



MCB Bank Limited

Treasury & FX Group

## *Quid Pro Quo*

*Issue # 46*

*Economic report*

October 3<sup>rd</sup>, 2007

### **Is the Change Even Needed?**

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Since the early 1990s, an increasing number of central banks have adopted inflation targeting as their preferred framework for monetary policy. This has replaced frameworks involving using targets for the exchange rate or monetary aggregates. Although initially only industrialized countries adopted this strategy, recently an increasing number of emerging market economies have also executed this framework, spurred in part by the success of inflation targeting countries in achieving and sustaining low levels of inflation.

This report will outline the basic principles of an inflation targeting regime while examining the conditions that must exist within an economy before it can execute this strategy to achieve low and stable inflation. In the light of evidence of some emerging economies that pursue an inflation targeting regime and the facts examined, the report will then explore the possibility of implementing an inflation targeting regime in Pakistan.

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## A Global Phenomenon?

In recent years, the aim to achieve price stability has emerged as the single most important objective of the central banks around the world. In their quest for price stability, these central banks have tried with various tools and strategies, including monetary and exchange rate targeting. In December 1989 the world was introduced with yet another monetary policy framework by the Reserve Bank of New Zealand, known as *inflation targeting*.


Ever since, monetary economists and central bankers have expressed growing interest in inflation targeting as a framework for implementing monetary policy. Following the steps of New Zealand, explicit inflation targeting has been adopted by a number of central banks around the world, including those of industrialized countries (such as Australia, Sweden, Switzerland, and the United Kingdom) as well as those of emerging economies (such as Brazil, Chile, Columbia, Czech Republic, Iceland, Israel, Mexico, Peru, the Philippines, Poland, and South Africa). Besides the aforementioned economies, many other are now considering a shift towards inflation targeting. In the United States, there has been public debate over inflation targeting and some bills have already been introduced in Congress to mandate the use of explicit targets for inflation while the European Central Bank already has a two-pillar system in place with inflation being one of the policy targets.

### **Inflation Targeting: What does it mean after all?**

Although no general agreement exists among economists over the definition of inflation targeting, following has been accepted as the most appropriate definition which was put forth by Ben Bernanke in his book, *Inflation Targeting-Lessons from the International Experience*:

*Inflation targeting is a framework for monetary policy characterized by the public announcement of official quantitative targets (or ranges) for the inflation rate over one or more horizons, and by explicit acknowledgment that low and stable inflation is monetary policy's primary long-term goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining those objectives.*

In other words, inflation targeting is a monetary policy strategy with an explicit objective of achieving and maintaining price stability through a comprehensible numerical target value of inflation.



The specific measure of inflation used in inflation targeting may be defined as core or headline inflation. Core inflation excludes items of volatile price movements from the CPI, thus eliminating temporary price shocks and focuses on long-term price movements. In this fashion core inflation is a good indicator of the underlying long-term inflation trend and thereby future inflation. However a core measure may be unrepresentative of increases in the cost of living, so that its calculation may not be credible in the eyes of the public. Headline inflation on the other hand looks at the rate of change in the consumer price index, average price of a standard basket of goods and services. In this way, headline inflation measures the changes in the cost of living based on the movements of the prices of goods and services in the basket of a representative economic agent and perhaps do dominate the public's inflation expectations. One aspect of inflation targeting is thus a choice between a core inflation indexes versus a headline inflation index. The US Federal Reserve focuses on core inflation because in the US this measure has proved to be a better predictor of future headline inflation. By contrast, the European Central Bank focuses on headline inflation, and there is evidence that in the Euro area headline inflation is a better predictor of future inflation.

Once the choice of index has been decided according to the economic conditions of the country, a target is specified. A target can be specified as a single point, a range or a ceiling. A single point provides a better focus for inflation expectations but is very difficult to achieve. A target specified in terms of a range requires a tolerance band while the focus of a ceiling is only the upper band with no lower band specified. In this way, a single point target is consistent with a policy of rule while a range or a ceiling gives discretionary policy flexibility to the central banks.

The central bank can use either strict or flexible inflation targeting. Under strict inflation targeting regime, the central bank is only concerned with achieving the inflation target while under flexible regime, the central bank is also concerned with the stability of output and/or the real exchange rate. If a divergence from target appears, strict inflation targeting requires central banks to bring inflation back to its target level as quickly as possible involving considerable movements in instruments. These instrument movements may lead to output and real exchange rate movements. However, flexible inflation targeting would lead to a gradual approach to bring inflation back to its target minimizing the movements in instruments and hence providing more stability to output and real exchange rates. Therefore, a flexible inflation targeting would involve a tolerance band and relatively long time horizon giving central banks some discretionary power. The experience of emerging economies suggest that they have, in general pursued flexible inflation targeting regime giving discretionary power to the central banks to make some adjustment in monetary instruments.



## Two-Way Mirror

As mentioned earlier the main objective of inflation targeting is to achieve low and stable inflation in an economy. Low and stable inflation is associated with reduced relative price variability, less distortion in inflation taxation, enhanced financial development, less arbitrary redistribution and subsequently long term growth. Being the most popular and appropriate mechanism for achieving price stability, inflation targeting thus has the advantage of reducing price volatility in the economy.


In addition to this, inflation targeting has the important advantage of being easily understood by the public since inflation target announced under this strategy clearly provides a nominal anchor for the path of the price level just like a fixed exchange rate anchor. Theoretically the central bank's commitment to meeting a stated price-stability objective makes its communication with markets clearer and less susceptible to misinterpretation. It also furnishes a tool for accountability; with an explicit targeting regime the public can readily judge whether or not the monetary authority has accomplished its goal. The resulting transparency increases the potential for promoting low inflation expectations, which helps to produce a desirable inflation outcome.

Also, like a fixed exchange rate or a monetary targeting strategy, inflation targeting reduces the pressure on the monetary authorities to pursue short-run output gains that lead to the time-inconsistency problem. An inflation-targeting strategy also avoids several of the problems arising from monetary targeting or fixed exchange rate strategies. For example, in contrast to a fixed exchange rate system, inflation targeting can preserve a country's independent monetary policy so that the monetary authorities can cope with domestic shocks and help insulate the domestic economy from foreign shocks.

In addition, inflation targeting can avoid the problem presented by velocity shocks because it eliminates the need to focus on the link between a monetary aggregate and nominal income; instead, all relevant information may be brought to bear on forecasting inflation and choosing a policy response to achieve a desirable inflation outcome.

Nevertheless at the same time inflation targeting does have some disadvantages. Due to uncertain effects of monetary policy on inflation, monetary authorities cannot easily control inflation. Thus, it is far harder for policymakers to hit an inflation target with precision than it is for them to fix the exchange rate or achieve a monetary aggregate target. Furthermore, because the lags of the effect of monetary policy on inflation can be very long, much time must pass before a country can evaluate the success of monetary policy in achieving its inflation target. This problem does not arise with either a fixed exchange rate regime or a monetary aggregate target.

Another potential disadvantage of an inflation target is that it may be taken literally as a rule that precludes any concern with output stabilization. An inflation target, if rigidly



interpreted, might lead to greater output variability, although it could lead to tighter control over the inflation rate. For example, a negative supply shock that raises the inflation rate and lowers output would induce a tightening of monetary policy to achieve a rigidly enforced inflation target. The result, however, would add insult to injury because output would decline even further.

Despite the criticisms put forth with respect to the strategy, inflation targeting has been a success in almost all countries that have adopted it as the evidence shows that inflation targeting countries have been able to reduce their long-run inflation below the levels that they would have attained in the absence of inflation targeting.


### **The Right Ambiance**

Many emerging economies with very diverse structures have successfully adopted inflation targeting. This suggests that inflation targeting is a flexible framework that can be adapted to the conditions of a particular country and over time. Nevertheless there are certain preconditions that should exist in an economy before it can shift to an inflation targeting regime. The existence of these conditions become all the more integral if the economy aims to follow an explicit inflation targeting regime; example New Zealand.

Firstly the central bank of the respective economy must enjoy a reasonable degree of economic and political independence. The economic independence of a central bank refers to the restrictions on its ability to finance the government's budget deficits and to the role it plays in banking supervision. Political independence on the other hand refers to the extent to which the central bank is free from the influence of the political regime of the country. Indicators of political independence include central bank responsibilities, the procedures for appointing its governing bodies, the degree of government control over monetary instruments and the procedure for appointment and removal of the head of the central bank.

Next, inflation targeting must be supported by sustainable fiscal policies. The conduct of monetary policy should not be constrained by fiscal deficits due to an inefficient taxation system or an underdeveloped secondary market for domestic bonds. This implies that fiscal deficits should be financed by using revenue-based measures rather than being financed by domestic borrowing. The monetization of large government deficits sooner or later always leads to higher inflation and therefore heavy dependence on domestic borrowing will create problems in achieving the goal of inflation targeting.

Thirdly in order to adopt an inflation targeting regime it is important to avoid targeting level or path of any nominal variable including nominal exchange rate. However some economists are of the view that a nominal exchange rate target and inflation target can co-exist as long as the latter has preference over the former.



Moreover it is also important particularly for emerging economies to have information regarding monetary policy transmission mechanism, its duration and policy lags before shifting towards an inflation targeting regime. Any information that may help to forecast inflation, such as the status of leading indicators, is important and helps to minimize the deviation from the target. In addition to this the central bank should be completely committed towards price stability as the principal goal of monetary policy and must ensure that inflation targeting takes precedence over all other objectives. Strong coordination between the monetary policy and other economic policies is required provided that the target is consistent with other objectives. Lastly and very importantly increased transparency in terms of monetary policy strategy, price mechanisms and increased accountability of the central bank to achieve the inflation target is a necessary condition for implementation of inflation targeting strategy.


However it must be noted that the evidence from emerging economies in Latin America and Asia suggests that not all of the pre-conditions were met when they initially adopted an inflation targeting regime. In fact the move to an inflation targeting regime was gradual and the monetary authorities in these countries tried to bring inflation down before a policy of inflation targeting was fully implemented.

### **Must Pakistan Follow the Steps?**

With many developed and developing economies shifting towards inflation targeting regime an important question arises: Should monetary authorities in Pakistan adopt explicit inflation targeting? In order to address this critical question it is important to analyze if the conditions necessary for inflation targeting as outlined in the previous pages are present within our economy.

The State Bank of Pakistan has enjoyed a reasonable degree of autonomy in the recent past while the economy has been able to achieve remarkable growth performance since 2003. Regulatory capacity of the SBP has been enhanced which has introduced greater accountability of commercial bank executives. The banking regulations and supervisions are now more compliant with international standards than ever before. The reforms have also focused on consolidation of the various aspects of the financial services including risk identification as well as risk assessment, measurement, monitoring, and control. There is a greater liberalization of interest rates and a greater strengthening of transmission mechanism of monetary policy. These circumstances though create a case for a shift towards explicit inflation targeting regime, there are other conditions present within the economy which make execution of inflation targeting regime very difficult.

Firstly though Pakistan has a more flexible exchange rate system than in the recent past, the SBP frequently intervenes in the foreign exchange market to avoid large fluctuations




in the external value of the rupee. Such interventions are reflective of a breach of a major requirement for an inflation targeting regime.

Another condition which makes implementation of inflation targeting a challenging task is the little role that monetary policy plays in determining the CPI. CPI remains inelastic with respect to money supply both in the short and the long run which necessarily means that a small change in inflation rate would require a substantial change in money supply growth rate. This is primarily because the food component carries a weight of 40% in the measurement of CPI for our economy and the food prices are determined by supply forces and government intervention. Hence the price mechanism that prevails in the economy is not that of a free market where the prices of goods and services are determined generally by the supply and demand law with no government intervention in the regulation of costs, supply and demand. This violates another requirement of an inflation targeting regime.

The government intervenes every now and then to control the prices of most agricultural commodities which primarily form the food portion of the CPI. There are times when the prices are too high for the consumers and other times when they are too low for the farmers; and often the government is asked to intervene, buying for or selling from stocks, prohibiting export or import, increasing or reducing import duties, introducing/withdrawing export taxes, or taking other measures to protect the consumer or the producer. In such circumstances domestic prices often vary from international prices giving rise to arbitrage opportunities while further distorting the prices. Case in point- Wheat: The government committed to maintain the wheat price at PKR 14-16/kg level despite rising international prices. Export of wheat was also restricted to protect any cuts in supply for domestic consumers. Nevertheless domestic wheat prices have continued to surge as severe supply shortages prevail; wheat producers are alleged with smuggling wheat in international markets (like Afghanistan) where wheat prices are higher. This puts an upward pressure on the CPI. Besides wheat, the government provides support prices for cotton, rice, sugar and several other commodities. This again results in price volatility. Under such uncertain conditions it is very difficult for the government to pursue a strict inflation targeting regime as likelihood of missing a target is very high.

Evidence shows that countries which have adopted inflation rate targeting policy tend to miss their targets about 40% of the time and often by substantial amounts for prolonged periods. As a consequence, countries have to keep adjusting their monetary growth rate every now and then. If the same experience is repeated in Pakistan and the monetary policy has to keep adjusting money supply growth rate, a large fluctuation in money supply and economic growth could occur for a prolonged period. This would lead to economic instability and uncertainty defeating the major purpose of an inflation targeting policy.



In addition to this, frequent adjustments in monetary policy to achieve the inflation target will negatively impact the output. For example, if prices continue to rise and put upward pressure on inflation, the government if following an explicit inflation targeting regime will have to keep tightening its monetary stance to control prices. This will reduce economic activity in terms of output. Being an economy with extensive range of unutilized resources, this is an outcome that we cannot afford. Instead the government should mobilize these resources to stimulate output and growth further. This would mean increased fiscal expenditure and thereby stronger inflationary pressures. However a corollary of this view is that if the government expenditure expands to generate employment of unutilized and underutilized resources then an equivalent amount of savings would accrue in private hands. This shall result in an increase in tax revenues and in this fashion the fiscal deficit will finance itself. Thus it is clear that as long as the government increases its spending in employment of inactive resources, the subsequent deficit is in fact beneficial in the medium and long term. In shorter term we still may witness rising inflation.

Inflation targeting is primarily aimed at bringing down higher rates of inflation in addition to minimizing fluctuations in the rate. During a period when fiscal policy is rather expansionary in nature, this may be a challenging task. The likelihood that inflation targeting has a negative impact on output growth particularly in the initial stages makes it ever more difficult.

### **To Be or Not to Be!**

Whether State Bank should adopt an explicit inflation targeting regime is a debatable subject for the economy's monetary policy and requires a more detailed and serious consideration before it is addressed and any decision is made. As we argued earlier, frequent SBP's interventions in the foreign exchange market, government's policy of providing support prices for major commodities like wheat, cotton and sugar and thereby weak relation between CPI and monetary policy, and strong likelihood of considerable loss of output at the initial phase raises serious concerns about the feasibility and effectiveness of inflation targeting in our economy.

***“Imagine believing in the control of INFLATION by curbing the money supply! That is like deciding to stop your dog fouling the sidewalk by not feeding it. It is highly unlikely to succeed, but if it does it kills the hound.”***



## Economic Snapshot

Fiscal year 07-08														
	Units	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug
<u>Inflation</u>														
Headline Inflation	%	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0	6.4	6.5
Core inflation	%	6.60	6.60	6.00	5.9	5.7	5.7	6	5.90	5.6	5.2	5.7	6.0	6.0
Food inflation	%	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7	8.5	8.6
Non-food inflation	%	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1	4.9	4.9
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69	8.69	9.05
6 month	%	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9	8.90	9.12
12 month	%	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16	9.16	9.39
<u>External Sector</u>														
Export	Mln US\$	1,392	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583	1,434	n.a
Import	Mln US\$	2,267	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373	2,423	n.a
Trade balance	Mln US\$	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)	(989)	n.a
<u>Remittances</u>	Mln US\$	435	422	410	448	475	391	457	520	513	537	505	495	489
<u>Forex Reserves</u>	Mln US\$	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182	15,723	n.a
n.a = Not available														



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