Monetary Policy, Inflation, and Economic Growth

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Overview

- Design and conduct of monetary policy
- Monetary policy and inflation
- Inflation and economic growth
- Future monetary policy framework for Pakistan

Objectives, Targets, and Instruments

Objectives	• Inflation, growth, employment, preventing financial crises, etc.
Targets	• Intermediate targets; operating targets
Instruments	• Direct instruments; indirect (market-based) instruments

Monetary Policy Targets

Target

- Serves as communication tool
- Reveals policymakers' intentions and priorities
- Indicates policy actions

Price or Quantity

- Price
  - Exchange rate, price of gold, inflation rate
- Quantity
  - Money and credit aggregates
  - Nominal income

Nominal Anchor

- Target establishes a "nominal anchor"

Choice of Nominal Anchor

- Countries have chosen either monetary or exchange rate targets as nominal anchors

- Advantages of monetary over exchange rate targets
  - Countercyclical policies
  - Seigniorage revenue
  - Lender of last resort
  - Automatic stabilizer during adverse trade shocks
  - Reduce speculative currency attacks

Monetary Aggregates Targeting

- Advantages
  - Greater control
  - Easier to reach
  - Credibility

- Disadvantages
  - Less easily understood by the public
  - Requires a stable relationship between the monetary aggregate and inflation rate (demand for money)

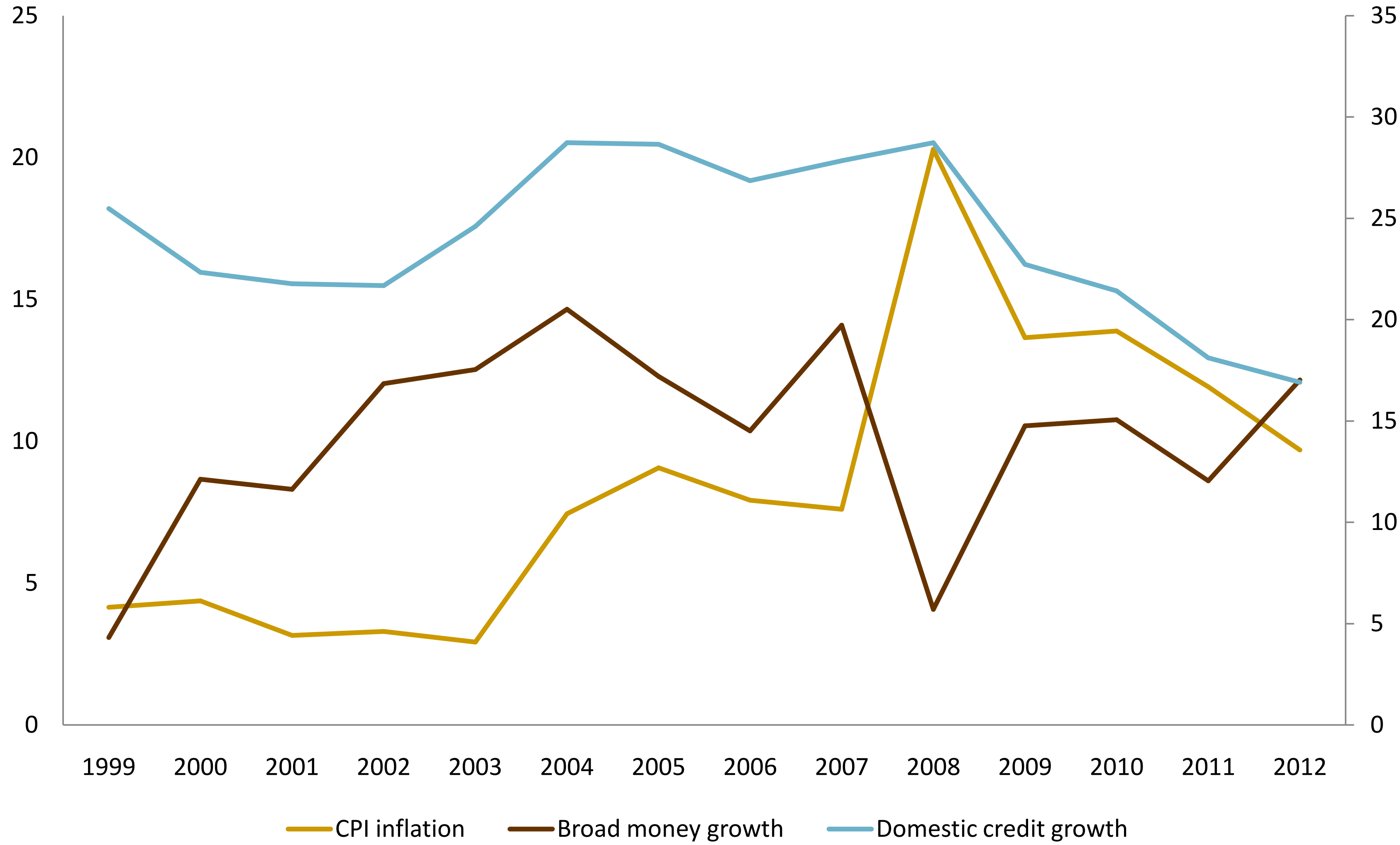
Current Pakistan Monetary Framework

- SBP objectives: inflation, growth, international reserves (exchange rate)

- SBP primarily targets monetary aggregates
  - Able to affect outcome variables with degree of predictability
  - Pakistan has series of IMF programs, which give credit preeminent role- “credit ceilings”

- Current framework depends on:
  - Stability of money demand function
  - Close link between monetary aggregates and inflation

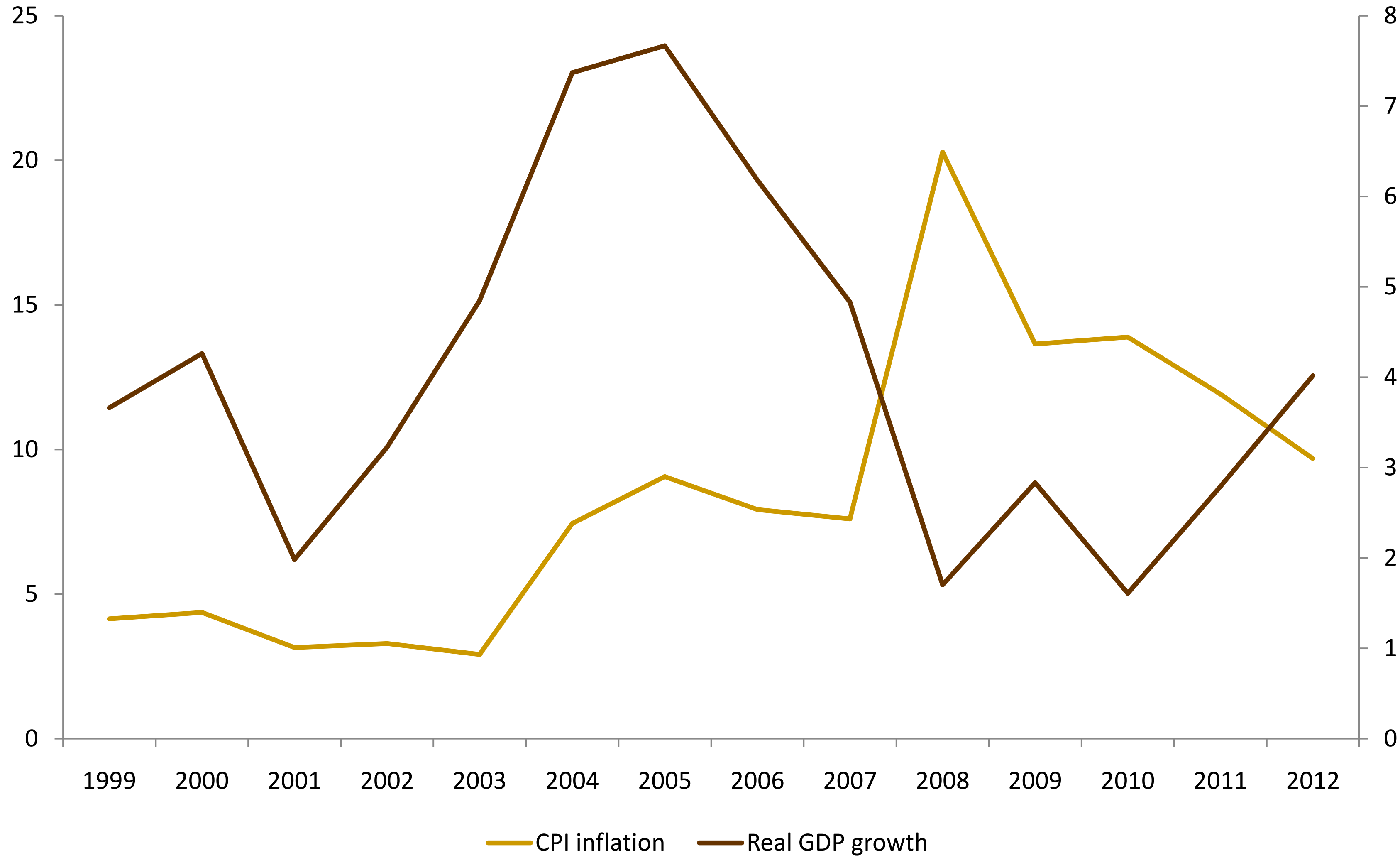
Monetary Growth and Inflation, 1999-2012



Inflation and Economic Growth: Nonlinear Relationship

- Negative effects of inflation on long-term growth
- How low should inflation be?
- Many studies show relationship between inflation and growth is nonlinear
  - Low levels of inflation– no relationship
  - High levels of inflation– negative effect
  - Threshold level of inflation?

Inflation and Economic Growth, 1999-2012



Threshold Estimates

- Developing countries
  - Khan and Senhadji (2001) — 7-11 percent
  - Khan, Senhadji & Smith (2006) — 4-6 percent
- Pakistan
  - Mubarik (2005) — 9 percent
  - Hussain (2005) — 4-6 percent
  - Ayyoub, Chaudhry & Farooq (2011) — 7 percent
  - Hussain & Malik (2011) — 9 percent
- India
  - Reserve Bank of India (2014) — 4-4.5 percent
  - IMF (2012) — 5-6 percent

Future Monetary Policy in Pakistan

- Many countries have moved to inflation targeting regimes
  - Instability of demand for money
  - Weak link between monetary aggregates and inflation

- Requires operational framework
  - Relationship between policy instruments and inflation; relative effectiveness of different monetary instruments; lags
  - Methodology to produce inflation forecasts
  - Forward-looking operating procedure (policy reaction function)

Preconditions for IT in Pakistan

a) Commitment to price stability

- High priority for SBP

b) Flexible exchange rate

- Not freely floating, but has considerable flexibility

c) Independent central bank

- Operations still significantly influenced by Ministry of Finance

d) Absence of fiscal dominance

-Fiscal dominance is a problem in Pakistan

e) Transparency and operation capacity

-Publication of inflation report and monetary policy decisions

- Tools and capacity are available

Conclusions

- Overall, move to inflation targeting by SBP is desirable
- Preconditions need to be satisfied
  - Inflation should be highest priority
  - Exchange rate should be flexible
  - Fiscal dominance should be reduced
- Trilemma: capital mobility, fixed exchange rates, independent monetary policy
- Inflation targeting is a solution to the "impossible trinity"