Shamshad Akhtar: Monetary policy in Pakistan

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Federation of Pakistan Chambers of Commerce & Industry, Karachi, 30 April 2007.

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Background

Monetary policy management and financial sector stability are two primary roles of State Bank of Pakistan (SBP). Monetary policy and process of its formulation in Pakistan has undergone changes with the evolving economic dynamics within the country and the improved empirical and theoretical understanding of the monetary policy across the world.

Monetary policy in Pakistan, in line with SBP Act, has been supportive of the dual objective of promoting economic growth and price stability. It achieves this goal by targeting monetary aggregates (broad money supply growth as an intermediate target and reserve money as an operational target) in accordance with real GDP growth and inflation targets set by the Government. Over the years, while maintaining the broad legal mandate, SBP has improved the quality of monetary formulation and its process quite significantly.

This morning, I propose to first outline measures taken by the Government and SBP to strengthen the monetary policy management. Second, I will discuss the rationale and key elements of SBP current monetary policy stance which I believe is helping bring down inflation without stifling credit or economic growth. Finally, I will discuss the impact of SBP's policy actions, and challenges in its implementation.

Changes in monetary policy management

SBP shifted its reliance from an administered monetary policy regime governed by ad hoc changes in reserve ratio's, directed credit and regulated interest rate policies in mid 1990s to a liberal and market oriented monetary policy management. Abolishing sector and bank credit limits, central bank adopted "3-day SBP discount rate" as a major policy instrument to signal easing or tightening of monetary policy which essentially responded to the demand pressures of the economy in line with the growth trends in monetary liabilities and monetary assets – with former capturing the growth in currency and deposit base and latter the growth in domestic credit (including both government borrowings and private sector credit).

Generally monetary module of the economy is the least understood area. This is largely because monetary segment of the economy deals with on one hand the changes in stocks and flows of money supply and on the other hand trends in it subsumes and defuses the impact of developments of fiscal and balance of payments accounts. Notwithstanding both sides of the balance sheet of monetary accounts impact price behavior.

As highlighted above, broad money supply growth has to be consistent with the targets of growth in real GDP and inflation rate. However, if there are excessive demand pressures either because of high fiscal deficit or because of the excessive foreign inflows money supply grows faster than the growth in productive sectors and generates demand pressures which manifests itself in rise in inflation rate.

Despite all contests and debates, inflation is primarily a monetary phenomenon. To keep it under control it is critical that macroeconomic imbalances are kept within the permissible limits. Fiscal profligacy in the past has resulted in Government's unlimited recourse to low and fixed interest rate financing. While interest rates were kept low to nurture private sector credit growth – this did not traditionally happen as private sector investment remained subdued due to host of structural problems facing the economy. Instead low interest rates nurtured fiscal indiscipline as the Government continued to borrow at cheaper rates to finance expenditures.

Recognizing this dilemma, qualitatively monetary policy formulation and its implementation underwent profound changes. In 1997, SBP and its Central Board were empowered to formulate, conduct and implement monetary policy and a Monetary and Fiscal Coordination Board was established to ensure fiscal policy is well coordinated with the monetary policy – specific provision of SBP Act mandates Central Board to impose limits on Government's central bank borrowing. In 2005, the *Fiscal Responsibility and Debt Limitation Act* 2005 requires Government to reduce its revenue deficit to zero by 30th June 2008 and maintain it thereafter, and concurrently reduce public debt to sixty percent of GDP by 2013 and below that limit thereafter. Compliance with the two pieces of legislation has been underway and over the period will help in eventually curbing more effectively Government's recourse to central bank borrowing – which traditionally has complicated monetary policy management.

With greater powers to formulate monetary policy, SBP moved to market oriented monetary policy where it relied more on interest rate to serve as a policy fulcrum and developed its capacity to manage financial markets and related activities effectively. Proactive conduct of monetary operations and management of market volatility has helped improve market flows. The Open Market Operation (OMO) process has been institutionalized with better flexibility vis-à-vis tenors and frequency.

In 2005, SBP introduced the Money Market Computerized Reporting System (MM-CRS) for banks which helps in assessing the market liquidity. SBP's treasury operations and gradual improvements in its liquidity management have together helped OMOs and money market development.

Current monetary policy stance

Public, businesses and market needs to develop understanding that monetary policy does indeed, over the long run, determine the behavior of the price level. While inflation is precipitated by supply shocks, hoarding, official restrictions, import prices, and so on, but these influence *price level* in a given year. However, it is monetary policy that can prevent an effect on the rate of inflation over a more extended period. That is, following the initial price level shock, an appropriate adjustment of the interest rate (if necessary) can stop a potential *second round* of repercussions on wages and prices.

Specialists use measures of core inflation, which exclude volatile prices, as a way to see through one-off shocks. Core inflation is very useful to the central bank itself, as a guide to the appropriate setting of its monetary policy stance. Unexpectedly low (high) core inflation usually indicates the need for easing (tightening) in the policy stance.

The ultimate objective of a central bank, and the measure of success of its policy, is in terms of overall (i.e. headline) inflation. In this context, the way to deal with price level shocks is to stress their *temporary* nature with respect to the inflation rate. This involves: ensuring that the effect on inflation *is* only temporary – this may or may not require a policy action, and realizing that as monetary policy influences the trend of prices with a lag of at least a year and a half, headline inflation should return to its pre-shock rate not within not 1 year but 2 years.

Price signals in a market economy operate less effectively when the price level is unstable; in addition, resources are diverted to unproductive speculation and hedging. Thus, countries with unstable price levels – high inflation or deflation – almost always experience weak output and growth. Thus, low inflation is not merely an end in itself, but also a means to good overall economic performance.

The main cause of high interest rates is high inflation, through the expected-inflation premium. Conversely, the best prospect for low interest rates is a stable environment of low inflation. In this context, the relatively high interest rates that may be necessary to achieve a desired disinflation represent "short-term pain for long-term gain". SBP, therefore, has a current focus on anti-inflation policy which will ensure steady growth in the long run.

Since April 2005 in response to the headline inflation reaching 11.3%, SBP has been and remains in monetary tightening phase. It has to be recognized that the inflationary pressures build up in 2005 because of the preceding few years of easy monetary policy. While SBP addressed this overhang by raising policy discount rate from 7 to 9% in April 2005, there were renewed demand pressures as fiscal and external account deficits rose in wake of both international oil price increase as well as unforeseen spending demands triggered by the earthquake. To offset additional demand pressures, SBP had to further raise its policy discount rate by 50bp in July 2006 along with 4.5 percentage point upward revision in reserve ratios.

In line with the evidence observed for developing countries, impact of monetary tightening on curbing inflation started to be visible after 12-18 months or so. As aggregate demand pressures moderated, CPI fell to 7.9 percent in FY06 (remaining well within the annual target of 8%) and CPI continued to decline to 7.7% in March 2007 with core inflation being still low at 5.4%. However, CPI remains above annual target of 6.5% largely because of a number of factors that disrupted the impact of monetary tightening:

(i) food prices remained quite volatile during FY07 due to supply disruptions;

(ii) higher fiscal pressures resulted in greater than planned recourse to the central bank borrowing. More specifically, government has borrowed Rs. 180 billion for budgetary support by 14 April 2007 compared with only Rs. 37 billion during the same period last year. During the later part of FY the Government has been retiring part of the central bank borrowing and financing its deficit by external flows or commercial bank borrowings;

(iii) heavy borrowing from commercial banks seems to have been crowding out private sector borrowing for long-term investment as banks find it convenient to park their funds in government securities rather than lending;

(iv) SBP being mandated to provide higher than projected refinancing for the textile sector – besides its high borrowing to meet working capital requirements through EFS, textile exporters were allowed debt swap and new long term borrowings which ranged around Rs50 billion; and

(v) higher than expected foreign inflows are expected to enhance the levels of net foreign assets and result in monetary expansion.

Together these factors have resulted in 16.9% YoY growth in reserve money by 14 April (compared to 11.2% last year) which has translated into broad money supply growth of 17.3% by 14 April 07 – higher than the monetary policy statement's original projection of 13.5%.

To avoid adverse impact of monetary tightening on investment demand in the economy and the long-run growth momentum, SBP has ensured proper liquidity management. Not only have the overnight rates been kept close to the discount rate, but the volatility in the short-term interest rates also reduced during H1-FY07. 6-months KIBOR rose by 58 bps to 10.2% during July-April 07 and banks weighted average (marginal) lending rate has increased from 9.9 % in June 2006 to 10.5 % in February 2007.

During July-April 14, net credit to private sector grew by Rs266.4 billion (or 12.6 %) against Rs 339.7 billion (or 19.8 %) in the corresponding period of FY06. Despite liquidity in the system, commercial banks are not able to lend because of low demand for private sector's credit that has borrowed quite heavily in last few years. While there has been growth in working capital, the demand for fixed investment has been subdued. In some cases, corporate sector is further meeting their demand either from retained earnings or foreign borrowings. In some sectors, banks have deliberately slowed down to now assess and develop their own capacities to lend more prudently. The process of mergers and acquisition in a number of banks also impact private sector credit as most "acquired banks" slowed down their business.

Trends in key macroeconomic variables indicate that SBP monetary policy stance has proved successful in striking the required balance between curbing the demand side inflationary pressures and supporting the growth momentum. Indications are that the economy continues to grow at a robust pace on account of acceleration in Large-scale Manufacturing (LSM) and agriculture, and the persistently strong performance of services sector.

More importantly, core inflation, which had registered a sluggish decline in FY06, has already witnessed a substantial deceleration during the first nine months of FY07. By March 2007, YoY core inflation has come down to as low as 5.4 percent, which is 1.25 percentage points lower than the 6.7 percent level recorded during the corresponding period last year, 0.9 percentage points less than the level observed in June 2006. This comforting decline in core inflation, however, is eclipsed by the persistently high food inflation stemming principally from supply side disturbances. In totality, the average consumer price index (CPI) saw a rise of 8.0 percent during July-March FY07 relative to the annual target of 6.5 percent for FY07.

With inflation in Pakistan being relatively higher compared to its competitors and trading partners, the Relative Price Index (RPI) increased by 5.8 percent during first three quarters of FY07. Higher domestic inflation has offset the gains emanating from nominal depreciation and the real exchange rate, measured in terms of the real effective exchange rate (REER) index, appreciated slightly by 2.5 percent during first three quarters of FY07.

Conclusion

To conclude, so far, the current monetary policy posture appears to be striking the balance of gradually reducing the excess demand pressures from the economy, without prejudice to the high-growth prospects. In the short-term, SBP will need to maintain its monetary tightening stance and enhance its communication to influence inflation expectations, and effectively communicate that concerns about the adverse effects of higher interest rates on competitiveness and/or growth are ill founded as the real interest rates in Pakistan are low relative to its competitors.

However, it is important to recognize that monetary policy alone will not be able to contain the rise in inflationary pressures. The Government will need to continue to alleviate supply-side constraints because of problems of market structure and distribution system. Success in containing inflation further depends on continued effective monetary management which requires minimizing Government's recourse to central bank borrowing, mitigating the monetary pressures arising from the surge in capital flows ensuring that these are sterilized and keeping refinancing within manageable limits, while complementing these measures with check and vigilance on food prices.

Going forward, SBP will be launching preparatory work on inflation targeting. There will be need for introducing supportive legal and regulatory framework which allow for targeting inflation and allow greater operational independence to the central bank, while ensuring that SBP has the desired transparency and communication strategy critical for transition to an eventual adoption of inflation targeting.