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Pakistan: Prospects for Private Capital Flows and Financial Sector Development

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I. INTRODUCTION

In less than a decade after the debt crisis of 1982, developing countries have experienced a surge of capital inflows in recent years. This trend became more pronounced in the 1990s resulting in overall balance of payments surpluses and accumulation of reserves. Total private capital inflows to developing countries exceeded $173 billion in 1994, compared to annual average inflows of $34 billion during 1983–90 [World Bank (1995)]. Although the characteristics of capital inflows in this episode are different than in the period prior to the last debt crisis, nevertheless concerns about macroeconomic stability, loss in competitiveness, financial sector vulnerability and excessive borrowing remain the same.

While the rise in inflows during 1991–93 was supported in part by low interest rates and weak economic activity in industrial countries, improved economic policies and prospects in most recipient countries also played an important role. The larger share in inflows of those countries that achieved greater progress in economic reforms, is evidence of the importance of recipient country policies. During this period, the composition of private flows to developing countries also became more diversified. Foreign direct investment (FDI) accounted for 45 percent of total equity inflows in 1994, with debt accounting for 32 percent and portfolio flows accounting for the remaining 23 percent.

According to a recent assessment [World Bank (1995)], overall private capital flows to developing countries are likely to continue to increase in the medium term, though at a much slower pace than in the early 1990s, growing on average at about 7–10 percent annually. Many countries are at the limit of prudential borrowing, so at most their net liabilities can rise in line with exports. However, within this overall trend, some economies in Asia and several transitional economies are likely to see a larger increase.

Pakistan has experienced substantial private capital inflows throughout the 1980s. Most of these inflows were in the form of workers' remittances and to a lesser extent, private short-term and some medium-term capital inflows recorded in the capital account. However, it was only in 1993-94, that private capital inflows

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grew substantially, totalling almost $ 4.5 billion, in 1994-95, and producing surpluses on the overall balance of payments in both 1993-94 and 1994-95 which contributed to a rapid accumulation of reserves. While Pakistan experienced the "inflow phenomenon" later than many developing countries in Latin America and Asia, regional trends in capital flows and Pakistan's continued commitment to reforms promises further inflows in the coming years.

The experience of developing countries that received large inflows suggests that the initial promise of capital inflows was positive. Inflows eased external financing constraints and held the potential for higher investment and growth. However, as capital inflows became large, they threatened macroeconomic stability by contributing to an acceleration in domestic demand and activity, feeding developments that signalled overheating. With significant variations in experiences of countries, these signals included a widening of the external current account deficit, higher consumption financed by inflows, weaker monetary control and rising inflation, real exchange rate appreciation and vulnerability to reversal of inflows.

The reasons for differences in the experiences of countries were mainly rooted in the causes of the inflows and the policy responses adopted by governments [Carkovic *et al*. (1993)]. One cause of inflows was changes in real domestic economic policies including structural changes that improved potential productivity, or reduction in fiscal deficits promising greater macroeconomic stability. Inflows also occurred as a result of tightening domestic credit policies or an increase in administered interest rates. External influences contributed to inflows significantly especially lower foreign interest rates and recession abroad. And in some cases, inflows were caused by band-wagon effects, which may have reflected over-reaction of financial markets to new information or the pursuit of current trends.

Whatever the causes of inflows, policy-makers have taken offsetting policy actions, seeking to accommodate higher investment and growth afforded by the inflows while trying to insulate their economies from their destabilising effects. This is the challenge facing policy-makers in Pakistan as well. After analysing various forms of private capital inflows to Pakistan this paper presents the existing evidence on their causes and stability. There is a review of the possible effects of inflows on the financial sector and potential impact of the planned privatisation and energy investment programme. The paper ends with a discussion of various policy options available to increase the impact of inflows on investment and growth, while limiting its destabilising influence.

II. RECENT ECONOMIC DEVELOPMENTS AND REFORMS

Pakistan embarked on a comprehensive programme of macroeconomic adjustment and reform in 1988-89. In the ensuing period, Pakistan achieved significant progress in efforts to: (i) liberalise the exchange and trade system; (ii)

reform the financial sector; (iii) liberalised domestic and foreign investment activities; (iv) initiate a wide ranging privatisation programme and open up areas of the economy previously reserved for the public sector. The beneficial impact of the structural reform was reflected in strong GDP and export growth, improvement in the structure of output, higher domestic and foreign direct investment. However demand management remained weak as a result of insufficient fiscal retrenchment. During 1993-94–1994-95, after a year of political uncertainty and poor economic performance, efforts have been made to revitalise the economy. The real GDP growth rate has gradually picked up from 2.3 percent during the through in 1992-93 to 4.7 percent in 1994-95 (Table 1). The fiscal deficit is being gradually brought under control and monetary expansion slowly restrained. This, partly due to surge in capital inflows during the last two years which have contributed to a rapid accumulation of foreign exchange reserves.

Table 1

Pakistan—Main Economic Indicators

	1990-91	1991-92	1992-93	1993-94	1994-95
Read GDP Growth Rate (Percent)	5.6	7.7	2.3	3.8	4.7
Investment/GNP (Percent)	18.5	19.9	20.6	19.4	19.1
National Savings/GNP (Percent)	13.9	16.9	13.5	15.6	14.9
CPI (Percent Change)	12.7	9.6	9.3	11.2	12.9
Federal Budget Deficit (Percent of GDP)μ	8.7	7.4	7.9	5.8	5.5
Broad Money M2 (Percent Change)	16.3	30.3	18.0	16.9	16.6
Current Account Deficit (Percent of GDP)	–3.1	–2.1	–6.4	–3.3	–3.5
Gross Official Reserves (in Weeks of Imports)	3.3	5.5	2.2	12.6	13.5

Source: State Bank of Pakistan.

Recent developments in the balance of payments have reflected in large measure the structural reform programme that Pakistan has been implementing since 1988-89 (Table 2). Specifically, the programme has fostered the growth of merchandise exports, the liberalisation of imports of goods and services, and encouragement of private capital inflows of foreign direct and portfolio investment. These inflows have bolstered the declining trends in traditional forms of capital inflows through workers remittances and non-resident foreign currency deposits.

The current account deficit as percent of GDP, gradually decreased from a steady 3.4 percent during the late 1980s to 2.1 percent in 1991-92 before rising sharply in 1992-93 reflecting policy shippages and then falling to 3.5 percent of GDP in 1994-95. The current account deficit was partly financed by a surplus on the

Table 2

Pakistan—Balance of Payments (in Millions of U. S. Dollars)

	1990-91	1991-92	1992-93	1993-94	1994-95[P]
Trade Balance	–2483	–2236	–3267	–2038	–2253
Exports Fob	5902	6762	6782	6685	7884
Imports Fob	–8385	–8998	–10049	–8723	–10137
Service Balance	–1790	–2225	–2748	–2372	–2546
Trade and Service Balance	–4273	–4461	–6015	4410	–4799
Private Transfers	2292	2961	2327	2390	2397
O/W: Workers' Remittances	1848	1468	1562	1446	1866
Resident FCA	190	1318	543	752	381
Official Transfer (Net)	604	441	357	314	312
Current Account Balance	–1377	–905	–3331	–1706	–2090
Capital Account	1447	1205	2708	3150	2395
Public and Publicly Guaranteed	1291	363	1554	1138	582
Medium and Long-term	607	766	815	926	1162
Project and Non-project Aid	758	966	846	804	850
Commercial Banks and IDB	–151	–165	–42	132	201
FCBCs 5 Years, Eurobonds		21	66	32	183
Other		–56	–55	–42	–72
Short-term	684	–403	739	212	–580
Commercial Banks and IDB	208	–133	315	288	–40
FEBCs and DBCs	93	32	67	18	8
Other	383	–302	357	–94	–548
Private Sector, Total	156	842	1154	2012	1867
Private Non-bank	448	1109	836	1676	2079
Medium and Long-term	278	1134	1229	1425	1929
Direct Investment	246	335	306	304	354
Portfolio Invest. (Excldg. FEBC, DBC, FCBC)	–9	219	137	289	1069
Private Unguaranteed (Suppliers Credit)	34	559	503	366	464
Other Non-bank	7	21	283	416	42
Short-term Non-bank	170	–25	–393	251	150
Deposit Money Banks	–292	–267	318	336	–266
Medium- and Long-term	3	–5	1	–3	–
FCDs	286	–61	62	413	–94
Other Short-term	–581	–201	255	–74	–172
Errors and Omissions	–73	–25	30	147	–64
Overall Balance	–24	130	–589	1585	–242
Financing	24	–130	589	–1585	–242
Net Int. Reserves (Increase –)	114	–352	512	–1882	–342
State Bank of Pakistan	71	–431	613	–1788	–
Deposit Money Banks	43	79	–101	94	–
Use of Fund Credit	–120	222	77	297	100

Source: State Bank of Pakistan.

P = Provisional.

capital account which fluctuated between 3-4 percent of GDP during 1988–1992. Reflecting large private capital inflows, the capital account surplus rose sharply to 6.4 percent of GDP in 1993-94. The overall balance of payments showed large surpluses in 1993-94 and 1994-95; as a result, international reserves of the State Bank rose by about $ 2.2 billion in the last two years.

Considerable progress has been made in the implementation of structural reforms specially with regard to trade and payments liberalisation. Pakistan has achieved full convertibility of the rupee on current account transactions.

The financial sector, has undergone significant structural changes since 1989-90, aiming to improve mobilisation and allocation of loanable funds within the formal sector. Measures initially adopted included the institution of a mechanism for auctioning government debt, raising rates of return on concessional lending, limiting mandatory lending and credit from the SBP to nonbank financial institutions, strengthening SBP's supervisory and regulatory role, and enhancing the balance sheets of nationalised commercial banks (NCBs).

In 1991-92 the Pakistan authorities intensified the financial sector reform programme. The objectives of the intensification were to strengthen financial intermediation through steps to rationalise the structure of rates of return on a wide range of public debt instruments, to move toward indirect monetary control, to reduce the distortionary effects of mandatory and concessional credit allocation, to strengthen the financial system through enhanced supervision and regulation, and to encourage private sector participation in domestic banking and financial services.

The centrepiece of the Government's programme to rationalise the rate structure on public debt instruments and to move toward indirect monetary control, has been the implementation of an auction programme for government securities which began in March 1991.

Privatisation of banking activity has been an important component of the authorities' financial sector reform programme. It is motivated by the intention to increase the competitiveness and efficiency of the banking system. Prior to the reform programme, state-owned NCBs dominated domestic banking activity. Since their nationalisation in 1974, the NCBs had generally not operated on commercial principles, with the result that their efficiency, market responsiveness, and financial strength were adversely affected. Consequently, the government has sought private sector participation in domestic banking through the privatisation of NCBs and the establishment of new privately owned banks.

In January 1992, the SBP issued new prudential regulations—in order to enhance the supervision and regulation of the banking system. The new guidelines include more stringent limits on credit concentration and on contingent liabilities; stiffer guidelines on the separation of bank ownership and management; tighter margin requirements on equity-based advances; and a strengthened system of

classification and provisioning for nonperforming assets. In addition, amendments were made to the Banks' Nationalisation Act of 1974 aimed at enhancing the administrative and advisory role of the Pakistan Banking Council in commercial banking.

In 1993, through an amendment in the State Bank Act, 1956, the State Bank of Pakistan has been given operational independence to conduct monetary policy and regulate and supervise the banking sector.

In 1994-95, the government continued efforts to move towards the adoption of indirect instruments of monetary control and took measures to liberalise interest rates further.

III. PAKISTAN: CHARACTERISTICS AND STABILITY OF CAPITAL INFLOWS TO PAKISTAN

The timing, persistence and size of various forms of capital inflows into Pakistan reflect the special circumstances and domestic policies that had a bearing on these inflows. Traditionally workers' remittances have been the main form of inflows reflecting the immigration of Pakistan labour to the Middle East region during the oil price boom of the 1970s. Later with the liberalisation of capital controls and structural reforms in trade and the financial sector, capital inflows also appeared in the forms of foreign currency deposits, and portfolio and direct investment.

Pakistan also experienced the impact of the region wide capital inflow phenomenon as a consequence of its economic reforms although in more recent months there has been a substantial outflow. Partly as a result of the timing of reform of domestic policies, the allocation of international private capital flows towards South Asian countries became significant in the early 1990s. The recent increase in non-traditional capital inflows (FDI and portfolio inflows) are partly a reflection of investors perceptions of Pakistan's share of regional capital. Investor perceptions of prudential allocation towards Pakistan are sensitive to economic and political considerations in Pakistan and other countries in the region which compete for a limited pool of investible resources. Unless there is a change in domestic policies, inflows to Pakistan are likely to be influenced by regional trends in South Asia as well as its unique factors.

Workers' Remittances

During 1972-73–1994-95, nearly $ 37 billion in workers' remittances entered Pakistan financing about 82 percent of the cumulative merchandise trade deficit over the same period. Annually, remittances grew steadily to a peak of $2.9 billion in 1982-83 before declining along a trend to $1.5 billion in 1993-94 and $1.8 billion in 1994-95 (Table 3). In 1994-95, remittances were 44 percent of the current account

Table 3

Pakistan—Private Capital Flows (in Millions of U. S. Dollars)

	1990-91	1991-92	1992-93	1993-94	1994-95
Workers' Remittances	1848	1488	1562	1446	1866
Resident FCA	190	1318	543	752	381
Private Non-bank	448	1109	836	1676	2079
Direct Investment	246	335	306	354	354
Portfolio Investment	–9	219	137	289	1069
Private Unguaranteed (Suppliers Credit)	34	559	503	366	464
Other Non-bank	7	21	283	416	42
Short-term Non-bank	170	–25	–393	251	150
Deposit Money Banks	–292	–267	318	336	–266
Medium and Long-term	3	–5	1	–3	–
FCDs Non-resident	286	–61	62	413	–94
Other Short-term	–581	–201	255	–74	–172
Publicly Guaranteed	150	–245	406	470	352
FCBCs, 5-years, Eurobonds	–	21	66	32	183
FEBCs, DBCs	93	32	67	18	8
Commercial Banks and IDB					
(Med. and Long-term)	–151	–165	–42	132	201
(Short-term)	208	–133	315	288	–40
Total Private Capital Inflows	2344	3383	3665	4480	4412
Current Account Deficit[1]	3435	3836	5431	3904	4337
Overall Balance of Payments	–24	130	–589	1585	242
GDP	45064	50000	51969	51697	59763
Inflows as Percent of Current Account	68.2	88.2	67.5	114.7	101.7
as Percent of GDP	5.2	6.8	7.1	8.7	7.4

Source: State Bank of Pakistan.

[1]Current deficit excluding workers' remittances and resident FCAs.

deficit and amounted to 3 percent of GDP. Currently about three-fourths of remittances originate in the Middle-East while the rest come from OECD countries [Economic Survey (1994-95)]. Following the deregulation of resident foreign currency accounts in 1991, some remittances are now flowing into these accounts.

Two basic approaches have been tested in the literature to identify the determinants of workers' remittances. One approach treats remittances like other capital movements and considers the 'portfolio choice' by the immigrant worker focusing on cross border return differentials, comparative asset characteristics (risk, liquidity, taxes) and institutional factor (capital controls, financial regulation etc.). The alternative approach links migration, earnings abroad and remittances. The model in [Karim (1994)] tests the impact on remittances of various factors like the number of migrant workers, expected length of stay, host per capita income, home per capita income, home-host interest rate differential and institutional factors. Using

monthly dollar value of remittances, the model is estimated over the period July 1983 to June 1992. Dummies were introduced to reflect the introduction of resident foreign currency deposits in 1991, the Gulf war and the oil price crash of 1986.

Estimates suggests that in the case of Pakistan, remittances are primarily determined by the basic demographic (number of workers) and income variables (in workers' host countries) which are inherently relatively stable compared to portfolio considerations which have a smaller impact on remittances [Karim (1994)]. Remittances to Pakistan were also significantly affected by the oil price crash of 1986 and the introduction of resident foreign currency accounts in 1991; the latter allowed workers' to retain savings without the exchange rate risk and made portfolio considerations more important. This evidence together with the fact that Pakistani migrant workers are spread across a number of countries and involved in numerous professions, suggests a continuation of remittance inflows along existing stable trends especially in light of expected stable growth prospects in the Middle East and OECD countries [IMF (1994)].

Portfolio Inflows

The term portfolio flow refers to the flow of funds resulting from a country's access to international financial markets and also to the flow resulting from activities of international investors in domestic financial markets.

Portfolio investment flows into Pakistan are best understood in the context of changes in the structure of international capital flows. External financing for developing countries from bank sources has declined in importance during the last decade. Foreign portfolio investment (external funds raised as equity or debt in international markets) has played a major role in the shift towards non-bank financing. Prospects for high economic growth rates in developing countries, usually reflected in higher returns on portfolio investment, is one of the major reasons for increased portfolio flows to emerging markets.

Portfolio Debt Flows

The shift towards portfolio investment has been mostly on account of debt flows. A variety of debt instruments have been used by developing countries. Pakistan has participated in the external financial markets for sometime now but mainly with public instruments and by offering foreign currency deposits [Kwang (1990)]. Publicly guaranteed instruments include foreign exchange bearer certificates (FEBCs) issued by the Federal Government in exchange for foreign currency deposits (introduced in the early 1980s) and dollar bearer certificates (DBCs) of 1 year maturity, offered a return of a fraction above LIBOR; DBCs are no longer issued since November 1994. Although FEBCs are available in a range of a

maturities upto 6 year, because of the poor yields offered, inflows on account of FEBCs and DBCs over the last five years have been mostly of short-term maturity. These inflows add to $ 218 million during the period (Table 4). These instruments were aimed at both residents and non-residents but the maturity of mobilised funds was not suitable for financing longer-term development requirements. To meet this deficiency, Foreign Currency Bearer Certificates (FCBCs) were introduced in March 1992 with the aim of improving the term structure of foreign currency liabilities. FCBCs carry a five-year maturity and are issued at par in US dollars, deutsche marks, pound sterling and yen. FCBCs bear fixed rates of return set by the State Bank with a 2.5 percent margin over the yields on bonds in respective currencies FCBCs can be encashed after a minimum holding period of two years; a fee of 1.5 percent per annum is charged for the unexpired period. After a slow start capital flows related to FCBCs now total over $ 300 million since their introduction in 1992.

Table 4

Pakistan—Short-term Capital
(in Million of US Dollars)

	1990-91	1991-92	1992-93	1993-94	1994-95[P]
Public Sector	684	–403	739	214	50
Commercial Banks	206	–137	225	310	–
IDB	2	4	90	20	–
FEBCs and DBCs	93	32	67	18	50
Other	383	–302	357	–94	–
Private Sector	–125	–287	–76	590	67
Non–bank(Ebills. Non–resident FCDs)	170	–25	–393	251	100
Deposits Money Banks	–295	–262	317	339	–33
FCDs(16.5)	286	–61	62	413	100
Other	–581	–201	255	–74	–133
Total	264	–952	980	1143	83

Source: State Bank of Pakistan.
P= Provisional .

Although Pakistan has been able to access external financial markets through internal instruments, (deposits and short and medium term certificates), access through external instruments has been limited because of investors' concerns over the country's creditworthiness. Dewan Salman Fibre Ltd. has been the first company to float Eurodollar Convertible Bonds worth $ 35 million in the international market.

New issues have been discouraged by the rise in international interest rates [Economic Survey 1994-95)]. For the first time, the Government of Pakistan floated Sovereign Bonds in the Eurodollar Market worth $ 150 million with a five year maturity at 385 basis points above the US Treasury Bond rate. Following down grading of Pakistan's credit rating by Moody's from Ba3 to B1 in July 1995, the cost of borrowing has risen to over 700 basis points over the US Treasury Bond rate.

Box 1
FCAs and FEBCs

Foreign Currency Accounts (FCAs can be opened by resident (RFCDs) and non-resident (NRFCDs) nationals. The scheme is also open to foreign nationals residing abroad and diplomatic missions etc. Interest rates payable are capped at fractions of a percent above LIBOR, varying with maturity. These accounts are exempt from wealth tax, zakat, source disclosure and all foreign exchange control restrictions. These accounts can be held in US dollars, Yen, D. Mark and Pound Steling.

Foreign Exchange Bearer Certificates (FEBCs) are publicly guaranteed debt instruments issued by the Federal Government in exchange for foreign currency deposits. FEBCs are available in a range of maturities upto 6 years, at interest rates determined by the issuer (a maximum of 15 percent on 6 year certificates).

Dollar Bearer Certificates (DBCs) are publicly guaranteed, issued by the Federal Government of one year maturity and bearing an interest rate of 0.25 percent above LIBOR. The issue of DBCs have been discontinued since November 1994.

Foreign Currency Bearer Certificates (FCBCs) are publicly guaranteed, issued by the Federal Government, with a maturity of 5 years. Issued at par in US dollars, deutsche marks, pound sterling and yen, FCBCs bear interest rates that reflect a 2.5 percent margin over the respective government bond of same maturity.

Portfolio Equity Flows

Portfolio equity flows to developing countries grew from insignificant amounts in early 1980s to about $ 40 billion in 1994, with the major shares going to Latin America and East Asian and Pacific region [World Bank (1995)]. These equity flows include America Depository Receipts (ADRs) and Global Depository Receipts (GDRs)[1] issued on international markets, investment in country or regional funds and direct equity purchases on the stock markets by foreign investors.

Pakistan was among the first countries in emerging markets to take measures to open up stock markets to international investors. However, in relation to the total flows directed to developing countries, interest in Pakistan has been very modest. Direct equity purchases by foreigners are not monitored by Pakistan and there is no systematic collection of statistics for such flows because these pass through several different channels and are hard to estimate. In the absence of systematic data on the magnitude of direct portfolio investment, it is estimated that about $ 700 million were invested by foreign investors at end 1994, which was 5 percent of total market capitalisation (Table 5). GDRs issued by Pakistani corporations include Pakistan Telecom $ 898 million; HUBCO $ 175 million; and Chakwal Cement $ 100 million.

[1]ADRs and GDRs are internationally traded equity-based instruments backed by a trust, holding shares of domestic companies.

Table 5

Pakistan—Net Inflow of Foreign Private Investment
(in Million of US Dollars)

Period	Direct[1] Investment	Portfolio[2] Investment	Total Investment
1985-86	145.2	16.0	161.2
1986-87	108.0	21.0	129.0
1987-88	162.2	10.5	172.7
1988-89	210.2	7.2	217.4
1989-90	216.2	–4.7	211.5
1990-91	246.0	–9.0	237.0
1991-92	335.2	218.5	553.7
1992-93	306.4	136.8	443.2
1993-94	354.1	288.6	642.7
1994-95	354.2	1068.9[3]	1423.1
(July–Apr)			
1993-94	288.1	297.9	586.0

Source: Statistics Department. State Bank of Pakistan.
[1]Includes cash, capital equipment and reinvested profits.
[2]Excluding government securities.
[3]Includes $ 862.2 million of PTC vouchers.

Country funds are an indirect channel for foreign investors to invest in equity markets especially when there are restrictions on foreign portfolio investment. Pakistan's first country fund was set up by Citicorp in April 1991 with a capitalisation of $ 22.6 million listed on the Hong Kong Stock Exchange. A number of country funds were set up subsequently listed in the table below. Some regional funds are also understood to have targeted Pakistani equities recently [Kwang (1990)].

Pakistan Funds Currently Operating

Name	Listed at	Type	Capitalisation
Pakistan Fund (Morgan Grenfell)	Hong Kong	Closed End	$ 25 Million
Pakistan Investment Fund (Morgan Stanley)	New York	Closed End	$ 102 Million
Pakistan Growth Fund (Credit Lyonnaise) (Domicile)	Cayman Islands	Open End	$ 17 Million
Pakistan Trust Fund (Jardine Fleming)	Cayman Islands	Open End	$ 11 Million
Pakistan Special Situation Fund (Credit Lyonnaise)	Cayman Islands	Open End	$ 6 Million
Pakistan Portfolio (Paribus Asset Management)	Ireland	Open End	$ 2 Million
Regent Moghul Fund (Regent Capital Management)	Ireland	Open End	$ 33 Million
Thornton New Tiger Pakistan (Thornton)	Bermuda	Open End	$ 2 Million

Source: Emerging Market Fund Monitor.

Table 6

Pakistan—Source Inflow of Foreign Private Investment[1]

	1989-90			1993-94		
Country	Direct[2]	Portfolio	Total	Direct	Portfolio	Total
USA	93.9	–2.0	91.9	114.5	34.0	148.5
UK	22.8	–0.2	22.6	32.0	50.0	82.0
UAE	15.9	–2.8	13.1	7.5	2.6	10.1
Germany	11.2	–	11.2	9.1	3.3	12.4
France	6.0	–	6.0	11.1	–	11.1
Hong Kong	0.9	–	0.0	1.2	–19.2	–18.0
Italy	3.8	–	3.8	0.3	–	0.3
Japan	16.1	–4.2	11.9	29.7	0.8	30.5
Saudi Arabia	1.1	0.6	1.7	1.9	–	1.9
Canada	0.9	0.1	1.0	1.2	8.8	10.0
Netherlands	5.3	0.7	6.0	–0.1	0.1	0.0
Others	39=8.3	3.1	41.4	145.7	208.2	353.9

Source: State Bank of Pakistan.

[1]Exculding government certificates.

[2]Consists of cash, capital equipment brought-in and reinvested earnings.

After a modest beginning in international placements of equity issues, as part of the privatisation programme, the Pakistan Government offered 5 million Pakistan Telecommunications (PTC) vouchers in the international market during 1994-95 which were fully subscribed, mobilising $ 862 million. With large public corporations being offered for sale and a second PTC issue likely soon, inflows on this account are likely to grow in the years ahead.

Portfolio inflows, because of their inherently volatile nature, have proved to be reversible more than other forms in developing countries. Their potential volatility is great in Pakistan as well since portfolio investment in Pakistan is directed mainly towards short-term and some medium-term public debt instruments and the stock exchanges, while access to capital markets through the use of external instruments has been limited. Analysis[2] of the forms of portfolio flows that are invested in Pakistan shows that external factors such as the secular decline in international interest rates, were more important in portfolio allocations towards Pakistani assets than domestic developments.

[2]Using a portfolio choice model in Karim (1994), portfolio flows are related to LIBOR, stock marked index and inflation. Model performance in weak.

Foreign Currency Accounts

Foreign currency accounts for non-residents were introduced in 1973 (Annexure 1). Resident foreign currency deposits were deregulated in February 1991. Both types of accounts are protected from disclosure requirements regarding source of funds. The interest rates payable on these accounts are capped at fractions of a percent above LIBOR, varying with maturity of deposit. The margins range between 3/8 percent for 3-month deposits to 15/8 percent for 3-year deposits. Commercial banks are required to surrender foreign exchange to the State Bank in a swap agreement, with the period of the swap corresponding to the initial maturity of these deposits. In June 1992, SBP phased out its policy of providing free full-forward exchange cover to the financial institutions in respect of these deposits and introduced a fee of 3 percent per year. The fee is currently at 4.5 percent. As of April 30, 1995, the stock of FCDs outstanding was $ 5670 million, of which $ 3300 million were held by residents. In 1993-94, the year of peak inflows into FCDs, especially RFCDs, these financed nearly a quarter of the current account deficit in that year (Table 7).

Table 7

Pakistan—Foreign Currency Accounts
(in Million of US Dollars)

	Non-residents					
Period (End June)	Foreign Banks (Institutional)	Individual Banks	NBFI's	Total	Residents FCDs	Total FCA
1975				26.13	–	26.13
1976				77.68	–	77.68
1977				104.00	–	104.00
1978				108.30	–	108.30
1979				114.50	–	114.50
1980				115.25	–	115.25
1981				201.85	–	201.85
1982				259.51	–	259.51
1983				550.77	–	550.77
1984				638.27	–	638.27
1985				597.83	–	597.83
1986				1094.82	–	1094.82
1987	839.40	654.38		1493.78	–	1493.78
1988	893.70	755.34		1649.04	–	1649.04
1989	913.46	639.00		1849.46	–	1849.46
1990	1088.46	1027.49		2115.95	–	2115.95
1991	950.78	1251.95		2202.73	386.46	2592.19
1992	905.74	1083.51		1989.25	1070.01	3696.26
1993	864.45	1186.04	177.00	2227.49	2250.41	4477.90
1994	1058.94	1404.08	457.14	2920.16	3002.44	5922.60
End Mar 1995	1010.84	1354.96	642.01	3007.81	3254.65	6262.46
14th June 1995	–	–	–	3066.30	3259.72	6362.02

Source: State Bank of Pakistan.

Box 2

Forward Foreign Exchange Cover

The State Bank of Pakistan provides forward cover on all FCAs deposits to commercial banks who are required to surrender such deposits with the State Bank. The State Bank previously also provided forward cover on foreign currency loans for trade finance and working capital at a fee of 10 percent. The fiscal cost of the latter cover to the State Bank varied with the rate of devaluation of the rupee. Recently the State Bank has discontinued providing forward cover on such short-term foreign currency loans. A number of commercial banks are now providing forward cover at varying rates listed below.

Although complete information on the maturity structure of FCA and FCDs is not available, there is evidence that most deposits are of less than 1 year maturity. However the maturity structure of FCDs are implicitly lengthened by the widespread use of these deposits as a form of collateral. Recently, these deposits, especially those held by residents, demonstrated their stability as they withstood the test of a confidence crisis during the balance of payments crisis of summer 1993. FCDs, because of the anonymity of source of funds, to some extent also represent the earnings in the grey economy. For example, deposits of Pakistanis in international banking centres declined after the introduction of RFCD scheme in 1991 (as seen in data published by IFS, IMF). As long as the rules governing these accounts do not change, the attraction of FCDs for this reason will remain intact.

The stability of FCDs depends to a large extent on the motivation to hold a foreign currency asset. Two alternative explanations have been tested:[3] FCDs constitute a portfolio investment, driven mainly by rate of return considerations. In this case a confidence crisis could result in a large capital outflow from these accounts. Alternatively, FCDs could be representing a more permanent variety of investment associated with workers' remittances and the informal economy, in which case FCDs are likely to be more stable. Tests of FCD behaviour indicate that the share of FCDs in total money supply is not sensitive to portfolio considerations and resident FCDs have a strongly positive relationship to exchange rate depreciation expectations [Karim (1994)]. This confirms the non-portfolio nature of FCDs in Pakistan. The overlap between the expatriate worker population and FCD holders also argues for the similarity of FCDs to workers' remittances. Resident FCDs constitute a channel for remittance transfer without exposure to currency risk. Since remittances are significantly related to long-term demographic and contractual income factors, resident FCDs are also likely to display similar stability.

[3]Using a currency substitution regression model in Karim (1994), monthly data on FCDs was regressed against exchange rate expectations, rates of interest and stock adjustment variables.

Foreign Exchange Forward Cover Premium Charged by Commercial Banks (in Percent per Annum)

Name of Bank	June 1995 Monthly Average
MCB	6.50
Citibank	5.32
Habib Bank AG Zurich	6.33
ANZ Grindlays	4.36
Bank of America	5.14
Union Bank	11.00
UBL	7.08
HBL	7.91
NBP	9.00
Soneri Bank	6.90
ABM Amro	4.92

Foreign Direct Investment (FDI)

Foreign direct investment in Pakistan has grown at a moderate pace compared to the surge of other forms of inflows during the last five years. Compared to an average annual flow of about $157 million during 1987-88–1988-89 before the start of the reform process in the country, inflows during the last two years have averaged about $ 330 million, growing by about 18 percent annually. FDI constituted about 8 percent of total private inflows in 1994-95, lower from its 14 percent share in 1990-91–1991-92 (Table 8).

Table 8

Pakistan—Breakdown of Direct Foreign Investment (in Millions of US Dollars)[1]

Type	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95 Jul–Apr	1993-94 Jul–Apr
Cash Brought in	167.3	166.9	254.6	224.2	180.5	225.2	139.2
	(77.4)	(67.8)	(76.0)	(73.2)	(51.0)	(72.0)	(48.3)
Capital Equipment	14.7	27.1	19.8	14.9	96.2	34.2	83.1
Brought in	(6.8)	(11.0)	(5.9)	(4.9)	(27.2)	(9.6)	(28.8)
Re-invested	34.2	52.0	60.7	67.3)	77.4)	65.0	65.8
Earning	(15.8)	(21.1)	(18.1)	(22.0)	(21.9)	(18.4)	(22.8)
Total	216.2	246.0	335.1	306.4	354.1	354.2	288.1

Source: Statistics Department SBP.

[1]Figure in Parentheses represent percentage share in total.

The decision-making process regarding FDI involves a choice of project as well as the country in which to invest. The host country must possess some locational advantage to attract investments. Pakistan's policy with regard to attracting FDI compares well with those of other countries in the region in respect of investment incentives, especially tax treatment and regulations controlling repatriation of profits and capital. However there are continuing weaknesses in physical infrastructure and power supplies, shortage of educated skilled labour which erodes the low-cost advantage of Pakistan labour, and a poor law and order situation.

Analysis of the determinants of FDI in Pakistan [Karim (1994)] suggests that macroeconomic stability and the structural reforms are the main determinants. In addition, investment regulations and political stability are also important [Karim (1994)].

IV. EFFECTS OF CAPITAL INFLOWS ON THE DOMESTIC FINANCIAL SECTOR

The growing volume of capital inflows into Pakistan in recent years has raised some important issues, such as: What are the effects of capital inflows on the banking system and capital market? Have financial risks in Pakistan's banking system increased as a result of the changes in balance sheets and asset private volatility brought about by rapid changes in the volume and composition of capital inflows? Is the existing financial infrastructure—including regulatory, supervisory, and accounting arrangements—capable of fostering an adequate management of these risks?

The ability of Pakistan to attract and effectively intermediate a growing volume of financial flows depends importantly on the comprehensiveness, independence, and enforceability of the regulatory and supervisory framework in the financial sector. This framework needs to ensure: (1) that the banking system, which is going to remain the main conduit for the flows of funds into the country, allocates credit efficiently in an environment where balance sheets are expanding as a result of capital inflows; and (2) that the stability of the domestic capital market is not adversely affected by cross-border flows, and that the capital market possesses sufficient integrity and transparency to retain investor confidence [Liliana and Weisbrod (1994)].

The Impact on the Banking Sector

In Pakistan, banking problems have been the result of poor credit decisions and inadequate management of credit risk, including overexposure to certain types of risk. The phenomenon of capital inflows in recent years have set up a systemic risk of relatively volatile capital flows which can contribute to these problems. The impact of volatile flows can be significantly adverse when bank balance sheets are

badly structured by causing large swings in bank liquidity resulting in alternating periods of credit expansion and contraction. Two major areas of concern are the ability of the banking system to assess, price, and manage risk, and the adequacy of the supervisory and regulatory frameworks to prevent and contain systemic risk, particularly in the presence of the problem of moral hazard. Large and volatile capital flows can exaggerate risk exposures and impair the ability of both banks and supervisors to adequately assess and manage risk.

Capital Inflows and Banking Sector Exposure

Total private capital inflows increased from $ 2.3 billion (5.2 percent of GDP) in 1990-91 (prior to the inflow phenomenon) to a peak of $ 4.5 billion (8.7 percent of GDP) in 1993-94 before subsiding somewhat to $ 4.3 billion (7.1 percent of GDP) in 1994-95. Inflows financed 68 percent of the current account deficit (excluding workers' remittances and RFCDs) in 1990-91, and nearly 115 percent of the current account deficit in 1993-94.

The evidence above suggests that workers remittances, FDI and resident FCDs represent considerably stable forms of inflows. The maturity structure of FCDs is not known currently but it is lengthened in practice by the growing practice to use these deposits as a form of collateral.

The most striking feature of private capital flows into Pakistan is that portfolio investment, non-resident foreign currency deposits and other short-term capital, present a potential risk of a reversal of flows in a very short-term. The flow reversal can create a banking crisis, and result in both exchange rate and interest rate volatility. If the State Bank lacks an adequate stock of international reserves to meet the outflow, it may cause a balance of payments crisis.

To assess the exposure of the banking system to the potential capital outflows, more relevant than the import cover of reserves, in this context, is the degree to which official reserves and the foreign currency balances of banks provide a cushion against a reversal of inflows. For this purpose the total potential outflow is estimated to be equal to the cumulated flow of portfolios inflows and resident and non-resident FCDs plus other short-term capital during the recent period of surge in inflows, e.g. 1991-91 to 1994-95. Gross official reserves and foreign exchange reserves with the commercial banks need to be adequate to meet the potential outflow. Table 9 shows that the ratio of banking system reserves to cumulate volatile inflows declined from 1.27 in 1990-91 to 0.69 in 1992-93 and then remained below 0.8 in subsequent years. The same ratio excluding resident FCDs (a component which has displayed greater stability in recent years) peaked at 2.89 in 1992-93, but declined to 1.42 in 1994-95. The ratio of exposure warns of a weak reserve base to support growing capital inflows, whose composition is rapidly changing towards the more volatile components.

Table 9

Pakistan—Reserves and Inflows (in Million of US Dollars)

	1990-91	1991-92	1992-93	1993-94	1994-95
Private Capital Inflows					
Short-term					
(Public and Private)	264	–952	980	1143	84
Resident FCDs	190	1318	543	752	381
Portfolio	–9	219	137	289	1069
FDI	246	335	306	354	354
Workers' Remittances	1848	1488	1562	1446	1800
Volatile Flows					
(Portf: FCDs, Short–term)	445	585	1660	2184	1534
Excldg RFCDs	255	–733	1117	1432	1153
Cumulative Volatile Flows	445	1030	2690	4874	6408
(Since 1990-91):					
Excldg. RFCDs	255	–478	639	2071	3224
Official Gross Reserves	572	1038	462	2302	2771
Commercial Banks					
Foreign Exchange Balances	4	27	1384	1547	1781
(Nostro Account, E-bills)					
Banking System					
Reserves	576	1065	1846	3849	4552
Ratio of Exposure	–	–	–	–	–
Reserves/Cum.					
Volatile Flows	1.27	1.03	0.69	0.79	0.71
Excldg. RFCD	2.26	–	2.89	1.86	1.42

Source: State Bank of Pakistan.

State Bank Intervention and Risk Allocation

Regardless of whether foreign capital flows into the market as foreign direct investment, equity portfolio investment, bond issuance, or bank borrowing, there is an associated increase in bank deposits and reserves. The later can potentially lead to an increase in bank lending, unless the local currency deposits/reserves are either used to import goods and/or assets, or absorbed by the central bank through its sterilisation policy. In the latter case, the composition of domestic financial assets and liabilities is altered. In practice, reflecting the response of Pakistan's policy-makers and private decision-makers to the surge in inflows, there has been some increase in imports, a rise in reserves reflecting attempts by the SBP to sterilise inflows, but also an expansion of domestic credit to both government (for budgetary support) and to the private sector.

To Sterilise or Not

The evidence presented in the earlier section suggests that at least a part of the private capital inflows, especially portfolios flows and short-term non-resident foreign currency deposits, may be transitory and could be followed by capital flight. A sudden capital outflow of a large magnitude could have serious consequences for the banking system and the equity markets in Pakistan. In light of the possibility of a flow reversal, there is serious concern associated with the quality of the expansion of domestic credit that has taken place. There are some important policy considerations which must be taken into account when making a decision, and these are discussed in the following.

When the banking system is sound and efficient, and there is effective regulatory and supervisory control over banks, capital flows will not create additional risks to the financial system. When extending credit, banks are able to anticipate the effect of a reversal of capital flows on the revenues of their borrowers (interest rate and exchange rate risks) by pricing loans accordingly, accumulating reserves against such loans, and reducing the concentration of their loan portfolios to sectors that may be affected by capital flow reversals.

On the other hand when credit institutions operate in a regulatory environment that allows them to misallocate credit and mismanage their balance sheets, a distinct possibility in Pakistan, a capital inflow induced expansion of bank credit will create further opportunities for banks to expose the financial system to a larger risk of financial loss [Liliana and Weisbrod (1994)]. In pursuing a policy f nonsterilisation with a weak banking sector, the State Bank runs the risk that it may have to provide liquidity, or equity to troubled or insolvent banks. Moreover, in the event of a reversal of capital flows, weak banks would become especially vulnerable. This would apply to some of the NCBs in Pakistan as well as some newly established private banks which have expanded too rapidly. The history of bank crises, including a recent crisis, clearly demonstrates how high the costs can be of such rescue operations.

As a preventive measure, the authorities can resort to a policy of sterilisation to control domestic credit expansion. The decision to sterilise or not implies a decision to concentrate resources in the State Bank versus the commercial bank; in practice resources should be channelled to the institutions who can manage those funds better. In the case of Pakistan, the choice is clearly in favour of the State Bank. However policy-makers cannot ignore the limited effectiveness of sterilisation as a monetary instrument in the absence of capital controls and fixed exchange rate and also the quasi-fiscal costs of that policy. Furthermore, the policy decisions extend beyond the desirability of sterilisation to the benefits and costs associated with different methods of sterilisation.

Choosing a Method of Sterilisation

Sterilisation is carried out through the balance sheet of a central bank. The central bank can conduct sterilisation either by increasing reserve requirements on commercial bank liabilities or by issuing liabilities to nonbanks who cannot use that instrument as a vehicle to expand domestic credit. The health of the domestic banking system can play an important role in the choice of alternative sterilisation methods. The SBP has at its disposal several tools to sterilise the impact of capital inflows on the domestic economy, and in particular, on the pace of domestic credit expansion. These include: direct instruments, such as increasing reserve requirements[4] on commercial bank liabilities—and indirect instruments, such as conducting open market operations.

The use of reserve requirements has two important implications. First, to the extent that reserves are remunerated below market interest rates,[5] they impose a tax on bank intermediation by increasing the wedge between interest rates on bank deposits and bank loans. Second, they may not be an effective tool for sterilising capital inflows that are intermediated by nonbank financial institutions and by the capital markets, such as in the case of bond or equity portfolio flows. For instance, in Pakistan non-resident FCDs deposited with non-bank financial institutions have grown rapidly since June 1993, and now account for over 21 percent of all non-resident FCDs.

By increasing the cost of funds to some institutions, sterilisation through reserve requirements can place banks at a competitive disadvantage *vis-à-vis* nonbank financial institutions, which often are not subject to the same regulations. Over time, bank disintermediation may occur as nonbanks replace banks as a source of private credit at more competitive rates.

Alternatively, the State Bank can conduct open market operations. But there are limits to sterilisation conducted through open market operations by the SBP imposed by the ability of domestic money markets to absorb the sale of government securities or State Bank bills. In addition, there are high and rising quasi-fiscal costs to open market operations as domestic short-term interest rates have remained well above international rates which the SBP can earn on its reserves. Furthermore, the increase in short-term interest rates due to open market operations act as a further stimulus to short-term inflows, thus reducing the effectiveness of sterilisation.

Dollarisation and Policy Constraints

Evidence suggests that the growth of FCDs can be explained as a switch in

[4]Reserve requirements were increased by SBP from 5 percent to 6.5 percent and repurchase option rate from 15 percent to 15.5 percent to regulate liquidity during 1994-95.

[5]The SBP pays—percent interest on commercial banks' reserves held with the SBP, compared to 13 percent interest on 3-year FIB in June 1995.

the choice of currency denomination by resident investors and in particular expatriate workers. In the literature the use of foreign exchange instead of local currency as a medium of exchange is referred to as currency substitution while the use of foreign exchange as a store of value is commonly referred to as dollarisation. Evidently, the growth of FCDs constitutes dollarisation. Apart from the policy issues related to the potential flow reversal discussed above, there are some issues associated with the effect of dollarisation. For purposes of this paper, dollarisation is measured by the ratio of resident FCDs to total domestic liquidity. This ratio increased from 2.6 percent in 1991 to about 14 percent currently. Although dollarisation is still fairly limited in Pakistan, the increase in financial intermediation in recent years is primarily due to the use of foreign currency deposits. The changes in the ratio of M2/GDP suggests an increase in financial intermediation, while the ratio (M2/RFCDs)/GDP shows the contribution of RFCD towards this (Table 10). Foreign currency deposits encourage intermediation of informal sector funds, and contribute to financial efficiency. They lower transaction costs, and expands the availability of foreign exchange through formal prudentially controlled channels.

Table 10

Pakistan—Selected Financial Statistics
(in Billions of Rupees)

	1990-91	1991-92	1992-93	1993-94	1994-95
Currency in Circulation(MI)	136.9	151.8	166.9	184.9	218.2
Demand and Time Deposits	219.2	292.3	334.6	375.3	403.0
Resident FCDs	9.5	43.0	61.3	92.1	99.9
Domestic Liquidity (M2)	368.8	480.5	567.2	657.9	734.3
GDP	1020.6	1211.4	1314.6	1564.6	1866.5
M1/GDP (Percent)	13.4	12.5	12.4	11.8	11.6
M2/GDP (Percent)	36.1	39.6	42.3	42.0	39.3
RFCDs/M2 (Percent)	2.6	8.9	10.8	14.0	13.6
(M2–RFCDs)/GDP (Percent)	35.3	36.1	37.7	36.2	34.0

Source: State Bank of Pakistan; and estimates.

The growing use of foreign currency deposits reduces the inflation tax base and lowers the incentive to inflate. It is possible that a higher rate of inflation may accelerate the pace of dollarisation. Similarly the authority's ability to tax domestic currency holding through a devaluation is also reduced [Karim 1994)].

Foreign currency deposits thus contribute to a loss of control and effectiveness of monetary and exchange rate policy tools. The State Bank of Pakistan has little control on the foreign currency component of the money supply, and it limits the effectiveness of the latter as a tool of demand management. In addition the use of FCDs implies the indexation of a part of the money supply to the exchange rate, which reduces the expenditure switching impact of the exchange rate. In light of this the reliance on fiscal policy becomes even greater in demand management.

The Commercial Banks and Capital Inflows

Capital account liberalisation and bank deregulation in Pakistan led to greater access of commercial banks to funds before improvements in regulatory and supervisory frameworks were fully implemented and were capable of adequately safeguarding against systemic risk. Improvements in prudential regulation were introduced by the State Bank in 1992, but regulations specifying the definition of bank capital, provisioning requirements for various classes of substandard assets, and the levels of lending and exposure limits are still not according to international standards.

Risk Management

Structural weaknesses in the publicly owned commercial banks that might surface during periods of large and volatile capital flows—can be traced, in part, to the use of commercial bank loans to achieve government economic policy objectives and to interference in the allocation of credit for political reasons. As a result, public sector banks have little incentive to properly assess and price their credit risk. In addition, because banks can avoid identifying and providing reserves against, problem loans, some banks in Pakistan could carry bad loans as performing and capitalise unpaid interest. [Since the government guarantees the deposit base in the Pakistani banking system, weak bank balance sheets, create the potential for sizeable quasi-fiscal costs in case of bank failures.]

Aggregate bank lending is not currently concentrated in particular economic sectors. Concentration of lending should be avoided, since it increases the vulnerability of the banking sector, and of the financial system, to sector-specific economic developments.

Public sector institutions have less of an incentive to manage risk properly because there is a greater presumption of a public sector bailout of a failed state-owned institution than of a failed private bank.

Even in private institutions, internal risk management is inadequate as witnessed in the case of a recent private sector bank. The essence of internal control is the measurement and assessment of risk exposures (including the creditworthiness

of the borrowers and market risk) and the implementation of banking practices that make these risks manageable. Poor accounting standards and limited information disclosure requirements make the assessment of the riskiness of creditors very difficult. Accounting standards are widely perceived as being relatively weak in Pakistan. Reliable information is available only for the very large listed companies. In many cases, the maintenance of multiple accounts, greatly diminishes the reliability of reported information.

Regulatory and Supervisory Framework

The lack of enforcement of existing regulations is a source of problems in Pakistan. A minimum requirement of an effectively operating bank is that there is independent internal oversight of lending decisions by a credit review committee. Such oversight would provide a check against abuses such as lending without proper collateral or in excess of credit exposure limits. An equally important contribution of the review process is the subsequent follow-up as part of a systematic effort to monitor the quality of the loan portfolio.

The general requirements of a sound prudential regulatory structure include the ability of the SBP to examine bank operations and balance sheets, to inject liquidity or capital into banks to contain financial crises, to close banks and to restrict dividend payments, to issue cease and desist orders, to establish entry criteria and capital adequacy rules, to define exposure limits, to delineate and enforce permitted and prohibited activities, and to enforce asset classification and provisioning rules. An important contribution of bank supervision is to relate the true economic value of a bank's portfolio to the bank's capital base. Poor accounting standards may mean, however, that banks have inadequate information about the quality of their loan portfolios, and that even detailed examination by supervisors and regulators may not reveal more information. Current regulations governing the reporting of asset quality in Pakistan fall short of international practices. Amendments in the State Bank Act in 1993, have given the SBP the required degree or autonomy to conduct its supervisory and regulatory role effectively.

To avoid loan losses, bank regulators in Pakistan have imposed limits on bank lending in a variety of forms, including liquidity requirements and exposure limits. However, such controls are easily circumvented because regulations and accounting practices are weak.

Strong legal and accounting systems are important elements of the regulatory support for risk management. In Pakistan the legal framework is being strengthened to enhance the effectiveness of bank claims to seize collateral in the event that loans are not properly serviced.

Capital inflows have been encouraged into Pakistan by deregulation measures. The potential negative impact they could have on financial institutions

should not elicit a response, to try to reverse temporarily the factors that attracted foreign capital in the first place. Instead, pressures from foreign capital flows should be used to promote deregulation and reforms in the domestic markets.

Impact of Portfolio Flows on the Equity Market

Market Linkages and Price Volatility

The benefits to Pakistan of greater access to global capital markets include lower funding costs as a result of diversification of funding sources, and improved liquidity and market depth. However these benefits can be offset by risks associated with exposure to turbulence in international markets and by effects of fluctuation in capital flows.

The increased participation of foreign investors can potentially strengthen the linkage between local and foreign markets. It can magnify the effect of industrial country market turbulence (as experienced in Mexico during the first quarter of 1994) on the emerging equity markets. Because local investors generally have no information about why foreign investors are changing their portfolios, investors will tend to react to such moves. Such reactions will magnify the effect of foreign turbulence on the local market.

The presence of foreign investors especially through large mutual funds can also increase stock price volatility by magnifying price fluctuations in the local market. Outflows are likely to occur when small and illiquid markets are weak. Investors tend to redeem their shares from the fund, and fund managers are then obliged to sell shares in the local market, which further depresses prices. In this way, the participation of large mutual fund might have a destabilising impact on the local market.

Market Liquidity

The rapid increase in foreign demand for emerging market equities combined with their relatively limited supply has fuelled sharp increases in equity prices during the early 1990s. In Pakistan the rise in stock prices was particularly pronounced during 1993 before easing somewhat in 1993, and then again rising sharply in 1994. The surge in prices, in turn, contributed to a marked rise in market capitalisation and an equally dramatic increase in price-earnings ratios. The market capitalisation increased from $ 2.8 billion in 1990 to $ 13.5 billion in 1994 (Table 11). Since March 1994, the index of share prices has declined partly due to selling by foreign funds in the aftermath of the Mexican crisis. A sudden withdrawal of funds by foreign investors has produced variation in market liquidity, which was reflect in market volatility. This liquidity effect was large, especially since, the stock exchanges in Pakistan are operating without specialists or without securities dealers who will use their inventory to provide liquidity and smooth price fluctuations.

Table 11

Pakistan—Stock Market Activity

					End March	
	1991	1992	1993	1994	1994	1995
General Index of Share Price	100	188.5	161.7	290.2	308.8	204.0
(Percent Change)		(88.5)	(–14.2)	(79.5)	(91.0)	(–29.7)
Market Capitalisation of Ordinary Shares (Rs Billion)	68.4	218.4	214.4	404.6	424.6	316.9

Source: State Bank of Pakistan.

Accounting and Disclosure Requirements

One fundamental reason for high price volatility in developing countries like Pakistan is a lack of information. When information is uncertain and disclosure is inadequate, unsubstantiated rumours cause volatility. Differences in the availability and quality of information and the speed of information dissemination can affect the impact of sudden changes in portfolio flows on both price and volume volatility. Recently, the Karachi Stock Exchange has undertaken various measures to modernise its functioning: it has expanded its computer retrieval service and is in the process of establishing a central depositing company system. However the stock markets in Pakistan are in need of modernisation.

Although a fairly complete legal and institutional framework is in place, implementation and enforcement of regulation relating to investor protection is weak. The possibility of insider trading can undermine investors confidence and can be detrimental to market development. This contributes to the volatility of prices as well.

Size of Market and Trading Instruments

The effect that portfolio flows can have on an emerging stock market depends importantly on the size of the flow relative to the size of the market, and the capacity of the market to quickly process and absorb the number of foreign orders and transactions. Portfolio flows at their peak were less than $ 300 million during the year or about 2½ percent market capitalisation of $ 13 billion. But these inflows were a substantial proportion of the turnover during that year.

It is often argued that derivative products, due to their highly leveraged nature, can also facilitate speculation, which can lead to higher stock market volatility and more extreme price movements. The stock markets in Pakistan allow margin trading and short-selling, which are other means of obtaining greater leverage. In order to check excessive margin trading and short selling, the stock exchange could impose limits on aggregate margin and short-selling positions.

Finally, the proper design and implementation of clearing and settlement systems for stock transactions is essential for maintaining the ability of the emerging stock markets to absorb and to allocate financial resources to their most productive uses, especially in the presence of large price fluctuations caused by rapid inflows and outflows of large amounts of foreign portfolio capital. Automated trading systems can reduce transaction costs and improve investors' participation and market liquidity.

V. EVALUATION AND POLICY RECOMMENDATIONS

Economic growth during the last two years is recovering gradually from the slow down experienced in 1992-93 due to weather, politics and external terms of trade developments. At 4.7 percent, the real GDP growth rte in 1994-95 remains well below the average of 6 percent during most of the 1980s. The full potential of economic growth in the country is constrained mainly by deficiencies in the physical infrastructure, harnessed energy resources and in human resource development, reflecting years of inadequate investment. Neglect of the social sector during the last decade adversely affected living standards, and is now contributing to growing social unrest with serious consequences for confidence of private sector investors.

The requirements for investment resources is large and growing rapidly under pressures of population growth and desire for development. The Government's ability to meet development investment is constrained by the need to reduce the large fiscal imbalance which together with the recent surge in capital inflows is contributing to inflationary pressures and crowding out private sector activity. The fiscal deficit at an estimated 5.5 percent of GDP in 1994-95 reflects structural rigidities in expenditure and weak revenue growth during the current transitional period of an ongoing tax reform. As a consequence, the role of the government is undergoing a major transformation; the authorities are continuing with an accelerated privatisation programme to generate revenues and the private sector is being invited into areas like energy, that were previously public sector domain. Both of the latter initiatives involve foreign private sector participation which will result in additional capital inflows.

The external current account deficit at 3.5 percent of GDP in 1994-95, has grown slowly in terms of GDP with rising imports and deficit on the services account. The current account deficit has been financed by large private capital inflows during the last two years which have contributed to the overall balance of payments surplus and accumulation of reserves. The import cover of official gross foreign exchange reserves is equal to 13.5 weeks of imports. The nominal exchange rate of the rupee has remained almost steady against the US dollar through 1994 and early 1995. The rupee was devalued by 7.5 percent against the US dollar in late October.

Monetary expansion has been contained through open market operations which have built up a cushion of State Bank reserves and increases in reserve requirements and discount rates. Broad money growth has been reduced from 18 percent in 1992-93 to 16.6 percent in 1994-95. Short-term money market interest rates fluctuated widely during 1994 reflecting budgetary needs and capital inflows in the market.

Private capital inflows have grown rapidly during the 1990s, peaking at $ 4.5 billion in 1993-94 and remained strong at $ 4.4 billion in 1994-95. These inflows have eased the foreign exchange constraints of Pakistan, financing a growing current account deficit and helping build up large foreign exchange reserves. These large inflows have eased concerns about the short-term impact of trade liberalisation; and in the case of FDI, participated in the country's investment efforts. But at the same time, private capital inflows have contributed to demand pressures and set up a systemic risk to the banking sector. The coverage of that portion of inflows which is estimated to be volatile, remains less than 75 percent. The volatility of portfolio flows has taken its toll of price fluctuations in the country's stock markets. However, by and large, the major portion of capital flows are of a stable nature and are expected to continue growing along trend. These are likely to be complemented by inflows related to the sale of public corporation shares in international markets and investments in the energy sectors.

Looking ahead, the Government will need to respond in a manner that will accommodate the higher investment and growth afforded by the inflows while curbing their destabilising effects.

Box 3

Lessons from the Mexican Crisis in Managing Capital Flows

Recent development in Mexico have brought into sharper relief the differences in the composition and management of private capital flows between different regions of the world. These differences have important implications for future flows to these region and for policies for managing the flows.

For example, East Asian countries maintained more stable macro-economic environment during periods of large inflows, which was more favourable to sustain high growth. East Asia also maintained high annual saving and investment rates as compared to countries in Latin America. Higher investment in East Asia was financed primarily with domestic resources. Inflows into East Asia have tended to increase investment rather than consumption while some Latin American countries experienced a consumption boom. East Asian export growth has been stronger, signalling a better future capacity to service foreign liabilities in contrast to Latin American countries, where inflows outpaced the growth of exports. East Asia provided investors and exporters a more stable financial environment reflected in lower inflation and a lower variability of inflation and real exchange rates than in Latin America, while protecting external competitiveness. In several Latin American countries real exchange rates appreciated and the erosion of competitiveness was associated with rapidly widening current account deficits. In general East Asian countries also made greater use of fiscal restraint in coping with inflows.

The lesson for Pakistan is that stronger economic fundamentals and sound macro-economic responses to large capital inflows increases the likelihood that these inflows would be sustained, and less vulnerable to volatility. Pakistan must move quickly to reduce the budget deficit and restrain monetary expansion. Measures should be taken to avoid appreciation of the real exchange rate and competitiveness maintained to expand export.

Among steps to increase the absorptive capacity of the economy to stimulate investment and growth, three areas need urgent attention: the first is the ability of the banking system to intermediate a large increase in credit efficiently; the second is to ensure adequacy of physical infrastructure; and the third is to proceed with the trade reform to ensure efficient allocation of large inflows throughout the economy.

Financial Sector Reform

The need to remove remaining distortions in the financial sector and weaknesses in banking supervision and prudential standards, has taken on added urgency as a result of the surge in inflows. To address the issues of exchange risks and general loan risks, regulations to ensure adequacy of capital bases and limit banks exposure to foreign exchange risk are essential. Pakistan should adopt capital adequacy standards in accordance with guidelines under the Basle accord. Details of specific measures needed in the area of accounting, information etc. are discussed in Section IV. Financial sector reforms are needed not only to reduce the risk of bank failures if there is a reversal of inflows, but also to improve intermediation to take full advantage of the increased inflows.

Infrastructure

The need for developing infrastructure to accommodate higher investment stemming from inflows may seem to conflict with the desire to reduce the fiscal deficit. To reduce the conflict, the Government has invited private sector participation in development of the power sector. Other areas for private sector participation should be explored. In addition, fiscal adjustment can rely on other areas of the budget for savings to reduce the deficit.

Trade Reform

The initial motivation for trade reforms, to improve economic efficiency, has become more important as large inflows need to be allocated throughout the economy to the most productive activities. Moreover the inflows have eased any perceived constraints on the speed of trade liberalisation and tariff reduction.

The Government needs to continue with efforts to contain demand pressures emanating from capital inflows. There are various measures that should be considered.

Sterilisation

Sterilisation is most effective when accompanied by fiscal restraint. This is the preferred policy mix of Pakistan. Some degree of sterilisation will help further build up foreign exchange reserves with the State Bank to increase the cover against

volatile outflows. It will contain domestic credit expansion through a banking system which is currently weak and unable to assess, price and manage risk associated with volatile inflows. It is likely to be effective as a tool of monetary policy since the majority of inflows are evidently insensitive to interest rate developments in Pakistan.

Total reliance on sterilisation to contain domestic demand will not be advisable. First, sterilisation carries a quasi-fiscal cost which will grow over-time. Second, sterilisation deflects inflows into purchases of government bonds and raises interest rates, thus depriving the economy of the benefits of inflows—higher domestic investment and growth.

Open market operations should be used more often as a tool for sterilisation since it places less of a burden on the banking sector. For this purpose, the State Bank should issue its own paper to supplement its portfolio of T-bills.

Fiscal Policy

An increase in public sector savings seems to be the only sustainable policy to contain demand pressures and protect the real exchange rate. To the extent that some of the inflows into Pakistan stem from an unsustainable policy mix, (tight credit with an easier fiscal policy) reducing the fiscal deficit will eliminate the problem at source.

However in view of the need to protect the public sector investment programme, especially the development of the infrastructure, the form of fiscal adjustment will need to be carefully considered. First, fiscal adjustment should aim to reduce demand for non-traded goods and services e.g. reduction in the wage bill, which reduces domestic inflationary pressures (rather than cutting expenditures on imported goods which will add pressures for exchange rate appreciation). Second, expenditure restraint will have a stronger impact on domestic demand than revenue increases because the latter absorb resources that might have been saved. Third, notwithstanding structural rigidities in fiscal expenditures, there is need to reduce waste, and corruption and to improve governance to increase the productivity and effectiveness of public expenditure.

Exchange Rate Policy and Capital Account

Net capital inflows can be reduced by liberalising capital outflows through the capital account, and by increasing the exchange risk faced by participants in the market. The latter can be achieved by enlarging the band within which the exchange rate can move. Permitting some flexibility, increases the exchange rate risk for foreign investors.

***Annex* 1**

FOREIGN CURRENCY ACCOUNTS SCHEME IN PAKISTAN

The Scheme

Foreign currency accounts scheme, which was introduced in January, 1973, was initially meant for Pakistani nationals residing abroad. The scope of the scheme was gradually widened. Permission to Pakistani residents to open and maintain these accounts and general permission for credit to these accounts was granted as part of the overall package of foreign exchange reforms announced in February, 1991. Presently, banks may, without the prior approval of the State Bank, open with them foreign currency accounts of Pakistani Nationals residing in or outside Pakistan including those having a dual nationality. Resident firms and resident companies including investment banks and the companies incorporated in Pakistan with foreign share-holdings are also eligible to open and maintain foreign currency accounts in Pakistan. The facility is also available to diplomatic missions accredited to Pakistan, their Diplomatic Officers, International Organisations in Pakistan, foreign firms/ corporations other than banks incorporated and operating abroad provided these are owned by persons who are otherwise eligible to open foreign currency accounts.

The balances held in foreign currency accounts and income therefrom are exempt from the levy of Wealth Tax, Income Tax, and compulsory deduction of Zakat at source. Banks can also grant rupee loans to the account-holders, to a certain extent of their balances and can also issues guarantees on their behalf in favour of residents/non-residents. State Bank covers exchange risk of all such deposits against payment of prescribed fee. Rules and Regulations regarding F. C. As are given the attached sheets.

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