Chasing inflation will unhinge the macro economy

Mushtaq Khan, July 16, 2019

SBP will announce its monetary policy today. The likely justification for breaking with its past practice of issuing its monetary policy in the last week of the month (and on a Saturday), is that in the second half of this month, SBP will conduct both T-bill and PIB auctions. Sending out an interest rate signal before these auctions makes sense – the central bank would like commercial banks to participate heavily (to help retire government borrowing from SBP) and also to encourage them to invest in longer maturity instruments.

This would also be the first set of auctions in the newly minted 39-month Extended Fund Facility. The IMF program has moved the economy into a stabilization phase, with a stated goal to sharply reduce the twin deficit.

There is a remarkable market consensus about what SBP will do. In a survey of analysts, out of the 12 research houses that have been tracked, eight have stated that the benchmark interest rate will increase by 100bps, while two each expect a 50 and 75 bps increase. All have the same rationale for their prediction – SBP will target to maintain positive *real* interest rates, and since inflation is edging up, so will interest rates.

For those analysts who have been interviewed, the number-crunching follows a similar pattern:

- the discount rate is currently at 12.25%;
- average inflation is projected at 11-12% in the first quarter of FY20;
- if SBP targets a *real* interest rate of at least 200 bps, then interest rates must be 13-14%;
- this means the discount rate must be increased by 75-125 bps, so to round it off, a 100 bps increase is a safe bet.

There are several reasons to make this a safe bet: (1) the IMF program has a stated goal to keep real interest rates positive; (2) the IMF has said that it expects average inflation to hit 13% this fiscal year; and (3) after the last 150 bps increase in May 2019 (which surprised the market), it makes sense to be less aggressive this time. This also means that during the course of FY20, using the rule of thumb of targeting *real* interest rates (and assuming inflation does settle at 13% in FY20), SBP could increase interest rates by 275-325 bps during the course of the year.

Flawed thinking

In our past papers, we have repeatedly stressed that inflation in Pakistan is not driven by demand-pull pressures, but more by supply-push factors like the Rupee parity and retail fuel prices. In an earlier blog (*Will SBP be able to change Pakistan's nominal anchor*, 9 May 2019), we argued that while the IMF would like Pakistan's nominal anchor to shift towards interest rates, price-setting behavior is determined by the two most important prices in Pakistan – the Rupee-Dollar parity and retail fuel prices. In simple terms, a nominal anchor is a benchmark that people use to set retail prices – as we have seen in the recent past, if wholesalers & retailers focus on the Rupee and fuel costs, they will price up their goods and services accordingly.

What the IMF would prefer is that Pakistanis stop looking at the Rupee and fuel prices, and focus instead on interest rates as the nominal anchor. In developed economies where interest rates strongly influence consumption patterns, retailers view rising interest rates as an indication that consumption spending will fall, and therefore they will not increase their prices as much. Hence, from the central bank's perspective, raising interest rates should lower future inflation.

But this doesn't happen in Pakistan, even if the IMF (and now SBP) would like this to happen. Changing the country's nominal anchor is not like an *on-off* policy switch – it's about changing grass-root behavior and cannot be imposed top-down. If Pakistani retailers see no causality between interest rates and the demand for their goods and services, why would interest rate changes influence their pricing behavior? Or will rising interest rates tone down their price-setting behavior, when they continue to witness a weaker Rupee and rising fuel prices? More simply, why should SBP focus on demand factors when underlying inflation continues to follow supply-side factors?

Switching gears a bit, why should policymakers even target positive *real* interest rates? Economic theory has a water-tight answer: higher interest rates will reduce bank borrowing, which means less demand pressure, which in turn should ease inflation. So, increasing interest rates when private sector credit growth is too high makes sense. But what if credit disbursement and overall money supply growth are low to begin with?

Private sector credit growth in FY19 was around Rs 683 bln compared to Rs 769 bln in FY18. Yes, money supply grew by 12.2% in FY19, but most of this was borrowing by the government (average inflation in FY19 was 7.3%, which suggests that M2 growth of 12.2% is not excessive). Furthermore, while private sector borrowers are sensitive to interest rates, the government is not. So increasing interest rates will not reduce government borrowing, which has been driving M2 growth in recent years.

It gets worse. Analysts often tend to focus on SBP's discount rate as if this is the rate at which the private sector can borrow. This is not the case, as the government borrows at higher rates (T-bill rates are above the discount rate), then come the banks (Kibor is above T-bill rates), then the top-rated corporates (the prime lending rate is higher than Kibor), then other corporate borrowers, and lastly, individual borrowers who avail consumer financing. The margin between the discount rate and consumer financing rates could be as large as 350-500 bps (if not more).

With slow off-take of bank credit, and credit-based consumption being a small component of total demand, why should SBP's inflation control only focus on interest rates? Also, will raising interest rates reduce government borrowing from commercial banks, which is necessary to reduce the growth of money supply in FY20? What we have seen, is that rising interest rates will increase debt servicing and the size of the fiscal deficit, which means government borrowing will increase. If the government has to borrow to repay its mounting debts, it will, *irrespective* of the interest rate at which it has to borrow.

In our view, it is futile to use interest rates to reduce inflation in Pakistan – chasing inflation is also a dangerous policy direction (more later). At best, increasing interest rates to tackle the *secondary* (inflationary) effects from a weak Rupee or rising fuel prices, may blunt the *primary* effect but it cannot reverse the direction of inflation. However, as interest rates increase, this puts pressure on the fiscal deficit and the quantum of government borrowing – *this* drives up money supply and could trigger the need for higher interest rates.

The real problems

In our view, the more pressing challenges facing the central bank are as follows: (1) to increase the maturity of Pakistan's market debt (i.e. get banks into longer term T-bills and PIBs); (2) to ensure that rising interest rates do not encourage risky lending by the weaker banks; and (3) to somehow signal a credible end to the cycle of monetary tightening. In terms of the latter, if SBP is unable to convince banks that interest rates have maxed out, this could push Pakistan into a debt spiral that could lead to hyper-inflation.

1. With rising interest rates, banks will continue to pile into 3-month T-bills. This means the maturity of Pakistan's market debt will become even shorter, which increases roll-over risk and could become a systemic problem (it will also leave the financial system more vulnerable to future interest rate changes). To entice banks into longer term instruments, SBP must signal the end of the tightening cycle. Only this will give banks the confidence to invest in PIBs, which is necessary to improve the country's domestic debt dynamics. But if SBP is chasing inflation (with no end in sight), and inflation is projected to keep increasing in FY20, Pakistan's market debt will remain dangerously short-term.

2. Rising interest rates will also put smaller (and weaker) banks at a disadvantage. As things stand, smaller banks are only able to compete with market leaders by paying more for deposits and lending at higher interest rates. As interest rates increase and the economy slows, these banks are likely to adopt more risky lending practices. SBP must be watchful that while it increases interest rates (in its misguided effort to control inflation), it does not make weaker banks a systemic risk for the entire financial system.

3. Finally, chasing inflation will push the country deeper into a debt trap. If the government is unable to raise sufficient tax revenues and the increase in debt servicing keeps upward pressure on the fiscal deficit, this will push the country into a vicious cycle: the government's borrowing needs will eventually exceed what commercial banks are able to finance, which means it will have no choice but to resort to central bank financing. History shows that governments that borrow from the central bank just to meet their debt obligations, regress into hyperinflation. While this is unlikely in Pakistan, it is not impossible.

What will SBP do?

It is clear that SBP will increase interest rates – the issue is how much. The market cannot be faulted for its view that SBP will increase interest rates by 100 bps. However, this will certainly not change the auction behavior of commercial banks, which means the government will struggle with its domestic debt. The question is whether SBP has the intention to signal the end of the tightening cycle, and if so, when.

In our view, the smartest thing to do is to increase interest rates by 150-200 bps in one go, and make it clear to the market that the tightening cycle has ended. SBP could point to the interest rate increases last year as a lead-in to the EFF, and declare that the process is now complete. While such a large interest rate hike will be condemned by the stock market bandits, it will at least put the country's banking system (and its debt dynamics) on a sounder, more predictable trajectory.