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Central Banking in Fragile States: An examination of the State Bank of Pakistan's management of monetary relations under financialised globalisation

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introduction

A new literature on the globalisation of financial markets and central banking has developed, especially since the crisis beginning in 2008. While the 'New Consensus' literature developed throughout the 'Great Moderation' and established inflation targeting as a central banking standard, the new literature of globalisation and central banking looks beyond the New Consensus literature by addressing rising issues in central banking. This new literature grapples with the liberalisation of capital markets and the proliferation of financial instruments, in quantity as well as quality, as these changes affect central bank roles of regulating money. Indeed the relatively closed national economies of twentieth century theory are superseded by incredible growth in financial flows, which complicate the inter-locking tasks of maintaining the value of a currency through limiting the expansion of credit and manipulating the demand for foreign currency, while ensuring adequate availability of money as well as system-wide growth and stability.

While these demands on central banks are difficult to reconcile in wealthy countries, and even more so in 'emerging economies', a further set of complex imperatives face least-developed and fragile states. This paper explores central banking in Pakistan in light of the new literature on central banking in order to better understand how changes in global financial markets, and their mediation by the State Bank of Pakistan (SBP), are being played out in the domestic economy. Pakistan offers an important case study in this regard because it undertook radical reform in the 1990s to align its financial markets and monetary policy with globalizing financial markets. As a result, Pakistan has a sophisticated financial infrastructure and open financial markets that accommodate standard marketised monetary policy as well as non-bank financial firms and complex securitized financial products. Yet it is also very much a fragile state, both politically and economically, with vast poverty, extremely low social indicators and a low level of financial participation amongst the population.

The paper proceeds with a brief review of major themes in the new literature on globalisation and central banking, touching on central banking in emerging economies before considering the relevance of the issues raised to the case of Pakistan and exploring some of the permutations of monetary policy roll-out in Pakistan.

New literature on globalisation and central banking

The new literature on challenges to central banking deals with overarching themes of greater volatility in monetary indicators and greater impacts of external conditions on domestic economies that arise with greater integration in both trade and financial markets. As capital flows and trade are liberalised, the domestic economy no longer functions as a captured market for financial instruments, and inputs as well as final products from abroad make up a greater share of GDP. For the economy in general, the external sector becomes increasingly important, which carries through to the balance of payments as the current account exhibits greater flows, and surpluses or deficits must be transmitted through the capital account (otherwise known as the financial account). At the same time, greater financial flows both within and between domestic markets (that is, both spatial and functional capital mobility) (Watson, 2007) weaken the central bank's control of the aggregate money supply and introduce aspects of competition to selling and buying debt because captured markets are no longer compelled to buy, for example, government debt regardless of its quality and price. These changes constitute a major overhaul of the international financial system, exposing national economies to a level of volatility and contagion, as well as convergence in interest rates, completely removed from the circumstances of the Bretton Woods system or those that preceded it.

Foundational to the new literature on globalisation and central banking is the loss of central banks' control over the circuit of money in the domestic economy as relatively closed economies become opened to a proliferation of variously formed capital flows. It is broadly accepted that financial innovation has created new assets that perform at least some of the functions of money, which invalidates a central bank's control over the quantity of money. That is, there was once an understanding that a central bank can limit the quantity of money in the economy in order to maintain the value of each unit of money in relation to its functions of being spent, lent, saved or used as collateral on a loan. Whilst the idealized policy agenda of monetarism, which was attached to this discourse of money and proposed monetary aggregate targeting, had only a short period as central bank orthodoxy, there remains a conception that the state's monitoring of the quantity of money in circulation is critical to effective monetary policy. Indeed money supply (M2, M3 etc.) remains an important monetary indicator and a significant number of mostly developing countries continue to target monetary aggregates, usually as part of IMF-sponsored programs (IMF, 2012; Lim and Sriram, 2003). Yet as other forms of capital start to undertake some of these functions of money, the money aggregate loses its ability to represent the amount of 'money' in the economy. With this proliferation of near-monies as well as a new mobility between different forms of asset class and a new mobility between different national financial markets, a central bank's task of controlling the value of money by controlling its availability is significantly undermined. Moreover as central banks shifted their targeting to the price of money (interest rate targeting), banks became increasingly able to access 'off shore' money, be it directly or through derivatives, which similarly diluted central bank control over money in the economy both directly, as central bank control over the availability and price of money weakened; and indirectly, as impacts of official interest rates on the exchange rate no longer played out predictably. This loss of control over the national monetary economy relates to the greater synchronization of the business cycle across the globe and the increasing responsiveness of interest rates and asset prices to international conditions.

Moreover, without a currency's value anchored even indirectly in the value of gold, the value of the unit of measure is volatile and becomes itself an asset class. Volatility in the unit of measure itself raises the specter of incessant volatility as balance sheets are constantly revalued in the absence of any certain value. One way that the new literature deals with this issue is in terms of central bank balance sheets by casting it as a problem of 'the valuation channel', whereby exchange rate movements revalue the external position of a country (Lane and Milesti-Ferretti, 2005). The scope of the valuation channel to affect an economy has increased significantly because foreign asset and liabilities holdings are larger and more dispersed under financial globalisation.

Another aspect of central banking under increasing instability relates to the competitive nature of soverign debt issue and the relationship between central banks and fiscal policy. YV Reddy refers to this as the ‘fiscalisation of the financial sector’ and the ‘financialisation of fiscal policy’, whereby the consideration of global financial markets’ views on sovereign viability become increasingly important in the absence of the captured markets of the pre-1980s (Reddy, 2012). While this raises a raft of issues related to new limitations on fiscal policy under financialised globalisation, an immediate aspect of the financialisation of fiscal policy, at least insofar as government borrowing from the central bank becomes increasingly attractive, is the issue of the size of central bank balance sheets vis-à-vis financial market growth. While rapid financial market growth implies the relative shrinking of central bank balance sheets and therefore a shrinking of central bank clout and affectivity in influencing prices, complications arise when central bank balance sheets become too large. Certainly this issue was revealed in the 2008 global financial crisis whereby the scale of the crisis forced the US Federal Reserve to undertake dramatic lender of last resort activity as well as large-scale purchases of securities issued by the Treasury. As such, growing financial markets can blowout central banks’ balance sheets to quantitative levels incongruous with the taxing capacity of governments that stand behind their central banks (Davies and Green, 2010: 20; Cecchetti, 2011). Moreover, the riskier asset composition of outgrown central bank balance sheets in the wake of the crisis raises the same issues (Lamfalussy, 2011), which loom large given that key central banks became “something completely new” during the crisis by assuming a new role as ‘dealer’ or ‘market-maker of last resort’ (Mehrling, 2011: 2). This is a problem of systemic insecurity as well as weakened credibility, which arises with larger (and riskier) central bank balance sheets as central banking adapts to larger financial markets.

However the massive growth of central bank balance sheets in advanced economies has also raised concerns over the prospects of future winding back of the marketisation of monetary policy, generating debate around the separation of central banks from government debt management as envisioned in the doctrine of central bank autonomy (Davies & Green, 2010; Eichengreen et. al., 2011) by raising the specter of the re-politicisation of central bank policy (James, 2010; Cecchetti 2011; Lamfalussy, 2011) because governments in advanced countries have incurred large amounts of debt in their response to the financial crisis and may again need captured banking markets to maintain that debt (Eichengreen et. al., 2011). These developments in the relationship between central banks and fiscal policy are a major threat to the Consensus that had arisen ba1ed on the dual goals of price stability and central bank independence (Lamfalussy, 2011), leaving an open question around how central banks can generate impact on financial markets without assuming a portfolio so large that it defies central bank credibility and limits the central bank’s ability to function unhindered by the demands of elected government.

The threat posed to the global financial system by the global financial crisis has also prompted calls for a revision of central banking norms seeking to better account for financial stability (Goodhart, 2011; Borio, 2011; Eichengreen, et. al., 2011; BIS 2011). This has generated discussion around new macroprudential tools to reduce the risk of crisis and contain contagion, however there is little consensus on the financial stability mandate (Crockett, 2011) both because the denationalized nature of modern firms and production imposes difficult conditions upon this task (Davies & Green, 2010) and because a greater role for central banks in financial stability again puts central bank independence under question (Lamfalussy, 2011; Caruana, 2010). Debates around greater emphasis on financial stability, furthermore, raise difficult questions around central bank resistance to targeting financial asset price inflation since asset prices play the crucial role of providing a rate of return on capital (Bryan, 2011). The prospect of targeting asset price inflation thus sits uncomfortably with the market-oriented foundations of the consensus that developed in monetary policy before the global financial crisis around inflation targeting.

It is not, however, only the financial crisis that has prompted a new literature on new monetary policy tools. Rather globalised financial markets have been threatening the traditional transmission mechanisms of monetary policy for some time. Although the financial crisis clearly demonstrated the limitations of central bank balance sheets given huge growth in financial markets, the limited sway on prices of smaller central bank balance sheets amidst bigger financial markets has been a looming issue since long before the crisis (Clerc & Thuadet, 2007). Moreover, financialised globalisation affects each of the transmission mechanisms as discrete national markets give way to integrated global markets. Indeed foreign borrowing and lending, and disintermediation more generally, reduce the impact of monetary policy changes on credit supply and complicate the relationship between interest rates, exchange rates and bond prices. For example, when foreign interest rates are low, foreign borrowing can circumvent domestic central bank attempts to reduce credit supply or capital inflows can increase with the formation of a carry trade, pushing bond prices down due to external demand in times of monetary tightening (Singh, 2012). Such cross-border spillovers have arisen as an important issue especially since quantitative easing programs have become a key monetary policy mechanism in some advanced countries (Eichengreen et. al., 2011; Chen et. al., 2012) reflecting the increased impact of external conditions on local economies and the weakening of central bank control over national economies.

Financialised globalisation and monetary policy in emerging economies

This new body of literature on rising challenges to central banking includes a considerable body of work on emerging economies, largely prompted by the global financial crisis. Aside from the issues raised above, this body of literature focuses largely on the problem of reconciling management of the contradictory imperatives of the exchange rate, interest rates and inflation in open, export-dependent economies. These issues relate to foreign reserve management, sterilization, global imbalances, debt composition and exchange rate regimes, all of which have generated a considerable literature.

Crucial to emerging economies, financial innovation and the liberalisation of capital flows has fostered financialisation of commodity markets creating greater volatility in commodity prices: as commodities have become a financial asset class through commodity derivatives, commodity prices have decoupled from more steady dynamics of supply and demand related to production and consumption, resulting in increasing price volatility (UNCTAD, 2011). These fluctuations in value clearly complicate a central bank's task of maintaining stability across the economy since sharp fluctuations in commodity prices can open large and unexpected gaps in the current account and can pass-through external inflation. These issues are particularly pertinent in emerging economies where commodity trade is central, and represent a set of problems that are magnified with greater integration. Problems in maintaining price stability are magnified given that greater integration brings higher levels of imports, including in intermediate goods, that can create inflation with local currency depreciation (Orlik & Toporowski, 2007) or with import price instability in commodities (Singh & Gokram, 2012). A central bank's response to inflation related to commodity imports, moreover, is complicated by the free capital flows of financialised globalisaiton. Under a regime of open capital flows, central banks' traditional response of raising interest rates to suppress inflation can attract capital inflows and appreciate the currency, reducing competitiveness of economies in which external sectors have become increasingly important. While capital inflows can be sterilized, this in turn carries costs, which have become a significant concern for central bank governors in recent years (Mihaljek, 2012). The increasing importance of this problem of trade and capital's contradictory pulls on exchange rates, especially in the extremely low-interest rate post-crisis environment, has generated discussion around alternative tools, such as capital controls, to limit inflows and protect competitiveness without compromising interest rate movements aimed at inflation control. While the IMF has begun to grudgingly accept that capital controls may be useful in some limited circumstances (IMF, 2012), the widespread use of capital controls threatens to wind back past decades' very large gains in financial and trade liberalisation.

Debates around alternative tools to minimize these issues, such as capital controls and reserve requirements, are then a response to the failure of the automatic adjustment mechanism of floating interest rates (Eichengreen et. al., 2011) because of the imperative of external competitiveness in an integrated global economy. Indeed developing countries have in recent years moved away from freely floating currencies, reflecting the fact that exchange rate management to support external competitiveness is an important policy priority in many countries with open markets (Moreno, 2012). These issues tie into debates over international imbalances as surplus countries defy market revaluation of their currencies in order to prolong their exports' competitive edge in the global market, accumulating large foreign reserves in the process which allows them to intervene in foreign exchange markets to maintain 'undervalued' exchange rates and sterilize foreign inflows. The particularly severe threat to global stability that has arisen in recent years with the failure of the automatic adjustment mechanism to avoid the generation of persistent imbalances has raised analogies in the literature with the failure of the adjustment mechanism under extraordinary debt levels ('imbalances') in the inter-war years (Ahamed, 2009).

Without delving into the extensive literature on exchange rate regimes, characterized by a debate over whether or not emerging economies can viably maintain intermediate regimes between either a hard peg or a free float (Eichengreen, 2002), a final aspect of the literature on globalisation and central banking in emerging economies relates to the composition of central bank balance sheets. Of debate here are concerns over a general shrinking of maturities in emerging economies, reflecting negative market perceptions of emerging economy public and private debt (Schmukler and Vesperoni, 2006). While this raises issues around maturity mismatch and instability particularly pertinent after the crises of the 1990s, a broader perspective reflects concerns around the dearth of long-term investment in many developing and emerging economies as structural development is dependent on financial market funding, the outlook of which tends to be very much short term in nature, in a way that did not apply to advanced economies' development (Moreno, 2012). Another concern, raised in the aftermath of the 1990s crises, is of currency mismatch relating to foreign borrowing whereby the unviablity of issuing local currency-denominated emerging economy debt in international markets is raised as extremely costly to emerging economies as well as contradictory to financial rationality (Eichengreen et. al., 2005). This concern prompted discussion in the literature, followed by policy action, around replacing foreign debt with domestic debt. However various more radical alternatives seeking to circumvent the related inability of developing countries to 'deflate their way out of debt crisis' by overvaluing their currencies in order make foreign debt servicing more affordable, are generally deemed unviable.

Financialised globalisation and monetary policy in Pakistan

This brief review of the new literature on central banking reflects the seeds of a rethinking of monetary policy prompted largely by the global financial crisis, but also by the processes of financialised globalisation more generally. The New Consensus's assumptions about the primacy of inflation targeting as a goal of monetary policy has been unseated with the problem of financial instability; the separation of central bank policy from fiscal concerns has come into question with the large acquisitions undertaken in response to the global financial crisis; and international spillovers from monetary policy decisions have arisen as a new and significant concern at the same time as the transmission mechanisms of monetary policy themselves have appeared increasingly threatened by global financial integration. While some label this a crisis of central banking (The Economist, 2007) or a time of 'seismic shift' (Goodhart in Cecchetti, 2010: 5) as central banking enters 'uncharted waters' (Lamfalussy, 2011), the additional issues that arise in least-developed and fragile states represent additional complication to an already opaque exercise in monetary control. Indeed the kinds of issues raised in the new literature apply in many regards to least-developed and fragile states. Using the case study of Pakistan, an economy that is at once largely undeveloped, with only some 10% of the population holding bank accounts (Khan, 2012) politically and economically fragile; and with relatively open financial markets, it becomes apparent that the SBP faces many of these challenges posed by financialised globalisation. This section proceeds by discussing how the issues raised in the new literature relate to monetary circumstances in Pakistan.

The proliferation of near-monies is cited as an issue in Pakistan that has weakened the SBP's money supply targeting regime, which persists despite money-supply targeting being long abandoned in advanced countries (Zaidi & Zaidi, 2011). Rapid structural change and financial innovation in Pakistan have made relationships between interest rates and money unstable, undermining the central bank's control over money in the economy (Akhtar, 2008; Moinuddin, 2009).

The problem of constant repositioning of the country's external investment position is also very much a concern in Pakistan given the country's high external debt obligations. One measure undertaken in response to instability in the valuation channel has been requirements that private foreign exchange loans be hedged by derivative contracts (SBP, 2011: 64). The SBP faces contradictory pressures in this regard insofar as currency appreciation is favourable to reducing the value of the state's very large foreign debt holdings yet currency depreciation is favourable to supporting economic growth through the export sector and balancing external payments. This dilemma is one aspect of Eichengreen and Hausmann's 'original sin' (Eichengreen et. al., 2005).

The issue of the competitive nature of sovereign debt issue and the relationship between central banks and fiscal policy is also a prominent concern in Pakistan. However while these issues have arisen in advanced economies only in the wake of the global financial crisis, they have long been of concern in Pakistan. Indeed the loss of captured markets for government securities has raised the cost of state borrowing so that Pakistan consequently finds itself on the precipice of debt crisis (Ahmad, 2011; IMF, 2012). The minimal foreign currency-denominated debt issues that the state has undertaken (Das et. al., 2008) reflect the weak competitive position Pakistani sovereign state on international markets, resulting in high costs of these issues. The weak viability of such eurodollar issues thus pushes the state towards higher rupee-denominated debt issue, which removes potential currency mismatch but remains limited because of the relatively small demand for state debt in the domestic economy and weak international demand for rupee-denominated assets.

As reflected in the literature, the SBP faces a precarious situation in maintaining an optimal balance sheet, both in terms of size and of the quality of assets. On the one hand, its balance sheet must be large enough in relation to growing financial markets so that central bank operations exert some sway on prices, whilst on the other hand the credibility of the SBP is undermined when the balance sheet is discordantly large in relation to the taxing ability of the state that stands behind it. The SBP's poor record of meeting its targets suggests that the bank has, indeed, little sway on prices (Meenai, 2010). In relation to the credibility of ballooning central bank balance sheets, a major issue in this regard in Pakistan, and analogous to advanced economies' responses to the financial crisis, is the very significant problem of non-performing loans in the Pakistani economy (IMF, 2012). The SBP faces a difficult balance in retiring these non-performing assets without prompting a chain of financial sector failures nor undermining its own viability and credibility by assuming too much failed debt on its own books.

More pertinent in the literature, however, is the problem of fiscal deficits compromising the ostensible independence of the central bank. With extremely low levels of taxation, a series of natural disasters in recent years and high levels of subsidies on basic-needs items, international prices of which have fluctuated significantly in recent years, fiscal deficits have remained high (IMF, 2012). The difficult place that the government and the SBP find themselves in over this issue reflects a fear of popular discontent in the face of a full carry-through of international commodity price instability in the economy, which must be weighed up against the demands of the IMF, funding from which is intermittently imperative to the viability of the state. Certainly the SBP works very hard with the IMF to present itself as an independent central bank and although a series of formal arrangements between the government and the SBP propose central bank independence (Janjua, 2008), a tacit arrangement appears to exist reflecting the substantive subordination of the SBP to the government's debt requirements. While a question mark has only recently arisen in advanced economies over the viability of central bank independence as fiscal policy is increasingly beholden to market perceptions yet has accumulated significant new levels of debt that are of questionable sustainability, the SBP has long been battling with this issue that the advanced economies are only recently beginning to face. That said, the winding-back of the marketisation of monetary policy does not appear to be a prerogative of the SBP. Given Pakistan's dependence on IMF loans, it is unlikely that Pakistan will radically alter its monetary policy structures and processes without the support of the IMF.

While the debate on putting greater emphasis on macroprudential measures as core to the central bank's tasks has produced little consensus in the international arena, the implementation of macroprudential measures present a greater challenge in countries such as Pakistan where the growth imperative weighs more heavily in the trade-off between financial stability and economic growth. Indeed the former governor of the SBP calls for limited implementation of Basel rules in Pakistan so as to avoid constraining the fledging financial sector (Husain, 2011), echoing broader concerns of Basel implementation raising credit costs constraining economic growth (Subbarao, 2012). This desire to avoid suppressing financial market development may explain persistent implementation gaps in the regulation of the non-bank sector (Husain, 2011), however it poses a threat to systemic stability, not least because of uneven financial market development that has created some sophisticated financial products and trading strategies that contrast the country's otherwise fairly shallow financial markets.

In regards to the weakening of monetary policy transmission as financialised globalisation gathers pace, it is recognized in the small body of literature on monetary policy in Pakistan that financialised globalisation is effecting transmission in a series of ways. Firstly, financial innovation, as mentioned above, is altering the relationship between money and inflation making the dynamics of transmission uncertain (Akhtar, 2008). The instability of the rupee leads to greater dollarisation in borrowing and lending as well as in the holding of savings, which undermines monetary policy by permitting greater substitutability between domestic and foreign assets (Mirakhor and Zaidi, 2004) and by generating contradictory wealth effects through the exchange rate (Eichengreen et. al., 2005). The greater role of imported intermediate goods as well as the imperative to protect external sectors through exchange rate intervention undermines the exchange rate channel. Shallow financial markets limit the asset price channel and uncompetitiveness in the banking sector limits the traditional interest rate channel by limiting the carry through of rate changes into deposit and lending rates. Finally, it appears that the bank lending channel is weakened by the high reserve positions held by banks due to their dependence on buying and holding treasury bills, seen as both lucrative and risk-free (SBP, 2011) in an economic environment of low investment and credit demand (IMF, 2012: 8-9). In this regard, a loosening of monetary policy, then, fails to induce banks to lend more because excess reserves ensure that banks are not positioned near their threshold of maximum lending in relation to their reserve levels.

Other characteristics of least-developed and fragile states such as Pakistan create additional obstructions to the smooth implementation of effective monetary policy. The low degree of monetization combined with an informal market, estimated at greater proportions than the formal market (Arby et. al. 2010), hinder monetary policy by putting large parts of the economy, including capital flows, beyond even the notional control of the SBP while providing a set of black market interest rates that do not respond to official rate changes. Typical of least-developed and fragile states, these issues are exacerbated by the failure of foundational micro- and macro-economic relationships in the formal economy and dysfunction in the financial sector. For example, money demand is found to be unstable (Moinudden, 2009), low savings rates have resisted responding to higher interest rates since financial reform in the 1990s and investment rates, too, do not appear to relate to interest rates (Nasir & Khalid, 2004; Agrawal, 2000). In fact, the banking sector is barely intermediating between savings and investment, with rates of both very low and spreads between deposit rates and loan rates very high reflecting an uncompetitive banking sector despite privatization and the entry of foreign banks (IMF, 2011). Instead of performing a traditional intermediary role, the banking sector is instead dependent on buying and holding government securities in order to remain viable (SBP 2011). Similarly, other sectors are also considerably profitable yet do not perform their traditional roles in supporting economic growth. For example, like in other developing countries, despite high returns (SBP, 2011) the stock market does not fund investment and stock index movements tend to be related to external, rather than internal, dynamics (Orlik &Toporowski, 2007) while corporate bond markets remain marginal (Khalid, 2007). Shallow financial markets as well as a largely unmonetised economy and dominant informal market all impede central bank functions.

Finally, a brief analysis of the applicability of issues raised in the literature on globalisation and central banking in emerging economies suggests that Pakistan faces the same issues as more developed, open, export-oriented economies.

Imported inflation from commodity price instability is of significant concern in Pakistan (Moinuddin, 2009; IMF, 2012: 9) and the large current account deficits on account of sudden large increases in commodity import costs in recent years has threatened balance of payment crisis, carrying over into pressure on foreign exchange reserves (Akhtar, 2008) and prompting greater foreign debt accumulation with IMF emergency intervention. Thus, given that the current account represents one of Pakistan’s single greatest vulnerabilities, commodity price instability raises difficult problems for the SBP’s pursuit of stability in the domestic economy and balance of payments.

Moreover in regards to imported inflation, inflation levels indeed appear to be rooted largely in commodity price instability, especially in regards to oil-related imports, which presents significant challenges to SBP inflation control given that raising interest rates to control inflation at once dampens domestic growth and can attract capital flows that then appreciate the PKR, undermining export competitiveness. In fact this predominance of commodity-related imported inflation suggests that inflation in Pakistan is a problem of supply, not of demand (Arif, 2011) and that interest rate movements cannot close the output gap. As Ul Haque (2011) points out, unutilized capacity is primarily related to problems in electricity supply rather then to aggregate demand. Higher interest rates to suppress inflation, then, work against economic growth with little effect on inflation itself, evident in widespread findings that monetary policy has had little affect on controlling inflation in Pakistan (Dars, 2011).

Similarly, and as per the literature on emerging economies, Pakistan also faces the problem of contradictory pulls on the domestic economy as global capital flows complicate the management of the exchange rate, the interest rate and inflation, invalidating traditional policies to promote growth. For example, in 2003 and 2004, the SBP loosened its monetary policy stance in order to keep the PKR from appreciating in the face of large foreign inflows in an effort to stimulate growth through low interest rates and a low PKR value, rather than endure higher interest rates and a higher PKR value through sterilization. However this fuelled a boom in consumer credit that raised the burden of non-performing loans in the years to come, straining future banking sector viability, as well as feeding bubbles in the stock market and real estate sectors, which destabilized the economy further. Moreover the SBP's growth stimulus spilled over into greater imports, which worsened the trade deficit, threatening the balance of payments (ul Haque, 2011). Conversely, after the 2008 financial crisis in Pakistan, the SBP sought to raise interest rates and restrain monetary expansion in order to reduce the fiscal deficit and inflation. However with the PKR still low from the crisis and real interest rates low due to inflation, the nominal increase in interest rates yielded high real returns in terms of foreign currency. This fuelled inflows of foreign capital undertaking carry trade transactions, which pushed up the value of the PKR at the cost of external competitiveness (ul Haque, 2011).

In regard to these problems of managing the exchange rate under open markets, Pakistan's retreat from a push towards a free float of the PKR (IMF 2012) reflects strong pressures from the domestic business community to restrict exchange rate fluctuations (Akhtar, 2008), which is also important to the SBP given that exchange rate and default premiums on bonds rise with currency volatility (Khalid, 2007). Certainly the SBP, like most other developing countries, has prioritized exchange rate intervention. However intervention requires ample foreign exchange reserves, which have been severely constrained in recent years given the country's high current account deficit, exacerbated by a collapse in FDI and portfolio investment and reductions in aid flows. Thus while some advocate for the free float of the rupee so that it can perform a role as automatic adjustment mechanism (Zaidi & Zaidi, 2006), the SBP's resistance suggests that the costs on the external sector are deemed too high. However, the failure of the automatic adjustment in turn brings its own costs, not least a precarious level of reserves bringing intermittent threats of balance of payments.

Indirect impacts of monetary policy in pakistan

The SBP's attempts to resolve the kinds of issues raised in the literature related to globalisation and central banking has generated secondary impacts on the economy. This section very briefly explores some of these impacts in order to get a better sense of how globalised financial markets are affecting central banking as well as the wider economy in a fragile and least-developed state such as Pakistan.

Arguably the single biggest problem that has emerged out of the SBP's attempts to harness financialised globalisation through radical market-based reform of financial markets and monetary policy is the problem of funding recurrent current account deficits. This imperative has been fulfilled by a number of short-term strategies that bode poorly for the future sustainability of the economy and the PKR.

Firstly, the state has been forced to undertake a series of IMF bail out loans in times of acute balance of payments stress. These loans have contributed significantly to foreign debt accumulation, exposing the state to currency mismatch that presents a conflict with other sectors of the economy that seek a cheaper PKR in order to protect export industries. More importantly, debt-servicing costs constitute the national budget's greatest outlay, representing massive costs where development spending is urgently required (IMF, 2012b).

Secondly, the SBP has developed a very significant reliance on remittances to cover current account gaps (SBP 2012). Aside from the social costs of a significant expatriate, largely male and unskilled workforce, the incentives that the SBP has introduced to secure these flows has generated a series of problematic outcomes for the economy more generally. At the most direct level, incentives schemes to bring remittance flows from informal channels (ie. the *hundi* market) into the formal market entail costs as the SBP reimburses commercial banks at a percentage of the flows that they attract and maintains tax-free status on foreign currency deposits (Amjad et. al. 2012). More importantly, however, the 'no questions asked' policy relating to the source of funds in foreign currency accounts (ul Haque, 2011), which ostensibly serve expatriate workers, equates to the central bank formalizing informal market revenues given the imperative of hard currency accumulation in the economy. The same practice is found in some domestic-currency instruments operated through the National Savings Scheme as well as a series of amnesties for financial market investment, which provide money-whitening tools for informal market revenues (Reuters, 2013). Such a path towards balancing payments falsifies the assumption that the central bank is working within the formal economy to strengthen the formal economy while the informal economy works outside of the formal state; the informal economy is in fact an important and highly integrated component of the national economy and its formal management.

Another aspect of the financial infrastructure built by the SBP to support its reliance on remittances is the hedging facility that foreign currency deposits provide to the minority of the population that has access to hard currency. Foreign currency deposits, which are also tax-free, provide a hedge against the decline of the rupee which leaves the burden of currency risk on the bulk of the population who are without access to hard currency; that is, on those both least able to afford and least able to resist the cost of currency risk. The same dynamic plays itself out across the very uneven landscape of financial market development in Pakistan whereby hedging products such as derivatives and better value savings instruments are only available to a very small portion of the population. Those least able to afford risk exposure because they don't have access to hedging facilities seek economic viability and stability for their families through labour migration, the human face of the remittance flows crucial to the SBP's exchange rate management strategy, as well as through recourse to informal markets and resistance to expanding monetization, for example through subsistence agricultural cultivation and resistance to the imposition of money wages (as opposed to sharecropping) in the farming sector.[1]

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[1] Resistance to the conversion of sharecropping arrangements to daily wage arrangement between landowners and cultivators has arisen as an important issue in the agricultural sector since the Musharraf era, as cultivators resist the greater insecurity in their incomes that arises with wage labouring (see Gazdar, 2009). The conflict at Okara Military Farm in 2004, which mobilized the international human rights lobby, was initiated by

Finally, the imperative of attracting hard currency flows has affected the structure of the economy through upward pressure on the exchange rate in line with the phenomenon of 'Dutch disease'. Heavy remittance flows have caused appreciation of the PKR which puts pressure on the trade balance and concentrates profits in the non-tradeables sector; that is, away from agriculture and industry where the greatest productivity gains tend to be developed and towards services and real estate (Makhlouf & Mughal, 2001). In a direct fashion as well, remittances have fuelled consumption with very little remitted money put towards investment (Meenai, 2010). Similar problems arise in relation to other inward hard currency flows, such as FDI and aid flows, which have become crucially important with an open capital account bringing greater integration and a consequently larger current account deficit. FDI, for example, has tended to be concentrated in sectors serving local consumption, as well as in mineral extraction and the financial sector, offering little benefit to productivity growth in the economy more generally (Khan & Khan, 2011).

It is noted that these permutations that arise as a result of the SBP's efforts to sustain the economy's current account apply to advanced countries only to a much lesser degree. Like ballooning post-crisis central bank balance sheets that are discordant with the taxing ability of the state, advanced economies can also run significant current account deficits. In both regards, a balance sheet approach suggests that financial markets will detect weak 'fundamentals' in an unsustainable current account deficit and a precarious central bank balance sheet, and will respond by selling off assets in the economy's currency. However, the advanced economies remain largely immune to these problems. Least-developed and fragile states, on the other hand, carry debt levels and domestic-denominated assets that are not backed by political-economy reputations of the order of those of advanced states so face a glass ceiling, largely unrecognized by 'rational' approaches to monetary economics such as the balance-sheet approaches employed by the IMF.

Conclusion

This brief review of the new literature on central banking and the globalisation of financial markets has attempted to develop a sense of the complexity of the monetary aspects of state fragility under rapidly changing conditions of financialised globalisation. The overarching themes of greater instability and greater exposure of the domestic economy to external conditions that arise in the new literature on central banking under conditions of financialised globalisation are shown to be of pertinent concern to the SBP. This brief review provides context to findings in the literature of the weakness of monetary policy transmission in Pakistan (Dars, 2011; Meenai, 2010). As the preceding discussion suggests, the SBP has been neither able to control inflation, regulate financial stability nor ensure compliance with conditions required for the automatic stabilization mechanism of freely floating the rupee. This raises questions around the legitimacy of the SBP and central banking more broadly under conditions of financialised globalisation.

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cultivators' resistance to the transfer of cultivators' status from sharecropping to day labouring contracts (see Human Rights Watch, 2004).

In regards to inflation, greater integration imports inflation into the economy invalidating the tightening of monetary policy as a tool to close the output gap and produce price stability. Thus the SBP's core task of controlling inflation is in fact largely beyond its grasp. Moreover, financialised globalisation has complicated policy outcomes, so that a monetary policy tightening may raise systemic instability by prompting capital inflows as well as generating sterilization costs.

In regards to financial stability, as the former SBP governor Ishrat Husain suggests (2011), the possibility of addressing financial stability is severely limited by the need for financial market depth that is prerequisite to monetary policy efficacy as per the current consensus on central banking. This dynamic is echoed in the greater weight of the growth imperative in the broader trade-off between stability and growth in least-developed and fragile states. A further aspect of ensuring financial stability, moreover, is the targeting of asset prices in policy approaches to inflation. Yet asset price targeting introduces a new level of regulation over the rate of return in the economy raising a new domain of political conflict (Arestis & Sawyer, 2004) while contradicting the core premise of the dominant consensus's market-based monetary policy.

In regards to the automatic stabilization mechanism of freely floating currencies, the SBP's prioritisation of the external sector that is reflected in its foreign exchange intervention program reflects the same policy choices as those of developing countries in general. This resistance to free floating shows that, again, the SBP's control over the domestic economy is reduced under financialised globalisation and its policy tools both complicated and undermined. That is, the SBP faces adversity insofar as it cannot provide requisite conditions for the automatic stabilization mechanism of a freely floating currency because integration has elevated the external sector to a position of inflexible prioritization. Yet without an automatic stabilizing mechanism, a raft of new costs and consequences associated with foreign exchange intervention arise.

This discussion suggests that the SBP cannot control monetary indicators under financialised globalisation. This concurs at once with the mainstream literature's findings of ineffective monetary transmission in low-income countries (Mishra & Montiel, 2012) as well as the broader concerns of the heterodox literature that propose endogenous money and an element of paradox to the apparent effectiveness of inflation targeting during the 'great moderation' (Arestis & Sawyer, 1998; Lavoie & Seccareccia, 2004). Indeed this discussion points beyond standard mainstream calls for better data collection or deeper financial markets, towards more fundamental issues of incongruity between financialised globalisation and central bank control over domestic monetary indicators. By emphasizing strong pressures that undermine monetary policy affectivity in Pakistan, this analysis provides evidence of the increasing relevance of a political economy perspective on central banking that elevates the role of central banking discourse in normalizing dominant economic structures, over central banking roles in controlling monetary indicators (Gabor, 2011; Grabel, 1998). That is, the SBP can be understood to face a series of impossible tradeoffs in undertaking its mandate that equate to policy impotence. Yet the SBP provides a stabilizing discourse that normalizes the shift towards integration into global markets and provides a key partner to the IMF and other bi- and muli-lateral donors.

In summary then, the new literature on central banking and financialised globalisation presents a crisis of central banking that is only more severe in least-developed and fragile states as states struggle to maintain economic management capacities amidst greater global integration. The progressive weakening of central bank capacities suggests that other central banking roles beyond conventional monetary policy may constitute more salient central banking tasks under financialised globalisation.

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