

TECHNICAL SESSION-3: MACROECONOMIC POLICIES AND INSTITUTIONS

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Paper Title: The limit of monetary policy: A trivariate analysis of inflation, policy rate, and economic growth in Pakistan

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Abstract: Inflation has emerged as a serious challenge for policy makers in both developed and developing countries in recent years. In developing countries, inflation is primarily a supply-side phenomenon driven by increases in food and energy prices. Therefore, maintaining a high-interest rate is not an effective measure to curb inflation in such contexts. The purpose of this paper has been to explore causal nexus between the policy rate and inflation in a tri-variate context for a developing country like Pakistan. We examined the causal relations with monthly data between inflation, policy rate and economic growth using Granger causality for the sample period from July 1992 to April 2023 as well as for shorter sample period from July 2008 to April 2023. The findings of the paper suggest that inflation is pre-dominantly caused by supply side factor (food and energy prices), tightening monetary policy or keeping interest rate at higher level is not the solution. Interest rate is the cost of capital and capital is one factor of production. A higher interest rate raises the cost of capital, leading to increased production costs. The message of the paper is simple. The Central Banks in developing countries in general and Pakistan in particular, should not follow “Aspirin Approach to Monetary Policy.” They should first determine the root causes of inflation and then devise policy accordingly. If inflation is caused by excessive demand (as in the case of developed economies), tightening of monetary policy, or raising policy rate is the right instrument. Interest rate is regarded as a demand management instrument. If the inflation is caused by supply side factors (as in the case of developing countries in general and Pakistan in particular), tight monetary policy or raising policy rate is not the right instrument. Improving food supply by raising domestic production or by importing food plus extreme caution in raising energy prices may be exercised. Raising interest rate has failed to control inflation in Pakistan.

Discussant: Dr. Abid Rehman, Research Fellow, PIDE, Islamabad