

# A good legacy

Ishrat Husain finished his second term as governor of the State Bank of Pakistan in December with a sense of accomplishment: the country's stagnant banking system has been turned into a healthy industry catering to the needs of the middle class and SMEs. He talks to Adrian Murdoch.

One of president Pervez Musharraf's first appointees, Ishrat Husain took over the governorship of the State Bank of Pakistan in December 1999. At the time, the economy was a mess. Growth was stagnant, banks were bloated and clinging on in the public sector. Indeed, the financial sector as a whole was mired in corruption. Self-interest was the order of the day.

President Musharraf's faith in the former chief economist of the World Bank's East Asia and Pacific region has been justified. As one Karachi paper suggested, Husain has, in many ways, been south Asia's answer to former US Federal Reserve chairman Alan Greenspan, changing policies to suit changing economic situation, but without deviating from market orthodoxy. There is no doubt that he has been the linchpin in the economy's revival ever since, overseeing massive inflows of foreign capital as the economy recovered, which has led to unprecedented foreign exchange reserves and a stable rupee.

At the same time, Husain has led Pakistan's war on terror from a financial point of view, clamping down on money laundering and terrorism by encouraging banks to know their customers better. Here too he has been successful in creating an environment where potential customers who have suspect paperwork are turned away.

At the end of his second term of office and in one of his last interviews as governor, Husain explains to Global Agenda how Pakistan is now moving to a new level of economic maturity and muses on his time in office.

**GLOBAL:** The high international price of oil in recent months has had a negative effect on inflation. Does this cause concern?

**ISHRAT HUSAIN:** Inflation is now coming down, and we hope that it will decline further as oil prices drop. After all, the price of a barrel of oil is now \$57 compared to \$60. You must also remember that it is now the middle of winter. Oil prices will continue to decline as we enter spring, which will have a positive impact on inflationary expectations. On top of that, we have a tight monetary policy which is already having the desired effect. Private sector credit was down in the first four months of this fiscal year, and broad money supply is declining – both of which are continuing to dampen inflation.

**GA:** Your new capital adequacy regulations for banks call for a phased increase to PKR6 billion (\$100 million) by 2009. What do you expect the effects to be?

**SHEIKH:** Twenty banks in Pakistan carry out 95% of all business in the country. There are a further 18 banks, which carry out only 5% of business. These banks have no particular advantage in this market. They don't have any network, products, technology, scale or human skills. Their contribution is insignificant. The idea behind the regulations is that Pakistan should have 20 stronger and well-networked banks that can service a broad spectrum of our population.

**GA:** If these 18 banks have little to offer, what is the point of mergers?

**SHEIKH:** You are getting whatever branches you have. You are adding to your network.

**GA:** Prime minister Shaukat Aziz has spoken of the need for second-generation reforms in the banking sector. What do you understand by that?

**SHEIKH:** We need to deepen our capital markets because the big corporate houses should not rely on banking finance for their long-term capital needs. They should go to the equity markets, have IPOs, enter the bond market and even go to foreign markets to raise debt and equity.

**GA:** Last year saw a five-fold increase in corporate debt instruments – 12 worth approximately PKR15.5 billion in 2005. Is that something you welcome?

**SHEIKH:** From my perspective, it is still very little, because we want to deepen the market. We want to do more. We want to ensure that the resources of the banking sector are available for Pakistan's middle-income groups, for small and medium enterprises, and for small farmers. When the benefits of the banking industry are widely distributed, that will give rise to sustainable and equitable growth. The more purchasing power you put in the hands of the majority of the population, the better the distribution of the benefits of growth.

**GA:** Has the landscape for SMEs improved?

**SHEIKH:** Last year, 17% of entire bank credit was channelled towards this sector, and it is increasing every year. We have completely



revised our prudential regulations for small enterprises which are now based on cash flow lending. This will open up the doors for SMEs who have neither collateral nor security. We are one of the few countries in the world with tailor-made regulations to meet that sector's needs.

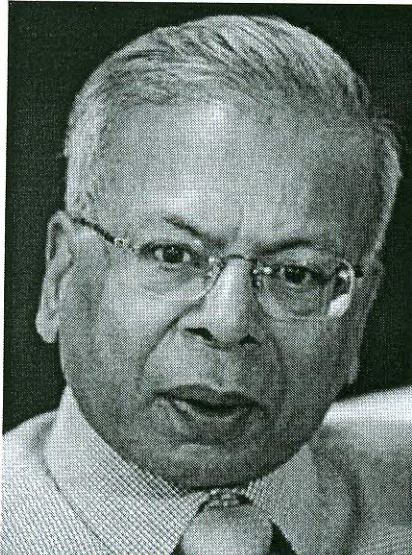
GA: Do you see Pakistan emerging as a project financing centre in the region?

SHEIKH: When you are going in for mega-projects like pipelines you need both domestic and international project finance. We have to develop our in-house capacity for project finance, but we also need to use our resources to tap international markets for it. This is a specialized field and we think we should have the expertise. Certainly, there are a lot of lenders willing to lend for this kind of deal.

GA: Pakistan's recovery has been partly down to low interest rates. Does the rise of rates to 9% last April signal the end of boom?

SHEIKH: This is not something we should rejoice about. We should have a steady but sustainable growth. Anywhere between 6-8% growth of GDP is acceptable and will lead to poverty reduction over the next 10 years. One year we may have 6%, another year 7%, depending on a

Ishrat Husain



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variety of external and internal economic circumstances. If we have a good crop we might hit 8%, but then, again, if there are external shocks like the price of oil or the earthquake, we may have a lower growth rate. But as long as we remain within the range, that is what we are trying to achieve.

GA: Has the rate of poverty come down in Pakistan?

SHEIKH: I don't know whether it has come down or not. The last data we have is from 2001/2002, and we won't know with any degree of confidence whether poverty has come down or not until the results of the household income and expenditure survey in December. My own hunch, as an economist, is that if you have such high rates of growth over the last four of five years, poverty is bound to decline.

Nonetheless, much needs to be done in the social sectors, in investment and education, in female education, health, water supply, farm-to-market roads and the agricultural sector to help lift the poor from their subsistence levels. We have helped to introduce products and services which were not available before. Micro-credit has hit 500,000 people, and we soon hope to reach 3 million households. We have gone to 1 million agriculture households, mostly small farmers; hundreds of thousands of SMEs; the middle class and salaried workers who are now getting consumer loans. Within the last five years, the number of households getting loans has quadrupled. The central bank has done a great deal to broad-base the access of the middle and poor classes to banking assets.

GA: And yet, only one in five Pakistanis is within the formal banking sector.

SHEIKH: The figure is going down. When you have four times more borrowers coming in, they are no longer going to the informal sector. I estimate that by 2010, half of farming households will be within the fold of the banking system and, as a result, informal activities will decline.

GA: So how do you break down informal banking networks?

SHEIKH: The new borrowers are making money. The corporate sector gives them a margin of 50 basis points over their funding

costs. Agriculture borrowers are giving them 400-500 basis points. If you were a businessman where would you put your money? We don't create targets, we create the regulatory environment and framework for banks to give credit to borrowers in agriculture, and the SME and consumer sectors.

GA: What is your legacy at the State Bank of Pakistan?

SHEIKH: The banking sector used to cater to the needs of a miniscule segment of the population: the government and public sector corporations, as well as big corporate houses with an element of trade financing thrown in. My major satisfaction over the last six years is that we have enabled the banks to extend credit to SMEs, the middle class, the poor and landless, and farmers. At the same time, banks have become sound and are owned and managed by the private sector, and now work in a competitive environment.

What has been the most difficult aspect of the job?

SHEIKH: Pakistan has a lot of rent seekers, always looking for concessions, privileges and preferential treatment. I was opposed to this culture and was not very popular with people I fended off. I believed in a level playing field, a uniform and non-discriminatory environment which was based on merit, as well as on credit worthiness. People were not used to this line of thinking. Today, banking is all very much based on professionalism. Political interference in the allocation of credit or appointments has been reduced to nothing.

GA: What do you plan to do next?

SHEIKH: I am going to start a think-tank to provide an independent and objective view on public policy issues and to help in healthy debate and dialogue on national economic policies.

**CV DR ISHRAT HUSAIN**

Dr Ishrat Husain was until December 2005 the Governor of the State Bank of Pakistan. In recognition of his lead role in the revival of Pakistan's economy, The Banker nominated him Central Bank Governor of the Year for Asia in January 2005.