SMEs a neglected lot

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National financial integration can best be evaluated through the progress of two principal processes: the share of the SME sector (the dominant national business employer) in national credit, and the distributional balance of bank credit across regions/provinces of the country. Both these processes, never robust in Pakistan, have lost even more steam in recent years. SME credit has fallen to under 7% of total bank credit, and no province/region outside Punjab and Sindh uses more than 9% of their own deposit base for lending within their domain.

Sharply increasing inequality in financial access, between the big and the small business sectors, and in between national regions, closes the prospect of upward income mobility for large sections of the population - presaging social polarisation and its political consequences. The present drift of national finance serves only a narrowing group of interests: it must be checked and reversed.

Pakistan's banking is highly concentrated. Over 70% of banking assets are held in its top five banks. Collecting deposits from all over the country, the banks hold over 80% of their assets in government securities, and in lending to larger companies in the private sector. This concentration does little for deepening the national economic base - in particular, as government debt, which forms the dominant share of banking assets, finances mainly operational losses run by government entities, rather than development.

Since the 19th century, as countries progressed through their development phase, strong inclusion of SMEs and national regions was inherent in the distribution of finance. Government backed this process. 'Mass' banking in Western Europe and the US, in the beginning, consisted of many, small/medium sized, local and regional banks, supporting local businesses.

In the US, individual states restricted banks' operations to within their borders, and often, to single locations within the state. The fundamental objective was to ensure that local savings served community interests by supporting local enterprise. In addition, the states themselves took initiatives to reinforce SME development. Most state-awarded contracts required that SMEs be given a significant percentage of the value of the work. The states also invested directly into SMEs, and provided debt guarantees on their behalf. In addition, an agency of the federal government (FSBA) specifically interceded and intermediated on behalf of SMEs across the country. Official support became a strong catalyst in accelerating SME lending, by local commercial banks. Even though barriers to inter-state banking began erosion starting in the 1970s, 34% of the US banks are still regional.

In Germany, regional development was managed by banks owned by the German states (Landers), the Landesbanks. They financed local projects and SME businesses. They also acted as the apex banks and service providers to municipality owned Banks, the Sparkassens, and to local co-operative banks. Credit from the Landesbanks was the primary catalyst to the emergence of the Mittelstand, Germany's medium-sized and frequently family-owned businesses that make up the backbone of German industry. The 66% of German banking is still regional.

In the UK, banking started with co-operative banks and building societies, serving regional and local communities. Mainly owing to London's historical role as the global financial capital, Britain saw a huge consolidation of banking post-WW2, into the big five British banks. SME neglect grew, and only 3% of British banking remains regional. Today, the UK politicians, across the party divide, strongly back the revival of regional banking and the reinvigoration of SME lending - the German model is often quoted now as central to building the UK's economic Strength in the long-term.

In contrast to this broad-based organic process, national banking started with large metropolitan banks in countries that came late to economic development ('Emerging Markets'). The SME and regional assimilation process then ran tops-down: to achieve this, and other development goals, countries maintained state ownership and control of most of the national banking system (China and India currently, Korea earlier). Even where commercial banks were privately owned, governments both created publicly-owned development institutions, and sometimes imposed state-directed development lending stipulations upon the private banks.

Pakistani banking operations today do not match either the early European or US experience, or follow the models of other major Emerging markets. Here, banking support of SMEs/agriculture, and the distributional range of bank lending across regions, never significant, has nonetheless deteriorated steadily. Capacity or interest for other development goals, based on specialised project or lending for infrastructure is evidently limited. Share of the SMEs in total bank credit has declined to 6.8%, from 17% in '08, and agriculture to 6.5%, from over 7.5%. But an even Sharper adverse skew lies in the regional distribution of credit.

Based on SBP data as of June 2013, total deposits in Pakistan were Rs 7.1 trillion, and total credit, Rs 3.7 trillion - the difference represents bank investment in federal government securities. So, on a national basis, Pakistani banks advanced, on average, credit equal to 53% of their deposit base, and invested 47% of their deposits in government securities.

But the regional distribution of this credit varies dramatically. Banks in Sindh advanced credit equal to 65% of their deposits within the Sindh Province, and 51% of Punjab's deposits were lent within the Punjab. But for KP, the corresponding figure was 9%; for Balochistan, 6.5%, and for AJK, 4.5%. The excess balance of deposits over loans from the smaller provinces was effectively transferred to the two larger provinces, and to the Federal government

The total stock of such transfers was roughly Rs 800 billion as of June '13. Deposits in KP were about Rs 500 billion, and loans Rs 45 billion; in Balochistan, Rs 155 billion and Rs 10 billion; AJK, Rs 203 billion and Rs 9 billion. "Capital" exported, out of KP, was thus Rs 455 billion; Rs 194 billion from AJK; and from Balochistan, Rs 140 billion. And because loans in both KP and Balochistan have actually fallen in nominal terms since 2008, this internal 'wealth transfer' has been growing.(some loans into the smaller provinces, and some deposits from businesses located there, may be booked outside the Province - netted out, volumes shown above are unlikely to be materially different).

In development terms, a vicious cycle is at work here. Taking KP as an example, a low business enterprise in KP creates increased unemployment, which encourages labour migration to the Gulf, and to other parts of Pakistan, notably Karachi. The counterpart flow of external and internal remittances back to families adds to deposits in KP. The vast majority of the deposits are essentially then recycled out of KP by the banks, as shown above - creating credit and jobs outside KP. A steady resource depletion process is at work; its continuity will only make the climb back to development and political 'normalcy' harder.

Sustaining the creation of jobs and general income over time can now only come from a massive reinforcement of credit within the smaller provinces. While large-scale development projects, such as in mining and energy in KP and Balochistan, will generate substantial revenues for the provinces concerned, they cannot become the engines of region-wide, recurring and broad-based, production and employment; that role can only be performed by the SMEs.

Kick-starting our faltering engine will require various forms of government interventions. Credit is only one part: equally, what is needed is building SME capacity through provision of common overheads. Needs can be 'hard', such as creating business parks and providing common technology platforms (back-offices), and pooled energy sources; or 'soft, such as in training, marketing, and in helping develop a facilitative legal and regulatory environment.

The Youth Business scheme announced by the Government, aimed at the 'S' of the SMEs, is an individual initiative. We need to go further, and aim to develop a rounded and institutionalised, self-sustaining, approach to SME and regional regeneration. A couple of basic suggestions for how a fast-track approach can be adopted in Pakistan to stimulate broad-based momentum are made below.

First, a major avenue for SME support would open up if each of the province-owned commercial banks (Banks of Punjab, Sindh and Khyber, respectively) are charged with a dominantly SME development mandate. Their access to government and public agency deposits should be leveraged for regional development. Importantly, given their linkage with respective provincial governments, provincial banks can be credible intermediaries in resolving legal, regulatory and infrastructural impediments to SME growth, so facilitating incremental investment in the sector.

The banks should also work closely with SMEDA. Feedback will provide SMEDA valuable guidance with respect to fine-tuning its support functions. Further, their knowledge platform and their technology capacity could positively complement SMEDA's efforts in the provision of common 'overhead' facilities for SMEs in technology, training and marketing.

Secondly, SMEs in developed countries are primary areas of Venture Capital (VC) interest. An important Government intervention would be to set up a VC company, jointly with the Commercial banks, under private-sector management - to invest convertible debt or equity into SMEs. Well-managed VC funds aim at returns on equity of 30%+; thus banks that are reluctant to lend, should have much more interest in supporting a VC equity proposition. In turn, there will be a positive reinforcement - the availability of VC equity and the VC's expert oversight moderates the relatively higher risk of lending to SMEs and would by itself spur greater commercial bank lending.

Such a public-private structure is likely to have a more fundamental impact in achieving and sustaining substantial results, than individual private initiatives. This is because, fed by their wide branch networks, banks could generate a greater and more consistent pipeline of proposals; in time, the relationships of banks with larger domestic companies could help them, selectively, develop SME-based supply chains, an essential SME function; and the potential variety and regularity of their deal flow would allow banks to run diversified portfolios of VC funds, by business sector and by region.

The task of vitalising the base of Pakistan's economic pyramid must now be taken firmly in hand. The associated planning task, which essentially focuses on stimulating financial flows, should be assumed between the SBP/SECP and representatives of the provincial governments and the banks. A change of tack to galvanise finance for broad-based employment and income growth across the regions of Pakistan - the bedrock for long-term national stability - is long overdue. *(The writer is a former Governor of State Bank of Pakistan)*

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