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The Commandant PAF Air War College, Members of the Faculty and the Future Leaders of the Armed Forces

Respected guests, esteemed servicemen, and students at this fine establishment, assalam-o-alaikum!

I'm glad that you could join us today and thank you for inviting me to introduce you, very briefly, to the role of the financial sector in the Pakistani economy.

Our roles at the State Bank, and your roles in the armed forces, are not very different from each other. We are both tasked with guarding national interests and we both seek to actively mitigate threats – both from within our boundaries, and from the outside world. Today, I hope to be able to share with you, how we, at the central bank, guard and

guide this economy towards a path of sustainable growth and stable prices.

The focal point of any economy is the financial sector. In fact, no economy has ever grown continuously without a concurrent and similar growth in its financial sector. That's because the financial sector performs a very important function: it transfers money from those who have an excess (i.e. savers) to those who need that capital (i.e. borrowers). And that has multiple advantages for the economy. The most obvious of those, is that money can flow into investment projects, such as roads and bridges, hospitals, schools and other public sector infrastructure. Similarly, private sector projects, such as factories and other industries, can also be established using money that has been channeled through the financial system. Investment increases the productive

capacity of the economy and sets the course for faster economic growth, and contained inflation.

At the same time, the presence of large financial intermediaries, i.e. those entities that shuttle money between savers and borrowers, also pools risks. Since these intermediaries have a wide and diverse group of savers and borrowers, the chance that *all* of them will be in trouble, and at the risk of default, is relatively low. However, it is not zero – and that's something that happened in the recent global financial crisis, which I'll touch upon at the end of this lecture. The point to remember here is that large financial intermediaries manage to pool risks and that keeps the economy stable. Simultaneously, these institutions, by virtue of their size, can also reduce their costs of intermediation – something that's more commonly referred to as economies of

scale. The reduced costs mean better efficiency and a more transparent financial sector.

There's another important function that the financial system provides: it acts as a payments system. This, in essence, encourages the exchange of goods and services, since banks provide a variety of instruments that eliminate the need to carry cash. Without an efficient payments system, the costs of transactions may, at times, be too high to even merit an exchange of goods.

Economists differ on whether financial development causes economic growth or if economic growth leads to greater financial development. It's a bit of a chicken and egg problem: which came first? What we do know is that one can't happen without the other. Most empirical studies, however, have concluded that financial development and a more efficient banking system *accelerate* economic growth.

Unfortunately, the economy is not something you can experiment with, but every economist will agree that financial development and sustained economic growth have always gone hand in hand.

Now that we've established the importance of the financial sector as the focal point in any advanced economy, let's dive into a history of our own financial development – and how it's contributed to economic growth. Policy initiatives taken in the early 70s had drastically increased the size of the government in the banking sector. That was in line with the government's broader vision of greater control over resources to promote a more equitable distribution of capital and wealth. So the major sources of deposits in banks were public corporations, and the major users of banks' funds were also government-run entities. Therefore, the financial system of the 80s was made up of just the banking sector,

which was largely government controlled. Interest rates were set by the government, which also decided how much credit was to be extended to which sectors. Although the system was consciously implemented to allocate capital judiciously, it was soon evident that it had not achieved its objectives. Economic growth had started stalling and one of the key reasons for that was the repressed financial system, which could not properly allocate resources into the best possible investment projects.

The reforms process was initiated in the early 90s and focused on more private sector participation as financial intermediaries; developing more robust regulatory frameworks; restructuring banks; and developing non-bank financial institutions (also known has NBFIs), as well as equity and bond markets, as alternatives to the banking system for both investors and borrowers. The financial

sector was essentially given a completely new look during the course of that decade. The purpose of all these changes was to enhance competition and efficiency in the financial sector. That would mean that capital gets allocated into productive investment, which can further drive growth. Simultaneously, as banks became more efficient, savers could receive a better return on their deposits and borrowers could finance themselves at lower rates.

The question now becomes: how well did we do? Well, we've come a long way since then in my opinion. Banks have gone from receiving government funding to contributing to the national exchequer in taxes. Non-performing loans, which are loans that are overdue and have been defaulted upon, have fallen manifold since then. Our equity market has been a consistent feature in Asia's best performing stock markets. Since we established a secondary market that can buy and

sell government debt, our financial markets have become a lot more agile and responsive to policy changes. That's actually been one of the most important outcomes of the financial sector's reformation. The State Bank's monetary policy tools have become incredibly more potent since the introduction of secondary markets that trade government securities, and the removal of distortions from within these markets.

But there's always room for improvement and that's why our long-term vision for the financial sector includes more efficient debt markets, better regulatory practices that protect the economy from risks, and broadening the scope of the financial sector to extend financial services to previously unbanked sectors such as agriculture, small and medium scale enterprises and housing. With that in mind, the State Bank's banking sector strategy focuses on the following ten

points: (i) to implement a financial inclusion program for underserved economic sectors such as those I just mentioned; (ii) to strengthen consumer protection through legislation and codes of conduct; (iii) to strengthen competition and efficiency with greater transparency; (iv) to consolidate the banking sector's corporate governance and risk management practices; (v) to strength prudential regulation and supervision of banks; (vi) to introduce consolidated supervision frameworks that supervise financial groups and conglomerates; (vii) to develop a safety nets for small depositors, unviable institutions and unforeseen market crises; (viii) to strengthen the Bank's powers to maintain monetary and financial stability by updating the SBP Act regularly; (ix) to deepen the financial sector by developing debt markets, stock markets and NBFIs; and finally (x) to develop the financial

infrastructure, including payment systems and credit information systems to facilitate transactions.

That is a long list by any standards and I hope I haven't put you to sleep by reciting it. But I want to emphasize that all these measures are focused at creating an efficient, competitive, and robust financial system that can provide the impetus for faster economic growth, while guarding the interests of all stakeholders involved. That, in a nutshell, is all we seek to do.

We seem to have been fairly successful at it too in fact, especially when it comes to expanding the reach of the financial sector to underserved sectors. The World Bank, and publications such as the Financial Times and The Economist, have recognized the State Bank's role in promoting innovative solutions, especially in microfinance, to get more people into the banking sector.

But there's another reason we need a vibrant and robust financial sector. The State Bank regulates the economy as a whole by using monetary policy instruments, which are transmitted through the financial sector. If you could permit me here, to do away with tons of research on the subject, and be exceedingly simplistic, I would say that the potency of our monetary policy instruments depends on how many people are actively using formal channels of borrowing and lending. In fact, I think that a clearer explanation of monetary policy is in order now.

Monetary policy aims to stabilize the economy. If the economy is slowing down, then monetary policy can provide the necessary stimulus and if the economy is expanding too fast, then monetary policy can act as a necessary drag. Is there any such thing as too much growth? Well an economy that grows too fast too quickly risks high inflation. And the

risks associated with high inflation will give any economist lots of sleepless nights. I don't think I need to recount the costs of inflation here. While Pakistan has never undergone a bout of hyperinflation, the past few years have seen higher than average inflation, the effects of which every individual has felt.

So why does inflation happen? In a simple world, it happens because the demand for goods and services is growing faster than the supply of those goods and services. Monetary policy aims to dampen, or stimulate, if required, the demand side of the equation. The supply of goods and services is a function of the structural aspects of the economy and cannot be changed overnight. Thus, policymakers aim to manage demand – at least in the short-run. Increasing interest rates increases the cost of borrowing and hence discourages consumption and investment. That dampens the demand for

goods and services and inflation recedes. That happens in an ideal world. Unfortunately, Pakistan's economy is not always like that.

One of the drivers of demand is money creation in the economy. This is the money created when the government is unable to finance its fiscal deficit and must turn to the central bank for borrowing. The excess money in the economy creates excess demand, which then creates inflationary pressures. It also blunts the State Bank's use of monetary policy tools for that reason.

There's another driver of inflation and that's expectations. If people across the economy expect a certain rate of inflation, they will adjust their decision making accordingly. For instance, a retailer may expect a ten percent rise in his cost and raise his prices by the same amount. A daily wage earner may expect a similar rise in his cost of living and

renegotiate his wages upwards. That's the problem with inflationary expectations: they are self-fulfilling. Unfortunately for us, they are a lot tougher to attack, as compared to the demand-supply gap, with conventional monetary policy tools, and they usually take time to recede.

Now that I've told you all about the problems we face in implementing monetary policy in Pakistan, allow me to tell you about how and why monetary policy does work in the country. As I highlighted before, monetary policy tools target the interest rate. It's important to understand just how they do that. Different central banks use different tactics, but at the State Bank, we intervene primarily in the overnight interbank market. This is the market where interest rates on loans that banks make to each other for a day. The central bank itself is a player in this market and steps in to either provide funds in times of need or drain

money in times of excess. By doing that it manages the overnight rate to keep it within a certain band. The monetary policy rate that is announced in the press indicates the ceiling of this band. The overnight rate is linked to all other interest rates in the market. By changing the ceiling of the band, which the overnight rate fluctuates in, the central bank is able to influence interest rates.

The instrument that the State Bank uses to influence these rates is called an open market operation or OMO. They involve the buying and selling of government securities to various banks. This is the reason why having an efficient and competitive secondary market for government securities is so important. It is the backbone to our monetary transmission mechanism. Once interest rates are changed in the overnight market, interest rates across the economy

adjust accordingly and consumption and investment activities are affected.

Let's also be clear here that this entire process takes time. Therefore, the effects of a change in monetary policy may not be apparent initially. I would also like to emphasize that monetary policy can fine tune the economy, not steer it. Ultimately, long-run economic growth is a function of the ability and capacity of the economy's resources to produce. The economy's resources are like the engine; monetary policy acts as the accelerating and braking mechanism in the car. The car's speed and acceleration is naturally constrained by its engine. It's also the transmission mechanism that determines how well the car responds when you push down on the pedal, or release it. That transmission mechanism here is the financial sector. A smooth, well-oiled

financial system can ensure that monetary policy signals are transmitted effectively into the economy.

The question now becomes, well what is the State Bank supposed to do with monetary policy? Unlike most central banks, and similar to the US Federal Reserve, the State Bank has a dual mandate: it must tackle the issue of maintaining price stability, while also keeping an eye on economic growth. The preamble to the SBP Act of 1956 defines that the institution has "to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources". So at the State Bank, we need to pay close attention to both monetary stability and fuller utilization of the country's resources.

That is a tough balance to strike in the best of times. The Bank's policy is to use any room available to cut interest rates in order to promote economic growth. After being in double-digits almost consistently for two years, inflation has reduced markedly in the past few months. It was because of this that the Bank decided to reduce its interest rate into single-digits as well. The benchmark rate now stands at 9.5 percent. We also expect that average inflation for the year will remain below 9.5 percent. A part of the reduction in inflation may be attributed to State Bank's active monetary management policies. Interest rates are reviewed and may be revised every two months, which allows our policy responses to be nimble and respond quickly to any sharp changes in the economic environment. The Bank also ensures that the money market is never short of, or in excess

of funds, and this means that monetary policy signals are transmitted efficiently.

Ladies and gentlemen, at this point I would also like to clear up some misconceptions about inflation. For instance, developing economies like ours, by their very nature, have higher rates of inflation than developed ones. Inflation rates of 4-6 percent are considered healthy in a developing economy, but such rates are considered high for developed countries. So inflation, per se, is not a bad thing. In fact, a certain amount of inflation is considered a necessary condition for a healthy economy. High inflation, on the other hand, has considerable detrimental effects. High inflation is any central bank's cause for concern. Hyperinflation is any central bank's nightmare. Fortunately, this country has never experienced a bout of hyperinflation, and I'm confident that with the controls that the State Bank has in

place and with its monitoring of the financial system, this country will never experience an episode of hyperinflation.

Now, if you remember I had mentioned at the start of my talk that I would touch upon the global financial crisis. If you've been paying attention, I'd also mentioned that a large financial system reduces risks, but does not eliminate them. And so when something goes wrong with the financial system, there's a big problem. This is the economy's transmission system, and if any of you have had trouble with your car's transmission system, you'll know how tough it is to diagnose a problem with the transmission system – and indeed at times, to figure out whether there's a problem at all – until the car's come to complete standstill. It is incredibly difficult to know when a problem with the financial system will materialize because the symptoms are not unique. Unfortunately, this is the reason why such

problems evolve into full-blown crisis. The economy comes to a grinding halt and price stability may be threatened.

The global financial crisis was somewhat similar. It was a collection of situations and scenarios that *individually* seemed benign, but *collectively* developed into almost a perfect storm. Those conditions included low interest rates in major economies for a substantial period of time; the rapid increases in property value and the ensuing bubble; the creation and proliferation of complex financial instruments; the relaxation in regulatory oversight; and the rise in public and private debt. The storm's effects are well-known and have been documented across journals, books and movies. Of the five large investment banks in the world, one went bankrupt, two got bought by other banks and the other two had to be bailed out by the government. A large insurance provider had to be bailed out and two giants in the

housing sector had to be nationalized completely. And this was just in the US.

While some claim that Pakistan's economy was immune to the global financial crisis, I believe otherwise. In an age where the world is increasingly interconnected, it would be imprudent to assume that a crisis of this magnitude will not affect us. Since our financial sector relies mostly on domestic deposits as its source of funding, the financial system remained largely sound. However, the global slowdown meant that our export-oriented industries were affected. This affected their profitability and their ability to repay bank loans on time and was one of the reasons behind the increase in non-performing loans during that time. Simultaneously, investors started winding down their portfolios and foreign inflows slowed down substantially. However, the State Bank's constant monitoring of the

banking sector's portfolio has meant that today our banks are profitable, extremely healthy and robust.

But we are also diligently monitoring global conditions in the aftermath of the crisis.

[Governor's outlook on the global financial sector and conclusion]

A. GFS

- U.S.
- Europe (Greece, etc. Debt/GDP @ 180%)
- Growth Rates low going forward i.e. recession (Europe)

B. Future Outlook (Regional Focus)

- Asian Growth/potential
- Trade Links: China, Korea, Turkey, Middle East (Largest Trade partner U.S.?)
- Currency Swaps
- New Banks; offshore investor confidence
- Pakistan Growth sectors (Agriculture, SME, R.E)
    i. Branchless Banking; Microfinance/Telecom
    ii. Financial Inclusion.