

## Special Section 1: Why Credit-to-GDP Ratio is Falling in Pakistan? A Comparison with Regional Economies

Role of private sector credit in promoting investment and economic activity can hardly be over-emphasized in a developing country like Pakistan.<sup>1</sup> As in a bank-dominated financial sector, commercial banks are a major source of funding for private sector businesses; bank-credit-to-GDP ratio therefore becomes one of the key indicators that appropriately captures the significance of credit in economic activities.<sup>2</sup>

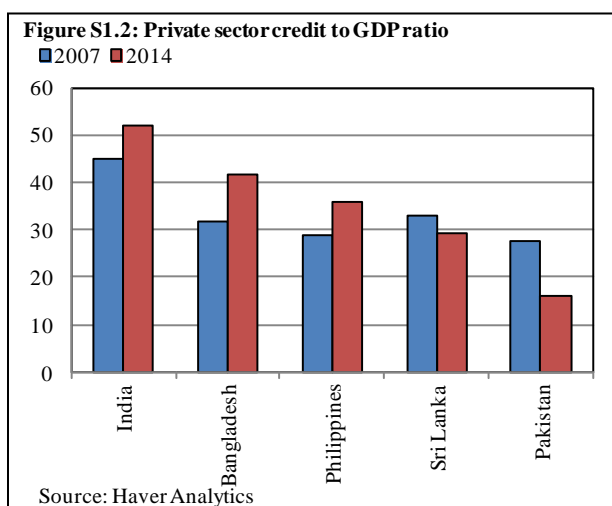
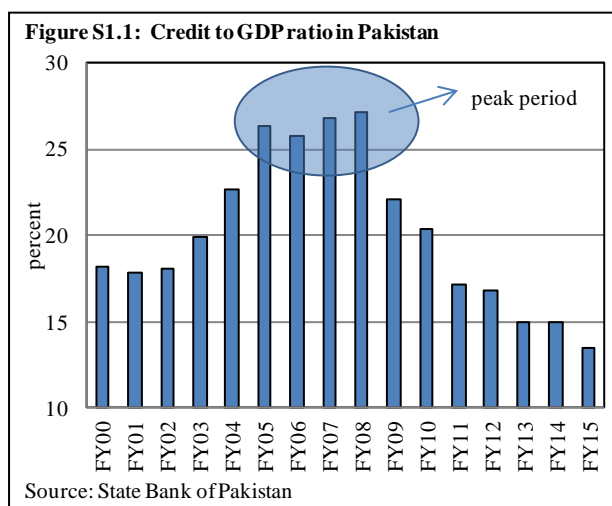
This special section explores why credit-to-GDP ratio has been falling in Pakistan in recent years; and whether this trend pertains to Pakistan only, or shared by other emerging economies. This analysis relies on cross-country comparison.

### Some Stylized Facts

Commercial banks' credit to the private sector (in terms of GDP) in Pakistan has witnessed a noticeable decline since FY08 (**Figure S1.1**), plunging from 27 percent in FY08 to just 13 percent in FY15. Long-term analysis also shows that after witnessing a credit boom from FY05-08, credit-to-GDP ratio has reached historic lows.

This ratio is among the lowest in selected developing economies (**Figure S1.2**). In fact, while in other countries this ratio surpassed the level of 2007 (i.e., the year before the global financial crisis, when credit activities were at their peak), Pakistan faces a steep decline.

While we expect sectors that contribute most to GDP would receive greater share in credit, this does not hold true for many countries included in the analysis (**Table S1.1**). Pakistan stands out the most because of the highest share of manufacturing in overall credit allocation; the services sector (which contributes over 55 percent of the GDP) gets less than 20 percent of the total credit – the lowest in the sample.



<sup>1</sup> In literature, credit to private sector and economic growth share a two-way causality. While credit expansion promotes economic activity, higher output in return also drives credit growth in the economy.

<sup>2</sup> A higher use of credit is supposed to boost economic activities as resources are allocated among various segments more efficiently through the financial sector. Therefore, a higher credit to GDP ratio suggests financial deepening of the economy and allocation efficiency.

**Table S1.1: Allocation of credit versus share in GDP**

Percent	Bangladesh		India		Pakistan		Sri Lanka		Malaysia		Philippines	
	CPS	GDP	CPS	GDP	CPS	GDP	CPS	GDP	CPS	GDP	CPS	GDP
Agriculture	5.9	16.3	12.6	18.2	8.9	20.9	12.7	10.1	4.3	7.9	3.7	9.8
Industry	37.4	29.6	44.8	16.9	63.2	20.3	36.2	32.3	32.7	40.1	29.6	25.9
Services	50.4	54.1	23.8	64.8	16.9	58.8	24.1	57.6	32	52	56	47.2
Consumer financing	6.2	NA	18.8	NA	11	NA	27.1	NA	31	NA	7.7	NA

Source: Bangladesh Bank, Reserve Bank of India, Bank Negara Malaysia, Central Bank of Sri Lanka, Pakistan Bureau of Statistics and Bangko Sentral ng Pilipinas

An assessment of the distribution of loans by size in Pakistan also provides useful insights. The share of large sized borrowers (Rs 10 million and higher) in total loans of the banking sector is more than 80 percent, while such borrowers are less than 2 percent of total borrowers. In simple words, only 1.8 percent of borrowers are getting more than 80 percent of the total loans.<sup>3</sup> This suggests that bank credit is heavily skewed towards big corporations, while consumers and SMEs are underserved sectors.<sup>4</sup> This skewed distribution of credit has not changed considerably over the period of past 10 years (**Table S1.2**).

**Table S1.2: Distribution of loans to private businesses by size**

percent of total number of accounts and percent of total amount of loans

	FY05		FY15	
	No. of accounts	Amount	No. of accounts	Amount
Less than 10 million	99.2	27.2	98.2	18.7
More than 10 million	0.8	72.8	1.8	81.3

Source: State Bank of Pakistan

### Assessment

There are various factors, both demand and supply side, that have influenced the credit pattern in Pakistan.

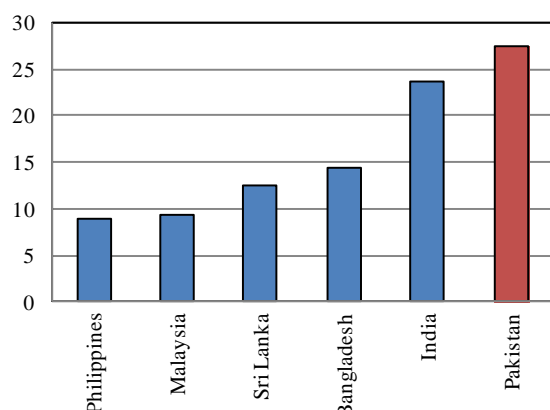
### Supply-constraints

#### i) *Presence of a dominant borrower*

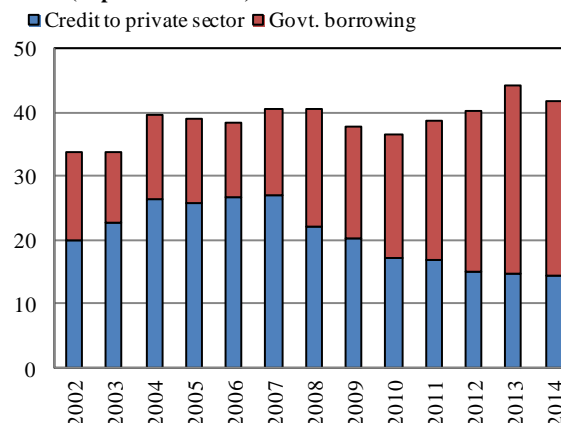
By limiting the pool of funds in the banking system, the dominant borrower (i.e., the government) marginalizes the credit for private sector activities. **Figure S1.3a**, mirror image of private sector credit-to-GDP ratio, shows that the central government borrowing (as percent of GDP) from the banking system has remained highest in Pakistan among selected countries. Facing a persistently large fiscal deficit over the years, the government has relied on financing from the domestic banking system. **Figure S1.3b** shows that while the overall credit extended by the banking system in Pakistan has increased, its composition has shifted in favor of risk-free government lending. Nonetheless, cognizant of its impact on the supply of loanable funds for the private sector, SBP stepped up its liquidity injections through open market operations (OMOs) to ensure adequate supply of credit.

<sup>3</sup> The share of large size borrowers (Rs 500 million and higher) in total loans is almost 40 percent, while such borrowers make 0.8 percent of total borrowers.

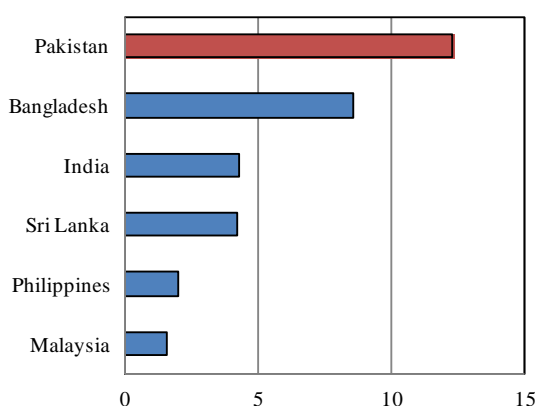
<sup>4</sup> During FY15, disbursements under agri-finance remained Rs 515.9 billion, against the market demand of Rs 946 billion. Similarly, out of 8.3 million farmed households in Pakistan, only 2.2 million are being formally served. Similarly, against 3.2 million SMEs as of June 2015, only 152,495 are borrowers (SME's outstanding credit is only one percent of GDP).

**Figure S1.3a: Central government borrowing as % of GDP (2014)**

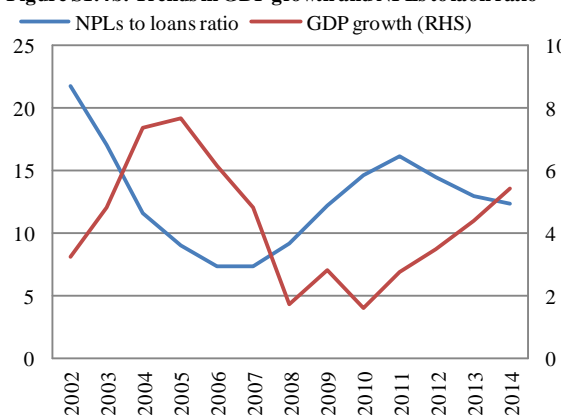
Source: World Development Indicators

**Figure S1.3b: Govt. sector borrowing versus credit to private sector (as percent of GDP)***ii) Higher credit risk*

With risk-free and growing credit demand from government, banks have little incentive to extend loan to risky private sector. Country comparison reveals highest infection ratio (non-performing loans as percent of total loans) for Pakistan in this group (**Figure S1.4a**) – reflecting degree of risk in lending

**Figure S1.4a: Non-performing loans as % of total loans (2014)**

Source: World Development Indicators

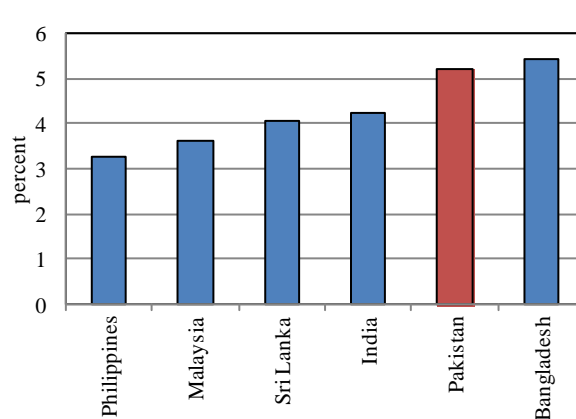
**Figure S1.4b: Trends in GDP growth and NPLs to loan ratio**

Source: State Bank of Pakistan

to private sector. A negative association between NPLs of the banking sector and overall economic activities (generally proxied by GDP growth) is well documented in both theoretical as well as empirical literature. **Figure S1.4b** clearly suggests that in case of Pakistan, a large part of the increased NPLs coincides with the low GDP growth, i.e., a phenomenon which is cyclical in nature.

*Demand-side issues**i) Low incentives due to high cost of borrowing*

Real cost of borrowing is an important factor that discourages private sector to borrow

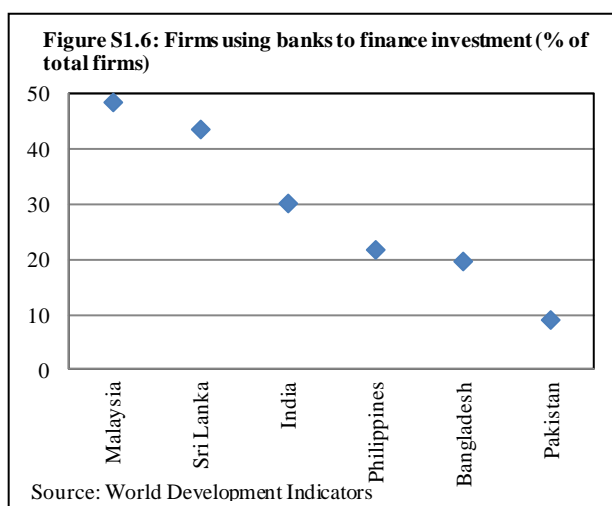
**Figure S1.5: Real cost of borrowing (3 year avg from 2012-2014)**

Source: World Development Indicators

from the banking system. Lending rate adjusted for inflation shows that the 3-year average real cost of borrowing in Pakistan, barring Bangladesh, is highest in the group (**Figure S1.5**).

Low financial deepening & awareness

Financial deepening is another area where Pakistan needs to accelerate. World Development Indicators show low penetration of banking sector in Pakistan, as only 25 out of 1,000 adults borrow from commercial banks. Even in Bangladesh – the country with higher real cost of borrowing than Pakistan – there are 84 borrowers per 1,000 adults. Furthermore, only a small fraction (less than 10 percent) of registered firms in Pakistan avails financing from the banking system (**Figure S1.6**). High cost of borrowing; low financial literacy; and bank-corporate nexus are the some of the reasons.

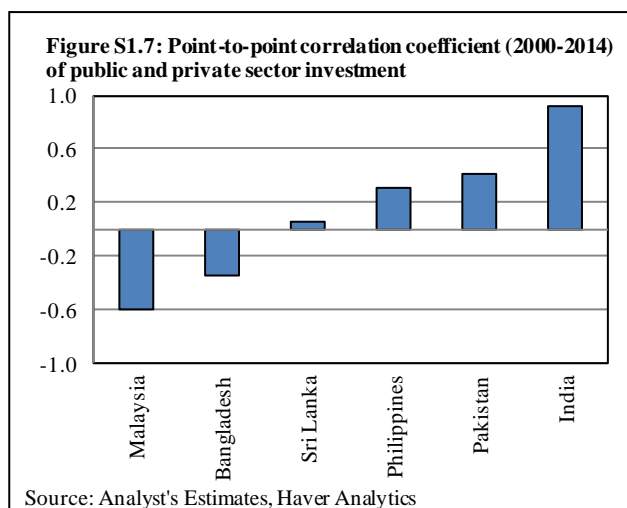


Another indicator for low financial deepening and awareness in Pakistan is the number of new entrants (businesses) in the formal market. According to WDI, the new business density (new registration per 1,000 people in a year) in Pakistan is just 0.04 compared with 0.09 in Bangladesh and 0.12 in India.<sup>5</sup>

ii) Lower participation of private sector in gross fixed capital formation

The share of private sector in gross fixed capital formation is also low in Pakistan. Gross fixed capital formation by private sector (as percent of GDP) is only 9.6 percent in Pakistan, compared to more than 20 percent in Bangladesh, Sri Lanka and India. Most of the firms in Pakistan have excess capacity that inhibits investment and leads to low credit off take.

Furthermore, the impact of public investment (government development expenditure) on private investment has been assessed to check the crowding-in effect. Using cross country data from 2000-15, correlation coefficient shows that public investment induces private investment significantly in India. However the impact is less significant in case of Pakistan, Sri Lanka and Philippines i.e. crowding-in effect is low in Pakistan. Point-to-point correlation coefficient suggests that public investment did not induce private investment in Bangladesh and Malaysia during that year (**Figure S1.7**).



iii) Structural issues more severe in Pakistan

Structural issues (e.g., energy shortages and law & order situation) have forced businesses to operate below their optimal level in Pakistan, which resulted in low credit demand over the years. World Development Indicators show that on average, firms in Pakistan faced 70 power outages during a month in 2014, compared to 65 in Bangladesh, 14 in India and 4 in Sri Lanka.

<sup>5</sup> New businesses registered are the number of new limited liability corporations registered in the calendar year.

In terms of political stability and absence of violence, Worldwide Governance Indicator shows that Pakistan stands at 1<sup>st</sup> percentile, i.e., 99 percent of countries are better than Pakistan in terms of political stability and law & order situation.<sup>6</sup>

In addition, the size of informal sector also explains why credit to GDP ratio is low in Pakistan. One of the proxies used to check the size of undocumented economy is the ratio of broad money as percent of GDP, i.e., lower the ratio, larger is the size of the informal economy. Broad money to GDP ratio in Pakistan is 41.2 percent, compared with 62.7 and 76.7 percent in Bangladesh and India respectively. Another proxy is currency in circulation as percent of GDP, i.e., higher ratio reflects scale of the informal economy. In Pakistan, this ratio is 9.4 percent, the second highest after India (10.6 percent).<sup>7</sup>

iv) *Averse Attitudes towards formal borrowing:*

SBP's survey on access to financial services shows that most people in Pakistan prefer to avoid borrowing money and 3/4<sup>th</sup> of the population have acquired no current formal or informal loans. Only 25.4 percent of the entire adult population borrowed from both formal and informal sources. Among people with active loans granted by banks, only 2.4 percent have borrowed from microfinance institutions and leasing companies. While most people in Pakistan avoid borrowing money, other borrows mainly from informal sources (which represent 23.7 percent of population) due to convenience, proximity, and ease of access and acquisition of loans. Non-borrowers, who are in majority, do not intend to borrow during the next 2 to 3 years because of lack of understanding about credit, absence of credit history, and high costs.

v) *Dearth of demand based financial products*

Research shows that the non-borrowers in both rural and urban areas, who are considering borrowing in the future, want to

**Box 1: Access to Finance Survey**

SBP conducted Access to Finance Survey (A2FS) in June 2015.<sup>1</sup> According to this survey, the total number of adults with a bank account has increased from 11 percent in 2008 to 16 percent in 2015, while 23 percent are now formally served with deposit accounts including M-wallet, credit, leasing, National Savings Schemes, pensions, life insurance and over-the-counter (OTC) services offered by branchless banking providers. Furthermore, bank account ownership among women has grown to 11 percent in 2015 (up from 4 percent in 2008), while male account ownership has reached 21 percent from 19 percent in 2008. The growth in female's access to financial services in the past few years has come from an increased female work force participation, as well as the Benazir Income Support Program, which has provided women with access to formal payment channels.

The survey reveals a huge potential for consumer finance, as only 2.4 percent of the entire adult population uses formal channels for borrowing. For the most susceptible groups that experience regular economic exigencies, shopkeepers are by far the main credit providers in Pakistan. Sixty one percent of the respondents rely on shopkeepers and suppliers to grant them very small loans to cope with occasional liquidity shortages as well larger loans while 58 percent of all borrowing is sought between the ticket sizes of Rs 10,000 and Rs 50,000. The evidence points towards market demand for viable bridge financing solutions which can be readily tapped by the banks.

The financing structure of Pakistan is based on collateral based borrowing, where banks prefer to provide credit to Corporates, FMCG's etc, that subsequently extend credit to their dealers/ wholesalers. This line of credit indirectly cascades to the retailers, which in response, creates a cushion against sale of consumer goods on credit. When compared to 2008, formal loans granted by banks as well as supplier credit, have both increased in 2015. Hence with the increase in banked population, the subsequent strengthening of retail value chain, and the advent of branchless banking, a pronounced shift in the financial access strand is underway. The informally served population is now gradually shifting to formal modes, which shows promising use of branchless banking to catalyze digital financial inclusion.

<sup>6</sup> Bangladesh, India and Sri Lanka stand at 8<sup>th</sup>, 12<sup>th</sup> and 26<sup>th</sup> percentile respectively.

<sup>7</sup> Currency in circulation as percent of GDP is 3.4, 3.7, 5.9 and 7.0 percent in Sri Lanka, Malaysia, Bangladesh and Philippines respectively.

do so primarily for short term bridge financing to pay bills, meet unforeseen emergency expenses, wedding expenses, or to purchase land. This reveals that for middle income groups, there is a huge demand for consumer, auto, leasing and housing finance facilities. However, banks are not geared up to cater to this unmet demand. Moreover, there is a need for financial literacy programs to create awareness about financial services among masses, and simplify procedures.

## Conclusion

This assessment identifies both demand and supply side factors responsible for suppressing private sector credit in Pakistan. The hefty demand for credit from government is the most important factor that weighs heavily on banks' incentive to extend credit to private sector. Since large government borrowings also limits the supply of loanable funds to private sector, only the blue-chip corporate gets priority in banks' loaning decisions. It is clear that unless the government diversifies its borrowing sources, banks would not get a meaningful push for extending credit to the private sector.

Banks also need to diversify their portfolio as excessive exposure on government debt is hampering financial intermediation in the economy and eroding the effectiveness of monetary policy.<sup>8</sup> Furthermore, any sudden decline in credit demand from dominant borrower (for example, due to positive external shock) would only stash banks with ample liquidity.

**Table S1.3: Segment-wise advances & Infection ratios**

	Share in advances	Infection ratio
Corporate sector	67.1	13.7
SMEs sector	5.7	32.0
Agriculture sector	5.4	14.1
Consumer sector	6.2	11.7
<i>of which</i>		
Credit cards	0.5	2.4
Auto loans	1.6	3.8
Consumer durable	0.0	0.1
Mortgage loans	1.1	13.8
Personal loans	3.0	14.9
Commodity financing	9.9	1.1
Others	5.8	7.7

Source: State Bank of Pakistan

Hence, banks should go beyond blue-chip corporate, particularly to SMEs and household consumers – both are severely underserved segments (**Table S1.3**).<sup>9</sup> Banks are usually hesitant in providing finance to SME and consumer sectors due to inadequate information (preference to remain undocumented). This makes it difficult for banks to evaluate the underlying risks of their business.<sup>10,11</sup> SBP has taken initiatives for promotion and development of SME banking and consumer financing.<sup>12, 13</sup> Banks should exhibit a concerted effort to understand the market and develop demand based financial products that cater to the unmet requirement of low and middle income masses of the country. Furthermore, they should explore viable collateral free lending products. The role of

<sup>8</sup> Price signals often fail as a desperate borrower does not respond to price signals. While in normal case, increasing interest rates if sufficient to deter an individual from borrowing more, in the case of government: the rising cost of credit will not deter fresh borrowing, but will only increase the government's indebtedness and squeeze the fiscal accounts further (see Special Section "Macroeconomic Dynamics with a Dominant Borrower (Government)" published in the *Third Quarterly Report of FY13*)

<sup>9</sup> The combined share of SMEs and consumer sectors is just above 10 percent.

<sup>10</sup> According to World Bank Development Indicators, the depth of credit information index shows that information content in Pakistan is one of the lowest in the region. Countries like Sri Lanka, India, Malaysia and Philippines have better quality of credit information to make lending decisions.

<sup>11</sup> Depth of credit information index measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. The index ranges from 0 to 8, with higher values indicating the availability of more credit information, from either a public registry or a private bureau, to facilitate lending decisions.

<sup>12</sup> SBP issued separate PRs for both small and medium enterprises, introduced schemes for SMEs (like credit guarantee scheme, PM Youth Business Loan Scheme) and proposed a secured transaction registry in the country.

<sup>13</sup> Weak foreclosure standards, high cost of borrowing, lengthy judicial procedures, inconsistent procedures amongst various housing schemes, and non-automation of documentation are few factors which explain low housing financing in Pakistan.

financial literacy programs is also critical to reduce the demand side bottlenecks and facilitate awareness of formal financing opportunities.

With macroeconomic stability, improvement in security situation, government increased focus on development projects (in particular planned investment under the China-Pakistan Economic Corridor), and overall optimism on Pakistan provides a perfect environment for private sector to take off, and push GDP growth to a higher trajectory. If sufficient supply of funds is made available and banks diversify their lending, then credit-to-GDP ratio would improve considerably in coming years.