Shamshad Akhtar: Pakistan – selected perspective on economic challenges and outlook

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at a roundtable discussion at receiving the "Best Central Bank Governor of the Year 2008 for Asia", arranged by The Banker, Karachi, 30 April 2008.

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Irrespective of changes on political front, economic liberalization and reforms have helped Pakistan emerge as an open and liberal economy. Foreign investment enjoys equal treatment with domestic players and often assigned preferential treatment to ensure swift entry. As a result of these policies Pakistan has managed to attract a number of global players and significant investment offering a stable and fertile return environment. To quote few success stories, though not an exhaustive list by any means, today over half of the banking assets are with global banks but interestingly they operate as local subsidiaries. Telecom operators are now managing virtually bulk of the mobile businesses and growth of mobile subscribers has risen substantially. Pakistan has managed to unbundle its power sector, privatized its electric company operating in the port and industrial city of Karachi. Incentive regime has been made conducive for energy operators and both generation and distribution sectors have been offered to the private sector. Free entry in manufacturing sector now for quite some time has helped multinationals to operate freely. The process of economic liberalization has been facilitated by the smooth privatization of public enterprises that has been a key agenda of all the three to four successive governments. This will continue to unleash the potential of companies under good management with new investments to yield better results.

Economic potential of the country can be judged based on fairly good trends observed in all critical economic variables ranging from real GDP growth that averaged above 7 percent over last few years to the narrowing of macroeconomic imbalances. Most of all given opportunities and high risk premium on all businesses, in recent years, Pakistan did attract substantial foreign inflows – foreign direct investment cumulatively was around $ 11.9 billion and portfolio flows averaged annually $ 1.04 billion.

Today, Pakistan has to be judged in the context of the challenging political and international economic environment it operates in. Despite growing political challenges as the election drew closer, FY07 ended with realization of most critical economic targets. Real GDP growth turned out to be reasonable and slippages in fiscal and external current deficit were manageable. Outstanding was the flow of FDI which reached over $ 5.14 billion, portfolio flows were $ 2.3 and remittances which reached $5.5 billion. These flows combined with Pakistan's decision to float sovereign bond issues and GDRs for some companies helped to build the reserves significantly that reached record highs of $16.4 billion. Building up of reserves was a decision taken in anticipation of the emerging difficult domestic and external environment.

It turns out that this served well in preserving the exceptional shocks Pakistan faced in 2007. The severity of the shocks Pakistan has faced in recent months has been complicated by the multi-dimensional nature of these shocks. Economy has had to deal with series of adverse events on the domestic front for instance, episodes of terrorism, which hit political leaders and businesses, and protracted the political transition process. Consequently, this to some extent resulted in postponement of investment decisions (though these are expected to come on line with the new Government now in place). At the same time there has been pressure on spending, among others stemming from the need to build up security and conduct election.

While grappling with domestic shocks, Pakistan, like other developing countries, is dealing with the impact of unprecedented hike in global commodity prices which have induced fresh vulnerabilities in the balance of payments and fiscal deficit segments of the economy. These complications could magnify vulnerabilities since the after affects of financial market turmoil is still unfolding even though the present slow down in advanced economies is already impacting demand for Asian exports including Pakistani exports.

A few important development challenges Pakistan faces today are:

(i) Restoring macroeconomic stability both by taking some short term measures and launching work to develop a coherent macroeconomic framework for the medium term. Immediately after coming into power, the Government has taken some concrete actions to reduce the bulge in fiscal deficit; admittedly more will have to follow. The actions range from pass through of the price increase of strategic products like wheat and oil products and Government's belt tightening through reduction in recurrent expenditures and postponement of non-priority development expenditures.

(ii) Reducing inflationary pressures, while a challenge, as Government allows more and more pass-through of the global commodity prices, is warranted given that it has been rising continuously and have crossed double digits. In this context, improving availability of products, using utility stores to provide goods at proper prices and ensuring proper availability through appropriate involvement of provincial and district administration are some of the measures being taken. Alongside, the Government has improved the pricing for procurement of wheat to incentivize farmers not to be distracted by other options. Similarly on rice, efforts are underway to ensure adequate availability of domestic supplies without disrupting the private sector initiatives to export. Proper availability of commercial financing for key products and curbs on hoarding through borrowings is being controlled through central bank measures.

(iii) On its part the central bank has benefited from its continued pursuance of monetary tightening which had yielded visible results in May 2007 when core inflation fell much below the FY07 target of 6.5%. However this trend has been now disrupted by an unabated rise in Government borrowings from the central bank which has magnified risks for inflation. Some short term measures are being contemplated to lower these borrowings to ensure that the end year results show less SBP borrowings by Federal Government. The impact of the high borrowings has however permeated and penetrated in inflation and it will take stronger measures to unwind it and results will emerge with lag.

(iv) On its part central bank has continued pursuance of a managed floating exchange rate regime. SBP has been quite transparent in its exchange rate management and has underscored the mechanics on how the exchange rate is determined. Since the central bank does not target a specific level, the exchange rate is market determined reflecting the demand and supply dynamics. To avoid spikes and excessive volatility on a day to day basis, central bank has been supporting upto 100% of oil payments between November 04 to the third quarter of 07 but has since only supported 80% of the oil payments with 20% being handled by private sector. Beyond this, the interventions are minimal. In recent days, the central bank has enhanced its vigilance in markets given the broadening of band between inter-bank and kerb rate and this has been narrowed with improved liquidity in kerb markets and other measures. All market participants have been advised that speculators and others who violate market ethics will be dealt with appropriate actions. Exchange rate of Pakistan has enjoyed a high degree of stability as evident from the foreign inflows and will continue to do so. SBP will take strict measures to combat any excessive build up of speculative tendencies among banks and exchange companies as warranted.

(v) Reserve build up will be a continued priority of this new Government and central bank. The reserve build up achieved during FY07 was a conscious decision to ensure that Pakistan has adequate reserves to provide cushion for any eventuality as it entered into a political transition period. Reserves have served well the purpose of acting as a buffer and cushion when there was some slow down in FDI inflows which are now waiting to enter into the country. The stress on reserves however was more than expected because of two elements:

- International oil prices have risen beyond expectations and are perhaps still volatile and the recent announcement of President of OECD that it may hit $ 200 per barrel is discomforting for oil importing countries. This is clearly a shock the world was not prepared to bear and/or address but international efforts and coordination are required to address this problem and on its part Pakistan will have to move to a new plateau of energy conservation and launch fast track efforts for substituting oil imports with domestic sources of energy – an option available to us with gas, coal and hydro resources available on the doorstep of Pakistan; and
- Food imports which had to be lined up to build our strategic reserves and meet an unusual decrease in domestic supplies as Pakistan consumption levels have risen in the wake of higher incomes and remittances flow. Here again Pakistan is blessed with abundant agricultural potential and efforts to unleash this and raise yields are critical to bring the country back to self sufficiency given the population size.

To wrap up my remarks let me state that in any political transition process one has to further recognize that there is need for the new Government to also comprehend the multiple dimensional challenges it faces. In this case the nature and type of political transition is different from normal election events. Coming in office the new Government has been fast to incrementally recognize issues at hand and now various agencies are gearing up to develop appropriate policy stance to tackle both short and medium term challenges. Central bank on its part continues to support the new Government and is working towards nurturing more effective demand management environment, while encouraging greater fiscal-monetary coordination.