FINANCIAL REFORM AND ECONOMIC INTEGRATION

The Case of Pakistan

Ishrat Husain

Pakistan faced serious economic difficulties in the last few years particularly 2008 and has been able to achieve some stability in the last few months with the assistance of the IMF. But paradoxically the global financial crises had very little to do with it. The trouble in Pakistan started because of misgovernance, postponed policy decisions for the sake of short term political expediency, the assassination of the most popular leader and the resulting political instability, fall out of terrorism and a flawed transition from the Military to the democratically elected regime. As a mater of fact, the financial sector reforms carried out for more than a decade was able to insulate the economy from the adverse spill over effects of the global financial crisis. In this respect Pakistan just like China and India has demonstrated for the second time in the last 12 years some essential ingredients that can act as a safety valve against the onslaught of the tidal waves of globalization and financial integration.

Although different observers may have varied interpretations and readings of the Asian crisis in 1997-98 and the ongoing crisis I would attribute the following factors as contributing to the damage control in case of Pakistan.

First, Pakistan followed a "cautious liberalization" strategy. The current account transactions were made fully convertible but the controls on capital controls remained intact. Only foreign direct investment inflows were encouraged into certain sectors of the economy while portfolio investment flows were both regulated and discouraged. Residents were not able to freely convert their domestic savings into foreign currencies and businesses were allowed to invest abroad under tightly restricted conditions. Exotic derivative products were not allowed.

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Second, the capital adequacy ratios were enhanced beyond the prescribed level of Basle I and Tier I, Capital consisted mainly of undiluted shareholders' equity which held the real value intact and financially engineered products having the potential of value erosion were not permitted. Variable ratios wee introduced to reward the sound and efficient banks and penalize the weak and inefficient banks on the basis of their CAMELS indicators determined by the Central Bank supervisor.

Third, incentive structure for branch expansion and new business product offerings were linked to the performance of each bank evaluated and rated by the bank supervisor. This in-built transparent mechanism held back the weaker or relatively unsound banks from mobilizing retail deposits. This mechanism was applied across-the-board and if the big banks failed to meet the soundness criteria they met the same fate. Thus the bias towards "Too big to fail" was indirectly contained in this manner.

Fourth, the banks were encouraged to clean up their balance sheets by removing long standing non performing loans that had low or no probability of recovery. The Central Bank evolved a generalized scheme under which the collaterals possessed by the lenders were allowed to be liquidated at their forced sale value and adjusted against the principal amount outstanding. Loan loss provisions were then invoked to set off the residual value of loans outstanding. The Gross NPL ratio of the banking system declined from 25 percent to 6 percent within five years giving a big boost to the profitability of the banks.

Fifth, the cleaning up of the balance sheets, strict restrictions on the off balance sheet contingent liabilities, and the increased profitability of the banks attracted strong international players to Pakistan. As foreign banks were treated at par with the domestic banks and had no restriction on the limit to which they could own equity they rushed in with capital, acquisitions of weaker banks, expansion of distribution channels, new technology and products. Financial services industry was the second largest recipient of FDI and in the peak years the annual flows averaged more than $ 1 billion. Despite the presence of these international banks the domestic regulatory environment kept them away from excessive risk taking and undesirable innovation.

Sixth, the introduction of the private sector into the banking changed the whole human resource profile. There was a gradual transformation from low productivity manual unskilled workers to high productivity educated knowledge workers. This up-gradation and substitution of human resource base, hardly noticed, has made a lot of difference in the service standards to the customers, reduction in transaction costs, provision of value added products, separation of back and middle office functions from the front line interaction and on the bottom line of the banks. Along with wide dispersal of automation and technology across the network the efficiency levels of the banks improved significantly.

Finally, last but not the least the Central Bank invested in developing its own capacity as a regulator, watch dog, supervisor and monitor of a largely private sector owned banking system. The natural tendency of the private owners and managers to maximize their profits and bonuses by taking excessive risks with the depositors' money had to be kept under control. The SBP took effective enforcement actions shunning all political interference that resulted in cancellation of licenses, removal of top managers, supercession of the Board of Directors, forced change in the ownership of the banks. The fit and proper criteria were strictly enforced. This added to the credibility of the regulator and induced a strong deterrent effect which restrained the behavior of the players in the industry. The regulators' philosophy that a market based banking system should always be accompanied by a strong and credible regulator is in my view the crux of this problem.