Capital market's recovery

Eco Pak. Eco

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ON two consecutive days, the Karachi Stock Exchange, Pakistan's largest capital market, crossed a series of thresholds. On August 7, the KSE-100 index set a new record at 4205 to be beaten again on the following day when the market rose by another 119 points to reach 4323. The record in terms of the number of shares changing hands was also set on August 7 when it reached 959 million. The following day even this record was beaten when 961 million shares were traded.

One company, Hubco Power, saw 311 million of its shares traded, adding to the breathless pace at which the market was moving. By the time this article appears in print, the market may have set new records. Or, it may have moved through a correction. That notwithstanding, it is worth asking some questions. What is happening to the Pakistani capital market? Is its recent spectacular performance the consequence of speculative pressures that may produce a bubble that would get pricked later? Or are we seeing the initiation of a new trend, the birth of a new and buoyant market? Are foreigners bringing portfolio capital into Pakistan?

There is no doubt that some recent reporting by the western financial press is bringing Pakistan's capital markets back into focus. That this is happening is not only because of the brisk pace at which the KSE-100 index has advanced in the last few months. It has reached a level unimaginable when the recovery in the capital market started a few months ago.

The market's capitalization has reached the point where it will begin to appear on the radar screens of foreign money managers. Foreign investors are noting other aspects of the performance of the Pakistani market as well, not just its level. There is little doubt in my mind that fresh capital will flow into Pakistan. That might take the KSE-100 index to new heights. Or, at least, infusion of new money may keep the KSE-100 index at or near the heights to which it has already climbed.

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and Washington, could become active again.

While the foreigners' interest in the Pakistani market is now palpable, it is worth noting that in spite of the many positive economic developments, the country is not regarded as "emerging" by several reputable financial publications. To take just one example, *The Economist*, in the statistical section that appears at the end of the magazine, provides a host of what it calls "emerging market indicators."

These data are presented for 25 countries. Pakistan is not among them. Ten Asian countries are included in the list — China, Hong Kong, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand. The list includes seven countries from Latin America, three from West Asia (Egypt, Israel and Turkey), four from East Europe and one from Africa (South Africa). The day the editors of *The Economist* decide that Pakistan's economic and financial performance is worth tracking in order to bring it to the attention of the investor community, there will be an increase in interest by foreign money managers to invest in the country.

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Let me go back to the question with which I began this column: What has provoked interest in the Pakistani capital market. The first reason is the realization by some financial analysts and writers that the international money markets may be overlooking the entire South Asian region as an area of considerable economic potential. This recognition has come in spite of the tremendous excitement about India that has been around for quite a while. But there are other countries in the region and they have sizable economies. Pakistan is one of them.

Gary Kleigman, a British financial writer,

Financial analysts are, of course, noticing the impressive run-up in several South Asian bourses in recent months. Pakistan's $12 billion capital market — the level reached before the present run up and, therefore, now considerably higher at over $18 billion — outperformed that of India by a wide margin. After having more than doubled in 2002, the KSE-100 index registered a further increase of 20 per cent in the first six months of 2003.

The $140 billion Indian bourse — twelve times as large as that of Pakistan while the size of the Indian economy is only eight times that of Pakistan — rose by 13 per cent in the first half of 2003. Interestingly, it is Sri Lanka that produced by far the best performance in the region with its $2 billion stock market advancing by 47 per cent in the first half of this year.

The country was reaping the peace dividend as the government and the Tamil separatists continued to move towards some kind of a accommodation.

We could witness the same sort of run up in the stock markets of India and Pakistan if the slight easing of tensions between them picks up momentum and the world of finance is convinced that the dark clouds of military confrontation have finally begun to thin. They had darkened for a long time the economic landscape of these two rival nations. It was only in Bangladesh that the performance of the stock market was relatively poor with the index increasing by only 2.7 per cent in the first six months of the year.

The more positive reading of the Pakistani economic situation was certainly helped by the rating increases made by several well known agencies. Moody's upgraded its rating from Coal to B3 and Standard and Poor revised it from B- to B. This was a highly welcome development since, for quite a while, Pakistan's credit rating had dropped even lower than those given to some of the world's least developed countries.

Improved assessment by credit agencies lowers what financial analysts call "country risk." When the risk is high, capital markets are reluctant to lend to the borrowers, even to the governments. If money does become available, it is very costly with large spreads — the difference between the rate charged from the most credit-worthy borrower and near the heights to which it has already climbed.

Before going on to discuss the aspects of the Pakistani market that have begun to attract the attention of the foreign investors, I should first emphasize that portfolio flows from abroad do not always result in nirvana. Short term capital looking for high returns on investment is terribly skittish: it can fly in and move out at the flick of a computer's switch.

This is one reason why financial and monetary authorities in both Islamabad and Karachi should take a careful note of what is happening and be prepared to step in when action is required. Developing world's recent financial history is full of adverse turns in fortunes when foreign investors, having been attracted to a particular market by some feature that delighted them, took flight when something untoward happened. The foreign investors' flight brought the great financial crisis of East Asia in 1997-98 that nearly devastated the economies of the region.

The more recent health scare created by the rapid spread of the Severe Acute Respiratory Syndrome (SARS) took a lot of air out of the markets of several East Asian countries. Pakistan also has experienced its share of unpleasant surprises. The May 1998 explosion of nuclear devices in the mountains of Chaghai, Balochistan, persuaded money managers in the world's financial markets that the Pakistani risk was not worth taking for assembling their portfolios.

The sanctions that followed those explosions convinced the investors that their fears about Pakistan and moving money into the country were justified. Pakistan's risk factor jumped a few more notches following "nine-eleven." The Karachi market was seen sitting on top of a volcano that, having burst once with the terrorists' attack on New York tries in the region and they have sizable economies. Pakistan is one of them.

Gary Kleigman, a British financial writer, noted in a report published in early August that "foreign investors dismissed 2002's top emerging market performance by Pakistan as a fluke and were dubious about prospects elsewhere in South Asia, but those markets reported double digit gains in the first half of this year and attracted strong inflows as a result." That the South Asian performance was not accidental and may not even be a bubble was attributed to some fundamental changes in economic policies pursued by several countries in the area.

These included shifts in interest rates, that had declined significantly, and improvements in balance of payments that were equally significant. India was now sitting on a mountain of foreign reserves, estimated at $80 billion. These were still small compared to those accumulated by China ($331 billion), Taiwan ($175 billion) and South Korea ($128 billion). Nonetheless, among the 25 countries in the emerging world followed by *The Economist,* Indian reserves were the sixth highest.

Pakistan had also done exceedingly well in this area — unexpectedly so. Its reserves at about $10.7 billion were now in the comfortable zone. They were more than at least four of *The Economist's* 25 emerging markets — Colombia, Peru, South Africa and Venezuela. Foreign investors draw comfort from the level of reserves a country's central bank holds.

It is one indication that the economy is not likely to go into a deep balance of payments crisis if something quite unpleasant happens, say a sudden spike in the price of oil. With enough money in the kitty to pay for about ten months of likely imports, Pakistan should be able to weather many future storms.

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The recent improvements in the reading of the credit agencies has resulted in a sharp narrowing of the spreads. For instance Eurobond spreads for Pakistan declined significantly, from 670 basic points (6.7 percentage points) to 255 basic points. Pakistan is now able to borrow from the international markets at rates considerably lower than those available to such countries as Brazil and South Africa.

A recent development in the way investors view opportunities has helped the Pakistani capital market become an attractive destination. After the "dot.com" fiasco when the investment community was prepared to pour money into companies that promised results in the future — sometimes in the very distant future — investors have now begun to view with considerable favour the companies that provide immediate returns. These are available in the form of dividends.

The recent changes in the United States' tax law which has significantly lowered the government's take on divided income, has also brought back into focus the enterprises that pay immediate returns to investors. As a financial analyst puts it, "the hunt for dividend yield is becoming a global phenomenon." Dividend returns in the Pakistani markets at about 11 per cent are among the highest in the world.

There is now enough positive economic news coming from Pakistan to attract foreign portfolio flows into the country. They will continue to help the markets advance but the country's regulators should keep a close watch on the developing situation. The markets' rise must be based on fundamentals, not on speculation.