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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 200 basis points to 13 percent, effective December 17, 2024, following a decline in headline inflation to 4.9% year-on-year in November. The slowdown is attributed to falling food prices and the fading impact of last year's gas tariff hike. However, core inflation remains sticky at 9.7%, and inflation expectations among consumers and businesses continue to fluctuate. The MPC highlighted that short-term inflation volatility is likely but expects it to stabilize within the 5% to 7% medium-term target. Growth prospects have improved, supported by positive high-frequency indicators, as the policy rate adjustments aim to balance inflation control and economic recovery.

The MPC also noted key economic developments, including a third consecutive current account surplus in October 2024, which has boosted SBP's foreign exchange reserves to $12 billion despite external debt repayments and weak financial inflows. Global commodity prices remain favorable, helping reduce inflationary pressures and the import bill, while private sector credit has grown due to improved financial conditions. However, tax revenues remain below target. The Committee concluded that the impact of recent policy rate cuts is beginning to unfold and will strengthen in the coming months, ensuring price stability and sustainable economic growth.

MPC Observations on Key Sectors

Real Sector

- Economic growth prospects have improved, with reduced downside risks in agriculture.
- Cotton arrivals surpassed expectations, and initial data shows positive trends for wheat crop sowing.
- Industrial activity is strengthening, led by growth in textiles, food, automobiles, petroleum products, and tobacco in Q1-FY25.
- High-frequency indicators, including cement, auto, fertilizer, and petroleum product sales, reflect sustained industrial growth.
- Improved performance in commodity-producing sectors and lower inflation are expected to boost the services sector.
- Business confidence and easing financial conditions are likely to further support economic growth.
- The MPC projects FY25 real GDP growth to remain in the upper range of 2.5% to 3.5%.

External Sector

- The current account recorded a $0.2 billion surplus during Jul-Oct FY2025 period, fueled by strong remittances and export growth.
- Exports increased by 8.7%, led by high-value-added textiles, rice, and petroleum products.
- Favorable global commodity prices helped contain the import bill, despite higher import volumes.
- Workers' remittances stayed strong, aided by policy measures and a narrower exchange rate gap.
- The current account surplus and higher foreign investment boosted SBP's reserves despite weak official inflows.
- Sustained growth in remittances, exports, and favorable commodity prices are expected to keep the current account deficit low.
- SBP's FX reserves are projected to surpass $13 billion by June 2025.

Fiscal Sector

- Revised fiscal data for Q1-FY25 showed improvements in both overall and primary balances.
- FBR revenues grew 23% in July-Nov FY25 but fell short of the annual target.
- Lower domestic debt interest payments due to declining yields will help contain the fiscal deficit.
- Meeting the primary surplus target remains challenging, requiring enhanced efforts to achieve revenue goals.
- Fiscal reforms to expand the tax base are essential for achieving fiscal consolidation.

Money and Credit

- M2 growth slowed to 13.9% by November, down from 15.2%, due to reduced government borrowing and higher NFA contribution.
- Bank lending to private and non-bank financial institutions rose, driven by eased financial conditions and ADR compliance efforts.
- Private sector business credit surged, and consumer financing saw significant growth in October 2024.
- On the liability side, deposits continued to be the primary driver of M2 growth, although the currency-to-deposit ratio increased slightly.

Inflation Outlook

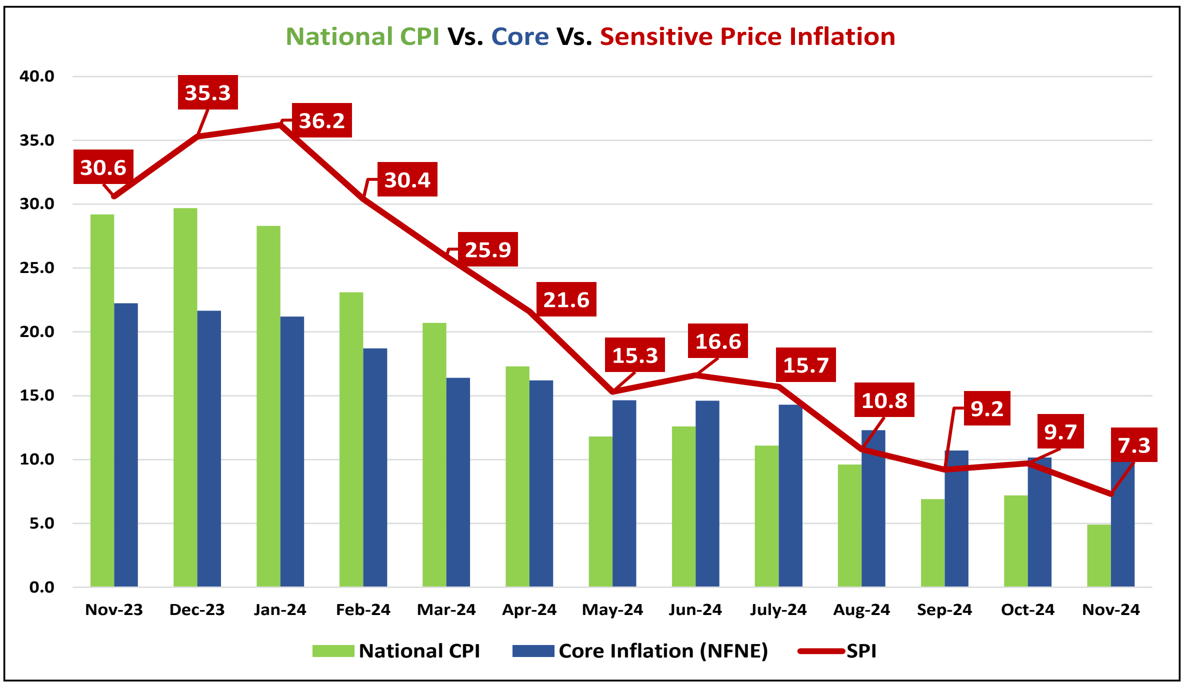
- Headline inflation dropped to 4.9% in November from 7.2%, due to a favorable gas price base effect, lower food inflation, and stable global commodity prices.
- Inflation is expected to remain lower, with FY25 inflation now projected to be well below the previous range of 11.5% to 13.5%, driven by continued favorable factors.
- Core inflation slightly declined in November, but consumer inflation expectations rose.
- Inflation risks include more fiscal measures, food inflation, and higher global commodity prices.

ICMA Analysis

ICMA's LinkedIn poll prior to the monetary policy announcement revealed that 48% of participants expected a 200 basis point rate cut. The MPC's decision to reduce the policy rate by 200 basis points aligned with these expectations, boosting investor and business confidence and signaling a positive shift toward economic growth.

Additionally, ICMA conducted a comparative analysis of three inflation indicators to assess their impact on consumers across different income levels. Relying on a single indicator is insufficient to capture the inflationary effects on all income groups. For instance, the Headline (National) Consumer Price Index, which includes over 350 items in its basket, reflects smoother price fluctuations. However, many of these items—such as dry fruits, branded ice creams, cars, and frequent travel by train and airplane—are not commonly purchased by low-income individuals. In contrast, middle and low-income consumers spend more on essential goods, such as food, clothing, and energy. The price fluctuations of these necessities are better captured by the Core Inflation (Non-Food & Non-Energy) and the Sensitive Price Index (SPI) which has 51 essential items in its basket, making them more relevant for assessing inflationary impacts on lower and middle-income groups.

Figure: 1



Source: Pakistan Bureau of Statistics, analysis by ICMA. National CPI Includes 350+ items in the Basket, Core Inflation excludes Food and energy prices and is calculated by taking the average of Urban and Rural core inflation. The Sensitive price index (SPI) includes 51 essential items, and reflects the inflation for the Quintile:1 (Expenditure group who spend up to Rs. 17,732).

Figure 1 shows the comparative analysis of CPI, Core, and SPI inflation rates. The CPI data reveals a significant decline from 29.2% in November 2023 to 4.9% in November 2024, indicating a substantial easing of overall price pressures. However, Core Inflation decreased more gradually, from 22.25% to 9.7%, suggesting that structural challenges persist, although it remains high compared to the target range. This is calculated as an average of urban and rural core inflation. Meanwhile, the SPI for the lowest income group (Quintile 1, with expenditures up to Rs. 17,732) showed a decrease from 30.6% in November 2023 to 7.3% in November 2024, indicating a still moderate inflation rate.

Experts' Insight

Dr. Ashfaque Hasan Khan, a renowned economist and former Economic Advisor at the Ministry of Finance, described the reduction of the policy rate to 13% as an excellent and appropriate decision by the SBP during his discussion with the ICMA Research Department. However, he observed that the policy rate remains high given the current inflationary trend in the country. He noted that at 13%, the real interest rate exceeds 8%, significantly surpassing the projected growth of real GDP, which could lead to economic destabilization. He highlighted that this also contradicts the principle of debt sustainability. Dr. Ashfaque recommended that the policy rate may be gradually reduced to 7% or 8% by June 2025 to positively impact Pakistan's budget. He further stated that such a reduction could lower interest payments in the budget by over Rs. 1,500 billion during 2024-25, which could help achieve the budget deficit and primary deficit targets, while slowing the growth of public debt.

Dr. Ikram ul Haq, a member of the Advisory Board and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE), stated to ICMA Research Department, that the significant reduction in the policy rate to 13% from its peak of 22% is a positive development. With inflation now at 4.9%, this decrease reflects a marked improvement from the hyperinflationary peak of 38% experienced in 2023.He highlighted that, to ensure the benefits of lower interest rates and reduced inflation reach the general public, the government must establish effective mechanisms for price monitoring and regulation. Strengthening consumer protection laws and increasing market transparency, he noted, can help curb unwarranted price manipulation by intermediaries. Furthermore, he emphasized the need to prioritize subsidies for essential goods and implement targeted assistance programs to reduce the financial burden on low-income households. Public awareness campaigns, he suggested, can also play a key role in informing citizens about government initiatives and promoting responsible consumption practices.

Mr. M. Amayed Ashfaq Tola, President of Tola Associates, stated in a conversation with ICMA that the SBP's decision was driven by a year-on-year decline in headline inflation to 4.9% in November 2024, attributed to easing food prices and the waning impact of last year's gas tariff hike. However, he noted that core inflation remains high at 9.7%, reflecting its stickiness despite lower inflation expectations. Mr. Tola opined that achieving the targeted GDP growth of 3.6% will require a further reduction in interest rates by 3-4%, which would still ensure a positive real interest rate. He further projected that inflation is likely to remain within the 5-8% range for the remainder of the fiscal year. Additionally, he emphasized that achieving a realistic rupee parity would strengthen Pakistan's economic position and enhance stability. If the PKR adjusts to its true value, it could potentially lead to deflation under current conditions, creating additional scope for further interest rate reductions. Consequently, GDP growth could exceed forecasted figures, supporting a faster economic recovery.

Syed Fawad Basir, Head of Research at KTrade Securities Limited, shared with ICMA that the 900-bps decline in the policy rate since June 2024 has already begun to reflect in cyclical sector data releases. With the base effect in inflation expected to persist over the coming months, he anticipated that the pace of rate easing would slow down moving forward. He noted that the latest policy rate cut, in line with consensus expectations, is likely to further boost market sentiment. On a sectoral level, he highlighted that the decision could drive price outperformance in cyclical sectors, particularly steel, autos, and cement. He added that the decline would also benefit banks in the short term, as the liability side adjusts more quickly. Downstream oil distribution companies, he explained, stand to gain as the reduced finance costs related to working capital funding improve their financial outlook.

In a conversation with ICMA, **Mr. Muhammad Sabir, Principal Economist at the Social Policy and Development Centre (SPDC),** described the 200-basis point reduction in the policy rate as a significant step toward growth, reflecting the SBP's confidence in economic stabilization. This move offers relief to businesses and the government by easing financing pressures. While real interest rates remain above 7%, there is room for further cuts. Mr. Sabir noted that the SBP's cautious approach prioritizes macroeconomic stability, with future cuts dependent on sustained, credible inflation reduction. He added that the rate reduction is expected to redirect resources into productive sectors, including the stock market, ease liquidity constraints, and encourage capital investments, particularly in manufacturing. It will also stimulate demand in housing, infrastructure, and automobile sales due to lower financing costs.

Mr. Aadil Nakhoda, a faculty member at IBA Karachi, noted that the recent interest rate reduction was as expected. However, he emphasized the need to examine the factors behind the current account surplus in recent months. While a shift to a current account deficit is expected as interest rates decline, the surplus remained positive in October 2024, with a similar trend anticipated in November 2024. He pointed out that export growth continues to outpace imports, and remittances remain strong. However, while the demand for petroleum imports in dollar terms has remained stable, there has been an increase in imports of machinery and power-generating equipment. He questioned whether this widening gap between machinery and petroleum imports is a short-term or long-term trend. Mr. Nakhoda stressed that while import demand is likely to rise, the government should focus on restructuring the economy to drive demand for productive inputs instead of non-productive imports. He cautioned that monitoring import trends as interest rates decline will be crucial in determining whether Pakistan will need another IMF program. He concluded by asking how long the current account can remain under pressure with curtailed demand.

Business and Industry Viewpoint

Mr. Zubair Motiwala, Chief Executive of the Trade Development Authority of Pakistan (TDAP), shared his views with ICMA's R&P Department on the recent decision by SBP to reduce the policy rate. He praised the 2% reduction as a positive step but emphasized that the ultimate goal should be to achieve a single-digit rate, ideally around 9%. While the reduction is gradual, Mr. Motiwala believes SBP's careful approach, whether monthly, bi-monthly, or quarterly, is logical. With six months remaining in FY 2024-25, he expressed confidence in SBP's gradual interest rate reduction. This approach, he said, will provide relief to industries, especially large-scale industry, currently burdened with high leverage and borrowing costs. Mr. Motiwala also highlighted that lower business costs could encourage industries to pursue BMR projects and revive projects previously stalled. He, however, cautioned that challenges such as rising gas and electricity rates, as well as policy uncertainties, must be addressed on priority. For example, the gas supply closure announced for December 31, 2024, continues to create uncertainty for investors.

Despite these concerns, Mr. Motiwala pointed out positive indicators for Pakistan's economy, such as the record performance of the Stock Exchange, a decline in interest rates, current account surpluses, and gradual increase in forex reserves. He noted that foreign leaders visiting Pakistan and expressing a willingness to invest reflect growing global confidence in the country's economic potential. In conclusion, he emphasized the need to proactively respond to these opportunities. While investors remain cautious and adopt a "wait-and-watch" approach, he remains optimistic that an additional 2% reduction would further boost industrial and economic activities in Pakistan.

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 on the policy rate reduction. He emphasized that a single-digit interest rate, ideally around 9%, is necessary to boost business and industry. He noted that banks have significant liquidity, and the economy needs a boost, with a single-digit interest rate being an effective solution.

Mr. Saquib Fayyaz Magoon, Senior Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI), while talking to R&P Department stated that while the recent policy rate reduction is a positive step, it needs to be reduced further. With the inflation rate at 4.9%, he believes the policy rate should be cut by 4-5%, but only 2% has been reduced. He urged the government to reduce financial costs immediately, as the high cost of doing business and the rising energy rates are major challenges. While acknowledging that the reduction to 13% is a good step, he emphasized that further adjustments would encourage investment and capital inflows.

Mr. Asif Inam, Vice President of FPCCI, stated that while the recent policy rate reduction is a positive step forward, the business community had anticipated a larger cut. Given that inflation has dropped to below 5%, their expectations were for a more significant reduction. He remains hopeful that the next meeting will bring another positive move in the right direction, God willing, and is eager to see what happens.

Policy Recommendations

- **Further Policy Rate Reduction:** ICMA recommends that the State Bank of Pakistan further reduce the policy rate to align with the current inflation rate, targeting a gradual reduction to 7-8% by mid-2025. This will stimulate investment, encourage consumption, and promote private sector growth while reducing the fiscal burden of public debt. A lower policy rate will also ease financial pressures on businesses and individuals, making credit more accessible and affordable.

- **Persistent Monitoring:** ICMA emphasizes the importance of continuously monitoring inflation trends and adjusting the policy rate as necessary. Future rate reductions should be gradual, based on real-time data, to ensure inflation remains under control and the benefits of lower rates are fully realized without destabilizing the economy.

- **Exchange Rate Optimization:** Maintaining the exchange rate at an optimal level is essential. A stable exchange rate will control imported inflation, especially from capital goods and energy imports, while enhancing the competitiveness of Pakistan's exports. This will help stabilize the external sector and support positive trade and current account balances.

- **Monetary and Fiscal Coordination:** ICMA stresses the need for a coordinated approach between monetary policy and fiscal reforms. Efforts should focus on broadening the tax base, improving revenue collection, and reducing reliance on external borrowing. Fiscal discipline will strengthen monetary policy measures, ensuring long-term economic stability.

- **Structural Reforms to Tackle Core Inflation:** ICMA highlights the need for structural reforms in agriculture, industry, and energy to boost productivity, reduce production costs, and enhance competitiveness. Addressing high energy costs, improving industrial productivity, and strengthening price control mechanisms will be crucial in managing core inflation.