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Rate hike to slow credit growth: Fitch

The State Bank of Pakistan""s (SBP) aggressive pre-emptive hike in interest rates will help to cool inflationary pressures over the coming months, and will also likely have downside effects on credit growth as well as economic activity, says Fitch Solutions. The Fitch Solutions in its latest report, "Economic Analysis - State Bank of Pakistan to stand pat in 2019", projects that the SBP would hold its benchmark interest rate at 12.25 percent through 2019, which would stabilize inflation while credit growth is likely to slow over the coming months.

Pakistan and the International Monetary Fund (IMF) reached a staff-level agreement on a 39-month Extended Fund Facility (EFF) package of around USD 6 billion on May 12.

Following a 5.7 percent devaluation of the Pakistani rupee to around Rs148/USD on May 17, from around Rs140/USD previously, the SBP announced a 150bps increase in its benchmark interest rate to 12.25 percent on May 20.

According to SBP""s monetary policy statement, the decision was driven by the ""underlying inflationary pressures from: (i) higher recent month-on-month headline and core inflation; (ii) recent exchange rate depreciation; and (iii) an elevated fiscal deficit and its increased monetization; and (iv) potential adjustments in utility tariffs.

Given its expectation for inflation to stabilize, Fitch Solutions forecast the SBP to maintain its benchmark interest rate at 12.25 percent throughout 2019. The 150bps interest rate hike will likely support stabilization in inflation over the coming months. In particular, the interest rate hike has brought the real interest rate firmly into positive territory of around 3.5 percent, which should help to stabilize the rupee and hence prices of imported goods.

Higher interest rates and a more stable currency will ease consumer price inflation which has already started to fall slightly to 8.8 percent y-o-y in April, from 9.4 percent y-o-y in March. Even though Fitch Solutions oil and gas team forecasts Brent Crude prices to average USD73.00/bbl in 2019 (from year-to-date average of around USD66.00/bbl), it is believed that the recent hikes will be able to counter the inflationary pressure resulting from rising oil prices.

Fitch Solutions forecasts inflation would stabilize to an average of 7 percent in fiscal year 2019-20 (July-June), slightly higher than SBP""s target of 6 percent for fiscal year 2018-19, but considerably lower than the 8.8 percent y-o-y recorded in April.

The rating agency further maintains that inflationary pressures will ease as credit growth in both private and public sectors slow, and the transmission mechanism of monetary policy improves. Given the higher costs of borrowing and the likely reduction of public spending following the finalization of an IMF deal, credit growth to the government (which rose by 14.5% y-o-y in April from 11.8% y-o-y in April) will likely slow.

"The combination of rising interest rates and slowing economic growth (we forecast real GDP growth to slow from 5.4 percent in fiscal year 2017-18 to 4.4 percent in fiscal year 2018-19, but will be revising down our forecast within the coming weeks) will also discourage the private sector borrowing which should also help curb inflationary pressures", the report notes.

Moreover, there is a chance that the interest rate hike could improve the interest rate transmission mechanism in the economy. According to the SBP, the government""s heavy reliance on the SBP for funding was due to the reluctance of the commercial banks to lend to the government, which had ""diluted the impact of previous monetary tightening"".

With a weaker demand for credit from the private sector, commercial banks could be more willing to lend to the government at the new higher interest rates, thereby potentially improving the transmission mechanism of monetary policy.

Given the aggressive hike in interest rates, Fitch Solutions maintain that Pakistan""s growth is set to slow over the near term. In addition to the likely fiscal consolidation measures agreed as part of the IMF EFF deal, the 150bps interest rate hike will discourage investment as well as consumer spending.

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