SUMMARY of the "Inflation and Devaluation" article, Miftah Ismail, Dawn, January 11th, 2024

The article delves into Pakistan's persistently high inflation, reaching 29.7% in December 2023 compared to the previous year, with year-on-year inflation consistently above 20%. Despite recent positive signs, including a lower monthly increase in December, the writer highlights the root cause – a significant increase in the money supply due to a ballooning budget deficit. Over the past five-and-a-half years, the money supply has surged by over 100%, primarily driven by government borrowing to finance the deficit. The writer emphasizes that the country's failure lies in not using government spending to boost worker productivity or the economy's capacity. With a focus on increasing the labor force rather than improving skills and knowledge, the nation faces challenges in achieving sustainable economic growth. The article concludes with recommendations to reduce inflation by addressing the budget deficit, investing in education and productivity, and maintaining a flexible, market-driven exchange rate for export growth.

Easy/Short SUMMARY:

The article discusses Pakistan's persistent high inflation, reaching 29.7% in December 2023. Despite recent positive signs, the root cause lies in a significant increase in the money supply due to a growing budget deficit. The writer emphasizes the need to invest in education and productivity to achieve sustainable economic growth and recommends reducing inflation by addressing the budget deficit while maintaining a flexible exchange rate for export growth.

SOLUTIONS of The Problem:

1. Reduce Budget Deficit:

Address the root cause of inflation by implementing measures to reduce the budget deficit.

2. Invest in Education:

Allocate resources to improve education, skills, and technological know-how to enhance worker productivity and the country's productive capacity.

3. Increase Productivity:

Promote policies that focus on increasing productivity, especially in labor and capital, to drive national income growth.

4. Flexibility in Exchange Rate:

Maintain a flexible, market-driven exchange rate to boost exports and prevent sacrificing exports for short-term relief.

5. Rational Economic Policymaking:

Adopt rational economic policies to ensure long-term economic stability and avoid deviations that may lead to short-term relief but cause long-term damage.

6. Control Money Supply:

Implement measures to control the rapid growth in money supply, especially stemming from government borrowing to finance the budget deficit.

7. Encourage Export-Oriented Policies:

Promote policies that encourage exports, ensuring a balance between current prices, voters' satisfaction, and maintaining a competitive international position.

8. Address Smuggling and Hawala:

Address issues like smuggling and hawala while ensuring the State Bank of Pakistan (SBP) does not sell dollars in the interbank market to artificially maintain the rupee's value.

9. Prioritize Education and Skill Development:

Make education and skill development a priority to improve the overall skill and knowledge levels in the country.

10. Long-Term Vision:

Develop and implement policies with a long-term vision to address economic challenges comprehensively.

IMPORTANT Facts and Figures Given in the article:

- Consumer prices in December 2023 were 29.7% higher than the previous year.
- Year-on-year inflation has consistently been above 20% for more than a year.
- In the last five-and-a-half years, the money supply has increased by over 100%.

MCQs from the Article:

1. What was the year-on-year inflation in December 2023?

A. 10%
B. 20%
C. 29.7%
D. 15%

2. What is identified as the main driver of the increase in

money supply in Pakistan?

A. Private sector borrowing
B. International trade
C. Government borrowing for the budget deficit
D. Foreign investments

3. According to the writer, what is the primary reason for Pakistan's anaemic economic growth in the last two decades?

A. Lack of natural resources
B. Global economic downturn
C. Increase in labor force without improving skills and knowledge
D. Insufficient foreign aid

VOCABULARY:

1. **Persistently** (adverb) (□□□□□□□□): In a manner continuing firmly or obstinately.

2. **Ballooning** (adjective) (□□□□ □□□□□): Experiencing rapid growth or expansion.

3. **Tapering Down** (phrase) (□□ □□□ □□ □□): Gradually decreasing in intensity or extent.

4. **Aggregate Demand** (noun) (□□□□□□ □□□□): The total quantity of goods and services demanded across all levels of an economy.

5. **Debt Service Payments** (noun) (□□□□□□□□ □□□□ □□□): Payments made on the interest and principal of debt.

6. **Anaemic** (adjective) (□□□□□): Lacking in quantity, quality, or vigor.

7. **Policymaking** (noun) (□□□□□ □□□□□□): The process of formulating policies to address various issues.

8. **Deviation** (noun) (□□□□□□): The action of departing from an established course or standard.

9. **Rational** (adjective) (□□□□□): Based on or in accordance with reason or logic.

10. **Comprehensively** (adverb) (□□ □□□ □□□□): In a way that includes or deals with all or nearly all elements or aspects.

11. **Sacrificing** (verb) (□□□□ □□□□□□): Giving up something valuable for the sake of other considerations.

12. **Arise** (verb) (□□□□ □□□□): To emerge or become apparent.

13. **Hawala** (noun) (□□□□□): An informal system of transferring money without any actual movement.

14. **Adopt** (verb) (□□□□ □□□□): To take up or start to use or follow a particular thing or practice.

15. **Stunted** (adjective) (□□□□□ □□□□□): Prevented from growing or developing to normal size.

16. **Wasted** (adjective) (□□□□ □□□□): Excessively thin or emaciated.

17. **Policies** (noun) (□□□□□□□): A course or principle of action adopted or proposed by a government, party, business, or individual.

18. **Perspective** (noun) (□□□□□): A particular attitude toward or way of regarding something; a point of view.

19. **Flexible** (adjective) (□□□□□□): Capable of bending easily without breaking.

20. **Technological Knowhow** (noun) (□□□ □□ □□□□□□□□): Practical knowledge and skill in using techniques and methods associated with a particular field of activity.

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Inflation and devaluation
Miftah Ismail

IN December 2023, consumer prices were 29.7 per cent higher compared to December a year earlier. Worse still, every month for more than a year our year-on-year inflation number has been above 20pc.

There was however positive news in the recent inflation data too. Prices in December rose by only 0.8pc over November, which was the second smallest monthly increase in a year. And just like November 2023, the increase in prices was only due to the increased cost of gas and electricity — in fact, food prices declined in December. The tight monetary policy being pursued by SBP has finally been able to wring the juice out of our economy and we are going to see inflation and interest rates come down.

But why does Pakistan have such persistently high inflation when inflation never went so high globally and has receded for months?

To understand, let's think of a simple economy with three sellers each selling a food packet and three buyers each given Rs100 by the government. It stands to reason that packets would sell for Rs100 each. Now if the price of these food packets abroad is one dollar, we will have an exchange rate of one dollar being equal to Rs100. If the government had given each consumer Rs200 and we still had three food packets available, then the price for each food packet would have been Rs200. Again, since the international price of a food packet is one dollar, the rupee would have depreciated by 100pc and the new exchange parity would have been Rs200 to a dollar.

To reduce inflation we must reduce the budget deficit.

The only thing that changed in this economy was twice as much money chasing the same amount of goods, therefore doubling the price and depreciating the rupee. This is our difficulty. In the last few years, as our budget deficit has ballooned, to pay for the deficit we have printed more and more money and as more rupees are chasing the same amount of goods, we have experienced persistently high inflation and rapid devaluation.

In five-and-a-half years since the start of fiscal year 2018, our money supply has increased by over 100pc, with the fastest increase coming in the six-monthly period between January and June of last year, with February to May showing the four highest monthly inflation numbers in our history. Since then the rapid growth in money supply has declined and we are witnessing inflation tapering down.

The two main ways money supply increases are when the private sector borrows from banks or when the government borrows to finance its budget deficit. Since our private sector borrowing is decreasing, this means the money supply is increasing primarily to finance the budget deficit. This has caused inflation; it is to contain this inflation that SBP has been raising interest rates.

Some argue that this model doesn't apply to Pakistan or that ours is a "cost-push" inflation and hence the SBP shouldn't have raised interest rates. However, if interest rates are much below inflation, people will not save and borrow just to park money in land, gold or foreign currency. Central banks raise interest rates to constrain aggregate demand and borrowing. This the SBP has successfully done in the case of our private sector. But unfortunately our government, in the face of higher interest rates leading to higher debt service payments, has not been able to cut the deficit. Instead it has borrowed more, causing the money supply to increase. This has led to the persistence of our inflation.

In our simple economy with three consumers and three food packets, we saw that when money doubled, so did prices. But if the number of food packets had also doubled when the money supply doubled, prices wouldn't have increased. This means that if our economy had been able to increase the output of goods and services as money supply rose, we wouldn't have seen inflation.

Pakistan is not unique in running a budget deficit or increasing money supply. But we stand out in our almost total failure to use our government spending to increase worker productivity or the economy's productive capacity.

Economists argue that national income (or output) grows when labour or capital grows or primarily when there is technical progress — ie increases in education, skills and technological knowhow. But this has never been a priority for us. In a country where 58pc of kids under five are either stunted or wasted and where 78pc of 10-year-old kids cannot properly read, such improvement in productivity remains a pipe dream.

So the anaemic economic growth we have had over the last two decades is due primarily to the increase in our labour force and a little increase in capital and not because of any improvement in skills or knowledge.

Going back to our simple economy one last time, with food packets each priced at

Rs200 and the international price of food packets being one dollar, each dollar should be for Rs200. Now, if our government decides to sell dollars for Rs150, it would mean that no food packet could be exported from Pakistan and traders would turn to importing food packets. This has happened to Pakistan too, when various governments, to keep current prices low and voters happy, sacrificed exports and manufacturing and gave rise to huge current account deficits. (This is not to say that we should not stop smuggling or hawala. But SBP should not be selling dollars in the interbank market to keep the rupee at some predetermined value).

There are no magic solutions to our economic problems. We are a poor and uneducated country and will remain poor until we remain uneducated. However, to reduce inflation we must reduce the budget deficit. At the same time to achieve growth, we must invest in our people and increase their productivity and the country's productive capacity. Finally, it is important to keep a flexible, market-driven exchange rate so our exports can increase.

Deviations from rational economic policymaking will perhaps get us short-term relief, but as has always been the case, it will cause long-term damage.

The writer is a former finance minister.

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