

Financial Market Reform in Pakistan

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The paper argues that the finance dimension of economic development has often been treated as an afterthought by researchers and politicians alike, because it is considered to be too “sophisticated” to matter for “simple” economies. The role of the financial sector was considered to be primarily for mobilising resources to increase growth. However, experience has also revealed that financial development, including stock market development, is correlated with current and future economic growth, capital accumulation, and productivity improvements. It is suggested that a strategy for financial market development in emerging economies is better evolved from the perspective of the “functions” of financial markets as envisaged in modern financial literature. It is also argued that financial sector policies in emerging economies should focus on enhancing, rather than inhibiting, the *multiple* roles of financial markets.

INTRODUCTION

The finance dimension of economic development has often been treated as an afterthought by researchers and politicians alike, because it is considered to be too “sophisticated” to matter for “simple” economies. In addition, institutional aspects of economic development were neglected while policy and research focused on improving the “real” side of the economy. Recent research, however, has shown that institutional arrangements, such as legal, financial and economic rules underpinning exchange have very real consequences for emerging economies [Barro (1997)]. Experience has also revealed that financial development, including stock market development (as measured by market liquidity, capitalisation, turnover, efficiency of pricing of risk, etc.), is correlated with current and future economic growth, capital accumulation, and productivity improvements [Levine and Zervos (1996)].¹

It is the *policy* premise of this paper that the financial sector policies in Pakistan should focus on enhancing, rather than inhibiting, the *multiple* roles of financial markets. Like-wise, the depth of the financial market infrastructure has to be judged on the basis of the efficiency with which these various functions are carried out. For instance, the

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¹ This is in contrast to the previous literature which had focused almost exclusively on banking development and growth.

mere erection of stock exchanges is inconsequential, if the environment is hostile against opportunities for risk-sharing and liquidity provision and transformation. Moreover, the mere existence of banks is of little value, if their existence is merely to purchase government securities at the expense of commercial lending. In fact, such practices prevent banks from serving as *informed* agents or intermediaries on behalf of the society, and hence building vital information capital for efficient allocation of resources. Unfortunately, this pattern of financial dis-intermediation or dysfunctional intermediation is still observed in many emerging economies.²

The paper is organised as follows. Section II is a critique of the dominant perspective in economic (and financial) development and the associated financial sector policies. Section III provides a functional perspective to policy guides in financial market development. Section IV provides a brief assessment of the functionality of observed financial systems in emerging economies by using the functional paradigm as a benchmark, with a focus on the African experience. Taking these observations as a challenge, Section V provides financial sector policies, guided by the multiple functional role of financial markets and incentive, and market-based, regulatory schemes. Section VI concludes.

THE FINANCIAL SYSTEM IN PAKISTAN³

In the immediate post-war era, development economists held the view that prices and markets in these countries did not work, as well as the desire for forcing a faster pace of development, led to the design of activist and interventionist policy in trade and industry.⁴ The prevalent view was that developing countries had to make a "big push" from their existing concentration in primary commodity production, the terms of trade for which were on the declining trend, to the production of higher value-added manufacturing goods [Nurske (1958)]. Policy and market development, including financial market development, were considered to be means toward the objectives of the "promotion of this faster pace of development" and the "big push" for industrialisation. The major constraints to economic development were perceived to be the shortage of domestic resources to meet the investment demand and the lack of external resources for import of capital goods that were required for the desired industrialisation [Chenery and Strout (1966)]. The role of financial markets in this scheme was merely to collect and

²Only recently has the functionality of the financial system been appreciated in the context of economic development in developing countries [Levine (1997)]. In fact, there is very little in the literature linking the *functionality* of the financial system to financial sector *policies*, including financial market development. This is surprising in view of the voluminous literature linking financial system and economic development, beginning with the seminal work of McKinnon (1973).

³For more details see Haque and Kardar (1995).

⁴How the development economist perceived developing countries and economies is relevant to the understanding of the evolution of economic policy and institutions in those countries. For example, development economists debated for years whether the peasant in developing countries was rational in the sense of responding to economic incentives [see Schultz (1964)]. Note this is similar to the Krueger's contention on the stylised facts that shaped trade policy in the early post-war period.

provide savings for industrial development.⁵ Foreign exchange controls, with surrender requirements for export, were put in place to conserve foreign exchange and concentrate it in the hands of the government planner who had the master-plan for development. Banks were among the first financial institutions that policy encouraged but “primarily to promote economic development” and not “primarily to make profits” [Fry (1995)]. The promotion of development objective led to increasing intervention in the banking system of developing countries by the government and donors in this early period. The banking system that was created through such policy was inefficient and overtaxed. Large operating costs and lending for purposes other than pure bank profitability has resulted in years of banking sector difficulties that many countries are still contending with.⁶

Because of this view of development, “postwar financial development in developing countries differs in several important respects from financial development in the industrial countries” (Fry, 1995). *First*, the pace of development was forced in developing countries with government intervention occurring with increasing frequency. *Second*, concentration is far higher in the banking industry in developing countries now than it was in the industrial countries prior to World War I. *Third*, financial systems are segmented with several specialised financial institutions that were created for meeting particular development needs limited in their competition with each other.

The lack of instruments and market rates of return in these repressed financial markets led to the development of *informal* or curb markets. These markets, which sought to circumvent official controls and to provide market rates of returns to savers, performed many functions, including loans, and forward and foreign exchange transactions.⁷ Very little real research was collected on these markets or regulation developed to allow these markets to be ‘formalised’, but they were regarded with a considerable degree of suspicion.⁸

In keeping with this prevalent view in development economics, the financial sector in Pakistan has evolved over the years in response to Government of Pakistan (GOP) planning process. Because of this objective, GOP came to stifle growth and innovation, eliminate price, product and institutional competition, reduced policing and supervision, and increased its own ownership of the institutions within the sector. This policy has led to increased losses in the sector which have to be borne by the taxpayer and the depositor.⁹

⁵In other words, the focus has been on the *quantity* of capital. However, the functional properties and the *quality* of capital need to be guiding principles in financial sector reforms.

⁶Lindgren *et al.* (1996) note that “since 1980, over 130 countries, comprising almost three-fourths of the International Monetary Fund’s member countries, have experienced significant banking sector problems.”

⁷For a detailed analysis of informal financial markets in developing countries, see Montiel, Agenor and Haque (1993).

⁸Wai (1980) questions whether “such arrangements should even be called markets,” while Chang and Jung (1984) describe the curb market as “non-competitive, less developed, and fragmented”.

⁹See Box 1 which summarises Haque and Kardar (1993).

Box 1**Reform of the Financial Sector**

The salient features of the financial sector in Pakistan.

- The government maintains a dominant role in the sector not as the guardian of the system but as the main the largest provider of financial services in the system.
- The system is dominated by inefficiently run government owned financial institutions which subject to considerable political interference, and have as a result developed a poor quality portfolio of assets, substantial overstaffing and poor human capital.
- Competition from foreign banks and the newly created banks provide limited competition and remain niche players. They are, however, more profitable than NCBs because of better in-house skills, more focused activities and a much greater degree of freedom in conducting credit related operations.
- Money and capital markets are small and trading is generally carried out in government securities and in the equities of a relatively small number of companies.
- The government finds the commercial banks captive for absorbing its securities: by its pre-emption powers to obtain funds at below market rates and through its policies on subsidised and directed credit it has heavily burdened the financial sector.
- Cumbersome legal processes for contract enforcement and the indifferent application of accounting, auditing and supervision standards have contributed significantly to the poor performance of financial institutions.

The financial sector as it stands in Pakistan today is, therefore, unable to perform many important financial functions:

- Risk sharing arrangements, hedging, and portfolio diversification, are all limited by the lack of availability of instruments.
- Market solutions to dealing with asymmetric information remain limited in view of the difficulties of contract enforcement, and inadequate regulation and supervision of financial institutions.
- The inordinately large role of government in this sector as a supervisor, regulator and owner of institutions and instruments, has resulted in limiting arbitrage so necessary to market efficiency.
- Moreover, the moral hazard associated with such an arrangements has led to the nationalised banks holding a large portfolio of bad debts the cost of which will be borne by the taxpayer.

Against this background, the various recommendations on reform can be classified into the following (It should be recognised that there are a fairly large complementarities between these four elements of the strategy. Efficient financial intermediation would require that movement should rapidly be made on all these fronts.):

- deregulation, liberalisation and privatisation with an emphasis on market and instrument development;
- improvement in regulation and supervision of financial institutions and markets (including the independence and institutional development of independent regulatory agencies for the money market (SBP) and the securities market (the Securities and Exchange Commission (SEC));
- improvements in the payment system and the information technology; and
- improvements in the legal system for better contract enforcement including debt recovery or collection of collateral.

The government has been the dominant agent in financial markets: Government controlled institutions such as the Nationalised Commercial Banks (NCBs) and Development Financial Institutions (DFIs) account for over 60 percent of all loans and a little less than half of the sum of all deposits and government borrowing; government bonds, which are used primarily for financing the deficit of the government, constitute more than 40 percent of financial wealth; the largest players in the securities market are two public sector mutual funds.

The financial institutions in Pakistan can be essentially classified into two broad categories, banking companies and non-bank financial institutions, with both being controlled primarily by the central bank, the State Bank of Pakistan. They are also regulated, depending upon the nature of the institution, by the Corporate Law Authority, the Ministry of Finance and the Religious Board. A brief description of these institutions is presented below:

Commercial Banks: Domestic commercial banks were nationalised in 1974 and have been in the process of being privatised since 1992. Although the private sector has recently been allowed into banking, the nationalised commercial banks (NCBs) are dominant in the banking industry holding over 60 percent of all deposits. Foreign banks remain small niche players which have been successful because of their superior management skills, better access to international financial markets, ability to cherry-pick, as well as they are free from political influence. The NCBs are inefficient and have accumulated sizeable non-performing of the nationalisation. As a result privatisation has not been slowed. Reflecting the difficulties of the NCBs and the government's financial repression, interest rate spreads are large and deposit rates have been negative in real terms quite frequently. While the NCBs despite these spreads are incurring losses, foreign banks, who have the lowest cost per unit of deposit are the most profitable.

Development Financial Institutions: These were set up to provide long term debt and constitute a small percentage of the total financial assets. They relied almost entirely on government funding or lines of credit from multi-lateral agencies, guaranteed by government. Given their financial difficulties as well as the limited availability of further financing, DFIs are increasingly being marginalised. Recent privatisation efforts have had limited success. There are two large government organisations that provide mutual fund services in Pakistan. They remain large institutional investors on the equities market. However, their role as a disciplining force on company management, as well as their financial solvency, have been questioned given that they are believed to be susceptible to non-market pressures.

Non-bank Financial Intermediaries: These were allowed as part of the 1990 financial liberalisation and comprise of leasing companies, *modarabahs*, an Islamic mutual fund, and investment banks.

Debt Market: This is primarily based on government debt although a commercial paper has just been initiated. Two types of government paper are issued:

Federal Investment Bonds which are auctioned although the government does not allow the market to completely determine the interest rate; and Several Savings Certificates are issued at fixed interest and area available on tap. A number of savings instruments and bearer investments certificates are issued by the state-owned DFIs.

The Equities Markets: The stock market is not perceived by the average investor to be either efficient or fair and judicious in terms of providing the investor a fair return. Insider trading is considered to take place frequently but there have been no indictments on that count yet. Regulation and supervision of companies is weak the small investor is not able to obtain reliable information. As a result multinationals (MNCs) command a premium. The stock market in Pakistan remains very thin: limited quantities of a firms stock are traded and price jumps are quite common. As a result, their share prices exhibit a great deal of volatility because of fluctuations in the market. These prices cannot, therefore, be regarded as true indicators of the fair value of these shares. Poor credit practices that have led to the accumulation of nonperforming loans with banks, created an environment of financial indiscipline and, hence, inhibited market development. In 1990-91, for the largest 20 domestic firms less than 8 percent of the equity was in the hands of the small shareholder while about 33 percent was held by the institutional investors and other public sector agencies, while about 54 percent was held by the large shareholder (board of directors and their proxies). Settlement procedures remain cumbersome and expensive and information. Full use of technology has not been made for the timely dissemination of information as well as the verification of trades.

Foreign Exchange Markets: The SBP maintains a managed float system, pegging to an undisclosed basket of foreign currencies. Forward market activity is only provided by the SBP at a fixed non-market premium and all foreign exchange deposited in banks is surrendered to SBP. The rapid growth of foreign currency deposits and the resulting SBP foreign exposure has become an important policy issue.

Insurance: Because of the nationalisation of life insurance, the insurance business has not really developed as it should.

The Informal Financial Markets: Pakistan has a dynamic, parallel/non-formal sector which has seldom been studied. Essentially three types of financial activities take place in the informal sector. There is a parallel currency market that basically intermediates in the pool of workers' remittances and some illegal transactions. An informal credit market, a component of which is the system of granting credit within the stock market. Finally recently because of information technology, trading has become possible of the international futures' markets and is being conducted beyond the pale of any regulation and supervision.

Financial Innovation: The regulatory environment has not been innovation-friendly. Experiences of setting up NBFIs—the finance company crash of 1978, again in 1987, and in 1990 the cooperatives—resulted in a complete loss of deposits without any indictments or supervisory actions in the interests of depositors. See Samad (1993)

for details. He also argues that the regulators' hostility to these companies was the main reason for the crash of the entire system. The State Bank retains no data on those crashes and, as noted by Said (1993) probably exacerbated the crash in 1987.

The Institutional Capability of the Regulatory Agencies: The regulatory bodies do not have the capacity—in terms of financial resources and staff members and skills—and the autonomy to perform their supervisory functions and enforce regulations. In part, the weakness in the supervisory capacity of the SBP is because officials are overburdened by routine work (and there is no incentive structure) and in part because of the constraints imposed by personnel policies. The securities market is regulated by the corporate law authority which is not autonomous and fully mandated with the development of the market. (The government intends to put in place an independent Securities and Exchange Commission in place and SBP independence has recently been enacted.)

ASSESSING THE FINANCIAL SYSTEM

The prevailing policy perspective, which has viewed the financial sector as a mere conduit for capital mobilisation, is not consistent with modern finance for two reasons. First, it does not take into account the deeper roles of financial sector under conditions of *uncertainty* and hence the effects of liberalisation targeted only to capital mobilisation. Under uncertainty, there is not just capital allocation (supply-side) that is the sole issue, but the issue of risk allocation (demand-side) is also paramount. Second, in an environment characterised by a host of imperfections in information dissemination and observability, incentive problems are likely to prevail. In this case, capital markets provide for efficient contracting among conflicting parties and for disciplining of corporate insiders through markets for corporate control.

Financial markets and intermediaries change over space and time according to the size of the country, complexity of transactions, available technology, as well as differences in political, cultural, and historical backgrounds. Even when the names of institutions are the same, the functions they perform often differ dramatically. For example, banks in the United States today are very different from what they were fifty or a hundred years ago and they are also very different from those in Germany, Japan and Korea. Consequently, in order to understand the financial system, we will take the vantage point of the functions that these markets perform in an economy. We do so for two reasons:

- The functions of a financial system do not change much over time and space while the forms and functions of institutions and intermediaries do;
- the forms of financial institutions are a product of innovation and competition among participants for the more efficient performance of functions of the financial system.¹⁰

¹⁰Studying financial systems from a functional view has important implications for sequencing and development of financial markets and products, banking and equity markets, and insurance and derivatives in emerging economies, such as Pakistan.

The most fundamental role of the financial system remains that of intermediating between savers and investors such that efficient resource allocation of the available resources of the economy is undertaken. From this viewpoint, we can determine the following seven basic or core functions performed by the financial system:

Function 1: The Mobilisation of Capital. Unless financial markets are able to provide market participants with a variety of instruments of differing maturities that are traded in markets that have the depth to allow speedy exit, capital mobilisation will be less than adequate. For example, capital providers desire liquidity (ability to exit on short notice), risk exposure, while entrepreneurs need to commit capital for long-term investments. Financial markets resolve this divergence through provision of alternative instruments to facilitate diversification, and allow for maturity transformation. These *liquidity* and *maturity* transformation functions of financial systems are very basic functions that require instrument and market development.

Function 2: Risk Management and Resource Allocation. In an environment where uncertainty prevails, risk sharing and insurance are the two most fundamental functions that a financial system provides. A well-functioning financial market enables multiple investors to share a project's risk allowing high-risk, high-return investments to be undertaken. In the absence of such risk-pooling and risk sharing arrangements, such high-risk, high-return projects may be *rationed* out of the market, destroying, rather than creating, value for the economy. Financial markets, therefore, facilitate allocational efficiency. Risk-allocation mechanisms supported by well-functioning financial markets allow for diversification, hedging insurance and leveraging.

Function 3: Pooling of Resources and Diversification of Ownership. A financial system provides a mechanism for the pooling of funds to undertake large-scale indivisible enterprise that may be beyond the scope of anyone individual to undertake. They also allow individual households to participate in investments that require large lump sums of money by pooling their funds and then subdividing shares in the investment. The pooling of funds allows for a redistribution of risk as well as the separation of ownership and management.

Function 4: Information Production, Price Discovery, and Exchange of Control. Price signals contain information on quantity, scarcity and value, and thereby help agents allocate resources to their best use. Nowhere is this more true than in the financial sphere!¹¹ A well-functioning financial market processes and aggregates all available information into the value or price of the commodity. From a welfare point of view, the financial system, through this price discovery function, allows capital to flow toward its most productive use and bring about allocational efficiency.

¹¹ A major failure of a simplistic view of development finance, based on resource mobilisation, was the suppression of price signals (through interest and credit controls) to channel savings towards politically-guided investment priorities. Repressing price signals (or, equivalently, returns) has often led to a misallocation of capital with disastrous consequences for economic welfare and a country's well-being.

Function 5: Facilitating Better Governance and Control. Financial markets promote efficient governance and control of an organised enterprise (especially on a public trade corporation) by exerting *external* pressure and discipline on its operation. In the presence of uncertainty and informational asymmetries, the allocation of capital involves the control of capital so that it is efficiently exchanged to allow it to be put the best use. Inefficient management is typically removed through takeovers which allow unfriendly raiders to accumulate shares in the open market and take control of the firm. Often, the very *threat* of such takeovers is a powerful mechanism for disciplining management. In its absence, management becomes entrenched and misallocates or misappropriates resources from the firm leading to far-reaching economic inefficiencies.

Function 6: Efficient Clearing and Settling. An important function of the financial system is to provide an efficient way for people and businesses to make payments to each other when they wish to buy goods or services. Modern day complex transactions involve movements of goods, services as well as financial assets across time, space, and, quite often, across national borders. Efficient payments and settlement technology allows the speedy completion of such transactions. If financial markets are to handle large transactions rapidly, clearing house and depository functions are necessary elements of the enabling environment. Long delays in intercity check-cashing and lengthy time requirements for registration of financial assets are serious impediments to market development. A payments and settlement systems depend on the supervisory and regulatory system that eventually stands behind the final settlement of all transactions. In an economy where the such system is not very efficient, transactions will be primarily cash-based requiring the maintenance of idle cash balances.

Function 7: Dealing with Incentive and Agency Problems. Modern finance theory views the firm as a *nexus of contracts*: shareholders/owners borrow from creditors and delegate the task of running the firm to professional managers. Ownership and control of the firm is, therefore separated. The various relationships are determined by contractual relationships that are written within the regulatory umbrella provided by the government. Financial markets promote *contractual efficiency* in an environment characterised by incentive conflicts and hence lead to allocational efficiency. Incentive contracts for alignment of diverse interests between management, shareholders, and bondholders can be facilitated through financial contracts.

Since the root of modern financial regulation is thought of revolving around alleviation of the consequences of market failure, regulatory intervention is often thought of as a *substitute* for the markets' functions. However, the newer literature, both in finance and other fields of economics, has shown that it is more appropriate to think of markets and regulation as *complements*. Similarly to enhancing the efficiency of financial contracting, markets contribute to making regulatory arrangements more efficient. The fundamental mechanisms are also very similar to the arguments presented regarding contractual efficiency: by conditioning regulation—the application of rules

and regulator's incentives—on *market-based information*, regulatory outcomes can be significantly improved upon.

IMPLICATIONS OF THE FUNCTIONAL VIEW FOR PAKISTAN

To repeat, our premise is that financial sector policies should be guided and anchored by *functionality* of the financial system. Table 1 presents an assessment of the financial system in Pakistan from a functional viewpoint. The dysfunctionality of the current system that is shown in this table is not surprising.

Table 1

*Functional Assessment of Financial Markets in Pakistan*¹²

Function	Assessment
Capital Mobilisation	Limited instruments and exit is not easy from markets other than bank deposits. Debt and deposit instruments concentrated toward a shorter term.
Managing Risk	No derivative markets. Limited ability to diversify across markets.
Diverse Ownership	Illiquid and poorly supervised stock markets do not inspire faith in the small investor limiting the pooling of ownership and the diversity of ownership.
Information Development and Price Discovery	Illiquid, thin, and poorly supervised stock markets inhibit the process of price discovery. No takeover threat as a disciplining device. Limited ability to arbitrage across markets.
Providing Clearing and Settlement	Non-competitive institutional structures combined with weak regulation leads to inadequate development of clearing and settlement systems.
Dealing with Agency Issues	Since market discipline is absent, optimal contracting is difficult for the overcoming of agency problems. Limited ability to allow use different markets for this purpose.
Attracting Inflows	Volatile inflows to take advantage of arbitrage situations only.

Using the functional approach we wish to provide a policy agenda for Pakistan in its effort to develop financial markets. At the core of our discussion of the ingredients for financial market development are mechanisms for fostering *public confidence* and

¹²For more detailed information on the entries in Table 1, see Haque and Kardar (1993).

appropriate incentives for a well-functioning financial system. No amount of knowledge or technology, or even economic fundamental, makes financial markets workable unless there is an environment of trust and public confidence, i.e., even playing field, open and honest market place, fair treatment of participants by securities operators, honest and transparent management of public companies. In view of this and the preceding discussion, we can conclude that the without the provision of an adequate public infrastructure, financial market development is not likely to be well founded. It is the development of this infrastructure that policy should seek to develop first.

The Necessary Public Infrastructure

In the development of public confidence and informational efficiency, GOP has a vital role to play in ensuring enforceability of private contracts, and creating an environment of transparency and investor confidence. It is perceived as an independent efficient arbiter of financial disputes as well as the last resort for speedy enforcement of all contractual arrangements. The mere existence of legislation, which declares and grants inalienable property rights, is insufficient. An independent judiciary strongly enforcing and protecting these rights, must stand at the core of such a system [see Stiglitz (1993)].

Financial market development must be underpinned by a credible, national regulatory scheme that promotes, rather than inhibits, private initiative, whereby investors and savers build confidence in the financial systems.¹³ Without this foundation, the financial system will be deficient in terms of *informational* and *operational* efficiency, vitiating public confidence, resulting in inefficient pricing of financial assets, as well as inhibiting liquidity and reducing turnover. It is this lack of a regulatory foundation that is an important reason why market development remains poor in less-developed countries.

Following the approach taken in the advanced economies, it seems appropriate that government regulation of financial markets should be more of an *oversight* over *self-regulatory* agencies, such as the stock exchanges and brokerage industry.¹⁴ Self-regulation builds on the capacity and wisdom of men and women inside the member firms that participate in the capital market process directly rather than government bureaucrats who lack intimate knowledge of the day-to-day functions of markets which are increasingly sophisticated.

¹³Savings will be attracted away from the informal sector, as the credibility of the formal system improves.

¹⁴While the financial system is supported and enhanced by a well-functioning regulatory environment, and in turn supports a more efficient, market-based, regulatory system (*regulatory efficiency*). Thus, financial system efficiency and regulatory efficiency are mutually reinforcing.

Sequencing of Financial Reform

In industrial countries, the development of financial markets followed a particular historical sequencing: commercial banks developed first; followed by the development of primary markets for government debt and paper; primary markets for equity and commercial paper were then developed; secondary markets followed; and finally the markets for derivatives arrived. Motivated by the view that less developed follow the development path of the advanced countries, development advice has tended to follow this historical sequencing which is really based on the accident of discovery.

This approach, however, does not permit any "institutional leap-frogging." The difficulty with a stages of financial market development is that it does not emphasise the need for developing a full set of institutions necessary for market development early in the development cycle. As a result, a partial set of institutions is developed that, very often, exacerbates market incompleteness. Moreover, as we have seen there are complementarities across markets and hence institutional complementarities that can be exploited if the historical sequencing were to be relaxed. Espousing a functional perspective on financial system development permits this issue to be side-stepped. By focusing on the various functions and letting the development cycle determine their natural sequence, one automatically sidesteps the kind of institutional fallacies that have often plagued policy advice for financial development.

Fostering Financial Innovation

A form of financial repression that had been practiced in Pakistan is a resistance to financial innovation. Concerns for a potential adverse impact of financial innovation on the stability of the financial system through increased systemic risk are natural and even felt in more advanced economies. However, financial innovation increases market depth and efficiency as well as expands the menu of instruments and mechanisms available for the performance of financial functions. Risk is better priced and trading increased which may contribute to increased volatility.¹⁵ The new equilibrium will have greater social value (output) but has become more risky (with greater market volatility).¹⁶ However, increased volatility may tempt the policy-makers to stifle innovation, discouraging foreign competition and investment and curb domestic speculative trading. Such ill-conceived policy interventions have been observed in many economies.

It should be recognised that financial innovation takes place both in the formal and *informal* sectors. Informal sector develops as a response to official impediments. The official response for too long has been to stifle it. As such, it is a in response to a

¹⁵Indeed, it is possible that greater speculative activity and greater participation by international investors in the local stock market leads to greater trading activity with more information production, and possibly more price volatility.

¹⁶The specialisation in trading risk according to comparative advantage makes society better off.

perceived need for a financial innovation.¹⁷ Consequently, rather than discouraging the informal sector, regulators should be guided by signals coming from the informal sector for fostering innovation in the formal financial sector.¹⁸

Market Development

Market development has been impeded more by the regulation or the lack of it than any other single item. Rather than stifle innovation and trading in the market place, including erecting barriers to globalisation, policy-makers should facilitate liquidity and promote market transparency. Government policies should be targeted toward reducing the costs of the financial system. These include costs relating to trading, intermediation, and legal enforcement. Trading costs can arise implicitly from the lack of market development. In a nutshell, the policies should create an enabling environment for capturing the full functional potentialities of markets. For instance, there is a need to build capacity in the provision of risk allocation facilities.

CONCLUSIONS AND IMPLICATIONS FOR PAKISTAN

This paper argues that financial sector policies in Pakistan should focus on enhancing, rather than inhibiting, the multiple functions of financial markets. As noted above, the financial system in Pakistan has been stifled by the government which is not playing the role of the guardian of the system but that as the largest provider of financial services in the system. The system is dominated by inefficiently run government owned financial institutions which subject to considerable political interference, have developed a poor quality portfolio of assets, substantial overstaffing and poor human capital. Money and capital markets are small and trading is generally carried out in government securities and in equities of a relatively small number of companies. The government finds the commercial banks captive for absorbing its securities: by its pre-emption powers to obtain funds at below market rates and through its policies on subsidised and directed credit it has heavily burdened the financial sector. Cumbersome legal processes for contract enforcement and the indifferent application of accounting, auditing and supervision standards have contributed significantly to the poor performance of financial institutions.

The financial sector as it stands in Pakistan today is, therefore, unable to perform many important financial functions that we have identified above. Risk sharing arrangements, hedging, and portfolio diversification, are all limited by the lack of availability of instruments. Market solutions to dealing with asymmetric information remain limited in view of the difficulties of contract enforcement, and inadequate regulation and supervision of financial institutions. The inordinately large role of

¹⁷Informal sector can provide signals to policy (see Montiel, Agenor, and Haque (1993).

¹⁸See Samad (1993) and Said (1993) for a discussion of how financial innovation was stifled in Pakistan.

government in this sector as a supervisor, regulator and owner of institutions and instruments, has resulted in limiting arbitrage so necessary to market efficiency. Moreover, the moral hazard associated with this system has led to the nationalised banks accumulating a large portfolio of bad debts, the cost of which will be borne by the taxpayer.

Against this background, the design of reform should be very mindful of the functions that will be required of the financial system. For market development, it is very important that the government quickly move out of the provision of financial services to that of the regulator of the system. This would mean that an immediate priority should be to put in place a supervisory and regulatory base at the centre of the financial system. (See Box 1.) This supervisory and regulatory core should foster market development but through letting private initiative and innovation take the lead. It should seek only to deal problems related to asymmetric information and moral hazard, through disclosure and direct surveillance. There must also be adequate legislation—such as a framework for speedy contract enforcement, debt recovery, and bankruptcy—to support the financial system. (See Box 1.)

The importance of developing markets helps in the achievement of many objectives. In addition, market and instrument development tends to be complementary. For example, allowing forward markets to develop in foreign exchange can reduce the vulnerability of the SBP. Another example is that of stock market development, which may be an important means for introducing transparency into the privatisation process. Capital market-based privatisation can, in turn, also enhance the deepening of existing stock exchanges.

The regulatory and supervisory agencies must be independent professional agencies responsible for the soundness of the financial system. Research has shown that independence of the central bank is very important for the effective conduct of monetary policy and the sound supervision of the banking system. This was enacted recently in Pakistan. The securities market continues to be run by a semi-autonomous body of the government—the Corporate Law Authority. There is an urgent need to put in place a fully independent Securities and Exchange Commission to take full responsibility of the development and the supervision of the securities market. To be effective, both the SBP and the SEC, when it is initiated, will need to be professionally staffed. Professionalisation of government agencies is, however, resisted by the current establishment.

While developing the regulatory core, vigorous efforts will have to be made for privatisation of government interests in banking and security markets. The policy of financial repression where high liquidity ratios for banks provide a captive market for government paper will have to be discontinued. The private sector will have to be given room to develop financial services with the diminishing role of the government.

The advantage of having in place a professional and independent financial sector will presumably allow improvements in payments and settlement systems to reduce the current high transaction costs associated with financial transactions. This is of obvious importance to the development of financial system in Pakistan.

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