Complying with the IMF conditionality

By Hassan Tariq Ghani

AS the global economic turmoil takes its toll on a large number of developed as well as emerging markets, most policy makers have resorted to an expansionary or a loose monetary stance to prop up crippling economies. Lower taxes coupled with higher government spending form an integral part of the fiscal stimulus.

The scenario in Pakistan has been somewhat different as the State Bank grapples to curtail the inflationary pressure by maintaining a tight monetary stance. The government expenditure is being reduced, as is evident from a Rs100 billion cut in the PSDP.

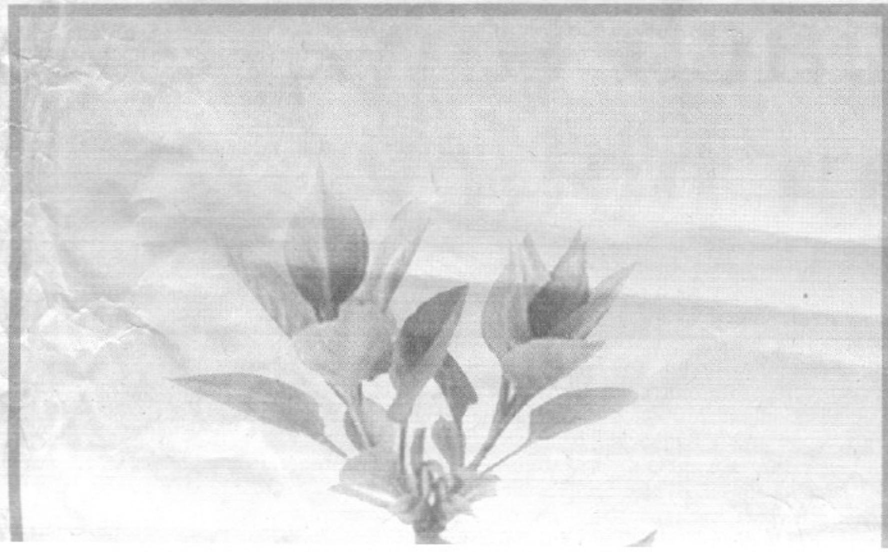
As Islamabad entered into a standby agreement with the IMF back in 2008, the fund proposed a 350 to 400 bps hike in the discount rate, so as to tame inflation, hovering around 25 per cent. After abiding by the IMF conditionality, the headline inflation measured by the CPI is close to 20 per cent and the average annual inflation target for fiscal 2008-2009 has been revised upward to 20 per cent. A general perception is that the double-digit inflation rate can be attributed to the high fuel prices because of withdrawal of subsidies and petroleum development levy.

This can be contradicted by the fact that core inflation (non-food, non-energy) has been stubborn at around 18 per cent over the past few months. In its last monetary policy, the SBP chose to maintain its key policy rate at 15 per cent — a decision that has attracted severe criticism by manufacturers.

Under current circumstances, a discount rate of 15 per cent translates into a real rate of return that lies in the negative zone (-6 per cent). This signifies that any cash deposited at a bank bearing profit or interest lesser than 20 per cent is losing its value in terms of purchasing power. If one takes into account the 20 per cent rate of inflation, only a discount rate at more than 20 per cent would result in a positive real rate of return, maintaining the purchasing power of the money deposited at a bank or a financial institution.

Countries with positive real returns have been more efficient in averting capital flight and attracting foreign investment. The US and most European nations have been experiencing very low inflation rates on account of tumbling consumption, whereas economies such as that of China and Thailand are facing a deflationary pressure. While a low inflation rate depicts a rise in the general price level at a sluggish rate, a deflationary pressure causes a steep decline in the prices of essential commodities.

This factor might help explain why these economies have opted for an expansionary monetary policy by lowering key policy rates to as low as 0.1 per cent. For the sake of simplicity, lets say hypothetically that country X has a negative rate of inflation (falling prices) and a zero per cent interest rate.



Depositors in this particular economy are likely to be better off in contrast to another country Y, where inflation rates exceed the interest rates. Noteworthy is the fact that only those economies that have a "positive real rate of return" have so far been able to lower key policy rates to spur economic growth and stimulate consumption.

The rationale behind the recent decline in KIBOR rates and T-Bill cut off yields deserves due consideration. With the banking sector under severe distress due to the liquidity crunch (as a result of the run on local banks) back in 2008, the SBP injected liquidity into the banking system by slashing the cash reserve requirement (CRR) by 400 bps to five per cent and relaxed the stringent SLR requirements. . The central bank thwarted the liquidity crisis..

The sharp decline in credit off-take coupled with lower CRR rates has enabled banks to maintain liquidity levels far exceeding their requirements. The excess liquidity lying within the system might be accountable for the plummeting demand of inter-bank borrowing, which has subsequently led to the steep fall in KIBOR rates by approximately 320 bps.

The overwhelming bids put forward by local banks during open market operations (T-Bill auctions) conducted by the State Bank indicate that a major chunk of liquidity still lies within the banking sector. As a result of lower demand for funds from the banks as well as the corporate and consumer side, banks prefer to invest in risk free government securities to cover their costs.

High incidence of risk aversion among banks and other financial institutions and their reluctance to lend to consumer/corporates sector due to high default rates may explain this bias.

Whereas a positive real rate of return transfers wealth from a borrower to a lender, a negative real return does totally the opposite, i.e. it makes the borrowers even wealthier. In a market where for instance, the annual inflation rate hovers close to 10 per cent and the cost of borrowing comes to around five per cent, a borrower can pocket a risk free gain of five per cent by borrowing $100 for a year, buying a commodity with the borrowed funds, and selling the same commodity a year later when it is priced at $110 while repaying the accrued debt of $105.

As a result, the banks and other lenders

crued debt of $103.

As a result, the banks and other lenders are likely to suffer. Lenders are not fairly compensated for the eroding purchasing power of their money. When simultaneously faced with high default rates, these lending institutions are prone to become more risk averse and prefer to make risk free investments.

The stubbornness of commodity prices in the domestic market can be attributed to the "sticky" nature of prices in an economy as suggested by the proponents of the Keynesian school of thought. Monetary tightening in its initial stages undoubtedly incurs a trade-off by hampering economic growth.

Likewise, high inflation rates in an economy might distort the reality pertaining to the economic growth by presenting a skewed image vis-à-vis what exists in reality. Economic expansion and growth ought to be achieved by higher production volumes while keeping prices constant. In the long run, monetary tightening can confer its benefits upon economies suffering from high prices.

With the cost-push inflation being tackled at the global level by tumbling international commodity prices, the demand-pull inflation needs to be addressed at the domestic level. The domestic economic situation demands strict compliance to the IMF conditionality.