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Quid Pro Quo

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Irrational Exuberance

Controversy-

With headline inflation sliding to 7.89% in November, are inflation gremlins a thing of the past?

Contention-

High base effect and aid dollars indicate that low November inflation was a one-off event, and unlikely to be replicated soon.

Market impact-

Earthquake dollars pose potent economic challenges. To achieve the inflation target, aid dollars would have to be sterilized, worsening the twin deficits, and increasing the public debt. Meanwhile, any appreciation of the exchange rate would also risk contraction of the Dutch Disease and further worsening of the current account.

Risk-

Our analysis assumes that sizeable aid inflows and subsequent reconstruction activities will begin this fiscal year. If the efforts are delayed until next fiscal year, the corresponding macro-economic challenges shall also be postponed.

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November inflation- Cause for Concern

November headline inflation of 7.89% took many of us by surprise. To the layman, it was a source of genuine optimism regarding the future of the economy. In better informed financial circles, it seemed to indicate justification of a gradual shift in the tight monetary policy stance.

The purpose of this article is not to propose or reject any conspiracy theories in that regard. What we argue here is that the trend of falling CPI numbers is unlikely to be replicated anytime soon. Our contention is based on two separate sets of factors. The first one being that November inflation figures were distorted due to a high base effect. The second argument revolves around the inflationary impact of eagerly awaited earthquake dollars.

The high base effect argument goes something like this; inflation in November 2004 was high compared to October and December of last year. This has two implications. The first is that headline inflation in November 2005 was significantly lower not due to a substantial slowdown in prices during the month {Month on Month (MoM) inflation was .76% } but owing to the high prices we experienced last November. Because we calculate inflation on a Year by Year (YoY) basis, sudden changes in the base (CPI index of the previous year) can often result in misleading inflation numbers. The second implication of the base effect is that going forward, particularly in December and January; it would be difficult to emulate November inflation figures.

The problem shall be most pronounced in this very month of December. Compared to November 2004 inflation of 9.26%, December 2004 inflation stood at a relatively benign 7.37%. The price level of the CPI basket actually fell in Dec 04 from the levels of November 04. We did the required number crunching (calculations are shown in Appendix I) and came up with a few stylized facts. Even if MoM inflation



is zero in December 05, inflation would be 8.81%. Moreover, the zero MoM inflation assumption is optimistic at best. A more realistic MoM inflation of .5% would result in December 05 inflation figure of 9.32%. Interestingly, these would be the last inflation figures announced before the monetary policy statement for January-July FY06. Food for thought indeed! Those who were expecting a reversal in monetary policy in the New Year would be well advised to think again!!


Earthquake dollars: Invisible strings

The base effect argument holds implications for the possible path of the monetary policy statement for January-June FY06. However, it is worth remembering that the high levels of the CPI index in the February- May period of last fiscal year will actually help in achieving the inflation target of 8% in the latter part of this fiscal year. The inflation problems were most severe in March and April of FY 05. Correspondingly, all else equal, this would imply that we should witness low levels of inflation in March and April of FY06. All else is however, not equal. The inflow of earthquake dollars and initiation of reconstruction activities threaten to destabilize the macro-economic status quo.

We feel excessive emphasis has been placed on the possible impact of the earthquake on economic growth targets. Dissatisfaction has also been voiced at the majority of aid being in the form of loans. In our view, that was necessary to avoid running into problems of moral hazard, a potential risk when undertaking a task of such colossal magnitude.

The more pertinent issue is to examine how the aid flows might affect key macro-economic variables such the exchange rate, the twin deficits, and inflation. The finance ministry (MoF) is of the view that the aid funds will not significantly affect inflation in the economy, and thus, there should be minimal or no effect on the






monetary policy stance due to these aid proceeds. However, we felt the need to understand how exactly our economy would accommodate such a substantial inflow of foreign exchange. Surely it should show up somewhere, in the form of a rising fiscal deficit, a greater trade imbalance, an appreciating exchange rate or a rise in reserve money. As they say, in economics there is no such thing as a free lunch!!

According to standard economic literature, the government has four possible options in utilizing the foreign funds. We shall go through each of them, outlining their theoretical attractiveness and drawbacks, while also examining their feasibility in the present Pakistani context. A diagrammatical representation of the various scenarios is presented in Appendix II.

Scenario I- Import the Reconstruction

The first option is for the government to use the aid inflow solely and wholly to import all the ingredients required in the reconstruction project, while injecting no money into the local economy. This would result in concurrently higher fiscal and current account deficits, but key macro-economic variables such as inflation, interest rates, and the exchange rate will remain unchanged. Infact this is the textbook technique; the first best way to appropriate aid inflows by a government. A real transfer of resources occurs from abroad and the domestic equilibrium is not affected. However, it might not always be practical to undertake this option.

In Pakistan's case, the twin deficits are already out of the comfort zone. Adding aid dollars could well take the fiscal deficit upto 5% of GDP, and the current account gap in excess of 6% of GDP; levels that would be both politically and economically untenable. Moreover, importing inputs such as cement and labor in the large quantities required for earthquake reconstruction is not even a physical possibility.



The above scenario also does not allow accumulating the aid dollars in the foreign currency coffers. With declining exchange reserves (import coverage of 5 months and decreasing), it might be very tempting for the government to prop up their greenback stock with some of the aid inflow. This can be done in two ways...

Scenario II- Stash the dollars with the SBP

The first one is to not spend the aid money and just add it to the reserves of the central bank. Some African countries with low forex reserves, such as Ghana and Ethiopia, have been known to do this in the past. This option is attractive for the reason that it helps mitigate depreciation pressure on the country's currency. It might also be desirable in a high inflation environment, as the aid does not become available to finance increased domestic spending. By not augmenting domestic liquidity, the aid flows do not add to inflation pressures. The funds can be released sometime in the future, in a more favorable macro-economic environment. For Pakistan, however, in the present context, this option is not feasible. The very nature of the funds (being for earthquake reconstruction and rehabilitation) necessitates prompt usage. A solution could be to divert resources to the earthquake relief cause from alternative domestic uses. However, the government of Pakistan is unwilling to divert funds from the Public Sector Development Fund (PSDF), for well-founded fear of derailing the growth momentum.

Scenario III- Save the buck, spend the rupee...

A viable option should stabilize exchange reserves and simultaneously allow domestic spending of the aid by the government. Our third option allows for that possibility. Using this strategy, the government could transfer the earthquake dollars to the central bank and instruct it to print money in exchange. The money would then be used by the government on domestic goods and services, as the govt increases its fiscal deficit. This response is analogous to a fiscal stimulus in the absence of aid.



However, such an increase in the money supply can fuel inflationary pressures in the economy. If inflation is low, such an increase in money supply may be easily accommodated. In our present context, it would be counterproductive to allow the money supply to increase and feed sustained higher core inflation. The solution to this problem is Treasury bill sterilization. By selling treasury bills, the SBP can eliminate the excess liquidity that it injected into the system initially. However, the basic law of supply dictates that to induce greater supply, a higher price needs to be paid. In this case, to induce greater supply of loans from the public to the central bank, the SBP will have to raise cut-off yields. Historically, episodes of sterilization have been accompanied by rising interest rates. Raising interest rates may or may not be in consonance with the existing monetary policy. The apparent reluctance of the State Bank to raise cut-off yields recently indicates that sterilization could result in a potential conflict of interest between fiscal and monetary policies and a mounting burden of public debt.

Scenario IV- Sweet dreams....

In theory, a fourth and final option also exists. The central bank could sell aid dollars to the public, and in turn, draw out liquidity from the domestic market. There is no increase in the government expenditure – a lid is kept on the fiscal deficit. This is a perfect recipe to “cool down” an overheating economy like Pakistan’s; a complementary mechanism, along with Open Market Operations, to conduct a tight monetary policy. Infact, the government can substitute aid for domestic financing of the fiscal deficit. The aid dollars would end up with the public, who can then import the necessary raw materials. However, even in the current craze of privatization, the nature and magnitude of the reconstruction project dictates that it cannot be left to the free market. The private sector should have a role, but it can only be complementary and supportive. Despite obvious temptations, one cannot advocate economic wisdom at the expense of social and political suicide!!






Given the constraints, what can one realistically expect the government of Pakistan to do? Scenario II and IV are ruled due to their restriction on the use of funds by the government. The first option of completely “importing the reconstruction”, while being theoretically attractive, is not practical in the face of burgeoning fiscal and current account deficits. Moreover, given the nature of work and the tight regional cement demand-supply situation, a whole-hearted implementation cannot be reasonably expected. That being the case, economics dictates that the next best alternative is to forego the aid totally!! However, for those whose sensitive toes I may have stepped on, I hasten to admit that economics is not the only consideration in the realm of policy-making.

History suggests that ground reality shall pan out to be a combination of Scenario I and III. To the extent the government can economically and physically afford to, it shall import the raw materials for reconstruction and rehabilitation. Materials such as iron, steel, cables, glass, and fuel, which are already short in domestic supply, will be imported. The bulk of the funds, however, would have to be injected into the economy for buying domestic raw materials and labor.

Of Cement and CPI

This is where the potential source for both cost-push and demand-pull inflation lies. Demand-pull inflation is easy enough to understand. With liquidity being injected into the economy, it is the same old story of more money chasing the same amount of goods. However, the experience of the Tsunami dictates that the more potent threat is from cost pressures. The typical case would be cost increases in the construction industries due to increased demand for construction inputs. The two most major inputs that threaten to come under pricing pressure are cement and labor. For the inflationary scenario, this is far from good news. Cement prices have irked the





government for some time, and the additional demand now makes a strong case for a sustained high price. One source of comfort is that cement manufacturers are coming online with additional supply. However, before all of the additional capacity comes online, a short-term rise in cement prices continues to threaten. Additional labor demand may also trigger a wage-price spiral once the reconstruction starts in earnest.

What are the implications for the inflation target of 8% for FY06? Our calculations indicate that inflation would have to be contained to an average Month on Month (MoM) level of .5% from December onwards for the 8% target to be met. The assumed .5% MoM inflation is below the current fiscal year average of .77% - however, with stable oil prices and declining food inflation, it is not unreasonable to assume.

However, earthquake-injected liquidity threatens to destabilize the potential equilibrium. It is safe to assume, given the SBP's keenness to fight inflation, that aid spending will be accompanied by some degree of Treasury bill sterilization. If T-bill yields stay at their current levels, attempting sterilization would exert an upward pressure on the discount rate. The recent reluctance of the central bank in raising the interest rates indicates that sterilization might be preceded by a slight dip in cut-off yields.

Meanwhile, earthquake dollars and the high base effect indicate that the decrease in November CPI figures is nothing more than a flash in the pan. To declare victory would be not only be premature, but unwarranted. The central bank had thrown the market off balance by rejecting 3 and 6 month T-bill bids in the previous auction. Second-guessing the central bank is not an easy task, even at the best of times. In uncertain times, with a new governor at the helm, people wondered; could the new governor be signaling a policy reversal? We do not pretend to know the method to that madness. To our mind, more than anything else, it sought to eliminate any lingering expectations of an interest rate hike. If any reduction in short-term interest rates does occur, it promises to be temporary and insignificant in nature. The inflation



horizon is not yet clear and the October earthquake in Muzzafarabad and Balakot may form the thrust of continued monetary contraction well into the New Year.

In summary, we foresee profound implications for our economy. The government cannot prevent fiscal and external account hemorrhaging if it wants to keep inflation in check. A given aid dollar should either be used to build up reserves or increase the fiscal deficit but not both. By attempting to do both, the government of Pakistan is certain to compromise on important long-term macroeconomic targets. The irony in our case is that the compromise seems not only inevitable, but unavoidable.



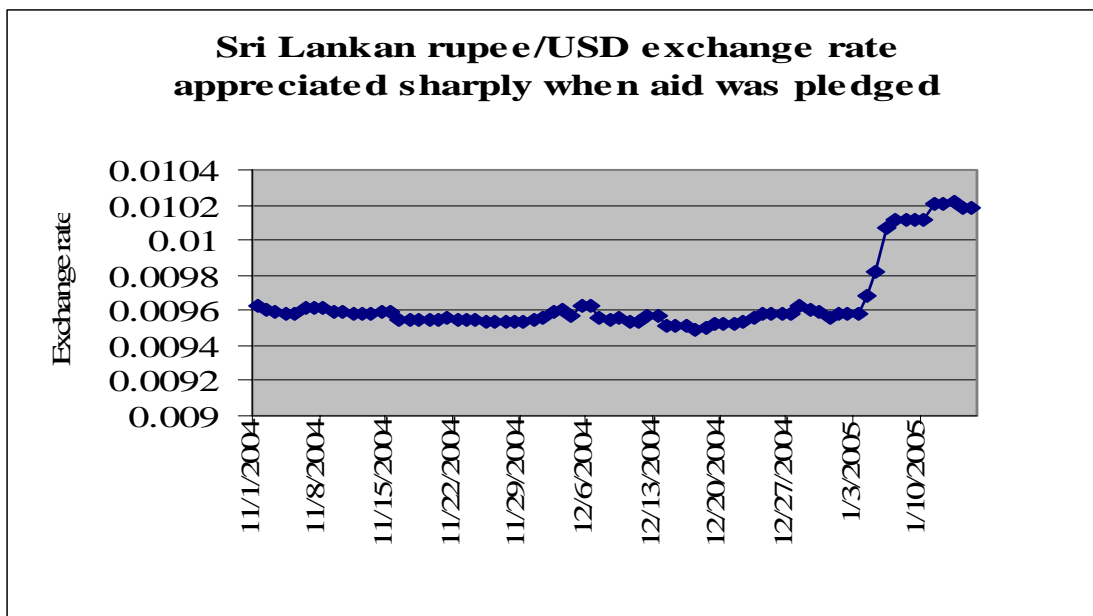
Dutch Disease- Do we risk contracting it at the worst possible time?


Definition-

The diversion of a nation's resources from the traded goods to the non-traded goods sector that occurs when an extraordinary event raises the value of that nation's currency, making manufactured goods less competitive with other nations, thereby increasing imports and decreasing exports. The term originated in Holland after the discovery of North Sea gas, leading to a windfall gain in export revenue. The currency appreciated sharply, leading to a contraction of local industry.

The case of Tsunami-hit Sri Lanka is certainly an ominous precedent - where the pledged aid had a tangible and immediate impact on the Sri Lankan community. The most visible sign of this euphoric mood was witnessed in the country's foreign exchange markets. The Sri Lankan rupee reversed its long and sustained depreciation and appreciated sharply.

This trend can be seen in the figure below, which shows that the Sri Lankan rupee appreciated by 7% in just two weeks. Eventually, the central bank intervened to prevent further appreciation of their exchange parity.






Our case is analogous in many respects- the similarity of the natural disaster, the substantial pledges of aid, and the falling exchange reserves prior to the disaster. However, despite USD 6.2 billion being pledged by the international donors, we cannot accuse ourselves of being similarly euphoric at the prospect of the international aid. The donor conference has unpopularly been dubbed the “lender’s conference.” That in itself is a blessing in disguise. It means that expectations of currency appreciation are not in place, and we are witnessing a classic case of “less is more.”

However, with sizeable aid flows set to pour in, one thing seems clear. Even if the rupee-dollar parity does not appreciate considerably, the current scenario of falling foreign reserves and depreciation pressure on the rupee is expected to reverse in the coming months. Does Pakistan run the risk of contracting the Dutch Disease, albeit in a mild form?

Let’s examine how this can happen. Our ballooning current account deficit indicates that the rupee-dollar parity will remain under depreciation pressure. Running down of foreign reserves is indicative of the SBP’s willingness to postpone this exchange rate depreciation till inflationary pressures have reduced. However, with current exchange reserves standing at a mere five months of imports, the cushioning of the exchange rate could not be expected to continue for any length of time. Ironically, the earthquake which “rocked” the northern areas of Pakistan and Azad Kashmir is expected to provide a measure of “stability” to the parity. However, in this case, stability might not be a desirable end. Here is why...

Economists have long been of the view that exchange rate depreciation is needed to correct our external imbalances (trade deficits). This would render our exports more competitive and imports would correspondingly become more expensive, and thus, less attractive. The trade balance would, in turn, be lowered. It is widely expected that once inflationary pressures subsided, the central bank will allow the currency to depreciate in an effort to rein in the external account. Aid inflows now promise to keep our currency



artificially strong for some time to come. This is bad news for exporters. Domestic inflation being higher than global inflation, and an artificially stable exchange rate, were already harming their global competitiveness. It meant, in effect, an appreciating real exchange rate. The prospect of continued appreciation in the real exchange rate now beckons. And with the earthquake reconstruction and rehabilitation program promising significant job creation, contraction of the Dutch disease is a real threat. Resources could move out of the less competitive export sector into the production of houses, roads, raw materials and infrastructure in the quake hit areas. Of course, the government could intervene to minimize any appreciation of the rupee. However, that would entail an increase in the money supply. At a time when inflation continues to threaten, the trade deficit touching new peaks and the Millennium Development Program 2005 stressing export led growth as top priority; the government faces a tough balancing act in the judicious use of eagerly awaited foreign funds.

Appendix I

FY04-05		
	CPI Index	CPI inflation
	<i>FY04-05</i>	<i>MoM</i>
Jul-04	117.56	1.38
Aug-04	118.24	0.58
Sep-04	118.69	0.38
Oct-04	120.1	1.19
Nov-04	121.44	1.12
Dec-04	120.41	-0.85
Jan-05	121.58	0.97
Feb-05	122.78	0.99
Mar-05	124.37	1.29
Apr-05	126.53	1.74
May-05	125.97	-0.44
Jun-05	126.09	0.10

FY05-06			
Assuming Month on Month inflation to be zero from December 05 to June 06			
	CPI Inflation	CPI index	CPI Inflation
	<i>MoM</i>	<i>FY05-06</i>	<i>YoY</i>
Jul-05	1.62	128.13	8.99
Aug-05	0.04	128.18	8.41
Sep-05	0.50	128.82	8.53
Oct-05	0.94	130.03	8.27
Nov-05	0.76	131.02	7.89
Dec-05	0.00	131.02	8.81
Jan-06	0.00	131.02	7.77
Feb-06	0.00	131.02	6.71
Mar-06	0.00	131.02	5.35
Apr-06	0.00	131.02	3.55
May-06	0.00	131.02	4.01
Jun-06	0.00	131.02	3.91

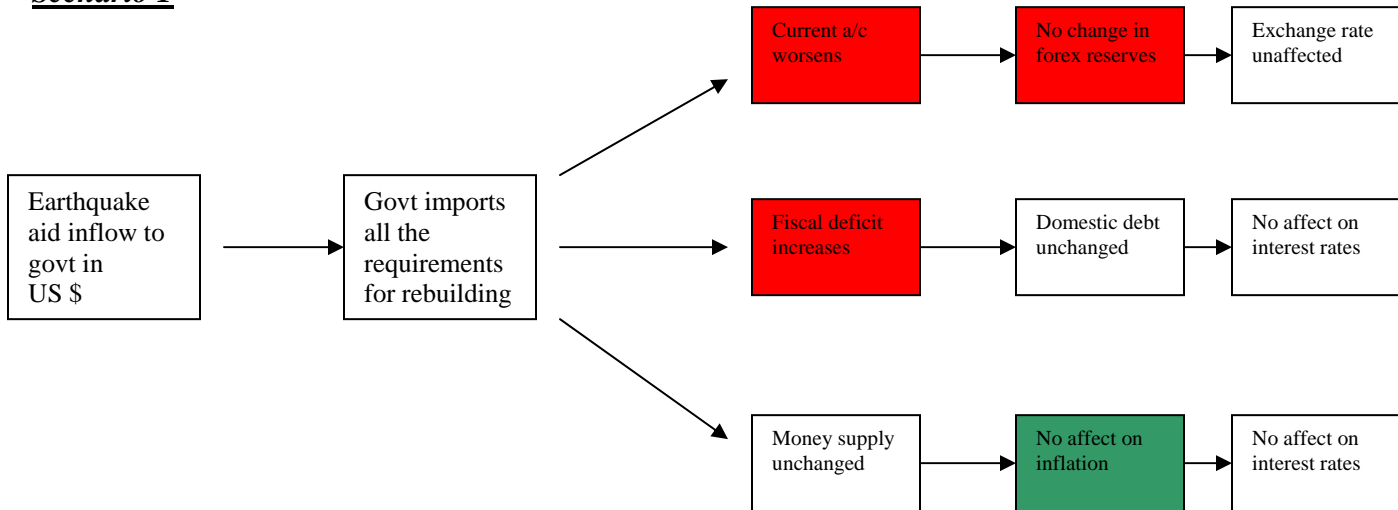
FY05-06			
Assuming Month on Month inflation be be .5% from December 05 to June 06			
	CPI FY05-06	CPI index	CPI Inflation
	<i>MoM</i>	<i>FY05-06 (projected)</i>	<i>YoY</i>
Jul-05	1.62	128.13	8.99
Aug-05	0.04	128.18	8.41
Sep-05	0.50	128.82	8.53
Oct-05	0.94	130.03	8.27
Nov-05	0.76	131.02	7.89
Dec-05	0.5	131.63	9.32
Jan-06	0.5	132.24	8.77
Feb-06	0.5	132.86	8.21
Mar-06	0.5	133.48	7.32
Apr-06	0.5	134.10	5.98
May-06	0.5	134.72	6.95
Jun-06	0.5	135.35	7.34
FY05-06 inflation	8.00		



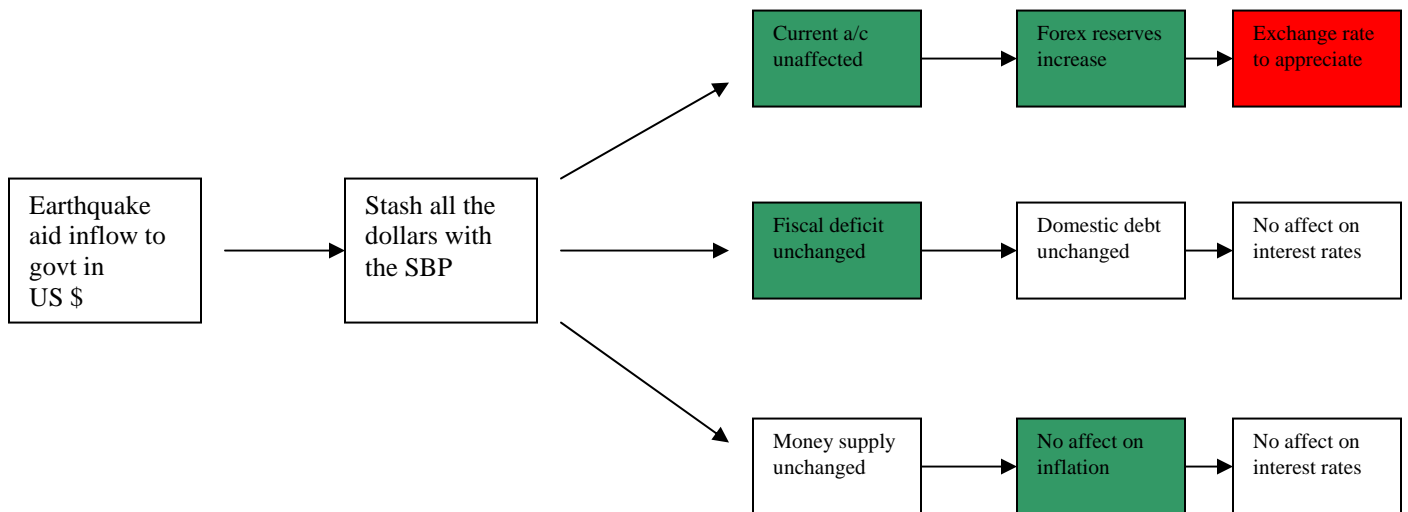
Appendix II

Key: ■ Negative for economy ■ Positive for economy

Scenario 1

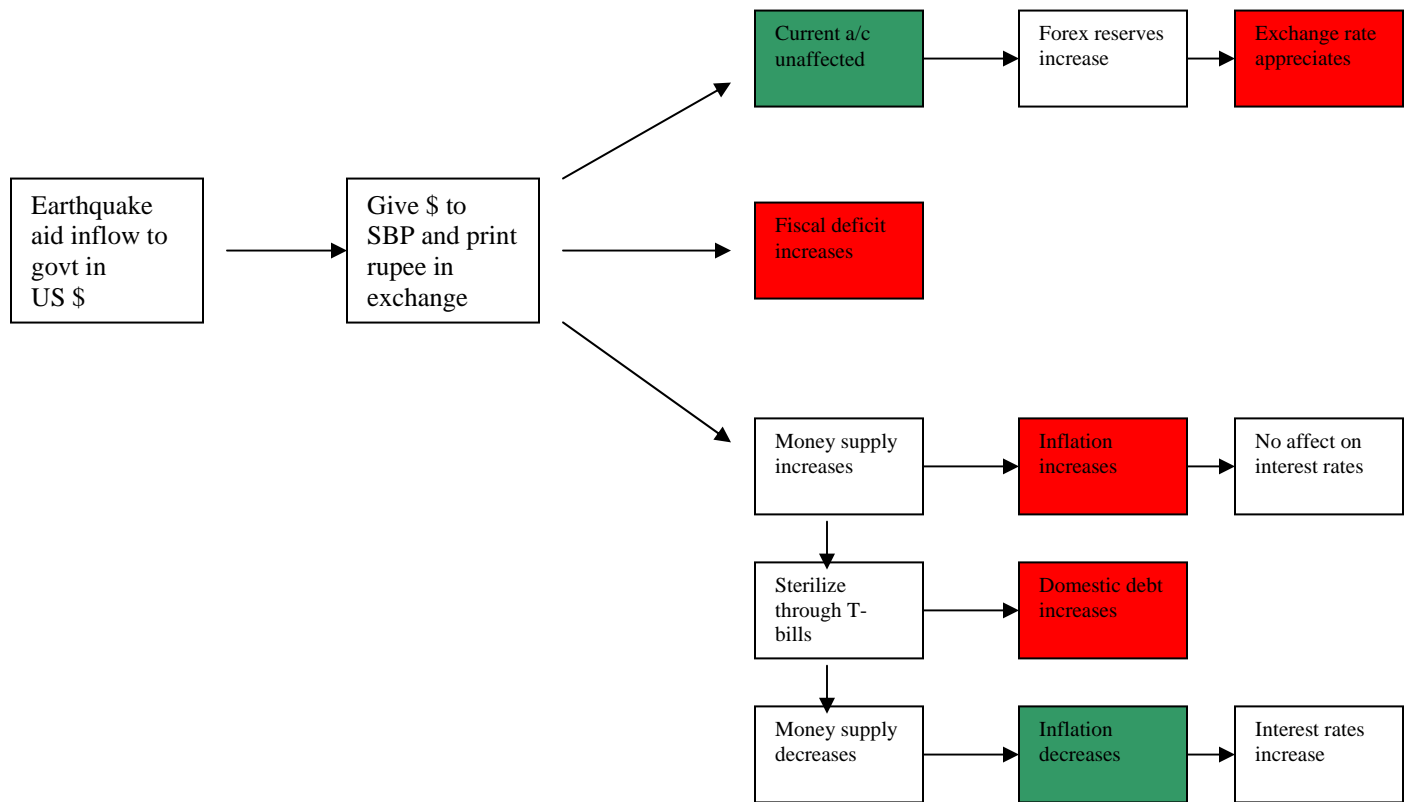


Scenario 2

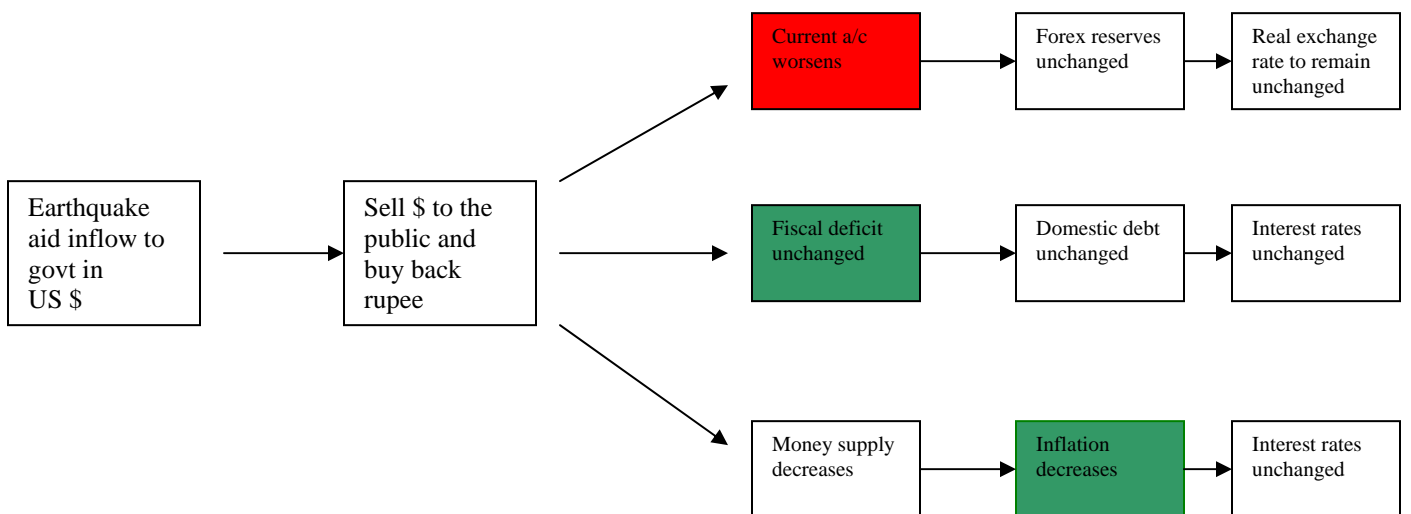




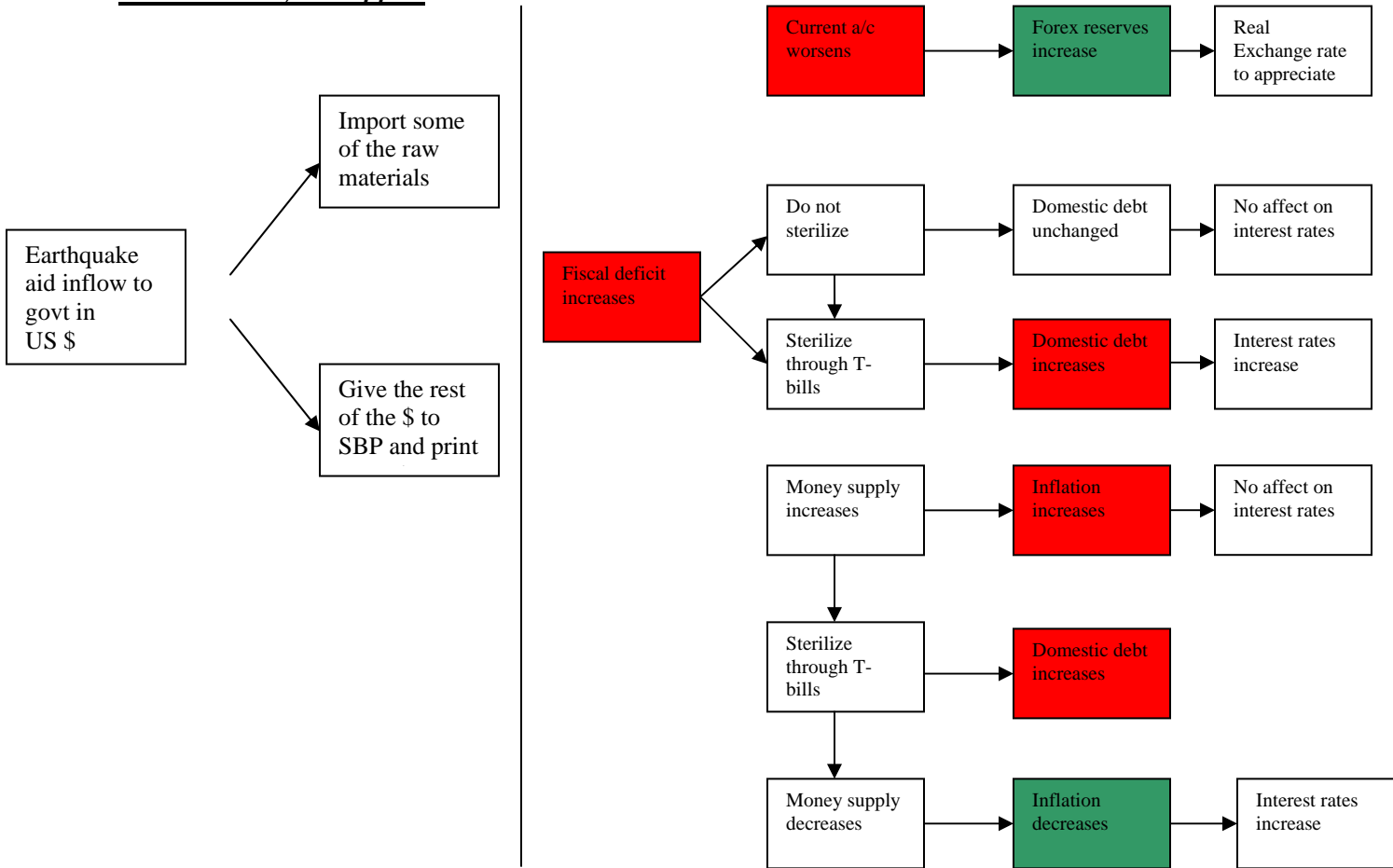
Scenario 3



Scenario 4



What is Likely to happen



Economic Snapshot

Fiscal year 06							
	Units	July	Aug	Sep	Oct	Nov	July- Nov
<u>Inflation</u>							
Headline Inflation	%	8.99	8.41	8.53	8.27	7.89	8.4
Core inflation	%	7.62	7.55	7.58	7.81	7.59	7.6
Food inflation	%	9.73	7.82	7.52	6.41	5.84	7.5
Non-food inflation	%	8.47	8.83	8.25	9.61	9.38	8.9
<u>T-bill</u>							
3 month	%	7.69	7.99	8.1	8.1	bid rejected	n/a
6 month	%	7.97	8.12	8.14	8.14	bid rejected	n/a
12 month	%	8.69	8.78	8.79	8.77	8.79	n/a
<u>External Sector</u>							
Export	million US \$	1272	1408	1499	1329	1120	5508
Import	million US \$	1997	2235	2322	2328	2300	8882
Trade balance	million US \$	-725	-827	-823	-999	-1180	-3374
Remittances	million US \$	313.14	348.41	341.1	372.5	308.81	1375.15
Total Foreign Investment	million US \$	129.5	161.4	182.8	208.3	n.a	682
Forex reserves	million US \$	12613.2	12124	12000	11715	11321	n/a
<u>Key</u>							
n.a		Not available					
n/a		Not applicable					



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