Comments

This paper is a significant addition to the existing literature on the potential determinants of inflation in Pakistan. The basic conclusion that emerges from the paper is that it is the credit to the private sector which is the main driving force for inflation in Pakistan in both the short run and long run. The conventional wisdom that it is broad money that adds to inflation in the long run does not get any support from this study. Therefore, the lesson for SBP is to closely monitor and control credit flows to the private sector to contain inflation. This also calls for an even more effective role of open market operations (OMOs) for SBP.

The study also shows that supply side factors such as wheat support prices are important in the short run for inflation determination.

Furthermore it points out that periods of high growth in Pakistan are associated with periods of low inflation and vice versa. Therefore, the paper suggests that SBP should be even more watchful of private sector credit movements in the country and target inflation at around 5 percent to maximize growth and attain price and financial stability.

I have identified a few points that undermine an otherwise fine attempt on the inflation determination in Pakistan.

The study uses credit to private sector as a proxy of monetary conditions in Pakistan but this proxy may be questionable because the role of the government which is a significant player in the credit market is completely ignored.

If you look at the most recent economic history of Pakistan you would notice that there are at least three major developments that have taken place since the turn of the century:

1. prevalence of historically low interest rates;
2. unprecedented stability of exchange rates;
3. substantial increase in credit to the private sector.

The paper does capture the movements of credit flows but ignores the impact of exchange rates and interest rate movements. The paper does estimate a range of models to uncover potential determinants of inflation but the one opted for inferences does not capture the role of exchange rates and interest rates; these variables are dropped from the model on the grounds that they are either insignificant or show a wrong relationship with inflation.

Also in my opinion, the paper has undermined the role of exchange rates by picking the wrong proxy, i.e. nominal effective exchange rate (NEER). NEER might not be a true representative of Pakistan's trade with the rest of the world anymore because it is computed on the basis of trade weights based on 1989-91 data. Therefore, a better proxy for exchange rate would have been the rupee-dollar parity as around 80 percent of Pakistan's international trade is dollar denominated.

Similarly, the study should have tried overnight rates or bank lending rates as a proxy for interest rates to capture the role of interest rates effectively.

Finally, I would like to make a suggestion to the authors that they may like to address similar issues based on structural VAR because they are based on structural relationships rather than reduced-form relationships as is the case with this paper.

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