FINANCE, GROWTH AND POVERTY – THE EXPERIENCE OF PAKISTAN

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The linkage between financial sector and economic growth is well understood but its impact on poverty reduction is still nebulous. There is no automaticity between growth and poverty reduction and this link needs to be nurtured. The notion is to work on this linkage through income distribution component of poverty reduction.

It is also obvious that the days of State-owned Development Finance Institutions (DFIs), directed credit and mandatory targets for priority sectors, subsidized interest rates, public sector owned specialized financial institutions are over. The channeling of credit to the poor and middle-income classes has to be achieved through market-based financial system.

The recent experience of Pakistan demonstrates that only when a combination of macro-economic reforms, financial sector reforms, and carefully designed enabling regulatory framework are deployed in a strategic manner bank credit can be channeled to this desired target group without distorting marked based competition and incentive structure.

Macroeconomic reforms have brought about a reduction in fiscal deficit, reduction in public debt burden, privatization and restructuring of state-owned enterprises. These measures have reduced the credit demand from the public sector and increased the supply of loanable funds in the system.

Financial sector reforms have transformed a predominantly state-owned banking into a private sector-owned and managed system. Market based determination of lending and deposit rates has spurred prudent risk management by banks themselves and led to efficiency and lower intermediation costs. Competition among the banks has squeezed the profit margins on traditional modes of lending and forced them to innovate, extend their geographical outreach and

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come up with new products and services. Automation and greater use of technology has improved the standards and quality of services.

Enabling regulatory framework has also been altered in many ways to reinforce the macro and sectoral reforms and to buttress banks' efforts to move into new business areas of direct relevance to the poor and middle classes. Minimum capital requirements, stringent corporate governance standards, tackling the problem of non-performing loans have helped weed out weak institutions leading to mergers, acquisition and consolidation and forcing changes in management and ownership in some cases. The Government has reduced corporate tax rates on banks from an exorbitantly high 58 percent to 42 percent and aims to bring them down further to 35 percent in the next two years.

This confluence of improved incentives for the banks, greater competition and reduced pre-emption by the public sector have brought about dramatic reduction in average lending rates from 14 percent to 5 percent. These low interest rates have made borrowing affordable for middle and lower income groups for the first time in Pakistan while fierce competition has squeezed the bank margins in the traditional corporate sector business forcing the bank management to focus diversity to non-traditional sectors such agriculture, SME consumer financing and microfinancing.

This market innovation and diversification was further supported by rewriting of the Prudential Regulations (PRs) for agriculture, SMEs, consumer financing, mortgages and micro financing in consultation with the commercial banks and the stakeholders. "One size fits all" approach of prudential norms was discarded and the unique and peculiar characteristics of each one of these different sectors were captured and incorporated into separate PRs for each type of business activity. For example, cash flow lending, programme lending and credit scoring methodology were introduced for SME sector instead of the traditional collateral based lending applicable to the corporate sector. Revolving Credit reflecting the production cycles in the agriculture sector was introduced to facilitate small farmers avail of credit without hassle of frequent approvals.

Financial sector infrastructure was also strengthened. Credit Information Bureau was set up to provide real time information on the credit history of the bank borrowers. Accounting and Auditing practices were changed to conform to international accounting and auditing standards. New laws on foreclosure were enacted that facilitated the banks to repossess property of defaulters. Willful default was made a criminal offence under the National Accountability Bureau (NAB). Separate Banking Courts were set up to speed up banking related trials. A Banking Law Reforms Commission was entrusted with the revision of banking laws.

What has been the outcome of these efforts? Although it is still too early to evaluate the results, the preliminary findings show a positive trend. The most encouraging results have emerged from agriculture lending. Commercial banks, which were reluctant until three years ago to extend credit to this sector despite mandatory targets and penalties, have overtaken Agricultural Development Bank in the volume of disbursements. The volume of commercial bank lending has grown by 35 percent annually and almost tripled since FY 2000. This increase has been accompanied by a greater outreach to the farming community. The number of borrowers served by the banking system has risen by almost one quarter. But even then, the number is hardly one million households covering only 15 percent of the farming population. The expectation, however, is that if this momentum is maintained, the number of borrowers will rise to more than 3 million in the next 5 years. Most of the disbursements have accrued to small and subsistence farmers.

Landless farmers and other urban dwellers without any tangible assets are among the poorest. To help them, micro finance institutions have been set up with the assistance of the Asian Development Bank and IFC. Although in their two years' existence these institutions have reached out to only 100,000 borrowers but they have overcome their initial organizational and teething problems. The target is to have at least 1 million borrowers in the next 5 years.

The other promising sector which is labour intensive and can generate productive employment opportunities is the SME sector. SME sector lending is going through a new phase of training the bankers, coordinating with the technical assistance providing agencies, using information technology to monitor the performance of borrowers and adopting a new credit appraisal technology. The switch over to new separate prudential regulations has ignited interest among the banks as well as the SME entrepreneurs. The number of borrowers has significantly risen during the last one year, i.e. by almost 50 percent and the volume of lending to sector has begun to show some high growth in the last few quarters.

To conclude, it is possible to strengthen the linkage between finance, growth and poverty by a well-designed strategy that combines the macroeconomic reforms, financial sector reforms and regulatory reforms moving in tandem in the same direction reaching out to the target group of the low and middle-income groups within the context of a market based banking system. The preliminary evidence from Pakistan's experience during the last two to three years shows positive movement. The challenge is to keep up the momentum and spread out the benefits to a larger section of the population in the lower and middle income groups.