1 GLOBAL AND DOMESTIC DEVELOPMENTS: FINANCIAL STABILITY IMPLICATIONS FOR PAKISTAN

The operating environment of the financial sector experienced significant deterioration in 2007 and 2008, due to a confluence of factors emanating from both the domestic and international economic and financial developments. While the domestic environment was characterized by weakening macroeconomic indicators and the uncertainty caused by the prolonged period of political transition, the global financial crisis and the commodity price hike had a feedback impact on the financial sector through the real sector of the economy. This chapter analyses the impact of this confluence of factors on financial stability in Pakistan in the broader context of Asia.

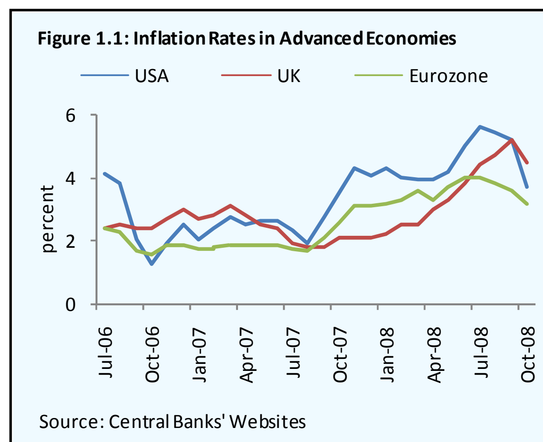
The benign global macroeconomic environment which prevailed for an extended period until a year ago, and was even termed as the 'great moderation', gave way to a financial crisis with global reverberations in August 2007: something which would have seemed like a far-fetched idea at best while the going was good, with easy access to credit, low risk premiums, and the average (four-year) growth rate for the global economy at 5.0 percent. The crisis emanated in the sub-prime mortgage loan portfolio, which incidentally thrived on the (flawed) assumption of continued increases in house prices,[1] and entered a tumultuous new phase in September 2008 which badly shook the confidence in global financial institutions and markets. Consequently, the US government announced a bail-out package of US$ 700 billion under TARP,[2] triggering a fresh round of rate cuts by leading central banks in a coordinated move.[3] Estimated losses from the crisis currently stand at US$ 1.4 trillion.[4]

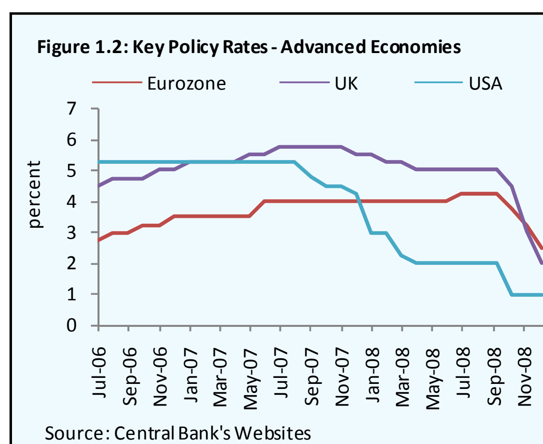
Central banks' hard-earned credibility in the domain of monetary stability, with an extended period of low and stable inflation during this period of great moderation, has also come under close scrutiny due to some of the unorthodox measures employed by them[5] to overcome and minimize the threats to financial stability. Among other issues, a wider base of acceptable collateral for liquidity provision by central banks has given rise to concerns about the potential credit risk, which central banks do no traditionally face.

While the distorted incentive mechanism of the 'originate-to-distribute' model is deemed to be one of the main culprits of the crisis, the role of deepening financial globalization which augmented easy flows of capital across borders, and the search for yield in a prolonged era of excess liquidity encouraged the use of increasingly complex securitized instruments. Initially viewed as a tool for diversification of risks, this resulted instead in risk-concentration which aggravated financial losses, and was the underlying reason for the intensifying solvency concerns, and subsequent bankruptcies, for a number of financial institutions in the US and Europe. One of the reasons for this particular unraveling of events is that the process of extensive financial leveraging was not accompanied with a proportionate strengthening of the associated regulatory structures with adequate comprehension of complex derivative products, and monitoring of banks' ability to transfer risk exposures to off-balance sheet investment vehicles (SIVs): a phenomenon termed as the *shadow banking system*.[6]

[1] Cechetti et al (2008)
[2] Troubled Asset Relief Programme, announced by the US Treasury. This amount will now be used for re-capitalization of distressed financial institutions.
[3] Rate cuts were announced by the Federal Reserve, Bank of Canada, Bank of England, European Central Bank (ECB), Swiss National Bank (SNB), Sveriges Riksbank, and Bank of China, on October 8, 2008.
[4] World Economic Outlook and Global Financial Stability Report, October 2008, IMF.
[5] Annexure 1 to this chapter gives a summary of changes in the key policy rates of various central banks in 2007 and 2008.
[6] The "shadow banking system" encompasses the money market funds, securities dealers, hedge funds and other non-bank financial institutions that define deregulated finance.

With no end in sight of the persistent crisis, financial stability concerns have reigned supreme for leading central banks, who were faced first with rising inflation in the initial phase of the crisis, and then a subsequent decline in prices (**Figure 1.1**) in an environment of historically low policy rates (**Figure 1.2**). The impact of the crisis was exacerbated by the unprecedented rise in global commodity prices, such that the trade-off for the policy-makers was no longer just between growth and inflation, which had re-emerged due to high energy and food prices, but also between monetary and financial stability, both of which required an equal and opposite policy reaction under the circumstances.[7]



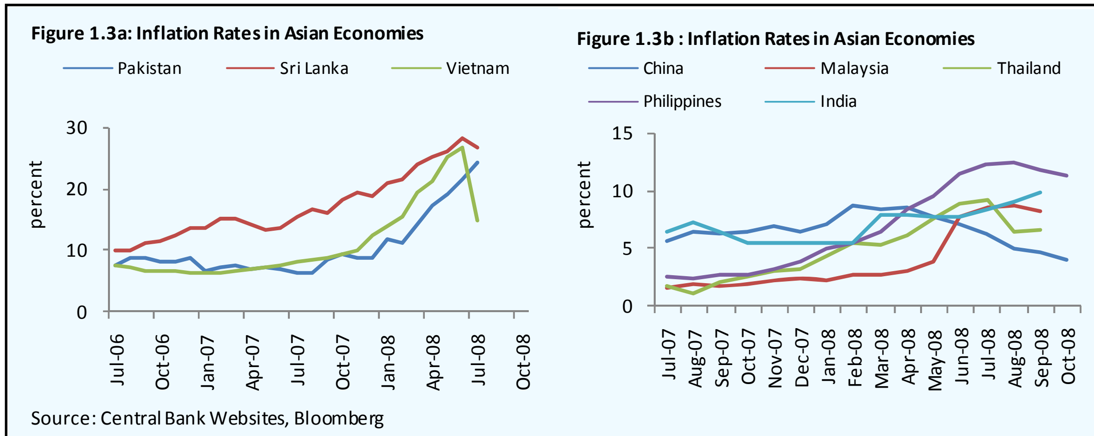


As the crisis unfolded and spread in subsequent months, spillover effects into the real sector became evident as household and corporate balance sheets came under stress, with limited availability of credit and the increasing number of defaults. These events are a fresh reminder of the costs associated with financial globalization, particularly when there are gaps in the oversight of markets, and risk management guidelines are compromised and violated.[8]

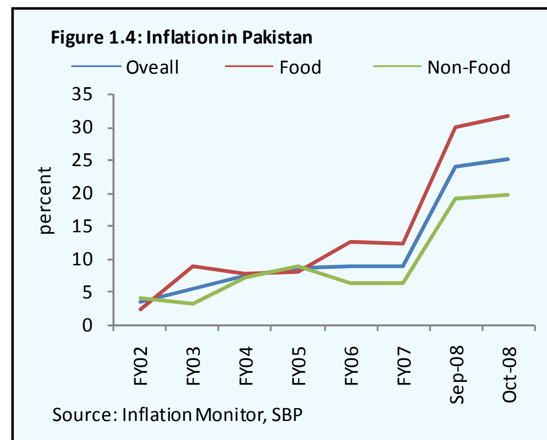
Contrary to previous episodes of financial crisis, the epicenter for this crisis was concentrated in mature economies around the world, with emerging economies in Asia and other regions having been influenced only marginally for a better part of the duration of the crisis. However these economies are now beginning to be affected through the protracted slowdown in global economies and the impact on trade volumes. The resilience shown by these economies in face of this turmoil is due to their more gradual approach towards financial globalization. In particular, most of these countries, having already experienced the large economic costs associated with financial crisis, as in case of the East Asian crisis of 1997, had concentrated more on building surplus reserves, inculcating discipline in the regulatory framework and benefiting from global capital flows in the investors' search for yield.

Notwithstanding, a bigger threat for emerging markets in subsequent months emerged from the unabated inflationary pressures, exacerbated by the rising food and oil prices. **Figure 1.3(a) & (b)** amply demonstrate this fact by showing separately the hardest hit economies in Asia (Pakistan, Sri Lanka and Vietnam) with inflation rates in excess of 20.0 percent, and the other group, with still high, but relatively more moderate inflation. Commodity prices have started to ease off in recent months as a result of which inflationary pressures in most of these countries have also subsided.

[7] It is generally believed that monetary and financial stability mutually reinforce each other in the long run. For an informed discussion of the debate between the trade-off, please see Chapter 2, "Dimensions of Monetary and Financial Stability" in this edition of the FSR.
[8] As elaborated in a speech by the Governor SBP at the ADB Annual Conference in Madrid, on May 4, 2008.



Source: Central Bank Websites, Bloomberg



Source: Inflation Monitor, SBP

Pakistan, which remained largely unscathed from a direct impact of the crisis, has been more concerned with issues relating to monetary stability due to rising inflation since before the advent of the crisis (**Figure 1.4**). With a thriving banking sector, increasingly resilient to a wide variety of shocks,[9] increasing but still relatively less correlation of domestic financial markets with global financial developments, a proactive and vigilant regulatory environment, and most importantly, no direct exposure to securitized instruments, risks to financial stability were largely contained and well-managed as the crisis unfolded and impacted the financial sectors in advanced economies.

However, growing macroeconomic imbalances and other adverse developments have resulted in credit stresses of its own kind, which led to the downgrade of Pakistan's sovereign credit ratings to B2 from B1 (Outlook Negative)[10] by Moody's, and from B+ to B (Outlook Negative) by S&P's in May 2008, with a subsequent downgrade to B3[11] and CCC,[12]respectively. Additionally, with a visible slowdown in economic growth in leading developed economies as a consequence of the protracted duration of the crisis, and spillover effects from increasingly fragile financial sectors in the advanced economies, repercussions from second round effects cannot be disregarded. While assessing the impact of these second round effects on the domestic economy and the financial sector, it would be well to bear in mind that a factor peculiar to Pakistan i.e. political instability since November 2007, was also pervasive during most of the period under assessment. Importantly, it would be difficult to disentangle the combined influences of the financial markets turmoil, the bizarre trends in the commodity market, and the largely unstable internal conditions which almost exactly coincided with the unfolding of the crisis.

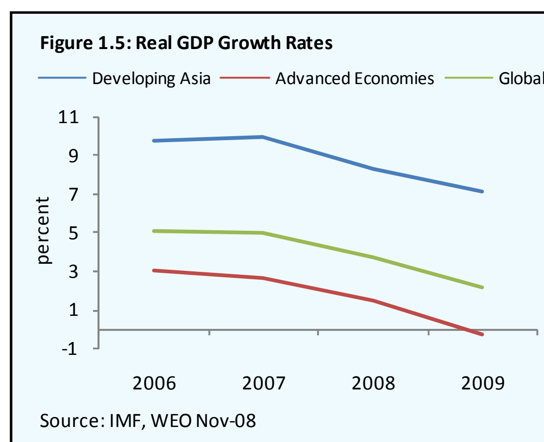
Keeping in view these various factors, this chapter gives an assessment of the impact of the financial markets' turmoil on financial stability in Pakistan, while recognizing that a *direct* impact

[9] A detailed analysis of the banking sector is given in Chapter 3, "Stability of the Banking System", in this edition of the FSR.
[10] Outlook downgraded on September 23, 2008.
[11] Rating downgraded on October 28, 2008.
[12] Rating downgrade announced on November 14, 2008, the lowest level in 10 years.

of the crisis on the financial sector has been negligible, and that the *indirect* impact is transmitted through the feedback loop of the real sector. The chapter examines the various channels of transmission and their combined influences, based on the wider context of repercussions of the crisis in the Asian region, given that the spillover effects in the region have been relatively small, and doing so also provides the opportunity to assess Pakistan's trade and financial linkages within and across the region, and hence the impact of financial globalization on the economy.

Economic Growth Outlook

According to latest estimates,[13] growth in advanced economies is expected to decline to 1.4 percent in 2008, and -0.3 percent in 2009 (**Figure 1.5**), whereas global growth is expected to moderate to 3.75 percent in 2008, and 2.2 percent in 2009 – the slowest pace since 2002, driven by the relatively lower, but still high growth in emerging markets. These estimates effectively indicate an ensuing recession, with an expected recovery in late 2009,[14] albeit at a much slower pace than before, due to the ongoing financial market deleveraging.



In the wake of growing economic diversity and divergence of Asia, it is no surprise that the impact of global developments varies considerably across the region. Asia performed fairly well in the last two quarters of 2007 when, in the first round, the US slowdown was confined primarily to the housing sector. As the liquidity crunch deepened, defaults grew and financial losses magnified, resulting in a fall in US consumer spending and confidence. These and associated developments started to filter down across Asia and are now visibly impacting key economic indicators of the region. The economic cycle in emerging Asia started to show signs of weakness in early 2008, and this process is expected to continue due to the slowing demand from advanced economies, along with growing strains in regional financial markets.

There is now a broad consensus that Asia's economic growth is likely to slow down. IMF[15] forecasts that Emerging Asia's growth in 2008 will be 6.6 percent, about 1.4 percentage points lower than 2007. Growth of China, with its growing global linkages, is anticipated to be 2.2 percentage points lower than the 2007 outcome, and India about 1.5 percentage points (**Figure 1.6 & 1.7**). Notwithstanding these estimates, the 2008 outlook for Asia would invariably depend on how the uncertainty regarding the US and European financial turbulence resolves itself.

Pakistan on the other hand has faced a challenging economic environment since the last quarter of 2007, with growing macroeconomic imbalances, high levels of inflation, an expansionary fiscal policy and a plethora of factors emanating from the domestic political environment. The growth rate moderated in FY08 to 5.8 percent due to a combination of factors, in particular the impact of the rise in the global commodity prices, specifically oil and food, showing up in domestic inflation and the growing macroeconomic imbalances.

[13] World Economic Outlook Update, November 6, 2008, IMF.

[14] This forecast is based on 3 assumptions: (i) stabilization in commodity and oil prices will relieve pressure on inflation, (ii) US housing prices will hit bottom within the next year, and (iii) the elements of the systemic solution to the financial crisis will prevent further worsening of financial intermediation, as discussed in the Foreword of the WEO, October 2008, IMF.

[15] World Economic Outlook, October 2008, and Regional Economic Outlook, Asia and Pacific, April 2008 - International Monetary Fund.

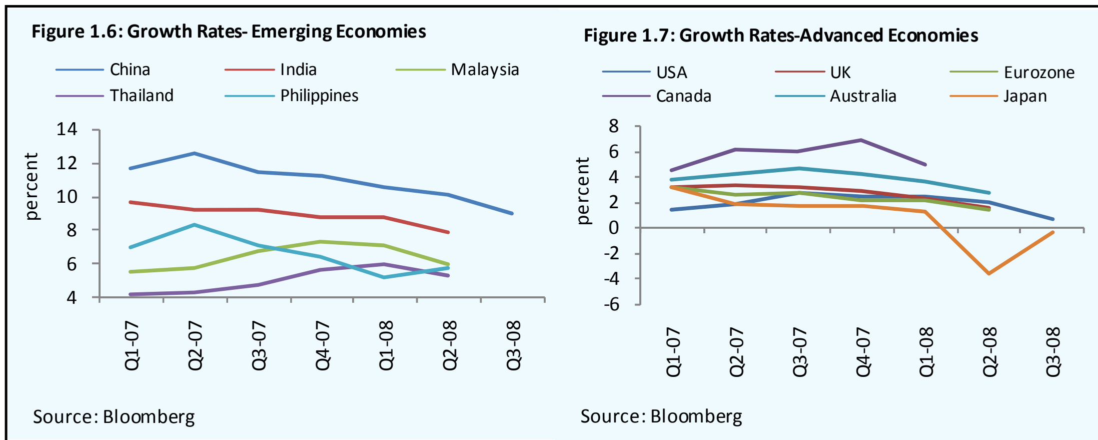


Figure 1.6: Growth Rates- Emerging Economies

Source: Bloomberg

Figure 1.7: Growth Rates-Advanced Economies

Source: Bloomberg

Notably, Pakistan's' average economic growth rate was 7.1 percent for FY04-08: during these 5 years economic growth was above 7.0 percent in two years and 9.0 percent in FY05, confirming the rise in *trend* growth rate and capturing well the real economic potential (**Figure 1.8**).

Figure 1.8: Real GDP Growth Rate of Pakistan

Source: SBP

Notwithstanding, macroeconomic stability in Pakistan has been under stress on account of both domestic and external vulnerabilities. The fiscal stress continues to be high. After registering record borrowings of Rs 689.0 billion from the central bank in FY08, government borrowings have continued to rise unabated in FY09 also. This excessive recourse to the central bank continues to cause complications for effective liquidity management. Weaknesses in the external sector, in particular, constitute a major source of concern. Despite the consistently strong inflow of workers' remittances and a reasonable export performance, the external current account deficit remained at an unsustainable level of 8.4 percent of GDP in FY08. With considerable slowdown in private as well as public financial inflows, the financing gap has widened and consequent outflow of foreign exchange drained the rupee liquidity from the system, straining the domestic money market: the Net Foreign Assets (NFA) of the banking system have depleted by Rs 317.4 billion in FY08 (and 346.4 billion during the first few months of FY09),[16] as shown in **Figure 1.9**.[17] The central bank has strived to contain the aggregate demand pressures in the economy in face of rising inflation. Since July 2007, the SBP policy rate has been raised by 550 bps to 15.0 percent,

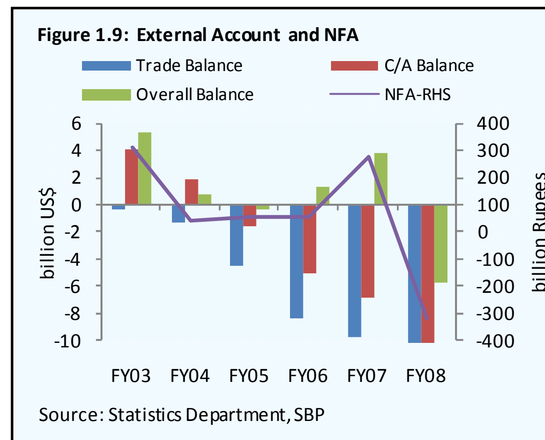


Figure 1.9: External Account and NFA

Source: Statistics Department, SBP

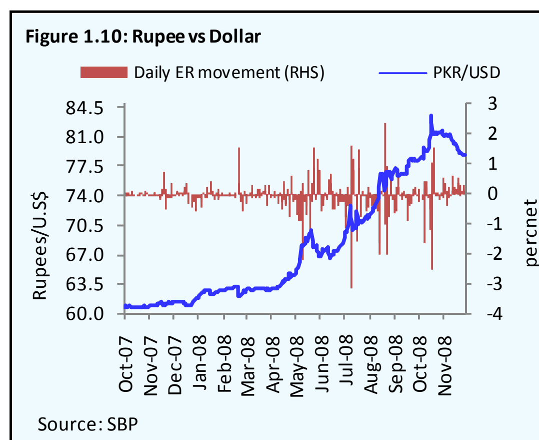
[16] Upto November 15.

[17] www.sbp.org.pk

and the reserve ratios (CRR and SLR) by 100 bps each.[18] Despite aggressive measures, slippages in the inflation target in FY08 were inevitable given the uptrend in the global commodity prices as well as structural complexities of wholesale and retail markets. To complicate matters further, the exchange rate of the PKR against the US$ depreciated by 23.0 percentage points from October 2007 to end-November 2008 (**Figure 1.10**), due to the liquidity constraints emanating from reduced foreign exchange inflows.

In recognition of the urgent need to arrest various problems, the government's economic policies for the rest of FY09 and FY10 are aimed at stabilizing the macroeconomic situation and restoring investor confidence. This is intended to be achieved by focusing on fiscal consolidation, keeping close vigilance on inflationary trends, maintaining an appropriate monetary stance and strengthening the international reserves position.

Figure 1.10: Rupee vs Dollar



Source: SBP

Having given this overview on the outlook of economic growth, the next section discusses the channels through which the various factors can impact the economy, and the financial sector. The four key areas in which Pakistan is most impacted given this confluence of factors are: (a) impact of the commodity prices on macroeconomic imbalances, b) trade prospects, (b) access to international markets for raising funds through sovereign bond issues and privatization of state owned enterprises through GDR listing, etc. and (c) outflow of portfolio investments, which otherwise would have found higher returns in the investor's ongoing flight to quality.

1.1 Macroeconomic Imbalances – the Commodity Price impact

The unprecedented rise in commodity prices in 2007 and the first half of 2008 (**Box 1.1**), has had a most damaging impact on Pakistan's economy. Pakistan was one of the most severely hit economies in Asia due to the surge in global commodity prices, which peaked in mid-July 2008, and which have seriously impaired its macroeconomic stability. The twin deficits, brought down to sustainable levels in the recent past, had started to widen since FY05, but witnessed an unexpectedly unprecedented rise during FY08. Besides the excess demand pressures already persisting in the economy, a key source of these macroeconomic-imbalances was the massive rise in commodity prices in the international market, given the dependence of the country on oil and food imports.

Though the trade deficit was already high, rising commodity prices played a key role in pushing up imports to US$ 40.0 billion during FY08 (YoY growth of 30.9 percent), compared to US$ 30.5 billion in FY07. A further break up of data shows that approximately 28.7 percent of the increase in imports during FY08 was attributable to the surge in oil prices, while another 10.5 percent increase was due to food items, especially wheat and edible oils: such that the total impact of the high commodity prices in international markets accounted for a 39.2 percent increase in the import bill during FY08. This situation was further aggravated during July-October FY09, as the imports of petroleum products witnessed YoY increase of 69.2 percent to reach US$ 4.8 billion compared to US$ 2.9 billion during July-October FY08. This is because of the lagged impact of the

[18] CRR was progressively decreased by 400 bps starting from October 11, 2008 to November 1, 2008, to address temporary liquidity constraints being faced by the banking sector, as discussed in the Special Section: Liquidity Pressures in the Banking System.

Box 1.1 : The Rise and Fall of Global Commodity Prices

The recent sustained rise in commodity prices, which continued unabated until mid-July 2008, is a phenomenon last seen in the 1970s. In the previous six years of the build up to peak levels, prices have risen at an average annual rate of 15.0 percent. Given that this rise in prices has been largely broad-based, there are concerns that it effectively signals the end of the prolonged period of price stability. Emerging markets in particular have seen the impact of high commodity prices creeping into inflationary tendencies, driven by the composition of the CPI basket with high weightage of food and oil.

Commodity price inflation stems from both demand and supply side factors, and causes include both microeconomic explanations, as well as macroeconomic ones. Notably, while dollar denominated gains have exceeded those in most currencies, the gains remain pronounced when expressed in any major currency.

On the demand side, the rising demand of emerging economies for specific commodities is believed to be a key reason of the sustained build up in prices. On the supply side, output prospects of non-renewable commodities such as oil are viewed with far more caution than in the 80s and the 90s. While varied explanations are given for the bizarre trends in commodity prices, this section focuses in particular on the *dollar factor* explanation.

Inverse Relationship between Gold, Oil and Commodity Prices vs. US Dollar Strength Has Intensified

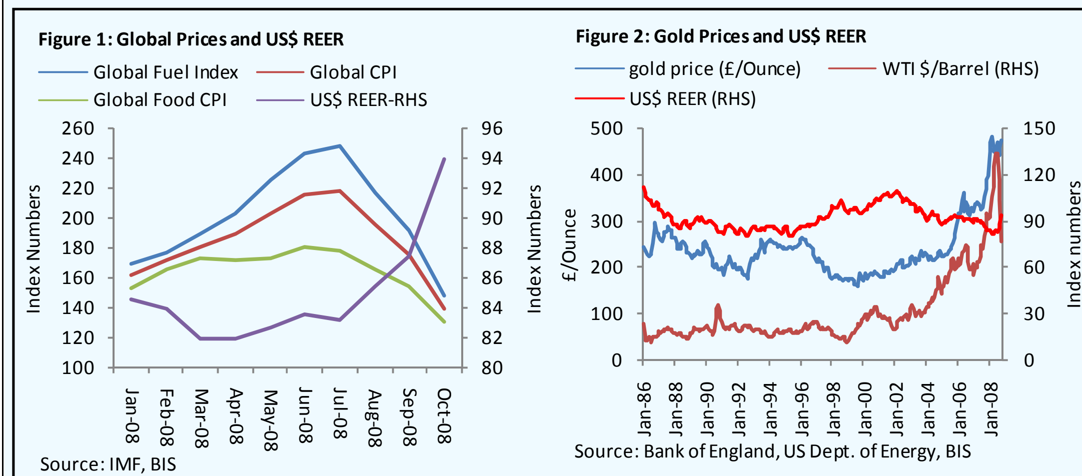
Simple correlation tests conducted on commodity, gold and oil prices against US dollar strength shows that the inverse relationship has grown statistically more significant in recent years. Correlation results using data of US$ REER and Global commodity price index since 1992 were –0.27 whereas data from 2000 showed correlation of –0.82, a result which is much stronger and statistically significant (**Figure 1**).

Correlation results of Oil and US$ REER grew from –0.29 when observing data from 1986 onwards, to -0.82 when using data from 2000 onwards. Similarly, the inverse relationship of gold to US$ REER intensified with correlation of 1986-2008 data showing a result of –0 .33 which increased to -0.76 when using 2000-2008 data (**Figure 2**). An unexpected observation was the extremely high correlation result of gold and oil prices at +0.93 over the past 22 years.

Table 1: Correlation Results

US$: CPI* since 1992	US$: CPI* since 2000	US$: Oil since 1986	USS: Oil since 2000	US$: Gold since 1986	US$: Gold since 2000	Gold: Oil Since 1986
-0.27	-0.83	-0.16	-0.82	-0.34	-0.76	+0.92

Source: IMF, BIS, Bank of England, US Department of Energy *Global CPI as determined by IMF

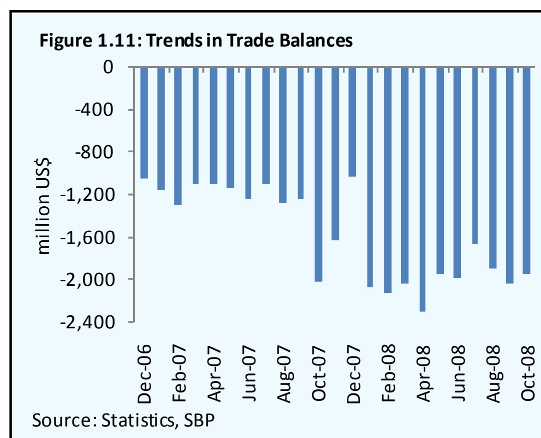


Source :

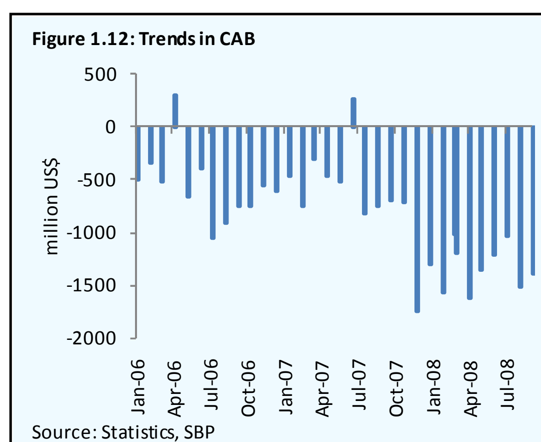
Rising Global Commodity Prices: Causes and Consequences, Special Briefing, June 12, 2008, Institute of International Finance (IIF).
Is Inflation back? Commodity Prices and Inflation, Chapter 3, World Economic Outlook, October 2008, IMF.
The Greenback and Commodity Prices, Steve Hanke, Globe Asia, September 2008.

pass-through of the decline in international oil prices. Wheat import over the same period also played an important role in pushing up the import bill to US$ 14.3 billion during July-October

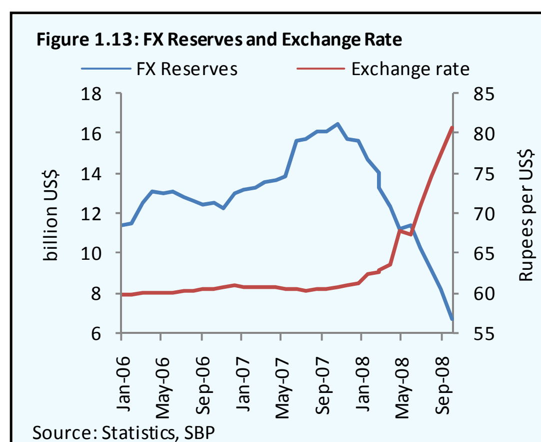
FY09, compared to US$ 11.4 billion over the same period last year. Even though exports grew reasonably well over the period of analysis (YoY increase of 12.2 percent in FY08 and 16.3 percent during July-October FY09), this growth could not entirely finance the substantial increase in imports. As a result, the trade balance registered significant deterioration over this period (**Figure 1.11**). Specifically, the average trade deficit per month during July-October FY09 reached US$ 1.9 billion compared to US$ 1.4 billion over the same period last year. Similar deterioration in recent months is also visible in the external current account balance despite the robust growth in workers' remittances. The external current account deficit reached US$ 5.9 billion during July-October FY09 compared to US$ 3.0 billion during July-October FY08 (**Figure 1.12**).



With reduced inflows of foreign investments and foreign loans, the massive deterioration in the external current account balance in recent months was primarily financed by drawing down foreign exchange reserves, which declined by US$ 9.7 billion since October FY08 to reach US$ 6.8 billion by end October FY09 (**Figure 1.13**). The institutional breakup of the reserves indicates that SBP reserves saw a decline of US$ 10.7 billion over the last one year to reach US$ 3.5 billion, while the reserves with scheduled banks steadily increased to US$ 3.2 billion by end October FY09, compared with US$ 2.2 billion as of end October FY08.



The above changes in reserves have had strong implications for the domestic exchange rate in the FX market and the liquidity position in the money market. The Pak Rupee depreciated by 15.4 percent during July-October FY09, before recording modest appreciation during November FY09.

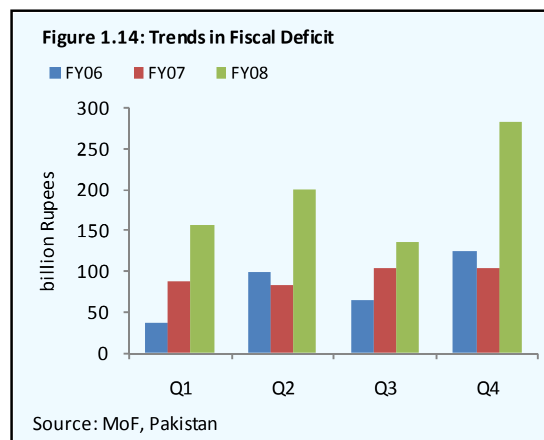


On the monetary front, massive depletion of foreign exchange reserves emerged as a major source of liquidity drain in the money market, as also mentioned earlier.

The impact of rising commodity prices is also visible in the other key indicator of macroeconomic stability, i.e. the fiscal balance. Lack of fiscal discipline undermines the confidence of both domestic and international investors, and has strong negative implications for the overall performance of the economy. The government's decision to keep the domestic oil prices unchanged in the presence of a steep rise in international oil prices added to the expansion of the

fiscal deficit. Subsidies on energy and food, coupled with the surge in debt servicing due to the maturing expense of NSS debt issued in 1997-98 at relatively higher rates, added to this pressure. As a result, fiscal deficit more than doubled in FY08, to reach Rs 777.2 billion compared to Rs 377.5 billion during FY07 (**Figure 1.14**). The financing composition of the budget deficit indicates that the government heavily relied on domestic sources, as the external financing (net) constituted only 19.5 percent during FY08, compared with 52.9 percent in FY07. Within domestic resources, massive borrowing from the central bank created serious challenges for monetary management in Pakistan. This trend continued during the first few months of FY09, with budgetary borrowing from the central bank reaching Rs 376.3 billion in the first few months of FY09.[19]

Figure 1.14: Trends in Fiscal Deficit



Source: MoF, Pakistan

Besides contributing to high fiscal deficit, delayed policy action in passing on the impact of high energy prices to consumers also exacerbated the problem of circular debt among the Public Sector Enterprises (PSEs) and oil companies. As a result, the credit demand of PSEs increased sharply to reach Rs 51.6 billion in the first few months of FY09, compared Rs 0.5 billion over the same period last year. This, along with robust credit requirements of the private sector, further impacted the liquidity position of the banking sector as discussed in the **Special Section: Liquidity Pressures in the Banking System**.

1.2 Trade Prospects

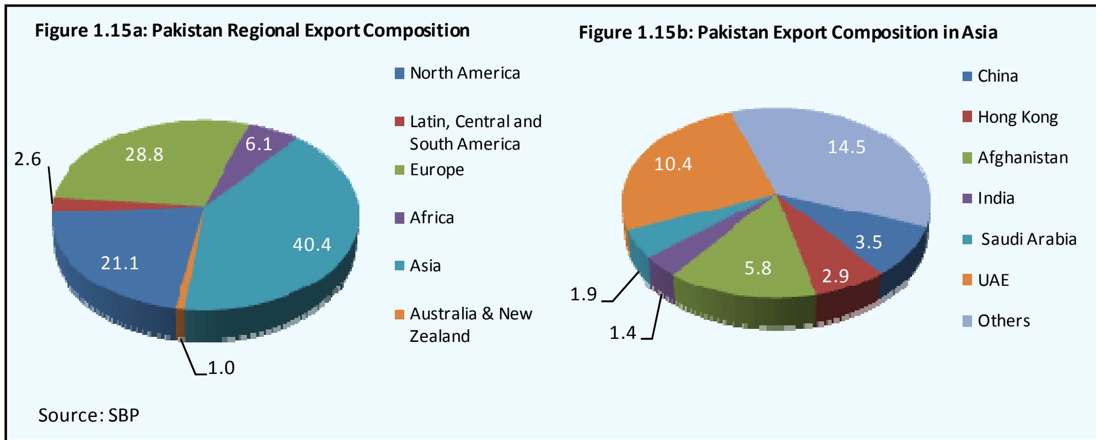
Given the export-driven nature of Asia's growth, a drop in external demand from the US and Western Europe affects the Asian region *foremost* through the trade channel, with the traditional dependence of its exports on the US and the Euro Area.[20] Evidence shows that countries with the strongest trade links with the United States and Europe are slowing down markedly.

Notwithstanding, growing trade integration within the region has served Asia well: intra regional trade accounts for 41.0 percent of total emerging Asia exports, versus 23.0 percent in 1986. This growth particularly stems from growing trade with China, which accounts for almost 20.0 percent of intra-regional trade over the past 20 years. Consequently, intra regional trade is set to grow further as Asia gears itself for greater market diversification. Impetus to this will come as China deepens its trade with Latin America and other regions, and India opens up further on the back of growing middle class incomes and demand. The regional integration is also evident from the growing momentum and scale of regional free trade agreements.

Pakistan's level of global trade integration, in its capacity as a small open economy, has substantial room to grow, with exports to GDP ratio of 11.5 percent in FY08. Its primary dependence is still on the US as its single major trading partner (at 20.0 percent of total exports for FY08,[21] average of 23.6 percent from FY03-FY08), despite gradual diversification of export destinations over the years (**Figure 15a & b**). In FY08, US and Europe together constituted 49.0 percent of all exports, and the expected slowdown in both regions is bound to have repercussions on the volume of exports in FY09 and beyond, depending on the duration and intensity of the ensuing recession. On the positive side, Pakistan's level of trade integration

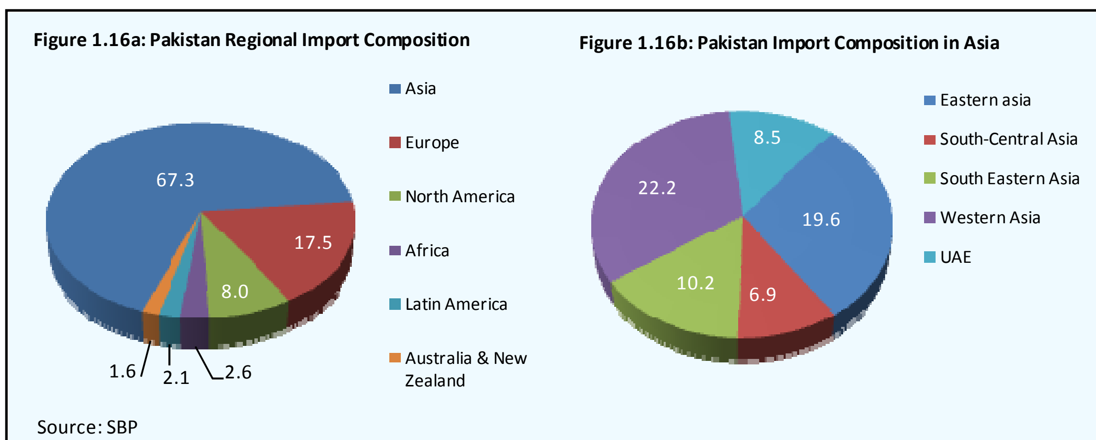
[19] Upto November 15.
[20] As also discussed in the Regional Economic Outlook, Asia and Pacific, International Monetary Fund, April 2008.
[21] FBS data.

within and across Asia shows an encouraging and growing share of around 40.0 percent, and it would serve the country's interests well to diversify its market share by increasing its exports' outreach within Asia.



Besides prospects of increasing trade with India, another potentially lucrative region within Asia is the Middle-East, which continues to enjoy robust consumption demand. However, with gradually declining but still a large dependence (average 60.0 percent over FY06-08) on the textile sector as the mainstay of Pakistan's exports, and little diversification in the range and destinations for products (share of US at 36.0 percent) offered by the sector, estimates for FY09 exports might need to be reconsidered as weaker global growth can indeed reduce the demand for textile and clothing by the advanced economies. While factors such as the steep depreciation of the domestic currency against the US$ might make Pakistan's exports more attractive for trading partners, concerns regarding a possible disruption in supply chain (due to the uncertainty associated with the domestic macroeconomic cum political environment) might keep buyers at bay.

While the exports figure for the first four months of FY09 has shown an increase of 16.3 percent YoY,[22] continued downside risks to the growth of the exports base can be mitigated by focusing on high growth destinations, and striving to diversify the product base. Encouragingly, cement exports have increased by 11.7 percent during FY08 (in response to demand from the Middle-East, India and Africa), while rice had the largest contribution (18.0 percent) in the overall export increase during the year.

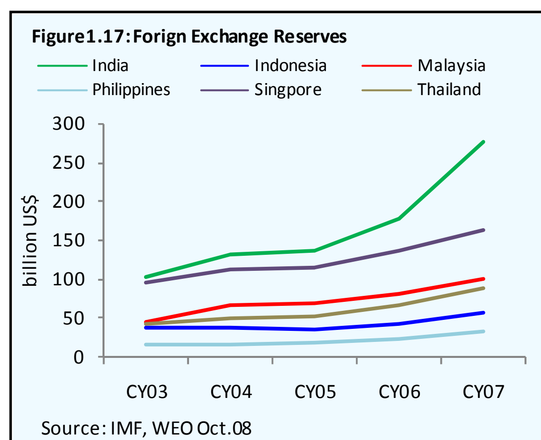


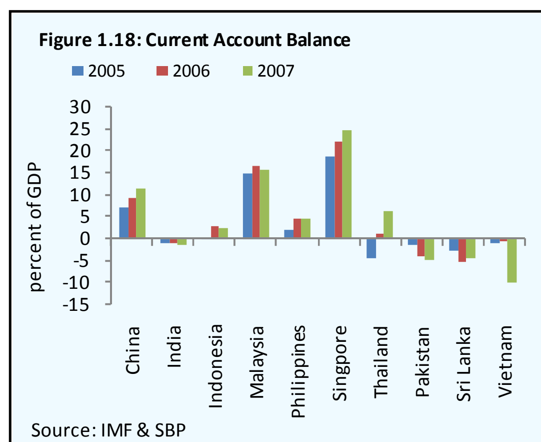
[22] FBS data.

A composition of Pakistan's imports, on the other hand, both in terms of destinations and products, shows quite a different picture (**Figure 16a & b**). With a large dependence on petroleum imports, as discussed in the previous section, there is relative inelasticity of import demand. Over two-thirds of the imports are from Asia, reflecting a significant degree of intra-regional trade.

1.3 Access to international Markets: Sovereign and Private

Larger economies of Asia and the ASEAN-5[23] have a dual cushion of continued large, if not growing, external current account surpluses and exceptionally high foreign exchange reserves (**Figure 1.17**). However, few economies face growing macroeconomic vulnerabilities. Largely reliant on import of oil and now food, external current account deficits in these countries have reached unsustainable levels (**Figure 1.18**). Macroeconomic instability and developments in the international environment have also impacted foreign inflows to these countries, with negative implications on the country's reserves.





Pakistan, which had re-entered international capital markets in 2004 on the back of improved macroeconomic performance, and currently has 4 outstanding sovereign bond issues (**Table 1.1**), faced a challenging environment in FY08. External financing inflows into Pakistan have deteriorated considerably since October FY08, impacted both by the global economic conditions as well as the uncertainty caused by domestic economic and political factors. Importantly, while FDI flows were strong and even exceeded marginally the flows in FY07, foreign portfolio investment (FPI) which takes a more short-term view, was more fickle and all but disappeared in FY08, after registering a tremendous growth in FY07.

Table 1.1 : Pakistan Sovereign Bonds

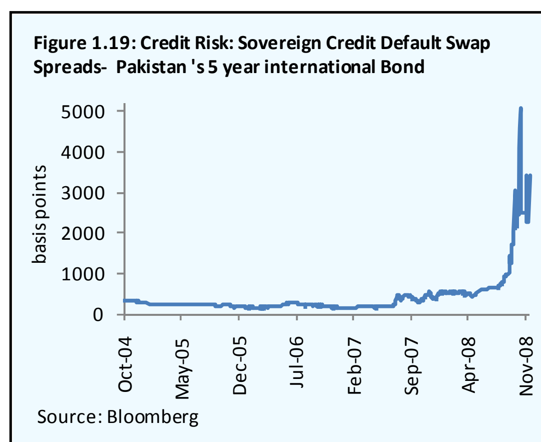
Value in million US$

	Bond	Tenor	Maturity	Value	Interest rates
FY04	Euro	5 years	FY09	500	6 m Libor + 323 bps (6.75%)
FY05	Sukuk	5 years	FY10	600	6 m Libor + 220 bps
FY06	Euro	10 years	FY16	500	10 years US t-bill + 240 bps (7.125%)
	Euro	30 years	FY36	300	30 year US t-bill + 302 bps (7.875%)
FY07	Euro	10 years	FY17	750	10 year US t-bill + 200 bps (6.875 %)

Source: Annual Report 2006-07, State Bank of Pakistan

[23] ASEAN 5 includes Indonesia, Malaysia, Philippines, Thailand and Vietnam.

Credit Default Swaps (CDS), a measure of insurance risk, on Pakistan's outstanding bond issues in the international markets, have been rising since the last year or so, and went up to as high as 5000 points in late October 2008, and are currently hovering around the 3400 level, having surpassed Argentina in terms of carrying the riskiest sovereign debt. Despite the pressing need for external financing, plans to issue another sovereign bond in the international market in FY08 were deferred in light of the liquidity constraints caused by the financial turmoil as well as the deteriorating macroeconomic conditions, and downgrade of the sovereign ratings (**Figure 1.19**).



Similarly, GDR issues, the preferred route adopted for privatization by the Government and for business expansion by private sector entities in FY07, were put on hold during FY08, though the Lucky Cement GDR in May FY08 was an exception. Trading of GDR issues on international bourses was also impacted, as reflected in the volume of trading price, and the rapid conversion observed in recent months (**Table 1.2**).

Table 1.2 : Issued and listed GDRs

amount in million US$, Numbers in millions

	Issuance Year	Amount Raised	No. of Issuance		No. of Conversion till Nov 2008		No. of Re-issuance till Nov 2008	
			GDRs	Ordinary shares*	GDRs	Ordinary shares*	GDRs	Ordinary shares*
MCB**	Oct-06	150	17.3	34.5	17.9	35.7	0.9	1.7
OGDCL	Dec-06	738	39.1	390.6	36.3	362.7	2.2	21.7
UBL	Jun-07	650	50.6	202.3	29.3	117.4	5.5	22.0
Lucky Cement	May-08	107	15.0	60.0	9.5	38.1	0.04	0.16

*against GDRs

** MCB has changed the conversion ratio in April FY08, from 1:4 to 1:2

Source: Local custodian banks

Interestingly, neither the liquidity crunch nor the political situation had an impact on the prospects of foreign borrowing by large corporate entities in Pakistan, as reflected in the quantum of foreign private loans. This is because large corporate entities, mostly from the telecom sector,[24] have borrowed on the strength of their own balance sheets for meeting their financing needs. Multi-national entities are seen to be using this facility for borrowing from their parent companies. This is unlike the trend seen in emerging Asia, where access to foreign funding has been considerably limited since the advent of the crisis.

1.4 Implications for Financial Markets

Relative to trade, Asia's financial markets are less integrated particularly within the region. Emerging Asia (excluding Japan) holds only 10.0 percent of the world's total value of bonds, equities and bank assets. Three-fourths of the portfolio flows to Asia were directed to equity markets.

[24] Around 46.0 percent of total outstanding foreign currency borrowing in FY08.

During the initial phase of the crisis, financial stress resulted in delays in certain financial deals with Asia but had otherwise little impact on the region's banks and financial institutions. Steeper impact was observed in equity markets, and to a lesser extent on bond markets, driven by revaluation of risks in financial markets and worries about the global economic outlook. In some cases this resulted mainly in correction of valuation/returns on securities. While the equity markets recovered towards the end of 2007 - with several indices hitting new highs in October – they came under pressure in the beginning of 2008 as myths regarding Asia's decoupling from the US and Europe faded (**Box 1.2**). By mid-March 2008, most Asian equity indices were down 15–25 percent for the year.

Box 1.2: De-Coupling: Myth or Fact?

Asia has been the major driver of growth in recent years, and shows promising prospects to carry the global growth wave in the current period of ensuing recession in advanced economies. Given the increasing strength of the region, and the recent debate[25] on the *shift* of global power to Asia, with strong growth performance exhibited by both India and China, an emerging question has been whether these developments point to a certain degree of de-coupling of Asia from developments in the US, or in other words, to what extent are Asia's growth and financial cycles synchronized with the US.

Various facets of this debate can be captured by estimating the spillovers from United States to Asia, how these spillovers have evolved over time, and how they vary across countries in Asia, looking at both direct and indirect transmission channels. Indirect channels look at the transmission of developments in the US through Europe to Asia, given its capacity as the second largest trading partner of most Asian countries, and in the current market turmoil, implications for how financial stress may amplify real sector spillovers.

Estimates for spillovers over the last 15 years show that a 1.0 percentage point slowdown in the US has led to a ¼ percentage point slowdown in Japan, and a ¼ - ½ percentage point average slowdown in emerging Asia, with substantial variation across countries in the region. However the increasing level of trade and financial integration of Asia with the US lends credence to the fact that the impact of the current crisis can potentially have a significantly larger impact.

Table 1 shows that while direct trade exposure based on Asian exports to the US as a percent of GDP, have declined in 4 Asian countries over the past 15 years, total exposure has increased for all countries but one, and by a larger proportion than the level of direct exposure.

Table 1: Export Exposure to Industrial Countries
Percent of GDP

	Exposure to the U.S.				Exposure to the E.U-15			
	Direct		Total		Direct		Total	
	1994	2006	1994	2006	1994	2006	1994	2006
Japan	2.5	3.4	3.0	4.4	1.4	2.2	2.0	3.5
Australia	0.9	1.1	1.6	2.1	1.5	1.9	2.2	3.1
New Zealand	2.8	3.0	3.7	4.0	3.7	3.6	4.8	5.1
China	5.6	9.6	7.6	12.2	3.9	7.7	6.0	11.7
India	1.7	2.4	2.0	3.1	2.6	3.1	3.3	4.5
Hong Kong SAR	16.7	14.8	20.0	21.8	12.6	15.7	16.9	24.7
Korea	4.9	5.1	6.1	8.7	2.7	5.0	3.9	8.2
Singapore	23.9	17.3	31.9	30.8	17.0	20.1	25.5	35.7
Taiwan POC	10.4	9.9	12.9	15.5	5.2	7.1	7.9	13.6
Indonesia	3.3	3.5	4.5	5.6	3.4	3.7	4.8	6.4
Malaysia	18.0	22.7	25.0	31.7	11.4	13.8	18.3	25.4
Philippines	8.8	8.0	9.8	12.0	3.7	7.1	5.0	12.5
Thailand	7.0	10.5	8.9	15.1	5.2	8.7	7.5	14.7
Vietnam	1.4	15.2	2.8	18.5	6.6	15.0	8.6	20.8
Pakistan	0.5	3.3			1.3	2.8		
Asia	7.7	9.0	10.0	13.3	5.8	8.2	8.3	13.6
Industrial Asia	2.1	2.5	2.8	3.5	2.2	2.6	3.0	3.9
Emerging Asia	9.2	10.8	12	15.9	6.8	9.7	9.8	16.2

Source: IMF, REO Asia and Pacific April 08

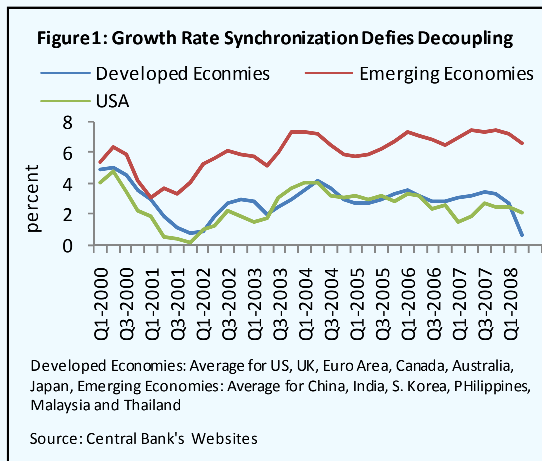
[25] The New Asian Hemisphere: The Irresistible shift of global power to the East, by Kishore Mahbubani (2008).

This can be further assessed on the basis of the synchronization of the growth rate for developed and emerging economies with the United States, as shown in **Figure 1**. Growth in Asia is substantially more correlated with the U.S. growth cycle than in the early 1990s, such that the average correlation has increased from 0.1 percent in the pre-Asian crisis 1990s, to 0.4 percent since 2000. This is true for all countries except China.

It is also clear from this brief discussion that while Asia has not decoupled, it now carries a considerable growth momentum of its own.

Source : Regional Economic Outlook, April 2008, IMF

Figure1: Growth Rate Synchronization Defies Decoupling



Developed Economies: Average for US, UK, Euro Area, Canada, Australia, Japan, Emerging Economies: Average for China, India, S. Korea, PHilippines, Malaysia and Thailand

Source: Central Bank's Websites

In more recent months however, a behavior akin to 'herd instinct' has been observed in almost all of Asian economies, as risk-averse investors have pulled out from these markets, in response to their need to sell assets to raise cash for margin calls. Spillover effects of the crisis, particularly due to the fresh turn of events in September 2008, have been more obviously reflected in the equity markets, which have fallen by record amounts from their peak level (**Table 1.3**).

Table 1.3: MSCI EM Asia Performance from Peak Level in 2008*

Country	% decline in local currency	% decline in US dollar
China (SSEA)	-65	-63
India (SENSEX)	-50	-59
Korea (KOSPI)	-35	-53
Thailand (SETI)	-49	-53
Indonesia (JKSE)	-49	-50
Philippines (PSI)	-42	-50
Taiwan (TWII)	-45	-48
Malaysia (KLSE)	-38	-43
Pakistan (KSE)	-41	-53

*till October, 2008

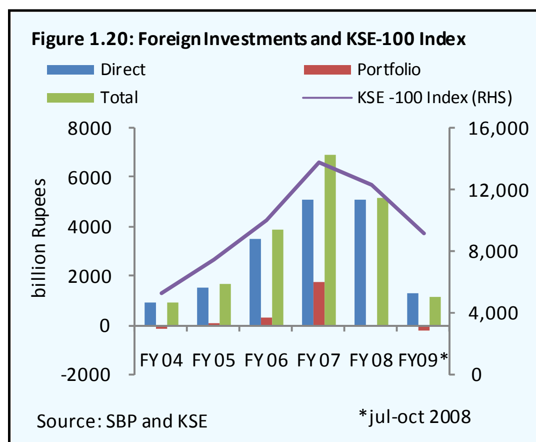
Source: Bloomberg

MSCI EM : Morgan Stanley Composite Index Emerging Markets

Pakistan has also been impacted by the reversal of flows in foreign portfolio investment, particularly so since the peak level of 15,676 points touched by the KSE-100 index on April 18, 2008. While the equity market in Pakistan declined by over 40.0 percent since then, imposition of a floor of 9,144 points from August 28, 2008 has in a way insulated the domestic market from the catastrophic global financial developments in September 2008.

As mentioned earlier, while FDI takes a long-term view of the economy, FPI flows are usually based on short-term considerations, and are driven more by investor sentiments and confidence. FPI to Pakistan have been particularly impacted by the prevalent political instability in FY08 (**Figure 1.20**). Going forward, the equity market faces the risk of FPI outflows once the floor is removed.

Figure 1.20: Foreign Investments and KSE-100 Index



Source: SBP and KSE

*jul-oct 2008

1.5 Conclusion

The current financial market turmoil has brought forth a long-standing view propagated by Hyman Minsky: *financial*

markets are inherently unstable, and stable finance is an illusion.[26] Minsky argues that economic stability encourages ever greater leverage and ambitious debt structures. While historical episodes of financial sector crises give evidence to the association of financial booms with cheap money and low perceptions of risk, the unraveling of recent events has also brought in focus the lax regulatory standards in mature economies, which let the shadow banking system grow beyond limits, with far-reaching consequences for the global financial system. The extent of losses and the protracted duration of the crisis are now starting to impinge in full force on global economic growth.

The remarkable turnaround and monumental growth in Asia, particularly since the East Asian crisis, has been based on the premise of high savings and investments, and an export-led growth model. Leading Asian economies are now the driving force behind the shift in global economic power. These economies have also built their financial sector on sound foundations, which are closely regulated and are still in the process of acquiring sophistication in terms of innovative product offerings. Securitization, in particular, is not rampantly used, and the incentives structure for banks is still based on traditional foundations instead of the distorted mechanism propounded by the originate-to-distribute model. These factors place these economies in a position of strength in dealing with the adverse spillover effects of the current market turmoil. Notwithstanding, emerging markets have not de-coupled from the US, and will continue to face difficult external financing conditions, and those with large current account deficits and/or other vulnerabilities will remain under most pressure.

As one of the fastest-growing Asian economies, Pakistan's financial sector has undergone a sea-change in the last decade or so. Predominantly bank-based in performing the function of financial intermediation, the financial sector is strong and resilient, and is regulated on a principles-based approach. While capital markets are still small and shallow in terms of liquidity and the size of new offerings, the ongoing implementation of financial sector reforms is gradually addressing these issues, with the broad objective of enhancing financial sector depth. Economic growth in Pakistan on the other hand, is in contrast with Asia, based on a consumption-led model, with low levels of financial savings (**Special Section: Trends on Financial Savings in Pakistan**) and a rather gradual increase in the investment to GDP ratio.

Given this confluence of factors, challenges to financial stability in Pakistan are largely transmitted through the real sector. Given the growing macroeconomic imbalances and high inflation, stability of the financial sector can be potentially jeopardized by the spillover effects on bank customer's balance sheets, from adverse developments in the macroeconomic environment, as well as repercussions from monetary instability, as evidenced in the high inflation and current liquidity constraints being faced by financial institutions. The economy's capacity to service the persistent and large external account deficit will remain in question until the macroeconomic situation is visibly improved, and inflation is reined in.

[26] The Financial Instability Hypothesis, Hyman P. Minsky, Working Paper No. 74, May 1992.

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Annexure 1: Central Banks' Policy Rates

	Jan-07	Jul-07	Dec-07	Jul-08	Dec-08
USA	5.25	5.25	4.25	2.00	1.00
UK	5.25	5.75	5.50	5.00	2.00
Eurozone	3.50	4.00	4.00	4.25	2.50
Canada	4.25	4.50	4.25	3.00	2.25
Australia	6.25	6.25	6.75	7.25	4.25
Japan	0.25	0.50	0.50	0.50	0.30
China	6.12	6.57	7.47	7.47	5.58
S. Korea	4.50	4.75	5.00	5.00	4.00
Malaysia	3.50	3.50	3.50	3.50	3.25
Thailand	4.75	3.25	3.25	3.50	2.75
Philippines	7.50	6.00	5.25	5.75	5.75
India	7.50	7.75	7.75	9.00	7.50

Source: Central Banks' Websites