

## ASSESSING THE IMPACT OF FINANCIAL REFORMS ON PAKISTAN'S ECONOMY

Shahrukh Rafi KHAN and Safiya AFTAB\*

### 1. Introduction

As in many other less developed countries, policy makers in Pakistan have accepted a series of neo-liberal reforms. Included among these are financial sector reforms such as interest rate liberalization.<sup>1</sup> We demonstrate in this paper that there is very weak support at best for the neo-liberal hypotheses concerning financial liberalization and that such liberalization is regressive.

McKinnon, (1973); and Shaw, (1973); were the major advocates of financial reform. They argued that financial repression in the form of controlled, and hence often negative, real interest rates reduced incentives for saving and hindered financial intermediation. Liberalizing and allowing positive market driven interest rates would channel funds from consumption, cash holdings, less productive self-investment, and overly capital intensive investments to more productive investments.

Disputing this contention, neo-structuralists have argued that following financial liberalization, the funds would be drawn from the informal credit markets (kerb markets), which are actually more efficient at intermediating funds because there are fewer leakages and no reserve requirements.<sup>2</sup> Given the lack of data on intermediation in the informal sector and responses following bouts of liberalization, the debate is potentially difficult to resolve. However, Cho, (1990) has disputed the validity of the neo-structuralist arguments on a conceptual level.

The McKinnon-Shaw hypotheses spawned a theoretical and empirical literature and represents conventional wisdom. The 1989 World Development Report of the

\* Authors are research fellow and research assistant at the Sustainable Development Policy Institute.

<sup>1</sup> We view financial reform as the broader term which includes financial liberalization of interest rates and credit but also includes denationalization, privatization, public sector debt management and prudential regulations, and related issues of capital flows, exchange rate and foreign investment liberalization.

<sup>2</sup> Wijnbergen, (1983); and Taylor, (1983).

World Bank was devoted to the subject of financial sector reform and qualified the McKinnon-Shaw hypothesis by pointing out that to be successful, financial reforms must be preceded by macro-stabilization, structural adjustment and prudential regulations. This represents a broader approach in that it highlights the importance of the environment in which the financial reforms are to occur.

The second section briefly reviews the course of financial sector reforms in Pakistan. There are three main aspects to this reform which include interest rate liberalization, deregulating credit controls and denationalization and privatization. Our focus in this paper is on the first and the third aspect of financial reform.

The third section reviews the evidence, primarily focusing on interest rate liberalization, to see if Pakistan is likely to derive benefits from such liberalization. The fourth section analyzes the political economy of interest rate liberalization. The fifth section reviews the evidence to date on the success of banking denationalization and we conclude with the sixth section.

## II. Financial Reform in Pakistan<sup>3</sup>

We review financial sector reforms in Pakistan in the context of the neo-liberal prescriptions stated in the last section. The two major elements of financial liberalization entail eliminating controls on the interest rate and on credit.<sup>4</sup> In addition, such reforms are expected to be accompanied by denationalization, privatization and prudential regulations.

All commercial banks in Pakistan were nationalized in January, 1974. The move was aimed at making bank credit available to "high priority" sectors of the economy which previously had limited access to investable funds.<sup>5</sup> Nationalization was also supposed to act as a de facto "anti-trust" legislation in that it was supposed to check the concentration of ownership in the banking sector. Finally, banking services were to be extended to the rural areas.

Credit was to be directed via the National Credit Consultative Council (NCCC). A system of credit budgeting was introduced whereby the NCCC determined credit ceilings for the individual commercial banks and directed the flow of credit to "preferred" sectors. Interest rates and the liquidity ratio continued to be fixed by the State Bank.<sup>6</sup>

<sup>3</sup> Haque and Kardar, (1993) contains a much fuller interpretive account of financial sector reforms in Pakistan.

<sup>4</sup> Khan, M.S., (1985) has written on interest rate formation in the absence of controls.

<sup>5</sup> The ability to do this successfully as part of industrial policy is partly viewed as the cause of the economic success of Japan and the East Asian NICs. Market determined credit allocation may be preferable in the absence of good governance.

<sup>6</sup> The liquidity ratio is also called the liquid asset requirement. All scheduled banks are required to maintain a given proportion of their deposits in the form of government securities. This liquidity requirement is over and above the five percent cash reserve requirement.

Financial sector reform in the seventies consisted of the introduction of a set of financial instruments that were intended to eventually replace the system of interest rates in the economy. These reforms were part of a larger set of economic reforms aimed at the "Islamisation" of the economy.<sup>7</sup> Equity based financial instruments such as *modarabas*, participation term certificates and long term financing by *musharikhah* were introduced over a period of two years from February 1980 to July 1982. These instruments were supposed to operate on the basis of profit and loss sharing.

In principle, the system of profit and loss sharing could make the financial sector more market oriented since the interest rate was being implicitly deregulated. However, in practice, the rates of profit sharing on PLS deposits were declared by the commercial banks only after they had been approved by the State Bank. The extent to which profit rates were determined by the market was therefore limited. The rates of return on government securities and on scheduled bank advances continued to be fixed by the State Bank.

A more conventional set of neo-liberal financial reforms were introduced in the fiscal year 1990-91. There was a gradual liberalization of controls on banking activities and credit creation, as well as a rationalization of the interest rate structure. The process of deregulation of the financial sector began with the denationalization of two commercial banks. In addition, ten private commercial banks were given permission to start operations in August 1991.

In March 1991, the government began auctioning the public debt in the open market with the introduction of treasury bills and federal investment bonds. Four non-bank institutions were given permission to send in their bids for the auction of these bills. There has thus been a concerted effort on the part of the government to create a secondary market in government securities to facilitate monetary policy. Thus the creation of an established government bill market could obviate the need for credit controls and excessive reliance on the imposition of reserve requirement ratios.

As the secondary market in government debt took root, the government abolished the scheme of credit ceilings in August 1992, and replaced it with a system of credit/deposit ratios which allowed commercial banks to extend credit upto thirty percent of their rupee deposits and thirty percent of their foreign currency deposits.<sup>8</sup> As such, this move represented a significant deregulation of the money market.

<sup>7</sup> Khan (1987).

<sup>8</sup> Under the system of credit ceilings, the commercial banks were given monetary limits on credit creation. This inevitably led to the incidence of excess liquidity in commercial banks, which was channelled to the government through the facility of tap T-Bills, i.e. government securities yielding a return of about 6 per cent on average, which were available to commercial banks on demand. The system of credit ceilings thus acted as a tax on the commercial banking system. The facility of tap T-Bills has now been withdrawn and replaced by the new Treasury Bills issued in March 1991 which are of 6 months maturity and yield market determined rates of interest.

However, the institution of the credit/deposit ratio was followed in August 1992 with a 5 per cent increase in the liquidity ratio. Four months later, the State Bank raised the liquidity ratio by another 5 per cent, bringing it to an all time high of 45 per cent.<sup>9</sup> Thus the State Bank continued to rely heavily on bank borrowing to meet the budget deficits, although the creation of a secondary market in government debt should lead to higher absorption of debt by the public and thus reduce the need for bank borrowing.

Liberalization affected both the financial and foreign exchange markets. Commercial banks allowed depositors to open foreign currency accounts. In February 1991, the stock exchange was opened to foreign investors, and the resulting rush of speculative investment from overseas resulted in an increase in market capitalization of over 200 per cent.

Following IMF/World Bank recommendations, a set of prudential regulations were issued by the State Bank requiring banks and non-bank financial institutions (NBFIs) to follow prescribed limits on debt-equity ratios and finance facilities to single companies and individual investors.

What has been achieved by Pakistan in the context of the neo-liberal prescriptions stated in the first paragraph of this section? There has been a move to make the real interest rate positive, hence reducing financial repression. Credit is still directed, although commercial banks now have more leeway since absolute amounts are not specified. There has been significant deregulation, denationalization and privatization, trends which will probably continue. Finally, prudential reforms have been instituted, a secondary market in government debt initiated, and an ordinance passed to make the State Bank autonomous. Neo-liberal financial reformers have every reason to give Pakistan a good progress report. But what does Pakistan expect from these reforms?

### III. The anticipated impact of Financial Liberalization in Pakistan.

Since most of the fundamental financial reforms have occurred recently, one could argue that it is not as yet possible to determine their actual quantitative impact on the economy. Even so, some neo-liberal hypotheses have been tested in Pakistan by using historical data.<sup>10</sup> Inferring support from a pre-reform environment for the reform certainly appears to be a flawed method. Nonetheless, we employed this method not to endorse it but to contrast our results with studies which have used this

<sup>9</sup> On October 27, 1993, the State Bank lowered the liquidity ratio to 35 per cent and raised the credit/deposit ratio from 30 to 32 per cent.

<sup>10</sup> Fry (1984); Khan [(1982), and (1988)]. To justify their analysis, they could conceivably have argued that term deposit rates, the variable of interest, has varied a great deal from more to less negative and even positive in several years.

method to endorse neo-liberal reforms in Pakistan. In all these exercises, we took account of the non-stationarity of most of the variables we used.

#### a) *Saving and real interest rates*

Cross-country evidence about a positive association of saving on interest rates is decidedly mixed.<sup>11</sup> Nonetheless, to see if it holds for Pakistan, we used time series data from 1970 - 1990.<sup>12</sup> Since growth is hypothesized to increase savings and is in turn affected by investment, we estimated the saving function, as is conventional, using the two stage estimation procedure.<sup>13</sup> To compute the expected real interest rate, we estimated expected inflation as a polynomial distributed lag of current and past inflation rates. Similarly, we computed permanent or expected per capita GNP.<sup>14</sup> However, we found much stronger results from simply using the log of per capita GNP and the real interest rate. The results are reported in Table 1.<sup>15</sup>

We identified a statistically significant positive association of interest rate and saving although the magnitude is virtually negligible. A ten percent increase in the real interest rate could be expected to be associated with a 0.03 percent rise in saving.<sup>16</sup> A positive association of real saving with per capita GNP and a negative one with official transfers are as expected.<sup>17</sup>

One could argue that the truly endogenous component of saving is household saving. Unfortunately, we did not have the complete data series, but we did find that between 1980-81 and 1989-90, household saving constituted at least three fourths

<sup>11</sup> Lee, [(1991), pp. 6 - 7]

<sup>12</sup> Admittedly twenty one observations is not a long time series, but it is fair to say that neo-liberal economists have the burden of proof.

<sup>13</sup> Apart from investment ratio and labour force growth, the exogenous variables included in the estimation of the first stage growth function were the long run terms of trade, dependency ratio, growth in exports, export ratio, official transfers, real interest rate and log of per capita GNP. The fitted growth rate from the first stage was used in the second stage saving function. The exogenous variables represent the variables conventionally used as saving rate predictors. Saving was defined as gross national saving divided by gross national product. Given our sample size, we used variable deletion tests to identify the robust and significant predictors of the saving rate. Data on the dependency ratio and labour force were extracted from the data diskette of the *World Bank Social Indicators of Development*. The nominal interest rate series was constructed as a weighted average of rates of return on scheduled banks deposits. The figures were taken from various issues of the *State Bank of Pakistan Annual Reports*.

<sup>14</sup> The inflation and income adjustment coefficients were 0.92 and 0.94, respectively.

<sup>15</sup> All variables except the fitted growth rate and the interest rate were non-stationary as evident from Dicky Fuller tests for unit roots. Using the Johansen Maximum Likelihood Procedure we identified the existence of a co-integrating vector for the saving function which captures a long run association between the series.

<sup>16</sup> This coefficient is smaller than that identified by Fry, [(1984), p.49]. We essentially used the same method so the results are comparable.

<sup>17</sup> We did not find the coefficient of the lagged saving rate to be significant and therefore rejected the hypothesis that adjustment occurred with a lag.

TABLE 1

Association of the Saving Rate with the Real Interest Rate  
(Dependent Variable is Saving)

Regressor	Coefficient	T-Ratio
INPT	- 1.4438	2.56**
OTR	- 0.6951E - 5	2.42**
R	0.0026	5.54*
LPCGNP	0.1901	2.75**
FGR	0.0036	1.87**

R-Bar-Squared 0.86, F-Statistic F(4, 15) 30.88, RSS 0.0021, D-W Statistic 2.12.

Notes: \* Significant at 1 per cent level of significance.

\*\* Significant at 5 per cent level of significance.

\*\*\* Significant at 10 per cent level of significance.

OTR = Official Transfers      R = Real Interest Rate

LPCGNP = Log per capita GNP      FGR = Fitted Growth Rate

of total saving.<sup>18</sup> Private saving is defined as corporate plus household saving. Using private saving as a percentage of GNP as our dependent variable, we obtained results virtually identical to those reported in Table 1.

#### b) *Interest Rate and Financial Saving*

The theory is that a positive real interest rate should deepen the market by encouraging more saving in the form of various financial assets. Thus even if a higher real interest rate does not lead to higher real saving, it is viewed as leading to higher financial saving. Given the right incentives, households are expected to change the form in which they hold their saving, i.e., from real to financial assets. We tested this proposition by first estimating a money demand function and next by more directly testing the association of financial deepening with interest rates. The results of the estimation of the standard money demand function are reported below in Table 2.<sup>19</sup>

<sup>18</sup> State Bank Annual Reports, various years.

<sup>19</sup> The dependent variable was log of per capita real money holding, where the broadly defined measure of money was used. Once again, the results were better using actual rather than permanent variants for the interest rate and per capita GNP. Interest rate was the only stationary variable, and once again we identified a cointegrating vector indicating the existence of a stable long run association between the variables.

The equation explains a great deal of the variation in the dependent variable as is revealed by the high value of R-Bar-Squared, and the signs are as expected. The real interest rate has a positive and highly significant impact on financial savings. However, the magnitude of the short run impact is still modest, with a 10 per cent rise in the real interest rate associated with a 0.1 per cent rise in financial saving. We used the significant coefficient of lagged money to estimate the long run equilibrium effect. A 10 per cent increase in the interest rate can be expected to be associated with a 0.2 per cent rise in financial savings. While the long run interest effect doubles, it is still very modest.<sup>20</sup>

#### c) *Interest Rates and Financial Deepening*

Neo-liberal theory contends that financial liberalization leads to financial deepening. We tested the association of interest rates and financial deepening by regressing the ratio of  $M_3$ /GDP as a measure of financial deepening (FD) on the real interest rate.<sup>21</sup> The results are reported in Table 3 below.

While the interest rate variable was positive and highly significant, once again our results show that a 10 per cent rise in interest rate would lead to only about a 0.1 per cent rise in financial deepening.

#### d) *Financial Deepening and Investment Productivity*

Higher financial saving or financial deepening is not viewed as an end in and of itself. The hypothesis is that financial saving is intermediated towards real investment with beneficial effects for the economy. Financial deepening is also viewed as a worthy goal because it is expected to lead to a more efficient allocation of financial resources towards real investment.<sup>22</sup> The inverse of ICOR or incremental capital output ratio is used as a proxy for investment productivity (PROD), and so the hypothesis is that regressing the inverse of the ICOR on financial depth ( $M_3$ /GDP) would result in a positive and significant coefficient.

In fact our result contradicts the hypothesis stated above.<sup>23</sup> The coefficient of financial deepening is an elasticity estimate which suggests that a one percent increase in financial deepening is associated with more than a three percent decline in investment efficiency as measured by the inverse of ICOR. This result may be

<sup>20</sup> Fry [(1984) p.62] reports a much more substantial effect based on an earlier time series.

<sup>21</sup> We obtained the best fit by lagging both variables one period and logging financial deepening. Both variables were stationary.

<sup>22</sup> A statement of this and the previous hypothesis on financial deepening and investment productivity is contained in World Bank [(1987), p.32]

<sup>23</sup> Our dependent variable was the log of the lagged inverse ICOR, and this was regressed on the log of lagged financial deepening. Both variables were stationary.

TABLE 2

Money Demand Function:  
The Association of Financial Saving with the Real Interest Rate  
(Dependent Variable is Money Demand)

Regressor	Coefficient	T-Ratio
INPT	- 1.6272	- 0.63
T	- 0.0129	- 1.40
R	0.0110	9.01*
LPCGNP	0.7366	1.98***
LMI	0.4199	4.29*

R-Bar-Squared	0.960	F - Statistic	F(4, 15)	134.44
RSS	0.019	D - W Statistic		2.22

Notes: \* Significant at 1 per cent level of significance.

\*\* Significant at 5 per cent level of significance.

\*\*\* Significant at 10 per cent level of significance.

T = Time Trend.

LMI = Log Money Demand lagged one period.

TABLE 3

Association of Financial Deepening with the Real Interest Rates  
(Dependent Variable is Financial Deepening)

Regressor	Coefficient	T-Ratio
INPT	- 0.6077	- 14.17*
T	- 0.0102	- 3.46*
R (-1)	0.0127	5.99*

R-Bar-Squared	0.65	F - Statistic	F(2710)
RSS	0.056	D - W Statistic	0.77

Notes: \* Significant at 1 per cent level of significance.

\*\* Significant at 5 per cent level of significance.

\*\*\* Significant at 10 per cent level of significance.

R (-1) = Real Interest Rate lagged one period.



TABLE 4

Association of Inverse ICOR with Financial Deepening  
(Dependent Variable is Inverse ICOR)

Regressor	Coefficient	T-Ratio	
INPT	- 4.9645	- 4.06*	
T	- 0.0709	- 2.62**	
LFD1	- 3.2590	- 2.15**	
R-Bar-Squared	0.36	F-Statistic	F(2610)
RSS	6.68	D-WStatistic	1.22

Notes: \* Significant at 1 per cent level of significance.  
 \*\* Significant at 5 per cent level of significance.  
 \*\*\* Significant at 10 per cent level of significance.  
 LFD1 = Log Financial Deepening lagged one period.

explained by the observation of many analysts concerning the crowding out of the more efficient private sector investment, as the state issued various high yielding financial assets to cover its own expenditures.

However, private sector credit as a proportion of the total has been steadily increasing from about half in the early eighties to about four-fifths of total credit in 1992.<sup>24</sup>

#### e) *Financial Liberalization and Growth*

A greater availability of credit via financial liberalization is also asserted to have a positive impact on growth.<sup>25</sup> We tested this hypothesis by including the real interest rate in a standard neo-classical growth equation, and the results are reported below in Table 5.<sup>26</sup>

The dependency ratio and log of the terms of trade index are significant and have the expected signs. The interest rate, however, has a small but significant negative association with the growth rate. Arbitrage opportunities created by the

<sup>24</sup> Various issues of the State Bank Annual Reports.

<sup>25</sup> Asian Development Bank, (1985).

<sup>26</sup> We substituted the real interest rate for the ratio of investments to GDP normally included in the growth equation to capture the positive impact of interest rate on investment as more funds become available. Except for growth and interest rate, all other variables are non-stationary. However, we identified a cointegrating vector, which suggests a stable long run association between the series.

TABLE 5

Association of the Growth Rate with the Real Interest Rate  
(Dependent Variable is the Growth Rate)

Regressor	Coefficient	T-Ratio
INPT	97.1808	2.14**
GLF	-0.3973	-0.26
R	-0.1312	-2.64**
LTT	10.8817	2.90**
T	-0.2295	-1.15
DR	-152.6843	-3.77*

R-Bar-Squared	0.63	F-Statistic	F(5, 14)	7.40
RSS	23.8518	D-W Statistic	2.57	

Notes: \* Significant at 1 per cent level of significance.

\*\* Significant at 5 per cent level of significance.

\*\*\* Significant at 10 per cent level of significance.

GLF = Growth in Labour Force

LTT = Log of Terms of Trade Index

DR = Dependency Ratio.

spread between subsidized credit and the high interest rates on government schemes could have impeded investment. Insofar as there is a strong association between deposit rates and lending rates, the negative association between interest rate and growth could also represent the negative effect of the higher cost of capital on investment.

### III. Political Economy of Interest Rate Liberalization

Since no economic reason appears to have been established, at least to date, to liberalize the interest rate in Pakistan, it is all the more important to discuss the political economy of this reform. In other words, one needs to discuss the important issue of who gains and who loses from interest rate liberalization. In a newspaper interview, the current Governor of the State Bank asserted that financial repression hurts the small saver.<sup>27</sup> It is not clear what size of deposit represents that of the small saver? If we view the small savers as those with deposits of less than Rs. 10,000, then about eighty five per cent of the depositors could be considered small savers.<sup>28</sup> If we

<sup>27</sup> "Dr. Yaqub says banking system exploitative, inefficient and corrupt", *Dawn*, 1(1993), p.1].

<sup>28</sup> Data are drawn from the State Bank Annual Reports 1991-92, Statistical Appendix, p.63.

view the top 15 per cent of depositors as large savers and the rest as small savers, even then the small savers account for only a third of total deposits.<sup>29</sup> Thus a disproportionate percentage of the benefit from higher deposit rates probably accrues to upper income groups, who therefore stand to lose most from financial repression.

Given the high prevalence of tax evasion, one could consider financial repression as an implicit tax on the rich.<sup>30</sup> We have already shown that there are unlikely to be any negative repercussions on real and financial saving. On the other hand, high deposit rates are likely to result in a ballooning of the fiscal deficit.<sup>31</sup> We explored the association of the real interest rate on government bonds with the deficit and the results are reported below in Table 6.

TABLE 6

The Association of the Budget Deficit with the Yield on<sup>32</sup> Government Securities

Regressor	Coefficient	T-Ratio
INPT	- 7673.9	- 1.01
T	- 3419.1	- 13.57
RPAK	2885.4	3.15

R-Bar-Squared	0.92	F-Statistic	F(2, 15)	92.79
RSS	4.15E+08	D-W Statistic	1.19	

Notes: \* Significant at 1 per cent level of significance  
 \*\* Significant at 5 per cent level of significance  
 \*\*\* Significant at 10 per cent level of significance  
 RPAK = Yield on Government Securities.

<sup>29</sup> Data are drawn for 1990 from the State Bank Annual Reports 1991-92, Statistical Appendix, p.63. Since individuals do not report income and assets when opening bank accounts, conjecture is the best one can do. Not even the Governor of the State Bank is privy to the information about the distribution of depositors by income group. Such information can be ascertained from a survey of deposit holders, although misreporting of income and assets is likely.

<sup>30</sup> Giovannini and DeMelo (1993) have recently made a case for viewing financial repression as a tax and demonstrated that it can yield substantial revenue, equivalent in some cases to that derived from seigniorage. They estimated that the revenue from financial repression for Pakistan for 1993 was 20.5 per cent of total tax revenue.

<sup>31</sup> Interest payments amounted to one-fifth of total federal government expenditure in 1991-92 or about four-fifths of the overall deficit of 78265 billion in 1991-92. *Economic Survey 1992-93*, Statistical Appendix, pp.116 and 118.

<sup>32</sup> Data on the interest rate on government bond yield was taken from the IMF (1992), p.554]. Both the deficit and interest rate are non-stationary and we rejected that the two series are co-integrated. Thus our findings are only suggestive.

Our results show that a one per cent rise in the interest rate on government bonds increases the deficit by about three billion rupees.

There are several options for containing the deficit. One option is to keep term deposits low until fiscal balance is attained. If term deposit rates rise, the deficit has to be curtailed by sharper cuts in expenditure and/or higher tax rates. If the government can raise revenues via progressive taxation, which is unlikely, that is the first best option from a progressive viewpoint. If it opts for expenditure cuts, the poor are likely to be hurt the most. "Progressive expenditures" such as targeted food subsidies and social sector spending are viewed as the most vulnerable budget items and so the poor bear a disproportionate burden of the deficit cuts. If neither of these deficit reduction options is pursued, an inflation tax resulting from deficit financing is almost inevitable and researchers have shown that the poor once again bear the greater burden.<sup>33</sup> It therefore appears that in the short run repressing the interest rate is a progressive option for containing the deficit while fiscal balance is being restored.

#### **IV. Denationalization and Efficient Banking**

The hypothesis that denationalization will lead to more efficient banking cannot be tested yet in a satisfactory manner because there are only two years of experience to draw on since the two commercial banks were denationalized. Nevertheless, what we find might be indicative of future trends. We compare the before and after record of these two banks in terms of the profit/assets ratio, deposit growth, loan recoveries and the ratio of non-performing loans. We also compare the recent record of the denationalized banks with commercial banks still in the public sector using these performance criteria. Finally, we cite evidence on the performance of nationalized commercial banks relative to foreign commercial banks. The relevant tables are reported in the appendix.

In April 1991, the Muslim Commercial Bank became the first public sector bank to be privatized. Fifty per cent of the bank's shares were acquired by the National Group, a consortium of industrialists. This was followed by the privatization of the Allied Bank in September 1991. The bank was restructured as an institution jointly owned by its employees through the Employees' Stock Ownership Plan (ESOP), formulated by the Allied Management Group.

It is interesting to note that the profit/asset ratio of the MCB actually fell after the bank was privatized. The value of net assets of the bank rose by 38 per cent, as it invested heavily in Federal Investment Bonds and in Treasury Bills following the implementation of Prudential Regulations. The profit/asset ratio of the Allied Bank, on the other hand, showed a considerable improvement, rising to almost one in

<sup>33</sup> Afridi, Qadir and Zaki (1984).

1992. The rate of growth of pre-tax profits was particularly impressive, averaging just over 250 per cent.

The growth rate of deposits after denationalization was impressive in both the newly privatized banks. The average annual growth rate of deposits of the MCB was 11.7 per cent for the three years from 1988 to 1990, but it rose to 42.8 per cent in 1992. For the Allied Bank, the growth rate of deposits for 1992 showed an increase of almost 20 percentage points over the annual average for the years 1988 to 1990. In contrast to the substantial gains made by these banks, primarily as a result of extensive deposit mobilization campaigns, the performance of the nationalized banks remained fairly constant over the last five years.<sup>34</sup> Whether the growth of bank deposits will continue remains to be seen. Even so, the newly privatized commercial banks have captured the lion's share of the increased liquidity in the market. This seems to be due to a more efficient approach towards deposit mobilization.

The privatized banks have also been more successful in loan recovery. The total value of outstanding loans from all commercial banks, DFIs, etc., was Rs.80.35 billion on June 30,1993; of which Rs.51 billion were owed to the three nationalized commercial banks. This state of affairs may have arisen because loan disbursement in the nationalized commercial banks became increasingly politicized in recent years, with commercial banks being pressurized to extend loans to influential applicants without adequately enforcing collateral requirements. As can be seen from Appendix (Table 3), their loan recovery drive has not been very successful. The three nationalized commercial banks (NCBs) have collectively recovered only about 3.8 per cent of their outstanding debt.

The two newly privatized commercial banks fared better. Both the Muslim Commercial Bank and the Allied Bank launched campaigns to recover their outstanding debt immediately after their respective de-nationalizations. The MCB formed a Special Assets Management Group for the recovery of outstanding debt, while the Allied Bank designated 1992 as the year of "recoveries", and award schemes were introduced to encourage staff to formulate programs for the recovery of "problem loans". This initiative was taken at a time when loan recovery had not yet become an issue on the national scene.

Appendix (Table 4) reports non-performing loans as a proportion of total loans disbursed by the five major commercial banks. Once again, the NCBs are in an unfavourable position relative to the newly privatized commercial banks, as "bad" loans constitute 25 to 30 per cent of their total credit advancements.

Lari (1993) used various performance indicators including profitability, efficiency, leverage and capital adequacy ratios to develop rankings of NCBs relative

<sup>34</sup> The growth of deposits of the two newly privatized commercial banks should be interpreted with caution. The substantial increases in the value of bank deposits is at least partially attributable to the collapse of the cooperatives in Punjab and the resulting slump in property prices, which rendered investment in real estate largely unprofitable. Another reason for these high deposit growth rates could be stock market volatility and bearish trends resulting from political instability.

to foreign banks. Out of twenty-five banks ranked for 1990, the five major NCBs scored the twentieth to the twenty fourth positions.

## V. Conclusion

Our primary objective in this paper was to test a series of neo-liberal hypotheses about the likely benefits of financial liberalization. Financial deepening and investment efficiency are the channels via which a higher interest rate is expected to benefit the economy. In addition, a direct positive impact on growth is anticipated as credit becomes more readily available.

Judging from Pakistan's experience over the last two decades, the association of real interest rates and real saving, while positive, was negligible. By estimating a money demand function we found the expected positive association of real interest rates and financial saving but of modest magnitude. Similarly, real interest rates had a modest positive association with the related variable of financial deepening.

Neo-liberal theory posits that financial deepening can contribute to efficiency of investment and we tested this hypothesis by regressing the inverse of incremental capital output ratio as a proxy for the efficiency of investment on real interest rates. We found a significant but negative association between the two variables. We also found a negative and significant association of growth rates and interest rates contrary to the neo-liberal hypothesis of a positive association via more credit becoming available. Among other reasons, it is possible that the adverse impact of a higher cost of capital is an important reason for this negative association.

In the Pakistani context, perhaps one reason to refrain from liberalizing interest rates is the enormous size of the budget deficit and the large contribution of interest payments to this deficit. Given that the real saving rate is not responsive to interest rates and financial saving appears to be very modestly so, the government could view an interest ceiling as an implicit tax on the upper and upper middle class without impeding real or financial saving. Our reasoning indicates this to be the most progressive way of dealing with the deficit.

The one unambiguously positive reform appears to be the denationalization of two state owned banks. In terms of the growth of assets their performance improved dramatically compared to their past performance and also relative to the nationalized banks. They also out-performed the nationalized banks in recovering loans and in terms of their ratio of bad loans. If better management is more likely to be associated with privatization, the evidence to date suggests there is a strong case for denationalization in a competitive environment. However, the same cannot be said for interest rate liberalization.

*Sustainable Development Policy Institute,  
Islamabad.*

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## APPENDIX

TABLE 1

## Profit-Asset Ratios of Commercial Banks

Banks	1988	1989	1990	1991	1992
MCB	0.80	0.77	0.44	0.47	0.42
ABL	0.31	0.28	0.26	0.35	0.93
HBL	0.53	0.52	0.32	0.26	0.27
UBL	0.29	0.27	0.25	0.19	n. a.

Source: HBL Annual Report 1992; MCB Annual Report 1992; ABL Annual Report 1992; UBL Annual Report 1991.

TABLE 2

## Average Annual Growth Rates of Deposits of Commercial Banks

Banks	1988-1992	1988-1990	1991-1992
MCB	19.8	11.7	42.8
ABL	21.1	15.4	34.8
HBL	12.4	13.1	15.6
UBL	10.7	-	11.7 *

\* Growth rate for 1990-91

Source: HBL Annual Report 1992; MCB Annual Report 1992; ABL Annual Report 1992; UBL Annual Report 1991.

TABLE 3

## Loan Recovery in Major Commercial Banks

Banks	Total outstanding debt  (billion Rs.)	Amount recovered as on 21-9-1993 (million Rs.)	Amount recovered as on 29-9-1993 (million Rs.)	Proportion of total debt recovered ( per cent )
N.B.P.	13.7	14.3	15.9	1.2
H.B.L.	24.7	108.1	134.6	5.4
U.B.L.	12.5	32.3	58.9	4.7
M.C.B.	4.7	33.7	34.9	7.5
A.B.L.	2.0	n.a.	26.4	13.5

Source: Dawn September 21, and 29, 1993

TABLE 4

## Non-Performing Loans as a Proportion of Total Loans Disbursed

Banks	Proportion of bad loans ( per cent )
National Bank of Pakistan	31.3
Habib Bank Ltd.	30.0
United Bank Ltd.	25.1
Muslim Commercial Bank Ltd.	17.2
Allied Bank Ltd.	11.7

Source: Dawn, September 29, 1993