

Rate hike uncalled for

So, 50 bps it is. Get ready for the IMF; forget fundamentals or what is happening in the world. The IMF wants Pakistan programme as close as it can get to the Egypt case - not a good country to follow. Last week currency was under measured pressure and the SBP tightened the policy further. This happened at an augmented scale four months ago.

The theory compelling market participants to believe so is that the currency is to be adjusted further, and to counter the expected inflation interest rates are to increase. On the fiscal side, the note printing has to increase to finance alarmingly high deficit, and to curb inflationary pressure emanating from it, the interest rates need to go up. Energy sector subsidies are at unmanageable level; the tariffs have to be revised and to counter inflationary pressures from it, higher rates are required. And lastly, the oil prices are too approaching dangerous zone.

Well, these all are theories and are not substantiated by any numbers. The inflation peaked in March-19, while the high base effect created last April, will end by March; and CPI may come down below 8 percent in April-19. SBP has revised down its June-19 inflation forecast to 6.8 percent. And government has plans to adjust energy prices in stages; hence not to expect too much inflation from of it.

Based on today's numbers, the inflation may remain between 7-8 percent in FY20, and the market is expecting a reversal in interest rates by 3QFY20.

The upward risks to this assumption are higher oil prices and currency level. The million-dollar question is what will be the level of currency, and what adjustments are warranted subsequently. On fundamentals, there is no reason for rupee dollar parity to slide beyond 145.

The question is what is going to be negotiated with the IMF. In early days of negotiations there were talks of adjusting currency levels to 170-180, and increasing interest rates to 15-17 percent. Today, with improvement in current account deficit amid better US-Pak relations, the conditions are perceived to have softened. However, seeing the monetary policy decision, anything is possible.

An educated guess of what interest rates and exchange rate could be in the next 6-12 months would be based on the targets IMF would set for NDA, NFA and NIR. The NFA is falling for some time now while the pressure on NDA is building up with higher fiscal deficit. Both NFA and NIR are dependent on how much direct foreign borrowing government can fetch, or how much FDI can be attracted. For details read "Loan for China -welcome change". Once IMF letter of intent is out and the conditions and quarterly targets are laid, the movement of currency and interest rates can be gauged. On today's reality, there was no need of an increase in the policy rate. For details read "Interest rates: no rationale for hike".

The core of the economic problem is fiscal. Theory says that higher rates could curb the government demand and that would help in lowering deficit. That is not true in Pakistan's case today. The development spending has already been cut significantly, while the rest of the fiscal spending is sticky and interest rates are irrelevant.

The fiscal structure is lopsided, major spending space is with the provincial governments while the debt servicing is a federal headache. This disconnect is exacerbating the problem for federal government. One percent increase in interest rates almost increases the domestic debt servicing cost by half a percent of GDP.

That will require further note printing, and need of further monetary tightening. It's a vicious cycle.

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