

## Pakistan Economy

### SBP maintains Policy Rate at 22%. Upgrades inflation estimates citing risks.

In line with expectations, the State Bank of Pakistan maintained the Policy Rate at 22% and noted that, on a forward-looking basis, real interest rates were now “significantly” positive.

#### Monetary Policy Highlights:

**Real interest rate differential significant but still does not warrant a rate cut:** The SBP noted in its MPC statement that “the real interest rate differential remained significantly positive”. The Governor noted that considering rising risks, the real interest rate differential is not significant enough yet to warrant a rate cut.

Headline inflation has averaged 28.8% in 1HFY24. The SBP’s 2% range for FY24 inflation (23% – 25%), implies a 2HFY24 average inflation range of 17.2% to 21.2%. Firstly, we note that the SBP is looking at a potential path in which inflation does not recede below 20% beyond March 2024. This would be contrary to most expectations and has important implications for expectations of a rate cut in the March meeting. Furthermore, this inflationary path, if realized at ~21%, would imply that real interest rate differentials are not in fact, significantly positive.

We believe this is an appropriately cautious stance by the SBP, considering rising uncertainty. Even if we assume that the midpoint of the range is the most likely outcome i.e. 19%, it will imply that a 3% interest rate differential is not large enough for the SBP to cut rates. This stance would fall in line with Pakistan’s historical record where interest rate differentials have risen under the auspices of the IMF such as in 2013 – 2016.

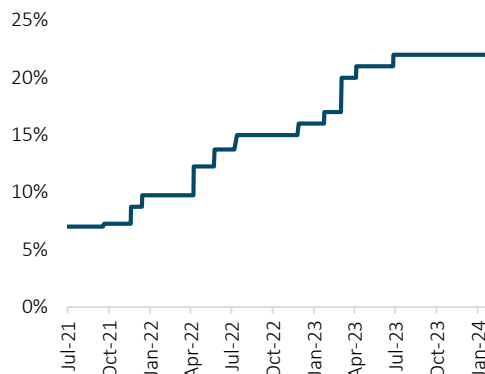
**Inflation estimates revised citing risks:** The SBP has revised its average inflation expectation for FY24 to a range of 23% – 25%. Despite recent moderation in core, wage, and food inflation metrics, sizeable adjustments in administered prices coupled with “evolving risks” have led to the estimate revision. Interestingly, despite the upward revision, the SBP has moderated its language on inflation in the MPC statement and briefing relative to the December MPC where it was noted that inflation expectations “remain at an elevated level”.

While the MPC noted the decrease in oil prices in the December meeting, there was scant mention of the risk posed by elevated oil prices in today’s meeting despite Brent having risen from \$73/bbl to \$82/bbl between the two meeting dates. However, the MPC did note that rising freight charges pose a risk to inflation estimates.

The SBP maintained its September 2025 inflation target of 5-7%. In the absence of large base effects, translating into MoM implied inflation of 0.5 – 0.6%. Given recent readings, the potential of a further gas price hike, rising geopolitical uncertainty, and any additional potential inflationary catalyst under a new IMF program in 2H2024, we believe these estimates are highly optimistic.

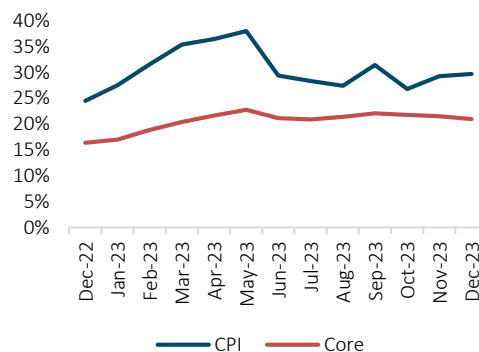
Tuesday, January 30, 2024

#### Policy Rate



Source: SBP, BMA Research

#### Monthly CPI and Core Inflation



Source: SBP, BMA Research

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**BMA Capital Management Ltd.**

**CAD expected at 0.5 – 1.5% of GDP:** 1HFY24 deficit clocked in at USD 800mn. Exports rose 5.3% y/y due to higher rice prices and higher textile export volumes. At the same time, imports declined 15.8% Y/Y. Non-oil import prices continue to decline even as oil import prices have risen recently. Lower oil import volumes and lower non-oil import prices have so far diluted the impact of rising oil prices and rising non-oil imports.

We would like to highlight that there are three risks on this front. Firstly, the oil price rise is a very recent phenomenon and is yet to be reflected fully in the import bill. Secondly, economic activity and hence petroleum product sales are usually on the lower end in the winter months, especially in December. Even so December 2023 sales, at 1.2 mn tons are 23% below the average sale for the same month in 2021 and 2022. While sales have contracted in 2022 and 2023, the expected pickup in economic activity, as noted by the SBP, will have repercussions for the import bill.

The Governor noted that CAD is expected at the low end of the 0.5 – 1.5% of GDP range. If the SBP continues to maintain a significantly positive real interest rate, we believe the CAD may be at the very low end of this range i.e. ~ USD 2 bn.

**M2 growth accelerated to 17.8% Y/Y in December 2023 amid record high reverse repos:** While the fiscal deficit in July – October has declined from 1.5% in FY23 to 0.8% in FY24, the SBP rightly noted that this was on account of restrained current expenditures (excluding debt servicing) amid sharply higher revenues. However, M2 has continued to accelerate due to higher reverse repos by the SBP and the impact of higher net foreign assets on the monetary base (assuming the SBP does not sterilize these inflows through a mop-up operation).

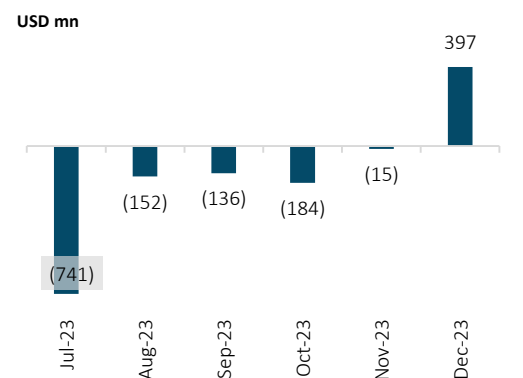
On a question regarding the PKR 8 trillion outstanding OMOs, the Governor highlighted that these are expected to gradually decline and M2 growth is expected to decelerate from current levels. Overruns on the fiscal deficit can have implications for M2 growth and we believe it may not decelerate as quickly as envisioned.

During 1QFY24, on an annualized basis, net federal revenue/GDP rose 0.78% Y/Y while total expenditure excluding debt-servicing declined 0.95% Y/Y. The combination of higher revenues and lower expenditures led to a decline in the primary deficit; however, this has resulted in a severe decline in real expenditures which is not sustainable in the medium – long term. Expenditures tend to rise in the later quarters of the year and combined with higher debt servicing costs (due to higher inflation and policy rates), may lead to overruns on the fiscal deficit and result in higher M2 growth.

**Reserves expected to strengthen despite USD 5 BN financing gap:** The SBP highlighted that out of USD 24.5 bn gross financing requirement for the current year, USD 10 bn remains to be re-financed. USD 5bn is expected to be rolled over while a USD 5bn gap remains.

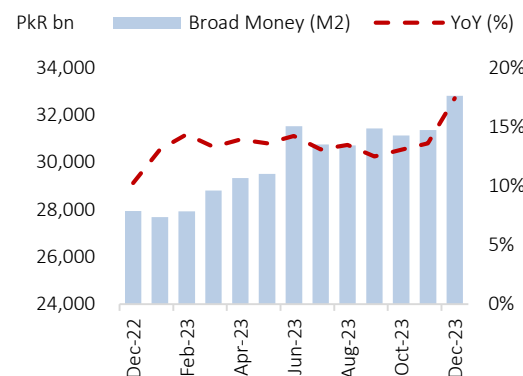
The State Bank expects reserves to rise by ~USD 1 bn to reach ~USD 9 bn by June 2023 implying an inflow of USD 6bn on the external front. We believe considerable risks remain to this forecast and it remains to be seen how the external gap is plugged.

#### Monthly Current Account Balance



Source: SBP, BMA Research

#### M2 Growth

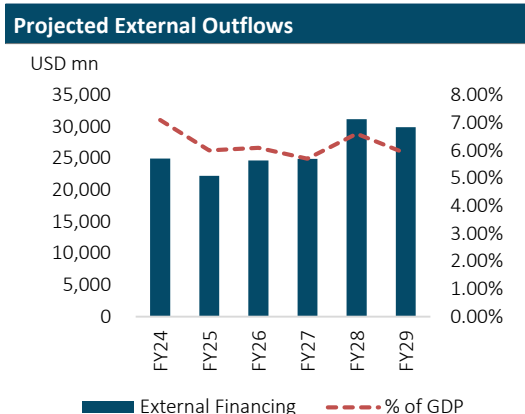


Source: SBP, BMA Research

While we are confident about the CAD estimates and meeting external financing requirements in the very short term, the SBP's forecast (based on IMF estimates) for the CAD drops from 1.6% of GDP to 1.5% of GDP from FY24 to FY25. We believe this is unrealistic given the recovery in the real economy and expected GDP growth of 2-3% in FY24 followed by further recovery in FY25. This estimate is also inconsistent with previous programs wherein the Fund has forecasted a long-term average CAD of 3% of GDP for Pakistan. Given the slow growth in remittances (continue to remain below IMF forecasts) and exports, and the expected recovery in the real economy, we do not believe a 1.5% CAD is achievable in FY25 unless remittances or exports surprise significantly.

In answering a question regarding the USD 27.4 bn "pre-determined net drains on foreign currency assets", the Governor highlighted that the actual repayable portion is expected to be lower, without going into the specifics. The Governor also noted that the composition of external debt has further shifted away from commercial sources and towards bilateral and multi-lateral sources and this is a net positive from a debt sustainability perspective.

We would however like to highlight that even bi-lateral and multi-lateral lenders are not above purely financial and economic considerations. We stress, as does the IMF, that the path to debt sustainability remains narrow, with little room for policy slippages.



Source: IMF, BMA Research

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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.)