PREFACE

The role of the government in economic growth and its relation with financial development is an old and extensively debated topic. It is a well recognized fact that in a given economic framework, the government acts both as a principal as well as an agent. This assertion immediately begs the question as to why there is heterogeneity in the reaction function of different governments even when they are faced with a similar set of economic conditions. The answer to this complex question needs to acknowledge that government is a unique amorphous entity with a multiplicity of factors giving it a shape. It may be defined in terms of its size, the type of roles it acquires, and the institutional arrangement it develops for contract enforcement. Government, by definition, is entitled to identify the trajectory of economic development and to objectively assert its dominance to achieve national economic objectives. However, to accomplish these objectives it needs an enabling economic and financial architecture which offers leverage against shifting constraints.

To objectively understand the government, focus needs to be developed on its role in the functioning of an economy, or in a particular sector of the economy such as the financial system. In the last few decades, the economic system in a number of industrial countries underwent a transition to a free-market system, and it was widely propagated that government intervention in the financial system is a necessity *only* in case of a market failure. In particular, the sequence of events in the recent global financial crisis (GFC) forced governments not only to intervene and save the financial system from a complete collapse, but also take up ownership of insolvent financial institutions to sustain their commercial viability. In effect, this process of *take-over* by the government marks a reversal of the process of privatization, deregulation and liberalization in advanced economies.

Notably, government's presence as the owner and regulator of the financial system is more strong in developing and emerging economies, where financial system development needs to be guided and monitored in the early stages of development and the regulatory system is more rule-based rather than principles-based. However as the financial system is liberalized and deregulated, the incentive structure of interacting players changes and it becomes necessary for the government to step back from its role as simply a supervisor, to a market player with capacity and authority for *selective intervention*, as and when circumstances demand. In a market-based system this approach allows the *mechanism design* to work efficiently, especially when compared to a centralized economic system with state ownership and control of financial resources.

Notwithstanding the above, the financial system *cannot* function entirely on its own with little or no regulation. Given that financial markets generally suffer from information asymmetry, the individual self-interest does not necessarily lead to the good of the society. To maximize individual gains, there always remains room for hiding or manipulating material information, even when those gains are zero-sum games. This is when regulation is needed to ensure stability and collective viability of financial markets. Notably, the negative consequences of the "light-touch" regulatory approach have already been seen in the repercussions of the GFC.

The question then arises as to whether there needs to be "too much government" in the functioning of the financial sector. One answer is that without the government's active intervention, some components of the financial sector will not develop. The government essentially needs to set the direction and the pace of reforms for financial sectors in developing economies. For instance the development of the bond market is only facilitated when the government first takes the step to establish a risk-free yield curve by issuing long-term bonds which provide benchmark rates for pricing private debt, which then aids in the development of the secondary market for financial instruments.

Hence the Government's essential role is that of an enabler and facilitator in the process of financial intermediation and financial development. Its role is to minimize uncertainty, and bring confidence in the functioning of the financial system. So how does the presence of the government jeopardize this very objective? It is not only the size of the government but also its extended 'presence' in the financial system which causes problems; for essentially the government's role needs to be phased out as the liberalization and reform process progresses. Any delay in this process may raise questions about the moral hazard induced by the ongoing presence of the government.

The essence of financial intermediation is to channel funds from savers to investors, thus propelling long term economic growth. When the private sector gets pushed out and the government becomes the dominant user of funds generated by financial intermediation, prospects of long-term growth, savings and investments in the economy are all jeopardized. Where the growth of the financial sector in Pakistan is driven by the need to accelerate financial development and penetration, the active presence of the government impedes this process. This is not to say that government should or could be completely kept out of the financial system, but that it needs to strike a balance between the cost it permeates to the economy and the developmental role it provides to the financial system.

Keeping these various considerations in mind, this edition of the Financial Stability Review focuses on the role of the government in the financial sector in the first 3 chapters of the report, constituting the thematic portion. The remaining 5 chapters review the performance of the components of the financial sector.