

# MPS REVIEW

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

ICMA Research and Publications Department

## Preamble

The State Bank of Pakistan's (SBP) Monetary Policy Committee (MPC), in its March 9, 2026 meeting, decided to keep the policy rate unchanged at 10.5 percent, citing heightened uncertainty following the outbreak of conflict in the Middle East. The war has pushed up global fuel prices as well as freight and insurance costs, posing risks to trade and supply chains. Meanwhile, inflation rose to 5.8 percent in January and further to 7 percent in February 2026, prompting SBP to maintain a cautious stance to preserve price stability.

On the domestic front, economic indicators showed moderate improvement. Large-scale manufacturing (LSM) grew by 0.4 percent year-on-year in December 2025, with cumulative growth reaching 4.8 percent during July–December FY26. The current account recorded a surplus in January, allowing SBP to increase foreign exchange reserves to \$16.3 billion by February 27, 2026, while consumer confidence improved and business sentiment remained stable. However, FBR tax collection remained below target during January–February, widening the fiscal shortfall. Looking ahead, the MPC highlighted risks from volatile global commodity prices, supply chain disruptions, and new US tariffs, while emphasizing the need for prudent policies and structural reforms to sustain economic stability and growth.

## ICMA MCTG Analysis Reveals SBP Can Boost Manufacturing Growth with Targeted Low-Rate Credit While Keeping Policy Rate Steady

The ICMA analysis highlights the credit liquidity constraints faced by Pakistan's manufacturing sector. For this purpose, ICMA has applied the Manufacturing Credit Transmission Gap (MCTG) model, which evaluates whether banking sector lending is keeping pace with the expansion potential of the manufacturing activity.

The MCTG model's concept and formula are directly derived from well-established Credit Gap frameworks used globally by central banks, the IMF, and the Bank for International Settlements (BIS) to measure credit–output relationships and monetary transmission.

### Manufacturing Credit Transmission Gap (MCTG) Model:

The **Manufacturing Credit Transmission Gap** represents the difference between the growth of bank credit to the manufacturing sector and the growth of manufacturing output.

#### Formula:

$$\text{MCTG} = \% \text{ Manufacturing Credit Growth} - \% \text{ Manufacturing Output Growth}$$

#### Rule to Judge the MCTG Ratio:

- MCTG > 0 (Positive Value):** Credit to the manufacturing sector is growing faster than output, indicating strong financial support. While this can help industrial expansion, excessively high positive gaps over time may risk inefficient credit allocation or over-leverage.
- MCTG < 0 (Negative Value):** Manufacturing output is growing faster than credit, signaling a liquidity constraint and weak credit transmission. In such cases, the sector may not receive sufficient funding to fully realize its growth potential.
- MCTG ≈ 0 (Near Zero):** Credit growth closely matches output growth, representing a balanced and optimal scenario. This ensures that financial support is adequate without creating overheating, reflecting efficient credit transmission from banks to the real economy.

## With MCTG near balance at -0.31% in Q2 FY26, Policy Window Opens to Strengthen Manufacturing Growth

Table:1

Fiscal Quarters	Average Manufacturing Credit Growth %	Manufacturing Output Growth %	MCTG % (Calculation)	Interpretation of MCTG Analysis
Q1 FY25	-0.70	1.78	$(-0.70 - 1.78) = -2.48$	<b>Negative Gap:</b> Credit contracted while output grew, indicating early liquidity constraints and weak credit transmission.
Q2 FY25	9.66	0.49	<b>9.17</b>	<b>Positive Gap:</b> Credit expansion exceeded output growth, reflecting temporary improvement in financial support, though sustained high gaps may not be ideal.
Q3 FY25	-4.32	0.95	<b>-5.27</b>	<b>Significant Negative Gap:</b> Sharp contraction in credit despite output growth, highlighting high financing stress and under-support of the sector.
Q4 FY25	-0.58	4.76	<b>-5.33</b>	<b>Negative Gap:</b> Credit remained stagnant while output surged, showing persistent financing bottlenecks that limit industrial expansion.
Q1 FY26	-0.66	5.78	<b>-6.43</b>	<b>Widening Negative Gap:</b> Manufacturing output accelerated but credit lagged further, intensifying liquidity constraints and highlighting weak monetary transmission.
Q2 FY26	3.83	4.14*	<b>-0.31</b>	<b>Near Zero Gap:</b> Credit growth closely matches output growth, representing the <i>optimal scenario</i> , where financing adequately supports manufacturing expansion without over-leverage.

Data Sources: SBP, Analysis and MCTG Model generated by ICMA.

Note: The (\*) shows the LSM (QIM) growth value is used as a proxy for the Manufacturing Output Growth in Q2 FY26.

ICMA's MCTG Analysis shows that Pakistan's manufacturing sector has historically faced credit constraints, with output growth often outpacing credit, leading to persistent negative gaps and liquidity bottlenecks. Notably, in Q2 FY26, the MCTG narrowed to -0.31%, bringing credit growth nearly in line with manufacturing output. This marks a critical opportunity for policymakers: by adjusting the policy rate strategically, the State Bank of Pakistan can help maintain a balanced MCTG, ensuring that credit continues to support industrial expansion without creating over-leverage, and strengthening overall monetary transmission to the real sector.

## ICMA Policy Recommendations

### 1) Targeted Credit Support for Manufacturing While Maintaining Policy Rate

- With MCTG near balance (-0.31%), SBP should provide sector-specific low-interest loans to the manufacturing sector while keeping the general policy rate at 10.5%.
- This will strengthen industrial growth without fueling overall inflation, following successful precedents like the European Central Bank (TLTROs) and People's Bank of China sectoral refinancing.

## 2) Maintain Inflation Vigilance with Flexible Monetary Tools

- Continue to monitor core and headline inflation closely, especially due to energy price volatility.
- Use macro-prudential tools (like sectoral credit caps or liquidity windows) instead of broad rate cuts to support growth, avoiding overheating of the economy.

## 3) Enhance Export and Remittance Support

- Introduce export credit guarantees, reduced export financing costs, and incentives for high-value exports, reducing reliance on remittances.
- Strengthen trade facilitation and logistics to improve competitiveness amid global supply chain disruptions.

## 4) Strengthen Fiscal Revenue Mobilization

- Reduce dependency on borrowing from the banking system to free up credit for private investment.
- Implement tax base broadening and improved compliance measures to meet revenue targets without raising rates sharply.

## 5) Support Key Sectors and Agriculture Spillovers

- Provide targeted financing or subsidy schemes for strategic sectors (textiles, chemicals, machinery) and agricultural support programs (fertilizer, irrigation).
- This ensures balanced sectoral growth, which will have positive spillovers for services and trade.

## 6) Diversify Import Sources

- Build foreign exchange buffers and diversify import sources, particularly for energy, to mitigate geopolitical and supply chain risks.
- Develop contingency credit lines for critical imports to avoid disruption in production and inflation spikes.

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ICMA Research and Publications (R&P) Department reached out to renowned experts, as well as businessmen and industrialists, to gather their insights on the recent decision of the SBP to keep the policy rate unchanged at 10.5% amid rising inflation risks from global oil prices and regional tensions. Their views and perspectives are summarized below.

## Experts' Insight

**Dr. Manzoor Ahmad, member of the Prime Minister's Committee on Tariff and former Pakistan Ambassador to the WTO,** observed that the decision by SBP to keep the policy rate unchanged is a prudent one. He added that with international energy and other prices remaining highly volatile, it is important to remain vigilant about potential inflationary pressures in the domestic economy. He further noted that he fully supports the central bank's "wait and see" approach.

**Dr. Ikram ul Haq, Advisory Board member and Visiting Senior Fellow at the Pakistan Institute of Development Economics (PIDE)** shared with ICMA R&P Department that the decision is well-founded in the backdrop of the ongoing US-Israel war on Iran, which is disrupting the global economy. He added that the closure of the Strait of Hormuz is cutting 25% of oil supply, creating serious implications for Pakistan. The government has already increased the prices of petrol and diesel by Rs. 55, which is expected to exert inflationary pressure. He further noted that the decision to keep the policy rate at 10.5% is both prudent and justified.

**Mr. Muhammad Sabir, Principal Economist at Social Policy and Development Centre (SPDC)** in a conversation with ICMA R&P Department, said that maintaining the policy rate at 10.5% is a measured response to the recent fuel shock and rising global energy uncertainty. He added that by preserving an adequately positive real interest rate and avoiding premature easing, the SBP anchors inflation expectations and provides a vital fiscal buffer against cost-push pressures. He further noted that this disciplined stance prioritizes long-term macroeconomic predictability over short-term growth, shielding the domestic economy from volatile global price cycles.

**Mr. Abdul Azeem, Head of Research at AL Habib Capital Markets (Pvt.) Ltd,** observed that SBP's decision to hold the policy rate at 10.5% reflects a strategic pause in its easing cycle as the central bank navigates an increasingly uncertain geopolitical landscape. He noted that while domestic macroeconomic fundamentals have strengthened, with a current account surplus, foreign exchange reserves at USD 16.3 billion and large-scale manufacturing growing by 4.8 percent in 1HFY26, the outbreak of war in the Middle East has introduced significant risks to the outlook. Mr. Abdul Azeem added that SBP now projects inflation to remain above 7 percent into FY27, with every USD 10 per barrel increase in oil prices expected to add 0.2 percent to inflation and widen the current account deficit by USD 1.5 billion. By holding rates steady, SBP is prioritizing the preservation of hard-earned price stability and signalling that further easing will depend on geopolitical conditions and the impact of imported inflation.

**Mr. Aadil Nakhoda, a faculty member at IBA Karachi and Chair of the Economic Advisory Group (EAG),** when contact by ICMA R&P Department, stated that the SBP is not taking an aggressive policy stance, unlike the price hikes and austerity measures introduced by the federal government. He explained that the volatility and rapidly changing environment make it difficult to commit to six weeks of monetary policy. Therefore, he noted that the wait and see approach adopted by SBP is continuing. He further observed that SBP likely expects this war to be short term and does not believe the overall long-term trend will differ significantly from the current economic environment. As a result, it has maintained the policy rate instead of implementing the slight upward adjustment that was anticipated following the fuel price hike announced by the government.

## Industry's Perspective

**Mr. Miftah Ismail,** a Pakistani political economist and former Federal Minister of Finance, commented to ICMA that he believes this was a prudent decision by the SBP. He added that increasing or decreasing the policy rate at this time would have been inappropriate.

**Mr. Asif Inam, Vice President of the Federation of Pakistan Chambers of Commerce and Industry (FPCCI),** told ICMA that the decision is highly sagacious and prudent given the current economic situation. He added that the SBP has made a wise choice by keeping the policy rate unchanged.

**Mr. Usman Shaukat, President of the Rawalpindi Chamber of Commerce and Industry (RCCI),** in a message to ICMA, noted that maintaining the policy rate at 10.5% seems like a prudent move given the current geopolitical uncertainties and global inflation concerns arising from energy price hikes and supply chain disruptions. He added that increasing rates could indeed dampen business confidence, so it is wise to tread carefully. He further observed that SBP's careful approach will be crucial in balancing inflation control with economic growth.

**Mr. Kashif Anwar, former President of the Lahore Chamber of Commerce and Industry (LCCI),** remarked to ICMA that the decision is prudent, noting that the business community would not have opposed an interest rate increase given the parallel trend with inflation. He explained that earlier, when inflation was falling, businesses had urged rate cuts, while the recent rise in petrol prices (increased by Rs. 8 and a further Rs. 55) would fuel inflation and impact other costs. Mr. Kashif highlighted uncertainty over the prolonged war's effect on industrial growth, emphasizing that unlike the COVID-19 pandemic, the current situation involves limited supplies, raw material shortages, and rising prices. He also cautioned that disruptions to Gulf sea and air routes due to the Strait of Hormuz closure could further affect inflation and interest rates, concluding that the business community is navigating an uncertain economic environment.

## MPC Observations on Key Sectors

### Real Sector

- High-frequency indicators; auto sales, cement dispatches, electricity generation, and POL sales showed strong growth during July–January FY26.
- Manufacturing supported by lower Cash Reserve Requirement, reduced export loan markups, and energy tariff cuts.
- Agriculture: Wheat sowing largely completed, favorable conditions support output.
- Services expected to benefit from industry and agriculture spillovers.
- GDP outlook: Real GDP projected at 3.75% to 4.75% for FY26, with risks from ongoing geopolitical developments.

### External Sector

- Current account posted a \$121 million surplus in January 2026, keeping the July–January FY26 deficit at \$1.1 billion.
- Imports declined, while exports and workers' remittances largely stabilized; remittances continued to finance a significant portion of the trade deficit.
- Financial account: Net official outflows recorded in January, with slight increase in foreign investment inflows. SBP FX purchases continued, supporting reserve buildup.
- Outlook: External environment remains challenging due to the Middle East conflict; current account deficit expected within 0% to 1% of GDP for FY26.
- Policy focus: Timely realization of planned official inflows needed to achieve SBP FX reserves target of \$18 billion by June 2026.

### Fiscal Sector

- Overall fiscal balance recorded a surplus, with the primary surplus remaining close to last year, supported by contained expenditures and lower interest payments.
- Tax collection rose 10.6% during July–February FY26, remaining below the pace required to meet the annual target.
- Policy focus: Emphasis on continued fiscal consolidation, base-broadening measures, and structural reforms to ensure macroeconomic stability and sustainable growth.

### Money and Credit

- Broad money (M2) growth slowed to 16.0% as of February 20, driven by a sharp reduction in net budgetary borrowing, while NFA's contribution to M2 growth increased.
- Lower budgetary borrowing and liquidity from CRR reduction created space for greater private sector lending.
- Private sector credit (PSC) expanded by Rs 790 billion up to February 20, supporting working capital and fixed investment, particularly in textiles, wholesale/retail trade, and chemicals; consumer financing also increased.
- Currency in circulation rose, deposits declined, leading to an increase in the currency-to-deposit ratio and reserve money growth.

## Inflation

- Headline inflation rose to 7.0% y/y in February, with core inflation at 7.6%, due to fading low-base effects and higher household electricity charges.
- Partial offsets from improved food supply and favorable agriculture prospects may limit second-round impacts.
- Risks: Geopolitical tensions, volatile food prices, and unexpected energy adjustments could keep inflation above 7% for the rest of FY26 and into FY27.

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