

HOW MONETARY POLICY STRANGULATES INVESTMENT

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On July 30^h, 2010 the State Bank dealt another crippling blow to investment by raising the policy rate by 50 basis points to 13 percent.

This despite the fact that investment as a ratio of GDP has been declining in 2007-2008, 2008-09 and 2009-2010. During 2009-2010 private investment fell by 5.1 percent. In 2009-10 the investment to GDP ratio stood at 10.6 percent — lower than at any point during the past decade.

The July 2010 Monetary Policy Statement justifies the increase in the base rate as a means for “containing aggregate demand pressures mainly from (an) expansionary fiscal position”(p4). CPI inflation which was estimated at 11.7 percent for FY2010 (an incredible estimate) is expected to remain at between 11 to 12 percent during 2011. The inability to meet the SBP’s inflation target is attributed to “upward adjustments in electricity prices, increase in general sales tax and revisions in government’s employees wages” (P1). Will any of these factors be affected by the rise in the policy rate?

The SBP statement notes the strong relationship between the rise in the Net Domestic Asset to Net Foreign Asset ratio on the one hand, and CPI growth on the other. But according to the statement “(The increase in the Net Domestic Assets of the banking systems(in FY2010) of Rs. 488 billion can be largely explained by the government’s operations. The need for continued reliance on the banking system, both from scheduled banks and SBP to finance the fiscal deficit essentially emanates

from low tax revenues, high current expenditure and shortfalls in expected external financing” (P1). There was a shortfall of Rs. 53 billion in tax collections during 2009-2010 and a shortfall of about Rs. 200 billion in projected foreign inflow.

Will an increase in interest rates reduce the need for budgetary support and commodity operations? Will it lead to improved tax collections? Will it increase the realization of foreign commitments?. There is no theory and no empirical evidence which justify such expectations.

The State Bank itself does not expect the government to meet the four percent deficit to GDP target for FY2011. “The FY fiscal deficit could exceed 5 percent of GDP. Moreover, meeting the FBR tax collection target of Rs. 1667 billion would require a 25.6 percent growth which seems unlikely” (P2). Why raise interest rates then?

Pakistan’s relatively high interest rates compared to other countries in the region such as India and China have failed to have a positive impact on private inflows. Both foreign direct and portfolio investment have fallen during FY10 and the growth of SBP’s external reserves is due to realization of Coalition Support Fund commitments and IMF tranche releases. Needless to say this cannot directly be attributed to changes in interest rates.

The increase in the NFA of the banking system has been quickly neutralized by the State Bank’s open market operations. The State Bank has thus struggled to ensure that improved liquidity conditions in the money market do not lead to a reduction in short turn interest rates. Thus “the consistency of the overnight money market repo rate with the monetary policy stance”(P2) has been achieved by strangulating loan growth.

The State Bank does not expect the rise in interest rates to reduce NDA growth “which would largely depend on government borrowings from the banking system, the latter would be contingent upon the realization of foreign financial flows matching the expected increase in the current account deficit” (P3).

The largely fictitious 4.1 percent GDP growth in FY2010 was mainly fuelled by the growth in government consumption which grew by 13.4 percent in FY2009-2010. Private consumption grew by only 3.8 percent — thus per capita private consumption growth was not significantly different from zero. Private investment fell by 5 percent and the domestic saving rate remained stagnant.

The State Bank recognizes that “a decline in investment means reduced capital per worker and a weakening physical infrastructure. Adding to the difficulties are present energy shortages and a poor law and order situation” (P3). Yet it does not use monetary policy to reduce these supply side constraints.

Instead it jacks up interest rates to reduce the consumption demand of the poor and the investment expenditure of the private sector. The State Bank is pursuing an immiserising monetary policy for higher interest rates are invariably passed on to consumers in the form of higher commodity prices.

The State Bank is accommodating higher government consumption (which is not affected by interest rates) through private consumption and investment expenditures strangulation. Macro economic “stability” is being purchased at the cost of higher poverty levels, increased unemployment and a greater system wide incapacity to replace obsolete production technology. This increased incapacity of the industrial sector to service its operations is graphically illustrated by the rise in non performing loans — up from about Rs. 250 billion in January 2008 to almost Rs. 500 billion today.

Market based monetary policy has failed. Under this policy regime the State Bank must continue to serve as a strangulator of growth — specially the growth of private sector investment. A return to credit planning — the monetary policy regime which operated so efficiently during 1976-1993 — is a pre-requisite if monetary management is to become an effective instrument for equitable development and industrial productivity growth.