ABSTRACT
Inflation is an important monetary phenomenon which affects the growth of the economy adversely if it is unstable. The State Bank of Pakistan regulates the inflation mechanism in order to maintain the price level. High levels of inflation impacts the real growth negatively. Hence, controlled inflation and stable price is the prime objective the monetary policy of the State Bank of Pakistan. Therefore, it is important to predict and forecast the future price levels and plan accordingly to keep them stable. This thesis uses the P-star model of Hallman et al. (1991) as the leading indicator of inflation and compares its forecasting ability with univariate Seasonal Auto Regressive Moving Average and Auto Regressive Conditional Heteroskedastic models. Macroeconomic variables of Consumer Price Index, Real Gross Domestic Product, Income Velocity of Money, and Money Supply are used for Pakistan from the period 1970:1 to 2013:4. The three different approaches to estimate and forecast inflation are incorporated with structural breaks. The P-star model successfully predicts fluctuations in the inflation rate thereby providing the policy makers with a useful tool to control the price level.