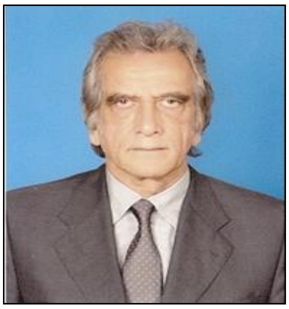

Governor's Message

As the global financial system grappled with the resurgence of the financial markets turmoil in September 2008, when the collapse of one of the world renowned financial institutions gave fresh impetus for panic, Pakistan's economy faced its own challenges in an increasingly difficult operating environment, emanating from a confluence of both external and domestic factors. Growing macroeconomic imbalances, which had been persistently building up since FY05, finally manifested themselves in the form of rapidly deteriorating economic and financial fundamentals. Inflationary pressures continued unabated, the fiscal deficit grew rapidly, current account deficit reached a record high, the stock market was virtually closed for over four months, and foreign investment flows dried up. The only redeeming features were the consistently strong home remittances and the resilience shown by the banking sector, albeit under the strains of rising NPLs emanating from the downturn in economic activities. It was in the face of the rapid deterioration in the economy that led the economic authorities to formulate a home-grown macroeconomic stabilization program, started in November 2008 with the support of the IMF Stand-By Arrangement (SBA).

Focused on its core mandate, SBP strived to maintain a balance between price stability and growth. But notably, continued to remain more concerned about inflationary pressures given the established fact that economic growth cannot be nurtured in an era of high inflation. At the same time, SBP continued to ensure and safeguard the stability of the financial system by proactively responding to emerging risks and challenges to the banking system, and taking appropriate corrective measures timely.

The implementation of the macroeconomic stabilization program was primarily driven by tightening monetary and fiscal conditions to facilitate the resolution of structural problems. These measures yielded results in subsequent months: fiscal deficit was substantially contained, from Rs777.2 billion in FY08 to Rs680.4 billion in FY09, at 5.2 percent of GDP (down from 7.4 percent in FY08), on the back of elimination of subsidies as well as a cut in development expenditure. Monetary tightening, on the other hand, had a visible impact on CPI inflation which fell from its peak of 25.3 percent in August FY09 to 13.1 percent by June FY09; giving SBP the much needed breathing space to switch the direction of its policy stance. Furthermore, after unabated expansion in the last four years, the current account deficit contracted considerably to 5.3 percent of GDP during FY09, from 8.4 percent in FY08. These positive developments need to be viewed with caution, however, given that the economy continues to be fragile, and an assessment of the balance of risks continues to present a mixed picture.

In response to the changing economic and business cycle, the central bank also stepped in to facilitate the banking sector by rationalizing the minimum capital requirements to Rs10 billion, to be implemented in a phased manner by December 2010, and allowing the use of 30 percent of the Forced-Sale Value (FSV) of collateral in calculating provisioning requirements for the rising base of NPLs. In view of the complex regulatory requirements of large financial conglomerates, SBP also signed a Memorandum of Understanding (MoU) with the SECP to undertake consolidated supervision. At the same time, progress on modernization of the legislative framework including the revamping of SBP Act, 1956, and the Banking Companies' Ordinance 1962 is underway, while efforts are underway to introduce a Deposit Protection Scheme and a Consumer Protection Act.

Price Stability. Given the easing inflationary pressures, SBP reduced its policy rate by 100 bps each in April FY09 and August FY10, to 13 percent. Notably, it was the consistent approach to curbing excessive demand pressures which helped subdue inflation. SBP, however, has to tread with caution given the lagged impact of the phased out subsidies on expected inflation in the coming months and other macroeconomic vulnerabilities. In FY09, SBP issued three monetary policy statements (MPS), i.e., for the first half and then one each for the last two quarters of the year. In November FY09, SBP also announced interim monetary policy measures. Cognizant of the uncertain and rapidly changing macroeconomic environment, and to enhance the effectiveness of monetary policy, SBP decided in January FY09 to increase the frequency of its monetary policy statements first to quarterly basis, and from August FY10, the frequency was further increased to six times in a fiscal year. Henceforth, monetary policy decisions will be announced in the last weeks of July, September, November, January, March, and May. To further enhance the transparency and credibility of the monetary policy formulation process, SBP has constituted an independent Monetary Policy Committee (MPC) consisting of both internal and external members, which will start its deliberations from November FY10.

With the objective of strengthening the monetary policy framework, segregation of debt and monetary management was the highlight of FY09. In January FY09, the responsibility of deciding the cut-off yields in the primary auctions of Treasury Bills (T-bills) and Pakistan Investment Bonds (PIBs) was shifted to the Ministry of Finance, while SBP's role was to manage the operational aspect of the auctions. This measure was taken to communicate that changes in the cut-off rate are not reflective of the monetary policy stance, while allowing SBP to focus on liquidity management consistent with the requirements of monetary policy implementation.

Reserves Management. The first half of FY09 was characterized by a continuation of pressures in the foreign exchange market. During Jul-Oct FY09, the trend deterioration in current account deficit seen in FY08 accelerated further, mainly owing to higher import prices and a sharp fall in financial inflows. This led to a rapid depletion of foreign exchange reserves along with substantial pressure on the exchange rate. The fall in reserves severely impaired the country's ability to meet its external obligations and the global markets turmoil rendered the economic managers unable to access international capital markets. The subsequent implementation of a macroeconomic stabilization program led to a marked improvement in the external account position in the ensuing months. This also helped SBP build up foreign exchange reserves which had dropped to US$ 6.7 billion in October FY09, back to the almost end June FY08 level of US$ 11.4 billion.

In continuation of SBP's efforts to strengthen its reserve management capabilities, substantial value was added to its profitability through active management of the investment portfolio in FY09. On gross return basis, SBP managed to earn a return of 2.31 percent, which while less than the 4.9 percent return in FY08, is still significant given the situation in the global financial markets.

Financial System Stability. The mandate for maintaining financial stability in Pakistan rests with the State Bank of Pakistan (SBP) in its capacity as the central bank and the regulator of the banking sector.[1] State Bank of Pakistan views its objective of safeguarding financial stability in the context of smooth and efficient financial intermediation, encompassing financial institutions, financial markets and the financial infrastructure, such that the process can withstand disruptions caused by internal and external events, and potential threats and risks are managed with the objective of minimizing systemic risk.

[1] SBP also regulates and supervises Development Finance Institutions and Foreign Exchange Companies

SBP's formal review of financial stability is now in its third year and carries rich analysis of developments in both the domestic and international financial sectors. In addition to the ongoing monitoring and assessment of the banking sector, SBP undertakes, as part of its financial stability assessment mechanism, an independent review of the Non-Bank Financial Companies (NBFCs), the Insurance sector, Pension Funds, and Capital Markets, though these segments of the financial sector are under the oversight of the Securities and Exchange Commission of Pakistan (SECP).

The recently established Financial Stability Department (part of the Monetary Policy and Research group) is mandated to independently assess financial stability from a policy-formulation and research perspective, and is also responsible for preparing the annual Financial Stability Review (FSR) and for developing a macro-prudential framework for financial stability. The Financial Stability Department has initiated work on devising a Financial Stability Framework for SBP and initiated the first phase of Macro Stress Testing of the banking sector.

Access to Financial Services. One of the major objectives of financial sector reforms in Pakistan was to broaden the outreach of financial services to the under-served areas. For this purpose, SBP had established the Development Finance Group in 2006 which has taken several initiatives to broaden access to financial services to the marginalized sectors of the economy.

In July FY09, SBP in partnership with the UK Department for International Development (DFID) launched the Financial Inclusion Program. The Financial Inclusion Program worth UK £ 50 million is to be implemented by the State Bank of Pakistan. The program was designed and developed through broader consultations with the stakeholders and will help SBP implement Pakistan's Microfinance Strategy which was approved by the Prime Minister in 2007. The program aims to develop microfinance sector's capacity to reach out to 3.0 million microfinance users by the end of 2010, and 5.0 million borrowers by 2015. The program is designed to manage sector transformation from a subsidy-based informal institutional setting to a market-based regulated institutional system. In addition, the program also aims to support financial inclusion through improved remittance systems, branchless banking, expansion of SME and rural financing.

The FIP is targeted at delivering access to financial services, and using market based principles to poor and marginalized groups. Under the Financial Inclusion Program, delivering sustainable financial services to micro, small and rural enterprises is a key priority, for which specialized facilities have been launched. The program has made substantial progress during its first year which was considered to be an inception phase. SBP's Microfinance Department (MFD) has successfully launched three of the program's most important interventions namely the Microfinance Credit Guarantee Scheme (MCGF) (£10m), the Institutional Strengthening Fund (ISF) (£10m) and the Technical Assistance components. In addition, given FIP's focus on the microfinance sector, the FIP office has now been merged with the Microfinance Department. A motivated team of professionals with gender balance, and an established structure necessary for the two components, i.e. ISF and MCGF, is in place. In the second phase the program will focus on launching a Financial Innovation Fund (£10m), Small and Rural Financing Guarantee (£10m) and projects on remittances, branchless banking and financial literacy. A multi-donor Credit Enhancement Fund is also being developed.

Consolidated Banking Sector Regulation and Supervision. In Pakistan, financial markets and institutions have witnessed significant changes during the last few years in terms of consolidation as well as diversification. Since 2000, more than 40 transactions of mergers and acquisitions have been executed within banks and between banks and non-bank finance companies. On the other hand, a number of banks/ DFIs as well as their holding groups have expanded their activities into the areas where the banks hitherto were either not allowed or not interested. These include insurance, asset management, brokerage, leasing and other non-banking finance services essentially through separate entities. Along with financial services, various groups that control different banks have also stakes in non-financial / real sector of economy. These stakes in financial and non-financial sectors also cross over to and from foreign jurisdictions. This gives quite a diversified spectrum of activities that a bank is involved in and has related relationship with, which raises various supervisory concerns for the State Bank of Pakistan.

Cognizant of the challenges posed by the complex and dynamic environment and to ensure compliance with the core principles of effective banking supervision, SBP initiated a project for formulating a framework for consolidated supervision of the banking system. Initially a framework was drafted by SBP in FY08 and extensively discussed at different forums within the bank. The framework, along with proposed amendments in legislations, has been shared with the Ministry of Finance and Securities & Exchange Commission of Pakistan (SECP) and is under consultation between SBP and SECP for enhancing its effectiveness. SBP and SECP are deliberating upon the features of the framework and necessary amendments in legislations and related rules and regulations.

Strengthening of Payment Systems. The Payment system infrastructure in Pakistan has gradually evolved from the traditional cash and paper-based modes of payment to a more sophisticated technologically driven system. A key development in this process of evolution was the launch of Pakistan's Real Time Interbank Settlement Mechanism (PRISM) for the settlement of large value transactions, with effect from July 1, 2008. To facilitate its operations, SBP issued PRISM Operating Rules for the convenience and guidance of the participants.

Major services offered by PRISM include the real time settlement of cash payments and payments related to government securities. The system also allows online trading of government securities among the direct participants. The real time execution of these transactions requires sufficient balances in participants' settlement accounts. To address this issue, the system offers two major options to the participants. First, the payment can be queued for settlement at a later time when sufficient funds become available. Participants can manage their own queues by changing their priority levels. Alternatively, the participant can avail the collateralized Intra-day Liquidity Facility (ILF) offered by SBP.

Information Technology and Supportive Infrastructure. Core IT Systems implemented at SBP have matured into a sophisticated platform now, adding high value to SBP operations. This platform has been made more robust incorporating low risk features by the introduction of backups and eliminating redundancies in the areas of Power & environment, network connectivity, and Disaster Recovery Setup. IT Security has been tightened and operational risks mitigated. There have also been substantive additions of new functionalities in the main applications during the last year. State Bank is also now well placed to leverage its IT platform for strategic advances in automation.

Management of Human Resource. In FY09, the Human Resources Department continued to implement policies aimed at strengthening and motivating its human resource base. Major policy reviews have been made in the areas of recruitment, employee orientation, Performance Measurement & Improvement System (PMIS) and promotions.

In conclusion, I acknowledge the support of the SBP Central Board of Directors in discharging my statutory responsibilities in challenging economic times. Backed by dedicated and competent staff, SBP continues to deliver its mandate and support to the Government.

Syed Salim Raza
Governor, State Bank of Pakistan