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ICMA
MONETARY POLICY STATEMENT

MPS REVIEW

ISSUE # 15 | MARCH 11, 2025

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 decided to keep the policy rate unchanged at 12 percent, effective March 11, 2025. This decision follows a lower-than-expected inflation reading in February 2025, primarily driven by a decline in food and energy prices. However, the Committee highlighted risks associated with the volatility of these prices, which could disrupt the ongoing disinflationary trend. Core inflation remains elevated, suggesting underlying inflationary pressures persist, while economic activity continues to gain momentum, supported by a cumulative 1,000 basis point rate cut since June 2024.

Key developments include a shift in the current account from surplus to a deficit of $0.4 billion in January 2025, declining foreign exchange reserves due to weak financial inflows and debt repayments, and a continued shortfall in tax revenues during January and February. Large-scale manufacturing output contracted during H1-FY25 despite a notable month-on-month increase in December 2024. Meanwhile, consumer and business confidence improved, but heightened global uncertainty, particularly due to escalating tariffs, poses risks to trade, commodity prices, and economic growth. Given these factors, the MPC emphasized the need for a cautious monetary policy stance to stabilize inflation within the 5% to 7% target range and support sustainable economic growth alongside structural reforms.

MPC Observations on Key Sectors

Real Sector

- High-frequency indicators show continued economic momentum, with growth in automobile, POL, cement sales, imports, and private sector credit.
- LSM shrank by 1.9% in H1-FY25, as gains in textiles, pharma, autos, and POL were offset by declines in low-weight sub-sectors.
- Rabi crop outlook improved after recent rainfall, reducing downside risks.
- Economic growth is expected to recover in H2-FY25, with GDP projected at 2.5% to 3.5% for FY25.

External Sector

- Current account posted a deficit in January 2025, reducing the July-Jan FY25 surplus to $0.7 billion.
- Higher import volumes and rising global commodity prices drove up import payments.
- Strong remittances and moderate export growth helped finance rising imports.
- Net financial inflows remained weak, but major debt repayments for the year have been completed.
- SBP's FX reserves expected to exceed $13 billion by June 2025, supported by planned inflows and lower repayments.
- Strengthening external buffers remains crucial amid global economic uncertainty.

Fiscal Sector

- Overall and primary balance improved in H1-FY25, driven by higher revenues and controlled expenditures.
- FBR tax revenue shortfall widened in January and February 2025, posing fiscal challenges.
- Lower interest payments and controlled spending may help keep the fiscal deficit near the target.
- Achieving the primary balance target remains difficult, requiring continued fiscal consolidation and tax base expansion.

Money and Credit

- Broad money (M2) growth remained steady at 11.4% y/y.
- Government borrowing from banks increased, while private sector credit (PSC) saw higher-than-seasonal net retirement after aggressive Q2-FY25 lending.
- PSC growth at 9.4% remains strong, reflecting easier financial conditions and economic recovery.
- Currency in circulation rose, while deposit growth slowed further.

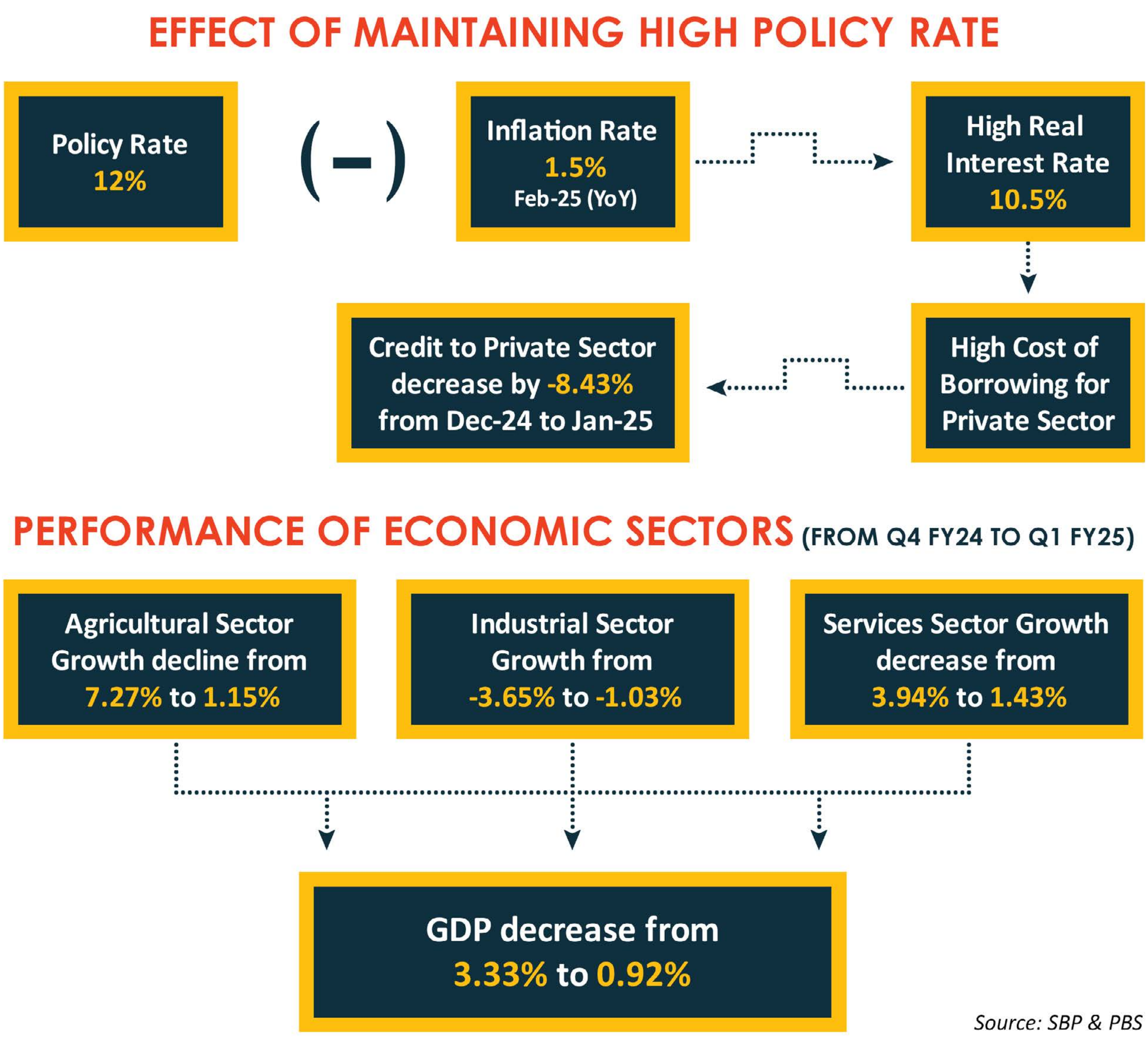
Inflation Outlook

- Headline inflation fell to 1.5% y/y in February 2025, down from 2.4% in January, driven by lower food and energy prices.
- Perishable food prices declined sharply, while non-perishable stocks remained stable.
- Energy prices benefited from lower global oil prices, a stable exchange rate, and a favorable base effect.
- Core inflation remains elevated and sticky, with mixed inflation expectations from consumers and businesses.
- Inflation is expected to decline further before stabilizing within the 5% to 7% target range, though risks remain from food price volatility, energy price adjustments, and global uncertainties.

ICMA Analysis

ICMA Pakistan is of the view that the State Bank of Pakistan's (SBP) Monetary Policy Committee (MPC) should have reduced the policy rate by 100 basis points to 11%, considering the latest economic indicators. As shown in Figure: 1, inflation has been steadily declining, from 2.4% in January 2025 to 1.5% in February 2025, while the policy rate remains at 12%. This has resulted in an excessively high real interest rate of 10.5%, which is constraining economic activity. Since the central bank's primary objective is price stability, maintaining a high policy rate is no longer justified. Additionally, private-sector credit growth declined by 8.43% from December 2024 to January 2025, indicating tighter financial conditions that are slowing investment and economic expansion. A gradual reduction in the policy rate would have eased borrowing costs, improving credit access for businesses and households without compromising inflation stability.

Figure: 1



Source: SBP & PBS

Pakistan's economic growth has slowed significantly, with GDP growth declining from 3.33% to 0.92%, mainly due to a sharp drop in agricultural growth from 7.27% to 1.15%, while industrial and services sector performance remained weak. The persistently high policy rate has contributed to this slowdown by discouraging investment and limiting demand. Lowering the interest rate would have provided much-needed support to businesses, boosting production and employment while keeping the economic recovery on track. Additionally, a moderate 1% rate cut, rather than an aggressive reduction, would have signaled a balanced approach—supporting growth while maintaining confidence in price stability. Given the current economic conditions, keeping rates unchanged risks prolonging economic sluggishness. Therefore, a carefully planned rate reduction would have supported macroeconomic stability and created a more favorable environment for sustainable economic growth.

ICMA Research and Publications (R&P) Department reached out to renowned economists and experts, as well as the businessmen and industrialists, to gather their insights on the recent decision of SBP to maintain the policy rate at 12 percent. Their views and perspectives are summarized below:

Experts' Insight

Prof. Dr. Shahida Wizarat, a renowned economist, stated when contacted by ICMA R&P Department, that IMF conditions and sanctions imposed on Pakistan are influenced more by political and strategic considerations than by purely economic factors. She explained that if the policy rate were determined solely by economic conditions, such as inflation and growth dynamics, it would have been reduced. However, she noted that the decision to keep the policy rate unchanged indicates the influence of external geopolitical strategies aimed at maintaining economic stagnation rather than supporting recovery.

Dr. Ikram ul Haq, a member of the Advisory Board and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE), shared his views while talking to ICMA R&P Department. He stated, "The decision to not reduce the policy rate has disappointed businesses, which were asking for it to be brought down further. In the wake of a historic reduction in inflation, everyone was expecting a downward revision to 10%. The decision confirms that the MPC of the SBP is taking cautious action in view of vulnerabilities on both external and domestic fronts.

Mr. Asad Ali Shah, CEO of Asad Ali Shah Associates and Former Advisor to the Chief Minister of Sindh on Finance, noted in a conversation with ICMA that the SBP's decision to hold the policy rate at 12% reflects a cautious approach in the face of mixed economic signals. Although headline inflation has eased due to lower food and energy prices, the persistence and volatility of core inflation remain significant concerns, similar to challenges seen in other emerging economies. While the MPC rightly emphasizes the importance of stabilizing inflation and maintaining external buffers amid fiscal and external vulnerabilities, market sentiment had anticipated a 50-bps cut to further stimulate growth. This conservative stance risks delaying additional monetary easing, which many believe is critical for spurring a much-needed economic recovery.

Mr. M. Amayed Ashfaq Tola, President of Tola Associates, stated in a conversation with ICMA that achieving the targeted GDP growth of 3.6% would require an additional interest rate reduction of 3-4%, while still maintaining a positive real interest rate. He anticipated that inflation would remain within the 5-8% range for the rest of the fiscal year. Additionally, he emphasized that a realistic rupee parity would strengthen Pakistan's economic position and enhance external sector stability. Aligning the rupee with its real value could potentially push inflation into deflation, creating further room for interest rate cuts. This, in turn, could accelerate economic recovery and surpass growth expectations.

Mr. Aadil Nakhoda, a faculty member at IBA Karachi, stated that the government is taking a cautious approach given the ongoing review by the IMF, inflationary pressure as core inflation has yet to settle to lower levels, and the resurfacing of the current account deficit after reporting a surplus. It seems that the priority right now is to alleviate pressures on the external account and ensure the accumulation of reserves rather than pursue further expansionary monetary policy. The government is exercising caution due to the fact that pressures on the external account have created instability and raised fears of a balance of payments crisis. The "wait and see" approach, amid all the uncertainty in the global market, suggests that the government is in no hurry to push for higher growth levels.

Industry's Perspective

Mr. Saquib Fayyaz Magoon, Senior Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI), shared his thoughts with ICMA that the decision to keep the interest rate unchanged was unexpected and contrary to market expectations, especially given that inflation has dropped below 2%. He was of the view that this presented an ideal opportunity for the government to ease the financial burden on industries and businesses and added that reducing interest rates at this stage would have provided significant relief, particularly as energy prices, which were promised to be lowered and stabilized, remain a pressing issue. He stressed that a rate cut would have directly reduced financing costs across various sectors, boosting economic growth and improving competitiveness. Magoon further said that the business community had anticipated a rate reduction of at least 2% to 3%, with an urgent need for a deeper cut of 4% to 5% to align with the sharp decline in inflation. He urged the government to act swiftly and prioritize lowering interest rates to create a more favorable environment for industry and trade.

Mr. Aman Paracha, Vice President, the Federation of Pakistan Chambers of Commerce & Industry (FPCCI), stated that the State Bank of Pakistan's decision to maintain the policy rate at 12 percent was unexpected. He noted that the business community had expected a 4 to 5 percent reduction to bring it into single digits. Given the current inflation rate, he suggested that the policy rate should be around 7 to 8 percent. He urged the government to reconsider, emphasizing that a lower policy rate is essential for industrial growth and economic activity. He also highlighted that high interest rates and electricity costs are major challenges for businesses. Addressing these issues, he stressed, is crucial to revitalizing industries and boosting exports.

Mr. Usman Shaukat, President of the Rawalpindi Chamber of Commerce and Industry (RCCI), shared his perspective when approached by the ICMA R&P Department. He stated that the KIBOR rate should have been reduced, as the business community is eagerly anticipating the rate to drop to single digits as soon as possible. This expectation has also been highlighted by the Ministry of Finance, emphasizing the need to lower lending rates to encourage investment and support business expansion. He expressed hope that the SBP will reduce the rate by 200 basis points (bps) in its upcoming meeting.

Mr. Kashif Anwar, former President of the Lahore Chamber of Commerce and Industry (LCCI), stated that since inflation is declining, it is logical for the interest rate to also be reduced, as the two are closely correlated. He explained that interest rates were previously raised to control rising inflation, so with inflation now decreasing, a corresponding reduction in the policy rate would be expected. However, he noted that maintaining a high interest rate despite falling inflation raises questions about the rationale behind monetary policy decisions. Mr. Kashif Anwar further emphasized that lowering the markup rate alone will not be enough to stimulate industrial growth. He stressed that for a meaningful revival of the economy, additional structural measures are necessary, such as improving exchange rate stability, reducing utility costs, and implementing tax reforms. He concluded that without addressing these fundamental issues, relying solely on interest rate adjustments will not be sufficient to drive industrial expansion and economic recovery.

ICMA Policy Recommendations

1. **Gradual Interest Rate Adjustment with Data-Driven Policy Making:** While the SBP has maintained a cautious stance, a gradual reduction in the policy rate (e.g., 50 to 100 bps) could have support economic recovery without destabilizing inflation expectations. Experts suggest that external factors, including IMF conditions and geopolitical considerations, may have influenced this stance rather than purely economic fundamentals. ICMA recommends that the SBP should base its monetary policy decisions primarily on domestic economic indicators such as inflation and growth trends to ensure a more responsive approach.

2. **Strengthening Foreign Exchange Reserves through Export Diversification:** To mitigate external sector vulnerabilities, ICMA suggests to reduce dependence on debt-based financial inflows and increase non-traditional exports, including IT services and high-value agricultural products. A targeted export diversification strategy, supported by preferential financing for export-oriented industries, can improve the trade balance and stabilize the rupee against external shocks.

3. **Fiscal Discipline and Structural Tax Reforms:** The persistent shortfall in tax revenues remains a significant risk to macroeconomic stability. The ICMA urge the government to implement broad-based tax reforms, focusing on expanding the tax base rather than increasing tax rates, such as recent hike in agriculture tax reform, which will push the inflationary effect across all sectors of the economy. Digitalization of tax collection, addressing tax evasion, and integrating the informal sector into the tax net will improve fiscal sustainability without excessive reliance on those taxation, which disproportionately burdens lower-income households.

4. **Reducing Business Borrowing Costs and Enhancing Credit Availability:** The current tight monetary stance has led to an 8.43% decline in private sector credit, restricting industrial expansion and job creation. The ICMA recommend SBP to introduce targeted lending schemes for SMEs and critical industries, such as textiles, pharmaceuticals, and renewable energy. Incentivizing long-term investment credit through lower-cost refinancing schemes could support growth without fueling inflation.

5. **Addressing Structural Challenges Alongside Monetary Easing:** Experts argue that monetary policy alone cannot drive economic recovery—structural challenges such as high energy costs, exchange rate volatility, and tax inefficiencies also need to be addressed. ICMA suggests that interest rate adjustments by the SBP should be complemented by broader economic reforms to create a more favorable business environment and support long-term industrial development.

6. **Proactive Measures to Address Global Uncertainties and Supply Chain Risks:** With rising global protectionism and supply chain disruptions, Pakistan should enhance trade partnerships and diversify import sources to ensure stable access to raw materials. ICMA recommend SBP and the Ministry of Finance must collaborate on a contingency strategy to manage external risks, including potential shocks in global oil prices and tariff escalations affecting key exports.

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