Workshop for Journalists
Understanding Macroeconomics, Financial sector and Banking

Monetary Policy Formulation and Implementation in Pakistan

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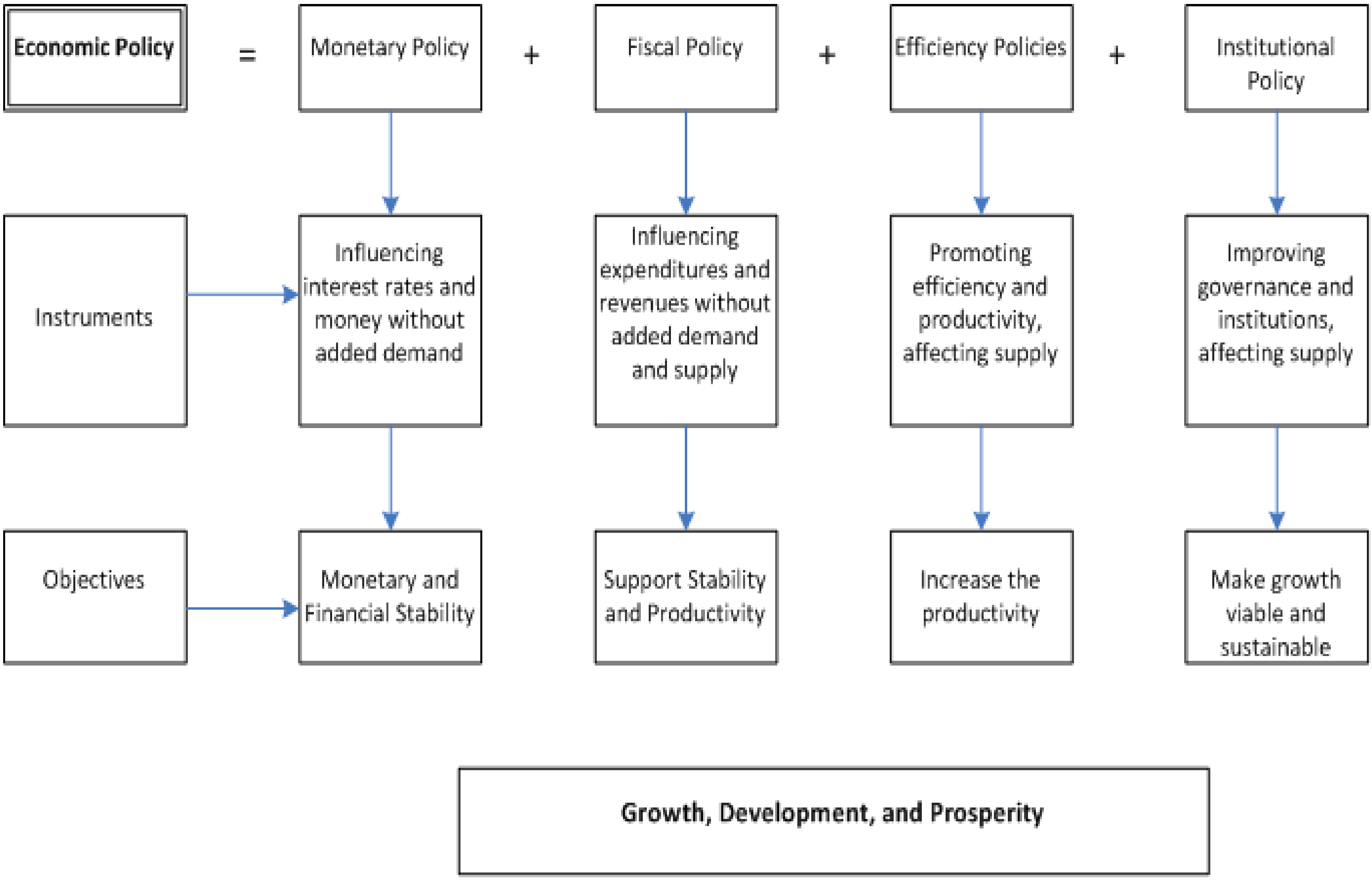
Outline

Monetary Policy Concepts, Framework, and Experiences

Monetary Policy: A component of economic policy



What is Monetary Policy?

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

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

Objectives of monetary policy in Pakistan

- Section 9A of the SBP Act 1956 lays out the objectives of monetary policy as follows:

"The Central Board shall, in order to secure monetary stability and soundness of the financial system —

a) Formulate and monitor monetary and credit policy and determining the expansion of liquidity, take into account the Federal Government's targets for growth and inflation and ensure that the Bank conducts monetary and credit policy in a manner consistent with these targets and the recommendations of the Monetary and Fiscal Coordination Board with respect to macro-economic policy objectives:"

- Within this broad mandate, SBP focuses on controlling inflation close to its target while taking into consideration implications of monetary policy changes for short-term growth prospects.

  Price Stability **is defined as a situation where inflation remains in a specific range for a certain time period or low enough so that it does not affect people's decision making.**

What monetary policy can and cannot achieve?

- 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.

  - Aggregate demand reduces by tightening (or increases by loosening) after a lag, but aggregate supply is primarily constrained by potential output.

- 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.

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

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, 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-offs -- for example, monetary tightening might help in controlling inflation, but might cause unemployment to rise in the short-run.

An overview of monetary policy framework

"Institutional arrangements under which decisions are made and implemented"

- **Ultimate objective or target** – the variable that central bank eventually aims at; mostly, price stability but there are variations.
  - Pakistan: Monetary stability; Soundness of the financial system; Fuller utilization of country productive resources
- **Intermediate target** – an economic variable that central bank can control with reasonable time lag and has a relative stable relationship with the ultimate target; e.g. monetary aggregate (M2), exchange rate, inflation target, etc.
  - Pakistan: Inflation and assessment of monetary aggregates
- **Operational target** – the variable that central bank wants to control and can definitely control to a large extent on a daily basis using its monetary policy instruments; e.g. short-term money market interest rate, monetary base, etc.
  - Pakistan: money market overnight repo rate
- **Instruments** – tools available to the central bank that it can use to achieve its operational target; e.g. standing facilities, OMOs, reserve requirements, etc.

Operational target

- **Overnight money market repo rate** is a weighted average interest rate on overnight repos against treasury bills/PIBs in the interbank market, using share of respective transactions in total amount 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.

Other interbank rates

- ***Clean rate***: weighted average lending rate on all uncollateralized (clean) transactions held between the financial institutions;
- ***Call rate*****:** weighted average lending rate on all uncollateralized transactions held among scheduled banks with the option of being called by the lender at any time before the maturity;
- Most of the interbank transaction are repo based; about 85% of interbank transactions are repo based
- **KIBOR**—Karachi Interbank Offered Rate—is an average of clean 'offer rates' quoted by the banks in the KIBOR club (currently, 18), excluding three highest and three lowest offered rates;
  - KIBOR is used as benchmark for corporate lending;
  - indicate participant banks' view on clean lending and borrowing rate levels in interbank market for various tenors;
  - is calculated and disseminated by Financial Markets Association of Pakistan (FMAP);
  - each bank in the club submits KIBOR (KIBID) for all tenors on Reuters and FMAP web on a daily basis for a minimum amount of Rs100 million;

Monetary policy strategy to achieve these objectives

- SBP make adjustments in the policy rate in the direction it deem necessary to control inflation close to its target;
  - Control money supply to manage aggregate demand in line with economy’s potential to supply over the medium term.
- Decision about change in the policy stance (rate) is broadly based on the assessment of **near-term inflation path and inflation expectations** vis-à-vis announced inflation target;
  - Occasionally, SBP has adopted accommodative stance, but only when SBP’s assessment clearly indicated inflationary pressures to ease and inflation to remain within the target.
- SBP also shares its forecasts and projections of key macroeconomic variables including reserve money, M2 and its major components, imports and exports, and current account balance;
  - these are aimed at assessing demand pressures in the economy and draw implications or information content for future economic activity and inflation;

Monetary policy strategy to achieve these objectives (Cont…)

- Operationally SBP focus on controlling short-term inter bank interest rates – overnight money market repo rate;
- This has effects on other market interest rates, such as secondary market rates, KIBOR, that are used as benchmark for lending to businesses and households;
- The resulting changes in behavior of businesses and households then influence (consumption and savings) aggregate demand and thus output and prices;
- The transmission of monetary policy actions to ultimate objectives, however, depends on how businesses and households respond to these changes.

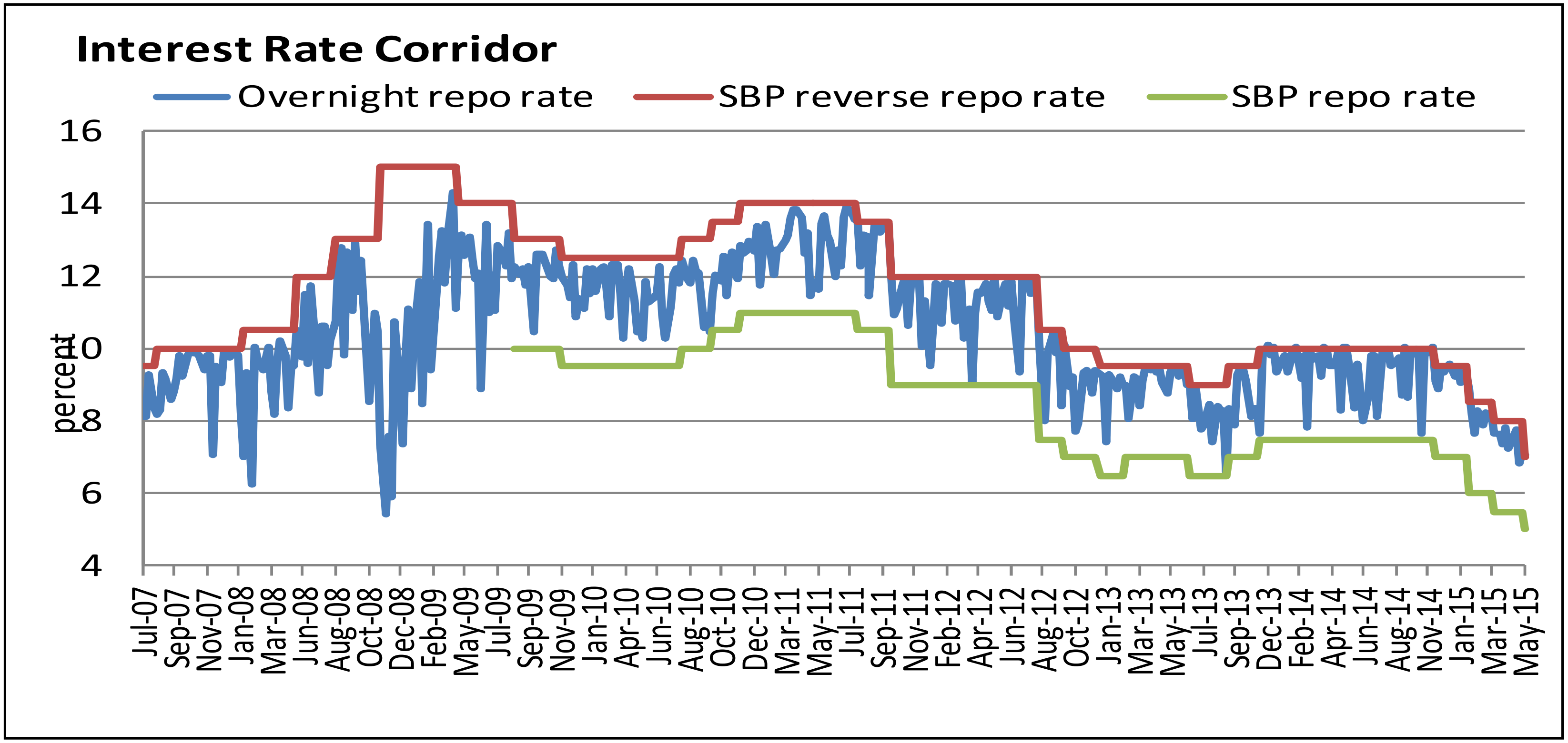
Liquidity management: interest rate corridor

The current IRC comprises the following:

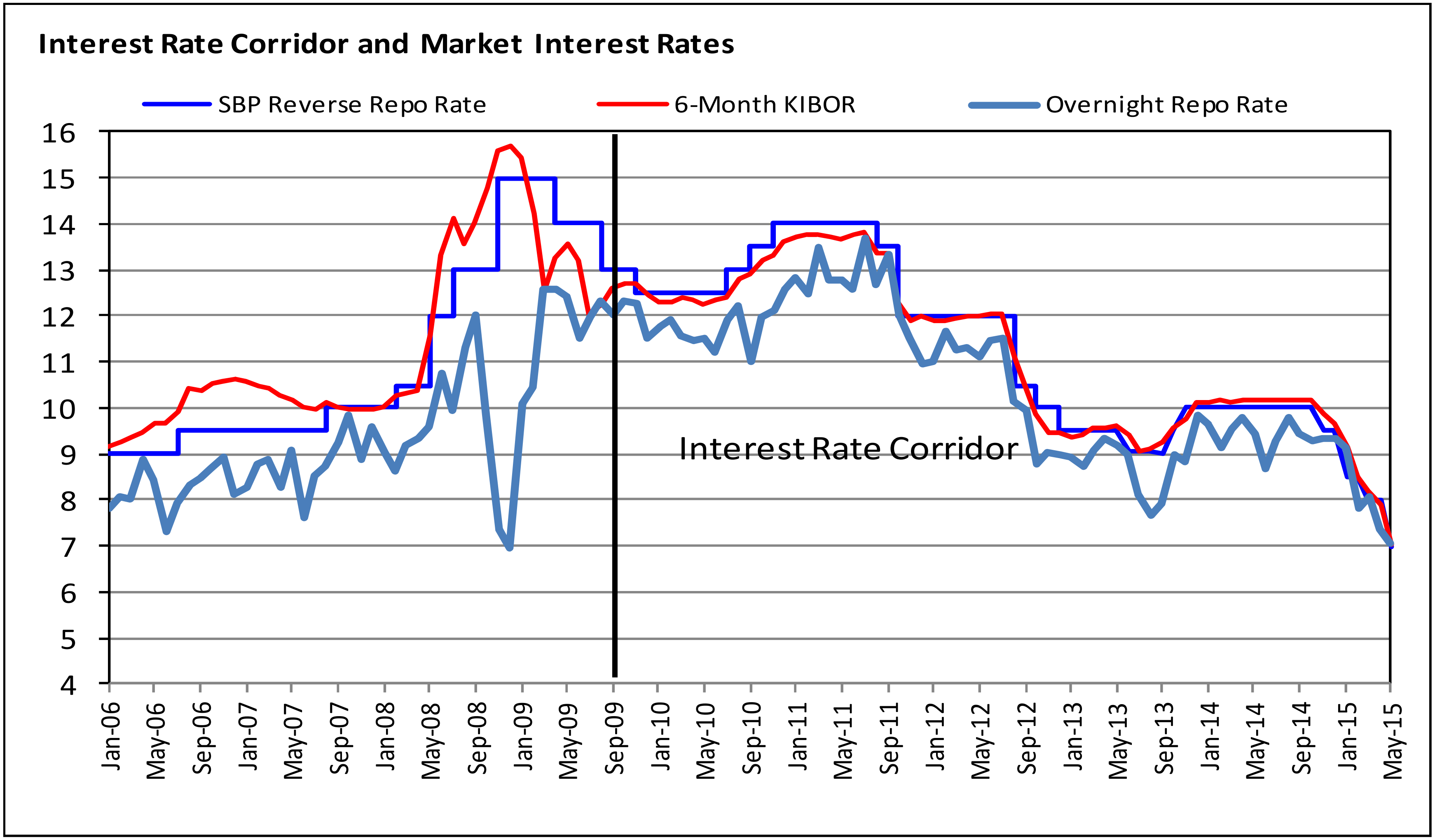
(i) SBP overnight reverse repo rate serves as the effective ceiling for overnight money market repo rates;

(ii) SBP repo rate provides a binding floor to the downward movement of overnight money market repo rates;

(iii) SBP 'Target Rate' for overnight money market repo rate - a new 'Policy Rate' to unambiguously signal SBP's stance of monetary policy.



Effectiveness of operational framework



Monetary policy instruments

Rates on standing facilities

- SBP Target rate / new policy rate at 6.5 percent (effective 25 May 2015) - SBP expresses its monetary policy stance
- SBP reverse repo rate (Discount rate); 7.0%; 50 bps higher than the target rate
- SBP repo rate—currently at 5.0% is 200 bps below SBP reverse repo rate

Open Market Operations

- conducted regularly.

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 foreign currency 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

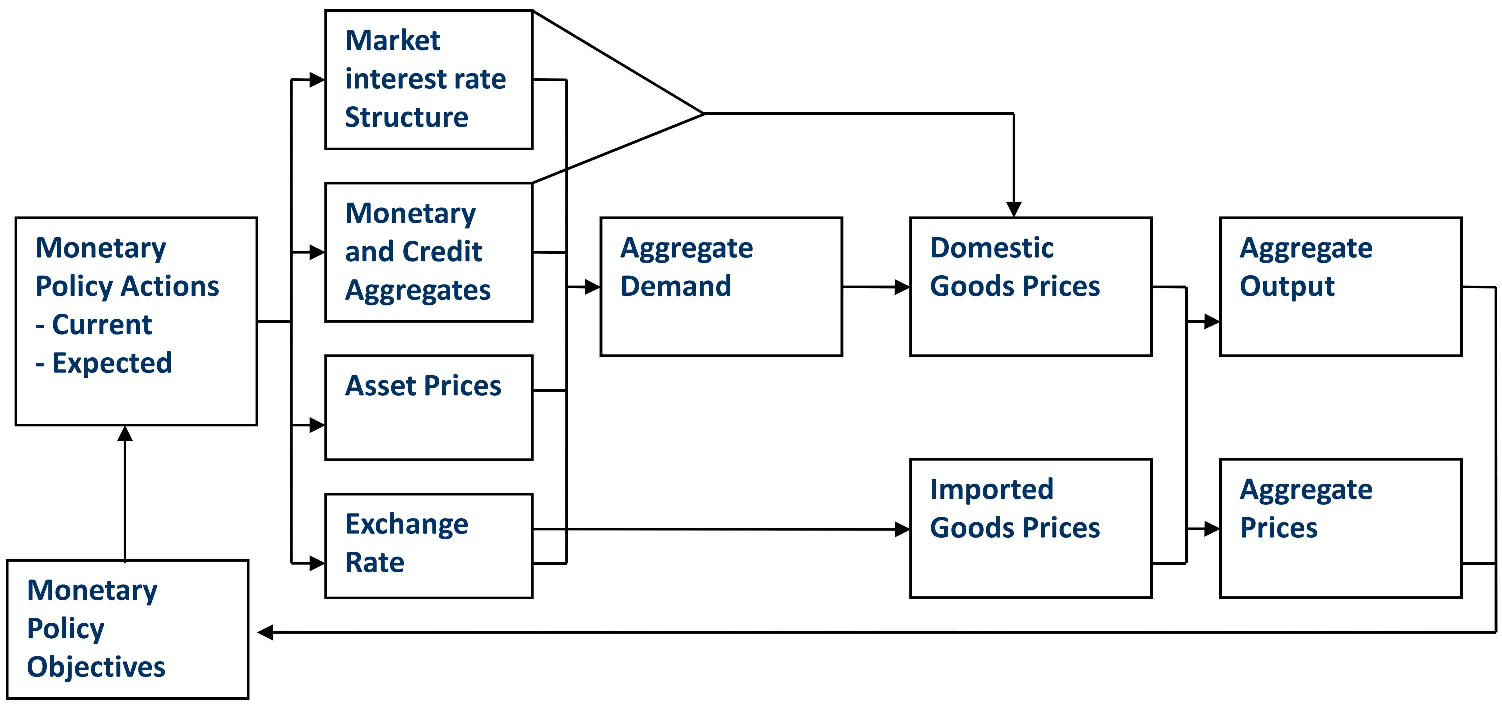
Forex Swaps

- Typically used in forex market but also affects rupee liquidity

How monetary policy works?

- Monetary policy affects the goal variables (i.e. inflation and economic activity) through adjustment in aggregate demand brought about by changes in interest rate and money supply in the economy.
- This process is known as transmission mechanism of monetary policy.
- The changes in policy rate, working through various channels—called transmission channels, affects the interbank and other retail interest rates in the economy directly as well as through changing the 'expectations'.
- The resulting changes in retail interest rates affects the consumption and investment behavior of the economic agents 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



Typical constraints to monetary policy

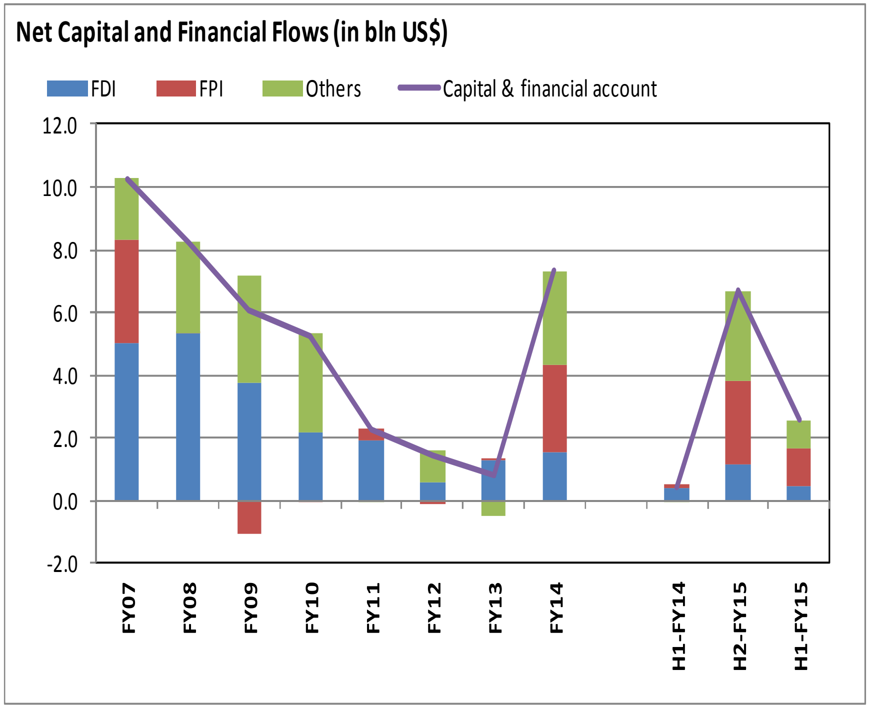
Typical constraints to monetary policy include:

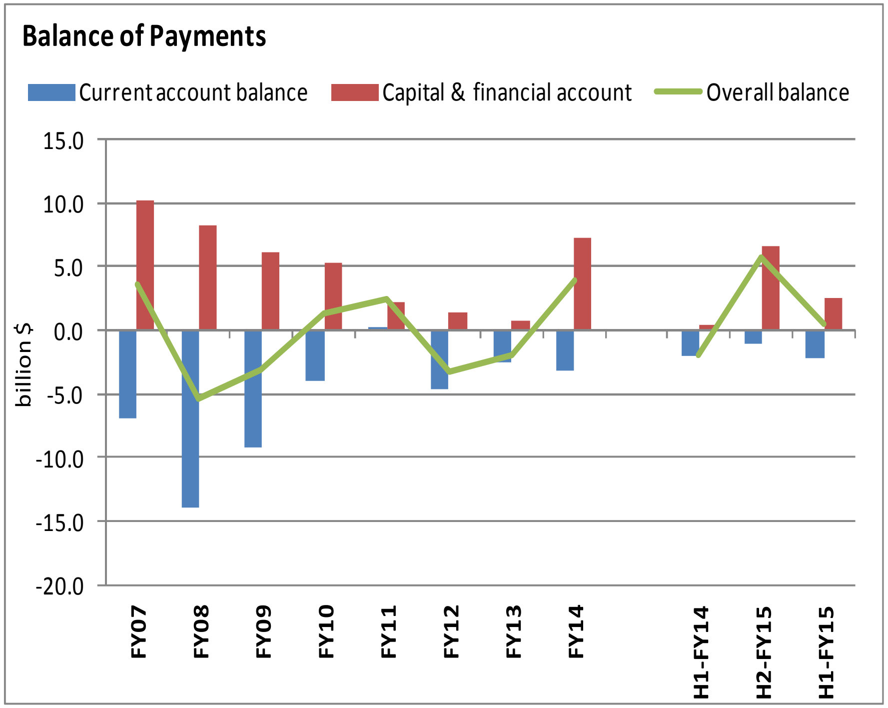
- **Risks to external sector**
  - Increase in balance of payments deficit with changes in current account deficit not commensurate with capital and financial account balance has an impact on foreign exchange reserves positions and the exchange rate.

- **Fiscal weakness**
  - Large fiscal deficits *may* lead to increased borrowings from the banking system and crowd out private sector credit.

Risks to External Sector

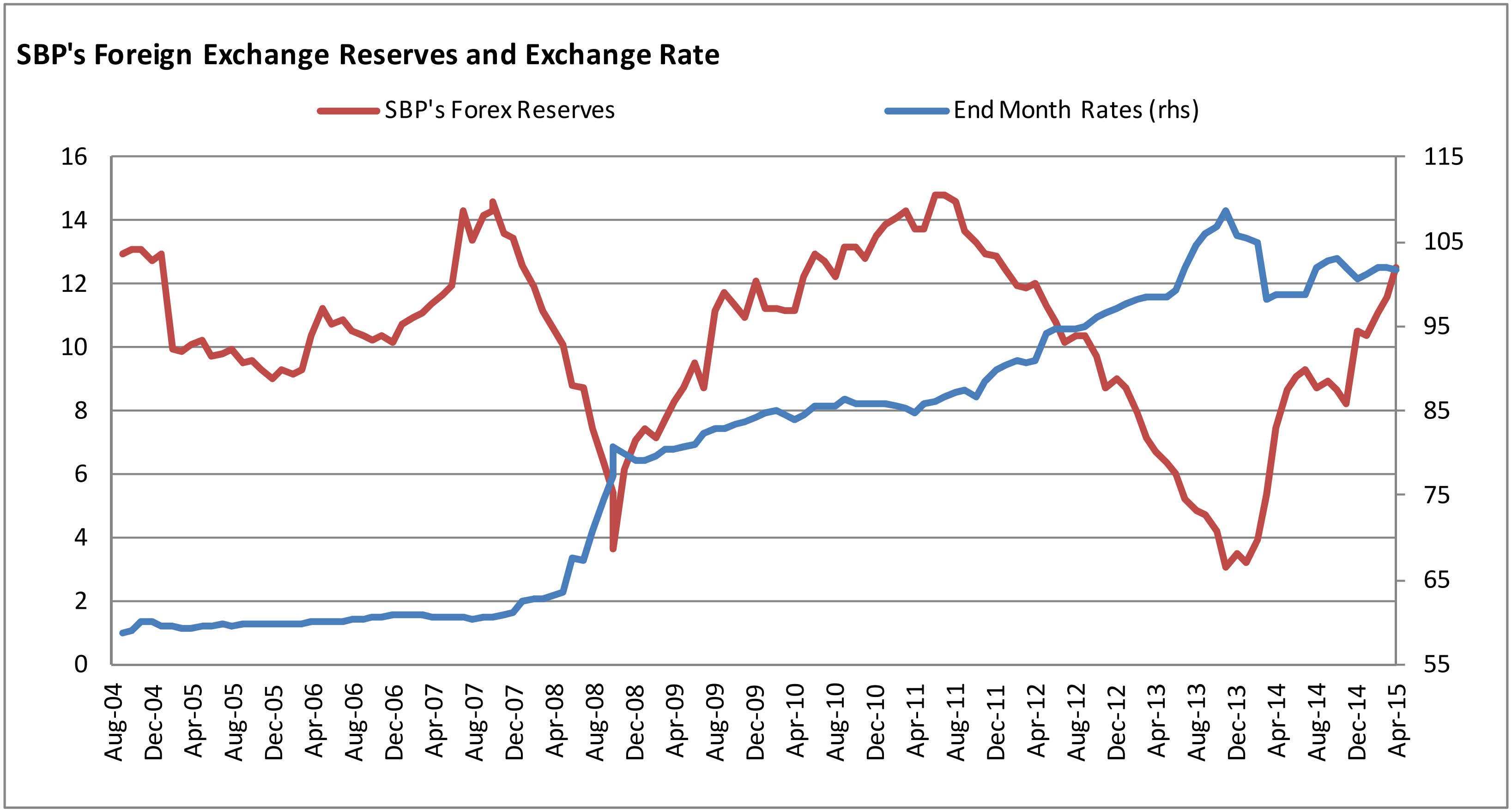
- Private foreign inflows, which have been one of the major sources of financing current account deficit in previous years, has declined sharply.
- Slowdown in these net financial inflows made even lower current account deficits unsustainable leading to pressures on foreign exchange reserves and exchange rate.
- More recently, the financial flows have improved significantly to reduce such pressures.



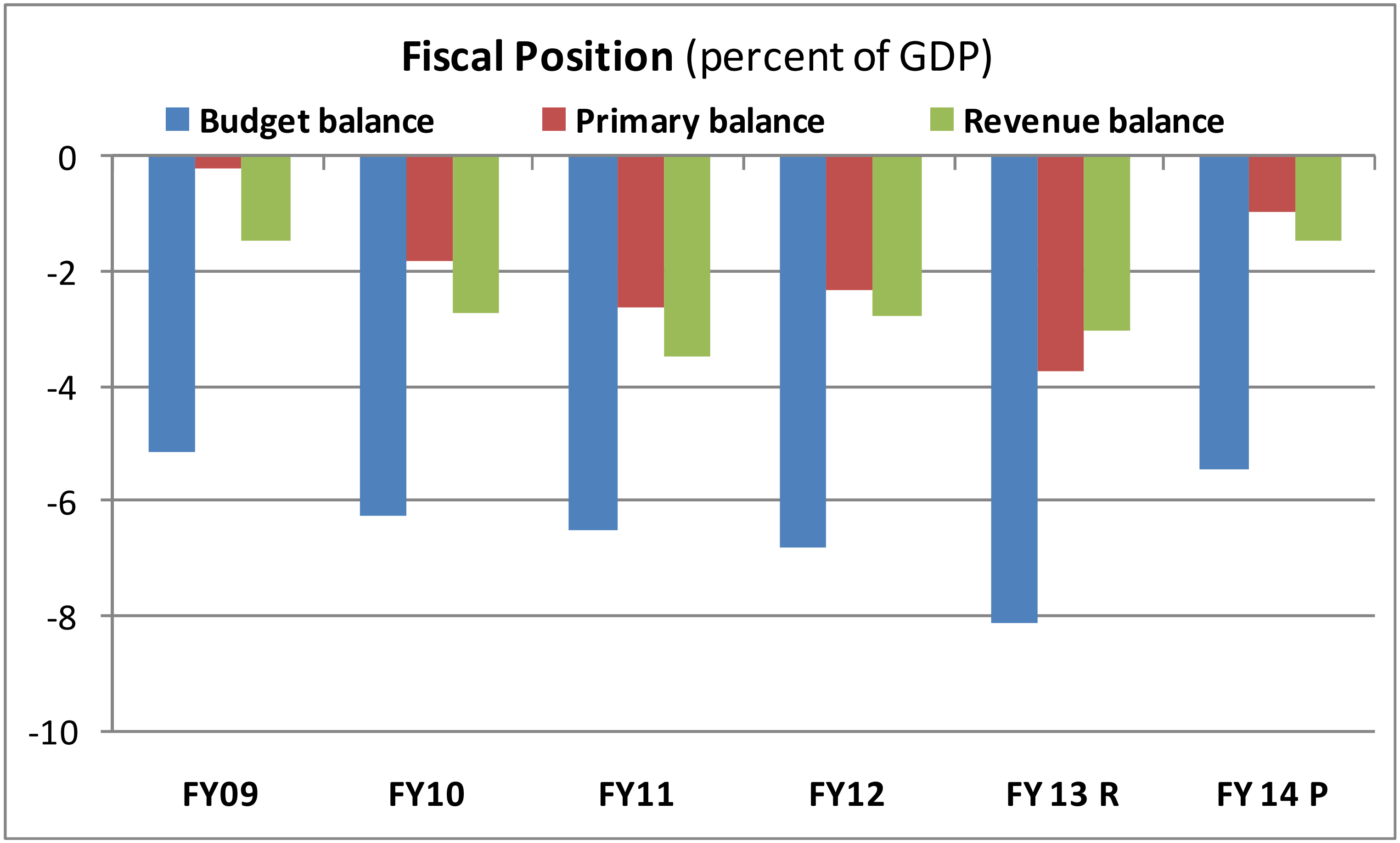


Risks to External Sector (Contd.)

- Initially, exchange rate did not adjust with the deterioration in current account, requiring a much bigger adjustment later on.

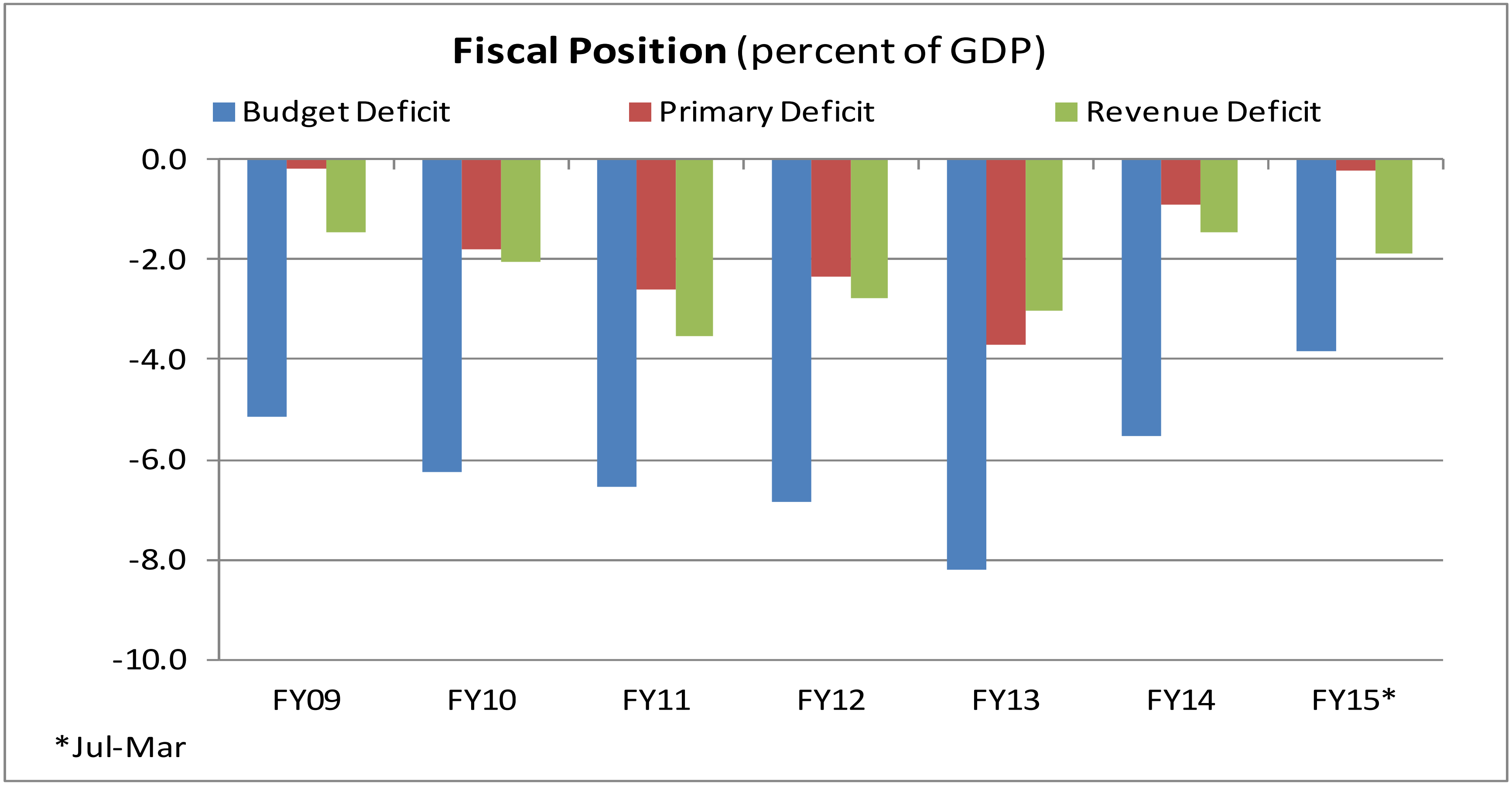


Fiscal Position



Fiscal balance = total receipts – total expenditure
Revenue balance = total receipts – current expenditure
Primary balance = total receipts – (total expenditure – interest payments)

Fiscal Position



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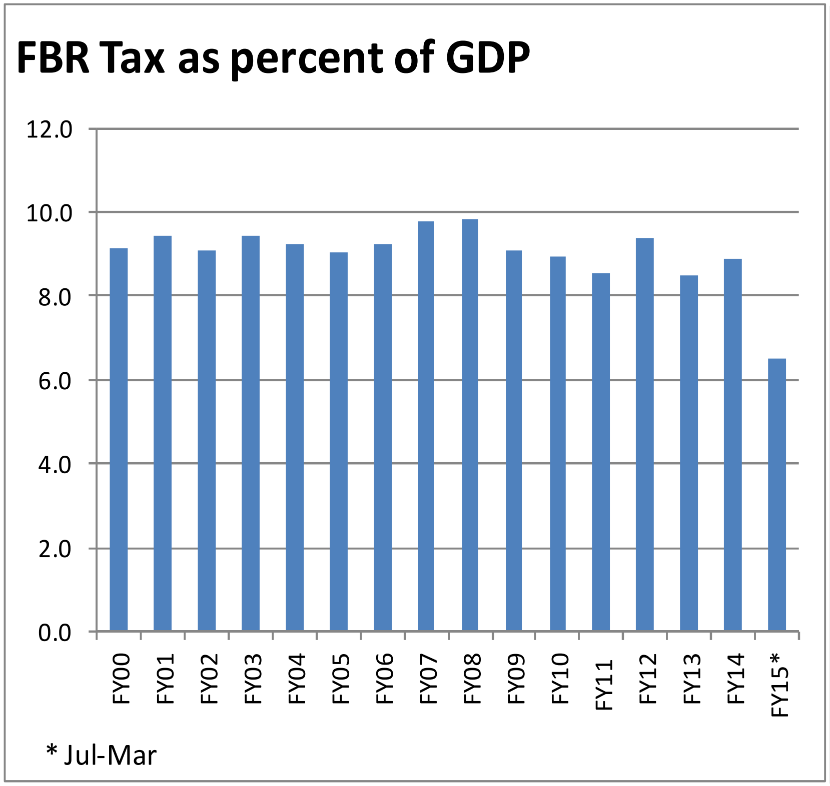
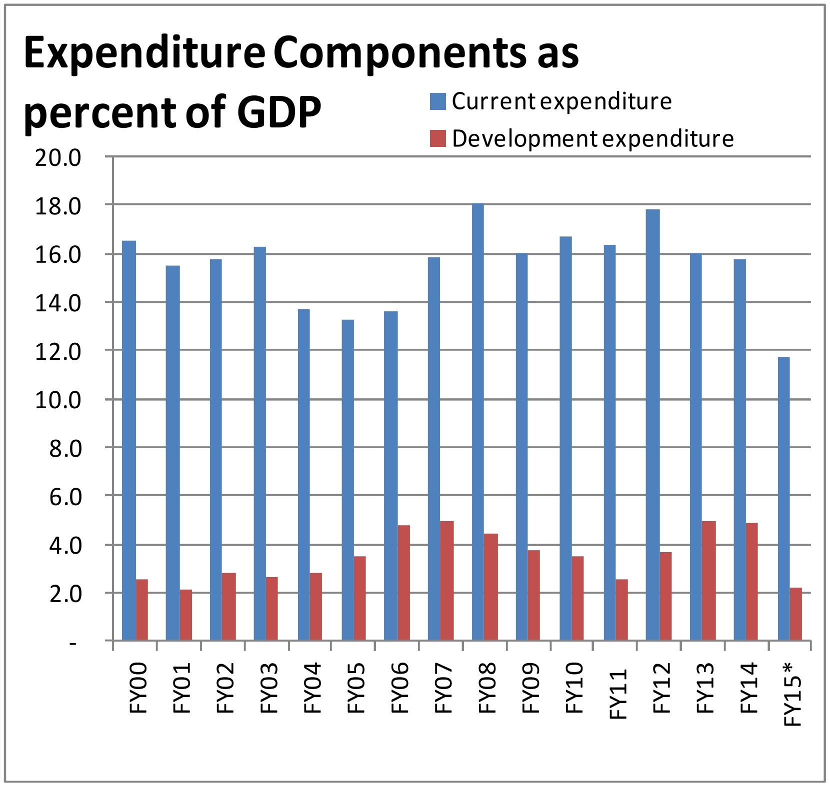
Tracing the fiscal stress

- Revenue generation has been low and showing a declining trend.

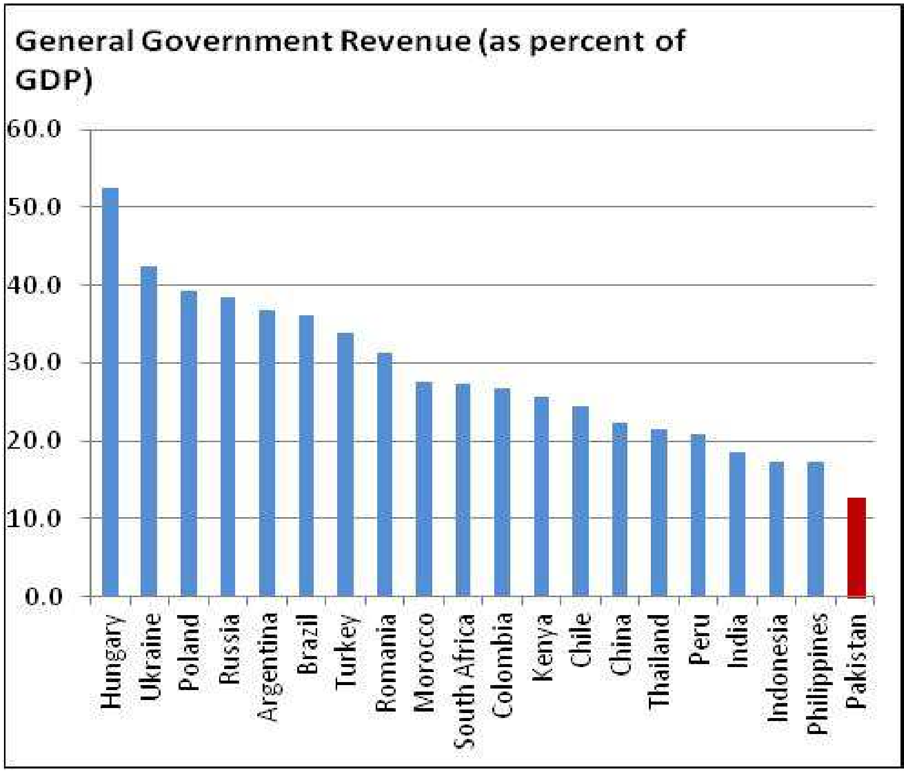
- At the same time, there have been breaches in current expenditure targets, especially on subsidy account.

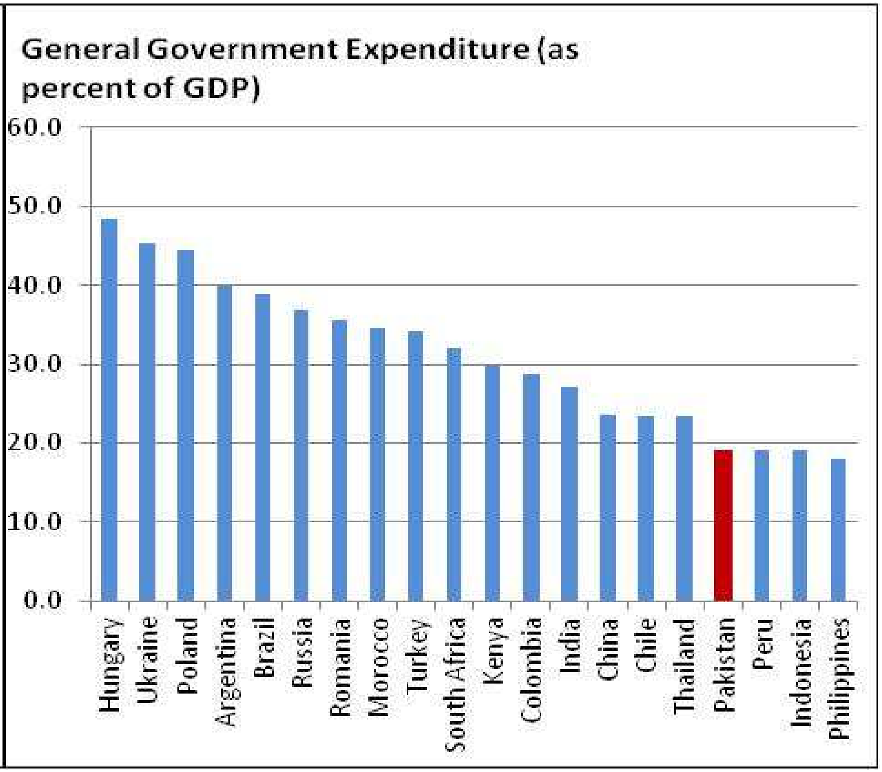




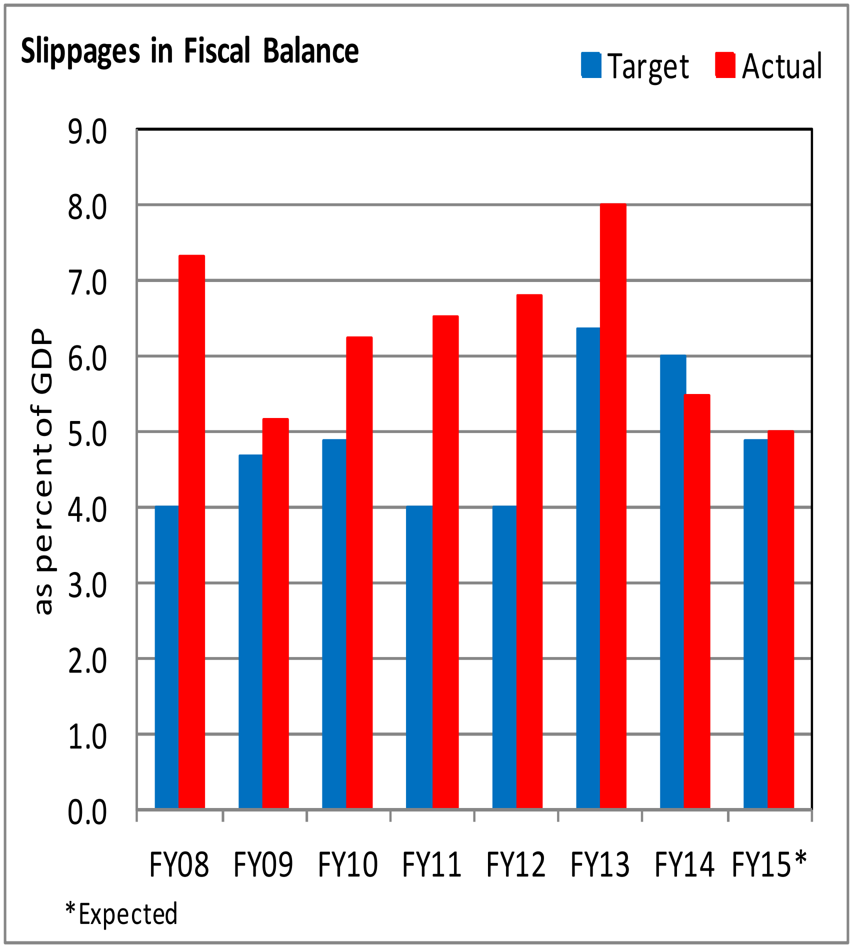
Revenue and expenditure level comparisons

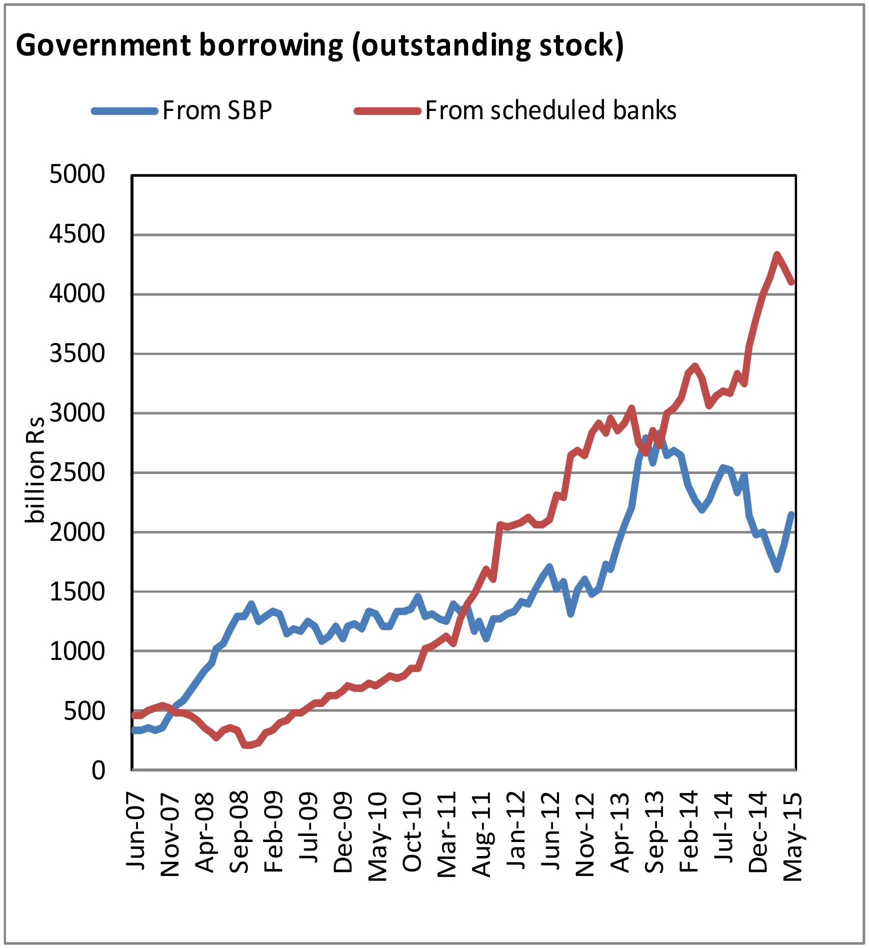
- On revenue account Pakistan is a clear outlier in comparison to emerging markets, with revenue collection to GDP ratio.
- Expenditure to GDP ratio however is quite low, suggesting that revenue collection is not in line with resource needs of the country.





Fiscal deficit and its financing

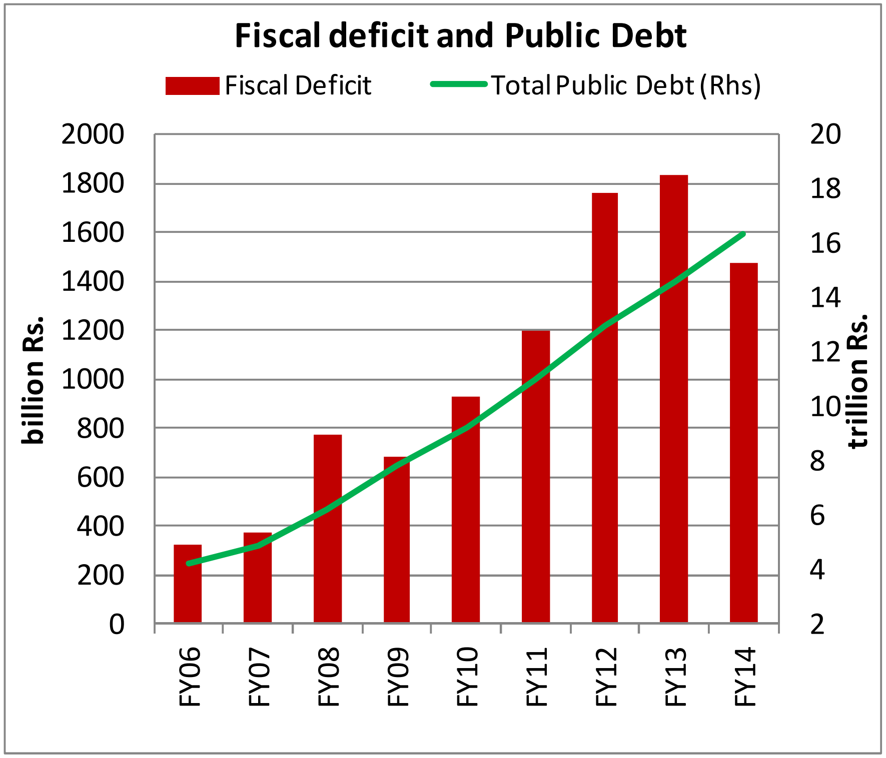


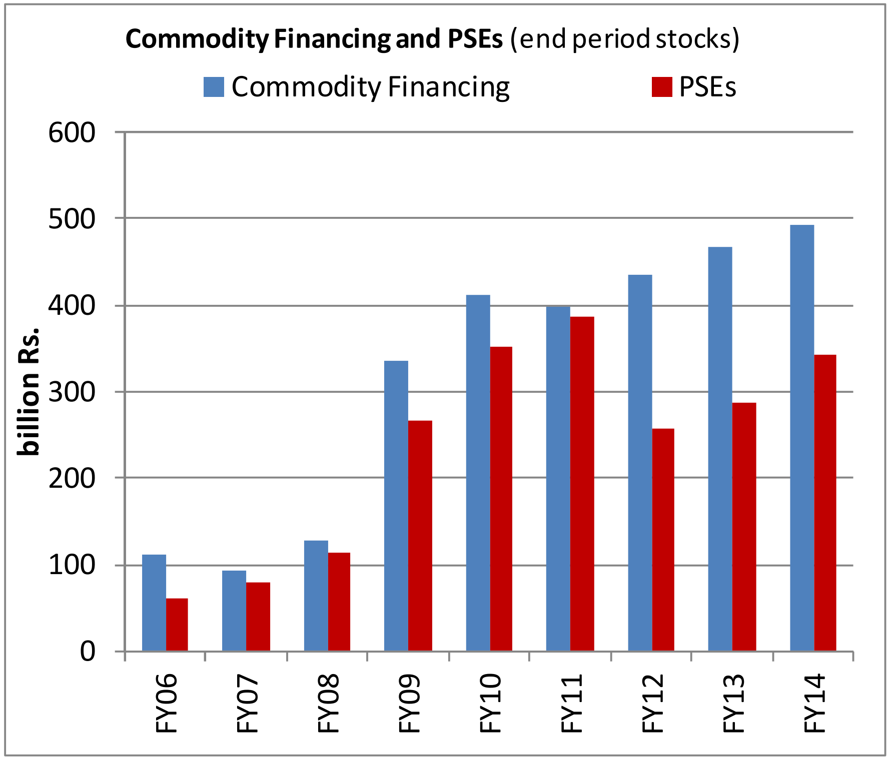


Fiscal and quasi fiscal borrowings and rising debt burden

- Due to a large fiscal deficit, total debt and liabilities stock has continued to surge, reaching Rs16.2 trillion by end-June 2014.

- Borrowings by the Public Sector Enterprises (PSEs) and for commodities operations of the government have also reached to abnormally high levels.





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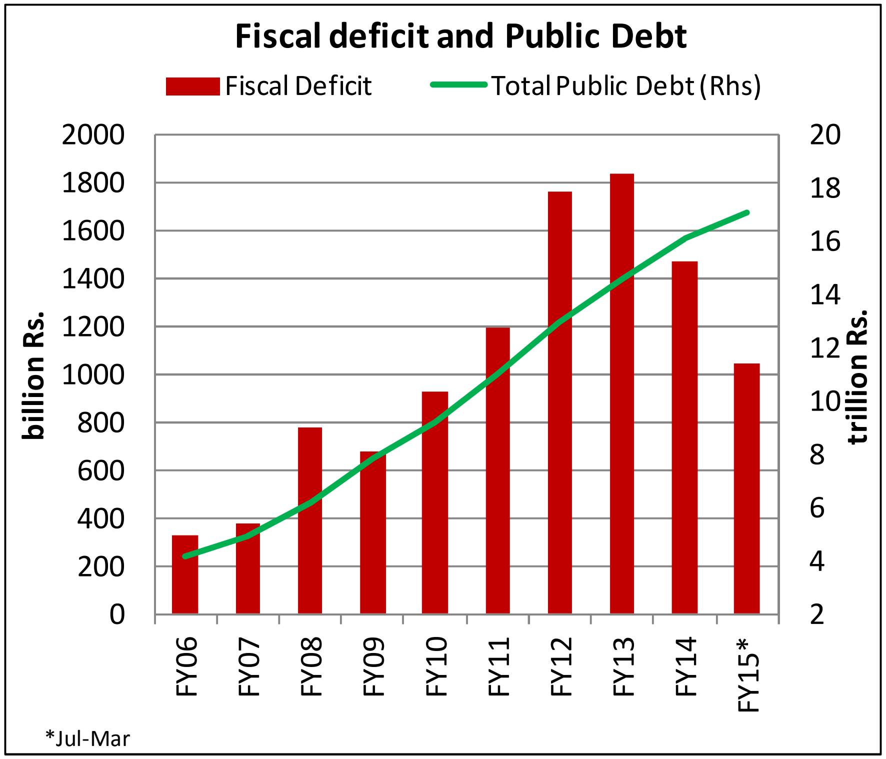

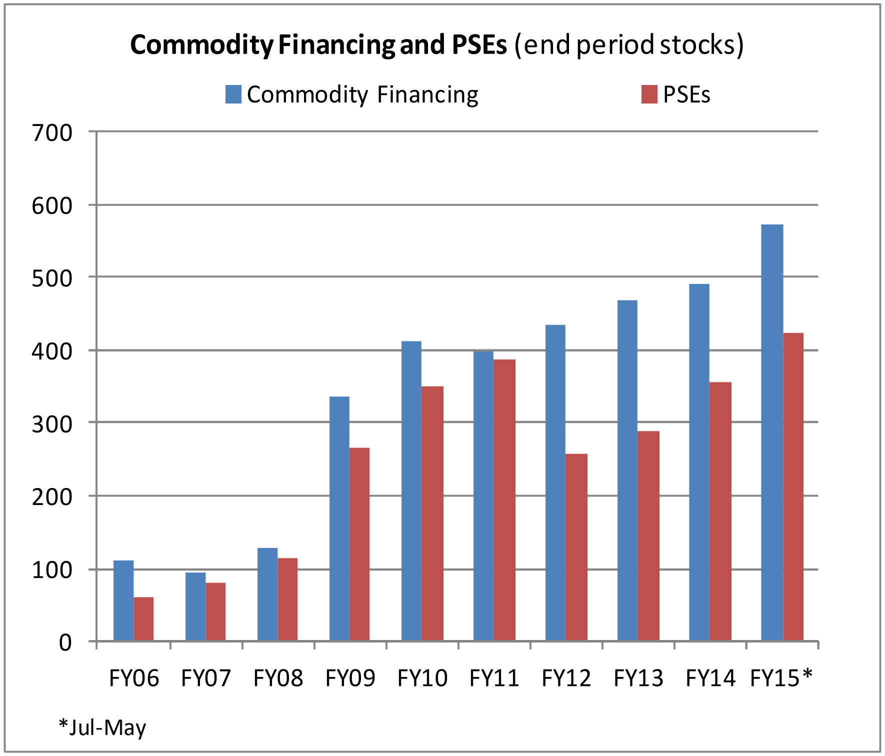

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