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# AN EMPIRICAL ASSESSMENT OF PAKISTAN'S DISCRETIONARY MONETARY POLICY STRATEGY USING NOVEL DISCRETION AND INFLATION BIAS INDICATORS

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Zafar Hayat

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# ABSTRACT

Although price and output stability have been the major goals of monetary policy, contention remained over their mutual compatibility and substitution for one another. It is challenging for monetary policy makers to maintain a balance between the price and growth objectives. The pursuit of a balance historically has led monetary policy to evolve under many guises. Discretion and commitment are the two popular monetary policy guises advocated for achievement of the twin objectives of inflation and growth. Under commitment, the long-term growth stability is assumed to be achieved via price stability, and therefore the overriding focus is the inflation objective. Under discretion, the achievement of the dual objectives requires sufficient flexibility with the central banker to adjust monetary policy as and when necessary, and as frequently as desired, to maximize monetary policy benefits. This thesis seeks to empirically investigate to what extent Pakistan's typical discretionary monetary policy strategy has benefited the economy both in terms of achievement of inflation and growth objectives as well as maintaining a balance between them for a 50-year timeframe. Using a novel discretion assessment approach, new inflation bias indicators and its determinants as well as a new discretion indicator, the thesis demonstrates that Pakistan's discretionary monetary policy strategy failed to deliver on its core mandate. Instead, the policy proved to be self-defeating as it produced results contrary to its *very purpose*. On one side, the State Bank of Pakistan (SBP) exercising its discretion, induced long-term excessive inflationary pressures in the economy and on the other side hindered the real growth than potentially would have been. This failure of the discretionary monetary policy on both the counts of inflation and growth objectives cast nontrivial doubts on its efficacy to fully reap the benefits of price and growth stability. The major findings of the study call for a reorientation of the focus of the SBP towards the inflation objective as against the growth objective. For this transformation to occur, monetary policy must change from the existing discretionary set-up to a commitment-based policy framework. Under such a framework, the SBP will have to commit to a certain low level of inflation and should not renege upon it to help build its credibility and capability to effectively anchor inflation expectations to ensure price stability, and hence growth-stability.

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Indeed, it is the most appropriate time to comment on the common joke that PhD stands for a ‘Permanent Head Damage’. As per my experience, I would rather state that it should stand for a ‘Permanent Hair Damage’. Nevertheless, the deal is still lucrative as the corresponding gain at the expense of partial hair-loss is voluminous. I can state with confidence that the time spent over my PhD is the most progressive, fruitful and promising time ever. I feel blessed and really want to thank my creator (ALLAH almighty) for giving me endurance to pursue this long-term ambition. I now have the feeling that through my research ALLAH has enabled me to potentially benefit the 180 million people of my country Pakistan, suffering from high inflation rates since decades.

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# LIST OF ABBREVIATIONS

| | | |
|---|---|---|
| ADF | - | Augmented Dicky-Fuller |
| AIC | - | Akaike information criterion |
| ARDL | - | Autoregressive distributed lag |
| ARMA | - | Autoregressive moving average |
| ARIMA | - | Autoregressive integrated moving average |
| CB | - | Central bank |
| CPI | - | Consumer price index |
| CUSUM | - | Cumulative sum of squares of residuals |
| CUSUMQ | - | Cumulative sum of squares of recursive residuals |
| C.V | - | Critical value |
| DF-GLS | - | Dicky-Fuller generalized least squares |
| DW | - | Durbin Watson |
| ECB | - | European central bank |
| ECM | - | Error correction model |
| e.g. | - | Exempli Gratia (for example) |
| i.e. | - | Id Est (that is) |
| FDI | - | Foreign direct investment |
| FIML | - | Full information maximum likelihood |
| GARCH | - | Generalized autoregressive conditional heteroskedasticity |
| GDP | - | Gross domestic product |
| GNP | - | Gross national product |
| GMM | | Generalized method of moments |
| HP | | Hodrick and Prescott |

# LIST OF ABBREVIATIONS

| | | |
|---|---|---|
| HQC | - | Hannan and Quinn criterion |
| LSM | - | Large scale manufacturing |
| MLE | - | Maximum likelihood estimation |
| NLLS | - | Non-linear least squares |
| OECD | - | Organization of economic cooperation and development |
| OLS | - | Ordinary least squares |
| PP | - | Phillips Perron |
| RPI | - | Retail price index |
| RPIX | - | Retail price index (excluding mortgage interest payment) |
| SBC | - | Schwarz Bayesian criterion |
| SBP | - | State bank of Pakistan |
| SPI | - | Sensitive price index |
| SUR | - | Seemingly unrelated regressions |
| U.S | - | United States |
| U.K | - | United Kingdom |
| VECM | - | Vector error correction model |
| WDI | - | World development indicators |
| WPI | - | Wholesale price index |
| 2SLS | - | Two-stage least squares |