

Bhutto's shock to finance

pak. eco
Dawn
28.1.03

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BHUTTO in the title of this article is not Benazir — who also shocked the financial system in many different ways during her two tenures as prime minister in the 1990s — but her father, Zulfikar Ali. We will get to the Benazir Bhutto story later in this series of articles. For the moment our focus will be on the impact Zulfikar Ali Bhutto's policies had on the financial system.

Bhutto, Pakistan's prime minister for more than five years — from 1972 to 1977 — instituted what his administration termed "reforms." The main objective of the series of moves made by him was to reduce the economic power of the industrial and financial houses that had been identified — wrongly, we believe — as having captured the country's economic system. Nationalization of the assets owned and managed by these houses was the blunt instrument used by the Bhutto administration to reduce the political influence of urban wealth.

As was suggested in the article last week, Ayub Khan's government had created an environment in which various components of the financial sector had developed very well and had also prospered. By the end of the Ayub period, Pakistan had one of the more vibrant financial sectors in the developing world. Commercial banks had expanded their presence; insurance companies had begun to develop new products and attract new customers; the stock exchange in Karachi, helped by the National Investment Trust and

gives enormous power to the bureaucracy and, if the civil servants are beholden to politicians — as they increasingly became during the Bhutto period — it brings in political interference in the process of allocation of financial resources. This is precisely what happened. Civil servants, sometimes urged on by politicians and at other times acting on their own, began to influence the allocation of capital by the banking sector. The creation of the NCC, therefore, was the first significant foray of politics into finance.

But Bhutto was not satisfied. For him this was too complicated a way of controlling the distribution of money by financial institutions. A better way was to bring them under the direct control of the government — of the bureaucracy and its political masters. That was done on January 1, 1974 — two years after the first wave of nationalization.

In the second nationalization wave, the government took over all commercial banks and insurance companies and placed them under its control. This move was to have a much greater impact on the economy than the earlier take-over of large industries. By

Finance Corporation (RDFC). Together, the two public sector financial institutions received a significant amount of financing from the multilateral development banks. They came to dominate the financial sector.

Bhutto made other changes in the financial sector as well, some of which affected the quality of governance. Two of these were significant. First, the Planning Commission lost most of the authority it had gained during the Ayub period when it tightly controlled all public sector investment. This was done through due diligence of the projects to be financed, selected according to strict economic criteria. Bhutto, an impatient politician with contempt for serious economics, began to short-circuit the Commission. Increasingly the public sector development programme came to include projects that could not be justified on economic grounds. Among the most costly of these was the Karachi Steel Mill.

Second, Bhutto had no use for an independent central bank that could oversee the working of the various parts of the financial sector. Over time, the State Bank lost most of

its authority and, effectively, became a part of the ministry of finance. If it sought to present a point of view different from that of the prime minister, Bhutto did not hesitate to remove its governor. This happened to Ghulam Ishaq Khan, who, in a well reasoned speech, had painted a more sombre picture of the economy than Bhutto was prepared to endorse.

In sum, Bhutto set the stage for the rapid bureaucratization and politicization of the financial sector. The stage was also set for a steady deterioration in the efficiency of the institutions functioning in the sector and for the arrival of

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the Investment Corporation of

Pakistan, had begun to broaden the base of ownership of the various parts of the economy; and development finance corporations were successfully intermediating foreign assistance and making it available as equity and debt to new and old entrepreneurs. The only area left unattended by the government was the regulatory system.

Had the Ayub administration focused some attention on the task of regulating the various institutions operating in the financial system, some of the sins that were to be attributed to them by Zulfikar Ali Bhutto might not have been committed. There is no doubt that "crony capitalism" had flourished during the Ayub period. This had created alliances — described in exceptionally pungent terms by Bhutto as he campaigned around the country before the 1970 elections — involving the banking and the industrial sectors and the powerful civil bureaucracy.

Bhutto used nationalization to break up these alliances. He moved quickly to take over the industrial units owned by the large industrial houses. On January 1, 1972, the government assumed the management and control over 31 industrial units. However, he waited for two years before bringing the financial sector under the control of the government. The economic bureaucracy of the time, led by the indefatigable A.G. N. Kazi, seemed to have persuaded the prime minister that direct ownership of financial assets was not necessary to meet his political objectives. This could be done by persuasion — always an effective tool in a semi-authoritarian system — and the use of the regulatory system. Using these devices Bhutto would ensure that the resources managed by banks and insurance companies were channelled into the sectors he favoured.

Bhutto accepted this argument and delayed the nationalization of the financial institutions for two more years. Following his socialist instincts and determined to reduce the political influence of the big industrial class, the prime minister wished to move financial resources into the small and medium sectors. To achieve that objective, his administration created the National Credit Council (NCC) under the State Bank of Pakistan in May 1972. The NCC was mandated to get capital into small and medium enterprises. As an incentive, commercial banks lending money to the enterprises were to share all risks with the State Bank of Pakistan.

This way of controlling the flow of credit

bringing 31 large industrial enterprises under its direct administration, the government did not acquire a significant presence in the sector. Its enterprises employed only four per cent of the industrial workforce and accounted for perhaps five to six per cent of the industrial output. But by nationalizing banks and insurance companies, the government was the complete master of the financial sector and, through, it of the entire industrial sector.

As economists are fond of saying, the financial sector is the heart of an economy — any economy, developed or developing, socialist or capitalist, industrial or agricultural. By nationalizing all modern financial institutions the government now held the economy's heart in its hands. Inevitably the heart weakened over time. It failed to pump blood into the parts of the economy that needed it most. Without stretching this metaphor very far, it would be correct to say that by taking over the financial sector in its entirety, the Bhutto government turned what was once a vibrant economy into an increasingly sick entity.

While the proportion of industrial workforce employed and output produced by government-owned institutions following the nationalization of January 1, 1972, did not amount to much, the administration expanded the government's presence through a series of new investments, mostly in the public sector. To do this, it turned to the instrument of the "development finance corporation" created in the 1950s and further developed by Ayub Khan in the 1960s. But, as we discussed in this space last week, Ayub Khan's administration had used the DFCs such as PICIC, IDBP and ADB to provide finance for the development of enterprises in the private sector.

Almost the entire lending by these institutions came from the World Bank, the Asian Development Bank and some bilateral donors who subscribed to this model of development. But Bhutto wanted a DFC that could cater to the resource needs of the industrial enterprises acquired by the government in the first wave of nationalization. He also wished the public sector to make new investments.

These considerations resulted in the creation of yet another DFC — the National Development Finance Corporation (NDFC). A few years after its birth, the NDFC acquired an affiliate, the Regional Development

sector and for the arrival of corruption and political favouritism as the preferred criteria for conducting business.

Those who have chronicled Bhutto's years in power have not given sufficient attention to the long-term damage that was done to the economy by the reckless way in which the financial sector was changed and restructured. This neglect may in part be due to the fact that the importance of the financial sector for sustained economic growth has begun to be fully appreciated only in recent years. Our awareness of this was increased by the great financial crisis that hit East Asia in the middle of 1997, demonstrating the fragility of the economies that had, until then, been regarded as exceptionally robust.

Since the East Asian crisis, analysts have begun to focus on the contribution finance makes to development. A weak financial system can shock even the strongest economy. A strong financial system can protect even weak economies against external shocks.

While there are exceptions to every generalization, a considerable amount of empirical work carried out by multilateral development banks suggests that disappointing macroeconomic performance is almost always associated with a significant public sector banking presence. A recent study by economists La Porta, Lopez-de-Siniales and Shlafer shows that a higher initial level of government ownership of banks leads to slower rates of economic growth. The conclusion from all this is obvious for understanding the loss of economic momentum during the Bhutto years. Simply by increasing the presence of the public sector in the field of finance, the Bhutto administration set the stage for anaemic growth rates for decades to come. Thirty years after Bhutto's nationalization of the financial sector, Pakistan continues to struggle with the process of reversing the change introduced by the Bhutto government in 1974.

Before concluding, it will be useful to add a caveat to the general proposition that public sector banking inhibits economic growth. Several countries have turned publicly owned banks to successful enterprises. Examples of these include BNDES (Brazil), DSK Bank (Bulgaria), Bank Mandiri (Indonesia), and Bank Bumiputra (Malaysia). How this was done is a subject we will pick up in the next article in this series when we look at the handling of the financial sector by the government headed by General Ziaul Haq.