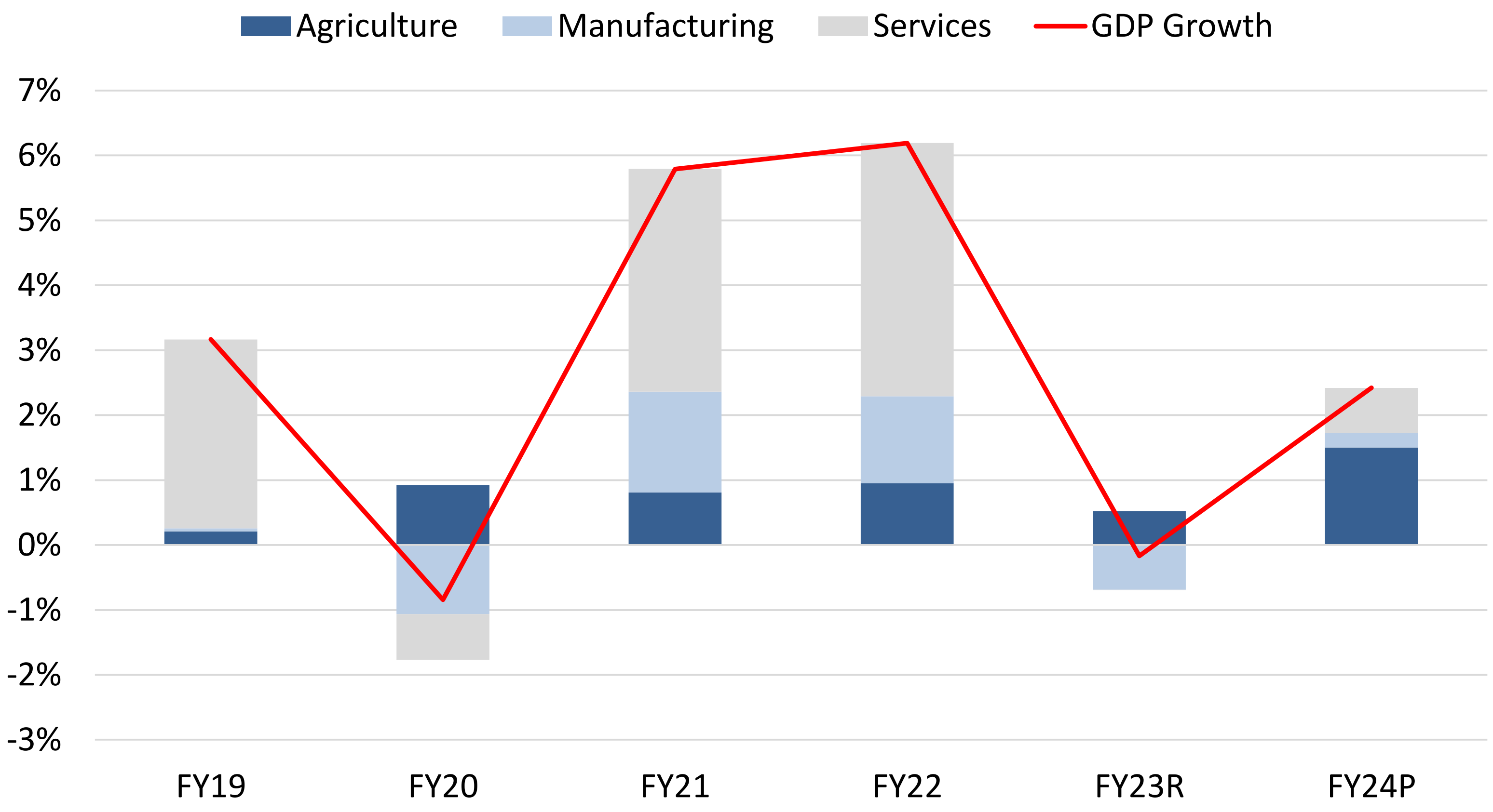
$$\frac{d\left(\frac{D}{GDP}\right)}{dt} = (r - g) \times \frac{Debt}{GDP} + \frac{Deficit}{GDP}$$

- A larger real interest rate and real GDP growth differential will lead to greater increase in Debt/GDP ratio.
- Debt servicing is already expected to reach record high to over 120% of Federal Net receipts in FY24.

Agriculture contributed 62% to the FY24 GDP, Industry contribution remained low at 9%

$$GDP = C + I + G + (X - M)$$

C = Consumption
I = Investment
G = Government Spending
(X-M) = Net Exports

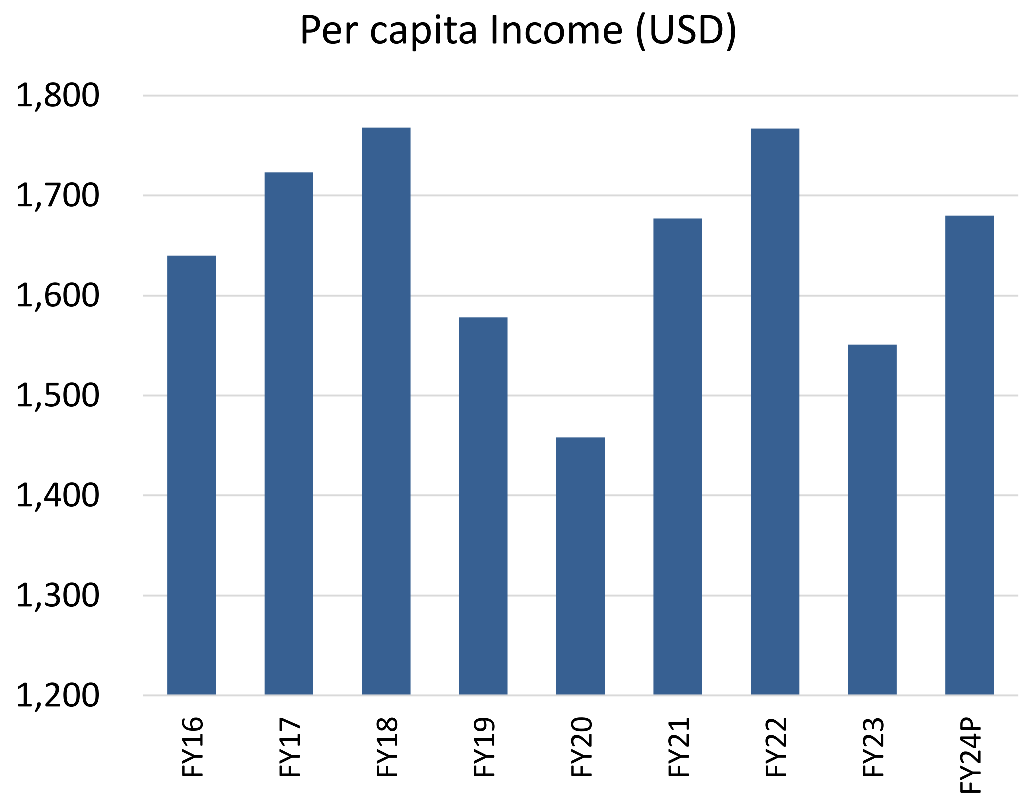


Source: SBP, Optimus Research

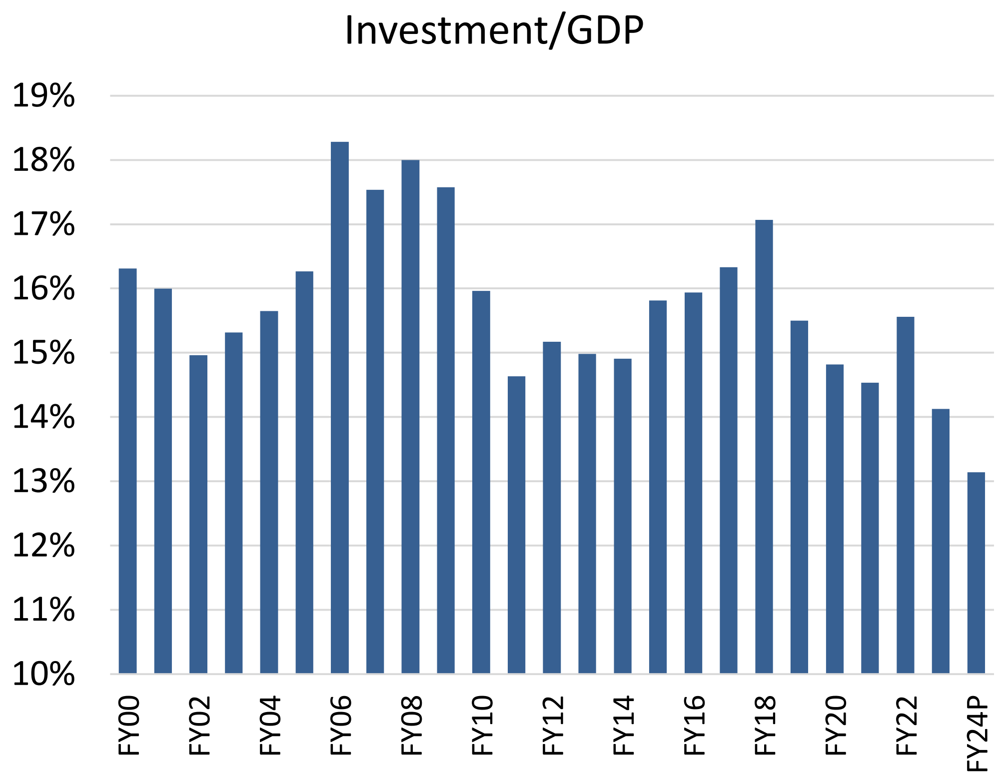
GDP Growth is Expected to Remain in 2-3% Band in FY25

- Erosion in purchasing power is keeping domestic demand low.
- Fiscal policy is expected to remain tight due to high debt servicing cost.
- Interest rates are expected to remain high vs historical averages amid relatively low FX reserves and high external repayments.
- Both weak investor sentiments and high interest rate are expected to keep private investments muted.

Per capita income has stagnated; investment has dropped to multi-decades low

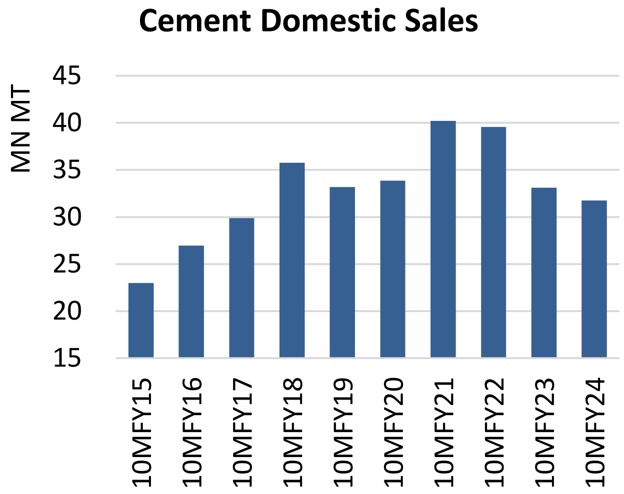


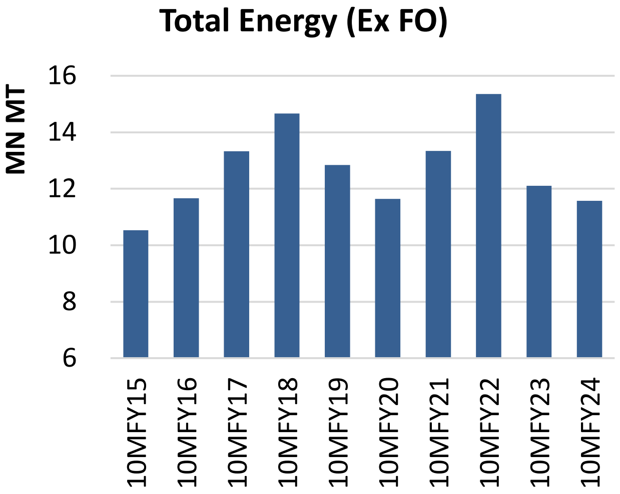
Source: PBS, Optimus Research

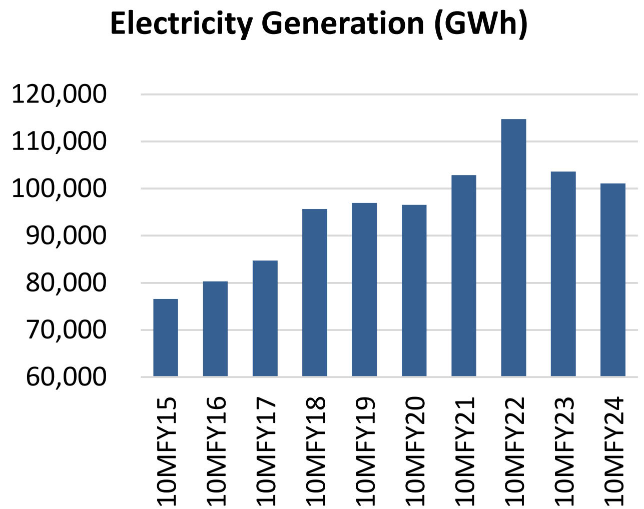


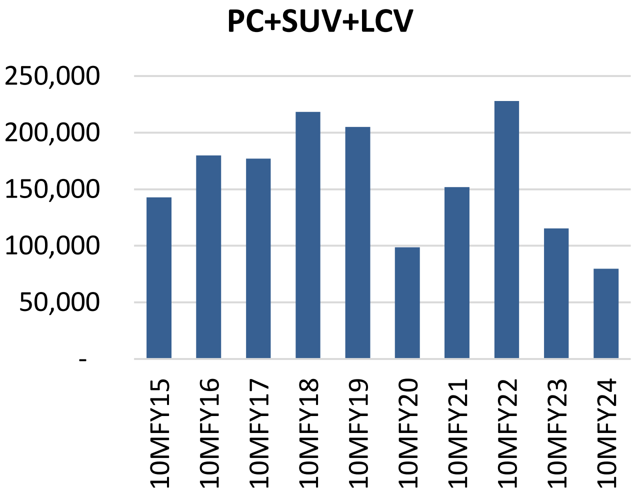
Source: PBS, Optimus Research

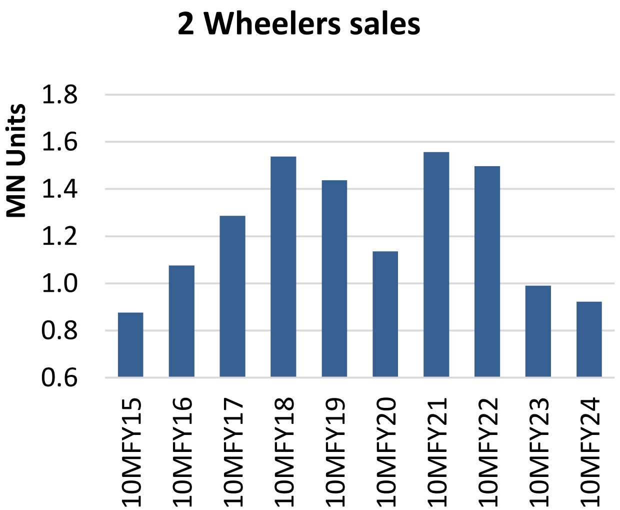
Demand has fallen sharply; FY24 industrial GDP is expected to be lower by 2.6% vs FY22

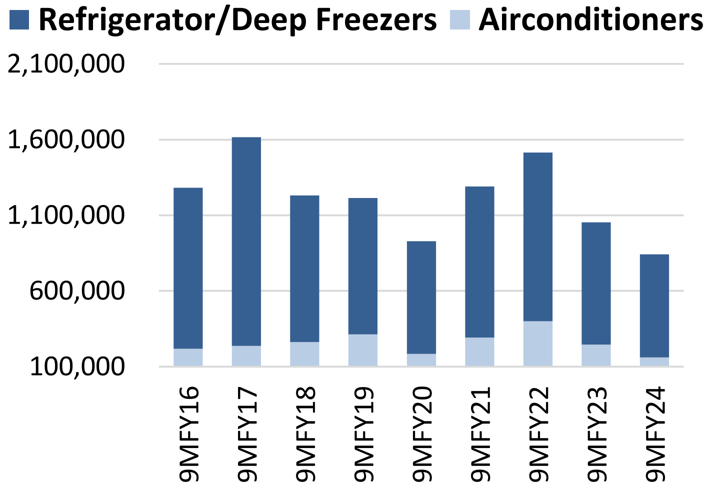






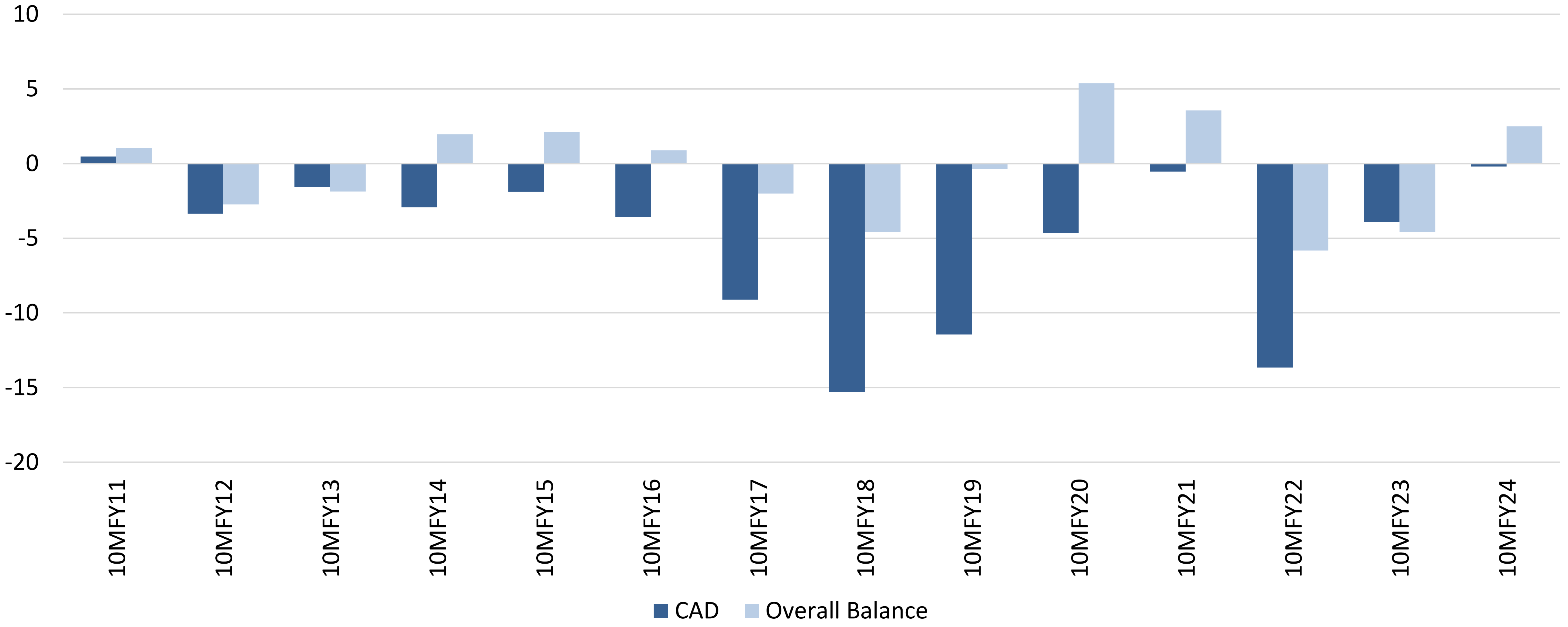






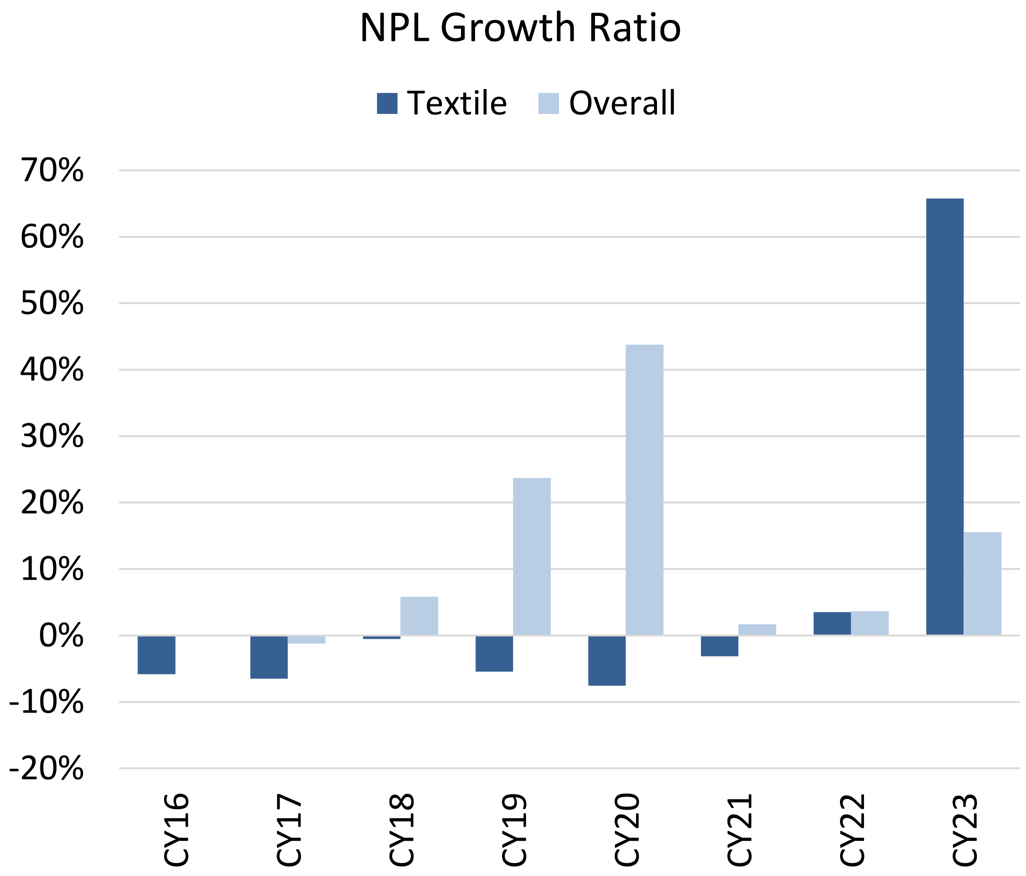
Source: Zakheera, Optimus Research

CAD Has Contracted To Multiyear Low Despite No Apparent Import Restrictions

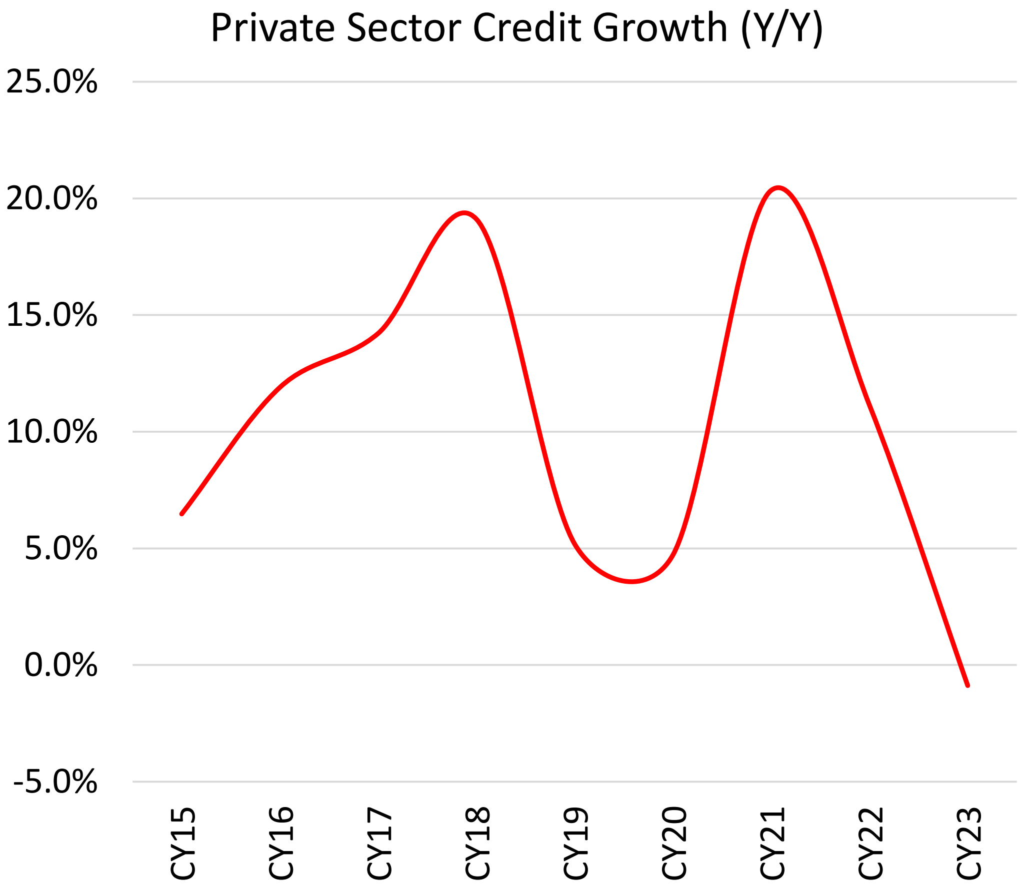


Source: SBP, Zakheera, Optimus Research

Textile NPL has sharply risen; private sector credit demand has collapsed

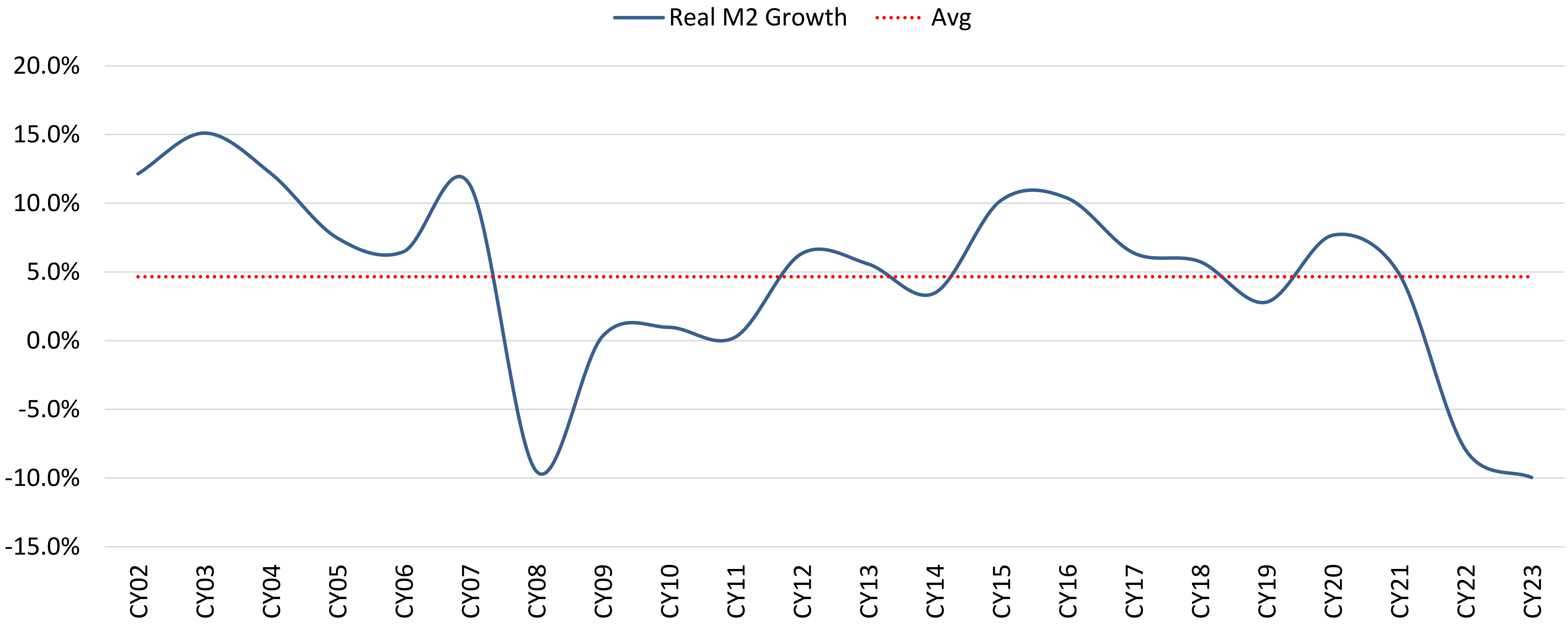


Source: Zakheera, SBP, Optimus Research



Source: Zakheera, SBP, Optimus Research

Real M2 growth has fallen to 2008 financial crisis levels.



Source: Zakheera, PBS, SBP, Optimus Research

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