**When good is bad**

Syed Asad Ali Shah

Saturday, Oct 21, 2023

In recent years, Pakistani banks have been posting exceptional profits, while the rest of the economy has been contracting. This paradox can be attributed, in part, to the monetary policy advised by the International Monetary Fund (IMF) and enforced by the State Bank of Pakistan (SBP) to control inflation.

With a policy rate at a staggering 22 per cent, banks have found a safe haven in lending to the government of Pakistan at a mark-up rate of 23 per cent, resulting in an astounding spread of 10-12 per cent compared to their average deposit costs. Unfortunately, this trend has serious repercussions for the broader economy.

Flourishing banking sector amidst economic contraction: Pakistan’s overall GDP contracted by 0.6 per cent in FY2023, but the banking sector reported a record-high profitability. According to a recent clarification by the SBP, the banking sector posted a robust profit of Rs284 billion in the first half of calendar year (CY) 23, making a staggering 125 per cent increase compared to the same period in CY22. Furthermore, the Capital Adequacy Ratio (CAR) of the banking sector surged to 17.8 per cent by the end of June 2023, significantly surpassing the SBP’s minimum regulatory requirement of 11.5 per cent and the international standard of 10.5 per cent.

While shareholders, management, and employees in the banking sector are benefiting from this remarkable growth with increased profitability, dividends and attractive remuneration packages, the condition of ordinary citizens in the broader economy is looking bleak. During the last financial year, the per capita income dropped steeply from $1614 to $1400 (-13 per cent), pushing the rate of poverty to 39.4 per cent and adding 12.5 million Pakistanis below the poverty threshold. Additionally, large-scale manufacturing recorded a negative growth of 10.6 per cent, and inflation soared to over 30 per cent. This situation raises two possibilities: one, the country’s banking sector is an oasis of excellence in a dwindling economy; and two, there is something seriously wrong with our policy framework.

Fiscal deficit is the key driver of banking-sector growth: Interestingly, the primary driver of the banking sector’s asset growth and profitability is the fiscal deficit of the government. In fact, the higher it goes, the higher the windfall for banks, since over 50 per cent of their total assets are now invested in theocratically risk-free government securities with high interest rates. However, this phenomenon is counterproductive, because it has led to a squeezing of the private sector, which is supposed to be the engine of economic growth in a market economy.

According to a recent SBP report on mid-year performance of the banking sector, the advances to the private sector have declined by 7.0 per cent over the last six months, with significant loan repayments by all three segments – corporate, small and medium, and consumer finance. Each of these sectors is reported to have retired Rs535 billion, Rs94 billion and Rs40 billion respectively during the last six months, which paints a concerning picture for the economy. So, on the one hand, the cost of bank financing is becoming unaffordable for the private sector, while on the other, there is virtually no availability of equity financing to support private entrepreneurs in the country owing to a complete absence of venture capital and private equity funds, and dismal state of our capital market where raising of funds is nearly impossible.

A review of the balance sheet of the banking sector over the past two years reveals an alarming trend. Bank investments in government securities have increased by Rs7.4 trillion, exceeding the total increase in bank deposits of Rs5.3 trillion. This suggests that the government’s budgetary rupee needs (fiscal deficit) are far more than the increase in total deposits made by the people of Pakistan in the banking system. To bridge this gap, banks have been borrowing from the SBP through its operate market operations (OMOs).

Vicious cycle of stagflation and growing cash economy: It appears that the country is caught in a vicious cycle where the economy is contracting alongside rising inflation for two reasons.

One, the higher interest rate only increases the government’s borrowing costs and fiscal deficits, which is mainly financed through bank deposits and remaining through SBP financing routed through banks at higher costs.

Second, the private sector, which produces goods, services and employment in a free market economy, has reduced its credit requirements due to lower demand and higher borrowing costs. This has led to businesses either retiring existing loans or struggling to survive with current loans at a higher cost. Consequently, many businesses have scaled back operations due to decrease in demand, resulting in supply shortages and cost escalation – both of which are inflationary.

While banks are reaping phenomenal profits without undertaking significant risks or innovation, the overall impact on the country is stagflation – a combination of economic stagnation and inflation. Furthermore, the financing of inefficient public-sector projects, which inherently includes significant leakages in the form of kickbacks and commissions, fuels the expansion in the informal cash economy, as reflected in the sharp rise in Cash in Circulation during the last few years.

The size of the SBP’s OMOs, through which the SBP in substance is lending to the government via banks, has ballooned to Rs9.4 trillion by the end of September 2023, compared to less than Rs2 trillion in June 2021. A substantial portion of this increase and overall increase in the bank’s lending to the government seems to feed into the cash economy through big leakage in the public-sector expenditure, particularly federal and provincial development programmes.

Breaking the vicious cycle: In conclusion, Pakistan’s low savings rate and the misallocation of such meagre domestic savings to unproductive public-sector expenditure, happening incessantly for decades, has hindered productivity and innovation for a long time. The excessive financing of unproductive expenditure at an exorbitant cost is also exacerbating inflation, shrinking the economy, and contributing to the growth of the cash economy, which does not significantly contribute to its revenue collection.

To break this destructive cycle, the size of government at all levels must be drastically reduced. This reduction should include the elimination of unproductive expenditures and the excessive role of governments in the economy to allow more resources to flow to the private sector to promote productivity growth. It will necessitate a disruptive roadmap to restructure the economy through what I had described in my earlier articles as ‘creative destruction’, including closure of redundant departments and agencies that do not add value and are cost ineffective.

This will necessarily entail massive privatization of state-owned entities to alleviate the continuous drain on the country’s resources. Further, to promote a productive and competitive private sector, a major overhaul is required to improve and strengthen the quality of our regulators.

The writer is a former managing partner of a leading professional services firm and has doneextensive work on governance in the public and private

sectors. He tweets/posts @Asad\_Ashah