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Research Paper

Impact on Pakistan's Economic Growth by Lowering Pakistan's Interest Rate

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Executive Summary

This paper examines the potential impact of lowering Pakistan's policy interest rate on economic growth within the post-stabilisation context of 2024–2026. Using recent macroeconomic data and Pakistan-specific monetary transmission evidence, the study analyses how interest rate easing affects GDP growth, inflation, private investment, employment, fiscal dynamics, and external balance. The findings indicate that a gradual, data-dependent reduction in the policy rate can support higher economic growth by stimulating private consumption and investment, particularly in credit-sensitive industrial sectors, while easing fiscal debt-servicing pressures. However, the relationship between policy rates and inflation is positive but lagged, and excessive or premature easing risks reigniting inflation, weakening the exchange rate, and undermining external stability. Sectoral analysis shows that industry is most responsive to monetary easing, services respond moderately with lags, and agriculture remains largely insensitive to interest rate changes. Monetary easing can raise Pakistan's growth toward its potential without destabilising macroeconomic conditions, whereas aggressive front-loaded cuts pose significant stability risks.

1. Background and Context

1.1 Pakistan's Recent Macroeconomic Conditions (2023–2025)

Pakistan's economy has been in a stabilisation phase through 2024–2025, marked by a deliberate disinflation and external adjustment following the 2022–2023 balance-of-payments crisis. Annual inflation, since last year, has fallen. By July–April FY2025, CPI inflation was only 4.7%, down from 26.0% in the same period of FY2024 (PES., 2024-25). In fact, monthly inflation hit a multi-decade low of just 0.3% year-on-year in April 2025 (Ministry of Finance., 2025), reflecting a combination of tight monetary policy, fiscal consolidation, improved food supply, and stable exchange rates (Ministry of Finance., 2025). This sharp disinflation provided the space for the central bank to begin easing monetary policy. The SBP had held its policy interest rate at a record-high 22% from mid-2023 to mid-2024 to combat the inflation surge (Ministry of Finance., 2025). As inflation started dropping into single digits, the SBP commenced a monetary easing cycle in June 2024. By May 2025, the policy rate was cut to 11%, a cumulative reduction of 1,100 basis points (Reuters., 2025). After pausing for several months at 11%, another small cut in December 2025 brought the rate to 10.5%(Reuters., 2025).

These policy moves were enacted under an IMF-supported program and alongside strict fiscal measures. Economic growth, which had almost stalled during the crisis has started to recover. Real GDP growth reached 2.4% in FY2024 and 2.7% in FY2025, according to official estimates (IMF., 2024). This rebound indicates the economy responded to improved stability especially a better agricultural output and some industrial recovery after 2022's floods (Reuters., 2025). The fiscal deficit has been brought down during this period: in July–March 2025 it was 2.6% of GDP compared to 7.9% in FY2023 (PES., 2024-25). Pakistan even achieved a primary fiscal surplus of around 2–3% of GDP in FY2025 (PES., 2025), an unprecedented improvement supported by higher tax revenues and restrained spending.

On the external front, Pakistan's balance-of-payments position improved markedly due to import compression, improved remittances, and stable exports. The current account, which historically was in deficit, recorded a surplus of $2.1 billion in FY2025 (SBP., 2025). This was a sharp turnaround from the $17.5 billion deficit just three years prior in FY2022 (SBP., 2025). Foreign exchange reserves, reinforced by IMF loan tranches and other inflows, more than doubled from critically low levels in mid-2023. By late 2025, total reserves exceeded $15.8 billion (Reuters., 2025), with SBP's own reserves at about $14–15 billion. The exchange rate (PKR) stabilized as a result the rupee found equilibrium in 2024, aided by SBP's market purchases of forex during surplus periods (SBP., 2025).

This paper contributes to the Pakistan monetary policy literature by advancing an integrated framework for regulating monetary easing that reconciles growth objectives with macroeconomic stability. First, this paper argue that the appropriate operational anchor for policy should be a forward-looking, modestly positive real interest rate, rather than backward-looking nominal benchmarks or headline inflation alone. This approach better aligns monetary conditions with expectations management, capital flow stability, and exchange rate sustainability. Second, this paper demonstrate that any easing trajectory must be explicitly consistent with Pakistan's balance-of-payments constraint, recognising that lower interest rates are likely to stimulate import-intensive domestic demand and thereby require adequate external buffers, stable capital inflows, and continued alignment with IMF-supported financing arrangements. Third, this paper proposes a dual-inflation targeting framework in which core inflation serves as the primary guide for operational policy decisions, while headline inflation informs communication and risk assessment. This framework provides a coherent basis for gradual, data-dependent monetary easing that supports economic recovery without compromising price stability or external sustainability.

1.2 Why Interest Rates Matter for Growth in Pakistan

Interest rates are a key lever of economic management, particularly in Pakistan's credit-constrained economy. A high policy interest rate transmits to high borrowing costs across the economy (e.g. the 6-month KIBOR) in 2023 soared above 20%, which dampened private credit and investment. Lower interest rates reduce the cost of capital for businesses and consumers, encouraging borrowing and spending. In Pakistan, where private-sector credit to GDP is relatively low and businesses often face liquidity shortages, the "credit channel" of monetary policy is especially relevant. Lower rates make bank loans more affordable for firms seeking to expand capacity or invest in new projects, and for households purchasing durables or homes. For example, during the recent easing, average bank lending rates fell in line with SBP's cuts, and private sector credit growth accelerated significantly in FY2025 (SBP., 2025b). Cheaper credit can "crowd in" private investment that was previously deterred by the high cost of borrowing. This is crucial for Pakistan's growth, as the country has suffered from chronically low investment and needs private capital formation for job creation and productivity gains. The current consumption-driven growth model is import-intensive and socially fragile. Food insecurity has risen sharply in recent years despite GDP growth, indicating that growth has not translated into broad-based welfare gains. A shift toward export-led and productivity-driven growth is therefore essential for both external sustainability and poverty reduction.

Interest rates also influence growth via aggregate demand. A lower policy rate tends to stimulate consumption by reducing monthly installment costs on consumer loans and by improving consumer confidence. In Pakistan, consumer spending is a large portion of GDP, but in recent years it was suppressed by high inflation and borrowing costs. As rates were cut in 2024–25,

consumer financing picked up and manufacturing sectors sensitive to domestic demand began recovering (Ministry of Finance., 2025).

Interest rates matter not only for growth, but for macroeconomic stability, which in turn feeds back into sustainable growth. High interest rates were used to contain inflation and defend the currency; if reduced prematurely, there is a risk of undoing those gains. Pakistan's challenge is a policy trade-off: how to lower rates enough to spur growth and credit, but not so much or so fast that inflation resurges or the currency comes under pressure.

Pakistan aims to accelerate its economic growth and job creation after a period of stabilization. Lowering the central bank's policy interest rate is a potential tool to achieve this, as it can stimulate investment and consumption. However, the policy trade-off is delicate, easing monetary policy too far or too fast could reignite inflation and could put downward pressure on the exchange rate, undermining external stability.

The core question is:

How much and how quickly can Pakistan lower interest rates to support growth, without destabilising prices or the balance of payments?

Policymakers must balance the short-term growth boost from rate cuts against the risk of eroding the hard-won confidence of investors and the IMF in Pakistan's macroeconomic discipline.

Inflation Expectations: Inflation is currently within the target band (Dawn., 2025). The SBP's credibility is on the line; it has signaled that real interest rates remain positive on a forward-looking basis to keep expectations anchored (SBP, 2025a). A premature large cut could lose expectations, especially given elevated core inflation levels and potential supply shocks.

Exchange Rate & External Financing: Pakistan's external account is currently manageable, but lower interest rates could trigger capital outflows or reduce inflows, at the same time that stronger domestic demand would suck in more imports. The IMF has explicitly warned against premature easing, urging a "data-dependent" approach until external buffers are rebuilt (SBP., 2025c). If the rupee starts depreciating rapidly, it could import inflation and force the SBP to reverse course with hikes, derailing the growth objective.

Monetary Transmission Lags: Even if the SBP lowers the rate, the growth payoff is not instantaneous. Empirical evidence suggests monetary policy impacts output and inflation with lags of 18–24 months in Pakistan (SBP, 2025a). This means overly hasty easing could coincide with the tail-end of past inflationary pressures, making it hard to discern if inflation is truly on a stable

downward path. The question becomes one of timing: implement rate cuts gradually now, or wait longer to ensure inflation is durably low?

Pakistan faces a trade-off between growth and stability. The policy decision is how to calibrate interest rate cuts such that they maximise support to growth and employment while minimising the risks of resurging inflation or external imbalance.

2. Analytical Framework: How a Rate Cut Transmits to the Economy

When the State Bank of Pakistan lowers its policy rate, it sets off a chain of effects through the monetary transmission mechanism. Table 1 below maps these channels, showing the immediate effect of a rate cut, the direction of impact on growth, associated inflation or external risks, and Pakistan-specific evidence.

Table 1: Monetary Transmission of an Interest Rate Cut in Pakistan

Channel	What changes when rate is cut	Impact on Growth	Inflation/External Risk	Pakistan-Specific Evidence (2024–25)
Interest Rate/Credit	Bank lending rates fall; credit availability rises. Cheaper loans for businesses and consumers	↑ Investment and consumption, higher GDP (credit-fueled demand).	Demand-pull inflation may rise; higher imports can worsen trade balance.	FY25: Private sector credit +PKR 2.09 trillion in H1 FY25 vs PKR 0.48tr last year (SBP., 2025b); LSM output rebounded as borrowing costs fell.
Expectations	Signals easier policy stance. If credible, can boost business optimism. If seen as "premature," could raise future inflation expectations.	↑ Growth if confidence improves (firms invest expecting stable low rates).	If credibility lost: ↑ inflation as price-setters anticipate SBP leniency.	IMF urged SBP to stay data-driven to keep expectations anchored (SBP., 2025c). So far, inflation expectations have moderated with policy credibility (core inflation halved in FY25) (SBP., 2025)

Channel	What changes when rate is cut	Impact on Growth	Inflation/External Risk	Pakistan-Specific Evidence (2024–25)
Exchange Rate	Lower yield on PKR assets; potential capital outflow; PKR depreciation. Exports cheaper abroad, imports more expensive domestically.	Mixed: ↑ net exports if currency depreciation is mild and exporters respond; but ↓ growth if instability hurts investment.	↑ Imported inflation (fuel, food) with weaker PKR; possible BoP stress if capital exits or import bill surges.	Past episodes: 2017–18 easing led to PKR overvaluation and later sharp correction. 2023–24 tight policy helped stabilize PKR; IMF warns too-fast cuts could renew FX pressure.
Asset Price/Wealth	Lower discount rate → higher asset values (stocks, property). Firms' net worth up, borrowing capacity improves.	↑ Growth slightly via wealth effect and easier financing conditions (e.g., higher equity prices allow firms to raise capital).	Minimal direct inflation effect; asset bubbles possible if exuberance.	2024: KSE-100 rose ~50% Jul–Mar FY25 after rate cuts and IMF deal, indicating restored investor confidence which can foster investment.
Fiscal/Debt Service	Government interest costs decline on new debt and floating-rate debt. Frees up budget resources (or lowers need to borrow).	↑ Growth if savings used for productive spending or deficit reduction lowers crowding-out of private sector.	Lower rates could reduce banks' appetite for govt securities marginally, but overall risk premia might drop if debt sustainability improves.	FY25: Domestic interest payments growth slowed; primary surplus achieved (PES., 2024-25). Lower rates aided in reducing deficit to ~5.4% of GDP (SBP., 2025d). However, public debt is still high (~80% of GDP), so sustained low rates depend on

Channel	What changes when rate is cut	Impact on Growth	Inflation/External Risk	Pakistan-Specific Evidence (2024–25)
				keeping inflation low.

SBP research indicates the full effect of a policy rate change materialises over 18–24 months in Pakistan (SBP., 2025a). Thus, the above channels explain gradually. Strengthening these transmission channels can enhance the growth impact of monetary easing.

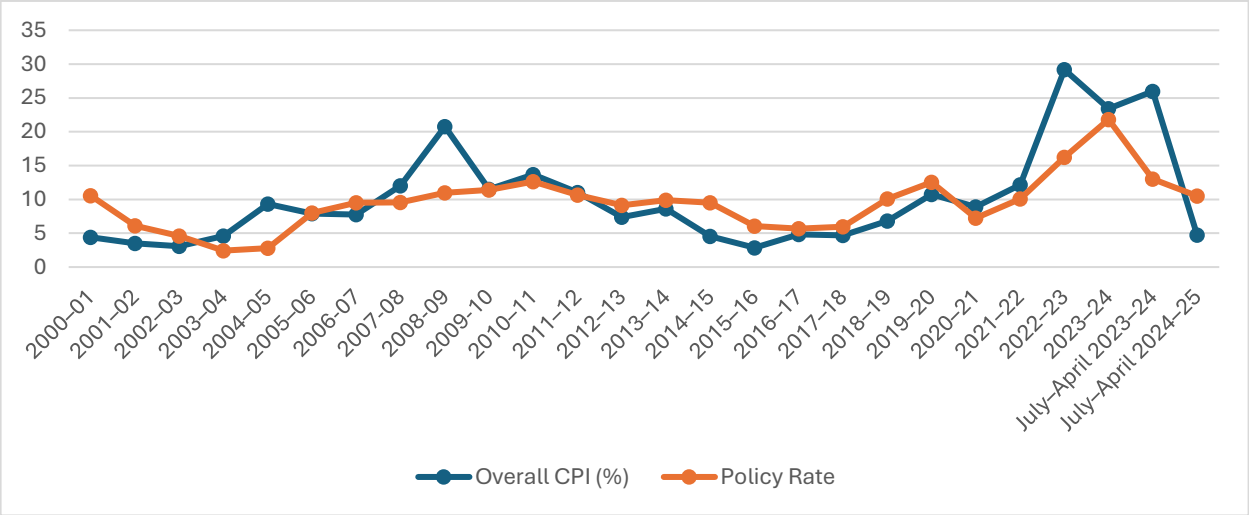

Figure 1: Inflation (CPI) Vs Policy Rate

2.1. Relationship between the Policy Rate and Inflation

The policy rate typically reacts with a delay as the central bank assesses whether inflationary shocks are persistent. Moreover, the correlation is not one-to-one because inflation in Pakistan is influenced not only by demand conditions but also by supply-side factors such as energy prices, exchange rate depreciation, food shocks, and taxes. As a result, while the long-run correlation is positive, it indicates that policy rates rise in high-inflation periods. The short-run correlation can appear weak or uneven. The graph highlights that monetary policy in Pakistan is largely reactive to inflation trends, with interest rate changes aimed at stabilising prices over the medium term rather than tightly tracking CPI movements in the short run.

The policy interest rate set by the State Bank of Pakistan (SBP) influence inflation through the demand channel of the economy. When SBP increases the policy rate, borrowing costs for businesses and households rise, making loans for working capital, investment, and consumer spending more expensive. As a result, consumption and private investment decline, leading to a

reduction in aggregate demand. This slowdown in economic activity gradually eases price pressures, causing inflation to fall over time, typically with a lag of about six to twelve months. Conversely, when SBP lowers the policy rate, borrowing becomes cheaper, encouraging higher consumption and investment. This expansion in aggregate demand increases inflationary pressures, especially if supply conditions do not adjust quickly. Overall, the diagram highlights the central role of monetary policy in managing inflation by influencing credit conditions and aggregate demand in Pakistan's economy.

2.2. Relationship between Policy Rate Vs Inflation and Sectoral GDP

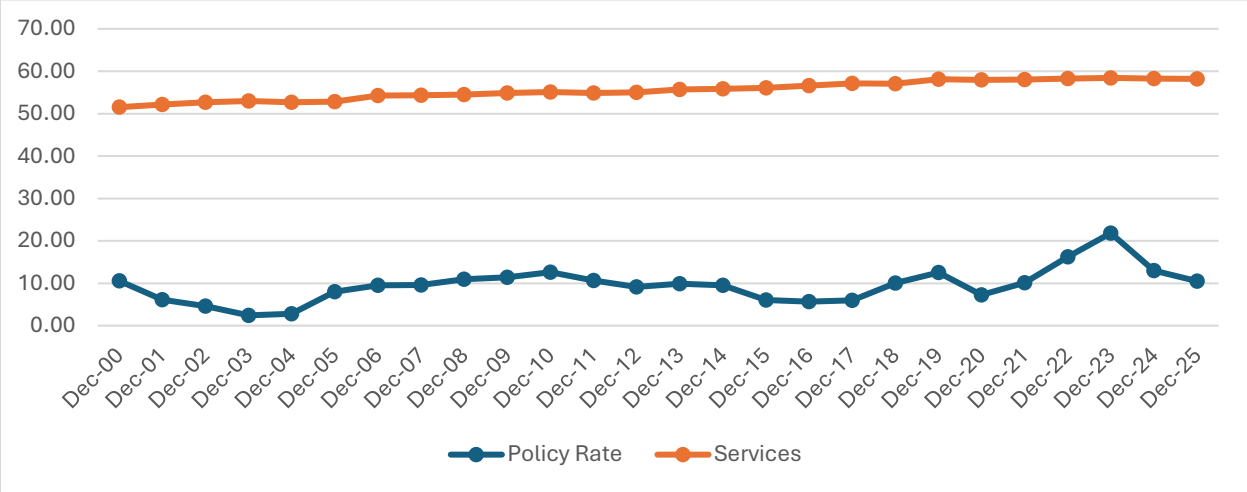

Figure 2: Policy Rate and Services Sector

The graph shows that the services sector follows a relatively smooth and gradually rising path, while the policy rate fluctuates sharply, especially in later periods. This suggests a moderate and lagged correlation between the policy rate and services activity. Higher interest rates tend to slow the momentum of services rather than cause a sharp decline. This is because much of the services sector is less dependent on bank credit and more driven by household demand, wages, and government spending. When the policy rate rises, higher borrowing costs and weaker consumer confidence reduce discretionary spending, which dampens services growth. Conversely, when the policy rate eases, consumption improves and services activity gradually strengthens, though the response is not immediate or dramatic.

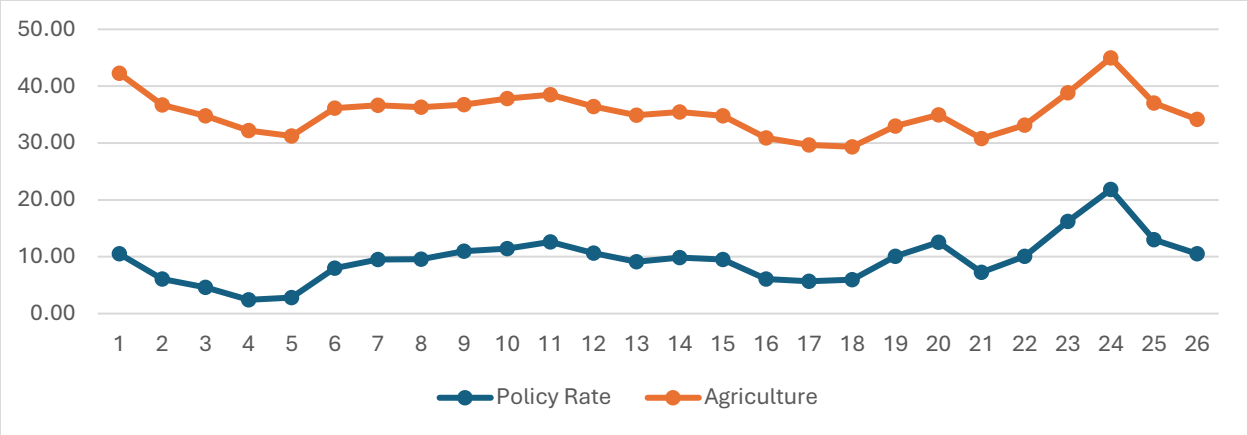

Figure 3: Policy Rate Vs Agriculture Sector

The agriculture graph shows high volatility in agricultural performance with no consistent movement alongside the policy rate, indicating a weak correlation between the two. Agricultural output fluctuates even when interest rates are stable or rising, reflecting the dominance of non-monetary factors such as weather conditions, crop cycles, input availability, government support prices, and subsidies. While interest rates do affect the cost of agricultural credit many farmers rely on informal financing or subsidized credit, which weakens the direct transmission of monetary policy. As a result, changes in the policy rate influence agriculture only at the margins, making monetary policy a relatively blunt tool for stabilizing or stimulating this sector.

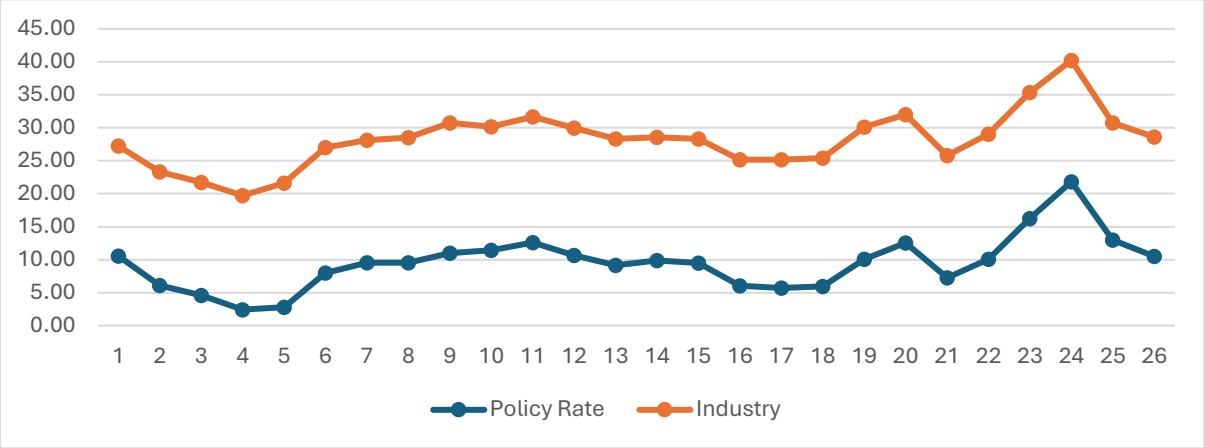

Figure 4: Policy Rate Vs Industry

The industry graph shows a clear direct correlation between the policy rate and industrial activity, making this sector the most sensitive to monetary policy. Periods of rising policy rates coincide with slower industrial growth or contraction, while periods of easing are followed by recovery. This strong relationship exists because industry is capital-intensive and highly dependent on bank financing for both working capital and investment. Higher interest rates raise production costs,

discourage new investment, and reduce capacity utilization, while lower rates improve indicated project viability and cash flow. Consequently, changes in the policy rate transmit most directly and powerfully to the industrial sector, making it the primary channel through which monetary policy affects real economic growth and employment. The international literature finds that monetary transmission is often attenuated in emerging markets and financially repressed systems due to shallow capital markets, fiscal dominance, and bank balance-sheet constraints (Mishra, Montiel & Spilimbergo, 2012; Reinhart & Sbrancia, 2015).

3. Impact Analysis: Effects of Lower Interest Rates on Key Indicators

Assuming Pakistan proceeds with lowering its interest rate, this section analyzes the expected outcomes on major macroeconomic variables, drawing on economic theory and Pakistan's recent evidence. This Paper consider a scenario where the SBP reduces the policy rate in measured steps over the next year under the condition that inflation remains moderate.

3.1 GDP Growth and Aggregate Demand

A reduction in interest rates is generally expansionary for GDP growth. Lower borrowing costs stimulate aggregate demand through higher consumption and investment. In Pakistan's case, consumer spending has been depressed by high inflation and interest rates; as inflation fell and policy eased in 2024, signs of revival emerged (Ministry of Finance., 2025). If rates are lowered further:

- **Private Consumption:** Installment financing becomes cheaper, boosting demand for consumer durables and housing. Even those not borrowing benefit indirectly, banks might offer lower deposit rates, encouraging households to spend rather than save. Greater consumer confidence also plays a role: with the cost of living increases slowing (only +3.0% inflation in Aug 2025 (Monthly Economic Outlook), consumers may be more willing to spend. Overall consumption could accelerate, lifting GDP growth. The risk is if demand outpaces supply capacity, causing shortages or price rises in certain goods.

- **Private Investment:** Perhaps the biggest gain from rate cuts would be in private fixed investment. High interest rates were cited by businesses as a top constraint in 2023–24. Firms could not afford capital expenditures or expansion working capital at >20% interest. At a lower cost of capital, more projects become financially viable. Expected increased capital outlay in manufacturing, infrastructure, and possibly energy sectors if financing is accessible. In FY2025, gross fixed investment was still only ~13.8% of GDP (PES., 2025). With cheaper credit and improving sentiment, this could rise, adding directly to GDP and also expanding future productive capacity.

Pakistan's potential growth is around 5%, but actual growth has been ~2–3%. Responsible monetary easing can help bridge that gap, possibly lifting growth into the 4% range over the next two years. Indeed, the SBP itself projects FY2026 growth in the 3.25–4.25% range, partly on the expectation of easier financial conditions (Reuters, 2025).

3.2 Inflation and Price Stability

The flip side of stronger demand is potential upward pressure on prices. Pakistan's recent disinflation owes much to suppressed demand and improved supply. A revival of demand from rate cuts could lead to demand-pull inflation: more money chasing the same goods. Sectors with supply constraints could see prices rise if financing suddenly becomes easier. Additionally, if rate cuts cause any currency depreciation, imported inflation will tick up. The SBP noted that inflation could temporarily rise toward the upper single digits in late FY2026 due to base effects. With a looser policy, that risk increases.

However, the extent of inflation resurgence depends on slack in the economy and expectations. Pakistan's output gap has been negative. In such a scenario, a pickup in demand can be met by increased production rather than higher prices, at least initially. For example, large-scale manufacturing (LSM) had been contracting for much of 2023; by late 2025 it is growing again as factories ramp up utilization (Reuters., 2025). This suggests some headroom before demand hits capacity limits. Moreover, inflation expectations currently appear fairly well-anchored: core inflation has nearly halved and stayed around 7-8%, while headline CPI is within target. If the SBP clearly communicates it will not tolerate a return to double-digit inflation, businesses may be cautious in raising prices.

In quantitative terms, Pakistan's CPI inflation could remain in the mid-single digits with a gradual easing which is still moderate and arguably a worthwhile trade-off for growth. But an aggressive cut that overstimulates demand or undermines the rupee could push inflation back up more sharply. Indeed, the IMF projects inflation could temporarily accelerate to 8–10% in FY2026 even under a cautious policy. The SBP must be ready to pause the easing cycle if monthly inflation readings show a troubling rise.

Logic Behind Targeting a Modestly Positive Real Policy Rate

Monetary policy operates through real, not nominal, interest rates. The real policy rate is defined as the nominal policy rate minus expected inflation. When real rates are negative, borrowing becomes artificially cheap, inflation expectations rise, capital flows outward, and pressure builds on the exchange rate and external balance. Conversely, excessively high real rates suppress investment, slow growth, and increase public debt servicing costs.

If SBP's inflation objective is to maintain headline inflation in the 5%–7% range, then anchoring expectations and preserving monetary credibility requires keeping the forward-looking real policy rate modestly positive. A real rate in the range of +1% to +2% signals commitment to price stability, maintains the attractiveness of domestic financial assets, and reduces the risk of capital flight and exchange rate instability.

Given inflation expectations of 5%–7%, this real rate objective translates into a nominal policy rate of approximately 6%–9%. However, in Pakistan's context of high import sensitivity and historical boom-bust cycles, monetary easing must proceed gradually and remain explicitly conditional on inflation staying within target and external sector stability. Premature or aggressive rate cuts risk reigniting import-driven current account pressures, reserve losses, and renewed inflation.

In essence, a modestly positive real policy rate balances three objectives: anchoring inflation expectations, safeguarding external stability, and avoiding unnecessary suppression of growth.

In operational terms, the forward-looking real policy rate should be anchored to transparent and verifiable measures of inflation expectations. The SBP can triangulate expectations using three complementary indicators: (i) survey-based measures of household and business inflation expectations; (ii) market-based signals, including breakeven inflation derived from government securities and yields on inflation-linked instruments where available; and (iii) model-based forward inflation projections from the SBP's forecasting framework. A consistent cross-check across these sources would allow the SBP to assess whether real rates are genuinely positive in expectation, rather than merely in backwards-looking terms, thereby strengthening the operational credibility and accountability of the real-rate framework.

3.3. International Practice on Dual Use of Headline and Core Inflation

This dual-inflation targeting approach is consistent with international practice. The Bank of England, the Reserve Bank of New Zealand, and the Bank of Canada routinely rely on measures of underlying or core inflation as key inputs to policy deliberations, while maintaining headline inflation as the primary public reference point. This distinction allows central banks to respond to persistent demand pressures while avoiding overreaction to transitory supply shocks, thereby reinforcing the credibility and effectiveness of the policy framework

Table 2: Global dual-inflation targeting approach

Central Bank	Headline Inflation (Public Target / Communication)	Use of Core / Underlying Inflation in Operations	Rationale for Dual Approach
Bank of England (BoE)	Headline CPI is the formal target	Regularly monitors a range of core and domestic inflation measures in policy deliberations	Distinguishes persistent demand pressures from transitory supply shocks, reducing risk of overreaction to energy/food volatility.
Bank of Canada (BoC)	Headline CPI is the official target	Actively uses core measures as key guides for policy decisions	Core measures better reflect underlying inflation trends and medium-term price dynamics.
Reserve Bank of New Zealand (RBNZ)	Headline CPI is the formal target band	Considers "non-tradables" and core inflation indicators in forecasting and policy setting	Helps assess domestically generated inflation and reduce noise from import price fluctuations.
European Central Bank (ECB) *(optional alternative to BoE)*	Headline HICP is the primary reference	Closely tracks measures of underlying inflation in policy assessments	Allows policy to focus on persistent inflation drivers while avoiding undue tightening/loosening from temporary shocks.

3.4 Investment, Business Confidence, and Private-Sector Credit

Lower interest rates are clearly positive for investment and credit expansion. As noted, Pakistan experienced a dramatic increase in bank lending to the private sector once the SBP began cutting rates in 2024. According to the Finance Division, in the first half of FY2025 banks' loans to private businesses jumped by PKR 1.916 trillion, compared to only PKR 443 billion in the same period a year earlier (Ministry of Finanace, 2025). This was driven by both working capital needs and fixed investment loans, indicating businesses were taking advantage of improved financial conditions to expand operations (Ministry of Finance., 2025). Sectors like textiles, cement, and automotive benefited from lower financing costs and showed production recoveries. If interest rates are reduced further:

- **Credit to the Private Sector** will likely continue to grow at a healthy pace. Bank liquidity is ample given the retirement of government debt in early FY2025 (Ministry of Finance.,

2025), so banks are in a position to lend to businesses. Lower rates could also reduce non-performing loan risks and improve banks' risk appetite to extend credit. Credit to private sector expect to grow in the double digits if rates move downward and confidence holds. This credit enables firms to finance inventory, capital expenditure, and new projects.

- **Business Confidence and Investment Climate:** Interest rates send a signal about the economic trajectory. A well-telegraphed easing cycle can improve business sentiment, firms interpret it as support for growth and an indication that inflation is under control. The Pakistan Business Confidence Index, which was deeply negative during the 2023 crisis, turned positive by late 2025 as stability returned and financing costs fell. Investment commitments that were deferred earlier may be revived. Additionally, foreign investors consider interest rates in their decisions: while high rates attract some short-term funds, sustained lower rates along with macro stability could attract foreign direct investment into real sectors, seeing that the central bank prioritizes growth.

- Liquidity created by monetary easing translates into productive fixed investment or is absorbed into short-term working capital, inventory accumulation, or speculative asset allocation ultimately depends on key structural conditions. These include the degree of policy certainty surrounding energy pricing, taxation, and trade regulations; expectations about future demand, particularly export orders; and whether project internal rates of return exceed the real cost of capital adjusted for risk premia. This distinction can be evaluated by tracking the composition of incremental private credit and by examining import patterns to assess whether machinery and intermediate goods imports are rising faster than consumer goods. If monetary easing is effectively stimulating productive investment, growth in machinery imports and export-oriented capacity should outpace increases in discretionary consumer imports. Importantly, lower interest rates primarily relax cost-of-capital constraints, but investment may still remain subdued if firms face elevated policy uncertainty (e.g., around energy pricing, taxation, or trade rules) or an onerous effective tax structure that keeps required rates of return above the risk-adjusted cost of borrowing.

Another area is SME financing and consumer lending. These were severely hit by high rates. The SBP's refinance schemes at subsidized rates helped somewhat, but broad-based rate cuts will naturally ease credit conditions for smaller borrowers who pay premium rates. More SMEs accessing credit means more expansion and job creation at the grassroots level. For consumers, housing finance and auto loans may see a rebound. The current stock of mortgage lending in Pakistan is extremely low; even a modest uptick can stimulate construction and allied industries. Subsidised credit schemes should not be a permanent feature of the policy toolkit, but rather used only counter-cyclically and temporarily during periods of severe credit stress, with a clear sunset clause and transparent targeting to avoid long-term distortions.

3.5 Exchange Rate and External Balance

The exchange rate (PKR) is a critical variable that could be affected by interest rate changes. Pakistan's currency has a history of volatility tied to external imbalances. A high interest rate has been one factor supporting the rupee since 2023, as it made PKR deposits and bonds attractive relative to alternatives. As Pakistan lowers rates, the interest rate differential with other markets will shrink, potentially reducing financial inflows. For example, yields on Pakistan's treasury bills had drawn investments from local and some foreign investors; those may diminish if yields fall. Moreover, some domestic investors might shift into foreign currency assets if returns in PKR drop and they fear future depreciation.

Import-intensive consumption-led growth heightens exchange rate vulnerability by widening the trade deficit and increasing dollar demand, which, if not offset by capital inflows, translates into reserve drawdowns and greater reliance on central bank intervention.

The likely outcome of a rate cut is mild depreciation pressure on the rupee. Indeed, analysts caution that "premature rate cuts could pressure the rupee even with anticipated IMF inflows". However, the extent of currency movement will depend on confidence. If the easing is gradual and seen as aligned with fundamentals. The rupee's adjustment might be limited. Importantly, Pakistan's external account is currently in much better shape: the current account was roughly in balance in 2024–25, so there isn't an inherent excess demand for dollars from trade. Also, foreign reserves have been rebuilt to a modest cushion. The SBP could potentially manage excessive volatility through interventions if needed.

Imported Inflation: Any depreciation that does occur will feed into inflation. Pakistan's import basket means that a 5% rupee depreciation, for instance, can add perhaps 1–2 percentage points to CPI over a year, all else equal. This is not negligible. It highlights that interest rate policy must be knowing of external signals. If markets sense that Pakistan is easing responsibly, the exchange rate might move only gradually. Conversely, a sharp or unexpected cut could trigger a faster PKR slide, as happened in 2019 when a surprise cut under differing circumstances led to capital flight.

Balance of Payments: With stronger domestic demand from lower rates, imports are likely to increase. Consumer goods imports, machinery, and raw materials for industry could all rise as economic activity picks up. The question is whether export earnings and remittances will also rise to offset the import bill. Exports might benefit from any competitive boost of a slightly weaker rupee and from improved global demand if growth is reviving, but in the short run, export volumes may not respond quickly to a rate cut; they depend more on global conditions and structural factors. Remittances historically are more influenced by conditions in host countries and currency parity; a moderate PKR depreciation can actually encourage remitters to send more money. In FY2025, remittances jumped 31% as the exchange rate stabilised and incentives were given.

On balance, a controlled easing should keep the current account deficit manageable; possibly it might move from near-zero toward a deficit of 1–2% of GDP as imports normalize. The SBP in Oct 2025 expected the current account to remain within 0–1% of GDP in FY2026 (SBP., 2025c). Even with rate cuts, staying in that range is feasible if fiscal policy does not overstimulate demand. Any larger deficit would need financing; that again ties to confidence.

3.6 Fiscal Deficit and Public Debt

A reduction in interest rates will have direct and indirect effects on fiscal outcomes:

- **Interest Costs:** Pakistan's government debt is heavily tilted toward short-term and floating-rate instruments. As the SBP policy rate falls, the yield on new government debt issues will also decline, lowering the interest payments the government makes. In FY2024, interest payments consumed a significant share of revenue. By FY2025, with policy down to ~12–13% on average, debt servicing pressure eased. The Ministry of Finance reported a primary budget surplus of 0.4% of GDP in Jul–Mar 2025, indicating that excluding interest, the budget was in surplus. Further rate cuts would continue this trend: it is estimated that a 100bps cut could save roughly 0.2–0.3% of GDP in annual interest costs for the government. This is significant fiscal space in a tight budget environment.

- **Deficit and Debt Dynamics:** With interest savings, Pakistan could either reduce its fiscal deficit or reallocate spending to priority areas without increasing the deficit. Ideally, some of the savings should reduce borrowing needs, helping slow the accumulation of debt. Pakistan's public debt-to-GDP ratio, around 78–80%, is high but has stabilised; a combination of revived growth and lower interest costs can put debt on a more sustainable downward path. The SBP's annual report noted FY2025 fiscal deficit was about 5.4% of GDP, a multi-year low, and the primary surplus was 2.4% (SBP., 2025d). Continued easing that doesn't reignite inflation could allow deficits to stay moderate (~5% range) while supporting growth. Essentially, monetary easing, when done in tandem with fiscal discipline, can create a virtuous cycle

  lower debt service -> lower deficit -> less need for central bank financing or crowding out -> more room for private credit, etc.

- **Crowding-Out Effect:** High interest rates often go hand-in-hand with government dominating borrowing. As rates come down and the government's deficit financing need is contained, should see reduced "crowding out." Banks will be more inclined to lend to businesses if government securities yield less and the government is borrowing less. This further amplifies the pro-investment effect of rate cuts.

3.7 Employment and Unemployment

Employment is a lagging indicator that will respond to economic growth dynamics. The period of stabilization saw higher unemployment and underemployment, especially in industry and services, as output stalled. With GDP growth expected to pick up with monetary easing, job creation should improve over the medium term. Lower interest rates primarily influence employment through two channels:

- **Investment and Business Expansion:** As firms invest in new projects or expand production, they will hire more workers. Sectors like manufacturing and construction, which are credit-sensitive, can absorb a large number of semi-skilled workers. Pakistan have already seen that large-scale manufacturing output started to recover by 2025 – if this translates into reopening shifts at factories, that brings back jobs. Similarly, construction activity correlates with housing and infrastructure finance; easing financial conditions should revive construction jobs, which have high multiplier effects due to linkages with materials and local labor. SMEs, which account for the majority of employment, also benefit from easier credit and tend to hire incremental labor when business improves.

- **Cost of Capital vs. Labor:** In a high interest environment, firms might have been hesitant to borrow for expansion or prefer automation to avoid high financing costs of labor-intensive projects. Lower rates reduce the user cost of capital, making it feasible to undertake labour-intensive operations. While automation is not as widespread in Pakistan's current industrial base, generally, an environment of growth and affordable financing encourages entrepreneurs to start new ventures, often employing additional workers.

Official unemployment data for Pakistan is infrequent, but it's estimated that unemployment touched around 8–10% during the 2023 crisis. Growth returning to ~4%, unemployment would gradually fall. Perhaps it could decrease by 1–2 percentage points over two years of sustained growth. Pakistan has a very large youth labor force entering each year. To absorb them, growth needs to be consistently above 5%. Interest rate cuts alone won't achieve that level, but they are a necessary step toward a more expansionary macro stance that, complemented by structural reforms, can move growth higher.

One metric to watch is the employment in export-oriented industries. If the exchange rate remains competitive and credit is available, these sectors can scale up and hire more. For example, textile sector output grew 2.2% in FY2025 after an 8.8% contraction prior year, as stabilization took hold, and presumably recalled some workers. With stronger orders and better financing, textile mills could employ more people but they also need reliable energy and other inputs, which goes beyond monetary policy.

3.8 Balance of Payments (BoP) and Current Account

The balance of payments will reflect the net outcome of all these effects. A simplified expectation: with rate cuts, imports will likely rise faster than exports in the short term, potentially widening the current account deficit somewhat. But how much it widens will determine if it's problematic or manageable. The current account went from a deficit of 4.7% of GDP in FY2022 to a surplus of 0.5% in FY2025 through drastic import suppression and policy tightening. It is neither realistic nor desirable to keep the external gap at zero if growth is to accelerate. The question is ensuring the deficit stays within safe financing limits.

Scenario analysis: Suppose interest rate cuts help push GDP growth to ~4% and domestic demand rises accordingly. Imports could grow perhaps 10–15% after being nearly flat or negative in the stabilization period. Exports might grow 5–10% with global recovery and any competitive effects of a weaker rupee. Remittances might grow moderately. Under such a scenario, the current account might swing to a deficit on the order of 1–2% of GDP. For instance, if imports increase $5–6 billion and exports + remittances increase $3–4 billion, the gap might be $2–3 billion. This is an illustrative figure actual outcomes can differ. But crucially, this level of deficit is financeable as long as Pakistan is in an IMF program and has access to external funding. The SBP projects reserves continuing to rise to ~$18 billion by June 2026 with planned inflows, implying that expected capital inflows exceed any current account shortfall.

However, the risk scenario is if easing is mismanaged, and confidence in Pakistan's reform path falters capital inflows might slow or reverse at the same time imports surge, leading to an external funding gap. That would draw down reserves and put pressure on the currency. Pakistan want to avoid that by coordinating policy moves with lenders and keeping the IMF on board. Additionally, Pakistan should pursue policies to support exports and remittances alongside rate. This balance-of-payments (BoP) growth ceiling should be formally recalibrated at least annually as part of the medium-term macroeconomic framework review, and updated more frequently if there are material changes in external financing conditions, reserve adequacy, or trade dynamics.

3.9 Higher Taxation

Statutory corporate income tax (CIT) in Pakistan is commonly reported at around 29%, yet the actual tax burden faced by firms can be substantially higher due to additional layers such as the super tax, which applies progressive rates on large corporate incomes, along with other sector-specific levies and withholding mechanisms. When these components are combined, effective tax rates exceeding 40% are possible for highly profitable or large-scale corporations, even though the headline CIT rate appears lower. This elevated effective taxation increases the required pre-tax rate of return on investment, thereby discouraging marginal projects and weakening private-sector capital expenditure. As a result, monetary easing alone may be insufficient to stimulate investment

unless complementary reforms address tax complexity, trade policy uncertainty, and high energy costs that jointly raise business risk (PWC., 2026).

Table 3: Policy Trade-Off Matrix: Interest Rate Cuts in Pakistan

HIGH STABILITY RISK	
External Instability (IV) • Sharp PKR depreciation • Capital outflow • Reserve losses	Overheating Risk (III) • Demand outpaces supply • Inflation re-accelerates • Import surge widens CAD • Policy reversal risk
Growth Neutral (II) • Limited growth • High real rates • Investment • remains weak	Safe Easing (I) • Gradual GDP acceleration • Inflation contained • Manageable FX movement • Credit recovery
LOW STABILITY RISK	

Table 4: Pakistan Key Macro Indicators (FY2024–FY2026) (Projected effects of lower interest rates)

Indicator	FY2024 (actual)	FY2025 (actual)	FY2026 (projection)*
Policy Interest Rate (end-period)	22.0% (Jun 2024)	11.0% (Jun 2025) (Reuters., 2025)	~9.0% (Jun 2026)**
Real GDP Growth	2.4% (IMF., 2024)	2.7%	~4.0% (if easing implemented)
CPI Inflation (annual avg)	23.4% (SBP., 2025d)	8–9% (est.)***	~7% (with slight uptick)
Fiscal Deficit (% of GDP)	~7.7% (FY24)	~5.4% (SBP., 2025d)	~5% (assuming interest saving used to offset other spending)
Public Debt (% of GDP)	~78%	~75% (decline with growth and PKR stability)	~73% (gradual downward trend)
Current Account (% of GDP)	-0.6% (deficit)	+0.5% (surplus)	-1.0% (small deficit as imports pick up)
Unemployment Rate	~8% (est.)	~7% (est.)	~6–7% (improving with growth)

Indicator	FY2024 (actual)	FY2025 (actual)	FY2026 (projection)*
FX Reserves (SBP)	$4.5 bn (Jun 2024)	$14.1 bn (Jun 2025)	$17 bn (Jun 2026)****
Exchange Rate (PKR/USD, avg)	255	280	290–300 (slightly weaker)

Projections are illustrative, assuming a moderate easing bias and continuation of reform program. Assumes cumulative ~200 bps cut in FY26 if conditions permit. FY2025 average inflation estimate ~8–9% (headline fell sharply mid-year; year-end FY25 inflation ~6%). SBP reported FY25 avg NCPI 4.5%, but that is skewed by base effect – full-year headline average was higher due to high early months (SBP., 2025d)**.** **Projected reserves per SBP/IMF, contingent on reform program inflows.

The above table summarises the macro outlook: with interest rates easing from 22% to potentially high single digits by FY2026, growth could strengthen to ~4% and inflation remains in single digits, while the fiscal and external accounts are kept in check through prudent policies. These outcomes hinge on executing the interest rate cuts in a calibrated manner.

4. SBP Inflation Targeting Framework

SBP started targeting monetary aggregates in the early 1990s, focusing on the management of short-term interest rates. During this period, inflation was the ultimate target, broad money the intermediate target, and base money the operational target (Felipe, 2009). Monetary aggregate targeting is principally based on a stable and predictable relationship between inflation and monetary aggregates (Moinuddin, 2009).

Pakistan officially announced the adoption of an inflation-targeting framework in January 1993, with implementation beginning in 1995 to manage price stability following financial liberalization. While monetary aggregate targeting continued, the State Bank of Pakistan shifted toward using inflation targets as a key anchor in the mid-1990s, formalizing and fully strengthening this framework over subsequent years.

Many central banks have shifted from the monetary targeting regime as shocks to the demand for money and an unstable transmission mechanism imply that a stable growth of the monetary aggregates can lead to unstable behavior in prices. For this reason, today, policy makers in many countries are engaged in aggregate demand fine tuning through interest rate management (Felipe, 2009). SBP introduced an interest rate corridor in August 2009 to stabilize the overnight money market repo rate. Later in May 2015, SBP further refined this framework by introducing a formal "Target Rate" for the overnight money market repo rate to provide a clearer signal of its monetary policy stance.

The Government's annual CPI inflation target is largely based on recent price trends and keeps on changing both up and down and sometimes by big margins (Hussain, Rehman, 2020). Such frequent changes in inflation targets are not conducive to anchoring inflation expectations. Hence,

the SBP shifted towards a flexible inflation targeting regime, focusing on a medium-term inflation band of 5-7%. While the long-term goal remains a full-fledged inflation-targeting framework where the policy rate anchors inflation expectations, Pakistan's progress has been hampered by structural realities such as inflation projection capabilities, fiscal dominance, supply-side shocks (like energy and food prices), and the need to manage external imbalances and exchange rate pressures.

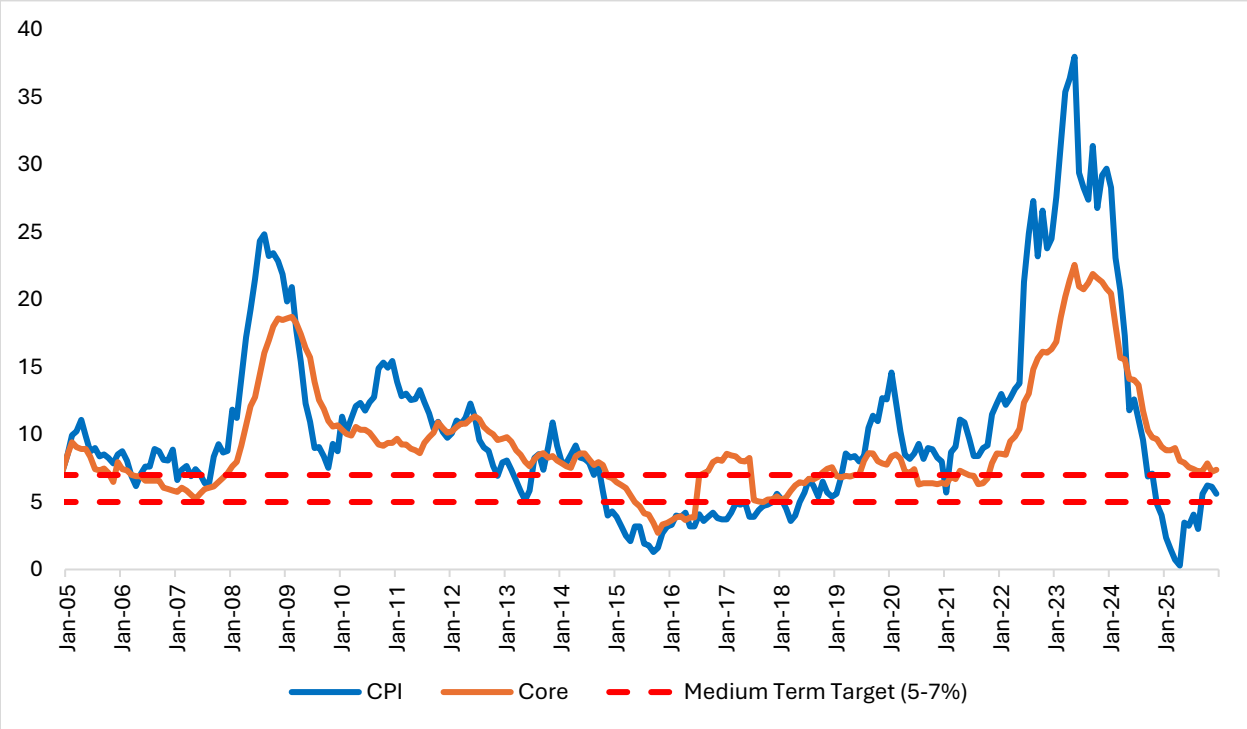

Figure 5: CPI & Core Inflation

Data from last 20 years depict that both CPI and core inflation levels have seldom remained within the medium-term threshold. CPI headline inflation remained with the 5-7% range during October 2014 to February 2019, and more recently from September 2025 to January 2026. On the other hand, core inflation remained less volatile than CPI and remained within the target range for greater time periods during the last twenty years (April 2006 to November 2007, November 2014 to July 2016, July 2017 to September 2018, and July 2020 to October 2021).

4.1 Inflation Targeting

SBP's medium-term inflation target range of 5-7% was formally announced in the January 2023 Monetary Policy Statement. This marked a transition away from the annual inflation target regime that was followed earlier by the SBP.

Inflation Targeting (IT) focuses on maintaining steady prices by setting a clear, public numerical goal for inflation, for the purpose of sustained growth and economic prosperity. To succeed, the bank must have the independence to choose the best financial tools to achieve the target, providing a predictable environment that helps the economy grow without sudden price shocks. Price stability doesn't imply a constant price level or zero inflation. Instead, it means keeping inflation

at a steady, predictable rate, usually within a small "safety range" or tolerance band to ensure the economy stays balanced over the long term (Khalid, 2006).

Masson et al. (1997) identify two prerequisites for successful inflation targeting: fiscal discipline, ensuring monetary policy isn't compromised by government deficits, and central bank priority, where inflation control takes precedence over other variables like exchange rates. Once these prerequisites are met, central banks choose between strict or flexible inflation targeting. A strict regime focuses solely on reaching targets quickly through aggressive interest rate adjustments, risking economic shocks and exchange rate volatility.

Conversely, a flexible regime balances price stability with economic output. This flexibility may be introduced through explicit ‘escape clauses’, pre-defined rules that allow a central bank to temporarily bypass its inflation target during exceptional circumstances, such as a natural disaster or a global oil shock. By allowing for temporary deviations, banks can prevent policy-induced shocks and avoid further destabilizing the economy. For countries such as Pakistan prone to frequent economic shocks and volatile inflation, however, explicit escape clauses might be unsuitable. Using them often damages the central bank's credibility and transparency, as the public may view these "exceptions" as mere excuses for policy failure. Instead, a large number of central banks have chosen to adopt a ‘range inflation target’ over a medium-term period as a means of introducing flexibility in the monetary policy regime amidst sudden shocks (Babar, et.al, 2023).

New Zealand was the first country to adopt an inflation targeting regime in March 1990 (Blejer, et.al, 2000). Since then, many emerging economies in Asia, Latin America and Europe have switched to inflation targeting as their monetary policy objective. Globally, most emerging economies target inflation between 2% and 6%, while advanced economies typically aim for a lower range of 1% to 3%. Because emerging market central banks often lack the credibility and independence of those in developed nations, they struggle to anchor inflation expectations. To compensate for this susceptibility to government influence, these economies typically establish higher inflation targets than their developed counterparts (Hussain, Rehman, 2020).

4.2 Inflation Targeting Measure

For accurate inflation targeting, it is imperative for an appropriate measure of inflation to be defined. It could measure either the entire basket of consumable goods and services (CPI) headline inflation, or an underlying rate which excludes components of headline index, called core inflation. Some findings of academics suggest that CPI is frequently skewed by extreme price shocks in specific items, rendering it a misleading measure. Therefore, core inflation is deemed a more reliable gauge for monetary policy. By disregarding highly volatile items—such as food and energy, which are prone to temporary supply shocks—core inflation allows central banks to see past the "noise" of headline figures. However, recent cross-country analyses of economies adopting inflation targeting reveal that with the exception of Uganda, there was a significant preference for headline CPI as an appropriate measure (Babar, et.al,2023). These included emerging economies such as Ghana, Kazakhstan and Peru, in addition to more advanced economies including the UK, Germany and New-Zealand. Even though using core inflation might be viable from an economic standpoint, CPI represents the actual “basket of goods” purchased by consumers, including food and fuel. If a central bank targets core inflation while essential prices for food and energy are surging, the public may view the policy as manipulative or out of touch, ultimately eroding trust and undermining the bank's ability to anchor inflation expectations.

4.3 Determining an optimal real rate

Determining an optimal real policy rate range for Pakistan is essential to achieving long-term price stability, anchoring inflation expectations, whilst balancing growth prospects. We have compiled insights from advanced and emerging economies to estimate the relationship between inflation and interest rate trends, to further deduce the range of real interest rates during periods of stable inflation. In this context, stability refers to inflation staying within a country's stipulated target range set by the central bank.

Research on inflation and interest rate trends in the U.S. and the Euro Area over the last 10 years indicates that both economies have maintained negative real rates during periods of stable inflation. In the U.S., a minimum negative real rate of 1.5% was witnessed in February 2021 while headline inflation was at 1.7%. Only in 2019 did the U.S. maintain a positive average real rate of 0.6% as inflation remained sticky around the target level of 2%.

Table 5: United States of America

	Average Inflation	Average Interest Rate	Average Real Rate	Minimum Real Rate	Maximum Real Rate
Jan 2016-Nov 2016	1.2%	0.5%	0.0%	-1.2%	-0.3%
Dec 2018-Oct 2019	1.8%	2.4%	0.0%	-0.1%	1.0%
Mar 2020-Feb 2021	1.1%	0.3%	0.0%	-1.5%	0.2%

On the other hand, ECB consistently maintained a negative real rate environment during stable inflation periods. Data indicates that E.U. maintained on average a negative real rate of 1% where inflation was less than the target level of 2% during the last ten years.

Table 6: Euro Area

	Average Inflation	Average Interest Rate	Average Real Rate	Minimum Real Rate	Maximum Real Rate
Jul 2016-Jun 2018	1.3%	0.0%	0.0%	-2.0%	-0.2%
Nov 2018-Jun 2021	0.9%	0.0%	0.0%	-2.0%	-0.3%

The developed economy framework often proves to be incompatible with the structural realities of a developing country like Pakistan. For emerging economies, maintaining a positive real interest rate is not merely a policy preference but a structural necessity to prevent capital flight, protect domestic savings from erosion, and compensate for higher risk premiums (Zaidi, Zaidi, 2011).

Successful inflation targeting regimes in emerging economies provide a roadmap. Analysis indicates that maintaining a disciplined real interest rate gap led to price stability and sustainable growth. Chile is often cited as a successful inflation-targeting emerging economy. During 2000-2010, Chile kept a positive real rate of 1-2%, anchoring inflation at the target level of 3%, while

real GDP growth averaged around 4%. Research analysis on Colombia highlights a positive real rate in the range of 0-1.5% when inflation was within its 2-4% target level throughout 2018 and 2019. Simultaneously, GDP growth during these years recorded a steady uptick, from 1.4% in 2017 to 3.2% in 2019.

India has witnessed multiple periods of price stability in the previous ten years; from 2016 to 2019, and for the majority of 2023-2025. The central bank's strategy involves maintaining inflation within a 2–6% range, with real interest rates hovering between 0% and 4.5% once that objective is achieved.

Kazakhstan, with an inflation target range of 4-6%, operated with a positive real rate range of 3-4.5%, from June 2018 to February 2020. Contrastingly, GDP growth witnessed a moderate increase to 4.5% in 2019 from 4.1% in 2018. Separate analysis of Indonesia during multiple periods of stable inflation (2016-2020, 2023-2024, and late 2025) indicated positive real rates within a range of 0.5-4% when inflation was within the target range of 2-4%. However, more recently in February 2025, high positive real rate of 5.85% was also witnessed with inflation of -0.1%. No significant relationship was observed with real GDP growth, which averaged around 5% during the above-mentioned time periods.

Table 7: Global Examples

Country	Period	Average Inflation	Average Interest Rate	Average Real Rate	Minimum Real Rate	Maximum Real Rate
Kazakhstan	Jun 2018–Feb 2020	5.40%	9.10%	3.70%	2.90%	4.50%
Indonesia	Apr 2016–Mar 2017	3.40%	5.00%	1.60%	1.00%	2.20%
Indonesia	Jul 2017–Jun 2020	3.10%	5.10%	1.90%	0.60%	3.50%
Indonesia	Jun 2023–Aug 2024	2.80%	6.00%	3.30%	2.30%	4.20%
Colombia	Jan 2018–Jul 2020	3.30%	4.10%	0.80%	-0.30%	1.40%
India	Jan 2016–Nov 2019	4.00%	6.20%	2.20%	-0.30%	4.50%
India	Apr 2023–Aug 2025	4.50%	6.30%	1.80%	-0.90%	3.90%

Drawing from the real rate trends in emerging economies, Pakistan’s optimal real policy rate should ideally lie within the 0-4% range, helping anchor price expectations and achieve full growth potential of 5%. Negative real rates may offer short-term relief but often lead to asset bubbles (e.g., housing and stock market spikes seen in Pakistan’s history), which are not conducive to sustainable growth. Simultaneously, excessively high real rates (above 5%) can also obstruct growth by significantly increasing the cost of debt servicing and private investment. For a developing economy like Pakistan, which faces a higher country risk premium and fiscal dominance, a slightly higher real rate (3–4%) is often necessary to prevent capital flight and keep the currency stable, compared to advanced economies where real rate is often kept negative. By keeping real rate at a

higher level also sends signal to IMF and global investors that the SBP is prioritizing on containing inflation rather than chasing higher growth. With the SBP's nominal policy rate at 10.5% against a medium-term inflation outlook of 6.0%, the current real rate stands at a restrictive 4.5%. This positioning validates a path for measured monetary easing towards the 4% level. Moreover, academics frequently cite that Pakistan's inflation threshold level should rise no more than 6%, beyond which economic growth may potentially be impeded (Ali, Arby, 2017). This level aligns with the State Bank's current inflation target range of 5-7%, which warrants monetary policy to be adjusted accordingly to achieve the ideal real rate figure

5. Policy Options for Interest Rate Adjustment

Pakistan's policymakers have a spectrum of options regarding the pace and extent of interest rate reduction. This paper outline three broad options: (1) an aggressive, front-loaded rate cut strategy, (2) a gradual and conditional easing, and (3) holding rates at current levels while using other tools to stimulate growth. Each option has pros, cons, and differing implications for the economy.

5.1 Option Comparison Matrix:

Key assumptions underlying the scenarios:

All three policy options are assessed under a common baseline that assumes: (i) a gradual decline of headline inflation toward the 5–7% range over FY2026, with core inflation remaining broadly stable; (ii) continued fiscal discipline consistent with the IMF-supported programme, including a maintained primary surplus and no large discretionary stimulus; and (iii) a broadly neutral global environment, characterised by stable commodity prices (particularly oil and food) and orderly global financial conditions without a sharp tightening of international liquidity. Deviations from any of these assumptions would materially alter the growth–stability trade-offs across the three options.

Table 8: Option Comparison Matrix

Option	Growth Impact	Inflation Risk	FX/BOP Risk	Fiscal Impact	Feasibility & Timing
1. Aggressive Front-Loaded Cut	High short-term boost (credit boom, consumption surge) but unsustainable; risk of boom-bust.	High – likely reignites inflation quickly, could overshoot target.	High – rupee under pressure, possible reserve loss if capital exits.	Short-term deficit relief but risk of later instability (higher borrowing costs if credibility lost).	Not advisable now; feasible only if deflationary conditions and strong reserve backup.

Option	Growth Impact	Inflation Risk	FX/BOP Risk	Fiscal Impact	Feasibility & Timing
2. Gradual Data-Dependent Easing	Moderate sustainable boost; growth rises to potential over 1-2 years.	Moderate – inflation may drift up but stay in high single digits, around target's upper bound.	Manageable – slight depreciation possible, but time to adjust and manage flows; maintains IMF confidence.	Steady deficit reduction from interest saving; manageable debt path.	Highly feasible; aligns with IMF advice. Timing: begin easing in small steps, adjust pace as needed by data.
3. Hold Rates, Use Other Tools	Low – growth remains sluggish, may improve marginally through fiscal projects, etc.	Low – inflation likely continues to fall or stay subdued.	Low – rupee stable, reserves build further.	Initially higher interest costs persist; fiscal stimulus limited by tight rates; debt might improve via lower inflation but hurt by slow growth.	Feasible but not optimal; would extend economic pain. Suitable only if serious external threats require full caution.

This matrix illustrates why Option 2 (gradual easing) is the preferred compromise: it offers a clear path to improving growth while containing risks within acceptable bounds. Option 1 tilts too far toward growth at the expense of stability, and Option 3 tilts too much toward caution at the expense of economic recovery. The next section will consider the risks that remain even under the recommended path, and how to mitigate them, before finalizing the recommendations.

6. Key Risks and Mitigation Strategies

Even with a gradual, well-calibrated easing of interest rates, Pakistan must navigate several **risks** to ensure the intended benefits materialize without adverse side-effects. Moreover, premature or poorly sequenced monetary easing can amplify Pakistan's exposure to global external financing cycles by increasing reliance on volatile capital inflows at precisely the point when global liquidity conditions may tighten. Below identify major risks and propose mitigation measures for each:

Table 9: Summary of Key Risks and Mitigation Strategies

Risk	Core Risk Summary	Key Mitigation Actions	Severity / Likelihood
1. Resurgence of Inflation	Inflation may re-accelerate due to excess demand, supply constraints, or external shocks (food, energy), undermining real incomes and forcing policy reversal.	Data-dependent easing; pause cuts if inflation rises. Strengthen inflation forecasting and early warning systems. Improve food supply management and communicate inflation targets clearly.	**High Severity / Medium Likelihood**
2. Exchange Rate & External Pressures	Rate cuts could trigger capital outflows, weaken the rupee, and widen the current account if imports rise faster than exports.	Maintain FX reserves ≥3.5 months of imports. Secure IMF and multilateral inflows. Use macroprudential tools and intervene against disorderly FX moves.	**High Severity / Medium–High Likelihood**
3. Credibility Risk (IMF / Markets)	Rapid easing could spook markets or IMF, raising yields and forcing an abrupt policy reversal, damaging credibility.	Align pace of easing with IMF engagement. Maintain fiscal discipline and reserve accumulation. Clear forward guidance stressing flexibility and vigilance.	**Medium–High Severity / Medium Likelihood**
4. Weak Monetary Transmission	Banks may not pass on rate cuts due to risk aversion, high NPLs, or wide spreads, limiting growth impact.	Narrow interest rate corridor, guide KIBOR. Encourage loan restructuring. Expand targeted refinance schemes and promote banking competition.	**Medium Severity / Medium Likelihood**
5. Fiscal Slippage	Lower interest costs may fuel populist spending, raising deficits and undermining macroeconomic stability.	Enforce fiscal targets (IMF-aligned). Save part of interest gains, prioritize one-off investment. Publish medium-term debt strategy and ensure policy coordination.	**High Severity / Medium Likelihood**

Other risks like global economic downturn or commodity price shocks need contingency plans. Pakistan should maintain diversification of import sources and build strategic reserves of critical commodities to buffer price shocks, since those can cause inflation regardless of domestic demand.

7. Recommendations

Drawing together the analysis above, this paper recommends the following actions for Pakistan's policymakers:

- The SBP should cut rates in small, data-dependent steps, contingent on inflation remaining within 5–7% and continued improvement in external buffers, while keeping real rates modestly positive.
- Core inflation should guide operational policy decisions, while headline inflation remains the primary communication benchmark to manage expectations and transparency.
- The SBP should provide regular inflation outlooks and clearly signal that easing will pause or reverse if inflation risks re-emerge.
- Maintain timely IMF and multilateral inflows, encourage FDI, closely monitor trade flows during easing, and build reserves when conditions permit.
- Use interest savings to reduce deficits or fund productivity-enhancing investment, avoid populist subsidies, and preserve a primary surplus.
- Complement rate cuts with well-targeted, time-bound refinance schemes for SMEs and priority sectors, while gradually deepening capital markets and credit information systems.
- Intensify monitoring of inflation, FX markets, capital flows, and credit trends, with regular reporting to the MPC and continued engagement with multilateral partners.
- Implement gradual, well-timed easing after disinflation to support growth while preserving macroeconomic stability.

8. Conclusion

Pakistan's optimal monetary stance is a gradual, data-dependent easing toward a modestly positive forward-looking real policy rate, calibrated to keep inflation expectations anchored while supporting recovery in credit and investment. The State Bank of Pakistan should operationalise a dual inflation framework in which core inflation guides policy decisions, while headline inflation remains the primary benchmark for communication and accountability. Growth can and should be supported by lower rates, but only within a clearly defined balance-of-payments ceiling that is reviewed annually and adjusted when external conditions materially change. Monetary easing must therefore proceed in tandem with continued reserve accumulation, stable capital inflows, and IMF-aligned macro discipline. At the same time, rate cuts alone are insufficient to lift potential growth; they must be sequenced with structural reforms to lower investment risk and improve productivity. If these elements are implemented together, Pakistan can achieve higher, more durable growth without sacrificing price or external stability.

A lowering of Pakistan's interest rate, done in a calibrated manner, is expected to have a positive impact on economic growth, supporting higher output and employment. The monetary transmission channels will ensure cheaper financing flows to businesses and consumers, thereby

stimulating demand. Crucially, however, the authorities must remain ready to adjust course if needed, monetary easing is a tool, not a goal in itself. The ultimate goal is sustainable, inclusive economic growth with low inflation.

The recommended path forward is to proceed with cautious optimism: implement a gradual easing of monetary policy in tandem with disciplined fiscal management and vigilant monitoring of inflation and external metrics. This approach essentially seeks a “Goldilocks” outcome, not too hot to reignite inflation, not too cold to stall growth. By maintaining this balance, Pakistan can emulate the success of other economies that cut interest rates after stabilizing and saw their growth rates rise without sparking a new crisis.

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