SBP Amendment Bill 2021

Issue Brief

Background

State Bank of Pakistan (SBP) has come under discussion recently due to a contentious bill cleared by the federal Cabinet for introduction in parliament. The said bill has been kept under wraps by the government, but many of its provisions and objectives have come to light. The SBP Amendment Bill 2021 aims at granting wider autonomy to the Bank and modifying its mandates to put price stability as the Bank's primary objective, with financial stability and fostering economic development taking second and third priority respectively. Herein, our objective is to evaluate the said bill by looking at its main provisions within the economic context of Pakistan, and to provide recommendations to achieve a better outcome. To begin, we look at SBP's historical background, its main functions, and some notable past legislation regarding the Bank.

Pakistan's central bank, the State Bank of Pakistan, was inaugurated by Quaid e Azam Muhammad Ali Jinnah in July 1948. It was set up to regulate currency and ensure stability of the monetary system. At the inauguration speech, Quaid envisioned SBP to work towards achieving Islamic ideals and to not rely solely on Western economic models. He said:

> "I shall watch with keenness the work of your Research Organization in evolving banking practices compatible with Islamic ideas of social and economic life. […] The adoption of Western economic theory and practice will not help us in achieving our goal of creating a happy and contended people. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice.

A more comprehensive mandate was given to SBP in the SBP Act 1956, under an amended version of which it operates till date. In its preamble, the SBP Act 1956 requires the Bank 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". The above-stated preamble is akin to a dual mandate whereby SBP is to ensure simultaneously both a fuller utilization of productive resources, which implies low unemployment, as well as monetary stability, which implies price stability.

The main functions of State Bank are conducting the monetary policy, regulating the financial system, issuing banknotes, providing credit to banking sector and the government, and acting as the lender of last resort. Other functions include managing foreign exchange, conducting economic research, and advising the government on policy matters. SBP also plays its role in improving the financial framework, institutionalization of savings and investments, Islamization of the banking sector, providing training facilities to bankers, and conducting quasi-fiscal operations for government's priority sectors. Therefore, SBP is the cornerstone of the monetary and financial system of Pakistan.

Under the 1956 Act, State Bank's Governor is appointed by the President for a renewable term of 3 years. One or more Deputy Governors may be appointed by the Federal Government, for terms not exceeding 5 years, with possibility of reappointment.

The Act states that the agreed salaries and terms and conditions may not be altered later at the disadvantage of the Governor and Deputy Governors.

Past Amendments

It is not the first time that amendments are being made in the State Bank Act 1956. SBP was granted greater autonomy in February 1994 under financial sector reforms. In 1997, this autonomy was further supported by issuing three Amendment Ordinances (which were approved by the Parliament in May, 1997) namely, State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974[1].

The modifications in the State Bank Act gave full and exclusive authority to the Bank to control the banking sector, to conduct an independent monetary policy and to set limit on government borrowings from the State Bank of Pakistan. The amendments in Banks Nationalization Act put an end to the Pakistan Banking Council (an institution established to look after the affairs of Nationalized Commercial Banks (NCBs)) and institutionalized the process of appointment of the Chief Executives and Boards of the NCBs and Development Finance Institutions (DFIs), with the State Bank having a role in their appointment and removal. These amendments also increased the autonomy and accountability of the Chief Executives and the Boards of Directors of banks and DFIs.

Salient features of the SBP Amendment Bill 2021

It should be mentioned at the outset that the official version of the bill draft has not been made public by the Federal Government. The analysis herein is based on a brief shared by Ministry of Finance[2], credible media sources, and discussions of academics and analysts.

On March 9th, 2021, the federal cabinet cleared the proposed SBP Amendment Bill 2021 for being put to the Parliament. The salient features of the proposed bill are:

- Primary objective of SBP to be price stability, with financial stability as secondary objective, and supporting government's economic policies to foster development and fuller utilization of resources, to become the tertiary objective.
- Governor's term to be increased from 3 to 5 years, with a possibility of another 5-year term.
- Monetary and Fiscal Policies Coordination Board (MFPCB) to be abolished; instead Governor SBP and Minister of Finance are to establish a close liaison.
- SBP to no longer lend directly to the government.
- All SBP employees, Board of Director members, members of any Board committee and monetary policy committee, including also former Governors, Deputy Governors, and Directors to have legal indemnity for any act of commission or omission done in good faith. No action, investigation, or proceedings may be done against them by NAB, FIA, or any other institution, without prior approval of Board of Directors of the State Bank.
- Quasi-fiscal operations on behalf of the government are to be discontinued; a few re-financing schemes to remain in operation.
- Secretary Finance to no longer serve on the SBP Board.
- Instead of the current quarterly reporting to the Parliament, there shall be an annual report to the Parliament by the Governor, regarding Bank's objectives, policies, performance, and economic and financial outlook. The Bank is to also submit to the Parliament and government a report on the economy at least twice a year.

Assessment of the SBP Amendment Bill 2021

There is a general consensus about the need for State Bank's autonomy, and the need to reduce the political economy's influence over SBP. The proposed amendment bill, however, provides for some unnecessary and excessive autonomy measures for SBP. There are serious concerns regarding the proposed change of SBP's mandate, and the lack of transparency shown in this process by the government. Granted that Pakistan does not rank high in central

[1] https://www.sbp.org.pk/about/Lf.asp
[2] Salient Proposed Changes in the State Bank of Pakistan Act, 1956. Ministry of Finance. http://www.finance.gov.pk/SBP_Amendment_Act_2021.pdf

bank independence among emerging markets[3], a better approach is needed to improve that rating.

The SBP Amendment Bill 2021 comes as a pre-condition for the resumption of the $6 billion IMF loan package. There is a lack of scrutiny and debate on the IMF proposals, especially considering that the IMF policies have proved to be disastrous in many emerging countries, as evidenced in Latin America, East Asian countries, and Greece. The 2008 financial crisis further proved that Washington consensus has severe defects. The air of secrecy regarding this crucial bill is concerning as well, as the bill is being hidden from the public. Not allowing an informed discussion of important legislation is ill-advised for a democratic setup. Therefore, an indigenous initiative and wider stakeholder engagement is of utmost importance in legislating on an issue of such paramount national importance.

The proposed bill aims to remove government scrutiny over SBP and to instead have Parliamentary oversight. In principle, there is nothing objectionable about this change. In the current situation, however, it is not a viable proposal if effective accountability of SBP is desired. In advanced economies, the debate hinges on whether central bank should be overseen by government institutions or elected representatives. Both their legislatures and government can exercise effective accountability of central bank. In Pakistan, parliamentary committees need capacity-building measures and properly trained research staff at their disposal before they can effectively critique SBP's performance. Apart from that the governmental oversight on these type of institutions is mandatory. As things stand right now, freeing SBP of government accountability mechanisms will make SBP above any effective accountability. Furthermore, exempting former senior officials of SBP from legal proceedings in the interest of autonomy is a dubious gesture. The fears are exacerbated considering that the top leadership of SBP, including the current often has interests outside Pakistan, and that they will not stay in Pakistan to see their policies through when the country finds itself in hot water.

It is also disputable whether price stability should be the sole primary objective of SBP, and whether cutting credit to government will help in that regard. Pakistan differs from many developed countries in that the single largest portion of Pakistan government's expenditure is debt servicing. In the 2020-21 federal government budget, interest payments constituted more than 40% of total government expenditure. In order to keep the country running despite such high interest payments, the government will continue deficit financing, with or without SBP credit. Moreover, government's deficit financing is not the primary reason behind inflation; rather inflation in Pakistan is determined more by the supply side factors such as increasing fuel prices, lowering of productive capacity, shortages of raw materials, and monopolistic hold of some groups in essential commodities sector. There is not much a central bank can do to influence these cost-push factors. SBP cannot, for example, do much about high sugar and electricity prices. Consequently, this proposal will neither cut deficit financing nor the part of inflation coming from government demand; if anything, higher cost of borrowing from private sector will increase the fiscal deficits.[4] That will also further crowd out private sector investment, as the government will take an even bigger portion out of the domestic credit pool.

Relegating growth and employment objectives to tertiary level as a price for price stability is misplaced in Pakistan, especially amid a global recession due to COVID-19 pandemic. Pakistan is a young and developing country, needing more than a million new jobs each year to accommodate the large number of youth entering the labor force annually. Economic growth should be Pakistan's primary concern, in order to generate sufficient employment and better living standards for its people. The pandemic has not spared Pakistan's economy either, as 37% of the working-age population (20.63 million people) were rendered

[3] Cheema, Nadir (2021). State Bank independence. Dawn.
https://www.dawn.com/news/1620435/state-bank-independence

[4] In a 2008 study, Acemoglu et. al, suggest that central bank reforms prove ineffective in countries with weak political constraints. They present evidence pointing to what they call the "see-saw effect": when central bank tries to curb inflation, politicians address the demands of political economy through other means such as increasing government spending. Therefore, inflation targeting may also cause a widening of fiscal deficits through this channel.
Acemoglu et. al (2008). When Does Policy Reform Work? The Case of Central Bank Independence. Brookings Papers on Economic Activity.

unemployed due to the disease and lockdowns.[5] A massive growth effort is needed to make up for the lost employment and to create future bulwarks, for which SBP should be on the same page as the government. However, the bill will bring about a void between government and SBP by removing Finance secretary from SBP Board and abolishing MFPCB, while only proposing an informal liaison between the two sides. The proposed liaison is vague and cannot serve as a constructive alternative to an institutional framework such as the MFPCB. The gap between SBP and government, combined with other autonomy measures, will create space for the SBP to set a monetary policy which may be contrary to the growth needs of the country at a time when growth policies are needed the most.

In light of the above issues, the recommendations below should be followed to redress some of those concerns.

Recommendations

- Legislation must be carried out indigenously. Extensive local research and debate needs to be done regarding the actual needs of Pakistan economy that SBP can cater to. Footprints of foreign organizations like IMF taint the reforms process; therefore, foreign involvement should be minimized.
- Contents of the proposed bill should be made public. Greater transparency will generate a more informed discussion, and ensure greater inclusiveness.
- Comprehensive accountability mechanisms for SBP need to be designed that strike a balance between autonomy and answerability. A wide circle of stakeholders, academics, and policymakers should be engaged in this process. It is extremely important that SBP officials have answerability for their actions.
- For SBP, growth and employment objectives should be on par with the objective of price stability, if not a higher priority. The current dual mandate is more desirable. However, the preamble of the current Act is vaguely worded and an amendment should be brought to make the dual mandate much clearer.
- Regarding the candidacy for Governor SBP, such criteria may be set that ensure greater reliability and readiness: the candidate does not hold any citizenship other than Pakistan's; he/she should be an active tax payer, has been based in Pakistan for at least 2 years prior to appointment, and is willing to sign an agreement to not join any foreign organization for a specified period after stepping down as Governor.
- Government control of the SBP should be retained until Parliament has the requisite capacity to hold the SBP accountable.
- Institutional liaison between government and SBP is indispensable; either the MFPCB should be retained with some modifications, or a comparable institution be set up to ensure that SBP keeps pace with the government's direction.
- An additional objective for SBP ought to be considered whereby the central bank also works to reduce economic inequalities in society.

A much needed appraisal of SBP's evolution is required and its trajectory should be adjusted according to Quaid's vision. In line with that vision, a comprehensive and self-sustained financial model should be established as per the rules and regulations of Islamic teachings with the ultimate aim of eliminating Riba from the economy.

[5] Pakistan Bureau of Statistics (2021). Special Survey for Evaluating Socio-Economic Impact of Covid-19 on Wellbeing of People.
https://www.pbs.gov.pk/sites/default/files//other/covid/Final_Report_for_Covid_Survey_0.pdf

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