

Comments

The paper evaluates some monetary policy rules in terms of their performance in achieving the goal of macroeconomic stability: the rules have been termed as Inflation Targeting (IT)—a baseline, Stronger Inflation Targeting (SIT), Output Stabilization (OS) and Exchange Rate Smoothing (ERS). The paper evaluates these rules on the basis of different criteria including standard deviations of inflation, depreciation, output gap, and interest rate and welfare level of a representative household. A standard framework of stochastic dynamic general equilibrium has been used for this purpose by incorporating price and wage rigidities along with monopolistic competition. The important contribution of the paper, in my opinion, is that it illuminates how it is imperative to identify the nature of a shock before a central bank reacts to it.

The reaction function of the monetary authority used in the paper is an open economy version of the standard Taylor rule (with an addition of policy response to exchange rate variations). I would make two minor comments on this function: first a monetary authority can either be forward looking, in which case it would react to expected inflation; or it would be backward looking in which case it reacts to the previous period's inflation. The original formulation of the interest rate rule by Taylor (1993) was for a backward looking central bank, while Clarida et al. (2000) have formed a rule for a forward looking central bank. So these are the only two possibilities; a central bank cannot react contemporaneously to price changes as formulated by the paper under discussion; second the given reaction function is typical for a developed economy where a positive α_2 implies that the monetary authority will raise interest rate when actual output is higher than the target and reduce it when it is lower. However, a central bank of a developing economy may not always react in this way; particularly it may not raise interest rate when output is higher than the target (as long as inflation is within target). As a matter of fact we shall be jubilant if some year GDP growth surpasses the target and our prime minister will call a special press conference to announce that remarkable achievement. On the other hand, if actual output is less than the target then obviously the response would be to reduce interest rate. Thus a reaction function of a central bank of a developing country should look different than the one used for a developed country.

As regards the numerical values of the parameters, the assumed values look plausible except for a few of them: for example, the paper takes the elasticity of substitution between non-traded and traded goods as 1.1; no clear reason has been given why it should be more than unity. This parameter plays a crucial role in the analysis of the macroeconomic equilibrium of a small open economy for which

the author rightly has assigned a weight of 0.4 to traded goods. As I understand the non-traded goods—primarily services—are imperfect substitute of traded goods like manufacturing and agriculture so an elasticity of substitution less than *one* may be more plausible. Rozada and Neumeyer (2003) have estimated elasticity of substitution in non-tradable and tradable goods of 0.4 and 0.48 from two different data sets of a small open economy of Argentina. So in case of Pakistan too it should be in this range as Pakistan also is a small open economy. Similarly, the paper uses an equal adjustment cost of 400 for prices and wages; however, since wages are usually stickier than prices, a higher adjustment cost for wages than that for prices may be more appropriate.

The simulation results show that stronger inflation targeting should be preferred over other rules if utility index is made the selection criterion. However, this criterion is deficient as it does not capture the effect of exchange rate volatility on welfare, as reported by the author himself. The other selection criteria include standard deviations of four key variables that are inflation, depreciation, interest rate and output gap. According to these criteria, the rule of OS comes out as the best performer in case of interest rate parity shock and the ERS performs well in case of productivity and export demand shocks. Thus the set of appropriate interest rules should include OS and ERS; SIT should be excluded—as it comes out from the results of this paper.

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References

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