Rising to the Challenge in Asia: A Study of Financial Markets

Volume 9

Pakistan

Asian Development Bank
1999

Asian Development Bank
P.O. Box 789
0980 Manila, Philippines

Published by the Asian Development Bank

Publication Stock No. 060699
ISBN 971-561-236-9

Foreword

The Asian currency and financial crisis has had far-reaching effects on the regional economies and their trading partners. These effects have threatened to wash away the region's significant social and economic advancement achieved during the preceding years of rapid growth. The crisis has also unveiled many intricate problems and challenges in macroeconomic management, banking and capital markets management, institutional capacity, and governance of the financial systems in the region.

Recognizing the urgency of addressing these problems and challenges, the Economics and Development Resource Center of the Asian Development Bank undertook a regional study of financial markets in nine developing member countries: People's Republic of China, India, Indonesia, Republic of Korea, Malaysia, Pakistan, Philippines, Thailand, and Viet Nam. The objectives of the study were to analyze and deepen the understanding of the sources of the crisis in currency and financial markets, to provide a useful basis for designing and implementing preventive measures and refocused country strategies, and to help the Bank and its member countries build robust and sustainable financial systems in the region.

The study was designed, supervised, and coordinated by S. Ghon Rhee, Resident Scholar, 1997–1999. A large number of Bank staff and renowned scholars and experts contributed to this study.

Regional policy issues and recommendations based on the findings of the study were discussed at the High-Level Workshop on the Asian Financial Crisis in Tokyo, on 25–26 March 1999. This workshop was hosted by the Bank, the ADB Institute, and the Institute of Fiscal and Monetary Policy of the Ministry of Finance of Japan.

The present series of publications seeks to bring the research findings to a much wider audience and hopes to contribute to a better understanding of the Asian financial crisis and how its recurrence can be prevented in the future.

Jungsoo Lee
Chief Economist

Preface

Rising to the Challenge in Asia: A Study of Financial Markets presents the findings of a study carried out under *Regional Technical Assistance 5770: Study of Financial Markets in Selected Member Countries.* Many Asian Development Bank staff members and outside experts contributed to the study's successful completion.

The core members for the study were Ramesh Adhikari, David Edwards, Tobias Hoschka, Sudipto Mundle, Soo-Nam Oh, Pradumna Rana, Yutaka Shimomoto, Reza Siregar, Peggy Speck, Ramesh Subramaniam, and Vo Van Cuong. The outside experts were Stephen Cheung (Hong Kong, China), Yoon Je Cho (Republic of Korea), Jang-Bong Choi (Republic of Korea), Catherine Chou (Hong Kong, China), G.H. Deolalkar (India), Maria Socorro Gochoco-Bautista (Philippines), Akiyoshi Horiuchi (Japan), Masahiro Kawai (Japan), Mohammad Zubair Khan (Pakistan), Joseph Y. Lim (Philippines), Sang-Koo Nam (Republic of Korea), Anwar Nasution (Indonesia), Edward Ng (Singapore), Jaeha Park (Republic of Korea), Mohd. Haflah Piei (Malaysia), Ken-Ichi Takayasu (Japan), Khee Giap Tan (Singapore), S. K. Tsang (Hong Kong, China), Stephen Wells (United Kingdom), Richard Werner (Germany), Min-Teh Yu (Taipei,China), and Barents Group LLC (KPMG).

Thirty-seven reports are contained in a series of 12 volumes:

Volume 1: Regional Overview
- Macroeconomic Policy Issues
- Banking Policy Issues
- Capital Market Policy Issues

Volume 2: Special Issues
- Asset Management Entities
- Deposit Protection Schemes

Volume 3: Sound Practices
- Corporate Governance (Hong Kong, China)
- Currency Board (Hong Kong, China)
- Central Provident Fund (Singapore)
- Dichotomized Financial System (Singapore)
- Banking Sector (Taipei,China)

Volumes 4–12: Country Studies
- Macroeconomic Policy Issues
- Banking Policy Issues
- Capital Market Policy Issues

The volumes benefited extensively from constructive comments from the Bank interdepartmental working group, and the ministries of finance, central banks, and securities and exchange commissions of the nine member countries that participated in the regional technical assistance study program and in the High-Level Workshop on the Asian Financial Crisis in Tokyo, on 25–26 March 1999. Mitsuo Sato, former President of the Asian Development Bank; Bong-Suh Lee, former Vice-President (Region West); and Peter Sullivan, Vice-President (Region East) provided strong support and guidance throughout this project.

Soo-Nam Oh coordinated the research and publication activities. Wilhelmina Paz, Lagrimas Cuevas, Anthony Ygrubay, Ruben Mercado, Virginia Pineda, and Rosalie Postadan provided administrative and technical support. The volumes were edited by Gloria Argosino, Mary Ann Asico, Graham Dwyer, and Muriel Ordoñez. Typesetting, computer graphics, and conceptualization of the cover design were done by Segundo de la Cruz, Jr.

S. Ghon Rhee
K. J. Luke Chair of International Finance and Banking
University of Hawaii
Resident Scholar of the Asian Development Bank
(June 1997–June 1999)

Contents

Foreword iii
Preface v
Acronyms and Abbreviations viii

Liberalization and Economic Crisis in Pakistan 1
Mohammad Zubair Khan

EXECUTIVE SUMMARY 2
INTRODUCTION 5
OVERVIEW OF MACROECONOMIC DEVELOPMENTS DURING 1992–1998 6
THE LIBERALIZATION PROCESS, 1988–1998 8
Monetary Policy 8
Fiscal Policy 11
Exchange Rate Policy 13
Trade Liberalization 14
Investment Policy 16
Privatization Program 17
Export Processing Zones Authority 17
Industrial Estates 18
ASSESSMENT OF DEGREE OF GLOBALIZATION 18
Macroeconomic Policy Management 18
Vulnerability to Crisis 24
Crisis Management 25
NOTES 27
APPENDIXES 28

Transforming Banking in Pakistan 37
Mohammad Zubair Khan

EXECUTIVE SUMMARY 38
INTRODUCTION 39
Overview of the Banking Sector 39
The Early Reforms 44
Constraints to Further Liberalization 45
1997–1998 BANKING REFORMS AND ISSUES 45
Major Problems of the Banking Sector on the Eve of the 1997–1998 Reforms 45
Root Causes of the Problems 47
1997–1998 Banking Reforms 50

REMAINING ISSUES AND RECOMMENDATIONS ON BANKING SECTOR REFORM 56
Issues and Recommendations 56
The Issue of Capital Mobility 60
NOTES 62
APPENDIXES 63

Reforming Pakistan's Capital Markets 71
Catherine Chou

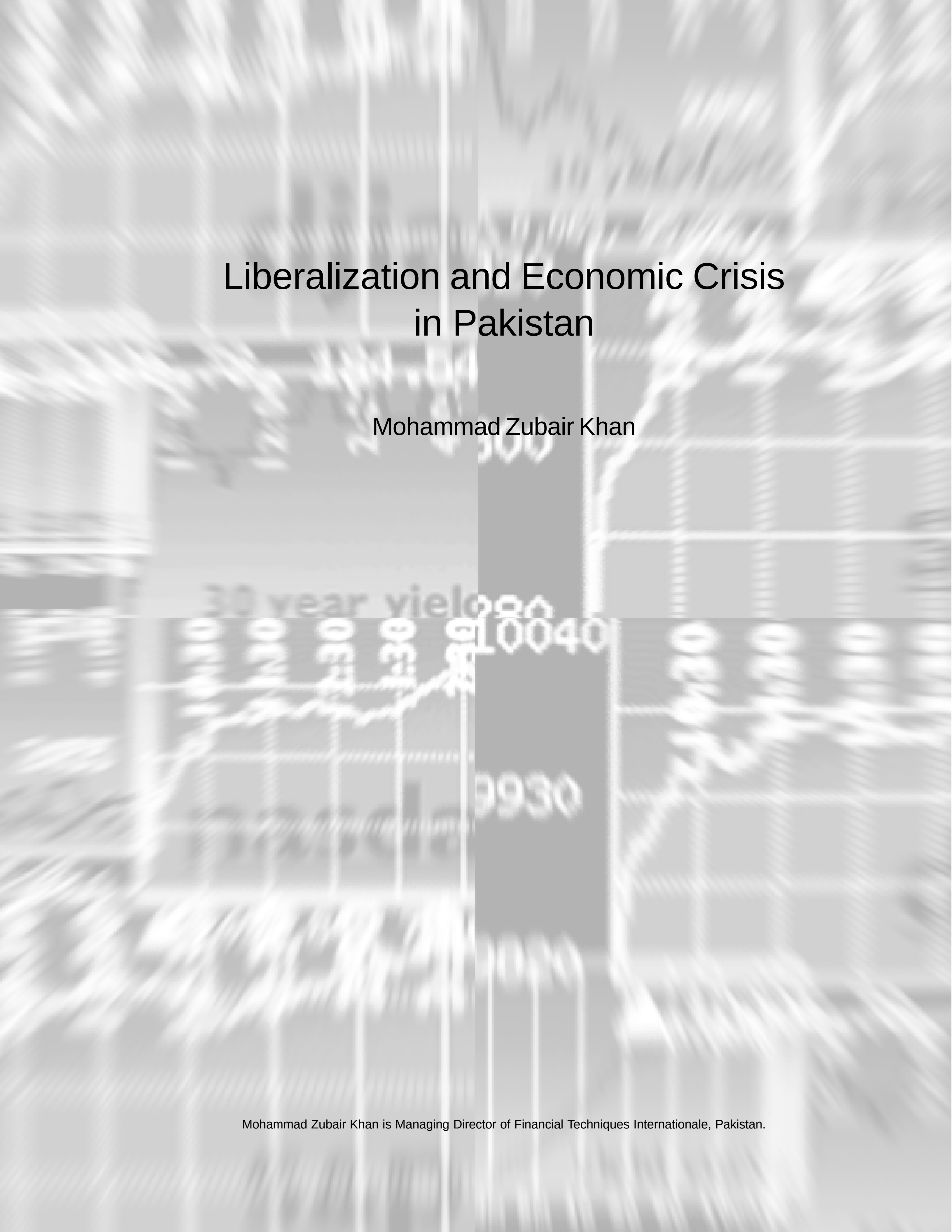
INTRODUCTION 72
BACKGROUND 72
Foreign Exchange Market 72
Bond Market 72
Equity Market 75
RECENT DEVELOPMENTS 79
Preempting the Crisis 79
Events Leading to the Crisis 80
POLICY ISSUES 82
Market Infrastructure 83
Market Regulation 83
Corporate Governance 83
Accounting and Disclosure 84
Tax Incentives 85
Human Resources 86
Institutional Investors 86
POLICY RECOMMENDATIONS 86
Market Infrastructure 86
Market Regulation 86
Corporate Governance 87
Accounting and Disclosure 88
Tax Incentives 88
Human Resources 89
Institutional Investors 89
CONCLUSION 89
NOTES 90
APPENDIXES 91

Acronyms and Abbreviations

ABL	Allied Bank Ltd.
ADB	Asian Development Bank
ATC	Agreement on Textiles and Clothing
BEL	Bankers' Equity Ltd.
BIS	Bank for International Settlements
BOI	Board of Investment
bp	basis point(s)
CDC	central depository company
CDS	Central Depository System
CED	Central Excise Duty
CI	Controller of Insurance
CLA	Corporate Law Authority
COI	Certificate of Investment
CMDP	Capital Market Development Program
DFI	development finance institution
EFF	Extended Fund Facility
EPZ	export processing zone
EPZA	Export Processing Zones Authority
ESAF	Enhanced Structural Adjustment Facility
FCD	foreign currency deposit
FDI	foreign direct investment
FIB	Federal Investment Bond
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GST	General Sales Tax
HBL	Habib Bank Ltd.
HUBCO	Hub Power Company Ltd.
ICP	Investment Corporation of Pakistan
IDBP	Industrial Development Bank of Pakistan
IMF	International Monetary Fund
IPP	independent power producer
ISE	Islamabad Stock Exchange
KSE	Karachi Stock Exchange
LAP	Leasing Association of Pakistan
LIBOR	London interbank offered rate
LSE	Lahore Stock Exchange
MAP	*Modaraba* Association of Pakistan
MCB	Muslim Commercial Bank
MFA	Multifiber Arrangement

MUFAP	Mutual Fund Association of Pakistan
NAFTA	North American Free Trade Area
NAV	net asset value
NBFI	nonbank financial institution
NBP	National Bank of Pakistan
NCB	nationalized commercial bank
NCSS	National Clearing and Settlement System
NDFC	National Development Finance Corporation
NIC	National Insurance Corporation
NIT	National Investment Trust
NPA	nonperforming asset
NPL	nonperforming loan
NSS	National Savings Scheme
PACRA	Pakistan Credit Rating Agency
PIC	Pakistan Insurance Corporation
PICIC	Pakistan Industrial Credit and Investment Corporation
PIRA	Pakistan Insurance Regulatory Authority
PRs	Pakistan rupees
PRS	Pakistan Revenue Service
PSDP	Public Sector Development Programme
PTCL	Pakistan Telecommunication Company Ltd.
REER	real effective exchange rate
ROA	return on assets
ROE	return on equity
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SLI	State Life Insurance Corporation
SLR	statutory liquidity requirement
SOE	State-owned enterprise
SRO	self-regulatory organization
T-bill	Treasury bill
TFC	Term Finance Certificate
UBL	United Bank Ltd.
WAPDA	Water and Power Development Authority
WTO	World Trade Organization

Note: $ is assumed to be US dollars unless otherwise stated.
Exchange rate as of July 1999 was $1 to PRs51.61.



Liberalization and Economic Crisis in Pakistan

Mohammad Zubair Khan

Mohammad Zubair Khan is Managing Director of Financial Techniques Internationale, Pakistan.

Executive Summary

Pakistan adopted economic stabilization and structural reform policies in 1988 in an effort to reduce domestic financial imbalances and external deficits. However, there have been problems with the implementation of these policies, in terms of consistency and sequencing. The period 1988–1996 was characterized by repeated attempts to stabilize the economy amid weak efforts at structural reforms. Since policy measures were not able to achieve their objectives, the Pakistan economy continued to be trapped in a vicious circle of poverty, low growth, low savings, and low investment, which further hampered growth and poverty alleviation.

Economic difficulties worsened as a financial crisis hit Pakistan at the end of May 1988. Reserves plummeted from \$1.2 billion to about \$0.6 billion, and default seemed imminent. The crisis was triggered by the country's testing of nuclear devices on 28 May 1998 amid threats of economic sanctions from the United States and other countries. Unjustifiably, fearing capital outflows, the Government froze all foreign currency accounts. As a natural response, private sector remittances also practically ceased, cutting off about \$2.5 billion in inflows projected for that fiscal year. Commercial bank short-term lending to the Government and State Bank of Pakistan (SBP) dropped drastically. Two sources of foreign exchange borrowing—official sources and private transfers—which had remained seemingly insensitive to changes in economic fundamentals, now due to political reasons (in the case of official inflows) and poor decisions by the Government (in the case of foreign currency accounts) suddenly dried up and precipitated a financial crisis.

Government policy reforms initiated in the financial and monetary sectors refer back to policies in 1987/88 to support structural reforms in the areas of fiscal and trade policy. At the time, the consolidated federal and provincial fiscal deficit which was 6 percent of gross domestic product (GDP) or more in the 1980s reached 8.5 percent of GDP and became unsustainable. Thus, fiscal reforms became the main focus of reform efforts. The deterioration of Pakistan's fiscal position reflected, *inter alia*, persistent expenditure overruns, the narrow and inequitable tax base, low elasticity of the tax system, and a heavy reliance of revenues on international trade taxes. The medium-term fiscal reforms initiated at the time aimed to reduce the deficit through structural reforms of direct and indirect taxes and a forceful restraint of current spending.

Pakistan has gradually liberalized its tariffs, reducing the maximum tariff rate from 225 percent in 1986/87 to 65 percent in 1995/96. Until end-March 1997, however, the country's complex and exemption ridden tariff regime continued to give rise to high levels of effective protection, nurtured inefficient industries, generated a strong antiexport bias, put a heavy burden on consumers, diverted resources to rent-seeking activities, and encouraged corruption and smuggling.

The Government has pursued an export promotion policy in one form or another since the late 1950s. The year 1988 marked a watershed in economic policymaking in Pakistan, as the country turned decisively away from inward looking policies towards trade liberalization and export promotion. Successive governments consistently strengthened these policies in the subsequent period. While considerable progress was made in the design and implementation of these policies, as reflected in substantial growth in export earnings, there is much scope for improvement in trade liberalization and export promotion policies.

Tariff policy remains one of the most important policy instruments to influence resource allocation or investment decisions, by affecting relative prices and profitability in the country. However, its impact is eroded to a large extent by the Government's credit policy and by its investment policy administered through the Board of Investment (BOI). Furthermore, development finance institutions (DFIs) and commercial banks are formally and informally guided by the Gov-

ernment in selecting particular industrial sectors for venture capital investment. Apart from the export processing zones (EPZs), there is no separate institution for financing investments in export activities.

Privatization of State-owned enterprises (SOEs) has been pursued in Pakistan since 1991, following the wave of liberalization, deregulation, and minimization of the role of the state in economic activity across the world. In the first two years, the pace of privatization was rapid and 70 units were privatized. But after 1993 it slowed due to various factors such as demand for greater transparency and financial vulnerability of some of the units.

Building on the basic economic programs of previous governments, the Government in March 1997 initiated structural reforms and stabilization measures to stimulate growth, reduce inflation, improve the balance of payments, and strengthen Pakistan's competitiveness in world markets. Yet economic activity is in deep recession, inflation persists, and external reserves are not improving. Government inaction and conflicting statements and signals before implementation of structural reform policies suggest a lack of commitment and stamina. To compound matters, there are apparently some miscalculations emerging about the response of the economy, the size of the markets in Pakistan, and the combined impact of some of the structural policies being implemented. To top it all, the financial support from multilateral agencies for such an extensive reform process is too small.

Reducing the fiscal deficit is one of the most important corrections needed. Not only is the extent of fiscal adjustment a subject of debate, especially seen in a three-year context, the quality of adjustment also needs a review. Government efforts to achieve more revenues from income and sales taxes have suffered for a number of reasons. On the expenditure side, rigidities due to debt service and defense needs limit the scope of adjustment except by improving public sector productivity. Apart from a wavering commitment to downsize or rightsize, the Government has not undertaken an extensive and indepth review to improve the efficiency of its spending. As always, cuts in the development budget are most prominent. But all fiscal efforts are discredited by the pursuit of large and costly luxury projects such as motorways, airports, and rail systems that cannot be justified in terms of relative rates of return.

Reform of the banking sector is pivotal to the revival and development of the economy. Unfortunately, the process is beginning to falter. The loan recovery process is also marked by perceptions among defaulters of unequal treatment by the Government, and the banking courts have yet to prove that the new law is adequate for speedy recovery. Notwithstanding the above, the reforms overestimate the speed at which loans can be recovered. It would be better to transfer these bad assets to a separate fund for the lengthy process of recovery, and as a result lower the burden of the bad portfolio on banks so that they could reduce the spread between the deposit and lending rates.

There is consensus in the country on privatization of public corporations. However, the poor financial state of the corporations and the slowdown in markets have been major constraints.

There are other considerations that warrant a careful review of existing policy. More problems confronting the economy include the hugely indebted public corporations and the inadequate financial resources of the Water and Power Development Authority (WAPDA). There are pressures to deal with the latter issue through tariff increases, particularly in electricity. However, there are arguments against raising tariffs on a continued basis to address WAPDA's fiscal gap. First, a tariff increase will not only be unbearable to consumers but will cripple an already uncompetitive industrial sector. Currency devaluation may follow to shore up the uncompetitive industries. Since fuel prices are indexed to the exchange rate, a spiral of inflation would follow. Second, WAPDA is a monopoly and, therefore, its distribution losses of 29 percent of generated power can be largely attributed to the company's inefficiencies.

Thus, passing on the cost of these inefficiencies would be unreasonable. It is estimated that about PRs1 billion could be saved for each percentage point reduction in line losses.

A trade liberalization policy through tariff reforms has been proposed to reduce protection given to import-substituting industry and to encourage the export sector, so that existing industries would become more efficient and new resource allocation would shift toward more competitive export industries. This policy, however, has been poorly implemented. There is a need to shift the focus from further tariff reductions (except on inputs) to direct assistance to the export sector in improving marketing and technical know-how, productivity enhancement, reducing overhead costs, and increasing credit availability.

Tariff reform did not progress due to a number of mutually reinforcing reasons. First, it was undertaken simultaneously with ongoing tax reforms that aimed to broaden the tax base, promote income tax compliance, and introduce a general sales tax. Second, to complicate matters, a large fiscal imbalance existed even in 1993, and correcting this was crucial to stabilization of domestic prices and improvement of the external reserves position. With laxity in public current expenditures, and a need to reduce the fiscal deficit, there was no room left for pursuing tariff reform with rigor. Third, the pace of tariff reductions was relatively fast considering the ability of the Government to develop alternative sources of revenue and private industry to make adjustments.

The exchange rate policy of the Government that had dual objectives of restraining inflation and promoting exports has not been successful. Through periodic step devaluations following periods of relative nominal stability, the exchange rate policy has sought to recover export competitiveness that has been eroded as a result of higher domestic inflation compared with trading partner countries. In effect, the policy has accommodated persistent fiscal and monetary slippages and assured authorities that expansionary financial policies would not erode competitiveness. In fact, targeting of the real exchange rate index has failed to compensate exporters for the loss of competitiveness due to declining labor productivity and higher energy costs.

The current economic program is the sum and extension of initiatives taken by various governments during the last 10 years. The menu of reform is extensive and ambitious in its targets. It aims to rectify distortions developed during many decades. It is also cognizant of the need to provide social safety nets to the labor force directly affected by the reforms. It must equally recognize the needs of industry and agriculture to respond to the new set of relative prices, competition, and opportunities. Most structural reforms by their very nature carry short-term costs and benefits that accrue in the medium term and, more important, some of these reforms are mutually dependent for their success. Not only are there indications of wavering commitment of the Government to the total reform process, the resources committed in support of such an extensive program seem meager.

While Pakistan did not immediately suffer a financial crisis when East Asian countries were economically destabilized, there are certain underlying weaknesses that are disturbing and pose a threat to financial stability:

- Pakistan's financial sector remains weak, and despite government efforts, the recovery of bad loans is making little progress;
- the Government is continuing with low priority, long gestation infrastructure projects; and
- the East Asian crisis has increased Pakistan's vulnerability to foreign exchange liquidity problems.

There are several explanations why Pakistan did not experience the crisis that hit the East Asian economies:

- While the East Asia boom was financed by highly "sensitive" private sector capital in the form of portfolio capital and short-term debt, Pakistan's deficits have been largely financed by official

flows and private sector bank deposits by residents and nonresidents that have displayed extraordinary stability during repeated balance of payments crises in the 1990s.

- The foreign currency exposure of the private sector in Pakistan was low. Despite repeated attempts, this sector had limited success in raising capital from international sources.
- While Pakistan did receive some portfolio investment in 1994 at the peak of inflows into emerging markets, its poor economic performance, political instability, and the relatively better prospects in East Asia at that time limited such flows. The Karachi stock market peaked in 1994 and lost more than one third of its value by July 1997. By then, most foreign institutional investors had already withdrawn from the market.
- Banking reforms were introduced in early 1997 and, together with better monitoring of prudential regulations, put the brakes on poor credit decision making.

At the end of May 1998, a financial crisis finally hit Pakistan and default seemed imminent. The two sources of foreign exchange borrowing—official sources and private transfers—which had remained stable and seemingly insensitive to changes in economic fundamentals, suddenly dried up and precipitated the crisis.

The Government took a number of steps to restore confidence but the market seemed unimpressed by the measures. The loss of credibility due to the mishandling of the media trial of foreign investors, which caused the stock market crash, and the freezing of foreign currency accounts will take time to recover.

Introduction

In 1988, Pakistan adopted policies geared towards economic stabilization and structural reforms, in an effort to reduce domestic financial imbalances and external deficits. The measures were also intended to promote trade liberalization, reduction in capital controls, more open investment policies, and the adoption of market-oriented monetary policy. The change in policy direction coincided with a return to democracy and free elections after nearly 12 years of military dictatorship.

The task before the Government was twofold: (i) to develop institutions and regulations in tune with openness after a period of controls and (ii) to direct the economy along more efficient lines while accommodating the cost of adjustment. Unfortunately, the period was mired by declining standards of governance from already low levels, further increases in corruption, and political instability. Seven administrations ruled the country in the 10-year span covering the period 1988–1998.

The period 1988–1996 was characterized by repeated attempts to stabilize the economy amid weak efforts at structural reforms that pushed the economy into a series of vicious cycles. In particular, increased taxation on a shrinking tax base led to its further contraction due to tax evasion and the expansion of the underground economy, and resulted in further tax hikes. Sluggish budgetary revenues led to cuts in public investment in human capital and infrastructure, undermining the profitability of private sector investment and production, thus reinforcing weakness in revenues. Low employment generation by the private sector was partly compensated by overstaffing in the public sector, which further reduced its efficiency. Double-digit inflation created the need for nominal depreciation, which fed back into inflation. Declining profitability in the banking system depressed the rate of return on bank deposits, leading to disintermediation, which in turn led to a further decline in bank profitability.

More broadly, the Pakistan economy continued to be trapped in a vicious circle of poverty, low growth, low savings, and low investment, which further hampered growth and poverty alleviation. Moreover, these structural problems eroded the institutional fabric of society, contributing to deterioration in governance and in security conditions. The attempts

during recent years to correct macroeconomic imbalances have fallen victim to slippages in policy, inconsistencies and sequencing problems in adjustment policies, and sometimes policy reversals triggered by, among other factors, a slow response from the economy. The result has been a worsening fiscal and external position, reflected most conspicuously in repeated foreign exchange crises and a ballooning public debt. The country is at a point where reserves can be depleted no further, nor further borrowing sustained.

The most troubling aspect is the Government's heavy reliance on foreign currency deposits to meet external financing requirements. In the past two years, inflows into resident foreign currency deposits (FCDs) have covered one fifth to two fifths of the trade deficit. As of 28 May 1998, the total outstanding balance in foreign currency deposits stood at $11.2 billion, equivalent to one third of total external debt. About 86 percent of foreign currency deposits were either demand deposits or had a maturity of one year or less. In the shadow of the financial crisis of East Asia, this was of particular concern.

Overview of Macroeconomic Developments During 1992–1998

In 1992/93, reflecting the impact of devastating floods, viral attacks on crops, and political instability, gross domestic product (GDP) growth plummeted, and the external current account deficit widened to 7 percent of GDP creating a balance of payments crisis.

In mid-1993, Pakistan embarked on an ambitious medium-term program of macroeconomic adjustment and structural reform that sought to address deep-rooted structural problems and mounting macroeconomic imbalances that had led to a near balance of payment crisis. The program achieved, initially, remarkable stabilization, including a sharp reduction in the external current account deficit, a strong buildup of reserves, and decrease in the budget deficit to 6 percent of GDP, 2 percentage points lower than in the previous year. Significant progress was made in privatizing industrial units, deregulating economic activities, liberalizing the financial system, and opening up the economy through a relaxation of trade and exchange restrictions.

The stabilization achieved in 1993/94 was short lived and its benefits quickly eroded as the adjustment and structural reform process lost momentum and slippages in policy implementation started to surface, particularly with the proliferation of tax exemptions and concessions. As a result, inflation accelerated, the trade deficit widened, and capital inflows weakened. The announced 1995/96 budget clearly confirmed the pause in the process of adjustment and reform, eliciting an adverse market reaction. This precipitated a rapid deterioration in the external reserves position, bringing the country back to the brink of a foreign exchange crisis in October 1995.

During this period, Pakistan's economy performed below its potential. Following the sharp decline in 1992/93, the growth of real GDP recovered over the next three years, helped in part by the recovery in agriculture, investment in the energy sector in response to the new energy policy in 1994, and expansion of small-scale, export-oriented enterprises. But recovery was modest and the growth rate fell from an average of 6 percent in the 1980s to 4 percent in 1992/93–1995/96. This decline reflected, *inter alia*, poor weather conditions, a deterioration in the physical integrity of the irrigation and drainage systems, inadequate public spending on essential infrastructure and its maintenance, distortions in pricing policies, impaired international competitiveness, and stagnant productivity.

The authorities reacted by introducing, in late October 1995, a package of corrective measures, consisting of a devaluation of the rupee by 7 percent and fiscal measures in an amount equivalent to 1.7 percent of GDP on an annual basis, including a

10 percent regulatory duty on imports. Nevertheless, expenditure overruns and stagnant revenue fully reversed the fiscal adjustment achieved in 1993/94–1994/95, and the budget deficit widened again to close to 7 percent of GDP. The 7 percent devaluation—in the absence of a tightening of fiscal policy and in the context of an accommodating monetary policy—proved insufficient to halt the deficit, which expanded to a record high of close to 7 percent of GDP ($4.4 billion). This deteriorating trend continued in early 1996/97, leading to a depletion of gross reserves and bringing the economy yet again to a near foreign exchange crisis. In response, the Government introduced a second package of corrective measures in October 1996, including a devaluation of 8.5 percent and fiscal measures amounting to 1.5 percent of GDP. In 1996/97, in the context of renewed political instability that undermined private sector confidence, growth declined to 3.1 percent, barely sustaining the level of real GDP per capita. This poor performance was led by a negative growth of major crops, with repercussions on all other sectors. Growth of large-scale manufacturing has been particularly weak and became negative in 1996/97.

The fiscal year 1997/98 was marked by political and constitutional crisis and the impact of the East Asian crisis. It ended with the dramatic events of nuclear testing by India and Pakistan amid threats of sanctions from some Western countries. According to official estimates, real GDP grew by 5.4 percent supported by good crops and recovery in the manufacturing sector led by the sugar industry. Inflation came down from 11.6 percent to 8 percent in the first 10 months. On the external side the current account deficit fell sharply as imports were cut due to effective demand management policies and a general slowdown in the economy. The reserves grew slightly to about $1.2 billion, reflecting some improvement in exports, workers' remittances, and a sharp increase in the inflow of resident FCDs. The main weakness was in tax mobilization efforts, which together with lower imports belied the official estimate of robust GDP growth rate.

Gross national savings continued to fall short of the country's investment expenditure, with the gap rising from 3.6 percent of GDP in 1993/94 to 6.6 percent on average during 1996/97–1997/98. The available data suggest that the widening of the savings-investment gap was primarily caused by a sharp deterioration in national savings (about 12 percent of GDP) due to a decline in private and public savings. Domestic investment also decreased marginally (to about 18 percent of GDP), with an increase in private investment offsetting most of the decline in public investment.

Reflecting the savings-investment imbalance, Pakistan's external accounts deteriorated substantially over the three years ending 1996/97. The current account deficit, which had been contained between 4 and 5 percent of GDP since 1988/89, widened to 6.8 percent of GDP in 1995/96. This was mainly driven by import growth exceeding 16 percent in dollar terms on account of loose demand policies, and in the absence of timely exchange rate adjustments. The deterioration of the current account deficit was hardly reversed in 1996/97 as imports and exports declined. In 1997/98 the deficit was less than 5 percent of GDP mainly on account of import contraction.

The overall balance of payments turned from a surplus in 1994/95 to increasing deficits during the next three years, amounting to more than $1 billion in 1996/97. The capital account surplus rose in 1995/96, mainly through public short-term borrowing and the accumulation of FCDs by nonresidents. However, these short-term inflows could not be sustained in 1996/97, in part because of the unstable political situation. As a consequence, the deficit was largely covered by a depletion of the official reserves—from the equivalent of 12 weeks of imports as of end-1994/95 to less than three weeks in late 1996/early 1997, before partially recovering in June 1997/98. From 1995 to 1998, the total external debt (including

the financial institutions' external liabilities) increased substantially, reaching $30 billion at end-June 1998.

Developments in exports and imports have displayed great variability over the last six years, reflecting Pakistan's dependence on agricultural output and highly volatile world prices, especially for cotton products. Export trends show an average growth in dollar terms of less than 5 percent compared to 8 percent in the 1980s. Persistent antiexport biases in trade and tariff policies, lagging structural reforms, and protracted commercial tensions in Pakistan's traditional markets are the main factors underlying the declining export performance. Import growth was slightly lower than 5 percent during the same period in dollar terms, slightly less than GDP growth. The country's terms of trade have deteriorated by more than 10 percent cumulatively since 1993/94, reflecting a sharp increase in the price of key imported commodities (petroleum products, wheat, edible oil) and, more recently, a decline in world prices for its major exports (cotton and rice).

Pakistan was able to increase the mobilization of capital inflows in 1995/96 to cover large current account deficits, mainly through FCDs and short-term debt. This strategy, however, rapidly gave rise to adverse market anticipations, accelerating the depletion of official reserves and precipitating the foreign exchange difficulties in the second half of 1996. Following the elections, market confidence has been increasing with the Government's package of structural reforms, and some international lenders have renewed their interest and support. Resident FCDs increased by nearly $1.7 billion during 1997/98. However, nondebt creating inflows, particularly foreign direct investments (FDIs), are still sluggish and the external situation remains fragile.

Gross official reserves (kept by the SBP) were held above 12 weeks of imports in 1994/95, but fell to five weeks of imports by end-1996/97 ($1.2 billion). During the near exchange crisis of September–October 1996, official reserves bottomed out at $600 million, equivalent to less than three weeks of imports. This was followed by a gradual recovery after the announcement of the October 1996 policy package (which included an 8.5 percent devaluation of the rupee), the reduction of political uncertainties in the first half of 1997, and the launching of the new Government's economic program. Foreign exchange reserves stood at $700 million at end-August 1998.

Pakistan's fragile external reserve position is compounded by the accumulation of short-term foreign currency liabilities by the banking system, mostly residents' and nonresidents' FCDs. About 40 percent of the $11.5 billion stock of FCDs at end-June 1998 were demand deposits, while the rest were time deposits concentrated in three-month to one-year maturities.

With a stock of public and publicly guaranteed external debt amounting to $29.6 billion at the end of 1996/97, Pakistan may be regarded as a highly indebted developing country. As a ratio of exports of goods, services, and private transfers, the public and publicly guaranteed debt was close to 220 percent at end-1997/98, and the related debt service reached 27.9 percent. Given the relatively limited openness of the country, the debt-to-GDP ratio has been contained to less striking levels—43.8 percent in 1996/97, a slight drop from 44.5 percent in 1994/95. However, the decline in the external debt to GDP ratio has not reduced Pakistan's vulnerability to exchange rate fluctuations, because of the SBP forward cover mechanism for FCDs.

The Liberalization Process, 1988–1998

Monetary Policy

To support structural reforms in the areas of fiscal and trade policies, the Government initiated reforms in the financial sector and in monetary policy in 1987/88. While continuing to exercise credit control through direct methods, it took steps to improve debt

management and promote the establishment of a capital market. It also rationalized the rate structure of the National Savings Scheme (NSS) and introduced market-oriented rates of return on government debt instruments, including short-term Treasury bills (T-bills), as a prelude to eventually adopting market-oriented techniques of monetary control. The auction of government securities began in March 1991.

While foreign currency accounts for nonresidents were introduced in 1973, resident FCDs were deregulated in February 1991. Both types of accounts are protected from disclosure requirements regarding the source of funds. The interest rates payable on these accounts are capped at fractions of a percent above the LIBOR (London interbank offered rate), varying with maturity of deposit. Commercial banks are required to surrender foreign exchange to the SBP in a swap agreement, with the period of the swap corresponding to the initial maturity of these deposits. In June 1992, the SBP phased out its policy of providing free full forward-exchange cover to financial institutions with respect to these deposits and introduced a forward exchange fee of 3 percent of the deposits per year.

On 1 July 1992, the SBP adopted the credit-to-deposit ratio and the auction of T-bills to develop its ability to control monetary and credit aggregates, although direct credit controls also remained operational. It also limited the use of mandatory lending and credit to nonbanking financial institutions (NBFIs). The objectives of financial sector reform at this time were to:

- strengthen financial intermediation through the rationalization of structures of rates of return on a wide range of debt instruments,
- reduce the distortionary effects of mandatory and concessional credit allocation,
- strengthen the financial system through enhanced supervision and regulation, and
- encourage private sector participation in domestic banking.

Privatization of banking has been an important component of the authorities' financial sector reform program. It was intended to increase the competitiveness and efficiency of the banking system. Before the reform program, nationalized commercial banks (NCBs) dominated domestic banking. Since their nationalization in 1974, the NCBs had lost their commercial orientation, adversely affecting their efficiency, market responsiveness, and financial strength. Consequently, the Government sought private sector participation in domestic banking through the privatization of NCBs and the establishment of new, privately owned banks.

In January 1992, the SBP issued new prudential regulations to enhance the supervision and regulation of the banking system. The new guidelines included 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 strengthened system of classification and provisioning for nonperforming assets (NPAs). In addition, amendments were made to the Banks' Nationalization Act of 1974 aimed at enhancing the administrative and advisory role of the Pakistan Banking Council in commercial banking.

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

In 1994/95, the Government continued efforts to move toward the adoption of indirect instruments of monetary control and took measures to liberalize interest rates further.

The development of the auction market for government securities has left the financial system of Pakistan with an important role. One of the reasons for this is that the rate of return on the T-bill gives an approximate idea of the market's valuation of a low-risk asset. In this context, the Government introduced the auctioning of government securities in 1991 and rationalized the structure of national saving schemes.

MARKET-BASED MONETARY CONTROL

Considerable progress has been made in the years prior to 1997 in the use of market-based instruments for monetary control. Building on the introduction of an auction system for government securities, the SBP has been managing domestic liquidity, to a large extent, by intervening in the secondary market through open market operations. For a period following the elimination of absolute credit ceilings, the limits for credit expansion by the commercial banks were determined through a credit-to-deposit ratio mechanism (which has also been abolished). Ceilings on lending rates have been removed and the scope of mandatory and concessional credit schemes substantially curtailed.

During 1997/98, monetary reforms were carried out further with greater reliance on market-based instruments, as follows:

- the authorities initiated a reform of the primary dealer system for government securities;
- T-bills covering a range of maturities (three and six months, and one year) were introduced by steps in 1997/98; and
- the existing six-month federal bonds were eliminated as they were not well suited for trading in the secondary market.

Within this improved environment, the operational procedures for open market operations were refined with a view, among other things, to reduce short-term interest rate volatility in the interbank market. This included introducing two-way open market operations and a deposit facility at the SBP to absorb surplus overnight funds; the SBP also changed the reserve requirement from a daily to a weekly average basis. As a result, public debt management improved through the channeling of an increasing share of financial savings into marketable debt instruments both broadening the market for government securities and ensuring comparable and market-related terms on the various debt instruments.

REGULATORY AND SUPERVISORY REFORMS

The Government views the weaknesses of the financial system as a leading factor behind the slowdown in the real growth of the economy, the decline in domestic savings, and the emergence of unsustainable macroeconomic imbalances. Accordingly, it has endorsed and is fully implementing legal and regulatory/supervisory reforms in this area, specifically:

- laws have been enacted to strengthen the authority and autonomy of the SBP, to insulate the State-owned banks and DFIs from political interference, to facilitate loan recovery, and to unify the banking court system;
- banking regulations have been upgraded and the SBP's supervision capacity is being strengthened; and
- the management of the State-owned banks and DFIs has been professionalized while action plans to reduce operating losses, principally through appropriate downsizing, are being implemented under the direction of the SBP.

The continuing strategy is to insulate the banking system from political interference in order to provide proper governance and impose financial discipline. Further reforms will be based on a three-pronged approach, as follows:

- privatization of banks and DFIs. The privatization plan calls for divestiture of the Government's ownership interests in the banks and replacement of the bad assets (net of capital and reserves) of these institutions by government securities at the time of their privatization. In addition, with technical assistance from multilateral institutions, the Government is studying possible privatization of two mutual funds (Investment Corporation of Pakistan and National Investment Trust), as well as an insurance company (State Life Insurance Corporation);
- enhancement of the ability of the SBP to supervise banks and effectively enforce regulations (see Appendix 1); and

- improvement of the legal environment for loan recovery and enforcement of financial contracts.

In addition, further steps are being taken to enhance the regulatory and supervisory system, and to improve the legal environment and strengthen judicial institutions for loan recovery.

After Pakistan conducted nuclear tests on 28 May 1998 amid threats of economic sanctions from the United States and some other countries, the SBP, fearing that depositors would withdraw their FCDs, stopped all foreign exchange withdrawals from both resident and nonresident foreign currency accounts. However, depositors were allowed to encash their deposits in rupees at PRs46/$ while the official exchange rate was PRs44/$. In the ensuing days, the exchange rate in the open market fluctuated widely, rising as high as PRs70/$. By 12 September 1998 the rate was PRs58/$. On 22 July, the Government announced that exporters and importers would exchange their currencies at the average of the official exchange rate and the interbank rate, which was hovering at around PRs54/$. The Government has offered five-, seven-, and ten-year foreign currency bonds for nonresident depositors, but with little success so far.

Fiscal Policy

The consolidated federal and provincial fiscal deficit, which was 6 percent of GDP or more in the 1980s, reached 8.5 percent of GDP in 1987/88, and became unsustainable. The overall public sector borrowing requirement was even larger due to large deficits incurred by public enterprises, the main factor behind Pakistan's economic difficulties. Thus fiscal reforms have remained the main focus of the continued stabilization and structural reform efforts of successive governments since 1988. The deterioration of the country's fiscal position was reflected, among other things in persistent expenditure overruns and weak revenue generation system, including the narrow tax base, inelastic tax system, and a heavy reliance of revenues from international trade taxes. The medium-term fiscal reform initiated at the time aimed to reduce the deficit through structural reform of direct and indirect taxes and a forceful restraint of current spending (see Appendix 2).

TAX REFORM

The thrust of the tax reform program is to promote a more equitable distribution of the tax burden and greater compliance with tax documentary requirement. The salient features of the reforms are reductions in tax rates and a broadening of the tax base to include previously untaxed income and undertaxed sectors, supported by improvements in tax administration. These actions are being taken in the context of a new revenue-sharing arrangement under the 1997 National Finance Commission Award between the federal Government and the provinces, which has incorporated all federally collected taxes into the divisible pool and established a uniform sharing ratio across taxes. The new arrangement has removed the strong disincentive to tax reform that was associated with the allocation of most import taxes to the federal government and the bulk of revenues from domestic taxes to the provinces. Removal of this major structural distortion has provided an environment conducive to progress with reforms at both the federal and provincial levels. As a result, provinces will be able to reduce their dependence on nonmandatory grants and loans from the federal Government and, with a strengthened own-resource mobilization effort, will be able to better forecast and protect their priority expenditures on basic social services.

Significant progress has been made over the last two years in reforming the General Sales Tax (GST) into a modern, broadly based value-added tax. Important amendments to the 1990 General Sales Tax Act were introduced in June 1996, expanding the horizontal coverage at the manufacturing and import stages, removing excise-type features, and establishing a turnover threshold for registration. This was followed by improvements in the 1997/98 budget, including compulsory registration of importers,

wholesalers, and distributors, and abolition of replacement invoices; effective extension of the GST to two major sectors of the economy, namely textiles and steel; improvements in refund procedures; and strengthening of the legal provisions to deal with delinquent taxpayers, curb tax fraud, and minimize evasion. Also, following a simplification in March 1997 in the 1997/98 budget, the GST rates were unified into a single standard rate of 12.5 percent.

Steps aimed at expanding the income tax base have already been taken, effective 1 July 1997. The concept of taxable income has been redefined to include perquisites in cash and in kind, and certain deductions have been reduced. With regard to the rate structure, personal income tax rates have been decreased to 5, 10, 15, and 20 percent (from 10, 20, 30, and 35 percent, respectively) while corporate tax rates have been lowered to 30 percent for public limited liability companies (from 33 percent), to 35 percent for private limited liability companies (from 43 percent), and to 55 percent for banks (from 58 percent). These changes took effect on 1 July 1998.

The Government committed to implement meaningful taxation on agricultural income. The recent enactment of land-based taxes by all four provinces represents a breakthrough in the tax policy area. The imposition of these taxes is expected to meet the dual objectives of promoting equitable sharing of the tax burden across different sectors as well as tapping a potentially significant additional source of revenues for the provinces. Initially, the provincial governments opted for a presumptive land-based tax, with exemption limits based on farm size, and variation in rates by irrigation status and coverage of types of farmland across the four provinces. The land revenue will continue to be collected with this new tax. Simultaneously, domestic output prices (especially wheat) in the agricultural sector will be set at border prices to reverse the deterioration of the terms of trade of agriculture that has taken place in the past, while credit availability to agriculture will be enhanced.

REFORM OF TAX ADMINISTRATION

Efforts are being initiated and will be intensified over the next three years to improve tax administration in support of the above policies regarding the GST and income tax. In this context, the Central Board of Revenue will be strengthened through incentives to assure continuity in recruitment, and will be provided with appropriate resources to acquire and maintain suitable facilities, equipment, and supplies. To promote voluntary tax compliance, an information exchange program encompassing income tax, GST, and customs is being developed. The Central Board of Revenue is being restructured under a new leadership from the private sector, into the Pakistan Revenue Service (PRS) with the aim of improving tax administration. The capacity of the PRS is being strengthened, tax collection processes reengineered, and management improved. Enhancing the tax administration will be a challenging task for the Government since the costs of adjustment will have to be borne at a time when revenues are declining (due to a shrinking economy). Moreover, tax reform is changing the emphasis from traditional sources of revenue, while taxpayers' willingness to pay is at a low point due to poor provision of public services.

EXPENDITURE REFORMS

In line with the policy to emphasize greater effectiveness and improve developmental impact, in 1996/97 the Government took measures to control the level of expenditures, rationalized its investment program, and made considerable progress in reducing spending on lower-priority activities. Expenditures on defense, civil administration, and subsidies have been contained in nominal terms, while nonpriority expenditures of the development budget have been sharply cut.

With regard to the Public Sector Development Program (PSDP), the authorities continued to better prioritize, manage, and implement the Federal PSDP and will encourage the provinces to make similar efforts. The Planning Commission has shifted its fo-

cus toward strengthening the monitoring and evaluation of the PSDP. The Government has recognized the need to restore public investment in core areas of public sector responsibility.

Exchange Rate Policy

Before 29 May 1998, the exchange rate arrangements of Pakistan consisted of a managed float under which the SBP set the daily exchange rate at which it would purchase and sell dollars (the intervention currency) in its dealings with authorized dealers. The rate was adjusted frequently, taking into account the competitiveness of the tradable sector and the need to contain inflationary pressures.

Since 1982, the Pakistan rupee has been unpegged from the dollar and operated in a floating rate system based partly on a trade-weighted basket of major currencies. Market forces played a limited role in the short-term determination of the exchange rate, since the SBP fixed daily buying and selling exchange rates in transactions with banks and other authorized dealers.[1] In recent years, the SBP has sought to manage the rupee/dollar rate in a way that strikes a balance between containing inflationary pressures and maintaining a competitive tradable sector. This policy has resulted in long phases during which the SBP implements minor "technical" adjustments vis-a-vis the dollar, interspersed with more substantial step devaluations that have allowed the real effective exchange rate to recover eroded competitiveness.[2]

FOREIGN EXCHANGE REGULATIONS

Pakistan has a highly liberalized foreign exchange system. As of July 1994, it has adopted current account convertibility of the rupee and removed all multiple currency practices. As a result, it has accepted and fulfilled its obligations under Article VIIl of the Articles of Agreement of the International Monetary Fund (IMF).

Pakistan's foreign exchange regulations have also been liberalized for most aspects of the capital account. There are no restrictions on repatriation of profits and capital associated with FDIs. Before 29 May 1998, residents and nonresidents were allowed to maintain foreign currency accounts and were free to transfer their balances abroad.

The SBP has delegated authority to a number of banks and financial institutions to deal in foreign currency, to supervise surrender requirements, and to sell foreign exchange. Exchange receipts and payments abroad must be effected through an authorized foreign exchange dealer in any convertible currency. Letters of credit for imports must be established in foreign currency except certain settlements with specified countries. Payments for invisibles are controlled by the SBP and, in some cases, require prior approval.

Exporters are obliged to collect and surrender foreign exchange receipts with the SBP within four months of shipment, although the SBP may allow an extension to this period. Since 22 July 1998, exporters are allowed to surrender half of their earnings to the interbank foreign exchange market.

In recent years, the SBP took important steps leading to a gradual withdrawal of the SBP from its earlier central role in the foreign exchange market and the development of an interbank foreign exchange market.

After 29 May 1998, with the freezing of foreign exchange accounts, the rules and regulations were changed.

FOREIGN CURRENCY DEPOSITS

Before 29 May 1998, residents and nonresidents could open foreign currency accounts with banks and NBFIs. Since current banking regulations prohibit banks from lending in foreign currency and permit them to maintain only small uncovered positions in foreign exchange, banks surrender these deposits to the SBP against rupees for on-lending in Pakistan. The banks are then required to close the open position by purchasing a forward contract from the SBP.

On 29 May 1998, the SBP suspended withdrawal of foreign currency from all foreign currency accounts. Withdrawals could only be made in rupees at PRs46/$.

CAPITAL ACCOUNT RESTRICTIONS

Several minor additional liberalization measures regarding capital inflows have been implemented since 1994/95. Most of Pakistan's remaining restrictions on capital movements pertain to outward transactions. Residents (including firms) are not permitted to invest abroad except by purchasing foreign exchange bearer certificates.[3] Permission is subject to the condition that all proceeds should be repatriated to Pakistan through normal banking channels. Regarding inflows, foreign-owned companies can borrow any amount abroad but they need to obtain Government and SBP approval for the issuance of the debt instruments abroad.

Trade Liberalization

TARIFF REFORMS[4]

Pakistan has gradually liberalized its tariffs over the last few years, including a sequential reduction in the maximum tariff rate from 225 percent in 1986/87 to 65 percent in 1995/96. Until end-March 1997, however, the country's complicated and exemption-laden tariff regime continued to give rise to high levels of effective protection, nurtured inefficient industries, generated a strong antiexport bias, put a heavy burden on consumers, diverted resources to rent-seeking activities, and encouraged corruption and smuggling. It consisted of statutory rates modified by a comprehensive set of end-user exemptions and concessions, most of them linked to sectoral and regional policies, thus making it in effect a dual system, where about 40 percent of imports received special treatment.

Efforts to reform the tariff regime were limited and sometimes reversed during the period under review. The 1995/96 budget reduced the maximum import duty rate from 70 to 65 percent, but increased several intermediate rates for revenue purposes. Shortly after, with the stabilization program that accompanied a 7.5 percent devaluation of the rupee, the authorities reversed further the liberalization process by introducing a temporary 10 percent regulatory duty on imports.[5] The liberalization process resumed in March 1997 as the new Government reduced the maximum tariff rate to 45 percent and merged the 14 duty rates into a six-band system (10, 15, 20, 25, 35, and 45 percent). The 10 percent regulatory duty was eliminated, except on a few items, and the list of zero-rated imported goods was reduced to a minimum. As a result, a number of exemptions and concessions became redundant. An outcome of this reform is that the average rate of import duties is estimated to have fallen from 19 to 17 percent, with a significant parallel reduction in the dispersion. However, several tariff positions remain overly detailed and are characterized by the distinction between goods made in Pakistan and others.

Pakistan continues to use a system of import trade prices, rather than actual transaction values, in determining import values for customs purposes for a substantial proportion of imported items. The system, thus, spawns overstatements of import values, which leads to additional import protection. Under the General Agreement on Tariffs and Trade (GATT) Uruguay Round, Pakistan is committed to an invoice-based system by the year 2000, and to adjusting its Customs Act accordingly. The authorities have cancelled, effective March 1997, the contract of preshipment inspection with the Swiss company Société Générale de Surveillance, which had been in force since 1995.

Apart from the remaining import restrictions, mainly based on health, security, environment, and religious reasons, there are at least 28 nontrade barriers aimed at protecting local producers, and several schemes restricting imports. The negative list, which has been reduced to 68 items (from 214 in 1989) still contains several textile items that can com-

pete with local products (cotton fabrics, carpets, and other textile floor coverings, knitwear, and bed linen). At least 17 products are subject to procedural requirements, that *de facto* restrict imports, some of which are clearly geared toward protecting local industry. These include motor cars—which can only be imported unassembled and according to a specific program of progressive replacement of the imported parts by locally manufactured parts (the "deletion program")—and tractors.[6] Imports of petroleum products, lubricants, and specific inputs for the oil industry require administrative authorization, to protect the local petroleum industry.

EXPORT PROMOTION POLICIES[7]

Pakistan has pursued an export promotion policy in one form or another since the late 1950s. One such policy was the export bonus scheme that operated from 1959 to 1972. The foundation of the existing export incentive system was laid in 1972 following a devaluation and unification of the exchange rate system. The export incentive system during the 1970s was designed in particular for manufactured exports and included the following:

- exemption of exports from sales tax and central excise duty;
- a duty drawback scheme covering sales tax, central excise duty, and customs duty on inputs used in exports;
- export tax on raw material used in exports;
- a concessionary finance and export credit guarantee scheme; and
- facilities for import of raw materials and machinery used in the manufacture of exports.

However, these export incentives were limited in comparison to incentives for domestic production. Economic policy, in general, also had a bias in favor of import substitution activities.

The year 1988 was a milestone in economic policy making in Pakistan as the country turned decisively from inward-looking policies toward trade liberalization and export promotion. These outward-looking policies were consistently strengthened by successive governments. There was significant progress in the liberalization of the exchange and trade system, reform of the financial sector, liberalization of domestic and foreign investment, and initiation of a wide-ranging privatization program that opened up areas of the economy previously reserved for the public sector.

The current system of export incentives in Pakistan is based on three elements:

- concessional tariff rates on imports for re-exports, including a duty drawback system that allows reimbursement for import duties and domestic taxes paid on imported inputs that enter production for exports;
- exemptions under EPZs and bonded warehouses; and
- export financing at concessional rates through a refinancing facility provided to commercial banks by the SBP. Duty drawback rates were substantially increased in October 1995. More recently, export incentives have been made more attractive, including accelerating duty drawback repayments, zero-rating of imports of raw materials used mainly for exports, and making a wider range of exports eligible for concessional export financing schemes.

Despite considerable progress, as reflected in the substantial growth of export earnings, there is still much scope for improvement both in the design and implementation of trade liberalization and export promotion policies. Pakistan faces a number of tariff and nontariff restrictions on its exports, some of them requiring specific export policies. On textile products, the share of restricted exports is estimated at 63 percent. The authorities have introduced some improvements in these policies as well as in the country's capacity to react promptly to growing commercial disputes with its main trading partners.

Pakistan has been managing, since 1974, a system of quotas for textile products imposed by Canada, European Union, Norway, and US under the

Multifiber Arrangement (MFA).[8] The arrangement was amended and integrated into the GATT Uruguay Round concluded in 1993, under the Agreement on Textiles and Clothing (ATC). As provided by the ATC, the MFA is to be phased out in stages by 2004, with the importing country transferring to normal World Trade Organization (WTO) rules. This is not immediately expected to make a substantial impact on Pakistan's textile exports. In addition, the liberalization process for textile products has been counteracted by the multiplication of antidumping and countervailing investigations; in 1996/97, three of Pakistan's largest export items (cotton yarn, fabrics, and bed linen) were subjected to antidumping duties.

The existence of quotas has required a complicated administrative system that has imposed hidden costs on the economy. In the past, the allocation of quotas was often viewed as discretionary and politically motivated, leading to efficiency losses and expensive trading among exporters. The authorities have taken steps to make quota allocations more efficient, progressively shifting from a quantity-based to a value-added system. However, quotas remain allocated to established exporters, which makes it difficult for new exporters to break into the export allocation system.

Exports of noncotton products have increasingly faced trade barriers, as public opinion in industrialized countries has registered growing concerns about labor, environment, and health standards in developing countries in general, and in Pakistan in particular. For instance, the US withdrew the Generalized System of Preferences for carpets and rugs, sports goods, and surgical instruments on 20 October 1996, over the issue of poor labor standards in Pakistan, including those relating to child labor. Moreover, surgical goods have been facing antidumping measures and import restrictions for health and safety reasons, including the need to meet international standards such as the ISO 9000 series.

Investment Policy[9]

Tariff policy remains one of the most important policy instruments to influence resource allocation or investment decisions, through its impact on relative prices and profitability in the country. However, this impact is eroded to a large extent by the Government's credit policy and its investment policy administered through the BOI. Furthermore, DFIs and commercial banks are formally and informally guided by the Government in selecting particular industrial sectors for venture capital investment. Apart from the export processing zones, there is no separate institution for financing investments in export activities.

The BOI was established as a "one-stop shop" to tap the opportunities for investment in Pakistan. It performs a facilitating and coordinating role for domestic and foreign investors to meet all their needs. It has launched a worldwide campaign of investment promotion and projecting Pakistan as an investor-friendly country.

Over the past few years, the Government has tried to encourage private foreign investment in various sectors of the economy. Foreign investment on a repatriatable basis in the services/infrastructure, so-

Table 1: Foreign Investment, 1992–1998 ($ million)

Item	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98 (July–March)
Direct Investment	310	360	440	1,106	703	436
Inflow	310	362	442	1,106	713	436
Outflow	0	2	2	0	10	0
Portfolio Investment	137	289	1,090	202	268	204
Inflow	137	289	1,090	205	268	204
Outflow	0	0	0	3	0	0

Source: State Bank of Pakistan. Annual Report (various issues).

cial, and agriculture sectors was also allowed, subject to certain conditions. In the past, foreign investors have been weary of kickbacks and other “gray” dealings in sanctioning various projects, but the Government has tried to mitigate their concerns through the Corrupt Business Practices Ordinance of 1998. Private foreign investment remains the primary focus of policy initiatives since the 1990s’ broad-based economic reforms were initiated and the stance of economic policy was changed from inward to outward looking.

Privatization Program

Privatization of SOEs has been pursued since 1991, following the wave of liberalization, deregulation, and minimization of the role of state in economic activity across the world. In the first two years the pace of privatization was rapid and 70 units were privatized, but after 1993 it slowed due to various factors such as demand for greater transparency and financial vulnerability of some of the units. The emphasis has been changed from speed to greater level of scrutiny and transparency. The slower pace is also due to Government efforts to restructure public enterprises and institute a regulatory framework before privatization to minimize any negative impact.

The SOEs identified for privatization are divided into three categories, as follows:

- small manufacturing units and thermal power generation of WAPDA, which are for outright sales;
- large-scale manufacturing and services to be sold in suitable tranches on the national and international stock exchanges; and
- utilities and services such as electricity generation and distribution, banks, gas, and telecommunications, which will be first sold partially.

Privatization schemes and procedures have been designed to assure widespread dispersal of ownership (incorporating provisions for participation of employees and management) without excluding experienced entrepreneurs, especially in the sectors where managerial efficiency is of vital importance. These measures include transparency in the process of sale or transfer; thoroughness in the preparation of reports, information sheets, and bidding documents; and strong public awareness campaigns to build understanding and support among employees, investors, and the public.

Export Processing Zones Authority

To exploit the full export potential of Pakistan, the Export Processing Zones Authority (EPZA) was established in 1980. Its purpose was to plan, develop, and manage EPZs in economically viable areas across

Table 2: Privatization of State-owned Enterprises

Item	1991/92–1993/94	1994/95–1995/96	1996/97	1997/98	Total
Automobiles	7	0	0	0	7
Cement	9	2	0	0	11
Chemicals	7	5	0	0	12
Fertilizers	1	0	0	0	1
Engineering	5	2	0	0	7
Ghee	16	0	0	0	16
Rice	7	1	0	1	9
Roti plants	12	0	0	1	13
Banks	2	0	2	1	5
Power	0	1	0	0	1
Hotels, Resorts	0	0	0	8	8
Miscellaneous	4	2	0	0	6
Total	**70**	**13**	**2**	**11**	**96**

Source: Privatization Commission.

the country. The Karachi Export Processing Zone was its first project in 1981, with the objective of attracting foreign capital, technology, and modern management skills for export-oriented industries as well as opening new employment opportunities for the country's workforce.

Industrial Estates

Soon after Independence, given the country's low industrial base, policymakers banked upon small industrial estates to groom an entrepreneurial class that was nonexistent at the time. Pakistan's first industrial estate, the Sindh Industrial Trading Estate Ltd. Karachi, was established in 1947. The number of industrial estates increased to 72 by the end of March 1997. Industrial estates enjoy varying degrees of exemption from customs duty on imported machinery, and have other incentives and facilities available under the rural industrialization scheme, where applicable. Infrastructure facilities are also provided to these industrial estates.

Assessment of Degree of Globalization

As Pakistan has become more tightly integrated into world trade and financial markets, prospects for growth will be increasingly influenced by changes in the external environment and by policy responses to those changes. Although integration provides new opportunities for expansion, it also broadens the channels for transmission of external shocks commensurably.

Greater linkages have better positioned the country to take advantage of expected stronger growth in world trade, of markets opening to free competition in textiles and related goods covered by the MFA, of significant potential in the area of "long-distance" services trade and an accompanying reduction in pressures for migration, and of increased availability of external finance from private sources, especially FDI and portfolio equity flows. All of these factors are broadly supportive of domestic private sector activity and improved economic growth performance.

But at the same time, competition for export market share in basic manufactures is likely to be strong, and the increasing trend toward regionalism in trade (North American Free Trade Area [NAFTA], Asia-Pacific Economic Cooperation [APEC], and eventual eastward expansion of the European Union) confronts Pakistan with the risk of possible marginalization within the context of larger blocs. Moreover, despite the potential benefits of removal of MFA restrictions, long-run income elasticities for textiles and related products are low, particularly in contrast with higher-technology manufactures. Continued reliance on cotton and cotton-based products could subject the country to high degrees of uncertainty and potential instability of export revenues.

Additionally, the risk of escalation in prices of oil, food, and raw material (as occurred during 1994) could boost import bills significantly. Financial uncertainties facing Pakistan in a more integrated world economy include an expected further decline in global aid, potential volatility of private capital flows, and exposure to the risk of higher international interest rates and to swings in key currencies.

The pace of Pakistan's trade and financial integration has been largely favorable, but there remains a significant gap with the country's competitors.

As globalization accelerates in the coming decade, policies will need to be shaped not only to capture the opportunities for growth, but also to manage increasing exposure to risk in the external environment, such as financial shocks, including rapid shifts in major currency values as well as volatility in oil and commodity markets.

Macroeconomic Policy Management

Extending the basic economic programs of previous administrations, the Government has undertaken structural reforms and stabilization measures to stimulate growth, reduce inflation, improve the balance of

payments, and strengthen Pakistan's competitiveness in world markets. These initiatives have been formalized in a three-year economic program (July 1997–June 2000), supported by financial assistance from the Asian Development Bank (ADB), IMF, World Bank, and bilateral donors. Six months into the program, serious concerns arose about the reform process.

The performance of key economic variables should not be judged on a monthly basis since there are conflicting indications about the direction of inflation and balance of payments. Yet it is safe to infer that economic activity is in deep recession, inflation persists, and external reserves are not improving. Inaction and conflicting statements and signals from top functionaries, even before most of the structural reform policies have been implemented, suggest a lack of commitment and stamina on the part of the Government. To worsen the problem, some miscalculations are apparently emerging about the response of the economy, the size of the markets in Pakistan, and the combined impact of some of the structural policies being implemented. To top it all, financial support from the multilateral agencies to support such an extensive reform process is too small.

Reducing the fiscal deficit is one of the most important corrections needed. Not only is the extent of fiscal adjustment a subject of debate, especially in a three-year context, but the quality of adjustment also needs review. Government efforts to achieve more revenues from income and sales taxes have suffered for several reasons. First, no attempt has been made to promote people's willingness to pay taxes by improving the public services for which people are purported to pay taxes; nor have equity concerns, both horizontal and vertical, been adequately addressed. Public perceptions about tax evasion by influential people persist. Refusal to pay taxes by groups of communities has been weakly addressed. Although the latter phenomenon partly reflects the erosion of State authority due to its bad reputation, it is also due to the Government's bowing to political considerations at the expense of the larger national interest. It can also be argued that part of the problem is due to the Government's inadequate preparation for launching a sales tax at the retail level. Second, while it was a good idea to reduce marginal income tax rates, it was naive to expect voluntary payment of taxes. There is hardly any community in the world that would do so, not to mention a society that is being taxed for the first time. Third, an equally simple-minded approach was used to improve tax administration by sacking a few officers here and there summarily without due investigation of their offenses. Many taxpayers would agree on the predatory and exploitative attitude of some tax officials, but changing that requires a reengineering process, change of management, and the introduction of checks and balances. Government action has not made tax assessment more just, revenues have not increased, nor has the morale and efficiency of the tax administration improved. Recent efforts to form a Pakistan Revenue Service will require the induction of a number of tax experts. Irrespective of how well the Government improves tax administration, it should not overestimate the speed of transformation from informal to formal economic transactions to facilitate tax collection. The Government has overestimated revenue increases from income and sales taxes, and in anticipation, decreased tariffs accordingly. Reductions in maximum tariffs have been too rapid, especially since tariffs on intermediates and raw materials have not been fully adjusted to allow domestic industry to cope with lower protection.

On the expenditure side, apart from a wavering commitment to downsize or rightsize the bureaucracy, the Government has undertaken no extensive or in-depth reviews to improve the efficiency of its spending. Cuts in the development budget are most prominent. However, efforts to continue the process of identifying a core development budget that is immune to cuts and leaves enough room for new projects in the following years is an encouraging sign. But all fiscal efforts are discredited by the pursuit of large

and costly luxury projects such as freeways, airports, and rail systems that cannot be justified in terms of relative rates of return. The obsession with freeways illustrates the general approach to Pakistan's development. While many would agree that a well-developed road network in the country would contribute greatly to the development of agriculture, industry, and commerce, few would agree that this "need" translates into a single freeway between two cities. Contribution to development would be much higher if, for the same cost, a system of parallel roads (also of international standard) was built between every major city in the country. The populace at large would benefit as would the economy. The Government needs to be fiscally responsible and to spend national resources wisely and not according to its whims. The Planning Commission has time-tested methods of selecting projects for development. If these procedures are circumvented, it would not be surprising if the country were further burdened by debts and inflation as a result of projects with low economic return rate (such as freeways). The selection of grandiose projects is all the more unjustifiable if the scarcity of resources, the threat of bankruptcy, and the pitiable condition of the majority of the population are considered.

Trade liberalization policy through tariff reforms has been pursued to reduce protection to import-substituting industry and to encourage the export sector, so that existing industries would become more efficient and new resource allocation would shift toward more competitive export industries. Although the process of trade liberalization began in 1988, there are still no discernible indications of benefits. Instead, there are examples of industries closing down. The fault is not the policy itself, but its implementation. First, the pattern and schedule of tariff reductions have not been followed, resulting in a squeezing of tariff slabs to protect revenue generation on raw materials, and sending mixed signals to the market about price changes. Second, tariff cuts have been too rapid to allow industry to restructure and there is no financial and technical support available to help it do this. Third, while Pakistan has been quick to liberalize imports, export production has not been supported directly in an adequate manner. New investments and sales efforts in exports are hampered by lack of market intelligence, insurance devices to spread risks, and the reluctance of banks to lend for new projects, products or markets, or to support new exporters. This is a serious problem since expansion of exports comes from precisely these areas. The Government and external financing agencies contemplating further assistance in trade liberalization should shift their focus from programs to further reduce tariff for the time being (except on inputs) to direct assistance to the export sector in improving marketing and technical know-how, enhancing productivity, reducing overhead costs, and accessing credit.

There is a consensus in the country toward privatizing public corporations. However, the poor financial state of the corporations and the slowdown in economic activity have been major constraints to privatization. Apart from the general demand that the process should be transparent and proceeds should go to retire public debt, there are other considerations that warrant a careful review of existing policy. There is an urgent need to consider the capacity of the domestic market to absorb large public assets accumulated over many decades. This is against the backdrop of banks preparing to sell PRs120 billion-worth of collateralized assets to recover bad loans. Moreover, the capital market is underdeveloped and mobilization of equity is a serious impediment to investment in the country. Hence, the policy question is whether to divert the limited private sector investment capacity to purchase inefficient public investments (which would effectively mean a transfer of assets to the national Government, not new investments) or to encourage the private sector to invest in new, high-technology, high-value export-based industries. Lack of information about new investment opportunities has tended to bias market decision in fa-

vor of public assets. This will have significant consequences on industrial investment in the country and will undermine its ability to compete and develop further its export potentials. Another consideration in privatizing public corporations is the need to introduce professional and autonomous management in corporations before they are privatized. This will minimize further losses and prepare corporations for private ownership and management.

More problems confronting the economy include the hugely indebted public corporations and the inadequate financial resources of WAPDA. There are pressures to deal with the latter issue through tariff increases, particularly in electricity. However, there are arguments against raising tariffs on a continued basis to address WAPDA's fiscal gap. First, a tariff increase will not only be unbearable to consumers but will cripple an already uncompetitive industrial sector. Currency devaluation may follow to shore up the uncompetitive industries. Since fuel prices are indexed to the exchange rate, a spiral of inflation would result. Second, WAPDA is a monopoly and therefore, its distribution losses of 29 percent of generated power can be largely attributed to the company's inefficiencies. Thus, passing on the cost of these inefficiencies would be unreasonable. It is estimated that about PRs1 billion could be saved for each percentage point reduction in line losses.

Related to this problem is the financial obligation to buy back all private sector power when it comes on line. With economic activity in recession and consumer demand adjusting to higher prices, WAPDA's and Pakistan's financial woes will become more complicated. The issue is that electricity for immediate consumption is a nontradable good, which the nation has to produce using dollars and sell locally in rupees, causing a drain on foreign exchange. Unless users of power generate (or save) enough foreign exchange earnings from their products, the net result will be a drain on reserves. Some people have argued for a renegotiation of the buyback price with private generators. This will create a dilemma for the Government. On the one hand, reopening a deal reduces the credibility and reliability of investing in Pakistan to foreigners, while on the other, the country could face financial collapse. It would probably be best for the managers of the power industry to realize their collective gains in suggesting and agreeing to a new price for an interim period, to help WAPDA and Pakistan overcome the medium-term problem, before resuming their earlier commitments.

The current economic program is the sum and extension of initiatives taken by various governments over the last 10 years. The menu of reform is extensive and ambitious in its targets. It is aiming to rectify distortions developed during many decades. It is also cognizant of the need to provide social safety nets to the labor force directly affected by the reforms. It equally recognizes the needs of industry and agriculture to respond to the new set of relative prices, competition, and opportunities. Most structural reforms by their very nature carry short-term costs and benefits that accrue in the medium term and, importantly, some of these reforms are mutually dependent for their success. Notwithstanding the unwavering commitment expressed by the Government to the total reform process, the resources committed in support of such an extensive program seem meager. During the three-year program period, total project and nonproject aid from multilateral and bilateral creditors committed so far ($12.2 billion) barely equals the amortization and repayments of official loans that are due during the same period. The remaining financing gap is expected to be filled by private sector medium- and long-term capital and short-term capital inflows. If the financial support is inadequate, the short-term costs will seem more burdensome and the benefits will accrue much later. In the process, the will and commitment to reform might falter, thus jeopardizing the entire reform process.

With the scarcity of concessional long-term financing, Pakistan has increasingly relied on costly commercial and short-term external borrowing. Although still a small proportion of total outstanding external

debt, short-term external borrowing has almost doubled in the four years ending in 1996/97. The total commercial debt as a share of total public and publicly guaranteed debt rose from 2.3 percent in 1992/93 to 7.1 percent in 1996/97. The Government has also relied heavily on FCDs to meet external financing requirements. During 1995–1997, inflows into resident FCDs have covered one fifth to two fifths of the trade deficit. As of 31 December 1997, the total outstanding balance in FCDs stood at $10.5 billion, equivalent to one third of total external debt. About 86 percent of foreign currency deposits are either demand deposits or have a maturity of one year or less. Nondebt-creating inflows have not improved in recent years, with total foreign portfolio and direct investment remaining below $1 billion in 1996/97.

TARIFF REFORM

The lack of progress in implementation of tariff reform is explained by a number of mutually reinforcing reasons. First, the tariff reform was undertaken simultaneously with an ongoing tax reform that aimed to broaden the tax base, improve people's compliance with income tax, and introduce a general sales tax. Before that, tax revenues were mainly from customs duties and, therefore, a reduction of these depended to a large extent on the success in mobilizing more revenue from income and sales taxes. Second, to complicate matters, a large fiscal imbalance existed even in 1993, and correcting it was crucial to stabilization of domestic prices and improving the external reserves position. With laxity in public current expenditures, and a need to reduce the fiscal deficit, there was no room left for pursuing tariff reform with rigor. Third, the proposed reduction in tariffs was relatively fast considering the Government's ability to develop alternative sources of revenue. Also, the three-year period for reaching the target rate of 50 percent from 92 percent in 1993 was too short for private industry to make adjustments. The plight of private industry was worsened by failures in policy implementation. For instance, the Tariff Reform Committee failed to follow its own advice and never announced a three-tariff schedule to clearly lay out the reduction in phases of tariffs. As a result, industry could neither plan accordingly, nor voice its complaints to the National Tariff Commission of impending anomalies. Furthermore, a supportive credit policy to help industry restructure in response to tariff changes was never put together. In fact, interest rates remained high throughout the period due to the large fiscal deficit. The policy of helping labor relocate in the event of industrial restructuring never arose, although the impact on employment could create additional pressures against restructuring. Most important, industrial profits were unduly squeezed when maximum tariffs on final products were reduced, but tariffs on raw materials and inputs were not reduced at the same time (as the latter were important sources of tax revenue).

The effectiveness of the tariff regime in general and of the reform process in particular was subverted and eroded in several ways by policies prior to 1993 that remained intact or resurfaced in new shapes during the reform period. First was the reintroduction of paratariffs in the form of surcharges. Second was the imposition of a regulatory duty of 10 percent on almost all imports (with a few exceptions at 5 percent). Rationalized by the Government for revenue considerations, the measure not only reversed the earlier reduction in statutory rates, but also decreased the differential in rates between raw materials, intermediates, and final products. The result was an unexpected and unjustified squeezing of domestic value-added in many industries. This led to demands for relief, which industry received through exemptions and modifications announced through self-regulatory organizations. The lesson to be learned is that across-the-board changes in tariffs of such a large magnitude (10 percent compared with a maximum of 55 percent) are bound to create anomalies in the tariff structure in a complicated real world where

items cannot be uniformly classified as inputs and outputs across all industries and firms.

The third factor undermining the effectiveness of tariff reform involved the administrative difficulties in controlling smuggling. High tariff rates themselves were a major disincentive to payment of duties and therefore provided the authorities with an incentive to speed up reform. But in effect, Pakistan's geographical proximity with Afghanistan (which has no administration to control illegal movements) and obligations to provide free access to the transit trade to its landlocked neighbor complicate matters.

Last comes the valuation of imports. In principle, Pakistan moved correctly toward preshipment inspection to help customs authorities determine price and classification of imports. But the cost of the service provided by the international companies was considered too high compared with the benefits accruing to the Government in the form of better customs revenue collection. Following the revelation of some mistaken valuations in a couple of cases, and due to lingering doubts about the appropriateness of the original preshipment inspection contract, the valuation of imports reverted back to the use of a customs international trade price manual. The latter method continues to suffer from customs officers' discretionary powers, with the potential for corruption.

In essence, the tariff reform process has become unpredictable. Not only has the Government failed to follow through on its announced path, but the above factors have complicated the impact of tariffs on domestic relative prices. As a result, it is difficult to claim that reforms have had a significant impact on resource allocation in the case of new investments. Much less can be claimed for any benefit for existing industry.

Tariff policy by its nature is a collection of diverse decisions regarding taxes on thousands of commodities. Tariff reform in Pakistan has attempted to introduce a certain degree of uniformity of treatment and cultivate an environment of automaticity while discouraging discretionary treatment of issues. Yet the complexities of the microeconomic world will warrant special treatment for certain situations. In view of the need to deal effectively with the seemingly conflicting aims of introducing uniformity and addressing special problems, proper implementation of the tariff reform is crucial to its success.

The most critical aspect of the implementation strategy is an unwavering commitment by the Government to implement the reforms in full. This will be continuously tested by those segments of the economy that bear the brunt of the adjustment costs. After all, tariff reform is proposing to redirect Pakistan's industry toward exports more decisively than ever before and in the process will affect an industrial base that has operated under a different policy environment for 50 years. Moreover, the commitment to change will also be tested by the bureaucratic and institutional mindsets that have grown accustomed to regulating industry. The implementation strategy must develop a momentum that can overcome the inertia generated by vested interests, while remaining responsive to the genuine problems of the adjustment process.

In addition, to facilitate successful implementation of the reform, the following are essential:

- the reform package should be announced well in advance of changes to allow industry and the labor market to adjust. The phasing and timing of changes, once announced, should be strictly adhered to. Industry should be given at least five years to adjust before the final maximum tariff rate of 35 percent is enforced;
- a clear and unambiguous articulation of the reform package, its contents, aims, and timing are essential to assure proper transmission of the incentives; and
- to accommodate the views of industry on the classification of items in various categories enjoying different duty rates, a standing committee should be set up in the National Tariff Commission, including representatives of the Central Board of Revenue and Ministry of Industries.

To help industry and the labor market to adjust to the changes in incentives, the Government should undertake the following measures:

- ensure adequate lines of credit through DFIs and commercial banks to finance industrial restructuring;
- set up labor retraining programs to enable swift absorption of displaced labor; and
- provide technical advisory services to the industries hit hardest by the reform, to facilitate their adjustment.

Finally, these principles should result in the preparation of model tariff schedules for each of the years covering the reform package. The National Tariff Commission should take responsibility for producing these and making them available to the private and public sectors for their comments and suggestions, before including them in the budgets for future years.

EXCHANGE RATE POLICY

The current exchange rate policy of the Government, with its dual objectives of restraining inflation and promoting exports, has been unsuccessful. Through periodic step devaluations following periods of relative nominal stability, the exchange rate policy has sought to recover the competitiveness of exports that has been eroded through domestic inflation that is higher than in trading partner countries. In effect, the policy has accommodated persistent fiscal and monetary slippages and provided the authorities with the assurance that expansionary financial policies would not erode competitiveness. In fact, targeting the real exchange rate index has failed to compensate exporters for the loss of competitiveness due to declining labor productivity and higher energy costs. At the same time, the exchange rate policy has contributed to inflation since the market has recognized the policy goals and discounted all devaluations through price and wage indexation. It would be preferable to restrict exchange rate policy to maintaining competitiveness, while monetary policy is assigned the exclusive target of inflation.

Vulnerability to Crisis

The financial crisis that hit five East Asian economies during 1997/98 resulted in large devaluations of their national currencies, sharp declines in stock prices, and substantial increases in interest rates as the countries attempted to stem the outflow of capital. The erosion of confidence following the crisis led to a severe cut in gross foreign capital inflows and a reversal of net capital flows to the five countries. Economic growth in these countries, as a group, decelerated.

The economic situation prevailing in Pakistan during this period was similar to the economic and financial environment that contributed to the financial crisis in East Asia. The country's financial sector was burdened by a large portfolio of bad debts, the regulatory framework was only starting to be reformed, and the management of public sector banks had only recently been taken over by professionals. Macroeconomic mix-management led to persistent external current account and budget deficits reflected in an unsustainable debt burden that was increasingly composed of variable interest rate and short-term debt at about one month's worth of imports. Above all, short-term foreign debt, including nonresident FCDs, was nearly 10 times the gross official foreign exchange reserves of the SBP.

There are several reasons why Pakistan did not experience the crisis that hit the East Asian economies.

- The East Asia boom was financed by highly "sensitive" private sector capital in the form of portfolio capital and short-term debt. But Pakistan's deficits have been largely financed by official flows and private sector bank deposits by residents and nonresidents and have displayed extraordinary stability during repeated balance-of-payments crises in the 1990s.
- The foreign currency exposure of the private sector in Pakistan was low. Despite repeated attempts, the private sector has had limited success in raising capital from international sources.

- While Pakistan did receive some portfolio investment in 1994 at the peak of inflows into emerging markets, poor economic performance, political instability, and the relatively better prospects in East Asia at that time limited such flows. The Karachi stock market peaked in 1994 and lost more than one third of its value by July 1997. It seems that most foreign institutional investors had already withdrawn from the market.
- Banking reforms were introduced in early 1997 and, together with better monitoring of prudential regulations, limited poor credit decision making.

Although Pakistan did not immediately suffer a financial crisis when the East Asian economies were economically destabilized, there are certain underlying weaknesses that threaten the country's financial stability:

- Pakistan's financial sector remains weak, and despite Government efforts, the recovery of bad loans is making little progress while the weak economy is contributing to further business failures.
- The Government is continuing with low-priority, long gestation infrastructure projects, thus further worsening fiscal and external accounts imbalances.
- The East Asian crisis has increased Pakistan's vulnerability to foreign exchange liquidity problems.
- The worldwide market and investor confidence have weakened, resulting in reduced willingness to provide foreign capital to developing countries and harder terms. Inflows of medium- and long-term private capital to Pakistan, which were relatively small in the first place, have further declined in the aftermath of East Asia's financial crisis.
- Demand for some of Pakistan's exports to affected East Asian economies, such as cotton yarn, has fallen.
- There has been much stronger price and non-price competition from East Asia in third markets as a result of the large devaluations of their currencies. This could affect key exports such as textiles and rice.

Crisis Management

At the end of May 1998, a financial crisis, triggered by the nuclear tests, hit Pakistan. Reserves plummeted from $1.2 billion to about $600 million. Unjustifiably, fearing capital outflows, the Government froze all foreign currency accounts. As a natural response, private sector remittances also practically ceased, thus cutting off about $2.5 billion of inflows projected for the current fiscal year. Commercial bank short-term lending to the Government and the SBP fell drastically.

The two sources of foreign exchange borrowing, official sources and private transfers, suddenly dried up and precipitated a financial crisis. They had financed Pakistan's economy, and had remained stable and seemingly insensitive to changes in economic fundamentals. The change came about because of political reasons (in the case of official inflows) and poor decisions by the Pakistan Government (in the case of foreign currency accounts).

Since the fundamentals were already weak, the Government adopted the following measures after the crisis of May 1998:

- it introduced a new two-tier exchange rate mechanism (22 July 1998) comprising the official rate (on 25 July, PRs46/$) and the floating interbank rate (on 25 July, PRs52/$). With official, open-market money changers allowed to operate, there are now four exchange rates operating: the official rate, the interbank rate, the money changers' rate, and the "havala" (black-market) rate;
- it removed the SBP band (previously fixed at PRs46 for spot buying and PRs46.46 for spot selling);
- it increased gasoline prices by 25 percent;
- it introduced new dollar bonds of five-, seven- and ten-year terms available to holders of foreign

currency accounts and new dollar depositors. The bonds offer LIBOR, LIBOR plus 1 percent and LIBOR plus 2 percent for the three different terms. Exemption from taxes and identity of source of funds apply. They are redeemable in dollars upon maturity;

- it gave permission to open new foreign currency accounts with fresh foreign exchange inflows. With these accounts, the difference is that commercial banks do not have to surrender the foreign exchange to the SBP. Banks are expected, according to the new prudential regulations, to onlend foreign exchange, while covering their exchange rate risk; and
- with the introduction of the two-tier exchange rate system, it allowed exporters to retain half of their foreign exchange holdings and encash them in the interbank market. Similarly, importers must seek half of their foreign exchange requirements in the same market.

Two Government decisions were particularly harmful. First, the freezing of foreign exchange account and the second was the decision to conduct a media trial of irregularities in the award of contracts to build private power projects by foreign investors, particularly that given to a company called Hub Power Company (HUBCO).

The market seemed unimpressed by the Government's measures. The loss of credibility due to the mishandling of the media trial of foreign investors, which caused the stock market crash, and the freezing of foreign currency accounts, will take time to recover. More than $2 billion has been encashed for rupees from the $11 billion in foreign currency accounts. Fluctuations and rupee depreciation in the free market suggest that depositors have taken their funds abroad. The open market exchange rate is expected to devalue further.

Credibility is very crucial and the Government should exert greater efforts to regain it.

Notes

[1]With intermediation margins limited to 0.5 percent.

[2]Following a stable period in 1994/95 when the nominal exchange rate was only marginally adjusted downward, the rupee started appreciating against major currencies (in line with the appreciation of the dollar), putting pressure on foreign reserves and leading to an increase in the parallel market premium to more than 6 percent.

In October 1995, the rupee was devalued by 7 percent against the dollar, following which it was kept stable for a few months to check inflationary expectations. Creeping depreciation resumed in January 1996, leading to an additional depreciation by June 1996 of 2.5 percent against the dollar, but which fell short of protecting the real effective exchange rate (REER). During the summer of 1996, this policy did not prove credible and the premium on the parallel exchange market rose to 10.4 percent. In September–October 1996, two step devaluations were implemented, a total of 11.8 percent, which was followed by a period without any adjustment until April 1997. Thereafter, four modest adjustments reduced the value of the rupee by less than 1 percent.

Between 1995 and 1997, the REER (against a trade-weighted basket of currencies) was kept broadly constant, although fluctuating widely, as increases in the REER caused by the positive consumer price inflation differential with competing countries were periodically eliminated by step devaluations. Between November 1996 and June 1997, however, the substantial appreciation of the dollar and the absence of significant exchange rate adjustments increased the REER by an estimated 11.5 percent. The steep depreciation of several currencies in Southeast Asian countries had an impact on Pakistan's competitive position, reflecting the overlap of these countries' markets with those of Pakistan.

[3]These are one-year government papers, denominated in foreign currency, mostly in dollars, for which there is a secondary market.

[4]See Appendix 3.

[5]This regulatory duty was capped for the higher tariff positions, so that the consolidated maximum tariff rate was kept at 65 percent.

[6]However, specific schemes permit individuals to import cars for their own use, provided they pay import duty rates in the 100–265 percent range.

[7]See Appendix 4.

[8]In addition, a system of quotas on Turkey's imports was initiated in October 1996.

[9]For recent trends in foreign investment see Appendix 5.

Appendix 1

State Bank of Pakistan Prudential Regulations

The SBP revised prudential regulations with respect to various operations of commercial banks in July 1998 in view of the continuing changes in the financial sector. These regulations pertain to:

- limitation on a bank's exposure to a single person;
- limitation on a bank's exposure against contingent liabilities;
- limitation on a bank's exposure against unsecured advances;
- linkage between a borrower's equity and total borrowing from a bank;
- maintenance of debt-equity ratio;
- financing facility against shares;
- dealing with directors, major shareholders, and employees of banks;
- classification and provisioning for loans and other assets;
- management requirements; and
- bank charges and opening of accounts.

Appendix 2

Overall Fiscal Developments, 1989–1998

The 1989/90 budget included steps to expand the base of income taxes and improve auditing. Sales tax was extended to domestically produced and imported goods with plans to introduce a GST from 1 July 1990. Specific rates of customs and excise duties were revised, while expenditure control and monitoring procedures were strengthened.

Despite repeated efforts, the budget deficit remained high and again climbed to 8.2 percent of GDP in 1992/93, reflecting the continuing failure to generate much revenue. The tax/GDP ratio remained stagnant at about 13.5 percent, despite higher tax rates and a multiplicity of taxes.

Fiscal reforms had to address long-standing structural issues such as extending income taxation to agriculture, federal-provincial revenue sharing, improvements in tax administration, broadening the base of the GST, and reducing taxes on international trade. On the expenditure side, fiscal managers had to deal with the large share of defense spending, rising interest payments, compression of development spending, and chronic expenditure overruns.

During 1993/94 and 1994/95, there was substantial progress in reducing the fiscal deficit to 5.9 and 5.6 percent of GDP, respectively, mainly through a curtailment in both current and development expenditures by more than 3 percentage points. This was supported by a slight recovery in the tax effort, reaching 13.7 percent of GDP in 1994/95, but offset by a reduction of 1.4 percent of GDP in nontax revenues as inefficiencies in public corporations decreased transfers to the budget.

The 1995/96 budget targeted a consolidated deficit of 5 percent of GDP—a downward adjustment by 0.6 percentage points compared with the outturn for the previous fiscal year. To this end, it incorporated a host of revenue measures, including removal of tax exemptions and concessions for special industrial zones, higher withholding taxes, increased Productivity Index Unit values for the wealth tax (by 25 percent), and a doubling of the excise duty on banks' and travelers' checks. Also, there was a further expansion of the excise duty to cover more goods, services, and certain professions. Despite these measures and their reinforcement by the fiscal package of October 1995, budgetary revenue remained flat in relation to GDP and the consolidated budget deficit widened to 6.9 percent of GDP in 1995/96, reflecting an increase in current expenditure.

For 1996/97, the Government adopted a budget with a targeted deficit of 4 percent of GDP, seeking

an adjustment of nearly 3 percent of GDP in the deficit. To reach this target, a further package of revenue measures was announced that included important structural measures that would yield PRs40.8 billion. Among these measures were the extension of the GST to the import and manufacturing stages, with an increase in the standard GST rate by 3 percentage points (to 18 percent), and a reduction in the number of non-zero rates to three (5, 18, and 23 percent). Most general and industry-specific exemptions from the GST were eliminated, except for basic necessities, pesticides, fertilizers, electricity, and petroleum products. The 1996/97 Finance Bill also provided for a turnover threshold below which firms pay a turnover tax of 2 percent, and for refunds within a short period of the tax credit associated with purchases of capital goods and inputs for exports. The “fixed tax” schemes were eliminated, except for those on brick kilns.

The 1996/97 budget also included measures regarding direct taxes (curtailment of tax exemptions and holidays), central excise duties (extension to certain services and imported items), customs duties (withdrawal of exemptions and upward revision of some statutory rates), and increased federal taxation of the agriculture sector through the wealth tax (the rate of wealth tax per productivity index unit was raised from PRs250 to PRs400 and the base of the tax was broadened). At the same time, for revenue considerations, the authorities decided to defer the planned reduction in the maximum tariff rate from 65 to the 50–55 percent range and maintain the 10 percent regulatory duty imposed in October 1995.

The measures introduced with the 1996/97 budget caused serious adverse reactions, including disturbances and strikes. As a result, the Government was under strong pressure to make concessions by reintroducing some exemptions in virtually all categories of taxes and by lowering some rates. Furthermore, it cleared the backlog of duty drawbacks from the previous years. The total loss from post-budgetary adjustments and concessions amounted to PRs12.8 billion and contributed significantly to a deterioration in the budgetary situation and to the broader aggravation of Pakistan’s macroeconomic situation in the first quarter of 1996/97.

Subsequently, on 22 October 1996, the authorities introduced another PRs40 billion of measures deemed necessary to attain the budget deficit target. The package consisted of cuts in the noncore PSDP; reduced expenditures by provinces; lesser wheat and railway subsidies; decreased allocations for durable goods; banned fresh appointments; introduction of a land tax by provinces; imposition of a service charge for import inspection; higher petroleum surcharges, excise duty on gas distribution; and increased smaller taxes and fees such as passport fees.

As in the preceding year, implementation of the fiscal plan fell far short of the target despite the corrective measures. Difficulties stemmed partly from the fact that political turmoil and uncertainty adversely affected the budgetary performance for the first half of 1996/97 after the dismissal of the Government. Equally important, the low rate of GDP growth and the decline in imports contributed to lackluster revenue performance. On the structural side, three important improvements were initiated by the interim Government, which held office from November 1996 to January 1997. First, a new National Finance Commission Award was issued to address the existing structural distortions in the financial arrangements between the federal and the provincial governments. Second, the concessionary GST rate of 5 percent was eliminated in December with most of the goods moved to the 10 percent group. Third, all four provinces adopted ordinances introducing agricultural income taxation, which were later approved by provincial assemblies.

The new Government took steps during 1996/97 to consolidate these structural reforms initiated by the caretaker Government and, in addition, in April 1997, it implemented a lowering of tax rates concurrently with a broadening of the tax base. Work was

also started on a rationalization of expenditure on the basis of the Public Expenditure Review.

The 1997/98 budget consolidated the fiscal reform efforts of the present Government. The objective was to reduce tax rates and broaden the tax base to include the untaxed and undertaxed sector. The lower tax rates aim to stimulate production and investment and help tax administration through voluntary tax compliance. Specifically, the standard rate of the Generalized System of Preferences was reduced from 18 and 23 to 12.5 percent, personal income tax rates were halved, corporate income tax rates were reduced for those spending on workers' welfare, and investment in stocks and shares of quoted industrial units was exempted from the wealth tax up to 50 percent of stocks. The sales tax was to be extended to retail activities, but was unsuccessfully enforced.

Preliminary estimates indicate that the budget deficit was reduced from 6.2 percent of GDP in 1996/97 to about 5 percent in 1997/98. Tax revenues remained sluggish due to a slump in economic activity but showed some improvement as a percentage of GDP, while expenditure cutbacks were more significant with the share of development expenditure in total expenditure declining further to less than 15 percent.

Appendix 3

Tariff Policy Objectives and Details

Before the late 1980s, Pakistan's trade policy emphasized import substitution behind high tariff and nontariff barriers. Starting in 1988, Pakistan has been engaged in a broad program of economic reform, a chief component of which has been significant trade liberalization. Although successive governments have pursued tariff reform programs with varying levels of success and zeal, in 1993, the caretaker government produced a comprehensive document identifying the objectives, targets, and strategy of tariff reform. While success in implementation and the targets have varied subsequently, the broad thrust of the objectives and strategy has remained unchanged.

Efficiency gains from trade reform are likely to be far-reaching, particularly as policy changes redress the antiexport bias that has hampered the growth of Pakistan's export base for many years. Tariff reforms represent the most sweeping and broad-based attempt to change the direction of Pakistan's industrialization policy. However, most of the benefits of this outward orientation will accrue in the medium to long term, while some of the costs of the changes will be felt immediately. Policymakers have consequently adopted a cautious and pragmatic approach to phasing in the tariff changes, which has been necessary to allow both industry and labor markets to restructure in response to changing conditions.

OBJECTIVES OF TARIFF REFORM

The prime objective of tariff reform is the rationalization of the tariff structure to enhance the efficiency of existing domestic activities, especially in the manufacturing sector, and to improve resource allocation in the years ahead. In the process, tariff reform intends to reduce the bias against export activities and minimize distortions in the domestic price structure, which would result in a more equitable incentive structure for import-competing activities. Consideration must also be given to decreasing the burden of protecting domestic industry on final consumers and users of protected goods and activities. The attainment of these objectives will improve the growth potential of the country and increase employment opportunities.

Within the framework of these broad objectives, tariff reform aims for a number of more narrowly defined objectives while remaining cognizant of inevitable tradeoffs. Restructuring of the tariff regime and sales tax has been designed to bring down high protection and incentives traditionally given to im-

port-competing activities, especially in manufacturing, thereby reducing the disincentive against export activities. The nominal tariff rate structure has been cascading, rising with the stages of manufacture in an attempt to encourage greater value added. Tariff reform has aimed for greater uniformity across activities at the same stage of production by limiting the number of tariff rate tranches. The system of taxing imports has been simplified by merging surcharges, import license fees, and import duties into one rate. The distinction between commercial and industrial importers should eliminate windfall profits and improve the availability of inputs. The reform seeks to encourage investments by lowering the cost of machinery through a tax reduction on imported machinery that is not locally available.

While trying to achieve these objectives, the process of tariff reform has been constrained by concern over limiting the revenue impact of tariff changes. While revenue neutrality is not the aim of the tariff reform, fiscal feasibility of the new tariff structure is nevertheless essential. Some reduction in revenue from import duties as a result of the reform would not conflict with the need to reform Pakistan's overall tax system so that the current reliance on revenue from import duties is lessened, while direct tax revenues are increased. At the same time, the scope for raising income tax revenues and broad basing the sales tax is limited and involves considerable time. In view of these considerations, tariff reform aims for a tariff structure whose adverse revenue impact could be compensated by other feasible tax measures over the period of the reforms, minimizing adjustment costs arising from changes in relative prices and protection of domestic industry.

RECENT APPROACHES TO TARIFF REFORM

The interim government that took over in November 1996 quickly assessed the implementation of the 1993 reform. It suggested a two-pronged approach toward further liberalization: on one hand, trade reform policies aimed at achieving targets in across-the-board tariff reduction, simplification, and rationalization; while on the other, it was recognized that problems of specific sectors and industries should be identified and addressed at an accelerated pace but remedies should remain within the broad objectives of the overall reform.

In the first year of the reform, which coincided with the budget for 1997–1998, the Government removed the 10 percent regulatory duty, reduced the withholding income tax from 5 to 2 percent, lowered the maximum tariff rate from 65 percent to 55 percent, and decreased tariffs on raw materials by 5 percent.

The reform had both positive and negative impacts. On the positive side, the changes reduced the working capital requirements in the industry and finance sectors. Moreover, with less pressure for capital, pressure on interest rates also subsided. These measures also increased production and decreased costs, thereby encouraging exports. On the other hand, the changes resulted in a revenue loss to the Government of more than PRs18 billion.

Based on the experience of previous tariff reforms, the new Government proposed the deceleration of tariff reductions, reaching the target of 35 percent from a maximum of 65 percent in five years starting in fiscal year 1997/98. This would allow sufficient time for industry to adjust and for the Government to develop other sources of revenue while restraining expenditure. The first cut lowered the maximum tariff from 65 to 55 percent; thereafter, the maximum rate will be progressively reduced to 35 percent, at a rate of 5 percent per year, and the tariff tiers decreased to six.

Various additional issues will be discussed during the second phase of reform, including smuggling associated with Afghanistan's transit trade, the rationalization of the concessionary tariff regime, and tariff rationalization procedures. Changes in the tariff structure have been recommended for textiles, engineering products, and leather.

TEXTILE PACKAGE

Tariff changes for the textile industry introduced at end-1996 were designed to address the typical problems that this vertically integrated industry faces in Pakistan. The country produces cotton products from raw cotton to finished garments. The textile sector remains the largest industrial sector and exporter. The aim of the textile package was to revitalize this sector in addition to removing distortions and problems faced by other export groups. The underlying principle of the package is that of neutrality, i.e., no sector should receive benefits at the cost of another.

One of the major problems facing the textile spinning sector is the high price of imported raw cotton and man-made fibers, e.g., polyester, viscose, and acrylic. The textile package aimed to reduce distortions, while safeguarding the viability of investments in the man-made fiber sector, and the interest of cotton growers.

RAW COTTON

In view of the legitimate interests of the cotton growers, and the objective of providing a level playing field, the export of raw cotton was allowed without any export tax. This enabled cotton growers to receive a price for their crop that was in line with world market prices. To assure that raw material was available at world prices to the spinning sector, the import duty on raw cotton was removed. Previously, raw cotton imports were subject to customs duty, withholding tax, and an inspection fee. After including octroi duties, total levies exceeded 15 percent. Hence the 5 percent customs duty on raw cotton should be eliminated and the withholding tax imposed at the same rates as on the domestic trade in raw cotton. The inspection fee, however, will remain as it is a user charge. It is expected that irrespective of the size of the domestic crop and the extent of exports of raw cotton, the domestic spinning sector will not face shortages or an increase in domestic costs.

MAN-MADE FIBERS

Pakistan's textile products, at all stages of production, have been adversely affected by existing policies on man-made fibers. Protection given to the man-made fiber subsector has been at the cost of the rest of the textile sector. The share of man-made fibers in textile products is in the range of 10–20 percent, whereas the worldwide average is 55 percent. Changes in the import duty structure and other incentives are intended to rectify the structural deficiency in the composition of raw materials in the textile industry. This will enable the industry to diversify and encourage the production of blended fabrics, which will greatly enhance the value and marketability of Pakistan's textile products. It will also help optimize the production of polyester fiber domestically, which now has substantial idle capacity

The need for working capital was greatly reduced by allowing duty-free access to imports, since spinners will no longer have to hold stocks of domestic raw cotton for six months. The SBP was requested to insure that adequate credit is available on time for efficient inventory management by the industry.

Appendix 4

Export Promotion Policies

In addition to ensuring a competitive exchange rate and further lowering import duties to reduce antiexport biases, the authorities have adopted a targeted export promotion strategy, the main elements of which are institutional development and administrative streamlining. Specifically, the following reforms are being pursued: improving the computation of duty drawback rates, expanding the number of specific drawback rates, allowing exporters to claim

drawbacks on the basis of taxes and duties actually paid, integrating the duty drawback and sales tax refunds in one window to avoid unnecessary transactions, and strictly enforcing standards on timing of repayments. Pakistan has two schemes (temporary importation and bonded manufacturing) that permit exporters to hold tax and duties on imported inputs in suspense until the associated exports have been made; a key element of the schemes is to simplify their eligibility and operating requirements to encourage their use.

Some exports remain subject to quantitative restrictions, mainly to assure the adequacy of internal supplies at reasonable prices; however, most export duties were removed in 1994. In addition, exports are strongly encouraged through a multifaceted incentive system. The Export Trade Control Order (issued in 1997) lists 26 items (live animals, grains and beans, edible oils, minerals and ores, ferrous and nonferrous metals, and sugar) as nonexportable; other items need prior authorization from line ministries (raw cotton and fertilizers), the Export Promotion Bureau (rice), or a professional association (cotton yarn). Export quotas remain in place for cement and clinker. Petroleum products are exportable only through public sector agencies. Export duties are only enforced for unfinished leather products and crushed bones. In addition, nontextile exports are subject to a 0.25 percent levy on their free on board value, the proceeds of which are earmarked for the promotion of exports through an extrabudgetary fund.

There are five schemes designed to remove the disadvantages that Pakistan's exporters face in accessing inputs at prices that are comparable to those of their foreign competitors.

TEMPORARY IMPORT SCHEME AND BONDED MANUFACTURING SCHEME

Exporters can obtain a license under these schemes to manufacture export goods under bond. They must operate a warehouse facility to store the bonded duty-free and tax-free inputs, to be released for the manufacture of exports under official customs supervision.

CUSTOMS DUTY (AND EXCISE) DRAWBACK SCHEME

This scheme rebates at fixed rates customs and excise duties on inputs used in the manufacture of specified export products, after the product has been exported. It includes fixed drawback rates for all exporters in standard and specific notifications.

Previously, import-related sales tax was refunded together with excise and customs duties under this scheme. Since 1 January 1997, refund of import-related sales tax is administered separately under a different scheme.

The drawback scheme is the most widely used export promotion measure in Pakistan. The Central Board of Revenue has made a significant effort to improve the administration of this scheme. In this context, a large number of new notifications have been issued, raising the total to more than 400 standard and individual notifications.

REFUND OF SALES TAX

Introduced on 1 January 1997, refund procedures for import-related sales tax for exporters have been merged with the refund procedures for domestic input-related sales tax for exporters.

EXPORT PROCESSING ZONES

One EPZ is in operation in Karachi and another one is under construction in Sialkot. Both are operated by the public sector.

UTILIZATION OF THE VARIOUS EXPORT PROMOTION SCHEMES

Based on 1995/96 data, few exporters use the "no duty no drawback" schemes (i.e., temporary import and bonded manufacturing schemes). Similarly there are less than 200 EPZ licenses, of which only a fraction are in operation. Most exporters use the duty drawback scheme.

Appendix 5

Recent Trends in Private Foreign Investment

In recent years, many developing countries have increasingly resorted to private foreign investment as a source of capital, technology, managerial skills, and market access needed for sustained economic growth and development. As a result, total FDI flows in the world in 1996 reached $349.2 billion against $203.8 billion in 1990. Developing countries have succeeded in attracting a greater share of global inflows of FDI from 17 percent in 1990 to 37 percent in 1996. South Asia's inherent structural and institutional rigidities made it less attractive than its East and Southeast Asian counterparts, but even then, its FDI inflows grew from $464 million in 1990 to $3.46 billion in 1996. Pakistan's FDI inflows, in spite of political upheavals and policy inconsistencies, increased from $244 million 1990 to $690 million in 1996.

The recent economic crisis in Southeast Asia has eroded the competitiveness of countries in the region. Pakistan is also a victim of this. There was a slight improvement of 1 percent in net private foreign investment in the first nine months of FY1997/98. The power sector received the largest share of private FDI. Portfolio investment rose by 10 percent while FDI declined slightly by 2.7 percent during this time.

Foreign investment has been fully protected and has enjoyed high returns in the country. Transnational companies' experience has been good in terms of their expansion and prosperity. Those listed on the stock exchanges are regarded as "blue chips."Based on their experience, Pakistan would have attracted substantial foreign investment, but for the adverse impact of political instability and the cumbersome procedures causing inconvenience to foreign investors. Attempts have been made to remove these impediments in the New Investment Policy of 1997, which includes major policy initiatives. In the past, foreign investment was restricted to the manufacturing sector, which accounted for only 18 percent of GDP. Foreign investment is now allowed in sectors such as agriculture and services, which constitute more than three quarters of GDP.

Table A5.1: Foreign Investment ($ million)

	1996–1997			1996–1997 (July–March)			1997–1998 (July–March)		
Economy	Direct	Portfolio	Total	Direct	Portfolio	Total	Direct	Portfolio	Total
Canada	1.7	0.8	2.5	1.4	0.8	2.2	0.3	…	0.3
France	10.2	…	10.2	2.6	…	2.6	4.7	0.4	5.1
Germany	17.6	19.7	37.3	13.7	15.5	29.2	6.6	1.0	7.6
Hong Kong, China	7.5	(20.6)	(13.1)	6.3	(22.1)	(15.8)	2.0	200.6	202.6
Italy	1.8	—	1.8	1.7	—	1.7	…	0.1	0.1
Japan	36.6	6.9	43.5	16.0	6.9	22.9	12.5	(1.2)	11.3
Korea, Republic of	7.3	—	7.3	5.4	—	5.4	4.2	—	4.2
Netherlands	0.7	3.5	4.2	6.1	1.6	7.7	24.4	0.2	24.6
Saudi Arabia	(17.0)	…	(17.0)	(17.0)	—	(17.0)	1.2	0.5	1.7
United Arab Emirates	54.9	(5.2)	49.7	10.2	(7.6)	2.6	13.4	15.5	28.9
United Kingdom	240.1	77.9	318.0	183.0	45.7	228.7	72.0	(78.2)	(6.2)
United States	246.2	111.3	357.5	166.9	69.4	236.3	199.8	69.4	269.2
Others	67.5	73.1	140.6	52.1	75.1	127.2	95.0	3.4	98.4
Total	**675.1**	**267.4**	**942.5**	**448.4**	**185.3**	**633.7**	**436.1**	**211.7**	**647.8**

( ) = Negative values are enclosed in parentheses.
— = nil; … = negligible.
Source: State Bank of Pakistan, Annual Reports (various issues).

Table A5.2: Industrial Investment (PRs million)

Item	1995–1996	1996–1997	1997–1998	Percent Change (1996–1998)
Manufacturing	62,515	72,515	83,991	15.83
Public Sector	3,840	8,584	3,871	(54.90)
Private Sector	58,675	63,931	80,120	25.32
Large Scale	50,558	58,284	68,468	17.47
Public Sector	3,840	8,584	3,871	(54.90)
Private Sector	46,718	49,700	64,597	29.97
Small Scale	11,957	14,231	15,523	9.08
Public Sector	0	0	0	0
Private Sector	11,957	14,231	15,523	9.08

( ) = negative values are enclosed in parentheses.
Source: Federal Bureau of Statistics.

Transforming Banking in Pakistan

Mohammad Zubair Khan

Mohammad Zubair Khan is Managing Director of Financial Techniques Internationale, Pakistan.

Executive Summary

Pakistan undertook ambitious financial reforms in the early 1990s in an effort to establish a more market-based system of monetary management. The reforms were designed primarily to correct the distortion implicit in the administered structure of rates of return on various financial instruments, to do away with the directed credit programs, to enhance competition and efficiency in the financial system, and to strengthen State Bank of Pakistan (SBP) supervision. Accordingly, the Government partially privatized two nationalized commercial banks (NCBs), and introduced an auction system for government securities as steps towards interest rate liberalization and open market operations. The SBP was granted greater autonomy in February 1994. However, since interest rate liberalization preceded fiscal reforms, interest rates shot up, contributing to a further increase in debt servicing costs and the budgetary imbalance. Another important development was the deregulation of resident foreign currency accounts in February 1991.

Further financial liberalization was constrained by a marked deterioration in the financial position of the NCBs, which continued to dominate the banking sector. In fact, the banking sector as a whole experienced declining profitability, increasing inefficiencies, a weakening capital base, and a buildup of nonperforming assets (NPAs).

The stock of nonperforming loans (NPLs) grew from PRs25 billion in 1989 to PRs128 billion in June 1998, or 4 percent of gross domestic product (GDP), while total deposits grew only a little faster than inflation.

Several factors contributed to the disintermediation of deposits, including:

- an increasing dollarization of the economy;
- growing direct borrowing by the Government through attractive tax-advantaged national savings schemes to help finance the deficit;
- a low return on bank deposits due to high reserve requirements and the inefficiency of banks, especially the NCBs; and
- a lack of savers' confidence in the NCBs.

Foreign currency deposits grew rapidly to $11 billion by July 1997, accounting for half of the country's total bank deposits, compared to less than $3 billion in the early 1990s. Their rapid increase reflected an erosion of confidence in three factors: the rupee itself, strong tax incentives, and the anonymity regarding the origin of the foreign exchange. With difficulties in mobilizing long-term financing, the widening external current account deficits were financed by nonresidents' foreign currency deposits. Moreover, in accordance with existing policies, foreign currency deposits were exchanged by commercial banks for rupees with the SBP for domestic onlending, while banks purchased forward contracts from the SBP at a cover fee that was consistently 3 to 5 percentage points below the private market forward premium. As a result, banks found it increasingly profitable to intermediate in foreign currency deposits while the SBP suffered large quasi-fiscal losses.

Despite liberalization in the early 1990s, financial markets continued to be segmented into the private and public sectors owing to continuing controls on interest rates paid on government debt and to special credit programs.

Problems in the financial sector are rooted in the following:

- lack of financial discipline encouraged by distorted incentives and weak supervisory capacity of the SBP. In addition, banks are exposed to high risks, since recourse to the legal system is costly and lengthy;
- rising public sector deficits and discriminatory credit rationing. During the mid-1990s, the budget deficit averaged 6.6 percent of GDP, financed by borrowing from the SBP and through the auction of government securities to the banking sector, thus crowding out the private sector from credit;

- mismanagement of short-term capital inflows. Private capital inflows highlighted the inability of the banking system to assess, price, and manage risk, and the inadequacy of the supervisory and regulatory framework to prevent and contain systemic risk. The SBP did not manage foreign exchange resources prudently: by end-May 1998, short-term foreign exchange liabilities of the banking system were $11.2 billion against official gross reserves of $1.1 billion; and
- weak resource mobilization. Financial institutions, their industrial clients, and the Government have been unable to mobilize long-term fixed-rate resources for project finance.

Financial sector reforms in 1997/98 were undertaken mainly to promote financial saving, improve the process of financial intermediation, enhance competition, and assure efficient allocation of financial resources. Efforts to achieve these ends, however, have been hampered by political interference, aside from the lack of financial support to carry out banking reforms. Moreover, there are serious structural weaknesses in the banking sector reform strategies adopted. First, there is an overestimation of the capacity of the market to absorb assets that need to be liquidated to recover collateral from bad loans. Second, the development of the capital market has been overlooked. Third, project loans that have contributed significantly to the frequency of loan defaults have not been fully assessed. Fourth, the implementation of reform efforts has been handicapped by the loss of confidence resulting from the freezing of foreign accounts in May 1998.

To overcome these weaknesses, there have been several recommendations, as follows:

- the independence of the judiciary should be reestablished and accountability made impartial to improve governance and end political interference;
- banks' capital requirements should be harmonized, utilizing the standard under the Basle Convention, and a more competitive market structure should be developed. The SBP needs to strengthen its supervisory capacity so that banks' balance sheets reflect the true position more accurately;
- urgent steps should be taken to develop the capital market, extend the terms of project finance, or reschedule the loans of legitimate cases;
- with regard to the recovery of bad loans, bad assets should be transferred to a separate fund to lengthen the recovery process;
- steps should be taken to deal with market failure in pricing project finance;
- early privatization of the NCBs is a desirable objective, but it must be done through a transparent process with investors who possess integrity, as well as financial and managerial capacity;
- frozen foreign exchange accounts that reached $7 billion as of September 1998 should be merged with the "new" foreign currency accounts managed by the commercial banks, when a buildup of reserves allows it. Commercial banks could hedge against the exchange rate risk in a developed forward market for foreign exchange; and
- the recent Asian crisis demonstrated the need to proceed with caution in opening the capital account and to undertake liberalization with appropriate macroeconomic, exchange rate, and financial sector policies. In Pakistan's case, while capital inflows were not as large as experienced in Asian economies, there is a need to restore the confidence of foreign investors and domestic depositors in the banking system to revive the economy.

Introduction

Overview of the Banking Sector

The financial system of Pakistan consists of the State Bank of Pakistan (SBP), four nationalized commercial banks (NCBs), two partially privatized banks, 3 specialized banks, 21 foreign commercial banks, 12 private domestic banks, 3 provincial commercial banks, 12 development finance institutions (DFIs), 15 investment banks, 33 leasing companies, 51 *modarabas*,[1]

42 mutual funds, 3 stock exchanges, and 68 insurance companies (see Appendix 1). Although in recent years the share of the nonbanking financial sector has increased in terms of lending, the financial system is still dominated by commercial banks.

Between 1993 and 1995, the banking sector as a whole experienced declining profitability, increasing inefficiency, and a weakening capital base, even by Pakistani accounting standards. However, there was a marked difference in performance among the NCBs, partially privatized banks, foreign banks, and private domestic banks.

STATE BANK OF PAKISTAN

The SBP is the country's central bank. Apart from its traditional central bank functions, it is an important source of financing for the Government and certain State-owned DFIs. To a lesser extent, it channels funds through its refinancing operations to other financial institutions for special purposes such as lending for exports, for small-scale enterprises, and for the purchase of domestically manufactured machinery. It also directs credits by imposing mandatory credit targets on banks for priority sectors. The SBP is the regulatory and supervisory authority for banks, but until the late 1990s shared this role with the Ministry of Finance and the Pakistan Banking Council with respect to the NCBs and DFIs. It had been charged with the supervision of the nonbank financial institutions (NBFIs), but shares this responsibility with the Corporate Law Authority, with respect to nondeposit-taking NBFIs.

Amendments to the State Bank Act in early 1997 enhanced the SBP's autonomy. Recently, the SBP has strengthened its prudential regulations and improved its supervision of the banking system.

COMMERCIAL BANKS

Commercial banks represent the core of the financial system, holding about 90 percent of deposits and providing more than two thirds of total financing. At present, there are 24 domestic commercial banks (with 8,718 branches) and 21 branches of foreign banks (with 78 subbranches). Domestic commercial banks include the following:

- 3 large NCBs—the National Bank of Pakis-tan (NBP), Habib Bank Ltd. (HBL), First Women Bank Ltd., and United Bank Ltd. (UBL);
- 2 banks that were partially privatized—the Muslim Commercial Bank (MCB), with 25 percent government ownership, and Allied Bank Ltd. (ABL), with 49 percent government ownership;
- 4 small specialized State-owned banks;
- 3 provincial banks; and
- 12 private domestic banks.

In 1975, the banking system was nationalized, with a number of private banks merged into fewer larger institutions. Since the early 1990s, the Government has sought private sector participation in the banking system through the privatization of the NCBs and the establishment of new privately owned banks.

In 1990, two NCBs were partially privatized: MCB was sold to a diverse group of investors, and ABL to its employees and management. MCB and ABL were the smallest of the NCBs. They had about one seventh of the assets and deposits of the system, although more than a quarter of the branches. During 1996, the Government attempted to privatize another NCB—UBL—but was unsuccessful, partly because of UBL's large NPL portfolio and overstaffing, and due to militant and corrupt labor unions.

Some progress has been achieved and tangible shifts in market shares are taking place. Up to 1997, the four NCBs lost more than 10 percentage points of market share, with the gain equally shared between private domestic banks and foreign bank branches.

The private domestic banks experienced impressive growth during 1992–1997: their deposit-based market share increased from 5.6 to about 13 percent or by 132 percent, while their loan-based market share increased from 4 to 12 percent or by 200 percent. However, the market share of the four NCBs has

declined from 58 to 46 percent for deposits and from 49 to 39 percent for private sector loans during the same period. In contrast, the market share of branches of foreign banks grew by 35 percent to 22 percent for deposits and 19 percent for loans. The two partially privatized banks, despite improvements in their operations, have not managed to expand their market share during 1992/93–1996/97.

With regard to the market shares for foreign currency deposits, the branches of foreign banks enjoy the highest share: 46 percent for resident deposits and 67 percent for nonresident deposits. Private domestic banks are active mainly in the market for resident foreign currency deposits, with a market share of 25 percent. HBL and NBP together share about 20 percent.

The NCBs' profitability dropped due to an increase in nonperforming loans (NPLs) and declining productivity. If loan losses were adequately provided for, the NCBs would have shown negative returns and net worth, with a negative capital base estimated to be about 6 percent of total assets. Considering the large risks that remain in these institutions, the officially sanctioned capital base of 3 percent of deposit liabilities is inadequate. The cost of recapitalizing these banks in accordance with Bank for International Settlements (BIS) standards could be as high as $5 billion.

Although still hampered by the low yield on the old stock of loans and an inherited high-cost base, the partially privatized banks have increased their profitability through improved loan recovery and increased efficiency. Still, with a return on assets (ROA) of 0.2 percent and an efficiency ratio of 87 percent, the privatized banks were only marginally profitable in 1995. They have low deposits per branch and high personnel costs due to the recruitment of more qualified staff without a commensurate retrenchment of unqualified personnel.

Although profitability is declining, foreign bank operations in Pakistan are still profitable. The 21 foreign banks make up only 18 percent of the sector but consistently earn about two thirds of its profits. Earnings have come primarily from trade finance and foreign currency deposit collection surrendered to the SBP with good margins. In fact, the dramatic decline in profitability in 1995 was due mainly to reduced arbitrage gains as the SBP began to require banks to pay a forward cover fee for foreign currency deposits, although still subsidized, where there was none before. But with the freezing of the foreign currency accounts, this source of profits for the commercial banks has dried up.

Private domestic banks, with a few exceptions, are doing well. Profitability is comparatively high, as reflected in an ROA of 0.9 percent and a return on equity (ROE) of 15 percent. But as with the rest of the sector, profitability is declining. Moreover, these banks are still small and are highly vulnerable to any banking crises, as they have been dependent on foreign currency deposits.

DEVELOPMENT FINANCE INSTITUTIONS

In the early years of Pakistan's development, two banks were given a special mandate to address the long-term financing needs of specific clients of the private and public sectors. These are the Industrial Development Bank of Pakistan (IDBP), which was established to provide term finance to small industries, and the Pakistan Industrial Credit and Investment Corporation (PICIC) which extends term finance to medium and large industries. During the 1960s, while PICIC remained in the private sector and IDBP enjoyed relative managerial autonomy, they were well managed and became major sources of foreign exchange term financing for private industrial investment. In the 1970s, nationalization led to serious problems and in the 1980s both institutions were faced with serious portfolio deficiencies coupled with institutional problems, including loss of experienced staff.

The National Development Finance Corp. (NDFC) and Bankers' Equity Ltd. (BEL) were established in 1973 and 1980, respectively. NDFC was instituted as a bank for public sector enterprises while BEL was originally set up to promote Islamic instruments,

notably providing equity finance to private industry, underwriting equity issues, and arranging consortia finance participation from the NCBs.

Except for BEL, which was recently privatized, all industrial DFIs have boards that are controlled by the public sector. These boards have little autonomy in determining basic lending and recovery policies, staffing levels, and remuneration. The DFIs have been impaired by this lack of operational autonomy. Resources for the DFIs have come mainly from international lines of credit and SBP refinancing facilities. Domestically mobilized deposits are only about one third of the assets. Although DFIs have increased efforts at domestic resource mobilization in recent years, they have had little success, except for short-term deposits. With the drying-up of international credit-line sources and weak collection performance, the DFIs, as a group, have not only become insolvent but are also practically illiquid.

In 1982, three joint venture companies, Pak-Kuwait Investment Company Ltd., Pak-Libya Holding Company, and Pak-Saudi Industrial and Agricultural Investment Company were established to provide loans and venture capital to industry. As PICIC, IDBP, and BEL weakened, and NDFC stagnated, their market shares were taken over by the joint-venture DFIs.

Current ownership and loan disbursements of some DFIs are shown in Tables 1 and 2.

Table 1: Current Ownership of Some DFIs (percent)

Institution	Public	Private and Foreign
IDBP	100	0
NDFC	100	0
BEL	36	64
PICIC	51	49
Pak-Kuwait	50	50
Pak-Libya	50	50
Pak-Saudi	50	50

BEL = Bankers' Equity Ltd., DFIs = development finance institutions, IDBP= Industrial Development Bank of Pakistan, NDFC = National Development Finance Corp., PICIC = Pakistan Industrial Credit and Investment Corp.
Source: State Bank of Pakistan.

Table 2: Loan Disbursements of Some DFIs (PRs million)

Institution	1989/90	1995/96	1996/97[a]
NDFC	2,272	2,243	1,302
PICIC	1,230	583	350
BEL	1,461	489	710
IDBP	1,114	275	287
Pak-Kuwait	68	3,267	3,420
Pak-Libya	77	401	122
Pak-Saudi	182	285	337

BEL = Bankers' Equity Ltd., DFIs = development finance institutions, IDBP= Industrial Development Bank of Pakistan, NDFC = National Development Finance Corp., PICIC = Pakistan Industrial Credit and Investment Corp.
[a] excluding working capital.
Source: State Bank of Pakistan 1990/91 and 1995/96 Annual Reports.

INVESTMENT BANKS, *MODARABAS*, AND LEASING COMPANIES

Since the late 1980s, nine private investment banks have been established in Pakistan. So far they have remained small, accounting for less than 1 percent of financial assets. However, unlike the DFIs, since the investment banks were not created with ready-made funds from international financial institutions, they are better grounded in the domestic capital markets. The bulk of their business is in quasi-deposit-taking and short-term finance for Pakistani blue chip companies. But they are expanding their role in project and corporate finance, advisory services, and underwriting. The larger investment banks are also in stock brokerage and portfolio management. Unlike the DFIs, these investment banks seem to play an important role in Pakistan's capital markets and can become important players in the financial sector in the future, especially since credit lines to DFIs have substantially dried up in recent years. In 1996/1997, the overall financial assistance disbursed by investment banks, *modarabas*, and leasing companies declined by 14.6 percent from the previous period, as a result of a sharp decrease by 26 percent in working capital loans. During the same period, term finance sanctioned by *modarabas* increased by 174 percent and investment banks by 11.9 percent. However, the term finance sanctioned by leasing companies declined by 25 percent, reaching PRs9.5 billion during the same year.

The respective shares of *modarabas*, leasing companies, and investment banks in the total amounts

Table 3: Credit Indicators of *Modarabas*, Leasing Companies and Investment Banks (PRs billion)

Type of Assistance	1994/95 Sanctions	1994/95 Disbursement	1995/96 Sanctions	1995/96 Disbursement	1996/97 Sanctions	1996/97 Disbursement
Overall Assistance (i+ii)	45.5	42.9	54.5	52.9	46.7	45.2
i. Fixed Industrial Financing	15.3	14.1	21.4	20.1	22.2	20.8
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
Modarabas	1.2	1.3	1.9	1.9	5.2	5.2
	(7.8)	(9.2)	(8.9)	(9.5)	(23.4)	(25.0)
Leasing Companies	10.2	7.8	12.7	10.5	9.5	8.3
	(66.7)	(55.3)	(59.6)	(52.2)	(42.8)	(39.9)
Investment Banks	3.9	5.0	6.7	7.7	7.5	7.3
	(25.5)	(35.5)	(31.5)	(38.3)	(33.8)	(35.1)
ii. Working Capital Loans	30.2	28.8	33.1	32.8	24.5	24.4
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)
Modarabas	3.5	3.6	2.7	2.6	2.5	2.5
	(11.6)	(12.5)	(8.1)	(7.9)	(10.2)	(10.2)
Leasing Companies	1.0	1.1	1.1	1.0	0.4	0.4
	(3.3)	(3.8)	(3.3)	(3.0)	(1.6)	(1.6)
Investment Banks	25.7	24.1	29.4	29.2	21.6	21.5
	(85.1)	(83.7)	(88.6)	(89.0)	(88.2)	(48.1)

Figures in parentheses are percentage shares.
Source: State Bank of Pakistan.

approved for term finance during 1996/97 stood at 23.4, 42.8, and 33.8 percent, as compared with 8.9, 59.6, and 31.5 percent, respectively, during the previous period (see Table 3).

FOREIGN CURRENCY ACCOUNTS

Foreign currency accounts for nonresidents were introduced in 1973 (see Appendix 2), while resident foreign currency deposits were deregulated in February 1991. Both types of accounts are protected from disclosure requirements regarding the source of funds. The interest rates payable on these accounts are capped at fractions of a percent above LIBOR (London interbank offered rate), varying with the maturity of deposit. The margins range between 3 and 8 percent for three-month deposits to 5 and 8 percent for three-year deposits. Commercial banks are required to surrender foreign exchange to the SBP in a swap agreement, with the period of the swap corresponding to the initial maturity of these deposits. In June 1992, the SBP phased out its policy of providing free full-forward exchange cover to financial institutions with respect to these deposits and introduced a fee of 3 percent per year. As of end-March 1995, the fee was 4.5 percent and the stock of foreign currency deposits outstanding was $6.3 billion, of which about $3.3 billion was held by residents. In 1993/94, part of foreign currency deposits, especially residents' foreign currency deposits, financed nearly a quarter of the current account deficit (see Table 4).

Forward Foreign Exchange Cover

The SBP provides forward cover on all foreign currency account deposits to commercial banks that are required to surrender such deposits to the SBP. It previously also extended 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 SBP varied with the rate of devaluation of the rupee. Recently, the SBP has discontinued providing forward cover on such short-term foreign currency loans. Several commercial banks are now providing forward cover at varying rates.

Although complete information on the maturity structure of foreign currency accounts and deposits is not available, there is evidence that most deposits had less than one year maturity. However, the maturity structure of foreign currency deposits has been implicitly lengthened by the widespread use of these

Table 4: Foreign Currency Accounts ($ million)

Period (End June)	Foreign Banks (institutional)	Individual Banks	Nonbank Financial Institutions	Total	Resident Foreign Currency Deposits	Total Foreign Currency Accounts	Current Account Deficit
1987	839	654		1,494		1,494	1,682
1988	894	755		1,649		1,649	1,934
1989	913	639		1,552		1,552	1,891
1990	1,088	1,027		2,116		2,116	2,171
1991	951	1,252		2,203	386	2,589	1,346
1992	906	1,084		1,989	1,707	3,696	3,666
1993	864	1,186	177	2,227	2,250	4,478	1,965
1994	1,059	1,404	457	2,920	3,002	5,923	2,484
End March 1995	1,011	1,355	642	3,008	3,255	6,262	na
14 June 1995	na	na	na	3,066	3,260	6,326	na

na = not available.
Source: State Bank of Pakistan.

deposits as a form of collateral. These deposits, especially those held by residents, demonstrated their stability as they withstood the test of confidence during the balance-of-payments crisis in 1993.

The stability of foreign currency deposits before the recent change of rules depended largely on the motivation to hold a foreign currency asset. Research has confirmed that foreign currency deposits associated with workers' remittances and the informal economy are a more stable form of capital.

The Early Reforms

Pakistan's financial sector reforms in the early 1990s aimed to establish a more market-based system of monetary management. As part of the reform measures, the Government not only partially privatized NCBs so as to increase competition and efficiency in the banking system, but also, as a step toward interest rate liberalization, it introduced an auction system for government securities. This enabled the SBP to exercise indirect monetary control through open market operations. Subsidy to credit schemes was withdrawn. The SBP was granted autonomy in February 1994.

In order to assure better coordination among the macroeconomic variables, a high-powered statutory body, the Monetary and Fiscal Policies Coordination Board, was constituted in February 1994, through an amendment to the 1956 State Bank of Pakistan Act. The Board is headed by the Federal Finance Minister. It coordinates fiscal, monetary, and exchange rate policies, and assures consistency among macroeconomic targets for growth, inflation, and fiscal, monetary, and external accounts. It reviews the latest macroeconomic developments on a quarterly basis.

The most obvious outcome of market-oriented reforms in the monetary and banking sector is that there has been a visible shift in the assignment of priority in the credit plan from the government sector to the private sector. This has not only assured a balanced growth of money supply but has taken into account the genuine needs of the private sector. Overall, money supply has declined to the targeted path. Money supply (M2), which grew by an annual average of 20.5 percent in 1990/91–1992/93, contracted to 16.4 percent in 1993/94–1995/96 and further slipped to 12.2 percent in 1996/97 (below the projected target of 13.1 percent for that year). Similarly, annual average growth in domestic credit of 21.1 percent during 1990/91–1992/93 dipped to 14.5 percent in 1993/94–1995/96 and slightly inched up to 15.3 percent in 1996/97. However, since interest rate liberalization preceded fiscal reforms and a

decline in the budget deficit, interest rates shot up. The latter contributed to a further increase in debt service obligations of the Government, thus aggravating the budgetary imbalance.

Constraints to Further Liberalization

One of the main constraints to moving further with financial liberalization and reliance on market mechanisms of monetary control has been the marked deterioration in the financial position of the banking system, in particular of the NCBs, which continue to dominate the banking sector. In recent years, the sector has experienced declining profitability, increasing inefficiencies, a weakening capital base, and a buildup of nonperforming assets (NPAs). Loan defaults of banks and DFIs reached a level of PRs121 billion at the end of December 1996—nearly 21 percent of total advances, and close to 5 percent of gross domestic product (GDP). Of the total amount of PRs102 billion owed to banks at the end of December 1996, PRs83 billion have been loaned to the NCBs and to four small State-owned specialized banks. The bulk of "stuck-up" loans has been used mostly for project financing to large-scale textile industries. The largest 250 defaulters accounted for about 70 percent of the total loan defaults.

The declining profitability and increasing inefficiencies in NCBs were due to weakening government leadership and the burden placed on banks to fulfill several social objectives—creating employment, servicing remote areas at high cost, and providing subsidized and mandatory credit under an array of government-sponsored credit schemes. Analysis based on 1995 data found that the negative net worth of the NCBs was PRs60 billion (the equivalent of 2 percent of GDP), and that the cost of recapitalizing these banks according to BIS standards could be as high as $5 billion (equivalent to 7 percent of GDP). Moreover, the profitability of all banks continues to suffer from remaining forms of financial repression such as indicative credit ceilings and high liquidity requirements.

1997–1998 Banking Reforms and Issues

Major Problems of the Banking Sector on the Eve of the 1997–1998 Reforms

While Pakistan took great strides in deregulating the banking sector in the early 1990s, Government loss of control coupled with lack of credit discipline especially in the State-owned banking sector have aggravated structural problems, as evidenced by a rising level of NPLs and increasing disintermediation. Worsening macroeconomic imbalances led to a growing dependence on foreign currency deposits and increasing market intervention to contain the cost of financing a large fiscal deficit. Consequently, the insolvency of the banking sector rose, two large NCBs and the older DFIs experienced liquidity problems, foreign exchange reserves were boosted by potentially volatile and expensive foreign currency deposits, and access to credit by the private sector was increasingly curtailed.

DETERIORATION OF THE LOAN PORTFOLIO

Resource allocation, a key function of the financial sector, has been vitiated by political interference in lending and loan recovery decisions. As a result, the stock of NPLs has grown from PRs25 billion in 1989 to PRs128 billion as of June 1998, or 4 percent of GDP. On the other hand, total deposits were growing only at a little above inflation, with growth accounted for mainly by foreign currency deposits (before May 1998). So while the banking sector is still liquid, in terms of stock, there is an emerging liquidity problem, owing to the conservative reserve policies of the past (i.e., credit/deposit ratio not exceeding 65 percent). New deposits may become insufficient to cover the outflow from bad loans and operational losses.

SLOWDOWN IN DOMESTIC DEPOSIT GROWTH

Disintermediation of domestic deposits is caused by several factors, as follows:

- increasing dollarization of the economy as confidence in the rupee weakens,
- growing direct borrowing by the Government through attractive tax-advantaged national savings schemes to help finance the deficit,
- low return on bank deposits vis-a-vis inflation and overcompeting financial and real assets due to heavy taxation on financial intermediation (through high reserve requirements) and the inefficiency of banks—especially the NCBs, and
- increasing lack of confidence of savers in the NCBs (the traditional domestic deposit mobilizers) in the face of publicity about their large NPLs and poor service in comparison with the new private banks.

FOREIGN CURRENCY DEPOSITS

Foreign currency deposits had grown rapidly to $11 billion by July 1997, already accounting for half of bank deposits in Pakistan compared with less than $3 billion in the early 1990s. The rapid increase in resident foreign currency deposits reflected the tendency in recent years towards more external private transfers (mainly workers' remittances) being kept in foreign exchange rather than being surrendered to the SBP. This was caused by an erosion of confidence in the rupee, strong tax and other incentives to these deposits, and the "no questions asked" policy concerning the origin of the foreign exchange. Widening current account deficits and difficulties in mobilizing long-term financing has, on the other hand, led to increased reliance on mobilization of nonresidents' foreign currency deposits as a form of external short-term financing.

In so far as regulations prohibited banks from lending in foreign currency and permitted them to maintain only small uncovered positions in foreign exchange, foreign currency deposits were exchanged for rupees with the SBP for on-lending in Pakistan. The banks then closed their open position by purchasing a forward contract from the SBP. Despite several adjustments in the forward cover fee (one implemented in late March 1997 increased the fee to 5 percent for dollar deposits), they have proven inadequate to compensate for actual exchange rate depreciation, resulting in large losses (PRs11 billion in 1995/96 and PRs24.3 billion in 1996/97) for the SBP.

The level of the forward cover fee has also been consistently 3 to 5 percentage points below the private market forward premium.[2] The below-market level of this fee has served, in part, to lower lending interest rates—i.e., to provide a subsidy to the private sector that has access to bank credit and to mask the real cost of borrowing by the Government. On the other hand, it has afforded banks a comfortable intermediation margin estimated at 5 percent. As a result, banks have found it increasingly profitable to intermediate in foreign currency deposits, and thus they have increasingly relied on them as the principal source of funds. This has also contributed significantly to the rise in the share of foreign currency deposits in total bank deposits. In particular, banks and NBFIs increased their short-term foreign borrowings, the proceeds of which were "deposited" with the SBP, with the corresponding rupees loaned out to local clients. The foreign exchange cover scheme has also given banks and financial institutions attractive fee business when they bring in foreign currency deposits that are prearranged by "depositors" as loans to third parties in Pakistan. In all these transactions, bank depositors and borrowers arbitrage between foreign and domestic interest rates, with the SBP providing the hedge at a subsidized rate, thus creating large quasi-fiscal deficits. In 1996–1997, the annual losses of the SBP due to this scheme were 0.8 percent of GDP.

MARKET SEGMENTATION

Despite liberalization, the financial markets continue to be segmented, principally into private and public sectors due to continuing controls on interest rates paid on government debt. Yields on Treasury bills (T-bills) were artificially expressed by predetermining cutoff rates at the primary auctions, and requiring banks to hold large reserve requirements in

T-bills and other government paper. (For these reasons too, there was hardly any secondary market for government paper.) On the other hand, because of its appetite for funds, the Government borrows at much higher rates from the public through national savings schemes that offer higher yields and are tax advantaged. The spread between the yield on government securities (sovereign risk) and private sector debt (commercial risk) is large.

The other sources of market segmentation are the special credit programs. Although declining, these programs are still sizable. In 1995/96, the total cost of interest subsidies amounted to about PRs7 billion or 0.3 percent of GDP. The Government implements two types of special credit programs: mandatory credit programs and concessional credit programs. Under mandatory credit programs, the SBP prescribes minimum annual targets for Pakistani commercial banks to lend to certain priority sectors, such as agriculture, industry, and business. Concessional credit programs require banks and NBFIs to charge below-market interest rates on their loans for exports, local sale and export of locally manufactured machinery, tourism projects in specified geographic areas, and production loans to small farmers. Loans to the Government for financing commodity operations are also at concessional rates.

Mandatory credit targets and concessional credit schemes have been justified on grounds of market failure, which has constrained access to credit by certain sectors or classes of borrowers, and for social reasons—to provide relief to the disadvantaged. But contrary to expectations, interest repression has constrained the supply of credit and political clout has influenced the allocation of limited funds. Thus, these schemes have not only been costly for the budget, but have also become unsustainable and, to a large extent, ineffective in achieving their objectives. Besides, these schemes have had poor repayment records. The default risks have been so high that banks have preferred to pay the penalty of not meeting targets, rather than lose the principals of such loans.

Root Causes of the Problems

FAILURE OF GOVERNANCE AND LACK OF FINANCIAL DISCIPLINE

The financial sector leadership, including bank owners, bank regulators, market competitors, and the courts, either adopted distorted incentives or are too weak to provide proper executive ability or impose credit discipline. The Government, which owns most of the banking sector through its ownership of the NCBs and larger DFIs, has allowed political interference to twist credit allocation and loan recovery decisions of the NCBs and DFIs. Together they have accounted for 90 percent of the bad loans of the entire system. Similarly, loan recovery by the NCB and DFI officers and staff has been thwarted by fear of politically motivated retribution.

Because of the frustration over the devastation of the banking sector, there is consensus in Pakistan that the key solution lies in the privatization of State-owned banks. However, market conditions, slow restructuring of banks, bureaucratic inertia, and the political agenda have slowed down the privatization program since the initial spurt in the early 1990s.

Banking regulation and supervision over the NCBs and DFIs used to be shared by three agencies—the Ministry of Finance, the Pakistan Banking Council, and the SBP—whose authority had been weakened by conflicts of interest and questionable incentives. The SBP did not have the autonomy to exercise its supervisory powers over most of the banking sector, i.e., the NCBs and DFIs. Because of a conflict between the Banking Companies Ordinance and the Bank Nationalization Act (which set up the NCBs) the SBP could not exercise its powers to discipline the NCBs through various enforcement measures, especially the removal of management or withdrawal of banking licenses. Only the Government, through the Ministry of Finance and the Pakistan Banking Council, had the authority to appoint or remove NCB and DFI management. The Government, not the central bank, was the authority that granted banking licenses and permission to open branches.

The SBP's supervisory capacity is itself weak. Although it is trying to improve the quality of bank supervision, it will take time before the SBP can acquire the expertise to manage banking risks and anticipate bank failures, considering the years of neglect during the period of nationalized banking. Moreover, there are major organizational and systemic problems that work against the SBP's efforts to modernize, including a powerful labor union that resists personnel changes.

Although growing, competition in financial markets is still limited. The NCBs continue to dominate the market, also rendering market discipline weak. Among the NCBs, HBL and NBP account for half the market. Credit ceilings, although removed in principle, are still applied in practice, and prevent more dramatic shifts in market shares among the NCBs, the privatized banks, the private domestic banks, and foreign banks. Moreover, the playing field is not level. NCBs and privatized banks are allowed to operate *de jure* with less capital (although the situation is worse, *de facto,* since they have negative capital), enjoy lower tax rates, and have a preferred position to receive public sector deposits. A reduction in market concentration must be an important objective to aim for in the privatization of the NCBs. The sale of the NCBs, especially of HBL, in parts, rather than as wholes, must be a serious consideration.

Finally, the legal risks for banks in Pakistan are high. When a loan becomes nonperforming for any reason, legal recourse is costly because of the time it takes not only for decisions to be made but also to get the decisions executed. Lenders cannot foreclose on collateral without lengthy court procedures. The legal and judicial system in Pakistan has become a haven for defaulters rather than a deterrent to defaulting. Under Islamic banking practices, interest has to stop accruing 210 days after a case is filed in court, on the assumption that court decrees could be made and executed in 90 days and because of the Islamic principle that interest cannot accrue on interest. Since the experience shows that it takes years to get court cases resolved, a defaulter can enjoy an interest free loan beyond the initial 210 days allowed for accruing interest under Islamic banking practices.

PUBLIC SECTOR DEFICITS AND CREDIT RATIONING

During the five-year period, 1992/93–1996/97, the Federal Government budget deficit averaged 6.6 percent of GDP, contributing to inflationary pressures and imbalances in the external accounts, and resulting in a large buildup of public debt. The deficit was financed by borrowing from the SBP and through the auction of government securities to the banking sector, thus crowding out the private sector from credit. Following the introduction of market-based auction procedures, the interest rates on T-bills were liberalized, although initial auction procedures were far from ideal. Consequently, interest rates rose due to the poor sequencing of reforms, i.e., interest rate liberalization preceded fiscal adjustment.

Apart from crowding out the private sector, credit was allocated between banks and targeted sectors of the economy by the SBP on grounds of market failure.

MISMANAGEMENT OF SHORT-TERM CAPITAL INFLOWS

Pakistan experienced considerable private capital inflows throughout the 1980s in the form of workers' remittances and, to a lesser extent, private short- and medium-term capital inflows. These flows have financed most of the trade deficit since that period. However, it was only in 1993/94, that private capital inflows grew substantially, contributing to a rapid accumulation of reserves.

The initial expectation was that capital inflows would have positive impact, by easing external financing constraints and holding the potential for higher investment and growth. However, if capital inflows become large, they could threaten macroeconomic stability by contributing to an acceleration in domestic demand, feeding inflationary pressures. There

were significant variations in experiences of other developing countries that received capital inflows, due to the nature of the inflows and the policy responses adopted by governments. Nevertheless, policymakers have similarly sought to accommodate higher investment and growth afforded by the inflows while trying to insulate their economies from destabilizing effects. This was the challenge policymakers in Pakistan also faced.

The growing volume of capital inflows into Pakistan in recent years 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? Are the existing regulatory, supervisory, and accounting arrangements capable of fostering adequate management of these risks?

While there is evidence that workers' remittances and resident foreign currency deposits are relatively stable forms of inflows, the growing practice of using these deposits as a form of collateral has further enhanced their stability. On the other hand, portfolio investment, some nonresident foreign currency deposits, and other short-term capital present a potential risk of a reversal of flows in a very short time. It was feared this could create a banking crisis, and result in exchange-rate and interest-rate volatility. In view of this, two major areas of concern were addressed:

- the ability of the banking system to assess, price, and manage risk; and
- the adequacy of the supervisory and regulatory framework, e.g., of the SBP, to prevent and contain systemic risk, particularly in the presence of the problem of moral hazard.

To meet this risk, policymakers were required to ensure adequate gross official reserves and quality of domestic credit expansion. When the banking system is sound and efficient, in the process of 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, an expansion of bank credit induced by capital inflows will create further opportunities for banks to expose the financial system to a larger risk of financial loss. As a preventive measure, the authorities in Pakistan decided to collect foreign exchange reserves in the SBP instead of the commercial banks, thus asking commercial banks to surrender foreign exchange to the SBP. Unfortunately, the SBP and the Government did not manage foreign exchange resources from potentially volatile sources in a manner that was prudent and responsible. By the end of May 1998, the short-term foreign exchange liabilities of the banking system were $11.2 billion against official gross reserves of $1.1 billion.

TERM LENDING/RESOURCE MOBILIZATION

Financial institutions, their industrial clients, and the Government have been unable to mobilize long-term fixed-rate resources for project financing. As a result, most projects financed are repayable in five to ten years, implying a repayment of 10–20 percent of the principal every year, starting with the first year of operation. During the years of import substitution policies when ROEs were high, loans of five to ten years on projects were serviceable. Following the start of trade liberalization in 1988, and especially after tariffs were reduced sharply in 1993, ROEs have fallen sharply in Pakistan, and in line with returns in competitive international markets. This has adversely affected the debt servicing ability of businesses in the country due to the short repayment period.

Domestic investors have been locked into large equal repayments (in nominal terms) of principal, which implies heavily front-loaded real amortization patterns. This is not helpful to new projects, which

typically do not reach full capacity production or profits in the early years of operation. The outcome is loan default. The problem is aggravated by new prudential regulations that force banks to cut off working capital loans to such borrowers, thus resulting in a typical “sick industry.”

1997–1998 Banking Reforms

The problems of the financial sector had their origin in the nationalization of banking institutions, weakening of appropriate regulations, undue outside interference, and the erosion of an accountability mechanism. The thrust of the 1997/98 reform program is to improve the environment for, and ability of, bank owners, bank management, bank regulators, the markets, and the courts to provide better governance and regulation in order to promote efficient financial intermediation. The reform program focuses on:

- speeding up the privatization of State-owned institutions, and assuring necessary restructuring and improved management;
- improving the legal and judicial process for enforcement of financial contracts;
- centralizing the regulatory authority in the SBP;
- strengthening the SBP’s capabilities to perform its enhanced responsibilities; and
- improving prudential regulations and the supervision of financial institutions.

AUTONOMY OF THE STATE BANK OF PAKISTAN

To address structural weaknesses in the financial sector, the State Bank of Pakistan Act was amended to grant the SBP full autonomy in the conduct of monetary policy. Amendments were also made in banking laws to strengthen the SBP’s authority in bank supervision and regulation.

PRUDENTIAL REGULATIONS AND BANK SUPERVISION

The enactment of the amendments to the Banking Companies Law and to the Banks’ Nationalization Act made the SBP the exclusive regulatory and supervisory authority for the banking system, and insulated State-owned banks from political interference. The Pakistan Banking Council was abolished, and all its former responsibilities transferred to the SBP. Private sector bankers replaced the managers of HBL and NBP and their boards were reconstituted. Moreover, the SBP has developed a comprehensive plan to modernize and strengthen its banking supervision department, reorient its policy objectives, and adopt new supervisory techniques and data-collection methods.

LEGAL ENVIRONMENT AND INCENTIVES FOR LOAN RECOVERY

To improve the legal environment for loan recovery, Parliament passed in May 1997 the Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act of 1997. This law is expected to sharply reduce the legal and judicial costs to recover loans as it provides that default cases must be disposed of in 90 days, after which the defaulter is required to furnish security. Attachment of collateral is permitted before judgment and appointment of a receiver. In cases where a bank is authorized to recover or take possession of the collateral without filing a suit, the bank may, at its discretion, recover its loan by selling the collateral.

An incentive package was offered to defaulters vis-a-vis State-owned banks and financial institutions to voluntarily repay their overdue loans without facing legal action under the new law. The package provides incentives to all loan defaulters to settle their overdue obligations to NCBs and DFIs, offering some exemptions on payment of overdue interest. The defaulters would have to make an agreement with the respective financial institutions within one month and repayment would have to be made within six months.

ARRESTING THE FLOW OF BAD LOANS

Considering the deep-seated nature of the problems in the country’s banking sector, it will require persistent and constant efforts over the medium term to

remove them. However, in the immediate term, the Government and the SBP have taken measures to prevent the situation from getting out of hand. Based on an analysis of the 250 largest defaulters, the main source of default has been project lending by the NCBs. In December 1996, the Government, as owner, instructed the NCBs to refrain from making new project loans until June 1997. This was an emergency measure justified on grounds of stopping the hemorrhage. It also helped to restructure the market shares of the NCBs, partially privatized banks, private domestic banks, and foreign banks, which had remained static due to the previous credit ceilings. The SBP has stopped using informal credit ceilings to control liquidity, and is using more indirect means of monetary control.

In January 1997, the SBP required the new management of the NCBs and DFIs to submit for its clearance well-defined lending policies, including loan approval procedures and powers of various levels of management. It issued directives to tighten lending practices and increase transparency in lending. With its new powers over the NCBs and DFIs, the SBP has been closely monitoring compliance with the new lending policies.

PREVENTING FURTHER DETERIORATION OF THE NCBS AND DFIS

The management and boards of the NCBs and DFIs have been replaced. More important, the process of their appointment and removal has been changed through an amendment to the law. Appointment of presidents and board chairpersons are based on a list of qualified professionals, maintained and updated by the SBP. They serve for a fixed term of three years and have security of tenure. Similarly, the Government has appointed board directors in consultation with the SBP. Moreover, all selections, promotions, and transfers of NCB and DFI staff, and decisions on remuneration and benefits, are being made by the concerned bank presidents in accordance with personnel policies approved by their boards, under the guidelines of the SBP. Amendments to the law prohibit government departments from issuing directives to NCBs and DFIs that are inconsistent with those of the SBP. The Pakistan Banking Council has been abolished, making the SBP the sole regulatory and supervisory agency for the banking sector.

Acting as caretaker management until these institutions are privatized, the new managements of the NCBs and DFIs are implementing action programs approved by the SBP, aimed at conserving assets, reducing costs, downsizing staff and branches, increasing loan recovery, and limiting lending to borrowers that have no defaults with any other bank.

REDUCING THE STOCK OF NONPERFORMING LOANS

Efforts to reduce the stock of bad loans through vigorous recovery have also started. The Government and the SBP have launched a loan recovery program consisting of two phases. The first phase, from 5 June to 5 September 1997, was an amnesty program under which defaulters and “sick units” were given incentives to settle their overdue amounts. Cash settlement is typically 10 percent downpayment, with the 90 percent balance due by 5 December 1997. Under this program, some 34,000 defaulters and 770 sick units with loans amounting to PRs28.5 billion and PRs34.4 billion, respectively, were covered.

The second phase was the mandatory filing with the banking courts of default cases of borrowers who did not take advantage of the amnesty program by 30 September 1997. These defaulters will be pursued vigorously under the new loan recovery law. This law has strengthened the hand of the banks and DFIs to expedite loan recovery. Outside of the amnesty program, the new managements of the NCBs and DFIs have also pursued loan recovery more aggressively. Asset recovery departments under new management have been established. As of 30 June 1998, PRs16.3 billion had been recovered in cash,

while PRs14.7 billion in loans had been restructured or rescheduled, together constituting about 21 percent of total loan default at the time.

REFORMING GOVERNANCE THROUGH PRIVATIZATION

The overriding goal of privatization is to achieve good governance by selling the NCBs and DFIs (see Table 5) to private investors who possess the integrity, capital, banking expertise, management, and technology to run these institutions prudently and efficiently. The privatization plan consists of the following:

- complete divestiture of the Government's remaining ownership interests in MCB, ABL, PICIC, and BEL, and the sale of Habib Credit and Exchange Bank;
- full privatization of HBL, UBL, NBP, NDFC, and IDBP; and
- orderly liquidation of the bad assets that will be removed by the Government from HBL, UBL, NBP, NDFC, and IDBP when they are sold.

Reducing Political and Social Costs

Until the end of 1996, all the five large institutions to be sold were heavily overstaffed, while three NCBs, namely, National Bank of Pakistan, Habib Bank and United Bank had by far too many branches to achieve reasonable profitability. Overstaffing and overbranching were caused by political interference and by militant labor unions that resisted downsizing, making it difficult to attract bona fide investors. Thus, before privatization, the staffs and branches of these institutions are rationalized in accordance with the plans agreed with the SBP, through voluntary separation with the help of an attractive severance payment program. Through this program, 20,000 employees, or 25 percent of total staff, were shed from the NCBs and DFIs. The cost of the severance payment program is expected to be about $350 million on an after-tax basis.

Removal of Bad Assets

To attract bona fide investors and enhance the transparency of the privatization process, the Government will remove the bad assets in HBL, UBL, NBP, NDFC, and IDBP that remain after vigorous recovery efforts. However, to assure that financial restructuring is not carried out before there is a structural change in governance, the removal of bad assets will be undertaken only upon privatization.

Transparency of the Privatization Process

The Privatization Commission, the agency responsible for privatization, is contracting fully qualified investment advisers to assist in the structuring of the sales transactions and in developing related marketing plans. The Commission, in close collaboration with the SBP, is preparing a complete information package on each institution that would provide prospective bidders with sufficient information to undertake informed analyses of the transactions and perform their own thorough due diligence.

Table 5: Status of NCBs and DFIs, as of 31 December 1995

Item	Total	HBL	UBL	NBP	NDFC	IDBP
Number of Employees	77,492	31,761	22,102	21,549	1,200	880
Number of Branches	5,280	1,978	1,706	1,537	40	19
Total Assets (PRs billion)	893.0	336.6	182.2	320.2	33.0	21.0
Classified Loans (PRs billion)	121.4	52.0	32.0	17.4	8.0	12.0
Provisions (PRs billion)	42.0	18.7	4.5	10.9	2.9	5.0
Paid-up Capital (PRs billion)	6.1	2.5	1.5	1.5	0.4	0.2
Reserve Funds (PRs billion)	15.8	4.8	2.1	6.4	2.1	0.4

DFIs = development finance institutions, HBL = Habib Bank Ltd., IDBP = Industrial Development Bank of Pakistan, NBP = National Bank of Pakistan, NCBs = nationalized commercial banks, NDFC = National Development Finance Corp., UBL = United Bank Ltd.
Source: State Bank of Pakistan.

STRENGTHENING PRUDENTIAL REGULATIONS AND BANKING SUPERVISION

The general objective of banking reforms is to develop a regulatory and supervisory system that will accurately assess the conditions of banks and deposit-taking NBFIs and, where problems exist, take action to rectify them. The system will prescribe capital standards, loan concentration limits, provisioning norms, and reporting requirements consistent with international standards, and assure that such policies are pursued by NCBs and DFIs.

Reporting Disclosure for Off-site Supervision

At present, reports submitted by the banks to the SBP include substantial detail in some areas, but omit important information that is necessary to assess their condition. Banks are not required to submit an income report according to any format prescribed by the SBP. At present, annual audited financial statements are made available to the public once a year, three or four months after the end of the year. Apart from the time lag, the accuracy of these reports is questionable. Income and net worth do not reflect required provisioning for many banks.

The SBP has announced revised reporting requirements based on accounting standards that are consistent with international norms. Revised reporting began in 1997 along with initial efforts at off-site monitoring. The SBP required banks to report provisioning requirements and appropriately adjust net income and net worth in 1998, based on 1997 reports.

In due course, on-site examinations will help assure the accuracy of the reports. Once the quality of reporting reaches satisfactory levels, the information from individual banks will be available to the public, in an effort to make the overall financial system transparent and subject to greater market discipline.

Role of Bank Examiner

In the past, on-site examinations have focused, to a considerable extent, on determining whether banks were complying with certain legal requirements. Examiners paid little attention to such factors as determination of overall performance, risk profile, and the quality of management at the banks.

The SBP has hired the services of an international consulting firm, in consultation with the World Bank, whose mission includes, among other things, modernizing and reorienting on-site bank examinations in Pakistan. This will involve participating in on-site examination, developing a satisfactory examination manual that focuses on bank risk and performance, an appropriate examination report, and initiating training to enable supervisory staff to act effectively in the future.

Quality of Examination Staff

As a part of its plan to revamp its supervisory and regulatory side, the SBP has started a crash recruitment and training program to improve its long- and short-term staffing and skill requirements. In the short run, it has recruited several qualified and experienced middle-level staff in the banking supervision departments. In the long run, it is necessary to continually recruit qualified young professionals to keep up with growing staffing needs. The pay and quality of supervisory staff must be sufficient so that they eventually command the respect of the financial institutions. The SBP has developed a plan for staff compensation in 1997/98.

Capital Requirements

Currently, capital requirements are based on total callable liabilities. They are 7.5 percent for foreign banks, 8 percent for private domestic banks, and 3 percent for the NCBs and partially privatized banks. The Pakistani liability-based system does not raise the capital requirement for off-balance sheet exposure, nor lower it for holdings of cash and government securities, nor take account of borrowings. To strengthen the system's capital base and achieve international consistency, Pakistan will move to the Basle system of defining minimum capital requirements. These requirements will apply to consolidated bank balance sheets for all Pakistani banks.

Provisions for Loan Losses

Loan classifications and provisioning requirements are based principally upon the length of time that either or both interest and principal payments are in arrears on a particular loan. In calculating required provisioning, only liquid collateral is netted out. Some provisioning requirements may appear substantial in view of the value of nonliquid collateral. However, recovery experience from nonliquid collateral on NPLs has been bad.

Time-based provisioning will continue until satisfactory court reforms occur and loan collection experience shows improvement. In the immediate future, the best practice will be to continue time-based provisioning, supplemented by increased classification and provisioning in those situations where time-based rules understate likely present value loss. Required provisions as determined by the SBP will be made, regardless of their impact on net income and on a bank's net worth.

Loan Concentration

Single-borrower limits for commercial banks are reasonable and consistent with international standards. However, a single borrower, if a listed company, was allowed to borrow up to 20 percent of the assets of an NBFI. This is excessive and could lead to insolvency. Accordingly, the SBP has revised the relevant regulations to make the single-borrower limits of deposit-taking NBFIs consistent with those of commercial banks.

Large Credits

Large business groups account for a major share of bank borrowing in Pakistan and the performance and creditworthiness of these groups are important for bank performance. The SBP will establish a staff team within its departments that will analyze financial performance of major Pakistani groups and their affiliates and its findings will be available to those engaged in on-site examinations.

Problem Banks, Enforcement, and Bank Closing Procedure

The laws have been changed to make it possible for the SBP to identify problem banks, take measures to enforce prudential requirements, and initiate closing procedures if a banking company does not show improvement.

Deposit Insurance

The Government guarantees deposits with nationalized banks, but this is not the case with deposits with private domestic banks, which account for about 7 percent of total bank deposits. During the next several years, a deposit insurance system will be developed. Such a system will provide limited deposit insurance coverage when a bank fails, making it more feasible to close banks and lessening the potential exposure of the Government or the SBP in the event of bank failure.

Bank Audit

The SBP has the authority to prescribe standards for external audit. Apparently, many bank audits do not meet rigorous standards. The authority to prescribe audit contents and to maintain an approved list of auditors will be pursued more vigorously and made to complement and strengthen the SBP's supervisory activities.

PROMOTING MARKET INTEGRATION

Market integration reforms should remove the major causes of segmentation of the credit market. Significant progress has already been made in this direction. For instance, control on yields on government securities through a restriction on the volume at auction has already been abolished, statutory reserve requirements for banks and DFIs have been lowered, and interest rate subsidies on special credit programs have been virtually eliminated. The forward foreign exchange cover program for foreign currency deposits by the SBP has been removed. However,

the administered rates on national savings schemes continue, but the interest rate structure is in the process of rationalization.

STATUTORY LIQUIDITY REQUIREMENT (SLR) AND AUCTIONS OF GOVERNMENT SECURITIES

Previously, banks and NBFIs were required to invest 25 and 19 percent, respectively, of their demand and time liabilities in approved securities. Effective June 1997, the SLR was reduced by 5 percentage points, thereby reducing SLR of banks and NBFIs to 20 percent and 14 percent, respectively. This is expected to improve banks' profitability, provide higher returns for depositors, increase financial savings, and, eventually, lead to better resource allocation.

At the same time, the SBP has started the practice of preannouncing the volume of securities to be auctioned each time and allowing the bidding process to determine the yield on T-bills. These measures probably contributed to the rise in interest rates on public debt instruments to about 17.5 percent, a rate considered in line with the budget deficit, the inflation rate, and prevailing market conditions. By early 1998, as loan demand from the private sector slackened, the T-bill rates fell back to about 15.5 percent.

SPECIAL CREDIT PROGRAM

The authorities have reduced mandatory and concessionary credit schemes and are committed to substantially phasing them out, in line with the gradual removal of excess burden of stuck-up loans and the high administrative costs on the rates of interest.

The only significant program for which concessionary SBP refinancing is being provided is export financing. Although recent changes have made the scheme less attractive to lenders (e.g., the lender's spread has been lowered from 3 to 2 percent), the lending rate itself has been reduced, and the amount disbursed has increased in line with other private sector financing. Due to the need to boost exports, the SBP does not consider it timely to phase out this scheme until other alternatives can be found.

COLLATERAL AND FORECLOSURE LAW REFORMS

As part of the Banking Sector Reform Program, the following laws have been passed:

- Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act, 1997;
- Banks (Nationalization) Act, 1997 (Amendment);
- Banking Companies Act, 1997 (Amendment); and
- State Bank of Pakistan Act, 1997 (Amendment).

Various amendments have also been made to the Banking Companies Ordinance of 1962 to enhance the effectiveness of the SBP as a supervisory and regulatory body and to safeguard the interests of banks and depositors (see Appendix 3).

Until 1997, there were two parallel systems of bank loan recovery courts: special banking courts, with jurisdiction over interest-based transactions; and banking tribunals, with jurisdiction over noninterest-based (or so-called Islamic) transactions.

With the enactment of the Banking Companies Act of 1997, the previous parallel systems were replaced by a new unified system of banking courts. Under the new system, one unified court system deals with the recovery of all loans, whether interest- or noninterest based. The Act also creates a more effective two-tier system, in which cases of up to PRs30 million are to be tried by the banking courts, and cases above this amount by the high courts. This division of work will enable the courts to expedite the disposal of the heavy load of pending recovery cases, and help the financial institutions recover their debt quickly. To increase effective court capacity, the Government has established 34 banking courts, pursuant to the new law.

FREEZING OF FOREIGN CURRENCY ACCOUNTS

At the end of May 1998, amid threats of economic sanctions from the United States and other countries for testing nuclear devices, and fearing capital outflows, the Government froze all foreign currency accounts.

Remaining Issues and Recommendations on Banking Sector Reform

The importance of banking sector reform cannot be overemphasized. Apart from reducing the cost of financial intermediation, it could result in the restructuring of existing sick industrial units and lay the foundation for better credit decisions. This will contribute greatly to higher GDP growth and improve the balance of payment position through better resource allocation.

Despite reforms, the banking sector still suffers from serious structural weaknesses rooted in governance failure, lack of financial discipline, and macroeconomic imbalances. These difficulties are further aggravated by the country's weak external position, stagnant economy, and loss of confidence in the financial system. The measures already taken by the Government and the continuing efforts to improve the banking system represent a fairly wide-ranging set of reforms. However, the Government's commitment to the reforms is beginning to be in question and there are some doubts about its capacity to carry them through fully. Moreover, there are other issues that need to be addressed to make the reforms successful.

Issues and Recommendations

FAILURE OF GOVERNANCE

The failure of governance that afflicts the NCBs and the SBP is a reflection of the general weakness in governance across the various development sectors. There has been a disrespect for the law and the judiciary has been subjugated to political power. Harassment of the private sector is frequent through misuse of law enforcement powers and abuse of tax authorities, while others are rewarded through selective application of the law. Even the accountability mechanism set in place is biased and lacks credibility. The SBP's autonomy is an example. While the SBP has been granted greater autonomy in the conduct of monetary policy through a legal enactment, in effect this autonomy has not been exercised. The main reason is that the overall balance of power is heavily tilted in favor of the Prime Minister. Parliament and the Cabinet are circumvented in policy making so that the Governor of the SBP can hardly challenge the direction of the Prime Minister in any matter. This was visibly demonstrated during the foreign exchange crisis in the post-May 1998 period, when SBP circulars were issued but were contradicted by the Prime Minister.

Similarly, the independent management of the NCBs is most often countered by government announcements. Political interference in banks' management decisions was publicly demonstrated when some private sector loan defaulters advertised in the free press that they were willing to reschedule their outstanding loans on the same conditions as those provided to the Prime Minister's family businesses by some banks. This shows that there are different criteria applied for evaluating loan decisions of the influential.

Prospects of political change to rectify the underlying causes of poor governance are slim. In fact, recent constitutional changes have further concentrated power in the hands of the Prime Minister, stifled dissent in Parliament through mandatory party consensus on all issues, and given law enforcement agencies unquestioned powers through emergency and antiterrorist laws.

The independence of the judiciary should be reestablished and accountability made impartial.

LACK OF FINANCIAL DISCIPLINE

The appointment of independent and professional management of the NCBs, and new SBP prudential

regulations have contributed toward the improvement in financial discipline of banks. However, there is still much to be achieved. Apart from stopping political interference, it is recommended that capital requirements of publicly and privately owned banks be harmonized with the standards set under the Basle Convention. Moreover, factors that hinder a more competitive market structure should be removed, such as lower tax rates applied to NCBs, better access of NCBs to public sector deposits and, most important, implicit credit ceilings for each individual bank that assure the NCBs a larger share of the market.

The SBP needs to strengthen its supervisory capacity so that banks' balance sheets reflect the true position more accurately.

DETERIORATION OF LOAN PORTFOLIO

Commercial banks' loan portfolios are deteriorating for a number of reasons. First, better accounting procedures have led to a reclassification of loans into the nonoperating and bad loan categories. Second, poor economic conditions and changing domestic prices have eroded the operating margins of many businesses, forcing them to default. The matter has been further complicated by the stricter enforcement of SBP prudential regulations that cut off working capital to businesses that are behind their project loans, which virtually guarantees their total collapse. With an underdeveloped capital market, and five-year terms on most project loans, firms are increasingly unable to service project loans that require an annual repayment of 20 percent of the principal, especially since the economy is in a slump and tariff liberalization has reduced profit margins. Mergers or bank takeovers of the management of failing businesses are practically unheard of in Pakistan. In this kind of environment, it is not surprising that banks have become even more conservative in their lending policies, cutting off possibilities of rescheduling loans or encouraging financial restructuring among their borrowers.

There is a wave of sentiment against all defaulters due to the criminal and deliberate default by a corrupt political elite. Genuine businesses are equally maligned and unable to negotiate on fair terms. Ironically, the class of defaulters that has provoked the ire of the country due to its criminal defaults is still able to reschedule its loans due to misuse of political power.

Urgent steps should be taken to develop the capital market, extend the terms of project finance, or reschedule the loans of genuine cases. This will require a case-by-case analysis. Rescheduling must be associated with some or total management takeover by the commercial banks or their chosen management consultants who would help turn the businesses around. Prudential regulations also need to be revisited to find ways to avoid precipitating the financial collapse of firms that are beginning to have problems. In addition, some financial institutions such as the DFIs could develop longer-term debt instruments and explore the use of other instruments.

RECOVERY OF BAD LOANS

Legislative and administrative support is in place to promote the speedy foreclosure of collaterals. However, little progress has been made regarding this matter due to several reasons. First, press statements by government functionaries regarding decisions taken by the newly appointed professional managements with respect to downsizing cast doubt about the autonomy of banks in making decisions and delay and jeopardize the restructuring process. Second, by introducing a distorted incentive scheme to loan defaulters and then by extending the deadline to avail of the same, the SBP has sent the wrong signal to the market about its commitment to recover loans. The loan recovery process is also marked by perceptions among defaulters of unequal treatment by the Government, and the banking courts have yet to prove that the new law is adequate for speedy recovery. Third, notwithstanding the above, the reforms overestimate the speed at which loans can be recovered. For instance, even if the total current defaults of PRs120 billion were properly collateralized, and

courts were able to give early verdicts in favor of liquidation, it is highly unlikely that such a large portfolio could be sold in such a depressed market, especially since these would be all cash transactions without bank credit support. It would be better to transfer these bad assets to a separate fund for the lengthy process of recovery, and as a result lower the burden of the bad portfolio on banks so that they could reduce the spread between the deposit and lending rates. The latter is the ultimate objective of the reform to enhance financial intermediation and stimulate economic activity. Another important advantage would be that banks could, as a consequence, improve their balance sheets so that when these are eventually privatized, they could fetch a good price and help pay back some of the public debt. The current hurry to sell all NCBs is purposeless since they will not get a good price. Rather, by appointing professional autonomous managers, much of the gains to the financial system can be attained.

MARKET FAILURE IN PRICING PROJECT FINANCE

While efforts have been made to professionalize the process of loan provision, a concern has been raised that most commercial banks and even the DFIs have sharply curtailed project finance. Part of the reason is that a large segment of existing bad debt is related to projects, and since project finance by its nature is more risk-prone, banks shy away from lending in this area. Until July 1997, the SBP imposed a moratorium on project finance lending by the banks that has subsequently been relaxed only sparingly. The consequences of such a policy for industrial investment and growth can be significantly adverse. The issue has become more acute since prospects of opening new international lines of credit for project investment through DFIs are low and DFIs may also not be keen to take project risks, especially when they are privatized as well. This is a clear case of "market failure" or a divergence between the private and social benefits of project finance. One way to resolve this would be to allow banks to charge high rates of interest on project finance, but that would choke off industrial investment altogether. A second option is to adopt a cautious speed in privatizing the remaining DFIs and assure through their charters a significant share in their portfolios for project finance. The last option is to guarantee independent, private, and professional management. Similarly, banking reform, in its drive to make everything market-based, should not overlook "market failure" in the case of the unwillingness of banks to lend to the agriculture sector.

Another issue related to project finance is that banks in general require investors to undertake projects with a debt to equity ratio of 60:40 and, in some cases, 70:30. The required ratios are the result of banks' own perceptions of risk and in consideration of existing prudential requirements. Since capital market development is at an early stage in Pakistan, such equity requirements often lead to circumvention of debt/equity requirements through selective waivers on a discretionary basis (presenting an opportunity for corruption) or to overinvoicing of machinery to generate "equity". In light of this, it will be advisable to standardize equity requirements consistent with a debt to equity ratio of 70:30, strengthen collateral requirements, and lengthen the term of the loans. Currently, most local-currency project loans are of five to seven years duration, thus squeezing investors of not only a high debt service burden of 20 percent of principal alone but also the lack of equity. By extending the terms of project finance to 15–20 years, the burden would be drastically reduced even if debt to equity ratio was 60:40.

PRIVATIZATION

Early privatization of NCBs is desirable. In the interim, the establishment of professional, honest, and independent management will achieve all the economic gains that privatization ultimately will. The sale of public assets has the added advantage that the proceeds could go towards retirement of public debt.

However, privatization should not be rushed at the cost of jeopardizing the restructuring process or recovering bad loans. An attempt was made to privatize UBL in 1997, but obscure procedures brought about by conflicting interests doomed the sale from the start. The failed privatization of UBL has underscored the lesson that the main goal must be to sell the banks through a transparent selection process to private investors who possess the integrity, financial and managerial capacity, and the expertise to run these banks.

To a large extent, the SBP has shifted to indirect instruments (especially open market operations) in the conduct of monetary policy. The use of market-based methods to control monetary aggregates is commendable since it encourages the efficient use of resources. However, there are indications that the shift to the use of indirect instruments is not yet complete. Due to the Government's continuing practice of borrowing directly from the SBP, the expansion of reserve money is sometimes not commensurate with the targets for growth in overall liquidity, leading the SBP to suggest "notional" credit targets to various commercial banks. Adoption of notional credit targets does not contribute to the efficient allocation of credit, prevents the restructuring of the banking sector, and impinges on the profitability of individual banks by forcing them to be more liquid than desired. The SBP should try to adhere to targets of reserve money and refrain from suggesting notional credit targets to banks. In a related issue, the procedures of open market operations should be made transparent. The size of T-bill auctions, once announced, should not be exceeded if they are oversubscribed.

FOREIGN CURRENCY ACCOUNTS

The freezing of foreign exchange accounts is the largest failure of the banking system in Pakistan's history, affecting accounts worth $11 billion (PRs533 billion), causing a loss to depositors of at least PRs100 billion at the kerb[3] exchange rate of PRs55 per dollar. The loss could be more as the kerb rate inevitably rises. Significantly this is not a commercial bank failure, but a reflection of the lack of prudential management by the SBP and the Government, which are the supervisors and regulators of prudential behavior in the banking system. The affected depositors are ordinary citizens of Pakistan, whose $11 billion deposits financed a large portion of the country's current account deficit since 1991. This resulted in a loss of annual inflow of $2.5 billion into the Government's reserves at a time of uncertain official aid commitments and poor export prospects.

In view of Pakistan's limited success in tapping international financial markets with other instruments, the significance of foreign currency accounts in financing the balance-of-payments deficits cannot be overemphasized.

Foreign currency deposits, because of the anonymity of source of funds, to some extent also represent the earnings in the informal sector. For example, deposits of Pakistanis in international banking centers declined after the deregulation of resident foreign currency deposits in 1991. Now that the rules governing these accounts have changed, most of this money will flow back to overseas accounts. Already nearly $4 billion has been withdrawn at the official rate of PRs46/$, and according to secondary data, it has left the country through the black market for foreign exchange. There are three reasons for this: first, domestic financial assets do not provide the inflation and exchange rate hedge that can be derived from foreign currency accounts, while domestic real estate does not provide the liquidity ensured by foreign currency accounts. Second, a loss of confidence due to freezing foreign currency accounts has spilled over to all Government and banking financial instruments. Third, the bizarre manner in which the Government handled its differences with the foreign investors in the power sector led to a crash in the stock exchange market, thus discouraging depositors shifting their resources in the capital market.

The growth of foreign currency deposits constitutes dollarization, which is measured by the ratio of

resident foreign currency deposits to total domestic liquidity. The ratio increased from 2.6 percent in 1991 to about 33 percent in 1998. Its rapid growth was a reflection of the lack of confidence in the state of economy by the depositors. This was the response of people to poor economic management and expectations of inflation and devaluation.

The recent Government decision to freeze foreign currency deposits cannot eliminate dollarization or the desire of economic entities to hold a safe, reliable currency. By forcing the conversion of foreign accounts into rupees, people will either hold dollar balances outside the banking system or transfer their foreign exchange funds abroad to offshore banks as they were doing before 1991. In either case, the open market exchange rate will result in sharp devaluation, inflation, and further outflows. No emergency law can stifle market forces. Industrial countries' central banks together have failed to counter foreign exchange market forces. It would be suicidal for the SBP to try to manipulate the market. All these actions will result in large-scale financial disintermediation and an inevitable financial crash. The worst aspect is that the freeze on foreign exchange accounts has cost Pakistan about $2.5 billion in annual inflows in the balance of payments.

About $7 billion remain frozen in foreign currency accounts while the country's gross foreign exchange reserves are a little less than $600 million. Depositors await the Government's final decision amid conflicting reports. Since the freezing of the accounts, the Government has taken several other steps that have further shaken foreign investor confidence in the credibility of its commitment to direct investors, participants in privatization, and depositors in the banking system. There has been little success in converting these deposits into long-term bonds. The question is: what should the Government do with these deposits? And what kind of foreign currency account scheme should be operated?

A significant portion of the $7 billion remaining in foreign currency accounts has been collateralized against rupee-denominated advances over the last few years, and to some extent these deposits are unlikely to be withdrawn even if the restrictions are removed. Yet these could be settled against the advances at the market exchange rate. The rest of the deposits should be merged eventually with the "new" foreign currency accounts managed by the commercial banks. To carry this out, the following measures should be undertaken. First, it will be necessary for the SBP to transfer adequate foreign exchange to the commercial banks when a buildup of reserves allows it. The new foreign currency accounts should be operated by the commercial banks, which could either or both hedge against the exchange rate risk in a developed forward market for foreign exchange and invest abroad under relaxed capital account regulations of the SBP. In this regard, it is necessary to immediately develop a forward foreign exchange market, and the SBP should completely withdraw from its operations to provide exchange rate cover. Second, the SBP regulations regarding capital flows should allow commercial banks to participate in the international markets while managing deposits in new foreign currency accounts. Third, as the official gross reserves improve, a portion of the frozen foreign currency accounts could be gradually unfrozen in phases, as equivalent foreign exchange is transferred back to the commercial banks for management. The merit of the latter proposal will be that the confidence (though tenuous) that can be developed in the new foreign currency accounts will also transfer to the gradually unfrozen foreign currency accounts.

The Issue of Capital Mobility

The Mexican and Asian crises took most policymakers by surprise since both were preceded by buoyant financial markets for assets and major inflows of capital. In both cases, investors abruptly changed their perceptions about the economy, leading to massive outflows of capital, unleashing profound crises in domestic financial systems, and threatening the productive sectors.

One lesson from the crises is that financial globalization quickly exposes and punishes countries' economic weaknesses and facilitates the worldwide transmission of financial turmoil. It is essential for countries to maintain appropriate policies and measures that reduce the risks of capital outflows, e.g., sound macroeconomic fundamentals, strong fiscal position, external viability, improved supervision and regulation, and transparency of financial systems.

Some of the conclusions drawn by commentators on the Asian crisis are worth closer examination.

- The economic and financial damage resulting from the crisis was not inevitable and was exacerbated by policy errors that further reduced investor confidence.
- The role of a fixed or pegged exchange rate policy in precipitating the currency crisis has been exaggerated. The crisis was brought about by inconsistent policies that finally lost credibility.
- The role of capital outflows in triggering the crisis has been overestimated, in essence, treating symptoms of deeper problems as if they were the problems themselves.
- Halting and eventually reversing capital flight is a difficult task even in the best of circumstances. Unless the underlying problem is recognized, there is little chance that the injection of new external capital alone—even in large doses—can prove effective in ending a financial crisis that is essentially a crisis of confidence.
- Any solution to the crisis will necessarily rely on private funding. Thus, restoring investor confidence is the main challenge. Large-scale public funding is not a practical alternative to capital market stabilization. Strengthening the financial markets will contribute substantially to rebuilding confidence.
- A long tradition of regional exchange rate stability had encouraged domestic investors to assume significant currency risk. These investors incurred large losses on unhedged positions when central banks abruptly withdrew from the foreign exchange market without providing a clear rationale for their decision to float their currencies.

The long-running debate about the desirability of unrestrained capital movements has intensified in the wake of the Asian financial crisis. Do capital controls have a role in today's world economy? This question needs to be addressed in the context of the economic role of government and the limits of economic policy as viewed today.

There is a widely held view that the role of government is to allow and support, not to restrain or compete with, private initiative. Government responsibilities for economic performance do not include direct management of the economy but, rather, involve maintaining a stable macroeconomic framework, supporting the economic infrastructure, and developing an institutional infrastructure (legal, regulatory, social, economic, as well as a competitive open economy).

Regarding the limits of macroeconomic policy, the empirical evidence suggests that most countries have moved in the direction of using economic policy as a means for encouraging market forces rather than competing with them. The main issue that emerges is whether the case for market forces has been stretched to the point that it conflicts with a sustainable balance between national and international interests.

The experience of the Asian economies demonstrated the need to proceed with caution in opening the capital account. Liberalization needs to be undertaken with appropriate macroeconomic, exchange rate, and financial sector policies. The issue relates more to the sequence of reforms than to their speed. It is also critical to recognize that a country's economic policies will be constrained by its choice of exchange rate arrangements. Therefore, attention has to be given to the maintenance of an appropriate, sustained, and consistent policy mix to prevent a

country from attracting short-term inflows on a scale that it cannot absorb.

Capital inflows in Pakistan were not as large as those in Asian economies. Nevertheless, the country also experienced the instability of these inflows, particularly of short-term deposits. Weak economy, a financial system overburdened with debts, and threats of sanctions by donor institutions on political grounds contributed largely to this instability. Government policies, particularly the freezing of foreign currency accounts, have triggered the loss of confidence of foreign investors and domestic depositors in the banking system. Economic revival depends on bringing back this confidence to solidify the country's financial system.

Notes

[1]*Modaraba* refers to term financing devised in 1980 to comply with Islamic mode of financing. It is an agreement between two parties whereby one provides 100 percent of the capital for a project and the other party manages it.

[2]A private market in forward cover related to trade transactions, although still thin, has developed in recent years.

[3]Open market.

Appendix 1

Domestic and Foreign Financial Institutions, as of 31 March 1998

A. Nationalized Scheduled Banks
1. First Women Bank Ltd.
2. National Bank of Pakistan
3. Habib Bank Ltd.
4. United Bank Ltd.

B. Denationalized Scheduled Banks
1. Allied Bank of Pakistan Ltd.
2. Muslim Commercial Bank Ltd.

C. Specialized Banks
1. Agricultural Development Bank of Pakistan
2. Federal Bank for Cooperatives
3. Punjab Provincial Cooperative Bank

D. Private Scheduled Banks
1. Askari Commercial Bank Ltd.
2. Bank Al-Habib Ltd.
3. Bolan Bank Ltd.
4. Faysal Bank Ltd.
5. Habib Credit & Exchange Bank
6. Indus Bank Ltd.
7. Metropolitan Bank Ltd.
8. Platinum Bank Ltd.
9. Prime Commercial Bank Ltd.
10. Prudential Bank Ltd.
11. Schon Bank Ltd.
12. Soneri Bank Ltd.

E. Provincial Commercial Banks
1. The Bank of Khyber
2. The Bank of Punjab
3. Union Bank Ltd.

F. Foreign Banks
1. ABN AMRO Bank N.V.
2. Albaraka Islamic Bank BSC (EC)
3. American Express Bank Ltd.
4. ANZ Grindlays Bank Ltd.
5. Bank of America (NT & SA)
6. Bank of Tokyo Mitsubishi Ltd.
7. Bank of Ceylon
8. Banque Indosuez
9. Citibank N.A.
10. Deutsche Bank A.G.
11. Doha Bank Ltd.
12. Emirates Bank International Ltd. PJSC
13. Habib Bank A.G. Zurich
14. Hongkong and Shanghai Banking Corp. Ltd.
15. International Finance Investment and Commerce Bank Ltd.
16. Mashreq Bank PSC
17. Oman International Bank SOAG
18. Rupali Bank Ltd.
19. Société Générale the French Int. Bank Ltd.
20. Standard Chartered Bank
21. Trust Bank Ltd.

G. Development Financial Institutions
1. Bankers' Equity Ltd.
2. Housing Building Finance Corp.
3. Industrial Development Bank of Pakistan
4. Investment Corp. of Pakistan
5. National Development Finance Corp.
6. National Investment Trust
7. Pakistan Industrial Credit and Investment Corp.
8. Pak Kuwait Investment Company
9. Pak Libya Holding Company
10. Regional Development Finance Corp.
11. Saudi Pak Industrial and Agricultural Investment Corp.
12. Small Business Finance Corp.

H. Investment Banks
1. Al-Faysal Investment Bank
2. Al-Towfeek Investment Bank
3. Asset Investment Bank
4. Atlas BOT Investment Bank
5. City Corporation Investment Bank (Pak) Ltd.
6. Crescent Investment Bank
7. Escort Investment Bank
8. Fidelity Investment Bank
9. First International Investment Bank
10. Franklin Investment Bank Ltd.
11. Islamic Investment Bank
12. Orix Investment Bank (Pak) Ltd.
13. Prudential Investment Bank
14. Security Investment Bank
15. Trust Investment Bank Ltd.

Source: Finance Division, Government of Pakistan.

Appendix 2

Foreign Currency Accounts Scheme in Pakistan

The 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 for Pakistani residents to open and maintain these accounts was granted as part of the overall package of foreign exchange reforms announced in February 1991. At present, banks may, without the approval of the SBP, allow Pakistani nationals residing in or outside the country, including those having dual nationality to open and maintain foreign currency accounts in Pakistan. Resident companies, including investment banks and companies incorporated in Pakistan with foreign shareholdings, are also eligible. The facility is also available to diplomatic missions and their officers, international organizations in Pakistan, and foreign firms/corporations other than banks incorporated and operating abroad, provided that they are owned by persons who are eligible to open foreign currency accounts.

The balances held in foreign currency accounts and income therefrom are exempt from the wealth and income taxes, and compulsory deduction of *zakat* (Islamic tax of 2.5 percent for welfare use) at source. Banks can also grant rupee loans to account holders up to a certain limit of their balances and can also issue guarantees on their behalf in favor of residents or nonresidents. The SBP covers exchange risk of all such deposits against payment of prescribed fee.

Appendix 3

Amendments to Banking Legislation

In January 1997, the caretaker Government promulgated three ordinances amending the SBP Act, the Banks Nationalization Act, and the Banking Companies Law. In May, these ordinances were approved by Parliament. The amendments aimed to give the SBP full autonomy in the conduct of monetary policy, to strengthen its regulatory and supervisory powers, to insulate it and State-owned banks from government interference, and to promote good governance of State-owned banks.

AMENDMENT TO THE SBP ACT

To give the SBP full autonomy in the conduct of monetary policy, its board of directors has been given the authority to determine and enforce a limit on the credit to be extended by the SBP to the Government and its agencies. The Government will have to meet its additional requirements directly from commercial banks through market-based auctioning system to be conducted by the SBP. Moreover, no government agency has the right to issue directives to any banking company that is inconsistent with SBP directives.

AMENDMENT TO THE BANKING COMPANIES LAW

The amendment gives the SBP the sole authority for supervising banks and NBFIs. All previous rights for the federal Government to interfere in the activities of the banks have been transferred to the SBP. Penalty rates on various violations have been raised. The period of takeover of the management of a bank by the SBP has been increased from two to three years.

AMENDMENTS TO THE BANKS NATIONALIZATION ACT

The aim of the amendment was to insulate the NCBs and NBFIs from government interference, giving them autonomy to operate as commercial institutions. The Pakistan Banking Council, which used to have great power in overseeing the activities of all NCBs, has been dissolved. All its assets and liabilities were

transferred to the SBP. Each bank will have a board of directors consisting of a chairman, a president, who is also the chief executive, and between five and seven other members. All board members shall be appointed by the federal Government in consultation with the SBP. The chairman and the president will be chosen among a panel of bankers maintained and updated by the SBP. The term of all board members is three years. The board of directors is solely responsible for determining all bank policies. No person with a political appointment can serve in the board of directors of any bank.

Appendix 4

Selected Bank Indicators

Table A4.1: Market Share of Banks, 1992/93–1996/97 (percent)[a]

Item	1992/93	1993/94	1995/96	1996/97	Percentage Change 1992/93 and 1996/97
Deposit Market Share[b]					
Nationalized Commercial Banks	58.3	53.6	49.7	45.6	(21.8)
Habib Bank Ltd.	25.0	21.9	19.7	18.3	(26.8)
National Bank of Pakistan	20.4	19.3	20.9	18.3	(10.3)
United Bank Ltd.	12.7	12.2	8.8	8.7	(31.5)
First Women Bank	0.2	0.2	0.3	0.3	50.0
Partially Privatized Banks	20.1	18.2	19.6	18.0	(10.4)
Muslim Commercial Bank	13.4	11.8	12.9	11.9	(11.2)
Allied Bank Ltd.	6.7	6.4	6.7	6.1	(9.0)
Specialized Banks	1.4	1.4	1.5	1.5	7.1
Private Domestic Banks	5.6	8.1	10.5	12.7	126.8
Branches of Foreign Banks	16.6	18.7	18.7	22.3	34.3
Loan market share[c]					
Nationalized Commercial Banks	49.4	46.9	41.8	39.0	(21.1)
Habib Bank Ltd.	23.2	20.5	17.7	16.8	(27.6)
National Bank of Pakistan	15.4	15.8	14.9	14.0	(9.1)
United Bank Ltd.	10.7	10.5	9.1	8.1	(24.3)
First Women Bank	0.1	0.1	0.1	0.1	0.0
Partially Privatized Banks	12.6	12.8	14.1	14.5	14.3
Muslim Commercial Bank	8.3	4.3	9.2	5.2	(37.3)
Allied Bank Ltd.	4.3	8.5	4.9	9.3	116.3
Specialized Banks	20.2	18.1	17.0	15.6	(22.8)
Private Domestic Banks	4.0	7.4	10.4	12.3	207.5
Branches of Foreign Banks	13.8	14.8	16.8	18.7	35.5

( ) = negative values are enclosed in parentheses.
[a] Based on end-of-period data. Data for 1994/95 are not available.
[b] Deposits include banks' liabilities to the nongovernment sector plus deposits of the federal and provincial governments.
[c] Includes lending to the private sector, public enterprises, and autonomous bodies.

Table A4.2: Foreign Currency Deposits, 1992/93–1996/97 ($ million)

Item	1992/93	1993/94	1994/95	1995/96	1996/97[a]
By Source					
Residents' Deposits	2,250	3,002	3,384	4,147	5,495
Nonresidents' Deposits	2,227	2,933	3,192	4,158	4,352
With Domestic Banks	2,050	2,476	2,524	3,050	2,657
Institutional Deposits	864	1,059	1,199	1,592	1,533
Individual Accounts	1,186	1,417	1,325	1,458	1,134
With Domestic Nonbank Financial Institutions	177	457	668	1,108	1,685
Total	**4,477**	**5,935**	**6,576**	**8,305**	**9,846**
By Type					
Demand Deposits	2,115	2,687	2,723	3,413	3,748
Current	158	153	160	217	203
Call	43	103	49	68	120
Savings	1,914	2,431	2,514	3,127	3,425
Time Deposits	2,362	3,248	3,853	4,892	6,099
1 month	92	173	99	266	407
3 months	992	1,342	1,409	1,720	1,773
6 months	314	882	1,039	1,160	1,347
1 year	781	678	1,001	1,396	1,419
Above 1 year	183	173	305	351	1,153
Total	**4,477**	**5,935**	**6,576**	**8,305**	**9,847**
			In percent		
Demand Deposits to Total	47.2	45.3	41.4	41.1	38.1
Of which: 6 months and less	31.2	40.4	38.7	37.9	35.8
Memorandum Items:					
Share of Foreign Currency Deposits in Total Deposits	24.2	28.3	26.7	31.2	36.8
Share of Resident Foreign Currency Deposits in M2 Deposits	14.3	17.8	17.2	20.7	28.1
Share of Resident Foreign Currency Deposits in M2	10.3	13.1	12.7	15.6	21.4

[a] Preliminary.
Source: State Bank of Pakistan and author's estimates.

Table A4.3: Classification of Scheduled Banks' Advances by Type of Borrower—All Banks (PRs million)

Borrower	End June 1990	1995	1996	1997
Foreign Constituents	77.4	246.2	3.7	na
Business	77.3	241.7	3.2	na
Individual	0.1	4.5	0.4	na
Local	216,912.5	453,666.9	502,641.2	577,917,6
Government	23,990.0	44,336.9	50,615.9	55,598.7
Public Sector Enterprises	15,980.7	26,426.2	31,779.5	44,708.7
Agriculture, Forestry, Hunting & Fishing	42.0	127.8	203.3	364.2
Mining & Quarrying	552.7	1,731.2	2,003.4	3,598.7
Manufacturing	8,884.2	10,519.1	11,865.3	17,214.6
Construction	805.0	125.8	333.2	746.8
Electricity, Gas, Water & Sanitary Services	3,492.0	4,509.2	6,031.6	6,085.4
Commerce	450.9	2,800.6	3,645.6	5,608.1
Transport, Storage & Communication	207.1	2,721.5	4,292.5	7,566.6
Services	44.5	1,425.2	745.6	133.2
Private Sector (Business)	155,794.1	332,019.0	358,503.4	404,445.8
Agriculture, Forestry, Hunting & Fishing	39,915.9	59,139.1	55,012.4	59,726.8
Mining & Quarrying	850.8	2,797.9	4,087.7	3,642.1
Manufacturing	63,977.8	149,812.0	174,917.5	203,506.3
Construction	4,313.9	7,976.3	6,856.6	8,835.9
Electricity, Gas, Water & Sanitary Services	624.9	4,346.1	5,263.5	4,669.6
Commerce	35,375.9	61,517.2	64,493.8	69,593.8
Transport, Storage & Communications	1,220.3	13,991.6	13,380.1	14,311.3
Services	2,207.9	3,111.4	4,550.6	5,578.4
Other Private Business	7,306.7	29,327.4	29,941.2	34,581.6
Trust Funds & Nonprofit Organizations	441.1	446.1	506.6	1,603.2
Individual	20,545.0	49,323.2	60,489.7	70,151.9
Others	161.6	1,115.5	746.1	1,409.3
Total	**216,989.9**	**453,913.1**	**502,694.8**	**577,917.6**

na = not available.
Source: State Bank of Pakistan, Annual Report (various issues).

Appendix 5

Chronology of Banking Sector Events

1973. Nonresident foreign currency accounts (FCAs) introduced.

1973. National Development Finance Corporation established.

1975. Nationalization of all commercial banks.

1980. Bankers Equity Ltd. established.

1982. Joint venture companies established:

- Pak-Kuwait Investment Company Ltd.;
- Pak-Libya Holding Company; and
- Pak-Saudi Industrial and Agricultural Investment Company.

1990. Two nationalized commercial banks partially privatized (Muslim Commercial Bank and Allied Bank Ltd.).

1991. Resident FCAs deregulated. Auction of government securities started.

June 1992. State Bank of Pakistan (SBP) introduces a fee of 3 percent to replace its free full forward exchange cover.

July 1992. SBP adopts use of credit/deposit ratio to regulate credit and phase out direct credit controls.

1993. Amendment in State Bank Act towards greater autonomy.

1995. Credit/deposit ratio established as instrument of credit control.

1996. Unsuccessful attempt to partially privatize United Bank Ltd., the largest of NCBs.

1997. Further Amendment in State Bank Act to grant autonomy.

1997. The SBP stopped providing forward cover for foreign exchange to bankers.

1997. T-bills of three, six, and 12 months maturities introduced.

1997. Banking Council established, making the SBP the sole regulatory authority.

1997. Government and the SBP launch loan recovery program.

1997. As part of banking sector reform program, the following laws were enacted:

- Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act, 1997;
- Banks Nationalization (Amendment) Act, 1997;
- Banking Companies (Amendment) Act, 1997; and
- State Bank of Pakistan (Amendment) Act, 1997.

May 1998. Freezing of FCAs.

July 1998. New FCAs permitted with fresh foreign exchange inflows.

Reforming Pakistan's Capital Markets

Catherine Chou

Catherine Chou is Director, China Concept (HK) Limited. She was formerly Senior Economist (1996–1997) at Indosuez (WI Carr) Securities, Hong Kong, China, and Senior Economist/Investment Strategist (1991–1995), BZW Securities, London and Hong Kong, China.

Introduction

In the development of its capital markets, Pakistan has faced issues similar to those in other emerging markets in Asia. But the economic turmoil presents Pakistan with some unique problems.

The country has already achieved a moderate level of capital mobilization through the bond and equity markets at 43 and 22 percent of gross domestic product (GDP), respectively, at the end of 1997. However, the figures are deceptive as government issues dominate the corporate bond market—with corporate bonds accounting for only 1 percent of GDP. Similarly, the equity market has become more skewed over the past three years, resulting in the top five stocks representing more than 70 percent of market capitalization by May 1998.

The downturn in the capital market dates back to late 1994. After several attempts to address the country's macroeconomic imbalances and deep-rooted structural problems, shortcomings in policy implementation came to light, bringing the country to the brink of a foreign exchange crisis in October 1995. Between the end of 1995 and April 1998, the rupee depreciated by 24 percent. Since 1995, the threat of currency devaluation has deterred foreign portfolio investment.

From 1996 onward, deteriorating law and order in Karachi, the Government's prolonged tussle with foreign independent power producers (IPPs), and the constitutional crisis in late 1997 all dampened growth of the capital market. In March 1998, the withdrawal of tax exemption granted to corporate holders of Term Finance Certificates (TFCs) also hit the corporate bond market.

Finally, in the aftermath of the nuclear tests of 28–30 May 1998, austerity measures were imposed. With the freezing of foreign currency accounts and sanctions imposed by G-8 countries, activities in the foreign exchange market almost ground to a halt and so did foreign portfolio flows. The currency plunged in the kerb market amid fears of an impending debt default. Under the threat of a recession, the bond and equity markets have yet to recover. The negative market sentiment is reflected in the decline of the key Karachi Stock Exchange (KSE)-100 index, which plunged 56 percent during 1998, reaching a record low in July of that year.

In view of the political and economic uncertainties, the target implementation schedule of project activities outlined in the second phase of the Asian Development Bank's (ADB's) Capital Market Development Program (CMDP) have not been met. Moreover, though continuous efforts have been made by market participants to sustain the pace of restructuring of the capital market, the process is unlikely to gather momentum until the political and foreign exchange situation is resolved.

Background[1]

Foreign Exchange Market

Since foreign exchange liberalization measures of 1991, the stock of foreign currency deposits (FCDs) almost quadrupled to $11 billion by May 1998, bringing FCDs' share in the domestic economy to 18 percent of GDP, from about 6 percent in 1991. Thus, the dollar level was high compared with other moderately dollarized economies. Part of the reason behind the growth in FCDs is the guarantee provided by the SBP in the form of forward cover.

Although the FCD and other foreign exchange instruments have succeeded in attracting foreign exchange, and helped finance the chronic current account deficit in the past, the forward cover scheme has been costly to the State Bank of Pakistan (SBP), and culminated in quasi-fiscal losses amounting to 1.5 percent between mid-1995 and mid-1997.

Bond Market

GOVERNMENT

At 40 percent of GDP (as of June 1998), the domestic bond market in Pakistan is deceptively large. It is deceptive in that the various forms of government debt take up nearly 39 percent of GDP. The total outstand-

ing domestic government debt stood at PRs1,185 billion (about three times the equity market cap), of which 29 percent is in the form of either Treasury bills (T-bills) or Federal Investment Bonds (FIBs), the two most popular and actively traded government papers. Taking into account the external debt, the total share of government debt in terms of GDP reaches 93 percent, more than double that of other emerging markets of similar population size, such as the Philippines (43 percent) and Turkey (40 percent).

Persistently large fiscal imbalances over the past two decades have resulted in the ballooning of domestic government debt from 19.1 percent in the 1970s to more than 40 percent of GDP in the 1990s. Consequently, the Government relies heavily on domestic nonbank borrowing, by offering high tax-favored rates of return. The diversion of nongovernment savings to the public sector has been cited as one of the main reasons behind Pakistan's low national savings ratio (11.4 percent in 1997), particularly when compared with its Asian neighbors.

In fact, the National Savings Scheme (NSS), absorbing some PRs312 billion in June 1997, competes directly with bank deposits, and so deprives the banking system of much-needed funds for on-lending to potential corporate clients. For instance, the three-year Special Savings Accounts offered 16–18 percent for registered certificate holders (12–14 percent for the bearer, paid semiannually), while a three-year time deposit at scheduled banks gave an average return of 10.8 percent. This crowding out of the bond market by the NSS is an issue that has to be resolved primarily through fiscal reticence and improved tax collection.

Before the enhancement of the SBP's autonomy in January 1997, there was no distinct link between monetary policy and interest rate movements in the bond market. The dislocation is illustrated by the case of the most heavily traded six-month T-bills. Yields of the T-bill were influenced by a myriad of factors, ranging from the amount of fiscal shortfall to the level of forward cover for FCDs, with no clear direction. Primary dealers had only the previous auction cutoff yield of the T-bill as a guideline, and although the SBP did indicate a preauction target (of the amount it would pick up) for each type of securities, the actual pickup may vary substantially from the target, leaving dealers perpetually perplexed as to the prevailing yield levels.

The SBP has gradually brought the fluctuations in T-bill auction cutoff yield in line with the trend in discount rates (three-day repo, at 18 percent in May 1998), partly through its increased open-market presence. The improved transparency between the SBP's policy stance and direction of interest rates also helped to guide the pricing of government securities in the secondary markets, which in turn set a more coherent path for the secondary yields. Given that the T-bill was the most liquid instrument eligible for statutory liquidity requirement (SLR) for banks and NBFIs, the six-month T-bill has become the benchmark short-term rate.

In contrast, although the FIBs are tradable through the stock exchanges and are also widely held by banks and financial institutions for SLR, the secondary market activity of FIBs pales in comparison with that of T-bills, as most investors hold the bonds to maturity. As a result, the secondary market FIB yields are less indicative of the underlying long-term interest rate trends than in the more developed bond markets. At the beginning of May 1998, the six-month T-bill was yielding about 16 percent on the secondary market, while the five-year FIB yields were below 15 percent. The inverted yield curve reflected the tight monetary policy that the Government was obliged to adopt as part of the policy requirements attached to the International Monetary Fund (IMF) loan secured in October 1997.

In the wake of the austerity measures imposed after 28 May 1998, the SBP has switched to an ostensibly loose policy in an attempt to underpin domestic economic growth. Interest rates, as indicated by the six-month T-bill cutoff yields, dropped to below 12 percent, while yields at the long end hovered

at pretest levels. In other words, the yield curve flipped to positive. The Government has also focused on short-term funding, introducing new T-bill terms of three months, five months, and one year to the biweekly auctions. Trading in primary and secondary T-bills remained active. On the other hand, FIB issuances and trading have been in limbo since August 1998, as the Government steered away from long-term liabilities until a clearer fiscal picture emerges (essentially that of debt-servicing, presently about 48 percent of total expenditure in 1998).

CORPORATE

A five-year bond issued in 1988 by the Water and Power Development Authority (WAPDA), a statutory corporation, was Pakistan's first corporate debt. The issue carried a coupon of 13.5 percent and raised PRs3.1 billion, exceeding the target of PRs2 billion. Since then, WAPDA has raised PRs23.2 billion with seven issuances, the first six guaranteed by the Government. However, only the third and sixth issues, both of 10-year maturity, are listed on the two stock exchanges of KSE and Lahore Stock Exchange (LSE). The last three issues between 1993 and 1997 failed to raise the targeted amount because of limited investor interest and the fairly illiquid secondary market.

In line with Islamic financing principles, the corporate bond was packaged as TFCs with maturities of more than three years. As early as 1985, privately placed TFCs issued by development finance institutions (DFIs) had been in existence. However, it was not until February 1995 that the first public TFC issue by Packages Ltd. was listed on the stock exchange. The listing signaled the birth of a corporate debt market and was swiftly followed by three others, with yields of between 17.8 and 19 percent, bringing the stock of listed TFCs to a little more than PRs2 billion. While listed TFCs are not approved securities for commercial banks' SLR, nonbank financial institutions (NBFIs) were allowed to invest in TFCs as SLR from May 1997 onward. Though there has been a concerted effort to simplify the listing requirement for TFCs (currently the same as for equity listing), the procedure has yet to be shortened.

In September 1997, additional incentives in the form of tax exemption (on the 10 percent withholding tax) were granted to TFC holders, including corporate entities such as banks, giving a boost to the investor base of TFCs. The market immediately took off, with about 15 issues (PRs10 billion–PRs15 billion), offering yields up to 6 percent above T-bills. Six months later, the retraction of part of the tax exemption, leaving only individuals tax exempt, dealt a heavy blow to the fixed income market. Since March 1998, issuers and underwriters have shelved all issues while awaiting clarification on the tax concessions in the 1998/99 Federal Budget. Given that no such tax benefits were announced, it is believed that the TFC primary market will stay passive for the time being.

Two types of organizations were set up specifically to facilitate the development of corporate debt market—discount houses and rating agencies. There are three discount houses and two rating agencies in Pakistan. The first discount house was set up in 1989 to discount WAPDA bonds. Since then, discount houses have broadened into FIBs, T-bills, and TFCs (mostly those of International Chemical Industries [ICI]-Pakistan). However, these activities have been halted since 28 May 1998. In contrast, the rating agencies have been less affected as NBFIs, from whom compulsory rating is required by the SBP, remain a key source of business. Following its inception in 1994, the Pakistan Credit Rating Agency (PACRA) rated 67 entities and 25 instruments up to May 1998.

While it is expected that long-term securities would be priced relative to government bonds, in reality, TFCs' pricing (coupon and price) was based on NSS. The reason is twofold: first, secondary FIB trading and pricing are yet to evolve to the stage where FIB yields are long-term benchmark rates; and second, NSS constitutes more than a quarter of all domestic government debt and is aimed mostly at the public, which the TFCs, through listing at the stock exchanges, are also targeting. As of May 1998, for a

three-year top-rated TFC (credit rating AA long-term, with FIBs as AAA), a coupon rate of 17.5 to 18 percent (same as that of Special Savings Account of NSS) would suffice, with each step down in credit rating adding about 75 basis points (bp).

Certain financial institutions, such as investment banks, DFIs, and leasing companies, are allowed to issue an alternative form of corporate debt—Certificates of Investment (COIs), introduced ten years ago. Given that COIs are unsecured debt papers, company rating is mandatory. Issuance is only approved for qualified institutions and can vary from three months to five years, with both principal and profit (interest) encashable upon maturity. An estimated PRs4 billion–PRs5 billion of COIs were outstanding as of April 1998, about two thirds of which are under one year, with yields ranging between 13 and 17 percent. The main issuers of COIs (excluding DFIs) are given below.

Investment banks

The first investment bank was set up in 1989, and since then 14 more have been established, with sector market capitalization of PRs3.2 billion and assets of about PRs40 billion. Initially, the sector concentrated on short-term trade financing and equity trading, both on their own and clients' accounts. As the equity rally fizzled out in 1994, the sector switched to fee-based corporate finance services, ranging from underwriting and placement of securities, to debt syndication and new financial product packaging. The sector is regulated by the SBP and is subject to 58 percent income tax (the same as commercial banks). Minimum paid-up capital has been raised to PRs300 million and capital adequacy ratio is 10 percent. Cost of raising funds through (mostly short-term) COIs was high in the past, as competition for funds was intense between financial institutions.

Leasing Companies

Leasing companies have been instrumental in the development of corporate bond markets around the world and have also given a boost to asset-backed securitization. The first leasing company in Pakistan was established in 1984 and listed the following year. With an unprecedented 25–30 percent annual return, the number of leasing companies has grown to 33 with total assets of about PRs42 billion. About 16 *modarabas* are also engaged in leasing, while several DFIs and commercial banks are also testing the market.

Plant and machinery account for 60 percent of the sector's leasing portfolio (PRs34 billion), with the rest split between motor vehicles (30 percent) and office equipment (10 percent). The sector is increasing its exposure to motor vehicles, which was identified as a high-growth area.

Funding is long-term biased, and the sector has hitherto sourced through two main channels: foreign credit lines of five to ten years (60–70 percent of financing); and COIs. Given that the cover for foreign currency loans was withdrawn by the SBP in 1995, the leasing companies faced an increase in dollar financing cost, with an extra 5 percent in foreign exchange hedging fees. The sector sees this treatment as unfair compared with FCDs (short-term, at times "hot" money), which are covered by the SBP. As for COIs, the experience of the sector is that the instrument, while theoretically up to five years, is not feasible above two years as it comes in direct competition with NSS certificates. Thus, financing through COIs has been limited to short term and the industry is seeing gradual maturity mismatch between its assets and liabilities. The recent entry of commercial banks also put the leasing companies at a disadvantage in terms of funding costs, although the banks lack experience in the sector. Nonetheless, any further competition from banks may force a change within the sector.

Equity Market

The equity market underwent rapid expansion in the first half of the 1990s, with market capitalization of the KSE increasing more than fivefold between

end-1990 and end-1994, to PRs400 billion ($13 billion). The market was invigorated primarily by privatization and the liberalization of foreign investment. There were 108 public sector enterprises (out of a total of 128) initially slated for privatization through public offering, outright auctions, and strategic sales to investors. By 1996, the number of enterprises to be privatized increased to 118. The injection of substantial public sector listings to the stock market has greatly transformed the sector distribution. The market changed from being textile-dominated (22 percent of market capitalization in June 1992) to one that revolves around three to ten large-capital stocks. None of these top 10 stocks comes from the textile sector.

As the bull market days of 1994 (which saw the KSE-100 index surging above 2600) came to an end, the market sidelined, with the index hovering between 1400 and 1900. However, new listings remained buoyant until 1997, partly due to the drying up of privatization issues. As of May 1998, the KSE market capitalization stood at PRs431 billion ($9.5 billion, 15.6 percent of GDP). While the reasonably high turnover ratio (monthly rate of 0.4 percent of market capitalization as of June 1998), compared with other emerging markets (less than 0.1 percent of market capitalization per month), suggests a moderately efficient secondary equity market, anecdotal evidence indicates that the high trading volume has been mainly attributable to speculative trading activities by brokers and local retail investors in recent months.

In terms of market penetration, Pakistan clearly lags behind other emerging markets, even allowing for the impact of Asian financial crisis on various regional stock markets. As of June 1998, Pakistan's market capitalization accounts for only 0.7 percent and 0.3 percent of emerging Asian and total emerging market capitalization, respectively, contrasted with 3.5 percent for Malaysia and 1 percent for Egypt in terms of share of total emerging market. When measured by share of GDP, again Pakistan seemed to have been capped below a third, falling from 28 percent in 1993 to 8 percent in mid-1998. Compared with Malaysia (which shrunk from 363 percent to 68 percent) or Egypt (which rose from 9.7 percent to more than 30 percent) during the same period, the capital mobilization via the equity market in Pakistan seems paltry.

Moreover, the large number of listed companies on the Pakistan stock market (779 in June 1998), compared with about 200 in most markets, indicates the high degree of fragmentation in the smaller sectors in the country. Indeed, about 500 listed companies are considered delinquent and are being transferred onto the list of defaulting companies in accordance with the conditions outlined in the listing rules. The key market participants in the equity markets are as follows.

CORPORATE LAW AUTHORITY

While in the process of being restructured into the new Securities and Exchange Commission of Pakistan (SECP), the Corporate Law Authority (CLA) is still overseeing and regulating the securities market, as well as registering companies. The new policy board of SECP, with both public and private sector representation, was appointed in May 1998 and will provide policy guidelines, through its monthly meetings, to the SECP. The SECP, an independent and autonomous regulatory body, began operation on 1 January 1999, as scheduled in the ADB's CMDP.

STOCK EXCHANGES

There are three stock exchanges in Pakistan, the KSE, LSE, and Islamabad Stock Exchange (ISE), of which the KSE is the largest and oldest. Each stock exchange is a self-regulatory organization (SRO) that had its governing board restructured in 1997 as part of CMDP. All three stock exchanges moved to fully computerized trading by mid-1998 and are also linked to the Central Depository System (CDS) in scripless settlement on more than 100 listed securities. Consequently, many of the trading abuses, such as front

running, have been eliminated. However, there is a large number of cross-listings between one stock exchange and another, in the absence of real-time linkage among the three trading systems. Price differentials quoted on the same stock listed separately are frequently arbitraged by brokers.

Market turnover has been concentrated in only two counters: Hub Power Company Ltd. (HUBCO) and Pakistan Telecommunication Company Ltd. (PTCL). The former is listed only on the KSE. Thus, KSE is responsible for more than three quarters of the daily trading volume. There is a considerable price difference between membership of KSE (where all 200 seats are taken) and the other two exchanges (where there are still vacancies on reserve). A seat on the KSE cost as much as PRs38 million in 1994, but the price is now about PRs15 million. On the other hand, membership costs only PRs4 million at the LSE and ISE. The disparity over member seats is an obstacle to further integration (such as through electronic real-time trading linkup and a national clearing system) of the three exchanges.

All three exchanges are in the process of setting up an investor protection fund, to be financed from trading fees or members' contributions. In addition, each exchange also invested in its own power generating facility, to combat occasional shortages in electricity supply. As trading is conducted on computers, any power cut would result in temporary suspension of trading, though occasionally the open-outcry system steps in to bridge the gap.

MUTUAL FUNDS

With a portfolio of PRs27 billion (late 1997), the public sector open-end National Investment Trust (NIT) takes up the biggest portion (87 percent of total industry portfolio) of the domestic mutual fund industry. Most of the private sector mutual funds (closed-end) were floated in 1994 and 1995, following the easing of market entry in 1993, even though the first private sector fund was listed in 1983. The industry covers 40 listed closed-end funds (of which 26 are managed by the State-owned Investment Corporation of Pakistan [ICP]), and two open-end funds.

The two public sector industry giants have been undergoing reform, as proposed in the CMDP. The investment policy and management of NIT (established 1962) and ICP (established 1966) date back to the 1960s, during which public funds were mobilized to finance about 100 industrial projects. With the nationalization of large- and medium-size businesses in the 1970s, the two funds were loaded with government holdings. Each received entitlement to a preferential allocation of listed shares, resulting in NIT's "diversified" portfolio of 633 stocks (including many of the defaulting textile and sugar companies), despite having 23 percent of its portfolio in one stock (Pakistan State Oil Co. Ltd.).

In particular, the portfolio of NIT has been hit by redemption (PRs3 billion) since 1996. A new management team took over in late 1996, and moved to a daily quoted net asset value (NAV) of its unit trust in November 1997, abolishing the previous repurchase price guaranteed at PRs13.7 by the Government (NAV price was down to PRs9.9–PRs9.5 in mid-May 1998). Fewer than half of the original 270 employees were retained after a voluntary retirement scheme, and the number of NIT branches was reduced by four to 23. In return, NIT has appointed 600 sales agents since end-1997, operating on commission.

A full-time fund manager was put in charge of restructuring the portfolio in April 1998. The initial plan is to split the portfolio into several specialized funds, including a small money market and a small fixed income fund (NIT has about 5 percent of its $500 million invested in fixed income securities). As for the large single-stock holdings, NIT is obliged to keep them in the portfolio, on behalf of the Government, until such time NIT is privatized.

The Finance Act of 1997 attempted to level the playing field in the tax treatment of public and private sector mutual funds by granting them exemption from income tax, upon distribution of 90 percent

of income. But industry members have identified inconsistencies. Specifically, the definitions of distributable income and taxable income, between the Income Tax Ordinance of 1979 and that of the Investment Companies and Investment Advisers Rules of 1971, are different. The tax authorities disregard any capital loss and diminution in value of marketable securities in the calculation of income. In the case of a mutual fund not being able to distribute a dividend as a result of account capital loss, it is still being taxed under the definition anomalies.

MODARABA COMPANIES

The *modaraba* sector is going through a critical phase. After experiencing an initial boom in the 1980s, as a mode of business financing in accordance with Islamic principles, the sector suffered a setback when income tax exemption was withdrawn in 1993. Since then, the sector has struggled to stay afloat, while those engaged in equity trading have been hit again by the fall in share prices since 1994. Worse still, the bulk of the investment portfolio of the *modarabas* was locked in textiles (a sought-after sector back then), of which many are now technically insolvent. In aggregate terms, the sector has lost some PRs14 billion in market capitalization since 1993 and with the exception of two companies, is mostly trading at 30–40 percent below par value. In the present economic gloom, the sector, dependent on the demand for long-term project financing, is unlikely to be revived and may see many mergers in the near term.

Some of the *modarabas* have turned to the more profitable leasing industry in recent years. However, the sector is at a disadvantage in its funding, as *modarabas* are not allowed to use debt financing. Direct bank borrowing, with the required clearance from the SBP since 1996, has also become effectively blocked. Balance sheet expansion is thus only possible through rights or bonus issues (of *modaraba* certificates)—not a viable option given the market slump.

Members of the industry regard the mandatory transfer since 1998 to the Central Depository Company (CDC) as costly for *modaraba* companies. Owing to its peculiar no-gearing structure, the sector has larger paid-up capital than others. Since CDC fees for issuers of capital (i.e., listed companies) are based on paid-up capital, nearly half of the sector has to pay the top bracket fee (PRs100,000 per annum). For a sector already constrained in its operations, and with an average of only 8 percent of its listed certificates traded, the charges levied by CDC on the sector border on the high/unfair side.

CONTRACTUAL SAVINGS INSTITUTIONS

Allocation of the assets of contractual savings institutions can greatly influence the development of a country's capital market. In Pakistan, the majority of contractual savings financed government debt. The sector is comprised of insurance companies as well as pension and provident funds. The largest insurance company, State Life Insurance Corporation (SLI), had an investment portfolio of about PRs49 billion in June 1997. In spite of the relatively large portfolio size, the contractual savings institutions have been limited in their exposure to nongovernmental securities.

In May 1997, investment capitalization in listed securities, outside of those approved by the Government, for both types of institutions, was raised from 10 to 20 percent or by 10 percentage points each. Insurance companies appear to be investing new premiums with a bias for listed equity, although equity yields have failed to match the highly rewarding NSS, or even bank deposits in recent years. For instance, in the past four years, SLI portfolio's average annual return was 13 percent, largely due to the high interest generated by its holdings of government debt. Nonetheless, reflecting the sector trend as promoted by the CMDP, SLI's portfolio strategy is to shift new allocations into equity, raising the equity holding from the current 11 to 15 percent in the medium term.

The proliferation of insurance companies, especially in the general insurance sector, has intensified

competition. As of 1998, there are 68 insurance companies, out of which three are public sector companies: SLI; Pakistan Insurance Corporation (PIC), the sole reinsurance company in the country; and National Insurance Corporation (NIC), responsible for underwriting public sector properties. In spite of the rising number of insurance companies, the sector has become increasingly oligopolistic, with the top five companies enjoying a 65 percent share of total revenue. Of the 62 private sector general insurance companies, 10 are foreign firms.

The CMDP has proposed reforming the insurance industry to enhance the coverage of social security, while mobilizing long-term resources. In the past, the Controller of Insurance (CI) lacked authority and power, and regulated only the private sector companies while the big three public sector companies remained outside its coverage. It has, therefore, been proposed that a Pakistan Insurance Regulatory Authority (PIRA) be established to replace CI, to promote the sound development of an effective insurance sector, while protecting the interest of policyholders. PIRA is to play a key role in policy and regulatory development in all areas of insurance for the public and private sectors, market regulation, enforcement and compliance, and inspection and investigation.

CENTRAL DEPOSITORY COMPANY

The CDC, incorporated in 1993 and started operations in September 1997, manages and operates a book entry system on electronic ledgers, to enable the change of ownership in securities without any physical movement of scrips or transfer deeds. Listed securities are in the process of being transferred to CDC. Once on the system, trading in the eligible counters will become scripless. As of August 1998, 122 scrips totaling 1 billion shares, among which were the most actively traded securities, were being handled by CDC. The transfer of the remaining 657 (smaller capitalization) listed securities was due to be completed by mid-1999.

Recent Developments

Preempting the Crisis

There are three prerequisites for the development of a sound capital market, as follows:

- an autonomous central bank, with policies that nurture the establishment of market-determined interest rates, and ensure stability in the currency and financial system;
- an open and private sector-dominated market that facilitates (foreign) transfers of financial and technical skills to market participants; and
- a well-defined legal and administrative framework that allows the enforcement of financial contracts.

It seems that the authorities in Pakistan have understood these principles, and since 1991 have set about putting the necessary conditions in place. First, almost all exchange controls were lifted in 1991. Since then, foreigners and locals have had access to foreign currency accounts, and have been able to bring in and take out foreign currency without government approval. More important, income derived from foreign direct investment (FDI) and portfolio investment can be repatriated without permission. The exchange rate system also shifted from a fixed-rate regime to managed float.

Second, in January 1997, amendments to the State Bank Act of 1956, the Banking Companies Ordinance of 1962, and the Banks Nationalization Act of 1974 paved the way for the full autonomy of the SBP. From then on, the SBP was in a position to formulate an independent monetary policy. Armed with strengthened regulatory and supervisory powers, the SBP, in principle, is insulated from government interference.

Third, the 1997 Banking Companies Act (Recovery of Loans, Advances, Credits, and Finances) was promulgated in May 1997 to improve the legal environment for loan recovery. The law is expected to sharply reduce the cost of resorting to the legal and judicial system to recover a loan. Under this Act,

default cases must be disposed of in 90 days, within which the defaulter is required to furnish security. Banks and NBFIs may be authorized to recover or take possession of the collateral without filing a suit, or proceed to recover the loan via sale of collateral. At the end of 1997, the SBP disclosed that the total amount of default loans stood at PRs143 billion (equivalent to 24 percent of total scheduled bank advances), owed by 8,074 parties.

In addition, the Government of Nawaz Shariff, which assumed office in February 1997, expedited the pace of market development by adopting the ADB's CMDP in October 1997. The objective of the program is to augment mobilization of long-term resources and to improve the efficiency of their allocation by developing a diversified and competitive capital market that encourages broad-based participation of issuers and investors.

Eight key objectives have been identified and various policy measures were designed to be implemented in two phases: November 1996 to October 1997, and 1998 to December 1999. The objectives as lifted from the ADB CMDP are as follows:

- to create an enabling policy environment to enhance competition and a level playing field—by liberalizing investment restrictions on institutional investors, and rationalizing tax anomalies for the equity market, tax and interest rate structure anomalies for the debt market, and the tax regime for mutual funds;
- to strengthen securities market governance, institutions, regulations, and supervision—develop strong regulatory bodies for the securities market to support the orderly growth of companies and boost investor confidence, modernize the supportive legislation to improve enforcement by the SECP, improve the corporate governance of the stock exchanges and reorganize them to enhance their management and operational efficiency, improve self-regulation of the stock exchanges, and encourage other selected capital market participants toward self-regulation;
- to improve and modernize securities market infrastructure and its integration—upgrade automated trading systems to pave the way for the eventual integration of the national market, and promote development of the CDC as well as national clearing and settlement systems;
- to develop the corporate debt market—promote development of an over-the-counter debt market;
- to reform the mutual fund industry—strengthen the regulatory and policy framework of mutual funds, and restructure the industry;
- to develop the leasing industry—streamline the regulatory framework, strengthen the capital base to encourage an orderly growth, and tap alternate long-term financing sources for the industry;
- to promote contractual savings through reforms of the insurance sector and pension and provident fund industry—strengthen the policy, legislative, and regulatory framework to promote and ensure the orderly growth of the insurance industry, adopt more stringent financial standards for the insurance industry, take steps to improve professional and ethical standards, promote restructuring and divestment of public sector insurance companies, and develop reforms for pension and provident funds; and
- to enhance institutions.

Events Leading to the Crisis

Pakistan has been mired regularly in political and economic uncertainties, interspersed with foreign exchange crises. In 1993, the KSE-100 index rose 74 percent in local currency terms (49 percent in dollar terms), to give one of the highest returns in global equity markets. Investors all over the world suddenly took notice of what could have been another "tiger" market in the making. With the market already opening and several sizable initial public offerings in the pipeline, many foreign fund managers jumped in, expecting high returns.

The capital market boom in the run-up to 1994 took authorities and regulators by surprise. After deregulation to 100 percent foreign ownership in most sectors of the economy, and setting up a timetable for privatization, the amount of foreign interests generated in turn drove domestic investors' enthusiasm. It was all clearly beyond what the Government had expected. Between June 1991 and 1995, a net portfolio inflow of $3.3 billion (about 30 percent of total equity market capitalization) was recorded.

According to local brokers, "where the foreigners go, the locals follow." Foreign players were exclusively institutional investors (among the 40 or so regular foreign investors, there were nine dedicated single-country/regional investment funds totaling about $210 million in 1996) and were seen to have the technical know-how in playing the market and picking top stocks. The positive correlation between market turnover and the KSE's reported net foreign fund flows demonstrated that market liquidity, until end-1997, remained largely foreign-driven, as domestic institutional players were still sitting on the portfolio bought at the peak of April 1994 (with enormous book losses).

But 1993 turned out to be an exceptional year. Not long after the postelection euphoria of the Benazir Bhutto Government (in October 1993), the market sobered up and realized that all was not well on the economic front. A burgeoning budget deficit, inflation accelerating to double-digit levels, and the delay in the tariff reduction process all fell short of IMF targets. The suspension of the IMF's Enhanced Structural Adjustment Facility/Extended Fund Facility (ESAF/EFF) in early 1995, coupled with a deterioration in external accounts, pushed the country to the brink of a foreign exchange crisis. A mini budget was passed in October 1995, including a 7 percent devaluation of the rupee against the dollar, as part of the preconditions for securing a standby IMF loan.

By mid-1995, as some of the foreign investors' optimism faded and they exited the market, trading settled within a range of 500 points between early 1995 and mid-1997. In February 1997, the newly elected Shariff Government introduced an Economic Revival Program, which eventually led to the IMF approval of a new ESAF/EFF in October 1997. The recognition that Government economic policy was on the right path gave investors an excuse to buy, pushing the index to a three-year high in the same month.

Unfortunately, the specter of political turmoil, this time in the shape of an executive-judiciary tussle, hit the market again between September and November 1997. The administration came to a complete standstill at a time when the economy required the undivided attention of the country's leadership. The crisis, occurring at a time of growing anxiety over the contagion effect of the Asian financial crisis, precipitated the outflow of foreign currency deposits. By end-November 1997, foreign exchange reserves shrank to $1.2 billion.

More enduring and damaging to foreign investor confidence is the ongoing tussle between the Pakistan Government and the independent power producers (IPPs) since April 1997. The row has its roots in the allegedly corrupt power contract agreement signed between the Bhutto administration and the independent power producers (IPPs). Among the IPPs is the $1.8 billion Hub Power (HUBCO), which is one of the two most actively traded stocks and the biggest project of its kind in Asia. Corruption cases have been filed against top executives of the company, said to be involved in a fraud of PRs17 billion, with HUBCO's foreign staff experiencing travel restrictions and other problems in the interim. The company has already gone for arbitration in the international court.

The impasse has dealt a serious blow to foreign investors' (FDI and portfolio) confidence in Pakistan's foreign investment policy. Specifically, the share price of HUBCO, while impacted to a certain extent by other negative market factors, nose-dived from PRs64 to a face value of PRs10 by October 1998.

To complicate matters, State-owned WAPDA, which generates, transmits, and distributes 85 percent of the country's electricity, has experienced a financial crisis, and thus has been unable to service projected tariff payments to IPPs. The Government has been forced to renegotiate tariff cuts with some IPPs, canceling a few projects on the side. The situation is even more ironic considering that Pakistan's 1994 power policy was once cited by the World Bank as one of the most successful independent power policies in Asia.

Racial tensions across the country, particularly between the local populations and the Mohajir settlers from India (MQM) in Karachi, have been on the rise since early 1997. Routine bombing and shootings, plus infighting between rival MQM groups, have occasionally left foreign visitors injured or even dead, and sometimes prominent businessmen have been targeted. In June 1998, about 170 people were killed in ethnic violence in Karachi alone. It is not surprising that Karachi ranks low on a regional/emerging market fund manager's visit agenda, as it is simply perceived as one of the riskiest cities in Asia. Many foreign institutional investors prefer to rely on reports from local analysts or recommendations from local/foreign brokers instead. As foreign visitors have dwindled, overseas interest in the market has also tapered off.

While these events have all contributed to the current capital market woes, the decisive moment came when the Government decided to conduct nuclear tests on 28–30 May 1998, despite international warnings of sanctions and suspension of multilateral loans. Since Pakistan needs nearly $5 billion a year to meet interest repayments on its $32 billion foreign debt, continued access to multilateral loans as well as inflow of foreign exchanges in the form of foreign currency deposits have been crucial to debt-servicing.

In an attempt to prevent a dollar run on the banks, $11 billion of foreign currency accounts were frozen on the night of 28 May, and could be withdrawn upon conversion to rupees at the rate of PRs46 to the dollar. Remittances dried up in June, just when the country's foreign exchange reserve was being depleted to critical levels ($700 million at end-August 1998, or a little more than two weeks' import cover). With the threat of debt-default looming, investors naturally have been steering clear of long-term investments.

While the equity and short-term bond market volumes have maintained a respectable level, trading activities have been largely limited to price arbitrage or speculative punts. According to KSE statistics, in the first eight months of 1998, foreign portfolio recorded a net outflow of PRs317 million ($6 million). With the exception of dedicated single-country funds, it is unlikely that Pakistan will feature in any foreign investment portfolio even after the sanctions and foreign currency account restrictions have been partially lifted at the end of 1998.

Policy Issues

A broad range of factors has contributed to Pakistan's capital market turmoil, including macroeconomic, political, social, structural, legal, regulatory, and supervisory issues. This study will concentrate only on the last three. For the purpose of analysis, this section assumes that political issues such as economic sanctions are lifted, social issues such as restoration of law and order in Karachi are resolved, and legal issues such as the enforcement of the accelerated loan recovery process and macro issues such as the budget deficit and foreign currency account restrictions are settled.

Specifically, the development of the capital market hinges upon the gradual downsizing of government borrowing from the private sector. The case of public debt crowding out private borrowing can be best illustrated by two simple figures: the stock of domestic debt is roughly three times that of the equity market capitalization, and almost 40 times that of the corporate bond market. For more resources to be readily allocated to the private sector, the issue of (excessive) fiscal borrowing needs to be addressed and reduced.

Market Infrastructure

Any foreign visitor to the KSE, in the days before the full automation of its trading systems, was bound to feel a sense of time warp. For the stock exchange, situated in an old building with a maze of dark corridors dotted with broker offices, and its frenetic trading sessions on the floor, seemed unaltered since its inception in 1947. It was inconceivable how the large volume of transactions could be followed through. It took at least seven days to settle a trade, between 45 and 60 days for share transfers to be registered, and about three months before the share certificates were delivered. Everything, it would appear, was done manually. The long settlement period afforded the exchange members an opportunity to speculate on the market (including short-sell, officially not permitted), as long as they squared their positions within the same period.

Fortunately, the transformation of the trading and settlement system towards greater efficiency and transparency is already underway. All three exchanges are now trading on a computerized screen-based system and, more actively, stocks are already being settled through the CDC. In short, Pakistan's equity markets have arrived at scripless trading, and market movements are becoming more transparent.

Market Regulation

The main market regulator, the CLA, has been perceived as reactionary and lacking market know-how. As part of the CMDP, the CLA is in the process of a change into an independent and autonomous SECP. It is envisaged that the SECP will have five professionally qualified and experienced commissioners, including the chairman, to be appointed by the Government. In addition, the SECP will have a staff of 350, with professionals in each of its divisions.

There are four main types of SROs regulated by the CLA: the stock exchanges, the Mutual Fund Association of Pakistan (MUFAP), the Leasing Association of Pakistan (LAP), and the *Modaraba* Association of Pakistan (MAP). The last two were formerly regulated by the SBP under NBFIs, and became under the CLA's jurisdiction in 1997. Self-regulation of each SRO is encouraged, while regulatory standards and internal compliance within each SRO are being upgraded.

The three stock exchanges, KSE, LSE, and ISE, have all seen their governing boards restructured to include seven members outside the broking community. The majority of members on the stock exchanges are individuals, as opposed to corporates—though it is generally acknowledged that broking firms are more professional and more likely to act in the interest of (institutional) investors. While all three stock exchanges have advocated their members to upgrade toward corporate membership, representation was still as low as 15 percent by mid-1999. Thus even with the restructuring of the governing board with seven outside members, the stock exchanges are still perceived to be run by a majority of individual broker-dealers, whose self-interest may influence the exchanges' day-to-day decision-making process.

However, market participants have noted an increasingly nonpartisan stance taken by the boards. Still, the market is far from efficient, affording plenty of opportunities for insider trades. Similarly, incidents of front-running and short-selling are cited almost daily, with no interference or repercussions from the regulatory bodies. While the exchanges have suspended members from trading in the past, the suspensions were mostly limited to brokers defaulting at the clearing house instead of other malpractices. Vested interests, at various levels of the public and private sectors, have hindered regulation and enforcement against trading abuses.

Corporate Governance

The dominance of the equity market by a handful of stocks, both in terms of market capitalization and trading volume, may be traced to the demise of the commodity-based manufacturing industries—textiles, cement, and sugar. The three sectors once accounted for 30 percent of the total market capitalization

(end-1991), but shrank to a little more than 10 percent of the market by April 1998. Once the darlings of the foreign (and local) investment community, the textile stocks are now mostly trading below face values. Worse still, many have not been paying dividends for the last few years. In accordance with suspension and delisting procedure, the KSE has placed 64 companies from the textile sector alone on the Defaulters' Counter.

One salient feature in these stricken sectors is the ownership pattern—most of the companies are family-run, with tight shareholding structure. In essence, minority shareholders (such as institutional investors) were in no position to interfere with the decision of the (mostly interrelated) board members. The Companies Ordinance of 1984, by allowing an existing board to stay intact for three years, precludes minority shareholders from enforcing management accountability. As of May 1998, about 130 listed companies have been transferred to the Defaulters' Counter, though the KSE has classified another 370 companies as delinquent.

A separate list of bank loan defaulters, published by the SBP, featured many influential politicians and prominent industrialists—mostly familiar names from the textile, cement, and sugar companies. For instance, the biggest defaulter, Mohid Group, owes PRs2 billion to the financial system. Yet two of the listed companies under the group, Mohid Textiles and Mohid Exports (combined paid-up capital at PRs555 million) have not yet been moved to the Defaulters' Counter, despite the fact that share prices of both crashed to a tenth of face value, largely discounting the group's technical solvency. Scrips such as these are rarely traded. In the flight-to-quality, investors are left with a few choices of well-managed, profitable, and liquid stocks.

On the surface, high raw material prices, sector overcapacity, and the slowdown in agricultural and economic activities were to blame for the sectors' woes. However, many owners of these distressed companies have been siphoning funds out of them.

Accounting and Disclosure

Accounting standards in Pakistan are roughly in line with international standards, except in the valuation of assets. All assets are based on book value until maturity or being sold, and valuation of some corporate investment portfolios can be several decades out of date. For instance, real estate holdings, based on purchase prices in the 1920s and 1930s, accounted for 5 percent of the portfolio of SLI. If revalued, SLI's property holdings would have dwarfed its entire portfolio. For securities with significant price fluctuations, the disclosed accounts fail to capture the market value of the assets held. Specifically, for financial institutions with typically higher asset to capital ratio, the price distortion could be misleading during times of market volatility.

At first glance, disclosure seems to be adequate, bordering on too many details. Yet the presence of about 500 delinquent listed companies, representing nearly two thirds of all listed counters, hints at lax public auditing procedures and incomplete disclosure, masking the financial strengths or weaknesses of companies. In adapting international standards to local business, there is plenty of room for ambiguities, particularly over commodities. Such loopholes have not gone unnoticed. In fact, they have enabled many now-defunct textile and sugar companies to pull the wool over the eyes of potential investors.

An important element in window-dressing textile and sugar companies' accounts is the unregulated and volatile prices of the raw materials used. Owners have been able to hide funds by adjusting the financial accounts with arbitrary raw material prices as befitted the situation. Such practices are impossible in the cement and fertilizer sectors, where raw material and product prices are clearly defined or controlled.

Lack of credit records or reluctance to share information between the banking sector and market participants have enabled counters that were already defaulting on bank loans at the time of public offering, to be listed. In the words of one market partici-

pant, "1993 was a great and profitable party for everyone." Some companies, and even their underwriters, deliberately concealed prelisting defaulters' credit histories from prospective investors. Their presence on the stock exchanges is a reminder of past indiscriminate and lax requirements for equity listing.

A common complaint from the three sector SROs (MUFAP, LAP, and MAP) is the amount of paperwork involved in reporting to CLA. Leasing companies submit some 288 reports annually, while MAP members have to submit seven weekly and more than 30 monthly reports. The mountain of financial statements is time-consuming and the information disclosed is not always understood by the recipient, resulting in ad hoc requests from CLA staff for information already submitted. Under the CMDP, MUFAP and LAP are expected to eventually oversee industry compliance under prescribed prudential standards; perform onsite supervision based on agreed criteria; conduct registration and testing/examinations; develop cooperative programs with governmental agencies and industrial organizations to resolve problems affecting investors; and provide arbitration as dispute resolution mechanisms.

Tax Incentives

In order to finance fiscal deficit, the Pakistan Government borrows heavily from the general public and private sector, via government bond sales and the NSS, nearly all of which are exempt from income, wealth, withholding, and *zakat*[2] taxes. In an attempt to squeeze more tax from the private sector, the Government slapped a whole spectrum of taxes on almost every aspect of private businesses. As a result, the capital markets suffer complicated taxation at every transaction stage. When it came to tax exemptions, private sector market participants were clearly at a disadvantage, having missed many of the tax concessions granted to public sector participants on issuances. The tax distortion has already been addressed in the CMDP, and throughout 1997 the disparity gradually ironed out.

Specifically, the CMDP has supported the following taxation measures:

- equity market: exemption of listed securities from capital gains tax until June 2001. Elimination of the tax on bonus shares and on earnings from sales of rights shares, as well as the 0.5 percent turnover tax on shares. Reduction in stamp duty on the transfer of securities by CDC from 1.5 percent to 0.1 percent;
- debt market: abolition of the 10 percent withholding tax on rated and listed TFCs. Elimination of tax on interest income derived from government and corporate fixed income securities for foreign investors; and
- mutual funds: abolition of the income tax for mutual funds provided they distribute at least 90 percent of their profits to adopt uniform tax treatment for public and private mutual funds.

The Government retracted part of the tax exemption on TFCs in March 1998, making corporate holders of TFCs no longer exempt from the 10 percent withholding tax. Since then some PRs10 billion–PRs15 billion of TFC issues have been stalled in the pipeline. The rationale was to prevent banks from profiting from converting their taxable loan portfolio to tax exempt TFCs (with high yields). The move reflected badly on the Government's policy consistency, and snubbed out primary activities in the corporate bond market.

Inconsistencies in the definition of distributable and taxable income, between the mutual fund industry standard and that under the Income Tax Ordinance, have so far prevented the sector from enjoying the tax concession intended. The issue could be resolved simply by an amendment of the definitions in either one of the governing rules. With regard to the minimum 90 percent dividend pay out, the high distributed portion prevents reserves buildup.

The withdrawal of income tax exemption on *modarabas* has hampered the industry's growth. Given that the *modaraba* sector exists to cater to financing in accordance with Islamic principles and

is thus already restricted, it should be granted special tax exemptions.

Human Resources

With the adult literacy rate at 35 percent, it is not surprising that Pakistan's capital market faces a shortage of professionals at all levels. Even the main regulatory body, the CLA, was perceived to lack specialized market or sector knowledge to provide effective regulation. With the advent of the new SECP and its crew of professionally qualified staff, the formerly unregulated atmosphere of the equity market is expected to be reined in, with professional standards and ethics improving as the market evolves.

With the introduction of computerized trading and the phasing out of runners, the stock exchange should work on raising the professional standard of its members.

Given that the mutual fund and leasing sectors require special skills, the CMDP encourages the SROs to impose a minimum professional standard and conduct qualification tests on their members. So far, the mutual fund industry has already outlined a certificate course on fund management to train professionally competent fund managers on market knowledge, sector analysis, and portfolio strategy.

Institutional Investors

Institutional investors have been a key driving force in the development of the capital markets. In the US, they have been the main contributing factor behind the advent of competitive bidding for corporate issues, the abolition of minimum commissions on equity trading, and the restructuring of stock exchanges. Furthermore, the hedging needs of US pension funds have been instrumental in stimulating the development of immunization techniques and derivative products.

The Government has raised the investment limits on provident funds, though as a whole the sector is still underdeveloped. While the two public sector mutual funds in Pakistan are undergoing reform, as part of the CMDP, the private sector mutual funds have an important role to play, which at the moment is being shackled by investment restrictions. To cite but one, there is only one private sector open-end mutual fund. If the sector is to flourish, the Government should gradually liberalize investment rules.

Policy Recommendations

Market Infrastructure

The CMDP has already identified the need to set up a National Clearing and Settlement System (NCSS), based on the existing CDC network, to ensure efficient clearing, settlement, transfer, and payment of securities. By merging two systems with clearly similar structures, the integrated NCSS and CDC will pave the way to faster settlement and clearing, and greatly reduce the probability of transaction error. It is envisaged that CDC will switch to T+3, once all the scrips are on board. This should reduce the speculative element in the market, as well as move Pakistan a step closer to international clearing and settlement standards.

As for the integration of market trading, given that membership fees at LSE or ISE are not likely to catch up with that of KSE due to subdued market activities, the most logical way forward is to reduce the transaction cost on trades originating from KSE members. Since one of the most actively traded stocks, HUBCO, is neither listed on LSE nor on ISE, members of the two stock exchanges seem willing to pay a slight premium to benefit from real-time price quotation and direct access to HUBCO. As a pilot scheme, the intermarket trading system should be limited to a handful of active cross-trade stocks, expanding to include other high-volume scrips once the system proves its merits.

Market Regulation

The main objective of the SECP should be to provide investor protection and to ensure that securities markets are fair and honest. Promotion of adequate

and effective disclosure of information to the investing public should be the first step, but as a safeguard the SECP still needs to be kept abreast of market activities. To enable the SECP to monitor the markets directly, it is essential that the market supervision division be linked to the three stock exchanges electronically. Staff with market trading experience are essential for the proper dissemination of market statistics. Although the stock exchanges are to duplicate market surveillance, they lack experience in enforcing compliance. The SECP is in a better position to set guidelines for market regulations and disciplinary standards for all three exchanges.

Whether it comes down to devising new rules governing mergers, acquisitions, hostile takeovers, management buyouts, or margin trading; or in defining punitive measures against insider dealing, noncompliance, or short-selling, the SECP should again take the lead and provide a standard set of trading and sales practices. The SROs should adopt and fine-tune the regulations for their own sectors, then actively enforce the rules, appropriately sanction, or even suspend members in accordance with the severity of the infringement. Until market players comply with trading rules and none is seen as above the law, the Pakistan equity market will suffer from an image problem with domestic and foreign investors.

One way of reducing the frequency of malpractice is by raising the ethical and professional standard of the stock exchange members. The stock exchanges are of the view that this can be partially achieved through a gradual conversion of individual memberships into corporate ones. To encourage membership transfer, a one-off tax exemption on the capital gains in corporatization of stock exchange membership was delivered in the 1998/99 budget. For their part, the stock exchanges should each propose a membership transfer schedule to speed up the process. Ultimately, the exchange boards should set up a minimum professional standard among members, as best practice can be achieved only by education and active enforcement.

Corporate Governance

The majority of listed defaulting companies should be removed from the market. The KSE listing regulations Section IX states the conditions for delisting, suspension, and Defaulters' Counter as follows:

- listed securities quoted below 50 percent of face value for three consecutive years;
- failure to declare dividend or bonus for five years consecutively, or in the case of manufacturing companies, five years from the date of commencement of production;
- failure to hold an annual general meeting for three consecutive years;
- being liquidated, either voluntarily or under court order; or
- failure to pay the annual listing fees.

Lax regulations and conditions explain why most defaulting companies have yet to be delisted or placed on the Defaulters' Counter. The stock exchange governing board should review the list of delinquent companies, with reference to the SBPs' defaulters' list, and expedite the delisting process. In short, the conditions for delisting need to be tightened, for instance, the no-dividend pay-out grace period could be reduced to three years. Until the defaulting counters are weeded out, the market will remain burdened with a large number of "dormant" scrips.

On the other hand, the exchanges should tighten the minimum requirement for new equity listing. At present, no historical profit record is required by the KSE, although the CLA, through the Companies (Issue of Capital) Rules, specifies a one-year minimum. The stock exchanges should demand a minimum demonstrated income record, say for the past three years, as well as consider raising the PRs50 million (less than $1 million) minimum paid-up capital requirement. After all, it is the quality of the listed securities, not the quantity, that counts.

The SECP policy board and the stock exchanges should work on amending the existing Companies Ordinance to govern mergers and acquisitions, and to facilitate board restructuring. With its sizable

holdings in more than 600 listed securities, the NIT has begun to take a more proactive role in placing the management of companies under scrutiny. Likewise, the regulatory bodies should expand their roles in enhancing corporate governance.

Accounting and Disclosure

It is time that Pakistan reviews and tightens its accounting standards, and fills in the gaps on accounting definitions of various indigenous business transactions. In accordance with International Accounting Standards, the valuation of liquid assets, covering most capital market instruments, should be marked to market on a regular basis. Further, since objective and unbiased external auditing is the key to establishing a true financial picture of corporate entities for all shareholders, the SECP or SROs should initially designate a list of approved Chartered Accountants, with unimpeachable integrity and reputation, for the external audit of listed companies and member firms, until such time that the professional integrity of all Chartered Accountants is deemed beyond reproach.

In publishing the bank defaulters list in late 1997, the SBP has not only offered the public a glimpse of the extent of corporate fraud, but also subjected management of defaulting companies to public censure. With appropriate and adequate disclosure of corporate accounts and activities, abuse of power by majority shareholders or cases of embezzling of corporate funds should be kept in check. In addition, as the two credit rating agencies expand their activities, there should be a greater transparency and awareness of listed companies' creditworthiness, even though the ratings are centered on NBFIs.

Separately, credit history screening should be made compulsory for new listing candidates, with the listing committee furnished with the credit history of the company. There should also be a flow of credit record between main creditors (commercial banks/NBFIs) of the listed corporate clients and the stock exchanges, to ensure that the exchange boards are informed swiftly of any new listed defaulter, even if the company in question has attempted to delay or withhold disclosure. To discourage companies from obscuring vital information, the SECP and stock exchange boards should enforce prompt and adequate disclosure of financial statements and other corporate related news from all listed companies, and penalize those willfully concealing or misrepresenting such information.

If the SROs are to increase their self-regulatory function, the SECP should entrust disclosure to the SROs. To cut down unnecessary paperwork on financial reporting, the individual submission of multiple weekly statements should be abolished, while monthly statements should be submitted by the SRO on behalf of its members, with individual data incorporated into the sector summary. This way, the SECP will be presented with a sector view and comparison, which is more relevant for regulation. In case further details are required, the SRO can then forward the materials required.

Tax Incentives

At the initial stage of corporate bond market development, it is imperative that market participants are given the right impetus though incentives. TFCs are the most likely vehicles in the development of a much-needed long-term corporate bond market, and should be supported at all cost. In short, the Government should amend the withholding tax exemption on TFCs, granting exemption to corporate holders only on, say, the rated and listed TFCs, or on TFCs with maturities over five years. The possibility of banks' portfolio-switch can easily be curtailed by imposing a 5 or 10 percent TFC holding ceiling.

The CLA or SECP should intervene on behalf of the mutual fund industry in ensuring that the Central Board of Revenue understands the situation at hand and redefines taxable income on mutual funds in line with industry standards. The authorities should also

review the minimum payout ratio, perhaps moving to a progressive ratio, to enable the mutual funds to accumulate reserves in the initial years.

As for *modarabas*, the Government should reconsider its strategy with regard to this Islamic mode of financing. If the survival of the sector is deemed crucial to the economy, then *modarabas* should benefit from tax incentives and other privileges, to compensate for the limitations on their scope of business.

Human Resources

The weakest area in professional standard and ethics seems to be within the stock exchange. It is essential that each stock exchange set licensing requirements, and provide an introductory course on capital market rules and regulations to all members, as well as investment advisors working under its corporate members.

The SECP should encourage the establishment of private sector trainings on the various aspects of financial and capital markets. The development of the capital markets will need to draw on more skilled workers. For those outside the financial industry, short of studying or working abroad, it is virtually impossible to attain advanced knowledge on the workings of the markets. Therefore, some form of professional training ground to groom future market participants is needed. Since the SROs will be responsible for training industry participants, the temporary but regular courses will be better served by a dedicated course center, catering to nonindustry students during the off-season. This way, the costs of running the training center can be partially recovered through the course fees generated from outside students.

Institutional Investors

Mutual funds are allowed to float only one investment company (fund) each. This restriction should be lifted for funds with a good performance record. Moreover, the sector comprises only balanced funds with no sector or instrument specialization. Thus, the Government should encourage diversification into specialized funds, including fixed-income funds, all under the same mutual fund umbrella. Provident funds and pension funds, lacking a dedicated fund manager, should be entrusted to professionally trained mutual fund managers.

Conclusion

Following the implementation of the CMDP in November 1996, the capital markets in Pakistan have already undergone remarkable transformation. Until early 1998, progress was more or less in line with the program targets, barring a few hiccups. In the wake of the nuclear tests at the end of May 1998, the foreign exchange market dried up, while the bond and equity markets suffered heavy setbacks. Subsequent sanctions imposed on the country also derailed the second phase of the CMDP**,** leaving program targets postponed until the political uncertainties cleared up.

A prerequisite to the development of the capital market is the reduction in the Government's share of nonbank funding. Within the market, infrastructure upgrade takes precedence over other issues, as half of the malpractices and problems stem from the previously primitive trading, clearing, and settlement system. Next, the regulatory framework needs to be strengthened and the independence of the SECP has to be put in place. Then the authorities and SROs can tackle one of the most serious problems in business and the market—poor corporate governance.

In addition, tax incentives for the private sector participants, to put them on equal footing with those in the public sector, are crucial. So is the notion of professionalism and ethical practices, and adequate market knowledge for all those involved in the markets. Finally, further reform and liberalization in the mutual fund industry should provide an additional force in driving market developments.

Although Pakistan's capital market turmoil is in part due to exogenous factors, it exposed the gaps in the system. However, lessons learned from its Asian neighbors should prevent it from following the bubble route. With the resumption of the CMDP, and further perseverance from market participants, Pakistan's capital market will most certainly evolve on firmer ground than many other emerging markets.

Notes

[1]Further details on the regulatory developments and environment, institutional structure, and statistics on the capital market are given in the Appendixes.

[2]*Zakat* is an Islamic tax levied at 2.5 percent annually on specified assets, such as savings bank accounts and government securities. The tax is deposited in the *Zakat* Fund which was established to assist the poor.

Appendix 1

Chronology of Regulatory Developments

1969. Securities and Exchange Ordinance issued.

1970. Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance issued.

1971. Investment Companies and Investment Advisors Rules promulgated.

1976. Foreign Private Investment (Promotion and Protection) Act enacted.

27 November 1976. Clarification made on the Insurance Act of 1938 regarding the types of approved investment for insurance companies.

20 January 1981. Regulations established concerning *modaraba* companies.

1984. Issuance of the following ordinances:

• Companies Ordinance,

• Banking and Financial Services Ordinance, and

• Banking Tribunal Ordinance.

February 1991. Residents' foreign currency deposit scheme introduced to encourage deposits and remittances by residents and overseas workers alike.

1991. Foreign investment liberalized: foreign nationals and corporations can invest up to 100 percent of the equity in any industry except defense and other sensitive industries such as security printing; and capital gains on any investments paid in foreign exchange to be fully repatriable without any permission from SBP.

August 1992. A third stock exchange in Islamabad, set up to promote investment and industrialization in the federal capital and the northern barani areas, commenced trading.

1993. Tax exemption to *modaraba* income withdrawn under Section 37 of the Income Tax Ordinance.

1 July 1994. Full current account convertibility of the Pakistan rupee under IMF's Article 8.

18 August 1994. First credit rating agency PACRA set up to provide an independent and systematic credit rating for domestic debt instruments.

February 1995. First listed corporate fixed income securities, known as Term Finance Certificates, issued.

20 May 1995. Asset Management Companies Rules required all asset management companies to have a minimum paid-up capital of RPs30 million.

Investment must be at least 50 percent of assets in listed securities.

Exposure to any company capped at 10 percent of the NAV of the scheme, while exposure to a single sector must be kept below 25 percent.

8 February 1996. The Companies (Issue of Capital) Rules specified that companies with at least one year of operational profit record may apply to issue shares to the public.

The offering must be fully underwritten by at least two financial institutions, and the premium should not exceed the amount charged on foreign or local placements.

26 February 1996. Employee's Provident Fund (Investment in Listed Securities) Rules outlines the conditions for investment in listed securities, where total investment should not exceed 10 percent of the fund.

Investment in the listed securities of any single company must be less than 1 percent. Investment in debt instruments subject to rated securities above investment grade.

4 June 1996. Leasing Companies (Establishment and Regulation) Rules set the minimum paid-up share capital of a leasing company at PRs100 million.

3 September 1996. Banks required to obtain clearance from the SBP, in the form of a "no objection certificate," before granting financing facilities to *modarabas*.

January 1997. Effective 1 January 1997, banks allowed to provide fund management and other investment advisory services through subsidiaries. The minimum paid-up capital required for the subsidiary is PRs100 million, with at least 51 percent of the capital contributed from the bank.

Amendments to the State Bank Act 1956 gave the SBP full and exclusive authority to regulate the banking sector, to conduct an independent monetary

policy, and to set limit on government borrowings from the SBP.

Amendments to Banking Companies Ordinance 1962 empowered the SBP to supervise and regulate banks and financial institutions.

Amendments to Banks Nationalization Act 1974 repealed the exclusive right of the Federal Government and its corporations to establish a bank; in addition, the Pakistan Banking Council was to be dissolved.

May 1997. Two former recovery laws, the Banking Tribunal Ordinance of 1984, and the Banking Companies (Recovery of Loans) Ordinance of 1979, repealed. A new Banking Companies (Recovery of Loans, Advances, Credits, and Finances) Act promulgated to speed up recovery process.

The main features of the Act included the establishment of banking courts and the shortening of the disposal of a suit to 90 days.

2 May 1997. Islamabad Stock Exchange commenced fully automated trading.

6 May 1997. A Capital Market Package is unveiled in an attempt to stimulate the market. Among the tax concessions are capital gains tax exemption extended to 30 June 2000; tax exemption on bonus shares; exemption from turnover tax (previously 0.5 percent) on shares; exemption from income tax for foreign investors investing in federal investment bonds (FIBs), short-term federal bonds (STFBs), as well as corporate fixed income securities such as TFCs.

Investment ceiling of Provident Funds on listed securities raised from 10 to 20 percent, while the single company exposure increased from 1 to 5 percent.

Mutual funds exempted from tax on dividend payout and income derived from listed fixed income securities.

Minimum level of investment in government and other approved securities for life insurance companies reduced to 50 percent, and further to 40 percent in 1998.

NBFIs allowed to invest in listed debt securities as an SLR.

June 1997. Promulgation of the Central Depository Act.

7 June 1997. SLR for NBFIs reduced from 19 to 14 percent.

10 June 1997. NBFIs allowed to invest in listed debt securities.

1 July 1997. Lahore Stock Exchange commenced fully automated trading and clearing.

3 September 1997. Central Depository System became operational.

4 September 1997. Karachi Stock Exchange commenced computerized trading in the afternoon session from 3:30 p.m. to 6 p.m.

6 October 1997. A new $1.56 billion three-year package of ESAF and EFF agreed upon with the IMF.

October 1997. Implementation of new criteria/procedures for the incorporation of life or general insurance companies. The minimum paid-up capital for life and general insurance set at PRs100 million and PRs40 million, respectively.

26 December 1997. Enactment of the Securities and Exchange Commission of Pakistan Act to provide for the establishment of the SECP as an autonomous and independent body, responsible for overseeing the development of the securities market, ensuring investor protection, and regulating corporate affairs.

17 March 1998. Central Board of Revenue withdraws part of the tax exemption on TFCs, with the tax exemptions now only available for individuals and unregistered firms. Thus, companies and banks are no longer exempted from the 10 percent withholding tax on income derived from the investment.

18 May 1998. Seven members of the new SECP Policy Board appointed.

26 May 1998. The last three stocks traded on the open outcry system transferred to the Karachi Automated Trading System, thus completing full automation in trading across the country.

28 May 1998. Foreign Currency Accounts frozen, conversion to rupee fixed at the rate of 46 to the dollar upon withdrawal.

14 July 1998. Pakistan's long-term foreign currency credit rating downgraded by Standard & Poor's from B- to CCC.

22 July 1998. Details of Foreign Currency Bond unveiled.

14 September 1998. KSE experiments with two-tier trading for an initial period of two months, whereby only stocks with daily turnover under 500,000 shares are allowed to trade in the afternoon session.

Appendix 2

Markets and Regulatory Environment

FOREIGN EXCHANGE MARKET

The Market

Size

- Official monthly transactions averaged $6.5 billion in the first three months of 1998; another $2 billion–$4 billion estimated to go through unlicensed money dealers.
- Foreign currency accounts in the financial system totalled $11.2 billion at end-April 1998 (for breakdown see Tables A4.1 and A4.2 in Appendix 4).
- Foreign Exchange Bearer Certificates (FEBCs) stood at $241 million at the end of April 1998.
- Foreign Currency Bearer Certificates (FCBCs) accounted for about another $95 million.
- Combined daily turnover of FEBCs and FECBs, before the foreign currency accounts were frozen at end-May 1998, was about PRs30 million.

Participants

- All commercial banks are authorized forex dealers, which include three nationalized, 21 private, and 21 foreign commercial banks.
- There are 262 licensed foreign exchange dealers (roughly 300 as of June 1998); the licensing fee for operation has been revised upwards in July 20 as follows (in rupees):

First time registration	300,000 (up from 50,000)
Annual renewal	50,000 (up from 10,000)

- In addition, the number of unauthorized money changers across the country is estimated at 800.
- There are also 22 interbank foreign exchange brokers, licensed by the Foreign Exchange Rate Committee (FERC, comprising of six leading foreign banks and two nationalized schedule banks), acting as intermediaries in the interbank market.
- While the 15 investment banks are not authorized dealers, many are involved in trade financing.

Regulatory environment

- All market players are regulated or supervised by the SBP.

Instruments

- Foreign Currency Deposits:
  - liberalized in February 1991 to include residents. The exchange rates are guaranteed by the SBP, which provides forward cover for the deposits;
  - total FCDs have jumped nearly fourfold from less than $3 billion in the early 1990s. By end-May 1998, residents' FCDs accounted for about 64 percent of the $11 billion outstanding balance;
  - apart from FCDs, there are two other bearer-type certificates, both income and wealth tax exempt, to cater to depositors preferring anonymity.
- Foreign Exchange Bearer Certificates:
  - introduced in 1985 in a move to absorb money from the informal sector, they are denominated in rupees with a maturity of three years;

– may be purchased in foreign currency by locals and foreigners without limit. FEBCs may be encashed at the discretion of the holder either in rupees or foreign currency at the spot rate;
– may be traded through banks or KSE/LSE.

• Foreign Currency Bearer Certificates:
– denominated in dollars or pounds sterling, otherwise similar to FEBCs;
– can be encashed after six months at banks.

BOND MARKET

The Market

Size

• The domestic debt market is dominated by government securities. As of June 1998, government domestic debt stood at PRs1,185 billion (39 percent of GDP), of which about 30 percent is in T-bills and FIBs.

• T-bills (replacing the short-term federal bonds) and FIBs are mostly bought by commercial banks to hold as part of SLR (reduced to 15 percent on 22 July 1998); daily turnover is around PRs1 billion-PRs5 billion in the secondary market.

• Corporate debt market is small. The combined Term Finance Certificate (TFC), and COI and WAPDA bonds are PRs26.9 billion as of June 1998, with the former two accounting for only PRs2.3 billion (0.5 percent of GDP).

Participants

Primary Market

• The Government of Pakistan is the key borrower in the market, both via regular auctions of FIBs and T-bills, as well as directly through savings certificates under the National Savings Scheme (NSS) (see Appendix 4, Table A4.3).

• Bidding is by yield with a minimum at PRs1 million (with no upper limit) for T-bills, and a cut-off yield is announced at each auction whereby all bids below the cut-off are accepted. For the other government papers such as FIBs, bidding is by price (at discount to face value). In a particular auction, bidders get the amount at their own bid price if accepted.

• NSS instruments are tax exempt, competitively priced (e.g., first year yield on Defence Savings Certificates was at 14.5 percent in June 1997, compared with 10.9 percent offered on a one-year fixed bank deposit).

• WAPDA is one of the few statutory corporations tapping the debt market so far. There have been seven issues since 1988, bringing the total amount raised to about PRs23.7 billion (only PRs15 billion outstanding). The third and sixth WAPDA bonds, issued in denominations of PRs10,000, are listed on KSE and LSE.

• Following the first TFC launch in February 1995, there have been three more listed on KSE, with at least half a dozen in the pipeline. However, the withdrawal of tax exemption on the instrument, previously made available to corporate holders, now deprives the TFC market of interested investors.

• Leasing companies, investment banks, and DFIs are also able to tap another source of funding through the COI.

Dealers/Underwriters

• Commercial banks and financial institutions are the primary dealers in the T-bill and FIB auctions—there are 77 primary dealers;

• Banks and NBFIs participate in underwriting TFCs, among whom a lead market maker could also be assigned to facilitate secondary trading;

• There are three discount houses, of which the First Credit and Discount Corporation was the pioneer in the field. It was set up in 1989 to promote secondary market activities in WAPDA bonds. Activities gradually broadened to include T-bills, FIBs, and TFCs.

Secondary Market

• Commercial banks and NBFIs hold government debt securities as part of their SLR; in June 1997,

12 percent of all scheduled banks' total assets invested in FIB and T-bills.

- There are 10 money market brokers, licensed by Foreign Exchange Rate Committee, to act as intermediaries in the interbank market.
- Listed vehicles such as WAPDA bonds and TFCs have theoretically a wide range of investors, though the instruments are mainly held by financial institutions.
- By contrast, COIs tend to target high net worth individuals and corporate treasurers as their main investors, and there is no secondary market as the instrument is to be held until redemption.

Regulatory environment

- Commercial banks, DFIs, and investment banks are regulated by the SBP. Listed corporate entities and leasing companies are regulated by both the CLA and the corresponding stock exchanges.
- All NBFIs (investment banks, leasing companies, *modarabas, inter alia*) are required by the SBP to obtain credit rating since 1995. Naturally, any corporate entities, listed or otherwise, seeking to issue debt through the primary market must also obtain a credit rating from one of the two credit rating agencies.
- Pakistan Credit Rating Agency:
  – incorporated in August 1994 with the objective of promoting the development of the corporate debt market in Pakistan;
  – PACRA is a joint venture between IBCA (UK-based international rating agency), International Finance Corporation, and the LSE. IBCA provides the technical training in all aspects of the rating process;
  – three types of rating are available: instrument rating, entity rating, and individual rating, with the last specially designed to address the risk/return profile of *modarabas;*
  – total entities rated by sector (as of May 1998):

Sector	Total Rated
Leasing Companies	30
Modarabas	34
Investment Banks	3
Commercial Banks	4
Insurance Companies	2
Total entity ratings	**73**

  – companies can request either a long- or short-term rating, depending on the financing requirement. The procedure takes about one month on average.
- DCR-VIS Credit Rating Company:
  – established in March 1997 to provide independent rating services, as a joint venture between Duffs & Phelps Credit Rating Co. of the US, the KSE, ISE, and Vital Information Services, a local research house;
  – seven entities and three instrument rates as of April 1998.

Types of Securities

- Federal Investment Bond:
  – three-, five- and ten-year terms carrying semi-annual fixed coupons of 13, 14, and 15 percent per annum, respectively;
  – monthly auctions conducted by the SBP with bids on price;
  – traded in secondary markets and approved for SLR requirement.
- Treasury Bill
  – has replaced the six-month short-term federal bonds (STFBs) since 26 June 1998;
  – offered in three-, five, six- month, and one-year maturities;
  – issued on a discount basis and bid by yield at auctions;
  – very liquid and approved for SLR requirement, but the bulk of transactions are through repos.
- Term Finance Certificate:
  – does not feature coupon in line with rules in Islamic financing, but is structured to replicate cash flows of a zero-coupon bond;

– only listed companies have the option to issue TFCs, which can also be listed on any of the stock exchanges, though not compulsory;
– rating compulsory for listed TFCs;
– secured and fully underwritten;
– the four listed TFCs and their respective features are as follows: (based on 19 May 1998 price):

TFC issuer	Coupon Rate (%)	Rating	Market Capitalization (PRs mn)
Packages	18.50	A+	234
Sui Southern Gas	18.25	AA	508
Nishat Tek	18.00	A	250
Imperial Chemical Industries (ICI) Pakistan	18.70	AA-	1,022
Total			**2,014**

• Certificate of Investment:
– maturities may range from three months to five years;
– issuing entity must obtain a minimum investment grade credit rating;
– designed for leasing companies and DFIs, with a minimum of two years of profit record;
– though theoretically fixed return (rate), the final payout amount is sometimes renegotiated.
• Short-term Finance Certificate:
– equivalent to commercial paper;
– first issued in 1997 and privately placed with mainly nonfinancial institutions or individuals.

EQUITY MARKET

The Market

Size

• market capitalization at the largest stock exchange, KSE, was PRs431 billion ($9.7 billion) at the end of May 1998;
• turnover at the KSE, which accounts for an anecdotal 75–80 percent of total volume of all three exchanges, averaged PRs1.18 billion ($27 million) daily in the first five months of 1999;
• for historical trading records and other statistics on the market, see Appendix 4, Tables A4.4–A4.6.

Participants

Stock Exchanges and Members

• KSE, which dates back to 1947, has 150 active members out of a total 200. Out of the 28 corporate members, there are five foreign brokerage firms. A total of 778 securities are listed on the KSE.
• Lahore Stock Exchange, the country's second largest, was inaugurated in 1970, with 105 active members out of 150 seats on the exchange. There are currently 631 securities listed, many of which are cross-listed with the other two stock exchanges.
• Islamabad Stock Exchange, came into existence in 1992, and has since then attracted 285 listings. Of the initial 100 members, about 45 are active.

Mutual Funds

• There are two open-end funds and 40 listed closed-end mutual funds, 26 of which are managed by the State-owned Investment Corporation of Pakistan (ICP).
• Of the two public sector mutual funds, National Investment Corp., with 70,000 unit holders and NAV exceeding PRs27 billion (as of November 1997), accounts for more than 4 percent of the stock market and about 87 percent of the local mutual fund combined portfolio.

Provident Funds

• Can invest up to 20 percent of portfolio in listed securities.
• A number of public and private sector provident funds can invest an estimated total of PRs20 billion in the equity market.

Insurance Companies

• Sector assets totaled PRs61 billion in 1996, of which PRs49 billion alone came from State Life Insurance Corp. (SLI).
• SLI holds about 11 percent of its portfolio in equities (PRs5.5 billion).

- Insurance companies can invest 50 percent of their portfolios outside of list of approved securities.

Foreign Investors

- Foreign ownership of the market is estimated at 15 percent, between \$1.2 billion and \$1.5 billion.
- Anecdotal evidence indicates that about 40 foreign (mostly institutional investor) clients invest and trade in Pakistan equities.
- Net foreign portfolio investment through the KSE is reported at PRs1.9 billion (\$47 million) in 1996, while a net outflow of PRs1 billion (\$22 million) was recorded in the first eight months of 1998.
- To facilitate trading in local securities, foreign investors pay and settle through Special Convertible Rupee Accounts (SCRAs), which can be opened with any authorized foreign exchange dealer in the country. Fund transfer to and from SCRA in foreign currency, from outside or local FCAs or SCRAs can be made.
- No formal permission is required for entry to and exit from the secondary markets, but the investor bears all the foreign exchange risks in SCRAs although conversion and transaction costs are minimized.

Regulatory environment

- The Corporate Law Authority (CLA), a division of the Ministry of Finance, was set up in 1981 to perform the dual tasks of enforcing the company law and regulating the capital markets:
  - the Corporate Wing oversees company registration (about 40,000 companies incorporated, of which about 3,000 are public, unlisted firms), public offerings, and corporate governance;
  - the Securities Wing regulates the market participants including the three stock exchanges (and about 150 brokerages under the exchanges), 33 leasing companies, 51 *modarabas* companies, 40 closed-end mutual funds, one venture capital company, two credit rating companies and the Central Depository Company, in addition to reviewing the financial accounts of registered companies;
  - major legislation that governs the market and corporate sector includes:

Legislation	Year Enacted
The Securities and Exchange Ordinance	1969
Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance	1970
The Securities and Exchange Rules	1971
The Companies Ordinance	1984

  - as part of Asian Development Bank's Capital Market Development Program (CMDP), the CLA is undergoing transformation into an independent and autonomous Securities and Exchange Commission of Pakistan (SECP);
  - an SECP policy board was set up in May 1998, with three private sector members and four ex-officio members;
  - the new SECP will consist of six divisions:

Division	Function
Market Supervision	regulation of stock exchanges, registration of intermediaries, market surveillance, enforcement, compliance, insider investigation, over-the-counter (OTC) bond market;
Primary Market and Investment Management	mutual funds, investment, co-regulation of SROs, public issue of securities, CDC, credit rating;
Companies Regulation	registration of companies, supervision and inspection, liquidation, complaints;
Finance and Accounts	examination of accounts, leasing, *modaraba* licensing;
Legal and Enforcement	adjudication and litigation, appeals and investigation, legislation, rules, regulation;
Administration, Finance and Human Resources	administration and finance, information technology, training, research.

- Stock Exchanges
  - stock exchanges are recognized as SROs;
  - KSE corporate members required to have a minimum paid-up capital of PRs20 million;

– as part of the CMDP, the Governing Board of each stock exchange restructured in 1997, to include seven outside directors, two nominated by the SECP;
– each stock exchange should set up an investor protection fund;
– market monitoring and control features are in place along with full automation of the trading system.

• Mutual Funds
– the Mutual Fund Association of Pakistan (MUFAP), an SRO, has 16 corporate members, of which 13 are private. Members include the State Asset Management Co., which is unlisted, and ICP, which manages 26 individual closed-end mutual funds;
– the industry is governed by the Investment Companies and Investment Advisors Rules of 1971, and the Asset Management Companies Rules of 1996;
– minimum paid-up capital is PRs30 million for any asset management companies, but in practice the industry proposes an increase to PRs100 million;
– mutual funds are required to invest more than 50 percent of their assets in listed securities; short-selling is prohibited;
– maximum borrowing of a scheme is to remain below 25 percent of its total NAV;
– MUFAP proposed that its members declare NAVs as well as their portfolios on a monthly basis;
– MUFAP encourages members to obtain credit rating for their funds.

• Leasing Companies
– the Leasing Association of Pakistan, an SRO setup in June 1995, has 41 members, of which eight are leasing *modarabas;*
– the industry is governed by the Leasing Companies (Establishment and Regulation) Rules of 1996, minimum paid-up capital for a leasing company was subsequently raised to PRs200 million in November 1997;
– the total paid-up capital of the 33 leasing companies is PRs4.5 billion, and with another PRs2.2 billion coming from leasing *modarabas*;
– a leasing company may apply to issue COIs provided that it has been actively engaged in the business for two years and demonstrated profit return above 15 percent, and has obtained a minimum investment grade credit rating;
– a leasing company is required to invest 70 percent of its funds in leasing business and disclose all loans exceeding 20 percent of its paid-up capital;
– exposure to a single group is capped at 20 percent of leasing portfolio; business dealings in real estate not allowed; all leasing activities must exceed three years.

• *Modaraba* Companies:
– the *Modaraba* Association of Pakistan, an SRO, has 51 members, all of whom are listed on the stock exchanges;
– *modaraba*, or term financing, devised to comply with Islamic mode of financing in 1980, refers to an agreement between two parties whereby one provides 100 percent of the capital for a project and the other party manages it. Profits arising from the project are distributed according to a predetermined ratio and any losses are borne by the investor;
– the sector is generally divided into two categories: (1) equity/commodity trading and investment; (2) leasing; some *modarabas* have also been involved in manufacturing projects but in general the sector remains focused on financial services and investments;
– the industry is governed by the *Modaraba* Companies and *Modaraba* Rules of 1981, and the management is required to provide 10 percent of the total paid-up capital;

– there is no minimum paid-up capital, but the lowest in the sector is PRs30 million, and half of the sector has a paid-up capital in excess of PRs100 million. The total paid-up capital of the sector is about PRs9 billion;
– *modarabas* are registered under the Registrar of *Modaraba;*
– fund are raised through Certificates of *Modaraba*, issued directly to the public;
– in line with Islamic Ideology, *modarabas* are not allowed to raise funds through debt.

• Controller of Insurance (CI), a department under the Ministry of Finance, regulates the insurance industry:
– the sector is governed by the Insurance Act 1938 and the supporting rules framed in 1958;
– under ADB's CMDP, CI will be replaced by an independent and autonomous Pakistan Insurance Regulatory Authority (PIRA) to promote sector development and protect the interest of policyholders;
– it is envisaged that the PIRA will be responsible for licensing, delicensing, and registration of insurance companies and intermediaries; general supervision and monitoring of the industry and enforcement of compliance with insurance law; and assessment of the financial soundness of the companies;
– the last insurance licence was issued in 1994.

• Insurance Companies:
– the Insurance Association of Pakistan, an SRO, has 68 members, of which 63 are in general insurance, four in life insurance, and one in reinsurance;
– there were 97,510 licenses issued to insurance agents and 812 to insurance surveyors as of end-1997;
– the sector's assets stood at PRs61 billion as of June 1996, of which PRs18 billion was from gross premium;
– the minimum paid-up capital for an insurance company is PRs40 million for general insurance and PRs100 million for life insurance;
– solvency margin increased to PRs2.5 million (from PRs500,000) in October 1997;
– it is specified that 30 percent of the portfolio must be in government securities, with another 30 percent maximum in other approved instruments or government securities.

Types of Securities

• There are 778 listed companies (including mutual funds) on the KSE, of which about 100 to 130 are traded regularly.
• There are no derivative products available for the time being.

Appendix 3

Market Infrastructure

TRADING SYSTEMS

Computerized Screen-based Trading

KSE

• All scrips traded through the Karachi Automated Trading System (KATS) as of 25 May 1998. Previously, the three most active stocks (accounting for more than 90 percent of daily market turnover) remained traded through the open outcry system in the morning session.
• Official trading hours are 10 a.m.–2 p.m. for the first session, and 3 pm-4:30 p.m. for the afternoon session.
• A minimum of 100 shares of PRs10 each are traded. Transaction below 100 shares (odd lots) usually incur an extra cost.
• The system can handle up to 40,000 trades per day, compared to the pre-KATS average of 12,000 trades.
• A two-tier system was introduced on 14 September 1998 for a two-month trial, in an attempt to improve liquidity on the less-actively traded

counters. Only those counters with average daily turnover below 500,000 shares the previous month are to be traded in the afternoon session.

LSE

- The Lahore On-Line Trading System handled all the listed counters from 1 July 1997. The system is being enhanced to include special transaction types, besides the regular and negotiated deals currently covered by the system.
- Contingent order (e.g., stop loss) type as well as market control ability will be featured in the new version.
- Remote trading facilities were enabled with the new system, to accommodate those members located physically outside the LSE.

ISE

- The Islamabad Stock Exchange Computerized Trading System became fully operational on 2 May 1997.
- About 70 percent of trading is crossed with the other two exchanges (via telephone), particularly with KSE, where the most actively traded stock, HUBCO, is listed exclusively.

Open Outcry

- Though formally abolished, the system remains on stand-by in the event of power cuts, which are not infrequent.
- Under this system, two company boards representing different sectors, run simultaneously on the floor. The first board comprises of sectors 1–8, the second sectors 9–27.
- The sectors are traded in numerical sequence while scrips within each sector are being called upon in alphabetical order. Once a stock is called upon on the "ready board," it is given a maximum two minutes to trade if there is interest.
- Trading jargons, derived from the memoni language, are used in KSE, as most of its members come from the small memon community.

Off the Board

- Transactions between members off the floor, during or after trading hours, or cross trades, are referred to as "off-the-board transactions."

Interbank

- Trading in foreign exchange between commercial banks and money market brokers is conducted either through the Reuters Dealing System or by phone.

CLEARING, PAYMENT, AND SETTLEMENT SYSTEMS

Central Depository System (CDS)

Background

- The Central Depository Company (CDC) was incorporated with a paid-up capital of PRs50 million on 21 January 1993 to implement and operate the CDS. CDC is to operate as a central securities depository on behalf of the financial services industry.
- In January 1997, the Government promulgated the Central Depository Ordinance, setting the stage for scripless delivery and settlement of securities.
- Stamp duty on transfer of shares in the CDS is being levied at 0.1 percent, compared with 1.5 percent on physical delivery.
- The CDS commenced operation, with a selected group of eligible scrips, on 3 September 1997. As of August 1998, about 122 listed securities were being handled by the CDS, representing about 75 percent of turnover.

Main Features

- The CDS is a real-time, on-line electronic book entry system to record and transfer securities. Under the system, ownerships of scrips are transferred without any physical movement of certificates.
- The CDS acts as a trustee for investors and holds the securities as a nominee on the investor's behalf. Current operations include:

– deposit of existing and new securities into the depository;
– withdrawal of securities in the form of certificates to cater to investors who prefer physical possession of certificates;
– free transfer, an instantaneous book-entry transfer of securities without any associated cash movement, no stamp duty will be levied;
– pledging securities in favor of a lender. This is expected to reduce the risk of fake share certificate and also decrease paperwork.

- The system is undergoing an upgrade to include facilities such as stock borrowing, cash-only movement, and Delivery vs. Payment (DVP).
- The CDC is located in the KSE building, and is linked to the other two exchanges via a combination of leased line/VSAT link and local area network (LAN).
- Transaction via the CDS is compulsory for those listed securities whose eligibility has been declared. The remaining non-CDS companies have to register before June 1999 in order to avoid being suspended.
- Account Structure

– there are five types of accounts:

Account	Features
Main	allocated to each participant, mainly as a transit account for movement of securities;
House	for securities owned beneficially by participants;
Sub	for individual clients of a participant;
Group Client	for clients unwilling to open separate subaccounts;
Cash	for participants opting for DVP facility; a rolling settlement fund is required in advance.

– participation in CDS is limited to stockbrokers, custodian banks, financial institutions, and qualified private investors. Retail investors have to participate through these institutions.

Settlement

- The settlement period is currently the same as that of CDS, which is a minimum of T+7. For each clearing period, Monday to Friday, the settlement date falls on Wednesday the following week.
- In a move to reduce speculation and short selling, the KSE proposed to shorten the settlement period to T+3 from 27 May 1998. However, due to opposition from members, the decision was deferred two days before coming into effect.
- Spot transactions take place at least 14 days before the closure of share transfer books as notified by listed companies, in which case settlement is within 24 hours.
- It is envisaged that once the transfer to CDS is completed, settlement will be shortened to T+3.

Clearing and Payment Systems

Non-CDS transactions

- At present, each stock exchange has its own centralized clearing house, adopting the Continuous Net Settlement system. Clearing dates are notified in advance.
- The sales, purchases of shares, and financial obligations of each member/firm within a clearing period are netted out, and the net receivable or payable position is then calculated.
- Instructions for deliveries of the netted outstanding securities are issued. Payments to and from members are routed through the Clearing House.
- The standard practice is DVP, whereby payment and delivery are made simultaneously. Most foreign investors and some of the large local institutions such as NIT settle through DVP.
- Non-DVP is still common. In essence, payment before noon on Wednesday (settlement date) and delivery on Thursday, although the stock exchanges are encouraging all members to switch to DVP.

Central Depository System Transactions

- The clearing house procedure is largely the same, except no physical delivery of securities takes

place. In addition, payments are settled via a book-entry form through CDS.

- Regulations are being drafted on electronic fund transfer to support a system for electronic and nonpaper based payments.
- An on-line accounting system is being developed, to facilitate intrabank, interbank, and intercity electronic transfers by banks.

Interbank Systems

- Clearing and settlement are through a book entry system at T+0, before 12:30 p.m. Payment (DVP) is done though the Subsidiary General Ledger Account (SGLA) held by all banks with the SBP on the same day.
- Once cleared and paid, trades are confirmed by the SBP by 1:30 p.m. Physical delivery could be effected if required.

ACCOUNTING AND DISCLOSURE

Accounting Standards and Audit

- Broadly in line with the International Accounting Standards.
- All NBFIs are required to have an internal audit department, the head of which is to report directly to the chief executive.
- External auditing is to be performed by a chartered accountant, as defined in Chartered Accountants Ordinance of 1961.

Reporting and Disclosure

- NBFIs are to submit regular reports to the respective regulators:
  - two weekly: statement of affairs, liquidity position;
  - three monthly: investment held for SLR, equity and liability (and contingent);
  - quarterly, half yearly, and annual reports with ascending orders of details.
- All listed companies are required to submit to the respective exchange:
  - Semiannually: unaudited financial statements including balance sheet, profit and loss;
  - annually: audited financial accounts;
  - ad hoc basis: any material information with potential impact on share price.

LISTING PROCEDURES

Minimum Requirements

- Issue of capital is governed by the Companies (Issue of Capital) Rules of 1996, the main conditions for first time public offering being:
  - for loan-based projects: to verify that at least 30 percent of the plant and machinery has been installed and that 80 percent of the subscription received has been utilized in the project;
  - for equity-based projects: issue must be fully underwritten, and the underwriters, not being associated companies, shall include at least two financial institutions;
  - profitable operational record of at least one year; and
  - premium on public offering must not exceed those charged on placements with foreign or local institutions.
- Listing eligibility is subject to the listing regulations of each stock exchange. For KSE listings, the main requirements are:
  - minimum paid-up capital of PRs50 million and this is to be subscribed by at least 500 investors;
  - for companies with capital below PRs200 million, at least 50 percent of the capital is to be offered to the public;
  - for companies with capital above PRs200 million, at least PRs100 million or 25 percent of the capital is to be offered, whichever is higher;
  - in the case of *modarabas*, 30 percent of the total paid-up capital shall be subscribed by the sponsors or associates, and the balance of 70 percent to be offered to the public; and
  - prior approval from the CLA is required.

Appendix 4

Selected Statistics on the Capital Market

Table A4.1: Turnover of Official Foreign Exchange Transactions ($ billion)

	1995–1996	1996–1997	1997–1998[a]
Interbank Trades	50.24	56.73	52.53
Notes Purchased	4.03	5.47	4.69
Total	**54.27**	**62.20**	**57.22**

[a] June 1997 to March 1998 only.
Source: State Bank of Pakistan.

Table A4.2: Details of Foreign Currency Account Holdings, End-April 1998 (billion)

	$	£	DM	¥
Banks	8.22	0.37	0.34	35.43
Nonbank Financial Institutions	1.85	0.01	0.07	3.90
Total	**10.07**	**0.38**	**0.41**	**39.33**

Source: State Bank of Pakistan.

Table A4.3: Domestic Government Debt and Saving Instruments Outstanding (PRs billion)

	1992	1993	1994	1995	1996	1997
Total Debt	525.1	611.3	711.0	798.6	909.2	1,041.8
(percent of GDP)	43.3	45.6	45.3	42.8	42.0	43.3
Floating Debt	197.3	215.8	257.6	294.2	361.6	433.8
(percent of total)	37.6	35.3	36.2	36.8	39.8	41.6
T Bills/STFB[a]	71.7	62.8	95.1	58.0	58.7	148.2
Permanent Debt	185.1	245.5	264.2	293.6	294.7	296.2
(percent of total)	35.3	40.2	37.2	36.8	32.4	28.4
Federal Investment Bonds	83.4	137.0	149.7	168.8	165.8	156.5
Foreign Exchange Bearer Certificate	8.5	11.0	11.8	13.5	12.0	10.6
Foreign Currency Bearer Certificate	0.5	2.2	3.1	3.5	4.1	4.1
Prize Bonds	29.7	34.6	39.3	44.7	51.0	60.5
Unfunded Debt	142.7	150.0	189.2	210.8	252.9	311.8
(percent of total)	27.2	24.5	26.6	26.4	27.8	29.9
Defense Savings Certificate	47.5	53.0	64.4	85.0	105.2	136.6
Special Savings Certificate	43.0	62.2	68.4	76.9	88.3	102.1
Regular Income Certificate	2.9	1.1	5.4	9.4	14.1	30.6
National Savings Center Certificate	76.0	85.8	101.5	122.1	146.5	191.5

GDP = gross domestic product, STFB = short-term federal bonds.
[a] End December.
Source: State Bank of Pakistan.

Table A4.4: Number of Institutions

Item	1992	1993	1994	1995	1996	1997	1998[a]
Stock Exchanges	2	3	3	3	3	3	3
Broker/Dealer (active):	na	na	na	na	na	na	na
KSE Corporate	na	10	na	na	24	28	29
KSE Individual	na	101	na	na	106	108	121
LSE Corporate	na	na	na	na	8	9	10
ISE Corporate	na	na	na	na	15	20	20
Investment Banks	na	na	na	11	13	15	15
Mutual Funds	28	29	34	40	42	42	42
Leasing Companies	14	18	24	22	29	33	33
Modarabas	32	41	44	40	49	53	51
Insurance Companies:	na	48	na	62	62	68	68
Life	na	1	na	4	4	4	4
Reinsurance	na	1	na	1	1	1	1
General	na	46	na	57	57	63	63
Rating Agencies	na	na	1	1	1	2	2

na = not available.
ISE = Islamabad Stock Exchange, KSE = Karachi Stock Exchange, LSE = Lahore Stock Exchange.
[a] as of May 1998
Sources: CLA, SBP, KSE, ISE, LSE, MUFAP, Controller of Insurance.

Table A4.5: Listed Capitalization of Institutions

	As of 30 September 1997			As of 19 May 1998		
Item	Number Listed	Mkt. Cap. (PRs billion)	% of Total Mkt.	Number Listed	Mkt. Cap. (PRs billion)	% of Total Mkt.
Mutual Funds (closed-end)	39	4.33	0.8	39	3.76	1.0
Leasing Companies	31	5.04	0.9	32	3.86	1.0
Modarabas	52	3.75	0.7	48	3.00	0.8
Insurance Companies	39	8.20	1.5	36	6.69	1.8
Investment Banks	na	na	na	14	3.18	0.9
Securities Firms	na	na	na	6	0.93	0.3
Venture Capital	na	na	na	1	4.25	1.2

na = not available.
Source: Karachi Stock Exchange.

Table A4.6: Equity Market Summary, End Period

	1991	1992	1993	1994	1995	1996	1997[a]	1998[b]
Number of Listed Companies								
KSE	542	628	653	724	764	782	781	773
LSE	417	505	552	570	616	640	637	631
ISE	na	113	185	218	260	282	285	285
Market Capitalization[c] (PRs billion)								
KSE (PRs billion)	189.52	203.80	370.20	400.52	327.78	471.67	524.15	268.47
($ billion)	7.67	7.93	12.29	13.00	9.57	11.73	11.87	5.84
(percent of GDP)	18.6	16.8	27.6	25.5	17.6	21.8	21.8	9.7
LSE (PRs billion)	161.14	175.25	208.43	359.05	290.57	296.01	496.76	365.39
ISE (PRs billion)	na	50.71	188.16	237.65	217.10	166.12	326.59	293.93
Listed Capital[c] (PRs billion)								
KSE	37.02	58.20	69.47	104.14	134.43	202.69	208.81	210.64
LSE	29.95	49.86	59.70	77.24	99.75	119.42	187.00	187.13
ISE		11.43	32.05	51.00	75.47	89.93	147.64	149.29
Number of New Listings								
KSE	61	86	38	72	41	30	4	1
Capital Raised (PRs billion)								
KSE	6.40	19.36	8.56	30.65	23.56	54.79	4.17	na
(percent of mkt. cap)	3.4	9.5	2.3	7.7	7.2	11.6	0.8	na
IPOs	5.30	15.28	5.57	25.61	17.90	45.00	2.27	0.22
Rights Issues	1.10	4.08	2.99	5.03	4.95	8.54	1.90	na
Debt	na	na	na	na	0.71	1.25	na	na
Ave. Daily Turnover[c] (PRs million)								
KSE	na	113.00	297.10	296.00	340.00	684.16	1947.70	1,179.60
($ million)	na	4.5	10.6	9.7	10.7	18.9	47.1	26.5
Annual Total (PRs billion)	55.84	86.68	117.00	320.80	342.06	514.98	807.56	311.00
(percent YOY)	na	55.2	35.0	174.2	6.6	50.6	56.8	na
Annual Total (PRs billion)	15.23	24.44	51.58	97.47	101.45	na	na	169.70
Ratio (percent of mkt. cap)	8.0	12.0	13.9	24.3	30.9	na	na	39.4
No. of Shares (million)	na	na	5.50	7.80	13.93	29.40	56.10	56.90
LSE (PRs million)	na	na	na	na	160	364	na	747
ISE (PRs billion)	na	na	na	na	na	17	na	na
KSE-100 index	1672	1244	2164	2049	1498	1340	1754	1,017
(percent YOY)			74.0	(5.3)	(26.9)	(10.5)	30.9	(42.0)

( ) = negative values are enclosed in parentheses, na = not available, YOY = year-on-year.
ISE = Islamabad Stock Exchange, KSE = Karachi Stock Exchange, LSE = Lahore Stock Exchange.
[a] Certain 1997 figures are estimates.
[b] Actual 1998 figures up to end-May.
[c] Up to April 1998.
Sources: KSE, LSE, ISE, SBP, IFC.

Table A4.7: Pakistan vs. Emerging Equity Markets, June 1998

		Market Capitalization			Turnover	
	No. of Listed Companies	($ billion)	(%)	(% of world)	Average ($ million)	Ratio (%)
Argentina	137	50.99	2.7	0.0023	51.1	0.10
Egypt	700	20.78	1.1	0.0009	19.4	0.09
Malaysia	728	66.95	3.5	0.0030	59.1	0.09
Pakistan	779	5.63	0.3	0.0002	24.4	0.43
Philippines	223	29.45	1.5	0.0013	23.3	0.08
Sri Lanka	243	1.70	0.1	0.0001	1.4	0.08
Turkey	271	60.98	3.2	0.0027	328.9	0.54

Sources: IFC, MSCI.

Table A4.8: Top Ten Stocks, May 1998

Stocks	By Market Capitalization PRs billion	Percent of Market	Stocks	By Turnover PRs million	Percent of Market
PTCL 'A'	97.94	26.6	Hub Power	1,410.59	59.5
Lever Brothers	92.62	25.1	PTCL 'A'	747.87	31.5
Hub Power	32.34	8.8	ICI Pakistan	42.93	1.8
FFC Jordan	21.75	5.9	PSO	37.38	1.6
PSO	16.53	4.5	MCB	22.58	1.0
ICI Pakistan	11.12	3.0	FFC Jordan	13.45	0.6
Engro Chemical	10.28	2.8	Adamjee	13.29	0.6
Shell	6.43	1.7	Shell	12.29	0.5
MCB	6.15	1.7	Fauji Fertilizer	12.26	0.5
Sui Southern Gas	5.48	1.5	Engro Chemical	5.60	0.2
Total	**300.64**	**81.6**	**Total**	**2,318.24**	**97.8**

FFC = Fauji Fertilizer Co., Ltd.; ICI = International Chemical Industries; MCB = Muslim Commercial Bank, Ltd.; PSO = Pakistan State Oil Co., Ltd.; PTCL = Pakistan Telecommunication Co., Ltd.
Sources: IFC, MSCI.

Table A4.9: Nonbank Financial Institutions Sector Profile

	FY 1994–1995	FY 1995–1996	FY 1996–1997
Credit Disbursement (PRs billion)	42.9	52.9	45.2
Fixed Industrial Financing	14.1	20.1	20.8
Investment Banks	5.0	7.7	7.3
Leasing Companies	7.8	10.5	8.3
Modarabas	1.3	1.9	5.2
Working Capital Loans	28.8	32.8	24.4
Investment Banks	24.1	29.2	21.5
Leasing Companies	1.1	1.0	0.4
Modarabas	3.6	2.6	2.5
Gross Premiums (PRs billion)	na	15.1	15.5
Life Insurance	na	7.3	8.1
General Insurance	na	7.8	7.4
Major Investment Portfolio (PRs billion)	152.8	81.2	87.4
State Life Insurance	37.9	43.1	48.5
In Listed Securities	4.8	5.5	5.5
National Investment Trust	na	26.0	27.0
Investment Corporation of Pakistan	na	3.9	3.6
In Listed Securities	na	2.7	2.8
Employees Old Age Benefit	15.0	na	na
Employees Provident Funds (private)	75.0	na	na
Benevolent Funds	20.0	na	na

na = not available.
Sources: SBP, Controller of Insurance, SLI, NIT, ICP, PACRA.