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**Financial Sector Reforms and Economic Growth:  
A Time Series Data Analysis for Pakistan**

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## List of Acronyms

ADBP	Agricultural Development Bank of Pakistan
ADs	Authorized Dealers
ARDL	Autoregressive Distributed Lag
ATMs	Automated Teller Machines
BSAL	Banking Sector Adjustment loan
CDNS	Central Directorate of National Savings
CDR	Credit to Deposit Ratio
CRR	Cash Reserve Requirement
DEA	Data Envelopment Analysis
DFIs	Development Finance Institutions
GDP	Gross Domestic Product
GMM	Generalized Method of Moments
GNP	Gross National Product
ILO	International Labor Organization
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
KSE	Karachi Stock Exchange
LDCs	Less Developed Countries
NAB	National Accountability Bureau
NBFIs	Non-Bank Financial Institutions
NPLs	Non Performing Loans
NSS	National Savings Scheme
PBC	Pakistan Banking Council
SAPs	Structural Adjustment Programs
SBP	State Bank of Pakistan
SLR	Statutory Liquidity Requirement
SMEs	Small and Medium Enterprises
TFP	Total Factor Productivity
UK	United Kingdom
US	United States
VAR	Vector Auto Regressive
VECMs	Vector Error Correction Models

## **Abstract**

This study addresses the key issues in the financial development and economic growth literature and provides an in depth analysis of theoretical and empirical debate and assesses the financial sector reform process and its impact on Pakistan economy. The important findings of this report are that financial sector reforms that have been pursued persistently and vigorously over a decade or so have removed many distortions and minimized the financial repression in the country. However, a large segment of population and geography in the country is still under served from the existing financial markets. The reforms helped to increase credit availability to private sector, however, there is a need to increase the share of agriculture and services sector in banks' credit thereby enhancing the growth performance. Finally, within the regional context Pakistan's financial system despite its growth is still small. The country is lacking in the areas such as financial deepening and credit to the private sector. Although the financial sector reforms were effective in bringing positive change in key financial sector and real sector variables, however, there is a need to further broaden and deepening the financial system to help to achieve higher and sustainable economic growth, develop a dynamic, robust and stronger system and mobilize the domestic and foreign resources for private investment and deepen financial penetration for poor and underserved regions.

## 1. Introduction

In the early 1980s, many developing countries experienced worsening situation of their macroeconomic performance. The economic policies pursued by these countries in the past and the inhospitable external economic environment have mainly been responsible for various macroeconomic difficulties. These countries eventually turned to the International Monetary Fund (IMF) for its assistance in designing a policy package that includes measures to restore macroeconomic stability and sustainable economic growth. Finally many developing countries agreed to implement the Structural Adjustment Programs (SAPs) of the IMF.<sup>1</sup> These programs then become standard to qualify for a new World Bank and IMF loan.

The SAPs prescribed a series of liberalization and deregulation policies encompassing most of economic activities including reform in financial sector. The common guiding principles of SAPs were to follow a policy of export-led growth, privatization and liberalization, and put emphasis on the efficiency of the free market. SAPs also required to devalue the currency against dollar, left import and export restrictions, balance the budget (by raising taxes and cutting expenditures), and remove price control and state subsidies.

As a part of SAPs, financial sector reforms were also required with a view to improving the effectiveness of monetary policy by making a shift from direct to indirect monetary control and greater reliance on market forces. The major components of the financial sector reforms were-liberalizing interest rates, reducing direct government intervention, and strengthening the role of the market forces in allocation of resources, improving the capacity of financial institutions for domestic resource mobilization efforts, enhancing the effectiveness of monetary policy instruments, promoting competition and efficiency in the financial system, and strengthening the supervisory role of the central bank

The state of financial sector in Pakistan during the 1980s showed that it mainly accommodated the financing needs of the government, public sector enterprise and priority sectors. Financial institutions were insulated from competition through barriers to entry in the sector. In such environment, distortions were wide spread; where real interest rates were negative, savers were taxed and subsidies were given to inefficient investment. Credit was controlled through both quantity and price instrument and excessive regulations hindered the activities of financial institutions. Consequently, economic efficiency remained low and growth suffered from relatively low savings and low investment in private sector.

In order to improve monetary management as well as the quality of financial intermediation, like other developing countries, Pakistan also started a far reaching financial

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<sup>1</sup> The main countries that adopted SAPs and also faced opposition within the countries were Algeria, Bolivia, Ecuador, Jamaica, Jordon, Nigeria, Sudan, Uganda, Zambia, Venezuela, and Zaire.

sector reforms program at the end of 1989. These reforms were expected to bring about significant economic benefits, through effective mobilization of domestic savings and more efficient allocation of resources. The focus of these reforms was to strengthen the market forces and competition in financial markets through denationalization of banks, liberalization of interest rates and the introduction of indirect monetary policy instruments.

The review of existing literature in the field of Finance-Growth nexus shows that studies in this area mainly focused on either testing whether financial development plays a positive role in stimulating economic growth or examining the direction of causality between these two variables. However, there is little empirical evidence providing policy makers with the necessary comprehensive information as to whether financial sector reforms have made any impact on the financial system, and hence on growth, particularly in case of Pakistan. Since data on several variables is available, this provides an intensive for a long time series data analysis for pre and post reform periods. Thus, this study evaluates the effects of such policy reforms on monetary aggregates, savings, investment and economic growth. The current study also provides more solid underpinning of the financial sector reforms and set directions for further financial sector reforms.

To study the financial sector reform process and its impact in Pakistan, we divide the period from 1980 to 2008 into three sub periods, namely the pre-reform period (1980-89), the reform period (1990-99), and the post reform period (2000-08). The main body of the data is taken from the Handbook of Statistics on Pakistan Economy and various issues of the Annual Reports, Quarterly Reports, and Statistical Bulletins (State Bank of Pakistan, SBP), Pakistan Economic Survey and its Statistical Supplements (Finance Division, Government of Pakistan). For cross country data, we used Annual Reports (Central Bank of the Country), International Financial Statistics (International Monetary Fund) and World Development Indicators (World Bank).

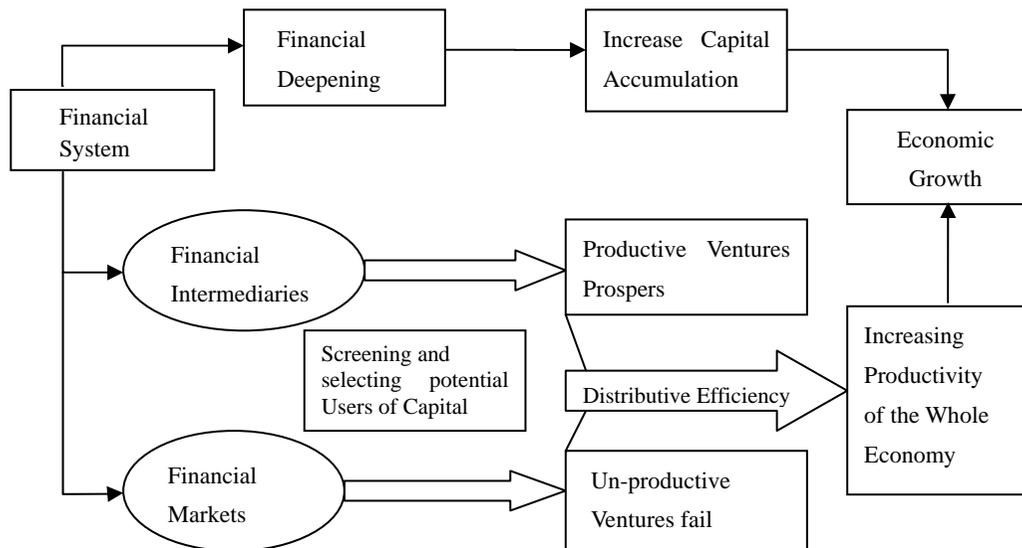
This study is organized as follows. Following introduction, section 2 presents the theoretical linkages between financial system and economic growth and discusses the conflicting views on financial sector liberalization. Section 3 provides the review of selected empirical studies on finance growth relationship. Section 4 discusses in detail the pre reform structure, the process of financial reforms in Pakistan, and post reform structure of the financial sector. Section 5 assesses the financial sector reform and discusses its impact on key financial indicators and key macroeconomic performance indicators. This section also provides a regional comparison of financial sector development. Final section set the directions for further financial sector reforms measures and concludes the study.

## 2. Financial Development and Economic Growth

### 2.1. Finance Growth Linkages

The main function of financial system is to facilitate the transformation of savings from surplus sectors to deficit sectors. Very often, the surplus sectors are the households, who save money, and the deficit sectors are the entrepreneur and government, who borrow money for investment purposes. However, the financial market finance only part of a country's total investment, because firms and households finance much of their investment directly out of their own savings. Only when investment exceeds savings it is necessary to borrow, just as when saving exceeds investment it is necessary to lend. The explicit task of the financial sector is to move excess savings from economic units in surplus to those in deficit.<sup>2</sup> Figure 2.1 shows how financial system effect economic growth through different channels.

**Figure 2.1: Theoretical Linkages between Financial System and Economic Growth**



Source: State Bank of Pakistan (2003).

<sup>2</sup> See World Bank (1989).

A well functioning financial sector promote economic growth through two important channels; quantity effect (increase in savings and investment) and through quality effect (increase in the productivity). Historically, the quality of investment has been at least as important for growth as the quantity. Empirical studies generally find that less than half of the growth in output is attributable to increase in labor and capital. Higher productivity explains the rest (World Bank 1989).<sup>3</sup> Higher growth, increased investment and greater financial deepening all come partly from higher savings. However, greater financial depth contributes to growth by improving the productivity of investment. World Bank (1989:27) shows that investment productivity as measured by the ratio of the change in GDP to investment (the inverse of the incremental capital output ratio-ICOR), is significantly higher in the faster-growing countries, which also had deeper financial system. This suggests the link between financial sector and real sector of the economy. Efficient intermediation will ensure that the better investments are financed and will thereby increase the average productivity of investment.

Similarly, Greenwood and Jovanovic (1990) develop a model in which both the extent of financial intermediation and the rate of growth are endogenously determined and conclude that financial intermediation promote growth because investment could be more efficiently undertaken in a developed financial market. Furthermore, Bencivenga and Smith (1991) show that the development of financial intermediation will increase real economic growth by channeling savings to the activity with high productivity.

In this line of research, Neusser and Kugler (1998) investigate the relationship between financial sector development and economic growth from a time series perspective and find that financial sector is conintegrated for many OECD countries not so much with manufacturing output but mostly with manufacturing total factor productivity. Similarly, Benhabib and Spiegel (2000) argue that a positive relationship is expected to exist between financial development and total factor productivity growth and investment.

Xu (2000) uses a multivariate vector autoregressive (VAR) approach to examine the effects of permanent financial development on domestic investment and output in 41 countries between 1960 and 1993. The results show that financial development is important to GDP growth and that domestic investment is an important channel through which financial development affects economic growth.

In a recent study Rioja and Valev (2004) investigate the channels through which financial development influence economic growth in a panel of 74 countries during 1961-1995. They find that finance has a strong positive influence on productivity growth primarily in more developed countries. In less developed countries, the effect of finance on output growth occurs primarily through capital accumulation.

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<sup>3</sup> Higher labor productivity is achieved by good health, skills, education, and through experience and efforts. Increase in the productivity of capital can be achieved through technical progress and more efficient use of savings.

In general, the above mechanism suggests that financial development should have a significant positive effect on economic growth as it fosters capital accumulation and leads to productivity gains thanks to a better allocation of resources.<sup>4</sup>

## **2.2. Views on Financial Liberalization**

Realizing the importance of financial sector in economic growth, the government in developing countries (including Pakistan) sought to increase their ownership of banks and other financial institutions, in order to direct credit towards priority sectors. Thus, the financial sector was under strict state control and their activities were limited. However, the poor performance of the financial sector and their limited contribution to economic growth necessitated liberalization of the financial sector. In the existing literature, however, there are conflicting views over the issue of financial liberalization that results from financial sector reforms. In the following sub sections we discuss these views in detail.

### **2.2.1. Pro Liberalization Views**

The view that development of a financial system is crucially important in stimulating economic growth is not new in the development economic literature and can be traced back to Schumpeter's (1911) Theory of Economic Development. In his theory it is pointed out that 'banks and loans' foster economic development. The policy implication of this view point is to expand the financial system in order to foster economic growth. This includes creating more financial institutions, and providing a greater variety of financial products and services, in order to generate a positive effects on savings-investment process and hence on growth. However, this view had little impact on development policy making in the early post war decades, due to dominant influence of the Keynesian financial repression ideology.<sup>5</sup>

The above view gained momentum when Goldsmith (1969), McKinnon (1973), Shaw (1973) and others, stresses the connection between a country's financial superstructure and its real infrastructure and were of the view that the financial superstructure of an economy accelerates economic growth and improves economic performance. They consider that all forms of public control on the financial market achieved by quantitative instruments (directed credits for selected strategic sectors, high reserve ratios) or price instruments (interest rate ceiling) generate a financial repression situation characterized by negative real interest rates, low levels of savings, investments and therefore growth. Consequently, they underscore the need for financial liberalization, the elimination of all forms of public intervention and freeing the interest rate.

Furthermore, it is believed that financial sector development may improve the level of

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<sup>4</sup> For a detailed review of theoretical research on the connections between the operation of the financial sector and economic growth, see Levine (2005).

<sup>5</sup> See Ang (2008).

savings, by widening the range of available instruments and providing the higher real interest rates. In turn, higher savings are likely to raise investment and growth. However, the link between the real interest rate and savings are ambiguous. On the one hand, higher real interest rate implies a higher return on savings and thus a higher long run income (wealth effect), which should increase current consumption. On the other hand, the opportunity cost of current consumption increases as the return on savings increases, which should lead to higher savings (substitution effect). Since wealth effect is less important in low income countries, a priori one would expect to find a positive relationship between savings and real interest rates in developing countries.<sup>6</sup>

It is also believed that positive interest rate should deeper the market by encouraging more savings in the form of financial assets. Thus, even if a higher real interest rate does not lead to higher real saving, it may lead to higher financial savings. A developed financial sector would provide an incentive to household to change the form in which they hold their wealth, i.e. to hold more financial assets. The higher financial savings is intermediated towards real investment and if there is more deepening, it is expected to lead to a more efficient allocation of financial resources towards real investment. Thus, efficient allocation of financial resources would result higher economic growth in the country.

### **2.2.2. Anti Liberalization Views**

Disputing the McKinnon and Shaw view that high time deposit rates, particularly positive in real terms are good for LDCs for high growth, Wijnbergen (1983) theoretically examines the likely impact of change in bank lending and deposit rates on economic activity, inflation and growth. The author believes that the portfolio shift depend upon whether deposits are close substitutes to ‘unproductive’ assets providing no pass through into capital, like cash, gold or commodity stocks, or to ‘productive’ assets like loan extended in curb market. The author finally concludes that when time deposit rates are increased, it will accelerate inflation, and if they are contractionary, this will lower profit and therefore investment and medium term growth.

It is also believed that financial liberalization would result transfer of the funds from the informal credit markets that are more efficient at intermediating funds as there are fewer leakages and no reserve requirements<sup>7</sup>. The services offered by financial institution require the collection and processing of a great deal of information, which make their services expensive. Furthermore, financial institutions must cover administrative costs, taxes, and losses from default. All these costs are covered by charging fees for specific services and interest on loans. Since informal financial entrepreneurs rely on personal knowledge of borrowers; their information costs are low.

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<sup>6</sup> See Ogaki et al. (1996).

<sup>7</sup> Informal finance, such as loans within families and between friends or from pawnbrokers and moneylenders, is still important in many countries including Pakistan.

Stiglitz (1993) disputes the argument that financial repression leads to inefficient allocation of resources. According to him, financial repression increases firms' equity and then firms are more likely to select good projects when they have more of their own capital at stake. Similarly, most of the successful economies of East Asia have relied on directed credit programs. Because, directed credit, in contrast to subsidies, does not require the government to raise revenues in an underdeveloped tax system of such developing countries. For him, lack of competition leads to high interest rates, but it also leads to higher profits. And higher profits increase the strength of financial institutions and reduce the risk of insolvency. Like the US has had the most competitive banking system and the incidence of bank insolvencies, however, has been higher than in any other countries. Furthermore, from a theoretical perspective, Jappelli and Pagano (1994) argue that improvements in resource allocation would not necessarily lead to higher economic growth. In fact, under certain conditions, higher returns on savings that result from financial sector development can reduce savings rates to such an extent that overall growth slows.<sup>8</sup>

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<sup>8</sup> The overall impact of higher returns on the savings rate depends on the relative strength of the implied income and substitution effects that work in different directions.

### 3. Studies on Financial Development and Growth

The theoretical debate on the issue of financial liberalization is still unresolved. However, this debate has resulted in a series of cross country, panel and time series empirical studies. The first subsection discusses selected cross country and panel studies of growth and finance. The second subsection presents evidence from selected time series and case studies.

#### 3.1. Cross Country Studies

There are many cross country empirical studies that support the positive association between financial development and economic growth. Some of the selected cross country studies are discussed in the following paragraphs in chronological order.

The first path breaking study on finance and growth is conducted by Goldsmith (1969) using data on 35 countries over the period 1860 to 1963. Using the value of financial intermediary assets as a share of economic output, the author assumed that the size of the financial intermediary sector is positively correlated with the quality of financial functions provided by the financial sector. Goldsmith graphically documented a positive correlation between financial development and the level of economic activity. However, the author did not come up with a definite conclusion about causal relationship between financial development and economic growth.

Roubini and Sala-i-Martin (1992) analyze the relationship between the degree of financial development and the growth performance of a large cross section of countries at the theoretical and empirical levels. The empirical study is for 53 countries for the period 1960-1980 and a Barro type growth model is used. They show that financial repression reduces productivity of capital and the growth rate of the economy.

King and Levine (1993) study the relationship between financial development and economic growth for 80 countries over the period 1960-1989, accounting for other factors than the financial structure alone, which may influence economic growth. They use four measures for the level of financial development<sup>9</sup> and find strong positive relationship between each of the financial development indicators and the three growth indicators i.e. long run real per capita growth rates, capital accumulation and productivity growth. They also perform causality analysis and conclude that, initially level of financial development predicts economic growth, indicating a causal relationship from financial development to economic growth in early stages of growth. They emphasize that policies that alter the efficiency of financial intermediation exert a first order influence on growth.

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<sup>9</sup> These indicators were (i) the ratio of liquid liabilities to GDP; (ii) ratio of deposit money bank assets to total assets; (iii) the ratio of non financial private sector credit to total credit; and (iv) ratio of claims on the non financial private sector to GDP.

Demirguc-Kunt and Levine (1996) collected and compared a broad array of indicators of stock market and financial intermediary development, using data from forty-four developing and industrial countries during the period from 1986 to 1993. They find that from 1986 to 1993 the most developed stock market in the world were in Japan, the US and the UK, and the most underdeveloped markets were in Colombia, Venezuela, Nigeria, and Zimbabwe and the growth rates of the countries considered reflect this different significantly. They also find that most stock market indicators are highly correlated with the development of efficient functioning of the banks, non bank financial institutions, and private insurance companies and pension funds.

Levine and Zervos (1998) construct numerous measures of stock market development to assess the relationship between the stock market development and economic growth, capital accumulation, and productivity growth in a sample of 42 countries over the period 1976-93. They control for many other potential growth determinants, including banking sector development. They find that the initial level of stock market liquidity (turnover ratio)<sup>10</sup> and initial level of banking development (bank credit) are positively and significantly correlated with future rates of economic growth, capital accumulation, and productivity growth even after controlling for other potential variables.

Rajan and Zingles (1998) using the data for 41 countries for the period 1980-1990, find that industries which heavily depend on external finance grow faster in countries with well developed intermediaries and stock markets than in countries with less developed financial system. They emphasized that financial development lowers the costs of external financing and therefore foster economic growth.

Levine (1999) first examines the effects of legal and regulatory environment on financial development and then the link between financial intermediary development and economic growth. Using data on 77 countries over the 1960-89 period, the author finds that financial intermediaries develop more in countries with legal system that assign high priority to creditors, more effectively enforce contracts, and have information disclosure. Then using a sample of up to 45 countries over the same period with GMM method the author finds strong positive relationship between measures of financial intermediary development and economic growth. The author concludes that legal and regulatory changes that boost financial intermediary development will induce a rapid acceleration in long run economic growth.

Beck, Levine and Loayza (2000) study the empirical relation between the level of financial intermediary development and (i) economic growth, (ii) total factor productivity growth, (iii) physical capital accumulation and (iv) private savings rates. They use cross-country instrumental variable estimator to extract the exogenous component of

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<sup>10</sup> Turnover ratio equal to the total value of shares traded on a country's stock exchange divided by stock market capitalization (the value of listed shares on the country's stock exchange).

financial intermediary development, and a panel techniques to control for biases associated with simultaneity and unobserved country specific effects. After controlling for these potential biases, for 63 countries for the period 1960-1995, they find a robust, positive link between financial intermediary's development and both real per capita GDP growth and total factor productivity growth. However, they find that the long run links between financial development and both physical capital growth and private savings rate are although positive but sensitive to alternation in estimation techniques and measures of financial intermediary's development.

Levine, Loayza and Beck (2000) using a varying sample of 63 to 74 developed and less developed countries over the period 1960-95, go beyond previous studies recognizing the potential biases induced by simultaneity, omitted variables and unobserved country-specific effect on the finance growth nexus. To effectively deal with these problems, they use GMM as well as cross sectional instrumental variables estimators where legal rights of creditors, the soundness of contract enforcement and the level of corporate accounting standards are used as instruments to examine the effect of exogenous component of financial development on economic growth. Using both cross-section and panel techniques, they find that exogenous component of financial intermediary development is positively associated with economic growth. They suggest that legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices can boost financial development and accelerate economic growth.

Khan and Senhadji (2000) estimate the empirical relationship between financial depth and growth by estimating a standard growth equation with financial development indicators that cover both the banking sector and market securities. The results confirm the strong positive and statistically significant relationship between financial depth and growth in the cross-section of 159 countries for the average of 1960-99.

Loayza and Ranciere (2004) estimate the short-run and long-run impacts of financial intermediation on growth. They use a panel error correction model, where short and long run effects were estimated jointly from a general autoregressive distributed lag (ARDL) model and where short-run effects were allowed to vary across country. The sample consists of 75 countries with annual data during the period 1960-2000. They find that economic growth (growth rate of GDP per capita) is positively and significantly linked to the measure of financial intermediation (private domestic credit as ratio to GDP) in the long run. They show that 1 percent increase in the ratio of private credit to GDP leads to a rise of 0.7 percentage points in the growth rate of per capita GDP. They also find that the short run average relationship between the growth rate of GDP per capita and the measure of financial intermediation is strongly negative.

Christopoulos and Tsionas (2004) investigate the long run relationship between financial depth and economic growth via panel cointegration analysis. For 10 developing countries, the empirical results provide a clear support for a single equilibrium relation

between financial depth, growth and ancillary variables.<sup>11</sup> They also find a unidirectional causality running from financial depth to economic growth.

Recently Aghion et al. (2005) analyze the financial development and steady state growth using cross-section data on 71 countries over the period 1960-1995. They use private credit GDP ratio, as a measure of financial development. They conclude that all countries above some critical level of financial development should converge in growth rate, and that in such countries financial development has a positive but eventually vanishing effect on steady state GDP.

### 3.2. Time Series Studies

To overcome the number of statistical problems that are associated with cross-country studies, there are some time series and case studies that examine the finance-growth relationship using a variety of techniques.

Jung (1986) investigates the international evidence on the causal relationship between financial development (measured by currency to M1 and M2-GDP or GNP ratio) and economic growth (measured by per capita GNP or GDP) by using Granger test for 56 countries (with 19 industrial countries) with varying sample period. The author finds that when the currency ratio is used as a measure of financial development for the LDCs causal direction runs from financial development to economic growth and for industrial countries the reverse causal direction exist. On the other hand, the M2-GDP (or GNP) ratio does not appear to distinguish LDCs and industrial countries in terms of causality direction.

Demetriades and Hussein (1996) using cointegration, causality and error correction test for 16 countries with varying annual observations find little support to the view that finance is a leading sector in the process of economic development. However, they find that the relationship between financial development and economic growth is bi-directional. They conclude that reforms in the financial sector may contribute to the more general process of economic development.

Rousseau and Wachtel (1998) examine the nature of link between the intensity of financial intermediation and economic performance for five countries<sup>12</sup> over the past century (1870-1929) using Vector Error Correction Models (VECMs). They conclude that there exists a long run relationship among measures of financial intensity and real per capita levels of output and the monetary base.<sup>13</sup>

Rousseau (1999) examines that role of financial factor in rising investment rates and per capita income in Japan over the 1880-1913 period. Drawing inferences from cointegrated vector autoregressive (VAR) system, the author finds a single long-run

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<sup>11</sup> These variables were output share of investment and inflation.

<sup>12</sup> The five countries were US, UK, Canada, Norway, and Sweden.

<sup>13</sup> The intensity was measured by the asset of different financial institutions.

relationship between the macroeconomic indicators and measures of financial development.<sup>14</sup> The results of the causality test indicate that financial variables Granger-cause output, while output does not Granger-cause the financial variables. The author concludes that financial reforms in Japan during Meiji transition (1868-1884) played a leading role in the rapid expansion of output and investment over the next three decades.

Arestis, Demetriades and Luintel (2001) utilizing time series data from five developed economies<sup>15</sup> and using VAR framework, examine the relationship between stock market development and economic growth, controlling for the effects of banking system and stock market volatility. They measure output by the logarithm of real GDP, and stock market development by the stock market capitalization to GDP, banking system development by the logarithm of the ratio of domestic credit to nominal GDP, and stock market volatility by an eight-quarter moving standard deviation of the end-of-quarter change of stock market prices. They find that although both banks and stock market promote economic growth, the effects of the former are more powerful. Furthermore, stock market volatility exerts negative effects both on financial development and output. They support the view that bank-based financial system may be more able to promote long-term growth than capital-market-based ones.

Fase and Abma (2003) examine empirical relationship between financial development and economic growth for nine emerging countries in Asia<sup>16</sup>, using data of varying length, and an error correction framework as econometric methodology. Their main finding is that financial development matters for economic growth and that causality runs from the level of financial intermediation and sophistication to economic growth. They conclude that improvement of financial structure in developing countries may benefit economic development, and that the policy of financial reform in the selected countries is likely to improve economic growth.

Khan, Qayyum, and Sheikh (2005) test the relationship between financial development and economic growth for Pakistan over the period 1971–2004 using Autoregressive Distributed Lag (ARDL) technique. The results of the study suggest that in the long-run, financial depth and real deposit rate are important factor contributing to economic growth in Pakistan. However, the relationship between growth and financial development is though positive but remained insignificant in the short-run.

Waheed and Najia (2009) recently examine the long-run relationship between financial development and economic growth for Pakistan for the period 1971 to 2006. The

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<sup>14</sup> The macroeconomic indicators were GNP, gross fixed investments and their ratios with GNP. The financial variables were (i) total financial intermediary assets, (ii) intermediary assets, corporate stocks and bonds, and (iii) currency in circulation.

<sup>15</sup> They employed quarterly data for Germany for 1973:1-1997:4, United States for 1972:2-1998:1, Japan for 1974:2-1998:1, the United Kingdom for 1968:2-1997:4, and France for 1974:1-1998:1.

<sup>16</sup> These nine countries were Bangladesh, India, Malaysia, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, and Thailand.

co-integration test results show that there exist a significant robust long run positive relationship between financial development and economic growth in Pakistan. Moreover, the econometric analysis shows that the other macroeconomic variables also provide some proof in explaining the real per capita income of Pakistan. They find that the level of investment and Government spending on education also exerts a positive and statistically significant impact on real per capita income in the long run.

Financial development and economic growth are thus clearly related, and this relationship has been proved by many cross country and time series studies. However, the direction of causality is remained unresolved in both theory and empirics.

## 4. Financial Sector Reforms in Pakistan

In this section we discuss the financial sector reform process with specific reference to Pakistan, which offers an interesting case study. However, before we discuss the financial reforms, it is essential to highlight the reason as to why the system reached to the point where the reforms become necessary.

### 4.1. Pre-Reform Structure

A total of 24 commercial banks were doing business in Pakistan in the pre reform period out of which 7 were large state-owned banks and 17 were foreign banks as on end June 1990. In non-bank financial institutions (NBFIs), there were 12 development finance institutions (DFIs)<sup>17</sup>, 5 investment banks, 5 leasing companies, 10 modaraba companies, 2 mutual funds, one housing finance and one discount house. Furthermore, there was a Central Directorate of National Savings (CDNS)<sup>18</sup> and two equity markets in the country by the end of June 1990.

During the pre-reform period, despite the opening of non-bank financial sector for the private investment in mid 1980s, state-owned financial institutions held the bulk of assets, advances and investments of the entire financial sector at the end of 1980s. From Table 4.1 it is clear that during the pre-reform period the assets of the banking system were highly skewed towards state-owned commercial banks and DFIs, who were holding more than 90 percent of the assets, advances, and investment of the financial sector. The entry of foreign banks and domestic private NBFIs did not result in any significant change.

**Table 4.1: Pre Reform Structure of Financial Sector in Pakistan (1990)**

(share in %)						
	Number	Branches	Assets	Advances	Investment	
<b>Banks</b>						
State-owned	7	7043	92.2	92.1	93.5	
Private	0	0	--	--	--	
Foreign	17	45	7.8	7.9	6.5	
<b>NBFIs</b>						
State-Owned	13	--	92.8	96.3	97.4	
Private	23	--	7.2	3.7	2.6	

Data source: State Bank of Pakistan (2000).

<sup>17</sup> The objective of DFIs is to provide large quantities of term finance at affordable rates and to assist that segment of the corporate sector that has no access to the regular banking system.

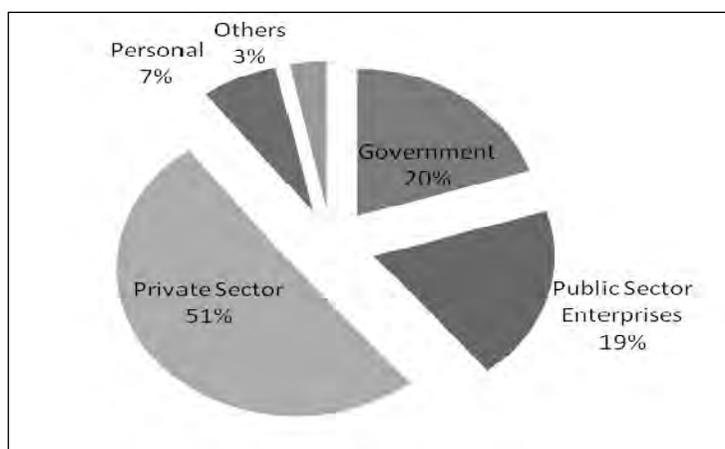
<sup>18</sup> CDNS is an attached department of the Ministry of Finance and is engaged in the operations of various National Savings Scheme (NSS) in the country.

During the pre reform period the interest rate restrictions were in the form of *floors* on deposit rates and *ceilings* on lending rates<sup>19</sup> of commercial banks. These restrictions were imposed with a desire to provide low cost financing to encourage investment in priority sectors. Hence, the real interest rates on deposits remained negative for most of the time. This has discouraged savings and led to financial dis-intermediation.

The State Bank of Pakistan (SBP) was conducting the monetary policy in the country with the instruments of direct control. Every bank was required to maintain at least 5 percent of demand and time liabilities in cash with SBP as cash reserve requirement (CRR). These were non-interest bearing assets with SBP. Furthermore, there was the statutory liquidity requirement (SLR), where banks were required to maintain 35 percent of time and demand liabilities in cash or low yielding government securities.<sup>20</sup> There has been direct credit control with bank specific credit ceiling and selective credit allocation.

Thus, both price instrument (interest rate ceiling) and quantity instrument (direct credit control) were used to control credit. As a result the state owned commercial banks were quite contended by charging their private sector borrowers' high lending rate because they had a large captive client i.e. the government. During this period the fiscal deficit averaged 7.1 percent of GDP and the government borrowing was at high level. Similarly, public sector enterprises and large agriculture-based manufacturers were often short of funds for new investment, operation and maintenance. The government very often instructed to banking system to finance such state owned enterprises. These public sector enterprises (see Figure 4.1) were also taking a large share of banking sector credit in the pre reform period.

**Figure 4.1: Classification of Scheduled banks Advances by Borrowers**  
(end June 1983)



Data source: State Bank of Pakistan (2005), calculated by author.

<sup>19</sup> Interest rate ceiling is the absolute maximum rate of interest that a financial institution can charge for an adjustable rate mortgage or loan.

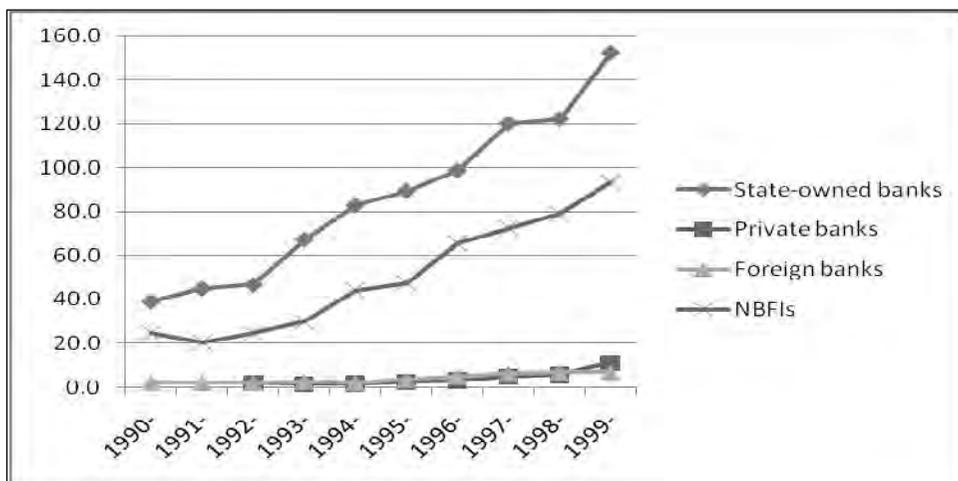
<sup>20</sup> See, State Bank of Pakistan (2000:15).

Since up to 1996 the focus of the reform was not the Non Performing Loans (NPLs)<sup>21</sup>, the state owned banks and NBFIs faced the increasing quantum of NPLs (see Figure 4.2). Some of them were willful and reflected collusion between the bankers and the borrowers, while other may be due to government’s inconsistent policies, pure commercial setbacks or external shocks. Furthermore, political interference worsens the performance of the banking sector as borrowers most often expected not to repay loans they took, especially from the state owned banks.

There was a wide dis-intermediation in the banking system. While National Saving Schemes (NSS) of the Central Directorate of National Savings were offering a variety of tax incentive and relatively high returns (up to 15 percent per annum tax free) at zero risk to the end investors, whereas the financial institutions were providing 7 to 9 percent per annum on time deposits.<sup>22</sup> Interestingly, the banking sector was not allowed to invest in such instruments of NSS. Banks mainly held treasury bills which were offering 2.1 percent rate of return after tax. As a result of this, not only banks share in financial savings decline, but also SBP role as a monetary authority was weakened.

In the pre-reform period, the money market consisted of a primary market for treasury bills and government treasury deposit receipt, call money market<sup>23</sup>, and a market for sale and

**Figure 4.2: Quantum of Non Performing Loans (NPLs) during 1990s**  
(Billion Rupees)



Note: Data for banks and NBFIs are of end calendar and fiscal year respectively.  
Data source: State Bank of Pakistan (2000).

<sup>21</sup> According to the prudential norms, loans are classified as non-performing when payments of principal or interest are over due by 90 days or more from the due date.

<sup>22</sup> See State Bank of Pakistan (2000:21)

<sup>23</sup> To maintain daily cash balances for clearing purpose and meeting the cash reserve requirement of SBP, all banks were allowed to lend and borrow overnight in this market.

purchase of unutilized portion of credit ceiling. Secondary market for treasury bills and government treasury deposit receipts did not exist, because of presence of discount window in SBP, which allowed early discharge of these bills.<sup>24</sup>

During 1980s, there were only two stock exchanges in Pakistan (in Karachi and in Lahore), where Karachi Stock Exchange (KSE) was larger with more listed companies. There were certain structural issues that constrained the market progress as the market capitalization in terms of GDP was only 5.7 percent in fiscal year 1989. In this period, foreign nationals were not allowed to make investment in equity market without permission and were also barred from owning 100 percent share of a company. Furthermore, there were restrictions on foreign exchange movement that made foreign investors reluctant to invest in the market.

The foreign exchange market of the country was heavily regulated by SBP through a system of exchange controls. All commercial banks were authorized dealers (ADs) and exchange rate was given by the SBP. Furthermore, ADs rates (buying and selling) for public were set at 0.1 percent margin with respect to SBP's buying and selling rates. The SBP maintained its own foreign currency reserve and also maintained the foreign reserve deposits of its ADs. The participants of market were exporters, remitters, tourist (as suppliers) and importers and government sector organizations (as demanders).

The SBP's autonomy was limited and its supervisory domain was undermined by the Pakistan Banking Council (PBC), a body formed to oversee the affairs of the state-owned commercial banks. Moreover, the supervisory framework lacked proper risk mitigation elements and supervisors lacked requisite supervisory skills in this regards. In addition, the regulatory capacity was inadequate to regulate a market oriented financial system.

The state-owned banks became overcrowded and over staffed for political reasons and there was deterioration in their service standard. The Trade Unions in state-owned banks had played a role in harassing, black mailing the senior officials and indulging in malpractices and corruption.<sup>25</sup>

The bank staffs were unskilled in terms of financial knowledge and information/technological system. The employees were too often idle, and there was a need to improve the morale of the banking staff to encourage them to work harder even without managerial monitoring. All these resulted in large operating losses, administrative laxity, and poor governance.

Thus, there were both physical and institutional weaknesses in the financial sector of Pakistan in the pre-reform period. The limited competition due to entry restriction and restrained activities of foreign banks hampered the development of the financial sector. In addition, underdeveloped money and capital markets limited the role of financial sector in terms of intermediating funds between lenders and borrowers. As a result, firms and

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<sup>24</sup> See State Bank of Pakistan (2000)

<sup>25</sup> See Hussain (2004b).

individuals started to meet their long term financing needs from informal sector.

The result of these weaknesses were reflected in low economic efficiency and low domestic savings rates (that is 7.7 % of GDP during 1980s) and low investment rate in the private sector (that is 7.8 percent of GDP during 1980s). Furthermore, the interest rate spread was very high, the problem of non-performing loans became serious and banks started to face liquidity problem. Thus, there was a wide spread financial repression in the country during the pre reform period.

## **4.2. Financial Reforms**

In order to improve monetary management as well as the quality of financial intermediation, the authority started a far reaching financial reform program. These reforms were started under the macroeconomic and financial sector restructuring guidance of the International Monetary Fund (IMF). The World Bank and the Japanese government also co-financed the banking sector adjustment loan (BSAL) to support government efforts. The objective of these reforms were to reduce direct government intervention and strengthen the role of market forces in allocation of resources, improve the capacity of financial institutions for domestic resources mobilization efforts, enhance the effectiveness of monetary policy instruments, promote competition among banks, and strengthen their financial soundness. The key reforms that have been implemented since 1989 are discussed below.<sup>26</sup>

As stated earlier, in the beginning of the 1990s state-owned banks accounted for more than 90 percent of total assets, advances and investment in the financial sector. The first focus of the reform was the gradual liberalization of controls on banking activities. The process of deregulation of the financial sector began with the denationalization of two commercial banks. In addition, Government started to issue licenses for new commercial banks, investment banks, and leasing companies in the private sector.<sup>27</sup> In order to avoid the mushroom growth of banks a moratorium was imposed in 1995 and entry of new bank was made difficult. However, the branch policy for both the domestic private banks and foreign banks was eased to provide an opportunity to the existing banks to grow.

As a step in the direction of interest rate liberalization, an auction system has been introduced for government securities. In March 1991, the government began auctioning of the treasury bills and federal investment bonds in the open market, where four non bank financial institutions were given permission to send in their bids for the auction of these bills.

As the secondary market in government debt took root, the government abolished the

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<sup>26</sup> This reform process gained momentum since 1997, when a crucial set of reforms aiming at institutional strengthening, restructuring of banks was introduced.

<sup>27</sup> Government issued licenses to 10 new commercial banks in the private sector to start operation in August 1991 (see State Bank of Pakistan 2000:25).

scheme of credit ceiling in August 1992 and replaced it with a system of Credit/Deposit Ratio (CDR), which allowed commercial banks to extend credits up to 30 percent of their rupee deposits and 30 percent of their foreign currency deposits. Thus, the extension of credit was linked with the deposit mobilization efforts of the commercial banks. However, this system was abolished in September 1995, and SBP declared that credit to the private sector would be regulated through market based instruments of Open Market Operation such as changes in liquid assets and cash reserve requirements.

In 1991, the external sector further opened up, exchange control was virtually abolished, new debt instruments denominated in foreign currency were introduced and many incentives were given to the foreigners. The residents have also been allowed to hold foreign currency accounts on an indefinite basis. The persons maintaining foreign currency accounts in Pakistan with authorized dealers have been allowed to sell forward the balances held in their accounts to importers in order to bring depth in the short term forward cover market.<sup>28</sup>

In 1991, the government gave licenses to moneychangers to operate in Pakistan and thereby “legalized” a second exchange rate that prevailed in the market of moneychangers. The Hundi system under which these moneychangers transferred funds was previously a hidden source of capital flight. With the introduction of the resident foreign currency deposits scheme and licensing of moneychanger in 1991, not only capital flight was legalized, an attractive instrument for keeping domestic savings in foreign exchange was also created.<sup>29</sup>

In the equity market, exchange and payment reforms were introduced in early 1990s. Islamabad Stock Exchange started functioning in 1992. Foreign investors and non-resident Pakistanis were allowed to trade in shares at the domestic stock exchanges and also to freely repatriate initial investments as well as profits. Furthermore, foreigners were allowed to own 100 percent equity in a venture. These steps gave much needed support to the equity market in Pakistan.

To reduce the cost and operate more efficiently, the banks have been allowed to close down any of their existing branches provided that the area is not left without an alternative arrangement for provision of banking services to local community. Furthermore, banks were allowed to shift or relocate their banked area branches within the same city/town/village and on country wide basis. As a result of this, there has been retrenchment of surplus staff through the “Golden Handshake Scheme” and closure of over-extended branches.

To deal with the problem of NPLs, a multi-track strategy was adopted which included enacting of new loans, creation of institutions to pursue recovery of bad loans, and an incentive package for genuine cases. As a result new Banking Courts and Tribunals have been established to strengthen the loan recovery process and to resolve the disputes related

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<sup>28</sup> See Ayub (1996).

<sup>29</sup> See Janjua (2004).

to NPLs through legal procedures. The, State bank of Pakistan was also authorized to publish the list of defaulters after notifying and hearing from them in advance. Furthermore, a number of cases of willful bank defaulters were referred to National Accountability Bureau (NAB) for taking legal actions and recovering the amounts due.

To facilitate the depositors to make informed judgments about placing their savings with banks, it has been made mandatory for all banks and non-banks financial institutions to get themselves rated by one of the approved credit rating agency.<sup>30</sup> These ratings were then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies.

The Small and Medium Enterprises (SMEs) are the backbone of an economy and carry significant economic benefits. The development of this sector leads toward creation of jobs, enhancement of competition and exports, while propelling the overall economic growth. The access of Small and Medium Entrepreneurs to credit has been a major constraint to the expansion of their business and up gradation of their technology. To tackle this issue, a Small and Medium Enterprise (SME) bank has been established to provide leadership in developing new products such as program loans, new credit appraisal and documentation techniques.

There have been various restrictions on mortgage financing and consumer durable financing during pre reform period. During 2000s most of these constraints have been removed. Banks and financial institutions were encouraged and enabled to move into mortgage and consumer financing. The commercial banks have started consumer financing during 2003. The beneficiaries of this sector are mostly the middle income group borrowers and the most common types of financing have been auto financing and credit cards. The mortgage financing and consumer durable have begun to attract increased attention.

In recent years, micro finance has been promoted as a means of directly linking finance with growth and poverty reduction. Primarily in informal sector, the micro finance sector is now becoming a part of formal financial sector. The Microfinance Ordinance 2001, supported by SBP's dedicated prudential regulations, provides the legal and regulatory framework for microfinance banks. So far, SBP has approved licenses for six microfinance banks in the country and set a target to achieve 3 million active borrowers by 2010.

There are large gender disparities in Pakistan than other comparable developing countries. The First Women's Bank has been established in 1989 to take care of SMEs and micro finance for women. The bank now established branches throughout the country.

A large number of people in Pakistan have remained withdrawn from commercial banking because of their strong belief against riba-based banking. Taking this issue, the State Bank of Pakistan has set up a full fledged Islamic Banking Department and a Shariah

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<sup>30</sup> From April 1995 all non-bank financial institutions and from June 2000 all banks are required to have themselves rated by one of the approved credit rating agency.

Advisory Board to help it in the promotion of Islamic Banking in the country. The full fledged Islamic banks have been established in the country that opened the doors for businesses and several other banks have branches that deal to Islamic banking product and services.

The State Bank of Pakistan has also been given considerable autonomy to act somewhat more neutrally. In February 1994, the Board of Directors of the SBP was given full autonomy in all matters relating to administration and conduct of business of the bank. There has been strengthening in the central bank's supervisory role over the commercial banks and the bank extended its supervisory responsibilities for the first time to the non-bank financial institutions (Khan, 1995). In 1997, SBP legislation was amended to enhance its independence and to empower its Board to deal more effectively the monetary management matters. Furthermore, Pakistan Banking Council was abolished and Central Bank staff was trained in relevant areas to build capacity at all levels.

#### 4.3. Post Reforms Structure

The results of liberalization so far have been impressive. The banking sector which was fully dominated by state-owned commercial banks has been opened up to the private sector and the number of local private banks, microfinance banks, investment banks, and other financial institutions (such as leasing companies, modaraba companies, and mutual funds) has increased drastically. Table 4.2 provides a comparison of number of financial institution in pre and post reform period.<sup>31</sup>

**Table 4.2: Pre and Post Reform Comparison of Financial Institutions in Pakistan**

(end June)

Financial Institutions	1990	2000	2005	2008
State-owned Banks	7	8	4	4
Local Private Banks	0	12	20	26
Foreign Banks	17	19	11	7
Specialized Banks	0	0	4	4
Microfinance Banks	0	0	0	6
Investment Banks	5	16	12	12
Development Finance Institutions	12	12	5	6
Other Financial Institutions	19	128	100	141

Note: SME Banks have been transferred from DFIs to Specialized Banks from June 2005.

Data source: State Bank of Pakistan (2000, 2007-08a and back issues).

<sup>31</sup> The number of foreign banks reduced in the country either because they could not meet central bank requirement to raise their paid up capital or because they were part of an international merger.

It is clear from Table 4.2 that financial sector reforms resulted remarkable increase in the number of financial institutions in the country. The number of local private banks increased to 12 during reform period and reached to 26 by the end June 2008 in the post reform period. Similarly, to deepen and broaden the financial markets and to lessen the dependence on banks for credit, the non bank financial institutions were also allowed to increase during the reform process. As a result of this, by the end of June 2008, there were six DFIs and 141 other non-bank financial institutions operating in the country.<sup>32</sup>

As a result of the reforms, the private sector emerged as the single largest owner of the financial sector in Pakistan. Its share in assets of all banks increased to 74.89 percent by the end of March 2009. Similarly, the share of state owned banks in total banking assets has declined from 92.2 percent in 1990 to 18.70 percent by the end of March 2009 (see Table 4.3). The significant change is also visible in number of banks, bank branches and the share in advances and investment.<sup>33</sup> The above development clearly suggests that the financial sector has witnessed substantial changes due to the reform measures.

To have an assessment of whether financial sector reforms have actually brought about more efficient allocation of credit, changes in the share of private sector in total credit provide important insight, since private sector is assumed to use resources more efficiently than the public sector.<sup>34</sup> It is clear from Figure 4.3 that share of government and public sector enterprises in total credit has significantly declined, while that of private sector significantly increased by the end June 2008.

**Table 4.3: Post Reform Structure of Financial Sector (end March 2009)**

(share in %)

	Branches	Assets	Advances	Investment
Commercial Banks				
State-Owned	1592	18.70	18.05	17.33
Private	5970	74.89	76.01	78.53
Foreign	68	4.17	3.21	3.17
Specialized Banks	539	2.24	2.72	0.97
All Banks	8169	100.00	99.99	100.00

Note: Bank branch figures are up to December 2007.

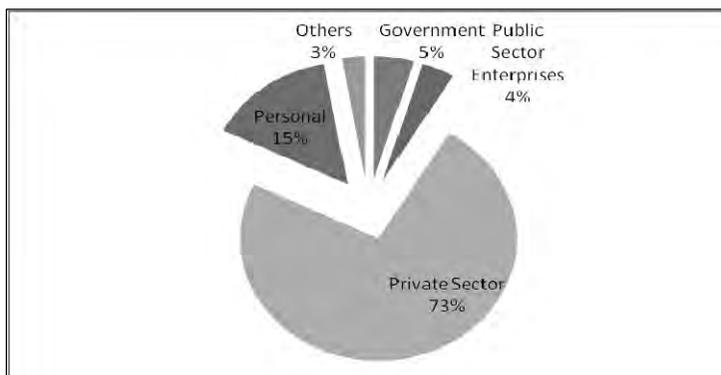
Data source: State Bank of Pakistan (2007a, 2009b), calculated by author.

<sup>32</sup> This includes leasing companies, modaraba companies, mutual funds, housing finance corporation, discount houses and venture capital companies.

<sup>33</sup> The share of NBFIs in total assets of the financial sector was 10.1 percent for the end December 2007.

<sup>34</sup> See Janjua (2004).

**Figure 4.3: Classification of Scheduled banks Advances by Borrowers**  
(end June 2008)

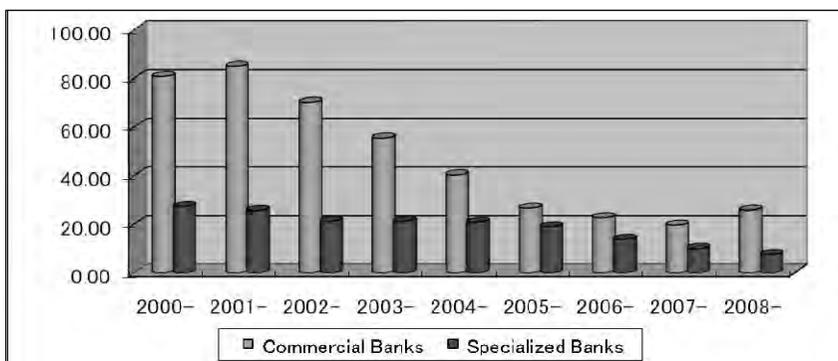


Data source: State Bank of Pakistan (2007-08a), calculated by author.

The rapid transformation of predominantly nationalized state owned banking system into a private sector owned has brought about fundamental changes in the ground rules governing the allocation of credit. Furthermore macroeconomic reforms and consequential stability has reduced fiscal deficit and the privatization of many state owned enterprises thus, reduced the demand for bank credit by the public sector, which freed resources for the private sector.

For many years the state-owned commercial banks and DFIs have been facing the increasing quantum of NPLs. The multi-track strategy followed by State Bank of Pakistan for NPLs as discussed earlier brought about significant decline in the quantum of NPLs of commercial banks and specialized banks in the financial sector. Figure 4.4 shows this improvement from 2000 to 2008.

**Figure 4.4: Quantum of Net Non-Performing Loans during 2000-08**  
(Billion Rupees)



Note: Data pertains to end period calendar year. 2008 data is for end June. Net NPLs is the value of non-performing loans minus provision for loan losses.

Data source: State Bank of Pakistan (2005, 2007-08a)

Over the past few years, e-banking has emerged on the global financial market as a major force, changing the business from consumers as well as organizational perspective. Liberalization and competition in financial sector forced domestic banks in Pakistan to introduce more modern technological innovations such as facility of automated teller machines (ATMs), telephonic banking, and internet banking. During the 2000s a large expansion in ATMs has been witnessed. It is clear from Table 4.4 that the improvement in electronic banking has been quite significant.

It has been estimated that a banking transaction through ATM costs one fourth as much as a transaction conducted over the counter in a traditional branch—and the similar transaction over the internet costs a mere fraction of the traditional teller cost.<sup>35</sup> Thus, the development of e-banking in the financial sector will significantly reduce the operational cost of the financial institutions.

Responding to the positive initiatives of government and the central bank, there has been significant growth in microfinance sector in the country over the last five years. Table 4.5 shows that the asset base of the industry has increased from Rs. 7.8 billion in 2003 to Rs.

**Table 4.4: Performance in Electronic Banking**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Number of Online Bank Branches	322	450	777	1581	2475	3265	3947	4979	5282
Number of Automated Teller Machines (ATMs)	206	259	399	552	786	1217	1948	2618	3121
Number of Credit/Debit/ ATM Card Holders (000)	240	415	736	1257	1874	4257	5102	6671	6733
Number of Transactions (Million)	4	6	10	15	24	30	43	60	35
Value of Transactions (Million Rupees)	13	22	39	69	120	181	262	382	239

Note: Data pertains to end period calendar year. 2008 data is for end June.

Data source: State Bank of Pakistan (2007-08a and back issues)

**Table 4.5: Performance in Microfinance Sector**

	2003	2004	2005	2006	2007
Total Assets (Billion Rupees)	7.8	9.6	13.4	17.5	22.9
Number of Offices	329	386	570	1073	1165
Number of Active Borrowers (000)	333	451	613	835	1267
Number of Active Women Borrowers (000)	165	199	273	434	640
Gross Loan Portfolio (Rs. Billion)	2.6	4.0	5.7	8.4	12.7

Data source: ILO-SBP (2009)

<sup>35</sup> See Hussain (2004b)

22.9 billion in 2007. Gross loan portfolio has also increased from Rs. 2.6 billion in 2003 to Rs. 12.7 billion in 2007. Presently a network of 1165 branches across the country is catering the needs of around 1.3 million active borrowers. The coverage of microfinance institutions is still remain lower however if the current rate of expansion continues, this institution is like to cover a large segment of potential active borrowers in the country.

The first Islamic banking license was granted on 31<sup>st</sup> January 2002. Since then the industry has been continuously showing impressive growth. Table 4.6 shows that in 2003 only one bank operated as the full fledged Islamic bank and the total assets of the Islamic banking industry accounted for a market share of about 0.5% and the total branch network comprised of 10 branches. This has increased to six banks with 186 branches in 2007. Similarly there is significant increase in assets, deposits and investment share of Islamic banks in the country. The ever expanding Islamic finance industry is providing opportunities to a fairly large segment of population that previously kept themselves away from the conventional banking sector. This, in turn will lead to further financial deepening in the country.

The banking industry has been showing a positive change in the corporate governance practices. Banks are now managed and run by better cadre of professional. The stakeholders now play an active role and take keen interest in the affairs of banks. The boards meet regularly and managements at majority of banks are equipped with professional competence and high degree of integrity. Banks have displayed high level of eagerness to up-grade their system.<sup>36</sup>

**Table 4.6: Performance in Islamic Banking**

(end December)

	2003	2004	2005	2006	2007
Number of full fledged Islamic Banks	1	2	2	4	6
Number of branches of Islamic Banks	10	23	37	93	186
As a Percentage of Banking Industry					
Total Assets	0.5	1.5	2.0	2.8	4.0
Total Deposits	0.4	1.3	1.8	2.6	3.8
Financing & Investment	0.5	1.3	1.7	2.3	3.5
Non Performing Financing to Total Financing (%)	0.7	0.9	1.0	1.3	1.2
Net Non Performing Financing to Total Financing (%)	0.0	0.2	0.2	0.4	-0.1

Data source: State Bank of Pakistan (2007b).

<sup>36</sup> Shamshad (2006).

#### 4.4. Empirical Studies on Reform

There are few studies that analyze different aspects of the financial sector's development in Pakistan during reform and post reform period. Khan and Aftab (1994) review the effect of interest rate liberalization and denationalization and privatization aspects of financial reforms in Pakistan. They conclude that denationalization of banks improved performance of these banks in terms of growth of assets, recovery of loans and ratio of bad loans. With reference to the interest rate liberalization, they find that although the relationship between the real interest rates and real savings was positive but almost negligible.

Imi (2003) uses micro data over the period 1997 to 2001 of five major state owned banks to examine the efficiency changes during and after the banking sector reform. The author utilizes production function approach where using labor (number of employees working for each bank) and capital (number of branches for each banks), banks were supposed to produce output (that is, performing loan defined by the total credit minus NPLs). The author finds that two of the banks improved the technical efficiency over the reform period, while the technical efficiency of other tends to be fluctuating. The author concludes that banks in Pakistan suffer from over-branching and over-employment and suggested for continue restructuring of the entire banking industry.

By the end of 1999, although the commercial banks were given mandatory targets for agriculture credits, they normally failed to achieve it. Only Agricultural Development Bank of Pakistan (ADBP) and provincial cooperative banks were active in giving credit to more than 60 percent of the population that was dependent on agriculture. In the year 2000, as a result of incentive to commercial banks, the commercial banks overtook the ADBP and cooperative banks in distributing loans to small and middle class farmers. Hussain (2004a) shows that the agriculture credit had an increasing trend in the post reform period by an average annual increase of 14.1 percent from 2000 to 2003. The data also shows that more than two third of the agricultural credit is delivered to the substance and small farmers. The author believes that this may generate economic activity and employment in agriculture and alleviate poverty.

Shamshad (2006) points out that even after reforms there is high sector concentration in the banking sector as the top five banks hold more than 50 percent of industry assets, advances and deposits. However, the author believes that this may improve in future due to increase competition from the small banks.<sup>37</sup>

Burki and Niazi (2006) investigate the impact of financial sector reforms on efficiency of state-owned, private, and foreign banks in Pakistan by taking data of 40 banks for the

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<sup>37</sup> The recent data shows that the share of top five banks in total assets and in total deposits was 51.9 percent and 54.6 percent respectively by the end March 2009 (See State Bank of Pakistan 2009b:47) .

period 1991-2000. They use frontier efficiency measure of Data Envelopment Analysis (DEA) to construct efficiency index for each bank.<sup>38</sup> They find that for the reform period (1993-96) efficiency declined because the banks were adjusting to liberalization, enhanced competition. However, they find improvement in efficiency after 1996.<sup>39</sup>

Khan (2009) measures the degree of concentration and competition in banking sector of Pakistan by using panel data of 26 banks from 1997 to 2007. Using the traditional measures of concentrations (M-Concentration ratio, Coefficient of Variation, and Herfindahl-Hirschman Index) the author finds that there has been visible improvement over the last decade. For competition test, the author finds that banking structure cannot be characterized as following perfect competition. However, the test results show that banking structure of Pakistan is consistent with a monopolistically competitive market structure.

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<sup>38</sup> Data envelopment analysis (DEA) is a linear programming based technique for measuring the relative performance of organizational units where the presence of multiple inputs and outputs makes comparisons difficult.

<sup>39</sup> The mean cost efficiency of state-owned, private, and foreign bank was 60%, 75%, and 80% respectively for the period 1991-2000.

## 5. Analysis of Financial Sector Reforms

The outcome of the financial sector reforms in Pakistan is evaluated by comparing relevant indicators before and after the introduction of reforms. These indicators were used by previous empirical studies for the assessment of performance of the financial sector. In practice more than one monetary aggregate are usually defined in the hope that multiple aggregates may collectively provide more information. In Pakistan four different types of monetary aggregates M0, M1, M2 and M3 are used to define the stock of money as well as for policy formulation. Reserve money (M0) consists of currency in circulation, currency in tills of scheduled banks, banks' deposits with SBP and other deposits with SBP. Narrow money (M1) consists of the outstanding stock of currency in circulation, the demand deposits of scheduled banks and other deposits with the State Bank of Pakistan. The first broad money (M2) includes M1 plus the outstanding stock of time deposits of scheduled banks and the outstanding stock of the resident foreign currency deposits. The second broad money (M3) includes; the outstanding stock of M2, outstanding deposits of the national saving schemes (NSS), and the outstanding deposits of the provincial cooperative banks.<sup>40</sup> The following sub-section uses these monetary aggregates in different ratios and analyzes their behavior during the study period.

### 5.1. Financial Sector's Performance

#### 5.1.1. Financial Intermediation

The 'level' of financial intermediation is a useful tool to assess financial sector development. Various measures to gauge this level include (a) currency to deposits, M2 and GDP ratios, and (b) various deposits to M2 ratios. The trends of these ratios in pre and post reform period are discussed below.

Currency and deposit are two compelling financial assets. People like to keep both in certain proportion depending upon their taste, spending habits, cost of holding currency, quality of financial services and efficiency of payment system. The currency ratios tend to fall in a financial environment where market forces dominate, where there are alternative savings and investment instruments (stocks, bonds, mutual funds etc), where access to the banking system has expanded.<sup>41</sup> Figure 5.1 shows the trend of currency ratios during pre and post reform period.

The currency to total deposits ratio had an increasing trend in the second half of pre-reform period as it increased from 43.01 percent in 1986 to 51.37 percent in 1989. The

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<sup>40</sup> See State Bank of Pakistan (2005) and Government of Pakistan (2005-06)

<sup>41</sup> See Nashashibi et al. (2001).

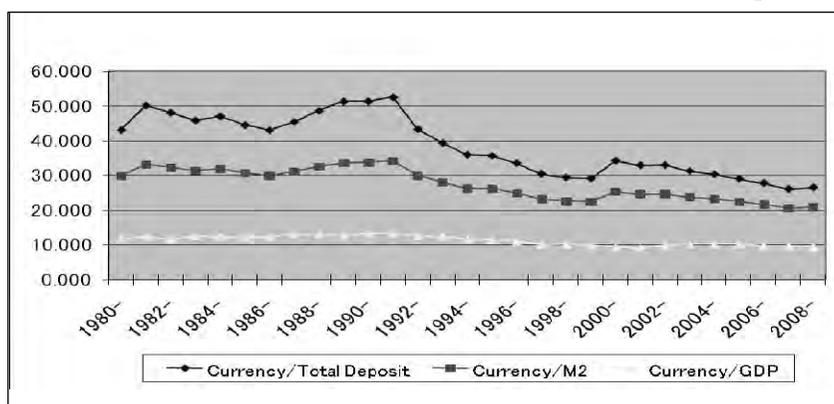
currency to M2 ratio was also high (30.69 percent in 1985) and had an increasing trend during the second half of the pre reform period. Same was true for currency to GDP ratio, which was 11.95 percent in 1985 and had an increasing trend. This indicated a growing size of parallel economy. It can be seen that all these currency ratios had declining trend during the reform and post reform periods and reached to a level of 26.53 percent as a ratio of total deposits, 20.94 percent as a ratio of M2 and 9.37 percent as a ratio of GDP by the end of fiscal year 2008. This indicates increasing cash inflow in the banking system and reduced size of the parallel economy.

During the pre reform period, since the profitability of commercial banks declined and they were unable to offer attractive returns, a shift took place away from time deposits to national savings scheme (NSS). As a result, there occurred a gradual decline in deposit ratios. A review of the data indicates that during the second half of the pre reform period time deposits to M2 ratio was 35.31 percent in 1985 which had a declining trend and reached to 28.95 percent in 1989. Total deposit to M2 ratio was 68.9 percent in 1985 and had a declining trend during the second half of the pre reform period and reached to a level of 65.35 percent in 1989.

Figure 5.2 shows that both deposits indicators (time and total) had increasing trend during the reform and post reform period. This indicates growing confidence on banking system and reduced size of the parallel economy. It should be noted that in the second half of the pre-reform period total deposit to M2 ratio was declining indicating shortage liquidity in the banking system. However, in the reform and post reform period this ratio has increasing trend, showing an improvement in liquidity position of the banks.

**Figure 5.1: Currency Ratios for Pre and Post Reform Periods**

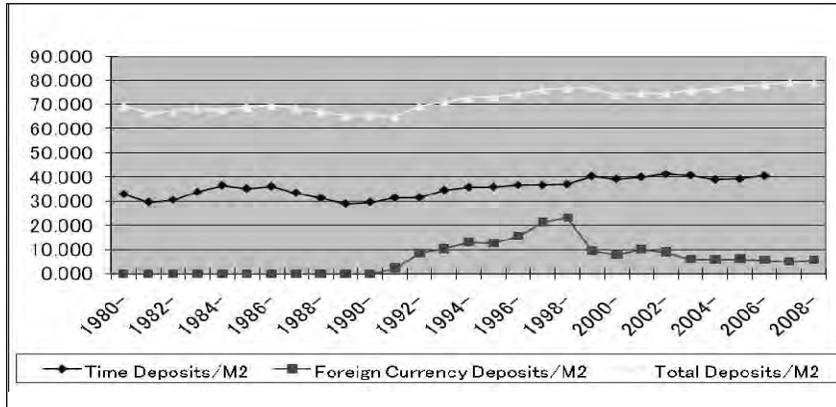
(percent)



Data source: State Bank of Pakistan (2005, 2007-08a) and Government of Pakistan (2008-09 and back issues), calculated by author.

**Figure 5.2: Deposit Ratios for Pre and Post Reform Periods**

(percent)



Data source: State Bank of Pakistan (2005, 2007-08a) and Government of Pakistan (2008-09 and back issues), calculated by author.

During the pre reform period residents were not allowed to have foreign currency deposits. In 1991 the residents were allowed to open foreign currency account with banks in Pakistan. This has resulted a sharp increase in residents' foreign currency deposits which increased from 2.37 percent of M2 in 1991 to 23.1 percent in 1998. However, due to freezing of the residents foreign currency deposits in 1998 the foreign currency deposits as a ratio of M2 declined to 9.44 percent in 1999.<sup>42</sup> Since then it has a fluctuating trend and remained low between 5 to 6 percent of M2. The freezing of foreign currency also had serious effect on other deposits that can still be seen in such aggregates.

### 5.1.2. Financial Deepening

The most commonly used indicator of financial sector deepening is the ratio of M2 to Gross Domestic Product. As economy develop, the ratio of M2 to GDP tends to rise as access to banking and saving instruments spreads. But as markets mature, the M2 to GDP ratio tends to decline as other financial instruments become available.<sup>43</sup> Table 5.1 shows that M2-GDP ratio average 38.40 percent during first half of the pre reform period and 39.91 percent during second half of the pre reform period. During the reform period it started to rise and reached to an average of 44.02 percent during 1995-99 and 45.40 percent during 2005-08.<sup>44</sup>

<sup>42</sup> Due to nuclear test in May 1998, in fear of expected economic sanctions, the country froze the foreign currency accounts.

<sup>43</sup> See Nashashibi et al. 2001.

<sup>44</sup> During 2000-04 the M2/GDP ratio declined because the other instruments outside the M2 become available in the financial sector.

**Table 5.1: Monetary Aggregates during Pre and Post Reform Periods**

	(percent)					
Period	M2/GDP	M3/GDP	M1/M2	M2/M3	M2/M0	GDP/M2
1980-84	38.40	45.26	67.26	84.54	2.55	2.61
1985-89	39.91	55.33	66.96	72.28	2.52	2.51
1990-94	41.99	57.47	60.51	73.07	2.52	2.39
1995-99	44.02	60.72	46.24	72.65	3.09	2.27
2000-04	40.15	59.72	52.17	67.17	3.00	2.51
2005-08*	45.40	59.60	54.44	75.75	3.30	2.20

Note: \*Ratios that include M3 are averaged for the period 2005 and 2006. M2/M0 and GDP/M2 are ratios.

Data source: State Bank of Pakistan (2005, 2007-08a), Government of Pakistan (2008-09 and back issues), calculated by author.

The M2/GDP ratio although increased but still seems to be low and reflect that despite reforms measures, the financial sector of Pakistan was unable to strengthen and widen its scope in the economy. Because, there is a large unrecorded underground economy in the country, and this ratio could still be lower, if we consider the underground economy as well.

The M3 to GDP ratio suggests the banks' ability to stimulate long run savings. We observe an increase in this ratio (from an average of 45.26 percent during 1980-85 to 55.33 percent during 1985-89) even during pre-reform period due to high return on government's national saving schemes. During reform period and post reform period this ratio increased slightly and averaged 59.59 percent for 2005-06. A slight decline in this ratio during post reform period was due to decline in return on national saving schemes.

The ratio of M1 to M2 provides a proxy for the extent to which a country's financial system succeeds in mobilizing savings. A low ratio indicates relatively developed banking sector, significant foreign currency deposits in the banking system and the substantial real interest rates on saving accounts.<sup>45</sup> This ratio averaged 66.96 percent during second half of the pre reform period. After reforms, it declined to 46.24 percent for 1995-99. During 2000-08 this ratio again started to increase due to significant decline in resident foreign currency deposits.

A declining M2/M3 ratio indicates increasing cash flows out of the banking system. We observe that this ratio declined from 84.54 percent during 1980-85 to 72.28 percent during 1985-89. But as a result of reforms, this ratio again started to increase and reached to a level of 75.75 percent for 2005-06.<sup>46</sup>

Similarly the difference between M3/GDP and M2/GDP ratio indicates the holding of longer term financial assets by the depositors. This difference was only 4.38 in 1981. This

<sup>45</sup> See Nashashibi et al. 2001.

<sup>46</sup> Data is not available for M3 after 2006.

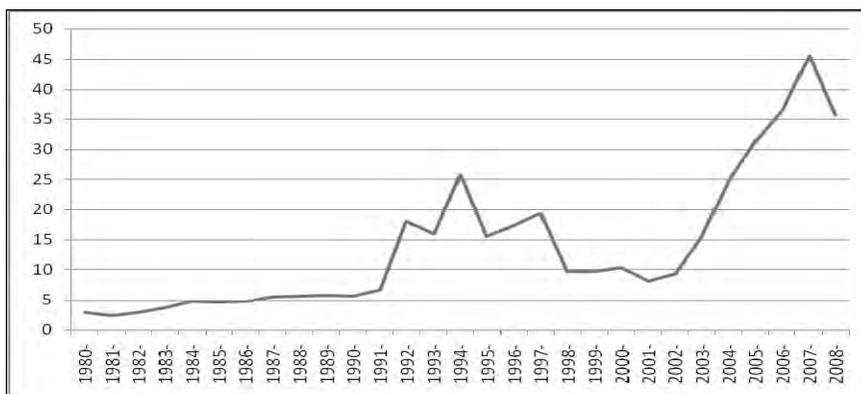
difference increased gradually and reached to 13.33 percent in 2006. Hence depositors started to hold longer term financial assets to take advantage of the interest rate differential across maturities.

Money multiplier (M2/M0 ratio) is an important indicator of financial sector deepening. High but stable multiplier indicates a well-developed and active financial sector with high responsiveness to central bank policy changes. An unstable money multiplier renders the results of monetary policy measures unpredictable and thus makes monetary management more difficult.<sup>47</sup>

The value of money multiplier was low during the pre reform period and reached to its lowest value of 2.39 percent in 1989. The value of money multiplier started to rise during the reform period and reached to a value of 3.17 in 2008. Concerning the stability of the money multiplier, it witnessed high fluctuation during 1980-89, while its variance was 0.011. Similarly its variance was also high up to the level of 0.111 during 1990-99, because there were frequent policy changes during this period. During 2000-08 its variance declined to 0.042 showing relative stability in the system.

Income velocity of money (GDP/M2 ratio) is defined as the number of times the existing stock of money is used to finance the total transactions of goods and services in the economy in a particular time period. A continued decline in the income velocity of money is regarded as a reflection of broadening the domain of monetary policy in the economy. From Table 5.2 it is evident that the average income velocity of money has declined from 2.61 during 1980-84 to 2.2 during 2005-08. A fall in the income velocity of money is a welcome development as it is accompanied with low inflation and high growth. This shows that the non-monetized sector is gradually becoming a part of the documented sector which is likely to improve the effectiveness and scope of monetary policy in the country.

**Figure 5.3: Aggregate Stock Market Capitalization as a percent of GDP**



Data source: State Bank of Pakistan (2005, 2007-08a), calculated by author.

<sup>47</sup> See State Bank of Pakistan (2000).

The development of capital market is a powerful indicator of the depth of the financial sector.<sup>48</sup> To measure the level of capital market development in terms of depth, we use the ratio of aggregate stock market capitalization to GDP.

The growth of stock market capital was remarkable with market capitalization to GDP ratio rising from 8.14 percent in 2001 to 45.63 percent in 2007. Pakistan had the second largest equity market in the region after India. However, there is lack of stability in the market. There is a need of regularity measures and corporate governance for the sustainable development of the capital market.<sup>49</sup>

### 5.1.3. Financial Efficiency

Interest rates directly affect business conditions and economic activity, and thus represent a powerful policy instruments. As interbank markets develop, and if there is adequate competition in the banking sector, interest rates would be expected to converge toward the central bank discount rate, while lending rates should be above this level.<sup>50</sup>

The trend of interest rate reveals that Pakistan's interest rate structure has been quite

**Table 5.2: Banks' weighted average lending and deposits rates and interest spread**

(percent)

Institutions	2002	2003	2004	2005	2006	2007	2008
<b>Lending Rates</b>							
State-owned Banks	11.89	6.69	4.06	8.84	10.91	10.22	13.87
Private Banks	12.75	8.81	5.31	8.33	10.18	10.74	12.82
Foreign Banks	10.69	6.24	4.04	7.30	8.26	8.85	11.75
Specialized Banks	14.05	13.21	12.35	9.02	9.47	9.71	9.88
All Group	12.12	7.58	5.05	8.21	9.93	10.32	12.75
<b>Deposits Rates</b>							
State-owned Banks	3.60	1.64	1.16	1.84	2.51	3.55	4.64
Private Banks	5.88	2.89	1.20	1.75	2.94	3.98	5.27
Foreign Banks	3.96	1.44	1.19	2.42	3.22	5.42	5.99
Specialized Banks	10.07	5.54	3.84	4.39	4.54	5.32	4.32
All Group	4.17	1.90	1.21	1.85	2.89	3.98	5.18
<b>Interest Spread</b>							
State Owned Banks	8.29	5.05	2.90	7.00	8.40	6.67	9.23
Private Domestic Banks	6.87	5.92	4.11	6.58	7.24	6.76	7.55
Foreign Banks	6.73	4.80	2.85	4.88	5.04	3.43	5.76
Specialized Banks	3.98	7.67	8.51	4.63	4.93	4.39	5.56
All Group	7.95	5.68	3.84	6.36	7.04	6.34	7.57
<b>Inflation rate</b>	3.54	3.10	4.57	9.27	7.92	7.77	12.00

Data source: State Bank of Pakistan (2005, 2007-08a and back issues), calculated by author.

<sup>48</sup> See Sophastienphong and Kulathunga (2009).

<sup>49</sup> Sophastienphong and Kulathunga (2009).

<sup>50</sup> See Nashashibi et al. (2001).

volatile and unstable. After a period of exceptionally high interest rates in the pre reform period, which were a manifestation of the public sector banks' inefficiencies, misallocation of credit and reckless lending accompanied by large defaults, the lending rate fell by 2004, but it again started to rise and reach a high level.

From the Table 5.2 it is clear that real interest rates on deposits are still negative even after financial sector reforms.<sup>51</sup> It is simply because the financial sector reforms were usually one component of the broader structural adjustment programs. The effectiveness of financial sector reform may be undermined if it takes place in an environment of high inflation and unsustainable fiscal balances. Such environment might create pressures to revert to financial repression and undermine the credibility, and thus the impact of the reforms.<sup>52</sup>

Interest rate spreads are an important indicator of financial sector's competitiveness and profitability. Spreads reflect the intermediary's cost, expected loan and trading losses, reserve requirements, and taxation. Spreads typically decline when competition increases. The low interest rates pursued by central bank coupled with enhanced competition helped narrow spread for all banks by 2004 (see Table 5.2). However, it again started to rise in recent years due to upward adjustment in SBP repo rate<sup>53</sup> in the wake of growing inflationary pressures, without a concomitant rise in deposit rates.

High spread indicates that the financial institutions are still facing high cost in operating the business in the country. The increased cost is passed on partly to the borrowers in the form of higher lending rates and partly to the depositors as lower deposit rates. This trend has an important bearing on savings, investment and economic growth. High lending rates increase the cost of borrowing which discourages investment, while low deposit rates discourage savings, ultimately economic growth will suffer. Hence, through improvement in efficiency the banks will be able to reduce the lending rate and increase the deposit rate in the country.

Before reforms, there was financial distress in the banking sector. An important question in this context is whether the financial sector reforms made banking system less vulnerable to financial distress. We use two ratios namely the ratios of NPLs to total loans and Net NPLs to Net loans, to assess the quality of assets and adequacy of capital of the banks. It should be noted that as the banks grant new loans of good quality after careful appraisal and due diligence, these ratios are bound to decline over time and the overall quality of assets of the system will improve. More important, it is non-provisioning of these

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<sup>51</sup> It is also worth noting that financial institutions were paying low (sometime negative) interest rates on deposits and yet were able to raise large deposits. This suggests that other factor such as convenience and safety may far outweigh interest rates in determining the level of deposits in the country.

<sup>52</sup> See Jbili et al. (1997).

<sup>53</sup> Repo stands for Repurchase Offer for treasury bills. It is used to have temporary impact on reserve money.

**Table 5.3: Non Performing Loans during Post Reform Period**

(percent)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>NPLs to Total Loans</b>									
State-owned Banks	26.3	25.9	25.5	20.4	13.3	10.0	9.0	8.4	12.3
Local Private Banks	15.4	16.3	15.4	11.3	9.0	6.4	5.2	6.0	7.8
Foreign Banks	4.7	4.3	3.8	3.1	1.6	1.2	1.0	1.6	2.9
Specialized Banks	52.4	53.0	54.7	55.6	54.1	46.0	39.1	34.3	28.9
<b>Net NPLs to Net Loans</b>									
State-owned Banks	12.7	13.1	12.8	8.1	3.4	1.5	1.5	1.0	2.9
Local Private Banks	10.3	10.4	7.0	4.5	2.9	1.6	1.1	0.8	2.2
Foreign Banks	1.7	1.1	1.1	0.7	0.0	-0.6	-1.0	-0.9	0.2
Specialized Banks	31.6	31.5	28.5	32.5	29.3	23.1	18.7	14.0	10.2

Data source: State Bank of Pakistan (2009b) and back issues.

NPLs which pose a systemic threat to the health of the banking system. The higher is the provisioning, the lower is the systemic risk.<sup>54</sup> The trend of the NPLs ratios after reforms is shown in Table 5.3.

It is clear that ratio of NPLs to total loans was high for specialized banks followed by state-owned banks in 2000. Similarly, the net NPLs to net loans ratio was high for specialized banks followed by state owned banks. However, due to reform measures these ratios have declining trend since 2000, which is reflecting the reduction of perceived credit risk. Furthermore, because local private banks dominate the banking sector in terms of lending, a continuous decline in NPLs ratios of these banks is expected to bring positive impact of on the performance of the sector. From Table 5.3 it can be observed that the NPLs ratios are much lower for foreign banks in the country. Thus, there is need for further improvement in these ratios for domestic banks as it is also one of the causes of large spread between the deposit and lending rates.

## 5.2. Macroeconomic Performance

Pakistan is a lower-middle-income country with a per capita income of US \$ 1046. Analysis of economic structure reveals that share of agriculture in GDP was 21.3 percent in 2008 and it has been declining over time. The share of manufacturing sector was 18.5 percent and the services sector<sup>55</sup> had dominant share of 53.0 percent in GDP in 2008.<sup>56</sup>

<sup>54</sup> See Hussain (2003).

<sup>55</sup> The services sector consists of Transport, Storage and Communication; Wholesale and Retail Trade, Finance and Insurance, Ownership of Dwellings, Public Administration and Defense; and Social and Community services.

<sup>56</sup> Rest of the contribution in GDP is made by Mining & Quarrying, construction, and Electricity and Gas distribution. Government of Pakistan (2008-09).

As discussed earlier in the theory and empirics, it is widely accepted that financial development has strong positive relationship with economic growth. Considering this interdependence, it is imperative to assess the behavior and trends of the key macroeconomic performance indicators during post reform period. Table 5.4 shows that macroeconomic indicators have shown robust performance during 2001-08. GDP growth shot up to 9 percent in 2005 and averaged to over 5 percent in the remaining years. Undoubtedly, consistent and stable economic policies provided the business with confidence. However, easy availability of funds on the back of historically low level of interest rates to the manufacturing sector eventually proved to be the real determinant of high economic growth. The financing to SMEs and Micro-finance segments of the economy has also contributed to economic growth and carries special importance with respect to future economic growth.

The financial sector reforms, however, have not penetrated deep down or spread across population and region. Vast majority of the population does not have access to financial services. From Table 5.4 it is clear that domestic saving rate although increased but still far below the desired level. The access to finance is still weak as the number of deposits holder

**Table 5.4: Key Macroeconomic Performance Indicators**

	(percent)									
	1980s	1990s	2001	2002	2003	2004	2005	2006	2007	2008
<b>Growth Rates (%)</b>										
Real GDP	6.5	4.6	2.0	3.1	4.7	7.5	9.0	5.8	6.8	4.1
Agriculture	5.4	4.4	-2.2	0.1	4.1	2.4	6.5	6.3	4.1	1.1
Manufacturing	8.2	4.8	9.3	4.5	6.9	14.0	15.5	8.7	8.3	4.8
Service Sector	6.7	4.6	3.1	4.8	5.2	5.8	8.5	6.5	7.0	6.6
<b>As % of GDP</b>										
Fixed Investment	17.0	16.6	15.66	15.28	15.10	14.98	17.46	20.54	20.92	20.37
Public Investment	9.2	7.5	5.61	4.13	3.92	4.05	4.35	4.83	5.52	5.42
Private Investment	7.8	9.1	10.5	11.15	11.18	10.93	13.11	15.71	15.40	14.95
Domestic Savings	7.7	14.0	17.8	18.1	17.6	15.7	15.4	16.3	15.6	11.5
<b>Fiscal Sector</b>										
Tax Revenue	13.8	13.4	10.5	10.7	11.4	10.8	10.1	10.5	10.3	10.2
Budget Deficit	7.1	6.9	4.3	4.3	3.7	2.3	3.3	4.3	4.4	7.6
<b>External Sector</b>										
Exports	9.8	13.0	12.8	12.6	13.4	12.6	13.1	12.9	11.9	11.6
Imports	18.7	17.4	14.9	14.3	14.7	15.9	18.8	22.4	21.4	24.4
Trade Deficit	8.9	4.4	2.1	1.7	1.3	3.3	5.7	9.5	9.5	12.8
Current Account Deficit	3.9	4.5	0.7	+1.8	+3.8	+1.3	1.6	4.4	5.1	8.6

Data source: Government of Pakistan (2007-08, 2008-09), calculated by author.

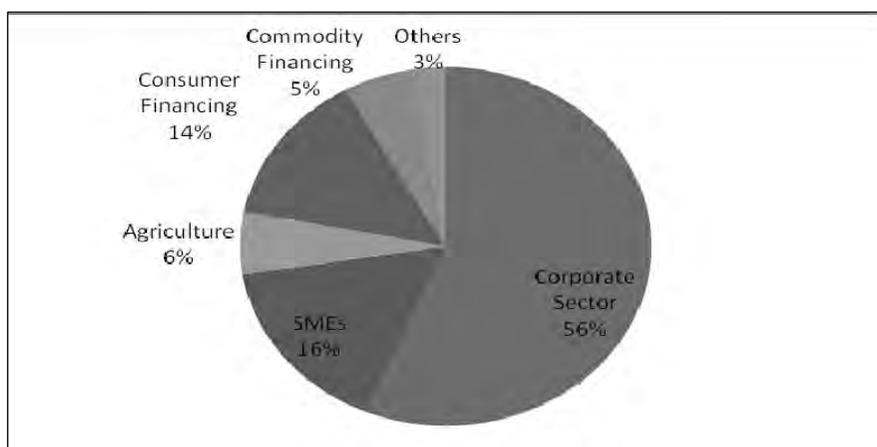
in the country were only 25.09 million as of December 2008<sup>57</sup>, which also include multiple accounts by same persons/entities. For a country with a population of approximately 163 million, these numbers are very low since it only accounts for 15.39 percent of total population. This requires that banks should raise deposit rates to stimulate savings which have been partly hurt by low return and partly by high propensity to consume.

Financial sector affect the economy through its expansion in private sector credit. In the last few years, the banks have recorded a high growth in credit to private sector. This has helped to serve the economy well in number of ways. It has fuelled economic activity, revived and enhanced industrial capacities, met crop and non crop requirements and has supported steady growth in services sector whose contribution to GDP has grown to 53.0 percent. Figure 5.4 shows that the corporate sector accounted for 56.6 percent, agriculture sector 5.6 percent, SME financing 16.2 percent, and consumer financing 13.8 percent of total credit outstanding of banks by the end December 2007.

During the pre reform period, agriculture sector was receiving mandatory and concessionary credit to fulfill its needs. However, after reforms, banks did not properly substitute the concessionary and mandatory credit with the credit on commercial terms.<sup>58</sup> It is also worth noting that the share of manufacturing in GDP is less than that of agriculture but its share in banks' credit is much higher than agriculture. Highly skewed distribution of credit in favor of manufacturing sector has serious consequences for economic growth and distribution of income in the country.

**Figure 5.4: Sectoral Diversification of the Loan Portfolio**

(end December 2007)



Data source: State Bank of Pakistan (2007-08b)

<sup>57</sup> State Bank of Pakistan (2009a).

<sup>58</sup> Due to high administrative cost and informational problem, the lending to small farmers on purely commercial basis is unlikely to be viable for the banks.

There has been considerable progress on fiscal front. Strong fiscal adjustment has led to significant reduction of fiscal deficits which reached to 2.3 in 2004. However, despite introducing tax reforms, the tax to GDP ratio is still low. The weak tax administration and an exemptions-ridden tax system has dealt a severe blow to Pakistan's efforts to broaden the tax base. The continued strain imposed by public sector enterprises on fiscal resources is another important area of public finance where desired results could not be achieved. It should be noted that huge budget deficit alter the resource allocation in the economy as government borrows the bulk of available credit from the domestic financial sector, in addition to borrowing from abroad. Furthermore, the presence of the government in the money market put upward pressure on interest rates and as a consequence, some private sector projects become unfeasible. Moreover, budget deficit may force the central bank to print money to finance it, which put inflationary pressure in the economy and can adversely affect the financial system and hence economic growth.

On the external sector also there have been significant improvements. Current account turned around from chronic deficit to surplus during 2002 to 2004, mainly due to renewed export growth and resurgence of workers' remittance. It is quite established that the economic fundamentals in Pakistan have taken a turn for better during the 2000-07.

It is important to know the effects of financial reforms on productivity growth. There are two studies that estimate the impact of financial sector reforms on total factor productivity (TFP) in Pakistan. Khan (2006) utilizes the conventional growth accounting framework to estimate the determinant of TFP in Pakistan for the period 1960 to 2003. The study shows that TFP growth declined during the second half of 1980s and during 1990s; however it had increasing trend since 2002. Furthermore, the study finds that financial depth measured as M2 to GDP ratio has significant positive effect on total factor productivity in the country.

Similarly, recently Ahmed and Bukhari (2007) show the impact of economic reforms (fiscal and monetary) and other economic measures on TFP, using the data of Pakistan economy from 1973 to 2006 at both at aggregated and disaggregated sectoral levels. They find that slowdown of TFP during 1992-2002 was due to contractionary fiscal policy (reduction in development expenditures) and also contractionary monetary policy (fall in the provision of credit to private sector). The rise in TFP during 2002-06 was the result of expansionary fiscal policy (increase in public financing of development process) and expansionary monetary policy (increase in the credit to private sector). They conclude that the macroeconomic reforms have contributed significantly in enhancing TFP and hence growth in Pakistan in recent years.

### **5.3. Regional Comparison of Performance**

While an isolated analysis of Pakistan's financial sector could tell the improvement or

deterioration over time, a comparison of different indicators of financial sector with regional competitors would certainly be more instructive. For this purpose a group of South Asian countries (Pakistan, India, Bangladesh, and Sri Lanka) was selected to perform a peer comparison. This comparison would show Pakistan achievements vis-à-vis other countries in the region and would also reveal prospects for the financial development in the country.

From Table 5.5, it is clear that in 2000, all countries in the group except for India had a low M2 to GDP ratio. Pakistan was better in terms of financial depth as compare to Bangladesh and at par with Sri Lanka. However in 2006, the level of financial depth in Pakistan is not much different from these countries. This reveals that the large size of the informal financial sector in Pakistan is limiting the deepening of financial market in country. The currency to M2 ratio was also highest in Pakistan in 2000, which remain kept the country at the same comparative level in the region even in 2006. Comparison of money multiplier reveals that it was lowest for Pakistan in 2000 vis-à-vis other selected countries, but had remain lowest in the region in 2006. This indicates that Pakistan still has the shallow financial system.

**Table 5.5: Financial Sector Performance of Selected South Asian Countries**

(Percent)

	Pakistan		India		Bangladesh		Sri Lanka	
	2000	2006	2000	2006	2000	2006	2000	2006
Currency to M2 ratio	25.4	21.7	17.4	15.9	13.6	12.7	13.0	11.2
M2 to GDP ratio	36.9	44.7	55.6	69.9	31.5	43.5	38.4	41.0
Money Multiplier	2.8	3.4	4.1	4.7	4.4	4.8	4.6	5.0
Bank Rate	13.0	9.5	8.0	6.0	7.0	5.0	25.0	15.0
Private Credit to GDP ratio	29.4	29.0	29.0	45.0	24.7	36.2	28.9	32.8
Market Capitalization to GDP ratio	8.9	35.9	32.2	89.8	2.5	5.8	6.6	28.8
Banks' NPLs to Total Gross Loan ratio*	9.0	7.7	6.6	3.5	17.6	13.2	....	9.6
Gross Domestic Savings to GDP ratio	17.1	16.3	23.2	34.3	17.9	20.3	17.4	17.0
Exchange rate per US \$ (period average)	53.7	60.3	44.9	45.3	52.1	68.9	77.0	103.9

Note: \*These figures are for 2004 not for 2000.

Data Source: World Bank (2008), International Monetary Fund (2008), and Annual Reports of the respective country's Central Bank.

The indicators discussed above describe a qualitative characteristic of mobilization side of intermediation. Higher credit allocation to the private sector shows the use of limited and precious financial resources to the most productive ends. The private sector credit to GDP in case of Pakistan reveals a dismal situation, which is lowest compare to other selected South Asian countries.

In terms of capital market development, Pakistan made remarkable progress as its market capitalization to GDP ratio become second highest among selected countries in the region in 2006 but it is far below compare to India. Similarly, Pakistan position is relatively better in terms of quality of assets and adequacy of capital measured as NPLs to total gross loans. However, the domestic savings rate is still lower compare to selected South Asian countries.

A recent study by Sophastienphong and Kulathunga (2009) shows that among South Asian countries India leads the region in the financial sector development efforts followed by Pakistan, Sri Lanka, Bangladesh, and Nepal. On the access to finance, Pakistan ranks 4<sup>th</sup>, but on performance and efficiency Pakistan ranks the top position. In terms of financial stability and capital market development, Pakistan stands second, after India. In terms of market concentration and competitiveness, Pakistan ranks fourth position, however, in terms of corporate governance Pakistan ranks top position in the selected countries of the region.

Thus, the above comparison of financial sector indicators of different countries in the region indicates that although reform made significant improvement in Pakistan, but the financial sector of the country still has a long way to go to catch up other countries in the region.

## **6. Directions for Further Reforms and Conclusion**

### **6.1. Direction for Further Reforms**

While the transformation of the financial system is impressive, however, the task of financial sector reforms is far from complete. Further reforms are needed to consolidate the measures already taken with the objective to ensure credibility and viability of the system. Based on the assessment of the financial sector reforms, following further reforms measures are suggested for the financial sector.

1. A large segment of population and geography in the country is still under served from the existing financial markets. Only 15.39 percent of the population has bank accounts. Since more than 60 percent population of the country still live in rural areas, the provision of financial services to such areas will increase financial depth in the country and will contribute to economic growth.
2. A large segment of population has excluded itself from the financial sector for faith reason. Although there are Islamic Banks in the country, but their share is small in terms of number, branches and deposits. There is a need to promote the growth of Islamic banks to bring such people under formal financial system. A proper liquidity management framework and instruments will allow the Islamic Banks progress in a prudent and sound manner.
3. There is a need that financial sector should render good service and deal fairly with the customers. There are issues relating to transparency, confidentiality, availability of statements, account servicing and protection against fraud. Proper legislation would result appropriate dispute settlement mechanism between customer and financial institutions.
4. Currently a bulk of financing requirement of the country is met by the banks. However, there is high concentration in the sector as top five banks accounts for 51.9 percent in total assets and 54.6 percent in total deposits. There is a need to diversify the financial sector to reduce the concentration.
5. While there is increased competition in the banking sector, they have also added to potential problem of financial frauds. If timely measures are not taken to deal with such situations tactfully, they may inflict heavy loss not only to the individuals but also to the system's credibility.
6. In the banking sector, state owned banks have made limited contribution. Their dismal performance requires regular provisioning from the Central Bank. Given the fiscal stress, the privatization of the remaining state owned banks should be the top priority. However, the procedure of privatization should be well planned and

prudent with the caution that under pricing of shares based on political and other non-professional motives is avoided.

7. Currently, National Savings Scheme (NSS) are regulated by Central Directorate of National (CDNS) which is under Ministry of Finance. There is a need to improve the performance of this department to increase savings in the country.
8. Although autonomy has been granted to the central bank but political interference in highly technical economic management issue still places a barrier on free functioning of the SBP on prudential ground. Furthermore, excessive borrowing by the government has tended to neutralize the impact of central bank's efforts to contain monetary and credit expansion. The continued excessive public sector borrowing is also a major cause of concern from the point of view of containing the inflation in the country.
9. The growth of the stock market is remarkable however there is lack of stability in the market. There is a need of regularity measures and corporate governance for the proper functioning and stability of the market.
10. The strategy followed by State Bank of Pakistan for NPLs has brought about significant decline in the quantum of NPLs of commercial banks and specialized banks. However it is observed that the NPLs ratios are much lower for foreign banks in the country. Thus, there is need for further improvement in these ratios for domestic banks.
11. Most credit to enterprises sector goes to manufacturing, which receives a disproportionately high share of bank credit compared with this sector's contribution to GDP. There is a need to increase the share of agriculture and services sector in banks' credit as the contribution of these sectors in GDP is very high.
12. Within the regional context Pakistan's financial system despite its growth is still small. The country is lacking in the areas of financial deepening and credit to the private sector.

Thus, financial sector reforms that have been pursued persistently and vigorously over a decade or so have removed many distortions and minimized the financial repression in the country. However, further reform measures stated above are expected to bring further financial deepening in the country will allow financial institutions to play an important role for promoting economic growth.

## **6.2. Concluding Remarks**

In developing countries, government impose restriction and price distortion on the financial sector such as high inflation tax, high required reserve ratios, subsidized or directed credit, collusive contracts between public enterprises and banks, credit rationing, and ceilings on deposit and loan interest rates. This is believed to lead to a segmented credit

market in which favored borrowers obtain directed credit at subsidized rates of interest, while less privileged borrowers are forced to seek credit in high cost informal market. Such policy of financial repression undermines economic growth.

A more efficient financial system provides better financial services and this enables the economy to grow faster. On the other hand, a weak financial system spills over unfavorable into the economy. An inadequately supervised financial system may be crisis prone, with potentially negative effects on the sector. Thus, the financial sector requires special attention of the policy makers.

This study addressed the key issues in the financial development and economic growth literature and tried to provide an in depth analysis of theoretical and empirical debate and assess the financial sector reform process and its impact on Pakistan economy.

The analysis shows that financial sector reforms were effective in bringing positive change in key financial sector and real sector variables. However, there is a need to further broaden and deepening the financial system: to help to achieve higher and sustainable economic growth; to develop a dynamic, robust and stronger system, to mobilize the domestic and foreign resources for private investment; and to deepen financial penetration for poor and underserved regions.

In conclusion, we can say that Pakistan's financial sector needs to grow at a faster pace to not only to meet the domestic requirements but also to be able to position itself to receive the foreign capital inflows. The broadening and deepening of this sector is also important to ensure the profitability and sustainability of banks. At the same time financial sector will have to focus on product innovations while exploring their reaching out to new and under-banked regions.

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## Major Research Works

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