The Unexpected Interest Rate Hike

Dr Mushtaq Khan[1], January 30, 2018

The monetary policy decision of 26th January was notable for two reasons: the decision and announcement took place on a Friday; and SBP shocked everyone by not maintaining the status quo (it increased the benchmark rate by 25 bps). Since this is the first change in interest rates since May 2016, market analysts are still trying to figure out what motivated the decision.

The stock answer is the IMF. While this may be true, we think there is more to it.

Macro conditions

It's not as if there has been a sudden deterioration in the overall macro environment, which could justify this decision. Money supply grew by only 1.9 percent during the period July 1st 2017 to 12th January 2018, compared to an increase of 3.5 percent in the corresponding period last fiscal year. Furthermore, (net) credit expansion to both the government and the private sector was lower this fiscal year (in terms of flows, government borrowing fell from Rs 470 bln to 402 bln this year, while private sector borrowing fell from 342 bln to 287 bln this year).

On the inflation front, the 12-month moving average rate was 4.1 percent in December 2017, and from our earlier projections (*Stepping into the Unknown*, 22nd January 2018) we expect average inflation in FY18 to be 4.9 percent, which is below the target set for the year.[2] Furthermore, with low M2 growth in the past two years, there is no monetary overhang that needed to be addressed, which could have justified preemptive action. SBP's monetary policy statement predicts that headline inflation will increase in 2018, and its stated rationale for increasing interest rates was to counter this. The central bank claims the inflationary impetus will come from the lagged impact of the PKR depreciation (in December), and rising oil prices.

We agree that inflation will increase in 2018 due to the weaker PKR and higher retail fuel prices, but we would argue that these are supply-push factors that have little to do with demand pressures.[3] So again: why the interest rate move, and why now?

Likely repercussions

Before discussing the possible reasons for the interest rate move, let's talk about the likely repercussions that should have factored into SBP's decision-making process. Since this is the first use of interest rates since May 2016, we would flag the following developments:

1. The increase in interest rates has unhinged the market's expectations. This means the bid patterns in the bi-monthly primary auctions (put forward by commercial banks), will change. More simply, all bids will focus on 3-month T-bills, and this will kill off all appetite for longer term PIBs. This means the maturity of Pakistan's market debt would begin to shorten significantly.
2. The reluctance to bid for longer-term T-bills and PIBs will continue till the market is convinced that SBP has completed its cycle of interest rate hikes. This will translate into mounting pressure on SBP

[1] The author would like to acknowledge the many thoughtful discussions with Danish Hyder in preparing this paper.
[2] For this reason, we argued that the authorities would delay an interest rate increase till early FY19.
[3] As discussed in some detail in our previous paper (*Stepping into the Unknown*, 22nd January 2018), the main impetus for rising inflation is an increase in administered prices (the PKR-$ parity and retail PoL prices) and not demand conditions.

to raise interest rates in March and May 2018 (the scheduled monetary policy decisions – MP), if the central bank seeks to normalize bank behavior.

3. The interest rate increase will surely discourage banks from availing short-term liquidity from SBP via open market operations (OMOs), especially closer to the next MP decision (end-March). This means the volume of outstanding OMOs will fall, which will tighten market liquidity and reinforce expectations that interest rates will increase further.
4. This behavior of commercial banks will immediately shift government borrowing towards SBP (which is considered inflationary). It will reverse a healthy trend seen in 1H-FY18, wherein GoP reduced its borrowing from the central bank.
5. In our last paper, we projected YoY inflation would increase from 4.6 percent in December 2017, to over 9 percent in July 2018. If the 25 bps increase was justified as a preemptive strike against rising inflation, this suggests that SBP is looking at increasing interest rates by 100-125 bps in the remaining part of FY18.
6. This could create debt servicing pressures in late FY18, which will make fiscal management more challenging in FY19.

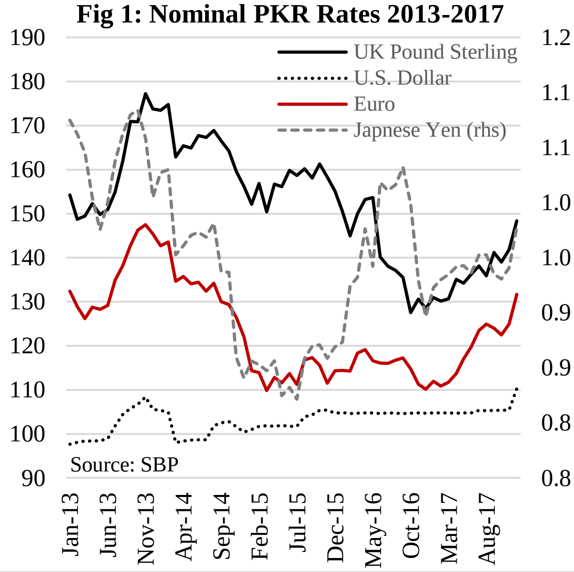
Possible motivation

With such adverse repercussions, why play with interest rates? We at **doctored papers** are even more surprised than the market, as we expected SBP to make further PKR adjustments in early Q3-FY18, as narrowing the external deficit is a far more pressing policy matter than dampening inflationary pressures.

In terms of economic orthodoxy, there are two ways to narrow the external deficit: weaken the currency to make imports more expensive, or increase interest rates to reduce the demand for imports. Some have argued that perhaps our policymakers did not want to adjust the PKR further, and opted instead to initiate a tightening cycle. While this is plausible, the 25 bps move will hardly dent our imports, but it will certainly have consequences.

Furthermore, we do not think theoretical links between domestic interest rates and demand management, or interest rates and the strength of the PKR, are as relevant for Pakistan. First, consumer spending in Pakistan is not sensitive to interest rates, as consumer credit is a very small component of total consumption spending. Far more important in driving consumer spending (and imports), is the real estate *wealth effect*, over which the government has almost no control. Second, an increase in domestic interest rates will not attract fixed-income investment from abroad, as there is very little foreign appetite for Pakistani government bonds (this means higher interest rates will not make the PKR stronger).[4]

Fig 1: Nominal PKR Rates 2013-2017



Some have argued that a PKR-$ parity adjustment is not required, as the US Dollar is already weak against hard currencies, which means the Rupee's nominal effective exchange rate (NEER) has already depreciated (see **Figure 1**). While we cannot argue

[4] If anything, higher domestic interest rates that increase debt servicing – and the fiscal deficit – would actually reduce foreign appetite for Pakistani debt, as it would reduce their confidence in Pakistan's macro economy.

with the logic, we think this policy optimism is misplaced.

As shown in **Figure 1**, the PKR has indeed weakened against other hard currencies during much of 2017, yet the external deficit continues to rise. In our view, this is because Pakistanis tend to gauge the strength/weakness of the currency, only against the dollar. If they see a fixed PKR-$ parity, while SBP's FX reserves are depleting, they know devaluation is likely. Hence, even with the 5 percent adjustment of the PKR in December, if SBP's reserves continue to fall at the same rate as in the recent past, people will start hedging against the Rupee and Dollarization will gain momentum.

Our assessment

We would frame the issue of *why now*, more broadly. A few points should be clear enough: (1) the external sector problem requires an IMF program, which will entail a weaker Rupee, higher interest rates and greater revenue collection; (2) Pakistan's policymakers and politicians are adept at passing the blame or finger-pointing, *and* SBP is in the direct line of fire (PKR-$ and interest rates); and (3) the next elected government will have little choice but to stay within the parameters of a stabilization program.

Knowing all this, perhaps SBP decided to initiate an irreversible move towards stabilization, using a token 25 bps increase in interest rates. Since this will trigger a series of events in the money market, it will effectively compel the interim government to continue increasing interest rates[5]. Failure to do so, would worsen the balance of GoP borrowing (from the banking system) and reduce the maturity of the country's market debt. Additional steps (like adjusting the PKR-$ parity and increasing retail fuel prices), will also be required in the remaining part of this fiscal year.

From the IMF's perspective, curbing SBP's injection of liquidity into the system, will begin rectifying the market distortion created by one-sided OMOs, which have allowed SBP to artificially reduce its lending to GoP, and keep interest rates lower than they should be.[6] A stabilization program would effectively force the government to face the real consequences of its fiscal inaction and power sector mismanagement.

In the lead up to general elections, these economic constraints will make it difficult to launch and sustain populist policies. With the interim government committed to economic stabilization, the next elected government could simply blame the interim government (or past governments) for the economic hardship the country must endure. The new government would not be able to change course in early FY19, as it would place Pakistan on a path to sovereign default.

Conclusion

Despite the confusion created by SBP's decision to increase interest rates, we think there is some logic to this move. In our view, the unexpected increase in interest rates, could be a clever strategy to enter an IMF program, while simultaneously defanging contentious political parties in a very uncertain election year.

[5] This could play out in one of two ways, but with similar end results. One: the incumbent government realizes that the economy will struggle going forward, and opts to use its political capital to gain seats in the Senate elections (in early March). Soon after this, it calls for early elections and hands over power to an interim government in mid-to-end March 2018. The interim government takes the hard steps and the political class blames them for the economic pain. The other option, is that the incumbent government continues for its full term, but begins talking to the IMF. Either way, SBP has little choice but to follow through with stabilization measures – interest rate increases and a weaker PKR. In our view, an interim set-up in March is more likely.

[6] Additional liquidity in the face of greater government appetite for credit, allows SBP to keep interest rates low. This helps keep debt servicing down, which prolongs GoP's ability to finance large fiscal deficits.

However, as we have mentioned earlier, even this surprise policy move (and subsequent steps), will not solve the balance of payment (BoP) problem that is upon us. We still stand by our view that the external deficit will require a weaker PKR and higher retail fuel prices, which in turn, will push inflation into a higher steady-state level. Barring an unforeseen positive shock (that translates into billions of dollars of non-debt creating inflows), Pakistan's unaddressed twin deficits will translate into an increase in inflation, higher interest rates, a weaker Rupee, and lower growth. The resulting pain may be the only avenue towards meaningful structural reforms.

