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An interview with Governor State Bank of Pakistan

'Our goal is solidifying stability to secure growth,' Dr Reza Baqir

Dr. Reza Baqir was appointed as the Governor SBP on May 04, 2019 for a period of 3 years. He has eighteen years of experience with the IMF and two years with the World Bank. He was the Head of the IMF's Office in Egypt and Senior Resident Representative since August 2017. He has also held positions as IMF Mission Chief for Romania and Bulgaria, Division Chief of the IMF's Debt Policy Division, Head of the IMF delegation to the Paris Club, Deputy Division Chief of the IMF's Emerging Markets Division, IMF Resident Representative to the Philippines, and numerous other positions.

Dr. Baqir's research has been published in top journals of the economics profession, including the Journal of Political Economy and the Quarterly Journal of Economics. He holds a Ph.D. in Economics from the University of California at Berkeley and an A.B. (Magna cum Laude) in Economics from Harvard University.

Following are the edited excerpts of a very detailed conversation BR Research recently had with the Governor State Bank:

BR Research: With your vantage point of having worked with the IMF, how is Pakistan's programme different from that of others?

Reza Baqir: As you mentioned, before taking this job, I was with the IMF where I had the opportunity to work on a number of programmes in different countries. With the benefit of that experience, I can say that we have started this programme with the IMF with momentum on our side, as opposed to against us.

Let me explain this further. There was a lot of news recently about the July and August current account numbers showing a sharp reduction over the corresponding levels last year. At the SBP, we have been analyzing the current account numbers for some time and these last two numbers were a confirmation to us of a declining trend in the current account deficit that started several months ago. The key point is that we have entered the IMF programme when the current account deficit had already begun to contract and momentum was on our side. I have seen many situations when a programme started and the current account deficit was widening and those programmes were always harder because the amount and pace of needed external adjustment were greater.

To go over a bit of history, our current account deficit in FY15 was just 1 percent of GDP and then it began to increase until it reached a historical high of around $2 billion per month in FY18. During that time, the bilateral exchange rate was mostly fixed, but the real effective exchange rate (REER) that takes into account inflation differentials with trading partners was appreciating. As the real exchange rate was appreciating, the current account deficit was increasing. This was not unexpected.

With due credit to my predecessors Pakistan began to address the exchange rate overvaluation since December 2017, as a result of which the REER started to depreciate. The primary question, then, was whether the current account would respond. That response has been visible: the current account deficit has been declining with the depreciation in REER and has halved since its peak. This suggests that the underlying macroeconomic relationships are working.

A potential criticism of the current account improvement is the claim that this improvement has come about by slowing down the economy and is largely driven by import compression without growth in exports. This is not entirely correct. While it is true that import compression has played a part—as generally is the case in countries that undergo external adjustment—it is also the case that export volumes have actually responded well to the exchange rate depreciation and have been growing. The natural question, then, was why the export values were falling. We found out that the unit prices for Pakistan exports had been falling for some time; however, Pakistan was not alone in experiencing this trend. We observed that unit prices of exports have also been falling for our competitor countries as well.

These two observations regarding the trend improvement in the current account and the nature of its improvement are the reasons why we feel that momentum is on our side. Nevertheless, we, as a central bank, remain cautious while optimistic. As it is often said, central banks, by nature, should be conservative and while we take encouragement from these initial positive signs we recognize that there is a lot more work to be done.

There is another important change that I would like to highlight with respect to the exchange rate. We made a qualitative change to the way in which the exchange rate responds to external developments. In the past, the exchange rate used to be devalued and then remain unchanged at the same level. In May 2019, we decided to move to a market based exchange rate system. This was challenging from the perspective of smooth operations of the markets as the players were not used to of it. We had to first educate the market. We had interactions with banks, explaining to them that the SBP is now not going to fix a rate. We also gave them the comfort that a market-based exchange rate does not mean that there is no intervention at all. We told them that the interventions will only be to smoothen out excessive volatility. And even when we do that, we are not going to take all the risk off the table. There is risk-sharing now, which is healthy for market development.

What we want for the market is to plan for outflows and inflows. Previously, the market had become very comfortable with the earlier approach, knowing that the SBP was wedded to a rate. Therefore, we started a dialogue with them to explain the changes and why this was the right change to make. At that time, in the market and in the media, people were talking about very adverse potential scenarios. There were shocking numbers being thrown about, and people had suspicions that a secret rate had been agreed with the IMF; and there were many other such stories. I can comfortably tell you that the market in terms of indicators of liquidity, turnover and sentiments is in a good place now. Today, we do not hear those types of numbers. And the kind of uncertainty that was there a few months ago has receded.

The market is adjusting well to the new flexible exchange rate system and this qualitative change in the market functioning gives us confidence as well. We find it very critical that this system is internalized. They have to get over their fear. A large number of modern emerging economies have a market-based system and are doing very well financially. Our goal is to make the market comfortable with this transition and to make the market participants realize the benefits of such a system. This also helps to avoid the perils of obsession with a particular level of exchange rate. Once these things are internalized, and people realize that the benefits are high and the costs are much lower than they think, there will be a bigger constituency against making any changes to it.

BRR: Let us take it forward from the conversation that you have built. What is the optimal level for the exchange rate if you view it from the REER lens? We keep hearing that it varies from one economy to another. What, in your view, is the optimal REER level?

RB: I am glad you asked this question because there is often misunderstanding about the concept of REER.

REER is an index, and, by definition, the level of the index does not mean much. It is based on a particular year, and the reading of "100" just means it is indexed to the level in that base year. Many people have this misconception that if the level is 100, the currency is in equilibrium. A meaningful interpretation of REER lies in the change in index over a specific period of time with reference to your analysis. So, for instance, if I am interested in knowing that how much competitiveness of exports has eroded over the last six months due to appreciation of REER, I would calculate a change in REER index between the most recent available index and the one six months before.

Let’s now move to your question, as to what is the equilibrium level for REER. There is an economist’s way to answer this question, which is to do the analysis of the current account equilibrium from a medium-term perspective, a long-term analysis of the REER, and an analysis of the external liabilities’ positions. These are at least three different approaches that are used by the IMF in their external balance assessments.

Now, before I get into what the IMF analysis shows, let me just preface by saying that these are all medium to long-term concepts. They are not necessarily good predictors of where the exchange rate will be in the near-term. In the near term, the exchange rate is determined a lot more by sentiments and financial flows.

If you look at the latest analysis done by the IMF, you will see that two of the three models are only based on data up to June 2018. Based on that, they had calculated some extent of overvaluation. Now if you factor in the depreciation since June 2018 you will find that the bulk of the gap that had been identified by the IMF has already been addressed because of the depreciation that has occurred. From our perspective, what is now more important is that the exchange rate is market based and therefore the level of the exchange rate has important information about where the market thinks it should be.

On that note, I would like to draw your attention to another aspect of the exchange rate market. That is the forward market. The latest numbers on our forward book are very encouraging. The forward short position has come down from the peak of $8.0 billion to $7.2 billion. That signals a turnaround in sentiments. The movement in the forward position has to be taken in the context of total foreign exchange reserves on our balance sheet, because these two together give you some sense of the net reserves and exchange rate dynamics.

One of our goals is to build the Net International Reserve (NIR), which are reserves net of short term and other liabilities. In simple words, these are reserves not built with borrowed money. It is encouraging that our NIR has been improving recently.

BRR: With a comfortable forward position and other favourable factors, would you agree that the market may not be expecting excessive volatility in the medium term?

RB: Generally, you would not get a comment from a central bank governor on exchange rate movement, and for good reasons. I can share with you our goals with respect to the exchange market. First, we want to build net international reserves in order to build strong buffers. If we have permanently strong buffers we will not need to repeatedly seek financial assistance from the international community when we have temporary economic and financial shocks. And strong buffers will attract more inflows. Secondly, we aim to build deeper and liquid FX markets, which mean that there is continued two-way trading with reasonable bid/offer spreads. Even in the early stages of adjustment in exchange rate under the new flexible mechanism, the market never stopped trading. Our third goal is to avoid excessive volatility and what is referred to as disorderly market conditions. Such volatility adversely affects market sentiment and undermines investor outlook.

BRR: Are you suggesting that the exchange rate will be kept in a corridor?

RB: There is no corridor. What is important for us is to build our reserves gradually so that we get out of our repeated boom-bust cycles. We want a deep foreign exchange market, which is conducive to a market determined ER regime. And we want to avoid excessive volatility, which creates panic and undermines people’s faith in the market.

BRR: Building reserves appears to be the cornerstone of your strategy, around which we are hearing about the opening up of portfolio debt investment for foreigners. Some observers term this approach as attracting “hot money”. There are impediments on the taxation and the clearing sides. Besides, there are apprehensions over the short-term nature of such inflows. How do you see this whole scenario?

RB: Let me first clarify the preface of your question: we are looking at portfolio debt investment in the context of deepening the capital market, rather than in the context of building foreign exchange reserves.

In our current structure of the capital market for government securities, there is one predominant form of buyer of government debt and that is banks. It is always good to get some competition. Therefore, why not make it simpler for international investors to buy our debt. This would deepen our capital market and reduce the interest cost of debt for the government. Our debt market is huge – only the marketable securities are close to Rs9 trillion. Foreign investors like big deep markets so they can enter and leave without moving the market. Our government debt market has a lot of scattered bond issues along the curve. Liability management operations that create deep pockets along the curve would also help to deepen the markets. By doing so, we can provide a good funding base for provision of long-term finance to the private sector. Right now, long-term finance is not that easy to get. Banks are primarily interested in government bonds.

When you look at the nature of what is being done, it is a simplification of the tax regime, and not necessarily a provision of incentive. Many countries from where such potential investors might come have taxation treaties with Pakistan, which means that the de facto tax rate is already very low. But taxation treaties are cumbersome, and for investors, one thing that always goes the right way in terms of attractiveness of the country is simplicity.

Right now, Capital Gains Tax is 29 percent, while interest is taxed at 10 percent which discourages investment in bonds compared to treasury bills. We want to focus on the longer term bonds for provision of finance, and we also want to reduce the incentive for shorter term debt. Longer term maturity debt is better for debt sustainability, because then the government will not have to roll over frequently. Right now, bulk of the total outstanding marketable debt has a maturity of 90 days. If you remove this disincentive and the volumes shift towards longer term, it is good for debt sustainability.

About the concern regarding ‘hot, money’, which is metaphorically used for portfolio investment, I would like to draw your attention to our equity market in which there has historically been large inflows and outflows of investment over a sustained period of time. These flows never generated any concerns of hot or cold money.

Another important point is that you cannot lose what you do not have. If you look at the experience of other countries, usually only a fraction of money goes out. For example, in Egypt, tens of billions of dollars came in, and when the Fed raised rates, only a fraction went out. And more importantly, in a few months, all of it came back.

BRR: The market fears that since it is carry trade and works on the interest-rate differential, it gives the central bank an incentive to keep the interest rates high. The apprehension is that once the capital flow is here, the SBP may want to keep the rates on the higher side to prevent the money from moving out. What is your take on it?

RB: Such apprehensions are uncalled for since one of the core mandates of the State Bank is to pursue price stability. That is how we present our policy rate decisions in the monetary policy statements. Specifically, we have laid out important considerations that guide these decisions including our projections for inflation and our forward looking estimates for real interest rates. Moreover, we are also transparent in sharing our inflation projections. In the July 2019 monetary policy statement, we gave out our projected inflation at 11-12 percent. The government has announced a medium-term inflation target of 5-7 percent. This target is very important now that we have moved away from an exchange rate that could be kept fixed.

By sharing information pertaining to how the MPC makes interest decisions we are in effect tying our hands down. Once we see that the projected inflation is coming down, that would provide a good basis for the MPC to consider reducing policy rates. The money coming in or going out would not be a primary consideration in deciding policy rates.

It’s also important to note that we like all types of foreign investment, not just portfolio investment. As the outlook for growth for the economy improves we also expect the outlook for growth to improve.

BRR: Your inflation expectations at 11-12 percent appear a tad higher than the market estimate of 10-11 percent. We expect the inflation to tame after September or October this year, as the base effect comes into play.

RB: We are happy to consider arguments for why projected inflation should be lower. More generally, we are always looking for ways to improve our methodology for projecting inflation. In the meantime, we are confident in our inflation projections based on information that was available to the MPC at the time of the last policy rate decision. I would also note that we look at both year-on-year and month-on-month inflation. Year-on-year growth rates can be affected by base effects and month-on-month rates, adjusted for seasonality, give a good sense of underlying momentum in inflation.

BRR: Given that the rebased CPI with altered methodology for computation is now in place, does it not alter your inflation projections?

RB: We want the market to get comfortable with the new base CPI, and for the last meeting we used the old base, as the new base had just been released. We are looking at the rebased CPI and will re-run our models with it. Once we have done the work that we need to do, we will start using the new one. The underlying trends are very similar between the new and old methodologies.

BRR: Speaking of core inflation, why is core inflation not the benchmark CPI for monetary policy purposes?

RB: Before we go into core and headline inflation debate, I want to mention that for analytical purposes when we look at real interest rates, we look at nominal interest rates minus the expected inflation, not historical inflation. A lot of confusion arises when analysts use past inflation numbers to calculate real interest rates.

When we look at central banks around the world, we see that headline inflation is used by 95 percent of the central banks for inflation targeting. So when we are using headline, we are not doing anything unique; we are part of the vast majority of inflation targeting central banks. Core inflation is, undoubtedly, a useful measure, but it has its downsides, as it excludes nearly half of the CPI basket. Focusing on just half of the prices can be subject to different criticism.

Finally, the headline inflation is easier to communicate, especially in an environment like Pakistan where particular stakeholders might be suspicious. You can have five different definitions of core inflation from five different economists, and that becomes subject to different interpretations. Therefore, in the context of Pakistan and also what happens across the world, we use headline inflation for the purpose of inflation expectations. We do look at core inflation from the perspective of underlying inflationary pressures.

BRR: But were we not using core inflation as the benchmark in the previous two programmes?

RB: I do not know off-hand, but I would want to share a very important thing. The Fund programme is, of course, important, but what is more important is how we want to conduct monetary policy. We want to build our institutions. We are trying to answer questions from research using facts and figures. And we want to convince ourselves that this is the better way of doing things. And that is how it will be in the programme, because that is how we think. Usually, country authorities know more about the country than the IMF.

BRR: The inflation-targeting is aimed at compressing demand. But in Pakistan, bulk of the credit goes to the government; only 20 percent goes to the private sector, and around 4 percent to the consumer. Even within the private sector, over 40 percent is for working capital needs. It raises the question: how effective is the monetary policy in such a scenario where demand is based on cash?

RB: Our research shows that there is a response between interest rates and credit growth, as you would expect. There is also a direct response of interest rates to inflation, especially when people are forming inflation expectations. Don't forget that the only tool that a central bank has to bring down inflation is through influencing aggregate demand.

Another important channel in Pakistan is the exchange rate channel. Right now, many people are converting their dollars into rupees, because they are not earning anything on those dollars. We are noticing de-dollarization.

Consumption growth also responds to interest rate increases. There are many ways in which consumers get credit. One is from stores; when you buy on installments it may not necessarily get picked up in the banking channels. Then there is the wealth effect – in case the stock market or the real-estate market does not perform well when interest rates rise, it also impacts the consumption pattern. We are quite comfortable that interest rates do work in bringing inflation down. That is the number one reason why interest rates were increased.

As we were working on securing stability and also trying to send the signals to the market that the measures would be credible, we wanted to take the tough decisions earlier rather than later. It is better to get the things that people are worried about out of the way earlier, so that there are less of lingering concerns for the market participants. That is much better than bringing stability in a gradual manner, where the market thinks there is more bad news to come. You should also keep in mind that both the dollar value and the interest rates were already on their way up, even before the programme. That is where you cannot draw comparisons with Egypt, because in Egypt's case, the exchange rate did not move until the start of the programme. Therefore, whatever we felt was left; we wanted to get that out of the way at the beginning.

BRR: Are you concerned at all about the impact it may have upon businesses, employment and the ability of non-export sector to meet their working capital needs?

RB: We are concerned, but everything that you have said is part of the way monetary policy works. When you raise interest rates, you want to contain demand, and you make credit more expensive. This is a temporary phase to bring inflation down and as soon as the central bank feels comfortable about projected inflation coming down, then it will lay the foundation for lowering rates.

On our part, it is equally important to communicate that inflation is costly as well. If you do not fight inflation and it remains high, it is not good for the business environment. And for the middle class in particular, it is worse.

The other angle is that if you look at the sensitivity of private investment and policy rates, it is actually not that high. This suggests that there are other factors that impact private investment. These factors have to do with the ease of doing business, documentation, and so forth.

BRR: One of the reasons for low private investment is low mobilization of savings in Pakistan. Tell us how the interest rates will help mobilize more savings. And what are medium-term and long-term plans for financial inclusion?

RB: I think that is the most important issue from a medium-term perspective. Stability is just the first part of our plan – it is necessary for growth, but it is not sufficient. Raising interest rates is of course going to help with mobilizing savings. Giving a sense of stability in the country is going to help bring money back into the formal sector.

The documentation drive that is going on will also help. We have a broad agenda on financial inclusion, including digital systems, that we think will promote greater participation of people in the formal economy and spur savings. But it is a very rich agenda that the SBP runs, and it needs an entire session to touch upon. Financial inclusion is going to be a game changer for Pakistan in terms of mobilizing additional savings, and also from the perspective of anti-money laundering.

BRR: As you have repeatedly emphasized on effective communication, would the SBP also be open to sharing ideas with relevant stakeholders?

RB: We, at the SBP, want to encourage a culture of using facts and figures to answer policy questions. We are not saying that the way we think is the only way. Instead, we are saying that we want informed discussions on policy issues. We would like to seek opportunities to partner with other stakeholders who share the same goal. We also want people to gradually begin to think that it is OK to be optimistic. From experiences in the past, people may have reasons to be skeptical. But the only way you change the outlook is through objective discussion.