A reinterpretation of Pakistan's "economic crisis" and options for policy makers

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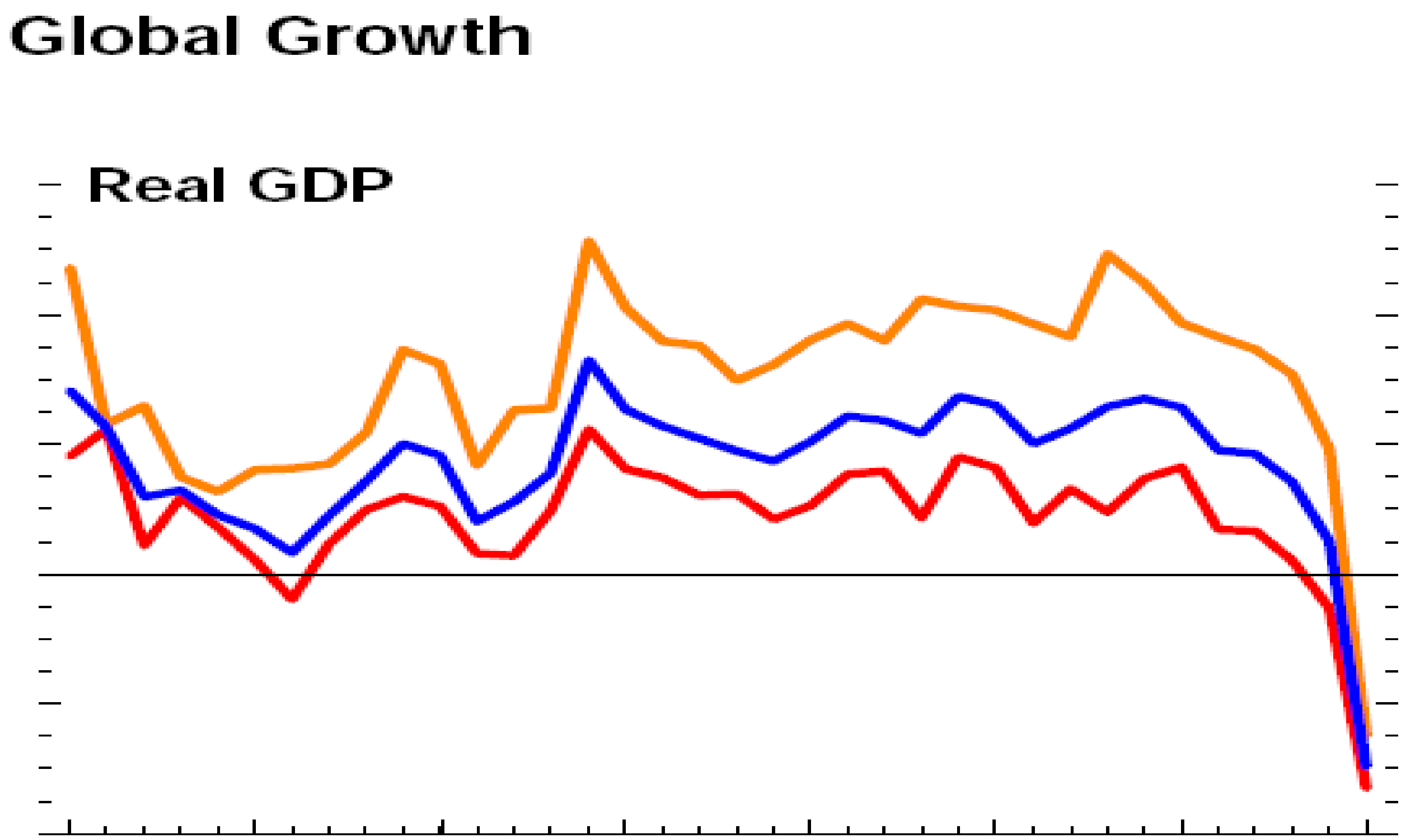
Overview of the Presentation

I. Why is Pakistan in trouble again?
II. The IMF Program
III. Objectives of Pakistan’s Government
IV. Macroeconomic foundations of an alternative policy approach
V. Full Employment and Price Stability: The Job Guarantee (JG) Approach
VI. Proposals to deal with the crisis

The global context … IMF G-20 outlook



IMF G-20 outlook …

- “Global activity is expected to decline by around ½ to 1 percent in 2009 on an annual average basis, before a recovery emerges gradually in the course of 2010.

  The turnaround depends critically on more concerted policy actions to stabilize financial conditions as well as sustained strong policy support to bolster demand.”

IMF G-20 outlook …

- "… central banks should … keep … rates low until a recovery firmly takes hold."

- "With constraints on the effectiveness of monetary policy, fiscal policy must play a central role in supporting demand …"

IMF G-20 outlook …

- "In most countries, corporates will be forced to primarily access domestic banks …
- Some governments may be called on to support firms that face high rollover needs but are not able to raise financing"

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Main Messages (1)

- Pakistan is in trouble. Polices that led to high growth were unsustainable.
- In the short run, there was no alternative but to urgently restore FOREX reserves
- The IMF program will help restore FOREX but it may have negative implications for long-run growth
- Pakistan's long-run objectives should be full employment and price stability

Main Messages (2)

- Growth is not an end in itself; BOP and budget balance are misrepresented objectives.
- A floating exchange rate plus a sovereign currency provide a Government with options that are not fully understood by many economists.
- An employment buffer allows government to achieve full employment and price stability.
- Although Pakistan has entered an IMF program with conditionalities, it still has some flexibility to minimise the damage arising from the crisis.

I. Why is Pakistan in trouble again?

- The *Economist* - country has been living beyond its means.
- Both inflows of capital and workers' remittances, together with government deficits promoted high growth rates.
- But the stimulus was not accompanied by increases in productive capacity.
- The FDI and net government spending were biased towards consumption.

I. Why is Pakistan in trouble again?

- Result: aggregate supply and demand moved in opposite directions - generated inflation and depleted foreign reserves.
- This approach relied on capital inflow outpacing the rising CAD (adding foreign reserves).
- But it became unsustainable in 2008 as the pace of inflows slowed and the country started running out of reserves.

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I. Why is Pakistan in trouble again?

- The depreciating rupee will not solve the CAD alone, given Pakistan's trade composition.
- Depreciation also:
  - adds to the inflation bias.
  - promotes expectations of further depreciation which fuels the currency run out.
- There may be no interest rate high enough to counter expectations of losses due to depreciation and possible default.

I. Why is Pakistan in trouble again?

- We agree that the model was unsustainable and that the country had to ask for assistance … or default.
- In the short run there is probably no alternative but to urgently restore FOREX reserves.
- Key: But will the IMF conditions hinder sustainable development?
- Is the “cure” worse than the “disease”?

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II. The IMF Program (Nov. 2008; US$7.6 bn.)

- Aims: To restore macroeconomic and social stability.
- How?
  - External balance;
  - Fiscal balance;
  - Monetary tightening;
  - Financial institutions reform;
  - Foreign exchange intervention by the SBP;
  - Social assistance to be strengthened.

What problems do we see?

- The IMF program is not clear on:
  - the nature of currency sovereignty;
  - the nature and financing of the budget deficit;
  - the nature and financing of the trade deficit
- Clearly, the past policy mix exacerbated the problems that the global meltdown has generated …
- But, we think an austerity program will make matters worse!

What problems do we see?

- Stiglitz *et al*. (2006: 245): “Stabilization policy cannot be separated from growth policy. Failure to stabilize may hurt growth, but stabilization, in the traditional sense of the term (price stability and fiscal adjustment), does not necessarily lead to economic growth.”
- Experience of East Asia 1997-98: Growth 2.5% p.a. lower in the 5 most affected countries.
- Must set in place policies that balance growth objective with other key objectives given the constraints.

What problems do we see?

- Pakistan has huge idle resources (labour)
- Pakistan's inflationary bias is therefore not a simple story of excessive demand.
- Fiscal policy has <u>not</u> been *too* expansionary.
- Fiscal restraint is not the solution when Pakistan is living *below* its means - as indicated by idle or underutilised resources.

Why reduce the budget deficit?

- The medium-term challenge - achieve sustainable development – by mobilising *domestic* resources to improve incomes and reduce supply bottlenecks.
- Austerity is unlikely to promote these aims.

Conclusion about IMF approach

- Immediate access to reserves necessary to avoid default.
- But austerity conditions are only appropriate if there is full employment (labour and capital).
- Conclusion: With huge underutilised resources, restraint will not help Pakistan to achieve sustainable development.

Deficits and nation building …

- You cannot nation-build without the national government running deficits.
- All the western countries ran deficits in the Post World-War II period for decades to finance private savings and generate strong growth in capital formation and productive capacity.
- Further, all advanced economies are *now* moving into deficit to counter the crisis.

III. What should Pakistan's government aim at?

- Typical macroeconomic objectives:
  a) Full Employment;
  b) Price Stability;
  c) Sustainable economic growth;
  d) Equilibrium BOP and budget balance;
  e) Equitable income distribution.
- (c) should be a means to achieving better living standards – not an end in itself.
- (d) is typically misrepresented.

Goals of a sovereign government …

- The relevant question is:

  What are the desirable macroeconomic aims for a sovereign government that enjoys a currency-issuing monopoly?

- A *sovereign government* has the fiscal capacity to ensure full use of domestic resources and a more "equitable" distribution.
- Economic growth *per se* is not enough.
- Full employment and price stability should be the *primary* policy goals.

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Benefits of full employment …

- Labour underutilisation creates huge net income losses.
- The social costs are huge (poverty, crime, health issues, family breakdown, social instability, terrorist responses etc).
- Full employment provides
  - training and skill development in a paid-work context;
  - poverty alleviation;
  - community building;
  - intergenerational stability.

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IV. Macroeconomic foundations of an alternative policy approach

- Key questions in the context of the IMF program:
  - What are the best policies available to Pakistan to maximise the advantages of the IMF injection?
  - Are conditions imposed by the IMF in the best interests of the country?
  - Are they are consistent with the achievement of the macroeconomic policy objectives?

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IV. Macroeconomic foundations of an alternative policy approach

- Need to reassure international markets that Pakistan is moving toward a sustainable development path.
- The elimination of BDs and CADs *should not* be viewed as ends in themselves.
- These balances should only be assessed in terms of the movement toward a sustainable path.

Modern monetary theory …

- A monetary system characterised by a floating exchange rate (so domestic policy is freed from the need to defend foreign exchange reserves) and the monopoly provision of sovereign currency.
- The monopolist is the national government – which therefore faces no financial constraints.
- This provides options to the national government that are not fully understood by most economists.

Key Macro National Accounts equation

- Government deficit = Non-Government surplus.
- Government deficit spending adds to private income and (net financial) saving.
- Deficits accommodate net private desire to save and thus serve to eliminate unemployment.
- Budget surpluses reduce private savings and wealth, typically generating unemployment.
- Government cannot 'save in its own currency' – intergenerational myths, etc.

Public spending is not revenue constrained

- There is no Government Budget Constraint; there is an *ex post* accounting identity.
- Households, the users of the currency, must finance their spending prior to the fact.
- Government, as the issuer of the currency, must spend first (credit private bank accounts) before it can subsequently tax (debit private accounts).
- Government spending is the source of the funds the private sector requires to pay its taxes and to net save and is not revenue constrained.

Taxes do not finance government spending

- Taxes do not finance government spending.
- So what do they do?
- Under a sovereign currency system, the monetary unit is defined by the government; the currency is issued in that unit
- The demand for the currency is ensured by imposing taxes which must be paid in that unit.
- Taxes are accounted for and scrapped!

How does Pakistan’s Government spend?

- It credits private bank accounts.
- It does not spend by “printing money”.
- This operation is not revenue-dependent.
- Pakistan’s Government cannot run out of money.
- The conceptualisation in macroeconomic textbooks of government’s having three sources of finance: (a) taxes; (b) bonds; (c) printing money is misleading.

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What is the role of government debt?

- Mainstream macroeconomics considers debt as the way in which government finances its deficit spending.
- But in fact it is part of the interest-rate maintenance operations of monetary policy.
- How does this work?

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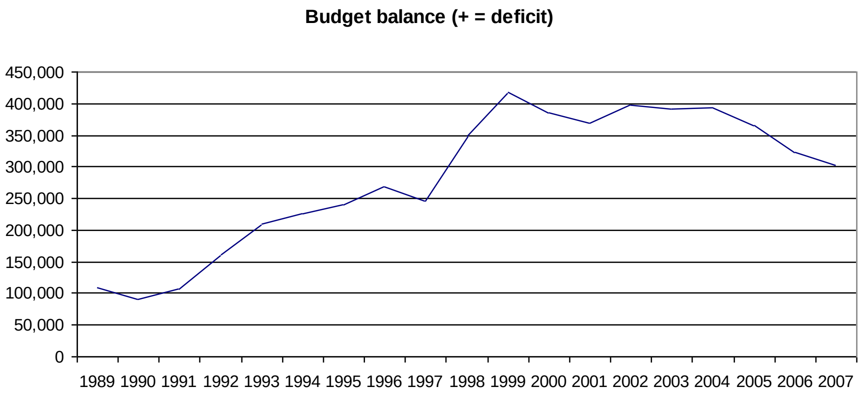
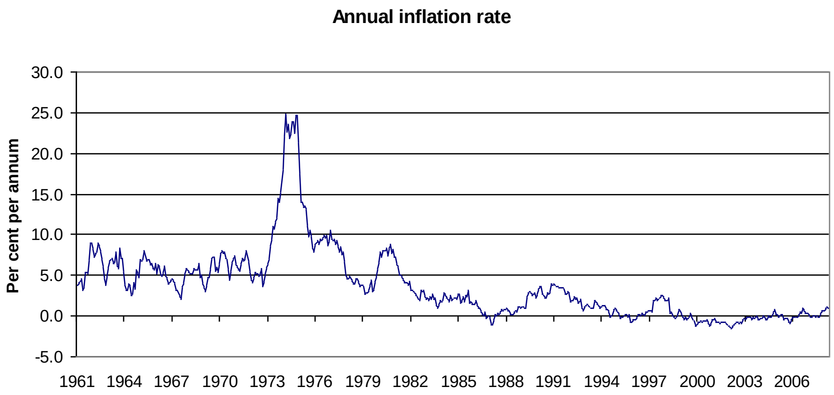
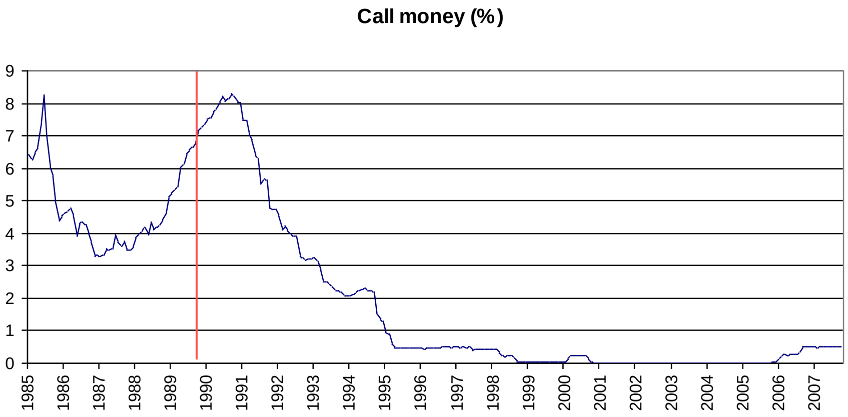
Who sets the interest rate in Pakistan?

- The SBP not the market!
- What if there is a budget deficit?
- Excess reserves in the cash system!
- Direction of interest rates – down!
- Penalty for not borrowing? – see Japan!
- Bonds are an interest-rate maintenance part of monetary policy (even when newly issued).
- Financial crowding out is a nonsensical notion!

Japan - a modern monetary economy …







- Budget deficits growing year by year
- Inflation rate negative
- Interest rates zero

V. Full Employment and Price Stability: Buffer Stocks and the JG Approach

- To understand the options available to any currency-issuing government which aims to stabilise prices we compare two different *buffer stock* options:
  - Unemployment buffer stocks (NAIRU approach)
  - Employment buffer stocks (Job Guarantee approach)

Unemployment buffer stocks

- Central banks now manage monetary policy via interest rate manipulation to target inflation (the NAIRU approach).
- A major component of this monetary policy stance is the persistence of a pool of unemployed (and other forms of labour underutilisation).
- Unemployment is now a policy instrument rather than a policy target.

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Costs of the NAIRU approach…

- The NAIRU theory predicts:
  – Transitory (and small) real effects
  – Optimisation of real output around long-term (supply-driven) trend.
- But the reality is that the cumulative costs of this strategy are substantial:
  – Lost output – sacrifice ratios are significant and durable.
  – Other costs – social pathologies.
  – Skill deterioration.
  – Regional decay.

Deterioration of the price anchor …

- But the effectiveness of the unemployed buffer stock is duration-dependent and deteriorates over time.
- The longer is the average duration the larger the unemployment pool has to be.
- Could this be the most cost effective way to achieve price stability?
- We *do not* think so!

Employment buffer as a price anchor

- A superior use of the labour slack necessary to maintain price stability is to implement an employment buffer program.
- This is called the Job Guarantee.
- It is an unconditional offer of a public job at the minimum wage to anyone who wants to work.
- Represents the minimum government spending to achieve "loose" full employment – hiring off the bottom.
- Purchasing at zero bid.

In-built inflation control …

- The fixed JG wage provides an in-built inflation control mechanism.
- When the private sector sector is contracting, the government uses its fiscal authority to increase the JG pool.
- It is a high quality anchor – maintains an effective labour supply.

The Job Guarantee …

- It provides a framework to reduce the hiring costs to private business.
- It provides for intergenerational advantage.
- It is not the panacea to everything.
- But it is better than the unemployment buffer stock option.

Other benefits …

- They can provide career and training paths.
- They underpin community development and environmental sustainability.

Employment guarantees in developing countries?

- Is the Job Guarantee applicable to developing countries?
- Where the developing country has a sovereign currency system the JG approach is imperative.
- Two fold development strategy: (a) get the adults into work; (b) get the kids into child support then education.

What is the real cost of the JG?

- Nominal budget entries are not costs.
- Whether it is 10 billion or 100 billion is not indicative.
- True costs are the real resources that are used in such a program – food, materials.
- We always need to keep that in mind.

VI. Proposals to deal with the crisis (1)

- It is of paramount importance to understand the overall developmental challenges that the country faces: economy characterised by vastly underutilised resources
- Concentrating exclusively on the financial problems will not provide a long-term solution and a sustainable development path.
- Stabilization and long-run growth are linked
- IMF-support should not be conditional on the size of the deficit – as an end in itself.

VI. Proposals to deal with the crisis (2)

- What options does Pakistan have?
  - (i) Dealing with the crisis: combination of external funding with few conditions and lower domestic rates (moderate monetary policies).
  - (ii) Policies for the medium-term:
    - Full employment and price stability, away from growth-for-its-won sake policies.
    - Reformulate tax and transfer policies.
    - Address the external deficit and the fall in international reserves in a manner that does not lead to domestic stagnation.

VI. Proposals to deal with the crisis (3)

- Policies for the medium term (ADB's contribution):

  - ADB could help design an investment program to achieve full employment.
  - ADB could contribute to the design of a program of export diversification and upgrading (work in progress).
  - ADB could contribute to the design of a Job Guarantee Program specific for Pakistan.

Thank you