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

ICMA Research and Publications Department

Preamble

On October 30, 2023, the Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) convened as scheduled and chose to maintain the policy rate at 22 percent. In their previous meeting on September 14, the MPC had likewise opted to leave the policy rate unchanged. Market analysts had expected a 100 basis points rate reduction this time, given the improving economic landscape.

MPC noted that CPI inflation had risen in September to 31.4% but expected it to decrease in October and beyond. The MPC noted both risks and positive factors in the economic landscape, including global oil price fluctuations, impending gas tariff increases, targeted fiscal consolidation, improved commodity availability, and exchange rate alignment.

MPC observed that the real interest rate will remain positive in the near future which is necessary to bring down the inflation rate. MPC emphasized the importance of continuing with the existing tight monetary policy to achieve the medium-term inflation target of 5-7 percent by the end of FY25, provided fiscal consolidation and planned external funding remain on track.

MPC Observations on Key Sectors

Real Sector:
- Latest data on economic activities shows a moderate growth this year.
- Kharif crops have witnessed a substantial rise in comparison to the last year.
- A moderate recovery in cement, petroleum, oil, lubricants (POL) & automobile sales.
- Improvement in large-scale manufacturing (LSM) output, driven by domestic sectors.

External Sector:
- Substantial improvement in the current account balance, with a 58% deficit reduction.
- Positive growth in exports and remittances in September.
- Reforms and actions bolster FX market sentiment and liquidity.
- FX reserves steady at around $7.5 billion by October 20, despite limited official inflows.
- Timely IMF-SBA review crucial for securing extra financing.

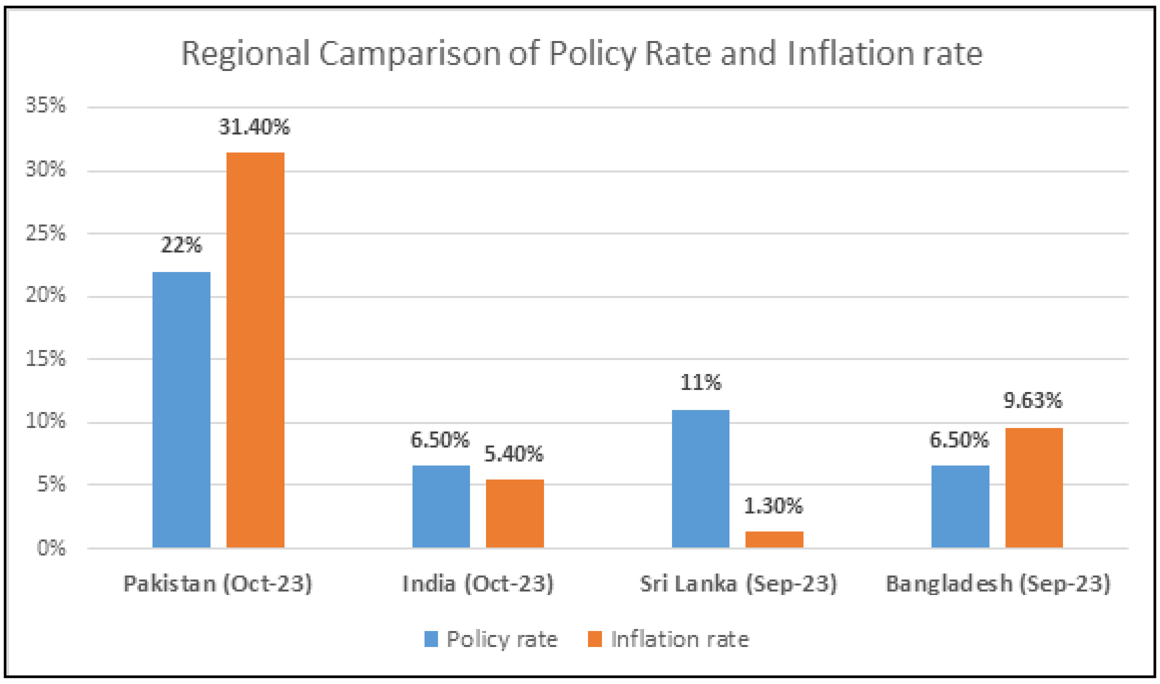
Fiscal Sector:
- Q1-FY24 fiscal indicators improved.
- Fiscal deficit reduced to 0.9% of GDP, primary balance in surplus at 0.4%.
- Better revenue collection and controlled spending.
- FBR's revenue grew by 24.9%.
- Non-tax revenues almost doubled due to PDL rate increase.
- Total expenditures maintained last year's level with subsidy reductions.
- Maintaining fiscal discipline is crucial for lowering inflation.

Money and Credit:
- M2 growth slowed to 12.9% by September.
- Private sector credit and currency in circulation contributed to the slowdown.
- Reserve money growth also decreased, primarily due to less currency in circulation.
- NFA of SBP and banking system grew with significant FX inflows.
- Expected fiscal consolidation and external inflows will boost private sector credit and NFA.

Inflation Outlook:
- September saw a surge to 31.4% in headline inflation.
- Significant October decline expected due to lower fuel prices and eased food costs.
- Anticipating substantial inflation reduction in the second half of FY24.
- Upside risks from volatile global oil prices and gas tariff hikes.
- Core inflation persists at around 21%.
- Fiscal policy and food availability are helping stabilize and reduce inflation.

Regional Analysis

ICMA Research Department analyzed how Pakistan's economic policies and interest rates compare to those of its neighboring countries. It is concluded that in October 2023, Pakistan stands out with a notably high policy rate of 22% and a concerning inflation rate of 31.4%. While there's hope for a decrease in inflation by mid-2024, these numbers still raise concerns. In contrast, India maintains a relatively lower policy rate of 6.5% and projects a more stable inflation rate of 5.4%. Bangladesh has also set its policy rate at 6.5% for 2023-2024, with an inflation rate of 9.63% in September 2023. Meanwhile, Sri Lanka has set its policy rate at 11% and boasts the lowest regional inflation rate, at just 1.3% in September 2023. This comparison underscores the need for Pakistan to explore effective strategies to align its monetary policies more closely with regional standards, fostering economic stability and growth.



Experts' insight

Prof. Dr. Shahida Wizarat, a renowned Economist and Dean at the Institute of Business Management's College of Economics and Social Development (IOBM), provided her insights to ICMA. She asserted that, in the context of our economy facing cost-push inflation, it would have been more appropriate to lower the policy rate as a counter-inflationary measure. She highlighted that the current high-interest rate is exacerbating inflation and acting as a deterrent to investment, economic output, and job creation.

Syed Fawad Basir, Head of Research at AL Habib Capital Markets Pvt Ltd., told ICMA that the market movement along with the decline in yields had hinted towards an inflection point where whispers of a 50bps decline were expected however status quo followed by an increase in Gas prices clarified the situation where although inflation is expected to take a softer tone, is still high. Secondly, concerns about the USD depreciation again in the midst of no major inflows can also be attributed as a cause of concern.

In a conversation with ICMA, **Dr. Ashfaque Hasan Khan, a distinguished economist and former Economic Advisor at the Ministry of Finance,** discussed the sudden change in market expectations. Despite no significant changes in Pakistan's economic fundamentals or a decline in inflation, these expectations were manipulated through illicit activities involving certain elements in the market. He added that this manipulation has since been controlled, resulting in market stability with the rupee gaining strength against the dollar. Furthermore, interest rates have not changed in the last three monetary policy statements due to uncertainty about their impact on reducing inflation.

Muhammad Fawad Khan, CFA, an Equity Research Analyst and Director at Tharaa Financial Center (formerly Center for Financial Studies) in Saudi Arabia, shared his perspective during an interaction with the ICMA R&P Department. He praised the SBP's decision, deeming it a well-balanced move that takes into account the nascent stability in the external account, the looming threat of inflation, the impact of rising gas prices, and the prevailing uncertainty in energy prices. Mr. Khan also noted that the secondary market yields might continue to reflect optimism concerning a potential rate cut. Looking ahead to the second half of fiscal year 2024, he highlighted the importance of maintaining stability in the exchange rate, bolstering remittances, and boosting exports as crucial factors for the central bank's success, in his opinion.

Speaking with ICMA, **Mr. Abdul Azeem, Head of Research at Spectrum Securities Limited,** pointed out that recent fluctuations in global oil prices and the upcoming rise in gas tariffs from July 2023 introduce uncertainty into the inflation and current account outlook for fiscal year 2024. The impending IMF review heavily influences the formulation of the MPS. Consequently, the SBP has chosen to maintain its current policy rate. Looking ahead, the anticipated decline in inflation due to various factors and the stability of the PKR could lead to a more accommodative monetary policy stance by the SBP.

Business and Industry Viewpoint

Fazal Karim Dadabhoy, Managing Director of M.H. Dadabhoy Group of Companies, while talking to ICMA said that the Monetary Policy Committee (MPC) decided to maintain the policy rate at 22% which is in accordance with the market's expectations of maintaining the status quo. He said that this decision is taken keeping in view the recent oil price swings (hovering around USD 90/bbl.) and a gas tariff hike as potential upside factors affecting FY24 inflation.

Pervez Madraswala, CEO of Clipsal Pakistan Private Ltd in an exclusive message to ICMA said that the 'export figures are quite depressing and there is no change in monetary policy rate despite the expectations from the business community".

Speaking with ICMA, **Mr. Ahsan Akbar Farooqui, Director of Operations at UNICO Paint Industries Pvt. Ltd** suggested the use of sectoral debt rationing by the State Bank of Pakistan (SBP) as an alternative to raising interest rates. This could help manage the money supply without increasing government deficits and taxes. He also pointed out the success of a lower interest rate strategy during Dr. Shamshad Akhtar's time as SBP Governor and recommended a similar approach by the current Finance Minister.

Recommendations

ICMA strongly recommends to the State Bank of Pakistan to gradually lower the current policy rate from 22% to a more favorable 20%. This decision should be influenced by the strengthening Pakistani Rupee and the country's ongoing economic recovery. Such a measured policy change will not only boost market confidence but also encourage businesses to invest more in the local economy, driving growth and prosperity in Pakistan.

Additionally, ICMA suggests giving top priority to fiscal discipline by managing the budget carefully, improving revenue generation, and ensuring responsible spending. It's crucial to promote the diversification of exports by supporting sectors with export potential and exploring new markets. Creating an environment that attracts both domestic and foreign investments through policy reforms, incentives, and simplified administrative procedures is also vital. Lastly, addressing the energy challenge by promoting renewable energy sources and optimizing monetary policy mechanisms is essential for ensuring economic stability and growth in Pakistan.