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MPS REVIEW

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

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On March 2, 2023, the State Bank of Pakistan (SBP) increased the key policy rate to 20%, the highest since October 1996. Following this decision, there has been speculation in the market that the SBP may further raise the policy rate due to the uncertainty and delay in reaching an agreement with the IMF and the rising CPI inflation. Additionally, the IMF has also been urging Pakistan to align its policy rate with the inflation rate. Consequently, the Monetary Policy Committee (MPC) reconvened on April 4, 2023, and announced increase in the policy rate by another 100 basis points to 21% on the demand of the IMF. This rise in the policy rate is relatively modest, considering that experts had predicted a minimum surge of 200 basis points.

MPC Observations on economic outlook

The Monetary Policy Committee (MPC) observed three significant developments that impacted the macroeconomic outlook since the last meeting. Firstly, the current account deficit has narrowed more than expected due to significant import containment, though the overall balance of payments remains strained due to low FX reserves. Secondly, progress has been made towards completing the 9th review under the IMF's EFF program. Lastly, recent strains in the global banking system have led to tighter global liquidity and financial conditions, posing challenges for emerging market economies like Pakistan to access international capital markets.

In the **Real sector**, MPC noted a broad-based economic slowdown marked by a significant decline in sales volumes of automobiles and POL and contraction in the LSM sector that led to low electricity generation. In agriculture, the wheat production target is likely to be missed. GDP growth in FY23 is expected to be lower than the post-flood assessment of November 2022.

In the **External sector**, MPC observed that the current account deficit of $3.9 billion in July-Feb FY23 is about 68% lower than the same period last year, which was possible due to a contraction in imports. Workers remittances are expected to improve in the coming months. The FX reserves, however, are under stress due to higher loan repayments; hence, an IMF loan is imperative to rebuild reserves.

In **Fiscal sector**, MPC noted that the fiscal deficit came down to 2.3% of GDP in Jul-Jan FY23 compared to 2.8% in the same period last year. Tax revenue collection was below target mostly due to economic slowdown and import reduction. Fiscal consolidation is vital to complement the monetary tightening policy to achieve price stability.

Inflation outlook

The CPI inflation rate in Pakistan is breaking records with every passing month. In March 2023, the headline inflation peaked at a record-breaking 35.37% on a year-on-year basis, which is the highest increase seen in the last 50 years, compared to the 31.5% inflation rate in February 2023. The Pakistan Bureau of Statistics has attributed the rise in CPI inflation to the soaring prices of food, cooking oil, and electricity. Analysts are of the view that Pakistan is now on the brink of experiencing hyperinflation, where prices spiral out of control and exceed 50 percent.

The underlying inflation is expected to stay high due to the repercussions of the undervalued local currency against the dollar, continuing debt repayment, and decreased financial inflows. However, MPC has observed that by raising policy rate further by 100 bps is an important step towards anchoring inflation expectations around the medium-term target, which is critical for achieving the objective of price stability.

Inordinate delay in reaching IMF agreement

Pakistan has been in talks with the IMF since January this year to seek $1.1 billion from a $6.5 billion bailout package that was agreed upon in 2019. To meet IMF's pre-conditions, Pakistan has already taken some tough decisions of withdrawing subsidies, removing artificial cap on exchange rate, raising the policy rate, increasing power and gas prices and imposing new taxes worth Rs. 170 billion. The Finance Minister seems optimistic that by taking all these prerequisite measures, agreement with the IMF would be reached soon.

The prolonged delay in finalizing an agreement with the IMF has caused economic uncertainty, a deceleration in growth, and a rise in inflationary pressures, which are posing existential threats to businesses. Due to the decrease in productivity and exports, a number of industries have been forced to lay off their employees, resulting in significant levels of unemployment. The uncertainty pertaining to the IMF program is also causing pressure on the PKR which plunged to record low of Rs. 287.90 on April 4, 2023.

Furthermore, the increase in policy rates has led to higher borrowing costs for these industries from banks. According to official data from the State Bank of Pakistan (SBP), lending by banks to the private sector has dropped significantly to Rs. 248 billion between July 1, 2022, and March 10, 2023, from Rs. 911 billion during the same period last year. This substantial decrease in lending to the private sector indicates a slowdown in business activities and investments. Another contributing factor is the high interest rates, which have incentivized investors and banks to invest in government papers and bonds to earn risk-free profits rather than extending loans or investing in productive economic activities.

The pending IMF loan agreement has also compelled the Government to increase its borrowing from the domestic banking system to finance the fiscal deficit. As per the official figures released by SBP, the Federal Government borrowed Rs. 2.6 trillion from banks during the period from July 1, 2022 to March 11, 2023 as against Rs. 723.2 billion in the same period of last fiscal year. This shows an increase of Rs. 1.88 trillion.

Experts' insight

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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 "high interest rate itself is contributing to inflation". He was of the view that we are heading to hyperinflation and the main reason is IMF; adding that 'I think Pakistanis should pay the price of going to the IMF'.

Mr. Fahad Rauf, Head of Research at Ismail Iqbal Securities told ICMA that the 'SBP's focus is solely on curtailing inflation, and rightly so, as its primary objective is to achieve price stability. However, the effectiveness of the interest rate tool is questionable in the current scenario. There is not much private sector credit demand at these rates, and the economy is in contraction."

Mr. Fahad said that the problem is led by supply chain crisis amid import restrictions which cannot be solved by increasing rates. "The only solution is to beef up FX reserves and ease the supply shock' he added.

He expressed concern that increasing interest rates would exacerbate the challenges faced by businesses that are already struggling and shutting down. Furthermore, the government, being the largest borrower, would be the most affected by this increase. According to Mr. Fahad, every 1% increase in interest rates would result in approximately PKR 200 billion of additional interest costs for the government annually.

Mr. Muhammad Arsalan Siddiqui, Head of Research at Optimus Capital Management told ICMA that SBP's cumulative 600 bps rate hikes in four months were mainly taken to curb the mounting inflationary pressure and a possible meeting of IMF's prior condition. Despite the tightening, there is no sign of inflation easing off and rather it is dampening economic activities. The primary issue for inflation is currency devaluation and supply-side risks which are majorly emerging amid a fragile external account situation.

"Any delay in the IMF program will further deteriorate external, inflation and fiscal controls, subsequently impacting MPC decision making", Mr. Arsalan added. He said on a year-on-year basis, inflation will dip from Jun-23 amid a high base effect that will narrow the real interest rate negative trajectory going forward.

Syed Fawad Basir, Head of Research at AL Habib Capital Markets Pvt Ltd. while talking to ICMA said that the increase in policy rate by 100bps to 21% in line with the IMF condition set to keep real rates positive. He further said that the market consensus was of 100bps and traditionally the knee jerk reaction was expected to be negative. One thing is for certain that step by step majority of the IMF conditions are being met currently and the expectation of fund disbursement is in the current month which is expected to pave way for further inflows from friendlies and international development agencies in various forms. "The program is key to Pakistan at this point in time due to the external balance situation and in order to kick start the economy which in a sense is in hostage until the flow of USD resumes" Fawad Basir added.

Business and Industry concerns

The business community has refused to accept the recent rise in policy rate by SBP, as communicated in a press release by the Federation of Pakistan Chambers of Commerce and Industry (FPCCI).

ICMA reached out to FPCCI and had a conversation with **Engr. M.A. Jabbar, Vice President of FPCCI**, who was of the view that the dynamics of the current surge in inflation are different and that an increase in interest rates through monetary policy would only benefit the rich, who have enough money to deposit and earn more. He also said that the government is seeking help from short-term managed policies instead of developing policies for sustainable economic growth. He added that doubt and delays in reaching an agreement with the IMF have also created uncertainty in the market.

Haji Muhammad Yaqoob, Vice President of FPCCI, expressed his concern over the rising trend in interest rates and said that 'further hikes in the interest rate will damage confidence in the business sector and encourage people to earn easy money from bank deposits instead of channelizing money into the productive sectors that can provide jobs".

ICMA approached the **Pakistan Automotive Manufacturers Association (PAMA)** and had a conversation with its **Director General, Mr. Abdul Waheed Khan**, who said that rise in policy rate would have a negative impact on economic growth as it would reduce demand, spending and investment and increase cost of borrowing. He told ICMA that purpose to control inflation would not be achieved as most of our economy is outside the banking system called--- informal economy because of which the demand would largely persist.

Regarding the Auto industry, Mr. Abdul Waheed said that being the part of formal economy, it would suffer badly as the increasing cost of borrowing dampens the demand. The uplift of passenger cars that was once about more than 60% through Bank financing has now gone down under 25%. "The auto industry has already gone down by over 50% due to import restriction on crucial parts and raw materials." he added.

ICMA Policy Recommendations

ICMA believes that attaining price stability and lowering core inflation should be the primary goals of monetary policy to ensure long-term economic growth. However, simply raising the key policy rate through monetary tightening would not be effective in taming inflation, particularly in Pakistan, where supply-side issues like fuel and energy price hikes, shortages of goods, and currency devaluation are the root causes.

ICMA is of the view that a frequent and rapid increase in the policy rate may be counterproductive beyond a certain threshold, potentially resulting in reduced economic growth, underutilized production capacity, and increased unemployment. Moreover, this strategy may also diminish the purchasing power of businesses and consumers, particularly those already operating in an unfavorable environment, as high interest rates may not be conducive to their operations.

Given the prevailing circumstances, ICMA recommends that the State Bank of Pakistan (SBP) take a prudent approach to striking a careful balance between fighting inflation, managing debt servicing costs, and stimulating economic growth.

ICMA also believes that the government has an obligation to maintain food inflation at reasonable levels, as it adversely impacts the purchasing power of vulnerable and middle-class individuals. The rapid increase in food prices, in contrast to other commodities, disproportionately affects low-income families, who spend a greater proportion of their income on food. In the absence of an effective price control system, an abnormal surge in the prices of essential goods has been observed.

ICMA proposes that the government should establish alternative measures to augment the supply of vital commodities in the market, along with strict measures against unfair market practices such as hoarding, artificial shortages, and the enforcement of laws prohibiting exorbitant pricing.

A recent statement by Joseph Stiglitz, a renowned Nobel Laureate economist and professor at Columbia University in the USA, suggests that "increasing interest rates is unlikely to resolve the issue of inflation" and that "rate hikes do not address the underlying supply-side bottlenecks that contribute to inflation." This observation by Stiglitz provides valuable insights and food for thought for our policymakers.