ICMA INTERNATIONAL lead strategically

ICMA MONETARY POLICY STATEMENT

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

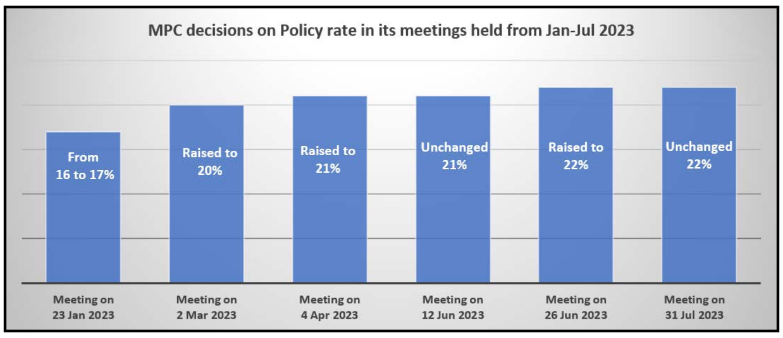
ICMA Research and Publications Department

Preamble

On September 14, 2023, the SBP's Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 22 percent. This decision considers recent inflation trends, which have gone down from a high level of 38 percent in May to 27.4 percent in August 2023. MPC predicts that despite of global oil price increases and adjustments in energy costs, inflation will continue to drop, especially later this year. It also noted that real interest rates will remain positive in the near future and improved agricultural output and actions taken against risky trading in foreign exchange and commodity markets are likely to help lower inflation.

The MPC observed four key developments since its July meeting viz. (1) improved agricultural prospects, (2) rising global oil prices exceeding $90/barrel, (3) a current account deficit in July [after in surplus for last four months] due to eased import restrictions, and successful measures to stabilize essential food commodity availability and reduce disparities between interbank and open market exchange rates.

The MPC pledged to monitor inflation risks and take necessary action for price stability while emphasizing the importance of maintaining a prudent fiscal stance to control aggregate demand. This approach aims to achieve a sustainable reduction in inflation and reach the medium-term target of 5-7% by the end of FY25.



MPC Observations on Key Sectors

Real Sector:

- Recent indicators show improved economic activity.
- Moderate increase in sales of key products (e.g., fuel, fertilizer, cement).
- Better agriculture sector outlook.
- Controlled domestic demand due to monetary tightening and fiscal consolidation.

External Sector:

- July 2023 had a current account deficit of $809 million after four months of surpluses.
- Imports to stay controlled by lower non-oil prices, steady demand and improved cotton production).
- Favorable rice prices and exchange company reforms boost exports.
- Current account deficit aligns with FY24 projections.

Fiscal Sector:

- First two months of FY24 saw a 27.2% increase in tax revenues.
- Achieving a 0.4% GDP primary surplus crucial for price stability.
- Broaden tax base, target subsidies, and reform public sector entities to lower inflation and aid growth.

Money and Credit:

- As of September 1, M2 growth slowed to 13.6% YoY, driven by decreased private sector credit.
- Reserve money growth also decelerated due to reduced currency in circulation.
- Expected fiscal discipline, external funding, and economic growth to boost private sector credit.

Inflation Outlook:

- August CPI inflation dropped to 27.4% from 28.3% in July.
- Decrease influenced by global oil price impact on energy prices.
- Short-term inflation expectations reversed due to FX market uncertainty.
- Regulatory measures address supply constraints and FX market issues.
- Improved agriculture and tight monetary policy will lower inflation, especially in H2.
- September inflation to rise due to base effects and energy adjustments, then fall from October onwards.

Experts' insight

When contacted by ICMA, **Mr. Asad Ali Shah, CEO of Asad Ali Shah Associates and former President of ICAP, as well as a former Advisor to the Chief Minister Sindh on Finance,** termed the MPC's decision to maintain the policy rate as "a prudent move by the SBP." He argued that raising interest rates does not alleviate inflation; it has the opposite effect. Mr. Shah also highlighted that the Government of Pakistan, as the largest borrower in the economy, bears a substantial interest burden, which currently constitutes 85% of FBR revenue. He expressed concern that if the trend of escalating interest rates persists, this figure may soon reach 100% or exceed it.

Furthermore, Mr. Shah remarked that as the government's borrowing costs rise, so does its fiscal deficit, resulting in increased borrowing. He elucidated that this deficit is financed through bank loans, which presently exceed the net growth in total bank deposits. As a consequence, the SBP is compelled to provide loans to banks to cover the government's borrowing expenses, a process that involves printing additional currency notes and, consequently, leads to heightened inflation.

In a conversation with ICMA, **Dr. Ashfaque Hasan Khan, a renowned economist and former Economic Advisor at the Ministry of Finance,** as well as the Principal of NUST School of Social Sciences and Humanities, praised the decision as "highly commendable." He firmly believed that the policy rate must be lowered as it is unrelated to inflation. Dr. Khan also emphasized that merely raising the policy rate cannot effectively counter inflation. Furthermore, he noted that in an environment where the borrowing cost hovers in the range of 24% to 25%, it consistently depresses the sentiment of the private sector.

Mr. Fahad Rauf, Head of Research at Ismail Iqbal Securities conveyed to ICMA that businesses, already grappling with weak economic growth and escalating interest costs, would welcome this decision as a sigh of relief. He further explained that an additional rate hike would have placed the banking sector under more credit stress. Mr. Rauf also pointed out that the Government's interest expenses had surged, matching FBR revenue in July, and any further increase in rates would have added to the fiscal pressure.

Talking to ICMA, **Mr. Abdul Azeem, Head of Research at Spectrum Securities Limited,** stated, "While there had been widespread expectations of a policy rate hike in line with the stipulations of the IMF program, pressures exerted by the business community have effectively deterred any such interest rate increase." He further mentioned that the anticipated alleviation of supply constraints, driven by improved agricultural output, as well as recent regulatory measures aimed at curbing speculative activity in foreign exchange and commodity markets, are poised to provide further support to the inflation outlook. He lamented that, under the current circumstances, the SBP's primary focus lies in fostering economic growth, reducing excessive financial burdens, and ensuring responsible fiscal management.

Business and Industry Viewpoint

When contacted by the ICMA R&P Department for his perspective on SBP's decision, **Mr. Irfan Iqbal Sheikh, President of the Federation of Pakistan Chambers of Commerce & Industry (FPCCI),** expressed his view that maintaining the policy rate, aimed at moderating demand, did not align with Pakistan's economic realities. He emphasized that recent price hikes were primarily caused by supply-side pressures, including supply bottlenecks, a global upswing in commodity prices, rupee depreciation, and repeated energy price increases. He voiced concerns that these energy price hikes might trigger stagflation, contradicting the declining trend observed in Pakistan over the past two months.

President of FPCCI further noted that the 'strategy of raising interest rates had been counterproductive'. He highlighted that since the initiation of these rate hikes, inflation had risen from 8.4% to 27.4%, despite a 1500 basis point increase in the policy rate during the same period. He also pointed out that SBP attributed the recent decrease in inflation to supply-side regulatory measures. He recommended a more prudent approach of reducing the policy rate instead of maintaining it, considering the substantial strain these increased rates had placed on the nation's business and industrial sectors. In comparison to regional counterparts like China (3.45%), India (6.5%), and Bangladesh (6.5%), Pakistan's policy rate remained the highest.

Mr. Dewan Mohammad Yousuf Farooqui, Group Chairman of Yousuf Dewan Companies (YDC) and a former Minister for Finance, Information, and Industries in the Government of Sindh, shared with ICMA that the total bank deposits as of August 2023 amount to Rs. 26.1 trillion. He expressed concern about this figure, attributing it to a low demand for financing from the private sector, which he finds alarming. Mr. Farooqui highlighted that on a year-on-year basis, bank deposits have surged by 18%, equivalent to Rs. 3.95 trillion. Moreover, in August 2023 alone, deposits saw a 1.6% increase, equivalent to 408 billion rupees. He further commented that at this rate, no business can maintain profitability.

Regional Analysis

Let's examine the policy and interest rates in the region comparatively. In August 2023, Pakistan stands out due to its remarkably high policy rate of 22%, along with a concerning inflation rate of 27.4%, although it has decreased from 38% in May 2023. In contrast, India maintains a relatively lower policy rate of 6.5%, even though it grapples with an inflation rate of 6.83%. Meanwhile, both Bangladesh and Sri Lanka have policy rates of 6.5% and 11%, respectively. Bangladesh faces a relatively high inflation rate of 9.92%, the highest in over a decade, while Sri Lanka's inflation rate has recently eased to 4% in August from 6.3% in the previous month. These numbers emphasize significant differences, with Pakistan having notably higher policy rates and facing substantial challenges regarding inflation when compared to its neighboring countries.

Recommendations

ICMA emphasizes the importance of implementing measures to control inflation and reestablish business confidence for the sake of ensuring economic stability. It is imperative that the government assesses how inflation affects consumers and businesses and devises targeted policies to address it. Furthermore, transparency and effective communication regarding the government's commitment to maintaining price stability can be instrumental in rebuilding trust among businesses and investors. A stable and predictable economic environment, as a result, can stimulate investment and foster economic growth.

ICMA underscores the importance of incentivizing banks to promote lending to the private sector, which can facilitate capital formation and encourage productive investments. This can be achieved through actions such as reducing interest rates on loans for businesses operating in productive sectors, offering tax incentives to banks supporting private sector financing, and simplifying the loan approval process to stimulate lending to businesses. Ensuring businesses have access to affordable credit can drive economic growth, create jobs, and contribute to a more stable economy. With bank deposits reaching Rs. 26 trillion in August 2023, it is essential to harness these funds effectively to finance private sector projects, thereby stimulating economic activity.

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