

Promise and peril of low policy rates

Dr. Rubina Ilyas | 27th July, 2025



In an unprecedented policy action that has taken international markets and other domestic players by surprise, the State Bank of Pakistan (SBP) has carried one of the most aggressive interest rate cuts in its history. The policy rate has crashed from a high of 22 percent in June 2024 to 11 percent by May 2025 — a total of 1,100 basis-point reduction in less than one year. While this change reflects new-found optimism in the macroeconomic landscape, particularly the steep

deceleration in inflation, it also provokes a few red flags about the sustainability of the economic trajectory of Pakistan.

The argument for cutting interest rates is intuitively appealing. Despite soaring to almost 40 percent in mid-2023 in the wake of supply shocks, exchange rate depreciation and a surge in global commodities, headline inflation has plummeted to a mere 0.3 percent in April 2025 — the lowest in over 30 years for Pakistan. This disinflation has afforded the central bank a leeway to cut borrowing costs to incentivize private-sector credit, increase investment and deliver fiscal relief through cheaper government borrowings.

Furthermore, the external sector has evidenced temporary stabilization. During July-March FY25, the current account surplus was recorded at USD 1.9 billion, supported by remittances, low import requirements and relatively stable global oil prices. The PKR is stable at around 275-285 per USD and far away from the jumpy performance in 2023. These are good tidings for a country perennially suffering from both twin deficits as well as a decline in foreign exchange reserves.

But upon closer examination, the situation is more complicated. One, headline inflation has plummeted, but core inflation (which strips out volatile food and energy prices) is still running at about 8 percent as of April 2025. That indicates that underlying price pressures, especially in services and rents, are still sticky. Added to this is the upturn in wage increases; the hike in administrative prices; and the coming delivery, under the new IMF agreement, of the increase in energy tariffs, which could all help revive inflation in the second half of the year.

Another cause for concern is the distress in rural economy. Over recent years, much of the disinflation has been the result of unprecedented falls in prices of some agricultural commodities. Wheat prices are down more than 35 percent over the past year, and electricity and fuel costs have

eased. Although urban consumers have embraced lower food inflation with open arms, it has hit rural incomes hard. Farmers are unable to meet input costs, and lower crop profitability is eroding the sowing cycle that will come, which in turn could reverse food inflation trends and exacerbate food security fears.

The external front looks better, but is not without its vulnerabilities. Pakistan's trade deficit surged to USD 3.4 billion in April, as import appetite started to rebound with credit markets reopening and import restrictions easing. At the same time, FX reserves — now between USD 9bn and USD 14bn — are dangerously low compared to the country's external debt commitments. Pakistan has to repay approximately USD 19 billion in external liabilities per year and a delay in projected inflows from the IMF, bilateral creditors or Eurobond issuance could once again be too much for its reserves. A reverse in commodity prices as well as geopolitical event risk could compound these weaknesses.

Fiscal sustainability is another important issue. Although policy rates are lower and save the government money in borrowing costs from the domestic market, this may also result in a situation where the government becomes less vigilant in managing the budget. The total public debt is estimated to be 74 percent of GDP, and the interest payments almost cover 50 percent of total government expenditures. It is very easy to lose space that lower interest payments created for the budget in case of any slack in revenue collection, subsidy reforms, or privatization attempts. Pakistan's tax-to-GDP ratio is still below 10 percent, one of the lowest on the planet, and most of the attempts to broaden the tax base have been blocked over and over by political opponents.

Most importantly, the swift process of monetary easing may damage the credibility of inflation targeting by the State Bank. Currently, inflation

figures may warrant a conservative approach, but perception of political motivations behind these cuts largely dampens investor sentiment. This comes at a delicate moment during Pakistan's next IMF review, where the Fund scrutinizes fiscal and monetary policy alignment. Straying from set targets or structural benchmarks risks slowing down disbursements, halting Pakistan's access to vital external funding.

Moreover, savers' habits and financial stability are at risk. Even though real interest rates are currently positive, savers may be drawn to speculative investments, such as gold and real estate, as bank deposit rates are below inflation-adjusted returns in alternative assets. This could erode official financial intermediation and lead to asset bubbles.

Pakistan's high non-performing loan ratios and other regulatory hurdles suggest that commercial banks may be slow to redeploy capital towards profitable private-sector lending now that they have once again benefitted from high risk-free returns during the recent tight cycle.

Though Pakistan's transition to a low interest rate environment has provided a short term relief, it isn't the solution to the country's permanent economic problems. It is necessary that policymakers keep vigilance and avoid assuming that rotational improvements are equivalent to structural strength.

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