

## **Editors' Introduction**

The Center for Research in Economics and Business (CREB) of the Lahore School of Economics, hosted the Seventh Annual Conference on the Management of the Pakistan Economy from May 4<sup>th</sup> – May 6<sup>th</sup>, 2011 and the theme of this year's conference was 'Financial Sector Development and Management'. Since Pakistan has undergone significant economic and financial changes over the last decade, the objective of the conference was to present an overview of the Pakistan economy and then focus on financial sector management and monetary management issues facing Pakistan.

The topics and papers covered in the conference were:

### **Session I: Macroeconomic Management in Pakistan**

Over the last few years, Pakistan has been confronted with a host of macroeconomic challenges. Keeping this in mind, the conference began with an overview of the issues facing the Pakistan economy over the last few years and recommendations on how to address the key macroeconomic challenges. Shahid Amjad Chaudhry's<sup>1</sup> paper, 'Pakistan 2011: Policy Measures for the Economic Challenges Ahead', discussed the balance of payments and public finance related issues facing the Pakistan economy. The author argued that these issues can be addressed without resorting to a new IMF programme if certain critical policy changes are made. His key policy recommendations were: (i) allowing the orderly depreciation of the exchange rate in the foreign exchange interbank market by about 5–15 percent or to PKR90–100/US dollar, (ii) imposing import surcharges of 10–20 percent on nonessential imports, (iii) re-imposing measures originally imposed to increase the cost of import letters of credit, (iv) gradually reducing the State Bank of Pakistan's policy rate by 300 basis points in the fiscal year (FY) 2012 from its present level of 13.5 percent, thereby reducing the interest burden on public debt, (v) utilizing these savings to restart the stalled public sector infrastructure development program, (vi) increasing the sales tax rate from its present 16 percent to 18 percent, (vii) increasing custom duties by 10–20 percent on nonessential imports (as also recommended for the balance of payments, and (ix) increasing regulatory and excise duties and restoring their original (FY2011) coverage.

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The paper by Rashid Amjad<sup>2</sup> Musleh ud Din<sup>3</sup> and Abdul Qayyum<sup>4</sup>, 'Pakistan: Breaking-Out of Stagflation into Sustained Growth', also examined the macroeconomic challenges facing Pakistan. The authors discuss that the underlying cause of the macroeconomic problems facing Pakistan today are a series of supply shocks that have constrained output growth. The authors go on to argue that while the current debate has solely focused on government expenditures and revenues, it is critical to also address the acute energy shortages that are constraining supply. The authors then present four recommendations for breaking out of the present stagflation: (i) prudent macroeconomic management, (ii) reviving the role of the government in development while restoring fiscal balance, (iii) loosening monetary policy in order to spur the private sector, and (iv) improving social safety nets.

Inayat Ullah Mangla's<sup>5</sup> paper, 'Reconstructing the Performance of Pakistan's Political Economy: Another Paradigm', looked at the major factors limiting economic growth in Pakistan. The author then analyzed the structural problems faced by Pakistan today and went on to the challenges facing monetary policy makers in Pakistan as well as the problem of the 'twin deficits', budget and trade deficits. The author concluded with a discussion on the key institutional changes needed in Pakistan.

The last paper in this session was presented by Matthew McCartney<sup>6</sup>: 'Pakistan, Growth Dependency and Crisis'. The author addressed the notion that Pakistan was an economy that was dependent on external factors such as trade, financial flows and foreign asset markets, and found that the evidence was far from convincing. The author went on to present a new methodology to test dependency, that of case studies of growth and stagflation, and concluded that the results of this analysis found that growth in Pakistan was primarily driven by the dynamics of the domestic economy.

## **Session II: Capital Account Convertibility and Debt in Pakistan**

Over the last decade, Pakistan and other South Asian countries have aggressively pursued policies aimed at developing capital markets.

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In order to understand these policies in the Pakistani context, the second session focused on capital account convertibility, external and internal debt and the issue of bond market development in Pakistan. The first paper in the session was presented by Irfan ul Haque<sup>7</sup>: 'The Capital Account and Pakistani Rupee Convertibility: Macroeconomic Policy Challenges'. The author looked at the history of capital account liberalization in Pakistan over the last two decades and concluded that the Pakistani capital account is effectively free of restrictions. The author then discussed how the open capital account and rupee convertibility have made Pakistan more vulnerable to external shocks. The author then focused on three major challenges facing the Pakistan's economic policy makers: macroeconomic management, controlling tax evasion (which has been made easier by rupee convertibility) and minimizing the real cost of portfolio investment into Pakistan. The author concluded his paper by offering ideas on how these challenges could be met.

The next paper in this session was presented by Eatnaz Ahmad<sup>8</sup>: 'A Quantitative Analysis of Pakistan's External and Internal Debt'. The author discussed how poor debt management combined with the policies of donor agencies (particularly the IMF) have brought on the present domestic and foreign debt crises. The author presented a qualitative account of the debt in Pakistan and then analyzed the debt data using various debt burden indicators. The author then went on to analyze the economic and social costs of debt overhang in Pakistan and found that net foreign resource flows to the private and public sectors tended to crowd out private and public savings respectively and that public savings is crowded out by resource flows from the private sector to the public sector. Finally, the author found that the resource allocation between development and non-development expenditures did not depend on whether government expenditure was financed by revenues or government borrowing and that more resources are directed towards development activity when government expenditure is financed by foreign resource flows rather than domestic resource flows.

The final paper in this session was presented by Jamshed Uppal<sup>9</sup>: 'Government Budget Deficits and the Development of the Bond Market in Pakistan: Issues and Challenges'. The author discussed how greater fiscal

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discipline could be achieved through enhanced institutional checks and balances as well as through better market discipline. The author went on to look at how bond market development is dependent on sound fiscal policy and how bond markets can, in turn, provide signals on how prudent fiscal policy is. The author concluded that a liquid bond market can play a crucial role in improving fiscal discipline though fiscal discipline can only be achieved through a comprehensive strategy.

### **Session III: Monetary Policy in Pakistan**

In the face of double digit inflation, the monetary authorities in Pakistan have been forced to take aggressive measures, the impact of which was examined in the third session. The first paper was presented by Hasan Muhammad Mohsin<sup>10</sup>: 'The Impact of Monetary Policy on Banks' Lending and Deposit Rates in Pakistan: Empirical Evidence from Pakistan'. The author estimated the impact of monetary policy on lending and deposit rates in Pakistan using data from 2001 to 2011. Though the author found a long run relationship between the lending and discount rates, he did not find a significant relationship between deposit rates and discount rates, which implies that monetary policy pass-through is not complete. The author found that banks only pass on 20 percent of the impact of a change in the discount rate to lenders in the first month and that this pass-through varied across banks. Finally the author performed a short-run analysis and found a pass-through of only 0.16, implying that monetary policy effectiveness is limited in Pakistan.

The second paper in this session was presented by Ather Maqsood Ahmed<sup>11</sup> and Wasim Shahid Malik<sup>12</sup>: 'Macroeconomic Activity and Economics of Inflation: Rules vs. Discretion'. The objective of the paper was to estimate a monetary policy reaction function for Pakistan using data over the period 1992 – 2010. The authors found that the State Bank of Pakistan (SBP) reacts to changes in the inflation rate and economic activity in a way consistent with the Taylor (1993) rule with an explicit objective of interest rate smoothing and exchange rate management. Moreover, they found that for most of the sample period, except for the last two years, policy remained consistent. However during the last two years (a time of significant price hikes and massive depreciation of the

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rupee), there was a significant change in the parameters of the State Bank's policy reaction function. Finally, the authors found evidence of nonlinearity in the State Bank's reaction function since the response to inflation rates above 6.4 percent was found to be more aggressive compared to low inflationary episodes.

#### **Session IV: The Banking Sector, Capital Markets and Governance in Pakistan**

Though Pakistan has tried to pursue financial sector, capital market and governance reforms, there is a lack of consensus on the effectiveness of these reforms. The final session looked at important banking sector, capital markets and governance issues in Pakistan. The first paper in this session was presented by Ayesha Afzal<sup>13</sup> and Nawazish Mirza<sup>14</sup>: 'Market Discipline in Commercial Banking: Evidence from the Market for Bank Equity'. The authors looked at market discipline in the Pakistani banking sector using stock prices from 2004-2009. They found a significant relationship between risk variables (including market risk, value at risk, size and value premiums, default likelihood indicators and relative prices) and GDP growth. The authors also found a significant relationship between their risk indicators and the cost of deposits, implying that banks align direct compensation with their risk perception. Finally, they did not find any link between the market perception of risk and deposit switching.

The second paper in the session was presented by Idrees Khwaja<sup>15</sup>: 'Interest Margins and Banks' Asset-Liability Composition'. The author looked at the determinants of the interest rate margins of Pakistani banks and found that short-term government bonds and the larger share of interest rate insensitive deposits held by banks are the key determinants of interest margins. This result is in contrast to the generally held belief that the market power of banks contributes to high interest margins. The author concludes that while behavioral shifts may reduce the share of interest insensitive deposits, government debt depends on macroeconomic management, implying that containing interest rate margins will be a tall order.

The third paper in the session was presented by Abid Burki<sup>16</sup> and Shabbir Ahmad<sup>17</sup>: 'The Impact of Bank Governance on Bank Performance

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in Pakistan'. The authors looked at the impact of changes in bank governance on bank performance in Pakistan and they found that the cost efficiency of banks improved with changes in bank governance. The authors also found that these governance changes improved the total factor productivity (TFP) of banks that had not themselves undergone governance changes. Finally, the authors found that bank selection for governance changes had a mixed impact on TFP change while bank consolidation seemed to be more effective in improving TFP changes.

The fourth paper in the session was presented by Mahreen Mahmud<sup>18</sup> and Nawazish Mirza: 'An Evaluation of Mutual Fund Performance in an Emerging Economy: The Case of Pakistan'. The authors examined the performance of mutual funds between 2006-2010 and found the most pronounced growth in Pakistani Islamic funds, despite their lackluster performance. The authors also found that income funds appeared to have suffered as a consequence of underdeveloped bond markets and high t-bill rates. The results also show that stock funds in Pakistan consistently hold large cap stocks but not value-oriented stocks. Finally, the authors find no fund managers to outperform the market as all of them exhibit consistently negative or insignificant alphas.

The next paper was by Hamna Ahmed<sup>19</sup> and Naved Hamid<sup>20</sup>: 'Financing Constraints; Determinants and Implications for Firm Growth in Pakistan'. The authors looked at the extent to which firm level growth is constrained by financial constraints and also examined the determinants of financial access in Pakistan. Using data from the World Bank's 2007 Investment Climate Assessment Survey, the authors found that finance is a binding constraint in Pakistan and that access to finance is better where there is a greater penetration of financial infrastructure. Finally, the authors found that a range of internal factors, ranging from size to export status, quality of human capital and organizational form, are important determinants of external financial access in Pakistan.

The final paper was presented by Theresa Thompson Chaudhry<sup>21</sup>: 'Norms of Cooperation, Trust, Altruism, and Fairness: Evidence from Lab Experiments on Pakistani Students'. The author presented results on a

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series of behavioral experiments conducted with students from a university in Lahore, including the prisoner's dilemma, trust game, dictator game, and ultimatum game. The results indicate similar behavior to student subjects in other countries, particularly in the dictator and ultimatum games. The student sample exhibited lower levels of trust and reciprocity compared to both other student and non-student populations. Women behaved similarly to men in the dictator and ultimatum games, exhibited greater tendencies toward cooperation in the prisoner's dilemma game, but lower trust and trustworthiness in the trust game.

The papers presented in the annual conference were aimed at academics, policy makers and the general public. To conclude, we, the editors, hope that this Special Edition of the Lahore Journal of Economics can help to inform the policy debates taking place nationally and internationally regarding economic planning and development in Pakistan.

We would also like to offer special thanks to Inayat Ullah Mangla for his efforts in designing the conference program and organizing the participation of the Speakers.