Pakistan-China Financial Market Integration

By: Rabia Manzoor, Vaqar Ahmed

and Abbas Murtaza Maken

Authors are affiliated with Sustainable Development Policy Institute. The usual disclaimer applies. Corresponding author: Ms. Rabia Manzoor (rabia@sdpi.org).
A publication of the Sustainable Development Policy Institute (SDPI).

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Sustainable Development Policy Institute is an independent, non-profit research institute on sustainable development.

**First edition:** January 2019

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**Mailing Address:**

PO Box 2342, Islamabad, Pakistan

**Telephone:** 0092-51-2278134, 2278136, 2277146, 2270674-76

**Fax:** 0092-51-2278135,

**URL:** www.sdpi.org
ABSTRACT

This study examines how the greater financial market integration can be promoted between China and Pakistan. Based on secondary data and stakeholders’ interviews, the study explores the possible opportunities and key challenges arising due to financial market integration. Over time, both the countries have made efforts to develop and integrate several financial market segments. The study analyzes the macro-economic dependence, volatility, current liquidity, efficiency and integration level of key financial market segments-money, equity, forex and government securities. It identifies that lack of coping mechanisms for systemic risks, inadequate joint financial guarantee instruments, meager portfolio investments in stock markets, and low uptake of currency swap are the major challenges in the way of financial market integration. It concludes that a greater understanding of financial services in economies, promotion of investors’ confidence and long-term interests, greater competition and corporate governance in financial sector of Pakistan can help promote greater financial integration and trade in financial services.

**Keywords:** financial market integration, cross-border capital mobility, brokerage firms, stock exchanges, securities markets
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1. INTRODUCTION

Financial market integration is the amalgamation of neighbouring, regional and global financial markets into a larger one (Park 2013). The manifestation of this process can be gauged through cross-border capital flows, greater participation in domestic markets, knowledge sharing, skills and practices among financial institutions, which ultimately result in an improved market infrastructure. Since the dawn of globalization in the late 1980s when the world saw the disintegration of communist regimes in the Soviet Union and elsewhere, followed by the massive wave of privatization, global capital markets have become ever more intertwined. Equity and bond markets started integrating at an unprecedented pace due to the proliferation of joint-stock companies, brokerage firms, and stock exchanges.

The provision of securities markets by commercial and investment banks, brokerage firms, and mutual funds and interest ceilings helped mitigate the real exchange volatility and heightened risk in those years. Integrated financial markets have since been serving as a potent means of amassing capital in the destination targets, developing the financial sector and auguring capital flows. This has often involved raising domestic savings to boost economic growth and investments, improving the performance and efficiency of intermediaries, while also being the main source of financial contagion.

Markets, thus, are more innovative, cost effective, productive and competitive, offering ample opportunities of productive investment (low risks, high returns) for investors, exponentially boosting investment and consolidating financial integration. Henceforth, researchers and policy experts have shifted their focus towards assessing the impact of regional and domestic financial integration in the world, specifically examining how such changes in the developed world impacted the developing countries. Therefore, these academics meticulously observe the contemporary determinants of economic growth like the development of industries, services and financial markets.

In Pakistan too, the integration of the country’s financial system with other countries in the region and those around the globe has increased since Pakistan started liberalizing its economy in the 1990s (World Bank 2017a). Since then the relationship between the Karachi Interbank Offer Rate (KIBOR), London Interbank Offer Rate (LIBOR), and government treasury-bills has only fortified over time. Owing to the ubiquity of speculation and arbitrage in financial matters, the domestic security market is still not adequately developed (Muhammed et al. 2012). Since a substantial share of financing is achieved through increasing debt, therefore, a fraction is done through equity.

Though the degree of integration of financial markets varies across south Asia, it has uniformly increased after the introduction of economic reforms in this region (particularly in Pakistan, India, Bangladesh, Sri Lanka, and Nepal) over the last decade of the 20th century (Mohsin and Rivers 2011). However, out of all proximate countries, Pakistan has chosen to cooperate closely with China to strengthen the bilateral financial and economic linkages. In recognition to this, both countries have embarked upon the ambitious programme of the China-Pakistan Economic Corridor (CPEC). This corridor envisages a three-pronged strategy consisting of the modernization of transport networks, the initiation of energy projects and the creation of Special Economic Zones in Pakistan (Khan 2017).

In terms of capital account, the Pakistan’s economy is by and large free from restrictions, however, the actual integration of Pakistan’s economy into the global economy in comparison to other emerging markets such as China is still limited (Haque, Ahmed & Shahid 2011). Preliminary research reports
indicate that CPEC has a huge potential to enhance regional connectivity and financial integration by providing better access to cross-border capital flows (Munir 2017).

Currently, Industrial and Commercial Bank of China (ICBC), a Chinese commercial bank, is operating in Pakistan, and the National Bank of Pakistan (NBP) has set up its branch in China. Besides, Pak-China Investment Company Limited (PCICL), a leading Chinese development financial institution, has partnered with Pakistani government to set up a joint investment company to promote development finances in Pakistan. With the initiation of the CPEC, there are abundant opportunities for the opening of cross-border banks and the strengthening of ties between financial institutions.

Therefore, the integration of Chinese and Pakistani financial markets through ventures like CPEC, and with the requisite safeguards, have the potential to accrue innumerable benefits through the facilitation of bilateral currency swaps, subsidized financing arrangements, investment funds, syndicated loans and insurance coverage for corridor related activities. Yet, such financial co-operation among the respective central banks, regulatory bodies and financial institutions can also be stymied and impeded by challenges arising from the infeasibility of cross-border transactions and the pre-existing differences between legal, regulatory and financial frameworks in both countries in addition to the linguistic differences. Thus, more research needs to be done to explore the opportunities therein along with assessing the nature and magnitude of these problems and develop solutions accordingly.

This study broadly aims to:

- explore the possible opportunities arising from financial market integration between China and Pakistan;
- examine the key challenges in cross-border financial market integration, and
- evaluate key reforms and policy measures necessary for integrating the financial markets between China and Pakistan.

The next section provides a research methodology. This is followed by brief literature review on this subject and also highlights some gaps in the existing studies. Some of these gaps may be covered in this paper. Section 4 then covers findings from our qualitative research exercise. Section 5 concludes the study and provides specific policy recommendations.

2. Research Approach and Methodology

Our research methodology relied on three key instruments to approach our research questions. First, a select body of literature, inclusive of the various approaches to ascertain the situation of financial market integration between China and Pakistan, was reviewed. The data analysis, guided by context analysis and structural assessment, was used to determine the presence of certain concepts in literature. The recent scientific papers were reviewed comprehensively to determine the recurring themes and to gauge its congruence in the context of the data collected from other qualitative sources.

Similarly, the structural assessment of the literature involved examining and evaluating the key components of integration between financial markets, including, banking, capital, insurance and leasing markets. This was done in order to appraise the current and potential challenges in the amalgamation of Pakistani and Chinese markets along with identifying the potential reforms for the mutual convergence of markets.
Key informant interviews were conducted for which a semi-structured questionnaire was furnished. This questionnaire among other sections included the following specific questions.

I. What are the possible opportunities for financial market integration between China and Pakistan?
II. What are the key challenges in cross-border financial market integration?
III. What should be done at the policy and implementation levels to integrate the financial markets between China and Pakistan?
IV. How have other emerging market economies financially integrated with China? Are there any lessons for Pakistan?

During the data collection process, several issues were encountered, e.g. while several institutions at the government level dealing with CPEC, however very few officials had actual insight into current discussions with the Chinese counterparts as regards the financial integration. The communication gap within the government needs to be narrowed down. Also, the government is expected to issue at least preliminary minutes of the meetings held on this subject, which are still difficult to find.

SDPI team also benefited from a panel discussion around this topic. This was hosted as part of the 20th Sustainable Development Conference. Similarly, SDPI and Embassy of China jointly celebrated the five years of CPEC. On this occasion, experts from China and Pakistan expressed their views that have now been incorporated in the sections below.

3. LITERATURE REVIEW

3.1 Theoretical Framework

Extensive research on financial market integration has been conducted by using various different theoretical frameworks. According to this research, financial markets can be successfully integrated if barriers on cross-border capital mobility are addressed and lending and borrowing across borders is allowed. More specifically, restrictions on the investors in equity and bond markets should be curbed or fully lifted to encourage greater investment. A highly developed bonds and equity market would help global, regional and national corporate sector in obtaining external financing, raising the transparency of their dealings and lead to market discipline. A disciplined market (ensured through a responsible regulator) can exercise considerable influence on business activity and capital flows (Stiglitz 2000).

The two defining elements of financial integration are: a) increasing level of capital account openness, and b) volatility in global growth (Bekeart and Mehl 2017). Affirming the latter’s finding, Jalil and Ma (2008) hold that financial services work by raising investments and efficiently allocating capital through the mobilization of resources and expanding credit to the private sector. There may exist interest rate differential between different markets if financial markets are not integrated. This, in turn, could give rise to adverse market premiums. The presence of intermediaries in the market can lower the credit rationing and the interest differentials in different markets (Boyd and Smith 1992).

Even though the fortification of links between respective financial institutions can make an economy resilient to shocks and usher in development, it may pose the risk of cross-border financial contagion (Yu, Fung & Tam 2010). Thus, Sutherland (1996) finds that with greater integration of financial markets, shocks in money markets lead to higher variations in economic variables whereas shocks in
the goods markets lead to the opposite. Welfare gains from greater integration may be largest under competitive markets and when underlying assets are substitutes (Sutherland 2004).

Fluctuations in exchange rates and prices of securities dramatically alter the interest rates and variations in share prices. The rate of deposits at a bank determines the inflow and outflow of funds in the domestic stock market and also affects the government’s borrowing cost from non-bank sources (Aazim 2013). Increased Foreign Direct Investment (FDI) on economic growth and domestic capital formation which comes about as a result of bank penetration should be viewed with caution. Credit may not be optimally allocated due to the arrival of foreign bank penetration (Agenor 2003).

3.2 Emerging economies

The trajectory of financial integration has followed a “swoosh” shape since it was relatively lower than the past century, while being high at the start (1913) and turn (1990) of the century (Bekeart and Mehl 2017). Most of the highly developed financial markets, at the turn of the previous century were inextricably linked to the US currency subsequent to World War II. Since, the US, through dispensing its currency under the aegis of the Internal Monetary Fund and the World Bank was the financial guarantor of its European allies (World Bank 2017b), therefore the presence and interest of the American government and corporate sector led to the merger of western European markets.

The integration of emerging markets is also correlated with world market returns – which may see changes as a result of a lower cost of capital, improved credit ratings, real exchange rate appreciation and increased economic growth (Bekeart et al. 1998). The increased level of financial globalization across the emerging market economies means that there is a diversified ownership of multinational banks. We see in the case of six Latin American economies during the period 1988 to 2001 that the pace of integration in this region was faster until mid-1990s, however after the financial market crisis in these economies, the pace of integration slowed down (Barari 2004).

Prior to the Asian financial crisis, East Asian countries witnessed tremendous growth in their financial markets (Yang et al. 2005). Primarily due to the exponential rise in bank lending to the manufacturing, commercial and real estate sectors, the economic growth of these countries boomed from the 1980s to the mid-1990s.

In particular, the Newly Industrialized Economies (NIEs) such as Singapore, Malaysia, Indonesia, Thailand, Taiwan, Korea, Hong Kong, and some ASEAN countries had average growth rates of 10 per cent. The liberalization of capital markets, removal of interest rate ceiling, market entry restrictions, licensing requirements, growth of Non-Bank Financial Institutions (NBFIs), securities firms, and insurance companies led to capital inflows in the form of domestic and foreign investment.

Starting in 1997 from Thailand to Indonesia to the wider region, financial markets experienced a severe credit crunch as banks became insolvent due to non-performing loans to domestic firms. In addition, due to losses from foreign-currency denominated liabilities, lending and borrowing transactions were carried out in US dollars. The long-run relationship as well as the causal linkages in the short run among 10 countries with emerging markets in Asia were consolidated during 1997 and 1998 (Yang, Kolari, and Min 2010).

Even though the emerging and developing Asian economies have taken numerous steps to integrate themselves with their neighbours, these countries are more integrated with global financial markets. In
conjunction with this, Hsiao, Yang & Chang (2005) said that in order to prevent such setback to the progress of financial markets, consolidating the bonds market, involving emphasis on issuance arrangements is necessary. Moreover, the creation of regional credit rating agencies and settlement systems are imperative for financial cohesion.

The extent, to which a single equity market in Asia may be amalgamated into others, is contingent on the political, socio-economic and institutional structures prevalent in that country (Yu, Fung & Tam 2010). Often low liquidity and poor financial development in Asia has pushed investors to allocate funds to other financial centers. These countries were at the time vulnerable to shocks in the regional and global bonds and equity markets. To preserve regional financial stability, there should be mechanisms to mitigate the associated financial risk with increased integration (Asian Development Bank 2008).

Within South Asia, concerted efforts have been made for the amalgamation of financial markets across the region. This has manifested through the South Asian Free Trade Agreement (SAFTA), which was a result of South Asian Association for Regional Cooperation (SAARC). Yet, there has not been an efficacious push towards this goal due to the lack of adequate institutional frameworks and regulatory preparedness which inhibits trade and financial liberalization between South Asian countries (Goyal, A 2012 and Manzoor et al. 2017). A failure to implement SAFTA in true spirit has resulted in SAARC member countries resorting to bilateral preferential trade arrangements (Ahmed, Suleri and Javed 2015).

While both the stock and equity markets are integrated in the four major financial centers of South Asia, i.e. India, Pakistan, Bangladesh and Sri Lanka, stock market integration is much stronger as opposed to the underdeveloped and data deficient bond markets (Perera, A and Wickramanayake, J 2012). In particular, Latif et al. (2014) found a significant trading relationship between the stock markets of India and Pakistan and that the elimination of obstacles could further attract mutual investors by minimizing risks and maximizing returns. The integration of markets across South Asia can also raise domestic savings, capital inflows and augment economic growth in South Asia (Bhunia & Das 2012, and Aiyer 2017).

3.3. The case of Pakistan and China

The discussions regarding financial market integration between China and Pakistan have gained momentum, as both the countries moved to the advanced stages of CPEC. In the case of Pakistan, liberal reforms in the economy and the deregulation of various sectors meant that indicators of financial markets in Pakistan like the stock prices, exchange rates and interest rates have become entirely contingent on market forces. In this context, Khalid and Rajagura (2006) using an empirical approach find that internal and external shocks in the currency market affect the stock market which, in turn, impact the money market. Aleemi and Azam (2017), while investigating the same relationship between the money, currency and capital markets from 2001 to 2014, found that a bi-directional causality exists between currency market and stock market and a uni-directional causality from stock market to money market. Pakistan’s economy is presently affected by global food and fuel prices and this has implications for the country’s balance of payments (Ahmed 2010).

Though economic growth may have exacerbated income inequality in Pakistan, there is still a potential for well-structured and developed financial sector to drive down income inequality. Shahbaz and Islam (2011) find that there is an extremely strong relationship between economic growth and stock market.
Authors also found a unidirectional causality in the short run from stock market development to growth and bidirectional causality in the long run.

Financial markets in China rapidly grown in the 1990s (Yang et al. 2005). Later from 1995 to 2000, the capitalization ratio of stock markets to GDP dramatically increased from 10 per cent to over 50 per cent, yet it fell to 27 per cent in 2002. The authors observe that the banking sector remained dominant player in the securities market. The Shanghai Stock Exchange (SSE) created in the 1990s, allows bonds to be traded on it through a centralized bidding system. Four major banks have dominated the banking sector in China with the debt to GDP ratio being in excess of 100 per cent in 1997 that increased to 120 per cent in 2002. The growth of the Chinese financial markets, in particular the stock market, has coincided with the exponential economic growth and the accompanying refurbishment of the infrastructure. The stock markets also rose to a prominent role after the need for foreign investors to have their target companies be listed and registered, became more pronounced.

Jalil and Ma 2008, while examining the financial reforms in Pakistan and China between 1960 to 2005, find differing results for the consequent relationship between financial development and economic growth. The author observes that the Deposit Liability Ratio (DLR) and Credit to Private Sector (CPS) have had a positive and tangible effect on Pakistan’s economic growth whereas in the case of China only the DLR has a tangibly positive impact on growth.

Historically, Pakistan and China have been strong trading partners and these trade relations have extended over a period of four decades (Ahmed 2017). Both the countries have signed and implemented numerous trade agreements like Bilateral Trade Agreement in 1963, Free Trade Agreement (FTA) in 2006 and FTA for Trade in Services in 2009. Moreover, the magnitude of trade between China and Pakistan is continuously increasing. Total trade volume between the two countries significantly increased to $13.77 billion in the fiscal year 2015-16 from $4 billion in 2006-07. During the period, Pakistan’s exports grew to $1.69 billion from $575 million. Imports from China, however, witnessed a sharp growth to $12.1 billion from $3.5 billion.

The performance of Pakistani stock exchanges has been phenomenal as it rose by 15% in 2016 due to growing investor confidence primarily. This happened because of the greater business confidence emanating from CPEC, mobilization of internal liquidity, reduction in interest rates and improved security situation.

Additionally, Pakistan Stock Exchange (PSX) is more resilient as opposed to the Indian and Chinese stock markets to shocks and investor confidence in the global economy. This may have positive and negative implications for Pakistani markets as the susceptibility of domestic market to foreign market shifts is low. However, the Pakistani markets lose out an opportunity to diversify their portfolio and may not have uncorrelated assets to spread any potential risk. It is however encouraging to note that Chinese portfolio investors have recently invested in PSX. This enabled Pakistan Stock Exchange to become the first self-listed capital market in South Asia in 2017 (Farooq 2017).

According to the Associated Press of Pakistan (2017), 30 per cent of the PSE shares were sold to a Chinese consortium comprising three Chinese exchanges, namely Shenzhen Stock Exchange (SSE), China Financial Futures and Exchange Company Limited (lead bidder). While five per cent were sold to domestic financial institutions, namely the Pakistan-China Investment Company Limited and Habib Bank Limited. Pakistan’s government has put forth plans to create CPEC bonds to deal with balance of payments difficulties from falling exports and rising imports. Already a currency swap arrangement
is in place which should reduce Pakistan’s reliance on US dollar as a currency for settling payments with China.

With the announcement of US $54 billion investments in Pakistan under CPEC, volatility in the securities market has decreased and the market gained more stability. Thus, the PSX has spurred overall investment confidence (Mahmood and Ahmad 2017). Recognizing the efforts of the Securities and Exchange Commission of Pakistan (SECP) as the apex regulator of the capital markets to implement a strong enforcement and compliance regime, the Morgan Stanley Capital International (MSCI) reclassified Pakistan as an emerging economy (Reporter 2015). Several factors like the transfer of expertise particularly in the financial arena, investors’ protection, technical capacity building, and exposure to best practices in regulation, improved governance and speedy resolution of payment disputes are a prerequisite for deriving benefits (Riazuddin 2016).

An increase in FDI has a significant effect on economic growth when done in the manufacturing and agriculture sectors (Ali 2016). This has immense importance for Pakistan because agriculture still constitutes a substantial share of the GDP and is the primary source of employment (Ahmed and Mustafa 2015). Conversely, the impact of FDI was negligible for the services sector. This finding is particularly important in the light of the CPEC, as it has various policy implications for the flow and direction of Chinese investment in Pakistan (Ali 2015). It is assumed currently in the policy circles that CPEC related investments will bring about additional growth in services economy of Pakistan. Likewise, financial integration of both economies will help Pakistan diversify its production base that depends on agricultural or low value-added manufacturing. In the medium to long-term, this diversification should reduce macroeconomic volatility (Kose et al. 2009).

CPEC involves the usage of two channels of financial integration. The first one is the inflow of Chinese direct and portfolio investment in Pakistan. This is illustrated by the exponential rise in the share of foreign direct investment to Pakistan during FY17 with $1.186 billion, up by 11% from $1.064 billion in the last year.

The second channel for financial integration is the cross-border expansion of financial institutions with at least one branch of a commercial bank having been established between both countries (Riazuddin 2016). Commercial cooperation between the financial institutions particularly banking entities in both economies can be strengthened if the private sector from both countries engages overtime in joint ventures (Karim 2017).

3.4. Research Gaps

Perhaps, the most pertinent problem encountered while examining and analyzing information from secondary sources was the dearth of information regarding the extent of financial market integration between China and Pakistan in general and specifically under CPEC. The various processes of financial integration were only confined to official sources and unfortunately it has not been explored in the literature produced by private sector associations. There is clearly a knowledge gap in understanding how Chinese financial sector can bring about benefits for Pakistan if cooperation is deepened.

Limited research is available that investigates inter-linkages between money, currency and capital markets in both countries. This is the reason that until now we do not see any scientific study on the benefits of currency swap between China and Pakistan. Similarly, there is no study on how the current free trade agreement between China and Pakistan can strengthen financial integration.
4. DISCUSSION AND FINDINGS

Based on the above-mentioned methodology, key qualitative findings are given below. In the subsequent section, we also identify those government institutions, which would be responsible for possible implementation in future.

4.1. Challenges to Financial Market Integration

Most of our respondents were of the view that the legislative and regulatory systems currently governing the financial markets in both the countries are different. There is, therefore, a need for formalizing the memorandum of understanding between the financial regulators concerned on both sides, including the central banks. The cooperation between the corporate sector regulators, e.g. Securities and Exchange Commission of Pakistan also needs to be strengthened.

Two key motivations to expedite the above-mentioned cooperation may be: a) Pakistan’s need to attract more development funding from Chinese private sector in public-private-partnership mode, and b) luring greater private sector investments from sunset industries of China towards Pakistan’s Special Economic Zones. Furthermore, following specific risks will have to be addressed.

4.1.1. Lack of Coping Mechanisms for Systemic Risks

Currently, there is no mechanism in place to handle systemic risks. Legally, Chinese and Pakistani banks should undertake the function of preventing and reconciling systemic risks and maintaining national financial stability at their end. For this, a strengthened cooperation between private and state-owned commercial, investment and intermediary banks is required. Owing to lack of information sharing, both countries lack systems for measuring, analyzing, warning and controlling systemic risks (in the other countries).

4.1.2. Banking Supervision

Effective banking supervision mechanisms are also needed in Pakistan to prevent any misuse of free flow of money between the two countries. Such measures will also help Pakistan’s pursuit to fulfill the requirements desired by Financial Action Task Force (FATF). Pakistan has already put in place legislative mechanisms, e.g. Anti-money Laundering Act 2010.

4.1.3. Joint Financial Guarantee Instruments

There is a vast scope for cooperation in asset and financial insurance sectors in both countries. In particular, the joint projects initiated by both countries should have joint guarantees by both governments and their nominated financial institutions to cover for the investors’ interests. Similarly, in the case of hire purchase and leasing, consumer interest guarantees are required so that potential supply chain players in any sector can benefit from deferred payment facilities. This will greatly boost the utilization of China-Pakistan Free Trade Agreement.
4.1.4. **Sharing of Capital Market Risks**

Imperfections in capital markets are also major constraints in the way of financial market integration between China and Pakistan. A respondent said:

> “strong capital markets require strong contractual compliance, property rights, robust supervision, sound accounting standards and corporate governance, strong financial institutions, a meaningful disclosure regime and independent credit rating agencies”.

Under CPEC, both states are facing challenges to access larger government bond markets, a more liquid and transparent corporate bond markets and a legal system in which private equity can flourish. In addition, existing bond market in the case of Pakistan is stifled due to excessive regulations and may not interest institutional players from China. The bond markets in both countries currently do not allow the large segment of private sector particularly individual participants, access to debt instruments across the border.

4.1.5. **Portfolio investment in stock markets**

According to respondents, existing stock market flow of capital is at fairly preliminary stages. While Chinese investment has been invited in PSX, however the small size of this exchange can only accommodate limited investment pool, which will remain sensitive to any variations in the regulatory principles.

Smaller stock markets in the region are seen more vulnerable to internal and external shocks and makes trading more expensive, stunting their growth and preventing them from becoming deeper and more liquid. To bolster efficiency, a respondent suggested:

> “Cross-border financial transactions on various stock exchanges should be guided by a common regulatory framework specifying common rules and ethics as well as accounting, clearing, and settlement systems and standards”.

4.1.6. **Inadequate banking facilities**

Problems relating to the less use of banking services in Pakistan have been observed and this is due to a combination of factors, including low income, illiteracy, and poor knowledge of the banking system, the remoteness of structures, lack of infrastructure, long procedures for opening an account, high cost of services and lack of information. On the other hand, nearly 08 out of 10 adults in China have a bank account. In addition, Pakistan had around 9 ATMs for every 100,000 adults as of 2015, compared to 76 for China. In fact, China had almost as many ATMs per 100,000 adults back in 2006, as we have today. This indicates that China has leveraged technology and digitization to expand financial access. China’s banking system is still transitioning to a modern, efficient and market driven system with proper controls and management.

As Pakistan expands its banking inclusion programme, it can help a larger segment of rural population to get integrated with the formal financial sector inside and outside Pakistan. Currently, several informal sector traders, who do business with China, are either doing this through a third (formal) party after the payment of a premium; or deal in foreign currency denominated cash. As bank branches that cater for low and middle income groups in both
countries open up across the border, the insurance sector and other entities responsible for risk management would also benefit.

4.1.7. Low uptake of currency swap facility

Both the governments have allowed currency swap facilities. However, the private sector has not made an optimal use of this facility for its large import and export transactions. Greater outreach is required to provide confidence to the large-scale exporters on both sides. For the small and medium enterprises wishing to integrate in China-Pakistan supply chains, there is a need for orientation which can be facilitated through the Chambers of Commerce and Industries on both sides. The Board of Investment in Islamabad may like to establish a web portal to guide traders as to how they can use this facility.

China and Pakistan are also trading with economies in the region which have low levels of banking sector integration. Neighbours such as Iran can be helped if both governments agree to extend swap facilities for ventures which involve supply chains of three or more countries in the region. This will also help vertical and horizontal integration of production processes in the region (Shabbir et al. 2012).

4.2. Pre-requisites for Financial Market Integration

The scope of economic relations between China and Pakistan raises the possibility for increased cooperation between the countries’ money and capital markets. This section further highlights certain regulatory and policy reforms in financial market integration as possible entry points that can promote financial market services between China and Pakistan.

4.2.1. Stable and Liberalized Economies

Mounting debt levels have been an issue in the case of China, but in the case of Pakistan sustaining macroeconomic stability and avoiding large external and internal imbalances should be a priority. The exchange rate management, monetary and fiscal policies along with the regulatory regime in Pakistan should aim to limit moral hazard and related abuses in the market. Importantly, there must be reserved accumulation during the period of high capital inflows which would be used to ensure the stability of the exchange rate and curbed uncertainty.

4.2.2. Promoting Investor Confidence

The enforcement of financial contracts and respect for property rights are key indicators in the World Bank’s doing business index which investor’s carefully monitor before participating in a foreign economy’s money and capital markets.

Developing economies such as Pakistan need to ensure certainty of economic policies. The lack of confidence, because of frequent reversals of demand management, policies in the past may hinder the elimination of capital controls even if all prerequisites are in place. Such perceptions regarding the economy may need to change as a pre-requisite to the proposed integration of the financial markets.
4.2.3. Greater Competition and Corporate Governance

Competitive assets and goods markets are essential if Pakistan’s SMEs are to graduate towards becoming larger production houses and integrate with the regional supply chains. This will require a key role of the Competition Commission of Pakistan (CCP) towards checking “*abuse of a dominant position in the market, certain types of anti-competitive agreements, and deceptive market practices. It also reviews mergers of undertakings that could result in a significant lessening of competition. Combined with its advocacy efforts, the commission seeks to promote voluntary compliance and develop a ‘competition culture’ in the economy*”. Financial sector should ultimately be geared towards compliance with globally recognized corporate governance principles. In particular, rules which prompt the requisite financial closure as that will incentivize the participation of new shareholders and potential bidders and should be promoted to assist the market stakeholders in monitoring corporations (Stulz 2005).

4.2.4. Impact on the real estate sector

With the expansion and intended integration of the financial system, the real estate sector would have easy access to long-term funds at reduced interest rates. Other benefits derivable from consolidation of banks include, greater efficiency and cost effectiveness, enhanced ability to compete in the market place, both domestically and internationally, leveraging on technology and diversification of operations, controlling risks and provision of broader array of products. Amid the construction boom in Pakistan, some private Chinese property developers have exhibited an interest to enter the real estate and property development in Pakistan’s housing sector.
5. CONCLUSION

This study was conducted with the aim to explore the possible opportunities arising from financial market integration between China and Pakistan. Additionally, the study also aimed to examine the key challenges in cross-border financial market integration and to evaluate key reforms and policy measures necessary for integrating the financial markets between China and Pakistan.

Using a qualitative methodology, key informants and stakeholders were engaged in focus group discussions to see what are the possible opportunities for financial market integration between China and Pakistan? We also wanted to document their perceptions regarding key challenges in cross-border financial market integration? And, what should be done at the policy and implementation levels to integrate the financial markets between China and Pakistan? An additional interest was to also learn how other emerging market economies financially integrated with China?

The paper provides a roadmap for the integration of financial markets and calls for appropriate regulatory measures. In this regard, specific roles of Ministry of Planning Development and Reforms, State Bank of Pakistan, Competition Commission of Pakistan, Securities and Exchange Commission of Pakistan and Pakistan Stock Exchange on Pakistan side have been highlighted. We suggest that there is a room for further research, and a detailed enterprise-level survey is recommended to assess the preparedness of Pakistan’s banking sector, Pakistan Stock Exchange, asset management companies and insurance firms to integrate with their Chinese counterparts.
6. POLICY RECOMMENDATIONS

- The State Bank of Pakistan (SBP) may like to conduct a rapid policy evaluation of past cooperation activities with People's Bank of China, Bank of China, and Industrial and Commercial Bank of China Limited. This is particularly important if uptake of recent financial arrangements such as currency swap has to be encouraged.

- The Memorandum of Understanding (MoU) signed between Securities & Exchange Commission of Pakistan and China Securities Regulatory Commission calls for promoting investor protection and integrity of securities, futures and other related investment products. The operationalization of this MoU in true letter and spirit is desired. The business community on both sides should be informed as to how their rights and entitlements are protected through this cooperation between both regulators.

- A similar MoU and collaborative framework is also required between CCP and their counterparts in China. This is important not only to address market imperfections faced by new entrants but also to ensure consumer protection.

- Pakistan’s Ministry of Planning, Development and Reform, and China’s National Development and Reform Commission need to expedite efforts for creating formal business-to-business linkages between private sector commercial and investment banks, asset management companies, and insurance firms. This exercise can also be helped by the Board of Investment in Pakistan and their counterparts in China.

- The construction of Gwadar Port at the Gwadar Free Zone should be modelled on the pattern of pilot Free Trade Zones in China. The FTZs in China and Pakistan should co-ordinate their activities in financial ventures. These FTZs through the development of economic co-operation zones as well as industrial parks can act as investment channels through which multi-national industrial value chains can be augmented.
REFERENCES:


