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Limitations on Monetary Policy

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Since there are both demand pull and cost-push factors influencing inflation it is not possible to manage inflation through just one/two policy instruments-especially when one instrument, the interest rate, is expected to achieve multiple objectives. The reason is that the sources of demand in the economy are households, corporate sector and government, who in turn receive money from different sources. The role of each source and what can be done about it is somewhat limited, especially because the acts of one can nullify the actions of others, at times as a result of unanticipated developments. For example, when the State Bank (SBP) increases the interest rate it expects a change in behaviour of the borrower. However, if the largest borrower, government, continues borrowing to finance expenditures more than its revenues it negates the objective of raising the interest-rate. Again, policy instruments to contain domestic demand can be rendered redundant by inflows of remittances or donor assistance which create additional demand for goods and services.

The effectiveness of SBP's policy to 'target' inflation is constrained by the structural nature of the problems. Monetary policy instruments have limitations. An increase in the interest rate cannot fight imported or food inflation when the latter is high because a) the support price of wheat is above its international price; b) increases in price of energy and oil raise the cost of farming, processing and transportation; c) yields per acre of crops' continue to be low and d) of hoarding, and cartelization.

Similarly, there are cost-push factors affecting large areas of the economy resulting from a) rigidities in prices administered by government (e.g of electricity, gas, etc.); b) poor governance adding to costs; c) a tax structure that is heavily dependent on high rates of GST and other indirect taxes; and d) powerful cartels manipulating prices. These prices are not affected by weakening in demand for goods and services and the profligacy of government that keeps budget deficits high-whose financing raises the interest rate on borrowings and crowds out the private sector seeking funds for investment.

It is factors like these that make it difficult to handle inflation. For instance, addressing food inflation requires a comprehensive policy package comprising policies that incentivize increase in yields and cost efficiencies in production processes and an open trade policy to counter cartel formation, measures beyond the scope of monetary policy.

The stubbornness of a high rate of inflation in a relatively depressed economy also reflects the gap between falling demand and supply capacities of the economy (the latter manifesting the rate of growth of the economy's output). Such an outcome can only be possible if productive capabilities are either not keeping pace with demand (getting reflected as higher imports) or have actually declined, a truly worrisome development and that too only partly because of lack of availability of energy at affordable prices, the latter being a particularly serious issue for SMEs.

This has happened because of weak private sector investment (although there is some recent improvement, mainly in sectors getting under-priced gas), despite the large scale manufacturing sector having picked up market share from SMEs (that were winding up) and made decent profits. Other key factors have been poor productivity (failure to get higher output from existing resources) and investment in un-productive or projects that have stalled.

Furthermore, simply pursing single mindedly the goal of checking inflation can adversely impact growth and employment creation. The SBP does not have an adequate set of policy instruments in its armour to stimulate growth, lower the rate of inflation and ensure stability of the exchange rating of currency, all at the same time. Moreover, inflation targeting has not been adopted as the sole objective by all central banks? Two economic power houses, China and USA, are seemingly non inflation targeting countries.

In this writer's view, the monetary policy should only be focusing on tackling the domestic business cycle. In developing countries if growth has to be given an impetus it requires low interest rates. But a sharp decline in inflows of external capital may warrant high rates of interest a) to check switching of portfolios (depositors switching from rupees to dollars on the expectation that the rupees would depreciate at a rate faster than interest rate on rupee deposits); and b) to incentivize foreign inflows (as has been one of our arguments for jacking up interest rates) which, in turn, can worsen the adverse movement in the domestic business cycle.

The internal and external imbalances of advanced economies can be addressed simultaneously. They can afford the luxury of printing currencies, because their currencies can be freely converted and traded in international financial markets. In other words, they can conduct their monetary policy freely to meet the requirements of the domestic business cycle. The currencies of developing countries, on the other hand, are not freely convertible and tradable. These economies need capital inflows and donor support to maintain foreign exchange reserves in tradable currencies to enable them to face any crises in financing external obligations. In our case, external payment crises require bail outs by the IMF and other multilateral and bilateral donors and 'special friends' like the Saudis.

The Pak rupee is ‘free floating’ when it comes to trade in goods and services as well as on the ‘capital account’ (especially when it comes to non residents). Any restriction on bringing in and repatriating foreign capital will make the external investors reluctant to bring in this money. And reliance on large inflows of borrowed capital on a continuous basis is not sustainable. It enlarges these imbalances overtime, creating conditions for external payment crises. The threat of such crises forces countries like Pakistan to opt for a monetary policy instrument, a higher interest rate, to tackle external crises, an intervention more likely to fail.