

Economy now needs monetary easing

The International Monetary Fund (IMF) has warned that global economic growth in 2020 is expected to remain below the 2019 level of 2.9 per cent — itself the slowest pace since the outright contraction of 0.7pc in 2009. Being more specific, the Organisation for Economic Cooperation and Development (OECD) predicts that global growth could hit 2.4pc this year — obviously due to the economic damages caused so far by the coronavirus.

In January, the IMF thought the world economy would grow by 3.3pc. Easing of trade tensions between the United States and China had emboldened the Fund to make this optimistic forecast.

The GDP of our main trade and investment partner China, most affected by the deadly virus, is projected to grow just 4.9pc, against the previously projected rate of 5.7pc, according to OECD. The head of research and strategy at MUFG Bank, the largest bank of Japan, says he expects the Gulf Cooperation Council's (GCC) economic growth to fall to 1.7pc this year from 2.5pc last year. We not only receive 54pc of our remittances from GCC but about 10pc of our export earnings come from there as well.

So our external sector can face some challenges in the near future. Exports and remittances both may not grow as much as they could have in the absence of the coronavirus-triggered global economic crisis. Pro-growth policies that were needed in Pakistan even before this crisis have, thus, become all the more necessary.

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The government has recently approved yet another package of incentives for boosting remittances. Prime Minister Imran Khan has asked his cabinet to cap electricity and gas prices for export-oriented industries at regionally competitive rates (of 7.5 cents/kilowatt-hour and \$6.5/million British Thermal Units). The twin moves are aimed at sustaining recent gains in export earnings and remittances. But that is not enough.

Accelerating industrial output, reviving agriculture and enabling the services sector to deliver more is essential to avoid a sharper than a politically-and-socially affordable decline in economic growth. That seems very difficult if the State Bank of Pakistan (SBP) still keeps its policy rate unchanged at 13.25pc. Indications are that the SBP may consider lowering the rate by at least half a percentage point in its monetary policy review this month. Markets have already started pricing it in.

Cut-off yields for long-term Pakistan Investment Bonds fell 15-46 basis points in a recent auction. And 6-month and 1-year Karachi interbank offer rate (Kibor) fell gradually from 13.45pc and 13.56pc at the end of February to 13.25pc and 13.07pc respectively on March 5. Year-on-year headline inflation came down to 12.4pc in February from 14.6pc in January.

The declining trend in international oil prices with the reduction passed on to consumers this month, the recent cut announced for fertiliser prices, plus the ongoing administrative actions to contain the prices of essential items are factors that are expected to keep the inflation under check in the coming months.

In a recent meeting of the Fiscal and Monetary Policy Coordination Board, the government made a compelling case for the lowering of the interest rate. Its basic argument was that high interest rates have increased the cost of domestic-debt servicing, leaving no fiscal room for it to offer tariff concessions to support export-oriented industries. Fiscal authorities also argue that the continuation of a tight monetary policy is not helping industries grow fast enough to contribute significantly to the required expansion in tax revenue.

Independent economists and business lobbies hold the view that inflation is now partly cost-push in nature and demand easing of the monetary policy to spur economic activity. In January, the IMF had projected 2.4pc GDP growth for Pakistan this year, down from 3.3pc last year.

If the SBP goes for a rate cut the first negative impact will be on the inflow of hot money or foreign investment in government debt papers. After the release of lower inflation numbers for February at the beginning of this month, foreign investors have already started withdrawing such investment. However, a widely-anticipated 50bps cut in the SBP policy rate may still keep the downward-adjusted treasury bills yields attractive enough for foreign investors. In the first seven months of this fiscal year, Pakistan attracted \$1.84 billion investment in short-term government debt papers. But if foreign investors opt for taking out their investment in a big way, that will be a real problem.

It would be naïve to expect that in case of a 50bps policy rate cut, banks' effective lending rates would fall so much as to prompt large additional private sector borrowing. But the very beginning of a monetary easing would provide banks and businesses with a clue regarding how the central bank wants them to behave now and where the economy is heading.

That, over some time, should create more demand for private sector credit and encourage banks to lend more to the private sector, particularly to large-scale manufacturing (LSM). The output of LSM grew 9.7pc year-on-year in December 2019 after recording negative growth in the preceding five months. For July-Dec 2019, however, LSM output still showed a 3.35pc contraction.

Much would also depend on how soon fiscal conditions improve and the government frees up space for private sector lending by reducing its dependence on commercial bank borrowing.

In a little less than eight months of this fiscal year (between July 1, 2019, and Feb 21, 2020) the federal government borrowed Rs819bn. In the comparable period of the last fiscal year, it had retired Rs682bn worth of commercial banks loans as it was borrowing heavily from the central bank. Banks' net lending to the private sector, meanwhile, plunged to just Rs195bn from Rs600bn a year ago.