

Is State Bank of Pakistan doing its job?^{1/}
ISHRAT HUSAIN
Governor, State Bank of Pakistan

To address the above question we have to begin by spelling out the mandate of the State Bank Pakistan. Like all other central banks the SBP is charged with ensuring financial stability, monetary stability, external sector stability and payments and settlement system of the country. The SBP was granted legal autonomy in 1997 and is supervised by a Board of Directors. Currently, the Board consists of seven individuals from the private sector drawn from academia, agriculture, small and medium business, large industrial groups, one retired civil servant and a representative of the Ministry of Finance. While legal autonomy is necessary for independence of the central banks it is earning the respect of the nation by exercising responsibility with accountability which makes the real difference.

The SBP is therefore endeavoring, with the full support and guidance of its Board, to transform itself into a non-political, non-partisan,

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professional institution which enjoys the trust and confidence of all segments of the population. To achieve this goal we have to become more transparent, credible in our words and actions and pursue the rule of law. The SBP through its Quarterly and Annual Reports and research studies, which are circulated widely, presents an objective and critical appraisal of the economy, identifies the key constraints and makes recommendations for action. Through a pro-active disclosure policy the SBP makes available all kinds of data and information to the public through its website and press releases. For example, unlike the neighboring countries which report a single number of foreign exchange reserves including the non-resident foreign currency deposits we have taken pains to separate out the reserves held by the banking system in form of foreign currency deposits from the reserves held by the State Bank of Pakistan. We had no hesitation in reporting our reserves which at one time were hovering around \$ 1 billion. Similarly, all circulars and manuals are posted at the website and can be accessed by any one.

The SBP is involved in consultative processes and engages the exporters, business community, the banks and other financial industry organizations in a continuous dialogue. Formal Credit Advisory Committees have been established at all the 16 major cities where the SBP has branches and the day-to-day problems and complaints of businessmen are resolved at this forum. Every single draft policy circular or prudential regulation to be issued by the SBP is circulated among the members of the Sub-Committees appointed by the Pakistan Banks Association. We are pleased with this consultative process as we had no need to withdraw or modify any of our circulars after they were issued. The level of satisfaction with the services and responses of the SBP staff has increased significantly among the banks and financial institutions.

The SBP has taken major and minor actions against certain banks and financial institutions who have violated the rules or regulations or betrayed the confidence of the depositors. For the first time in the history of Pakistan we cancelled the licence of a scheduled bank and our decision was upheld in the court of law. We changed the ownership and management of another

scheduled bank and transferred it to a sound investment house. The SBP forced the merger of a major development financial institution which had become almost bankrupt with a strong and large commercial bank. The depositors did face some inconvenience for a few days but they got back every single penny. In another major bank we removed the Directors from the Board and debarred them from holding office in any banking institution. In carrying out these responsibilities we had to follow the process as defined in the Banking Companies Ordinance. We had to be satisfied through a proper inquiry about the nature of the offence and then had to issue show cause notices, consider their replies, afford them opportunities for personal hearing and then make a decision based on the merit of each case. Some of our critics rightly feel that we take too much time but let me admit that in every single instance we will follow the rule of law and not resort to arbitrary actions.

To make the SBP an effective institution we are focusing on a major restructuring and capacity building exercise. As you are aware the SBP has been split into three entities – one charged with the functions of the Central

Bank, the second entrusted with the affairs of the 16 branches dealing with public and the third a subsidiary to undertake massive training and retraining of our staff. This restructuring has enabled the senior managers to concentrate on their core functions of central banking in a more cohesive manner while ensuring that the public dealings are made more prompt, efficient and responsive.

At the Central Bank which now consists of almost 1200 persons the emphasis is on development of human resources through competitive and merit based recruitment, promotion, performance management and training at all level. We are also undertaking the largest automation and information technology project in the country to improve our business processes, obtain real-time data and have a management information system which will enable us to take timely decisions. Finally, we are working on Real time payment and settlement system whereby the banking customers will be able to carry out transactions on the same day throughout the country without waiting for checks to be cleared in a week.

I have taken a few minutes of your valuable time to dwell on this aspect of the working of SBP as I believe that the credibility of an institution is established when you show the results of your efforts rather than announce the plans. This is for the first time in last 2½ years that I have shared the results of our reforms in the SBP at a public forum. As a public servant my doors are open to everyone and I welcome questioning, suggestions and ideas for improving the institutions. Let me say that like all human beings we may commit mistakes, we may also not come up to your expectations all the time but let me assure you that we will not lack in sincerity, effort or integrity.

Let me now turn to the performance of the SBP during the last 30 months in the areas of external sector, monetary sector, financial sector and payments system. The last one of them i.e. the reform of payments system has been initiated only very recently and it will take at least 2 years before we can see any discernible results. So I will therefore focus on the other three areas of responsibility.

You will all vividly recall that in the early days of this government the most popular topic of conversation and coverage by media was the imminent danger of default by Pakistan on our external debt. This concern was not without any foundation. Pakistan had tested its nuclear capability a year ago, widespread economic sanctions were in force, international financial institutions had completely withdrawn and freezing of foreign currency deposits had scared the non-resident Pakistanis with a big dip in the workers' remittances. On the top of all this, a military government had taken over the reins of the country – an action which was not popular among the western countries.

The first and foremost order of the day for reviving the economy was therefore to secure the external sector of the country by averting default, obtaining a sustainable level of debt relief and building up a cushion against unanticipated shocks of all kinds. To achieve this objective we had no choice but to approach the International Monetary Fund (IMF) as debt restructuring was not possible without a formal program with the IMF. Instead of reviving the three year ESAF program which was disrupted due to

May 1998 events the IMF insisted that we had to take a number of prior actions to establish our credibility and seriousness. These actions were the measures which were agreed between preceding governments and the IMF in the context of various arrangements during the decade of 1990s and were never fulfilled. Even when we took all these tough measures which I need not repeat here as I have spelled them out in my earlier speeches the IMF decided to keep the country under a watch for one year. They therefore agreed, after all the prior actions were taken, to enter into a 10 month stand-by program. I have said that before and I have no hesitation in confessing that these actions were highly unpopular among the masses as they imposed additional costs at a time when the economy was stagnating, real purchasing power and incomes were declining and unemployment was rampant. But there was hardly any choice at that time if we had to achieve the objective of external sector security and stability. This compliance with the IMF program resulted in Paris Club rescheduling for 1 year which gave us some breathing space and immediate benefit. We also received inflows of fresh funds from international financial institutions. At the same time we resorted

to purchasing foreign currency from the kerb market to bolster up our reserves and make external payments on time. Some of you will be really surprised to know that the biggest quantum jump in our reserves had taken place between July 2000 and June 2001 i.e. well before September 2001. During this one year period the reserves increased by 138% to \$3.2 billion. The pace of increase slowed down in July 01 – May 02 period despite all the external grants, saving in oil imports, huge inflow of workers' remittances. The reserves have increased during the last 11 months by 73% to \$5.56 billion. Thus it should be noted that the windfall gains of September 11 in building up Pakistan's reserves are highly exaggerated and the real turn around had in fact begun to take place a year before that. The major reason for this improvement was rescheduling of debt by Paris Club and purchases by the SBP.

The second misconception is that the Poverty Reduction and Growth Facility (PRGF) program with the IMF and the Structural Adjustment Credit (SAC) from the World Bank have been made possible due to our support to the U.S. against terrorism. This is far from truth. The negotiations with the

IMF and World Bank had already been successfully concluded well before September 11 and the documents had been circulated for the approval of the Board before this date. In fact the PRGF and SAC were earned by Pakistani people who had made a lot of sacrifices in meeting the hard conditionalities of the stand-by program of the year 2000. Pakistan, for the first time, had met all the tranche release conditions on time and thus established its track record and credibility with the international financial institutions. It was on the basis of this track record that we were able to access the three year concessional facilities from the World Bank, IMF and ADB. More important, this approval by the IMF enabled us to reprofile our Paris Club debt on a sustainable basis obviating the need for frequent rescheduling and approaching the IMF. Pakistan is the fourth country after Egypt, Poland and Jordan which has been given this extraordinary treatment. The government which comes to power in October 2002 will have very little to worry about coping with the external debt problem of this country. Paris Club reprofiling was not the only action we have taken to get out of the debt trap but we have also reduced, for the first time in the history of Pakistan, the stock of our

external debt and liabilities from \$38 billion in October 99 to \$36 billion in June 2002. We have repaid our expensive commercial and short term debt to the extent of \$4.5 billion but at the same time contracted new soft term concessional loans to the tune of \$2.5 billion. Those who criticized our debt strategy that we were taking new loans to pay back old loans should calculate for themselves the savings on debt servicing the country has made in the long term through this substitution.

The third misperception in the popular media is about the SBP's purchases from the kerb market and inter bank market. Let me respond first to the kerb market purchases. A large number of overseas Pakistani workers particularly in the Middle East were sending remittances to their families through the hundiwalas. The reasons were quite understandable – there was a premium of Rs 2-3 per dollar and the service of delivery was very quick as compared to the banks. Thus there was a pool of remittances of Pakistani workers available in the kerb market. This was mainly being used by the private sector. The SBP took a policy decision to tap this pool and pay the same premium which was being paid by the private sector and buy the

excess supplies of foreign exchange from this market. However, we entered the market only at the time when there was an excess supply so that the exchange rate was kept stable. In 1999-00 and 2000-01 we made purchases of almost \$4 billion from the kerb market. The rate in this market follows the inter bank rate and when there was a depreciation of rupee in the inter-bank rate there was a similar depreciation in the kerb market too. So what in fact we were doing was that we were getting hold of the workers' remittances channeled through this market.

Some of well trained economists writing newspaper columns have also questioned as to what happened to Rs 240 billion generated by the purchase of this amount. First, you can see for yourself that these purchases were made over two year period and thus the actual amount involved was average of Rs 120 billion annually. It must be realized that the money is created from the inflows which are surrendered to the SBP and any outflow will have an opposite impact on monetary expansion. So it is the net impact of inflows and outflows that adds to the supply of the money in the system. Money supply has two components – Net domestic assets (NDA) and Net

foreign assets (NFA). So when the SBP purchases from the kurb market, the NDA of the scheduled banks increase as a result of the deposit of the equivalent rupees in the bank accounts of kurb market operators. These deposits are then distributed by the money changers to the families of the workers. To the extent that they keep some of these amounts in bank deposits there is some increase in NDA of the scheduled bank. But 66% of the remittances are estimated to be spent on consumption by the families of these workers.

But the SBP had to make payments to its external creditors in form of foreign exchange and therefore the NFA of SBP declined to that extent. It is the net changes in NDA and NFA which relate to the expansion in money supply. SBP's target of money supply expansion has been 9-10% annually and it has closely adhered to this target as is evident from the published monetary statistics. Any money supply above this target is sterilized by the SBP through open market operations. Thus the fear that the impact of these purchases made two years ago in form of hyperinflation is totally misplaced.

As a matter of fact the rate of inflation is even below the target i.e. less than 3%.

The equation in the case of Inter-bank market is much simpler. Since the introduction of free float exchange rate all earnings and inflows of foreign exchange to the country are surrendered to the authorized dealers in the inter bank market. All the demand by the private sector for imports of goods and services, profits and dividends, debt servicing are met by the inter bank market through an offer-bid spread. If there is excess supply of foreign exchange available at the exchange rate prevailing on that day the SBP mops up the supply and adds to its reserves. In case there is excess demand the SBP injects into the market. Care is taken that the underlying exchange rate remains stable. In this transaction, the SBP's purchases simply decrease the NFA of the scheduled banks and increase their NDA due to receipt of rupees for settlement of the deal. With these purchases, while the NFA of SBP increases, the overall NFA of the banking system remains unchanged. This does not change scheduled banks' over all quantum of monetary assets. It is simply a shift of one kind of assets to the other. Again if the NDA is in

excess of the stipulated monetary target the SBP sterilize it through open market operations.

Since July 2001 Pakistan has been able to maintain stability in exchange rate. After a depreciation of 18 percent a year earlier the exchange rate stabilized around Rs 64 to a dollar. Post September 11 events led to an appreciation of rupee to around Rs 60 and this level has remained unchanged since then. Subsequent unanticipated shocks to the economy have, unlike in the past, left the exchange rate unaffected.

Had the country not developed this cushion of reserves there was a strong likelihood that the speculative attacks which had characterized all the previous crisis points would have been repeated in the aftermath of September 11, December 13 and the recent events of May 2002.

The end result of the above measures is that Pakistan has generated a current account surplus for the first time in many decades and has enough reserves to cover 6 months' imports. Its vulnerability to external shocks has reduced to a large extent and the confidence in our ability to meet our

obligations on time and in full has raised our credit rating in international financial markets. But the issues of security, tensions with India, internal law and order situation, political dissension have not allowed these gains to be translated into new investment by domestic or foreign businesses.

In terms of monetary stability, the rate of inflation has slowed down from 5% in 1999-00 to less than 3% currently. The reasons for this slow down are quite obvious. First, prices of staples have remained fairly stable due to surplus of food supply and this component accounts for 50 percent of the index. Second, there has been a decline in international inflation and thus imported inflation has been contained. Third, the rupee has appreciated in terms of foreign currency and thus the prices of imported goods and raw materials have become relatively cheaper. Finally, monetary growth has been kept well below the target or when it has exceeded the target as this year the reserve money growth is curtailed. The end result is that the country is enjoying stable prices. It is true that the prices of petroleum products, gas, and electricity have moved upwards but their share in the

consumption basket of an average Pakistani is so low that the aggregate effect remains muted.

The SBP has eased its monetary policy since October 2001 and reduced its discount rate by 550 basis. Treasury bill rates have come down to 6.5 % while Export refinance rate is back to 8 percent from 13 percent. Average lending rates by the commercial bank have been reduced by 200 basis points from 14 to 12 percent without materially lowering the deposit rates. These rates are still high in real terms because of the drag of non-performing loans in the portfolio of nationalized commercial banks. Until these NCBs are privatized and exposed to competitive pressures there will only be only marginal gains.

Finally, in terms of financial stability the banking sector is being completely reformed. Nationalized commercial banks are being privatized and small private banks are being encouraged to merge into a fewer but stronger banks. Capital adequacy ratios are satisfactory and minimum capital requirements are being raised. Non-performing loans are being

recovered, restructured, transferred to CIRC and large provisions are being made by the banks. The profitability of the banking system has improved this year and supervision of banks has been strengthened. This topic requires a more detailed discussion but suffice to say that as a regulator the SBP is satisfied with the progress which is being made to make our banking system sound and healthy.