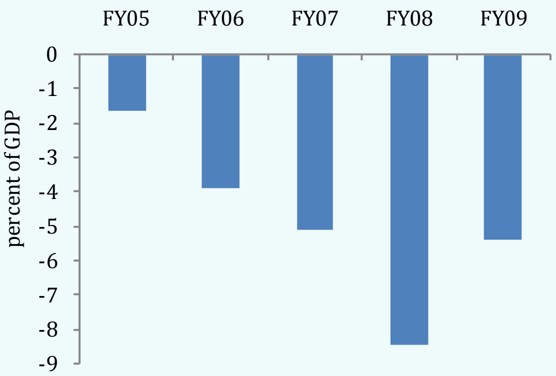
Special Section 4: Trends in National and Financial Savings

Introduction

Macroeconomic instability in Pakistan since the second half of FY08 has its roots in substantial macroeconomic imbalances and deterioration in economic fundamentals. The building up of twin deficits initially financed by large capital inflows and later by drawing down foreign exchange reserves, along with large scale monetization highlight the dearth of savings in the economy. Specifically, the savings-investment gap had widened considerably in the last few years and witnessed some correction in FY09 following the implementation of the macroeconomic stabilization program with IMF's support in FY09 (**Figure1**). It is important to note that this correction primarily came from a slowdown in investment activities, which is not the preferred source of adjustment due to its key role in economic growth. On the other hand, national savings in terms of GDP, an ideal source of narrowing the gap increased by only 0.8 percentage points to 14.3 percent during the year. In this backdrop, this section assesses changes in national and financial savings during FY09 over previous years.

Figure 1: Savings Investment Gap



Source: Economic Survey

Low National Savings

While the increasing savings-investment gap highlights the country's dependence on foreign savings and building up of vulnerabilities, it hides important information regarding the source of the problem, i.e. is the gap a result of low savings, or extraordinary investment activities, or a combination of both? The components of the gap indicate that the total investments to GDP ratio averaged at 21.1 percent during FY05-09 as against the national savings to GDP ratio of 16.2 percent over the same period, implying that the real problem lies with the level of savings in the economy, while the investment ratio of around 20 percent is not sufficient for sustaining real GDP growth of 5 to 6 percent.

A cross-country comparison also supports this finding as Pakistan is categorized among countries with low national savings even after controlling for the difference in per capita income (**Table 1**). In addition to the overall low level of savings, their declining trend in

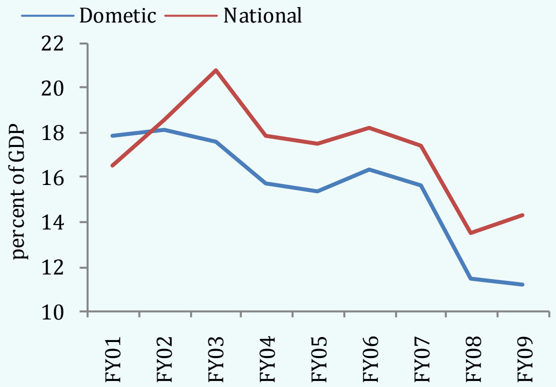
Table 1: Country Comparison of National Savings

percent of GDP

Country	2003	2004	2005	2006	2007	2008	2009
Bangladesh	24.5	25.4	25.8	27.7	28.7	30.2	32.4
Sri Lanka	21.5	22.0	23.8	22.3	23.3	18.2	n.a.
Pakistan	20.8	17.9	17.5	18.2	17.4	13.5	14.3
India	26.3	29.8	31.7	34.2	35.7	37.7	n.a.
Canada	21.2	23.0	24.0	24.4	24.4	23.7	18.6
France	19.1	19.0	18.5	19.1	19.3	19.1	19.2
Germany	19.5	22.0	22.2	23.9	25.9	26.0	26.3
Italy	19.8	20.3	19.5	19.6	20.0	18.2	18.7
Japan	26.1	26.8	27.2	27.7	28.8	26.6	23.2
United Kingdom	15.1	15.0	14.6	14.2	15.6	14.9	14.9
United States	12.9	13.4	14.4	15.0	13.7	14.8	15.2

Source: World Economic Outlook, and Central Banks Websites recent years is a more serious concern. Specifically, national savings as percent of GDP has declined from 18.2 percent in FY06 to 13.5 percent in FY08, prior to recording some improvements in FY09. It may be noted though that the improvement in the national savings to GDP ratio during FY09 is entirely attributed to an independent factor i.e. a quantum leap in workers' remittances. This is also visible from the increased gap between national and domestic savings in FY09 (**Figure 2**). The significant decline in domestic savings during FY08 and FY09 is primarily attributed to; (1) sharp reduction in overall economic activities; and (2) strong inflationary pressures during the year which eroded household purchasing power, which ultimately reduced savings in the economy. Generally however, the major reasons for low savings in Pakistan include a high dependency ratio, poor inflation adjusted returns on financial instruments (especially on deposits), cultural factors such as heavy expenses on marriages, social functions and religious ceremonies, low level of financial deepening, and preference to use cash to settle majority of transactions.[1]

Figure 2: Trends in Savings

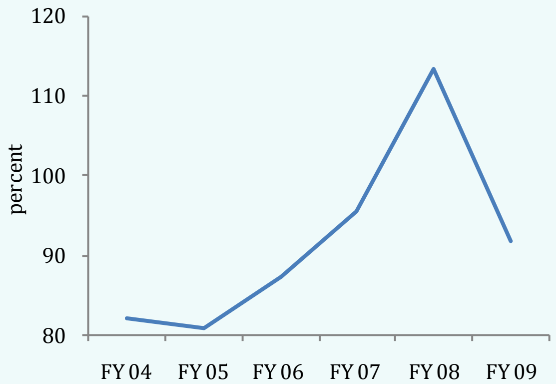


Source: Economic Survey

Composition of National Savings

Composition of national savings in terms of ownership indicates that the private sector has a predominant contribution in the overall level of savings. It accounts for 91.9 percent of national savings for FY09. **Figure 3** shows that the share of private sector savings has witnessed visible changes in the recent past. Further information on this front indicates that these changes have their roots in wild fluctuations in public sector savings. Specifically, public sector savings in terms of GDP were 1.2 percent during FY09 as against dis-savings of 1.8 percent for FY08 (**Figure 4**). This situation is a reflection of weak fiscal control, as public savings primarily comprise of the revenue surplus of the government.

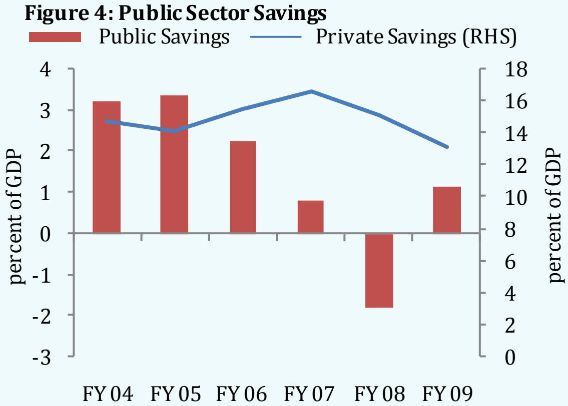
Figure 3: Share of Private Savings in National Savings



Source: Economic Survey

Private sector savings, on the other hand, have also declined for the second successive year to 13.2 percent (**Figure 4**). Among other factors, this decline is attributed to the erosion in households' purchasing power due to prevailing high inflationary pressures, and increase in unemployment. Within private savings, the household sector

Figure 4: Public Sector Savings



Source: Economic Survey

[1] Gallina A. Vincelette (2006), Determinants of Savings in Pakistan, South Asian region, PREM Working paper Series NO. SASPR-10, World Bank.
Khan A.H., Lubna Hassan and Afia Malik (1992), "Dependency Ratio, Foreign Capital Inflows and the Rate of Savings in Pakistan", The Pakistan Development Review, Volume 31, No.4, pp. 843-856.

accounts for over 85.0 percent of private sector savings, with the balance originating from the corporate sector.

Given the overall position of National savings in the economy during FY09, the rest of this section discusses trends in financial savings which are a subset of national savings.

Financial Savings

Financial savings[2] in FY09 nose-dived to the low level of 3.0 percent of GDP as against 6.3 percent of GDP for FY08 (**Table 2**). The sharp reduction is attributed to a variety of factors including high inflationary pressures prevalent during the year, increase in unemployment, slowdown in overall economic activities and substantial reduction in the value of financial instruments especially of mutual funds.

Table 2: Trends and Structure in Financial Savings

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
					billion Rupees				
Accumulated Savings (Stock)	2,511	2,771	3,252	3,690	4,183	4,686	5,477	6,128	6,522
Deposits of Banking Sector	1,264	1,411	1,671	1,975	2,405	2,772	3,310	3,701	3,791
Investments in NSS	762	847	982	984	940	934	1,000	1,094	1,359
Currency in circulation	374	434	494	578	666	739	839	981	1,157
Deposits of NBFIs	80	41	40	47	48	61	56	41.3	21.6
Mutual funds	12	19	45	85	103	135	228	269	152
GP fund	18	19	20	22	22	44	43	43	40
					Accumulated Savings(growth in percent)				
Accumulated Savings (Stock)	7.8	10.3	17.4	13.5	13.4	12.0	16.9	11.9	6.4
Deposits of scheduled banks	11.4	11.6	18.4	18.2	21.8	15.3	19.4	11.8	2.5
Investments in NSS	6.5	11.1	16.0	0.2	-4.5	-0.6	7.1	9.3	24.3
Currency in circulation	5.3	15.8	14.0	16.9	15.1	11.1	13.4	17.0	17.9
Deposits of NBFIs	-12.3	-48.6	-2.2	16.2	3.4	26.0	-7.8	-26.2	-47.6
Mutual funds	-5.9	56.7	132.1	88.1	21.6	31.2	69.0	17.8	-43.3
GP fund	-2.0	1.2	5.3	9.9	1.0	103.9	-2.6	-1.9	-5.4
					Accumulated Savings(percent of GDP)				
Accumulated Savings (Stock)	60.3	62.9	67.4	65.4	64.4	61.7	62.9	59.6	49.8
Deposits of scheduled banks	30.4	32.1	34.6	35.0	37.0	36.5	38.0	36.0	29.0
Investments in NSS	18.3	19.2	20.4	17.5	14.5	12.3	11.5	10.6	10.4
Currency in circulation	9.0	9.9	10.3	10.2	10.2	9.7	9.6	9.5	8.8
Deposits of NBFIs	1.9	0.9	0.8	0.8	0.7	0.8	0.6	0.4	0.2
Mutual funds	0.3	0.4	0.9	1.5	1.6	1.8	2.6	2.6	1.2
GP fund	0.4	0.4	0.4	0.4	0.3	0.6	0.5	0.4	0.3
					Flows as percent of GDP				
National savings	16.5	18.6	20.8	17.9	17.5	18.2	17.8	13.9	14.3
Domestic Savings	17.8	18.1	17.6	15.7	15.4	15.3	16.1	11.7	11.2
Financial savings (Flows)	4.4	5.9	10.0	7.8	7.6	6.6	9.1	6.3	3.0
Deposits of scheduled banks	3.1	3.3	5.4	5.4	6.6	4.8	6.2	3.8	0.7
Investments in NSS	1.1	1.9	2.8	0.0	-0.7	-0.1	0.8	0.9	2.0
Currency in circulation	0.5	1.3	1.3	1.5	1.3	1.0	1.1	1.4	1.3
Deposits of NBFIs	-0.3	-0.9	0.0	0.1	0.0	0.2	-0.1	-0.1	-0.2
Mutual funds	0.0	0.2	0.5	0.7	0.3	0.4	1.1	0.4	-0.9
GP fund	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0

Source: Statistical bulletin and annual Reports of SBP; Economic Surveys, MoF

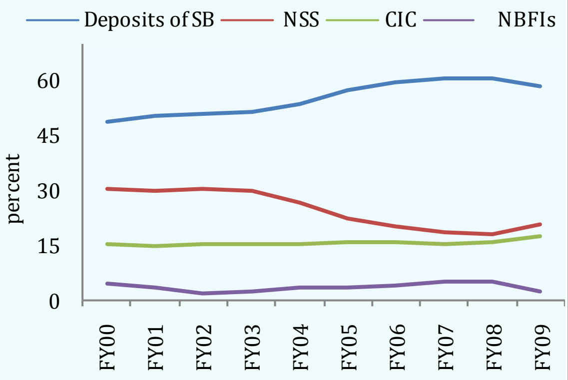
[2] Financial savings include changes in bank deposits, investments in National Saving Schemes (NSS), currency in circulation (CIC), deposits of NBFIs, investments in mutual funds and General Provident Fund (GPF) during the year.

The low level of financial savings during the year is also visible from accumulated financial wealth, which saw a YoY rise of 6.4 percent in FY09 to Rs 6.5 trillion, as against an increase of 11.9 percent in the previous year. The composition of financial savings reveals savers' increased preference for low risk and fixed income financial instruments (**Table 2**). Specifically, net investments in National Savings schemes (NSS) and currency in circulation (CIC) witnessed YoY rise of 24.3 percent and 17.9 percent respectively. This makes perfect sense from the savers' point of view as the element of uncertainty increased substantially during FY09. Factors such as the imposition of the floor of 9,144 points on the KSE-100 index for almost 4 months, temporary liquidity stress in the banking sector, and the financial crisis at international level played an important role in increasing uncertainty in the domestic financial sector.

Deposits of Banking Sector

Bank deposits are the most preferred mode for accumulating financial savings, accounting for nearly 60.0 percent of accumulated financial savings. However, their share has slightly reduced during FY09 to 58.1 percent as compared to 60.4 percent in the previous year (**Figure 5**). In absolute terms, banking sector mobilized deposits of Rs. 90.8 billion in FY09 as against Rs 390.2 billion in FY08. This substantial slowdown in deposit growth is attributed to a variety of factors including: (1) stiff competition from National Savings Schemes, (2) overall slowdown in economic activities, (3) strong inflationary pressures, and (4) the process of deposit withdrawals around the Eid festival compounded by low confidence in the banking sector which badly affected banks' deposit mobilization during H1-FY09. These adverse developments even overshadowed the potentially positive impact of introducing the minimum rate of return of 5.0 percent on all PLS savings deposits by the SBP, w.e.f. June 2008.[3] However, monthly data on bank deposits indicates some improvement during the last quarter of FY09.

Figure 5: Share in Financial Wealth



Source: SBP calculations

Currency in Circulation

The CIC is the third largest component of accumulated financial savings (**Figure 5**). Its share in accumulated financial savings reached 17.7 percent by end FY09 as against 16.0 percent for the previous year. In absolute term, the stock of CIC has seen YoY growth of 17.9 percent during FY09 to reach Rs. 1,157.0 billion. This strong growth in CIC as compared to bank deposits highlights increased liquidity preferences of the economic agents. Strong inflationary pressures during the year also contributed to this increase. It is important to note that despite noteworthy progress in the retail payment system, cash is still the preferred mode of transaction due to a variety of factors including lack of customer awareness, limited access to other means of payments due to low financial penetration, issues related to tax evasion, preference to avoid documentation of transactions, etc.[4] Withholding tax on cash withdrawals from bank accounts may also be a contributory factor.

Savings Mobilized by the NBFIs

Given the substantial changes in the overall structure and performance of NBFIs, their role in mobilizing financial savings has also witnessed significant changes, especially during FY09.

[3] For detailed discussion on bank deposits, please see Chapter 4, "Stability of the Banking System', in this edition of the FSR.
[4] For details, please see Chapter 10, Payment and Settlement System, in this edition of the FSR.

The share of deposits mobilized by NBFIs in accumulated savings has dipped to 0.2 percent of GDP by end FY09 as against 0.4 percent of GDP in the previous year. In absolute terms, deposits held by NBFIs dipped to Rs 21.6 billion by end FY09 as against Rs 41.3 billion in FY08. This decline of almost 50 percent is a reflection of the challenges faced by the NBFIs in mobilizing funds.[5]

Notably, Mutual Funds, an important segment of NBFIs, had registered tremendous growth in the recent past: the market value of financial savings mobilized by mutual funds approximately doubled to Rs 268.9 billion during the period from FY06 to FY08. However, a sharp reversal in the market value of financial savings mobilized through mutual funds was observed during FY09. Specifically, the stock of financial savings held by mutual funds plunged to only Rs 152.4 billion by end FY09. This sharp reversal is the upshot of exceptional developments in the equity market. The equity market turmoil which was started in April FY08 worsened further during H1-FY09. Despite gradual improvement in recent months, the market is still trading far below the highest level of the KSE-100 index achieved during FY08.[6]

National Savings Schemes (NSS)

Unlike banks and NBFIs, the share of NSS in accumulated financial savings increased to 20.8 percent by end FY09, as against 17.8 percent for the previous year. Investments in NSS saw YoY increase of 24.3 percent to Rs 1,359.5 billion by end FY09. This strong flow of funds to NSS as compared to bank deposits is the result of: (1) upward revision in profits rates on major NSS instruments, especially during H1-FY09; (2) increased uncertainty in domestic financial markets which increased the appeal of risk-free sovereign instruments; (3) low returns on bank deposits; and (4) the aftermath of the temporary liquidity stress in the banking system. It may be added here that although profits rates on major NSS instruments have been revised downward since April FY09, these rates are still slightly high when compared to the profit rates prevalent in June FY08.

Although banks, NBFIs and CDNS compete for financial savings in the economy, their objectives differ strongly from one another. CDNS mobilizes funds not only to promoting financial savings in the economy but also to generate much needed funds for financing of budgetary deficit. It also offers senior citizens and retired government officers specific savings schemes. Given its multiple objectives and the huge size of investments in NSS, CDNS is a key component of the overall financial sector. The volume of funds mobilized by the CDNS have strong implications for the overall performance of the banking sector. In this backdrop, the rest of this section reviews financial savings mobilized by CDNS during FY09 and its implications on the financial sector.

Net investments in NSS increased by Rs 266.0 billion during FY09. Scheme wise data indicates that approximately 50 percent of this increase came from Special Savings Certificate (SSCs) - a 3-year maturity scheme with profit payments on completion of each six months. Provision of early encashment and payment of profits on six monthly basis renders these certificates effectively of a six-month maturity (**Table 3**). This makes the SSCs especially attractive for investors. Moreover, individuals and institutions[7] both are allowed to purchase these certificates.

Among other schemes, Behbood Savings Certificates (BSCs) and Regular Income Certificates (RICs) also increased by Rs 78.5 billion and Rs 40.0 billion respectively during the year.

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[5] For details, please Chapter 8 on Performance Review of Non-Bank Financial Institutions" in this edition of the FSR.
[6] For details, please Chapter 7 on "Stability Assessment of Financial Markets", in this edition of the FSR.
[7] Institutions include: (1) Registered Charities (Non-profit bodies); (2) Public Sector Enterprises excluding Banks; (3) Private Educational & Health Institutions; (4) Employees Old Age Benefit Institutions (EOBIs); (5) Private Corporate Sector registered with the SECP excluding Banks; and (6) Non-Bank Financial Institutions (NBFIs) excluding Insurance Companies.

Table 3: Major Characteristics of selected NSS instruments

Characteristics	DSCs	SSCs	RICs	BSCs
Maturity Period	10 Years	03 Years	05 Years	10 Years
Minimum holding period	1 month	1 month	-	-
Early encashment penalty	Nil	Nil	0.5% to 2%	0.25% to 1%
Profit Payments	Bullet bonds	Bi-annually	monthly	Monthly
Zakat	compulsory	compulsory	exempted	exempted
Withholding Tax	@10%*	@10%*	@10%	exempted
Maximum Investment Limit	No limit	No limit	No limit	3,000,000/-
Institutional Investment	Allowed	Allowed	Allowed	Not allowed

* Withholding tax is exempt if the total investment does not exceed Rs.150,000/-.

Given the specific characteristics of the BSCs especially with respect to maximum limit and eligibility criteria, the massive rise in investments in these certificates is quite interesting. Looking at gross investment of Rs 314.3 billion in BSCs during FY09 along with maximum limit of Rs 3.0 million per person indicates that at least 102,179 individuals (widows and senior citizens) have invested in this scheme. Trends in competing NSS indicate that a portion of the increase in BSCs is attributable to a shift in investments from Defense Savings Certificate (DSCs) to BSCs. The former saw a net decline of Rs 27.0 billion during the year. This substitution is primarily attributed to the relatively higher net returns on the BSCs.

Given the developments in major NSS during FY09, the impact of funds mobilized by these schemes on other segments of the financial sector are discussed follow:

- ***NSS and Deficit Financing:*** Funds mobilized through NSS are an important source of deficit financing. Net flows in NSS during FY09 constitute 39.1 percent of the budgetary deficit for the year. Massive increase in net inflows helped the cash starved government to fund its expenditure from non-inflationary borrowing especially in the presence of the cap on government borrowings from the central banks under the Stand By Arrangement (SBA) of the IMF. However, one should keep in mind the fact that NSS is a costly source of borrowing as funds are mobilized at relatively higher returns as compared to other government debt instruments (T-Bills and PIBs).

- ***NSS and Domestic Debt***: The outstanding stock of NSS constitutes 35.3 percent of domestic debt. Given the high rate of return on NSS instruments along with provision of early encashment, Rs 1,359.5 billion stock of NSS as of end FY09 has strong implications for debt management.
    - Funds mobilized through NSS are costly as compared to other sources of borrowing. This increases the debt servicing- burden on the fiscal account.
    - Provision of early encashment facility (i.e. implicit put option) on most of the schemes distorts the maturity profile of government debt. Effectively, these schemes have no maturity profile, which ultimately undermines government's efforts to manage its financing.
    - Stock of NSS is not a true reflection of government debt liabilities as it represents the face value of NSS investments, without taking into account accrued interest. Official numbers can be quite misleading given that DSCs are bullet bonds – requiring payment of principle and accumulated returns (which accrue on annual basis) on demand.

- ***NSS and Liquidity Management***: Given the lack of an effective maturity profile, the huge stock of NSS instruments also complicates liquidity management in the interbank market. Institutional investment in various NSS instruments further complicates this issue due to the large volumes involved.

- ***NSS and development of the Bond Market***: Various characteristics of NSS along with high returns are one of the major impediments for the development of the nascent bond market in the country. Provision of institutional investments in NSS severally affects the demand for corporate bonds. At the same time, risk-free returns on these schemes distort price discovery of corporate debt instruments.

Lastly, while NSS plays a key role in mobilizing financial savings in the economy, there is an urgent need for reforms in this area as NSS creates distortion in the financial sector. Specifically, these reforms should be aimed at : (1) reducing the wide gap between profit rates on various NSS instruments and other competing financial instruments; (2) promote trading of NSS instruments in the secondary market by withdrawing the early encashment facility; (3) take into account the accrued interest on various NSS instruments, especially on DSCs for accounting purposes; and (4) upgrade CDNS infrastructure by utilizing IT services. Given the huge size of investments in NSS, a restructured and well-equipped CDNS can strategically be used to deal with market failures of certain nature, such as promoting outreach of financial services to remote areas. It may be added here that these are only initial thoughts, which can be analyzed in detail for the overall restructuring of the CDNS, which is outside the scope of this brief discussion.

Conclusion

Although National savings as a proportion of GDP increased 40 bps during FY09 to 14.3 percent, the savings rate in Pakistan is the lowest among neighboring countries. Moreover, this minor increase was primarily attributed to the surge in workers' remittances during the year as domestic savings as a percent of GDP declined from 11.5 percent in FY08 to 11.3 percent in FY09. The decline in savings during FY09 is primarily attributed to the sharp reduction in overall economic activities and strong inflationary pressures in the economy.

As a component of national savings, financial savings dipped to 3.0 percent of GDP during the year as against 6.3 percent in FY08. However, this decline was not observed across all components of financial savings. Specifically, the CIC and stock of NSS grew by 17.9 percent and 24.3 percent respectively. Bank deposits, with a 60.0 percent share in accumulated financial savings, grew by only 2.5 percent. There are also indications of some substitution among the major components of financial savings, especially between banks deposits and NSS instruments.

In sum, while NSS play an important role in mobilizing financial savings in the economy, huge stock of NSS along with unique characteristics of these schemes create distortions in the financial sector. It is suggested that CDNS is restructured in such a manner that it can continue to play its vital role in mobilizing financial savings in the economy without creating significant distortions in the financial sector.