Yaseen Anwar: Fiscal and monetary policies

Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at National Defence University, Islamabad, 4 November 2013.

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Respected guests, esteemed servicemen, and students of this prestigious institution,

Assalam-o-Alaikum!

I am delighted to be invited to the National Defence University to talk about Fiscal and Monetary Policies in general and in the context of Pakistan.

It is a fact, not many students like economics as a subject. But it is also true that not many subjects impact our lives as does economics. It is therefore not surprising that everyone likes to jump into discussion on economic issues even if their knowledge (on the subject) is rudimentary. One just has to flip thru channels on TV to see the variety of views on the subject, which are not always correct or informed. Over the years SBP through its various publications and seminars, has been trying to enhance the understanding of the general public on various economic issues. I would like to think that it is partly because of SBP's efforts, that the general public today is much more aware of economic issues than they were, say ten years ago.

I am sure you already have heard a great deal about monetary and fiscal policies, and there may be little I can add to enhance your knowledge on the subject. What I can do however, is to try to bridge the gap between theory and practice. In text books, monetary and fiscal policies appear simple enough and desired objectives can be achieved by manipulating policy instruments. The question arises:

- Why do countries find it so difficult to get their policy mix right?
- Why countries cannot strictly control the supply of money to keep inflation in check?
- Why do countries struggle to smooth out economic fluctuations?
- Why are countries' fiscal accounts always imbalanced?

The reason is that policy goals often conflict with each other, and economic variables cannot be determined in isolation. Therefore, while it is important to know about the policies individually it is equally if not more important to understand how these policies interact with each other.

Broadly speaking, monetary policy involves central banks' use of policy instruments to influence interest rates and money supply in order to keep overall prices and financial markets stable. The policy could be "*expansionary*", to stimulate economic growth or "*contractionary*", to check the rising price levels (inflation).

Fiscal policy, on the other hand, is government's management of its revenues and expenditures to achieve economic stability. The revenues mainly come through direct and indirect taxes besides non-tax collections through privatization and auction of license (like 3G licenses in telecom sector). Hence one can say that Fiscal Policy is managed by the Government whereas Monetary Policy is conducted by the Central Bank.

Best practices require that both policies are coordinated in order to achieve the common objectives of financial and economic stabilization to promote sustainable growth.

The global financial crisis and the subsequent recession, particularly in the developed world, have, however, elicited unconventional changes in the design and implementation of monetary as well as fiscal policies. The magnitude and the spread of the crisis have not only tested all the policy options available to policymakers across the board but have also renewed debate on the longstanding pillars of macroeconomics. Monetary authorities in the advanced economies responded by aggressively cutting policy rates and adopting several other "unconventional" measures aimed at providing stimulus to the economy directly. These measures represent important policy relevance for the existing institutional framework and policy instruments across world economies.

Governments, these days, through their fiscal policy, do not limit themselves to accounting for revenues, expenditures and budget making. Nor do they restrict themselves to just mobilizing, allocating and redistributing national resources in the short and medium term. The ever changing economic landscape has forced countries to expand the ambit of their policies, both monetary and fiscal, to ensure financial stability as well. The global financial crisis of 2008 is one such example where the governments of the developed world (like USA and UK) had to step in and bail out their distressed financial institutions, at an unprecedented scale, using tax payer's money.

The ripple effects of the crisis, which primarily began in the developed countries, soon spread globally. Especially, those countries which had borrowed beyond their capacity to repay were the hardest hit. As cheap liquidity dried up and lenders started demanding higher interest rates or in some cases even refused to lend, highly indebted countries of Europe such as Greece and Italy, then had to agree to severe austerity measures proposed by the Troika (IMF, European Commissions and European Central Bank) as part of the bailout terms. The imprudent fiscal policies of the governments of those countries were to blame for their plight.

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The use of monetary policy was also broadened from keeping prices in check through optimal determination of interest rates, to fighting recessions. During the crisis, apart from utilizing standard tools such as interest rates, central banks around the world used unconventional measures such as *quantitative easing* (QE) to provide cheap liquidity in the market to stem erosion of investor confidence. Thus, fiscal and monetary policies are no longer restricted to their traditional roles.

In Pakistan, however, the situation under which the fiscal and monetary policies have to operate is fundamentally different and far more complicated. First, we have not had sustained periods of political and economic stability in recent history. We have been at the forefront of the war on terror for over a decade now. Besides damage to life and property, this participation has resulted in a huge strain on our country's meager resources, which has not been fully compensated for. Second, the power sector crisis has crippled a significant part of economic activity. Inappropriate policies, which offered guaranteed equity returns and disregarded what is an appropriate fuel mix for the country,[1] price distortions, expensive and poorly targeted subsidies, inefficiencies in the energy supply and distribution, and low recoveries have resulted in a crisis gripping the power sector. Persistent energy shortages have resulted in a decline in the productive capacity of our industrial sector which has lead to an increase in unemployment. Third, lack of diversification and innovation in the economy combined with scarcity of entrepreneurial talent has made us depend on a few sectors for economic growth and export earnings, such as textiles.

Fourth, instead of exploring and developing abundant natural resources in the country, we import a number of essential goods like crude oil, that are, to a large extent, price inelastic (FYI every $5 reduction in price saver us $750 million in FX for the year). Fifth, from general public to higher echelons there is a general culture of tax evasion which limits the ability of the government to raise an appropriate amount of revenues. Sixth, a sizeable chunk of our

1 Munir, Kamal A. and Khalid, Salman. 2012. "Pakistan's Power Crisis: How Did We Get Here?" *The Lahore Journal of Economics* 17: 73–82.

economy is in the informal sector which remains undocumented and therefore beyond the tax net. Seventh, public sector enterprises instead of being a source of revenue for the government eat up scarce resources every year.

Finally, we have had the misfortune of sufferings due to natural disasters i.e. floods and earthquakes in the recent past. All these endogenous and exogenous factors have resulted in domestic and external sector deficits with the private sector unwilling to invest and limited participation of foreign investors.

Given these circumstances and successive government's failure to implement major reforms, fiscal policy in Pakistan in recent years has mostly been "fire-fighting". We have been trying to bridge the gap between growing expenditures amid falling revenues mostly through borrowings (both internally and externally).

Since the year FY06, we have not witnessed any substantial primary surplus in our budget. The current revenues have not been enough to account for current expenditures of the government. If we add to it the ballooning interest payments, our budget deficit has been hovering around 6.5 percent of GDP, on average, over the last five years (FY09–FY13). In FY13 alone our budget deficit was 8 percent of GDP, which is one of the highest for Pakistan.

The primary reason for these large budget deficits has been low tax collections. Although there has been a consistent gap between Federal Board of Revenue's (FBR) budget targets and actual outcomes in the last few years, the gap of Rs445 billion in FY13 was exceptionally high. In fact, this was more than the cumulative shortfall of Rs349 billion during the last five years. Not surprisingly, therefore, the estimated fiscal deficit of 8.0 percent of GDP in FY13 was considerably higher than the budgeted target of 4.7 percent of GDP.

Development expenditures, needed to sustain economic growth in the wake of receding private investments, have remained in a narrow range of 2.8 percent to 3.6 percent of GDP, during the last five years. On the other hand, debt servicing to current expenditure has jumped up from 35 percent in FY08 to 42 percent in FY13. This has resulted in average real economic growth remaining around 2.9 percent during the last five years. In fact the stock of government's domestic debt i.e. borrowings has almost tripled since FY08 to reach Rs9.5 trillion as of end FY13.

That the private sector investment is being crowded out due to excessive government borrowing from the banking system does not bode well for the external front as well. Despite SBP's incentive scheme for exporters, the exports have remained stagnant at around 10 percent of GDP while imports have increased to 17 percent of GDP over the last five years. The resulting trade deficit coupled with meager net capital and financial flows and the external debt servicing costs put tremendous pressure on the reserve position of the central bank. A ray of hope is our workers' remittances, which were around USD14 billion in FY13 with a 9% increase in the first quarter of this financial year. However, unless we are able to bring our trade deficit to a manageable level and create an enabling environment to help increase net foreign capital and financial flows, workers' remittances alone cannot provide sustained support to our reserves position.

Under these circumstances, the Government had to approach the IMF again for a medium term loan (i.e. Extended Fund Facility or EFF) to ease pressure on our balance of payments. Being in the IMF program increases the chances of receiving a higher amount of financial inflows besides stabilizing markets and improving the credibility of the country.

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As a consequence of dwindling foreign inflows and low tax collection, the government had to resort to high level of borrowings from the banking system. During FY13, it borrowed over Rs1.4 trillion from the banking system of which Rs506 billion was borrowed directly from the central bank and the rest from the scheduled banks. Considering that the proposed outlay of the entire budget was Rs3.2 trillion, this volume of borrowing constituted 43 percent of the budget. This trend is indeed problematic and does not augur well for the economic management and growth of the country.

Given this fiscal dominance and its impact on the balance sheet of the central bank, the role of monetary policy has been severely restrained. Some might argue that the State Bank, as an independent organization, should have taken a tough stand against the government's insatiable bank borrowings. But, it is imperative to understand that any disruption in payment systems can potentially result in as negative repercussions for the economy as its inflationary consequences. This is the reason that SBP, despite not being comfortable to the idea, allowed the government to borrow from the banking system. Nevertheless, this trend needs to be checked in future.

Notwithstanding constraints, SBP took several measures to achieve price stability and economic growth. In addition, it also took steps to safeguard depositors' interest in recent years. SBP followed an accommodative monetary policy by lowering interest rates by 500 basis points over the last two years in the wake of declining inflation. It also undertook interventions to contain volatility in the foreign exchange market. It calibrated its liquidity operations in a manner that balanced financial stability considerations and medium-term inflation risks.

Moreover, to protect the depositors of the banking system from any undue decrease in interest rates by the banks, SBP imposed a minimum rate of 6 percent on savings deposits and has recently linked this minimum rate to its repo rate. The minimum rate on savings deposits now stands at 6.5 percent.

As a result of these actions, the weighted average lending rate declined by 423 basis points by end-July 2013 while deposits of the banking system grew by 15.9 percent and the depreciation of the exchange rate was limited to 5.1 percent in FY13. Moreover, a declining interest rate environment did contribute in a marginal pick up in loans to some sectors of private businesses in FY13 and Q1-FY14.

However, as has been the case for some years now, most of the credit disbursed during FY13 was utilized for working capital requirements only; loans availed for fixed investments show retirement. Thus, there has been no real broad-based recovery in credit utilization by the private sector. As a result, real private investment expenditures have declined for the fifth consecutive year, reaching 8.7 as percent of GDP in FY13.

This shows that higher interest rates were not the major constraining reason for the private sector credit off-take. Two fundamental factors responsible for the lackluster increase in credit demand are: persistence of energy shortages and deterioration in law and order conditions. Unless we overcome these, chances of reviving the economy through monetary policy stimulus would remain thin.

Despite being in the IMF program, going forward, however, the challenges remain. The pressure on the external front has not fully abated. The foreign exchange reserves of the central bank as of October end, 2013 stand at US$4.3 billion and rupee dollar parity at Rs106 per dollar. Moreover, there are certain performance criteria for the IMF loan that we have to meet. We also need to implement strict reforms on the fiscal side. It needs to be understood that these reforms are absolutely essential. The aim of these reforms is to balance the budget in the medium term and reduce public debt to create space for private sector investments.

Further, we need to be highly cautious and selective in terms of public expenditures as our debt burden continues to grow. It should be kept in mind that excessive public indebtedness cannot be cured with more debt. No government can sustain itself for long by borrowing heavily from the banking system. The unsustainable level of public debt and its borrowing costs can severely impact the economy. Some countries in the European Union, like Greece and Cyprus are an example.

Furthermore, a host of issues need to be tackled including but not limited to law and order situation and energy shortfalls. A sustainable level of public debt will create space for the development expenditure to build infrastructure for sustainable economic growth; the deterioration of law and order situation is a big barrier and erodes investors' confidence, both local as well as overseas; and the energy shortages hamper industrial growth and hence the real growth of the economy. A long term and sustainable solution to these problems should top the economic agenda of the government.

In the end, I would like to say that if we commit ourselves to making tough decisions and implement reforms in the fiscal and external sectors then the problems faced by us can be resolved.

Thank you