1 Pre-Reform Structure in 1990

At the beginning of 1990s, financial structure of Pakistan continued to reflect the policy initiatives taken in early 1970s that drastically enlarged the role of government in the process of deposit mobilization and credit allocation. Despite the opening of non-bank financial sector for private investment in mid 1980s, public sector financial institutions held the bulk of assets, deposits, advances and investments of the entire financial sector at the end of 1980s (see **Table 1.1**). Financial system was predominantly characterized by high government borrowing, bank-by-bank credit ceilings, interest rate controls, and directed and subsidized credit. Although the system was consciously put in place to promote economic and social goals, it was increasingly becoming evident that it largely worked to the contrary, and also proving as a hindrance to private sector initiatives.

Table 1.1: Structure of Financial Sector in 1990

shares in percent and amount in billion Rupees

	Numbers	Assets		Advances		Investment	
		Amount	Share	Amount	Share	Amount	Share
Banks	24	425.6	61.5	218.5	48.7	111.3	89.0
State-owned	7	392.3	56.7	201.2	44.8	104.1	83.2
Private	-	-	-	-	-	-	-
Foreign	17	33.4	4.8	17.3	3.9	7.3	5.8
NBFIs[1]	36	133.9	19.4	98.3	21.9	13.7	11.0
State-owned	13	124.3	18.0	94.7	21.1	13.3	10.6
Private	23	9.6	1.4	3.6	0.8	0.4	0.3
CDNS	1	131.9	19.1	131.9	29.4	-	-
Equity markets[2]	2	90.0	-	-	-	-	-
Total	**63**	**691.5**	**100.0**	**448.7**	**100.0**	**125.1**	**100.0**

[1] NBFIs also include four specialized banks and HBFC

[2] Market capitalization of KSE in lieu of assets; not added in total

1.1 Pre-Reform Financial Structure

The financial system consisted of commercial banks (including foreign banks) and non-bank financial institutions (including development finance institutions). At the apex, State Bank of Pakistan (SBP) was responsible for guiding and regulating the banking system of the country. However, there was substantial overlapping of regulatory functions, especially with Pakistan Banking Council (PBC) in matters relating to public sector banks and development finance institutions (DFIs), and with the Corporate Law Authority (CLA) for non-bank financial institutions (NBFIs). In 1990, the structure of financial system, especially of domestic banks and DFIs, was very close to the one that emerged following nationalization in 1974.[1] Since assets and deposits of the banking system were highly skewed towards nationalized commercial banks (NCBs) and DFIs, entry of foreign banks and domestic private NBFIs did not result in any significant structural change.

1.1.1 Banks

A total of 24 commercial banks (7 domestic and 17 foreign) were doing business in Pakistan as on 30th June 1990 (see **Table 1.2**).[2] Domestic banks, with absolute public sector ownership and a broad branch network, were catering to major commercial banking needs of the economy. This explains their very large share (around 90 percent) in total assets and total deposits of the banking sector.

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[1] During this period, only two domestic banks were established in the public sector.

[2] Six Indian banks (vested in custody of India since September 1965) are not included.

Foreign banks, on the other hand, were holding only 7.8 percent of total assets, and 7.0 percent of the total deposit base. Their activities were generally related to foreign trade. In addition, with restrictions on number of branches that foreign banks could open, their business was concentrated in large cities. However, the pattern of banking activities of the two groups was very similar as both had about 50 percent of their assets in the form of advances, and around one-fourth in investment.

Table 1.2: Structure of Banks in 1990
shares in percent

	Number of		Assets	Advances	Investment
	Banks	Branches			
State-owned	7	7,043	92.2	92.1	93.5
Private	0	0	-	-	-
Foreign	17	45	7.8	7.9	6.5
Total	**24**	**7,088**	**100.0**	**100.0**	**100.0**

1.1.2 Non-bank Financial Institutions (NBFIs)

Since the establishment of one of the largest DFIs in early 1970s,[3] before nationalization of banks, NBFIs grew more rapidly up to 1980s at the expense of banks, primarily due to the emphasis of government policy for promoting industrial development through long-term financing. Although the business activities of NBFIs varied widely across each category; like banks, their structure was also heavily dominated by the public sector (see **Table 1.3**).[4] More specifically, DFIs, housing finance companies, and mutual funds, which were in the public sector, constituted a large part of NBFIs. However, in terms of number of institutions, these were only 15 out of 36 (see **Table 1.4**). Similarly, the breakup of assets and advances in terms of each category of NBFIs reveals that these three categories control over 90 percent of the business.

Table 1.3: Structure of NBFIs in 1990
shares in percent

	Assets	Advances	Investment
State-owned	92.8	96.3	97.4
Private	7.2	3.7	2.6

Table 1.4: Non-Bank Financial Institutions in 1990
shares in percent

	Number	Assets	Advances
Development finance institutions[1]	12	78.6	80.4
Investment banks	5	1.8	1.7
Leasing companies	5	4.7	1.9
Modaraba companies	10	n.a.	n.a.
Housing finance companies	1	12.3	14.8
Mutual funds	2	1.9	1.1
Discount houses	1	0.7	0.0
Total	**36**	**100.0**	**100.0**
Amount (billion Rs)	**-**	**133.9**	**98.3**

[1] DFIs also include four specialized banks.

1.1.3 Central Directorate of National Savings (CDNS)

Also known as National Savings Organization, CDNS is an attached department of the Ministry of Finance. This organization is engaged in the operations of various National Savings Schemes (NSS) and had mobilized Rs 131.9 billion till 30th June 1990. CDNS had a network of 363 National Saving Centers as on 30th June 1991. Operations were executed by these centres across the country, directed by a head office and supported by several regional offices. Furthermore, some NCBs and Pakistan Post Offices also worked as its operating agents.

1.2 Supervisory Authorities

In 1990, there were three supervisory/regulatory bodies: (1) SBP, dispensing its functions under the SBP Act, 1956; (2) Pakistan Banking Council (PBC), monitoring the performance of nationalized commercial banks under the Banks (Nationalization) Act, 1974; and (3) Corporate Law Authority (CLA), regulating the equity market under Securities and Exchange Ordinance, 1969.

[3] National Development Finance Corporation (NDFC) was established in 1973.
[4] For details on business activities of each category of NBFIs, see **Annex 4.1**.

1.2.1 State Bank of Pakistan

Conduct of Monetary Policy

SBP was conducting monetary policy with the instruments of direct control. More specifically, the cash reserve requirement (CRR) as prescribed under the SBP Act, required every bank to maintain at least 5 percent of demand and time liabilities in cash with SBP. On the other hand, the statutory liquidity requirement (SLR) was prescribed under the Banking Companies Ordinance and fixed by the federal government. Accordingly, banks were required to maintain 35 percent of time and demand liabilities in cash or government securities. The bank rate was set at 10 percent since 1977.[5] However, bank-wise credit ceilings were used as active instrument of monetary control. This system was established after adoption of credit planning through the National Credit Consultative Council (NCCC), set up in SBP in 1972. Under this system, credit ceilings were allocated to banks depending upon their share in total deposits during previous year, size of the capital fund, foreign currency deposits and previous year's utilization of credit ceiling. In addition, SBP was also administering a number of directed credit schemes with subsidized financing.[6]

Exchange Rate Management

SBP was also pursuing the exchange rate policy under the provisions of Foreign Exchange Regulation Act, 1947. The exchange arrangement, introduced in January 1982, was characterized as managed floating. Frequent, but small adjustments continued to be made in Rupee/Dollar parity by the Foreign Exchange Rate Committee of the SBP under the chairmanship of the Governor.

With a view to regulate all dealings and debt instruments in the foreign exchange market, SBP set limits on open exchange position and balances of individual Authorized Dealers (ADs) over and above their daily operational requirements.[7] ADs were required to maintain square or near square exchange positions and keep their ready balances to the minimum in line with the operational requirements. In addition, SBP was providing forward exchange cover in respect of private foreign currency loans and suppliers' credit.

Banking Supervision

SBP was carrying out off-site surveillance of banks by requiring them to submit various returns, besides undertaking regular on-site inspections. However, the effectiveness of supervision had deteriorated over the years, largely due to the presence of Pakistan Banking Council (PBC), which was also empowered to carryout inspections of nationalized commercial banks. As a result, enforcement of regulations declined considerably for NCBs, largely due to the directives of government being passed on to these banks through PBC for compliance. Lack of empowerment and clear demarcation of roles in supervision of nationalized commercial banks resulted in gradual decline in quality of SBP supervision.

1.2.2 Pakistan Banking Council

Pakistan Banking Council (PBC) was formed under the Banks (Nationalization) Act, 1974 to perform various functions in line with the objectives of nationalization, i.e. "… to provide for directing banking activities towards national socio-economic objectives, co-ordinating banking policy and co-operation in various areas of feasible joint activity without eliminating healthy competition in various fields of operation, and ensuring complete security of depositors' funds…".[8]

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[5] The bank rate was the rate at which SBP could buy or rediscount bills of exchange or other eligible commercial papers. On 7th June 1977, this was increased to 10.0 percent from 9.0 percent (set on 3rd September 1974).

[6] For export sector, SBP was providing refinance to banks at 3.0 percent; for agriculture sector, refinance to the Federal Bank for Cooperatives at 0.5 percent and to Agricultural Development Bank of Pakistan at 6.0 percent; and for local industry, refinance for locally manufactured machinery at rates ranging from 3.0 to 4.5 percent.

[7] Open exchange position at any given time is the extent to which an AD has bought or sold foreign exchange on its own account without covering contracts with its constituent, the SBP, or other ADs.

[8] Source: Para (ii) of preface of Banks (Nationalization) Act, 1974.

PBC operated as a holding company and caused considerable distortion in the supervisory role of SBP, largely because of a wide nature of functions prescribed for PBC under the Banks (Nationalization) Act. In particular, the Act prescribed 21 specific functions broadly falling in six areas, some of which were exactly identical with the functions of a central bank. For example, PBC had authority to lay down performance criteria and formulate performance targets for banks, to monitor banks' progress in terms of profitability and efficiency, and carry out their inspection. Furthermore, it was also empowered to act as an arbitrator in inter-bank dispute settlements. It was also assigned the task of developing modernization schemes for nationalized banks, framing recruitment policy for bank officers and undertaking their pre-service and in-service training.

1.2.3 Corporate Law Authority (CLA)

The supervisory responsibility for capital market was vested in Corporate Law Authority (CLA), established in 1948 and working under the Ministry of Finance (MOF) with its headquarter in Islamabad and offices throughout the country. The main responsibilities of CLA under the Securities and Exchange Ordinance, 1969 were: (1) to grant registration to stock exchanges and ensure maintenance of their accounts as well as submission of annual reports; (2) listing of securities, ensuring annual general meetings by listed firms, and timely circulation of their half-yearly accounts, free transferability of shares, and dividend payment within 45 days of the declaration; (3) to ensure balloting of new issue applications within ten days of subscription and refunding to unsuccessful applicants within ten days of the ballot; (4) to ensure the issue of share certificates of new companies within thirty days of allotment; (5) to prescribe qualification requirements for the members of the stock exchange; and (6) to prescribe manner of transaction of stock brokers and ensure maintenance of their proper books of account. However, the CLA delegated much of its authority to the Stock Exchange Boards, which were largely self-regulated.

The capital market also had other regulators: the Controller of Capital Issues (CCI) and the Monopoly Control Authority (MCA). The Controller of Capital Issues was established in 1947 through Act No. XXIX that required companies to obtain prior approval from CCI for the issuance of securities. The Monopoly Control Authority was established in 1970 to check undue concentration of economic power. It had the authority to make recommendation to government to prevent or eliminate undesirable monopoly power or unreasonably restrictive trade practices.

1.3 Financial Markets

1.3.1 Money Market

The money market consisted of a primary market for treasury bills (tap) and government treasury deposit receipts (GTDRs), call money market, and a market for sale and purchase of unutilized portion of credit ceilings. Secondary market for treasury bills and GTDRs did not exist because of presence of discount window in SBP, which allowed early discharge of these bills.

Primary Market for Short-term Government Debt

The instruments traded in this market included: (1) three-month treasury bills sold to the banks at a fixed yield of 6.0 percent; and (2) GTDRs sold to non-banks at fixed return of 7.8 percent, 8.5 percent and 9.0 percent for maturity of 3, 6 and 12 months respectively.[9] Segmentation in the short-term government debt market was maintained by disallowing banks to purchase GTDRs. Market activity in these instruments consisted of almost continuous issues through the tap counter, discharge on maturity and rediscounting before maturity from the discount window. The former resulted in draining bank's liquidity, whereas the latter two activities provided continuous cash accommodation to banks.

[9] Outstanding amount of T-bills (tap) and GTDRs was Rs 58.7 and 16.1 billion respectively, as on end June 1990.

Call Money Market

With a view to maintain daily cash balances for clearing purpose and meeting the cash reserve requirement of SBP, all scheduled banks were allowed to lend and borrow overnight in the interbank money market.[10] All transactions were settled through cheques, which were ultimately recorded in respective banks' current account with SBP on the date of transaction.

Credit Ceiling Market

Bank-wise credit ceilings were set by SBP to achieve the global credit target fixed in the credit plan. Since it was almost impossible to achieve the exact target for each bank, they were allowed to trade in the unutilized portion of their ceilings. This enabled banks to avoid penalty due to over extension of credit, besides helping SBP to achieve credit plan targets. Similar to the call money activity, trading in credit ceilings did not involve any collateral. The rate was determined on the basis of market forces but tied to the call money rate.

1.3.2 Capital Market

The capital market, at the beginning of 1990s, consisted of market for equities (with three stock exchanges), term-loans, corporate debt, and mutual funds (with two mutual fund management companies). DFIs were dominant players in term-loan market, whereas the other NBFIs and commercial banks were providing market support for corporate debt issues, which were mostly issued by public sector enterprises.

The capital market at that time was not adequately supplementing the intermediary role of banking system as its activities were effectively confined to the Karachi Stock Exchange.[11] In addition, market for term-loans consisted of project financing at subsidized rates through DFIs, and as such was not a proper part of the capital market. In terms of corporate debt market, although some issues by public sector enterprises were outstanding, these were held mostly by banks and DFIs. Overall, participation of non-bank sector was not only very thin, but also confined to a few shares listed at KSE. The major reasons for companies not going public was the lack of proper investment advisory skills, weak underwriting capacity in the financial system, and poor distribution capacity of the stock market intermediaries.

Equity Market

In 1990, there were only two stock exchanges in Pakistan, one in Karachi and the other in Lahore.[12] Karachi Stock Exchange (KSE) was larger with more listed companies. During 1980s, KSE made some progress in terms of listed companies (see **Table 1.5**). However, this progress could not be considered significant, as only 150 companies were listed during the decade. This highlights certain structural issues that constrained the market progress. For example, foreign nationals were not allowed to make investment without prior approval from government and were also barred from owning 100 percent shares of a company. Moreover, restrictions on foreign exchange movement in and out of the country kept the foreign investors away from Pakistani markets.

On the supervisory front, though CLA was the primary regulator, its control over capital market was compromised due to lack of autonomy and overlapping of some functions with Monopoly Control Authority and Controller of Capital Issue. In addition, inadequate professional capacity restricted these agencies to exercise their supervisory functions effectively. On the other side, stock exchanges lacked proper infrastructure for trading and settlement. In particular, trading was carried out through

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[10] Average call rate during FY90 was 6.7 percent per annum and money at call and short notice stood at Rs 10.0 billion (end June 1990).
[11] Market capitalization in terms of GDP remained very low at 6.4 percent in FY90.
[12] Islamabad Stock Exchange started functioning in 1992.

open outcry system. Due to lack of automation, turnover remained very low, and in the absence of a depository company, investors had to take physical delivery of shares.

Table 1.5: Profile of KSE

	Listed companies at KSE	Market capitalization (billion Rs)	Turnover of shares (million)	SBP general index[1]
FY80	312	6.7	36.6	129.8
FY81	311	6.6	29.4	128.5
FY82	326	9.4	36.5	100.3
FY83	328	13.3	67.7	131.6
FY84	347	19.7	88.9	182.4
FY85	362	22.0	84.2	176.3
FY86	360	24.4	175.2	171.0
FY87	378	31.6	147.0	222.7
FY88	385	38.2	175.2	260.6
FY89	416	43.9	172.7	273.2
FY90	462	48.6	236.4	283.5

[1] Base 1980-81=100

Almost all financial institutions in Pakistan were involved in the securities business. Nationalized Commercial Banks (NCB), Investment Corporation of Pakistan (ICP), National Investment Trust (NIT), newly created investment banks, and Development Finance Institutions (DFIs) were among the major players active in the underwriting business. Despite the active participation of these institutions, the equity market in Pakistan remained small. Since the corporate sector was relying more on DFIs for their financing needs, this did not allow equity market to develop significantly. This was a policy-induced outcome as most of the DFIs were in the public sector and were providing long-term finance at concessionary rates.

The activity in the capital market was further restricted due to liquidity constraints, narrow trading base, and limited use of technology. This limited the number of listed companies and their market capitalization. Consequently, the market was characterized by the limited equity of established, reputed and well-managed companies. Closely held companies were unwilling to go public for a variety of reasons. First, cost of equity was significantly higher than the debt as dividends were paid out of after-tax profits while interest on loans, invariably subsidized, was tax deductible. Also sponsors were generally able to finance projects with very low equity share. Second, fearing consequent dilution of shareholding and loss of control, family controlled companies were reluctant to go public and enlarge their capital base. Finally, listing involved obligation to disclose information, which these companies preferred to avoid.

Market for Term Loans

Term financing by NBFIs remained a significant part (mainly due to its concessionary price) of overall capital market activity. Data for selected DFIs show that during FY90 these DFIs approved an amount of Rs 18.3 billion, of which Rs 5.2 billion was actually disbursed (see **Table 1.6**). In view of the size of the equity market, this represented a significant amount.

Table 1.6: Sanctions and Disbursements by Selected DFIs in FY90

million Rupees

	Outstanding deposits	Sanctions	Disbursements
NDFC	12,422	5,123	2,272
RDFC	128	459	239
BEL	1,771	4,152	1,462
PICIC	1,191	8,591	1,239
Total	**15,512**	**18,325**	**5,212**

Corporate Debt Market

During 1960s and early 1970s, corporate debentures issued by Pakistani companies were not only listed on stock exchanges, there was even a secondary market for these instruments. However, following nationalization in 1972, this activity came to a standstill. In 1984, traditional debt instruments were substituted with TFCs (Term Finance Certificates) to make it conform to the principles of Islamic Sharia. However, till 1990, only major state-owned corporations like Water and Power Development Authority (WAPDA) issued TFCs, while private sector companies did not issue any TFC during this period.

Mutual Funds

National Investment Trust (NIT)

This institution was established in 1962 to cater the needs of small investors by promising them fixed returns in the equity market. This is a management company, with National Bank of Pakistan acting as a trustee. During FY90, net sale of NIT units stood at Rs 2,371million showing a rise of 74 percent over the previous year (see **Table 1.7**). Being a government-controlled company, NIT enjoyed some preferential treatments, like quota allocation in all new offerings. This meant that a portion of every new issue was offered to the trust before being made public. Although the trust had a right to refuse such offerings; once bought, it was required to hold these shares for at least two years. During FY90, an amount of Rs 328 million was offered to NIT by 46 new offerings, of which NIT opted to subscribe equity of 42 companies worth Rs 291 million. NIT had also attracted savings in the form of participation in open-ended mutual funds.

Table 1.7: Net Sales of NIT Units

	million Rs	percent change
FY88	1,036	-
FY89	1,362	31
FY90	2,371	74

Investment Corporation of Pakistan (ICP)

The ICP was established in 1966 in public sector to develop and broaden the capital market. Since its inception, management of the company primarily focused on this mission. This undertaking clearly implied that priority should be given to national economic development. As a result, the focal point of ICP had been the broad market achievements, such as number of new companies listed, number of new projects financed, and aggregate new funds raised for investment in capital market. The key functions of ICP, among others, were to:

- act as underwriter of securities;
- act as a broker and investment counselor;
- manage investment portfolios; and,
- act as a trustee for ICP mutual funds.

For this purpose, ICP established a series of closed-end mutual funds for both institutional and individual investors (see **Table 1.8**). The closed structure of these funds did not permit investors to withdraw, and thus protected ICP during years of disappointing markets activity. During FY90, ICP approved Rs 580 million for different purposes; a bulk of this amount, i.e., Rs 339.1 million was committed for underwriting of shares. Disbursements during the same year stood at Rs 150 million, of which a major chunk was allocated for the take-up of Participation Term Certificates (PTCs).[13]

Table 1.8: ICP Mutual Funds

million Rupees

	Year listed	Paid up capital
1st	1967	5
2nd	1968	15
3rd	1969	20
4th	1970	15
5th	1972	5
6th	1973	10
7th	1975	10
8th	1976	10
9th	1976	10
10th	1977	10
11th	1978	10
12th	1979	10
13th	1982	10
14th	1983	10
15th	1985	10
16th	1986	10
17th	1988	20
18th	1989	50
19th	1990	50

1.3.3 Foreign Exchange Market

Foreign exchange market was heavily regulated by SBP through a system of exchange controls. All commercial banks were authorized dealers (ADs) and one of them was selected to work out the appropriate cross rates for major currencies by using the rate given by SBP and the rates closing the previous evening at the New York market. These rates were immediately sent out to other ADs.

Being the central bank, SBP had the responsibility of formulating exchange rate policy and conducting daily management of exchange regime. This was entrusted under provisions of the Foreign Exchange Regulation Act, 1947. This Act also required that all transactions in foreign

[13] PTCs were introduced in 1980 to replace debentures for providing medium and long-term rupee finance. The holders of PTCs participate, as a rule, in profit or losses of the company in each financial year.

exchange should be effected at rates authorized by SBP. Since the US Dollar remained the intervention currency, SBP set the Rupee rate at which it would purchase and sell US Dollar in its dealings with authorized dealers (ADs).[14] Furthermore, ADs rates (buying & selling) for public were set at 0.1 percent margin with respect to SBP's buying and selling rates. All foreign exchange transactions by customers were conducted through ADs and authorized money changers (AMCs) at SBP's prescribed rates, whereas inter-bank transactions were taking place at rates varying within the range determined by SBP buying and selling spread.

In the forward market, SBP was not only assuming the responsibility of buying and selling US dollar from/to ADs in forward up to 12 months against their transaction with customers, but also regulating the forward premium charged by ADs. Furthermore, it was providing forward exchange cover in respect of private foreign currency loans, suppliers' credit and repatriable foreign currency loans for working capital requirements. In order to regulate sale and purchase of foreign exchange by ADs, the SBP prescribed limits on open exchange position and balances of individual ADs, after taking into account their daily operational requirements. The SBP maintained its own foreign currency reserves with the corresponding central banks and also maintained the foreign reserve deposits of its ADs.

In terms of market participants, exporters, remitters and tourists were main suppliers of foreign exchange, whereas importers and government sector organizations were major users. To manage the transactions between suppliers and users of foreign exchange, a system of ADs and AMCs was in place.[15]

1.4 Financial Repression

Complete nationalization of all domestic banks in January 1974 significantly altered the financial landscape of the country. The objectives of nationalization were to direct banking activities towards national socio-economic objectives and ensure complete security of depositors' funds. It is worth mentioning that monetary policy mechanism of SBP had already been changed a couple of years before nationalization through adoption of direct monetary controls and establishment of National Credit Consultative Council (NCCC). The new system was designed to limit the quantity of credit the banking system could extend to the private sector, while ensuring the flow of credit to government and priority sectors. Though the system was supposed to promote economic development and growth, it had its own repercussions, which are discussed in the following sections.

1.4.1 High Government Borrowing

Over the years, the deteriorating budgetary discipline had resulted into high domestic borrowings by the government (see **Table 1.9**).[16] The resulting domestic debt structure, which was characterized by presence of short and long-term government securities with administratively set yield structure, had been an important source of financial repression. In overall terms, the domestic debt was classified into permanent, floating and unfunded categories. The permanent debt consisted of government bonds (held by banks and financial institutions), and bearer instruments (held by individuals or corporate bodies), the floating debt comprised of three-month treasury bills sold to banks through tap system and adhoc treasury bills

Table 1.9: Fiscal Deficit and Financing (average 1984-90)

Overall fiscal deficit (as percent of GDP)	7.5
Financing (percent share in total)	
External borrowing	23.9
Bank borrowing	21.7
Non-bank borrowing	54.4

[14] The spread between buying and selling rate was equal to Rs 0.0156 per U.S. Dollar up to April 24, 1987, afterwards it was changed to 0.5 percent of the spot buying rate.
[15] For details on foreign exchange market participants, see **Annex 1.3**.
[16] In view of narrow tax base, lack of expertise in tax administration and expenditure controls, and limited foreign loans, the government had relied heavily on domestic borrowings that were a much easier source of funding expenditures.

purchased by SBP. Unfunded debt, on the other hand, consisted of various certificates and schemes of CDNS with very high rates of return and various tax incentives and exemptions.[17]

In terms of non-bank financing, the National Savings Schemes (NSS) had been the major source of funding as its average share in the total increased from about 12 percent in the second half of 1970s to 67 percent in the second half of 1980s. With a view to attract sufficient resources, the rate of return on Khas Deposits Certificates (KDCs) was increased to 15 percent on three-year maturity period, while the Government Treasury Deposit Receipts (GTDRs) were offering a maximum of 9 percent. Interestingly, the banking sector was not allowed to invest in both of these instruments.

As for the bank borrowing, the commercial banks were required to hold, as statutory liquidity requirement (SLR), 30 percent of their deposits in the form of government securities. Banks mainly held treasury bills, which were offering 6 percent rate of return that was also taxable. After tax, the return was only 2.1 percent compared to return on KDC of 15 percent for three-year maturity period. This 'on tap' availability of treasury bills meant that banks would require more securities with the increase in their deposits. In addition, the government also borrowed from SBP by selling adhoc treasury bills at 0.5 percent per annum, which was the most inflationary financing and termed as the monetization of government debt.

This composition of domestic borrowing adversely affected the banking system and the monetary control mechanism. Firstly, this led to low returns on banks portfolio. More specifically, although, commercial banks were obliged to accept all deposits, their lending operations were restricted in view of ceilings and subsidized credit to certain priority sectors. Furthermore, at least 30 percent of the deposit base had to be maintained in low yielding government securities as SLR, as stated earlier. This was in addition to a minimum of 5 percent CRR to be deposited in non-interest bearing accounts with SBP. In sum, these regulations led to low returns on assets portfolio, while a certain proportion of unutilized funds did not earn any return.

Secondly, this led to dis-intermediation in the banking system. While, NSS were offering a variety of tax incentives and relatively high returns (up to 15 percent per annum tax-free) at zero-risk to the end-investors, the financial institutions were providing 7 to 9 percent per annum on time deposits. Consequently, NSS was able to attract a large amount of funds away from the financial institutions. As a result, not only banks' share in financial savings declined, but also SBP's role as a monetary authority was weakened. The high currency/M_2 and M_1/M_2 ratios and declining M_2/M_3 ratio indicated increasing cash flows out of the banking system (see **Table 1.10**). Moreover, high currency to total deposit ratio implies the growing size of parallel economy.

Thirdly, the market segmentation (banks vis-à-vis non-bank) and resulting dispersion in interest rate structure, added to inefficiency of banking system as evident from high M_1/M_2 and M_3 to GDP ratios, suggesting the inability of banks to stimulate long-term savings. The ratio of M_2 with GDP had also been declining since 1986-87, suggesting that the financial sector was loosing its attractiveness for depositors (see **Table 1.10**).

1.4.2 Credit Controls

The absolute credit ceilings, which were widely used as a direct tool for controlling monetary expansion, also led to distortions in the financial sector. More specifically, since ceiling of individual bank was determined mainly on the basis of outstanding stock of deposits, it placed undue emphasis on historic market shares instead of bank's success in attracting new deposits. This, in turn, was impeding competition among banks for deposit mobilization.

[17] The average return on DSCs during 1980s was 15.6 percent against 7.1 percent on bank deposits.

Table 1.10: Selected Indicators of Financial Sector

	Currency/ total deposits	Time deposits/total deposits	Currency/M_2	M_1/M_2	M_2/M_3	Time deposits/ GDP	M_2/GDP	M_3/GDP
FY81	50.1	44.8	33.2	70.3	89.6	11.2	37.6	42.0
FY82	48.1	45.5	32.3	69.5	87.0	11.0	35.9	41.3
FY83	45.9	49.6	31.3	66.1	82.7	13.6	40.1	48.5
FY84	47.1	54.1	31.9	63.4	78.9	14.3	38.9	49.3
FY85	44.5	51.2	30.7	64.7	77.0	13.8	38.9	50.6
FY86	43.1	51.9	30.0	63.9	76.0	14.8	41.0	54.0
FY87	45.5	49.0	31.1	66.5	72.5	14.0	41.9	57.8
FY88	48.6	46.8	32.6	68.7	68.6	12.5	39.9	58.1
FY89	51.4	44.3	33.6	71.0	67.3	10.9	37.7	56.1
FY90	51.4	45.1	33.7	70.4	67.7	11.8	39.9	58.9

Note: M_3 series has been taken from Pakistan's Economic Survey for FY91.

The system of credit ceiling was also repercussive as the magnitude of credit flows to the private sector was determined only after accommodating public sector credit requirements. Hence, it was only the private sector that came under the ceiling. In addition, the ceiling also tended to accommodate established borrowers even if they were simply meant to rollover their loans, as banks were generally not willing to incur the cost of screening and evaluating new projects.

With these ceilings in place, the practice of accruing interest on infected loans by banks was very damaging. Since the unrealized income was liable to taxation, it reduced banks' ability to augment their capital base and to extend new loans.[18] At the same time, these ceilings also had an in-built incentive to evade. For example, with a view to avoid ceiling, a bank could arrange a loan from any NBFI against its guarantee. Hence, bank would book loans off-balance sheet by acting as a loan arranger for a fee, with the actual transaction being recorded on books of NBFI.

1.4.3 Sectoral Credit Allocation

The higher share of directed credit programs resulted in investments with low rates of return, which subsequently burdened banks with large non-performing loans.[19] The effectiveness of such programs was also questionable on the ground that it was difficult to ensure that the credit was being used by actual intended beneficiaries.

Over the years, concessional credit schemes have led to excessive monetary expansion, which in turn contributed to rising level of financial repression. Mandatory credit targets at concessional rates distorted the interest rate structure, thus widening the market segmentation. Moreover, profitability of the banking sector was also wiped out, to which the banks responded by pushing up their rates on other lending while keeping deposit rates down.

1.4.4 Administered Interest Rates

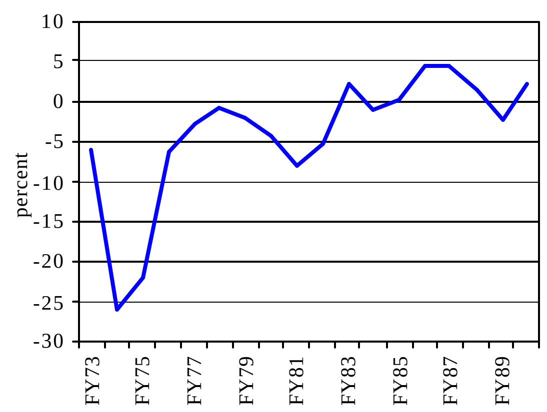
The interest rate restrictions were in the form of floors on deposit rates and ceilings on lending rates of commercial banks. These controls were motivated by a desire to provide low cost funds to encourage investment, particularly for priority sectors, and to safeguard against their increase as it was deemed politically or socially undesirable. Hence, the real interest rate on deposits remained virtually negative for most of the time, thereby discouraging savings and leading to financial dis-intermediation (see **Figure 1.1**).

[18] Bank's capital base was one of the determinants of credit ceiling.
[19] The share of directed credit is provided in **Table 6.6**. This partly explains the larger share of state owned banks in total NPLs (see **Table 3.2**).

1.4.5 Implicit Risk Insurance

In some cases, like mandatory targets, credit risks were taken over by the government; liquidity risks were limited, as banks were allowed to discount excess treasury bills with SBP on daily basis; interest rate risks were negligible due to administered interest rates; and foreign exchange risk cover were provided by the government. In addition, government provided explicit guarantee to all depositors of NCBs and DFIs. This broad assurance reflected the desire to protect depositors and to maintain confidence in the stability of the financial system. However, such policies weakened market signals and stimulated risky investments (both by depositors and banks) without adequate checks and compensation.

Figure 1.1: Real Return on Deposits



1.4.6 Other Factors

The limited competition due to entry restrictions on new institutions and restrained activities of foreign banks, hampered the development of the financial system. Moreover, dominance of the public sector enabled successive governments to seek political power by distributing rents through banking system. The resulting inefficiencies of the system, required authorities to further tighten controls to achieve policy results, thereby creating a vicious circle of growing checks that became increasingly less effective.

In addition, underdeveloped money and capital markets limited the role of financial sector in terms of intermediating funds between borrowers and savers: firms and individuals were meeting their long-term financing needs from informal sector. Also, the absence of secondary market for government papers led to limited number of money market instruments, thus curtailing SBP's capacity to conduct short-term monetary operations.