NBP Fullerton
Asset Management Limited
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Impact of Foreign Flows on Capital Markets

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Net foreign aid to Pakistan has turned negative. This means that Pakistan is now paying more in debt servicing than receiving in new loans and aid. Net foreign aid was a negative US$455 million in 2009 and increased to a negative US$964 million in 2010 (Source: Dawn, March 21, 2011). This is a very dangerous trend that cost Pakistan's economy a lot in the late 1990s and early 2000s. The main focus of the successive governments was to meet this negative gap rather than addressing the structural issues facing the economic and social sectors. Pakistan was able to come out of this debt trap only when the Musharraf Government was able to reschedule Pakistan's foreign debt in the aftermath of September 11, 2001. It is important that the main focus of this Government should also be to restructure Pakistan's debt, otherwise we carry a high probability of falling back into this vicious circle of borrowing at a higher rate to pay off loans taken earlier at a lower rate.

Net foreign aid and current account are the most critical factors that will determine the fate of Pakistan's economy and capital markets in the coming years. Pakistan's exports are expected to rise by 14% and cross US$ 22.5 billion in FY 2011 (SBP projections). However, our imports are estimated to grow to US$ 35 billion in FY 2011, thus the expected trade deficit is estimated at US$ 12.5 billion. This deficit will be mostly met by remittances from Pakistanis that is estimated at US$ 10.5 billion for this FY. However, what is worrying is that exports have risen due to the increase in international prices of commodities and not by increase in volumes. Exports are expected to grow slowly in the next few years due to power shortages, security situation, and low economic growth rate. Also, imports may jump if oil price continues its upward trend.

Chart 1 below shows the relationship between foreign aid + current account with the stock market. The relationship is positive and significant, which means that as our foreign cash flow account improves the stock market starts performing well, and as our foreign cash flow account deteriorates the stock market starts performing poorly as well. Fifty-two percent of the variation in the stock market over the last 11 years can be explained by our foreign cash flow position. Deterioration in the foreign cash flow balance is also inversely related to interest rates. As foreign cash flows deteriorate, the liquidity in the system tightens, which in turn results in upward trend in the interest rates. Thus, for our economy to grow and our businesses to flourish it is important that the government carefully monitor and manage the foreign cash flow account. One key reason for deterioration in our foreign cash flow account in FY08 and FY09 has been that despite inflation of above 10% p.a., the previous governments did not devalue Pakistani currency for several years. This made our exports non-competitive in international markets and our imports cheap, resulting in large trade deficits that we could not sustain for too long resulting in major devaluation of the Pakistani rupee by 26% in FY09. Despite the cost of devaluation on our foreign debt servicing, it is important that our currency is kept fairly valued by devaluing it gradually over time. The magnitude of devaluation should depend on the inflation rate differentials between Pakistan and our trading partners. We advise our investors with exposure to currencies, stock market and / or interest rates to carefully watch the foreign cash flow account while making their investment decisions.

Chart 1