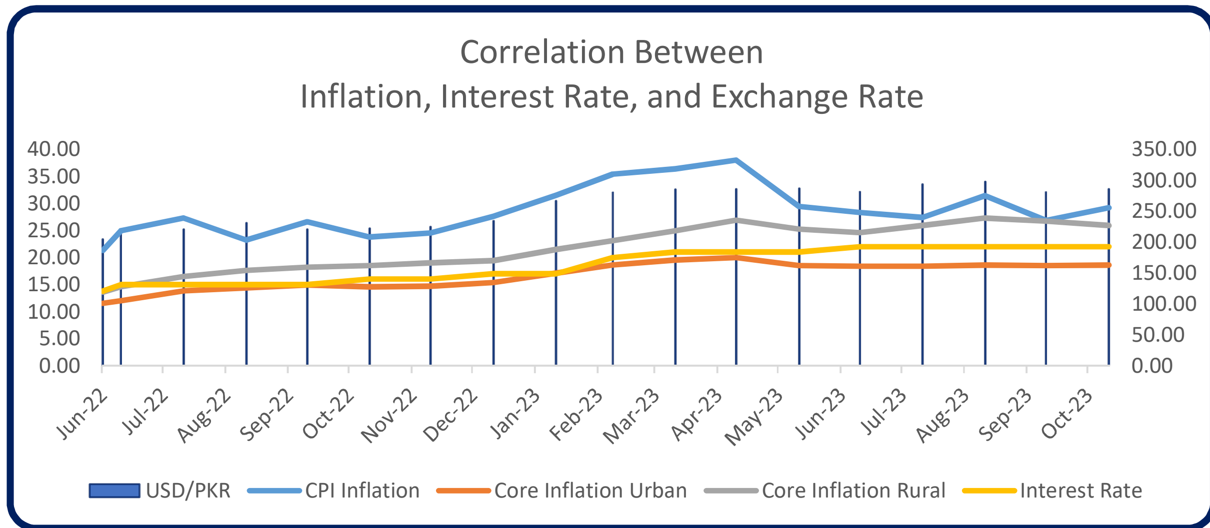
Unveiling the Paradox: The Ineffectiveness of Rising Interest Rates in Pakistan's Economic Resurgence.

In recent times, Pakistan has grappled with the persisting challenge of rising inflation. While conventional wisdom often suggests that increasing interest rates is a reliable tool to curb inflation, the current scenario in Pakistan challenges this notion. The State Bank of Pakistan's ("SBP") decision of raising interest rates in the face of escalating inflation has stifled the economy and has created hardship for doing business in Pakistan. This move has sparked debates about the efficacy of interest rate adjustments, especially when the inflationary pressures stem from cost-push factors rather than the more traditional demand-pull dynamics. Moreover, inflation in Pakistan is attributed to a dual impact of elevated global commodity prices and currency devaluation.

Since June 2022, the economy of Pakistan has grappled with an alarming inflation rate exceeding 20%, persisting for 18 months to-date. In an attempt to curb this inflationary surge, the SBP took the conventional step of raising the interest rate from 13.75% in May 2022 to 22% in July 2023. Subsequently, the SBP has decided to maintain the interest rate at 22%. However, despite the drastic increase in the interest rates, the inflation rate has not shown signs of significant reduction. The policy of raising the interest rates has not proven effective in addressing the persistent inflationary pressures, highlighting the complexities and challenges faced by the central bank in managing the economic situation.

Unlike demand-pull inflation, which results from increased consumer demand outpacing available supply, cost-push inflation is driven by rising production costs. In Pakistan's case, factors such as soaring energy prices, particularly in the form of escalating petroleum costs, have played a pivotal role in fueling inflationary pressures. Moreover, major industries mostly depend on imported machineries and raw materials. As such, the depreciation of domestic currency has also resulted in hiking the cost of manufacturing. In the past six months, during which the inflation rate has gradually come down to below 30%, the SBP did have reasonable grounds to decrease the interest rates. However, the decision by the SBP not to decrease interest rates is an opportunity that has been missed.

Furthermore, in the meeting of the Monetary Policy Committee ("MPC") held today on 12th December 2023, the SBP has decided to maintain the policy rate at 22 percent, considering the impact of recent gas price hikes on inflation. Despite the higher-than-expected inflation in November, the MPC expects a decline in inflation due to various factors. Moreover, the MPC believes the current monetary policy stance is suitable for achieving the inflation target by end-FY25.



The graph *supra* showcases the correlation among key macroeconomic indicators of Pakistan's economy.

The argument for a potential decrease in interest rates gains strength when we consider recent developments in key economic indicators. Notably, the prices of petrol and diesel have witnessed a significant decrease in recent months, and the exchange rate has also appreciated which has made room for the international investors. However, due to persistent negative real interest rates, where inflation is higher than the interest rate, no investor wants to decline the real value of their assets. Furthermore, a deficiency in investment results in a scarcity of dollars, consequently impacting currency devaluation.

Beyond the immediate economic stimulus, there are fiscal considerations that make a compelling case for lowering interest rates. A 1% reduction in interest rates, for instance, translates to substantial savings for the Government. In the context of Pakistan, this could result in a saving of around PKR 400 billion in debt servicing costs. Such savings could be strategically deployed towards critical areas such as infrastructure development, social welfare programs, or reducing the fiscal deficit.

These developments present a compelling case for the SBP to consider lowering interest rates by 1% to 2%. A reduction in interest rates under these circumstances could potentially stimulate economic activity by easing borrowing costs for businesses. This approach aligns with the central bank's goal of striking a balance between controlling inflation and fostering sustainable economic growth.

The decision not to decrease the interest rates also has the effect of slowing down economic activity in Pakistan, which, in turn, hampers growth opportunities. The revised GDP growth projection for the Fiscal Year 2022-23 stands at a contraction of 0.17%, a decline from the initial estimate of 0.29%, as per the National Accounts Committee ("NAC"). With Pakistan's population growing at

a rate of 2.6% per year, any economic growth rate beneath this threshold implies an increase in poverty, unemployment, and malnourishment for the Nation.

With a population exceeding 240 million, Pakistan requires comprehensive planning for both structural development and human capital enhancement. This can only be achieved when there is an influx of more investors into the country. To facilitate this, the development of robust road infrastructure is essential, creating an environment conducive to investment and fostering economic progress. Adequate attention to both structural and human capital development is crucial for steering the nation towards sustainable growth and prosperity.

Moreover, the recent decline in petrol, diesel, and Brent Crude prices provided the central bank with an opportune moment to consider a reduction in interest rates. Such a move could have provided the necessary impetus for economic growth while simultaneously offering fiscal relief. As the SBP navigates the complexities of inflation management, a flexible and responsive approach that considers both immediate economic indicators and broader fiscal implications will be paramount for steering Pakistan's economy towards stability and prosperity.

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