

The Macroeconomics Policy Research Cluster, IGC Pakistan Programme

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The IGC Pakistan Leadership Team is working in collaboration with the IGC and its network of researchers to; provide policy advice to Pakistan that draws on the research of leading experts; strengthens local academic capacity to produce country-specific research in collaboration with a global network of researchers; provide an independent expert forum that promotes policy dissemination and discussion between government and stakeholders; and create an interface between government and leading thinkers on growth, sustainability and poverty reduction. The Pakistan Programme has three pillars of research – new growth initiatives, macroeconomic stabilization, and state capability and social services. Research on firms is part of the new growth initiative.

To promote research on macroeconomics, IGC Pakistan has formed a cluster of local and international academics who have undertaken extensive theoretical and empirical work. The cluster has been set up under the leadership of Dr. Ehsan Choudhri and Irfan Ahmad Qureshi of the Lahore University of Management Sciences.

To encourage networking and collaborations, the IGC organized the first meeting of the cluster at the State Bank of Pakistan in Karachi. The meeting, chaired by Dr. Ehsan Choudhri, was attended by researchers from the State Bank of Pakistan, the Pakistan Planning Commission, the World Bank and academic institutions along with the IGC Pakistan team.

An introduction to IGC's Pakistan Programme

Dr Riaz Riazudin (Economic Advisor to the State Bank of Pakistan) began the proceedings with an overview of the state of the economy. He pointed out the need for cutting edge research in the field of macroeconomics and the importance of forming a cluster of international and national academics capable of such research.

Dr Ijaz Nabi (IGC Country Director) and Dr. Naved Hamid (IGC Resident Country Director) presented the IGC country programme and three pillars of research. Dr Nabi explained that the IGC has two modes of engagement - Rapid Response notes and medium term research products. Outlining some of the IGC projects, he explained that IGC policy support to government is based on rigorous empirical analysis with the aim of improving growth in Pakistan.

Dr Nabi identified a lack of informed decision-making stemming from a dearth of research, and a lack of engagement between academics and policy makers. Specifically, introducing a macroeconomic policy research cluster would encourage the collaboration of academics and the State Bank of Pakistan under the IGC umbrella. Dr Nabi said that micro empirical analysis is an important aspect of research in macroeconomic policy topics.

Presentations

Dr Ehsan Choudhri

Ehsan Choudhri opened the formal proceedings with an overview of contemporary macroeconomic issues in Pakistan, emphasizing the need for empirical verifications as well as extensions of macroeconomic models. Possible extensions include incorporating liquidity constraints, addressing problems of inequality and poverty, accounting for the informal sector and allowing fiscal dominance over monetary policy. He also stressed the need to improve Pakistan's data to enable better econometric analysis.

His presentation particularly focused on designing monetary policy in the context of fiscal deficits. Pakistan's government is running a large fiscal deficit financed by borrowing from the central bank. Despite the limitations, optimal monetary policy can play an important role in Pakistan.

Dr Ahmad Khalid

Pakistan requires growth rates of around 7% to deeply reduce poverty, but has hovered around 2% over recent years. Pakistan has the lowest level of investment, and domestic and national savings, in the region. Dr Khalid identified major constraints:

- a) Domestic sector imbalances
- b) External sector imbalances
- c) Energy crisis
- d) Security
- e) Government controls and intervention

Given that Pakistan has a large government and poor tax collection, along with weak and inefficient PSEs, the government was forced to run high and persistent deficits. This put pressure on the central bank resulting in both high inflation and lack of investment due to crowding out effects. Pakistan has faced international pressure to increase taxes to reduce the burden of high domestic and external debt. The three major challenges which policy makers face in Pakistan are security, governance and market failure, which call for structural reforms and re-allocation of resources. Pakistan suffers from low comparative competitiveness, unsophisticated financial markets, and failures of governance resulting in ill-defined property rights, nepotism and corruption.

Ahmad Khalid emphasized the need to separate short-run goals from long run targets. The main short-run goals should be to realise higher output through better utilization of capacity in the context of macro stability (especially reducing inflation, which is eroding competitiveness, and providing better management for expenditure and resource mobilization). Improving the energy sector through power sector reform, which may include introducing a supportive legislative framework, financial and demand side measures and supply side interventions, will positively impact growth.

Dr Khalid highlighted the need for potential research in the following areas:

Financial markets

- Stock market collapse
- Financial deepening
- Pricing of financial instruments (in secondary market)
- Regulatory reforms (e.g., impact of BASEL II)
- Banks profit margins and profitability
- Impact of financial innovations (smart card on money supply and demand)
- Impact of entry of foreign firms/banks on efficiency
- Expectations formation

External sector

- Explaining capital flows
- Verification of conventional theory (CIPC; FE, etc.)

Energy sector

- Supply-demand analysis – future demand
- Innovations
- Banks profit margins and profitability

Services sector

- Communications
- Assessment of past and existing policies
- Benazir income support fund
- Open economy has been explored but fiscal and monetary sectors still lack comprehensive research

Finally Ahmad Khalid proposed some incentives the IGC macro research cluster can offer:

- Seed funding for research projects
- Research collaboration
- Fora for discussion and debate, and dissemination of research:
 - a. Roundtable
 - b. Workshops
 - c. Blogs
 - d. Video conferencing
- Publications
 - e. Working papers
 - f. Journal articles

Dr Azam Chaudhry

Dr Azam Chaudhry stressed four main areas of interest to macroeconomists: theoretical macroeconomics, cross country empirical macroeconomics, country level empirical macroeconomics and the importance of microeconomic foundations in macroeconomic modelling. He discussed his theoretical work on the role of governments in repressing growth, political competition between countries and economic growth and the political economy of income comparisons. His empirical work has covered a structural VAR analysis of Pakistan's textile exports, the impact of cultural vs. geographic distance on growth spillovers and other areas. Dr Azam Chaudhry identified areas of potential research for the IGC macroeconomic cluster:

- The political economy of Pakistan's growth policies and its potential technology and growth spill-overs
- Identifying countries with cultural links to Pakistan to explore potential for increased trade
- Using firm-level data to understand phenomenon such as technology adoption, technology spillovers and the transmission mechanism of monetary policy

Limitations to empirical and theoretical macroeconomic research were acknowledged including accuracy and availability of data, and lack of local and international networks of economists who could discuss ideas and receive feedback. Moreover developing micro foundations of macroeconomic models required financial assistance which was unavailable and had not been high on the agenda of previous research collaborations. Dr Azam suggested some interventions for the IGC:

- Promotion of data sharing and collaborative efforts
- Creation of a newsletter that updates people both locally and internationally on research being done by Pakistani researchers
- Promote international collaboration

Dr Azam Chaudhry identified an abundance of research potential in Pakistan as well as untapped data resources. Collaborative efforts are required to generate high quality theoretical, empirical research in macroeconomics leading to better policy recommendations for the government.

Dr Hamza Malik

Hamza Malik acknowledged the failure of traditional IS-LM models to explain inflation and introduced the basic New-Keynesian model including the policy function, a central tool in the hands of the central bank which determines monetary policy, inflation and short run output.

Hamza Malik pointed out that a lack of understanding of inflation has been a major constraint on policy analysis and identified three areas of research:

Incorporating the role of money in models

In this area of research there are two opposing strands of literature, the understanding of which is crucial to identifying optimal monetary policy.

On one side, economists, such as Woodford, provide a convincing set of arguments in support of no role of money and emphasize the discretionary commitment by the central bank to a non-inflationary policy and highlight the role of *expectations*. Woodford argues that only the inflation rate relative to the nominal interest rate matters and one does not need to monitor the money growth to tell if an undesirable long run inflation trend is developing; measurement of inflation suffices for this.

Sceptics argue that models without money only model temporary departures of inflation from steady-state inflation, which can only be understood by taking account of the long run growth rate of money. A unified treatment of the inflation trend and fluctuations around the trend remains an unresolved problem. The central question then becomes whether a model without money require one to believe that efforts by the central bank to control money supply will have no effect on the economy. Are balance sheets of central banks irrelevant? Moreover financial frictions and distortional transactions need to be considered as changes in real money generate effects on real aggregate demand, which are not summarized by the real interest rate on short-term securities.

Real-balance corrections can be incorporated in the baseline model, but have been shown to be insignificant, stressing the need to model the financial sector in order to understand if the key impediment to efficient financial intermediation relates to the circumstances of borrowers (the 'credit channel') or some inability of banks to obtain sufficient funds to lend (the 'bank lending channel'). The aim is to analyze if the size and evolution of such frictions has any connection with any monetary aggregate. Modelling the banking sector will also enable policy makers to better understand whether the distinction among short term interest rates matters for monetary policy and the age-old commitment versus discretion debate. Can a money growth target be delegated to a central bank that focuses on price stability?

Fiscal aspects of mainstream models

Most modern models assume an unwavering commitment to price stability by an independent central bank. They assume that fiscal policy will adjust to ensure that the government's inter-temporal budget is always in balance. The central question facing the central bank is that it cannot prevent inflation on its own in the presence of an uncooperative or irresponsible fiscal authority that behaves without much regard to its inter-temporal budget constraint. This is especially true for Pakistan where the fiscal authority sets its expenditures and taxes without regard to any requirement of inter-temporal budget balance. If the present discounted value of these taxes is not sufficient to finance expenditures, 'inflationary finance' must adjust to ensure that government's inter-

temporal budget constraint is satisfied. Moreover the inter-temporal budget constraint is satisfied only at the equilibrium price level. That is, if the fiscal authority generates a continuing stream of primary deficits that evolve independently of government's debt, then the equilibrium price level has to jump to assure fiscal solvency.

Hamza proposed two central research projects that could be conducted:

- Must the government pick expenditures, taxes, and inflationary finance to ensure that budget identity holds for all possible values of the initial price level and interest rate? Or is it an equilibrium condition that need only hold at the equilibrium price level and interest rate?
- Is the government's budget identity (that relates the real value of debt to the discounted present value of primary surpluses) a constraint or an equilibrium condition?

Hamza Malik stressed that either the government or the central bank should be targeting inflation and make it a central policy theme. The need to find the benchmark level of inflation was not only crucial when discussing the transmission mechanism of monetary policy but also determining the sustainable level of government debt as well as exchange rate and capital flow volatility.

Conclusion

The meeting ended with the following decisions:

1. A core team of macroeconomists was identified, who will meet and define a research agenda for the next three years. This agenda will generate research proposals for the IGC. The core-team will take ownership of the IGC macro cluster and define a clear role and a suitable direction.
2. A summary of the state of macro-models will be identified to reduce the gap between research done and what remains to be done, as a means of shaping the work programme.
3. Everyone will send the following to the cluster leader:
 - a. Current CVs
 - b. Suggestions for other people who conduct research on macroeconomics issues
 - c. Sharing of research documents including working papers that might be useful for the cluster
4. A follow-up meeting will be arranged with participation from the researchers based abroad around June 2011.

Name	Institution/Organization	Designation
Dr Ijaz Nabi	LUMS-DPRC-IGC	Dean, LUMS-country director, IGC
Dr Anjum Nasim	LUMS-DPRC	Professor, Department of Economics
Dr Antonio Maresco	LUMS-DPRC	Associate Professor, Department of Economics
Dr Ahmad Khalid	LUMS-DPRC	Visiting Professor, Department of Economics
Dr Ehsan Chaudry	LUMS-DPRC	Visiting Professor, Department of Economics
Irfan Qureshi	LUMS-DPRC-IGC	Teaching Fellow, Economics, Coordinator Macro Cluster
Saad Gulzar	IGC	In-country economist
Yasir Khan	IGC	In-country economist
Dr Azam Chaudhry	Lahore School of Economics	Dean, Department of Economics
Dr Naved Hamid	Lahore School of Economics, IGC	Professor, Department of Economics
Dr Idrees Khawaja	Pakistan Institute of Development Economics	Secretary, PSDE
Dr Shahid Kardar	State Bank of Pakistan	Governor
Dr Hamza Malik	State Bank of Pakistan	Director Monetary Policy
Dr Riaz Riazuddin	State Bank of Pakistan	Economic Adviser
Dr Ali Chaudry	State Bank of Pakistan	Director, Research Department
Azam Ali	State Bank of Pakistan	Statistics & DWH
Sajawal Khan	State Bank of Pakistan	Joint Director, Research
Moinuddin	State Bank of Pakistan	EAD
Nasir Hamid Rao	State Bank of Pakistan	Monetary Policy Department
Waqas Ahmed	State Bank of Pakistan	Research Department
Kalim Hyder	State Bank of Pakistan	Joint Director, Monetary Policy
Farooq Pasha	State Bank of Pakistan	Research Department
Dr Hafiz Pasha	BNU	Dean and Professor, Public Policy
Dr Jose Lopez-Calix	World Bank	Lead Economist, SASEP
Dr Haroon Sarwar	Planning Commission	Assistant Chief