8 Financial Sector Development

8.1 Overview

A well-developed financial sector plays an important role in the overall economic development. Literature on economics and finance has identified a number of channels through which financial sector supports economic growth. The major channels that have widely been discussed include financial sector's ability to (a) reduce risk involved in financial transactions by pooling and diversifying risk factors; (b) lower the cost of financial intermediation by exploiting benefits from economies of scale and economies of scope; (c) mobilize savings and channelize these funds into investment activities; (d) optimize the allocation of resources available in the economy.[1]

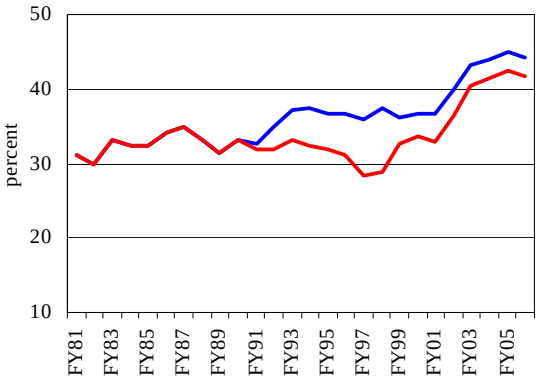
The financial sector liberalization in Pakistan being pursued since late 1980s tended to improve financial sector efficiency by providing more scope to market forces in determining intra and inter temporal prices in the financial markets and allocation of financial system credit. The financial sector reforms were primarily aimed to promote economic development of the country in general and the financial intermediation in particular.

In this backdrop, this chapter assesses the performance of Pakistan's financial sector by analyzing trends in various macro indicators of financial deepening and intermediations since FY00. Moreover, it also analyzes trends in financial savings and changes in credit allocation among various sectors in the economy during FY00-FY05.[2]

8.2 Financial Deepening and Intermediation

Financial deepening and intermediation show the extent of penetration of financial products in the economy at large. A high penetration level is generally attributed to stability and soundness of the financial system as confidence of economic agents on the financial sector plays a vital role in improving the financial deepening in a country. Trends in widely used indicators of financial sector deepening and intermediation suggest substantial improvement in Pakistan during the last five years. These are discussed below.

Figure 8.1: Monetary Aggregates to GDP Ratio



Broad money to nominal GDP ratio is widely used as an indicator for financial sector deepening, where higher values represents a more developed financial sector (see **Box 8.1**). Historically, in Pakistan M2 (the broad definition of money) to GDP ratio has made a very little progress and has almost stagnated during 1990s (see **Figure 8.1**).[3] However, since FY01, the ratio has witnessed a substantial rise, as it increased from 36.7

[1] Study by Ross Levine (1997) on "Financial Development and Economic Growth: Views and Agenda", published in Journal of Economic Literature, American Economic Association, vol. 35(2), pages 688-726, June; provides a good review of literature on this subject area.

[2] Trends and determinants of intermediation cost and progress made in improving the NPLs have already been discussed in earlier chapters. These two areas represent the first two major functions mentioned in the opening paragraph.

[3] This is with the exception of an uptake in the initial two years of 1990s due to introduction of the Resident Foreign Currency Deposits (RFCDs). In fact, excluding RFCDs the M2 to GDP ratio has followed a downward trend during 1990s.

percent in FY01 to 44.3 percent in FY06 showing improvement in financial deepening.

Box 8.1: Significance of Monetary Aggregates to GDP Ratios

Monetary aggregate to nominal GDP ratio is widely used as a broad indicator for deepening of financial sector in a country; a higher value of the ratio is interpreted as higher monetization of economic activity. In fact, many cross-country studies have found a positive correlation between development of financial sector and monetary assets to GDP ratio. This is possibly because people normally prefer to hold monetary assets only when they feel convenient to keep their wealth in monetary instruments given the underlying nature of risk, return and efficiency in payments. A well-developed financial sector generally offers instruments that have optimal mix of these characteristics.

A faster growth in money supply than nominal GDP is required to raise this ratio. However, using an easy monetary policy or maintaining this higher growth in monetary aggregate only depends on a country's ability to absorb the excess money supply without building inflationary pressures. In other words, the elasticity of money demand with respect to nominal GDP should be greater than 1 for a persistence rise in this ratio.

In this perspective, in a typical developing country like Pakistan, a sustained rise in financial deepening is required to (a) enhance the outreach of the financial institutions to remote areas; (b) increase in the literacy rate, as it helps in creating awareness and understanding the use of the financial services; (c) increased documentation and enhance coverage of taxable population.

The rapid increase in financial depth during FY01-FY06 was an outcome of many factors including both supply and demand side incentives. On the supply side, low inflation for most of the period, easy monetary policy by SBP during FY02-FY04; improved financial health of banking sector; diversification of credit portfolio towards previously underserved segments such as consumer, agriculture and SME financing; introduction of new financial products, especially plastic money; increased branches and ATM network of private sector banks; etc have contributed in increasing the depth of financial sector. On the other hand demand side factors include sustained high economic growth; efforts made in documenting the unreported sector; and improved literacy levels in the country.

Encouragingly these factors have also brought in some positive changes in M2 composition. On assets side, it was the sharp growth in Credit to Private Sector (CPS) since FY03 that has pushed the M2 to GDP ratio up. The CPS to M2 ratio surged from 45.6 percent in FY02 to 61.9 percent in FY06 (see **Table 8.1**). This relatively faster growth in CPS has played an important role in stimulating strong economic activity during the past few years.

Table 8.1: Indicators of Financial Deepening

percent

Indicators	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
M2 to GDP	36.7	36.0	37.4	36.2	36.6	36.7	40.0	43.1	44.1	45.1	44.3
Money multiplier	3.0	3.2	3.3	3.2	2.8	2.9	3.0	3.1	3.2	3.3	3.4
Currency to total deposits	33.6	30.4	29.4	29.2	34.3	32.9	33.0	31.3	30.3	29.0	27.7
Currency to M2	24.9	23.2	22.6	22.5	25.4	24.6	24.6	23.8	23.2	22.4	21.7
Currency to GDP	9.2	8.3	8.5	8.1	9.3	9.0	9.9	10.3	10.2	10.1	9.6
CPS to M2*	46.5	48.0	49.0	52.7	49.5	49.2	45.6	46.7	51.2	57.7	61.9
CPS to GDP*	17.1	17.3	18.3	19.1	18.1	18.0	18.2	20.1	22.6	26.0	27.4

*: CPS = Credit to private sector

Source: SBP

Similarly on the liability side, phenomenal growth in the local currency deposits primarily contributed in raising financial deepening ratio. On the other hand, growth in currency in circulation was

significantly lower than deposits and overall M2. As a result, currency to deposit ratio has depicted a declining trend in FY02 period, showing increased intermediation in the country. This indeed reflects an increased utility of banking services and improved confidence of general public on banking system, as strong growth in deposits was realized despite negative return on the deposits.

The fall in currency to deposit ratio along with improved banks' reserve management practices led to increase in Money Multiplier (MM) value.[4] In fact, the MM saw a trend reversal since FY00 and gradually increased from 2.8 to 3.4 in FY06 that coincided with the trend in currency to deposits ratio (see **Figure 8.2**). More importantly, volatility of MM has also declined, as reflected by a fall in co-efficient of variation from 0.6 percent in FY00 to 0.3 percent in FY06. It is important to note that a well-developed and active financial sector generally characterized by a high and stable value of MM.[5]

Figure 8.2: Trends in Money Multiplier

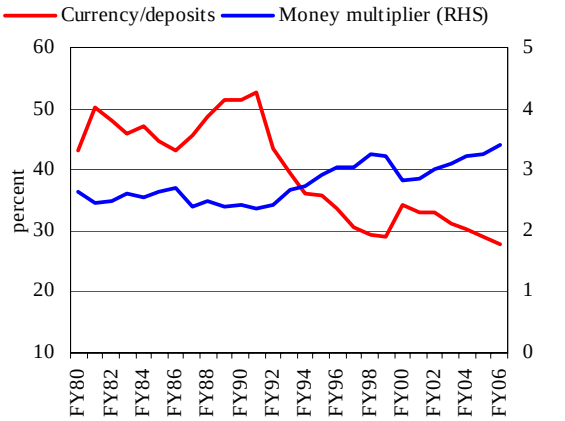


Table 8.2: Pakistan's Relative Position in Financial Deepening

	Pakistan		India		Sri Lanka		Bangladesh	
	FY96	FY05	FY96	FY05	FY96	FY04	FY96	FY05
Broad money to GDP	36.7	45.1	45.6	67.5	37.6	42.3	29.4	44.7
Money multiplier	3.0	3.3	3.3	4.6	3.4	5.0	4.3	4.9
Currency to M2	24.9	22.4	20.8	16.6	14.7	11.6	14.0	12.5
Currency to GDP	9.2	10.1	9.5	11.2	5.5	4.9	4.1	5.6
Credit to private sector to GDP	17.1	26.0	23.9	41.2	29.9	31.5	21.6	31.7
Credit to private sector to total credit	45.4	65.3	51.9	67.5	77.2	70.8	71.4	71.7
	Indonesia		**Philippines**		**Thailand**		**Malaysia**	
	FY96	**FY05**	**FY96**	**FY05**	**FY96**	**FY05**	**FY96**	**FY05**
Broad money to GDP	52.7	44.1	56.3	52.8	80.8	95.9	88.5	105.8
Money multiplier	7.6	3.9	3.6	5.0	8.1	4.6	3.5	9.9
Currency to M2	8.0	10.3	10.1	9.6	8.2	9.5	8.4	5.8
Currency to GDP	4.2	4.6	5.7	5.1	6.6	9.1	7.5	6.1
Credit to private sector to GDP	55.5	24.8	49.0	26.0	101.7	75.5	95.7	115.9
Credit to private sector to total credit	100.8	54.2	72.1	56.2	101.0	82.3	88.8	97.1

Source: SBP for Pakistan; International Finance Statistics, IMF for the other countries.

Although the macro indicators suggest improvement in financial deepening and intermediation, in relative terms Pakistan is still far behind compared to the developed economies and newly industrialized countries of East Asia (see **Table 8.2**). Even the regional countries including India, Sri-Lank and Bangladesh have relatively higher intermediation ratios than Pakistan. There is a strong need to further increase the financial intermediation and depth in the country. However, a continuous

[4] Banks excess reserves as percent of total demand and time liabilities (on average) declined from above 1 percent in FY00 to close to 0.5 percent in FY06. However, the decline was partly attributed to monetary tightening by SBP since Q4-FY04.
[5] While a low money multiplier represents a shallow and passive financial sector that has a low responsiveness to the central bank monetary policy changes; an unstable money multiplier makes the impact of monetary policy measures unpredictable, thereby making monetary management more difficult.

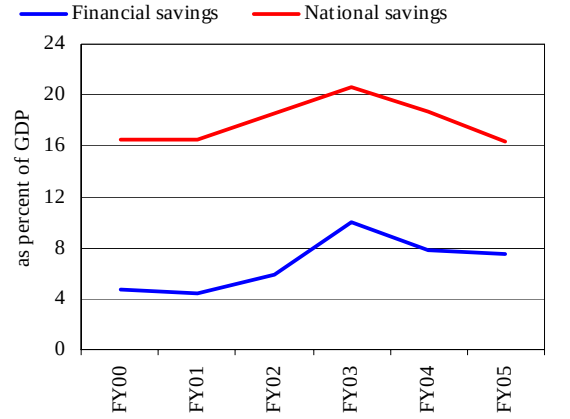
rise in M2 to GDP ratio requires sustained strong growth with low inflation; increasing documentation of the large undocumented sector; expanding outreach of formal financial sector; improving literacy; etc.

8.3 Trends and Structure of Financial Savings[6]

As described by Ross Levine (1997),[7] saving mobilization is one of the key functions of the financial sector – an important determinant of economic growth. Efficiently working financial intermediaries provide opportunities to households and firms to hold diversified asset portfolios, offering optimal returns according to liquidity and risk profile. In other words, the financial sector provides better opportunities to savers in the economy, thereby contributing to economic growth.

During FY01-05, financial savings in Pakistan witnessed a rapid average growth of 21.9 percent per annum, which was significantly higher than the nominal GDP growth. Hence, financial saving as a percentage of GDP surged from 4.8 percent in FY00 to 7.5 percent in FY05 (see **Figure 8.3**). Accordingly, the financial wealth to GDP ratio has increased to 67 percent in FY05 from 61 percent in FY00.[8] This performance of financial savings is however, concentrated in two years, viz. FY02 and FY03 when financial savings increased by 42.5 percent and 82.5 percent respectively.[9] Baring these two years, financial savings show hardly any increase during the FY01-05 period (see **Table 8.3**).

Figure 8.3: Trends in Savings Rates



The changes in financial savings generally followed the trends in national savings. As evident from **Figure 8.3**, the shares of both national as well as financial savings in GDP rose steadily before falling during FY04 and FY05. Given the fact that saving ratios in Pakistan are already very low, the fall in saving rate is quite disturbing.

A major reason for the fall in the saving rate was the decline in real returns on savings. As evident from **Figure 8.4**, real interest rates, even on NSS instruments, turned negative by FY04. Further, effective returns on foreign currency accounts, another important avenue for savers in the past, were

[6] Financial savings can be defined as the change in the amount of deposits and other savings held by financial institutions for households, business organizations and other institutions. Here, it is computed by adding six components: (i) deposits of scheduled banks, (ii) deposits of NBFIs, (iii) investment in government debt instruments by non-bank, (iv) currency in circulation, (v) investment in mutual funds held by household and non-financial institutions, and (vi) contribution in general provident fund.

[7] Ross Levine (1997),"Financial Development and Economic Growth: Views and Agenda", Journal of Economic Literature, vol. 35(2), pages 688-726.

[8] Financial wealth is defined as the stock of deposits and other savings held by financial institutions for households, business organizations and other institutions. It may be important to note that in earlier Financial Sector Assessment Reports financial wealth has been termed as stock value of Financial Savings. This also explains the difference in values of financial savings given in **Table 8.3** here from that reported in the earlier reports.

[9] While the rise in savings during FY02 was due to a sharp rise in investment in NSS and larger amount of currency in circulation, growth in financial savings during FY03 reflects increased activity in NSS and a rise in bank deposits.

also low due to stable exchange rate.[10] Such low returns on savings may have led to an increase in consumption.

Table 8.3: Trends and Structure in Financial Savings

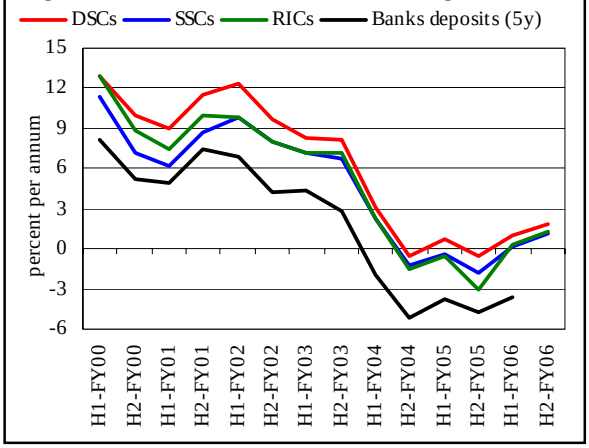
	FY00	FY01	FY02	FY03	FY04	FY05
			Billion Rs			
Financial savings (billion Rs)	**182.3**	**182.1**	**259.6**	**481.5**	**438.0**	**491.5**
Deposits of scheduled banks	26.2	129.0	147.0	259.2	304.3	429.9
Investments in NSS	91.4	46.8	84.9	135.9	1.9	-46.0
Currency in circulation	68.4	19.0	59.2	60.8	83.7	87.4
Deposits of NBFIs	-13.0	-11.2	-38.8	-0.9	6.5	1.6
Mutual funds	7.0	-1.0	7.0	25.6	39.6	18.3
GP fund	2.3	-0.4	0.2	1.0	1.9	0.2
			Growth			
Financial savings	8.5	7.8	10.3	17.4	13.5	13.3
Deposits of scheduled banks	2.4	11.4	11.6	18.4	18.2	21.8
Investments in NSS	14.7	6.5	11.1	16.0	0.2	-4.7
Currency in circulation	23.8	5.3	15.8	14.0	16.9	15.1
Deposits of NBFIs	-12.5	-12.3	-48.6	-2.2	16.2	3.4
Mutual funds	110.4	-7.3	56.7	132.1	88.1	21.6
GP fund	13.9	-2.0	1.2	5.3	9.9	1.0
			Share in Financial Savings			
Deposits of scheduled banks	14.4	70.8	56.6	53.8	69.5	87.5
Investments in NSS	50.1	25.7	32.7	28.2	0.4	-9.4
Currency in circulation	37.5	10.4	22.8	12.6	19.1	17.8
Deposits of NBFIs	-7.1	-6.2	-15.0	-0.2	1.5	0.3
Mutual funds	3.8	-0.5	2.7	5.3	9.1	3.7
GP fund	1.3	-0.2	0.1	0.2	0.4	0.0
			As percent of GDP(mp)			
National savings	16.5	16.5	18.6	20.6	18.7	16.4
Financial savings	4.8	4.4	5.9	10.0	7.8	7.5
Deposits of scheduled banks	0.7	3.1	3.3	5.4	5.4	6.5
Investments in NSS	2.4	1.1	1.9	2.8	0.0	-0.7
Currency in circulation	1.8	0.5	1.3	1.3	1.5	1.3
Deposits of NBFIs	-0.3	-0.3	-0.9	0.0	0.1	0.0
Mutual funds	0.2	0.0	0.2	0.5	0.7	0.3
GP fund	0.1	0.0	0.0	0.0	0.0	0.0
Financial wealth (billion Rupees)	**2,329.1**	**2,511.3**	**2,770.8**	**3,252.4**	**3,690.3**	**4,181.8**
As percent of GDP	60.9	60.3	62.9	67.4	65.4	63.5

It may be pointed out that the healthy economic growth in Pakistan achieved during FY05 was mainly driven by higher consumption. In fact, it can be argued that the development in the financial sector has supported the increased consumption trends in the economy. As discussed in the following section, the easy and affordable access to credit has allowed household to shift their future consumption demand for products such as consumer durables and housing to current periods. In the absence of this credit facility, people would have been saving more to purchase these goods in future. Thus the availability of financial products has probably reduced the need to save more and thereby contributed towards declining saving rates in the economy.

[10] The high return on foreign currency accounts was mainly because of sharp depreciation/ devaluation of local currency; on average Pak Rupee depreciated by around 12 percent per annum during the 1990s.

An important development during the last few years is the narrowing of the gap between national saving rate and financial saving rate; the gap between the two significantly declined from the peak of 12.7 percentage points in FY01 to 8.9 percentage points in FY05 (see **Figure 8.4**). This indicates the growing role of the financial sector in the economy.

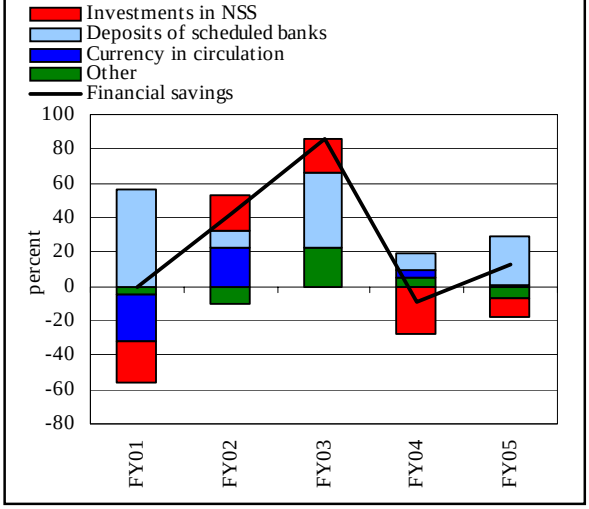
Figure 8.4: Real Return on Financial Savings



Composition of Financial Savings

Analyzing the composition of the financial savings suggests that the slowdown in FY04 and FY05 was primarily due to net outflows in NSS instruments (see **Figure 8.5**). In fact, financial savings fell by 9 percent (Rs 43.6 billion) during FY04, mainly led by Rs 134 billion decline in NSS investment. While the fall in NSS investment continued in FY05, this was more than offset by the sharp increase of Rs 125.6 billion in bank deposits. The financial savings as a result increased by 12.2 percent (Rs 53.6 billion) during FY05.

Figure 8.5: Contribution to Growth in Financial Saving



In the hindsight, the fall in NSS investments was mainly on account of restriction imposed by the government on institutional investments in March 2000[11] and rationalization of return on NSS investment[12] in line with other interest rates in the economy. However, the investment in NSS remained attractive during FY02 and FY03. This mainly reflects the arbitrage opportunities that had emerged due to the wide interest rate differential between NSS rates and banks' lending rates on loans secured against NSS instruments. This renewed interest in NSS instruments bolstered the financial savings growth during FY02 and FY03.[13] Later on, when banks were prohibited from selling NSS instruments effective from June 15, 2003, the net investment in NSS again started declining. Thus, the combined impact of the ban on institutional investment, fall in returns on NSS and checks on arbitrage opportunities held back the growth in financial savings.

The deposits of scheduled banks on the other hand continued to grow steadily, contributing significantly to financial savings throughout the period FY01-05. As discussed earlier, the strong growth in scheduled banks' deposits was mainly driven by substantial influx of foreign remittances and a strong activity in the economy.

[11] The ban on institutional investment in NSS was expected to have significant impact on financial savings.
[12] In FY00, the interest rates on NSS instruments were linked to the rate of return on Pakistan Investment Bonds (PIBs), which is a market-based instrument. The sharp decline in interest rates during FY03 and FY04 partially diverted private savings towards other investment options such as listed shares, real estate, mutual funds, etc.
[13] Had there not been an arbitrage opportunity in NSS investment, the financial savings would have started falling immediately following the ban.

8.4 Credit Allocation

A well-diversified credit portfolio is one of the important features of efficient credit allocation by the banking system. It serves the following three purposes: (1) lowers the credit risk, as high concentration of credit in a few sectors of the economy makes the financial sector vulnerable to the performance of these sectors; (2) improves credit availability to important sectors of the economy; and (3) helps to increase the deepening of financial products, as banks have to innovate upon their financing products to cater to the needs of different sectors of the economy.

Traditionally, the commercial banks in Pakistan have focused on meeting the financing needs of the corporate sector in their normal course of business. However, during the preceding five years, the banking industry in Pakistan has phased in significant changes in terms of credit diversification, as reflected by the continuously falling Herfindahl concentration index of banks' credit portfolio (see **Figure 8.6**)[14]. This decline in concentration index is mainly attributed to the decline in the share of manufacturing sector in total bank credit; and increase in the shares of personal, commerce, services, transport and NBFI sectors (see **Figure 8.7**).

Figure 8.6: Sectoral Concentration of Credit

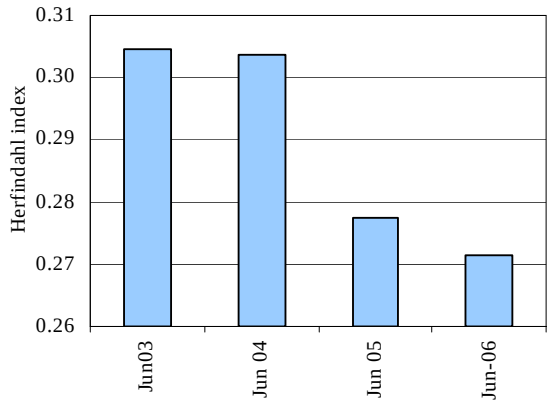
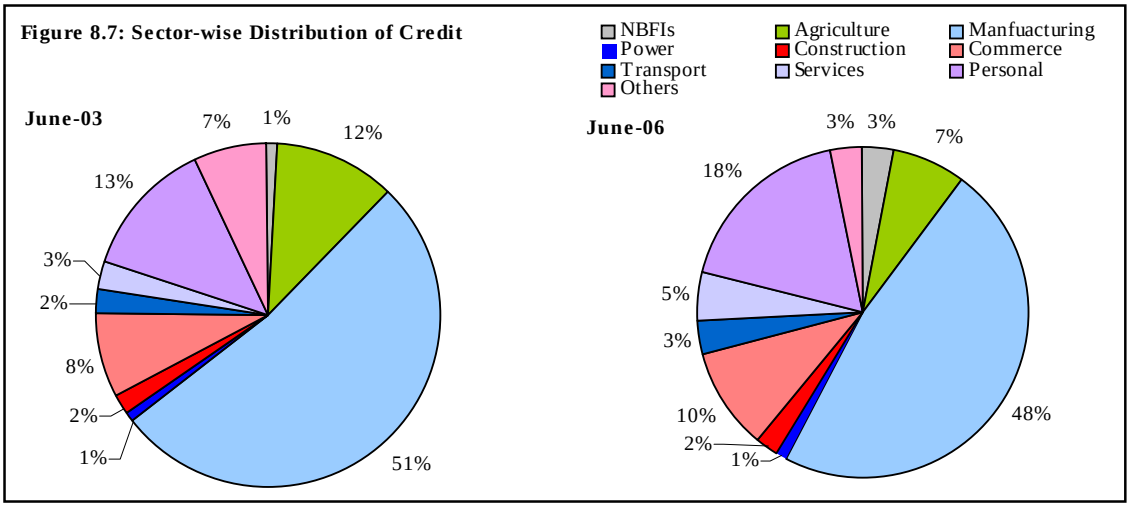


Figure 8.7: Sector-wise Distribution of Credit



The increased diversification of bank credit was largely an outcome of low interest rates and the availability of ample liquidity in the interbank market during most of the period that forced banks to

[14] Herfindahl Index, a measure of concentration, is obtained by summing the squared sectoral-share of banks' credit. Mathematically, it can be defined as

$H = \sum_{i}^{n} \alpha_i^2$; where α_i is the sectoral share of banks credit.

Decreases in the Herfindahl index generally that sectoral concentration of the banks' credit is declining, whereas increases imply the opposite.

diversify the clientele and product mix.[15] Further, in order to facilitate banks, SBP not only identified various sectors but also provided guidelines for their financing. As a result, banks introduced new financing modes focusing mainly on the financially underserved sectors of the economy including the consumer, small and medium enterprise and the agriculture sector. Moreover, with a surge in the overall economic activities, credit demand from the more traditional sectors has witnessed rapid growth, as well. All this led to a sharp rise in the bank credit and widened the clientele of the banking sector.

Specifically, the number of borrowers registered a significant growth in recent years in almost all the major sectors of the economy (see **Table 8.4**). Most of the increase in number of borrowers was registered in the consumer sector reaching at over 2.4 million households at end December 2005 from just 0.7 million at end December 2003. This was followed by the SME sector where more than 69,000 more enterprises entered the banking services clientele in the preceding two years.

Table 8.4: Sector- wise Number of Borrowers

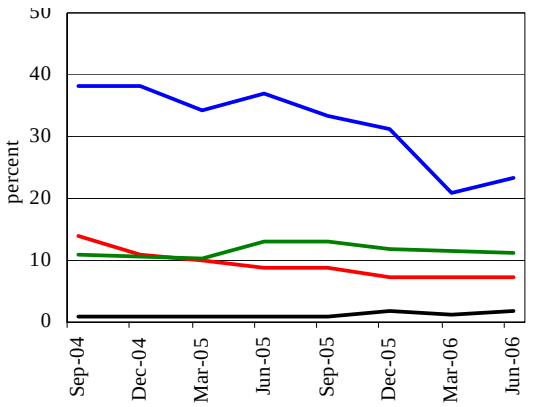
at end period (in thousands)

	CY03	CY04	CY05	Jun-06
Corporate sector	17.7	19.3	19.9	19.6
SMEs	91.7	106.2	161.3	158.0
Agriculture	1411.5	1503.8	1534.5	1535.1
Consumer finance	721.2	1619.2	2407.8	2476..4
Commodity finance	2.1	3.2	6.7	5.8
Staff loans	69.8	72.6	72.9	70.8
Others	63.7	73.7	44.1	42.6
Total	2377.7	3398.2	4247.3	4308.3

Source: Banking Supervision Department, SBP

Even more encouraging is the fact that the said improvement in allocative efficiency of the banks was not achieved at the cost of the asset quality of the banking industry. Specifically, despite the robust growth in credit to agriculture, SME and consumer sector, during the preceding three years; the credit quality has remained intact as the net NPLs to net advances ratio in most of the sectors has either declined or has remained unchanged (see **Figure 8.8**).[16]. Although the infection ratio in the agriculture sector is quite high at over 20 percent; it should be noted that this was mainly due to ZTBL's accumulated NPLs over the years. This view is supported by a much lower infection ratio of 7.1 percent of commercial banks in agriculture sector at end-June 2006.

Figure 8.8: NPLs to Loan Ratio (Sector-wise)



8.4.1 Consumer Finance

Prior to FY02, in Pakistan only a few foreign banks and a small number of privatized banks were providing consumer finance to a very limited clientele. The facility even remained confined to fully secured loans against tangible liquid securities. The main reason for this low interest of bank in consumer finance was the easy availability of alternative high-earning avenues, including investment in government securities. Moreover, with the mindset that consumer financing is a risky business, banks were charging very high interest rates that kept the demand at low level for consumer loans. However, 2002 onwards, the demand and supply of consumer finance increased significantly. While

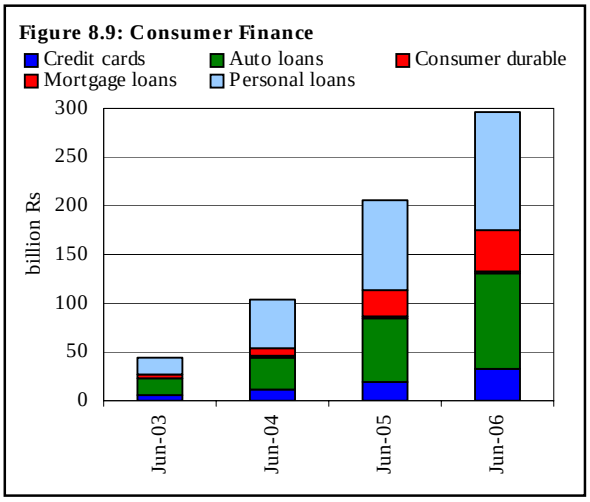
[15] While SBP was following easy monetary policy during FY02-FY04, improved fiscal balance and availability of funds from other sources reduced the government requirement for bank borrowings. As a result, the liquidity available in the interbank market was well in excess to meet the traditional bank credit demand.

[16] Although the ratio has increased slightly in the consumer finance but the magnitude is too small.

the former was driven mainly by the low interest rate environment; the latter was caused by increased liquidity with the banks and sharp fall in return on the traditional avenues. As a result, consumer financing has recorded a rapid growth during the last couple of years (see **Figure 8.9**).

At present, banks are providing consumer finance to their customers through credit cards, auto loans, housing finance, loans for consumer durables and personal loans. Of these, the most popular products are auto loans and the personal loans. For auto loans, banks are offering a variety of schemes. For instance, many banks have allowed their customers to choose among (1) fixed and flexible interest rates; (2) leasing and financing mode; (3) pay up (low installment earlier; large installments later) or pay down (large installments earlier; low installments later) approach of repayments, etc. Similarly, customers may decide upon which tenure they want to get loan for and the amount for down payment. Certainly all these flexibilities added up to the demand for auto loans and hence the demand for automobiles.

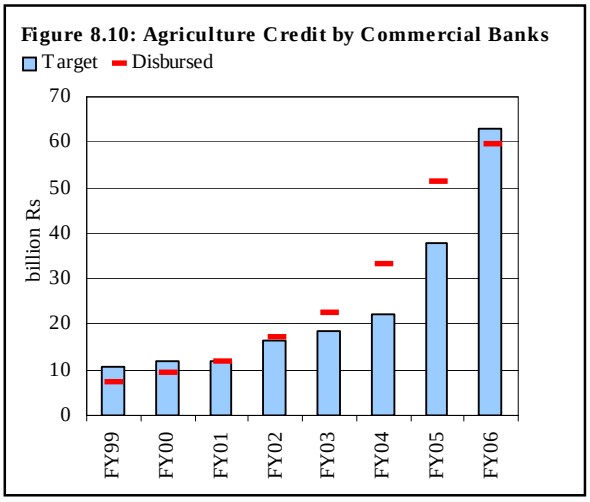
Figure 8.9: Consumer Finance



Likewise, personal loans are convenient from customer perspective for not being linked to any specific purpose and quick loan processing. In addition, compared with other consumer finance products, the monthly installments of personal loans are also smaller. As a result this facility is being availed by customers, in addition to other purposes, for paying off the installments of credit cards and auto loans.

Mortgage loans, though still constituting only 15 percent of the total consumer finance, have witnessed a tremendous growth of 139 percent (on average) in the preceding two years; mainly due to competitive rates and simplified eligibility criteria. Finally, the credit card business (that was earlier conducted by only two foreign banks) has also witnessed a robust growth of 63 percent on average during the preceding two years. This growth was caused mainly by (1) door to door marketing; (2) simplified eligibility criteria; and (3) offering of convenient repayment modes.

Figure 8.10: Agriculture Credit by Commercial Banks



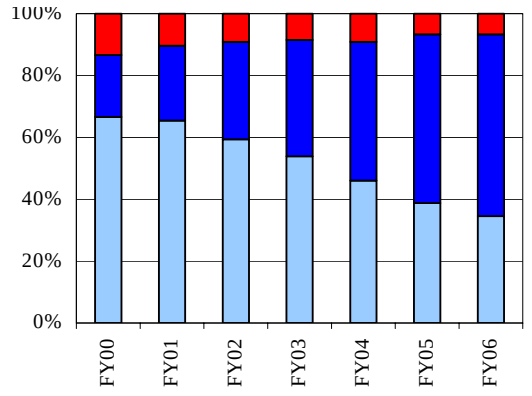
8.4.2 Agriculture Finance

Although commercial banks had entered the business of agriculture finance during 1973 when for the first time mandatory agriculture targets were set; it was only in the preceding five years that these banks have increased lending in this area with intent. In specific terms, commercial banks have kept away largely from agriculture finance prior to FY01, due to high risk associated with the sector in terms of uncertain repayment capacity of borrowers. Instead, banks were rather contended in getting penalized by the SBP for

not meeting the annual targets.

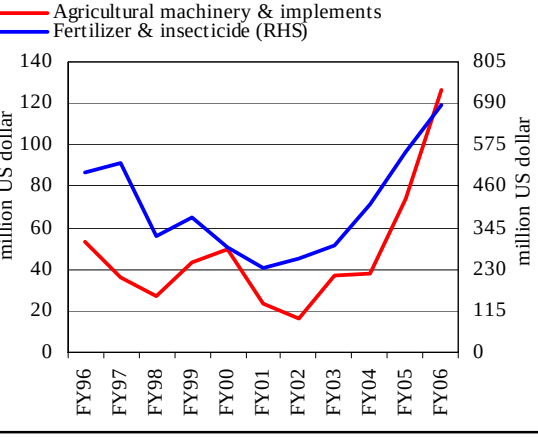
This trend changed drastically from FY01 onwards. Specifically, commercial banks have considerably increased agriculture lending in the preceding five years and have actually been lending more compared to their set targets mainly because of the excess liquidity at their disposal (see **Figure 8.10**). Interestingly, in addition to the big five commercial banks, other domestic private banks have also entered in the agriculture finance business and their share in outstanding agri-credit is increasing gradually. As a result, there appeared a visible shift in the institutional break-up of agriculture disbursements with commercial banks taking over the largest share (see **Figure 8.11**).

Figure 8.11: Institution-wise Break-up of Agri Finance



Within agriculture finance, both the farm and non-farm credit registered a significant growth in the preceding five years. While the latter was driven mainly by a tremendous increase in credit to livestock, dairy farming and the poultry sector; former was driven by both the growth in production as well as development loans. Specifically, major impetus to the farm loans came from the revolving credit scheme[17] which was redesigned to facilitate farmers with timely disbursements and one-time documentation. Additional support to the farm loans came from the developmental loans including mainly financing to purchase tractors.

Figure 8.12: Import of Agriculture Inputs



The impact of credit availability to agriculture sector is visible in the sharp increase in the import of agriculture inputs including machinery, implements, and chemicals like fertilizers and insecticides during the preceding five years (see **Figure 8.12**).

8.4.3 SME Finance

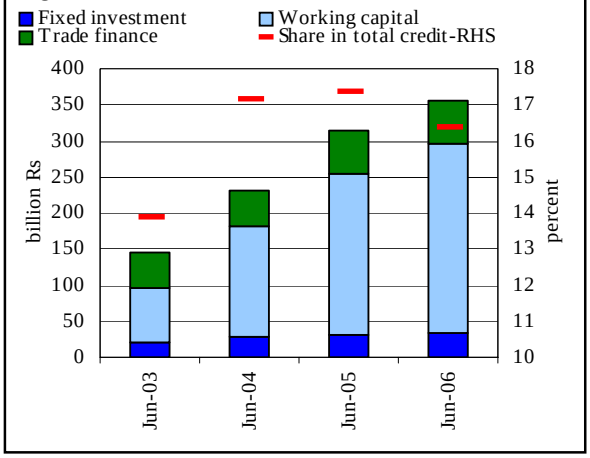
SME finance was another area where prior to FY01, banks have paid little attention. This was because of two reasons; (1) absence of book keeping practices due to which SMEs were not in a position to fulfill the documentation requirements for formal financing; (2) provision of inadequate collateral has also prevented banks from increasing their focus on SME finance. Realizing this, the SBP issued separate Prudential Regulations for SME finance whereby guiding all the banks to assess

[17] ACD circular No. 06 dated October 09, 2003. The scheme was introduced to facilitate farmers in availing timely credit by avoiding unnecessary documentation and bank visit. The Scheme offers automatic renewal and the added convenience of full repayment (principal and mark-up) by the borrowers once a year, at a time of their convenience.

the repayment capacity of borrower on the basis of asset conversion cycle and expected future cash flows instead of relying solely on collateral.[18]

In addition, with the increased emphasis on microfinance over the preceding four year, SME sector also got the main focus of the government as it is considered one of the most important factors for employment generation. Moreover, with the increased liquidity in the financial sector this sector received more focus from the banks. As a result, an increase can be observed in the overall credit to SME sector. As shown in **Figure 8.13**, not only the volume of SME finance has risen in the preceding four years, the share of SME finance in total credit has also increased.

Figure 8.13: Credit to SME Sector



8.4.4 Composition of Business Sector Loans

Within the business sector loans, as customary, the textile sector has remained the largest recipient of bank credit and registered 28.0 percent average growth rate during FY03-06. However, a large portion of this growth depicts the financing of BMR[19] activities in the sector. In addition to the textile sector, a number of other sectors contributed to a robust credit growth in the preceding three years including cement, food, chemicals, power, telecommunication sectors, etc.

Credit to the cement sector registered a robust growth of 70.6 percent on average mainly on the back of a sharp rise in construction related activities in the country during the period FY03-06. As a result, the share of credit to cement sector in total business sector credit more than doubled during the same period from 1.9 percent at end FY03 to 4.2 percent at end FY06. Other sectors that gained significantly from the construction activities in the country were paints and varnishes and basic metal industries. Further, the consistent performance of agriculture sector during FY03-06 has also increased the activities in chemical industries including fertilizer and pesticides sectors. Finally the opening up of new cellular companies in the country has resulted in a sharp growth in credit demand, especially for fixed investment purposes, from the telecommunication sector during the period.

Table 8.5 Sectoral Distribution of Outstanding Credit

in billion Rupees

	Jun 04	Jun 05	Jun-06	FY03-06 AAGR
Agriculture & fishing	111.4	132.4	136.2	11.2
Manufacturing	593.3	755.9	900.0	26.7
Power	10.1	15.4	18.9	39.6
Construction	18.3	31.4	42.3	40.7
Commerce	102.1	144.8	191.1	39.3
Transport	26.3	50.6	62.6	54.6
Services	44.9	71.2	94.9	57.2
Others	38.0	42.5	45.6	13.3
Total business sector	**944.4**	**1244.0**	**1491.5**	**28.1**
Shares in percent				
Agriculture & fishing	11.8	10.6	9.1	
Manufacturing	62.8	60.8	60.3	
Power	1.1	1.2	1.3	
Construction	1.9	2.5	2.8	
Commerce	10.8	11.6	12.8	
Transport	2.8	4.1	4.2	
Services	4.8	5.7	6.4	
Others	4.0	3.4	3.1	

To further diversify the banks' lending portfolio; the SBP has encouraged banks to

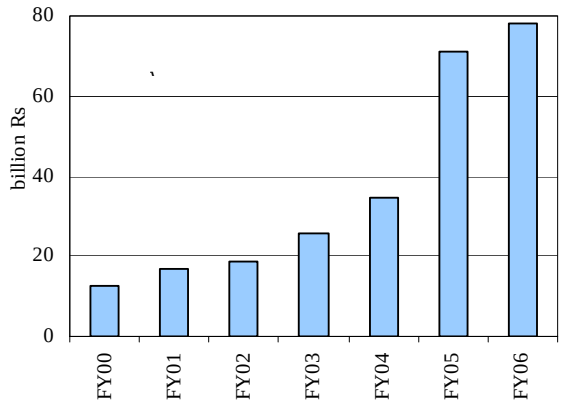
[18] Vide BPD Circuclar No. 35 of 2003 dated October 28, 2003.
[19] Balancing, modernizing and replacement activities.

provide finances to infrastructure projects in the country. In this regard, SBP has already issued detailed guidelines to facilitate private sector infrastructure projects and also to develop expertise among banks for financing such projects. [20]

Types of Financing

Though most of the bank credit continued to concentrate in the corporate sector; it is encouraging to see that the nature of financing has seen considerable changes during FY01-FY06. Specifically, while the working capital loans registered an average growth rate of 29.5 percent during FY03-FY06; the fixed investments loans also registered a tremendous growth of 26.5 percent in the same period and contributed significantly in the credit boom during FY03-06.

Figure 8.14: Financing of Fixed Industrial Investment



As shown in **Figure 8.14**, the disbursements for Fixed Industrial Investments (FII) increased tremendously from FY02 onwards especially in textile, cement, transport and electronics industries. While the FII in textile industry is reflective of the disbursements under the textile vision 2005 program; the financing under FII in other industries was attributed to the increase in the capacity utilization and the installed capacity in these sectors.

Similarly, during the period FY01-FY05, trade financing also saw visible changes. In particular, banks were allowed to utilize FE-25 deposits to finance trade activities in the country. The advantage of this scheme to the exporters/importers was the relatively low interest rates on dollar denominated loans compared with the Rupee loans. In addition, a new Rupee financing scheme was also introduced to finance the long-term export oriented projects in the country. Under this scheme, banks are encouraged to give preference to the SME sector by utilizing up to 50 percent of the available limit for meeting the financing needs of this sector.

8.5 Conclusion

During the last five years, Pakistan has seen a remarkable financial sector development as evident from the trends in widely used indicators of financial sector deepening and intermediation (M2 to GDP ratio, money multiplier, currency to deposits ratio, etc.). Conducive macroeconomic environment, surge in workers' remittances, increasing documentation of the economy and improved literacy rate and the improvement made by the financial sector in the various areas such as automation, outreach, product innovation, diversification of credit portfolio, etc have significantly contributed in the financial sector development.

As a result of financial sector development, not only financial saving as percent of national saving increased from the assets side but the credit concentration also declined from the liability side. The latter is a welcome development as it has widened the clientele of the banking sector not only in the traditional sectors but also in financially underserved sectors of the economy including the consumer, small and medium enterprise and the agriculture sector. Specifically, the number of borrowers

[20] See BPD Circular No. 23 dated July 23, 2005 on "Guidelines for Infrastructure Project Financing (IPF)" and http://www.sbp.org.pk/publications/gipf.pdf .

registered a significant growth in recent years in almost all the major sectors of the economy. Most of the increase in number of borrowers was registered in the consumer sector reaching at over 2.4 million households at end December 2005 from just 0.7 million at end December 2003. This was followed by the SME sector where more than 69000 additional enterprises entered the banking services clientele in the preceding two years. In this regard, SBP has played a vital role by identifying various untapped sectors and providing guidelines for their financing.

Despite the financial sector development and their positive impact on economic growth during the last five years, Pakistan is still well behind from peer countries in terms of financial deepening and intermediation. Therefore, there is a strong need to further increase the financial intermediation and depth in the country which requires sustained strong growth with low inflation; increasing documentation of the large undocumented sector; expanding outreach of formal financial sector; improving literacy; etc.