Some aspects of central banking in pakistan 1948-1966

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ABSTRACT

This study attempts to review and analyse central banking in Pakistan It has four objectives (i) to discuss the role of the State Bank in the growth of commercial banks and the money market, (ii) to describe and analyse the operation of the commercial banks, (iii) to discuss the control of the money supply by the State Bank, and (iv) to examine the part played by the Bank in the setting up and operation of specialised financial institutions created to promote the development of agriculture and industry

We begin with an account of the salient features of the Pakistan economy to enable readers not familiar with the country to see the banking system in its economic setting We then go on to examine various facets of the organization, functions and operation of the State Bank, its relationship with the commercial banks and the reasons why it has failed to establish a money market One of the functions of the State Bank is to control the money supply and in Chapter 5 we show why it has failed to do so and argue that, contrary to the Bank's own view, the absence of a money market is not the real explanation We shall show why it is that in Pakistan the conventional mechanisms for curtailing the money supply appear to have had an opposite effect In the final chapter this analysis is extended to show how the public's desire to hold cash balances has been influenced by changes in the rate of interest payable on deposits

In this chapter we also argue that the agricultural and industrial development banks' concern to provide cheap credit has restricted their ability to mobilise resources and made them unnecessarily dependent on Government and State Bank finance We conclude by showing that the commercial banks could easily provide more finance for development without endangering their liquidity

SOME ASPECTS OF CENTRAL BANKING IN PAKISTAN

1948-1966

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Chapter 1.

THE ECONOMIC BACKGROUND.

The object of this study is to examine the role of the State Bank of Pakistan in the developing economy of the country. For this purpose, an understanding of the economic background, against which the Bank is functioning, is necessary. This is because the monetary and banking system of any country is the product of the political, economic and even social structure of that country. The monetary and financial system in each country is unique in this sense that it has to operate in a particular economic milieu and has to adapt not merely its techniques but also the scope of its functions accordingly. It is therefore necessary to give a brief sketch of the economy for the proper understanding of the functioning of the monetary and banking system. It is the object of this chapter to describe briefly some aspects of the economic structure of Pakistan. We shall limit ourselves to only those characteristics of the economy which appear to have a direct impact upon the monetary and financial system.

Area and Population.

Pakistan came into existence as an independent state on August 14, 1947, as a result of the partition of the Indo-Pak sub-continent. It has a total area of 365,529 square miles, of which West Pakistan accounts for 310,403 square miles or 84.9 per cent of the total area. East Pakistan, which is separated from West Pakistan by about one thousand miles of Indian territory, has an area of 55,126 square miles, or about 15.1 percent of the total area. This geographical separation of the two provinces of Pakistan has serious economic implications.

Pakistan has a total population of 118.4 million, with an average density of 324 persons per square mile. West Pakistan, with a population of 54.1 million, has a density of 174 persons per square mile and East Pakistan, with a population of 64.3 million, has a density of 1,166 persons per square mile, which is nearly seven times that of West Pakistan.[1]

For the purpose of future economic development, it is the rate of growth of population which is of basic importance. A higher growth rate implies a larger development effort even to maintain the current low level of standard of living, and it affects the key economic factors,

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1. Planning Commission, Govt.of Pakistan, Estimates of Population for 1966-67 quoted by the World Bank Mission in their "Report on the Current Economic Position and Prospects of Pakistan", April 1967, (mimeographed).

including aggregate and per capita income, savings and consumption, the composition of output and employment by major production sectors and the degree of dependence on import of capital The estimates of the rate of growth of population have varied widely [1] The recent estimates of the Planning Commission modified on the basis of 1961 census are annual compound rate of growth of 2 3 per cent for the decade ending June 1960, 2 6 per cent annual compound rate of increase for the Second Plan period (1960-65) and 2 7 per cent for the Third Plan period (1965-70) [2] Even these estimates are not considered firm.[3] The World Bank Mission in their recent report have indicated the rate of growth of population at 2.6 - 3 per cent per annum The difference in annual increase in population at the lower and higher limits comes to half a million people at the base figure of 118.6 million people in 1966. For the purpose of development planning it seems better to err on the higher side than on the lower side.

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1. Government of Pakistan. The Second Five Year Plan (1960-65), p. 331

2. Worked out from population figures of Planning Commission as given in Table 1, Gross National Product, in Pakistan Economic Survey, 1966-67, Government of Pakistan.

3. "... a rate of population growth of 3 per cent for West Pakistan and somewhat over 3 per cent for East Pakistan must from now on be reckoned with as a clear possibility". K.J. Krotki and Nazir Ahmad. "Vital Rates in East and West Pakistan - Tentative Results from the PGE Experiment", The Pakistan Development Review, Vol. IV, Winter 1964, p. 756.

About eighty-five per cent of the total population lives in the rural areas. It is estimated that urban population has been increasing since 1960 at an annual compound rate of 5.5 per cent or more than double the rate of growth of total population. The ratio of urban population to total population is estimated to have increased from 12.8 per cent in 1960 to 14.7 per cent in 1965 and is expected to increase to 17 per cent in 1970.[1] The rapid urbanisation has not been matched by an equally rapid increase in housing and other urban services and consequently there has been a growth of slums.

Unemployment and Employment Policy.

There is a good deal of unemployment in the rural as well as urban areas The unemployment is estimated at about 20 per cent of the total available labour force. In fact, the position is more serious in rural areas where the entire labour force remains idle particularly between the harvesting and sowing seasons. The unemployment increased steadily during the fifties Its rising trend seems to have been checked in recent years as is evident from the table below.[2]

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1. Government of Pakistan. The Third Five-Year Plan, p 366.

2. For labour force and employment see also Third Five-Year Plan, Government of Pakistan, p.151.

TABLE 1-1. Total Labour Force and Its Distribution (numbers in millions)

Fiscal Year	(1) Total Labour Force	(2) Agri-cult-ure	(3) (2) as perce-ntage of (1)	(4) Indu-stry.	(5) (4) as perce-ntage of (1)	(6) Serv-ices	(7) (6) as perce-ntage of (1)	(8)= (2) + (4) + (6) Total Emp-loyed	(9)= (8) - (1) Total Unem-ployed	(10) (9) as percentage of (1)
1950	24 0	13.8	58	1.3	5	5.2	22	20.3	3.7	15
1955	26.5	14.2	54	1.7	6	5.8	22	21.7	4.8	18
1960	29.2	14.6	50	2.1	7	6.2	21	22.9	6.3	22
1965	32.5	16.0	49	2.6	8	6.9	21	25.5	7.0	22

Source Mahboob-ul-Huq. The Strategy of Economic Planning A Case Study of Pakistan, Oxford University Press, 1963.

The Government, although aware of the gravity of the unemployment problem, had no specific employment policy or targets until 1961. The government was more concerned about a specific increase in national income than in employment. It did not think it advisable to digress from the usual capital-intensive production techniques. Its development policy was oriented to achieve the maximum increase in production and to improve the balance of payments position. "Thus the employment effects of the economic growth generated through the successive Plans were more a by-product than a target. The same applies, to a degree, to the Third Plan. In all these cases employment effects were assessed after the Plan was made".[1] The Government, however, could not ignore this problem altogether indefinitely. The realisation grew that the investment effort in the Second Plan would not be able to create sufficient employment opportunities to absorb the increase in the labour force, not to speak of absorbing the existing unemployed labour force. It was further realised that the existing backlog of unemployment could not be reduced even with a shift to more labour-intensive techniques. So, in 1961, the Government introduced a Rural Works Programme, outside the Plan framework, to provide job opportunities

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1. Planning Commission, Government of Pakistan, The Third Five-Year Plan (1965-70), page 149.

nearer home to the under-employed labour force in rural areas, and at the same time infra-structure to the agricultural sector by labour-intensive methods. It will also have the side effect of reducing the flow of surplus rural population to the urban centres - where not many of them could be gainfully employed - to a manageable magnitude. The government has also started an Urban Works Programme, which will concentrate on low cost housing, community centres, recreational facilities, etc., and thus provide jobs for the unemployed in urban areas.

The lack of a consistent employment policy on the part of the government of Pakistan, while 22 per cent of the population is unemployed, may seem surprising. It looks all the more surprising when one sees that the achievement of 'full employment' has been accepted as one of the most important objectives of government's policies in every advanced country. The main reason for this is the marked difference between the economic and social structure of Pakistan and the advanced countries. The concept of 'unemployment', as it is understood in the Western countries, is meaningless in the conditions of Pakistan The unemployment in advanced economies is generally the result of an inadequate effective demand and "since effective demand is deficient, the unemployment of labour goes together with unemployment of other complementary factors of production".[1] The unemployment or under-employment in Pakistan, on the other hand, is due to "an insufficiency of cooperant factors of production to set them (labour force) to work".[2] In rural areas, where about 90 per cent of the population lives, the unemployment manifests itself in the form of over-crowding of land. This is the result of the paucity of land relative to the manpower employed in agriculture. In urban areas, the under-employment is evident from the large numbers engaged in petty trades and services. This is due to lack of opportunities for productive employment. As Reddaway points out, in an under-developed country like Pakistan there is "an appalling problem of inadequate openings for productive work, but the problem is in 'the productivity dimension' rather than the 'number' dimension .. The important magnitude seems to be the income or the output, rather than the number employed".[3]

Income Levels.

Pakistan is one of the poorest countries in the world with an average per capita income of about Rs. 372 per annum. The Gross National Product in real terms, i.e. at the constant factor

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1. Bauer,P.T. and Yamey, B.S. The Economics of Under-developed Countries, Cambridge University Press, 1963, p.75.
2. Bauer and Yamey, ibid. p.74.
3. Reddaway, W.B. The Development of the Indian Economy, George Allen and Unwin, 1963, pp. 24-25.

cost of 1959-60, increased at a modest annual rate of 2.5 per cent during the decade ending 1959-60. Since population increased at the same time by an estimated 2.3 per cent per annum, the increase in per capita real product was insignificant. The economy made impressive progress in the subsequent six years. The Gross National Product increased at an annual compound rate of 5.5 per cent during 1960-65. This was more than double the rate of growth of population at 2.6 per cent. As a result, the per capita real product increased at an annual rate of 2.5 per cent. This increasing trend slowed down during 1965-66.

The data in Table 1-2 regarding distribution of income reveals that the average rural income is less than one-sixth of the average urban income. The per capita rural income in 1965-66 was below the level prevailing in 1949-50, in spite of the fact that the gross national product per capita increased by 20 per cent over this period. This shows that the growth of the living standard of the rural masses, compared to that of the urban population, has been more effectively restrained. The Third Plan has acknowledged that "there was a considerable transfer of savings from the agricultural to the industrial sector".[1] According to one estimate, "agriculture annually transfers about Rs. 3,600 million of resources to the urban

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1. Planning Commission, Government of Pakistan, The Third Five-Year Plan, page 7

TABLE 1-2. Gross National Product and Per Capita Income, 1949/50 - 1965/66.
(1959-60 Prices)

Year	G.N.P. at Factor Cost: Rs. in million.	G.N.P. at Factor Cost: Index 1949-50 =	Value Added in: Agriculture	Value Added in: All other Sectors	Value Added in: Total	Population (In millions): Rural	Population (In millions): Urban	Total Population	Per Capita Income: Rural Population: Rs.	Per Capita Income: Rural Population: 3-year moving average	Per Capita Income: Urban Population: Rs.	Per Capita Income: Urban Population: 3-year moving average
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
1949-50	24,466	100	14,669	9,797	78.8	71.0	7.8	311	207		1,256	
1950-51	25,373	104	15,112	10,261	80.6	72.4	8.2	315	209	204	1,251	1,256
1951-52	25,395	104	14,549	10,846	82.4	73.8	8.6	308	197	201	1,261	1,248
1952-53	26,139	107	14,917	11,222	84.3	75.2	9.1	310	198	202	1,233	1,234
1953-54	27,776	114	16,053	11,723	86.3	76.6	9.7	322	210	203	1,208	1,210
1954-55	27,908	114	15,654	12,254	88.3	78.0	10.3	316	201	200	1,190	1,199
1955-56	27,834	114	15,135	12,699	90.3	79.7	10.6	308	190	197	1,198	1,193
1956-57	29,497	121	16,266	13,231	92.4	81.3	11.1	319	200	195	1,192	1,192
1957-58	29,719	121	16,089	13,630	94.5	83.0	11.5	315	194	194	1,185	1,184
1958-59	30,144	123	15,923	14,221	96.7	84.6	12.1	312	188	192	1,175	1,175
1959-60	31,439	129	16,753	14,686	98.9	86.3	12.6	318	194	193	1,165	1,176
1960-61	33,086	135	17,285	15,801	101.5	88.2	13.3	326	196	197	1,188	1,186
1961-62	35,043	143	18,183	16,860	104.1	90.1	14.0	337	202	199	1,204	1,203
1962-63	36,284	148	18,272	18,012	106.8	92.0	14.8	340	199	202	1,217	1,232
1963-64	39,284	161	19,411	19,873	109.6	94.0	15.6	359	206	204	1,274	1,261
1964-65	41,058	168	19,761	21,297	112.4	95.9	16.5	365	206	203	1,291	1,291
1965-66	42,968	176	20,075	22,893	115.4	102.5	17.5	372	196		1,308	

Sources: (1) For Columns (2),(4),(5) and (6): Ministry of Finance, Govt. of Pakistan, Pakistan Economic Survey, 1966-67, Karachi, Statistical Section, pp.2-3.

(2) For Column (7): Keith B. Griffin, 'Financing Development Plans in Pakistan' in The Pakistan Development Review, Volume V, No.4, Winter 1965, p.628.

(3) Columns (3),(8) to (13) calculated.

sector This represents over 15 per cent of the value of its gross output at least 63 to 85 per cent of the savings transferred from agriculture are dissipated in higher consumption in urban areas"[1] This transfer of resources from agricultural to urban sector was achieved by deliberate government policies such as compulsory government procurement of foodgrains at low prices to subsidise the cost of living of the urban population, export taxes on jute and cotton, and incentives to industrial sector like tariff protection, tax concessions, and the provision of foreign exchange earned by the agricultural sector at cheaper rates to the industrial sector. The disparity in the lowest and highest income groups in the urban areas is all the more great. There is evidence that people in the bottom 50 per cent of the income scale in Karachi - the largest urban centre in Pakistan - have a lower standard of living than those in the bottom half of rural income scale.[2]

Structure of Economy

1. Agricultural Sector.

The low level of income is the result of the structure of the economy and in turn is responsible for perpetuating that

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1. Keith B Griffin, op.cit pp 612-613

2 Planning Commission, Government of Pakistan, The Third Five-Year Plan, p.29.

TABLE 1-3.

Structural Change in the Gross National Product at Constant Factor Cost.

(1959-60 prices)

(Rs. in million)

SECTOR	1949 - 50		1954 - 55		1959 - 60		1964 - 65		1965 - 66		Average Annual Rate of Growth (%)			
	Absolute	Percentage of Total	Absolute	Percentage of Total	Absolute	Percentage of Total	Absolute	Percentage of Total	Absolute	Percentage of Total	1949-51 to 1954-55.	1954-55 to 1959-60.	1959-60 to 1964-65.	1965-66 over 1964-65.
1) Agriculture	14,669	60.0	15,654	56.1	16,753	53.3	19,761	48.1	20,075	46.7	1.3	1.4	3.6	1.6
2) Manufacturing	1,433	5.8	2,220	8.0	2,930	9.3	4,711	11.5	4,949	11.5	11.0	6.4	12.2	5.1
a) Large-Scale	346	1.4	1,002	3.6	1,565	5.0	3,156	7.7	3,354	7.8	38.0	11.0	20.3	6.3
b) Small-Scale	1,087	4.4	1,218	4.4	1,365	4.3	1,555	3.8	1,595	3.7	2.4	2.4	2.8	2.6
3) Construction	238	1.0	4.5	1.5	651	2.1	1,921	4.7	1,825	4.3	14.9	11.4	39.0	-5.0
4) Transport, Storage and Communications	1,239	5.1	1,588	5.7	1,857	5.9	2,424	5.9	2,761	6.4	5.6	3.4	6.1	13.9
5) Public Administration and Defence	1,063	4.3	1,243	4.4	1,331	4.2	1,790	4.4	2,429	5.7	3.4	1.4	6.9	35.7
6) All others	5,824	23.8	6,788	24.3	7,917	25.2	10,451	25.4	10,929	25.4	3.3	3.3	6.4	4.6
7) Total	24,466	100	27,908	100	31,439	100	41,058	100	42,968	100	2.8	2.5	6.1	4.7

Source: Government of Pakistan - Economic Survey, 1966-67.

structure The largest sector of the economy is agriculture, which is carried on on a subsistence basis. By 'subsistence basis' we mean that the bulk of the foodgrain production, which accounts for more than 80 percent of the total cultivated area, is consumed by the producers According to one study, the marketed surplus of foodgrains is about 10 per cent in East Pakistan and 17 per cent in West Pakistan [1]

The productivity of labour employed in agriculture and the yield per acre are among the lowest in the world due to primitive production methods, insects and plant diseases, and lack of fertilizers, good seed and finance. The growth of agricultural sector at a nominal rate of 1 3 per cent per annum until 1959-60, was disappointing The population increased at almost twice this rate over this period. As a result, the country was faced with growing food deficit,[2] there was an increase in the subsistence sector as most of the labour and resources were devoted by the farmers to maintain their own consumption,[3] and the imports of capital goods suffered to the extent of a fall in foreign exchange earnings and the expenditure of foreign exchange on the import of foodgrains. The shortfall of 30 per cent in the implementation of the First Five-Year Plan (1955-60),

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1 Mohd Raquibuzzaman, 'Marketed Surplus Function of Major Agricultural Commodities in Pakistan', The Pakistan Development Review, Vol. VI, No.3, Autumn 1966, Karachi, p.380.

2. The import of foodgrains increased from Rs 11 million in 1951-52 to Rs 462 million in 1960-61 See Parvez Hasan, 'Balance of Payments Problems of Pakistan', The Pakistan Development Review, Autumn 1961, p.48

3 The area under wheat and rice increased from an average of 32,855 thousand acres during 1950-53 to 35,064 thousand acres during 1957-60. There was a corresponding decline in areas under jute and cotton

in terms of 1955-56 prices, is attributed to the slow growth of the agricultural sector in general and to the lack of foreign exchange resources in particular.[1] Finally, the decline in agricultural incomes depressed the demand for manufactured goods and thus affected adversely the growth of the industrial sector.

The production in the agricultural sector increased at an annual rate of 3.6 per cent during 1960-65. This higher rate of growth is significant both because of the size of the agriculture sector in the economy and because of the dependence of crucial targets of exports, savings and prices on agricultural development.[2] The increase in agricultural production is attributable to favourable weather, improved incentives provided to farmers by the removal of foodgrain price controls, decrease in export duties etc ,[3] and the change in the terms of trade between agricultural and industrial sectors in favour of agriculture.[4]

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1. Mahboob-ul-Huq, The Strategy of Economic Planning A Case Study of Pakistan, Oxford University Press, 1963, pp.141-2.

2 Planning Commission, Government of Pakistan, Final Evaluation of the Second Five-Year Plan, 1966, page 43

3 Falcon, W.P. and C.H. Gotsch, Agricultural Development in Pakistan Lessons from the Second Plan Period. Multilith (Cambridge Centre for International Affairs, Harvard University), June 1966.

4. Lewis, S.R. and S.M. Hussain, 'Relative Price Changes and Industrialisation in Pakistan 1951-1964', The Pakistan Development Review, Autumn 1966, p.424

2 Industrial Sector

The industrial sector was a small segment of the economy in the early years. It grew rapidly under the fostering care of the government. The contribution of large-scale industrial production to gross national product increased from 1.4 per cent in 1949-50 to 7 8 per cent in 1965-66, while that of small-scale industries declined from 4 4 to 3 7 per cent over this period The large-scale industrial production increased rapidly up to 1956. It suffered a setback during 1957 and 1958, as due to the shortage of foreign exchange, the supply of industrial raw materials was severely curtailed The foreign exchange position eased in 1959 and 1960 and with the increase in the supply of raw materials the growth rate in the industrial sector picked up. Thus, on the whole, the large-scale industrial production increased by about 55 per cent during 1955-60. The growth rate of industrial sector accelerated to 20.3 per cent per annum in the subsequent five years. The following factors contributed to it (a) The availability of foreign exchange remained adequate throughout this period. This was due to substantial expansion in exports as well as increase in foreign aid and loans This allowed the import of capital equipment for new industrial units and the import of industrial raw materials for the fuller utilization of installed capacity (b) The commercial and foreign exchange policies were designed to allocate an increasing share of foreign exchange resources

to the import of capital goods and industrial raw materials.
(c) The fiscal policy was oriented to provide every incentive to the growth of the industrial sector by providing tax holidays, etc.
(d) The strengthening of institutional credit facilities through the Industrial Development Bank, the Pakistan Industrial Credit and Investment Corporation, and National Investment Trust also made an important contribution to the growth of the industrial sector. On the demand side, (e) the home market was reserved for domestic industries by protective tariffs. (f) The home market for manufactured goods expanded due to increase in income and purchasing power of the rural masses as a result of increase in agricultural production
(g) The introduction of Export Bonus Scheme encouraged the export of their products.

The Industrial sector, no doubt, has made significant progress over the last sixteen years. However, the industrial policy has come under serious criticism over the last few years on the following counts. (1) The emphasis on import-substitution in consumer goods industries has led to "domestic pressure for higher consumption levels which emerge when the capacity of consumer goods industries is expanded".[1] In order to restrict this "unplanned increase" in

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1 Planning Commission, Government of Pakistan, The Third Five-Year Plan, p.34. Also see (i) Khan, A.R., "Import Substitution, Export Promotion and Consumption Liberalisation A Preliminary Report", Pakistan Development Review, Summer 1963, pp.208-231, and (ii) Power, J.H , "Industrialisation in Pakistan· A Case of Frustrated Take-Off", Pakistan Development Review, Summer 1963, pp.191-207.

consumption, the Third Plan advocates more emphasis on the import-substitution of intermediate and capital goods.[1] (2) The industrialisation has not helped in removing the following three disequilibria in the economy. Firstly, it has not helped in closing the gap between average productivity in agriculture and industry by absorbing the surplus labour from the agricultural sector Secondly, in spite of large-scale transfer of resources from agricultural sector to the industrial sector and the rapid progress of the latter, the rate of savings remained well below the rate of population growth. The low rate of saving made it difficult to transfer labour from low-productive employment in agriculture to more productive employment in the industrial sector.[2] Thirdly, the disequilibrium between exports and imports has increased In the process of industrialisation, the import requirements have increased more than the exports.

Foreign Trade

Foreign trade plays a vital role in the economy of Pakistan. Its importance does not lie in the fact that a large proportion of country's product is exported or imports form a bulk of

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1 This suggestion came earlier from Soligo, R and J J Stren, "Tariff Protection, Import Substitution, and Investment Efficiency", Pakistan Development Review, Summer, 1965, pp

2 Power, J H , op cit

total consumption It is important in this sense that the development effort is constrained by the availability of foreign exchange This is because at its present stage of economic development, Pakistan has to import almost all the required capital goods and industrial raw materials. The stepping up of investment effort means an increase in the requirement of imported capital goods. Thus both export and import policies have all along been oriented to allow the import of an increasing amount of development goods.

Exports

The main objective of the export policy in Pakistan has been to increase the volume and value of exports in absolute amount and in relation to total output This is because increased exports mean increased savings, which can be translated into increased productive investment by importing more capital goods The second objective of the export policy has been to reduce the dependence on traditional imports, viz. jute and cotton, by encouraging the production and export of manufactured goods.

The reasons to transform the composition of exports are (i) to increase the stability of earnings, (ii) to shift from the sale of commodities for which the world has low income elasticity of demand to those with high elasticity, and (iii) to raise the growth rate of earnings.

TABLE 1-4. Average and Marginal Ratios of Exports and Imports to G.N.P. (at current factor cost)

(In million Rs.; current prices)

	1949-50	1954-55	1959-60	1964-65	1965-66	Pre-Plan Period (July 1949 - June 1955)	First Plan (July 1955 -June 1960) (Annual Average)	Second Plan (July 1960 -June 1965)
Imports of Goods (M)	1,853	1,575	2,461	5,374	4,208	2,085	1,950	3,984
Export of Goods (E)	1,706	1,747	1,843	2,408	2,718	2,328	1,596	2,119
G.N.P. at Current Factor Cost	19,893	21,147	31,439	45,535	49,685	21,320	27,423	39,346
M/G.N.P.	9.3	7.4	7.8	11.8	8.5	9.8	7.1	10.1
E/G.N.P.	8.6	8.3	5.9	5.3	5.5	10.9	5.8	5.4
M/ G.N.P.		-22.2	8.6	20.7	-28.1		-2.2	17.1
E/ G.N.P.		3.3	0.9	4.0	7.5		-12.0	4.4
E/M	92.1	110.9	74.9	44.8	64.6	111.7	81.8	53.2

Source: Govt.of Pakistan - Economic Survey, 1966-67.

1) The figures of imports and imports up to June 1955 have been adjusted for devaluation of the Pakistan rupee in 1955 to make the figures comparable to the subsequent years.

The range of manufactured goods, which Pakistan can hope to produce for export, is necessarily limited to 'light manufactured goods' of simple kinds. Here again a spectacular rise in exports does not seem to be feasible. Most of these products have a market at home The increase in exports would depend on appropriate policy instruments, viz. fiscal, monetary and commercial policies to create a structure of incentives that would (a) encourage savings and discourage consumption, and (b) encourage production for export rather than for domestic market Secondly, the expansion of exports to advanced countries has to surmount the measure of protection they offer to their own manufacturers. Thirdly, the long-run prospects of exports to under-developed countries are also not very bright as each country would like to develop the production of these light manufactures itself.

The exports of Pakistan showed considerable variations in the early years which are attributable mostly to the changes in world demand The exports more than doubled during 1950-51 due to the Korean war boom in the world commodity markets The export proceeds declined continuously in the following four years. In 1954-55, they stood at Rs 1223 million.[1] At this level, they were 48 per cent of the export earnings in 1950-51 and only 2.4 per cent higher than in 1949-50.

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1. These figures differ from those given in the table 1-4 below because the figures in the table are adjusted for the devaluation of rupee in 1955.

The decline in the foreign exchange earnings was attributable largely to the fall in the prices of exports. The index of unit value of exports (April 1948 - March 1949 = 100) fell from 119.5 in 1951 to 72.8 in 1955.[1] The volume of raw cotton exports also declined over this period due to increase in consumption at home following the expansion of domestic textile industry.

The Pakistan rupee was devalued by 30 per cent in July 1955. As a result, exports increased by about 46 per cent in 1955-56,[2] but then once more declined in the subsequent three years to touch the low level of Rs. 1325 million in 1958-59. As a percentage of money national income, export receipts dropped from 7.9 per cent in 1955-56 to 4.7 per cent in 1958-59. At the same time, the ratio of exports to imports declined from 134.6 per cent to 84.0 per cent. The following factors contributed to decline in exports Firstly, the output of agriculture increased very little whilst the expansion of cotton and jute textile industries was encroaching upon the exportable surplus of these fibres Secondly, although the two major industries, jute and cotton textiles, had developed large export potential, a buoyant home market and overvaluation of the rupee until 1959 prevented their export potential from being realized

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1. The State Bank of Pakistan. The Report on Currency and Finance, 1959-60, pp 187-188.

2 This improvement seems to be illusory if we look at the export receipts in terms of foreign currency earned during the year. The export earnings in terms of pound sterling increase only by £2 million from £132 million in 1954-55 to £134 million in 1955-56 (See Government of Pakistan, The First Five-Year Plan (1955-60), Government of Pakistan Press, Karachi, 1956, page 171).

Export earnings increased substantially during the Second Plan period (1960-65). Annual average exports during this period were about 33 per cent higher than in the First Plan period. The ratio of exports to G.N.P. at the margin also showed substantial improvement from 0.9 per cent over 1954/55 to 1959/60 to 4.0 per cent over 1959/60 to 1964/65 The acceleration in exports was largely due to, first, a marked increase in the agricultural production, which led to sharp rise in earnings from the export of rice and cotton. Secondly, the Export Bonus Scheme strengthened the incentive to export manufactured goods Table 1-5 shows that the share of manufactured goods in total exports increased from 13 per cent in 1957 to 28.6 per cent in 1959-60 and stood at 43.0 per cent in 1965-66 Thirdly, it is claimed in government reports that "fiscal policy has also helped in curbing consumption and diverting a larger proportion of increased production to the export market.[1] But if this were so it would be difficult to explain the decline in the ratio of exports to Gross National Product regardless of whether one compares 1959/60 with 1964/65 or the First Plan with the Second Plan. Secondly, the ratio of exports to imports also declined from 74.9 per cent in 1959/60 to 44 8 per cent in 1964-65 and from 81.8 per cent in the First Plan to 53.2 per cent in the Second Plan period.

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1 Planning Commission, Government of Pakistan, Final Evaluation of The Second Five-Year Plan, 1966, p.22.

TABLE 1-5 Exports by Commodity Groups

(Rs in million)

Year	Total	Food		Raw Materials		Manufactures	
		Value	Percentage Share	Value	Percentage Share	Value	Percentage Share
1951	2,525	2 2	8 0	2,309	91 4	14	0 6
1953	1,406	58	4 1	1,332	94.7	16	1.1
1955	1,496	136	9.1	1,265	84.6	95	6.3
1957	1,604	56	3.5	1,340	83.5	208	13.0
1959-60	1,843	166	9.0	1,149	62.3	528	28.6
1960-61	1,799	130	7.2	1,165	64.7	505	28.0
1961-62	1,843	209	11.3	1,165	63.2	470	25.5
1962-63	2,247	337	15.0	1,386	61.7	525	23.4
1963-64	2,299	257	11.2	1,311	57.0	732	31.8
1964-65	2,408	268	11.1	1,359	56.4	781	32.4
1965-66	2,718	200	7.8	1,338	49.2	1,180	43.0

Source Govt.of Pakistan, Economic Surveys, Statistical Section.

Imports

Imports are restricted by exchange control, import-licensing and tariffs. Exchange control is administered by the Foreign Exchange Committee which allocates the available foreign exchange between the public and private sectors. Import-licensing authority allocates foreign exchange earmarked for the private sector among various uses and users Tariffs are levied on both imports and exports. The exchange rate system does not aim at establishing equilibrium in the balance of payments. Rather the balance of payments is protected by quantitative restrictions on imports The restrictions on total imports and their composition are determined every year to adjust imports to total availability of foreign exchange resources, including foreign aid The first priority is given to government imports and the remaining foreign exchange is allocated to the private sector. The second objective of import policy throughout this period has been to curtail the import of inessential goods and increase the share of development goods The limited foreign exchange resources are rationed with a preference for the uses deemed most important for essential consumption and investment.

At the prevailing rate of exchange the demand for imports is far in excess of foreign exchange earnings The excess demand for imports is clearly revealed in a recent study which showed that the domestic prices of imported goods are, on average, about 60 per cent higher than their landed cost, i.e. the c i.f. cost plus import duty and sales tax [1] Another index of this excess demand is the existence of a large premium on import-bonus vouchers On average, the market premium on import-bonus vouchers has been around 150 per cent.[2] The gap between earnings and payments has increased mainly because industrial development has depended heavily on capital imports, but also because of the high, albeit suppressed, income elasticity of demand for imports. The dependence on capital imports is likely to increase further due to the change in the industrial strategy from consumption good industries to more capital-intensive capital good industries.[3]

Imports increased by 56 per cent from Rs. 1575 million in 1954-55 to Rs. 2461 million in 1959-60. The ratio of imports to the Gross National Product, however, increased only from 7.4 per cent to 7.8 per cent. Imports more than doubled over the next five years and the ratio of imports to the Gross National Product increased to 11.8 per cent during 1964/65. The marginal import ratio over this period was as high as 20 7 per cent. The same trend emerges if we look at the average figures during the First and the Second Plan periods.

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1 Pal, Mati Lal "The Determinants of the Domestic Prices of Imports" The Pakistan Development Review, Vol IV, No.4, Winter 1964

2. Economic Advice, Government of Pakistan, "Economic Survey, 1966-67" Table 41, page 84.

3. Planning Commission, Government of Pakistan, "The Third Five-Year Plan 1965-70" page

The composition of imports has undergone a significant change over the period under study. This is evident from Table 1-6 below. The ratio of consumer goods to total imports declined from 44 per cent in 1951-52 to 21 per cent in 1965-66. The bundle of consumer goods imports itself has changed over time. The import of food and food products, which on average represented 45 per cent of total consumer goods imports during 1951-55 increased to 63 per cent over the Second Plan period. At the same time the import of cotton textiles declined from 28 3 per cent to 1.4 per cent The share of raw materials for consumer goods to total imports also came down from an average of 19 per cent during 1951/55 to 15 per cent during the First Plan period and remained at that level during the Second Plan period On the other hand, the annual average imports of capital goods during the Second Plan at Rs. 1872 million were five times higher than in 1951/55 Thus the ratio of capital goods to total imports increased from 27 per cent during 1951/55 to 47 per cent over 1960/65. The annual average ratio of raw materials for capital goods to total imports increased from 12 per cent in the pre-Plan period to 14 per cent over the ensuing decade.

The quantum of imports has been subject to wide fluctuations. This is due to changes in the availability of foreign exchange, which depends on the export proceeds and loans and advances. It is evident from Table No.7 below that the fluctuations in imports

TABLE 1-6. Growth and Composition of Imports. (Rs. in million)

Year	Total Imports		Consumer Goods		Materials for Consumer Goods		Capital Goods		Materials for Capital Goods	
	Amount	Percent of total Imports	Amount	Percent of total Imports	Amount	Percent of total Imports	Amount	Percent of Total Imports	Amount	Percent of Total Imports
1951-52	2097.9	100	926.3	44	514.6	24	474.5	23	182.5	9
1952-53	1292.5	100	661.9	51	184.1	14	297.0	23	149.6	12
1953-54	1082.9	100	425.1	39	196.3	18	308.7	29	152.7	14
1954-55	1043.7	100	309.9	30	163.3	16	419.5	40	151.1	14
1955-56	1220.3	100	398.2	33	212.1	17	446.6	37	163.4	13
1956-57	2169.8	100	875.8	40	347.6	16	704.5	33	241.9	11
1957-58	1990.8	100	831.3	42	243.5	12	659.1	33	256.9	13
1958-59	1523.1	100	520.6	34	198.4	13	540.4	36	263.7	17
1959-60	2392.4	100	736.6	31	408.1	17	904.0	38	343.7	14
1960-61	3151.2	100	935.5	30	453.4	14	1,206.5	38	555.9	18
1961-62	3062.6	100	682.4	23	476.4	15	1,459.4	48	444.4	14
1962-63	3810.2	100	804.5	21	644.7	17	1,941.1	51	419.9	11
1963-64	4429.4	100	980.8	22	621.2	14	2,150.4	49	676.1	15
1964-65	5368.9	100	1367.8	26	796.4	15	2,600.5	48	602.7	11
1965-66*	4508.0	100	938.0	21	667.0	15	2,319.0	51	584.0	13

Source: i) Nurul Islam, "Imports of Pakistan: Growth and Structure. A Statistical Study", P.I.D.E., Karachi, September 1967.

ii) For 1965-66 Planning Commission, Govt. of Pakistan. Evauation of the First Year (1965/66) of "The Third Five-Year Plan" (1965-70), May 1967, page 151.

were highest during the First Plan period. This is because in the preceding pre-Plan period the shortfalls in the export earnings were met by drawing on the foreign exchange reserves. In the Second Plan period, the fluctuations were toned down due to generous supply of foreign aid and loans. The fluctuations in the four broad categories of imports show a pattern which is in line with the government's policy objectives. These are to give priority to capital goods and to industrial raw materials needed to prevent the underutilisation of installed capacity When cuts have had to be made, it is the consumer goods which have borne the brunt.

TABLE 1-7. Average Annual Percentage Fluctuations in Imports of Pakistan.

Year	Total Imports	Consumer Goods	Materials for Consumer Goods	Materials for Capital Goods	Capital Goods
1951-55	19.4	30.5	29.2	7.1	25.7
1955-60	36.7	46.9	49.6	19.1	31.2
1960-65	19.3	26.7	16.7	31.8	23.8
1961-65	26.0	35.3	32.2	21.2	27.1
1965-66	16.0	31.4	16.2	10 8	3.1

Source Calculated from Table 1-6.

Chapter 2.

THE STATE BANK OF PAKISTAN.

The object of this chapter is to describe in successive sections, first, the factors leading to the establishment of the State Bank of Pakistan, then its organisation and functions and, finally, its objectives and relationship with the government.

I

Pakistan did not set up its own central bank until the end of June, 1948. Under the partition arrangements it was decided that in the interests of smooth transition the Reserve Bank of India would remain common central bank both for India and Pakistan until September 1948 [1] The Government of Pakistan, however, was expected to take over the management of public debt and exchange control earlier. The agreement laid down the basis for the division of Assets and Liabilities of the Reserve Bank of India at the time of establishment of its own central bank by Pakistan

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1. Pakistan (Monetary System and Reserve Bank) Order, 1947, issued on 14th August, 1947, by the Governor-General of undivided India

This arrangement of joint central monetary authority, however, fell short of Pakistan's requirements Firstly, the government business suffered owing to the closure of a large number of offices of the Imperial Bank of India, which was acting as agent of the Reserve Bank of India for government treasury work. Secondly, the Reserve Bank of India was unwilling to accommodate the Government of Pakistan with advances or ad-hoc securities in a period of unusual financial difficulty following the temporary withholding by the Government of India of part of the cash balances to which Pakistan became entitled at the time of Partition.[1] Thirdly, the political relations of the two governments became seriously strained and it was felt that the infant state of Pakistan was exposed to grave danger if it did not achieve financial autonomy immediately So the Government of Pakistan felt compelled to seek premature termination of joint monetary arrangements and to establish their own central bank in advance of the stipulated date. After negotiations in March 1948, the governments of India and Pakistan mutually agreed that Pakistan should arrange to assume all central banking responsibilities in her territory with effect from 1st July, 1948.[2]

There were many difficulties in the way of establishing a central bank - the most serious being the acute shortage of trained

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1 Zahid Husain, 'Central Banking in Pakistan', Federal Economic Review, October, 1954, p 7

2 Pakistan Monetary System and Reserve Bank (Amendment) Order, 1948

banking personnel The staff of the Reserve Bank of India had been given the option to elect for service in either country, but only eight officers and thirteen superintendants, of which seven were probationary assistants, opted for Pakistan.[1] The shortage on the cash department side was especially acute in all grades. In spite of all these difficulties the government was determined to establish a central bank. The facts that inter alia influenced this decision were that the banking system had practically collapsed at the time of partition and required revival Secondly, most of the banks in the country were of foreign origin and it was necessary to watch and when necessary to control their operations in the interest of the state. This was not possible without a central bank.

There were only three months left to organise a central bank. It was not a sufficient time for detailed expert investigation in this matter. Thus it was considered expedient to model the proposed institution on the Reserve Bank of India Draft legislation was issued in the form of the State Bank of Pakistan Order, 1948, on 12th May, 1948 The functions, duties and powers of the State Bank were to be broadly similar to those of the Reserve Bank of India As the Reserve Bank of India itself was patterned on the Bank of England, the State Bank was also indirectly modelled on it. Thus the constitutional provisions incorporated in the State Bank of Pakistan

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1. The State Bank of Pakistan, Annual Report 1948-49, p.4.

Order gave to the State Bank the shape of an orthodox central bank. The only major difference in the constitutional provisions governing the Reserve Bank of India and the State Bank of Pakistan lay in their relationships with the Government. The Reserve Bank of India was at that time a shareholders' bank,[1] but it was decided to have 51 per cent government participation in the share capital of the State Bank of Pakistan This was in line with the modern thinking on the subject and with central banking practice in the post-war period, which witnessed the nationalisation of a number of central banks and the establishment of several others with majority participation by the government [2]

The State Bank of Pakistan came into existence on 1st July, 1948. Immediately after its establishment, it became necessary

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1. The establishment of the Reserve Bank of India as a shareholders' bank represented a victory for the exponents of shareholder principle in the long drawn controversy of shareholder versus state-controlled bank. But several features were introduced toning down the aspect of private ownership to make it acceptable to those who wanted a State Bank. A token contribution by the Government of India towards the share capital of the Bank, government right to fix the rate of dividend, accrual of surplus profits to the government, the right to nominate a certain number of Directors and the appointment of Governor and Deputy Governors by the Government of India in the light of recommendations made in that behalf by the Central Board of Directors were some of these features Despite these saving clauses it is, however, obvious that, in essence, the exponents of the shareholder principle got what they wanted, namely that the Bank should not be responsible for its actions to the popular Legislatures who would otherwise be free to mould its policy K.N.Raj, The Monetary Policy of the Reserve Bank of India, Bombay, 1948, pp.66-67

2 Theodore Gregory, The Present Position of Central Banks, The Stamp Memorial Lecture, October 1965, The Athlene Press, page 7

to enforce the division of assets and liabilities of the Reserve Bank of India The State Bank received stirling assets worth about Rs 1,000 million from the assets of the Banking Department of the Reserve Bank, which were equivalent to the outstanding amount of deposits of the government and banks in Pakistan. Their release for overseas expenditure, however, was a matter for separate negotiation with the British government. Under the agreement Pakistan was entitled to the assets of the Issue Department of the Reserve Bank of India equivalent in value to Pakistan inscribed notes issued by it until June, 1948, and the amount of India notes of Rs 2 and above encashed by the Government of Pakistan in her territories and delivered to the Reserve Bank of India up to 30th June, 1949 The various types of relevant assets in the Issue Department of the Reserve Bank were to be transferred to the State Bank of Pakistan in the same proportion as were held by the Reserve Bank on 30th June, 1948. The assets falling to the share of the State Bank of Pakistan were in turn to form part of the assets of its Issue Department.

The State Bank withdrew from circulation and transferred to the Reserve Bank of India notes of the value of Rs 1,250 2 million within the stipulated time, which added to Rs 515.7 million representing the amount of Pakistan inscribed notes in circulation on 30th June, 1948, brought the total claim of Pakistan on the assets of the Issue Department of the Reserve Bank of India to Rs 1,765.9

million. Out of these total assets to which the Government of Pakistan became entitled, the State Bank of Pakistan had received assets of the value of Rs. 1,276.7 million by 23rd March, 1949, when further transfer of assets was withheld by the Reserve Bank of India under the instructions of the Government of India. The reason advanced for the stoppage of further transfer of assets was that among the notes delivered to the Reserve Bank of India there were some that had been issued by the Reserve Bank after 30th June, 1948, against which Pakistan was not entitled to receive assets. The Government of Pakistan did not accept this contention on the ground that under the agreed arrangements there were no restrictions, on the movement of notes from one country to the other. Despite prolonged negotiations conducted time and again by the two countries, the dispute remains unsettled to this day.

The State Bank of Pakistan has a paid-up capital of Rs 30 million, of which at least 51 per cent is to be held by the central government and the rest by the general public. The central government may allow an increase in the capital of the Bank at the request of the Central Board of Directors to any amount, subject to the condition that not less than 51 per cent of the additional capital shall be issued to the central government. The private shareholders of the Bank are divided into three regional groups, viz Karachi, Dacca and Lahore, but there are no rules about the proportion to be held by each. The shareholders are entitled to dividends at rates determined every year by the central government subject to a minimum of 4 per cent After allowing for appropriation to the reserve fund and Rural Credit Fund, surplus profit of the Bank is paid to the government The Rural Credit Fund was established in 1961 to provide medium and long-term credit to the cooperative banks and the Agricultural Development Bank At the end of June, 1966, reserve fund amounted to Rs. 120 million and Rural Credit Fund to Rs. 50 million

The general superintendence and direction of the affairs and business of the Bank have been entrusted to the Central Board of Directors. The Central Board consists of the Governor, one or more Deputy Governors, six Directors nominated by the central government and three elected Directors - one from each of the three regional groups of shareholders mentioned above Of the six Directors nominated by the central government, one is government official and the rest are non-officials. Both Governor and Deputy Governors are appointed by the Government One of the Deputy Governors is stationed at Dacca in East Pakistan A certain degree of decentralisation of day-to-day administration seems necessary as the country consists of two widely separated wings The elected Directors hold office for a period of three years and are eligible for re-election Nominated Directors remain in office at the pleasure of the central government In each of the three specified regions, a Local Board is constituted comprising of two elected members and three members nominated by the central government. In nominating the members, the central government endeavours to secure representation of territorial or economic interests not already represented and in particular the representation of agricultural interests and the interests of co-operative Banks The function of the Local Boards is to advise the Central Board on such matters as may be referred to them.

II

A central bank, according to Macmillan Committee, "should possess four rights the right of note issue, the right to hold the reserves of the commercial banks, the right to buy and sell securities, and the right to discount".[1] The State Bank has been given all four rights It is entrusted with functions generally performed by the central banks, namely the note issue, the banker to the government, the administrator of foreign exchange and bankers' bank.

Note Issue

The State Bank has the sole right to issue notes in the country. For this purpose, the Bank has an Issue Department, which

1 Report of the Committee on Finance and Industry Cmd 3897, Her Majesty's Stationery Office, London, Reprint 1961, page 30.

is kept separate and wholly distinct from its Banking Department, and the assets of the Issue Department are not subject to any liability other than the liability of the Issue Department viz total notes issued [1] This distinction between the Issue and Banking Departments has been inherited from the Reserve Bank of India, which borrowed it from the Bank of England There the distinction was drawn in 1844[2] under the influence of the long defunct 'currency principle' which held that in 'a sound and well regulated state of things', the amount of paper money in circulation should never exceed the value of precious metals that would circulate if no paper had existed.[3] Since deposits were not regarded as money, their regulation was not considered necessary The Bank of England was considered to unite two operations that were quite distinct the issue of a paper currency as a substitute for a metallic one, and the making of loans to merchants and others The Issue and Banking Departments were created to correspond to these two activities. Now

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1 The State Bank of Pakistan Act, 1956, Section 32.

2. An interesting summary of theories which led to the separation of Departments of the Bank of England is given by J.K Horsefield, 'The Origins of the Bank Charter Act, 1844', Economica, November 1944 For detailed analysis see E V.Morgan, 'The Theory and Practice of Central Banking 1797-1913', Frank Cass and Co Ltd., London, 1965

3 Elmer Wood, 'English Theories of Central Banking Control 1819-1858', 1939, page 110.

it is recognised that there is no reason why a central bank should treat its obligations towards the holders of its notes differently from those towards its depositors or other creditors. Deposits are convertible into notes and vice versa. The separation of Departments in the case of the State Bank is, therefore, a borrowed tradition with no economic justification

The note issue in Pakistan until recently was based on the proportional reserve system. The entire liabilities of the Issue Department, representing the notes issued, had to be backed by an equivalent amount of assets, of which not less than 30 per cent were required to be maintained in the form of gold coin, gold and silver bullion and approved foreign exchange.[1] This includes the assets recoverable from the Reserve Bank of India under the Pakistan (Monetary System and Reserve Bank) Order 1947, as amended in 1948, amounting to about Rs 489 2 million The requirement pertaining to maintenance of 30 per cent of assets of its Issue Department in the form of gold coin, gold and silver bullion and approved foreign exchange, could, however, be suspended by the Bank in exceptional

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1. The currency of any country can be declared by the central government, on the recommendation of the Central Board of the Bank, to be 'approved foreign exchange', which if held as an asset of the Issue Department, must be in the following forms (a) Balances standing to the credit of the Bank with the central bank or any other bank of a country whose currency is in approved foreign exchange, (b) bills of exchange bearing two or more good signatures, drawn and payable at any place in a country whose currency is approved foreign exchange, and having a maturity not exceeding one hundred and eighty days, and (c) securities of such governments with an unexpired currency of not more than five years

circumstances with the prior sanction of the central government for periods not exceeding 30 days in the first instance which may with likewise sanction of the central government be extended from time to time by periods not exceeding fifteen days The remaining assets were to be held in the form of rupee coins, rupee securities of any maturity, and such bills of exchange and promissory notes as were eligible for purchase or discount by the Bank.

Let us now look into the rationale of the principle of reserve requirements. The main policy issue in relation to the note issue is how far the central bank should be given free discretion and to what extent its powers should be limited by reserve requirements. Originally, the principle of reserve requirements was meant to serve three distinct purposes First, it was intended to give the public confidence in a paper currency. Under the gold standard, the central bank was obviously in need of a gold reserve to maintain convertibility. But even after the breakdown of the gold standard and the suspension of convertibility of paper currency into gold, it was considered advisable for the central bank to be able to point to a gold backing of the currency. It is doubtful whether this notion has much merit even in the least developed monetary system It is now widely recognised that the confidence of the public in currency depends on the success of the central bank to maintain monetary stability and not merely on reserve backing [1]

The second objective of reserve requirements was to limit the access of the Government to central bank finance. The idea was strengthened by the post-war inflation in the twenties in Western Europe, which was thought to have been caused by deficit financing However, experience has shown that the statutory limits on the expansion of note issue are no safeguard, if a government really wants to resort to central bank finance.[2] After all, these statutory limits are self-imposed by the government and, if necessary, they can suspend or raise them.

Thirdly, under the gold or gold exchange standard, the currency reserve requirements linked the domestic supply of money to the balance of payments and thus provided a device for the automatic maintenance of external balance The principle still survives in the central banking laws of many countries - in its present form in the 100 per cent reserve system of the British colonial currency boards and in the modified form of proportional reserve requirements and fixed fiduciary system in many other countries. The link between the note issue and the balance of payments is gradually being severed for the following reasons Firstly, it

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1. By this we do not mean that the monetary policy alone is sufficient to achieve the objective of monetary stability.

2. Edward Nevin, Capital Funds in Underdeveloped Countries, Macmillan and Co. Ltd., London, 1963, p.40.

is now recognised that changes in domestic money supply generally are not the best way of maintaining balance of payments equilibrium. Secondly, as the deposit money came to form the bulk of total money supply, the significance of currency reserve requirements declined. Thirdly, it is being increasingly recognised that the primary role of foreign exchange reserves is to cushion the economy in times of temporary balance of payments difficulties. This supports the case against immobilising these reserves as backing of currency.

The experience of Pakistan corroborates the remark of Keynes about the proportional reserve system of note issue that this method possesses "no sound foundation in logic or common sense. In spite of its inclusion in the quite modern United States Federal Reserve System and in most of the Currency Reforms in Europe associated with the restoration of the gold standard, I have never seen in print a reasoned defence of its provisions. It appears to combine all the possible defects of systems of note regulation".[1] In Pakistan as the actual backing of the note issue by gold and approved foreign exchange was quite high in the initial years, the minimum requirement of 30 per cent failed to function as a check of any practical value on the imprudent financial policies of the government On the other hand, in recent years as the actual ratio

1. J M Keynes, A Treatise on Money, Vol. 2, Macmillan and Co., 1930, p 268.

approached the required minimum, it made it difficult for the Bank even to meet the genuine currency requirements of the economy. Moreover, the requirements of currency in circulation were increasing at a considerable rate due to increase in national income and monetisation of the subsistence sector. This is because the currency in circulation still looms large in the total money supply both as a medium of exchange and store of value. With the increase in the outstanding volume of currency in circulation, it was necessary to block a large amount of foreign exchange as 'backing'. This could not be made available for meeting the temporary deficit in the balance of payments for which it was actually needed. This was an unnecessary luxury at a time when the country was borrowing at a large-scale to meet the foreign exchange requirements of the development programme.

In the light of the above discussion, we shall now describe briefly the developments in the system of note regulation in Pakistan. We have noted above that, under the proportional reserve system, the State Bank was to maintain 30 per cent of its assets in the form of gold and foreign exchange and the remaining 70 per cent of assets were to be held in the form of government securities and domestic bills of exchange and promissory notes. The Order stipulated that only two kinds of internal bills could form part of the assets of the Issue Department. These were (i) the commercial and trade bills of exchange with a maturity of not more than 90 days, and

(ii) bills issued for the purpose of financing seasonal agricultural operations or the marketing of crops and having maturity of not exceeding nine months

The State Bank of Pakistan Act, 1956, increased the list of assets which the Bank can keep against its note issue. Firstly, the period of maturity in respect of bills pertaining to the finance of seasonal agricultural operations and marketing of crops was increased from 9 to 15 months Secondly, bills of exchange having maturities not exceeding five years and issued for financing the development of agriculture and industry were allowed to form part of the assets of the Issue Department.

Recently, with the stepping up of economic activity in the country and substantial increase in national income, the currency requirements also increased appreciably. The Bank was feeling constrained to bring about desired expansion in currency due to inadequacy of eligible assets. The Bank could, of course, increase its note issue to any amount by acquiring rupee securities from the Government but that would have serious inflationary consequences. So, firstly, the Bank since December, 1964, for the first time started re-discounting or purchasing bills of exchange as is evident from table No. 2-1 below. Formerly, the Bank used to extend loans to banks against the collateral of these bills instead of re-discounting them. Secondly, by a recent amendment to the Act, the list of permissible assets to be held in the Issue Department has been further widened to

TABLE 2-1

Balance Sheet of the Issue Department of the State Bank of Pakistan

(Rs. in million)

30th June.

	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Notes held in the Banking Department	61	51	55	62	105	127	120	125	117	73	100	116	159	126	109	85	80	135
Notes in Circulation	1690	1714	1924	2093	2080	2238	2417	2835	3202	3391	3413	3566	3609	3667	3988	4488	4832	5854
Total Liabilities or Assets	1751	1765	1980	2155	2185	2365	2537	2960	3319	3464	3513	3682	3768	3793	4097	4573	4912	5989
Gold Coin and Bullion and Silver Bullion	42	42	42	79	79	79	79	113	113	115	234	247	249	250	250	252	252	252
Foreign Securities	1166	815	950	848	513	528	566	1134	860	626	578	707	810	665	725	766	758	829
Assets Receivable from Reserve Bank of India	488	342	342	342	342	342	342	489	489	489	489	489	489	489	489	489	489	327
Government of Pakistan Securities and Rupee Coins	55	566	645	886	1251	1416	1550	1224	1857	2234	2212	2239	2220	2389	2633	3066	3237	4291
Internal Bills of Exchange and other Commercial paper	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	175	290
Ratio of gold and approved foreign exchange to total notes issued	96.7	67.8	67.3	58.8	42.6	40.0	38.8	58.6	44.0	35.4	36.9	39.1	41.0	36.9	35.7	32.9	30.5	23.5

Source: State Bank of Pakistan - Banking Statistics (Annual).

supplement the current eligible assets which were inadequate to provide cover for the desired expansion in currency.[1] The promissory notes obtained by the Bank in respect of advances and loans made to local authorities, scheduled banks, co-operative banks and the agricultural and industrial financing institutions, against stocks, funds and securities, other than immovable property, and gold and silver or documents of title to the same, have been made eligible assets for the Issue Department. Moreover, the promissory notes obtained by the Bank in respect of advances to co-operative banks and institutions or banks specially established for the purpose of promoting agricultural or industrial development in the country have also been made eligible assets for the Issue Department.

More important, the provision in the Act that 30 per cent of the assets of the Issue Department should be kept in the form of gold coins, gold and silver bullion and approved foreign exchange has also been waived.[2] Now the amount of assets to be held in the Issue Department in the form of gold coins, gold and silver bullion and approved foreign exchange would be specified by the Central Government from time to time in consultation with the Bank. This brings the constitutional provisions in respect of the regulation of note issue in Pakistan in line with the latest thought on the policy of note issue.

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1. Administration Circular No. 4/67 dated February 9th, 1967.

2. Administration Circular No.67/65 dated November 24th,1965.

Government Banker and Financial Adviser

The State Bank acts as banker to both the central and provincial governments Superficially, the relationship between a central bank and the government looks like that between an ordinary commercial bank and its customers The routine banking business performed by a central bank for the government, however, has far-reaching policy significance This is because the liabilities of the central bank constitute the "cash" of the system and thus the government expenditures and receipts directly affect the liquidity of the banking system. In return for banking services, the government is required to entrust the Bank with all their cash balances free of interest. This, however, does not debar governments from keeping their balances with other banks at places where there is no branch of the State Bank or its agent. The State Bank manages the public debt of both the central and provincial governments and issues their new loans and treasury bills.

The Bank makes ways and mean advances to the central and provincial governments without any collateral security for a period of three months In addition, provincial governments can borrow money from the Bank on the collateral of central government securities. There is no statutory limit on the government's borrowings from the Bank, but so far normally the amount has not been big and is intended to ease temporary shortfalls between treasury receipts and disbursements The government can secure additional financial accommodation from the Bank through the sale of government securities and the issue of ad-hoc treasury bills. There is no statutory limit on the size of individual advances of this type. There were, however, ceilings on the State Bank's total holdings of government securities in both of its departments The limit on the absolute value of the securities to be held in the Issue Department was set by the statutory requirement that at least 30 per cent of its assets should be kept in the form of gold and foreign exchange. By an amendment in the Act in February 1967 this statutory limit has been removed and now the central government, after consultation with the Bank, can reduce the ratio to any extent. To this extent, the Bank can now hold more government securities or bills of exchange The Bank can hold securities of any maturity in the Issue Department

In the Banking Department, the Act required that the value of government securities should not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and 60 per cent of the deposit liabilities of the Banking Department Recently the limit has been raised to the aggregate amount of the share capital, reserve fund and 80 per cent of the deposit liabilities of the Banking Department. The restriction on the maturity of securities has also been removed.

Administrator of Exchange Control•

The Bank has been assigned the responsibility to hold country's external reserves and to administer exchange control The broad allocation of foreign exchange expenditure between government and private sectors is made by the government through the Exchange Control Committee comprising the permanent heads of various ministries and the Controller of Foreign Exchange of the State Bank. The share of the private sector is allocated to different users and uses by the import-licensing authority. Within these broad allocations, the Bank administers the actual transactions.

As an administrator of the foreign reserves of the country, the State Bank has not only intimate and up-to-date knowledge of the balance of payments position of the country, which is one of the important factors affecting the money supply, it can use it as a deliberate tool of monetary policy. Secondly, it enables the Bank to present its point of view about the monetary situation in the country at the time of preparation of annual development budgets and the commercial policy. The consultations between the different ministries of the government and the Bank thus lead to better coordination of fiscal, commercial and monetary policies, which is essential for sustained economic growth in an environment of monetary stability.

Bankers' Bank

The State Bank has extensive powers for regulating the banking system in the country. It is empowered to change Bank Rate as well as to conduct open market operations. It can request the central government to change the legal reserve requirements to any extent or completely dispense with them, as warranted by the exigencies of changing situations. Another constraint upon banks concerning their assets and ultimately limiting their power of credit expansion is the requirement of a liquidity ratio. Every scheduled bank[1] is required to maintain 20 per cent of its demand and time liabilities in the form of cash in bills, balances with the State Bank and gold and unencumbered approved securities The 'unencumbered' means that these securities have not been used as collateral for borrowings from the State Bank

The Bank is also entrusted with comprehensive powers of selective and direct credit control It can regulate the credit policies of banks in general or prohibit them from making advances for some specific purpose It can fix the margins to be maintained by banks in respect of secured advances. It can also fix the rates of interest on deposits and advances

In return, the Bank acts as a lender of last resort. It is empowered to discount bills with maturities ranging from 90 days to 5

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1. See below, Chapter

years, depending on the nature of the bills It makes advances against government and approved securities and in times of emergency it can advance money on any security It makes almost all the assets of the scheduled banks shiftable to the State Bank in times of need

III

Objectives of the State Bank

There are no standard objectives of central banking to which all central banks should adhere at one period of time or any central bank should pursue for all times to come. Central banking, which grew out of the requirements and experiences in the developed countries, especially in Great Britain, is a relatively new art and is still in the process of evolution. The old classical concept of the central bank of a country as note issuing authority and as a banker's bank has given rise to a much more comprehensive concept. While certain objectives are common to all central banks, there are, in practice, variations in their scope and emphasis resulting from the nature of a country's economy, the structure of its credit institutions and the respective stages of growth of both economy and structure. Even in the case of any one central bank, it is not considered advisable to wed its objectives to current ideas on monetary management for ever [1]

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1. E.A. Goldenweiser, American Monetary Policy, McGraw-Hill Book Company Inc., 1951, p.76.

The State Bank of Pakistan was established 'to regulate the issue of Bank notes and the keeping of reserves, with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage'. This wording adopted from the Reserve Bank of India Act, 1934, conveyed clearly the regulatory functions of the central banking authority. Under the Banking Companies Control Act 1948, the State Bank was vested with extensive and effective powers for influencing the policies of the banks, if necessary, by issuing directives of a binding nature. This legislation strengthened the control exercised by the State Bank and granted it specific powers but did not alter in any respect the prevailing view regarding the purpose of central banking according to which a central bank supervises the banking and credit system and operates it so as to make it subserve the public interest. This view of the purpose and responsibility of a central bank was in harmony with its theory as evolved in the advanced countries. The central banking had developed in the advanced countries to regulate and control the policies and operations of commercial banks and other financial institutions in the interest of public good, as it was conceived from time to time, and consistent with the prevailing view in respect of free enterprise. These countries had already well-developed commercial, industrial and agricultural banks and other financial institutions and any direct and active interference by the central bank to promote their growth would have been resented.

This was a very restricted and wholly inadequate view of the objectives of central banking in the conditions of Pakistan. We shall see in Chapter 3 that the areas comprising Pakistan had a fairly developed banking system. It was, however, entering only to the credit requirements of commerce.The banking system received a shattering blow at the time of Partition. Thus the only sector, viz. commerce, for which credit facilities were available before Partition were also disrupted. There were no institutions to meet the credit requirements of industry and agriculture. Under these conditions the assignment of only regulatory functions to the State Bank was out of place. Secondly, the Government of Pakistan committed itself from the outset to planned economic development, by which was meant the active participation of the government in economic development. The share of public investment in total investment increased from 28 per cent in 1949-50 to 48 per cent in 1964-65. The government's development programmes might have been hampered if they did not make full provision for the promotion and development of a credit system which, it was felt, could not be left to the private initiative.

So instead of confining its activities to the regulation of the monetary and credit situation, the State Bank had to accept the development of an efficient monetary-institutional framework as one of its foremost duties. Moreover, the State Bank had not only to develop these institutions, it had to influence their behaviour, outlook and practices in such a way as to bring them into harmony with the major national economic objectives. The basic idea was that the State Bank should develop the banking system and mould it in such a way that it becomes an effective engine of growth.

The amendments made from time to time in central banking legislation in Pakistan clearly reflect this concern for the development of the monetary institutional framework. These wider objectives of the central banking, as they are accepted today in Pakistan, were embodied in the preamble to the State Bank of Pakistan Act, 1956, which states that "it is necessary to provide for the constitution of a State Bank to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interests with a view to securing monetary stability and fuller utilisation of the country's production resources". The Bank is now expected not only to regulate the monetary and credit system but also to foster its growth in line with the country's requirements. More important, it has to join hands with the Government in the fuller utilisation of the country's production resources. The Bank's objectives have now become more comprehensive compared to the traditional view of the functions considered proper for a central bank.

Thus the fundamental objectives of the State Bank's policies are to help the government in attaining maximum and steady rate of growth, to maintain price and exchange stability and to develop money and capital markets. While the broad objectives of policy are easily stated, the actual implementation sometimes brings to the surface certain apparent conflicts. This is particularly true in countries like Pakistan that have embarked on ambitious development programmes where the conflicts appear to be quite sharp, at least in the short-run. A very rapid growth of the economy may endanger the maintenance of domestic price stability and strain the balance of payments. On the other hand, excessive concern about stability may appear to endanger economic growth through failure to stretch fully resources available for development. Since in its day-to-day working monetary policy is primarily concerned with the maintenance of financial stability, its objectives superficially appear to conflict with the attainment of maximum growth. Thus if inflationary pressures emerge during the implementation of development plans, the monetary authorities may be forced to adopt measures like increasing the cost of credit or reducing its availability to the borrowers, leading to the impression that the tempo of growth is being affected. This type of conflict of objectives is, however, of a short-term character and of a superficial nature In the long run, rapid growth of the national economy takes place most effectively in the general framework of price and exchange stability and is better promoted if the burdens of development are appropriately distributed rather than indiscriminately thrown upon the weakest elements of the community through the forced savings of the inflationary process. In such a situation not only are savings extracted in an inequitable manner, but the resources thus released are liable to be frittered away in unproductive or lower priority investments. Thus there is no real conflict between economic expansion and financial stability in the long run.[1]

State Bank's Relationship with the Government

No precise definition or description of the relationship between the Government and the State Bank and of the methods and manner in which the policies of the Bank are to be coordinated with those of the Government have been laid down in the law. The constitution of the Bank in this respect is patterned on or influenced by the British central banking tradition which left the subject of the relationship of the Government to the central bank legally undefined, to be moulded by tradition, convention or need. This is subject to the following qualifications. As we noted above, the central government holds 51 per cent of the shares of the State Bank. Its voting power is in fact greater than its proportion of holdings of the Bank's shares because a private shareholder cannot cast more than 10 votes. The Governor and Deputy Governors are appointed by the central government. Out of nine Directors of the Central Board of the Bank, six are nominated by the central government and hold office at its pleasure. The Act empowers the government to supersede the Central Board of Directors, if in the opinion of the government the Board has failed to carry out any of its obligations imposed on it under the Act. These provisions ensure government control over the affairs of the Bank which is expected to

1. B.K Madan, "The Role of Monetary Policy in Economic Development", in State Bank of Pakistan (ed.) SEANZA Lectures, Vol.1, p.64.

work in the national economic interest. On the other hand, there are provisions in the Act which ensure that the Bank does not become simply a department of government. Firstly, the Governor and Deputy Governors are appointed for a fixed period, and during the tenure of their office the terms and conditions of their service cannot be altered to their disadvantage. Moreover, they cannot be removed from office except under the conditions specifically laid down in the Act. Secondly, of the six nominated Directors of the Central Board, only one is a government official while the remaining five represent agricultural, industrial and commercial interests in the country. The Bank is free in the conduct of its credit control policy. Finally, there is no provision in the legislation for the government to issue directives, which the Bank may be forced to carry out. "The spirit of the legislation appears to be that, except in abnormal circumstances justifying the use of sweeping emergency powers of the government, the Bank should be allowed to function freely under the expert direction of the Governor and the Central Board of Directors. Successive governments in Pakistan have recognised the need for the central bank to maintain an independent position, there have been no crises in their relationship despite differences in viewpoints on matters of importance".[1]

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1. Dr Ziauddin Ahmed, op cit., See also inaugural speech of Finance Minister of Pakistan, SEANZA Lectures, 1964.

The cordial relationship between government and the State Bank seems to have been established at the expense of the latter The two major fields of conflict between the government and the State Bank are deficit financing and interest rate on government debt placed with the banking system. Prior to 1958, the governments in Pakistan did not pay much attention to the advice of the State Bank regarding recourse to deficit financing.[1] The government's insistence on low interest rates on its debt has not only destroyed the chances of developing security market in Pakistan, it has also destroyed whatever hopes the State Bank might have had of exerting indirect monetary controls in the economy.[2] In June, 1966, the State Bank was holding ad hoc treasury bills worth Rs 2,398 million bearing only one-half per cent interest. Recently, the Bank has come under pressure to enlarge its assistance to government-sponsored financial institutions for development of agriculture and industry at concessional rates of interest[3]

In future, the financial position of the government is likely to be more strained due to increase in development expenditure

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1. Speech delivered by Mr Abdul Qadir, Governor, State Bank of Pakistan, at the Seventh Annual General Meeting of the Institute of Bankers in Pakistan, Journal of the Institute of Bankers in Pakistan (January, 1959), pp 62-63.

2 For a detailed discussion see Chapter 5 below.

3 For a detailed discussion see Chapter 6 below.

in the public sector The increase in the resources of the government may not be commensurate The government may hesitate to increase taxes, which are politically unpopular, or cut down its non-development expenditure, which needs painful readjustments It may thus take the easy but dangerous course to the deficit financing Secondly, we shall discuss in chapters 5 and 6 below that at present there seems to be a strong case for an upward readjustment of market rates of interest, especially the rates charged by the development banks. This will be possible only if the Bank is able to pursuade the government to revise its cheap credit policy. In such a situation, it is necessary that the State Bank should be in a position to give sound and objective advice and that the government pays the attention to it. It is pertinent to point out that the government is also committed to financial stability [1] But the fact remains that the government's main concern is with maximising the rate of growth and the volume of employment and with promoting equity

In these circumstances, the present arrangement in Australia seems more suitable for an underdeveloped coutry like Pakistan, which is committed to planned economic development In

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1. "One of the important aims of the Plan is to maintain a reasonable degree of financial stability". Second Five-Year Plan (1960-65), Govt of Pakistan, p.57, "Price stability would continue to be a basic policy objective during the Third Plan", Third Five-Year Plan, (1965-70), Government of Pakistan, p.73

Australia, the law requires the Reserve Bank to keep the Government informed from time to time of its monetary and banking policy and provides that if in the opinion of the Government that policy is wrong, the Governor of the Bank and the Treasurer shall confer and seek to resolve their differences. If they fail to do so, then the Government may issue a direction to the Bank which the Bank must give effect. When such a direction is given, the Government is required to inform Parliament and to lay on the table of the House a statement by the Treasurer and the Governor of the Bank, setting out their respective views on the issues involved. This arrangement has many advantages. Firstly, it authorises the Reserve Bank to formulate its own policy Secondly, it ensures that the policy of the Bank remains in harmony with the policies of the government Thirdly, it ensures that the advice of the Bank will not be taken lightly by the government.

The following observations of the former Governor of the Reserve Bank of India are quite revealing "It is of the essence of sound working relationships between a Treasury and the Board of a Central Bank that the Board should consist of people who are independent and who feel that they express their views with candour and without fear. That is the case in the United Kingdom. But the extent of Government's control in India in economic matters is vastly more comprehensive than in the United Kingdom. Having regard to the stage of economic development through which we are passing, a planned and controlled economy is inevitable, whatever may be the arguments about particular forms and details of control. It follows, however, as a consequence, that non-official members of Statutory Boards taken from industry and commerce, however high their sense of duty, may possibly, on occasions, feel somewhat inhibited in expressing their views with complete frankness. The fact that a Minister represents the power of the State which is pretty all-pervasive in matters of industrial development and that the members of the Board have often to make requests for official sanctions under various enactments could possibly affect their relations in a manner which does not happen in countries less subject to control such as the United Kingdom".[1] This is true about Pakistan also.

It will be helpful to have the nature and extent of the Bank's autonomy embodies in the legislation. The government will still remain final authority but it will introduce healthy checks and balances. In some countries the government's recourse to control bank credit has been limited by law.[2] This, however, has obvious drawbacks. Sometimes it may be in the national interest to incur

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1. Iengar, H.V.R., Monetary Policy and Economic Growth, Vora and Co. Bombay, 1962

2. Edward Nevin, Capital Funds in Underdeveloped Countries, Macmillan, 1963, p.39; E.E.Juker-Fleetwood, Money and Finance in Africa, George Allen and Unwin, 1964, p.94.

deficit-financing and these limitations may stand in the way. Ultimately, however, we have to depend "on the good sense and probity of the government of a territory and on nothing else, solvency and sound finance cannot be provided by statute".[1]

1. Edward Nevin, op.cit., p.40.

Chapter 3.

THE DEVELOPMENT OF COMMERCIAL BANKS AND THE MONEY MARKET.

The object of the present chapter is twofold to discuss the principles of the banking policy of the State Bank of Pakistan and their impact on the evolution of the present structure of the banking system, and to examine its role in the development of money market.

I

The main features of the banking policy of the State Bank have been (1) to accept responsibility for the active promotion of the banking system, (2) to ensure that the predominant section of the banking structure is of local origin, (3) to ensure that the expansion of banks is controlled and orderly, (4) to facilitate the consolidation of banking in a relatively small number of large institutions, and (5) to safeguard the soundness of the banking system.

The Effect of Partition on the Banking System.

The areas now constituting Pakistan had a fairly well developed banking system before Partition. The banking system was comprised of the Reserve Bank of India, which was the central monetary authority for undivided India, commercial banks and indigenous bankers and money-lenders. The commercial banks could be divided into two main groups, namely scheduled banks and non-scheduled banks. The scheduled banks were those banks which had a paid-up capital and reserves of Rs. 0.5 million or more and were included in the Second Schedule of the Reserve Bank of India Act, 1934 Prior to Independence, the number of scheduled banks operating in territories now comprising Pakistan was 46 with as many as 631 offices [1] Of these seven were exchange banks[2] with a total number of 19 offices. As regards non-scheduled banks, although the number of their offices at 704 stood higher compared to scheduled banks' offices, their deposits and loans and advances were only a small fraction of the total advances and deposits.[3] The scheduled banks were heavily

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1. The State Bank of Pakistan - Its Growth, Functions and Organisation, Karachi, p.2.

2 The term "exchange banks" owes its origin to the fact that foreign banks in the Indo-Pak sub-continent were, prior to Independence, engaged primarily in the financing of foreign trade and as such participated largely in foreign exchange business.

3. S.A. Meenai, Banking System of Pakistan, State Bank Press, Karachi, 1964, p.15.

concentrated in larger cities and were catering to the credit requirements of only big and well-established business concerns Farmers, who form more than 75 per cent of the working population and small businesmen and manufacturers, rural as well as urban, had no access to the banking facilities. Thus the burden of meeting the credit needs of the overwhelmingly large proportion of the population of the area was being shouldered by the indigenous bankers and money-lenders who, according to one estimate, were financing nearly 90 per cent of India's internal trade [1] They were also supplying as much as 70 per cent of rural credit in India [2] Moreover, through the mediation of indigenous banks, the commercial bank credit was percolating among the small traders to the extent that the commercial banks were prepared to sanction limits to the indigenous bankers to discount their 'hundis' or indigenous internal bills of exchange

The commercial banks in these areas had two principal features Firstly, they were geared to meet almost exclusively the credit needs of commerce. This was owing to the fact that the economy of these regions was primarily agricultural and export

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1. Wilson, J.S.G., "The Business of Banking in India" in R S. Sayers (ed) Banking in the British Commonwealth, Oxford University Press 1952, p.177.

2. Report of the Committee of Direction All India Rural Credit Survey, Vol.II, 1954.

oriented even by sub-continental standards. Thus banks serving them could do no more than finance the seasonal flow of food and raw materials to larger cities and ports The exchange banks had the monopoly of financing foreign trade while Indian[1] banks were concentrating on internal trade Secondly, the banking business was almost entirely in the hands of Hindus and Europeans Of the 39 Indian scheduled banks operating in these regions before partition, all, except one small bank, were owned, managed and manned by Hindus. As these non-Muslims were dominating in commerce, they also figured prominently as borrowers and depositors of the banking system.

This banking system which Pakistan inherited virtually collapsed just after Independence. It was attributable to the fact that the Hindus, who had a monopoly of banking business, migrated en masse to India due to country-wide communal riots and bloodshed of an intensity and character almost unparalleled in history. This resulted in large-scale closure of bank offices and a transfer of funds to India By the end of June, 1948, the number of scheduled banks operating in Pakistan had declined from 46 to 38 and the number of their offices was sharply reduced from 631 to 195. Of these, two were Pakistani banks with 25 offices, 7 exchange banks with 19 offices,

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1. Banks with head office in India and owned and managed by Hindus.

and 29 Indian banks with 151 offices [1] Most of these Indian scheduled banks were functioning in name only pending the winding up of their business in Pakistan. This is evident from the fact that during the period from July, 1948, to June, 1952, as many as 16 Indian banks withdrew from Pakistan.[2] The number of non-scheduled bank offices has declined steadily over the years from 704 before partition to 30 in 1966. Their share in total bank advances and deposits is now just a fraction of one per cent. With the exodus of Hindus, the indigenous banker and money-lender has become almost completely extinct in Pakistan. According to different surveys in Pakistan, the money-lenders' share in the supply of credit in rural areas ranged between 1.3 per cent and 8.9 per cent only compared to 70 per cent in India.[3] This shows that the only sector, viz. commerce, for which credit facilities were available before partition were also disrupted. There were no institutions to meet the credit requirements of industry and agriculture.

In order to meet the situation depicted above, the State Bank first of all offered a moratorium of three months to every

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1. The State Bank of Pakistan, Twelve Years of Banking in Pakistan, Karachi, 1960, p.3.

2. The State Bank of Pakistan, Annual Reports, 1948-52.

3. Board of Economic Inquiry, Punjab, Report on the Need and Supply of Credit in the Rural Areas of Punjab, Publication No.101, Lahore, 1951, Socio-Economic Survey Board, Dacca University "Rural Credit and Unemployment in East Pakistan 1956".

commercial bank which needed protection on account of panicky withdrawal of deposits. Secondly, through an Inter-Dominion Agreement on Banking of April, 1949, the State Bank tried to safeguard the interests of Pakistani depositors having accounts with the branches of Indian banks, which were rapidly closing down.[1] Under this Agreement an Inter-Dominion Committee was formed to facilitate (a) the transfer and payment of the bank deposits of the persons who had migrated from one country to the other, (b) orderly withdrawing of banks from Pakistan, and (c) to exchange information regarding inactive deposit accounts with banks to facilitate the tracing of the depositors or their successors. The commercial banks in Pakistan were allowed to close their business and remit their surplus funds provided they deposited the equivalent of their outstanding liabilities in Pakistan with another bank approved by the State Bank.

These were just emergency measures. As a first positive step towards the rehabilitation and expansion of banking services, the State Bank, within one month of its establishment, sponsored a training scheme to impart an intensive course of theoretical and practical training in commercial banking to 100 university graduates.

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1. The State Bank of Pakistan, Annual Reports 1949, pp.23-26, 1950, p.22.

The scheme has been repeated almost every year. The State Bank gave it first priority because it realised that the shortage of trained personnel was the most serious bottleneck holding up the growth of banking. An Institute of Bankers was established in 1951 to improve the operational efficiency of the commercial banking system and to provide better facilities for training and education in banking to the in-service personnel. In 1959, two Bankers' Training Institutes were set up, one in each wing of the country The result of these measures was that by 1953 the "shortage of trained men, except in the higher grades, was no longer a bottleneck".[1]

The second step taken to expand banking facilities was to sponsor a scheme for setting up of a commercial bank with government participation in its share capital. The need for a state sector in commercial banking was recognised from the outset.[2] It was felt that with all the encouragement from the State Bank the pace of growth of private banks would not be adequate. The private commercial banks, which are run strictly on considerations of profitability, would not find it profitable to open branches in smaller towns due to low deposit potential and the inability of

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1. The address of Governor, The State Bank of Pakistan, to Rotary Club, Karachi, January, 1953

2 Annual Speech of the Governor, The State Bank of Pakistan, September, 1950, p.8.

borrowers to offer acceptable security. Moreover, the State Bank wanted a Pakistani bank which should be able to take up its agency functions from the Imperial Bank of India. These conditions warranted the establishment of a bank with a truly national outlook and which could take up and preserve a bold programme of branch expansion relatively uninfluenced by considerations of immediate gain or loss. The constitution of the State Bank did not allow it to contribute directly to the share capital of the new institution On the request of the State Bank, the government agreed to lend its support to the promotion of a private shareholders' bank with at least 25 per cent government participation in its share capital The National Bank of Pakistan was established by Ordinance on November 8th, 1949, and is now the largest bank in the country

More recently, it became apparent that certain regions continued to suffer from a relative inadequacy of bank offices Since the government placed high priority on the balanced regional economic growth, the Planning Board in the First Five-Year Plan recommended that the State Bank, in collaboration with the leading Pakistani banks, should sponsor the organisation of regional banks It was suggested that the State Bank should provide not only technical guidance and a few experienced officers, but also a part of the capital of the new banks.[1] The State Bank accepted this proposal and

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1. Planning Commission, The Government of Pakistan, The First Five-Year Plan (1955-60), 1957, p.161

at its request the government amended the State Bank of Pakistan Act, 1956, in February, 1959, to enable the Bank to subscribe to the share capital of a banking company established for the purpose of promoting agricultural or industrial development in the country. Under this power, the Bank helped in the setting up of a regional bank in East Pakistan, namely the Eastern Mercantile Bank.

As an integral part of its developmental activity, the State Bank, in collaboration with the scheduled banks, has set up a Banking Publicity Board to popularise banking habit and saving amongst the masses The State Bank also provides remittance and clearing facilities to the banks. The remittance facilities are important because a two-way flow of funds between metropolitan and small centres ensures the integration of small credit outlets with the main channels of funds thereby developing a truly country-wide money market

It is evident from Table 3-1 that due to the State Bank's effort and the initiative of the Pakistani enterprise, the commercial banks have not only recovered from the earlier setback but have made rapid progress in recent years The number of banks operating in 1966 was still below that in 1948 Over this period 12 Pakistani banks were established and 4 new exchange banks opened their offices in Pakistan. This was, however, more than balanced by the withdrawal of 20 Indian banks. At present although there are only 34 banks operating

TABLE 3-1 Growth of Commercial Banks in Pakistan

Period End-June	No of Banks	No. of Bank Offices	Population per Bank Office (In thousands)	Bank Deposits (General)		Bank Credit	
				Per Office (Million Rs).	Percent* of G.N.P. at Current Factor Cost	Per Office (Million Rs).	Percent* of G.N P. at Current Factor Cost
1948	38	195	383	4.52	5.6	1.01	2.4
1955	32	251	352	7.13	8.0	3.52	4 3
1960	28	407	243	7.23	9.0	3.97	4.9
1965	34	1,470	76	4.68	14.3	4.34	12.7
1966	34	1,846	63	4.33	14.6	3.57	13.1

Source (i) The State Bank of Pakistan
(a) Annual Reports on Currency and Finance
(b) Annual Banking Statistics of Pakistan
(ii) Government of Pakistan, Economic Survey, 1965-66.

* The figures of bank deposits and bank credit used in these columns are weekly averages of the fiscal year, July-June. The percentage figures in the first two relate to the year 1949-50, as the figures of G.N.P. before this are not available.

compared to 46 in the pre-partition period, the number of bank offices has gone up almost three times There is now one bank office per 63 thousand persons as against one bank office for every 383 thousand persons in 1948 and 114 thousand persons before Independence. At the same time, the banking business has increased substantially. One pointer to the growth in the business of commercial banks is the rise in the ratio of bank deposits and bank credit to gross national product at current factor cost Both ratios increased from 5 6 per cent and 2.4 per cent in 1949-50 to 14 6 per cent and 13 1 per cent respectively during 1965-66. The business per bank office, however, has tended to decline recently.

2 State Bank's Emphasis on Promoting Pakistani Banks

In 1950, the State Bank decided to restrict the opening of new branches of foreign banks only to port towns or larger cities where substantial foreign trade was carried on. In the interior of the country only Pakistani banks were allowed to open branches The creation of this monopoly was, of course, discriminatory, but in this Pakistan is not unique. In the United States, for instance, foreign banks are not allowed to accept deposits and have to confine their activities to foreign exchange only,[1] and discrimination against

1. The Annual Speech of Governor, The State Bank of Pakistan, September, 1951, pp 9-10

foreign banks is to be found in Ceylon and Ghana, amongst others.[1]

The justification for discrimination is that it is often alleged that foreign banks in underdeveloped countries concentrate excessively on financing foreign trade and "expatriate industries" and neglect local industry and agriculture, that they judge worthiness by criteria which may be appropriate to the metropolitate countries but which when applied to underdeveloped countries retard the process of economic development, and that with access to funds from parent offices, they are less amenable to control by the central bank [2]

The State Bank restricted the expansion of offices of foreign banks in the interior to shelter Pakistani banks from more powerful competitors with superior management and organisation, and because Pakistani nationals had very little chance to occupy key posts in foreign banks As the policies of banks exert a strong influence on the economy, it was thought necessary to ensure that these policies remain in the hands of Pakistani nationals This expedient seemed preferable to that the alternative of obliging foreign banks to employ local people in key posts It was also thought that whilst Pakistan banks would of course also want to maximise their profits, in their case the profit motive might be tempered by sentiments of patriotism [3]

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1. Crick, W.F., (ed.), Commonwealth Banking Systems, Clarendon Press, Oxford, 1965, p 35

2 Nevin, E , Capital Funds in Underdeveloped Countries, Macmillan and Co , London, pp 45-56, and references therein

3. The Annual Speech of the Governor, State Bank of Pakistan, September 1951.

Let us now examine the effect of State Bank's policies on the structure of banking in Pakistan. The Indian banks remained dominant for some time after Partition in spite of the withdrawal of a number of these banks from Pakistan. At the end of 1948, they still held 40 per cent of total deposits and were responsible for 64 per cent of total bank credit. Their share in the total banking business has declined steadily and in December 1965 they accounted for only 1.7 per cent of total deposits and less than one per cent of bank credit. The main reason for their decline, apart from the strained political relations between India and Pakistan is that since their business was confined entirely to financing trade with India, the drastic decline of this trade since 1949 removed most of their business An analysis of their balance sheets as at the end of December, 1965, shows that the cash in tills and balances with the State Bank of Pakistan formed 25 8 per cent of their deposits liabilities. This is too high a ratio by any conservative standard of liquidity The credit-deposit ratio of these banks was as low as 44 5 per cent

The number of exchange banks has gone up from 7 in 1948, mostly of British origin, to 11 banks from six different countries in 1966 This reflects the diversification of trade and financial relations of Pakistan Some of the exchange banks of British origin were merged on account of growing competition from local and other banks. The National Bank of India and the Grindlays Bank were merged in 1958 and the new National and Grindlays Bank absorbed Lloyds Bank in 1961. In July, 1948, foreign banks were responsible for 31 per cent of total deposit liabilities and they accounted for 17 per cent of total bank credit, i e. advances and bills purchased and discounted By January 1, 1960, their share in total bank credit had increased to 28 per cent and in bank deposits it had declined to 28 per cent In subsequent years, although their business registered substantial increase in absolute terms, the proportion of both their deposits and credit to the total bank deposits and credit declined to 14 1 per cent by the end of December, 1965

In this group, British banks account for 59.4 per cent of deposits and 70 per cent of bank credit and the share of American banks comes to 36.5 per cent and 20.3 per cent respectively The deposits of American banks have increased sharply by virtue of transfer of U.S owned counterpart funds from the State Bank to them. The growth in their credit operations has not been commensurate as they are relatively new entrants and have not been able to form wide connections with the business and industrial communities. Most of their funds they lend to other banks in the inter-bank call money market The balance sheets of American Express Inc and the First National City Bank for December 1965 reveal that the balances with other banks were 41 2 per cent of their deposit liabilities On the other hand, their credit-deposit ratio was as low as 38.3 per cent The main borrowers in the inter-bank call money market are British banks. Their borrowings from banks were 42.3 per cent of their deposit liabilities in December 1965. This enabled them to maintain credit-deposit ratio at 110 per cent.

The foreign banks have, to a great extent, held their field in the face of increasing competition from Pakistani banks and the adverse effect on their growth of the State Bank's restriction on opening of branches They have lost relatively more depositors than borrowers Firstly, this is because the "number of domestic branches is less important criterion to bank borrowers than to depositors".[1] Secondly, and more important, the foreign banks have radically increased the scope of their business. Table 3-2 below reveals that the share of non-trade sectors in total advances has increased rapidly over the years The second more interesting feature is that the ratio of advances to non-trade sectors to total advances is higher in the case of foreign banks than for the Pakistani banks.

The Pakistani banks have moved fast from a small segment to a dominant force in the banking system of the country At the end of 1948, they accounted for only 29 per cent of total deposits and their share in total bank credit at the end of 1949 was hardly 19 per cent On December 18, 1959, they held 62 per cent of total bank deposits and were responsible for 63 per cent of total bank credit.

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1. Porter, R.C., "Liquidity and Lending The Volume of Bank Credit in Pakistan, The Institute of Development Economics, Karachi, 1963, p.40

TABLE 3-2 Classification of Advances of Pakistani and Foreign Banks by Economic Groups

(Per cent)

	Pakistani Banks		Foreign Banks	
	1953	1966	1953	1966
1. Agriculture	31.47	2 38	10.53	1.13
2 Mining and Quarrying	-	0 29	-	1.37
3 Manufacturing	23 28	39.02	9 21	37.18
4. Construction	0 43	1.28	1.97	8.60
5 Electricity, Gas, Water and Sanitary Services	0.43	0.49	-	0.09
6 Commerce	29 74	40.61	65.13	33 78
7. Transport, Storage and Communications	0.43	2 79	5 92	1.03
8. Services	6 90	7.01	4.61	8.85
9. Others	7.33	6.14	2 63	7 95
10. Total	100.00	100.00	100 00	100.00

Source State Bank Banking Statistics of Pakistan

By the end of December, 1965, their share in total bank credit had increased to 85 per cent and in total bank deposits to 84 2 per cent. Their credit-deposit ratio at the end of December 1965 was 80.7 per cent. The position of individual banks, however, varied greatly. In the last three years, the ratio of advances to deposits for all banks has swung mainly between 80 and 90 per cent with an average seasonal variation of about 10 percentage points. Table 3-3 gives the summary of the structure of the banking system at the end of December, 1965

3 Planned and Orderly Growth of Banks

The State Bank has prevented the opening of weak institutions as it is consulted by the Controller of Capital Issues before sanction is granted for the issue of capital to any banking company At the same time, the approval of the Bank is needed before banks are amalgamated or wind up their business Moreover, all banks need the State Bank's permission to open a new branch or to change the location of an existing branch. Before permitting a bank to open a new branch, the State Bank carefully examines the condition of its finances, the general character of its management, the adequacy of its capital structure, the earning prospects and the public interest likely to be served by the branch. Secondly, it is intended to encourage banks to spread into the interior of the country and to

TABLE 3-3. Structure of Commercial Banks in Pakistan.

(Rs. in million).

	Total (1)	Pakistani Banks (2)	(2) as % of (1) (3)	Foreign Banks (4)	(4) as % of (1) (5)	Indian Banks (6)	(6) as % of (1) (7)
1. Number of Banks.	34	14	41.2	11	32.4	9	26 4
2 Number of Bank Offices	1,846	1,774	96.1	39	2 1	33	1.8
3. Deposits	7,887	6,639	84.2	1,116	14.1	132	1.7
4. Cash in tills and Balances, with State Bank.	929	803	86 4	92	9.9	34	3.7
5. Advances.	5,807	4,933	85.0	820	14.1	54	0.9
6 Bills Purchased and Discounted.	497	426	85.7	66	13.3	5	1.0
7. Investment.	1,913	1,653	86.4	237	12.4	24	1.2
8. Capital & Reserves.	N.A	262	-	N.A.	-	N.A.	-
Ratio of							
9. (4) to (3)	11.8	12.1		8 3			25.8
10 (5 + 6) to (3)	80 0	80 7		79.4			44 5
11. (7) to (3)	24 3	24.9		21.2			17.8
12 (8) to (3)	N.A.	3 9		N A.			N.A

Source State Bank of Pakistan - Annual Banking Statistics of Pakistan.

discourage over concentration of bank offices in big cities For this purpose, the Bank has laid down that for every new branch in a big city, bank should open two offices in smaller towns. As a result, the number of places served by scheduled banks has increased from 90 in June, 1957 to 449 in June, 1966

Why have banks been so reluctant until recently to open offices away from the big cities ? First, because, according to banks, there is little commerce to be financed in small towns and rural areas and most farmers and small traders are insufficiently credit-worthy to be eligible for loans, so that the main form of business is to attract deposits. But to mobilise deposits in these areas is costly if only because poor communications make the movement of cash to far off offices an expensive business. The alternative is to leave the cash where it is deposited, but then it earns nothing. Secondly, the farmers are likely to show interest in only deposit and saving accounts As a considerable portion of farmers' money income is concentrated in the cash crop harvesting season, one would expect a part of the average farmer's saving deposits to consist of transaction balances This implies that a banking office serving a rural community would require large cash resources relative to deposit liabilities on which the bank would have to pay interest.

These factors are losing force gradually New industrial and commercial centres are emerging in the interior of the country

TABLE 3-4. Receipts, Disbursements and Net Profits of Scheduled Banks[1] in Pakistan.

(Rs. in million).

End-June	Pakistani Banks									Foreign Banks						
		Receipts		Disbursements			Profits			Receipts		Disbursements			Profits	
	Capital and Reserves	Total	Interest and Commission etc.	Total	Interest and Commission etc.	Working Expenses	Amount	Percent of Capital and Reserves	Percent of Total Disbursement	Total	Interest Commission etc.	Total	Interest Commission etc. Paid	Working Expenses.	Total	Percent of Total Disbursements.
1953	48.5	34.6	33.7	22.7	6.3	14.3	11.9	24.5	52.4	35.2	34.1	29.8	9.7	18.7	5.4	18.1
1960	149.4	108.7	105.3	73.9	27.2	40.3	34.8	23.3	47.1	72.8	70.6	56.9	26.3	27.1	15.9	28.0
1965	225.2	473.2	459.2	387.1	189.6	162.7	86.1	38.2	22.5	120.9	117.0	105.9	58.6	41.8	15.0	14.2

Source: The State Bank of Pakistan, Banking Statistics of Pakistan, 1948-57, 1960-61 and 1965-66.

1. The table excludes the Industrial Development Bank of Pakistan and the Agricultural Development Bank of Pakistan.

The State Bank has set up an efficient and cheap system of remittance facilities The banks have come under increasing pressure of demand for bank credit so that they seem to be more inclined to venture into new areas in search of loanable funds. It is evident from table 3-5, that although the average per office deposits are much lower in small towns, they have in total increased from 11 7 per cent of total deposits in June, 1962 to 20 3 per cent in June, 1966 Over the same period, the number of deposit accounts in smaller towns has gone up from 188,253 to 1,004,811 and their share in total deposit accounts has increased from 22 9 per cent to 36 3 per cent The bulk of the deposits mobilised in these areas is siphoned off to large cities, a feature which will be discussed in more detail later Here we examine only the effect of branch expansion on the profitability of the banking system.

Table no 3-4 gives the summary of receipts, disbursements and net profits of the scheduled banks by the nationality of the banks. It shows that the profits of Pakistani banks have gone up not only in absolute amount, but the annual rate of increase has also accelerated from 27.5 per cent during 1953-60 to 29.5 per cent in 1960-65 On the other hand, the profits of foreign banks registered a decline in the second period. Secondly, the ratio of profits to capital and reserves in the case of Pakistani banks has recorded a substantial increase in the latter period as against a decline in the former period The comparison of profits of foreign and Pakistani

TABLE 3-5. The Distribution of Bank Offices, Bank Deposits and Bank Advances by Cities.

(Rs. in million).

City	30th June, 1962.							30th June, 1966.						
	Bank Offices	Bank Deposits			Bank Advances			Bank Offices	Bank Deposits			Bank Advances		
		Amount	Per Office	Percent of Total	Amount	Per Office	Percent of Total		Amount	Per Office	Percent of Total	Amount	Per Office	Percent of Total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Karachi	102	1630.5	15.99	44.32	1,075.5	10.54	41.48	226	2,667.6	11.80	32.73	2,432.3	10.76	38.51
Lahore	57	442.0	7.75	12.01	404.1	7.09	15.59	113	1,091.7	9.66	13.40	760.8	6.73	12.04
Dacca	31	285.1	9.20	7.75	308.4	9.95	11.89	97	261.5	8.88	10.57	1,215.1	12.53	19.24
Chittagong	29	246.6	8.50	6.70	166.7	5.75	6.43	73	457.8	6.27	5.62	363.3	4.98	5.75
Rawalpindi	17	149.9	8.82	4.07	31.0	1.82	1.20	36	383.4	10.65	4.70	103.1	2.86	1.63
Lyallpur	12	77.9	6.49	2.12	91.6	7.63	3.53	30	204.0	6.80	2.50	135.7	4.52	2.15
Hyderabad	12	71.5	5.96	1.94	51.0	4.25	1.97	36	108.4	3.01	1.33	83.0	2.31	1.31
Narayanganj	12	53.6	4.47	1.46	68.5	5.71	2.64	25	92.2	3.69	1.13	133.3	5.33	2.11
Multan	14	50.3	3.57	1.37	49.1	3.51	1.89	29	102.8	3.54	1.26	74.8	2.58	1.18
Peshawar	13	47.7	3.67	1.30	29.9	2.30	1.15	27	106.4	3.94	1.30	54.7	2.03	0.87
Khulna	10	36.4	3.64	0.99	18.1	1.81	0.70	19	85.3	4.49	1.05	70.0	3.68	1.11
Sargotha	7	31.4	4.49	0.85	16.4	2.34	0.63	11	62.1	5.65	0.76	26.6	2.42	0.42
Gujranuzla	8	26.8	3.35	0.73	16.7	2.09	0.64	9	64.4	7.16	0.79	40.8	4.53	0.64
Sialkot	5	26.8	5.36	0.73	8.7	1.74	0.34	12	68.5	5.71	0.84	24.3	2.02	0.38
Quetta	6	26.5	4.42	0.72	5.4	0.90	0.21	13	58.2	4.48	0.71	30.6	2.35	0.49
Sukkar	6	22.5	3.75	0.61	9.0	1.50	0.35	12	39.6	3.30	0.49	11.6	0.97	0.18
Montgomery	5	22.3	4.46	0.61	11.4	2.28	0.44	8	44.0	5.50	0.54	29.5	3.69	0.47
Sub-Total	346	3247.8	9.39	88.28	2361.5	6.83	91.08	776	6497.9	8.37	79.74	5589.5	7.20	88.49
Rest	273	431.2	1.58	11.72	231.2	0.85	8.92	1070	1651.7	1.54	20.26	727.1	0.68	11.51
Total	619	3679.0	5.94	100.00	2592.7	4.19	100.00	1846	8149.6	4.41	100.00	6316.6	3.42	100.00

Source: State Bank of Pakistan - (Quarterly) Statistics in Scheduled Banks in Pakistan.

banks reveals that the profits of the latter have not been affected adversely by the opening of branches in rural areas. Secondly, in the case of Pakistani banks, the opening of a far larger number of offices in rural areas during 1960-65 compared to the earlier period has not affected the rate of growth of their profits. This is partly because the banks are not simply intermediaries which collect loanable funds and lend them to other parties They create credit as well. By opening offices and offering higher rates on deposits, the banks have succeeded in reducing the ratio of currency in circulation to money supply which has enabled them to build a larger pyramid of earning assets on a given cash base.

However, the ratio of profits to total disbursements in the case of both Pakistani and foreign banks has gone down significantly over the last five years. This is due to a sharp increase in disbursements. The increase in their disbursements is largely attributable to rise in interest payments which, in turn, have increased due to rise in deposit rates and the shift to time deposits.

4. Size Distribution of Pakistani Banks

The following analysis of banks by size is confined to Pakistani banks only This is because the growth of foreign banks has been restricted to large cities. The classification of banks by size is based on their deposit liabilities. Banks having deposits of less than Rs 50 million have been classified as small. Those having deposits of Rs 50 million, but less than Rs 150 million, are regarded as medium-sized, and large-sized banks are those having deposits of Rs 150 million and above. There is nothing sacrosanct about size distribution of banks by amount of deposits. It could have been based as well on amount of credit or number of offices. According to our classification five banks fall in the category of small-sized banks, 3 are medium-sized banks and 6 large-sized banks. Of the total number of 1,774 branches, large-sized banks account for 1,604 offices, medium-sized banks for 147 offices and small-sized banks for only 23 branches.

Table No.3-6 below gives selected items of the balance sheets of the three categories of banks as on December, 1965. It reveals, among others, the following points (1) The small banks account for 2.1 per cent of deposits and 3.1 per cent of credit. If we exclude the Punjab Provincial Co-operative Bank, their share in business comes to less than 1.5 per cent. At the other end of the scale, the large banks account for 92.3 per cent of deposits, 91.5 per cent of credit and 94.4 per cent of investments. (2) It shows that the classification of banks by size on any basis is extremely arbitrary. Within each group, every bank has such an individual identity that it merits separate treatment. For that reason, we have given the position of some individual banks in the table. (3) The cash ratio is highest in the case of medium-sized banks and lowest in the case of small banks, excluding the Punjab Provincial Co-operative

Bank. In view of their small size and of the fact that all of them are operating in big cities, presumably in competition with large banks, one would have expected them to have a higher cash ratio than the large banks. One possible explanation of their low cash ratio is that although they are operating in large cities, they do not compete with the large banks. The large banks' criterion of credit-worthiness makes them reluctant to cater for small business which do not come up to their standard. They leave these "second-best" customers to the smaller banks. (4) The capital base, i.e. the ratio of paid-up capital and reserves to deposits, is small in the case of large and medium-sized banks. The position of individual banks varies from the lowest level of 2.4 per cent for the United Bank Ltd. to 4.4 per cent for the Habib Bank Ltd. (5) A high credit-deposit ratio for the National Bank of Pakistan shows its aggressive credit policy and the lowest credit-deposit ratio for the second biggest bank, viz. Habib Bank, shows an extremely conservative loans policy.

Among Pakistani banks, the National Bank of Pakistan needs special mention. It was established in November, 1949. It has a paid-up capital of Rs 30 million, of which not less than 25 per cent is held by the central government. Initially its activities were restricted to the task of financing the marketing of jute with the assistance of the State Bank, which stepped in under its

TABLE 3-6. Selected Items of the Balance Sheets of Pakistani Banks as on December 31, 1965.

(Rs. in million).

	All Pakistani Banks	Large-Sized Banks: All Large-Sized Banks	Large-Sized Banks: National Bank of Pakistan	Large-Sized Banks: Habib Bank Ltd.	Large-Sized Banks: United Bank Ltd.	Medium Sized Banks	Small-Sized Banks: All Small-Sized Banks	Small-Sized Banks: Excluding Punjab Provincial Co-operative Bank Ltd.
1. Capital and Reserves	262	224	73	88	27	15	24	5
2. Deposits	6,638	6,127	1,989	1,974	1,155	374	138	92
3. Due to other Banks[(a)]	1,362	1,224	1,069	-	108	45	93	7
4. Cash (net)[(b)]	656	567	195	154	111	57	34	5
5. Bank Credit	5,359	4,906	2,129	1,234	833	282	171	62
(i) Advances	4,933	4,513	1,977	1,127	764	250	169	60
(ii) Bills Purchased and Discounted	426	393	152	107	69	32	2	2
6. Investments	1,653	1,561	643	538	202	67	25	15
7. Ratio of Capital and Reserves to Deposits	3.9	3.6	3.6	4.4	2.4	3.7	17.1	5.9
8. Ratio of Inter-Bank Borrowing to Deposits	20.5	20.0	53.7	-	9.3	12.0	67.4	7.6
9. Cash Ratio	9.9	9.3	9.8	7.8	9.6	15.2	24.6	5.4
10. Credit-Deposit Ratio	80.7	80.1	107.0	62.5	72.1	75.4	123.9	67.4
11. Investment Deposit Ratio	24.9	25.5	32.3	27.3	17.5	17.9	18.1	16.3

Source: State Bank of Pakistan - Banking Statistics (Annual), 1965-66.

emergency powers to provide the necessary funds. The jute trade in East Pakistan was facing a crisis due to the trade deadlock with India. The Indian traders were not only the largest buyers of jute, they were the main suppliers of finance for the jute trade as well. In the initial stages the bank borrowed from the State Bank but soon afterwards it obtained considerable funds by way of fixed deposits and inter-bank call loans, which it was allowed to accept in sums of not less than Rs 0.1 million in the former case, and Rs 2.5 million in the latter. The National Bank supported the jute market by making direct advances to the purchasing agents of the Government Jute Board to the extent of Rs 40 million and more effectively still by overcoming through its presence the hesitation of other banks to make advances against jute. In 1950 and 1951, the period of the Korean war boom and recession, it helped in the stabilisation of the cotton market in West Pakistan by providing 75 per cent of the total cotton finance. After the transitional period, the National Bank undertook all types of banking business, including exchange banking. Even now the major function of the National Bank continues to be the financing of the cash crops and other agricultural commodities. It has also undertaken special financing operations connected with government price support schemes and has also financed their food procurement and stockpiling programme. It extends credit facilities to co-operative societies in order to assist the rural economy of the country. It will help to forge a link between the co-operative credit structure and the commercial banking system. In its role as a pace-setter, it has broken new ground in regard to credit to small borrowers. It started the People's Credit Scheme in January 1964 to provide credit facilities to small traders and industrialists. By the end of 1966, it had sanctioned small loans amounting to Rs 325 million. In June, 1966, it had a network of 528 branches, accounting for 28.7 per cent of the total branches of scheduled banks in the country. In December, 1965, it accounted for 25.2 per cent of total scheduled bank deposits and 33.8 per cent of total bank credit.

5. Regulation and Safeguarding the Soundness of the Banking System.

The State Bank has wide powers under the State Bank of Pakistan Act 1956 and the Banking Companies Ordinance 1962 to ensure soundness of commercial banking. The Bank keeps a close watch over the affairs of banks through periodical returns and regular inspections. If the inspection report reveals an unsatisfactory position of the business of any bank, the State Bank has powers to depute its officers to improve the management of the bank or require the bank to make necessary changes in its management. It may prohibit the bank against entering into any particular transaction or class of transactions or, on its recommendation, the government may prohibit the bank to accept fresh deposits or order the winding up of the bank.

The Bank has taken care to weed out unsound institutions. It de-scheduled as many as 16 banks by the end of June, 1952. Of these two were amalgamated with other scheduled banks and the rest were liquidated. During 1955-60, 10 more banks were de-scheduled, of which seven were liquidated and 3 were merged with other banks. In the last six years this process has slowed down as the number of weak institutions has appreciably declined.

All banks are required to maintain within the country a certain percentage of their assets against their demand and time liabilities, which at present is 80 per cent. This provision is designed not only to protect the interests of depositors but also to ensure that resources raised by banks in Pakistan are largely employed in the country itself.

The Bank is authorised to control the capital and reserves of banks because an adequate level of capital and reserves is necessary to cushion the losses incurred due to bad debts or depreciation in the value of gilt-edged investments following rise in interest rates, and to facilitate ventures into fields, such as medium-term credit and loans to small borrowers, which have a larger element of risk than the conventional short-term lending. Finally, although the safety of depositors ultimately lies in the quality of advances and the adequate liquidity of banks, the strong capital base does enhance public confidence in banks.

Every Pakistani bank is required to have a minimum aggregate paid-up capital and reserves ranging between Rs 0 1 million and Rs 1.0 million, depending on the geographical coverage and location of the bank concerned. They are required to transfer every year 20 per cent of their net profit to the reserve fund until it is equal to the paid-up capital. Every foreign bank is required to keep an aggregate of paid-up capital and reserves amounting to at least Rs 2 million or an amount equal to 5 per cent of its demand and time liabilities in Pakistan, whichever is higher. This amount should be deposited with the State Bank in cash or unencumbered approved securities by transfer of funds from abroad. The object of this deposit requirement is that foreign banks should have some risk capital of their own in this country.

The ratio of capital and reserves to deposits in the case of Pakistani banks has declined rapidly over the last six years. The position is worse in the case of large banks. This is due to the marked growth of deposits and an inadequate increase in capital and reserves. It has been suggested that the requirement of capital and reserves should be fixed as a certain percentage of deposit liabilities.[1] In India, the local banks are required to transfer

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1 Andrus, J.R. and A.F. Mohammed, Trade, Finance and Development in Pakistan, Oxford University Press, Karachi, 1966, p 116.

TABLE 3-7. The Capital Base of the Pakistani Commercial Banks.

(Rs in million)

	Paid-up Capital (1)	Reserves (2)	Deposits (3)	Ratio of (1) + (2) to (3) (4)
June 1953	34.9	13.6	777.2	6.2
December 1953	34 9	13.7	800.9	6.1
June 1955	40.0	17.2	1,012 6	5.6
December 1955	41.3	27.7	1,002.9	6.9
June 1960	72.9	46 4	2,035.6	5 9
December 1960	75.5	51.0	2,076.9	6.1
June 1965	124.8	100 7	5,833.6	3.9
December 1965	140.2	102.6	6,417.3	3.8
June 1966	140.2	114.2	7,399.6	3.4

Source State Bank of Pakistan - Banking Statistics of Pakistan, (Annual).

20 per cent of their profits to reserve fund every year and the foreign banks are required to deposit the same percentage of their profits with the Reserve Bank of India.[1]

Most of the Pakistani banks are owned by big businessmen and industrialists, or they have controlling interest in them. The banking law does provide some safeguards to prevent the misuse of the resources of banks for their personal ends. But these safeguards seem to be inadequate. It has been recommended that the Boards of Directors of banks should be made more broad-based and the share ownership of banks should be widely dispersed.[2] It might be better if the State Bank established a cell in every Banking Control Department of its offices on the lines of Service Central des Risques in the Bank of France. Then every bank should be asked to submit detailed information about its sizeable loans and overdrafts to different parties. This will provide a check on the misuse of bank resources by the big businessmen having controlling interest in banks. The Bank will know the extent of accommodation a party has received from different banks and it will be "of great practical value to the individual banks in the event of customers attempting to buttress an untenable position by increasing their borrowings from other banks".[3]

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1. Madan, B.K., India, in Crick, W.F. (ed.), op.cit., pp.203-204.
2. Meenai, S.A., An Appraisal of the Credit and Monetary Situation in Pakistan, State Bank Press, Karachi, 1962, p.91.
3. Wilson, J.S.G., France in R.S. Sayers (ed.) Banking in Western Europe, Oxford, 1962, p.13

II.

The Money Market.

In this section we shall discuss the role of the State Banks in the development of money market[1] in Pakistan. The main objectives of developing a money market, among others, are as follows (1) The money market, by providing a wide array of relatively liquid assets, encourages the economy in general to economise in the use of cash. (2) It specifically enables the commercial banks to operate with a minimum and stable reserve base. In the normal course of business, the banks gain and lose deposits to each other. Thus some banks become long of cash and others short of cash. The inter-bank call money market enables the banks long of cash to utilise the sterile excess reserves profitably and the banks short of cash can borrow in the call money market before being forced to resort to the central bank finance.[2] In this way

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1. For the definition of money market, see Fonsek, P.G., Foreign Central Banking The Instruments of Monetary Policy, Federal Reserve Bank of New York, 1957, p.82, Wilson, J.S.G., 'The Structure of Money Markets', in Monetary Policy and the Development of Money Markets, George Allen and Unwin Ltd, 1966, p.218, Newlyn, W.T. and D.C.Rowan, Money and Banking in British Colonial Africa, Oxford University Press, 1954, p.143.

2. In U.K., the banks long and short of cash adjust their cash reserves by extending and withdrawing call loans to the Discount Houses. In U.S., the banks adjust their cash reserves in the Federal Funds market either by direct inter-bank dealings or through a dealer. See Dacey, W.M., The British Banking Mechanism, Hutchinson and Co.Ltd., 1967 (Reprint) pp.56-57, Sayers, R.S., 'The New York Money Market through London Eyes' in Central Banking after Bagehot, Oxford University Press, 1957, pp.139-40 Newlyn, W T., Theory of Money, Oxford University Press, 1965 (Reprint), p.26.

the banks stretch their reserves to the limit. (3) A broad and integrated money market makes monetary policy relatively more effective. The existence of a broad range of short-term monetary assets and the stabl cash reserve ratios of banks at the minimum level, allow an effective and flexible use of open market operations and Bank Rate The transactions of a reasonable magnitude in the market by the central bank affect the reserve ratios of banks without upsetting the prices of monetary assets The banks also have to resort to the central bank finance (directly in the case of U S A and Pakistan and indirectly through Discount Houses in the United Kingdom) more frequently due to rigidity of their cash ratios at a low level This makes the Bank Rate an effective instrument of control.[1] (4) The availability of proper kind of assets, having a reasonable degree of liquidity, to investors would, firstly, encourage the direction of the flow of savings to most suitable and important ends. Secondly, the availability of attractive, safe and lucrative outlets for the employment of savings would increase the rate of savings.[2]

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1. Sayers, R.S., 'Introduction' to Sayers (ed.), Banking in the British Commonwealth, pp XII to XV, Dorrance, G.S., The Bank of Canada, in Sayers (ed.) op cit , pp.121-24.

2 Nevin, E , op cit., 1963, p 89, Fousek, op cit , p 83.

Market for Bills of exchange

The demand for bank credit in Pakistan until recently was subject to strong seasonal pressures. The banks were forced to seek financial accommodation in the busy season and were left with surplus funds in the slack season. They sought the State Bank's assistance either by selling government securities to it or borrowed against their collateral. The State Bank had to extend financial accommodation to the banks to facilitate the movement of export crops. It also had to avoid sharp fluctuations in the securities markets. It could, in particular monetary situations, have inflationary consequences So the State Bank introduced a Bill Discounting Scheme in 1952 to impart a degree of automatic seasonal elasticity to the bank credit in conformity with genuine commercial requirements.[1]

Under this Scheme, the scheduled banks were required to split up their current overdrafts and cash credits into two parts, a part of these overdrafts, etc., was to be converted into usance (time) promissory notes and the rest was to continue to be covered by

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1. Annual Speech of Governor, The State Bank of Pakistan (1951), p.4, The SBP, Annual Report (1953), p.9.

demand promissory notes of their constituents as usual. The idea was that this would enable banks to offer the same facilities to their customers as before and at the same time they would be able to lodge the usance promissory notes with the State Bank as security for advances. The State Bank announced its readiness to rediscount or make demand loans to banks against the security of their demand promissory notes supported by usance promissory notes of their constituents at a concessional rate of 0.5 per cent below Bank Rate. It also agreed to bear half of the stamp duty.[1] Table No.3-8 shows that the ratio of bills of exchange purchased and discounted to total bank credit was hardly 4 per cent in 1948-49. After increasing to 15 5 per cent in 1953-54, it has gone down again to 5 8 per cent in 1965-66. The reasons for the unpopularity of bills of exchange and hence the failure of the State Bank to establish a broad-based market for them are as follows

(1) It is cheaper for the customers to borrow from the banks in the form of overdraft and cash credit than to discount bills. In the case of overdraft, a borrower can draw up to an agreed limit, but he pays interest only on the daily amount by which his account is overdrawn. Under cash credit, the customer is granted loan on which he can draw in instalments. However, he has to pay interest

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1. Meenai, S.A., <u>Banking System of Pakistan</u>, op.cit., p.58.

TABLE 3-8. Distributions of Bank Credit between Advances and Bills Purchased and Discounted.

(Rs in millions)

Period (July-June)	Advances	Bills Purchased and Discounted	Total Bank Credit	Ratio of Bills to Bank Credit
1948-49	358	14	372	3.9
1951-52	683	75	758	9.9
1953-54	634	117	751	15.5
1955-56	880	153	1,033	14.8
1958-59	1,187	166	1,353	12.3
1959-60	1,368	176	1,544	11.4
1962-63	3,046	261	3,307	7.9
1964-65	5,385	420	5,805	7.2
1965-66	6,128	379	6,507	5.8

Source: The State Bank - Annual Reports on Currency and Finance.

N.B. The figures are weekly averages for the fiscal year.

on an agreed portion of the loan whether he actually utilises that loan facility at all or not. On the remaining amount of the loan, he pays interest only to the extent he draws the sum exceeding the compulsory interest bearing limit.

(2) It is more convenient for the customer to borrow in the form of overdraft and cash credit. Bills are issued for a specified period and must be honoured at the time of maturity. Technically, overdraft and cash credit are repayable on demand. But in practice, as in other countries, overdraft facilities are normally renewed on expiry. This facility of rolling over of loans is conspicuously absent in the case of discounting of bills.

(3) The commercial banks also prefer advances from the State Bank to rediscounting bills with it for the same reason that they can more or less choose themselves when to repay them.

(4) The use of bills of exchange to finance internal trade has declined due to growth of branch banking and the use of telegraphic transfers.

(5) Finally, due to absence of discount houses and other intermediaries, market transactions in commercial bills have not developed. The government Planning Board recommended in 1957 the establishment of discount houses. The Board was assured that various firms and individuals with adequate funds were ready to establish

discount houses.[1] The proposal for the establishment of discount houses, with the powers of "acceptance", was again repeated in 1959 by the Credit Enquiry Commission. They also recommended the appointment of guarantee brokers.[2] The State Bank has so far shown no enthusiasm for these proposals. This is perhaps due to lack of substantial amount of bills of exchange for reasons discussed above.

Treasury Bills Market.

Following the decline in the use of bills of exchange, the central banks have attempted to broaden money markets on the basis of treasury bills and short-dated government bonds. These have the advantage of high credit-standing, their volume can be easily adjusted to suit the current needs of the economy, and they can be issued regularly at short intervals and with different maturities to suit the taste of the people looking for short-term investment of funds. But if the Bank is to be successful, the supply of treasury bills needs to be tailored to the requirements of

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1. National Planning Board, Government of Pakistan, The First Five-Year Plan (1955-60), 1957, p.161.

2. Government of Pakistan, The Report of the Credit Enquiry Commission, 1959, pp.109-110, See also Government of Pakistan, The Report of the Credit Committee, 1962, p.17.

the economy and not to the financial needs of the government. The bills need to attract a relatively high rate of interest, and the central bank needs to ensure their liquidity by generous rediscount facilities. Lastly, there needs to be institutions or intermediaries for holding 'stock in trade' and for marketing these bills to keep the short-term funds 'revolving'.[1]

The State Bank has however, failed to create a demand for treasury bills because it has not offered a sufficiently high rate of interest. The average rate of interest was always well below 1 per cent until the last quarter of 1957. At the same time, the interest rate on savings deposits ranged between 1 per cent and 2½ per cent. This explains why no one, except the scheduled banks ever bought treasury bills, and the latter only until 1960. In June 1956, the treasury bills constituted 8 per cent of their total investments in government securities. After that, their holdings of treasury bills started declining and they completely disappeared from their portfolios in 1960. The banks bought treasury bills in the early years because they were often loaded with surplus funds in the slack season. They had the choice between investment in treasury bills and loans in the inter-bank call money market and as most of them experienced excess liquidity simultaneously, the demand

1. Nevin, E., op.cit., p.94.

for funds in the inter-bank call money market was small and the inter-bank call money rate would go down as low as 0.25 per cent (see table No. 3-9 below). In this situation, investment in treasury bills during the slack season was more profitable. As the seasonal fluctuations in the demand for bank credit became less intense and the demand for bank credit rose sharply after 1960, the investment in treasury bills ceased to be profitable. The issue of treasury bills on tender was stopped in 1960. The government started issuing 3 month treasury bills on tender again in 1964, carrying 3 per cent rate of interest. In the meantime, the deposit rates and the call money rate had also gone up. The interest rate on savings deposits was 3.5 per cent in 1966 and the minimum inter-bank call money rate during 1965-66 was 3.75 per cent. No wonder the State Bank remains the sole holder of treasury bills.

The second reason for the failure of the Bank to establish treasury bills market is that it is committed to lend to the banks against the collateral of government securities. This makes the securities of all maturities equally liquid. Moreover, the State Bank has all along aimed to keep the prices of government securities stable. Thus the banks have no fear of capital loss, and since, in addition the rate of interest on long-dated securities is comparatively high, it is no wonder that there has been a sharp increase in the long-dated securities in their portfolios. Between

1958 and 1966 their proportion in the government securities portfolios rose from 6 per cent to 45 per cent.

Thirdly, on the supply side, the central government borrows from the State Bank by issuing ad hoc treasury bills at a nominal rate of interest. The State Bank was holding ad hocs worth Rs. 2,398 million in June 1966. These bills are not marketable due to their extremely low rate of interest. Moreover, the borrowings of provincial governments from the commercial banks under the counterfinance agreement are also not marketable debt. Finally, there are no financial intermediaries for holding 'stock in trade' and arranging active market for buying and selling of these low-yield short-dated assets.

Call Money Market

The call money market is the core of money market in Pakistan. Only scheduled banks participate in it. It is similar to the Federal Funds market in the United States in that it is also a market in deposits held at the central bank. The banks, which are long of cash, lend in the call market instead of holding excess reserves and banks short of cash borrow in the call market before resorting to the central bank finance. The loans may be made through brokers, but generally the transactions take place directly between banks. Although the market is located in Karachi, in practice it serves the entire country. This is because the scheduled banks have an extensive network of branches spread all over the country. The head offices of almost all big banks are in Karachi. Branches remit their surplus cash to the head office, while those short of cash borrow from the head office. The State Bank has a network of currency chests all over the country and provides remittance facilities at concessional rates of interest.

The figures of call money[1] and the call money rates in table No. 3-9 below show two distinct characteristics. First, both the funds borrowed or lent in this market and the money rate are subject to strong seasonal fluctuations, stronger in the case of the latter than the former. This is because all banks are subject to the same seasonal influences. If we assume that all banks followed the same portfolio policies as well, there would be no transactions in the call money market below the Bank Rate during the busy season. The transactions at or above the Bank Rate would take place only when some banks have no collateral to borrow from the State Bank (liquidity restraint) or their borrowings have already reached the limit fixed by the State Bank. During the slack season, all banks would have surplus

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1. These are the figures reported on the asset side of the scheduled banks' weekly returns. For different estimates of net inter-bank reallocation of funds from the published balance sheets of banks and the problems involved in it, see Porter, R.C., Liquidity and Lending, op.cit., pp.58-62.

funds and the call money rate would fall to zero. In fact, different banks pursue different portfolio policies. The Habib Bank and the American banks are the main lenders in the call money market. The main borrowers are British banks. Due to restrictions on the opening of branches, they have lost more depositors than borrowers. Secondly, they have always worked on fine cash reserve ratios. Some Pakistani banks also borrow in the call market.

The second main characteristic is the sharp increase in the volume of funds borrowed or lent in the call money market after 1959-60. This is due to sharp increase in credit demands following the stepping up of investment activity and the consequent pressure on the resources of banks. The call money rate has also gone up sharply. Up to 1959, the call money rate seldom went above the Bank Rate because of generous financial accommodation made available by the State Bank. Since the imposition of the Quota System in 1963 on scheduled banks' borrowings from the State Bank, the maximum call rate has generally exceeded the Bank Rate during the subsequent busy seasons. It even exceeded the 'top slab' rate of the State Bank.

TABLE 3-9. The Call Money and the Call Money Rates.

(Rs. in million)
(Rate % per annum)

Fiscal Year (July-June)	Call Money		Call Money Rate	
	Minimum	Maximum	Minimum	Maximum
1954-55	28	85	0.50	2.50
1955-56	38	122	0.50	3.00
1956-57	47	128	0.75	3.50
1957-58	85	173	0.50	3.00
1958-59	49	145	0.25	2.75
1959-60	31	146	0.50	4.50
1960-61	107	246	1.50	4.75
1961-62	149	327	2.75	4.00
1962-63	223	340	2.25	3.50
1963-64	218	362	1.75	4.50
1964-65	208	367	2.50	7.25
1965-66	234	539	3.75	7.00

Source: The State Bank of Pakistan, Annual Reports on Currency and Finance.

Chapter 4.

THE OPERATION OF THE SCHEDULED BANKS IN PAKISTAN.

In the last chapter we described the role of the State Bank in the growth of the banking system. The object of this chapter is to analyse the performance of the scheduled banks, which constitute the largest segment of the monetary system In the first section we shall describe the growth of the assets of banks over time in absolute amount and in relation to the deposit liabilities of the banks and the factors influencing their growth. In the second section, we shall enquire into the distribution of banks' earning assets, viz. bank credit and investments, into claims on the public and private sectors and the reasons for their relative importance over time. In the third part, we shall discuss the sources of funds, namely bank deposits and borrowings from the State Bank. We shall examine in some detail the relative roles of increase in interest rates on deposits and the branch expansion programme of the scheduled banks in the mobilisation of deposits.

I

1. Cash Assets

The cash assets of an individual bank consist of cash in tills, balances with the central bank, and balances with other banks. For the banking system as a whole, only the first two assets are relevant. Banks can increase their cash assets either by borrowing from the central bank or by selling some of their assets to it or finally by inducing the public to hold less cash and more bank deposits. The balances with the central bank consist of statutory reserves and excess reserves. We shall concentrate on the excess reserves and cash in tills, first, because it is only the excess reserves upon which the banks can draw to accommodate customers' demand for cash, and secondly, because the analysis of banks' attitude towards cash assets over time would not be affected by changes in legal reserve requirements.

Once the banks have, by experience, come to establish a safe ratio between deposit liabilities and cash assets, it is in the interest of banks from the point of view of profitability to keep it stable at that level. This, however, presupposes the presence of two conditions. First, there is an active market for short-term funds. Secondly, the banks can have resort to central bank finance in times of emergency. Even in the presence of these conditions, the cash ratios may not be stable. This is because the banks are all the time trying to keep balance between considerations of liquidity and profitability. If there is an increase in demand for credit, the banks might try to squeeze their cash reserve ratio and at other times they may let it rise a little higher The actual cash ratio at a time may vary from bank to bank depending on its attitude to liquidity and the supply of secondary reserves.

The absolute amount of cash assets held by banks rises with the increase in deposits, though not necessarily in the same proportion. In order to remove this secular trend, the cash assets in Table 4-1 have been presented as a ratio to deposit liabilities (general, i.e. non-bank deposits).

The data regarding cash assets of the scheduled banks shows two distinct trends. Firstly, the ratio of cash assets, i.e. cash in tills plus excess reserves, to deposit liabilities (general) has declined from 14.9 per cent in 1948-49 to 3.3 per cent in 1960-61. Since then it has become almost stable at that level. The break-up of cash assets reveals that the decline in cash in tills in relation to deposit liabilities up to 1959/60 has been steady but small. Since then the ratio has edged up, but it is far below the level prevailing in the earlier years. The excess reserves, on the other hand, have registered a sharp decline over the period under study. The main reason, as we shall see, is that the sharp increase in the demand for bank credit has not been accompanied by a commensurate increase in deposit resources. It has induced the banks to economise in their reserves. Secondly, it is evident from table 4-2 that the wide seasonal fluctuations in the excess reserves, which characterised the banking system up to 1959/60, have declined substantially. Moreover, the net free reserves of banks have completely disappeared since 1961.

TABLE 4-1 Ratio of Cash Assets of the Scheduled Banks to Total Bank Deposits (General).

	All Scheduled Banks			Pakistani Banks	Foreign Banks
	Cash in Tills	Excess Reserves	Cash in Tills plus Excess Reserves	Cash in Tills + Balances with the State Bank	Cash in Tills plus Balances with the State Bank
1948-49	3.4	11.5	14.9	N.A.	N.A.
1949-50	3.2	10 0	13.2	N.A.	N.A.
1950-51	3.1	4.1	7.2	N.A.	N.A.
1951-52	3.2	6.2	9.4	N.A.	N.A.
1952-53	2.9	4.2	7.1	10.9	14.7
1953-54	2.6	4.0	6.6	9.9	13.7
1954-55	2 5	2.7	5 2	9.9	12.7
1955-56	2.3	3.5	5 8	9.7	13.5
1956-57	2.3	3.2	5.5	9.3	11.1
1957-58	2.2	2.5	4 7	10.1	10.1
1958-59	2.2	2.8	5.0	10 8*	10.6*
1959-60	2.1	2.4	4.5	10.1	9.3
1960-61	2 2	1.1	3.3	8.7	7.9
1961-62	2.3	1.0	3.3	9.1	7 8
1962-63	2.3	1.1	3.4	N.A.	N.A.
1963-64	2.5	0.9	3.4	10 1	9.1
1964-65	2 3	0.7	3.0	N.A.	N.A.
1965-66	2.4	0.8	3 2	9.9	8.9

Source The State Bank Annual Banking Statistics of Pakistan.

1) The ratios in the first three columns are calculated from the weekly average figures of cash assets and bank deposits (general) as reported in the Weekly Statements of the Scheduled Banks.

2) The ratios in the last two columns are based on the quarterly average figures as reported in the Quarterly Balance Sheets of the Scheduled Banks. These two columns are not comparable with the first three, as the cash assets here include cash in tills plus entire balances with the State Bank. As the main purpose of these two columns is to compare the relative position of Pakistani and foreign banks, and the statutory reserve requirements are the same for both Pakistani and foreign banks, this change in definition should not make any difference.

* The rise in the reserve ratio during 1958-59 was largely due to unearthing of hidden wealth, which was being used for the purpose of black marketing, smuggling and hoarding of goods. These activities ....

/continued.

The study of cash reserve policies of Pakistani and foreign banks separately reveals that up to 1956/57 the foreign banks were maintaining a larger ratio of cash assets to total deposit liabilities (general). Since then they have maintained a somewhat lower ratio compared to Pakistani banks. The main reason for this change is that the Indian banks, which were an important segment of foreign banks up to 1956/57, have declined in importance. We have seen in Chapter 3 that the Indian banks keep a very high cash ratio. So with their decline, the ratio for foreign banks has gone down.

It would be of interest to compare our findings with those of Professor Porter [1] Our conclusions differ from those of Professor Porter on two counts. The first difference relates to the behaviour of ratio of cash in tills to deposit liabilities (general) for all banks While Professor Porter found no trend in it, table 4-1 shows a definite declining trend. This difference in results may be attributed to the fact that he took into consideration the position of banks as on the last Friday of December each year, while we are comparing the weekly averages of the fiscal year But the ratio, based on the figures for the last Friday of June each year, also shows a

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... were restricted, for the time being, after the imposition of Martial Law in 1958, and the hidden wealth came to surface after the declaration of Tax Amnesty Scheme. This, firstly, increased the liquidity of banks. Secondly, it reduced the demand for bank credit in the short run.

N.A. = Not Available.

1). Porter, R.C., Liquidity and Lending. The Volume of Bank Credit in Pakistan, The Institute of Development Economics, Karachi, 1963, pp.80-85.

TABLE 4-2. Excess Reserves and Net Free Reserves of Scheduled Banks
(Weekly Averages)

(Rs. in million)

	Excess Reserves					Net Free Reserves*				
	1948-49	1955-56	1958-59	1961-62	1964-65	1955-56	1958-59	1961-62	1964-65	1965-66
Fiscal Year (July-June)	122	64	70	34	30	23	41	- 412	- 1077	- 1224
July-September	185	86	133	31	53	100	153	- 279	- 533	- 1291
October-December	100	37	33	23	21	- 10	- 44	- 354	- 953	- 1304
January-March	79	37	32	31	24	- 93	- 64	- 571	- 1344	- 1390
April-June	123	97	84	51	24	95	118	- 445	- 1476	- 912

Source The State Bank of Pakistan - Annual Reports on Currency and Finance.

* Net Free Reserves = Cash in Tills + Excess Reserves - Borrowings from the State Bank.
The figures with minus sign indicates 'net borrowed reserves'.

declining tendency On average, it has gone down from 0.0304 during 1949-60 to 0.0257 in 1961-66. Moreover the range between which the ratio varies has also narrowed from 0.022 - 0.045 in the first period to 0.024 - 0.027 in the second period. There is bound to be some fluctuation in the ratio as the decisions are made daily by hundreds of branch managers and it is humanly impossible, with all the efficiency and effort to economise on reserves, to keep the cash ratio daily stable at the lowest level.

Secondly, Professor Porter came to the conclusion that the ratio of cash assets to deposits in the case of foreign banks was about half that of Pakistani banks. He attributed this difference to the fact that "the foreign banks, with almost no increase in branches over these years, were able to reduce, almost steadily, the cash ratio by half. This follows from elementary large-number theory if deposits (per branch) double, a bank need not as much as double its vault cash to cover the same degree of risk of temporary shortage. The branch expansion of the Pakistani banks has precluded them from sharing these economies of scale. Not only is their cash ratio double that of the foreign banks, but it is rising".[1] Table 4-1 shows that although the ratio is somewhat higher in the case of Pakistani banks since 1959-60, the difference is not as great as Professor Porter has indicated. He came to a different conclusion due to the fact that

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1. Porter, R.C., op.cit., pp.82-84.

he calculated the ratios of cash in tills to deposit liabilities for Pakistani and foreign banks separately. He found that the ratio in the case of Pakistani banks was more than twice that of foreign banks. Then he calculated the ratio of excess reserves to deposits for all banks jointly. This shows that he presumed that all banks had reduced the excess reserves to the same extent. This, however, is not the case. The Pakistani banks keep a larger proportion of their cash assets in the form of cash in tills while foreign banks keep a larger proportion of their cash assets by way of balances with the State Bank. In June 1964, the ratio of excess reserves to deposits in the case of foreign banks at 2.5 per cent was more than double that for Pakistani banks at 1.2 per cent. In June 1966, the ratios for foreign and Pakistani banks were 1.8 per cent and 0 9 per cent respectively. This is understandable. The foreign banks have their branches only in big cities, where the State Bank too has its branches. The Pakistani banks are scattered all over the country and have a large branch network. They are naturally inclined tokeep a larger portion of their cash assets in the form of cash in tills. It is, however, true that the ratio of total cash assets to deposit liabilities is somewhat higher in the case of Pakistani banks as compared with foreign banks.

2. Bank Credit to the Private Sector

The outstanding level of bank credit to the private sector, i.e. bank advances to the private sector plus bills purchased and discounted amounted to Rs. 372 million during 1948-49. The absorption of bank credit increased substantially by Rs. 386 million to Rs. 758 million during 1951-52. The sharp expansion in the volume of bank credit was almost entirely due to a rise in the volume and prices of exports and imports, following the post-Korean boom. The level of bank credit declined in the subsequent two years of recession to Rs. 751 million in 1953-54. After increasing marginally to Rs. 769 million in 1954-55, the outstanding level of bank credit increased sharply to Rs. 1,057 million in 1956-57 due to larger trade activity following devaluation in July 1955. The benefits of devaluation were soon lost due to inflation at home, which was a by-product of massive deficit financing. The exports started declining and the import restrictions were gradually tightened. As a result, the growth of bank credit slowed down up to 1958-59. Bank credit increased by Rs. 157 million during 1955-56, Rs. 131 million during 1956-57, Rs. 76 million during 1957-58, and Rs. 67 million during 1958-59.

The private sector of the economy absorbed additional credit at the rate of Rs. 83 million per annum up to 1958-59. The slow growth in bank credit over this period, in spite of steady increase in bank offices, was largely due to small increase in the demand for

TABLE 4-3. Bank Credit and Related Data. (Rs. in million)

Period (July-June)	Bank Credit to the Private Sector (1)	Advances to the Govt. Sector. (2)	Total Bank Credit. (3)	Ratio of Total Bank Credit to Total Deposits (General) (4)	Imports (5)	Exports (6)	Private Invest-ment (7)
1948-49	372	-	372	35.1	1,258	958	N.A.
1951-52	758	-	758	53.4	1,430	2,009	580
1953-54	751	-	751	49.3	735	1,286	690
1955-56	926	107	1,033	55.3	990	1,784	750
1958-59	1,200	153	1,353	55.0	840	1,325	890
1959-60	1,377	167	1,544	54.9	1,682	1,843	900
1962-63	2,992	315	3,307	80.2	2,800	2,247	2,640
1964-65	5,183	622	5,805	89.4	4,418	2,408	3,390
1965-66	5,921	586	6,507	90.0	3,363	2,718	3,330

Sources i) The State Bank - Weekly Statements of Scheduled Banks published in Reports on Currency and Finance.
ii) Government of Pakistan, Economic Survey, 1966-67.

N.B. The figures in column (3) are weekly averages for the fiscal year.
Figures in column (2) are averages of end-June and end-December figures.
Column (1) = Column (3) - Column (2).

bank credit. The following factors restrained the demand for bank credit. Firstly, the private sector, in the sense of the market economy, was not only small, it was working under a number of direct controls on the price and distribution of goods. This inhibited the demand for bank credit. Secondly, the limited availability of foreign exchange to the private sector restricted the level of private investment activity. Thirdly, there was an excessive liquidity in the economy due to large-scale deficit financing, which obviated the need for bank credit. Finally, the lending policy of banks, based as it was on the traditional criterion of credit-worthiness, was very conservative. This is evident, firstly, from a very high percentage of credit to commerce in early years, and secondly, from the concentration of about 63 per cent of bank credit in only 222 accounts in March 1959.

In short, the growth in bank credit to the private sector up to 1958-59 was small and fluctuated more in sympathy with foreign trade than any other factor Secondly, the rate of expansion of bank credit to the private sector during this period was determined by the demand for bank credit - which satisfied the strict credit-worthiness criterion.

The situation changed radically after 1958-59. The absorption of bank credit over the next seven years was pronouncedly higher compared to earlier years. The average annual growth of bank credit to the private sector at Rs. 674 million was more than eight times that in the preceding decade. This, however, conceals the fact that the annual absorption of bank credit increased steadily from Rs. 177 million in 1959-60 to Rs. 1,392 million in 1964-65 It came down to Rs. 738 million in 1965-66. The factors contributing to the sharp increase in bank credit, among others, were the following (i) The government removed direct controls on the price and distribution of a number of essential commodities in 1960 This process of liberalisation of the economy from direct controls was maintained in the later years. (ii) The most important factor was the increase in private investment (at current prices), which rose steadily from Rs. 890 million in 1958-59 to Rs. 3,390 million in 1964-65. (iii) Exports more than doubled over this period due to fast expansion of the industrial sector and the break-through in the previously almost stagnant agricultural production. (iv) Imports on private account increased almost four times. This was made possible by larger export earnings and a substantial increase in foreign aid.

As a result of the factors mentioned above, there was an upsurge in the demand for bank credit. The nature of demand for credit was such that it met the most conservative standards of the 'commercial loan' theory. First, with the expansion of the industrial sector, the banks were faced with an increasing demand for working capital The loans for working capital are in line with the theory.

Secondly, the increase in demand for bank credit arising out of larger exports and imports also satisfied this criterion The increase in demand for credit was so large that the banks felt constrained to satisfy it. First of all, they economised on their cash reserves. This we have discussed above. Secondly, they took increasing recourse to borrowings from the State Bank. In the first decade, they used to borrow from the State Bank at the peak of the busy season. In the slack season, they were left with surplus funds. After 1960, however, their indebtedness to the State Bank became a permanent feature. Not only that, their 'net borrowed reserves' increased tremendously after 1963 and, on average, amounted to Rs. 1,224 million during 1965-66 (see table 4-2)

Advances to the Government Sector.

The central and provincial governments borrow from the banks under the 'counter-finance' scheme for the purpose of state trading. The 'counter-finance' scheme was introduced in 1954 when government undertook large-scale foodgrain procurement operations. Under this scheme, the commercial banks provide financial assistance to the government and in lieu thereof are entitled to assistance from the State Bank. Originally, it was expected that the banks would meet the government demand for funds mainly from their own resources and would turn to the State Bank for marginal assistance. However, with the tightening up of their liquidity position in recent years, the banks are financing government almost wholly by means of borrowings from the State Bank. Under these circumstances, the government borrowing from the commercial banks is tantamount to borrowing from the State Bank. The government borrowings under 'counter-finance' scheme increased considerably from Rs. 4.9 million in 1956-57 to Rs. 622 million in 1964-65. At this level, they constituted about 11 per cent of total bank credit. This is in spite of the fact that the foodgrain trade was transferred to the private sector in 1959-60

We would mention briefly only three points regarding government borrowings from the banks under this scheme. (i) Professor Porter has asked that "why governments prefer to borrow from commercial banks instead of issuing ad hoc bills to the State Bank is a mystery"[1] This is partly because the bulk of the borrowing under this scheme is by the provincial governments, who are not entitled to issue ad hocs. Secondly, the government considers borrowing from commercial banks, as against the central bank, less inflationary.

(ii) The second point concerns the effect of government borrowings from banks on the availability of credit to the private sector. Dr. Meenai has suggested that, "in spite of supporting facilities from the State Bank, the greater claim of Government on

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1. Porter, R.C., op.cit., p.54.

commercial bank credit has had the effect at least technically of reducing the availability of credit to the private sector This is for the reason that the total assistance that the State Bank provides to the banks is determined in the light of the overall monetary situation. Moreover, commercial banks also operate with due regard to the overall size of their indebtedness to the State Bank".[1] The following factors, however, indicate that government borrowing from the banks under this scheme does not affect the availability of credit to the private sector.[2] The government borrows mainly from the National Bank of Pakistan and to a small extent from the Habib Bank and the Eastern Mercantile Bank. The State Bank has to ensure that it should not in any way affect the capacity of these banks to extend credit to the private sector relative to other banks. Otherwise, it would have one of the two effects. Firstly, these banks would refuse to lend to the government. Secondly, if they are forced to lend, it would be discrimination against them, and the central bank simply cannot afford discrimination in its dealings with the banks.

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1. Meenai, S.A , 'Pakistan' in W.F Crick, Commonwealth Banking Systems, Oxford University Press, 1965, p.276.

2 We shall discuss the implications of government borrowings from the commercial banks under the counter-finance scheme for the credit control policies of the State Bank in the next chapter.

(iii) The scheduled banks make advances to the government at or below Bank Rate. The State Bank, in turn, provides counterfinance at a concessional rate of interest to the banks. To be more precise, the rate of interest charged by the Bank is one-half per cent below that charged by banks from the government to cover their costs.

3. Investments.

The data regarding investments of banks is not available up to 1952. In 1953, the investments of banks stood at Rs. 590 million. Thereafter, excepting 1960-61, the investments kept on increasing steadily and reached the level of Rs. 1,961 million in 1965-66. The yearly accretions to investments, for reasons discussed in the second part of the chapter, ranged between 2.7 per cent and 20.4 per cent. The bulk of the investments consists of government securities. Their investments in private securities remained very small until 1961-62. This year, however, marks a turning point in the attitude of banks. Since then, they have stepped up investment in private shares and consequently their share in total investments has gone up from 3 per cent in 1961-62 to 15 percent in 1965-66.

The ratio of investments to total deposits (general) remained fairly high up to 1959-60. Thereafter, it declined steadily from 44 per cent in 1959-60 to 27 per cent in 1965-66. The decline in the ratio of investments to deposits is mainly explained by the

TABLE 4-4: Investments of Scheduled Banks

(Rs. in million)

	Investments @			Ratio of		Maturity Distribution of Investments in Govt. Securities*				
						Treasury Bills	Securities Maturing in			
	Govt. Securities	Others	Total	(2) to (3)	(3) to Total Deposits (General)		Under 5 years	5 to 10 Years	10 to 15 Years	Over 15 years
							Percent			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1952-53	567	23	590	3.9	45.0		40	55	2	3
1953-54	611	20	631	3.1	41.4	8	64	25	2	1
1954-55	699	20	719	2.8	42.8	8	72	17	2	1
1955-56	771	21	792	2.6	42.4	8	78	12	2	-
1956-57	819	18	837	2.1	42.3	6	81	9	4	-
1957-58	930	23	953	2.4	42.7	7	87	4	2	-
1958-59	1,021	31	1,052	2.9	42.7	4	75	7	14	-
1959-60	1,201	32	1,233	2.6	43.8	-	75	7	18	-
1960-61	1,290	32	1,322	2.4	42.8	-	66	15	19	-
1961-62	1,264	35	1,299	2.7	38.6	-	75	18	7	-
1962-63	1,251	84	1,335	6.2	32.3	-	77	18	5	-
1963-64	1,393	105	1,498	7.0	29.4	-	72	26	-	2
1964-65	1,608	195	1,803	10.8	27.8	-	54	36	3	7
1965-66	1,671	290	1,961	14.8	27.1	-	55	33	7	5

Source: The State Bank: i) Annual Banking Statistics of Pakistan.
ii) Reports on Currency and Finance.

@ The figures of total investment and its components are weekly averages.

* The percentage distribution of investments in govt. securities by maturities is based on the end-June figures of every financial year.

expansion of economic activity and the consequent rise in the demand for bank credit. Banks have modified their asset structure in favour of advances, which are more remunerative, by absorbing less of the new government issues offered. Secondly, it seems that the banks since recently are adopting somewhat bolder lending policies. This is evident from substantial increase in their holdings of private scripts.

The distribution of scheduled banks' holdings of government securities by maturity shows a trend towards securities of longer maturities. The treasury bills, which had declined from 8.5 per cent of the total investments in government securities in 1954 to 4 per cent in 1959, disappeared altogether from bank portfolios afterwards, except for a short period in 1962. The reason for shift to longs seems to be higher yield of these securities. The banks in advanced countries generally prefer shorts because they are afraid of capital loss on longs due to rise in interest rates. The banks in Pakistan have no fear of capital loss because the State Bank has all along been supporting securities market. Secondly, whatever the maturities, the securities are, for all practical purposes, quite liquid for banks as they can borrow against them from the State Bank.

II

Distribution of Banks' Earning Assets into claims on private and public sectors

The classification of scheduled banks' earning assets into claims on public and private sectors is quite revealing. The claims on the private sector constituted 57.9 per cent of total earning assets of banks in 1952-53. Their share came down to 48.3 per cent in 1954-55. After increasing to 55.3 per cent in 1956-57, their share again fell to 50.7 per cent in 1959-60. Thereafter, the claims on the private sector started mounting and their share in the total earning assets increased to 73.3 per cent in 1965-66. The reverse happened in the case of claims on the public sector. The break-up of claims on the public sector into investments in government securities and advances to the government sector shows that the latter have gained in importance in recent years relative to investments in government securities. The ratio of bank advances to the government sector to investment in government securities declined from 20 9 per cent in 1954-55 to 6.0 per cent in 1956-57 and then increased steadily to 38 7 per cent in 1964-65. It came down to 35.1 per cent in 1965-66

How do banks distribute their earning assets between the private and public sector, keeping in view the facts that banks want to maximise profits, the advances to the private sector are more profitable compared to investment in government securities or advances to the government, and the difference in yields exceeds the margin to cover the risk differential ?

The law requires banks to maintain minimum cash reserve and liquidity ratios. Under the latter restraint, the banks are required to keep 20 per cent of their demand and time liabilities in the form of cash in tills, balances with the State Bank and unencumbered approved securities. The cash in tills and balances with the State Bank, which also serve the purpose of cash reserve ratio and working balances, earn no income. The rest of the assets, to fulfil the condition of liquidity ratio, are held in the form of government securities. If the investments of the banks in government securities are at a much higher level than is warranted by liquidity ratio considerations, then there can be two explanations for it. Firstly, given the inflexible standard of credit-worthiness, there is inadequate demand for bank credit in the private sector. Secondly, if the demand for bank credit in the private sector is there, then the only possible explanation can be the coercion from the central bank forcing the banks to invest in government securities more than they would have willingly done.

Up to 1961-62, the banks were holding government securities in their portfolios far in excess of the liquidity ratio requirements.[1] We shall now enquire into this seemingly unprofitable portfolio distribution and try to determine which of the two factors mentioned above, viz. the coercion of the State Bank or the lack of demand for credit, was responsible for it. We shall concentrate on

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1. Porter, R.C., Liquidity and Lending, op.cit., 1963, pp.

the portfolio policies of scheduled banks as a whole.[1] Professor Porter, while analysing this problem, had come to the conclusion that "some one-fourth of the Scheduled Banks' assets are held for reasons which can be only partly explained by economic analysis Some of these securities they are required to hold by law (for the liquidity ratio requirements), the rest are held for a mixture of largely non-economic reasons, mostly because of State Bank pressure".[2]

His argument is based on two factors The banking system, including the State Bank, holds 92 per cent of the marketable government debt. So if the State Bank wants to sell securities, it can place them only at the doors of the scheduled banks. Conversely, the scheduled banks, as a whole, can sell securities only to the State Bank. The liquidity of the securities in the portfolios of banks thus depends solely on the willingness of the State Bank either to purchase securities at the initiative of banks, or to monetise these securities by making advances against their collateral. In addition to the lack of broad-based securities market, the actual yield on government securities is below the equilibrium yield so that the State Bank has "to force the Scheduled Banks to hold more securities than they wish".[3]

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1. For the estimates of liquidity ratios for Pakistani and foreign banks separately, see Porter, op.cit , pp 94-100.

2. Porter, op.cit., p.28.

3. Porter, op.cit , p 21.

TABLE 4-5 Scheduled Banks' Claims on the Government and Private Sectors.

(Rs. in million).

Period (July-June)	Claims on Govt. Sector[a]	Claims on Private Sector[b]	Change in (1)	Change in (2)	Ratio of (1) to (1 + 2)
	(1)	(2)	(3)	(4)	(5)
1949-50	481*	469	-	-	50.6
1950-51	514*	677	+ 33	+ 208	43.2
1951-52	462*	758	- 52	+ 81	37.9
1952-53	567	779	+ 105	+ 21	42.1
1953-54	611	771	+ 44	- 8	44.2
1954-55	845	789	+ 234	+ 18	51.7
1955-56	878	947	+ 33	+ 158	48.1
1956-57	868	1,075	- 10	+ 128	44.7
1957-58	1,009	1,156	+ 141	+ 81	46.6
1958-59	1,174	1,231	+ 165	+ 75	48.8
1959-60	1,368	1,409	+ 194	+ 178	49.3
1960-61	1,406	1,794	+ 38	+ 385	43.9
1961-62	1,596	2,340	+ 190	+ 546	40.5
1962-63	1,566	3,075	- 30	+ 735	33.7
1963-64	1,803	3,896	+ 237	+ 821	31.6
1964-65	2,231	5,378	+ 428	+1,482	29 3
1965-66	2,257	6,210	+ 26	+ 832	26.7

Source i) State Bank of Pakistan - Annual Reports on Currency and Finance.
ii) Government of Pakistan - Economic Survey, 1966-67.

* Estimated.

a) Investment in government securities plus advances to the central and provincial governments.

b) Advances to the private sector, bills purchased and discounted and investment in private shares and debentures.

In support of his argument, he points to the following empirical evidence. First, he found that in the years of 'tight' liquidity position, the National Bank of Pakistan absorbed relatively more securities compared to other banks. In the years of 'comfortable' liquidity position, the roles were reversed. This, according to Professor Porter, shows that during the years of tightness the State Bank was unable to coerce the banks to absorb all securities, which it wanted to place with them. Thus, the National Bank of Pakistan, which we have seen in Chapter 3, has a special relationship with the State Bank, absorbed lion's share. Secondly, he found "some slighter evidence that the State Bank itself holds a larger share of the securities when the Scheduled Banks show reluctance".[1]

Professor Porter's contention that the State Bank forced the banks to hold a larger amount of government securities in their portfolios is not altogether supported by the evidence. The portfolio policies of banks were neither irrational nor uneconomic. The real reason seems to be the lack of 'eligible' demand for bank credit from the private sector. As the demand for bank credit increased after 1958-59, the share of bank advances to the private sector in the total earning assets of banks started rising. On the other hand, the ratio of investments to total earning assets declined

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1. Porter, op.cit., pp.22-23.

to 19.2 per cent in 1965-66. Andrus and Mohammed have suggested that "this was achieved by investing at a diminishing rate in government securities as deficit-financing operations were curtailed".[1] This is partially true. The banks did invest at a diminishing rate, but on average there has been no decline in the deficit financing. The annual average gross deficit financing during 1960-66 was Rs. 505 million compared to the annual rate of Rs. 453 million during 1955-60 and Rs. 294 million in 1950-55[2] This shows that with an increase in 'eligible' demand for bank credit, the banks were able to raise the share of loans to the private sector in their total assets, in spite of increase in deficit financing.

The second pointer to the lack of demand for credit is the behaviour of the excess reserves of the banks. The banks on average kept relatively large excess reserves up to 1958-59. Once the demand for credit increased, the excess reserves were almost complately wiped out [Table 4-1]. The position of 'net free reserves' also confirms one hypothesis. In the early years, the banks used to have substantial 'net free reserves' in the slack season. Now they are continuously depending on 'net borrowed reserves'. [Table 4-3].

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1. Andrus, J.R. and A.F. Mohammed, Trade, Finance and Development in Pakistan, Oxford University Press, London, 1966, pp.116-117.

2. The figures of deficit financing are the net increase in the claims of banks, including the State Bank, on the central and provincial governments, without adjustment for accretions to counterpart funds.

The banks in Pakistan, as we shall see below, can borrow from the State Bank against, among others, the collateral of government securities. The upper limit to borrowings against government securities is set either (a) by their holdings of government securities above the liquidity requirements, or (b) by the State Bank which, to be an effective restraint, should be below the excess holdings of securities by the banks. If the banks have excessive securities and do not fully utilise the limit sanctioned by the State Bank for borrowing, then the only possible explanation can be lack of profitable opportunities to utilise these funds. The maximum borrowings of banks from the State Bank against government securities were Rs. 56 million in 1958-59 and Rs. 203 million in 1961-62 against the sanctioned limits of Rs. 315 million and Rs. 576 million respectively.[1]

III

Sources of Funds

Bank Deposits

The bank deposits of scheduled banks in Pakistan are classified into two main categories, viz. demand deposits and time deposits. The demand deposits consist of 'current deposits', 'call

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1. Meenai, S.A., An Appraisal of the Credit and Monetary Situation in Pakistan, The State Bank Press, Karachi, 1962, p.34.

deposits' and that part of 'savings' and 'other deposit accounts' which can be withdrawn on demand. The time deposits include all fixed deposits and that part of 'savings' and 'other deposit accounts' which is liable to payment after a notice. The policies of banks regarding withdrawal of savings deposits are not consistent. Some of the banks limit the number of withdrawals per week and the others put limit on the amount which can be withdrawn in a week without notice. In the case of former banks, the amount under 'savings' and 'other deposit accounts' is divided into demand and time deposits according to a set ratio determined by each bank in consultation with the State Bank. In fact, the holders of all kinds of deposit accounts, except fixed deposits, are issued with cheque books and the limits on the withdrawals on 'savings' and 'other deposit accounts' - whether by way of restriction on number of cheques drawn per week or amount drawn per week - are exercised in a very flexible manner.

Total bank deposits (general) increased at an annual rate of Rs. 117 million or (8.9 per cent) from 1949 to 1955. The growth of bank deposits rose to Rs. 231 million per annum (or 10.6 per cent) during the five years ending June, 1960. In the following six years, the rate of growth accelerated further to Rs. 841 million (or 18.2 per cent) per annum. The break-up of total deposits into demand and time deposits reveals that the time deposits formed only 17.0 per cent of total deposits in 1949. The ratio of time deposits to total deposits increased to 29.0 per cent in 1955 and edged up to 32.1 per cent in 1960. Afterwards, it went up sharply to 50.6 per cent in 1966. This is due to the fact that the marginal ratio of time deposits to total deposits at 47.7 per cent up to 1955 , at 37.0 per cent up to 1960 and at about 61.3 per cent thereafter, was well above the average ratio.

We shall now enquire how far the growth of bank deposits was the result of an increase in reserve money and the desire on the part of banks to acquire more earning assets The banks can materialise their desire to increase their earning assets and liabilities by (i) economising on their cash assets, (ii) inducing the public to hold more deposits and less currency, and (iii) by borrowing from the State Bank. The banks can induce the public to hold a larger proportion of their liquid assets in the form of deposits by spreading the network of their offices and by offering a higher rate of interest on deposits. Moreover, we shall examine the factors underlying the larger growth rate of time deposits compared to both demand deposits and currency in circulation.

Total bank deposits (general) increased by Rs. 1,743 million in the decade ending June, 1960. Over the same period, bank credit increased by Rs. 1,126 million. The growth of bank deposits at the rate of more than one and a half times the growth of bank credit indicates that the increase in bank deposits up to 1960 was not due to the desire on the part of the banks to acquire more earning

TABLE 4-6 Bank Deposits (General)

(Rs. in million)

June (Last Friday)	Total Bank Deposits			Demand Deposits			Time Deposits		
	Amount	Change	Percentage Change	Amount	Change	Percentage Change	Amount	Change	Percentage Change
1950	1,200			1,000			200		
1951	1,375	+ 175	+ 14.6	1,098	+ 98	+ 9.8	277	+ 77	+ 38.5
1952	1,288	- 87	- 6.4	1,045	- 53	- 4.8	243	- 34	- 12.4
1953	1,422	+ 134	+ 10.4	1,118	+ 73	+ 7.0	304	+ 61	+ 25.1
1954	1,635	+ 213	+ 15.0	1,202	+ 84	+ 7.5	433	+ 129	+ 42.6
1955	1,790	+ 155	+ 9.5	1,270	+ 68	+ 5.7	519	+ 86	+ 19.9
1956	1,995	+ 205	+ 11.5	1,431	+ 161	+ 12.7	564	+ 45	+ 8.5
1957	2,059	+ 64	+ 3.2	1,490	+ 59	+ 4.1	569	+ 5	+ 0.9
1958	2,389	+ 330	+ 16.1	1,689	+ 199	+ 14.1	700	+ 131	+ 23.1
1959	2,623	+ 234	+ 9.8	1,870	+ 181	+ 10.7	753	+ 53	+ 7.6
1960	2,943	+ 320	+ 12.2	1,997	+ 127	+ 6.8	946	+ 193	+ 25.6
1961	3,218	+ 275	+ 9.3	1,991	- 6	- 0.3	1,227	+ 281	+ 29.7
1962	3,697	+ 479	+ 14.9	2,190	+ 199	+ 10.0	1,507	+ 280	+ 22.8
1963	4,715	+1018	+ 27.5	2,780	+ 590	+ 26.9	1,935	+ 428	+ 28.4
1964	5,706	+ 991	+ 21.0	3,274	+ 494	+ 17.8	2,432	+ 497	+ 25.7
1965	6,883	+1177	+ 20.6	3,655	+ 381	+ 11.6	3,228	+ 796	+ 32.7
1966	7,988	+1105	+ 16.0	3,949	+ 294	+ 8.0	4,039	+ 811	+ 25.1

Source State Bank of Pakistan - Reports on Currency and Finance.

assets. The decline in the ratio of bank reserves (cash in tills plus balances with the State Bank) to total reserve money (currency in circulation with the public plus bank reserves) from 0.096 in June, 1950 to 0.085 in June, 1955 and further to 0.061 in June,1960, and the presence of net free reserves in the portfolio of banks amounting to Rs. 106 million in June, 1960, also seem to lend support to this view

The main source of increase in bank deposits seems to be the high rate of expansion of reserve money, which increased by Rs 2,145 million largely due to purchase of government debt by the State Bank. As a result of money creating operations of the government, bank resources were plentiful and funds flowed into the banks without much effort. Interest rates on deposits were exceptionally low and there was virtually no competition amongst banks on deposits. While making over its savings to it, the private sector, for reasons discussed earlier, was unable to make a substantial demand on the resources of the banking system.[1]

The rise in bank deposits was much faster than that of national income up to 1955 for a number of reasons. The first factor seems to be the desire of the public to build up their cash balances after the tremendous political and social upheaval of Independence and

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1. Meenai, S.A., Banking System of Pakistan, The State Bank Press, Karachi, 1964, p.31.

Partition. In the immediate poást-Independence period 'currency and bank deposits were probably not even the most liquid of assets, and they were certainly not the least risky. From a time when money balances were mistrusted and even eschewed there was undoubtedly a long period of rising desires for real balances (and for those near moneys which complement a stable political environment, e.g. time deposits)'.[1] As a result, the increase in both bank deposits and currency in circulation was far higher than the rise in Gross National Product at current factor cost. The average ratio of money supply (including time deposits) to G.N.P. increased from 0.144 in June 1950 to 0.200 in June 1955, the ratio of currency in circulation to G.N.P. increased from 0.083 to 0.117 and that of deposits from 0.061 to 0.083. The marginal ratio of money supply to G.N.P. was as high as 0.912, of this marginal ratio for currency was 0.545 and for deposits 0.367.

Another reason for the phenominal increase in the marginal ratio of bank deposits and currency in circulation to G N.P. seems to be the severe import restrictions after 1951-52, which led to a postponement of consumption and investment expenditures.[2] This was, firstly, due to lack of sufficient supply of competing domestic

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1. Porter, R C., "Income Velocity and Pakistan's Second Plan", The Pakistan Development Review, Summer, 1961, p.42, See also Andrus and Mohammed, op.cit., p.92.

2. Parvez Hazan, Deficit Financing and Capital Formation - The Pakistan Experience 1951-59, The Institute of Development Economics, Karachi, 1962, pp.20-26.

goods. Secondly, most of the essential commodities were subject to price and distribution controls.[1] This led to forced savings and the building up of cash balances. Moreover, the profits of importers and the small but growing industrial sector increased substantially. In the short run, there was a tendency towards hoarding of these profits. Furthermore, the shortages of goods and the price and distribution controls gave rise to a large black market. This partly explains the large increase in currency in circulation compared to bank deposits. By 1955, the domestic production of essential industrial consumer goods, especially cotton textiles, had increased substantially. Theimports of consumer goods under the U.S. commodity aid programme further relieved shortages. The postponed consumption expenditures, therefore, tended to increase in the subsequent period.

Professor Porter, for the first time, analysed in detail the role of the expansion of bank offices and the increase in interest rates on savings and fixed deposits in the mobilisation of deposit resources. The number of bank offices more than doubled from 202 in June 1950 to 430 in June 1960. The interest rates on savings and fixed deposits, however, remained very low and edged up only slightly. In fact, after the increase in Bank Rate from 3 per cent to

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1. For the analysis of the effect of price controls on the desired cash balances, see Porter, R C., op.cit., pp.43-47.

4 per cent in January 1959, the banks entered into an Agreement to the effect that no bank should raise its deposit rates beyond an agreed limit, which was kept very low. Professor Porter summed up his analysis in the following words "The banks prefer branch expansion to deposit-rate rises as the means of achieving this (mobilisation of deposit resources). But there is great doubt whether either of these methods can increase the propensity of the public to use bank deposits. For the banking system as a whole, the stability of the currency-deposit ratio makes it unlikely that new reserves can be uncovered in this way".[1]

The average annual increase in bank deposits at Rs. 841 million during July 1960 - June 1966, was almost five times that in the preceding decade. However, it was slightly above the growth in bank credit, which increased at an average annual rate of Rs. 829 million. This is in sharp contrast to the situation prevailing in the preceding decade when the growth of bank deposits was more than one and a half times that of bank credit. The analysis of growth in bank deposits over the third period reveals the following points The average ratio of total bank deposits to money supply increased substantially from 43.8 per cent in June, 1960 to 57.9 per cent in June, 1966. This was due to sharp increase in marginal ratio

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1. Porter, R.C., Liquidity and Lending, op.cit., p.50.

from 45.5 per cent in the first period to 70.8 per cent in the latter period. The ratio of time deposits to money supply more than doubled from 14.1 per cent in 1960 to 29.3 per cent in 1966. This increase took place almost entirely at the cost of currency in circulation. During 1966-67, the ratio of total deposits to money supply has gone up to 63.9 per cent and that of time deposits to 33.4 per cent. This shows that, contrary to the conclusion of Professor Porter, the banks were able to "increase the propensity of the public to use bank deposits".[1] The average ratio of deposits to G.N.P. at current factor cost rose significantly from 0 091 in 1960 to 0.148 in 1966 The ratio of currency in circulation to G.N.P., on the other hand, declined from 0 114 to about 0 106 over this period. The ratio of money supply to G.N.P. increased from 0.204 in 1960 to 0.253, almost entirely due to sharp increase in time deposits.

The State Bank of Pakistan has extended the scope of the published data since December 1961. Some aspects of the data regarding bank deposits, such as its distribution by ownership and types is available since September 1960. We shall base the analysis of the growth of bank deposits during 1960-66 on this quarterly published data.

The distribution of bank deposits by ownership reveals that the manufacturing and commerce accounted for only 9 per cent of

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1. Porter, R.C., op.cit., p.50.

TABLE 4-7: The Classification of Bank Deposits by Ownership and Types and Interest Rates on Deposits.

(Rs. in million)
(Interest percent per annum)

Ownership of Deposits	June, 1961	June, 1966	Change	Percent of Total Change
Foreign Constituants	319	562	+ 243	4.9
Government	527	1,625	+1098	22.0
i) Central and Provincial Govts	141	378	+ 237	4.7
ii) Govt. Agencies and Govt. Bodies	386	1,247	+ 861	17.3
Business	1,149	2,251	+1102	22.1
i) Agriculture	47	134	+ 87	1.7
ii) Manufacturing	245	389	+ 144	2.9
iii) Commerce	287	589	+ 302	6.1
iv) Others	570	1,139	+ 569	11.4
Trust Funds, Non-Profitable Organisations.	171	313	+ 142	2.8
Personal	992	3,398	+2406	48.2
Total Deposits	3,159	8,150	+4991	100.0

Types of Deposits	June, 1961	June, 1966	Change	Percent of Total Change	Weighted Average Interest June 1960	Weighted Average Interest June 1966	Rates up to 23rd June 1965	Banker's Association Rates introduced from 24th June, 1965	State Banks' Rates Announcement on Aug. 16th 1965	State Banks' Rates Announcement on Oct. 16th 1967
Current Deposits	1,523	2,645	+1,142	22.5	0.28	0.01				
Call Deposits	124	215	+ 91	1.8	2.01	1.83	2.25[*]	2.25[*]	2.25[*]	2.25[*]
Other Deposit Accounts	355	965	+ 610	12.2	0.53	1.87	2.50[@]	2.50[@]	2.50[@]	2.50[@]
Savings Deposits	390	1,757	+1,367	27.4	1.53	3.47	2.50	3.50	3.50	4
Fixed Deposits	767	2,567	+1,800	36.1						
i) Up to 6 months	236	559	+ 323	6.5	2.44	3.21	2.50	2.50	3.50	4
ii) 6 months to 1 year	393	1,123	+ 730	14.6	2.37	3.51	2.75	3.25	3.75	4
iii) 1 year to 2 years	116	169	+ 53	1.1	3.37	4.06	3	4	4	4.25
iv) 2 years to 3 years	19	108	+ 89	1.8	3.00	4.44	3.25	4.25	4.25	4.50
v) Over 3 years	3	608	+ 605	12.1	2.85	4.82	3.50[b]	4.50[b]	4.50[b]	4.50[b]
							4[c]	5[c]	5[c]	5[c]
Total Deposits	3,159	8,150	+4,991	100.0						

* Rates of interest on special notice accounts or deposits with-drawable at notice of up to 29 days.

@ Rates of interest on special notice accounts or deposits with-drawable at notice of up to 80 days or more.

b Rates of interest on fixed deposits for a period of 3 years to 4 years.

c Rates of interest on fixed deposits for 4 years and over.

N.B. It is permisslbe for the scheduled banks incorporated in Pakistan and falling under the following categories to quote rates of interest on deposits higher than those prescribed above, to the extent mentioned against each category:-

i) Banks having deposits up to Rs.150 million - 1 per cent above the prescribed rates; ii) Banks having deposits of over Rs.150 million but not exceeding Rs.300 million - $\frac{3}{4}$ per cent above the prescribed rates; iii) Banks having deposits of Rs.300 million but not exceeding Rs.500 million - $\frac{1}{2}$ per cent above the prescribed rates; The above rates apply to all deposits except inter-bank call deposits accepted from institutions already approved for the purpose.

the total increase in deposits At the same time, these two sectors claimed more than 75 per cent of the increase in bank advances This is understandable, These sectors are traditional borrowers and their working balances do not rise in proportion to the growth in their operations. In sharp contrast to this, the agricultural sector was net creditor to the banks. Its deposits at Rs. 134 million in June 1966 were one and a half times its borrowings from banks (excluding Agricultural Development Bank of Pakistan). This is due to conservative loan policies of banks. The deposits of 'other business' doubled over this period and accounted for 11.4 per cent of total increase in deposits. This category seems to include small traders and manufacturers.

The government sector was responsible for 22 per cent of the increase in deposits. In the government sector, the really sizeable increase took place in the deposits of the central and provincial government agencies and local bodies. The increase in their deposits is in line with the increasing role assigned to them in the execution of the development programme. The government is allocating funds to these agencies, such as Water and Power Development Authority and Pakistan Industrial Development Corporation, on an increasing scale for their projects. They deposit a part of these funds with the banks pending their utilisation. If the size of their deposits is related to their total budgets, it may appear that the ratio of deposits to total annual flows is not much larger.

The increase in bank deposits, although widely shared by all categories, was mainly due to a steep rise in personal accounts. The personal accounts were responsible for 48 per cent of the total increase in bank deposits and their ratio to total deposits improved from 31 per cent in June 1961 to 42 per cent in June 1966. The bulk of the personal deposits are in the form of interest-earning savings and fixed deposits. In June 1966, more than 75 per cent of personal deposits were in the form of these two categories of deposits. The analysis of growth of bank deposits by types corroborates this fact. Of the total increase in bank deposits, 63 5 per cent was in the form of savings and fixed deposits. Thus their ratio to total deposits increased from 36.6 per cent in June 1961 to 53.1 per cent in June 1966 Current and call deposits, on the other hand, accounted for only 24.3 per cent of the total increase in deposits.

The sharp increase in personal deposits is attributable largely to three factors, namely (i) the growth of national income, (ii) the expansion of the banking system, and (iii) the increase in interest rates on deposits. The paucity of the published data does not allow to quantify the effect of these factors individually. We can, however, arrive at some tentative conclusions by comparing the magnitudes of these factors.

(i) The G.N.P. at current factor cost increased by 43 per cent from 1960-61 to 1965-66 The increase in nominal per capita income was 25 4 per cent and in real per capita income only 14 1 per cent. The personal deposits, on the other hand, increased by 243 per cent This shows that, even if we expect a somewhat larger growth rate of deposits than income, the increase in national income explains only a small part of the rise in personal deposits.

(ii) The commercial banks in Pakistan believe that "their experience has clearly demonstrated that the only effective approach to the problem of deposit-mobilisation is to improve the coverage of the banking system by opening new branches".[1] The Credit Committee also came to the same conclusion. They recommended that "an essential requirement for developing new deposit resources is to extend the coverage of the banking system, particularly in the less developed areas ... The banks should be urged, even under compulsion, to spread out in the less developed areas ... The expansion of the banking system is of extreme importance in the drive for mobilising deposits".[2] Professor Porter, on the other hand, doubts that "the system as a whole can induce much shift from currency to deposits in this way".[3] Although it is difficult to quantify the role of branch

1. Meenai, S.A., op.cit., p.98.

2. Report of the Credit Committee, Government of Pakistan Press, Karachi, 1962, p.9.

3. Porter, R.C., Liquidity and Lending op.cit., p.49.

expansion in deposit-mobilisation in the absence of data regarding the amount and types of deposits that are placed in the new branches, we can form a rough idea from the published data. We can safely assume that the deposits in small town branches of banks are mostly personal and that bank accounts are used for the safe custody of savings, while current transactions are conducted mostly for cash.

The total number of commercial bank offices went up from 619 in June 1962 to 1,846 in June 1966. At the same time, bank deposits increased from Rs. 3,679 million to Rs. 8,150 million. The average deposits per office fell from Rs. 5.94 million in June 1962 to Rs. 4.41 million in June 1966, and the marginal deposits per office amounted to Rs. 3.64 million. The break-up of bank offices and deposits into 17 large city centres and the smaller towns reveals that the number of bank offices in the former group rose from 346 to 777 and the deposits increased from Rs. 3,428 million to Rs. 6,498 million. In the latter group, the number of offices went up from 273 to 1069 and the deposits increased from Rs. 431 million to Rs 1,652 million. The following points of interest emerge from these statistics. (i) The average deposits per office in smaller towns were almost one-sixth of that in the centres. (ii) Although the smaller towns claimed 65 per cent of the increased in the number of bank offices, their contribution to the increase in deposits was 27 per cent only. Their average share in total deposits, however, increased from 11.7 per cent in June 1962 to 20.3 per cent in June 1966. (iii) The average deposits per office remained stable in the smaller towns while they recorded 11 per cent decline in the case of larger cities.

The increase in the ratio of deposits mobilised in the smaller towns to total deposits and the stability of average per office deposit in that group shows that the spreading out of banks in the interior of the country has helped in the mobilisation of deposits. The increase of Rs. 1,221 million in deposits in smaller towns compared to the rise in Rs. 496 million in bank credit there shows that a greater part of these deposits was transferred to cities. The decline in the average deposits per office in the large city centres and comparatively a very low amount of deposits per office in the smaller towns, on the other hand, shows that an exclusive reliance of banks on branch expansion for deposit-mobilisation may yield decreasing returns.

(iii) The deposit rates in Pakistan are quite low. The weighted average rate of interest on deposits in December 1961 was as low as 1.14 per cent. Since then there has been an upward movement in interest rates on deposits and the weighted average rate of interest has almost doubled. The best part of this increase took place in 1965-66, the weighted average deposit rate rose from 1.57 per cent in June 1965 to 2.23 per cent in June 1966. This is because after an increase in Bank Rate from 4 per cent to 5 per cent in June 1965 the State Bank directed the banks to increase their deposit rates on savings and fixed deposits by one per cent.

The commercial banks in Pakistan, until recently, were opposed to the rise in deposit rates.[1] They came to believe from their experience that deposits were interest-inelastic[2] For that reason, when the Bank Rate was raised from 3 per cent to 4 per cent in January 1959, the banks entered into an agreement to the effect that no bank should raise deposit rates beyond an agreed limit. The belief in the inelasticity of deposits to interest rates rested on the high and stable ratio of currency to money supply up to 1958. Strangely enough, in spite of stable currency-money supply ratio, the banks argued that their branch expansion programme had been successful in mobilising deposits. At the same time, they argued that while increase in deposit rates would not attract fresh deposits, it would re-allocate existing deposits in favour of interest-bearing savings and fixed deposits. This would increase the average cost of existing amount of deposits and would reduce the profits of banks. The reduced profits of banks would make it difficult for them to expand their network, which, in turn, would hamper their deposit-mobilisation effort. The banks, in fact, were suggesting that while actual depositors were interest-conscious, the potential depositors

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1. Porter, R.C., Liquidity and Lending, op.cit., p.45.

2. Meenai, S.A., (i) An Appraisal of the Credit and Monetary Situation in Pakistan, State Bank Press, Karachi, 1962,pp.95-99, 122-124, (ii) The Banking System of Pakistan, The State Bank Press, Karachi, 1964, pp.102-104, (iii) 'Pakistan' in W.F.Crick, Commonwealth Banking Systems, Oxford University Press, London, 1965, pp.277-278, (iv) Money and Banking in Pakistan, The Allies Book Corporation, Karachi, 1966, pp 223-225.

were not As regards the profits of banks, they are not determined solely by the deposit rates. They rather depend on the spread between the interest rates on deposits and bank advances. The weighted average rate of interest on advances increased from 4.21 per cent in December 1958 to 5.26 per cent in December 1961. It rose to 6.64 per cent in June 1965 and further to 6.98 per cent in December, 1966. The spread between weighted average rates of interest on deposits and advances has increased from 4.03 per cent in March, 1962, to 4.64 per cent in December, 1966.

The Credit Committee endorsed the contention of commercial banks that deposits are interest-inelastic. "A large number of depositors are not interest conscious. Under the circumstances, many of the experienced witnesses and majority of the members of the Committee are of the view that the conventional approach of increasing interest rates to attract more deposits may not solve the problem. It is true that a daring experiment of effecting a sharp increase in rates of interest on deposits has not been carried out in Pakistan and it is possible that if the rates were increased substantially, say from 2 per cent to 4 per cent, the response may be good. We do not, however, consider such a step practicable for the present".[1] The Planning Commission, on the other hand, has been advocating an upward adjustment of the interest rate

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1. Report of the Credit Committee, Government of Pakistan Press, Karachi, 1962, pp.8-9.

structure. "There exists a good case for an upward revision in interest rates. Productivity of investment is ... as high as 30 per cent in large scale industry. The interest rate structure should bear some relationship to profitability of investment ... In fact, higher interest rates should not only attract higher savings but also bring about selectivity in investment".[1] They again emphasised that "it is necessary to set the rewards of saving and the cost to users of credit in line with the true economic rate of interest as far as possible ... the return on savings has remained inadequate".[2]

The State Bank has always favoured an increase in interest on deposits. However, its moral pressure on the banks to raise the deposit rates until recently seems to be half-hearted. At its instance, the banks raised the interest rate on saving deposits only from 2 per cent to 2½ per cent on 14th May, 1962. In July 1963, the State Bank introduced Quota System to encourage the banks to mobilise deposits. This failed to stem the increasing dependence of the banks on the central bank finance. Rather their borrowings from the State Bank increased at an accelerated pace. After the increase in Bank rate from 4 per cent to 5 per cent in June 1965, the State Bank for the first time exercised its statutory powers and raised the

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1. Planning Commission, Government of Pakistan, <u>The Second Five-Year Plan</u> (1960-65), June 1960, pp.77 and 79.

2. Planning Commission, Government of Pakistan, <u>The Third Five-Year Plan</u> (1965-70), June 1965, p.123.

deposit rates on savings and all categories of fixed deposits by one per cent. The Bank seems to have acted on the suggestion of Dr.Meenai that, while the scheduled banks' agreement on deposit rates should remain, it should raise the deposit rates upward. This would avoid unhealthy competition among banks.[1]

It is evident from table 4-8 that the weighted average rates of interest on savings and fixed deposits have recorded rise over the last five years. The rise in deposit rates was particularly sharp during 1965-66. The increase in deposit rates also seems to have contributed to the sharp rise in saving and fixed deposits. The annual average rate of increase in saving and fixed deposits more than doubled from Rs. 425 million during 1961-64 to Rs. 946 million during 1964-66. This is in line with the experience in other countries. In South Africa, "the commercial banks have during recent years made vigorous efforts to attract savings and time deposits, and have succeeded in doing so by stepping up their savings and time deposit rates".[2] In India, "a much sharper increase in time deposits was largely due to a rising trend in the interest rates offered on such deposits".[3] In Australia, while the proportion

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1. Meenai, S.A., An Appraisal ... op.cit., p.96.

2. Arndt, E.H.D., 'South Africa' in Crick, W.F., Commonwealth Banking Systems, Oxford University Press, 1965, p.326.

3. Madan, B.K., 'India' in Crick, W.F., op.cit., p.205.

TABLE 4-8: Savings and Fixed Deposits and Weighted Average Rate of Interest.

(Rs. in million)
(Interest per cent per annum)

	Savings Deposits		Fixed Deposits									
			Up to 6 months		6 months to 1 year		1 year to 2 years		2 years to 3 years		Over 3 years	
	Amount	Interest	Amount	Interest	Amount	Interest	Amount	Interest	Amount	Interest	Amount	Interest
September, 1960	364	1.54	212	2.53	488	2.33	24	3.27	8	2.99	1	2.94
December, 1960	393	1.50	193	2.55	400	2.70	121	2.65	9	3.11	-	3.07
March, 1961	388	1.48	197	2.57	383	2.90	156	2.82	9	3.4	2	4.15
June, 1961	390	1.72	236	2.48	393	2.78	116	1.79	19	3.25	3	4.04
September, 1961	413	1.73	250	2.52	504	2.68	34	2.88	18	3.28	7	3.99
December, 1961	425	1.79	292	2.74	523	2.76	40	3.21	19	3.28	12	4.00
March, 1962	433	1.79	290	2.73	571	2.72	38	3.13	25	3.37	18	4.00
June, 1962	488	1.97	279	2.78	586	2.75	109	2.82	30	3.28	25	3.92
September, 1962	528	2.05	375	2.55	661	2.74	43	3.31	30	3.44	37	3.84
December, 1962	564	2.09	391	2.50	679	2.84	43	3.22	35	3.50	53	4.06
March, 1963	601	2.10	403	2.51	681	2.82	53	3.36	36	3.45	60	4.07
June, 1963	666	2.10	376	2.53	711	2.85	53	3.30	35	3.41	72	4.07
September, 1963	739	2.09	379	2.48	749	2.76	75	3.13	30	3.43	79	4.04
December, 1963	782	2.11	382	2.54	763	2.86	91	3.24	31	3.54	92	3.66
March, 1964	889	1.90	354	2.52	812	2.79	78	3.23	34	3.52	110	3.70
June, 1964	967	2.09	389	2.54	832	3.16	94	3.11	31	3.52	120	4.03
September, 1964	1,067	2.10	414	2.49	896	2.81	93	3.23	37	3.54	157	3.62
December, 1964	1,136	2.12	486	2.49	928	2.87	108	3.22	39	3.55	198	3.92
March, 1965	1,206	2.11	402	2.63	1,070	2.89	138	3.08	46	3.52	249	3.75
June, 1965	1,292	2.16	315	2.70	1,107	2.91	114	3.22	43	3.53	327	4.11
September, 1965	1,312	3.37	374	3.08	1,088	3.38	112	3.75	60	3.84	395	4.49
December, 1965	1,433	3.44	404	3.26	1,088	3.33	140	3.86	62	4.07	445	4.64
March, 1966	1,557	3.45	491	3.23	1,088	3.41	161	3.96	82	4.27	522	4.74
June, 1966	1,757	3.47	559	3.21	1,123	3.51	169	4.06	108	4.44	608	4.82

Source: State Bank of Pakistan: Bulletin (monthly), July to November, 1967.

of fixed deposits to the total deposits has declined from 60 per cent to 20 per cent due to "low interest rates enforced by the central bank", again increased "to 30 per cent under the incentive of higher interest rates".[1]

2. Borrowings From the State Bank of Pakistan

The understanding of the procedure of scheduled banks' borrowings from the State Bank is important for the analysis of the determinants of the volume of bank credit and its control. The scheduled banks can replenish their cash reserves by selling government and trustee securities to the Bank, rediscounting eligible bills of exchange or by borrowing from it against the collateral of securities and bills.[2] The State Bank is not legally obliged to lend unlimited amounts against their collateral, in fact, it fixes limits for such borrowings each year. The banks can also borrow to the extent of advances they have made to the central and provincial governments for state trading purposes. This, as we have seen above, is termed 'counterfinance' Finally, the Bank may lend money to the scheduled banks against government guarantee or any other form of security, which in its opinion is sufficient.[3]

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1. Holder, R.F., 'Australia', in Crick, W.F., op.cit , p.68

2. The State Bank of Pakistan Act, 1956, Section (17(4) (a) and (c), and 17(2) (a) and (b).

3. The State Bank of Pakistan Act, 1956, Section 18(1) (b).

TABLE 4-9 Scheduled Banks' Borrowings from The State Bank.

(Rs. in million)

	Weekly Average (1)	Weekly Minimum (2)	Weekly Maximum (3)	Sanctioned Limit (4)	Ratio of (1) to Bank Credit
1954-55	73	4	172	N.A.	8.0
1956-57	105	27	214	N.A.	9.5
1958-59	83	10	228	762	6.2
1959-60	79	7	212	N.A.	5.1
1961-62	523	340	776	1,273	19.8
1963-64	616	219	974	1,856	14.7
1964-65	1,268	652	1,746	2,298	21.8
1965-66	1,457	952	1,777	2,965	22.4

Source State Bank of Pakistan - Banking Statistics (Annual).

The scheduled banks' borrowings from the State Bank remained small and seasonal in character up to 1959-60. Their borrowings tended to increase during the busy season to finance the movement of cash crops, viz. jute and cotton. After the marketing of crops, the funds would flow back into the banking system and they would reduce their indebtedness to the State Bank. This is evident from the weekly maximum and minimum figures in table 4-9. Since 1959-60, the banks have not only taken increasing recourse to the State Bank assistance, their borrowings to a great extent have lost their seasonal character. This is evident from the sharp increase in the weekly average level and the narrowing down of the difference between the weekly maximum and minimum levels of scheduled banks' borrowings The ratio of funds borrowed from the State Bank to total bank credit has gone up from 5.1 per cent in 1959-60 to 22.4 per cent in 1965-66. This is because the average annual expansion of bank credit at 27.7 per cent after 1959-60 far outstripped the average annual increase of 17.3 per cent in bank deposits. The smoothening of the seasonal variations is largely due to the increase in the proportion of advances to the non-commercial sectors to the total bank advances from 31 per cent in December 1953 to 60 per cent in June 1966 (excluding advances of the Agricultural Development Bank and the Industrial Development Bank).

Chapter 5.

CREDIT POLICY AND CONTROL OF THE MONEY SUPPLY.

In the present chapter we are going to discuss the control of the money supply by the State Bank in the interest of monetary stability. For this purpose the Bank has been entrusted with a wide array of credit control weapons to control both the volume and direction of bank credit. These include (i) variation in the Bank rate, (ii) open market operations in government securities of any maturity, (iii) unlimited variation in the legal cash reserve ratio, and (iv) changes in the liquidity ratio. The Bank can fix ceilings on its advance and discount facilities to the banks, fix the rate of interest on deposits and advances of banks and impose margin requirements on advances. It is also empowered to determine the lending policies of banks in general or of each bank individually and they are bound to follow these policies. The last power gives the Bank a very effective direct control over the volume and direction of bank credit.

Although the State Bank has all these powers, we shall argue that by its policy of support to government securities and by entering into agreement with the banks to provide counterfinance for their loans to the government, it has lost control on money supply through quantitative credit control measures. The Bank takes the view that its quantitative credit control weapons are ineffective due to the absence of a well developed short-term money market and insensitiveness of market interest rates, but we shall show that the data do not support this view and that the Bank can have effective control over the money supply through these indirect measures if it would drop its present policies of providing cheap credit. More important, we intend to examine why under the present arrangements the Bank's efforts to control the expansion of bank credit to the private sector and money supply through increase in the Bank Rate, seem to have the reverse effect, viz., accelerate the pace of their growth. We shall postpone the discussion of adverse implications of cheap credit policy for the Bank's third main objective of assuring adequate provision of credit for development purposes to the next chapter.

We shall start by defining the money supply. The money supply in Pakistan is defined to include (a) currency in circulation outside the banking system (Cp.), consisting of the State Bank notes and treasury currency, and (b) demand deposits of the public with the scheduled banks (D) and 'other deposits' with the State Bank, excluding Counterpart Funds and other loan accounts (Od). We shall call this active money supply and in notations

$M_1 = Cp + Dm$, where $Dm = D + Od$.

The official definition of money supply excludes time deposits. In fact, in the analysis of monetary expansion, the expansionary influence emanating from the increase in bank credit to the private sector is offset by the growth of time deposits. This view is based on the comparatively smaller turnover of time deposits as is evident from the data set out in table 5-1. Recently, the Bank has started emphasising that, while guaging monetary flows in the economy, the continuing sizeable accumulation of time deposits should be taken into account. This is, firstly, because they are a very close money substitute and presumably add to the total liquidity of the economy in much the same way as money supply (as defined by the Bank). Secondly, the size and composition of near-money assets have a bearing on changes in the velocity of money, which in turn, affect the level of effective demand.[1] We shall treat time deposits as idle money (M_2), Total money supply thus consists of active money balances plus idle money, i.e., $M_s = M_1 + M_2$.

Growth of Money Supply and Its Determinants.

The State Bank analyses the expansion or contraction of the money supply in terms of the 'causative' changes of (1) the private sector, (2) the government sector, and (3) the foreign sector to such expansion or contraction. The 'causative analysis' of the

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1. Annual Speech of the Governor, State Bank of Pakistan, 1966, p.5, see also Andrus and Mohammed, op.cit., p.94.

TABLE 5-1. Turnover of Deposits

(April - June quarter)

Type of Account	1962	1963	1964	1965	1966
Current Deposits	9.17	9.78	9.67	10.36	10.20
Call Deposits	9.28	7.39	7.38	3.53	3.97
Other Deposit Accounts	4.03	3.99	2.67	3.28	3.64
Savings Deposits	0.60	0.97	0.94	0.83	0.81
Fixed Deposits	0.59	0.52	0.66	0.45	0.49
All Deposits	5.09	5.34	4.76	4.39	4 17

Source The State Bank of Pakistan - Statistics on Scheduled Banks in Pakistan (Quarterly).

Bank is based on the combined balance sheets of the State Bank and the scheduled banks in the following form

Liabilities.		Assets.	
$C_p + C_b + O_d$	$=$	$F + G_1 + B$	... (1)
$D + T + B$	$=$	$C_b + G_2 + L + A$	. . (2)

The first identity refers to the balance sheet of the State Bank and the second to the combined balance sheets of scheduled banks. By adding (1) and (2)

$$C_p + O_d + D + T = M_s \quad = \quad F + G_1 + G_2 + L + A \qquad \text{... (3)}$$

According to definition of the money supply used by the Bank

$$M_1 = F + G + (L - T) + A$$

and also.

$$\Delta M_1 = \Delta F + \Delta C + (\Delta L - \Delta T) + \Delta A$$

The symbols on the right side of the identities stand for the following items in the balance sheets

F = Foreign assets in the portfolio of the State Bank.

G_1 = State Bank's investments in government securities and treasury bills, advances to the government adjusted for government balances and counterpart funds with the Bank, it also includes treasury currency in circulation with the public and in the tills of banks,

B	=	Scheduled banks' borrowings from the State Bank.
C_b	=	Cash in tills plus banks' balances with the State Bank.
G_2	=	Scheduled banks' investments in government securities and advances to the government.
L	=	Scheduled banks' advances to the private sector, bills purchased and discounted and investment in private securities.
A	=	Net other assets of banks.
G	=	$G_1 + G_2$

Total deficit financing, i.e. net government borrowings from the entire banking system, depends on the fiscal policy of the government. The Bank is obviously in no position to determine the actual pattern of government fiscal policy, though it can advise the government in a particular situation. The outstanding level of foreign assets in the portfolio of the Bank - the sole custodian of foreign exchange reserves - is also the net result of autonomous export proceeds and foreign aid and the import policies of the government. The Bank, therefore, assumes the impact of fiscal operations and of changes in the volume of foreign assets on money supply as given. Thus the Bank can control money supply only by regulating scheduled banks' claims on the private sector.

We have set out the growth of money supply and its determinants in table 5-2. It shows that active money supply increased by Rs. 2,783 million during 1950-59. Of the total increase in active money, the deficit in government financial transactions was responsible for Rs. 2,589 million (93 per cent), surplus in balance of payments for Rs. 23 million (1.0 per cent), and the scheduled banks' claim on the private sector, adjusted for shift to time deposits, for Rs. 88 million (3.2 per cent) The State Bank did not take any quantitative credit control measures over this period, in spite of a sharp rise in active money during 1955-58, because (a) 94 per cent of the rise in active money was due to autonomous factors, (b) the banks were already following very conservative lending policies and the net increase in credit to the private sector was small, and (c) it was afraid that a reduction in credit to the private sector might hamper production.

During 1959-67, the active money increased by a larger amount of Rs. 4,872 million. The single major contributing factor was bank credit to the private sector, which increased sharply by Rs. 7,188 million and even after adjustment for accumulation of Rs. 4,387 million in idle money it accounted for 57.4 per cent of the increase in active money as against 3.2 per cent in the preceding period. The State Bank imposed a number of credit control measures but failed to restrain the growth of bank credit

TABLE 5-2. Causative Analysis of Money Supply. (Million Rs).

(July-June)	Increase in Active Money (ΔM_1)	Expansionary (+): Govt. Sector $\Delta G_1 + \Delta G_2 = \Delta G$	Expansionary (+): Private Sector: Gross (ΔL)	Expansionary (+): Private Sector: Adjustment for Time Deposits (ΔM_2)	Contractionary (-): Foreign Sector (ΔF)	Contractionary (-): Other Factors ΔA
1950-51	396	- 152	+ 59	- 77	+ 437	+ 129
1951-52	130	+ 574	+ 230	+ 34	- 670	- 38
1952-53	57	+ 620	- 101	- 61	- 398	- 3
1953-54	273	+ 266	+ 130	- 129	- 13	+ 19
1954-55	271	+ 351	- 50	- 86	+ 71	- 15
1955-56	629	- 266	+ 99	- 45	+ 830	+ 11
1956-57	466	+ 408	+ 237	- 5	- 217	+ 43
1957-58	366	+ 729	+ 42	- 131	- 266	- 8
1958-59	194	+ 59	- 5	- 53	+ 249	- 56
1959-60	302	- 90	+ 358	- 193	+ 216	+ 11
1960-61	29	+ 83	+ 416	- 282	- 90	- 98
1961-62	222	+ 39	+ 690	- 279	- 86	- 142
1962-63	847	+ 205	+ 793	- 428	+ 272	+ 5
1963-64	1029	+ 735	+ 914	- 497	- 197	+ 74
1964-65	681	+ 224	+ 1715	- 796	- 335	- 127
1965-66	1222	+ 1385	+ 367	- 811	+ 287	- 6
1966-67	540	+ 1225	+ 1935	- 1101	- 672	- 847

Source 1) State Bank of Pakistan - Reports on Currency and Finance (Annual).
2) Information supplied by the State Bank.

The function adopted by the State Bank for the analysis of money supply has many drawbacks. First, it lumps together the net claims on the government sector of the State Bank and of the scheduled banks and treats them as a single autonomous factor. This only reveals how far fiscal policy, which determines the aggregate deficit financing, was active. It does not reveal anything about monetary policy, which is concerned with the distribution of government debt between the State Bank and the scheduled banks This would be justified if (i) the government had complete control over the distribution of government debt between the State Bank and the scheduled banks, that proportion remained always stable, and the banks were not able to increase their reserves by borrowing from the State Bank against the security of a part of their holdings of government debt, or (ii) if the State Bank pursued an absolutely passive monetary policy and left the determination of the money supply to the fiscal and commercial policies of the government and the commercial banks and their borrowers, who determine demand for bank credit.

Secondly the State Bank's analysis is based on the banking theory developed in the United Kingdom and the United States and on the assumptions which are related to the institutional setting in those countries. Under this theory, the change in the monetary liabilities of the central bank leads to proportionate change in bank reserves which, in turn, leads to a secondary expansion or contraction of money supply of an amount indicated by the ratio of currency in circulation to money supply and the ratio of cash assets to bank deposits. These two ratios are considered to be reasonably stable in the absence of changes in legal reserve requirements. Thus money supply can expand or contract only if there is an increase or decline in the monetary liabilities of the central bank. We shall discuss below that the data in Pakistan do not support the Bank's view that currency-money ratio is stable, and this makes the function adopted by the Bank for the analysis of money supply inadequate. First we intend to enquire into the reasons for the ineffectiveness of quantitative credit control weapons in the conditions of Pakistan.

The Bank Rate Policy

The Scope and Objectives of the State Bank's Accomodation to Banks

The Bank is empowered to rediscount bills of exchange drawn for the purpose of (a) commercial or trade transactions and maturing within 90 days, (b) financing seasonal agricultural operations and marketing of crops with maturity of up to 15 months, (c) holding or trading in government securities and maturing within 90 days, and (d) financing the development of agriculture and industry and maturing within 5 years. The Bank also makes advances, repayable on demand or for a fixed period not exceeding 90 days, against the security of (a) government and other approved securities, (b) bills of exchange eligible for rediscount by the Bank, and (c) promissory notes of the banks supported by government guarantee or documents of titles relating to goods pledged with them by their customers in lieu of overdrafts and cash credits. Finally, it provides counterfinance to the banks.

The main objectives of allowing the banks access to the State Bank credit on such a wide scale are (a) to impart elasticity to the credit structure by enabling the banks to meet the seasonal demand for bank credit, and (b) to enable the banks to expand credit to meet the growing credit requirements of the developing economy. The Bank's concern for the promotion of credit facilities is evident from the extent of accommodation it has provided to the banks. The outstanding level of scheduled banks' borrowings has increased from Rs. 11 million in June 1960 to Rs 1688 million in June 1965 At this level, the State Bank accommodation constituted 28 per cent of the scheduled banks' claims on the private sector. These objectives make the Bank more a Bank of accommodation than a machinery of control and regulation of bank credit. For this purpose, the Bank has been empowered to change the Bank rate and to fix ceiling on its accommodation to banks.

<u>The Experience of Bank Rate Policy in Pakistan.</u>

The Bank rate was raised for the first time in January 1959 from 3 per cent to 4 per cent to lend support to the new fiscal policy aimed at curbing excess demand. It is evident from table 5-3, that in the following three years bank credit increased at an accelerated pace and became the primary expansionary influence on money supply. Scheduled banks' borrowings from the State Bank also rose to unprecedented high levels.

In August 1963 the State Bank introduced a Quota System in respect of its advances to the scheduled banks against government securities in order to restrain the expansion of bank credit to the private sector. Under this arrangement, each bank was assigned a 'quota' every quarter equal to half of its statutory reserves with the State Bank in the preceding quarter. Borrowing within this quota was charged interest at the Bank rate and borrowings beyond this limit were charged progressively higher rates ranging from 0.5 per cent to 2 per cent above the Bank rate, as follows:-

i)	Borrowings up to the limit of the quota	4 per cent (i.e. Bank rate).
ii)	Borrowings in excess of the limit under (i) but limited to 100 per cent of the quota	4½ per cent

iii) Borrowings in excess of the aggregate of (i) and (ii) above but limited to 200 per cent of the quota	5 per cent
iv) Borrowings in excess of the aggregate of (i), (ii) and (iii) above but limited to 200 per cent of the quota	$5\frac{1}{2}$ per cent
v) Borrowings in excess of the aggregate of (i), (ii), (iii) and (iv) above	6 per cent

The reasons for the imposition of Quota System instead of a straight rise in the Bank rate were (a) to raise the marginal cost of credit expansion to the banks without significantly affecting the average cost and thus to influence only further expansion of bank credit without restricting credit to the existing users, (b) to protect the securities market which is adversely affected by a straight rise in the Bank rate, and (c) to encourage deposit mobilisation by linking the Quota with the statutory reserves. We may mention that at the same time banks' borrowing against eligible bills was also restricted to the maximum amounts availed of by the banks during 1962-63.

In spite of these measures, the borrowings of the banks more than doubled from Rs. 386 million in June 1963 to Rs. 783 million in June 1964, and bank credit to the private sector registered a rise of Rs. 917 million in 1963-64 compared to Rs. 793 million in the preceding year.

In view of further steeping up of credit creation in the private sector, the State Bank, among other measures, made the Quota system more stringent in January 1965, firstly by reducing the amount of quota from 50 per cent to 25 per cent of the average statutory reserves in the previous quarter, and secondly by making it applicable to all types of borrowings of banks from the State Bank. The borrowings of banks more than doubled from Rs. 783 million in June 1964 to Rs. 1,688 million in June 1965 and bank credit increased by Rs. 1,715 million, or about 40 per cent, over this period.

In June 1965 the Bank rate was raised from 4 per cent to 5 per cent. The quota system was modified and the new slabs were as follows

i) Borrowings up to 350 per cent of the quota	5 per cent (i.e. New Bank Rate)
ii) Borrowings in excess of the limit under (i) but limited to 100 per cent of the quota	$5\frac{1}{2}$ per cent
iii) Borrowings in excess of the aggregate of (i) and (ii) above	6 per cent

The borrowings of banks declined by Rs.609 million during 1965-66. The fall in banks' indebtedness to the State Bank was partly due to a reduction in the legal reserve requirements from $7\frac{1}{2}$ per cent to 5 per cent in the first quarter of the fiscal year The funds released were used to retire their debt to the Bank instead of increasing their claims on the private sector. The rate of credit expansion had slowed down due to temporary disruption of trade and investment activity following armed conflict with India in September 1965. As the situation returned to normalcy, the borrowings of banks reached an all time high of Rs. 1,784 million in June 1967 and bank credit registered a record rise of Rs. 1,935 million during 1966-67.

The question to which we must now address ourselves is why, in the present conditions of Pakistan, Bank Rate seems to be ineffective in controlling bank credit.

Let us assume that the Bank rate policy is the only instrument of credit control available to the State Bank. Secondly, we assume that in each year there was a prima facie case for holding the amount of bank credit at the previous year's level.

We have set out the growth of bank credit to the private sector and the sources of additional reserves in table 5-3. It shows that banks can finance the expansion of bank credit in five different ways. The effect of an increase in the Bank rate on the cost of reserves needed to finance the expansion of bank credit is different for each source of additional reserves. Thus the effectiveness of Bank rate changes in regulating bank credit depends on the source of finance on which the banks draw for additional reserves.

TABLE 5-3. Scheduled Banks' Claims on the Private Sector and Sources of its Finance.

(Million Rs).

Year (Ending last Friday of June).	Changes in Scheduled Banks' Claims on the Private Sector (ΔL)	Sources of Finance				
		Change in Borrowings from the State Bank (ΔB)	Cash Reserve Ratio $r = \frac{Cb \times 100}{D+T}$	Change in Claims on the Govt. Sector (ΔG_2)	$C_a = \frac{Cp \times 100}{M_1 + M_2}$	Autonomous Change in Reserve Money $\Delta C - \Delta B = \Delta G_1 + \Delta F$
1950-51	+ 59		16.4		58.4	+ 342
1951-52	+ 230	+ 132	12.4		62.1	- 12
1952-53	- 101	- 124	12.8		60.1	+ 146
1953-54	+ 130	+ 6	11.4	+ 84	58.8	+ 189
1954-55	- 50	- 4	13.2	+ 201	58.4	+ 246
1955-56	+ 99	+ 18	15.7	+ 26	59.0	+ 486
1956-57	+ 237	+ 68	9.5	- 13	61.1	+ 204
1957-58	+ 42	- 54	10.3	+ 234	59.5	+ 314
1958-59	- 5	- 29	12.3	+ 196	57.4	+ 121
1959-60	+ 358	+ 1	8.3	+ 64	55.8	+ 95
1960-61	+ 416	+ 327	8.3	+ 250	53.8	- 270
1961-62	+ 690	+ 65	8.2	- 24	50.5	- 11
1962-63	+ 793	- 17	8.3	+ 91	46.1	+ 364
1963-64	+ 914	+ 397	8.9	+ 340	44.5	+ 250
1964-65	+ 1715	+ 905	10.8	+ 228	41.4	- 384
1965-66	+ 367	- 609	8.4	+ 185	41.8	+ 1443
1966-67	+ 1935	+ 705	10.9	+ 84	35.8	- 548

Source i) State Bank. Annual Reports on Currency and Finance.
ii) Information supplied by the State Bank.

(a) Excess Reserves. The excess reserves were one of the major sources of finance for the expansion of bank credit up to 1960. Bank credit registered sizeable increases during 1951-52, 1956-57 and 1959-60. The banks reduced their reserve ratios from 16.4 per cent in June 1951 to 12.4 per cent in June 1952, from 15.7 per cent in June 1956 to 9.5 per cent in June 1957, and from 12.3 per cent in June 1959 to 8.3 per cent in June 1960. The expansion of bank credit to the extent of absorption of excess reserves cannot be influenced by an increase in the Bank rate. This shows that up to 1960 the large amounts of excess reserves with the banks reduced the effectiveness of an increase in the Bank rate to control the expansion of bank credit.

The bank credit declined in 1952-53 and 1954-55. What was the scope for preventing the contraction of bank credit by reducing the Bank rate. The decline in the Bank rate is an inducement to the banks to expand credit by making the accommodation at the central bank cheaper. This inducement would work only if the contraction of bank credit were due to shortage of reserves at a reasonable rate. The decline in bank credit in the above mentioned years was not due to lack of reserves. Rather the banks were accumulating excess reserves. In these circumstances, the decline in the Bank rate would not have prevented fall in bank credit

The excess reserves of the banks have been completely wiped out in recent years. Since 1960, the banks are operating on minimum and stable cash reserves. This has removed at least one obstacle to the effectiveness of the Bank rate to control credit creation of banks

(b) Autonomous Increase in Reserve Money

The rise in the monetary liabilities of the State Bank due to autonomous factors, viz. surplus in the balance of payments and deficit in the fiscal operations of the government (G_1), leads to increase in the cash reserves of the banks and consequently in their ability to lend more and vice versa. The autonomous increase in reserve money at a time when the State Bank desires expansion of bank credit will reinforce its policy measure and the decline in the reserve money due to autonomous factors will reinforce its measures to control the expansion of bank credit. On the other hand, the expansion of reserve money during restrictive credit policy of the Bank and the decline in reserve money during the expansionary credit policy would make its measures ineffective

The autonomous increase in the monetary liabilities of the Bank was the major source of reserves and expansion of bank credit up to 1959. The scheduled banks' net indebtedness to the Bank, except in the busy season, was generally nil. The increase in

Bank rate could not have succeeded in restraining the growth of bank credit over this period. Since 1959, this factor is also not working against Bank rate policy. During 1959-65, the autonomous increase in reserve money was responsible for only Rs. 63 million (or 1 per cent) out of total expansion of Rs. 5585 million in bank credit. In fact, during 1963-65, when the Quota system was in force, this factor exerted a net contractionary influence of Rs. 284 million.

(c) Scheduled banks' borrowings from the State Bank

The State Bank has to a large extent lost control over scheduled banks' borrowings from it and consequently on their credit creation through Bank rate policy by entering into agreement with them to provide 'counterfinance'. The amount of counterfinance depends on the level of government borrowings from the banks, which the Bank is unable to influence. Moreover, up to January 1965, when the quota system was extended to cover all types of borrowings of banks, the Bank was even obliged to provide this counterfinance at a concessional rate of interest. It is pertinent to point out that since 1960 the counterfinance has generally accounted for a substantial part of total borrowings of banks and its outstanding level has gone up from Rs. 264 million in June 1961 to Rs. 606 million in June 1965.

Secondly, the State Bank has been under pressure in recent years to extend finance liberally to certain banks against their demand promissory notes, guaranteed by the central government, to meet the credit requirements of certain specific sectors, such as agriculture. The Bank's advances to the Agricultural Development Bank and co-operative banks have gone up from Rs. 107 million in 1960-61 to Rs. 420 million in 1965-66. The Bank makes these advances at concessional rates of interest. The Governor of the Bank recently protested against the pressure on the Bank to enlarge its assistance to the banks for development purposes and underlined the dangers of excessive involvement of the central bank in direct financing and reducing it to the position of lender of first resort [1]

(d) Shifting of government debt to the State Bank or borrowings against their collateral.

The second real impediment to the effectiveness of rise in the Bank rate to restrain the expansion of bank credit remains the commitment of the State Bank to peg the prices of government securities at low interest rates. After the State Bank, the banks are the largest holders of government securities. It, no doubt, makes them very susceptible to the 'locking in' effect of the rise in Bank rate in case the Bank does not support the prices of government securities.

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1. Annual Speech of the Governor, State Bank of Pakistan, 1966, pp.10-11.

Secondly, the fall in security prices would decrease their lending capacity. But in the State Bank's opinion this short-term advantage is outweighed by the long-term considerations for the development of securities market because the decline in their value, following the rise in Bank rate, may have highly unsettling effects on it. In the absence of support, the banks will no longer consider securities as liquid assets for investment and will be unwilling to subscribe to the new issues. It may force the government to place them with the State Bank and that will be relatively more inflationary Such a situation is likely to do great damage to the growth of investment in government securities. On the other hand, if the Bank supports the prices of government securities, the banks will unload them at it and extend credit to the private sector where the yield is much higher This defeats the purpose of rise in the Bank rate. The magnitude of this source of finance depends on the securities in their portfolios in excess of liquidity requirements.

Open Market Operations

Open market operations have hardly been used as an instrument of credit policy in Pakistan. However, the Bank has been conducting open market operations for other purposes to tide the banks over seasonal monetary stringency, to enable them to invest their funds in the slack season, to assist the government in borrowing at cheap rates, and to maintain orderly conditions in the securities market. The Bank has not been able to use open market operations as credit control weapon because the gilt-edged market is still not sufficiently broad-based to allow purchases or sales of securities in reasonable amounts, in order to affect the cash reserves of banks, without serious fluctuations in security prices, (ii) the Bank has found from experience that even if it is able to sell securities, the banks tend to replenish their cash balances by rediscounting bills or taking advances from it.

The security market has remained narrow partly because the economy is underdeveloped. But the main factor responsible for the continued narrowness of the market seems to be the cheap credit policy of the government. The yields on government securities are too low to compensate most non-bank potential investors for the risk of being unable to sell the securities when they wish. The result is that almost all of those newly issued securities which are offered to the public by the State Bank are purchased by the scheduled banks. The banks, as we discussed in chapter 4, are interested to buy these securities because among the assets which they are required to hold for liquidity purposes, government securities are the only interest-bearing asset. Secondly, they can use these securities as collateral for advances from the Bank. The Bank is ready to honour these securities as collateral because in its opinion the fall in their prices would adversely affect the growth of security market. This, however, means that, without direct intervention by the Bank, the quantity of scheduled banks' borrowings from it is determined not by the Bank but by the demands of the scheduled banks and their holdings of government securities in excess of liquidity requirements.

Cash Reserve Requirements.

In a developing country, where the government tends to resort to planned deficit financing or is compelled by circumstances to do so, it seems imperative to arm the central bank with the power to change the reserve ratio of banks. The deficit financing operations, i.e. government borrowings from the central bank, are likely to put substantial resources at the disposal of banks, which they can use for further credit creation. The rise in Bank rate in these circumstances will not be effective to check the expansion of bank credit. Similarly, due to limitations noted above, the central bank cannot mop up the excessive resources of banks by recourse to open market operations. The variable reserve requirements are considered more effective, their impact on each bank is predictable and in proportion to its deposits, their use does not upset interest rates and thus does not disturb the market for government securities.[1]

The 1948 State Bank Order laid down that the scheduled banks would hold 5 per cent of their demand liabilities and

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1. Meenai, S.A., op.cit., p.157.

2 per cent of their time liabilities with the State Bank. In case of default, the banks will have to pay interest on the balance at the rate of 3 per cent above the Bank rate in the first week and 5 per cent above the Bank rate thereafter. The Bank is authorised to raise these requirements to any limit or completely dispense with them. The above-mentioned ratios remained unchanged up to July 1963, when the required ratio for time liabilities was raised to 5 per cent. The object was to restrain the growth of bank credit and to avoid the natural tendency of banks to encourage a shift from demand to time deposits and thus defeat the purpose of credit policy. Moreover, there was no logical basis for distinction between reserve requirements for demand and time liabilities. The concept of reserves as a required minimum of liquidity to protect depositors, and hence higher reserve ratio for demand deposits with greater turnover, has become obsolete because the rediscounting facilities of the commercial bank have made all sound assets of the commercial banks convertible into cash.

The reserve ratios were raised from 5 to 6¼ per cent on April 1, 1965, and further to 7½ per cent on 1 May 1965. They were reduced to 6¼ per cent in August and 5 per cent in September, 1965. Earlier, in January, the Quota system was also tightened and a number of selective credit control measures were introduced. In spite of all these measures, the bank credit to the private sector increased by Rs. 468 million during January-June, 1965, compared to the rise of Rs. 281 million in the corresponding period last year At the same time scheduled banks' borrowings from the State Bank increased by Rs. 312 million compared to the rise of Rs. 274 million during January-June 1964

The increase in the reserve ratio seems to have failed to restrain credit expansion for the following reasons (i) the rise in reserve ratio leads to a proportionate decline in the volume of securities needed to meet the liquidity requirements. The banks can sell these securities to the central bank. If the central bank is keen on pegging the prices of securities, the increase in reserve requirements may simply lead to a transfer of securities from the commercial banks to the central bank without exerting any restraint on credit expansion. The adjustment in the portfolio of commercial banks, i.e. now a larger proportion of total 'liquid' assets in the form of non-earning cash assets, will somewhat add to the cost of the banks to maintain the same level of credit. But so long as the higher cost can be passed on to the borrowers, without affecting demand for bank credit, it will affect neither the lending capacity nor the profits of the banks. In Pakistan, the banks can simply borrow from the central bank against the collateral of these securities. This is exactly what they did when reserve ratios were raised by the State Bank. The balances of banks with the Bank increased by Rs. 95 million during the week ending April 2, and by Rs. 69 million during the week ending May 7, and their borrowings from the State Bank increased by Rs.109 million and Rs.134 million respectively over these periods The advance rates increased from 5.49 per cent in December, 1964 to 5.67 per cent in March, 1965, and further to 6.64 per cent in June, 1965.

Secondly, the impact of a given change in the reserve ratio on money supply and bank credit depends, besides the extent of multiple credit creation by banks, on the ratio of bank reserves to total reserve money, i.e. C_b/C. A given change in the reserve ratio has a smaller effect on the money supply if the money multiplier and the ratio of bank reserves to total reserves money are small. We shall see below that the money multiplier, defined either as $\frac{1}{C_a + r(1 - C_a)}$, where $C_a = \frac{Cp}{M_s}$ and r is actual reserve ratio, or $\frac{M_s}{C}$, was small up to 1960, as the currency-money ratio (C_a) was as high as 60 per cent. The C_a has gone down to 36 per cent in June, 1967 but, as Professor Porter has pointed out, the partial elasticity of supply of money with respect to changes in reserve ratio is not very large even when C_a is fairly low. "If $r = .10$, the (absolute value of the) elasticity of M with respect to r is .05 when K(i.e. C_a) = .67 and only 17 when K = 33 The elasticity does rise rapidly for further declines in K".[1] Mr. Ahrensdorf has pointed out that the percentage by which

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1. Porter, R C., 'The Promotion of the "Banking Habit" and Economic Development', The Journal of Development Studies, July 1966, footnote no.36, p.365.

average reserve ratio needs to be raised is equal to the ratio of the amount of autonomous increase in reserve money to the existing amount of bank reserves.[1] The Cb/C was only 0.061 in June, 1960, but it has gone up to 0.161 in June, 1967. It shows that a small change in reserve ratio by the State Bank could not have a more than nominal effect on the expansion of money supply and bank credit. A sharp rise in the reserve ratio, given the policy of the Bank to support security prices, would have simply added to the cost of loanable funds of the banks, without restraining the expansion of credit and money supply.

Liquidity Ratio

The 1962 Ordinance requires the banks to maintain 20 per cent of their demand and time liabilities in the form of cash, balances with the State Bank and unencumbered approved securities, valued at current market price The Bank is authorised to change the liquidity ratio but it has not done this so far. The Bank does not publish relevant information to estimate liquidity ratio. The data supplied by the Bank on request, and set out in table 5-4, shows

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1. Ahrensdorf, J., 'Central Bank Policies and Inflation· A case study of four less developed economies, 1949-57', I.M.F.Staff Papers, Vol.VII No.2, pp.287-288, see also Madan, B.K., 'The Role of Monetary Policy in Economic Development', SEANZA Lectures, State Bank Press, Karachi, 1964, Vol.I, pp.74-75, Goode, R., and R.S. Thorn, 'Variable Reserve Requirements Against Commercial Bank Deposits', I M.F. Staff Papers, 1959-60.

following characteristics (i) For reasons discussed in Chapter 4, the actual liquidity ratio of banks, as a whole, was more than twice the legal requirements in June 1960 and in earlier periods. It has gone down since then, but the decline is not commensurate with the sharp rise in the borrowings of banks from the Bank. This is because a large part of the increase in borrowings was against counterfinance, which does not affect liquidity ratio. (ii) The Pakistani banks generally maintain higher liquidity ratio relative to foreign banks. This is because, of the two largest Pakistani banks, Habib Bank follows conservative lending policies and hardly borrows from the Bank, and the National Bank, though most liberal in making advances, generally prefers to borrow against counterfinance and government guarantee. (iii) The liquidity ratio of foreign banks shows the expected seasonal fluctuations. The ratios of Pakistani banks, due to above-mentioned reasons, are not affected by seasonal increase in demand for bank credit. (iv) The data shows that although for most of the banks the liquidity ratio is still not a constraint on the expansion of credit, for some foreign banks, at least in the busy season, this requirement becomes a real constraint on their operation.

TABLE 5-4. Liquidity Ratio.

	Total Scheduled Banks	Foreign Banks	Pakistani Banks	Pakistani Banks excluding ADBP and IDBP
June, 1955	48.7	50.4	47.5	47.5
December, 1955	44.3	36.7	50.7	50.7
June, 1960	42.8	41.4	43.4	42.9
December, 1960	33.8	27.7	37.5	37.3
June, 1966	32.9	31.2	33.2	33.0
December, 1966	33.1	27.2	34.0	34.0

Courtesy State Bank of Pakistan.

II

We shall now discuss why the increase in Bank Rate by the State Bank to restrain the expansion of bank credit and money supply, on the contrary, appears to have the opposite effect, i e accelerate the rate of their growth We shall first explain it by an illustration and then examine the actual operation of the banking system in Pakistan.

This unexpected response of bank credit and money supply to the rise in Bank rate can be explained if we assume the following conditions and sets of relationships between the relevant variables Let us assume

1) that the commercial banks feel unable to meet any increase in the demand for credit arising from their customers' wish to increase their rate of capital formation,
2) that when the Bank rate is raised, both advance and deposit rates go up as well,
3) that a rise in the rate charged for advances does not affect the rate of growth in the demand for bank credit because this demand is very inelastic in respect to interest rates,
4) that a rise in deposit rates not only induces the public to hold more of their assets in the form of deposits but also increases their marginal propensity to save

Given these conditions and relationships, the increase in Bank rate will lead to a rise in both advance and deposit rates. The demand for bank credit will remain unaffected by the increase in advance rates. The shift from currency to time deposits in the portfolio of the public, following the rise in deposit rates, will provide the banks with more cash reserves at a given level of total cash base (C), and thus enable the banks to provide more credit. This will lead to a rise in total money supply as well as in its active component. Let us illustrate this in some detail with a numerical example.

Suppose that the banking system in the country is at Stage I. The legal reserve ratio is 6 per cent and the banks are keeping 4 per cent of their deposit liabilities as working reserves, so that total cash reserve ratio is .10 (D + T), and remains unchanged throughout our exercise. The legal liquid asset ratio is .20 (D + T) and, following the State Bank, is defined as

$$C_b + G_2 - B = .20\ (D + T)$$

which also remains unchanged. We shall assume that the central bank has placed ceiling on banks' borrowings against the collateral of government securities at Rs. 10, as it does not want the money supply to exceed the present level, and that there is no market for securities outside the banking system.

Now we suppose that the government insists on a cash deficit of Rs. 10 and spends it in the form of currency. Given the currency/money ratio at 60 per cent, Rs. 4 will flow into the banks to serve as a basis for a secondary expansion of money supply. If there is no interference from the central bank, the banking system will settle down at Stage II. The central bank, however, wants to bring down money supply to the level of Stage I and for that purpose it raises the Bank rate. This leads to rise in deposit rates which, in turn, induces shift from currency to time deposits. As a result, the ratio of bank reserves to total reserve money, i.e. Cb/C, goes up from 0.062 in Stage II to 0.155 in Stage III, bank credit rises to more than three and a half times and money supply to more than one and a half times.

As regards the operation of the Bank rate in Pakistan, we intend to show that.

i) the entire structure of market interest rates, contrary to general belief, is closely related to the Bank rate, provided there is no interference by the State Bank,

ii) the demand for advances is insensitive to advance rates due to high profits in trade and industry and the supply of credit is constrained by the shortage of lendable funds.

iii) the savings and fixed deposits have shown a very good response to the rise in deposit rates, especially after the increase in Bank rate in 1965, and the increase in savings and fixed deposits has been at the cost of currency in circulation and not demand deposits, and

(iv) the decline in the ratio of currency in circulation to money supply, or in other words the distribution of cash base (reserve money) in favour of banks, following the rise in deposit rates has led to continuous increase in money multiplier.

(i) Bank Rate and Market Rates of Interest.

The State Bank has always maintained that the money market in Pakistan is too underdeveloped to transmit interest rate changes, with the result that changes in such rates as the Bank can directly affect, the Bank rate and /or government securities rates, will not induce changes in the yield of advances, deposits, call money or in rates prevailing in the unorganised money market.[1] Non-scheduled banks and other "indigenous bankers" are of sufficiently little importance that their rates and terms may be neglected. Data regarding changes in the Bank rate and the rates of interest in the "organised" market, set out in table 5-5, does not support contention of the Bank. Following rise in the Bank rate in January 1959, the rates on advances and call money responded readily. The

1. Meenai, S.A., Money and Banking in Pakistan, Allies Book Corporation, 1966, pp.150-151.

Illustration.

		Stage I	Stage II	Stage III
A. Commercial Bank				
Liabilities		290	296	720
Demand Deposits	D	210	216	359
Time Deposits	T	70	70	351
Borrowings from the Central Bank against Govt. Securities	B	10	10	10
Assets		290	296	720
Cash in tills plus Balances with Central Bank	C_b	28	28.6	71
Investments in Govt. Securities	G_2	108	108	108
Advances	L	154	159.4	541
B. Central Bank				
Liabilities	C	448	458	458
Cash assets of Commercial Banks	C_b	28	28.6	71
Notes with the Public	C_p	420	429.4	387
Assets		448	458	458
Govt. Securities	G_1	315	325	325
Foreign Assets	F	123	123	123
Advances to Commercial Banks against Govt. Securities	B	10	10	10
C. Public				
Assets	M_s	700	715.4	1097
Central Bank notes	C_p	420	429.4	387
Demand Deposits	D	210	216	359
Time Deposits	T	70	70	351
Liabilities				
Advances from Banks	L	154	159.4	541
D. C_p/M_s		.60		.353
D/M_s		.30		.327
T/M_s		.10		.320
G.N.P. (at current prices)	Y	3,500		4,388
M_s/Y		.20		.25
M_1/Y		.18		.17
M_2/Y		.02		.08

TABLE 5-5. Bank Rate and Market Rates of Interest.

(Percent Per Annum)

	Bank Rate	(1) Call Money Rate	(2) 3-month Treasury Bill Rate (Average)	Deposit Rates on Saving and Fiscal Deposits (Weighted Average)	Advance Rates (Weighted Average)	Issue-Yield on Central Govt Securities with maturities up to (3)		
						5 years	6 to 10 years	Over 10 years
1958 June	3	0.50-0.75	0.70	N.A.	4.19			
December	3	2.50-2.75	0.50	N.A.	4.21	3.00	-	3.50
1959 June	4	0.25-0.50	0.67	N.A.	4.96			
December	4	3.75	2.50	N.A.	5.14	3.50	-	4.00
1960 June	4	2.00-2.25	-	N.A.	5.15			
December	4	4.50-4.75	-	2.26	5.28	3.75	-	-
1961 June	4	3.50-3.75	-	2.27	5.14			
December	4	4.00	-	2.47	5.26	3.75	-	4.00
1962 June	4	2.75-3.00	-	2.54	5.30			
December	4	3.25-3.50	-	2.58	5.45	3.75	-	4.50
1963 June	4	2.25-2.50	-	2.59	5.46			
December	4*	4.25-4.50	-	2.59	5.54	3.75		4.75
1964 June	4*	3.50	-	2.68	5.40			
December	4*	4.00-4.25	3.00	2.61	5.49	-	4.00	5.00
1965 June	5	7.00-7.25	3.00	2.73	6.64			
December	5	5.00-5.25	3.00	3.56	6.68	5.00	5.00	-
1966 June	5	4.00	3.00	3.68	6.84			
December	5	6.00-6.25	3.00	3.72	6.98	-	-	5.00
1967 June	5	7.25	3.00	3.75	7.10			

Source The State Bank of Pakistan, i) Annual Reports on Currency and Finance, ii) Annual Reports of the Bank, iii) Quarterly Statistics on Scheduled Banks.

N.A. - Not Available. * = The effective rate was somewhat higher due to introduction of the 'quota system'.

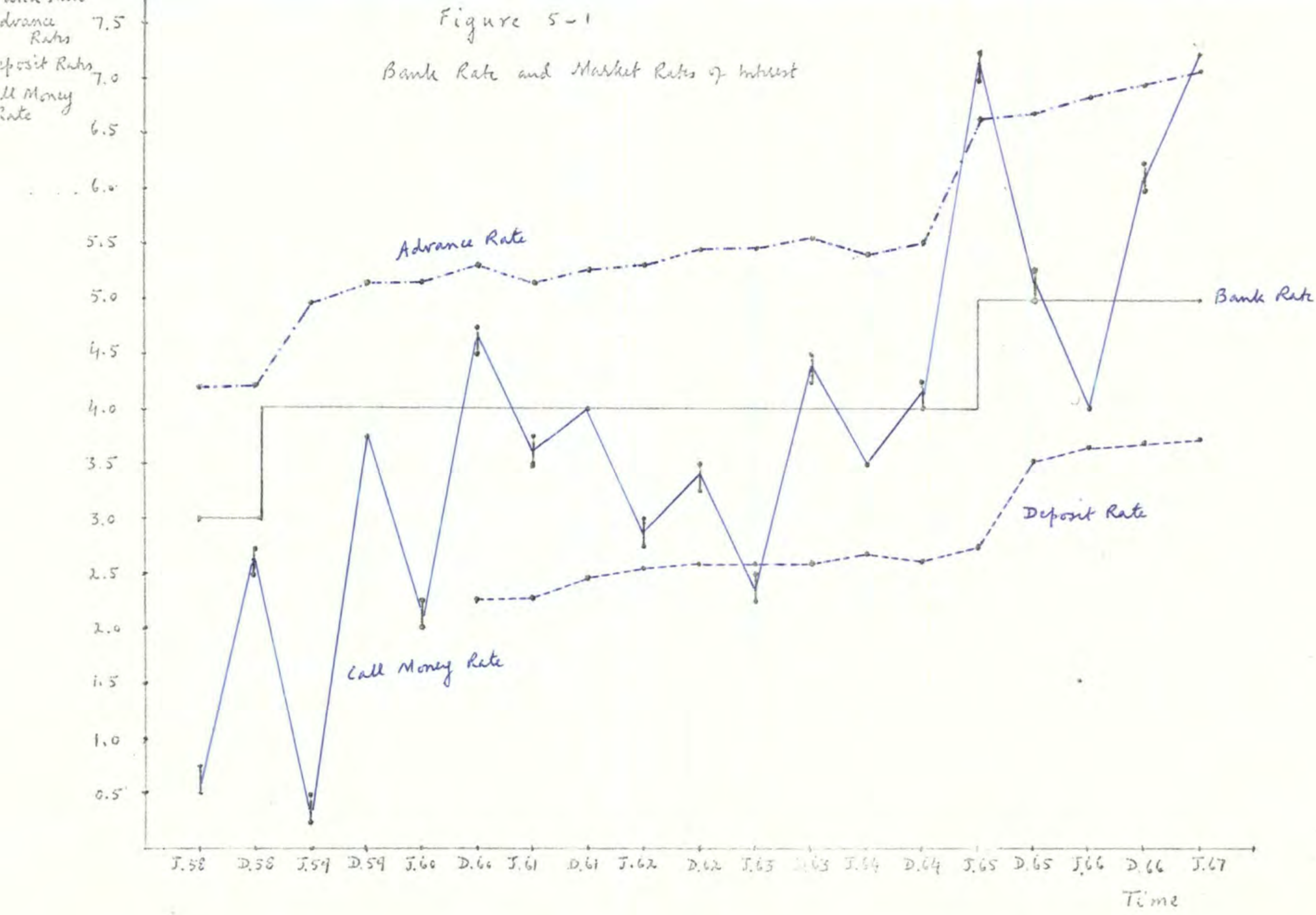
1). The rates are for the last Friday of the corresponding month.

2). The issue of treasury bills was discontinued from 1959 to 1964.

3). These are rates on loans issued by the central govt. during the corresponding calendar year.

Figure 5-1

Bank Rate and Market Rates of Interest



rates on securities and deposits were sluggish, but it was largely the fault of the Bank itself for "failing to persuade itself to lower values (of securities) in line with the rise in the Bank rate",[1] and for permitting oligopsonistic collusion of banks in the determination of ceilings on time deposit rates.[2] However, under pressure of demand for bank credit and a tight liquidity position, the deposit rates showed a rising tendency. The issue yield on government securities was also raised to bridge partly the increasing gap between advance rates and security yields. The increase in issue yield was hardly sufficient. In 1958, the issue yield on loans of up to 5 years maturity was equal to the Bank rate. It was raised to 3.5 per cent in 1959 and further to 3.75 per cent in 1960, but it remained well below Bank rate up to 1964. The issue yield on loans of longer maturity, which was 0.5 per cent higher than Bank rate in 1958, was raised to the level of Bank rate in 1959, and after remaining at that level up to 1961, it was gradually raised to 5 per cent in 1964. Following rise in the Bank rate in June 1965, the rates on advances, deposits and call money responded immediately. Thus we can assume that the market interest rates are adequately responsive to rise in the Bank rate.

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1. Meenai, S.A., op.cit., p.152.

2. Government of Pakistan - Report of the Credit Committee, 1962, pp.8-9, Porter, R.C., Liquidity and Lending, IDE, Karachi, 1963, p.45, Meenai, S.A., op.cit., p.223-225.

(ii) Advance Rates and the Demand for Bank Credit.

We have discussed in Chapter 4 that up to 1960 it was the demand for bank credit from credit-worthy borrowers that determined its supply. Since then, due to factors discussed there, the demand for bank credit has been increasing at an accelerated pace and in spite of large-scale borrowings from the State Bank, the banks are feeling constrained to satisfy it. The demand for bank credit is insensitive to changes in advance rates due to high rates of return on investment and trade activities made possible by bank advances. The marginal efficiency of capital is estimated to be as high as 30 per cent.[1] The insensitivity of bank credit to the present range of advance rates is evident from table 5-6 and scatter diagram No. 5-2.

(iii) Deposit Rates and Savings and Fixed Deposits

The statistical estimates of the relationship between weighted average deposit rates (id) and savings and fixed deposits (D_{SF}) set out in table 5-7 are

$$\text{(a)} \quad D_{SF} = \underset{(477)}{-3809 + 2268\, id} \quad \text{(for September 1960 to June 1967)}$$

$$n = 28 \quad R = 0.93$$

---

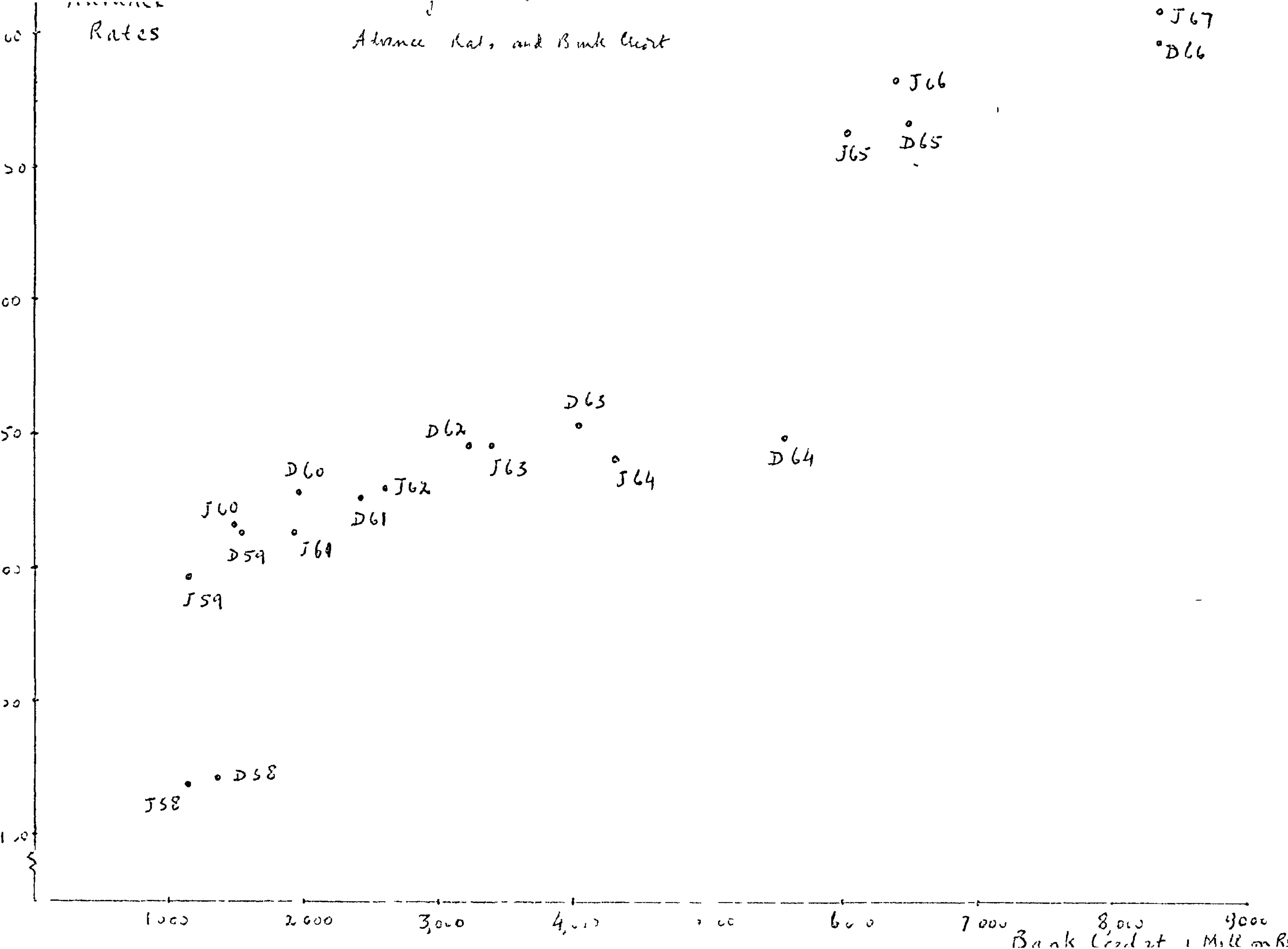
1. Planning Commission, Government of Pakistan, Second Five-Year Plan (1960-65), p.77, see also Moinuddin Baqai, 'Savings in the Corporate Sector in Pakistan (1959-63)', Finance and Industry, Supplement on Stock Exchange, April 1967, p.32.

TABLE 5-6. Weighted Average Advance Rate and Bank Credit to the Private Sector.

Period	Advance Rate p.c. p.a.	Bank Credit* to the Private Sector (Rs. in million).
June 1958	4.19	1,137
December 1958	4.21	1,351
June 1959	4.96	1,132
December 1959	5.14	1,509
June 1960	5.15	1,490
December 1960	5.28	1,958
June 1961	5.14	1,906
December 1961	5.26	2,417
June 1962	5.30	2,597
December 1962	5.45	3,212
June 1963	5.46	3,389
December 1963	5.54	4,022
June 1964	5.40	4,303
December 1964	5.49	5,550
June 1965	6.64	6,018
December 1965	6.68	6,488
June 1966	6.84	6,385
December 1966	6.98	8,323
June 1967	7.10	8,321

* Includes Advances, bills purchased and discounted and investment in private securities.

Courtesy State Bank of Pakistan.


Advance Rates and Bank Credit
Rates
J67
D66
J66
J65
D65
D63
D62
J63
D64
J64
D60
J62
J60
D61
D59
J61
J59
D58
J58
1000
2000
3000
4000
6000
7000
8000
9000
Bank Credit

(b) $D_{SF} = -7046 + 3576 \, id$ (for September 1960 to June 1965)
$$\qquad\qquad\qquad (402)$$

$n = 20 \quad R = 080$

(c) $D_{SF} = -23479 + 7617 \, id$ (for September 1965 to June 1967)
$$\qquad\qquad\qquad (214)$$

$n = 8 \quad R = 0.95$

where n is number of observations, R is the correlation coefficient and the numbers of parentheses under the coefficients are their standard errors. This shows that saving and fixed deposits have responded well to the rise in deposit rates following the rise in Bank rate in June 1965.

The second point which needs to be established is the source of growth in time deposits. The banks have all along opposed a rise in deposit rates because in their opinion it would only lead to a shift from demand to time deposits. Among others, the State Bank also until recently accepted this view. The data in table 5-8 suggests that since 1957 the increase in time deposits has been entirely at the cost of currency in circulation.

Ratio of Currency in Circulation to Money Supply and Money Multiplier

It is evident from data presented in table 5-8 that the average ratio of currency in circulation to money supply did not show any trend up to 1959. Since then it has declined steadily.

TABLE 5-7. Weighted Average Rate of Interest on Savings and Fixed Deposits.

Period	Rate of Interest p.c. p.a.	Amount (Million Rs.)
September 1960	2.13	1,097
December 1960	2.26	1,096
March 1961	2.35	1,135
June 1961	2.27	1,157
September 1961	2.35	1,226
December 1961	2.47	1,311
March 1962	2.47	1,375
June 1962	2.54	1,517
September 1962	2.53	1,674
December 1962	2.58	1,765
March 1963	2.58	1,834
June 1963	2.59	1,913
September 1963	2.54	2,051
December 1963	2.59	2,141
March 1964	2.47	2,277
June 1964	2.68	2,433
September 1964	2.55	2,664
December 1964	2.61	2,895
March 1965	2.64	3,111
June 1965	2.73	3,198
September 1965	3.49	3,341
December 1965	3.56	3,572
March 1966	3.62	3,901
June 1966	3.68	4,324
September 1966	3.71	4,554
December 1966	3.72	4,895
March 1967	3.75	5,119
June 1967	3.75	5,489

Source Calculated from quarterly data in State Bank Bulletin (Monthly).

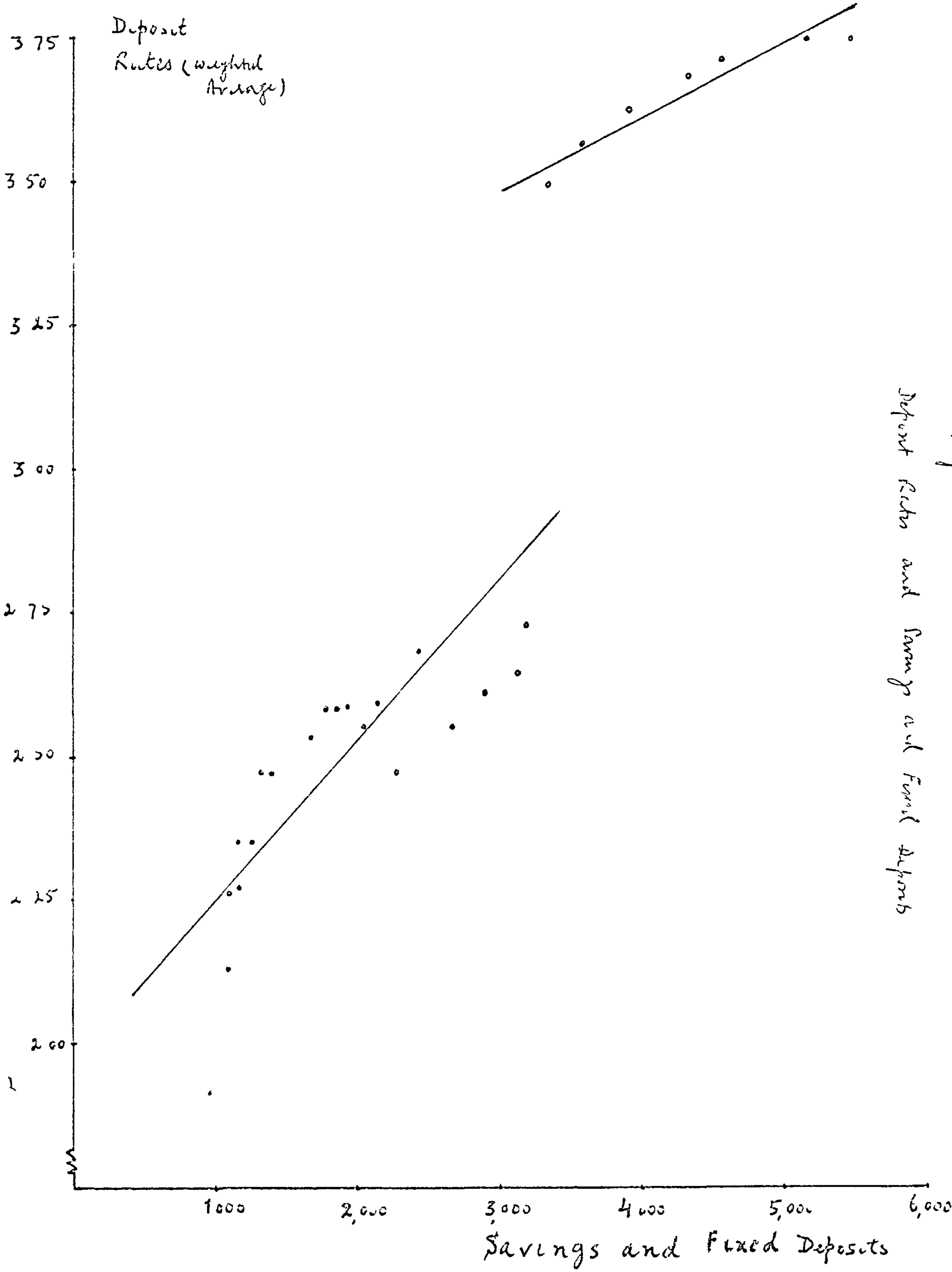


Figure 5-3
Deposit Rates and Savings and Fixed Deposits

The equation representing public holding of cash generally takes the form $C_p = a + b\,M_s$, where 'a' is any constant. Thus, it may be argued that as the money supply increases over time, the average ratio of currency in circulation to money supply may decline, with the marginal ratio (i.e. $\Delta C_p / \Delta M_s$) remaining constant. The estimates of C_m, however, clearly indicate that it has fluctuated very widely over this period

We have attempted three separate statistical estimates of the relationship between Cp and Ms, viz. (1) $Cp = a + bMs$,

(2) $\frac{Cp}{Ms} = Ca = a + bT$, and (3) $\frac{\Delta Cp}{\Delta Ms} = Cm = a + bT$. The numerical results are

(1) (a) $Cp = 1218 + 0.32\ Ms$ (for the period 1949 to 1967)

$R = 0.97 \quad n = 19$

(b) $Cp = 58 + \underset{(575)}{0.58}\ Ms$ (for the period 1949 to 1959)

$R = 0.997 \quad n = 11$

(c) $Cp = 2068 + \underset{(184)}{0.24}\ Ms$ (for the period 1960 to 1967)

$R = 0.974 \quad n = 8$

(2) (a) $Ca = 0.646 - \underset{(0.039)}{0.012}\ T$ (for the period 1949 to 1967)

$R = -0.87 \quad n = 19$

(b) $Ca = 0.623 - \underset{(0.012)}{0.025}\,T$ (for ther period 1957 to 1967)

$R = -0.99 \quad n = 11$

(3) $Cm = 0.606 - 0.028\,T$ (for the period 1949/50 to 1966/67)

$R = -0.30 \quad n = 18$

where n is number of observations, R is the correlation coefficient and the numbers of parentheses under the coefficients are their standard errors. We have plotted these results in ~~figures 5-3 and~~ 5-4. Two points clearly emerge from this. Firstly, Ca has declined steadily since 1957 and, secondly, the assumption that Cm is reasonably constant in the short-run is not warranted.

The banks allowed large changes in the cash reserve ratio up to 1959. Since then, this ratio has become stable at the lowest practical level and has varied only due to changes in legal reserve requirements.

We shall now examine the behaviour of the money multiplier. The average money multiplier can be expressed either as

$\acute{E} = \dfrac{1}{Ca+r(1-Ca)}$, or $E = \dfrac{Ms}{C}$, where C is the total monetary liabilities of the State Bank which include cash in circulation with the public (Cp) and cash in tills plus balances of banks with the State Bank (Cb). The estimates of the average money multiplier from these definitions show a slight discrepancy, because 'other deposits' with the State Bank have been treated as deposit money. We shall adopt

TABLE 5-8. Ratio of Currency in Circulation to Money Supply, Reserve Ratio and Money Multiplier.

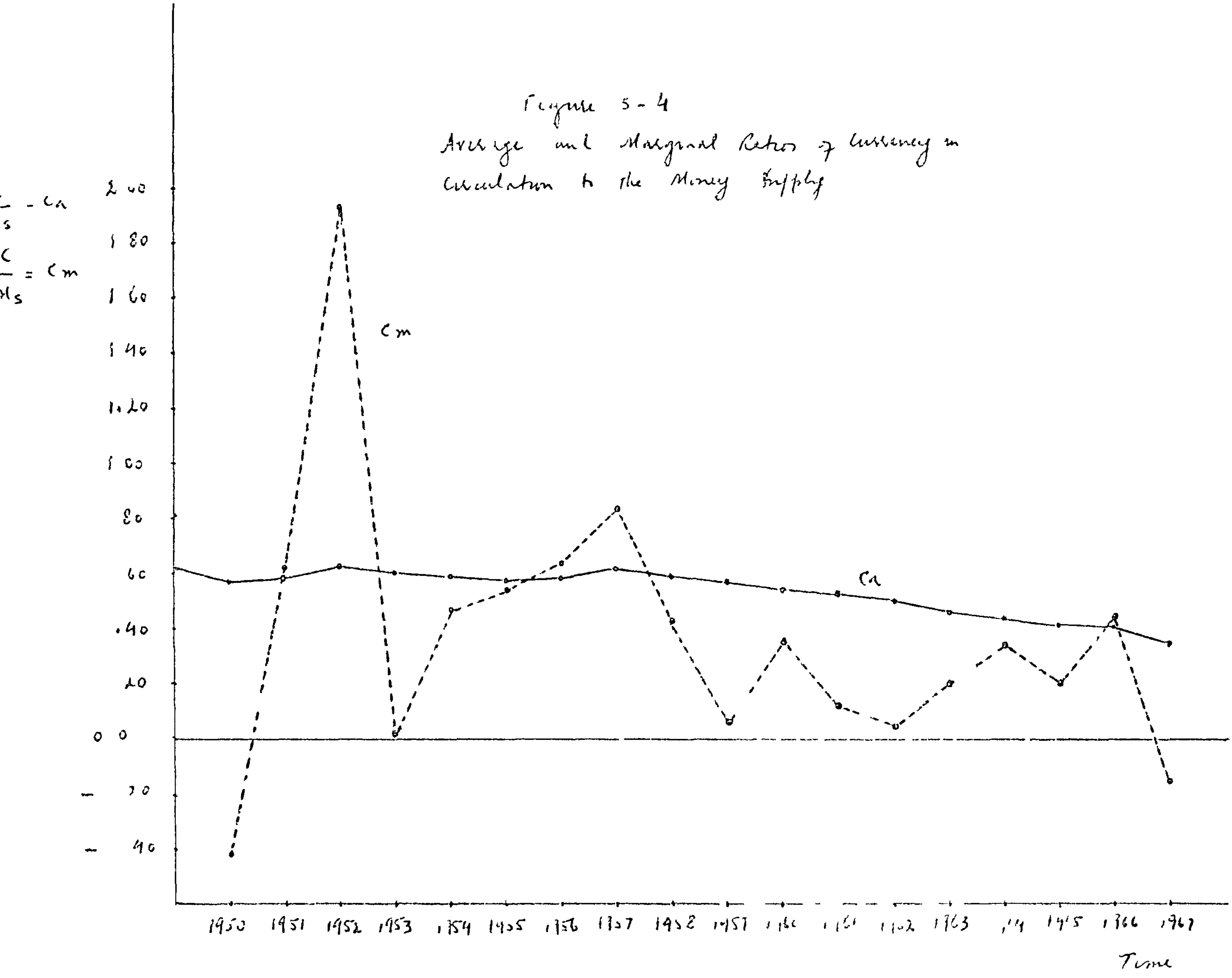
	$\frac{Cp}{Ms} = Ca$	$\frac{\Delta Cp}{\Delta Ms} = Cm$	$\frac{Cb}{D+T} = r$ (1)	$E' = \frac{1}{Ca+r(1-Ca)}$	$E = \frac{Ms}{C}$	$\frac{E'}{E}$	$E^{*} = \frac{\Delta Ms}{\Delta C} = \frac{1}{Cm+r(1-Cm)}$	ΔE
1949	0.606							
1950	0.578	- 0.42	14.9	1.545	1.565	.987		
1951	0.584	0.62	16.4	1.519	1.537	.988	1.383	- 0.028
1952	0.621	1.93	12.4	1.483	1.499	.989	0.800	- 0.038
1953	0.601	0.01	12.8	1.527	1.535	.995	5.363	+ 0.036
1954	0.588	0.47	11.4	1.568	1.576	.995	2.062	+ 0.041
1955	0.584	0.54	13.2	1.554	1.567	.992	1.475	- 0.009
1956	0.590	0. 63	15.7	1.510	1.532	.986	1.337	- 0.035
1957	0.611	0.83	9.5	1.522	1.547	.984	1.732	+ 0.015
1958	0.595	0.42	10.3	1.559	1.572	.992	1.912	+ 0.025
1959	0.574	0.06	12.3	1.587	1.598	.993	2.684	+ 0.026
1960	0.558	0.35	8.3	1.671	1.683	.993	5.156	+ 0.085
1961	0.538	0.11	8.3	1.724	1.736	.993	5.456	+ 0.053
1962	0.505	0.04	8.2	1.820	1.835	.992	9.277	+ 0.099
1963	0.461	0.20	8.3	1.966	1.977	.994	3.674	+ 0.142
1964	0.445	0.35	8.9	2.015	2 025	.995	2.358	+ 0.048
1965	0.414	0.20	10.8	2.087	2.100	.994	2.834	+ 0.075
1966	0.418	0.44	8.4	2.129	2.143	.993	2.437	+ 0.043
1967	0.358	- 0.15	10.9	2.322	2.340	.992	10.452	+ 0.197

Cb = Cash in tills plus balances of banks with the State Bak.
D = Demand deposits, and
T = Time deposits. $\bar{Ca}$ = 0.538 $\bar{Cm}$ = 0.37
Standard deviation (Ca) = 0.078 Standard deviation (Cm) = 0.48.

Source Calculated from data in Currency and Finance Reports of the Bank

Figure 5-4

Average and Marginal Ratios of Currency in Circulation to the Money Supply



the latter definition as it is statistically more convenient. In the same manner, the marginal money multiplier ($E'' = \frac{1}{Cm+r(1-Cm)}$) can be defined as $\frac{\Delta Ms}{\Delta C}$. The marginal multiplier has varied widely over the period under study owing to large variations in Cm. The average money multiplier showed small changes up to 1959, but there was no trend. Since 1960 it has increased steadily due almost entirely to a continuous decline in Ca, partly offset in some years by increases in the reserve ratio following a rise in legal reserve requirements.

Now we want to estimate how far the change in money supply each year is attributable to a change in (i) the State Bank's holdings of government debt and foreign assets, (ii) scheduled banks' borrowings from the State Bank, and (iii) the money multiplier We have seen above that

$$Ms = E\ C$$

where both E and C are variables. From the balance sheet of the State Bank we know that

$$C = F + G_1 + B$$

where F is foreign assets in the portfolio of the Bank, G_1, following the practice of the State Bank, includes government debt and other (net) assets of the Bank, and B is State Bank's advances to the banks in the form of loans and rediscounts. From the above two equations, we can derive the following equation

$$\Delta Ms = E_{t-1} (\Delta G_1 + \Delta F) + E_{t-1}(\Delta B) + \Delta E_t (C_t)$$

The numerical results are set out in table 5-9. It shows that money supply increased by Rs. 3,335 million during 1950-59. Of the total expansion of money supply over this period, Rs 3,165 million (or 94.9 per cent) is attributable to rise in the State Bank's holdings of government debt and foreign assets. The scheduled banks' borrowings from the State Bank accounted for Rs. 21 million (or 0 6 per cent) and the increase in money multiplier for Rs. 150 million (or 4.5 per cent) The pace of monetary expansion accelerated after 1959 and money supply increased by Rs. 9,259 million during 1959-67. The factors responsible for expansion of money supply over this period in order of importance are· (i) the increase in money multiplier, Rs. 3,856 million (or 41.6 per cent), (ii) Schedule banks' borrowings from the State Bank, Rs. 3,484 million (or 37.6 per cent), and (iii) increase in the State Bank's holdings of government debt and foreign assets, Rs. 1,919 million (or 20.7 per cent). Out of 8 years in the latter period, the expansionary effect of Δ E exceeded the expansionary role of Δ C in four years.

The analysis of growth of money supply presented above shows that the State Bank's analysis and presentation of changes in money supply in terms of consolidated balance sheets of the monetary

TABLE 5-9. Determinants of Change in Money Supply.

(Rs. in million).

(July-June)	Δ Ms	Determinants of change in Ms		
		$E_{t-1}(\Delta G+\Delta F)$	$E_{t-1}(\Delta B)$	$\Delta E_t\ (C_t)$
1950-51	+ 473	+ 535	-	- 62
1951-52	+ 96	- 18	+ 202	- 89
1952-53	+ 118	+ 219	- 186	+ 85
1953-54	+ 402	+ 290	+ 9	+ 104
1954-55	+ 357	+ 388	- 6	- 25
1955-56	+ 674	+ 762	+ 28	- 115
1956-57	+ 471	+ 313	+ 104	+ 54
1957-58	+ 497	+ 486	- 84	+ 96
1958-59	+ 247	+ 190	- 46	+ 102
1959-60	+ 495	+ 152	+ 2	+ 341
1960-61	+ 311	- 454	+ 550	+ 216
1961-62	+ 501	- 19	+ 113	+ 409
1962-63	+1275	+ 668	- 31	+ 635
1963-64	+1526	+ 494	+ 785	+ 246
1964-65	+1477	- 778	+ 1833	+ 423
1965-66	+2033	+ 3030	- 1279	+ 279
1966-67	+1641	- 1174	+ 1511	+1307

system preclude an identification of quantitatively quite important monetary changes that are due to behaviour variables. The explicit incorporation of the currency-money ratio, money multiplier and other relationships discussed above into the framework of monetary analysis and their continued observation would give the Bank more insight into the operation of the monetary system.

Chapter 6.

CENTRAL BANKING AND ECONOMIC DEVELOPMENT.

The third main objective of the State Bank is to assist in the fuller utilisation of the country's productive resources According to the classical standards of central banking this objective is unconventional. But in line with the considerable emphasis in the post-war period on economic growth, many writers[1] on central banking argue that the central bank in a developing economy should not view itself only as a stabilisation agency, but also as a promoter within its own field, of economic development The object of the present chapter is to examine the contribution of the State Bank to economic development, which can be conveniently discussed under the following topics (i) the provision of finance for development directly or indirectly, (ii) the creation of a suitable network of financial institutions, and (iii) encouraging the

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1 (a) Sayers, R.S., Central Banking After Bagehot, Oxford University Press, 1958, pp.115-123.
(b) United Nations, Domestic Financing and Economic Development, 1950, pp.67-70.
(c) Newlyn and Rowan, Money and Banking in British Colonial Africa, pp 272-292

flow of bank credit to productive uses and checking its flow to inessential uses

I

Money Supply and Economic Growth.

In the process of economic growth as real incomes grow, the demand for money increases The increase in the demand for money is likely to be greater than in proportion to the increase in production, if the provision is made for the extension of the monetized sector and some increase in the price level consistent with monetary stability. If the money supply does not expand to meet this demand adequately, it will lead to deflation and impede economic growth. The central bank by permitting the expansion of money supply to satisfy the desire of the public to increase their cash balances contributes to economic growth with price stability. The increase in the cash balances of the public represents savings matched by real resources that go into investment. If the expansion of money supply is the result of the accumulation of foreign exchange, the investment is represented by the foreign exchange To the extent that the expansion of the money supply takes place through government borrowing both from the central bank and the commercial banks, it makes available to the government the resources represented by such saving. To the extent that the expansion of the money supply takes place through business borrowing from the scheduled banks, it makes available to the private sector the resources represented by such saving.[1] The allocation of the bank credit among different borrowers affects the direction of investment arising from these savings.

The increase in money supply in excess of the rise in desired cash balances at a given price level is likely to lead to inflation, which might affect adversely the process of economic growth This means that the central bank should not only be in a position to control the expansion of money supply but also be able to assess the requirements of the public for cash balances We have discussed the State Bank's control over money supply in the preceding chapter Here we shall discuss the behaviour of the demand for money from the public.

The demand for money in Pakistan is predominantly of two types the 'transaction demand' for money corresponding to its function of means of payment, and the 'precautionary' or 'asset demand' for money corresponding to its function of store of value The precautionary demand for money is very important in Pakistan because most of the people live sufficiently near the margin of subsistence that they must make careful provision for emergency liquidity needs. Secondly, the unreliability of the markets for conversion of assets to money, makes it desirable to hold the bulk of precautionary balances

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1. I.M.F., Economic Development with Stability - A Report to the Government of India, 1953, pp 41-43

in the form of money [1] In developed countries there are substitute liquid assets, such as treasury bills, etc , and their prices (and yields) can seriously affect the desired money balances (or velocity of money). They are conspicuous by their absence in the portfolio of non-bank public in Pakistan The transactions demand for money, given the habits of payments and industrial integration, is considered a function of the level of income, while the precautionary demand for money is regarded a function of the rate of interest.

Any attempt to classify total holdings of money into transactions and precautionary balances will be arbitrary to a certain extent. We can, however, quite reasonably assume that all time deposits (or idle money balances) are precautionary balances and that the active money is largely composed of transactions balances The active money certainly contains an element of precautionary balances, but it is impossible to quantify that. For the purpose of analysis we shall assume that the active money represents transactions balances and the time deposits represent precautionary balances

We have set out the data regarding average cash balances in table 6-1. It is evident from column 1 that up to 1958 the State Bank could increase its monetary liabilities at a relatively higher rate than the growth of real income due to the desire of the public to

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1. Porter, R.C., 'Income Velocity and Pakistan's Second Plan', The Pakistan Development Review, Summer 1961, Karachi, pp.24-25

hold an increasing proportion of their income in the form of currency. The statistical estimate of the ratio of currency in circulation with the public to G.N.P. at current factor cost for the period 1950-58 is

$$\frac{Cp}{Y} = kc = .0864 + .0054\ T, \text{ where } T \text{ is financial year.}$$

The scope for the State Bank's contribution to savings with price stability has declined since 1958, firstly because the public wants to hold a larger proportion of their liquid assets in the form of interest-bearing deposits Secondly, the ability of the commercial banks to expand money on the basis of a given volume of reserve money is increasing. This, however, reduces but does not eliminate the need for further increase in the State Bank's monetary liabilities The reason is that tho ability of the commercial banks to expand money on the basis of a given volume of reserve money is limited This is so because the banks have to maintain a certain ratio of cash against their deposit liabilities and, secondly, it is unlikely that all money will be held in the form of deposits. The statistical estimate of currency - G.N P. ratio for the period 1958-1966 is

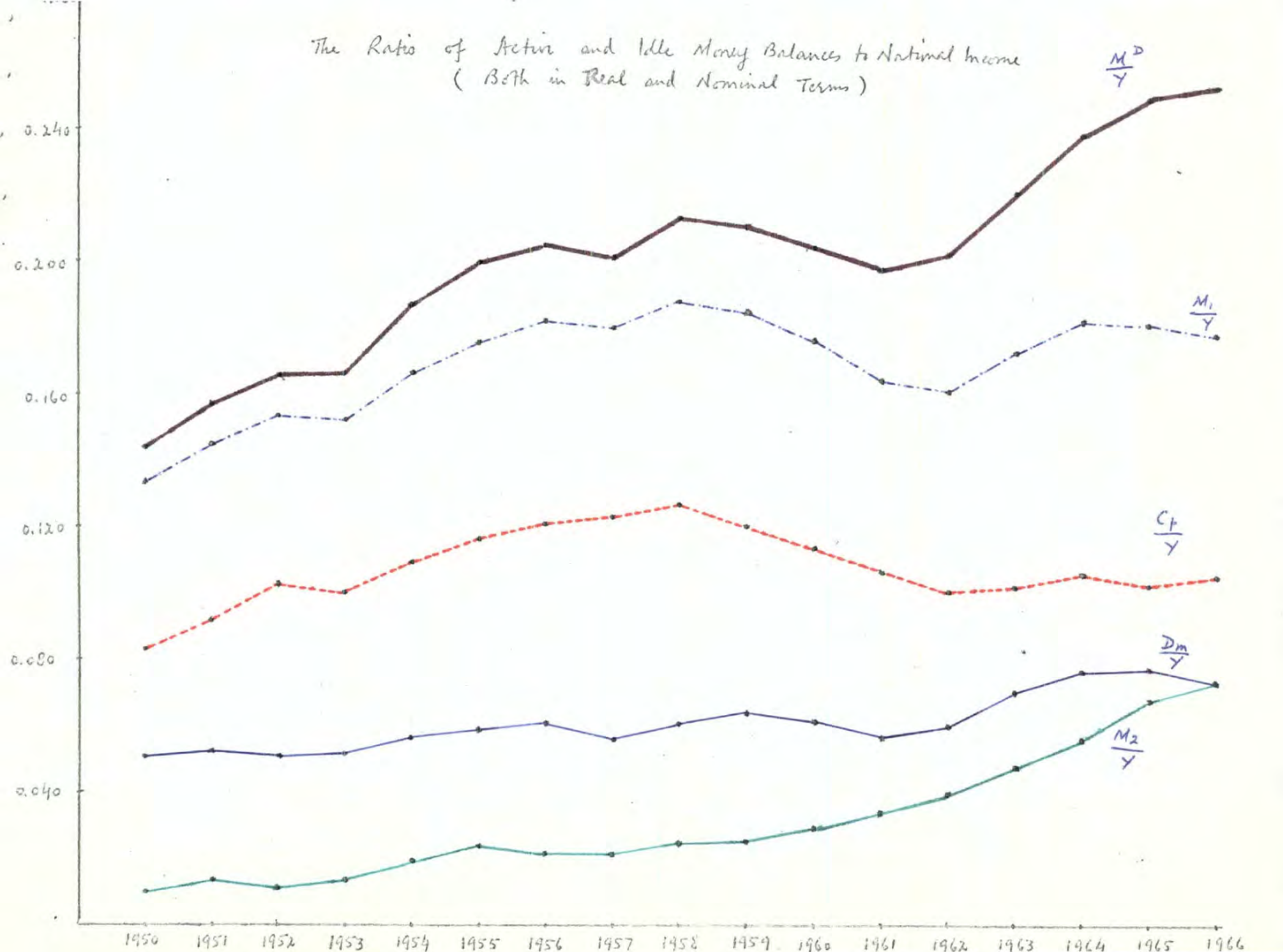
$$\frac{Cp}{Y} = kc = .1208 - .0027\ T, \text{ where } T \text{ is financial year}$$

TABLE 6-1 Average Cash Balances

June	$\frac{Cp}{Y}$	$\frac{Dm}{Y}$	$\frac{M_1}{Y}$	$\frac{M_2}{Y}$	$\frac{M^D}{Y}$
1950	083	051	134	010	144
1951	.092	.053	.145	.013	.157
1952	.103	.051	.154	.011	165
1953	.100	.052	.152	.014	166
1954	110	.057	.167	.020	.187
1955	.117	.059	.176	.024	.200
1956	.121	.061	.182	.023	.205
1957	.123	.057	180	.021	.201
1958	.127	.061	.188	.025	.213
1959	.121	.064	.185	.025	.211
1960	.114	.062	.176	.029	.204
1961	.107	.057	.164	.034	.198
1962	.101	.060	.161	.040	202
1963	.102	.071	.173	.048	.221
1964	.106	.077	.183	.056	.239
1965	.103	.078	.181	.068	.249
1966	.106	.074	.179	.074	253

Source Appendix Table No 5.

The Ratio of Active and Idle Money Balances to National Income
(Both in Real and Nominal Terms)



The ratio of demand deposits (including other deposits with the State Bank) to national income, which had gone up from 0.051 in 1950 to 0.061 in 1958, stood higher at 0.074 in 1966. This, however, partly offset the decline in the ratio of currency to national income so that the ratio of active money to national income declined over the latter period as against rise in the former period. This decline can partly be explained by the fact that the element of precautionary balances in the active money has declined since 1959 due to time deposits following the rise in deposit rates. It is also likely that the transactions demand for money is interest-elastic and as a result the increase in transactions demand for money has been less than proportionate to the growth rate of income.

The ratio of time deposits to national income increased from 0.010 in 1950 to 0.025 in 1958 and further to 0.074 in 1966. The statistical estimate of ratio of time deposits to G.N.P. is

$$\frac{M_2}{Y} = km_2 = 0.010 + 0.002\ T \quad \text{(for 1950-58)}$$

$$\frac{M_2}{Y} = km_2 = 0.0176 + 0.0066\ T \quad \text{(for 1958 to 1966)}$$

This shows that the ratio has increased at a far higher rate in the latter period compared to the earlier period. The increase in the asset demand for money more than offset the decline in demand for active money, so that the ratio of total money supply to national income rose in the latter period too. Thus, the banking system as a whole was able to contribute to national savings, though at a declining rate.

II

Studies conducted by the State Bank shortly after its establishment provided conclusive evidence that in all sectors of the economy the amounts of credit made available fall much short of requirements.[1] Credit was considered 'one of the gravest bottlenecks', and expansion of credit facilities became important objective of policy. Even during the periods of inflationary pressures, the State Bank advocated a policy of selective credit expansion because it believed that the very shortage of credit facilities was aggravating inflationary forces by hampering production.[2] The State Bank encouraged the growth of commercial banks to meet the credit requirements of commerce and the working capital requirements of industry. Specialised financial institutions were set up to provide finance to agriculture and medium and long-term credit to industry. The object of this section is to discuss the role of these institutions to eliminate or reduce the shortage in the supply of credit to agriculture and industry. ~~In~~ By reducing the shortage of credit, the Bank allows the rate of growth to be higher than it would otherwise be.

1. Annual Speech of Governor, State Bank of Pakistan, 1951, p.15.

2. op cit , p.15. See also Annual Speech of Governor, S.B.P 1954, p 8.

Agricultural Credit.

The Agricultural Development Finance Corporation (ADFC) was established in 1952 with a capital of Rs.50 million, subscribed entirely by the central government. Its only other source of funds was borrowings from the State Bank and the government. It was authorised to grant loans, both in cash and kind, for the purpose of seasonal agricultural operations, i.e. purchase of seeds, fertilizers, etc., and for the development of agriculture, such as purchase of mechanised equipment and the improvement of land. Up to June 1960, the total loans disbursed by the Corporation amounted to Rs.51.6 million. The rate of interest charged by the Corporation up to 1959 was 4 per cent for cooperative societies and 5 per cent for individuals In 1959, the rate for cooperative societies was also raised to 5 per cent and in November 1960, it was further raised to 6 per cent for both types of borrowers.[1] By the end of June 1960, the Corporation had incurred total loss of Rs. 3.1 million.

In 1959 another institution, namely the Agricultural Bank, was established with a paid-up capital of Rs. 32.5 million, of which the central government contributed Rs. 22.5 million and the provincial governments Rs. 10 million. The functions of the Bank were

1. State Bank of Pakistan, Agricultural Credit in Pakistan, 1962, p.89.

almost similar to those of the Corporation so a territorial division of jurisdiction was made between the two institutions. Up to June 1960, the Bank disbursed loans amounting to Rs. 21.1 million and incurred a loss of Rs. 1.4 million. The interest rate policy of the Bank was more complex. The interest charged to individuals up to 1959 was 6 per cent on loans for a period of 15 months, and 5 per cent on loans of longer maturity. The rates charged to cooperative societies and cooperative banks varied between 3½ and 6 per cent. In 1959, a uniform rate of 5 per cent was introduced for all types of borrowers and for all maturities of loans In 1960, the rate on loans up to 15 months was raised to 6 per cent.

Since both Agricultural Bank and the Corporation were performing similar functions and both of them were financed by the government, they were merged in 1961 into Agricultural Development Bank to facilitate the formulation of uniform rules and policy in the sphere of agricultural credit and to reduce administrative expenditure. The ADB is authorised to extend short-term credit for a period of 18 months for seasonal agricultural operations and marketing of crops, medium-term advances for a period of up to 5 years for the purpose of purchasing agricultural implements, dairy-farming, poultry-farming, cottage industries, etc., and long-term credit for the development of agriculture, construction of warehouses, installation of tubewells, etc. The advances are made against the hypothecation of crops, the security of land and other immovable property, and in the case of smaller loans against personal surity. In 1966, the Bank had a network of 124 branches.

The yearly disbursements of advances by the Bank increased from Rs. 69 1 million in 1960-61 to Rs. 87.5 million in the following year but declined to Rs. 76.9 million in 1964-65. They again rose to Rs. 109.5 million in 1965-66 following the allocation of a foreign currency loan to the Bank. The outstanding level of advances increased from Rs. 97 million in June, 1961 to Rs. 360 million in June, 1966. The average size of the loan comes to about Rs. 600 in East Pakistan and Rs. 7,000 in West Pakistan. This is because the land holdings in East Pakistan are small and the demand is generally for short-term loans for seasonal requirements. In West Pakistan the holdings are larger and there is substantial demand for medium and long-term loans for development purposes. In accordance with the emphasis on the mechanization of agriculture in the Third Plan, the bank is now required to concentrate on long-term credit.[1] The distribution of advances by maturity shows a sharp shift from short and medium-term advances to long-term advances since July 1965, the beginning of the Third Plan period.

The main sources of funds for the bank are (a) capital. The authorised capital of the bank is Rs. 200 million, but up to June,

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1. Government of Pakistan, Planning Commission, Third Five-Year Plan (1965-1970), p.423.

Period (July-June)	Short-term Advances	Medium-term Advances	Long-term Advances
	(in Percentage)		
1960-61	24.4	5.15	24.1
1961-62	46.1	25.0	28.9
1963-64	31.3	36.3	32 4
1964-65	33.5	38.5	28.6
1965-66	25.0	28.1	46.9
July '66 - Dec. '67	15.2	22.5	62.3

1966, only Rs. 100 million were subscribed - Rs. 90 million by the central government and Rs. 10 million by the provincial governments. (b) It is authorised to accept deposits but due to competition from commercial banks its deposits in June, 1966 amounted to Rs. 13.7 million only. (c) It can raise funds by issuing and selling bonds and debentures. In 1965-66 it issued debentures worth Rs. 5 million carrying 6 per cent interest with 10 year maturity and government guarantee. (d) The government had got an interest-free credit of Rs. 128.5 million from IDA, which it has re-lent to the bank at 4 per cent interest. (e) The main source of funds for the bank is borrowings from the State Bank, which have gone up from Rs. 3 million in 1961 to Rs. 222 million in 1966. In fact, over the four years ending June, 1965 borrowings from the State Bank accounted for 90 per cent of the expansion of bank's advances

Up to June 1965, the State Bank was lending to the Bank at the concessional rate of 3½ per cent, i.e. 0.5 per cent below the Bank rate, on the condition that the benefit of the low rate is passed on to the ultimate borrower In June 1965, the rate was raised to 4½ per cent following the rise in the Bank rate, but shortly afterwards the rate was restored to the original level of 3 5 per cent to provide relief to the ultimate borrower.[1] Thus the rise in Bank rate had no effect on rates charged by the Agricultural Development Bank which remained unchanged at 7 per cent on loans for period up to 5 years and 6 per cent on loans for longer periods.

The contribution of the Agricultural Development Bank to economic development in the coming years will depend on careful examination and diagnosis of three problems, viz. increase in and sources of loanable funds at the disposal of the bank, interest rate policy and the arrangements for the parallel increase in the supply of physical inputs to increase agricultural productivity For the State Bank only first two problems are directly relevant. The third problem is relevant only in this sense, that the provision of credit does not proceed far in excess of availabilities of improved seeds, fertilizers, bullocks and modern implements, etc., and thus simply lead to the

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1. State Bank of Pakistan - Annual Report, 1965-66, p.51.

inflationary pressures in the countryside.

The main problem confronting the ADB is the supply of loanable funds. Equity capital was supposed to be the main source of funds but in spite of sharp rise in its outstanding advances, the government has not raised its contribution to the equity capital of the bank since 1961. The bank could maintain its annual disbursements up to 1965 partly from repayments but the funds are likely to become less revolving under its new emphasis on long-term advances This means that to maintain the same level of disbursements the bank will have to seek relatively larger supplies of fresh funds. So far the State Bank has supplied the bulk of funds, but it will be extremely dangerous to persist in pressing the State Bank for a continued enlarged assistance The indiscriminate resort to the money creating powers of the State Bank even for productive purposes, after a certain limit, is bound to lead to inflation. This is because a mere creation of credit does not generate real resources. The resources must be simultaneously released through genuine savings. The net result would be the same if the government allocates funds to the equity capital of the bank by borrowing from the State Bank. This shows that the supply of loanable funds may become the most important limitation on the expansion of the activities of the bank, unless an appropriate interest rate policy is pursued.

The interest rate policy of the ADFC and ABP was examined in detail by the Credit Enquiry Commission in 1959.[1] It was argued by the witnesses giving evidence to the Commission that the rate of interest at 5 per cent charged by these institutions was too high because (a) they were raising their funds free of interest from the government and were asking for an unreasonable spread in charging 5 per cent, and (b) the productivity of capital applied in agriculture was low and the production was subject to the vagaries of the season. The Commission, on the other hand, rightly recommended a rise in the interest rates to 7 per cent 'given the current level of the Bank rate'. They argued that "interest is a price for loanable funds. It emerges from the interaction of demand as determined by the productivity of capital and of supply as determined by the population's ability and willingness to save. In establishing an appropriate rate, consideration must be given not only to the productivity factor but also to the higher cost at which genuine savings are forthcoming in a poor country. The equilibrium rate so determined relates to lending at minimum risk. A risk premium must be added to the basic rate. Since the risks inherent in agricultural credit are great, it follows that the effective lending rate must be high enough to meet the borrowing cost of the financing institution, its

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1. Government of Pakistan, Report of the Credit Enquiry Commission, Karachi, 1959, pp.73-76, 154-55.

establishment costs and an added element for creation of reserves against bad debts. Unless this is done, the agricultural credit institutions will need subsidies to meet their current running expenses and to cover their losses and will remain ever dependent for their working capital on budgetary appropriations or inflationary borrowing from the State Bank".[1] The F.A.O. had recommended rates as high as 13 to 15 per cent.[2]

We have seen above that the rate charged by the ADB remained unaffected by the rise in the Bank rate in 1965. Recently there is demand from the ADB and some other quarters that the State Bank should provide interest-free finance to the bank.[3] It is argued that with the opening of new offices the establishment cost is increasing, and secondly there is growing need for sufficient reserves for bad debts as the recovery rate is on the decline.[4]

To our knowledge, there has been no study of the productivity of the institutional finance provided to the agricultural sector. But according to two studies in another context the

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1. Report of the Credit Enquiry Commission, op.cit , pp 74-75.

2 op.cit., p.75.

3. Meenai, S.A., Money and Banking in Pakistan, op.cit., p.114, See also Economic Advisor, Government Pakistan, Financial Institutions.

4. Government of Pakistan, Pakistan Economic Survey for 1965-66, p.137, and 1966-67, p.152.

installation of tubewells is highly productive and they repay their cost in a period of two years.[1] Incidentally, a large part of the credit required for development purposes in the agricultural sector is for installation of tubewells. The recent IDA credit allocated to the bank is being used for this purpose If the productivity of the capital is as high there is no reason why the bank should not raise its advance rates. The rise in advance rates will enable the bank to offer better terms to attract resources from the market. The enlarged supply of loanable funds will enable the bank to increase its flow of credit to the agriculturalist In spite of rise in the advance rates, the cost of credit to the farmers in general would be reduced as the bank will be able to meet credit needs on a larger scale dispensing with the need for them to tap personal sources which are known to lend on extortionate terms

Industrial Finance.

In the immediate post-independence period, there were no institutions to extend medium and long-term credit to the industrial sector. In order to fill this gap in the credit structure, the Pakistan Industrial Finance Corporation (PIFCO) was established in 1949 to grant loans, subscribe to ~~the~~ debentures and underwrite the issue of shares,

1. Ghulam Mohammed, 'Development of Irrigated Agriculture in East Pakistan', Pakistan Development Review, Autumn 1966, p.365, Robert Dorfman, Roger Reville and Harold Thomas, 'Waterlogging and Salinity in the Indus Plain', P D.R. Autumn 1965, pp.342-343

bonds and debentures of industrial concern. It was, however, debarred from contributing directly to the equity capital of the industrial companies. The Corporation had a paid-up capital of Rs.20 million, of which 51 percent was contributed by the government. It was allowed to supplement its resources by accepting deposits and by issuing bonds and debentures. However, its total liabilities in respect of borrowing, guarantees and underwriting agreements were to remain within the limit of 5 times its capital and reserves

Total assistance provided by the Corporation in various forms up to June, 1960 amounted to Rs.147 million, of which Rs.47 million were outstanding. The size distribution of outstanding loans in 1959 was as follows

Size of Loan	No.of Loans	Amount (million Rs)	Percent of Total
Up to Rs 0 2 million	27	23 1	4 0
Above Rs 0.2 million and up to Rs. 0.5 million	32	105.6	18.6
Above Rs. 0.5 million and up to Rs. 1.0 million	20	147.9	25.9
Above Rs. 1 million and up to Rs. 2 million	12	177 0	31.0
Above Rs. 2 million and up to Rs. 3 million	4	117.0	20.5
Total	95	570.6	100.0

Source Report of the Credit Enquiry Commission.

The institution suffered from certain inherent weakness. It could not finance establishment of new industries or grant loans against prospective assets. Its finance was therefore of limited use for development and could in any case be used only by industries already in the field Moreover, it could provide loans only in local currency which could not be used effectively for development in the absence of foreign exchange component necessary for importing capital goods.

Taking note of this lacuna in the institutional framework for industrial finance, the State Bank sponsored a scheme for the establishment of an institution on the pattern of industrial development banks set up in many parts of the world [1] The new institution, namely the Pakistan Industrial Credit and Investment Corporation (PICIC) was set up in 1957 to provide medium and long-term finance, both in local and foreign currencies, to large-scale industrial enterprises. The minimum lending limit for a project is Rs. 1.5 million for foreign currency loans and Rs. 2.5 million for local currency loans. The minimum lending limit for foreign currency loans has been reduced recently to Rs. 1.0 million in case of new projects in East Pakistan and to Rs. 0.25 million for balancing and modernisation of medium-sized units. It is also authorised to participate directly in the equity capital and provide underwriting facilities. In the case

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1. William Diamond, Development Banks, The Johns Hopkins Press, Baltimore, 1957.

of large projects, it can make arrangements with the financial institutions abroad for joint financing. In fact the overriding objective of the Corporation is to attract foreign capital, both private and official

The rupee resources of the Corporation, consisting of capital, reserves and long-term loans from the government and the U.S AID, amounted to Rs. 167.5 million in December, 1966. The breakup shows that the Corporation has a paid-up capital of Rs. 40 million, of which 60 percent is contributed by the Pakistani private investors and 40 percent by the International Finance Corporation and foreign private interests. It has received three long-term loans from the government - Rs.30 million in 1957, Rs.30 million in 1961 and Rs.10 million in 1965. The first loan is interest-free, the second and third loans carry 4 percent and 5.5 percent interest respectively. The U.S. AID has sanctioned a rupee loan of Rs.30 million in 1966 from the Counterpart Funds at 5.5 percent interest. These loans are treated as equity for the purpose of debt-equity ratio. In foreign currencies, it has received lines of credit equivalent to Rs. 955 million of which credits from IBRD account for Rs. 518 million

The loan operations of the PICIC are set out in table 6-2. Total loans sanctioned by the Corporation since inception up to end-1966 amounted to Rs. 1,186 million, of which Rs. 1,148 million were in foreign currencies and Rs. 38 million in local currency Loans disbursed over this period amounted to Rs 650 million, or about 55 percent of the amount sanctioned. Its outstanding equity investments amounted to Rs. 41 million. In addition, its arranged finance from abroad for 11 of its larger projects totalling Rs.237 million and sponsored 20 joint ventures with the foreign interests which resulted in the inflow of foreign capital equivalent to Rs 58 million.[1]

Both PIFCO and PICIC were catering to the long-term credit requirements of large industrial enterprises. The medium and small-scale industries had no access to the institutional finance - both short-term and long-term, and were starved of credit.[2] In order to fill this gap, PIFCO was reorganised into Industrial Development Bank (IDBP) to provide long-term credit to small and medium-scale industries It was considered that the commercial banks will take care of the short-term credit requirements of these industries The IDB provides loans both in local and foreign currencies. It lends against existing as well as prospective assets. The foreign currency resources of the Bank consist of the allocation made by the government from loans negotiated with foreign countries and international agencies. Its rupee resources, as at the end of June 1966, are set out below

	(Million Rs.)
Paid up Capital	30
Reserves	23
Loans from Govt.	62
Borrowings from State Bank	122
Deposits	67
Total	304

1. PICIC - Ninth Annual Report for the year ending December, 1966, p.8.

2 Andrus and Mohammed, op.cit., p.181.

The IDBP sanctioned loans amounting to Rs. 1,126 million since inception up to June, 1966, of which 69 percent were foreign currency loans. In addition, it administered guarantees on behalf of government for loans amounting to Rs. 363 million. To finance small industries, the Bank has working arrangements with the small Industries Corporation in East and West Pakistan, who sponsor loan applications to the Bank and share the risks with it.

The PICIC and IDB have played a useful role in fostering private investment which, since 1960, has exceeded the Plan target.[1] PICIC has helped in the industrial capital formation to a far greater extent than is indicated by its loan operations. This is because PICIC normally supplies only the foreign exchange cost of the project and the rupee resources have to be raised by the investor. It is estimated that one rupee of PICIC assistance mobilised Rs. 1.16 of private funds.[2] The lending policies of the IDB seem to be more flexible as the prospective investor is expected to arrange 30 to 40 percent of the cost of the project. It is pertinent to point out that their operations have expanded due to the decision to channel foreign assistance arranged by the government to the private sector through them and to keep them well-supplied with local funds by advances from the government and the State Bank

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1. Planning Commission, Govt.of Pakistan, Final Evaluation of the Second Five-Year Plan, 1966, pp.10, 15.

2. Ahmad Said, 'Ten Years of PICIC', Investment and Marketing, November, 1967, p.100.

TABLE 6-2 Loans and Equity Investments of PICIC and IDBP Loans*

(Rs. in million)

	PICIC				IDBP			
	Loans Sanctioned	Loans Disbursed	Loans Outstanding	Equity Investments Outstanding	Loans Sanctioned		Outstanding Loans	
					Local Currency	Foreign Currency	Local Currency	Foreign Currency
1958	36	5	5	N A.				
1959	46	18	22	N.A.				
1960	60	44	63	N.A.				
1961	102	34	88	N.A.				
1962	133	53	133	14	56	113	100@	130@
1963	145	123	235	18	56	124	132	175
1964	253	106	298	27	83	261	167	297
1965	158	141	402	35	105	131	194	245
1966	253	126	473	41	45	152	218	332
Total	1,186	650			345	781		

* The figures for the IDB are for the fiscal year (July-June).

Source i) Annual Reports of PICIC and PICIC at Work, 1965, pp 10, 14.
ii) Annual Reports of IDBP.

Both PICIC and IDB, like ADB discussed above, have confined themselves to channelling funds placed at their disposal by the government. They have not got into the field of mobilising resources themselves. Nor have they established links with the banking system which in recent years has become the largest mobiliser of savings. At present unless the government is in a position to pump more money through these institutions, their operations may be severely curtailed. Their foreign currency loans may not suffer if the government is able to contract foreign loans and continue to allocate a part of these loans to them. The IDB, however, would need more regular flow of rupee finance to supplement its foreign exchange resources, if it has to continue to serve as an institution catering to the requirements of small and medium-scale industries rather than duplicate the efforts of PICIC.

The main reason why PICIC and IDB have remained simply purveyors of credit and have failed to serve as instruments of capital accumulation[1] seems to be their low interest policy Both PICIC and IDB charge interest at the rate of 7 5 percent on foreign currency loans. On rupee loans PICIC charges 6.5 percent and IDB 7 to 8 percent depending on the size of the loan. These rates have remained unchanged since 1959. They were relatively high compared to the advance rates of

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1. Planning Commission, The Second Plan, op.cit., p.77.

commercial banks in the earlier period. Due to continuous rise in advance rates of commercial banks over the last few years, the loan operations of these institutions have become relatively cheap. Allowing for the operational cost, it is therefore impossible for them to borrow from the market at rates which they can offer. It suggests that these institutions will have to adjust their interest rate policy, if they want to become viable institutions and get integrated into the money market.

The low interest rate policy is justified, firstly, on the ground that there will be an insufficient demand for their funds from the private sector if they were to charge rates of interest high enough to cover their administrative costs, to provide for bad debts and to reflect the 'true' cost of capital.[1] This argument assumes that the productivity of capital is low, while studies by the Planning Commission and others have shown that the productivity of capital, especially in the large-scale industry, is very high.[2] We have seen in chapter 5 that inspite of rise in the average advance rates from 4.2 percent to about 7.4 percent, the pressure of demand for credit on the commercial banks is increasing. Secondly, the Credit Committee in their report have argued that the rise in interest rates will adversely affect the emergence of middle class entrepreneur.[3] It is sufficient to point

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1. Andrus and Mohammed, op.cit , p.184
2. Planning Commission, Second Plan, op.cit., p.77, and Baqai, op.cit. p.
3. Govt.of Pakistan, Report of the Credit Committee, 1962, p.7

out that the Committee later in their report admit "that the element of interest is hardly a major obstacle in the way of the small man".[1]

III

Credit Policy for Development

In this section, we shall discuss the allocation of credit by the commercial banks. First, we shall analyse their lending operations and conventions. Then we shall discuss whether their policies are in harmony with the needs of the economy or they need to refashion their outlook and functions if they are to become effective partners in the process of economic growth and what part the State Bank can play in it.

The classification of bank credit by economic growth shows that in December, 1954 about 77 percent was committed for commerce and another 13.1 percent for 'manufacturing'. With the growth of the industrial sector, the banks have directed increasing amounts for meeting working capital needs and the 'manufacturing' sector accounted for 36.8 percent of the total bank credit in June, 1966 The share of commerce has correspondingly declined to about 42 percent. The proportion of bank credit claimed by these two sectors has declined from 90 3 percent in December, 1954 to 82.5 percent in June, 1960 and further

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1. op.cit., p.16.

to 78.9 percent in June, 1968. The major beneficiary has been the 'services' sector, which includes hotel industry, recreation services, etc This, however, conceals certain imbalances in the distribution of growth in bank credit Of the total increase of Rs.4,456 million in bank credit during 1960-66, commerce claimed 40.2 percent, 'manufacturing' 37.4 percent and 'services' 7.6 percent. The share of all other sectors, such as agriculture, construction, mining and public utility services, etc. comes to less than 15 percent of the total increase in bank credit. The bulk of the credit provided to the industrial sector has been used largely by a small number of people.[1] The relative share of each sector is set out in table 6-3

The classification of advances by securities pledged, set out in table 6-4 , shows that banks in Pakistan generally insist on securing their loans. The proportion of unsecured advances and advances secured by guarantee, however, seems to have gone up from 6.4 percent in June, 1960 to 11.2 percent in June, 1966. The most favoured security still remains 'merchandise', though its share has decreased from 71.4 percent in December, 1957 to 55.4 percent in June, 1966. The breakup of 'merchandise' into exports, imports, and 'other commodities', reveals that the decline has occurred entirely in respect of advances against export commodities. The breakup of 'merchandise' into 'agricultural' and 'other commodities' shows that

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1 Govt.of Pakistan, Third-Plan - op.cit , p.121, see also 'Concentration of Bank Credit' below.

TABLE 6-3 Classification of Bank Credit[1] by Economic Groups.

(Rs. in million)

	December 1954		June 1960		June 1966	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
1) Agriculture	10	1.04	50	3.10	153	2.52
2) Mining and Quarrying	3	0.31	15	0.93	24	0.40
3) Manufacturing	126	13.05	566	35.07	2,233	36.78
a) Food, Beverage & Tobacco Manufactures	11	1.14	45	2.79	245	4.04
b) Textiles	68	7.05	206	12.76	963	15.86
c) Chemicals and Chemical Products	1	0.10	14	0.87	105	1.73
d) Basic Metal, Machinery and Transport Equip.	6	0.62	89	5.51	325	5.35
e) Others	40	4.14	212	13.14	595	9.80
4) Construction	24	2.49	15	0.93	128	2.11
5) Electricity, Gas, Water and Sanitary Services	4	0.41	7	0.43	27	0.44
6) Commerce	745	77.20	766	47.46	2,559	42.15
7) Transport, Storage & Communication	12	1.24	15	0.93	156	2.57
8) Services	17	1.76	78	4.83	416	6.85
9) Others	24	2.49	103	6.38	375	6.18
All Economic Groups	965	100.00	1,614	100.00	6,070	100.00

1) Excludes advances of A D.B P. and I.D.B.P.

Source: The State Bank - Banking Statistics (Annual).

TABLE 6-4 Classification of Bank Advances by Securities Pledged.

(Million Rs.)

	December 1957		June 1960		June 1966	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
1) Precious Metals	14	1.3	23	1.6	47	0.8
2) Stock Exchange Securities	65	6.1	139	9.6	477	8.3
a) Govt.Securities	10	0.9	52	3.6	85	1.5
b) Others	55	5.2	87	6.0	392	6.8
3) Merchandise	755	71.3	951	65.8	3,175	55.4
i) a) Exports	487	46.0	353	24.4	1,153	20.1
b) Imports	148	14.0	283	19.6	998	17.4
c) Other Merchandise	120	11.3	314	21.7	1,024	17.9
ii) a) Agricultural Commodities	473	44 7	431	29.8	1,271	22.2
b) Others	282	26.6	520	36.0	1,904	33.2
4) Machinery and Other Fixed Assets	43	4.1	35	2.4	197	3.4
5) Real Estate	20	1.9	37	2.6	304	5.3
6) Financial Obligations	29	2.7	54	3.7	286	5.0
7) Others	133	12.6	207	14.3	1,243	21.7
Total	1,059	100.0	1,445	100.0	5,729	100.0

Source The State Bank of Pakistan - Banking Statistics (Annual).

the decline has occurred entirely in advances against agricultural commodities. The predominance of 'merchandise' as security is in line with the bulk of advances made to commerce and industrial sector. The advances to the industrial sector are also made generally against stocks of goods-in-process and unsold finished products. This seems to explain the increase in relative importance of 'non-agricultural merchandise' as security. The rise in advances against real estate may be related to the increased loans to hotel industry.

The predominance of bank advances committed to commerce and working capital of industry and of 'merchandise' as security is attributable to the fact that the portfolio policies of Pakistani banks are based on the commercial loan theory of banking which asserts that the banks should confine their lending operations to the financing of short-term, self-liquidating 'real' transactions The acceptance of this orthodox view, both by the commercial banks and the monetary authorities, is basically a historical accident The modern banking was introduced in pre-Partition India by the British bankers who, in addition to their traditional standards of 'sound banking', were interested only in financing the foreign trade of dependent countries As regards the preference of British commercial banks for short-term lending, it needs to be recognised that this was the outcome of certain historic and economic factors peculiar to that country [1] In Germany

1 Report of the Committee on Finance and Industry, Her Majesty's Stationary Office, London, 1930, pp.161-174.

and France, where capital was scarce and diffused, and the entrepreneurial talent too was in deficient supply, the banking system developed traditions of 'mixed' banking, forging close links with industry and in consequence became a powerful lever of industrialisation.[1] In the United States, the commercial banks regard 3-year loans for equipment as consistent with sound banking practice.[2] This shows that there is no unique pattern of 'high banking standards'. In fact, each banking system has to adapt itself to the economic environment in which it is operating and only then it can become effective partner in the process of growth.

This orthodox function of commercial banks in Pakistan is defended on the ground that since their deposits are payable on demand or at short notice, their assets should also be correspondingly short-term. Moreover, it is argued that the loan agreements are largely based on the judgement of branch managers and they can reasonably be expected to assess the capacity of a borrower to repay in a short time, though they could have no assurance in estimating long-term profitability.[3] It is further argued that the commercial banks by providing working capital enable the industrialists to use their

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1. Madan, B.K., 'Role of Commercial Banks in Developing Countries and Measures for Improving the Adequacy of Banking Facilities', in SEANZA Lectures, Vol.I, (ed) State Bank of Pakistan, 1964, pp.149-153.
2. I.M.F., Economic Development with Stability - A Report to the Govt. of India, 1953, pp.46-48.
3. Report of the Committee on the Working of the Monetary System, Her Majesty's Stationary Office, London, 1959, para 136.

own resources for investment. Dr Marquez believes that the concentration of bank credit in commerce does not matter so long as it is not used to build up excessive inventories. In his opinion, the credit for distribution is as important as credit for production and credit for working balances is as long-term as credit for fixed capital and, from the point of view of economic development, it does not matter whether banks finance the one or the other.[1] Though it is recognised that there is substantial truth in these arguments, writers on central banking[2] nevertheless argue that the commercial banks in an under-developed country like Pakistan can give more medium and long-term credit in order to finance fixed investment in agriculture and industry.

The following factors suggest that a moderate proportion of loans in medium and long-dated maturities would not constitute a threat to the liquidity of the commercial banks. First, the pattern and composition of their deposits has significantly changed in the last decade. The growing shift to time deposits should enable banks to take a more positive view of term lending. Secondly, although all loans are formally repayable on demand, a significant proportion of these are renewed from year to year. Recently, a rough approximation was attempted

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1. Marquez, Javier, 'Financial Institutions and Economic Development', in H.S.Ellis and H.C.Wallich (ed) Economic Development For Latin America, Macmillan, London, 1966, pp.179-182.

2. Sayers, R.S., Central Banking After Begehot, Oxford University Press, pp.121-122, U.N.Economic Development and Planning in Asia and the Far East, November 1956, p.413.

TABLE 6-5 Classification of Bank Credit[1] by Maturity (Million Rs).

	Short-Term Credit		Long-Term Credit		Total Bank Credit	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent
June, 1955	658	74.4	226	25.6	884	100.0
December, 1955	903	79.9	227	20.1	1,130	100.0
June, 1957	894	80.7	214	19.3	1,108	100.0
December, 1957	1,053	84.2	198	15.8	1,251	100.0
June, 1959	1,031	80.0	257	20.0	1,288	100.0
December, 1959	1,309	80.8	312	19.2	1,621	100.0
June, 1964	3,437	77.5	995	22.5	4,432	100.0
December, 1964	4,390	77.7	1,262	22 3	5,652	100 0
June, 1965	4,607	76.5	1,415	23 5	6,022	100.0
December, 1965	4,904	76.6	1,502	23.4	6,406	100.0
June, 1966	4,677	72.2	1,797	27.8	6,474	100.0
December, 1966	5,743	73.5	2,070	26.5	7,813	100.0

1. Excludes advances by IDBP and ADBP, and includes investments of banks in private securities.

by the Working Group appointed by the Ministry of Finance on Credit and Finance on the basis of certain assumptions.[1] The classification of bank credit by maturity on the basis of these assumptions is set out in table 6-5. It shows that about one-fourth of bank credit is, in actual practice, for long-term purposes It would, therefore, make no radical departure from existing practice if commercial banks formally start giving medium and long-term credit for production purposes. That would enable the borrowers to plan ahead their investment, production and repayment schedules.

Moreover, the liquidity of bank assets does not necessarily depend on their 'marketability' or their 'self-liquidating' character. It rather depends on their 'shiftability' to the central bank and thus leading to the creation of additional reserve money.[2] The State Bank can devise an institutional arrangement which, through refinance facilities can eliminate or alleviate the illiquidity of such loans. In India, a Refinance Corporation has been established to provide relending facilities against loans given by the banks to industrial concerns for the purpose of increased production.[3] The State Bank can also encourage banks to provide more development finance by

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1. Courtesy State Bank of Pakistan.
2. Dacey, W.M., <u>The British Banking Mechanism</u>, Hutchinson University Library, London, 1964, pp.85-88.
3. Guptn, G.P., <u>The Reserve Bank of India and Monetary Management</u>, Asia Publishing House, 1962, pp.334-335, 372.

increasing their investments in industrial securities, by participating in the equity and debentures of the specialised financial institutions and by participating with the specialised institutions for joint ventures. This would, by forging a link between commercial banks and specialised institutions, mark a step towards integration of the short-term money market with long-term capital market. This will, however, not be possible so long as the specialised institutions persist in their cheap credit policy.

Another problem which requires close attention, is the concentration of bank credit in few hands. It is evident from table no 6-6, that both PICIC and IDB are catering mainly to the credit requirements of large-scale industry. The concentration of commercial bank credit was first pointed out by the Credit Enquiry Commission, which observed that at the end of March, 1959, 63 percent of bank advances were locked up in only 222 accounts involving Rs. 1 million and above. At the other end, advances up to Rs.25,000 to small borrowers accounted for only 5.6 percent of total bank advances. The proportion rose to only 13 percent even if advances up to Rs. 0.1 million were included. They also pointed out that before Partition, the small industrialist and businessman was able to obtain finance from money-lenders and indigenous bankers, largely in the form of discounting of 'hundis'. The indigenous bankers in turn were able to rediscount 'hundis' with the commercial banks. With the migration of indigenous bankers after Partition, the small business has lost this source of finance.[1]

There appear to be three main sets of reasons accounting for the concentration of bank credit. Firstly, the basic factor seems to be the industrial and commercial policies of the government. In the industrial field, the government encouraged the distribution of income in favour of a small class of entrepreneurs. This is because in view of low level of per capita income and saving potential and the inadequacy of financial institutions to mobilise savings, rapid industrialisation was considered possible only through reinvestment of corporate profits.[2] These industrialists also became importers as import licences were issued to them as industrial consumers. Finally, they were encouraged to participate in the export trade through export incentive schemes. It is obvious that bank credit must follow the overall pattern of government policy. If the import licences and sanctions to set up new industrial units continue to go to a handful of family groups, it would be unrealistic to expect that the banks would refuse credit to them and direct the flow of credit to the small man who may have little productive use to make of such funds in the absence of licences and sanctions. Recently, the government has

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1. Govt.of Pakistan - Report of the Credit Enquiry Commission, 1959, Chapter XV.

2. Govt.of Pakistan (Planning Commission), Third Five-Year Plan (1965-70), p.117.

decided to induct new comers into industry and trade.[1] It has come to realise that each family group of entrepreneurs is engaged in such a broad spectrum of industrial, commercial and trading activities that it may include the manufacture of cotton textiles, chemicals, consumers goods, agricultural produce, commercial trading, banking, insurance, shipping lines and sale agencies for foreign manufactures. As a result, the management is inefficient, productivity is low and overall contribution to the economy is poor.[2] In spite of high cost of production due to poor management, the profits are quite high owing to protective tarrifs and sheltered domestic market. The new entrants into the industrial and commercial fields are finding it difficult to obtain credit from the banks and some of them sell their licences to the established parties.[3]

The second factor is the reluctance of the banks to extend credit to the small and middle level entrepreneur. This is because they find it difficult to establish the 'credit-worthiness' of these borrowers, the cost per rupee for administering small loans is high and in the case of default the expenditure on legal proceedings for recovery is out of proportion to the sums involved.

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1. Third Plan, op.cit., p.118, see also Annual Speech of the Governor, State Bank of Pakistan, 1966, p.14.

2. Third Plan, op.cit., p.447.

3. Govt.of Pakistan, Report on the Credit Committee, 1962, pp.14-17, Annual Speech of the Governor, State Bank of Pakistan, 1966, pp.14-15.

TABLE 6-6 Size Distribution of Loans of PICIC and IDBP.

	P I C I C (Cumulative as on December 31,1964)			I D B P (Cumulative as on March 31, 1967)		
	No. of Projects	Amount (Million Rs).	Percent of Total	No. of Projects	Amount (Million Rs)	Percent of Total
Up to Rs 0.5 million	126	40	5.1	2,442	289	22.3
Over Rs. 0.5 million to Rs. 1 million	84	65	8.4	299	214	16 5
Over Rs. 1 million	195	670	86.5	245	793	61.2
Total	405	775	100.0	2,986	1,296	100.0

Source 1) PICIC - PICIC at Work, 1965, p.15.

2) Govt. of Pakistan, Economic Survey - 1966-67, p.148.

Thirdly, the small entrepreneur is unable to offer suitable security, he has no regular business with the banks to gain their confidence and understanding, and he is not used to maintaining elaborate financial statements of his business. On the other hand, the banks find advances to large parties not only profitable, but they are also very careful not to lose them to other banks.

The Credit Commission (1959) and the Credit Committee (1962) made a number of recommendations to bring about a wider disposal of bank credit. These included a) the setting up of a Peoples Finance Corporation, b) appointment of guarantee brokers and the establishment of discount houses, and (c) to earmark a certain percentage of bank deposits for making advances to small borrowers. The idea of establishing a Finance Corporation, dependent for its financial resources on government budgetary appropriations, was rejected on the ground that it would not be able to command sufficient resources or spread its network widely. The other two recommendations, for the reasons discussed below, were also not accepted by the government. The State Bank was asked to use its moral pursuation with the banks to encourage them to lend more to the small parties.

The State Bank, unarmed with any special powers to coerce the banks, has sought to bring about the desired change in the distribution of bank credit by using its influence with the banks. In addition, the Bank took positive measures, such as, the exemption of advances up to Rs.50,000 from margin requirements imposed on certain categories of bank advances in 1960 and 1964 Secondly, under the Quota System introduced in 1963, it was provided that in addition to the quota the banks could borrow at the Bank rate amounts equal to their advances of Rs 25,000 or below, subject to the condition that the benefit of the basic rate, i.e., the Bank rate, was passed on to the small borrowers. Since January, 1964, the National Bank of Pakistan has introduced a Peoples Credit Scheme to provide credit to the small traders and industrialists. The lower and upper limits for loans under this scheme are Rs. 250 and Rs. 50,000 respectively. In the first year, it sanctioned loans amounting to Rs. 222 million. In the subsequent two years, loans under this scheme have declined drastically. It seems the early enthusiasm of the National Bank has gradually subsided. It might be partly due to the fact that at the end of 1966 about 60 percent of the outstanding advances were overdue for more than one year.

There has been some progress towards wider dispersal of bank credit. The ratio of advances up to Rs. 25,000 to total bank credit has gone up from 4.7 percent in December, 1957 to 11.0 percent in June, 1966. The improvement is particularly significant as at the latter date the ratio is related to a much larger total figure. At the other end, the ratio of advances involving more than Rs. 1. million per account has declined from 60.2 percent to 51.9 percent over this period. But this improvement in the supply of credit to the small man seems to be inadequate to meet the growing demand for credit, and it is

TABLE 6-7 Loans and Recoverıes Under the People's Credıt Scheme. (Rs. ın mıllıon).

	1964		1965		1966		Progressıve total up to 31.12.1966.	
	No.of A/Cs	Amount	No. of A/Cs	Amount	No. of A/Cs	Amount	No. of A/Cs	Amount
1. Loans								
ı) Up to Rs.10,000	17,649	95	4,557	29	3,354	19	25,560	143
ıı) Above Rs.10,000 and up to Rs. 25,000	4,003	79	1,274	19	491	13	5,768	111
ııı) Above Rs.25,000	1,189	48	141	6	198	7	1,528	61
TOTAL	22,841	222	5,972	54		39	32,856	315
2. Recoverıes								
ı) Overdue for more than one year		-		20		58		N.A.
ıı) Overdue less than one year		76		57		19		N.A.
ııı) Amount realısed		74		65		78		217
3. Total Outstandıng on 31.12.1966								98

Source Govt of Pakıstan - Economıc Survey - 1966-67, pp.140-141.

felt that this process needs to be further accelerated.

Both Credit Commission and Credit Committee had recommended that a certain percentage of bank deposits should be earmarked for loans to the small parties. The Bank does not support this view on the ground that, apart from practical difficulties of implementation and the risk of circumvention, it would lead to regimentation of banks' activities. The Bank is also opposed to the suggestion of placing a ceiling on advances to the individual parties,[1] because it might lead to waste of scarce resources. It points out that the small man was more bereft of credit facilities in 'fifties, when the banks were loaded with surplus loanable funds, than in the 'sixties, when the banks are facing increasing pressure on their resources So, it argues, that the denial of credit to the big parties would in no way ensure larger supply of credit to the small man. There are real difficulties, such as higher cost and risk in the way of expansion of bank credit to the small man which need to be removed first. It is, however, hard to understand that the Bank has not only done precious little to remove these difficulties, but also it has all along insisted on cheap credit to the small borrowers.[2]

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1. Mohammed Uzair, 'Recent Trends and Problems in Banking', DAWN (Daily Paper), Sept.15, 1968, Hasnie, S.A., 'Rising Dangers in Banking' Supplement to DAWN, March 24, 1967, p.III.

2. Governor, State Bank of Pakistan, Annual Speeches, 1961, p.12, 1962, p.20.

The establishment of the Peoples Finance Corporation on the lines of the Small Business Administration of the U.S.A. and the Peoples Finance Corporation in Japan, with powers not only to provide direct assistance, but also to guarantee the loans of the scheduled banks might partly reduce the risk element. In India, a credit guarantee scheme is in operation since July, 1960 to encourage the banks to enlarge their credit to the small-scale industries. Under this scheme, the government has assumed a major portion of the risk by sharing the bulk of the losses incurred by the banks. The scheme is administered by the Reserve Bank on behalf of the government.[1] Even after the establishment of such an institution credit to the small man will not be at par with that to the big parties. Unless the difference in the price of credit, based on the risk and cost elements, is allowed, the availability of credit to the small man will remain limited.

In recent years, the advance rates have started rising following the rise in deposit rates which, in turn, is due to directives issued by the State Bank. The general upward movement of advance rates is likely to knock out demand for credit for certain unproductive, marginal or undesirable investments. It would discourage undue accumulation of inventories and might ease the pressure

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1. Gupta, G.P., The Reserve Bank of India and Monetary Management, Asia Publishing House, London, 1962, pp.335-337.

TABLE 6-8 Classification of Bank Advances by Size of Account.

(Rs. in million)

	December, 1957			December, 1961			June, 1966		
	No.of A/Cs	Amount	Percent of Total	No.of A/Cs	Amount	Percent of Total	No.of A/Cs	Amount	Percent of Total
Advances up to Rs. 25,000	26,104	57	4.7	63,195	175	8.0	155,964	631	11.0
Advances from Rs.25,000 to Rs. 1 Lae*	1,803	90	7.5	4,752	228	10.4	11,749	700	12.2
Advances from Rs.1 lac to Rs. 5 lac	903	204	17.0	1,833	363	16.6	4,726	940	16.4
Advances from Rs. 5 lac to Rs. 10 lac	179	128	10.6	278	237	10.8	695	483	8.4
Advances from Rs. 10 lac to Rs. 50 lac	184	386	32.1	305	581	26.5	540	1,119	19.5
Advances above Rs.50 lac	33	338	28.1	41	619	27.7	134	1,856	32 4
TOTAL	29,206	1,203	100.0	70,404	2,196	100.0	173,808	5,729	100.0

1. Excludes advances of IDBP and ADBP .

* Lae = 100,000

Sources Govt.of Pakistan - Report of the Credit Committee, 1962, p.12. The State Bank of Pakistan - Statistics on the Scheduled Banks (Quarterly), June, 1966.

of demand for credit from large parties. The large parties are generally accomodated by the banks at concessional rates of interest. It is evident from table 6-9 that in June, 1964, 19.1 percent of total bank credit was at or below Bank rate. The ratio has declined to 6.9 percent in June, 1966. The State Bank should fix minimum advance rates like the Reserve Bank of India which has set the minimum limit for advance rates at 2 percent above the Bank rate. This step is likely to discourage excessive demand for bank credit from the big parties/

TABLE 6-9 Classification of Scheduled Banks' Advances*

by Interest Rates.

(Rs in lacs)

June Rate of Interest	1958	1959	1960	1962	1964	1966
00.00	150	279	296	406	678	956
0.25-3.00	1,766	59	180	140	226	349
3.25-4.00	3,175	2,235	2,161	3,793	7,277	451
4.25-5.00	4,001	3,419	3,857	7,051	9,523	2,562
5.25-6.00	1,083	4,084	6,571	9,400	13,751	16,036
6.25-7.00	221	752	988	4,442	10,279	14,872
7 25 and above	194	175	396	693	1,686	27,960
Total	10,590	11,003	14,449	25,925	43,420	63,166
			(Percentage)			
00.00	1.4	2.5	2.1	1.6	1.6	1.5
0.25-3.00	16.7	0.5	1.2	0.5	0.5	0.6
3.25-4.00	30.0	20 3	15.0	14.6	16.8	0.7
4.25-5.00	37.8	31.1	26.7	27.2	21.9	4.1
5.25-6.00	10.2	37.1	45.5	36.3	31.7	25.4
6.25-7.00	2.1	6.8	6.8	17.1	23.7	23.5
7.25 and above	1.8	1.6	2 7	2 7	3.9	44 2
	100.0	100.0	100.0	100.0	100.0	100.0

Source The State Bank of Pakistan - Banking Statistics of Pakistan, 1965-66.

* Includes advances by the IDBP and ADBP

N B. - The Bank rate was raised from 3 percent to 4 percent in January, 1959 and further to 5 percent in June, 1965.

APPENDIX TABLE NO:1. Consolidated Balance Sheet of the State Bank of Pakistan (Rs. in million)

	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
1. Notes in Circulation	1682	1714	1924	2094	2081	2240	2417	2835	3202	3373	3411	3566	3609	3645	3953	4444	4817	5746	5618
2. Balances of Banks[a]	217	149	189	109	146	164	194	275	161	209	262	194	196	230	306	384	584	491	759
3. 'Other Deposits'[b]	35	37	40	38	21	20	30	73	88	46	44	44	45	50	50	54	64	92	132
Total (1)+(2)+(3)	1934	1900	2153	2241	2248	2424	2641	3183	3451	3628	3717	3804	3850	3925	4309	4882	5465	6329	6509
4. Government Deposits	820	560	797	444	377	199	172	178	72	180	182	124	70	259	167	311	276	241	221
5. Counterpart Funds and Loan A/C[c]	-	-	-	-	-	-	-	155	601	637	664	822	1086	873	1057	785	977	779	729
6. Other Special Deposits[d]	-	-	3	3	3	4	8	26	5	5	5	12	72	66	66	7	83	310	332
7. Capital, Reserves and Rural Credit Fund	60	60	60	60	60	60	60	60	60	60	60	72	82	97	112	127	143	163	253
8. Other Liabilities	34	29	59	42	74	55	48	87	142	127	145	159	175	225	222	224	310	363	353
Liabilities = Assets	2849	2549	3072	2790	2763	2742	2928	3689	4331	4637	4772	4993	5335	5446	5931	6334	7254	8184	8396
Foreign Assets	2514	1747	2184	1514	1116	1103	1174	2004	1787	1521	1770	1986	1896	1810	2082	1885	1550	1837	1165
Govt. Securities and Treasury Bills	324	614	814	1028	1423	1432	1579	1494	2341	2867	2801	2733	2967	2968	3216	3358	3661	4794	5009
Loans and Advances to Govt.	1	-	2	2	103	75	54	-	-	110	87	125	15	96	56	132	140	242	129
Advances to Banks[e]	-	-	-	132	24	31	25	30	94	42	19	43	347	445	440	816	1739	1126	1826
Other Assets	10	188	71	113	97	102	96	161	109	97	96	105	110	126	136	143	163	185	266

a) Includes balances of non-scheduled banks.
b) That part of 'other deposits' reported by the Bank which form part of money supply.
c) and d) They are reported under 'other deposits' in the balance sheets of the Bank.
e) Includes advances to non-scheduled banks.

Source: State Bank of Pakistan - Reports on Currency and Finance and information supplied by the Bank.

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APPENDIX TABLE NO:2 Reserve Money (C) (Rs. in million)

June (Last Friday)	Composition of Reserve Money: Monetary Liabilities of the State Bank — Notes in Circulation	Scheduled Banks' Balances*	Total	Treasury Currency	Total Reserve Money	Reserve Money Held by: Public C_p	Scheduled Banks C_b	$\frac{C_b}{C}$
1950	1714	132	1846	25	1871	1692	179	0.096
1951	1924	173	2097	116	2213	1987	226	0.102
1952	2094	103	2197	136	2333	2172	161	0.069
1953	2081	133	2214	141	2355	2173	182	0.077
1954	2240	143	2383	167	2550	2363	187	0.073
1955	2417	188	2605	187	2792	2556	236	0.085
1956	2835	264	3099	197	3296	2982	314	0.095
1957	3202	142	3344	224	3568	3373	195	0.055
1958	3373	194	3567	261	3828	3582	246	0.064
1959	3411	253	3664	256	3920	3598	322	0.082
1960	3566	180	3746	270	4016	3772	244	0.061
1961	3609	184	3793	280	4073	3806	267	0.066
1962	3645	207	3852	275	4127	3825	302	0.073
1963	3953	262	4215	259	4474	4082	392	0.088
1964	4444	360	4804	317	5121	4612	509	1.099
1965	4817	574	5391	251	5642	4902	740	0.131
1966	5746	476	6222	254	6476	5802	674	0.104
1967	5618	720	6338	295	6633	5562	1071	0.161

* As reported in the combined balance sheets of scheduled banks.

Source: State Bank of Pakistan - Reports on Currency and Finance (Annual).

APPENDIX TABLE NO: 3

The Causative Analysis of Changes in Reserve Money

(Rs. in millions)

	1950-51	1951-52	1952-53	1953-54	1954-55	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61	1961-62	1962-63	1963-64	1964-65	1965-66	1966-67
Notes in Circulation	+ 210	+ 170	- 13	+ 159	+ 177	+ 418	+ 367	+ 171	+ 38	+ 155	+ 43	+ 36	+ 308	+ 491	+ 373	+ 929	- 128
Balance of Banks*	+ 40	- 80	+ 37	+ 18	+ 30	+ 81	- 114	+ 48	+ 53	- 68	+ 2	+ 34	+ 76	+ 78	+ 200	- 93	+ 268
Treasury Currency	+ 91	+ 20	+ 5	+ 26	+ 20	+ 10	+ 27	+ 37	- 5	+ 14	+ 10	- 5	- 16	+ 58	- 66	+ 3	+ 41
Total Reserve Money	+ 341	+ 110	+ 29	+ 203	+ 227	+ 509	+ 280	+256	+ 86	+ 101	+ 55	+ 65	+ 368	+ 627	+ 507	+ 839	+ 181
Foreign Assets (F)	+ 437	- 670	- 398	- 13	+ 71	+ 830	- 217	- 266	+ 249	+ 216	- 90	- 86	+ 272	- 197	- 335	+ 287	- 672
Govt.Debt and Other Assets (net) (G_1)	- 94	+ 646	+ 520	+ 208	+ 170	- 282	+ 448	+ 532	- 142	- 140	- 157	+ 58	+ 98	+ 453	- 70	+1193	+ 192
Borrowings of Banks (B)	-	+ 132	- 108	+ 7	- 6	+ 5	+ 64	- 52	- 23	+ 24	+ 304	+ 98	- 5	+ 376	+ 923	- 613	+ 700
Breakup of G_1																	
Govt.Securities and Treasury Bills	+ 200	+ 214	+ 395	+ 9 *	+ 147	- 85	+ 847	+ 526	- 66	- 68	+ 234	+ 1	+ 248	+ 142	+ 303	+1133	+ 215
Govt.Borrowings	+ 2	-	+ 101	- 28	- 21	- 54	-	+ 110	- 23	+ 38	- 110	+ 81	- 40	+ 76	+ 8	+ 102	- 113
Govt.Deposits	- 237	+ 353	+ 67	+ 178	+ 27	- 6	+ 106	- 108	- 2	+ 58	+ 54	+ 189	+ 92	- 144	+ 35	+ 35	+ 20
Counterpart Fund, Loan A/Cs, Other special Deposits	-	3	-	- 1	- 4	- 173	- 425	- 36	- 27	- 165	- 324	+ 219	- 184	+ 331	- 268	- 29	+ 28
Capital Reserve Fund	-	-	-	-	-	-	-	-	-	- 12	- 10	- 15	- 15	- 15	- 16	- 20	- 90
Other Assets (Net)	- 147	+ 59	- 48	+ 24	+ 1	+ 26	- 107	+ 3	- 19	- 5	- 11	- 34	+ 13	+ 5	- 66	- 31	+ 91
Treasury Currency	+ 91	+ 20	+ 5	+ 26	+ 20	+ 10	+ 27	+ 37	- 5	+ 14	+ 10	- 5	- 16	+ 58	- 66	+ 3	+ 41

* As reported in the Balance Sheets of the State Bank of Pakistan. It includes balances of non-scheduled banks as well.

APPENDIX TABLE NO: 4 — Determinants of Money Supply. (Rs. in million)

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967
Currency in Circulation (Cp)	1692	1987	2172	2173	2363	2556	2982	3373	3582	3598	3772	3806	3825	4082	4612	4902	5802	5562
Deposit Money (Dm)	1037	1138	1083	1139	1222	1300	1504	1578	1735	1914	2041	2036	2240	2830	3328	3719	4041	4822
Active Money Supply (M_1 = Cp + Dm)	2729	3125	3255	3312	3585	3856	4485	4951	5317	5511	5813	5842	6064	6911	7940	8621	9843	10383
Idle Money (Time Deposits) (M_2)	200	277	243	304	433	519	564	569	700	753	946	1228	1507	1935	2432	3228	4039	5140
Money Supply ($M^s = M_1 + M_2$)	2929	3402	3498	3616	4018	4375	5049	5520	6017	6264	6759	7070	7571	8846	10372	11849	13882	15523
Scheduled Banks' Claims on the Private Sector (L)	491	550	780	679	809	759	858	1095	1137	1132	1490	1906	2596	3389	4303	6018	6385	8320
Scheduled Banks' Claims on the Govt. Sector (G_1)	481*	514*	462*	567	651	852	878	865	1099	1295	1359	1609	1585	1676	2016	2244	2429	2513
State Banks' Claims on the Govt. Sector (G_2)	153	-32	594	1109	1291	1441	1149	1570	2065	1928	1774	1607	1670	1784	2179	2175	3375	4516
Foreign Assets Held by the State Bank (F)	1747	2184	1514	1116	1103	1174	2004	1787	1521	1770	1986	1896	1810	2082	1885	1550	1837	1165
Other Factors (A)	57	186	148	145	164	149	160	203	195	139	150	52	-90	-85	-11	-138	-144	-991

Source: State Bank of Pakistan - Reports on Currency and Finance and information supplied by the Bank.

APPENDIX TABLE NO 5 G.N.P., MONEY SUPPLY AND ITS COMPONENTS

Period (end-June)	G.N.P. (At current factor cost)	Currency in circulation	Demand Deposits + Other Deposits with S.B.P.	Time Deposits	Money Supply	National Income Deflator
1950	20,316	1,692	1,037	200	2,929	81 5
1951	21,620	1,987	1,138	277	3,402	85 2
1952	21,151	2,172	1,085	243	3,498	82 1
1953	21,810	2,173	1,139	304	3,616	80 9
1954	21,491	2,363	1,222	433	4,018	77 2
1955	21,902	2,556	1,300	519	4,375	78 6
1956	24,625	2,982	1,504	564	5,049	85 9
1957	27,496	3,373	1,578	569	5,520	94 6
1958	28,211	3,582	1,735	700	6,017	94 3
1959	29,731	3,598	1,914	753	6,264	96 6
1960	33,112	3,772	2,041	946	6,759	102 6
1961	35,635	3,806	2,036	1,228	7,070	104 6
1962	37,563	3,825	2,240	1,507	7,571	105 3
1963	39,963	4,082	2,830	1,935	8,846	105.8
1964	43,409	4,612	3,328	2,432	10,372	108 1
1965	47,610	4,902	3,719	3,228	11,849	113.3
1966	54,936	5,802	4,041	4,039	13,882	124 6

* The figures are averages of two financial years

Source (i) State Bank of Pakistan - Reports on Currency and Finance
(ii) Government of Pakistan, Economic Surveys

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