**Intrusive and misplaced**

BY S A K I B S H E R A N I 2021-03-26

THE government is seeking to rush through (via presidential ordinances) consequential legislation to meet IMF conditionality. One of these pertains to changes in the Nepra Act that will, among other actions, remove the discretion of the government in notif ying electricity tarif f s, and will bind the regulator to a predetermined schedule for very substantial increases over the next two years. This marks the continuation of a failed strategy the IMF and World Bank have imposed on Pakistan to counter the disastrous consequences of the 1994 power policy introduced in collaboration with the latter.

The other perhaps more consequential piece of legislation concerns fundamental changes to the SBP Act. The primary purpose is to make the central bank completely independent of any oversight and accountability from parliament or the government and its agencies. The main elements of the amended act include increasing the tenure of the State Bank governor to five years, with complete protection from removal of office as well as from accountability proceedings or investigations by government agencies, and other fundamental changes to the governance of the central bank. The central bank is also debarred from lending in any form to the government, while it`s `developmental` role via its financing schemes for various sectors will be completely jettisone d.

Arguably, the most controversial and problematic change concerns the State Bank`s mandate.

Under the long-standing SBP Act, 1956, the central bank was given a dual mandate of promoting economic growth along with ensuring monetary stability. Under the IMF-mandated amendments, the State Bank`s primary objective will be ensuring price stability. Support for economic policies of the government has been relegated to a `tertiary` (not even secondary) objective. In effect, the bank will become an inflation-targeting institution and join a handful of mostly developed countries with this sole mandate for their central bank.

These proposed amendments are not entirely new, with the IMF including them in conditionality for each of its programmes with Pakistan since 2008. So why has the IMF pushed for these radical changes? Prima f acie such changes are necessary inthe context of fiscal domination (ie when the central bank is relegated to the money-printing arm of the government), or in the presence of dynamic (or time) inconsistent policymakers. One form of the latter problem could be a less-independent central bank forced by a government f acing elections to sacrifice economic stability and take measures to support the incumbent government`s short-run political objectives. In the current push by the IMF, however, there appears to be an FATF angle too which has brought urgency to the government`s moves.

Nonetheless, it is unclear why the existing regime needs to change in the IMF calculus. While fiscal domination has been a reality in the past, the central bank has increasingly asserted its autonomy over the past decade, if not longer. No State Bank governor has been removed from office by any government midway through a tenure in Pakistan. The existing monetary and financial system in the country has been working well, ensuring coordination between the government and the central bank and promoting economic stability as a result. The financial markets have been comfortable with the status quo and there is not an iota of evidence to suggest that the credibility of the central bank is undermined presently and will be enhanced as a result of this draconian move towards full independence.

Importantly, the proposed amendments will strip the central bank of an inherent mandate of helping the government respond to emergency situations, such as Covid-19, or support for much-needed initiatives such as low-cost housing or export refinance.

Worse, even the theoretical underpinnings for, and `cookie-cutter` application to, a developing country is questionable, especially in the case of inflation-targeting. In developed countries, inflation is more likely to be a result of the economy `heating` up due to a faster increase in aggregate demand than supply (ie a situation of excess demand). This is referred to as a `positive` or inflationary output gap, where the economy is operating at beyond its full capacity. Pakistan, on the other hand, with an average growth rate of 3.6 per cent over the past 10 years,is operating at approximately half its potential rate of output growth. This meansthat inflation in Pakistan, at least over the past decade, has been a function of supply-side factors, terms of trade shocks, currency devaluations, increases in administered prices (such as electricity tariffs) and market-imperfections rather than excess demand.

How an inflation-targeting framework is going to address the issue of inflation in Pakistan`s contextis not just puzzling but also outright questionable. An inability to control inflation has been the government`s Achilles heel over the past two years. In addition, the near-term outlook for inflation is very unfavourable. Hence, while the need to control inflation is beyond doubt or question, given its ramifications for the poor and vulnerable, it requires applying the right policy instruments. For a developing country like Pakistan, inflation-targeting is not among them.

If anything, the clear and present danger is that its premature adoption threatens to permanently suppress economic growth. Pakistan is short on economic growth, and long on constraints to it. The last thing it needs is for a completely avoidable institutional constraint to be added to the list. Here, empirical work on the link between inflation and growth is illustrative. Using data from140 countries (comprising both developed and developing countries) from 1960 to 1998, Khan and Senhadji (2001) found that the threshold level of inflation above which inflation significantly slows growth is estimated at 11pc to 12pc for developing countries.

Ironically, this was published as an IMF staf f paper.

In a seminal paper on the effects of inflation on long-run growth, Bruno and Easterly (1998) found, based on cross-country econometric analysis that `The ratio of fervent beliefs to tangible evidence seems unusually high on this topic`.

In sum, the IMF-proposed amendments to the SBP Act agreed by the government are misplaced, unnecessary, unwarranted and excessively intrusive. Worse, this bad policy advice is not based on a solid foundation.  The writer is a former member of the prime minister`s economic advisory council, and heads a macroeconomic consultancy based in Islamabad.