ECONOMIC AND FINANCIAL RISK ASSESSMENT

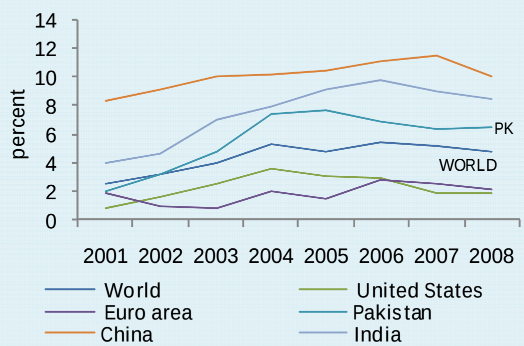
Pakistan has a progressive and dynamic financial sector which has grown rapidly particularly in the last few years, in response to the mounting financing needs of the economy. Predominantly bank-based in performing its basic function of financial intermediation, it also includes a wide range of financial institutions operating as Non-Bank Financial Institutions (NBFIs), Insurance companies, Microfinance banks, Islamic banks and the Central directorate of national savings (CDNS), in addition to swiftly evolving financial markets. Financial sector assets amounted to Rs 6.9 trillion at end June 2007, whereas market capitalization of the Karachi stock exchange grew YoY by 38 percent in FY07 to reach 46 percent of GDP. Strong economic fundamentals and structural transformation of the financial sector due to the dedicated implementation of the reform process were the major contributing factors in the current composition of the financial sector and its growth in recent years. Furthermore, in response to the growing demands of financial globalization, the financial system is starting to integrate with international financial markets, albeit at a gradual pace. Financial integration was particularly expedited in FY07 in which record high foreign portfolio investment was made in equity securities, both through the issuance of GDRs and in the stock market.

The objective of this chapter is to give an overview of the financial sector, by first discussing the broader context of the global and domestic macroeconomic environment in which it operates. Subsequent sections discuss the composition and the ownership structure of the financial system, and the performance and risk assessment of the various components.

I.1 Global Macroeconomic and Financial Developments

The global economy has now for some time enjoyed good economic growth (**Figure 1**) and increasing depth in financial markets, accompanied by significant financial innovation. This growth co-existed with a rare combination of favorable economic indicators, with relatively benign inflation levels under the watchful eye of increasingly more independent central banks around the world, low risk premia, and an easy access to finance, though oil prices (and rising commodity prices in general), and continuing global imbalances remained significant risk factors for the sustainability of this growth pattern. World economic growth was 5.5 percent in 2006, driven largely by consumption spending, and was projected to grow by 5.2 percent in 2007.[1] Globalization has been accompanied with growing economic and financial integration which allowed enhanced leveraging and risk taking by the financial markets. Until recently the risks associated with such developments seemed to be contained, however gains from the benign macroeconomic environment of the last few years have been dealt with a severe blow in the form of the liquidity crunch triggered off by incidents related to the US sub-prime mortgage market. Even though the first signs of the current market turmoil surfaced in February-March 2007, it was not until a series of events which unfolded in rapid succession from mid-July 2007 onwards that the actual extent of the impact of the credit squeeze on financial markets was realized by central banks and market participants around the world. These events have brought to the forefront some global economic and financial vulnerabilities whose prolonged impact could pose certain risks given that the world is more integrated today than ever before.

Figure 1: World Economic Growth



Source: World Economic Outlook 2007, IMF

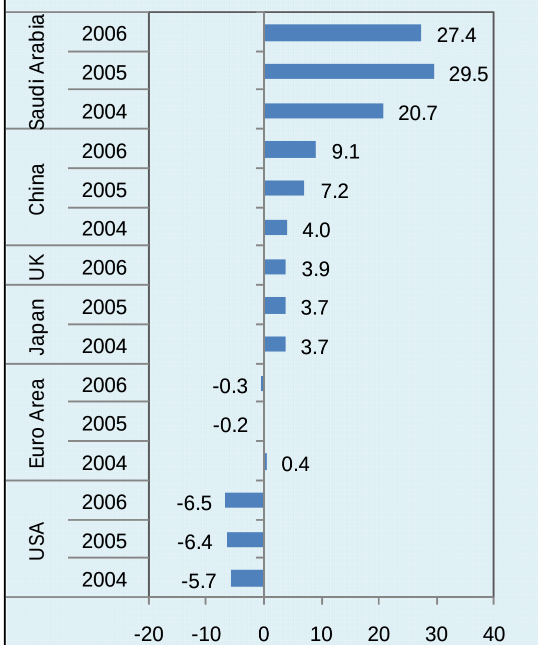
[1] World Economic Outlook, July 2007, IMF.

Even though the ripples caused by this credit crunch are wide and far reaching, the repercussions are incidentally largely external to Asia and confined to mature economies, with limited, if any impact on emerging market economies in general.

The ensuing turmoil in financial markets led the prominent central banks to intervene and reduce the impact of the crisis by injecting liquidity in the market, to stabilize short-term interest rates, with the Fed Reserve having cut the Fed funds rate in quick succession by 50 bps, and then by 25 bps, since September.

Due to strong growth in the first half of 2007, the projected growth figure for the year is expected to remain the same, though the growth figure for 2008 has been reduced by ½ percentage point, with the largest downward revision in the projected growth for the United States, which is now expected to grow at 1.9 percent in 2008, as opposed to the 2.8 percent growth projected earlier.[2]

Figure 2: Current Account Balance
as percent of GDP



Source: IMF

Despite these developments, some of the factors contributing to favorable economic growth remain relevant in an analysis of global developments. The most significant among these trends was the emergence of global savings in the last couple of years. This phenomenon particularly established a foothold in Asian economies subsequent to the East Asian crisis which led the countries most impacted by it to specially focus on issues related to financial sector stability. While this has had a positive impact on these economies, the US current account deficit continues to be a cause for concern, especially since it is being funded by savings of the Asian economies, and there are concerns about the sustainability of this pattern. **Figure 2** shows the current account balances of the economies which are part of IMF's Multilateral Consultation on Global Imbalances.[3]

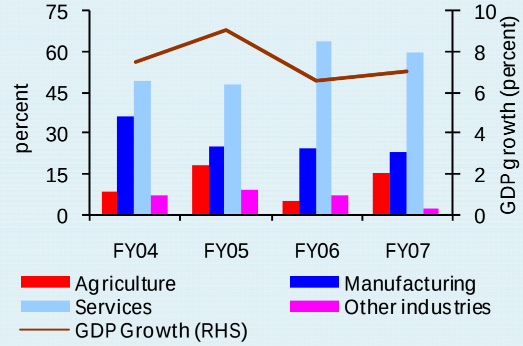
In parallel to the economic vulnerabilities induced by global economic imbalances, there are concerns regarding growing financial vulnerabilities. These concerns have emerged largely from a number of factors which were laid bare during the liquidity and credit crisis, such as expansion in financial innovation backed by scoring and rating, under-pricing of risks, alongwith the spreading of risks through securitization and packaging of tranches of asset-backed securities and offloading these to investors through off-balance sheet transactions, CDO structures, and special investment vehicles (SIV) such as hedge funds, which encouraged excessive leveraging. Given the attractive returns on riskier assets, investors drifted into such investments without adequate assessments of the probability of defaults. In today's financially integrated world, a financial crisis or crunch in one segment of the financial market has wider global consequences and could often lead to a contagion effect. A consequence of the combination of these developments is the changing financial landscape which continues to challenge conventional norms of regulation. Regulators' primary concern

[2] World Economic Outlook, October 2007, IMF.
[3] IMF Issues Brief, Issue 07/03, April 2007, IMF Staff Report on Multilateral Consultations on Global Imbalances, June 29, 2007.

in this environment is the actual diversification of risks and ensuring resilience of the system to large shocks, as seen recently.

The potential instability arising from capital inflows is another such risk. A substantial level of inflows, as has been the case in Asia, presents considerable challenges for macroeconomic management, and exposes the countries that receive them to an abrupt reversal of flows when sudden shocks occur. Emerging economies can best respond to such developments with a twofold response: sound macroeconomic management and financial sector deepening.

Figure 3 : Contribution to real GDP growth

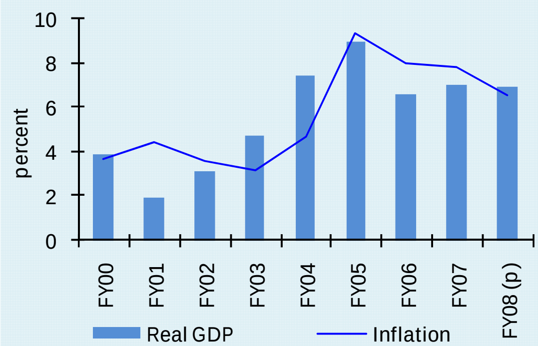


Source: Economic Survey of Pakistan

I.2 Domestic Macroeconomic Environment

Emulating a trend akin to global growth, Pakistan's economic performance in the last few years has been remarkable. With strong GDP growth over a period of 5 years (average 7.0 percent from FY03 – FY07), the economy has undergone structural changes in the last few years. Growth has been broad-based and there has been a marked shift in the underlying sources of growth, with a dominant contribution from the services sector (**Figure 3**). Investment, a key determinant of growth, reached a record level of 23.0 percent of GDP in FY07. Some of the key economic indicators are shown in **Table 1.** Rising inflation due to demand pressures generated in the economy since FY05 has led the central bank to tighten monetary policy to contain inflationary pressures (**Figure 4**), the impact of which is starting to reflect in core inflation more obviously than in headline inflation, with continued concerns regarding the unrelenting food inflation.

Figure 4: Trends in Growth & Inflation



Source: Economic Survey of Pakistan

Table 1: Macroeconomic Indicators

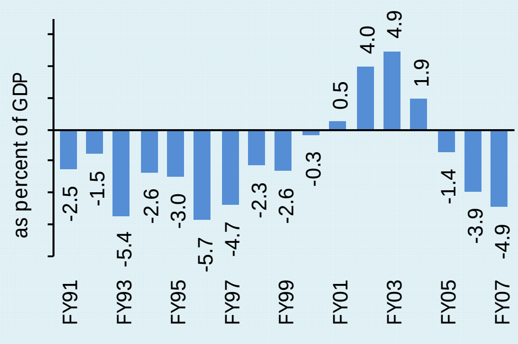
	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Growth rates (percent)								
Real GDP	3.9	2.0	3.1	4.7	7.5	9.0	6.6	7.0
Agriculture	6.1	-2.2	0.1	4.1	2.4	6.5	1.6	5.0
Industry	1.6	4.1	2.7	4.2	16.3	12.1	5.0	6.8
Services	4.2	3.1	4.8	5.3	5.8	8.5	9.6	8.0
Inflation	3.6	4.4	3.5	3.1	4.6	9.3	7.9	7.8
Private Sector Credit	2.7	8.1	7.0	20.9	34.3	33.5	23.5	16.9
Money Supply (M2)	9.4	9.0	15.4	18.0	19.6	19.3	15.2	19.3
billion US Dollars								
Total Liquid Reserves	2.0	3.2	6.4	10.8	12.4	12.6	13.1	15.6
Home Remittances	1.0	1.1	2.4	4.2	3.9	4.2	4.6	5.5
Foreign Investment	-0.1	0.2	-0.01	0.6	1.3	2.1	4.5	8.4
FDI	*0.5*	*0.3*	*0.5*	*0.8*	*1.0*	*1.5*	*3.5*	*5.1*
FPI	*-0.5*	*-0.1*	*-0.5*	*-0.2*	*0.3*	*0.6*	*1.0*	*3.3*
As Percent of GDP								
Fiscal balance	-5.4	-4.3	-4.3	-3.7	-2.9	-3.3	-4.3	-4.3
Trade deficit	-2.4	-2.1	-1.7	-1.3	-3.3	-5.6	-9.4	-9.3
Current account balance	-0.3	0.5	4.0	4.9	1.9	-1.4	-3.9	-4.9

Source: SBP and Economic Survey of Pakistan

Financial Imbalances

Current account deficit during FY07 was recorded at US$ 7.1 billion, higher than the full year target of $6.3 billion, at 4.9 percent of GDP (**Figure 5**). Trade deficit has also increased sharply from US $8.4 billion in FY06 to $9.9 billion in FY07. While imports decelerated significantly (8.1 percent growth in FY07 as compared to 31.6 percent in FY06), the trade gap widened due to sluggish export growth (3.2 percent in FY07 compared with 14.3 percent in FY06).

Figure 5: Current Account Balance

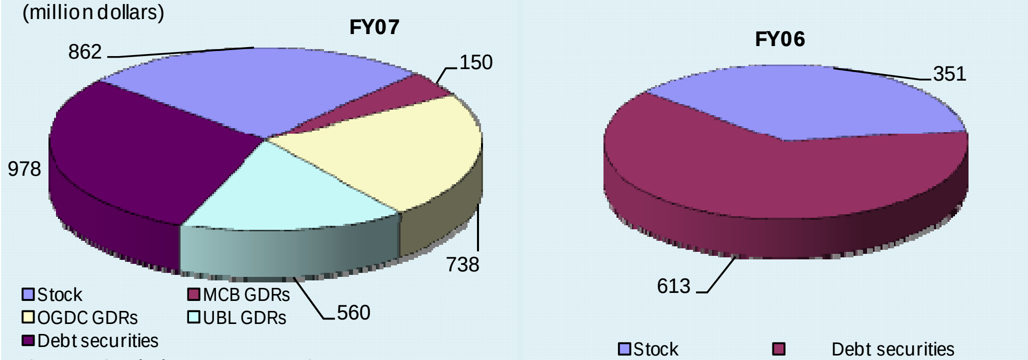


Source: Statistics Department, SBP

Pakistan is still not very well integrated with international markets. On the positive side, this has kept the economy insulated from a number of negative developments which tend to have a domino impact on the more integrated industrial and emerging economies. For example, the current trends in the credit risk transfer markets, growth of hedge funds and carry-trade transactions, in addition to the increased dependence on Leveraged Buy-Outs (LBOs) to finance the current M&A wave, are all developments in the global market which have a negligible impact on Pakistan's economy.

However, this is now gradually starting to change. In FY07, Pakistan has also seen substantial capital inflows like other emerging markets in Asia. These inflows have been in the form of both Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI) (**Figure 6**) with 3 major GDR issues, FDI in strategic sectors and issuance of a sovereign bond during the year, leading to excess liquidity in the system. This has helped in keeping the overall external account in a surplus position, despite the increasing current account deficit, while also contributing substantially to the growth of reserves.

Figure 6: Composition of FPI
(million dollars)



Source: Statistics Department, SBP

These inflows are a result of the structural changes in the economy. With the success story of the banking sector making headlines around the world, the listings of GDRs issued by MCB Bank and United Bank Limited (UBL) on the London Stock Exchange during FY07 have been a tremendous success.

Going forward, sustained economic growth would require consistent implementation of supportive policies which help in minimizing economic imbalances.

II. Overview of the Financial Sector

Supervision of the Financial Sector

Financial institutions in Pakistan are regulated and supervised by the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP). Islamic financial institutions function in parallel with conventional institutions. SBP is primarily responsible for regulating and supervising the scheduled banks (both conventional and Islamic), Microfinance Banks (MFBs), Development Finance Institutions (DFIs) and Exchange Companies. The rest of the financial institutions including Investment banks, Leasing Companies, Modarabas, Discount Houses, Venture capital companies, Asset management companies, Mutual funds, Housing finance companies, and Insurance companies are regulated and supervised by the SECP. The National Savings Schemes (NSS) are managed by the Central Directorate of National Savings (CDNS), a department of the Ministry of Finance.

Table 2: Asset Composition of the Financial Sector

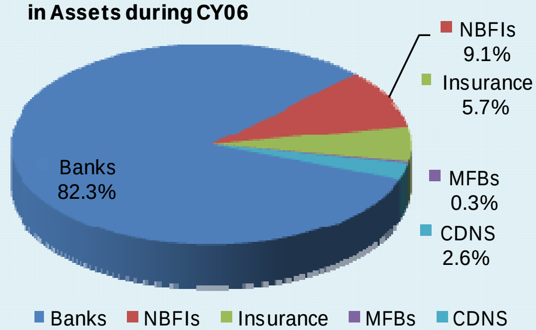
	CY01	CY02	CY03	CY04	CY05	CY06	H1-CY07
Assets (bln Rs)	3044.6	3420.7	3948.2	4523.9	5210.0	5966.3	6864.2
Growth (%)		12.4	15.4	14.6	15.2	14.5	15.0
Share in Assets							
MFBs	0.1	0.1	0.1	0.1	0.2	0.2	0.2
NBFIs	6.7	6.3	6.7	7.2	7.7	7.9	9.0
Insurance	3.7	3.8	3.8	3.8	3.9	4.1	4.1
CDNS	25.7	24.8	25.0	21.6	18.0	16.1	14.6
Banks	63.8	65.0	64.4	67.3	70.2	71.8	72.1
Assets as Percent of GDP							
MFBs[1]	0.0	0.1	0.1	0.1	0.1	0.1	0.1
NBFIs[2]	4.7	4.6	5.0	5.3	5.7	5.8	7.1
Insurance[3]	2.6	2.8	2.9	2.8	2.9	3.0	3.2
CDNS	18.1	18.2	18.8	16.1	13.3	11.8	11.5
Banks[4]	44.8	47.7	48.3	50.1	51.9	52.5	56.9
Overall	70.3	73.3	75.1	74.5	73.9	73.2	78.8

[1] MFBs consist of Microfinance Banks supervised by the State Bank of Pakistan.
[2] NBFIs include Development Finance Institutions (DFIs), Leasing Companies, Investment Banks, Modarba, Housing Finance Companies, Discount Houses, Venture Capital Companies, and Mutual Funds.
[3] Insurance sector include life and non-life insurance companies, and the re-insurance sector.
[4]. Banks include all scheduled banks operating in the country
Source: SBP Calculations

Composition of the Financial Sector

The financial system in Pakistan is pre-dominantly bank-based. Banking sector assets constitute 72.1 percent of total financial sector assets (**Table 2**). As evident from the data, banks have been gradually strengthening their market share over the years. While NBFIs have increased their market share due to the strong performance of mutual funds in recent years, the share of CDNS instruments in total assets continues to decline. On the other hand, the insurance sector constitutes a small share of total financial sector assets, with a marginal improvement in CY06. The declining share of CDNS is not altogether a negative development, as relatively higher profit rates on national savings schemes tend to shift funds away from the banking system and financial markets.

Figure 7: Segment-wise contribution to growth in Assets during CY06



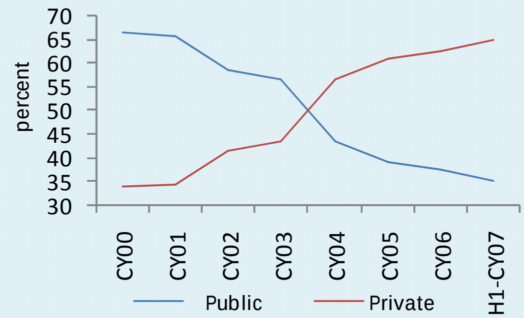
Source: SBP Calculations

In line with its asset share in the overall financial sector, the banking industry is the largest contributor to the YoY growth in the total assets (**Figure 7**). Asset growth of the other components of the financial sector shows that while NBFIs contributed 9.1 percent, over 20.0

percent YoY growth in the assets of MFBs and the insurance sector have jointly contributed only 6.0 percent in the overall growth of financial sector assets.

This composition of the financial sector gives credence to the concern that the overall dependence on the banking sector has increased further during CY06. However, ongoing financial sector reforms are paving the way for a more diversified financial sector, equipped to facilitate the economic growth process. Strong growth of mutual funds – being managed by professional and reputable asset management firms – is largely attributed to the improved performance of the domestic financial markets and points to the gradual but steadfast process of diversification of the financial sector. Furthermore, the outreach of the financial sector continues to gain ground with the expanding network of commercial banks, microfinance institutions and Islamic banks in all parts of the country.

Figure 8: Ownership Structure of Financial Sector

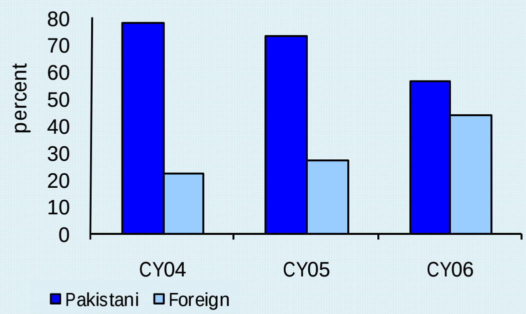


Source: SBP Calculations

Ownership Structure

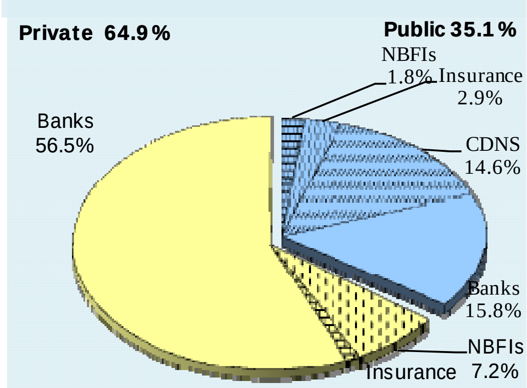
The reform process, and in particular the on going mergers and acquisitions (M&As), have exerted a profound impact on the ownership structure of the financial sector. The financial sector is now led by the private sector, constituting of both domestic and foreign financial institutions, controlling 64.9 percent of overall assets (**Figure 8**). Foreign direct investment (FDI) in the banking sector is on the rise, with some significant transactions having been consummated during CY06-CY07. Acquisition of a strong mid-sized domestic commercial bank by Standard Charted Bank plc to establish Standard Charted Bank (Pakistan) Ltd, another acquisition of a mid-sized domestic commercial bank by ABN Amro Bank N.V., and of majority shares of Crescent Commercial Bank by the SAMBA[4] financial group, are some of the noteworthy transactions. Another contributing factor in this trend is the growing interest of foreign banks in the Islamic Banking industry. As a result of these developments, foreign stake in the banking sector increased to an all time high of 43.4 percent (**Figure 9**) by end-CY06. In case of Standard Chartered Bank and ABN Amro Bank, the emerging entities subsequent to their respective acquisitions have been incorporated as local subsidiaries of their parent organizations, and are categorized as domestic local banks in the country. Consequently, the asset share of

Figure 9: Position of Shareholding in Banking System



Source: Banking Surveillance Department, SBP

Figure 10: Ownership Structure as of H1-CY07



Source: SBP Calculations

[4] Saudi American Bank.

foreign financial institutions in the industry has declined, reaching 5.1 percent by end June 2007 as compared to 9.3 percent as of end CY05. Similarly, the number of foreign banks has also declined from 11 in CY05 to 7 as of end June 2007.

Institution-wise ownership structure of the financial sector indicates that private sector banks (holding 78.0 percent of banking sector assets) and private sector NBFIs (with market share of 66.1 percent in total NBFIs assets) are the major players in their respective segments (**Figure 10**). However, in terms of asset holdings, the insurance sector is still dominated by public sector entities.

Having given an overall perspective of the composition and the ownership structure of the financial sector, we now move on to a more detailed discussion of the performance and risk assessment of the various components of the financial sector, with the purpose of identifying potential risks to financial stability, and how the financial sector is gearing itself to meet the challenges stemming from its growth.

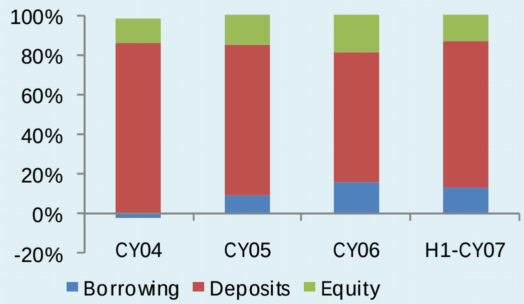
III. Performance and Risk Assessment

This section gives an overview of the performance of the financial sector in CY06, as well as an assessment of the emergent risks.

1. Banking Sector

The remarkable performance of Pakistan's banking sector has attracted considerable FDI into the industry in recent times. Commercial Banks in Pakistan operate on a sound capital base with an enviable record of financial performance, particularly in the last 3 years. As of end-CY06, banking sector profitability was Rs 123.6 billion. A 17 percent YoY increase in assets during CY06 has pushed the overall size of the banking sector to Rs 4.3 trillion (which further increased to Rs 5.0 trillion by end H1-CY07). This asset expansion was funded by an increase in deposits (YoY growth of 13.0 percent), strong growth in equity in the wake of increased minimum capital requirements (55 percent of the increase in equity is due to the higher paid-up capital amount), and relatively higher borrowing (**Figure 11**).[5]

Figure 11: Funding Structure of the Banking Sector



Source: Quarterly Reports of Condition and Annual Audited Accounts

These developments augur well for the industry's capacity to address potential challenges in its operating environment and expand its operations further. This view is particularly supported by the results of the ***Financial Soundness Index*** (FSI), constructed for the purpose of assessing the stability of the banking sector (details in *Chapter 6, Stability of the Banking System*). The FSI, constructed on the basis of capital adequacy, asset quality, profitability and liquidity indicators, indicates that the performance of the banking sector has improved substantially over the last five years. Results of a ***stress-testing*** exercise, to quantify the impact of potential shocks caused by credit risk, interest rate risk, exchange rate risk, equity price risk and liquidity risks also indicate the increased resilience of the banking sector to withstand adverse developments in its operating environment.

The quality of the risk-based capital provides further comfort as the share of core capital in the overall risk-based capital has reached 80.3 percent by end H1-CY07, compared to 73.7 percent in CY05. These changes in the capital adequacy ratio, together with the improved

[5] This includes inter-bank borrowing.

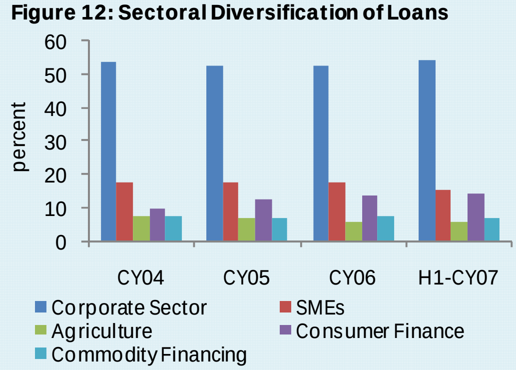
quality of capital, suggest that the resilience of the banking sector to withstand unexpected shocks has strengthened during CY06.

Growing volume of Bank Credit

Sustained growth in advances remained the major source of expansion in assets during CY06. However, given the monetary tightening stance of the central bank, YoY growth in advances declined from 26.5 percent in CY05 to a more sustainable level of 20.0 percent in CY06. A positive development seen in the credit off-take during the year was an acceleration in fixed investment loans.

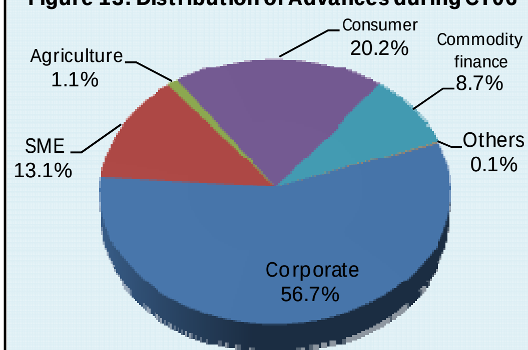
Banks have been fairly successful in their efforts to make inroads into the previously under-served segments, and this is clearly evident in the diversification of bank credit in recent years (**Figure 12**). Sectors such as SME, Agriculture and Consumer Finance have shares in outstanding credit of 15.4, 5.8 and 14.3 percent respectively at end H1-CY07. This development is particularly remarkable, given that these shares have been achieved from virtually negligible levels prevalent as recently as FY02. Sectoral distribution of advances indicates that the corporate sector continues to be the dominant borrower of bank credit, with an over 56 percent share in advances disbursed during CY06 (**Figure 13**). Consumer sector was next in line, with a share of 20.2 percent in advances given during the year.

Figure 12: Sectoral Diversification of Loans



Source: Banking Surveillance Department, SBP

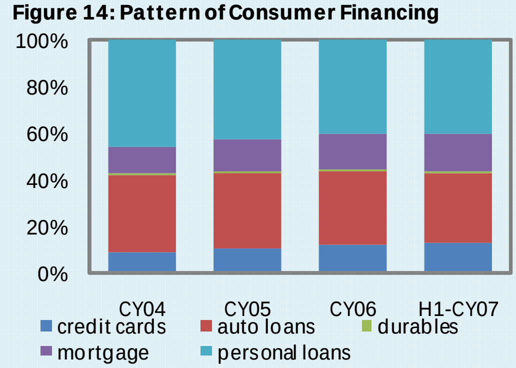
Figure 13: Distribution of Advances during CY06



Source: Banking Surveillance Department, SBP

Penetration into these diversified sectors still has considerable room for improvement and both supply and demand challenges need to be addressed in order to increase penetration (details in *Thematic article 5, Issues in Sectoral Allocation of Credit*). Expansion in Consumer Financing (CF) in recent years (**Figure 14**) has generated considerable debate due to its riskier nature, and its impact on the overall consumption behaviour of economic agents. In order to view this in perspective, it would be appropriate to point out that : (1) consumer finance is probably the most sensitive to interest rates, and monetary tightening in the last two years has arrested the growth in these loans, especially the growth in loans for consumer durables, which have declined by 22.9 percent, (2) the share of CF in total assets of the banking system is still not too high at 14.3 percent as at end-June CY07, (3) CF forms just 5.0 percent of total financial sector assets, (4) NPL infection ratio for CF is 3.6 percent which in a way negates the intensity of concerns, and finally, (5) CF as a percent of GDP is rather small at 4.0 percent. These factors show that statistics should ideally be

Figure 14: Pattern of Consumer Financing



Source: Banking Surveillance Department, SBP viewed in conjunction with subjective analysis in order to gain a more logical perspective of reality.

Stability of the borrowers

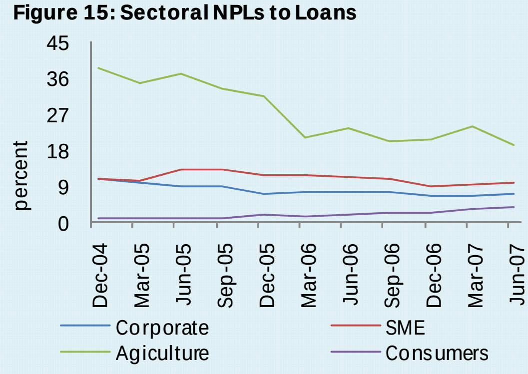
In relation to bank credit and banks' portfolio of advances, financial stability concerns arise largely from the financial position of the borrowers – be they households, corporate, farmers or small businessmen. While strong economic growth helps in strengthening the ability of borrowers to honor their obligations, this impact is not similar for all sectors of the economy as gains from economic growth are not equally distributed. The Special Section on the *Non-Finance Sector* makes an attempt to assess the financial position of two major borrowers of the financial sector i.e. the corporate sector and the households, with total share in credit at 68.5 percent at end-June CY07. Indicators of households' financial wealth, such as the growing proportion of personal deposits in total deposits of the banking sector (44 percent at end-CY06) in the last few years, rising investment of individuals in the stock market and NSS instruments, signify considerable improvement in the financial health of the household sector.

The corporate sector, as the largest recipient of bank credit, has greatly benefited from the consumption boom which resulted from factors such as an unanticipated large inflow of workers' remittances and easy access to consumer financing, especially in a benign interest rate environment which prevailed from FY02 to FY04. The consumer financing schemes by various commercial banks in particular, created demand for consumer durables and other products which resulted in a large increase in the production of automobiles and home appliances. The construction sector also witnessed a strong surge in the demand for building materials and related products. Financial performance of the corporate sector, assessed on the basis of trends in liquidity, solvency and profitability ratios indicates a healthy position of the corporate sector.

Asset Quality

The rapid expansion in credit brings forth concerns regarding the quality of banks' lending portfolio (*details in chapter 6, Stability of the Banking System*). With attendant risks in global financial markets emerging partly due to the inadequate quality of credit standards, the financial sector needs to continue to be vigilant in making its lending decisions.

Figure 15: Sectoral NPLs to Loans



Source: Banking Surveillance Department, SBP

Sectoral break up of NPLs indicates that the NPLs to Loans ratio has a generally declining trends for all categories of credit, however financing extended to the agriculture sector is relatively riskier for banks. This is not entirely surprising because besides the vagaries of nature, agriculture and rural finance is a relatively new area for most of the banks and their credit risk assessment procedures are gradually gaining strength with the benefit of experience. In so far as other sectors are concerned, the NPLs to advances ratio of the SME sector is only slightly higher than the corporate sector, and has declined slightly during CY06, whereas the proportion of NPLs of consumer loans has remained largely stagnant (**Figure 15**). Stringent provisioning requirements by SBP have ensured that the level of NPLs is managed prudently.

The above composition of assets and the funding structure of the banking sector have helped banks in realizing all time high profits of Rs 123.6 billion in CY06. Specifically, the after tax return on assets (ROA) was 2.1 percent in CY06 – a level significantly higher than other countries in the region. Capital adequacy has reached 12.7 percent in CY06 as compared to 11.3 percent in CY05. The on-going implementation of Basel II is likely to strengthen the risk-management position of the banking sector.

Banking Sector Consolidation

As the transformation of the banking sector through consolidation picks up pace, and well-capitalized, large banks start to emerge, it is important to assess the implications of the consolidation process on the stability of the financial system. An in-depth analysis (*details in Thematic article 2, Consolidation of the Financial Sector*) of the ongoing consolidation process within and across the banking sector (with NBFIs) assesses the causes of financial sector consolidation and the potential impacts on the structure and stability of the banking sector. Specifically, it assesses the impact of consolidation on competition, financial risk profile, conduct of monetary policy, efficiency of financial institutions, and implications for SBP as the regulator/supervisor of the banking sector. The results based on an econometric analysis and temporal changes in various indicators suggest that there is no indication of a negative impact of financial consolidation on the banking sector, which is generally perceived on theoretical grounds.

In particular, the analysis yields the following results :

Effects on Competition: The level of concentration has a declining trend and has witnessed considerable reduction during CY06. Concentration is likely to decline further and healthy competition is expected to take hold as small banks will have to join hands with bigger entities in the wake of the on-going consolidation process.

Effects on Efficiency: The administrative expense to total expense ratio and the after tax return on assets (ROA) is used to analyze the impact of M&As on the cost and profit efficiency of individual institutions. The results suggest that large institutions have benefited from M&As to some extent, while these gains were not visible in case of small financial institutions.

***Effects on Financial Risk*:** There is no substantial change in financial risk at the institutional and aggregate level as a result of the consolidation process. Specifically, there is an indication of a decline in financial risk at the individual institution level, due to gains from geographic and product diversification. On the other hand, there is no indication of an increase in contagion effect generally associated with M&As. The primary reason for this seems to be that a large number of M&As have generally involved weak and small banks and non-bank financial institutions.

***Impact on implementation of Monetary Policy*:** The impact of M&As on the conduct of monetary policy is gauged by looking at the minimum number of participants for the efficient market functioning of both the primary auction market and the market for OMOs. The results suggest that there is still considerable room for more M&A transactions, as the minimum number of existing market participants are still considerably lower than the overall number of market participants.

***Impact on Supervisory Issues*:** As regulatory and supervisory requirements generally increase in response to cross-category and cross-border M&As, there is a need to strengthen the ongoing co-ordination mechanism between the regulators of the financial sector.

In sum, the findings suggest that the ongoing consolidation has had a generally favorable impact on the banking sector, and that SBP is well on its way to create a well-capitalized and strong banking sector to cater to the needs of the growing economy more efficiently.

Efficiency of Financial Intermediation

However, an analysis of the efficiency of financial intermediation focused on the cost of financial intermediation explores the determinants of the wide banking spreads (detailed analysis in *Thematic article 1*, *Efficiency of Financial Intermediation – An analysis of Banking Spreads*). The analysis indicates that factors such as the structure of bank deposits (with 25 percent of total deposits in non-remunerative accounts) and the liquidity preference of depositors have a significant bearing on the level of banking spreads. Concerted efforts by banks to increase the proportion of fixed deposits are likely to narrow these spreads. The process of a gradual shift towards fixed deposits has already started, in particular due to the incentive given by the central bank to zero rate fixed deposits in its reserve requirements.

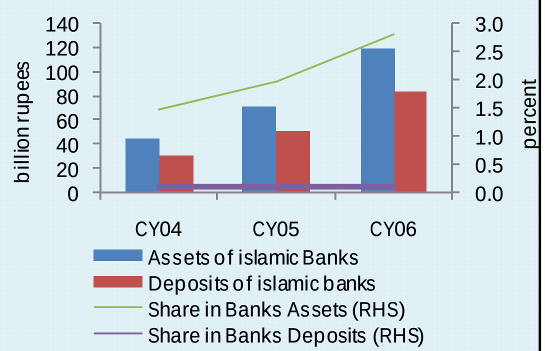
1.1 Islamic Banks

Initially conceived in response to a faith-based logic of conforming to the principles of *Shariah* in all spheres of life, the astounding growth of the Islamic Financial industry also drew on the wealth accumulation in oil-rich countries in the ensuing years, and reflects its potential of being a financially viable and lucrative segment of the global financial system. Over time, Islamic Financial Institutions (IFIs) have been successful in tapping the previously *exluded* market on faith-based considerations, as well as the already *included* segment on preference-based considerations, by giving them the opportunity to choose between the two parallel modes of financing and investment.

The Islamic Financial industry in Pakistan has grown substantially since the launch of SBP's focused strategy to promote a parallel Islamic Banking system in 2001. This performance is commendable for such a short period, given that other countries have achieved similar levels of growth in their respective Islamic banking industries after several years of existence. The Islamic Banking industry which started with 2 dedicated institutions a few years back, now comprises of 6 full-fledged banks and dedicated Islamic branches of conventional banks, offering a range of *shariah* compliant services, with a combined network of 197[6] branches, reflecting an extended degree of outreach of Islamic banking in comparison with previous years (*details in Chapter 9, Islamic Financial Services*).

Besides banks, IFIs in Pakistan include Islamic mutual funds, shariah-compliant housing finance services, *takaful* companies and modarabas. *Sukuk* issuances have also attracted considerable attention in the recent past.

Figure 16: Assets and Deposits of Islamic Banks



Source: Islamic Banking Department, SBP

Expanding at an annual growth rate of 67 percent, the industry's assets have increased to Rs.159 billion by end-June CY07, from Rs.71 billion in CY05 (**Figure 16**), whereas the deposit base has increased from Rs. 50 billion in CY05 to Rs. 108 billion in June CY07. With this expansion, the share of the Islamic Banking industry in the overall assets of the financial sector increased to 3.4 percent by end June CY07. The rapid expansion also gives an indication of the sustainability of these institutions.

Table 3 : Financing Products by IBs

Share in Percent

Mode of Financing	CY05	CY06
Murabaha	44	48
Ijarah	30	30
Musharaka	0	1
Mudaraba	0	0
Diminishing Musharaka	13	15
Salam	1	2
Istisna	0	1
Qarz/Qarz-e-Hasna	0	0
Others	12	3

Source: Islamic Banking Department, SBP

Product-wise financing patterns (**Table 3**) indicate that Murabaha has the highest share of financing products, followed by Ijarah and Diminishing Musharaka. Murabaha's share has increased from 44 percent in CY05 to 48 percent in CY06, indicating a conservative stance in lending practices.

[6] End-August CY07.

Indicators of financial performance reflect the healthy position of Islamic Banks. Capital adequacy of these institutions has reached 18.3 percent in CY06 against 13.7 percent in CY05. NPLs to advances ratio is less than 2 percent. After tax ROA for CY06 is in the normal range of around 1.0 percent.

As the Islamic Financial Institutions develop alongside conventional financial institutions, the industry is faced with certain challenges and issues in the form of the rather gradual development of international standards and accounting practices, relative dearth of liquidity management instruments, possibility of regulatory arbitrage with two parallel financial systems where the range of *shariah* compliant financial services are regulated by two separate regulators, competitive pressures from the conventional financial system, etc. Credibility of market practitioners remains an important factor in gaining and maintaining the confidence of the public in shariah-compliant financial solutions for the future growth of this industry.

While not a threat to financial stability given the total size of the industry at 3.4 percent of total assets of the banking system, potentially systemic issues arising from IFIs bear relevance for analysis, given the growth potential of the industry, their interaction and linkages with systemically important conventional banks, and the possible concentration of risks in a smaller number of institutions.

As the industry develops, SBP continues to provide an enabling environment for Islamic Banks. Work is underway on the development of Bait-ul-Maal certificates to provide a sovereign instrument for liquidity management, and risk management guidelines have been issued to address risks peculiar to a shariah-compliant environment. Moreover, In order to expand outreach, shariah-compliant microfinance guidelines have also been issued.

1.2 Microfinance Institutions

The operations of MFIs, including Microfinance Banks (MFBs), Non-Government Organizations (NGOs), Rural Support Programs (RSPs) and Commercial Financial Institutions (CFIs) have witnessed significant improvements during CY06, which is reflected in almost all aspects of the microfinance industry. Number of new MFBs branches has grown, total assets have increased, products are being gradually diversified, outreach is being extended, branch network is being expanded and growth has been achieved in the total number of borrowers and advances (**Table 4**).

Table 4: Outreach of Microfinance Institutions
million Rupees

	MFBs		MFIs		Total		Change %
	CY05	CY06	CY05	CY06	CY05	CY06	CY06 over CY05
Number of Branches	91	145	462	847	553	992	79.4
Advances	2,258	3,444	3,344	4,907	5,602	8,351	49.1
Borrowers('000')	248	326	365	509	613	835	36.2
Deposits/Voluntary savings	680	1,420	675	929.5	1,355	2,350	73.4
Depositors ('000')	32	71	1,183	1,294	1,215	1,365	12.3
Borrowings	4,328	5,139	1,004	730.4	5,332	5,869	10.1

Source: OSED, State Bank of Pakistan and Pakistan Microfinance Network Annual Report 2006

During CY06, assets of Microfinance Banks (MFBs) recorded YoY growth of 24.3 percent to reach Rs.10.5 billion. This growth was facilitated largely by the expanding outreach of MFBs. With the inception of a new Microfinance bank during 2006, the network of MFBs rose to six banks. Performance of MFBs in terms of growth in outreach and financial services can be termed satisfactory as: (1) MFBs are setting up, on average, 30 new branches every year since CY01; and (2) MFBs facilitated 231,408 new borrowers during CY04-06 compared to 95,000 during CY01-03. During CY06 alone, the total number of borrowers has reached 0.33 million as compared to 0.25 million in the same period last year. On the other hand, the total loan portfolio, which is the major focus of MFBs, amounted to Rs.3.4 billion. However, despite the sharp rise in total number of borrowers, the outreach still has substantial room for improvement given the potential market of 25-30 million people.

With a focus on expanding microfinance outreach to 3 million borrowers by 2010, a strategy for *Expanding Microfinance Outreach* (EMO) has been developed by the SBP which was approved by the Government in February 2007. The EMO strategy stresses on the fact that commercialization of the sector is key to financial and social sustainability.

2. Non-Bank Financial Institutions (NBFIs)

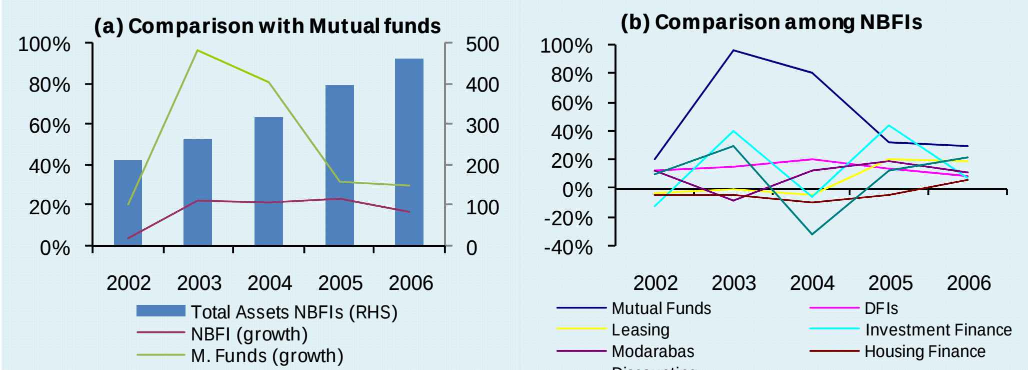
The key market players in the non-bank financial sector of Pakistan are Non-banking Finance Companies (NBFCs), mutual funds, modarabas and Development Finance Institutions (DFIs). As of the end of FY06, the size of the non-bank financial sector was Rs. 462.3 billion (**Table 5**) in terms of total assets, and 188 in terms of the number of operative entities. Relatively, its assets were a mere 7.1 percent of GDP and constitute 9.0 percent of total assets of the financial sector, while its deposits formed 2.3 percent of the total deposits mobilized by the financial sector (*details in Chapter 8, Performance and Risk Review of the Non-Bank Finance Sector*).

Table 5: Assets of NBFIs

	FY00	FY05	FY06
Asset (bln Rupees)	239.7	393.7	462.3
Shares in Percent			
DFIs	38.2	27.4	25.3
Mutual Funds	10.6	34.6	38.3
Leasing	17.1	13.6	13.8
Investment Banks	17.3	13.0	11.8
Modaraba	6.4	5.5	5.2
HFCs	9.3	4.7	4.3
Others	1.2	1.2	1.3

Source: Annual Audited Accounts

Figure 17: Growth of Non-Bank Financial Sector



Source: Annual Audited Accounts

The non-bank financial sector has historically played an important role in the mobilization and channeling of savings in the financial system. The NBFIs have, in recent years, benefited from an environment of low interest rates coupled with high economic growth but have been unable to create an impact as well-functioning, specialized financial intermediaries. As banks have made rapid inroads into business segments traditionally serviced by NBFIs, market share of NBFCs and modarabas has eroded considerably, so much so that Investment finance and discounting are likely to disappear as stand-alone activities in the non-bank financial sector while leasing and modaraba sectors are faced with the dilemma of 'diversify or die'. In addition, housing finance and venture capital industries have failed to take off despite significant demand potential. The only success story among NBFIs is that of mutual funds (**Figure 17**).

The major objective of the introduction of the concept of 'NBFCs' i.e. Non-Banking Finance Companies in 2002, was to enable the existing (largely) single-product institutions serving specific market niches, to offer a whole variety and range of financial products through a one window operation akin to universal banking, subject to compliance with the prescribed progressively-tiered regulatory requirements. It was expected that consolidation of different financial services under one umbrella would lead to the emergence of stronger, well-capitalized entities, which will provide a fillip for the future development of the non-bank financial sector. However, the role of the NBFC model in shaping growth opportunities for non-bank financial services, particularly fund-based activities, has been debatable.

The issues surrounding NBFCs and modarabas pose significant challenges for sustaining growth in the non-bank financial sector, unless remedial measures are taken to enhance market outreach, promote product innovation, increase capitalization and restructure the under-developed segments. In the area of product development, the increasing focus of the Securities and Exchange Commission of Pakistan (SECP) to create an enabling framework for new financial products/structures is a positive step.

However, in the ongoing consolidation process in the financial sector, the tendency of NBFIs to merge their operations with commercial banks, has significant bearing on the dynamics of the industry. Banks have adequate liquidity, capital, human resources and organizational infrastructure, and most importantly, profitability, in comparison to NBFIs. By directly competing with NBFIs in providing financial services that were traditionally within the domain of the latter, banks have squeezed the revenue streams for the non-bank financial sector. With the ongoing M&As of viable NBFIs with banks, the ability of the non-bank financial sector to withstand competition from the banking sector would be further constrained.

NBFCs and modarabas have also suffered from a dearth of funding sources and high reliance on borrowings. It is essential to enable these institutions to diversify funding avenues at a lower cost of funds. This may be possible through providing flexibility in accepting deposits, generating long term and overnight borrowings from the money market and development of attractive corporate debt instruments.

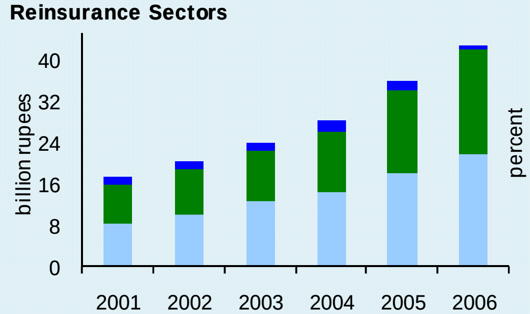
On the regulatory side, risk management of NBFCs and modarabas merits attention. Major differences in the regulatory approach towards banks and NBFIs can lead to regulatory arbitrage, which can pose challenges to financial sector stability. A risk-based approach to oversight and effective enforcement of laws is particularly important in the case of deposit-taking institutions, to avoid the social implications of excessive risk-taking and poor performance. In the absence of a financial safety net framework and insolvency regime in Pakistan – to provide for an orderly exit of institutions that have become inoperative, unprofitable or illiquid – protecting depositors' interest is a paramount issue.

3. Insurance Penetration

The role of the insurance sector is significant in promoting the stability, not just of the financial sector, but also of the overall macroeconomic environment as it provides protection against uncertainty to economic agents by an equitable transfer of risk. Life insurance companies in particular, due to the long-term nature of their premiums, are also among the large institutional investors for capital and money market instruments.

The insurance sector in Pakistan, consisting of life, non-life and the sole reinsurance company (PRCL), has seen considerable improvements since CY01 on account of rise in the demand for insurance by corporate, households and public sector entities. However, with two-thirds of the population living in rural areas and low per capita income, the insurance sector faces various hurdles in its growth and its share in the assets of the financial system of the country was 4.1 percent in CY06 (**Figure 18**). Pakistan's share in the US $3.42 trillion global insurance industry stands at a meager 0.03 percent which is much lower than other

Figure 18: Net Premiums of Insurance and Reinsurance Sectors



Source: Annual Audited Accounts

countries in the region, such as India's 0.73 percent and China's 1.76 percent. Furthermore, the insurance penetration in Pakistan was 0.8 due to which it is ranked number 82 in the world (*details in Chapter 10, Risk Analysis of the Insurance Sector*).

The ownership structure of the insurance industry is in sharp contrast to the private sector-led nature of the rest of the financial sector. The insurance industry, comprising of 53 companies, is largely owned and operated by government-based entities. However, private sector entities in both the life and non-life insurance sector have a dominating share of the insurance business, with an 86.7 percent share of total premiums of the industry. Despite fewer companies in the life insurance sector, it accounted for 67 percent of total insurance assets in CY06. Concentration of business among the top 10 players, though still high, has reduced by 9.0 percentage points in CY06, from 91.6 percent of gross premiums in CY05 to 82.6 percent in CY06.

The growth in insurance sector is reflected in the increase in premiums and profitability, as well as assets for both life and non-life insurance. Private sector companies have launched innovative products in the recent past, such as livestock and crop insurance, which will help promote the quality of banks' lending to the agriculture sector.

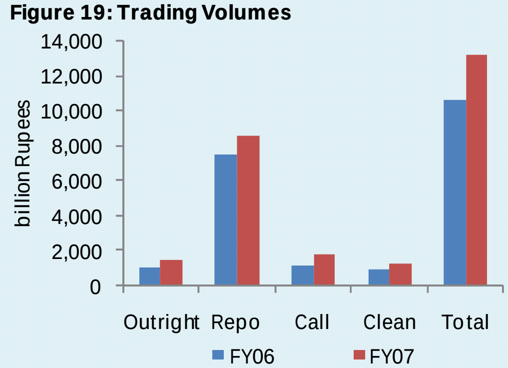
The low insurance penetration highlights the need for concerted efforts to bring about reforms that would increase the competitiveness and outreach of Pakistan's insurance industry. As a step in this direction, Insurance Ordinance 2000 has laid out targets that will help the expansion of the industry in the coming years, for instance, the recent increase in capital requirements will result in the emergence of stronger players in the industry. Appointment of the Insurance Ombudsman is another measure which would also go a long way in boosting the confidence of the public by settling complaints expeditiously. Other insurance sector reforms envision the privatisation of State Life Insurance Corporation (SLIC), the largest state-owned operator in the life insurance sector. Moreover, Postal Life insurance is planned to be brought under the ambit of the Insurance Ordinance 2000. Foreign investment rules in the insurance sector have also been amended in order to attract FDI in the sector. In particular the Government has allowed 100 percent foreign equity in the insurance sector subject to a few minimum conditions.

4. Financial Markets

Efficiencies of deep, liquid and open financial markets are a vital source of stability in the financial system. Financial markets in Pakistan comprise of fairly developed money market, foreign exchange market and capital markets, while the derivative market is still in a nascent stage of development.

The ***money market*** in Pakistan has developed substantially since the process of liberalization of the financial system began in the early 1990s. A vibrant inter-bank money market not only helps to transmit monetary policy signals but also provides stability to financial institutions through meeting short-term liquidity requirement with relative ease and at competitive rates.

Figure 19: Trading Volumes



Source: DMMD, SBP

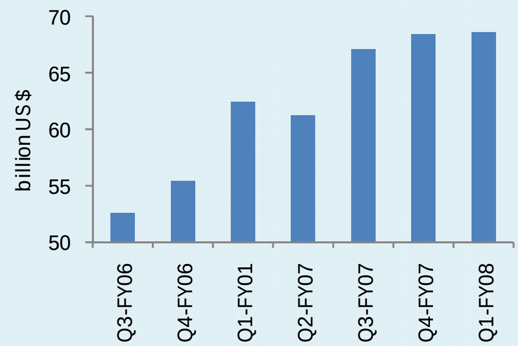
As shown in **Figure 19**, the trading volumes in the interbank money market increased by 23.9 percent during FY07. This primarily reflects the increasing depth of the money market. The scope and range of activities has also increased as all the components of money market—namely; outright, repo, call and clean—showed sizeable increase during FY07. In particular, the outright market for government securities has shown an increase of over 38 percent. In addition, uncollateralized markets have effectively complimented the collateralized market to meet the funding requirements of the financial system without jeopardizing its stability.

An important development of FY07 was the extension of the yield curve to 30 years, with the floatation of Pakistan Investment Bonds (PIBs) of 30 year tenor in December FY07. While developing the longer-end of the yield curve – whose slope has flattened substantially in the last few years (**Figure 20**) due to relative inactivity in the issuance of long-term sovereign bonds – this has essentially served to provide benchmark interest rates over a range of tenors, i.e. from 3-months to 30 years. Having this array of sovereign benchmarks is imperative for the pricing of commercial debt instruments for different segments of the economy with varying funding requirements, with activities ranging from working capital loans to mortgage / infrastructure financing. Furthermore, this helps the transmission mechanism of monetary policy through the provision of an extended term structure of interest rates.

Figure 20: Slope of Yield Curve

Source: PKRV, Rueters

Figure 21: FX Volumes



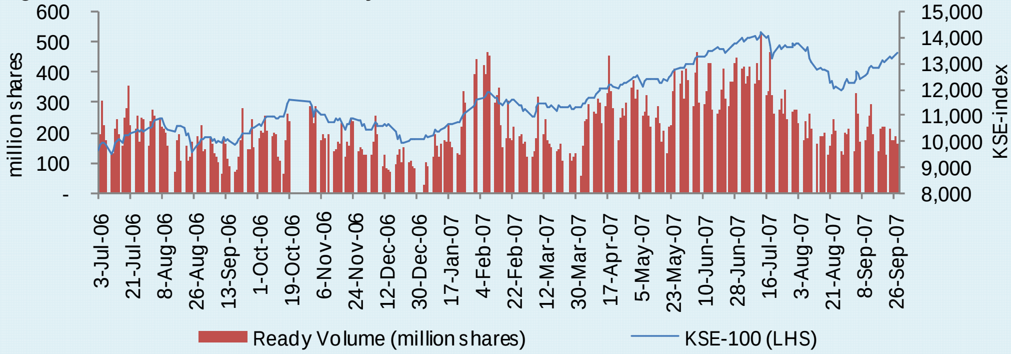
Source: FSCD, SBP

Continued strong economic activities along with increasing foreign exchange inflows supported the increased volume of transactions in the ***foreign exchange market*** in FY07. The quarterly volume of transactions reached US$ 82.5 billion in Q1-CY07 against US$ 65.3 billion in Q3-CY06, indicating a growth of 26.2 percent (**Figure 21**). In other words, daily average volume increased to over US$ 1.0 billion during Q1-CY07. The volume of transactions in the interbank FX-market also witnessed similar changes, reaching over US$ 25.0 billion in Q1-CY07, with an increase of US$ 5.3 billion during the same quarter last year. Strong inflows even led to a slight appreciation of the nominal exchange rate during H2-FY07 despite increased current account deficit over the same period. The ***Foreign exchange market pressure index (FEMPI)*** constructed by taking into account foreign exchange reserves, bilateral changes in the exchange rate and interest rates, also indicates relative stability in the FX market (*details in Chapter 7, Financial Markets*).

Capital markets continued to perform well during FY07, with market capitalization at Rs. 4.0 trillion by the end of the year, and the KSE-100 index at 13,772 points, a historically high level depicting a growth of 38 percent over FY06 (**Figure 22**). The salient feature of the year was the volume of capital inflows, and of foreign investment in the equity market. Equity investments routed through SCRA in FY07 showed an impressive increase of 178 percent over FY06. Foreign participation as measured by SCRA flows reached a level of 6.8 percent of the market capitalization level in FY07. KSE was one of the best performing markets in the region, and with a projected P/E ratio at 11.8x,[7] it continues to trade at a discount in comparison with regional economies (average P/E at 15.1x), which is a reflection of its growth potential. Its dividend yield is one of the highest in the region, and it is also one

[7] Expected earnings in FY07.

Figure 22: KSE-100 Index and Ready Volumes



Source: Karachi Stock Exchange

of the most liquid markets, as signified by the average daily turnover of 211 million shares in FY07, despite the decline since FY06 when the average daily turnover was 320 million shares.

Despite the many positive features detailed above, there are factors which raise concerns and need to be addressed. Specifically, trading in the market is concentrated in a few sectors, the CFS mechanism continues to be the mainstay of leveraged positions and is susceptible to manipulation by the brokers, and the volume of financing raised from both the equity and the corporate debt market remains low. Both corporate governance and risk management measures, being implemented by the regulator, will help in minimizing market distortions and instilling depth in the functioning of the market.

Table 6: Recent GDRs Issued

Amount in USD Millions, Numbers in Millions

			No. of Issuances		Conversion upto Oct 2007	
	Issuance Date	**Amount Raised**	**GDRs**	**Ordinary shares***	**GDRs**	**Ordinary shares***
MCB	Oct-06	150	8.6	34.5	4.6	18.5
OGDCL**	Dec-06	738	39.1	390.6	33.0	329.7
UBL	Jun-07	650	50.6	202.3	11.8	47.2

*against GDRs

** GDR re-issuance totaled to 14.8 million of ordinary shares till October 2007

Source: Local custodian banks

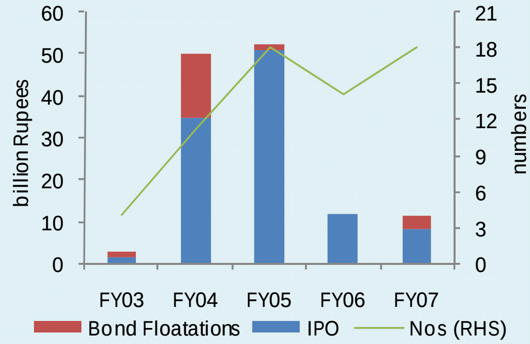
Recently, there has been a renewed trend to raise funds and to privatize public-sector entities by the issuance of GDRs. Pakistan saw a revival of GDR issuances during 2006-07 and so far MCB, Oil and Gas Development Corporation Limited (OGDC) and United Bank Limited (UBL) have successfully launched GDRs (**Table 6**) amounting to a total of US$1.5 billion at the London Stock Exchange (details in *Special Section: GDR Issuances*).

As mentioned earlier, the ***Derivatives market*** is still in its early stages of developments. Under the Financial Derivates Business Regulations (FDBR) issued by the SBP, the institutions authorized to deal in the derivates markets are allowed to undertake three types of transactions including Interest Rate Swaps (IRS), Foreign Exchange Options and Forward Rate Agreement (FRAs). The outstanding volume of derivative transactions reached Rs 337.7 billion during FY07 in comparison with Rs 115.5 billion in FY06.

5. Financial Sector Diversification

Given the over-dependence on the banking sector for meeting the financing needs of the economy, the need for financial diversification in the form of developing an active debt market in the financial sector, is stronger than ever. Apart from the gradual development of the local currency bond market, new listings in the equity market also remain low (**Figure 23**), and the growth in recent years has largely emanated from an enhanced volume of trading in a limited number of scrips. This concentration also brings forth concerns for the development of efficient and deep capital markets in the economy. *Thematic Article 3 - Need for Financial Diversification: Development of a Debt Market in Pakistan* examines the reasons for the slow growth in the corporate debt market and points to the need for a regular supply of long-term sovereign bonds as a pre-requisite for this development. As the central bank plays its role in strengthening the monetary policy transmission mechanism, and improving secondary market activity, market psyche also has a major role to play in taking the focus away from the short-end horizon towards taking initiatives to promote the long-end of the yield curve. Effective development of the term structure of interest rates will ensure the requisite commitment from both the issuer and the investor, and is another significant pre-requisite for the development of the debt market. In addition, improved liquidity, efficiency of the price discovery mechanism and a broader investor base would make it easier for new companies to raise longer term risk-capital from the capital market and reduce their reliance on conventional lenders like banks. By following improved governance practices, for instance a high level of disclosure, listed companies should be able to get better terms from lenders than similar unlisted companies.

Figure 23: IPOs and Floatations in KSE



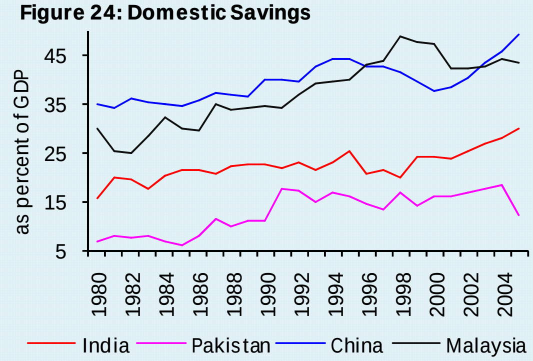
Source: Karachi Stock Exchange

In recognition of these risks and challenges, both the regulators and the stakeholders are working towards a more strengthened mechanism of financial sector development which addresses these concerns.

6. Financial Savings

While Asia is awash with liquidity which finances the developed world's financial imbalances, Pakistan continues to be categorized among the low savers of the world. Historically, the highest national savings rate has been much lower than regional peers, some at the same income level (**Figure 24**). This points to the need to acknowledge the paucity of savings instruments that an individual has access to, which in turn is possibly one of the strong reasons for the informal savings channel to thrive. *Thematic article 4, Trends in Financial Savings* assesses the reason for a low savings rate in the country, and suggests that the financial system now needs to focus on providing innovative liability products to give the investor and saver various options to choose from, according to his own risk/return preference. The role of Private Pension Schemes is particularly important as an incentive to smooth out consumption patterns over the life-cycle, by providing a forced saving mechanism aimed at overall social security.

Figure 24: Domestic Savings



Source: World Development Indicators, World Bank

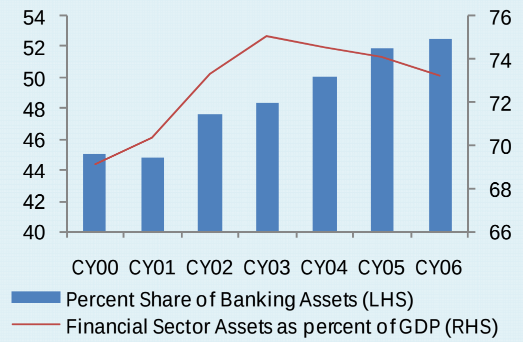
7. Payment and Settlement Systems

The payment and settlement system in Pakistan has witnessed substantial changes in recent years (*details in Chapter 12: Payment and Settlement System*). The role of electronic transactions and related infrastructure is strengthening with the passage of time. Although increasing, but small share of electronic transactions in overall retail transactions signifies the room for future developments in the payment and settlement system. SBP is in the process of implementing the Real Time Gross Settlement system namely "Pakistan Real-time Interbank Settlement Mechanism' (PRISM) in order to automate large value interbank transactions. This system will help in minimizing the risks associated with inter-bank transactions due to the time lag involved in settlement.

Conclusion: A word on Financial Depth

Pakistan's bank-based financial system is largely attributed to the rapid development of the banking sector in comparison with capital markets, as is usually the case in emerging economies. The Karachi Stock Exchange has made tremendous gains in the last five years, so much so that it is now considered to be a lucrative emerging market investment option by investors around the globe. However, the volume of financing raised from the stock market or the corporate debt market remains small despite these gains. Banks, which have continued to perform exceedingly well and have yielded above-average returns (particularly from CY04-CY06) in a de-regulated, market-based environment, continue to meet the financing needs of a rapidly growing economy but still have substantial room to improve the efficiency of financial intermediation. Furthermore, despite concerted efforts of the banks in extending outreach of financial services and the rapid expansion in bank credit in the last few years, financial depth and penetration, still has substantial room for growth (**Table 7**). This is also evidenced by the size of the financial sector as percent of GDP (**Figure 25**).

Figure 25: Assets of Banking Sector



Source: SBP Calculations

Table 7: Indicators of Financial Deepening

Percent

Indicators	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
M2 to GDP	36.7	36.0	37.4	36.2	36.6	36.2	39.6	42.6	44.1	45.6	45.0	46.7
Money multiplier	3.0	3.2	3.3	3.2	2.8	2.9	3.0	3.1	3.2	3.3	3.4	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	26.1
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	20.7
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	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	61.0
CPS to GDP*	17.1	17.3	18.3	19.1	18.1	17.8	18.0	19.9	22.6	26.3	27.8	28.5

*: CPS = Credit to private sector

Source: SBP Calculations

Whereas the existence of a two-way causal relationship between finance and economic growth is now well beyond debate, there is still an argument on which type of structure of the financial sector is most appropriate for economic growth – market-based or bank-based. However, in the context of developing countries, increasing the financial depth is more important than the concern about whether the financial system is bank-based or market-based. Financial depth is the core feature for building and maintaining financial stability. As markets and banks continue to develop and move forward, what really matters is increased total depth, from which efficiency gains are also perceived to increase.[8]

[8] "Financial Services View", propagated by Ross Levine (2001)