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The Role of Monetary Policy in the Current Environment: Myths and Reflections¹

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Abstract

In 2023, Pakistan experienced arguably its worst-ever period of stagflation, with growth plummeting and inflation close to all-time highs. In response, monetary policy was tightened considerably, with the policy rate raised to 22 percent and held at that level for one year. This policy was criticized by many in the media. This paper attempts to draw lessons from this episode. It reviews the literature and international experience to evaluate the underlying basis of the criticism. It finds that much of the criticism is based on myths that either reflect outdated thinking or have no empirical basis. Nevertheless, some of the criticism is worth engaging with. Together with the findings of the review, these more informed critiques provide useful guidance for appropriate monetary policy settings under different economic environments. The paper concludes with a discussion of what this guidance could imply for monetary policy settings as the economy stabilizes and inflation comes down.

1. Introduction

The year 2023 marked a significant economic crisis for Pakistan⁴. Growth plummeted to 0.3 percent, while average headline inflation soared to 29.2 percent—both approaching historical extremes. In response to rising inflation, the Monetary Policy Committee (MPC) of the State Bank of Pakistan (SBP) raised the

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⁴ Here, by year 2023 the reference is to Fiscal Year 2023, i.e., from July 1, 2022 to June 30, 2023.

policy rate by 850 basis points to 22 percent and then maintained it at that level for twelve months. This policy garnered considerable criticism in the media.

In this policy paper, we begin with a recap of the severe economic crisis Pakistan faced in 2023. Our review discusses the main factors that contributed to the crisis and the ensuing policy response, notably fiscal and monetary tightening, which contributed to the stabilization of the economy in 2024. Next, we engage with the main criticisms leveled at the monetary policy response, based on a review of the literature and international experience. We characterize much of this criticism as ‘popular myths’ because we find that it is either based on outdated thinking or lacks empirical support.

Concurrently, however, certain critiques do offer valuable insights. Coupled with the findings of our review, these more informed analyses provide useful guidance for appropriate monetary policy settings under different economic circumstances. Accordingly, we conclude with reflections regarding the adjustments in monetary policy settings that could be warranted as the economy stabilizes and inflation recedes.

2. Recent Economic Developments

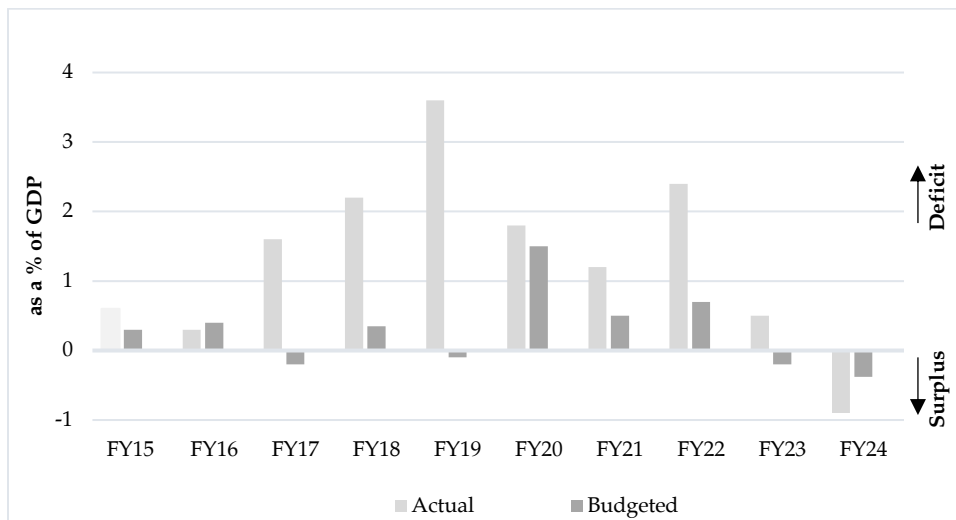
The Great Unraveling of 2023⁵

In Fiscal Year (FY) 2022, following two years of fiscal consolidation, the government adopted an unbudgeted expansionary fiscal stance. This policy reversed prior consolidation gains and contributed to an overheating of the economy.

Consequently, the fiscal deficit increased to 7.9 percent of GDP, from 6.1 percent the previous year. The primary deficit doubled from 1.2 to 2.4 percent of GDP, contrasting sharply with the budgeted fiscal consolidation of 0.7 percent of GDP (see Figure 1).

⁵ See Syed and Hamid (2024) for a more detailed discussion of the events leading up to the crisis of 2023 and the role that monetary policy attempted to play to stabilize the situation.

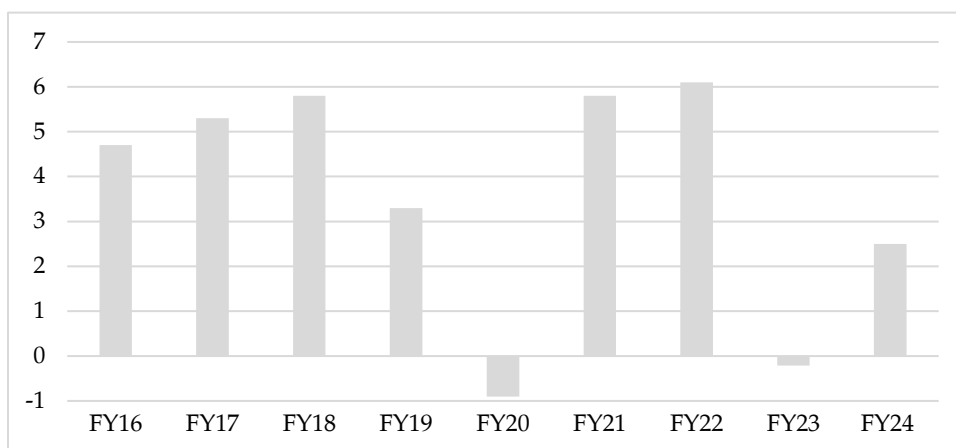
Figure 1: Pakistan's Primary Deficits (Actual vs Budgeted Estimates)



Source: State Bank of Pakistan and Ministry of Finance

Simultaneously, monetary policy settings were accommodative, predicated on the assumption of fiscal consolidation. However, this did not materialize. Instead, growth which had rebounded from the COVID-19 recession to 5.7 percent in FY 2021, accelerated further to 6.1 percent in FY 2022, spurred by these stimulative macroeconomic policies (Figure 2).

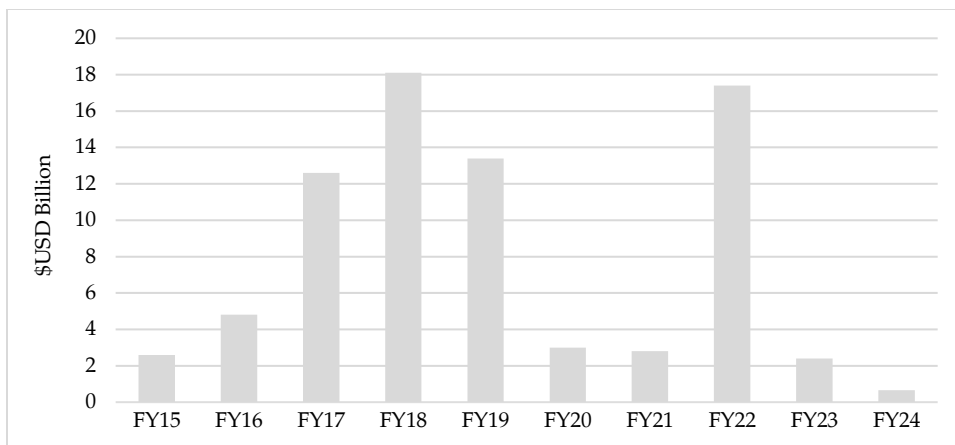
Figure 2: Pakistan's Growth Rates (percentage change in real GDP)



Source: State Bank of Pakistan

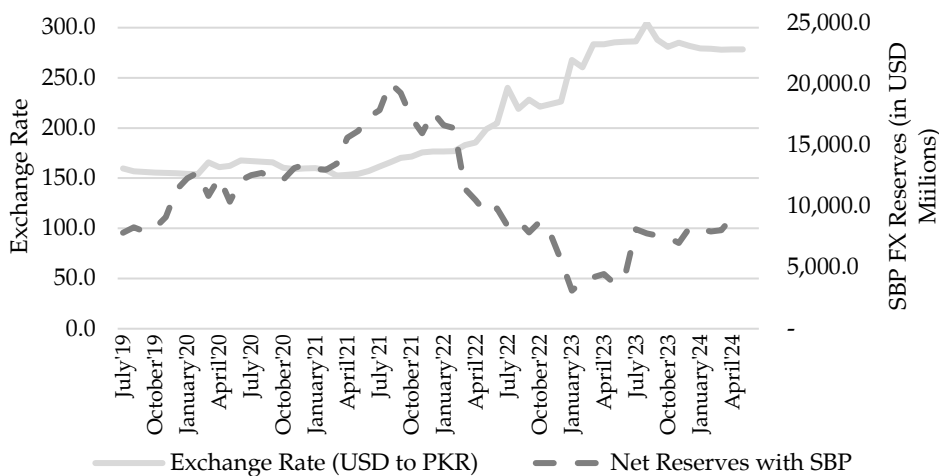
Coupled with the post-COVID recovery in global commodity prices, this overheating in domestic demand precipitated a substantial widening of the current account deficit reaching US\$17.4 billion in FY 2022, a sharp increase from US\$2.8 billion the previous year (see Figure 3). Consequently, SBP foreign exchange (FX) reserves declined from US\$20 billion in August 2021 to \$11.4 billion in March 2022 (see Figure 4). Inflation also increased, rising from 8.4 percent in June 2021 to 12.2 percent in February 2022.

Figure 3: Pakistan's Current Account Deficits



Source: State Bank of Pakistan

Figure 4: Exchange Rate & Foreign Exchange Reserves



Source: State Bank of Pakistan

Following February 2022, the economy encountered a series of significant and unanticipated shocks:

- First, the Russia-Ukraine war in February 2022 precipitated a surge in oil and food prices.
- Second, extreme political uncertainty due to the “No Confidence Motion” in the National Assembly, culminating in a change of government in April 2022, succeeded by dissolution of the provincial governments in Punjab and Khyber Pakhtunkhwa in January 2023.
- Third, acute economic uncertainty stemmed from delays in completing reviews under the IMF Extended Fund Facility (EFF) arrangement, eventually leading to its cancellation and the approval of a new Standby Arrangement in July 2023.

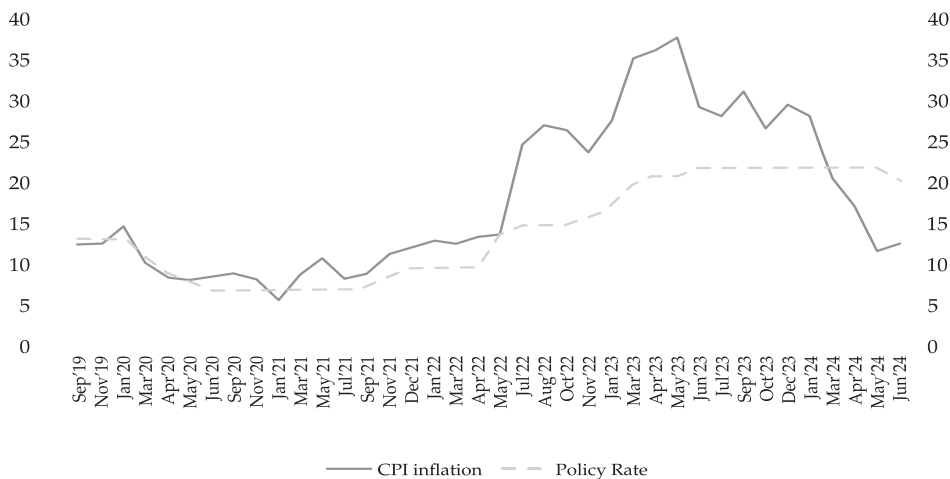
Largely due to acute political and economic uncertainty, as well as a lack of financing for the current account deficit, the Rupee depreciated significantly by, about 40 percent, from Rs180 per US dollar in March 2022 to Rs294 by June 2023 (see appendix Box 1).

Due to the lagged impact of two years of vigorous economic growth, the pass-through of the commodity price shock of February 2022, and the substantial depreciation of the exchange rate, inflation escalated from 12.2 percent in February 2022 to 21.3 percent in June 2022 and 38 percent in May 2023 (see Figure 5). This rise in inflation also led to a de-anchoring of inflation expectations (see appendix Box 2).

In response, the MPC sharply accelerated the monetary tightening cycle initiated in September 2021, raising the policy rate by 675 basis points in FY2022 and an additional 825 basis points in FY 2023. Fiscal discipline also improved markedly, with the primary deficit narrowing from 3.1 percent of GDP in FY 2022 to 0.8 percent of GDP in FY2023.

This coordinated withdrawal of monetary and fiscal stimulus effectively tempered domestic demand. Concurrently, as SBP FX reserves plunged close to a historic low of US\$3.1 billion in January 2023, FX controls were imposed on imports.

Figure 5: Inflation and Policy Rate

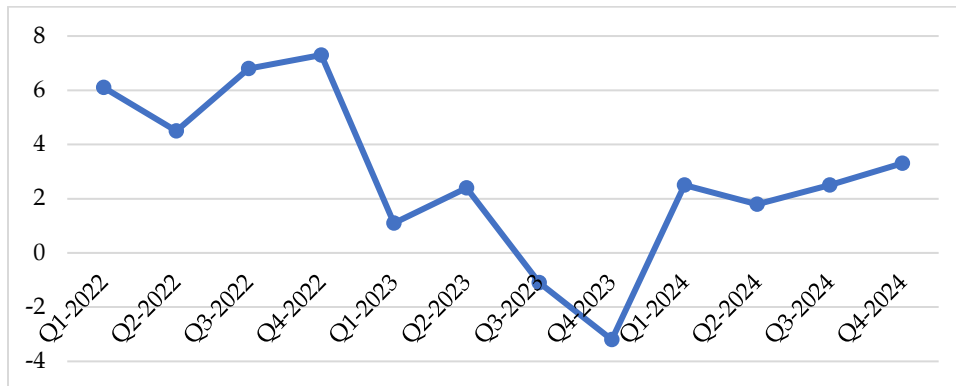


Source: State Bank of Pakistan

To ensure adequate liquidity in the interbank market, SBP increased the average outstanding stock of open market operations (OMOs) by Rs3,328 billion, equivalent to 51 percent of the fiscal deficit in FY 2023. This measure was crucial for maintaining market rates proximate to the policy rate, especially considering the substantial fiscal deficit, limited external inflows for budgetary support, pronounced economic uncertainty and panic surrounding the fate of the IMF program. Nevertheless, by increasing liquidity, these OMOs might have also to some extent inadvertently contributed to the protracted moderation of inflation.

Overall, heightened economic uncertainty, stringent macroeconomic policies and import restrictions precipitated a pronounced deceleration in economic activity, contributing to a reduction in the current account deficit to \$2.4 billion in FY 2023. Specifically, growth declined from 7.3 percent in the fourth quarter of FY 2022 to 1.1 percent in the first quarter of FY 2023 and further contracted to 3.2 percent in the fourth quarter. (See Figure 6)

Figure 6: Quarterly GDP Growth Rates - 2022 to 2024



Source: National Income Accounts, PBS (2024)

Stabilization in 2024

Following a nine-month hiatus, the IMF approved a US\$3 billion nine-month Stand-By-Arrangement for Pakistan on July 12, 2023. General elections, originally scheduled for 2023, transpired on 8 February 2024, subsequently leading to the constitution of new national and provincial governments. Ergo, both economic and political uncertainties have abated from their earlier extreme levels.

On the policy front, the government instituted a prudent fiscal policy, with a primary surplus of 0.9 percent of GDP in FY 2024, contrasting favorably with the primary deficit of 0.5 percent last year. Concurrently, monetary policy maintained an appropriately restrictive posture, with the policy rate unchanged at 22 percent for 12 months, ending in June 2024. This yielded a positive real interest rate prospectively, given projected disinflation. The exchange rate has demonstrated resilience, hovering around Rs280 against the US dollar since October 2024, while SBP FX reserves stabilized at approximately US\$8 billion.

Notwithstanding, inflationary pressures persisted, primarily fueled by substantial upward revisions in administered prices of electricity and gas. During the first 7 months of FY 2024, headline inflation fluctuated between 28 and 30 percent; however, a disinflationary trend has been evident since February 2024, with inflation decelerating to a 30-month low of 12.6 percent by June 2024.

3. Was Monetary Policy Too Tight? Key Myths and Criticisms

Despite the nascent moderation of inflation following two years of elevated price pressures, many contend that the monetary policy response—characterized by an increase in the policy rate from 7 percent at the beginning of FY2022 to 22 percent by end FY2023, and its subsequent maintenance at that level for 12 months—was

unduly aggressive and counter-productive. These reservations typically emanate from three principal lines of reasoning or critiques directed at monetary policy in Pakistan, which we will now address seriatim.

Monetary policy should not be used when inflation is caused by supply-side factors

One argument posits that because monetary policy primarily mitigates inflation by curtailing demand within the economy, it is ineffectual when inflationary pressures stem from supply-side shocks.⁶ This perspective gained prominence among economists during the 1970s when the United States, United Kingdom and other industrialized economies grappled with stagflation precipitated by the OPEC oil price shock. At that time, a prevailing belief held that a reduction in aggregate demand constituted the sole mechanism through which monetary policy could influence inflation.

However, this viewpoint represents an oversimplification, as contemporary understanding acknowledges a more nuanced perspective (see Bander et al. (2023) for a review, and Ocampo and Ojeda-Joya (2023) for emerging market implications). The current mainstream view accords greater importance to inflation expectations. The prevailing consensus suggests that if inflation arises from a supply shock, the central bank may countenance a transient breach of its medium-term inflation target, contingent upon the firm anchoring of long-term inflation expectations, thereby mitigating second-round effects via wage and price adjustments.

Furthermore, the central bank cannot presume the stability of inflation expectations; failure to act decisively against inflation risks can contribute to a de-anchoring of these expectations, as evidenced during the 1970s and early 1980s, potentially necessitating a more abrupt and destabilizing monetary policy tightening subsequently.

Thus, the optimal policy response is contingent upon the prevailing economic situation within a country. Specifically, should the probability of inflation becoming entrenched in expectations be elevated, the central bank needs to act forcefully even if inflation is supply driven. In addition, external supply shocks, exemplified by oil price shocks in Pakistan, often engender exchange rate depreciation, thereby exacerbating inflationary pressures.

Thus, in economies such as Pakistan, characterized by a pronounced exchange rate pass-through and vulnerable inflation expectations, the central bank may need to countenance an aggressive response to meet its inflation targets, even when the

⁶ As discussed in the previous section, the extent to which the recent inflationary episode was purely supply-driven is debatable, particularly given the very high growth rates and large fiscal deficits in the preceding two years.

price shock is supply-side driven. Moreover, in a country like Pakistan confronting low foreign exchange (FX) reserves and a binding balance of payments constraint, central bank inaction in the face of a supply shock could precipitate exchange rate instability, thereby augmenting the risk of high inflation becoming entrenched in expectations.

Monetary policy is ineffective when government borrowing is dominant

In this context, it is essential to examine the role of government borrowing in shaping monetary policy effectiveness. Some argue that when government borrowing constitutes a significant portion of outstanding bank credit and accounts for most of the new credit in a country, monetary policy becomes ineffective. This ineffectiveness arises because government borrowing is largely unresponsive to changes in interest rates, raising critical considerations for policymakers in managing economic stability.

However, the assumption that government expenditure is unaffected by interest rates lacks empirical support. High interest rates have been shown to be effective in exerting pressure on governments to either curtail discretionary spending or increase revenue generation. In any case, this argument is flawed because, even under such conditions, monetary policy retains some effectiveness. As long as some private sector credit exists, monetary policy will dampen aggregate demand. Conversely, an easing of monetary policy will stimulate private sector demand, thereby intensifying inflationary pressures.

Moreover, bank credit is not the only channel through which tighter monetary policy influences demand and inflation expectations. Tighter monetary policy also lowers inflation by supporting the exchange rate, dampening property and asset prices (thereby reducing private demand through wealth effects), and raising interest rates in the informal economy (see Agha et al., 2005; Husain et al., 2022).

High policy rates make inflation worse through their impact on the budget deficit

Another set of critics alleges that higher policy rates increase debt service costs and the fiscal deficit, which in turn boosts demand and adds to inflationary pressures. While there is some validity to this argument, several other factors must be considered to assess the extent of its impact on inflation (see Zoli, 2005):

- First, as stated earlier, a high policy rate should encourage a prudent fiscal agent to cut its borrowing requirements and the fiscal deficit.
- Second, the impact depends on how the higher fiscal deficit is financed. If it is financed through money printing, it is more likely to be inflationary. Conversely, if it leads to the crowding out of private credit, it is less likely to have such an effect.

- Third, as noted above, failure to maintain a high policy rate in the face of high inflation would activate other inflationary channels—such as inflation expectations, increase in asset prices and exchange rate depreciation—which would further contribute to inflationary pressure.

4. Conclusions

Debunking Common Myths and Building Guideposts for Monetary Policy in Pakistan

We end with some conclusions regarding the major criticisms typically leveled at monetary policy in Pakistan, particularly considering the monetary policy response over the last two years, based on our review of the literature and international experience.

These conclusions help to provide guideposts for monetary policy decision-making under various economic circumstances for an economy like Pakistan, which is prone to crises and balance of payments (BOP) constraints:

- First, even when inflation stems from a supply shock, monetary policy plays a crucial role by limiting second-round effects, reducing the risk of entrenched inflation, and preventing inflation expectations from becoming de-anchored. When inflation expectations are unstable, a forceful central bank response is critical.
- Second, in situations where exchange rate pass-through to inflation is high and foreign exchange reserves are low, inaction can lead to exchange rate instability and significantly higher inflationary pressures.
- Third, even when government borrowing dominates, monetary policy remains effective because it imposes a premium on fiscal discipline and controls inflationary pressures through other channels.
- Fourth, the central bank must account for the fiscal authority's current stance; if fiscal policy lacks prudence, monetary policy may need to attempt to offset it. While this is far from ideal and the central bank's capacity to compensate is limited, failing to act could exacerbate both inflationary pressures and external account vulnerabilities.
- Fifth, the central bank should prioritize the “real” interest rate over nominal rates, as nominal rates tell us nothing about the stance of monetary policy. For example, if inflation is accelerating at 30 percent annually, an interest rate of 25 percent imposes minimal burden on borrowers and fails to sufficiently incentivize savers. The objective should be to maintain a positive real interest rate on a forward-looking basis, ideally aligned with historical norms in Pakistan, typically 2 - 3 percent. During episodes of extreme crises or when

foreign exchange reserves are critically low and external balances are fragile, the real interest rate may need to temporarily exceed 2 – 3 percent to stabilize external accounts.

Implications for Future Monetary Policy Settings

Finally, we use these guideposts to speculate on the future trajectory of monetary policy as the economy stabilizes and inflation further subsides. Given that the poor are disproportionately affected by rising prices, controlling inflation must be a paramount major national priority. Simultaneously, an acceleration in the economic growth rate is also urgently required.

For the central bank, achieving a reduction in inflation to the medium-term target of 5-7 percent over the next 18 to 24 months should take precedence, as this aligns with its primary objective according to the SBP Act. Once the economy is firmly on a path toward this goal, the MPC can shift its focus to promoting economic activity, considering balance of payments constraints as indicated by the position of foreign exchange reserves. However, it is important to note that a sustainable increase in the growth rate cannot be accomplished solely through loose fiscal and monetary policies; it necessitates structural reforms.

As Pakistan's economy stabilizes, negotiations with the IMF for another Extended Fund Facility (EFF) program advance, and real interest rates become increasingly positive as inflation declines, there should be scope for a reduction in policy rates over time, provided other conditions remain stable.

However, caution is warranted, particularly since inflation expectations have yet to stabilize around the 5-7 percent medium-term target. The experiences of 2022-2023 serve as a reminder against prematurely declaring success in fiscal discipline and external support. At this juncture, alongside inflation, the sustainability of the current account and exchange rate stability must be pivotal factors in determining the monetary policy stance.

The potential for rate cuts hinges on maintaining prudent fiscal policy, the pass-through effects of tax increases and administered price adjustments in the budget that will influence inflation trajectories, and ensuring that the external situation remains manageable under the auspices of an IMF program with adequate external financing. Additionally, global commodity prices must be continuously monitored, given ongoing developments in the Middle East.

Furthermore, the impact of the growth on imports must be carefully monitored, since rapid expansion under the existing economic paradigm can precipitate balance of payments pressures in the form of an escalating current account deficit and dwindling FX reserves (see Rosbach and Aleksanyan, 2019). Therefore, until

structural reforms raise Pakistan's BOP-constrained growth limit, the central bank must exercise heightened caution once the growth rate rises above a certain prudent range.

Finally, regarding OMOs, while increasing outstanding OMOs may have been unavoidable over the last 18 months, the scale and tenor of the OMOs should be meticulously calibrated. Large scale, long tenor, one-sided liquidity injections should not become routine, as they can spur unwarranted increases in the money supply and add to inflationary pressures, particularly as the economy rebounds.

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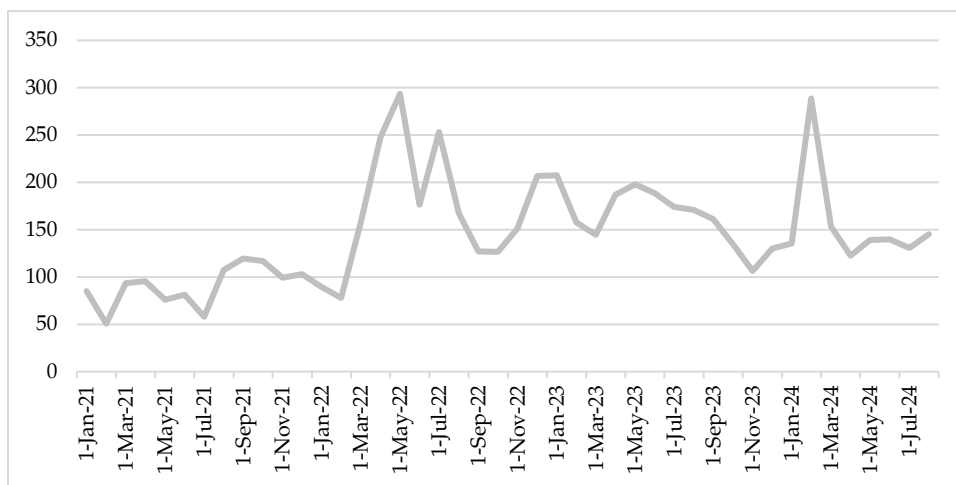
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Appendix

Appendix A: Impact of Economic Uncertainty on Inflation in an Economy with Inadequate Foreign Exchange Reserves

Due to numerous economic and political shocks starting in February 2022, the Pakistan economy has faced a high degree of uncertainty in the last three years. A leading proxy measure of uncertainty is based on the frequency of references to policy-related uncertainty in the newspapers (see Ozturk and Xuguang (2017)). Fortunately, SBP has developed such a measure and regularly publishes an index of Economic Policy Uncertainty in Pakistan. This index shows an explosive increase in uncertainty in March 2022 and, while this episode of uncertainty peaked in May, it has remained elevated since then with another peak coinciding with the national elections in February 2024 (see Figure 1).

Figure 1: SBP Economic Policy Uncertainty Index (4 newspapers)



Source: State Bank of Pakistan

It is well-known that economic and political uncertainty affects investment, consumption and production decisions and thus indirectly inflation. A few studies that have looked at its impact on price dynamics show that higher uncertainty is associated with higher inflation (Aisen and Veiga (2006), Khan and Saqib (2009)) and according to a recent SBP (2024) study “uncertainty was the second largest contributor during the current inflationary episode”. Moreover, in the case of an economy with inadequate foreign exchange reserves like Pakistan, there are other channels that can greatly enhance the impact of uncertainty on inflation when the external situation deteriorates significantly and risk perceptions spike. According to Pirzada (2024), “the increase in current and expected risk premium was the key

driving factor leading to the surge [in inflation] during the period under consideration [May 2022 to May 2023]". As a proxy for the risk premium, he uses the premium on one-year credit default swaps (CDS) for Pakistan which increased from around 5 percentage points before the crisis to an average of 40 percentage points during the second half of 2022.

That a change in Pakistan's country risk premium could have such a large and immediate impact on the domestic economy may seem surprising given that Pakistan does not have de jure capital account convertibility, although it has had de facto capital account convertibility since the early 1990s (Haque, 2011). The sharp increase in the risk premium is likely to have prompted households and businesses to adjust their portfolios by increasing their foreign currency holdings vis-a-vis rupee holdings, compounding the pressure on the exchange rate from the burgeoning current account deficit. There were two episodes of depreciation of the Rupee, the first was between March and July 2022 because of the political instability caused by the vote of no confidence and change of government in March-April 2022, and the second was in the first half of 2023 because of the economic uncertainty resulting from the delay and failure of negotiations with the IMF team for the ninth review under the Extended Fund Facility (EFF) programme in November 2022-February 2023. During the first episode the rupee depreciated by about 18% against the dollar and in the second episode it depreciated by 21%. An important indicator of the capital flight, as a result of the currency portfolio adjustment, is that during this period there was a decline in workers remittances of almost \$4 billion, or over 1% of the GDP in FY2023 compared to FY2022.

In developing countries, the exchange rate pass-through to inflation has tended to be significant and generally large, particularly in high inflation regimes (Edwards, S. (2007), Ndou and Gumata (2017), Musa, N. (2021), Hanif et al. (2022)). Therefore, it is plausible that the decline in the exchange rate from Rs180/\$ in March 2022 to Rs294/\$ in June 2023, which was largely because of the economic and political uncertainty in addition to lack of financing for the current account deficit, was primarily responsible for the surge in inflation in this period.

Appendix B: Inflation Expectations Anchor Adrift?

Inflation expectations are the rate at which people expect prices to rise in the future. It has been shown that households' inflation expectations affect decisions regarding consumption and savings, while firms' inflation expectations are relevant for price-setting, investment and hiring decisions (Andrade, P., et al. (2023), Coibion, O., et al. (2018)). Inflation expectations of households and businesses in one period strongly influence inflation in the next period.

Inflation expectations are important for monetary policy because as long as they remain anchored (i.e. households and businesses expect that the impact of any supply shock on prices will be temporary, and inflation will return to its previous level) monetary policy is effective in controlling inflation. However, if inflation expectations become unanchored, then it requires more aggressive actions on part of the central bank, and takes much longer, to bring inflation back to the target level.

Surveys of households and business expectations, along with long-term interest rates, are used by central banks to monitor inflation expectations. The State Bank of Pakistan (SBP) conducts consumer and business confidence surveys, which include questions on inflation expectations, to inform its monetary policy decision making. The diffusion index is the most used measure to summarize the information from inflation expectations surveys⁷. The diffusion index for the period January 2021 to September 2024 have been plotted in Figure 1. It shows that initially there was some up-and down movement in the index but it remained in a relatively narrow band until May 2022, indicating that inflation expectations were well anchored. However, the diffusion index being consistently above 70 in this period indicates that the anchor was possibly somewhat higher than the SBP's target inflation range of 5 to 7 percent. This is not surprising, as recent research "suggests that (personal) experiences matter a lot for how people form inflation expectations" (Adrian, T. (2023) and inflation in Pakistan has been higher than 7 percent during two-thirds of the period from 1970 to 2023, with the most recent episode of above 7 percent inflation, prior to the current one, in 2005-2015 (SBP 2024). After May 2022, the diffusion index is quite volatile and increases rapidly until March 2023, which suggests that at this point inflation expectations may have become unanchored.

Since March 2023, the diffusion index has declined and in recent months it was in the range seen in the pre-May 2022 period. However, it remained highly volatile suggesting that inflation expectations are not yet completely anchored.

To better predict when inflations expectations are anchored a deeper analysis of the inflation survey data is required than what is contained in the published information on the diffusion index. According to a recent IMF study, it is the shape of the distribution of household expectations that helps predict future inflation and "variance and skewness of household expectations' distributions add predictive power beyond and above the median, especially in periods of high inflation CPI inflation" (Marques et al. (2023)). It is hoped that SBP will also start publishing, along with the diffusion index, information on variance and skewness of the distribution seen in the monthly inflation expectations survey.

⁷ The Diffusion Index is a weighted average of the responses to the question in the survey on the expected increase in prices over the next six months, with the respondents having to choose from the following five options: increase significantly, increase, unchanged, decline, and decline significantly. The diffusion Index ranges from 0 to 100 and a value greater than 50 indicates that positive views are more than negative views and an increase in the index implies an increase in inflation expectations.

Another measure of inflation expectations published by SBP is information based on the quantitative question “expected price of an item in six months that costs Rs100 today”. This information is plotted in Figure 2 for the period January 2021 to September 2024. It confirms the conclusions of our analysis based on the diffusion index, except that it indicates a creeping up of inflation expectations starting in July 2021, well before the likely de-anchoring of inflations happened in May 2022. Possibly, as argued in Syed and Hamid (2024), if the SBP had been also looking at the shape of the distribution of household expectations it would have had an early warning of the possibility of inflation expectations becoming unanchored.

Figure 2: Inflation Expectations I – Diffusion Index

