Key Note address by Mr. Yaseen Anwar
Governor, State Bank of Pakistan at
MAP's Seminar on "The State of Pakistan's Economy"
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Members of the Management Association of Pakistan, thank you for inviting me as you celebrate the revival of MAP's Lahore chapter. I wish you all the best of luck, and hope that your endeavors to develop Pakistan's human capital to bring our corporate sector at par with international standards will bear fruit.

It is an interesting time to be an economist. Be assured that the past few years and the current economic turmoil will occupy the pages of history textbooks in the coming decades. While the world faces a novel set of problems – with the stability of the Euro in question, at one end, and the shaky revival of the American economy on the other – we, here in Pakistan, seem to be tackling more or less the same set of issues all over again. But let's be clear that I am, personally, optimistic about the country's future, and am confident that our economic managers – who have steered the

country through much choppier seas – will guide this resilient economy to the path of stability and prosperity.

Let's also be clear about the key challenge that this economy faces: the deficits in the fiscal and external accounts. But even here, ladies and gentlemen, the problem is not the size; it is the situation.

And what do I mean by that?

Our projected fiscal deficit is around 6 percent of GDP; and our projected current account is around 2 percent of GDP. These are hardly indicators of an impending catastrophe. But we find ourselves in interesting times: the OECD economies are busy tending to their own backyards at the moment, and consequently, external financing is tougher to obtain than it was even a few years ago. However, I believe that managing such deficits is the primary job description of any economic manager. Let's also remember: it's not the size, it's the situation.

Through our publications – the reports on the state of the economy and the monetary policy statements – we have clearly communicated

our reservations regarding the fiscal deficit to the federal government– but we are also aware that fiscal reforms are tough to implement in the current environment. We have also highlighted the effects of using commercial bank borrowing for financing the fiscal deficit: such borrowing reduces the pool of credit available for private investment and "crowds out" – as economists like to call it – the private sector. In essence, such borrowing dampens growth.

When asked by the Senate Finance Committee earlier this week as to why I do not restrict the banks in investing in Government paper and why is SBP injecting liquidity to support such borrowing, I cited the following: a) In a free market economy, no central bank places such restrictions on its sovereign paper. If such an exercise were taken under our current conditions, there may be certain investors who may interpret such action by the central bank as downgrading its own sovereign paper and as such, the rating may be adversely affected. b) Injection of liquidity is intended to ensure payments stability in the banking sector. Not

injecting would increase the cost of borrowing in the interbank market, particularly for the smaller banks that have heavier reliance on interbank lines from the larger banks. Such increased costs would not only be passed on to their borrowers, thereby impeding economic growth but also could potentially make that small bank vulnerable to collapse and in turn trigger systemic risk. Thus liquidity injections are essential to maintain Financial Stability, a core responsibility of a central bank. (the other being Price Stability).

The other option to finance the deficit is not any prettier: it involves central bank financing – or deficit monetization. This is essentially equivalent to printing money to pay off the deficit; and has broad-based inflationary repercussions for the economy. So, in terms of financing the deficit, it may seem that we're stuck between a rock and a hard place, but let's keep the *magnitude* of the deficit in perspective before jumping to any conclusions.

To manage this deficit, the federal and provincial governments have been working in close coordination with the bureaucracy. All stakeholders are conscious about the challenges that the economy faces in this regard, and discussions have been extremely frank and straightforward.

To help manage the deficit without too much of an impact on economic growth, the State Bank has also ramped up efforts to broaden and deepen financial markets – both primary and secondary. We have undertaken an initiative with the SECP to develop debt markets in Pakistan, and we believe that this will go a long way towards mitigating the negative effects on the economy of government borrowing from commercial banks. Moreover, it will lessen the corporate sector's dependence on banks as the primary source of raising debt. This will mitigate the effects of crowding out and increase financial inclusion in the economy – a key goal of the State Bank. Such reforms will also make the State Bank's policy

tools more effective, in fine-tuning the workings of the economy, and allow us to drive the engines of growth even more efficiently.

What are those engines of growth? The three key areas are SME, Agriculture, and Housing Finance. Our banking structure currently is not performing its key role as a financial intermediary as none of these sectors have been adequately penetrated. SME is not only about lending…..it is about packaging non-credit related products i.e. letters of credit, collections, remittances, money transfer, and cash management. The SME sector is key to job creation and sustained economic growth. Agriculture represents 21% of our GDP and 45% of our work force. We have huge potential to improve yield and generate export revenue. We are the fifth largest milk producer in the world, yet our cows produce only 10% of milk as compared to American cows. Nestle has already recognized potential in this area and has established major farms to realize that potential. This area of course is ripe for Islamic Finance as it is Shariah compliant. Housing Finance currently represents

only 1% of GDP as compared to 65% in the U.S. and 110% in the U.K. The lack of a fixed income market of up to 25-30 years and weak provincial legal structure have impeded the growth of this key sector. As mentioned earlier, we are working to develop the Corporate Debt market to facilitate financing to this sector.

A similar challenge awaits the country on the external front. While the country's external accounts remained healthy in FY11, with an improvement in the balance of trade; a sustained and substantial improvement in workers' remittances following SBP's efforts to incentivize formal financial channels; and inflows on account of the IMF SBA arrangement, the situation has worsened slightly this year. The balance of trade has deteriorated with the rise in oil prices – driven by the standoff between the US and Iran; a fall in cotton prices; and reduced demand for our exports as the recovery in the West has slowed down.

And, analogous to the fiscal situation, it is the financing of the current account deficit that will remain a challenge this year. Net

financial inflows have slowed down to only $1.9 billion in FY11 after peaking at $8.7 billion in FY07. To manage the situation, the bank has entered into currency swap agreements with Turkey and China in order to mitigate the pressure of any adverse development in the developed world on our external accounts and reserves. Other such arrangements are in the pipeline with other countries that could relieve pressure on our external accounts. Our reserve management policies are transparent and the bank has not experienced any substantial pressure on its reserves yet – despite the recent repayment of a $400 million installment to the IMF as we start paying our loans. The foreign exchange market did not react adversely to this large outflow, reflecting the confidence it places in SBP's policies and procedures. The State Bank managed to successfully manage market expectations and avoid any untoward movements in the exchange rate.

The State Bank also remains dedicated towards managing excessive exchange rate volatility, while clamping down on

speculative pressures on the rupee, to provide a stable exchange rate environment for the domestic industry. SBP's efforts to incentivize the transmission of remittances, through formal channels, has also borne fruit, as remittances have increased markedly in the past few years, and supported our external accounts.

I've talked at length about the challenges faced by the economy. But let's take a moment here to reflect on some of the positives that can be drawn from recent years. To keep things in perspective, this was a period when we faced two floods (one of which inundated a significant portion of the country's bread basket) and also have been involved in a costly war on one of our borders.

Firstly, the resilience of the economy manifested itself in the pace of recovery that was witnessed after the flooding in Sindh in the early part of FY12. Greater crop production in Punjab outpaced the losses in Sindh, and the agricultural sector is on the path towards greater growth than last year. And this leads me to my second point…

The improvement in food supplies has already dampened food inflation, which has been edging down continuously. This is especially good news for the lower strata of society, which spends roughly half of its income on food. Headline inflation has followed suit and fell to less than ten percent for the first time in two years. And let's not forget that this improvement in supply has allowed the country to remain relatively self-sufficient in food – an extraordinary achievement for a country which has around 180 million mouths to feed.

Thirdly, agri-based industries also stand to gain with this increase in supply, and the resultant decrease in prices. Our textile and sugar industries are expected to do well this year. Construction activity has also picked up with support from the rise in remittances; a growing population; and the initiation of public sector development projects. This also bodes well for the transportation, and the wholesale and retail sectors. In the services segment, the profitability of banks continues to show improvement.

Aside from the currency swaps, the largest bank in the world, Industrial Commercial Bank of China (ICBC) opened its branches in 2011 in Karachi and Islamabad. Soon I will be announcing another foreign bank's entry into Pakistan that reflects offshore investor confidence improving. Clearly, there is much to be optimistic about.

But let me add a disclaimer here: growth across the real sector has been constrained significantly by our energy problems. However, the government is very well informed about the energy situation and has been taking steps to alleviate the problem. One such step was the debt swap that was recently conducted to free up liquidity for companies across the energy sector, increase power generation and reduce the level of circular debt in the energy sector.

As mentioned earlier, we are working towards the development of the Corporate Debt market that would lead to a secondary market, thereby creating ample liquidity to absorb the circular debt as a long term remedy. The depth and breadth of the

market comprising both institutional and individual investors, would also alleviate government borrowing from SBP and the commercial banks. Naturally monetary policy would then become more effective in managing inflation.

Finally, despite the fiscal deficit, the country's debt to GDP ratio has not increased substantially; in fact, it has declined in the last three years. To put this in perspective, Pakistan's debt to GDP ratio is half that of most European countries and one-third that of Japan. Moreover, most of the country's debt is denominated in rupees and the external debt is long-term in nature. Thus, I believe there is absolutely no chance that Pakistan will be facing a Greece-like debt crisis anytime in the near future.

Therefore, I believe that while the economy is going through some testing times, the challenge in front of us can scarcely be classified as daunting. Our twin deficits are, in my opinion, the most significant challenge at the moment. Even then, it is not the size that's the problem; it's the situation. And unlike the problems that

engulf the economies of the West, we know precisely what needs to be done. In that regard, we are extremely fortunate.

Let me end by emphasizing that our economy's resilience may well be unparalleled. We have survived two major floods; one catastrophic earthquake; a war on one border; and a balance of payments crisis – all in the past decade without any bouts of hyperinflation, a run on bank deposits or a deep recession. This only goes to show the enormous potential for growth that the country holds. We know what our problems are. Unlike many other countries, the solutions to our problems are straightforward. All they require is a good measure of willpower and the determination to see reforms through these interesting and challenging times.

Thank you.