Conclusion

On-going implementation of financial sector reforms alongwith favorable macroeconomic conditions have led to significant changes in the size, structure and performance of the financial sector during CY04. One of the most striking features of these changes is the shift in the ownership structure from the public to private sector. This is a significant development given that it is for the first time since the nationalization drive of 1974 that private sector institutions have acquired such a dominant share of the financial sector. These changes in the ownership structure clearly reflect the government's efforts to promote the role of the private sector in the economy. The institutional composition of the financial sector indicates that it not only continues to be heavily skewed towards banks, but the dominance of the banking sector has gained more strength in the overall financial sector.

Another prominent aspect is the exceptional growth in credit during the year. Although strong credit growth can have potentially negative implications for credit risk, key financial performance indicators clearly reflect the resilience of the financial sector to both internal and external shocks. Due to prudent regulatory measures, the risk-taking capacity of the banking sector has witnessed a visible rise in the recent past. As the economy is now at a high growth trajectory and its trickle down affects are likely to create more business activities in the future, the financial sector will continue to receive the requisite vital support from the macroeconomic environment. Given these dynamics, the strong banking sector performance is likely to sustain in the foreseeable future.

It is thus concluded that banks are now in a better position in terms of loan diversification in various sectors such that financial distress in any particular sector will not affect their overall asset quality bank. However, changing macroeconomic factors may have some impact on credit growth in the months to come as the lending rates have started to rise in line with SBP's tightening monetary policy stance which aims to contain inflation without adversely impacting economic growth. Keeping in view the growth momentum that the economy has achieved and the conducive business environment, it is quite unlikely that rising interest rates would give a major set back to credit demand. Nonetheless, the pace of credit expansion might slow down in comparison to the last few years.

It is also important to note the significantly increased pace of activities in the area of Islamic Banking during CY04. During 2004, the State Bank has not only issued licenses to a number of Islamic Banking branches, but also gave in principle approval for the incorporation of two more full fledged Islamic banks, and opening of 34 more branches in 2005 by 6 existing Islamic banking institutions. These developments reflect promising future prospects for the growth of Islamic banking in Pakistan.

It is also important to note that despite the increased competition from the banking sector, Non-Banking Financial Institutions have shown a remarkable resilience to the changing market dynamics. The most interesting feature to note in this sector is the pace of increased activities in the Mutual Funds industry which has not only undergone a drastic change in terms of ownership of assets from the public to the private sector in 2004, but has also seen a tremendous growth in its asset base on the back of the strong performance of the stock market. Given increased awareness among individual investors of the investment options provided by mutual funds, and the growth in the number of professional asset management companies, this sector is set to grow rapidly in the coming years.

Going forward, the increased resilience of the financial sector has paved the way for enhanced sophistication in the development of asset and liability products with a strong emphasis on risk management. In the short to medium term, the banking sector is expected to consolidate and build on the existing initiatives in Agriculture, SME and Microfinance and continue to increase its outreach to various sectors of the economy. Moreover in order to build the human resource base equipped to handle the increasingly diversified asset base of the banks, extensive training initiatives need to be undertaken in the next few years. Moreover, in line with the increased emphasis on second-generation reforms, asset based securitization will be particularly required with the rapid expansion in the mortgage portfolios of banks. Additionally, a smooth transition from Basel-I to Basel-II and institutionalization of stress testing is expected to strengthen the existing risk management regime.

Despite the prominent role of Banks in Pakistan's financial sector, the importance of financial markets cannot be over emphasized. Efficiently operating financial markets complement the banking system in increasing the base of financial savings and in providing access to both financing and investment options.