ICMA INTERNATIONAL lead strategically

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

During the last six months of the previous fiscal year (Jan-Jun '23), the Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) convened five times and increased the key policy rate from 16% to 22% in order to counter the upward trend in inflation. The rate increases were effective from the following dates:

- On 23rd Jan '23, the MPC decided to raise the policy rate by 100 bps from 16% to 17%.
- On 2nd Mar '23, the policy rate was increased by 300 bps to 20%.
- On 4th Apr '23, the policy rate was again raised by 100 bps to 21%.
- On 12th Jun '23, the MPC decided to keep the policy rate unchanged at 21%.
- On 26th Jun '23, the policy rate was raised by 100 bps to 22 percent.

The MPC convened the first meeting of the current fiscal year on 31st July 2023 which reviewed the key developments since its last meeting on 26th Jun-23 and decided to keep the policy rate unchanged at 22%.

MPC Observations on economic outlook

Based on the following four significant developments since its last meeting on 26th Jun-23, the MPC decided to keep a tight monetary policy stance to achieve medium-term inflation target of 5% to 7% by the end-FY25:

1) Pakistan secured a 9-month SBA with the IMF, stabilizing external concerns and boosting FX reserves.
2) Increased electricity tariffs may contribute to inflation in the coming months.
3) Global commodity prices rose but are below recent peaks.
4) IMF slightly raised 2023 global growth projection - 2024 projection remains unchanged

The MPC in its monetary policy statement has made projections/ forecasts for the following key sectors:

Real Sector: The real GDP growth is projected to be in the range of 2% to 3% in FY24.

External Sector: Current Account Deficit (CAD) to remain in the range of 0.5% to 1.5% of GDP in FY24.

Fiscal Sector: Fiscal and primary deficits set to exceed FY-23 estimates, fueling inflation.

Money and Credit: FY24 to see moderate private sector credit expansion with improved external financing and economic uptick.

Inflation Outlook: In FY24 average inflation to remain in the range of 20% to 22%, down from 29.2% in FY23.

Sri Lankan Perspective

The ICMA Research Department analyzed Sri Lanka's key developments since the Central Bank of Sri Lanka (CBS) adopted a tightening monetary policy in August 2021 due to increasing inflation and balance of payments pressures. Inflation peaked in September 2022. Subsequently, in March 2023, the CBS raised its policy interest rates by 100 basis points (bps) following negotiations with the IMF, fulfilling a prior action of the Extended Fund Facility (EFF). However, in June and July 2023, as inflation moderated, the CBS began easing the monetary policy stance by reducing policy interest rates. Rates were cut by 250 bps to 13% (Standing Deposit Facility Rate - SDFR) and 14% (Standing Lending Facility Rate - SLFR) in June 2023.

The latest Monetary Board meeting on July 5, 2023, resulted in a further reduction of the SDFR and SLFR by 200 bps to 11% and 12%, respectively. This decision taken keeping in view swift disinflation and positive inflation outlook and aimed at keeping inflation around mid-single digits in the medium term, and ease financial market pressures. CBS has urged the banking and financial sector to pass on the benefits of this significant monetary policy easing to individuals and businesses.

Outlined below are the key developments resulting from CBS's tightened monetary policy stance:

- The SL economy has stabilized with timely macroeconomic policies and structural reforms.
- External sector improves with increased FX inflows, stronger BOP and a stable Sri Lanka rupee.
- International reserves gradually build up, reducing external sector vulnerabilities.
- Colombo Consumer Price Index (CCPI) inflation moderates from 70% to 12% by June 2023.
- Year-on-year CCPI-based core inflation has also fallen below 10 percent by June 2023.
- Domestic economic activity expected to rebound with eased monetary conditions
- Credit to productive sectors likely to improve, contributing to economic stabilization and rebound.
- Projections of inflation and real economic growth have both upside and downside risks, with medium-term projections skewed to the upside.

Experts' insight

Mr. Fahad Rauf, Head of Research at Ismail Iqbal Securities told ICMA that the SBP's decision marks the end of the tightening cycle, barring any shocks. He added that there are still some challenges on the inflation front as the impact of recent electricity prices, and the expected increase in petroleum prices is yet to be reflected. However, the higher base effect would still bring down the inflation rate to an average of 20% in FY24, implying a positive real rate of 2%. Mr. Fahad Rauf projected that the real rate would increase as we move ahead into the fiscal year as inflation is expected to fall sharply in second half of FY24. He also stated that the equity market will take it positively as there were still some expectations around the rate hike. For the business community, he opined that they would have to wait a few more months before the easing cycle starts and the cost of financing reduces. He concluded that the most important factor would be to continue compliance with the IMF program, which would enable the economy to move from consolidation phase towards the growth phase in FY25.

Syed Fawad Basir, Head of Research at AL Habib Capital Markets Pvt Ltd., told ICMA that inflation has been declining for the past three months, dropping from 38.4% in May-23 to 28.3% in July-23, aligning with expectations. Considering this trend, the SBP maintained a status quo in its last MPC meeting on 31st July. The IMF's SBA program and deposits from friendly nations have provided breathing space to the country. He was of the view that further interest rate hikes would put severe pressure on the fiscal side due to high PIBs and T-Bill costs. The decision reflects the need to kickstart the economy and achieve stability.

Mr. Muhammad Arsalan Siddiqui, an Industry Expert while talking to ICMA, opined that SBP's unchanged policy rate stance indicates forthcoming improvement in macro variables due to the revival of the IMF program. Despite a downward inflation trajectory in FY24, SBP remains concerned about upside risks from recent energy tariff hikes and rebounding international commodity prices. He added that this may delay the monetary easing cycle in the next MPC meeting scheduled in Sep-23 until the second-round inflationary impact is contained, and the risk of imports recovery remains limited. He also suggested that SBP may adopt a data-driven approach, considering factors such as the pace of demand recovery, oil price volatility, FX reserves position, and currency movement for future monetary policy decisions. Looking ahead, twelve months forward-looking real interest rates are expected to be in the high single digits by the end of 2023, allowing room for interest rate cuts. However, the magnitude of the rate cut will depend on external account stability, potentially resulting in policy rates remaining in the high to mid-teen range throughout 2024.

Talking to ICMA, **Dr. Ashfaque Hasan Khan, renowned economist, former Economic Advisor at Ministry of Finance** and Principal of NUST School of Social Sciences and Humanities said that "This decision will simply minimize the cost to the economy. The best course of action would have been for the SBP to reduce the interest rate by 2.0 percentage points to 20%."

Mr. Irfan Hassan, an Islamic banking expert told ICMA that while IMF conditionality will be met, borrowers will be overburdened by excessive financing costs. As a result, businesses will pass on this cost to consumers, leading to further increases in the prices of consumable goods. He further told ICMA that future increases in the discount rate could be counterproductive and may lead to stagflation.

Business and Industry viewpoint

Mr. Almas Hyder, Chairman, Synthetic Products Enterprises Ltd. and Former President of Lahore Chamber of Commerce and Industry while talking to ICMA, mentioned that inflation is driven by imported goods, particularly primary products like oil, food, and raw materials. He observed that no interest rate increase will affect or reduce imports or have any impact on inflation. He questioned why our country should bear the burden of poverty by considering a rate increase. Additionally, he emphasized that inflation is a result of the balance between supply and demand. He pointed out that inflation can be curbed by controlling demand or increasing supply. The example of potatoes was given to illustrate that they are sold at Rs. 8 during the surplus supply at harvesting time but increase to Rs. 40 or more when supply becomes constrained after six months. The lesson learned is that to control inflation, production should be increased, he added.

Mr. Farough Ali Naweed, CEO of DigiTech Synergy (Private) Limited, informed ICMA that increasing Markup rates can only control Demand Pull inflation. However, in Pakistan, high markup is not only the cause of high inflation but has also led to an economic downturn. He mentioned that businessmen might contemplate moving from Pakistan to developing economies like Bangladesh, particularly in the textile sector. Hence, reducing the markup rates is imperative as it addresses the current need of the time.

What Next?

So, what comes next? After the State Bank of Pakistan's decision, different experts have different thoughts. Some see the tightening cycle possibly ending, while others are concerned about ongoing inflation. Most agree that looking ahead involves improving the bigger economic picture, boosting the economy, and keeping inflation in check. The future entails adjustments and meticulous economic planning, especially with the new caretaker setup scheduled to assume power by the end of August or early September 2023.

The ICMA Research Department engaged in a discussion [on LinkedIn] with Mr. Navin Perera, a Sri Lankan Economist, to explore the impact of the Central Bank's tight monetary policy on the Sri Lankan economy. He expressed that *'the significant tightening of monetary policy led to a historic surge in market interest rates, resulting in a noticeable contraction/moderation of credit/broad money. Without such monetary tightening, the potential outcomes could have been even more unfavorable, potentially leading to uncontrollable inflation. Moreover, there was an increase in taxes, reducing disposable incomes and partially aiding in alleviating demand pressures. The decrease in food and energy prices also played a role in easing inflation'.*

We asked him as to what is his viewpoint on the tightening monetary policy stance by State Bank of Pakistan. He told ICMA that *'Pakistan's case has many similarities with that of Sri Lanka - high inflation, escalating energy prices, sluggish economic growth, a vulnerable external sector, fiscal challenges, reliance on IMF assistance, political instability, and more. Looking at it from a monetary policy perspective, and considering price stability as a primary goal, the State Bank of Pakistan (SBP) might have somewhat delayed tightening its monetary policy (MP), in my view. As I currently observe, Pakistan is experiencing a slight reduction in both headline and core inflation (YoY), and this downward trend is projected to continue, reaching approximately 20-22%. The question that arises is: within what timeframe? Will it occur by the year's end or over the medium term (in 6-8 quarters)? If the latter holds true, it suggests that inflation might persist for a longer duration. Nevertheless, this moderation in inflation is largely attributed to the high statistical base effect."*

In conclusion, considering the Sri Lankan experience, ICMA is of the viewpoint that it is vital for the State Bank of Pakistan (SBP) to carefully evaluate core inflation and its endurance. Keeping a tight monetary policy (MP) might be needed unless inflation pressures are set to ease. Maintaining price stability is crucial to avoid a return of inflation. It's important to watch energy and food prices while being mindful of excessive MP tightening, which could negatively affect the economy and people's well-being. Achieving the right balance is crucial. As inflation forecasts show moderation towards target levels in the medium term, considering easing MP is prudent, as long as significant inflation risks don't arise.

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