The Developing Economic Scenario

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State Bank of Pakistan reduced the Discount Rate by 50 basis points in its last monetary policy announcement, and is expected to further reduce it in the upcoming monetary policy statement on October 8. We analyze the impact of this policy on the economy. One of the key reasons that Pakistan's economic growth rate has declined considerably over the last 3 years, to about 2%-3% per annum, is high interest rates primarily due to excessive government borrowing. High interest rates have increased the cost of doing business in the country, and have discouraged businesses from going into expansion. From this perspective, reduction in interest rates will give a relief to the business community and will promote investments.

Interest rate reduction will have negative implications for the Pakistan economy IF it is not supported by a reduction in inflation. The main culprit is not interest rates but inflation. If inflation remains high and interest rates are brought down there is a risk of selling pressure on the rupee as investors may convert from the rupee to other currencies, resulting in flight of capital. This is because high inflation has to be offset by devaluation of the rupee versus other currencies. Otherwise our exports will become expensive and imports will become cheaper, resulting in trade and current account deficits widening to unmanageable levels. The international Purchasing Power Parity theory states that a country should devalue its currency based on the inflation differential with its trading partners. For example, if inflation in Country A is 10% per annum, and inflation in Country B is 4% per annum, then Country A should devalue its currency by 6% versus currency of Country B. Otherwise, exports of country A will become expensive, imports will become cheaper, and its trade deficit will increase vis-à-vis country B. Country A can put off devaluation for some time, but the longer it puts off devaluation the higher the trade and current deficits, and risks to its economy. This is what Pakistan experienced when it did not devalue its currency for about 4 years from 2003-2007 period, resulting in the trade deficit ballooning to US$ 17 billion in CY2008, and reserves dropping by US$ 5 billion in the same period, forcing the government to devalue the rupee by a massive 28% in 2008.

It is essential that interest rates are only brought down when inflation is contained at a lower level for a long period. In order to bring down inflation, it is required that the Government broadens its tax base by taxing all sources of income including agriculture and real estate, controls its non-productive spending, abstains from printing of money, and avoids imposing further indirect taxes. If this strategy is not followed, inflation may rise substantially within a year, and the State Bank will be forced to increase the interest rates again. One factor that may help contain inflation is that international commodity and oil prices may not rise substantially in the near future due to a slowdown in global economic growth rate, led by the weakening of the United States and European economies.

To summarize, the economy and the stock market are expected to respond positively to the decline in the discount rate by the State Bank. However, this decline is only sustainable if it is backed by other steps on the fiscal side such as limiting the government borrowing and printing of currency. Otherwise we will be risking flight of capital and rise of interest rates within a year.