6

16th International Conference on Management of Pakistan's Economy Monetary Policy in the time of Corona: Lessons from Pakistan*

Murtaza Syed and Naved Hamid*****

Abstract

The paper examines the performance of Pakistan's monetary policy during the COVID-19 pandemic (2020-2022), a period that ended with a serious balance-of-payments crisis, precipitous decline in foreign exchange reserves and soaring inflation. The initial policy response to the COVID-19 pandemic, well-coordinated fiscal and monetary policy, proved relatively favorable for Pakistan's economic performance. However, by end-FY2022 the country was in deepening economic distress because monetary policy effectiveness was undermined by internal and external shocks, namely the Russia-Ukraine War and internal political turmoil, and the situation was exacerbated by unplanned fiscal expansion and unwarranted delays in IMF program. In this context, the paper discusses possible explanations for Pakistan's economic crisis, evaluates the role of monetary policy in this crisis, and offers recommendations for future policymakers. It concludes that even if monetary policy had been tightened earlier and more aggressively, and the unconventional stimulus injected into the economy had been smaller, it is doubtful that SBP could have single-handedly prevented the economic crisis. The main lessons that are derived for policy makers are that there is a need for significantly better real-time economic data to counter the increasing complexity of the challenges posed; SBP should maintain a healthy degree of skepticism and caution regarding fiscal projections by the Ministry of Finance, especially during times of political stress such as the national elections; SBP must recognize that the

* The authors would like to acknowledge the most valuable comments and feedback on the paper received from Ali Choudhary, professor of Economics and Public Policy, Loughborough Business School. However, the views expressed in this paper are entirely those of the authors.
** Murtaza Syed is currently the head of Ecosystem, Asian Infrastructure Investment Bank; served as the governor, SBP of Pakistan, during the COVID-19 period.
*** Naved Hamid is a professor at the Faculty of Economics and Director, Center for Research in Economics and Business at the Lahore School of Economics; served as a member of the Monetary Policy Committee for SBP during the Covid-19 period.

exchange rate can be extremely volatile when international reserves fall below a certain minimum level, which can impact domestic inflation significantly, and it should be extremely conservative in its assessment of expected capital inflows; and finally, it should be aware that supply shocks can evolve into more persistent issues, especially if they are recurrent and prolonged.

Introduction

This paper assesses the performance of Pakistan's monetary policy during the COVID-19 pandemic (2020-2022). Upon conclusion of the period under review, Pakistan was confronted with a severe balance-of-payments crisis, coupled with the highest inflation rate in 50 years, alongside the depletion of foreign reserves to near-zero levels, all indicating a period of economic failure. Therefore, it could be argued that the performance of the State Bank of Pakistan (SBP) deserves an "F".

However, the reality is more complex. Monetary policy faced unprecedented challenges: multiple waves of the COVID-19 pandemic, a commodity super-cycle triggered by the Russia-Ukraine war, and Pakistan's worst political turmoil since 1971. These external shocks, coupled with poor fiscal management, explain why Pakistan has ended up where it presently finds itself. In this context, monetary policy is just one part of a larger problem.

This paper offers a practitioner's perspective on the macroeconomic developments during the first three years of the COVID-19 pandemic. Arguing that Pakistan initially managed the COVID-19 pandemic well compared to other countries, with a supportive monetary policy contributing to declining inflation and a cautious fiscal policy due to high debt. However, within a year, a balance of payments crisis emerged. We therefore ask three main questions.

1) What went wrong and how did Pakistan end up in its current economic predicament?
2) How did monetary policy contribute to the current situation?
3) Finally, what lessons can be drawn from this experience for improved monetary policy decisions during economic shocks in the future?

A Brief Recap of the COVID-19 Shock and the Policy Response

Let us begin with an overview of the COVID-19 pandemic period. In response to the unprecedented COVID-19 shock, the macroeconomic policy response was well-coordinated in fiscal years (FY) 2020 and 2021. Monetary policy was aggressively eased as inflation and the current account deficit declined sharply, while fiscal policy focused on consolidation due to high public debt levels.

Figure 1a (see Appendix) illustrates a pronounced decline in the current account deficit following the onset of the COVID-19 pandemic in April 2020. Notably, a surplus was recorded in the third quarter (July to September 2020) due to a drop in commodity prices. A dramatic drop in inflation is also observed simultaneously, explained by the decline in growth and plummeting commodity prices. This allowed for a policy rate cut, which was brought down from 13.25% to 7%, in a short duration of three months, making it SBP's initial response to the COVID-19 shock.

Figure 1b (see Appendix) also illustrates a well-coordinated fiscal and monetary policy response. A declining primary deficit is observed during FY2020 and 2021, indicating fiscal consolidation. This fiscal consolidation, coupled with an easing monetary policy, depicted in the declining interest rates provided the economy the support it needed in the aftermath of COVID-19 shock.

SBP also eased several regulations and refinancing facilities to bolster faltering growth during the COVID-19 pandemic. These unconventional monetary policy measures, similar to those adopted by other central banks globally, post-COVID-19, aimed to support the economy. One of these notable SBP measures currently garnering significant attention, is the Temporary Economic Refinance Facility (TERF). This facility offered refinancing to investors committed to establishing factories in Pakistan, which resulted in injecting approximately 1% of GDP into the economy. TERF has been controversial due to concerns that short-term measures alone were insufficient to address the COVID-19 shock, since its complete impact would materialize in the medium to long term. Further controversy arose from the perception that TERF contributed to the recent surge in imports. We revisit this later in the paper, but what is imperative to note is that SBP's response involved more than just interest rate cuts (see Figure 2, Appendix). To counter the COVID-19 shock, SBP injected approximately 5% of GDP into the economy through various monetary stimulus measures.

This initial phase of the COVID-19 pandemic was characterized by a positive trajectory for Pakistan's economy. Commendable containment measures by the health authorities coupled with effective macroeconomic policies, resulted in a relatively modest contraction of approximately 1% of GDP in 2020 (see Figure 3a, Appendix), compared to other countries. Subsequently, Pakistan demonstrated remarkable resilience, showing a robust economic recovery in 2021, as depicted in Figure 3b (see Appendix).

Another positive development observed was the strengthening of Pakistan's international reserves, traditionally a point of vulnerability. As illustrated in Figure 4 (see Appendix), gross international reserves surged from approximately US$5 billion to US$15 billion between June 2019 and June 2021. This improvement is even more pronounced when considering the simultaneous decline in forward liabilities. Consequently, net reserve buffers shifted from a negative position in June 2019 to a positive one in June 2021, signifying a dramatic improvement in the external position.

Pakistan also deserves commendation for reducing its government debt-to-GDP ratio by over 5% between 2019 and 2022 through fiscal consolidation. This stands in contrast to the debt accumulation experienced by most countries, both developed and developing, whose debt levels surged between 5% and 25% of GDP, post-COVID-19. (see Figure 5, Appendix).

The COVID-19 pandemic presented an unprecedented challenge with multiple waves. Consequently, SBP had to unwind its loose monetary policy stance, commencing this process in September 2021 (FY2022). Compared to other countries, SBP's policy tightening was relatively swift (see Figure 6, Appendix). While a few countries like Brazil initiated tightening earlier (March 2021), most followed suit later (for example, Egypt in March 2022 and India in May 2022). However, the emergence of unforeseen international and shocks, including the Ukraine War, new COVID-19 variants, and internal political instability, complicated the pace and timing of Pakistan's monetary tightening due to their complex implications for growth and inflation.

The preceding analysis provides a context for Pakistan's initial two years of the COVID-19 pandemic, a period marked by commendable performance. However, the current economic landscape presents a different picture. Like many other countries, Pakistan has overshot its inflation target significantly. Figure 7a (see Appendix) illustrates that all advanced economies and approximately 87% of emerging economies, including Pakistan (see Figure 7b, Appendix), exceeded their inflation targets in 2022. Specifically, Pakistan's inflation rate surpassed the midpoint of its 5%-7% target range by 6%.

To provide context, we briefly examine SBP's historical inflation forecasting performance. Figure 8 (see Appendix) shows that SBP's inflation forecasts have generally been accurate, with realized inflation (green line) aligning closely with the forecasted range (red dots and blue area) for most years, including the initial COVID-19 period (FY2021). However, a significant divergence emerged in FY2022, with realized inflation of 12% exceeding the forecasted range of 7%-9%. This trend persisted in FY2023.

While the past two years might be considered outliers, given SBP’s strong inflation forecast record five years prior, it is essential to question whether structural changes occurred in FY2022 which directly impacted inflation. One potential explanation could be the discontinuity in the link between international reserves, the exchange rate and inflation. As Pirzada (2024) argued in his paper at this conference, during financial crises, a sharp increase in both current and expected future default risk becomes a primary driver of inflation. This sudden increase in default risk can undermine the forecasting performance of existing models and weaken the channels through which monetary policy affects the economy.

We now return to our earlier question: Where does Pakistan stand today. Pakistan's current account deficit surged to 4.5% of GDP in FY2022 (see Figure 9a, Appendix). As this deficit widened, Pakistan's foreign exchange reserves plummeted from an all-time high of approximately US$20 billion, in September 2021 (see Figure 9b, Appendix). In summary, the high inflation, expanding current account deficit, and depleted foreign exchange reserves of FY2022 marked a disappointing end to a previously promising two-year period.

What Went Wrong?

In this section, we explore potential explanations for the economic challenges faced in FY2022 through the lens of five theories. It is important to note that these theories may not be mutually exclusive, and the actual situation likely resulted from a combination of factors. Nevertheless, examining each theory individually provides valuable insights into what transpired.

The first potential explanation hints at the possibility that we underestimated the strength of the global rebound from COVID-19 in FY2021 and FY2022, like the rest of the world. Figure 10a (see Appendix) illustrates the global growth forecast performance for 2020, 2021 and 2022 by International Monetary Fund (IMF). In both 2021 and 2022, IMF underpredicted growth, which proved to be significantly stronger, especially in 2021. A similar pattern is observed in international commodity prices including non-fuel commodities and crude oil prices (see Figure 10b, Appendix), where we see actual levels in 2021 and 2022 far exceeded IMF projections. Clearly, the global economic rebound and surge in commodity prices was surprising, leading to unexpected global inflationary pressures, which in turn exacerbated Pakistan's current account deficit. It is imperative to note here that Pakistan's current account deficit is highly sensitive to global commodity prices and GDP growth, particularly when growth surpasses the 4%-5% range.

The second potential explanation introduces some internal factors to complement the external factors discussed above. Both the government and SBP misjudged growth forecasts in Pakistan, as shown in Figure 11 (see Appendix). Figure 11 compares forecasted and actual growth rates for FY2021 and 2022, revealing underestimations in both years. Consequently, the output gap was significantly smaller than SBP predictions during the Monetary Policy Committee (MPC) meetings. While the unprecedented COVID-19 shock contributed to this miscalculation, fiscal policy decisions also played a pivotal role. In FY2022, the budget projected another year of a relatively low primary deficit. However, the actual primary deficit was nearly four times larger than planned (see Figure 12, Appendix). Consequently, a significant reason for the inaccurate growth forecasts was that fiscal policy proved to be far more expansionary than the budget indicated.

The third potential explanation is that imported inflation significantly contributes to Pakistan's overall inflation, and the rupee's depreciation far exceeded SBP's projections based on exchange rate valuation models and inflation differentials with trading partners. Typically, in the absence of major misevaluations, the exchange rate should align with a country's inflation differential relative to its trading partners, maintaining a relatively stable real effective exchange rate. However, in FY2022, the rupee depreciated dramatically by approximately 29%—while inflation stood at 12% (see Figure 13, Appendix). This depreciation primarily stemmed from severe uncertainty caused by unforeseen delays in IMF program review and political instability in Pakistan (see Figure 14, Appendix).

Consequently, anticipated capital inflows failed to materialize, and speculative or precautionary capital outflows likely occurred through the gray market. This intensified pressure on Pakistan's international reserves as external payments for current account deficits and debt servicing continued despite dwindling inflows. The sharp decline in reserves further impacted the exchange rate, contrary to SBP expectations. Furthermore, in contrast to the assumption of MPC, policymakers were unable to complete the IMF review in time. As a result, the exchange rate and reserves faced unprecedented pressure, subsequently fueling unforeseen inflationary pressures.

The fourth potential explanation is that, in addition to the excessive exchange rate depreciation, monetary conditions were also relaxed due to substantial stimulus injections into the economy through refinance facilities. The share of private sector credit through these refinancing facilities, surged during FY2020-22 (see Figure 15a, Appendix), as the government sought to stimulate an economy still reeling from severe COVID-19 shocks and a stressed private sector. We hypothesize that this contributed to looser monetary conditions, as shown in Figure 15b. While this stimulus might have been justified during a period of fiscal consolidation and a persisting global COVID-19 impact, it could have contributed inadvertently to overheating pressures when fiscal policy unexpectedly expanded in FY2022 (as shown in Figure 12, Appendix).

Finally, the fifth potential explanation is that SBP may have overemphasized the median of inflation expectations, a crucial anchor for monetary policy, while underestimating the dispersion or standard deviation of the distribution. While this is common practice among central banks, recent research advocates also considering the skewness of inflation expectations in response to unusual supply shocks. In Pakistan, the median indicated reasonably well-anchored inflation expectations throughout the COVID-19 period. However, a less observed dispersion surged in July 2022 and has persisted at a high level since (see Figure 16, Appendix). Retrospectively, greater attention to this dispersion might have signaled the need for swifter and more aggressive monetary tightening, as it suggested a potential transformation of the initial contained supply shock into a more complex issue.

What Role Did Monetary Policy Play?

In the previous section, we outlined some possible explanations for inflation overshooting the expected levels in the last two years.

This naturally leads to some questions regarding the culpability of monetary policy. First, could tightening monetary policy earlier and more aggressively have independently prevented this undesirable outcome. The decision was complicated by multiple waves of COVID-19, which posed risks to growth. What is clear, however, is that more front-loaded and aggressive monetary policy tightening would have lowered growth and increased unemployment. Overdoing it could have even precipitated a recession. Inflation would have been arguably lower, but the extent is uncertain, given the simultaneous fiscal expansion and unprecedented exchange rate depreciation due to political uncertainty and prolonged IMF review delays. The point is, while inflation might not have been as high, it is doubtful that SBP could have single-handedly prevented the economic crisis and achieved the inflation target solely through monetary policy tightening.

The second crucial question is: what if the unconventional stimulus of 5% of GDP injected into the economy by SBP had been smaller. The key point is that SBP was attempting to maintain a delicate balance amidst a highly uncertain shock and anticipated fiscal consolidation. Without that support, COVID-19 would have had a far more severe economic impact. However, it could also be argued that once it became apparent that COVID-19 was not affecting Pakistan's economy as severely as feared, perhaps the policy support should have been tapered off sooner.

In this context, the appropriate size, duration, and modalities of unconventional support in an economy like Pakistan deserve deeper exploration in future research. Should measures such as the TERF be repeated in the future? How should it be modified? What level of forward guidance about the future trajectory of monetary policy is suitable for a vulnerable emerging market like Pakistan? These are promising avenues for further discussion and research.

Conclusion: Potential Lessons for Future Monetary Policy Decision-Making

Where does this all lead us? We have argued that monetary and fiscal policies were well-coordinated in the two years following the unprecedented COVID-19 shock, combining monetary stimulus with fiscal consolidation. This helped mitigate the damage to growth and fiscal sustainability. However, the situation deteriorated in FY2022 as global commodity prices spiked following the Ukraine war and Pakistan's external accounts came under severe additional pressure due to unplanned fiscal expansion and unwarranted delays in IMF program. This unexpected impetus to inflation, resulting in economic overheating and significant exchange rate depreciation, caught SBP off guard. Nevertheless, it remains unclear whether tightening monetary policy earlier and more aggressively could have independently prevented this undesirable outcome. It is highly unlikely that the detrimental effects of fiscal imprudence, IMF program disruption, and political instability could have been reversed solely through monetary policy actions. Nonetheless, several technical and governance lessons can be derived from this episode to improve the effectiveness of monetary policy in Pakistan.

On the technical side, four main lessons can be derived for policy makers.

First, we require significantly better real-time economic data to counter the increasing complexity of the challenges posed. The miscalculation of the output gap by SBP can be explained by the absence of quarterly GDP estimates and inadequate demand indicators. Recent research initiatives by SBP such as "Measuring Economic Performance in Pakistan through Satellite and Big Data" provide findings and the required infrastructure to generate accurate and timely quarterly GDP estimates. Initiating and operationalizing such projects is imperative for improved and more informed monetary policy decision-making.

Second, SBP should consistently maintain a healthy degree of skepticism and caution regarding fiscal projections by the Ministry of Finance (MoF), distancing itself from the MoF, especially during times of political stress such as the national elections. SBP should create regular quarterly projections of likely fiscal outcomes, which could remain confidential but be utilized for discussions and decisions within the Monetary Policy Committee.

Third, Pakistan's recent experience has demonstrated that the exchange rate can be extremely volatile when international reserves fall below a certain minimum level, which, in turn can impact domestic inflation significantly. Therefore, monetary policy, primarily focused on inflation, must consider more than traditional demand management economic variables, and should incorporate exchange rate stability as a key intermediate objective. To achieve this, SBP must meticulously evaluate external forecasts, particularly anticipated capital inflows to Pakistan, the potential impact of delayed or unrealized inflows on international reserves, and underlying current account pressures. SBP must exercise greater caution and be conservative in its monetary policy stance as the potential risks of overly optimistic projections are substantial.

Fourth, SBP should be aware that supply shocks can evolve into more persistent issues, especially if they are recurrent and prolonged. In such instances, it is crucial to consider the entire distribution of expectations measures, not just the median, particularly given Pakistan's history of persistent core inflation.

In conclusion, we propose a critical reassessment of the framework governing economic policy decision-making in Pakistan. Given the country’s history of fiscal volatility and external vulnerability, a fundamental overhaul of the existing system is imperative.

First, enhanced coordination between fiscal and monetary policies is essential. However, this collaboration must respect the distinct mandates of each institution. The Monetary Policy Committee, SBP, and the Ministry of Finance have different mandates, yet they must coordinate policies while preserving each other's independence. This is especially crucial when balancing short-term growth with long-term macroeconomic stability and sustainable development.

Second, SBP must devise a method to inform the parliament and the public transparently and comprehensibly about external sector developments and the country's reserve position. This approach can foster a broader constituency beyond SBP that advocates against irresponsible decisions by politicians and the Ministry of Finance.

Third, it is crucial to fully realize the benefits of a market-based exchange rate regime and finally abandon the persistent pursuit of an overvalued rupee, which inevitably collapses. This requires deepening and improving the functioning of foreign exchange markets, whilst simultaneously granting MPC a role in defining the broad parameters of exchange rate management, including the timing and extent of intervention. Additionally, establishing clear and simple rules governing transactions within and outside the inter-bank foreign exchange market might be beneficial. These rules could even incorporate a quarterly current account deficit ceiling, based on expected financing and desired foreign exchange reserves. Essentially, such regulations would function as a domestically imposed IMF program to maintain macroeconomic stability and prevent crippling external crises.

Finally, in terms of financing the current account deficit, there should be a significant reduction in government borrowing to bolster foreign exchange reserves. To mitigate external instability and escalating public debt, government borrowing should no longer be the primary source of current account deficit financing, since it is an unsustainable strategy for a modern economy and leaves

Pakistan vulnerable to external crises. Instead, private sector including corporate and banking sectors must assume greater responsibility for funding current account deficits, whilst prioritizing non-debt creating inflows, such as equity investments.

References

Pirzada, A. (2024). Inflation surges under incomplete markets. In *Policy challenges for macroeconomic management and growth in Pakistan*. Lahore School of Economics.

Appendix

Figure 1

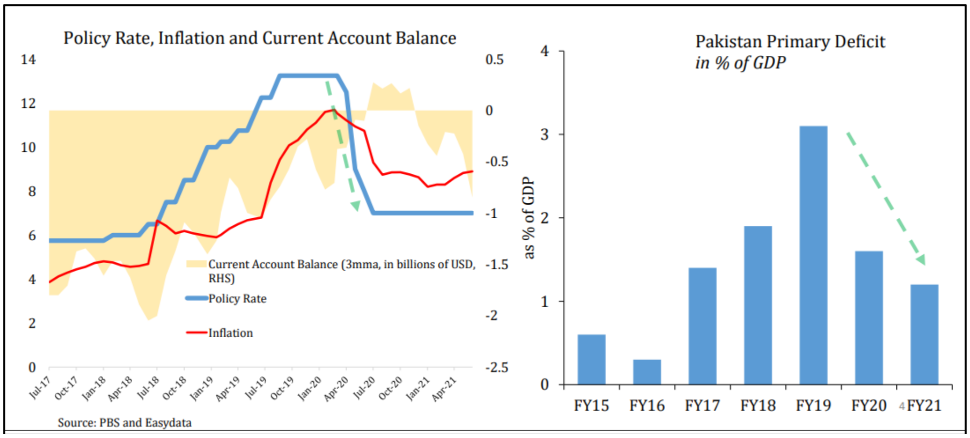

Figure 2

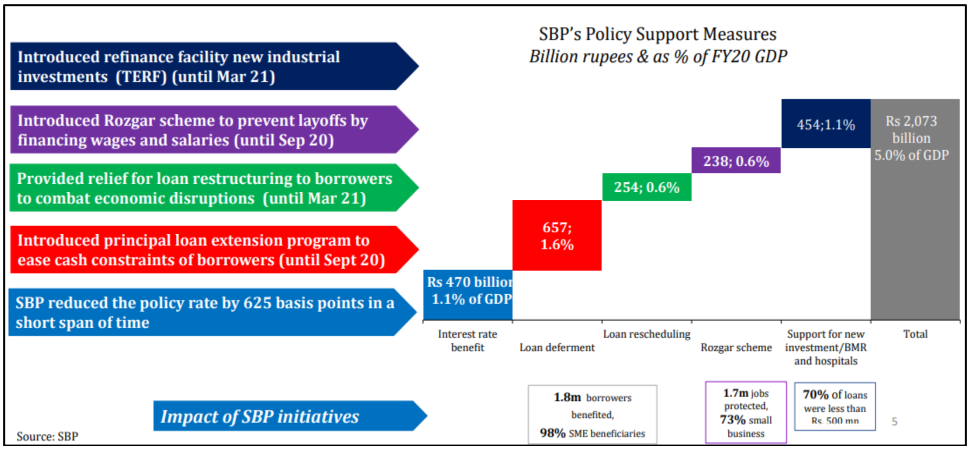

Figure 3(a)

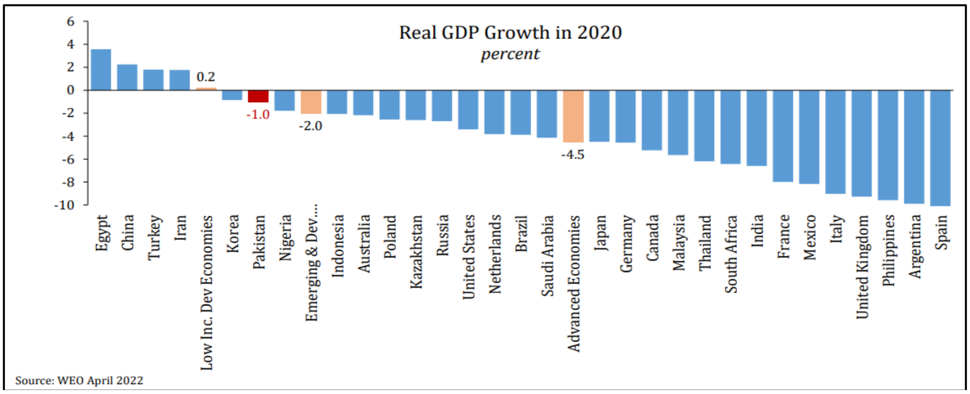

Figure 3(b)

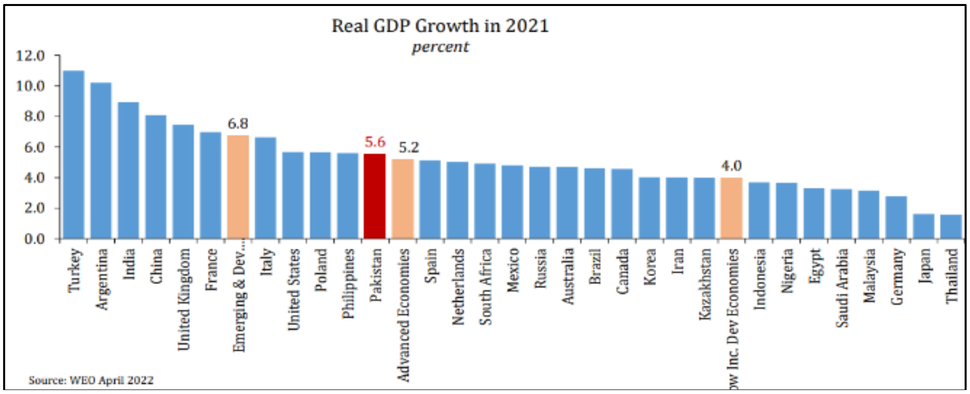

Figure 4

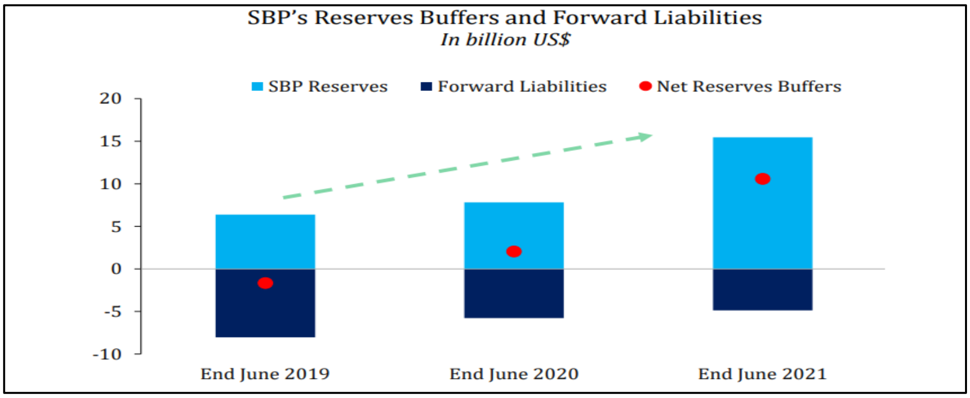

Figure 5

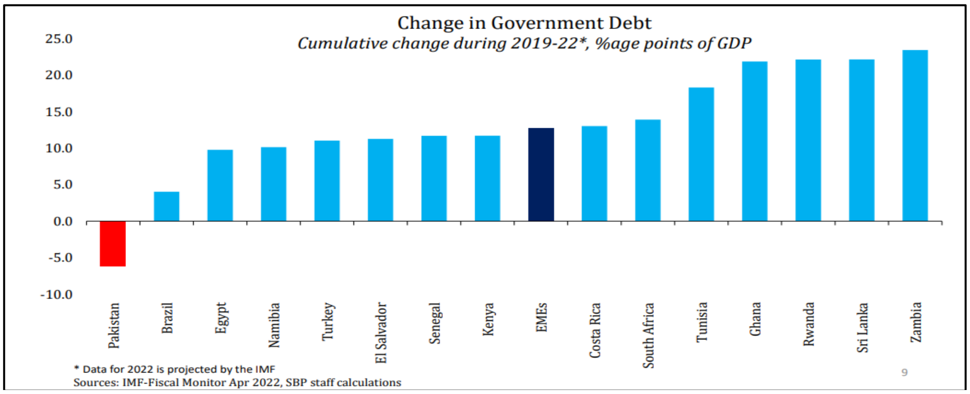

Figure 6

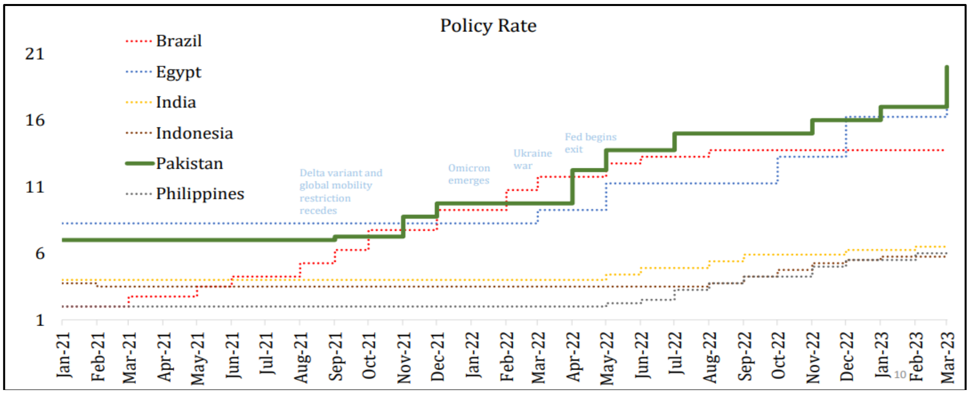

Figure 7

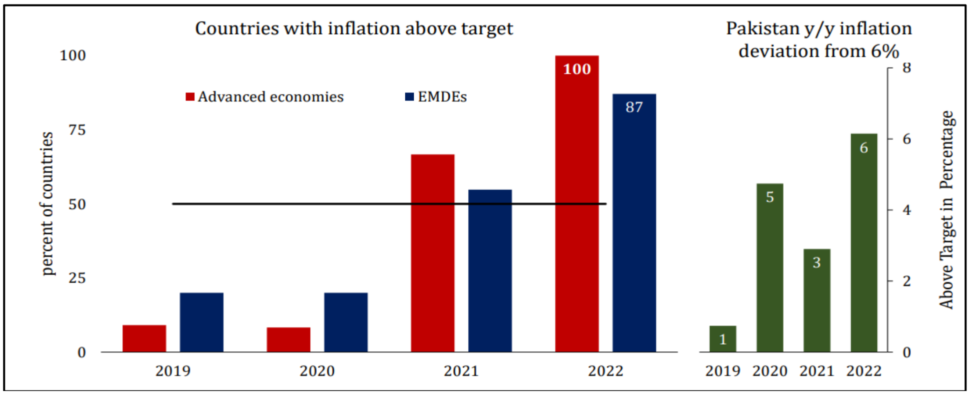

Figure 8

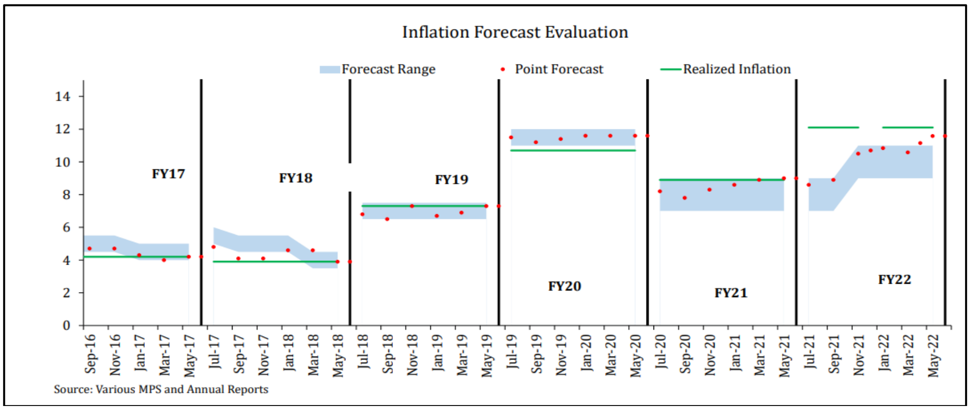

Figure 9

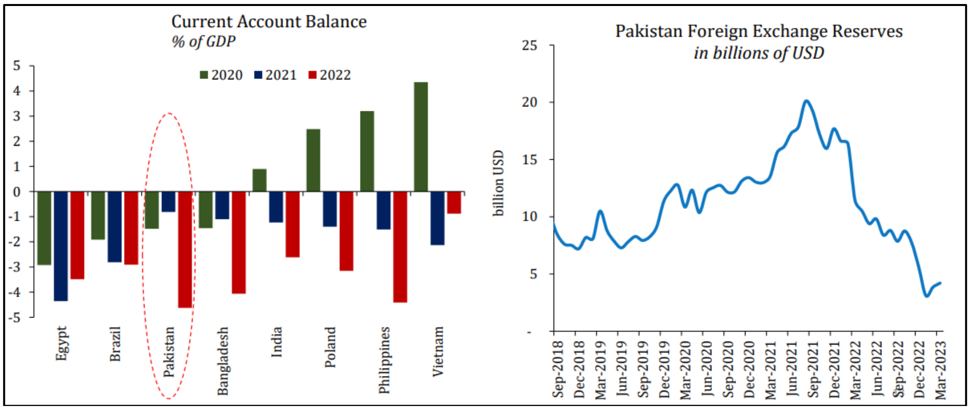

Figure 10

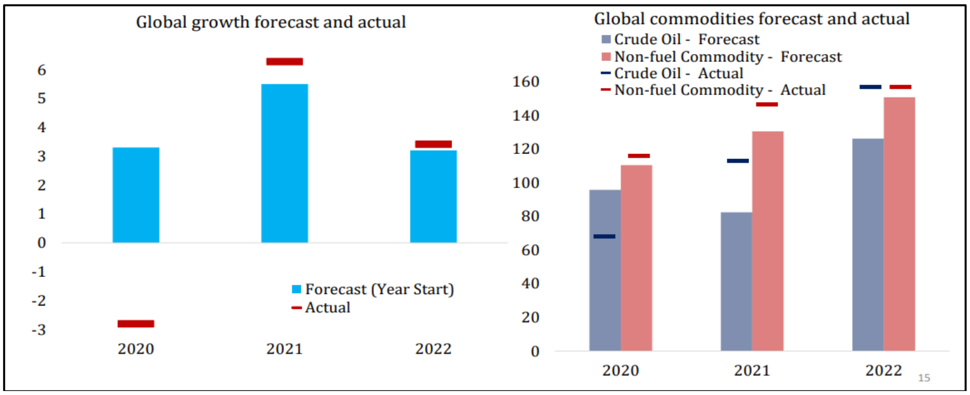

Figure 11

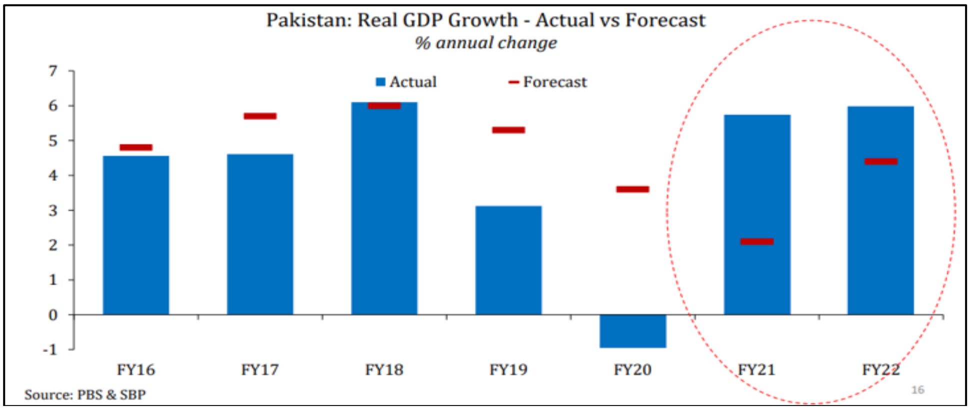

Figure 12

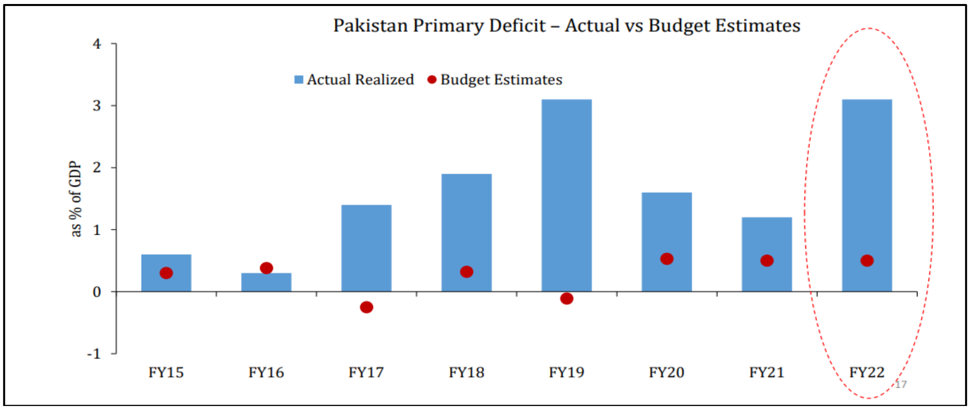

Figure 13

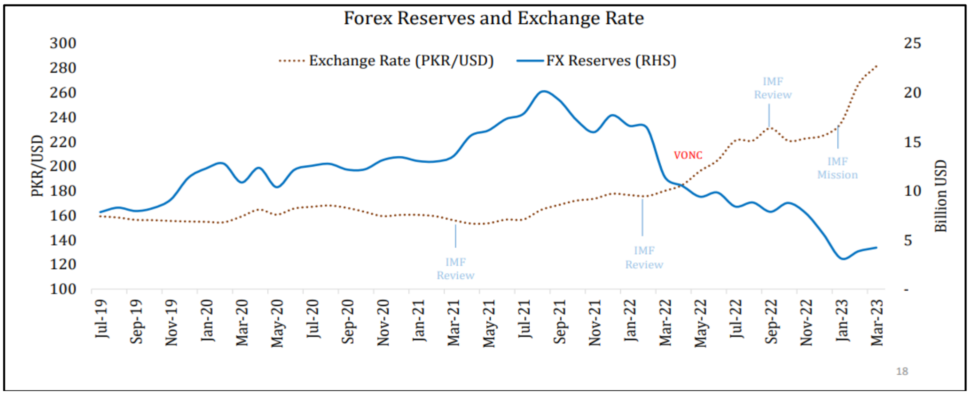

Figure 14

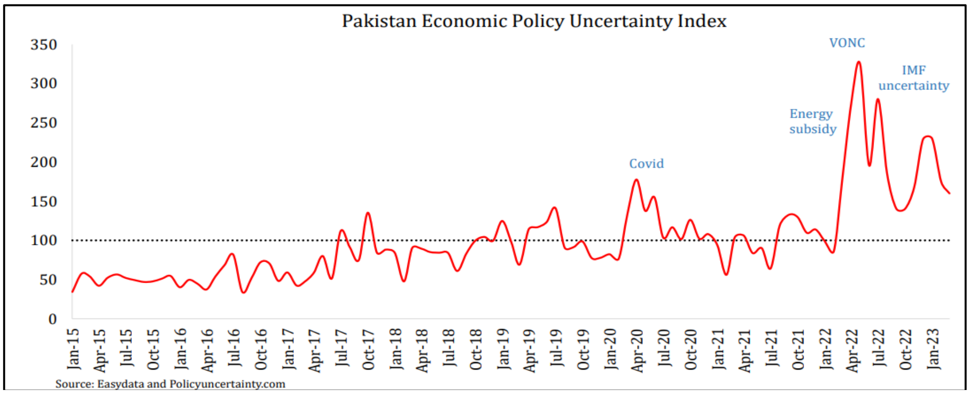

Figure 15

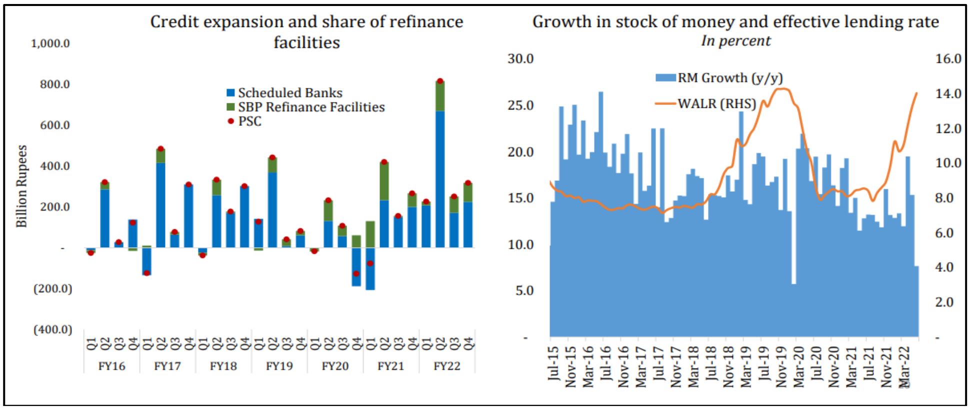

Figure 16