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The Causes of Economic Crisis in Pakistan and Its Remedial Measures

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1. Introduction

The State Bank of Pakistan (SBP) had indicated in its letter of invitation to the Conference that the topic on which I should speak is "Economic Policy after the Crisis". My reaction was that, if this topic was to relate to the situation in Pakistan, we should not talk about economic policy after the crisis, but rather economic policy in the crisis, or, at best, before an economic crisis that is brewing in Pakistan. Accordingly, I chose to speak about the main causes of economic crisis in Pakistan and its remedial measures.

2. Historical perspective

A casual review of the speeches and statements of successive government representatives in Pakistan during the last two decades will lead an objective observer to conclude that there has been a consistent pattern of each government criticizing the economic management of preceding governments, praising their own policies and programs and complimenting themselves for doing a better job, but in reality adhering to similar short term, and short sighted, approach to economic management with similar results.

In the nineties of the last century, several governments changed hand and each criticized economic policies of the previous government but continued similar policies during their own period. Early in the current decade, economic managers of the then government declared the nineties as a "lost decade" from the point of view of economic management but did not do anything different, or any better, during their time and left the country in a deeper economic crisis. In fact, they could not even understand that Pakistan was still in the Ricardian era of saving/investment deficiency rather than in the Keynesian period of idle capacity and lack of effective demand, and they tried to promote economic growth through consumption liberalization and cheap money policy, and landed the country in double digit inflation, deeper internal and external debt and ultimate slowdown in economic growth.

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In the recent period of democratic rule also there has been a widespread criticism of economic management of the previous government but no positive change has been seen in economic policies in this period either. In fact, economic decision-making divorced from considerations of merit has increased recently and the government, instead of launching a long term strategy for acceleration in economic growth with relative price stability, remained trapped in the day to day problems and difficulties, and all the indicators point to a further deterioration in the underlying economic situation of the country.

3. Natural calamities

Superimposed on man-made impediments to full exploitation of the economic potential of the country have been natural disasters, like earthquake and flood, which added to the economic misery of the ordinary people of Pakistan, damaged infrastructure, contributed to budgetary weaknesses, pushed up prices and further jolted the already fragile economy.

However, natural disasters are only a small part of the story. In fact, it can be argued that flooding was directly linked with lack of long term economic planning and inability of the top leadership of the country to develop a consensus for water resource management, in particular building of dams. In the case of earthquake, if large foreign aid flows were utilized effectively and honestly, the natural destruction could be turned into an opportunity for economic betterment of the affected region. Instead, mishandling of natural disasters, and reported misuse of funds collected to help rehabilitate the disaster affected people and infrastructure, not only eroded further the credibility of the government but also provided an additional proof that bad governance was indeed the main cause of poor economic management of the country.

4. IMF and World Bank

It is worthwhile to note that IMF and World Bank, which have been involved with the economy more often than not during this entire period, have also exhibited no better pattern in their performance in Pakistan. While diagnosing economic problems in a professional manner, and producing some good analysis of several aspects of the economy of Pakistan, they went along with short term economic policy patchwork undertaken by successive governments, without a long term strategy for economic and social development. In particular, they easily accommodated lapses in policy promises and commitments, particularly in the budgetary and governance areas, mainly with a view to supporting and sustaining even inadequate and collapsing programs to avert a foreign debt default by Pakistan that could engulf them also in a crisis.

Endorsement by international financial institutions of inadequate short term policies, and their willingness to assist the authorities in obtaining additional foreign loans based on such policies, provided life support to various governments, and enabled them to remain current in repayment of foreign debt, but landed the country in deeper long term debt difficulties. Moreover, attitude, and nature and severity of conditionality of international financial institutions fluctuated from time to time depending on the attitude and influence of their largest shareholders, who, in turn, were driven by their own changing security and strategic national considerations.

Most of the bilateral and multilateral loan inflows arranged under programs with IMF and World Bank dissipated in foreign debt repayments, technical assistance for various purposes, training programs for manpower abroad, consultancy fees, hiring of national and international experts at expensive rates and leakages through pilferage and corruption. There is no evidence on the ground to show that the large amount of accumulated foreign debt of the country was used productively in building up of the base for export sector, agricultural and industrial development or viable infrastructure projects that could help generate foreign exchange for future repayment of foreign debt. As a result, increasing foreign debt servicing liability, without a corresponding expansion in foreign exchange earning capacity, has entrapped the country in a vicious circle of more external borrowing and more foreign debt servicing.

These multilateral institutions, if they are serious about economic welfare of Pakistan, should change their approach and make a genuine and bold effort to reduce foreign debt burden of the country through concessional rescheduling, and restructuring and write offs, rather than keeping governments afloat through additional lending that enables foreign creditors to continue to get paid on time. For this change to take place in IFIs, the government and people of Pakistan need to first decide and demonstrate determination to move on a self sustaining, and self respecting, path of economic and social development. Simultaneously, and in the context of a comprehensive strategy to reduce foreign debt burden, these institutions should help the Government to implement long term structural reforms in several areas to increase domestic saving rate to a level that can finance a large component of domestic investment requirements.

A continuation of the past approach of indiscriminate bilateral and multilateral borrowing, and its ineffective use by Pakistan government, is bound to land the country in a much more serious balance of payment and economic crisis, from which it will find increasingly more difficult to recover.

5. Good governance requirements

Viewed in the historical perspective of Pakistan, or cross section data of developing countries, it appears that an effective economic policy framework cannot be evolved and implemented in the absence of good governance. The first essential requirement for launching a program of sound long term economic management in Pakistan is the emergence and continuation of good governance, and of a competent, stable and sincere government that adheres to the rule of law, promotes social and economic justice, ensures peace and security, adopts austerity measures, strengthens institutional framework, does not raise false hopes and expectations, makes no false promises, tells people the truth about the state of the economy and of the budget to take them into confidence for tough economic policy choices.

Narrowing down of the existing “trust deficit “of the leadership, building up of political consensus on national economic development strategy to be adhered to by every government, strengthening of decaying state institutions and good governance in all its other dimensions can lay the foundations on which the edifice of sound economic management can be built.

Whether, and when, foundations of good governance can be created for better economic management is any body’s guess. In the last 63 years, the country has seen regression, and not progression, in this area, and no hopeful signs are seen on the horizon. But let there be no doubt that there can be no real breakthrough in economic management of the country without the emergence and solidification of good governance and stable institutional foundation.

6. Macroeconomic problems of Pakistan

Implementation of difficult policy choices, and not their diagnosis, is the real problem of economic management in Pakistan. The main macro economic problems of Pakistan are well know to even ordinary citizens and well articulated by professionals. These are: slow and erratic economic growth, persistently high inflation, extreme poverty of the bulk of the population coexisting with prosperity of a few, deep and rising debt burden, and huge budget deficit.

On the face of it, these seem to be problems emanating from diverse sources but in reality these are mainly the product of one factor, and that is poor governance giving birth to mismanagement of public finances which, in turn, has become the mother of all economic ills.

It should be clear by now that Pakistan cannot dig itself out of its deep rooted budgetary problems by continuous reliance on printing of notes by SBP in excess of country's capacity for their non-inflationary absorption and/or by continuous accumulation of expensive and ineffectively used external debt by the government.

Continuation of such a course will intensify inflationary pressures, plunge the country in a steeper hole of debt trap, accentuate structural problems, impede long term economic development and socially and politically destabilize the country in a big way. Pakistan desperately needs a clean break from this failed approach, and implementation of policies to place the budget on sound footing is the first order of business for Pakistan.

Budgetary measures should include mobilization of additional revenue resources, severe curtailment of inessential and unproductive government expenditure, and honest and efficient use of development expenditure to facilitate economic development and improve economic wellbeing of the majority of the population. In addition, SBP should implement a prudent monetary policy that is not hostage to the financing needs of the government.

The subsequent section of this paper is devoted to an outline of the direction in which fiscal policy, and its twin, monetary policy, must move in actual practice, with only a passing reference to some of the other pressing policy issues.

Mobilization of domestic savings

To have a visible impact on the living standards of the majority of the population within a generation or so, the country needs to have a policy framework to sustain annual rate of growth of 6-8 percent with growth impulses emanating from all the productive sectors of the economy, and fruits of growth being shared by all segments of the society. Economic prerequisite for the achievement of such a high rate of economic growth on a sustained basis is, inter alia, a national investment level of 20-25 percent of GDP. This level of investment must be financed by a gradual increase in real domestic savings complemented by foreign non-debt creating inflows like grants and foreign direct investment.

It is the mobilization of real domestic savings for economic development that can ensure an environment of relative price stability, soundness of the financial and fiscal systems, balance of payment viability, and efficient resource utilization that increases agricultural yield and improves industrial efficiency. The real long run policy issue, therefore, is as to what can be done to raise the domestic low rate of saving, which in combination with external non debt creating inflows, can match up with the required rate of investment.

Domestic rate of saving in Pakistan is low compared with other developing countries and in relation to investment requirements of the country (See Table 1). In spite of a critical need to raise domestic rate of saving, there has not been enough focus on reviewing the factors for its low and declining rate and developing a long term strategy for raising the rate of national saving. Without a concerted effort to mobilize real domestic savings, the country will not be able to get out of its debt trap, moderate inflationary pressures and achieve the stage of self sustaining growth.

Table 1. Key Economic Indicators of Pakistan

	FY05	FY06	FY07	FY08	FY09
Real GDP growth	9.0	5.8	6.8	3.7	1.2
M2 growth	19.1	15.1	19.3	15.3	9.6
CPI Inflation	9.3	7.9	7.9	12.0	20.9
Gross Domestic Investment (% of GDP)	19.1	22.1	22.5	22.1	20.2
Domestic Savings (% of GDP)	15.4	15.7	15.6	11.4	11.5

Public finances and public sector saving

In Pakistan, government has impeded more than facilitated the process of saving, capital formation and economic growth. The consumption expenditures of the federal and provincial governments and public sector enterprises have in the last several years exceeded their revenue with the result that they had to rely on printing of currency notes and foreign borrowings to meet the deficit in the current operations of the government. In addition, the government has relied on borrowing to finance its development expenditure (See Table 2).

Table 2. Public Sector Borrowing

	FY05	FY06	FY07	FY08	FY09
Government borrowing (% of non-Govt. borrowing)	141	200	137	479	399
Government borrowing (% of non-Govt. NDA)	71	97	86	105	100
Public Sector Contribution to M2 (%)	25	24	23	32	40

The consequent fast accumulation of internal and external debt necessitated setting aside an increasing amount of tax revenue for debt servicing, thereby further lowering the prospects of public sector saving (See Table 3). This has entrapped the government, and indeed the country, in a vicious circle of rising debt burden, higher debt service obligations, and widening deficit in current operations of the public sector necessitating more borrowing.

Table 3. Public Sector Debt, Debt Serving and Defence Expenditure

	FY05	FY06	FY07	FY08	FY09
Total Public Sector Debt (% of GDP)	62.1	57	55.1	59.1	57.5
Total Debt Servicing (% of tax revenue)	51.2	46.3	55.9	60.5	72.3
Defence Expenditure (% of tax revenue)	32.1	30.0	28.1	26.4	25.1
Debt serving and defense expenditure (% of tax revenue)	83.3	76.3	84.0	86.9	97.4

Source: SBP Monthly Statistics

True cost of government operations

Instead of facing the budgetary problem squarely, bureaucrats of the Ministry of Finance have been engaged for a long time in statistical manipulations to conceal the true cost of public sector operations and hide the real level of budget deficit and budgetary difficulties from the public and even the top political leadership. Separation of the loss making public sector entities from the federal budget was one such step so that a lower budget deficit could be shown. As a result, perpetual losses and wide deficit in the current operations of public enterprises, separated from the budget, lead to recurrent interagency debt, which, for all practical purposes, should be treated as a part of the budget deficit.

Inefficiency, waste, corruption, high administrative cost and price distortion in public sector enterprises have created recurring losses and interagency debt that is repeatedly covered by government-dictated financing by commercial banks at below market rates, with its adverse implications for monetary policy and for the banking system. Such government directed credit subsidizes inefficient public sector enterprises, crowds out the efficient private sector from access to bank credit at reasonable rates, distorts asset side of the balance sheets of commercial banks, and promotes excessive monetary expansion.

It is worthwhile to mention that such instructions and coercion of commercial banks by the Federal Ministry of Finance for provision of credit to public sector enterprises violate section 46(B) of SBP Act that specifically states that "no government or quasi government body or agency shall issue any directive, directly or indirectly, to any banking company or any other financial institution regulated by the Bank which is inconsistent with the policies, regulations and directives issued by the Bank pursuant to this Act, the Banking Companies Ordinance or any other law in force" This provision was added in SBP Act to avoid the past practice of undue interference of the Ministry of Finance in the banking and monetary matters of the country. It would be very unfortunate if either SBP does not ensure that government does not violate the letter and spirit of this section or under one pretext or the other it allows this provision to be modified or removed.

Similarly, for some time the true cost of government debt servicing was concealed by budget makers by paying, and recording in the budget documents, below market rate of interest on treasury bills held by SBP, and by artificially maintaining a fixed official exchange rate. For example, up to 1991 Ad hoc Treasury bills were forcibly sold to SBP at the annual rate of interest of 0.5 per cent and to commercial banks at the rate of 6.0 percent. The official exchange rate was kept at an overvalued level for a long time through various devices like the Export Bonus Scheme and quantitative import controls and exchange restrictions, understating the real rupee cost of foreign debt servicing.

The true debt servicing burden came to the surface when financial sector reforms were introduced in the nineties, and Treasury bill rates were priced at the market rate, showing in budgetary accounts a higher domestic debt servicing liability at the same level of internal debt. Similarly, exchange rate depreciation, reflecting mainly a sharp rise in inflation in Pakistan relative to its competitor countries, increased burden of rupee cost of external debt servicing at a given level of liabilities in foreign exchange.

For some time, the fiscal authorities created confusion by blaming financial sector reforms and devaluation for rising debt servicing. The real situation was that successive governments resorted to reckless external borrowing and their wasteful use and concealed the true cost through interest rate and exchange rate manipulations. Interest rate reforms brought on the books the true cost of domestic borrowing that was kept hidden in the fiscal accounts of the government for a long time. Similarly, the exchange rate depreciation was the consequence, and not the cause, of rising debt servicing liabilities; in other words, exchange rate depreciation reflected the cumulative impact of excessive domestic and foreign borrowing by the government for a long time that fueled inflationary pressures, eroded the external value of rupee and necessitated devaluation. What financial sector and exchange rate reforms did was to bring out in the open the true cost of government debt that was kept hidden in budget documents through interest rate and exchange rate distortions.

It may also be pointed out that higher interest payment to SBP due to financial sector reforms was only a book keeping entry because the consequent higher SBP profits accruing from higher interest payments got transferred back to the Budget or were diverted by the government to other uses. Similarly, a more depreciated exchange rate did increase the rupee cost of debt servicing but at the same time it also generated a larger amount of rupee counterpart of a given amount of new external debt in foreign exchange. To the extent that inflow of new foreign loans exceeded the repayment of external debt the budget was a net beneficiary from the exchange rate depreciation in rupee terms.

Nevertheless, it remains true that the rising cost of internal and external debt servicing, as recorded in government budget divorced from inflow in rupee terms of new foreign loans, and transfer of SBP profits to government, combined with high burden of defence expenditure, began to exceed total tax revenue (that failed to keep pace even with nominal GDP) leading to negative saving in the public sector.

Improper use of privatization proceeds

Another budgetary practice that has been used to postpone the inevitable need of mobilizing additional revenue resources and controlling wasteful government expenditure is use of privatization proceeds to finance government expenditure. Even for a household, use of sale proceeds of its silver to meet a high level of recurring expenditure is neither advisable nor sustainable. It is more so in the case of a government or a nation.

Way back in 1994, SBP had advised the Government that “ the best use of these proceeds would be to retire debt; it will create more fiscal space for future, divert resources available on a continuous basis from debt servicing to development expenditure, and improve the budgetary and monetary situation and credit rating of the country”. SBP had further warned through analysis that the “use of rupee counterparts of sale proceeds of assets to finance additional current expenditure or to cover budgeted revenue gaps is similar to that of printing of money to finance excessive government expenditure” (See “Alternative Uses of Sale proceeds of public sector assets (Privatization Proceeds) and their Implications” Major Economic Policy Issues in Pakistan, SBP, 1998).

The policy of using privatization proceeds for retirement of most expensive debt was at least partially followed by the governments in the nineties but has been abandoned since then, and these proceeds have been used to meet budget gap, thereby concealing the real budgetary situation, delaying action to address the underlying budgetary problems, and adding to inflationary pressures.

Agenda for budgetary reform

It is quite clear that the current state of public finances is very serious and unsustainable, and budgetary problems of the country are deep rooted. Major structural reforms are warranted in accounting and budget- making practices and on both the revenue and expenditure side of the fiscal policy to reduce the burden of the government on national resources and to generate public sector savings.

First, restoration of integrity of fiscal statistics and proper consolidation of total budget deficit is of paramount importance for the formulation and implementation of a sound fiscal policy. The first requirement for genuine budgetary reforms is cleaning up of public finance statistics to reflect the true budgetary position by removing window dressing, consolidating accounts at their correct cost, separating transitory revenue from the underlying picture, factoring in the deficit in the operations of public enterprises, and figuring out the true picture of the revenue deficit and of the overall budget deficit inclusive of provincial governments and public enterprises. The true budgetary picture would demonstrate the enormity of the task and the urgency to move on several fronts, and would make it clear that temporary patch work would neither increase public savings nor sustain economic development on a durable basis.

Second, there has been a general resistance from powerful lobbying groups to the documentation of the economy as well as lack of serious effort to develop a program for documentation on the part of the tax authorities, and both the tax payers and tax collectors have taken undue advantage from this vacuum. A genuine effort would need to be made for documentation of the economy and improve reporting system to the tax authorities for self policing and for introduction of checks and balances. Documentation would expand the tax base, reduce tax evasion and improve tax collection.

Third, the large underground economy must be dismantled and gradually brought in the tax net. The underground economy has been estimated in the range of 30-50 percent of the recorded GDP in Pakistan and there are studies that show that it is expanding. Smuggling, black-marketing and tax loopholes need to be effectively dealt with and policies reformed to make the underground activities less attractive.

Fourth, a long term program of a complete overhaul of the revenue and expenditure structure at all levels of government and public corporations would have to be carefully and transparently developed with a consensus by all political parties and stack holders and commitment to undertake reforms regardless which party is in power. A time bound phasing in of structural reforms would be necessary requiring surgical operation in all fiscal areas to generate savings in the public sector at some point in time.

Fifth, it is important for the government to overcome the constitutional and other hurdles in the way of introduction of a universal system of income tax that covers all incomes at relatively lower tax rates and that ensures progressivity in effect. Income taxation must be based on universal principle of equal taxation of all at the same income level (horizontal equity) and higher tax payment as a percentage of income at higher income levels (vertical equity). The agriculture and service sectors have so far escaped income tax payments and thus the bulk of the economy is not even covered by income taxation. If federal income tax cannot be extended to agriculture due to constitutional constraints then provincial governments should be made to impose a corresponding agricultural income tax.

Sixth, indirect taxes should focus on taxing consumption and promoting savings. The best way to do that would be to introduce a broad based value added tax mainly on consumption items that could gradually become a mass consumption tax covering all consumer goods and all sectors and provinces. This should eliminate the need for several indirect taxes that are selective and discriminatory and distort the price structure and lead to misclassification of transactions.

Seventh, tax laws must be simplified; tax administration improved and tax leakages and corruption controlled. Several studies indicate a substantial revenue generation potential of measures to plug the tax loopholes, improve tax administration and reduce the collusion between tax payers and tax collectors that costs heavy revenue loss to the government. An expansion of the tax base and lowering of tax rates and plugging of tax loopholes will go a long way to improve tax collection and also increasing effective tax rates at all levels.

Eighth, on the expenditure side, conspicuous consumption of the government and of the upper echelons of the society coexisting with large scale poverty is not only morally offensive, it has its adverse implications for the rate of saving and the rate and quality of economic growth. Austerity must start at the government level not only to reduce inessential government expenditure but also to inculcate saving habits among the people in general. There should be full accountability and transparency in all government expenditures, current expenditures should be severely curtailed and development expenditures properly prioritized and effectively utilized and wasteful use of expensive foreign loans should be stopped.

Ninth, the current trend of unlimited appetite to spend of the provinces with no effort at all to mobilize resources needs to be reversed. Provincial revenue base should be expanded and higher expenditure on health, education, provision of basic services and poverty alleviation should be directly linked with mobilization of resources at the local and provincial levels.

Tenth, public sector development program itself should shift its focus from prestige projects to essential infrastructure, better education and skill creation, energy and water resource development and provision of social services that help promote social harmony and economic stability.

Eleventh, the deficit implications of the implementation of the latest National Finance Commission Award need to be fully grasped and addressed. While it is a step in the right direction for the strengthening of the Federation, larger resource transfer to provinces must be accompanied by one of the following actions or a combination thereof to limit its impact on the consolidated budget deficit. Either the Federal Government should reduce a corresponding amount of its current expenditure or raise additional resources to compensate this revenue loss at the level of the Federal Government or provinces should generate a surplus in their budgets equivalent to the increase in the deficit of the Federal Government. If neither of these steps is taken, the consolidated budget deficit will go up requiring more internal and external borrowing and printing of notes.

Fiscal reforms on the above lines should lead to a gradual emergence and increase in public sector savings, which, supplemented by external grants and selective concessional loans, should gradually reach the level of public sector development program. This is the only way for the public sector to avoid siphoning off private savings and implicit taxation of people through inflation fueled by printing of excessive notes.

Government, monetary expansion and inflation

It is recognized by all quarters that Pakistan is suffering from a high rate of inflation (See Table 1), and actual inflation is in fact much higher than the officially recorded inflation due to inadequate and outdated method of construction of price indices and their coverage. It is also generally accepted that a high rate of inflation is very harmful for economic and social stability and hurts the process of economic development. It is a regressive form of taxation and worst enemy of financial savings and long term economic growth. It taxes the poor and penalizes savers and subsidizes the rich and rewards borrowers, and in the process transfers resources from the poor to the rich and from saving to consumption.

As regards the causes of inflation, there may be some difference of opinion on the initiating factors but ultimately inflation is a monetary phenomenon whereby too much money chases too few goods and services. Gottfried Haberler, one of the most renowned economists, had put it more clearly that “there is no record in the economic history of the whole world, anywhere or at any time, of a serious and prolonged inflation which has not been accompanied and made possible, if not caused, by a large increase in the quantity of money.” Proper regulation of money supply for the containment of inflation is therefore of critical importance.

For the convenience of presentation, the causative factors for monetary expansion are usually classified into those emanating from foreign sector, public sector and private sector; in other words, money supply may expand from accumulation of foreign exchange reserves, public sector borrowing of various types from the banking system and extension of credit to the private sector.

For regulation of money supply and inflation, it was important that SBP had autonomy to professionally manage its balance sheet so as to have an effective control on the level of reserve money in the hands of the banking sector. If government influences balance sheet of SBP through forced borrowing from it on budgetary considerations, it would tantamount to subordination of reserve money creation and monetary policy to haphazard budgetary requirements. Similarly, it was important to recognize that interest rate was an instrument of monetary policy to be used effectively by SBP for the regulation of private liquidity in the system.

Unfortunately, up to early 1990s, by law, and in practice, SBP was administratively and functionally subordinated to the Ministry of Finance, nationalized commercial banks and development finance institutions were being controlled by Pakistan Banking Council, which was an arm of the Ministry, and SBP was not allowed to use instruments of credit control for the private sector without government approval. Excessive public sector borrowing from the banking system remained a major contributory factor in reserve money creation and monetary expansion. Equally importantly, interest rates were not treated as an instrument of monetary policy by fiscal authorities in Pakistan and the government regulated and kept them low in real terms to provide subsidy to its own borrowings at the cost of savers and private sector investors.

Monetary policy after SBP autonomy

The negative implications for savings, investment and growth of a monetary policy that was subservient to the financing requirements of the government, and was unable to use interest rates as a major instrument, were recognized in the nineties by the policy circles in Pakistan. Accordingly, SBP was given administrative and functional autonomy, with guarantee of tenure to the Governor and SBP Board of Directors and some influence on the determination of government borrowing from the banking system through legislative reforms in 1994. As these legislative reforms were not adequate to control Federal government borrowing from SBP, SBP Act was amended again by the Parliament in May, 1997.

This time the revision was done much more carefully and professionally to ensure that excessive government borrowing from SBP and interest rate suppression on fiscal considerations was stopped completely, and SBP was given explicit authority to have complete control on its own balance sheet and on interest rate policy. Specifically, it was stipulated in section 9A of SBP Act that "the Central Board {of SBP} shall, in order to secure monetary stability and soundness of the financial system, formulate monetary and credit policy – and determine, and enforce, in addition to the overall expansion of liquidity, the limit of credit to be extended by the Bank to the Federal Government, Provincial Governments and other agencies of the Federal and Provincial Governments for all purposes."In addition, the scope of Monetary and Fiscal Policies Coordination Board, set up under Section 9B of SBP Act in 1994, was restricted mainly to reach an agreement on macro economic targets of growth, inflation and balance of payment and to coordinate fiscal, monetary and exchange rate polices. It was made clear at the end of the same section that "the Coordination Board shall not take any measure that would adversely affect the autonomy of the State Bank of Pakistan as provided in this Act."

Thus, all ambiguities were removed from the SBP Act by 1997 and SBP was given exclusive authority and responsibility for formulation and implementation of a proactive monetary policy with explicit power to "determine and enforce" government borrowing from SBP by all layers of government and public sector entities. This was a major step forward to enable SBP to control the growth of reserve money and of money supply and thereby conduct an independent monetary policy that ensured relative price stability while meeting the credit requirements of the productive sectors.

Track record of monetary policy after autonomy

Immediately following the banking sector reforms of 1994 and 1997, SBP began to formulate and implement an independent monetary policy with a view to containing monetary expansion within limits that would facilitate the achievement of inflation target agreed with the Government. That was achievable only if Federal and provincial governments were to contain government borrowing from SBP within safe limits prescribed by SBP on monetary policy considerations. For that reason, the National Assembly amended the SBP Act giving powers to SBP to determine and enforce limits on all layers of the government on monetary policy considerations. In implementing the new provisions immediately after their enactment, whenever governments failed to voluntarily contain their borrowing from SBP, SBP did indeed begin to use the legal authority to limit it. Initially, SBP started restricting borrowing by provincial governments from SBP within the approved limits. When some provinces did not take SBP warnings seriously, the then Prime Minister Benazir Bhutto was informed and Prime Minister extended full support to SBP and, in response to its submission, wrote a letter to the provincial Chief Ministers in 1996 reminding them of SBP's legal powers to dishonor cheques issued by provinces in excess of their SBP approved borrowing limits. When some provinces failed to pay attention to the advice and the warning, SBP did stop payments of defaulting provinces on six different occasions (See History of the State Bank of Pakistan 1988-2003: SBP, pp759-763).

A beginning was also made by SBP to indicate to the Federal government the amount of borrowing that it could resort to from SBP in the fiscal year 1997-98 based on monetary policy considerations, and the Federal government did begin to adhere to the limit prescribed by SBP. The Monetary and Fiscal Policies Coordination Board also began to meet regularly to agree on targets of growth, inflation and external accounts that were used to determine safe limits of monetary expansion by SBP on the basis of a reserve management framework. Similarly, the sale of Government securities to commercial banks began to be based on auctioning conducted by SBP, and cut off rates began to be determined by SBP.

SBP also put in place a comprehensive framework of analysis to determine credit requirements of the private sector for the attainment of growth target and to ensure smooth flow of credit to the private sector. The safe limit of government borrowing from SBP was residually determined by SBP based on a reserve money program, and communicated to the Government as an input to the scheme of budget financing. Accordingly, by FY1997-98 all legal, professional and procedural steps were put in place for the conduct of an independent monetary policy.

It was a promising beginning and continuation and further refinement of this framework would have changed the direction of budget financing in general and ensured containment of monetary expansion and inflation in particular. However, this promising beginning proved short lived and autonomy in the conduct of monetary policy was in practice abdicated by SBP early in Musharraf era with the result that printing of notes on the instructions of the government was resumed, and has since been continued, resistance to government interference in monetary and banking affairs was abandoned by SBP in the name of “team work” and monetary policy began to narrowly focus on credit policy for the private sector. As a result, monetary expansion again began to be determined mainly by fiscal operations of the government.

A premier organization like SBP, that had earned statutory autonomy after a long struggle and great deal of effort, was supposed to formulate its policies and give advice to the government based on legal and national considerations. Its main task was to promote national economic interests by fulfilling its duties as enshrined in its Charter, and not to win popularity contest within the government by becoming subservient to the dictates of the Ministry of Finance. In a law abiding country, it would be inconceivable to deliberately ignore the implementation of a law on consideration of expediency or personal agenda.

A casual reading of recent monetary policy statements makes it clear that SBP has not followed the law and by now has lost control on government borrowing from it. Indiscriminate public sector borrowing has once again become the main engine of reserve money creation and monetary expansion (See table 2). Similarly, the government, that had earlier begun to indicate only the volume of periodic borrowing from commercial banks and accept SBP decided cut off rates, has reversed the practice, and the Federal Ministry of Finance has again begun to decide the cut off rates. The Ministry of Finance has thus once again begun to determine both the volume and price of its borrowing from the banking system, and contrary to the requirements of SBP Act, SBP has readily accepted this dictation. There is also no evidence of regular quarterly meetings of the Monetary and fiscal Policies Coordination Board, for reaching an agreement on inflation, growth and balance of payments targets and for coordination of monetary and fiscal policies, which is a legal requirement.

Without a limitation on government borrowing from SBP, and consequent loss of control on its balance sheet by SBP, and with no authority to determine cut off rates for government borrowing from commercial banks, SBP has in practice lost control over interest rate policy, over reserve money and over monetary policy. By failing to discharge its statutory responsibility and by abdicating its central role to "determine and enforce" government borrowing from SBP, SBP has become a party to fuelling of high inflation that is being experienced in the country.

There have been lame excuses given by some senior SBP officials for this state of affairs, and they have publically stated that SBP did not have the power to stop the government borrowing from SBP or from determining its cut off rate, and that a new law was required if it was to be done. Those SBP officials must not have read/understood the revised SBP Act because the fact is that the law was carefully revised on monetary policy considerations in 1997 and it is unambiguous and it is there giving authority to the Central Board of Directors to "determine and enforce" the limit on borrowing by government from SBP. The law cannot implement itself and, for that matter, any new law will also meet the same fate, if kept merely lined up in the shelves in SBP offices or in its library.

In the context of the unwillingness or inability of SBP to enforce the law, let us learn from the experience of other institutions having constitutional or statutory autonomy. Pakistan had long periods of unconstitutional governments not because the Constitution was not there or it was ambiguous but rather because it was not respected and followed in practice, and similarly the superior courts of Pakistan did not exhibit independence till very recently not because their independence was not guaranteed by the Constitution but because there was no will to exercise that independence in practice. In the same way, monetary policy of SBP has been practically subordinated to the fiscal requirements not because there was no law but because there was no respect for the law and/or not enough courage to enforce the law.

Instead of exerting leadership in enforcing the existing provisions of SBP Act, SBP has reverted back to the old habit of obeying even illegal instructions of the Ministry of Finance and extending unlimited credit to the government and its agencies in violation of its newly revised charter. Excessive printing of notes on the instructions of the Ministry of Finance thus became the main cause of the high inflation in Pakistan in the recent past. Moreover, unable or unwilling to enforce the existing provisions of the SBP Act, SBP initiated a process for the demise of its own de jure autonomy in the matter of monetary policy.

It appears that with totally erroneous briefing to the IMF about the causes of excessive government borrowing from SBP, SBP prompted, and IMF agreed, to propose abolition of the existing provisions of SBP Act relating to monetary policy, and the proposed revisions will take away from SBP de jure power to determine and enforce government borrowing from it as well as to formulate and implement an independent monetary policy. If enacted as proposed, Government borrowing will be decided by the government and credit policy for the private sector will be formulated by an independent Committee, including outsiders. It is unfortunate that the so-called IMF experts were unable to apply their own mind and read, understand and interpret the existing provisions of the Act correctly before agreeing with the proposed changing in the existing provisions that will bring to an end autonomy of SBP in monetary matters that was attained after a long struggle.

There are three changes that are being made in SBP Act. First, approval of credit policy will be taken out of the hands of the Central Board of SBP and handed over to a Committee, including outside experts. Second, government borrowing from SBP will be linked with tax revenue or some other variable of the budget in a mechanical manner and taken away from the Central Board of SBP. Linking government borrowing to a fiscal variable and not to the safe limit of monetary expansion derived from monetary policy considerations will make SBP again de jure subservient to the budget. Handing over the core central banking function of formulation of monetary policy to an outside Committee will make SBP Board redundant. Ironically, this is being done in the name of enhancing autonomy of SBP.

It may be kept in view that if the existing provisions of Section 9A and 9B of SBP Act are removed/modified using one pretext or the other, SBP would never be able to get back the statutory authority that it has on books now in the matter of government borrowing from the banking system. Most governments would find it convenient to indirectly and indiscriminately continue to rob people through money creation and inflation rather than to directly tax them through a transparent and fair tax system.

If at all further reforms were to be made, those could relate to the reformation of the composition and qualifications of the Board, and the way it is appointed, and further clarification of the functions of Monetary and Fiscal Coordination Board rather than its abolition. Making the SBP Board redundant by renting out its functions to an outside group or enabling the government to automatically borrow from SBP a certain percentage of their revenue receipts or making Prime Minister Chairman of MFPCB will diminish and not enhance SBP autonomy. The fact that such changes were endorsed by IMF does not make them right for Pakistan.

Private sector saving

Simultaneously with generation and expansion of public sector savings, and containment of inflation through a proactive and independent monetary policy, a strategy needs to be adopted to promote private savings that are usually divided between corporate savings and household savings.

Corporate savings depend on the efficiency and profitability of the corporations and policy incentives to encourage them to plough back in further investments or keep as retained earnings an increasing share of their profits. A sound investment policy and supportive fiscal, exchange rate and monetary policies, and a promising environment for new investments, are the main instruments that can be used for the promotion of corporate saving and investment. A stable political environment, reasonable law and order situation, strong anti-monopoly framework and an effective and transparent legal system for the corporate sector will go a long way in promoting corporate saving.

Household savings depend on many complex factors, the most important being income levels, relative price stability and positive real rates of return on savings. Slow growths in real per capita income and increasing disparity in incomes have in the past promoted consumption rather than savings. Lavish life style of the rich and subsistence living of a large segment of the society has led to lowering of the saving rate in the country. Added to that is the demonstration effects of conspicuous consumption of the rich and powerful, consumption liberalization through cheap money policy in this decade, and discouragement of savings by the high rate of inflation and negative real rates of return on most financial savings.

If the rate of inflation can be brought down to a moderate level of 4-6 per cent a year through appropriate demand management policies, SBP can also use tools at its disposal to gradually improve nominal rates of return on financial savings so as to ensure a positive real rate of return to savers.

Some quarters doubt elasticity of savings in relation to the rate of return but it may be noted that the same argument was used for quite some time in the case of agricultural products, and control on agricultural product prices became a vehicle for providing agricultural products at relatively cheap prices to the more vocal urban sector and thereby transfer resources from rural areas to the urban areas through unfavourable terms of trade for the agricultural sector. Similarly, the banking system of Pakistan is currently discouraging financial savings by offering a negative rate of return in real terms and is also instrumental in transfer of income from the poor to the rich. The bulk of banking sector deposits are owned by small savers and a large proportion of loans are taken by the relatively rich people. Negative real rates of return on savings combined with low/negative real rate of interest on borrowings, and a large amount of wilful loan defaults, amount to implicit taxation of the poor and subsidization of the rich through the banking system. It is important that SBP adopts policy measures to ensure that the banking system gives positive rate of return on savings held in the form of deposits, and thereby rewards rather than retards financial savings.

Interest spread and private sector saving

Negative real rate of return on financial savings has been accentuated by the recent abnormally high spread between the average deposit rate and the average lending rate of banks, which has inflated the profitability of banks. A large interest spread has been allowed to exist not only at the cost of financial savers but also at the cost of private sector borrowers, who are the main engine of economic growth in the country. SBP has the institutional responsibility and legal authority to bring down this spread within the normal limits obtaining in other countries and on that basis to ensure a higher nominal rate of return on deposits and lower cost of borrowing of the private sector. In the absence of a concerted effort on the part of SBP to ensure positive real rate of return on financial savings, the rate of saving through financial instruments will remain depressed, and whatever savings take place will find their way in real estate, commodities and speculative activities. Moreover, such an interest rate policy would continue to promote inefficiency in resource allocation and hampers long run economic growth.

Other measures to promote private sector saving

The government can also take institutional and other measures to encourage household savings. It can introduce contributory retirement schemes gradually replacing the traditional pensions that would become increasingly more costly with increase in life expectancy, and further strain the budgets of the government and public sector entities. Tax incentives to promote savings can be carefully planned so that those do not become avenue of tax evasion and in fact promote household savings, and new instruments of financial savings could be encouraged. Austerity in government expenditures and simplicity in the life style of the so-called elite of the country, based on the age old principle of simple living and high thinking, can set the stage for promotion of saving habits in the masses. Development of capital markets and discouragement of conspicuous consumption can all play their part. But for simple living to take hold in the society, leadership needs to set the trend.

Resource allocation

Resource allocation is as important as resource mobilization for economic growth but, it being a vast subject in itself, cannot be covered in this paper in any details.

A rise in domestic saving rate is a necessary but not sufficient condition to accelerate economic growth. Higher national saving must be efficiently used for capital formation and economic growth. It is important that reform in this area also starts from government development expenditure.

First of all, development expenditure needs to be properly defined and unproductive activities undertaken in the name of development expenditure should be weeded out. A close scrutiny of the components of development expenditure would show that several expenditures included in the development program have no direct relevance to economic development of the country. It is for this reason that correlation between so-called public sector development expenditure and the rate of economic growth is very weak.

Second, development expenditures should be reprioritized to direct them to projects that help create an enabling environment for private sector investment activity. In particular, there should be concentration on development of water and energy resources, promotion of professional education that leads to production of skills rather than educated unemployment and creation of rural road network and other infrastructure aiding private sector development activity rather than building of prestige projects like highways and airports.

Third, the past neglect of the social sectors in allocating development expenditure has proven very costly, and allocations for these sectors need to be expanded. Pakistan's allocation of resources to education and health is one of the lowest in the world and there is no evidence in world history of a country making steady progress in economic development without an improvement in the quality and quantity of education and of health services.

Fourth, a proper policy framework for improving agricultural yields and industrial efficiency and promoting private sector investment activity and export led growth is of paramount importance. A flexible exchange rate policy that promotes exports, a trade policy that discourages non-essential imports and a regulatory framework that is less bureaucratic and more efficient should constitute essential ingredients of such an investment and development strategy.

Fifth, it is important that less developed areas are developed faster to bring them at par with relatively more developed areas of the country. With lopsided development, the less developed areas and people would begin to hold back development in the entire country.

Sixth, any incentive given to agriculture, industry, region or group of people should be direct and transparent, and price distortions to promote their development need to be avoided. Price subsidies by distorting price signals will lead to permanent misallocation of resources.

7. Concluding remarks

Pakistan is rich in human and material resources but poor governance of the country has impeded the process of exploitation of these resources. Some of the essential ingredients of good governance that are lacking in Pakistan are rule of law, effective institutional checks and balances, transparency and accountability, safety and security, well defined and well functioning federation, strong state institutions, and a coherent long term national economic agenda that, along with foreign policy, is jointly approved by the major political parties, and implemented by all governments through a transparent institutional framework, and not on the basis of ad hoc decisions or individual whims. Good governance in all these dimensions is a prerequisite to get out of the present economic crisis.

Among macroeconomic problems faced by the country, budget mismanagement is the mother of most economic ills in Pakistan. Fiscal policy has been directly responsible for low domestic saving rate, high rate of inflation, steep rise in external debt and balance of payment difficulties. The recent high rate of inflation also reflects failure of SBP to discharge its statutory responsibility given to it in 1997 to "determine and enforce" government borrowing from it and to follow a monetary policy that ensures relative price stability and facilitates steady economic growth.

The most fundamental change in economic policies that is required to address economic crisis is that the past practice of large scale financing of government operations through external borrowings and internal money creation should be abandoned. This would be possible if the government makes a concerted effort to increase domestic revenue, to control inessential current public sector expenditure and to create policy framework favourable for private saving and investment. Tax revenue needs to be mobilized on war footing at all levels of the government and from all sectors of the economy, a severe cut in current expenditure should be attempted through effective austerity measures, and development expenditure has to be diverted towards energy and water resource management, creation of infrastructure for agriculture and industry and skill development of the younger population.

An autonomous monetary policy will have to play an active role in moving the country towards better economic management and macroeconomic stability. SBP has to have effective control on all sources of reserve money creation, including the government, and should be able to effectively use the rate of return as an instrument of monetary policy. SBP cannot control money supply only by regulating credit to the private sector while allowing the government to borrow at will from it. There is thus a heavy responsibly that rests on the shoulders of those who are privileged to occupy leadership positions in SBP to "determine and enforce" limit on government borrowing from it and to formulate and implement a prudent monetary policy.

Any further delay in taking measures to promote economic self reliance, increase domestic savings, both in the public and private sector, and to launch a long term economic development strategy, while ensuring relative price stability, will prove very costly for the country in the long run. Weakening of SBP autonomy pretending that it was being enhanced is also no service to SBP or the country.