DAWN

21th May, 2019

Monetary policy hike

THE State Bank shrugged off pressure from vested interests on Monday when it decided to raise the discount rate by a massive 1.5pc, sending shock waves through the business community that is already struggling with rising costs from inflation and devaluation, and must now prepare for even higher debt-service costs. The rate hike will also hit government finances for next year as it will raise debt-service expenditure that is already the fastest-growing item in expenditures all through this fiscal year. It is now clear that it will remain the fastest-growing item in government expenditures all through next year as well.

The central bank did the right thing by disregarding the entreaties for restraint in the cycle of monetary tightening that has been under way since January 2018. The stock market brokers have taken the lead in trying to impact the direction of monetary policy at the State Bank, even meeting the new governor on Saturday in an effort to influence him on the interest and exchange rate policy, among other things. But the State Bank has to take a holistic view of the economy, and not one based on the narrow considerations of a section of the business community. On many occasions, it has to take unpopular decisions keeping in mind what is necessary to prevent the growing imbalances and deficits in the economy from getting out of control. Continuously rising inflation combined with runaway fiscal and external-sector deficits can lead the country towards a severe balance-of-payments crisis that would include massive capital flight and a potential run on the banks. The country came perilously close to this situation in 2008, and must never flirt with such outcomes again. The State Bank can prevent a repeat of that episode only if it continues to act independently in such matters and shows its willingness to take the steps that are necessary to avert such crises, no matter how unpopular the measures might be.

In its accompanying statement, the State Bank has painted a bleak picture of what is to come. Inflation has continued to rise despite ferocious monetary tightening all throughout 2018, the statement says, adding that “inflationary pressures are likely to continue for some time”. Next year, inflation is expected to be “considerably higher” due to a forthcoming “rationalisation of taxes” in the budget coming up, expected hikes in power and gas tariffs, and possible increases in international oil prices. The realities the statement describes include stubborn and persistent inflation, a rising fiscal deficit that is being monetised and financed with the printing of money, and an external-sector deficit that is being narrowed mainly through import controls and remittances, whereas exports are stagnant in dollar terms. With such a heavy menu, the market should prepare for further monetary tightening in the months ahead.

Editorial