

MPS REVIEW

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

ICMA Research and Publications Department

Preamble

27 October 2026: The State Bank of Pakistan (SBP) raised the policy rate by 50 basis points to 12.0%, effective 27 October 2026, in response to rising inflation risks from Middle East tensions, high global energy prices and domestic wheat-supply pressures. The Monetary Policy Committee (MPC) aimed to keep inflation expectations under control, limit the spread of these price increases across the economy, and bring inflation within the medium-term target range of 5–7%.

Pakistan's economic conditions showed both improvement and concern. Headline inflation reached 10.3% in September 2026 compared with the same month last year, while core inflation remained high at around 8.4%. However, economic activity showed signs of recovery, with large-scale manufacturing growing by 1.9% year-on-year during July–August FY27. The MPC kept its FY27 GDP growth forecast at 3.5–4.5%. It also highlighted risks from geopolitical tensions and adverse weather conditions, and stressed the need for fiscal discipline, stronger external reserves and continued economic reforms to support stability and sustainable growth.

The Case for a Policy-Rate Maintain *versus* a Policy-Rate Reduction

Monetary policy involves balancing inflation control with economic growth. Keeping the policy rate at 11.5% could have avoided higher borrowing costs, while reducing it by 100 basis points to 10.5% could have made loans cheaper for businesses and encouraged investment. However, both options carried risks given high energy prices, rising food costs and uncertainty caused by geopolitical tensions. Keeping the rate unchanged might not have been enough if inflation continued to rise, while cutting it too early could have increased inflation and pressure on the rupee. International research highlights the importance of preventing temporary supply shocks, such as higher oil prices, from causing wider and more lasting increases in prices (Baba & Lee, 2022; Gopinath, 2025).

ICMA's Pre-MP Outlook provides further insight into these risks. The External Economic Stress Index (EESI) fell to -6.12 in August 2026, mainly because global economic activity improved. However, oil prices and supply-chain pressures remained concerns. This means that the lower index reading did not indicate that all external risks had eased. The following cases examine the potential implications if SBP had kept the rate at 11.5% or reduced it to 10.5%, compared with its actual decision to raise it to 12.0%. Each case considers the possible effects on inflation, the rupee, businesses and Pakistan's wider economy.

Case 1: If the Policy Rate Had Been Maintained at 11.5 Percent

Supporting Business Activity and Investment

Maintaining the policy rate at 11.5% could have helped businesses avoid higher borrowing costs. This would have provided some relief to firms already facing expensive energy, working capital and imported raw materials. It could also have supported investment and economic activity while the effects of earlier rate increases continued (Gopinath, 2025).

Allowing Time to Assess External Shocks

Keeping the rate unchanged would have given SBP more time to assess how the Middle East conflict, high global energy prices and rising domestic wheat prices were affecting inflation. Monetary policy cannot directly reduce prices caused by external supply shocks. Raising the rate immediately could therefore have increased business costs without addressing the original cause of higher prices (International Monetary Fund, 2025). SBP also identified geopolitical tensions and wheat-supply problems as risks to Pakistan’s inflation outlook.

Risk of Persistent Inflation and Exchange-Rate Pressure

However, keeping the rate unchanged could have been risky if oil and food prices continued to rise. In September 2026, headline inflation reached 10.3% year-on-year, while core inflation remained around 8.4%. SBP warned that higher food and energy prices could increase inflation expectations and eventually push up other prices. If these pressures continued, the existing rate might not have been enough to control inflation. External uncertainty could also have put pressure on the rupee, making imported fuel and industrial inputs more expensive.

ICMA Assessment: Maintaining the policy rate at 11.5% could have helped businesses by avoiding an immediate increase in borrowing costs. However, this approach would have depended on whether inflationary pressures were temporary. If higher oil and food prices began pushing up prices across the economy, keeping the rate unchanged could have increased inflation and pressure on the rupee.

HISTORICAL EVIDENCE: Russia–Ukraine War: Holding Rates Amid Geopolitical Uncertainty (March 2022)		
<p>Policy Rate</p> <p>9.75%</p> <p>in March 2022</p> <p>↓</p> <p>12.25%</p> <p>in April 2022</p> <p>Inflation</p> <p>12.2%</p> <p>Year-on-year, February 2022</p>	<p>What happened?</p> <p>Russia’s invasion of Ukraine increased uncertainty around global oil prices and financial conditions. In March 2022, SBP maintained the policy rate at 9.75% while assessing the impact of the conflict. As inflation risks and pressure on Pakistan’s external payments increased, the policy rate rose to 12.25% in April 2022.</p>	<p>Relevance to the current case:</p> <p>This episode shows that SBP may initially hold the rate while assessing an international shock. However, if higher oil prices begin pushing up domestic prices and increasing pressure on foreign payments, a rate increase may become necessary. For the current case, maintaining the rate at 11.5% would have depended on whether inflation risks remained manageable.</p>

Case 2: If the Policy Rate Had Been Reduced to 10.5 Percent

Supporting Business Activity and Investment

A 100-basis-point cut, from 11.5% to 10.5%, could have made borrowing cheaper for businesses. Lower loan costs could help firms manage expenses, buy equipment, expand production and hire workers. However, these benefits would depend on whether banks also reduced the interest rates charged on loans.

Limited Room for Monetary Easing

Lower interest rates can encourage people and businesses to spend more. But if oil and food prices were already rising, additional spending could have made inflation harder to control. A rate cut would therefore have been more suitable if inflation was falling steadily and the pressure on prices was easing.

Risk of Exchange-Rate and Inflationary Pressure

A rate cut could also have put pressure on the Pakistani rupee. If the rupee lost value against the US dollar, Pakistan would have to pay more rupees to buy the same amount of imported fuel and industrial materials. Businesses could then pass these higher costs on to consumers through higher prices.

Research on Pakistan also examines how changes in monetary policy and economic activity affect the exchange rate (Xu et al., 2026). This means that cheaper loans could have helped businesses, but rising import costs might have reduced that benefit.

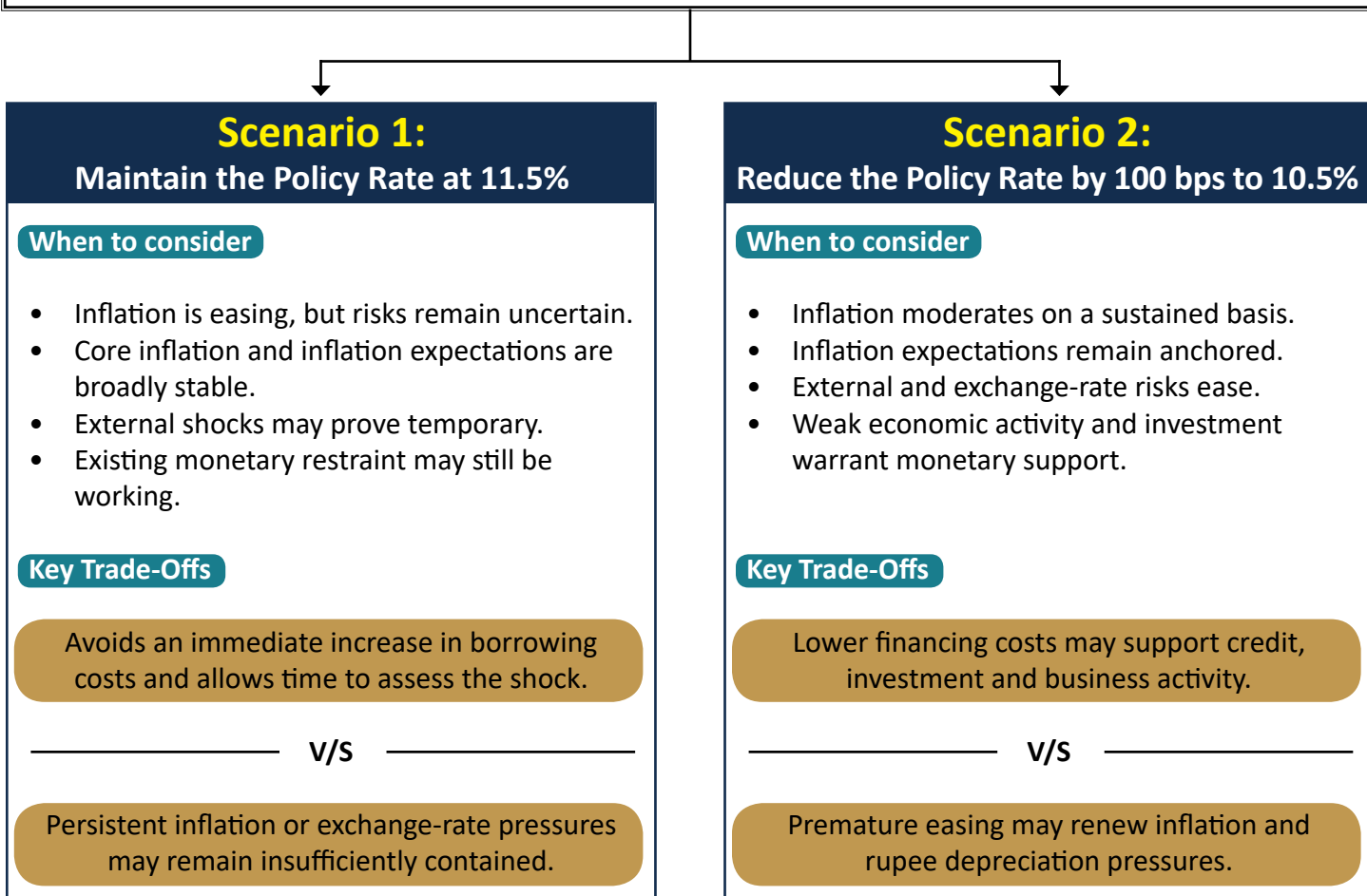
ICMA Assessment: A 100-basis-point cut could have reduced borrowing costs and supported business investment. However, with oil and food prices putting pressure on inflation, cutting the rate too early could have made prices rise further and increased the cost of imports.

HISTORICAL EVIDENCE:**COVID-19 Pandemic: Monetary Easing to Support Economic Activity (2020)**

Policy Rate 12.50% on 17th March 2020 ↓ 7.0% in June 2020 Inflation 8.2% Year-on-year, May 2020	What happened? The COVID-19 pandemic disrupted businesses, reduced spending and weakened economic activity. Global oil prices fell and inflation pressures eased. SBP reduced the policy rate from 12.50% in March to 7.0% in June 2020 to make borrowing cheaper and support businesses, jobs and economic activity.	Relevance to the current case: This episode shows how lower interest rates can support businesses when economic activity weakens and inflation pressures ease. Cheaper loans can help firms manage costs and continue investing. However, the current situation differs because high oil prices and geopolitical tensions pose risks to inflation. A reduction from 11.5% to 10.5% would therefore have been more suitable if inflation had eased steadily and external pressures had declined.
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Assess Inflation and External Risk

Core Inflation, Inflation Expectations, Exchange Rate, Global Commodity Prices, and External Financing Conditions

**Evidence-Based Policy Assessment:**

Compare both alternatives against current inflation, core prices, exchange-rate risks and the external outlook.

Actual SBP decision: Policy rate increased by 50 bps to 12.0%

The decision to raise the policy rate by 50 basis points to 12.0% reflects the need to contain rising inflation risks amid higher global energy prices, domestic wheat-supply pressures and geopolitical uncertainty. However, monetary tightening cannot directly resolve supply-side constraints and may increase financing costs for businesses and exporters. The effectiveness of the decision will therefore depend on whether it helps contain inflation expectations and second-round price increases without unnecessarily weakening productive investment. SBP should assess subsequent inflation data, core-price movements, exchange-rate developments and credit conditions before deciding on further adjustments. Complementary measures to improve food supply, reduce energy costs and strengthen fiscal discipline remain essential.

ICMA Policy Recommendations

- **Check Whether the Rate Increase Is Helping Control Inflation**

SBP should assess whether the 50-basis-point increase to 12.0% is helping control inflation and preventing higher energy and food prices from spreading to other goods and services. It should monitor headline inflation, core inflation, prices outside the energy sector and expectations about future prices. If higher prices are temporary, further rate increases should not be automatic. However, if prices continue to rise across different sectors, keeping interest rates high may be necessary to control inflation.

- **Assess the Impact of Higher Oil Prices and a Weaker Rupee on External Payments**

SBP and the Ministry of Finance should assess how higher oil prices and a possible fall in the rupee's value could affect fuel import costs, Pakistan's need for foreign currency and domestic prices. They should compare expected import payments with foreign-exchange inflows from exports, remittances and other sources. This would help identify potential funding gaps early and determine whether further rate increases are needed or whether the pressure mainly comes from higher import costs.

- **Reduce Energy and Financing Costs for Businesses**

The government should take practical steps to reduce energy and transport costs for exporters and small and medium-sized enterprises (SMEs), particularly those that depend on imported fuel and raw materials. Priorities should include improving energy efficiency, reducing delays in transporting goods and helping viable exporters obtain the working capital they need. These steps would help businesses manage higher costs while addressing the causes of price increases, without relying only on further rate increases or cutting rates too early.

Industry and Experts' Insights

Questioning the effectiveness of conventional monetary tightening against supply-driven inflation, **Mr. Muhammad Sabir, Principal Economist, Social Policy and Development Centre (SPDC)**, in his assessment to the ICMA Research and Publications Department cautioned that monetary tightening against petroleum-driven, cost-push inflation risks exacerbating financing costs, fiscal pressures and investment constraints without addressing the underlying supply-side shocks. With economic growth projected at a modest 3.5%, he warned that reliance on restrictive monetary measures to counter predominantly cost-push inflation risks undermining an already fragile economic recovery without addressing its underlying inflationary drivers.

In an exclusive commentary for the ICMA MPS Review, **Mr. Faisal Sharif, Director, South Asia Region, GAC Group** noted that price stability is a prerequisite, not the ultimate measure of economic progress, and Pakistan's policy priority must convert macroeconomic stability into productive investment and export diversification for sustainable economic growth. He emphasized the need to complement monetary discipline with fiscal prudence, decisive energy-sector reforms and productivity-driven growth. While prioritizing targeted relief for vulnerable households amid constrained fiscal resources.

Drawing attention to the policy dilemma of elevated inflation and a weakening growth trajectory, **Mr. Muhammad Raza, Chairman, Rice Exporters Association of Pakistan (REAP)**, observed in his commentary to the ICMA Research and Publications Department that while inflation containment and macroeconomic stability remain essential, monetary tightening alone cannot adequately address price pressures arising from external shocks and domestic supply-side constraints. He emphasized the importance of preserving industrial liquidity and affordable financing for small and medium enterprises (SMEs) and export-oriented industries, cautioning that restrictive credit conditions could further constrain productive activity and competitiveness.

Highlighting the growing disconnect between monetary policy decisions and industrial realities, **Mr. Junaid Naqi, Former President, Korangi Association of Trade and Industry (KATI), and Chairman, Institute Management Committee (IMC)**, expressed strong reservations over the SBP decision in his commentary to the ICMA Research and Publications Department. He highlighted the disparity between banks' PKR 342 billion earnings in H1 2026 and mounting industrial distress, warning that a 37.5% surge in power fuel costs, PKR 134 per litre in petroleum taxes and levies, and a 22% manufacturing tax burden, compounded by import restrictions, make further monetary tightening detrimental to industrial liquidity and competitiveness. Cautioning that economic pressures could persist for another year even if geopolitical tensions ease. In his assessment, monetary policy requires greater economic realism and analytical rigor, with stronger emphasis on productive financing and export competitiveness for the sustainability of domestic manufacturing.

Mr. Hamid Zahur, Former Chairman of the Pakistan Tanners Association, expressed concern to the ICMA Research and Publications Department over the policy rate increase despite moderating inflation, which eased from 11.1% in August to 10.3% in September 2026. He argued that the decision contradicted market expectations and risked exacerbating already elevated financing costs, industrial liquidity constraints and debt-servicing pressures. He cautioned that heightened uncertainty could weaken manufacturing activity, capital market confidence and investment prospects. In his assessment, maintaining or reducing the policy rate would have been more conducive to industrial competitiveness and business confidence for sustained economic recovery.

Sharing his assessment with the ICMA Research and Publications Department, **Mr. Usman Shaukat, Vice Chairman, Pakistan Pharmaceutical Manufacturers Association (PPMA), and Former President, Rawalpindi Chamber of Commerce & Industry (RCCI)**, strongly opposed the SBP decision arguing that the decision contradicts easing inflationary trends and risks undermining investor confidence. He argued that supply-driven price pressures warrant monetary relief rather than costly credit that constrains industrial investment, pharmaceutical production, export competitiveness and fiscal space. While advocating a gradual shift towards a single-digit policy rate through greater industry consultation before each decision is announced.

Offering his perspective to the ICMA Research and Publications Department, **Dr. Imran Batada, President, Pakistan Freelancers Association (PAFLA)**, remarked SBP decision as a measured response to renewed inflationary risks, particularly amid international oil prices exceeding US\$100 per barrel. He emphasized that price and exchange rate stability are essential for sustaining confidence in Pakistan's digital economy. He cautioned that elevated financing costs could impede technology investment, startup financing, talent acquisition and infrastructure expansion. Given the IT sector's strategic contribution to foreign exchange earnings, he warned that constraining its growth could inadvertently intensify external vulnerabilities. He advocated concessional financing, targeted energy and connectivity relief, and streamlined formal remittance channels to safeguard digital exports. In his assessment, monetary stability must be complemented by sustained policy support that transforms Pakistan's digital workforce into a stronger engine of export competitiveness, employment and economic resilience.

Examining the delicate balance between inflation containment and economic recovery, **Mr. Zulfiqar Alam, CEO, Pakistan Housing Finance Company Limited**, in his commentary to the ICMA Research and Publications Department observed that the State Bank of Pakistan's 50-basis-point policy rate increase marks a shift from its earlier cautious stance amid international economic uncertainty. Cautioning that excessive tightening could erode household purchasing power, suppress investment and employment, and jeopardize economic recovery without directly addressing imported inflation.

MPC Observations on Key Sectors

Real Sector

- Economic activity is gradually recovering, with large-scale manufacturing (LSM) growing by 1.9% year-on-year during July–August FY27, compared with 0.4% growth in Q4-FY26.
- Cement and POL sales, private-sector credit, purchasing managers index and services-sector indicators also point to improving activity.
- Better-than-expected initial Kharif crop estimates have improved the agricultural outlook.

Outlook: ICMA expects the recovery to continue, although geopolitical tensions and adverse climate conditions may constrain growth. Higher financing costs could also affect private investment.

External Sector

- The current account recorded a deficit of US\$874 million during Q1-FY27.
- Exports of rice, high-value-added textiles and services are recovering, while workers' remittances remain resilient.
- Imports are rising alongside economic activity and higher prices. The FY27 current account deficit is projected to remain within 0–1% of GDP.

Outlook: ICMA expects exports, remittances and financial inflows to support external stability. However, elevated commodity prices, tighter global financial conditions and supply constraints remain key risks.

Fiscal Sector

- FBR tax collection grew by 7.0% year-on-year during Q1-FY27, exceeding the target by Rs. 33 billion.
- Substantial SBP profit transfers and contained expenditure are expected to keep the overall fiscal and primary balances in surplus.

- The MPC emphasized tax-base broadening, stronger revenue mobilization and structural reforms.

Outlook: ICMA considers fiscal discipline and sustained tax reforms essential to support macroeconomic stability, particularly as higher global energy prices complicate fiscal management.

Money and Credit

- Broad money (M2) growth increased to 12.7% year-on-year by 9 October 2026, compared with 11.4% on 28 August.
- Private-sector credit grew by 14.1%, supported by working capital, fixed investment and consumer financing.

Outlook: ICMA expects credit to support economic recovery. However, the increase in the policy rate to 12.0% may raise financing costs and moderate borrowing by smaller firms and interest-sensitive industries.

Inflation

- Headline inflation reached 10.3% year-on-year in September 2026, exceeding MPC expectations, while core inflation remained elevated at around 8.4%.
- Higher energy and wheat prices, alongside renewed Middle East tensions, worsened the inflation outlook.
- The MPC increased the policy rate by 50 basis points to 12.0% to maintain a sufficiently positive forward-looking real policy rate and bring inflation within the medium-term target range of 5–7%.

Outlook: ICMA considers the increase a response to rising inflation risks and potential second-round effects. However, targeted measures addressing food supply, energy costs and supply-chain disruptions remain necessary to complement monetary restraint.

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