



# Research Broadcast

March 2016

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### Price Setting and Price Stickiness: A Developing Economy Perspective

by M. Ali Choudhary, Abdul Faheem, Nadim Hanif, Saima Naeem and Farooq Pasha; *Journal of Macroeconomics*, 48, June 2016 (see [LINK](#)).

Sticky prices are fundamental to modern day macroeconomics as they imply that instead of being vertical the aggregate supply curve is upward sloping. As a result, aggregate demand and output may comove; monetary policy can influence the business cycle through demand management. The question therefore is: Are prices really sticky in Pakistan? If so, what type of price setting rules are used in the economy? The reason for this question is because different price setting rules lead to dramatically different predictions about non-neutrality of money. A related equally important question is: what does price stickiness mean in the context of an economy having a large informal sector. Indeed, the informal sector as a percentage of GDP, period average of 1999-2007, is 35.7% for Pakistan. The study shows that:

- The median frequency of price change in PK is 3; it is 1 and 1.4 in the EU and the US respectively;

- Pricing is mainly cost-based in PK. As in the EU and the US, firms are more sensitive to cost-driven shocks in PK. Within the realm of costs, energy and exchange rate shocks are more important than labor costs;

- Time-dependent rules dominate state-dependent ones, but a deeper study of these rules for Pakistan raises far more complex questions;

- Informality contributes to price rigidity: Firms interacting with the informal sector firms (43%) adjust their prices less frequently, but also incorporate most shocks into their pricing with as much delay as firms having no connections with the informal sector.



#### Key Questions

Why is price stickiness so important for monetary policy? What is the extent and the nature of price stickiness in Pakistan? Is the conventional view that the informal sector weakens monetary policy transmission correct? These are few questions addressed in Choudhary et al. (2016).

#### Key Answers

The frequency of price adjustment in Pakistan is three times higher than in the U.S. and EU, which means that policy transmission through the real interest rate channel is weak in Pakistan, but not non-existent. This channel forms the basis for other unconventional channels of policy transmission, hence the importance of studying price stickiness. Challenging is the result that the informal sector strengthens this channel as it allows formal sector firms, relying on inputs from the informal sector, delay their price adjustments.