

Preamble

The State Bank of Pakistan's (SBP) Monetary Policy Committee (MPC), in its January 26, 2026 meeting, kept the policy rate unchanged at 10.5 percent, citing persistent core inflation at 7.4 percent and external sector pressures. The decision came despite market expectations of a 50–100 basis points cut, reflecting SBP's cautious approach to maintaining macroeconomic stability. Headline inflation stood at 5.6 percent in December 2025.

Real GDP grew provisionally by 3.7 percent in Q1-FY26, led by industry and agriculture, while consumer and business confidence strengthened. Resilient remittances and stable global commodity prices helped contain the current account deficit, even as the trade gap widened. SBP's foreign exchange reserves reached \$16.1 billion, while FBR revenue growth slowed to 7.3 percent in December. The IMF slightly revised up global growth for 2026 amid geopolitical and commodity risks. The MPC noted that the real policy rate remains positive to anchor inflation expectations and emphasized the need for coordinated monetary-fiscal policies and structural reforms to sustain higher economic growth.

ICMA Analysis shows the Pakistan's Debt can be reduced by approx. Rs. 1.94 trillion over the period, if the Policy Rate declines to 9.5%

The ICMA's previous review of the Monetary Policy Statement shows that Pakistan's inflation is largely driven by supply factors and cannot be easily controlled through interest rate changes. However, the policy rate directly affects the real interest rate, which determines the government's borrowing costs: a higher policy rate increases interest expenses, widening the gap between debt servicing costs and economic growth and potentially pushing the debt-to-GDP ratio higher. Conversely, a lower policy rate reduces borrowing costs, narrows this gap, and supports debt sustainability, especially when combined with a healthy primary surplus and stable economic growth.

Debt Sustainability Framework:

In this section, ICMA analyze the role of policy rate in improving Pakistan's debt sustainability using the following Debt Sustainability Framework. Similar analytical methodologies are employed by leading international institutions; including the IMF, World Bank, European Central Bank, and OECD; to assess debt dynamics, fiscal risks, and long-term sustainability.

Change in Debt to GDP Ratio =

$$(Real\ Interest\ Rate - Medium-Term\ GDP\ Growth) \\ \times\ Debt\ to\ GDP\ Ratio - Primary\ Surplus$$

Rule to Judge the Debt Sustainability:

- If the Change in Debt to GDP Ratio is **Positive** → Debt is Unsustainable
- If the Change in Debt to GDP Ratio is **Negative** → Debt is becoming Sustainable

ICMA Analysis Evaluates the Pakistan's Debt Sustainability

Cases	(a) Policy Rate (i)	(b) Inflation (Dec-25 YoY)	(c) Real Rate ($R = i -$ INF)	(d) Medium- Term Growth (G)	(e) $R - G$	(f) Debt to GDP Ratio (DP) As on Jun- 25	(g) $(R - G) *$ DP	(h) Primary Surplus as % GDP (PS) Q1 FY26	(I) Change in Debt to GDP Ratio% = $(R - G) * DP$ - PS	Debt Condition
1)	10.5%	5.6%	4.9%	3.5%	+1.4%	70.8 = 0.99%	0.014 * 70.8 = 0.64%	2.7%	-1.71%	Low Sustainability
2)	10.0%	5.6%	4.4%	3.5%	+0.9%	70.8 = 0.64%	0.009 * 70.8 = 0.64%	2.7%	-2.06%	Moderately Sustainability
3)	9.5%	5.6%	3.9%	3.5%	+0.4%	70.8 = 0.28%	0.004 * 70.8 = 0.28%	2.7%	-2.42%	Moderately Sustainability

Sources: SBP, Ministry of Finance and IMF. Analysis by ICMA.

Interpretation: Debt Sustainability Analysis

- Debt reduction under the current 10.5% policy rate**

Under current economic conditions, setting the policy rate at 10.5% would lead to a -1.71% change in the debt-to-GDP ratio, showing that public debt is slightly decreasing relative to the size of the economy. With a total debt of Rs. 80.52 trillion, this would result in a reduction of about Rs. 1.37 trillion in the debt burden over the period. This indicates that the debt is relatively sustainable, as borrowing costs are largely balanced by economic growth and fiscal measures, keeping the debt ratio stable within a narrow margin.

- Debt reduction if the policy rate declines to 10%**

Under current economic conditions, a policy rate of 10% would result in a -2.06% change in the debt-to-GDP ratio, indicating that public debt remains nearly stable relative to economic output. With a total debt of Rs. 80.52 trillion, this corresponds to a reduction of approximately Rs. 1.65 trillion in the debt burden over the period. This suggests that the debt position is moderately sustainable, as fiscal efforts and economic growth just offset borrowing costs, creating more room to absorb shocks or rising interest expenses.

- Debt reduction if the policy rate declines to 9.5%**

Under current economic conditions, a policy rate of 9.5% would result in a -2.42% change in the debt-to-GDP ratio, indicating that public debt would decline faster relative to economic growth. With a total debt of Rs. 80.52 trillion, this corresponds to a reduction of approximately Rs. 1.94 trillion over the period considered. This suggests a clear improvement in debt sustainability, moving the debt trajectory toward a more comfortable and sustainable path.

Descriptions of Variables:

Economic Variables		Variables Definition
Change in Debt to GDP Ratio		The change in Total Public Debt of an economy over the period of time.
Inflation Rate (INF)		Inflation Rate (CPI) in Dec-25 Year on Year basis.
Policy Rate (i)		Current Policy Rate set by SBP in Dec-25
Medium Term GDP Growth (G)		The Average Value of the projected annual Real GDP Growth Rate over a 3 to 5 year period.
		(Currently the IMF Projects the Real GDP Growth for Pakistan at 3.6% to 4.5% over 2026 to 2030 period).

Economic Variables	Variables Definition
Real Interest Rate (R)	Policy Rate minus Inflation Rate = $i - INF$
R – G	There difference shows how much faster debt costs grow compared to the economy.
Debt to GDP Ratio % (DP)	$DP = (\text{Total Public Debt} \div \text{GDP}) * 100$
Total Public Debt	Rs. 80.52 trillion (As on June-25)
(R – G) * DP	Example: $R - G = 2.9\% , DP = 70.8\%$ Calculation: $(R - G) * DP = 0.029 * 70.8\% \Rightarrow 2.1\%$
Primary Surplus as % GDP (PS)	It captures the government's fiscal effort. How to Calculate: $PS = \text{Net Federal Revenue} - (\text{Total Federal Expenditure} - \text{Interest Payments})$

ICMA analysis shows that Pakistan's debt sustainability improves as the policy rate declines. Lowering the policy rate to 9.5% reduces the real interest rate, narrowing the interest-growth gap and allowing the debt-to-GDP ratio to decline faster by 1.3%, Rs. 1.05 trillion approx., making the debt comfortably sustainable. This highlights that managing borrowing costs, maintaining growth, and sustaining a primary surplus are key to ensuring Pakistan's debt remains under control.

ICMA Policy Recommendations

1. Gradual Policy Rate Cut to Support Growth and Debt

ICMA analysis shows that lowering the policy rate to 9.5% could reduce debt servicing costs by roughly Rs. 1.05–1.94 trillion, supporting debt sustainability.

ICMA recommends a gradual reduction of the policy rate by 50–100 bps over 2–3 quarters, with careful monitoring of inflation and exchange rate stability, to keep borrowing costs manageable without triggering demand-driven inflation.

2. Strengthen Fiscal Consolidation and Primary Surplus

ICMA analysis shows that FBR revenue growth (9.5% in H1-FY26) lags behind targets, limiting the space for debt reduction.

ICMA recommends broadening the tax base, improving compliance, and privatizing loss-making SOEs, along with containing non-essential expenditures. These measures will maintain fiscal discipline and create room to reduce debt without compromising growth.

3. Reduce Interest Burden and Boost Investment

ICMA analysis shows that persistent trade deficits and slow exports growth highlight structural weaknesses, while high interest costs and capacity constraints are limiting industrial investment. ICMA recommends introducing targeted incentives for high-value exports and industrial expansion, including lower financing costs, sector-specific credit lines, and support for SMEs to diversify export revenue and reduce the current account deficit.

4. Leverage Remittances and FX Reserves

ICMA analysis shows that resilient remittances and FX inflows are helping contain the current account deficit, supporting external sector stability.

ICMA recommends facilitating remittance channels, encouraging diaspora investment in productive sectors, and maintaining FX reserves above three months of import cover, to buffer external shocks while supporting macroeconomic stability.

5. Implement Supply-Side Reforms

ICMA analysis shows that inflation is largely supply-driven, and structural bottlenecks in agriculture, energy, and industry are constraining growth.

ICMA recommends investing in supply-side measures, such as improving agricultural productivity and food security, rationalizing energy tariffs to remove distortions, and reducing non-tariff barriers, to accelerate growth without triggering demand-driven inflation.

ICMA Research and Publications (R&P) Department reached out to renowned economists and experts, as well as the businessmen and industrialists, to gather their insights on the recent decision of SBP to keep the policy rate steady at 10.5 percent. Their views and perspectives are summarized below:

Experts' Insight

Dr. Ikram ul Haq, Advisory Board member and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE), while talking to the ICMA Research and Publications Department, remarked that the decision by SBP is well-founded and economically sound. He said that the inflationary risks arising from the rising trade deficit remain the main reason behind keeping the policy rate unchanged. He added that this also confirms that the Monetary Committee is fully cognizant of the structural weaknesses of the economy, which still cannot absorb external and internal shocks and unexpected pressures. He concluded that the decision is prudent and necessary to keep the stabilization process moving forward.

Dr. Ashfaque Hasan Khan, Former Economic Advisor, Director General Debt Office and Special Secretary Finance, and currently Director General, NUST Institute of Policy Studies, when contacted, expressed that sometimes SBP refers to core inflation and sometimes to headline inflation. He added, "Beauty lies in the eyes of the beholder. I was expecting a 100-bps cut."

Mr. Aadil Nakhoda, a faculty member at IBA Karachi and Chair of the Economic Advisory Group (EAG), in a message to the ICMA R&P Department, said that the major reasons for the policy rate remaining unchanged appear to be the stickiness in the core inflation rate, the widening trade deficit in recent months, fiscal slippages with tax revenue growth below expectations, and global uncertainty amid evolving geopolitical developments. He added that SBP also aims to maintain a positive interest rate to support foreign exchange reserve inflows. However, he noted that the SBP seems to be overlooking market signals favoring a discount rate reduction and the fact that inflation has remained at lower levels for more than 1.5 years. He further observed that higher interest rates may continue to weigh on investment and business confidence. With Ramadan approaching, SBP seeks to maintain control over inflation while anticipating that remittance inflows will increase as Eid approaches. He concluded that the SBP is likely to reconsider its stance after Ramadan and Eid.

Mr. M. Amayed Ashfaq Tola, President of Tola Associates, while talking to ICMA, said that the SBP's decision to maintain the policy rate at 10.5% reflects an overly cautious stance. He noted that the rationale citing elevated core inflation and a widening trade deficit overlooks structural factors such as weak export diversification and capacity constraints rather than excess demand. Headline inflation averaged a stable 5.0% in H1FY26 and rose only marginally to 5.9% in December 2025, suggesting that inflation remains contained. He added that there is a strong case for exchange rate rationalization alongside a 200–300 basis point cut in the policy rate to provide fiscal relief and support CPI moderation.

High interest costs are a key driver of the federal fiscal deficit, and a one percentage point rate cut could reduce debt servicing by around Rs. 546 billion, implying savings of nearly Rs. 2.2 trillion from a four-point reduction. Lowering the policy rate to 7–8% would reduce production costs, stimulate industrial activity, encourage new investment, and support supply expansion, helping ease inflationary pressures over the medium term.

Syed Fawad Basir, Head of Research at KTrade Securities, shared his view that the SBP's MPC decision to keep the policy rate unchanged at 10.5% came as a surprise to markets, which had expected a 50–100bps cut. He noted that the decision reflects persistent core inflation, a widening trade deficit, and stronger-than-expected domestic economic activity, reducing the need for additional stimulus. He added that the SBP remains focused on sustainable growth and price stability, taking steps to strengthen the economy's resilience. From a market perspective, he observed that there could be a short-term pullback after last month's mutual fund-driven rally of PKR 217 million, but ongoing results, US\$ inflows via the defense sector, and favorable geopolitical developments are likely to support confidence and deepen the market over time.

Industry's Perspective

Mr. Usman Shaukat, President of the Rawalpindi Chamber of Commerce and Industry (RCCI), in a message of ICMA R&P Department said that the Chamber is disappointed over the State Bank of Pakistan's decision to keep the policy rate unchanged at 10.5%. He noted that inflation indicators had been showing signs of stabilization and key monetary policy signals were positive, making the case for a rate cut compelling. He emphasized that an immediate reduction in the policy rate is essential to stimulate industrial growth and investment, reduce the cost of capital, encourage manufacturing sector expansion, and support broader economic recovery. Mr. Shaukat urged the SBP to reconsider its stance and implement a rate cut at the earliest opportunity to create a more conducive environment for industrial and economic growth.

Mr. Kashif Anwar, former President of the Lahore Chamber of Commerce and Industry, questioned the SBP's decision to keep the policy rate unchanged at 10.5% in the first MPC meeting of 2026. He noted that globally, inflation and interest rates move in parallel, and if inflation has declined as claimed, the same principle should apply in Pakistan. He highlighted that the economy continues to face a growing trade deficit, declining exports, and falling foreign investment, with multinationals exiting due to high business costs, utility tariffs, taxes, and interest rate uncertainty. Recalling post-COVID and flood-period policies, he said the 100% cash margin requirement for opening LCs constrained industry and hurt investor confidence. He stressed that while lowering interest rates alone is not enough, meaningful recovery depends on restoring investor confidence, easing tax and audit compliance, ensuring profitability, and removing structural impediments, without which tight monetary policy will continue to suppress industrial growth and investment.

Muhammad Ikram Rajput, President of the Korangi Association of Trade and Industry (KATI), expressed disappointment over the State Bank's decision to maintain the policy rate at 10.5 percent, stating that it contradicts the business community's demands. He highlighted that inflation remains at 7.4 percent while exports have declined by 6 percent annually, signaling that a reduction in the policy rate was warranted. He noted that economic indicators showed room for at least a 1 percent cut, but the Monetary Policy Committee, following a cautious approach in line with IMF expectations, chose to keep the rate unchanged. Mr. Rajput added that the central bank's projected growth of 3.75 to 4.75 percent does not reflect ground realities, stressing that economic growth requires promoting industrialisation. He further observed that rising imports, falling exports, and high interest rates are increasing production costs, limiting investment, and constraining SMEs, which are key for employment generation. He urged the government and the State Bank to bring the policy rate into single digits to support industrial growth, create jobs, and sustain industrial activity.

Mr. Khalid Tawab, Chairman of the Tawab Group and former Senior Vice President of FPCCI, criticized the SBP's decision to keep the policy rate unchanged, calling it unfair to the business community and the public. He added that rising unemployment and industrial closures are already weighing on economic growth. While past interest rate hikes were justified by high inflation, with inflation now under control at around 5 percent, the rate should have been lowered. Keeping it unchanged risks slowing industrial growth and economic recovery. He noted that the business community had expected a single-digit rate in line with inflation and urged authorities to take measures to support industries, investment, and job creation.

Mr. Mukhtar Hussain Dossani, CEO of Dossani Enterprises, said the policy rate should have been reduced to single digits, given the decline in exports and easing inflation. He observed that a 10.5 percent interest rate keeps borrowing costs high, discouraging investment in new industrial units and the expansion of existing ones. He added that elevated financing costs raise production expenses, weaken competitiveness especially against regional rivals, and limit financial access for businesses, putting additional pressure on the export sector.

Ms. Yasmin Dadabhoy, CEO of Troy Group of Companies, when asked for her views on the MPC decision, said that keeping the policy rate at 10.5% reflects a cautious but understandable approach. She noted that while headline inflation has eased and markets were expecting a cut, core inflation remains sticky and pressures on the external account are re-emerging. "In this context, holding the rate steady makes sense and underscores a broader reality," she added, "monetary policy alone cannot address structural weaknesses. Without sustained progress in exports, productivity, and fiscal discipline, rate cuts may offer short-term relief but are unlikely to deliver durable growth."

MPC Observations on Key Sectors

Real Sector

- Real GDP grew 3.7% y/y in Q1-FY26, up from 1.6% last year, showing strong economic momentum.
- LSM posted 6.0% cumulative growth (July–Nov FY26), led by autos, cement, POL, fertilizer, and machinery imports.
- Agriculture: Wheat prospects favorable, supporting overall commodity output.
- Services expected to benefit from robust agriculture and industry performance.
- GDP Outlook: FY26 growth projected at 3.75–4.75%, with momentum likely to strengthen in FY27.

External Sector

- Current account deficit was \$244 million in December 2025, totaling \$1.2 billion in H1-FY26, driven by widening trade deficit from higher imports and lower exports.
- Export weakness mainly due to fall in food exports (rice), while HVA textiles remained resilient.
- Workers' remittances and ICT services exports helped contain the deficit.
- SBP's FX reserves strengthened through interbank purchases; projected to surpass \$18 billion by June 2026, approaching three months of import cover.
- Outlook FY26: Current account deficit expected within 0–1% of GDP; risks include global trade fragmentation and geopolitical uncertainty.

Fiscal Sector

- FBR tax revenues grew 9.5% in H1-FY26, below last year's 26% growth, resulting in a Rs329 billion shortfall.
- Fiscal balance improved in H1-FY26 due to contained expenditures and lower interest payments, supporting the full-year deficit target.
- Achieving the annual primary surplus remains challenging.
- MPC highlighted the supportive role of fiscal consolidation for macroeconomic stability.
- Emphasis on durable structural reforms, including broadening the tax base and privatizing loss-making SOEs, to sustain growth.

Money and Credit

- Broad money (M2) growth picked up to 16.3% by January 9, driven by private sector credit and government borrowing.
- Private sector credit expanded by Rs578 billion (FY26 till Jan 9), led by textiles, wholesale & retail trade, chemicals, and increased consumer financing.
- SBP reduced the Cash Reserve Requirement for banks from 6.0% to 5.0%, expected to further boost private sector credit.

Inflation

- Headline inflation eased to 5.6% y/y in December from 6.1% in November, supported by moderation in food prices despite higher wheat-related costs.
- Energy inflation increased due to fading favorable base effects in electricity tariffs.
- Core inflation remained elevated at around 7.4% in H1-FY26, though consumer and business inflation expectations eased.
- Outlook FY26–FY27: Inflation expected to stabilize within the 5–7% target range, with temporary overshoots possible.
- Risks include global commodity and domestic wheat price volatility, energy price adjustments, and a stronger-than-expected pickup in domestic demand.

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