Conference on
Deepening Financial Sector Reforms and Regional Cooperation in South Asia

Session # 1
Financial Sectors in South Asia in the Backdrop of Financial Sector Reforms

"How Pakistan is progressing with its Financial Sector Reforms"

Ladies and Gentlemen,

It is indeed a great privilege to have been invited to speak in this conference on a very topical and contemporary issue regarding the South Asian Financial Sector; its reforms and potential for future cooperation. I must congratulate the Indian Council for Research on International Economic Relations (ICRIER) and InWEnt for taking this important initiative to bring together financial sector policy makers, regulators and stakeholders in South Asia to ponder on the great potential of mutual benefit and prosperity for our people through South Asian Cooperation in the Financial Sector.

Ladies and Gentlemen:

The financial sector has assumed a pivotal role in the development process of a country in a globalized world driven by global financial, product, services and labor markets. With the demise of the erstwhile Soviet Union and the market reforms carried out by China and former Eastern European and other command economies the role and acceptance of markets has continued to grow rapidly albeit with frequent calls to regulate market behavior to ensure and protect the public interest and prevent market failure. Notwithstanding the current global financial crisis, countries like India and China have demonstrated that high growth rates can be achieved by Global Investment flows and market led growth strategies where the private sector is the dominant decision maker. For the developing and the emerging economies the potential of growth is enormous as these economies continue to operate at levels much below their human potential due to many imperfections that also include most importantly underdeveloped investment channels due to poor financial systems.

The problems arising from asymmetric information; moral hazard and adverse selection are rampant in these economies and this prevents investment flows to reach entrepreneurs with highly productive uses. For our economies larger investments means higher growth in output, larger employment generation, higher incomes and lower poverty. Thus, Financial globalization has the potential of funding development in the emerging world at an unprecedented rate provided our financial systems are robustly designed and effective in bringing global and domestic resources to the most productive users in our economies.

Take the case of Pakistan. I had the great privilege to serve my country as the head of the financial and economic sectors over the last four years and observed the great potential we have. In spite of the negative image created by the war on terror, Investment opportunities are all over the place. We are the sixth largest population of the world. With a current level of 160 million of which over 100 million are below the age of 25, a rapidly growing middle class that is fueling unprecedented growth averaging over seven percent in the last five years, Pakistan is rapidly transforming into a major market economy with large scale product, services and labor markets. Globalization has arrived in Pakistan. Attracted by our markets significantly large foreign investors have come into our product, financial and services markets. Notwithstanding the current global financial turmoil and our political transition that has somewhat slowed our surging economy, we have created an investment environment that will help Pakistan achieve its full potential. We have now in place the ingredients of a growing economy, a dynamic entrepreneurial private sector, a robust financial sector to match, a vibrant parliament, a totally free media, and a reasonably functioning bureaucracy.

Our PPP per capita is around $3000 which implies that the purchasing power of population can sustain large domestic demands for all kinds of modern goods and services. We have the scale and talent to be a world class manufacturing and servicing centre of the region. Though we will not be as big as China or India, we will definitely be in the league of Brazil, Indonesia and Russia from amongst the emerging economies.

My paper will focus on the strategic direction we in the last Government were taking and what changes will follow due to the new government. I believe, that there will be continuity in strategic thinking. The new government is in the process of charting a new course but the transition has led to a certain derailment of the momentum we had acquired in the last government. But first let me lay out what was our strategic thrust.

To deliver our potential, Pakistan was building a modern private sector driven competitive market economy that met the needs of the people of Pakistan. Our effective implementation of liberalization, deregulation and privatization policies were designed to create an enabling environment for Pakistan to benefit from opportunities unleashed by globalization.

Our industrial strategy was based on providing a competitive advantage to our industry through cost competitiveness and a hassle free environment. Modern industrial parks, special economic zones and free trade and warehousing zones, with all the requisite infrastructure facilities and communications and connectivity were being created.

The SME clusters all over the country were being supported by programs for technology up-gradation, marketing linkages, financial support and employee training. The objective was to promote creation of new businesses that generate sustainable employment. The competitive support fund, the business support fund, the agriculture support fund, Kushhaal Pakistan Fund and a host of supporting institutions had been started and in due course of time will yield positive results.

We needed value addition in our agriculture sector through innovative research and development. Introduction of modern farm practices and optimization of the use of our water resources. We announced Construction of five Mega Dams on the river Indus and expansion of cultivable area as the necessary measures that are underway. Several projects including raising of Mangla dam, Neelum Jhelum power project and Bhasha Dam were started. Each mega dam will cost over $6 billion and annually add 3% to GDP growth.

This three pronged attack of research, innovation and water optimization was designed to provide the push in turning subsistence agriculture to commercial agriculture through a quantum jump in our agricultural yields and higher valued crops. Coupled with initiatives to develop agri-business we expected our rural incomes to multiply and create an environment for sustainable growth.

If you look at the map and you will see our strategic location in the region. We fully intend to exploit this competitive advantage. We are destined to become the logistics, trade, tourism, energy and manufacturing hub that connects China, Central Asia, West Asia, and the Middle East with India and South Asia.

Creating the infrastructure for the hub including trade infrastructure, transport, oil and gas pipelines to bring Central and West Asia's riches to the world markets will bring immense benefits for our people and can become a major growth driver for the regional economy. We will be the preferred conduit for the oil and gas, goods and services needed by Western China as it develops.

We know that our region rich in resources and markets is the next growth area of the world and Pakistan will be at the centre of it. To develop as a regional economic powerhouse we will have to develop a network of modern communication systems including electronic, road, rail, sea and air networks. Our ports have to be vastly improved. Work has already been initiated through the $5 billion north-south trade corridor project with participation by the world bank, Asian development bank and the private sector.

We have over a dozen large cities of million plus population that include the mega cities of Karachi and Lahore. We are upgrading urban facilities for our cities to become more attractive living and work places. Their growing middle class will also be the engine of growth for the adjoining rural areas. Construction activity is at an all time high with development of new hotels, commercial properties and housing projects leading the growth. Urban retail and wholesale markets and supply chains are being modernized. Public private partnerships to implement Mass rail transport systems and water and sanitation systems are being put in place.

Our energy requirements are growing at double digits rates. To ensure security in energy, to maintain accelerated growth and to remain competitive: Gas pipelines, LNG terminals, exploitation of new domestic reserves, and development of thermal and hydel power projects are in various stages of implementation.

To create jobs and to train our work force in global skills including information technology, to become more innovative, productive, competitive and efficient we are establishing nine new engineering and technology Universities with the assistance of leading developed economies of the world. An accelerated program for technical and vocational training has been launched. Investments in higher education and technical training will continue to increase rapidly to produce the manpower to man the knowledge based economy of the 21st century Pakistan.

As can be seen the work is cut out for the financial sector in Pakistan. It has to package the projects in the private sector, design public private partnerships in infrastructure and become the channel for domestic and global investment into Pakistan's development opportunities. Thus we need a state of the art financial system that can carry out this task. Work on this system started 18 years ago after the collapse of the Soviet Union.

During the nineties financial reforms were launched to move the country from a system based on state directed credit allocation to a market based credit allocation and investment decision making system driven by the private sector. Thus we moved from a system of direct monetary policy controls like credit ceilings and credit rationing to a system of indirect tools of market based discount rates and OMO for monetary policies transmission. The exchange rate was gradually moved to a market based system where the central bank could intervene through the inter-bank market to support the rupee by affecting supply and demand of dollars. Bank supervision was brought in line with Basel committee core principles and banks were pushed into modern internal control systems and MIS technology. The Central bank also acquired the authority to wind up banks that did not meet the standards. Bank privatization was initiated and private banks were allowed to enter the market. How-ever, the reforms were partially successful and with the real economy faltering the economic growth in the nineties fell from around 6 percent in the eighties to 4 percent in the nineties. The debt to GDP ratio crossed 100% and the non performing loan portfolio of the banks jumped to Rs 270 billion reaching 25% of all advances. The banking spreads jumped from 2.4% in 1990 to 8.3% in 1999.

After the induction of General Musharaff Government in October 1999 2nd generation reforms were launched reforming the real and financial economy along with rebuilding institutions of the Government under a new PRGF program with the IMF. This program yielded high dividends with the result that Pakistan graduated from the IMF PRGF program in 2004 and has since also been tapping the global capital markets very successfully. The reforms were wide ranging and included

Fiscal responsibility and debt limitation law.
Financial Sector Reforms and privatization of banks
Capital Market Reforms.
Tax Reforms.
Deregulation of the economy.
Agricultural Reforms.
Governance Reforms including civil service, police and judicial reforms.
Privatization of telecom and manufacturing sector
Industry and Investment Reforms.

IFC and the World Bank in the report entitled “Doing Business in 2006: South Asian Countries Pickup Reform Pace” declared Pakistan as the top reformer in the South Asian region and number 10 reformer globally. In short we were doing our utmost to unleash the potential of our entrepreneurs by removing the shackles of over-regulation and poor state services. The focus of our strategy was to make Pakistani economy globally competitive and globally integrated.

Pakistan’s privatization program was one of the most advanced in the region attracting investment from all regions particularly from the Middle-east, East Asia and Europe. All public sector holdings were to be privatized. Opportunities existed in infrastructure, financial sector, power, oil and gas, manufacturing and ship building. Foreign investors enjoy an even playing field. Our second generation reforms were designed to create effective institutions of a private sector driven competitive market economy. We established a new competition authority, a new statistical authority, and reinforced our security and exchange commission and deepened our capital markets. We are demutualizing our stock markets and introducing new systems to ensure transparency of transactions. Our public institutions are being reformed and so is our private sector. We rationalized and reduced the number of taxes, created a tax system that widens the tax net. We are improving our labor laws and deregulating arcane regulations that have stifled our industry and commerce. We are directly tackling and reducing the cost of doing business in Pakistan.

Pakistan re-entered the international capital markets on February 12, 2004. We issued $500 million, 5 year Eurobonds due in 2009. This transaction attracted strong demand from high quality and diversified international investors. Encouraged by this response, Pakistan floated Islamic Sukuk bonds worth $600 million in January 2005. This was followed by another ten year Eurobonds of $500 million and 30 year $300 million bonds in March 2006 and a ten year $750 million in 2007. We completed a 813 million OGDC GDR issue in 2006. A $ 750 million UBL GDR in 2007. The leading investment houses have enthusiastically participated in these issues showing the confidence and endorsement of the international markets in our economy. We have regularly achieved rating upgrades over the last few years. Foreign investment has increased 10 fold since 2001 and in 2007 crossed the $8 billion mark. The debt to GDP ratio continues to decline and touched 55% in 2008 a far cry from the over 100% ratio in 2000

In tandem with the real sector we promoted the financial sector as it has to not only keep pace with the needs of the real sector but also lead the way for the growth and modernization of the economy. The banking system now comprises over 72% of the financial sector. The insurance sector is a miniscule 4.1%, NBFI's (investment banks, leasing companies, mutual funds, etc.) comprise 9% while Government saving centers constitute 14.6% and Micro finance banks have a meager 0.2% share. We introduced tough standards of corporate governance, strengthened the legal infrastructure for banking foreclosures, strengthened surveillance, cleaned up the balance sheets of state owned banks by moving bad loans from the banks to a corporate and industrial restructuring corporation and injected new equity into the insolvent banks and privatized them. Today the same banks command the highest valuations in Asia as confirmed in our listing of these banks on international stock exchanges. We demarcated the authority of the Central bank and the Securities and Exchange Commission of Pakistan (SECP). Reinforced the autonomy of these regulators, merged the informal and formal foreign exchange markets by formalizing the foreign exchange companies to reduce the spread between the inter-bank market and the kerb market. The interest rates on government savings schemes that were kept artificially high to finance Government expenditures were rationalized to market rates as determined by central bank auctions of T bills and Pakistan investment bonds. New technology was introduced for the payment and settlement systems and a central depository was created to deal with paperless transactions in the stock market.

The financial sector in Pakistan has undergone a sea change and is now primarily owned and managed by the private sector with very heavy representation of foreign ownership, has strong balance sheets and is leading the way in innovation and expansion of the economy. Our banking system is increasing its outreach and also expanding its coverage from a corporate focus into agriculture, consumer, retail, SME, housing and infrastructure finance. In the near term the banking sector has to lead and connect the regional economies with a financial services industry capacity that can channel billions of dollars into the needed infrastructure projects. New Public private partnerships for infrastructure investments will be spearheaded by the banking sector.
Mergers entry of new banks.

The next major step for the banking sector would be to embark on a judicious external commercial borrowing system for the corporate sector for infrastructure project finance , corporate bonds and other structured finance products. They will also be in the forefront for arranging private equity flows into Pakistan.

Pakistan needs to attract billions of Dollars of investment from both domestic and global investors and the financial sector has been reformed to do the job. The total Financial assets have reached a level of around \$175 billion (110% of GDP). The banking system deposits base has reached \$60 billion and their advances are above \$47 billion. Aggregate profits amount to around \$2 billion. Risk based capital adequacy ratio is at 13.2% The financial sector has been totally revamped with 1) a fully autonomous central bank in command with very strong capacity for banking supervision and surveillance. 2) It has enforced a very tough code of prudential regulations and corporate governance on the banking system. 3) It takes prompt corrective action when needed 4) The Financial sector which was almost 100% owned by the Government in the nineties is now over 80% in the private sector, with a substantial foreign ownership. Most global banks have a major presence.

The stock market has been rated as amongst the best performing over the last six years in the emerging markets in the world. Going from 1200 points in 2000 to around

16000 in April 2008. The mismanagement that happened in the transition phase of the new Government has seen the index collapse to 9000 points and the exchange is moribund under anti market regulations.

In the capital markets the Securities and Exchange Commission of Pakistan (SECP) was reformed to regulate and supervise the non banking financial institutions and markets. It successfully shepherded the stock market from a market capitalization of around 5 billion dollars to over 80 billion in the passage of seven years introducing new technology including market monitoring systems, new governance codes and rules and regulations. Stock market demutualization is under processing. While the stock market has performed well the development of corporate bond market has not seen similar success.

To its credit Pakistan financial sector has been unaffected by the financial tsunami unleashed by the sub-prime mortgage credit in the United states and that infected the entire world . However Pakistan has also been facing a financial crisis generated by its internal dynamics. Since the February elections and the advent of the new populist government economic indicators have sharply deteriorated. The Currency has fallen by 25 percent against the Dollar, the stock market index has fallen by 6700 points from its peak in April leading to an asset value loss of 43 percent amounting to loss of market capitalization of around US $ 40 billion; the largest loss in the history of Pakistan. This loss of confidence in the economy of Pakistan has been unprecedented.

In May 2007 we issued US dollar global bonds. The bonds were a huge success with over subscription of seven times amounting to $ 3.5 billion while we were seeking only $500 million. The spread was under 200 basis points above US government ten year securities. In December 2007 when Benazir Bhutto was assassinated the spread jumped to 600 basis points. However, after the elections, the investor community welcomed the peaceful transition by pushing the spread down to 500 points. The stock market also reacted favorably and reached its highest point of 15800 in our history in April, 2008. Since then lack of focus on economic issues due to the political transition has led to the collapse of the stock market to 9000 points and the spread has jumped to almost a 1200 points.

In the previous government we had been highly successful in crafting a very positive brand image of Pakistan as one of the fastest growing emerging economies in Asia. After our exit from the IMF program and a successful reforms, investors favorably compared Pakistan to Asia’s emerging stars India, China and Vietnam. Every time we did a road show we were highly successful in our endeavors whether it was the OGDC flotation or UBL GDR or Euro bonds or large privatizations, investors flocked to our offerings. We were a success story in the international financial markets and most of our issues became benchmark issues.

Unfortunately, in an inexplicable move the new Government cancelled major planned capital account transactions in April/May 2008 disrupting huge dollar inflows at a time the country was experiencing a major hike in dollar outflows because of the enormous increase in oil prices and the resultant rising oil import bill, this placed a huge pressure on the reserves and the currency. Indirectly the loss was probably twice as much as foreign investors withdrew to the sidelines and domestic investors moved their investments overseas. It might be mentioned that while the government failed to take advantage of the window of opportunity, A privately owned bank taking advantage of the great valuations on the stock market in April 2008 privately placed some 20% of their equity with a foreign bank for $ 850 million. If the Government had not cancelled its transactions, it could have generated sufficient flows to prevent the meltdown which ensued. Reserves drawdown would have been avoided, the spread on our international bonds would have narrowed down to May 2007 levels, borrowing from the State Bank would have been halved and the government would have had a stable environment for tackling the oil import bill and food inflation. Our current predicament is clearly a creation of our own.

What could have been done in April/May 2008 with the market at 15700 points cannot be done in September/ October 2008 with the market at 9100 points. The international markets are closed to us. We have to wait until our markets get back to their historical levels and investor confidence is restored. How will this be achieved? The biggest challenge for the new government is to restore the eroded 'Pakistan Brand' back to its original luster and in the process revive the investment flows that can sustain our growth going forward. This is where the SAARC regional Cooperation can play a major role. The regional South Asian GDP has now exceeded a trillion US dollars. If East Asian regional group ASEAN is any indicator we can safely assume that in the next five years intra regional trade in South Asia can easily reach 10 % of regional GDP or over $100 billion a year, infrastructure expenditure requirements will be close to 7-8 percent of GDP per year or $ 80 billion per year.

Pakistan needs to continue to grow at 7 to 8 percent to create the 3 to 4 million new jobs per year needed to accommodate our youth and create a dent in poverty in our lifetime. We must unleash the potential of our people, exploit our competitive advantages, take advantage of global finance, integrate with global markets, and continue building a dynamic market economy with world class infrastructure to achieve our growth objectives This is the recipe for the future and the way forward for

Pakistan. In all this the financial sector has to provide the resources to push the real sector to its potential. In the immediate future we have to focus on energy and the growth areas of the economy.

In the energy sector, we have now reached a stage where the issue is no longer energy availability rather it is energy affordability. The Furnace oil used for thermal generation has become extremely expensive and beyond the ability of consumers to pay for. The exorbitant power price increase can only be avoided if transmission and distribution losses are dramatically curtailed and in the medium term we substitute imported fuel with domestic sources. At a price of over $100 per barrel, thermal power based on imported oil costs around Rs 16 per unit (Kwh) whereas hydel power from major dams would cost Rs 2 per unit. The power from domestic Thar coal will cost around Rs 8 per unit. We have a hydel potential of100,000 MW and coal reserves for the next 150 years. To develop this potential we will need mega investments for mega projects and not only can we supply power for our own consumption but also for the region. Energy generation and energy sharing in the region can benefit from an energy fund that can create the infrastructure to connect the energy grids of South Asia.

In the agriculture sector, We have to ensure that we pass on the benefit of higher global prices to our farmers by deregulating agriculture prices. The other incentive our farmers need is predictable water supply. Value added agriculture also needs modern technology and investments, with India's expertise in the area Pakistan India and others in the region must collaborate in the agriculture sector and the financial sector has to facilitate to create enormous opportunities and advantage for our people.

Pakistan is a large country with 160 million people and 100 million under the age of 25. With dependency ratios going down we can reap a demographic dividend over the next several decades. These youngster are already becoming a huge engine of growth for our markets, that are growing at fabulous rates to meet the demands of these Pakistani 'baby boomers', Just like in Europe and South Korea after the 2nd world war, our baby boomers will be the back bone of our middle class and will determine the growth of our economy over the next 40 years until they start to retire.

This gives our businesses an historic opportunity to grow and produce the goods and services the population needs. In an era when world is facing a crisis of aging populations we are blessed with opportunities of a young and dynamic population. In this regard we are now going beyond textiles into engineering, electronics, chemicals, food processing, construction materials, real estate, retailing, hotels and tourism and many other sectors based on our domestic markets. As these markets continue to expand we will reach economies of scale that will make our producers and the large associated vendor industry competitive on a global scale and the same producers will be the base for diversifying our exports into more sophisticated and fast growing sectors of the world. Ultimately, we will become one of the workshops of the world along with India and China. We have the opportunity in the region to integrate our engineering and manufacturing industries to promote economies of scale and achieve global competitive advantage. This will require that trade has to promote intra-regional linkages backed up by financial and banking structures and processes that are efficient and effective.

In the infrastructure sector there are hundreds of infrastructure projects at various stages of implementation including the National trade corridor, Neelum Jhelum hydro power project, KKH up-gradation, Urban renewal in Karachi and Lahore, mass transport projects, airports, Baluchistan road network ,Gawadar port, industrial parks etc., these projects have to be completed on time and scope. We need yearly investments of over 12 billion dollars to meet our infrastructure requirements. In the SAARC region, India made a head start in infrastructure finance that we in Pakistan can learn from and benefit.

In the social sectors health education and welfare we can learn from each others experience. We have set a target of 6 percent of GDP for social sector and education expenditures with 1.5 % allocated to university education. Collaboration in the SAARC region in the provision of social services will be a very profitable and win-win situation for all member countries.

In the financial sector we have created a world class banking system with our banks featuring amongst the leaders in Asia. The challenge is to further increase the reach and competitiveness of the financial sector with Microfinance playing a much greater role. Our microfinance frameworks are the best in the world and a strong base has been established which can grow manifold to bring financial services to the masses. The growth of the financial sector will continue at a sizzling rate as the financial sector expands into consumer and housing finance, rural and agriculture finance and development of debt and bond markets, growth of mutual funds, pension funds and other savings instruments.

The Financial sectors in the SAARC region have a huge menu to choose from as the region starts towards serious economic integration. The banking networks have to become intra regional to promote tourism and trade to start with and then to investments through capital markets, debt and equity markets including FDI and private equity.

In conclusion, we have a huge potential for Intra regional cooperation and I propose that the time has come to develop the intra regional financial sector frameworks and linkages needed to underpin the intra regional economic integration. We should now setup financial sector working groups to work on the following:

1. Developing intra- regional banking network regulations to promote regional trade
2. Frameworks for Regional Investment and funds for
    a. Regional tourism infrastructure
    b. Regional manufacturing collaboration
    c. Regional logistics infrastructure
    d. Regional energy generation and transmission infrastructure
3. Regulations for Intra regional investment in stock markets and intra regional listings.
4. Regional funding for private social sector initiatives in Health and Education
5. Activate the SAARC poverty reduction fund.

Thank you for your Patience.