

Private Capital Outflow from Pakistan

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1. INTRODUCTION

An important and often ignored aspect of Pakistan's economy during the Seventies and the Eighties has been the high degree of mobility of domestic private capital despite the prevalence of explicit capital controls. In a foreign exchange constrained situation the capital outflow arising from increasing private claims abroad can have macroeconomic consequences leading to welfare loss through the reduction of domestic real investment, foreign exchange availability and a shrinking tax base, which result in the loss of potential growth.

It is important to have some estimate of 'capital flight' in order to uncover the 'concealed' transactions in the balance of payments and to reveal the actual behaviour of institutional agents, since a part of the balance of payments difficulties are due to the demand for foreign assets by the private sector channelled through unrecorded transactions. Because of their hidden nature these transactions have remained unrecorded in the official economic accounts and are consequently neglected. Thus, despite the importance of this phenomenon, often identified as 'capital flight', there have been few attempts to investigate the issue in Pakistan [with the exception of Khan and Haque (1987)]. The main reason for this being the difficulty in identifying 'capital flight' within the recorded balance of payments.

The objective of this paper is to provide estimates of the scale and magnitude of private asset acquisition abroad by Pakistani residents. The paper focuses on the 'concealed' transactions in the balance of payments and provides estimates of the net acquisition of private foreign assets on the basis of various standard measures. The three estimates commonly used in the literature show positive private asset acquisition abroad by Pakistani residents. The differences in the results are not surprising as the measures estimate different aspects of capital flight. The results have important implications for the estimation of domestic savings as well as for the recording of the flows in the balance of payments. One implication is that domestic savings are higher than recorded; Second, as trade misinvoicing is the main channel through which domestic savings 'sneak' abroad the current account deficit may not be as large as recorded. In this context, the demand management policies which focus on reducing government expenditure may not be as appropriate as the policies which reduce the export of private capital.

The lay out of the paper is as follows: the next section discusses concepts of private capital outflow and methods of measurement. Preference is given to, what in the literature is called, the 'broad' measures, which consider all private capital outflow as a welfare loss to the country. Section 3 provides estimates of the private capital outflow using the three standard measures after correcting for the misinvoicing of trade. The last section gives the summary and conclusions.

2. CONCEPTS AND MEASUREMENT OF PRIVATE CAPITAL OUTFLOW

In economic literature private capital outflow is defined in two conceptually different ways: as capital 'fleeing' domestic jurisdiction see e.g. Dooley (1986); Boyce and Zarsky (1988) and Lessard and Williamson (1987) and, as all private capital outflow, including short-term and long-term, portfolio or equity investment see e.g. Erbe (1985); Rodriguez (1987) and Vos (1991). The two ways of defining private capital outflow stem from different perceptions of the causes and consequences of the problem. The former concept views 'capital flight', in a strict sense, as outflow reacting to domestic policy and thus being 'abnormal' and separate from outflow that occurs as a consequence of 'normal portfolio decisions' which yield an income stream recorded in the balance of payments see Khan and Haque (1987). While this may be the correct approach to estimate 'capital flight', as defined above, there are practical measurement problems involved which make it difficult to draw a clear distinction between 'abnormal' capital outflow and normal capital movements. Studies based on this concept, e.g. Dooley and Khan and Haque, derive a flow estimate of 'capital flight' from the difference of the total stock of foreign assets and a stock measure of 'normal' or non-flight asset accumulation, which is imputed using the recorded investment income received from abroad and some measure of the rate of return on foreign assets. An underlying assumption of this methodology, which may not necessarily be true, is that all the income from the 'normal' portfolio investment is remitted back to the country.

The second concept—adopted in this study—views all private capital outflow as domestic resources evading taxation and utilised abroad, and thus, constituting a welfare loss to the domestic foreign exchange constrained economy. In the prevailing situation where Pakistan's economy faces an external transfer problem (i.e. of how to achieve a tradable surplus) and an internal transfer problem (i.e. of how to mobilise sufficient resources to service the external debt) then any outward movement of private savings is important as it raises adjustment costs. Despite the conceptual merits of this approach it relies on residual measures which undermine the reliability of the estimates. A 'broad' measure of the total net acquisition of private assets abroad is used, which can be classified into two types i.e. 'inclusive' or 'exclusive', depending on whether the holdings of external assets by the banks are included in the measurement. The measure estimates the private capital outflow residually, under the assumption that the difference between the recorded inflow

and the recorded uses of foreign capital is the unrecorded private use of foreign capital abroad.

Private capital outflow is measured in three different ways: (i) based on the World Bank's 'inclusive' measure as the difference between the inflow of capital (defined as the increase in the external debt and the net foreign direct investment), on the one hand, and the current account deficit and the increase in the official reserves on the other hand see World Bank (1985). Specifically, private capital outflow defined in this way (COF_1) is equal to the change in external debt (ΔD), and the net foreign direct investment (IF), minus the current account deficit (CAD) and the change in official reserves (ΔR)¹ i.e.

$$COF_1 = \Delta D + IF + CAD - \Delta R \quad \dots \quad \dots \quad (1)$$

(ii) An exclusive measure of the net acquisition of the private external assets based on the Morgan Guarantee estimate excludes from (1) the net acquisition of the foreign assets by the banks see Morgan Guarantee (1986). It can be written as:

$$COF_2 = \Delta D + IF - CAD - \Delta R - \Delta Ab \quad \dots \quad \dots \quad (2)$$

where, ΔAb is the net acquisition of the foreign assets by the banks;² (iii) A definition of the net acquisition of the private external assets based on the short-term capital movements or 'hot money' employed originally by Cuddington is derived by adding the errors and omissions of the balance of payments, which conceal the speculative capital flows, to the private non-bank short-term capital (ΔAnb) see Cuddington (1986).³ According to this definition the capital outflow (COF_3) can be written as the following:

$$COF_3 = -EO - \Delta Anb \quad \dots \quad \dots \quad (3)$$

where, ΔAnb is the net non-bank acquisition of the foreign assets.

The three measures of capital outflow mentioned above may not be properly estimated if the balance of payments figures are recorded incorrectly. This can arise because of the trade misinvoicing and the underrecording of the workers' remittances. The underinvoicing of exports and overinvoicing of imports allows the traders to obtain the foreign exchange which may not be recorded in the

¹The change in the external debt is measured from the *World Tables*, net foreign direct investment, current account deficit and change in official reserves from the *Balance of Payments* of the IMF (the corresponding codes are 3Y.X4, A.C4 and 2.X4 respectively). The figures are multiplied by the US dollar to SDR exchange rate.

²The net acquisition of foreign assets by banks is measured from the *International Financial Statistics* (line 7ad).

³The errors and omissions item and the private non-bank short-term capital are from the *Balance of Payments* IMF, codes A.X4 and 8.2X4 respectively.

government statistics. In Pakistan, where strict capital controls have been exercised throughout the period under consideration, external assets have been acquired by misinvoicing the trade transactions, which can take either form: the overinvoicing of imports and the underinvoicing of exports, though in both the cases opposing factors were also at work: the presence of high import taxes creates the temptation to underinvoice the imports, while the export rebates may reduce the temptation to underinvoice the exports. The evidence of rampant misinvoicing, however, suggests that these effects have not been dominant and that the black market premium has been substantial. In this study a correction for the trade misinvoicing has been made to the estimates of private capital outflow.

The estimate of the private capital outflow through trade misinvoicing can be derived from the partner-country trade data as the sum of the export underinvoicing and the import overinvoicing see e.g. Bhagwati (1964) and Bhagwati, Krueger and Wibulswasdi (1974). The partner countries here refer to the industrial countries on the assumption that these countries report their trade data accurately. The export underinvoicing (UI_x) is measured as the difference between the industrial countries' imports from Pakistan (M_{ic}) and the exports of Pakistan to the industrial countries (X_p) adjusted by the cif-fob factor. The import overinvoicing (OI_m) is measured as the difference between the recorded imports of Pakistan from the industrial countries (M_p) and their exports to Pakistan (X_{ic}) adjusted by the cif-fob factor (Ad).⁴ In other words

$$UI_x = M_{ic} - X_p * Ad \quad \dots \quad \dots \quad \dots \quad (4)$$

and
$$OI_m = M_p - X_{ic} * Ad \quad \dots \quad \dots \quad \dots \quad (5)$$

Another channel for private capital outflow is through the parallel foreign exchange market catering to the workers remittances called the '*hundi*'. The workers abroad deposit their foreign exchange earnings to the '*hundi*' agents in their country of work and receive the rupee equivalent in Pakistan. The money exchange also works in reverse. But exchanging the money is not the sole purpose of the exchange dealers who use the foreign exchange to import goods, through illegal channels, for sale in the domestic 'black market' to generate the rupee funds. Some idea of the magnitude of this market can be obtained by comparing the remittances received by the households with the remittances recorded in the balance of payments. The difference between the two would be the amount of the remittances channelled through the parallel foreign exchange market. However, up till 1983-84, the household surveys of income and expenditure did not provide the appropriate disaggregation of the source of the household income. Beginning with the 1984/85 Household Income and Expenditure Survey such information has become available

⁴The trade data are from the *Direction of Trade Statistics* IMF, and the cif-fob factors from the *International Financial Statistics*.

but the reported figure appears to be grossly underestimated falling far short of even the balance of payments figures.⁵ In the absence of the proper correction for the capital movement in the parallel exchange market the estimates of capital outflow are underestimates.

3. ESTIMATES OF PRIVATE CAPITAL OUTFLOW

Table 1 provides three estimates of private capital outflow derived from the definitions above and adjusted for trade misinvoicing. One point made clear in Table 1 is that private capital outflow from Pakistan is substantial though the estimates are only part of the total private capital outflow i.e. they exclude the part

Table 1
Estimates of Private Foreign Asset Accumulation
(Million US \$)

	COF ₁	COF ₂	COF ₃
1970	66	37	59
1971	203	234	63
1972	200	219	187
1973	351	296	130
1974	-22	-126	227
1975	-3	5	216
1976	460	588	198
1977	422	408	274
1978	369	302	238
1979	-33	-71	415
1980	-6	-102	338
1981	-27	-40	153
1982	1075	1065	385
1983	81	-49	612
1984	632	545	980
1985	653	640	615
1986	1065	940	726
1987	1908	1798	1028
1988	-183	-211	1111

channelled through unrecorded workers' remittances. The large annual capital outflow highlights the importance of the issue for two main reasons: First, in so far as the capital outflow is saving not available for domestic investment it can result in

⁵One reason could be that a larger proportion of remittance receiving households, who are concentrated in specific areas of the country, may have been left out from the sample.

the loss of potential growth; Second, there appears to be a positive correlation between the level of the external indebtedness and the private capital outflow, and the size of the capital outflow is not very different from the net annual increase in external debt.

The three estimates show different movement in the capital flow which reflects the conceptual differences between the measures—the World Bank estimate captures the effect of all private capital outflow while the Cuddington measure reflects mainly the financial influences. Because of the approximate nature of the methodology the three measures should be interpreted as broad indicators of capital flight.

The third measure (*COF*) has failed to capture the negative capital movement or 'return capital flight', which occurred during the mid-Seventies and again after a period of three years. In the other years, there is a rising trend, broadly similar in all the measures, culminating in the very large capital outflow during the final years of the decade of the Eighties. A number of factors may have contributed to the overall rising trend in the capital outflow including the increasing external debt accumulation, large interest rate differentials, downward exchange rate adjustment, expectation of higher taxation etc. The determinants of private capital outflow are not investigated in this paper.

4. SUMMARY AND CONCLUSIONS

This paper has shown that the analysis of the country's economic and financial linkages with the rest of the world is not complete without reference to the unrecorded transactions in the balance of payments. A fairly significant source of demand for foreign exchange stems from the net acquisition of the assets abroad by the private sector. The approximate calculations of such transactions based on the 'residual' measures puts the annual estimate close to the current account deficit. The scale of the capital flight should focus attention on the following issues which have important implications: the domestic capital that goes out of the country reduces the potential for domestic capital formation and increases the growth costs; the apparent positive relation between capital outflow and external indebtedness suggests that while the acquisition of the external debt may have supported the process of unrecorded private capital export, it is not so much the public sector as private sector portfolio decisions which drain the country's foreign exchange earnings. In this context, the demand management policies which focus on reducing government expenditure may not be as appropriate as the policies which reduce private capital export.

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Comments on "Private Capital Outflow from Pakistan"

According to the standard two-factor neoclassical growth model poor countries should experience an outflow of labour and an inflow of capital given that they have a lower capital/labour ratio and thus a higher marginal product of capital relative to rich countries. However, the phenomenon of capital flight contradicts this prediction.

While capital flight has gone on for some time, it has received serious research attention since the Latin American debt crisis in the mid-1980s. This was precipitated by the finding that for every \$1 of foreign lending to Argentina, Mexico, and Venezuela, approximately 30 cents left the countries over the 1976-1984 period. Studies on capital flight since then have proliferated. As of now, estimates of capital flight have been obtained for ten countries in Latin America, Egypt, India, Indonesia, Jamaica, Jordan, Malaysia, Nigeria, South Africa, Syria, Tunisia, Turkey, Zambia, and Zaire.

This study adds to the list of countries experiencing capital flight by providing three sets of annual estimates of private capital outflows over the 1970-1988 period for Pakistan. It employs procedures developed in the recent literature. The first two sets of estimates reported as COF_1 and COF_2 employ the same procedure known more commonly as the Residual Approach. The estimates reported as COF_2 net out foreign assets held by domestic banks from COF_1 . As will be noticed these two series show similar movements over time and it is a matter of preference which one ought to be considered as more accurate in measuring "capital flight". According to Morgan Guarantee COF_2 is the preferred measure. I am inclined to agree since bank lending abroad is more likely to be governed by portfolio diversification considerations than strictly capital fleeing the country.

The series COF_3 (the Cuddington way) is obtained by adding errors and omissions in the Balance of Payments to private non-bank short-term capital outflows. Clearly, this measure is not comparable to the first two since they include net long-term capital outflows whereas this one does not. Therefore for purposes of analysis COF_2 ought to be used.

Now that we have a series of estimates of private capital outflows from Pakistan the next step is to uncover the causes and consequences of these outflows. Hopefully, these estimates will stimulate research along these lines. The remainder of my comments are devoted to a preliminary analysis of the estimates. Dr Kemal has informed me that the total outstanding foreign debt of Pakistan is approximately \$20 billion. Summing COF_2 from 1970 to 1988 and including interest compounding the total private capital outflow amounts to around \$7 billion. This implies that for every \$1 of foreign loans received by Pakistan over the 1970-1988 period, 30 cents

left the country. This is similar to the experience of Latin American countries such as Argentina and Mexico.

Another interesting thing to note is that sizeable inflows and outflows coincide with significant political and economic policy changes in Pakistan. For instance, during the period 1970 to 1973, there were sizeable outflows. This was the period of considerable uncertainty regarding Pakistan's political and economic future with first the civil war and then the onset of the Z. A. Bhutto government along with its nationalisation plans. Notice that, except for 1974, there were sizeable capital outflows during the entire time that the Z. A. Bhutto government was in power. This was probably the consequence of nationalisation policies pursued by the government. The early Zia years coincide with private capital inflows presumably due to the widespread belief that the economy would be privatised.

In summary, it appears that Pakistan has had repeated bouts of capital flight. I agree with the author's concluding observation that what is called for is policies which reduce private capital export. I would go further and say that what is called for is not only a change in macroeconomic policies but also a change in ethics. As Williamson and Lessard (1987) rightly point out:

"... policies are not always mere miscalculations. They are major sources of state power, and they are unlikely to be definitely changed until there is both a public awareness of their distorting, demoralising effects and a political commitment to honest government. A society that lacks the social cohesion to ensure that its leaders place public duties ahead of personal gain may well be condemned to repeated bouts of capital flight" (p. 34).

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