**Perils of direct SBP credit**

BY R I A Z R I A Z U D D I N 2022-02-22

WHY is direct lending by the State Bank of Pakistan to the government mostly harmful? And why is government borrowing from commercial banks less harmful, despite being a bit more expensive? These two questions continue to perplex many experts. As direct credits from the SBP to the government will be illegal following the legislation of recent amendments to the central bank law, answers to these questions are of paramount importance. Ill-informed discussions lead to misleading conclusions. So let us be informed about the related issues of lending and borrowing.

A financial system based on interest always works through the process of `financial intermediation`. The primary step of this process is the mobilisation of savings by raising deposits. The secondary step is the channelling of these savings to investors through lending. Both the primary and secondary steps are essential to this process, notwithstanding their connotations. Lending cannot take place without the mobilisation of deposits, but without lending, deposit mobilisation can still take place. Our banks and non-bank financial institutions work as `financial intermediaries`. They raise deposits cheaply and lend on high rates, meeting their expenses and making a profit through a margin (the difference between lending and deposit rates.) When we make a deposit, we are lending our money to the bank at their deposit rate. In addition to this rate, we are comfortable knowing that our money remains safe with them, and we can take it back anytime. We, therefore, agree to receive a lower return compared to what banks receive in extending loans. Banks must charge a higher rate to cover for the risk of default by borrowers. In this system, people with an account are incentivised to save their surplus funds with the lure of safekeeping, meeting withdrawal needs, making payment to others and getting returns that would not be possible if they kept the cash with themselves.

Whenever lending rates go up, deposit rates also go up, although not necessarily at the same rate. In short, this system promotes savings, while lending funds to investors.Now imagine a big entity (government) starts borrowing from the commercial banks. This raises the demand for credit, without an increase in deposits (savings of the people). Lending rates will then go up and deposit rates will rise thereafter, giving people with cash some additional incentives to increase deposits. This process of financial intermediation has some built-in mechanisms to promote savings, besides mal(ing loans accessible. In popular and even in expert discussion forums on the borrowing or interest rate, the entire debate revolves around the `poor borrowers` and seldom around savers. So do not expect to be enlightened by these discussions. In fact, these discussions always have the ability to mislead anyone.

It should be clear by now that government borrowing from commercial banks should promote savings. Is this also true when the government borrows from the central bank? Of course not. Why? Because it depresses the interest rate that would have resulted otherwise. Therefore, government borrowing from the SBP hinders savings. This leads to lower amounts of loanable funds in our financial system, lowering investments. Our financial system becomes constrained in lending to the private sector. It is not necessarily high lending rates which restrict our investments. It is low savings rates.

While there are many reasons for low savings, one of these is government borrowing from the SBP.

Now imagine a situation when the SBP does not give any direct credit to the government but continues to meet the demand for liquidity by banks through open market operations. Commercial banks, in turn, continue to lend to the government, albeit at slightly higher rates, which filters down partly to depositors keeping them incentivised to save more. The ill-informed discussants will concentrate on the aspect of commercial banks taking undue advantage of the government`s lost power of borrowing directly from the SBP and keep on ranting about unrelated issues about sovereignty, forgetting that no one can take away the power of issuing fiat money from the government.

Direct credit from the SBP to the government impedes savings. This can be aptly called an `effec-tive saving inhibitor`. This is not the only drawback of this lending which comes out of thin air and not from anyone`s money saved earlier. Direct credits lead to the printing of additional currency. Most of us are already familiar with the inflationary impact of government borrowing from the SBP, but its main illness stems from a savings inhibition.

One might object to the reasoning given here and say that indirect credits to banks also lead to money printing. Even if the entire amount of money borrowed by the government from commercial banks is injected by the SBP, it will not impede savings.

Often, the amount injected is less than the borrowed amount. As savings start to build up, this may further go down. The most critical point here is that savings mobilisation should be the prime mover catering to the borrowing needs of economic agents including the government. Direct central bank credits should not be the prime movers, but should always be available to banks through open market operations or other refinancing windows as supplemental mechanisms.

The strong negative association between direct SBP lending to government and national savings would be extremely hard to miss by quantitative researchers of time series data, some of whom fail to find a positive association between this harmful lending and inflation. The prevailing media obfuscation of political, economic and financial issues, under the garb of alleged loss of sovereignty, is nothing but a fear originating from moribund minds. Real sovereignty comes from our own national efforts, our own savings and our own investments as opposed to borrowed efforts, borrowed savings and borrowed investments. National sovereignty should never be confused with the ability to borrow from one`s own central bank, or the fiat of issuing unlimited currency. I am glad to observe that many young researchers, economists and analysts, and a few older ones, are free from this confusion, which bodes well for our future.  The writer is a former deputy govemor of the State Bank of Pakistan.

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