World Development, Vol. 17, No. 8, pp. 1289–1297, 1989.
Printed in Great Britain.

0305–750X/89 $3.00 + 0.00

Private Finance Companies in LDCs: Lessons from an Experiment

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Summary. — In many LDCs liberalizing the financial sector will involve creating new financial institutions in the private sector to attract untapped savings and provide new services. This paper provides a detailed account of an experiment with Private Finance Companies (PFCs) in Pakistan. The complex legal, ideological and economic factors which explain the initial success and the ultimate failure of that experiment are identified. It is concluded that PFCs have an important role in mobilizing rural savings, but to safeguard depositors a legal framework has to be provided. Care should be taken that nationalized banks, acting in their self-interest as monopolists, do not create hurdles in the provision of such minimum regulation.

1. INTRODUCTION

Government intervention in the financial markets of less developed countries (LDCs) is extensive, often involving direct public management or ownership of banks (see for example Virmani, 1982). This is said to lead to segmentation of the capital market into a highly regulated "formal" market with low interest rates and credit rationing, and an "informal" market with high interest rates and limited supply of lendable funds (McKinnon, 1973) often operating on the fringes of the legal financial system. Such segmentation is known to distort investment behavior of borrowers, leading to inefficient use of scarce capital (Tybout, 1983; Nabi, forthcoming). Highly regulated financial markets have another important consequence for the economy; the complex procedures, usually inadequate branches, and barriers to entry discourage potential small savers, particularly in rural areas, from inculcating the "banking habit" (Porter, 1966). This retards financial intermediation and limits the availability of lendable funds. To remedy this, the LDCs are advised to deregulate their financial markets (Balassa, 1982) and allow entry of privately-owned financial institutions to compete with those run by the public sector. In this paper, we present direct evidence from Pakistan on the complex issues involved in allowing new entrants, and analyze their impact on the financial market.

Between 1977 and 1979 Pakistan became an interesting laboratory case for an experiment with new, privately-owned, financial institutions. During the remittances boom (mainly from the Middle East), the government adopted an attitude of benign neglect toward the mushrooming growth of private finance companies (PFCs). This is particularly remarkable in view of the fact that a large, nationalized, formal banking structure already existed in the country, which had much to lose from competition. As we shall see, the monopolistic institutions eventually succeeded in thwarting the experiment. While it lasted, however, the experiment encompassed complex ideological, legal and economic issues from which much can be learned about liberalizing the financial sector in LDCs. The paper is structured as follows: Section 2 presents the economic and ideological background that al-

*The authors are grateful to the referees of this journal for their valuable comments. The paper is based on a report prepared for the Asian Development Bank. The views expressed herein are the authors' and should not be attributed to the Asian Development Bank, the World Bank, or their affiliated organizations.

lowed the experiment to take place. Section 3 discusses the early stages of PFC existence. The organization, structure and growth of PFCs are discussed in Section 4, and their collapse in Section 5. Section 6 presents some lessons for future efforts at liberalizing the financial sector.

2. THE ECONOMIC AND IDEOLOGICAL BACKGROUND

Perhaps the most significant factor in Pakistan's economy in the period 1977–79 was the sharp increase in the number of Pakistani migrant workers in the oil-rich countries of the Middle East. Table 1 (column 2) shows that between 1975 and 1977 there was a sevenfold increase in the number of Pakistanis working abroad (most of this increase was in the Middle East). Consequently, in the same period, remittances increased sixfold (column 3). A large proportion of the migrants belonged to the relatively poorer sections of the society and had their dependents in rural areas of Punjab (ARTEP, 1983). Potentially, therefore, there was a large pool of small savings in rural areas which could be mobilized to finance development.

The existing financial sector in Pakistan was in bad shape. In the early 1970s, Bhutto's populist government nationalized the scheduled banks. Whatever the original intentions of the government, an unfortunate consequence of nationalization was that banking procedures became excessively bureaucratic, the quality of service at the counter deteriorated remarkably, and morale in institutions, such as the stock exchange, fell sharply. Another weakness of the financial structure was the limited number of bank branches in rural areas which, along with poor rural communications, meant that existing financial institutions were inaccessible to many small rural savers. The combined effect of these features was that scheduled banks were unable to fully tap the new saving potential. Thus there was an obvious lacuna in the financial structure of the economy of which imaginative entrepreneurs could take advantage.

Table 1. *Migration and growth in remittances between 1975 and 1979*

Year	Net migration from Pakistan (number of workers)	Net factor income from abroad (US$ million)
1975	23,077	201.21
1976	41,690	553.54
1977	140,522	1226.16
1978	130,525	1467.88
1979	125,507	1846.87

Source: Government of Pakistan (1983).

The ideological environment was also well suited. The new military government was, by the middle of 1978, preparing grounds for a long tenure and had committed itself to Islamize the economy. The most important feature of the existing mixed-economy framework that the new ideology attacked (at least in public) was the interest on capital. The more perceptive finance companies pointed out that interest on capital was too deeply entrenched in the existing financial structure, and that its removal required the creation of new institutions. Such arguments not only helped the companies to acquire respectability in the prevailing ideological environment, but also made them attractive to many savers who, for religious reasons, would not deal with the scheduled banks (which used interest on capital as an instrument). The religious argument had another dimension. Along with the abolition of interest, the government was committed also to the imposition of *Zakat* (religious tax) to be deducted annually on savings deposits held in scheduled banks. This factor, in addition to the growing inefficiency of the scheduled banks due to nationalization, had disillusioned many depositors who were on the lookout for alternative financial institutions. It was in these circumstances that the private finance companies (PFCs) were born.

3. THE PRIVATE FINANCE COMPANIES (PFCs): THE EARLY STAGES

The publicly-stated objectives of the PFCs (based on a careful examination of the public statements of several successful companies) were: to create a large pool of investment funds by tapping the savings of small, rural investors; to invest these savings in new as well as ongoing industrial projects; to finance credit-starved small industries; to invest in agro-industry, agricultural land, and urban real estate; to invest in transport and travel agencies; to finance trading in the domestic as well as the international market; to create an interest-free financial sector; and to become forerunners in instituting the Islamic concept of *mudārabah*.[1] Some welfare projects were also intended to gain public respectability. Thus it was declared that the PFCs would help establish schools, hospitals, and printing presses.[2]

It is clear that the publicly-stated objectives were carefully chosen and worded to coincide with attempts at credibility and legitimacy by the newly-established government of General Zia-ul-Haq. All three ingredients on the economic front were present: to bring back respectability to private enterprise; to help create institutions that would foster Islamic ideology; and to undertake public welfare projects. These objectives were to be met, largely, by mobilizing rural savings. Credibility in the public eye was bolstered further by playing up the Middle Eastern and Northern European connections of owners of the PFCs.

In the early stages, the relationship between the PFCs and the state authority was of a dual and contradictory nature. The public institutions dealing directly with the companies, such as the Registrar of Joint Stock Companies' Office, were suspicious of the intentions of the companies right from the beginning. They tried to check their growth by interpreting registration requirements stringently. Also, the Banking Council became wary of the companies because they were threatening to break the scheduled banks' monopoly in finance. Fairly early, the council complained to the government that the companies were acting as banks and therefore should be banned because they violated the Banking Companies Ordinance of 1973, which prohibited private banking. On the other hand, the judiciary was quite supportive, upholding, in a few test cases, the right of the companies to function. By identifying with the ideological objectives of the new government, the companies had gained respectability, so that powerful representatives of the state, such as ministers and district commissioners, were glad to be photographed at opening ceremonies of branches. This helped to smother the voices of those who advocated caution. We shall see in Section 4 that this contradictory attitude of the state was very important in the ultimate chaos that resulted and led to the failure of this potentially important experiment.

Before we move on to analyzing the operations of the PFCs, their structure and growth, and finally the causes of their failure, it is appropriate to summarize our own view of the phenomenon at its early stages. First, the original companies in the hands of capable owners established themselves quickly and were very successful as an instrument of mobilizing rural savings, particularly in Punjab. Second, the excellent early performance of these companies had created enormous good will between them and a large section of small savers; they were usefully complementing the existing banking institutions and thus enlarging the financial sector in the country. The third important feature at this early stage was the government's ambiguity toward the PFCs caused, in part, by the Banking Council. As a monopolist in the financial market, the council was hostile to the PFCs and hoped that they would disappear in the financial mess that would follow in the absence of regulation. As we shall see, this strategy eventually worked very well.

4. OPERATIONS

(a) *Organization*

In the first phase, i.e., in the case of the first few companies, the owners were businessmen or bankers. They did not have too much capital, but capital was not required. To register as a public company with the Registrar of Joint Stock Companies, all they needed was to submit an application with the names of three directors and a fee of US$50. The second group of companies were generally spinoffs from the first few whose employees, originally drawn from the banking sector, left to set up companies of their own. The third group consisted of those who jumped on the bandwagon in the hope of making quick money and were almost all of dubious financial background.

The organizational structure of the large companies was similar to that of the commercial banks. The companies started by first going to the villages and tapping markets which had not been reached before. They then opened branches in small towns and only made a big push in the large cities when they had generated sufficient resources to have impressive offices and expensive publicity campaigns necessary to convince the less simple city-dwellers of their financial soundness. Not only were the PFCs organized on more or less the same lines as commercial banks, but they also operated like banks, offering various types of deposit accounts similar to current, savings, and fixed deposit accounts in banks. They also provided the depositors with withdrawal slips similar to checkbooks. The actual banking procedures were, however, rather simple reflecting, perhaps, "appropriate technology" in local banking. For instance, branch managers and other employees were mostly untrained and only a rudimentary system of accounts was maintained at the branch level; proper receipts were seldom given and, in general, withdrawals were discouraged. Since branches of the PFCs did not have adequate security arrangements for keeping large amounts of cash on their premises, they maintained accounts with the nearest branch of a commercial bank where they kept their surplus cash, drawing funds as needed. From time to time the PFC branch would transfer part of the surplus funds to the head office account.

(b) *Structure and growth*

By the middle of 1979, the phenomenon of the PFCs had been in existence in Pakistan for nearly 18 months and a structure had emerged. The salient features of this structure are presented in Table 2. The five largest PFCs together had 984 branches with total deposits of US$37.78 million. Figures regarding total employment generated, the number of branches, and total value of deposits are all impressive. The smallest and the largest companies had, on average, about US$35,000 worth of deposits per branch. The medium-sized companies had perhaps over-expanded, having deposit values per branch of US$22,000.

Three features of the structure were striking. One was that, overwhelmingly, the branches were in rural areas. Second, corresponding to the pattern of overseas migration in the country, the companies were concentrated in Punjab with very few branches in other provinces. Third, the average deposit size was small. The 16 medium-sized and 49 small companies reported average deposits of US$190 and US$66 respectively. Notably, most of the PFCs were quite small. Even the large companies operated through several small branches and their share of total deposits was nine times that of small companies.

A comparison with the scheduled banks in the country (Table 3) shows that in a short period of 18 months, the PFCs had generated as much as 25% of the employment of scheduled banks. In terms of number of branches and personal deposits, the shares, though less, were still substantial (18 and 12% respectively). The average personal deposits per branch of the scheduled banks were only about twice those of the recently established PFCs.

It is difficult to obtain concrete evidence on the growth of the PFCs given that they existed for the brief period of 18 months from late 1977 to mid-1979. Some idea, however, can be had from a comparison of the growth performance with the scheduled banks over this period. Between 1978 and 1979, the scheduled banks expanded their personal deposits by US$0.6 billion, from US$3.4 billion to US$4 billion, compared to the expansion of finance companies from scratch to US$0.05 billion, over this period. This shows that about 8% of the personal deposits created in this period were captured by the financial companies. An idea of PFCs' growth can also be had from the experience of individual companies. For example, in December 1977, an engineering and transportation concern in Gujrat started a company, Industrial and Commercial Finance Limited, with paid-up capital of US$40,000. When the company was closed down in October 1979, it had more than 300 branches and deposits exceeding US$6 million. Similarly, an ex-employee of Habib Bank set up Express Commercial Finance International Limited in January 1978. At the time it was closed down, the firm had nearly 400 branches and almost US$10 million in deposits. Evidence of impressive growth performances is also provided by the optimistic statements regarding anticipated expansion by the finance companies themselves. The Executive Director of Allied International Express Limited stated, "At present (December 1978) we have opened 30 branches in cities/towns/villages and our target is to open 75 branches by the end of March 1979."

(c) *How were deposits attracted?*

It seems that most people were aware that the PFCs did not enjoy government support, particu-

Table 2. *The size structure of PFCs — June 1979*

Size of the company	Total companies	Total employees	Total branches	Total value of deposits (US$ million)	Value of deposits per branch (US$)
Large	5	10,131	984	37.78	38,384
Medium	16	2,360	173	3.92	22,223
Small	49	1,376	133	4.48	33,333
Total	80	13,867	1,290	46.18	35,796

Source: *Pakistan Economist*, June 23, 1979.

Table 3. *Comparative data on scheduled banks in Pakistan*

Number of Pakistani scheduled banks	Number of employees (1982)	Number of branches (1982)	Total deposits (1979) (US$ billion)
5	53,397	7,318	6.26 4.04 (personal accounts)

Source: State Bank of Pakistan (1983), p. 28; State Bank of Pakistan (1982), p. 116; and REPAC (1983).

larly after the State Bank's advertisements in the newspapers to the effect that the PFCs were not banks and anyone depositing money with them would do so at their own risk. But still the depositors did not withdraw their money; in fact, the deposits and the popularity of the PFCs continued to grow. Thus the question which comes to mind is why were the finance companies so successful in attracting deposits in the face of competition with the commercial banks?

The available evidence seems to indicate that although the PFCs promised an attractive rate of return on investments to the depositors, these rates were only a few percentage points above the existing bank rate and, considering the greater risk involved, could hardly explain the observed response. We feel that there were several other reasons for their success in mobilizing savings on such a large scale in so short a time. These may be divided into two broad categories, the original and innovative methods employed by the PFCs to attract deposits, and the limitations of the existing banking system.

In their campaigns, the PFCs capitalized on two important aspects of the rural scene, namely, the large number of educated, unemployed youths in rural areas belonging to well-to-do families, and the strong hold of the *Bradri* (kinship) systems in the village. Employment was offered to these youths, particularly to sons of village *Lumbardars* (headmen) and *Choudhries* (notables), at attractive salaries provided they brought in a certain minimum amount of deposits. They were also promised rapid promotions if further deposits targets were met. Thus important rural families used their influence in their area *Bradri* to get deposits. In the urban areas, the strategy was to hire employees of commercial banks on extremely attractive terms provided they too brought deposits with them.

The other strategy was to exploit the shortcomings of the existing banking system. Thus, branches of PFCs were located in remote villages where scheduled bank branches did not exist. This physical proximity and the resulting convenience was very important in attracting local depositors. Besides, employees in rural branches were hired locally so that depositors felt comfortable with them, unlike the commercial banks' employees who have urban backgrounds and attitudes. Furthermore, the PFCs were much more flexible and nonbureaucratic in their dealings with the depositors. For the illiterate villagers, this was important. To attract small business in urban areas, the PFC branches maintained longer working hours and remained open for business until late in the evening. In brief, the PFCs provided much better service to depositors compared to the commercial banks.

In addition to the factors listed above, several others are worth noting. The PFCs played up the interest-free nature of their operations and thus appealed to the religious sentiments of rural folk by promising an attractive return on their savings, untainted with interest. They promised to invest, without charging interest, in small business ventures of depositors and for personal loans to purchase items such as motorcycles, or for construction of homes (in each branch a few such loans were actually made to establish credibility). In urban areas, massive advertising and publicity campaigns were undertaken; moreover, in addition to the "friendliness" and convenience aspects mentioned above, the branches were lavishly done up to create an impression of financial soundness. Thus at least some of the methods used by PFCs were in conformity with their stated objectives listed in Section 3.

(d) *Utilization of deposits*

The funds were put to several important uses. Perhaps the largest share of the PFCs' investment was in real estate speculation, for construction of shopping plazas (to cater to the growth in retail trade resulting from remittances) and development of housing colonies. The less scrupulous

PFCs are accused of inflating book costs of such ventures, and pocketing the difference. By and large, however, these investments proved to be very profitable because of the land price boom which followed.

Some investments were made in the highly profitable public transportation and trucking businesses. In fact, the PFCs were the initiators of luxury "flying coach" service in Pakistan, which has now become an important part of the long-distance intercity transport system.

Funds were also lent on a very short-term basis for trade and working capital to the unorganized business sector, at extremely high effective rates of interest.

A substantial portion of the funds, possibly as much as 50%, was deposited in commercial banks. (This suggests a conservative reserve policy adopted voluntarily.) When the Banking Council ordered the nationalized banks to close down these accounts, the funds were transferred to foreign banks, personal accounts in the nationalized commercial banks, or spent elsewhere. This act of the Banking Council was the most shortsighted and the least comprehensible step taken by the government in relation to PFCs. The resulting damage to the public interest, discussed in the next section, was tremendous.

Not all investments, however, were sound. Some of the large companies claimed to have initiated a number of joint ventures in the industrial sector, which included cement plants, sugar mills, rice mills, textile units, etc. No details of such ventures can be found, however, and it is likely that, even if such projects existed, the companies were closed down before much progress had been made in their implementation.

Current expenditures are alleged to have been very high, compared to the prevailing norms of the regulated banking industry. This is especially true of expenditures on branch decor, salaries of employees, advertising and publicity, and bribes to government officials.

A significant proportion of funds is reported to have been diverted to owners' luxury consumption at company expense, such as purchase of expensive cars and large residences. This was in addition to the amount that was illegally transferred to personal accounts, or used to promote their own business ventures, or transferred abroad.

5. FINANCIAL CHAOS AND CLOSING DOWN

(a) *Unregulated growth creates problems*

We have already noted that from the beginning the Banking Council of Pakistan, which controlled the nationalized banks in the country, had been hostile toward the PFCs. The council felt that the success of PFCs, if continued, would pose a serious threat to its monopoly. Thus it was on the lookout for any signs of corruption or mismanagement in the structure of the PFCs to launch an all-out attack. Weaknesses in the structure soon appeared in the activities of the unscrupulous newcomers who took advantage of the lack of proper government regulation, control, and monitoring of the PFCs. It was not long before reports began to appear in newspapers that some depositors had been unsuccessful in withdrawing money from their accounts. It is possible that the initially reported cases came about because the companies, not being ordinary banks, were not organized to operate normal banking accounts. They did not always have ready cash in far-flung branches for depositors to withdraw at short notice. That would have defeated the legitimate objectives for which they were created, i.e., undertaking investment. Swindlers, however, did exist who had put the deposits to personal use in dubious ventures, not all of which were successful. When the depositors did not receive a satisfactory return, they responded by attempting to withdraw their deposits. In the latter half of 1979, newspapers in Pakistan were full of harrowing accounts of poor, small depositors having been swindled by the finance companies.

(b) *The PFCs' request for regulation*

The genuine PFCs were caught in a dilemma. If they operated accounts as normal banks, they were open to charges by the Banking Council and the State Bank that they were contravening banking laws. If they did not, they were liable to be lumped together with the swindlers in the public's eye and would lose the credibility that they had built up in the previous 18 months. For them the only way out of this dilemma was to clarify their legal status. To this end they began to appeal to the government through newspapers and direct representations for regulatory legislation.

The specific suggestions regarding regulation made by owners of the PFCs (*Pakistan Economist*, June 1979) were: the institution of government-appointed audit teams to monitor the activities of the finance companies every half year; the formulation of rules for operations such as branch opening, staffing, salaries, investment portfolios, collection and disbursement of participants' funds; deposit account withdrawals and reporting methods; legal penalties of a severe nature for default; representation of the Ministry of Finance or the State Bank on companies' Boards of Directors; an annual license fee to cover the auditing expenses; that the State Bank should hold a security deposit of a sizable amount not below one-third of the authorized capital of a PFC, 25% of the authorized capital be paid up at the time of registration and the balance paid within five years of operations; making it obligatory to carry investment insurance with the State Insurance Authority and, finally; holding company directors liable for all omissions, commissions and malpractices at all levels of the company.

These were fairly comprehensive self-regulations and would have gone far to restore public confidence in PFCs.

(c) *Government's response and closing down*

The government, however, did not respond to this reasonable call for regulation and control. The Banking Council had declared war on the companies by announcing in an editorial in the government-controlled newspaper, *The Pakistan Times* (May 31, 1979), that the finance companies were operating as banks and therefore stood in contravention of the law. It was declared that through their illegal activities the companies had deprived the state banking sector of deposits worth billions of rupees. At the same time, the Ministry of Finance, under whose aegis the nationalized banks operated, declared (*Pakistan Times*, June 8, 1979) that the Federal Investigation Agency, and the State Bank of Pakistan would conduct an inquiry into the "irregularities" committed by the companies. The companies thus stood condemned in the public eye even before the inquiry committee was constituted.

In June 1979, it was declared that the companies could not maintain accounts in the nationalized commercial banks. The hostility toward the PFCs created by the aggressive public statements of government officials, stern press releases and government-inspired newspaper articles succeeded in destroying the PFCs' public image. The carpetbaggers among them, realizing that the end was near, started a wholesale transfer of deposits into personal accounts. Some company owners disappeared altogether, taking deposits with them and leaving the depositors high and dry. This triggered a run on the PFCs' deposits which even the soundest scheduled banks could not have withstood. Thus even the largest and the most successful of the PFCs were on the brink of bankruptcy when, in October 1979, the government decided to impose a total ban.

It is difficult to make sense of government's decision to disallow the maintenance of PFCs' accounts in commercial banks, particularly in view of the public mood (reported in the press), which advised the government against such a measure. Presumably, it was done to remove all possible claims of legitimacy by the PFCs. The period of uncertainty which followed gave the companies both the motivation as well as the ability to embezzle deposits worth at least half a billion rupees. After the ban, the government had recourse only to legal measures for the recovery of deposits. Thus the government had unnecessarily tied its hands regarding the recovery of deposits from the companies. After liquidating the PFCs, the government took over their assets and appointed wards (mostly lawyers with expertise in commercial law) to look after their affairs while an inquiry was initiated to verify depositors' claims.

As of 1988, the inquiry was still being conducted. The owner of at least one big PFC, who had invested in real estate, paid back some of the depositors through the sale of company-owned property; the property values having gone up appreciably as a result of inflation and a general increase in the demand for real estate. Meanwhile, the court-appointed liquidators, enjoying the comforts of plush offices and luxury cars, were in no hurry to settle matters. Depositors complained that they were even more difficult to deal with than the PFC owners.

6. SOME LESSONS OF THE PFC EXPERIMENT

In our opinion, the idea behind the PFCs was basically a good one. They could have evolved into an extremely effective institution for mobilizing small savings, particularly in the rural areas. Such institutions exist in many countries and form an important component of the financial system, e.g., saving and loans associations and credit unions in the United States, house building societies in the United Kingdom, and finance companies in the Far East. The PFCs' strategy of hiring branch managers and other employees from areas in which the companies were located was very effective. The fact that the PFC staff personally knew the clients (small businessmen and farmers) made it easier to ascertain risk and establish credit worthiness. Thus PFCs could have become the vehicle through which credit could be channeled to those sectors of the economy not catered to by the existing financial institutions. Moreover, the PFCs could also have provided healthy competition to the nationalized banks, forcing them to improve their deteriorating service at the counter. They could also have competed with the existing, informal, *Hundi* system (which handles a substantial portion of the remittances and involves long delays), and thus may have helped to restrict the funds going into smuggling and other illegal economic activities. The PFCs had the potential to make an important contribution to the financial sector of the country and, as their early success indicates, the timing was right for the development of such institutions.

If the PFCs were such useful institutions and if the circumstances were also favorable, then what went wrong? It is ironic that the tremendous initial success of the PFCs was possibly also the primary cause of their ultimate failure. The PFCs were so successful that orderly growth could not take place; company expansion in terms of opening new branches was too rapid and there was no time for consolidation. Meanwhile, success had attracted unscrupulous persons so that quickly the positive elements of the movement were obscured by large-scale fraud. But under the capitalist system, particularly in its early stages, most successful entrepreneurs have had these tendencies and it is the role of the state to provide regulations to prevent such flagrant abuses. In its evolution, private banking in the United States saw many such episodes, including widespread bank failures, but through judicious regulation abuses were checked without stifling the inherent dynamism of private banking.

A major cause of the experiment's failure was the inability of the government to understand the movement and provide a regulatory framework for firms' growth. The rapid growth of the PFCs aroused immediate hostility from the Banking Council, which saw its monopoly threatened, while the State Bank felt a challenge to its control of the financial system. Perhaps the Banking Council understood the threat to its monopoly all too well and adopted the strategy of not recommending a regulatory framework for PFCs with the hope that they would destroy themselves with too much freedom. If this was the underlying strategy it worked very well. An important lesson for the government in this is to understand clearly the true nature of barriers to new entrants and to identify correctly the threatened monopolies which are likely to fight back.

The PFCs' collapse inflicted much suffering and misery on those who lost their life savings. The overall impact on Pakistan's economy, however, was minimal because of the PFCs' brief existence. Possibly, their real estate activities contributed to the land price boom at the time, which may have diverted savings of a large proportion of the population into real estate speculation and away from productive investment. More importantly, failure of the PFCs may have had a negative impact on the saving habits of persons affected by it, particularly in rural areas. Any future attempts to mobilize rural savings through institutional channels will be affected by the cynicism and lack of confidence which this experience has instilled in the depositors.

A number of lessons can be learned from the PFCs' experience regarding mobilization of savings by financial institutions:

(i) Direct incentives to employees (such as salary-cum-commission payments, like those of insurance agents) for mobilizing deposits can be extremely effective. Banks and other financial institutions located in rural areas should utilize the services of the rural, educated unemployed to mobilize deposits and to inculcate banking habits in the rural population.

(ii) Attractive rates of return on deposits seem to be important in mobilizing savings. Thus a case exists for removal of ceilings on interest rates. If, in addition, the return is not seen to be an interest-like payment, it may be even more effective (in attracting savings of the religious minded).

(iii) Accessibility and physical proximity are important to depositors, which means that branches should be opened at the village level. The experience of PFCs shows that a simple, one-room operation with a staff of two persons, preferably locally recruited, would be adequate. The capital and running costs of such village branches would be nominal and they would be preferred by the villagers to the existing commercial banks with their urban culture and complicated procedures.

(iv) The PFCs' experience suggests that if depositors feel that funds mobilized in their areas are also invested in that area, they are more willing to deal with financial institutions. Such a tie between lending and borrowing is quite feasible. There is a large, unsatisfied, small business and farmer demand for credit which the existing "formal" financial system is incapable of meeting because of high information and processing costs. On the other hand, village branches would have the information for ascertaining risk in such cases and thus would enable the "formal" financial system to reach this neglected part of the economy.

(v) The enthusiastic reception of the PFCs shows that depositors are sensitive to the quality of service. The poor service offered by the nationalized banks may have turned away many depositors from the banking system as a whole. Thus additional savings could be mobilized by improving the quality and variety of services offered by banks.

Finally, one can sum up the experience of the PFCs with the conclusion that there is a place and a need for small financial institutions which serve local needs, particularly in rural areas with which the villagers can identify. To succeed, however, these institutions require a regulatory framework. This may be evolved by initially allowing a few rural banks, each restricted to a certain area and operating under the supervision of the central bank. PFCs at the national level should be encouraged only if these experiments are successful. This cautious approach is dictated by the sensitivity of this vital sector of the economy to abuse through unregulated competition, which can inflict severe, long-term damage to the "banking habit."

NOTES

1. "Under *mudārabah* arrangements, surplus funds are made available by the owner to the entrepreneur to be invested in a productive economic activity in return for a predetermined share of the profits earned. Financial losses are borne exclusively by the lender. The borrower, as such, loses only the time and effort invested in the venture. This arrangement, therefore, effectively places human capital on par with financial capital" (Khan and Mirakhor, 1987, p. 6).

2. "To bring out healthy magazines!" President, Express Commercial Finance Company.

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