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Policy Brief

Inflation in Pakistan: Monetary or Fiscal Phenomena

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Executive Summary

Price stability has always been an important concern for policymakers. Post-COVID inflationary episodes, the Russia-Ukraine war, Supply chain disruptions, and increased commodity prices the issue resurfaced across all economies. Monetary policy is considered to be responsible for controlling inflation across all economies. However, recent inflationary conditions came as a realisation for most economies that controlling inflation through monetary policy alone is insufficient and inflation is not always a monetary phenomenon. The fiscal theory of price level suggests that for countries with high fiscal deficits and debt liabilities, inflation becomes more of a fiscal problem and can be addressed by having a mix of fiscal and monetary policy with fiscal policy guiding the monetary policy. Also, expectations of future inflation and policy rates are important for effectively setting the policy rate. To effectively accommodate the expectations in the inflation-targeting process, the State Bank of Pakistan (SBP) needs transparency and autonomy. Monetary policy transparency may be improved by publishing the minutes of the Monetary Policy Committee (MPC). By introducing reforms in the taxation and energy sector, restructuring State-Owned Enterprises (SOEs), and improving the investment climate of the country, the government can effectively improve the fiscal conditions of the country.

Policy Recommendations

- Design a fiscal policy that takes charge of controlling inflation with support of monetary policy in such a way that the living conditions of the general public are not worse off.
- Introduce tax reforms by incorporating well-performing sectors into the tax net and focusing on welfare taxation.
- Restructuring of State-owned enterprises and reforms in the energy sector to reduce circular debt. Investment in human capital, infrastructure development, increased expenditure in education and health sector.
- Work on improving the investment climate of the country by facilitating the investors and simplifying the process of industry setup to attract investors.

- PBS can update the consumer basket every 5 years like the practice adopted by most of the countries. Relevant consumer items can be added and irrelevant can be excluded.
- Also, PBS may update the number of selected urban and rural sectors for data collection for a more representative CPI.
- By regularly updating the CPI basket, the government may better understand consumer behaviour. This will help the government to make better policies to address the challenges faced by consumers.
- SBP may set the policy rate in line with the market expectations of consumers and businesses. Inflation targeting can be done in the best way possible by incorporating the future expectations of policy rates and inflation.
- To incorporate the consumers and business expectations the SBP may use the New Keynesian Philips curve instead of relying on the Taylor-type rules.
- For effectively targeting inflation and incorporating inflation expectations, the SBP needs to have a due autonomous status for transparency in policy policy-setting process. For effectively targeting inflation and incorporating inflation expectations, the SBP needs to have a due autonomous status for transparency in the policy-setting process. To improve the communication and transparency of monetary policy, SBP may publish the minutes of MPC timely with a detailed discussion of the voting preferences of individual members.
- SBP may reassess the constitution of the Monetary Policy Committee (MPC) as the policy decision rests completely at the discretion of the governor.
- PBS may construct a PCE price index for Pakistan as a measure of inflation that serves as a better measure of inflation.

"Without price stability, the economy doesn't work for anyone. In particular, without price stability, we will not achieve a sustained period of strong labour market conditions that benefit all." (Federal Reserve Chair Jerome Powell, 26th August 2022)

Introduction

Inflation is generally defined as the rate at which prices rise over time. It is broadly measured as an overall price increase or a consumer's cost of living.[1] Therefore, Price stability is essential for every economy. It is often believed that slow and stable inflation promotes economic growth in a way that it promotes savings, and investment and directs the economy towards economic progress. Globally, macroeconomic policies prioritise long-term economic development and price stability as primary objectives. Monetarist Economists like Milton Friedman believed that inflation is solely a monetary phenomenon and is only caused by the increase in money supply.[2] Non-monetary theorists relate rising prices to factors including the cost-push effects, fiscal policies, and changes in private expenditures.[3] However, an increased supply of money is considered to be the cause of inflation globally. Therefore, to support sustainable economic growth, price stability is the primary objective of almost all the central banks around the world. Money supply and interest rates in the economy are controlled by the use of different instruments of monetary policy to maintain stability in overall price levels and financial markets. The State Bank of Pakistan (SBP) Act 1956, outlines the objectives of monetary policy as follows: (i) maintaining domestic price stability by regulating Pakistan's monetary and credit system, (ii) contributing to the stabilisation of the financial system, and (iii) assisting the economic policies of the government to promote development and fuller utilisation of country's resources[4].

[1]Ceyda Oner, "*Inflation: Prices on the Rise*" https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Inflation accessed on 12 June 202

[2]Humphrey, Thomas M. "A monetarist model of the inflationary process." Economic Review 61 (1975): 13-23. accessed on 12 June 2024

[3]Humphrey, Thomas M. "A monetarist model of the inflationary process." Economic Review 61 (1975): 13-23 accessed on 12 June 2024

[4] "Monetary Policy Objectives", State bank of Pakistan.https://www.sbp.org.pk/m_policy/mpf-01.asp accessed on 13 June 2024

Is CPI Truly Reflecting the Economic Reality of Pakistan?

High and persistent inflation rates have been a concern for Pakistan. Inflation can be effectively controlled if the instrument for measuring inflation is accurate and reflects the consumer preferences for goods and services. Following is an analysis of how inflation is measured and the possible issues in measuring inflation that can be addressed.

In Pakistan, 3 indices are used for calculating inflation namely, wholesale price index (WPI), Sensitive Price index (SPI) and Consumer Price Index (CPI). However, CPI is the main instrument to measure inflation in Pakistan, as in many other countries. It measures the changes in the overall cost of buying a fixed basket of goods and services and generally represents the country's inflation rate. Currently, the Pakistan Statistical Bureau (PBS) has been publishing 5 indices on a monthly/weekly basis: National Consumer Price Index (NCPI), Urban Consumer Price Index (UCPI), Rural Consumer Price Index (RCPI), Wholesales Consumer price index (WPI) and Sensitive Consumer Price Index. A total of 487 items of goods and services divided into 12 major commodity groups are covered in the CPI. In the new base year 2015-16, the weighted average of Urban CPI and Rural CPI for 12 commodity groups is used to calculate the National CPI. Urban CPI includes 356 consumer items and 35 cities. Whereas, Rural CPI includes 244 consumer items and 27 rural centres. For each item, 4 price quotations are obtained from different shops in the markets. The markets are selected based on sales volumes, assuming the maximum consumers purchase goods from them.

In 2014, the PBS governing council announced to rebase the National Accounts and Price Statistics every 10 years with 2015-16 serving as the current base year[5]. One of the issues with Pakistan's CPI is its base year. Recently, Pakistan has witnessed a sharp decline in the CPI Inflation rate to 11.8% in May 2024 from 37.97% in May 2023. This decrease in the inflation rate has not lessened the burden for the common people as in reality prices of consumer goods and services have not reduced as this decline is attributed to the High base year effect.

[5] "Methodology of Price Statistics Base Year 2015-16", Pakistan bureau of statistics, September 2019. https://www.pbs.gov.pk/sites/default/files/price_statistics/methodology_of_price_statistics_base_year_2015-16.pdf accessed on 14 June 2024

The weights of items in the consumer basket are derived and revised from the Family Budget Survey. PBS has conducted a Household Integrated Economic Survey (HIES) during the years 2004-05, 2007-08, 2010-11, 2013-14, and 2015-16, and the latest survey was conducted in 2018-19. However, to rebase price indices and compute the separate weights of all items, a special survey namely, the Household Integrated Income and Consumption Survey (HIICS) was conducted in 2015-16.

Obtaining a price census for every consumer transaction in the country is not attainable, hence the composition of a basket of goods. However, the basket should be consistent with people's changing consumption and expenditure patterns. Currently, Pakistan's CPI basket accounts for a small number of goods and services.

Another, major issue with the current composition of the CPI basket is that it may not accurately reflect societal consumption trends or their future trajectory. Several items in the RCPI and UCPI list are irrelevant and need to be excluded, while new items that should be included in the consumer basket are overlooked. In the UK, items in the consumer basket of CPI are reviewed at the start of the year, irrelevant items are excluded and new items introduced in the markets are added to the consumer basket. Such statistical updates are important because they take into account the changes in expenditure patterns of the consumers.

Table 1 Data Collection Practices for CPI Statistics in Different Countries

Countries	***Number of items***	***Base year Revision***	***Weights Revision***
China	600	5 years	5 years
Malaysia	552	Last updated as 2010	2 years
Japan	582	5 years	5 years
United Kingdom	744	5 years	5 years
Vietnam	752	5 years	5 years
Mauritius	194	5 years	5 years
India	448 (Rural CPI) 460 (Urban CPI) 465 (CPI IW) 85-106 (CPI AL)	10 years	5 years
Bangladesh	469 (Urban CPI) 341 (Rural CPI)	10 years	10 years

The price data for Urban CPI is currently collected from 68 markets across 35 cities. Each city selects the number of markets, from 1 to 13, for price collection. Currently, the chosen marketplaces in Pakistan's major metropolitan cities are as follows: Karachi (11), Lahore (7), Faisalabad (2), Rawalpindi (5), Gujranwala (1), Peshawar (3), Multan (3) and Hyderabad (4). The representation of these majorly populated cities is quite low. Lahore, being the 2nd most populous city, deserves better representation in CPI data as price collection is done from only 7 selected markets. The price collection is done from only 7 markets. In 2022, the rural population counted for 62%[6], however, price collection is done from 27 rural centres only.

Overview of Inflation Dynamics of Pakistan

The COVID-19 pandemic tremendously impacted the global economy. The disruption in global supply lines with the post-lockdown increase in demand and expansionary fiscal measures resulted in inflationary pressures worldwide. Following the global inflationary trends, Pakistan has also been experiencing inflationary pressures since FY2020, after witnessing mild disinflation between 1970 -2019.

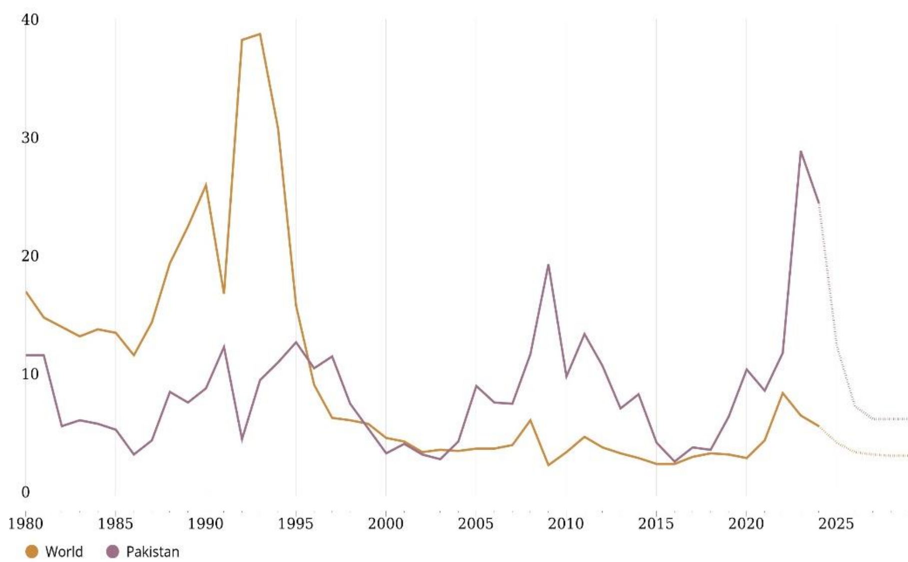

Figure 1: Inflationary trend of Pakistan and the World

Source: IMF Data Mapper[7]

[6] "Rural population (% of total population) – Pakistan", World Bank Group. https://data.worldbank.org/indicator/SP.RUR.TOTL.ZS?locations=PK accessed on 15 June 2024

[7] "World Economic Outlook (April 2024)", International Monetary Fund. https://www.imf.org/external/datamapper/ accessed on 15 June 2024

In contrast to the long-term global trends of disinflation, Pakistan did not experience a significant reduction in inflation[8] as shown in Figure 1.

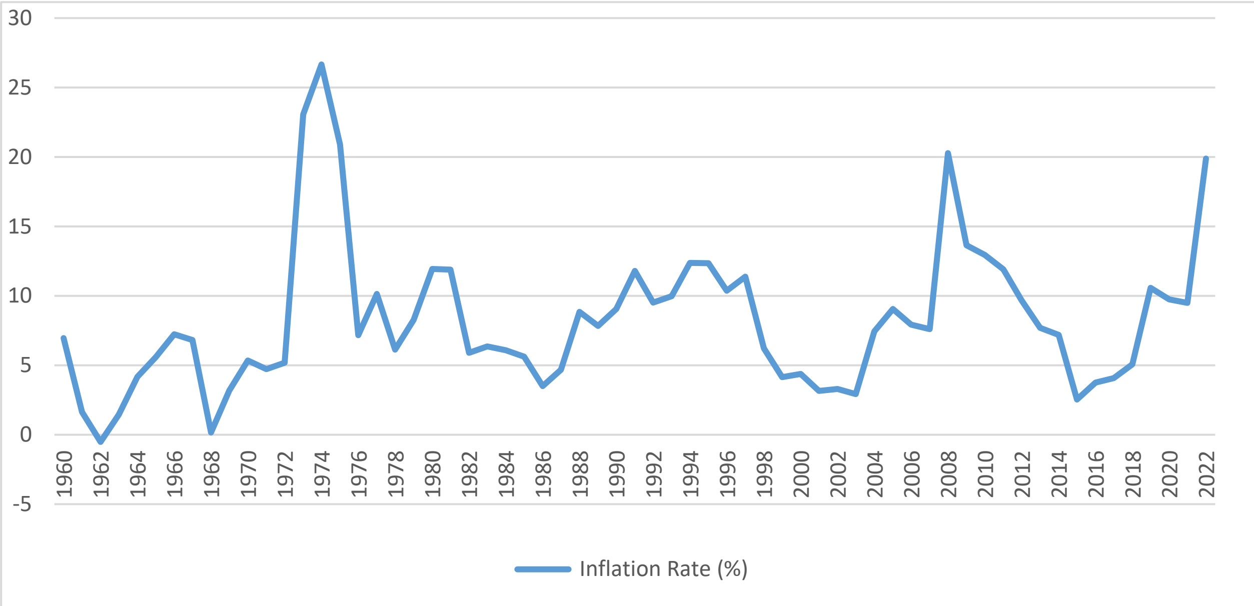

Figure 2: Pakistan's Inflation Rate 1960-2022

Source: World Bank[9]

The above figure shows the rate of inflation from 1960-2022. The country witnessed four periods of high inflation during this time when the inflation rate was higher than the threshold level of 7% for 3 consecutive years including (i) FY73-78 (ii) FY89-98 (iii) FY05-15 and (iv) FY20- FY24 (H1). Pakistan's headline inflation has been relatively higher in all these inflationary episodes including the food and energy inflation. This evidence supports the idea that domestic as well as global demand and supply shocks including high commodity prices specifically oil prices affect Pakistan's economy. Moreover, expansionary monetary and fiscal policies, inflation expectations, exchange rate fluctuations, economic and political uncertainty, and natural disasters such as floods and droughts are the key determinants of inflation in Pakistan[10]. Political instability, commodity prices, risks attached to climate change, and global financial conditions result in higher

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[8] "Half Year Report 2023-2024-The State of Pakistan's Economy", State Bank of Pakistan. https://www.sbp.org.pk/reports/half/arFY24/Half-index-eng-24.htm accessed on 16 June 2024

[9] "Inflation rates in Pakistan", WorldData.info. https://www.worlddata.info/asia/pakistan/inflation-rates.php#:~:text=During%20the%20observation%20period%20from,the%20price%20increase%20was%2013%2C454.75%25. accessed on 16 June 2024

[10] "The State of Pakistan's Economy Half Year Report 2023-2024",Stae Bank of Pakistan.https://www.sbp.org.pk/reports/half/arFY24/Half-index-eng-24.htm accessed on 17 June 2024

inflation and slower GDP growth[11]. In Pakistan, during 1992-2021 medium and long-term inflation was influenced by increased global commodity prices. However, in the short to medium run, exchange rate fluctuations were the driving force of inflation. Also, government borrowing affected inflation both in the short run and long run[12]. Economic and political instability have a strong impact on the level of inflation in any economy. In Pakistan, the rate of inflation increases with the rise of political instability. These increased rates of inflation directly impact the purchasing power of consumers[13]. However, the major drivers of inflation during the current inflationary period are fiscal policy, especially after high fiscal deficits during FY21 and uncertainty in FY2020 during the COVID-19 pandemic. From FY22 onwards, the country witnessed increased political and economic instability on the account of general elections of 2024. Exchange rate depreciation, inflation expectations, and an increase in global commodity prices also contributed to the current inflationary episode[14].

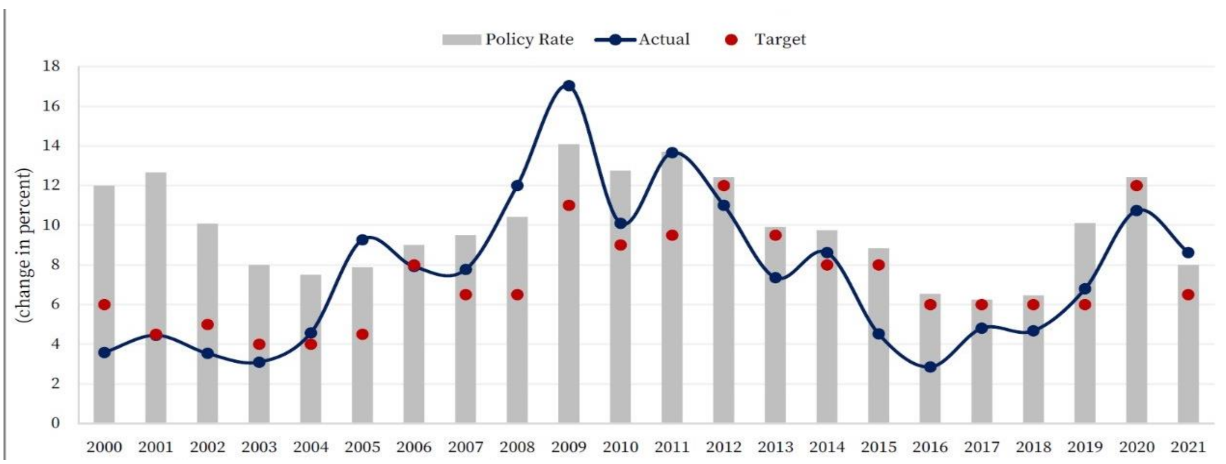

Figure 3: CPI Inflation: Actual vs Target 2000-2021

Source: Pakistan Statistical Bureau, Ministry of Finance

[11] Ahmed and Waliullah. “Bayesian Estimation of a Pragmatic Model for Monetary Policy Analysis: The Case of Pakistan” State Bank of Pakistan, Working Paper Series, 2024 accessed on 17 June 2024

[12] Hanif, Muhammad Nadim, Sajjad Zaheer, and Javed Iqbal. *Time-Frequency Analysis of Determinants of Inflation Rate in Pakistan*. No. 111. State Bank of Pakistan, Research Department, 2022. accessed on 18 June 2024

[13] Azhar, K. M. D. M. M., and Zainab Murtaza. "Impact of Agitational Politics on Inflation: A Case Study of Pakistan." (2020). accessed on 18 June 2024

[14] Half Year Report 2023-2024 (The State of Pakistan's Economy): https://www.sbp.org.pk/reports/half/arFY24/Half-index-eng-24.htm accessed on 18 June 2024

The above figure shows the actual CPI Inflation vs its target and the policy rate for 2000-2021. Over the last decade, only once actual inflation was equal to its target value i.e. in FY 2006. Otherwise, inflation has either been higher than its targeted value or lower. In Pakistan, only in 2011, the policy rate exactly equal to the actual inflation value, otherwise, the policy rate has been kept higher even in times of low inflation.

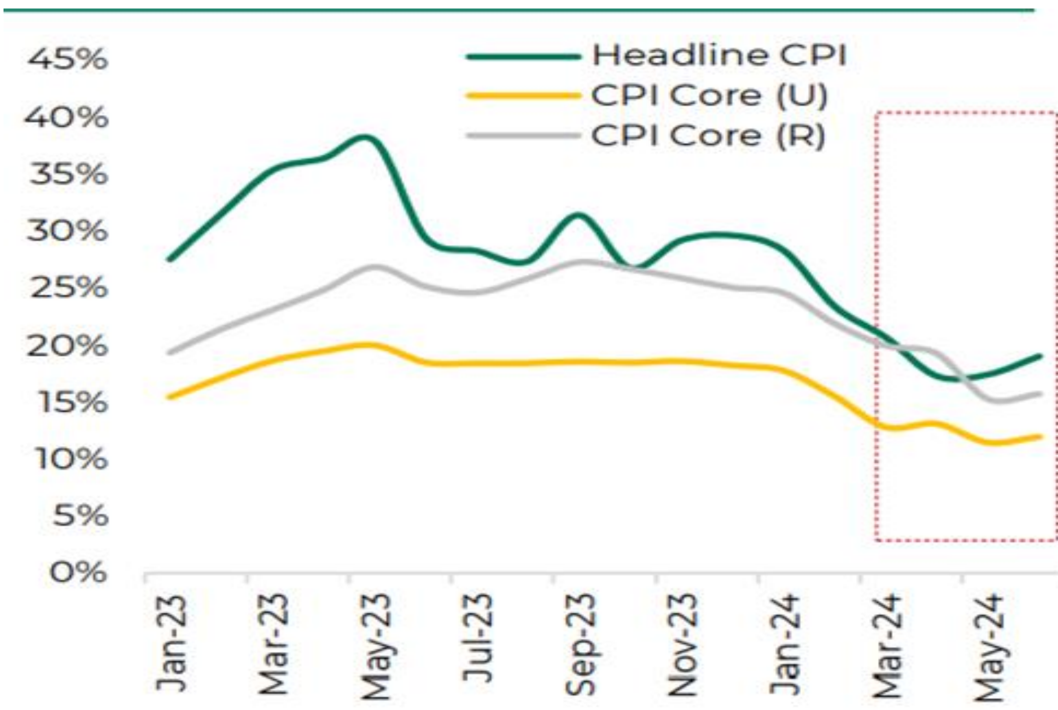

Figure 4: Headline CPI, CPI Core (U) & CPI (R)

Source: KTrade research[15]

In 2024, CPI inflation finally started to decline due to the high base year effect with 23.1% in February 2024 compared to 31.5% in February 2023 with core CPI urban and rural both started to ease. Countries including China, India, Sri Lanka, Japan, United Kingdom, and Thailand have been able to tame down post-COVID inflation, unlike Pakistan, Turkey and Argentina[16].

[15] "CPI Review", Trade research, 2 May 2024.https://kasb.com/research/ accessed on 27 June 2024

[16] "Inflation Monitor June 2024", State Bank of Pakistan. https://www.sbp.org.pk/publications/Inflation_Monitor/2024/Jun/IM_June_2024.pdf accessed on 21 June 2024

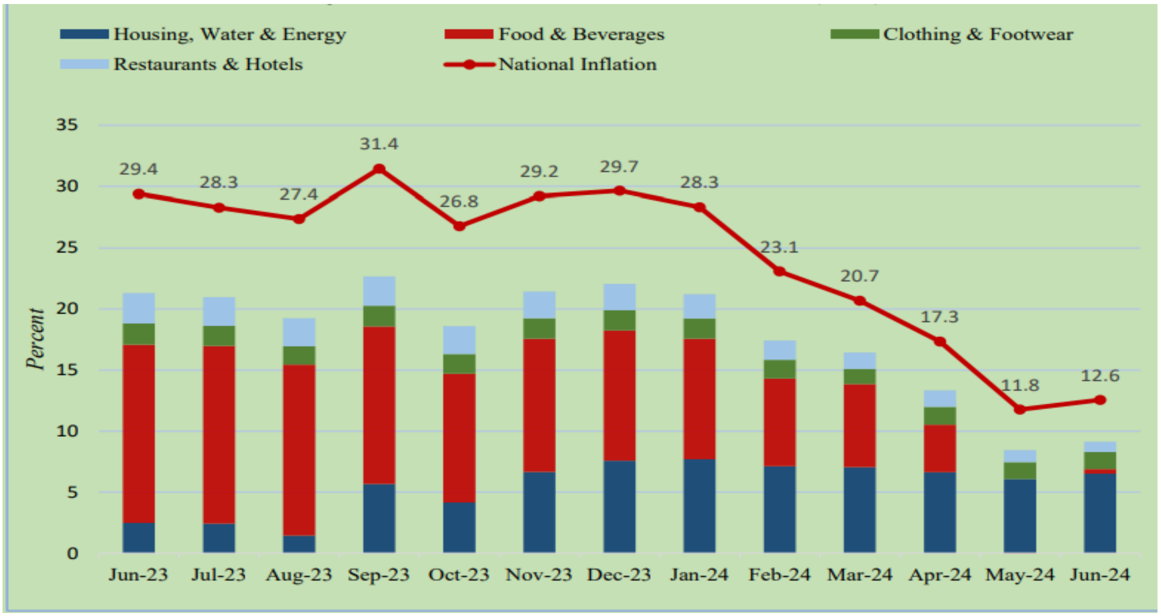

Figure 5: Major Contributors to National Inflation (YoY)
Source: Inflation Monitor 2024, SBP[17]

The figure above shows the major contributors to national inflation from June 2023 to June 2024. Given the impact of supply chain disruptions on account of the Russia-Ukraine war, the share of food and beverages was the highest from June 2023. World food prices and exchange rates have a greater impact on domestic food prices[18]. However, on account of increasing fuel prices and hikes in electricity tariffs, the share of the Housing, Water & Energy group has been growing since September 2023.

Monetary Policy amid Post-Covid Inflation

Post Covid high global prices increased inflation and trade deficit in Pakistan. Therefore, during the first half of FY22, SBP decided to tighten the monetary policy by increasing the policy rate to 9.75%. Headline inflation rose to 11.5% and the trade deficit accounted for USD 5 billion[19]. Inflation expectations elevated because of an increase in 3 categories: food, energy, and Non-Food Non-Energy. However, increased energy prices majorly

[17] Inflation Monitor 2024, SBP https://www.sbp.org.pk/publications/Inflation_Monitor/2024/index2.htm accessed on 22 June 2024
[18] Ahmed and Waliullah. "Bayesian Estimation of a Pragmatic Model for Monetary Policy Analysis: The Case of Pakistan" State Bank of Pakistan, Working Paper Series, 2024 accessed on 22 June 2024
[19] "Monetary Policy Statement", State Bank of Pakistan, 14 December 2021. https://www.sbp.org.pk/m_policy/2021/MPS-Dec-2021-Eng.pdf accessed on 22 June 2023

raised inflation. Moreover, the government borrowed Rs 474.9 billion in Q2-FY22[20]. Amid increased inflationary pressures and worsening current account the SBP continued with tight monetary policy by increasing the policy rate to 22% in FY23[21]. Elevated inflation expectations, along with domestic supply-side factors and surpassing gas prices contributed to 3.2% to the 29.2% y-o-y inflation. Despite the significant decline in the current account deficit, strict external financing conditions resulted in a reduction in SBP reserves to USD 9 billion in mid-July FY2022[22]. In FY2023, the government borrowing from banks increased amounting to Rs 309.8 billion reflecting large fiscal deficits and inadequate external flow. The impact of global supply shock pushing up the levels of inflation was further amplified by domestic factors. Firstly, the July 2022 outbreak of massive floods significantly damaged agricultural products, compounding the effect of high global commodity prices. Secondly, the increased electricity tariffs as a result of fiscal measures resulted in increased energy inflation[23]. Finally, the impact of tight monetary policy lowered global commodity prices, and improved domestic agriculture output resulting in cooling down the food and core inflation and improved the inflation expectations of consumers and businesses. However, the monetary policy continued its stance of maintaining the tight monetary policy keeping the policy rate maintained at 22% instead of moving in the direction of inflation expectations. In June 2023, the stand-by agreement by the IMF lowered the risk attached to the external account deficit. Simultaneously, a reduction in oil import volumes, improved domestic crop production and a drop in global oil commodities resulted in a significant drop in imports[24]. In the last Monetary Policy Committee held on June 10, 2024, SBP reduced the policy rate for the

[20] "Half Year Report 2021-2022 the State of Pakistan's Economy", State Bank of Pakistan. https://www.sbp.org.pk/reports/half/arFY22/Chap-3.pdf accessed on 22 June 2024

[21] "Monetary Policy Statement", State Bank of Pakistan.12 December 2023 https://www.sbp.org.pk/m_policy/2023/MPS-Dec-2023-Eng.pdf accessed on 23 June 2024

[22] Iqbal, Shahid. "SBP reserves hit two-year high above $9bn", Dawn, 10 May 2024.https://www.dawn.com/news/1832576#:~:text=The%20country's%20overall%20forex%20reserves,found%20support%20to%20stop%20falling accessed on 23 June 2024

[23] "State Bank of Pakistan Half Year Report 2022-23", State Bank of Pakistan. https://www.sbp.org.pk/reports/half/arFY23/Chap-3.pdf accessed on 23 June 2024

[24] "Monetary Policy Statement", State Bank of Pakistan, 29 January2024. https://www.sbp.org.pk/m_policy/2024/MPS-Jan-2024-Eng.pdf accessed on 23 June 2024

first time keeping it constant for 2 years to 20.5% from 22%. The rate of inflation was reduced to 11.8% for May 2024 and inflation expectations also reduced significantly[25].

Fiscal Stance of Government in Recent Inflationary Episode

The fiscal side of the country implemented fiscal consolidation which resulted in increased tax revenues. In FY2020-21, due to increased tax revenue and non-interest spending the fiscal deficit was reduced to 6.1% of GDP from 7.1% than previous year. Tax revenue showed a growth of 18.4% in FY2020-21[26]. At the end of June 2021, the total public debt amounted to Rs.39, 861 billion. One of the reasons for debt accumulation was interest servicing. Domestic and external interest payments made by the government in FY2020-21 were Rs 1357 billion and Rs 118 billion respectively[27]. Secondly, the increase in cash balances of the federal government[28]. Given the central bank reserves declining to below the critical level of USD 5 million, the nation seeks an IMF Standby Agreement. Pakistan took fiscal measures set by the IMF to meet its budgetary needs. The last IMF SBA focused on helping the implementation of the FY24 budget, returning to a market-determining exchange rate and functioning of a foreign exchange market, maintaining tight monetary policy with the goal of disinflation, making progressive structural reforms especially relating to the SOE governance, energy structure and climate resilience[29]. The second and final review under the IMF concluded a USD 3 billion SBA. However, the authorities have stressed the cost side reforms for restoring the energy sector and agricultural recovery reforms. In 2023, the debt servicing increased to 74% of FBR tax revenue. Due to few choices of funding debt servicing i.e. downgrading in credit rating by international agencies, 95% of the fiscal deficit is being financed by domestic banks leaving behind no money for private businesses. In June 2024, the government presented

25 "Monetary Policy Statement", State Bank of Pakistan, 10 June 2024. https://www.sbp.org.pk/m_policy/2024/MPS-Jun-2024-Eng.pdf accessed on 24 June 2024

26 "Fiscal Policy Statement "Ministry of Finance and Revenue, January 2022. https://www.finance.gov.pk/publications/FPS_2022.pdf accessed on 25 June 2022

27 "Mid-Year Budget Review Report FY2020-21", Government of Pakistan Finance Division. https://www.finance.gov.pk/budget/mid_year_Budget_review_2020_21.pdf accessed on 25 June 2024

28 "Fiscal Policy Statement "Ministry of Finance and Revenue, January 2022. https://www.finance.gov.pk/publications/FPS_2022.pdf accessed on 25 June 2022

29 "IMF Executive Board Approves US$3 billion Stand-By Arrangement for Pakistan", IMF, 12 July 2023. https://www.imf.org/en/News/Articles/2023/07/12/pr23261-pakistan-imf-exec-board-approves-us3bil-sba accessed on 25 June 2024

a fiscal budget of PKR 81 trillion with an ambitious tax revenue target of 13 trillion. The government has targeted the collection of Rs 5.545 trillion through income tax revenue with a proposed hike in both direct and indirect taxes. To achieve the revenue target, the government has imposed restrictions for non-filers including measures like blocking the Sims of non-filers, deducting 90% of their mobile recharge, and restricting them from travelling abroad. Increased corporate taxes for exporters, imposing a tax on domestic and foreign countries. On the expenditure side, the current expenditure increased by 21% out of which 50% will go towards debt servicing, and salary hike of 25%, and a 15% increase for pensioners[30]. The government has shown interest in the development of infrastructure and public sector projects increasing by 50% compared to last year. However, the Budget has not targeted the sectors performing well in tax net including agriculture sectors, retailers, and real estate. The investment climate is not good enough to attract foreign investors to the industry which is required to address the fiscal issues of the country. Pakistan's high current account deficit, fiscal deficit, and trade deficits are contributing to the increased inflation.

Recent Inflationary Episode and the response of different countries.

The pandemic has taken a toll on the world economies. Future uncertainties, loss of lives, and prolonged lockdown resulted in depressed economies. The decline in consumer spending globally, accelerated global food prices, and supply chain disruptions resulted in expansionary policies by almost all the countries around the world. As the economies recovered from the pandemic, the economic uncertainties began to fade. However, the factors that aided in restoring economies contributed to the high levels of inflation globally. Since economies are globalised, one country's inflation has a considerable impact on others. Therefore, below are examples of how different countries tackled Post Covid inflation:

China

In 2022, the National Bureau of Statistics (NBS) of China reported the fastest increase in CPI since 2020. However, this increase of 2.8% was insignificant as compared to the inflationary increases that other economies witnessed. Moreover, core inflation (excluding

[30] Salman, Aneel. "Pakistan's Budget 2024-25: Promises to Policies",Friedrich Nauman Foundation, 27 June 2024 https://www.freiheit.org/pakistan/pakistans-budget-2024-25-promises-policies 28 June 2024

food and energy prices) slowing to 0.6%[31]. China's response to the pandemic, along with its policy responses were quite different from the rest of the world. China kept inflation under control by carefully employing expansionary monetary policy and avoiding massive stimulus injected into the economies like other countries in the West specifically. Its strong Zero Covid policy helped in reducing the overall demand.

Sri Lanka

In 2009, by the end of the civil war, Sri Lanka decided to rely on imports for the provision of goods to the domestic market, resulting in growing import bills. For years the country struggled to repay debts and this resulted increasing amount of debts. However, the country was able to borrow since its tourism industry was performing well to support the economy before COVID-19 happened. This exerted pressure on the finances of the economy as the expenditure to run the economy shot up while the tax receipts fell. The balance of payment crisis caused Sri Lanka to default with a foreign debt of more than USD 50 billion in April 2022 with y-o-y inflation rising to 69.8% in September 2022[32]. The stabilisation measures taken by the government included: economic stabilisation measures i.e. tightening of monetary policy to control inflation, increasing taxes, and lifting electricity and fuel subsidies. IMF bailout program, debt restructuring with bilateral creditors, and privatisation program for commercial State-owned enterprises (SOEs) including Sri Lankan telecom, Sri Lankan insurance, and Sri Lankan Airlines.

India

India outperformed all the leading countries in post-Covid rebound, with the lowest inflation rates. India's inflation maintained within the Reserve Bank of India's target range, because of refusal to inject extra cash into the economy. The government rather opted for direct food distribution to millions of people. Global rise in commodity prices, supply chain interruptions, and volatility in domestic demands affected flood inflation in the country. The government announced a comprehensive post-COVID recovery program of

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[31] Barnes, Samantha, "How China Has Managed to Avoid the Inflation Bug", International banker, 5 December 2022. https://internationalbanker.com/finance/how-china-has-managed-to-avoid-the-inflation-bug/ accessed on 28 June 2024

[32] Wignaraja.Ganeshan, "Is Sri Lanka transitioning from an economic crisis to recovery?", Observer Research Foundation.19 May 2023.https://www.orfonline.org/expert-speak/is-sri-lanka-recovering-transitioning-from-an-economic-crisis-to-recovery accessed on 29 June 2024

Rs 6.28 lakh crore addressing every sector[33]. Programs like Pradhan Mantri Garib Kalyan Yojana[34] and Aatmanirbhar Abhiyan[35] aim the sectors like healthcare infrastructure, support vulnerable populations, and stimulate economic recovery through targeted fiscal and structural reforms.

Proposed Framework for Controlling Inflation

High inflation can significantly reduce the purchasing power of fixed-income groups and financially weak households, exacerbating income inequality, eroding entrepreneurs' competitiveness, and discouraging investment. Therefore, controlling inflation is important for policymakers. Monetary policy is considered to be the only one responsible for maintaining the price stability of the country. The primary tool used by central banks around the world to control inflation is the sharp increase in interest rates and maintaining it for the year even if it results in a recession in the economy. Similarly, in response to Post COVID inflationary episode, the SBP tightened its monetary policy by increasing the interest rate to tame inflation. The policy rate was kept at 22% for two consecutive years. However, this constantly high interest rate affected the economy by affecting the investment climate of the country and raising the face value of debt owned by the country. Despite maintaining the stance of tight monetary policy for 2 years, rates of inflation did not seem to slow down nor did the inflation expectations of consumers and businesses improve. This sparked a debate about whether inflation is truly a monetary phenomenon or whether inflation in Pakistan is fiscal-driven. Monetary policy lives under the shadow of debt, simply put, for countries with significant amounts of national debt where debt to GDP ratio is soaring, the maximum amount of government expenditure goes into interest-servicing, and inflation becomes a fiscal issue as a 1% increase in interest rates increases their interest cost by 1%.

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[33] Banerjee.Anindya,"Narendra Modi's India Controlled Post-Covid Inflation Better Than Biden's US, Meloni's Italy or Trudeau's Canada: Study", New 18, 29 May 2024.https://www.news18.com/elections/narendra-modis-india-controlled-post-covid-inflation-better-than-bidens-us-melonis-italy-or-trudeaus-canada-study-8908042.html accessed on 29 June 2024

[34] "Pradhan Mantri Garib Kalyan Package (PMGKP)", National Portal of India, https://www.india.gov.in/spotlight/pradhan-mantri-garib-kalyan-package-pmgkp accessed on 29 July 2024

[35] "atmanirbhar-bharat-abhiyaan", Invest India. https://www.investindia.gov.in/atmanirbhar-bharat-abhiyaan accessed on 29 July 2024

John Cochrane shifted the focus towards "fiscal inflation" and put forward the Fiscal Theory of Price level. The theory states that the present value of budget surpluses falls, goods and services in the country become expensive. Simply when the country's debt keeps increasing the businesses and consumers lose confidence that the government will not be able to pay when the inflation rises. The theory is of the view that the massive expansionary fiscal measures during COVID-19 resulted in recession in the economies worldwide. COVID stimulus checks resembled the helicopter drop, the countries did not transfer fresh money to the families in the form of support programs rather they introduced new debt equaling to the amount of emergency COVID support programs. The theory states that in the presence of large fiscal debts and interest servicing, controlling inflation requires a blend of both monetary and fiscal policy in the right proportion in such a way that fiscal policy supports the stance of monetary policy. Countries that managed to control the post-Covid inflation had well-coordinated fiscal and monetary policies. The theory advocates the reversal of roles of monetary and fiscal policy and wants fiscal policy to come into play at the front foot and monetary policy following the way of fiscal policy.

In monetary policy decision-making, while setting the policy rate, the market expectations of future inflation and policy rate must be considered as the expectations about future policy rate drive long-term interest rates and asset values which eventually influence the economic activity and prices. For the monetary policy to be effective, market expectations of future policy rates must be aligned with the actual policy rate. Getting businesses' inflation expectations in line with the inflation target, and stabilisation of inflation around its target become easy[36]. Incorporating expectations successfully and implementing an effective monetary policy is impossible without conveying the policy goals and objectives to the general public and businesses. Transparency is a key mechanism for improving central bank accountability, which is the foundation of central bank independence. Additionally, transparency lowers the informational imbalance between the private sector and the central bank. Following the central banks worldwide, SBP shifted towards a relatively transparent monetary policy. SBP publishes a Monetary Policy Statement (MPS) briefly explaining the decisions taken by the Monetary Policy Committee (MPC).

[36] Svensson, Lars EO. *What rule for the Federal Reserve? Forecast targeting*. No. w23993. National Bureau of Economic Research, 2017. accessed on 29 July 2024

However, the minutes of the MPC are published for the general public after a significant time lag and lack of information regarding the voting preferences of all members of the committee. SBP needs to improve transparency by publishing the minutes of MPC and by discussing the rationale behind the voting preference of all members of the Committee. Moreover, the constitution of MPC needs to be reassessed as the decision-making completely rests on the discretion of the governor of the SBP.

The Monetary Policy Department makes policy decisions based on comprehensive forecasting models. Based on the data from the Consumer Confidence Survey (CCS), business Confidence Survey and IMF framework of forecasting inflation forecast of major economic variables including inflation, exchange rate, imports and exports and money demand etc are presented to MPC. Additionally, the research department uses the Forecasting and Policy Analysis System and New Keynesian Dynamic Stochastic General Equilibrium to forecast economic indicators including headline inflation, real interest rate gap, output gap and real bilateral exchange rate gap etc. Based on the forecast received from different models monetary policy decisions are taken. [37] Currently, MPC is targeting the Core inflation for decision-making. Since core inflation excludes food and energy prices, the SBP needs to monitor both headline and core inflation for policy-making decisions, as food and energy prices constitute a major portion of spending of consumers and their changing prices significantly affect consumer behaviour.

CPI is considered to be the true measure of inflation and is being used by many economies around the world. However, the Bureau of Economic Analysis in the USA publishes the Personal Consumption Expenditure Price Index (PCE) as a measure of inflation which is used by the Federal Reserve’s Federal Open Market Committee (FOMC) when it comes to interest rate decisions. PCE is an indicator of household consumption that examines price changes in the goods and services purchased by consumers. It reflects the consumption patterns of households and their economic well-being. The PCE price index can accurately reflect changing consumer behaviour as well

[37] “Monetary Policy Decision-Making Process”, State Bank of Pakistan https://www.sbp.org.pk/m_policy/mp-deci-imp.asp accessed on 12 August 2024

as capture inflation or deflation in the economy.[38] How CPI is better than the PCE price index lies in the differences between the two indices. Firstly, both indices are constructed using different index formulas referred to as “formula effect”. The PCE is constructed on Fisher’s Ideal Index model whereas, CPI is constructed on the Laspeyres formula. Secondly, the weights assigned to CPI are based on household surveys and are revised yearly. However, the PCE price index employs relative weights derived from business surveys. These weights are adjusted monthly to reflect how consumers substitute goods and services when prices change. These differences are known as the “weight effect”. Lastly, some items in the PCE price index are not included in the CPI and some items of CPI are out of the scope of the PCE price index which is known as the “scope effect”.[39] However, the building blocks of both indices are essentially the same. However, in the case of the USA’s economy, the CPI tends to overestimate the inflation relative to the target, while the PCE inflation has historically been closer to the target level. This difference between CPI inflation and PCE inflation is attributed to the difference in the weights of the indices. Therefore, the PCE price index is used by the FED in its monetary policy decisions.[40] Pakistan is currently using the CPI as a measure of inflation but it does not reflect the country’s economic reality and needs to be updated. In addition to constructing the CPI for measuring inflation, SBP should develop a PCE price index that better captures changing consumer preferences and more appropriately reflects the economic reality of the country.

Conclusion and Policy Recommendations

Controlling inflation has been a top priority for policymakers, but with post-COVID supply shortages, global price hikes, and expansionary monetary and fiscal conditions, this issue has resurfaced across all economies. Pakistan also faced post-Covid supply-chain disruptions, rising commodity prices, and increased domestic demand; in response, the government tightened monetary and fiscal policy. But, even with a policy rate as high as

[38] “Prices & Inflation”, Bureau of Economic Analysis. https://www.bea.gov/resources/learning-center/what-to-know-prices-inflation accessed on 12 Aug 2024

[39] McCully, Clinton P., Brian C. Moyer, and Kenneth J. Stewart. "Comparing the consumer price index and the personal consumption expenditures price index." Survey of Current Business 87, no. 11 (2007): 26-33.

[40] Hansen Sarah, “What’s the Difference between the CPI and PCE Indexes?” Morningstar, 2 May 2024. https://www.morningstar.com/markets/whats-difference-between-cpi-pce accessed on 8 August 2024

22%for 2 years in a row, policymakers were unable to control inflation. On the fiscal side, the government increased taxes and reduced expenditures. But with debt servicing mounting to 74% of total FBR revenues and the government operating on an average fiscal deficit of 7.33% solely relying on monetary policy to control inflation is insufficient. Pakistan needs a relative mix of fiscal and monetary policy with roles reversed as fiscal policy on the forefront of controlling inflation with supportive monetary policy. Also, the SBP should move the policy rate in the direction of consumer's and businesses' expectations of future policy rates.

To achieve this the government may,

- Design a fiscal policy that takes charge of controlling inflation with support of monetary policy in such a way that the living conditions of the general public are not worse off.
- Introduce tax reforms by incorporating well-performing sectors into the tax net and focusing on welfare taxation.
- Restructuring of State-owned enterprises and reforms in the energy sector to reduce circular debt. Investment in human capital, infrastructure development, increased expenditure in education and health sector.
- Work on improving the investment climate of the country by facilitating the investors and simplifying the process of industry setup to attract investors.
- PBS may update the consumer basket every 5 years like the practice adopted by most of the countries. Relevant consumer items can be added and irrelevant can be excluded.
- Also, PBS may update the number of selected urban and rural sectors for data collection for a more representative CPI.
- By regularly updating the CPI basket, the government may better understand consumer behaviour. This will help the government to make better policies to address the challenges faced by consumers.
- PBS may construct a PCE price index for Pakistan as a measure of inflation that serves as a better measure of inflation.
- SBP may set the policy rate in line with the market expectations of consumers and businesses. Inflation targeting may be done in the best way possible by incorporating the future expectations of policy rates and inflation.

- To incorporate the consumers and business expectations the SBP may use the New Keynesian Philips curve instead of relying on the Taylor-type rules.
- For effectively targeting inflation and incorporating inflation expectations, the SBP needs to have a due autonomous status for transparency in the policy-setting process. To improve the communication and transparency of monetary policy, SBP may publish the minutes of MPC timely with a detailed discussion of the voting preferences of individual members.
- SBP may reassess the constitution of the Monetary Policy Committee (MPC) as the policy decision rests completely at the discretion of the governor.

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