Pakistan Economy

SBP maintains rate. On 6M forward looking basis, the real interest rate differential is the highest since October 2001!

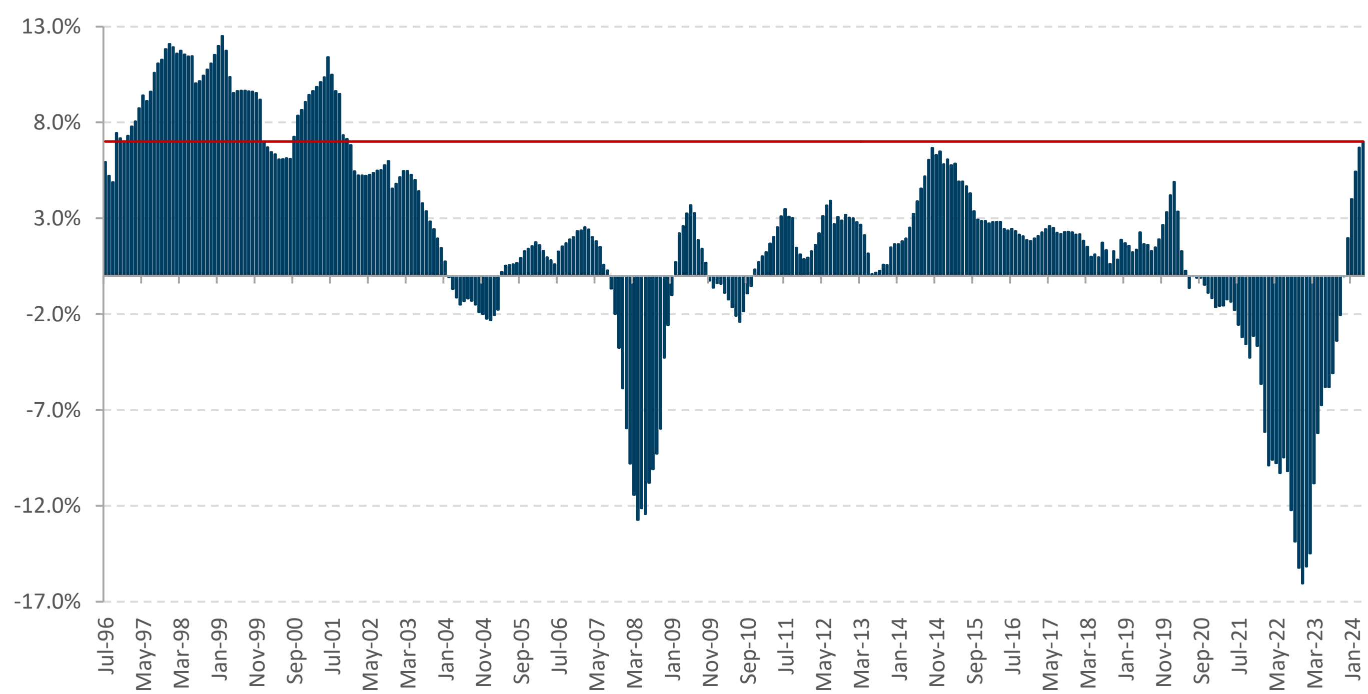
Tuesday, March 19, 2024

SBP maintains rate amid highest real interest rate differential (RIR) in two decades: In the latest MPC meeting the SBP decided to maintain the Policy Rate at 22%. We look at what this implies for the RIR. The chart below shows RIR as the difference between the Discount Rate in any given month and the 6 month forward average realized CPI as a proxy for 6 month forward inflation expectations in the past. Recent data such as the RIR as of March uses actual BMA inflation forecast data.

The RIR currently stands at ~7.0% based on our inflation outlook for April – September 2024. This is the highest RIR since October 2001 when the DR was 10% and 6M forward inflation was 2.7%.

This re-affirms our stance that, under the next IMF EFF program, RIR is likely to be significantly higher than that seen in the recent past. For a detailed discussion please see our 15th Feb report "Higher For Longer".

Highest RIR in two decades on 6M forward looking basis



Source: BMA

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We note significant changes in the SBP's language from January to March: In January the MPC noted that "inflation is expected to remain on a downward path". In March, the SBP has added qualifiers to this language by noting that the inflation outlook is **"susceptible to risks amidst elevated inflation expectations"** and that **"this warrants a cautious approach and requires continuity of the current monetary policy stance"**. Lastly they noted that "this assessment is contingent upon continued targeted fiscal consolidation & realization of planned external flows".

In January, while discussing key developments, the SBP noted "significant financial inflows" and commented on the improvement in business sentiment while devoting only 1 line to geopolitical risks upending the inflation outlook. In contrast, in the March MPC, the SBP has expanded on this discussion and noting the rise in commodity prices, escalating geopolitical tensions and the cautious shift in the stance of global central banks such as the Fed, BOE and ECB given recent core inflation surprises.

After conveying these heightened risks, the SBP notes in March that "the current account deficit is likely to remain closer to the lower band of 0.5% to 1.5% of GDP" while in January the MPC simply suggested that the CAD would be within the 0.5% to 1.5% range. Given the adverse developments on the oil price, we see no reason for this change in language and continue to forecast a 1.0 – 1.2% CAD for the current fiscal year.

Most tellingly, in the final paragraph on the inflation outlook, the "**expected significant decline in (inflation) the second half**" has been omitted entirely in the March statement. Instead the MPC notes that administered price increases continue to contribute to inflation "directly and indirectly" and that "**Going forward, any further adjustments in administered prices or fiscal measures that may push prices up pose risk to the near and medium term inflation outlook**"

Our view: We welcome the increases attention paid to geopolitical conflicts and the very real risks these pose for oil prices, the CAD and consequently inflation. Discussion of the indirect impact of higher administered prices and the risk they pose has been absent in some previous statements and we note the change in language shows the SBP is taking a more holistic view of the inflation outlook.

We continue to hold our view that RIR will likely average 3% in the medium term and that consensus expectations of ***sharp*** declines in interest rates in the current calendar year are unfounded.

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Old rating system

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)