

A reinterpretation of Pakistan’s “economic crisis” and options for policymakers

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Abstract: In this paper we provide an in-depth analysis of Pakistan’s macroeconomic situation. We argue that although the stabilisation program signed with the IMF in November 2008 could restore some "macroeconomic stability", it will depress the investment and unemployment outlook, and it will not create the conditions that Pakistan needs for sustainable long-term development. We put forward the foundations for a sustainable macroeconomic program for Pakistan. This contains policy advice that differs markedly from that of the IMF. The essence of the proposal is the consideration that a government that issues its own currency faces no financial constraints or solvency risk. This implies that the usual “government budget constraint” has no economic content. Based on this, we examine the potential role that the country’s fiscal and monetary policies could play in promoting growth and in generating full employment and price stability.

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1. Introduction

Pakistan is currently undergoing an economic crisis that requires firm and decisive policy action if it is to be overcome quickly without undermining the potential for future sustained economic development, while at the same time maintaining social stability and equity. The problems are clear – excessive inflation; a lack of foreign reserves to support import levels (until the IMF started providing assistance); a lack of productive capacity building; and significant waste of labour resources through unemployment and underemployment.

Most recent analyses of Pakistan's fragile situation tend to concentrate on the financial aspects of the crisis. We refer to it as the *conventional Economist's view*. For example, in its October 23, 2008 edition under the title *The Last Resort*, The Economist wrote:

... Pakistan faces economic meltdown ... The economy is close to freefall. Inflation is running at about 30%. The rupee has devalued by about 25% in just three months. The fiscal deficit is a whopping 10% of GDP. Foreign-exchange reserves cover just six weeks of imports. A \$500m Eurobond matures next February, but the market has already decided it is junk. The country needs at least \$3 billion in short order, and a further \$10 billion over the next two years to plug a balance-of-payments gap. Without it, default abroad might well coincide with political anarchy at home.

It followed up with another analysis on October 29, 2008 entitled *Pakistan's wounded sovereignty*, where it continued to emphasise that:

Without foreign help, Pakistan won't be able to afford its imports, repay its debts, or quell the insurgents encamped within its borders. Thanks to protracted power cuts, it cannot even keep the lights on in its towns and villages. It is not, in other words, a state in full command of itself. And yet despite these dispiriting facts, or perhaps because of them, Pakistan is acutely sensitive to any infringement of its sovereignty. Those outside powers in a position to help it, from the International Monetary Fund to the American military, are as likely to offend its pride as to earn its gratitude.

Pakistan is running out of hard currency. It spent \$3.6 billion on imports in September, including a \$1.5 billion petrol bill that was 180% higher than a year earlier but earned only \$1.9 billion from its exports. The central bank's foreign-exchange reserves, which stood at a smidgeon over \$4 billion on October 17th, are falling by over \$1.3 billion a month.

The deterioration in Pakistan's economy has escalated quickly in recent months and the Pakistan Government has now formally requested \$US15 billion in financial assistance from the International Monetary Fund (IMF) using the IMF's Emergency Financing window. The reality is that it will likely receive around \$US2 billion per year for three years as a reflection of its Statutory Drawing Rights (SDR) quota.

The Government clearly needs time to deal with the burgeoning balance of payments deficits and the unsustainable loss of foreign exchange reserves. The aims of the Government in seeking IMF funds is to, as it sees it, stabilise the macroeconomic imbalances, generate a buffer of foreign exchange reserves and stimulate investment expectations.

The overriding view among economists is that there is a gross imbalance between insufficient aggregate supply and excessive aggregate demand in Pakistan (each moving in opposite directions) which has generated inflation and rising imports. These problems have, in turn, seen a rapid depletion of foreign exchange reserves and sharp markdowns in the rupee. As Standard and Charter (2008: 2) argued recently: ‘the focus of the stabilisation plan will be on fire-fighting the aggregate demand pressures that have built up and contributed to large macroeconomic imbalances.’

The financial problems, however, should not be seen in isolation from the real problems – the constrained supply and the persistently high rates of labour underutilisation--for, doing so, would narrow the range and scope of policy options and, ultimately, would limit the capacity of the economy to redress the real problems. A viable policy framework must seek to solve both sets of problems and provide a sustainable development path.

The objective of this paper is to provide an in-depth analysis of Pakistan’s macroeconomic situation. In particular, we examine the role that the country’s fiscal and monetary policies can play in promoting growth and in generating employment and lay the basis for a macroeconomic program for Pakistan that contains policy solutions that differ from those currently being discussed in the context of the IMF program signed in November 2008.

The rest of the paper is organized as follows. Section 2 summarises the standard analysis of Pakistan’s precarious economic situation. Section 3 offers a discussion and critique of the main points underlying the IMF agreement. This agreement will determine macroeconomic policy in the medium term. Sections 4, 5 and 6 discuss our alternative proposal. Section 4 argues that the achievement of full employment should play a much more significant role in Pakistan. Section 5 introduces the macroeconomic foundations of the proposal. The basis of the proposal is that a sovereign government that has currency-issuing monopoly spends by crediting accounts and does not face a financial constraint. Section 6 discusses the essentials of the Job Guarantee approach to achieving macroeconomic stability. This program can contribute directly to ensuring full employment and controlling inflation. Finally, section 7 proposes a number of specific proposals in order to create the conditions for economic stability and development in Pakistan.

2. *The Economist’s analysis of Pakistan’s situation*

In this Section we will examine the conventional view of Pakistan’s situation. We will use the exposition provided by *The Economist* because we think it is relatively representative. We do agree with some parts of the analysis. And much of the data presented is quite useful for analysis. However, we deviate sharply on key issues and interpretations of the data. In a later section we will provide the framework we use. Hence, we present the conventional view here and offer some brief critical insights which point to the broader critique that we present in Section 5. . As one difference, it will be seen that the conventional view attributes a good deal of Pakistan’s current problems to its supposed previous propensity to “live beyond its means” and recommends policy that would scale back government spending and private consumption. Our assessment is fundamentally different: Pakistan had substantial unused capacity and underutilized resources, so it could not have been living beyond its means. For this reason, we disagree with the austere policy recommendations that come from conventional analyses.

Given that the empirical dimensions of Pakistan’s economic situation are now well known we do not provide a detailed analysis of them in this paper (see Felipe and Lim, 2008 for details). Suffice it to say that standard analyses conclude that Pakistan’s growth episode between 2004 and 2007

was the result of a policy framework that aimed at achieving a high growth rate but used misguided policies to do so. Both inflows of capital and workers' remittances, together with government pump-priming not matched by an increase in the tax effort (which led to a rising fiscal deficit) led to high growth rates. However, the demand stimulus was not accompanied by a concomitant increase in the productive capacity of the economy. High growth prompted an increase in imports (which led to the trade deficit), driven mainly by consumption. Export growth, which lagged behind that of imports, suffered from a structural competitiveness problem, which led to a dependence on inflows of overseas remittances, FDI, portfolio investment and loans to finance the current account deficit.

Increased Government spending, together with an increase in business confidence, crowded-in the private sector with investment running ahead of savings. This growth model could perhaps have been sustained longer, as long as capital inflows exceeded the current account deficit (leading also to a build up of foreign exchange reserves). But as the external deficit continued increasing, the situation became riskier. This is indeed what happened during 2008 as inflows of capital started decelerating. In part this was due to a general global run to the safest assets.

Overall, we agree that this was a questionable strategy for sustainable growth and development, even if we do not agree with the conventional assessment of causes and solutions. We can also agree on an assessment of recent developments. During the second half of 2007 and the early months of 2008 global and domestic macroeconomic conditions deteriorated quickly, first, as a result of the global economic slowdown initiated by the subprime crisis in the US; and second, as a consequence of the worldwide rapid growth of food and other commodities prices. This contributed to a general worsening in the situation. At the same time, world fuel prices accelerated at an unprecedented pace in 2008, and this drove up price inflation. Rising commodities prices can be attributed to a variety of causes, including demand-supply mismatch, price manipulation, and speculative pressures. While it is clear that the commodities price boom has already come to an end, which is helping to relieve inflation pressure, rapid collapse of these prices could engender further financial crisis around the globe, with negative consequences for Pakistan. It is too early at this point in the downturn to make firm projections.

As a consequence of the political uncertainty and the economic deterioration (increasing external deficits and reduced capital inflows), foreign exchange reserves, rising since 2001, started declining in November 2007 and the deterioration in the overall reserve position accelerated thereafter. From a total of \$16 billion (in liquid foreign reserves) in October 2007, reserves fell to \$7.3 billion on October 17, 2008. The deterioration was caused by rising imports of fuel and food products, increased outflows of portfolio investment and the use of foreign exchange reserves to defend the rupee.

The rising trade deficit over the short run threatened Pakistan's dwindling international currency reserves. In addition, the rupee depreciated by about a third. While orthodoxy would expect this to improve the trade balance there is no evidence yet available to which suggests that this has been the case.¹ Given the composition of Pakistan's imports and exports, it is likely that the trade imbalance cannot be resolved through currency depreciation alone. The depreciation, in turn, raises the relative costs of imports, and imparts an inflationary bias to the economy. Moreover, depreciation leads to expectations of further depreciation and fuels the run out of the currency.

¹ The Marshall-Lerner condition is not satisfied in Pakistan. See Felipe et al. (2009a).

There may be no interest rate that is high enough to counter expectations of losses due to depreciation and possible default. In the short run there was probably no alternative but to quickly restore reserves of foreign currency through external borrowing.

The orthodox interpretation of the external situation that Pakistan faces is that the burgeoning current account deficit indicated that Pakistan was “living beyond its means” - with excessive domestic demand that boosts imports; the excessive demand also fuels inflation that restricts exports. The presumption is that this current account deficit must be “financed” by flows of foreign reserves, which for the most part must be attracted by high returns and a stable political, economic, and social environment. So the worsening trade account implies that local Pakistani consumption became dependent on the whims of foreign lenders. Further, given its large budget deficit, Pakistan’s government is said to be increasingly dependent on the foreign purchases of its debt to supplement domestic savers’ purchases of government debt. If Pakistan cannot attract these needed reserves, it must slow its growth to reduce imports; lower prices and wages could also encourage exports. The obvious portent of the default on foreign debt obligations then is used to argue in favour of restricting government spending. Thus, both monetary and fiscal policy ought to be tightened to encourage such capital flows even as this reduces the need for them.

This situation is what created the crisis atmosphere, which caused Pakistan to turn to the IMF and other international lenders for help. As expected, the funds came with strings attached, including tighter fiscal and monetary policy. The SBP actually increased its interest rate target in advance of the IMF loan, to 15 per cent (the highest in South Asia) - the opposite to the monetary policy adopted in much of the developed world in reaction to the snowballing global economic crisis. It remains to be seen whether the combination of high interest rate policy plus international lending will be able to turn-around expectations.

Likewise, the orthodox interpretation of the fiscal trends is that lax fiscal budgets drive interest rates up (through competition for limited loanable funds) while generating inflation (excess demand). High interest rates, in turn, are argued to squeeze out productive investment, making the nation less competitive internationally. This hinders improvement in the trade balance, and competitiveness is further hurt by inflation. Thus there is a fairly direct link claimed to follow from budget deficits to trade deficits – the so-called “twin deficits” hypothesis. This is why the “conventional view” believes it is imperative to reduce budget deficits. According to the logic, that would allow interest rates to fall. Further, inflation would be reduced, lowering pressure on the external balance and exchange rates.

The supposed link between government net spending and interest rates is predicated on the notion that sovereign governments have to “finance” any deficit spending, in the same way that a household has to fund spending above income (ignoring asset depletion options) and that the pool of available investment funds is fixed at any point in time. Further, expanding the pool of loanable funds is only possible if returns to saving (interest rates) increase. We argue below that any such link is purely voluntary and that it is not required for a sovereign government that wishes to maintain a sustainable fiscal strategy that results in budget deficits. The “twin deficits” hypothesis is further based on crucial assumptions about the private domestic balance (relationship between saving and investment) which have rarely held in practice. Finally, the “crowding-out” and “twin deficits” arguments are critically based on a supposed relation between government “borrowing” and interest rates—with deficits pushing interest rates higher. We will show in Section 5 that this belief is wholly without foundation and reflects a fundamental misconstruction of the way interest rates are determined.

In Section 5, we also discuss in more detail government spending, budget deficits and debt. For now, it is crucial to understand that budget deficits by themselves do not push up market interest rates. Hence the usual argument that budget deficits drive up interest rates, crowd out investment, appreciate the currency, and result in trade deficits is incorrect. There is, however, an alternative link between the trade and current account deficits. A budget deficit helps to hold up non-government sector demand. Indeed, a budget deficit is identically equal to the non-government sector's surplus. If the domestic non-government sector is to run a surplus ("save"), then there must be a government deficit, a current account surplus, or both. To put it another way, holding the domestic non-government sector balance constant, any growth of the government's deficit will be equal to growth of the current account deficit. There is, thus, a link between the two deficits that arises from a macroeconomic identity. But, it has nothing to do with exchange rates or interest rates.

3. Assessment of the IMF Program and its conditionalities

At the time of writing this paper, an agreement with the IMF had just been reached where a 23-month "Stand-by Arrangement" amounting to around \$US7.6 billion has been made available to Pakistan to support its 'economic stabilization program' (IMF Press Release, No. 08/303 November 24, 2008). The arrangement releases around \$US3.1 billion immediately and then quarterly reviews will determine the availability of the remaining tranche. The arrangement is five times the Special Drawing Rights (SDR) quota available to Pakistan as a member of the Fund. The IMF (2008a) note that the two key objectives of the support are:

- 1) To restore macroeconomic stability and confidence through a tightening of macroeconomic policies; and
- 2) To ensure social stability and adequate support for the poor and vulnerable in Pakistan.

The specific areas that are being targeted to meet these key objectives are:

- External balance to be targeted via a fiscal tightening.
- Fiscal balance – the program requires a fiscal tightening from a deficit of 7.4 per cent of GDP for the fiscal year 2007-08 to 4.2 per cent in 2008-09 and then 3.3 per cent in 2009-10. The tightening will come principally by 'phasing out energy subsidies, better prioritizing development spending and implementing strong tax policy and administration measures' (IMF Press Release, No. 08/303 November 24, 2008).
- Monetary tightening through increase in the policy discount rate –to contain inflation, offload central bank borrowings and build reserves.
- Financial institution reform – structural changes to deal with risk contingencies, insolvent banks and to 'strengthen the SBP's bank resolution capacity' (IMF Press Release, No. 08/303 November 24, 2008).
- Some foreign exchange intervention by the SBP but only 'geared toward achieving the program's reserve targets and smoothing excessive exchange rate volatility' (IMF Press Release, No. 08/303 November 24, 2008).
- Social assistance to be strengthened but better targeted such that 'spending on the social safety net will be increased ... to 0.9 per cent of GDP in 2008/09' (IMF Press Release, No. 08/303 November 24, 2008), an increase of 0.6 percentage points of GDP.

The IMF agreement reflects what we termed above the “conventional” approach to dealing with macroeconomic imbalances, which we outlined in Section 2. While we recognise the macroeconomic reality that Pakistan faces, as well as the fact that the IMF agreement is now finalised and will influence government policy over the next few years, we argue that there is still latitude within the constrained policy environment to pursue more sustainable outcomes than those established by the limited horizons set by the IMF agreement.

The problem with the Fund’s approach is that it is less than clear on: (a) the nature of currency sovereignty; (b) the nature and financing of budget deficits; and (c) the nature and financing of trade deficits. This matters because while it is true that Pakistan’s problems are largely the result of misguided policies, it does not mean that the only solution available is to subject the economy to an austerity program. In the words of Stiglitz *et al.* (2006, p.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.”² Further, we believe that the IMF program does not correctly portray the source of the inflation pressures, or the constraints on economic development.

Ironically, Pakistan faces high inflation and insufficient progress toward development even as it experiences persistent and significant unemployment of its domestic resources. Hence, what Pakistan needs to do over the medium-term in order to achieve sustainable development mostly requires a mobilisation of domestic resources to improve incomes and reduce supply bottlenecks through expansion of domestic capabilities. Given substantial levels of redundant resources, it should have been obvious that Pakistan’s inflationary bias could not be a simple matter of excessive demand. Thus, in appraising the inflationary impact it is incorrect to presume that fiscal policy has been excessively expansionary. Budget deficits can result from *insufficient* aggregate demand - with the budget deficit endogenously expanding via revenue losses and spending increases when gaps in private spending appear. Using budget deficits as evidence of excessive expansionary policy is therefore erroneous, unless the deficits have pushed the economy beyond full capacity use of its resources. For this reason, fiscal restraint may not be the medicine that is required in a situation in which a country is actually living *below* its means - as indicated by idle or underutilised resources.

We do recognise that Pakistan’s current situation is one in which robust growth (above about 5 per cent) will tend to generate a current account deficit (See Felipe *et al.* 2009a). This is the result of a relatively low income elasticity of demand for the country’s exports. From the orthodox perspective the consequences for Pakistan of having balance-of-payments problems are straightforward. When Pakistan encounters a balance-of-payments problem before short-term capacity utilisation is reached, demand is curtailed, disguised and open unemployment increase, and capital accumulation has to be reduced. This leads, in the long run, to a relative deterioration of the country’s export potential compared with that of its main competitors. This situation tends to lead to a vicious circle with further balance-of-payments problems.

² ADB (2007) notes that although the Asian countries hit by the crisis of 1997-98 recovered (in the sense that their per capita incomes now surpass the pre-crisis levels), “growth has settled down on a lower trajectory. Comparing the period 2000-2006 with 1990-1996, growth has slipped by an average of 2.5% a year in the five countries that were most directly affected (Indonesia, Korea, Malaysia, Philippines and Thailand). The persistence of such gap implies large permanent losses of income compared with precrisis trends” (ADB 2007, p.46).

While we recognise the problem, we do not endorse the orthodox solution. Given that Pakistan operates with what we define below as a “modern money regime” (more about which later), that includes flexible exchange rates, we consider it has sufficient domestic policy space to pursue an alternative, sustainable growth path. It can make use of this space, as discussed below, to pursue economic growth and rising living standards, even if this means expansion of the current account deficit and depreciation of the currency. Of course, such a recommendation is for the medium term—this is not something that can be done in a crisis—nor can continuous currency depreciation be sustainable. While there is no strict balance-of-payments growth constraint in a flexible exchange economy in the same way that one exists in a fixed exchange rate world, the external balance still has implications for foreign reserve holdings via the level of external debt held by the public and private sector.

However, we do agree with the orthodox analysis that Pakistan needs to foster conditions that will reduce its dependence on imports. Further, we will show that the growth and development path chosen makes a difference to the country’s capacity to import. However, we consider that the orthodox solution to a current account deficit will actually make it more difficult for Pakistan to reduce dependence on imports.

Indeed, we believe that the IMF lending and the accompanying conditions summarised above will reduce the capacity of the government to engineer a solution to the problems of inflation and falling foreign currency reserves without increasing the unemployed buffer stock. While the IMF statement suggests it is keenly aware of the need to deploy a “socially acceptable” solution, we consider that a policy strategy based largely on fiscal austerity will create unacceptable levels of socio-economic hardship.

Further, we do not think the program addresses the failures in the policies of the previous government, largely focused on a consumer-driven growth strategy despite the import-dependent nature of the economy. It is clear that while the country enjoyed very high levels of foreign direct investment (FDI) the funds were largely concentrated in the consumer sector. This had two consequences: (a) it increased demand for foreign exchange; and (b) it created a foreign exchange liability. The other significant point is that this investment did not generate corresponding amounts of foreign exchange revenue because it did not improve export capacity.

The policy emphasis on fiscal restraint is also fraught with problems. Targets to reduce the budget deficit as required by the IMF agreement may help lower inflation, but only because the “fiscal drag” acts as a deflationary mechanism that forces the economy to operate under conditions of excess capacity and unemployment. This type of deflationary strategy does not build productive capacity and the related supporting infrastructure, thus offers no “growth solution”. Likewise, fiscal restraint may not be successful in lowering budget deficits for the simple reason that tax revenue can fall as the taxable base shrinks because economic activity is curtailed.

Moreover, the lessons of how the international crises of the 1990s and early 2000s were dealt with should not be forgotten: fiscal discipline has not helped developing countries to deal with financial crises, unemployment, or poverty even if they have reduced inflation pressures. It is necessary to create an alternative package of policies that will maintain price stability while creating jobs and raising domestic living standards as a way to reduce social unrest. This has to be done while using FDI to build productive capacity rather than to finance consumption.

Another government policy emphasis has been to stabilise the exchange rate. The typical method used in many nations is to target inflation, reduce budget deficits, and encourage exports. This is

exactly the logic of the current IMF agreement. It is possible that this package of policies can generate short-run benefits by allowing accumulation of foreign currency reserves that can be used to appreciate the currency. However, this outcome conflicts with promotion of long-run economic and political sustainability. Indeed, there are some inherent conflicts between maintaining a strong currency and promoting exports - a conflict that can only be temporarily resolved by reducing domestic wages, often through fiscal and monetary austerity measures that keep unemployment high. The best way to stabilise the exchange rate is to build sustainable growth through high employment with stable prices and appropriate productivity improvements. An export-led growth strategy based on restraining wage increases sacrifices domestic policy independence to the exchange rate. Moreover, this is a policy stance that at best favours a small segment of the population.

The IMF is particularly concerned with SBP financing of the budget deficit. Since July 1, the government is said to have borrowed about \$2.5 billion from the SBP; the government's goal is to reduce that to zero. Such borrowing is thought to be effectively "government printing of money" to finance its deficit; the orthodox view is that this is highly inflationary. Hence, the goal is to eliminate such borrowing for the remainder of the year, forcing the government to turn to "markets" for its borrowing. It will then need to offer sufficiently attractive interest rates on its debt; this will allow the government's borrowing costs to rise to market rates (as mentioned, this would be at least 15 per cent now).

A response at a press conference called to explain the IMF position on the bail-out package exemplifies the orthodox position in this regard. Juan Carlos Di Tata, IMF Senior Advisor, Middle East and Central Asia Department, noted that "government borrowing from the State Bank of Pakistan ... is a very important issue ... it needs to be corrected. The idea in the program is to discontinue this borrowing for the period between November – June of this fiscal year. And in order to eliminate this borrowing from the central bank, what is important is that in the auctions of Treasury bills, the interest rates will have to be sufficiently attractive for commercial banks to purchase enough Treasury bills, so that the domestic borrowing requirements of the government is covered through commercial bank sources, and also from other non-bank sources like Pakistan investment bonds, for instance, and the national savings scheme." As we shall argue in Section 5, such beliefs do not adequately reflect the coordinating procedures of central banks and sovereign treasuries.

In considering these "prescriptive" policy approaches that are derived from orthodox macro development theory, we note the sound advice from Rodrik (2008: 1-2) who argues that the "emerging "consensus" revolves not around a specific list of policies, but around how one does development policy. In fact, practitioners of this "new" development economics—whether of the "macro" type or "micro" type—tend to be suspicious of claims to *ex ante* knowledge about what works and what does not work. The answer is neither the Washington Consensus nor any specific set of initiatives in health or education. What is required instead is recognition of the contextual nature of policy solutions. Relative ignorance calls for an approach that is explicitly experimental, and which is carried out using the tools of diagnostics and evaluation. Old dichotomies between states and markets play little role in this worldview and pragmatism reigns. The proof of the pudding is in the eating: if something works, it is worth doing."

The recently fashionable "new monetary consensus" (that underlies monetary policy formulation in most of the major countries) claims that high inflation is inimical to economic growth. This is a justification for focusing policy - especially monetary policy - on maintaining a low inflation

environment. However, Barro (1997) found that inflation and growth are unrelated when inflation is below 20-30 per cent. Bruno and Easterly (1998) found that there is no evidence that inflation rates below 40 per cent have adverse effects on growth. Dornbusch (2000) cites a study by the World Bank according to which truly damaging inflation does not start until about 40 per cent. Dornbusch argues that: “Countries with 15 percent inflation per month must stabilize with urgent priority: nothing is likely to be more important. On the other hand, countries with 15 percent inflation per year certainly should not belittle inflation. They definitely should attempt, on average, to bring inflation down. But they must see this as one of a number of priorities, and they should view it as a process of five or even more years” (Dornbusch 2000: 52). These results have been corroborated recently by Pollin and Zhu (2006), who find that higher inflation is associated with moderate gains in GDP growth up to an inflation threshold of about 15-18 per cent. Stiglitz *et al.* (2006, Table 2.1) have examined growth in several countries (Argentina, Brazil, Chile, Israel, Poland and Turkey) that have experienced episodes of low, moderate and hyper inflation. Their data show that (i) low inflation is not associated in general with high growth; (ii) hyperinflation is, in general, associated with low growth; and (iii) moderate rates of inflation, 20-30 per cent per year, have been associated with rapid growth quite often. While there is no doubt that high inflation is undesirable, there is little evidence that inflation at the moderate rates that have prevailed in recent times in most countries around the world has any significant harmful effects on output, employment, growth, or the distribution of income.

This puts into context the IMF’s urging of Pakistan to move toward fighting inflation and perhaps even to adopt inflation targets. Not only does the preponderance of empirical evidence suggest that moderate inflation does not hinder economic growth, but also recent experience in those countries that have adopted inflation targets or even less restrictive Taylor-type rules for policy formation casts doubt on such approaches. It is somewhat ironic that the wealthy, developed countries are abandoning such policy while Pakistan is being encouraged to adopt it. Many observers now believe the world is heading into a highly deflationary environment. Aside from “pass through” inflation that will continue if Pakistan’s exchange rate does not stabilize, it is difficult to see where inflation pressures are going to come from in coming months.

There is also very little evidence for the claim that inflation targeting has succeeded where it was tried (see Mitchell and Muysken, 2008: Chapter 6 for comprehensive evidence contradicting the view that inflation targeting countries have enjoyed superior outcomes). Moreover, in practice, inflation targets are often not achieved (about 40 per cent of the time) for prolonged periods, and are missed by wide margins. Emerging market countries seem to be more vulnerable to large misses than industrial countries (Roger and Stone 2005). Until the current commodities price boom, it did appear that inflation targeting was associated with lower inflation in those countries that adopted the policy; however, it has been shown that even countries that did not adopt such targets experienced similarly low inflation rates. This indicates that inflation targeting happened to be adopted during a low inflation period, rather than proving the case that the targeting itself led to low inflation.

A second important question to be raised concerns the ability of monetary policy to lower inflation through the use of inflation targets. Even if it is believed that inflation targeting following some kind of a Taylor rule – increasing interest rates when prices are rising too fast - can fight some kinds of inflation, there is little reason to believe that monetary policy can successfully fight inflation pressures that arise outside a nation. If inflation comes largely from commodities and other imports (or even from domestic output that competes in international markets hence that

experiences the same price pressures), it is hard to see how higher domestic interest rates can reduce inflation pressures. In some cases, tighter monetary policy might appreciate the exchange rate, so that “pass through” inflation could be reduced. However, it should be noted that commodities prices rose so fast in the recent bubble that currency appreciation could hardly resolve the problem for most countries - eight of the most important commodities saw price hikes above 500 per cent in this cycle; the 25 commodities included in the main commodities futures indexes experienced prices rising by an average of 200 per cent. Exchange rate movements sufficient to offset such rapid commodities price hikes would have to be so large that they would make exports non-competitive and would likely generate a flood of imports. There is little reason to believe that interest rate hikes in Pakistan have, or could have, lowered inflation pressures that largely came from the supply side.

The recent collapse of commodities prices will likely lead to some improvement in Pakistan’s price pressures as well as to reduction of net imports—but at this point it is too early to make firm projections. Some inertial pressures still remain as wages and prices strive to catch-up with some lag to the inflation that had been fuelled by the commodities price boom. Thus, it is possible that some core inflation will persist. However, that is very likely to dissipate. And while we do not expect oil prices to remain in the forty dollar range (well below the price that OPEC will try to maintain), other commodities prices - especially agricultural prices - will likely remain quite low. For these reasons, we do not believe that Pakistan faces significant danger of inflation coming from external sources—except from exchange rate pass through effects. Hence, what is most important is to stabilise the exchange rate.

In any case, economists have come to recognise that monetary policy is not nearly so powerful a stabilisation tool as it was once thought to be. The real economy is not normally sensitive to interest rates movements. During recessions, monetary policy has little proven effects in activating an economy. In bad times lower interest rates do not induce consumer expenditure. And likewise, lower interest rates do not induce more investment (by making borrowing cheaper) as during these periods there tends to be excess capacity and output is not sold. Empirical evidence suggests that the interest elasticity of investment is at best low, non-linear, and asymmetric. While an increase in interest rates might in some cases moderately reduce investment during economic booms (when the economy is at or above capacity), the reverse is not true. In general, it is the outlook for profitability, rather than the price of credit, that influences investment. For this reason, direct credit control is a more effective instrument of monetary policy than the interest rate. If monetary policy includes direct credit controls it may be reasonable to assume that there will be some effect on aggregate demand.

Certainly, in Pakistan’s current situation raising domestic interest rates to control inflation may not be as effective as desired unless it causes a major recession and collapse in aggregate demand. This is because the combination of low growth with inflation seen today is caused by supply-side factors, most of them coming from outside the country. How a nation controls supply-side inflation is a major challenge and the strategy employed depends a great deal on the nature of the influential external factors. In this sense, it is important to recognise that a substantial share of Pakistan’s macroeconomic problem has to do with the international situation. This means that although domestic measures must be taken, Pakistan depends on global and regional cooperative efforts to tackle the food and oil price boom and bust and the securities-related (world) economic slowdown.

Some analysts believe that increases in interest rates will have a significant impact in preventing the depreciation of the rupee and insulate, the domestic economy to some extent from imported

inflation. The down side is that higher interest rates may dampen investment prospects and the higher value of the rupee may negatively affect exports. History is full of many examples of countries trying to use higher interest rates to protect the currency, only to find that the policy was impotent (for example, Indonesia during 1997-98).³ Raising interest rates by hundreds of basis points cannot compensate investors for losses due to large currency depreciations. To the contrary, the higher rates can stoke a run out of the currency as currency speculators bet that the monetary policy will fail to stabilise the currency. And, indeed, the recent interest rate hikes have done almost nothing to stem the rupee's slide. What has been far more important is the willingness of international agencies to come to the rescue and the government's demonstration that it is ready to begin to implement reforms.

In addition, using high interest rates to target inflation generates other undesirable consequences. Interest is a cost of doing business, and tends to be included in price. For this reason, raising interest rates will reduce inflation only if the effects on interest-sensitive spending (lowering aggregate demand) are greater than the effects on costs and prices. When inflation comes from the supply side, higher interest rates will probably add to supply-side induced inflation by raising costs. Also, interest rate increases will increase the debt service burden. There is one commonly cited condition for sustainability: the interest rate should not exceed the growth rate of income and GNP. If it does, debt will tend to grow faster than ability to service the debt at a constant burden (ratio of debt service to income). While this constraint is often inappropriately applied to sovereign government (a sovereign government can always service its debt in its own currency), it should be applied to the private sector (and non-sovereign government such as states and provinces or local governments). Indeed, it has been shown that in much of the developing world interest rates are chronically far above the income and GNP growth rates that can be realistically achieved (Kregel, 2004). This is the major cause of debt crises (often reflected in exchange rate crises because a lot of the debt is held externally). For this reason, use of monetary policy to fight high inflation is particularly inappropriate for a developing nation, and especially for one with a large ratio of private debt.

All this raises serious issues about use of monetary policy to fight inflation. Given the impotence of monetary policy to deal with inflation that did trend upwards in much of the world over the past 3-5 years, and also the incapacity in dealing with the global financial crisis that began a year ago in the US, the whole edifice of the new monetary consensus has been thrown into disarray. It is unlikely that the developed nations will go back to this now discredited theory once economies recover. We now know that monetary policy cannot successfully fight inflation that comes from the supply side. We also know that easy monetary policy as indicated by low interest rates cannot help to pull an economy out of recession. It is certain that fiscal policy will play a much larger role from this point forward, and that alternative methods of fighting inflation pressures will be developed. We will discuss in Section 6 some strategies that can be adopted.

4. Macroeconomic objectives of Pakistan's Government

In this Section we start introducing the alternative strategy that could be used to deal with Pakistan's situation by first clarifying what we consider to be imperative macroeconomic

³ This was the policy advice offered by the IMF to the East and Southeast Asian countries during the 1997-98 crisis.

objectives for the country. The Government of Pakistan's dominant stated goal is to maximise the economic growth rate.

We believe that while growth is important there are other objectives of economic policy, in particular the achievement of full employment, which should also guide economic policy. This consideration will help us formulate an alternative proposal in Sections 5 and 6. Full employment was a key objective of policy makers in many countries between WWII and the 1970s. Since then, the concept of full employment has lost traction among policy makers due to the belief propagated by some influential scholars that its pursuit would compromise price stability. Today, however, many important voices are once again echoing the need to return full employment to the top of the policy agenda in order to deal with the current international crisis.

4.1 What are legitimate macroeconomic policy objectives?

If we polled macroeconomists of all ideological persuasions, and asked them to outline the major macroeconomics policy objectives then the following consensus would probably emerge: (a) full employment; (b) price stability; (c) a robustly sustainable rate of economic growth; (d) maintaining a sustainable balance in both the current account and in the government's budget; and (e) achievement of an "equitable" distribution of resources (although exactly what that means would probably be debated). While these goals are so general that they lack clarity and are regularly used by different economists in ways that do not permit meaningful dialogue we can use them to motivate our discussion.

While (a) and (b) and (e) are supportable (and will be discussed in more detail below), we believe goals (c) and (d) are poorly articulated. Goal (c) is often stated as an end in itself, rather than as a possible means of achieving better living standards for the population. We will argue that growth, by itself, may not be a worthwhile goal.

The goal of achieving government budget balance and a positive external balance, as well as the links between the two balances, is often expressed in a theoretical framework that has no application in a sovereign currency monetary economy, such as Pakistan. So the relevant questions should be: What are the desirable macroeconomic aims for a sovereign government that enjoys a currency-issuing monopoly? What should be the goal for a sovereign nation's external balance? What are the links between the budget and external balances? In this context, (c) and (d) have to be clarified to ensure they are consistent with the attainment of goals (a), (b), and (e).

A government that issues a sovereign currency has the fiscal capacity to create full employment and to achieve price stability using employment buffer stocks (discussed below) rather than by using unemployment buffers (as in the orthodox non-accelerating inflation rate of unemployment ('NAIRU') approach which underpins an "inflation first" strategy). It is also able to ensure full use of domestic resources (most importantly, labour and physical capital) to achieve the desired "equitable" distribution. Economic growth alone does not ensure full employment and price stability, nor does it ensure that the desired distribution is achieved.

However, much of the conventional views about the balance of payments would actually reduce fiscal policy space and prevent use of the sovereign currency powers to achieve full employment, price stability, and equitable distribution. Indeed, much of the "open economy" analysis, which underlies the IMF conditions, has no application in the "modern money" paradigm that has been developed to analyse the situation of sovereign nations that issue currency.

We will provide detailed explanation below on the supposed “balance of payments” constraints and on how fiscal policy space can be preserved. This will be based on analysis of monetary systems where the sovereign government possesses a currency-issuing monopoly (which is underpinned by its legislative power) and where private agents have to obtain that currency to resolve their legal tax obligations. So the question should be: what are the desirable macroeconomic aims for a sovereign government that enjoys a currency-issuing monopoly? Can it obtain and sustain full employment?

For purposes of our analysis, we define full employment in terms of a number of jobs rather than a rate of unemployment relative to the inflation rate. Mass unemployment and underemployment reflects a systemic failure to provide enough jobs to meet the desires of the labour force for hours of work. Specifically, we define full employment as a situation in which anyone who is ready and willing to work is able to obtain as much work as desired within a reasonable length of time. This is more or less consistent with the old Beveridge (1944) notion that there should be more job vacancies than job seekers - although we wish to emphasise that if those vacancies are only for part-time, contingent work in the presence of job seekers who wish to have full-time permanent work, then we would see this as a state with involuntary unemployment. Although the Pakistan economy is a long way from producing full employment so defined, it remains a legitimate goal of any modern economy and should be prioritised by the Government.

Developments in economics in the 1950s and 1960s saw the concept of full employment morph into the Natural Rate Hypothesis (NRH) and then the non-accelerating inflation rate of unemployment (NAIRU). In practical terms the two concepts equally undermine the pursuit of full employment defined as a sufficiency of jobs because they make our conception of full capacity contingent on inflation control. So full employment becomes merely any level of employment where inflation is stable. Of-course, this may result as we have seen in most economies around the World in high rates of unemployment and underemployment.

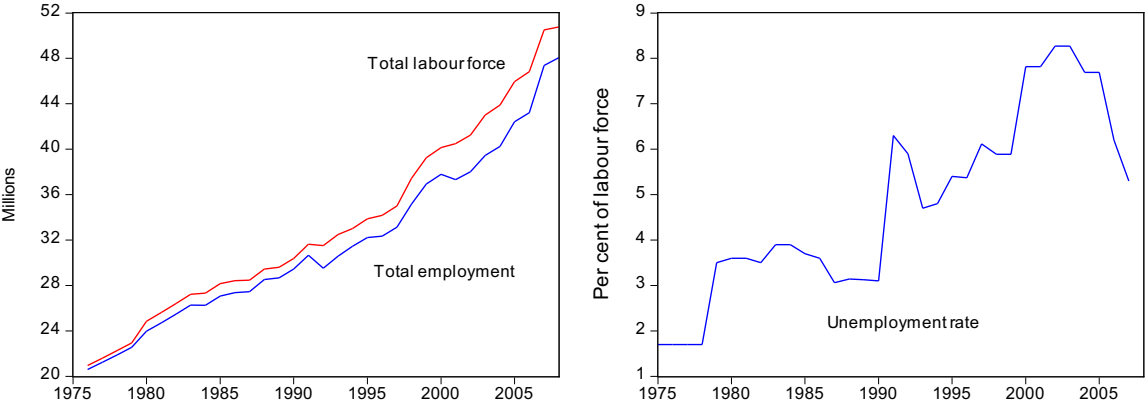
4.2 Does growth generate full employment?

As argued in Section 2, Pakistan’s high-growth episode of 2004-2007 was in part the result of a model that aimed at achieving a high growth rate by concentrating activity into the burgeoning consumption sectors. The policies that were pursued were not well-designed. Both private sector deficits and public sector deficits led to high growth rates. However, these were not accompanied by a concomitant increase in the productive capacity of the economy. High growth supported an increase in imports (which led to the trade deficit as exports did not rise as much and in consumption. Increased Government spending, together with an increase in business confidence, crowded-in the private sector with investment growing rapidly. Further, as noted above, FDI was increasingly focused on the broad consumption sectors including cars, beverages, cement, construction, cigarettes, electronics, financial and personal services, and food.

Rapid growth, in turn, was associated with inflation and with little improvement in the outlook for labour markets. Despite the relatively robust economic growth between 2004 and 2007, Pakistan’s labour market failed to generate a sufficient number of jobs. The employment gap will now worsen as the world recession spreads and the austerity program imposed under the IMF agreement bites. We argue in Section 6 that there is a real case that the contribution from the government sector should be higher to ensure that the available labour resources are fully employed. This will also contribute to a more equitable distribution of resources, and can be done without fuelling inflation.

Figure 1 shows the persistence of the employment gap (the difference between the available labour force and total employment). While the deterioration began in the late 1970s, the gap widened appreciably in the early 1990s following the downturn in 1992 and has persisted since that time. The history of the unemployment rate since 1975 is shown in Panel (b). However, the aggregate employment and labour force data is insufficient to fully understand the extent of labour underutilisation in Pakistan’s labour market.

Figure 1 Labour force aggregates in Pakistan, 1975-2007.



Source: ABD Statistical Database System.

The fall in the official unemployment rate between 2005-06 and 2006-07, from 6.2 per cent to 5.3 per cent hides two problems. First, underemployment is very high. The State Bank of Pakistan (2006) reported that in fiscal year 2003-04, the percentage of the employed and the percentage of the labour force working less than 35 hours were 14 per cent and 12.9 per cent, respectively. This estimate of underemployment is conservative since it doesn’t include those working more than 35 hours but who want additional employment. Second, an increasing percentage of the employed are now subsumed under the category “unpaid family workers”. This component increased from 20.8 per cent of total employed in 2001-02, to 26.9 per cent in 2005-06. Lubna *et al.* (2008) report that 88.03 per cent of the unpaid family workers are in agriculture, 6.97 per cent in retail trade, 3.73 per cent in manufacturing, 0.65 per cent in personal services, 0.58 per cent in construction and 0.54 per cent in finance and business services.

Our assessment of the current situation in Pakistan is that growth by itself is not an adequate goal given the needs of the country (see also Felipe and Hasan, 2006). Policy must be designed to pursue the goal of full employment, price stability and equity. While Pakistan’s latest growth experience during 2004-2007 initially led to high growth, it has now become clear that this growth model failed to address the main problems afflicting the Pakistani economy: (a) a crisis of confidence in the government that was unable (or unwilling) to undertake strong economic measures, such as creating jobs, solving the power and water shortages, and relieving poverty; (b) an inability to keep inflation in check; (c) a neglect of some important components of the supply side of the economy (that is, productive capacity, technological upgrade of the economy); (d) perceived inability to address the increasing fiscal and current account deficits that are believed in many quarters to be undesirable; and (e) inadequate response to security threats.

Like other developing countries that have implemented questionable domestic policies, external shocks have put Pakistan in a very difficult situation. However, inducing a reduction in aggregate demand through recessionary policies to cure problems that have strong supply-side causes (that is, the oil and food price shocks and poor infrastructure) will not help Pakistan.

Often international institutions such as the IMF have been excessively preoccupied with fears of inflation, budget deficits, and trade deficits. Excessive austerity has forced countries to cut spending on high return public investments unnecessarily, and has led to higher unemployment and to larger gaps between actual and potential output. All this has ended up harming growth. The very painful lessons of the East Asian crisis (although it had different roots), and of the subsequent Turkish and Argentine economic collapses (as a result of the ‘shock treatment’ approach), have led some economists to recommend more pragmatic economic policies in periods of crises, to replace the ideologically-based Washington Consensus policies (see Rodrik quote above). Achieving political stability is a key piece of the solution. Austerity measures in the monetary and fiscal fronts will not restore, on their own, much-needed confidence. Unfortunately, the recent IMF help has come with some of the “old strings” attached. While many international institutions as well as governments of developed nations have recognised that the Washington Consensus policies are precisely the wrong medicine for the ills that face the global economy, they still recommend this bad medicine for developing countries.

4.3 What are the benefits of full employment?

The United Nations Universal Declaration of Human Rights includes the right to work, not only because it is important in its own right, but also because it underlies other important rights. In a market economy, many of the other economic and social entitlements proclaimed in the Universal Declaration to be human rights cannot be secured without paying jobs (Mitchell and Burgess, 1998). In many societies, joblessness creates a long list of problems—both for the individuals and for society as a whole: self-pity, self-loathing, and rage at society (Mitchell and Muysken, 2008); absolute and relative poverty, damage to social status and self respect, adverse psychological and physical health effects, stress, suicide, crime and other anti-social behaviour.

Amartya Sen (1999) supports the right to work on the basis that the economic and social costs of unemployment are staggering with far-reaching consequences beyond the single dimension of a loss of income (see also Rawls 1971). However, the private sector does not provide jobs for all those who want to work—and this is even truer in developing nations that may have a small formal sector. Even worse, public policy is biased against the creation of a sufficient supply of jobs on the belief that full employment is not consistent with price stability. Often, joblessness (as well as underemployment) is concentrated among groups that suffer other disadvantages: racial and ethnic minorities, immigrants, younger and older individuals, women (especially female-headed households with children), people with disabilities, and those with lower educational attainment. Hence, at the very least, safeguards are required to protect the minority that suffers the consequences of policy that fights inflation by imposing large costs on a small minority for the benefits of lower inflation that accrue to society as a whole (see for example, Mitchell 1998; Wray 1998; Harvey 2004; ; Mitchell and Wray, 2005; Mitchell and Muysken, 2008).

There are several approaches to explaining the problem of long-term joblessness, of which the most important views are behaviouralist (problems with the individuals who are unemployed), structuralist (for example, skills mismatch), and job shortage (Harvey 2000). The first two of these are invariably adopted by most economists and policy-makers. Mitchell and Muysken (2008) term

this approach, which is exemplified by the widespread acceptance of the OECD Jobs Study (1994), as the “full employability” framework. It replaced the “full employment” paradigm which created strong growth and sufficient jobs in most countries between 1945 and the mid-1970s.

The full employability approach relies on supply-side policies that try to motivate and train the unemployed - to improve their characteristics, together with promotion of greater “flexibility” that would reduce labour market “frictions”. All of this is supposed to make them more appealing to employers and/or improve their work ethic.

However, if the problem is job shortage, that is, that the economy does not generate a sufficient supply of jobs, all that such policies can do is to redistribute unemployment among the unfortunate, who are blamed for their joblessness. Especially in an expansion, those left behind generally do have undesirable characteristics as employers will always recruit the most desirable employees first. But it is a mistake to then conclude that unemployment exists because these people are unworthy of employment - no amount of training or self-improvement will reduce the number of unemployed when the true problem is a chronic job shortage.

We believe that the only way to ensure employment is guaranteed is through a government employment program that offers a paying job to anyone who is ready and willing to work. Our preference is for a program that sets a uniform base compensation (wage and benefits) for all employed in the program. For reasons that will be discussed in Section 6, this provides a compensation anchor that ensures that full employment will not generate inflation pressures. This approach to ensuring full employment has been variously referred to as the “employer of last resort” (ELR) program or the “Job Guarantee” (JG) program (see, for example, Mitchell, 1998; Wray, 1998). In this paper, we use the Job Guarantee nomenclature.

Full employment has many advantages in addition to increasing output and providing income to the employed. As an economy “develops” it tends to provide more of the social provisioning through paid, formal sector, work. This, in turn, also increases the importance of paid work for developing social networks. Paid work also is often the source for access to health care and eventually to retirement funding. Feelings of self-worth become linked to paid work, with those who do not “work” increasingly seen as less deserving of access to society’s resources. So paid work becomes much more than being just a means to obtain income. Social isolation and exclusion as a result of inability to secure paid work afflict the long-term unemployed/underemployed.

A key justification for direct job creation by the government is that no capitalist society has ever managed to operate at anything approaching true, full, employment on a consistent basis without the government playing a significant role as a direct employer. Indeed, it could be argued that all societies that have been able to achieve (or come close to achieving) full employment used a variety of job creation strategies - with the “Swedish model” as a good example that maintained nearly full employment (without inflation) for decades.

Ormerod (1994: 202-203) argues that the Post-WWII period of strong GDP growth, balance of payments stability, and high investment could still have occurred without the low unemployment. However he argues that “the sole difference would have been that those in employment would have become even better off than they did, at the expense of the unemployed.” The higher tax rates and buoyant government sectors allowed the flux and uncertainty of aggregate demand to be

shared. In other words, there are two paths to strong growth: the high employment path that leads to shared prosperity or the low employment path that generates inequality.⁴

While the bulk of the OECD has abandoned this method of sharing, some economies have maintained high levels of employment into the current period despite the dislocation that followed the OPEC oil crises in the mid-1970s and early 1980s. Ormerod (1994: 203) suggests that Japan, Austria, Norway, and Switzerland, among others have (in their own ways) “exhibited a high degree of shared social values, of what may be termed social cohesion, a characteristic of almost all societies in which unemployment has remained low for long periods of time.” Moreover, he argues that (1994: 203) ‘... the countries which have continued to maintain low unemployment have maintained a sector of the economy which effectively functions as an employer of the last resort, which absorbs the shocks which occur from time to time, and more generally makes employment available to the less skilled, the less qualified’ (see also Mitchell, 1998 on buffer stocks).

This buffer stock capacity is particularly important because the burden of joblessness is borne unequally, always concentrated among groups already facing other disadvantages. For this reason, equity considerations require that jobs be made available to all.

Finally, only the government can offer an infinitely elastic demand for labour (offering to hire all those who cannot otherwise find employment) because it does not need to heed narrow market efficiency concerns. Private firms can only hire the quantity of labour needed to produce the level of output expected to be sold at a profitable price. Government can take a broader view to include promotion of the public interest, including the right to work. For these reasons, government should and must play a role in providing jobs to achieve social justice.

5. An alternative proposal: Pakistan as a modern monetary economy⁵

In this Section we consider how monetary and fiscal policies should be integrated to ensure that full employment and price stability are achieved. We take as given that Pakistan has entered into an agreement with the IMF to stabilise its external accounts, and that it is likely that additional loans will be required in the future. The questions that have to be asked are: what are the best policy arrangements available to Pakistan that will maximise the advantages that the IMF injection will provide? Are the policies that accompany the financial package agreed with the IMF in the best interests of the country? And, are they consistent with the achievement of the macroeconomic policy objectives discussed in section 4?

We want to emphasise that the primary goal of economic policy must not be the reduction of budget and current account deficits. We do recognise the need to reassure international lenders and markets that Pakistan is moving toward a sustainable development path. However, we argue that the elimination of the budget and current account deficits should not be viewed as ends in

⁴ During the post-WWII period, governments made choices to achieve low unemployment as we all enjoyed strong growth, high investment, etc. via redistributive policies that had the consensual support of the population. However, they could have used profit-biased redistribution policies, leading to the same outcomes without low unemployment, but countries would have been in an unsustainable growth path.

⁵ Underlying this proposal is a view of money that integrates the Post-Keynesian endogenous money approach; the Keynes-Veblen-Marx monetary theory of production; the state money approach of Knapp and Keynes, and the credit-money approach of Innes. For an in-depth analysis see Wray (1998, 2004).

themselves; rather, budgetary and current account outcomes should be assessed with regards to movement toward a sustainable path.

As discussed above we believe that serious doubt should be cast on the belief that interest rates should be used as an inflation-fighting tool, and on the belief that the central bank can “fine-tune” the economy. Is there an alternative theory of monetary policy that can guide policy formation? In this Section we discuss a “modern money” view of the role of monetary policy and of coordination of monetary and fiscal policy. This alternative view of money leads to quite different conclusions regarding monetary and fiscal policy. It rejects the fundamental orthodox view that money is neutral in the long-run while at the same time our alternative approach downplays the short-run effectiveness of monetary policy. It also generates insights on exchange rate regimes and international payments systems. The premises of this view are: (i) the central bank (the SBP in the case of Pakistan) has a currency-issuing monopoly; and (ii) with a floating exchange rate system, the central bank has to set an interest rate as it is the sole supplier of net balances for the payments clearing system with the member banks.

In orthodox analysis it is common to separate central bank operations from treasury operations. We believe this represents two kinds of misunderstandings. First, central banks are creatures of government. Even if they are nominally independent they are still subject to rules of the legislature. It is very difficult to conceive of a situation in which the central bank bounces treasury checks without censure by the government. As a representative example, the current situation in the US shows how interdependent the central bank’s (Fed) operations are to Treasury. The Fed’s balance sheets have expanded to \$2 trillion as it helps the Treasury and Congress deal with the financial crisis. If it had refused to do so, few observers would doubt that Congress would have changed the laws guiding central bank behaviour. Second, and of more immediate concern, central banks operate with interest rate targets - no matter what they might claim. And to hit these targets they must coordinate operations with the treasury. This is because treasury operations have potentially huge impacts on bank reserves, which then have huge implications for central bank interest rate targeting. This is a topic to be treated below. In short, regardless of claims about central bank independence, any real world independence really boils down to the setting of interest rate targets. All other central bank behaviour is actually accommodative - directed to hitting those targets.

The implication of this for the discussion that follows is that because central banks and treasuries must coordinate operations (to prevent checks from bouncing and to ensure the central bank can hit its interest rate targets), we can actually merge their balance sheets for the purposes of much of our analysis.

5.1 The role of fiscal and monetary policies

(i) Fiscal policy

It is commonly believed that fiscal policy faces a budget constraint according to which its spending must be “financed” by taxes, borrowing (bond sales), or “money creation”. Since many nations prohibit direct “money creation” by the government’s treasury, it is supposed that this option is possible only through complicity of the central bank—which could buy the government’s bonds, and hence finance deficit spending by “printing money”. It is also believed that a government’s budget constraint operates very much like the one an individual faces. However, given the currency-issuing monopoly of Pakistan’s government, this cannot be a constraint with economic content.

Actually, a government that issues its own currency spends by crediting bank accounts - using banks as “agents” of government - while tax payments result in debits to bank accounts. Deficit spending by government takes the form of net credits to bank accounts. Those receiving net payments from government usually hold banking system liabilities while banks hold reserves in the form of central bank liabilities (we can ignore leakages from deposits and reserves into cash held by the non-bank public as a simple complication). While there are fairly complex coordinating procedures followed by the central bank and treasury, the logical point is that deficit spending by the treasury results in net credits to banking system reserves (see Mitchell, 1998; Wray, 1998; Bell 2000, Bell and Wray 2002-03, and Mitchell and Muysken, 2008 for detailed analyses).

If these net credits lead to excess reserve positions, overnight interest rates will be bid down by banks offering the excess in the overnight interbank lending market. Unless the central bank is operating with a zero interest rate target, declining overnight rates trigger automatic open market bond sales to drain excess reserves. It is possible that the central bank agrees to pay the commercial banks the equivalent of the overnight rate on any excess reserve positions that exist. This is the situation in the US at present (April 2009) and means that the reserve drains via bond sales are unnecessary. Hence, on a day-to-day basis, the central bank intervenes to offset undesired impacts of fiscal policy on reserves when they cause the overnight rate to move away from target. The process operates in reverse if the treasury runs a surplus, which results in net debits of reserves from the banking system. This puts upward pressure on overnight rates that is relieved by open market purchases. When fiscal policy is biased to run deficits (or surpluses) on a sustained basis, the central bank would run out of bonds to sell (or would accumulate too many bonds, offset on its balance sheet by a treasury deposit exceeding operating limits). Hence, policy is coordinated between the central bank and the treasury to ensure that the treasury will begin to issue new securities as it runs deficits (or retire old issues in the case of a budget surplus). Again, these coordinating activities can be varied and complicated, but they are not important to our analysis (see Bell and Wray 2002-03 for details.) When all is said and done, a budget deficit that creates excess reserves leads to bond sales by the central bank (open market) and the treasury (new issues) to drain all excess reserves; a budget surplus causes the reverse to take place (bond purchases) when the banking system is short of reserves.

Bond sales (or purchases) by the treasury and central bank are, then, ultimately triggered by deviation of reserves from the position desired by (or required of) the banking system, which causes the overnight rate to move away from target (if the target is above zero). Bond sales by either the central bank or the treasury are properly seen as part of monetary policy designed to allow the central bank to hit its target, rather than as a government “borrowing” operation. The interest rate target is exogenously “administered” by the central bank. Obviously, the central bank sets its target as a result of its belief about the impact of this rate on a range of economic variables that are included in its policy objectives. In other words, setting of this rate “exogenously” does not imply that the central bank is oblivious to economic and political constraints it believes to reign.

The discussion above means that sovereign governments do not borrow in their own currency. Rather, they sell debt in order to drain excess reserves held in the banking system. Each bond sold by government (whether by the central bank or by the treasury) results in an equal debit to banking system reserves. This is true whether the ultimate owner of the bond resides in the country or abroad. There are no complicating issues that arise from foreign ownership of government debt.

As long as the debt is denominated in the domestic currency the government can always service it by crediting interest to bank accounts.

Given that a government can always finance its budget deficit and can always service its own debt (so long as it is denominated in domestic currency) there are no solvency issues that are raised by government deficits and debt. However, this does not mean that government spending, taxing, and resulting deficits cannot have undesired economic and political consequences. It does matter what the government spends on, how much it spends, who it taxes, and how much it taxes. Hence it is important to emphasise that the composition of expenditures in the budget needs to ensure that the budget is conducive to economic sustainability and to full employment of Pakistan's resources. The budget will be inflationary if spending continues to rise once the economy reaches full employment. It can be inflationary even long before full employment is reached if its spending and taxing are directed to inappropriate areas.

In sum, the notion of a "government budget constraint" only applies *ex post*, as a statement of an identity that has no significance as an economic constraint. When all is said and done, it is certainly true that any increase of government spending will be matched by an increase of taxes, an increase of high powered money (reserves and cash) and/or an increase of sovereign debt held. But this does not mean that taxes or bonds actually "finance" the government spending. Government might enact provisions that dictate relations between changes to spending and changes to tax revenues (a balanced budget, for example); it might require that bonds are issued before deficit spending actually takes place; it might require that the treasury have "money in the bank" (deposits at the central bank) before it can cut a check; and so on. These provisions might constrain government's ability to spend at the desired level. However, economic analysis shows that they are self-imposed and are not economically necessary - although they may well be politically necessary.

While a sovereign government is not financially constrained it still issues debt to control its liquidity impacts on the private sector. Government spending and purchases of government bonds by the central bank add liquidity, while taxation and sales of government securities drain private liquidity. These transactions influence the cash position of the macroeconomic system on a daily basis and on any one day they can result in a system surplus (deficit) due to the outflow of funds from the official sector being above (below) the funds inflow to the official sector. The system cash position has crucial implications for the central bank, which targets the level of short-term interest rates as its monetary policy position. Budget deficits result in system-wide surpluses (excess bank reserves).

What is the significance of this? It means that the Government of Pakistan can take advantage of its role in the monetary system to mobilise resources in the public interest, without worrying about "availability of finance" as long as it can spend in its own currency. We believe that it is far more sensible to design a budget with a view to the economic effects desired, rather than with a deficit target in mind (what Abba Lerner called functional finance—see Wray 1998). In other words, tax and spending reform should be formulated to accomplish economic, social, and political objectives rather than to hit a deficit target. Government still must worry about "availability" of real resources: are resources underutilised? If not, increased government use of resources means that other activities will have to be curtailed - a trade-off that should be carefully evaluated. But in the normal situation in which significant portions of national resources are underutilised, the government can use the monetary system to put them to work, simply through its spending that is "financed" by crediting bank accounts. If this results in a budget deficit, that is no cause for alarm.

Fiscal deficits result in net injections of banking system reserves that are drained through sales of government debt either in the new issue market (by Treasury) or through open market sales (by the central bank). In recent years, the State Bank of Pakistan (SBP) (like other financial institutions) has accumulated treasuries as it drained excess reserves. Both the SBP and the international financial markets erroneously believe that this accumulation of treasuries represents “monetisation of the deficit”, and that this contributes to inflationary pressures, although the empirical evidence is scant. If there is inflationary pressure, it would result from the Treasury’s spending, not from the bond sales that drain excess reserves. As we argued above, Pakistan does not suffer from excessive aggregate demand, so government spending has not been excessive. But we emphasise that this does not mean we consider the composition of the net government spending in Pakistan over recent years to be desirable. It is certainly possible for fiscal spending to cause inflation even in the absence of full employment of resources. This could result, for example, if government were spending on output of sectors experiencing bottlenecks so that production could not expand to meet the combined demand of government and the nongovernment sectors. In any case, the notion that the deficit is “monetised” by the SBP, or that bond sales by themselves could be inflationary is not consistent with actual fiscal and monetary operating procedures.

Problems are greatly compounded if the nation has issued foreign-currency denominated debt. If this debt is issued by private firms (or households), then they must earn foreign currency (or borrow it) to service debt. To meet these needs they can export, attract FDI, and/or engage in short-term borrowing. If none of these is sufficient, default becomes necessary. There is always a risk of default by private entities, and this is a “market-based” resolution of the problem. If however the government has issued (or taken over) foreign currency denominated debt, default becomes more difficult because there is no well delineated international method. Often, the government is forced to go to international lenders to obtain foreign reserves; the result can be a vicious cycle of indebtedness and borrowing. Since international lenders request austerity, domestic policy becomes hostage. For this reason, it is almost always poor strategy for government to become indebted in foreign currency, which really does expose it to solvency risk.

By contrast, a sovereign government can never face insolvency in its own currency. Sovereign government can always “afford” whatever is for sale in terms of its own currency. It is never subject to “market discipline”. A sovereign government spends by crediting bank accounts, and it can never “run out” of such credits. When it credits the bank account of any recipient of its spending (whether this is for purchases of goods and services or for social welfare spending), the central bank simultaneously credits the bank’s reserve account. If this leads to excess reserves, these are then exchanged for treasury debt. While the IMF and other observers criticise sales of treasury debt to the SBP, it actually makes no difference whether treasury sells the debt to private banks. In effect the sales directly to the SBP simply bypass the bank “middlemen”.

For example, in the USA, the Federal Reserve (the “Fed”) buys very little debt directly from the treasury. Instead, the treasury sells its debt to special depository banks. In order to buy these bonds, the banks must have reserves in their accounts at the Fed; this is accomplished by the Fed lending the reserves to them. When they then buy the bonds, their reserves are debited and the Fed then credits the Treasury’s account. When the Treasury then spends, its deposits are debited and bank reserves are credited. Because this will almost certainly result in excess reserve positions, the Fed then sells the bonds back to banks, debiting their reserves. If the banks later need reserves, they sell the bonds to the Fed. The end result is no different if the Fed were to simply buy the bonds directly from the Treasury: banks would end up with reserve credits once the Treasury spends and

the Fed would sell the bonds to drain any excess reserves. Direct sales to the Fed would thereby simplify the process, but the end result would be the same.

It is only a misunderstanding of reserve accounting that leads to the belief that it makes a difference whether treasury debt is first sold to the SBP or to private banks. The end result will be the same: the distribution of treasury debt holdings between the SBP and the private sector will depend on portfolio preferences of the private sector. These preferences are reflected in upward or downward pressure on the overnight interest rate. To hit its target, the SBP must accommodate private sector preferences by either taking the debt into its portfolio, or by selling the debt to reduce bank reserves.

The only complication is that the treasury can issue debt of different maturities. Very short-term treasury debt is equivalent to bank reserves that earn interest. Long term treasury debt is not a perfect substitute because capital gains and losses can result from changes to interest rates. Hence if there is a lot of uncertainty about the future course of interest rates, trying to sell long-term treasury debt to private markets can affect interest rates and the term structure. For example, selling long-term debt that is not desired by the private sector will lead to low prices and high interest rates for that debt. In this case, it is not really the case that budget deficits are affecting interest rates, but rather the decision to sell debt with a maturity that is not desired by markets. The solution would be to limit treasury debt to short-term maturity.

(ii) Monetary policy

There was a long-held belief that the central bank could and should control the money supply as a mechanism to control inflation- a view that lost credence during the 1990s as major nations abandoned any pretext of hitting money targets. The alternative view is that the central bank has no discretion regarding its issue of reserves, nor of the private supply of money (bank deposits). Further, the rate of growth of any monetary aggregate provides no information of use to policymakers - whether we are talking of HPM, M1, M2, or any broader monetary measure (see Moore 1988). The quantity of an outstanding “money stock” is simply an aggregation of some portion of the quantity of credits (and, equally, debits) outstanding at some point in time. It can grow through time either because the rate of creation of new credits (and debits) has risen, or because the rate of “retirement” of credits (that is, matching credits and debits to clear them) has fallen. Either of these can result from a variety of circumstances, and correlation with some measure of the “value” of money (as measured by an index of prices of a selected basket of marketed commodities) could be entirely coincidental. This is why all major nations abandoned any pretense of hitting money targets in favour of explicit interest rate targeting.

The SBP currently pursues monetary aggregate targeting. This assumes that the money demand function is stable and that there exists a predictable relationship between monetary aggregates and inflation. However, empirical work indicates that the money demand function is unstable. Moinuddin (2007) has argued and shown empirically that as Pakistan’s money demand function, that is, demand for real balances as a function of real GDP, and real interest rates is unstable, monetary aggregate targeting is not feasible. Likewise, Akbari and Rankaduwa (2006) have estimated a price model (as a function of the exchange rate, foreign prices, money supply and GDP) and concluded that, overall, monetary policy exerts a weak impact on domestic prices.

In reality, the SBP really only targets overnight interest rates. In direct response to questions we posed to the SBP concerning its procedures, it provided the following clear explanation:

Q: What is the current policy of the SBP?

A: **The policy rate of SBP is the 3-day repo rate (also known as the discount facility).** This is a standing lending facility available to commercial banks and other eligible non-bank financial institutions. Typically, this facility is used as a last resort—that is, when financial institutions are unable to raise the required funds from the interbank money market—to meet any shortfall in the reserve requirements that banks have to keep with SBP. SBP provides cash accommodation against approved government securities to eligible financial institutions by undertaking an overnight reverse repo transaction. The transaction period can be up to 3 days and is extendable to cover official holidays. The approved securities include government papers like treasury bills, Pakistan Investment Bonds (PIBs) and Federal Investment Bonds (FIBs).

Q: Has it followed the US in converging the three rates?

A: **There are no other interest rates offered by SBP for lending or deposit purposes** other than the policy rate. Like the federal funds rate in the US, there is no particular rate which is officially targeted by the SBP. To achieve monetary policy objectives, however, SBP attempts to maintain overnight interbank repo rate within a band for operational purposes. The policy rate serves as a ceiling of the band whereas the floor is set internally and is not communicated to the public specifically. This practice has been adopted over the last couple of years only.

Q: Or is the support rate still below the policy rate which is below the discount rate?

A: As mentioned earlier, the discount rate is the policy rate in SBP and **no support rate for deposits is currently being offered.**

So, to conclude, the SBP sets a short term discount rate for its loans of bank reserves, and it operates in the market to keep the interbank lending rate within a desired band. The discount rate is the ceiling rate for that band, while the floor rate is known only to the SBP. Finally as the SBP does not pay interest on reserves, excess reserve holdings do not earn interest and therefore will always be minimized by the banking system. This means that all else equal, banks will try to lend excess reserves or will use them to buy earning assets such as treasuries. Since the SBP has adopted an interest rate target, it must as a matter of logic provide reserves on demand; this implies that it has no direct control over the money supply. It must use interest rate changes—not money supply changes—to try to influence inflation rates.

Moreover, even if the link between “money growth” and “inflation” were more than coincidence, which policy might constrain “money growth” is far from unambiguous. Direct “credit controls” that constrain lending for, say, real estate purchases could be effective in cooling overheated housing construction markets, which *could* reduce the growth of a price index that included housing prices, and could *perhaps* reduce the growth of some monetary aggregate. However, it is hard to see why the usual tool used by modern central banks - rate hikes - would generally result in lower money growth and inflation (however defined). Interest rate changes have multifarious effects on spending, income distribution, solvency and hence financial stability, and costs. For example, rate hikes will shift the distribution of income from debtors to creditors, which has complex, perhaps offsetting effects on spending (consumption, investment, government, and foreign sector). While it is generally believed that rate hikes reduce borrowing and spending, lowering aggregate demand and thus price pressures, this could be offset (as mentioned in Section 3) by the effects of higher interest costs on businesses that have to finance wages, inventories, and

capital projects. Finally, government is a net payer of interest in most nations, and as rates rise, government spending rises, which increases interest income and presumably the spending of the non-government sector. It is no wonder that empirical studies have not been able to find consistent evidence in favour of the conventional views of interest rate-spending-inflation relations.

In conclusion, even if there is a link between “money” and “inflation” (however defined), it is not at all clear that conventional monetary policy has any predictable effect on inflation (or spending). This does not mean that money is neutral, for money is key to the production process in a capitalist economy. But it does cast serious doubt on the new monetary consensus call for fine-tuning of “demand gaps” through use of monetary policy.

Note that these arguments are predicated on adoption of a floating exchange rate. A country that operates on a gold standard, or a currency board, or a fixed exchange rate is constrained in its ability to use the monetary system in the public interest, because it must accumulate reserves of the asset(s) to which it has pegged its exchange rate. This leads to significant constraints on both monetary and fiscal policy because they must be geared to ensure a trade surplus that will allow accumulation of the reserve asset. This is because such reserves are required to maintain a credible policy of pegging the exchange rate. On a fixed exchange rate if a country faces a current account deficit, it will need to depress domestic demand, wages and prices in an effort to reduce imports and increase exports. In a sense, the nation loses policy independence to pursue a domestic agenda. Floating the exchange rate effectively frees policy to pursue other, domestic, goals like maintenance of full employment.

An important point to be made regarding treasury operations by a sovereign government is that the interest rate paid on treasury securities is not subject to normal “market forces” unless the government voluntarily chooses to do so (as in Australia with its auction system). The sovereign government only sells securities in order to drain excess reserves to hit its interest rate target. It could always choose to simply leave excess reserves in the banking system, in which case the overnight rate would fall toward zero. When the overnight rate is zero, the Treasury can always offer to sell securities that pay a few basis points above zero and will find willing buyers because such securities offer a better return than the alternative (zero). This drives home the point that a sovereign government with a floating currency can issue securities at any rate it desires—normally a few basis points above the overnight interest rate target it has set. There may well be economic or political reasons for keeping the overnight rate above zero (which means the interest rate paid on securities will also be above zero). But it is simply false reasoning that leads to the belief that the size of a sovereign government deficit affects the interest rate paid on securities.⁶

For a real world example, one need only look at the case of Japan over the past fifteen years or more, which has long had by far the largest government deficit (relative to GDP - reaching to 8 per cent) as well as the all-time largest outstanding government stock of debt (in absolute and relative terms, at 150 per cent of GDP) of any major developed country. However, Japan long

⁶ We do not consider the question of why so many analysts have pursued false reasoning and encouraged governments to voluntarily constrain their options. In Australia, for example, the auction model whereby the government debt is sold at whatever price the market sets was introduced by a conservative governments to provide fiscal discipline. Under the prior “tap” model, the government would set the rate and then sell whatever debt was demanded. Shortfalls would be made up from “cheaper” central bank funds. Allegedly, the availability of “cheap” funds led to lax fiscal standards.

maintained interest rates on government securities at a few basis points above zero (and sometimes, for technical reasons, even below zero!). The US Treasury accomplished the same feat during WWII, when short term treasuries paid 3/8 of one percent even as the deficit-to-GDP ratio reached 25 per cent of GDP - three times higher than Japan's current ratio! This indicates that a sovereign nation with a floating exchange rate can choose to “enjoy” interest rates on government debt as low as it wants. By the same token, the sovereign government could have interest rates above 100 per cent if it so desired. All it need do is set the overnight rate target at 100 per cent and then sell securities whenever excess reserves placed downward pressure on that rate. This drives home the point that the interest rate is exogenously set in any sovereign nation. Whether the base rate will be zero or one hundred is a policy matter, not subject to market determination.

Competition between the commercial banks to create better earning opportunities on the surplus reserves then puts downward pressure on the cash rate. But importantly, these transactions cannot eliminate the surplus reserves. Only transactions between the government and non-government sector adds to and subtracts from the reserve system. In the context of a budget deficit, if the central bank desires to maintain its target cash rate then it must provide an alternative to this surplus liquidity by selling government debt – the “draining” of excess reserves we mentioned above. In other words, government debt functions as interest rate support via the maintenance of desired reserve levels in the commercial banking system and not as a source of funds to finance government spending. The “penalty” for not issuing the debt would be that the central bank would “lose control” over the short-term interest rate which would fall to zero (if no rate was paid on commercial bank reserves held at the central bank or whatever support rate the central bank offered on the same reserves).

When the central bank desires to target a non-zero interest rate, budget deficits will thus lead to growing debt and increased interest payments. However, the interest rate is (or at least can be) a policy variable for any sovereign nation (recall this requires a flexible exchange rate.) It is conceivable that the government can increase its deficits and its outstanding debt while simultaneously lowering its interest payments by lowering interest rates. However, in recent months, the central bank of Pakistan raised its target rate so that market rates have risen (to about 15% for the 3-month rate; and to almost 25% for the 10-year dollar denominated government bonds rate). Given a government debt ratio of about 50 per cent of GDP, and a central bank target of 15% interest rate, government debt service will converge toward at least 7.5 per cent of GDP (once all outstanding government debt resets at the higher rates; it will converge to a higher number if interest rates are increased further, or if the debt ratio rises). Debt service alone will then absorb half of all government revenue (currently about 13 per cent of GDP). Cutting the target interest rate by half (that is, so that market rates fall below 7.5% per cent) would free more fiscal policy space than is likely to be obtained either by draconian cuts to other spending or by huge increases to tax rates. Lower target interest rates would also have beneficial impacts on the private sector by reducing the rate of return that investments would have to achieve, lowering debt service costs to households, and likely reducing income inequality (since interest recipients are likely to be higher income households).

Let us contrast the discussion above with the situation of a non-sovereign nation (one that operates without a sovereign currency) that tries to peg its exchange rate. A non-sovereign government faces an entirely different situation. In the case of a “dollarised” nation, the government must obtain dollars before it can spend them. Hence, it uses taxes and issues IOUs to obtain dollars in anticipation of spending. Unlike the case of a sovereign nation, this government must have “money

in the bank” (dollars) before it can spend. Further, its IOUs are necessarily denominated in dollars, which it must obtain to service its debt. In contrast to the sovereign nation, the non-sovereign government promises to deliver third party IOUs (that is, dollars) to service its own debt (while the US and other sovereign nations promise only to deliver their own IOUs).

Furthermore, the interest rate on the non-sovereign, dollarized government's liabilities is not independently set. Since it is borrowing dollars, the rate it pays is determined by two factors. First, there is the base rate on dollars set by the monetary policy of the US government (the issuer of the Dollar). On top of that is the market's assessment of the non-sovereign government's credit worthiness. A large number of factors may go into determining this assessment. The important point, however, is that the non-sovereign government, as user (not issuer) of a currency cannot exogenously set the interest rate. Rather, market forces determine the interest rate at which it borrows.

For a real world example of the benefits of adopting a floating, sovereign, currency we can look to Argentina. Between 1991 and 2002, it essentially adopted a currency board by pegging the Argentine peso to the US dollar for reasons we will not explore here. This led to a social and economic crisis that could not be resolved while it maintained the currency board. However, as soon as Argentina abandoned the currency board, it met the first conditions for gaining policy independence: its exchange rate was no longer tied to the dollar's performance; its fiscal policy was no longer held hostage to the quantity of dollars the government could accumulate; and its domestic interest rate came under control of its central bank. One of the first policy initiatives taken by newly elected President Kirchner was a job creation program that guaranteed employment for poor heads of households. Within four months, the *Plan Jefes y Jefas de Hogar* had created jobs for 2 million participants which was around 13 per cent of the labour force.

This not only helped to quell social unrest by providing income to Argentina's poorest families, but it also put the economy on the road to recovery. Conservative estimates of the multiplier effect of the increased spending by *Jefes* workers are that it added a boost of more than 2.5 per cent of GDP. In addition, the program provided needed services and new public infrastructure that encouraged additional private sector spending. Without the flexibility provided by a sovereign, floating, currency, the government would not have been able to promise such a job guarantee.

Argentina also benefited from currency depreciation that was made possible by dropping the peg to the dollar, as her exports became competitively priced. The US expansion as well as the world-wide rise of commodities prices helped Argentinean exports. To be sure, there always was some degree of precariousness inherent in the reliance on export-led growth driven simply by price competitiveness. It remains to be seen whether Argentina will cope with the global economic slowdown and the collapse of commodities prices. Currency sovereignty allows the nation to use fiscal policy (and to a lesser degree, monetary policy) to continue to create jobs in the private and public sectors—although we do not know that it will.

A nation that adopts its own floating rate currency can always afford to put unemployed domestic resources to work. Its government will issue liabilities denominated in its own currency, and will service its debt in its own currency. Whether its debt is held internally or externally, it faces no insolvency risk. Further, the floating currency gives domestic policy an additional degree of freedom. This does not mean that the nation will necessarily ignore its trade balance or movements of its exchange rate, but it does mean that it can put domestic employment and growth at the top of its policy agenda.

Today, it is widely recognised that monetary policy sets the overnight interest rate target; the central bank then supplies or drains reserves as necessary to hit the target. The reserve accounting discussed above does not change this; in other words, whether there are budget deficits or not has no implication for the determination of overnight interest rates. Indeed, coordination between treasury and central bank operations is undertaken to ensure that overnight rate targets can be hit; this is the reason why procedures are adopted to ensure that banks are neither short of reserves nor left holding excess reserves. All things equal, budget deficits place downward pressure on short term interest rates; this is relieved through bond sales (new issues or open market sales). Budget surpluses place upward pressure on rates, relieved through bond purchases (retirement by treasury or open market purchases).

In Section 3, we provided a comprehensive critique of the view that the central bank has strong influence over inflation rates. There is neither theory nor evidence to support the belief that raising interest rates is effective in fighting inflation; or that lowering rates fights deflation. In Section 6, we will discuss an alternative method of fighting inflation. Most importantly, if the source of inflation is not coming from excess private sector demand, it makes little sense to try to fight inflation by raising interest rates in the hope this will diminish interest-sensitive spending. For example, if inflation comes from government subsidies or from rising oil prices, raising interest rates is not a good method of fighting inflation.

5.2 Overview of Pakistan’s macro balances

Examination of Pakistan’s economy by using the sectoral balances framework (shown in Figure 2) complements the analysis above and allows us to elaborate a number of important points regarding the fiscal and current account deficits. We can think of the economy as being composed of 3 sectors: a domestic private sector, a government sector, and a foreign sector. If one of these spends more than its income, at least one of the others must spend less than its income because for the economy as a whole, total spending must equal total receipts or income. While there is no reason why any one sector has to be in balance at any point in time, the system as a whole must . Often, though not always, the private sector runs a surplus—spending less than its income. This is how it accumulates net financial wealth. Private sector saving (or surplus) is a leakage that must be matched by an injection. The current account deficit is another leakage that drains domestic demand.

Obviously, this framework is another way of viewing the National Accounts of an economy. By equating the uses of factor income with the major expenditure aggregates, we get the familiar statement that the Government balance is exactly the opposite, rupee for rupee, of the Non-government balance:

$$(G - T) = (S - I) + (M - X)^7 \tag{1}$$

⁷ We start with $Y = C + I + G + (X - M)$, where Y is nominal GDP, C is household final consumption, I is private gross investment, G is total government spending, X is total exports and M is total imports. Total factor income (Y) can be used for consumption (C), Saving (S) and Taxation (T) so that $I + G + (X - M) = S + T$ or $(G - T) = (S - I) + (M - X)$. In other words, the Government balance is exactly the opposite, rupee for rupee, of the Non-government balance. The latter is further decomposed into the domestic private balance ($I - S$) and the Current Account deficit ($X - M$). Clearly, some behavioural underpinnings are

$(G - T)$ is the budget deficit, $(S - I)$ is domestic saving and $(M - X)$ is foreign saving in rupees (otherwise known as the Current Account deficit). Therefore, for the non-government to net save, the government balance must be in deficit. Holding the domestic non-government sector balance constant, growth of the current account deficit will be identical to growth of the government's deficit. This can be explained in the old Keynesian leakage-injection terms: the current account deficit is a leakage that must be matched by the government sector deficit. The important aspect of this stock-flow consistent approach is that a sector's spending flow must equal its income flow plus changes to its financial balance. This implies that a sector can spend more than its income, but this implies a deduction from its net financial assets. Likewise, the deficit spending of one sector implies that at least one other sector must be spending less than its income, accumulating net financial assets.

Obviously, Pakistan can run a current account deficit only if the rest of the world wishes to accumulate financial claims on the nation. For the most part, these claims are in the form of government debt which is issued as the government runs deficits. Since there is no default risk on government debt, such a situation is "sustainable" and should not be interpreted to be necessarily undesirable. We repeat that it depends on the usefulness of the government's spending program. If it enables the nation to achieve the five major goals we discussed earlier, then any required budget deficit would have been desirable. This is what Abba Lerner (1943) called the "functional finance" approach: rather than adopting some desired budgetary outcome, government ought to spend and tax with a view to achieving "functionally" defined outcomes.

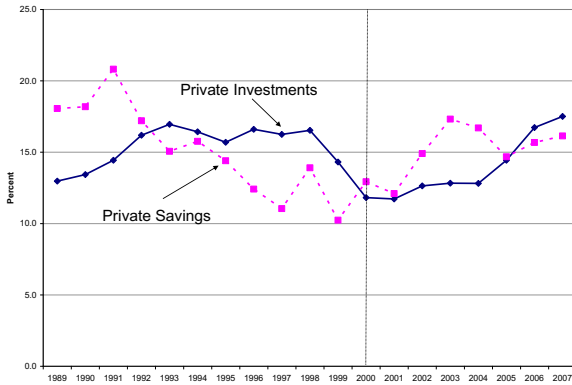
The consequences of a budget surplus are also clear. The non-government sector will be forced into deficit and the domestic private sector will be forced into increasing indebtedness to maintain expenditure. This is an unsustainable growth strategy because eventually the private sector will reduce its balance sheet precariousness by saving more and the resulting drop in aggregate demand will reinforce the deflationary impact of the fiscal drag (the budget surplus).

Figure 2 shows the Pakistan's three macroeconomic balances, private, public and external. For 2007 we see that the government deficit (about 5%) equals the sum of domestic private saving less investment (almost negative 1%) and imports less exports (about 6%). Over the last few years, Pakistan's private sector balances have moved to larger deficits - from a position of net saving in 2005 to an estimated deficit of 0.6 per cent of GDP in 2007. It is interesting to note that up until 2005 the private balance was deteriorating in line with the reduction in the public deficit. This occurred as the external balance was less variable and moved within a band of around 2 to 5.5 per cent of GDP. The push to reduce budget deficits squeezed the private sector of liquidity which made it harder for that sector to save. Essentially, budget deficits "finance" non-government sector saving by creating the income that can be saved. The private balance improved sharply during the Current Account surpluses of 2002-2004 where the desire by foreigners to accumulate Rupee-denominated financial assets declined.

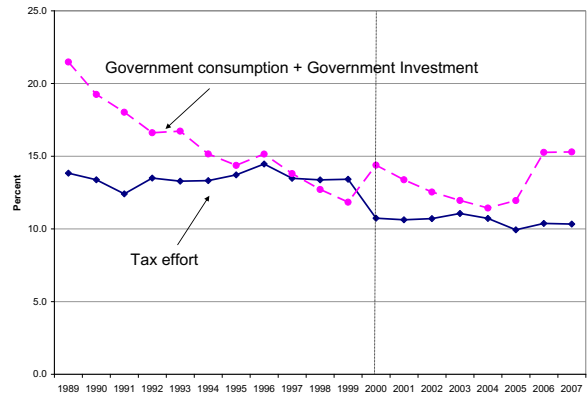
required to move from an accounting statement to an understanding of policy choices for any particular country.

Figure 2: Pakistan's Sectoral Balances, 1989-2007 (% of GNP)

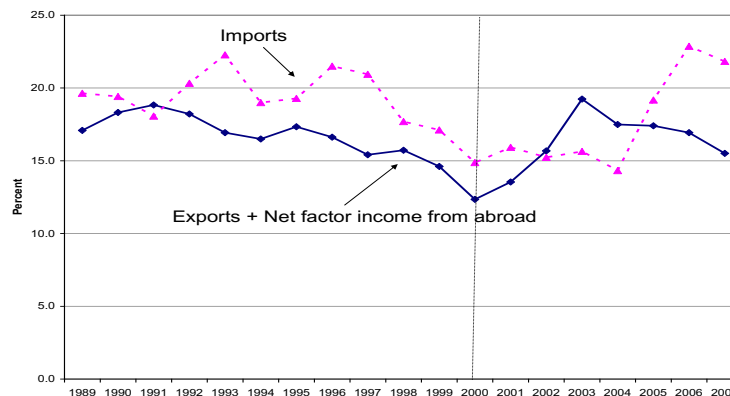
2a. Private saving and investment



2b. Taxes and government expenditure



2c. (Exports + NFIA) and Imports



Source: ADB Key Indicators 2007

It is important to understand that the domestic balance must equal the external sector balance. The domestic balance can be further divided into a government sector and a private sector. By construction, the private sector deficit plus the government sector deficit equals the external sector deficit (more technically, the sum of the government sector deficit and the domestic private sector deficit equals the capital account surplus). The figure shows that during the last few years, private sector balances have moved to larger deficits, and that the public sector deficit has also grown. This is due to a combination of rising government spending (from about 12 per cent of GDP to 15 per cent currently) while tax revenues have remained at about 10 per cent of GDP. These two deficits imply a large external current account deficit – 5.3 per cent of GDP in 2007. The current account deficit increased as a percentage of GDP in fiscal year 2007-2008.

In general, nation building requires the national government to run 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 hence productive capacity.

Further, we want to emphasise that Pakistan is not unusual in running a budget deficit in recent times. For example, in the US, the government sector taken as a whole almost always runs a budget deficit, reaching to around 5 per cent under Reagan and both Bushes. For the US, that has been the main injection that offsets the “normal” private and occasional foreign sector leakages. With a traditional private sector surplus of 2-3 per cent and a more or less balanced trade account, the “normal” budget deficit needed to be about 2-3 per cent during the early Reagan years. Until the Clinton expansion, the private sector never ran a deficit. However, since 1996 the private sector has been in deficit every year except one (during the depths of the recession in 2000), and that deficit climbed to more than 5 per cent of GDP at the peak of the boom. Currently, the budget deficit is climbing above 5 per cent of GDP and is likely to reach 8 per cent (or more) next year. At the same time, the private sector continued to run a budget deficit up through 2008. We have yet to see if the curtailment of investment and consumption that is now occurring will allow the private sector to return to a surplus. If it were to go toward a surplus of 10 per cent of GDP (which was common in previous recessions such as the 1974-5 recession as well as the Reagan recession), and if the current account remained in deficit, the budget deficit could rise above 10 per cent of GDP.

A trade deficit represents a leakage of demand from the domestic economy to foreign production. There is nothing necessarily bad about this, so long as we have another source of demand for domestic output, such as a federal budget that is biased to run an equal and offsetting deficit. Private sector net saving (that is, running a surplus) is also a leakage; however, like the US, Pakistan’s private sector is running a deficit - another injection. These injections equal (by identity) the current account deficit that Pakistan has today (6.5%-7% per cent of GDP). Let us presume that in the snowballing global financial crisis Pakistan’s private sector turns toward a surplus. This leakage would have to be made up by an injection from the third sector, the government - the only way to sustain a large leakage (private surplus plus external deficit) is for the overall government to run a deficit of the same size. The government budget deficit is largely non-discretionary over a business cycle, and at least over the shorter run we can take the trade balance as also largely outside the scope of policy—with imports a function of domestic demand but exports depending on ROW demand.

A driving force of the cycle, then, is the private sector leakages (however, this is not to be interpreted incorrectly as an endorsement of the view that leakages “cause” or “finance” injections – which would reflect a “backwards” reasoning). The important point is that when the private sector has a strong desire to save, it tries to reduce its spending below its income. Domestic firms cut production, and imports might fall too. The economy cycles downward into a recession as demand falls and unemployment rises. Tax revenues fall and some kinds of social spending (such as social support) rise. The budget deficit increases more-or-less automatically. When the private sector has a high desire to spend, it can run deficits on its balance, driving the current account into deficit and reducing (or, even eliminating) the budget deficit.

The fiscal stance thus plays a very important role in providing “balance” to the economy; it fills the “demand gap” that is opened up by operation of the non-government sectors (domestic private sector plus rest of world sector). The budget outcome is not really a discretionary variable - it “balances” the outcomes of the other two sectors. Essentially, a government deficit can result from

two outcomes - one preferred over the other. Slow economic growth will lower tax revenues and increase some kinds of government spending (those on social support). That is the “bad” budget deficit. A budget deficit can also result from a positive fiscal stance that generates adequate and sustainable economic growth, providing the income and growing net financial wealth that meets the private and external sectors’ desires at full employment. This should always be the goal of budgetary planning; by contrast, a budget deficit that results from inadequate growth should be viewed as a failure. In other words, simply observing a deficit outcome cannot by itself tell us anything about the success or failure of government fiscal policy. This is what Abba Lerner meant when he advocated “functional finance”: formulate tax and spending policy with a view to achieving the public purpose rather than with a view to any arbitrary budgetary outcome (such as achieving a balanced budget).

If the current crisis had been avoided, was Pakistan’s chronic current account deficit a problem? Our assessment is that eliminating a current account deficit it is not a necessary medium-term policy goal for Pakistan. First, it must be remembered that for an economy as a whole, imports represent a real benefit while exports are a real cost. Net imports means that a nation gets to enjoy a higher living standard by consuming more goods and services than it produces for foreign consumption. Further, even if a growing trade deficit is accompanied by currency depreciation, the real terms of trade are moving in favour of the trade deficit nation (its net imports are growing so that it is exporting relatively fewer goods relative to its imports). Second, deficits reflect underlying economic trends, which may be desirable (and therefore not necessarily bad) for a country at a particular point in time. For example, in a nation building phase, countries with insufficient capital equipment must typically run trade deficits to ensure they gain access to best-practice technology which underpins the development of productive capacity.

A current account deficit reflects the fact that a country is building up liabilities to the rest of the world that are reflected in flows in the financial account. While it is commonly believed that these must eventually be paid back, this is obviously false. As the global economy grows, there is no reason to believe that the rest of the world’s desire to diversify portfolios will not mean continued accumulation of claims on Pakistan. As long as Pakistan continues to develop and offers a sufficiently stable economic and political environment so that the rest of the world expects it to continue to service its debts, its assets will remain in demand.

However, if a country’s spending pattern yields no long-term productive gains, then its ability to service debt might come into question. Therefore, the key is whether the private sector and external account deficits are associated with productive investments that increase ability to service the associated debt. Roughly speaking, this means that growth of GNP and national income exceeds the interest rate (and other debt service costs) that the country has to pay on its foreign-held liabilities. Here we need to distinguish between private sector debts and government debts. The national government can always service its debts so long as these are denominated in domestic currency. In the case of national government debt it makes no significant difference for solvency whether the debt is held domestically or by foreign holders because it is serviced in the same manner in either case - by crediting bank accounts. In the case of private sector debt, this must be serviced out of income, asset sales, or by further borrowing. This is why we suggest that long-term servicing is enhanced by productive investments and by keeping the interest rate below the overall growth rate. These are rough but useful guides. Note, however, that private sector debts are always subject to default risk - and should they be used to fund unwise investments, or if the interest rate is too high, private bankruptcies are the “market solution”. Only if the domestic government

intervenes to take on the private sector debts does this then become a government problem. Again, however, so long as the debts are in domestic currency (and even if they are not, government can impose this condition before it takes over private debts), government can always service all domestic currency debt. Whether government should take over private debt is a matter beyond the scope of this paper; however, we would recommend that government never take over foreign currency denominated debt.

In recent months, Standard and Poor's downgraded Pakistan's debt rating. And both Standard and Poor's and Moody's have termed Pakistan a "highly speculative" country for bond investment. The rating agencies' reputation has already been severely hurt by their failure to recognise the extreme riskiness of various securitised debt products issued in America. Some years ago, it was also tarnished when they downgraded Japan's debt rating. We note that domestic currency sovereign debt issued in a floating rate regime has no default risk, a fact that is sometimes acknowledged by the credit rating agencies. Unfortunately, they erroneously continue to downgrade such debt based on inappropriate deficit and debt ratios (government debt and deficit to GDP ratios, as well as trade deficit ratios). When pressed, the raters argue that what they really are rating is exchange rate risk, which is the probability that the currency might depreciate against foreign currencies. It should be noted that there is no evidence that exchange rate forecasting based on these ratios, or any other economic data, does better than random predictions. Hence, there is no justification for the downgrading that has been done for sovereign debt.

Private debt is a different matter as there is default risk, and it is plausible that Pakistan's non-government sector does now face higher default risk - although as discussed above, most external debt is government debt. Still, there is little that Pakistan can do to stop rating agencies from downgrading public sector debt. While Japan had protested such downgrading in the past, its efforts were not successful in stopping this erroneous practice. Still it should be noted that in spite of the downgrading of Japan by credit raters - to a level on par with the rating given to Botswana - interest rate spreads on Japan's sovereign debt were barely affected by the ratings.

However, in the case of Pakistan, the ratings are consistent with the pessimistic view of the international financial markets about Pakistan's government policy and capacity to deal with the current crisis. On August 19, 2008, the spread of Pakistani sovereign bonds had a risk premium of 912 basis points, more than twice that of Vietnam. A package of emergency measures (such as the international funding agreement already reached) and medium term policies can help to reassure markets.

Partly in response to international pressure, the government had planned to shift domestic purchases of government bonds by the SBP to the issuance of government bonds and securities to commercial banks at market rates. However as discussed above, this plan reflects a misunderstanding of the purpose of bond sales. And to the extent that fiscal operations result in credits of reserves to the banking system, bonds will need to be sold to avoid impacts on the overnight interbank borrowing rate. To the extent that government spends its own currency, and issues bonds in its own currency, there is no default risk entailed. This holds true whether the treasury bonds are held domestically or by foreigners.

Summing up, how is the new government doing in dealing with the current crisis, and setting the economy on a sustainable course? As discussed above, the national government is trying to implement a series of measures to stabilise the economy and in this way set the basis for a successful recovery; and at the same time it is trying to deal with the inflation problem. In our

view, while some measures taken appear to be sensible, it is counterproductive to try to achieve the target budget deficit. We believe that it is far more sensible to design a budget with a view to the economic effects desired, rather than with a deficit target in mind. In other words, tax and spending reform should be formulated to accomplish economic, social, and political objectives rather than to hit a deficit target.

Our view is that the Government will find it very difficult to achieve its budget deficit target even if it were to cut its spending on social services (education, health, etc.) and development expenditures drastically. This is because such draconian cuts would be likely to throw the economy into a deep recession that would reduce tax revenues. If this were done, it would have serious repercussions for Pakistan's political stability and for its future. A better strategy would be to negotiate with the multilateral agencies a program that would allow the country to service its external debt and gradually reduce its trade deficit until it reaches a more manageable level. During this time, the structure of spending should be analysed, and a realistic development program should be devised.

For these reasons, we do not believe there is any need to impose a balance of payments constraint on Pakistan for the medium-to-long term. We would suggest, however, that the government of Pakistan should be wary of taking over private debts and should monitor the amount of foreign currency denominated debt that it takes - which does have default risk.

6. An alternative framework for stability and sustainability: the Job Guarantee

6.1 Overview

In this Section we consider the concept of a national employment guarantee for Pakistan. We provide a framework for understanding the different ways in which buffer stocks can be used to control inflation. We show that the Job Guarantee (JG) provides government with a buffer stock alternative that delivers both full employment and price stability (Mitchell, 1998; Wray, 1998; Mosler, 1997-98; Mitchell and Mosler, 2002, 2006; Mitchell and Muysken, 2008.).

The discussion in the previous section provided the essential conceptual background to recent developments in modern monetary economics and this background, in turn, engenders an understanding of how the introduction of a JG is consistent with sound macroeconomic management by providing the basis for maintaining full employment with price stability.

The JG is an integral part of a broad macroeconomic policy framework based on the recognition that modern monetary systems are in fact public monopolies *per se*, which introduce imperfect competition to the monetary system itself. In this type of economy, the imposition of taxes coupled with insufficient government spending generates unemployment in the private sector.

Mainstream economics uses unemployment as an inflation control mechanism. The wave of support for the concept of the NAIRU by policy makers is indicative of the level of influence the orthodox theories have had over the last 30 years. Under a NAIRU regime, inflation is controlled using tight monetary and fiscal policy, which leads to a buffer stock of unemployment. The "elusive" NAIRU is a costly and unreliable target for policy makers to pursue as a means for inflation proofing.

The JG alternative uses an employment buffer stock approach. Under a JG, the inflation anchor is provided in the form of a fixed wage (price) employment guarantee. Full employment requires that there are enough jobs created in the economy to absorb the available labour supply. Focusing on some politically acceptable (though perhaps high) unemployment rate is incompatible with sustained full employment.

The employment buffer stock approach (the JG) exploits the imperfect competition introduced by the operations of the sovereign (flexible exchange rate) currency which provides the issuing government with pricing power and frees it of nominal financial constraints. The JG approach represents a break in paradigm from both traditional Keynesian policies and the neo-liberal NAIRU-buffer stock approach. The difference is a shift from what can be categorised as spending on a *quantity rule* to spending on a *price rule*. For example, under the policy frameworks typically employed by many countries, including Pakistan, the government generally budgets a quantity of currency to be spent at prevailing market prices. This is what we mean by spending on a quantity rule. In contrast, with the JG option, the government additionally offers a fixed wage to anyone willing and able to work and thereby lets market forces determine the total quantity of government spending. We categorise this as spending based on a price rule.

Under the JG scheme, the government continuously absorbs workers displaced from private sector employment. The JG workers thus constitute a buffer employment stock and would be paid the minimum wage. Many economists who are sympathetic to the goals of full employment are sceptical of the JG approach because they fear it will make inflation impossible to control.

We address these issues by outlining the inflation control mechanisms inherent in the JG model. Briefly stated, if the private sector is inflating, a tightening of fiscal and/or monetary policy shifts workers into the fixed-wage JG-sector to achieve inflation stability without unemployment.

6.2 Unemployment buffer stocks and price stability

Mitchell and Muysken (2008) argue that there have been two striking developments in macroeconomics over the last thirty years. First, a major theoretical revolution occurred in macroeconomics (from Keynesianism to Monetarism and beyond) since the mid 1970s such that the neo-liberal policy agenda has dominated at least the current crisis, which appears to have resurrected Keynesian policy (see Wray 2009). Second, unemployment rates have persisted at the highest levels known in the Post World War II period.

The almost exclusive central bank focus on maintaining price stability on the back of an overwhelming faith in the NAIRU theory has marked the final stages in the evolution of an abandonment of earlier full employment policies. Under inflation targeting (or inflation-first) monetary regimes, unemployment has become a policy tool rather than a policy target. To some extent, the labour market slack that this has created has been successful in that inflation is now no longer driven by its own expectations. One explanation is that unemployment temporarily balances the conflicting demands of labour and capital by disciplining the aspirations of labour so that they are compatible with the profitability requirements of capital. Similarly, low product market demand, the analogue of high unemployment, suppresses the ability of firms to pass on prices to protect real margins.

How useful is the NAIRU as a guide to policy? Mitchell and Muysken (2008) analyse a growing literature which points to the conclusion that the NAIRU is useless as a guide to policy. Evidence from the OECD experience since 1975 suggests that deflationary policies are effective in bringing

inflation down but impose huge costs on the economy and certain demographic groups, which are rarely computed or addressed.

The overwhelming quandary that the NAIRU approach to inflation control faces is whether the economy, once deflated by restrictive aggregate demand management, can be restarted without inflation. If the underlying causes of the inflation are not addressed, a demand expansion will merely reignite the tensions and a wage-price outbreak is likely (Cornwall, 1983; Rowthorn, 1980). As a basis for policy the NAIRU approach is thus severely restrictive and provides no firm basis for full employment and price stability.

Several researchers have found that sacrifice ratios associated with inflation targeting remain significant and persistent, meaning that GDP losses during disinflation episodes are substantial. In recent econometric work on Pakistan, Akbari and Rankaduwa (2006) estimate an output-inflation trade-off model for Pakistan and find out that “a one percent decline in inflation rate caused by a permanent reduction in monetary growth rate would result in a cumulative output (GDP) decline of 0.87 percent below its potential level . . . if monetary policy were to target the inflation rate of 3.4 percent, the resulting cumulative decline in output below its potential level (trend) would be about 5.1 percent” (Akbari and Rankaduwa 2006, 185).

Additionally, a major component of this monetary policy stance is the persistent pool of unemployed (and other forms of labour underutilisation, for example, underemployment) (see Ball, 1994; Ball and Sheridan, 2003, Mitchell and Muysken, 2008) as a buffer stock for wage and thereby price stability.

The question that arises is whether using a persistent pool of unemployed (and underemployed) is the most cost effective way to achieve price stability? For sovereign governments such as Pakistan a better alternative would be to utilise an employed buffer stock approach.

6.3 The basics of a Job Guarantee

While the concept of employment guarantees has a long history dating back to the Great Depression and was mentioned sporadically in the literature after that time, the modern JG proposal was conceived independently by Mitchell (1996, 1998) and Mosler (1997-98). The basis of the proposal is that the public sector offers a fixed wage job, which we consider to be price rule spending, to anyone willing and able to work, thereby establishing and maintaining a buffer stock of employed workers.

This buffer stock expands (declines) when private sector activity declines (expands), much like today's unemployed buffer stocks, but potentially with considerably more liquidity if properly maintained.

The sovereign government is thus offering to purchase a resource for which there is currently no market price – a zero bid input. In this sense, it expands its spending not by competing with other resource users but by utilising an unemployed resource.

The JG thus fulfils an absorption function to minimise the real costs currently associated with the flux of the private sector. When private sector employment declines, public sector employment will automatically react and increase its payrolls. The nation always remains fully employed, with only the mix between private and public sector employment fluctuating as it responds to the

spending decisions of the private sector. Since the JG wage is open to everyone, it will functionally become the national minimum wage.

While it is easy to characterise the JG as purely a public sector job creation strategy, it is important to appreciate that it is actually a macroeconomic policy framework designed to deliver full employment *and* price stability based on the principle of buffer stocks where job creation and destruction is but one component. Mitchell (2000) discusses the link between the JG approach and the agricultural price support buffer stock schemes like the Wool Floor Price Scheme introduced by the Australian Government in 1970.

It is possible to place restrictions on the unconditional nature of the job offer if a public purpose was being served. Qualifications required of participants could include age range, gender, family status, family income, educational attainment, residency, and so on. The most general program would provide a universal job guarantee, in which government promises to provide a job to anyone legally entitled to work – it is this general model that we call the JG.

The program could provide for part-time and seasonal work, as well as for other flexible working conditions as desired by the workers. The package of benefits would be subject to congressional approval, but could include health care, child care, payment of Social Security taxes, and usual vacations and sick leave. The wage would be set by the legislative power and fixed until a rate increase is approved—much as the minimum wage is currently legislated. The perceived advantage of the uniform basic wage is that it would limit competition with other employers as workers could be attracted out of the JG program by paying a wage slightly above the program's wage.

Proponents of a universal JG program funded by the government argue that no other means exist to ensure that everyone who wants to work will be able to obtain a job. Benefits include poverty reduction, amelioration of many social ills associated with chronic unemployment (health problems, spousal abuse and family break-up, drug abuse, crime), and enhanced skills due to training on the job.

Forstater (1999) has emphasised how a JG can be used to increase economic flexibility and to enhance the environment. The program would improve working conditions in the private sector as employees would have the option of moving into the JG program. Hence, private sector employers would have to offer a wage and benefit package and working conditions at least as good as those offered by the JG program. The informal sector would shrink as workers become integrated into formal employment, gaining access to protection provided by labour laws. There would be some reduction of racial or gender discrimination because unfairly treated workers would have the JG option, however, the JG by itself cannot end discrimination.

6.4 Inflation control under a Job Guarantee

The fixed JG wage provides an in-built inflation control mechanism. Mitchell (1998) called the ratio of JG employment to total employment the Buffer Employment Ratio (BER). The BER conditions the overall rate of increase of wage demands. When the BER is high, real wage demands will be correspondingly lower. If inflation exceeds the government's announced target, tighter fiscal and monetary policy would be triggered to increase the BER, which entails workers transferring from the inflating sector to the fixed price JG sector. Ultimately this attenuates the inflation spiral. So instead of a buffer stock of unemployed being used to discipline the distributional struggle, the JG policy achieves this via compositional shifts in employment. The

BER that results in stable inflation is called the Non-Accelerating-Inflation-Buffer Employment Ratio (NAIBER) (Mitchell, 1998). It is a full employment steady-state JG level, which is dependent on a range of factors including the path of the economy.⁸

A crucial point is that the JG does not rely on the government spending at market prices and then exploiting multipliers to achieve full employment which characterises traditional Keynesian pump-priming. The JG is motivated by the government “buying off the bottom” – that is, purchasing labour that has no current demand price.

Would the NAIBER will be higher than the NAIRU? It might be argued that because JG workers will have higher incomes (than when they were unemployed) a switch to this policy would always see demand levels higher than under a NAIRU world. As a matter of logic then, if the NAIRU achieved output levels commensurate with price stability then, other things equal, a higher demand level would have to generate inflationary impulses. Further, the introduction of a JG reduces the threat of unemployment which serves to discipline the wage setting process. However, the main principle of a buffer stock scheme like the JG is straightforward – it buys off the bottom (at zero bid) and cannot put pressure on prices that are above this floor. The choice of the floor may have once-off effects only.

Additionally, while it is clear that JG workers will enjoy higher purchasing power under a JG compared to their outcomes under a NAIRU policy, rising demand *per se* does not necessarily invoke inflationary pressures because by definition, the extra liquidity is satisfying a net savings desire by the private sector. Additionally, in today’s demand constrained economies, firms are likely to increase capacity utilisation to meet the higher sales volumes. Finally, it is not inevitable that aggregate demand overall would rise with the introduction of JG if the government employed other fiscal measures to reduce spending elsewhere in the economy (see Mitchell and Wray, 2005).

Importantly, the impact on the price level of the introduction of the JG will also depend on qualitative aspects of the JG pool relative to the NAIRU unemployment buffer. The JG buffer stock is a qualitatively superior inflation fighting pool than the unemployed stock under a NAIRU because the JG workers are far more likely to have retained higher levels of skill than those who are forced to succumb to lengthy spells of unemployment. It is thus reasonable to assume that an employer would consider a JG worker, who is already demonstrating commitment to working, a superior training prospect relative to an unemployed and/or hidden unemployed worker. This changes the bargaining environment rather significantly because the firms now have reduced hiring costs. Previously, the same firms would have lowered their hiring standards and provided on-the-job training and vestibule training in tight labour markets.

We thus argue that the NAIBER would in fact be lower than the NAIRU.

6.5 How is the JG different from a generalised demand expansion?

The JG does not operate like the standard Keynesian approach to stimulating an economy, i.e., by raising aggregate demand. Mitchell and Wray (2005: 236) show that the JG approach cannot be

⁸ There is an issue about the validity of an unchanging nominal anchor in an inflationary environment. The JG wage would be adjusted in line with productivity growth to avoid changing real relativities. Its viability as a nominal anchor relies on the fiscal authorities reigning in any private wage-price pressures. Clearly, in a hyperinflation environment, the discipline of the JG wage would fail. But in historical experience these circumstances have been rare.

characterised as Keynesian ‘pump-priming’ because it is a buffer stock programme, that is, it ‘hires off the bottom’ (paying the minimum wage). The size of the buffer stock of jobs is determined by private activity levels (principally fluctuations in private investment) and non-JG government spending. The stock will fluctuate with movements in aggregate demand. However, the maintenance of full employment under a JG is independent of the state of aggregate demand.

In contradistinction, Keynesian pump priming the aim is to ensure that spending is sufficient to purchase all available output by the government itself. They purchase goods and services at market prices, or by the government providing incentives to profit-seekers to expand activity. Both policy measures will be conducive to private employment expansion. Typically, public and private capital formation is targeted.

We argue the JG is a superior strategy for four reasons (see Mitchell and Wray, 2005). First, indiscriminate demand expansion in isolation is unlikely to lead to employment opportunities for the most disadvantaged members of society. Second, generalised expansion fails to address spatial labour market disparities which are now common across OECD economies. Third, generalised expansion does not incorporate an explicit counter-inflation mechanism. Fourth, how does generalised expansion address environmental concerns given that market allocations are the basis for the employment expansion?

The regional disparity issue is addressed by Mitchell and Juniper (2007) in what they call a Spatial Keynesian framework. They show that a generalised expansion will not have the capacity as a stand-alone policy to target regions in need of employment creation which may be reliant on a declining industry. Further, aggregate policy is not able to account for feedback or spill-over effects between regions such that social networks and neighbourhood effects transmit shocks from one region to another. This behaviour underpins the observations common in OECD economies that clusters of high unemployment regions or *hot spots* form as a result of spatial interdependency (Mitchell and Bill, 2006).

We do not want it thought that the JG is the only solution available to government. While advocates of the generalised expansion approach usually ignore any role for a buffer employment stock policy, which allows the government to guarantee full employment using automatic stabilisers by purchasing at fixed prices, the fact is that both approaches can co-exist as long as the inflation anchor provided by the JG is not compromised. Further, the JG does not replace social security payments to persons unable to work because of illness, disability, or parenting and caring responsibilities. Clearly, and emphatically, a mixture of both approaches is likely to be optimal – a generalised expansion alone is not preferred.

6.6 The Job Guarantee and skills development

The JG also does not preclude training initiatives (see Mitchell, 1998). Appropriately structured training within a paid employment context helps overcome the churning of unemployed through training programmes, workfare and other schemes under current neo-liberal policies. Specific skills are usually more efficiently taught on the job.

As a consequence, a properly designed JG can help previously unemployed persons to make transitions into careers in the private sector and also stimulate employers to modify their recruitment behaviour.

6.7 A Job Guarantee for a developing nation

A small developing nation presents several challenges. First, it may produce a small range of commodities and import a large number of types of goods that it does not produce (although many of these may not directly enter the consumption basket of much of the population). Further, its exports might be limited to an even smaller range of commodities. Growth of monetary income could immediately pressure the exchange rate. Second, the formal sector could be small, with most production and employment in the informal sector—and with a large disparity between wages paid in the formal versus the informal labour markets. Third, the administrative capacity of the national government might be quite limited. Domestic infrastructure might be inadequate to allow significant expansion of productive capacity. And finally, its exchange rate is likely to be pegged—perhaps to the currency of its former coloniser.

If a JG program is implemented with a wage equal to the minimum wage in the formal sector, there would be a flood of workers from the informal sector. Monetary incomes would rise and the demand for consumption goods - including most importantly the “luxury” imports that had been beyond reach for most of the population - would increase. The trade balance would deteriorate, and the government would quickly lose the international reserves necessary to maintain the peg. Domestic prices would rise (although direct pressures on prices of domestically produced goods would be limited if these were inferior goods, mostly purchased by poor families), but more importantly, import prices would rise as the currency depreciates. An exchange rate crisis would be likely to trigger an economic crisis. Is there any way to avoid these consequences?

First, let us see how this nation can reduce impacts on prices, the exchange rate, and the trade balance. It will need to limit the program’s impact on *monetary* demand, which can be done by keeping the program’s *monetary* wage close to the average wage earned in the informal sector. Thus, rather than setting the wage at the minimum wage in the formal sector, it is set at the wage of the informal sector. However, poverty can be reduced if the total compensation package offered by the JG includes extra-market provision of necessities. This could include domestically-produced food, clothing, shelter, and basic services (health care, child care, aged care, education, and transportation). Because these would be provided “in kind”, JG workers would be less able to use monetary income to substitute imports for domestic production. Further, production by JG workers could provide many or most of these goods and services - minimising impacts on the government’s budget, as well as impacts on the trade balance.

If the JG program directly provides basic necessities as well as monetary income equal to that previously earned in the informal markets, there will be some net impact on monetary demand. Further, production by JG workers might require imports of tools or other inputs to the production process. Careful planning by government can help to minimise undesired impacts. For example, imports of required tools and materials can be linked to export earnings or to international aid. Because production techniques used in a JG program are flexible (JG production does not have to meet usual market profitability requirements - see Forstater 1999), government can gradually increase “capital ratios” in line with its ability to finance imports. Further, JG projects can be designed with a view to enhance the nation’s ability to increase production for export. The most obvious example is the provision of public infrastructure to reduce business costs and attract private investment.

A phased implementation of the program will help to attenuate undesired impacts on formal and informal markets, while also limiting the impact on the government’s budget. Further, starting small will help the government to obtain the necessary competence to manage a larger program.

Argentina limited its program by allowing participation by only one head of household from each poor family. The program can start even smaller than that, allowing each family to register a head of household, but allocating jobs by lottery so that the program grows at a planned pace. The best projects proposed by individual community organisations (for example, at the village level) can be selected to employ a given number of heads of households from the community (again, with selection of workers by lottery). Decentralisation of project development, supervision, and administration can reduce the administrative burden on the central government while also ensuring that local needs are met.

International aid agencies can provide some financing for the JG program. However, borrowing should be avoided unless the JG program will directly increase exports to service international debt. Note that international financing is required only if imports are needed for the program. It could be the case that some equipment or materials need to be imported for use by program participants. Some of the output of the JG program can be sold in domestic and perhaps in international markets to generate revenue. For example, *Jefes* workers in Argentina produce clothing and furniture that is sold in formal markets. Further, some of the output of the program can substitute for government purchases; for example, *Jefes* workers produce uniforms for the government. Generally, however, JG production should not compete with the private sector. Still, use of the JG program as part of a development strategy can enhance a nation's ability to produce for export to earn foreign currency revenue. This can help to mitigate any rise of imports caused by rising consumption by participants in the program.

Finally, government can use the traditional methods of protecting its trade balance and exchange rate peg: tariffs, import controls, and capital controls. To the extent that JG raises monetary wages and monetary consumption its impact on the trade balance and exchange rates is similar to the impact of domestic growth more generally. The arguments for and against "intervention" in the area of international trade and capital flows are well-known and need no further discussion here. While there has been a strong bias against such intervention, the consensus has shifted somewhat in recent years toward the view that protection is acceptable on a case-by-case basis. We wish to emphasize that the case just analysed is quite extreme—a non-sovereign, small, open economy. Pakistan's case is not nearly so difficult. It operates with a sovereign currency. It has a large population and substantial productive capacity (even if its export sector needs upgrading). While it faces significant challenges, its government has some competency for administering programs. We also emphasize that a JG need not be centralized, nor does it have to be implemented all at once. The program can be decentralized, and can be phased-in. Is the scale of the unemployment problem too large in developing countries such as Pakistan for a viable JG? This is a common argument made by development economists against employment guarantees as a solution to poverty arising from mass unemployment. However, these criticisms typically are based on notions of financial unsustainability underpinned by a government budget constraint. In modern monetary economies such as Pakistan these orthodox neo-liberal notions of fiscal unsustainability are without foundation.

We consider there to be nothing intrinsically different in a developing economy that maintains sovereignty of its own currency that would prevent the introduction of a JG, particularly when such economies lack adequate social and economic infrastructure. There are political, ideological and perhaps administrative issues that need to be confronted but these are common to any development proposal. Further, the JG can be used to create some of the infrastructure needed—

for example, roads, simple housing, schools, and water and sewage facilities are ideal projects for a JG.

Recently, India passed the National Rural Employment Guarantee Act (2005) that commits the government to providing employment in a public works project to any adult living in a rural area. The job must be provided within 15 days of registration, and must provide employment for a minimum of 100 days per year. (Hirway 2006) According to some recent field research conducted by UMKC PhD candidate, Shakuntala Das, progress is being made in some communities toward meeting the requirements of this Act. Further, the types of projects listed above—especially creation of water-holding capacity—are commonly completed by participants. To be sure, it is too early to conclude that the program will achieve the goals of the Act, but preliminary successes indicate that where communities are motivated, useful employment can be created.

We conclude that Pakistan can embark on a path to achieve full employment with price stability. Pakistan's situation is not nearly so dire (once this current crisis is past) as that of the "small developing nation" that we have analysed in this section. We have just outlined a program that could succeed in such a nation. We also note that Pakistan's neighbour, India, has adopted a limited job guarantee.

6.8 Conclusion concerning the use of JG for stability and sustainability

It is clear that the more employable are the unemployed the better the price anchor will function. The government has the power to ensure a high quality price anchor is in place and that continuous involvement in paid-work provides returns in the form of improved physical and mental health, more stable labour market behaviour, reduced burdens on the criminal justice system, more coherent family histories and useful output, if well managed.

It is also the case the training in a paid-work environment is more effective than contextually isolated training schemes, which have become the fashion under the active labour market programmes pursued by governments in all countries over the last two decades.

There have been many job creation programs implemented around the world, some of which were narrowly targeted while others were broad-based. The American New Deal included several moderately inclusive programs including the Civilian Conservation Corp and the Works Progress Administration. Sweden developed broad based employment programs that virtually guaranteed access to jobs, until government began to retrench in the 1970s (Ginsburg 1983).

In the aftermath of its economic crisis that came with the collapse of its currency board, Argentina created *Plan Jefes y Jefas* that guaranteed a job for poor heads of households. (Tcherneva and Wray 2005) The program successfully created 2 million new jobs that not only provided employment and income for poor families, but also provided needed services and free goods to poor neighbourhoods. Further, the program helped to foster economic and social stability, and there is no evidence that it generated inflation of wages or prices (although it did successfully implement a wage floor, with virtually all formal sector jobs paying more than the program wage).

More recently, India passed the National Rural Employment Guarantee Act (2005) that commits the government to providing employment in a public works project to any adult living in a rural area. NREGA has generated millions of employment opportunities for poor rural workers and retarded the migration of these workers into the already overcrowded urban areas. The experiences of this programme would provide useful information for Pakistan.

We consider the advantages of using a mobilised JG workforce in Pakistan as a price anchor but an intrinsic vehicle for regional and community development would not only provide socio-economic stability in the form of poverty reduction and income certainty but, in doing so, would help underpin political stability. Such stability is essential for inclusion in the global investment community.

We conclude that Pakistan can embark on a path to achieve full employment with price stability. We have just outlined a program that could succeed in Pakistan. We believe that it is possible to formulate a program for Pakistan that would lead to success.

7. Proposals to deal with the crisis

As a consequence of the political uncertainty and the economic deterioration (that contributed to increasing external deficits and reduced capital inflows), Pakistan's foreign exchange reserves, rising since 2001, started declining in November 2007 and the deterioration in the overall reserve position accelerated during 2008, precipitating a full-on crisis. As the political situation in Pakistan also deteriorated, and as the global financial crisis sparked a run back to the US dollar, the flow of dollars to Pakistan began to reverse: as of November, 2008, reserves plummeted and were at levels equivalent to less than one month of imports. Meanwhile, the exchange rate depreciated, contributing to the run on the currency.

The immediate concern was loss of foreign currency reserves. There seemed to be no alternative but to seek foreign currency reserves, either from friendly nations willing to provide aid, or from international institutions such as the IMF. We discussed above the current IMF package of relief. Going forward, it is important that Pakistan try to obtain funding with the least onerous terms, particularly with respect to conditionalities that would require the government to cut necessary spending, or to increase taxes. To the extent that fiscal and monetary policy austerity is imposed, it will be much more difficult for Pakistan to begin to recover and to get onto a sustainable path.

Our policy advice has two time dimensions: (a) an awareness of the immediate urgency imposed by the foreign currency reserve crisis; and (b) a package of policies designed to underpin medium- to long-term growth and equity. We argue that sustainable development requires growth in economic activity with price stability but also equitable access to the benefits of this growth.

i) Dealing with the current crisis

Initially, by way of crisis management, Pakistan must either obtain substantial debt relief, or continue to seek international funds (aid or lending). Either strategy entails both advantages and disadvantages. Debt relief, however, would be more conducive to achieving medium and long term economic, political, and social stability. We offer two different types of approaches to deal with the problem.

The first path would focus on negotiated or unilateral debt relief.⁹ If Pakistan were somehow freed from its external, foreign currency denominated debt, it could move rapidly toward the medium term policy that we recommend (discussed below). Unfortunately, given the international financial crisis, Pakistan's meagre foreign currency reserves, and the nation's external debt situation, it is unlikely that it will be able to service its debt and maintain confidence in its currency without

⁹ Pakistan obtained debt rescheduling and debt relief from the Paris Club in 2001.

additional aid and lending from international institutions or governments. If, however, Pakistan were to insist on debt relief that would lower payments, it might be able to rebuild currency reserves. This would help to restore confidence in the currency.

There are examples of nations that have been able to limit external debt service to a portion of their export earnings. A more extreme step would be to convert all foreign-currency denominated debt to domestic currency debt at some exchange rate. Technically, this is default. We are not advocating such an approach because of the substantial political and perhaps economic repercussions.¹⁰ We merely lay it out as a possibility. In the aftermath of its financial crisis, Argentina defaulted on a portion of its external debt; relief from some of this burden plus other factors contributed to Argentina's ability to restore economic growth. While it is frequently argued that default on debt is dangerous because future access to credit will be denied, this does not appear to be the case, historically. Indeed, entering formal bankruptcy proceedings often eases access to credit markets for households and firms for the obvious reason that relief from debt burdens makes it easier to service new debt. Bankruptcy laws are adopted not only to protect borrowers, but also to protect creditors by establishing clear procedures regarding the allocation of losses. Bankruptcy laws are also in the social interest because excessive debt hinders economic performance. However, sovereign bankruptcy is a murky area. We argued above that a sovereign government can always service debt issued in its own sovereign currency and there is no default risk and hence no need for bankruptcy. Indeed, it could be argued that it would be illegitimate for a sovereign government to default on such debt. If the government has incurred obligations in a foreign currency, however, it may not be able to service the debt. Hence, there is always default risk.

The alternative is for a government, which is facing excessive foreign currency debt to approach international lenders for help by borrowing foreign currency. Usually, some conditionalities attached imply additional domestic burdens. However, there is a long legal history associated with the doctrine of "odious debts". There is no formal international law dealing with such debts, but there is customary international law – that is, what states have actually done in practice. Often these concern cases in which a previous government has incurred debts, sometimes with the complicity of creditors, to pay for spending that is perceived to be inconsistent with the public purpose. We take no position that such a case can be made with regard to Pakistan's current debt burden. We do note, however, that even in the US there is a long history of claims of odious debts, ranging from colonial debts to state debts, and to debts of the Confederacy and to Cuban debts (after the 1898 US-Spain Treaty). In other words, the US itself has a long history of debt repudiation. And in recent years there has been a growing movement pushing for recognition of the need for creation of formal procedures that would allow debtor nations to obtain debt relief especially in cases in which creditors are partly responsible for "debt pushing". Even where no wrong-doing on the part of creditors or debtors is involved, debt relief might be needed where

¹⁰ It is often claimed that a defaulting nation will lose access to international lending. Historically such effects have been of a short-term duration (for example, Argentina). At least some of the external currency debt is held by Pakistani nationals, so there will be wealth effects as well as domestic political repercussions if the government were to default. There could also be implications for international relations. All of these possible negative effects would have to be weighed against the benefits of the strategy. Negotiated debt relief would presumably have far fewer negative consequences.

economic conditions have deteriorated more than could have been anticipated by either creditors or debtors. Indeed, bankruptcy courts do not require culpability to order debt relief.

The second path would be to continue to seek international aid and lending, while negotiating for minimal conditionalities. It is highly likely that the IMF will continue to provide loans as needed, but with conditions including fiscal restraint. Unfortunately, this is a risky time for budget cuts - with respect to both economic and political repercussion. Significant budget cuts can only be made in the areas of military spending, food and fuel subsidies, pensions, or development. For obvious reasons, cuts in all of these areas would be problematic. The alternative is to raise taxes - again a highly problematic policy for a nation whose growth was already slowing even before the global crisis generated recession throughout much of the world.

There is one other possibility: reducing domestic currency debt service - that is, domestic debt relief. Debt service alone will likely absorb more than half of all government revenue. Cutting the SBP's target interest rate would free more revenue than is likely to be obtained either by draconian cuts to other spending or by huge increases to tax rates.

In the context of the immediate urgency imposed by the foreign currency reserve crisis that most likely will last at least through 2009-10, we recognise the reality that the short-term policy options will be heavily conditioned by the IMF arrangement. While it would have been better that Pakistan's government had been able to negotiate debt relief instead of entering the IMF agreement, we still believe that there could be some room to consider elements of a "debt relief" strategy within the IMF arrangement. We also think there is room to pursue a range of fruitful strategies even though the IMF agreement has been signed.

Pakistan's government should strive for a combination of external funding with few conditions and lower domestic interest rates.¹¹ Within the reality of international aid and lending (that is, the IMF agreement) we argue that the Pakistan government should negotiate for minimal conditionalities during the interim reviews specified in the agreement. The IMF and other international lenders have already provided a package of loans, and it is highly likely that the IMF and others will continue to do so in future years until the crisis subsides. These have already imposed, and most likely will continue to impose, conditions including fiscal restraint. Within the IMF agreement, funds will be available to stabilise the reserves. However, if in the period leading up to the review of the agreement (for example, in the first 12 months), economic conditions have not improved significantly, Pakistan's government may be able to insist on debt relief that would lower payments as an additional strategy to rebuild its currency reserves. This would also help restore confidence in the currency. In other words, negotiated or unilateral international debt relief is still not out of the question despite the fact that the IMF agreement is in place. Lower interest rates would lower government interest service domestically, freeing more of the budget to be used for pro-development policies; at the same time, fewer conditions on the support would also help maintain domestic policy space. Essentially, lower domestic interest rates can be thought of as internal debt relief; this should be politically more popular than external debt default or external debt relief.

¹¹ High interest rates are counterproductive if they increase the budget deficit (by increasing government debt service payments) and impede internal development by limiting public and private investment (if the higher interest spending forces policy-makers to cut spending that would favour development).

The danger is that lower interest rates might discourage international capital flows and thereby depreciate the currency even further. Maintaining a competitive exchange rate is fundamental for Pakistan and is a desirable target policy. Real exchange rate overvaluation is bad for growth (Rodrik 2007), while undervaluation promotes exports and thus raises growth as measured by GDP—but it also directly and indirectly causes inflation, by reducing the output that is domestically available and by stoking pass through inflation. Given the global financial crisis as well as Pakistan’s own internal instability, it is conceivable that a coherent set of economic policies to stabilise the current situation, and to put Pakistan on a sustainable economic path for the medium term, will do far more to placate international confidence than a high domestic interest rate policy.

A competitive real exchange rate contributes to employment generation through a number of channels (Frenkel and Ross 2006). The first is through its impact on the level of aggregate demand (the macroeconomic channel). The second is through its impact on the cost of labour relative to other goods and, thereby, affecting the amount of labour hired per unit of output (the labour intensity channel). And the third one is through its impact on investment and growth (the development channel). In an economy characterised by vastly underutilised resources, there are growth-related externalities derived from a policy of maintaining a competitive exchange rate, as the higher demand for exports, as well as the increasing production of import-competitive goods, can spill over into demand for non-tradables as a result of higher income in sectors that produce tradables. However, against these benefits must be weighed the reality that the growth-through-exports strategy means that Pakistani labour and other resources are devoted to producing output that is to be enjoyed by the rest of the world, and not by Pakistanis. Exports are a real cost, while imports are a real benefit. For this reason, export led growth should be pursued carefully to ensure that it is part of an overall strategy of development, rather than as an economic goal. All else equal, it would be better to mobilise Pakistan’s unused resources to produce goods and services to be used by her own citizens to raise their living standards, rather than to raise real living standards of the consumers of the developed world.

(ii) Policies for the medium-term

For the medium-term, policymakers in Pakistan should adopt a package of policies that includes:

- Reorient emphasis toward employment-creating policies and away from growth-for-its-own-sake policies. Growth must be placed within the context of achieving full employment with price stability.
- Reformulate tax and transfer policy: (i) replace regressive taxes with progressive direct taxes to reduce the burden on low-income and low-wealth households; (ii) switch from price subsidies to income subsidies with clear targeting mechanisms for poor households; (iii) protect vital social and economic services when poverty is increasing; (iv) allot funds to address the power and water shortages; and (v) eliminate subsidies to rent-seeking sectors.
- Address the external deficit and the fall in international reserves in a manner that does not lead to domestic stagnation, unemployment, and poverty. Government should seek debt relief and, especially, gradual elimination of foreign currency denominated debt. We recognise that major infrastructure projects (for example, road and power plant construction) are being undertaken in Pakistan by foreign companies working under foreign-currency denominated contracts. Being dependent on imported capital goods requires Pakistan to engage foreign suppliers in their own currencies. However, once the

current crisis is past, the government should minimise any additional government debt denominated in foreign currency.

- The Government should diversify the country's export basket with a view to promoting those sectors that will lead to sustainable economic development in the long-run. Experimentation of the sort proposed by Rodrik (2008) will be particularly useful in this regard. A well-designed export-led growth strategy can play an important role in Pakistan's development. The aim of this development strategy is not to direct domestic resources toward production for external consumers (instead of using them to produce for domestic consumption).¹² The objective of this program is to reduce import reliance and limit the external debt drains on foreign reserves. The key to this is to diversify and upgrade the country's export structure. As McCombie and Thirlwall (1994) and Hausmann *et al* (2005) argue, net benefits from exports will arise from a country specialising in those commodities for which world demand is growing most rapidly. However, Pakistan exports products with a low world income elasticity of demand. Hausmann *et al.* (2005) have found that there is a strong correlation between a country's level of productivity and the level of sophistication of its export package; but what is more interesting is that, after controlling for a number of "fundamentals" (for example, initial per capita income, human capital levels), countries with a higher level of export sophistication have faster growth rates. Felipe *et al.* (2009b) provide an in-depth analysis of the new sectors where Pakistan can diversify by increasing exports of higher sophistication.
- We recognise that the orthodox position considers that inflation control requires higher interest rates. For the reasons outlined in the paper, we do not consider monetary tightening to be a productive long-term inflation hedge. The persistently high core inflation should be addressed through a combination of: (i) more moderate monetary policies (lower interest rates), (ii) reduction of programs with a strong inflationary bias, and (iii) a program of wage stabilisation.
- In this regard, a comprehensive job creation program (that is, a Job Guarantee) can play an important role in moving the economy to full employment while simultaneously enhancing wages and prices stability.

(iii) What role can the Asian Development Bank (ADB) play?

First and foremost, it is of paramount importance to understand the overall developmental challenges that the country faces. It is an economy characterised by vastly underutilised resources. These resources are available for production and can help the economy respond in real terms to a *sustained* increase in nominal demand for goods and services. We recognise that in the immediate term (short-run), there may be supply bottlenecks that can retard growth. There is either disguised unemployment or a substantial traditional sector where productivity is below that in the modern sector.

Second, concentrating exclusively on the financial problems will not provide a long-term solution and a sustainable development path. For this reason, austerity programs, derived from the premise that Pakistan has been living beyond its means, will reduce the capacity of the government to engineer a solution to the structural problems that afflict the country. While it is true that from an accounting point of view Pakistan's problem is that domestic absorption has outpaced output, the

¹² In Pakistan there is, in fact, a substantial export bias. See Felipe *et al.* (2009a).

existence of very large underutilised resources indicates that Pakistan is living below its means. The austerity approach to policy may restore foreign reserves and slow inflation but it provides no sustainable path to engineer the conditions that will support growth. Once growth is reactivated, the same structural impediments which were dormant during the austerity period would return to endanger economic stability.

Third, budget support should not be linked to conditionalities about the size of the budget or of the deficit. The latter should be analysed in the context of the objectives to be achieved, in particular, how to keep the total spending in the economy at the rate necessary to ensure that all the goods that is possible to produce are purchased. In this sense, the idea of balancing the budget (over a decade, during a year, or at the end of each fortnight) becomes a meaningless objective. The budget deficit has to be as large as the savings desires of the non-government sector. If Pakistan wants to reduce reliance on foreign savings (that is, reduce its current account exposure) then it has to be able to “finance” domestic savings via net government spending (the “deficit”).

Fourth, ADB could contribute to the design of an investment program to achieve full employment. This program must take into account the budgetary implications for Pakistan.

Fifth, ADB could contribute to the design of a program of export diversification and upgrading.

Finally, ADB could contribute to the design of a Job Guarantee Program specific for Pakistan after consideration of the design and implementation of similar schemes that have been in operation elsewhere. The ADB could make its loans conditional on development of a strategy to achieve full employment with price stability. When Argentina faced its crisis, the World Bank stepped in with loans that were linked to the Jefes job creation program. Since program wages were paid in the local currency, World Bank dollar loans certainly were not necessary for creation of the Jefes program. Both the Argentinean government and the World Bank understood that the dollars would be used to bolster foreign currency reserves to enhance external stability. Argentina then used its sovereign currency to fund the Jefes program to enhance internal stability. Following this example, the ADB could provide dollar loans to Pakistan to be used to stabilize its currency, while Pakistan would phase-in a JG to stabilize its economy. This would help to put the nation on a sustainable growth path that would build international confidence in its currency such that dollar loans would not be needed in the future. Further, Pakistan can use the JG program for development projects to upgrade its infrastructure so that it would be better positioned in the global economy.

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