Yaseen Anwar: Brief strategy for the revitalization of the Pakistani economy

Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the Pakistan Navy War College, Lahore, 5 March 2013.

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Respected guests, esteemed servicemen, and students at this fine establishment, Assalam-o-Alaikum!

I'm glad that you could join us today and thank you for inviting me to introduce you, very briefly, to a strategy for the revitalization of the Pakistani economy.

Our roles at the State Bank, and your roles in the armed forces, are not very different from each other. We are both tasked with guarding national interests and we both seek to actively mitigate threats – both from within our boundaries, and from the outside world. Today, I hope to be able to share with you, how we, at the central bank, guard and guide this economy towards a path of sustainable growth and stable prices.

But before I go down that path, I would like to put some things in perspective here. For instance, I'd like to point out that we are *not* in the middle of an economic meltdown. In fact, we are not even close to being in an economic meltdown. That is why the topic of this lecture "A strategy to improve economic meltdown" may just have been a tad misleading. So yes, we certainly face challenges, but I assure you that they can hardly be categorized as a meltdown.

Since we're on the subject of economic catastrophes, I think it would be enlightening if we talk about a few countries that have seen their economies collapse in the past few years. Let's start with Greece. Their latest unemployment rate is roughly 27 percent. That means that more than one in four people remain jobless. Let me reemphasize that: *one out of every four* individuals does *not* have a job! Can such a high unemployment rate be socially acceptable or sustainable? Of course not. That's why the country was beset with riots, massive protests, political bickering and a very uncertain and bleak outlook.

Youth unemployment in Greece is more than 50 percent. That means that more than half of the youth – the most productive part of any labor force – remains jobless. Can you imagine how demoralizing that is for new entrants into the workforce? If you throw this into the mix, you will have some very strong incentives for social unrest, with sharp rises in crime, hooliganism, and general despondency. It's no surprise then that the suicide rate in the country has doubled in the past five years. 2013 will mark the sixth year of the Greek Depression. For six consecutive years, the economy has *shrunk*. The light at the end of the tunnel is a very, very long way off for Greece. That – ladies and gentlemen – is an economic meltdown.

In fact, southern Europe has been teetering on the edge of an economic disaster for a while now. Their governments borrowed incredible sums of money when times were good in the first few years of the 21st century, and are now struggling to repay their debts. In some instances, their debts reached 200 percent of their GDP – twice the size of their entire economy's output. It was fiscal irresponsibility at its worst. Pakistan's national debt is 60 percent of its GDP – and that is an uncomfortable level for us. 200 percent, on the other hand, is a completely different ballgame. Now they have to balance their books once more and live within their means. And they're discovering just how painful the process of deleveraging, or paying off their debts, can be. Their economies are facing serious difficulties, unemployment is very high, and the prospect of default looms large. Since their economies are so interconnected with the rest of Europe and indeed, with the rest of the world, they are threatening to plunge the entire world into a recession if their economic conditions deteriorate further. And if that happens, ladies and gentlemen, I will be inclined to believe that we are living in the middle of a global economic meltdown.

At this point, let me walk you through a meltdown that happened quite recently in the largest economy in the world: the financial meltdown of 2008–2009 in the US. It started off with irresponsible lending by the banks, which was backed implicitly by the government, to individuals who wanted to buy property – and not just one. Investment banks then bought these loans from the banks that had originated them, and proceeded to create complex financial products anchored to these loans, which were then peddled to other investors. Some of those investors were pension funds, and state governments – funds that basically came from hardworking families' taxes and savings. Such funds are only allowed to invest in riskless assets, ones which are considered as safe as possible.

But most investors did not truly understand the nature of these products, and instead turned to rating agencies for assurance. Rating agencies, such as S&P and Moody's, evaluate financial assets and rate them in terms of their riskiness. For reasons that should not be mentioned, these agencies decided that the toxic assets were of the highest quality, and least riskiness – equal to sovereign debt. All this while, the regulators had, more or less, gone to sleep.

Eventually, they woke up to a very rude shock. Since the financial system was so interconnected, one ripple is all it needed to create a tidal wave in such an unstable scenario. Banks' irresponsible lending meant that eventually, individuals defaulted on their mortgages. Once this cycle of defaults started, it spilled over from mortgage companies to investment banks. Of the five large investment banks in the US, one defaulted, two got sold, and two others had to be rescued by the government.

The fear and panic that gripped the financial markets meant that banks were reluctant to lend to each other – markets froze completely. The regulators had to no choice but to step in, but a lot of the damage had already been done. The economy went into recession, and the next four years brought a flickering flame of economic growth – vulnerable to the next gust of wind that threatens to blow it out altogether.

[Governor's comments on the future of the US and the Euro, and their efforts to rekindle their economies after the financial meltdown…]

Let me get back now to the Pakistani economy. The word that's been used to describe our economy quite a few times has been "resilient". I think it's worth talking about how that word describes this economy. In 65 years, Pakistan has *never* gone through an episode of hyperinflation; Pakistan has *never* defaulted on its international and domestic debts; in fact, our economy has grown consistently, but not spectacularly, over the past six decades. Not many countries in the developing world can claim to have achieved all of that. This has been despite periods of international alienation and sanctions, three expensive wars, two hostile fronts, regular political upheaval, social unrest, sharp increases in the price of oil, and much, much more.

However, it would be dishonest to say that the economy's resilience is completely by design. Yes, regulation and strict oversight has had a part to play in it. And I'd like to briefly touch upon that here. The State Bank has always ensured that the financial system of the country remains safe and stable. We may not have always gotten things completely correct, but we have made sure that banks remain healthy and depositors' money remains safe. We have managed to do this despite privatizing the banking system almost entirely. This means that capital is now allocated more efficiently, and private sector businesses can borrow freely for their requirements. I must add though that we are a little disappointed with the current risk aversion of the banks.

The reforms process was initiated in the early 90s and focused on more private sector participation as financial intermediaries; developing a more robust regulatory framework; restructuring banks; and developing non-bank financial institutions (also known has NBFIs), as well as equity and bond markets, as alternatives to the banking system for both savers and borrowers. The financial sector was essentially given a completely new look during the course of that decade. The purpose of all these changes was to enhance competition and efficiency in the financial sector. That would mean that capital gets allocated into productive investment, which can drive future growth. Simultaneously, as banks became more efficient, savers could receive a better return on their deposits and borrowers could finance themselves at lower rates.

The robustness of our financial system, is a direct consequence of the reforms process and the State Bank's constant vigilance. There's a lot that can be improved in our financial system – for instance, I would love to see the development of efficient debt markets, even better regulatory and reporting practices, and the broadening of the financial sector's scope to include largely unbanked, such as agriculture, small and medium enterprises, and housing. Despite this wish-list, the fact remains that our financial system is, by design, secure and does not pose any threat to the economy as a whole.

Now let's turn to the features of this economy that have, helped the country become and remain resilient in the face of adversity. I believe that our social system in Pakistan influences why the economy remains resilient. Our family structure is a huge blessing in economic terms. Children take care of their parents, and that spares the state from the responsibility of taking care of the elderly and sick. Governments in developed economies are currently struggling to meet their social commitments, with healthcare costs surging for an aging population. Our social fabric also ensures that informal employment is always readily available in some shape or the other – relatives and family friends usually help out in providing the unemployed with some form of work, and the immediate family supports unemployed individuals financially. That spares the state from paying out unemployment benefits to such individuals. I believe that the nature of our society and the close relationships of a family-oriented society, is one of the primary reasons for Pakistan's relatively low rate of unemployment and overall resilience to adverse conditions.

I would like to clarify here that this resilience has come with a cost: the size of the informal sector. The size of Pakistan's undocumented economy is, by some estimates, as large as the formal economy. The informal economy does not file taxes and, while it does absorb a significant chunk of the labor force, it also evades corporate and labor laws. Therefore, although close informal relationships do make the economy more resilient, they do so at a cost to the overall economy, by eroding the ambit of the regulators. Ideally, we, at the State Bank, would like to see a smaller informal economy, while society retains the structure that has made it so resilient.

The second factor that has unintentionally helped the country's resilience is the limited interconnectedness between the Pakistani and the global financial and economic system. Although the absence of such integration is by no means desirable, it has happened due to non-economic factors, and has insulated our domestic economy. It's also the reason that our financial system and financial markets remain relatively sheltered from global events.

Let me re-emphasize here, that greater integration with global markets is something that we should aspire towards. But that does not mean we should not have proper controls and mechanisms in place to safeguard our own interests. For instance, greater integration with financial markets will mean that capital will flow more quickly through our borders. It's definitely something that will boost the national economy, but, as most East Asian countries learned in the 90s, it can be a double-edged sword. Therefore, having some capital controls in place, which reduce the volatility of capital flows, is a necessary regulation in this day and age.

Personally, I believe the role of effective regulation only increases as the economy becomes more integrated and more market-oriented. Markets in themselves have no moral character. Inherently, they are neither good, nor evil. But they remain very powerful tools that distribute goods and services across the economy. Regulation is necessary because it gives markets a direction, and can govern them with a set of values, which markets do not possess innately.

Less, but more effective regulation is the need of the hour for our own economy too. It's an essential part of what is needed today to get the economy on a track for steady and sustainable growth. The government's footprint in some sectors of the economy is very large, and quite negligible in other sectors. Such divergence is unhealthy. For instance, the government has a very large presence in our agriculture and energy markets. Those sectors are, in some ways, over-regulated. Too much regulation and red tape can breed incentives for the abuse of power, mismanagement and corruption. It also acts as a disincentive for the private sector. And we must remember here that it is always the private sector that functions as the engine of the economy.

However, effective regulation is sorely lacking in other sectors. The tax machinery can be tightened considerably. One of the country's most challenging problems today is the size of the fiscal deficit – and a large part of the solution lies in increasing our tax base by enacting regulation that encourages tax compliance, and punishes tax evasion.

The link between better tax collection and faster economic growth deserves to be flushed out here. Better tax collection means that the government has to depend less on foreign support for its budgetary needs, and can decrease its fiscal deficit. More importantly, the government will not have to borrow as much from the domestic banking system to finance itself. Less borrowing from commercial banks will encourage market rates to fall and banks will lend more to the private sector. As investment picks up, the growth potential of the economy increases. Similarly, the government will need to borrow less money from the central bank as well. Borrowing from the central bank is popularly known as printing money. This is inflationary, and I don't think I need to introduce you to the problems associated with high levels of inflation. If government borrowing from the central bank falls, inflation will follow suit. Therefore, better tax collection is a necessary condition for faster economic growth. And for that we need to have more effective tax regulation.

Another problem that we desperately need to fix is our energy problem. It's something that has been affecting every citizen of the state, and I don't think that I need to highlight the scope of the problem here. Similarly, I think the effect on the economy of an energy shortage should be fairly straightforward: energy is one of the key inputs in any value-added production process. Less energy availability will translate into lower output. The solutions to the energy problem will take time – unfortunately, there is no magic pill here. We will need to invest in infrastructure for hydro-electricity, natural gas transportation and transmission, and more efficient power plants. Moreover, we will need to move to greater private sector participation in the energy sector. That means there will, once again, be a need for less, but more effective regulation – one that safeguards the rights of both producers and consumers, while ensuring adequate incentives for the exploitation of our natural resources

The most important incentive here will be prices. Unfortunately, a large part of our energy problems today can be traced to a mispricing of fuels. Under-pricing any commodity will always lead to a shortage – that's one of the fundamental axioms of economics. Letting the market decide the price is one way of ensuring that future shortages are averted. But remember that markets do not have morals – and that's why we will need regulation to make sure that those markets serve and protect the interests of all stakeholders.

At this point, I would also like to touch very briefly upon the State Bank's efforts to accelerate economic growth. As you may know, any central bank's primary policy tool is the discount rate – the basic interest rate which acts as an anchor for all other rates in the economy. Unlike most central banks, and similar to the US Federal Reserve, the State Bank has a dual mandate: it must tackle the issue of maintaining price stability, i.e. inflation, while also keeping an eye on economic growth. The preamble to the SBP Act of 1956 defines that the institution has "to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources". So at the State Bank, we need to pay close attention to both monetary stability and fuller utilization of the country's resources.

That is a tough balance to strike in the best of times. The Bank's policy is to use any room available to cut interest rates in order to promote economic growth. After being in double-digits almost consistently for two years, inflation has come down substantially in the past few months to single digit, because of this, the Bank decided to reduce its interest rate into single-digits. The benchmark rate now stands at 9.5 percent. We also expect that average inflation for the year will remain in the 8.50–9.50 percent range. Interest rates are reviewed, and may be revised, every two months, which allows our policy responses to be nimble and respond quickly to any changes in the economic environment. The Bank also ensures that the money market is never short of funds, which means that monetary policy signals are transmitted efficiently.

Our primary constraints to faster growth, however, remain the large size of the fiscal deficit and the energy shortfall. As with most economic problems, there is no immediate solution. Both problems require systemic changes that will take time to achieve, through the implementation of effective regulation and a move towards greater private sector participation. Meanwhile, rest assured that while our current economic situation is less than optimal, it is also very far from what may be described as an economic calamity. In fact, over the years, this economy has shown an inherent resilience, and I've shared my thoughts about why I think our economy has the ability to navigate through choppy waters. Nevertheless, this economy remains quite far below its potential – however, the solutions to our problems regarding faster growth are an open secret. It's only a question of implementing them.

I'd like to end my talk here on that relatively optimistic note. Unlike the problems of the US and the Euro, our problems have very attainable solutions. Those economies are still trying to work out what would work best for them. We already know what we need to do. It's only a matter of execution now. I'm excited by the economic potential that this country holds, and I encourage you all to become a part of the country's future, by becoming a part of the solution.

Thank you!