Getting growth from finance

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IN the essays contributed to this space over time I have repeatedly emphasized the importance of developing institutions to promote economic progress. Capital investment, human skill development and technological improvement are important determinants of growth. But institutions also play an important part by reducing what economists call "transaction costs". Since transactions among individuals, among businesses, between individuals and businesses, between government departments and agencies on the one side and individuals and businesses on the other underpin all economic activity, their cost influencing efficiency and economic growth.

Transaction costs are very high when an economy has a poor institutional base. They are low when institutions work well. A sound institutional base is defined by the way organizations in both public and private sectors are structured and the transparency and predictability of the rules that govern their operations. For that to happen organizations must operate within a legal framework that is transparent and efficient. That Pakistan's economy today is far less efficient than was the case in the 1960s — the golden era in the country's economic history — is largely the consequence of the collapse of the institutional base in the 1970s, 1980s and 1990s.

The close relationship between institutional strength and economic performance affects all sectors of the economy. But it is in finance that this relationship is of vital importance. Financial institutions such as commercial and investment banks, insurance companies and brokerage houses, stock and money markets, various types of regulatory agencies are needed to intermediate between those who have money to save and those who need money to invest. In underdeveloped economies savers and investors have a direct relationship with each other which results in high transactions costs and, consequently, a low rate of economic growth. In more developed economies, intermediation is done by institutions. These become more specialized as economies develop and modernize.

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Before handing over power to the new generation of politicians in the waning days of 2002, President Musharraf suggested that he would expect — perhaps also demand — that the civilian authorities continue with the reform programmes initiated by his economic team. The president is right in insisting on continuity. By changing course each time they assumed power, the nine regimes that held power in Islamabad in the fourteen-year period between 1985 and 1998 created an environment of uncertainty. Markets do not operate well in such a situation, in particular when uncertainty surrounds the working of the financial sector.

It is important, therefore, to build on the foundations that were laid in the 1999-2002 period. Will the politicians who have assumed power continue with the policies adopted by the administration of General Pervez Musharraf and continue to strengthen the economy's financial base? Or, conversely, will the new set of politicians succumb to the temptation that persuaded their predecessors to use financial institutions for their personal benefit? We will get to answer these questions over time. For the moment some general observations drawn from Pakistan's history are in order.

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For a student of finance, Pakistan offers a good case study of what are good and bad institutional practices in the realm of finance. Before making some suggestions on the approach the Jamali government may wish to adopt — a subject I will pick up later in this series of articles — it would be helpful to delve a bit into the country's history. It offers a number of important insights. At different points in time, Pakistan's policymakers emphasized the development of different parts of the financial system. The first priority was given to the creation of commercial banks but not in the public sector — as was done by a number of other developing countries once they gained independence — but, instead, in the private sector.

Without proper regulation and supervision, financial institutions can be captured by their owners whether they are private entrepreneurs or government bureaucrats. This is something Pakistan was to learn in the 1970s, 1980s and 1990s. By that time the country had already paid a heavy price. However, I am jumping ahead of the story.

Pakistan continued with the development of its financial sector in the fifties by establishing a development bank in the public sector to act as a catalyst for financing modern industries. The creation of the Pakistan Industrial Development Corporation (PIDC) was an important event in the evolution of Pakistan's financial sector. This was the first development finance corporation (DFC) to be set up in the country. Its purpose was clearly articulated and well understood by the first generation of managers appointed to develop the institution. The PIDC was mandated to move capital into the sectors of the economy that, because of associated risks, could not attract private savings. However, the state's catalytic role was to be performed only for a limited period of time — for as long as the private sector was unwilling or too shy to commit its resources into the sectors about which it had little knowledge. Once some level of comfort was achieved, the private sector would be allowed to obtain the assets the public sector had created.

In other words, "privatization" was built into the design of the PIDC and the institution remained committed to it. A number of enterprises established by the Corporation were ultimately sold to the private sector. The PIDC, in fact, helped create the industrial houses that were to dominate Pakistan's economy in the 1960s — the houses that were to become the victims of Zulfikar Ali Bhutto's political wrath in the early 1970s. We will return to that part of the story later.

The PIDC's initial success under the dynamic leadership of Ghulam Faruque, its chairman, laid the ground for the creation of other DFCs. The PICIC (Pakistan Industrial and Commercial Investment Corporation) and IDBP (the Industrial Development Bank of Pakistan) were created to channel funds from the public to the private sector. The PICIC was entrusted with the task of financing the establishment of enterprises that needed large amounts of capital. The IDBP was mandated to encourage the development of medium-sized enterprises. Both were provided funding by the World Bank.

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as economies develop and modernize.

Recent cross-country empirical research carried out at the World Bank has demonstrated that sound and efficient financial intermediation leads to higher economic growth by as much as an increment of two percentage points annually. If the World Bank's estimate is correct and holds also for Pakistan — a country that has seen a steady deterioration in its institutional base over the last three decades — a well performing financial system can increase the country's sustainable growth by as much as 30 to 50 per cent a year, from the present anaemic rate of 3.5 per cent to a reasonably respectable five to 5.5 per cent a year.

This increase in growth can occur even without an increase in the rate of investment. This is an important finding for a resource-strapped country such as Pakistan. An increase in growth without a sharp increase in investment offers a way out of the low level equilibrium in which the economy has remained trapped for several years.

A strategy that focuses on institutional development to produce growth should distinguish between the institutions that can work their magic almost immediately and those that will produce results over a longer period of time. Financial institutions belong to the first category; institutions needed to improve the quality of human resource belong to the second category. If the government that took office in November of last year wants to revive growth — as it must to ensure its own longevity — it should focus its attention on creating a strong institutional base in the sector of finance.

A great deal of impressive work was done by the Musharraf government to strengthen

countries once they gained independence — but, instead, in the private sector.

Mohammed Ali Jinnah, Pakistan's founding father, realized the importance of financial intermediation while he was campaigning for the creation of a separate homeland for the Muslims of India. He persuaded a group of wealthy businessmen to establish a commercial bank that could serve the Indian Muslim community. His initiative resulted in the creation of Habib Bank. The bank played an important role in mobilizing funds from the Muslim community to finance the All-India Muslim League's campaign for the establishment of Pakistan. Habib Bank also played an important role in channelling relief funds to the people hurt by repeated communal riots and violence that preceded the departure of the British from India.

After Pakistan was born, Habib Bank, at the urging of Governor-General Jinnah, moved its headquarters to Karachi, Pakistan's first capital. With that move Pakistan laid the foundations for erecting a financial system. For quite a while Habib Bank was Pakistan's premier commercial bank.

When Jinnah became Pakistan's first governor-general, he turned his government's attention towards creating another base for the financial system — a supervisory and regulatory structure. In the summer of 1948, a few months before his death, he spoke at a function to inaugurate the State Bank of Pakistan, the country's central bank. By the summer of 1948 Jinnah was sick with a debilitating disease. That he should take the time to inaugurate the central bank shows his understanding of the importance of a well functioning regulatory apparatus as the base on which to erect a modern financial system.

At that time, the World Bank ... promote industrial development by using institutional conduits for its own resources. The PIDC had provided public sector resources for setting up industrial enterprises in the public sector. PICIC and IDB were established to provide public money to private entrepreneurs. By taking this route and encouraging developing countries to follow it, institutions such as the World Bank sought to short-cut the normal process. Ordinarily, private sectors' need for finance was met by private institutions with the government's role confined to ensuring that the money put at the disposal of commercial and investment banks were not misused by their owners and managers.

This model was abandoned by the World Bank in favour of creating DFCs on the assumption that the development of a financial system by the private sector would take too long for industrialization to take place. Development practitioners in international organizations were people in great hurry. They could not wait for privately led financial development before industrialization could begin. The DFCs offered a way out.

Entrusting development to DFCs without a robust regulatory framework offered tremendous opportunities for corruption and misuse of public funds. Pakistan was not the only country to go down that slippery path. A number of other countries in the developing world fared equally poorly. However, before Pakistan saw the corruption of its economy by the misuse of financial institutions, it went through the period of Ayub Khan — to date the golden period in our economic history. We will deal with that part of history in the article next week.