5 ISSUES IN SECTORAL ALLOCATION OF CREDIT

Sectoral distribution of bank credit is highly skewed towards the manufacturing sector with a share of 43.7 percent in the overall advances of the banking sector. Within the manufacturing sector, the textile industry is the prime user of bank credit. Other industries, the agriculture sector and SMEs continue to have low penetration. This trend is also evident from the low credit to GDP ratio. A detailed analysis suggests that both supply and demand side factors impede the flow of funds to these sectors. Supply side factors include limited institutional capacity, gradual development of appropriate financing products and adequate delivery channels, and the need to strengthen banks' credit monitoring systems. On the other hand, factors such as the non-availability of collateral due to unclear titling (especially in agriculture/rural areas) and absence of proper book-keeping in the SME sector are also some of the contributory factors in limiting credit activities in the sector.

5.1 Background

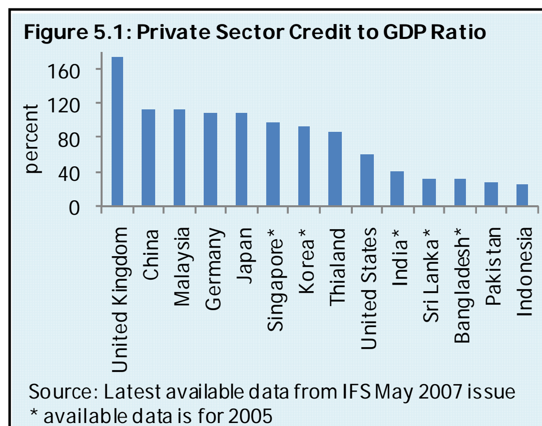
Economic growth is closely linked to the intricacies of the financial system. A well developed and efficient financial system helps in allocating financial resources to the best uses in the real sector, thereby promoting economic growth. As the real sector grows, the demand for financing increases and in this way the financial sector grows in tandem with the economy, signifying a two way causal relationship between finance and growth. In developed countries, financing generally flows both from the banking system and the capital markets, while in most developing and transition economies the capital markets lag behind, which shifts the burden of financing to the banking system. Pakistan is no exception and has a pre-dominantly bank-based financial system which caters to the financing needs of the economy.

5.2 Stylized Facts

Pakistan has seen a credit boom during FY03-06. One of the major reasons for this was the reversal of capital flight and a phenomenal surge in remittances in the aftermath of 9/11, which created a gush of liquidity in the banking system. Resultantly, interest rates declined to historic low levels (the real interest rates actually turned negative) which spurred credit growth in the economy. The credit boom was characterized by a credit extension to non-conventional sectors like consumer and housing finance.

However, despite this expansion in the volume of credit, a cross country comparison (**Figure 5.1**) shows that Pakistan still lags far behind most other countries in terms of banks' credit extension as a proportion of GDP. Our sample of countries includes developed economies (US, UK, Germany and Japan), emerging economies (East Asian Tigers) and regional countries. Among the selected sample of countries, Pakistan's private sector credit to GDP ratio is only slightly better than Indonesia. Though Pakistan is not much behind regional countries, the difference with developed and emerging economies is very wide. The relationship between GDP growth and bank credit is apparent, given that most of the developed countries, in addition to thriving capital markets, also have levels of bank credit well above 100 percent of the size of GDP, whereas most of the transition economies have a ratio of less than 50 percent. Dehesa et al. (2007)[1]

Figure 5.1: Private Sector Credit to GDP Ratio



Source: Latest available data from IFS May 2007 issue
* available data is for 2005

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[1] Dehesa, et al, (2007), 'Relative Price Stability, Creditors rights, and Financial Deepening' , IMF Working Paper WP/07/139.

have estimated the correlation between per capita GDP and credit to GDP ratio at a high level of 0.8. This suggests that banks still have a lot of room to expand credit in Pakistan.

Table 5.1: Growth in lending to various sectors
billion Rupees

	Dec CY03		Dec CY06		growth in % during Dec 03-Dec 06	
	No. of Borrowers	Loans (Amount)	No. of Borrowers	Loan (Amount)	No. of Borrowers	Loans (Amount)
SME	91,663	215	168,233	408	83.5	89.9
Agriculture	1,411,508	105	1,480,214	142	4.9	35.1
Consumer Finance	721,201	62	2,689,736	325	273	424.5
Mortgage Loan	0	4	24,313	49	NA	1,131.10
Total	2,224,372	386	4,486,678	2,401	101.7	522

Source: Banking Surveillance Department, SBP

As shown in **Table 5.1**, the number of borrowers has seen a tremendous increase of 102 percent over the last three years. The most notable increase is witnessed in consumer loans, while priority sectors like agriculture have lagged behind in comparison. Sector-wise credit allocation shows that the manufacturing sector has the highest share in total outstanding private sector credit, followed by consumer financing, at 17.4 percent, commerce and trade at 9.1 percent, and agriculture at 6.4 percent (**Table 5.2**).

5.3 Credit Allocation

As mentioned above, the sectoral distribution of credit is in sharp contrast to the sectoral distribution of GDP. Credit needs of each sector essentially depend on the business structure (including intensity of factor inputs, product type, payment cycle, ratio of fixed to variable costs, etc.) of that sector. While it is not easy to estimate the credit requirements and their growth for different sectors and segments of the economy, however a rough idea of the financing needs of different sectors can be gauged from comparing the shares of different sectors in GDP with their respective shares in the stock of credit. For instance, manufacturing sector is the prime user of bank credit with a 43.7 percent share in outstanding credit, while its contribution to GDP is only 19.1 percent.

Table 5.2: Shares in Private Sector credit and GDP (FY07)
percent

	Share		Share in GDP
	Credit flow	Credit stock	
Agriculture	3.7	6.4	20.9
Manufacturing	30.1	43.7	19.1
Commerce and trade	5.0	9.1	NA
Services	9.1	5.5	53.3
Consumer financing	14.7	17.4	NA

Source: SBP and Economic Survey 2007

Sector-wise credit allocation (**Table 5.3**) shows that the manufacturing and the commerce & trade sectors remained the prime users of bank credit. Another sector that received greater credit during FY07 compared to FY06 is the real estate, renting and business category, which has benefited from the soaring real estate prices in recent years. All the other sectors

Table 5.3: Share in Private Sector Credit (FY07)
billion Rupees, shares in percent

	Credit flow	Share (stock)
A. Agriculture	**12.6**	**6.4**
(1) Growing of Crops	17.2	4.5
(2) Livestock	2.7	0.8
B. Manufacturing	**103.7**	**43.7**
(1) Food Products	25.5	7.4
(2) Textiles	1.5	19.1
C. Commerce and trade	**17.2**	**9.1**
(1) wholesale and commission	-6.6	6
D. Services	**31.4**	**5.5**
(1) Education	1	0.2
(2) Health	1.7	0.2
(3) Real estate	20.8	3.9
E. Personal	**56.0**	**17.4**
(1) Consumer financing	50.7	15.2

Source: Statistics Department, SBP

maintained more or less a similar level of credit flow in FY07 as in FY06, except for transport, storage and communication that received almost half the flow of the credit in FY07 compared to the preceding year.

5.3.1 Manufacturing Sector

Within the manufacturing sector, the textile sector has the highest share of credit (at 19.1 percent) as reflected in the credit stock position at end FY07, with food products at 7.4 percent being the next in line. All the other sub-sectors in manufacturing have considerably lower shares. This suggests that bank credit utilized by the manufacturing sector is heavily concentrated in a very few sub-sectors. In terms of credit allocation, there is substantial room for further credit extension to the manufacturing sector in underserved sectors like leather, non-metallic minerals, machinery and equipment. Small flows of credit to these sectors also reflect a lower level of development in these sub-sectors as reflected in their small shares in the GDP.[2] A greater flow of credit to these underserved segments would not only help in diversifying banks' credit portfolio but also help diversify the structure of the economy by exploiting the potential in these segments.

5.3.2 Agriculture Sector

The commodity producing sector has an over 46 percent share in the GDP (FY07), however its share in credit was only 6.1 percent. Within the agriculture sector, livestock and others have a share of less than 2 percent of total bank credit (**Table 5.3**). The livestock sector is in fact around 10 percent of total GDP while its credit share is less than 1 percent, which shows the potential for credit penetration to develop this sector.

The total credit disbursements to agriculture through the formal banking sector amounted to Rs 168.8 billion during FY07 - an increase of 22.8 percent over the corresponding period of the previous year (**Table 5.4**). Though the overall disbursements showed reasonable growth during FY07, the composition of credit has shifted more towards production loans.[3]

The growth in production loans remained quite robust at 29.0 percent. However the institution-wise disbursements show divergent trends. The domestic private banks showed highest disbursement growth in both the production and development loans with specialized banks next in line. The top 5 banks showed considerably lower disbursement in development loans which resulted in overall lower disbursement for these loans despite positive contribution by other banks.

Table 5.4: Disbursement of Agriculture Production and Development Loans
billion Rupees

	FY06			FY07			Growth (%)		
	Prod. Loans	Dev. Loans	Total	Prod. Loans	Dev. Loans	Total	Prod. Loans	Dev. Loans	Total
Commercial Banks	68.9	15.1	84.0	93.1	11.3	104.4	35.1	-25.2	24.3
Major Commercial Banks	55.3	12.7	68.0	71.5	8.9	80.4	29.4	-30.0	18.3
Private Domestic Banks	13.6	2.4	16.0	21.6	2.4	24.0	58.3	0.2	49.6
Specialized Banks	47.7	5.8	53.5	57.4	7.1	64.5	20.3	22.4	20.5
ZTBL	42.8	4.8	47.6	51.8	4.7	56.5	21.0	-2.1	18.7
PPCB	4.9	1.0	5.9	5.6	2.4	8.0	14.5	135.3	35.6
Grand Total	116.6	20.9	137.5	150.5	18.4	168.8	29.0	-12.0	22.8

Source: ACD, SBP

Despite these developments, the agriculture sector still has substantial room for further penetration. According to the Agriculture Census of 2000, 65 percent of outstanding debt of all types of households in rural areas was provided by non-institutional sources. This reflects

[2] Economic Survey of Pakistan 2007, Table 1.2, page 15.

[3] Production loans are primarily given for purchase of different inputs while developmental loans are given to purchase agricultural machinery, installation of tube wells, etc.

the inability of financial institutions to meet the credit needs of the sector, which forces the borrowers to rely on informal channels which are usually excessively priced.

An obvious question that arises at this stage relates to the relative reluctance of formal financial institutions to extend credit to the agriculture sector. Specifically, rural finance has higher transaction costs due to lower population density, dispersion of rural households and slow development in rural areas, markets and institutions, underdeveloped infrastructure, and less access to information, education and training facilities. Agriculture sector is also prone to higher systemic risks, in particular due to the vagaries of nature, resulting in higher volatility of cash flows, thus making it difficult to make prudent credit decisions, implying that rural finance requires a separate skill set for making credit assessment decisions. On the supply side, the major problems faced by institutions are diverse geographical distribution, concentration of credit to the farm sector, limited institutional capacity, lack of suitable financing products, inadequate delivery channels and an inadequate branch network, and lack of banks' marketing and monitoring system.

On the demand side major issues relate to the lack of collateral (due to unclear land titling), viability of borrowers due to uneconomic farm holdings and substandard inputs. The most common collateral available to farmers is the passbook issued by the provincial revenue authorities. Non-availability of these passbooks, issues of fake passbooks and non-cooperation of revenue authorities with the banks and borrowers are some of the major bottlenecks impeding the flow of credit to this sector. Moreover, land distribution in Pakistan is quite uneven, costs of inputs are high and farm gate prices are very low, which are major disincentives for the farmers. In addition, they have to bear unforeseen losses in case of natural calamities due to the non-availability of loan and crop insurance. However, efforts are being made through the collaboration of public and private sectors to develop and introduce crop insurance schemes in line with some regional countries like India and Bangladesh. Leading insurance companies in the private sector have taken the initiative to introduce these products in the insurance sector.

Table 5.5: Credit to SME Sector (FY07)
million Rupees

Sector	Shares (stocks)	Flows		% Change in Flow	% Change in Stocks	
	FY07	FY06	FY07	FY07	FY06	FY07
Mining and Quarrying	-0.1	40	-32.612	-180.9	4.9	-4.0
Manufacturing	**28.8**	**12,940**	**7,644**	**-40.9**	8.4	5.0
Ship breaking	-1.6	391.618	-420.502	-207.4	40.8	-43.8
Electricity and gas	3.0	87.991	809	819.3	4.7	43.2
Commerce & Trade	**10.3**	**20,047**	**2,734**	**-86.4**	16.2	2.2
Services	**28.9**	**3,481**	**7,668**	**120.2**	15.0	33.1
Transport and communications	8.5	1174.463	2245.274	91.2	12.1	23.1
Construction	12.8	1,455	3,393	133.2	11.2	26.1
Others Private business	9.4	3,668	2,491	-32.1	11.3	7.7
Total	**100.0**	**43,285**	**26,531**	**-38.7**	12.1	7.4

Note: excluding agriculture & fishing sectors
Source: SBP

5.3.3 SME Sector

Besides agriculture another focus area for policy makers is the SME sector. SMEs play a vital role in the economic development of any country since they constitute a major share in both production and employment, especially in developing countries. Development of the SME sector rests crucially on the availability and access to finance at an affordable cost, especially through the formal institutional setup. As shown in **Table 5.5**, the flow of credit to the SME sector has declined gradually in the last three years. In specific terms, the credit flow during FY07 (at Rs 26.5 billion) is less than half of FY05 (at Rs 59.9 billion). Disaggregated data shows that credit flow and growth in the manufacturing sector was maintained at almost the same level during the last three years, whereas the credit flow to the commerce and trade

sector has declined considerably. This led to a decline in the overall credit flow to the SME sector during FY06-07. A more detailed analysis of the last two years reveals that apart from the communication and trade sector, other sectors show a more pronounced decline, especially in mining and quarrying, utilities, and other private businesses.

Despite being a priority sector, SMEs have a few problems that hinder the growth of credit to the sector. To begin with, there is a scarcity of skilled and educated human resources which creates problems in proper bookkeeping. In addition, there is lack of proper titling which results in lack of collateral. People generally tend to understate their incomes making it difficult for banks to ascertain present and future cash flow. The situation is made even worse as banks do not have sufficient resources to carry out original research on SMEs. Asymmetries of information, besides insufficient collateral, make SMEs less attractive for conventional banks so they charge higher interest rates. In addition, SMEs tend to rely on internal resources, which reduces transaction costs on one hand, but also constrains access to sufficient finance through institutional sources on the other.

Looking at major components of SME finance (manufacturing, commerce and trade and others), commerce and trade sector has declined the most. The possible reasons of the decline in flow of credit to the commerce and trade sector could be the increase in interest rates, slowdown in exports growth and decline in imports of inputs. A more detailed analysis of components of commerce and trade shows a considerable decline in wholesale and commission trade (including both export and imports of input), while other components have shown positive flow of credit.

5.4 Conclusion

Recent literature on private sector credit has also emphasized on the issues discussed in the above sections in developing countries. Shleifer, et al (2006)[4] found that creditors' legal rights and information sharing institutions (credit bureaus) have a statistically and economically significant impact on private sector credit. Authors have found that presence of both the private and public credit bureaus are strongly associated with private sector growth. Dehesa, et al. (2007)[5] opines that banks are more willing to extend credit to the private sector if : (a) it is easy to obtain collateral; (b) there is timely information on borrowers' economic conditions through some institution; and (c) there is an efficient exchange of information which helps banks in their credit assessment decisions.

In case of Pakistan, Credit Information Bureau (CIB)—the credit registry housed in SBP—has been upgraded both in terms of coverage and technology. The earlier credit reporting limit of Rs. 0.5 million has been eliminated and now its coverage is full and CIB has been converted to eCIB to provide online services to banks.

In conclusion, banks need to increase the penetration of bank credit to uniformly meet the needs of the growing economy. The major issue is that bank credit is heavily skewed towards the corporate sector, and even within the corporate sector only the textile industry is getting the bulk of credit. Agriculture and SME sectors that contribute immensely in employment need better access to credit, commensurate with their size and contribution to economy. In retrospect, banks are more inclined to serve the corporate / manufacturing sector as it generally does not have problems related to collateral, information and outreach. In terms of returns, the agriculture and SME sectors can probably provide higher interest rates as these sectors currently rely heavily on non-institutional credit which is usually available at exorbitant interest rates (higher than 50-100 percent in some cases). In order to improve penetration in these sectors, banks need to strengthen on their credit assessment and risk management systems to overcome the problems associated with lending to these sectors.

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[4] Shleifer, et al (2006), 'Private Credit in 129 countries' .

[5] Dehesa, et al, (2007), 'Relative Price Stability, Creditors rights, and Financial Deepening' IMF Working Paper WP/07/139.