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ICMA
MONETARY POLICY STATEMENT

MPS REVIEW

ISSUE # 01 | JANUARY 27, 2023

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

ICMA Research and Publications Department

With a prime focus on controlling elevated and persistent inflationary pressures against the backdrop of a sequence of domestic supply disruptions and global headwinds, the Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP), in its latest meeting held on January 23, 2022, jacked up the policy rate by 100 basis points to 17 percent.

This decision came largely in line with the market's expectations; however, some quarters in the market were expecting an increase of up to 200 basis points due to the recent uptick in secondary market bond yields and external account concerns. To align with the deteriorating macros, the target rate has been raised by 325 basis points since the fiscal year 2022-2023.

The decision is based on three important economic developments. First, the MPC noted that despite some signs of moderation in the last two months, the main risk was inflationary pressures that would remain sticky owing to uncertainty on their future path, which is reflected in businesses' and consumers' inflation expectations in the latest pulse surveys.

To note, the headline inflation rate of 25.02% YoY during 1HFY23 has stayed above the central bank's inflation forecast of 21-23% for the ongoing fiscal year. When we factor in this rising inflation, the purchasing power of the masses reduces inevitably, thus eroding their real income, the single biggest cost of inflation. And it seems that the inflation monster is unlikely to settle down in the near future due to the potential rise in energy prices.

Subsequently, the Governor SBP, Mr. Jameel Ahmed, said in a press conference, "The government's 2% economic growth estimate this year may see pressure."

Second, the lack of fresh financial inflows and ongoing debt repayments have led to a continuous drawdown in official reserves. Third, the global economy is navigating through rough waters driven by uncertainties in the near-to-short term, leading to mixed implications for the domestic economy.

That said, the outlook of exports and workers' remittances would be negatively affected which are the backbone of Pakistan. This would partly offset the gains from the import contraction. It is worth highlighting that the central bank placed restrictions on the opening of Letters of Credit (LCs) due to the low level of foreign exchange reserves.

To address the near-term external challenges faced by the nation, the MPC stressed engagements with multilateral and bilateral creditors to overcome domestic uncertainty. Most importantly, the revival of the ninth review of the International Monetary Fund's (IMF) programme is critical to unlocking inflows from friendly countries and multilateral partners.

How market experts see...

Fahad Rauf, Head of Research at Ismail Iqbal Securities told ICMA that this rise in interest rate would not help the business activities as they continue to contract due to subdued demand and high inflation that impact consumers' spending.

He is of the view that this increase in policy rates may be attributed to the resumption of talks between the IMF and the government since it is one of the conditionalities of the fund.

"However, it appears that the SBP has come under tremendous pressure, taking on much responsibility in areas where its current fiscal stance is incompatible with monetary tightening," he added.

This move would not help control inflationary pressures in the near future because interest rates are used to curb demand-pull inflation rather than cost-push inflation.

Under the challenging global economic situation and delay in the IMF program, Topline Securities noted that the rolling over of debt would remain a challenge unless the country swiftly completes reforms and get IMF on board.

A negative impact on business...

The conditions are so bleak for businesses as traders and industrialists remain deeply pessimistic about increasing interest rates, saying that this would bring a strong storm of inflation when they are already feeling the brunt of the non-opening of LCs to import raw materials along with high-energy tariffs. This decision would further discourage private sector growth due to the rise in debt servicing costs and make businesses uncompetitive.

The business community reacted strongly against the decision to raise the policy rate by 100 basis points and termed the central bank's actions "unwise."

Dr. Ikram Haq, a member of the Advisory Board and Visiting Senior Fellow of the Pakistan Institute of Development Economics (PIDE), has apprised ICMA that "The historic high policy rate of 17% will have a disastrous impact both for government and businesses, and the ultimate sufferers will be citizens." "The increase in government debt servicing, specifically interest payments, will be phenomenal."

The government is the largest borrower from commercial banks. The larger than anticipated payment of interest, called markup in Pakistan, will not only squeeze the fiscal space of governments, federal and provincial but also make it impossible for businesses to pay old liabilities based on flexible markup rates, he noted.

There will be huge write-offs by banks on account of non-performing loans. New investments based on borrowed money will be too costly to be absorbed. Even the existing businesses may not be able to pass it on due to demand contraction and the worsening purchasing power of citizens.

"It will certainly push the country toward growth retardation, new indirect taxes by governments to meet the fiscal deficit, and above all, no new investments and hyperinflation."

Speaking to ICMA, former Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI), Muhammad Waseem Vohra, said, "An increase in the policy rate by 1% means access to bank loans for trade and industry will be above 20%." At such exorbitant interest rates, no business can be competent. This move to raise the policy rate up to 17 percent will further increase inflationary pressure on the economy.

While commenting on SBP's move, President Karachi Chamber of Commerce & Industry (KCCI) Mohammed Tariq Yousuf termed it as an unfair hike, adding that, it would raise the cost of doing business.

"The recent devaluation of the rupee will lower business competitiveness. In the current scenario, the prices of imports will increase which in turn harms the economy with a non-competitive business environment and rising inflation," President KCCI told ICMA.

Two days after the MPC meeting on January 26, 2023, the Pakistani Rupee (PKR) witnessed the recent 10% DoD depreciation against US Dollar (USD) in an interbank trade when the Exchange Companies Association of Pakistan (ECAP) removed the price cap on the rupee-dollar exchange rate to reduce the spread between interbank and open market rates.

The next few months will be critical

In the fast-developing situation, an IMF mission is scheduled to visit Pakistan from January 31 to February 9, 2023 to continue the discussions under the ninth review that has been pending for four months.

The fund's resident representative Esther Perez Ruiz said, "The mission will focus on policies aimed at restoring domestic and external sustainability, including strengthening the fiscal position while supporting those affected by the floods, as well as power sector reforms."

With the revitalization of the IMF program, the country would be able to unlock other external avenues for funding, especially from friendly countries. Needless to say, the government is taking serious and responsive actions to meet IMF demands, which is a prerequisite for improving the debt management outlook.

This encouraging development comes right after accepting the IMF's demands; a market-determined exchange rate an increase in the policy rate.

Many experts are of the view that this development of removing a self-imposed cap on the rupee-dollar exchange rate is indeed welcoming in these tough times as it would eliminate the black market and bring back foreign currency inflows into the formal system.

"It is a good step. Ideally, the rate should be market-determined as per IMF requirements," said Fahad Rauf.

Meanwhile, considering the IMF's major demands, the imposition of additional taxes to make up for the revenue slippages and the increasing electricity and gas tariffs will further stoke up inflation.

Way Forward

Faced with higher energy and food prices, ICMA believes that the government must improve fiscal measures by moving from broad-based support to targeted cash transfers to help the most vulnerable segment while keeping a tight fiscal stance to rein in high inflation. Any attempt to limit price increases through subsidies and tax cuts would be counter-productive. Fiscal and monetary policies need to go hand in hand to achieve economic stability.

ICMA further recommends that the government adopt a three-pronged strategy to stimulate growth in exports, remittances, and industrial productivity. Unfortunately, all three of these macro indicators are on a downward trajectory and represent the prime reason for declining forex reserves. Immediate measures are required to rescue businesses and industries from the economic slowdown.

As far as relief to the masses is concerned, the government must take administrative measures to avoid any supply chain disruption. To note, higher food prices are the main driver of intensified inflationary pressures. In this regard, the government must direct all district commissioners to ensure that edibles are sold at fixed government prices while preventing profiteering and hoarding of essential edibles.