2017

Long Term Industrial Finance in Pakistan

Current Scenario & History of Industrial Growth

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Long term Finance refers to those requirements of funds by Manufacturing or Industrial businesses which are for a period exceeding 5 to 10 years which are usually catered by the commercial banks and DFIs in the country.

1. Current Environment for Long Term Industrial Finance in the Country

Conditions for Industrial Concerns are favourable in the country. Long term credit is available and large scale manufacturing industry is flourishing.SBP expected that the growth would gain some pace going forward, on the back of supporting policies and encouraging outlook for automobile, sugar, pharmaceuticals and construction-related sectors. The year 2016 however, saw export decline for successive few years despite SBP's easy monetary policy stance and supportive measures for exporters and entrepreneurs.

The large retirement of private sector credit in Q1-FY17 was commensurate with an extraordinary off-take during the month of June 2016. Moreover, a few large corporate also remained shy from borrowing despite the historic low interest rates. A positive development, however, was the higher loan demand for fixed investment purposes, particularly for energy-related capital expenditures.

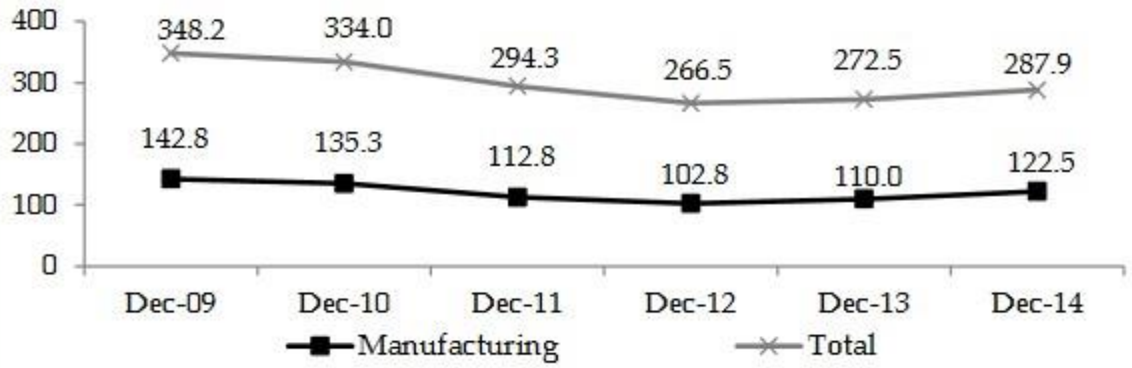
Fiscal incentives announced by the government in the FY17 budget and a historic low policy rate offer private businesses an opportunity to demonstrate that they can compete with their peers in other emerging markets and contribute to the growth momentum of Pakistan's economy.

The Large Scale Manufacturing sector also benefitted from the continued improvement in the supply of electricity and gas coupled with expansion in credit to private sector. The expansion in credit to private sector remained high due to lower cost of credit and better market conditions. A welcome development is the rise in the net credit disbursement for fixed investment. It appeared that many firms are expanding their operations by availing fixed investment loan. Credit for fixed investment reached to Rs. 150.147 billion (increased by 78 percent) during July-March, FY 2016 against Rs. 84.365 billion in comparable period of FY 2015. The expansion was particularly notable in sugar, fertilizer, pharmaceutical, telecommunication, road transport, construction of roads, manufacturing of electricity distribution, machinery, cement, chemical sectors etc.

2. Access to Long Term Credit

As per Economic Survey of Pakistan 2015-16, the manufacturing sub sectors that showed decline included Wood Product (58.03 percent), Engineering Products (17.64 percent), Paper and Board (2.90 percent), Electronics (9.98 percent) and Iron & Steel products (7.48 percent). If these sectors will get better access to long term financing facility, then the loss due to negative growth can be minimized. Small manufacturing concerns in Pakistan like fan industry still has problem in getting finance from Banks. A survey conducted by the Asian Development Bank suggests that in Pakistan only 6 per cent of fixed investment finance for SMEs comes from commercial banks and development finance institutions.

Figure 2: Credit flows to manufacturing SMEs vs. all SMEs (PRs bn)



Source: State Bank of Pakistan.

As evident from the graph above, manufacturing SME still lags behind in getting credit from Banks.

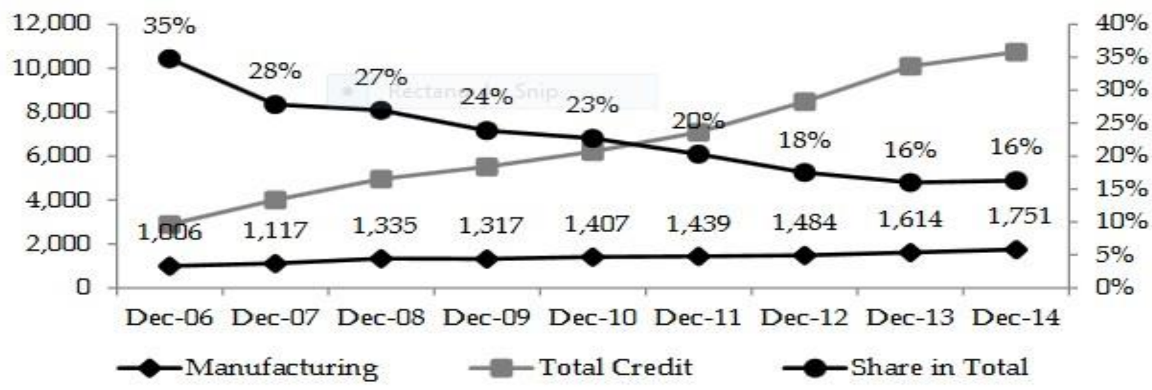
3. Demand for Long Term Credit

Manufacturing is the second largest sector of the economy accounting for 13.6 percent of Gross Domestic Product (GDP). This sectors mainly comprises textile industry, engineering goods and industry, agro based industry, chemical industry and small & medium enterprises. This sector provides employment opportunities of 15.3 percent to the total labor force. Large Scale Manufacturing (LSM) at 10.9 percent of GDP dominates the overall sector, accounting for 80 percent of the sectoral share followed by Small Scale Manufacturing, which accounts for 1.8 percent of total GDP. The third component of the sector is slaughtering and accounts for 0.9 percent of overall GDP.

The Large Scale Manufacturing (LSM) during July-March FY 2016 registered a growth of 4.70 percent as compared to 2.81 percent in the same period last year. On Year on Year (YoY), LSM grew by 6.75 percent in March 2016 compared to 5.80 percent of March 2015.

Therefore demand for credit will increase with growth of manufacturing sector in the country. Although credit is available however need of some sectors may be catered on special basis and special products may be formed for more sectors especially in the wake of CPEC as the demand for industrial credit will increase many fold. The demand of small scale industry like fan industry is still unmet in the country due to various reasons.

Figure 1: Flows to manufacturing sector and its share (PRs bn)



4. Lack of Finance - A Major Constraint in Industrial Growth

The lack of finance is the major constraint on new projects going on. Lack of working capital is not the same as unprofitability but the effects can be just as catastrophic. For a short time companies may be able to get through periods of negative cash flow by extending payment terms to suppliers, either simply by taking additional time to pay or negotiating longer terms. Reducing what capital they take out of the business, freezing salaries and increasing prices may all help to produce some respite.

Lack of finance will make it difficult for the existing firms to expand their business thus effecting the overall growth of the industry.

Example: Lack of access to viable credit is also a critical issue for the fan industry in Pakistan. This problem is exacerbated because of the paucity of reliable financial data. A survey conducted by the Asian Development Bank suggests that in Pakistan only 6 per cent of fixed investment finance for SMEs comes from commercial banks and development finance institutions. The problem of access to credit is more acute for the smaller sized firms in the fan cluster which are virtually shut out from access to bank credit. In fact, about 85 percent of the firms in the cluster reported 'self financing' as their primary source of funding (State Bank, 2011). This limited availability of viable bank credit is due to capacity issues faced by the firms and banks alike.

5. Long Term Finance Environment for the Engineering and Machinery Sector

Engineering sector in Pakistan is engaged in manufacturing cement and sugar plants, industrial boilers, chemical/petrochemical plant & equipment, construction equipment and power transmission towers, textile related engineering, automotive, etc. although growth in our steel industry has been relatively slower but downstream engineering industry has progressed with good pace thus building a base for producing value added industrial products like automobile and parts, electrical machinery/equipment, consumer durables, pipes valves etc.

State Bank had introduced LTFF to promote export led industrial growth in the country. Through this facility exporters are facilitated by providing subsidized financing for setting up of export oriented projects and modernizing their plant & machinery. There exists vast investment opportunities in different sectors of the equipment and light engineering.

6. Banking Sector's Role in Industrial Growth

To serve the non-commercial sector of the economy, *i.e.*, industry, it is essential that the commercial banks should be able to lend long term credit to the industrialists however the funds available with the Pakistani Banks are hardly sufficient to meet the seasonal demands of the market therefore it is not possible for them to block their capital for a long period.

On net basis, bank loans rose from Rs224b to the private sector in FY15 to Rs460.6b in FY16. The advances to deposit ratio (ADR) of banks remained as low as 45.5pc at end-September 2016 which shows that banks are not aggressively lending to private sector. Therefore banks should come forward to extend more finance to business & industry.

By limiting the pool of funds in the banking system, the dominant borrower (ie, the government) marginalizes the credit for private sector activities. The central government borrowing (as percent of GDP) from the banking system has remained highest in Pakistan. Facing a persistently large fiscal deficit over the years, the government has relied on financing from the domestic banking system. While the overall credit extended by the banking system in Pakistan has increased, its composition has shifted in favour of risk-free government lending. Nonetheless, cognizant of its impact on the supply of loanable funds for the private sector, SBP stepped up its liquidity injections through open market operations (OMOs) to ensure adequate supply of credit.

With risk-free and growing credit demand from government, banks have little incentive to extend loan to risky private sector. High infection ratio (non-performing loans as percent of total loans) for Pakistan, reflecting degree of risk in lending to private sector. A negative association between NPLs of the banking sector and overall economic activities (generally proxied by GDP growth) exists as large part of the increased NPLs coincides with the low GDP growth, ie, a phenomenon which is cyclical in nature.

Commercial banks' credit to the private sector (in terms of GDP) in Pakistan has witnessed a noticeable decline since FY08, plunging from 27 percent in FY08 to just 13 percent in FY15. Long-term analysis also shows that after witnessing a credit boom from FY05-08, credit-to-GDP ratio has reached historic lows. This ratio is among the lowest in other developing economies.

7. Phasing out of DFIs & its Affects on Industry

Due to large debt burden and heavy expenses, DFIs were considered white elephant by government, therefore it decided to restructure them by making them autonomous with less or no dependency on Government Funds, details of institutions is given as below.

Industrial Development Bank of Pakistan

Industrial Development Bank of Pakistan (IDBP) is one of Pakistan's oldest development financing institutions and was created with the primary objective of extending term finance for investment in the manufacturing sector of the economy. Over the years, however, the Bank has become an institution fostering the growth of Small and Medium Enterprises in the rural/less developed regions of the country. Industrial Development Bank of Pakistan is wholly owned by Pakistani government entities with 57% of its shares held by the Federal Government, 36% by the State Bank of Pakistan and 7% by provincial governments and other public sector corporations. Its Board of Directors consists of representatives of the private sector appointed by the Ministry of Finance.

The IDBP has suffered from significant losses due to loan defaults. By the mid-2000s, the IDBP had accumulated a loss of about Rs27 billion and was insolvent. The government merged IBDP with the profitable Investment Corporation of Pakistan in 2006 in an attempt to improve IBDP's financial performance. The bank continued to struggle commercially and by end of 2009 the accumulated deficit had risen to Rs28 billion. The government continues to explore ways to make IDBP economically viable.

Pakistan Industrial Development Corporation

PIDC was created to fill the financing gap. The agency, however, had a tendency to support the larger, more established enterprises which had good security and a known high rate of profit. For instance, in its policy of disinvestment in projects, the Pakistan Industrial Development Corporation (PIDC) was believed to have favoured established industrial families which were said to have achieved this position through association with PIDC.

National Development Finance Corporation

After 1999, the government shifted to a market based financial system, founded on banks and capital markets. Eleven existing DFIs were reconstructed through mergers, closure, liquidation and reorganization. The largest DFI, National Development Finance Corporation, was shut down, and its liabilities taken over by the NBP.

Phasing out of Specialized Banks did affect the industry as they could no longer get finance for their specialized needs as the phased out DFIs were short of funds and could not go overboard in catering the credit needs of Industrial Concerns.

8. Factors behind Slowdown in Manufacturing Sector Growth in 80s

From July, 1977 to 1980, the Government initiated a large number of measures to revise the economy. Cotton ginning rice husking and flour milling were denationalized. The private sector was encouraged to invest in large scale industries. The annual growth rate in manufacturing sector was 8.2% in the 1989's. The growth of large scale manufacturing slowed down to an average of 4.7% in the first half and further to 2.5% in the 2nd half of the 1990's.Factors causing the slowdown in manufacturing sector were;

Unfavorable Industrial Tariff & Duties Structure:

In Pakistan the protection structure favours consumer goods industries and does not favour the intermediate and capital goods industries. As a result there has been a marginal increase in the share of intermediate and capital goods industries.

Energy Crisis:

The energy crisis including electricity and gas load shedding has been adversely affecting the industrial production in the country. Moreover, the frequent fuel price changes in the annual budgets (Mini budget) do not have a good impact on the development and expansion of industries in Pakistan.

Political instability:

The political instability, lack of proper planning, heavy taxes etc are also responsible for the lagging behind of manufacturing sector. Since inception, the political system of Pakistan has remained instable. Frequent changes in the government have been taking place until now. There were only two long period governments that were run by military, while in this age of democracy all over the world, other governments do not like martial law because investors remain hesitant in making investment in the industrial sector.

Controversial Industrial Development Strategies:

In the past, there have been rapid changes in industrial development strategies because the planners have not been able to resolve the following issues:

- The extent of interdependence between agriculture and industry
- The rate of economic growth with or without equal distribution of wealth
- Establishment of capital intensive or labour intensive industries
- Industrial development through public or private sector investment
- Small scale or large scale industries to be patronized.
- Industries to be nationalized or denationalized and deregulated etc.

In the absence of a clear-cut industrial strategy, the growth of our industrial sector has been very slow

Lack of Capital:

The second major problem of industrialization in Pakistan is the lack of capital. In capital intensive industries like steel and iron, chemical, automobile etc. the amount of capital required is quite high. In industries like textile, carpet, sugar, paper board etc huge amount of capital is required to establish and expand these industries. Pakistan allocated a sum of Rs. 162.2 crore in the first five year plan for the development and growth of industries. In the sixth five year plan, an amount of Rs.18.1 billion had been placed for the growth of industrial sector in public sector and Rs.16.0 billion in the 7th plan. The amount was insufficient to meet the necessary preconditions for industrial take off.

Lower participation of private sector in gross fixed capital formation

The share of private sector in gross fixed capital formation is also low in Pakistan. Gross fixed capital formation by private sector (as percent of GDP) is only 9.6 percent in Pakistan, compared to more than 20 percent in Bangladesh, Sri Lanka and India. Most of the firms in Pakistan have excess capacity that inhibits investment and leads to low credit off -take.

Dearth of demand based financial products & high cost for Industrial borrowers

In Pakistan there's a dearth of demand based lending products and borrowing cost has been quite high except quite recently when discount rate has hit its lowest but banks are still charging quite high.

Lack of Public-Private Partnership

The dialogue between Public and private sector has always been short lived and hardly any long term partnerships have survived in Pakistan.

9. Manufacturing Sector Performance during 2001-2007

During the years 2001 to 2007, the private sector acquired a very prominent role. This was the fifth approach to industrial policymaking in the country's history. Under it, the pace of privatization quickened as did deregulation and the opening of the economy to the outside world. Some significant adjustments were made in the tariff regime that provided incentives for the development of such large scale industries as automobiles and consumer electronics. The government also gave considerable room to the financial sector to participate in the process of industrialization by making choices made on the basis of market considerations. The amount of room for manoeuvre allowed to the private sector did not develop enough confidence among the entrepreneurial class to stand on its own feet and deal with the changes occurring in the global economic system without government intervention. The failure of the textile industry to make use of the opportunities created by the end of the Multi-Fiber Arrangement (MFA) on January 1, 2005 is the most telling example of the lasting impact on entrepreneurial behaviour of the policies and approaches towards industrialization adopted in the past several decades.

While allowing considerable space to the private sector within the industrial domain, the government should have also developed the regulatory system to provide protection to consumers, encouraging competition in the private sector, and improving corporate efficiency.

Several regulatory bodies were set up in the sectors of finance, industry and public utilities but they were not allowed the autonomy without which they could not effectively operate. One way of ensuring the independence of the regulatory agencies from control of or influence by the executive branch of the government is to have the legislature /regulator approve the appointments of the chief executive. Although the Government created a number of regulatory bodies it appointed heads of the agencies that were close to the government. Consequently, most agencies did not achieve the desired amount of autonomy.

2003-2005

The share of industrial sector was 5.8% in GDP growth rate in 2003-04. However it increased to 13.1% in the year 2004-05. The main factors which contributed to rapid economic growth supporting were as follows;

- Monetary Policy
- Financial Discipline
- Consistency and Continuity of Development Policies
- Strengthening of Domestic Demand
- Continuously Improving Macroeconomic Environment
- A Stable Rate
- Global Expansion of Markets Due To Liberalization of Trade In 2005

2005-2006

In 2005 the contribution of industrial sector in GDP growth rate was 9.9% which declined to 4.1% in 2006.The decline in manufacturing sector is due to multiple reasons like the reduced production of cotton crops, sugar shortage, steel and iron problems and global oil price.

2006-2007

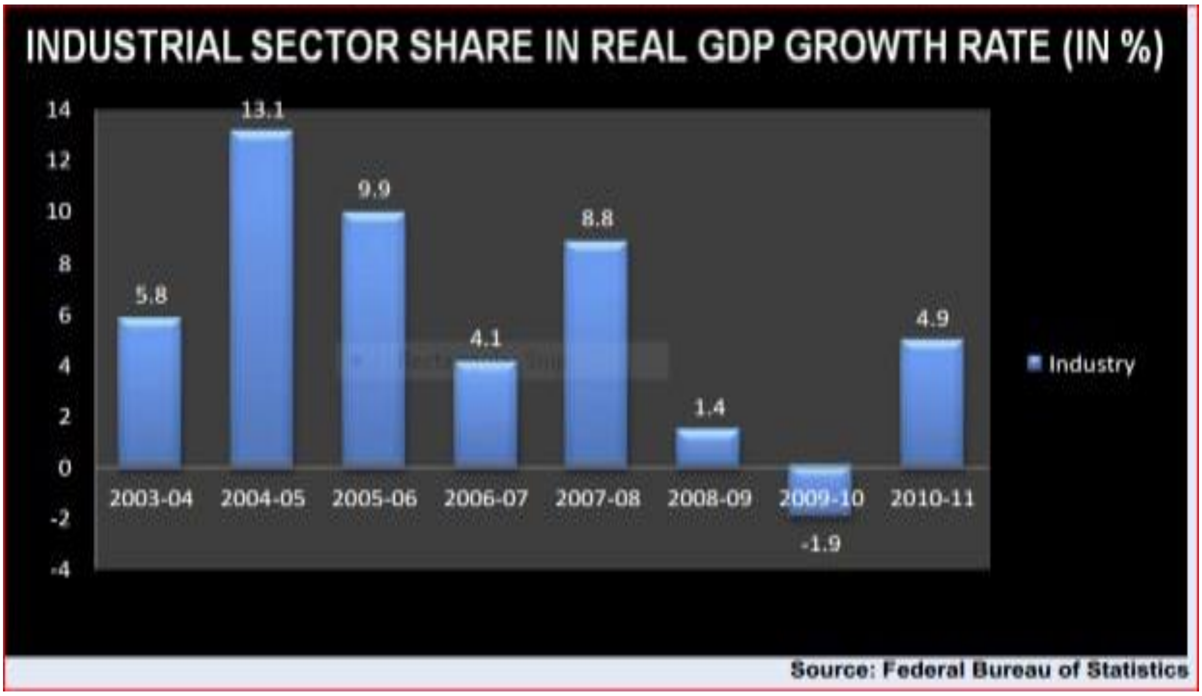
From 2006 to 2007 there was an increase in the industrial sector contribution towards the GDP growth rate. The reason were:

- Major reasons for the growth in 2007 was production of sugar which estimated at 61.5Million Metric Ton (MMT), an increase of 12% over previous year due to increase in area under cultivation and yield.

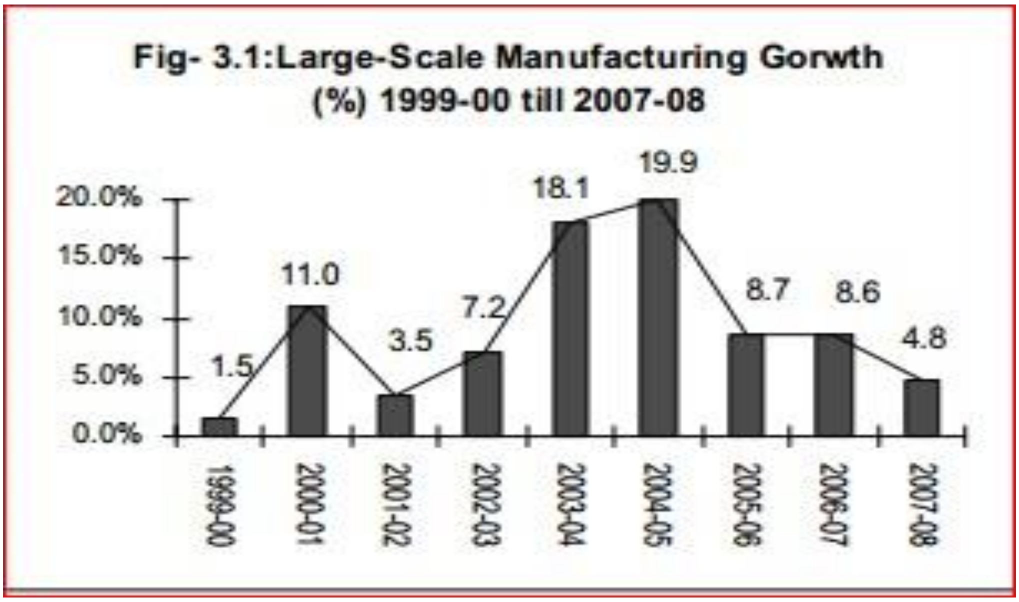
- In 2007, the industrial sector grew by 14% and accounted for 27% of the gross domestic product (GDP) based on purchasing power parity.

- Foreign direct investment in mining and quarrying and oil and gas exploration increased by 34% and 74%, respectively, in 2007 compared with that of 2006.

- Textile exports in 1999 were $5.2 billion and rose to become $10.5 billion by 2007. In 2007, the Government of Pakistan has offered a number of incentives for encouraging the use of CNG in the country.



Actual cement production in 2001-2002 was 9.83 million tons and in year 2007-2008, it grew to 26.75 million tons. After 2002-2003, most of the cement manufacturers expanded their operations, and increased production. Industrial sector registered 26% growth and construction activity was 17 years high. Industrial Parks were also being setup. LSM rose from 1.5% in 1999 to 19.5% in 2005, registering a 135% growth.LSM sector growth during discussed era.



10. ZTBL (formerly ADBP)'s Role & Experience in Project Financing

Zarai Taraqiati Bank Limited (ZTBL) being the successor of Agricultural Development Bank of Pakistan (ADBP) is the single largest financial institution of Agri. Financing. ADBP was established through the promulgation of ADB Ordinance 1961 on Februrary18,1961 by merging Agricultural Development Finance Corporation (1952) and Agricultural Bank of Pakistan (1957) to provide better credit facilities to the agriculturists for development and modernization of agriculture and for small cottage industries in the rural areas. "Technology for Agriculture" is the main moto of the Bank which is being practiced by the Bank since its inception. In the year 2002 responding to the market aspirations, ADBP was converted into a company limited as ZTBL, for providing better services to the target clients.

The Bank pioneered various initiatives contributing growth to the agriculture sector of the country i.e. introduction of combine harvesters, UHT treated milk processing units, development of poultry and potato chips industry in the country.

Project Financing started in the era of President Agriculture Development Bank of Pakistan, Mr. Jamil Nishtar in 80s when 7 billion Rupees were provided for agro-based industry. Bank provided long term finance to 12 cotton ginneries, 18 flour mills, 34 oil extraction plants, 75 feedmills,59 dairy & livestock projects,18 fish processing plants,19 units of milk processing. Bank also financed 116 combine harvesters ,27agri-implement projects, 40 post harvest facilities, 8 lather tanneries, 28 fruit & vegetable processing units and 68 storage and marketing units .Project financing continued from 80s till early of 90s and provided much needed finance to the agro-based industry. However due to increase in stuck up loans bank made strategic choice to focus exclusively on lending to farmers for production and development purposes.

11. Sources:

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2. Economic Survey of Pakistan
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