DAWN

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Rupee, interest rates and the economy

Our current account deficit in July-April was $11.58 billion, down from $15.86bn a year ago. But it is still too large.

Our budget deficit in July-March was Rs1.92 trillion against Rs2.26tr for the entire 2017-18.

So the twin deficits persist. This is why the rupee remains weak and inflation is still high.

In less than 11 months of this fiscal year, the rupee has lost 24.2 per cent value against the dollar in the interbank market. Despite enough monetary tightening, yearly headline inflation stood at 8.8pc in April against just 3.7pc in April last year.

The good news is that the external-sector problems will start easing in July with the activation of a Saudi deferred oil payment facility and the finalisation of the International Monetary Fund (IMF) lending programme.

But whether inflation will also start coming down is not clear. The State Bank of Pakistan (SBP) has warned that average headline inflation for 2018-19 will range between 6.5pc and 7.5pc and that "it is anticipated to be considerably higher in 2019-20". The policy rate is now at an eight-year high of 12.25pc.

A large current account deficit means foreign exchange earnings are far lower than outflows. We need more dollars every month. That is, demand for the dollar keeps growing. So its price is rising and that of the rupee is depreciating. In the absence of desired growth in tax revenues, a huge fiscal deficit necessitates big government borrowing from the banking system. Since the government borrowing from the central bank — i.e. printing of fresh currency notes — remains exceptionally large, the supply of the rupee is growing.

Some analysts assert that ruthless monetary tightening can choke economic growth as high interest rates increase the cost of production

This enhanced supply is making the rupee cheaper. That is, inflation is on the rise. So what can the SBP do under these circumstances?

The SBP can draw on foreign exchange reserves to bridge the gap between dollar inflows and outflows. That can keep the rupee stable for a while. But its reserves at $8.06bn (on May 17) are not enough to cover even two months of imports. So it cannot draw on reserves except for a very brief period.

And what can the SBP do to check inflation? It can force the government to contain its central bank borrowing, which is highly inflationary in nature. Historically, the SBP has not been doing that though.

It cannot do so unless it gains more autonomy.

The SBP can then make government borrowing expensive as that will mean reduced reckless printing of fresh currency notes. That's exactly what the SBP has long been doing. One chief assumption behind the recent 150-basis-point increase in its policy rate is just that. But what about the government's borrowing from commercial banks?

It is not as inflationary as borrowing from the SBP, but it helps the government continue switching between these two sources of deficit financing. A higher SBP policy rate means the government will have to pay a higher return to commercial banks on treasury bills and bonds. So it will be forced to cut its borrowing from that source as well.

Was the 150bps increase in the policy rate necessary to meet this objective and contain inflation? How about a 100bps increase or one even lower than that? That depends on the central bank's view on how the rupee depreciation combined with some other inflationary factors will impact the price line.

Central banks normally offer a full dose of monetary tightening when they believe that smaller doses cannot work well in current or future circumstances characterised by high inflationary pressures. The SBP says its outlook for considerably higher inflation in 2019-20 "is subject to a number of upside risks from an expected rationalisation of taxes in the upcoming budget, potential adjustments in electricity and gas tariffs and volatility in international oil prices".

Besides, a 150pbs rate hike also creates room for the SBP to keep its policy rate stable or go for a mild-to-modest increase when it reviews monetary policy stance again in July.

Wasn't the IMF demanding a big increase in the policy rate and depreciation of the rupee ahead of the formal approval of a $6bn package? Yes, it was.

The Fund gives its projections for exchange and interest rates based on its analysis of the economy. If the authorities of the borrowing country believe the IMF prescription is a bitter pill they will have to swallow anyway, they do just that.

In letting the rupee fall and sending the policy rate to an eight-year high, the SBP is also relying on its own justifications for the twin moves. But it is naïve to think it could have ignored the IMF's demands.

Some analysts and lobbying groups assert that ruthless monetary tightening can choke economic growth by decelerating the private sector's credit growth. They actually have a point that accelerated interest rates will likely add too much to the already high cost of production and slow down economic growth.

They are also not off the mark in their assessment that a tightened monetary policy will increase the cost of domestic debt servicing, forcing the government to squeeze its defence and development spending and hurting the economy. But then, an SBP study shows that inflation beyond 6pc also hurts economic growth in Pakistan any way.

So controlling inflation to avoid its negative impact on economic growth is also necessary. Besides, monetary tightening is called for when the rupee is falling for the obvious reason that the external sector's problems persist — interest-rate tightening helps stabilise the rupee value.

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