SBP Cuts Policy Rate by 200 Basis Points Amid Calls for Major Reduction.

The State Bank of Pakistan ("SBP") announced on Thursday that it has decided to reduce its key policy rate by **200 basis points ("bps") or 2.0%**, lowering it from 19.5% to 17.5%, in response to growing calls for a significant rate cut. Previously, the interest rate was 19.5%, while inflation in August 2024 recorded at 9.6% on a Year-on-Year ("Y-o-Y") basis, resulting in a positive real interest rate of 10%. This wide gap has prompted calls for a substantial rate reduction.

According to the statement, the Monetary Policy Committee ("MPC") assessed that "the real interest rate remains sufficiently positive to bring inflation down to its medium-term target of 5% to 7% and to support macroeconomic stability". Explaining the committee's decision, the MPC highlighted the sharp decline in global oil prices and noted that the SBP's foreign reserves stood at $9.5 billion as of September 6th, 2024, despite weak inflows and ongoing debt repayments.

Additionally, the MPC mentioned that secondary market yields on the Government securities have significantly decreased since the last MPC meeting. The statement also noted that inflation expectations and business confidence have improved in recent surveys, although consumer confidence has slightly worsened.

However, in a previous publication on Monetary Policy by **Tola Associates**, it was suggested that the SBP should reduce the policy rate by at least 3.0% to 5.5% on the basis of the estimation of real interest rate. For a brief overview thereon, please click here.

Furthermore, following today's decision, the real interest rate stands at 8%, which remains excessively high given the current policy rate of 17.5% and inflation at 9.6%. There is also a strong likelihood that inflation may continue to decline in the coming months, as the wholesale price index has slowed to 6.3% in August 2024 from 10.4% on a Y-o-Y basis, and this decrease may be reflected in CPI inflation in the coming months. Lastly, excessively high real interest rates can weaken the economic activity, slow growth, and increase financial instability if maintained for too long.