

## ***Book Reviews***

**M. Ashraf Janjua.** *History of the State Bank of Pakistan (1978–1988)*. Karachi: State Bank of Pakistan. 2003. 790 pages. Hardback. Price not given.

*History of the State Bank of Pakistan (1978–1988)* contains the major events relating to the real and financial sectors of the economy as well as a rich analysis of economic development in Pakistan. Although the book's main focus is the 1977–88 period, it also traces the developments since Independence up to 1972 to put relevant decade in its proper perspective. As such, the book would help in better understanding of the economic reforms that have been undertaken since 1988. It is also an important contribution towards understanding the evolution of economic policies in Pakistan.

There are twelve chapters relating to various aspects of growth in the real sectors; monetary policies and credit management; regulatory framework and prudent regulations; supervision of banks; exchange rate management; the State Bank and the government; role of the State Bank in economic development; Islamisation of banks; and management organisation and administration of the State Bank of Pakistan, followed by four appendices, a select bibliography, and an index.

Central banks play an important role in the process of economic growth. The State Bank of Pakistan is expected to regulate money and credit. At present, almost all the central banks of the world are working at controlling inflation. Stable prices make it easier for economic agents to make correct decisions, while volatile prices generate an uncertain atmosphere for decision-making. Targeting inflation implies that we should be able to predict price developments following changes in money supply. The author rightly suggests that predicting price developments depends on a number of factors including demand at home and abroad, wages, changes in the international prices of tradable goods, exchange rate movements, and changes in the prices of public utilities. But whether the State Bank had the capability of predicting such movements, the study fails to throw any light on this aspect.

Growth rates, investment and savings, agricultural and industrial policies, price trends, public finances, public debt, and balance of payments and its constituent parts are discussed in great detail in Chapter 2. The analysis of the real sector of the economy has been divided into two periods, viz., 1972–77 and 1977–88 periods.

The book points out that the nationalisation of banks was preceded by broad-based banking reforms to make the banking sector serve the socio-economic objectives of the regime. The National Credit Consultative Council (NCCC), set up in May, 1972, was responsible for credit budgeting. It involved ceilings on credit expansion by individual banks in terms of annual credit plans: to ensure adequate

flows of credit to the preferred sectors, loans to meet credit requirements of small business and industry, and seasonal credit for agriculture and housing, as well as medium-term loans for tractors, tubewells, and land improvements. However, the author notes that credit ceilings failed to achieve the objectives of restricting credit within the targeted limits. Imposition of ceilings on individual banks regarding credit expansion hurt the progressive and expanding banks by adversely affecting their incentive to mobilise resources. Moreover, it had serious implications for the health and growth of the banking sector and the economy.

Besides nationalisation of banks, insurance, shipping, education, health, and a large chunk of the manufacturing sector, the share of the public sector in investment increased substantially during this period. The government believed that an increase in the share of the public sector in the economy, as well as a labour policy tilted in favour of labour, would help in improving the functional income distribution. No doubt, the share of public investment in gross total investment grew from 45.3 percent to nearly 65 percent, and the ratio of public investment to GDP from 5.8 percent to 12.4 percent, over the 1972-73 to 1976-77 period. However, the author rightly points out that public sector projects were capital-intensive and, as such, could not have helped in improving the functional income distribution.

The labour policy comprised procedures for speedy and just settlement of disputes, a fair share in profits, participation in the management of industry, bonuses, better housing, and health and educational facilities. It did help in raising wages of unionised workers, but it also led to indiscipline and militancy resulting in an increase in the cost of labour. This, together with the uncertainty created by nationalisation, was a major disincentive for private investment in large-scale industry.

There had been significant developments in the external sector of the economy during the 1972-77 period. First, because of a series of exogenous shocks, in particular the steep rise in oil prices, affected Pakistan's balance of payments adversely. Second, there was a sharp increase in remittances and foreign borrowing that helped in financing the deficit in the balance of payments. Third, Pakistan devalued the currency by 56 percent. Fourth, the Export Bonus Scheme was abolished, tariffs were reduced, import policy was liberalised, but export duties were introduced to mop up windfall profits arising from the sharp devaluation. This helped in reducing the wedge between effective exchange rates for imports and exports though the anti-export bias continued. Fifth, the burden of servicing the public debt increased; and there was a hardening of the terms of external assistance. In May 1971, a Debt Moratorium was sought from the Aid Consortium countries, and as a result three protracted rounds of debt negotiations during 1972-74 led to substantial debt relief.

The author emphasises the privatisation and de-regulation policies in the 1977-88 period but concludes that despite successive attempts at privatisation, large

segments of banking, insurance, and industry remained under state control. The slow movement towards privatisation has been attributed to the fixation of prices of units far above their replacement value, uncertainty in Pakistan's political and economic environment, and over-staffing in the units.

Chapters 3 and 4 are the most crucial part of the book. While Chapter 3 examines the monetary policy and credit management over the 1950–1972 period, Chapter 4 deals with the 1972–88 period. This section of the book gives the basic framework through which the State Bank pursued its monetary policy. It is pointed out that the State Bank, by targeting a particular rate of increase in monetary assets, credit expansion, and allocation, assumed a transmission mechanism which is akin to the Quantity Theory of Money. The calculation of credit requirements was based mainly on targeted increases in GDP and prices. The author highlights the objectives, the intermediate targets of monetary policy, and the instruments used. The objectives included price stability, economic growth, employment promotion, balance of payments, and income distribution. The intermediate targets of monetary policy included reserve money, monetary assets, domestic credit, interest rate, exchange rate, and sectoral credit. The instruments referred to are reserve requirements, interest rate (discount rate, deposit and lending rates), open market operations, direct controls (credit ceilings, credit-deposit ratio), lending directives (selective credit controls, etc.), and moral suasion. Whereas the author points out that there may have been more than one objective to be pursued, and more than one policy instrument employed, he does not mention which objectives were being pursued and how the conflicting objectives were resolved. Information about pegging instruments to the objectives would have been useful.

The author also presents an analysis of the working of credit ceilings, and argues that more often than not the credit ceilings were violated. He makes the observation that mandatory credit targets were always exceeded. However, whether the intended beneficiaries obtained the loans is another question, which has not been discussed. The chapter also deals with the issue of concessionary finances for exports, industry, and agriculture. But we do not know the impact of such policies on economic growth or on the banking industry. The chapter further examines changes in the cost of borrowing of the government and points out that the share of non-bank borrowing increased from 16.0 percent in the 1973–79 period to 48.9 percent in the 1980–88 period. The cost of borrowing increased from 8.2 percent in 1972 to 13.2 percent in 1988. Once again, a comparison with the alternative costs would have been quite revealing.

Chapter 5 discusses the evolution of the regulatory framework for banks in five sub-periods, viz., 1948–62, 1962–72, 1972–74, 1974–85, and 1985–88. It has been pointed out that the nationalisation of banks affected their working as well as efficiency because of the political and bureaucratic interventions, directives by the Federal Ministers or their behest carried out by the Pakistan Banking Council, and

excessive influence of trade unions in the working of banks. These intervention affected the quality of banking operations. Apart from the deterioration in services, the intermediation costs rose significantly particularly because of overstaffing and inefficiency. Bank lending on political basis, and on considerations other than merit, grew visibly. As a result, there was an abnormal rise in non-performing loans; the lack of effort and legal impediments to recovery also did not help the banks. The depositor suffered because of heavy appropriations from profits for the provisioning of defaulted loan management, and because of labour union pressures for increased benefits, besides expanded concessionary credit.

It is understood that regulation and supervision of the financial sector is absolutely essential for the promotion of both price stability and financial stability. Foreign exchange controls were subject to frequent changes according to government policy as well as the level of reserves, etc. As in other developing countries, the State Bank has been the custodian of foreign exchange, although foreign exchange policy was broadly formulated by the government itself.

The author notes four major developments in the 1985–88 period in the financial sector: the inefficiencies and their consequences in the banking system and the awareness regarding deregulation of the banking sector; the introduction of interest-free banking; the resurfacing of Finance Companies; and the Co-operative Scam. The last two have been surfacing again and again, creating more problems for a large number of poor people.

Chapter 6 is devoted to elements of prudential regulations. It states that these existed even before 1990, though in a less organised form. Changes in 24 elements of Prudential Regulations, covering the main areas of banking regulation, are examined in detail in this chapter.

Chapter 7 is devoted to the inspection of banks. It suggests that before 1988, when new rules were promulgated, inspection was somewhat soft and based on subjective criteria. The loans were classified in three categories, namely, substandard, doubtful, and loss—on the basis of assessment of risk to banks, and with reference to the collateral security and past record of operations in the account, etc. Nevertheless, the inspection report, including appropriate observations regarding the weaknesses noticed during the inspection, used to be sent to the bank for information and compliance on its findings, and the bank was obliged to present the report before its Board of Directors for corrective measures.

Chapter 8 refers to the exchange rate arrangements which are handled by the State Bank of Pakistan on behalf of the Government. Pakistan adopted a 'discriminatory' managed floating exchange rate regime; on determining the basket of currencies of the country's major trading partners, different weighting schemes were used to compute export competitiveness. The author points out that Pakistan's exchange rate was not market-determined; the authorities had the power to adjust the domestic value of the currency with respect to this basket; and the Governor, State

Bank of Pakistan, made the decisions about changes in the rupee parity rate with the U.S. dollar before the opening of business every day. Thus the State Bank of Pakistan was allowed to intervene in the foreign exchange market. It is also mentioned that the foreign exchange balances were being kept with Bank of England, London, and Federal Reserve Bank of New York.

Chapter 9 examines the relationship between the State Bank and the government. It has been pointed out that the nature of the relationship between the Ministry of Finance and the State Bank has undergone changes over the years, as reflected in the changes and amendments in the relevant rules and regulations. Yet there are several arrangements/mechanisms through which the central bank and the government have co-operated and co-ordinated their policy actions.

It has been pointed out that during the 1973 to 1988 period, the government's bank borrowings for budgetary support were highly subsidised, i.e., *ad hoc* Treasury Bills carried a nominal rate of return of 0.5 percent while government borrowing from the commercial banks was through Treasury Bills on tap, which carried a concessionary rate of interest, i.e., 4.5 percent up to 1973, 5 percent in 1974, and 5.5 percent as well as 5.75 percent in 1975, and 6 percent from June, 1981 onwards. Similarly, the lending by the State Bank to the Agricultural Development Bank of Pakistan (ADBP), Federal Bank for Co-operatives (FBC), and House Building Finance Corporation (HBFC) and providing refinancing for Export Finance and Locally Manufactured Machinery (LMM), as well as payments to commercial banks on account of their *bona fide* losses on agriculture finance, all involved subsidies of varying amounts. As the manager of the public debt, the State Bank of Pakistan also provided advice to the government, keeping in view the market conditions, on such aspects as the timing of issue of loans, the rate of interest to be offered, the maturity profile, etc.

Chapter 11 examines in detail the measures taken to Islamise the banking sector. It has five annexures that show the major developments in the area. Chapter 12 reviews management, organisation, and administration of the State Bank.

The main conclusion of the book is that by the late 1980s, the State Bank, as a regulator of monetary policy, was completely marginalised, and was subservient to the fiscal requirements of the public sector. Government-directed credit at subsidised interest rates was a large component of the credit to the private sector. The rampant political, bureaucratic, and trade union interference in the banking business led to the infected policies of the banking sector, resulting in visible deterioration in banking services. The status of the State Bank was reduced almost to an 'attached department' of the Ministry of Finance and its independent voice in macro-economic matters was silenced. Even the release of its annual reports was made subject to approval by the Ministry of Finance. Some of the Governors of the State Bank, who tried to give independent advice on macro-economic policies or showed resistance to government interference, found themselves in trouble.

The book is of great value for all those who would like to trace the economic history of Pakistan. It would also help in understanding the significance of the Structural Adjustment Programmes.

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