

Global Uncertainty and Monetary Policy Effectiveness in Pakistan



Inayat U. Mangla

Professor of Finance, Lahore School of Economics

And

Professor of Finance Emeritus

Department of Finance & Commercial Law

Haworth College of Business, Western Michigan University



**WESTERN MICHIGAN
UNIVERSITY**

Syed Kalim Hyder

Senior Economist

Monetary Policy Department, State Bank of Pakistan



Outline

- Summary
- Introduction
- Literature review
- Stylized facts
- External flows to Pakistan
- Methodology
- Results
- Conclusions and Policy implications

Motivation

*“There is only one difference between a bad economist and a good one: the bad economist confines himself/herself to the **visible effect**; the good economist takes into account both the effect that can be seen and those effects that must be **foreseen**.”* Fredric Bastiat, 19th century French economist

Granger Causality + RE Model (Rational Expectation) in late 1970s

Summary

- *Paul Volker's disinflation episode has useful / greater insight for effective monetary policy*
- *Monetary Policy effectiveness in the developed World has implications for EM*
- *Aftermath of GFC*
- *Spillovers of global development after GFC*
- *Monetary policy effectiveness in Pakistan*
 - *External factors*
 - *Domestic Changes*
- *Easy monetary policy is biased in favor of capital and less for labor*
- *Fiscal and monetary policy Coordination is needed*

Four Major Global Financial Crises

1. *The slump of 1930s (Great Depression), which followed the Wall Street crash of 1929.*
2. *The stagnation of Japanese economy, which followed their stock market crash of 1990 and continuous occurrence of recessions in last twenty five years in Japan.*
3. *The Global Financial Crisis (GFC 2008) and economic weakness that followed sharp falls in financial asset and house prices-leading to a Great Recession.*
4. *The 'Severe Recession' of 1981 (also known as Volcker deflation).*

Monetary Policy Effectiveness

- **Era of effective monetary Policy (1980 - 2008)**
 - Credibility, independence and transparency
 - Effective management of Inflation expectations
- **Limitations and Asymmetries in monetary policy effectiveness**
 - Low bound interest rates
 - Effectiveness in Recessions and Expansions
 - International developments

Implications for monetary policy in Pakistan

Conventional Scenario

- Fed rate hike will hit the global economy in several ways;
- One interest rate hike in 2015 was a **tweak (not of D. Trump)**
- A second on March 15, 2017 is a step towards normalization.
- The third looks like a whole rising interest rates cycle

A Caveat;

- While everyone screams about a rising interest rate and normalization of yields, few seem to realize what is required for that to happen
- You cannot normalize yields unless you normalize growth and inflation expectations. Period.

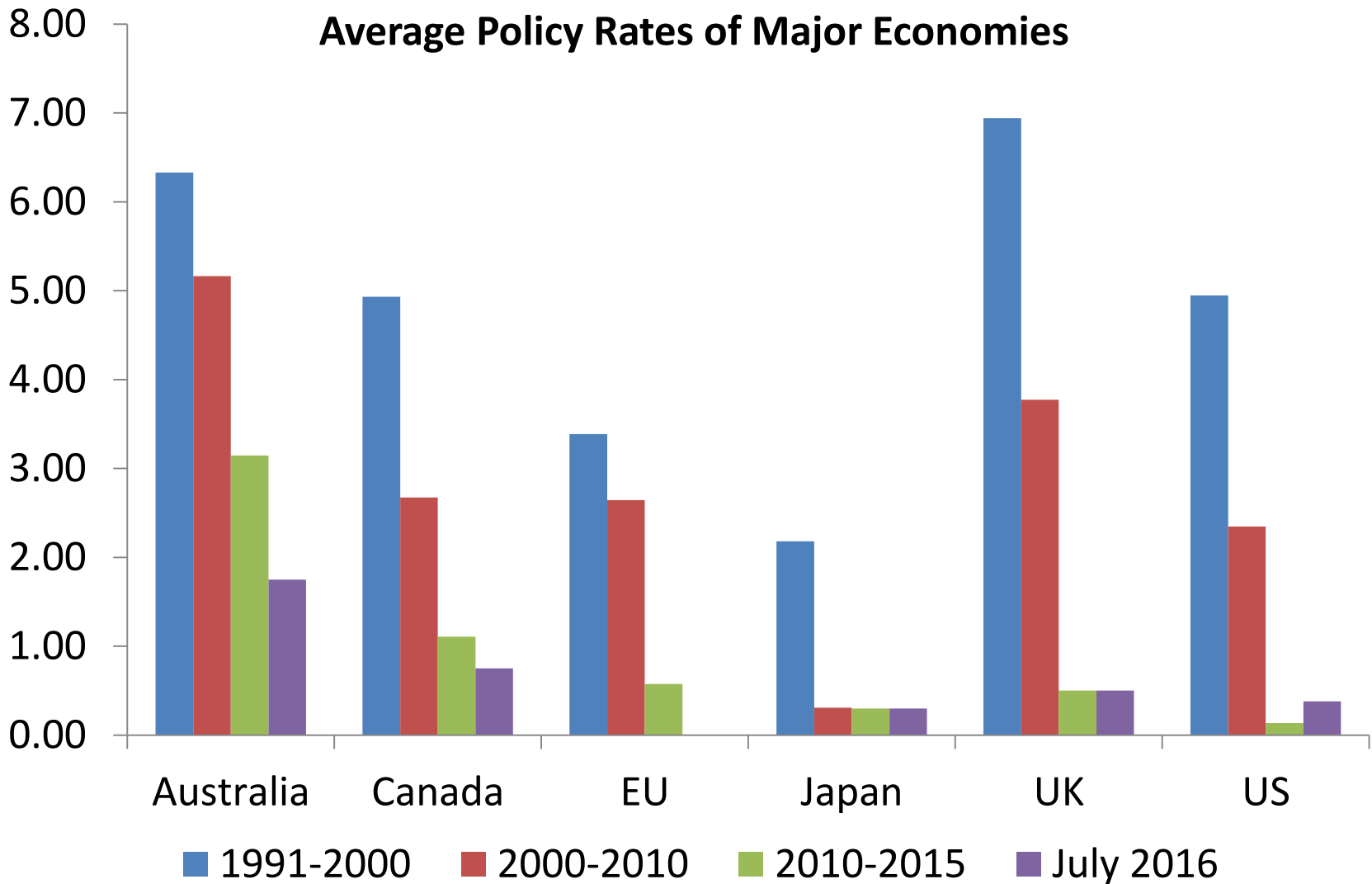
Five Big Trends to Watch

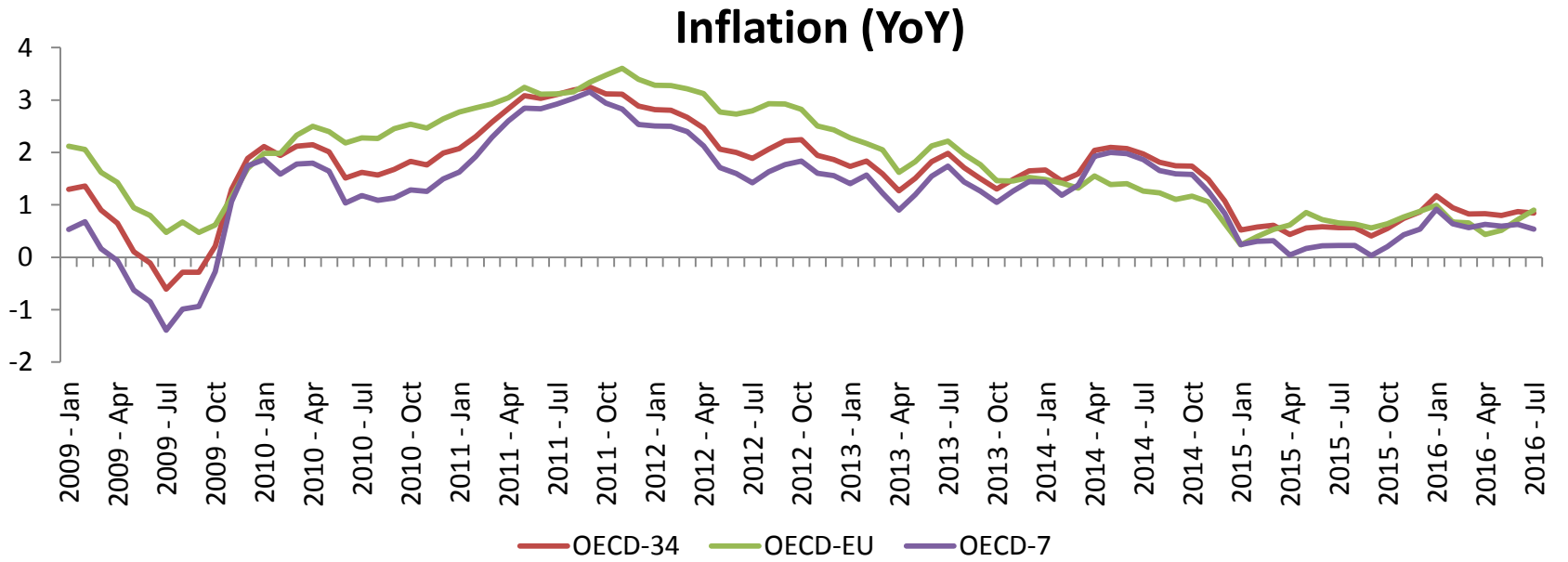
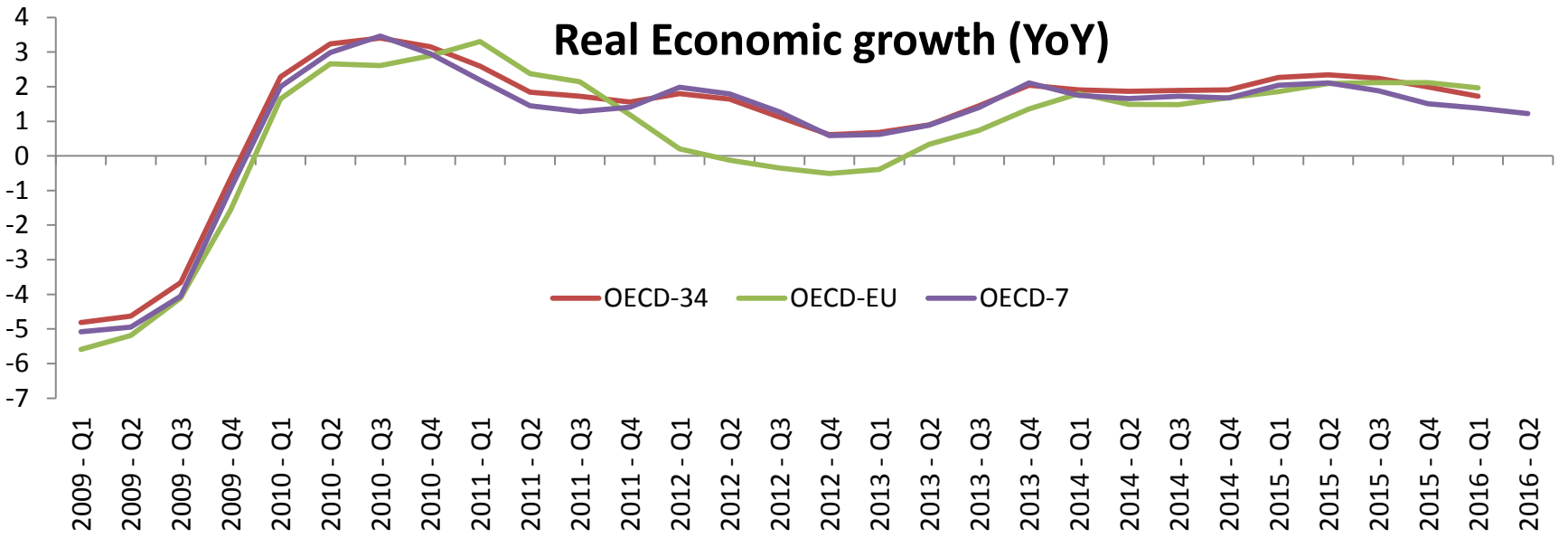
1. Super Cheap Money
2. Inflation Uncertainties
3. Expect Saving Rate to rise
4. Huge Budget Pressures on the governments
5. Expect Trade War (Specific US and EU, Est vs East)

The Second Scenario

- The other scenario as being suggested by the US Bond and Stock markets implies a ***Fed rate hike + low growth= recession***
- Near-zero rates have been the most important factor in the global economy for a decade.
- They have changed the way F. assets are priced, dictated saving rates and allowed governments to borrow
- BOTH scenarios will bring pressure for PAK external account and uncertainty for monetary policy
- Message for financial manager (SBP and MOF); Buckle up!!- greater uncertainty ahead

International Developments – Stylized Facts

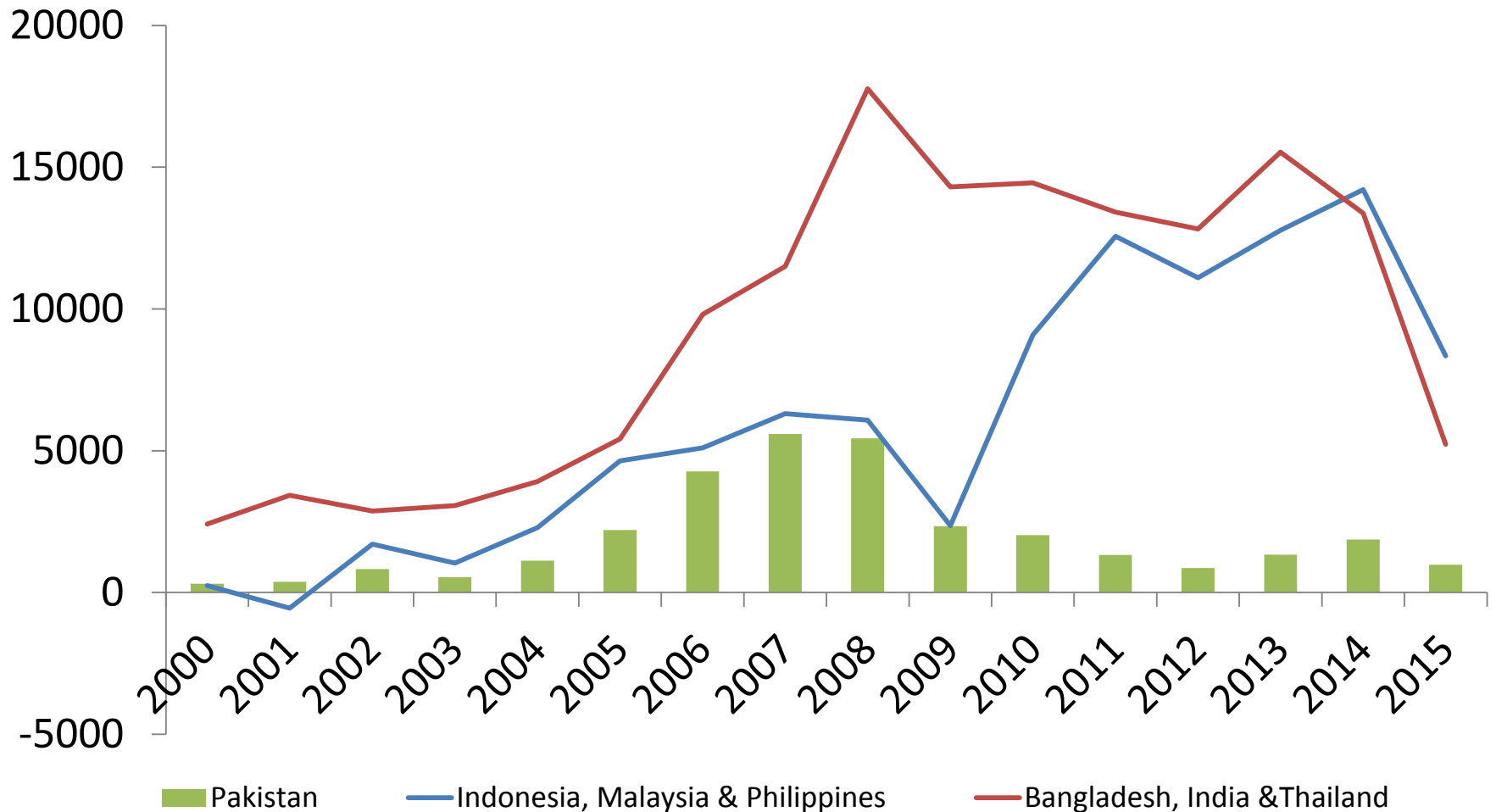




GFC and Pakistan

- **Aftermath of GFC**
 - Low interest rates
 - Depreciating currencies
 - Outflow of Capital
 - Declining prices of commodities
 - International oil Prices
- Spillovers of these developments to Pakistan

Average Foreign Direct Investment inflows to Selected Countries (Mil. US\$)



Methodology - Specification

- **Supply Shock**
 - International Oil Price inflation,
- **Global Demand Shock**
 - US industrial Production Growth
- **Monetary Policy**
 - Real Policy Rate
- **Domestic Factors**
 - Real Exchange Rate
 - Domestic industrial Production
 - Inflation in Consumer Prices

Methods and Robustness

- **Reduced form Recursive Structural VAR -**
(Ahmed 2003, Ahmed et al 2006)
- **Local Projections - Jordà (2005)**
- Long and short run Restrictions
- Robustness
- Structural Changes
- Sample 1991-2016

Impact of External Uncertainty

- Impulse response Analysis
 - External Shocks
 - Oil Prices shock
 - US Production Shock
 - Monetary Policy Response to external shocks
 - Exchange rate Response to external shocks
 - Domestic Economic Growth implications
 - Response of Domestic Consumer Price

Monetary Policy Effectiveness in Pakistan

- Monetary Policy Effectiveness
 - Exchange rate depreciation Shock
 - Inflation shock
 - Economic Growth surge
- Response of Exchange rate to domestic Shocks
 - Monetary Policy Changes
 - Inflation shock
 - Economic Growth surge

Policy impact assessment

Behavior of Most Endogenous variables

- Real Economic Growth
 - Response to Policy rate Shock
 - Response to Exchange rate Shock
- Inflation in Consumer price Response to
 - Policy rate adjustments
 - Exchange rate depreciations

Conclusions

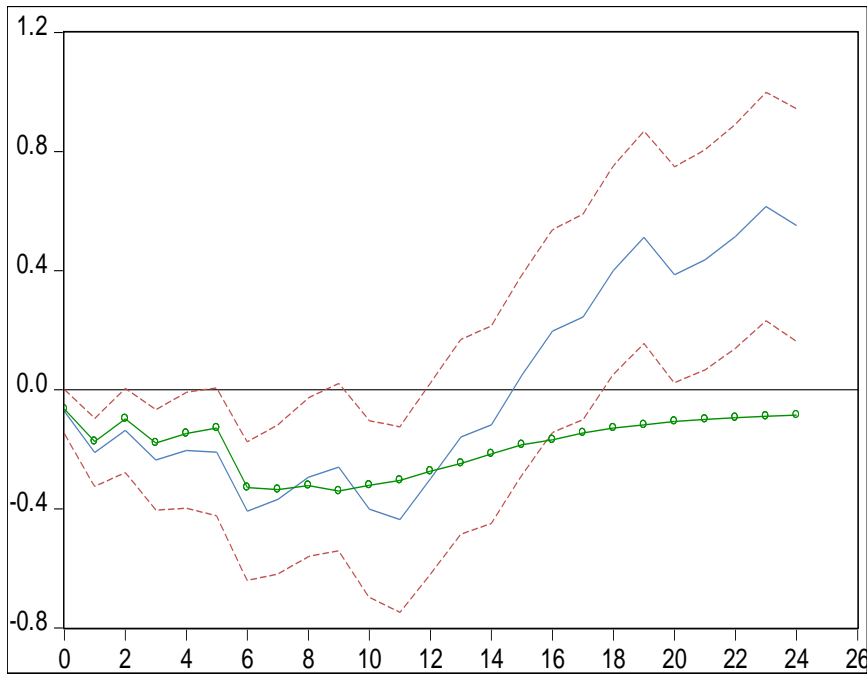
- International developments
 - Effectiveness of monetary policy
 - Spillovers of QE
- Policy response and implications of global uncertainties
- Effectiveness of monetary policy in Pakistan
- Do Asymmetries exists?

Policy Implications

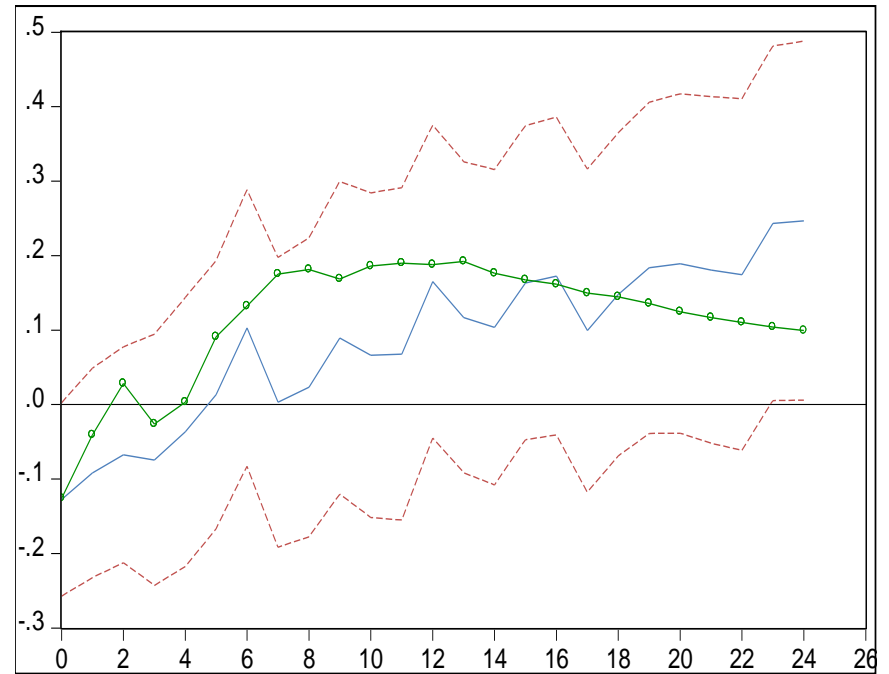
- More independence to Central Bank?
- Fiscal and Monetary Policy Coordination
 - Fiscal dominance
 - Monetary dominance
 - Balanced coordination
- Need to increase the scope of monetary Policy

Real Policy Rate – Oil price and US growth increase

Policy rate response to Oil price Shock

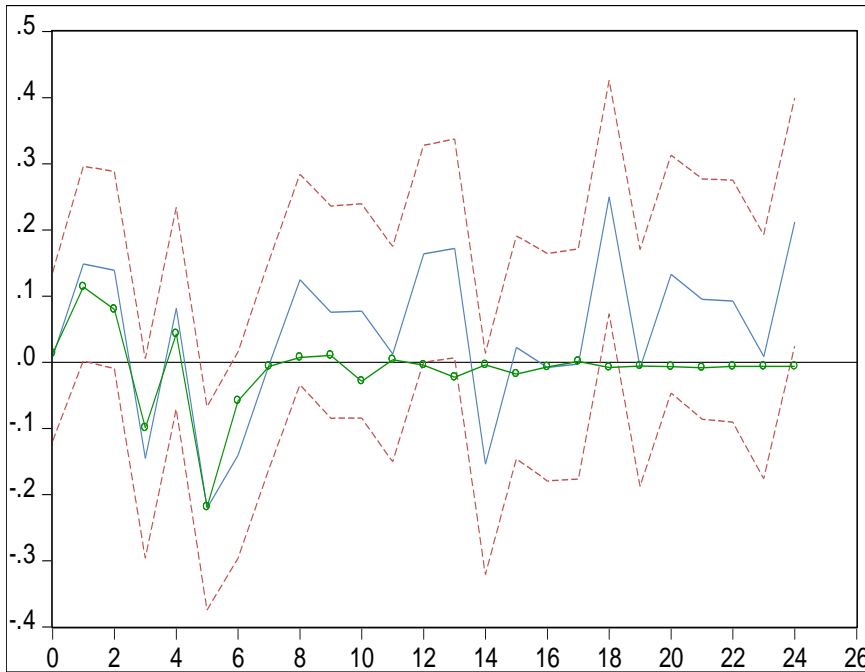


Policy rate response to US Growth Shock

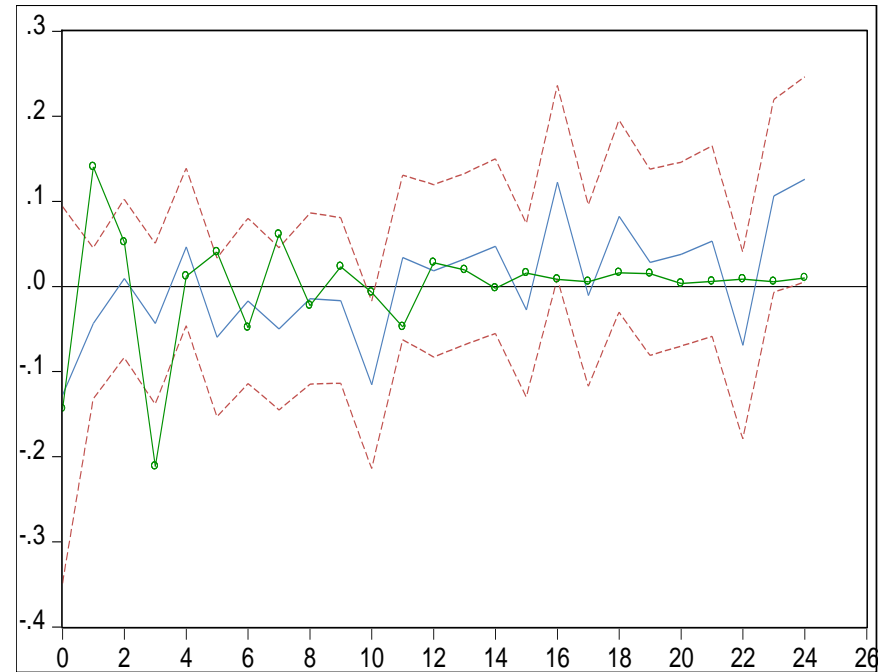


Real Exchange Rate – Oil price and US growth increase

Exchange rate response to Oil price Shock

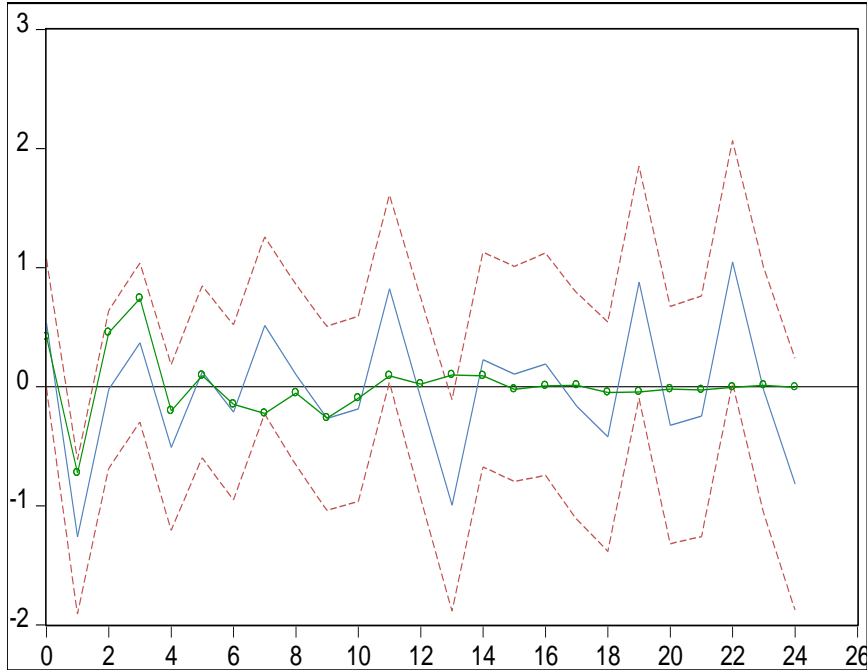


Exchange rate response to US Growth Shock

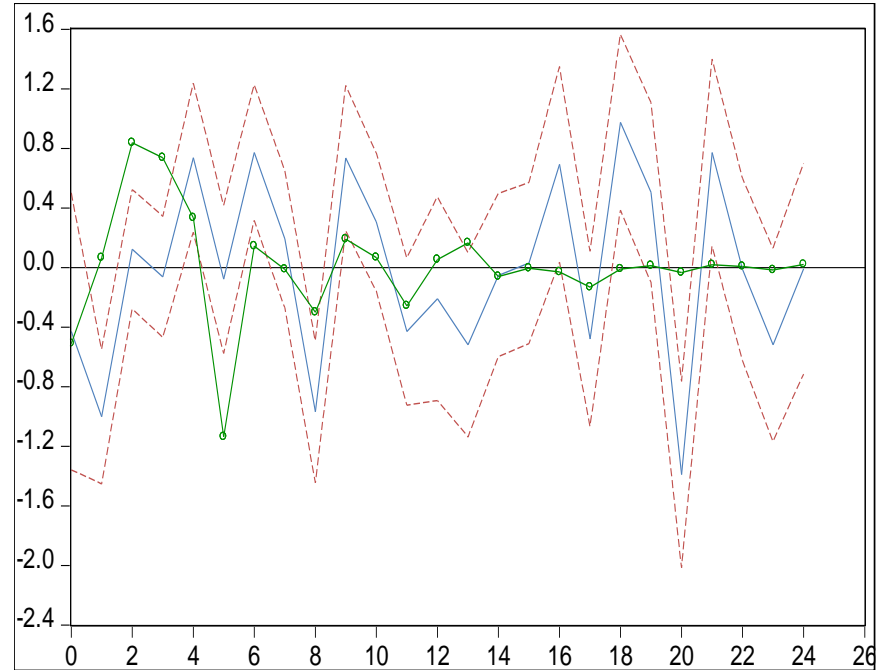


Domestic Growth– Oil price and US growth increase

Domestic growth - Oil price Shock

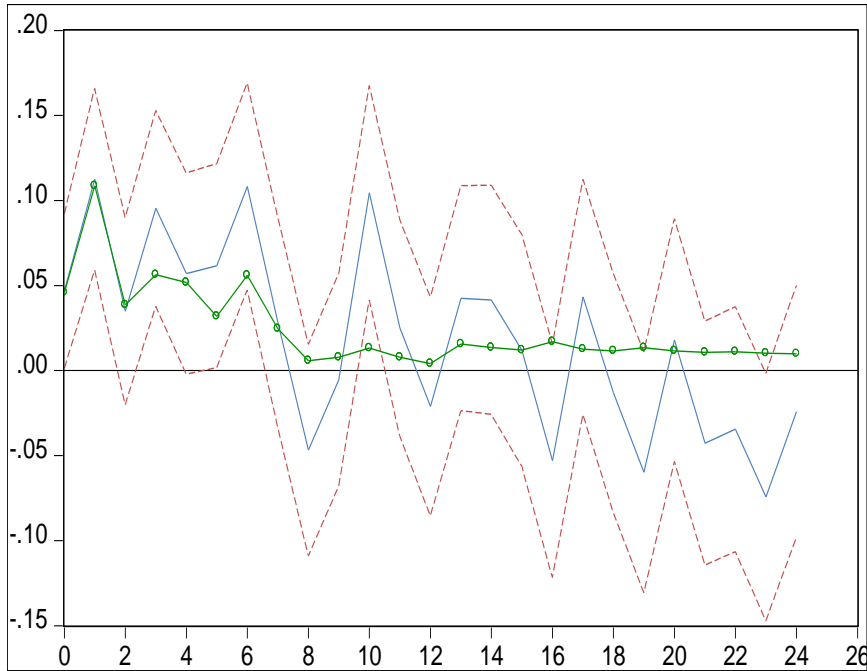


Domestic growth – US growth Shock

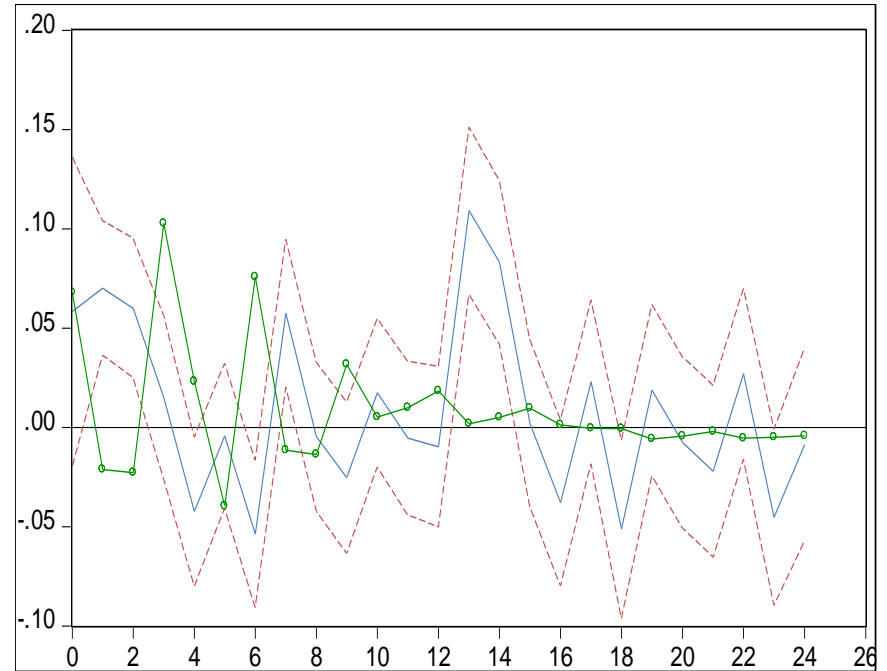


Inflation and external Uncertainties

Inflation response to Oil price Shock

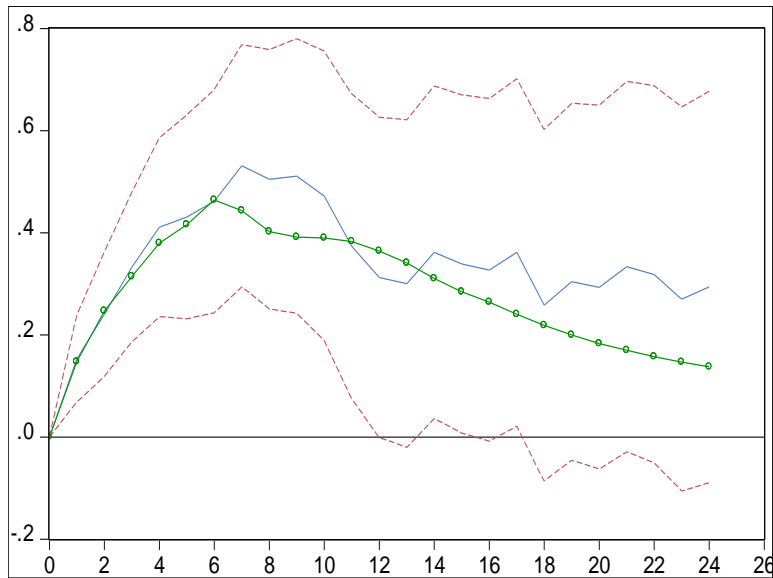


Inflation response to US growth Shock

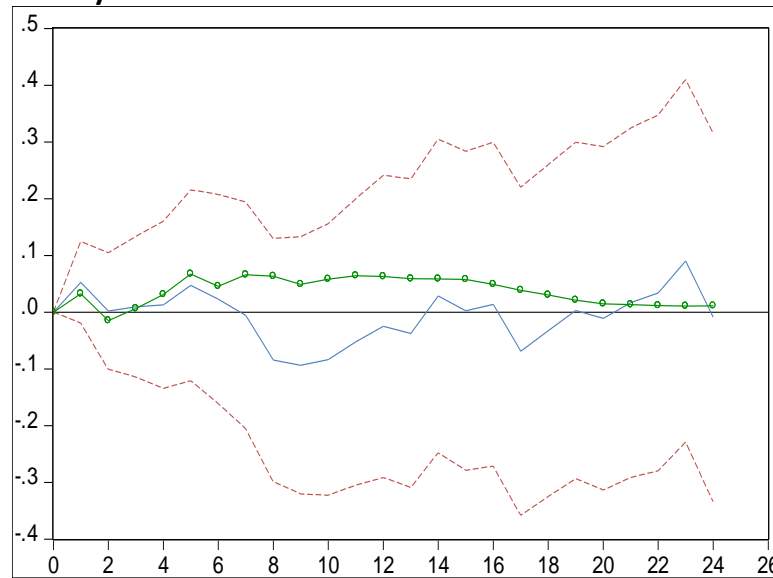


Monetary Policy Effectiveness

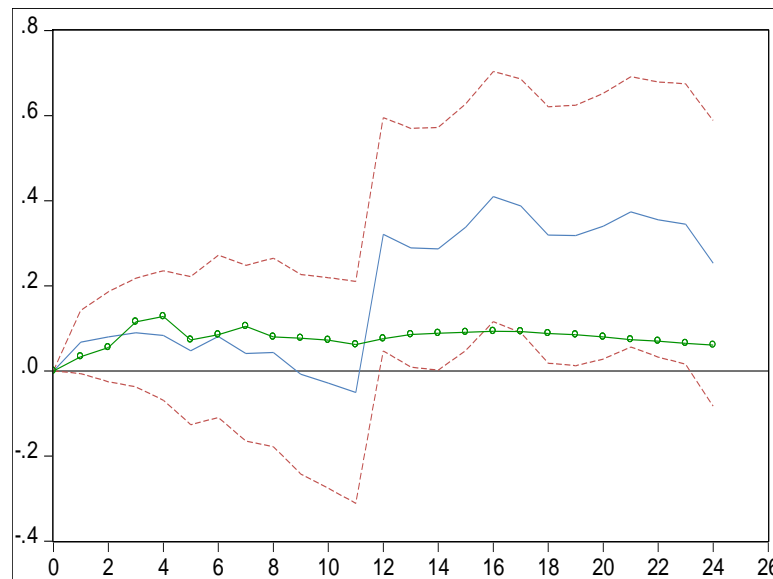
Policy rate – Exchange rate Shock



Policy rate – Domestic Growth Shock

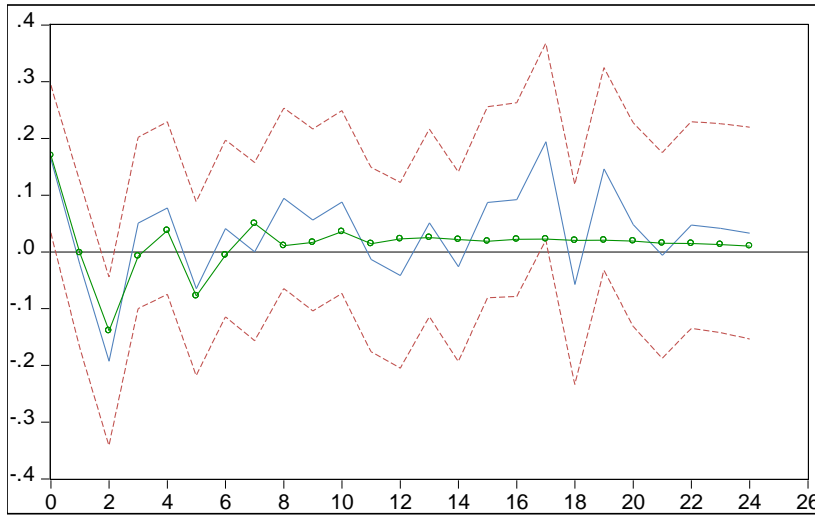


Policy rate
Response -
Inflation Shock

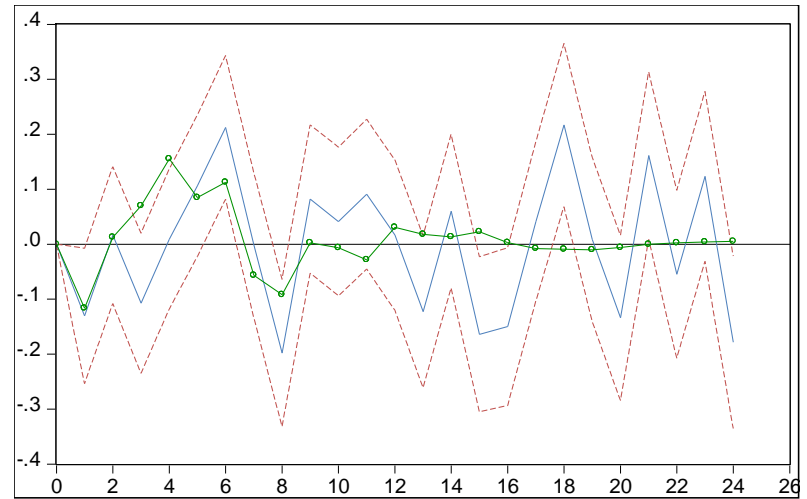


Response of Exchange rate – domestic Shocks

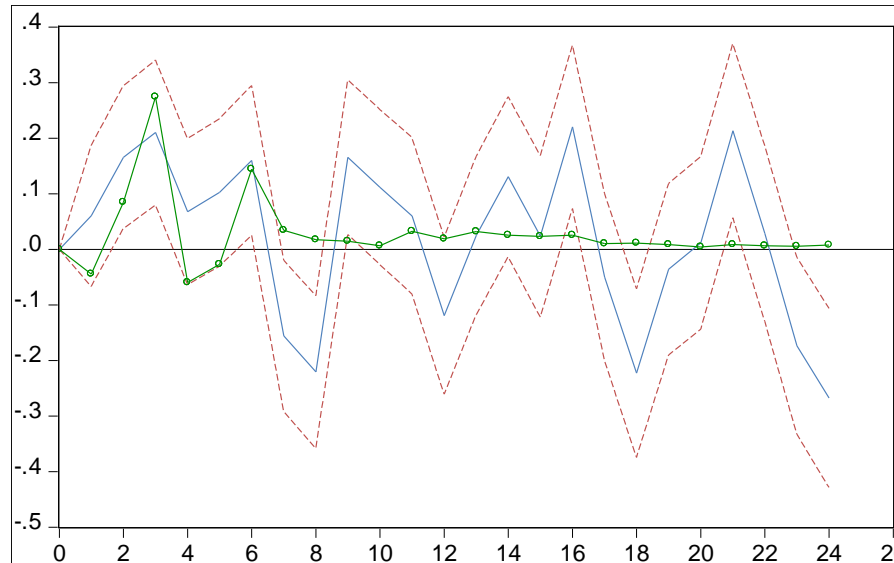
Exchange rate - Policy rate Shock



Exchange rate – Domestic Growth Shock

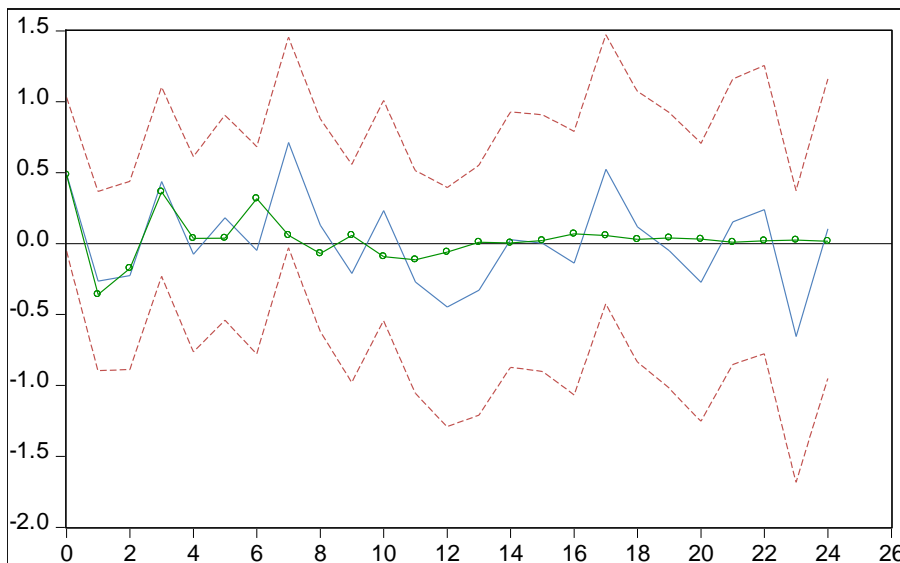


Exchange rate
Response -
Inflation Shock

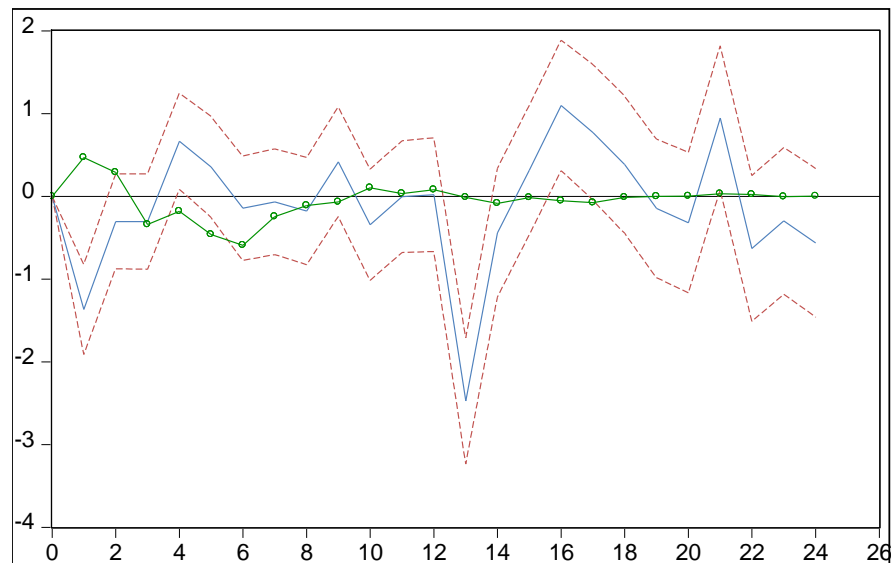


Economic Growth Response

Economic Growth – Real Policy rate Shock

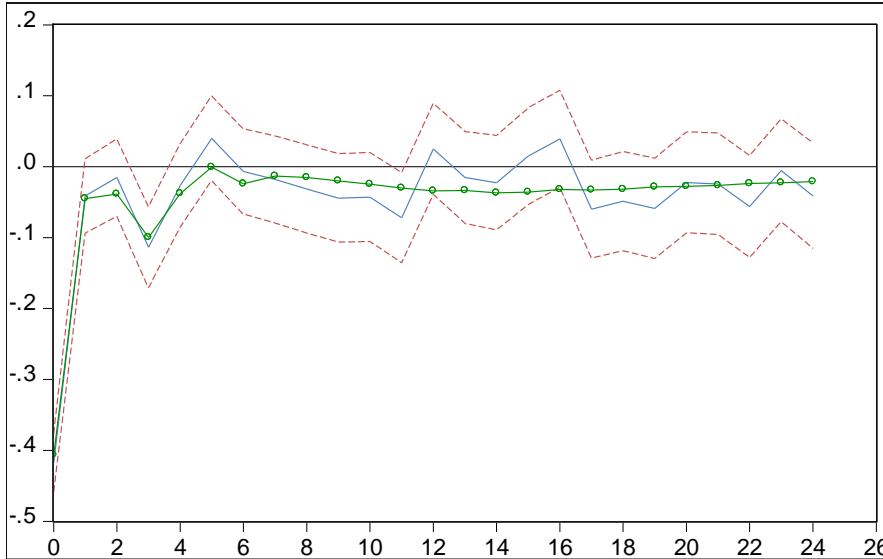


Economic Growth – Real Exchange rate Shock



Response of Consumer Prices- Inflation

Inflation – Real Policy rate Shock



Inflation– Real Exchange rate Shock

