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ECONOMIC GROWTH NEXUS TO PERFORMANCE OF BANKING SECTOR IN PAKISTAN

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ABSTRACT

This paper aims at finding the effect of financial liberalization in Pakistan's banking sector. The financial liberalization and reforms which were introduced in 1990s in Pakistan's banking sector, their impact on economic growth. The introduced reforms in the banking of sector of Pakistan were beneficial in a matter fact that they led to improved performance of the sector. Nationalized Commercial Banks in the country were privatized and their post privatization performance is much impressive as compared to when they were not privatized. There are a lot of mergers and acquisitions that took part within the domestic banks and the foreign banks in the country. As per the conditions set by the State Bank of Pakistan, the minimum capital requirement of Rs 1 billion to be maintained by all banks led to mergers and acquisitions, the amount of minimum capital requirement would be increased to Rs 6 billion in 2009. All the reforms that were untaken were beneficial to the banking sector and it led to better performance of the banking sector. Furthermore, it examines the relationship between financial liberalization and the performance of banks in Pakistan. An extensive analysis is carried on the performance of the banking sector on the basis of six indicators which are capital adequacy, asset quality, management soundness, earnings and profitability, liquidity and sensitivity to market risk. Similarly, M2 (broad money) to Gross Domestic Product ratio is also examined which tells us the relationship between the banking sector and economic growth.

KEYWORDS

Banking sector, Broad money, Financial liberalization, Economic growth, Reforms.

INTRODUCTION

Pakistan‟s banking sector reforms have been launched and implemented over 1990s.The reforms and restructuring introduced was in February 1994, when the State Bank of Pakistan was given full autonomy during Financial Sector Reforms. On 21st January, 1997 the Government of Pakistan issued three Amendment Ordinances those included the State Bank Act of 1956, Banking Companies Ordinance 1962 and Banks Nationalisation Act 1947. By these reforms introduced State Bank of Pakistan had the exclusive authority to regulate the banking sector and to conduct independent monetary policy. Banking sector liberalisation and reforms were well sequenced and well designed (Dr. Shamshad Akhtar, 2006). Pakistan has been implementing a wide range of structural reforms aimed at improving the economy. The reforms implemented are in the financial sector, capital markets reforms, tax and tariff reforms, reforms in tax administration, fiscal transparency, reforms in privatisation program, governance reforms and devolution and capacity building. Due to all these policies and efforts it has a targeted growth rate of 6 percent for the next five years. Pakistan‟s Gross Domestic Product for the year 2005-2006 was 6.6 percent and mainly the key drivers for this growth are the services sector and industrial sector. The services sector grew by 8.8 percent in 2005-2006; growth in the services sector was attributable to the strong growth in the finance and insurance sector, wholesale and retail trade and transport and communications sector. (Economic Survey of Pakistan, 2005-2006)

Financial liberalisation process in Pakistan has been remarkable. It did not just result in privatisation of large public sector banks but the process of privatisation also led to offering new management in most cases.

By the introduction of financial reforms the key issues like Non Performing Loans (NPL) decreased, allowed entry of private banks and Cash Reserves Requirement and Statutory Liquidity Requirement were increased which led to healthy performance of the banks. The stock of Non Performing Loans have decreased from Rs 18.8 billion in 2001 to Rs 14.0 billion in 2002 and Rs 7.0 billion in 2003.The main aim of introducing financial liberalisation and reforms was to

- ensure soundness of the financial sector
- maintaining price stability with growth
- prudent management of exchange rate
- strengthening of the payment system.

The reforms introduced in the banking sector focused on the strategic objectives and priorities such as (i) information technology and infrastructure development (ii) human resource development and (iii) improved accountability. Further more the reforms adopted by the State Bank of Pakistan include; further strengthening of prudential regulations, policy for opening and closing branches has been liberalised, a free floating market driven exchange rate system has been introduced. In addition, restrictions on buying and selling of foreign exchange by banks have been removed. Special banking courts have been established under this Act to facilitate the recovery of non performing loans and advances from defaulted borrowers. The Government of Pakistan has established the Corporate and Industrial Restructuring Corporate (CIRC) to deal with the non-performing loan portfolios of nationalised banks on certain agreed terms and conditions and issue government guaranteed bonds earning market rates of return. The purpose of establishment of CIRC is a two fold; to concentrate recovery efforts against loan defaulters and to improve profitability of nationalised banks. Appointment of independent persons to the Board of Directors of the Nationalised Commercial Banks is another reform introduced by the State Bank of Pakistan. The requirements for minimum capital of banks have been increased to Rs. 1 billion in order to encourage consolidation of smaller banks. The credit for all commercial banks has been made mandatory. State Bank of Pakistan in its reform agenda reduced the tax rate for commercial banks and tax laws have been changed to facilitate merger and acquisition of banks and financial institutions by allowing group tax loss relief. Another vital reform introduced by the State Bank is the issue of Government bonds against long outstanding tax refund claims of banks (Dr. Ishrat Hussain, 2002). The quality and reliability of reporting, the format of statutory accounts have been revised on the basis of international Accounting Standards. Further more in addition, the State Bank of Pakistan has published a list of approved auditors for various sizes of banks. All these reforms introduced by the State Bank of Pakistan is to develop good corporate governance culture, covering director‟s responsibilities, improved reporting and empowerment of audit committees and internal audit and independence of external auditors. State Bank of Pakistan has established a National Accountability Bureau (NAB) Cell to process the cases of the defaulters in order to facilitate debt resolution. Furthermore, a special law, the Financial Institutions (Recovery of Finances) Ordinance 2001 was enacted with a view to facilitate speedy recovery of loans.

LITERATURE REVIEW

Most of the economic theories and practical experiences indicated that the financial liberalisation and the performance of banking sector can stimulate economic development. Pakistan‟s Government adopted the plan of introducing reforms, deregulation and restructuring took a strong foothold in Pakistan as the government decided to privatise banks and allow entry of new banks, at the same time to stimulate Pakistan‟s economic development.

The term liberalisation refers to the freeing of trade, investment and capital flows between countries and so on. A lot of people recognised that it is an integral part of financial sector development. For e.g. government policies on trade liberalisation, interest rate deregulation and capital account opening. All of these methods may enhance economic growth and development. The function of public sector banks and other financial institutions in economic development has been examined in different studies.

According to Gerschenkron (1962) argues, "that governments can intervene through their financial institutions to direct savings of the people towards developmental sectors in countries where financial institutions are not adequately developed to channel resources in to productive resources." Understanding the importance of financial sector in economic development, most of the governments in developing countries sought to increase their ownership of banks and other financial institutions in 1960s and 1970s, in order to invest the credits towards the sectors of economy that perform well. Similarly, the government of ownership of state control finance through banks and other financial institutions effect in lower economic efficiency and resource allocation of these institutions. On the other hand Barth et al (2001) using cross country data on commercial bank regulation and ownership from 60 countries find that state ownership of banks is negatively associated with the performance of the banking sector. This means that if the banking is regularised by the government, it may not be productive, efficient and effective in countering towards the economic development. The banking sector and other financial institutions should be deregularised and should operate independently in order to be productive towards the economic growth and development. There should be no state regulation on the working of the state bank and other commercial banks in the country.

Another study by La Porta et al (2002) is based on government owned banks from 92 countries around the world, in his study he finds that government ownership of banks is high in countries which are characterised by "low levels of per capita income, underdeveloped financial institutions and inefficient governments and poor protection of property rights." Continuing further study finds evidence that state ownership of banks is associated with slower subsequent financial development, lower economic growth and especially lower growth of productivity in the economy. Now the question arises that how can the performance of banking sector be improved as a vital role towards economic growth.

According to Kaminsky and Schumkler (2003), "the financial liberalisation consists of the deregulation of the banking sector, the domestic financial sector, and the stock market sector viewed separately from the domestic financial sector. A full financial liberalisation occurs when at least two of the three sectors are fully liberalised and third one is partially liberalised. A country is partially liberalised when at least two sectors are partially liberalised."

Basing on Kaminsky and Schumkler‟s theory, it is vital to recognise that financial innovation and liberalisation are domestic. The restrictions on international financial transactions been relaxed, but also the regulations constraining the operation of domestic financial markets have been removed as countries have moved away from policies of financial repression. The Government of Pakistan launched and implemented the financial liberalisation and the banking sector reforms during the 1990s.

Secondly according to Barbara Stalling (2004),"financial liberalisation in the past two decades has profoundly transformed the financial system in developing economies around the world. First stage, liberalisation changed the rules under which financial sector operates, moving from a system where governments heavily influenced the volume, price and destination of loans to one where private sector institutions make such decisions on their own. Second stage, the resolution of crisis further changed the characteristics of the financial sector, third stage in many cases financial crisis, which required rescue programs absorbing large amounts of fiscal revenues and resulting in steep losses of output".

As in case of Pakistan, the financial reforms and liberalisation launched in 1990, it is more inclined towards Barbara Stalling‟s theory. Pakistan‟s liberalisation program aims to liberalise Pakistan‟s banking sector and its relationship towards economic growth. The Government of Pakistan introduced reforms in the State Bank of Pakistan and made it an autonomous institution and released restrictions to foreign banks, to expand their operations in Pakistan‟s domestic market. Privatization of nationalised commercialised banks which improved their profit efficiency and increase in minimum capital requirement from Rs 500 million to Rs 1 billion and would increase to Rs 6 billion by 2009.

Privatisation, financial liberalisation and reforms can improve efficiency of the banking sector without changing market structures if it hinders interventions by politicians and bureaucrats who would like to use the State Owned Enterprises to extend their political and personal gains. It is also argued that corporate governance is weaker in state owned enterprises than in private institutions or firms because of agency problems.

As Clark et al (2003) argues," State owned banks have multiple objectives and many principals who have no clear responsibility of monitoring. In under developed economies it is seemed as a major problem because state owned banks do not face a market for their skills or the threat of losing jobs for non performance". Using a combination of country case studies and cross country analysis conclude that privatisation of banks improves performance as compared to continued to state ownership.

Ekin Tokat (2005) addressed, "that in the process of financial liberalisation, banks become more pregnable, to external shocks if the banking system is not sufficiently developed". Economists have different perspectives on the theoretical link between financial development and economic growth. Schumpeter (1911) contends "that the services provided by financial intermediaries are essential drivers for innovation and growth".

By these explanations we are clear that financial intermediary such as banking sector plays a vital role in the economic growth and is a major driver for driving for development of economy. As economy grows it brings more demand for the financial services. So this means that financial liberalisation has an effect on the economy. There is no doubt that financial liberalisation can benefit to a nation‟s economic growth. Economic growth is defined as, "economic growth is the increase in the value of goods and services produced in the economy". Usually it is measured as a percent rate of increase in real gross domestic product (GDP). This means that if the performance of the services sector (that is the banking sector, development financial institutions and stock market) is impressive in the economy then it would increase the real Gross Domestic Product (GDP).

RELATIONSHIP BETWEEN FINANCIAL LIBERALISATION AND ECONOMIC GROWTH

Economists have different perspectives on the link between financial liberalisation and economic growth. Schumpeter (1911) argues that the services provided by financial intermediaries are essential drivers for innovation and growth in the economy. For an economy to be in booming it is necessary that there should be a well developed financial system channel in the country so that financial resource allocation could be made most productive. Robinson (1952) argues that finance does not exert a causal impact on economic growth. Instead, financial development (that is the banking sector of the country) follows economic growth as a result of higher demand of financial services. Dr.Ishrat Hussain (2000) argues, "when financial liberalisation and reforms were introduced in the Pakistani banking sector it led to better performance and thus had a viable effect on the economy as a whole."

The standard economic theory suggests that financial liberalisation leads to a more efficient resource allocation, high level of investment and higher economic growth. As McKinnon and Shaw (1973) suggest that," high interest rates brought about financial liberalisation and reforms would stimulate savings, which in turn would lead to higher level of investment and economic growth." Financial liberalisation can stimulate economic development through set different channels. The financial system that is the banking sector and development financial institutions system performs the important function for channelling funds, productive investment and important component of a country‟s strategy for economic growth.

According to various literatures on financial liberalisation it is observed that it could impact economic growth through different number of channels. When an economy is open that is market oriented, the different sectors in an economy can perform at their maximum level. Open market is a result of financial liberalisation and reforms that are introduced in banking sector or the financial regulation of the country by its government. If implemented in an effective and efficient manner can lead results to economic growth and prosperity for the country. When financial liberalisation is introduced in the banking sector, it allows flexibility in operations of different sectors of the economy that are Balance of Payments (BoP), Foreign Direct Investment (FDI), remittances, stock exchanges, brokerage house or firms and foreign reserves held by the State Bank or other private banks. Subsidies and relief in taxes provided by the government in boosting its efficient industry can lead to maximum output; hence it would be in an appropriate position to export. When the balance of payments is positive which are exports are more then imports thus it would lead to trade surplus. Similarly different saving schemes introduced by the banking sector of the country could lead to mass investments, this would increase the deposit mobilization rate of different banks. When there is excess of money held with the banking sector, the cost of borrowing would be cheap and it would lend its money to different sectors such as agriculture, large scale manufacturing, small and medium enterprises and micro finance schemes. When all these sectors have commensurate production and efficient output, thus it leads to economic growth in country. Firstly, foreign investors who enjoy the improvements in the diversification benefits will drive up the local equity prices permanently, by reducing the cost of capital. Bekaert and Harvey (2000) and Henry (2000) proved that the cost of capital goes down after the major financial regulatory reforms.

It is acknowledged that financial liberalisation is an extremely important component of a successful development strategy for economics. If financial deregulation is implemented in isolation then it may not promote growth and thus impede economic growth. “The importance of achieving macroeconomic stability prior to reforms is well known, yet structural reform and institutional development in the financial sector, especially prudential financial supervision is equally essential as liberalisation proceeds.” (IMF Working Paper No.95/123)

MONITORING AT BANKING SUPERVISION DEPARTMENT (BSD)

The objectives of off – site surveillance supervision department are as following:

- To monitor the condition of individual banks
- To evaluate their performance within the banking system
- To provide early identification of problems so that corrective action can be effected
- To target scarce on- site supervisory resources to areas or activities of greater risk

The banking supervisory department looks around receipt, review and analysis of financial statements by different banks operating in Pakistan and the returns submitted to State Bank of Pakistan. The off- site analysis at banking supervisory department facilitates the monitoring of each bank‟s performance and its observance of supervisory requirements over time, so that problems may be identified as soon as these emerge. The system also helps indicate those areas which reflect high probability of financial difficulties so that policies and corrective measures can be designed and implemented in accordance. In accordance with the responsibilities under the core principles recommended by the Bank Committee, the on- site examination capabilities at the State Bank of Pakistan have substantially augmented with the international standards. The regulations that have been designed or established by the State Bank of Pakistan for some time are aimed at convergence of essential industry indicators to the globally accepted criteria; a risk based approach to evaluations of the performance of banks has been adopted by all banks in all its assessments.

Timely or periodic on –site examinations of the financial condition of institutions within State Bank of Pakistan‟s jurisdiction, remains the most effective supervisory tool, which support Banking Supervision Department in maintaining a proactive approach in discharge of the statutory responsibilities. The State Bank of Pakistan‟s policy for frequency of inspection of banks and Development Financial Institutions (DFI) are aimed at designing to provide flexibility in scheduling inspections with the need to maintain safety and soundness. This policy devises a framework within which supervisory ratings, surveillance and financial monitoring results and other appropriate indicators of banks soundness are considered. There is a shift from supervisory focus from „ compliance oriented‟ to „Risk Assessment Approach‟ State Bank of Pakistan has developed a uniform bank rating system in conformity with international standards/benchmarks. Now the State Bank of Pakistan, which is the central bank, has been following a supervisory framework, CAMEL which involves the analysis of six indicators which reflect the financial health of financial institutions (banks). These are Capital Adequacy, Asset Quality, Management Soundness, Earnings and Profitability, Liquidity and Sensitivity to market risk.

METHODOLOGY AND EMPIRICAL ANALYSIS

RESEARCH APPROACHES AND STRATEGIES

According to the research objectives and questions, in this report we will use empirical analysis of the secondary data which is the deductive approach, which means developing a theory and designing a research strategy to test the hypothesis. It is often useful to combine the deductive and inductive approaches together. But in this paper, all questions needs a proper answer by describing what actually is happening and need to know the relationship between the banking sectors of Pakistan to economic growth. As there is a vast wealth of information which includes the working paper, literatures review reports and analysis. So therefore it is very much suitable to adopt the deductive approach. Deductive approach can save a lot of time and can be performed on this empirical analysis study. It is much quicker as compared to inductive approach and thus is a low risk strategy. These are all the reasons for choosing the deductive approach for the paper. As in order to answer the research questions, case studies, working papers and descriptive studies are the best option to answer the research questions and objectives. “A strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence”(Robson, 2002). By using this strategy researchers can answer why as well as what and how. The objective of descriptive studies is to actually portray an accurate profile of persons, events or situations (Robson, 2002). It should be very clear to researcher what data collection he needs to carry out before he starts his research. After complete evaluation of data it is necessary to give a conclusion. As this report mainly adopts the case study and descriptive study to answer the research questions and meet the research objectives. The aim of this paper is to find out what is happening and explore existing theory. Working papers and case studies are very much appropriate to answer research questions and match the research objectives.

DATA COLLECTION AND ANALYSIS

This paper will only use the secondary data to answer research questions and meet research objectives. Secondary data is the data which is actually already been collected for some purpose. In secondary data both qualitative and quantitative data are included. They are used in explanatory studies. The data includes raw data and published summaries. In this paper raw data will mainly be used. The other raw data that would be used or adopted is the written documents such as journals and magazines, articles, transcripts, government publications, speeches and internet. Different banks, financial intermediaries and markets store a variety of data to support their operations, government departments undertake several surveys and publish official statistics covering all social and economic topics. Annual report is published by all the banks. Secondary data is mostly used in case study analysis and survey type research. In these different sets of statistics figures and diagrams will be used to analyse quantitative and qualitative data from either a deductive or an inductive perspective. The secondary data is less expensive; it can save time and money. As my independent data collection would not be of quality and standard as collected by agencies and different organisations.

APPLICATION OF APPROACHES, STRATEGIES AND DATA COLLECTION ANALYSIS

Application of first objective

The first research objective is to examine the performance of the banking sector in Pakistan. The first question is what is the performance of the banking sector pro and post privatization process? Similarly would study the impact of financial liberalisation and reforms that were introduced by the government. So in order to answer these questions, the following data would be needed as follows:

Six indicators of performance

- Capital Adequacy
- Asset Quality
- Management soundness
- Earnings and Profitability

- Liquidity
- Sensitivity to market risk

The relevant data we are going to analyse for our study would be from 1990 to 2000. In this time frame we would study the performance of banking sector after privatisation and financial liberalisation and reforms introduced by the Government of Pakistan. The source of six indicators that we are going to employ in our empirical analysis would be taken from State Bank of Pakistan's Annual Reports, official URLs and published reports. The time period for this analysis would also start from 1990 – 2000. In this analysis we are going to study the aggregated sector; Public Sector Banks, Privatised Banks, Domestic Private Banks, Foreign Banks and the Banking System.

The performance of banking sector in Pakistan can be analysed using the supervisory framework, CAMEL. This involves six key indicators which would be discussed as following:

CAPITAL ADEQUACY

Capital Adequacy of any financial institution is instrumental in the formation of risk perception about it amongst its stakeholders. This refers to the ability of the capital base of a financial institution to absorb.(Shabbir H. Kazmi,2001)

In late 1998, State Bank of Pakistan introduced risk based system for capital adequacy in order to protect the interest of depositors as well as shareholders. According to capital adequacy banks in Pakistan are required to maintain 8 percent capital to Risk Weighted Assets (CRWA) ratio. The banks were asked to achieve a minimum paid up capital to Rs. 500 million by December 31, 1998. Further more the State Bank of Pakistan has raised this requirement to Rs. 1 billion and was given a deadline up to Jan 1, 2003 to comply with this. After 1998 this ratio has deteriorated due to economic sanctions imposed on Pakistan after it conducted nuclear tests. There was a shift in State Bank of Pakistan policy regarding the investment securities which led to decrease in the ratio. Most of the banks are able to maintain above the desired ratio as well as direct their investments towards most productive private sector advances. Another reason for decline in this ratio is due to the fact of higher promising of Non- Performing Loans (NPLs). This is considered as a positive development towards the performance of banking sector.

ASSET QUALITY

This is an important parameter for any banking institution, as the quality of its assets has a major bearing on the earning ability of that institution. Asset Quality is measured in relation to the level and severity of non- performing assets, recoveries and the level of promising. (Shabbir H. Kazmi, 2001)

Although, the Pakistani banking system is infected with large volume of Non-Performing Loans, its severity has stabilised to some extent. The rise over the years was due to increase in volume of Non-Performing Loans following enforcement of more vigorous standards for classifying loans, improved reporting and disclosure requirements adopted by the State Bank of Pakistan. In case of privatised and private banks, this ratio went up considerably and become a cause of concern. The level of infection in foreign banks is not only the lowest but also closes to constant. The ratio of net Non- Performing Loans to net advances, another indicator of asset quality, for all banks has declined. This has been remarkable in the case of Nationalised Commercial Banks, in terms of reduction in the ratio of loan defaults to gross advances. Privatised banks do not show significant improvement, their ratio is much lower than that of Nationalised Commercial Banks. The only exception is the group of private banks for which the ration has gone up due to bad performance of some of the banks in the group. It is still lower when it is compared with that of foreign banks.

MANAGEMENT SOUNDNESS

The management of a financial institution is measured against performance of its financial indicators. Management Soundness is rated in terms of performance in capital adequacy, asset quality, earnings and profitability, liquidity and sensitivity to market risk. (Shabbir H. Kazmi, 2001)

Nevertheless, total expenditure to total income and operating expenses help in gauging the management quality of any commercial bank. Pressure on earning and profitability of foreign and private banks caused their expenditure to income ratio to rise in 1998. The worst performers in this regard are the privatised banks, mostly because of high salaries and allowances.

EARNINGS AND PROFITABILITY

Profits add to while losses result in erosion of the capital base of a banking institution. Earnings and Profitability are usually measured in terms of returns obtained on assets or capital employed. (Shabbir H. Kazmi, 2001) Since, Nationalised Commercial Banks have significantly large share in the banking sector; their performance overshadows the other banks. Profit earned by this group resulted in positive value of Return on Asset of banking sector during 2000, despite losses suffered by Allied Bank Limited (ABL). Pressure on earning and profitability was most viable in case of foreign banks in 1998. The stress on earnings and profitability was inevitable despite the steps taken by the State Bank of Pakistan to improve liquidity. Treasury bills (T-Bills) portfolio of banks declined considerably, as they were less remunerative. Foreign currency deposits became less attractive due to the rise in forward cover charged by the State Bank of Pakistan. Banks reduced return on deposits to maintain their spread.

LIQUIDITY

A liquid position of a financial institution refers to a situation where it can obtain sufficient funds, either by increasing liabilities or by converting its assets at a reasonable cost. It is evaluated in terms of overall asset and liability management such that mismatches are minimised. (Shabbir H. Kazmi,2001) Liquidity indicators since 1997 indicates the painful process of adjustments made in the banking sector of Pakistan. Ratio of liquid assets to total assets has been on a constant decline. This was due to the fact that brought about by the monetary policy changes by the State Bank of Pakistan to manage the crisis-like situation created after 1998. Both the Cash Reserve Requirement (CRR) and the Statutory Liquidity Requirement (SLR) were reduced in 1999. These steps were reinforced by declines in State Bank of Pakistan's discount rate and T- bills yields to help banks manage rupee withdrawals and still meet the credit requirement of the private sector. Foreign banks have gone through this adjustment much more quickly than other banks. Their decline in liquid assets to total assets ratio, as well as the rise in loan to deposits ratio, is much steeper than other groups. Trend in growth of deposits shows the most painful part of the adjustment is over. This is reflected in reversal of decelerating deposit growth into accelerating one in year 2000.

SENSITIVITY TO MARKET RISK

Sensitivity to market risk refers to an institution's exposure to interest rate risk, exchange rate risk, equity price risk and country risk. (Shabbir H. Kazmi,2001) Rate sensitive assets have diverged from rate sensitive liabilities in absolute terms since 1997. The negative gap has widened. Negative value indicates comparatively higher risk sensitivity towards liability side, while decline in interest rate may prove beneficial.

APPLICATION OF SECOND OBJECTIVE

The aim of the second objective is to study the economic growth in Pakistan in relation to the performance of banking sector. What is the contribution of the banking sector towards economic growth? In this the data needed would be as follows:

- M2 (broad money) to Gross Domestic Product (GDP Ratio)

These two indicators which are to be employed for the empirical analysis would be taken from the State Bank of Pakistan's Annual Reports and official website. The time frame for the analysis of these two economic indicators would be from 1990-2000. It would be the extraction of data from the original source which would be analysed in depth with critics and relationship to the economic growth. There would be limitation regarding the analysis of this data because of the matter fact we may not be able to get M2 that is the broad money to Gross Domestic Product ratio for the time period of 1990-2000.

LIMITATIONS

There are some limitations in using of these methods. The research cannot be carried out in-depth detail because of the time limitation. Secondly, due to lack of some primary data. The available secondary data that we have would be inappropriate to the research question in this report, because they are collected by organisations or government for some certain purpose. The data used in this paper may not be of high quality due to the fact there are some aggregations and definitions which may be unsuitable.

ANALYSIS

The detailed analysis for each of the six key indicators of the supervisory framework, CAMEL is presented in this section. The CAMELS ratios, the period 1990-2002 are separately discussed for public sector banks, privatised banks, domestic private banks and foreign banks. The results for the entire banking system are discussed separately.

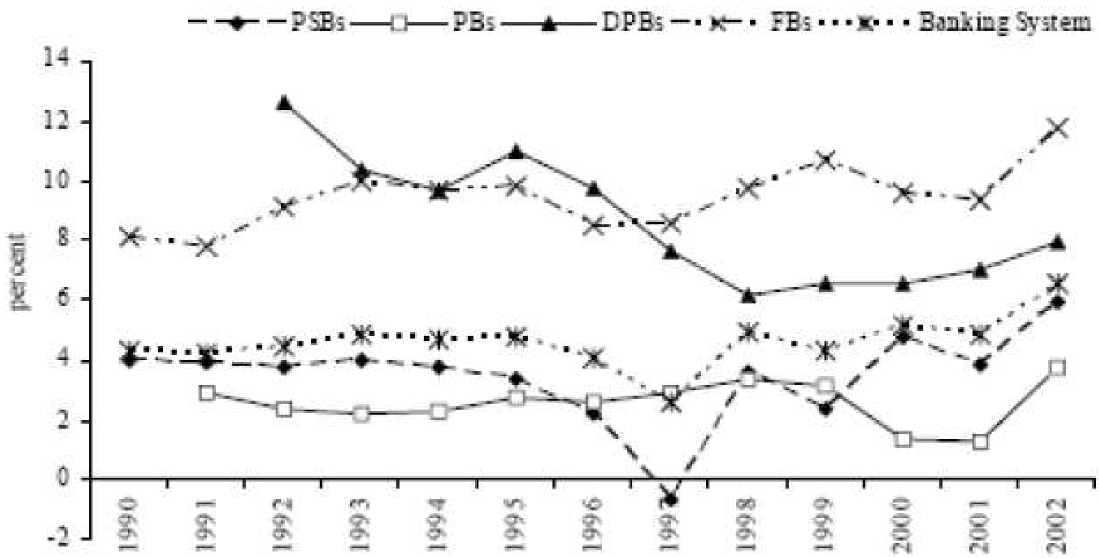
CAPITAL ADEQUACY

Public Sector Banks

The capital to liability ratio is used as a measure of capital adequacy in this study under examination. It basically shows the extent to which the capital held by the bank provided coverage to its liabilities (that is the depositors). This figure has been declining since 1990; this indicates that there is a decrease in the capital base of public sector banks. In the year 1997, this ratio became negative due to the fact that two of the largest banks in this sector made huge losses that are Allied Bank Limited and Muslim Commercial Bank. The subsequent recovery in this ratio can be explained by capital injection by the State Bank of Pakistan and revaluation of fixed assets in 1998. After 2000, improvement in the capital to liability ratio relative to pre-privatisation level can be seen for public sector banks. In order to keep on track, the State Bank of Pakistan had to provide capital support of Rs. 8 billion to one of these banks in 2000 to prevent further erosion of its capital base.

Privatised Banks

The group of banks comprises mainly of two banks that is the Allied Bank Limited and Muslim Commercial Bank with United Bank Limited joining in the year 2000. The capital to liability ratio for this group of banks is lowest amongst the four groups of banks that are analysed therefore it reflects poor capitalisation of these institutions. The ratio which showed improvement between 98-99 was in a plunge in 2000, due to capital base of these bank declining to just 1.3 percent of its liabilities due to heavy losses incurred by Allied Bank in that particular year. The capital adequacy improved when United Bank Limited joined the ranks of privatised banks in 2000, it was well capitalised. But still the capital to liability ratio remained below the average for the entire banking system.



Source: State Bank of Pakistan Figure 1. Capital to Liability Ratio

Domestic Private Banks

The capital adequacy of the newly established banks in the private sector is seen to be susbstainally higher than that of public sector banks and the privatised banks. The level of capital adequacy is seen to be much better than that of foreign banks, as in early years of their operations. As deposit mobilisation of these banks increased, their capital to liability ratio started declining from 12.6 percent in 1992 to less than half of that by 98 at 6.1 percent. This ratio started rising again and reached 8 percent by 2002.

Table 1. Indicators of Capital Adequacy

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Public Sector Banks													
Capital/ Liability	3.9	3.9	3.7	4.0	3.7	3.4	2.2	-0.6	3.6	2.4	4.8	3.9	5.9
Privatized Banks													
Capital/ Liability	-	2.9	2.3	2.2	2.2	2.7	2.6	2.9	3.4	3.2	1.3	1.3	3.8
Domestic Private Banks													
Capital/ Liability	-	-	12.6	10.3	9.6	11.0	9.7	7.6	6.1	6.5	6.5	7.0	7.9
Foreign Banks													
Capital/ Liability	8.1	7.8	9.1	10.0	9.6	9.8	8.5	8.6	9.7	10.7	9.6	9.3	11.8
Banking System													
Capital/ Liability	4.3	4.2	4.5	4.9	4.7	4.8	4.0	2.6	4.9	4.3	5.2	4.8	6.5

Source: State Bank of Pakistan

Foreign Banks

The capital to liability ratio of foreign banks operating in Pakistan as compared to public banks and domestic private banks during the period of our study is well above the level. It was 7.8 percent minimum in 1990, the ratio is still considerably higher than the maximum levels attained by the public sector and privatised banks between 1990-1992.

Banking System

The capital adequacy of the banking sector is seen to be improved due to the fact that government introduced financial liberalisation and reforms. As more of foreign banks started operating in the market, the competition increased and as the base of deposit mobilisation of these foreign banks was high, the capital adequacy was also stable. But in 1997, capital to liability ratio deteriorated susbstainally when of the biggest public sector banks made huge losses that is Allied Bank Limited and Muslim Commercial Bank.

Table 2. Indicators of Asset Quality

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Public Sector Banks													
Earning assets/ Total Assets	80.2	75.3	75.9	77.3	78.3	76.4	74.3	71.0	68.8	68.6	70.1	69.3	75.9
NPLs/ Gross Advances	18.1	21.6	20.0	23.6	28.3	27.1	27.2	32.0	30.2	32.4	26.3	25.9	25.5
Privatized Banks													
Earning assets/ Total Assets	-	78.4	81.9	79.8	79.2	79.3	77.5	81.0	79.4	77.1	83.1	82.2	87.4
NPLs/ Gross Advances	-	12.2	13.6	16.5	16.5	11.0	12.5	14.4	16.4	20.0	19.1	21.2	23.3
Domestic Private Banks													
Earning assets/ Total Assets	-	-	82.6	89.8	87.4	81.0	79.3	89.3	86.7	83.0	76.1	71.5	80.1
NPLs/ Gross Advances	-	-	20.6	10.9	7.6	5.9	5.9	6.3	9.8	13.3	11.0	11.1	7.6
Foreign Banks													
Earning assets/ Total Assets	77.2	76.7	80.0	77.1	76.1	72.9	74.4	74.4	73.7	64.4	76.6	67.8	75.2
NPLs/ Gross Advances	11.8	8.3	5.6	5.9	3.4	4.5	5.3	5.0	5.3	5.2	4.7	4.3	3.8
Banking System													
Earning assets/ Total Assets	80.0	75.9	77.6	78.3	78.7	76.8	75.3	75.4	73.5	71.1	74.1	71.4	79.6
NPLs/ Gross Advances	17.6	18.9	17.4	20.0	21.7	19.3	19.2	21.1	21.0	23.2	19.5	19.6	18.0

Source: State Bank of Pakistan

ASSET QUALITY

Public Sector Banks

The asset quality of any financial institutions is an important determinant of its financial health namely its earnings ability. The asset quality can be measured using indicators like earning assets to total assets and Non Performing Loans to total advances (gross). The asset quality of public sector banks does not seem to have improved much during the period under review. There is a deterioration observed in the ratio of earning assets to total assets as in the process of privatisation in the year 1991, when Muslim Commercial Bank and Allied Bank were handed over to private sector. Thereafter, some marginal improvement in asset quality can be seen up to 1994, after which the ratio has declined hitting its lowest level in 1999, when only 68.6 percent of the total assets were earning as compared to 80 percent in 1990 prior to initiation of the privatisation process.

Another vital indicator of asset quality is ratio of Non Performing Loans to total loans. There is an increasing trend in the public sector banks in the ratio of Non Performing Loans to total advances during the 90s, indicating a decline in their asset quality. This can be mainly attributed to the increasing amount of loans provided by public sector banks on political grounds. Another factor which is responsible for the increasing level of Non Performing Loans is due to the requirement of State Bank of Pakistan of higher disclosure in 1997, which forced banks to show their actual picture of stuck up loans. Thus, it resulted in a rise in the volume of Non Performing Loans. In 1990s, the ratio of Non Performing Loans to gross advances started declining after hitting a high of 32.4 percent in 1999.

Privatised Banks

The asset quality of the privatised banks as measured by the ratio of earning assets to total assets is seen to have improved during the period under review. The level of ratio of earning assets to total assets for this group of banks has consistently been higher that for the public sector banks, ranging from a low of 77.5 percent in 1996 to a high of 87.4 percent in 2002.

The ratio of Non Performing Loans to gross advances is another measure of asset quality, for privatised banks is seen to be lower that for the public sector banks. The ratio shows a rising trend over the years due to growing accumulation of Non Performing Loans in the portfolio of Allied Bank. Non Performing Loans as a proportion of gross advances for these banks reached 23.3 percent in 2002 when the United Bank with its large portfolio of Non Performing Loans joined the banks the ranks of privatised banks.

Domestic Private Banks

The asset quality of the domestic private banks is much better than of the public sector banks during the period under review and the privatised banks during the 90s. The ratio of earning assets to total assets show a high level of fluctuation during the period under study, with a low of 71.5 percent in 2001 and a high of 89.8 percent in 1997.

The ratio of Non Performing Loans to total advances, we see that this ratio is lower than that of public sector and privatised banks. There is a declining trend up to 96 after which it starts rising again. The reason may be due to the fact that domestic private banks were established only after 90s and therefore it would seek some time to see the effects of their lending policies.

Foreign Banks

The ratio of earning assets to total assets for the foreign banks was stable at around 75 percent throughout the year 90s. There is a noticeable decline towards the end of 1990s. The reason for this decline is due to the fact more than 95 percent of investment of foreign banks was in government securities.

The ratio of Non Performing Loans to total advances for foreign banks was stable around 4-6 percent during most of the period. This ratio is lower as compared to the banks in other three categories, the much lower rates of default and higher rates of recovery of the foreign banks.

Banking System
The asset quality of the entire banking system, by the ratio of earning assets to total assets has not seen much improvement as the result of privatisation. This ratio has declined in the later 90s mainly due to the deterioration in asset quality of the public sector banks. It is observed in 2000 that there is an improvement in this ratio when earning assets reached nearly 80 percent of total assets to the start of privatisation process in 90s.

OVERALL CONCLUSION
The major aim of this report is to study the economic growth in relationship to performance of banking sector in Pakistan, financial reforms and liberalisation, restructuring in the banking sector adopted by the State Bank of Pakistan and how the banking sector has a played a vital role in economic development of Pakistan. In chapter four an extensive analysis is carried on the performance of the banking sector on the basis of six indicators which are capital adequacy, asset quality, management soundness, earnings and profitability, liquidity and sensitivity to market risk. Similarly, M2 (broad money) to Gross Domestic Product ratio is also examined which tells us the relationship between the banking sector and economic growth. In order to follow the methodology in chapter three, chapter four analysed the performance of each indicator in respect of public sector banks, privatised banks, domestic private banks, foreign banks and the over all banking system.
After detailed analysis it is noticed that the performance of the banking sector is progressive and thus it is playing a vital role towards the economic development of the country. Similarly, the transformation of Pakistan‟s banking sector has given the success in developing a robust and a stronger system, which results in generation of positive economic growth. There still are emerging challenges and risks that are to be faced by the banking sector but they are not uncommon in financial system. Pakistan, like rest of the Asian economies that is China and India is growing at a fast pace with real Gross Domestic Product Growth of 6.6 percent, the rise in per capita income to $ 800, a large emergence of middle income group and a growing trend for retail banking industry in the country. To become a developed nation and an economy it needs to develop its financial institutions and the banking sector of the country.

RESULTS OF FINANCIAL LIBERALIZATION AND REFORMS
The financial liberalization and reforms which were introduced by the State Bank of Pakistan in the year 1991 led to better; induction of professional management, reduction in administrative cost versus total income and reduction in tax rates. The liberalization in the banking sector set a policy for opening and closing of branches all over the country. Foreign banks were also for the first time given the opportunity to come and invest in the country. Foreign Pakistani living abroad were allowed to open Foreign Currency Accounts (FCAs) thus this led to increase in the amount of remittances and the foreign exchange held by the State Bank of Pakistan and other commercial banks also increased. Similarly, a free floating market driven exchange rate system has been introduced. Restrictions on buying and selling of foreign exchange by banks have also been removed.
The soft monetary policy adopted by the State Bank of Pakistan in the early 90s led to increase in huge deposit mobilizations held by the banks. On the other side massive loans were credited to the private sector and they invested in development of their businesses which increased the output. The first and foremost vital step initiated by the State Bank of Pakistan was to ask the local banks to reduce the number of Non Performing Loans (NPLs) and advances from defaulted borrowers. All these effective and efficient measure led to better performance of the banking sector, which in result plays an important role towards economic growth.
To increase the Minimum Capital Requirement (MCR) and Statutory Liquidity Requirement (SLR) of the banks asked by the State Bank of Pakistan can make the banks stronger in terms of liquidity and more cash in hand for disbursements. This has also encouraged consolidation of smaller banks which led to Mergers and Acquisitions amongst the big players in the banking sector of Pakistan. It is noticed that the banking sector of Pakistan is deregularised and is independent in following fiscal and monetary policies. The Corporate and Industrial Restructuring (CIRC) established by the government; in a matter fact to improve the profitability of nationalised banks and the outstanding loans recovery from defaulted borrowers. The banking sector of any developing should be functioning in an effective and efficient manner, to have impressive economic growth in the country.
All these policies and reforms that were initiated in the 90s have resulted in these years with healthy economic development and growth in the country. Now the banking sector of Pakistan is more structured and is still moving towards well development of its financial institutions. Better functioning of this during these years from 1990-2000 have increased the foreign reserves, exports are on a rise, massive flow in Foreign Direct Investment (FDI) in different sectors of the economy such as real estate, telecom, textiles pharmaceuticals, Large Scale Manufacturing (LSM),oil and gas. There is a good corporate governance culture which is being enforced by the State Bank of Pakistan (SBP) and Securities and Exchange Commission of Pakistan (SECP) which resulted in improved reporting, empowerment of audit committees and internal audit and independence of external auditors. Further more, the format of statutory accounts has been revised on the basis of International Accounting Standards.There is also a large expansion of branch network which includes the Public Sector Banks, Private Banks, Domestic Private Banks and Foreign Banks and thus huge deposits by private and some foreign banks. There is a rationalisation of branches by nationalised banks.
State Bank of Pakistan (SBP) has emphasized on towards focusing on local rupee deposit, in order to keep the value stronger to dollar. There is also a significant increase in inward remittance business as a result of governmental clamp down on unofficial remittance channel following September 11.

FUTURE CHALLENGES FOR BANKING SECTOR OF PAKISTAN
There are some future challenges for the banking sector of Pakistan to face, to have a more progressive economic growth in the country. It still needs to struggle with some of the challenges which are discussed as following:

CHALLENGES FOR BANKING SECTOR
The first challenge for the banking sector of Pakistan is to have the sustainability and requires second tier of reforms in order to implement the reforms in a productive manner and achieve economic growth in the country. Pakistan banking sector is about to enter a long-term secular growth trajectory (Merrill Lynch, 2006). The high explosion in the industry has proven that the sector has potential and is well versed. The implementation of these reforms should be broad based and well sequenced. The reforms must be all encompassing: resultantly the process is arduous, complex and continuous. (Dr.Shamshad Akhtar, 2007)
The second challenge for the banking sector in Pakistan is the growing interest from foreign investors. The local domestic banks need to be competitive, as they have to compete in the open market and de regularised atmosphere. There might be a lot of mergers and acquisitions from large players in the market and thus this will help in the process of consolidation of the banking sector. The growing trend of Mergers and Acquisitions and recent issue of Global Depository Rate (GDR) of Muslim Commercial Bank at the London Stock Exchange have attracted close to $ 1 billion inflows and another equivalent amount is yet to flow in by other transactions in pipe line.
The third challenge for the banking sector of Pakistan is to strengthen risk management through effective implementation of prudential regulations, financial infrastructure and technology and internal controls within commercial banks. They still have to develop strong vigilance and improved credit risk management to have a control of Non Performing Loans (NPLs) at manageable levels. In order to cope with this challenge they must have E-banking in order to enhance the interconnectivity of ATM switches to fully exploit ATM network of all the banks.

CHALLENGES TO PROSPER ECONOMIC GROWTH IN PAKISTAN
Pakistan is a fast growing economy in the region, with the real Gross Domestic Product (GDP) growth rate of 7 percent target. There are still some challenges to be faced in order to prosper the economic growth of the country such as in the short run it would be necessary to address emerging macroeconomics imbalances while these are still small and manageable. The key macroeconomic imbalances include rise in the current account deficit, widening saving investment gap and a weakening in fiscal indicators. Inflation has shown some decline but concrete measure needs to be taken so that the figures significantly come down to low levels.
The tight monetary policy adopted by the government and the State Bank of Pakistan, should be continued in regard to reduce the inflationary pressures and the aggregate demand remains strong in the economy. Some of the key challenges that needs to be taken care of by the State Bank of Pakistan are heavy

dependence on import related taxes and dependence on potentially volatile non tax revenues. The government and the State Bank of Pakistan need to take concrete measures in order to raise the tax to GDP ratio. In this regard, the reported plan of the Central Board of Revenue to seek a one percentage point increase in the tax to GDP ratio in the next five years needs to be vigorously implemented. There is a need to increase the M2 to GDP ratio, the reason being for this is that as there is more money supply more credit disbursements could be carried out to private sector to increase their output. Similarly, investments gap needs to be narrowed down and more foreign investments are gathered within the banking system. The process of privatisation should be further strengthened so that it attracts foreign investors in the country that would lead to increase in the Foreign Direct Investment (FDI), which in result would increase the foreign reserves held by the State Bank of Pakistan and other commercial banks in the country. Furthermore, the exports of the country have been too increased so as to reduce the gap in the balance of payment. As there is the fast growing trend of aggressive globalisation and increasing regional competition, it is a very vital challenge for the government of Pakistan and the State Bank of Pakistan to continue with the sound macroeconomic policies.

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