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ICMA
MONETARY POLICY STATEMENT
ISSUE # 09 | JUNE 11, 2024

MPS REVIEW

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) has decided to reduce the policy rate by 150 basis points to 20.5 percent, during its meeting held on 10th June, 2024. This decision comes in light of a significant decline in inflation since February, with May's inflation figures surpassing previous expectations. The Committee observed that inflationary pressures are subsiding, supported by a tight monetary policy stance and fiscal consolidation. Core inflation has moderated, and inflation expectations among consumers and businesses have eased. However, the MPC remains cautious due to potential risks from upcoming budgetary measures and uncertain future energy price adjustments. Despite these risks, the cumulative impact of earlier monetary tightening is expected to maintain control over inflationary pressures.

MPC Observations on Key Sectors

Real Sector

- **GDP Growth:** Moderate at 2.4% for FY24, with agriculture showing strong growth, partially offset by subdued recovery in industry and services.
- **Growth in Q3-FY24:** Real GDP growth at 2.1%, an improvement from a contraction of 1.1% in the same quarter last year.
- **FY25 Outlook:** Moderate growth expected, with potential moderation in agriculture output and ongoing stabilization policies.

External Sector

- **Current Account Surplus:** Third consecutive monthly surplus in April, driven by robust remittances and exports, offsetting import upticks.
- **July-April FY24:** Current account deficit narrowed significantly to $202 million.
- **Exports:** Grew by 10.6%, mainly in rice and high value-added textile exports.
- **Imports:** Decreased by 5.3% due to lower international commodity prices and better domestic agriculture output.
- **Remittances**: Reached an all-time high of $3.2 billion in May 2024.
- **FX Reserves:** Improved to around $9 billion despite large debt repayments and weak official inflows.
- **IMF Program:** Government approached IMF for an Extended Fund Facility program to further build up forex reserves.

Fiscal Sector

- **Primary Surplus:** Increased to 1.5% of GDP during July-March FY24.
- **Overall Deficit:** Remained stable compared to last year.
- **Revenue Growth:** Driven by increased tax and PDL rates, higher SBP profit, and lower energy sector subsidies.
- **Fiscal Consolidation:** Emphasis on broadening the tax base and reforming loss-making public sector enterprises to achieve fiscal sustainability and reduce inflation.

Money and Credit

- **Broad Money (M2) Growth:** Decelerated to 15.2% y/y as of 24-May-2024, from 17.1% at end-March 2024.
- **Net Domestic Assets:** Deceleration contributed to reduced M2 growth.
- **Net Foreign Assets:** Positive contribution to M2 growth.
- **Deposits:** Main component of M2 growth.
- **Currency in Circulation:** Growth decelerated.
- **Reserve Money:** Growth declined sharply from 10.0% to 4.3%.
- **Monetary Aggregates:** Developments consistent with tight monetary policy stance, favorable for the inflation outlook.

Inflation Outlook

- **Headline Inflation:** Decelerated to 11.8% in May 2024 from 17.3% in April.
- **Core Inflation:** Decreased to 14.2% from 15.6%.
- **Effecting Factors:** Continued tight monetary policy, significant decline in prices of wheat, wheat flour, and other major food items, and downward adjustment in administered energy prices. But the sharp wheat price reductions have been proved to be temporary.
- **Near-term Risks:** FY25 budgetary measures and future adjustments in electricity and gas tariffs.
- **July 2024 Outlook:** Potential risk of inflation rising significantly before trending down during FY25.
- **Monetary Policy Stance:** Current stance deemed appropriate to ensure a downward inflation trajectory.

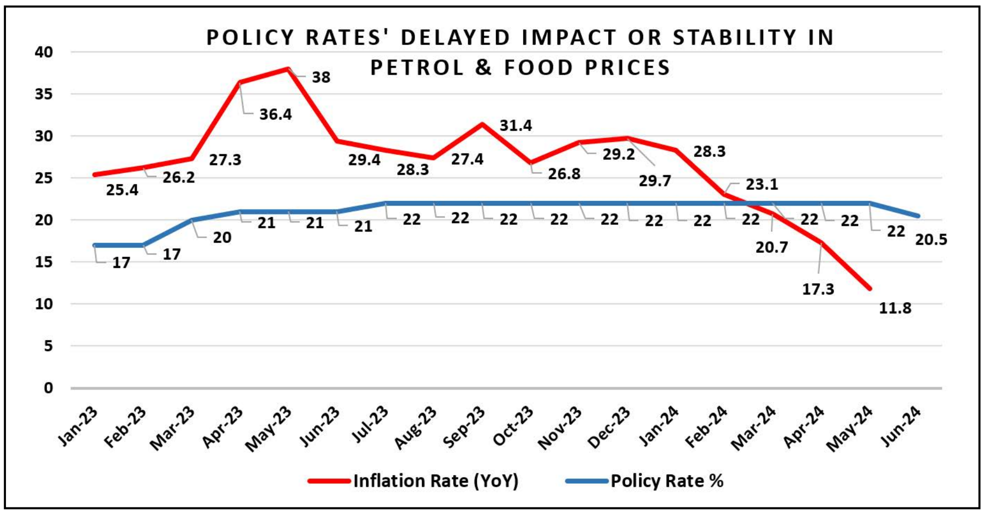
Economic Analysis

ICMA's Poll Analysis

The ICMA Research and Publications Department initiated a poll on LinkedIn just days before the announcement of the monetary policy, aiming to gauge the general expectations regarding the upcoming policy rate decision. According to the findings, the majority (46%) anticipate a 100 basis point reduction in the policy rate. Meanwhile, 32% of participants believe the policy rate will remain unchanged, and 22% predict a more substantial cut of 200 basis points. These results indicate a prevalent expectation among respondents for a decrease in the policy rate, reflecting sentiments that current economic conditions may warrant monetary easing to foster further economic growth and stability.

Inflation Control: Policy Rates' Delayed Impact or Stability in Petrol & Food Prices

It appears that policy rate adjustments have had a delayed yet ultimately positive impact on reducing inflation. Initially, despite the high policy rates, inflation continued to rise, primarily due to the persistent increase in cost-push inflation, which cannot be effectively controlled through contractionary monetary policy measures. While the consistently high policy rates may have contributed some what to the decline in demand-side inflation, the improvement in supply-side factors over the past two to three months—such as the decrease in petrol and food prices, coupled with a stable exchange rate—has played a significant role in moderating inflation levels. This transition has seen inflation rates move from hyperinflation to a relatively moderate level of 11.28% in May-24.



Source: *Pakistan Bureau of Statistics & State Bank of Pakistan. Analysis by ICMA.*

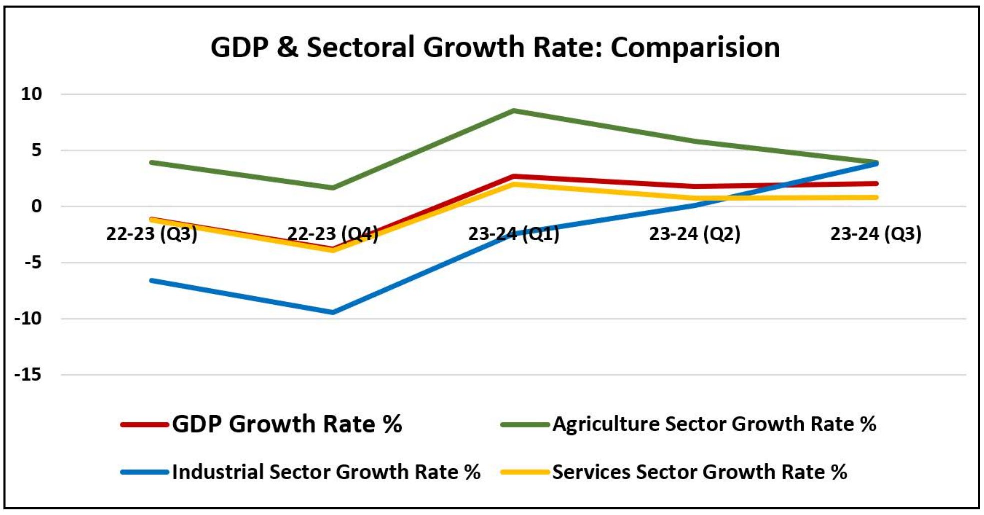
ICMA Analysis on Impact of Policy Rate on GDP and Sectoral Growth Rates

- **GDP Growth Rate:** The GDP growth rate experienced a significant turnaround from negative growth in FY 22-23 Q3 and Q4 (-1.1% and -3.74%, respectively) to positive growth in FY 23-24. The GDP growth rate improved to 2.71% in Q1 and stabilized around 2.09% by Q4. This suggests that while high policy rates may have initially constrained economic growth, the stabilization of inflation likely provided a more favorable environment for economic activities in the later quarters.

- **Agriculture Sector:** The agriculture sector showed resilience with positive growth throughout, peaking at 8.59% in Q1 of FY 23-24. This sector appears less sensitive to policy rate changes and more influenced by other factors such as weather conditions and global commodity prices.

- **Industrial Sector:** The industrial sector showed a gradual recovery from a steep decline of -9.45% in FY 22-23 Q4 to positive growth of 3.84% in FY 23-24 Q4. This recovery could be attributed to improved economic stability and investor confidence as inflation rates began to decline.

- **Services Sector:** The services sector, similar to the overall GDP trend, improved from negative growth in FY 22-23 Q4 to modest positive growth in FY 23-24. This sector likely benefited from overall economic stabilization and increased consumer confidence as inflation was brought under control.



Source: *Pakistan Bureau of Statistics & State Bank of Pakistan. Analysis by ICMA. Quarterly NATIONAL ACCOUNTS 2023-24.*

Experts Insight

Mr. Abdul Azeem, Head of Research at AL Habib Capital Markets (Pvt.) Ltd., stated to ICMA that the monetary policy easing cycle is beginning now, and the SBP's decision reflects declining inflation, moderate economic activity, and rising unemployment risks. "The rate cut was driven by a recovery in GDP growth, a narrowed current account deficit bolstering foreign reserves, and falling international oil prices". Mr. Abdul Azeem further commented that the reduction in the policy rate is likely to benefit the stock market, especially highly leveraged sectors. This reduction will notably decrease the financial burden on industries such as cement, steel, textiles, household appliances, and chemicals. He added that the effects of this easing are expected to manifest in the coming quarters, as lower interest rates enable companies to improve their profitability through reduced financing costs. Additionally, increased consumer demand, spurred by more accessible low-cost borrowing, is expected to boost revenues across these sectors.

Dr. Ikramul Haq and Mr. Abdul Raoof Shakoori, speaking to the ICMA Research Department, noted that with inflation easing to its lowest point in the past 30 months, the central bank has reduced the policy rate by 150 basis points after keeping it unchanged for seven consecutive sessions. They said this move aligns with market expectations and is anticipated to boost business confidence while reducing the debt servicing burden on the national exchequer. However, the Monetary Policy Committee (MPC) observed that short-term inflation remains susceptible to risks from FY25 budgetary measures and potential future adjustments in electricity and gas tariffs. In the long term, the reduced policy rate is expected to promote sustainable economic development by creating an environment conducive to investment, innovation, and industrial growth. They added that this will enhance productivity, create jobs, and improve the overall standard of living, contributing to a more resilient and robust national economy.

Speaking to ICMA, **Dr. Ashfaque Hasan Khan, a renowned economist and former Economic Advisor at the Ministry of Finance,** commented, "Bahut dair kardi meharban ne aate aate. The damage done is irreparable." He observed that, knowing Pakistan's inflation is largely a supply-side issue and that the government itself is exacerbating it by raising utility prices (electricity and gas), maintaining a high interest rate was an inappropriate policy to manage inflation. The interest rate is a demand management tool, and it is effective if inflation is driven by excessive demand. Therefore, for quite some time, I have been advocating and presenting empirical evidence that a high interest rate is actually contributing to inflation. I have been calling for a reduction in the interest rate, but no one heeded my advice. By keeping the interest rate high, we have undermined Pakistan's budget and economy. More cuts in the interest rate are urgently needed.

In a conversation with ICMA, **Mr. Muhammad Sabir, Principal Economist at the Social Policy and Development Centre (SPDC),** emphasized that the decision to slash interest rates by 150 basis points in the monetary policy is a prudent move in an economy burdened by high borrowing costs. He added that this action would help reduce government spending on debt servicing, particularly for future borrowings, and create the much-needed fiscal space, allowing for potential increases in public spending on infrastructure or social programs without significantly widening the budget deficit. Furthermore, Mr. Sabir observed that cheaper borrowing not only benefits businesses but also incentivizes investment in new projects and expansion due to lower rates. Investors may be enticed to reallocate funds from less productive areas to the real economy. This "crowding-in" effect channels funds into businesses that directly contribute to economic output and employment. In conclusion, Mr. Sabir stated that this interest rate reduction is a strategic move aimed at lowering inflationary expectations, improving the government's fiscal health, and stimulating economic activity.

Business and Industry Viewpoint

Mr. Dewan Mohammad Yousuf Farooqui, Group Chairman of Yousuf Dewan Companies (YDC) and a former Minister for Finance, Information, and Industries in the Government of Sindh, shared his view on the policy rate reduction that "It's definitely a positive sign and will send a good signal. This change was long overdue; we had expectations for this six months ago, and even earlier, but as the saying goes, 'dair aayed durust aayed'—better late than never. This adjustment was very much needed."

Mr. Saquib Fayyaz Magoon, Senior Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI), emphasized to ICMA the importance for the State Bank of Pakistan (SBP) to prioritize core inflation over general inflation in the immediate term. He highlighted the need for the government to ensure the effectiveness of price control measures through vigilant actions against hoarding and malpractices. Despite progressive and significant hikes in policy rates from 9.75 percent to 22 percent over a period of six quarters in 2022 and 2023, general inflation remained stubbornly high and did not respond to the policy rate adjustments, as explained by Mr. Magoon. He stressed that despite the successful completion of the IMF Stand-by Agreement (IMF-SBA) and the 22% policy rate, Pakistan continues to face challenges such as dwindling exports and economic instability. This situation underscores the imperative for the government to explore alternative policy tools to mitigate economic volatility.

Mr. Kashif Anwar, President of the Lahore Chamber of Commerce and Industry (LCCI), shared his views with the ICMA Research Department, stating that the reduction in the policy rate is the first positive step in a long time. He emphasized that this measure, along with the recent decrease in petrol prices, marks an important initial move towards reducing the cost of doing business by lowering interest rates. He noted that while the 1.5% reduction is a positive beginning, it is not sufficient on its own to solve the economic problems. Mr. Anwar highlighted the need to address other critical factors that contribute to input costs, such as electricity and gas prices, and the exchange rate of the rupee against the dollar. He cautioned that without reductions in these areas, inflation will remain a challenge. He urged the government to explore additional measures, stressing that sustainable economic recovery requires lowering electricity prices to single digits. He also pointed out that the high interest rates have made it more profitable for funds to be deposited in banks, thus diverting investment away from industry due to the high cost of borrowing. Therefore, merely reducing the interest rate will not be sufficient to rejuvenate the economy; a comprehensive approach that considers other cost factors is necessary.

Mr. Abdul Waheed Khan, Director General of the Pakistan Automotive Manufacturers Association (PAMA), when contacted by ICMA Research for his comments, remarked that the downward change in the policy rate from 22% to 20.5% is indeed a step in the right direction. However, with the rate still being so high, it may not bring about substantial change toward investment in the country. Truly, as the downward slide has begun, it shall produce a positive perception among future investors.

Policy Recommendation

ICMA strongly recommends and emphasizes the importance of supply-side policy measures for long term sustainable economic prosperity. The recent decline in inflation due to reduction in wheat and petrol prices may not endure without proper targeted policies to revive and enhance the economic potential by addressing the underlying factors causing cost push inflation. While the recent 150 basis point reduction in the policy rate is a positive step, additional rate cuts are necessary to stimulate investment and consumer spending. Moreover, the investment in primary sector, especially agriculture, can bring down import dependance and provide raw material to across all the sectors in the long run. Concurrently, the government should focus on broadening the tax base, reforming loss-making public enterprises, and enhancing fiscal consolidation to stabilize public finances. Reducing energy costs by reforming electricity and gas pricing mechanisms will lower cost of doing business. By implementing these measures, Pakistan can pave the way for a balanced economic recovery, improve business confidence, and enhance overall economic prosperity.

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