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High interest rates: a misguided policy for Pakistan

Pakistan's interest rates have intentionally been maintained at a high level for the past months, in a miscalculated effort to control inflation by means of a contractionary monetary policy. Although policies of this nature have been effective in reducing inflation for certain Highly Developed Economies, there is no evidence to suggest the same rules apply to the case of Pakistan. On the contrary, it is proven that a high interest rate in Pakistan leads to an increase in cost-push inflation.

A contractionary monetary policy operates by decreasing the money supply (M2) in order to increase the cost of borrowing. This measure normally decreases GDP and dampens inflation. The State Bank of Pakistan chose to maintain a high interest rate, decreasing the money supply in attempts to curtail inflation. However, an opposite impact has been observed in Pakistan's case. As depicted in the graph below, there is a directly proportional relationship between inflation and discount rate in Pakistan.

The graph shows that the higher the interest rate, the greater the cost of a basket of goods. This indicates that a high interest rate does not lead to a decrease in inflation.

The State Bank of Pakistan has, on average, printed Rs. 490 billion per annum from 2012-13 to April 2020, adding only 5% inflation to the economy, which is not that high. It is worth noting that this figure was a result of the past regime's policies, during an expansionary phase in the economy and when demand was higher. Pakistan's GDP growth was above 5% on average during the last two years of that regime (2016-2018). For most of this period, the interest rates were around 6%.

For countries such as Pakistan with a high debt-to-GDP ratio and a low tax base, it is essential to monitor the debt level and debt servicing requirements, as these have a great bearing on fiscal flexibility, thus determining the productive capacity of the economy. Unfortunately, flawed fiscal and monetary policies have resulted in a sharp rise in the cost of public debt servicing, which jumped to Rs1.9 trillion in the first nine months of the current fiscal year, according to the latest data from the Ministry of Finance.

The interest rate has been at an unprecedented high of over 13% for much of this period, so it comes as no surprise that the debt repayment also soared. The graph shows Pakistan's debt-to-GDP ratio over the years.

Since March 2020, Pakistan's economy has seen a net outflow of US$ 1.3 billion from treasury bills (dubbed as 'hot money'). This was a key objective of keeping the interest rate high, but now that that has been achieved, a slew of other problems has come to the forefront. It begs the question, was this extreme measure really worth it? Each unitary rise in the interest rate has had an exponential impact on debt servicing, while 79% of net federal receipts are comprised of debt servicing cost as of May 2020.

Although the State Bank of Pakistan decreased the interest rates thrice in the span of one month, it still remains at a high of 8% in May 2020, in an effort to strike a balance between the productivity needs of firms and the battle against high inflation. Rather than striking a balance, this policy is destabilizing the state of affairs on both accounts. The central bank has itself maintained that the current inflation rate is mostly driven by cost-push inflation due to supply side shocks, while demand-pull inflation is much lower. Demand-pull inflation ignores a hike in food or oil prices because it is caused by reasons beyond the control of the central bank, such as a crop failure or a ban on imports. Considering that this figure is still in a single digit in Pakistan, the rate of interest should be in line, and not determined by an anticipated level of cost-push inflation, which is circular in nature.

High interest rates belie the impression of a stable economy in the short run, while long-term economic health continues to be endangered, and this is a particular cause for concern as we stand at the brink of a recession. The World Bank estimated in April that a recession is likely in Pakistan due to the severe impact of the pandemic, with the economy expected to be shrinking up to 2.2%, as well as a painful decline in per capita income. We believe this to be grossly underestimated given that the impact of the nationwide lockdown is likely to be far more severe than previously anticipated.

The cost of doing business increases exponentially with each unitary rise in interest rate. This results in hindrances in access to capital, leaving businesses to fend for themselves through capital injection and struggle to make ends meet with no fallback option. At a time when investments are needed more than ever, investors are reluctant to consider options that come with high interest rates, as these are volatile, high-risk and promote short-term investments rather than sustainable industrial investments.

All these factors result in a spillover effect with massive downsizing, stifled economic activity and stagnation in GDP growth. Meanwhile, organisations across the globe are switching to a digital front due to social distancing measures, and IT is now central to how states function. Investment in technology is a more pressing need than ever before, and is likely to remain unattainable for as long as interest rates remain high. The point to note is that the SME sector that is the driver of IT innovations, and this is the precise sector that is affected most by high interest rates.

The abrupt rise in factory shutdowns and closure of export-oriented businesses is alarming. Exporters have greatly suffered as a result of high interest rate coupled with cancellation of existing orders due to the pandemic. Exports of readymade garments dipped 2.43 percent year-on-year in value and sharply fell in quantity by 34.83 percent during March. Bedwear exports fell 13.58 percent in value and 10.78 percent in quantity. Towel exports fell 5.72 percent in value and 26.23 percent in quantity, whereas those of cotton cloth fell 8.84 percent in value and 41.25 percent in quantity.

The demand for textiles in the EU and the United States is not expected to recover for at least a year, according to research conducted by Harvard Business Review and McKinsey. Unless affirmative action is taken by the government, the fall in demand will lead to a closure of around 30% of firms, and massive job losses. The discrepancy between relief packages provided by other states to protect businesses during the pandemic, and our government's relative inaction is worth noting. The table highlights this stark difference.

Country	COVID19 Relief Package (USD)
United States	Over 2 trillion
United Kingdom	417 billion
India	265 billion
Canada	56.8 billion
Turkey	15.4 billion
Pakistan	5.66 billion

Stimulus plans as a percentage of GDP

Organization or Government	Total amount ($ billion)	Debt to GDP	Stimulus % of GDP
Germany	$800	61%	20.5%
UK	$481	84%	16.6%
Spain	$219	98%	15.6%
Australia	$196	30%	13.7%
Denmark	$46	28%	13.0%
US	$2000	105%	9.8%
Australia	$72	30%	5.1%
Canada	$57	85%	3.4%
China	$394	61%	2.9%
EU, European Commission	$480	80%	2.6%

The IMF gave Pakistan a $1.386bn rapid financing package last month to tackle balance-of-payment problems amid economic fallout from the virus. The country's economy is now projected to contract 1pc to 1.5pc in the ongoing fiscal year, which we again view as grossly under-evaluated.

Many economists argue that the government should increase discretionary spending in recessions to stimulate private consumption and investment, an idea dating back to John Maynard Keynes's analysis of the Great Depression. Pakistan can greatly benefit from measures such as this, as increases in government spending give way to a multiplier effect and subsequent job creation. The US government has proposed radical measures aimed at providing financial relief for affected businesses in light of the pandemic, whereby $2 trillion of federal funds are being disbursed to households and firms through various channels. Low-interest loans have been made available to several small businesses and private, non-profit organizations. In Bangladesh, a $8.5 billion package was announced by the prime minister, promising to provide adequate support to small and large businesses in industry and services. Meanwhile, no real relief has been provided by to Pakistani firms by the government, in the form of any stimulus package. There have simply been deferments of loan repayments, and disbursement of refunds previously owed.

The State Bank's schemes to support industries by temporary economic relief facility, concessional finance for payment of wages and salaries, and deferment of principal loan repayments for a period of one year have proven essential, and future policies need to be developed in a manner that facilitate the business community further, rather than a reliance on high interest rates and foreign loans. In addition to this, the IMF agreement must be reconsidered, in addition to cutting down the tax rates and clearing all pending tax refunds, to further stimulate the economy and avoid deepening of the recession.