Advance Deposit Requirements for Imports in Pakistan

MANSOOR ELAHI*

The system of advance deposit requirements for imports, as a means of improving the balance of payments, has achieved some popularity in recent years. Most frequently used in Latin America, this technique, in the form of margin requirements at the time of opening a letter of credit, has also been employed in Pakistan from time to time. Advance deposit requirements serve as a selective credit control instrument to raise the cost of financing imports and thus directly affect the ability and willingness to import. Under certain conditions, the requirement can also be an effective general instrument of monetary policy through its indirect effects on the supply and demand for liquid assets in the private sector. These direct and indirect effects may then reduce the demand for imports and thus improve the balance of payments of the country concerned.

Imports in Pakistan were liberalized in August 1948, because at that time the limited productive activity in the country made large quantities of imports a physical necessity. In September 1949, the devaluation of sterling, followed by Pakistan's decision not to devalue its own currency, rendered importing very profitable. During 1950 the demand for imports increased as a result of rising incomes due to the Korean boom. To limit this demand, orders were issued in September 1950 by the State Bank of Pakistan requiring advance deposits on imports.

It was stipulated that before forward exchange was booked the importers must open irrevocable letters of credit supported by a deposit of not less than 35 per cent of the value of imports. Within a few weeks, the percentage was raised to 75 per cent for goods imported under Open General Licence[1].

The course of the Korean boom saw an unprecedented rise in the export earnings of the country. The current account surplus amounted to Rs. 578.0 million in 1950/51. This was followed by general import liberalization

*Mr. Mansoor Elahi is a Staff Economist in the Institute of Development Economics.
He is indebted to Dr. Umer Chapra, Senior Economist, and particularly to Dr. John H. Power, Research Adviser in the Institute, for many useful comments and suggestions on earlier drafts of the paper.

[1]. Speech delivered by Mr. Zahid Hussain, Governor, State Bank of Pakistan, on September 26, 1950, on the occasion of Second General Meeting of the Bank.

policies. The margin requirements were successively reduced beginning December 7, 1950, and finally abolished on March 9, 1951[2].

Subsequently, the liberalized import policy had to be drastically reversed as the prices of Pakistan's exports began to decline after the peak of the Korean boom in 1951. It is also to be noted that the fear of restrictions on imports arising from the decline in export earnings led to an undue expansion of import inventories. Hence, advance deposit requirements were introduced once again on June 21, 1952, at the rate of 75 per cent for goods under O.G.L. and 50 per cent for goods subject to specific import licences.

Imports of medicine, machinery and chemicals, however, were excluded from these restrictions, and compulsory margin requirements were not applied to imports made directly by the Government. Moreover, authorized dealers were not allowed to extend credit for the purpose of enabling the importers to make the necessary deposit. These measures were abolished on March 2, 1953[3] when emphasis was placed on other import control measures, the most notable of which was the extensive use of the licensing system, as O.G.L. was finally abolished in November 1952.

It is to be noted that although advance deposits were officially abolished, the deposit of the margins remained a matter for negotiation between the commercial banks and their customers. This unofficial margin requirement and its percentage depended upon the reputation of the party and varied from commodity to commodity.

After devaluation in 1955, the current account balance reached its lowest level (a deficit of 335.7 million rupees) in 1957/58. That year, like the previous years, was characterized by stringent direct import control measures. Advance deposits were again introduced on June 29, 1957, with the margin requirement set at 15 per cent of the value of imports[4]. This restriction was in effect until November 15, 1958[5].

Advance deposits were introduced again on January 10, 1962, and are still in operation. The requirement is imposed on a limited range of commodities with a 30 per cent margin for iron and steel and a 25 per cent margin

---

[2]. F. B. Arnold (*ed.*), *Economic and Commercial Conditions in Pakistan*. (London: Her Majesty's Stationary Office, 1954), p. 10.

[3]. Circulars on advance deposit requirements made available through the courtesy of the Research Department, State Bank of Pakistan.

[4]. State Bank of Pakistan, *Annual Report*, 1956/57.

[5]. State Bank of Pakistan, *Annual Report*, 1958/59.

for the rest[6]. These restrictions are not applicable, however, against licences issued to industrial consumers[7].

SECTION II: CHARACTERISTICS OF ADVANCE DEPOSIT REQUIREMENTS IN PAKISTAN

Advance deposit requirements as imposed in Pakistan have the following characteristics.

(a) The period for financing imports is lengthened as a partial payment must be made in advance, thus increasing the cost of financing imports. If the funds required to make the advance deposits are borrowed then the cost involved is the cost of borrowing itself. However, when the deposits are made from the importers' own resources (through liquidation of assets or past savings) the cost implicit is the opportunity cost of using the financial resources.

(b) The bank financing of advance deposits was prohibited in June 1952. No such restriction was placed in 1950, 1957, nor in the orders of January 1962. But even without the State Bank's prohibition to finance margin requirements, the commercial banks are likely to finance advance deposits only of trusted parties. Thus, the financially weak importers are likely to have considerable difficulty in raising the necessary funds.

(c) The imports of machinery, medicine and chemicals were excluded from these restrictions in 1952. Under present regulations the margin requirement for iron and steel is higher than for other commodities. Also, in the earlier years the margin requirement for items on O.G.L. was much higher than on those under the licensing system. This implies discrimination in favour of certain types of imports. In this manner, advance deposit requirements have been administered so as to affect not only the quantity but also the composition of imports in accordance with the general economic policy of the country.

(d) The time lag between the opening of the letter of credit and the arrival of the goods in the country is normally about three months. For

---

[6]. Chemicals, vaccum flasks including refills, typewriters and parts, office machines and office equipment and parts and accessories, packing for engines and boilers all sorts, ball roller and taper bearings, tractors (standard makes only) and spare parts for tractors, cinematographic films unexposed, tyres and tubes (excluding factory rejects), motor cycles and motor scooters not exceeding 200 c.c., trucks and buses (standardized makes), automotive conveyances, parts and accessories of all automotive vehicles (including spare parts for marine engines).

Through the courtesy of the Research Department, State Bank of Pakistan.

our subsequent analysis the period of retention for advance deposits will be assumed as such.

(e) Advance deposits were made with the commercial banks and not transferred to the State Bank. As will be seen, the choice of location has an important bearing upon the effectiveness of advance deposits as an instrument of credit control.

With this description, we will attempt in the following section to develop a theoretical scheme to assess the effectiveness of this tool of economic policy.

SECTION III: ECONOMIC EFFECTS OF ADVANCE DEPOSIT REQUIREMENTS

In analysing the economic effects of advance deposit requirements, it will be convenient to distinguish among the 'direct effect' on imports *via* the cost and profitablity of importing, the 'indirect effect' *via* the influence on the supply and demand for credit, and the discriminatory effect in favour of the financially strong and against the financially weak importers. Attention will be directed principally to the direct and indirect effects though this is not meant to imply that the discriminatory effect is unimportant[8].

The way in which the direct and the indirect effects operate depends upon the existing framework of institutions and economic controls. In particular, it depends upon other import controls, on the elasticity of the supply of credit, and on the particular way in which the advance deposit requirement is administered. It is not possible to consider all cases, but it is perhaps instructive to compare the effects under a system of no quota or exchange restrictions on imports (that is, where the advance deposit requirement is the principal import control device, in addition to the tariff structure) with those where the imports are partially controlled by an inflexible licensing system and partially determined by market forces under an export bonus scheme, as the economic controls exist in Pakistan today. In both cases, the elasticity of the supply of credit and the choice of location of deposits between the commercial banks and the State Bank will be seen to have a decisive influence.

Finally, the use of advance deposits as a built-in stabilizer, as well as a

---

[8] *See* also the analyses in J. Marshal, "Advance Deposits on Imports", International Monetary Fund *Staff Papers*, April 1958; E. A. Birnbaum and M. A. Qureshi, "Advance Deposit Requirements for Imports", International Monetary Fund *Staff Papers*, November 1960; and J. O. W. Olakanpo, "Monetary Management in Dependent Economies", *Economica*, November 1961.

discretionary instrument, under the scheme of analysis discussed above (without import controls and with import controls) will be considered.

Direct Effects without Import Controls

Advance deposits directly affect the decisions to import, as the rupee cost of financing imports is increased. Importers can finance their advance deposits by borrowing, by diverting funds from other uses, or by liquidating assets. In any case there is a cost—explicit or implicit—which can be expressed as an interest rate. In the limiting case, of course, an importer may have no access to loans, no funds to divert, and no assets to liquidate so that his interest rate is infinitely high.

Given the interest rate, the official margin requirement for advance deposits, the customary unofficial margin required by banks, and the period of retention, a calculation can be made of the additional cost of importing resulting from the advance deposit requirements.

Let C = additional cost of importing as per cent of imports

i = interest rate

M = official margin requirement as per cent of imports

m = unofficial margin requirement as per cent of imports

t = period of retention (years)

Then $C = i\,(M—m)\,t$

If for example, $i = 8$ per cent per annum, $M = 75$ per cent, $m = 25$ per cent, and $t = 3$ months ($\frac{1}{4}$ year)

then $C = .08\ (.75 — .25)\ .25 = .01$

or the additional cost of importing is equal to one per cent of the value of imports. Clearly, changes in C would be proportional to changes in i, (M—m), or t. But even with $i = 10$ per cent, $M = 100$ per cent, $m = 0$, and $t = 6$ months (a far more stringent set of circumstances than is likely to prevail) the additional cost would be only 5 per cent. In Table 1, some possible values of C are given in the matrix for varying values of i and M. The values

TABLE 1

Additional Cost of Importing as per cent of the Value of Imports

$M/_i$	.75	.50	.25
.05	.008	.005	.0025
.08	.013	.008	.004

of m and t are fixed at 10 per cent and 3 months. It is obvious that C does not add any significant burden to the cost of importing under any of the above assumptions.

It may be pointed out, that with an absolutely inelastic supply of credit or in the case of complete and effective prohibition of banks to finance advance deposits, some financially weak importers may have difficulty raising additional funds at any cost. In the limiting case (defined above), the importer would simply have to reduce his imports in the proportion (M—m). The net effect on total imports would depend on the extent to which the financially stronger importers took over the market shares of the weaker.

Moreover, the requirement that deposits be made at the State Bank would reduce bank reserves in the same manner as an open market sale of securities. Thus, the supply of credit would be reduced simultaneously with an increase in demand. The resulting rise in the cost and reduction in the availability of credit might greatly strengthen the direct effect of the advance deposit requirement. On the other hand, if the supply of credit is perfectly elastic and the commercial banks are allowed to finance advance deposits, the effect of advance deposits is not likely to be pronounced as the only cost involved is the additional cost of borrowing.

The effect will again be negligible if foreign exporters finance advance deposits in order to maintain their sales when importers may otherwise be forced to cancel or postpone their orders due to difficulty in raising funds. There is, however, in this case some favourable effect on the balance of payments from the short-term capital inflow.

Direct effects on imports depend on the size of C and the elasticity of demand for imported goods. Importers, however, may simply ignore C if

it is small in relation to the conventionally fixed profit margins. Even if they include C as a new element in unit cost, to which they add their customary margin, it is the magnitude of C and elasticity of demand that determines the effects on imports. However, from the standpoint of consumers there may be little response to a slight increase in prices (*i.e.*, a very low elasticity of demand). Therefore, the effect on imports may depend on the size of C in relation to existing profit margins as well as on the absolute value of C and elasticity of demand.

Indirect Effects without Import Control

A notable feature of advance deposit requirements is that it can also be an effective instrument of monetary management *via* its influence on the supply and demand for credit, and thereby affect imports indirectly as well as directly. The strength of the indirect effect depends on increased monetary demand for advance deposits in relation to total currency in circulation *plus* demand and time deposits, on the elasticities of supply and demand for money *plus* time deposits, and—in the case where deposits are held at the State Bank—on the contraction in the supply of credit resulting from reduced bank reserves.

A measurement of the ratio (R) of demand for advance deposits to total money supply can be made according to the following formula.

Let I = annual volume of imports subject to advance deposits

M = official margin requirement (weighted average) as per cent of imports

m = unofficial margin requirement as per cent of imports

t = period of retention (years)

A = additional advance deposits = I (M—m) t

C = total currency in circulation (average of twelve months)

T = time deposits (average of twelve months)

D = demand deposits (average of twelve months)

$$\text{then } R = \frac{I\,(M - m)\,t}{C + D + T}$$

Estimates of R for the years 1950-51 and 1952-53 are made in Table 2[9]. The value of R in 1950/51 was about 3.3 per cent and in 1952/53 about 4.5 per cent.

TABLE 2

Ratio of Demand for Advance Deposits to Money Supply (R)

(*million rupees*)

Year	(I^a)	(M)	(m)	(t)	(A)	(C+D+T)	(R)
1950/51 ..	1,170	.45[b]	.10	.25	102.4	3,090	.033
1952/53 ..	1,530[c]	.50[d]	.10	.25	153.0	3,315	.045

[a] Based on data from Central Statistical Office, *Statistical Bulletin*, 1953.

[b] Assuming three-fourths of imports on licensing, and the remainder on O.G.L., we derive a weighted average of M = .45.

[c] Figures for total imports exclude imports of medicine, machinery and chemicals as these were exempt from advance deposit restrictions.

[d] A weighted average of M for 1952/53 is also conceivable but O.G.L. was drastically reduced in 1952 and finally abolished in November 1952. We can safely ignore this discrepancy though at the cost of some negligible variation in R.

These percentages are so small as to suggest negligible indirect effects. Even if we assume that the credit supply was completely inelastic, a moderate elasticity of demand for money and time deposits would preclude any significant indirect effect in the absence of any change in the credit base. And, of course, the credit supply was far from being inelastic.

Significant indirect effects would seem to depend then, on an influence of advance deposits on the supply of credit—on the credit base—and this

[9]. No calculation is made for 1957/58 because the margin requirement was so low as to be insignificant.

would occur only if advance deposits were required to be transferred to the State Bank. In this case an influence equal to several times that estimated in Table 2 could be expected as bank reserves would be reduced by the amount of advance deposits. Still, the ultimate effect would depend also on the elasticities of supply and demand for money and deposits.

It should be pointed out also that, in this case, the State Bank can use advance deposit requirements as a substitute for open market operations through discretionary changes in margin requirements. The importance of this policy substitution is enhanced by the ineffectiveness of conventional open market operations in undeveloped money markets.

It is important to note that a strong indirect effect, raising the cost and reducing the availability of credit, will discourage imports not only *via* the reduction in general monetary demand, but will also strengthen the direct effect on imports *via* the explicit or implicit interest cost of financing imports. If, however, the indirect effect is weak and the direct effect strong[10], inflationary pressure may emerge depending upon the extent to which imports are curtailed. In a developed country with a high propensity to import, this curtailment could serve as a device to aid recovery from a slump period, as demand may be diverted towards home-produced goods. But in underdeveloped countries, short-run inelastic supply due to traditional bottlenecks implies primarily inflationary pressure when imports are reduced. However, if strong direct effects persist, the possibilities of import substitution should not be ignored.

Advance Deposits as a Built-in Stabilizer

Assuming flexibility of imports according to demand conditions, it can be seen that advance deposits may also act as a built-in or automatic stabilizer by dampening expenditure and income during a period of increased imports, and encouraging expenditure and income when imports are reduced. The stabilization aspect depends, of course, on changes in imports being induced, in turn by changes in monetary demand. The strength of the automatic stabilizer depends on the marginal propensity to import, as well as on the direct and indirect effects outlined above.

Direct and Indirect Effects under Rigid Import Licensing[11]

Under rigid import licensing, we must assume an excess demand for

[10]. This would be the case with a high margin requirement and a long period of retention combined with an elastic credit supply.

[11]. The present licensing system in Pakistan is not so rigid as is suggested in the following paragraphs. This affects, however, only the magnitude, not the direction of the effects.

licences if imports are effectively limited. In this case, the direct effect will operate simply to reduce the excess demand for import licences. Only if the value of C is very high or if profit margins on imports are controlled at low levels, will there be any direct effect on the volume of imports. The probable range of values for C suggested by the calculations made above indicates that this is not a likely possibility. At most, we can expect the liquidation of some marginal importers. The key point is, however, that under these conditions it is licensing, not advance deposits, that determines the level and composition of imports.

This means that under import licensing, the advance deposit system ceases to perform as a selective credit control instrument. It still functions, however, through the operation of the indirect effect, as an instrument of general credit control. The strength of the indirect effect depends as before upon R, the elasticity of the supply of and demand for money and deposits, and the location of advance deposits. Since the licensing system fixes the level of imports, advance deposits can be used like changes in reserve requirements or open market operations to influence the cost and availability of credit. Any built-in stablization effect is precluded, however, by the rigidity of import licensing.

Effects of an Export Bonus Voucher Scheme

An export bonus voucher scheme introduces an element of flexibility in licensing, so that imports are not rigidly fixed and can be influenced by advance deposit requirements. But imports can vary only with exports so advance deposit requirements can reduce the level of imports only by reducing the level of exports *via* the price of bonus vouchers. The decline in the price of bonus vouchers depends on the strength of the direct and indirect effects. This decline diminishes the incentives to export thereby reducing the amount of bonus vouchers earned and depressing the level of imports. Moreover, since bonus vouchers earned represent only a fraction of the value of exports, advance deposits can reduce imports only by reducing exports more, thus adversely affecting the balance of payments.

It should be noted that while the advance deposit requirement will continue to operate as a built-in stabilizer in the manner described before, its effect may be swamped by the destabilizing mechanism inherent in the bonus voucher scheme. This is because inflationary demand pressures lead to higher prices for bonus vouchers and greater incentives to export. Increased exports will themselves have an inflationary impact on the economy, and since the accompanying rise in imports will be only a fraction of the export rise, the net result will be further inflation of incomes. However, it may be

pointed out that the force of the destabilizing mechanism depends upon the degree of inflexibility of import licensing.

SECTION IV: THE EXPERIENCE OF 1950-53

It is extremely difficult to test empirically the effectiveness of advance deposit requirements in Pakistan during the years 1950/51 and 1952/53. This is partly due to the non-availability of statistical information. Even if more information were available, however, the problem of identification would remain, as it is not possible to isolate the effects of other policy measures and exogenous forces on imports. Nevertheless, for what it is worth, we will review very briefly the experience of 1950-53[12].

The following table reflects the fluctuations in imports over the year 1948/49 to 1952/53.

TABLE 3

Rate of change of Imports of the Private Sector: 1948/49—1952/53

Year (July/June)		Total imports of the private sector (million rupees)	Percentage rate of change
1948/49	..	755.8	..
1949/50	..	749.3	—.86
1950/51	..	1,170.0	+56.1
1951/52	..	1,758.7	+50.4
1952/53	..	1,170.7	—33.4

Source: Based on data from Central Statistical Office, *Statistical Bulletin*, 1953.

As pointed out earlier, advance deposits were introduced for the first time in September 1950 and remained in operation untill March 19, 1951. During the year 1950/51, imports rose above the previous year's level by 56.1 per cent. This was a period of high export receipts due to the Korean boom, and consequent inflation of incomes in the domestic economy. The following year (1951/52) in the absence of advance deposit requirements, the percentage increase of imports was 50.4 per cent. The Korean boom

[12]. No attempt is made to base a judgement on the 1957/58 experience because the margin requirement was only 15 per cent.

was on the wane and the index of Pakistan's terms of trade showed a decline to 118.1 from 124.8 of the previous year. But large foreign exchange reserves had been accumulated and these led to a liberalization of the import policy. Ultimately, with foreign exchange reserves exhausted and the Korean boom completely faded away, stringent direct import control measures were introduced in 1952/53. Advance deposit restrictions were more stringent this time, and also bank financing of advance deposits was prohibited. Imports declined by 33.4 per cent.

The above description of fluctuations in imports, does not make it possible to draw definite conclusions. But we may say that an extremely sharp rise in imports in 1950/51 was not prevented by the advance deposit requirements. The decline in imports in 1952/53, coinciding with more stringent margin requirements might on the surface suggest a conclusion in favour of its strong restrictive effects. This would, however, be misleading as imports were largely determined by the licensing system.

The possibility of ineffectiveness of advance deposit requirements in 1950/51 may be strengthened if we go back to our earlier estimates of C and R. The highest value of C achieved under the most stringent requirements comes to about 1 per cent of the total cost of importing. Thus, the direct effects were likely to be negligible, particularly since credit could be extended for the purpose of furnishing the margin requirements. The availability of financial resources to make advance deposits could not be a crucial bottleneck in decisions to import, because of the elastic supply of credit as suggested by the Table 4 on the following page.

The percentage expansion of bank credit during the period 1950/51 was at a maximum for the period covered, the change being +45.6 per cent. In 1952/53 with an inelastic credit supply, rigid licensing prevented any important direct effect from advance deposits.

The indirect effects are similar, as R for 1950/51 was estimated to be about 3.3 per cent. This is probably not sufficient to bring about any significant indirect effect, especially when the supply of credit during the year 1950/51 was very elastic. It is possible, however, that in 1952/53 the combination of higher margin requirements and inelastic credit produced a moderate indirect effect.

CONCLUSIONS

(1) The requirement of advance deposits on imports is not simply a selective instrument, directly affecting imports, but is a general credit control instrument as well (under the assumption of less than perfectly elastic credit

TABLE 4

Rate of change of Scheduled Bank Credit to the Private Sector: 1948/49—1952/53.

(*Million rupees*)

Year (July/June)	Total bank credit to the private sector	Percentage rate of change
	(average of twelve months)	
1948/49	378.2	..
1949/50	468.7	+23.9
1950/51	683.0	+45.7
1951/52	766.8	+12.2
1952/53	748.4	— 2.2

Source: *Banking Statistics of Pakistan*, 1948-57. (Karachi: State Bank of Pakistan, 1958).

supply). This is true even when advance deposits are located at the commercial banks, since the requirement increases the total demand for money and deposits. It is even more true, of course, when advance deposits are located at the State Bank, for then bank reserves are also affected. While at times general credit constraint would be desired along with a direct discouragement to imports, this may not always be true. In any case, there is some advantage in separating selective from general credit controls. If, however, the arsenal of credit control weapons is deficient, advance deposits on imports may be acceptable as a second-best alternative, since fluctuations in imports are likely often to be closely correlated to general movements of monetary demand. Under rigid licensing of imports, the system operates, of course, only as a general credit control instrument.

(2) The system has not been administered in Pakistan in the past so as to yield either a strong direct or indirect effect. For a stronger direct effect (C) what is required is some combination of higher margin requirements (M) and a longer period of retention (t) *plus* an inelastic credit supply and the prohibition of bank lending to finance advance deposits. Higher values for M and t will also produce a stronger indirect effect, as will an increase in the proportion of imports subject to advance deposit requirements. Furthermore, the strength of the indirect effect can be augmented several times simply by requiring the transfer of advance deposits to the State Bank.

(3) Under a system of import licensing[13] combined with export bonus vouchers, advance deposit requirements introduce a destabilizing influence in the balance of payments policy. Imports are discouraged only as exports are discouraged more. Therefore, it would seem desirable to remove advance deposit requirements from bonus voucher imports. Curiously, it is precisely on these imports that the present advance deposit requirements are imposed.

[13]. It is assumed that the licensing system is not so flexible as to match perfectly changes in exports with changes in import licences granted.