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Monetary and Fiscal Policies Integration: Evidence from Pakistan

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ABSTRACT

The purpose of this paper is to identify the areas in which the coordination between the Monetary and Fiscal policy exists, and recommend the policies to make the coordination effective and efficient. The systematic approach to the process of integration of Monetary and Fiscal polices is to get the design of the integration process, its working, benefits, identification of external factors and their effect on the economical environment, identification of the out comes if any damage came to the economical environment along with the recommendations about how to make the co-ordination more effective in the economy. The methodology used is "Analytical" where all the data from the authentic sources are analysed along with the latest literature review in the context. The finding of the paper includes areas and factors in which there lies the coordination between both the policies, also the importance of the coordination in certain sectors as the lesson learnt from the financial crisis for the developing economies, the implications of the wrong policy making in the developing nation and their recommended solutions.
Key words: *Monetary Policy, Fiscal Policy, Systematic Approach, Financial Crisis, Integration, Pakistan*

1. INTRODUCTION

The Monetary and the Fiscal policies are the basic tools to deal with the economy of the country. In developing nations it has more important job, as the common objective of both of the above mentioned policies is to increase the growth level of the country, along with keeping the inflation under control, both of these policies have there own area of influence and because of these different areas, they adopt different tools and techniques to accomplish the goals, where mostly both of these policies cancel the effect of each other in the economic growth. Designing a Monetary and Fiscal policy in such a way that, both never come across each others way is the core competency of state bank or the central bank (Soli *et al*, 2008)

In recent past when the developed economies were stuck in the financial crisis or if the more appropriate word is used, the credit crisis, the most affected were the developing nations because they did not have enough resources to cope with the financial crisis. Although the developing nations did not have direct hit from the financial crisis but indirectly the effect was much stronger than that of developed nation. The foreign investors in the developing economies suck their investments from the market, leaving them in jamming of the wheel of economy (see, Mitchell, 2005).

The only tool and hope remained with the developing economies was Monetary and Fiscal policy to be implemented upon the FDI (foreign direct investments) in the country e.g. foreign banks and MNCs. Now in short run this option looks effective but in long run this is the real damage to the economy, because slowly this FDI flows out of the country's economy.

1.1. Boundaries of Fiscal Policy

The two main instruments of Fiscal policy are government spending and taxation. Changes in the level and composition of taxation and government spending can impact on the following variables in the economy:

- Aggregate demand and the level of economic activity;
- The pattern of resource allocation;
- The distribution of income.

Fiscal policy refers to the overall effect of the budget outcome on economic activity. The three possible stances of Fiscal policy are neutral, expansionary, and contractionary:

- A neutral stance of Fiscal policy implies a balanced budget where G = T (Government spending = Tax revenue). Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.

- An expansionary stance of Fiscal policy involves a net increase in government spending (G > T) through rises in government spending, a fall in taxation revenue, or a combination of the two. This will lead to a larger budget deficit or a smaller budget surplus than the government previously had, or a deficit if the government previously had a balanced budget. Expansionary Fiscal policy is usually associated with a budget deficit.
- A contractionary Fiscal policy (G < T) occurs when net government spending is reduced either through higher taxation revenue, reduced government spending, or a combination of the two. This would lead to a lower budget deficit or a larger surplus than the government previously had, or a surplus if the government previously had a balanced budget. Contractionary Fiscal policy is usually associated with a surplus (Economic Survey of Pakistan, 2009-10).

1.2. Boundaries of Monetary Policy

Monetary policy is the process a government, central bank, or monetary authority of a country uses to control (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy. Monetary theory provides insight into how to craft optimal monetary policy.
Monetary policy is referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy involves raising interest rates to combat inflation. Monetary policy is contrasted with Fiscal policy, which refers to government borrowing, spending and taxation.

The present study has following sub-sections: Section 2 contains general proceedings of the economy. Literature review is in Section 3. Objectives of the study described in Section 4. Data sources and Methodological framework are given in Section 5. Conclusion and policy recommendation are in the last Section 6.

2. GENERAL PROCEEDINGS OF THE ECONOMY

When a country uses a high taxation tool, the corporations show loss in their balance sheet with the help of dummy expenses and get themselves exempted from the taxation that means in order to gain more revenues the country looses even the small amount of revenue. In order to save the economy from this loss, a proper policy is required to impose taxation, which still lacks in the charter of State bank.

It is important to understand that the masses came to know about the crisis on 14th of September 2008, after the crash of Wall Street. But originally crisis began in the mid of 2007 as the interest rate in the housing sector and mortgage sector started to rise. The easy lending of credit provided opportunities for the people to take loans even by the bad credit history. As in 2005 when the economy was on boom the mortgage business flourished by the record rate, property value increased and people refinance their homes with lower interest rates and take out second mortgage again the added value to use the funds for consumer spending. In US house hold debts percentage of income rose to 130% during the 2007, versus 100% earlier in the decade. The increase in interest rate in 2007 and 2008 make lenders to “walk away” from their homes because of the non payments of the loan, their income was much more less than that of the interest and principle amount of the loan. Some were unwilling to sell their homes. This create the situation of getting default and thus resulted in mortgage crisis because all of this investment was insured by the insurance tycoon AIG insurance and when the mortgage tycoon Lehman Brothers and others went to AIG for the insurance money, it was unable to pay billions of dollars and thus defaulted, leaving a big gap in the market and AIG was the insurance company of world insurance companies and by the default of AIG, all depended companies defaulted in the world, transforming a national crisis to international crisis. AIG was latterly bailed out by the government but by that time damage was done (see, World Bank, 2008, a).

Financial crisis in Pakistan is complex in nature. Pakistan was facing high inflation rate, international default risk, low foreign exchange reserves, stock exchange crash, and time to time government intervention in the market and last the balance of payments deficit problems. Initially the global crisis did not impact Pakistan in September 2008 and for investment point of view it was the ideal market (September and October 2008). At that time Pakistan was having high inflation rate i.e. 25%, but still it was a good market. Investor who had extracted it’s all investment from the world was looking forward a market like Pakistan to invest, it is important to understand that a investor merely concentrate on the profit, social predicament may neglected if the profit is healthy, even plans were made on the investment agencies level for the issue of investment in Pakistan. The months of September and October, 2008 were the opportunity period for the Pakistan but unfortunately these opportunities were not viewed (Economic Survey of Pakistan, 2009-10).

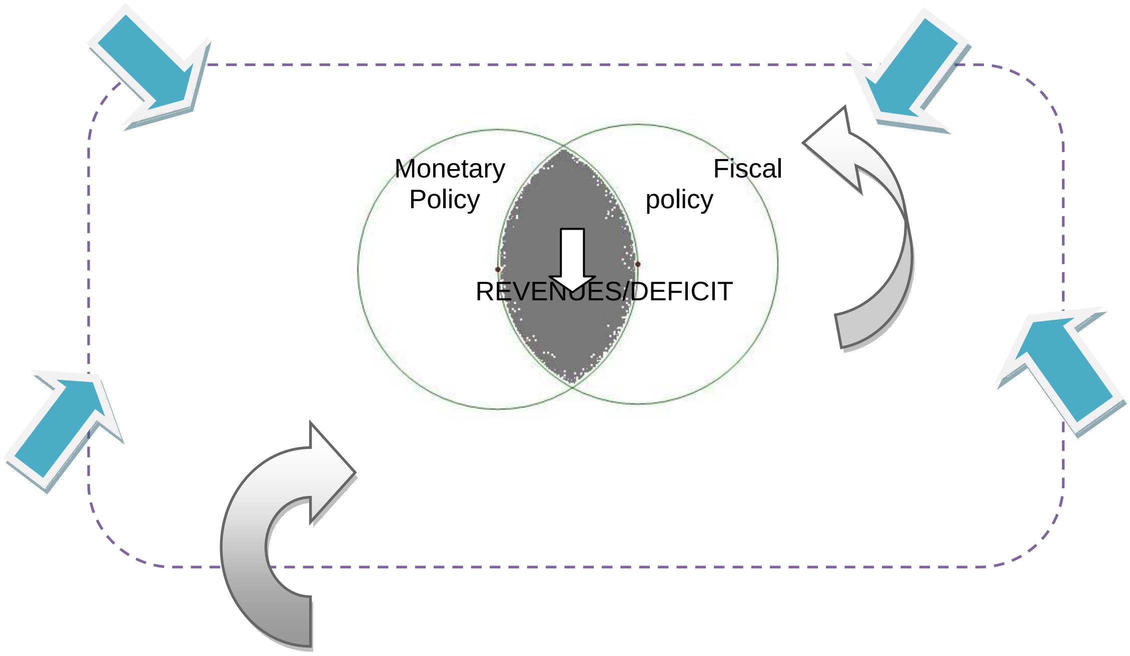
In mid of October, 2008 the advisor to prime minister of finance Mr. Shaukat Tareen gave a statement that “Pakistan will default in 30 days” and then things changed and investors flew from the market of Pakistan, almost $ 8.1 million has been flew from the market of Pakistan, point to be noted here that if this investment remained in Pakistan, the government had no need to ask the help of IMF. Pakistan is fighting a global war, therefore, for the international peace; all international community will help Pakistan. In October, 2008 domestic and international both investors changed directions of their investments to economy like India and china. By flow of this investment outside, Pakistan was surrounded by the financial crisis of the world. President of Pakistan, Mr. Asif Zardari knocked each and every door for the loan and it came to know that each house was itself in crisis and the Pakistan have to go to IMF. The BOP deficit increased day by day and in the situation when every one is saving each and every penny, Pakistan was importing items from all over the world and therefore IMF first condition was to spend that much you have in pocket.

Another aspect of the crisis was high commodity prices especially of oil and food, this damaged the world economy a lot and even in some parts of world like Pakistan it even started stagflation. It was 2008 when the oil prices rose to $147 per barrel although it came down soon but till then it had done the damage to the economies of the world. Another factor that could be seen is the wrong policies of the world and the war on terror. In history after both 1st and 2nd world war, the world economy have faced economic and financial crisis but 21st century is much more faster than before and the problem that have to be seen in next couple of years (World Bank, 2008, b).

The role of the state bank and its tools was as important as it will be always but, putting the entire burden on the state bank is not justice. The state bank has to make policies but its Fiscal policy could not stop government to spend on the war on terror and when there is a foreign aid, this aid is given to the government and then government gives that money to the state bank, the role of the state bank should be change in this aspect. The foreign aid, just like the loan of IMF, should directly go into the reserves of the state bank. The schematic flow chart in figure 1 is for ready reference.

Figure 1: Co-Ordinations in the Policies and the External Factors

Stock Market Crash **High Oil Prices**



Terrorism Currency Devaluation

In figure 1, the whole process of the Monetary and Fiscal policy co-ordination is sketched systematically, the Monetary policy have its own way of working and follow a specific orbit to gain the maximum benefit. On the other hand the Fiscal policy has its own working and its own orbit. Both of them work almost opposite to each other in opposite direction of making the economy run on the track. There is a very small portion that both of them share with each other and this share provides the government with the revenues. This process of gaining the revenues will continue until both the policies work under their own area with the same orbit and same speed.

But there are external factors mostly in the developing countries i.e. terrorism, stock market crash (most of the developing countries have weak markets), high oil prices and local currency devaluation and many others effect the span of there two policies. When these factors influence the working of Monetary and Fiscal policies the orbit and the way of working of these policies get 180 degree to their current rotation and cancels the positive effects of their co-ordination and instead of revenues, economy faces deficit. e.g. in the end of 2008 and start of 2009 when the oil prices were high to 148 $ per barrel, the government spending increased along with subsides to the industrial sector and to the direct consumers, as the transportation depends upon the fuel so high oil prices increased the percentage of inflation in the economy, to control the inflation the government have to restrict the spending by introducing high Monetary policy (World Bank, 2008, c).

There are certain ways by which the policy making of the government and state bank could engage risk of internal conflicts of both Monetary and Fiscal policy. Increase in imports and the policies for the social problems are the loop holes at the government end and borrowing unnecessary money to the government is the problem at the end of state bank. Also there is another factor that is the internal environments in which Monetary and Fiscal policy are working do have some other barriers like the foreign policy of the government and the budget and the expenditures design by the ministry of finance. The policies recommended by the state bank are mostly neglected while making a policy, proper policies should be define to include the recommendation of state bank in order to minimise the transparent barriers in the way of the policies and tools of state bank, so that there should be the smooth running of the tools of the state bank at least internally.

Before the policy is designed another aspect that should be considered is the complexity and area of working of the policies, in the diagram the diameter of each individual policy shows its area of working/influence. If the area of influence is designed broader than the capacity of the economy, which includes government reserves, infrastructure, consistency, increase in import bill and long term planning etc, then the economy has to face the situation of deadlock with its own polices. The best example could be the leasing of the cars in early 2000's. At that time policy was not designed by keeping the boundaries of economy in mind, and the diameter of the policy exceeded the economical environment. The effects of this design were seen in the form of oil crisis and the BOP deficit. The infrastructural element of the economy did not support this design and the government spending again increased in the form of developmental expenses of maintain and carpeting new roads and other infrastructures. Also when the diameter of policy exceeds the economic volume it collides with the boundaries of the economy jamming all the activities including the other activities that have no thing to do with the problematic design, same in the case of car leasing state bank in order to discourage the leasing of cars increased the interest rate that affected the other banking activities (World Bank, 2008 a).

Another important issue is the diameter of both of the policies, that means the importance and taking both of the policies together, none should be designed in a way that other become under estimated. If the diameters are different then the co-ordination area will decrease and the rotations of both of the policies will be effected, most probably they will jam one another and if not then the intervention of one policy in the others area will increase the possibility of jamming the whole system to economy and in case of Pakistan this is very dangerous, as the economical boundaries are playing the role of firewalls for the external effecting factors, if any hole or any weakness is seen in the boundary the external factors can damage the economical growth or environment from inside and it will become difficult for Pakistan to stabilize from the internal damage. Leave the economy behind, the survival of the public will become difficult, as there will be no source of income or in simple words there will be no economical activity in the country (World Bank, 2008 c).

The above mentioned figure (1) fully supports the phenomenon that the external influences of the social non state elements put certain amount of pressure on the working of Fiscal and Monetary co-ordination, which is already low due to their nature. A conclusion of the co-ordination can clearly be illustrated with, real time values and data, and proper percentage of the influence of the external factors. In the case of financial crisis this rotation moves faster making things more complex. The co ordination between the Monetary and Fiscal policy become vital for the economy, along with the involvement of other monetary matters into the Fiscal matters (see, Athey *et al*, 2005).

3. LITERATURE REVIEW

Fiscal Policy and Monetary Policy: How They Work Together to Stabilize the Economy

"Both Fiscal policy and Monetary policy each serves its own purpose and is most effective in its own way. Monetary policy succeeds in slowing economic growth while Fiscal policy succeeds in expanding economic growth. Together the two have the ability to stabilize the economy" (see, Leigh and Stehn, 2005)

Transcript of a Conference Call on the Executive Board Conclusion of the Third Review under Pakistan Stand-By Arrangement

"IMF Executive Board completed the third review on the standby arrangement, allowing Pakistan to obtain about $1.2 billion more from the IMF. The welcome news on the macro front is that stabilization is progressing. The budget and external current account deficits have declined. Reserves have increased to over three months of imports, and, importantly, inflation has declined from 25 to 10 percent, reducing the tax on the poor. The government has also taken important steps towards structural reform, putting in place the framework for moving toward a value-added tax, improving tax administration and also strengthening the central bank's ability to conduct Monetary policy more independently, and also with better abilities and powers to supervise the banking sector. Nevertheless, there are significant challenges that remain. Significantly, the budget needs to be managed better. There is a need to fully reverse the first quarter Fiscal outturn and slippage, and avoid future overruns to keep inflation low, build economic confidence and ensure that resources are available for poverty reduction, assisting internally displaced persons and boosting social spending. Given the likely need for higher security spending, this will require efforts to mobilize revenue and cut non-priority spending in the months ahead. International donors also need to disburse the pledges they made to Pakistan in the Tokyo meeting in April of this year. They need to do so promptly because these disbursements are meant to finance much needed investments in infrastructure, health, and education. As inflation continues to decline, monetary policy could become more flexible and allow interest rates to come down further. The uncertainties about the financing needs of the government are limiting the central bank's ability to lower interest rates" (see, IMF, 2009).

3.1. Monetary Policy

Pakistan Monetary policy is currently dealing with the serious problem of inflation. If the state bank dares to use it in the scenario of financial crisis, a new crisis will arise and Pakistan is not in a situation to have any more crises. Although this tool can be use with such a technique that it produce maximum results, but relying totally on monetary policy is foolishness. It could be use in such a way that it reduces inflations and also helps in attracting the potential investors to the country. This can be achieving in a way that tight Monetary policy should be used i.e., Open Market Operations etc. (see, Khurshid *et al*, 2009).

3.2. Import Taxations

Pakistan is facing a high BOP deficit and it is the biggest problem for the country, because of this deficit the foreign exchange reserves of the country are declining and Pakistan faced the risk of default. The biggest import of Pakistan is oil and automobiles. Oil is essential for the economy of developing nation and for industry but other than that a high import tax should be imposes on the entire luxury item, including cars, furniture and all consumer products. In this way the BOP deficit will reduce and revenues of the government will increase. It is important to understand that the Government of Pakistan is poor but not the people of Pakistan, 22 families of Pakistan have lot more of assets than the Government (Economic Survey of Pakistan, 2009-10).

4. OBJECTIVES OF THE STUDY

The main objectives of the study are given below:

- Identification of the reason behind the financial crisis 2008.
- To find out the effects of the financial crisis on Pakistan by recent happenings and with the help of economical data
- Identification of the areas of co-ordination of Monetary and Fiscal policy and identification of areas where this co-ordination is needed and should be improved and the effects of this lack of co-ordination of Monetary and Fiscal policy on over all economy
- Recommendations for the system when the co-ordination is not possible.
- Identification of the reasons because of which the co-ordination is not possible in governmental departments.

5. DATA SOURCE & METHODOLOGICAL FRAMEWORK

Publicly available data from renowned sources is utilized, i.e., Economic Survey of Pakistan (2009-10), World Bank reports (2009), IMF (2009), Asian Development Bank (2008), G-7, G-20 summits reports,

friends of Pakistan conference and International Financial Statistics. The methodology used is "Analytical" where all the data from the authentic sources are analysed along with the latest literature review in the context.
The boundaries and the limitations of the both Monetary and Fiscal policy along with the systematic approach to the working of the these policies it could simply be concluded that the co-ordination of the Monetary and Fiscal policy could lead to growing economy with a considerable amount of revenue but on the same time if there is in-coordination between them it could lead to the most worst damage to the economy and the economy have to face the deficit along with the risks of internationally default, same that has been seen in the case of Pakistan. The external factors also affect the working of both the Monetary and Fiscal policy together. In order to reduce the influence of external factors following recommendations could be made after anglicizing the data and facts.

5.1. Separating the Governmental Policies from the Tools of State Bank

The government should take steps in order to separate the policy making and the influence of the governmental policies on the external factors that influence the co-ordination of the Monetary and Fiscal policy. The external factors should be identified and must be reviewed after the fixed period of time. The political influence should also be reduce on the affairs of the state bank, the best example can be the central bank of USA, where the national congressman politics and policies are far away from the affairs of the central bank, it have both its advantages and disadvantages but there is a price of every gain, the very first law of doing successful business (ADB, 2009).

5.2. Increasing the Mutual Areas of Influence of Both the Policies

Increasing the area of influence of both, Monetary and Fiscal policy i.e. the shaded area in the diagram is difficult but by designing policy in a way that both co-ordinate with each other could be helpful e.g. in industrial and agricultural sector there are loans for specifically for these sectors along with the governmental subsidies in both of the sector, that means government spending and then the taxation is different from the other sectors of economy. In this way both Monetary and Fiscal policy can co-ordinate with each other.

Here this should also be noted that in both of the above mention economic sectors i.e. industrial and agricultural, Monetary and Fiscal policies are not co-ordinating efficiently that's why Pakistan have to face certain crisis in the agricultural sector and also a lot of industry is shut down. Leaving the sugar and wheat crisis behind, the farmers have to face micro level of crisis every time they intent to plough the farm.

The other sectors that could be included in the co-area of influence could be, small and medium industry (home based industry), banking (co-ordination is still lacking up to a considerable amount), automobile industry and most of all it could help in attracting the new foreign investors to the country. Special policy steps should be introduced for the investors who want to do FDI in the country, or if the investor is doing the investment first ever time in the country. This will help in encouraging the investors who still have fear of the financial crisis and have considerable amount of investment in hand (ADB, 2009).

5.3. Measurement Sample for the Country Progress

Developing countries have weak stock exchanges that mostly work on the speculations and rumours and these speculations are the major reasons for the stock exchange crashes in most of the developing country. Foreign investors do the financial decision on the basis of the stock market strength and growth, which is not in the favour of the developing countries. The most favourable sample to measure the growth rate should be the amount of investment in the infrastructural and other developmental investments in the country, as the developing nations always have good amount investment in these projects and is unable to invest in the area where the economical activities are fast, this is due to the many factors like, lack of infrastructure, poverty etc, and government have to do such spending that give relief of the public in general. This investment leads to the low foreign exchange too, which is again a measure mental tool for the growth and reliability of the country, which is again not in the favour of the developing nations, as the foreign investors will hesitate to invest in the country.

5.4. Exploiting the Useless or Out Of the Circle Resources in the Economy

In the case of Pakistan the out of the circle of the economical activity resource is the biggest province of Baluchistan. It is the duty of state bank to encourage the investors to invest in the areas of Baluchistan with the help of the available tools, for example the industry in Baluchistan is tax free for 10 years and some incentive on the Gawadar port and it will give two benefits

- The unused resource i.e. land, will be used. The coastal area and then the other adjoining areas will become the industrialized zone, as the industry will do the production and will directly export the product from Gawadar port.

- The trade in the way of export will increase from the Gawadar port, it will help in reducing the BOP deficit and also the port of Gawader will become the trade centre for the world

It have many other benefits for the domestic economy like reduction in the unemployment, increase in the income of people, educational boom, focus and burden from Karachi will reduce helping in making easy and friendly financial policies for the rest of the industrial zone (Economic Survey of Pakistan, 2009-10).

6. **CONCLUSION AND POLICY RECOMMENDATIONS**

The conclusion that could be extracted from the whole debate is that the recent financial crisis did gave certain lessons on the co-ordination of the Monetary and Fiscal policy but the bigger lesson was that relying on certain policy or the sector of economy is dangerous for the economy itself. The co-ordination between these two policies is difficult in good times and the co-ordination in the time of crisis is not more difficult then impossible. Until and unless the areas of the mutual influences are increased and make efficient the co-ordination make no sense, the developing countries should focus on designing the sectors of economy in such a way that they get influence both by Monetary and Fiscal policy. Co-ordinating them is good for nothing, making no difference but more difficulties. One other major aspect, that is emphasised above all is the separation of the affairs of the central banks and the national politics, so that the central banks could be sovereign in making decisions and then be responsible for the policies they made and be available for the court of justice in case of any lack of responsibility by experimental activities with the money of the 170 million tax payers in the case of Pakistan.

There are following proposed recommendations in this scenario:

- The policies for the Monetary and Fiscal policy should be long term and consistent
- The policies recommended by the state bank should be implemented/ included by the government in the federal policy making.
- Both of the policies should be design be keeping in view the growth and the other social activities in mind
- A proper commission should be made to forecast the coming crisis or booms in the market
- Political influences of the decision of state bank should be reduced to zero
- Proper forecasting in the major sectors of the economy should be made before designing any policy
- State bank should take steps to encourage the FDI in the un-skimmed area of economy so that the earning of the government increase and the internal and external borrowing of government should decrease.

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