

MONETARY POLICY EFFECTIVENESS IN INFLATION CONTROL AND STABILISATION



Researchers: Ehsan Choudhri and Hamza Malik
Partner organisation: the State Bank of Pakistan



IN BRIEF

- » Stable macroeconomic conditions are a major prerequisite for sustainable economic growth
- » The State Bank of Pakistan is concerned that analyses using their current modelling system suggest inflation and output do not respond to monetary shocks
- » Researchers are working closely with the monetary policy and research departments at the State Bank of Pakistan to examine the issue

Stable macroeconomic conditions are a major prerequisite for sustainable economic growth. Monetary policy plays an important role in advanced countries in controlling inflation and stabilising economic activity. Foreign exchange and credit markets in these countries represent important channels for the transmission of monetary policy effects. In Pakistan, credit markets are less developed and international capital flows are less dominant in the foreign exchange market. The State Bank of Pakistan is concerned that their current modelling system does not respond adequately to monetary shocks.

This project is a continuation of the collaborative work between the State Bank of Pakistan and Professor Ehsan Choudhri to develop a Dynamic Stochastic General Equilibrium (DSGE) Model for the State Bank of Pakistan. The previous project, which extended the DSGE model to include credit and foreign exchange markets, showed that these markets do not function in the same way as markets in developed countries.

The previous project showed that the presence of these frictions reduces the effectiveness of monetary policy, but it did not examine whether the effectiveness is sufficiently reduced to explain the empirical results. To explore this issue, the present project is using stochastic simulation of a DSGE model incorporating these factors to generate artificial series for key macroeconomic variables and estimate value at risks (VARs) based on these series. Once complete the project will be able to show with certainty if the underdevelopment of the credit and foreign exchange markets is indeed the reason behind ineffectiveness of monetary policy in Pakistan.

The IGC's recommendations are being used by the State Bank in monetary policy forecasting.