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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) decided to reduce the policy rate by 200 basis points to 17.5 percent, effective from 13th September 2024, during its meeting held on 12th September 2024. This decision was driven by the sharp decline in both headline and core inflation over the past two months, a pace faster than the Committee's earlier expectations. The delay in implementing planned energy price hikes and favorable global movements in oil and food prices contributed to this disinflation. However, the Committee has adopted a cautious approach, acknowledging the uncertainties surrounding these developments. It also highlighted the critical role that the tight monetary policy stance has played in sustaining the reduction in inflation throughout the past year.

The MPC further noted key developments since its previous meeting, which have implications for the broader macroeconomic outlook. Global oil prices experienced a sharp decline, though volatility persists. As of 6th September 2024, SBP's foreign exchange reserves stood at approximately $9.5 billion, despite continued debt repayments and weak financial inflows. In the secondary market, yields on government securities have significantly decreased since the last MPC meeting. Additionally, business confidence has improved, reflected in pulse surveys, while consumer confidence has slightly deteriorated. Meanwhile, tax collections by the Federal Board of Revenue (FBR) during July-August 2024 fell short of targets.

Taking these factors into account, along with potential risks to the inflation outlook, the MPC deemed the current real interest rate sufficiently positive to help bring inflation within the medium-term target range of 5-7 percent, ensuring macroeconomic stability. The Committee stressed that this stability is crucial for achieving sustainable economic growth over the medium term.

MPC Observations on Key Sectors

Real Sector

- **Economic Activity:** Recent data indicates a moderate increase in economic activity. The cement sales rose by 8.5% and POL (excluding furnace oil) by 6.8% month-on-month in August 2024.

- **Business Sentiment:** Business surveys reveal improved capacity utilization in manufacturing, indicating a moderate recovery.

- **Agriculture Sector:** Cotton production outlook weakened, with lower cultivation and reduced arrivals by end-August 2024, falling short of government targets.

- **Industrial & Services Growth:** The easing of inflationary pressures and recent policy rate cuts are expected to support growth in both the industry and services sectors.

- **GDP Growth Outlook:** The overall real GDP growth forecast remains aligned with earlier projections of 2.5 – 3.5% for FY25.

External Sector

- **Current Account Deficit:** In July 2024, workers' remittances and improved export earnings contained the current account deficit to $0.2 billion, despite higher imports. This strong remittance trend continued in August 2024.

- **Global Economic Environment:** Favorable global conditions, including softening crude oil prices and easing financial conditions, contributed to positive external dynamics.

- **Trade Deficit:** Imports are expected to rise as domestic economic recovery continues. The trade deficit is likely to remain manageable due to improved terms of trade, primarily driven by lower oil prices.

- **Export Earnings:** Stable export earnings anticipated, with growth in high-value textiles offsetting a potential decline in rice exports.

- **Current Account Deficit:** The current account deficit is expected to stay within 0 – 1% of GDP for FY25, supported by strong remittances and IMF inflows.

- **Foreign Exchange Reserves:** These developments will bolster the SBP's foreign exchange reserves, further stabilizing the external position.

Fiscal Sector

- **Tax Collection Growth:** FBR tax collection rose by 20.5% during July-August FY25. However, the pace must significantly accelerate in the remaining months to meet the annual revenue target.

- **Fiscal Consolidation Impact:** Fiscal consolidation efforts in recent years have aided in reducing inflation and restoring macroeconomic stability.

- **Public Debt Reduction:** The gross public debt-to-GDP ratio improved, falling from 75% in June 2023 to 67.2% by June 2024.

- **Future Expectations:** The MPC anticipates continued fiscal consolidation through reforms aimed at broadening the tax base, reducing PSE losses (especially in the energy sector), and creating more fiscal space for social and developmental expenditures.

Money and credit

- **Broad Money (M2) Growth:** M2 growth slowed to 14.6% by end-August 2024, down from 16.1% in June, largely due to higher-than-seasonal private sector credit (PSC) retirements and com-modity financing repayments.

- **Reserve Money:** Growth in reserve money saw a slight recovery after remaining low throughout FY24 but remains below historical trends.

- **Deposits:** Deposits continued to be the primary contributor to M2 growth from the liability side.

- **Impact of FX Inflows:** Planned official FX inflows are essential to reduce government reliance on domestic banking, improve the net foreign assets (NFA), and create more lending capacity for the private sector.

- **Private Sector Credit Growth:** Subdued Private Sector Credit growth is expected to rebound as financial condi-tions ease.

Inflation outlook

- **Headline Inflation Decline:** Inflation dropped to 9.6% year-on-year in August 2024, down from 12.6% in June 2024. Core inflation also decreased from 14.1% to 11.9% during the same period.

- **Reasons for Decline:** The inflation drop is attributed to controlled demand, improved supplies of key food items, favorable global commodity prices and delayed adjustments in administered energy prices.

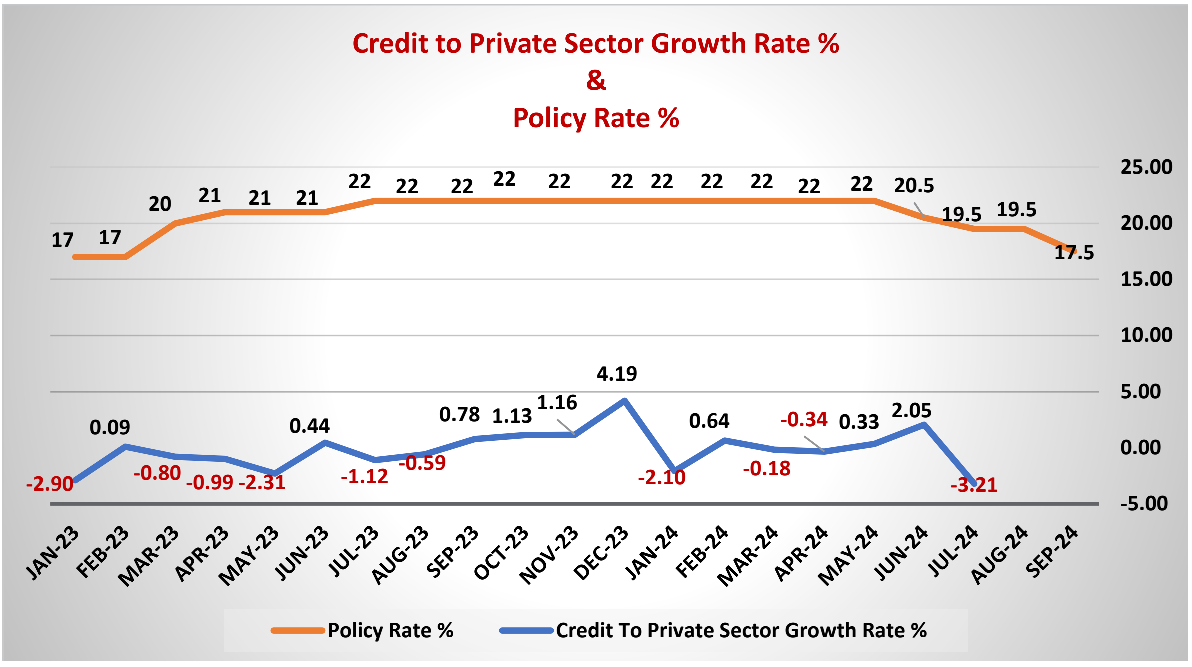
- **Risks to Inflation Outlook:**
    - a) Core inflation remains elevated.
    - b) Consumers' inflation expectations have risen, according to recent surveys.
    - c) Uncertainty exists around the timing and scale of energy price adjustments, global commodity prices, and potential new taxes to meet revenue targets.

- **Potential for Further Decline:** The MPC sees a possibility of average FY25 inflation falling be-low the earlier forecast of 11.5% to 13.5%, but this depends on achieving fiscal consolidation and realizing planned external inflows.

ICMA Analysis

Effectiveness of Policy Rate on Credit to Private Sector:

Figure:1



Source: SBP, Analysis by ICMA

- The data in Figure:1 shows that the growth of the Credit to the private sector has generally been negative or low during periods of high policy rates (22% for most of FY23-24). Notable increases in private sector credit (e.g., 4.18% in December 2023) occurred despite the high policy rate which seem to reflect other factors influence.

- The data also indicates a slight increase in private sector credit growth as the policy rate began to decline (e.g., June 2024 onwards when the policy rate fell from 22% to 19.5% and private credit grew by 2.05%). The peak policy rates (21% and above) correlate with periods of negative or stagnated private sector growth.

- This concludes that high policy rates restricted credit growth to the private sector. However, recent cuts in the policy rate, as seen from June 2024 onwards, indicate a potential rebound in credit expansion.

Experts' Insight

Dr. Ashfaque Hasan Khan, a renowned economist and former Economic Advisor at the Ministry of Finance, termed the policy rate reduction as an excellent decision and said this is exactly what he was expecting based on his own analysis. He added that the real interest rate is still very high. While the policy rate is now down to 17 percent, the inflation rate is 9.6 percent, making the real interest rate over 7.0 percent. He stated that the condition for debt sustainability is that the real interest rate should be less than the real GDP growth in an economy (r - g < 0). He further explained that the forecast for this year's real GDP growth is close to 3.0%. Hence, the real interest rate (7%) is much greater than the real GDP growth (~3.0%). In such an environment, he warned, Pakistan's debt situation will remain unstable. He recommended that by December 2024, the policy rate must come down to 15%.

Mr. M. Amayed Ashfaq Tola, President of Tola Associates, in conversation with ICMA R&P Department acknowledged the 2% reduction in interest rates as a positive step. However, he stated that, based on their analysis, there was room for a more substantial reduction in the policy rate, ranging from 3% to 5.5%, given the trend observed in the last four meetings concerning real interest rates. He added that after the rate cut, the real interest rate now stands at 8%, which is excessively high, especially considering the expected industrial growth of over 4% in FY 25. He cautioned that such a high real interest rate could hinder the country's economic expansion and further stressed that it also places a financial burden on the economy, noting that a 1% reduction in interest rates saves around PKR 472 billion in domestic debt repayments.

Mr. Muhammad Irfan, Manager Operations at Taurus Securities Limited, in a message to R&P Department said that the rate reduction is a positive step for speeding up Pakistan's economy. He suggested that to increase GDP, the reduction should lead to a lower cost of doing business, and investment should shift from deposits to the development of new industries. Additionally, lower financing costs could enhance competitiveness in the international market. He also noted that economic stability should result in stable prices. However, he cautioned that very low interest rates could lead to high inflation and emphasized the need to maintain interest rates to control inflation, stabilize prices, and manage the unemployment rate.

Dr. Manzoor Ahmed, Advisor for the Institute for Policy Reforms and a Senior Fellow at the Pakistan Institute of Development Economics (PIDE), shared his view that the MPC took a cautious stance, despite pressure from the business community for a 500-basis point cut. He added that while the 200-bps reduction may not fully meet expectations, it should still stimulate some economic growth and help ease the government's debt burden. He stated that the decision to avoid a larger cut was likely aimed at mitigating risks such as a resurgence of inflation, currency depreciation, and reduced returns on savings.

Dr. Ikram ul Haq, a member of the Advisory Board and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE), told ICMA that the reduction in the policy rate was expected after inflation reached single digits this month. He added that the reduction level is lower than expected, especially considering the official claims of a drastic decrease in inflation. He explained that the Committee is evidently concerned about the inflationary impact of taxes and the imprudent spending by the government, particularly the borrowing spree through money printing. Hence, it adopted a cautious approach and reduced the policy rate by 200 basis points, which he described as a prudent decision.

Prof. Dr. Shahida Wizarat, a renowned economist, while talking to ICMA R&P Department said that while the reduction is a step in the right direction, it should have been lowered to 15%.

Mr. Mansoor Ahmad, Senior Economic Reporter at The News International, while talking to ICMA, noted that even a 2 percent reduction is significant given the IMF program's current status. He emphasized the need to prioritize protecting the rupee and discouraging imports. He added that lower interest rates could encourage imports, which may not be advisable at this time.

Mr. Aadil Nakhoda, Faculty Member at the Institute of Business Administration (IBA), Karachi, stated that the reduction in interest rates aligns with expectations. He noted that while a 200-basis point cut might be more aggressive than the more gradual 100 basis point reduction anticipated, it reflects recent positive developments. These include lower inflation rates, which have re-entered single-digit zones, falling global oil prices, and a stable current account deficit, supported by high remittance inflows. He highlighted that the reduced interest rates will offer much-needed relief to investors and lower borrowing costs. The next step, he emphasized, is to ensure that the benefits of the lower interest rates are passed on to consumers, who are the ultimate beneficiaries of monetary policies.

Mr. Abdul Aziz, an experienced finance professional and Financial Controller at Avari Hotels (Pvt.) Limited, highlighted that the combination of a 2% reduction in interest rates, the approval of the IMF agreement on September 25, 2024, and falling oil prices could provide a significant boost to the economy. He emphasized that this period presents a critical opportunity for Pakistan to tackle its long-standing economic challenges. He identified key priorities for Pakistan during this phase, including energy pricing reform, taxation reform, privatization of loss-making public entities, building confidence with the IMF, and implementing long-term structural reforms. Beyond addressing immediate challenges, he stressed the importance of improving governance, reducing corruption, and enhancing the ease of doing business to create a more conducive environment for growth. Abdul Aziz concluded that if these steps are taken swiftly and effectively, Pakistan could transition from stability to sustained economic growth, paving the way for long-term prosperity.

Mr. Muhammad Ammad Ansari, an experienced accounts professional and taxation specialist, noted that while lowering borrowing costs can boost consumer spending by reducing loan rates, it also requires careful inflation management. He suggested that, if managed well, the reduction could support economic growth and provide much-needed relief to the business sector.

Business and Industry Viewpoint

Mr. Asif Inam, Vice President of the Federation of Pakistan Chambers of Commerce & Industry (FPCCI), shared his insights with the ICMA Research Department, highlighting that the expectation was for a 2.5% to 3% reduction in the monetary policy rate given the relatively controlled inflation rate of 9.6%. However, only a 2% reduction was applied. With a decreasing inflation rate, he suggests a timelier and more substantial rate cut in the next MPC meeting.

Mr. Asif Inam further told ICMA that **Mr. S M Tanveer, Patron-in-Chief of the United Business Group (UBG),** has criticized the 2% policy rate cut as insufficient given the current economic conditions. He pointed out that core inflation is expected to be around 7.0 percent for September, and international oil prices are at a three-year low. Tanveer expressed frustration that the SBP did not implement a more significant cut and emphasized that Pakistan's cost of doing business and access to finance are among the lowest compared to export competitors. He recommended an immediate reduction in interest rates to 12 percent to support Pakistani exporters and boost economic growth.

Mr. Musadaq Zulqarnain, Chairman of Interloop Limited & Interloop Holdings, welcomed the reduction in the policy rate, stating that it is always beneficial for the economy. He added that this reduction will help ease the debt servicing burden slightly for both private enterprises and the government. However, he noted that there was potential for a more significant reduction, which the MPC did not opt for, likely out of abundant caution. He stated that a larger reduction would have been much more helpful in the current economic environment.

Mr. Farouk Awan, President of Resources Fund Inc, USA, while talking to ICMA, suggested that the MPC should have cut rates by 400 basis points. He noted that declining oil prices will reduce the current account deficit, making it a good time for aggressive easing. He also warned that if industries continue to struggle, exports may drop, and the rupee could weaken further.

Policy Recommendations

ICMA recommends a more substantial reduction in the policy rate, advocating for a cut of up to 400 basis points to achieve a target rate of around 15% by December 2024. This adjustment is critical for aligning the real interest rate with expected economic growth and ensuring debt sustainability. Further, as mentioned in the ICMA's analysis based on Figure:1; the high policy rates throughout FY23-24 have restricted the growth of credit to the private sector, which is crucial for economic recovery. To improve Pakistan's economic conditions, it is recommended that the SBP continue with a gradual reduction in the policy rate, but at a faster pace to encourage private sector borrowing and investment.

In addition to adjusting interest rates, it is essential to address key structural issues, including energy pricing reforms, comprehensive taxation reforms, and the privatization of loss-making public entities. These reforms are crucial for enhancing the overall effectiveness of monetary policy and fostering long-term economic stability.

The focus should also be on providing targeted support to industries and exporters by significantly lowering borrowing costs. This will help reduce the cost of doing business and enhance competitiveness in international markets. It is important to balance these measures with careful inflation management to prevent potential inflationary pressures that could offset the benefits of lower interest rates.

Furthermore, improving governance, reducing corruption, and enhancing the ease of doing business are vital for creating a more favorable environment for growth. Implementing these recommendations will support economic development, stabilize prices, and contribute to sustained long-term prosperity.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Institute of Cost and Management Accountants of Pakistan