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

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With inflation climbing to the highest ever in February 2023, the State bank of Pakistan increased the pace and scale of the rate hike by 300 basis points (bps) to 20% to combat runaway prices in a preponed meeting held on Thursday i.e., March 02, 2023. This is the highest-ever policy rate since October 1996 and also by far the highest interest rate in the SAARC region.

Not only this, but the recent rally of bond markets also made the strong case for another rate hike where in the last auction held on February 22, 2023, the cut-off yields of 3M market Treasury Bills (T-Bill) jumped by 195bps to 19.95%. While cut-off yield for 6-month and 12-month T-bill increased to 19.90% and 19.79%, up by 206bps and 184bps respectively, showing the rising gap between the policy rate and yields.

Moreover, this aggressive hike was one of the four prior actions on the unfinished International Monetary Fund (IMF)'s bailout program of $7 billion.

Data over the past few months has shown high inflation to be stubbornly persistent amid supply disruptions. Also, the rise in core inflation and massive depreciation of the exchange rate keep pressure on the central bank. Hence, SBP recognized the need to move more urgently to rein in the upward drift in near-term inflation expectations.

So far, there is little sign of progress as higher prices have seeped into the cost of living and wages, primarily due to supply chain disruptions while the strict conditionalities of the lender badly affect the most vulnerable segments of society.

It is worth highlighting that the Monetary Policy Committee (MPC) itself expects inflation to rise further in the next few months as the impact of recent fiscal adjustments (increase in general sales tax (GST) and excise duties, reduction in subsidies and adjustment in energy prices) unfolds before it begins to fall, albeit at a gradual pace. The average inflation this year is now expected in the range of 27-29% against the November 2022 projection of 21- 23%. In this context, the MPC emphasized that anchoring inflation expectations is critical and warrants a strong policy response.

On the external front, the MPC noted that despite a substantial reduction in the current account deficit (CAD), vulnerabilities continue to persist. In January 2023, the Current Account Deficit (CAD) fell to $242 million, the lowest level since March 2021. Notwithstanding this improvement, scheduled debt repayments and a decline in financial inflows amid rising global interest rates and domestic uncertainties, continue to exert pressure on FX reserves and the exchange rate.

In a bid to improve its external position, the revival of the 9th review under the IMF's Extended Fund Facility (EFF) will help address the near-term challenges, SBP said.

Through the lens of experts

Prof. Dr. Shahida Wizarat, a renowned Economist and Dean, the College of Economics and Social Development at the Institute of Business Management (IOBM) shared her views with ICMA. She stated, "Witnessing economic meltdown, the Neo-liberalism model has failed. Our economic managers have badly failed to navigate the deeper structural problems."

"Since 1990, we have been following this model where the currency is devaluated to increase the volume of exports. And in the last 30 years, the exports have not increased significantly, however, our imports become way expensive as Pakistan is the importer of industrial raw materials, capital goods and oil which leads to a higher cost of doing business. Resultantly, the rising prices have been passing on to the consumers whereas as many businesses are shutting down," she stated.

In parallel, this monetary tightening by the central bank to keep inflation in check has a ripple effect on output growth due to the growing price pressures, low investment and high unemployment. In the current environment, as many as 750,000 people get unemployed in the textile sector only, Professor added.

Besides, this rising interest rate pushes up the cost of debt service.

PIDE
Pakistan Institute of Development Economics

"The unprecedented hike in the key interest rate to fulfill another condition of IMF will severely hurt the already struggling businesses," **Dr. Ikram ul Haq,** a member of the Advisory Board of the Pakistan Institute of Development Economics (PIDE), has apprised ICMA.

Furthermore, this historically high rate will not help combat spiraling inflation which are due to cost-push inflation, causing more economic hardships for the common people.

Mr. Haq said that this increase in the policy rate will lead to huge non-performing loans, which will create serious problems for the otherwise profitable banking sector. It will be almost impossible for businesses to take advantage of the new credit.

In the same vein, **Mr. Fahad Rauf,** Head of Research at Ismail Iqbal Securities told ICMA, "We have seen SBP has been continuously tightening for the past one and half year and so, but it has not got the desired results as inflation has gone up; the currency has devalued. He suggested that jacking up the interest rate is not effective in this environment as Inflation is due to supply chain disruption."

He further said, "While debt servicing cost keeps on rising because of the recent hike will take effect with a lag. Businesses and the corporate sector will get impacted as they are already suffering from low demand. Due to a shortage of imported raw materials, they are operating at a low level, hence, an increase in layoffs."

When asked about the solution to this messed up economy, he said, the core problem is a shortage of dollars. And the only viable solution so far is IMF. The resumption of the IMF program will open up other avenues of dollar inflows, especially from friendly countries like China, Saudi Arabia and UAE.

This hike in 300bps would slow down the economy more as financing costs will go up which will hurt the sectors like cement, steel, and auto; **Sunny Kumar,** Deputy Head of Research at Topline Securities said while talking to ICMA.

Going forward, he added that we need a big IMF program of around $10-12 billion after June 2023 whereas the Chinese loan has to be rescheduled to lower the external risks.

Businesses' concerns

Businesses and corporate sectors have also become increasingly concerned about upside inflation risks in recent months.

The combination of rapidly mounting prices with the consecutive rise in interest rates has put immense pressure on companies as it translates to higher costs on everything from the purchase of raw materials, and paying wages to business loans. It limits financing options for companies, especially those already in debt.

Speaking to ICMA on the recent hike in interest rate, **Mr. Musadaq Zulqarnain,** Chairman & CEO of Interloop Holdings said, "Textbook formulas don't work without considering other factors. In a country with more than half of the economy in Grey and with Government borrowing 2/3 of the total borrowing, hike in interest rates after a certain point adds to inflation - not arrest it. The current hike will exactly do the same."

Mr. Suleman Chawla, Senior Vice President FPCCI, in his discussion with ICMA said that coupled with the historical hike in the policy rate, the government has also abruptly withdrawn the subsidy to the 5 export-oriented sectors on power tariff – which are already burgeoned under the current abysmal ease of doing business environment & investor sentiment in the country.

Mr. Suleman Chawla was concerned about sustainable performance. The mainstay of Pakistani exports, i.e. textiles & allied products, can't even repeat FY22's export performance of $19.3 billion after these anti-industry & anti-exports measures, he added.

Way Forward

Nevertheless, restoring price stability is of utmost importance, and is a necessary condition for sustainable economic growth. The country has been experiencing supply chain bottlenecks that are creating delays, a lack of transparency and widening gaps between demand and supply.

The government must direct provincial authorities to take immediate measures to keep the prices of food commodities in check as the holy month of Ramadan is fast approaching.

Sensing the gravity of shortage of industrial raw materials and capital goods, potential dollar inflows from fund and other friendly countries will lessen these risks. However, if risks of trend inflation keep skewing towards the upside, ICMA believes that the central bank might continue monetary tightening for a while longer which could trade off growth.

ICMA also thinks that instead of raising the policy rate on a regular basis, the government should pursue other effective methods of containing inflationary pressures. The excessive depreciation of the Pakistani rupee must be addressed on a war footing, as it would not only increase the cost of doing business but could also result in mass unemployment due to the closure of industries.