December 13, 2010

Shahid Kardar stresses upon coordinated response to changing macroeconomic environment

Mr. Shahid H. Kardar, Governor, State Bank of Pakistan has said that the future strategy to control inflation must include coordinated and timely response to changing macroeconomic conditions along with a concerted effort to raise the productive capacity of the economy.

Addressing members of the business community at the Federation of Pakistan Chambers of Commerce and Industry (FPCCI) in Karachi today, Mr. Kardar stressed that any delay in implementing such a strategy would only make the policy trade-offs much more difficult resulting in continuing uncertainty regarding desirable economic outcomes.

Responding to various queries regarding Monetary Policy, SBP Governor said that Monetary Policy has played its part in correcting the macroeconomic imbalances, but other government policies have not been that supportive. “Had the SBP not responded, the inflation outlook and reserve position of the country would have been worse,” he added.

Mr. Kardar explained that the growth in broad money and thus inflation would have been much higher if the private sector had also continued to borrow unchecked from the banking system along with the public sector. He said some observers can comment that availability of cheap credit to the private sector would have supplemented productive capacity, helping reduce the output gap but given the deterioration in the law and order conditions and energy sector problems in the last three years, it is highly unlikely that investments in the country, by both local and foreign investors, would have grown rapidly.

“Thus in any case, rising inflation would have made the businesses uncompetitive by increasing the cost of production,” he said and explained that what we have learned about the dynamics of inflation in Pakistan is that in broad terms, inflationary pressures have been a mix of upward adjustments in administrated prices, a persistence of output gap and inconsistent macroeconomic policies negatively influencing expectations of inflation.

Mr. Kardar said that in cumulative terms, Pakistan’s economy has experienced an inflation of 66 percent between June 2007 and October 2010. “This is almost twice the level of inflation seen during June 2003 and June 2007, which was 36 percent,” he added.

He said that the credit extended for ‘commodity operations’, including both wheat and sugar, grew by 288 percent during the last three years compared to 33 percent in the three years before that. “Borrowings of this scale would not have been possible without an upward pressure on market interest rates,” he said and added that the borrowing of government agencies for financing its wheat, urea, and sugar trading operations was Rs 382 billion at just under 3 percentage points above KIBOR, indicating the interest rate regime that the private sector would have to face in competition with the sovereign.

Further, this led to an injection of a lot of cash in the rural areas, which was used for higher expenditures on consumer durables and possibly other food items as well, he said and added that an initial ‘supply shock’ turned into a ‘demand shock’ and adversely affected expectation of inflation remaining high.

Mr. Kardar explained in detail how heavily subsidized commodity prices including that of petroleum products, electricity and gas has resulted in heavy government borrowing from the central bank which consequently had negative impact on the inflation. He also talked about borrowings of the Public Sector Enterprises, which partially explain transfer of subsidies from the government’s budgetary expenditures directly to the power sector entitites, that grew by 305 percent during June 2007 and October 2010 compared to only 17 percent during 2003 and June 2007. “The contribution of this towards growth in money and thus overall inflation should not be discounted,” he said and explained that even if the food and energy group prices were excluded from CPI, there was substantial increase in inflationary pressures. Both non-food-non-energy (NFNE) and trimmed measures of core inflation validate this observation, he added.

SBP Governor opined that reduction in subsidies unfortunately did not help in reducing the fiscal deficit and easing aggregate demand pressure. In cumulative terms, he said, the fiscal deficit grew by 146 percent in nominal terms during June 2007 and June 2010 compared to 113 percent during June 2003 and June 2007. “If we take out the interest payments, which have been mentioned as a factor adding to the fiscal problems, and look at the primary deficit, the fiscal driven aggregate demand pressures look more pronounced,” he said.

He said that the stock of outstanding borrowings of the government from the SBP is in excess of Rs 1500 billion today compared to only Rs 53 billion at end-June 2003. Imagine the effect on market interest rate, if the government had borrowed this amount from the scheduled banks, he asked the FPCCI members and said that undoubtedly interest rates would have been much higher than they are now.

Mr. Kardar pointed out that another downside of the heavy presence of the government and its borrowings from the SBP had been the deterioration of the currency-to-deposit ratio of the banking system. He explained that during June 2003 and June 2007, currency in circulation grew by 70 percent and total deposits of the banking system, excluding government deposits, grew by 104 percent. In the following three years, currency in circulation increased by 82 percent while deposits increased by only 40 percent, he said and added that while currency in circulation has a strong positive relationship with overall inflation, deposits represent the main funding source for the banking system. “A decline in deposits tends to have a contractionary effect on market liquidity and puts an upward pressure on market interest rates,” he observed.

"The continuation of these trends is fueling expectations of inflation and, resultantly, in interest rates remaining high. Thus, if anything, the criticism on SBP's current monetary policy stance could be that it has not been tight enough," Mr. Kardar asserted.

He explained the reason for the SBP pursuing a relatively 'loose' monetary policy was its concern that it would further crowd out the private sector and negatively impact the growth rate. Faced with this trade-off, SBP has been trying to strike a very difficult balance between such considerations, he reiterated.

SBP Governor acknowledged that that the private sector has borne the brunt of required adjustment in the economy and government has considerably crowded out the private sector both through reduced availability and price of credit. Between June 2003 and June 2007 private sector credit cumulatively grew by 162 percent, while it increased by only 24 percent between June 2007 and November 2010, he said and added this in turn has negatively affected the future productive capacity of the economy, making it more difficult to meet the relatively lower aggregate demand and bring inflation down.

Earlier, President FPCCI Mr. Sultan Chawla welcomed the SBP Governor at FPCCI and gave his assessment of the current economic situation in the country and problems being faced by the business community. The meeting was attended, among others, by Managing Committee members of the FPCCI and senior executives of the State Bank.

Full text of the Governor's speech is available at State Bank's website www.sbp.org.pk.

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