

Rate hike — how much is needed?

The Monetary policy announcement is on Friday; the market is clearly expecting a 50-100 bps increase in interest rates. The reason cited for further rate hike, after 275 bps increase since Dec17, is that inflation is approaching double digits and to manage it the demand has to be curtailed, especially for imported goods. Talks with IMF did not culminate as the Fund was asking for tough conditions; and one of the conditions that became part of the discussion was to take interest rates to 12 percent from existing 8.5 percent.

There is no ambiguity on the direction of the monetary policy as hawks are ready to dominate. The question is that do we need, and by how much, the hike in interest rates on Friday. The entire mantra of tightening is based on controlling the twin deficit and managing inflation; and the consideration of IMF and monetary policy committee (based on previous meeting's minutes) are at the presumption of higher oil (and in turn other commodities) prices.

However, the oil prices have tanked recently; and that should have changed the thinking, which should be dynamic in nature. But beggars cannot be choosers. The government might like to negotiate with the Fund on the currency levels, new taxes and passing on the energy inefficiency burden on existing consumers.

In such times, accepting high interest rates or giving a signal of austerity through monetary tightening in a low leveraged economy is an easier option. Especially from the inflation lens – the CPI stood at 6.8 percent in October with core inflation at 8 percent. The CPI base is going to be high till March 2019 due to flawed methodology used in computing house rent index in April 2018.

With similar methodology error in computing gas price index in October, the CPI base is to remain high till September 2019 – SBP revised up its inflation expectation from 6.0-7.0 percent to 6.5-7.5 percent.

The point is that both CPI and core inflation are to remain high in the coming two quarters, at least, with double digit inflation in February and March 2019, and the SBP might not resist to continue tightening. Had the SBP reserves been enough to cover over 3 months of imports, the decision could have been of no-change seeing the falling oil prices. And had the country received \$3 billion from KSA in one go, the decision would have been different. And had the country not been in negotiation with the IMF, SBP's FPAS model prediction could have been tilted to a wait-and-see approach.

But none of this is a reality. The decision will most likely be of increasing the interest rates by around 100 bps. Last policy minutes indicate higher tightening in 2QFY19. The highest impact of higher interest rates would be on the ministry of finance. The debt servicing has already increased by 14 percent in the 1QFY19 primarily based on 275 bps increase in the interest rates – any further rate hike would not directly help in reducing fiscal deficit.

Yes, the fiscal deficit was alarmingly high in Jul-Sep 2019, which is warranting further fiscal austerity to control the deficit – that is already happening by reduction in PSDP and increase in gas and electricity prices. But not much room is left through monetary tightening to control fiscal deficit.

In terms of managing demand, the imported demand is well curtailed by massive currency depreciation, while consumer finance demand (mainly in automobile) is also curtailed due to higher rates and significant increase in automobile prices.

The SBP might see the pick-up in private credit – up by Rs245 billion in this fiscal year to date versus Rs44 billion in the same period last year. On the face of it, SBP might be enticed for bigger hike to curtail private credit.

However, the credit is primarily taken by textile sector, which is good for balance of payment.

In a nutshell, the marginal benefit of interest rates hike is diminishing, especially seeing the exchange rate adjustment and the recent fall in oil prices. But averting balance of payment crisis is top priority – IMF and other lenders would get the comfort by seeing higher domestic interest rates. The doctor order is to not go beyond 50 bps hike; but the buzz is of 100 bps increase to take the policy rate at 9.5 percent.

BR Research