

The inflation stew

THIS is the first time in more than two decades that inflation has actually risen when the implementation of an IMF programme begins. Consider that interest rates hit their peak of 13.25 per cent in July 2019 and programme implementation began in the same month. All Fund programmes begin with a rise in interest rates, depreciation of the exchange rate and cutting off government borrowing from the State Bank while setting ceilings on the size of the budget deficit. These measures have the effect of administering a jolt to inflation on the one hand (through the exchange rate depreciation), while at the same time cutting away the monetary roots of inflation by sharply curbing the growth of the money supply.

If you look at the history of inflation in Pakistan, you'll notice that it comes down shortly after 2000 as the country successfully implemented a short but very tough IMF programme in that year. It rises briefly after that but again comes down after 2002, when the country went on to another IMF programme that was supposed to last for three years. That programme was terminated by Pakistan in 2004 since the then government of Gen Pervez Musharraf felt it no longer needed the programme since all targets had already been met; inflation once again rose till it hit an all-time high of 25pc in August of 2008 (year on year).

In November 2008, the country once again went onto an IMF programme and inflation declined to 10pc by 2011, falling back into single digits by the end of that year. This was a sharp fall, but it was expected to be sharper still given the scale of the adjustment the country had just undertaken, but "the switch to government borrowing from commercial banks has been supported by large liquidity injections by the [State Bank of Pakistan], a policy that has similar inflationary effects as direct central bank financing," the IMF noted. "To reduce inflation and increase the SBP's policy credibility, such injections should be scaled back and direct government borrowing from the SBP should be avoided."

Having cut off the monetary roots of inflation, why are prices continuing to spiral?

By 2013, when the country again went on to an IMF programme, inflation was already on a sharply declining path. Nevertheless, interest rates were kept elevated at 9pc for a while longer to partially offset anticipated inflationary pressures building up via a hike in the sales tax rate, power tariffs and exchange rate depreciation. By 2015, the fiscal deficit was on its way down, government borrowing from the banking system was also down, and monetary expansion was largely contained. Interest rates fell to 6.5pc in acknowledgement of this.

When this government came into power, monetary expansion was out of control. Government borrowing from the State Bank, a practice akin to printing more money, doubled from Rs3.67 trillion in June 2018 to Rs7.6tr by February 2019 before it was more or less stabilised at that level. This alone was a stupendous rate of money creation, vastly expanding the money supply in a short span of time.

The result was inflation that spiked at 9.4pc in March 2019, catching the government by surprise. The government tried to spin this result, saying the Pakistan Bureau of Statistics had miscalculated the figure. They argued that inflation should be around one percentage point lower than what the PBS was reporting, due to some quibble with how gas prices were being treated.

Then it plateaued out. For the next few months it was stable at the elevated level and closed the fiscal year at a monthly average just above 7pc. That's when the Fund programme implementation began and interest rates peaked at the same time. Since then, monetary expansion has been controlled, with the government even bragging about having run a surplus in the primary balance for one month, built large cash buffers for its own liquidity management, and halted any further borrowing from the State Bank, in fact retiring some of the older overhang. The exchange rate appreciated slightly in the months that followed.

The rise in inflation that we saw in the months that followed July was in part due to the exchange rate depreciation that took place in the last quarter of FY2019, in part to the power and gas tariff hikes that were passed through in the first quarter of FY2020, and in part due to higher taxes on fuels. This was expected and usually happens when an adjustment begins, which is why adjustments of this sort are usually accompanied by interest rate hikes, to offset the rise of inflation.

Having cut off the monetary roots of inflation, why are prices continuing to spiral? To some extent this was anticipated, but we are near the upper reaches of where inflation had been forecast to be at. The government's projections say inflation will rise to somewhere between 11pc and 12pc, where the monthly average is already around 11.6pc, approaching the upper band. If the monetary roots are sorted, what explains this continuing spiral precisely at a time when a vigorous adjustment is being undertaken?

The government argues this is because of administrative reasons or "temporary supply shocks" as the State Bank puts it. The prime minister prefers to blame 'mafias' and 'cartels', implying there is a sinister and deliberate side to it.

The problem then is this: if these are "temporary supply shocks", then why are they persisting for months? The State Bank referred to these in November and again in January. And if these are cartels or mafias, then why is it that they have become operative under this government? Perhaps the prime minister should seek advice from his predecessors on how they kept these mafias and cartels in check.

Inflation comes about either through excessive creation of money or through rising costs of items whose price feeds into the price of other commodities. To have high inflation amid falling oil prices and contracting deficits and ongoing adjustment, points only in one direction: governance failure.

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