SBP Research Bulletin
Volume 7, Number 1, 2011

Editorial

The State Bank of Pakistan international conference on "Economic Policy after the Crisis" scheduled on December 2010 could not be held due to some unavoidable reasons. However, the papers written for the conference constitute this special issue of the SBP Research Bulletin. The theme of the conference was chosen in the background of recent financial crisis, which has forced policy makers and economists to revisit the existing economic policies and rethink traditional macroeconomic principles.

On the global financial crisis of late 2007-08, much has been written and said to explain what went wrong, what triggered the crisis, how economic managers responded to rescue the economies, which policies were more effective in limiting the damages, and what could be the implications of stimulus packages. The world has learnt painful lessons from the crisis; however, the most important outcome of the recent turmoil is that it has exposed the basic debilities in the global financial system.

With all its complexities and byzantine international financial linkages, the global finance experienced tremendous growth in recent past; however deceptively it was dominated by self-referential activities instead of real and tangible economic activities. The term financial engineering has increasingly become popular that has driven the global finance towards non-tangible endeavors and under-pricing of risks in financial markets. A dominant part of financial assets has been derived from other financial assets, which has fortified risks to the industry.

The risks associated with the global finance and strategies to address these risks have been well documented and discussed by professionals and economists in the context of developed countries. However, some of the fundamental policy implications of such a crisis of global origin for emerging economies like Pakistan have attracted little attention so for.

Although it is commonly said that countries like ours remained insulated from twinge of the crisis, the reality could be different: a real GDP growth of just 3 percent average in last three years (i.e. FY08 to FY10) compared with 5.6 percent average growth in other years of the decade (i.e.FY01 to FY07) and an average inflation of 15 percent in last three years compared with below 6 percent inflation in other years of the decade may point to a different story.

Thus it should be a useful debate that to what extent an economy like Pakistan could be affected – directly or indirectly – by economic crisis of global nature and what should be the design of economic policy to address it. For the sake of discussion, we can classify all economic policies into two categories: growth promoting policies and stabilization policies.

In case of ***growth promoting policies***, we can say this crisis is not going to renew the debate between capitalism and communism in traditional sense, however there is a need to rethink key policy issues as discussed below.

What should be the balance between the role of government and the role of market?

The crisis provides ample evidence that self regulating market could be destructive. The notion that *market discipline* will help ensuring effective risk management proved illusory. Free and so-called efficient markets were unable to quickly correct their mistakes without government intervention. Now the economists are emphasizing the regulatory role of government and its participation in market mechanism as rule-setter.

The developing countries like Pakistan already have large size of governments with strong role of public institutions in managing the markets. We have not only to rethink on the optimal level of public intervention in the light of recent crisis but also have to focus on governance issues. Quite encouragingly, overall framework of governance structure in Pakistan has already undergone positive developments in the form of devolution of administrative powers through 18th Constitutional amendment. However, practical difficulties and inefficiencies still exist that need to be addressed and quality of public services should be improved to the satisfaction of the people.

For developing countries what sort of risks are attached to economic and financial globalization?

There is no doubt that globalization has offered great opportunities to expand exports, acquire modern technologies and attract foreign direct investment. However, these benefits do not accrue automatically. The cost of globalization is generally underestimated. The recent crisis clearly shows the cost of increased interdependence. It also shows that how globalization could magnify the problem in one specific market of a country to rest of the world. The crisis has also reduced the trade volumes, foreign direct investment and access to international financing that damaged the global supply chains and adversely affected world real output growth and inflation.

Is the exports-led growth strategy still attractive?
The recent crisis has exposed weakness of the most popular strategy for growth led by exports, particularly when it is not supported with robust domestic demand. The Asian economies including China have struggled with falling exports and poor domestic demand, while the USA and Europe were heading towards recession. The countries were forced to implement stimulus packages consisting of increase in public spending, tax reductions, lower interest rates, etc., to revive their domestic demand.

The stimulus packages for the revival of economic activities in advanced economies have reinstated the trade protectionism. This makes export-led growth strategy more difficult to follow for the developing countries like Pakistan. We may also have to give attention to domestic demand as a supporting development strategy along with external demand (exports) for sustainability of real GDP growth in the long run.

On domestic fronts, policies for increasing technical efficiency, improving human capital by extensive training opportunities and quality education, and boosting investment demand by creating conducive business environment are the key challenges. The major impediment in the way of rebalancing between outward looking and inward looking policies is the existing structural bias in favor of tradable goods and services. Thus we need to rethink existing incentive structure for exporters vis-à-vis other segments of the economy.

Turning towards ***stabilization (demand management) policies***; the recent crisis has led to expansionary monetary and fiscal policies with multi-billion dollar stimulus packages in the form of historic low interest rates, massive increase in public sector outlays, tax concessions, etc. Most of these measures are still in place and policy makers of crisis-hit economies are contemplating on exit strategies. Moreover, the cost of implementing stimulus packages has raised concerns over future direction of fiscal and monetary policies.

A number of issues are now coming to the surface as aftereffects of aggressive policy packages are hitting the road; most serious of it is mounting debt obligations due to expansionary fiscal policies:

a) ***Expansionary fiscal policies*** have led to sharp increase in debt-to-GDP ratio of major advanced economies. For example, USA debt-to-GDP ratio has jumped from 48 percent in 2008 to 66 percent in 2010.[1] Such massive rise in

[1] Over the same period, debt-to-GDP ratio for Euro area has moved from 53 percent to 67 percent.

debt has created fiscal strains for these economies. Some of the countries in Euro area are already experiencing debt crisis, which is further undermining abilities of respective governments to fight out economic downturn. Moreover, high volatility in sovereign debt market could also stall the recovery process in advanced economies.

Currently, a large portion of advanced countries' debt is financed by savings of Asian economies. A decrease in net exports of surplus economies, notably in Asia may reduce their ability to refinance the existing stock of debt. Refinancing maturing debt could be a major issue for a number of countries, especially in Euro area. Any unexpected event in sovereign debt market could derail fragile recovery. It points out a self-defeating policy prescription; i.e., a policy that aimed at bringing the economy out of the recession risks throwing it back there. Emerging economies should learn from such a situation. Particularly, countries like Pakistan with scarce foreign exchange resources and low per capita income can hardly afford such expensive policy prescriptions.

b) Similarly, the response of ***monetary policy*** also needs to be prudent and careful even in case of crisis. At present, interest rates are at all time low levels in a number of advanced countries. The excessive liquidity in financial sector has already found its way to commodity and stock markets. These markets have recovered from crisis well before the revival of real economic activities. Until the real economy catches up the financial sector recovery, the risks of monetary overhang leading to inflationary pressures exist.

The crisis has actually highlighted the delicate nature of monetary policy framework. On the one hand there are temptations to employ selective credit controls with concessionary finance to some sectors of the economy; and on the other there is a need to make an across the board interest rate policy in an attempt to provide level playing field. The most suitable policy advice would be a package of monetary and fiscal policies instruments to be employed in a coherent manner.

c) ***Monetary and fiscal policy coordination***: In fact the recent financial and economic crisis and way the developed world responded to it have highlighted the need for *coordinated economic policy moves*. Despite the dichotomy in objectives of fiscal and monetary policies, coordination between the two in the form of timely exchange of information, setting mutually agreed upon and consistent macroeconomic targets and harmony in execution of policy

instruments are important for bringing the economy back to its stable long-term path.

However, coordination between fiscal and monetary policy should not be taken as monetary policy subservient to the fiscal coercions; the central bank's autonomy is to prevail for not only policy effectiveness but also for maintaining credibility of both the fiscal and monetary institutions.

d) Equally important is the self-surveillance of fiscal and other economic policies. While surveillance by multilateral institutions could induce the governments to remain prudent – particularly in their fiscal operations – the political pressures often force the government to offer excuses in executions of its commitments with such institutions. Thus there is a need to develop some in-house legal framework and self-surveillance mechanism to help governments be in discipline in all good and bad times.

At the end, the most important policy lesson one should draw from the recent crisis is the ***set of effective and proactive regulatory and supervisory techniques*** that keeps on evolving overtime. The crisis clearly showed that market discipline, existing prudential regulations and supervisory arrangements were unable to restrain excessive risk taking by financial institutions. Thus the focus of policy changes should be on institutionalizing the macro-prudential approach for supervision and to extending regulatory and supervisory framework to unregulated financial entities.