Response to Common Misperceptions about State Bank of Pakistan Amendment Act 2021

1. The State Bank will no longer focus on growth but only inflation, which is not the right model for a developing country like Pakistan

- Supporting economic policies of the government to foster development remains one of the three objectives of the State Bank under the proposed amendments, in addition to domestic price stability and financial stability.
- Focusing on price stability as the primary objective is sensible since inflation is one of the variables that the State Bank can influence directly through its tools, while generating growth is more in the hands of other actors, including other government agencies and the private sector. Moreover, inflation is very harmful and affects vulnerable segments the most.
- International experience has shown that price stability is a necessary condition for sustained growth and development. Countries where price stability is a primary objective tend to have lower inflation, as well as less volatility in both inflation and growth. In that sense, price stability is a necessary condition for sustained growth and development.
- Across the world, the majority of central banks have price stability as their primary objective and these include developing countries like Indonesia, Malaysia, Philippines, Colombia, Mongolia, Bhutan, and Jordan.
- Nevertheless, in practical terms, all three objectives would be kept in mind by the State Bank. For instance, if the economy is running above capacity so that too much money is chasing the same number of goods, inflation would rise, necessitating a higher interest rate to curb demand. This would help regulate the economy so that inflation is brought under control and growth is made more sustainable. Conversely, if inflation is not because of excessive demand but because of supply shocks in the form of administrative issues that are driving food prices higher or because of increases in administered prices like electricity, growth would be prioritized and interest rates would not be raised unless these price pressures became more broad-based. Instead, enhanced use of the State Bank's refinance facilities could be used to support the weak economy.

2. Curbing central bank lending to the government will impose hardships on the people

- Government borrowing from the central bank can lead to inflation and balance of payments difficulties. In Pakistan, recourse to such borrowing has also contributed to lack of fiscal discipline, low revenue generation in the form of one of the lowest tax-to-GDP ratios in the world, repeated booms and busts and the need for repeated IMF assistance.
- When the government borrows from the central bank, it is equivalent to printing money. Simply printing money does not create more real resources in the economy. All that happens is that more money ends up chasing the same number of goods, hence leading to an increase in prices, otherwise known as inflation. Inflation is extremely harmful and acts like an indirect tax on the public, which affects poor people the most.

- As inflation rises, domestic goods become more expensive and there is pressure on the currency to depreciate. If the exchange rate is not allowed to fall, imports are subsidized, exports become more expensive abroad and the current account deficit increases. As a result, more and more of the country's foreign exchange reserves have to be spent on defending the currency, and eventually leading to their depletion. This creates a balance of payments crisis and the need for IMF assistance since the country runs out of foreign exchange to be able to pay for imports and meet its external repayment obligations.
- Despite these costs, governments typically have a strong incentive to borrow from central bank due to political and fiscal reasons. The availability of this option creates complacency around fiscal discipline, since this easy source of financing reduces the incentive to increase tax revenues and cut wasteful spending. In addition, this option can be misused to fund a pre-election spending spree that can improve chances of re-election but leave a bigger problem down the road.
- To curb these harmful tendencies, most countries have included legal provisions to limit government borrowing from the central bank. In most advanced countries, half of emerging markets, and around one-fifth of developing countries, central banks cannot finance the fiscal deficit. In light of Pakistan's history, a similar restriction would be beneficial, by leading to lower inflation, greater fiscal discipline, increased efforts to raise the tax-to-GDP ratio, and fewer balance of payments crises in the future.

3. The State Bank will become a "state within a state" without accountability to the government, parliament or any law enforcement agencies

- The State Bank will continue to be a public institution that is owned by the Government and works for Pakistan only and to deliver the best outcomes for Pakistani citizens within the mandate given to it by the government.
- The State Bank will remain accountable for its actions. Indeed, accountability is being enhanced. **First,** by defining its objectives more clearly so that its performance can be better assessed. **Second,** by requiring that the Governor submit an annual report to Parliament on the extent to which these objectives were met and a separate report on financial stability, as well as explicitly giving the right to Parliament to ask for senior officials to appear before it as many times as needed. The current Act does not have any such provisions. Most central banks in developed as well as developing economies are accountable to Parliament using a similar mechanism, including Colombia, Mexico, Indonesia, Iraq, Korea, and Egypt, among others.
- NAB and FIA will have their full jurisdiction to investigate SBP officials for criminal or corruption related matters.
- However, indemnity is being proposed for actions taken in good faith, so that where due care and due process are followed, officials are not afraid to take actions. This is quite common in central bank laws and is considered an international best practice.

4. There will be no more coordination with the Ministry of Finance, resulting in policies that undermine those of the government

- Only the Monetary and Fiscal Policies Coordination Board is proposed to be abolished, as its terms of reference were infringing upon the work that has been assigned to the Monetary Policy Committee under the existing Act and such a mechanism for coordination goes beyond provisions in the acts of other central banks.
- Instead, a new mechanism for coordination is being proposed between the Finance Minister and the Governor, under which they would establish a close liaison through a mutual agreement and keep each other informed of matters that jointly concern the Ministry of Finance and the State Bank.
- In addition, the proposed amendments do not preclude the formation of new bodies or committees to further strengthen coordination between the government and the State Bank, while remaining cognizant of the respective mandates and governance of the respective institutions.

5. The amendments are being imposed on Pakistan by the IMF as part of an international conspiracy

- This is not the first time the State Bank Act is being amended. Major revisions were previously made using a similar process in 1994, 1997, 2012 and 2015. The current proposed amendments are a continuation of that practice to modernize the central bank in light of domestic realities, best international practices and, and international experience.

6. The amendments will eliminate checks and balances on key officials of the State Bank

- Key officials of the SBP include members of Board of Directors, members of the Monetary Policy Committee, Governor, and Deputy Governors—15 officials in total. Currently, all of these officials are appointed by the Government. Under the proposed amendments, *all of these officials will continue to be appointed by the Federal Government, as is the current practice*.
- All major policy decisions of the State Bank will continue to be made by the Board of Directors or the Monetary Policy Committee (MPC), which are constituted by Federal Government. In these meetings decisions are made either through consensus or voting. For instance, monetary policy decisions are made by the MPC through voting and the Governor has, like all other members, only one voting right.
- In fact, additional checks and balances on the management of the SBP are being added under the proposed amendments. **First,** the oversight powers and mandate of the government appointed Board of Directors are being strengthened, including by giving them explicit oversight over the affairs and functions of the Bank; the power to supervise the management, Bank's administration, operations; and right of access to all activities of the Bank. **Second,** the process of internal decision-making on all policy matters is being strengthened by forming an Executive Committee consisting of the Governor and the three Deputy Governors, with each having a single vote. **Third,** financial transparency is being enhanced through the formation of an Audit Committee, the creation of the position of a Chief Internal Auditor, and a comprehensive provision for the appointment of external auditors.

- The powers to dismiss key government appointed officials—members of the Board of Directors, MPC members, Governor, and Deputy Governors—will also remain with the Federal Government, as is the current practice. In an attempt to better balance the need for the key government appointed officials to be free from undue political pressure and the need for appropriate accountability, the conditions under which such a dismissal can take place are being strengthened to include *gross* misconduct. Nevertheless, this is only one of the ways in which a dismissal can occur under the proposed amendments and other disqualification criteria can still be invoked, including conflict of interest, mental or physical incapacity, truancy and financial delinquency.

7. The State Bank will share sensitive information with international agencies

- Exchange of information through mutual Memorandum of Understandings (MoUs) is a common international practice and central banks enter into MoUs for sharing of information with both domestic and foreign regulatory bodies. Such sharing is necessary for effective supervision of subsidiaries and overseas operations of financial institutions across jurisdictions.

- The proposed amendments allow the State Bank to enter into MoUs with domestic and international supervisory authorities, ***only after prior approval of the Federal Government***. In this context, the State Bank has also previously entered into longstanding MoUs with several international regulatory bodies/central banks, after approval of the Federal Government. The State Bank has also entered into MoUs with various domestic regulatory bodies/authorities like SECP, FIA, Audit Oversight Board.

8. Interest rate and exchange rate decisions will be made by the State Bank alone, without any accountability

- Under the 2015 amendments to the State Bank Act, interest rate decisions are already delegated exclusively to the Monetary Policy Committee (MPC). External members of the MPC are directly appointed by the government, as are the Board of Directors. The rest of the three members are from the staff of the State Bank. MPC decisions are made on the basis of majority voting and the minutes of the policy meetings are made public.
- The present government already made the decision of moving from a de facto fixed exchange rate system to a flexible and market determined one since July 2019. Under the new system, the exchange rate is determined by market forces, with intervention only when exchange conditions become disorderly, i.e. if there are sudden large movements in the exchange rate. This system has served the country well and for the first time in Pakistan's history we have had orderly two movement of the exchange rate—in the past, when the exchange rate moved, it would only result in depreciation of the Rupee.
- A market based exchange rate system also means that, unlike the past, the exchange rate is not kept artificially high, which encourages imports, discourages domestic production and exports, increases the current account deficit and results in the depletion of the country's foreign exchange reserves in defence of the currency. In Pakistan's own repeated experience, this eventually leads to painful balance of payments crises that result in higher

inflation as the exchange rate undergoes a sharp depreciation to correct its misalignment, as well as lower economic growth and employment.

- Under the proposed amendments, as noted above, accountability for interest rate and exchange rate decisions will be enhanced due to the need to present before Parliament the extent to which the State Bank was able to meet its mandated objectives.

9. The priority of the State Bank will be repayment of external debt, to the detriment of the domestic economy and resources for development

- No such provision is being proposed.
- All external debt is contracted by the government and not the State Bank, and it is the government's prerogative to decide about repayments.
- Pakistan has never defaulted on its external debt obligations, and this decision has not compromised domestic development. It has only served to increase domestic and foreign investor confidence, ensuring the continued supply of investment and foreign capital into the economy, thus helping Pakistan's development.