CONTENTS

Executive Summary

Monetary policy rests on the relationship between the rates of interest in an economy, that is, the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (to achieve policy goals). The beginning of monetary policy as such comes from the late 19th century, where it was used to maintain the gold standard.

A policy is referred to as contractionary if it reduces the size of the money supply or increases it only slowly, or if it raises the interest rate. An expansionary policy increases the size of the money supply more rapidly, or decreases the interest rate. Furthermore, monetary policies are described as follows: accommodative, if the interest rate set by the central monetary authority is intended to create economic growth; neutral, if it is intended neither to create growth nor combat inflation; or tight if intended to reduce inflation.

There are several monetary policy tools available to achieve these ends: increasing interest rates by fiat; reducing the monetary base; and increasing reserve requirements. All have the effect of contracting the money supply; and, if reversed, expand the money supply. Since the 1970s, monetary policy has generally been formed separately from fiscal policy. Even prior to the 1970s, the Bretton Woods system still ensured that most nations would form the two policies separately.

Within almost all modern nations, special institutions (such as the Federal Reserve System in the United States, the Bank of England, the European Central Bank, the People's Bank of China, and the Bank of Japan) exist which have the task of executing the monetary policy and often independently of the executive. In general, these institutions are called central banks and often have other responsibilities such as supervising the smooth operation of the financial system.

The primary tool of monetary policy is open market operations. This entails managing the quantity of money in circulation through the buying and selling of various financial instruments, such as treasury bills, company bonds, or foreign currencies. All of these purchases or sales result in more or less base currency entering or leaving market circulation.

Usually, the short term goal of open market operations is to achieve a specific short term interest rate target. In other instances, monetary policy might instead entail the targeting of a specific exchange rate relative to some foreign currency or else relative to gold. The other primary means of conducting monetary policy include: (i) Discount window lending (lender of last resort); (ii) Fractional deposit lending (changes in the reserve requirement); (iii) Moral suasion (cajoling certain market players to achieve specified outcomes); (iv) "Open mouth operations" (talking monetary policy with the market).

MONETARY POLICY

The regulation of the money supply and interest rates by a central bank, such as the Federal Reserve Board in the U.S., in order to control inflation and stabilize currency. Monetary policy is one the two ways the government can impact the economy. By impacting the effective cost of money, the Federal Reserve can affect the amount of money that is spent by consumers and businesses.

Monetary policy is one of the tools that a national Government uses to influence its economy. Using its monetary authority to control the supply and availability of money, a government attempts to influence the overall level of economic activity in line with its political objectives. Usually this goal is "macroeconomic stability" - low unemployment, low inflation, economic growth, and a balance of external payments. Monetary policy is usually administered by a Government appointed "Central Bank", the Bank of Canada and the Federal Reserve Bank in the United States.

Monetarist view of monetary policy.

Since the 1950s, a new view of monetary policy, called monetarism, has emerged that disputes the Keynesian view that monetary policy is relatively ineffective. Adherents of monetarism, called monetarists, argue that the demand for money is stable and is not very sensitive to changes in the rate of interest. Hence, expansionary monetary policies only serve to create a surplus of money that households will quickly spend, thereby increasing aggregate demand. Unlike classical economists, monetarists acknowledge that the economy may not always be operating at the full employment level of real GDP. Thus, in the short-run, monetarists argue that expansionary monetary policies may increase the level of real GDP by increasing aggregate demand. However, in the long-run, when the economy is operating at the full employment level, monetarists argue that the classical quantity theory remains a good approximation of the link between the supply of money, the price level, and the real GDP—that is, in the long-run, expansionary monetary policies only lead to inflation and do not affect the level of real GDP.

Monetarists are particularly concerned with the potential for abuse of monetary policy and destabilization of the price level. They often cite the contractionary monetary policies of the Fed during the Great Depression, policies that they blame for the tremendous deflation of that period. Monetarists believe that persistent inflations (or deflations) are purely monetary phenomena brought about by persistent expansionary (or contractionary) monetary policies. As a means of combating persistent periods of inflation or deflation, monetarists argue in favor of a fixed money supply rule. They believe that the Fed should conduct monetary policy so as to keep the growth rate of the money supply fixed at a rate that is equal to the real growth rate of the economy over time. Thus, monetarists believe that monetary policy should serve to accommodate increases in real GDP without causing either inflation or deflation.

Keynesian view of monetary policy.

Keynesians do not believe in the direct link between the supply of money and the price level that emerges from the classical quantity theory of money. They reject the notion that the economy is always at or near the natural level of real GDP so that Y in the equation of exchange can be regarded as fixed. They also reject the proposition that the velocity of circulation of money is constant and can cite evidence to support their case.

Keynesians do believe in an indirect link between the money supply and real GDP. They believe that expansionary monetary policy increases the supply of loanable funds available through the banking system, causing interest rates to fall. With lower interest rates, aggregate expenditures on investment and interest-sensitive consumption goods usually increase, causing real GDP to rise. Hence, monetary policy can affect real GDP indirectly.

Keynesians, however, remain skeptical about the effectiveness of monetary policy. They point out that expansionary monetary policies that increase the reserves of the banking system need not lead to a multiple expansion of the money supply because banks can simply refuse to lend out their excess reserves. Furthermore, the lower interest rates that result from an expansionary monetary policy need not induce an increase in aggregate investment and consumption expenditures because firms' and households' demands for investment and consumption goods may not be sensitive to the lower interest rates. For these reasons, Keynesians tend to place less emphasis on the effectiveness of monetary policy and more emphasis on the effectiveness of fiscal policy, which they regard as having a more direct effect on real GDP.

Types of monetary policy

Expansionary monetary policy.

A form of monetary policy in which an increase in the money supply and a reduction in interest rates are used to correct the problems of a business-cycle contraction. In theory, expansionary monetary policy can include buying U.S. Treasury securities through open market operations, a decrease in the discount rate, and a decrease in reserve requirements. In theory, open market operations are the primary tool of expansionary monetary policy. Expansionary monetary policy is often supported by expansionary fiscal policy. An alternative is contractionary monetary policy.

Expansionary monetary policy is an increase in the quantity of money in circulation, with corresponding reductions in interest rates, for the expressed purpose of stimulating the economy to correct or prevent a business-cycle contraction and to address the problem of unemployment. In days gone by, monetary policy was undertaken by printing more paper currency. In modern economies, monetary policy is undertaken by controlling the money creation process performed through fractional-reserve banking.

The Federal Reserve System (or the Fed) is U.S. monetary authority responsible for monetary policy. In theory, it can control the fractional-banking money creation process and the money supply through open market operations (buying U.S. Treasury securities), a lower discount rate, and lower reserve requirements. In practice, the Fed primarily uses open market operations for this control.

An important side effect of expansionary monetary policy is control of interest rates. As the quantity of money increases, banks are willing to make loans at lower interest rates.

Contractionary monetary policy:

Contractionary monetary policy is when the Federal Reserve uses its tools to put the brakes on the economy to prevent inflation. This usually means raising the fed funds rate. This increases the rate that banks charge each other to borrow funds to meet the federal reserve requirement. This requirement is the amount the Federal Reserve requires banks have on deposit each night when they close their books. Without this requirement, banks would lend out every dollar they get in. Raising the fed funds rate decreases the money supply because banks would rather lend a little less, and not have to pay a higher fed funds interest rate.

By contracting the money supply, a higher fed funds rate means banks will increase variable rate mortgages, consumers will borrow and spend less, and businesses will stop raising prices and giving raises. This usually heads off inflation.

The Fed's goal is to do this without pushing the economy into a recession. The opposite is expansionary monetary policy.

Objectives of Monetary Policy

The objectives of a monetary policy in India are similar to the objectives of its five year plans. In a nutshell planning in India aims at growth, stability and social justice. After the Keynesian revolution in economics, many people accepted significance of monetary policy in attaining following objectives.

1. Rapid Economic Growth

2. Price Stability

3. Exchange Rate Stability

4. Balance of Payments (BOP) Equilibrium

5. Full Employment

6. Neutrality of Money

7. Equal Income Distribution

These are the general objectives which every central bank of a nation tries to attain by employing certain tools (Instruments) of a monetary policy. In India, the RBI has always aimed at the controlled expansion of bank credit and money supply, with special attention to the seasonal needs of a credit. Let us now see all these objectives in detail.

1. **Rapid Economic Growth:** It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.

2. Price Stability: All the economics suffer from inflation and deflation. It can also be called as Price Instability. Both inflation are harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.

3. Exchange Rate Stability: Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.

4. Balance of Payments (BOP) Equilibrium: Many developing countries like India suffer from the Disequilibrium in the BOP. The Reserve Bank of India through its monetary policy tries to maintain equilibrium in the balance of payments. The BOP has two aspects i.e. the 'BOP Surplus' and the 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOP equilibrium can be achieved.

5. Full Employment: The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is Zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy.

6. Neutrality of Money: Economist such as Wicksted, Robertson has always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion. However this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.

7. Equal Income Distribution: Many economists used to justify the role of the fiscal policy is maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attainting an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

Effectiveness of monetary policy:

A. Strengths

1. Speedy and flexible

2. Somewhat isolated from political pressure

3. Hard money, restrictive policy by the Federal Reserve, has worked well recently.

B. Weaknesses

1. Easy money has not worked well.

a. In the early 1900's, it didn't stop a recession.

b. Low profit expectations by business and fears over possible employment loss by workers make lower interest rates ineffective.

c. Interest rate cuts in 2001 were not able to stop a recession.

2. Bank deregulation has made commercial banks a less important supplier of investment funds thus diminishing the effectiveness of monetary policy.

3. Changes in the velocity of money may negate some of the effects of monetary policy.

Three tools of the monetary policy:

The Federal Reserve System has three major 1. devices that it can use to control the money supply: (1) changes in the required reserve ratio, (2) changes in the discount rate, and (3) open market operations, that is, purchase and sale of government securities.

Minor tools include the margin requirement on securities, and moral suasion.

MAJOR TOOLS:

Reserve Requirements:

The Board of Governors is responsible for determining the reserve requirements of depository institutions within broad limits set by Congress.

Open Market Operations:

Open market operations consist of buying and selling securities on the open market. The term "open market" refers to the market for highly liquid, predominantly short-term securities, especially securities of the United States government. This is the method used most frequently by the Fed to adjust the money supply.

The Discount Rate:

The discount rate is the interest rate that a Federal Reserve Bank charges a depository institution when it gives the institution a loan. The Fed expects financial institutions to request loans only under special circumstances. As a result, although changes in the discount rate have "announcement effects" played up in the news media, they are not a very important monetary policy tool.

OTHER POLICY TOOLS

Margin Requirements on Securities:

The margin 1. requirement is the percent of the current market price of securities that must be used as a down payment. During 1986 the margin requirement was 50 percent.

Moral Suasion:

Moral suasion occurs when the 2. Federal Reserve attempts to achieve its policy goals by publicly urging banks or the general public to do one thing or another.

Monetary Policy Instruments:

Quantitative Instruments:

It is called quantitative, as they regulate the total quantity of money. In this category, the tools are

- Bank Rate or Discount Rate
- Open Market Operation
- Minimum Reserve Requirements
- Credit rationing or reserve

1) Changes in Bank Rate Policy or discount Rate:

The rate at which the central bank of the country gives loans to commercial banks is known as Bank Rate or re-discount rate, In Pakistan; State Bank charges 10% as bank rate. By changing such rate of interest, the central bank can influence the supply of money in the country. To control inflation the central bank increases the rate of interest. The commercial banks will also increase their rate of interest. Accordingly, the loans will decrease, investment, output and prices will fall. In this way, inflation will be controlled. Now, we assume that the country is facing deflation. To remove deflation central bank will decrease the bank rate, the commercial banks will also decrease the rate of inl91'Cst. In this way, people will get more loans. Investment production, employment and Prices will start rising up. Accordingly, deflation will be controlled.

Limitations:

But the success of the bank rate policy depends upon

- The fact that how flexible is the economic system. How rapidly, there will be the effect of bank rate on other variables of the economy, like prices, wages, Interest and output, etc.

- Commercial banks should abide by the instructions of the central bank. If the central bank brings changes in the rate of interest, the commercial banks should also change the rate of interest.

- If commercial banks already have excess reserves then commercial banks will not depend upon central bank. It this way, they will not care for changes in the rate of interest from central bank.

- If economic activity is flourishing or economy is having boom, then the business class will be prepared to pay even higher rate of interest and inflation will not to be controlled.

2) Open Market Operation

This is the second instrument of the monetary policy. Under this technique, the central bank sells or purchases 'government securities. If the central bank finds that commercial banks are providing excessive loans which are creating inflation. To remove the inflation, the central bank sells the government securities. The commercial banks will purchase these securities to earn interest against such securities. In this way, the resources of commercial banks will go down. They will advance less loans. Accordingly, the inflation will be controlled. If there is deflation in the economy. To control the deflation, the central bank purchases the government securities. Then the monetary base of the commercial banks will increase their loaning power will increase. As a result, investment will increase, income and prices will go up.

It also refers to purchase or sale by Central Bank of any securities, to regulate the credit creating capacity of Commercial Bank. Whenever the Central Bank purchases the securities, it does payment by cheque to sellers. The seller with deposit it with the Commercial Bank and the bank reserve increases. This is done when the central bank wants to increase the money supply in the economy. When the reserves with the Commercial Bank increases, the loan giving capacity of commercial Bank increases. On the other hand, Central Bank will sell the securities and accept cheque payments by the people who will be depositing the cheques in Commercial Bank. This leads to decrease in the reserve with commercial bank; as a result the loan giving capacity will decrease.

Limitations

The problem is that, in most of the countries the money market is not organized where the securities could be sold or bought.

The funds which are collected through sale of government securities should not be spent on unproductive fields.

3) Changes in Reserve Requirements

Each commercial bank has to keep a certain proportion of its deposits in the form of reserves just to meet the demands of the depositors. As in the case of Pakistan, each commercial bank has to keep 30% of its deposits to meet the needs of its depositors. The central bank can influence this reserve rate. If the central bank realizes that the commercial banks are advancing excessive loans, it will increase the reserve requirements. Accordingly, commercial banks could advance less loans.

On the other hand, in deflation, if the central bank reduces the reserve requirements, the commercial banks will be able to advance' more loans. Hence, deflation could be removed.

Every Commercial Bank has to maintain certain amount of reserve with Central Bank. Central bank has the power to set the reserve requirement to control the lending capacity of Commercial Banks. By changing the reserve requirement, it can control the money supply. Reserve maintained by commercial bank is called Statutory Reserve and the reserve over and above the Statutory Reserve is called ‘Excess Reserve’.

Excess reserve = total reserve – statutory reserve

Statutory Liquidity Requirement (SLR) is the minimum amount of liquid assets maintained by the banks, which is equal to or not less than a specific percentage of outstanding deposit liabilities.

4) Changes in Reserve Capital

Each commercial bank has to keep a certain ratio of its deposit with central bank. In case of Pakistan, each commercial bank has to keep 5% of its deposit in the central bank. By changing the reserve capital, a central bank can control the supply of money by commercial banks.

When there is inflation in the economy. To remove this inflation, the central bank will increase the reserve ratio. As a result, lending of commercial banks will fall. As a result the supply of money will decrease.

On the other hand, if central bank decreases the 'reserve ratio, the commercial banks will be having more funds to advance. Accordingly, the deflation could be controlled.

5) Changes in Marginal Requirements

Commercial banks do not give loans against leaves, rather they ask for pledges to make. How much a person will have to pledge is settled by the central bank. This is given the name of marginal requirement. The central bank can bring changes in the marginal requirements. If there is inflation in the economy, the marginal requirements will increase. In this way, people will get less loans. As a result, supply of money will decrease. During deflation the marginal requirements are decreased. Hence people will get more loans from the commercial banks. As a result supply of money will go up and deflation will be controlled.

6) Credit Ceiling/Rationing of Credit

The central bank can issue directions that loans will be given to commercial banks upto a certain limit. As a result, the commercial banks-will be careful in advancing loans to the people. But this is a very strict method, hardly adopted by the central bank. Moreover, if the commercial banks are having other sources to borrow, they will not bother for this policy.

Commercial Bank has to keep a deposit with the Central Bank. This amount of funds is equal to specific percentage of its own deposit liabilities. This is Cash Reserve Ratio. These reserve requirements of central bank work as a very strong weapon and cause sharp change in lending capacity of commercial bank.

Qualitative Instruments of Monetary Policy

They are also known as selective instrument of credit control. They are called qualitative tools, as they influence the type and composition of credit. These instruments are very popular in developing countries like India. Some important selective credit control measures are:

1) **Credit Rationing:**
   Under this, certain conditions are laid by the Central Bank to see proper regulation of consumer credit. This is to prevent excess expansion of credit.
2) **Direct Action:**
   This includes charging penalty interest rates, qualitative credit ceiling etc. on Commercial Bank. It has its direction and restrictive measures, which all the concern banks should follow regarding the lending and investment.
3) **Margin Requirement**:
   Here, margin refers to difference between market value and amount borrowed against the securities. Bank, while advancing loan against security, do not lend the full amount, but less. This is done keeping in view the difference between the value of security and the amount of advance to cover any loss.
4) **Moral Persuasion:**
   This is used by many countries. It has a great influence over the loan policy of banks. There is a co-operation between them. Under this, the Central Bank makes an informal request to Commercial Bank to contract loans in the time of inflation and expand loans in depression. It helps the Central Bank to secure the willingness and co-operation, but then that depends on the amount of respect and authority the Central Bank enjoys among the member banks.

CASE: LIMITS OF MONETRY POLICY

BY DR ASHFAQUE H KHAN

The Federal Bureau of Statistics (FBS) has released inflation numbers for the month of November 2010 and for the first five months (July-November) of the current fiscal year (2010-11).

CPI-based inflation continues to exhibit a rising trend. Inflation for the month of November stood at 15.5 per cent and averaged 14.4 per cent during July-November 2010. Food prices rose by 20.5 per cent in November and continued to remain the largest contributor to overall inflation.

Inflation is on the rise in many countries in the Asian region. Rising food prices are found to be the major driver behind inflation in the region. Rise in food prices in the region has ranged between 10-35 per cent since 2009. The rising food prices are causing a surge in overall inflation, particularly in low income countries where such prices account for a higher proportion of the inflation basket. For example, the weightage of food inflation in the overall inflation basket ranges between 33 to 46 per cent in China, India, Indonesia, Thailand and Pakistan.

Rising food prices are of a major concern because they represent a higher proportion of spending for the poor than for the general population, especially in low income countries. The poorest 20 per cent of the population spend nearly two-thirds on food whereas the richest 20 per cent spend only one-third. Given the persistent rise in food prices, the implications of this are staggering.

Why are food prices on the rise in the region, including in Pakistan? Increase in food price is largely driven by external factors, primarily weather-related international developments and the increasing incidence of financial speculation in commodity markets. Key crop harvests have been affected by adverse weather events, especially wheat production of major exporters such as Canada, Kazakhstan, Ukraine and Russia. Wheat prices were further affected by the announcement of an export ban by Russia in August 2010.

Apart from weather-related developments the entry of financial investors in international commodity markets is creating volatility in food prices. Massive liquidity injection resulting from easy monetary policy pursued by developed economies in the aftermath of the 2008 crisis is fuelling speculation in food markets and driving up food prices. Investment in commodity markets has crossed $300 billion in July 2010 and is causing a speculative bubble in these markets. In the case of Pakistan, the unprecedented floods that damaged crops and disrupted the supply situation as well as the weakening of state authority are contributing to the surge in food prices.

Coming back to the inflation numbers released by the FBS, a cursory look is sufficient to see that a 55.5 per cent contribution to the sharp pickup in overall inflation has come from the rise in food prices alone. Another 18 per cent has come from fuel, lighting, transport and communication. Thus, a 73.5 per cent contribution to the surge in current inflation is due to the rise in food prices, the continuous rise in power tariff, the rise in POL prices and increase in transportation charges. In other words, the current pickup in inflation is due largely to the rise in food prices and increases in government-administered prices.

The above analysis clearly suggests that inflation in Asia in general and Pakistan in particular is a supply-side phenomenon. Using monetary policy as a tool to combat such a rise in inflation is of serious concern. Monetary policy is considered to be more effective if inflation is of the demand-pull variety. In the absence of clear signs of an excess demand in Pakistan (the current account deficit is down by 55 per cent. It has remained in surplus for the last two months), tightening of monetary policy would thus be ineffective to deal with the root cause of inflation.

By tightening monetary policy, can we reduce food prices, improve the writ of the state, prevent government to raise power tariff, force the government not to pass on the rise of POL prices to domestic consumers, and stop the government from borrowing from the Central Bank to finance budget deficit? The answers to all these questions are obviously no. Monetary policy is an effective instrument to address the shocks emanating from the demand-side. It is not an effective instrument to deal with the supply-side shocks.

Dampening the general level of demand in the economy through further tightening of monetary policy is inimical to growth, job creation and poverty alleviation. Especially, a higher discount rate is raising the entire term structure of interest rates and hurting private sector investment. In such an environment growth would remain low, joblessness and poverty would continue to rise.

I have been advocating the pursuance of tight monetary policy until the last monetary policy announcement. I believe that the last increase in discount rate was unjustified and the SBP, at best, could have maintained a status quo. Before taking any decision regarding monetary policy, the sources of inflation must be identified. Simply tightening of monetary policy without finding the root cause of inflation is bad economics. Are the Research and Monetary Policy Departments of the SBP on the same page? The answer appears to be no. The Research Department believes that inflation in Pakistan is driven by food inflation for which monetary policy is not the right instrument. The Monetary Policy Department on the other hand, believes that “inflation is always and everywhere a monetary phenomenon”. Therefore the ‘aspirin’ approach to monetary policy continues.

Prudent monetary policy requires finding the root cause of inflation in the absence of demand pressure. I would urge the SBP to reconsider its monetary policy stance. The need to revive the economy has never been so great. Last three years of low growth have thrown millions below the poverty line and millions have joined the pool of the unemployed. With external balance of payments not so fragile, there is a need to review the monetary policy stance.

Conclusions and recommendation:

Monetary policy rests on the relationship between the rates of interest in an economy, that is, the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. There are several monetary policy tools available to achieve these ends: increasing interest rates by fiat; reducing the monetary base; and increasing reserve requirements. All have the effect of contracting the money supply; and, if reversed, expand the money supply. Monetary policy can be implemented by changing the size of the monetary base. Central banks use open market operations to change the monetary base. The central bank buys or sells reserve assets (usually financial instruments such as bonds) in exchange for money on deposit at the central bank. Those deposits are convertible to currency. Together such currency and deposits constitute the monetary base which is the general liabilities of the central bank in its own monetary unit. Usually other banks can use base money as a fractional reserve and expand the circulating money supply by a larger amount.

So nations should focus on controlling the inflation because monetary and the fiscal policies are the inflationary controlling policies one made by SBP and other by the government respectively. So the money supply should be controlled in the market in order to control one of the causes of the inflation and this should be done by the SBP in order to avoid the drastic effect of inflation which our nation is facing now-a-days.

STATE BANK OF PAKISTAN

MONETARY POLICY DECISION

Despite a recent improvement in the external current account, restrained government borrowings from SBP and stable financial markets, the focus must remain on addressing the structural fiscal weaknesses and reducing inflation to provide a sound platform for sustainable economic recovery in FY12. Although some measures have been announced to contain the fiscal deficit of FY11 and inflation has eased somewhat, more work is required to build on these initial efforts by maintaining progress on comprehensive tax reforms, transparent rationalization of subsidies, and the development of a forward-looking debt management strategy.

This will require support from across the political divide and from other state and civil society institutions to ensure their smooth implementation. These measures would help check the level of government borrowings from the banking system, creating space for the private sector and lowering their borrowing costs thereby supporting the utilization and expansion of the economy's productive capacity. Initiation of these reforms has become critical since private and public sector investments are falling while total debt is rising sharply and expectations of high inflation are becoming entrenched.

The decline in year-on-year inflation from 15.5 percent in December 2010 to 12.9 percent in February 2011 can be attributed to three factors. First, a gradual dissipation of the effect of the flood on food prices; second, an incomplete pass-through of high international oil prices to the domestic market and a smaller adjustment in electricity prices than required by the projected size of the power sector subsidy; and, third, a reduction and thereafter containment of the stock of government borrowings from SBP to around Rs1290 billion (on cash basis). The future path of inflation would be contingent upon the policy stance adopted with respect to the last two factors. In addition, the impact of the recent removal of General Sales Tax (GST) exemptions could also influence the inflation outlook.

The SBP is confident that the government will adhere to the mutually agreed borrowing limits from SBP and, in recognition of the high level of inflation, will aim to lower them further. This should facilitate SBP in aligning monetary expansion with the level of productive economic activity while improving its composition in favour of Net Foreign Assets (NFA). By 12th March 2011, the year-on-year growth in reserve money was 15.9 percent, which is slightly lower than the growth rate observed at the time of last monetary policy decision in

January 2011, and share of NFA of SBP in reserve money has increased to 27.5 percent compared to 22.5 percent at the beginning of FY11. A continuation of these positive trends can potentially have a beneficial effect on inflation in the next fiscal year.

However, the rise in public debt with a considerable short-term maturity profile combined with reduced availability of bank credit for the private sector at higher interest rates has created challenges for monetary management in terms of striking a balance between containing inflation and promoting economic growth. By end-December 2010, the year-on-year growth in government's total debt was 14.8 percent, with 45 percent of the tax revenue being absorbed by interest payments. The year-on-year growth in private sector credit, on the other hand, was only 5 percent up till 12th March 2011. Without increasing the private sector's investment and hence its contribution to economic growth it would become more challenging for the economy to generate sufficient revenues to meet its debt obligations in the future, especially with the terms of trade shifting in favour of sectors with modest contribution to tax revenues.

The recently announced tax measures, estimated to raise approximately Rs53 billion in the remaining months of FY11, together with a cut in planned development expenditures and postponement of some subsidy payments may help in reducing the fiscal deficit for FY11 to some extent. Given the delayed announcement and temporary nature of some of these measures, the improvement in the fiscal position will require these efforts to be consolidated in the forthcoming budget. Thus, implementation of a credible medium term budgetary framework and renewed efforts to abide by the principles of the Fiscal Responsibility and Debt Limitation Act (2005), geared towards reducing the revenue deficit, are required to strengthen the fiscal position on a sustainable basis.

On the financing side, only Rs48 billion were received for external sources to finance the budget during H1-FY11 against the budget estimate of Rs230 billion for the year. If these external flows are not released in a timely manner, there is a risk of further substantial government borrowings from the banking system, which will make liquidity management more challenging. The government has already borrowed substantial amounts, Rs329 billion during 1st July – 12th March, FY11, through various instruments, increasingly in the 3-month Treasury Bills. The incremental requirements of the government for Q4-FY11 and a debt plan that focuses on long term borrowings are awaiting announcement. There is growing uncertainty in the global economic environment also. The popular uprisings in the Middle East and North Africa (MENA) region and unprecedented damage to the Japanese economy because of an historic earthquake and tsunami have shaken the global economy once again, which has yet to fully recover from the repercussions of the financial and economic crises of advanced economies. One consequence of these uncertain times has been high international commodity prices, especially of oil. So far, the terms of trade shock has been favourable for Pakistan's economy. More than 90 percent of the incremental increase in export earnings during July – February, FY11 over the corresponding period of last year has been due to high international prices of Pakistan's exports. The contribution of high import prices, particularly of oil, to the import bill has been relatively low, but is substantial and rising. The turmoil in the MENA region may also influence the flow of remittances to Pakistan. However, assuming that the inflow of remittances continue its current trend for the remaining months of FY11, there are no immediate risks to the external current account balance. The financial account inflows such as foreign direct and portfolio investments, on the other hand, have remained fairly modest during July – February, FY11; almost half the level of inflows seen in the corresponding period of last year, which was also small compared to historical levels. The overall balance of payments position appears to be strong at the moment with a gradual build-up of foreign exchange reserves and a stable foreign exchange market. However, given the uncertainty with respect to foreign inflows, the developments in the external sector will need to be monitored closely in the coming months.

In conclusion, given a favourable external current account position and relatively disciplined government borrowings from SBP, the immediate risks to macroeconomic stability seem to have subsided, at least for the next two months. Therefore, SBP has decided to keep the policy rate unchanged at 14 percent. However, there is little room for complacency as the risks to the economy may increase if meaningful economic reforms are not initiated to address the structural weaknesses. Inflation persistence still remains high, which is largely formed by recent past levels of inflation and perceptions of economic agents about the credibility and direction of monetary and fiscal policies in controlling inflation and promoting long-term sustainable economic growth. Perceived credibility of monetary policy is also influenced by the behaviour of monetary aggregates. In this respect, while government borrowing from SBP has been contained to end-September 2010 level, growth in public sector borrowing is still very high and that of the private sector low. Further, given the financing requirements of fiscal authorities, budgetary as well as non-budgetary borrowings for the procurement of commodities and addressing the circular debt-related issues, the likelihood of an ease in such borrowings is small. This means that risks to macroeconomic stability could increase in the next fiscal year. The current stability in the financial markets provides valuable time to initiate structural reforms. Not only are urgent measures required to address the energy crisis to increase productive activity but the fiscal position also needs considerable strengthening to cope with rising debt obligations and to ease borrowing pressures on the banking system.