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Institutional Arrangements for Financial Sector Governance

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*Whenever the information is imperfect and markets incomplete, which is to say always, and especially in developing countries, then the invisible hand works most imperfectly****….*** *The market system requires clearly established property rights and the courts to enforce them; but often these are absent in developing countries. The market system requires competition and perfect information. But competition is limited and information is far from perfect – and well functioning competitive markets can't be established overnight.*

Joseph Stiglitz, Nobel Laureate (2002)

1. By Way of an Introduction

Under gold standard operated from 1880 till the end of first world war in 1914, gold content in currency was fixed; therefore, the exchange rate also remained fixed. In 1930 the effort to reestablish gold standard failed with the deepening of great depression. The Bretton Woods system established International Monetary Fund. This was a gold exchange standard with gold and convertible currency as international reserves. In 1961 gold pool was set up but it collapsed in 1968 and two-tier system was established. The use of the dollar as standard international currency gave the benefit of seigniorage to the United States. The immediate cause of the collapse of Bretton Woods system was the BOP deficit of the US in 1970 and the expectation of a larger deficit in 1971, which led to destabilizing speculation against the dollar. But the system had all along been known to lack an adequate adjustment mechanism. In February 1973 the dollar was devalued and in March 1973 the major currencies were allowed to fluctuate independently or jointly. From 1973 the world started to operate under managed or 'dirty' float. In March 1979 the European Monetary System was established and plans were to create a single currency and central bank by 1997, but the 1992-93 monetary crises pushed these plans farther into the future. However in 1997 a number of countries including Argentina, Estonia, Lithuania and Hong Kong established currency boards to provide an immediate adjustment to inflationary pressures.

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A most important development after 9/11 was the emergence of many developing countries as the recipients of capital flights. The world of finance witnessed a direct and immediate correlation between the tightening of financial regulations in developed countries and the quantum jumps in remittances and investment, portfolio and direct, in middle and low-income countries, catching unawares the monetary policy managers with only a rudimentary financial infrastructure at their disposal. Only a few years ago the currency crises and runs on the banks had left the global community bewildered. Monetary targeting became a fuzzy set during the East Asian crisis and the economic meltdown of Argentina in Latin America. Emerging economies were seen to-ing and fro-ing between the hard and soft pegs.

In the literature, the choice for long had been limited to exchange rate regimes, inflation targeting polices and debt monetization. The idea of rule based monetary policy is pretty recent. Institutions were mentioned only with some architectural detail, as catalysts in improving the effectiveness of monetary policy. Financial sector reform in developing countries revolves around deepening and broadening of local financial markets: deepening refers to greater loan disbursement, new inflow of deposits, higher stock market capitalization, etc., and broadening involves new bank and insurance openings, greater branch coverage by existing banks, enlisting new borrowers and larger portfolio of financial instruments for savers. It is, however, what the deepening and broadening processes achieve together that is of crucial significance. These can improve market's ability to price, intermediate, and settle transactions in a variety of instruments that lower transaction costs and spreads; widen the range of financial instruments to suit varying risk/reward preferences; enhance the quality of market institutions; expand the saver-investor participation in the formal sector; regulate market participants on the basis of better designed laws that are enforced also; provide a transparent market by wide dissemination of information on the companies raising capital, the transactions costs, price benchmarks, the financial state of market intermediaries; and ensure compliance of international standards of settlement, accounting, corporate disclosure and capital adequacy. In short, the reform institutes new rules of the game.

In Pakistan, financial sector reform started in 1989 with a focus on the market-oriented development of the sector (Haque 1993). An assessment up to 2000 indicated a decline in the role of public sector from 95 per cent to 70 per cent. Laws were also amended, including the State Bank of Pakistan Act allowing it "full operational autonomy" (SBP 2003).[1] A second generation of reform has

[1] Recently the Governor SBP talked of a single five-year tenure for the Governor rather than the present three-year renewable tenure with a view to ensuring autonomy. The present writer had made

continued since 2000 with greater vigor and the result has been described by a joint IMF/World assessment as the establishment of “a sound, efficient financial system that can withstand external exogenous shocks” (Hussain 2005b).

While the overall direction of reform has been towards better governance credit, discipline and competition, one cannot fail to notice the emphasis on *organizations* rather than *institutions.* This is reflected, for example, in the statement that the “progress on institutional reforms in Pakistan has not made any serious strides with a few exceptions such as the State Bank of Pakistan, Securities and Exchange Commission of Pakistan (SECP), Auditor General and more recently the Central Board of Revenue” (Hussain 2005b). As the institutional economists have always maintained, the economy is more than the market mechanism. Institutions, formal as well as informal, are the rules of the game, while organizations are players exploiting the opportunities created by institutions. Thus after the Glorious Revolution in England, “Parliamentary Supremacy, central (parliamentary) control in financial matters, curtailment of royal prerogative powers, independence of the judiciary (at least from the Crown) and the supremacy of the common law courts were established. A major consequence was an increased security of properly rights. The other major consequences were the rapid development of capital market and the formation of the Bank of England in 1694. These were ‘instrumental factors’ in the long term economic growth of England” (North 1990).

This paper argues for assigning institutions an active role in overall demand management and effective conduct of monetary policy. Until this capability is acquired at a critical minimum level, regimes change or choice is more a matter of academic taste than outcome-based policy targeting. The way forward for the emerging market economies is not a clear-cut choice but the path of muddling through while pursuing reform at a careful but steady pace. Financial sector ought to be viewed as a whole, with strong overlying macroeconomic and structural polices and credible underlying institutions.

2. Monetary Policy Perspective

It is not just the emerging economies that enter troubled waters as a result of monetary upheavals. Advanced economies with greater volume of capital flowing in and out are more prone to volatility. There is, however, a difference. The

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this proposal in a note of dissent to the Report of the Task Force on Strengthening the Banking Regulatory Functions of the State Bank in November 1996, chaired by the then Governor, who opposed the proposal.

Table 1. Country-Specific Monetary Crises

Country	Year	Nature	Results
Mexico	1994-95	Exchange rate crisis	Budget deficit increased leading to massive government borrowing. The resultant money supply expansion pushed up prices.
East Asia	1997	Bank run crisis	Capital flight. Bank run crises and currency run crises latter in 1999.
Russia	1998	Interest rate crisis	Huge rise in budget deficit.
Ecuador	1999	Currency crisis	Currency depreciated by 66.3% against the US dollar.
Turkey	2001-02	Interest rate instability	Overnight interbank interest rate increased by 1700%. Domestic interest rate reached 60%. Domestic stock market crashed.
Argentina	2001-02	Debt crisis	Default on public debt.

advanced economies may be shocked, but the readiness to cope reduces the span of volatility. In contrast, the emerging economies are overcome by crises. The weaker warning and diagnostic systems elongate the duration of a crisis. Economic agents are pushed into panic by failing responses; they forward advances and put off longer term contracts till the hurricane recedes. The crux of the matter is how the emerging markets can equip themselves with such mechanisms that stand ready to counter an exchange rate, interest rate or price related crisis. Countering such a crisis involves a two pronged strategy: (a) timely intervention by the central bank; (b) keeping the expectations of the economic agents towards anticipatory optimism. Failure to achieve the latter often leads to hot money expatriation or capital flights.

Table 1 lists some recent examples of country specific crises. A key question to address is whether or not the effects of these crises are transmitted to the neighboring countries or at least the trading partners. Here the East Asian example is most telling. As the region plunged into the first round of troubles known as a bank run crises (where people thought banks may not be able to meet their claims), depositors rushed to withdraw their holdings from their banks, eventually paralyzing the entire banking system of the region. The advanced countries remained unmoved in the Roosevelt tradition of “our dollar is Europe’s problem”. As time went on, the second round effects came harder on advanced countries because the domestic banks in East Asian countries had claims in the foreign banks based in them. Europe and America were shaken. They were unable to meet the longer term claims of East Asian banks at short notices, which ultimately found the region falling into a whole new tier of crises formally known as the currency run crisis, where economic agents lose confidence in domestic currencies and holdings shift into other currencies.

The accumulated debt brought another piece of bad news for these countries. As the value of their currencies fell, the debt stock became extremely expensive. Although IMF was concerned about the lost value of currencies, it was even more concerned as to how these countries were going to undertake amortizations. Consequently East Asia saw quite a few debt rescheduling arrangements take place. Although countries like Indonesia did request a complete write-off (one US dollar became equal to 50,000 Indonesian Ruppiah), the donors insisted on pouring in more for stabilization and structural adjustment.

Many researchers have analyzed monetary cum exchange rate policies in emerging markets. Agenor (1999) discusses basic requirements for inflation targeting, presents a formal analytical framework and shows how inflation targeting regime differs from monetary and exchange rate targeting regimes. The recent experience with inflation targeting is also analyzed and evidence presented on the convexity of Phillips curve for 6 developing countries. The conclusion is that it provides a flexible policy framework allowing the central bank to exercise some degree of discretion without disturbing its main objective of stable prices. In middle and high income developing economies it can improve the performance of monetary policy when compared with other policy alternatives.

Taylor (2000) shows that the use of monetary policy rules in emerging markets has more or less the same benefits that have been found in research and practice in developed economies. Thus monetary policy rules can provide a stable macroeconomic framework to make monetary policy decisions with relative certainty, help decide long term positions, communicate transparently with the public and financial markets and search for policy improvements. This is not to say that modifications are not needed for country specific dynamics.

Emerging market economies face a fluctuating series of shocks originating from global interest rates and terms of trade. Devereux and Lane (2001) assess the impact of different monetary policy rules operating under different exchange rate regimes. They show that the financial frictions impact the degree of exchange rate *pass through* in determining the relative performance of alternative regimes in stabilizing the economy in the face of external shocks. They conclude that when the exchange rate pass-through is high, a policy of non-traded goods inflation targeting is effective in stabilizing the economy. However when exchange rate pass-through is low a policy of strict CPI inflation targeting is a better idea[2].

Calvo and Mishkin (2003) maintain that the choice of exchange rate regime is irrelevant and the emerging market economies had much better concentrate on strengthening their financial institutions and governance capacities. Mishkin (2004) observes that inflation targeting policies could work for emerging market economies. Exploring the difference between emerging markets and developed economies, the author examines the successful case studies of Chile and Brazil who chose, with support from the IMF, inflation targeting policies. Little did they realize that implementing the policies would require the understanding of some complex processes. Hakura (2005) points out that the trend toward greater exchange rate flexibility, together with strong banking supervision, has allowed greater monetary policy independence in the emerging market economies.

By applying the multivariate cointegration technique, Qayyum and Khan (2003) analyze the response and effectiveness of SBP (State Bank of Pakistan) interventions to exchange rate shocks in terms of sterilization and response of foreign exchange reserves to changes in domestic credit. They find sterilization to the extent of 72 per cent of international reserve inflows in long the run and 88 per cent in the short run. Hussain and Abbas (2000) studied the causal relationship between money and income and between money and prices in Pakistan by using annual dataset and employing Granger causality and error correction models. There is, according to them, two-way causation between money and prices: increase in money supply raises the general price level which in turn increases the demand for money, which again in the next time period leads to an increase in supply of money. Thus money supply changes affect prices with a lag of one year but prices affect money supply with a lag of two years. The increase in money supply which results in inflation is due to increase in government borrowing to finance its expenditure which further fuels inflation.

The early 1990s brought another major challenge for emerging economies. It was presumed that the drive towards financial liberalization would be painful; but the extent of the pain was not fathomed. Financial liberalization basically involved

[2] Exchange rate pass through is the degree to which exchange rate changes are reflected in destination currency prices of traded goods. It is percentage change in local currency import prices resulting from a one percent change in the exchange rate i.e. the domestic price change attributable to a prior change in nominal exchange rate.

three things: (a) removing currency exchange controls; (b) allowing a relatively floating currency regime; and (c) market based interest rate structure. The experience, however, suggested that emerging economies were not ready for such a transition.

The question is why the emerging economies were not ready for the transition. To many the answer lies in a serious institutional gap: the nonexistence of supportive institutional arrangements for the conduct of an open economy monetary policy. This is a critical determinant of the capability to deploy effective response to global volatility and to mount desired adjustment.

Early 1990s saw the multilaterals pushing for indirect monetary policy instruments (Annex I). However, countries faced a painful period in the immediate aftermath of these changes. Between 1992 and 2000, the GDP in absolute terms was increasing but fixed investment to GDP ratio was on the decline. In most countries the consumer price index more than doubled, with massive exchange rate depreciation. Inflation was a much talked about indicator in Latin American countries particularly after the region fell into a deep crisis following the Washington Consensus. Argentina’s 18.6 per cent increase in CPI was high, but was understood as a success of the dollarization regime followed by the country. In Chile, the increase was as high as 74.8 per cent; India and Pakistan experienced rises of 86 and 97 per cent respectively. Indonesia was the worst hit, with the CPI rising by an alarming 196 per cent. The country was all set to make it to the category of middle income countries when the inflationary pressures pulled it back. On the exchange rate front, Chile saw a devaluation equivalent to 48 per cent, India and Pakistan 73 and 114 per cent respectively with Indonesia again being the worst hit, i.e. 315 per cent.

Inflation targeting came to be known as an important instrument for promoting transparency and accountability in monetary policy. This policy was thought to improve the design, implementation, and performance of monetary policy compared with the central banks' usual procedures, which tend to lack of transparency. It does so by providing a vehicle that is consistent both with recent developments in the theory and practice of monetary policy [(Masson, Savastano, Sharma 1997)].

However, is it possible for the developing countries to adopt such a framework straightaway? The answer may not be a simple one. For pursuing any demand management, there have to be some pre-requisites in place. First and the foremost, the economic managers have to be determined in pursing inflation target as the

Table 2. Debt Profile of Pakistan (as % of GDP)

	1987-88	1990-91	1991-92	1993-94	1995-96	1999-00	2001-02
Interest on Domestic Debt	3.30	3.50	4.20	4.90	4.80	6.70	4.70
Interest on Foreign Debt	1.20	1.40	1.20	1.20	1.20	1.50	1.60
Repayment of Foreign Debt	2.00	2.10	2.40	2.80	2.80	3.10	4.50
Total Debt Servicing	4.80	4.90	8.00	9.30	9.10	11.80	11.20
Domestic interest/Total Debt servicing	0.49	0.49	0.52	0.53	0.53	0.57	0.42

Source: *Economic Survey of Pakistan*, various issues.

main objective. In the short run such a stance can be very difficult to follow as other variables such as interest rates and exchange rate changes may require immediate attention. Next is the extent to which the central bank is independent to pursue its objectives. This does not simply imply the grant of autonomy for internal operations, but in fact is a reflection of leverage over the banking system as a whole. Further, the treasury has to demonstrate its determination to keep the fiscal deficit down. This is of particular importance for countries trying to work their way towards sustaining democracy, as they tend to base their fiscal expenditures purely on discretion which adversely affects the future. The IMF prescription in these situations is a rule based fiscal policy. Finally, there is the problem in developing countries of what the optimal inflation rate is.

Pakistan adopted indirect policy instruments around 1992. These include repurchase agreements (repos) and open market operations (outright transactions in government securities). Table 2 charts the painful path the country had to take before the stabilization policy finally showed some results.

Pakistan at the time of its foundation had an extremely small capital and infrastructure base. Over the years she had to rely heavily on external resources which by 1990s brought the country on the brink of bankruptcy. There were times when Pakistan was not only in the debt-default zone but also running low on its forex reserves required for the import requirements. A clear message of the Table 3 is that the country was *institutionally* not ready for a liberalized regime which was introduced around the start of the 1990s. All debt related indicators posed extreme difficulties for economic management. Interest on domestic debt increased by 670 per cent during the years 1988-2002. During the same period the interest on foreign debt increased by 638 per cent. This in turn created difficulties for the treasury, which had to divert fiscal resources away from the social sector and towards the repayment of debt and servicing of its interest. Consequently the repayment of foreign debt as percent of GDP more than doubled. The eventual result of this high debt accumulation was that the rising deficit situation not created difficulties for governments in office and for the domestic financial institutions. It would be no exaggeration to say that the banking sector faced a crippling market during the 1990s. The business community switched away from the risk-taking mode towards rent-seeking behavior. Small wonder, the capacity of local banking system, (not excluding National Saving Schemes) to finance the deficit was completely exhausted. As Table 2 indicates, the ratio of domestic interest to total debt servicing remained constant in the early and mid part of 1990s and declined by the year 2002, making external debt the inevitable option. Institutional preparedness is the key. But how best to arrange this?

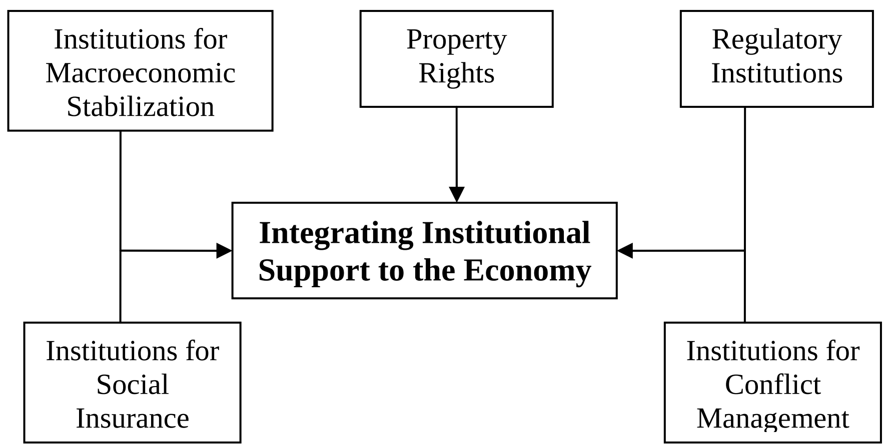
3. Institutional Arrangements for Financial Sector

The primary function of financial markets is to mobilize and allocate savings (Annex II). After 9/11 the whole scenario has changed globally. The emerging market economies represent the fast growing segment of the global economy. Huge remittances started to pour in after 9/11. Their GDP growth rates witnessed unprecedented sharp increases. Foreign exchange reserves stabilized and so did their respective exchange rates. As per capita incomes rose, consumer goods witnessed a sharp jump in their demand. Terms of trade have changed in favor of developing countries as countries like China, India and Brazil take the lead in world trade growth.

Domestically the emerging market economies do not have the desired strength in the financial sector interaction. These economies are strongly interlinked with developed counties and any changes in rich countries directly influence the short to medium term dynamics. The changes originate mainly from two sources: (a) global demand trends (b) Balance of payments fluctuations at international level. Recent recovery in the labor and goods markets of developing countries has increased the momentum of overall growth. Current account deficits of rich countries have translated into rising foreign exchange reserves of poor countries. This is an unprecedented phenomenon and has no roots to trace back in history.

At the start of the new millennium, several developing countries made a transition from the first tier of reforms to their second generation. The first tier mainly stressed reforms related to stabilization program relying on fiscal discipline and monetary base tightening. These reforms proved to be extremely painful for

Figure 1. Institutional and Economic Development



Source: Rodrik (1999)

countries already facing high inflation and a continuously depreciating currency. Examples included Turkey, Argentina, Indonesia, Mexico and Peru. These countries were heavily relying on debt backed fiscal deficit, which in future periods led to the monetization of debt, reducing home currency's value relative to other countries.

The second generation of reforms was introduced with the objective of making economic stabilization a norm and enabling growth to become sustainable through institutional strengthening and risk taking ability of economic agents. Figure 1 provides a picture of how to integrate the institutional reform agenda for developing countries with their economic development. There are five prongs to such an arrangement. Institutions for macroeconomic stabilization require harmony between the decisions of money issuing authority, fiscal expenditure body and revenue collection agency. As discussed earlier, the autonomy given to each of these organizations entirely depends on the countries own economic milieu. On several occasions there has been an effort to replicate the success stories of other countries. This has specially been the case in Latin American and East Asian countries.

However, the heterogeneity in the economic structures restricts the scope of complete replication and many a time the set of assumptions underlying specific policies differs to such an extent that it entirely changes the implementation perspective. Institutions that protect the profits of investors and property rights have certainly been given the most importance particularly in the second-generation reforms. The East Asian experience showed that a policy of perpetual financial liberalization complemented by institutions that protect the repatriation of profits and property holding rights for foreigners could result in a quantum jump in foreign direct investment.

In the developing countries the protection of property rights has to be implemented through four different channels: (a) documentation of property holdings; (b) simplifying the ownership laws including the removal of several anomalies; (c) removing ambiguities in laws related to lease of property and assets; (d) certainty of a timeframe if property disputes are taken to arbitration. The third prong suggests the putting in place of regulatory bodies to ensure the transparency and accountability in respective sectors. Development of anti-trust laws and regulatory bodies gained momentum in the developing countries in early 1990s when the multilaterals and donor clubs pushed for an early implementation of the privatization agenda. Institutions for social insurance and conflict management are in the early stages of reform.

An important question in the introduction of second generation reforms relates to the design and funding of the institutional capacity development. Three problems have been identified in this process. First the unreasonable expectations from the donors, second, the general lack of awareness regarding the importance of ownership of policies and their governance and, third, the financial laws that themselves become a hindrance to grass root operations. These problems arose from a delayed realization that financial sector reforms are not just needed for macroeconomic institutions but also for regulating the micro level financial set-ups. The belief that financial institutions cropped up somehow as the economy matured, has been belied by the knowledge that developing countries have to make a conscious effort to build the institutional quality of their financial sectors if they wish to maximize capital flows from developed nations.

Schmidt and Winkler (1999) identify the key elements of financial institution building, particularly from the point of view of micro-credit institutions in developing countries. The downscaling approach suggests that a target oriented change in the credit market is best achieved through the institutions of commercial banks. However, Schor (1997) points out that the commercial banks are sometime unable to serve this targeted group due to an inadequate credit-technology which involves risk and transaction costs that are many a time high enough to discourage the lending operations of these banks. Boven (1999) hints that the need for operational flexibility in the short run may discourage commercial banks.

The upgrading approach involves the transformation of existing informal institutions (e.g. NGOs working as credit providers) into formal financial institutions. This would require: (a) providing appropriate financial technology that can network this informal set up with the formal one and (b) reforming the overall organizational structure of these organizations. The latter is of particular importance as the informal sector money lending managers working in the developing counties are not intellectually equipped with the minute details of a formally run commercial or investment banking organization.

It is generally understood that developments in financial markets are usually led by prudent macroeconomic policy that is set in a congenial political milieu. However, building financial infrastructure can involve several steps like promoting private sector financial institutions, structuring investment funds, providing credit to intermediaries, engaging local authorities in policy dialogue regarding sectoral development and the role and regulation of private agents and promoting technical assistance and policy advice in creating or improving market systems and institutions.

The most important link in this process is the sequencing of above mentioned activities. Reforms have to set in a sequenced combination which is hospitable to the business community and those involved in international payment flows. As the *World Development Report 2002* states: "Financial regulation today mostly focuses on improving the informational efficiency of financial markets. To be effective, these regulations need to be enforced. Enforcement becomes much easier if the regulation is incentive-compatible, that is, if it encourages and makes use of the monitoring and disciplining ability of market participants.

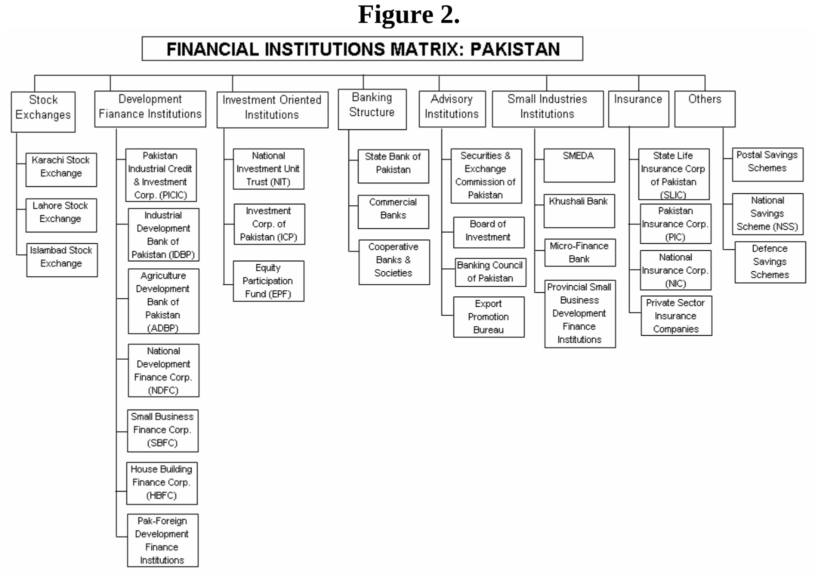
In addition an essential element of improving quality and effectiveness of market discipline for financial institutions is ensuring the accuracy and availability of information on the operations of these institutions. Countries with poor information and human resources that face problems in monitoring and enforcing regulations may still benefit from additional buffers – such as liquidity requirements or prompt corrective action rules – that are easier to observe and enforce information problems and the relatively high fixed costs of small-scale lending may limit access to financial services by the poor, and by small and micro enterprises. Improving the collateral laws and establishing collateral registries are effective ways of expanding access. Credit registries that collect information on payment histories can improve information flows on small borrowers and allow potential borrowers to use their good reputation to secure finance."

4. Financial Sector Developments

In the particular context of Pakistan following would be important questions to pose: (a) Is the financial sector reform process leading to increased competition in this industry? (b) Is this competition in turn leading to allocative efficiency? (c) To what extent these reforms are contributing to trade openness? (d) Is the financial sector information government controlled? If not then how does the private sector manage and respond to such information? (e) How transparent is the information provided? Is the access to information selective or across the board? (f) Are the external incentives, constraints and agreements contributing to the financial sector's institutional change?

Financial sector in Pakistan had to face more than the usual upheavals when compared to other developing and middle income countries. The nationalization in the 1970s put an end to the private initiative on the financial side. Even through the entire decade of the 1980s the Government sector remained dominant in the financial services and instruments. This situation discouraged the private sector participation and hindered efficient credit allocation and disbursement. As is evident from Figure 2, Pakistan has almost all the financial institutions in the

Figure 2.



book, but their capacity and operational strength leaves much to be desired. As part of overall effort to improve fiscal, interest rate and investment policy environment, several measures have been initiated simultaneously.

Pakistan is now on its way to a well-integrated institutional structure for its financial sector. After the success of the stabilization program, the country is now pursuing vigorously the agenda of the second generation reforms. Pakistan GDRs (Global Depository Receipts) have been placed on the international markets, country funds established and a domestic corporate debt market is fast developing with the potential to play an important role in financing both local firms and private infrastructure projects. An IFC (1998) report identifies three lessons from Pakistan’s experience: (i) Even in times of strong government control of a financial sector, leasing is an excellent way for the private sector to gain a foothold and help create a climate for eventual reform; (ii) Commitment to reform of securities markets regulation and infrastructure can lead to greater flows of new portfolio investment, which stimulate the climate for more positive change in the entire sector; (iii) In the process of strengthening securities markets, it is important to build a climate for new investment in not only equities but also debt instruments such as corporate bonds and commercial paper.

On the fiscal side, rationalization of tax treatment of financial instruments and investors is underway. This is being achieved through amendments in Income Tax Ordinance, and budgetary provisions by Ministry of Finance. In this regard CBR has worked closely with the SBP and SECP to chalk out rationalization of tax levy on short and long term financial instruments. Fiscal incentives for sustainable capital market development have also been encouraged. Capital gains on shares of public limited companies have been rationalized. Arrangements are being made to exempt contributions of stock exchanges to investor protection and clearing house protection funds. Tax deduction is being allowed on expenditures contributing towards the listing of a company on the stock exchange. Government is considering introduction of specific tax-exempt accounts with withdrawal restriction and targeted savings promotional plans such as investment retirement account of registered retirement savings plan. SBP is in the process of identifying banks for handling such accounts.

Financial sectors’ soundness has led to a strong boom in areas such as house, car and durables financing for which the banks came forward by lowering the interest rates and by allowing lease purchase at negotiable rates. For the promotion of venture capital, there is a strong realization that venture capital companies normally take more time to become operationally viable and should be provided tax exemption for a minimum period of 10 years; they are already exempt up to

2007. For consolidating the financial position of mutual funds, the companies have been allowed to retain the capital gains rather than distribute it. This facility is now also available for the unit trust companies.

Government has also expressed a strong commitment to promote corporate and financial sector restructuring and mergers. An important step in this direction was the permission to carry forward losses by banking and non-banking institutions. Proposals are being considered to allow cost of merger as deductible expense and in the case of merger or consolidation of two or more financial institutions which carry on different businesses, the business losses of the merged entity as well as the cost of merger may be allowed as deductible expense to the surviving entity to encourage consolidation.

National Savings Scheme (NSS) rates have been adjusted to a more market based benchmark mechanism. This was carried out systematically at regular intervals to an acceptable market based rate, keeping the entire process transparent, logical and intelligible to general public. Yield for early redemption has been reduced through higher encashment premiums and other means. Efforts are also being made to improve and restructure governance and administration of NSS.

Investment eligibility criteria for securities have also been rationalized. Principal amount of the security and interest thereon are guaranteed by Federal Government. The SBP has approached Federal Government to declare UTP as an approved security. For NBFIs, UTP has already been declared approved security. Distortions in the foreign exchange transfer for reinsurance have been removed i.e. the bar on remission abroad of life insurance premiums for accidental death risk has been eliminated. Life insurance companies are not permitted to remit reinsurance premiums on accidental death risk (unlike other insurance products) which is an impediment to growth of business. The entire insurance sector is being opened up because presently the life insurance business in the country is dominated by SLIC, which is a public entity, and reinsurance for public sector insurance companies is available through PIC.

In the banking sector the major reforms that were initiated and implemented include the privatization of nationalized commercial banks, corporate governance codes in banking, ensuring adequacy of capital requirements of banks, improving recovery rates, liberalizing the foreign exchange regime, measures to promote consumer financing, incentives for mortgage financing, introduction of financial institutions ordinance (2001), expanding the prudential regulations to cover the SME sector, providing credit access to small borrowers via micro-credit schemes, establishing of specialized SME bank, reducing tax rates in the banking sector, broadening the scope of agricultural credit schemes (including the complete overhauling of ZTBL), introduction of parallel Islamic banking modes, promoting E-banking technology and online banking services, evaluation of banks through credit rating agencies, expanding the supervision and regulatory capacity (the supervision of non-bank finance companies has been entrusted with SECP), division of overall responsibilities in SBP (one segment performing the task of central bank, while the other looking after the retail operations of the government) and finally the proposal to introduce electronic clearing system in all cities[3].

Banking Mohtasib Pakistan (BMP) is now fully operational as an independent statutory body for public grievances against scheduled banks in Pakistan. This would not only promote transparency but also force internal organizational efficiencies[4]. As the financial institutions in the country are now free to set their own lending and deposit rates, Government and public sector enterprises also have to pay market based rates on debt raised through banking system[5].

The role of government intervention cannot be exaggerated. In Pakistan, the market system suffers from abundance of regulatory bodies, inappropriate human resources in regulatory bodies, non-defined relationship of the regulatory bodies with the government and delayed decision making in cases shared by regulators and the government[6]. However the intervention cannot be totally ruled out especially in areas which top the future economic agenda. Developing countries need a facilitating legal framework for trade activities, strengthening intellectual property rights, improving labor conditions, rationalizing bankruptcy laws, predictable arbitration laws and promoting public private partnerships.

Legislation is always and everywhere an on-going process. In a country like Pakistan the objective ought to be to: (a) ensure an effective judicial system for predictability in economic transactions; (b) respect judicial independence to guarantee enforcement of contracts; (c) see that rule of law will fairly and consistently apply, without arbitrariness on the part of officials; (d) provide fair and consistent application of laws and rules for individuals and corporations to enable formation of long term business strategies; (e) address elements to promote investment such as international arbitration and enforcement of foreign arbitral awards; (f) review the archaic land ownership and rental laws.

[3] For details on banking sector reforms in Pakistan, see Hussain (2005a).
[4] Complaint forms available at all 7292 branches of scheduled banks within the country (BMP 2005).
[5] Hussain (2004).
[6] See GoP (2005a,b).

Table 3. Regulatory Agencies in Economic Sectors

Name of agency	Sector
National Electric Power Regulatory Authority	Electricity
Pakistan Telecommunication Authority	Telecommunication
Oil & Gas Regulatory Authority	Oil & Gas
Pakistan Electronic Media Regulatory Authority	Mass Media
Monopoly Control Authority	Anti-trust
Securities & Exchange Commission of Pakistan	Secondary market operations
National Highway Authority	Roads
National Housing Authority	Housing
National Tariff Commission	Trade
Pakistan Standards and Quality Control Authority	Quality Control
Small & Medium Enterprises Development Authority	SMEs

During 12 years starting from 1992, Pakistan has seen a rise in the number of operating regulatory agencies. Table 3 shows the various sectors considered for denationalization/ de-regulation and regulatory set-up. There is need for putting in place institutions for conflict management. Although not directly related to the financial sector regulatory institutions in these sectors are nevertheless important for macroeconomic stabilization through the capital account in the balance of payments. FDI has long been correlated with the law and justice scenario of recipient countries. Even the phenomenon of outsourcing has not been able to minimize the role of conflict management.

Table 4. Net FDI and Portfolio Investments in Asia ($ Millions)

	Cumulative flows (1993-96)	Share of total flows (percent)	Cumulative flows (2000-03)	Share of total flows (percent)
China	132,753	47	187,600	71
India	19,707	7	31,779	12
Korea	58,745	21	13,546	5
Indonesia	14,636	5	10,715	4
Thailand	10,186	4	10,473	4
Malaysia	29,243	10	4,358	2
Philippines	8,204	3	3,757	1
Pakistan	4,473	2	2,042	1
Vietnam	3,226	1	2,260	1

Source: Terada-Hagiwara (2005) and Institute of International Finance.
Note: Three financial centers; Hong Kong, Japan and Singapore are excluded.

The second generation system reform in the financial and real sectors will improve Pakistan's standing in attracting foreign capital investment which, as Table 4 indicates, has been low. Economies such as China and Korea embraced structural changes, whereas India and Malaysia capitalized on outsourcing and innovation in the productive sectors. Their shares in total flows suggest what is achievable through better institutional arrangements.

5. Future Directions

Institutional efforts have to focus on banking and capital market regulatory system, transparency in financial policies, discipline in fiscal policies, and sequencing the trade liberalization process.

Any possible development in the financial sector must concentrate on building the investors confidence to a sustainable level. Besides the availability of capital on affordable rates, skilled labor force and provision of security for profits and assets, the country needs to emphasize the strengthening of the financial sectors' governance, transparency and operational standards. There is an immediate need to review and streamline policy responsibilities and improve policy co-ordination of Government ministries for financial sector (including NBFIs, insurance and pensions systems). Ministry of Finance may create a single focal point within the ministry for improved coordination of financial policy issues between the Government and independent regulators. Direct government involvement in operational and regulatory matters needs to be reduced.

The development and improvement in the legal framework for financial transactions and corporate affairs is a continuous process that requires persistent and coordinated effort on the part of both the financial sector and the judiciary. The enforcement of laws and regulations for enhanced transparency in financial transactions including legislation for anti-money laundering and corporate insolvency needs to be a priority agenda. Furthermore there is a need to update the company's ordinance for ultimately incorporating improved corporate governance standards and to review trust act for modern investment needs.

On the side of regulation, SECP must be provided with enhanced mandate for broad based regulation of financial markets and services. There is a need to review existing structure and composition of the commission and policy board and to study possible transfer of selected powers of high courts in relation to implementation of company's ordinance to SECP. In this way matters which currently take a long time to settle in the court such as liquidation and reduction in capital issues will be resolved expeditiously.

The SECP Act needs to be updated to introduce new products, for regulatory powers, for pensions, to broaden the means of financing for leveraged investors thus removing constraints on the expansion of money and capital markets. The Act should facilitate the development of financial sector as whole, as interlinked markets enable the development of innovative products suitable for investments such as in physical infrastructure, an area in which Pakistan is just entering.

Another issue in this regard is the expansion in the capacity of SECP. For improving the market efficiency, one has to consider enhancing SECP capacity for market surveillance and supervision of NBFIs. This may be done by recruiting market professionals with industry/sectoral knowledge. Procedures have to be instituted for on and off-site inspection and monitoring. SECP will have to come forward for developing a generally accepted code for corporate governance through stakeholder participation. This is necessary so that the final outcome is applicable and acceptable to the corporate sector, financial intermediaries, Government and the concerned professionals. Corporate governance defines the interacting relationships of a company's management, its board, its shareholders and other stakeholders. This kind of governance if achieved is a key element for improving economic and financial efficiency. The development of the capital market as a significant financial intermediary for the economy will greatly depend on the framework of corporate governance adopted and the degree of adherence to the framework in practice. As the market develops, it in turn will play an integral role in promoting principles of good governance by enforcing financial discipline on companies that practice poor corporate manners.

The services of Institute of Charted Accountants of Pakistan (ICAP) may be relevant for improving quality in information disclosure. The market must be able to establish professional standards for accounting and auditing firms providing services to listed corporations. There are accounting standards that require immediate amendment or rationalization. Stock exchanges may introduce quarterly reporting by listed companies of accounts and encourage financial projections in offer documents or prospectuses. The SECP should encourage dematerialization of securities by implementing the new definition for listed securities as contained in the new income tax ordinance to clarify and follow up the pending high court cases. The new definition of listed securities will encourage the dematerialization of securities which will result in cost savings, reduction in stamp duties and enhance efficiencies. The stock exchange board constituents and nomination/selection procedures need to be revised. Proprietary trading of brokers may be regulated and the broker accounts must be separated from the investors' accounts. All three stock exchanges may encourage the opening of investors' account with depository or identified depository participants. Minimum capital requirement and other criteria for opening of investors' sub-account with brokers may be introduced. SECP can come forward and suggest different models of demutualization/integration of stock exchanges. These measures are necessary for strengthening risk management practices at the stock exchanges. Integrating existing stock exchanges will result in a unified national market, which will not only reduce regional barriers between investors, but also lead to a reduction in transactions costs.

Taking a leap forward, Government of Pakistan raised longer maturity funds from the international capital markets to establish an international rating for Pakistani bonds and equities. However, as Pakistan makes its move towards the commodity markets, it needs to strengthen the operational capability of price monitoring institutions. This year Pakistan achieved a GDP growth rate of 8.4 per cent, with an inflation rate of 9.7 per cent. During the same time period China achieved a growth rate of 9.2 per cent with an inflation rate of 3.9 per cent. Inflation is a tax that knows no bounds; beyond a threshold it can simply eat away the already achieved economic growth. Pakistan's recent experience with the price hike is quiet interesting as the situation was regularly being monitored by the Economic Coordination Committee (ECC). However, the weakness in implementing the price guidelines in time, delay in opening up of commodity markets for import of food items, failure to check the excessive export of eatables across the western border etc. accelerated the inflationary pressures. This is a matter of serious concern because it indicates that at times despite having formal institutions in place, the government remains powerless to monitor the price hikes and execute the decisions. This in the medium to long run makes the commodity markets unresponsive to the decisions of regulatory bodies.

Do the regulatory bodies in Pakistan lack implementation power? To some extent this may be correct. However another problem more acute than this is the weak inter-departmental coordination to carry out a given task. Again, going back to the example of commodity pricing in Pakistan, if a decision to rationalize prices is issued by the federal government, it takes a long time to reach the provincial and district levels. The key question here would be to what extent these tiers of government have been allowed the autonomy to exercise their powers? Most commonly it is noticed that these powers are not defined. Consequently in times of economic exigency, the time lost in acquiring approval to exercise a specific set of powers from the higher tier exacerbates the shock confronted by the economy.

If Pakistan is to pursue a sustained economic growth policy, then inflation has to be kept under strict check to avoid another episode of iniquitous growth. For doing so, the country needs a much more responsive interest rate policy that can act as a circuit breaker whenever the situation deteriorates. However, there is also a need to discover off-monetary policy measures to monitor sector-specific booms like stock price hike and property market explosion. Seeking a solution to the problem of rising food and oil prices with the standard monetary policy misses the point. In this case the administrative institutions require being persistently vigilant.

A common theme in all debates on Washington Consensus, Copenhagen Consensus, and now the second generation reforms was whether or not markets themselves could be termed institutions? In the true capitalist norms, is market an institution? This is a difficult question. In October 1929, Professor Irving Fisher of Yale University said: "… prices have reached what looks like a permanently high plateau." Speaking of the same price index, in the same country, on the same business cycle, Harvard University's Joint Centre for Housing Studies reported in June 2005: "in several metropolitan areas natural or regulatory driven supply constraints may have resulted in permanently higher prices". So then market is an institution that is not static; it is an actor when economic forces interact; it is also a coordinator between economic agents; it requires no guidance when left alone; and knows no bounds when on the road towards ruthlessness (often termed as the widening gap between rich and poor).

Talking in strict macroeconomic terms, if market is an institution, then this institution has its sub-institutions that have to be tamed before the market itself is tamed. In other words what are the precise components that may turn a market into an institution which embodies self-correcting mechanism, guards against possible internal and external meltdowns, incorporates micro-macro feedback responses and has the right kind of shock-absorbers required when the business cycles become counter-productive. To achieve the maturity of such an institution, Table 5 lays out a few characteristics that may be the cornerstone of reforming markets in emerging market economies.

Any progress towards institution building in the financial sector should ultimately lead to better risk management in the private sector, transparent yet firm regulatory powers of Government sector, increased and regular linkages of small businesses with the established domestic and international markets, better allocation of credit and finally the ability of market as an institution to help its agents in protecting themselves against any possible internal or external economic shocks. On the anvil, the choice of monetary-cum-exchange rate regime is a matter of pragmatic judgment to keep inflation and exchange rate fluctuations within reasonable bounds.

Table 5. Characteristics of Institutionally Interactive Markets

Property Rights that reduce the costs and risks of transactions	These rights include; right to control or manage productive resources, right to transfer or dispose of assets, right to trade in these rights, right to acquire or assemble assets and devote them to organized productive activity including the formation of new firms (Kotler, Jatusripitak and Maesincee 1997).
Regulation and Deregulation	Regulation is justified once the government is convinced that the particular sector is suffering from market failure, i.e. there is a need to control monopoly, there is need to correct spillover costs, there is dissemination of imperfect and asymmetric information regarding prices and quality. However markets that achieve a certain stage of maturity never allow the governments to overdo the regulation exercise as it is counter-competitive, and attacks the rights of risk enduring business community. Deregulation/privatization becomes imperative once the economic agents become responsive to market parameters.
Industrial Relations Policies	Industrial harmony and drive towards productivity requires a cordial relationship between management and labor. Markets must be able to institutionalize customs and practice, predictability, procedural mechanisms and acceptable terms governing conditions of employment.
Trade Unions	Korean experience reveals that markets can spur economic growth for unusually longer time periods, once the interests of trade unions are aligned with national goals. Many developing countries have missed this point and instead passed tougher legislation or repressed their workers in order to attract foreign direct investment.
Redistribution	Unlike the traditional understanding where it was thought that growth and distribution cannot go together, it is now known that an improvement in income distribution can actually increase total private savings (Tanzi 1991).
Information	Markets develop their information base and dissemination systems for the protection of both producer's rights and consumer's surplus.
Feedback Mechanism	Markets must be able to incorporate the responses of different economic agents operating in that market e.g. property booms in developing countries can easily turn ugly; and this is where emerging markets can learn from developed markets where the lag response periods have been reduced to a minimum in order to avoid market panics. So when the house prices rise too rapidly consumers simply back away from the market. Many will postpone their decision to buy a home others will buy a home that costs less and still others will negotiate a better deal for themselves. As sales slow, appreciating rates will settle down or even fall back a bit, giving incomes a chance to catch up in supply-constrained markets.

Annex I. Components of Financial Sector Reforms in Developing Countries

Countries	Interest Rates	Directed Lending	New Entry	Prudential Reforms	Restructuring of Govt. owned banks
Bangladesh	Fixed rates raised in late 1970s. Some controls on lending rates to priority sectors & a deposit rate floor retained.	Partial liberalization to priority sectors	Private sector banks allowed since 1978. Two Govt. banks nationalized in 1983. 20 private sector banks by 1995.	Loan classification provisioning rules in 1989 improved in 1995. New banking law, including capital adequacy rules introduced in 1991. Bank supervision restructured to include off-site surveillance. Credit Information Bureau set up for large loans.	Government injected new capital into NCBs. Measures taken to improve management & accounting standards. NCBs still expected to lend to SOEs and politically connected borrowers.
Laos	Controls gradually liberalized between 1991-95. Minimum saving rate remained until 1995.	Preferential lending eliminated in 1988, except for requirement to lend 10% of deposits to agriculture.	Monobank split into central & commercial banks in 1988. Private sector banks allowed in 1989, but branches restricted to Vientiane. 8 private sector banks (7 with foreign shareholding) by 1995.	Central Bank started annual audits & bank inspections, and issued guidelines on accounting procedures.	State Banks recapitalized in 1993-94. Bad debts transferred to Debt Disposal Unit of Central Bank in 1993.
Nepal	Liberlaisatinon began in 1986 with minimum & maximum deposit rates retained until 1989. TB & bond auctions introduced in 1988.	Sectoral credit directives remain in force.	Entry of foreign banks in partnership with domestic investors allowed in 1984. Foreign participation restricted to between 20 – 50% of equity. New licensing suspended in 1995. Central bank licensed finance companies (domestically owned & joint ventures) in 1995.	Regulations strengthened in 1989, including tighter capital adequacy, minimum capital, large loan exposures & provisioning. Connected lending is not allowed. Finance company act enacted.	Government repaid loan guarantees. Pressure to lend to SOEs reduced, but not stopped. NBL undertook internal reforms; reduced staff, closed some branches. Govt. reduced its stake in NBL from 51 to 46 per cent.

Annex I. (continued…)

Countries	Interest Rates	Directed Lending	New Entry	Prudential Reforms	Restructuring of Govt. owned banks
Malawi	Lending rates deregulated in 1987 and deposit rates in 1988. Preferential rate for agriculture abolished in 1989. Informal control maintained until 1990. TB auction introduced in 1992.	No explicit directives imposed prior to reforms.	Revised Banking Act in 1989 set out conditions, for new entry. But new entry by private sector banks did not occur until 1995.	Revised Banking Act enacted in 1989 covers all FIs & includes provision for minimum capital adequacy & large loan exposure limits. Central Banks' supervision department strengthened.	Bad debts owed by Press Corp. removed from banks' loan portfolio and replaced by government securities in 1984. Loan recovery efforts and credit procedures strengthened by banks since the mid-1980s.
Madagascar	Interest rates liberalized in 1990.	Liberalized	Private sector entry allowed since 1988.	Banking law passed in 1988, but lacked important prudential regulations. New banking law passed in 1996 allowing regulations to be imposed.	Banks wrote off bad debts in 1988, and revalued reserves with support of interest free loans from Government. Problems persisted and administrators appointed to manage two government owned banks in 1992. Government provided one bank with FMG 45 billion ($11 million) in fresh capital in 1996.
Tanzania	Nominal interest rates raised in 1987. Controls partially liberalized in 1991, but maximum lending rate retained until 1993. TB auction introduced in 1993.	Lending directives no longer imposed.	Revised Banking Act in 1991 allowed entry by private sector banks and FIs which meet strict licensing criteria imposed by Central Bank. 5 private sector banks and one FI began operations during 1993-95.	Banking act 1991 covering FIs, gives Central Bank authority to issue prudential directives. Regulations strengthened on licensing, capital adequacy & minimum capital, loan exposure, and provisioning. Central Bank supervision strengthened and directives issued for off-site reporting and on-site examination.	Government took over bad debts of crop marketing parastatals in 1987. Restructuring plan for National Bank of Commerce devised. Tanzanian Hosing Bank liquidated in 1995.

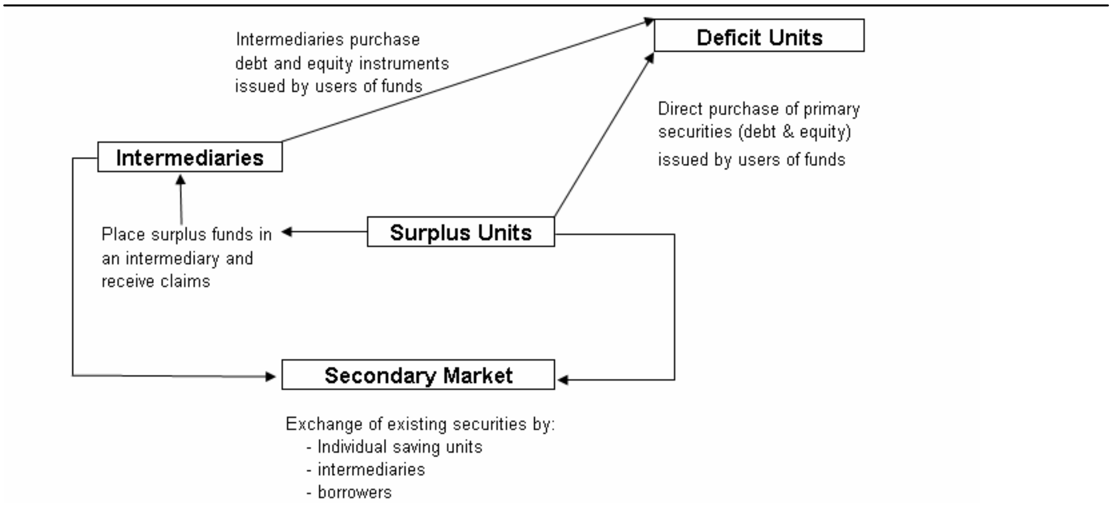
Annex I. (concludes)

Countries	Interest Rates	Directed Lending	New Entry	Prudential Reforms	Restructuring of Govt. owned banks
Uganda	Liberalization began in 1992 with some decontrolled and others linked to the TB rate. Link with TB rate severed in 1994. TB auction introduced in 1992.	Formal lending directives were not imposed.	New entry by banks and FIs allowed since mid-1980s. New Banking Act in 1993 raised entry requirements in terms of capital.	New Banking Act enacted in 1993 covering banks and other FIs gives Central Bank flexibility to issue prudential directives and take over distressed FIs. New act imposes minimum capital adequacy requirements and restrictions on large loan exposures and Insider lending. supervision reorganized, reporting requirements strengthened and inspection instituted.	Government injected capital into Uganda Commercial Bank. Its debts were transferred to Non-Performing Assets Recovery Trust in 1995-96 and replaced by government bonds. Staffing cut by half in 1995. Management was reorganized.
Zambia	Interest rates first raised and then decontrolled in 1992. TB auction introduced in 1993.	Sectoral lending directives not imposed prior to reforms.	New entry by banks allowed since 1984, entry criteria not made explicit. Increase in new entry during 1991-94 prior to enactment of new banking legislation indicates a de facto liberalization of licensing. New legislation raised minimum capital requirements.	New Banking Act enacted in 1994, covering banks and other FIs and gives Central Bank authorities to issue prudential directives e.g. capital adequacy requirements, restrictions on large loan exposure, insider lending etc. Bank supervision strengthened.	Government has not recapitalized Zambia National Commercial Bank. ZANACO implemented some internal reforms to strengthen management and internal controls.

Source: Brownbridge and Gayi (1998)

Annex-II

Capital Flows in Financial Markets



Source: McGrath and Viney (1999)

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