Restructuring of Financial Sector in Pakistan

Hanif, Muhammad N.

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By

Muhammad Nadeem Hanif

Email: muhammadnadeemhanif@yahoo.com

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The vision for the sector is for a market-oriented, predominantly private system that operates under a strong regulatory framework, supported by an effective legal and judicial system, and intermediates resources in response to price signals, independently of vested interests.

Backdrop

Financial sector of a country comprises entities engaged in transactions involving financial instruments in money, capital, and foreign exchange markets. This sector has strong linkages with other sectors of the economy like external, fiscal and real[1] sectors. Particularly, its implications for real sector and its role as an engine of economic growth has gained almost consensus among modern economists (although consensus among economists is a rare species).

The literature on financial aspects of development and growth dates back to the early work by Gurley and Shaw (1955). The intellectual basis for restructuring of the financial sector was provided by McKinnon (1973) and Shaw (1973). Then there were several empirical studies showing positive correlation between level of financial development and economic growth and a negative correlation between financial repression and growth. Caprio (1994) showed that efforts to reform finance paid off in higher efficiency and growth. Levine (1997) provides a comprehensive review of literature on financial development and economic growth. Most recent evidence of strong implications of financial distress and systemic instability on the real economy is provided by East Asian crisis.[2]

At the backdrop of the heroic works by McKinnon and Shaw, empirical studies in favour of financial liberalization, and conditionalities put by international donor agencies, process of financial restructuring was started in 1980s by most of the developing countries

[1] Real sector consists of output, inflation and employment. Note that inflation is studied under real sector, notwithstanding Friedman's notion that inflation is purely a monetary phenomenon.
[2] According to some estimates, East Asian economic crisis, one main cause of which was financial sector weaknesses (Azizul Islam, 1998), cost, 20-25 percent of GDP.

including Pakistan. This essay reviews the process of financial reconstruction in Pakistan. We open the discussion with the mechanism by which financial sector affects growth. Then we go on to an account of the era of financial repression (1972-90). After setting a locale, we will present theory and evidence of reforms in Pakistan. An evaluation of reforms in terms of certain indicators will be the next section. The essay will be concluded with some remarks based on the discussion put in the main text.

Financial System in Action

The emergence of financial sector is the result of time and space inconsistency of supply and demand of loanable funds, costs of acquiring information, and making transactions in an uncertain environment. Put differently, in a Arrow (1964) and Debreu (1959) state-contingent claim framework, with no information and transaction costs, there is no need for financial system. Thus, any theory of the role of financial system in economic growth adds specific frictions to the Arrow-Debreu model[3]. Financial markets may arise to ameliorate the problems created by information and transactions frictions. Different types and combinations of information and transaction costs motivate distinct financial contracts, markets, and institutions. According to Levine (1997), a financial system performs the following functions:

- Facilitates the trading, lodging, diversifying, and pooling of risk
- Allocates resources
- Monitors managers and exerts corporate control
- Mobilizes savings, and
- Facilitates the exchange of goods and services

Each of the above functions affects economic growth through two channels: capital accumulation, and technological innovation. The financial system affects capital accumulation and hence the economic growth either by altering saving rate and/or by reallocating savings

[3] For details, see Gertler and Rose (1994).

among different capital producing entities. It can also boost the pace of economic growth by encouraging technological innovations. However, the financial system can play its role when it is allowed to do so. A repressed financial system can hardly contribute positively towards economic growth.

The Era of Financial Repression in Pakistan - 1972-90

The period between 1972-73 and 1989-90 was marked with suppressed financial sector characterized by credit ceiling, directed and subsidized credit, control on deposit and lending rates, etc. In January, 1974 the banking industry was nationalized and an administrative body, the Pakistan Banking Council (PBC), was set up to control the activities of nationalized banks. The bureaucratic control on the management of banks along with lack of healthy competition rendered the banking services inefficient and eroded the accountability mechanism in the sector. Further, the regulatory mechanism for banking activities also became weaker due to multiple regulatory agencies like State Bank on the one hand and PBC on the other.

The direct methods of monetary control severely affected the banks' ability to respond flexibly to the credit demands of the economy. Mandatory allocations of banks credit for priority sectors, irrespective of their economic efficiency, and a regime of concessionary interest rates created distortions in the market and undermined the strength of the financial system.

The capital market was also a shallow institution in this era. The market was thin with low capitalization and rampant insider trading, which lacked a competitive price mechanism. Liberal credit policies also trounced equity market as easy availability of credit from public sector banks and DFIs to blue chip companies made debt the preferred instrument over equity.

The external sector was also characterized by restrictions on capital and current transactions during this period. The foreign exchange market lacked a market-based price mechanism and was inelastic to changes in demand and supply conditions in the external sector. The exchange rate, that was far from flexible regime and closer to the fixed rate regime, was not capable to reflect the market imbalances. As a matter of fact, the foreign exchange market was the most controlled one, among all financial markets, but fortunately there was massive inflow of external resources that veiled inefficiencies in this market for quite a long period of time.

Financial Restructuring (Theoretical aspects)

Financial sector restructuring comprises a set of actions aimed at reducing distortions and developing a competitive price mechanism in financial markets. It encompasses structural and institutional changes spread over time. A well-functioning financial system is an ongoing process, not an event at a point in time, and has a bearing on the social, cultural, economic and political structure of a country. Thus the design of financial sector restructuring process needs a thorough understanding of different aspects of the country. The sequence and intensity of restructuring measures depend on the initial conditions of the economy. This is why a single prescription for all economies can hardly achieve its objectives.

In general, the financial sector restructuring involves the following measures;

- Increasing autonomy to central bank in monetary management
- Reforming prudential regulations and the supervision system
- Fostering competition in the financial system and promoting institutional development of both banks and NBFIs
- Developing long-term capital markets, catering to needs of both public and private sector demand for funds
- Reforming clearing and settlement system for payments
- Developing foreign exchange market supported by appropriate measures to avoid risks

originating across the globe

It may also be appreciated that mere announcements of policy actions achieve nothing if the system is not capable of implementing them. The implementation requires technical skills as well as regulatory autonomy of the key public institutions, particularly, the central bank.

Financial re-structuring in Pakistan

The process of financial restructuring started in Pakistan on the advise of International Monetary Fund and World Bank in late eighties. They also provided technical and financial assistance for this purpose. The World Bank provided loan of $150 million in 1989 and $200 million in 1997 under Financial Sector Adjustment Loan. A Financial Sector Deepening and Intermediation Project of $216 million was started in 1995, and another loan of $300 million under Financial Sector Restructuring and Privatization Project was awarded in 2001. Asian Development Bank also lent her helping hand for the restructuring. In 1997 it assisted in Capital Market Development Programme.

The restructuring process in Pakistan included two types of actions: one for strengthening financial institutions and the other for developing efficient financial markets. A description of the measures taken during the last decade is given below.

Measures Taken to encourage new banks and enhance competition

a. Privatization

There are numerous problems associated with state ownership of financial institutions. When making key decisions such questions always arise; should the state act as owner, regulator, depositor, borrower, monetary authority, tax authority, dispute resolver, or election candidate. Moreover, the skill and compensation mechanisms in state-owned banks do not encourage good management, the goal of which is to maximize the return on invested funds.

As a recognizance of the problems, a process of privatization of nationalized commercial banks was started in early nineties that is still going on. During the year 1991-92 two state-owned banks ABL and MCB[4] were partially denationalized and their management transferred to the private sector. Habib Credit & Exchange Bank was also privatized and management was transferred in 1996. 10% Shares of NBP have also been sold recently through bourses. UBL is being offered for privatization on May 31, 2002, and HBL will be offered next year.

b. New commercial banks

Since 1991, permission has been granted to set up a number of private commercial banks in order to ensure greater competition within the banking industry. Appropriate amendments have been made in the Bank (Nationalization) Act 1974 to provide legal cover to these actions. Two other institutions, targeting exclusively the demand for micro-finance have also been set-up recently with donors' assistance. These are Pakistan Poverty Alleviation Fund (PPAF) and the Khushali Bank.

c. Non-bank Financial Institutions

To add variety to the non-bank financial institutions (NBFIs) and to lessen dependence on banks for credit, a number of non-bank financial entities were also allowed to operate. Presently, over 100 NBFIs are in operation in the country. On the other hand, in order to reduce inefficiencies mergers and amalgamations are also being encouraged. Recently NDFC has been merged into NBP, and RDFC and SBFC have been amalgamated to form a new SME Bank.

[4] At present government has only 9 % shares of MCB with her.

Rationalization of Interest Rate Structure

The restructuring of interest rate was undertaken in three dimensions: public debt; concessional rates; and caps on lending and deposit rates as discussed below.

- In March 1991, a full-fledged auctioning system was introduced, and systems of on-tap and adhoc treasury bills were done away with. In efforts to create a long-term yield curve of government securities that will provide a pricing bench mark for private sector securities, State Bank launched the Pakistan Investment Bond in December 2000, available in maturities of 5 to 10 years.
- The margins of subsidy on special financing schemes including LMM and export finance have been reduced. In order to ensure that the credit is not burdened by subsidies as well as to discourage misuse of credit, it has been decided not to formulate in future any new scheme involving concessional finance.
- Restrictions on banks' maximum lending rates except concessionary finance schemes were removed earlier in 1995. Since July 26, 1997, minimum lending rate has also been abolished. Effective June 16, 1998, SBP allowed banks and other financial institutions to determine their own deposit rates. Interest rate liberalization has given the banks an opportunity to charge market prices on their asset portfolio and has enabled them to earn higher profits compared with those in era of interest rate controls.

Monetary and Credit Management

A number of fundamental changes have been made in the conduct of monetary and credit management which essentially marked a transition from administrative controls and quantitative restrictions to market-based instruments. Apart from introducing public debt auctions, the following additional actions were taken in this regard.

- The credit ceiling as an instrument of credit control was abolished w.e.f. August, 1992 and replaced by CDR, which was removed subsequently (30th September 1995).
- Open Market Operation (OMO) has become the major instrument of monetary policy in Pakistan. A reserve money management programme has been developed at SBP under which the intermediate target of M2 is achieved by controlling the desired path of operating

target i.e. reserve money. Any deviation of actual supply of money is corrected by either way of OMO (i.e. Repo or reverse Repo transaction as the case may be)

- In order to bring flexibility in accommodating short term liquidity requirements of financial institutions, a 3-Day Repo facility was introduced by SBP from 1st February, 1992.

Regulatory Reforms

a. Autonomy of the SBP and its Restructuring

A central bank subordinate to the government cannot credibly commit to price stability – its ultimate goal - as the public will be aware of the dynamic inconsistency of its announcements and actions. An independent monetary authority can create incentives for, or might even force greater fiscal discipline on the part of the government.

The State Bank was granted autonomy in February 1994 by making amendments in the State Bank of Pakistan Act, 1956. The Bank now enjoys complete freedom to prescribe liquidity ratio for banks and to fix their cash reserves. On January 21, 1997, the State Bank's autonomy was further strengthened by three ordinances[5] amending State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974. According to new rules (a) the Central Board of Director of SBP is authorized to formulate and conduct credit policy by taking into account national macroeconomic targets (section 9-A), and (b) no governmental or quasi governmental body can issue any such directive to any financial institution controlled by SBP, that are inconsistent with the policies, regulations and directives issued by the Bank (section 46-B). With these amendments, the PBC was abolished and, SBP has become the sole agency to supervise and regulate the activities of nationalized commercial banks besides other financial institutions.

State Bank as an institution has also been subject of restructuring since 1994-95. In 1999-2000 the core and non-core functions of the Bank were separated and recently it has been bifurcated into two entities: State Bank of Pakistan and SBP Banking Services Corporation (Bank). The former is focusing on framing and conducting monetary policy, supervision and regulation of financial sector, foreign exchange management, and payments system; while the later[6] is responsible for retail banking and treasury functions. The objective of this bifurcation is to relieve the State Bank's management to focus on core functions and strengthen the Bank's regulatory and supervisory role.

Greater independence does not mean enabling central bank to design and conduct monetary policy willfully outside the framework of overall economic policy. State Bank carries out its duties within the framework of government's overall economic policy. It is only the *operational* independence that has been granted to the State Bank and not the *target* independence[7]. To enhance its monitoring, government has made State Bank responsible for quarterly reporting to the Parliament, in addition to the annual reporting.

b. Prudential Regulations and Other Regulatory Measures

Liberalization and prudent controls go hand in hand. The latter is essential to safeguard the interest of ultimate users of the services as well as the viability of service providers. In order to ensure a sound and viable financial system the SBP issued new prudential regulations (PRs) governing lending operations of banks and NBFIs. The PRs prescribed risk exposure limits, criteria for management, rules for the payment of dividends, and rules to check window dressing, money laundering and other unlawful activities.

The capital adequacy ratio requirement, one of the group of six indicators collectively form CAMELS, was enforced in line with Basel committee recommendations[8]. The CAMELS

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[5] Approved by the Parliament in May, 1997

[6] Which is subsidiary of the former.

[7] Operational independence means no one can tell the State Bank what to do. Target independence means setting objective to be pursued itself.

[8] The Basel capital adequacy ratio requires banks to have a specific measure of capital greater than or equal to 8% of a specific measure of assets weighted by their estimated risks.

framework is being used in Pakistan since end-December 1997 for On-site Supervision / Off-site Surveillance. It involves analysis of financial indicators for Asset quality, Management soundness, Earning and profitability, Liquidity, and Sensitivity to market risks in addition to Capital adequacy.

In late 1996, Pakistan's banking system was on the verge of a crisis with about one third of its assets stuck up in the form of defaults and non-performing loans (NPLs). Efforts were made since then to arrest the problem. In a latest bid, a Financial Institutions (Recovery of Finances) Ordinance 2001 has been promulgated with strict legislative provisions. Further, NAB Ordinance 1999 has added a new dimension to banks' efforts for recovery whereby willful default in the repayment of bank loans has been included in the definition of Corruption and Corrupt Practices.

The loan recovery efforts have also been supplemented through the establishment of an asset management agency, the Corporate and Industrial Restructuring Corporation (CIRC), which has assumed all 28 private sector NPLs of over Rs. 10 million that already have court orders for execution. With special legal powers, the CIRC is expected to be more successful in liquidating and disposing of assets than the banks.

Payments System Reforms

The health of the financial system depends, to a significant extent, on an efficient reliable, and rapid payments system. Payments system comprises rules, standards, instruments, institutions, and technical means of exchanging financial values between two parties. In Pakistan, manually operated and paper based payments system is in vogue. Currently over thirty million cheques are presented every year for clearing. In order to replace the manual system with a modern one the commercial banks took an initiative during 1996, for automation of cheques clearing by establishing an organization, National Institutional Facilitation

Technology (NIFT), in collaboration with the private sector.

Capital market reforms

As a part of liberalization programme, capital market was opened to foreign investors in early 1990s. Foreigners and oversees Pakistanis have been allowed[9] to make new investment in all industries excepting specified ones. Some other measures for capital market development are mentioned below under external sector reforms.

To develop an efficient and orderly market for corporate papers, a credit rating agency, PACRA was established in August 1994 as a joint venture between IFC, IBCA limited of UK, and Lahore Stock Exchange. Another credit rating agency named DCR-VIS Credit Rating Co. Ltd. was incorporated in 1997 that was subsequently renamed as JCR-VIS Credit Rating Co. Ltd.

In 1994-95, a Central Depository Company (CDS) was formed to implement paperless trading in stock exchange. CDS is an electronic book entry system intended to facilitate the transfer of stock ownership and efficiently handle the enormity of stock trade volume. It reduces the paper work for brokerage houses, custodian banks and other financial institutions and minimizes the risk of damage and loss, forgeries, and duplication of trade securities.

In 1997, the government formulated a Capital Market Development Programme (CMDP) to strengthen the capital market with the help of ADB. The key components of CMDP included: (i) creation of a level playing field to enhance competition; (ii) strengthening governance; (iii) modernizing market infrastructure and its linkages; (iv) developing the corporate debt market; (v) reforming mutual fund industry; (vi) developing leasing industry; and (vii) promoting contractual savings through reforms of the insurance sector and pensions and provident funds.

[9] Without approval from government.

The Corporate Law Authority, has been restructured and reconstituted as an autonomous Securities and Exchange Commission of Pakistan (SECP). The governance structure of stock exchanges has been improved by increasing regulatory powers of SECP. The consent of SECP has been made compulsory for the appointment of managing director of stock exchange. The SECP can order inspection of books and record of any member of the stock exchange at any time and for any purpose.

External Sector Reforms

The process of liberalization of exchange and payments regimes started since February 1991 in Pakistan. Some of the actions taken during the last decade in this regard are mentioned below;

- The government accepted the obligations of Article-VIII, Sections 2, 3 and 4 of the IMF Articles of Agreement w.e.f. July 1, 1994. As a result, Pak-rupee was made convertible on current international transactions.
- Non-Residents can freely invest in all industries except certain specified industries, remit dividends and disinvestment proceeds, and transfer shares without approval.
- Opening of a Special Convertible Rupee Account (SCRA) in 1996-97 by non-residents for purchase of shares quoted on the Stock Exchange was allowed.
- SCRA scheme has been introduced to accommodate investors that do not want to make interest based investments.
- Residents Pakistanis are allowed to open and maintain Foreign Currency Accounts (FCAs) with banks in Pakistan.
- Permission was given to the Authorized Dealers (ADs)/DFIs/Housing Finance Institutions to grant rupee loans to Pakistani nationals working outside Pakistan for purchase of residential flats/plots/houses in Pakistan.
- Section 23 of the State Bank of Pakistan Act, 1956 was amended in 1999 to empower the Bank to buy/sell foreign exchange from/to any person anywhere.
- During 1982-99 Pakistan followed a managed float[10] system for exchange rates. Effective May 19, 1999, market based unified exchange rate has been adopted by doing away with all sorts of direct control. ADs are not required to surrender any sort of

[10] Multiple exchange rate system was in vogue from July 22, 1998 to May 18, 1999.

foreign exchange, including export proceeds, to SBP[11] and demand for foreign exchange for all approved purposes is being met from inter-bank market. State Bank controls the exchange rate through market intervention.

Insurance Sector Reforms

Insurance is an important economic activity. It is a device of reducing the uncertainty inherent in all other economic activities. Though, in Pakistan - a thickly populated country of over 140 million people - a huge potential of growth in insurance industry existed, this sector remained underdeveloped due to host of reasons. The insurance companies failed to diversify their products and to constitute competitive price mechanism. They were also unable to invest in human resources resulting in the serious dearth of qualified and technical staff today, expand its paid-up capital base, invest its funds more prudently, and to devise ways to settle claims in a more satisfactory manner. Moreover, this sector has also been suffering from lack of attention from policy makers and facing an extremely high tariff structure.

As a major reform step, the office of the Controller Insurance has been abolished and effective from January 2000 the Insurance Sector has been put under the regulation and supervision of the SECP. During the year 2000, an Insurance Ordinance 2000 was also promulgated to better regulate the business, ensure better protection of interests of the policy holders and promote sound development of the insurance industry.

Accomplishments

The process of financial restructuring is still going on. Since the financial sector, by its very nature has long outside lags between actions and their consequences, we cannot say any thing concrete about achievements of restructuring exercise. However, on the basis of direction

[11] SBP is now fully out of the business of forward cover.

to which different financial and economic indicators are moving, we can draw some conclusions. In the forthcoming paragraphs we will be discussing implications of reforms for deepening of the financial sector itself as well as for growth and employment. But these may not be regarded final words for the reason mentioned above.

Financial deepening & intermediation

The most important indicator of financial deepening is the ratio of monetary assets to GDP. While an increase in broad money to GDP ratio is considered a positive development, that in narrow money to GDP ratio has opposite implications. A high narrow money ratio indicates a weak financial sector where public prefers to keep their monetary assets in more liquid forms. In Pakistan narrow money (M1) as a percentage of GDP declined from 25.9% in 1988-89 amidst fluctuation to 21.9% in 2000-01 (Table-1). It may be noted that this ratio was once as low as 17.7 percent in 1997-98 that showed economizing cash balances by the public and their preferences for banking. But after nuclear detonation of 1998, public confidence on banking sector shattered that resulted in reversal of trend in M1/GDP ratio. An opposite behaviour can be observed with respect to broad money (M2).

Within M2, the shares of currency in circulation and demand deposits declined over the years and that of time deposits increased. This change in composition of M2 indicates favourable public attitudes towards financial sector. Most notable feature is the share of foreign currency deposits that increased phenomenally until April 1998, the last month prior to the nuclear tests. Due to withdrawal from FCAs[12], their share declined to 8 percent in June 2000. However, in next year foreign currency deposits again witnessed some expansion mainly due to concerted efforts by SBP to restore public confidence in banking system and legislative changes to protect interests of FC deposit holders.

[12] The FC account holders were restricted to withdraw, if they desire so, only in Pak rupees after the detonation.

Development of financial institutions

After the introduction of financial sector reforms there has been a rapid increase in the financial institutions in Pakistan. The number, however, is on declining trend after June, 1997 due to mergers and closures of weak FIs (Table-2). In the same spirit, around 16% of bank branches have been closed/merged during the same period (Table-3). The commercial banks' deposits increased from Rs.248.9 billion in June, 1990 to Rs.1,293 billion in June, 2001 showing an annual compound growth rate of 16.2% (Table-3). Similarly the advances of commercial banks and their total assets demonstrated annual growth of 15.2% and 10.9% respectively during this period.

Allocative Efficiency

The impact of financial sector reforms on the efficient allocation of credit is a mixed one. Allocative efficiency in this perspective means more credit to those sectors that are more productive. The share of private sector credit is one of the important indicators of allocative efficiency when compared with that of government sector. During 1987-88 the share of government sector credit was about 56% in the total Domestic Credit which increased to 72% in 1991-92 (Table-4). During the same period the private sector credit declined from 67.1% of the total credit to 31.5%. This trend clearly indicates diversion of bank credit from private sector to the government. However, after 1991-92 this trend reversed primarily because of market-based allocation of credit. The increase in allocative efficiency can also be noticed in the reduction of the share of concessional and mandatory credit in total private sector credit during 1990s (Table-5).

Structure of interest rate

Efficiency of the financial sector can be gauged by interest rate structure. As a result of interest rate liberalization, the lending rates which remained stagnant at around 11% during 1985-92 increased to 13.6% in 2000-01. However, the average deposit rate moved in opposite direction (Table-6), which resulted into increase in interest rate spread. The increase in spread can be linked to the gradual increase in NPLs and administrative cost of financial institutions. The poor financial conditions had made it difficult for financial institutions to absorb the cost involved in liberalization process. Consequently, financial institutions adjusted deposit rate to pass on the cost to the savers.

Non-performing Loans

During the last couple of years, considerable efforts were made to arrest the growing non-performing loans. However, still there is a significant share of NPLs in the portfolio of banks and DFIs. The problem is more severe in case of specialized banks and DFIs; the NPLs make about 60% of their total advances (Table-7). About 40% of their total NPLs has been accumulated due to interest payments. Commercial banks have NPLs equaling 20% of their advances. Within banks, NCBs have about one fourth of their advances in the form of NPLs while foreign banks have the lowest ratio of NPLs.

Insurance Sector

The insurance sector, though on the face of it, witnessed an impressive growth in number of indicators during the last decade (Table-8) but it suffered lack of depth. A high growth at low base may not necessarily be an indicator of the strength. The paid up capital of the general insurance sector is 2.4 billion rupees (as of year 2000), while pre-tax profit is below one billion rupees.

Development of Capital Market

There are three stock exchanges in Pakistan; one each in Karachi, Lahore and Islamabad. The Karachi Stock Exchange (KSE), is the biggest one where 75-80 per cent of the trading takes place. The other two stock exchanges usually follow the market trend at KSE. Some key indicators of the performance of KSE are given in Table-9. Market capitalization witnessed an annual growth rate of more than 19.3 per cent in the post reforms period compared with 17.2 per cent during 1985-90. A rather stronger trend is witnessed in turnover of shares. In June 1990, there were 462 companies listed on KSE which increased to 759 by June 2001.

Macroeconomic Trends

The process of financial restructuring has not been very successful in improving the macroeconomic environment of the country. Table 10 gives an overview of the economy in terms of three key macroeconomic variables viz., real GDP growth[13], incremental capital output ratio (ICOR)[14], and inflation. Average GDP growth during 1990s was less than that during the pre-reform period. ICOR remained almost unchanged, on average. Similarly inflation during the reform period was also high until late 1990s, when it witnessed a declining trend.

Concluding Remarks

The process of financial sector restructuring started in Pakistan during early 1990s. For this purpose, international financial institutions, like World Bank and ADB, provided technical and financial resources. The objective of this exercise was to let financial system play its role in economic growth and development of the country in an efficient and competitive way. A lot of policy decisions have been made and implemented during the last decade to reduce distortions

[13] It serves as a proxy for economic growth.

and to develop competitive price mechanism in the financial markets.

The process of restructuring is still going on and it is a bit earlier to say some final words about its success, however, we are able to say, on the basis of the trend the financial and other indicators are following, that we have been partially successful in achieving the set objectives. The competition among financial institutions has been intensified during the restructuring period. Some positive developments have also been witnessed on the front of money and foreign exchange markets. Though there are some improvements, yet there is a lot to do for strengthening of insurance sector, capital market and bond market. The whole exercise remained less effective in increasing financial deepening, and in reducing intermediation cost (i.e., interest rate spread). Until end of 1990s, policy of privatization of NCBs and drive for recovery of NPLs could not be pursued vigorously and NPLs continued to grow. During the last three years some considerable efforts have been made for privatization of NCBs. Only recently, the size of the NPLs has started to stabilize due to some intensified recovery efforts and better quality of new loans. The size of the NPLs is primarily responsible for the deteriorated health of financial institutions. The overall macroeconomic outcome is also against the expectations.

Macroeconomic stability as well as proper sequencing of restructuring measures are necessary preconditions to the success of the whole exercise. In Pakistan, the financial restructuring process was introduced in an environment of large budget deficit and high and variable inflation i.e., in an atmosphere of macro-economic instability. Frequent changes in political set up of the country during 1990s also adversely affected this process. However, in the present milieu of political and economic management, it is expected that financial sector will be able to play its due role in economic growth and

[14] It serves as a proxy for economic efficiency. Lower the ICOR, higher the economic efficiency.

efficiency as the governance structure is improving, consistency in economic policies is being ensured, and political stability is envisaged.

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Acronyms

ABL	Allied Bank of Pakistan Limited
ACGR	Annual Compound Growth Rate
ADB	Asian Development Bank
ADs	Authorized Dealers
CDC	Central Depository Company
CDR	Credit-Deposit-Ratio
CDS	Central Depository System
CIRC	Corporate and Industrial Restructuring Corporation
CLA	Corporate Law Authority
CMDP	Capital Market Development Programme
DCR	Duff & Phelps Credit Rating Co.
DFIs	Development Financial Institutions
FC	Foreign Currency
FCAs	Foreign Currency Accounts
FIs	Financial Institutions
GDP	Gross Domestic Product
HBL	Habib Bank Limited
IAP	Insurance Association of Pakistan
ICOR	Incremental Capital: Output Ratio
IFC	International Finance Corporation
IMF	International Monetary Fund
ISE	Islamabad Stock Exchange
JCR	Japan Credit Rating Agency, Ltd.
KSE	Karachi Stock Exchange
LMM	Locally Manufactured Machinery
LSE	Lahore Stock Exchange
MCB	Muslim Commercial Bank
NAB	National accountability Bureau
NBFIs	Non-bank Financial Institutions
NBP	National Bank of Pakistan
NCBs	National Commercial Banks
NDFC	National Development Finance Corporation
NIFT	National Institutional Facilitation Technology
OMO	Open Market Operation
PACRA	Pakistan Credit Rating Agency
PBC	Pakistan Banking Council
PRs	Prudential Regulations
RDFC	Regional Development Finance Corporation
SBFC	Small Business Finance Corporation
SBP	State Bank of Pakistan
SCRA	Special Convertible Rupee Account
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprise
TBs	Treasury Bills
UBL	United Bank Limited
VIS	Vital Information Services (Pvt.) Limited

Table1: Composition of Monetary Assets

Year	As per cent of GDP					
	Currency in Circulation	Demand Deposits	M1	Time Deposits	RFCD	M2
1985-86	11.4	12.7	24.3	13.7		38.0
1986-87	12.3	13.8	26.2	13.2		39.4
1987-88	12.5	13.6	26.3	12.0		38.3
1988-89	12.2	13.3	25.9	10.5		36.4
1989-90	12.9	13.8	26.9	11.3		38.2
1990-91	13.1	12.0	25.4	12.1	0.9	38.4
1991-92	12.4	12.1	24.7	13.0	3.5	41.3
1992-93	12.3	11.6	24.3	15.3	4.5	44.1
1993-94	11.7	10.7	22.7	16.0	5.8	44.6
1994-95	11.4	10.7	22.3	15.6	5.5	43.5
1995-96	11.0	9.7	21.0	16.1	6.8	44.0
1996-97	10.0	7.9	18.2	15.9	9.1	43.2
1997-98	10.1	7.4	17.7	16.5	10.3	44.5
1998-99	9.6	11.6	21.5	17.2	4.0	42.7
1999-00	11.2	11.8	23.2	17.3	3.5	44.0
2000-01	10.8	10.8	21.9	17.6	4.4	44.0
	As per cent of M2					
1985-86	30.0	33.5	63.9	36.1		100.0
1986-87	31.1	34.9	66.5	33.5		100.0
1987-88	32.6	35.6	68.7	31.3		100.0
1988-89	33.6	36.4	71.0	29.0		100.0
1989-90	33.7	36.0	70.4	29.6		100.0
1990-91	34.2	31.2	66.2	31.5	2.4	100.0
1991-92	30.0	29.2	59.9	31.6	8.5	100.0
1992-93	28.0	26.3	55.1	34.6	10.3	100.0
1993-94	26.3	24.0	51.0	35.9	13.1	100.0
1994-95	26.1	24.6	51.3	36.0	12.7	100.0
1995-96	24.9	22.1	47.7	36.7	15.5	100.0
1996-97	23.2	18.3	42.1	36.7	21.2	100.0
1997-98	22.6	16.7	39.8	37.1	23.1	100.0
1998-99	22.5	27.3	50.2	40.3	9.4	100.0
1999-00	25.4	26.8	52.8	39.2	8.0	100.0
2000-01	24.6	24.6	49.9	40.0	10.1	100.0

Source: SBP

Table 2: Domestic & Foreign Financial Institutions

(Numbers)

Category	1987-88*	1993-94	1996-97	1997-98	1998-99	1999-00	2000-01
A: Overall (B+C+D)	**107**	**197**	**216**	**212**	**205**	**196**	**187**
B: All Commercial Banks	33	45	42	42	42	41	39
Domestic Banks							
National Commercial Banks	5	4	4	4	4	4	4
Privatised Banks	0	2	2	2	2	2	2
Private Banks	0	13	15	15	15	14	14
Foreign Banks	28	26	21	21	21	21	19
C: Specialised Banks and NBFIs	72	149	171	167	160	152	145
Specialized Banks	4	4	4	4	4	4	4
NBFIs							
DFIs	9	11	11	10	10	10	10
Investment Banks	6	12	15	15	16	16	16
Leasing Companies	5	21	32	32	32	32	31
Modarba Companies	0	48	54	50	47	44	40
Insurance Companies							
Domestic	38	45	49	50	46	42	40
Foreign	10	8	6	6	5	4	4
D: Stock Markets	2	3	3	3	3	3	3

*: All numbers in the table pertain to End June

Source: SBP, IAP, SECP

Table3: Performance of Scheduled Banks

(Billion Rupees)

Year*	Category	Deposits			Advances	Advances as % of Dep.	Total Assets	Bank Branches	Population (Million)	Persons(000) per Branch
		Demand	Time	Total						
1989-90	Pakistani	112.9	93.6	206.5	157.7	76.3	510.5	7344		15.3
	Foreign	11.8	30.6	42.3	25.5	60.3	123.4	67		1677.6
	Total	124.7	124.2	248.9	183.2	73.6	633.9	7411	112.4	15.2
1993-94	Pakistani	239.3	215.7	455.0	298.4	65.6	1083.1	7738		16.3
	Foreign	28.2	92.2	120.4	49.4	41.1	330.0	74		1709.1
	Total	267.4	307.9	575.4	347.9	60.5	1413.1	7812	126.5	16.2
1996-97	Pakistani	332.9	410.8	743.7	452.5	60.8	1616.6	8597		16.1
	Foreign	47.3	166.2	213.5	100.0	46.8	512.5	76		1817.9
	Total	380.2	577.0	957.2	552.5	57.7	2129.1	8673	138.2	15.9
1997-98	Pakistani	374.7	465.2	839.9	530.2	63.1	1294.3	8049		16.3
	Foreign	61.8	170.0	231.8	113.9	49.1	293.2	81		1623.6
	Total	436.5	635.2	1071.7	644.1	60.1	1587.5	8130	131.5	16.2
1998-99	Pakistani	436.5	522.9	959.4	610.3	63.6	1456.8	7973		16.9
	Foreign	56.1	146.8	202.9	115.6	57.0	277.5	85		1582.5
	Total	492.6	669.7	1162.3	725.9	62.5	1734.3	8058	134.5	16.7
1999-00	Total	522.7	663.1	1185.8	801.2	67.6	1806.6	7955	137.5	17.3
2000-01	Total	570.6	722.4	1293.0	866.5	67.0	1983.9	7253	140.5	19.4
ACGR (1990-2001)		14.8	17.4	16.2	15.2		10.9	-0.2	2.0	

*: As on 30th June

Source: SBP

Table 4: Distribution of Credit to Various Sectors

(% Share in total domestic credit)

Year	Government Sector	Autonomous Bodies	Public Sector Enterprises	Private Sector	others
1985-86	29.4	0.0	12.2	66.0	-7.7
1986-87	35.0	0.0	2.5	70.1	-7.7
1987-88	55.8	4.3	1.0	67.1	-28.1
1988-89	56.7	13.1	-7.1	64.1	-26.8
1989-90	43.6	7.0	1.1	43.6	4.7
1990-91	51.1	1.1	-7.4	46.8	8.5
1991-92	71.9	1.3	-0.1	31.5	-4.7
1992-93	60.6	3.2	-1.3	47.1	-9.5
1993-94	37.9	-1.1	-2.8	57.3	8.7
1994-95	56.2	3.4	2.7	67.5	-29.9
1995-96	44.8	2.1	1.9	37.5	13.7
1996-97	54.7	-0.2	1.5	40.5	3.4
1997-98	34.0	-0.5	5.7	44.8	16.1
1998-99	-166.6	29.2	15.2	229.7	-7.5
1999-00	65.7	2.6	8.3	15.6	7.7
2000-01	-88.9	14.1	31.2	91.4	52.3

Source:
SBP

Table 5 :Concessional & Mandatory Credit to Private Sector

(% Share in total private sector credit)

Year	Concessionary Credit				Mandatory Credit				Grand Total
	LMM Scheme	Export Finance	Others	Total	Industry	Agriculture	Others	Total	
1985-86	5.2	4.4	30.5	43.6	8.1	3.4	2.2	10.4	53.9
1986-87	4.6	4.8	27.8	41.3	8.1	4.1	2.5	10.5	51.9
1987-88	4.1	5.3	25.0	37.0	8.0	2.6	2.6	10.6	47.6
1988-89	4.0	5.3	23.7	34.4	8.3	1.4	2.8	11.1	45.5
1989-90	3.8	5.7	22.6	34.5	8.1	2.4	2.8	10.9	45.4
1990-91	4.1	5.7	23.6	35.5	8.3	2.2	2.6	10.9	46.4
1991-92	4.3	6.7	22.2	35.0	8.3	1.8	2.5	10.8	45.9
1992-93	4.5	7.5	24.6	37.9	8.2	1.4	2.9	11.0	49.0
1993-94	4.4	7.4	22.6	35.6	8.2	1.2	3.2	11.5	47.0
1994-95	3.7	7.2	22.5	34.5	8.0	1.0	2.7	10.7	45.2
1995-96	3.3	7.0	20.8	32.3	7.7	1.1	2.5	10.2	42.4
1996-97	2.8	7.3	18.7	29.9	6.8	1.1	2.2	9.0	38.9
1997-98	2.3	8.3	17.0	28.7	4.9	1.1	1.9	6.8	35.5
1998-99	1.8	10.8	16.8	30.6	3.8	1.2	1.7	5.5	36.1

Source:
SBP

Table 6: Behaviour of Interest Rates

(in Percentage)

Year	Nominal		Interest Rate Spread	Real		GoP TB Rate	
	Deposit Rate	Lending Rate		Deposit Rate	Lending Rate	Nominal	Real
1984-85	5.76	10.49	4.73	0.09	4.82	6.00	0.33
1985-86	8.80	10.91	2.11	4.45	6.56	6.00	1.65
1986-87	7.87	11.00	3.13	4.27	7.40	6.00	2.40
1987-88	7.67	10.70	3.03	1.38	4.41	6.00	-0.29
1988-89	7.95	10.89	2.94	-2.35	0.59	6.00	-4.30
1989-90	8.23	10.59	2.36	2.19	4.55	6.00	-0.04
1990-91	6.00	10.77	4.77	-6.66	-1.89	9.45	-3.21
1991-92	6.38	13.32	6.94	-4.20	2.74	12.16	1.58
1992-93	6.09	13.32	7.23	-3.74	3.49	12.43	2.60
1993-94	6.17	13.66	7.49	-5.10	2.39	10.96	-0.32
1994-95	6.25	13.74	7.49	-6.77	0.72	12.72	-0.30
1995-96	6.42	14.36	7.94	-4.37	3.57	13.03	2.24
1996-97	6.80	14.55	7.75	-5.00	2.75	16.05	4.25
1997-98	6.81	15.64	8.83	-1.00	7.83	15.70	7.89
1998-99	6.49	14.8	8.31	0.79	9.10	13.28	7.58
1999-00	5.47	13.52	8.05	1.87	9.92	8.66	5.06
2000-01	5.27	13.61	8.34	-0.13	8.21	10.46	5.06
Averages							
1985-1992	7.33	11.08	3.75	-0.10	3.65	7.20	-0.24
1992-1997	6.35	13.83	7.47	-4.86	2.61	12.89	1.68
1997-2001	6.17	14.42	8.26	-0.69	7.56	12.83	5.97

Source: SBP

Table 7: Non-performing Loans(NPLs)

(Million Rs.)

Category	1997-98@	1998-99@	1999-00@	2000-01@					As on 31-03-2002				
	NPLs	NPLs	NPLs	Advances	Non Performing Loans			NPLs as a %age of Advances	Advances	Non Performing Loans			NPLs as a %age of Advances
					Principal	Mark-up	Total			Principal	Mark-up	Total	
A: Overall (B+C)	**207,882**	**212,056**	**239,541**	**1,048,822**	**197,889**	**81,176**	**279,065**	**26.61**	**1,047,692**	**200,416**	**78,207**	**278,623**	**26.59**
B: All Commercial Banks	**137,582**	**134,285**	**127,312**	**843,081**	**125,495**	**33,975**	**159,470**	**18.92**	**867,664**	**133,165**	**37,913**	**171,078**	**19.72**
Domestic Banks													
National Commercial Banks	108,594	97,808	87,900	412,898	79,627	25,325	104,952	25.42	418,735	86,414	29,230	115,644	27.62
Privatised Banks	16,321	18,387	17,634	148,699	25,682	3,423	29,105	19.57	141,426	25,408	2,938	28,346	20.04
Private Banks	3,380	5,714	9,746	112,475	9,696	2,259	11,955	10.63	175,216	16,251	3,268	19,519	11.14
Foreign Banks	9,287	12,376	12,032	169,009	10,490	2,968	13,458	7.96	132,287	5,092	2,477	7,569	5.72
C: Specialised Banks and DFIs	**70,300**	**77,771**	**112,229**	**205,741**	**72,394**	**47,201**	**119,595**	**58.13**	**180,028**	**67,251**	**40,294**	**107,545**	**59.74**
Specialised Banks	19,394	31,372	56,988	116,508	38,705	22,460	61,165	52.50	122,842	46,003	24,117	70,120	57.08
DFIs	50,906	46,399	55,241	89,233	33,689	24,741	58,430	65.48	57,186	21,248	16,177	37,425	65.44

@: As on 30th June

Note:- The former NDFC (DFI) has been amalgamated with NBP (NCB) and thus the position of NDFC has been merged with NBP.

Faysal Bank and Bank Al-Falah have been shifted from foreign Banks and categorised as private banks from September, 2001

Source:SBP

Table 8:Insurance Sector of Pakistan*

(Million Rs.)

Year	Paid-up Capital	Free Reserves	Direct Gross Premium	Net Premium	Claims	Management Expenses	Pre-tax Profit
1989-90	483.3	568.7	2770.1	1667.4	834.0	624.3	271.9
1993-94	962.9	1299.1	5240.4	3008.8	1738.1	1075.3	678.1
1996-97	1681.8	1882.8	7622.1	4729.2	2646.0	1962.2	694.6
1997-98	1955.2	1914.8	6929.2	4258.2	2827.2	2814.8	495.1
1998-99	2183.5	1993.2	7038.7	4492.8	2302.0	2138.8	786.6
1999-00	2444.7	2439.0	7746.3	4662.8	2146.4	2326.6	830.8
ACGR(1990-00)	17.6	15.7	10.8	10.8	9.9	14.1	11.8

*: Only General Insurance

Source: IAP

Table 9: Karachi Stock Exchange

Year@	SBP General Index *	KSE-100 Index *	Market Capitalization	Turnover of Shares	No of listed Companies
			Rs. in Billion	Million Shares	
1989-90	283.5	1,150.0	48.63	236.4	462
1993-94	290.2	2,333.0	404.58	1,830.2	683
1996-97	143.0	1,565.7	469.60	8,095.1	782
1997-98	98.8	879.6	259.28	14,992.4	779
1998-99	106.4	1,054.7	286.22	25,524.8	769
1999-00	128.8	1,520.7	391.86	48,097.0	762
2000-01	118.7	1,366.4	339.25	29,165.3	759
ACGR (1990-2001)			19.3	54.9	4.6

@: End June

*: Base is 1980-81 for the indices for 1989-90; and 1990-91 for indices for 1993-94 and afterward.

Table-10: Macroeconomic Trends (Averages)

Year	Real GDP growth	ICOR	Inflation (CPI)
1986-90	5.6	1.6	6.1
1991-95	5.1	1.3	11.5
1996-00	3.8	1.6	7.9
1991-00	4.4	1.4	9.7
2000-01	2.6	1.6	5.4

Source: SBP, and own calculations