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The cost of confused macroeconomic policy

It seems to be a chicken and egg situation: inflation will fall first; only then will State Bank of Pakistan (SBP) lower its policy rate, or the policy rate will drop before inflation rate falls. In other words, it is impossible to decide which of two things caused the other one. Private economic agents – businessmen, investors, and consumers – on one side while the government, SBP, and the IMF on the other seem to be pitted against each other on this dilemma. Is this such a well-rooted Gordian knot that cannot be cut for more than a year now? Let's analyze:

Pakistan is a developing country where consumer-finance mostly, and investor finance to some extent, do not depend on bank financing, and hence have little connection with policy rate of the SBP; it goes up or down, yet not much impact on consumption or investment in relative terms. So the policy to rein-in aggregate demand through adopting a tight monetary policy has little consequence for denting inflation since inflation in developing countries like Pakistan is at least equally a fiscal phenomenon, and requires both fiscal and governance-related policies to deal with artificially-induced inflation on the back of institutionally weak markets, with heavy influence of cartels in manipulating demand and supply signals.

Hence, by trying to control inflation through an over-active monetary policy and little role of fiscal policy envisaged under the neoliberal/Washington Consensus-styled macroeconomic policy thought-process the fiscal and monetary authorities are actually giving a significant boost to inflation through the channel of cost-push inflation. Here, the high cost of working capital for investors/industry on the back of a tight monetary policy increases the cost of production and adds to inflation. At the same time, overall lack of institutional reform has meant that the aggregate supply side remains weak and uncompetitive, which nonetheless has contributed to cost-push inflation, and also led to demand-pull inflation since higher costs and lower productivity result in negative supply shock, which tends to outpace the demand curtailment since a significant section of the economy in the shape of the black/undocumented economy that works on cash remains outside the influence of the instrument of policy rate. In addition to monetary policy, what is needed is an active response in terms of a meaningful documentation drive and negative fiscal incentives in the shape of taxes, along with greater role of governance/administration-related policies.

The other chicken-and-egg situation is characterised by the fact that the government, SBP and the IMF are employing the high policy rate to curtail aggregate demand so that imports could be reduced and current account deficit is reined in – a 'milestone' that they have been able to achieve – and use this narrowed gap in the current account, and portfolio investment or 'hot money' to allow the build-up of foreign exchange reserves mainly as a stopgap arrangement, before exports increase, giving in turn SBP adequate space to lower policy rate. Yet, how will exports increase when high policy rate and heavily market-determined exchange rate have led more to reduced imports of

investment goods, machinery and whatever needed for greater domestic production and exports volume (the component of consumption-related imports is only one part of the narrowed current account deficit) have also reduced competitiveness of exports.

Reduced imports that are required for economic activity, especially in agriculture and manufacturing, the two mainstays of the economic growth and employment generation, have inflicted a deep dent on overall economy. Moreover, the cost of imports has also increased due to the way the two policy tools – policy rate and exchange rate – have been employed. Hence, rather than reducing inflation in a significant way, cost-push inflation has increased. Stagnating tendencies in economic activity have therefore caused a stagflationary consequence.

The question: how will exports increase in a subdued economic activity characterised by lower production in the manufacturing and agricultural sectors and growing uncompetitiveness, when there was a dire need to increase competitiveness of exports in the first place? Moreover, lack of any active focus on reforms on the institutional/supply-side of the economy has added to the costs of production, especially on the back of increasing electricity and gas tariffs since losses due to lack of reforms have meant greater reliance on tariffs. And if exports do not increase then how will the government be able to graduate from reliance on the highly fluid 'hot money' for building foreign exchange reserves that is causing a heavy burden on the government in terms of interest payments, on the back of a higher interest rate at which this portfolio investment is being attracted.

Hence, in both the situations the government, SBP and the IMF will need to dispel this confused macroeconomic policy, and work towards formulating it on the lines that are fully cognizant of ground realities. They need to show greater appreciation of the fact that the current policy is not even making any meaningful inroads into denting inflation (in fact it is only stoking it through the channel of cost-push inflation) to attain the stabilisation goals. Therefore, the macroeconomic policy needs to find a balance between monetary and fiscal/governance-related policies so that there is equal focus on the aggregate demand and supply sides of the economy. This will help reduce the undue sacrifice of growth in domestic production, increase employment levels, and enhance the competitiveness of exports.

Also, instead of looking to attract short-term portfolio investment and that too at a very high interest rate, the government, for instance, should mull over floating Eurobonds, which are more long-term in nature and much cheaper in terms of interest payments. Already, the cost of this confused policy has added to the misery of working and labour classes in particular, pushing many of them below the poverty line. Such economic disempowerment has also adversely affected income inequality and the quality of democracy in the country.

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