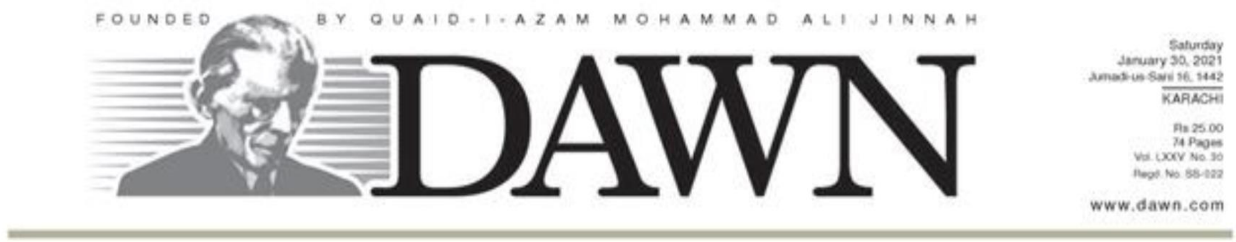
Following rebuttal published by Dawn on January 30, 2021 entitled "Not quite a bluff"



Not quite a `bluff`

T HIS is with reference to the article `State Bank`s bluf f` (Jan 28) which comprised an incorrect insinuation. As stated in paragraph 2 of the monetary policy statement, the goal of giving forward guidance was to provide policy predictability and facilitate decisionmaking by economic agents.

The choice of the word `bluf f`implies mal-intent on the part of the Monetary Policy Committee (MPC).

There is no reason for the MPC to undermine its own credibility by committing to a future course of action that it supposedly knows it will not be able to carry through.

While announcing the monetary policy decision, the MPC had clearly explicitly explained that while the recovery in the economy was gathering momentum, such guidance could be helpful in curtailing the considerable uncertainty created by the Covid-19 pandemic by bringing about policy predictability.

The MPC`s decision was based on a balanced assessment of the macroeconomic outlook and risks. It was f acilitated by the absence of demand-side price pressures and recent improvements in the external position of the country.

Furthermore, the decision is also in line with the practice of many other central banks, like the US Federal Reserve, the Bank of England, the European Central Bank, and, more recently, Bank Indonesia and the Central Bank of Brazil, that use such guidance to anchor expectations.

SBP Spokesperson Karachi

Following clarification/rebuttal was issued to Dawn in response to an article published on January 28, 2021 entitled ''State Bank's Bluff".

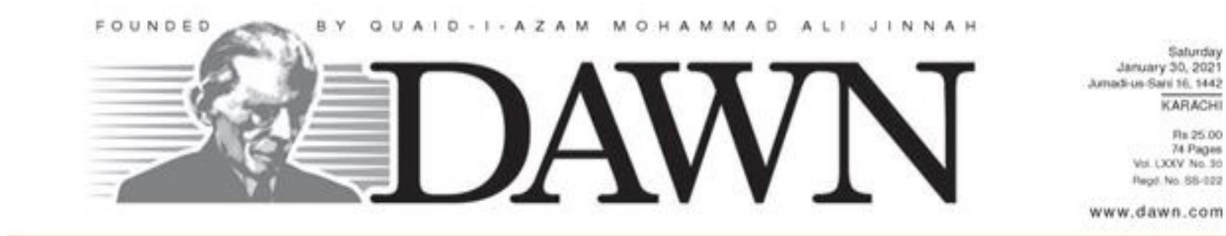
Rebuttal of the article "State Bank's Bluff" by Khurram Hussain in the daily Dawn of January 28, 2021.

An article titled "State Bank's Bluff" by Khurram Hussain appeared in the daily Dawn on January 28, 2021. The article claims that the forward guidance regarding near-term stability in interest rates provided by the State Bank of Pakistan's Monetary Policy Committee (MPC) in its latest monetary policy statement is a bluff based on a characterization of the behavior of market participants in the recent auction of government securities. This is an incorrect insinuation: as stated clearly in paragraph 2 of the monetary policy statement, the goal of giving forward guidance was to provide policy predictability and facilitate decision-making by economic agents. Calling it a "bluff" is therefore clearly at odds with the monetary policy statement. In addition, by the choice of the word "bluff", it implies mal-intent on the part of the MPC. Moreover, it begs the question of why the MPC would want to undermine its own credibility by committing to a future course of action that it supposedly knows it will not be able to carry through, as the word "bluff" means. It is unfortunate that regular columnists in a reputable newspaper like the DAWN would choose to characterize a venerable institution in such terms.

While announcing the monetary policy decision, the MPC clearly stated the reasons why it decided to adopt forward guidance. It was explicitly explained that while the recovery in the economy is gathering momentum, such guidance can be helpful in curtailing the considerable uncertainty created by the Covid-19 pandemic by bringing about policy predictability. The MPC's decision was based on a balanced assessment of the macroeconomic outlook and risks. It was facilitated by the absence of demand-side price pressures and recent improvements in the external position of the country. Furthermore, this decision is also in line with the practice of many other central banks who use such guidance to anchor expectations. Examples include the US Federal Reserve, the Bank of England, the European Central Bank, and more recently Bank Indonesia and the Central Bank of Brazil, to name a few.

The article also goes on to claim that the SBP gives sugar-coated presentations. The choice of such words, perhaps designed to be sensationalist and catch the eye of the reader, again imply mal-intent on the part of the SBP that an effort—allegedly—is being made to not present facts and figures about the economic situation as they are. As in the claim about a "bluff", no evidence is provided how any presentation is being sugar-coated. The State Bank of Pakistan has recently invested heavily in strengthening its communication including through post MPC analyst meetings and the feedback from the investor community has been overwhelmingly positive.

Following article published in Dawn on January 28, 2021



State Bank's bluff
By Khurram Hussain

IT didn't work, or so it seems anyway. Last week, the State Bank took the unusual step of issuing what it called "forward guidance" on where interest rates might go in the future, and told the markets that it "expects monetary policy settings to remain unchanged in the near term" barring "unforeseen developments". The message seemed to have the banks as its primary audience, since they have been increasingly bidding in short-term tenors in recent Treasury bill auctions, which is usually a sign that they expect a hike in interest rates soon.

Last week, they were disappointed when the State Bank opted to hold rates steady, citing an easing of inflationary pressures and a nascent economic recovery underway although the accompanying monetary policy statement admitted that interest rates are "in slightly negative territory on a forwardlooking basis". Shaved of the caveats, this admission forms the bedrock of the banks' expectation that at some point the central bank will be forced to start raising rates. And with that expectation in mind, they have been opting in recent T-bill auctions to not go much longer than three months with their bids for government paper. In the last auction held on Jan 13, for example, 96 per cent of the realised value was from three-month tenors.

This is how it works. When banks feel that interest rates have bottomed out and are now set to rise they start bidding in the shortest possible tenors so as not to lock themselves in at the bottom. When they feel rates have peaked they start going long with their bids, in an effort to lock in the highest rates on offer for the longest period of time. This pattern repeats itself year after year. Once rates rise and bids for longer tenors start pouring in, the government of the day often argues that the bidding behaviour of the market reflects confidence in their policies. It is nothing of the sort. It is just the banks locking in the higher rates while they are on offer.

The cycle has repeated itself once again. Of late the banks have been harbouring growing expectations of a rate hike and their bidding behaviour shows them crowding massively in shorter tenors. Then the State Bank came with its "forward guidance" last week, telling everyone that no rate hikes are planned for "the near term", the first time such a step has been taken. The idea was to assuage borrowers who might be apprehensive about a return to high-cost credit. But equally, if not primarily, it was a signal to the banks that their expectation of a rate hike is misplaced.

The debt auction held on Wednesday was the first real test of the story the State Bank tried to put out in its monetary policy statement of last week.

But it didn't work. In the auction held on Wednesday, the banks overwhelmingly opted to bid in three-month paper. As of this writing, the cut-off yields at which the government will accept the bids in various tenors have not been uploaded to the State Bank's website. But the bid report, which gives details on how much was bid in what tenor and at what yields has been released, and it does not paint a pretty picture.

Out of a total of 222 bids received, 194 were in three-month paper, meaning more than 87pc. Of the more than Rs789 billion that was offered (at face value) by the banks, almost Rs657bn was in three-month paper, meaning around 83pc. The trend of crowding around shorter tenors did not break despite the 'forward guidance'. And it gets better.

Only 19 of the bids in three-month paper were on yields below the weighted average yield on the same tenors in the last auction held on Jan 13 (these auctions are a fortnightly affair). The amount offered under these 19 bids was just over Rs11.5bn, less than 2pc of the total offered in three-month tenor. Not only has the market held on to its expectation of a rate hike it seems, it also overwhelmingly demanded higher yields for the same paper this time compared to the previous auction.

A gentle way of putting this would be to say that the banks remain sceptical of the State Bank's 'forward guidance' if their bidding behaviour in government debt auctions is anything to go by. A less gentle choice of words would simply say the markets have called the State Bank's bluff.

Conversations with a few treasury heads in a couple of large banks confirmed this. They are taking a less benign view on the inflation outlook than the State Bank is, and all expected that the central bank might well be forced to raise rates in the May monetary policy decision.

We will see how this works out. It is possible that the State Bank will find a way to convince the banks that this expectation is misplaced, and the subsequent auction scheduled for Feb 10 could see more participation in longer tenors. There are still around half-a-dozen auctions to go before we get to the May policy decision so there might still be time to work this out.

But financial markets are not as easily persuaded with sugar-coated presentations as some amenable individuals are. The debt auction held on Wednesday was the first real test of the story the State Bank tried to put out in its monetary policy statement of last week. That story told us the economy is recovering, inflation is easing, the difficulties of the external sector are fading and the real sector is revving.

All this may well be true. But for now the markets know something that the government — and it seems the State Bank as well since they appear to be on the same page — doesn't want to admit. Let's see what gets modified first — the government's economic story or the commercial banks' bidding behaviour on government debt.