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consequences (A case of Pakistan)**

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**The wrong impact of Fiscal Imbalance on economic growth and Monetary
Policy consequences
A Case Study of Pakistan**

Ovais Ahmed¹, Asim Mashkoo²

Abstract

This study is to investigate the wrong impact of fiscal imbalance on economic growth of country through contiguous monetary policy made by central bank of Pakistan. The purpose of the empirical study is to determine the solution of monetary policy which emulated fiscal deficit that cause to imbalance in money supply and diverges interest rate on bank borrowings. To keeping view of literatures, reveals the monetary policy and fiscal imbalance relationship which creates the view of fiscal challenges in economy. Data has been collected from prior research studies and literatures. In this study correlation and regression analysis are being used to measure the relationship between monetary and fiscal variables. For this analysis, these statistical measurements evaluated the fiscal imbalance and monetary policy. Besides, the ANOVA and Multicollinearity also were used. The research study is limited to economic statistics from 1980 to 2013 that possibly collected from Pakistan bureau of statistics. The conclusive point of this study that fiscal imbalance could be improvised by adopting monetary policy appropriately implemented in economy that could make sustainable growth in country. By this change, inflation indicates integral part of fiscal deficit and monetary stances. For this study, Correlation and regression analysis showed that predictive approaches of fiscal imbalance with inflation and monetary policy which is not adequately adjusted with economic growth.

JEL CLASSIFICATION: E52, E62

Keywords: Fiscal Imbalance, Monetary Policy, Inflation

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Introduction

Third world developing countries have many problems. Fiscal imbalance is one of them. The impact of fiscal imbalance on the monetary policy is not only very regressive but it negates the monetary policies as a whole. Monetary policy keeps the money position of the country stable through inflation and unemployment control. But fiscal imbalance not only damages the supply side of the economy but it creates a deficit in the fiscal side as well. Then the short term deficit financing needed to survive the deficit period. This short term deficit financing generated through monetary side. It enhances the pressure on the demand side of the economy. Inflation is one of the essential parts of economic growth which associated with monetary expansion and fiscal growth. Pakistan is not different from other developing countries where fiscal imbalance is disturbed by monetary imbalance. It is fact; inflation is general level of prices increases on goods and services. It is also associated with excess money supply in economy that resulted inflation or hyperinflation. In early 90s, State Bank of Pakistan (SBP) had faced critical task which was to contain targeted macroeconomic stability. Monetary stance is being developed and indicative of other sector of country. Money growth is associated by inflation and affected on money supply.

The new theory has suggested to prevent from economical barriers and remove fiscal imbalance causes through investing in long-term economic planning in assets of nations. Research have suggested and explained in their research study about assets of nation that providing safe drinking water, grow more trees and spread forest area so that it would mitigate the risk factor of defenceless flood threat and polluted environment. Furthermore, in this study, they put light on land of agriculture yield and mineral which are definite resource of our economic development. (Mashkooor & Ahmed, 2015)

There is a continuous struggle of economic policy implementation, one in the execution and the other aspect is the fiscal and monetary balancing. This is the most important issue with respect of the view that this problem can fail the best of the policies. Need of the fiscal management is the base of all the government economic plans. There are countries who implement their plans so religiously that the perks of the presidents and prime minister not even existed. (Millar, 1997) The performance of modern day governments is completely dependent upon their economic prowess. Their fiscal performance is monitored very closely by all the experts and the common public as well. If budgetary plans are failed and fiscal balance is disturbed it means the

implementation and execution of that government has failed completely. (Spiegel, Mark M., 2008)

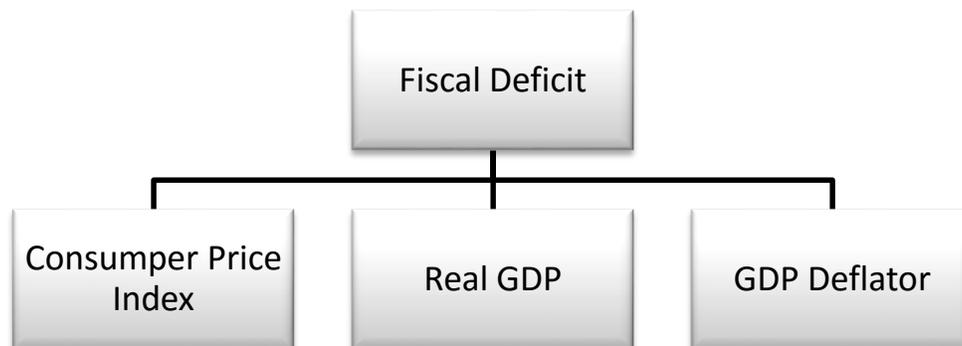
But this is only one aspect of the fiscal problem; the other side of the story is more dangerous and fatal in nature. Most governments try to balance their fiscal deficits and imbalances through monetary policy management plans. Most of these plans are short term and create great problems for monetary managers as well. Some remedies are so short term that it includes the access printing of currency, local market loans from the commercial banks and deficit financing through commercial banks. All these measures are extremely dangerous and it makes the monetary side of the economy extremely fragile. In Pakistan each and every government has its own economic plan. Many successful and few unsuccessful as well, but the problem comes when we scrutinized the performance on the sector wise parameter. Then the conclusive outcomes found that certain policies which are supposed to be very successful in fiscal terms caused so much pressure on monetary side of the economy. (Mester, 2005)

In this paper the research study will determine the impact of fiscal imbalances on the monetary policies of the Pakistan.

Research Question

What are the key factors of inflation and monetary risks that cause to create fiscal imbalance and impact on economic growth?

Theoretically Framework



Literature Review

In this literature section 2, describe the prior theoretical aspects of fiscal imbalance and inflation impact on economic growth. With the help of previous empirical researches on fiscal and monetary policies which are intuitively indulge on economic stagnancy and current condition of crisis.

Theoretically, the definition of inflation, “inflation is driven by money growth” described in (Quantity Theory of Money). It’s means that general level of commodity prices ups and down due to rate of money growth. Therefore, every rupee is replaced by two new rupees, by government. “The price in terms of new rupees would be twice as high”. There is no effect on employment due to changes in money supply executed. It will be associated with proportionate changes in level of prices. According to Friedman Dictum, “inflation is always and everywhere a monetary phenomenon.”

According to Sergent and Wallace (1981) they have argued by their seminal work that “if monetary policy is interpreted as Open Market Operations then monetary policy cannot control inflation even if all the monetarist assumptions are fulfilled.” they illustrated the results that monetarist assumptions are definitely associated with monetary base with price level. These assumptions are strong correlation. In order to power of monetary authority, to raise seignorage inflation could not control by monetary impact.

According to scenario of spending of developed countries, they face severe falling of the budget position which impact on the generation of the revenue too. The other sectors would have affected by worsening of this budget position. Financing health care is Medicare system and the social security program. Due to deterioration of budget planning, developed countries have the long and medium term problems which are caused by budget imbalance and less implementation of monetary policy that how to meet these challenges. (Mester, 2005) Keeping view of better decision making among the budget planning, the most essential concern is to focus of number of retirees who are increasing rapidly. Prior research proved that there are 3.25 workers in developed countries who contribute to the social security program. These contributions for each beneficiary of any nation will be double forecasted by 2030. In the meanwhile, the spending is expected to increase per Medicare beneficiary when the cost of medical care rises. (Sims, November 3, 2008)

The research is suggested that the concepts are incorporated and of provide a way to solve the budgetary plan of government which are faced drastically every year. This concept circulates between behavioural economics and government budget problems. According to Bush plan, the people chose to account plan into life cycle portfolio more than age of 45. People think into better way to know the situation of government problem that what they need. In contrast, People would have default option to make active choices in accord with recent principle of behavioural economics. According to Bush Plan is also criticized that people borrow against social security benefits and invest that money into stocks. (Malpass, November 16, 2006) For saving purpose, the diversified portfolio is better for people where they can put their money at long time. For those people are not believe in saving faced risk when stock market is volatile. To reduce the budget imbalance problem, health care spending must be cut off from federal budget, indeed, slow the per capita spending on health care by government, it also done by private sector to shifting the expenditures.

In prior research papers series, Researchers have documented the financial integration which meant for macroeconomic benefits are devised by International Monetary Fund. (Kose, Prasad, & Terrones, 2003a)They also suggested the income increased to consumption volatility for further financial integrated economies. Keeping the concepts of financial globalization has led to raised risk among market economies. Although this impact is engage with more financial

integrated economy. The rapid increase of financial globalization is leading to the financial integrated economy, relatively higher the risk-sharing of emerging stock markets. To enhance the stability of financial globalization, have to prevent from stagnant condition and mitigate the risk sharing among emerging economies. Although those economies are enormously showing growth evolve financial integration with rest of the world. Consequently, determine facts of financial globalization operations are correlated across countries. In the 1990, the fact of consumption correlation is not meant to evolve across countries. The rapid increase in financial globalization is corresponded in the period of 1990s. (Kose, Prasad, & Terrones, 2003a) In further studies, consumption volatility and financial integration is negatively related with growth and has significant change, this studies is fail to find the statistical results by Cross-country equity return has been incorporated and implied for monetary policy. A saving glut can be substitute to reducing real interest rates in Country which close to internationally and domestically change in rates is subjective by global aspects. In United States, Asian can play a vital of 'Saving Gluts' is likely to be that longer-term rates are a reduced amount of subtle to brief movement. (McCallum, 2002) The monetary policy as it loses effectiveness due to financial globalization? Various studies have given arguments in this regard. Mostly central banks are affected by financial globalization which meant for controlling monetary policy for interest rate and fiscal policy for government expenditure and infrastructures. It also implies that the effect of financial globalization has coveted priority on the long and medium term interest rates. (Plosser, December, 2011)

In this study, the clear concept is that, across countries is equal and same real interest rate. There is no mean of unitary elasticity of substitution of foreign and domestic good. Besides, in this study, there is no impact on domestic aggregate demand due to financial openness for current monetary policy. The impact of changes no need to be large in openness, it raises the possibility of changes. Another study has proved that monetary policy to control inflation and nominal expenditure by environment of equalized interest rates. The initial use of foreign monetary policy is to control inflation and domestic demand by its foreign output levels which leads to conclusively under the financial globalization which meant to standard theory of monetary authority must retain the domestic price level for reduction in inflation. (Epstein & Heintz, 2006) To keep in view that, if central bank has lost its monetary policy effect on interest rates does not mean that central bank lost to act in influence rates and concert over the long-term or

short-term. By inject liquidity in domestic economy indicates central banks initial act in concert. For instance; inject liquidity into financial system which can be significant impact. An improvement in policy actions is taken place by Federal Reserve Bank.

It is common indeed that financial globalization has opportunities for emerging market economies. These economies acquire capital at favourable interest rates. This creates new challenges for new emerging economies. Despite the prudential policies of monetary policy in economy, the possibility of intensified exchange rate volatility is raised by globalization. This exchange is caused to be source of variability. Hence, these economies might be affected by terms of trade shocks from real exchange rate. In this case, if nominal exchange rate variations are not passed by change in domestic prices therefore, term of shocks is being threaten to economy may suffer whole financial system of the country. Due to this, financial globalization also affected. Inflation is another threat in economies that inflationary pressure is leaded by exchange rate depreciations which caused to increase in import prices. (Al-Shiab, 2008) Other literature studies, have explained the different factors of potential disciplining effect. It raised international capital mobility in economy which improvise monetary policy. It also enhances international assets substitutability which eases inflation distresses. A source of government revenue is secured by reduction of effectiveness of using inflation which plays holding equal, this might be reduce pressure on central bank. Its results are lower average levels of inflation. (Kose M. , Prasad, Rogoff, & Wei, 2006) they also argued that monetary policies is not only to control interest rates and money supply in economy it is but also one of primary collateral benefit which related with financial integration in economy through central banks. (Krugman & Obstfeld, 1998; Tytell & Wei, 2004; Kroszner, 2007) It is particular stressed point that, any monetary policy is created if it will face difficulties that caused by financial globalization imbalance. Although these difficulties could measure through analysis of economic and financial conditions deeply. For the monetary policy implementation, assets prices are essential determination dependent on global financial conditions in the stir financial globalization. To control of fund rate which are correlated, are controlled by longer-term treasury bills and Federal Reserve. (Bernanke B. , 2007). Other study determines the fact of financial globalization that the desirability of monetary policy has been implied due to coordination. Financial integration is increased by coordination increase due to welfare gains helps from monetary policy. The ability of central banks heightens potential benefits of coordination. It is acting concert to astound of the

diminished transaction. These transactions are between federal funds rate and long term rates. Taylor gives argument of financial globalization that policy coordination is alternatives order of central banks. This alternative plays active role to control domestic inflation rate. To reduce the global shocks which increased exposure of financial threats may also lead to financial crises. Emerging economies carries on to liabilities denominated in exchange rate depreciation. It can lead to currency difference issues. The relative value of liabilities is raised by as exchange rate movement. This will cause to nation's economy imbalance. (H, Lietz, & Sutherland, 2007; Taylor, 2008)

According to Levchenko (2004) explained that more emerging market economies might be disruptive by financial globalization. The cause is to be lack of development of domestic financial sector. Another study as exemplify the core of financial globalization interruptions that consumption volatility could be increased by opening up to international market until domestic markets are comparatively undeveloped. Besides, due to heterogeneous access to external financial markets, agents are freely embossing their image in undeveloped market which caused to risk sharing is initially increasing within domestic economy. It can deteriorate the whole economy. Domestic agents are raising external risk-sharing opportunities for their own, not for all. This particular matter has no solution yet. (Levchenko A. , 2004). While neither the positive aggregate performance of the recent past nor the explosion of gross holdings of international assets over the same period can be denied, it must be granted that it has proven to be challenging to establish a link between financial globalization and macroeconomic stability. Sadly, it appears that establishing a robust connection between financial openness and monetary policy will be challenging as well.

Methodology

The data has been collected from online research journals and published materials of archive. The selection of variables is devise to understand the relationship. To keep the track of illustrative variables are correlated each other. In the meanwhile, the data indicates confront economic condition of Pakistan. In this study, the variables are focusing on fiscal imbalance due to monetary impact which made by central banks of Pakistan to control the money supply and inflation which prevents from increasing the bank borrowings. Subsequently, the data is

collected from SBP (State Bank of Pakistan) and Federal Bureau of Statistics of Pakistan. To extent the parameters of data analysis, the trend of economic indicators has taken from FY01 to FY12 to conduct the regression and correlation relationship with dependent to independent variables. ANOVA is also used for testing the relationship among variables. This study has selective variables which explained the quantitative measurement of fiscal changes and economic growth of country. The GDP Deflator and CPI (Consumer Price Index) are the indicators of measuring inflation. Consumer Price index has limited coverage. In spite of inflation factor is evident of increasing purchasing power parity. It is mainly use in quantitative research. The CPI data is being collected by Federal Bureau of Statistics of Pakistan. There are further variables which makes this study more valid for measuring fiscal imbalance in lieu of fiscal deficit. The consolidated budget and social indicators have been used in this study to determine the relationship between the inflation and fiscal sector. This study is derived through variables such as Fiscal Deficit is denoted by Pakistan Overall Deficit. Mostly data have been collected by Ministry of Finance and Government of Pakistan which clarify the exact measures of economic indicators. Furthermore, the data of Real GDP is also related with money supply and inflation which directly impact on fiscal imbalance.

1 Data Analysis

In this section 4, the data has been summarized by Statistical Software (SPSS) which made conclusive outcomes to analyse the purpose of the study that what are the influential cause of destabilize the economic condition in country. For the equivalency of units, we have taken logs of all variables to adjust the measurement of statistics.

The data of economic indicators have been retrieved from State Bank of Pakistan (SBP) and Federal Bureau of Statistics Pakistan. In this section, we have scrutinized the situation of current economic condition of Pakistan by statistics.

1.1 Correlation Analysis

		Correlations				
		Fiscal Deficit	Consumer Price Index	GDP Deflator	Real GDP	Exchange Rate
Fiscal Deficit	Pearson Correlation	1				
	Sig. (2-tailed)					
	N	12				
Consumer Price Index	Pearson Correlation	.628*	1			
	Sig. (2-tailed)	.029				
	N	12	12			
GDP Deflator	Pearson Correlation	.540	.870**	1		
	Sig. (2-tailed)	.070	.000			
	N	12	12	12		
Real GDP	Pearson Correlation	-.569	-.217	-.312	1	
	Sig. (2-tailed)	.054	.498	.324		
	N	12	12	12	12	
Exchange Rate	Pearson Correlation	-.682*	-.680*	-.554	.473	1
	Sig. (2-tailed)	.015	.015	.061	.120	
	N	12	12	12	12	12

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

The Above Table described the Pearson Correlation analyses was conducted the strength of relationship or degree of association among variables. In this Table Correlations between dependent variable and independent variables are highly measured. Fiscal deficit is the dependent variable which is determines the strength and direction of relationship with independent variables are strongly related with dependent variable. Recall the value of Correlation “r” of “Fiscal deficit” with CPI (.628*), GDP deflator (.540), Real GDP (-.569) and Exchange Rate (-.682*) at significance level of 0.05.

1.2 Regression Analysis

Model Summary ^b					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.792 ^a	.627	.413	.24894	2.548

a. Predictors: (Constant), Exchange Rate, Real GDP, GDP Deflator, Consumer Price Index

b. Dependent Variable: Fiscal Deficit

In model summary R is denoted with Coefficient of correlation is (.792) it is presenting the strength and degree of association that how dependent variable is well explained by predictors. Besides, the next column showing R-Square that represents the Coefficient of determination of each variable that how each variable well explains about other variables. The R^2 (.627) is indicating 61.1% showing information of dependent variable from predictors variables. Similarly, Adjusted R-Square is another statistical measure to further modify the R-square adjustments in variables.

The Durbin-Watson is indicating the information of independent variables leads to auto correlation. In this table the Durbin-Watson is nearly (2.54) that is preventing from auto correlation of the model. The values must be within 0 to 4 ranges.

ANOVA^a

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	.728	4	.182	2.937	.102 ^b
Residual	.434	7	.062		
Total	1.162	11			

a. Dependent Variable: Fiscal Deficit

b. Predictors: (Constant), Exchange Rate, Real GDP, GDP Deflator, Consumer Price Index

Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
1 (Constant)	-.229	2.812		-.081	.937		
Consumer Price Index	.333	.335	.572	.994	.353	.161	6.207
GDP Deflator	-.111	.274	-.203	-.406	.697	.212	4.715
Real GDP	-.256	.178	-.407	-1.441	.193	.667	1.499
Exchange Rate	-.401	.688	-.213	-.582	.579	.399	2.508

a. Dependent Variable: Fiscal Deficit

Equation:

$$\text{Fiscal Deficit (y)} = \beta_0 + \beta_1\text{CPI} - \beta_2\text{GDPDeflator} - \beta_3\text{RealGDP} - \beta_4\text{ExRate}$$

The regression equation indicates the linear relationship of Fiscal Deficit with perception of Consumer Price Index, GDP Deflator, Real GDP and Exchange Rate respectively. In addition, it is further entail that if CPI increases one unit, the change in Fiscal deficit impact vice-versa. In above illustrative table, the GDP Deflator variable is in negative hence it impacts on Fiscal deficit accordingly. Similarly, Real GDP and Exchange Rate are also in negative change leads to fiscal deficit. Therefore, the intercept of Fiscal Deficit is increases with perception of consumer price index due to step up of inflation rate. It directly reduces the rate of Real GDP and leads to currency depreciation against exchange rates.

Above Table summarize the statistical analysis of Fiscal Deficit as observatory variable with discernment of assorted independents. Likely, The T-test of CPI linearly related with dependent variable that indicates (.994) is not greater than ($T < 2.4$) where ($H_0 = 0$) that resulted the acceptance of null hypothesis, its means that consumer price index (CPI) is genuinely increases and it would have affected on overall fiscal deficit which led government budget to fiscal imbalance with high inflation and dearth of demanding commodities. Furthermore, significance level (.353) of CPI is not much good because of positive variation with fiscal deficit. Similarly, GDP Deflator (-.406), Real GDP (-1.441) and Exchange Rate (-.582) of T-test values are not falling in critical region i.e. ($T < 2.4$) i.e. fail to reject null hypothesis.

In Above Table exhibits the multicollinearity is detected by tolerance and variance of inflation factor (VIF). In the Collinearity Statistic Column suggested the small tolerance indicates in CPI that is (.161) i.e. this predictor is under consideration of perfect linear combination of independent variables that will impact in equation. Conclusively, small tolerance means to interpret the variable 70% to 90% of the variance given by the predictor which is not accurately well explained by other predictors.

Moreover, the diagnostic determined the multicollinearity problem exists in CPI and GDP Deflator variable because the VIF (Variance Inflation Factor) of both variables are exceeds (VIF

= 5) and nearer to (VIF<= 5) and the tolerance of Real GDP and Exchange rate variable are exceeding than 0.2 that means multicollinearity problems occur in both variables with respect to fiscal deficit. Thus, if the VIF is high of any variable leads to instability which reflects high multicollinearity of the *beta* and *b* coefficients.

Model	Dimension	Eigenvalue	Condition Index
1	1	4.812	1.000
	2	.145	5.758
	3	.034	11.821
	4	.008	24.389
	5	.000	123.685

In Above Table, several Eigen values are nearer to zero that means Collinearity diagnostic resulted problematic variations in multicollinearity. The next column of Condition index computed square root of highest Eigen value of each consecutive Eigen Value. As it is seen, in Condition Index column, if values are greater than 15 specifies possible problem in Collinearity, if values greater than 30 will be indicates serious problem. In above table, Dimension 4 and 5 are greater than 15 and 30 respectively.

Conclusion

This research paper established the empirical analysis of fiscal imbalance for unsustainable economic growth of Pakistan. The situations of fiscal dominance stick at monetary policy. To persistent unconditional increases in debts, interest rate, exchange rates and reduction in Real GDP growth rate that created economic stagnation and instability of fiscal governance persist. The above statistical figures described financial and economic situation of Pakistan where government needs to be enhance and revised monetary and fiscal policy. The analysis of consumer price index with respect to fiscal deficit has highly contributable of positive impact on inflation.

The central bank role is to control the money supply and interest rate variation by proper implementation of monetary policy, it reduces as much as fiscal deficit. The growth factor of

unsustainable condition is not able to stabilizing at certainty of adequate positive fiscal change. As a situation exists currently, the fiscal change would be complicated due to monetary issues which pressurize by central bank to finance in fiscal deficits. Particularly, government debt management has primary objective to minimize the financial burdens and economic crisis. The total bank borrowings are unable to meet further debt facility because due to unseen borrowings of government from central bank are highly inflated to uncertain economy, currency depreciation is increasing unconditionally.

Recommendation

In our country where unemployment rate is increasing day by day, for minimizing this rate, government must make appropriate steps against unemployment threat and increasing external debts. To better opportunities of employment, central bank must devise investment opportunities for private sector as well public sector which leads to fiscal balances. It is evaluated the results of social and economic indicators. This study summarizes the findings of inflation factor on economic growth that investigate the long-term relationship with GDP growth rate, exchange rates, and Consumer price index. Tax and non-taxes variables considerably applied on legal tax holder to control over monetary impact accordingly. This research study enormously implements monetary and fiscal policies in Pakistan to sustain economic health and must be considered as creation of investment opportunities for industrial levels to SMEs (Small Medium Enterprises).

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