Comments

I am honored to participate in SBP's conference on Monetary-Cum-Exchange Rate Regime and present my views on a research paper jointly written by Ather H. Akbari and Wimal Rankaduwa, which is concerned with determinants of inflation in Pakistan and whether inflation targeting regime is suitable for Pakistan under prevailing circumstances. The authors made an effective contribution by investigating the impact of changes in economic policy and political regimes on Pakistan's economic performance during the period from 1973 to 2005. Intuitively, the economic management in Pakistan underwent significant changes in the recent past as a result of financial and governance reforms. The paper particularly analyzed the independence of State Bank of Pakistan (SBP) in the conduct of monetary and exchange rate policies under different political and economic environment. The paper also made an attempt to explore determinants of inflation as well as output cost of reducing inflation through monetary tightening. Lastly, the authors assessed the feasibility of inflation targeting in Pakistan based on the results of their estimated model.

The authors have found that change of political governments in Pakistan significantly impacted the monetary policy stance in the past and hence resulted into frequent policy reversals, which impaired the credibility of monetary policy in managing aggregate demand effectively. However, the continuation of policies under the leadership of President Musharaf during the last five years has led to more credible and sustainable monetary policy despite the change of leadership within the central bank, which is also in line with the paper's finding that change of SBP's Governor does not have a significant impact on monetary policy. The Central bank independence has also increased significantly during this period owing to market oriented financial sector reforms, fiscal discipline, good governance at the national as well as institutional level and much improved economic environment amidst political stability.

The authors also confirm the earlier findings on inflation in Pakistan being dependent upon foreign price level, money supply and domestic output level. However, exchange rate pass-through has been found to be insignificant to domestic prices in line with Hyder and Shah (2004). Particularly, foreign price level has been found the most pronounced factor in determining the inflation level as opposed to the collective wisdom that money supply plays a fundamental role in setting inflation trajectory, which has a very little impact on inflation in Pakistan. Because of the inelastic nature of the relationship between money supply and inflation in Pakistan, the monetary authority (SBP) needs to make sharp adjustments in monetary policy in order to keep inflation on the desired path.

Resultantly, monetary targets have been surpassed quite often, which creates monetary instability and worsens the central bank's credibility.

The paper also provides an evidence of long and variable lag structure in monetary policy transmission mechanism and stipulates that output loss of reducing inflation through monetary tightening is significant in the short run by using the sacrifice ratio approach.

For any meaningful regression analysis it is imperative to check the stationarity of all variables used in regression in order to avoid any possibility of spurious regression. However, the paper lacks in applying thorough econometric tests while modeling inflation in Pakistan. Further, the prescribed model for inflation in Pakistan did not explicitly incorporate the determinants of cost-push inflation including administered prices of various crops, technological advancements, capacity utilization, weather conditions, etc. A closer look into the sector-wise inflation in Pakistan reveals that such supply-side factors are predominant in anchoring inflation in Pakistan. Interestingly, Agha et al. (2004) found a significant evidence for inflation to be a fiscal phenomenon in Pakistan and supported by the paper under discussion as well, however, the paper does not include budget deficit in the list of determinants of inflation in Pakistan.

The paper uses large-scale manufacturing (LSM) index as a proxy for national output, which has limitations in terms of its coverage, therefore, it is advised that industrial production index (IPI) may be used as proxy in order to improve the coverage of industrial base and better correlation with national output. The IPI index has been widely used as a proxy for national output in a number of studies featuring Pakistan.

It is also suggested that lag structure may be investigated by using the standard procedure of Hendry's methodology to improve model credibility. Further, dummy variable for exchange rate should be included for period of July 2001 onwards in lieu of free float of exchange rate in July 2001. Also, the central bank independence index should be calculated formally in line with Cukierman (1992). Lastly, sacrifice ratio should be calculated for different episodes owing to structural breaks in the economy.

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