

### **Monetary easing – go slow**

The monetary policy scheduled announcement is on Friday. This is after having two emergency meetings in the last few weeks. The SBP has cut the policy rate by 425 bps to 9 percent from its peak in two months. Monetary easing is the best stimulus an economy with cash strapped government can offer to fight COVID. With government debt to GDP ratio approaching 90 percent, the federal government has not much left in the kitty to offer.

That is why all the businesses are zeroing on the SBP to come up with another generous cut. But hold your horses; the equation is not that simple. There is a classic tradeoff between the lower interest rates and external account stability (read currency). Especially for a country, that is barely covering three months of import through central bank reserves.

The SBP under Reza Baqir is deploying a monetary policy of inflation targeting for the past one year. Last year same time, SBP started accelerating the tightening screw and peaked the rates at 13.25 percent in July 2019. The rationale was to keep real interest rates positive (1-2%) on forward looking inflation. SBP was forecasting inflation at 11-12 percent for FY20. Now with COVID inflation may come around 10.5-11 percent in FY20.

The medium term target was to attain 5-7 percent inflation in 24 months (in Jan-20). Now due to combination of demand tightening and COVID related slowdown, inflation may hover around 5-6 percent in next 3-6 months. Some houses are even forecasting lower inflation (below 5%). Seeing this and SBP's stated policy, some are arguing that SBP should show similar zest in easing as the institution had exhibited in tightening last year.

But they miss a fine point. Last year, tightening had dual objective. One was to target inflation and other to bring stability in the external account. The second purpose did serve well. There was case of dollarization during FY19. Domestic investors were not keen in keeping money in PKR for two reasons. One was anticipated currency depreciation and other was that low rates offered in PKR. That was undone by tightening. At one point when PIB rates were as high as 14 percent and there was a need for the government to wait for rates to come down, bankers and brokers used to argue that if the rates are lowered, no one will participate in government's auctions.

There was no trace of hot money back then. From Jul-Nov 19, the domestic investors started converting USD in PKR – both from FE 25 and from open market (visible from massive reduction in SBP forward liabilities). Later, the hot money started flowing in. Now, the hot money is not a concern as majority is already evaporated. If the rates are lowered today too aggressively, domestic investors may again look for safe haven in

USD or other foreign currencies. Money doesn't have any nationality and doesn't respect any boundaries.

If the currency comes under pressure, the whole equation of inflation outlook changes. Economic recovery after COVID may become slow. The SBP has already responded well by bringing rates in single digit. There was some pressure on currency due to easing but was curbed by support from multilaterals. The current account outlook is not clear yet. Exports are down to half (based on PBS) in April while imports are almost unmoved. Remittances are showing resilience. One reason for low fall in remittances and imports could be absence of netting off under-invoiced imports from through illegal channel remittances (more on this later).

Pakistan imports are already down by third in last year. There is not much room left. Exports and remittances could have adverse impact. Therefore, it is better to wait for dust to settle before too much easing. Inflation is not a concern; but external account is. That is why bringing rates down too fast could have adverse implications.

Recently the SBP's approach (since COVID) is to wait for the information to come in before taking a decision. Last decision of 200 bps cut was right after the IMF forecast of GDP growth at minus 1.5 percent. Now, let us wait for the actual numbers to come in by July and wait for budget to be made and wait for lockdown situation to be cleared before accelerating for the last mile.

A small informal survey of market participants is revealing expectations of 0 to 100 bps cut in rates on Friday. Some say these seths lobbying for aggressive cut are fast in moving funds abroad by accessing cheap funding at home. There are signs of manipulation due to distortion in rates. A few are using concessional funding to pay for bills and taking cash out (or converting to USD). Lower rates can accelerate the process.

Having said that, SBP may take the rates down to 6-7 percent in this calendar year. Some say this should happen at once like SBP did in tightening spree. They say that the world is moving towards very low rates. But not many economies have external vulnerabilities like Pakistan's. Doctor's order is to reduce rates by 50 bps to 8.5 percent on Friday.