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# **HOW MONETARY POLICY AFFECTS POVERTY: NEXUS AND CONSEQUENCES**

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## **ABSTRACT**

This case study provides some interesting insights and phenomena. It was observed that how monetary policy badly affected the poverty situation in Pakistan. This study covers three important aspects of the socio-economic changes in Pakistan in the recent past. First it describes the macroeconomic growth in the different political regimes. Second aspect of the study is to assess the poverty levels in Pakistan. In this part, we have compared the poverty in Pakistan with the selected countries and trends over the period have also been shown. Third aspect of the study is to identify the impact and contribution of monetary policy in poverty and income distribution.

## **I: Poverty: Changing Trends in Global Scenario:**

World economic history had never witnessed such dramatic, rapid and military-free revolutions, which were observed at the stage of global economy during the last fifteen years. The fall of Soviet Union and its division into independent states, changes in the political geography and systems in the Eastern Europe, the waves of mergers, acquisitions, privatization, globalization, and liberalization in the world economies, heavy fluctuations in the world stock markets, increasing number of liquidation and bankruptcy cases in the corporate sector, dramatic increase in the levels of poverty and inequalities, increasing trend of unemployment, formation of the Euro currency zone and other economic unions, and the clearly observable socio-political changes in Muslim World are those phenomena which have been observed during the last two decades.

During the recent years the responsibility of economic development has largely been shifted on corporate sector from the governmental agencies. The responsibilities of every types of development are being shifted from bureaucrats to the technocrats. The political roles and pressures of the armed forces, business leaders, international consultants, technocrats, and community leaders are being re-shaped. In the present transitory condition, the role and responsibilities of civil servants are also being changed. The financial markets experiences in the Far Eastern and South American countries in recent past have shown that the problems of corporate sector are not only the problems of investors, speculators and stockbrokers, they are also the problems of a common man. The financial problems in corporate sector cannot be segregated from the problems of unemployment, income distribution, poverty and development.

In the present scenario, it seems that the poor are being virtually penalized for the end of cold war. 'Globalization' is one of the prescriptions recommended by the builders of macroeconomic-models to solve the problem of poverty. It is a common phenomenon in all over the globe that all privileges and rights and positives of the globalization are only for richer segment of the societies. The poor do not have power to utilize the facilities of education, entertainments, information technology, migration, immigration, and mobility. Immigration and education are considered as modes of the reduction in poverty; they are creating further gaps.

According to Fukuyaman (2005), the past two decades have seen the growth of what is known as "rational choice" in political science, in which political scientists to seek to model political behavior using the same mathematical tools (game theory, for the most part) used by economists. Economists tend to believe that regularities in human behavior are universal and invariant across different culture and societies. As a result, regional studies fell seriously out of favor in the 1980s and 1990s (Fukuyaman: 2005). The socio-economic issues like poverty, unemployment, inflation and inequalities have been discussing and analyzing with the help of mathematical models and empirical testing tools. However, the global trends in poverty, unemployment and income inequalities in recent past show the failure of uniform and invariant economic modeling to solve the socio-economic issues. The study of macro growth models in a limited vision will be just

a mathematical jugglery. There is an urgent need to analyze those global problems in localized contexts.

## **II: Scope and Nature of the Study**

In this short study we analyzed the effect of monetary policies on poverty in Pakistan. This case study provides some interesting insights and phenomena. In a detailed study, we concluded that poverty is a globalized problem and its causes and consequences may also be uniform, however, its solution is always based on localized policies and mechanism. Economic modeling and universal policies cannot reduce the poverty. To consider poverty as a globally defined variable is misunderstood because of the poverty measuring tools and mechanism. The prevailing tools to measure the poverty and inequality (including estimation of poverty line, gini-coefficient, and number of persons earning less than \$1) do not consider the meaning of poverty in local scenario. To incorporate local scenario in defining the poverty, we should always consider the adoption of those professions or works by the peoples which are considered as 'inferior' or 'defamed' or 'bad people's activities' in a society. Begging, prostitution, theft, burglary and financial corruption may be included in those activities. The increasing number of peoples involved in those activities in a society is an indicator of the increasing poverty level. Such activities or 'inferior professions' may vary from the society to society. (Mehar: 2009)

This study covers three important aspects of the socio-economic changes in Pakistan in the recent past. First it describes the macroeconomic growth in the different political regimes. Second aspect of the study is to assess the poverty levels in Pakistan. In this part, we have compared the poverty in Pakistan with the selected countries and trends over the period have also been shown. Third aspect of the study is to identify the impact and contribution of monetary policy in poverty and income distribution.

## **III: Macroeconomic Growth, Poverty and Monetary Policy in Pakistan: Is There a Linkage?**

Macroeconomic indicators have been showing the significant improvement in the economy of Pakistan in the recent past regime. The painful situation is that the effects of macroeconomic growth have not been transferred to the lower income segment of the society. The economists are agreed that increasing income and wealth inequalities are usual phenomena at the time of take off stage of economic growth. The increasing inflation because of excess unplanned demand of the commodities is also a temporary phenomenon of high-speed economic growth. However, the absolute poverty can be avoided through economic policies.

It is notable that Keynesian school of thought in economics has been leading the capitalist world during the cold war era in bipolar regime. Various kinds of subsidies, taxation policies, protectionism, trade promotion through political agreements, demand-led business strategies, bilateral trade agreements and trade negotiations were the strategic tools of Keynesian economic policies. Now, in post Soviet regime, the capitalist world is again moving towards the classical economic policies. Business competitiveness,

knowledge creating activities, business sophistication, comparative advantages, compliance and standardization, corporate governance, CSR, professionalism and branding are the banners of free trade regime. Survival of the fittest is the natural outcome of this system. Such supply-side policies in globalization regime have changed the patterns of poverty and income distribution.

### COMPARISON OF ECONOMIC PERFORMANCE BY POLITICAL REGIMES

Macroeconomic Indicators	Bhutto (72-77)	Zia (77-85)	Junejo (85-88)	Benazir (88-90)	Nawaz (90-93)	Benazir (93-96)	Nawaz (96-99)	Musharaf (00-08)
GDP Growth (%)	4.9	6.6	6.2	4.7	5.2	5	3.4	5.8
Inflation (%)	18	8.3	4.8	8.2	10.7	11.7	10.1	10.3
<b>As % of GDP</b>								
Investment	16	18.1	18.6	18.8	19.9	18.8	17.3	21.6
Budget Deficit	7.3	6.8	8.3	7	8.1	5.9	5.8	4.0
External Debt	47.4	33.6	34.9	36.6	35.5	37.6	39.7	26.9
Current A/C Balance	-6.4	-4.1	-3.5	-4.8	-4.7	-5	-4.8	-6.9

### KEY MACROECONOMIC INDICATORS (Growth %)

INDICATORS	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09 (estimated)
-GDP	3.1	4.7	7.5	9.0	5.8	6.8	5.8	6.5
-Agriculture	0.1	4.1	2.4	6.5	6.3	3.7	1.5	4.0
-Manufacturing	4.5	6.9	14.0	15.5	8.7	8.2	5.4	8.5
-Services	4.8	5.2	5.9	8.5	6.5	7.6	8.2	6.7
GDP per capita \$	427	490	657	736	833	925	1085	1132
Fiscal Deficit (% of GDP)	4.3	3.7	2.3	3	3.4	3.7	4.01	4.7
Imports (\$ billion)	10.33	12.22	15.6	20.6	28.58	30.54	39.96	30.0
Exports (\$ billion)	9.13	11.16	12.3	14.4	16.45	16.97	19.22	22.10
Bal. of trade ( billion)	-1.205	-1.06	-3.28	-6.2	-12.13	-13.56	-20.74	-7.9
Inflation rate (%)	3.5	3.1	4.6	9.3	7.9	7.7	12.0	24.8 (Jul-
Unemployment (%)	8.27	8.27	7.7	7.7	7.7	6.2	5.2	4.6
Poverty (%)	36.4	38.2	36	-	24	23.9	23.9	21
FDI (in millions \$)	485	798	949	1524	3,521	5,124	3,600	N.A.
Foreign Debt (\$ billion)	32.7	33	33.7	34.2	35.6	38.86	45.9	41.2
Foreign Debt(% GDP)	45.6	40	35	31	27.7	26.3	26.9	22.3
Revenue receipts ( Rs.	619.1	701.6	761	875.3	1,023	1,214	1,545.5	1,679.238
Tax Revenue (Rs. Billion)	459.2	525.8	580.1	626.3	715.7	710	1005.56	1,251.462
Revenue Expenditure (Rs.	694.5	709.2	773.2	866.8	1072.2	1033.532	1516.261	1493.183
Currency in circulation	433.8	494.6	578.1	665.9	740.4	840.2	1026	N.A.
Credit to private sector	52969	167723	325215	437,848	401,797	365,718	369,850	644,000
Monetary	235,324	317,399	407,852	475,152	446,260	658,250	475,000	580,000
Current Account balance	-1338	-3165	-1314	-1753	-5649	-7361	-11,586	-12,500
KSE 100 Index	1770	3403	5279	7450	9989	13772	12130	N.A.
Gold and Foreign Exchange Reserves (in Mill. US \$)	7,065	11,472	13,155	13,338	14,590	17,924	12,300 (July to April)	N.A.

A higher GDP growth rate, building of foreign exchange reserves, accelerated stock market index and record growth in foreign investment in Pakistan have not been transformed in the living standard of a common man. The simultaneous improvement in macroeconomic indicators and accelerated inflation and poverty indicate obstacles in the transformation mechanism. A little trickle down effect was observed during this 'macroeconomic growth regime'. The macroeconomic growth has not been transformed into poverty reduction in the past regime of financial expansion.

On the basis of socio-economic evidences we can identify two major causes of simultaneous increase in absolute poverty and macroeconomic growth: The absolute poverty is calculated on the basis of household income and prices of essential commodities. The double-digit inflation in consumer prices shifted many households from above to below side of the poverty line. There are sufficient evidences to believe that privatization mechanism, down sizing in the industries because of stiff competition in the free trade regime, and the application of contemporary management styles including use of information technology without giving fair learning opportunities to old employees compelled them to leave the jobs or to work in underpaid environment. This condition ultimately led the reduction in households' incomes. The reduction in households' incomes and increasing inflation are transformed in the increasing poverty, and many households have been shifted at below the poverty line. The consumer oriented expansionary monetary policy artificially increased the purchasing power of the people, which ultimately led the demand-pull inflation in the economy. This demand-pull inflation affected the lower income class badly.

The most significant reason responsible for the incompleteness of trickle down chain was the blockage of money at middle class stage. Incomes of those middle classers increased significantly who have been helping the higher income groups to generate money in a business boom situation. This boom was clearly observable in the stock market; export trade, banking, cement, real estate, construction and services sector. The middle class professionals and services providers have adopted the contemporary tools to update their professional skills, so changes in the economic and technological environment have been favoring them. They have succeeded to get their due share from the higher income classers, but they have failed to transfer this share to the lower income segment of the economy because of two reasons:

They had preferred to secure their economic future by means of additional investment in non productive activities, e.g. purchase of properties, investment in stocks and deposits in non productive money making schemes or spending on services at abroad including education, traveling and tourism.

The consumer oriented unplanned expansionary monetary policy in the last decade provided incentives to the middle classers to spend on those products, which usually produced – partially or wholly – at abroad. The credit cards, e-money, leasing facilities and personal loans provided incentives to spend on consumer durables and luxuries. No doubt, this policy provided a mechanism to improve the quality of life in the country by

means of increase in the use of mobile sets, cars, computers, domestic appliances and luxurious items, however, it had three consequences:

Either it circulated the money among the middle classers or re-transferred it to the rich classers, but not shifted to the poor classers.

The improvement in living standard through medium-term borrowing and revolving credit facilities from banks and financial institutions added the repayment burden on middle classers, and they shifted this burden on their futures. As a consequence they are compelled to pay a big portion of their current and future incomes to the financial institutions in the form of installment, lease rentals or repayments etc. So they do not have anything to shift to the poor segment of the economy.

Moreover, they are compelled to spend more time on income generating activities to redeem their debts and to pay the interest on financial facilities they had availed to improve their living standard. They are not in a position to save or to transfer the money to the poor segments.

It is important to note that funds acquired through borrowing from the financial institutions were not spent on locally produced goods and services; usually they spent on those products and services which have their foreign origins. Current increase in the default rates either will increase the oversupply of forfeited assets - cars, real estates, and durables – or will deteriorate the social structure because of the over burdened households' economies. It may create health hazards because of over burden, tensions, and mental pressure.

In the government publication, the statistics show a rosy picture of poverty reduction in Pakistan. However, public media and living evidences in the streets have been showing entirely a different picture in contradiction of the government statistics. The public media has been highlighting the increasing number of cases of suicides because of poverty, unemployment and other economic reasons. The sale of children by their parents and the sale of human organs (kidneys) have also been being reported by the public media in the recent past. These evidences show a contradictory picture of the economic growth. What are the causes behind this substantial contradiction? Is it a media activism only or real economic situation is different from the picture painted by the state organizations. If it is because of media activation, it indicates that dangerous economic conditions were always in Pakistan, but the ruling groups have been hiding this dark side of the picture. Otherwise, there is a need to revise the reporting and statistical methodology in measuring the socioeconomic indicators.

The consumer oriented monetary policy has also been causing the accelerated trade deficit. Trade statistics show the increasing imports of consumer products including electronics goods, mobile sets, domestic appliances, chocolates and candies, dry milk and its products, cosmetics and other luxuries goods, and off course petroleum products because of increasing numbers of luxurious vehicles on the roads. The soft credit policies for personal loans, credit cards, and leasing facilities have played important role to surge

the demand of those imported products. The monetary policy provided incentives to the consumers to spend their income on the goods and services have their foreign origin. It induced the outflow of money to the abroad. On the other hand, it provided incentives to the banks and financial institutions to shift their portfolio from industry oriented to consumption-oriented loans. The industry has to pay the cost of this policy in terms of higher interest rates on borrowing for industrialization and investment. Another important implication of the present tightening in the monetary policy is the unusual high banking spread, which is contributing in a dampening effect on income inequalities and economic growth by discouraging savings.

### POVERTY COMPARISON

Countries	National Poverty Line (Population below the poverty line %)	International Poverty Line (Population below \$1 a day %)	Income inequality (Gini Index)
Pakistan	32.6	17	31.2
India	28.6	33.5	36.8
Sri Lanka	25	5.6	40.2
Nepal	30.9	24.1	47.2
Bangladesh	49.8	41.3	33.2
Indonesia	27.1	7.5	39.4
United States	..	..	40.8
United Kingdom	..	..	36

### POPULATION UNDER VARIOUS POVERTY BANDS IN PAKISTAN (% population)

Year	2000-01		2004-05		2005-06	
Non-Poor	over Rs.1446.8	13%	over Rs.1757.28	20.50%	over Rs.1888.94	20.90%
Quasi Non-Poor	Rs.904.25– s.1446.8	30.10%	Rs.1098.3 – Rs.1757.28	35%	Rs.1180.59-Rs.1888.94	36.30%
Vulnerable	Rs.723.40–Rs.904.25	22.50%	Rs.878.64 – Rs.1098.30	20.50%	Rs.944.47-Rs.1180.59	20.50%
Poor (Below Poverty Line)	Rs.542.55– s.723.40	22.50%	Rs.658.98 – Rs.878.64	16.40%	Rs.708.35-Rs.944.47	16.40%
Ultra Poor	Rs.361.7 – Rs.542.55	10.80%	Rs.439.32 – Rs.658.98	6.50%	Rs.472.23-Rs.708.35	5.40%
Extremely Poor	less than Rs.361.7	1.10%	less than Rs.439.32	1%	less than Rs.472.23	0.50%

### POVERTY ESTIMATES BY GOVERNMENT OF PAKISTAN

Poverty estimates	Poverty Estimates					
	Headcount		Poverty Gap		Severity of Poverty	
	2000-01	2005-06	2000-01	2005-06	2000-01	2005-06
Urban	22.7	13.1	4.6	2.1	1.4	0.5
Rural	39.3	27.0	8.0	5.0	2.4	1.4
Pakistan	34.5	22.3	7.0	4.0	2.1	1.1



**PATTERN OF IMPORTS**  
(**\$Million**)

Sl. No.	Commodities	2007-2008	2006-2007
	<b>Grand total</b>	<b>39,968</b>	<b>30,540</b>
A.	Food group	4,210	2,742
	Milk,cream & milk food for infants	74	84
B.	Machinery group	7,376	6,686
	Mobile phone	745	834
	Tele com apparatus	1,497	1,373
C.	Transport group	2,251	2,396
	Road motor veh. (build unit,ckd/skd)	1,345	1,414
D.	Petroleum group	11,380	7,335
E.	Textile group	2,349	1,566
F.	Agricultural and other chemicals group	5,829	4,430
G.	Metal group	2,542	2,346

When economic planners identified the causes of non-correlated movement in the direction of macroeconomic growth and poverty, a contractionary monetary policy was adopted to rectify the situation. However, this contraction further affected the industry because of increasing rate of interests and uncompetitive prices of industrial inputs including oil, gas and power.

#### **IV: Recommendations**

The only feasible solution to control over inflation and poverty is the rapid industrialization. To attract the foreign and as well local investment and to block the outflow of domestic capital is a natural requirement for rapid industrialization. These steps require the significant and visible improvement in the economic policies, which can provide a level playing, field in the age of competitiveness. To reduce the poverty in the country the transfer of macroeconomic growth to the poor segment of the society is required. One major strategy to achieve this goal is to provide maximum incentives to the domestic industry in terms of lowering the interest rates for both the types of financing: project financing (including BMR, expansion and new projects) and working capital financing (including export re-financing). The economic planners has to adopt some mechanism to reduce the availability of industrial raw materials and overheads including power, oil and gas at competitive prices. This strategy in one hand increases the employment opportunities and in the other hand will reduce the market prices of essential commodities, which ultimately led the reduction in poverty. Enhancement in employment generating activities by promotion of industrial investment provides a mechanism to transfer the effects of macroeconomic growth to the lower segment of society. Higher

interest rates for industrial lending have been discouraging the investment and industrial enhancement activities in the country. Our suggested strategy to achieve the goal is to provide maximum incentives to the domestic industry in terms of lowering the interest rates for both types of financing: project financing (including BMR, expansion and new projects) and working capital financing (including export re-financing). This strategy in one hand will increase the employment opportunities and in the other hand will reduce the market prices of the essential commodities, which ultimately lead the reduction in poverty.

**PATTERN OF GROWTH IN BANKS CREDIT**  
(% Change upto April)

<b>Types of Credit</b>	<b>2007-</b>
Consumer credit from foreign Banks	-7.8
Business credit from foreign Banks	13.1
<b>Business Sector</b>	
Working Capital	26.6
Fixed Investment	7.7
Export Financing availed by Exporters	14.3
<b>NPLs to Loan (Gross)</b>	
Consumers	4.9
Credit Cards	12.5
Auto Loans	29.8
Personal Loans	39
Housing	17.9

**INFLATIONARY TRENDS**

<b>Period</b>	<b>Overall CPI (Percentage Change)</b>	<b>Inflation Rate by Income Group upto Rs. 3,000 (Percentage Change)</b>	<b>Monetary Assets (M2) Growth Rate %</b>	<b>Un- employment Rate (% per annum)</b>
1995-96	10.8	10.6	13.8	5.4
1996-97	11.8	11.7	12.2	6.1
1997-98	7.8	7.9	14.5	6.1
1998-99	5.7	5.6	6.2	6.1
1999-00	3.6	3.2	9.4	6
2000-01	4.4	4.5	9	6
2001-02	3.5	3	15.4	7.8
2002-03	3.1	2.9	18.00	7.8
2003-04	4.6	5.3	19.58	8.3
2004-05	9.3	10.2	19.12	7.7
2005-06	7.9	7.7	15.07	7.6
2006-07	7.8	8.3	19.32	6.2
2007-08	10.3	11.9	19.9	5.23

For sustainable economic development and its visible effects on the socio-economic conditions of the people, the policy makers and statesmen have to take serious steps with political will power. Economic development is like a love affair; its earlier disclosure show cheapness, which may increase the chances of ultimate failure. Maturity, commitment and sustainability are the requirements for ultimate success in both. They do not need public announcement; they reflect themselves. The people like the reflection of the economic development in their personal lives. The efforts to improve the visible economic and financial markets indicators may derail the objectivity of economic policies. In most of the cases, economic development has to pass through a painful and time consuming process.

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