Research Title: Exchange Market Pressure and Monetary Policy: Pakistan’s Experience

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Abstract: Exchange Market Pressure and Monetary Policy: Pakistan’s Experience The term ‘Exchange market pressure’ generally refers to the magnitude of money market disequilibrium arising from international excess demand/supply of domestic currency. Girton and Roper (1977) specifically, define exchange market pressure (emp) as sum of exchange rate depreciation (in percent) and depletion of foreign reserves (scaled by monetary base). Under Managed float the monetary authority has the option to adjust the exchange rate or foreign reserves to restore the equilibrium in money market. In practice, quite often the adjustment is shared between foreign reserves and exchange rate. Therefore, under managed float, combined variations (i.e. emp) in foreign reserves and exchange rates represent an important transmission mechanism for restoration of equilibrium in money market. In this regime, to study money market disequilibrium a focus on either exchange rate or foreign reserves to the complete exclusion of the other would convey a misleading picture of external account. Therefore, under managed float, to examine money market disequilibrium and draw policy implications, the focal point should be emp as it incorporates the changes in exchange rate as well as variations in foreign reserves. The objectives of the study are: (i) to analyze the nature of relationship between exchange market pressure and monetary variables viz. domestic credit and interest rate; (ii) to identify the monetary tool(s) used to manage exchange market pressure; and (iii) to determine the degree of monetary autonomy enjoyed by State Bank of Pakistan (SBP). The study is focused exclusively on Pakistan. Our results show; that the relationship between exchange market pressure and monetary variables is positive. The relationship between interest rate and exchange market pressure is much weaker as compared to the relationship between domestic credit and exchange market pressure. Results from vector auto-regression as well as Granger causality imply that domestic credit and not interest rate, has remained the dominant tool of monetary policy during the span examined (1991:04-2005:12). However, during the active life of foreign currency accounts (1991:03-1998:05) interest rate has been used to defend the Rupee. Finally the results show that the extent of monetary autonomy enjoyed by SBP has remained highly restricted.