

Pakistan's inflation puzzle

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AS Pakistan passes through yet another episode of galloping [inflation](#), trite explanations — from the IMF bogey to 'external shocks' — abound to assuage public anger. However, there's more to inflationary dynamics in Pakistan, and we often bank on the wrong answers. What follows is an attempt at a layman's explanation of this complex issue.

Our story begins with the 16th-century conquest of South America by Spanish conquistadors like Cortés and Pizarro. They literally hit gold! Vast quantities of gold in the possession of the Inca and Aztec rulers fell into their lap. Most of that (plus silver) flew back to Spain to the delight of the rulers since money in those days was specie-based (gold, silver, copper, etc). Gold was the most valuable form of money. However, both Spain and the rest of Europe went through a 'price revolution' in the aftermath as prices rose precipitously.

We now move to three notable 20th-century episodes. In 1929, the New York stock market crash heralded the Great Depression, the most cataclysmic economic shock in recorded human history which saw severe contractions in GDP. Six years earlier, in Weimar Germany, 'hyperinflation' forced people to carry bags full of cash just to buy a loaf of bread. In the early 1980s, the US economy had to go through a painful period with surging unemployment, but it ultimately led to ameliorating the galloping inflation that had gripped the US and global economies since the breakout of the 1973 Arab-Israeli war.

What's common to all these episodes is the effect of money upon output (GDP) and prices. Large precious metal inflow heralded higher prices as money supply rose precipitously, an observation that became the basis of the 'quantity theory of money'. Friedman and Schwartz documented that an initial contraction of money supply made the Great Depression far worse. Weimar Germany learned the hard way (as did Zimbabwe and Venezuela this century) that printing too much money is a recipe for disaster. Tightening of money supply in the 1980s finally ameliorated high inflation in the US.

Why is our aggregate supply inelastic? One factor is government policies.

Even politicians understand this link well (ie money is purchasing power), which explains their penchant for expanding the money supply to rev up the GDP engine. Since July 2018, money supply in Pakistan has expanded considerably. As Khurram Husain reported, money in circulation stood at Rs7 trillion by June 2021, up from Rs4.7tr in July 2018. This is besides the deposits that have grown from Rs11tr to 17tr in the same period. That's a lot of money creation in three years.

Editorial: [Govt's arguments on inflation are a vain attempt to obfuscate reality, shift responsibility onto others](#)

Let's come to the other critical part of this puzzle: aggregate supply. Can aggregate supply in a country respond well to a rise in purchasing power? If not, we would encounter a known troubling predicament: money chasing the same or comparatively less amounts of goods and services, which will push their prices higher. Aggregate supply, in turn, depends upon the aggregate productivity within an economy. Omer Siddique, our PIDE colleague, found that aggregate productivity in Pakistan has been declining ([Total Factor Productivity and Economic Growth in Pakistan: A Five-Decade Overview](#)).

The end result of all this (growth in money supply against aggregate supply that is relatively inflexible) is the inflationary push within the economy. This is the primary reason for Pakistan's inflationary woes. The response of aggregate supply explains why rates of inflation are different around the globe despite shocks like the coronavirus pandemic affecting every country. In Pakistan, external shocks (eg oil prices and exchange rate changes) only serve to exacerbate an already choked aggregate supply, accelerating the higher price push. For context, inflation in Pakistan has been rising since 2018, well before the pandemic struck in 2020.

But why is Pakistan's aggregate supply inelastic? One overwhelming factor: government policies, especially heavy protection for domestic producers. Carmakers sell low-quality stuff at ridiculously high prices because there is little external competition, ensuring that the (induced) demand for cars is always ahead of supply (Romancing the car, Nadeem Haq). 'Agricultural' Pakistan imports billions of dollars of farm commodities because more than 100 public sector agricultural research institutes have little (if any) bearing upon agricultural output, a recipe for disaster given the runaway population figures. Power sector, critical for aggregate output, is in shambles due to the overwhelming government footprint.

Read: [*The stubborn inflation*](#)

The full gamut of inflation's repercussions is beyond the scope of this article. But a little primer can enlighten the reader. First, all the purchasing power generated may come to naught for a major portion of the population; by the time a pay rise for the labour force is realised, inflation has already eroded purchasing power to an extent that any raise would at best help sustain living standards rather than raise it, a fact that is aptly reflected in Pakistan's stagnant human development indicators. In economics, this result is neatly captured via 'monetary neutrality', which posits that in the long run, any advantage conferred by an expansion in money supply only serves to raise the aggregate price level, thus nullifying any short-run advantages.

Not everybody fares badly, though. Of the trillions in bank deposits, more than half go towards funding government expenses (eighty per cent of which are unproductive, non-development) through buying riskless treasuries and bonds that give handsome returns, largely compensating for loss in purchasing power, (depositors though get little). Moreover, as FBR and the World Bank have noted, subsidies to Pakistan's elite groups run in the trillions per year. Simply put, since subsidies are based on taxpayer money, Pakistanis are paying through their nose to keep the purchasing power of a small portion of populace intact (in fact, improving it) through a middleman, ie their own government! Interesting, isn't it? This is one way of exacerbating income inequalities in an economy.

For taming inflation, then, it's time to move beyond subsidy 'packages' which tend to be 'neutral' in the larger scheme of things. More than anything, what is needed is an understanding of how demand and supply forces interact, and how to improve aggregate productivity.

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