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Emerging Capital Markets Development: A Case Study of Pakistani Equity Markets

SYED FURQAN HAIDER SHAMSI and NIGHAT BILGRAMI-JAFFERY

I. INTRODUCTION

The purpose of the study is to trace and review the growth and development of the Pakistani Equity Market. The capital markets in Pakistan has been undergoing a major restructuring programme. Number of measures have been taken to liberalise investment procedures and encourage capital formation through stock exchanges, enlarge size and depth of capital markets.

We are witnessing globally a remarkable pace of change from a social and economic perspective. Capital markets being driven by the floods of competition and technology are experiencing so many new challenges and changes inducing them to incline more towards complex structures which would not have been considered possible few time back. Capital markets play an important role in the economic development of emerging capital markets. These markets are an important and efficient conduit to channel and mobilise funds to enterprises, and provide an effective source of investment in the economies they serve. Well functioning markets ensure that both corporations and investors get or receive fair prices for their securities. Their role for mobilising savings for investment in productive assets is acute which subsequently enhance the country's long term growth prospects. Therefore we can deduce here that their role is like a major catalyst for transformation of the country's economy into a more efficient and competitive emporium within the global workroom.

Applied privatisation efforts and reliance on market forces through the development of capital markets brought about unprecedented economic expansion for various economies. The known facts have shown that the improved economic performance of a country lead to a rise in the share prices. Consequently equity markets grow to be better organised coupled with more attractions for international investors prompt them to be more active. The presence of mature and comprehensive capital market is critical in achieving and maintaining a exceptional growth of a nation.

Syed Furqan Haider Shamsi and Nighat Bilgrami-Jaffery are Research Fellow and Senior Research Economist, respectively, at Applied Economics Research Centre, University of Karachi, Karachi.

The rest of the paper is organised as follows: The following section unfolds the development and growth circumstances of Pakistan. Section three covers the Institutional Framework and Regulatory Developments. Section four encompass the demand and supply of the equity followed by the Ratio Analysis as section five. The concluding remarks are given in Section six.

II. DEVELOPMENT OF PAKISTANI EQUITY MARKETS

The main equity market in Pakistan, The Karachi Stock Exchange (KSE), offers a set of circumstances that qualifies it as a good case study. Founded in 1947, it is being referred to as one of the oldest stock markets among the developing countries. There now dominates with 80 percent of the total trading. KSE is also one of the first emerging market to be largely opened to international investors, with the lifting of the restrictions. Between 1960 to 1981, the State Bank of Pakistan's Index of share prices increased at an annual compound rate of 3.3 percent whereas between July 1981 and June 1992 it grew at an annual compound rate of 19.74 percent. International Finance Corporation (IFC), the monitoring body for emerging capital markets, around the same period ranked Pakistan third after Argentina and Columbia in terms of one year performance.

The development of the capital markets is termed as necessary condition for the sustainable growth of the economy. But this growth itself depends upon the legislative and fiscal framework of the country, demand and supply patterns of the securities. The Pakistani government clearly focussed on the importance of the capital markets and moved more towards the market-oriented scenario. Government role in the sanctioning and approval for investment was quite eliminated but have still some room for reforms. Studies of Khilji (1993) shows that investors in the Pakistan stock market who have diversified portfolios comprising of stocks of different industries are subject to the same amount of risk as investors with one industry portfolio. The significant developments in the country's market are generally attributed to the government's increasing liberalisation measures that provided for loosening of foreign exchange controls, foreign investment to the market and easing of investment and banking sector regulation. These developments were the start towards the better channelling of financial resources for productive investments. The need was to control interest rates, which were and are conducive to the savings and investments. Basically capital market refers to institution and individuals, which helps in facilitating the societies saving into productive investments. The effect of the de-regularity and market opening reforms in 1991 was clear in the form of significant expansion of activity and institutional dynamism at KSE by showing increased number of companies listed, market turnover and market capitalisation. But facts also reveal that the after-effects of this increased activity were not much significant that reflect major investment based on the market fundamentals but rather the appearance of speculative bubbles associated with a

heightened volatility and complete not-linearity. Finding the market very attractive, the foreigners in 1991 responded well to the policy. On account of exemption from capital gain tax and relative under pricing, the market made much attraction for them. Such situation of foreign presence, establishments of central depository and custodian services have created better picture for the investors. The peak was reached on January 6th 1990 when the index was 1714. During 1991 the market was small and relatively inactive many blue chips were thus undervalued. However with increasing activity from local and foreign investors both due to reforms the stock prices rose across the board especially in the textile and the modarba sectors.

In the succeeding year the index after reaching its peak in 1992 declined to 1084 during 1997 and it is agreed that a correction of 37 percent within 15 months was made. This fall is attributed to the political situation prevailing in the country like the dismissal of the government at that time. Then in 1994 march the index reached the peak of 2661—a rise of 145 percent. The investors both foreign and local entered the market with great willingness and zeal.

The contagion effects of the Russian crisis, share prices in the late 1998 took a upward turn and improved substantially. The serious damage was observed in the following quarters of the nuclear denotations conducted by Pakistan. IFC's emerging market fact book reveals some interesting statistics (see Table 1–4). The IFC index was down 37.4 percent and the KSE-100 index[1] fell below the base level of 1000 in the first time in back decade. Equities on the Karachi Stock Exchange suffered along other emerging markets in 1998 as the consequence of the Asian crisis. The dollar based IFC Pakistan index shed 61.9 percent highest among India and Indonesia whereas Korea, Thailand and Malaysia increased—Korea being the highest from –68.7 percent to 122.1 percent while the local KSE-100 index fell 46.1 percent in rupee terms.

In 1998, Pakistan stock market was ranked 82nd out of 87 world markets by percentage change in price indexes in US$. It was ranked 9th among world markets and 7th among the emerging markets by turnover ratios percent. In terms of market capitalisation, it went up gradually from US$ 2457 in 1989 to US$ 12263 in 1994, exhibiting a major fall in the following years to US $5418 in 1998. Pakistan internal turmoil played a major role in undermining the confidence of both domestic and foreign investors. The growth of market capitalisation was an average against the other markets like India US$ 105,188 declined from US$ 128,468 during 1997. Thai US$ 34903 and Indonesian markets US$ 22104, which declined from US$ 91816 in 1996 to US$ 29105 during 1997 fluctuations in 1994-98. The IFC index for total returns show a mixed trend. Initially it went up to 1721 percent in 1991 then in the following years showed a negative and positive trend during 1992 and 1998. Other

[1]This includes 100 companies and also many small companies selected from all the sectors by computing their representations through the no. of listed companies in a particular sector, their paid up capital and turnover.

Table 1

IFC Total Return Index (%)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
India	4.3%	18.8%	18.4%	22.9%	18.8%	7.4%	–34.2%	–2.1%	7.1%	–13.6%
Indonesia	–	–0.6%	–42.3%	2.9%	113.4%	–19.3%	12.0%	19.8%	–73.7%	–28.7%
Korea	7.0%	–25.4%	–15.9%	3.6%	20.9%	19.1%	–6.9%	–38.2%	–68.7%	122.1%
Malaysia	44.0%	–11.2%	12.1%	27.9%	102.9%	–21.5%	3.6%	24.5%	–71.7%	1.4%
Pakistan	6.4%	11.1%	172.1%	–18.4%	56.2%	–8.5%	–31.1%	–19.5%	26.1%	–55.9%
Thailand	100.8%	–20.7%	19.2%	40.3%	103.0%	–11.3%	–1.4%	–36.5%	–79.3%	32.7%

Source: Emerging Stock Market FactBook 1999, IFC.

Table 2

Value Traded (US$ Millions)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
India	17362	21918	24259	20597	21879	27290	13738	26599	53954	64498
Indonesia	541	3992	2922	3903	9158	11801	14403	32142	41650	9709
Korea	121264	75949	85464	116101	211710	286056	185197	177266	170237	137859
Malaysia	6888	10871	10657	21730	153661	126458	76822	173568	147036	28835
Pakistan	193	231	620	980	1844	3198	3210	6054	11476	9102
Thailand	13452	22894	30089	72060	86934	80188	57000	44365	23119	20734

Source: Emerging Stock Market FactBook 1999, IFC.

Table 3

Market Capitalisation (US$ Millions)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
India	27,316	38,567	47,730	65,119	97,976	127,515	127,199	122,605	128,466	105,188
Indonesia	2,254	8,081	6,823	12,038	32,953	47,241	66,585	91,016	29,105	22,104
Korea	140,946	110,594	96,373	107,448	139,420	191,778	181,955	138,817	41,881	114,593
Malaysia	39,842	48,611	58,627	94,004	220,328	199,276	222,729	307,179	93,608	98,557
Pakistan	2,457	2,850	7,326	8,028	11,602	12,263	9,286	10,639	10,966	5,418
Thailand	25,648	23,896	35,815	58,259	130,510	131,479	141,507	99,828	23,538	34,903

Sources: Emerging Stock Market FactBook 1999, IFC. Various publications of Khadim Ali Shah Bukhari & Co. Ltd.

Table 4

No. of Listed Domestic Companies

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
India	2407	2435	2556	2781	3263	4413	5389	5999	5843	5860
Indonesia	57	125	141	155	174	216	238	253	282	287
Korea	626	669	686	688	693	699	721	760	776	748
Malaysia	251	282	321	369	410	478	529	621	708	736
Pakistan	440	487	542	628	653	724	764	782	781	773
Thailand	175	214	276	305	347	389	416	454	431	418

Source: Emerging Stock Market FactBook 1999, IFC.

markets in the region also reveal the same trend. An interesting feature in this context for the Pakistani Stock Market is, its negative correlation of total return index with the other world markets. This act as best indicator for the foreign investors to diversify their portfolios [Harvey (1995)].

Price and return patterns reveal many critical issues to be placed in the context of emerging markets. Many stock markets in developing economies offer yield far in excess of industrial-market returns and low-to-negative correlation with the world markets, which evidently suggest that unexploited profit opportunities may exist. Rapidly rising price earning ratio signal ongoing transition in emerging markets. IFC Emerging Markets Database (EMDB) tracked down a more than doubled price to earnings ratio and more than tripled in four economies includes Pakistan, Argentina, Chile and Turkey during 1988–91. High Price volatility in Pakistani equity market stemmed from small market effects and international imperfections. Investors typically have less information about firms and receive less frequent updates than do the investors in industrial markets. The interests in the public can be sustained through the formal informational networks. The current exposure of the stock market in the media is helping to bridge this gap. The peculiar risk of investing in the emerging markets, besides the currency, political and investment risk is the risk arising out of the development stage of emerging market. The major attraction of forming international portfolios lies in the risk reduction through diversification of the unsystematic risk. Pakistani equity market attracted international attention. The market took upward trend by adopting measures like liberalisation of the economy, relaxation of forex controls and easing of regulations on repatriation of profits, investment and operations of financial institutions.

There is an inherent fault in the interaction of the buyers and sellers at the KSE that neither side i.e. buyers and sellers of equity are willing to transact large volumes at reasonable prices. They only get into this condition when there is a demand or supply shocks, which certainly exhibits a problem of a non-liquid market.[2]

III. INSTITUTIONAL FRAMEWORK AND REGULATORY DEVELOPMENTS

The existence of a healthy capital markets provides individuals and institutions with saving, consumption and investment options. It facilitates the flow of society's savings into productive investments. Financial sector of Pakistan, starting in the seventies, was mostly dominant by the government. Financial scene of the Pakistan is divided into two broad categories; (a) non-securitised financial institutions; and (b) securities markets.

[2]Liquidity in an equity market is a condition created when buyers and sellers of securities are willing to trade large quantities at reasonable prices.

Non-securitised institutions consist of three categories further. First, Commercial banks second official development financial institutions and third leasing companies, Modarbas and investment banks. Early in the last decade, the banks focussed on the short-term trade financing or working capital requirement instead of term financing. The major supplier of the term financing in Pakistan is development financial institutions. Also included in the financial picture of country is lease financing. Second category of financial framework is the securities market, which had a market capitalisation of US$ 5418 in 1998. Number of listed companies were 773 with a trading volume of US$ 9102 falling from US$ 11,476 in 1997. For India increased to US$ 64498 from US$ 53954 and for Indonesia increased to 9709 from US$ 23119 With the recent trend of globalisation and the upcoming frenzies of world integration, and due to a large cross border transactions, the legislative framework of the country must also provide comfort to the foreign and domestic investors. As pointed out before, the regulatory framework of the country's capital market underwent many changes during the last decade. The increased role of the private sector has inevitably added to the importance of capital market as a source of financing not only industrial activity but also infrastructure facilities. Certain laws, regulation are contained in the regulatory scene of the capital markets in Pakistan. Significant laws include companies Ordinance, 1984 and the Securities and Exchange Ordinance, 1969 and rules framed in 1971.

Many aspects of the capital markets were governed by the Capital Issues (Continuance of Control) Act, 1947 along with the Capital Issues Exemption Ordinance and number of statutory orders under the act until 1995. Stock Exchanges, the self regulatory bodies, are governed by the respective articles an Memorandum of Association and various rules and regulations which are introduced after approval by the Corporate Law Authority (CLA), now Securities and Exchange Commission of Pakistan (SECP).

During 1994–1996, several amendments were observed in the law governing the capital markets with the objective of making the markets consistent with the policies of economic liberalisation and opening of the market to the foreign investors.

(1) Through the finance act of 1995, the Capital Issues (Continuance of Control) Act, 1947 was repealed and a new system consistent with the requirement of the then stage of the development in the market was introduced. More powers were transferred to the market forces in the pricing of the issues. Due to this, The companies were no more forced to issue capital to the general public irrespective of the size of the paid up capital. Initially Act of 1947 was to ensure chanellisation of resources to the activities that were productive. The act provided for control rather than regulation of the primary market.

(2) Another development trough the finance act of 1995 was that companies were allowed to issue term finance certificates (TFC) to the general public rather than raising resources only from the financial institutions. This helped removing the regulatory constraints for the growth of an investment instrument.
(3) Section 208 of Companies Ordinance dealing with inter-corporate financing by companies was reviewed through finance act of 1995. It was made sure that the injudicious use of the section was limited.
(4) For the prohibition of insider trading on stock exchanges, another section 15-A was included. Which provide that the employees and other persons who have privileged price sensitive information about a company during the last six months should not deal in securities of the company.

Over all as a result of financial reforms and the amendments introduced by the government, there was a qualitative change in the stock markets. These reforms have also been coincided with an increase in foreign fund portfolio flows to the most emerging markets at a level previously unknown. Mobius (1992) discussed that the taxation structure of a country should be well adapted to the operations of foreign funds in the country and it should be ensured that foreign fund managers do not face the problems of double taxation of their returns, i.e., once in the country of the emerging market, and again in the home country of the fund, once money is repatriated.

The regulatory framework itself needs to be more dynamic in response to rapidly changing stock markets. Although much work ahs been done regarding the reforms but the investors are unaware of the precise scope of the changes being introduced and the speed with which these will be instituted.

Government through institutions can do a lot to reduce the uncertainty and therefore risk, by increasing flows, by punishing those who violate laws and by other measures that will increase investor's confidence. In-fact it is a very difficult task to reconcile a policy of regulation of the securities market with the spirit of deregulation and liberalisation of the economy. What Drake (1977) has termed as Regulatory Overkill is not needed b the emerging markets. The market activity should be made viable, no to be dominated by speculative trading.

Major statutes relating to corporate and financial sector in Pakistan are as follows:

- The Securities and Exchange Ordinance, 1969 and the Securities and Exchange Rules, 1971.
- The Investment Companies and Investment Advisers Rules, 1971.
- The Companies Ordinance, 1984 and Companies Rules framed there under.
- The Capital Issues (Continuance of Control) Act, 1947.

- Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance, 1970.
- Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980.
- Institute of Chartered Accountants Ordinance, 1961.
- Companies (Appointment of Legal Advisers) Act, 1974.

The government of Pakistan with collaboration with Asian Development Bank (ADB) formulated a Capital Market Development Programme (CMDP) during 1997-98. Inasmuch as appeared in the State Bank of Pakistan (SBP)'s 1997-98 Annual Report as Appendix VII, it states that "The main objective of the CMDP are to increase mobilisation of long term resources, bring about efficient resource allocation, making the capital market diversified and competitive and thus encourage broader participation of issues and investors".

IV. DEMAND AND SUPPLY FOR EQUITY

Wai and Patrick (1973) revealed in their study that most savers in the less developed countries are risk averse due to capital market imperfections that demand for fixed yield claims with high liquidity. The scarcity of the information is one of the features, which affect the investor's decision, and further to the demand of the equity. Other reasons for the aversion to investment in equity market involves taxation policies, inflation and devaluation. High unstable and unanticipated inflation rate induces investors to move out of financial assets. During a period of high inflation, it is assumed that equity investments would provide a good hedge. When inflation is high and unanticipated, the firms are directly affected in terms of rising interest rates on debt finance. The inflation-induced needs of higher working capital often result in the reduction of cash dividends [Errunza *et al.* (1981)].

The best incentive for the favourable demand for equity is through attractive taxation measures in favour of investors. Many policies involving fiscal measures have not been able to guarantee a change in the behaviour in the equity markets. Although capital gain tax was exempted for a period, capital value tax was withdrawn and dividend income up to Rs 10,000 was tax exempt. Changing the investors' attitudes towards the equity market for a better mobilisation of the resources is needed. In this regard, the effective enforcement of several acts by CLA (now SECP) is committing a sound effect on the investors perception and demand for equity securities.

During the period 1989–98, there were increases in number of listings at KSE from 440 to 773. In terms of comparison with emerging markets, the number of listings, there is a significant increase in the market capitalisation. But in terms of float, it is very limited. In fact for the period 1989–94, there was a light control over share issues by several participants like sponsors, institutional investors and large

brokers. Another potential supplier of equity lies in the government held industrial units. Interest rate liberalisation from the supply pint of view is important in order for the supply of capital to be accurately priced. The common factor observed in the LDCs is the equity financing as the preferred mode of financing over the debt financing. Therefore, for many companies' equity financing remained a one-time venture by means of which more debt could be raised by pledging equity. In early 1990s, the borrowing rates increased from 15 percent to 23 percent which evidences that more borrowers were turned to equity finance.

V. RATIO ANALYSIS

Investigations in Tables 5 and 6 reveal that the current ratio showed an average of 1.01 over the last decade, which envisaged a 1:1 ratio (Figure 2). As this is a qualitative index of liquidity which is implying that for current and short-term liabilities to meet there were equal assets available. The flow of funds through current assets and liabilities were smooth resulting the notion that inflows exactly equalled maturing obligations. The trend of Quick ratio and debt-equity ratio was observed to appraise the financial structure of the joint companies. The relevant contribution of creditors and owners of business in the financing is being reflected by this. The figures fairly suggest that owners are equally participating for business financing while the debt ratio remained almost stagnant during the study period. The Z-score model was calculated to interpret the efficiency of the companies. Comparing with Altman's data yield that it is at par with the danger zone. Performance of the joint stock companies listed on KSE was on a downward trend during the last decade as measured by Return on Equity. Although it improved in 1993 but fell to 3.2 percent in 1994. (Figure 1)

Table 5

Dividend Ratio to Equity (%)—Pakistan

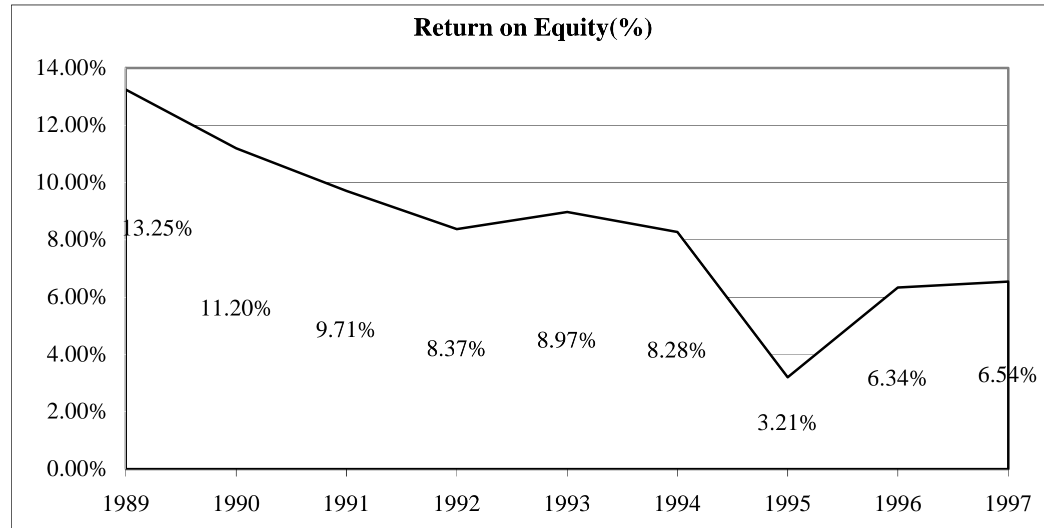
	Sectoral View		
	Overall	Public	Private
1989	6.2%	4.4%	8.8%
1990	5.0%	2.7%	7.3%
1991	4.5%	2.8%	5.9%
1992	5.5%	3.2%	6.8%
1993	4.8%	2.1%	6.3%
1994	4.4%	1.8%	5.4%
1995	3.0%	1.0%	3.7%
1996	4.3%	3.5%	4.8%
1997	6.3%	9.6%	4.4%
1998	–	–	–

Source: Balance Sheet Analysis of Joint Stock Companies Listed on KSE. State Bank of Pakistan (Various Issues).

Table 6

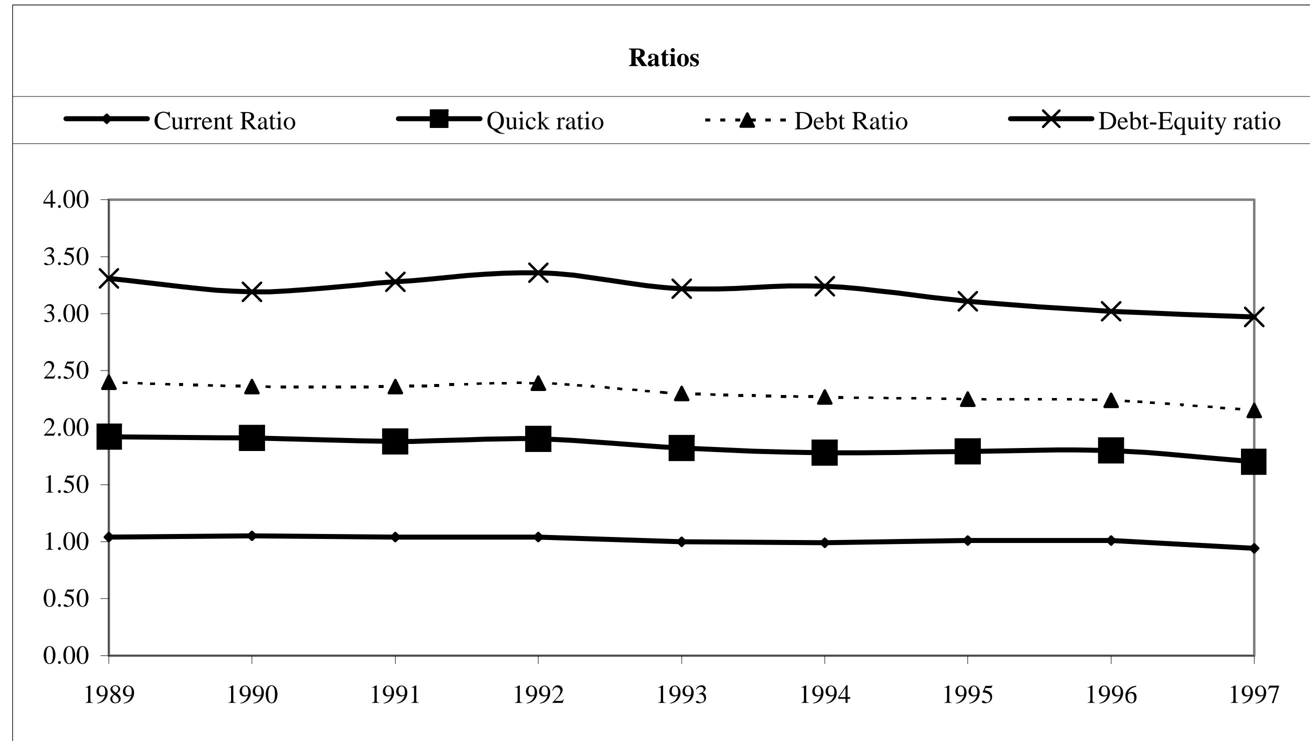
	1989	1990	1991	1992	1993	1994	1995	1996	1997
Current Ratio	1.04	1.05	1.04	1.04	1.00	0.99	1.01	1.01	0.94
Quick ratio	0.88	0.86	0.84	0.86	0.82	0.79	0.78	0.79	0.76
Debt Ratio	0.48	0.45	0.48	0.49	0.48	0.49	0.46	0.44	0.45
Debt-Equity ratio	0.91	0.83	0.92	0.97	0.92	0.97	0.86	0.78	0.82

Source: State Bank of Pakistan (Various Issues).



Source: State Bank of Pakistan (Various Issues).

Fig. 1.



Source: State Bank of Pakistan (Various Issues).

Fig. 2.

VII. CONCLUDING REMARKS

In the recent times East Asia has undergone economic miracles, yet not immune to short-term setbacks. Real estate and stock market reversals have occurred in many countries. As exchange rates have been adjusted in Indonesia and Thailand in the recent past all the regions economies need to develop their financial markets to mobilise long-term funds for infra structure financing and other long-term adjustments. Pakistan is not the exception. Equity market development is also essential for rapid structural changes in the real economy which is important for good corporate governance. Need of the day is to address the structural weaknesses quickly, understanding the importance of the integral global economy.

Today the issue is not whether to reform, but how and at what level, and at the same time also maintain the financial stability. The key factor is to modernise the financial system, which requires careful work and a broad range of topics e. g. automation in the market developing the infrastructure and necessary human skills. Expansion of investor base, developing of mutual funds and improving the liquidity of the securities markets.

To sum up, in order to achieve compliant and resilient financial system it is perquisite to adopt a consistent set of reinforcing policies—Financial reforms will take time though.

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Comments

The paper by Dr Nighat Bilgrami and Syed Furqan Shamsi is very interesting and contains some useful information regarding capital market.

I have some suggestions for the paper. I think that the paper is not very well organised. The authors should have started the paper by discussing the importance and role of capital markets in economic development and then proceeded to show the growth and development in the Pakistani equity market.

Moreover, some discussions are made without providing proper back-ground. For example, it is stated that International Finance Corporation (IFC) ranked Pakistan third after Argentina and Columbia but the period of the ranking is not mentioned. Similarly, it is claimed that the KSE offers a set of circumstances that qualifies it as a good case study, but these circumstances are not discussed. Another example, it is argued that significant developments in the country's market are generally attributed to the government's increasing liberalisation measures but it is not clear what really these significant developments are. What I mean to say by citing these examples is that the reader should be provided complete and comprehensive picture of what is going on.

Another problem with the paper is that conclusions are made without providing supporting evidence. For example, it is concluded that the negative correlations of stock returns in Pakistan with those in the other world markets act as a diversification tool to foreign investors but the correlations are not reported. Similarly, conclusions are made regarding two to three times increase in Price-Earning ratio without reporting these ratios. It would have been much better if these statistics had been provided.

The authors did a great job in the presentation of institutional framework and regulatory developments. Finally, the ratio analysis would have been more useful if these ratios had been compared to the average ratios of say, world capital market, emerging capital market, or selected regional markets.

Fazal Husain

Pakistan Institute of Development Economics,
Islamabad.