Pakistan Economy

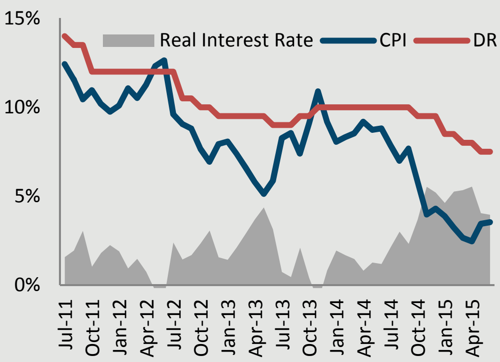
Soft inflation, Improving C/A bal; reiterate 50bps cut!

Friday March 20, 2015

Select Economic Indicators

CPI Inflation	Feb-15 YoY	3.2%
SPI Inflation	12-Mar-15 YoY	-1.9%
NFNE Inflation	Feb-15 YoY	6.2%
Reserves	13-Mar-15	USD16.2bn
Remittances	8MFY15	USD11.8bn
Trade Balance	8MFY15	USD(12.8)bn
Current A/c deficit	8MFY15	USD(1.6)bn
6 Month KIBOR (Offer Rate)	19-Mar-15	8.14%
10 Year PKRV	19-Mar-15	9.13%
Discount Rate		8.5%

Inflation vs. DR



Source: PBS, SBP, BMA Research

Summary of Current Account

USDbn	8MFY15	8MFY14	▲
C/A Bal.	-1.6	-2.5	-34%
A. Trade bal.	-11.7	-11.2	4%
Exports	16.1	16.7	-4%
Imports	27.7	27.9	0%
B. Service Bal.	-1.1	-1.8	-38%
o/w CSF	1.8	1.1	64%
C. Remittances	11.8	10.2	15%
C/A Def. to GDP (%)	0.8	1.5	

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Broad economic improvements continue as a sustained low CPI is followed by an improving current account balance with stable currency and ever improving reserves. Mar'14 CPI is expected at 2.6%YoY compared to 8.5% in Mar'14 where despite upward MoM pressure, a favorable base effect will likely keep inflation on the lower side. Average CPI for 9MFY15 is consequently expected at 5.2% as against 8.6% in 9MFY14. Despite expected summer related increase in food prices, inflation is expected to remain muted over the remainder of FY15 primarily due to high base effect. With CPI over remaining 4MFY15 at 3.0% (full year average CPI: 4.6%) and consequent real interest rates at 500+ bps, we expect the State Bank of Pakistan (SBP) to continue with its easing theme, albeit in a cautious manner. In this regard, the SBP will likely be mindful of potential headwinds particularly from upward revision in administered prices (gas tariffs). As such, we expect the SBP to err slightly on the cautious side where we anticipate a 50bps cut in the Mar'15 MPS (tomorrow), with concurrent cuts over later policy statements, depending on the economic direction. With regards to the market, lack of volumes has kept investors spooked off-late where any surprise in the MPS may unlock interest.

Soft Inflation Outlook intact: Following weekly trends in Sensitive Price Index (SPI) which resurged by 0.65%WoW (MTD stands at 0.96%) in the week ended Mar 12'15, we foresee retail inflation (CPI) likely accelerating by 0.4%MoM in Mar'15, taking YoY inflation to 2.7%YoY vs. 8.5YoY% in Mar'14. This takes average inflation for 9MFY15 to 5.2% as against 8.6% registered in 9MFY14. The MoM increase in CPI basket can be attributed to seasonal upturn in the prices of perishable food staples (chicken, fruits, onions etc.) as summers kick-in, resultantly we anticipate food basket to expand by 0.8% during the month. That said, muted imported inflation (lower fuel prices, stable exchange rate & bearish global commodity prices) coupled with favorable base effect are likely to arrest overall increase in headline inflation.

Moving forward, April '15 inflation reading will be a key check point in gauging future course of price stability as upward revision in gas tariffs (applicable from Apr'15) together with adjustments in House Rent Index (contributing 21.8% in CPI basket) will remain a potent risk to soft inflation. Given various news flows pertinent to increasing oil supply glut in the global market, we believe global oil price outlook to remain bearish keeping domestic petroleum prices soft in the medium term. In addition, given muted growth in broad money (up 4.6% FYTD) coupled with stable exchange rate, we expect FY15 year end inflation at 3.5%YoY, bringing average inflation to 4.6% (SBP target 4.5%-5.5%) vs. 8.6% in FY14.

Improving C/A balance: As per the latest external account statistics, the country registered a sizable C/A surplus of USD877mn (C/A deficit of USD74mn in Jan'15) in Feb'15, shrinking overall C/A deficit to USD1.6bn in 8MFY15, down by USD839mn or 34%YoY from USD2.4bn in 8MFY14. The strong C/A performance during Feb'15 can be attributed to robust growth in services exports (realization of CSF payment of USD716mn) to USD1.0bn, up 3.0x or USD683mn from USD339mn in Jan'15. Given notable improvement in C/A position, we downward revise our C/A deficit target to USD1.9bn, representing 0.7% of GDP as against initial expectation of 0.9%.

Bonds yields/bid patterns cueing towards another rate cut: In latest MTB auction, major participation was skewed towards the 6M and 12M tenors. According to the bid pattern, SBP received participation of PKR223bn and PKR234bn in 6M and 12M tenors, representing almost 94% of total bidding. At the same time, the SBP accepted a cumulative of PKR219bn in 6M+ tenor, contributing 90% of the amount borrowed. At the same time, we have also observed a 15bps-17bps contraction in cutoff yields to 7.98% and 7.83% in 6M and 12M, respectively. Interestingly, cutoff yield for 3M tenor stood at 8.2%, down by 4bps only from last cutoff. With a cumulative 50bps+ reduction in the cut-off yields of 6M+ paper since Feb'15, we believe there is a strong indication of a 50bps cut in the upcoming policy.

MPS Preview Mar'15; reiterate 50bps cut: In-line with global monetary easing theme along with consistently improving domestic macros, we believe SBP will potentially continue with its easing cycle in a phased manner on account of i) expected soft inflationary outlook given subdued imported inflation ii) improving external account position due to rising foreign flows and expected materialization of IMF tranche of USD518mn coupled with inflows from multilateral agencies, iii) weak economic growth as GDP is likely to grow by ~4.5% against the initial estimation of 5.1% in FY15 and iv) reinvigorating demand for private sector credit as off-takes reflects a weaker growth of 7% FYTD. Thus, we believe that SBP should adopt a more accommodative monetary policy approach and gradually reduce DR by 50bps to 8.0% (a third consecutive revision) in upcoming Monetary Policy Statement due on Mar 21'15.

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