November 17, 2020

PAKISTAN ECONOMY

REP-019

MARKET VISTA

Volatile food & energy prices cool off for soft Nov’20 read

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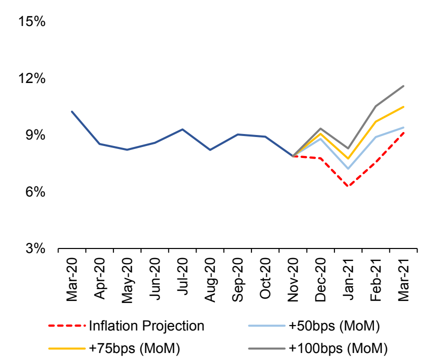
- **Preliminary price trends for the month of Nov’20 signal relative ease in inflationary pressures, with headline inflation expected to decline to 7.88%YoY in Nov’20 vs. 8.91%YoY last month and 12.67%YoY in Nov’19. Sequentially, the index is likely to marginally move up by 0.39%MoM vs. 1.70%MoM in Oct’20 and 1.35%MoM in Nov’19.**
- **The expected decline in inflation is mostly on account of i) price normalization in certain food items (i.e. wheat, pulses, & rice), ii) lower energy prices (i.e. both gov’t administrated POL product prices and electricity prices on account of lower Fuel Charge Adjustment (FCA)), and iii) high base effect.**
- **Soft near-term inflationary backdrop (expected to decline to ~6.5%YoY by Jan’21) together with an improved external account situation would keep MPC to hold interest rates steady in the upcoming monetary policy announcement later this month.**
- **Over the medium term, inflation and monetary outlooks hinge on the resumption of the IMF program and consequent timing and scale of the adjustments particularly on the energy and fiscal side. Besides, recovery in international oil prices particularly post-vaccine availability poses a major risk to inflation outlook.**

Favorable base effect, lower energy, and certain food prices to drive inflation lower: Preliminary price trends for the month of Nov’20 signal relative ease in inflationary pressures. We expect headline inflation to decline to 7.88%YoY in Nov’20 (vs. 8.91%YoY/12.67%YoY in Oct’20/Nov’19) driven mostly by i) price normalization in certain food items (i.e. wheat, pulses, & rice), ii) lower energy prices (i.e. both gov’t administrated POL product prices and electricity prices on account of lower Fuel Charge Adjustment (FCA)), and iii) high base effect. On an MoM basis, the index is likely to marginally move up by 0.39%MoM vs. 1.7%MoM in Oct’20 and 1.35%MoM in Nov’19. Food inflation – which remained a key driver of the headline inflation lately – is likely to see some moderation in the current month (13.37%YoY vs. 16.58%YoY in Oct’20 and 19.4%YoY in Nov’19), mostly on account of price normalization in certain food items. This is despite a seasonal increase in chicken prices – which are up ~18%MoM. A low energy price environment is another key factor pushing inflation lower. In this regard, both reductions in gov’t controlled POL product prices and lower FCA (PkR0.482 per Kwh vs. PkR0.837 per Kwh) will pull down their respective group indices, pushing overall inflation lower. Market wise, Urban inflation is expected to decline to 6.58%YoY vs. 7.36%YoY in Oct’20 and 12.07%YoY in Nov’19, while Rural inflation – with relatively more weight of food items – is likely to clock in at 9.86%YoY vs. 11.31%YoY in Oct’20 and 13.60%YoY in Nov’19.

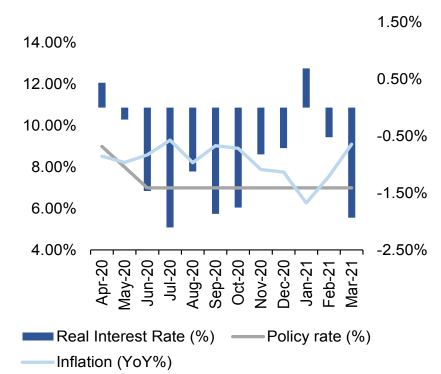
Soft near term inflation outlook will keep MPC on hold: In the near term, we expect the inflation to continue receding until Jan’21 (expected to decline to 6.3%YoY), driven mostly by favorable base effect and price normalization in certain food items – which saw an exorbitant increase in prices due to supply disruption. Soft near term inflationary backdrop together with improved external account situation would result in MPC holding interest rates steady in the upcoming monetary policy announcement later this month. Over the medium - long term, inflation outlook hinges on the resumption of the IMF program and consequent timing and scale of the adjustments particularly on the energy and fiscal side. For now, we have conservatively assumed a 20/10% hike in electricity/gas prices effective from Mar’21. With this, we expect headline inflation to average at ~8.78% in the FY21. Fiscal side remains challenging, which will also have an important bearing on the inflation outlook. While 4MFY21 tax collection numbers are encouraging (+3.8%YoY and +1.1% above soft 4M target), achieving full-year targets would still require an interim adjustment in the range of PkR500-600bn (1.1-1.3% of GDP), in our view. Moreover, recovery in international oil prices particularly post-vaccine availability is another major risk to inflation outlook, where we highlight an incremental impact of ~20bps on a MoM basis from every 5% increase in domestic fuel prices (assuming 60% pass-through on transport services as well). In our base case, we expect the tightening cycle to start by mid-2021, with the first 50bps hike in May’21.

Inflation sensitivity



Source: PBS, SBP, & AKD Research

Nominal vs. Real interest rates



Source: PBS, SBP, & AKD Research

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