

## Special Section: Trends in Financial Savings

---

### Introduction

National Savings represent a key determinant of long-term investment prospects of a country, and play a crucial role in the economic growth and development of an economy. Pakistan has generally been classified among those countries which are characterized by a low savings rate: the highest ever savings rate of 21.3 percent in FY72 is still much lower than its regional counterparts with a similar level of income. Various factors, such as the continued budgetary deficit sustained by the government sector, consumption-oriented behavior of the household sector, high inflation since FY05 which has reduced the real rate of return on savings, and limited availability of long-term savings options and instruments are some of the major contributory factors towards this trend. The existing savings instruments, other than deposits of the banking sector, such as mutual funds, pension funds etc. are still evolving and have not yet generated sufficient resources to meet the domestic investment needs. Giving the importance of savings for the growth of an economy, there is a need for more attractive savings instruments for both investors and savers that provide various options to investors according to their risk/return preferences.

Financial savings, a component of national savings, continues to be small, in addition to varying considerably from years to year. Specifically, while the average national savings rate during FY00-08 was 17.5 percent, the average financial savings rate was only 6.6 percent. It has declined to a minimum of 3.6 percent in FY08 from a maximum of 10.0 percent in FY03 (**Table 1**). A substantially low rate of financial savings in overall national savings indicates the extent of the non-documented and informal sector of the economy, as an average 37.9 percent of national savings go through the process of financial intermediation.

The components of financial savings indicate that deposits of the scheduled banks constituted 54.5 percent of financial savings during FY00-08, followed by funds mobilized through national savings schemes, cash balances of the private sector (currency in circulation) and funds mobilized by the NBFIs. These components of the financial savings clearly reflect the dominance of the banking system in the overall financial sector.

The lowest financial savings rate during FY08 since FY00 is attributable to a number of factors including increased uncertainty due to prolonged political transition and sharp deterioration of the macroeconomic environment. Specifically, visible slowdown in economic growth and strong inflationary pressures in the economy contributed to low financial savings. Despite low interest rate elasticity of scheduled bank deposits, high degree of negative real lending rate is also expected to be a contributory factor. Supply side factors such as the decline in income and increased expenditures also reduced surplus funds with the household sector.

The rest of this section reviews the performance of saving instruments in Pakistan and factors affecting savings in the economy.

### National Savings: Stylized Facts

Before looking into trends in savings, it is instructive to understand the calculation of savings rate in Pakistan. The total savings reported in National Accounts are indirectly calculated on the basis of investment activities during the year. Total investment (total gross fixed investment and changes in stocks) is estimated by using information from periodic surveys and several other sources. A number of technical mechanisms involving various assumptions related to the valuation of assets are also used for the calculation of total investment. Finally, the estimated total investment is equated to the total savings in National Accounts data. This simply means that investment activities taking place in the economy during a specific period are financed from

savings in the economy (domestic savings) and/or borrowing from abroad (foreign savings). This implies that if national savings are greater than total investment, there will be net external resource outflow in the form of accumulated foreign exchange reserves of the country and vice versa. Moreover, in this case domestic savings will be higher than the national savings. It may also be noted that national savings will be higher than financial savings as the former include savings of the non-monetized sector of the economy (like agriculture and non-listed companies).

**Table 1: Trends and Structure in Financial Savings**

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
<i>billion Rupees</i>									
<b>Accumulated Savings (Stock)</b>	2,329	2,511	2,771	3,252	3,690	4,183	4,686	5,477	5,858
Deposits of Scheduled Banks	1,135	1,264	1,411	1,671	1,975	2,405	2,772	3,310	3,436
Investments in NSS	715	762	847	982	984	940	934	1,000	1,091
Currency in Circulation	355	374	434	494	578	666	739	839	982
Deposits of NBFIs	91	80	41	40	47	48	61	10	1
Mutual Funds	13	12	19	45	85	103	135	274	306
GP Fund	19	18	19	20	22	22	44	43	43
<i>Accumulated Savings(growth in percent)</i>									
<b>Accumulated Savings (Stock)</b>	8.5	7.8	10.3	17.4	13.5	13.4	12	16.9	6.9
Deposits of Scheduled Banks	2.4	11.4	11.6	18.4	18.2	21.8	15.3	19.4	3.8
Investments in NSS	14.7	6.5	11.1	16	0.2	-4.5	-0.6	7.1	9
Currency in Circulation	23.8	5.3	15.8	14	16.9	15.1	11.1	13.4	17
Deposits of NBFIs	-12.5	-12.3	-48.6	-2.2	16.2	3.4	26	-83.6	-86.2
Mutual Funds	107.2	-5.9	56.7	132.1	88.1	21.6	31.2	103.1	11.5
GP Fund	13.9	-2	1.2	5.3	9.9	1	103.9	-2.6	-1.9
<i>Accumulated Savings( percent of GDP)</i>									
<b>Accumulated Savings (Stock)</b>	61.39	60.33	62.95	67.44	65.42	64.36	61.7	63	55.9
Deposits of Scheduled Banks	29.93	30.38	32.07	34.64	35.01	37	36.5	38	32.79
Investments in NSS	18.85	18.3	19.23	20.37	17.45	14.46	12.3	11.5	10.41
Currency in Circulation	9.37	8.99	9.85	10.25	10.25	10.24	9.74	9.6	9.37
Deposits of NBFIs	2.4	1.92	0.93	0.83	0.83	0.74	0.8	0.1	0.01
Mutual Funds	0.35	0.3	0.44	0.93	1.5	1.58	1.78	3.2	2.92
GP Fund	0.5	0.44	0.42	0.41	0.38	0.34	0.59	0.5	0.41
<i>Flows as percent of GDP</i>									
National Savings	16.5	16.5	18.6	20.8	17.9	17.5	18.2	17.8	13.9
Domestic Savings	16.93	17.78	18.1	17.63	15.7	15.4	15.3	16.1	11.7
Financial Savings (Flows)	4.8	4.38	5.9	9.98	7.76	7.59	6.61	9.1	3.63
Deposits of Scheduled Banks	0.69	3.1	3.34	5.37	5.39	6.61	4.83	6.2	1.19
Investments in NSS	2.41	1.12	1.93	2.82	0.03	-0.68	-0.08	0.8	0.86
Currency in Circulation	1.8	0.46	1.34	1.26	1.48	1.35	0.97	1.1	1.36
Deposits of NBFIs	-0.34	-0.27	-0.88	-0.02	0.11	0.02	0.16	-0.6	-0.08
Mutual Funds	0.18	-0.02	0.16	0.53	0.7	0.28	0.42	1.6	0.3
GP Fund	0.06	-0.01	0	0.02	0.03	0	0.3	-0.01	-0.01

Source: Statistics' Bulletin and Annual Reports of SBP

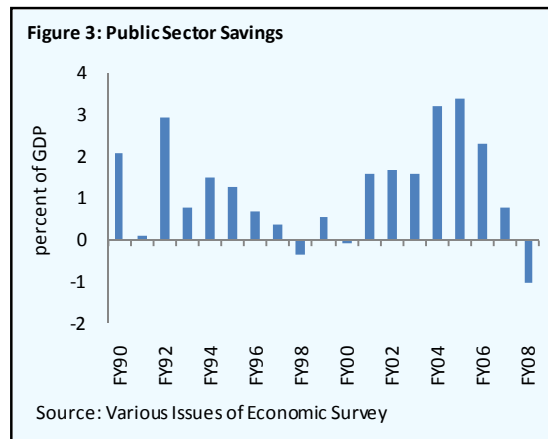
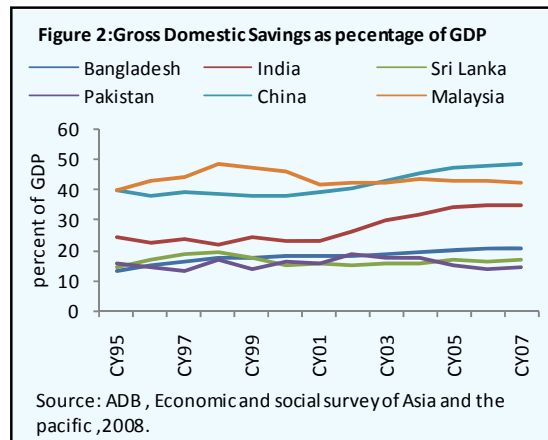
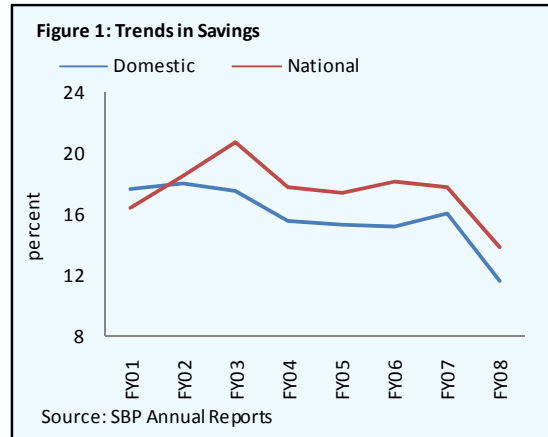
Looking at data reveals that the national savings rate, which reached 20.8 percent during FY03, has steadily dipped to 13.9 percent in FY08: the lowest rate since FY01 (**Figure 1**). Specifically, FY08 witnessed a steep decline of 390 bps in savings rate as compared to FY07. This sharp

decline in savings rate is largely attributed to slowdown in economic activities (achieving lower than targeted GDP growth of 5.8 percent in FY08--largely consumption led growth) and prevalent higher inflationary pressures in the economy. The prolonged political transition, energy crises and deteriorating law and order situation of the economy also contributed to lower savings rate. The low and decline savings rate in the presence of limited availability of foreign resources have emerged as a major constraint on sustaining healthy GDP growth in recent past.

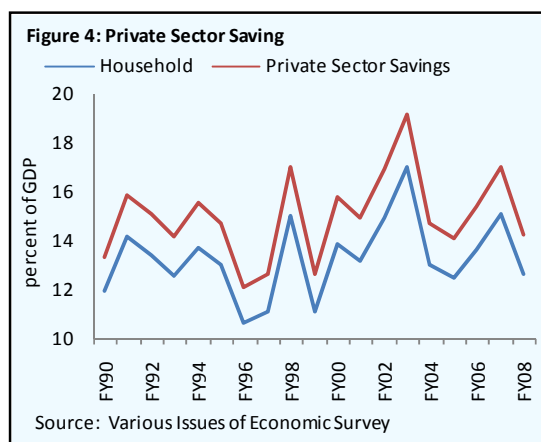
Regional comparison also shows that Pakistan's saving rate, since FY05 onwards, remained lowest viz-a-viz its regional counterparts and other emerging economies (Figure 2). Pakistan is even behind Sri Lanka in term of saving rate since CY05-2007. While the level of financial development in Pakistan is relatively better as compared to the regional countries, the low saving rate clearly reflects that consumption oriented behavior of the consumers.

**Components of savings**

National Savings are broadly classified into public sector and private sector savings. In Pakistan, the role of public sector, in term of its contribution to national savings remains minimal. Its average contribution of around 1.0 percent registered during the 1990s inched up marginally to 1.5 percent during the period FY00-08 (Figure 3). Public savings saw a rising trend since the start of FY01, which continued till FY05 to reach 3.4 percent (highest since FY90), however in the latter period it started declining sharply and turned into negative in FY08 (Figure 3). Low and volatile behavior of public sector reflect its weak financial performance. Specifically, while the consolidated position of fiscal operation generally indicate the presence of revenue deficit (gap between current expenditure and total revenue), most of the public sector enterprises also record losses. The sharp increase in public sector savings during FY02-FY06 was primarily attributed to revenue surpluses of the government and improving position of public sector enterprises in the wake of strong economic growth. Sharp increase in revenue deficit during FY08 and the emergence of circular debt among the public sector enterprises contributed to negative savings of the public sector.



Like public sector savings, considerable variability in private sector savings is also visible from **Figure 4**. However, the average savings rate of public sector is 13.3 percent during FY90-08 compared to 1.7 percent of the public sector over the same period. This reflects the structure of the economy, which is primarily controlled by the private sector. **Figure 4** also shows that the household sector is the primary source of private sector savings as the gap between private and household savings indicates the position of corporate sector savings. Specifically, the share of household sector savings in private sector savings is near 90.0 percent. The cyclical pattern in the household savings is attributable to number of factors including:



- Cyclical and occasional fluctuations in income from the agricultural-based segment of the economy, which still contributes around 20.0 percent to the GDP.
- It is generally observed that households increase their debt in case of negative income shock especially in rural areas. This behavior contributes to fluctuations in the overall savings in the economy.

Looking at data, household savings rate, which had reached to above 17.0 percent in FY03 subsequently dropped to 12.6 percent in FY08. The sharp decline in the household savings can be attributed to the erosion of household's purchasing power due to prevailing high inflationary pressures in the economy, rising cost of living, slowdown in economic activities.

Compared to household sector, the corporate savings rate remained low and relatively stable (fluctuated 1.4 and 2.2 percent) during FY90-08. Following trends in other sources of savings, the corporate saving rate also saw a decline of 32 bps during FY08 to reach 1.6 percent. This decline is largely the outcome of rising cost of production in the wake of increased cost of raw material. Specifically, hike in commodity prices across the world, pressure on wage increase due to high domestic inflation, increase in financial cost due to steady rise in lending rates, rising cost of energy inputs in the wake of all time high prices of oil, increased usage of oil due to acute shortage of electricity, and increased expense on security measures due poor law and order in the economy. In addition to that more dividend payouts are being witnessed by the corporate sector, in the last couple of years that has also impacted the corporate savings.

Given the overall position of National savings in the economy during FY08, the rest of this section discusses trends in financial savings. As mentioned earlier that financial savings are subset of national savings, the changes in the former will be effected by the developments in overall economy, not just the performance of the financial institutions. Importantly, these changes have considerable implications for the performance and stability of the financial institutions, which are in business of linking potential savors to the investors.

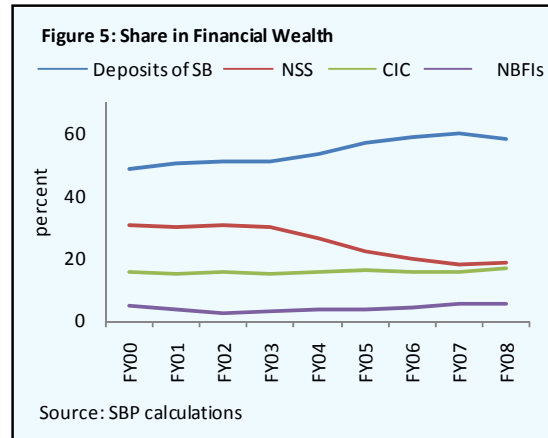
### Financial Savings

For the purpose of analysis, financial savings include bank deposits, investments in National Saving Schemes (NSS), currency in circulation (CIC), deposits of NBFIs, investment in mutual funds and General Provident Fund (GPF). The accumulated financial savings (or financial wealth) has

reached Rs.5.9 trillion with YoY growth of 6.9 percent during FY08, which is visibly lower than the increase of 16.9 percent during FY07. In absolute term, net increase in financial wealth of Rs 380.3 billion during FY08 is almost half of Rs 791.6 billion realized during FY07 (Table 1). Before looking into the factors responsible for this massive decline, a review of major components of financial savings will be instructive.

### Scheduled Bank deposits

Figure 5 clearly shows that deposits held by the scheduled banks constitute around 60 percent of financial savings. Specifically, the share of deposits in financial wealth has steadily increased from 48.8 percent in FY00 to 58.7 percent by end FY08. This increase primarily reflects the strong performance of the banking sector over the same period, which registered compound annual average deposit growth of 16.5 percent during FY00-FY07, and even higher during FY03-07. Strong deposit growth was largely facilitated by increased inflow of home remittances, increasing income due to surge in economic activities, especially during FY03-07.<sup>1</sup> An important point to note is the lower deposit rates (negative in real terms) prevailed over the same period and steady rise in the share of non-remunerative deposits. It implies that strong deposit growth largely contributed by supply side factors namely rise in domestic income and increased monitoring of funds transfer at international level.



Compared to strong deposit growth during FY03-07, there is visible slow down in deposit growth during FY08. As a result, the share of financial savings mobilized by the scheduled bank declined to 58.7 percent by end FY08 compared with 60.4 percent in FY07. This deceleration is largely attributable to slow down in overall economic activities and increase in nominal consumption on account of strong inflationary pressures. The increased extent of negative real deposit rates (despite the introduction of minimum floor on deposits 5 percent in June 2008) on account of high inflationary pressures also contributed to low deposit growths.

### National Savings Schemes of CDNS

Next to scheduled banks is the CDNS, which has mobilized financial savings of Rs 1.1 trillion by end FY08. However, its share in accumulated financial savings have witnessed steady decline during FY03-FY07 before recording a marginal increase of 36 bps during FY08 to reach 18.6 percent (Figure 5). Slowdown in savings mobilized through NSS, especially during FY04-06 was largely attributed to: (1) the bar on institutional investment in NSS as a part of reform process; (2) low accessibility due to disallowing sales of various certificates through commercial bank; and (3) reduced profit margins between NSS and other financial instruments due to linkage of profit rates to market based PIBs rates. Investments in the NSS's registered growths of 7.1 percent and 9.3 percent during FY07 and FY08 respectively, compared with average negative growth of 1.6 percent during FY04-06. This reemergence of growth in NSS is largely attributable to the lifting of

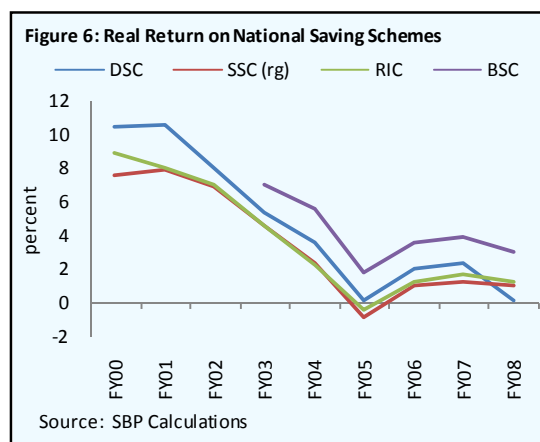
<sup>1</sup> Average GDP growth during FY03-07 was 6.9 percent compared to the long term trend growth of 5.0 percent. Similarly, the home remittances picked up increasing trend since 2001 and reached US\$ 6.5 billion during FY08 compared with only US\$ 1.1 billion during FY01.

bar on institutional investments in NSS schemes in October 2006, and upward revision in the rates on various NSS schemes<sup>2</sup>

The above NSS were introduced by the government to both encourage savings in the economy and to finance its budgetary deficit. The CDNS, an attached department to the Ministry of Finance, offers various savings schemes which include number of long-term bonds/certificates, deposit facilities etc. Given the range of benefits attached with these saving instruments, like risk free investments, tax incentives, consistent income stream and relatively high interest rates etc, it remained very popular among senior citizens, widows, pensioners and general public. However, the growth of investments in the NSS remained hampered low especially during FY03-06 due to above mentioned factors. Following the negative impact of these developments on NSS growth and increased government borrowing requirements due to widening fiscal deficit, the government revisited some to its earlier measures. As a result, ban on institutional investment has been withdrawn (except banks and insurance companies) and sale of certificates through commercial banks is allowed. Furthermore, government has also raised the rate of return on various NSS schemes. As a result of these positive measures, investment in NSS schemes has picked up during FY07 & FY08. Although government has increased profit rates on various schemes in June and October 2008, prevalent high inflationary pressures in the economy may restraint mobilizations through these schemes. For instance the inflation adjusted rates (real interest rate) on several NSS instruments are only between the ranges of 0.2 to 3.0 percent against the nominal rates upto 15 percent (**Figure 6**).

### Currency in Circulation

Currency in Circulation (CIC) remained the third largest component of financial savings (see Figure 4.5). Unlike deposits and the scheduled banks and investments in NSS, its share in accumulated financial savings has witnessed relatively lower changes since FY00. This implies that YoY growth in CIC generally remained near to the growth of the accumulated financial savings. Specifically, the average growth in CIC during FY01-07 was 13.1 percent, while the accumulated savings recorded an increase of 13.0 percent over the same period. The FY08 is the exception to this trend as CIC grew by 17.0 percent compared



with 6.9 percent growth in accumulated savings. This massive increase in CIC is largely the outcome of exceptionally high government borrowings from the SBP which grew at a faster pace for financing burgeoning fiscal deficit. In addition, prevalent high inflationary pressures in the economy also increased the cash holding requirements of household to finance higher consumption expenditures.

### Savings Mobilized by the NBFIs

Financial saving generating through NBFIs is rising steadily since FY02, the share of which has rose to 5.2 percent in FY08 from 2.18 percent in FY02. It is imperative to mention here that the financial saving of NBFIs is largely the outcome of buoyant growth in mutual funds industry. Excluding mutual fund, the share of NBFIs deposits drops to 0.02 percent only in FY08. These

<sup>2</sup> Profit rate on various NSS were revised upwards with effect from 1<sup>st</sup> Jul 2006, 23<sup>rd</sup> June 2007. The profit rates have been further increased with effect from 24<sup>th</sup> June 2008 and 1<sup>st</sup> October 2008.

shifting patterns in the shares of various instruments are the result of a host of factors, which are discussed below.

- The phenomenal rise in mutual fund share (above 5 percent) since FY07 onward is largely due to the robust performance of financial markets, especially equity and money markets. As a result, high profits are being reported by mutual fund industry since FY07 onward, which has around 20 new mutual funds into this industry.
- Consistent declining share of NBFIs deposits is largely the outcome of host of factors which include on-going mergers and acquisitions of NBFIs with the commercial banks, weak resource mobilization activities in the presence of credit line for select NBFIs, higher interest rates, and stiff competition from commercial banks.

### Contractual Savings:

In Pakistan, several occupational savings and pension schemes are being offered by both private and public sector employers (**Box 1**). These schemes exist predominately for government employees whereas the existing schemes for the private sector are not sufficient to support the future regular income needs. However, private sector has great potential of savings as a large proportion of labor force is working as self employed or in unorganized sectors. There is a dire need to untapped this potential class. In this direction, effective development of private pension schemes and well regulated environment for the private sector will not only provide after retirement secure benefits to general masses but also help mobilize long term savings that could serve as an additional funds for financing large infrastructure development projects and help reduce the government burden on social welfare expenditures.

#### Box: 1 Existing Occupational Saving and Pensions Schemes in Pakistan:

##### a) Schemes for Government Employee

- Civil Services Pension Schemes:
- General Provident Fund (GPF)
- Gratuity Scheme

##### b) Schemes for Private Sector Employees

- Employees Old Age Benefit Institution (EOBI)
- Provident Fund Schemes
- Gratuity Schemes
- Pension (Superannuation) Schemes

### Progress on Pension Funds

Keeping in view the welfare aspects and potential hidden in occupation savings or pension schemes, the government initiated reform process during 2001 to develop a regulatory framework for both public and private occupational saving and pension system and announced tax incentives for investments into these pension schemes. Further, SECP in January 2005 has designed a necessary formwork called Voluntary Pension System (VPS), the legal framework of which has been notified under the VPS Rules 2005.<sup>3</sup> Under this VPS, SECP has granted license to four asset management companies that would act as a Pension Fund Manager and are eligible to offer Voluntary pension funds under VPS Rules. So far seven pension funds have been registered which include four Islamic and three conventional pension funds.<sup>4</sup>

Being new entrants, a detailed performance review of these funds is not feasible; however some preliminary information is available to reflect their financial performance. During first year of operation (i.e. FY08), size of private pension funds industry has reached Rs 778.4 million. Asset composition of the pension funds shows that around 96 percent of total assets are currently placed in the form of investments and cash/deposits (**Figure 7**). Investment activities of the

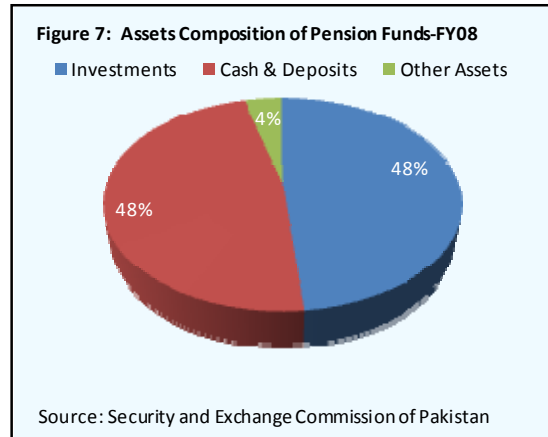
<sup>3</sup> See Box4.2 of FSR 2006 for characteristics of the VPS 2005. In addition to that important back ground information on this topic has also been discussed in chapter 4 of FSR2006.

<sup>4</sup> The four Islamic funds are Meezan Tahaffuz Pension Fund, Pakistan Islamic Pension Fund, Atlas Pension Islamic Fund and JS Islamic Pension Savings Fund. Three conventional funds include Pakistan Pension Fund, Atlas Pension Fund and JS Pensions Savings Fund.



pension funds are according to the investment policy as prescribed by SECP under VPA Rules, 2005, where these funds have been allowed to invest in various types of eligible funds. Therefore, investments of these pension fund is largely concentrated in three types of funds namely Equity Sub-fund, Debt Sub-Fund and Money Market Sub-Fund.<sup>5</sup> The shares of these funds in total investments are 52.3 percent, 25.7 percent and 22 percent, respectively. On liabilities side, these investments are largely financed by seed capital contributed by pension fund managers which constituted 91.5 percent of total contribution. The contribution from the employer and employees/individuals remained yet to accumulate. At the end of FY08, pension fund also recorded Rs 28.2 million as net investment income and Rs 14.8 million as operating expense.

The asset size of the private pension funds and the recent introduction of VPS by SECP indicate that these developments are still at an early stage of development. In order to encourage privately managed pension schemes such as VPS, there is a need to focus on the implementation of financial education programs meant to increase the knowledge and awareness of the young population on issues related to financing their future stream of income under these pension plans and to improve literacy of overall financial issues. The other determinants of expansion in coverage are strong and balanced economic growth and consistent tax incentives over the coming years. Going forward, the role of SECP, private fund managers, social organizations and the media would remain crucial in driving pension fund reforms.



<sup>5</sup> Equity Sub-Fund Invested in Listed shares, Debt Sub-Fund Invested in debt securities, maximum weighted average duration of the fund is 10 years. Money Market Sub-Fund Invested in debt securities. maximum weighted average duration of the fund is 10 years