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MPS REVIEW

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

ICMA Research and Publications Department

Preamble

In the most recent Monetary Policy Committee (MPC) meeting convened on January 29, 2024, the State Bank of Pakistan (SBP) decided to keep the policy rate unchanged at 22 percent. This resolution echoes the choices made in the preceding three meetings held in September, October and December 2024, during which the MPC consistently opted for policy rate stability. The rationale behind this decision encompassed various economic considerations, including the repercussions of administered energy price adjustments on inflation, as well as positive developments observed in foreign exchange reserves, fiscal consolidation, and business sentiments.

Looking forward, the MPC foresees average inflation falling within the range of 23 to 25 percent in FY24, with a continued noticeable decline expected in FY25. Despite the influence of geopolitical tensions on global trade, the SBP is resolute in maintaining a stringent monetary policy stance. This aligns with ongoing efforts in fiscal consolidation and external inflow strategies, all geared towards achieving the inflation target of 5-7 percent by September 2025.

MPC Observations on Key Sectors

Real Sector

- **Economic Recovery:** Current data shows a moderate economic recovery, primarily steered by the agricultural sector.
- **GDP Growth Projection:** Real GDP growth projection seems stable in the 2 to 3 percent range for FY24.
- **Crop Performance:** Kharif crops have outperformed last year's output, and the outlook for Rabi crops is optimistic due to improved input conditions.
- **Industry Performance:** LSM had a minor decline in Jul-Nov FY24, followed by an uptick in November. The Committee expects an upward momentum in the industrial sector from the second half of FY24.
- **Industry Capacity Utilization:** Recent surveys indicate a consistent rise in capacity utilization within the manufacturing sector.
- **Positive Business Sentiments:** Business sentiments, for both industry and services, turned positive for the first time since April 2022.

External Sector

- **Current Account:** The Dec-23 current account surplus substantially reduced the H1-FY24 deficit by 77 percent, reaching US$ 0.8 billion.
- **Export Growth:** Exports showed a 5.3 percent year-on-year growth in H1-FY24. This growth was supported by increased rice exports and higher volumes of High-value-added (HVA) textiles.
- **Import Decline:** Global commodity price decrease, better domestic crops, and lower oil imports caused a significant drop in overall imports, more than offsetting the rise in non-oil imports.
- **Remittances:** Workers' remittances showed improvement for the second consecutive month in Dec-23.
- **Financial Account:** Official inflows in December, coupled with the receipt of IMF-SBA tranche, bolstered the SBP's Foreign Exchange (FX) reserves, reaching $8.3 billion as of January 19, 2024.
- **Current Account Deficit:** Despite modest economic recovery and a heightened level of profit and dividend repatriation, the Committee highlighted an unchanged projection of the current account deficit for FY24 in the range of 0.5 to 1.5 percent of GDP.

Fiscal Sector

- **Fiscal Position:** The fiscal position exhibited improvement during Jul-Oct FY24.
- **Overall Deficit:** The overall deficit saw a decline, reaching 0.8 percent of GDP, down from 1.5 percent in the previous year.
- **Primary Surplus:** The primary surplus increased to 1.4 percent, compared to 0.2 percent last year.
- **FBR Tax Collections:** FBR tax collection witnessed a substantial growth of 30.3 percent in H1-FY24, attributed to a gradual recovery in economic activity and the sustained impact of taxation measures.
- **Non-tax revenues:** Non-tax revenues remained robust during this period.
- **Expenditures:** Non-interest spending, as a percentage of GDP, experienced a decline, contributing to keeping overall expenditures at contained levels.
- **Fiscal Consolidation:** The MPC emphasized the importance of continuing fiscal consolidation to ensure the sustainability of public debt and maintain overall macroeconomic and price stability.

Money and Credit

- **Broad Money:** Broad money (M2) growth, stable at 14% in FY24, spiked to 17.8% year-on-year by December 2023. However, this acceleration is temporary, with an anticipated reversal in the coming months, as per the latest weekly monetary data.
- **Net Foreign Assets:** The improvement in the external position contributed to an increase in the net foreign assets of the banking system.
- **Domestic Assets:** The banking system's net domestic assets growth slowed due to a decline in private sector credit (PSC), mainly driven by reduced fixed investment loans and a net retirement in consumer loans.
- **Currency to Deposit Ratio:** The currency-to-deposit ratio continued its decline, driven by robust growth in bank deposits and a reduction in currency in circulation.

Inflation Outlook

- **Food and Core Inflation:** Both food and core inflation have been moderating over the past few months, reflecting the positive impact of a tight monetary policy stance.
- **Energy Price Adjustments:** The Committee observed substantial adjustments in administered energy prices, particularly from November 2023 onwards. These changes significantly influenced inflation outcomes and the near-term outlook.
- **Emphasis on Reforms:** The Committee emphasizes the need for reforms to address underlying structural issues, particularly in the energy sector, for price stability on a sustainable basis.
- **Anticipated Inflation:** The MPC foresees FY24 average inflation between 23% to 25% and expects a continued noticeable decline in FY25, considering evolving risks.

Analysis of Inflation rate vis-à-vis Policy Rate

In 2023, Pakistan experienced a persistent challenge with high inflation rates, particularly in housing, water, electricity, gas, and other fuels (HWEG). SBP responded by progressively increasing the policy rate from 17% in January to 22% by the end of the year to curb inflationary pressures. However, a closer analysis reveals that relying solely on a high and escalating policy rate might not be sufficient to stimulate economic growth and mitigate inflation, especially when inflation in specific sectors, such as housing and utilities, remains a significant contributing factor.

Year-2023	YoY National Inflation Rate	YoY Inflation Rate in (Housing, Water, Elec., Gas and other Fuels)	Policy Rate % (Interest Rate)
January	25.4	7.8	17
February	26.2	13.6	17
March	27.3	17.5	20
April	36.4	16.9	21
May	38.0	20.5	21
June	29.4	11.6	21
July	28.3	10.8	22
August	27.4	6.3	22
September	31.4	29.7	22
October	26.8	20.5	22
November	29.2	33.0	22
December	29.7	37.7	22

Source: SBP

Throughout the year, the year-on-year overall inflation rate displayed a persistent rise, peaking at 38% in May 2023. Concurrently, inflation rates in housing, water, electricity, gas, and other fuels surged, reaching 37.7% in December 2023. This emphasizes one of the key reasons for the State Bank of Pakistan's choice to keep the policy rate at 22 percent since July 2023, aligning with its dedication to a rigorous monetary policy.

Despite the SBP's efforts to control inflation through policy rate hikes, the outcomes suggest that it might not be adequately addressing the root causes of price increases, especially in critical sectors like housing and utilities. The limitations of relying solely on a high policy rate become evident when considering broader economic implications. While an escalating policy rate effectively tackles inflation, it can also act as a double-edged sword by potentially dampening consumer spending and business investments, thereby impeding overall economic growth.

Experts Insight

Dr. Ikram ul Haq, a member of the Advisory Board and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE), informed ICMA that the SBP's decision to maintain the policy rate at 22% is influenced by the commitment to the IMF. He highlighted the expectation of further increases in gas and electricity prices to address the growing circular debt. Dr. Haq expressed concern that this rate may not effectively combat inflation or manage the increasing debt servicing, which underlies the perpetual fiscal deficit. He hopes the newly elected government in March 2024 will prioritize much-needed structural reforms to address issues in the energy sector and fiscal space, emphasizing the importance of aligning policies for higher and sustainable growth.

Dr. Ashfaque Hasan Khan, distinguished economist and former Economic Advisor at the Ministry of Finance conveyed to the ICMA Research Department that "sustaining the interest rate at an elevated level of 22% for an extended duration has severely impacted Pakistan's budget and economy. Presently, our revenue is essentially directed to the banks, as it falls short of covering interest payments, leading to a borrowing of Rs 207 billion." Dr. Ashfaque highlighted that the State Bank of Pakistan (SBP) has not effectively addressed Pakistan's inflation, attributing it mainly to supply-side factors and the government's practice of increasing administered prices, such as electricity and gas, which are subsequently passed on to consumers in the form of higher prices. His research indicates a bidirectional causation between the policy rate and inflation, a point supported by the Ministry of Finance's latest Economic Survey (2022-23), revealing a co-movement between the policy rate and inflation. Dr. Ashfaque concluded that despite substantial empirical evidence indicating the ineffectiveness of the current monetary policy, the persistent high interest rates continue to fuel inflation, causing continuous harm to the budget and the economy.

Mr. Hasnain Imam, Senior Manager in the Investment Banking Division at Bank AL Habib Limited, while speaking to the ICMA Research Department, mentioned that the market's consensus was that there would be no change in the Policy Rate until inflation comes down (close to March 2024 MPS). According to the MPS Jan 2024 survey conducted by CFA Society Pakistan, 71 percent of participants foresaw an unchanged monetary policy stance. Therefore, the MPS result was in line with expectations.

Mr. Muhammad Ali Kemal, Chief (SDG) at the Ministry of Planning, Development and Special Initiatives, in a conversation with ICMA said that "Inflation is not coming down; thus, the State Bank of Pakistan (SBP) does not want to take any risk. However, the non-decreasing inflation is mainly due to administered prices, which have a step-wise impact in the next few months. He said that he believes the discount rate must be reduced by 7 to 15 percent, as a lower real interest rate can generate extra profit and may help push inflation down, creating room for investment."

Business and Industry Viewpoint

Mr. Asif Inam, Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI) while talking to ICMA said that MPC's decision to maintain the policy rate at 22 percent aligns with expectations, considering the ongoing high inflation, recorded at around 29% in December. He emphasized the substantial impact on the textiles and apparel sector, currently grappling with a severe liquidity crisis due to the financial impracticality of borrowing at current interest rates. Additionally, non-bank supply chain finance, prevalent across various sectors, has diminished, as high savings account rates have encouraged investors to deposit their funds in banks.

Mr. Asif Inam highlighted the persistence of a shortage in working capital unless interest rates decrease, making manufacturing, especially for export, challenging. Given the past two years' rampant inflation and exchange rate depreciation, the same dollar-denominated order now requires approximately 40 to 50 percent more rupees to process. He noted that there is likely to be minimal investment in upgrading and expanding manufacturing capacity, which has significant implications in the medium term, especially as regional competitors, particularly India, heavily invest in expanding their manufacturing capabilities. He added that bringing inflation down to single digits to allow for a meaningful reduction in the policy rate is a top policy priority, as APTMA has also highlighted in our policy roadmap for the incoming government.

Mr. Muhammad Aman Paracha, Vice President of FPCCI, voiced concern over the government's abrupt withdrawal of subsidies to export-oriented sectors on power tariffs, adding to the challenges faced by these sectors amid the historical hike in the policy rate. Meanwhile, Pakistan's exports declined in the first half of the fiscal year 2023-24. During the July-December period of FY24, key sectors like leather garments and gloves saw a reduction in exports by 9.71%, with raw leather exports decreasing by 23.17%. Mr. Paracha argued that the current policy rate of 22 percent does not support economic activities and raised questions about achieving export targets in light of what he perceives as anti-industry and anti-export measures.

Mr. Zubair Motiwala, Chief Executive of the Trade Development Authority of Pakistan (TDAP) and former President of Karachi Chamber of Commerce and Industry (KCCI), shared his views with ICMA. He believed that the policy rate should have been lowered by at least 100 basis points to convey positive signals to the business community. He highlighted the apparent inconsistency where the State Bank of Pakistan (SBP) aims to limit inflation to 25%, yet refrains from reducing the interest rate. Mr. Motiwala emphasized that a reduction of at least 1% was anticipated, which could have conveyed a positive message to investors and the business community, indicating a favorable economic direction and boosting confidence. Such a move would have set the stage for future policies to bring the policy rate into a more affordable range.

Recommendations

ICMA recommends exercising caution in exclusively relying on a heightened policy rate to combat inflation, emphasizing potential adverse effects on consumer spending and business investments. ICMA further suggests adopting a more balanced strategy that not only addresses inflationary concerns but also fosters an environment conducive to sustained economic development.

ICMA is of the viewpoint that a targeted approach may be adopted, focusing on specific sectors such as housing and utilities. Collaborative initiatives with relevant government bodies and other stakeholders could be undertaken to tackle structural issues within these sectors. ICMA also thinks that a thorough evaluation of the policy rate's impact on economic growth may be carried out to highlight the importance of striking a balance between inflation control and support for sustainable development.

In conclusion, while acknowledging the SBP's commitment to controlling inflation through a heightened policy rate, ICMA strongly recommends a more comprehensive and targeted policy approach.

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