Finance sector's key role

Pak. eco
Dawn 21.1.03

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THAT the 1960s was a golden age for Pakistan's economic development is something few serious historians would dispute today. Under the direction of President Mohammad Ayub Khan, Pakistan's first military leader, the country was able to sustain a rate of GDP growth of 6.5 per cent a year in the eleven-year period between 1958 and 1969. Income per head of the population increased by an impressive 3.6 per cent per annum. The size of the Pakistani economy nearly doubled — more accurately, it increased by 99.9 per cent — during the Ayub era. Average income for Pakistan's citizens increased by 48 per cent between 1958 and 1969.

In the 1960s, Pakistan was one of the most rapidly growing economies in the developing world. There was an expectation then that it would be one of the few developing countries that would "take-off" — in the words of W.W. Rostow who had coined the term in the context of his "stages of growth" theory — from the stage of economic backwardness to that of sustained growth. In fact, the Pakistani economic miracle preceded that of the East Asian miracle which was to change the economic, social and political fortunes of half a dozen countries in that part of the world. Had Pakistan not deviated from the path it was taking in the 1960s, it would have joined the ranks of the 'Asian tiger' economies a long time ago.

These reflections on Pakistan's economic performance in the 1960s are not offered to invoke nostalgia. They are presented in order to underscore an important point: the economy did well in that period for the reason that it was provided with a strong institutional underpinning. The managers of the economy at that time who worked out of the Planning Commission and the ministry of finance had an instinctive understanding of the importance of institutions for supporting growth and development. They included institutional strengthening in their growth strategy long before institutional economics gained widespread respect.

tify. The only hint his analysis has of the importance of financial development for growth is the "unhesitating" use of foreign economic assistance. As we will see below, some of this assistance was channelled to industry and finance through development finance corporations. Hasan is not alone in not factoring in the importance of finance in advancing growth — or, conversely, distorting the pattern of growth and increasing bureaucratic and political corruption — in the country.

Hasan's is a more recent work on Pakistan's economic history. An equally seminal book was written by Gustav F. Papanek, who had spent many years advising Pakistan's Planning Commission. Published in 1967, Papanek's book analyzed what came to be celebrated as the decade of development, the eleven years of Ayub Khan's stewardship of the Pakistani economy. Although Papanek devoted a long section to the origin, management and contribution made by Pakistan Industrial Development Corporation, he devoted practically no space to the overall development of the financial sector or to the institutions that operated or were established by the Ayub government in that part of the economy.

It is important to underscore the absence until very recently of the importance of finance in academic and developing thinking in Pakistan. Such absence invariably influences public policy. It does not highlight both the positive and negative role financial policies can play in the development of an economy, in particular the economy in the developing world. Let us get back to the period of Ayub Khan and identify the four areas of financial development that were so critical for promoting growth at that time. These included the expansion in the role of

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It was the birth of crony capitalism or the close links between a small number of financial and industrial houses, both owned by a handful of very wealthy families, that was to give rise to the notion that a significant part of the wealth created during Ayub Khan's decade of development went into the pockets of the rich. This impression — for it was no more than an impression since facts spoke of an improvement in income distribution and a reduction in the incidence of poverty — led to the raising of the "22 families" slogan by Mahbubul Haq, Planning Commission's chief economist, to the fuelling of the political agitation against the military leader in 1968-69 and, eventually, to the ill-fated nationalization of businesses and banks ordered by the government of Zulfikar Ali Bhutto.

Development finance corporations constituted the second area of emphasis during the Ayub period. His government further expanded the role of DFCs adding Agriculture Development Bank to the three institutions that were already in place. The ADB — as was the case with PIDC, PICIC and IDB — obtained a line of credit from the World Bank. In the 1960s and 1970s, the DFCs continued to be favoured by the multilateral development banks and Pakistan was one of the countries to be favoured.

The third important initiative taken by the government of Ayub Khan in the field of finance was to develop capital markets. Entrepreneurs seek finance from generally three sources — their own savings, or savings of friends and relatives; the banking sector; and the capital markets. Much of Pakistan's early industrialization was financed from the first source while the second wave of investment in the late 1950s and early 1960s came from the banking sector. In the 1960s, the government of Ayub Khan began to promote the development of capital markets in which new companies or companies undertaking expansion and modernization could raise funds.

Equity capital became a popular source of money for industrialization. The Karachi Stock Market — the only one in operation at respect.

What were the sources of economic growth during the Ayub period? This question was addressed by a number of academics and practitioners who wrote copiously about that period. Most credit one sector — agriculture — for the country's remarkable performance during the period. Some also focus on government policies that put development high up on the administration's agenda as the driver of growth. However, none of the analysts with whose work I have some familiarity identify Ayub Khan's support for the development of financial sector as an important element in promoting growth.

Pervez Hasan's recent book on Pakistan's economy is a highly competent piece of analysis and a reliable history of the country's development experience. Nonetheless, in summarizing the reasons for the impressive economic performance during the 1960s, Hasan makes no mention of the role of the financial sector.

"Few periods in Pakistan's history stand out so clearly as 1960—65 for quickening the tempo of growth," writes Hasan. "Ayub's strong commitment to development, his support to public institutions for planning and development, his unhesitating use of foreign economic assistance, his unwillingness to reduce reliance on direct economic controls and thus improve the investment climate for the private sector, and his ability to delegate authority to his economic managers were all responsible for the dramatic turnaround in investment and growth in both East and West Pakistan, in sharp contrast to the economic stagnation in the second half of the 1950s."

All this is correct but it is interesting — and revealing — that Hasan makes no mention of the four equally important developments of this period that were as responsible for promoting growth as those he does iden-

These included the expansion in the role of commercial banks and development finance corporations, the development of capital markets, and the establishment of institutions to broaden the ownership of assets in the sectors of industry, communications, commerce and finance. Ayub Khan's approach to the development of the finance sector was also to influence the way this important sector was treated by the generations of politicians who followed him into power in Islamabad.

Under President Ayub Khan, Pakistan's financial sector developed rapidly, evolving — but for one area — in the right direction. The military leader continued with the policies initially adopted by Mohammad Ali Jinnah. He favoured the development of commercial banking in the private sector. During the 1960s, commercial banks greatly increased their activities, reaching out to potential savers in all parts of the country. The banks opened their branches in even the most remote parts. Habib Bank was joined by United Bank and Muslim Commercial Bank in the private sector while the National Bank of Pakistan, a publicly owned commercial bank, also expanded its operations. The commercial banking sector attracted a number of young professionals who were to play an important role in Pakistan's economic history at a later time.

Not only did the Ayub government encourage the expansion of commercial banking. It allowed it considerable operational latitude. It adopted the approach that was favoured in Europe and the emerging markets of East Asia in that industrial houses were allowed to own banks and permitted to draw funds for investment from them. A very close relationship developed between a number of industrial and financial houses with the inevitable consequence of the banks not subjecting the loans requested by the industrial

Stock Market — the only one in operation at that time — began to list a large number of companies through IPOs — initial public offerings. By getting companies to raise capital through the equity market, the government was able to broaden the base of industrial and financial ownership.

This was also helped by two financial institutions, the National Investment Trust (NIT) and the Investment Corporation of Pakistan (ICP), which acted as intermediaries between small savers and entrepreneurs seeking funds for investment. This was the fourth element in financial engineering undertaken during the Ayub period. The NIT was an open-ended fund with no limits placed on the amount of money it could raise from interested investors. It obtained money by making available its "units" which could be sold or bought with relative ease. The ICP floated "closed end" funds with specified limit on the amount of money to be raised and some indication as to how the funds obtained would be invested. The ICP shares were quoted on the stock markets and, like the NIT units, were also very liquid.

A significant amount of the large amount of investment made in industry during the Ayub period was financed from the capital markets. Bank financing remained important but increasingly entrepreneurs raised funds by offering equity in the stock markets.

Along with the development of commercial and development banking, the growth of the equity markets and broadening in the ownership of industrial assets was an important development during the Ayub era and contributed to the impressive growth of that period. But the government did not pay much attention to the simultaneous development of the regulatory system. This proved to be the Achilles' heel of the financial sector under Ayub Khan.