Yaseen Anwar: Monetary policy framework in the SAARC region

Address by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the SAARCFINANCE seminar on "Monetary policy framework in the SAARC (South Asian Association for Regional Cooperation) region", Islamabad, 14–16 June 2012.

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Distinguished speakers, honored guests and fellow colleagues, allow me to welcome you, on behalf of the State Bank of Pakistan, to Islamabad for the seminar on "Monetary Policy Frameworks in the SAARC region".

The seminar, as you all know, has been organized under the auspices of the SAARCFINANCE banner. The SAARCFINANCE initiative, now more than 14 years old, has been instrumental in providing a platform that enables knowledge-sharing across the SAARC region and allows for discussion and debate amongst the region's premier economic decision makers.

Let's move on to the subject of the seminar now.

Central banks are often synonymous with monetary policy. And why shouldn't they be? After all, monetary policy is any central bank's premier policy tool to achieve its objectives. Strictly academically, the monetary policy framework consists of an institutional arrangement, which provides an anchor to identify monetary policy objectives and describes how the policy is implemented through a set of instruments and their intermediate and operating targets. Wow, that was quite a mouthful! Let's make it simple. In essence, monetary policy has its means (i.e. the framework) and its ends (i.e. macroeconomic objectives). When those two are congruent, the monetary policy framework is considered well-defined.

Let's go backwards here and have a look at the ends first. The universal aim of monetary policy is achieving price stability; a secondary aim of monetary policy may be growth. For instance, the preamble to The State Bank Act states that the bank is supposed to "regulate the monetary and credit system of Pakistan… with a view to securing monetary stability and fuller utilization of the country's productive resources". Therefore, SBP is concerned with not just inflation and price stability, but also with economic growth.

That was the easy part. The tough part is actually finding and calibrating the tools that are required to achieve these ends.

Broadly speaking, central banks tend to target one or more of monetary aggregates, inflation or exchange rates. All three of these have an impact on the real economy and have implications for price stability. In the recent past, countries have moved towards inflation targeting regimes. However, such a regime requires that the central bank's policies remain independent of the fiscal authority, have market credibility and are time-consistent. Given that conditions in developing countries may not allow for such freedoms, inflation targeting may prove to be ineffective in such economies. Indeed, these are interesting times to be an economist; and in such times, we must occasionally toss conventional prescriptions aside and seek customized solutions. But for that it is necessary to fully understand our individual economies.

The Greeks may not be going through the best of times right now, but it was a Greek philosopher who first advised "know thyself". And, analogous to this, any competent policymaker must know his or her own economy inside out. He must know what makes the economy tick; how the linkages in the economy interact with each other; how signals and information gets transmitted through these linkages; and what each of the knobs and dials on his dashboard does to calibrate the economy. The process of self-discovery is as relevant for the individual as it is for the economy. The process of improving the economy starts after the process of understanding.

For instance, monetary policy may be transmitted through a variety of different channels. Most commonly, the real interest channel is used to influence aggregate demand and fine-tune the economy. But we must take a step back and ask ourselves: do the linkages hold as strongly in the actual economy as they do in theory, especially given the high level of inflation and the high frequency of price changes that most developing economies face? Monetary policy may also be transmitted through the balance sheets of banks and firms. Once again, we must know how bank lending and pricing behavior changes in response to changes in the policy rate. Then, there's also the exchange rate channel and finally, the expectations channel, which I shall discuss in a bit more detail later. But they key idea here is that a thorough understanding of all these transmission channels is needed in order to calibrate an effective monetary policy framework. Know thy economy!

Allow me to share my understanding regarding the workings of these channels in Pakistan. As I pointed our earlier, the real interest channel is extremely weak in times of frequent prices changes and high inflation. A recent survey carried out by the Research Department revealed that prices are revised roughly every quarter in the economy. Coupled with the fact that we have had, more or less, double-digit inflation for the past 4 years now, prices are very quick to adjust. Therefore, the impact on aggregate demand through the real interest channel is muted.

On the contrary, we have observed that the lending channel via the banks is quite robust. In fact, the transmission of monetary shocks through the lending channel is asymmetrically distributed; smaller banks, which have a higher cost of funds, tend to amplify monetary shocks for smaller borrowers. In fact, the bank lending channel is the primary channel through which monetary policy is transmitted to the real economy in Pakistan. On a related side-note, it's important to mention that Pakistan has moved away from credit allocation policies and now let's the market decide both the quantity and the price of credit to various sectors.

The country has also liberalized its foreign exchange markets and lets the forces of demand and supply dictate the rupee exchange rate. While this is an important step towards greater global integration, it has meant that the exchange rate channel is particularly relevant now – especially due to the implications that it has for inflation. Given the influence that full exchange rate pass-through has, SBP monitors the foreign exchange market very closely.

Finally, monetary policy may also influence inflation through the expectations channel. I can think of no better example to illustrate the mechanism of the expectations channel than Paul Volcker's time at the helm of the Fed. Having credibly committed to tackling inflation, Volcker raised rates drastically and managed to weed out the inflationary expectations that had taken root in the American economy after the oil shocks of the 70s. In my opinion, the two decades of low inflation that the American economy enjoyed following Volcker can at least be partially attributed to the suppression of inflation expectations. In fact, I also believe that a large part of the persistence of inflation in Pakistan's economy is due to the sustained period of high inflation, which has allowed inflationary expectations to incubate.

The transition from understanding these channels to developing the proper mechanisms to impact our objectives may not be smooth. After all, we should concede that there are some things that we have absolutely no control over in the short-run. Similarly, a certain policy measure may also produce conflicting outcomes, such as a reduction in inflation but a rise in current and fiscal accounts; how should we proceed then? We need to stay abreast of a very steep learning curve and constantly keep checking if the relationships that we have assumed, while developing our models, still hold. The economy is a living, evolving organism. Relationships between variables break down ever so often. This only adds to the excitement of being a policymaker, ladies and gentlemen!

The complexity and the uniqueness of our economy only emphasize the need to develop a thorough grass-roots understanding of the economy, and a customized toolbox to deal with the multiples challenges along the way. Far too often have we relied on conventional prescriptions without fully understanding the symptoms. I challenge you all to question the assumptions that you have based your frameworks on; let's take nothing as a given and let's make our policy directives as unique as the economies they target.

I'm in a room full of central bankers here and it is probably unnecessary to say this, but, at the end of the day and despite our best efforts, even seemingly seamless plans may fail and our policy instruments may let us down. Yes, it is tough to map out the behavior of an informal sector that is probably the size of the formal economy; yes, it is difficult to impose fiscal discipline; yes, it is almost impossible to control the international prices of fuels and grains; and yes, our textbooks seem to be clueless when it comes to tackling today's economic problems. But this only underscores the need – no, the necessity – to fully understand the nature of our economies. Know thy economy, ladies and gentlemen!

And now I invite you all to share your ideas and experiences with the rest of us. Tell us about the nature of your economies; tell us about your toolkits; and tell us how they have fared with time. I can tell you that we, at the State Bank, have come a long way from the days of rationalized credit and strict controls on exchange rate. We have moved towards a better understanding of our economy and we've made some significant progress towards discovering the impact that our monetary policy has on the real economy. I hope that you will get a chance to share your thoughts with us and lead our minds to previously unexplored territories.

The SAARCFINANCE seminar series was meant to facilitate the transfer of ideas and experiences. Today, I am excited about what we may learn from each other over the next few days.

On that note, ladies and gentlemen, let us share our insights regarding monetary policy frameworks; and let's get to know our economies.

Thank you for your time and I wish you all an amazing stay in Islamabad!