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

ICMA Research and Publications Department

Preamble

The Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) announced two consecutive policy rate reductions in the past 50 days due to decreasing inflationary pressures. The first cut, by 150 basis points to 20.5%, was decided at the MPC meeting on June 10, 2024. This was followed by a further reduction of 100 basis points to 19.5% during the meeting held on July 29, 2024. The June rate cut was the first in four years, aiming to boost economic activity after two years of sluggish growth due to IMF-imposed austerity measures. Pakistan recently secured a new $7 billion IMF bailout program, following the completion of a short-term program earlier this year, to stabilize the economy and promote growth.

These decisions reflect a marked decline in inflation since February, supported by tight monetary policy and fiscal consolidation. Despite potential risks from upcoming budgetary measures and uncertain energy prices, the MPC expects earlier monetary tightening to keep inflation under control. The MPC also noted key developments, including a sharply narrowed current account deficit, improved foreign exchange reserves, and easing prices of metals and food items. Given these improvements and a positive real interest rate, the Committee saw room to reduce the policy rate further in a controlled manner to support economic activity while keeping inflation in check. The monetary policy remains tight enough to guide inflation towards the medium-term target of 5-7%, contingent on successful fiscal consolidation and structural economic reforms.

MPC Observations on Key Sectors

Real Sector

- **Moderate Economic Activity:** Latest high-frequency indicators show moderate activity.
- **Sector Performance:** Auto and POL (excluding FO) sales and fertilizer offtake increased in June.
- **Large-Scale Manufacturing:** Sharp improvement in May 2024, driven by the apparel sector.
- **Agriculture Growth:** Expected to slow down this fiscal year after a strong performance in FY24.
- **Kharif Crops:** Satellite images and input conditions support a slowdown in growth.
- **Industry and Services:** Expected recovery due to lower interest rates and increased budgeted development spending.
- **GDP Growth:** MPC forecasts FY25 real GDP growth of 2.5% to 3.5%, up from 2.4% last year.

External Sector

- **Current Account Deficit:** Posted deficits in May and June after three months of surpluses. Narrowed to 0.2% of GDP from 1.0% in the previous year.
- **Deficit Causes:** Higher dividend and profit payments, seasonal increase in imports.
- **Exports and Remittances:** Significant increases offset by higher imports.
- **FX Reserves:** Improvement due to financial inflows.
- **Outlook:** Modest increase in imports expected, continued robust growth in remittances and exports to contain the current account deficit between 0-1.0% of GDP in FY25.
- **Financial Inflows:** Expected to help finance the current account deficit and strengthen FX buffers.

Fiscal Sector

- **FY24 Fiscal Balances:** Improvement with the primary balance turning into a surplus, and overall deficit declining.
- **Financing:** Increased reliance on domestic banking due to shortfalls in budgeted external and non-bank financing.
- **Private Sector Impact:** Concerns of squeezed borrowing space due to government reliance on banks.
- **FY25 Target:** Primary surplus target set at 2.0% of GDP.
- **MPC Emphasis:** Need for fiscal consolidation and timely external inflows to support macroeconomic stability and build fiscal and external buffers.

Money and Credit

- **Monetary Aggregates:** Trends consistent with a tight monetary policy stance.
- **Broad Money (M2) and Reserve Money:** Grew by 16.0% and 2.6%, respectively.
- **Bank Deposits:** Led almost all growth in M2, with currency in circulation remaining stable.
- **Currency to Deposit Ratio:** Decline from 41.1% at end-June 2023 to 33.6% at end-June 2024.
- **Net Foreign Assets:** Boosted monetary expansion due to improved external account.
- **Private Sector Credit:** Growth decelerated amidst subdued demand.

Inflation Outlook

- **Headline Inflation:** Rose to 12.6% y/y in June 2024 from 11.8% in May.
- **Drivers:** Higher electricity tariffs and Eid-related price increases, partially offset by lower domestic fuel prices.
- **Core Inflation:** Steady around 14% over the past two months.
- **FY25 Budget Impact:** Inflationary impact largely in line with expectations, but full impact may take time to reflect in prices.
- **Risks:** Fiscal slippages and ad-hoc energy price adjustments.
- **FY25 Average Inflation:** Expected to remain in the range of 11.5 – 13.5%, down from 23.4% in FY24.

ICMA Analysis

ICMA's analysis examines the impact of maintaining a high policy rate compared to the advantages of significant rate reductions. We evaluate how high rates affect borrowing costs and economic growth, and contrast this with the benefits of lower rates, such as increased business relief and economic stimulation. This assessment aims to inform better monetary policy decisions for enhanced economic performance.

(1) Challenges of Maintaining a High Policy Rate

- **High Borrowing Costs:** The current policy rate of 19.5% results in costly borrowing for businesses and individuals.
- **Impact on Manufacturing:** Elevated rates are negatively impacting the manufacturing sector in Pakistan by increasing operational costs and limiting growth.
- **Restricted Economic Growth:** High interest rates constrain investment and expansion, hindering overall economic progress of the country.
- **Burden on Debt Management:** A significant portion of borrowing is government-related, reducing available resources for private sector investment.
- **Inflation-Policy Disconnect:** High interest rates do not align with the current inflation rate, causing a mismatch between policy and economic realities.

(2) Benefits of Substantial Rate Reductions

- **Encouragement of Investment and Expansion:** Lowering the policy rate to single digits would reduce borrowing costs, foster investment, and drive economic growth.
- **Relief for Businesses and Consumers:** Substantial rate cuts would ease financial pressures, boosting economic activity and consumer spending.
- **Support for the Manufacturing Sector:** Reduced rates would lower production costs, enhancing the competitiveness of local industries.
- **Enhanced Fiscal Flexibility:** Significant rate reductions could provide more fiscal space, improving government budget management.
- **Improved Export Competitiveness:** Lower borrowing costs would strengthen the export performance of local businesses.
- **Alignment with Global Practices:** Adopting lower interest rates would align Pakistan's policy with international trends, creating a more favorable business environment.

Experts' Insight

Dr. Ashfaque Hasan Khan, a renowned economist and former Economic Advisor at the Ministry of Finance, provided a detailed interview with the ICMA Research Department regarding the SBP's policy rate reduction. He said, "My first comment is that 'it is too little, too late.' Keeping interest rate high for so long a period has totally damaged Pakistan's Budget as well as Pakistan's economy and it has further drowned the country into debt, thanks to the imported policy of the SBP.

In response to a question by ICMA on the impact of high interest rate, Dr. Ashfaque Hasan observed that he has been trying to argue for the last two years that in a developing country, keeping interest rate high will result in low growth, rising unemployment, rising poverty and more social unrest in the country. This is exactly what has happened. It is the Governor SBP as well as the SBP as institution which should be held responsible. He added that resultantly, keeping interest rate high, our interest payment last year was 60% of total revenue which is far worse than the average of the low-income countries. A country is regarded in 'Debt Distress' condition if its interest payment exceeds 20 % of the revenue. Now imagine, with 60% revenue is being consumed by interest payment, Pakistan is now an extremely debt distress country, far worse than many low-income African countries. He lamented, who put Pakistan in the league of poor African countries? Naturally the wrong policy of the SBP!

Dr. Ashfaque was of the view that after the policy rate reduction to 19.5 % and inflation at 12.6 %, the real rate of interest (19.5 - 12.6) is 6.9%. Our real GDP growth target for the year is 3.5 %. It means that real interest rate is twice as high as of real GDP growth. A nation can achieve debt sustainability if real interest rate is LESS than the real GDP growth. This is a sure recipe of debt destabilization.

Looking ahead, Dr. Ashfaque Hasan Khan suggested that there will be three more Monetary Policy Statements until December 2024. He proposed the following rate reductions:

September 12 = 17.5%
November 4 = 15.5%
December 16 = 13.0%

Dr. Khan emphasized that these adjustments will drastically reduce interest payments, cut the budget deficit, decrease borrowing needs, and slow the pace of public debt accumulation.

Aadil Nakhoda, Faculty Member at the Institute of Business Administration (IBA), Karachi, when contacted for his views on the policy rate reduction, said that the reduction at this time primarily seems a reflection on the current expectations of inflation and the low levels of the current account deficit. It seems that the IMF has also given approval for lowering interest rates. However, Mr. Aadil remarked that it is important to keep in view the impact of rising electricity and gas prices on inflation. This may have a lagged effect, and sharp increases in energy prices can create challenges if we see inflation increase. Mr. Aadil added that it is also important to consider the effect of rising import bills once the IMF-related and other donor-related flows increase, as well as debt payments are reduced due to negotiations. He suggested that the government must tread carefully as challenges can increase, especially if there is a delay in the negotiations with the IMF. The outcomes in the next few months will better define the trajectory.

Mr. Abdul Azeem, Head of Research at AL Habib Capital Markets (Pvt.) Ltd in a conversation with ICMA, noted that the Monetary Policy Committee's decision to reduce the policy rate was influenced by slightly better-than-expected June inflation, the aligned impact of FY25 budgetary measures on inflation, and an improving external account, as seen in increased SBP FX reserves despite debt repayments. He observed that the Committee saw room for a calibrated rate cut to support economic activity while managing inflation.

Business and Industry Viewpoint

Mr. Kashif Anwar, President of the Lahore Chamber of Commerce and Industry (LCCI), while talking to ICMA Research Department, said that while the government's recent 100 basis point reduction is appreciable but not satisfactory. The current interest rate needs to come down to a single digit. Due to the high cost of doing business, inflation, currency devaluation, and increased electricity bills, it has become difficult to sustain operations. If the government claims that the inflation rate has dropped to 12%, the interest rate should also be brought down to this level to improve the situation. Additionally, the cost of doing business must decrease, which includes reducing the interest rate and stabilizing the rupee to Rs. 200. Mr. Kashif Anwar held the viewpoint that resolving issues with International Power Projects (IPPs) is also crucial to keep the industry running and to create employment opportunities, which is the need of the hour.

Mr. Asif Inam, Vice President of the Federation of Pakistan Chambers of Commerce & Industry (FPCCI), shared his insights with the ICMA Research Department, noting that the expectation was for a 2-3% reduction in the monetary policy rate given the inflation rate of 11-12%. However, only a 1% reduction was applied. With inflation decreasing, he anticipates a more substantial rate cut in the next MPC meeting.

Mr. Muhammad Aman Paracha, Vice President FPCCI noted that although rate cuts are necessary at this time, the trade and industry sectors are facing a severe crisis due to record-high financial costs and difficulties in retiring their loans. Banks have reported that non-performing loans increased to Rs. 62 billion in 2023, the highest level in 13 years, accompanied by negative private credit growth.

Mr. Abdul Waheed Khan, Director General of the Pakistan Automotive Manufacturers Association (PAMA), when approached by ICMA Research Department for his comments, stated, "Lowering interest rates would indeed boost demand and stimulate much-needed economic activity. However, it is crucial to keep inflation in check, as the exact current rate of inflation and the degree to which it has been controlled remain uncertain".

Policy Recommendation

ICMA is of the considered view that the recent reduction in the SBP policy rate to 19.5% is a positive step in addressing inflation and stabilizing the economy. Based on feedback from the experts and the business community received by ICMA, the following recommendations are proposed:

1) **Further Rate Reductions:** To support economic growth and reduce borrowing costs, further reductions in the policy rate are recommended. Aiming for single-digit interest rates would encourage borrowing and expansion, benefiting the overall economy. Previous high rates led to costly borrowing and suppressed the manufacturing sector, making additional rate cuts essential.

2) **Inflation Monitoring:** Continuous monitoring of inflation is crucial, especially in light of potential increases in energy prices. Proactive adjustments are needed to manage inflationary risks effectively.

3) **Support for Business:** Additional rate cuts would alleviate the high cost of doing business. Addressing issues such as currency stabilization and energy supply is also important to support industrial activity and job creation.

4) **Financial Sector Stability:** Focus on improving liquidity and credit conditions in the financial sector to support economic recovery and address challenges such as rising non-performing loans.

5) **Structural Reforms:** Ongoing fiscal consolidation and structural reforms are necessary to maintain economic stability. Effective fiscal policy implementation and timely external negotiations are key to bolstering stability.

ICMA recommends that in future MPC meetings, the SBP may consider more substantial reductions in the policy rate to bring it closer to the inflation rate. This aligns with the demands of the business community and the recommendations of policy experts, aiming to further support economic growth and stability.

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