Shamshad Akhtar: Reflections on global and domestic developments

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the formal launching of Samba Bank Ltd. in Pakistan, Karachi, 1 November 2008.

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Year 2008 is and will be remembered as one of the most turbulent years in world's economic history. Impact of the sequence of global events, ranging from global financial market turmoil to surge in global commodity prices, has impacted regions differently and unevenly. United States being the epicenter of the Tsunami of financial market upheaval, has witnessed deeper and steeper reverberations whose tremors have impacted all of Europe. From what started as turmoil in one segment of financial markets i.e. Subprime mortgage market and the CDOs etc., which constituted a very small part of the global financial assets, the ravaging fire has spread across all segments of financial sector, and across continents. Flight to safety also put pressure on commodity prices which appeared to be an alternate avenue to hedge investors from financial market upheavals.

Financial markets' indulgence in over-leveraging and reckless issuance of mortgage securities without due diligence, with resetting of pricing in a rising interest rate environment, overwhelmed both the issuer and the investor. Major money and interbank markets witnessed liquidity crunch as counterparties faced settlement difficulties and defaulted, adversely impacting credit markets. The problem magnified as the global liquidity crisis eventually hurt global financial institutions that one after the other collapsed under the stress. This was marked by falling share prices of financial institutions, rising cost of funding and credit default protection, and depressed asset prices.

From a liquidity crisis, world financial markets faced a host of insolvency of global financial houses as the deleveraging gained momentum. Amidst all this, equity markets fell across continents and lost sizeable market capitalization with severe wealth effects at both industry and household levels. Financial markets and housing problems have significantly impacted global economic outlook that is now expected to slow down to 3% with advanced economies already in recession.

Central bankers and regulators have been now firefighting for over 15 odd months. Aside from the steady easing of monetary policy, liquidity injections of unprecedented levels through offers of rounds of term facilities and specialized arrangements, and taking off illiquid securities off the financial institutions' books etc., to a range of fiscal tax breaks and financial market revival packages that aim to recapitalize banks, liquidate troubled assets and further lubricate financial institutions have been offered. Global struggle to stabilize financial markets continues but has already changed the emerging financial landscape and has intensified exciting debates regarding the financial regulatory and supervisory architecture. The global scene has shaken confidence across economies and markets.

Amidst all this, there are several reviews on how Asia fared and withstood the global financial shocks. Generally, Asia has been impacted but the impact has been steeper in countries with weaker macroeconomic fundamentals and low foreign exchange reserves and those with high exposure to CDOs and related products. As events have unfolded, myths regarding decoupling of Asia have evaporated.

Abstracting from the larger debate of emerging complications for Asia, I propose to now concentrate on Pakistan. But before I dwell upon the domestic market, it is important to offer a qualifier that in the present environment there is a strong risk that analysis gets detracted by the global financial crisis and its diagnosis, and there is a tendency to draw parallelism between those developments and events and what has been happening in smaller developing countries. There is need for extreme caution and prudence in one's analysis to ensure that we offer correct diagnosis of the highly impacted countries. What is happening in

advanced countries is a financial market turmoil which manifested itself into a liquidity crisis that has now turned into an insolvency problem. The options and solutions being adopted are highly controversial, and unless accompanied by appropriate actions, could carry moral hazard and loss of tax payer's money. In the context of Pakistan, the diagnosis is different. So rather than facing a financial crisis, Pakistan is caught in a complex macroeconomic problem as twin deficits rose to unprecedented proportion in fiscal year 2007/2008 which remained unattended for some period.

Being an open and highly import dependent economy, Pakistan has been hit aggressively by the surge in global commodity prices whose impact magnified as the oil and other strategic import prices rose. As a result, the origins of economic ailments lie in the sharp growth in the domestic fiscal deficit and the external current deficit. Among others, a principal factor for growth in macro-economic imbalance is the continuous rise in import oil prices. On domestic account, subsidies on oil rose to Rs175 billion and on external account side oil import bill was equivalent to 6.9% of GDP or almost 80% of external current account deficit, as the price per barrel of oil touched its heights. During FY08, average price per barrel was $94.4 and the pressure intensified in Q1 of FY09 with average price barrel reaching close to $115.5. Another complexity was with local produce being short of requirements as well as distributional problems, both of which required the Government to import food items which were not anticipated at the start of the year. Concurrent with high global commodity prices, both public and private sector imports in value terms were much higher. Imports cumulatively in FY08 reached $40 billion – reflecting a growth of 30.9%.

Burden of fiscal expansion was clearly unsustainable. The level of stress of the macroeconomic burden can be judged by the growing recourse of the budget on central bank financing, visible in decline in foreign exchange reserves and the depreciation in the currency. Imported inflationary trends and persistent growth in inflationary financing, food inflation as well as pass through of oil, utility and exchange rate adjustments all have combined and have resulted in high inflation. Unless addressed, this high inflation will hurt the competitiveness of Pakistan economy and has eroded the purchasing power of the poor most. Proactive monetary tightening over FY08 was needed and but for it there may have been more complications.

The strengths of financial markets came under test during this chaotic period. The equity markets vibrated the most in line with the regional and international markets trends, but the domestic events also played their role. The banking system performed reasonably well despite the growing public and private sector demands for credit, but sentiments, rumor mongering and speculations regarding banks did trigger temporary liquidity constraints. Central bank's timely intervention has continued to lubricate the financial markets. In the first round between 11 October to almost 20 October, 2008, the central bank released close to Rs250 billion and on 1 November we have additionally released close to Rs 30 billion. The stress on liquidity of course stems from the high public sector borrowings (both Government and parastatals) from the banking system, withdrawal of Government deposits, seasonal eid cash withdrawals from the banks, and the low growth in deposits with few weeks of panic deposit withdrawals. Steadily public confidence is being restored and banks are regaining lost deposits.

The banking system has managed to thus far meet the financial requirements of the public sector, while also catering for the stock market as well as the non bank finance sector. However, a deeper analysis of financial stability which is underway has once again brought to the forefront the need for a more balanced growth of the various components of the financial sector. The efficiency of scale that emerges with the availability of long-term and alternative financing options from capital markets, has been conspicuous by its absence. The continued integration and deepening of financial markets is a significant issue for policy makers, and particularly for central banks that are entrusted with the formulation and implementation of monetary policy, since smoothly functioning and efficient financial markets are crucial in ensuring a smooth transmission of monetary impulses.

The financial sector is too bank-centric, and the outreach and growth of the Non - Bank Finance Companies and the Insurance sector have languished in recent years. NBFCs face direct competition from banks and are not likely to grow significantly until their funding sources and costs are streamlined. At the same time, growth in the insurance sector is weak, and private pension funds have only recently started to gather some pace. The insurance sector is unlikely to grow unless it gets an infusion of innovation and efficiency. This may require privatization and possible breakup of the dominant state-owned company. The interest from banks to associate themselves with insurance companies and develop new products for cross-selling may also revitalize the sector. Private pension funds have an enormous potential as indicated by the growth of such funds in other emerging markets, where they have become important and in some cases, principal institutional investors and the main providers of long-term funds.

To build on the pace and momentum of financial sector reforms, SBP launched the next 10 years' financial sector vision and strategy in July 2008. This strategy has been developed based on a comprehensive assessment and evaluation of the banking and the broader financial system that has helped identify the key issues and limitations. In order for the financial sector to develop and reach its potential, broad - based growth will be required, not only of the banking sector but also of other financial institutions and markets. Despite spectacular value growth in recent years – much of which has disappeared in 2008 – the relative size of the equity market is still well below peer countries and must grow in the future, based on new company listings and issues. The biggest growth potential lies in the private debt securities market, the development of which would be essential for private investment, especially in transportation and energy infrastructure as well as in housing.

The objective of the financial sector strategy will be to broaden and deepen the financial system to help Pakistan: (i) Achieve higher and sustainable economic growth, (ii) Develop a dynamic, robust and stronger system, (iii) Mobilize the domestic and foreign resources for private investment (which has to be the key driver of the economy), and (iv) Deepen financial penetration for poor and underserved regions.

The major areas of reforms advocated in the financial sector strategy are:

(i) **Central Bank Governance**: No reform can be complete without also further strengthening of the central bank. In this context, SBP has launched work to modernize the central bank legislation in line with the international best practices. Ours is one of the oldest laws in the world and as such it includes some outdated provisions, even though the law has served the central bank well in delivering several of its function. The new SBP Act ought to provide more autonomy of SBP, along with proper accountability, to pursue clearly defined goals of monetary and financial stability and would make explicit how the SBP has to report on its performance to the Cabinet and Parliament.

(ii) Adoption of a holistic **financial inclusion program** which is quite far reaching both in its depth and breadth. Recognizing how underserved people and the regions of Pakistan are by financial markets, SBP has advocated commercialization of the microfinance industry which will help provide financially and socially sustainable financial services. Under this program, effort will be made to enhance outreach to initially 3 million people relative to fewer than one million a year back. Ultimate goal being to raise it to 10 million. In the same view SBP is steering the Islamic finance industry to also deepen financial penetration to serve the requirement of that segment of population and industry which has self excluded itself for faith reasons. SBP is planning to launch several initiatives to enhance SME financing and such initiatives include, among others, development of credit scoring, credit enhancement mechanism and innovative product and modalities etc. Plan is to also meet 75-80% of agriculture requirements and SBP is steering several initiatives ranging from crop

loan insurance to offering guidelines for financing livestock, fisheries and horticulture etc.

(iii) **Strengthen consumer protection and financial education**. Under this rubric, SBP plans to introduce a Consumer Protection Bill, requires PBA to adopt a Banking Code to commit banks to fairness, disclosure and ethical standards, while nurturing competitive pricing of products, strengthen the Consumer Protection Department which was recently established in SBP, transforming banking sector ombudsman, introduce the small depositor protection scheme and launch campaign of financial literacy.

(iv) **Consolidate and strengthen the banking sector** by promoting continued mergers and acquisitions, while seeking to restructure the outstanding public financial institutions. To promote consolidation, SBP will maintain its moratorium on new licenses but will on exceptional basis issue license with capital requirements of $300 million – both existing conventional and Islamic banks will need to comply with these requirements over an agreed timetable. Licenses for Microfinance banks will continue but confined at national and provincial levels only.

(v) **Strengthening competition and efficiency**. Among others, SBP will be seeking for removal of structural distortions facing the banking sector that has resulted in suboptimal pricing regime for the depositor and borrowers. A major competitive force for banks would however involve a financial sector wide campaign to stimulate the equity and debt markets so that banks compete effectively with their competitor institutions.

(vi) **Strengthen prudential regulation and supervision** – while reputable experts have confirmed the adequacy of the regulatory regime, there is in my view need for debate and reflection of an adequate balance to be struck between rules versus principle based regulatory regime – but ultimately it's the right enforcement which will ensure this regime is respected. In line with the global trend, SBP has launched Basel II implementation which requires banks to align their capital with the risks taken. Requirement of capital would be lower only if banks work with corporate sector to seek appropriate external rating or credit scoring mechanisms. On its part the central bank is launching a project to use e-CIB to develop an industry wide scoring system based on credit history as captured by e-CIB.

(vii) Commercial banks now have de facto moved into **conglomerate structure** with or without holding companies framework. By and large banks have acquired stakes in NBF institutions including insurance, brokerage, financial advisory services etc. Financial conglomerate present a major regulatory and supervisory challenge as such structures are prone to contagion risk.

(viii) To address these concerns, there is need to reconsider the **regulatory architecture**. Our current regulatory architecture is not well suited for consolidated supervision and no agency has powers to oversee financial/nonfinancial conglomerate. SBP proposes to transfer all deposit and lending institutions for oversight to SBP and to entrust it with the responsibility of lead supervisor for consolidated supervision. This has been a major omission in financial sector laws and regulations.

(ix) Develop **financial safety net** frameworks which range from the introduction of small depositor protection scheme, empowering the central bank with the lender of last resort functions and developing an appropriate bank exit frameworks. It is critical that all these schemes are developed in line with international best practices while avoiding the moral hazard consequences.

(x) Development of **core financial infrastructure** is critical which ranges from development of RTGS and retail payment system to credit rating agencies and land and property registries and judicial system.