Menace of inflation is back

Pak. Eco.

By Dr Mohammad Zubair Khan

Daily 21/3/05

AFTER a period of low rate between 2000-01 to 2002-03, inflation started to pick up during the last two years. The upward trend in prices has accelerated during the last six months confirming that the menace of inflation is back. This period also witnessed a surge in world oil and non-oil commodity prices but that cannot explain the acceleration in Pakistan's inflation measured by CPI or in non-oil, non-food core inflation, especially since the government initially did not pass on the burden of higher oil prices to consumers.

The decision was subsequently reversed for budgetary reasons, so the full impact of higher oil prices is now coming through. No matter how one looks at it, inflation is on the increase. The latest data shows a further acceleration in the CPI to 10 per cent in February. What are the causes of the resurgence of inflation and what is the outlook?

A review of monetary and fiscal developments during the last three years shows that the government and the State Bank are directly responsible for the monetary and financial conditions that are feeding inflation now and the full impact of those actions is yet to come through. It all followed the adoption of a managed float exchange rate regime by Pakistan necessitated by years of current account convertibility and a gradual liberalization of the capital.

Previously the SBP followed a pegged exchange rate regime, which had an important advantage for Pakistan in providing a useful and credible nominal anchor for private expectations about the behaviour of the exchange rate and the warranted supporting behaviour of monetary policy to contain inflation.

trol. These were too many objectives for monetary policy alone.

Furthermore, the SBP abandoned the targeting of monetary aggregates (reserve money and net domestic assets of the SBP) and instead relied totally on the use of short-term interest rates to control credit expansion, principally by announcing the cut-off rate in the auction of six-month T-bills, while open market operations were conducted to manage liquidity and stabilize the overnight rate. The discount rate and reserve requirements have not been used for some time now.

The result was that during the last three years we have witnessed an unprecedented growth in both reserve money and broad money. Reserve money grew by 15 per cent in the last two years and is likely to exceed the SBP projections for the current year. Together with a rise in the reserve money multiplier, this has led to growth in M2 which exceeded the growth in nominal GDP by large margins in each of the last three years.

The State Bank must immediately tighten monetary conditions to contain inflation, which could slow down growth slightly for a short period, and be happy to achieve a 'soft landing', otherwise delayed action could warrant a tougher monetary stance leading to a 'harder landing' in terms of growth deceleration. Accordingly, in the short term, the SBP needs to sharply reduce liquidity through open market operations and raise interest rates. It should examine raising reserve requirements of commercial banks.

In contrast, growth in M2 had kept pace with nominal GDP over the previous ten years when inflation was in decline. Conventionally, it is believed that demand for money adjusts to an increase in supply, through changes in factors (like output, prices and interest rates)

sure on the rupee to appreciate also ended. Reserve money was no longer growing as a result of the accumulation of NFA. Yet reserve money continued to expand, this time due to growth in Net Domestic Assets of the SBP. The latter was triggered by government borrowing from the SBP. Although the governments' overall budget deficit continued to decline during FY04, its borrowings from the banking system increased, most of which was from the SBP.

In addition, as part of its debt management operations, when the government wanted to borrow rupee funds to pay off its expensive foreign loans, it borrowed the entire amount from the SBP which directly increased reserve money.

While the government's borrowings could, in practice, have been made from the commercial banks thereby restraining the growth of reserve money, this would also have strengthened prevailing market expectations of a sharp rise in interest rates, and contributed to a higher fiscal burden of interest payments.

Hence, to accommodate the government's debt management needs and protect the budget from higher interest payments, the SBP monetized government borrowing and added to inflationary pressures, contributing further to market expectations of a further rise in interest rates.

This episode seriously casts doubt over the de facto independence of the SBP from fiscal dominance in determining its objectives and conducting its operations notwithstanding the independence accorded under the State Bank Act. And it raises questions about the motive for letting the rupee appreciate earlier, since appreciation helps the government in reducing its debt servicing obligations but hurts the rest of the economy.

What can be done now? The SBP must immediately tighten monetary conditions to contain inflation, which could slow down growth slightly for a short period, and be happy to achieve a 'soft landing', otherwise tion.

Under a loosely managed float as adopted by Pakistan, market forces are allowed substantial latitude to influence the exchange rate. Through official intervention in the foreign exchange market and monetary policy adjustments, the SBP seeks to limit exchange rate fluctuations in the short term, but there is no explicit commitment to keep the exchange rate within some range or crawling brand. The exchange rate is no longer a nominal anchor for monetary policy.

Consequently, under the flexible exchange rate regime, a key issue for the SBP was to establish a credible alternative nominal anchor for the successful adoption of the new regime. Pakistan already fulfilled the first prerequisite, the operational independence of the SBP to help mitigate fears that the lack of an exchange rate anchor could let loose the money printing demon. But the successful adoption of a floating exchange rate arrangement also required the SBP to define the guiding objective for the conduct of monetary policy and accordingly provide the foundation for private sector expectations.

For this purpose, targeting a low level of inflation and consistent monetary aggregates were essential, especially since the relation between monetary growth and inflation is reasonably reliable in Pakistan and the SBP can exercise relatively good control of some monetary aggregates. Money growth targets are also useful since they are an effective means of communicating the intentions of the monetary authorities, as well as compelling authorities to explain deviations from their announced targets as an essential part of their public accountability.

Contrary to conventional wisdom on monetary policy under a flexible exchange rate regime, the SBP did not formally adopt an inflation target (although an inflation rate is given in their projections). This would have required the systematic adjustment of monetary policy instruments to maintain inflation in line with the target, apart from announcing and ensuring that controlling inflation was the overriding objective of monetary policy.

Instead, the SBP announced a wide range of objectives which included a resolve that the current growth and investment momentum in the country is not impaired in any significant manner; support for the government's debt management efforts; maintaining export competitiveness while inflation is kept under con-

factors (like output, prices and interest rates) that influence demand for money.

Consequently, it is natural that following such a rapid growth in money supply, we are observing some stimulation of output, but at the same time, prices are rising and there is pressure for interest rates to rise as well. Because the impact of monetary expansion on prices comes with a lag, inflationary pressures can be expected to continue for some time, also because the continuing rapid pace of expansion in reserve money in 2004-05 will impact M2 in the coming months. This will further impact prices in the future.

What were the acts of omission that led to the expansion of liquidity? The reasons for the growth in reserve money were different before and after mid-fiscal year 2004, and in each case the response of the SBP has been inadequate. During fiscal year 2003 and first half of 2004 when the external accounts were running surpluses, it created strong pressures for the rupee to appreciate. The SBP intervened in the foreign exchange market to moderate the rise of the rupee, and in the process accumulated NFA on its balance sheet contributing to an increase in reserve money.

Despite the SBP interventions, the rupee appreciated from Rs64 to Rs57 against the dollar. The SBP made some attempts to sterilize the accumulation of NFA by reducing NDA on its balance sheet to moderate the increase in reserve money, but the sterilization was not enough, with the result that reserve money grew excessively. What seems to be lost on the SBP is that during this period, since foreign exchange inflows were largely exogenous (private transfers including remittances), the pressure on the rupee to appreciate was symptomatic of a "dutch disease", as a result of which, both exports and domestic import substituting industries were losing competitiveness.

Under these circumstances, the SBP should have intervened in the foreign exchange market more aggressively to halt the appreciation of the rupee, accompanied by a more active sterilization of the additional NFA to constrain the growth of reserve money. Sterilization involves some quasi-fiscal costs, but these costs pale in importance relative to the need to maintain the competitiveness of exports and domestic import substituting sectors while restraining the growth of reserve money to control inflation.

As the surpluses on the external accounts subsided after mid-fiscal year 2004, the pres-

happy to achieve a 'soft landing', otherwise delayed action could warrant a tougher monetary stance leading to a 'harder landing' in terms of growth deceleration. Accordingly, in the short term, the SBP needs to sharply reduce liquidity through open market operations and raise interest rates.

It should examine raising reserve requirements of commercial banks to reduce the reserve money multiplier as well, even if it will reduce somewhat the profits of intermediation, (after all, the banks are making good money and corporate tax rates are coming down).

Over the medium term, the SBP must adopt targeting of reserve money and keep it consistent with an expansion of M2 that equals the growth in nominal GDP. Short-term interest rates alone are ineffective in impacting demand for two reasons in Pakistan.

First, the transmission mechanism for the six-month T-bill rate to impact lending rates is not well established. It was quite recently, in January 2004, that the SBP directed all banks to benchmark their corporate lending to KIBOR for purposes of establishing a uniform benchmark, and the SBP is still in the process of improving the transmission mechanism of T-bill rates to KIBOR through increased open market operations.

And secondly, because of the liberalized capital account, interest rate changes have an immediate impact on foreign exchange flows and the exchange rate.

The exchange rate management by the SBP to maintain export competitiveness also warrants a review. Prior to the commencement of the surge in foreign exchange inflows in Q3 of 2001, the exchange rate of the rupee/$ was Rs. 64.1 in the kerb market, and the nominal and REER index were 88.75 and 90.21 respectively.

During 2002 the rupee appreciated, and both the nominal and real effective exchange rate indices rose from the Q3 2001 levels to 93.48 and 96.73, respectively. Subsequently the two indices declined slowly, indicating a gradual depreciation of the rupee.

But during the next three years, the depreciation was so slow that the REER index in 2004 was at 91.82, or two per cent above the Q3 2001 level. This implies that competitiveness measured by the exchange rate changes and inflation differential was worse in 2004 as compared to the period immediately preceding the onset of the dutch disease.