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ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Course: Monetary Theory and Policy (811) • Level: M.Sc

Semester: Autumn 2026

Assignment No. 2 (Unit: 6-9)

Total Marks: 100 • Pass Marks: 40 • Credit Hours: 03

SOLVED ASSIGNMENT GUIDE

(For Study & Reference)

Note: This guide is prepared for study and reference purposes. Students are advised to read the relevant units of the course book, understand the concepts, and then write the assignment in their own words.

Copying this guide word for word is not recommended.

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Question 1: Neo-Classical Synthesis and Keynesian Economics Compared (20 Marks)

Compare and contrast Neo-Classical synthesis and Keynesian economics.

Introduction

The neoclassical synthesis was the dominant form of macroeconomics from the 1940s to the early 1970s. The term was popularised by Paul Samuelson for the reconciliation worked out by economists such as John Hicks, Alvin Hansen, Franco Modigliani and Samuelson himself between the economics of Keynes and the older classical (neoclassical) tradition that Keynes had attacked. Its guiding compromise can be stated in one sentence: Keynesian economics is correct for the short run, when wages and prices are sticky and demand determines output, while classical economics is correct for the long run, when prices adjust, markets clear and supply determines output. To “compare and contrast” the synthesis with Keynesian economics, therefore, is partly to compare Keynes with his own followers, for the synthesis claimed to be Keynes completed rather than Keynes rejected. This answer explains what Keynesian

economics asserts, what the synthesis added and changed, sets out the similarities and the differences systematically, and closes with the stagflation crisis that damaged both and the New Keynesian school that inherited their common ground.

Keynesian Economics: The Original Doctrine

Keynes's General Theory (1936) was written against mass unemployment. Its core claims were that aggregate demand — consumption, investment, government spending and net exports — determines output and employment in the short run; that saving and investment are made equal by changes in income rather than by the interest rate; that money wages and prices do not fall fast enough, or helpfully enough, to restore full employment, so underemployment equilibrium is possible; that investment is driven by volatile long-term expectations, so the private economy is inherently unstable; that money is non-neutral, working through liquidity preference and the rate of interest, although monetary policy may fail in a liquidity trap; and that active government, especially through fiscal policy, is therefore necessary to stabilise demand at a high level of employment. Keynes wrote mainly about the short run, distrusted long-run abstractions ("in the long run we are all dead"), and treated uncertainty — unquantifiable, not mere calculable risk — as a central fact of economic life.

The Neo-Classical Synthesis: What It Did

The synthesis translated Keynes into a formal, teachable model and bolted the classical long run back onto it. Hicks's IS–LM apparatus showed Keynesian results as a special case (a flat LM curve, or rigid wages) of a general system in which classical full employment was another special case (a vertical LM curve). Modigliani showed that Keynesian unemployment could be presented as the consequence of one particular rigidity — the money wage — within an

otherwise classical model. Samuelson's textbook combined Keynesian cross and multiplier analysis for demand with neoclassical microeconomics of relative prices, allocation and growth theory for supply. The policy product was a mixed programme: fiscal and monetary policy would manage aggregate demand so as to hold the economy near full employment, while free markets, competition and price incentives would handle allocation; and once demand management had secured full employment, the classical rules about prices, distribution and growth would again apply. The discovery of the Phillips curve seemed to give governments a practical menu, a stable choice between inflation and unemployment, on which this mixed policy could operate.

Points of Similarity

- Both accept that aggregate demand determines output and employment in the short run and that an economy can operate for long periods below full employment.
- Both give the state an active stabilisation role and regard the multiplier, the consumption function and the sensitivity of investment to demand and interest rates as the working machinery of policy.
- Both treat money as non-neutral in the short run and analyse it through liquidity preference / the LM curve rather than through the simple quantity theory.
- Both are demand-centred in method: the synthesis is built out of Keynes's own concepts (IS–LM is literally Keynesian apparatus), and its founders presented themselves as Keynes's interpreters, not his opponents.

Points of Difference

Table 1: Keynesian economics and the neo-classical synthesis contrasted

Point	Keynesian economics (Keynes)	Neo-classical synthesis
Status of classical theory	Rejected as a special, misleading case that assumes full employment	Restored for the long run and for microeconomics; Keynes applies to the short run only
Cause of unemployment	Deficiency of effective demand rooted in uncertainty and unstable investment; not curable by wage cuts	Largely one rigidity — sticky money wages/prices — inside an otherwise self-adjusting system
Nature of the system	Inherently unstable private economy requiring continuous public guidance	Fundamentally stable economy needing only occasional demand "fine-tuning"
Wages and prices	Sticky, and cutting them can worsen demand, debts and expectations	Sticky in the short run but flexible in the long run, so the economy self-corrects given time
Money and the long run	Non-neutral; emphasis on money's effects throughout, long run given little attention	Short-run non-neutrality but long-run neutrality and classical dichotomy restored
Expectations and uncertainty	Fundamental uncertainty and animal spirits are central and irreducible	Largely assumed away; agents treated as well informed, the future as a calculable risk
Policy emphasis	Fiscal policy primary; monetary policy weak in slumps; even "socialisation of investment" contemplated	Balanced fiscal–monetary mix, rules of demand management, plus free markets for allocation
Inflation analysis	Cost and bottleneck pressures recognised; no simple unemployment–inflation menu originally	Phillips curve treated as a stable policy trade-off between inflation and unemployment
View of growth and supply	Secondary; the problem is demand and employment now	Neoclassical supply side, production functions and growth theory added as the long-run half

The contrast in spirit is as important as the contrast in propositions. Keynes believed the economy's instability came from its nature — from uncertainty, speculation and the psychology of investment — and was therefore a permanent management problem. The synthesis, by

redefining Keynesian unemployment as the product of a single removable rigidity, quietly restored the optimism Keynes had challenged: remove or outlast the rigidity, keep demand sensibly managed, and the classical harmony returns. Critics such as Joan Robinson, who called the synthesis “bastard Keynesianism”, argued that in domesticating Keynes it had dropped his most revolutionary elements — historic time, fundamental uncertainty and the possibility that capitalism has no automatic tendency to full employment at all.

The Synthesis in Policy Practice

In government, the synthesis produced the confident demand management of the 1950s and 1960s: budgets were used counter-cyclically, central banks leaned against booms and slumps, and in the United States the 1964 tax cut was openly justified as Keynesian medicine delivered inside a neoclassical economy that would then grow along its classical path. This practical success is itself a point of contrast with Keynes's own expectations. Keynes had doubted whether monetary policy alone could secure full employment and had contemplated a much larger permanent role for public investment; the synthesis, by contrast, believed a modest, technocratic mixture of fiscal and monetary adjustments, operated by experts, would normally suffice, leaving ownership and allocation overwhelmingly private. Where Keynes saw a continuing political problem of managing an unstable system, the synthesis saw a technical problem of tuning a basically sound one — and that difference in temperament explains both its dominance in the stable post-war decades and its helplessness when the disturbances of the 1970s proved to be structural and expectational rather than merely cyclical.

The Crisis of Both: Stagflation and After

In the 1970s the simultaneous rise of inflation and unemployment — stagflation — struck the synthesis at its weakest joint, the supposedly stable Phillips curve, and revived doubts about Keynesian demand management generally. Monetarists argued that the trade-off vanishes once expectations adjust, and new classical economists attacked the theoretical foundations of both Keynes and the synthesis. Yet what replaced them, New Keynesian economics, is in many ways the synthesis rebuilt with better microfoundations: sticky prices formally modelled, demand still determining output in the short run, monetary policy conducted through interest-rate rules, and classical neutrality restored in the long run. The pattern of the synthesis — Keynes for the short run, classical principles for the long run — thus survived its own crisis in modern dress.

Conclusion

To conclude, the neoclassical synthesis and Keynesian economics agree on the short-run core: demand determines output, unemployment can persist, money is not neutral, and government must stabilise the economy. They differ on the status of classical theory, the cause and curability of unemployment, the stability of the private economy, the place of uncertainty, and the long run, in which the synthesis restores price flexibility, neutrality of money and market allocation that Keynes had questioned or ignored. The synthesis is therefore best described as Keynes formalised, narrowed and combined with the tradition he opposed — a combination so successful that it became the textbook orthodoxy, and so incomplete, on uncertainty and the Phillips curve, that the crises of the 1970s could break it and force its New Keynesian reconstruction.

Question 2: Friedman's Monetarism (20 Marks)

Discuss in detail Friedman's Monetarism.

Introduction

Monetarism is the school of thought associated above all with Milton Friedman of the University of Chicago, developed from the 1950s to the 1970s as a direct challenge to the Keynesian orthodoxy of the time. Its central proposition can be stated in Friedman's own famous words: inflation is always and everywhere a monetary phenomenon, produced by a more rapid increase in the quantity of money than in output. More broadly, monetarism holds that changes in the money supply are the dominant cause of changes in nominal income in the short run and of prices in the long run; that the private economy is basically stable; that the demand for money is a stable function of a few variables; and that governments therefore do more harm than good when they try to manage the economy discretionarily. Monetary policy should instead follow a steady, predictable rule. This answer explains the theoretical core — Friedman's restatement of the quantity theory and his demand-for-money function — then his natural-rate and expectations analysis, his policy rules and critique of Keynesian policy, the debate and evidence, and a final appraisal.

The Quantity Theory Restated: The Demand for Money

Friedman's 1956 essay “The Quantity Theory of Money: A Restatement” is the foundation. He insisted the quantity theory is first of all a theory of the demand for money. Money is an asset, one way of holding wealth among many — bonds, equities, real goods and human capital — and the quantity demanded depends, as demand for any asset does, on the wealth available and on the returns of money and its rivals. His demand function is written M/P = f(Yp, rb, re, πe,

w, u): the real balances demanded depend positively on permanent income (Yp, the expected long-run income that measures wealth), negatively on the yields on bonds (rb) and equities (re) and on expected inflation (πe), which is the return on holding goods, and also on the ratio of human to non-human wealth (w) and on tastes (u).

Two features of this function carry the whole monetarist argument. First, it contains no separate speculative motive and, empirically in Friedman's work, the interest elasticity of money demand turned out to be small; money demand is not the fragile, expectation-driven relation Keynes described, and there is no liquidity trap lurking in it. Second, and decisively, the function is stable: the variables in it move in predictable ways, so the amount of real balances people wish to hold, and hence velocity, behaves predictably over time. If demand is stable, then disturbances to nominal income must come mainly from the supply side of the money market — from the quantity of money the authorities create. That is the bridge from a demand function to the doctrine that money rules the economy.

Permanent Income and the Transmission Mechanism

Friedman's companion theory of consumption — the permanent income hypothesis — supported the same conclusions from the fiscal side. If consumption depends on long-run permanent income rather than current income, temporary tax changes and deficit spending have small effects on consumption, and the Keynesian fiscal multiplier shrinks. The monetarist transmission mechanism is also broader than the Keynesian one. Keynesians traced money's effect through a single price, the rate of interest on bonds, to investment alone. Friedman argued that an excess supply of money spreads across a wide spectrum of assets — bonds, equities, houses, durable goods — raising their prices and lowering yields generally, and

stimulating spending on new goods as wealth-holders rebalance their portfolios. Money therefore affects total spending directly and powerfully even when conventional interest rates move little, which is why monetarists thought Keynesians, watching only bond rates, had wrongly concluded in the 1930s that money was impotent.

The Natural Rate, Expectations and the Phillips Curve

In his 1968 presidential address Friedman (independently with Edmund Phelps) attacked the idea of a permanent inflation–unemployment trade-off. There is, he argued, a natural rate of unemployment determined by real factors — labour-market structure, search, skills, institutions — at which inflation is stable. If the authorities expand money to push unemployment below the natural rate, they succeed only while workers and firms are fooled by unexpectedly high inflation; once expectations adjust, unemployment returns to the natural rate with inflation permanently higher. Repeated attempts trace out a vertical long-run Phillips curve and produce accelerating inflation. Monetary policy thus cannot buy lower unemployment in the long run; it can only choose the rate of inflation. This expectations-augmented Phillips curve analysis, drawn in the figure, was spectacularly confirmed by the stagflation of the 1970s, which orthodox Keynesianism had not predicted and could not easily explain.

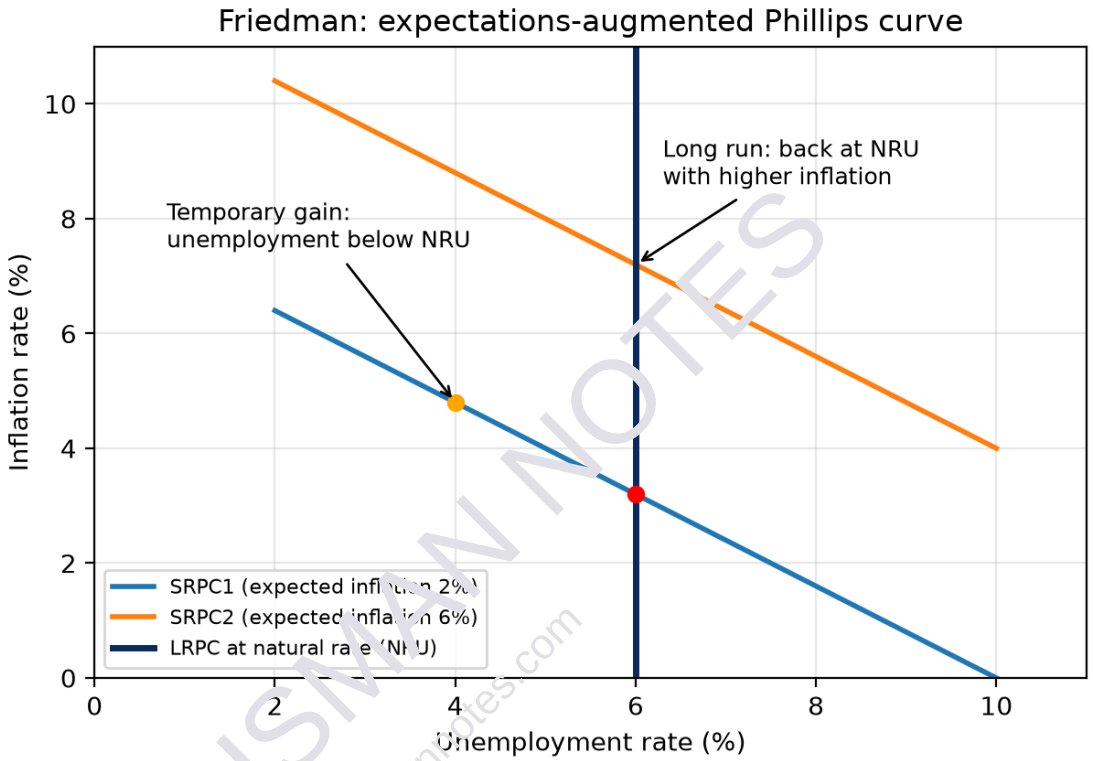


Figure 1: Friedman's expectations-augmented Phillips curve. Expansion can move the economy temporarily to lower unemployment along SRPC1, but once expectations adjust the short-run curve shifts to SRPC2 and unemployment returns to the natural rate (LRPC) at higher inflation.

Policy: Rules Rather Than Discretion

- The k-percent rule: the money supply should grow at a constant, pre-announced rate roughly equal to the long-run growth of real output (Friedman suggested a low single-digit rate for a broad aggregate), so that money accommodates growth without generating inflation or deflation.
- Against fine-tuning: monetary changes act with “long and variable lags”, so discretionary attempts to stabilise the economy, decided on old information and taking effect at unknown future dates, are as likely to amplify cycles as to damp them; the historical record, including the Federal Reserve's failure in the Great Depression, which Friedman and Anna

Schwartz documented in A Monetary History of the United States (1963), shows central banks as a source of instability rather than a cure.

- Against fiscal activism: deficit spending financed by borrowing crowds out private activity or must ultimately be monetised; only money-financed changes have powerful lasting effects, and those are inflationary.
- Free-market corollaries: flexible exchange rates, which Friedman championed early, insulate a country following a steady monetary rule from foreign disturbances; fixed rates import other countries' monetary policies.

Monetarism versus Keynesianism: The Core Disputes

Table 1: Monetarist and Keynesian positions compared

Issue	Monetarism (Friedman)	Orthodox Keynesianism
Demand for money	Stable function of permanent income and a few returns; low interest elasticity; no liquidity trap	Unstable, dominated at times by speculative expectations; liquidity trap possible
Cause of cycles	Erratic money growth by the authorities	Unstable private investment and animal spirits
Stability of the economy	Private economy basically stable at the natural rate	Private economy inherently unstable, needs stabilisation
Inflation	Always a monetary phenomenon; caused by money growth exceeding output growth	Demand-pull, cost-push and structural causes all admitted
Fiscal policy	Weak (small multiplier, crowding out) unless monetised	Powerful, especially in slumps
Policy prescription	Constant money-growth rule; no discretion	Active discretionary fiscal and monetary management

Evidence, Influence and Criticism

Monetarism changed practice worldwide. In the late 1970s and 1980s central banks in the United States, the United Kingdom and elsewhere adopted monetary targets, and the Volcker disinflation in the United States demonstrated Friedman's claim that sustained monetary restraint could break inflation, at heavy short-run cost. In developing countries, including Pakistan, the monetarist diagnosis that budget deficits financed by central bank borrowing drive inflation became a standard part of IMF-supported programmes, and legal limits on government borrowing from the State Bank reflect it. Yet pure monetarism also encountered decisive practical problems. Financial innovation made the definition and velocity of monetary aggregates unstable — money demand proved stable only until authorities targeted it, an instance of Goodhart's law — so by the 1990s most central banks had abandoned money-growth targets in favour of inflation targeting through interest rates. Keynesian and New Keynesian critics added that cause may run from income to money through bank credit rather than only from money to income, that wages and prices are sticky so monetary contractions cause real recessions, and that in the 2008 crisis and its aftermath huge expansions of base money did not produce proportional inflation, because velocity collapsed — behaviour much easier to explain with Keynesian liquidity preference than with a stable monetarist demand function.

Conclusion

To conclude, Friedman's monetarism rebuilt macroeconomics around the quantity of money: a stable demand for money expressed as a function of permanent income and asset returns; a broad portfolio transmission mechanism; a natural rate of unemployment with a vertical long-

run Phillips curve; the doctrine that inflation is always monetary; and the policy conclusion that money should grow by rule rather than by discretion, because long and variable lags make activism destabilising. Its permanent contributions — the natural rate, the role of expectations, the warning that sustained inflation cannot occur without monetary accommodation, and central bank credibility — are now part of every school. Its specific programme of monetary targeting failed on the instability of velocity under financial innovation, and modern inflation targeting is best seen as monetarism's goal pursued by Keynesian means.

Question 3: Tools of Monetary Policy (20 Marks)

What are the different tools of monetary policy? Explain.

Introduction

Monetary policy is the central bank's management of money, credit and interest rates in pursuit of its objectives — above all price stability, and, subject to that, sustainable growth, employment and external and financial stability. The State Bank of Pakistan, like other central banks, does not control spending directly; it works through a set of instruments, the tools of monetary policy, that change the reserves of the banking system, the cost of those reserves, or the terms on which particular kinds of credit are given. These tools are conventionally divided into general or quantitative tools, which affect the total volume of credit in the economy, and selective or qualitative tools, which affect the direction and terms of credit to particular sectors and uses. This answer explains each main tool, summarising their expansionary and contractionary use in a table, then looks at how the tools are actually used in Pakistan and at the limitations that blunt them in a developing economy.

General (Quantitative) Tools

1. The Policy (Bank / Discount) Rate

The policy rate is the rate at which the central bank lends to commercial banks against eligible securities, and in modern practice it is the central bank's principal signal and operating instrument. In Pakistan the State Bank's policy rate anchors its interest-rate corridor, with the overnight repo (ceiling) and reverse-repo (floor) rates around it. Raising the policy rate makes borrowing from the central bank and in the interbank market dearer; banks pass the increase into their lending and deposit rates, credit and money creation contract, and demand and inflationary pressure cool. Lowering it sets the opposite sequence in motion. Because almost all other interest rates in the economy take their cue from it, a policy-rate change is both a practical tightening and a public announcement of the central bank's intentions and inflation forecast.

2. Open Market Operations

Open market operations are the central bank's purchases and sales of securities, usually government treasury bills and bonds, in the open market. When the central bank buys securities, it pays by crediting the sellers' banks with reserves; bank reserves and the monetary base rise, the money multiplier works on a larger base, and credit expands, while the extra demand for securities also pushes their prices up and yields down. Sales reverse every step: buyers pay from their bank accounts, reserves drain away, and credit contracts. Open market operations are the most flexible of the tools — they can be used daily, in any amount, and reversed quickly — and in Pakistan the State Bank conducts them regularly, including through

Shariah-compliant instruments for Islamic banks, to keep the interbank rate near the policy rate.

3. Reserve Requirements (Cash Reserve Ratio and Statutory Liquidity Ratio)

The cash reserve ratio obliges banks to hold a stated fraction of their deposits as reserves with the central bank. Raising it immediately reduces the free reserves available for lending and lowers the deposit multiplier itself (in the simple model the multiplier is 1/r), so it is a powerful but blunt instrument, used sparingly because it taxes intermediation. Lowering it releases reserves and supports credit expansion. Alongside it, a statutory liquidity ratio requires banks to hold a further fraction of deposits in approved liquid assets, mainly government securities; in Pakistan this has historically also served the government's borrowing needs, which shows how monetary tools in developing countries are often entangled with fiscal finance.

4. Standing Facilities and the Interest-Rate Corridor

Modern central banks operate lending and deposit facilities at announced rates that form a corridor within which the market rate moves: banks short of reserves can borrow overnight at the ceiling rate, and banks with surplus funds can deposit them at the floor rate. Together with open market operations these facilities keep the overnight interbank rate aligned with the policy rate and prevent extreme volatility in money markets. The details differ between countries, but the function is the same — to make the policy rate effective rather than merely announced.

Selective (Qualitative) Tools

- Margin requirements: the central bank prescribes the margin — the borrower's own contribution — on loans against securities or specified commodities, so raising margins curbs speculative borrowing for shares or hoarding without raising all interest rates.
- Regulation of consumer credit: minimum down payments and maximum repayment periods on hire-purchase and personal loans restrain or encourage consumer demand selectively, including, in Pakistan, prudential limits on auto finance and personal loans.
- Credit guidance, ceilings and sectoral targets: the central bank directs banks to expand or restrain credit to priority or sensitive sectors — for example refinance and guarantee schemes for agriculture, small enterprises, housing and exports at concessional rates in Pakistan, and prudential exposure limits to discourage lending for speculation.
- Moral suasion: the central bank persuades and pressures banks, through meetings, letters and its supervisory authority, to follow the national policy line without a formal order; it works because banks depend on the central bank's goodwill and facilities.
- Direct action and differential rates: penalties, restrictions on rediscounting or denial of facilities to banks that defy policy, and different rates or refinance terms for different classes of paper, reward compliance and penalise defiance.

Summary: How the Main Tools Work

Table 1: Monetary policy tools and their effects

Tool	To expand credit (easy policy)	To contract credit (tight policy)	Main channel
Policy rate	Cut the rate	Raise the rate	Cost of funds throughout the system

Open market operations	Buy securities (inject reserves)	Sell securities (drain reserves)	Quantity of bank reserves / monetary base
Cash reserve ratio	Lower the ratio	Raise the ratio	Deposit multiplier and free reserves
Statutory liquidity ratio	Lower the ratio	Raise the ratio	Funds banks must lock in liquid assets
Margin requirements	Lower margins	Raise margins	Speculative borrowing against securities
Consumer credit rules	Easier down payments / longer terms	Harder terms	Household borrowing and demand
Moral suasion / guidance	Urge banks to lend to priority sectors	Urge restraint in sensitive sectors	Banks' behaviour without legal compulsion

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Monetary Policy Tools in Pakistan

The State Bank of Pakistan operates this standard kit with local features. Its Monetary Policy Committee sets the policy rate; open market operations and the corridor of standing facilities implement it; reserve and liquidity requirements bind the banks; and an extensive set of refinance schemes channels subsidised credit to exports, small and medium enterprises, agriculture, renewable energy and housing, reflecting developmental goals that a purely price-stability framework would not pursue. The State Bank also intervenes in the foreign exchange market and uses prudential regulations — which are really macroprudential tools — to protect financial stability. Its autonomy in setting these instruments was strengthened by amendments to the State Bank Act in 2022, which made price stability its primary objective and prohibited direct government borrowing from the State Bank, a reform aimed precisely at stopping the fiscal use of monetary tools.

Limitations of the Tools in a Developing Economy

The tools work less cleanly in Pakistan than the textbook suggests. A large cash-based informal economy and a sizeable undocumented sector lie outside bank credit altogether, so changes in bank conditions touch only part of total spending. Government borrowing from commercial banks on a large scale crowds out private credit and can force the liquidity created by open market purchases into financing the deficit rather than industry. Underdeveloped money and capital markets narrow the range of securities available for open market operations. Expectations and the exchange rate often dominate the policy rate: if depreciation is expected, tight money must work harder to defend prices. Finally, monetary tools cannot repair supply-side causes of inflation such as energy shortages and food supply failures; they restrain demand, at a cost in output and jobs, while the underlying problem awaits fiscal and structural policy.

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Conclusion

To conclude, the tools of monetary policy fall into two families. The general tools — the policy (bank) rate, open market operations, reserve and liquidity requirements and standing facilities — control the price and quantity of reserves and thereby the total volume of money and credit, expanding it when rates are cut, securities bought and ratios lowered, and contracting it by the reverse operations. The selective tools — margin requirements, consumer-credit regulation, sectoral guidance and refinance schemes, moral suasion and direct action — steer the composition of credit between uses. Used together by the State Bank of Pakistan they form a workable, if imperfectly transmitting, system whose effectiveness depends on developed

financial markets, fiscal discipline and central bank independence as much as on the instruments themselves.

Question 4: Causes of Inflation in Pakistan and How It Can Be Removed (20 Marks)

What are the causes of inflation in Pakistan? How can it be removed?

Introduction

Inflation is a sustained rise in the general price level, measured in Pakistan principally by the Consumer Price Index compiled by the Pakistan Bureau of Statistics, with food carrying a very large weight in the basket of the average household. Pakistan has suffered repeated bouts of high inflation, including the severe episode of the early 2020s in which inflation reached the highest levels in the country's history, driven by a collapsing exchange rate, imported energy prices, flood damage to food supply and years of fiscal and external imbalance. Such episodes are not accidents: they arise from a recognisable set of demand-side, cost-side and structural causes, most of which operate together and feed on one another through expectations. This answer sets out the main causes under those three headings, notes briefly why inflation is so damaging in Pakistan's conditions, and then gives a phased programme — monetary, fiscal, exchange-rate, supply-side and institutional — by which it can be brought down and kept down. “Removed” must be understood realistically: the practical goal is not zero inflation, which no country targets, but a return to low, stable, single-digit inflation that households and businesses can plan around.

Demand-Side Causes

- Fiscal deficits financed by money creation and bank borrowing: when the government persistently spends more than it collects and finances the gap by borrowing from the central bank or by forcing liquidity into the banking system, total demand and the money supply grow faster than the supply of goods, and prices rise. This fiscal dominance has historically been the single most important cause of inflation in Pakistan.
- Excessive money and credit growth: broad money expanding well ahead of real output, whether through deficit financing, rapid private credit booms or negative real interest rates that encourage borrowing and discourage saving, produces the classic demand-pull result — too much money chasing too few goods.
- Consumption-led demand and remittances: high propensities to consume, population growth and large inflows of workers' remittances raise demand for food, housing and services whose supply is slow to expand, bidding up their prices even without any printing of money.

Cost-Side (Supply-Shock) Causes

- Imported inflation: Pakistan imports most of its fuel, much of its edible oil and many industrial inputs, so world price rises and, even more, depreciation of the rupee pass directly into petrol, electricity, transport and food costs. The sharp depreciation episodes of recent years were the largest single proximate cause of the inflation surge.
- Administered energy prices and circular debt: delayed adjustments to electricity and gas tariffs accumulate as circular debt and are then imposed in large steps; each tariff increase raises costs for households and industry and works through the whole price structure.

- Indirect taxes and subsidy removal: increases in sales tax, petroleum levies and the withdrawal of subsidies, often under stabilisation programmes, raise measured prices directly, even when they are fiscally necessary.
- Wage–price and expectations effects: workers demand higher wages to catch up with past inflation, firms raise prices in anticipation of costs and of further depreciation, and inflation becomes self-perpetuating through expectations even after the original shock has passed.

Structural Causes

- Food and agriculture weaknesses: low crop productivity, water scarcity, post-harvest losses, dependence on imported pulses and edible oil, and periodic shocks such as the 2022 floods make food supply inelastic so any demand growth or currency fall shows up quickly in food prices — the largest component of the poor family's budget.
- Hoarding, cartels and weak competition: sugar, wheat flour, cement and other concentrated markets have repeatedly been found, by official inquiries, to involve hoarding and collusive pricing, while weak market regulation and poor storage and transport let middlemen widen margins in times of shortage.
- Low productivity and external imbalance: because exports grow slowly while import needs grow fast, Pakistan repeatedly hits a balance-of-payments crisis; each crisis ends in depreciation and an inflationary correction, making inflation cyclical and structural rather than accidental.

How Inflation Can Be Removed: Monetary and Fiscal Measures

The first requirement is to break fiscal dominance and demand pressure together, because neither works alone. The State Bank must keep the policy rate positive in real terms — above

expected inflation — long enough to make holding rupees attractive, restrain credit growth and anchor expectations, accepting the short-run cost to output as the price of disinflation. The government, for its part, must reduce the budget deficit by broadening the tax base (Pakistan's tax-to-GDP ratio is chronically low, with agriculture, retail and property undertaxed) and by cutting untargeted subsidies and losses of state enterprises, and it must finance what deficit remains from genuine savings rather than central bank credit — the prohibition on direct government borrowing from the State Bank enacted in 2022 points the right way. Monetary tightening unsupported by fiscal correction fails, because the market expects deficits to be monetised later; fiscal correction unsupported by tight money is overwhelmed by depreciation and expectations.

Exchange-Rate, External and Supply-Side Measures

Because so much of Pakistan's inflation is imported, stabilising the external account is anti-inflationary policy. A genuinely market-determined exchange rate, rebuilt foreign-exchange reserves, and export growth through energy pricing reform, productivity and market diversification reduce the frequency of depreciation shocks. Energy reforms — timely tariff adjustments instead of accumulated shocks, reduction of circular debt, and cheaper domestic and renewable energy — lower the cost-push impulse at its source. On the supply side, agricultural productivity (seed, water efficiency, storage, cold chains and reduced import dependence for edible oil and pulses), functioning commodity markets, action by the Competition Commission against cartels, and targeted protection of the poorest through cash transfers such as the Benazir Income Support Programme rather than general price controls

address the structural causes. Price controls and forced releases may suppress a symptom for weeks; they do not remove a cause, and shortages usually make them counterproductive.

Table 1: Causes of inflation in Pakistan matched with remedies

Cause	Remedy	Horizon
Deficit financing / money creation	Fiscal consolidation, broader tax base, no central bank financing of government	Medium term
Excess demand and credit growth	Positive real policy rate, prudent credit growth, SBP inflation focus	Short term
Rupee depreciation and imported costs	Market-based exchange rate, reserve rebuilding, export growth	Medium term
Energy tariffs and circular debt	Timely smaller adjustments, loss reduction, cheaper energy mix	Medium term
Food supply failures	Agricultural productivity, storage and cold chains, import planning	Long term
Hoarding and cartels	Competition enforcement, market information, strategic reserves	Short–medium term
Inflationary expectations	Central bank independence, consistent policy, clear communication	Continuous
Hardship to the poor during disinflation	Targeted cash transfers instead of general subsidies	Immediate

Conclusion

To conclude, inflation in Pakistan is caused by a combination of fiscal deficits financed in inflationary ways and excessive monetary growth on the demand side; imported fuel and food costs, rupee depreciation, energy tariff shocks and taxes on the cost side; and weak agriculture, concentrated markets and a chronic external imbalance on the structural side, all welded together by expectations. It can be removed only by attacking the causes together: a tight,

credible monetary policy with positive real interest rates; a smaller, honestly financed budget deficit; a stable external position and exchange rate; energy and agricultural reforms that expand supply; competition enforcement against hoarding and cartels; and targeted protection for the poor while adjustment proceeds. No single measure suffices, and the countries and episodes that succeed — including Pakistan's own stabilisations — are those in which monetary, fiscal and supply policies pull in the same direction for several years rather than for a few months.

Question 5: Role and Significance of Commercial Banks in the Economy of Pakistan (20 Marks)

Discuss the role and significance of commercial banks in the economy of Pakistan.

Introduction

Commercial banks are the core of Pakistan's financial system. Regulated and supervised by the State Bank of Pakistan under the banking legislation, they include large public-sector banks inherited from the nationalisation era, the privatised and new private banks that now dominate deposits, foreign banks, and a growing Islamic banking sector that operates under Shariah principles alongside the conventional one. Between them they hold the great majority of the country's financial assets, run its payment system, finance its government, its trade and much of its industry and agriculture, and transmit monetary policy to the rest of the economy. To discuss their role and significance is therefore to discuss the machinery through which saving is gathered, credit is created and allocated, and payments are made in Pakistan. This answer describes their main functions and the specific roles they play in a developing economy like

Pakistan's, summarises these in a table, gives a critical assessment of their weaknesses, and concludes on their overall significance.

Mobilising Savings and Providing Safe Deposits

The first role of commercial banks is to collect the savings of millions of households and firms into the organised financial system. Through current, savings and term deposits, profit-and-loss-sharing accounts in Islamic banking, and prize and remittance-linked products, banks offer the public safety, liquidity and a return in place of hoarding cash, gold or informal rotating savings committees. The branch networks of the large banks, now supplemented by branchless and mobile banking agents, reach into small towns where no other formal institution exists. Every rupee mobilised in this way becomes potential finance for investment elsewhere in the economy; conversely, Pakistan's relatively low deposit-to-GDP ratio shows how much saving still escapes the banks into cash and informal channels, limiting everything else they can do.

Credit Creation and Financing of Economic Activity

On the foundation of these deposits the banks create credit, multiplying deposits through the lending process described in monetary theory and, more importantly, directing finance to the sectors that need it. They provide working capital and term finance to large-scale manufacturing and textiles — historically Pakistan's leading export industry — trade and services; seasonal crop and livestock loans and input finance to agriculture, often through specialised windows, microfinance linkages and State Bank refinance schemes; credit to small and medium enterprises, which employ most industrial workers but receive a disproportionately small share of bank lending; housing and construction finance, long underdeveloped but promoted in recent years through subsidised schemes; and consumer

finance for vehicles and personal needs. In performing this allocation the banks appraise projects, monitor borrowers and price risk — functions that, done well, direct the nation's scarce capital to its most productive uses, and done badly produce the non-performing loan crises that have periodically shaken Pakistani banking.

Payments, Trade and Remittances

A third role is the operation of the payment and settlement system, the economy's plumbing. Banks run cheque clearing, interbank settlement, cards, ATMs and internet and mobile banking, and they operate on national instant-payment infrastructure such as Raast, making it possible for wages, bills, taxes and business payments to move safely across the country in seconds. Internationally, they issue letters of credit and guarantees that make imports and exports possible, deal in foreign exchange, and channel workers' remittances — one of Pakistan's largest sources of foreign exchange, encouraged since 2020 by the Roshan Digital Account for overseas Pakistanis. Without these services, modern commerce, e-commerce and formal trade would contract towards cash and barter-like informality, with corresponding losses in tax documentation and efficiency.

Services to Government and Transmission of Monetary Policy

Commercial banks are also the government's bankers in the market: they act as primary dealers, invest heavily in treasury bills and Pakistan Investment Bonds, collect taxes and make government payments, and thereby finance the budget deficit — a role so large in Pakistan that bank balance sheets are dominated by government paper, which is both a stabilising support for public finance and, as discussed below, a source of crowding out. Simultaneously the banks are the transmission belt of monetary policy: it is their deposit and lending rates, and their

willingness to expand balance sheets, that carry the State Bank's policy rate into the real economy. No decision of the Monetary Policy Committee reaches a farmer or a factory except through a commercial bank.

Financial Inclusion, Employment and Development

Finally, banks carry a developmental role. Islamic banking has brought into the formal system customers who avoided interest-based finance on religious grounds. Branchless banking and mobile wallets, operated with banks as the regulated core, have opened basic accounts for millions of previously unbanked people; banks execute government-to-person payments such as Benazir Income Support disbursements; and the banking sector itself is a major formal employer of skilled labour and a leader in the country's adoption of information technology. Through priority-sector targets, subsidised refinance for housing, youth enterprise, renewable energy and women entrepreneurs, and corporate social responsibility programmes, banks are used as instruments of inclusion and development policy as well as of profit.

Table 1: Main roles of commercial banks in Pakistan's economy

Role	What banks do	Significance for the economy
Mobilise savings	Accept deposits through branches, Islamic accounts and digital channels	Turns scattered saving into investible funds
Create and allocate credit	Lend to industry, agriculture, SMEs, housing, trade and consumers	Finances production, exports, jobs and investment
Payments system	Clearing, cards, mobile banking, Raast, government payments	Safe, fast, documented transactions nationwide
Trade and remittances	Letters of credit, foreign exchange, Roshan Digital Accounts	Supports exports, imports and a major source of foreign exchange

Finance government	Buy treasury bills and bonds as primary dealers	Funds the budget; links fiscal and monetary conditions
Transmit monetary policy	Set deposit/lending rates, expand or contract credit	Carries State Bank decisions into the real economy
Promote inclusion	Basic accounts, branchless banking, priority-sector schemes	Extends formal finance to the poor, women and rural areas

Critical Assessment: Weaknesses

The significance of Pakistan's commercial banks is qualified by serious weaknesses. Their lending is heavily skewed towards the government and large, well-connected borrowers, while private-sector credit relative to GDP is low by regional standards and SMEs and small farmers remain under-served — the crowding-out effect of persistent fiscal deficits. Non-performing loans have repeatedly risen after credit booms, revealing weak appraisal in parts of the system. Financial inclusion, though improving, still leaves a majority of adults, especially women and rural households, outside formal banking, and the economy remains heavily cash-based, which limits both deposit mobilisation and the reach of monetary policy. High spreads between deposit and lending rates have long suggested limited competition and high costs. These defects do not negate the banks' significance; they define the reform agenda — deeper competition, better credit information and collateral systems, digital documentation of the economy, and reduced government dependence on bank finance.

Conclusion

To conclude, commercial banks are significant in Pakistan's economy out of all proportion to their number, because they perform the functions on which a modern monetary economy depends: they mobilise the nation's savings, create and allocate credit to agriculture, industry,

trade, housing and consumers, operate the payments system and the channels of trade finance and remittances, finance the government, transmit the State Bank's monetary policy, and increasingly carry financial services to previously excluded citizens, with Islamic banking widening their reach on religious grounds. Where they fail — in lending too much to government and too little to small producers, and in leaving much of the population in the cash economy — the whole economy's growth and stability suffer correspondingly. Strengthening their soundness, competition and inclusiveness is therefore not a sectoral concern but a condition of Pakistan's economic development.

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