Asian Journal of International Peace and Security (AJIPS)

ISSN-e: 2707-8809

Vol. 10, No. 1, (2026, Spring), 89-105

The Impact of Interest Rates on Macroeconomic Performance: A Case Study of Pakistan

Humera Bahadar[1]

Abstract:

Interest rates are one of the most essential macroeconomic management instruments, influencing nearly every area of the economy, including consumption, investment, inflation, savings, currency rates, and employment. Central banks employ interest rates to control economic activity, stabilize prices, and promote long-term growth. This article presents a detailed and in-depth explanation of how interest rates affect an economy, integrating theoretical knowledge with practical applications. This study employed a qualitative and case study design relying mainly on secondary sources. Data analysis has been carried out through the document analysis technique. In this study, a case study of Pakistan is included, concentrating on monetary policy actions implemented by the State Bank of Pakistan between 2022 and 2026. The paper assesses how aggressive interest rate increases helped contain inflation while also creating challenges to economic growth and employment. By combining data analysis, comparative viewpoints, and policy recommendations, this essay emphasizes the necessity of balanced and well-coordinated monetary policy in attaining long-term economic stability.

Keywords: Pakistan, macroeconomic performance, interest rate, inflation, currency rate, investment, employment

INTRODUCTION

The rate of interest is the cost at which money is borrowed and the income from the saving of money. It is an essential aspect of any financial system and plays a vital role in influencing economic activities. An increase in the rate of interest influences the decision-making process of households, firms, and governments, thus impacting the overall economic performance (Belke & Polleit, 2009; Wray, 2015). The central banks adopt the rate of interest as their principal tool for monetary policy in order to attain various macroeconomic objectives, including the achievement of price stability, full employment, and growth. For underdeveloped countries, the role played by interest rates becomes even more important because of inherent weaknesses that affect their economies (Belke & Polleit, 2009). It is evident in Pakistan's case. State Bank of Pakistan (SBP) is the principal authority that plays a very important role in handling all these issues through the manipulation of policy rates. This paper analyses the effect of interest rates on different economic variables. The study would be based on a theoretical perspective as well as empirical data.

[1] Lecturer, Department of Management Sciences, Hazara University, Mansehra, Khyber Pakhtunkhwa, Pakistan. Email: humayousafzai85@gmail.com

Pakistan's economy experienced one of its most challenging macroeconomic periods between 2022 and 2025. The country faced persistent inflationary pressures, significant depreciation of the Pakistani Rupee, widening fiscal and current account deficits, declining foreign exchange reserves, and increasing external debt obligations. These challenges were further intensified by global economic disruptions, including the post-COVID-19 recovery, the Russia–Ukraine conflict, rising international energy and food prices, and tighter global financial conditions. As a result, inflation reached historically high levels, exceeding 35 percent during 2023, while economic growth slowed considerably. To restore macroeconomic stability, the SBP adopted an aggressive monetary tightening policy by gradually increasing the policy interest rate to 22 percent, the highest level in the country's history. The primary objective of this policy was to contain inflation, stabilize the exchange rate, restore investor confidence, and meet the stabilization requirements under the International Monetary Fund (IMF) Extended Fund Facility. Although the higher policy rate contributed to reducing inflation over time, it simultaneously increased borrowing costs for households and businesses, reduced private investment, slowed industrial production, and constrained employment generation. These developments demonstrate the complex trade-off between inflation control and economic growth in developing economies such as Pakistan.

Given these macroeconomic developments, Pakistan provides an important case for examining the effectiveness of interest rate policy in addressing inflation while balancing broader economic objectives. The country's recent experience offers valuable insights into the transmission of monetary policy under conditions characterized by structural weaknesses, external economic shocks, and financial constraints.

Although extensive theoretical and empirical literature examines the relationship between interest rates and macroeconomic performance, several important gaps remain, particularly in the context of developing economies. Most previous studies primarily investigate the relationship between interest rates and inflation or economic growth in isolation, while comparatively fewer studies examine the simultaneous effects of monetary policy on multiple macroeconomic variables, including investment, consumption, savings, employment, and exchange rates. Furthermore, existing studies on Pakistan largely rely on historical datasets and therefore do not capture the unprecedented monetary tightening implemented by the State Bank of Pakistan during 2022–2025.

The recent economic crisis in Pakistan provides a unique opportunity to evaluate how exceptionally high policy interest rates influence different sectors of the economy under conditions of elevated inflation, exchange rate volatility, and external financial constraints. Consequently, there remains a need for an updated and comprehensive assessment that integrates theoretical perspectives with recent empirical evidence to better understand the broader economic implications of interest rate adjustments in Pakistan.

This study contributes to the existing literature in several important ways. First, it provides a comprehensive assessment of the effects of interest rate policy by simultaneously examining its impact on inflation, investment, consumption, savings, employment, and exchange rates rather than focusing on a single macroeconomic indicator. Second, unlike many previous studies, this research incorporates Pakistan's recent monetary policy experience during the 2022–2025 period, characterized by historically high policy interest rates and significant macroeconomic instability. Third, the study combines established economic theories with current empirical evidence to provide a more holistic understanding of monetary policy transmission in a developing economy. Finally, the study offers policy recommendations that are specifically tailored to Pakistan's institutional and structural conditions, thereby providing practical guidance for policymakers seeking to balance inflation control with sustainable economic growth.

LITERATURE REVIEW

The relationship between interest rates and economic performance has been well studied in the literature both theoretically and empirically. According to Keynesian theory, interest rates influence aggregate demand through two channels: investment and consumption. The lowering of interest rates encourages borrowing, leading to an increase in demand, production, and employment (Dutt, 2010). According to (2021), interest rates affect households' decisions concerning their consumption and savings at different points in time. This aspect of behavior is particularly relevant in developing countries where there is a relatively lower level of income and higher consumption requirements. According to Blanchard & Sheen (2013), investment is highly sensitive to interest rate changes as businesses assess the return on investments against borrowing rates. Under uncertain economic conditions, even small interest rate increases can significantly reduce investment.

In the discussion provided by Brancaccio & Saraceno (2017), central banks play a significant part in maintaining price stability through changes in interest rates. Credibility plays a vital part when considering the effectiveness of monetary policies since expectations concerning future inflation determine today's actions (Krugman & Obstfeld, 2005). Take a global approach in their explanation, elaborating on how interest rates impact exchange rates and capital flows. In the case of open economies, higher interest rates attract foreign investments, causing currency appreciation.

According to empirical studies carried out in developing countries, the efficacy of monetary policy measures such as interest rates is often hampered by structural issues. This can be exemplified using Pakistan, where studies reveal that although higher interest rates help manage inflation, they lower industrial production and increase unemployment levels at the same time (Zahid, 2018).

Recent Empirical Evidence on Interest Rates and Economic Performance

Recent empirical literature provides growing evidence that interest rate policy continues to play a central role in influencing macroeconomic stability, although its effectiveness varies across developed and developing economies. Following the global inflation surge after the COVID-19 pandemic, central banks around the world adopted contractionary monetary policies by increasing policy interest rates to control inflationary pressures. While these measures successfully reduced inflation in many countries, they also resulted in slower economic growth, declining investment, and tighter financial conditions (van der Eng, 2024).

In the context of developing economies, Khan et al. (2023) found that the effectiveness of monetary policy largely depends on the level of financial sector development. Countries with well-developed banking systems experience a stronger transmission of policy rate changes, whereas economies with weak financial markets often observe delayed and less predictable outcomes. Their findings suggest that institutional quality significantly influences the relationship between interest rates and macroeconomic performance (Ali et al., 2025).

Similarly, Khan et al. (2024) examined Pakistan's macroeconomic performance under IMF-supported stabilization programmes and concluded that monetary tightening contributed to lowering inflation but simultaneously constrained private investment, industrial production, and employment generation. The study argues that interest rate policy alone cannot achieve sustainable macroeconomic stability without complementary fiscal discipline and structural reforms.

Using recent evidence from Pakistan, Kumar et al. (2025) demonstrated that inflation during the 2022–2025 period was influenced by both demand-side and supply-side factors. Although higher policy interest rates reduced aggregate demand and gradually moderated inflation, structural issues such as exchange rate depreciation, imported inflation, and rising energy prices continued to exert upward pressure on domestic prices. The authors therefore recommend a coordinated policy framework that integrates monetary, fiscal, and structural reforms.

From an international perspective, the International Monetary Fund (2024) emphasizes that monetary policy remains the primary instrument for maintaining price stability; however, aggressive interest rate adjustments should be implemented cautiously because excessive tightening may reduce investment, weaken labour markets, and slow economic recovery. Likewise, recent World Bank assessments highlight that developing economies face additional structural constraints that limit the effectiveness of conventional monetary policy, particularly where financial inclusion remains low and informal economic activity is widespread.

Recent empirical studies also highlight the distributional consequences of interest rate changes. O'Donoghue et al. (2024) argue that monetary tightening disproportionately affects lower- and middle-income households by increasing borrowing costs, reducing access to credit, and slowing employment growth. Their findings suggest that policymakers should evaluate interest rate decisions not only from the perspective of inflation control but also in terms of their broader social and distributional implications.

Summary of Literature and Research Gap

The reviewed literature demonstrates a broad consensus that interest rates are among the most influential instruments of monetary policy, affecting inflation, investment, consumption, savings, employment, and exchange rate movements. Nevertheless, previous studies primarily examine these variables independently or focus on developed economies where monetary policy transmission mechanisms are relatively stronger. Empirical evidence concerning developing economies, particularly Pakistan, remains comparatively limited and often relies on data collected before the recent period of exceptionally high inflation and monetary tightening.

Furthermore, limited research has comprehensively evaluated Pakistan's monetary policy experience during 2022–2025, when policy interest rates reached historically high levels. This study seeks to address this gap by integrating recent macroeconomic developments with established economic theories to provide a comprehensive assessment of how interest rate adjustments influence multiple sectors of Pakistan's economy. In doing so, the study contributes updated empirical evidence and policy insights that are relevant for researchers, policymakers, and financial institutions.

THEORETICAL FRAMEWORK

Classical Theory of Interest

According to the classical approach, interest rates are the price mechanism for balancing savings and investment. Higher interest rates lead to increased savings while reducing investments, keeping the loanable funds market in balance (Lawlor, 1997).

Keynesian Theory of Interest

The Keynesian approach focuses on the influence of interest rates on aggregate demand. Low interest rates encourage economic growth, while high interest rates discourage expenditures and investment (Dutt, 2010).

Monetary Policy Transmission Mechanism

The transmission mechanism explains how policy changes in rates affect the whole economy;

Interest Rate Transmission Mechanism: Policy rates influence interest rates directly.
Credit Transmission Mechanism: Interest rates influence the supply of credit, which in turn affects consumption and investments.
Exchange Rate Transmission Mechanism: Higher interest rates lead to increased foreign investments and affect exchange rates and balance of trade.
Channel of Exchange Rate: High interest rates will draw foreign investments, which will affect the exchange rate and balance of payments.
Channel of Expectations: Future expectations about economic conditions will influence current economic activity.

Both channels' effectiveness is dependent on the evolution of financial markets and institutional strength.

Inflation Targeting Framework

Inflation targeting has become one of the most widely adopted monetary policy frameworks across both developed and developing economies. Under this approach, central banks publicly announce an inflation target and use policy interest rates as the primary instrument for achieving price stability. The credibility of the central bank plays a crucial role in determining the effectiveness of this framework because inflation expectations influence the behaviour of households, firms, investors, and financial markets.

In Pakistan, the SBP has increasingly emphasized price stability as a primary objective of monetary policy. During periods of elevated inflation, policy interest rates are increased to reduce aggregate demand, moderate inflation expectations, and restore macroeconomic stability. However, the effectiveness of inflation targeting depends on several structural factors, including fiscal discipline, exchange rate stability, financial market development, and public confidence in monetary institutions. Consequently, while interest rate adjustments remain an important policy instrument, they should operate alongside sound fiscal policies and structural reforms to achieve sustainable economic growth and long-term price stability.

Impact of Interest Rates On Economic Variables (In-depth Analysis)

Consumption

The interest rate is very influential in determining consumer spending. In instances where the interest rate is low, the cost of borrowing is lowered, thus promoting consumer spending on mortgages, education, and durable goods. The increase in demand results in economic development; however, consumer spending at high levels can lead to inflation (Drobyshevsky et al., 2017).

In contrast, increased interest rates discourage borrowing and promote savings, resulting in reduced consumer spending. While this situation might be ideal for fostering economic development, it helps keep inflation in check.

Investment

Investments are highly sensitive to interest rates. Low interest rates reduce the cost of funds, encouraging businesses to grow, invest, and employ more people. On the other hand, high interest rates increase the cost of borrowing, reducing investments and hence hindering economic growth (Salahuddin & Islam, 2008). In Pakistan, high interest rates being quite high in the past have negatively impacted industries such as manufacturing and small businesses.

Inflation

Interest rates act as the primary mechanism through which inflation is addressed. As inflation starts increasing, policy interest rates are increased by the central banks to try and curb the demands for goods and services in the economy. An increase in interest rates increases costs of borrowing and ultimately spending. However, in most developing countries, inflation is caused not by demand side factors but by supply side factors such as volatile oil prices and continuous decline in currency value. Therefore, in such conditions, only interest rates may not play a significant role in curbing the rate of inflation since they do not address the cause of the problem (Drobyshevsky et al., 2017).

Saving

The higher the rate of interest, the better off people will be saving money along the savings schedule; thus, they will want to save a much larger percentage of their income or profits. The savings become more favorable when compared to spending. Therefore, savings can easily flow back to investments in order to finance business activities. On the other hand, when interest rates are relatively lower, there is low motivation towards saving and high motivation towards spending (El-Seoud, 2014).

Exchange Rate

Interest rates form an important factor influencing foreign investment decisions. An increase in the level of interest rates will make the nation more attractive to foreign investors who can earn higher profits from investing in their businesses, thus stimulating the demand for the national currency. High demand causes the national currency to appreciate. However, a fall in interest rates will cause capital outflows.

Employment

The effect of interest rates is indirect and affects the level of employment through the consequences that it brings about on investments and production. In the case of reduced interest rates, firms would be induced to take up investment programs, increase their production capacity, and thus employ more people, leading to employment creation. However, with high interest rates, borrowing costs rise, reducing production levels (di Giovanni & Shambaugh, 2008).

RESEARCH METHODOLOGY

This research is qualitative in nature. Secondary sources of data have been employed to extract and gather the data. Sources of data encompass books, research articles, news articles, and authentic web pages. Economic data has been extracted from the official websites of the IMF and the Government of Pakistan. Data analysis has been carried out through the document analysis technique. This study also highlighted the institutionalized and socioeconomic perspectives in which these policies were formulated and implemented, resulting in varying outcomes in both these states. Likewise, Literature on the subject was extensively reviewed to highlight recurrent policy trends, thematic patterns, and conceptual ideas related to this subject. Moreover, the data extracted from different websites was verified through other sources, with the objective of retaining the reliability and credibility of this research study.

A CASE STUDY OF PAKISTAN (2022 -2026)

Economic Background

During this time, Pakistan had to deal with numerous economic problems such as rising inflation beyond 35%, depreciating currency, and rising external debt. The above problems were compounded by economic disturbances globally and Pakistan's own structural problems (van der Eng, 2024).

Monetary Policy Response

In an effort to address all these challenges, the government adopted a monetary policy that is contractionary in nature. One of the actions taken under this policy was to increase the interest rate to around 22%. The main objective behind this was to stabilize the economy.

Influence of the IMF on Monetary Policy Formulation

The formulation of monetary policy in Pakistan was guided by the requirements set forth by the IMF, which entailed stringent financial discipline and inflation control policies (Khan et al., 2024).

DATA ANALYSIS

Year	Interest Rate (%)	Inflation (%)	Economic Condition (%)
2023	22%	35–38%	Crisis
2024	22% → 7%	23% → 7%	Stabilization
2025	~11%	6–8%	Recovery
2026	10.5%	6–7%	Stable Growth

(Ahmed et al., n.d.; "Impacts of the International Monetary Fund on the Economy of Pakistan," 2023)

The data shows a clear inverse relationship between interest rates and inflation, although the effect does not happen immediately. When interest rates were increased in 2023, inflation started to decline gradually over time rather than dropping right away. This happens because monetary policy takes time to affect the economy. Higher interest rates make borrowing more expensive, which reduces spending by both consumers and businesses. As a result, overall demand in the economy slows down, helping to bring inflation under control. However, this process is not instant, as people and businesses take time to adjust their financial decisions. These findings support economic theory, which suggests that interest rates are an effective tool for controlling inflation, but their impact is usually delayed. Therefore, policymakers need to act in advance and consider these time lags when making decisions.

Trend Analysis of Interest Rates and Inflation

The period from 2023 to 2026 reflects a significant shift in Pakistan's monetary policy stance. In response to rapidly rising inflation, the SBP adopted a contractionary monetary policy by increasing the policy interest rate to approximately 22 percent during 2023. This represented the highest policy rate in Pakistan's recent economic history and was intended to reduce aggregate demand, stabilize inflation expectations, and restore macroeconomic stability.

Although inflation remained elevated immediately after the policy tightening, a gradual decline became evident during 2024 and continued through 2025 and early 2026. This pattern demonstrates the existence of a policy transmission lag, whereby changes in policy interest rates require time to influence borrowing behaviour, consumption, investment decisions, and overall price levels. The observed trend therefore supports conventional monetary theory, which argues that the effects of monetary policy emerge gradually rather than instantaneously.

The gradual reduction in inflation also coincided with improved exchange rate stability, strengthened foreign exchange reserves, and greater confidence among domestic and international investors. Nevertheless, these improvements occurred alongside slower economic growth, highlighting the trade-off between inflation control and economic expansion.

Variable-Wise Analysis

Interest Rate

The policy interest rate served as the principal monetary policy instrument throughout the study period. The substantial increase in policy rates raised commercial lending rates, making borrowing more expensive for households and businesses. Consequently, private sector credit demand declined, reducing aggregate demand within the economy.

Inflation Rate

Inflation exhibited a gradual downward trend following monetary tightening. Although inflation remained persistently high during the initial months after policy rate increases, subsequent declines suggest that higher interest rates contributed to moderating inflationary pressures. However, the persistence of supply-side shocks—including rising energy prices, exchange rate depreciation, and imported inflation—limited the speed of disinflation.

Investment

Higher financing costs discouraged both domestic and private investment. Businesses postponed expansion projects, reduced capital expenditures, and adopted more conservative financial strategies due to increased borrowing costs and heightened economic uncertainty. Investment-intensive sectors such as manufacturing, construction, and real estate were particularly affected.

Consumption

Household consumption weakened considerably as higher borrowing costs reduced consumer credit availability while persistent inflation eroded real purchasing power. Consequently, households shifted expenditure toward essential goods and services while reducing discretionary consumption, contributing to slower aggregate demand growth.

Employment

Employment conditions deteriorated indirectly as declining investment and slower production reduced labour demand. Several firms delayed recruitment, postponed expansion plans, or implemented cost-reduction measures, leading to weaker employment generation, particularly within manufacturing and small business sectors.

Exchange Rate

Higher domestic interest rates improved the attractiveness of Pakistani financial assets, encouraging capital inflows and supporting exchange rate stability. Nevertheless, exchange rate movements continued to depend heavily on external factors, including foreign exchange reserves, IMF programme implementation, global financial conditions, and international commodity prices.

Economic Impact in Pakistan (Expanded Analysis with Real Data)

The increase in interest rates in Pakistan had several noticeable effects on the economy, especially during the period of high inflation in 2022–2023. At that time, inflation reached extremely high levels, peaking at around 37–38% in May 2023, which was one of the highest in the country's history. To control this, the State Bank of Pakistan (SBP) significantly increased the policy rate, which went up to around 22% in 2023 (Khan et al., 2023). One of the most important outcomes of this policy was inflation reduction. After the sharp increase in interest rates, inflation began to decline over time. For example, inflation dropped from over 30% in 2023 to around 12–13% in 2024 (Kumar et al., 2025) and further eased to around 7% by early 2026. This clearly shows that tighter monetary policy helped bring inflation under control, although the effect was gradual rather than immediate (Khan et al., 2023).

However, this improvement came with some trade-offs. There was a clear decline in investment across the country. With interest rates above 20%, borrowing became very expensive for businesses. Many firms reduced or delayed expansion plans, especially in sectors like construction, real estate, and manufacturing, which rely heavily on financing. As a result, overall economic growth slowed during this period. At the same time, household consumption also decreased. Due to high inflation and expensive credit, people had less purchasing power and became more cautious in their spending. Many households focused only on basic needs such as food and utilities, while cutting down on non-essential expenses. This demand reduction further contributed to the slowdown in economic activity (Khan et al., 2024).

Another important impact was on the exchange rate and external sector. Higher interest rates helped attract foreign investment in government securities, as investors were able to earn higher returns. This supported the Pakistani rupee to some extent and helped improve external balances. For example, Pakistan even recorded a current account surplus in early 2026, indicating some stabilization in the external sector. However, this stability was also influenced by other factors such as IMF support and import restrictions.

Therefore, there was pressure on employment and economic activity. As businesses faced higher costs and reduced demand, job creation slowed down. Some industries reduced hiring, while others cut costs to survive. This created challenges in the labor market, especially for low-income workers and fresh graduates.

Distributional Impact of Interest Rates in Pakistan

An important but often underemphasized dimension of interest rate policy is its distributional impact across socio-economic groups. In developing economies such as Pakistan, where financial inclusion remains limited and income inequality is relatively high, the effects of monetary tightening or easing are not evenly distributed. Pakistan’s monetary policy operates through multiple transmission channels, particularly the interest rate and credit channels, which influence lending rates, investment decisions, and overall economic activity. However, the effects of these policy changes are not uniform across the population (Kumar et al., 2025).

A relatively small segment of high-income households and large businesses has better access to formal financial services and investment opportunities, while the majority of the population remains either outside the formal financial system or only partially integrated into it. In contrast, middle- and lower-income households are more sensitive to changes in borrowing conditions, as they rely more heavily on credit for consumption, housing, education, and small business activities (ODonoghue et al., 2024). For these groups, an increase in interest rates directly leads to higher debt servicing costs and reduced affordability of credit. This can constrain household consumption and limit small business expansion (Agha et al., 2005). At the same time, even households that are not directly borrowing are affected indirectly through broader economic channels, including reduced business investment, slower job creation, and weaker income growth.

Therefore, interest rate changes influence the economy not only through financial markets but also through real economic activity. As a result, a large share of the population is affected either directly or indirectly, particularly through inflation, employment conditions, and changes in economic growth. This creates an important policy trade-off. While interest rate adjustments are essential for maintaining macroeconomic stability and controlling inflation, their burden is often disproportionately felt by lower- and middle-income groups. Therefore, monetary policy in Pakistan should be assessed not only in terms of inflation control and financial stability, but also from a distributional equity perspective, ensuring that stabilization measures do not unintentionally widen socio-economic inequality (Brandao-Marques et al., 2020).

Sector-Wise Economic Impact

The effects of higher interest rates varied considerably across economic sectors. The manufacturing sector experienced declining production as rising borrowing costs increased operating expenses and discouraged investment in new machinery and industrial expansion. Small and medium-sized enterprises (SMEs), which rely heavily on bank financing, faced greater financial constraints and reduced access to affordable credit, limiting business growth and employment creation.

The construction and real estate sectors were particularly sensitive to higher financing costs, resulting in slower housing demand and postponed infrastructure investments. In contrast, the banking sector experienced mixed outcomes. While commercial banks benefited from higher interest margins, increased borrowing costs reduced private sector lending and credit demand. The agricultural sector was also affected as higher financing costs increased production expenses for farmers and limited investment in agricultural inputs and technology.

These sectoral differences demonstrate that monetary policy does not affect all industries uniformly. Policymakers should therefore consider sector-specific support measures when implementing contractionary monetary policies to minimize adverse effects on productive economic activities while maintaining overall macroeconomic stability.

Comparative Analysis (Pakistan Vs. United States Inflation Experience)

When comparing the effectiveness of monetary policy across countries, there is a clear difference between developed and developing economies, especially when looking at inflation trends in Pakistan and the United States. In Pakistan, inflation reached extremely high levels in recent years, driven by a mix of demand pressures, currency depreciation, and supply-side constraints. For example, inflation surged to around 30.8% in 2023, one of the highest levels in decades, before declining to approximately 12.6% in 2024 after aggressive monetary tightening by the State Bank of Pakistan. This sharp fluctuation reflects both the severity of macroeconomic instability and the delayed impact of interest rate increases (Khoso, n.d.).

In contrast, the United States experienced a much more moderate inflation cycle. Inflation peaked at around 8% in 2022 and then declined to about 3–4% in 2023, following interest rate hikes by the Federal Reserve (Khoso, n.d.) The decline in inflation in the US was relatively smoother and more predictable compared to Pakistan, reflecting stronger institutional capacity and more stable financial markets. One key reason for this difference is the structure of the financial system. In the US, monetary policy decisions made by the Federal Reserve transmit quickly through banks, credit markets, and consumer lending channels. As a result, changes in interest rates rapidly influence borrowing costs, spending behavior, and inflation expectations. This allows inflation to be controlled more efficiently and with fewer extreme fluctuations. On the other hand, Pakistan faces structural challenges that weaken the transmission of monetary policy. A large informal economy, weaker financial inclusion, and reliance on supply-side imports mean that changes in interest rates do not affect all sectors equally. Even when the State Bank of Pakistan raised rates to around 22% in 2023, inflation remained high for some time before gradually easing, showing the delayed and uneven response of the economy. Another important difference lies in inflation expectations and policy credibility. In developed economies like the US, inflation expectations are more stable because central banks have strong credibility. In Pakistan, however, inflation is influenced by frequent external shocks such as currency depreciation, energy price changes, and fiscal pressures, making it harder for monetary policy alone to stabilize prices (Rehman, 2021).

DISCUSSION

The case of Pakistan clearly highlights the trade-off between controlling inflation and maintaining economic growth. On one hand, higher interest rates have been effective in reducing inflation by lowering demand in the economy. However, this comes at a cost, as it also slows down economic activity and can lead to rising unemployment. When borrowing becomes expensive, businesses tend to cut back on investment and expansion, which ultimately reduces job opportunities. In addition to this, Pakistan faces several structural challenges that further weaken the impact of monetary policy. Issues such as energy shortages, supply chain disruptions, and heavy dependence on imports continue to put pressure on prices. These factors mean that inflation is not driven only by demand, but also by supply-side constraints that interest rate changes cannot directly fix.

Policy Implications

The findings of this study demonstrate that interest rate policy should not be viewed as a standalone solution for macroeconomic stabilization. Although higher interest rates contribute significantly to controlling inflation, their effectiveness depends on supportive fiscal policies, institutional quality, and structural reforms. In economies characterized by supply-side constraints and external vulnerabilities, excessive reliance on monetary tightening may produce substantial economic costs without fully addressing the underlying causes of inflation.

For Pakistan, the evidence suggests that sustainable economic stability requires a coordinated policy framework in which monetary policy operates alongside fiscal responsibility, exchange rate management, energy sector reforms, and measures to improve productivity. Such coordination would strengthen policy transmission while minimizing adverse impacts on investment, employment, and long-term economic growth.

Policy Recommendations

The findings of this study suggest that monetary policy should adopt a balanced and forward-looking approach that simultaneously promotes price stability and sustainable economic growth. While higher interest rates are an effective instrument for controlling inflation, excessively restrictive monetary policy can discourage private investment, reduce household consumption, and weaken employment generation. Therefore, the State Bank of Pakistan should implement gradual and data-driven policy adjustments that respond to changing macroeconomic conditions rather than relying on prolonged periods of exceptionally high interest rates.

Monetary policy should also be supported by sound fiscal management and comprehensive structural reforms. Inflation in Pakistan is influenced not only by aggregate demand but also by supply-side factors, including energy shortages, exchange rate depreciation, imported inflation, and production inefficiencies. Consequently, fiscal discipline, improvements in tax administration, investments in energy infrastructure, and measures to enhance industrial productivity should complement monetary policy in achieving long-term macroeconomic stability.

Strengthening the financial sector remains equally important. Expanding financial inclusion, improving access to affordable credit for small and medium-sized enterprises (SMEs), and enhancing the efficiency of financial institutions would improve the transmission of monetary policy throughout the economy. Greater transparency and consistent communication by the State Bank of Pakistan would also strengthen policy credibility and help anchor inflation expectations among businesses and households.

Therefore, policymakers should consider the social and distributional consequences of monetary tightening. Higher interest rates disproportionately affect low- and middle-income households through reduced employment opportunities, declining purchasing power, and higher borrowing costs. Appropriate social protection measures, targeted business support programmes, and employment-generating initiatives should therefore accompany stabilization policies to reduce the adverse effects of contractionary monetary policy while maintaining macroeconomic stability.

Maintain Balanced Interest Rate Policies

First, it is important to maintain balanced interest rate policies. While increasing interest rates can help control inflation, excessively high rates can slow down economic growth and discourage investment. Policymakers should aim for a balanced approach where inflation is controlled without putting too much pressure on businesses and households. This requires careful timing and gradual adjustments rather than sudden or extreme changes in policy rates.

Strengthen Financial Institutions

A more developed and efficient financial system can improve the transmission of monetary policy. In Pakistan, not all individuals and businesses are fully connected to the formal banking sector, which limits the effectiveness of interest rate changes. Expanding financial inclusion, improving banking services, and strengthening regulatory frameworks can help ensure that policy decisions have a wider and more consistent impact across the economy.

Improve Coordination Between Fiscal and Monetary Policy

Another important recommendation is to improve coordination between fiscal and monetary policy. Monetary policy alone cannot manage all economic challenges. For example, if government spending is too high or poorly managed, it can increase inflationary pressures, making it harder for interest rate policies to work effectively. Better coordination between the government and the central bank can lead to more consistent and supportive economic policies.

Implementing Structural Reforms

In addition, Pakistan should focus on implementing structural reforms. Many of the country's economic issues, such as energy shortages, low productivity, and dependence on imports, cannot be solved through interest rate adjustments alone. Reforms in the energy sector, improvements in infrastructure, and support for local industries can reduce production costs and ease supply-side pressures on inflation.

Enhance the Inflation-Targeting Framework

A clear and credible inflation target can help guide expectations of businesses and consumers. When people trust that inflation will be controlled, they are more likely to adjust their behavior accordingly, which makes policy measures more effective. Strengthening communication, transparency, and policy consistency can improve the credibility of the central bank and support better economic outcomes.

Current Developments (2025-2026)

Following a period of aggressive monetary tightening, macroeconomic conditions in Pakistan began to show signs of stabilization during 2025–2026. With inflation easing from its 2023 peak to more moderate levels, the State Bank of Pakistan initiated a gradual monetary easing cycle. This policy shift reflects a recalibration from inflation control toward supporting economic recovery and restoring growth momentum. The reduction in policy rates has started to ease financial conditions across the economy. Lower borrowing costs are expected to support private sector credit uptake, revive investment activity, and improve consumption dynamics. Early indicators suggest a modest recovery in economic activity, although the pace remains uneven across sectors. Despite these improvements, the macroeconomic outlook remains subject to significant external risks. Global uncertainties including volatility in international energy prices, tightening global financial conditions, and ongoing geopolitical tensions continue to pose challenges for price stability and external sector management. Given Pakistan's structural reliance on energy imports, any upward pressure on global commodity prices could quickly transmit into domestic inflation.

Moreover, external financing conditions remain a key constraint. Shifts in global interest rates and investor sentiment may influence capital inflows, exchange rate stability, and overall balance of payments dynamics. In this context, maintaining policy credibility and adequate foreign exchange buffers remains critical.

Limitations and Future Outlook

Interest rate policy alone is insufficient to address Pakistan's deeper structural economic challenges. While monetary tightening can help contain inflation, it does not resolve underlying constraints that limit sustainable growth. Going forward, policy efforts should prioritize improving industrial productivity through technological upgrading and investment incentives, ensuring a more reliable and cost-effective energy supply, and strengthening fiscal management to reduce deficits and enhance resource allocation. A more integrated policy approach combining monetary, fiscal, and structural reforms will be essential for achieving long-term economic stability and resilience.

CONCLUSION

This study contributes to the growing literature on monetary policy by providing an updated assessment of Pakistan's recent experience with aggressive interest rate adjustments during the 2022–2025 period. By integrating theoretical perspectives with recent empirical evidence, the study demonstrates that while interest rate policy remains an effective instrument for controlling inflation, its broader economic consequences require careful policy consideration. The findings highlight the importance of balancing price stability with economic growth, investment promotion, and employment generation. Future research may further strengthen these findings by employing advanced econometric techniques using longer time-series data and examining sector-specific responses to monetary policy in Pakistan.

The analysis of interest rate policy highlights a clear distinction between its effects in developed and developing economies. In both cases, interest rates remain a key monetary policy tool used to manage inflation, influence demand, and stabilize macroeconomic conditions. However, the transmission and overall impact of this policy differ significantly depending on the structural strength of the economy.

In developing economies such as Pakistan, higher interest rates tend to have a stronger contractionary effect on economic activity. While they are effective in reducing inflation, they also significantly increase the cost of borrowing for businesses and households. As a result, private sector investment declines, expansion plans are delayed, and employment growth slows down. For businesses operating in such environments, high interest rates often lead to liquidity constraints, reduced profitability, and greater financial uncertainty. At the same time, although inflation may stabilize, the broader economy experiences slower growth and weaker aggregate demand (Shahbaz et al., 2008).

In contrast, developed economies such as the United States are better able to absorb changes in interest rates due to stronger financial systems, deeper capital markets, and higher levels of financial inclusion. When interest rates rise in these economies, the impact on inflation is generally more predictable and the negative effects on business activity are relatively moderate. Firms often have better access to diversified financing sources, allowing them to adjust more smoothly to tighter monetary conditions. Similarly, consumers and investors respond in a more stable and gradual manner, reducing the risk of sharp economic slowdowns. When interest rates are low, the effects also differ across these two types of economies. In developing countries like Pakistan, lower interest rates can stimulate economic activity by encouraging borrowing, investment, and consumption. However, if structural weaknesses persist such as energy shortages, supply bottlenecks, and fiscal imbalances the benefits may be limited and can potentially lead to inflationary pressures or external sector stress. In developed economies, low interest rates more effectively stimulate investment and consumption while maintaining macroeconomic stability due to stronger institutional frameworks.

Therefore, the comparison shows that interest rate policy has a dual impact: it is effective in controlling inflation but comes with important trade-offs for growth and employment, especially in developing economies. The experience of Pakistan demonstrates that while monetary tightening can stabilize prices, it also constrains business activity and slows economic recovery. Therefore, the effectiveness of interest rate policy depends not only on the direction of change (high or low rates) but also on the structural strength of the economy in which it is applied (Zahid, 2018).

References:

Agha, A. I., Ahmed, N., Mubarik, Y. A., & Shah, H. (2005). *Transmission mechanism of monetary policy in Pakistan*. *SBP Research Bulletin, 1,* 1-23.

Ali, I., Gusev, V., & Khadimullina, L. (2025). Analyzing the role of key macroeconomic indicators relating to Pakistan's GDP growth: A time-series examination. *BRICS Journal of Economics, 6*(1), 5-33.

Belke, A., & Polleit, T. (2009). Interest rate theories. In A. Belke & T. Polleit (Eds.), *Monetary economics in globalised financial markets* (151-93). Springer.

Blanchard, O., & Sheen, J. (2013). *Macroeconomics* (Australasian ed.). Pearson Higher Education.

Brancaccio, E., & Saraceno, F. (2017). Evolutions and contradictions in mainstream macroeconomics: The case of Olivier Blanchard. *Review of Political Economy, 29*(3), 345-59.

Brandao-Marques, L., Gelos, R. G., Harjes, T., Sahay, R., & Xue, Y. (2020). *Monetary policy transmission in emerging markets and developing economies*. International Monetary Fund.

di Giovanni, J., & Shambaugh, J. C. (2008). The impact of foreign interest rates on the economy: The role of the exchange rate regime. *Journal of International Economics, 74*(2), 341-61.

Drobyshevsky, S., Trunin, P., Bogachkova, A. V., & Sinelnikova-Muryleva, E. V. (2017). *The effect of interest rates on economic growth* (Working Paper No. 303). Gaidar Institute for Economic Policy. https://www.iep.ru/files/RePEc/gai/ppaper/ppaper-2017-303.pdf

Dutt, A. K. (2010). Keynesian growth theory in the 21st century. In P. Arestis & M. Sawyer (Eds.), *21st century Keynesian economics* (39-80). Palgrave Macmillan.

El-Seoud, M. S. A. (2014). The effect of interest rate, inflation rate and GDP on national savings rate. *Global Journal of Commerce and Management Perspective, 3*(3), 1-7.

Khan, M. A., Khan, Z., & Saleem, S. F. (2023). Monetary policy effectiveness in Asian developing economies: The moderating role of financial sector development. *Journal of Financial Economic Policy, 15*(3), 226-47.

Khan, N. F., Zahra, A., & Khan, J. (2024). The stability of Pakistan economy and IMF deals: An analysis. *Pakistan Social Sciences Review, 8*(1), 319-32. https://doi.org/10.35484/pssr.2024(8-I)29

Khoso, F. H. (n.d.). *Economic survey of Pakistan 2024–2025 (summarized)*.

Krugman, P. R., & Obstfeld, M. (2005). *International economics: Theory and policy* (7th ed.). Addison-Wesley.

Kumar, S., Ali, A., & Alam, M. (2025). Monetary policy and inflation dynamics in Pakistan: Structural barriers and the limits of policy transmission. *Pakistan Journal of Social Science Review, 4*(4), 270-92.

Lawlor, M. S. (1997). The classical theory of the rate of interest. In G. C. Harcourt, and P. A. Riach (Eds.), *A "second edition" of the general theory*. (343-70). Routledge.

Naeem, M., Rehman., Z. U., & Naveed, M. (2023). Impacts of the International Monetary Fund on the economy of Pakistan. *FWU Journal of Social Sciences*, *17*(4), 48-64.

O'Donoghue, C., Amjad, B., Linden, J., Lustig, N., Sologon, D., & Wang, Y. (2024). *The distributional impact of inflation in Pakistan: A case study of a new price focused microsimulation framework, PRICES* (arXiv:2310.00231). arXiv. https://doi.org/10.48550/arXiv.2310.00231

Rehman, A. U. (2021). Role of the State Bank's policy rate in Pakistan's economy. In H. M. Qadri, & I. Bhatti (Eds.), *Contemporary issues in Islamic social finance*. Routledge.

Salahuddin, M., & Islam, M. R. (2008). Factors affecting investment in developing countries: A panel data study. *The Journal of Developing Areas, 42*(1), 21-37.

Shahbaz, M., Ahmad, K., & Chaudhary, A. R. (2008). Economic growth and its determinants in Pakistan. *The Pakistan Development Review, 47*(4), 471-86.

Van der Eng, P. (2024). Pakistan's economy: Fallout of 2022 economic distress magnified the need for structural reforms. *Asian Economic Policy Review, 20*(1), 128-46.

Wray, L. R. (2015). Banking, finance and money: A social economics approach. In *Handbook of social economics*. Edward Elgar Publishing.

Zahid, M. (2018). Economic misery, exchange rate, interest rate, and foreign direct investment: Empirical evidence from Pakistan. *Journal of Policy Options, 1*(2), 81-95.

Zaman, A., Gull, A. A., Nasir, R., Bilal, M., Pervaiz, Y., Riaz, M. A., & Ashraf, M. (2013). Interest rate fluctuations and financial outcomes of banking sector: A case study of Pakistan. *CLEAR International Journal of Research in Commerce & Management, 4*(7), 125.

Ahmed, W., Rehman, M., & Sheraz, S. (2026, Jan.). *Macroeconomic responses to productivity and global demand shocks: A comparative analysis of developing and developed economies* (SBP Working Paper Series No. 120). State Bank of Pakistan.

Date of Publication	May 30, 2026