State Bank of Pakistan

Monetary Policy Formulation and Implementation

Fida Hussain

Economic Policy Review Department

State Bank of Pakistan

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Introduction

Monetary Policy Committee

Monetary Policy Process

Forecasts/Economic outlook

Monetary Policy

Monetary Policy Framework/Flexible Inflation targeting Framework

Monetary Policy Instruments/Interest Rate Corridor

Some background!

Evolution of central banking or a central bank

- Central banking originated from Europe;

- Some of the central banks started as government banks to **bring order in issuance of currency**:

  - Riksbank of Sweden, first central bank to be established in 1668 (also financed the wars of Age of Liberty);
  - Bank of France in 1800 and The Netherland Bank in 1814.

- Some were established to fund government operations, especially to **pay off debt or finance wars**:

  - Bank of England was established by King William in 1694 to lend to British government to finance its war against France.
  - First Bank of United States was established in 1791 to refinance the war related debt accumulated by different states; for the same purpose, second Bank of United States was established in 1816.

- During 20th century, majority were created for ***central banking functions***.

Functions of a modern central bank

Transformation of objectives rather than change in functions

Primary Functions

- Issue and manage national currency
- Formulate and implement monetary policy
- Regulate and supervise financial system
- Foster safe and efficient payment system
- Lender of last resort

Secondary Functions

- Public debt management
- foreign exchange management
- Advisor and banker to government
- Non-traditional development role

What is monetary policy?

"Regulation of money supply and interest rate in the economy to achieve economic goals"

"Way of managing supply of money in the economy"

"Monetary policy involves central banks' use of policy instruments to influence interest rates and money supply to keep overall prices and financial markets stable"

Why manage money supply?

To maintain the value of money and promote confidence of the public to hold domestic currency

- In modern times money is not backed by gold or silver – *its fiat money!;*
- Quantity of goods and services one can buy with a certain amount of money;
- Value of money decreases if same amount of money buys you less quantity;
  - This means prices have gone up – *inflation*
- Value f money increases if same amount of money buys you more quantity;
  - This means decline in prices - *deflation*

What is objective of monetary policy?

- **To control inflation and keep it low – known as price stability;**
- **An example:**
  - Suppose person X lends Rs 100 to person Y at an interest rate of 6% for the year;
  - Person Y must return Rs 106 at the year end to person X;
  - Both would be happy if there is no inflation;
  - If prices increase by 8% then person X gets: [106] – [100(0.08)] = Rs 98: actually losing Rs2 – here borrower is happy as she is returning less amount in real terms than what she borrowed;
  - What about the lender?
  - But, if person X anticipates inflation to be 8% then he might charge a nominal interest rate of 11%: [111] – [100(0.08)] = 103.

Why focus on price Stability?

To avoid costs of high inflation

- High inflation generally coincide with high degree of variability that:
  - makes it difficult for the individuals and firms to efficiently plan their decisions to consume, save and invest;
  - discourages investment because when firms are uncertain about future worth of their money, they become reluctant to invest—low investment reduces economy's potential to produce in future;
  - creates incentives for households to spend resources to manage inflation risk i.e. people generally prefer to spend when inflation is rising;
  - discourages long term contracts (due to uncertainty) and resources are wasted on frequent negotiations;
  - diverts resources away from efficient production;
  - undermines confidence in domestic currency;
  - impacts more severely fixed income and low income groups;
  - Redistributes wealth from savers to borrowers (mainly business community).

Why focus on price stability?

Low and stable inflation helps in achieving other objectives!

- Low and stable inflation facilitate:
  - businesses in making sound investment decisions;
  - maintaining value of domestic currency;
  - protecting savings of the nationals;
- These, in turn, ensure stability in the value of domestic currency and promote growth and job creation in the economy.
- Thus, price stability is consistent with the “other goals” in the long-run – there is no trade-off between inflation and employment in the long-run.
- However, there are short-run trade-off – for example, monetary tightening might help in controlling inflation, but might cause unemployment to rise in the short-run.

What monetary policy can and cannot do?

- Monetary policy plays a central role in reducing inflation and keeping it at moderate or low levels, broadly termed as ***price stability***;

- An expansionary monetary policy can stimulate economic activity only in the short run, that is, when actual output is much below potential and inflation is low.

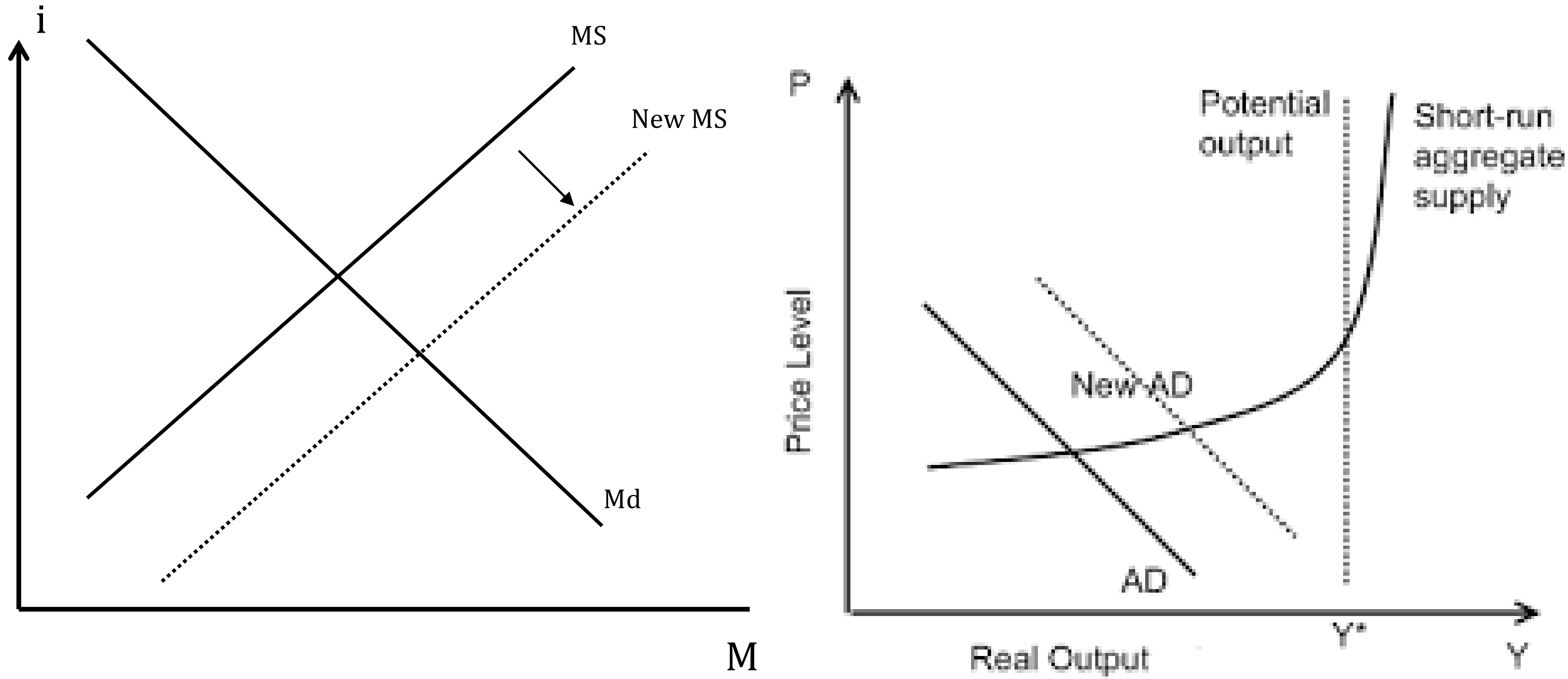
- There is no trade-off between inflation and growth in long-run.

- Monetary policy has little role in directly increasing country's capacity to produce goods and services.

- Monetary policy has a lasting effect on inflation but only a transient effect on output.

Monetary policy is a *stabilization/aggregate demand management* policy and can not impact long-term growth potential.

Monetary policy and demand management



When stabilization policies are needed

Stabilization policies at work

Simplified Economic Policy

The temporary tank only avoids a crisis temporarily, while the main problem is solved.

If the temporary tank overflows, an economic crisis of great proportion will ocurr

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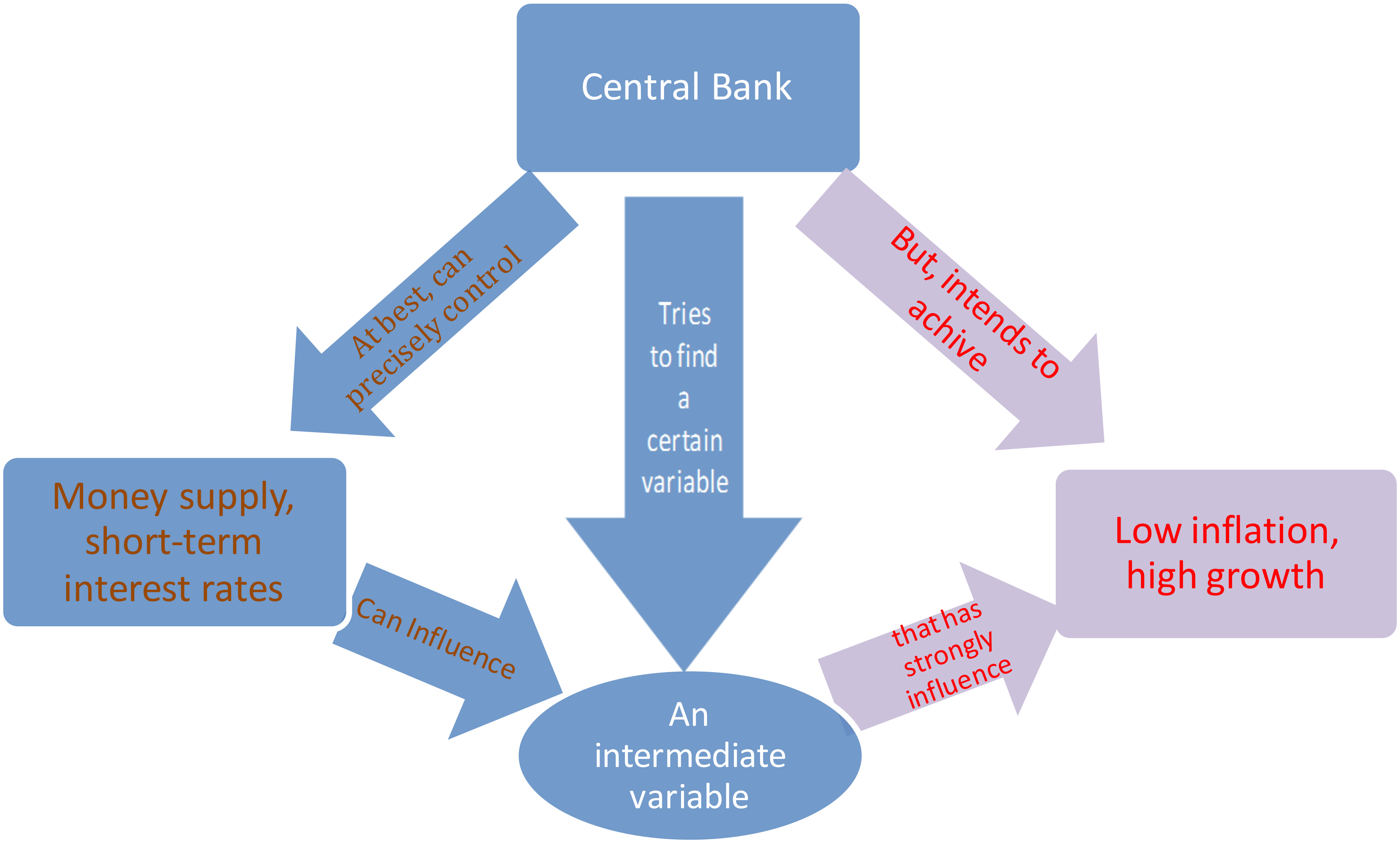
How to achieve these objectives?



How monetary policy works? Monetary transmission mechanism

- Monetary policy affects inflation and economic activity through adjustment in aggregate demand brought about by changes in interest rate (or money supply).

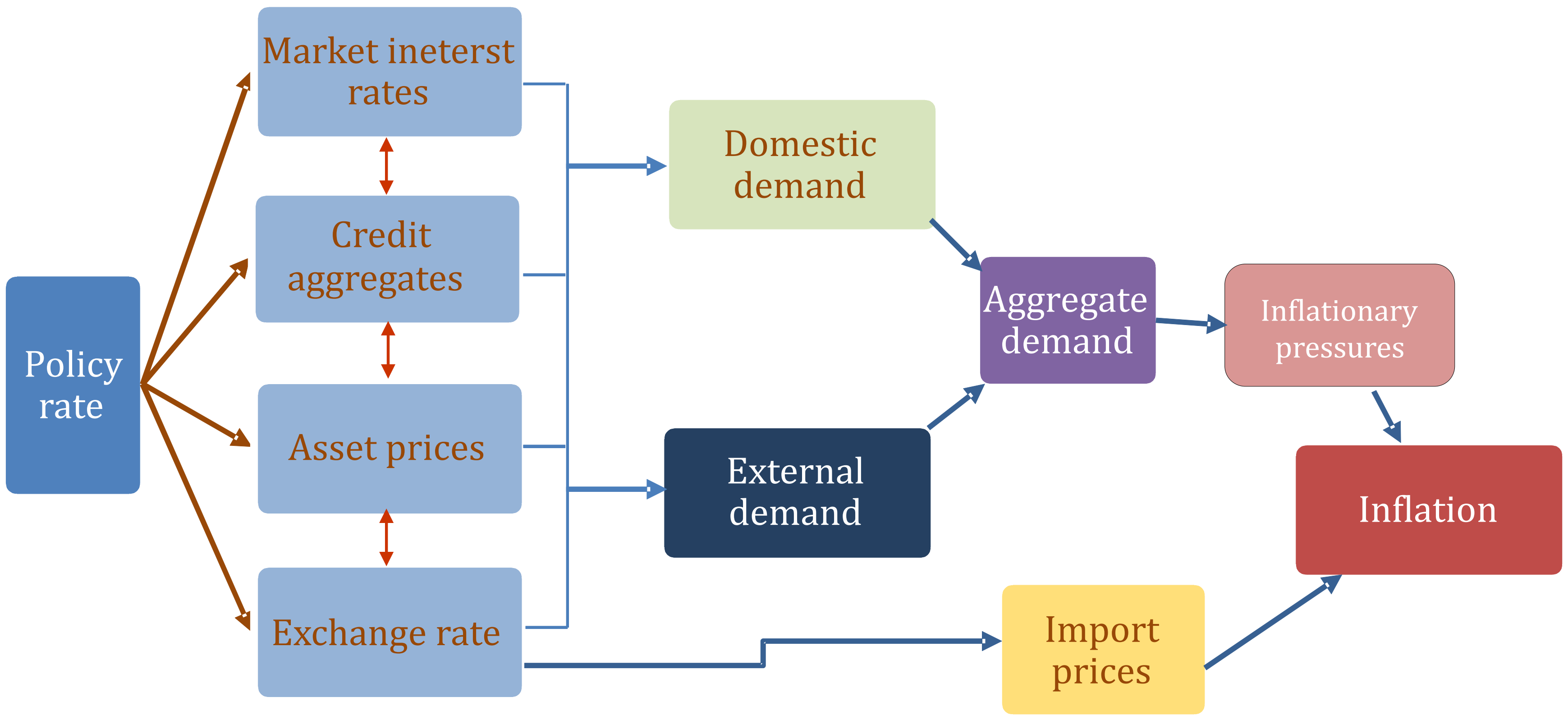
- This process is known as transmission mechanism of monetary policy.

- First the changes in policy rate affect interbank and retail interest rates directly as well as through ‘expectations’.

- The resulting changes in retail interest rates then affects the consumption and investment behavior of households and businesses and thus the level of aggregate demand in the economy.

- Finally, the adjustment in aggregate demand affects the general price level and thus inflation in the economy.

Monetary transmission mechanism



Monetary Policy Formulation and Implementation in Pakistan

Objectives of monetary policy in Pakistan

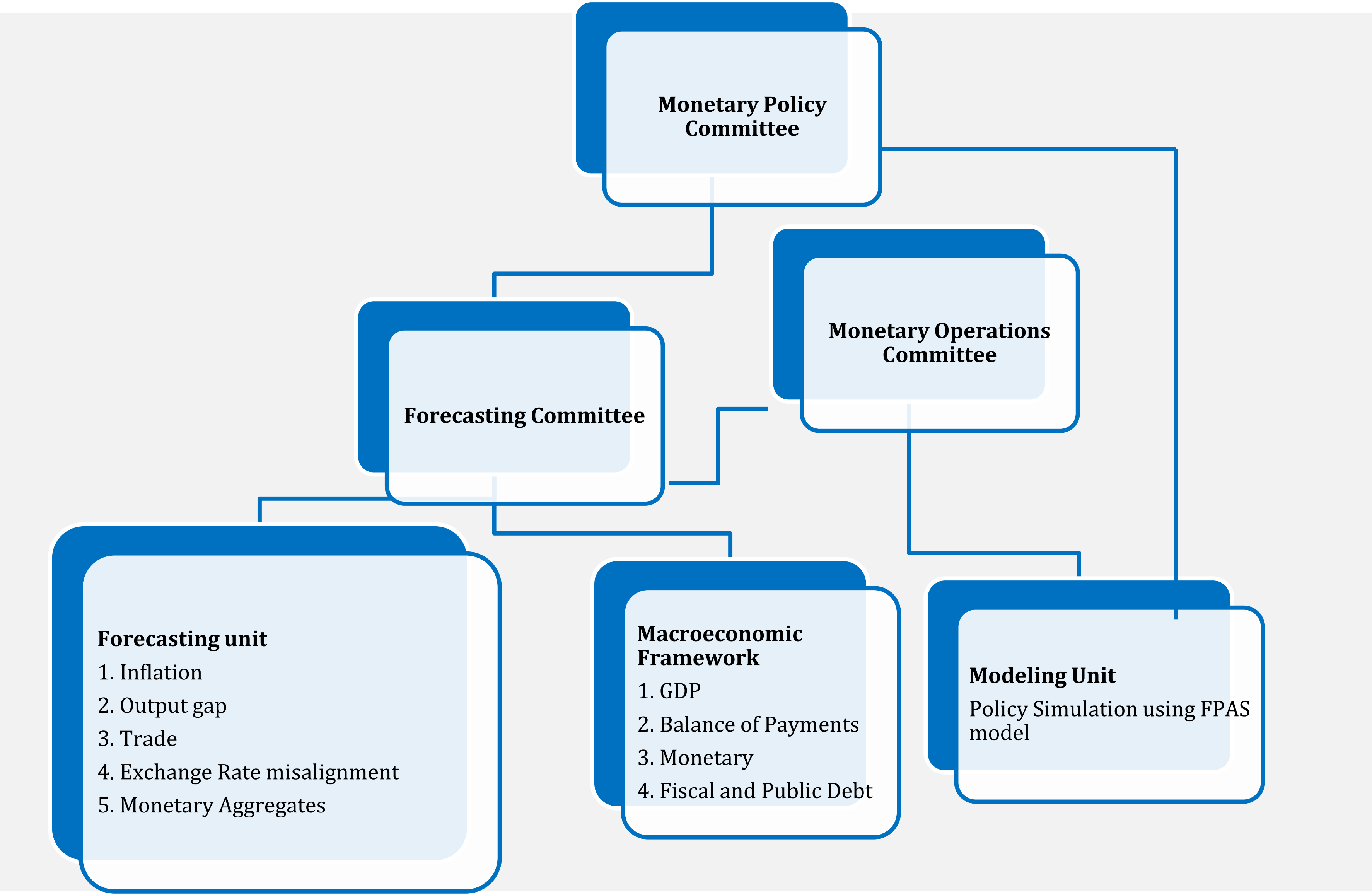
- *The preamble of the SBP (Amendment) Act, 1956 broadly defines monetary policy objectives:*
  - ‘*whereas it is necessary to provide for the constitution of State Bank to **regulate the monetary and credit** system of Pakistan and to foster its growth in the best national interest with a view to **securing monetary stability** and fuller utilization of the country’s productive resources*’
- This broad mandate of monetary policy could be interpreted in several ways;
  - For example, **monetary stability** is generally interpreted as price stability; however, it could also be seen as stabilizing growth in money supply or some monetary aggregate;
  - Similarly, effective **regulation of banks** guarding against decline in asset quality and bank runs is generally considered synonymous with soundness of financial sector, it is now sees as keeping stable conditions in the interbank market.
- SBP focuses on achieving monetary stability by **controlling inflation close to its targets** set by the government;
- At the same time, SBP also aims to ensure financial stability, particularly the smooth functioning of the financial market and the payments system.

Monetary policy decision making process
Institutional set-up

- The SBP (Amendment) Act 2015 empowers Monetary Policy Committee to formulate and implement monetary policy;
- At present, MPC consists of:
  - The Governor SBP, as chairperson with Deputy Governor (Policy) in Governor's absence;
  - Deputy Governor (FMRM & BPRG);
  - Chief Economist;
  - Executive Director BPRG;
  - Three Board members selected amongst themselves;
  - Three external experts/economists – Dr. Asad Zaman (PIDE), Dr. Qazi Massod Ahmed (IBA), and Dr. Aliya Hashmi Khan (QU);
- The MPC meets at least six times a year, in the second week of the alternate month, to decide monetary policy stance;

Monetary policy decision making process

Procedures



Monetary policy decision-making process

Main considerations

Prime considerations

- Assessment of near term inflation path and inflation expectations vis-a-vis inflation target
- Growth outlook in case inflation is expected to remain close to or below its target

Secondary considerations

- Assessment of external sector sustainability
- Likely pressures on exchange rate, which also have implications for inflation outlook

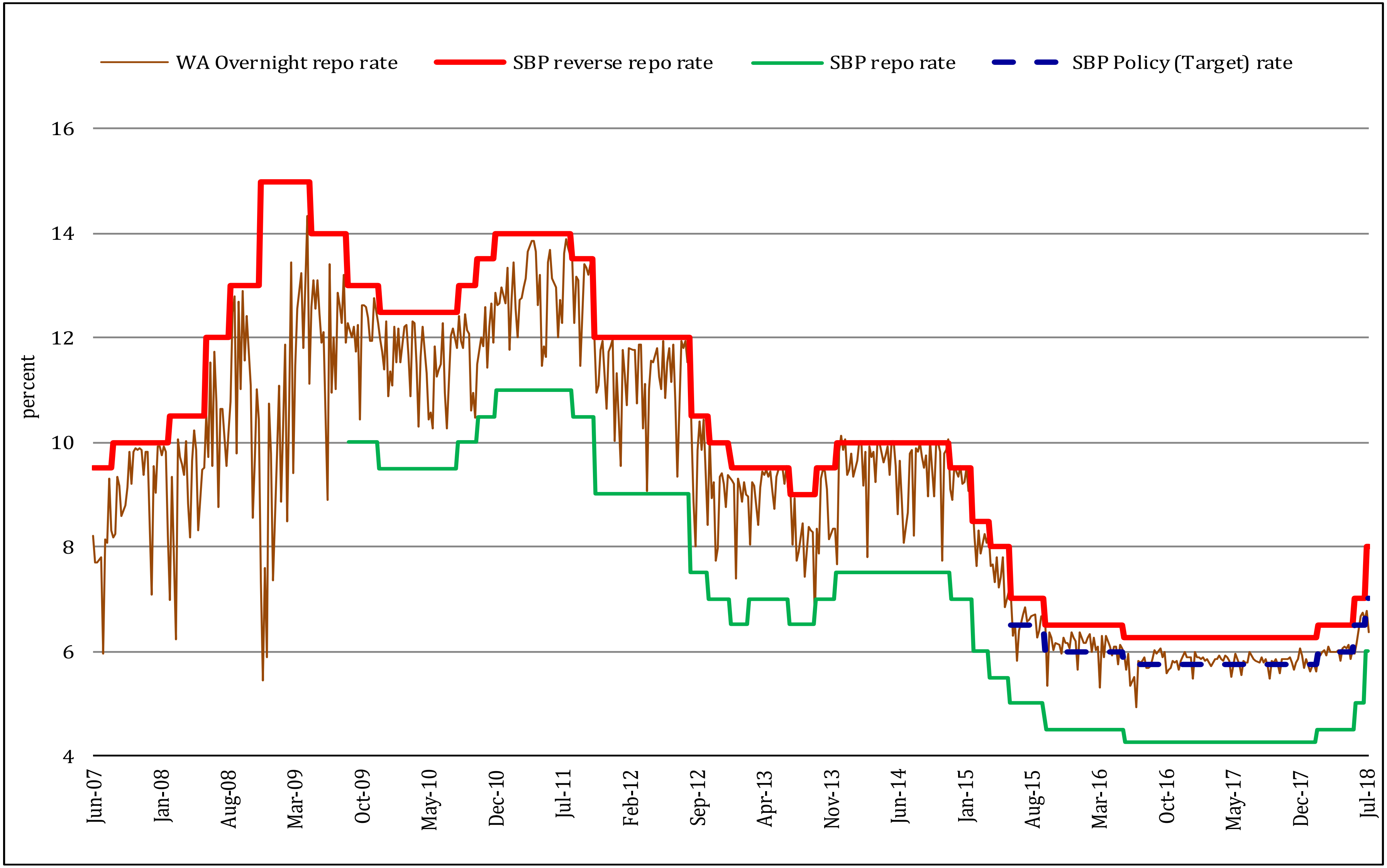
Monetary policy implementation

Operationally, SBP attempt to controlling **overnight money market repo rate close to the** SBP Target Rate , the Policy Rate

- Overnight money market repo rate is a weighted average interest rate on overnight repos against treasury bills/PIBs in the interbank market, with share of respective transactions in total repos during the day as weight.
  - *Repo* transaction is the spot sale of government securities with agreement to purchase (forward) the same.
  - *Reverse repo* transaction is the mirror image of the repo transaction i.e. spot purchase of government securities with the agreement to sell (forward) the same.

Monetary Policy Implementation

Interest Rate Corridor



Monetary policy instruments in Pakistan

- Rates on standing facilities
  - SBP reverse repo rate (Discount rate); 8.0 percent per annum; 50 bps above the SBP Target Rate or the policy rate currently at 7.5 percent;
  - SBP repo rate — 150 bps below the SBP Target Rate;
- Open Market Operations
  - are conducted regularly on Thursdays and on need basis on other days;
- Cash Reserve Ratio (CRR)
  - 5% for demand liabilities (including less than 1 year time deposits) and 0% for time liabilities of above 1-year tenor;
  - 5% as CRR and 15% special CRR on FCY deposits
- Statutory Liquidity Ratio (SLR)
  - 19% for demand liabilities (including less than 1 year time deposits) and 0% for time liabilities of above 1-year tenor;
- Forex Swaps
  - Are used depending on the situation in forex market.

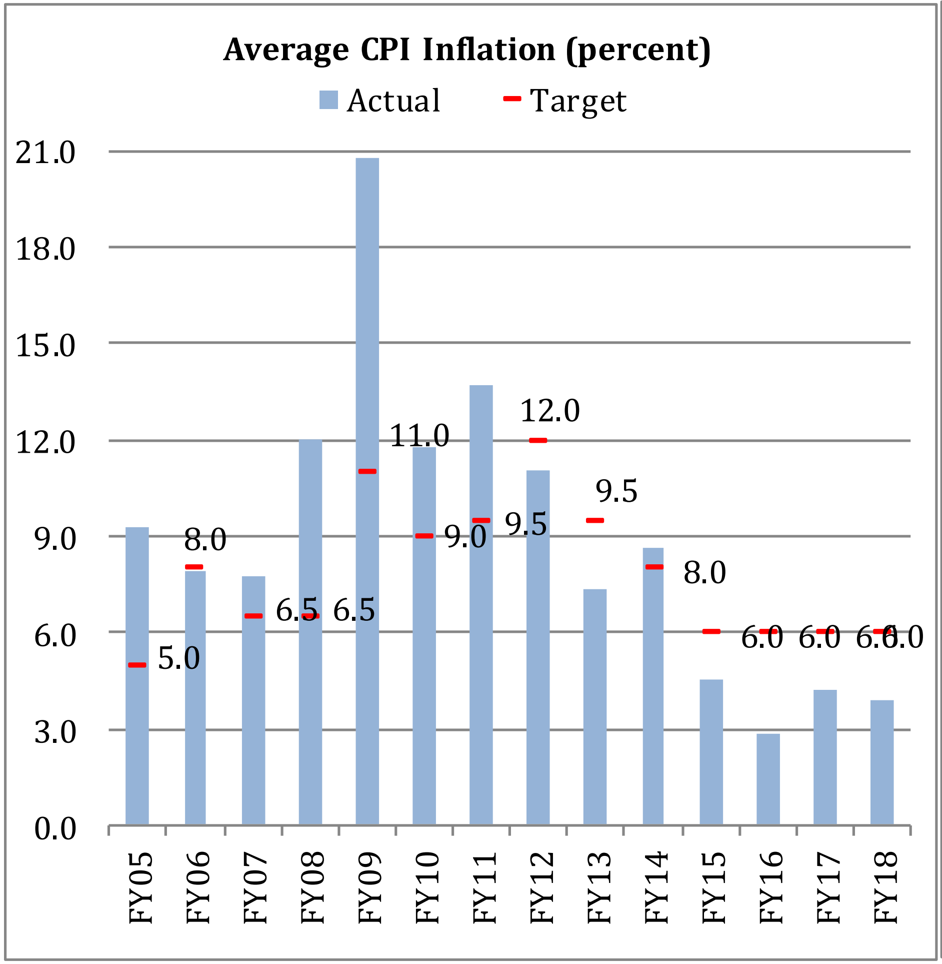
Monetary policy instruments

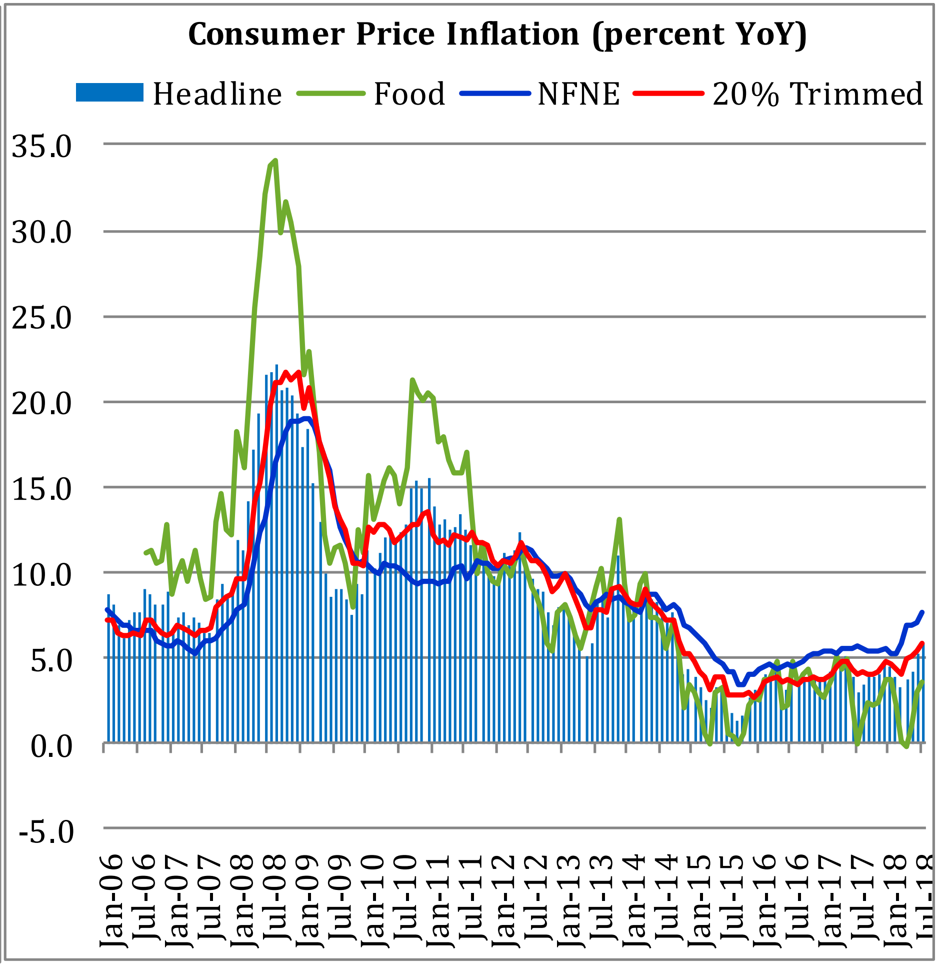
- Rates on standing lending/deposit facility
  - In case banks fail to raise needed funds from the market, they can approach central bank, as a last resort, and borrow the needed funds (collateralized or uncollateralized), and ***vice versa***;
- Open Market Operations (OMOs)
  - Central banks inject (*drain*) liquidity through purchase (*sale*) of government securities from (*to*) commercial banks generally with an agreement of sale (purchase)—reverse repo *(repo)*;
  - Outright sale or purchase of T-bills (in case market is expected to remain long or short over longer period).
- Forex swaps
  - Swaps are similar to repo operations described above;
  - Purchase of dollars results in injection of Pak rupees, while selling of dollars drains Rupee liquidity.
  - Transactions impact liquidity in both money and foreign exchange markets simultaneously;

Pakistan's Recent Monetary Policy Experiences

Macroeconomic environment

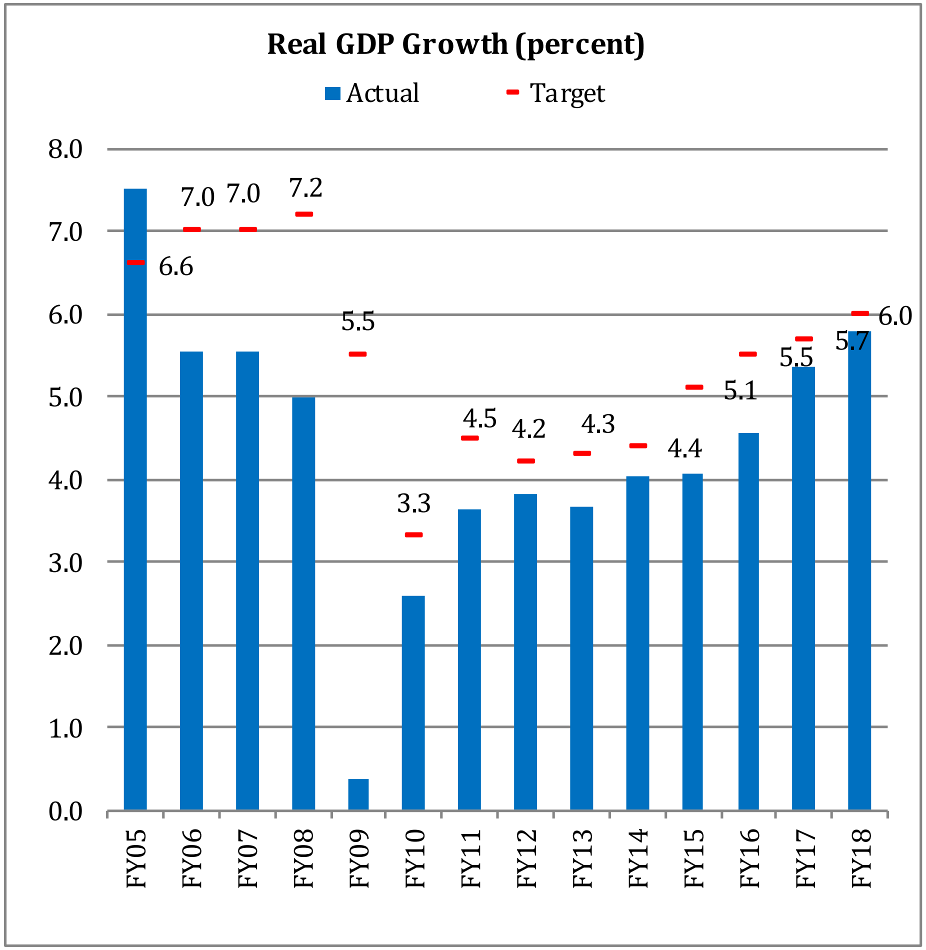
Inflation has remained below the target for the last four years; but inched up recently

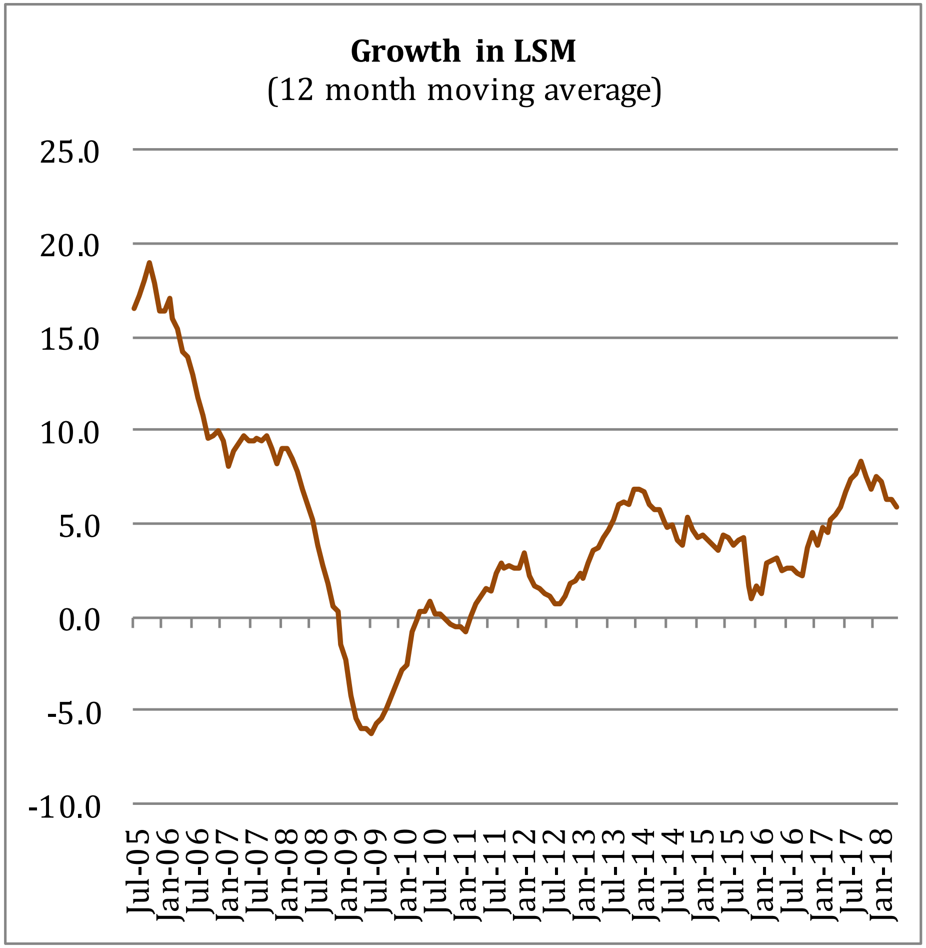




Macroeconomic environment

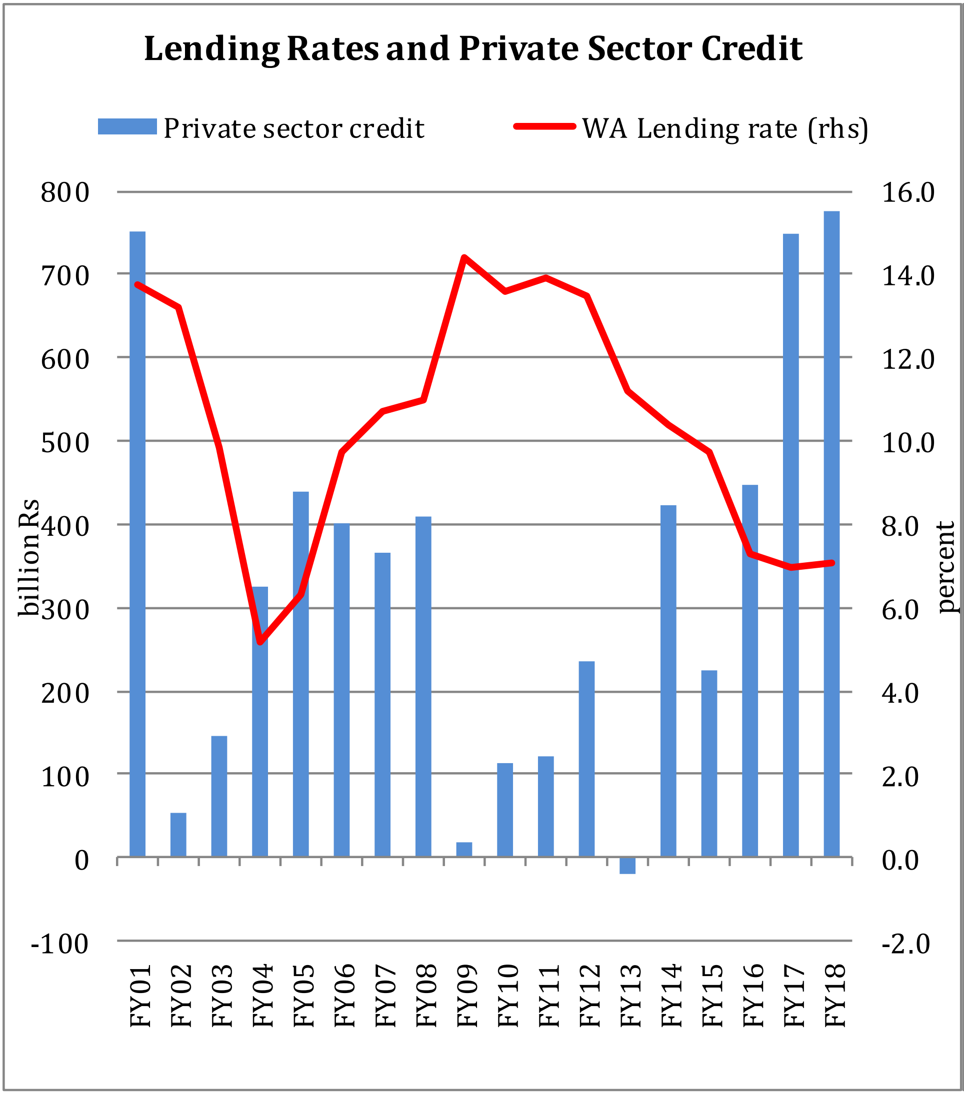
Weak real economic activity before getting some pace in FY17 and FY18

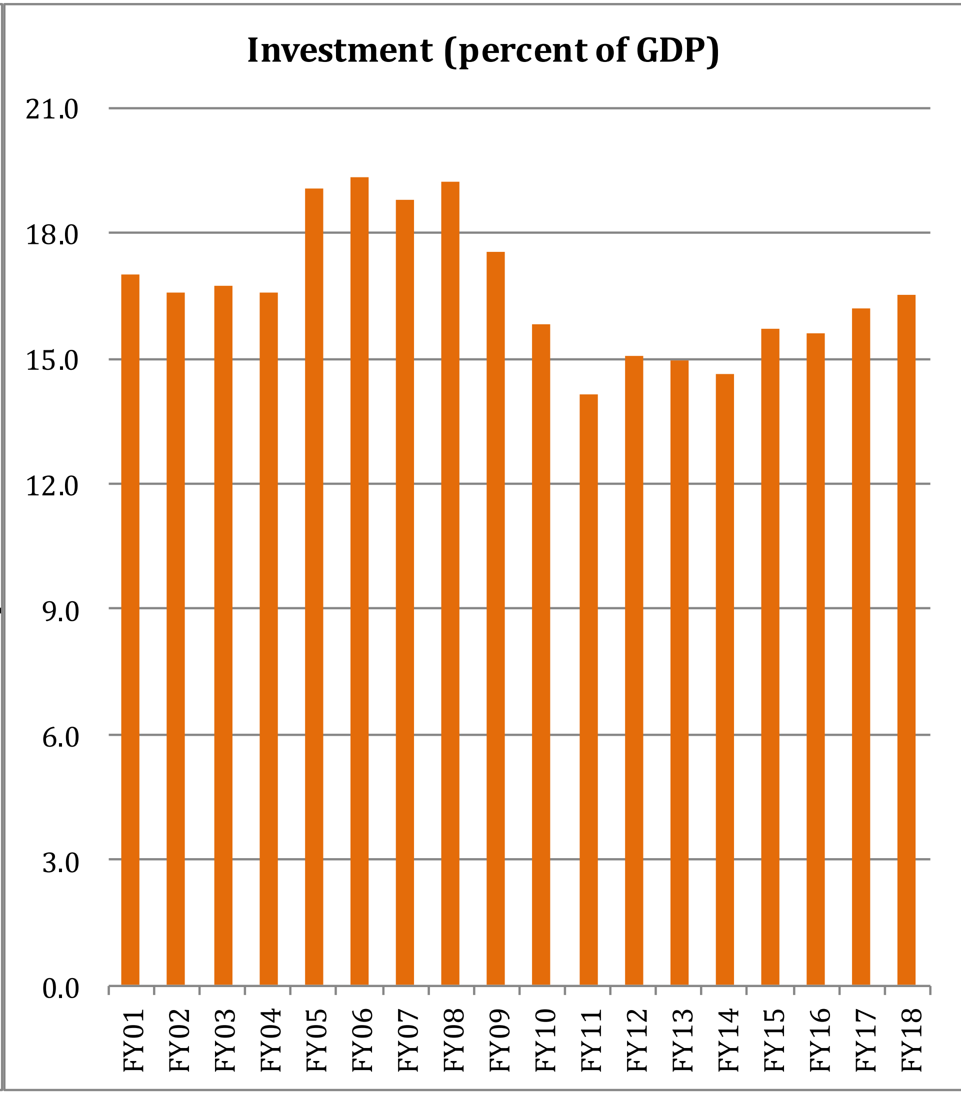




Macroeconomic environment

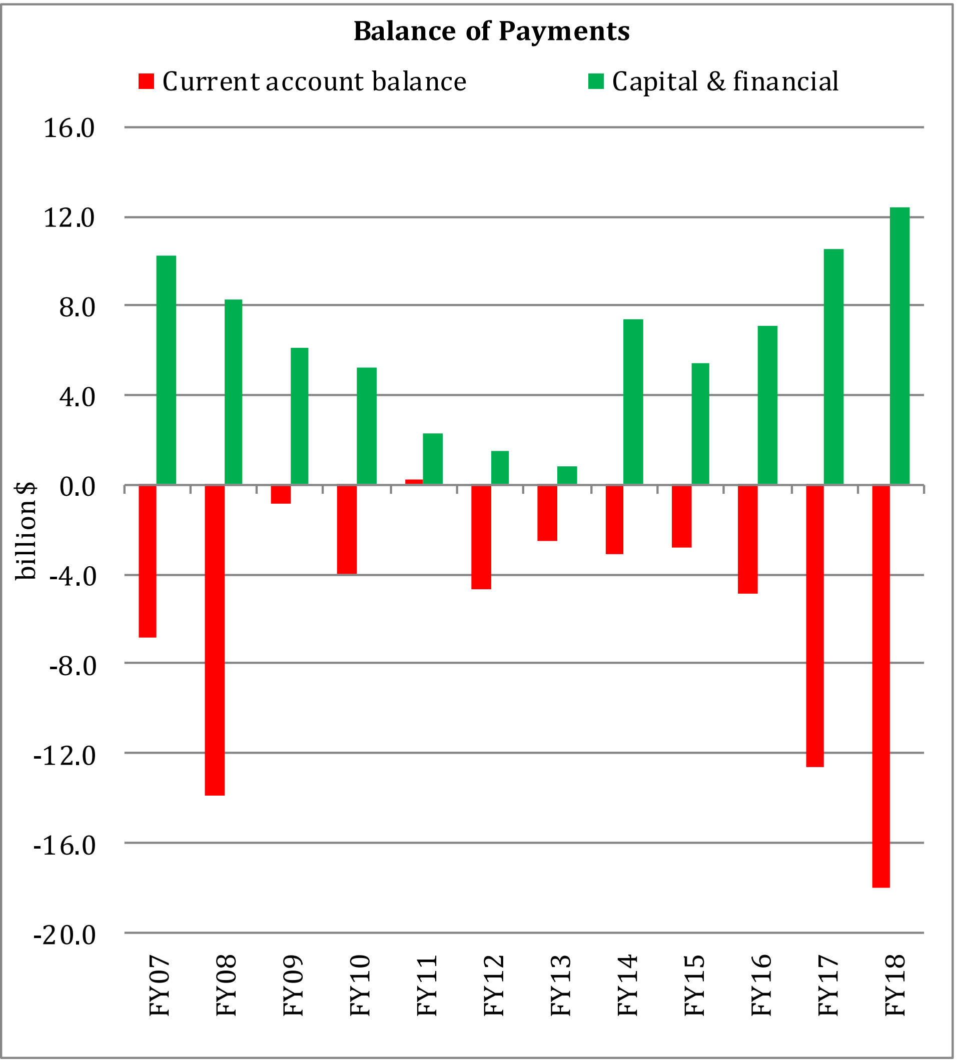
Gradual recovery in private sector credit and investment

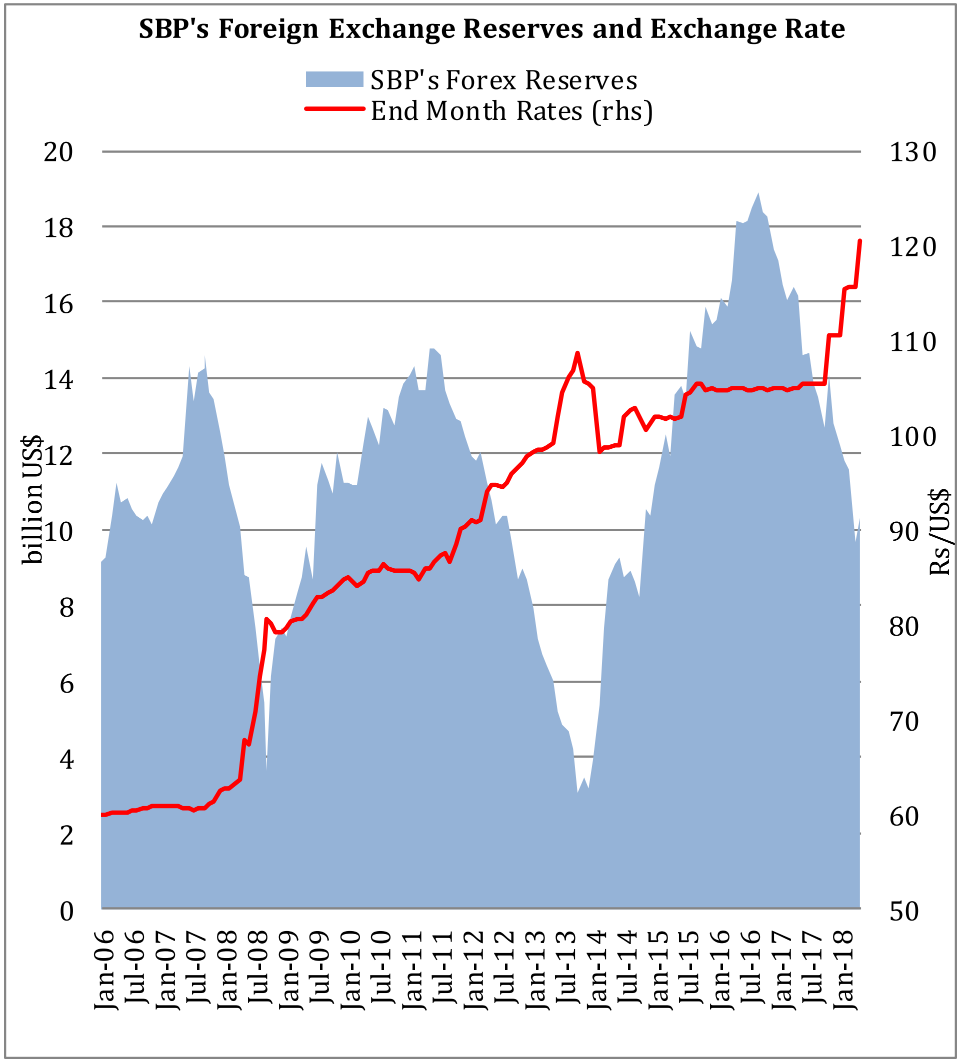




Macroeconomic environment

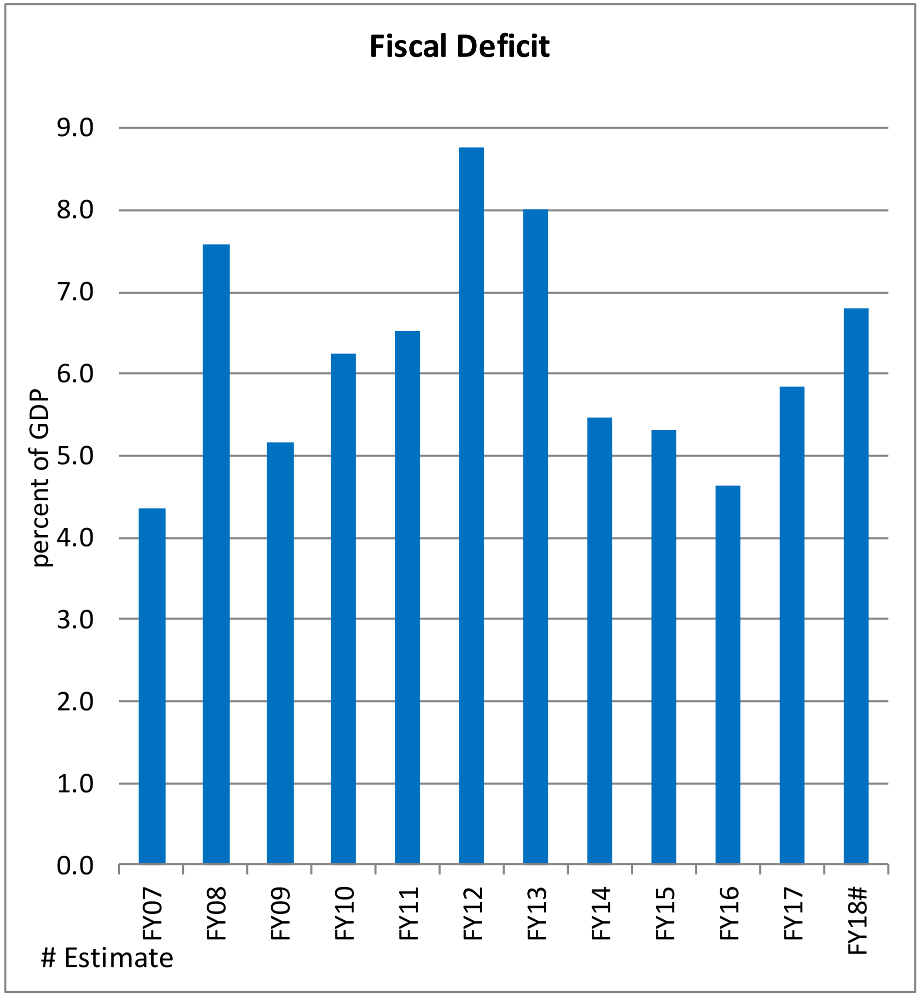
Balance of payment situation has remained a source of concern

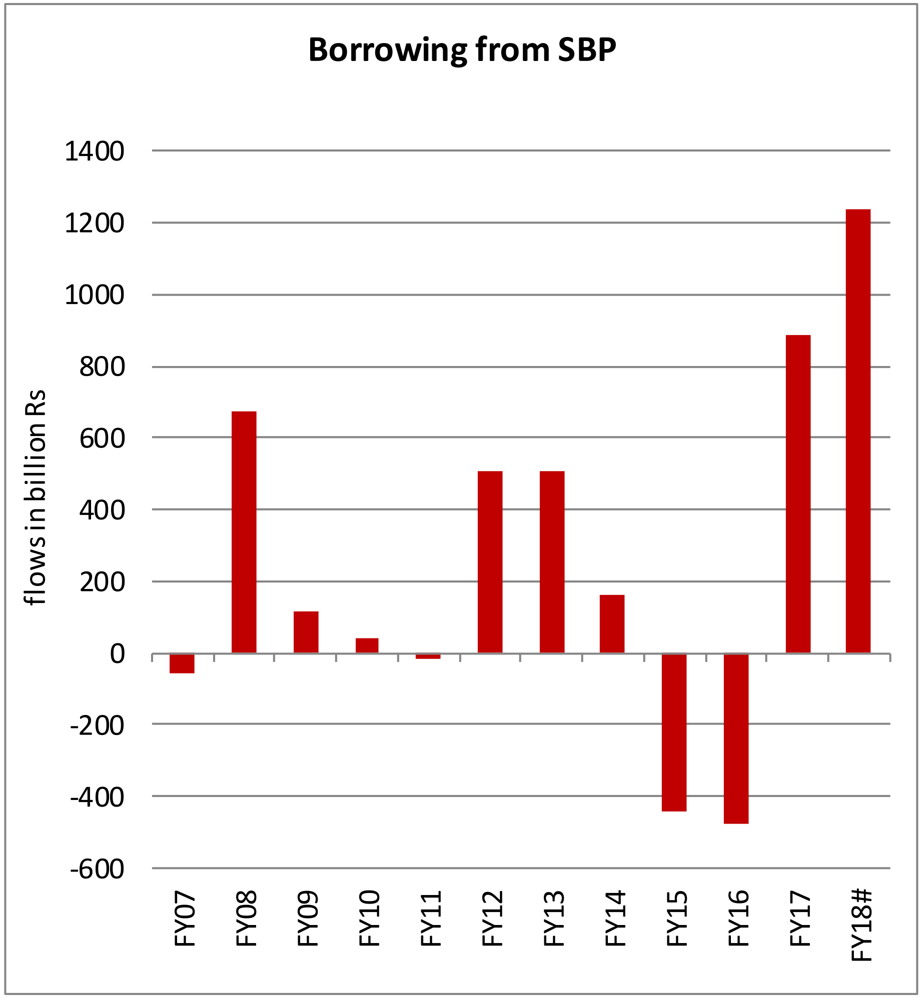




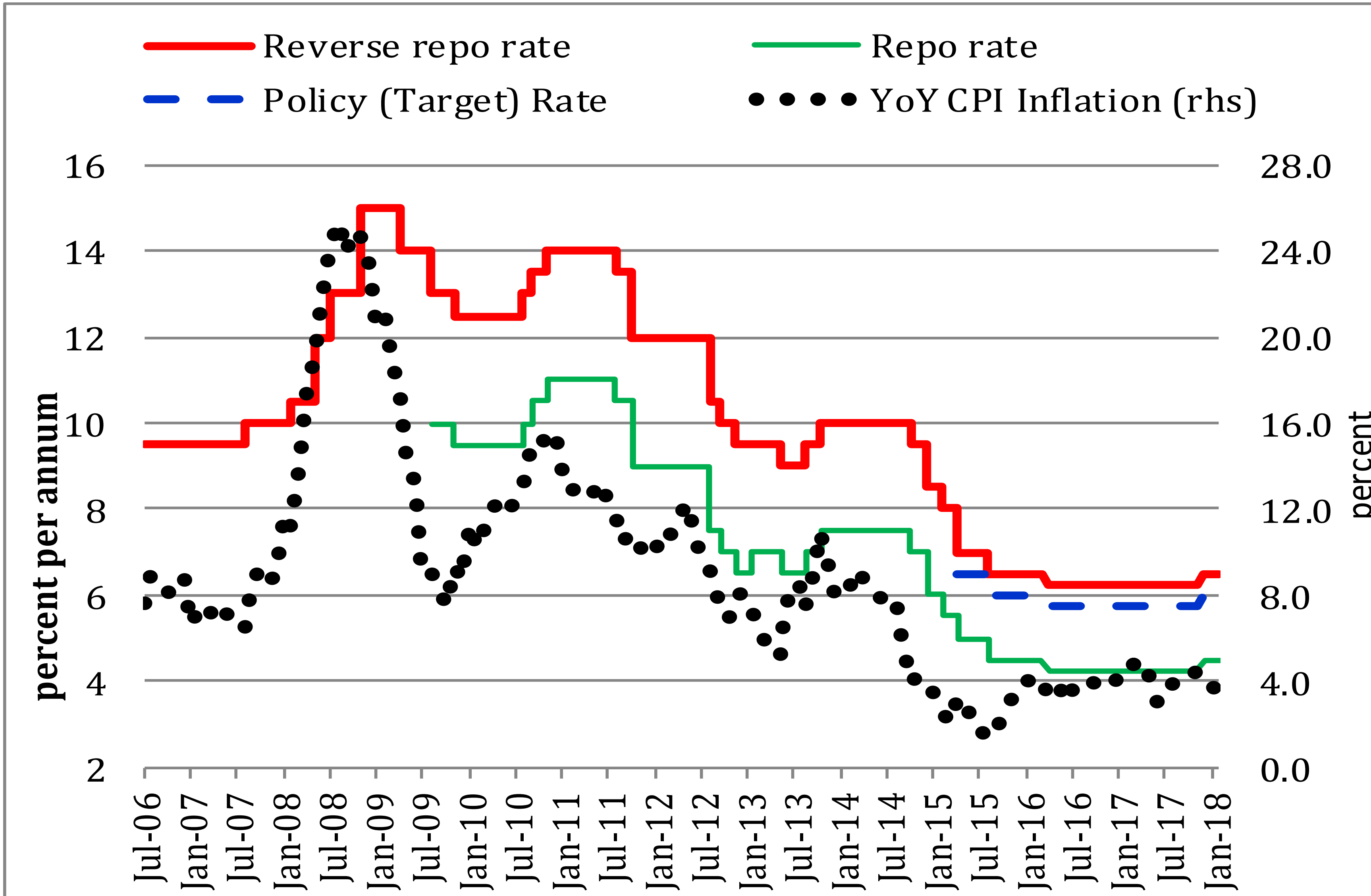
Macroeconomic environment

Uncertain fiscal position and volatile budgetary borrowing from SBP





Monetary policy stance



Thanks for the attention!