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ICMA MONETARY POLICY STATEMENT

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MPS REVIEW

A Brief Assessment of SBP's Monetary Policy on Business and Economy

ICMA Research and Publications Department

Preamble

The Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) opted to maintain the policy rate at 22 percent during its meeting on 29-April-2024. This decision reflects the Committee's acknowledgment of the ongoing macroeconomic stabilization efforts, which have resulted in significant improvements in both inflation and the external position amid a moderate economic recovery. However, the Committee remains concerned about the persistently high level of inflation, with uncertainties in global commodity prices and recent geopolitical events.

Additionally, forthcoming budgetary measures may further impact the near-term inflation outlook. In light of these factors, the Committee underscores the importance of continuing the current monetary policy stance to achieve the inflation target range of 5 to 7 percent by September 2025. Because of the current account significant surplus in March 2024, stabilization in SBP's foreign exchange reserves, substantial debt repayments, weak financial inflows and high consumer expectations for inflation in April 2024, the SBP has aimed to maintain a cautious policy rate which is align with the leading central banks, particularly in advanced economies.

MPC Observations on Key Sectors

Real Sector

- **Moderate Recovery:** GDP growth projected at 2 to 3%, led by agriculture sector.
- **Agriculture Growth:** Robust 6.8% growth in H1-FY24, supported by increased harvests.
- **Industrial Sector:** Slight 0.5% decline in large-scale manufacturing, an improvement from last year.
- **Services Sector:** Growth slightly below expectations due to subdued demand.
- **Expected Recovery:** Anticipated rebound in both manufacturing and services sectors.

External Sector

- **Current Account Surplus:** Surged to $619 million in March 2024 due to Eid-related increase in remittances.
- **Deficit Reduction:** Cumulative current account deficit decreased by 87.5% to $0.5 billion in July-March FY24 compared to the previous year.
- **Export Growth:** Steady growth, especially in rice exports, contributing to the reduction in the deficit.
- **Import Decline:** Decrease in imports driven by better domestic agriculture output and moderate economic activity.
- **Debt Repayments:** Enabled sizable repayments, including a $1 billion Eurobond, while maintaining FX reserves at $8.0 billion.
- **FX Buffer Importance:** MPC stresses the need for further FX buffer buildup to respond to external shocks and sustain economic growth.

Fiscal Sector

- **Primary Surplus Increase:** Increased to 1.8% of GDP in Jul-Jan FY24 from 1.1% in the same period last year.
- **Revenue Growth:** Continuous increase in revenue collection driven by taxation measures and ongoing economic recovery.
- **Non-Interest Expenditure Restraint:** Some restraint on non-interest expenditures contributing to the primary surplus.
- **Tax and Non-Tax Revenue:** Significant increase in both tax and non-tax revenues, reflecting the impact of taxation measures.
- **Interest Payments:** Increased due to high debt levels and reliance on expensive domestic borrowing.
- **Overall Deficit:** Rose to 2.6% of GDP in Jul-Jan FY24 from 2.3% in the same period last year.
- **Fiscal Consolidation Importance:** MPC stresses the need for continued fiscal consolidation, especially through broadening the tax base and reducing losses of public sector enterprises, to ensure price stability and durable economic growth.

Money and Credit

- **Broad Money Growth:** Increased to 17.1% y/y in March 2024 from 16.1% in February 2024.
- **Reserve Money Growth:** Rose to 10% from 8.2% in the same period.
- **Factors Driving M2 Growth:** Expansion in net foreign assets and increased net budgetary borrowing from commercial banks.
- **Private Sector Credit:** Continues to decelerate broadly.
- **Expected Deceleration in Monetary Aggregates:** MPC anticipates recent growth in monetary aggregates to slow down in the coming months.
- **Positive Impact on Inflation Outlook:** The underlying compositional changes in M2 are expected to have a positive impact on the inflation outlook, as viewed by the MPC.

Inflation Outlook

- **Inflation Moderation:** In H2-FY24, inflation continued to moderate noticeably.
- **Headline Inflation:** Declined to 20.7% y/y in March-24 from 23.1% in February-24.
- **Core Inflation:** Significantly decreased to 15.7% from 18.1% in February-24.
- **Factors Contributing to Moderation:** Coordinated tight monetary and fiscal policy response, lower global commodity prices, improved food supplies, and high base effect.
- **Inflation Outlook:** Expected to remain on a downward trajectory, according to the Committee.
- **Susceptibility to Risks:** Risks include recent global oil price volatility, bottoming out of other commodity prices, potential inflationary impact of resolving circular debt in the energy sector, and tax rate-driven fiscal consolidation.
- **Prudent Monetary Policy Stance:** The Committee assessed that continuing with the current monetary policy stance, characterized by significant positive real interest rates, is prudent at this stage.

ICMA Analysis on Effectiveness of Monetary Policy

FY 23-24	Inflation Rate (YoY)	Policy Rate % (Interest Rate)	GDP Growth Rate %
Jan-23	25.4	17	-0.42
Feb-23	26.2	17	-0.42
Mar-23	27.3	20	-0.42
Apr-23	36.4	21	-3.29
May-23	38	21	-3.29
Jun-23	29.4	21	-3.29
Jul-23	28.3	22	2.5
Aug-23	27.4	22	2.5
Sep-23	31.4	22	2.5
Oct-23	26.8	22	1
Nov-23	29.2	22	1
Dec-23	29.7	22	1
Jan-24	28.3	22	N/A
Feb-24	23.1	22	N/A
Mar-24	20.7	22	N/A

Source: SBP

- The above data in table shows that consistent increase in the policy rate from Jan-23 to Sep-23 had a limited immediate impact on controlling inflation, as inflation continued to rise or remained high during this period.

- Despite the high policy rate, GDP growth remained negative or low until Sep-23, indicating a limited effectiveness of monetary policy in stimulating economic activity.

- The recent decline in inflation from Jan-24 to Mar-24, despite the unchanged policy rate, suggests a potential positive impact of the maintained policy rate on inflation control. However, the effect on economic growth needs further observation.

Factors causing decline in Inflation Rate in April 2024

In April 2024, Pakistan's inflation rate fell to 17.3%, the lowest level seen in nearly two years. This is a decline from the 20.7% rate in March 2024, indicating a positive step towards greater economic stability for the country. The following are the factors contributing to this declining rate of inflation:

Moderation in Food Prices
- Decline in the inflation rate in overall food price index, contributing 42% to the fall in inflation.
- Significant moderation in prices of staple item like wheat flour, livestock products (milk, chicken), and fresh fruits.
- Big decline in inflation rate of imported goods like vegetable ghee, tea, and pulses.

Reduction in Non-food Prices
- Slowing down in the rate of increase in the non-food price index, contributing 58% to the fall in inflation.
- Major reduction in the price of gas, with a significant contribution to the overall inflation decrease.

Exchange Rate Stability
- Stability of Pak Rupee against the US dollar, with hardly any depreciation between March 2023 and March 2024.
- Nominal appreciation of the rupee, contributing to maintaining stability in prices.

Tariff Control and Policies
- Control over imports contributing to stability in the Rupee value and reduction in Current Account Deficit (CAD).
- Management of circular debt through potential escalation in electricity and gas tariffs.

External Factors
- Risk factors associated with likely movement in international prices, particularly oil prices.
- Potential rise in oil prices due to the situation in the Middle East, impacting inflation dynamics in Pakistan.

Experts Insight

Dr. Ikramul Haq & Mr. Abdul Raoof Shakoori conveyed to the ICMA Research Department that the decision by the Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) to keep the policy rate unchanged at 22 percent underlines the ongoing challenges faced by the economy, particularly concerning inflation and its negative impact on businesses. While this decision aligns with IMF conditions to finally secure the last tranche of the SBA and paves the way for negotiating the new package, it highlights a broader failure to implement necessary fiscal reforms and maintain fiscal discipline.

They further added that despite efforts to control inflation through high policy rates, businesses continue to struggle with elevated borrowing costs, limiting their ability to invest and expand. Furthermore, the lack of consistent revenue generation measures tailored to the country's economic profile exacerbates the situation. These shortcomings have resulted in persistently high policy rates in double digits over the past few years, reflecting a systemic failure to address primary economic issues and effectively manage inflationary pressures. As a result, businesses face an uphill battle in navigating an environment characterized by high borrowing costs and insufficient fiscal reforms.

Mr. Hasnain Imam, Senior Manager; Investment banking Division at Bank Al Habib Ltd while talking to ICMA said that the recent monetary policy decision, influenced by preceding polls, indicates an unchanged stance. The market expects no change in the upcoming announcements in April, May, and June, attributing it to a decline in inflation due to the large base effect. However, inflation's persistence and rising oil prices pose risks.

Mr. Hasnain further stated that the Federal Budget's fiscal measures may further fuel inflation, as noted by the IMF and SBP Governor. Concerns about a new round of inflation are evident. Loosening monetary policy could spur economic growth but may also lead to increased imports, widening the Current Account deficit, and pressure on the rupee. The IMF's approval of $1.1 billion aims to bolster FX reserves, reaching close to $9.1 billion. This stabilization effort is critical amid pending Moody's payments totaling $7.9 billion. Therefore, while economic teams aim for stability, premature policy loosening or sudden economic growth could disrupt this balance.

Dr. Aamir Hussain Siddiqui, Assistant Professor/ Research Economist, Applied Economics Research Center, University of Karachi while speaking to ICMA said that the SBP's decision to retain the interest rate at 22% is not justified by its own statements. The downward trend in inflation was not because of the interest rate, but solely due to growth in the agriculture sector and exchange rate stability. The worldwide phenomenon of inflation has reversed to a downward trend, and the world has seen a sharp declining trend in commodity prices. In Pakistan, low inflation has been recorded in the food sector due to better agriculture production and supplies.

Dr. Aamir further said that a very serious concern is the use of banking credit. According to the data, nearly 23% of the total banking credit was given to the private sector in the month of March, while the banking sector continues to credit the government sector, accounting for almost 77% of the total banking sector credit. This clearly implies that the savings of the people of Pakistan are not being used for investment purposes, which could have ultimately brought growth to the business and economy. Instead, it is used for government expenditure, which does not contribute to economic growth. This indicates a highly inefficient use of the Saving-Investment factor of the economy.

He further noted that the Government borrowing means more taxes on the economy, which may further accelerate inflation, while borrowing by the private sector means business investment, which would increase the supply of goods and services and decrease inflation. A high level of interest rate means low demand by the private business, and a high level of government borrowing at a higher interest rate would increase the fiscal deficit, thus resulting in more taxes and potentially more inflation.

Business and Industry Viewpoint

Mr. Asif Inam, Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI) shared his views with ICMA that the current high interest rate of 22% poses a significant challenge to our operational efficiency. In comparison, India maintains the rate around 5 to 6%, and in Bangladesh, they're below 10%. Interestingly, globally, rates tend to stay under 10%. It's worth noting that in March 2023, Japan managed a debt-to-GDP ratio of approximately 300% while maintaining an interest rate of 0 to 0.1%.

He advised to tackle these challenges by focusing on several key areas. Firstly, expanding our debt market could provide more flexible financing options. Secondly, it's crucial to boost exports and foreign reserves. Although we currently have a current account surplus, it's mainly due to our economy not reaching its full potential. Once it does, this surplus could turn into a deficit.

Mr. Inam also highlight the importance of affordable electricity price by setting an electricity rate of 9 cents per unit, which will attract investments, increase competition and improve our export potential. Ultimately, this could result in a decrease in interest rates, which would be advantageous for businesses across every sector.

Mr. Muhammad Aman Paracha, Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI) while talking to ICMA said that despite negative growth in industrial sector, (the LSM has shown a negative of -0.51%), the SBP surprisingly kept interest rates unchanged. The whole of industrial sector is badly affected and facing hardship since the practice of keeping high policy rates. Textile (-1.75), Paper & Board (-0.08), Iron & Steel Products (-0.05), Tobacco (-0.80), Electrical Equipment (-0.26), Automobiles (-1.14) and Furniture (0.72). Non-Metallic Mineral Products (-0.27), Fabricated Metal (-0.02), other transport Equipment (-0.07).

Mr. Paracha emphasizes to reduce the rate as 22 percent interest rate have so far been failed to counter the inflation, but we have to compromise our economic, industrial and other important sectors growth.

Mr. Kashif Anwar, President; Lahore Chamber of Commerce and Industry (LCCI), in a conversation with ICMA said that we are curious about the current economic situation. However, until we bring down our operational and input costs, our industry won't thrive, especially with a 22% interest rate. With such a high rate, securing financing for less than 25% to 26% becomes nearly impossible. So, how can the businesses sustain themselves with such exorbitant financing costs. If you also consider the increasing electricity and gas prices, the situation becomes even more challenging. Borrowing significant amounts from banks under these conditions is extremely difficult.

He further added that despite the progress made, our capital has diminished by 100%. Facing double, the cost of production our strength has diminished, and we need more finance but on low rates. Also, we need to reduce our operational and input costs and the lending facility rates. Otherwise, local investors will withdraw their funds or decrease their investment due to the high input costs. Reducing the costs will not only help to control inflation but also boost our exports. Therefore, it's crucial that people don't keep their money in banks for profit; instead, they should invest it in businesses to enhance productivity, which is essential for the growth and sustainability of our industries.

Recommendations

ICMA recommends to continue the current monetary policy stance while closely monitoring inflation and adjusting the policy rate when necessary to improve economic conditions. Fiscal consolidation efforts should be prioritized, focusing on revenue enhancement, expenditure control, and debt management. Supporting key sectors like agriculture and industry through targeted interventions and policy support is crucial for sustaining economic recovery.

Additionally, ICMA emphasizes the coordination between monetary and fiscal authorities, along with transparent communication with stakeholders, especially with the business community to encourage investment and employment opportunities which is essential for building confidence and ensuring stability in Pakistan's economy.

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