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Macroeconomic policies are meant to achieve non-inflationary, stable growth. There are two major groups of policy instruments to achieve the purpose; one is related to monetary conditions and the other to fiscal conditions. Monetary instruments are employed by the central bank and fiscal instruments are employed by ministry of finance. The objectives and implications of policy measures taken by the two institutions often conflict with each other and thus call for policy coordination for effective implementation of policy decisions to achieve the set targets. The policy coordination has to be supported by concrete institutional and operating arrangements like monetary and fiscal coordination board. In Pakistan there was no concept of such policy coordination before financial sector reforms which were initiated in 1989-90. This financial reforms and restructuring process necessitated the monetary and financial policy coordination and a monetary and fiscal policy coordination board has been established in Pakistan.

1. Introduction

The objectives of macroeconomic policies are to ensure that the economy achieves *non-inflationary, stable growth*. By this we mean purposeful manipulation of policy instruments such that fluctuations in employment, production and prices are minimized and potential growth in real output is realized. There are two major groups of policy instruments; one is related to monetary conditions and the other to fiscal conditions. Monetary instruments are employed by the central bank and fiscal instruments are employed by ministry of finance. The objectives and implications of policy measures taken by the two institutions often conflict with each other. Thus it is imperative to have a mechanism of coordination between the two authorities for the better functioning of overall economy.

In this paper we will be discussing the issues pertaining to the interaction and the coordination between the two authorities while performing their respective roles in order to achieve the above-mentioned objectives. Each authority has two instruments to use for achieving the set objectives. Monetary authority may use interest or money stock as policy instrument. Ministry of finance may use tax rate or tax revenue as policy instrument. The interaction between monetary and fiscal authorities relates to the financing of the budget deficit and its consequences for the monetary management. An expansionary fiscal policy will increase aggregate demand and hence have consequences for rate of inflation. The monetary policy stance affects the capacity of the government to finance the budget deficit by affecting the cost of the debt service and by limiting or expanding the available sources of financing.

In the late 1960s a big debate in macroeconomics was over the relative effectiveness of monetary or fiscal policy in demand stabilization. Today, though monetary policy is the predominant stabilization tool for most economies used by an independent and credible central bank, there are economists who see important stabilization role for fiscal policy working alongside monetary policy. Even there are economists who say, no matter how independent central bank is, the monetary policy may not be sufficient for determining the price level and there is role for fiscal policy. While both the monetary and fiscal policies are used to achieve set objectives, concerted efforts are needed to be made to use them in a coordinated way.

In the next section we review the literature on the issue of monetary and fiscal policy coordination. In the section 3, rationale for the coordination is discussed whereas section 4 describes the institutional and operating arrangements for the coordination. In section 5, we discuss the coordination between monetary and fiscal policies in Pakistan, and the last section concludes the paper.

2. Review of Literature

The literature on the monetary implications of fiscal in-discipline, which originates with Sargent and Wallace (1981), emphasizes that to the extent the path of a government's fiscal deficit is predetermined and unsustainable the monetary policy and the price level are no longer exogenous to it. A similar point arises in the context of the 'Fiscal Theory of the Price Level' (Woodford, 1995). However, in these frameworks the goals of fiscal policy are not explicitly discussed, and in particular they do not include macro stabilization. Nevertheless, the scenario analyzed by Sargent and Wallace has surely been influential in motivating the emphasis on fiscal discipline as a pre-requisite for monetary stability.

Lambertini, Luca and Rovelli (2001) argues somewhat against the Sargent and Wallace stance that "in-disciplined" fiscal policy, possibly unsustainable in the long run, forces the central bank to give up its independence and monetize the fiscal deficit, while emphasizing the need for coordination. Their argument is that even perfectly sustainable (in the long run) fiscal policies may undermine the policy stance adopted by the monetary authority.

Dahan (1998) develops a simple framework to examine budgetary implications of monetary policy. Dahan outlines various channels of influence that tight monetary policy, and consequent higher interest rate, may have on the budget deficit including price, expenditure, revenue, debt, seigniorage, sterilization, and swapping effects. Most of these effects tend to increase the budget deficit as a result of tight monetary policy. The reaction of the government to recession might be an increase in the budget deficit that may affect overall policies' credibility. The reaction function of the government may impair the monetary policy. Thus, he argues, there is a strong need for the monetary and fiscal policies coordination.

Tabellini (1986) analyzes the coordination of monetary and fiscal policies in the context of a differential game modeled for a single country, where the target variable is the path of government debt across time. He shows that policy coordination increases the speed of convergence to the steady state and leads the economy closer to the planned target as compared to the outcome of the non-cooperative game.

3. Rationale for Coordination

Monetary policy is concerned with the regulation of the availability, cost and allocation of money and credit in the economy. Fiscal policy refers to government's programmes for public spending and its resource mobilization strategy for meeting these expenditures. Monetary and fiscal policies are very closely related to each other despite the fact that these two sets of policies are sometimes different in terms of scope, transmission mechanisms and time involved in influencing the macroeconomic variables.

Fiscal and monetary policies have profound impact on the level and composition of savings, investment, output and employment as well as the viability of external account. The level and structure of taxation, magnitude and the pattern of public expenditures, the dimensions of the fiscal deficit and the sources of financing it, changes in money supply, availability and distribution of credit as well as its cost are major determinants of the production structure and employment levels aside from their significant impact on price level and movement of exchange rate.

The basic rationale for the monetary and fiscal policy coordination and the associated institutional and operational arrangements derive from the following interrelated objectives:

- To set internally consistent and mutually agreed targets of monetary and fiscal policies with a view to achieve non-inflationary stable growth.
- To facilitate effective implementation of policy decisions to achieve the set targets of monetary and fiscal policies efficiently through mutually supportive information sharing and purposeful discussions.
- To compel both the central bank and government to adopt a sustainable policy[†].

Without efficient policy coordination, financial instability could ensue, leading to high interest rates, exchange rate pressures, rapid inflation, and adverse impact on economic growth. A weak policy stance in one area burdens the other area and is unsustainable in the long run. For example lax fiscal policy will put pressure to tighten the monetary policy, even if the latter cannot fully compensate for fiscal imbalance. Moreover, the lack of credibility of overall policy framework caused by the long run inconsistency of such policy mix will diminish the effectiveness of the monetary policy. The effective implementation of macroeconomic policies thus requires extensive coordination between the two authorities - central bank and the government.

The establishment and development of domestic capital markets require an even greater degree of policy coordination. The domestic financial market provides least distortionary sources of financing the fiscal deficit, while the need to pay market determined debt service cost acts as a deterrent to large fiscal deficits. At the same time, these markets allow the central bank to conduct monetary policy more efficiently through the use of

[†] For example suppose that the government sets its policies on a course that will raise the debt-to-GDP ratio indefinitely. Initially, close coordination of this fiscal plan with the actions of central bank might serve to limit its real interest rate and exchange rate costs. However, the real interest rate still tend to rise over time, uncertainty and instability will increase, and - even with strong dose of coordination – monetary/fiscal policy mix will become unsustainable.

indirect market-based instruments. Finally domestic financial markets impose a discipline on both the authorities given their responsibilities in ensuring a stable financial environment that would be conducive to maintaining orderly and efficient conditions in such markets.

The need for policy coordination also arises in the case of structural reforms and liberalization of the financial sector. Such reforms can only proceed within the framework of a supportive fiscal policy that provides macroeconomic stability, fiscal discipline, and avoidance of taxes that discriminate against financial activity. Together with improved legal, accounting and regulatory systems in the financial sector, these are the prerequisites for successful financial liberalization [World Bank (1989)]. If high fiscal deficits persist while the authorities are undertaking the reforms of the financial sector, interest rates could reach very high levels or, if the interest rates are kept at artificially low levels, either inflation would surge or the demand for credit and distortions in resource allocations would grow significantly. In either case, the financial reform program more than likely will be unsuccessful.

4. Institutional and Operating Arrangements for Coordination

The coordination of fiscal and monetary policies has to be supported by concrete institutional and operating arrangements. Various possible types of such arrangements, their rationales, and the likely evolution are discussed below.

First, institutional arrangements may be to limit central bank credit to the government. It can reduce conflicts between the central bank and the finance ministry in decisions regarding the sources of deficit financing and enhance the operational autonomy of the central bank.

Second, institutional arrangement may be in the form of a debt and monetary management committee. It can play an important role in coordinating the volume of debt issuance in the primary market with monetary policy goals and help resolve conflicts concerning the stance of interest rate policy.

Third, arrangement may be an operational one to share information and to forecast variations in government balances with the central bank or in expected changes in the government's overdrafts. Such arrangements can help to facilitate appropriate day-to-day adjustments of instruments and the attainment of both the reserve money and debt issuance objectives.

Fourth, arrangements and rules for the treatment of central bank profits and losses may be institutionalized as such arrangements are important for maintaining central bank operational autonomy.

Fifth, efforts should be made to develop secondary markets in government securities as both the central bank and the finance ministry has a joint interest in it. Well-functioning secondary markets are important for the finance ministry since they stimulate demand and render the abortion of relatively large issue less problematic. Thus, the central bank may need to consider institutional arrangements to enhance secondary markets, such as establishing a secondary market window or developing market-makers, while arrangements in the primary market will need to be designed to enhance market deepening by improving the auction system.

At the early stages of setting up coordination mechanism, a high-level policy coordination committee, comprising finance ministry and central bank officials should be formed. The placement of limits on central bank credit to the government, and introduction of debt instruments and selling techniques to serve both monetary and fiscal objectives would be important aspects of coordination at initial stage.

In the transitional stage, the promotion of a secondary market should make it possible for the central bank to further develop open-market-type operations; this would require the establishment of an open market committee and direct-dealing relationships with market participants, and more intensive day-to-day coordination of primary issues with other instruments of management (e.g. credit auctions). At the same time, greater emphasis should be given to short-term liquidity forecasting for the conduct of open market operations, which would, in turn, require more frequent information about the central bank's balance sheets. In addition, increased information sharing between the central bank and the finance ministry would be needed to monitor and project government cash balances. Arrangements for primary auctions might switch from a minimum price tender (setting the cutoff rate) to market clearing auction (setting a fixed supply).

Given deepening financial markets in the developed stage, institutional arrangements may delineate separate objectives for debt management and monetary management policies, supported by greater reliance on market operations and market signals to ensure coordination, and further development of institutional arrangements to reduce policy conflicts. Such arrangements could include stricter limitations on direct central bank financing of the government, permitting only indirect purchases of government securities in the secondary market.

The establishment of coordination committees either formal or informal for debt management purposes is common in most countries. These committees meet on a regular basis to exchange information on the governments financing requirements, to discuss and analyze the results of the government's cash balance projections, to monitor overall liquidity and market development's and to discuss strategies for achieving debt and monetary management objectives. Committees (or groups) to coordinate monetary and public debt management issues take different forms in different countries, but they normally include officials of the finance ministry, and the central bank. The exact mandate of these coordinating bodies varies across countries.

5. Monetary and Fiscal Policy Coordination in Pakistan

Prior to the commencement of financial reforms in Pakistan, there was hardly any concept of coordination of the monetary and fiscal policies*; and SBP was not operationally independent. Monetary policy was practically subservient to fiscal policy.* During 1973-90, the deteriorating budgetary discipline resulted into high domestic borrowings by the government. The resulting domestic debt structure, which was characterized by presence of short and long-term government securities with administratively set yield structure, had been an important source of financial repression during this period. The rate of return structure, which was characterized of very low return on government securities offered to banking sector and very high return on national savings schemes offered to non-bank sector, was not consistent to the overall stance of monetary policy. In fact both the quantity and price of domestic credit were being determined by fiscal demands instead of any monetary deliberations.

The period of 1990s, however, witnessed radical changes in monetary management as well as domestic debt management in Pakistan. The debt management reforms were initiated with a view to: reduce the segmentation in government debt market; rationalize the cost of raising long-term government debt; establish a market-based rate of return structure for government securities; and pave the way for implementation of monetary policy through instruments of indirect monetary control. The system of government borrowing through securities on tap has been replaced by a fixed frequency auction mechanism of T-bills through primary dealers. This system also helped developing secondary market for government papers, which in turn provided a base for effective market-based monetary management.

<u>The most important development in 1990s was grant of autonomy to the State Bank of Pakistan in conducting monetary policy.</u> An amendment was made in the State Bank of Pakistan Act, 1956, in terms of which monetary policy was made sole responsibility of the State Bank of Pakistan. The Bank also now enjoys complete freedom to prescribe liquidity ratio for banks, fix their cash reserves and determine the rate of return structure. Amended section 46-B prescribes that no governmental or quasi-governmental body or agency shall issue any directive, directly or indirectly, to any banking company or any other financial institution regulated by the SBP, which is inconsistent with the policies, regulations and directives issued by the Bank. In order to ensure consistency in different macroeconomic policies, the Central Board of Director of SBP was mandated to formulate and monitor credit policy by taking into account the federal government's targets for growth, inflation and expected changes in net foreign assets of the banking system. <u>As a matter of fact, the autonomy of the State Bank is one of the most important reasons for institutionalizing monetary-fiscal coordination. If there is no such coordination then exercising autonomy by the central bank may worsen the economic performance of the country instead of improving it.</u>

Establishment of Monetary and Fiscal Policy Coordination Board

In Pakistan the Ministry of Finance and the State Bank of Pakistan coordinate fiscal and monetary policies to ensure that, as far as possible, these policies move in the direction of achieving the macroeconomic objectives mentioned in the very outset of the paper. In 1994, the coordination was institutionalized by establishing a Monetary and Fiscal Policies Co-ordination Board (MFPCB), through an amendment in Section 9-B of State Bank of Pakistan Act, 1956. In terms of the amended Section 9-B, which describes functions of MFPCB, the Board determines the extent of government borrowing from commercial banks taking into account the credit requirements of the private sector and liquidity expansion as determined by the Central Board of the SBP. The law establishes the mechanism for coordination.

The Board has five members.

- ✓ Federal Minister for Finance (Chairman)
- ✓ Minister for Commerce, or Secretary for Commerce.
- ✓ Deputy Chairman Planning Commission
- ✓ The Governor State Bank of Pakistan, and
- ✓ The Secretary Finance Division

The basic functions, which MAFP-COB has to perform, are:

- ✓ To coordinate fiscal, monetary and exchange rate policies
- ✓ To ensure consistency among macroeconomic targets of growth, inflation, fiscal, monetary and external accounts

Board meets quarterly to review the policies, revise (if needed) limits and targets, consider limits of government borrowings, and review the expenditures of the government.

6. Concluding Remarks

The objective of macroeconomic policy is to ensure that the economy achieves non-inflationary, stable growth. The two relevant authorities are central bank and the ministry of finance. Central bank has influence over monetary conditions and ministry of finance has power over the macroeconomic aspects of fiscal policy. Monetary policy is concerned with the regulation of the availability, cost and allocation of money and credit in the economy. Fiscal policy refers to government's programmes for public spending and its resource mobilization strategy for meeting these expenditures. Monetary and fiscal policies are very closely related to each other despite the fact that these two sets of policies are sometimes different in terms of scope, transmission mechanisms and time involved in influencing the economic variables. Fiscal and monetary policies have profound impact on the level and composition of savings, investment, output and employment as well as the viability of external account. The level and structure of taxation, magnitude and the pattern of public expenditures, the dimensions of the fiscal deficit and the sources of financing it, changes in money supply, availability and distribution of credit as well as its cost are major determinants of the production structure and employment levels aside from their significant impact on price level and movement of exchange rate. The rationale for the monetary and fiscal policy coordination derives from the interrelated nature of objectives. Without efficient policy coordination, financial instability could ensue, leading to high interest rates, exchange rate pressures, rapid inflation, and adverse impact on economic growth.

In Pakistan prior to the commencement of financial reforms of 1990s, there was no concept of monetary and fiscal policy coordination. Instead the monetary policy was subservient to the fiscal policies. However, during 1990s when public debt and monetary management mechanism was separated from each other and the State Bank was granted autonomy, and, therefore, the need for monetary and fiscal policies coordination aroused. A monetary and fiscal policy coordination board has been established that determines the extent of government borrowing from commercial banks, taking into account the credit requirements of the private sector and liquidity expansion, as determined by the Central Board of the SBP.

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