Ishrat Husain: What works best for emerging market economies?

Keynote address by Mr Ishrat Husain, Governor of the State Bank of Pakistan, at the SBP Conference on Monetary-cum-Exchange Rate Regime, Karachi, 14 November 2005.

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Conduct of monetary policy in emerging market economies is certainly no less challenging than it is in advance economies; it may be argued that it is, in fact, more challenging because of different nature of economic, socio-political and institutional structure of emerging market economies. However, the experience of advance economies in formulating and implementing monetary policy combined with the broad principles of economics and their own experiences provides a natural starting point for the central banks of emerging economies to actively search for improving their monetary regimes.

Last decade of twentieth century witnessed significant transformations in the institutional workings of central banks around the world starting with the landmark independence of Reserve Bank of New Zealand in 1989. Greater realization for the need to have independent central banks on the part of governments, and the need to enhance institutional competence on the part of central banks produced a wave of central banking reforms both in advance and emerging market economies. Pakistan had also immensely benefited from this evolution starting with the administrative and operational independence legislated first in 1994 and again in 1997 that completed its de jure independence.

Before SBP's independence, monetary and exchange rate regime had evolved from fixed peg up to early 1980s and managed float till 2000. From the onslaught of financial sector reforms in Pakistan, especially with reference to adoption of market-based or indirect instruments of monetary policy, SBP started to follow monetary aggregates targeting from early 1990s. With greater liberalization of interest rates and gradual strengthening of transmission mechanism of monetary policy, more attention was paid to management of shortterm interest rates, but within the framework of monetary aggregate targeting with inflation as the ultimate target, broad money as the intermediate target and base money as the operational target. Moreover, the focus of monetary regimes during 1993 to 2004 was on quantity variables like ceilings on SBP NDA and floors on SBP NFA, which is the hallmark of IMF monetary programs. Focus has since then shifted to base money rather than its subcomponents after the successful conclusion of Poverty Reduction Growth Facility (PRGF).

Over the years, especially during the last couple of years, practice of monetary policy implementation was broadened to include important indicator variables like the yield curve in addition to several aggregates other than broad money. Furthermore, several steps were taken to make the monetary policy more transparent. Indicative monetary planning, rather than strict credit rationing that used to be practiced prior to 1992, is done under the aegis of National Credit Consultative Council, which still makes the Credit Plan. Intermediate monetary targets are set there consistent with ultimate goals of inflation and real GDP growth. Interest rates were increasingly given more importance because of their superiority in signaling of monetary policy stance, yet within the framework of monetary and reserve money program. Transparency was increased by issuing six-monthly statements on monetary policy. Candid analytical reviews in SBP Annual and Quarterly Reports, not only on the real economy, but SBP's own monetary policy also added to increased transparency. Recent release of Monthly Inflation Monitor is also a step in this direction.

At this juncture, when SBP has established itself as an independent central bank, with a sound banking sector, it needs to carefully review the international best practices of conducting monetary policy. In fact, many good practices are already in place; my predecessor Dr. Yaqub institutionalized internal monetary policy operational consultative process by constituting a committee that drew senior members from the relevant Departments under the Chairmanship of Deputy Governor that met regularly. I enlarged the scope of the committee to coordinate both money market and foreign exchange operations in 2001. Monetary and Exchange Rate Policy Committee meets bi-monthly, reviews the current economic situation together with emerging monetary and exchange rate trends, and forms a recommendation by majority and I then act by again taking views and evolving a consensus. The system is well structured, takes a lot of information systematically into account and can be termed as an eclectic approach to monetary policy implementation, which Mishkin has sarcastically described as 'just do it strategy'.

Nonetheless, system needs continued strengthening, especially when the fad of inflation targeting has spread quickly not only in advance countries, beginning with New Zealand in 1990 and several developed countries during early to mid 1990s, but to several emerging market economies as well, which are not very different from Pakistan in many of economic and social characteristics. Inflation targeting seems to offer a lot of advantages, especially in terms of increasing transparency and credibility of a central bank.

However, the evidence of superiority of inflation targeting over other alternatives is, at best, partial. Cumulative experience of countries with inflation targeting is comparatively smaller than the historic experience of other regimes to conclude anything unambiguously. More importantly, monetary policy can not be formulated and implemented in isolation of government policies no matter how independent a central bank is whether of an advance or a developing country. This aspect is of utmost importance for developing countries that still have a relatively weak taxation regime, with lingering suspicion of fiscal dominance hovering most of the time. In Pakistan, the Government does not have a broad revenue base and the domestic financial markets do not have enough depth to absorb placements of public debt. So, although the precondition of Central Bank independence is met for pursuing inflation targeting the other conditions is missing. For example, selection of an appropriate price index itself to define the target is problematic in the choice of exchange rate regimes. As the role of market forces is expanding due to liberalization, deregulation and privatization of the financial sector there are changes taking place in the transmission mechanism of monetary policy also. The redefinition of the regulatory role of the SBP, the revision of the prudential norms, the revamping of the bank supervisory tools, the shift towards automation and electronic banking and financial innovations in products and services are contributing to the emergence of a different financial system.

I now turn to the Exchange Rate Regime in Pakistan.

Pakistan has adopted the floating inter-bank exchange rate as the preferred option since 2001. SBP has attempted to maintain real effective exchange rate at a level that keeps the competitiveness of Pakistani exports intact. But, like other Central Banks, it does intervene from time to time to keep stability in the market and smooth excessive fluctuations. The managed float has served us quite well as it has conferred a degree of certainty and predictability to the economic agents to make informed judgments about the relative movement of the exchange rate. The accumulation of reserves during the last four years has underscored the credibility of the exchange rate policy and minimized excessive speculative activity. At the same time and until mid 2004 – the exchange rate stability also helped contain inflationary expectations as unlike in the decade of the 1990s when the rupee was depreciating at an average of 120 per cent per year vis-à-vis the dollar, the rupee became strengthened.

The current framework of monetary-cum-exchange rate policies and the underlying economic analysis in Pakistan can, thus, be broadly characterized as judgment and discretion based rather than model or rule based. The main justification for the current practice is that the economy is undergoing fundamental structural transformation and thus the behavioral relationships among the variables and the time lags influencing the behaviour are in a state of flux and transition. An added complicating factor is that measuring and predicting expectations about the possible effects of policy changes makes it difficult to model the monetary and financial behaviour in a robust way. Furthermore, the Central Bank's own credibility is an endogenous variable that affects the outcomes and expectations. A model or rule based framework may, therefore, be inadequate at present to guide the SBP in meeting unanticipated exogenous shocks and managing unforeseen crisis or crisis like situations as our understanding of the empirical links between instruments and targets of monetary policy is incomplete and rudimentary.

We must all remember that the recent episodes of financial crisis in the 1990s occurred in countries where inflation was low, fiscal deficits were small or even absent and the public debt burden was at tolerable levels. Models based on the past data missed these episodes as they would have emanated danger signals only if the countries had high current account deficit, unsustainable external debt burden and serious fiscal imbalances or a combination of these.

In hindsight, a better way to detect the signs of danger would have been to complement the sound monetary and fiscal policies with flexible exchange rate, better regulations and supervision of the financial sector, greater disclosure, transparency and communication. This could have been possible if the policy makers did not concentrate on mechanistic tools but took a more holistic and broad-based view of the economic variables, their movements and assessed their relative impact on the macroeconomic outcomes.

In this perspective, I hope that the present conference will provide a stimulating intellectual impetus to SBP research and policy staff to chart out alternative courses of monetary strategies for the future. It has already been envisaged in the 5-year Strategic Plan of SBP that the current internal Monetary and Exchange Rate Policy Committee will be transformed into a conventional Monetary Policy Committee with decision making powers about altering the monetary policy stance in a transparent manner in future. I am also sure that the papers presented today and tomorrow will also give ample food for thought to journalists and academicians alike who will be listening carefully to form their own views and expectations about future strategy of SBP that is best for enhancing the economic welfare of Pakistan.