MONETARY POLICY - POST COVID-19 REGIME

QAZI MASOOD AHMED[1]

With the implementation of the IMF program, last year, the government of Pakistan initiated stabilization program using contractionary monetary policy. Was the IMF program essential for Pakistan economy or not is now not a relevant issue. More appropriate would be to ask whether with the widespread coronavirus epidemic, whether the process of stabilization of economy is sustainable or not? And what type of changes in the monetary policy is required to mitigate the adverse consequences of impending recession caused by the coronavirus epidemic.

Since the inception of current IMF program 2019, the SBP (State Bank of Pakistan), has sharply increased its policy rate in several meetings perhaps more than the required impetus in one year. In the normal circumstances the SBP would have had a longer time to see the impact of its policy rate and make necessary adjustments as required. However, this coronavirus epidemic has made life difficult for all policy makers around the world specially those dealing monetary and fiscal policies. This burden is more on Pakistani policy makers who are committed to follow IMF commitments and have to avoid the detrimental impacts of 2020 recession which is much stronger than the 2007 recession.

In a small span of time, from June 2018 to March 2020, the SBP has increased policy rate from 6.50% to 13.25%, which brought many positive and negative changes in the financial structure of Pakistan economy. On the positive side these includes, first the private investors shifted their investment to the long term government bond from the short term government bonds as desired by SBP; and second several foreign investors brought hot money in Pakistan and purchased government treasury bills. On negative side these includes; first, since the government was single largest borrower the increase in interest rate sharply increased its debt profile; second, the increase in interest rate has increased cost of borrowing for the private investors as well, which is reflected in the sharp decline in credit in-take by the private sectors; and third, though government was able to

[1] Dr Qazi Masood Ahmed is professor of Economics at Institute of Business Administration, Karachi.

generate money through long term bonds left very little money for private investors known as crowding-out investment effects and this process is not likely to end in near future because of government's unsatiated borrowing appetite.

In December 2019 coronavirus spread in China and then in the first quarter of 2020 it spread in geometric progression through-out the world. Unlike many other and definitely more dangerous diseases like Cancer, TB, AIDS and heart diseases it had much more impact on world daily economic and social activities. It had compelled almost whole world to lock-down their social and economic life. This had serious economic, social and political consequences throughout the world and because of its negative economic externalities the economy in each country is getting worse day-by-day. Pakistan economy which is heavily depended on its international trade and remittances also got affected by the adverse consequences of this coronavirus.

Like other countries, Pakistan government also announced generous economic package despite very ill health of the economy. It also appears that the reforms process which was already very slow will be further slowdown. The SBP following the federal government's instruction made changes in the monetary reform process. It reduced the policy rate twice almost in a week, from 13.25% to 11% to ease out the economy. What will be its effects on investment requires some time to judge - usually 6-8 months' time lag between the SBP's decision to change policy rate and its impact on real sector investment. Given the lockdown situation, lack of domestic demand and unavailability of the raw materials the profitability rates for investors have declined sharply which may cause delay in their response to such interest rate decline. However, some unintended negative effects can occur more quickly, in fact has already been seen. It can reduce the purchases of long term government bond by the investor and short term portfolio investment may again rise which is not congenial for the long-term investment. The impact of this fall in policy rate on debt servicing is ambiguous and already reflected in the balance sheet of the SBP. On the one hand, it may reduce debt servicing especially on the domestic debt but at the same may increase outflows of funds from the economy which depreciate the currency and can increase debt servicing on foreign debt. Almost 2 billion dollars hot money already drifted back.

Now the final comment on what the SBP can do to assist the government to mitigate recessionary effects caused by coronavirus. To answer this question, we must assess what were the channels of monetary transmission that were available to the SBP and how many of those are closed or near to close due to this crisis. This mechanism means how the effects of Bank's policy rate transmit to other variables. The transmission mechanism works through five channels 1) Policy rate/interest rate 2) Assets Price 3) Exchange Rate and 4) Expectations, 5) Credit Control. The Policy rate channel works through influencing the retail interest rates that banks charge on loans to businesses or offer on deposits to households. With the increase in policy rate the demand for credit falls as it becomes expensive for investors and general public to borrow from commercial banks. As a result, economic activity slows down and results in a fall in the demand for goods and services, fall in output and increase in unemployment. On the other side, the fall in interest rate will have converse effects but as the economic activity is already stagnant due to lockdown and the rate of profit for the producer is very low the interest rate channel will not work. In this scenario the reduction in policy rate will have very minimum desired results but will have more unintended negative effects. Therefore, instead of reducing policy rate directly, it should be reduced through the use of Income tax Schedule II which allow interest to be deductible for the calculation of tax liability. Under this catastrophe situation the rate of interest deductibility may be increased which effectively reduces interest rates for domestic producers but the interest rates for the savers and foreigner investors will remains unaffected. The second channel the exchange rate channel links domestic economy with international economies. An increase in the domestic interest rates makes the local currency financial assets and bonds more attractive for the investors and vice-versa. The appreciation and depreciation may decrease or increase exports respectively. However, in the present scenario because income and domestic demand of our trading partners have decreased so consequently our exports have fallen. Therefore, this coronavirus have also broken this channel for the time being. The asset price channel works through the returns on bank deposits as compared to returns on investing in other assets. The returns on financial assets are determined in the capital market, as the capital market is in shaky state and everyday market index decline sharply therefore, this channel is also not at work. The expectations channel deals with the expectations of general public and investors mainly about the future interest rates and inflation in the economy. As expectation changes it also affects the actual values of the interest rates and so on. In the current scenario both the current and future expectations are bleak and due to lockdown consumers and investors are not in better position to reveal their expectations properly and therefore, this channel of transmission is also not working properly. The Credit channel of SBP works through the credit portfolio of the economic agents which is affected by the decision of the SBP of setting targets for allocation of credit in each sector and their respective interest rate. This is only channel which is fully available during current economic situation and should be used effectively. Through this channel the SBP has already announced reduction in interest rate for few sectors and initiatives.

Finally, the most important suggestion to the SBP is to bring few major changes in the way it operates the policy. First, the use of credit channel must increase and so the coverage. To ascertain this objective the SBP must adjust maximum limit of commercial banks investment in government treasury bills to compel the banks to reach out real sectors of the economy. In the onset coronavirus pandemic, there is a need to support SMEs sector and housing for middle class particularly, so this imposition on commercial banks maximum investment in treasury bills will reduce crowding out and the banks can finance this needy investment. However, this has important implication for the expenditures policy of the federal government, the federal government will then have to cut down their expenditures significantly or have to find other sources of financing of their expenditures.

Another important suggestion for the SBP is to look into its policy rate/interest rate mechanism. There is a need for easing out monetary policy which should simultaneously cater the need for saver, foreign investors and domestic investors. This needs out-of-box thinking and exploring the ways the SBPSBP can use policy rate/ interest rate effectively. This option can't and should not be performed in isolation but in combination of other monetary policy options like credit allocation etc. and with combination and coordination of the tools of fiscal policy. They may review thoroughly the clauses of Second Schedule of Income tax that facilitates the production and businesses in Pakistan like the interest deductibility, exports rebates and many others; and develop a full package for easing out the economy under this stressed conditions.