Shamshad Akhtar: Economic transformation of Pakistan

Address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the US Chamber of Commerce, Washington DC, 20 April 2006.

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Abstracting from year to year changes, structural changes in Pakistan's economy have been significant and across the board. What is impressive is that these structural changes have been achieved despite the complications generated by shocks such as rising international oil prices. Pakistan is heavily import dependent and higher prices of oil alone accounted for 28% of the increase of import bill for and 47% of the increase in the current account deficit during July-Feb FY06.

The structural reforms are already showing visible results and have set in motion an economic transformation in different segments. In my talk today I propose to:

- First highlight some of the key structural changes, which I believe would be key drivers of change and hold promise for future economic prospects.
- Second, I would like to share some perspectives on monetary policy and financial sector reforms, which have played their role in rejuvenating the economy.
- Finally, I would be highlighting some emerging issues and challenges that the Pakistani economy faces which we propose to tackle to ensure the sustainability of economic growth and reforms.

I. Structural changes: production, trade and markets

First, in the agriculture sector it is encouraging that producers have responded positively to the increased access to market credit, and reforms encouraging private sector participation have led to pricing advantages in major crops, and contributed to growth in the non-farm sector (e.g. livestock and dairy). As a result, the growth of both farm and non-farm activities has gathered pace.

Second, growing demand, led by improving credit access and export supportive polices, has enabled industry to achieve full or higher level of capacity utilization in a number of critical sectors – e.g. textiles, cement, steel, automobile, paper and paper board, etc. New capacity will soon be on-stream in a number of areas.

Third, the services sector is emerging as a vibrant industry, which is not only contributing directly to real GDP growth, but is also supporting the productive sectors' performance.

Fourth, Pakistan's trade openness, as measured by the trade/GDP ratio – an indicator of global integration – has risen from 25.8% in FY00 to 31.7% in FY05. More significantly, Pakistan, while maintaining its edge in textiles has managed to diversify its export structure with the non-textile share in exports having grown from 35% in FY00 to 41% by FY05 reflecting a shift from agriculture and primary commodity exports to labor intensive, higher value added manufacturing exports. Within the textile sector, share of the medium to high value-added products (knitwear, bedwear, ready made garments, towels and synthetic textiles etc.) has improved. Pakistan has stood to benefit from the post MFA regime.

Sale of a number of strategic industries, with management control, will over the next few years help improve efficiency of critical public services. In the short term, resources mobilized through the sale of these assets have helped augment foreign reserves, while reducing government debt obligations - both have positive consequences.

Stock market of Pakistan has outperformed expectations in terms of growth in the KSE index and equity prices are at an all time high. Besides speculative trading, this significantly manifests growing corporate and banking sector profitability and restoration of investor confidence.

Non-debt flows, close to $7.6 billion, have now emerged to be a sizeable source of funding; these include remittances of $4.2 billion, privatization proceeds of $1.6 billion, and foreign portfolio investments of $1.8 billion.

Debt dynamics are favorable and foreign exchange reserves adequate. Exchange rate has been stable but allowed to free float to correct for appreciation as and when it emerges because of movements in relative prices and currency movements of Pakistan's trading partners.

II. Development of monetary policy formulation and its implementation

Economic performance has benefited from a highly supportive and accommodative monetary policy. Aside from continued financing of the budget, the low interest rate environment over the last four years helped facilitate a sharp growth in private sector credit from Rs. 18.3 billion in FY00 to Rs. 438 billion by end FY05, providing higher level of financing to the manufacturing and agriculture sector, while catering for consumer and personal loans, and trade and commerce financing. Consequently, broad money growth exceeded nominal GDP growth and fuelled aggregate demand pressures that translated and manifested itself in a sharp rise in inflation, which reached 11.1% by April 2005.

Anticipating continued and further build up of these pressures, the central bank raised the discount rate in April 2005. Continued monetary tightening over the past 12 months coupled with the decline in net foreign assets (triggered by a rise in trade deficit) would result in the containment of monetary expansion relative to FY05.

Notwithstanding the 1.5% rise in discount rate in April 2005, domestic demand pressures remained high as both private sector credit and government borrowings remained strong.

SBP's continued monetary tightening and government's supply side interventions to curb shortages of key products has together helped weaken inflationary pressures (built up since late 2004) with headline CPI declining from 9.3% on YOY end June 2005 to 6.9% in March 2006, and core CPI coming down from the range of 7.0-8.0% during Jun FY04-Oct-05 to 6.7% by end March 2006. It is expected that the CPI inflation rate would be in the range of 7.7-8.3 percent in FY06. Underlying these trends is the expectation that (i) monetary policy will remain tight, (ii) domestic fuel prices will not rise further in the remaining months of the fiscal year, and (iii) supply of essential products would be managed effectively.

Monetary policy, its conduct and transmission mechanism has also benefited from the structural transformation of the economy and the banking system, which forms a significant component of the financial system. What is appropriate to acknowledge is that the central bank's independence in monetary management has been respected despite the resistance to interest rate hikes. And that the dividends of interest rate adjustments are visible since inflationary trends have shown a persistent downtrend since the beginning of January 2006. Most encouraging is the fact that interest rate adjustment and its transmission mechanism has started to work. SBP has increased its interventions to ensure that the short term inter-bank market rates remain close to the discount rate. The higher inter-bank market rate, tight liquidity conditions and demand for credit have increased the weighted average lending rate by close to 200 bps over July-February FY06. While private sector credit remained robust, it rose by 18% relative to over 25% in the preceding year. Overall impact of this would be more visible but for high recourse of the government to SBP financing. Fiscal dependence on SBP generates inflationary pressures and deters growth of the long-term government securities market priced in line with the prevailing yield curve.

III. Transformation of the banking system

Process of modernization of the banking system is well underway as there is no scope for complacency in Pakistan after the tremors and economic losses caused by the Asian financial crises in 1997/98. It has to be recognized that Pakistan's banking system has witnessed a sea change:

(i) In terms of size, structure and ownership, the banking assets doubled over CY00-05 reaching Rs 3,649 billion (over $62 billon) by end-CY05. Around two thirds of the banking system is with local private banks and 9% with foreign banks, while the share of public banks has been scaled down to approximately 20% by end CY05, relative to 50% at end CY00. Interestingly, while foreign banks have a low deposit base, foreign shareholding of banks is quite significant, spread across 8 banks that account for 42% of the deposit base. Large foreign presence would facilitate adoption of international norms and practices and expose Pakistan's banking industry to e-banking etc.

(ii) Banks declared unprecedented profits in CY05 close to Rs 95 billion before tax and Rs 64 billion after tax, relative to losses of Rs 4.5 billion (after taxes) in CY00. Aside from the gains of a relatively high interest environment, banks benefited from an increase in the volume of business (especially increase in lending activities which are well supported by fee-earning activities), improvements in operational efficiency and better risk management (that helped contain administrative costs and loan infection).

(iii) Banks have managed to contain their credit risk at prudent levels, with the Net NPLs to Net Loans ratio at 2.4%, and gross NPLs to advances ratio at 9.0% for the overall banking sector. Among the various categories of banks, foreign banks have the lowest levels of NPLs and domestic private banks are second in ranking.

(iv) Concentration in size and ownership structure is prominent. 5 Large banks account for over half of the deposits and assets and remaining is held with smaller banks. The consolidation of the banking system generates efficiency and economies of scale as long as high system risks are well managed.

(v) Cross shareholding among banks and other financial institutions and the ownership of banks by big business houses and other segments of financial industry pose regulatory challenges for banking supervision where individual and group risk exposures in family owned banks need closer monitoring.

From a development perspective the key factor that the Pakistani banking industry has to work towards is enhancing access and improving financial intermediation, stimulating domestic savings, and broader financial innovation in services and products. Undoubtedly, banks have realized high profits by maintaining sizeable spreads and keeping deposit rates low, while charging higher interest on lending. There is no doubt that the spreads of the banking system have been high, but with the growing demand for credit and liquidity constraints on the margins, banks are having to pay higher deposits rates. With growing competition, it is expected that banks will need to tighten their spreads and offer better returns to depositors, while launching efforts to reduce the administrative costs to maintain their profitability.

IV. Conclusion

Effective economic management and liberalization together have helped Pakistan achieve a fair degree of economic stability, while setting the stage for economic restructuring and industrial development. However, preliminary results for FY06 outcome do highlight some short-term risks and vulnerabilities. The fiscal deficit is expected to exceed target in FY06, because of the unanticipated earthquake spending and continued stagnating of the tax/GDP ratio, despite enhanced tax collection. Simultaneously, the external current account deficit will be over 4.0% of GDP as the trade deficit is likely to reach $6.8 billion with import growth outpacing the rise in exports (even though exports will reach new record levels). While about one-fourth of the trade deficit stems from the rise in oil prices, the broad based growth in imports of machinery, capital goods and raw material augurs well for fresh investments and enhancement of industrial capacities.

Import dependence seems inevitable as Pakistan needs to raise its investment levels and expand and diversify its industrial base and capacities. Going forward Pakistan plans to raise its investment in infrastructure and human resources, as shortcomings in these areas are now hurting Pakistan’s industrial and export competitiveness.