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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 State Bank of Pakistan's (SBP) Monetary Policy Committee (MPC) has reduced the policy rate by 100 basis points to 12 percent, effective January 28, 2025, as inflation continued its downward trend, reaching 4.1% year-on-year in December 2024. This decline was driven by moderate domestic demand, supportive supply-side factors, and a favorable base effect. While inflation is expected to ease further in January, it may rise slightly in the coming months. Core inflation remains elevated, and economic activity continues to improve, supported by the cumulative 1,000 basis point rate cut since June 2024.

Key developments include slightly lower-than-expected GDP growth in Q1-FY25, a current account surplus in December 2024, and declining foreign exchange reserves due to low financial inflows and high debt repayments. Tax revenues, despite improving in December, fell short of H1-FY25 targets, while global oil price volatility and an uncertain global economic environment added risks. The MPC stressed the importance of maintaining a positive real policy rate to stabilize inflation within the 5% to 7% target range and ensure sustainable economic growth.

MPC Observations on Key Sectors

Real Sector

- High-frequency indicators show continued momentum in economic activity, with notable increases in automobile, POL, fertilizer sales, import volumes, electricity generation, and private sector credit disbursement.
- Real GDP growth for Q1-FY25 slowed to 0.9%, compared to 2.3% in Q1-FY24, mainly due to a sharp decline in agriculture sector growth (1.2% vs. 8.1% last year).
- Modest wheat crop output is expected, as indicated by satellite data.
- Decline in large-scale manufacturing (LSM) growth moderated, driven by low-weight items like furniture, while key sectors such as textiles, food and beverages, and automobiles improved.
- Business confidence remains positive, with GDP growth for FY25 expected to stay within the 2.5% to 3.5% range.

External Sector

- The current account posted a $0.6 billion surplus in December, bringing the H1-FY25 cumulative surplus to $1.2 billion.
- Strong workers' remittances and high-value-added (HVA) textile exports drove the surplus.
- Import growth accelerated due to higher volumes, reflecting improved economic activity, though remittances offset the widening trade deficit.
- The current account balance outlook has improved, expected to remain between a surplus and a deficit of 0.5% of GDP in FY25.
- Net financial inflows, though weak in H1-FY25, are anticipated to improve as major official debt repayments have already been made.
- SBP's foreign exchange reserves are projected to exceed $13 billion by June 2025, supported by improved current account trends and planned financial inflows.

Fiscal Sector

- FBR revenues grew by 26% during H1-FY25 but remain below the annual target.
- A significant acceleration in tax revenue growth is required to meet the annual target.
- Fiscal balance improved in H1-FY25 due to contained expenditures.
- Lower-than-budgeted interest payments are expected to help contain the fiscal deficit within its target.
- Achieving the target for the primary balance remains challenging.

Money and Credit

- Broad money (M2) growth decelerated to 11.3% y/y as of January 17, down from 13.3%.
- Decline in M2 growth primarily due to slower NDA growth.
- Government borrowing shifted from banking system to non-bank sources.
- Bank credit to the private sector grew sharply, driven by economic recovery, easing financial conditions, and banks' efforts to meet ADR thresholds.
- Bank deposits declined, while currency in circulation saw a slight increase.

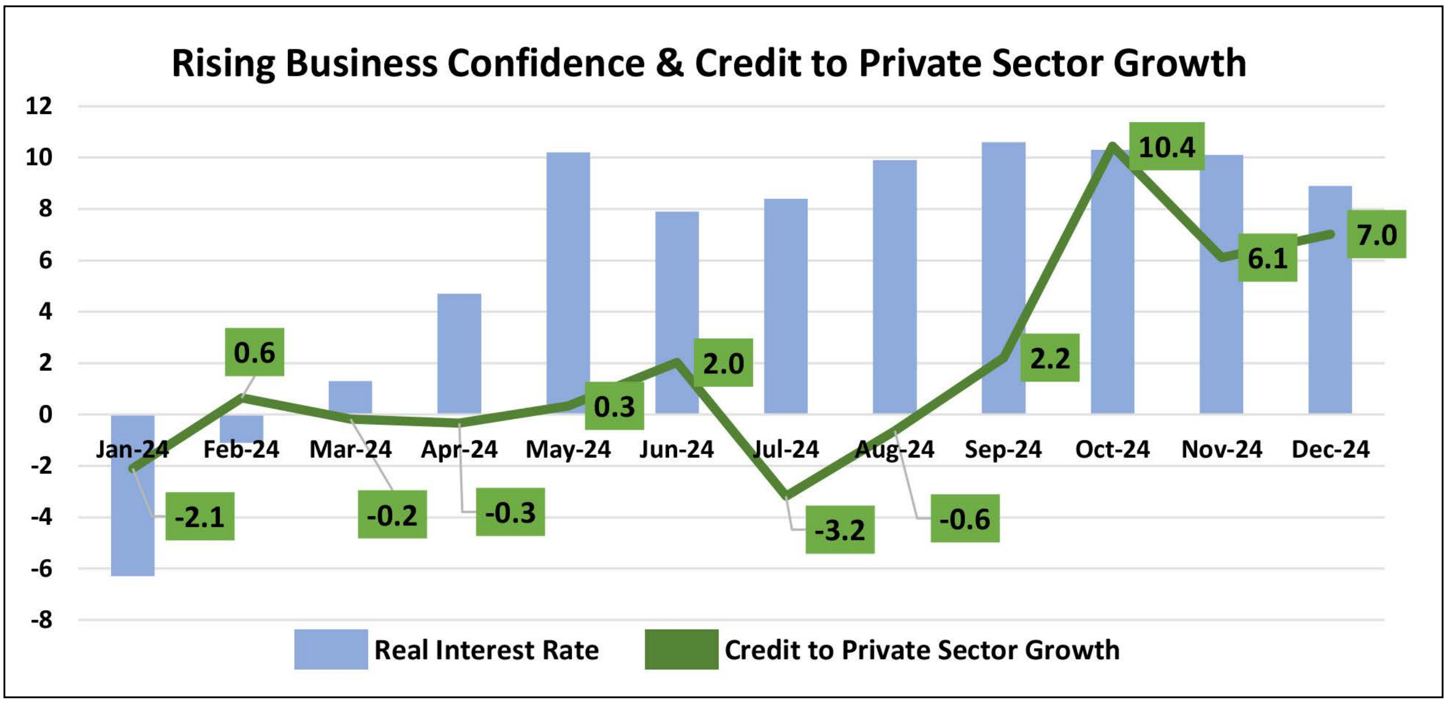
Inflation Outlook

- Headline inflation eased to 4.1% y/y in December, down from 4.9% in November.
- Inflation decline driven by lower electricity tariffs, stable food supply, stable exchange rate, and favorable base effect.
- Core inflation moderated but remains elevated due to contained domestic demand.
- Inflation expectations remained volatile.
- MPC expects inflation to rise toward the upper end of the target range 5.5% to 7.5% by FY25's end.
- Risks to inflation include global commodity price volatility, protectionist policies, energy tariff adjustments, and perishable food price fluctuations.

ICMA Analysis

The ICMA analysis examines the relationship between private sector credit growth and real interest rates in 2024, reflecting Pakistan's changing economic conditions. In figure:1, during the first half of the year (Jan-Jun 2024), credit growth remained subdued despite a significant shift in real interest rates from -6.3% in January to 10.2% in May. This stagnation highlighted cautious business sentiment, weak demand, and tight financial conditions. In July, credit growth contracted sharply by -3.2%, even with a positive real interest rate of 8.4%, suggesting seasonal or structural issues in the lending environment. However, the monetary easing measures introduced in mid-2024, which included a cumulative 1,000 basis point policy rate cut, began to take effect in the second half of the year. By Q4, private sector credit growth rebounded strongly, rising to 10.4% in October, 6.1% in November, and 7.0% in December, as improved financial conditions and business confidence encouraged lending activity.

Figure:1



Source: SBP, Analysis by ICMA.

These improvements suggests that businesses started to respond to improved financial conditions, supporting the State Bank of Pakistan's (SBP) expectations for economic recovery. The MPS of Jan 2025 acknowledged a gradual improvement in economic activity, particularly in industrial sectors such as textiles, food, and automobiles, which likely contributed to the rising credit demand. The 100 bps rate cut to 12% in Jan 2025 aims to further support this momentum while ensuring inflation remains within the target range of 5 to 7%. However, external risks such as volatile global oil prices, revenue shortfalls, and uncertain financial inflows remain key concerns that could influence economic conditions and credit expansion in 2025.

ICMA Research and Publications (R&P) Department reached out to renowned economists and experts, as well as the businessmen and industrialists, to gather their insights on the recent 100 bps reduction in the policy rate by the State Bank of Pakistan (SBP). Their views and perspectives are summarized below:

Experts' Insight

Dr. Ashfaque Hasan Khan, a distinguished economist and former Economic Advisor at the Ministry of Finance, congratulated the Governor SBP and the Monetary Policy Committee for continuing with the rate cut based on the declining trend in inflation. However, he emphasized that a more substantial reduction was necessary to revive the economy, adding that a cut of 100 bps was too conservative and he expected at least a 200-250 bps reduction. He noted that with the policy rate standing at 12% and inflation rate at 4.1%, the real interest rate was almost 8%. He explained that, given the growth projection of 3% for the current FY, having a real interest rate exceeding real GDP growth by such a wide margin would destabilize Pakistan's economy. He also said that such a high real interest rate, coupled with an unconducive business environment would keep investment subdued, and growth might hover between 2.5-2.7% in the current FY. He warned that persistence of such low growth would lead to higher unemployment and poverty.

Prof. Dr. Shahida Wizarat, another renowned economist from Pakistan, when contacted, stated that she thinks the policy rate should have been much lower, i.e., around 8 or 9%.

Mr. Asad Ali Shah, CEO of Asad Ali Shah Associates and Former Advisor to the Chief Minister of Sindh on Finance, noted that despite inflation dropping to 4% in December 2024 and expected to ease further in January, the SBP's decision to lower the policy rate by 100 bps to 12% falls short of addressing the stagnant economy and does not provide the necessary stimulus to spur investment and demand for economic recovery. He pointed out that KSE-100 Index dropped by nearly 1,300 points, signaling the market's disapproval of this insufficient move in the current economic environment. Mr. Shah emphasized that more bold and comprehensive actions are essential to drive meaningful growth and resolve the structural challenges facing the economy.

Dr. Ikram ul Haq, a member of the Advisory Board and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE), stated, "This meagre reduction is not in line with ground realities, as according to the government's claims, inflation is around 3% now. The cautionary approach of the Committee shows that it is still of the view that the stabilization process of the economy has not yet reached a satisfactory level. External vulnerabilities are casting their imprint on the balance of payments situation, and internal borrowing is increasing. In these circumstances, growth will remain timid. The debt burden of the government, including debt servicing, will not recede to a level that can substantially bridge the fiscal deficit.

Mr. Muhammad Sabir, Principal Economist at the Social Policy and Development Centre (SPDC), views the 100-basis point policy rate cut as a positive step, but one that falls short of expectations for a more substantial move toward a single-digit rate. He believes the State Bank adopted a cautious approach, likely influenced by the potential impact of the upcoming energy price hike. Mr. Sabir expects the rate cut to have a modest positive effect on growth, as reflected in the unchanged growth projection. It is also likely to reduce public expenditure, as domestic debt servicing costs are expected to decline. However, this benefit may be partially offset by a slight reduction in tax revenue due to interest payments.

Mr. Abdul Azeem, Head of Research at AL Habib Capital Markets (Pvt.) Ltd, in a conversation with ICMA, noted that 100 bps policy rate cut to 12% seems appropriate given the current economic conditions, striking a balance between controlling inflation and stimulating growth. With inflation easing to 4.1% in Dec-24 and GDP growth remaining subdued at 0.9% in 1QFY25, the reduction supports economic recovery while preserving price stability. A larger cut might have risked inflationary pressures, particularly through elevated import demand stimulated by increased domestic consumption. The decision reflects SBP's cautious approach to stabilizing the economy amid global uncertainties. However, further adjustments to policy rate may be necessary if economic activity continues to lag or inflation moderates faster than anticipated.

Mr. Aadil Nakhoda, a faculty member at IBA Karachi, stated that it appears the government is adopting a cautionary stance rather than an aggressive one in reducing the interest rate. He noted that the SBP had been relatively more aggressive in previous instances, making larger cuts. According to him, the SBP seems to prefer maintaining higher positive interest rates as inflation continues its downward trend. He also highlighted that with imports rising as economic growth recovers, there is likely to be pressure on foreign exchange reserves, which could lead to future balance of payments issues. Mr. Nakhoda suggested that the cautious approach is likely being adopted with the current account in mind. He added that the actions taken in the next MPC meeting will be crucial.

Mr. Muhammad Fawad Khan, CFA, Equity Research Analyst and a former Analyst on PSX, stated that the central bank has rightly adopted a measured approach in setting the policy rate. He mentioned that while progress on the external account and inflation in the first half of the year was encouraging, the expected pickup in economic activity will likely result in renewed pressure on the external account. He also noted that the low-base effect of the Consumer Price Index (CPI) is likely to wear out.

Industry's Perspective

Mr. Asif Inam, Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI), stated that the policy rate should be gradually reduced. He appreciated the SBP's decision to bring it down to twelve, considering it a good move. He suggested that further reductions should be made in each meeting, and after three or four meetings, the rate would be at an appropriate level. He expressed his appreciation for this approach.

Mr. Sohail Altaf, Group Leader of Rawalpindi Chamber of Commerce and Industry (RCCI), stated that a larger cut was required and that 100-bps reduction falls far below the expectations of the business community.

Mr. Dewan Mohammad Yousuf Farooqui, Group Chairman of Yousuf Dewan Companies (YDC) and former Minister for Finance, Information, and Industries in the Sindh Government, shared his perspective with ICMA R&P Department, stating that while the initiative is good, more action is needed to boost the economy. He emphasized that a single-digit interest rate is required for the revival of the economy.

Mr. Muhammad Jawed Bilwani, President of the Karachi Chamber of Commerce and Industry (KCCI), stated that the 100-bps cut in the policy rate fails to alleviate the financial strain on businesses, particularly small and medium enterprises (SMEs), which are struggling with rising input costs, including energy tariffs, fuel prices, and raw materials. He noted that the high 12% policy rate continues to act as a major barrier to accessing affordable credit, thereby hindering business expansion and economic recovery. Mr. Bilwani highlighted the contrast with regional economies, such as India, where the policy rate is 6.5%, enabling industries to thrive with lower financing costs. He argued that despite Pakistan's inflation dropping to 4.1% in December 2024—the lowest in over six years—the SBP's conservative approach does little to stimulate industrial growth or attract investment.

"A more meaningful reduction in the interest rate would have signaled to investors, both local and international, that Pakistan is serious about fostering a business-friendly environment," Bilwani emphasized. He added that high interest rates not only discourage investment in productive sectors but also redirect capital toward speculative markets, such as real estate and foreign exchange, further straining the economy.

Mr. Masood Naqi, Executive Director of Rajby Industries and Former Chairman of the Korangi Association of Trade and Industry (KATI), in a conversation with ICMA's R&P Department, shared that the announcement of a 200 bps reduction to 13% was made last month. Today, the rate has been further reduced by 100 bps to 12%. He commended this move as a positive step and emphasized that it should continue until the rate reaches single digits. This reduction will not only foster capacity building and industrialization but also stimulate trading activities. Additionally, it will play a key role in achieving export targets and boosting tax revenues.

ICMA Policy Recommendations

Based on the observations from the Monetary Policy Statement, ICMA is of the view that the following policy recommendations align with the current economic scenario and the monetary policy stance outlined by the SBP:

1. **Targeted Lending Programs:** Although ICMA had called for a 200-bps reduction, ICMA is of the view that the MPC's decision to reduce the policy rate by 100 bps is still a step in the right direction towards supporting economic activity and stimulating growth. In this context, ICMA suggests that it would be prudent to create a low-interest lending program targeted at high-potential export sectors like textiles, food, and automobiles. This initiative would foster growth in these key sectors while managing inflationary pressures, as these industries can contribute significantly to foreign exchange earnings and employment, in line with the MPC's projection of continued economic momentum.

2. **Leverage Digital Platforms to Close Tax Gap:** ICMA observes that the MPC has highlighted a shortfall in tax revenues and emphasized the need for fiscal discipline. To address this challenge, ICMA suggests leveraging digital platforms to enhance tax compliance, particularly for small-scale businesses. The adoption of a digital tax invoice system for SMEs would minimize underreporting and bring more businesses into the formal tax base. ICMA believes this would help bridge the gap between tax revenues and targets, aligning with the MPC's assessment of fiscal challenges.

3. **Targeted Credit Creation:** ICMA acknowledges the MPC's view that the policy rate reduction will support economic activity and facilitate growth. In light of this, ICMA is of the view that creating a startup financing initiative offering lower interest loans to startups in emerging sectors such as IT, AI, and renewable energy would stimulate innovation and entrepreneurship. This aligns with the MPC's expectation of continued growth and economic expansion, particularly in sectors with high growth potential that can contribute to the overall economic recovery.

4. **Agri-Tech & Greater Yield Farming:** Given the MPC's observations regarding the slowdown in agricultural growth, particularly in wheat production, ICMA thinks it is crucial to invest in Agri-tech solutions to improve productivity. Public-private partnerships focused on precision farming, climate-resistant crops, and advanced monitoring technologies would address agricultural challenges and improve yield. This recommendation is in line with the MPC's focus on managing supply-side dynamics and mitigating inflationary pressures from agriculture, which has been a key factor in controlling inflation.

5. **Pilot Digital Currency Launch:** ICMA believes that the evolving global economic environment, as noted by the MPC, calls for modernization of the monetary system. In this regard, ICMA is of the view that a pilot program for a Central Bank Digital Currency (CBDC) would not only enhance the efficiency of monetary transmission but also reduce currency in circulation and provide a more accurate tracking of money flows. This initiative would align with the MPC's objective of maintaining price stability and ensuring smoother implementation of monetary policy, particularly in the face of global economic uncertainty.

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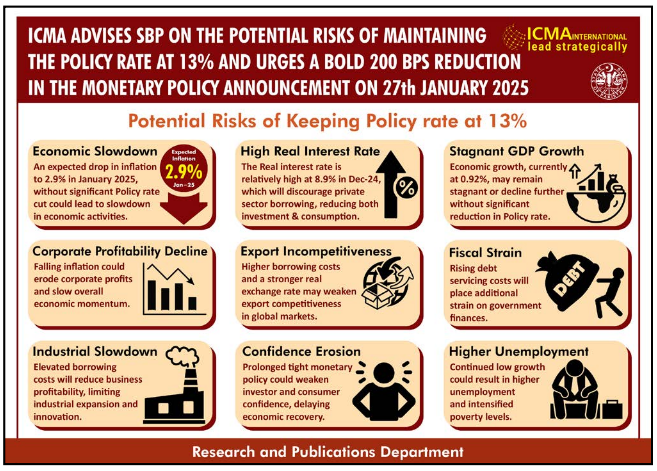

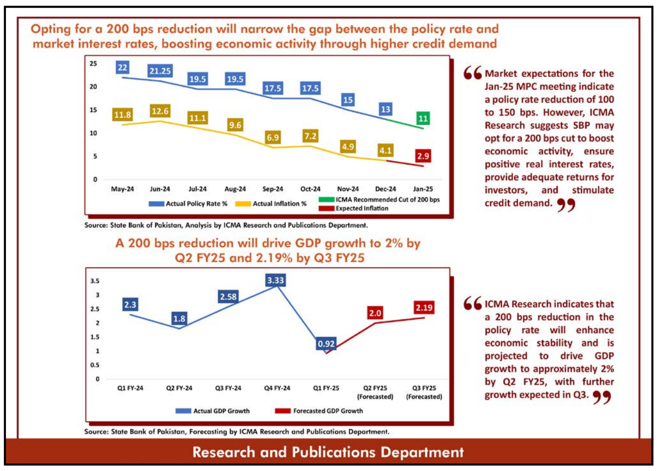

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