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FY-02 FY-09 Pakistans Economic
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Keynes Is Back: Global Economic Depression Monetary Policy Operations Fy-08 & Fy-09 Pakistan's Economic Scenario

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*"[The financial crises] are caused by excesses—frequently monetary excesses—which lead to a boom and an inevitable bust".
Taylor (2009)*

The paper presents economic explanation of recessionary shocks and convergence mechanism within the context of Keynesian and Classical Economic Theory. The paper also discusses the global counter-cyclical measures to avert the recent 2008s economic depression which started from US sub prime mortgage and spread all over the European and, then the Emerging market economies especially through trade channels.

In the context of Pakistan's economy, the major focus of the paper is on the inflationary stance which is not confined to the monetary growth, rather it is a related to a number of internal and external factors. The paper while reviewing the monetary policy measures of the State Bank of Pakistan over the period of 2007-08 & 2008-09, emphasizes the fact that monetary policy measures cannot show fruitful results to arrest inflationary pressures without effective management of supply side improvements and strict administrative price controls in the economy. Moreover, inflation up to the single digit can not be declined through the use of higher discount rate in the presence of higher cost of living, low pass through of decline in international oil prices to end consumers, higher wheat support price, and depreciation of rupee against basket of competitors' currencies in the economy.

1. Section I: Keynes Vs Classical Economic Theory

The Classical Economic theory rests upon the belief that economy fluctuates around a natural rate of output/unemployment and, any disequilibrium will be of transitory phenomenon which is to be automatically restored through the operations of free market forces in the economy. This Economic Model also relates economic fluctuations to the mismanagement in money supply which has also been empirically proved in the context of the unforgettable worst economic outcomes

of the twentieth century, the 1929's financial/stock market crash [Friedman and Schwartz (1963)] and 1970's stagflation [Barsky and Kilian (2001)]. The link of 2008s global economic depression to the money supply is also due to the unprecedented credit expansion in the global economy. However, the 2008's global economic depression has also emerged, after three distinct shocks, categorized into 'Financial Shock', 'Oil Price Shock' and 'Productivity Shock' in the global economy [Abbas (2008)]. The financial crunch started from US sub-prime mortgage and turned into an economic depression, which spread all over the

European and then emerging market economies through trade channels. Moreover, the economic recessions which arise from Financial Crises are unusually severe and long as well as the recovery is slow in comparison to the other shocks [World Economic Outlook (2009), IMF].

The formulation of economic packages to recover from 2008s recession is the most important debate around the world. In this behalf, the Leaders' Summit of the G-20 was held in London on 2nd April, 2009 with the basic purpose to combat the current economic depression through better coordinated macroeconomic action plan (especially Expansionary Fiscal Policy) and to reform the financial sector in the global economy. The exercise of expansionary fiscal measures has once again revived the importance of Keynesianism---the Economics of Great Depression. Contrary to classical economic theory, The Keynesian economic framework highlights the importance of outside policy assistance to correct the economic disequilibrium in the form of government intervention through Fiscal Policy operations. The economy can not be left at the mercy of free market forces because it can stay at multiple equilibria even in longer periods and, are ultimately determined by the confidence level of consumer and business community in the economy. The fall in confidence level leads to the fall in wealth and hence aggregate demand in the economy. In this situation, the operations of monetary policy even at zero-interest rates cannot work out to restore the aggregate demand without Keynesian-Style-Fiscal-Stimulus package as being exercised now a days in the whole global economy. The exercise of expansionary Fiscal Policy is regarded to be the potent counter cyclical tool to reinstate economic activities in the times of economic depression.

The second section of the paper presents an overview of the State Bank of Pakistan's monetary policy operations in the last two fiscal year; 2007-08 and 2008-09. We also mention efforts of other Central banks, in particularly, The Fed Reserve, The Reserve bank of India and Bank of Japan regarding interest cut policies to boost economic activities. Section III discusses the Pakistan's economic scenario in the context of food

inflation, exchange rate depreciation, burgeoning trade and current account deficits. This follows the concluding remarks in Section IV.

2. Section II: SBP's Monetary Policy Operations: FY-08 & FY-09

Along with banking recapitalization, governments around the world are now working with the combinations of interest rate cut Monetary Policy and Expansionary Fiscal Policy (i.e. fiscal stimulus) to restore economic activities both in the developing as well as in developed countries. The Federal Reserve responded by cutting down its interest rate to 1.0 per cent in November 2008 which has now gone down to almost 0-0.25 per cent. In particular, the Reserve Bank of India responded by cutting down its main Repurchase rate, key lending rate, to 7.5 per cent, Cash Reserve ratio, reducing by 100 bps to 5.5 per cent in November 2008. Later on, the Reserve Bank of India also cut Repo rate by 3.5 percentage points and Cash Reserve ratio by 4 percentage points. In another historic move, the Bank of Japan also cut the policy rate from 0.5 per cent to 0.3 per cent since after March 2001. In particular, the State Bank of Pakistan (SBP) also temporarily announced some soft monetary measures to overcome the liquidity crunch in the economic system. The bank announced to reduce the Cash Reserve Requirement (CRR) by 200 basis points to 6.0 per cent from 8.0 per cent and abolish the Statutory Liquidity Requirement (SLR) for deposits of one year maturity.

The global economic scenario reveals that the continuous decline in inflation has evaporated the fears of inflationary pressures in the world economy. Contrarily, the Pakistan's inflationary pressures are still quite higher though the reduction in general price level has been realized in view of decline in food inflation (See Figure # 1). The SBP has been continuously adopting tight monetary policy stance to defuse aggregate demand and, hence overcome inflationary pressures since April 2005. In this behalf, SBP recommended the government to follow quarterly and annual ceilings on budget borrowings from SBP and to adopt a balanced domestic debt strategy (i.e.

with greater reliance on long term financing sources) in first half of FY-08. In addition, SBP introduced more stringent measures in the second half and, then in interim Monetary Policy Statement of FY-08 by raising the discount rate to 12 per cent from 10.5 per cent and raising CRR by 100 basis points to 9.0 per cent from 8.0 per cent for deposits of maximum one year maturity. Thereafter, the Bank raised the discount rate to 13.0 per cent in the first half of FY-09 which was further jacked up to 15 per cent in the interim Monetary Policy Statement in November 2008. The Bank maintains its view that the inflationary pressures, widening fiscal and current account deficit calls up for the continuity of the tight monetary stance. Therefore, the Bank also decided to keep the discount rate unchanged at 15 per cent in Monetary Policy Statement for January to March, FY-2009. The other remarkable steps announced in this monetary statement inter alia include the following:

- Prior announcement of the volume based auction calendar for T-bills and PIBs.
- Transferring the decision of cut-off yields of the primary auctions of T-bills and PIBs to Ministry of Finance.
- Plan to introduce limits on the direct government borrowings from the SBP and eliminate this in a phased manner over next several years.
- The Bank also announced to enhance total limits under EFS (from Rs181.3 billion to Rs206.3 billion) and LTFF (from Rs9.5 billion to Rs19.5 billion) to support the industrial sector.

Later on, The State Bank of Pakistan announced to lower the interest rate by 100 bps to 14 per cent in the Monetary Policy Statement, April to June 2009. This decision was taken in view of predicting downward trend in inflation and improving fiscal and current account deficits in the economy. However, it is important to mention that inflation up to the single digit can not be realized in the presence of higher cost of living, higher wheat support price, low pass through of decline in international oil prices to end consumers, depreciation of PKR rupee against basket of competitors' currencies etc. in the economy.

3. Section III: The Pakistan's Economic Scenario

The Pakistan's economy is facing higher inflationary pressures on the internal side and the exorbitant trade and current account deficits on the external front. The more concerned is the food inflation for the common man in the country. Figure #1 shows that food inflation remains higher than the General and Non food inflation from August 2006 and, reached 34.1 per cent in August 2008, the highest record in the history. The inflationary pressures in general while food inflation in particular is sensitive to the crop productivity shocks rather than the impact of monetary policy operations in the short run. The production of various major and minor crops has not been in line with the growing consumer's demand in the commodity market. Generally, prices are determined by the forces of demand and supply conditions in the market. Price distortions will be observed either by the increase in demand or by decrease in supply in the commodity market while average demand for daily use food items does not change drastically in the short run. It is also equally important to build a mechanism through which daily use food items may be available at reasonable prices as sometimes the higher level of crop production does not even guarantee availability of food staples at lower prices in the market.

The burgeoning trade deficit and current account deficit has also significant impact on domestic inflation especially via exchange rate channel. The Data analysis shows that exports have not been in line with the upward trendy level of imports in the economy and, hence trade deficit has increased more than three times in FY-2008 ranging from \$ 4.3 billion in FY-2003 to \$ 20.7 billion in FY-2008. Moreover, the mismanagement in policies has also led to the sizable import bill of the commodities (i.e. wheat, sugarcane, raw cotton etc.) which can be produced at home sufficiently to meet the home consumption demand. In particular, the continuous depreciation of Pak. rupee has also led to the exorbitant trade deficit and current account deficit as well as inflation in the economy. Though, significant depreciation of rupee has bolstered up the level of exports to a limited extent, the ongoing global economic stress will simultaneously have direct negative impacts on exports in the times to come.

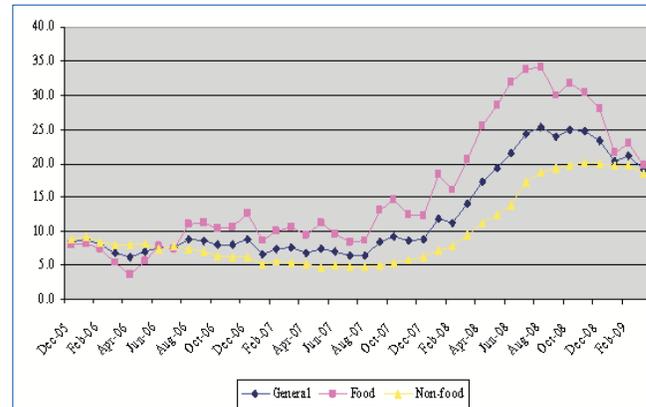
The global economic recession will lead to fall in demand for our exports especially in US and European Union, the major trading partners of Pakistan. Above all, the higher discount rate has multiplied the higher cost of doing business in the presence of already severe energy crisis as well as hikes in electricity and gas prices rather than reducing inflationary pressures in the economy.

4. Section IV: Conclusion

The paper presents economic explanation of recessionary shocks and convergence mechanism in the context of Keynesian and Classical Economic Theory. The exercise of expansionary Fiscal Policy is regarded to be the potent counter cyclical tool to reinitiate economic activities and restore the aggregate demand in the times of economic depression. The Keynesian-Style-Fiscal-Stimulus packages are now being exercised to avert the present 2008s economic depression which started from US sub prime mortgage and spread all over the European and then Emerging market economies especially through trade channels.

The paper presents the Pakistan's economic scenario in the context of food inflation, exchange rate depreciation, burgeoning trade and current account deficits but the major focus is laid on the inflationary stance. An overview of the State Bank of Pakistan's monetary policy operations is presented over FY-2007-08 and FY-2008-09 respectively. It is pointed out that inflationary stance is not confined to the monetary growth rather it is a wide spread phenomenon related to a number of internal and external factors. In this context, monetary policy measures cannot show fruitful results to arrest inflationary pressures without effective management of supply side improvements and strict administrative price controls in the economy. Moreover, inflation up to the single digit can not be dropped through the use of higher discount rate in the presence of higher cost of living, higher wheat support price, low pass through of decline in international oil prices to end consumers, depreciation of PK Rupee against basket of competitors' currencies etc. in the economy. Contrarily, the higher discount rate increases the cost of doing business; hence it hampers investment climate and thus growth in the economy.

Figure # 1
Inflationary Trends in Pakistan's Economy
(December 2005-March 2009)



The inflationary pressures remain higher but the sharp pick up starts in August 2007 in view of internal and external factors in the economy. The food inflation remains higher than the General and Non food inflation from August 2006 and touched the figure 34.1 per cent in August 2008, the highest record in the Pakistan's history.

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