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The role of Central Banks in supporting economic growth and creation of productive employment: The case of Pakistan

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Employment and
Labour Market
Policies Branch

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,[1] and which has now been widely adopted by the international community.

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Azita Berar Awad
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[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf
[2] See http://www.ilo.org/employment.

Foreword

This study explores different facets of the evolving structure, functions and conduct of Pakistan's central bank or the State Bank as it is usually called. The study commences by offering an overview of the country's macroeconomic, labour market and social indicators and evaluates how they have evolved over time. It attempts to gauge the conduct of the State Bank through its response to moments of economic significance faced by the country in the last two and a half decades. Specific attention is paid to the conduct of monetary policy, the role of the State Bank in channelling investment resources to priority sectors and its coordination with fiscal policy. This sets the background to highlight salient issues that require discussion and possible policy actions to ensure that the State Bank performs its existing functions better and contributes more meaningfully to Pakistan's development. These issues entail the continuing quest for financial inclusion, improving the regulatory structure and intermediation, reducing the degree of fiscal dominance that can crowd out private investment and ensuring greater efficiency and equity in regional financing. Hence, traditional monetary policy, with its primary focus on price stability, will be inadequate in responding to the multiple development challenges faced by Pakistan. It needs to be part of a broader policy framework that is coherent and coordinated.

Iyanatul Islam
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1 Introduction

This paper was prepared for the International Labour Organizations by the Collective for Social Science Research in Karachi. Its small core staff of researchers in the social sciences have extensive experience conducting multidisciplinary research both in Pakistan and internationally. Areas of research interest include social policy, economics, poverty, gender studies, health, labour, migration, and conflict. The Collective's research, advisory, and consultancy partnerships include local and international academic institutes, government and non-governmental organizations, and international development agencies.

The Collective is recognized for three main areas of innovation in the practice of applied social sciences in Pakistan: the introduction of a political economy perspective in macro- and micro-issues; the attention to informal collective action and social networks; and the combination of quantitative and qualitative research methodologies. The Collective's objective is to produce high quality academic research in the social sciences and to foster informed debate on social, political and economic issues and policies.

In preparing this paper, as well as consulting the wealth of literature, interviews were held with a number of current and former senior government officials. These officials were asked for their views on the following questions:

- What were major changes in monetary policy during the structural adjustment programme in the 1990s?
- How and in what ways did the role of the State Bank alter, what interventions did it make during the following periods, and what were the effects of those interventions in?
- What are your views about selection of priority sectors for special treatment through credit allocation and/or subsidized credit?
- Does the Government identify priority sectors or does the SBP identify them independently? If the latter, then how and through which process?
- Which instruments are mostly used and how does the SBP use them to enforce the policy approach?
- What is the process of coordination between the SBP and Government of Pakistan on credit allocation to priority sectors?
- What were the requirements for credit priority loans and how were they arrived at?
- What has been the direct and indirect impact of credit policy and priority sectors on growth and development?
- How and in what ways do fiscal policy priorities affect the SBP's monetary policy priorities?
- Please share your insights about the instances where the fiscal and monetary policy contradiction was most pronounced.

2 Pakistan's development and employment challenges

….igniting economic growth and sustaining it are somewhat different enterprises. The former generally requires a limited range of (often unconventional) reforms that need not overly tax the institutional capacity of the economy. The latter challenge is in many ways harder, as it requires constructing a sound institutional underpinning to maintain productive dynamism and endow the economy with resilience to shocks over the longer term. Ignoring the distinction between these two tasks leaves reformers saddled with impossibly ambitious, undifferentiated, and impractical policy agendas. (Rodrik, 2005)

2.1 Macroeconomic performance of Pakistan's economy

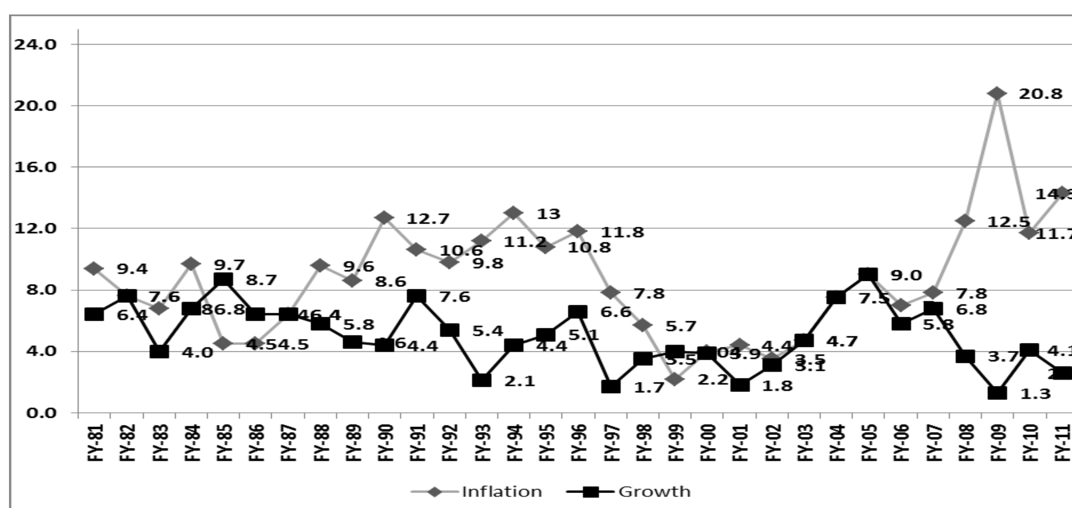
High and sustained economic growth, price stability, a low unemployment rate and exchange rate stability are important objectives of any macroeconomic framework. The macro economy is underpinned by a complex set of institutional and political economy variables. The extent to which the above stated macroeconomic objectives are achieved is not only contingent on policy choices but the underlying structural characteristics of the economy.

The structural weakness of Pakistan's economy is best exemplified by the recurrent boom-bust growth cycle (Figure 1), especially in the past two decades (Lopez-Calix, Srinivasan and Waheed, 2012). Volatility in growth rates appears to be equally pronounced in the 1990s and 2000s. Inflationary pressures, however, have been episodic. The period 1989-1997 witnessed successive double digit inflation and stagflationary trends in the economy. A decade later, i.e. in the period 2008-11, stagflationary trends returned on the back of external shocks in the form of an unprecedented spike in international oil and food prices.

The literature has identified an unsustainable fiscal deficit, high inflation, low tax revenues and balance of payment problems as proximate causes for the persistence of this boom-bust cycle over the last two decades[1]. Lately, electricity and gas shortages have become binding constraints on growth and are estimated to have wiped out 2% of GDP over the last five years.[2] Moreover, religious extremism and militancy is estimated to have given rise to direct and indirect losses to the tune of US$ 68 billion between 2001 and 2011[3].

[1]For example (Z. Iqbal and Zahid, 1998), (Kemal, 2003), (Khalid, 2005), (Agha and Khan, 2006), (Shahbaz, Ahmad and Chaudhary, 2008), (Yasmin and Waqar, 2013), (Jalil, Tariq and Bibi, 2014).
[2] Pakistan Economic Survey, Financial Year 2012-13, p. 01.
[3] Pakistan Economic Survey FY10-11, p. 220.

Figure 1: Pakistan's macroeconomic performance



Source: Government of Pakistan. Pakistan Economic Survey: Various issues, Islamabad

The above factors, however, are symptomatic of underlying structural weaknesses borne out of Pakistan's complex political economy. In the 1990s, the economy had gone through a significant dose of liberalization and de-regulation as a consequence of the Economic Reforms Act of 1991. Could the present situation be attributed to the challenges of transition during the structural reforms of the 1990s? A number of studies found that, at least in the immediate to short-run, structural adjustments did not produce the desired macroeconomic results.[4] Also, after experiencing high growth (with moderate inflation) in the period 2003-2007, the fact that the economy receded into a long period of stagflation demonstrates that it did not have the underlying resilience to withstand exogenous shocks.

Comparison with other more dynamic countries in the region provides a broader perspective when assessing Pakistan's macroeconomic performance. Table 1 presents a summary of per capita incomes and growth rates for Pakistan, India and China in the last two decades. The table shows that whereas the Indian economy more than doubled its real per capita GDP and the Chinese Economy experienced close to a seven-fold increase, Pakistan's real per capita GDP growth over the last two decades was less than double.

Table 1 : Pakistan, India and China – Growth Performance

Pakistan, India and China - Growth Performance						
(1990-2012) – Selected Years						
Years	**Pakistan**		**India**		**China**	
	Real GDP per capita [a]	**Real GDP per capita growth %[b]**	**Real GDP per capita [a]**	**Real GDP per capita growth[b]**	**Real GDP per capita [a]**	**Real GDP per capita growth [b]**
1990	**524.92**	1.43	**403.09**	3.41	**463.08**	2.29
1995	577.11	2.28	469.47	5.62	777.99	9.7
2000	596.68	1.9	578.22	2.12	1122.29	7.55
2005	693.18	5.75	740.11	7.68	1731.13	10.65
2010	748.01	-0.19	1034.24	9.13	2869.09	9.87
2011	755.68	1.03	1085.73	4.98	3120.93	8.78
2012	**772.9**	2.28	**1106.79**	1.94	**3348.01**	7.28

a- Constant 2005 US$ b- Annual Percentage
Source: World Development Indicators, available at http://databank.worldbank.org.

[4] See Bengali, Ahmed and Hijazi (2001), Kemal (2003), Khan and Khan (2007),

A more detailed and disaggregated picture of the salient macroeconomic picture is presented in Table 2. The table demonstrates that, apart from the mid-2000s, either agriculture (in the 1990s) or the service sector (in the 2000s) was the lead contributor to growth. Only in the mid-2000s does industry become the prime contributor to growth.

Seen from a structural change perspective, the share of the agriculture sector in GDP slightly declined from 26% to 24%, but that of industry decreased from 25% to 22%, while the share of the services sector increased from 48.8% to 53.6%. Although the decline in the share of agriculture conforms to the normal pattern of structural change at Pakistan's stage of development, the pace is remarkably slow. More worrying is the decline in the share of industry over the period.

Table 2: Pakistan - Major macroeconomic indicators (1990-2012)

Pakistan - Major macroeconomic indicators (1990-2012)							
	Year						
Indicators	**1990**	**1995**	**2000**	**2005**	**2010**	**2011**	**2012**
GDP growth rate*	4.46	4.96	4.26	7.67	1.61	2.79	4.02
- Agriculture sector growth rate*	3.03	6.57	6.09	6.48	0.23	1.96	3.45
- Industry sector growth rate*	6.43	4.14	1.27	12.12	3.42	4.69	2.66
- Services sector growth rate*	4.48	4.8	4.15	8.49	3.21	3.94	5.34
Inflation, GDP Deflator (annual %)*	6.45	13.87	24.89	7.03	10.85	19.66	5.63
Inflation, Consumer Prices (annual %)*	9.05	12.34	4.37	9.06	13.88	11.92	9.69
Overall Fiscal Deficit (as % of GDPmp)**	8.8	6.5	4.3	4.3	6.5	6.8	4.6
Trade Deficit (as % of GDP)**	5.5	5.9	1.8	6.5	4.9	7	4.7
Current Account Deficit (as % of GDP)**	4.8	7.2	0.7	4.4	0.1	2.1	0.4

*Source: World Development Indicators, available at http://databank.worldbank.org

** Pakistan Economic Surveys: Various issues.

Table 2 also shows that the fiscal deficit has consistently remained over 5% of GDP for the most part of the two decades. Causal factors for the high budget deficit in the 1990s and the post 2005 period are, however, different. In the 1990s, high current account deficits were the outcome of a serious external debt repayment obligation. This is vividly demonstrated by the fact that even with moderate trade deficits, the current account deficit in the mid-1990s was very high.[5] In post 2006 Pakistan, the fiscal deficit has been fuelled not as much by high debt obligations but a revenue-GDP ratio collapse and high government expenditures, primarily because of subsidies on electricity.

2.2 Labour market trends in Pakistan

The pattern of growth and structural change at the macro level is reflected in labour market trends. Pakistan's labour force data shows a disturbing picture on a number of fronts. For comparative purposes we have chosen a set of labour force indicators for 2001 and 2010-11 to discern patterns of change over a decade. First, the Labour Force Participation Rate is extremely low for women (see Table 3). This is not only true in the aggregate but also across rural and urban areas. At first sight, it is encouraging to see an improvement in the female Labour Force Participation Rate, particularly in rural areas.

[5] One indicator of external debt obligations fuelling the fiscal deficit in the 1990s was the fact that at that time the country was consistently running a primary budget surplus. See Sayeed and Rashid (2003) for analysis on the debt crisis of the 1990s.

Table 3: **Labour force participation rate: 2001-2002 and 2010-2011**

Labour force participation rate: 2001-2002 and 2010-2011		
	2001-2002	**2010-2011**
Aggregate	**41.48**	**43.04**
Male	68.46	66.50
Female	12.23	18.18
Urban	**38.75**	**37.96**
U-Male	65.43	63.87
U-Female	9.43	10.05
Rural	**43.64**	**46.46**
R-Male	70.91	68.29
R-female	14.42	23.57

Source: Labour Force Survey: Various issues

However, considering employment according to employment status (Table 4) it transpires that much of this employment is being generated and counted in the 'unpaid family help' category. While this is most pronounced in rural areas, incremental employment generation in urban areas also appears to be chiefly in this category, at least for women.

Table 4: **Employed labour force by employment status: 2001-2002 and 2010-2011**

Employed labour force by employment status: 2001-2002 and 2010-2011								
	2001-2002				**2010-2011**			
	Employer	**Self-Employed**	**Unpaid Family Helpers**	**Employees**	**Employer**	**Self-Employed**	**Unpaid Family Helpers**	**Employees**
Pakistan	0.941	37.741	19.195	42.123	1.541	34.665	26.592	37.068
P-Male	1.035	40.799	15.638	42.528	1.87	39.623	17.536	40.847
P-Female	0.281	16.211	44.234	39.274	0.178	14.15	64.06	21.433
Urban	1.816	31.42	10.49	56.26	3.32	31.66	11.75	53.06
U- Male	1.91	32.75	10.11	55.22	3.63	33.4	10.24	52.55
U-Female	0.844	18.48	14.26	66.41	0.753	17.223	24.22	57.26
Rural	0.343	42.06	25.15	32.44	0.6	36.24	34.42	28.62
R-Male	0.395	46.65	19.659	33.296	0.776	43.479	22.055	33.588
R-Female	0.037	15.224	57.263	27.476	0.042	13.423	73.476	12.965

Source: Labour Force Survey, Various issues

Unemployment rates over the first decade of the 2000s have hovered between 5.5% and 7.7% in Pakistan. Low unemployment statistics in Pakistan in particular and developing countries in general is not a surprising phenomenon, as without effective social protection there will be large swathes of the under-employed who will be counted as 'employed.' This is best exemplified by the large share of 'unpaid family help' across genders as well as the rural-urban divide.

Also, in terms of structural change, the pattern of employment across sectors paints a worrying picture. Table 5 shows that not only has employment in the manufacturing sector declined over the decade, but that it has been picked up in the main by the agricultural sector rather than services. It is also much more pronounced amongst women than men. This structural change in 'reverse' is clearly a worrying phenomenon as it alludes to slackening productivity in the economy as a whole.

Table 5: Sectoral composition of the labour force

Sectoral composition of the labour force						
	2001-2002			2010-2011		
Sector	Male	Female	Total	Male	Female	Total
Agriculture	38..38	64.62	42.09	36.01	75.44	44.87
Manufacturing	12.98	16.26	13.38	11.12	9.86	10.87
Electricity, Gas, and Water	1.13	0.13	1	1.22	0.36	1.05
Services	47.49	18.96	43.52	51.60	14.34	43.21
Total	100	100	100	100	100	100

Source: Labour Force Survey: Various Issues

2.3 Poverty and human development challenges in Pakistan

Poverty and inequality are related, yet distinct, themes, and several studies in Pakistan have been conducted to analyse the dynamics of both. In a seminal study covering three decades from 1963 onwards, Amjad and Kemal (1997) noted that, "Pakistan witnessed periods of high economic growth accompanied with increasing poverty levels, periods of low growth and reductions in poverty levels, as well as periods in which economic growth has had a positive impact on poverty alleviation". In relatively recent studies, including Raza, Cheema and Sial (2012) and Zaman, Khan and Ahmad (2012), the results of economic growth in reducing poverty and inequality are mixed; poverty is apparently on the decline, in some periods, at least. Hussain (2004, p. 22) posited that the percentage of the population below the poverty line increased from 26.6 per cent in 1992-1993 to 32.2 per cent in 1998-1999, in terms of the calorific criterion for measuring poverty and same was the case of the poverty gap and severity of poverty.

Based on the official poverty line of 2150 calories per day per adult equivalent, the Household Income and Expenditure Survey (HIES) provides official poverty estimates in Pakistan. According to these estimates, head count poverty in Pakistan shows a fluctuating trend over the last two decades. Head count poverty based on this measure was 26.11% in 1990-1991, and increased to 34.5% in 2001-2002. Since the beginning of the 2000s, poverty decreased consistently to 21% in 2005 and then 12.4% in 2010-2011. Figures for the 2000s are contentious to the extent that the Pakistan Government has not released the official figures for 2010-2011. For the 2005-2006 figures, the main assertion was that poverty had not shown a rapid reduction from the previous 2000-2001 estimate and the 2010-11 figures are problematic because growth rates since 2008 have been low.

By using different methodologies, researchers have come up with alternative and more plausible figures on poverty for the 2000s. Jamal (2011) has shown that poverty was around 38% in 2010-2011. Malik et al. (2013) tweaked the official methodology by using actual survey prices rather than the GDP deflator on the same data set. This yielded significantly different results for 2010-2011, with head count poverty at 49.1 per cent in the aggregate, broken down into 39.1 per cent for urban and 54.0 per cent for rural areas respectively.

Several authors have identified the underlying causes of poverty. Kemal (2005) identifies low skill levels for persistent poverty, Amjad (2003), Husain (2001 and 2008) and Ismail et al. (2000) consider the poor institutional framework as the central explanatory factor and Kabeer, Mumtaz and Sayeed (2010) identify weak or ineffective social protection mechanisms as the missing element in effective poverty reduction in Pakistan.

Human Development Indicators

Pakistan's human development profile is not very encouraging either. In 2012, Pakistan was ranked 146th in the UNDP Human Development Index (UNDP, 2013). Pakistan is also lagging behind in terms of fulfilment of the Millennium Development Goals (MDGs). According to the National MDG Report 2013, out of 34 MDG indicators, only 3 have been achieved, 6 are on track and a staggering 25 are off track[6]. Table 6 provides key data on social and human development indicators in Pakistan over the last two decades.

Table 6: Pakistan - Major social and human development indicators (1990-2012)

Pakistan - Major social and human development indicators (1990-2012)							
	Years						
Indicators	**1990**	**1995**	**2000**	**2005**	**2010**	**2011**	**2012**
Life expectancy at birth*							
- Female (years)*	61.89	63.32	64.69	65.98	66.99	67.17	..
- Male (years)*	60.52	61.83	63.13	64.41	65.3	65.44	..
Education*							
- Adjusted net enrolment rate, primary (% of primary school age children)*	n.a.	n.a.	n.a.	65.26	73.95	71.98	72.46
- Adjusted net enrolment rate, primary, female (% of primary school age children)*	n.a.	n.a.	n.a.	56.52	67.87	66.35	67.32

*Source: World Development Indicators, available at http://databank.worldbank.org

n.a. = not available

An improvement in human indicators requires consistent efforts from the public sector, as basic infrastructure for universal primary education, sanitation and health etc. fall within the public domain. Since the 1990s, however, the failure to reform the taxation system and raise domestic resources has hampered successive governments in providing resources to transform the social sectors.

Regardless of whether the State or the market plays the lead role in economic and social development, the role of the central bank will be critical. This is not only true with regard to coherence between fiscal and monetary policy but also in terms of access to credit, especially for long gestation projects. The role of the central bank in deepening the financial sector and creating conditions where effective intermediation of the investible surplus can take place is an important pre-condition. These issues are explored in detail in the following sections.

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[6] Pakistan MDG Report 2013, p. 14.

3 Historical role of the State Bank of Pakistan

The operations of State Bank of Pakistan (SBP) are governed by the State Bank of Pakistan Act, 1956. As in many other developing countries, the SBP performs both traditional as well as developmental functions. The traditional functions are broadly classified in two groups. Its primary functions include the issue of currency notes, regulation and supervision of the financial system (especially the money market), bankers' bank, lender of last resort, banker to the Government, and most importantly the conduct of monetary policy. Secondary functions include management of public debt, management of foreign exchange, advising the Government on policy issues as well as dealing with international financial institutions, especially the International Monetary Fund (IMF).

The 1956 SBP Act specifically states that the central bank is mandated "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 utilisation of the country's productive resources"[7]. Over the years, this mandate has been interpreted differently. From the 1960s to the 1980s, the SBP promoted long-term finance through development finance institutions (DFIs). During this period, it also devised instruments for the provision of credit to priority sectors, mainly agriculture, key industries, exports and housing. Since liberalization in the 1990s, the DFIs have been gradually phased out and priority sector lending has also reduced considerably. In keeping with neo-liberal trends, the SBP now interprets this mandate by operating an independent monetary policy and providing loans to small creditors through microfinance banks.

3.1 Institutional developments in the State Bank of Pakistan

Apart from policy shifts, significant institutional changes in the structure and functions of the SBP have been witnessed since the 1990s. The most salient of these is the appointment and tenure of the Governor of the State Bank of Pakistan. Up until the early 1990s, the Governor was appointed by the Federal Government for a period of five years. The Governor was eligible for re-appointment on expiry of the term of office. Through an amendment to the 1956 State Bank of Pakistan Act in October 1993, this tenure was fixed as a non-renewable term of five years. Soon after, in October 1994, the Act was again amended and the duration of the appointment of the Governor was reduced to the current three years with provision for re-appointment for another three years on completion of the first term.

There was a subsequent amendment pertaining to the appointment of the Governor in November 2002. This amendment removed the appointing authority from the Federal Government and vested it with the President of Pakistan. According to Janjua (2004, p. 883) this alteration in the procedure created the potential for conflict and disharmony in the functioning of the State Bank of Pakistan.

Over time, the numbers and composition of the Board of Directors of the SBP has also changed. The number of directors was increased from seven (in October 1993) to ten (from March 2012) to ensure participation from different provinces and sectors. The Board is chaired by the Governor of the SBP and the other nine members include the Federal Secretary of Finance (ex officio) and eight others, of which at least one should be from each province and all should be 'eminent professionals from the fields of economics, finance, banking and accountancy'. All eight directors are appointed by the Federal Government.

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[7] Available at http://www.sbp.org.pk/about/sbpact/SBP_ACT_1956.pdf

The Board of Directors is an important body that is entrusted by the 1956 SBP Act (Section 9A) with formulating and monitoring monetary and credit policy, determining the expansion of liquidity by taking into account the Federal Government's targets for growth and inflation and ensuring that the Bank conducts monetary and credit policy consistent with these targets and the recommendations of the Monetary and Fiscal Policies Coordination Board with respect to macroeconomic policy objectives. The Board is also responsible for determining and enforcing the credit limits to be extended by the Bank to the Federal and Provincial Governments, approving the credit requirements of the private sector, and tendering advice to the Federal Government on the interaction of monetary policy with fiscal and exchange rate policy. It is also responsible for submitting quarterly reports to Parliament on the macro economy.[8] All decisions of the Board are taken by a majority of members present and voting and in the event of equality of votes, the Governor may exercise a casting vote. The voting is usually skewed in favour of the opinion of Federal Government as its appointees dominate the composition of the Board.

After the appointment of Dr Ishrat Hussain as Governor in 1999, the SBP went through far-reaching organizational changes. A comprehensive account of these changes is given by Arby (2004), Janjua (2004), and Ahmad and Qureshi (2013). The salient features of this organizational overhaul were as follows:

- In 2001-02, the regulatory and banking services were split. The core strategic functions that relate to monetary and credit policies, supervision and regulation of financial institutions, exchange rate and reserve management as well as payment and settlement system were to be carried out by the central bank.[9]
- A subsidiary organization called the SBP Banking Services Corporation (SBP-BSC) was established in 2002 to look after ancillary and support functions. The responsibilities of the SBP-BSC include managing currency and foreign exchange operations, provision of banking services, development finance activities, implementing the export refinancing scheme and performing agency functions for the sale/purchase of prize bonds, prize money draws and the National Savings Scheme (NSS)[10].

The current organizational structure of the SBP reflects its functions not only as a monetary authority but also as an independent research organization equipped with qualified human resources[11]. It is important to note that whereas reforms within SBP enhanced its powers to regulate and supervise the banking industry, this was at the cost of severely reducing its developmental functions. This is in keeping with the new-found mandate of central banks to focus on their core domain of price stability through monetary policy. Furthermore, the privatization of previously state-owned banks and removal of entry barriers to the establishment of new banks and financial institutions were deemed to improve financial deepening and intermediation.

In a recent study, Munir and Naqvi (2013) have critically analysed the performance of Pakistan's banking sector in the post-reform era. They argue that private commercial banks have by and large failed to improve savings or financial intermediation in the economy. They have raked in large profits over the years on the back of lowered tax rates (from 56% to 35%), high interest rate spreads (averaging around 6% between 2004 and 2010), and lending to government at high interest rates. Hence, in the post-reform era, real sectors of the economy, i.e. agriculture and industry, have suffered in terms of bank credit and

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[8] The SBP Act 1956, amended up to 13-03-2012, p. 15
[9] Arby (2004, p 45).
[10] For more details, please see the SBP-BSC Ordinance 2001, available at: http://www.sbp.org.pk/about/ordinance/ordinance.pdf
[11] The complete organogram of SBP can be seen at: http://www.sbp.org.pk/reports/annual/arFY12/Vol-2/eng/Annexure-C.pdf

lending. In the pre-reform era, development finance institutions (DFIs) would finance long gestation infrastructure projects, but since privatization this particular market niche has suffered. Munir and Naqvi further argue that the banking sector in Pakistan is highly concentrated. The five largest banks, with the most extensive branch networks, account for around 60% of deposits and together generate almost 80% of all profits in the banking sector. Rather than competition, the authors contend, there is a great deal of collusion among the larger banks.

3.2 Highlights of key economic events and the role of the State Bank of Pakistan

One useful method of assessing institutional capacity and coherence of the central bank, the State Bank of Pakistan (SBP), is to analyse its role in responding to significant economic events in the country. Four significant events have been chosen over the last two decades that posed a significant challenge to Pakistan's economic managers.

3.2.1 1991 – Year of significant liberalization of the economy and autonomy of the SBP

The early 1990s were characterized by a significant dose of liberalization and de-regulation of the economy under the aegis of the 1991 Economic Reforms Act. The government of the day removed licensing requirements for industry, opened up the current account and some elements of the capital account to facilitate foreign exchange flows, reduced tariffs on imported goods, removed barriers to entry for industry and services, and embarked on an ambitious programme of privatization of state-owned enterprises. As a corollary to this policy, directed credit to priority sectors was to be abolished so that resource allocation takes place in response to market signals rather than administrative fiat. This framework also meant that the functions of the State Bank would be restricted to its core functions, and that in turn necessitated granting the State Bank autonomy from the Government.

Zaidi (2006, pp 286-289) lists the following changes in monetary management that followed in the wake of the 1991 liberalization initiative:

- The Government introduced a full-fledged system of auctioning of government debt and allowed the rate of return on Treasury Bills to rise from 6 per cent to 13 per cent,
- Long-term instruments in the shape of Federal Investment Bonds (FIBs) with a maturity of 3, 5 and 10 years were introduced,
- Credit ceilings for directed credit were discontinued in July 1992. Bank credit was to be regulated by setting a credit-deposit ratio (CDR). The CDR was subsequently abolished in September 1995,
- From January 1995, open market operations became the major instrument of market-based monetary management.,
- Before 1995, the maximum lending rate had been imposed by the SBP, ranging from 17.5 and 22 per cent between 1993 and 1995. The SBP decided not to impose any limit and removed the cap entirely in March 1995.

Another far-reaching decision of the time was to allow resident Pakistanis to open foreign currency accounts. These foreign currency accounts were to get a guaranteed rate of return (which was above LIBOR) and depositors could borrow in local currency against

these deposits. The State Bank provided the differential on the rate of return required by the banks.

The State Bank of Pakistan was granted autonomy in February 1994 as part of financial sector reforms through amendments to the State Bank Act of 1956.[12] The changes in the State Bank Act gave full and exclusive authority to the State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limits on government borrowing from the State Bank of Pakistan.[13]

Through much of the 1990s, the macroeconomic indicators painted a somewhat dark picture, as poverty was rising amidst the challenges of persistent fiscal deficits and decelerating economic growth. Some observers referred to is as a 'lost decade' (I. Hussain, 2000)[14], while others were critical of the nature and direction of the reform effort (Amjad, 2003, Zaidi, 2006 and Sayeed and Rashid, 2003). The constant theme running through the critique of reforms initiated in the 1990s was sequencing. It was argued that exposing the markets to foreign exchange liberalization when confronted with acute debt obligations led to frequent balance of payments crises and subsequent drawdown of reserves that created a recurrent cycle of panic in the markets. Furthermore, rather than first creating an incentive structure to enhance productivity and develop internal competition, the economy was exposed to global competition. Specific to the banking sector, removal of credit ceilings and directed credit meant that financing costs for hitherto protected industries suddenly escalated at a time when they were exposed to international competition.

On the operational side, the State Bank adjusted to these far-reaching changes reasonably well. It enhanced its regulatory and monitoring capacity in an environment where the financial sector expanded considerably. Apart from one mishap[15], this process proceeded smoothly. The SBP also started actively engaging in the foreign exchange market and managing the virtual 'free float' of the currency and again the SBP made a swift transition to this new function.

3.2.2 1998 – Year of nuclear tests sanctions and the foreign exchange crisis

Pakistan conducted nuclear tests in May 1998. In an environment where the country was already facing multi-faceted challenges on the macroeconomic front and was struggling to adjust to the path of liberalization it had chosen for itself, the international sanctions that the country would face as a result of these tests created[16] perhaps one of the most serious challenges with which the Government and the central bank were confronted.

Anticipating sanctions and a subsequent balance of payments crisis, the Government decided to freeze the foreign currency accounts of resident Pakistanis. Rashid (2003, p. 388) states that since there were no real reserves to back up deposits that had been already spent, the Government had little choice but to freeze these accounts. However, the Governor of the SBP at the time advised government officials not to freeze the accounts,

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[12] This process required three amendments to the State bank Act, which were finally approved by Parliament in May, 1997.

[13] Retrieved from http://sbp.org.pk/about/core_functions/ accessed on 28th April 2014.

[14] Available at: http://ishrathusain.iba.edu.pk/speeches/economicManagementPolicies/2001/economic_challenges_facing_pakistan.pdf .Accessed on 28th April 2014.

[15] The mishap was with the workings of Mehran Bank, mainly for political reasons. Still, the inability of the SBP to show a red flag at the time can be considered as monitoring failure.

[16] Morrow and Carriere (1999) have documented the degree to which Pakistan's macroeconomic woes were compounded by the sanctions.

but instead to convert them into rupee accounts at a higher exchange rate.[17] His advice was not heeded by the Finance Minister at the time.

Predictably, the foreign currency account freeze created panic in the market and there was what amounted to a run on the currency. To combat this situation, the SBP introduced a two-tier New Exchange Rate Mechanism (NERM) on July 22, 1998. Once the currency stabilized, the SBP reverted to a managed float, which entailed defending the exchange rate within a narrow band. This essentially meant that the SBP would purchase foreign exchange from the kerb market and channel it into the inter-bank market (Janjua, 2007). Given the difficult situation in foreign exchange management handed down to the SBP by the Government, it was managed as well as it could be under the circumstances.

3.2.3 2002-2005: The high liquidity phase

The events of 9/11 came about as a boon for the Pakistani economy as its most binding constraint, foreign exchange, was relieved. This relief came essentially through three channels; i) sanctions imposed by the US on Pakistan following the military coup were lifted after Pakistan decided to participate in the war on terror; ii) Pakistan obtained a reprieve on servicing its bilateral debt obligations from the Paris Club for a period of 15 years; and iii) overseas Pakistanis remitted their savings held abroad in fear of them being confiscated in the wake of 9/11. There was also an increase in aid from external donors but, as Dr Ishrat Husain, then Governor of the SBP, rightly claimed, donor financing was not the significant element in the foreign exchange inflows that did take place at that time.

This inflow of foreign exchange had a positive impact on a number of macroeconomic indicators. First, foreign exchange reserves were boosted from 2 billion US dollars in 2001 to over 10 billion by early 2005. Reduction in debt service payments and increasing remittances meant that from 2002 to 2004 Pakistan was running a current account surplus – a rarity in the country's history. Both these developments resulted in the exchange rate improving and ultimately becoming overvalued. Most importantly, however, this resource inflow resulted in significant monetary expansion.

Monetary expansion between 2002 and 2005 is estimated at Rs 1371.9 billion, a 90% increase over the stock of money in 2000-2001 (Janjua, 2005). As a result, interest rates remained low[18]

Low interest rates and a liquidity rush prompted a spate of private sector borrowing. While the rate of investment as a proportion of GDP did increase, the ensuing growth was mainly consumption-led. As noted by Amjad et al. (2011) the resultant economic growth was also mainly consumption-led and energy-intensive. Both domestic and foreign investment levels did increase but were clearly still low and were insufficient to deliver sustainable growth. Speculative activity received a massive boost as a result, mainly through the stock exchange and real estate markets.

By 2006, pressures on the economy started mounting again. Consumption-led growth led to inflationary pressures and an overvalued exchange rate. The comfortable position on reserves also led to increasing trade deficit. The State Bank responded by gradually increasing the discount rate but did not take a policy decision to adjust the exchange rate to contain high levels of imports and provide incentives for exports.

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[17] The precise advice given by the then Governor of the SBP was that the US dollar was trading at Rs 46 at the time. Foreign currency account holders should be offered Rs 50 per dollar and the currency converted at the latter rate. If they still needed dollars for a specific purpose then they would have to apply to the State Bank.

[18] The real policy rate during this period hovered around 1%.

By this time, the macro indicators were starting to exhibit an adverse trend: current account and trade deficits increasing, inflation on the rise and exports stagnant. Reserves were, however, still high and increasing and the country was able to attract foreign direct investment (FDI). As such there was an implicit sense of complacency amongst policy makers, including those at the State Bank. By mid-2007, the economy was once again confronted by external shocks and the unravelling, in terms of depletion of foreign exchange reserves, created another foreign exchange crisis that prompted recourse to another dose of IMF bailout.

This episode is an example of where the SBP has to share the blame for the troubles to which the economy was subjected from 2007 onwards. First, it did not stabilize the monetary expansion that took place in the wake of foreign exchange inflows. This led to the collapse of real interest rates and the ensuing consumer boom. Second, in the wake of increasing foreign exchange inflows, the real exchange rate was allowed to appreciate. This led to an increasing trade deficit as well as dissipation of reserves once exogenous shocks hit the economy.

3.2.4 The Crisis Years: 2007-08

International oil and commodity prices started increasing at an unprecedented rate by mid-2007. Given a high rate of consumption-led growth in Pakistan and a poor agricultural harvest, this impacted immensely on the country's balance of payments situation. With the Musharraf Government going into an election amidst myriad political problems, it decided to shield consumers from the international price shocks.

Because of policy choices, by the middle of 2008, the country was running an unprecedented fiscal deficit of close to 9% and a current account deficit of 8% of GDP. Reserves were declining at a rate of one billion dollars per month (Amjad, Din and Qayyum, 2011). CPI inflation by the middle of 2008 had touched 24% and food price inflation was in the 32-43% range.

That this meltdown of the economy happened on the heels of an unprecedented inflow of foreign exchange resources highlights the fact that half a decade of growth did not create enough productive capacity to absorb this exogenous price shock. Some have argued that because of lax regulation on the part of the State Bank (coupled with low interest rates), resources that could have been productively invested were squandered in speculative activity. These resources could have been used to plug key infrastructure bottlenecks, mainly in electricity generation that would have created positive externalities for the economy as a whole[19]. Others, point to the high investment ratios during the period to counter the accusation of resources having gone into speculation. Instead, they blame the Government's subsidization policy in 2007-8 that created the crisis[20].

In either case, the policy instruments in the purview of the SBP have had a role to play. It was either the low interest rates and lack of regulation or its inability to convince the Government not to subsidize energy and food items that resulted in government borrowing reaching a staggering Rs 680 billion against a target of Rs 80 billion for 2008.

In the last quarter of 2008, Pakistan had to revert back to the IMF to stabilize the currency and build up its foreign exchange reserves. The IMF agreement did introduce

[19] A current member of the State Bank, Zafar Masud and former Deputy Governor of the SBP, Mr. Ashraf Janjua, argued along these lines in interviews with the research team. Amjad et.al (2011) also takes a similar position.
[20] Former Governor of the SBP, Dr Ishrat Husain, is the principal proponent of this view, expressed in an interview.

some degree of stabilization in the foreign exchange markets but stagflationary trends in the economy could not be fully contained.

The period 2008-2013 provides a useful case study of monetary and fiscal policies pulling in opposite directions. Rising inflation, according to central bankers' perspectives, called for a tight monetary policy. But decelerating growth, on the other hand, demanded expansionary fiscal policy so far as the Government was concerned. In these years, macroeconomic growth was decelerating because of electricity shortages, and agricultural output suffered from severe floods. So the expansionary fiscal policy could and perhaps did fuel inflationary pressures. Moreover, the Government found it necessary to carry on with electricity subsidies. Thus, monetary and fiscal policies started to pull in opposite directions with perhaps conflicting objectives.

Though tight monetary policy may cause a reduction in aggregate demand through the interest-rate channel, in the presence of large fiscal deficits, the burden of high interest rates fell on the investment side, as noted by the Institute of Public Policy (IPP) (2011). Furthermore, there were serious questions about the effectiveness of monetary policy in curbing inflation through the interest rate channel in Pakistan.

4 The growth and development agenda of the State Bank of Pakistan

This section examines the methods, instruments and processes used by the SBP in performing some of its traditional and non-traditional functions. Directed credit to priority sectors has been its most salient developmental role over the years. Sectors prioritized for credit allocation have been agriculture, industry, exports and, lately, microfinance. Sections 3.1 to 3.5 describe the changes in procedures for performing these functions. Sections 3.6 to 3.8 then attempt an assessment of the impact of SBP policies on the economy in general and the prioritized sectors in particular.

4.1 Role of the SBP in credit for agriculture

Both in terms of its contribution to GDP and share of the employed labour force, agriculture remain an integral part of Pakistan's economy. The first directed credit scheme introduced by the SBP was in 1972. A dedicated bank, the Agricultural Development Bank[21] was set up for this purpose. In 1986, credit to agriculture was broadened as all commercial banks were mandated by the SBP to provide a dedicated credit ceiling to the agricultural sector at a subsidized rate. If the banks did not achieve the target, they were fined by the SBP. In 2001, the mandatory nature of the credit line was removed, but the subsidy remained.

However, the system had a loophole. In an interview with the research team, Mr. Ashraf Janjua, former Deputy Governor of the SBP, mentioned that although lending to agriculture was increasing under the directed credit schemes, these loans were going in other directions as well. For example, some landlords would take an interest-free agriculture loan and buy interest-bearing Defence Saving Certificates, retaining the differential profit when the agri-loan was repaid. Some experts suggested that currently around 6% of credit goes to agriculture which has an almost 20% share of GDP. Such a low credit share seems to be inadequate for a meaningful structural transformation of the agricultural sector.

4.2 Involvement of the SBP in export related finance

The SBP has also been involved in facilitating exports through credit subsidization. With the aim to increase and diversify exports, the State Bank introduced the Export Finance Scheme (EFS) in 1973. This Scheme created a provision for commercial banks to seek compensation from the State Bank against the financing facilities provided to exporters of non-traditional and newly emerging export items. The scope of the Scheme was enlarged in 1977 and financing was made available for all manufacturing goods. The Scheme was then divided into two parts: the first including financing facilities on a transaction basis while the second catered to the financing requirements based on performance. The scheme was subsequently revised in 1998, when banks were advised to give favourable consideration to financing requests from small and medium-sized exporters and/or indirect exporters. Later, in September 2001, the transaction-based financing facilities were simplified by streamlining the procedures and eliminating excessive documentation requirements.

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[21] Since the early 2000s, the bank has been renamed Zarai Tarqiyati Bank (ZTBL).

Financing under Part I of the Scheme is carried out through a firm export order / export letter of credit. The finance is granted by the bank to the exporter for a maximum period of 180 days. This facility can be drawn down both at the pre-shipment and post-shipment stage to meet exporters' cost requirements. Under Part II, a revolving finance limit is granted to the exporter, equivalent to 50% of his export performance during the previous year.[22]

4.3 Involvement of the SBP in financing industrialization

Financing industrial development has the longest history in the country. Two dedicated banks were established to finance industrial projects in the 1960s. The Pakistan Industrial Credit and Investment Corporation (PICIC) provided financing, including the foreign exchange component, for large-scale industrial projects. The Industrial Development Bank of Pakistan (IDBP) provided credit facilities to medium-sized industries. Both these institutions were merged with other commercial banks in the early 2000s.

In 1972, the SBP initiated a scheme for subsidized financing of locally manufactured machinery. Initially, this scheme also had two parts: Part A was intended to facilitate the setting up of projects in Pakistan based on locally manufactured machinery; Part B was meant to facilitate exports.

Subsequently, Part A of the facility was merged with the SBP's Long-Term Financing Facility (LTFF) for plant and machinery to provide a level playing field to entrepreneurs in general and exporters in particular for setting up export-oriented projects or units. [23]

4.4 Institutional mechanisms for allocating credit to priority sectors

SBP uses several institutional mechanisms to perform its functions related to the development of priority sectors. In the following sections, such institutional mechanisms are explained in order to understand their evolution and current status.

4.4.1 National Credit Consultative Council - NCCC

The National Credit Consultative Council (NCCC) was constituted in 1972 with the mandate to draw up an annual credit plan for directed credit to various sectors of the economy. Following the abolition of the system of credit ceilings and directed credit, it was abolished in 2006.

4.4.2 Private Sector Credit Advisory Council (PSCAC)

The Private Sector Credit Advisory Council (PSCAC) replaced the NCCC in late 2006. The PSCAC is mandated to identify impediments to credit availability and disbursement across the entire range of sectors and financing instruments. It is also mandated to review proposals of the Agricultural Credit Advisory Committee (ACAC).[24]

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[22] More details are available at http://www.sbp.org.pk/incentives/FAQs-EFS.pdf
[23] Details can be seen at http://www.sbp.org.pk/smefd/circulars/2013/C4-EFF-LMM.pdf
[24]ibid.

4.4.3 Agricultural Credit Advisory Committee (ACAC)

The Agricultural Credit Advisory Committee (ACAC) has been in existence since 1973. It is responsible for setting indicative targets for banks to disburse agricultural credit. It is mandatory for the ACAC to meet twice a year, but the latest meeting held in 2014 took place after a lapse of two years.[25]

4.4.4 Credit Guarantee Schemes

These schemes are an indirect tool for sharing credit risk with banks which provide funds to businesses. They ensure partial repayment of a delinquent loan in order to encourage lenders to lend to borrowers who do not normally have access to credit from the formal sector.[26]

4.5 Monetary and Fiscal Policies Coordination Board (MFPCB)

In order to coordinate fiscal, monetary, and exchange rate policies, the Monetary and Fiscal Coordination Board was set up under Section 9B of the1956 SBP Act. The Board is comprised of the following members:

(i.) Finance Minister as Chairman,

(ii.) Federal Minister or Secretary for Commerce (as member)

(iii.) Deputy Chairman Planning Commission, (as member)

(iv.) Governor of the State Bank of Pakistan (as member)

(v.) Secretary of Finance (as member)

(vi.) Two eminent macro or monetary economists with proven record of research and teaching to be appointed by the Federal Government.

The Board mainly acts as a mechanism to coordinate monetary, fiscal and exchange-rate policies, at least in principle. It is also responsible for ensuring consistency between macro-economic targets of growth, inflation and fiscal, monetary and external accounts (SBP Act 1956, 9B2b). For the purpose of this coordination, the Board has to meet before finalization of the federal budget to determine the extent of government borrowing requirements from commercial banks, keeping in view the credit requirements of the private sector, liquidity expansion, and net foreign assets. It has to meet on a quarterly basis to review the consistency of macroeconomic policies, and to revise limits and targets set at the time of formulation of the budget, keeping in view the latest developments in the economy (SBP Act 1956, 9B2d). In practice, the Board did not meet for five years until quite recently, on 28 May 2014.

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[25] A sub-committee of the ACAC, however, would meet regularly during this period and approved indicative targets for banks.

[26]http://www.sbp.org.pk/sbp_bsc/apr/Perf-10-11/Ch-07.pdf

4.6 Impact of institutional credit on growth of priority sectors

The three priority sectors in the development of which SBP has been actively involved are: agriculture, industry and exports. Initially, prior to the financial sector reforms, this was channelled through direct measures and later through indirect measures. The direct measures mainly included selective credit controls through credit planning, especially from 1972 to the early 1990s (Janjua, 2004).

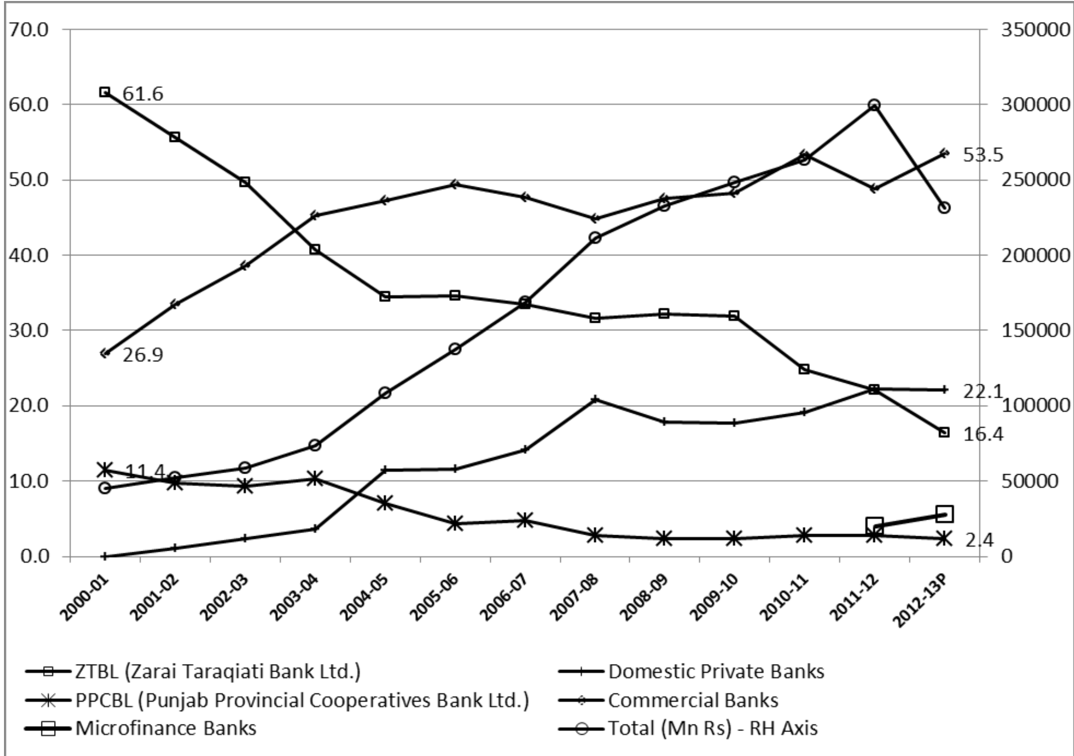
4.6.1 Impact on agriculture

The agricultural sector in Pakistan encompasses agricultural crops, poultry farming, livestock farming, fisheries and forestry. Between 1970 and 2010, the production value mix of agriculture in Pakistan gradually shifted towards livestock and away from cereal production. The share of cereals in the value of agriculture output was 29.5% in 1970, decreasing to 22.2% in 2010 while the share of livestock increased from 38.6% to 51.1% (Briones and Felipe, 2013). Further, according to the Annual Report of the State Bank of Pakistan 2012-13, "livestock (which includes both the animal population and their products) contributes 54.2 percent of the value addition by agriculture and 11.9 percent in GDP"[27].

In 2012-13, some 27 commercial, Islamic and microfinance banks with around 3,900 agriculture-designated branches were extending agriculture credit throughout the country[28]. The magnitude of institutional credit to the agriculture sector in Pakistan was around Rs 293.9 billion in 2011-12, of which two largest lenders were Zarai Taraqiati Bank Ltd with Rs 66.1 billion and commercial banks with Rs 146.3 billion. The remainder was disbursed by domestic private banks (Rs 60.9 billion), microfinance banks (Rs 12.1 billion), and the Punjab Provincial Cooperative Bank Limited (Rs 8.5 billion). An empirical study found a positive impact of institutional or formal credit on agricultural GDP, which showed that bank lending was an important factor in the growth of agriculture (M. Iqbal, Ahmad, Abbas and Mustafa, 2003). The following figure gives the institutional percentage share of total disbursement of agricultural credit from 2000-2001 to 2012-2013.

[27] Annual Report, State Bank of Pakistan 2012-13, p. 19.
[28] Pakistan Economic Survey 2012-13, p. 28.

Figure 2: Institutional percentage share of total disbursement of agricultural credit (2000-2001 to 2012-2013)



Source: Pakistan Economic Survey 2012-13, Statistical Appendix, Table 2.8

Note: Commercial Banks Include ABL, HBL, MCB, NBP and UBL.

It can be readily seen that the share of commercial and private banks has increased over the years while that of the state-owned ZTBL and Punjab Cooperative Bank has decreased. In addition, the five commercial banks (which were privatized during the 1990s) have led credit disbursement through their vast network of branches all over Pakistan, especially in rural areas. Iqbal et al. (2003) note a significant shift in institutional credit from investment in fixed capital like tube wells and tractors to loans for operational expenditures like purchase of seed and fertilizer, especially in the early and latter half of the 1980s and late 1990s'. This trend has continued in the 2000s.

In the aggregate, however, the share of share of agriculture in total lending has declined steeply over the last two decades (Table 7). This decline is most pronounced in the post-2000 period when credit ceilings for commercial banks were abolished.

4.6.2 Industry, exports and role of the SBP

The data presented in Table 7 demonstrate that the manufacturing sector receives the largest chunk of institutional credit across all sectors. Yet growth in that sector has been slack during most of this period. There appear to be two explanations for this phenomenon. One, that in all likelihood, a large chunk of this lending is going into working capital loans rather than long-term project financing. Second, the Economic Survey 2012-13 (p.37) reports that the textiles sector absorbs more than 40% of banking credit to manufacturing sector, and the same subsector constitutes around 60% of Pakistan's exports. This points to a concentration of bank credit in one, albeit the largest, manufacturing subsector. This also implies that the fortunes of the manufacturing sector are intimately tied up with growth in one sector, to the exclusion of industries that may exhibit higher productivity. Munir and Naqvi (2013) also point out that since the demise of the DFIs and concentration of credit disbursement through commercial banks, financing for long gestation projects has considerably reduced. In addition, the research team was informed that the demise of the DFIs has also meant that the capacity for project appraisal for new industries has declined (see Table 7 for some key numbers in this regard since June 1991).

Table 7: Classification of scheduled bank lending by borrower

Classification of scheduled bank lending by borrower (Percentage share of total lending)																
Borrower	06/ 1991	06/ 1993	06 1995	06/ 1997	06/ 1999	06/ 2001	06/ 2004	06/ 2005	06/ 2006	06/ 2007	06/ 2008	06/ 2009	06/ 2010	06/ 2011	06/ 2012	06/ 2013
Agriculture, hunting, forestry etc.	**21.8**	15.9	13.0	10.3	12.7	11.2	9.1	7.5	6.4	6.1	5.5	5.1	5.2	5.4	5.6	6.1
Manufacturing	**30.9**	31.8	33.0	35.2	43.2	41.1	46.1	43.4	41.8	40.2	41.8	38.5	38.7	40.6	38.2	38.7
Electricity, Gas, and water supply	**0.4**	0.3	1.0	0.8	0.5	0.5	0.7	0.8	1.0	1.8	3.8	4.9	6.6	8.0	7.7	6.0
Transport, storage, and communication	**0.5**	3.3	3.1	2.5	1.8	1.2	2.0	3.1	3.0	3.3	3.3	3.2	3.2	3.2	3.1	2.4
Real estate, renting and business activities	**0.1**	0.2	0.2	0.3	0.1	0.3	1.6	2.8	3.6	3.9	3.7	3.5	3.3	3.1	3.0	2.7
Personal Loans/ Advances	**8.7**	9.4	10.9	12.1	7.7	8.5	12.7	15.2	16.6	16.9	15.0	11.8	10.2	8.9	8.1	8.4
Memorandum items																
Share of Private Sector Enter-prises in total advances	76.0	75.3	73.1	70.0	76.5	70.8	73.2	70.9	69.8	70.3	73.7	68.1	69.1	71.4	67.8	66.3
Share of Government (Federal and Provincial)	7.9	9.4	9.8	9.6	6.0	8.8	4.1	4.9	5.2	4.2	4.7	11.1	13.4	12.3	13.1	13.5
Share of Public Sector Enter-prises in total advances	7.0	5.6	5.8	7.7	8.3	10.2	6.6	4.9	4.6	4.9	3.8	7.0	5.2	5.2	8.8	9.6

Note: Figures are for private sector borrowers, except the last two rows. Figures may not add up to 100% because of rounding.
Source: SBP Annual Reports – Statistical Supplements, various years.

It is also the case that in spite of the continuation of the Export Finance Scheme (EFS), both growth in exports and its product mix have remained virtually stagnant. Since a number of other factors determine a country's export trajectory, it is difficult to assess if the EFS has been successful or not. However, given the ossification in the product mix of exports (with two thirds still coming from the textiles and related industries), arguably the SBP could have played a more proactive role in extending credit to non-traditional export sectors.

4.7 Role of the SBP in the development of microfinance in Pakistan

Realizing the importance of microfinance in improving access of the poor to financial products and services, the SBP is engaged both in the development and regulation of microfinance institutions in Pakistan. The Microfinance Institutions (MFI) Ordinance issued in 2001, with subsequent amendments, provides a fundamental framework to streamline the establishment and working of microfinance institutions. The MFI Ordinance is supplemented by the Prudential Regulations for Microfinance Banks, which have also been amended from time to time to support the progressive development of the microfinance industry. Both these documents are fundamental to the functioning of microfinance banks.

In his interview with the research team, Dr Ishrat Hussain, former Governor of the SBP, recalled that during his tenure the microfinance industry had flourished. He attributed this to 'promotional regulation'. The strict capital and third party lending requirements applied to other banks were eased in the case of micro-finance banks.

Furthermore, the SBP spearheaded the formulation of the National Microfinance Strategy in 2007, and later in 2011 developed a Strategic Framework for Sustainable Microfinance in Pakistan[29].

The Microfinance Industry in Pakistan comprises three peer groups of retail players;

(i.) Microfinance Banks (MFBs),

(ii.) Microfinance Institutions (MFIs), and

(iii.) Rural Support Programmes (RSPs).

There are currently nine MFBs in Pakistan licensed as banks under the Microfinance Institutions Ordinance 2001, and governed by Prudential Regulations for Microfinance Banks, issued by the SBP from time to time. Both the MFIs and RSPs are primarily considered to be non-profit organizations registered under one of four separate legislative frameworks[30]. The share of MFBs in terms of active borrowers and loans has been increasing over the years and, as noted in the Economic Survey of Pakistan 2013-14 (p. 241), the total outstanding loan portfolio of all microfinance providers (MFBs, MFIs, RSPs, and others) was around Rs 52.9 billion as at 31 December 2013. Out of this total loan portfolio, Rs 29.4, some 56% of the total, is lent by the MFBs. However, in terms of active borrowers i.e. the number of individuals who currently have an outstanding loan balance or are primarily responsible for repaying any portion of the gross loan portfolio[31], the share of MFBs is around 39%[32] an increase from around 34% in 2010. Similarly, the SBP has amended the Prudential Regulations to incorporate the microenterprise credit worth Rs 500,000 for firms with less than 10 employees. It is hoped that this will improve the financial inclusion of microenterprises.

Moreover, the SBP is implementing the Financial Inclusion Programme (FIP) with financial assistance from the UK Department for International Development (DFID). It is composed of the following special initiatives:

- Microfinance Credit Guarantee Facility (MCGF): the £10 million MCGF was launched by the SBP in December 2008 under the FIP to cover partial risks on the loans extended to microfinance providers by the commercial banks.
- Institutional Strengthening Fund (ISF): launched in December 2008, this £10 million facility provides grants for strengthening the institutional and human resource capacity of microfinance providers.
- Credit Guarantee Scheme for Small and Rural Enterprises (CGS): launched in March 2010, this £10 million scheme facilitates credit to small and rural businesses for greater outreach.
- Financial Innovation Challenge Fund (FICF): a £10 million facility that aims to foster innovations that provide lower costs of delivery, more efficient systems and procedures and new ways of meeting unsatisfied demand for financial services.
- Technical assistance worth £10 million to support improved market information and infrastructure, including the national Microfinance Credit Information Bureau (MF-CIB)[33].

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[29] Available at http://www.sbp.org.pk/MFD/Strategic-Framework-SM-24-Jan-2011.pdf

[30] i.e. the Societies Registration Act, 1860, The Voluntary Social Welfare Agencies Ordinance, 1961, The Trust Act, 1882, and the Companies' Ordinance, 1984

[31] http://www.cgap.org/sites/default/files/CGAP-Consensus-Guidelines-Definitions-of-Selected-Financial-Terms-Ratios-and-Adjustments-for-Microfinance-Sep-2003.pdf, p. 09

[32] For details, see Economic Survey of Pakistan 2013-14, p. 242-243.

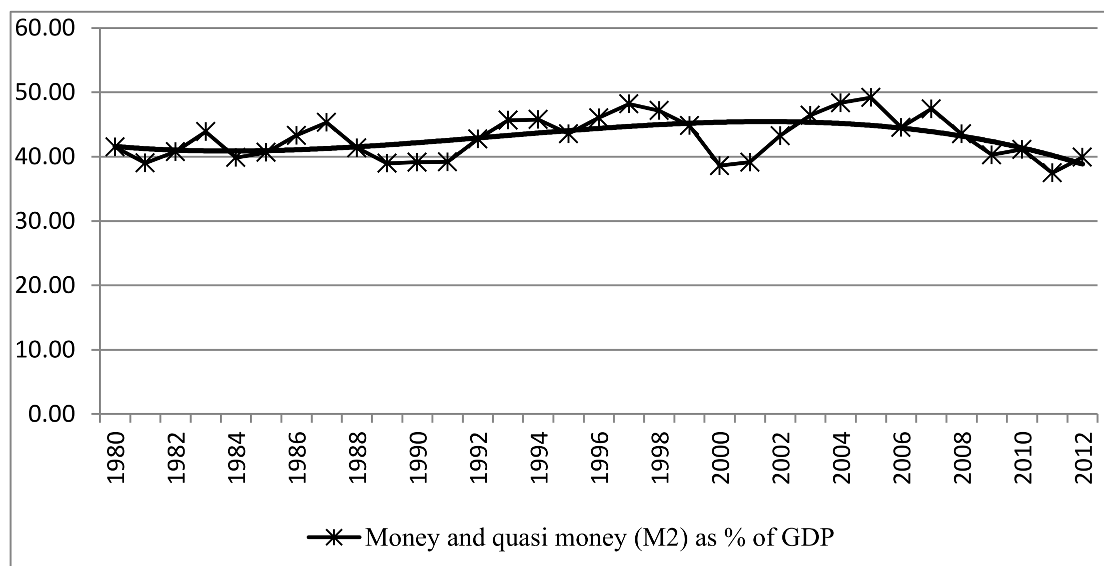
[33] SBP, Development Finance Review –December, 2013, pp 31-32

Increasing the outreach to poorer areas remote from major cities is one of the main issues in the development of the microfinance industry. With fewer economic opportunities and trapped in chronic poverty, many residents of these areas need grants and/or interest-free loans. Neither of these is within the purview of MFBs, but they are available from microfinance institutions and rural support programmes. Other organizations such as Pakistan Bait-ul-Mal, Benazir Income Support Programme, and the Pakistan Poverty Alleviation Fund (PPAF) also play a role in this sphere.

4.8 Financial deepening

As mentioned earlier, the key precepts of liberalization are improved efficiency in financial intermediation and financial deepening. Low growth and lack of structural change suggest that there has been scarcely any improvement in financial intermediation. Figure 3 also suggests that over a period of three decades the conventional measure for financial deepening, the M2 to GDP ratio also remains virtually stagnant.

Figure 3: Trend of M2 to GDP ratio in Pakistan (1980-2012



Source: World Development Indicators available at www.databank.worldbank.org

5 Contradictions in macroeconomic policy management tools

5.1 Background and theoretical considerations

High and sustained growth, low rates of inflation, stable exchange rates and low unemployment are usual objectives pursued by governments in the realm of economic management. While the main objective of fiscal policy is generally to increase, or contribute to the aggregate output of the economy, the main objective of monetary policy is to manage inflationary expectations in order to promote growth.

Theoretically, the effect of fiscal policy on aggregate output is more direct because of government expenditures on the demand side and taxes on the supply side. On the other hand, monetary policy impacts on the real sectors of the economy indirectly through interest rates, which in turn affect savings and investments, and also through expectations about inflation.[34]

Several schools of thought have been influential in guiding central bankers' policy decisions, ranging from monetarism, to neo-classical synthesis, new Keynesian, and post-Keynesian models. In the past couple of decades, the New Consensus Macroeconomics (NCM), which has roots in new Keynesian models, were used as a guide for formulating and conducting monetary policy, especially in developed countries. The NCM highlighted that price stability can be achieved through monetary policy since inflation is a monetary phenomenon; as such it can only be controlled through changes in the rate of interest. It was thus agreed that monetary policy is effective as a means of inflation control (Arestis, 2011). Furthermore, the NCM promoted a rule-based monetary policy, often using the Taylor Rule for its formulation.[35]

5.2 Contemporary monetary policy thinking in Pakistan

In Pakistan, the monetary policy stance has been greatly influenced by the strand of thought that argues for the use of the interest rate channel to control aggregate expenditures in the face of rising inflationary pressures. The popularity of rule-based monetary policy resonated in the corridors of the SBP as well. However, it is not certain whether monetary policy in Pakistan is actually guided by the Taylor Rule or some other mechanism like inflation targeting, if at all.

An expansionary fiscal policy should not be combined with tight monetary policy because that would raise interest rates and also fuel inflation, a phenomenon observed in 2008-10 in Pakistan. Since 1997, the SBP has had, at least on paper, greater autonomy to exercise monetary management. In practice, this has meant that the SBP appeared to be more concerned with inflation, rather than the growth trajectory of real sectors. Janjua (2004) notes that while the overall objectives of monetary policy have remained the same, policy content, intermediate targets, choice of instruments and controls etc., has varied considerably over the years.

On the Government's fiscal side, the Fiscal Responsibility and Debt Limitation Act (FRDL), 2005, was enacted to address issues related to the quantum of debt incurred by the Federal Government. Historically, Pakistan governments have borrowed heavily from the

[34] For a review of role of monetary policy in the economy, see Meltzer (1998).

[35] According to the Taylor Rule, monetary policy should be designed in a way that the short-term interest rate (the monetary policy instrument) responds to the deviation of the inflation rate from the target and that of output from its potential level (Ahmed and Malik, 2011).

SBP, causing sharp increases in the money supply. This caused inflation rather than growth. Subsequently, the SBP Act 1956 was amended in 2012, placing specific limits on federal government borrowing from the State Bank. In practice, however, government borrowing has continued unabated. The issue of the wage-price spiral, low growth and a challenging security environment in the recent past has made the issue of fiscal deficit, against the background of a low tax to GDP ratio, so grave that the Government feels itself committed to short-term, sometimes high cost, borrowing to finance its operations.

Although inflationary pressures have apparently eased and interest rates are declining, there is still no significant pick-up in private sector investment. From May 2011 to June 2013, the policy rate decreased by 400 basis points, yet investor confidence has not improved. It is an open question whether they are waiting for further cuts in the interest rates, or this is just a monetary policy lag. Perhaps a more important consideration in this regard is to look into the high frequency of changes in interest rates.

This point was also raised by Dr. Mushtaq Khan in an interview with the research team. In his view, monetary policy pronouncements were too frequent. According to him, they should not be made more than twice a year. Moreover, Mr. Zafar Masood, when interviewed by the research team, also doubted the effect of monetary policy owing to the size of the hidden and undocumented economy that does not show up in the GDP accounts used for monetary policy formulation. According to him, monetary policy made only a limited contribution in any case. The reason for that was that 70% of the money in circulation was in the hidden economy. Essentially, monetary policy only took into account the 30 per cent in the formal economy. Although the figure of 70% may be open to debate, the stance is not without substance.

Investors need a stable interest rate environment for long-term investment decisions in addition to price and exchange rate stability. Rapidly changing interest rates increase uncertainty in the investment climate and, from the investors' point of view, create ambiguities in the calculation of risks and alternatives. A rational private sector borrower/investor will tend to defer investment decisions until a further decrease in interest rates. This consequently increases the lag between a decrease in interest rates and private sector borrowing and investment.

6 Synthesis and main findings

This report has explored different facets of the evolving structure, functions and conduct of Pakistan's central bank. It started by setting the context through taking a bird's eye view of Pakistan's macroeconomic and social indicators. The report attempts to gauge the conduct of the State Bank through its response to moments of economic significance faced by the country in the last two and a half decades. Specific attention was paid to the conduct of monetary policy, the role of the State Bank in channelling investment resources to priority sectors and its coordination with Government. This section highlights salient issues that require discussion and possible policy action to ensure that the Bank performs its existing functions better and contributes more meaningfully to Pakistan's development.

6.1 Financial deepening

Since the liberalization of the Pakistani economy in the last two decades, the country's financial structure has broadened a great deal. Up until the early 1990s, Pakistan's financial structure was dominated by a handful of state-owned banks and development finance institutions (DFIs), a lone mutual fund, a thin insurance market and a stock market with very few listings.

In the two and a half decades since barriers to entry were removed, there has been a broad range of financial instruments available to the public. These ranges from microfinance banks to a whole host of commercial banks, Islamic financial institutions, leasing companies, mutual funds, insurance instruments, investment banks and one of the best performing stock markets in the developing world.

Theoretically, this level of financial deepening should enhance savings, increase the rate of investment in the economy and improve productivity by channelling resources to sectors where rates of return are high. However, as explained in Section 1, there is little evidence that the savings rate has gone up or that the investment to GDP ratio has improved or, indeed, indications of investible resources being channelled into high productivity sectors. The case of Pakistan, in fact, demonstrates that financial deepening has not resulted in either enhancing the investible surplus in the economy (through savings) nor has it resulted in more efficient intermediation.

This phenomenon may be due to market failures (discussed below) or because of extraneous factors, such as an uncertain political and economic environment and weakly enforced property rights. In either case, serious policy reflection is needed to address this fundamental disjuncture.

6.2 Regulatory structure and intermediation

As mentioned above, there is a broad range of financial instruments present in the market. However, the structure of deposits and advances is concentrated in the middle, i.e. short-term deposits and lending. Much of it hovers around commercial banks. The share of medium-term instruments, such as mutual funds and insurance, remains low and that of investment banks is miniscule. The stock market is a veritable casino where speculation is rife and there have been very few new listings in the last decade and hardly any equity is raised through it.

In the past, the development finance institutions (DFIs) were specialized institutions, with dedicated credit lines to lend for large, long gestation projects. In the wave of privatization, the DFIs have been privatized or merged with commercial banks. To the extent that these DFIs corrected a market failure, it can be argued that abolishing them has created a gap that has not yet been filled by emerging financial institutions in a liberalized environment. This gap can be rectified in two ways. One is to revert back to the DFI model. Because market signals are not prompting the establishment of such entities, it will have to be done by the State. However, it will be useful to pause and factor in the possibility of state failure, especially in a country like Pakistan, before recommending state ownership of financial entities. It is important to recall that part of the reason for their privatization was capture by influential lobbies and the ensuing phenomenon of a high rate of defaults.

Rather than ownership of DFIs, central bank regulation can create incentives for funds channelled into long-term finance. One view is that one regulatory lacuna is created by the fact that investment banks are not regulated by the SBP but by the Securities and Exchange Commission (SECP). As such, there is the anomalous phenomenon of these entities issuing credit cards. Conceptually, it should be the mandate of the central bank to protect the interests of depositors and lenders. Regulation by the SECP is to protect the interests of shareholders of corporate entities and not those of depositors and borrowers. The SBP can then set limits on the duration of financing that investment banks can undertake. Similarly, through regulation, the SBP can create an incentive structure for mutual funds and insurance houses to shift their portfolio towards longer-term lending.

6.3 Government – a single dominant borrower

There is consensus amongst experts on central banking in Pakistan that one important reason for the absence of effective intermediation is the heavy government borrowing requirements. According to one expert, who was recently at the helm of affairs at the State Bank, in the last eight years more than 50% of lending has gone to this dominant borrower. According to one source, in the period 2010-12, a staggering 92% of incremental savings were going into government borrowing.

This single dominant borrower is insensitive to interest rates and not only crowds out private investment but creates a perverse incentive structure for banks. If banks can lend to government, as they have done for long periods in the last two decades, there is no reason for them to develop instruments that cater to different niches in the private sector. They also do not have to develop their capacity for project appraisal and monitoring if a large part of their portfolio is invested in secure government paper.

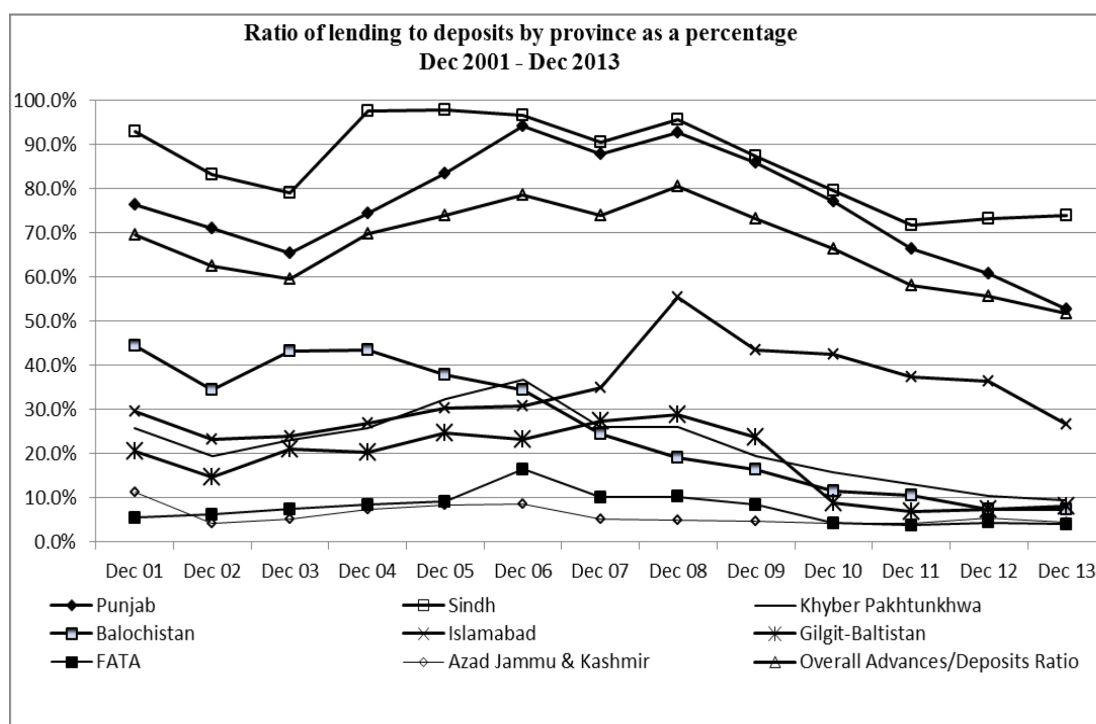
In the face of a relentless and sovereign borrower, there is little room for manoeuvre open to the central bank and there is little that the SBP can do in terms of convincing government not to exceed the borrowing limits set out in the Fiscal Responsibility and Debt Limitation Act, 2005. However, experts contend that through regulation the structure of debt can be transformed from the short to longer term. One expert lays the blame on the high frequency of changes in the SBP's monetary policy stance of. Because of this, banks and other financial institutions tend to invest only in short-term government paper. By reducing the frequency of monetary policy announcements, the incentive structure for longer-term borrowing can be developed. The SBP can also create a ceiling for both the share of government lending in the credit portfolio of financial institutions and strike a balance between short and longer-term securities.

6.4 Regional financing

Amongst the myriad socio-economic problems with which Pakistan is confronted, uneven development across regions is high in the pecking order. Better regional distribution of resources across regions is also important considering the federal structure of Pakistan and a contentious history of regional conflict.

Figure 4 shows lending in each region as a proportion of deposits mobilized for that region. We see that the healthiest ratios are those of Punjab and Sindh.[36] At the other end of the spectrum are the provinces of Khyber Pakhtunkhwa and Baluchistan. In the decade for which data is given their ratios are not only on the lower trajectory but are declining over time. These are two of the four constituent provinces that make up the Federation of Pakistan and also the most backward in terms of socio-economic indicators.

Figure 4: Ratio of lending to deposits by province as a percentage, Dec 2001-Dec 2013



Source: Authors' calculations based on data obtained from http://www.sbp.org.pk/ecodata/RA&D.xls

Ostensibly, the issue of regional development was to be addressed through the creation of banks created by three of the four provincial governments.[37] These banks are owned and managed by the respective provincial governments. However, the licences issued to them by the SBP are for banking in the entire country. As such, there is no incentive for them to channel resources towards their own provinces. The SBP can create a regulatory structure that incentivizes banks to draw deposits and advance loans within a given jurisdiction. This was the model for regional/local finance in the United States during its formative years and it contributed substantially in terms of regional development at that time.

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[36] In fact, if data for Sindh is disaggregated, it is likely to demonstrate that outside of Karachi, the ratio for the rest of Sindh will resemble Khyber Pakhtunkhwa or Baluchistan. This is because Karachi is the major investment hub not only of Sindh but Pakistan and attracts a large proportion of the investible surplus in the economy.

[37] The provinces of Punjab, Khyber Pakhtunkhwa and Sindh have started their banks.

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