Governor's Message

In line with its core legal mandate, central bank has performed its role and functions in steering the economy and financial markets. Global events of 2007 and 2008 and the ensuing international financial market turmoil, that has unfolded from being a sector-specific to a financial sector wide liquidity crunch, to insolvency of global finance houses, has preoccupied Central Bankers across continents. Newer and innovative ways have been engineered to infuse liquidity, and myths regarding state supported guarantees and state sponsored recapitalization have been set aside, to rescue economies and their financial systems.

Pakistan is facing its own challenges over the last 18 months, complicated by the impact of a surge in global commodity prices. In the wake of these developments, the State Bank of Pakistan (SBP) had to augment and expand its economy wide vigilance and position itself to deal with the emerging risks and challenges by taking appropriate corrective measures on a timely basis.

In the design of monetary policy, inflation risks continued to outweigh other economic considerations as the core inflation proved to be more stubborn with the impact of exceptional recourse of the Government to central bank financing – known for its inflationary consequences – rose. During FY08, of the total budgetary financing requirements of Rs 777 billion, approximately 90 percent (Rs 688 billion) were borrowed from the central bank. The challenges to monetary policy were magnified as the banking system faced liquidity shortages in wake of the cash and deposit withdrawals and the rising credit demands of public and private sector. Additionally there were also increased financing requirements of the other financial intermediaries, such as stock market and nonbank financial institutions, that faced investor redemption calls following the uncertainty created by the freeze on stock market trading.

Managing conflicting, and often unrealistic, expectations and demands of the different stakeholders has been complicated by the growing stress of rising macroeconomic imbalances. In the midst of all this, exchange rate depreciation, decline in stock market indices, and acceleration in inflation, all together aroused anxiety. Erratic behavior and speculation also generated unwarranted panic at some points in last 18 months. In light of these developments, central bank has been appropriately responding to risks and challenges and multiple policy packages were issued; first in July 2007 followed by those in January, May, July and November, 2008. Although the impact of recent interest rate adjustments has yet to filter down to curb inflation- given its stubbornness and the distortions created in financial markets by the economic turmoil.- these policy packages have not only helped contain a further acceleration in inflationary pressures, but have also helped arrest drift in foreign exchange markets and calm money markets.

In anticipation of the changing economic and business cycle, central bank had prepared and launched a comprehensive Financial Sector Vision and Strategy. With the objective of taking financial sector to new frontiers, this strategy aims to promote the depth and breadth of banking sector, its robustness and capacities to meet the growing requirements of the economy. To ensure an effective move toward this, the financial sector reforms underscore need for modernization of the central bank and banking legislation which have been drafted. Also central bank is working to strengthen its role and functions including a move from compliance to principle-based regulation and from stand-alone to consolidated and risk-based supervision as well as setting in place a deposit protection scheme. Diversification and improved access along with steps to improve efficiency of banking sector will help improve the quality of credit delivery.

Price Stability: Persisting tight monetary stance helped to successfully tame the excessive aggregate demand pressures in the economy and the inflationary pressures subdued to some extent at the end of FY07 and in the first few months of FY08. The year on year (YoY) core inflation, measured by non-food non-energy CPI, dropped to 5.1 percent by the end of FY07 from 6.3 percent at the end of FY06.

Just when price stability was to allow central bank an opportunity to change its monetary policy stance through easing of interest rates, there was a sudden spurt in inflationary trends which wiped out most of the gains from the tight monetary policy. Food prices rose and coinciding with it were insalubrious developments in monetary aggregates: unprecedented government borrowing and accommodation of exporters' demand through SBP refinancing schemes fuelled reserve money growth, stoking renewed inflationary pressures. With the inflationary borrowing reaching to all time record highs, global inflation continuing to rise, and the ongoing exchange rate depreciation all combined resulted in sharp rise in inflation rate.

To address these unprecedented developments, during FY08, SBP had to frequently adjust and tighten its monetary policy stance. Cumulatively in three rounds: the SBP policy rate was raised by 250 basis points, CRR and SLR on deposits below one year maturity increased by 200bps and 100bps respectively. Unprecedented macroeconomic developments had to be addressed through recurring but steady increment in policy rate. Given the unusual circumstances, central bank Management team enhanced its communication with the public and industry and issued its policy statement in local language for better dissemination of its messages to the common man.

Debates mounted as the inflation continued to rise despite monetary tightening stance. Central bank's position on this has been that (i) in absence of monetary tightening inflation would have been still steeper; (ii) hyper inflation carries dangerous consequences, SBP has to align its SBP policy rate to "core" inflation – if real interest rates are negative it does not generate enough momentum to arrest demand pressures; and (iii) multiple and continuous exogenous and endogenous shocks that have enhanced macroeconomic imbalances to unsustainable levels, and have to be corrected to avoid further inherent risks from the inflationary financing of budget and loss of foreign exchange reserves.

Reserve Management: Ironically, the last 18 months will be remembered for both, an extraordinary build up of foreign exchange reserves and its subsequent speed of decline. Consequences would have been more serious but for the buildup of FX reserves to $16.4 billion by October 2007. By end June 2008, FX reserves declined to US$ 14.0 billion largely due to the fact that reserves were used to finance the external current account deficit, which rose to US$ 14.0 billion and as a proportion of GDP to 8.4 percent. More specifically, oil import payments for the fiscal year had to be financed mainly by drawdown of reserves.

SBP has been strengthening its reserve management capabilities during last two years. During FY08 substantial value has been added to bank's profitability through active management of investment portfolio. On gross return basis, SBP managed to earn a return of 4.9 percent which was close to its benchmark and in line with the returns in the past three years. A comprehensive strategic asset allocation exercise is underway to examine the current asset mix and develop a new asset mix taking into account the global economic conditions to improve returns while keeping the risk at acceptable level.

Sharp increase in current account deficit arising from higher oil bill and reduced inflow in interbank market, resulted in declining trend in country's foreign exchange reserves from October 2007. The overall reserves of the country stood at US$ 11.2 billion at the end June 2008; down by US$ 5.2 billion from the peak of US$ 16.4 billion in Oct 2007. Declining trend in foreign exchange reserves and drastic increase in import bill has adversely affected reserve adequacy i.e. import coverage ratio declined to 18.1 weeks from 30.6 weeks in June FY07. Pressures on SBP reserves are likely to ease in the coming months due to rise in the inflows and financial assistance from multilateral agencies.

Financial System Stability: The central bank, given its dual mandate of monetary policy and financial regulation and supervision, has been conducting financial stability review since 2007. SBP monitors global, regional and domestic developments closely and tracks the monetary transmission mechanism and its impact on the economy and the financial sector. At the same time, vigilance on banking sector helps SBP to understand the financial transmission mechanism which helps in the formulation of the overall policy stance. The consolidated SBP's financial stability framework adopted last year consolidates evidence of the Financial Sector Assessment Report and quarterly and annual Banking Surveillance Reports and presents a comprehensive report, the Financial Stability Review (FSR), that offers a rich assessment of risks and vulnerabilities of financial sector and macroeconomic challenges.

To properly institutionalize the financial stability analysis, a new department was created to provide independent monitoring and analysis of financial stability on an ongoing basis, as done in other central banks around the globe. The Financial Stability Department was established in February 2008 in the Monetary Policy and Research Cluster and staff was sent for training at the Canadian central bank and more capacity development will be undertaken in this area.

Access of Financial Services: Financial inclusion is a prerequisite for sustainable economic growth and poverty reduction. In Pakistan, financial exclusion is still very high and financing is available to a relatively smaller proportion of population. Mainstreaming access to finance has been a priority area for SBP. To reinforce its commitment, SBP has restructured and strengthened its Development Finance cluster and established a separate Financial Inclusion Program Office (FIPO) to provide a focus for improving access to finance for poor. At the same time management of the Banking Services Corporation (BSC), a subsidiary of SBP, has been entrusted with a broader mandate to interact with the businesses, industry and agriculturists and understand issues of access and intermediation, facilitate their access to banking as well as to undertake financial literacy programs.

FIPO is now focusing on delivery of microfinance supported by the DFID assistance program under which SBP is launching a Credit Enhancement Facility to be guaranteed by a window set up in BSC. Concurrently, with DFID support SBP is to help microfinance and SME industry in financial innovation and product development, broadening access to underdeveloped regions through community development programs and strengthening risk management. SBP Task Force on Crop Insurance Scheme developed a new scheme which has been now supported by the Government and has been operationalized effective Rabi season, 2008. Initiatives have also been taken to explore the options of chalking out an alternative financing mechanism for SMEs. Similarly, SBP is also concentrating on infrastructure and housing finance- one of the main drivers of the economy- with backward and forward linkages.

Consolidated Banking Sector Regulation & Supervision: Pakistan's financial markets and institutions have achieved a fair degree of consolidation and diversification. Since 2000, SBP approved about 40 mergers and acquisitions of banks as well as nonbank finance companies. Banks through affiliates and subsidiaries have ventured into where the banks hitherto were either not allowed or not interested in. These include insurance, asset management, brokerage, leasing and other non-banking finance services essentially through separate entities. Some financial services groups that operate 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. The diversified spectrum of activities that a bank is involved in and has relationships raises supervisory concerns for the SBP.

Recognizing this, SBP has sought Federal Government's in-principle approval for the amendments in the Banking Companies Ordinance, 1962 to empower SBP, like all other banking regulators, to launch consolidated supervision system. The amendments also recognize and formalize the financial conglomeration structures and allow SBP to regulate the financial holding company licensed by SBP to oversee the financial group. The framework further enables SBP to supervise the banks/deposit taking institutions on consolidated basis and develop appropriate regulatory and supervisory frameworks to oversee the financial conglomeration.

Strengthening of Payment Systems: Efficient payment system reduces systemic and operational risks. Payment Systems Department at the SBP is constantly striving to be ahead of the game to ensure operation of state of the art architecture in payment system in Pakistan. The systems aim compliance with BIS core principles that promote safety and efficiency as well as innovative e-banking technologies and cross-border connectivity.

Corporate Governance: SBP has strengthened its internal governance to perform effectively its roles and functions. SBP has tweaked corporate governance structure and paradigm in FY07. The independence of Audit Department has been augmented, which conducts regularly internal audit of both SBP and BSC, and reports to the Central Board of Directors' audit subcommittee. Also the SBP has established a Risk Management office, empowered cluster heads while rendering them accountable and, encouraged stronger performance management of staff to seek excellence. The Central Board of Directors of the SBP has played a key role in central bank's policies, while keeping strong vigilance on the functioning of the institution itself. The standards of corporate governance adopted by SBP provide benchmarks for the banking industry, in order to safeguard the interests of all stakeholders.

Information Technology and Supportive Infrastructure: Modernizing SBP into a dynamic institution, SBP has introduced best IT practices, minimized paper work, and developed a centralized data warehouse to provide real time information which helps management make informed decisions. Last year our Information Systems & Technology Department (ISTD) devised a strategy to align information technology with business objectives of the bank and set in place Information Technology Security Framework to ensure IT security of SBP. Active role of ISTD in IT and Security components of Branchless Banking Guidelines resulted in timely issuance of appropriate regulatory guidelines for the outreach of financial services to rural areas. Implementation of oracle ERP, GLOBUS and Data warehouse systems in FY07 led way for implementation of Real Time Gross Settlement System (RTGS) in FY08. The RTGS named as PRISM (Pakistan Real Time Interbank Settlement Mechanism) handles large value, low volume inter-bank funds transfer and settlements in real time. Most emerging economies have graduated to this system. PRISM will help in minimizing settlement risk for the participating banks.

Management of Human Resource: Changes in human resource strategy and policy launched in 2007 have paid dividends this year. Staff motivation and morale has improved. Tightening of the implementation of performance management system has helped strengthen incentive system. Capacity building programs have been launched in different areas/sectors. Human resource department has been proactive in promoting good practices at Director and staff level, attracting, employing, and training professionals.

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 continued to deliver its mandate and support to the Government.

Dr. Shamshad Akhtar
Governor