"Financial Integration under CPEC and other Research Agenda"

Speech by Riaz Riazuddin, Deputy Governor, SBP

32nd PSDE AGM & Conference

December 13-15, 2016; Islamabad

بِسْمِ اللهِ الرَّحْمٰنِ الرَّحِيْمِ

Dr. Waqar Masood Khan, Secretary Finance,

Dr. Asad Zaman, President PSDE and Vice Chancellor PIDE,

Distinguished panelists, scholars, ladies and gentlemen,

Assalam-o-alaikum!

I am honored to be here on the occasion of the 32nd AGM and Conference of Pakistan Society of Development Economists. At the outset, I'd like to extend a special word of thanks to Dr. Asad Zaman for inviting me to speak in this session on financial integration under CPEC and other research agenda. The PSDE conference has a rich tradition and is one of the most eagerly-awaited events in the community of economists and practitioners – so it's really a privilege for me to be here.

The first part of my talk will focus on financial integration in the context of CPEC, while the second part will focus on research. Much of the discussion on CPEC has focused on aspects such as the amount of anticipated investment, the particulars of the eastern and western routes, and details relating to early harvest projects. However, the channels, possibilities and challenges of financial integration, which CPEC opens up, have gone relatively under the radar thus far.

Ladies and Gentlemen, we know that CPEC encompasses a number of energy projects, construction of roads, railway tracks, and ports. These would in turn, promote allied industries and services (like steel, cement, chemicals, fiber optics, transportation, mining and quarrying, and real estate). The corridor also envisages setting up of special economic zones to provide an impetus to the manufacturing sector of the country.

And how this will be financed? Well, it consists primarily of Chinese investment – and this, in essence, constitutes the first channel of financial integration. A direct consequence of CPEC is the increase of Chinese FDI inflows into Pakistan. Specifically, China's share in Pakistan's FDI amounted to a mere 6.6 percent back in FY13; in sharp contrast, this share rose to 53.6 percent, on average, for the subsequent three-year period, i.e. FY14-FY16. In effect, this channel represents surplus Chinese savings being efficiently deployed in Pakistan for high-potential development projects, in a win-win scenario for both the partners.

Another channel for financial integration is the cross-border expansion of commercial banks and other financial institutions. Both Pakistani and Chinese financial institutions are expanding operations to the partner country. One Chinese commercial bank is already working in our country, while a leading Chinese DFI has partnered with the Government of Pakistan to set up a joint venture investment company to promote development finance in Pakistan. Other players are also exploring the opportunities to enter the market. Similarly, a Pakistani bank is set to expand its footprint with the launch of its branch in Urumqi, China. These are welcome developments, since they have the potential to further facilitate business activities and cross border partnerships between stakeholders of both the countries.

The construction and operations of CPEC can also receive an added impetus from financial cooperation among the two countries' central banks, regulatory bodies and financial institutions. Such cooperation could involve facilitation of bilateral currency swaps, syndicated loans, subsidized financing arrangements, investment funds and insurance coverage for corridor related activities. At some stage, the viability of issuing RMB bonds of the Pakistan Government in Hong Kong can also be explored to raise capital for CPEC financing.

There is also a substantial scope for Chinese investors to finance the local currency component of their projects from Pakistani banks which have ample liquidity and strong capital base to meet the financing needs in Pak rupees. Furthermore, the domestic banks have an in depth knowledge and expertise of their market and the Chinese investors can leverage on this expertise in a win-win situation for both countries.

Moreover, an additional benefit that partner countries can derive from financial integration is the transfer of expertise. In the financial domain, this could include the learning that comes from exposure to best practices in regulation, technical capacity building, improved governance and investors' protection and swift resolution of payment disputes. From a broader perspective, Pakistan can also learn from China's experience in the domain of financial inclusion, given that nearly 8 out of 10 adults in China have a bank account. As you may be aware, our own National Financial Inclusion Strategy for Pakistan, initiated by SBP and the government, is looking to expand formal financial access, from 23 percent in 2015 to 50 percent by 2020. To give you just one example, Pakistan had around 9 ATMs for every 100,000 adults as of 2015, compared to 76 for China. In fact, China had almost as many ATMs per 100,000 adults *back in 2006,* as we have today. This indicates that China has leveraged technology and digitization to expand financial access in the past decade, and we can benefit from a close study of its approach to inclusion.

Of course, on the flip side, financial integration can also induce a new set of challenges. Foremost among these would be the demand for better risk management, at both the micro and macro levels. Cross-border transactions introduce an additional layer of complexity, and institutions need to be aware of legal and regulatory procedures of both countries. Integration also implies that exogenous shocks experienced in one economy can have significant repercussions for its partners, which also need to be factored into the forecasting frameworks and decision making of regulators and policy makers, in the interest of ensuring financial stability.

That being said, the SBP has made great strides in strengthening Pakistan’s financial and regulatory framework. Our regulatory and supervisory framework adequately complies with the internationally accepted best principles and practices. We have already implemented Basel III framework for banks and have a real time transactions settlement system in place.

In short, our own house – in terms of a stable financial system – is very much in order. We are now looking to consolidate this position further, while simultaneously making the most of enhanced financial integration induced by CPEC. Naturally, in the grand scheme of things, successful implementation of the economic corridor offers the promise of shared prosperity for the citizens of both Pakistan and China.

Ladies and Gentlemen, now let me turn to the second part of my talk which is about research in Pakistan; particularly in the area of macroeconomics. In doing so, I am directly addressing the young minds present at this conference. In the strategic Plan of State Bank of Pakistan for 2016-2020, we plan to enhance the effectiveness of monetary policy by strengthening its independence and implementing a framework for flexible inflation targeting that balances the need for maintaining price stability with sustainable economic growth.

As you know, we have already taken the first step towards this vision by instituting South Asia's first independent monetary policy committee. I invite you to carefully study the minutes of the deliberations of the committee to understand how decisions are made, what topics are discussed and also to come to a conclusion about the nature of its existing independence by looking at the voting patterns. These minutes will also give an important window onto research topics. I will give you an important research question in later part of my talk, which is not only very crucial for maintaining monetary and financial stability, but also critical to monetary policy independence and its coordination with fiscal policy.

To support the decision making process, we need to further strengthen our research capability. This includes modeling and understanding of Pakistan's economy using macro as well as granular data. As you know, models are simplified representations of a complex world, but provide a crucial window onto these interdependent relations, thus allowing us to see specific features of our economy more vividly. Without these models, the picture of our economy will remain chaotic and unclear, notwithstanding the weaknesses in the models.

We also need to better monitor and assess traditional monetary policy transmission mechanisms and how these mechanisms change in the presence of an informal sector in product, labor and credit markets. There is some work done in this, but it requires greater attention from all of us.

These areas of study are tall order for any organization let alone the Central Bank. On its own, the SBP can only achieve so much, but together with the academics, researchers and student body we can achieve greater heights. That is why I am inviting the academic community directly to collaborate with us to help us model better and understand Pakistan economy better. For example, I call upon our young audience to invest time on learning and building models having interdependent associations to forecast economic variables by using the general equilibrium approach. I invite you to invest also on studying transmission mechanisms. We stand ready to review and publish your work in our in-house publications.

A very good starting point for researchers will be to review the wisdom contained in the Zahid Hussain Memorial Lectures of the SBP. Since 1975, so far 21 lectures have been organized in which eminent economists of international repute have been invited to deliver the lectures on topics significant from central bank's perspective such as monetary policy and transmission mechanisms, financial inclusion and financial stability as well as economic growth and international economic trends. These lectures provide a platform to share the thoughts and to come up with research themes that are useful for better economic policy making.

Distinguished scholars, as I ask you to invest your precious time in these areas, the SBP is directly investing in the field of economics and finance by funding six Chairs in Economics at various public sector universities. After a competitive process, I would like to announce that after a lapse 10 years; these chairs (including a new Chair in PIDE) are in process of appointment. Chairs are in the names of Late SBP Governors; Msrs Zahid Hussain, Abdul Qadir, Shujaat Ali Hasnie, Mahbubur Rashid, S. Osman Ali and Shakirullah Durrani, respectively in University of Karachi, Punjab University, University of Sindh, University of Peshawar, Balochistan University and PIDE respectively. These chairs shall serve as a bridge between policy makers and the academia, as our ambassadors, as our evaluators and as our motivators.

So far I have talked about only one of the strategic goals of enhancing research capabilities to support monetary policy decision making. There are other strategic goals in which the SBP is making significant progress. These include increasing financial inclusion and to improve the efficiency of the financial system and to strengthen the financial system stability regime. If this is the area you fancy the most then we are interested in what you have to say.

Now let me come to the most important question for devising monetary policy. I want you to think deeply about this question and write papers for the benefit of your central bank:

How to strike the right balance between price stability and growth, while ensuring financial stability?

Research in this area is almost non-existent in the context of our country. In fact, this is not just one area, but the entire policy arena in which central banks operate not only in Pakistan, but all around the world. Issues of economic expansions, crises, depressions, recessions, recoveries, growth, and welfare are all linked with this question.

I have laid out central bank’s research vision in front of you and I invite you to participate in our endeavors. I ask you to join hands with us collaboratively and also individually to strengthen macroeconomic policy research in Pakistan.

Thank you.