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Role of DFIs in Industrial Growth and Transformation –

How East Asian Countries Succeeded and Pakistan did Not

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Role of DFIs in Industrial Growth and Transformation

How East Asian Countries Succeeded and Pakistan did not?

Abstract

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*In this paper we explore how development finance institutions, **DFIs** helped to promote industrial growth with active role of public sector in **emerging market economies** – Korea, China, India, Malaysia, Brazil, Mexico, Turkey. The DFIs provided long term credit financing which led to **structural transformation** of their economies of a type never witnessed before. These countries succeeded in spectacular fashion at this transformation over the past four decades but Pakistan did not; why?*

*There always has been an endless debate concerning **role of public sector** vis-à-vis private sector in promoting economic growth in industrial countries. This debate is still raging on amongst rich countries caught in the trap of almost zero interest rates, low inflation but hardly any growth. These economies have not responded to monetary mechanisms as anticipated. (see Paul Krugman, Noble Laureate in NY Tribune columns). This has shaken to the core the faith of many adherents of Friedmanesque type market mechanisms alone to deliver economic recovery and growth. Perhaps neo-Keynesians were right after all, in their call for old fashioned public sector spending to invigorate and restart engine of economic growth; be it a developing country or an advanced country. We have come back full circle. Let us wait while they discover which Economics to embrace.*

We shall stay away from this debate and leave it for academics to sort out how long rich countries will keep fumbling with market levers to resuscitate their moribund economies. Instead, we shall begin by asserting that historically public sector has been in the forefront in starting and sustaining economic growth. No two ways about it, and it is not a leap of faith. This has been the experience of emerging economies, while they have gone through structural adjustment, ushering market-based policy regime via economic reforms, liberalization, and opening up foreign trade and capital flows.

*Within this framework, the role of DFIs has been exemplary that I would like to speak of, based not only on piles of researched evidence available, but from my own field experience of East Asian economies during much of 1980s, where one could literally touch the outcome of public sector supported, World Bank (WB) funded **DFI** lending which nurtured industrial transformation, unfolding in front of all to behold. When industries of advanced countries began leaving in droves, WB had to endure full weight of their pressure to shut down industrial financing; which it did, and I am witness to it, but this could not help stem departure of **foot-loose industries,** exporting jobs overseas enabled by massive outflows of foreign direct investment for nearly four decades.*

*It is a fascinating saga and a relevant one to discover why Pakistan did not succeed at the type of industrial transformation which occurred in emerging economies, most of them comparator countries of Pakistan. This happened in spite of similar type of **DFI** lending for a long time and almost a manic devotion of government to the role of public sector, particularly in the era of nationalization cheered on by Fabian Socialists in Pakistan, and thereafter by reformers and redeemers of all hue and variety. Reforms and privatization is still going on; but industrial transformation remains as elusive as ever.*

Role of DFIs in Industrial Growth and Transformation

How East Asian Countries Succeeded and Pakistan did not?

Shakil Faruqi

1. Development Finance Institutions ***(DFIs)*** have played a salutary role in economic development mainly through industrialization in early stages of growth amongst most developing countries including Pakistan. These ***DFIs*** were state owned and funded institutions, established mostly with assistance of World Bank who extended long term foreign currency loans or standby credit lines with guarantee of the government. The ***DFIs,*** in turn, started on-lending these funds on retail basis mostly to state enterprises as foreign currency (forex) loans for new industrial units being established to jump start ***development by bootstraps*** – an expression much in vogue in those times.

2. The main function of ***DFIs*** was to provide industrial development credit finance and some agricultural finance for farm machinery, fertilizer and chemicals. This credit financing was for project based investment under well designed guidelines, rules and regulations to ensure completion of industrial units, initially in the public sector, and eventually in private sector, which later on saw vigorous growth during 1970s onwards all the way through the 1990s. The ***long term credit financing*** extended by ***DFIs*** was mainly to cover forex costs of plant machinery and equipment of industrial units being established mostly in the public sector. This onlending was done under an elaborate protocol which specified rules, regulations of use of borrowed funds, with strict oversight both by ***DFIs*** and the World Bank on the viability of industrial projects thus financed.

3. The ***DFI*** based financing mechanism served the needs very well because its ***fidelity*** was maintained. This was the golden period of ***DFIs.*** They performed very well and were instrumental in jump starting a fledgling industrial sector that did not exist before. Thus, two systems existed in parallel; a largely private commercial banking system which experienced major expansion with opening up of new ones like UBL, and a newly established or reorganized ***DFIs*** system. Gone were attitudes that banking is petty coin tending *(banyagiri)* - a derisive characterization of centuries old mercantilist tradition in Indian sub-continent.

4. These institutions fostered growth of new businesses and industries and new mercantile traditions, no matter how fledgling they were; and facilitated evolution of a class of enterprenure who simply did not exist in the country. In the start-up phase, this was the preferred mechanism of starting industrial development in the public sector. Later on, when a fledgling private sector came to life, ***DFIs*** began lending to private industrial units with sponsorship of public sector. The onlending was done often at subsidized costs to enable establishment of new units and their operations where none existed before.

5. The government articulated an elaborate foreign trade and investment policy and incentive regime which provided a protective umbrella to new industries to nurture their emergence mostly for ***import substitutions***. All this came to be accepted as ***infant industry*** development supported by ***DFIs*** established with express purpose of providing ***specialized financing*** facilities, custom designed and geared for needs of targeted industries or sectors with some grant element to support their installation and enable them to start operations – hence the name ***specialized financial institutions*** that we often come across.

6. In parallel, government invested heavily in supportive infrastructure facilities to enable start-up of new industries. The government built ***industrial sites and services*** with concentration of supportive infrastructure and services to enable emergence of industrial and commercial areas. These ancillary investments were made possible by generous foreign assistance funded by bilateral and multilateral institutions. This was the ***second leg*** of the triad, needed for jump starting industrial development. But availability of forex loans through ***DFIs*** and public sector investment in infrastructure, could not jump start industrialization in societies like Pakistan where business attitudes and enterpreneurship – the ***third leg*** of the triad were sorely lacking among Muslim populace at large, with the exceptions of a few ethnic groups left behind after partition, or those few who migrated from India.

DFIs and Early Industrialization

1. In the early years of industrialization in Pakistan, mid-1950s through 1970s, there were no contentions about the role of ***DFIs*** and support of public sector for industrialization. The start was establishment of basic consumer goods industries, textiles, cement, mechanization of agriculture sector and initiation of basic agro industries, all geared to import substitution. Development of export industries was not on the horizon; nor much attention was paid to comparative costs and competitiveness. Just have a look at five year plan documents of those years; or papers published by powerful advisory groups of world class academia, like Harvard Advisory Group set up in Pakistan.

2. In line with this strategy, import substitution oriented policy and incentive regime evolved, supplemented by controls, approvals, licensing and tightly controlled foreign trade regime; fixed exchange rates and overvalued domestic currencies which bestowed significant advantage to import substitution over export led industries. This strategy succeeded in initial rounds. From mid-1950s through mid-1960s, a large number of industries were set up in Pakistan, e.g., textiles, sugar, cement, fertilizer and petrochemicals units. In parallel a few private banks and insurance companies were established. The DFIs based financing mechanism served the needs of development by bootstraps very well because its ***fidelity was maintained***. This was the golden era of ***DFI*** financed industrialization in harmony with direct investment of public sector in large industrial units and supportive infrastructure. Pakistan was touted as one of the successful developing countries, ahead of many others; a role model to be emulated.

3. This led to phenomenal growth of reputable 'business houses' like Adamjee, Saigols, Isphanis, Dawood and a few others who were active mostly in West Pakistan because government did not put demarcation of group-linked ownership and resulting wealth concentration. These Houses established industrial and business units in East Pakistan though not on the same scale as in West Pakistan. The ***DFIs*** of those days in Pakistan had no qualms about lending to newly minted industrial and business houses because their ***business model*** was transparent with accredited accountability, a proven record of creditworthiness, high profitability, superior management and solid performance all around.

4. The feverish pace of group linked private investing, opening up of new industries, businesses, banks, insurance and companies and touched peaks never reached thereafter. This business model operated *in-sync* with much heralded *strategy of economic growth* that Pakistan had embarked upon. Their success, however, led to criticism of runaway accumulation and concentration of wealth among the largest 22 mercantile families. Following the war of 1965, the political upheavals, a loud chorus of disparities between East and West Pakistan, elections of 1970, denial of legitimacy of popular verdict, all led to a civil war, resulting into truncation of Pakistan - a tragedy of immense proportions.

Truncation and Nationalization – *the 1970s*

5. In the wake of truncation of Pakistan, ***DFIs*** lost nearly all of their asset in East Pakistan, while their client companies that survived in West Pakistan suffered major losses. Much of their asset base simply evaporated in the chaos swirling around. On top of it, the new government of Pakistan embarked on ***nationalization*** in the name of socialism with a frenzy that wiped out private corporate businesses, industries and commercial units, sparing none except small retail traders, artisans and small machine repair workshops. The Mao cap in vogue those days symbolized Chinese style socialism, but party intelligentsia averred to Fabian socialism; while the majority was at a loss to figure out what they were upto, nor they cared except for their own interests.

6. All industries, businesses, and financial institutions were nationalized sweeping in the dust bin all that existed before. This was done in the name of socialism, a newly discovered paradigm thrust upon surviving part of Pakistan. Nationalizing assets of ***22 families*** was not all that happened. The financial structure which had sustained commerce got dismembered and its markets evaporated. Whatever survived, was turned upside down, converting the banking system into a vehicle of resources transfer from public to the state. The government ended up owner of industries and businesses, their financier, banker, lender and borrower, all rolled into one, run by top notch bureaucrats who had never run any business before. But ***DFIs*** were not closed down since they were government owned. Their credit financing role did not vanish; instead, they ended up as a tool of financing state owned enterprises with disastrous consequences.

7. Next door, ***India*** followed a similar path of nationalization but not with the same frenzy as in Pakistan. The government allowed space to private sector to continue and provided as much assistance as it could. India did nationalize banking system the same time as Pakistan did – an uncanny coincidence – but refrained from taking over the financial system, and did not touch business houses, *seths* and conglomerates, the TATAs, Birlas and several others.

8. Instead, India continued nurturing business, large and small, and kept pursuing import substitution industries in the private sector behind an elaborate protective wall and did not succumb to pressures to open up its markets en masse; nor did it allow foreign ownership of industrial and commercial units, though it did encourage foreign capital inflows on its own terms. The ***license raj*** was heavy handed no doubt; growth rates were anemic, derisively called Hindu rate of growth, but the drive for industrialization was broadened and sustained. Their ***DFIs*** continued functioning and did not suffer catastrophic losses at industrial or ***SME*** financing. In short, foundations of industrial transformation continued to gain depth and strength which subsequently paid rich dividends in the 1990s and beyond to propel Indian economy to spectacular growth witnessed over the past couple of decades.

East Asian Countries – ***the early years***

1. At the opposite spectrum, East Asian countries, led by Korea, Taiwan and Malaysia, followed by Thailand, Indonesia and Philippines pursued a similar trajectory of state sponsored and protected industrialization in early stages of development, financed by ***DFIs*** mostly funded by the World Bank, though not in Taiwan. China joined later in the early 1980s. Their industrial growth model was starkly different. From the start, it was outward oriented for export-led growth, hence cost efficiency and ***competitiveness*** overseas, following the lead of Japan and subsequently Korea and Taiwan. Many would argue that Korea and Taiwan are special cases of preferred sponsorship of the US; Hong Kong and Singapore are city states, and so forth. But their success was emulated by most East Asian countries.

2. These countries promoted industries under a foreign trade regime with sophisticated protective umbrella so as not to invite outright retaliation from advanced countries. The key difference was that their governments did not get involved in owning and running industrial enterprises as they did in Pakistan after nationalization in the 1970s. They did not revile or repudiate local enterpreneurship; instead, they rallied to provide them full support under ***investment packages*** including state guaranteed foreign credit financing, investment incentives, access to facilities as feasible. They competed with each other to furnish incentives with an eye to attract foreign firms to invest in their countries.

3. Simultaneously, East Asian countries made heavy investment in technical education to nurture growth of well trained and disciplined local labor force. This was a key difference whose impact came later via acquisition of new technology

and licensed patents from Japanese companies in initial rounds; subsequently from European and US companies to start their operations, largely intended to export consumer goods back to host countries. By late 1970s they had succeeded in this mode of industrialization, enabling their industrial *'infants'* to grow up; and they did. China had not yet joined this club. That came later in early 1980s.

4. As the new industries in East Asian countries gained foothold, they began to pull them out from behind the protective curtain. The government charted foreign trade regime and provided all kinds of incentives for exporting. In parallel, these countries established export processing zones, ***EPZs,*** often with ***DFI*** based funding backed up World Bank credits. These ***EPZs*** were cordoned off from local economy to avoid levy of coustom duties with very low excise taxes for direct exports. These ***EPZs*** initially consisted of assembly line operations, established as subsidiaries of leading brand name Japanese, US and European companies.

5. These were the incipient beginnings of relocation of what later on came to be known as ***foot-loose industries*** of advanced countries, who were looking around for countries which could offer lucrative ***investment incentive packages*** to foreign direct investment. I supervised voluminous studies of investment incentives for Thailand and Malaysia in the early 1980s. At that time, East Asian ***DFIs*** were at the centre stage of industrial ***transformation*** that I observed in the field during 1980-86 at close quarters. Once assembly line operations became successful in export markets, they spawned supply chain industries, mostly ***SME*** units, based on local manufacturing content. By early 1980s, this transformation has taken root among emerging market economies; but not in Pakistan.

6. Before entry of China on the scene, once infant industries of East Asian countries matured, they began to export light manufactures such as textiles and garments, household consumer goods, light hand tools or electronic goods to US and Western European countries at substantially lower costs without compromising quality of items exported. Earlier on, Japanese manufactured exports of high end electronic goods like TV and VCR sets had wiped out RCA, Motorola TVs and VCRs in the US, and Phillips of Europe. Subsequently, same Japanese products were being manufactured in East Asian countries at lower costs and exported under the same brand name at even lower prices These were the beginnings; the avalanche of 'cheap exports' was to come later from East Asian countries in an ironic twist, replacing 'made in Japan' exports.

Enter China

7. In 1981 when China opened up and joined international financial institutions, the ***IFIs***, namely World Bank and the IMF, this enabled China to obtain foreign currency credits to modernize its economy and its industrial base. The first loan, a line of long term credit from World Bank was made to China Investment Bank *(CIB)* established with the assistance of World Bank. That was the start. Thereafter within a year CIB borrowed three loans and continued heavy borrowings for industrial sector. Meanwhile China opened other ***DFIs*** to finance infrastructure managed by

various state owned enterprises. The business model of client companies was transparent; their performance at implementation of projects was prompt and onlending of Chinese ***DFIs*** to mostly state owned enterprises was a resounding success. Private owned businesses had opened, but private industrial units were not yet on the scene.

8. I saw these disbursements at close quarters. Often I would be signing away disbursement requests in acting capacity on daily basis, which were a stream of payments from various World Bank lines of credit extended to ***East Asian DFIs.*** Almost all of the disbursement were for industrial machinery being imported form advanced countries. In early 1980s, this type of industrial financing laid the foundation for modern Chinese industries. Most of it was for import substitution; exports came later when the ***foot loose industries*** of advanced countries began to establish their manufacturing units with heavy inflow of foreign direct investments.

9. The ***transformation*** of Chinese industries had begun in earnest, initially with industrial finance channeled through its ***DFIs***, but industrial financing alone could not achieve this transformation. The key ingredient was ***enterpreneurship*** of Chinese diaspora and ***technological transfer***, that followed in the footsteps of Singapore and Taiwan. China invested heavily in technical education and training and succeeded, which was reminiscent of Japanese achievement in acquisition and internalization of technology in pre-War II years.

10. No one could anticipate that a time will come when front line manufacturing of high-end brand name consumer goods for European and US markets would be taken over by industries established by these corporations in China; nor one could foresee that sophisticated high tech IT equipment and machine tools would be licensed to the manufacturing units relocated in China for assembly operations, subsequently for eventual production that would be exported right back to the US and European countries. There is no parallel to this ***transformation*** of Chinese industrial sector which occurred during the past three decades and is gaining further momentum. The start was humble; the outcome was spectacular.

Foreign Direct Investment

11. A key element of this ***transformation*** was foreign direct investment (***FDI)*** inflows in East Asian countries, including China which began slowly and picked up momentum was these countries opened up their capital accounts; but the doors were only half ajar. That is, opening and liberalization was for capital inflows with guaranteed repatriation, while keeping strict control on outflows except as quid pro quo on selective basis, item by item, for industrial units receiving ***FDI,*** not free for all, as Pakistan did during reforms in early 1990s in reverse sequence. These ***FDI*** inflows were entwined with establishment of new plants and industries aimed at exporting back to the countries of ***FDI*** origins; not for domestic markets.

12. More importantly, ***FDI*** inflows financed new industries bundled together with ***transfer of latest technology*** embedded in assembly lines and production units which required training of local labor force at operation and maintenance of new

plants. This linkage was far deeper than just financial side of capital inflows. That is, ***FDIs*** were not just a wave of financial entries on capital accounts of balance of payments. Instead, ***it was a process*** which started the transformation of host economies, blooming into modern industrial states from humble beginnings. These flows started in mid-1970s; picked up momentum in East Asian economies during the 1980s; but this process eluded Pakistan.

DFIs in Pakistan – *pre-reform years*

13. While East Asian economies were surging ahead with the role of ***DFIs*** at the center stage, Pakistani ***DFIs*** or whatever was left of them after 1971, were receding in their role. They were mired in coping with their losses owing to losses of public sector enterprises ***(PSEs)***. Gone was dynamism of private enterpreneurship among import substitution type industries, often loss making owing to poor management, stuffed with employees appointed as political patronage and by labor unions, powerful enough to dictate ***PSE's*** management. The government as owner was obliged not only to fund and subsidize their operations, but was called upon to replenish equity base, enhancing the already overburdened fiscal deficits with no option left except to close down the enterprises or continue financial support.

14. The government kept up periodic equity replenishments of defunct ***PSEs*** as best as it could, sustaining their loan write-offs from special budget dispensation, The ***PSEs*** managed to survive as long as they could on government support which they garnered as political patronage; or lingered on and continued operations during tumultuous days of nationalization until start of reforms, structural adjustment and privatization in early 1990s.

15. By mid 1980s financial position of clients of ***DFIs*** had eroded beyond rescue. The World Bank shut down the tap as ***DFI's*** insolvency emerged, rooted as it was in the burden of non-performing loans with no hope of recovery, euphemistically called ***sick loans*** as though some kind of inoculation would cure large and very influential willful defaulters. Pakistani ***DFIs*** were not alone in this saga. A few ***DFIs*** in Indonesia, Malaysia, Philippines and in Latin American countries, also suffered from the same malaise. True, various governments had indulged in interest rate subsidies via ***DFI*** lending, hoping that their clients, the infant industries, will grow up into healthy adults, but they never got cured of their financial mis-management. They did not mature into competitive and financially strong industries that could withstand on their own, much less the onslaught of foreign competitors with the demise of quota system under ***WTO*** agreements.

16. Undaunted, Pakistani government established a new ***DFI***, Banker's Equity Ltd in early 1980s to provide long term credit to re-start private sector industries and businesses in the midst of nationalized and financially ailing giants. Their business model was predatory from the start, bereft of enterpreneurship, whereby these private sector clients would put forth minimal amount of equity to set up a new industrial unit mostly for import substitution variety business under heavy protection, tax holidays, subsidized infrastructure and finance and overvalued

exchange rates - the same formula of industrialization that prevailed decades earlier in Pakistan. Having garnered this support, they would borrow to the hilt from ***DFIs*** or nationalized banks; thereafter pull out their equity from the business. If the venture failed, as often it did, they would declare insolvency and arrange for loan write-off using their clout; and they usually succeeded. The State ended up being the ultimate loser in this kind of ***DFI*** funded private sector industrialization in the 1980s onwards. No wonder public sector came under heavy criticism from all quarters, but these businessmen went on to become new billionaires.

East Asian Exports – ***and their aftermath***

1. In stark contrast to this private business model of Pakistan, was the business model of East Asian enterprenures who were busy setting up industries on Japanese patterns. They would obtain industrial licenses and knowhow from reputable Japanese firms ensuring technology transfer, preferably with some investment by parent group, setting up industrial units with supplier's credit, otherwise funded by ***DFIs*** from access to forex line of credit obtained from the World Bank. Their government would design competitive investment incentive packages to attract foreign firms to invest; provide a superb business friendly environment; install requisite infrastructure; train their own labor force; educate engineers and executives to launch business operations. This model succeeded for all to behold.

2. These were the modest beginnings of giants of today; namely Samsung, LG , Kia and many others in Korea; US or European patented high tech IT products partly manufactured and assembled in ***EPZs*** of Malaysia or China; brand name high value items from India and other East Asian or Latin American companies. These were beginnings of new corporate businesses who grew fast into giants of current times. In short, East Asian countries together with successful emerging market economies of today underwent a ***structural transformation*** from subsistence type agro-rural economies to modern industrial giants.

3. There were a few failures; but by and large East Asian and Indian industries succeeded in penetrating foreign markets. Thus began onslaught of cheap exports to advanced countries as far back as late 1970s and gathered momentum during the early 1980s to the point where not only ordinary consumer goods but also sophisticated high value 'white goods' for housing and auto industries began to feel the heat of competition from imports. By late 1980s the game was over. The emerging economies were on front lines and had taken over much of foreign trade, accumulating trade surpluses and massive forex reserves.

4. The exports of newly industrialized countries created an uproar in importing countries. Their industries could sense plant closure and unemployment because they could not withstand competition. Often this uproar went to extreme, asking for a ban on canned fruits and seafood imports. They sued their government for protection, especially in the US, claiming that foreign exporters are indulging in unfair trade, supported by government guaranteed subsidized financing, channeled through ***DFIs*** and state owned banks. Large European and US consumer goods

industries were vociferous because cheap imports threatened their existence, causing rusting belts in many industrial cities which eventually did occur.

5. A good part of this ire was aimed at World Bank who was lending substantial amounts of long term industrial financing as lines of credit to the ***DFIs*** not only in Asian countries but also in Latin American countries, helping them to create an industrial base that eventually wiped out a good part of consumer goods industries in advanced countries. When some of these countries such as Korea and Taiwan began to export light machine tools, followed by heavy electric tools such as lathe machines, it caused a panic in the US, and brought pressure on the World Bank to stop lending for industrial growth. The World Bank shut down Industrial Finance Department in 1981 but did allow regional offices to continue ***DFI*** lending including East Asia, though only to those ***DFIs*** who had a healthy financial performance and no interest rate subsidies or state support to the new exporters.

6. This campaign to shut the tap was even more powerful against World Bank financed large industrial projects. Since early days of industrialization, World Bank Industry Department was busy setting up integrated steel mills, large machinery producing plants, refineries and petrochemical plants using the same formula of heavy public sector investment, ownership, state patronage of familiar variety, like subsidized infrastructure and energy supplies, grants or subsidized lending in the classic mode of ***import substitution*** in early stages. When these newly established units became strong and competitive enough, their exports impacted giant establishments of advanced countries led by Big Steel and Big Oil of US and Europe and their financiers, the money centre multinational banks. They mounted a concerted campaign against World Bank financing of industries and pressures were brought to shut down these operations; and they succeeded.

7. In the first round, World Bank pared down lending for large industrial projects; turned off lending for steel mills, refineries and petro chemical plants. By late 1970s, Industry Department of World Bank was reduced to launching studies of effective protection and industrial advisory that came into direct conflict of industrial development strategies which emerging countries were pursuing and were not going to oblige. Eventually Industry and Energy Projects Departments, both were shut down in early 1980s. In their place came emphasis on poverty alleviation, good governance and cash lending for reforms which suited both the client states and the World Bank. But recently, World Bank and ADB have restarted lending for large energy projects on case by case basis.

8. This uproar was very powerful, cheered on by Big Oil and Big Steel, Big Auto and large money center banks, forcing a massive retreat of public sector from a proactive role to supportive role subsumed under the leadership of private sector. In advanced countries, there was a paradigm shift which reshaped the landscape of industrialization. The slogan was markets are superior, better organised and more efficient than public sector. In short, government should get out of the business of promoting development, or providing safety net services to public, choking off their allied industries both in advanced and developing countries.

9. This about face coincided with the rise of conservative governments in the US and England under the leadership of Ronal Regan and Margret Thatcher. The conservative governments began a crusade against involvement of government or public sector in promoting economic development with state assistance following Chicago School view that markets can go do better than public sector; that government role is intrusive and not constructive. This role should be substantially pared down since it obstructs private sector initiatives, or competes with private sector on a turf funded and maintained by government.

10. This ***Friedmanesque market mantra*** spread like a wild fire; quickly spreading to other advanced countries; then percolating down to developing countries via overhauled financial aid and assistance. The battle cry was revamp policy and incentive regime, shift public sector ownership through privatization, embark on structural adjustment program and implement economic and financial reforms to remove financial repression. This mantra was lauded by leading economists, thinkers, opinion makers, and assorted specialists who kept repeating it *ad nauseam* in their strategy papers.

11. In case of financial system in general and ***DFIs*** in particular, ***Friedmanesque*** argument was that existing regulatory regime promoted ***financial repression***; given interest rate subsidized and ***layered system of directed credit*** which forced banks, ***DFIs***, and other financial institutions to continue supporting enterprises which otherwise should have been closed down long ago. In some countries financial distortions embedded in credit allocation were so acute that they stymied potential growth of countries concerned. In principle, there is no quarrel with this viewpoint, but in practice the system of layered credit allocations was effectively used in India and East Asian countries to achieve industrial growth as discussed in this paper.

Reform Era – *decade of 1990s thru mid-2000s*
Role of Public Sector vs Private Sector

1. This was the essence of sweeping economic and financial reforms undertaken during the 1990s at unprecedented scales, ushering in era of ***structural adjustment***, ***restructuring*** and ***privatization***, and revamped ***policy and incentive regimes*** which completely transformed most economies, including Pakistan. In their wake, there occurred several financial crises which were also of unheard magnitudes. It took global financial crisis of 2008 to drill in the realization that market mantra was flawed. That is, markets are not perfect; markets are neither self regulatory nor self-correcting; markets are notoriously unpredictable since they are manipulated by insiders; markets cannot be ordered to behave; and market operations are laced with ***moral hazard*** owing to regulatory loopholes, and these need to be reined in for public good. But that is a separate topic and should be dealt with on its own.

2. During 1980s, in Pakistan the realization spread that nationalization has not been the panacea that it was supposed to be since most ***PSEs,*** banks and financial institutions including ***DFIs*** were perennially in dire financial straits. Public sector was effectively bankrupt with no reprieve in sight. Amidst such financial crunch,

pressures for reforms came from the World Bank and IMF, *not from within,* to straighten out nationalized system that was no longer sustainable and did not deliver. In other words, government undertook reforms, structural adjustment and privatization not because it was convinced to do so, but because government had no other option but to borrow from ***IFIs*** owing to impending insolvency and need for forex liquidity. Most ***PSEs***, nationalized banks and financial institutions were slated for ***privatization***, the polar opposite of ***nationalization***.

3. This ***reversal*** occurred on the same grand scale as nationalization. One more time, the industrial sector was turned upside down. The lynchpin of reforms was a revamped policy and incentive regime and ***privatization*** of ***PSEs*** which peaked in the second half of 1990s and went on until 2005. The process was long drawn and more expensive than anticipated. The loss of networth and operational costs of privatization were borne by treasury, but were bundled up with low sale price received on the auction block at the time of privatization as compared to actual market worth of assets of these state owned institutions.

4. Privatization was carried out too far and was too expensive, since a good number of them were set up with money borrowed from ***DFIs*** who, in turn had borrowed from ***IFIs*** in hard currencies. The public sector was smothered, not because ***PSEs*** or ***DFIs*** were irrelevant to the genius of Pakistan, but because their privatization provided a mechanism to selloff national assets at a pittance to favored buyers of governing elite who discovered a bonanza amidst the debris of nationalized ***PSEs***. Many ***PSEs*** were slated for privatization at throw away prices to "investors" who had no stake to revitalize or operate these enterprises. They bought the ***PSEs*** at junkyard prices and stripped down plant and equipment, laid-off their employees, and sold off the remaining hulk, yet made a fortune. That is why there were so many adherents of privatization in those times while none were to be found in the 1970s. The same scenario is being repeated in current phase of privatization.

5. In contrast, East Asian Economies kept their ***industrial transformation*** on the same track as in earlier times, further emboldened by massive inflows of ***FDIs*** and technological transfer, embedded in factories of foot-loose industries that were being set up at feverish pace, thereby further deepening export based industries of East Asian countries. Their ***DFIs*** became stronger financial institutions than they were before – complete opposite of what happened in Pakistan.

6. There were a few ailing ***DFIs*** in East Asian countries no doubt, including some in Malaysia, Philippines and Indonesia, suffering from similar malaise as in Pakistan, namely poor lending practices, subsidized interest rates, mounting burden of non-performing loans owing to willful default, thus needing loan loss absorption by government. These ailing ***DFIs*** were restructured; their government cleared backlog of non-performing loans; replenished their equity base; revitalized them and put them back on stronger footing than before. Korea and China opened more ***DFIs,*** notably Korean and Chinese Development Banks and ***EXIM*** banks who enabled Korean and Chinese firms to operate overseas. Some of these firms are active in Pakistan.

7. In financial terms, role of ***DFIs*** in leading emerging economies remained promoting new industries and diversification of industrial base; while banking system took over financing of well established large industrial firms who did not need state supported financing for their ventures. These well established firms succeeded at manufactured exports of high tech items like automobiles, household electronic equipment and high-tech communications and IT equipment, previously beyond their capacity to produce at competitive prices for international markets. This was a transformation of industrial sector, similar to the success of advanced countries in the past when they globally dominated these high tech manufactures.

8. These developments were buttressed by mounting foreign trade surpluses of emerging economies of East Asia, supplemented by much enhanced inflows of foreign direct investment, ***FDIs,*** bundled with technology transfer to manufacturing sectors, previously beyond their industrial base in 1980s. As this transformation progressed, it was followed by large foreign portfolio investment, ***FPIs,*** growth of capital markets, massive accumulation of forex reserves and inevitably enhanced exposure to exchange rate risks. This cut a deep swath later on when speculative investing started in stock market and real estate, creating financial bubble that was destined to explode; and it did in the late 1990s.

9. In frenzied investing, memories of Japanese real estate bubble of 1991 had faded. When the financial crisis exploded, its swiftness and size left no room to escape. It seemed that East Asian ***miracle*** had turned into a ***debacle*** of major proportions. It is too tempting to get into the chronology of this financial crisis but let us stay back. Suffice to say that East Asian crisis needed massive intervention of central banks and governments in sync to contain it and they prevailed. Within a few years, East Asian economies were back on track they had traversed before.

10. More or less the same path of reforms was traversed by India during 1990s, except for the financial crisis. It began with reforms of financial system, loosening the grip of ***license raj*** over private sector in general and industrial sector in particular. But Indian ***DFIs*** did not close down, because their client base instead of vanishing had prospered to the point whereby the newly reformed banking system could take over financing needs of these clients – the infants had grown and become stronger to withstand competition in international markets. Indian ***DFIs*** moved on to finance new ***infants;*** the recently opened ***SME*** businesses and firms seeking a foothold first in domestic market, and as foreign trade regime became more open, they began to take steps to enter international markets. Indian industrial sector had matured for this transformation. But in Pakistan we were lurching between extremes; this time we were grappling with privatization amidst questions about the role of public sector if privatization were to reach such dimensions as it did in those turbulent years – an issue that we must return to below.

11. Both India and China have successfully maintained a sizable network of ***DFIs*** throughout the 1990s to present times and have always actively promoted SME financing. In India, there are three layers of ***DFIs.*** The top layer consists of flagship ***DFIs***, including development banks, such as Industrial Development Bank of India. IDBI; IFCI, IIBI, plus specialized financial institutions like IVCF, ICIC Venture

Funds. The next layer consists of DFIs regulated by Reserve Bank of India; EXIM Bank; bank for agriculture and rural development, NABARD, Small Industries Development Bank, SIDBI; and National Housing Bank. The ***third layer*** consists of state owned ***DFIs -*** a fairly large number of them are active in various types of financing to promote economic growth, mostly local SMEs. India did not buy into the argument of financial repression; nor did it disband ***DFIs.*** But it did maintain a financial discipline throughout, owing to the business model of its clients starkly opposite of that in Pakistan.

12. Same is the case with China. There are a large number of DFIs, led by China Development Bank, engaged in a range of financing activities, modernizing its various sectors, bringing industrialization to its far off regions and trying to integrate them in the mainstream economy. This is a more pervasive role than simply providing finance for industrial investment.

13. In Pakistan, during reforms, NDFC and IDBI was closed down; so was Banker's Equity Ltd mentioned earlier; PICIC was restructured into a commercial bank; agriculture development bank was resuscitated into ZTBL; SME Bank kept teetering on the brink, and in spite of an all out effort in early 2000s, it could not be revived; it has remains moribund; HBFC suffered from severe loan losses and was nearly closed down, but survived with considerable renewed financial support of the government and is still operational; Punjab Bank a provincial ***DFI,*** underwent a similar route and survived with massive provincial support and later on was resuscitated as a commercial bank.

Role of Public Sector in Pakistan - *Revisited*

1. For most years until late reform period, in Pakistan government shied away from demarcation of roles of public and private sectors even during the halcyon days of nationalization overlooking the process that had occurred in other countries. Many did not realize that it is easy to stick-in heavy machinery complex in cornfields of Taxila in the public sector and call it industrialization, but to create an ***industrial society*** in backward, peasantry laden rural and *tribal-sardari* society, is an entirely different proposition altogether. The ensuing conflict between perceived role of private sector versus public sector stymied growth. Worse yet, failure of many ***PSEs*** as going concerns and efforts of government to keep bailing them out through credits extended by ***DFIs*** and banking system proved insufficient.

2. During nationalization, ***PSEs*** kept operating at unsustainable prices and exchange rates and kept financing each other through internally generated IOUs. Often it took government several years of repetitive stabilization efforts to realize that until role of ***PSEs*** is rationalized, budget deficits and current account deficits will continue to emerge and reforms will not succeed. Failure to define roles of public and private sector, and failure to demarcate their spheres led to severe economic and financial problems even though Pakistan underwent reforms and restructuring at exorbitant costs.

3. Eventually, several ***PSEs*** were close down, restructured or privatized owing to conditionalities attached to stabilization, debt relief and restructuring funded by ***IFIs*** which generated severe opposition compounding the chaos. Without demarcation of role of public sector, policy and operational framework could not be designed much less implemented to ensure stability and growth. This did not support industrial transformation of the type that occurred among comparator countries, though Pakistan economy got diversified, became reasonably open and market-based after reforms were over. The primacy of public sector abated; though impact of past legacy lingered on for quite some time; but the type of transformation that we have discussed in this paper, eluded Pakistan.

4. Privatization cannot be successful unless it is accompanied by major steps undertaken in parallel as part of reforms. Foremost, as owner of financial institutions, government had to restructure them prior to their privatization and underwrite costs of restructuring embedded in asset revaluation and employee severance; cleaned up the balance sheet of dead weight of non-performing loans and other assets of dubious value, partly through massive loan write-offs and provisioning for the ***NPLs.*** In the process, state-owned financial institutions, banks and ***DFIs*** together, had to absorb loan losses of the ***PSEs.*** The government had to absorb these operational losses as well.

5. Overall, costs of privatization were staggering and were absorbed by the government and were financed by borrowed funds. What these costs were is not known for sure. The resulting post-reform structure turned out to be far different than the one prevailed before. Since government did not have resources of its own to meet costs of nationalization, it borrowed cash loans in hard currencies from ***IFIs*** for restructuring and reforms, thereby adding to debt burden during 1990s.

Post Reform Era – *current times*

1. In the early 2000s, the newborn private corporate sector was consolidating and setting up operations anew and needed long term industrial finance, but there were no surviving ***DFIs.*** The same process is currently transpiring in Pakistan amidst reforms and "do more" exhortations. Dimension of privatization in Pakistan can be gauged from changes in ownership structure of ***PSEs*** but we do not have data for the corporate sector, except for banking and financial system. If we look into it we shall find that there has been a major shift in the ownership of banking system towards private sector. The proportion of private share capital in total share capital of banking system was about one fifth at the start of reforms in 1990s. In current times it is virtually all in private sector with the exception of National Bank, ZTBL and a few others.

2. This was the magnitude of reversal, post-nationalization. But here is the rub in this scenario: share of government ownership did decline, but not its share in the use of total financial resources mobilized in the country. This is evident from public sector share in banking system credit and government borrowings from the banking

system. While structure of asset ownership shifted towards private sector, share of public sector in the use of total financial resources mobilized within the country did not decrease, and this does not get reflected by share of public sector in banking credit alone.

3. The reason is that a great deal of ***financial savings***, are being channeled to public sector through government borrowing from banking system and money market operations to arrive at an understanding of total resources used by public sector. We have to combine banking system credit to public sector with borrowings from money and capital markets, lodged as investments of banks, though these are loans to government in the guise of investment. If we combine all of this, we find that nearly 60 percent of annual flows of financial resources, namely ***financial savings***, are being channeled to public sector through financial system, plus NSS operations which are outside of financial system flows, currency seignorage and inflation tax. The same is ongoing in current times.

4. Consequently, public sector is still able to garner a hefty share of total financial resources generated in the country through operations of financial system, and thus acquire underlying real resources of the economy. The issue of ***crowding out*** of private sector has been mitigated but only in the arena of banking credit, not in the context of resources at macrofinancial level.

5. This goes back to the issue of who generates and supplies financial resources and who eventually uses it, and how good is the transfer mechanism, namely financial intermediation which facilitates this transfer. In all of this, how much of these resources are available to promote industrial sector gets muddled up; but the fact remains that the banking system is not known to provide term financing for establishment of new industries. The scope for ***DFIs*** is there, but there are no ***DFIs*** left in Pakistan.

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