

The financial markets showed strong resilience to external spillovers owing to improved economic conditions, effective policy implementation, and positive sentiments of domestic and foreign investors. The overall stability of financial market strengthened; PKR showed relative stability against US\$ compared to most of the other regional currencies, though some volatility was observed in equity market post Yuan devaluation period. More transparent and effective monetary policy implementation mechanism complemented by prudent liquidity management by SBP helped in effective implementation of SBP's monetary policy stance in the financial markets. The positive prospects and adequate capacity on domestic front is expected to keep financial markets running smoothly during CY16.

Global environment has been non-conducive for emerging markets in CY15...

The global financial markets were hit by bouts of volatility in CY15 due to dull growth prospects of the world economy and uncertainty about the future direction of economic policies in major economies. The currency and equity markets in majority of the emerging economies remained under pressure as the Chinese economy continued to slowdown, growth in the European Union remained subpar and commodity prices kept tumbling.

The devaluation of Chinese Yuan in August 2015 coupled with the – long anticipated - rise in policy rate by the Federal Reserve (Fed) led to market corrections and assets re-pricing in most emerging markets. The fears of global slowdown, deflation and declining world trade further aggravated the stress in the markets.

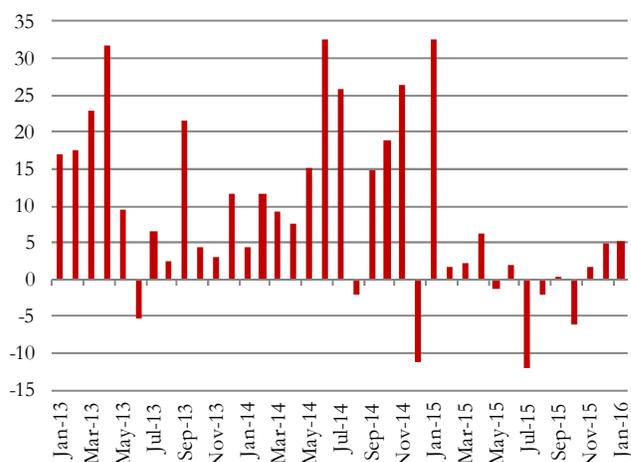
Owing to such non-conducive global environment, investors' risk appetite for emerging markets dwindled and funds not only flew out of the equity markets but investments also decelerated in debt markets (Figure 7.1).

Figure 7.1

### Net portfolio flows (debt) in emerging markets decelerated

Net Portfolio Flows (debt) in emerging markets

(IIF debt index)



Source: Institute of International Finance (IIF) / Bloomberg

Domestic financial markets exhibited strong resilience ...

Despite the spillover of global environment transmitting to the financial markets of Pakistan, the volatility in domestic markets remained relatively low. Positive developments on domestic front and strong performance in few corporate sectors helped instill some stability in the Equity market.

The introduction of SBP policy rate which targets the overnight money market repo rate in May 2015 coupled with prudent liquidity management that kept the short-term market rates relatively stable and

closer to the target rate, on average, succeeded in keeping the money markets calm.

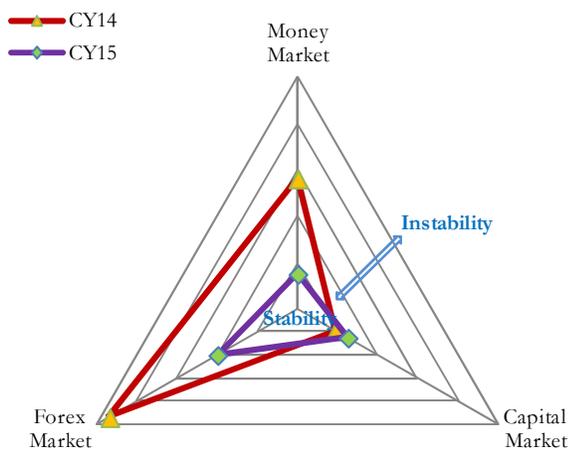
Further, large accumulation of liquid foreign exchange reserves and improvements in external accounts kept the domestic currency stable against US\$.

Overall the stability prevailed in the money, capital and foreign exchange markets in CY15 (**Figure 7.2**).

**Figure 7.2**

**Stability in financial markets have improved in CY15**

Financial market stability map in Pakistan



Note: Volatility in respective markets calculated using Exponential Weighted Moving Average (EWMA) method. Weekly ONR, daily KSE-100 index and daily ER in the interbank have been used as the indicators in the money, capital and forex markets. For details please see Technical Appendix. Source: SBP

## Money Market

*Structural Changes in interest rate corridor initiated concurrent with monetary easing ...*

After remaining flat at 10 percent throughout most of the CY14, SBP slashed its policy rate, cumulatively, by 400 bps since November CY14 to bring it down to multi-decade low of 6 percent at the end of CY15. The reduction was aggressive during the first half of CY15- down by 350 bps. Receding inflation and its benign outlook, improvement in balance of payment position, and

economic growth objective were some of the major reasons that motivated the change in the direction of the monetary policy.

The rate cut in the first half of CY15 was followed by structural changes in SBP corridor in May 2015. A target rate for overnight interbank money market repo rate (ONR) - set 50 bps below the SBP reverse repo rate or ceiling rate – was introduced as the new policy rate and the width of the Interest rate corridor (ICR) was reduced to 200 bps from 250 bps<sup>156</sup>. The intension behind the former policy change was to give unambiguous signal of SBP's stance of monetary policy and the latter was to curtail the dispersion in short-term rates in the money market<sup>157</sup>.

*Introduction of SBP policy target rate curtailed volatility in the money market...*

The initiatives paid off with the stronger transmission mechanism leading to a marked reduction in the volatility in the money market liquidity during the second half of CY15 (**Figure 7.3**). The weighted average ONR closely tracked the SBP target rate in comparison to last year<sup>158</sup>. The regulatory induced discipline is expected to help market participants plan their liquidity operations in a way so as to minimize disturbance of the market.

<sup>156</sup> Besides, SBP also withdrew the penal rate on frequent access (7 times in a quarter) to SBP Reverse Repo and Repo facilities.

<sup>157</sup> The unnecessary volatility in short-term rates creates disconnection between short-term and long-term rates which reduces the effectiveness of monetary policy and weakens its power to effect long-term rates.

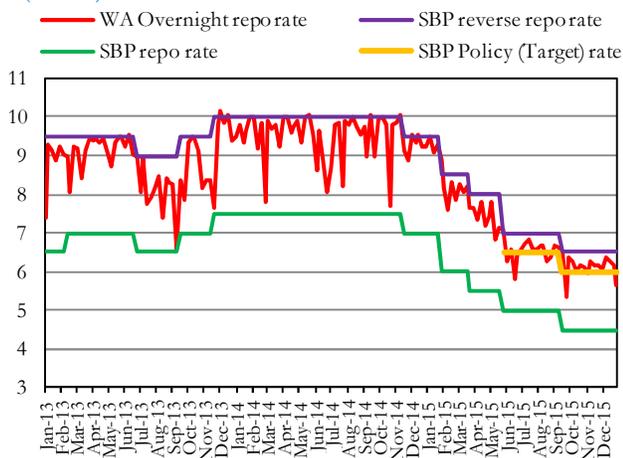
<sup>158</sup> Standard deviation of weekly ONR reduced to 0.35 and 0.16 in Q3 & Q4 of CY15 compared to 0.60 and 0.50 in Q1 & Q2 of CY15.

**Figure 7.3**

**Volatility in overnight repo rate (ONR) reduces after introduction of SBP target rate**

Trend in ONR

(Percent)



Source: DMMD, SBP

*Increased volume and frequency of OMOs were in line with monetary policy objectives...*

Increased instances of liquidity injections via frequent OMOs were needed to align market interest rates with the target rate. Average outstanding OMOs injections of PKR 1.2 trillion were recorded during Jul-Dec, 2015 (average acceptance to bid ratio of 0.94) compared to average injections of PKR 0.71 trillion during the first half of CY15<sup>159</sup> (Figure 7.4). Liquidity injections in CY15 were primarily in line with the easy monetary policy stance of SBP which envisaged money supply (M2 growth) to be consistent with keeping inflation low and providing support to growth<sup>160</sup>.

*Overwhelming banks' interest in PIBs remains intact...*

Investment in the Government securities, serves as a credit risk free source of income stream, continued to drive market liquidity. Medium tenor (3 and 5

<sup>159</sup> Besides, higher injections in second half of CY15 was also driven by high fiscal need and pick up in credit demand from private sector  
<sup>160</sup> For detail explanation, please see the press release at <http://www.sbp.org.pk/press/2015/Liquidity-13-Jan-15.pdf>

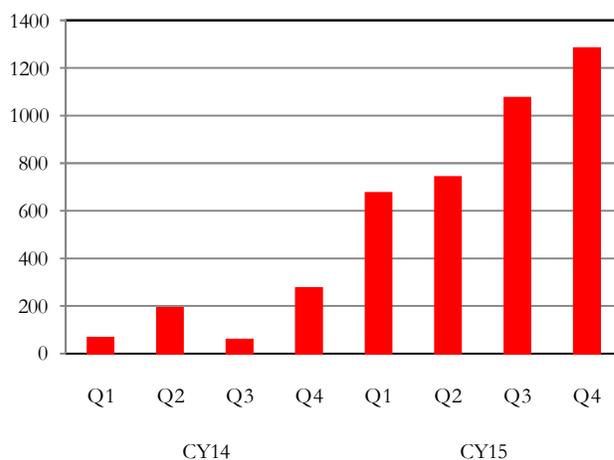
years) PIBs were the main attraction for the market (Figure 7.5). During CY15, banks offered aggregate amount of PKR 2.2 trillion for PIBs with bid-cover ratio (i.e. offer to target ratio) of around 3 on average.

**Figure 7.4**

**SBP conducted more OMOs in order to keep ONR close to the target rate**

Average outstanding Open Market Operations (OMOs)

(PKR billion)



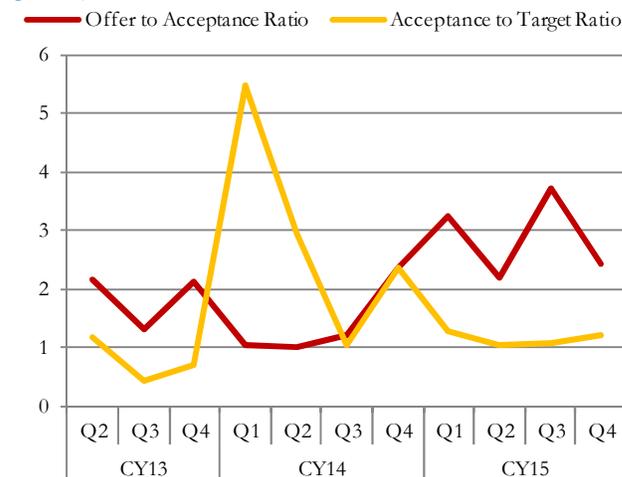
Source: DMMD, SBP

**Figure 7.5**

**Banks' offer to purchase PIBs remained overwhelming**

Target, Offer and Acceptance of PIBs

(percent)

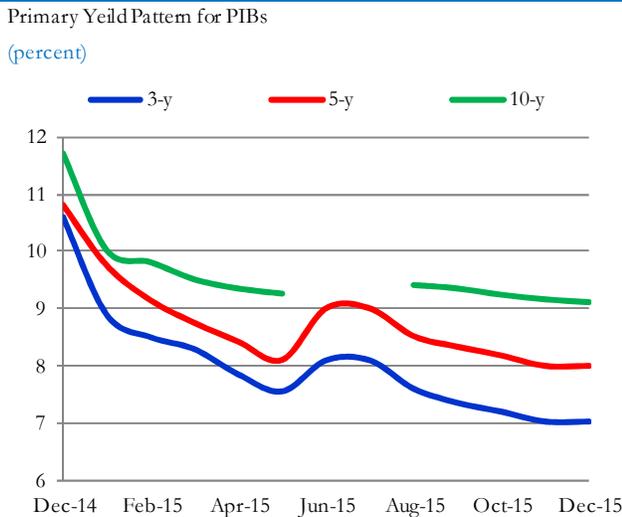


Source: DMMD, SBP

The banks' inclination to lock in their income stream through PIBs in CY15 might have been

driven by an anticipation of expected lower interest rates (due to falling inflation in the short-run and easing-off on external front)<sup>161</sup> (Figure 7.6). From the supply side, government's choice to raise longer-term debt might have been driven largely due to maturity preference (to avoid roll-over risk)

**Figure 7.6**  
**PIBs yield responded to easy monetary policy stance**

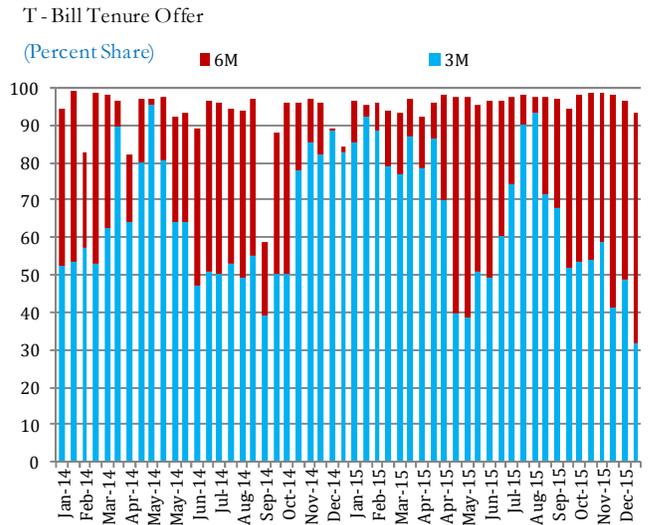


Note: Bids for 10-year PIB tenor were rejected in both June and July 2015 Auctions.  
 Source: DMMD, SBP

*MTB's witness no compositional change...*

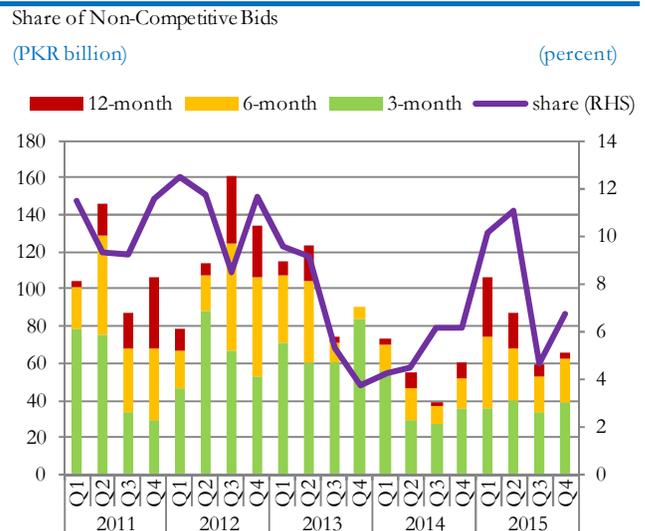
Banks participation in MTBs remained strong and was almost entirely distributed within 3 months and 6 months maturity buckets (Figure 7.7). Banks subscription of 12 months MTBs during CY15 was similar to their marginal participation in CY14.

**Figure 7.7**  
**T-Bills investment offers concentrated within 3 & 6 months securities**



Source: DMMD, SBP

**Figure 7.8**  
**Non-competitive bids' share rises in CY15**



Source: DMMD, SBP

*NCB's were also geared towards longer tenor ...*

Meanwhile, the participation of retail investors in the Non-Competitive Bids (NCBs) also picked up pace during CY15 (Figure 7.8). NCBs share in total acceptance increased to 8.2 percent, on average, in

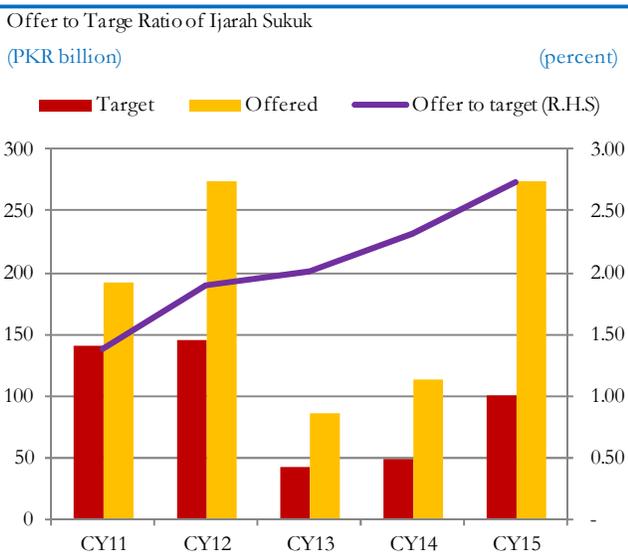
<sup>161</sup> The average monthly yield spread complement this fact as spread between 3 years and 6 months tenor significantly reduced during CY15 (yearly average 53 bps) compared to CY14 (yearly average 191 bps).

CY15 against average 5.3 percent in CY14. Government papers of short term maturity (3-months T-bills) remained attractive for liquidity purposes but longer term maturity papers (6 months & 12 months T-bills) gained popularity due to interest rate expectations.

*Ijarah Sukuk attracted IBIs...*

The much awaited Ijarah Sukuk of PKR 100 billion was issued in the last quarter of CY15. High liquidity parked with Islamic banks and limited avenues available to invest in Shariah compliant products made each issue of Sukuk extremely appealing. There is a consistent rising trend in offer to target ratio of Sukuk since CY13 and in CY15 the offer was 2.7 times the target of PKR 100 billion set by the government (**Figure 7.9**).

**Figure 7.9**  
Ample liquidity resulted in high offer to target ratio for Ijarah Sukuk



Source: DMMD, SBP

The current behavior of market for Shariah compliant investment products, on the one hand, implies that government can easily tap additional resources from this avenue. But, on the other hand, it also reveals that there are limited alternate avenues available in the private sector for Islamic banks to

finance. Perhaps, the lack of demand in the economy and the risk aversion of Islamic banks are the driving factors behind buildup of liquidity with the IBIs.

*Secondary market for government securities is working smoothly...*

An efficient and deep secondary market of government securities is prerequisite for better price discovery, diversification of investor base, liquidity management, and reduction in cost of borrowings. Pakistan has a mature secondary market for marketable government debt securities (MTBs, PIBs, and Sukuks).

CY15 has observed an overall trade of around PKR 11.0 trillion of government securities (PKR 10.6 trillion in CY14). In addition, if repo borrowings of PKR 13.4 trillion in the secondary market during CY15 (PKR 15.5 trillion in CY14) are also included, the overall trade volume reaches to PKR 24.4 trillion during CY15 (PKR 26.1 trillion in CY14). In recent years, SBP has taken several measures to improve the efficiency and depth of trading in secondary markets (e.g. online auction of government securities, issuance of international securities identification numbers, trading of government securities at stock exchange etc).

*Shape of the yield curve hints at rising inflation expectations beyond CY16...*

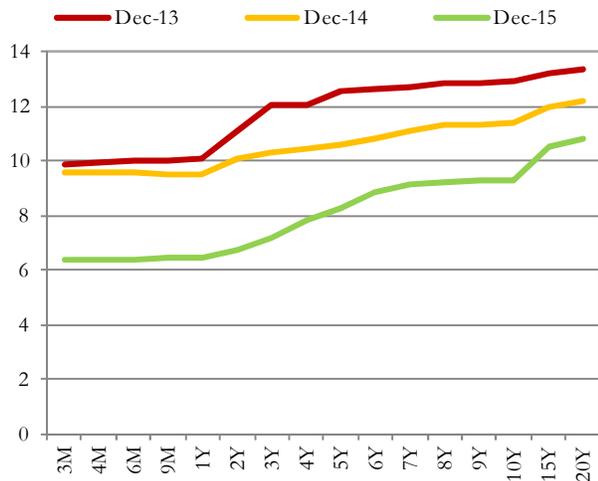
The 350 bps fall in the policy rate during CY15 has led to a downward shift in the yield curve (**Figure 7.10**); indicating the effectiveness of SBP's monetary easing policy. The yield curve as of end Dec-15 is quite flat till 1-year horizon and then rises afterwards. Also, in relation to Dec-14, the gap between the two yield curves is wider at the shorter end but narrower at the longer end.

**Figure 7.10**

**Yield curve depicts rising inflation expectations beyond CY16**

Term Structure of Interest Rates

(Percent)



Source: DMMD, SBP

The shape of the yield curve, therefore, suggests that market is anticipating benign inflation in the short-term and no change in the policy interest rate. However, market expects bottoming out of inflation on account of foreseeable recovery in international commodity prices<sup>162</sup> in the medium-term and likely rise in interest rates.

Since the banking book, at the moment, is exposed to market risk, any movement in interest rates against these market expectations would have adverse consequences for the profitability and solvency of the banking sector.

The pattern of government borrowing will also be a major factor driving the liquidity and volatility in the money market.

## Foreign Exchange Market

*Improved BOP position and accumulated reserves helped stabilize domestic currency...*

PKR against US\$ remained broadly stable, owing to improvement in the external account as well as favorable macroeconomic conditions<sup>163</sup> (Figure 7.11).

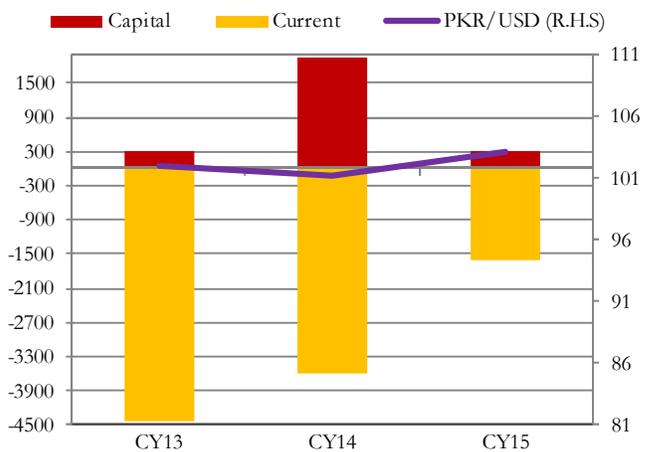
**Figure 7.11**

**BOP improved during CY15**

Developments in External Accounts

(USD million)

(PKR/USD\*)



\* Monthly weighted average Mid buying-selling of interbank rate

Source: S&DWHD, SBP

The low global commodity prices paid off in terms of low import bill, particularly, due to the reduced payments on oil products. This helped in narrowing the trade deficit down to USD 16.6 billion during CY15 as against 17.9 billion during CY14. The successful negotiations with IMF in each quarterly review mission under EFF program, consistent net inflows through worker remittances, receipts against coalition support funds (CSF) and issuance of Pakistan sovereign Bonds helped country's liquid foreign exchange reserves touch the unprecedented

<sup>163</sup> Owing to continued strengthening of external payment position and sustained progress in structural reforms under the government program with IMF, Moody's Investors Service upgraded Pakistan's foreign currency issuer and senior unsecured bond ratings to B3 from Caa1, and assigned a stable outlook in June 2015.

peak in Dec 2015<sup>164</sup> covering almost 28 weeks<sup>165</sup> of imports.

Though strengthening external sector stabilized the market sentiments which translated into relative stability in the foreign exchange markets, few concerns are still worth considering:

- i. The exports of Pakistan are consistently on the declining path (export growth: CY15: negative 8.2 percent, CY14: negative 1.2 percent). The economic slowdown in china (one of Pakistan's major trade partner) and devaluation of Euro have had a dismal impact on the exports of many emerging counties including Pakistan. The consistent appreciation in Real Effective Exchange Rate (REER) over the last couple of years<sup>166</sup> may also have impacted the export competitiveness.
- ii. Already low Foreign Direct Investment (FDI) in CY14 reduced further in CY15. Though, in recent past, FDI flows have also declined globally due to fragility in the global economy, policy uncertainty for investors and elevated geopolitical risks, FDI decline in Pakistan was much higher than the global trend<sup>167</sup>.
- iii. The recent dip in oil prices, if continues, may impact the inflow of remittances coming from the oil exporting countries,<sup>168</sup> going forward. The growth in remittances has

decelerated to 12.1 percent in CY15 from 17.9 percent during CY14<sup>169</sup>.

- iv. To better negotiate with future contingency on external front, permanent nature of foreign exchange inflows (e.g. exports, FDI etc) are needed.

The favorable external position and positive market sentiments complemented with SBP's prudent polices helped stabilize the value of domestic currency against most foreign currencies despite decline in exports receipts during CY15 (**Table 7.1**).

*PKR depreciation in CY15 is in line with trends in emerging markets...*

Though domestic currency recorded depreciation against USD by 4.2 percent during CY15 (mostly in second half of CY15), this was synchronized with accelerating exchange rate depreciation in many emerging economies against USD. The capital flight from emerging markets in search-for yield since US announced "tapering of quantitative easing" had started to build pressure on the currencies of these economies. Further, the devaluation of Chinese Yuan<sup>170</sup> in August 2015, probably to restore its export competitiveness, followed by replica of the same policy stance by many emerging economies - to keep their global share in exports intact - even hit the value of these currencies harder.

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<sup>164</sup> Further, Net International Reserves (NIR) also remained comfortable meeting IMF performance criteria in most of its quarterly review missions.

<sup>165</sup> Source: <http://www.sbp.org.pk/ecodata/FER/2016/Forex-11-Mar-16.pdf>

<sup>166</sup> REER appreciated by 5.2 percent during CY15 and 16.0 percent in CY14.

<sup>167</sup> Source: United Nation Conference on Trade and Development (UNCTD)

<sup>168</sup> Around more than 60 percent of worker remittances inflows are coming from GCC countries.

<http://www.sbp.org.pk/ecodata/Homeremit.pdf>

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<sup>169</sup> Partially, this deceleration may also be due to high base effect.

<sup>170</sup> In August 2015, the china devalued its Yuan by 3 percent in order to gain export competitiveness. China observed negative growth in its exports during July 2015.

**Table 7.1**

PKR Apr/Dep (-) against other currencies - CY15

	(Percent)
South Africa	29.3
Malaysia	17.8
Canada	15.0
Australia	7.4
Euro	6.7
Thailand	5.2
Sweden	4.3
Singapore	2.5
UK	0.8
India	0.4
China	0.4
Kuwait	-0.5
Japan	-3.4
Switzerland	-4.0
UAE	-4.1
<b>USA</b>	<b>-4.2</b>
Saudi Arabia	-4.1
Hong Kong	-4.1

Source: Bloomberg

Pakistan did not opt for the herd prescription of manipulating exchange rates and instead relied on domestic interest rates to spur growth. Moreover, the export growth in Pakistan, besides exchange rate, is mainly dependent upon structural bottlenecks which are beyond the control of any central bank.

#### *Volatility in currency market declines...*

The exchange rate both in the interbank and kerb markets remained stable<sup>171</sup>; though, some volatility was seen post Yuan devaluation after August, 2015 (**Figure 7.12**).

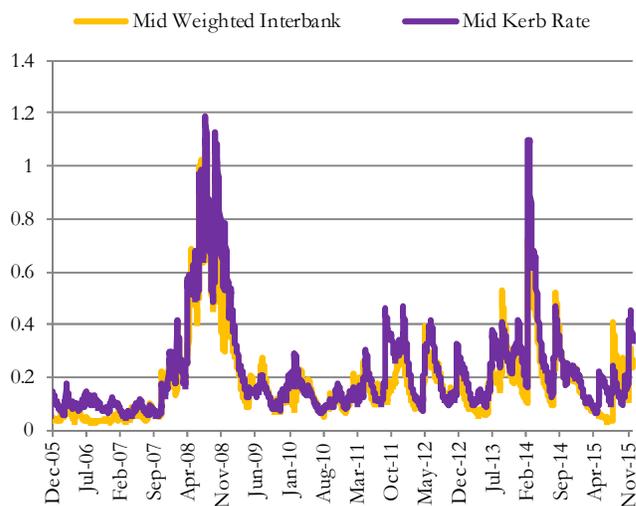
However, during CY15, daily average risk premium on PKR/USD exchange rate in the KERB market (over interbank market) slightly widened and moved

up to 0.78 PKR/USD from 0.59 PKR/USD during CY14 (**Figure 7.13**). The deviation was more pronounced in the second half of CY15.

**Figure 7.12**

Volatility in foreign exchange market curtailed

Exponential Weighted Moving Average of PKR/USD



Source: DMMD, SBP

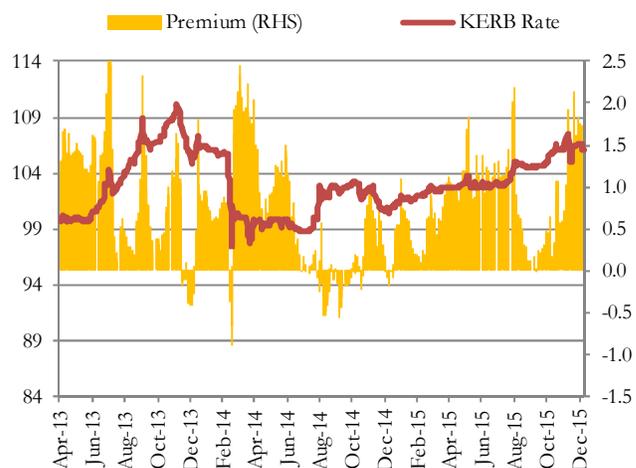
**Figure 7.13**

KERB premium escalated post Yuan devaluation

KERB Exchange Rate and Premium

(PKR/USD)

(PKR)



Source: DMMD, SBP

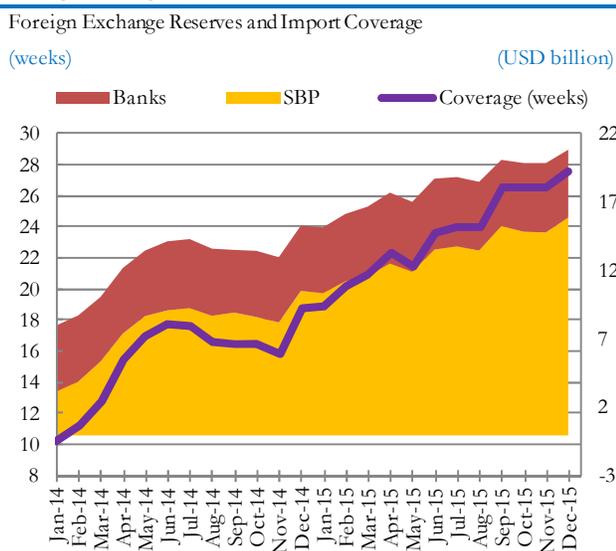
During the reviewed year, the speculative sentiments in retail currency market slightly emerged, perhaps, due to further depreciation of the local currency in

anticipation of rate rise by FED<sup>172</sup>. Further, the average bid-ask spread in Kerb market moved up to PKR 0.26 during CY15 (more so during the second half) compared to PKR 0.21 during CY14.

### Foreign exchange reserves rise in CY15...

With the addition of USD 5.5 billion during CY15 (almost entirely in SBP), the liquid FX reserves of the country touched unprecedented USD 20.8 billion as of end December 2015. Importantly, the scheduled obligations maturing during the year are fully covered by reserves (Figure 7.14).<sup>173</sup>

**Figure 7.14**  
Foreign Exchange (FX) Reserves reach unprecedented level



Source: DMMD, SBP

Going forward, the stability in foreign exchange market may keep on track keeping in view the adequate buffer in the form of liquid foreign exchange reserves held by SBP and depressed outlook of commodity prices especially oil prices.

Further, expected global recovery and developments on the CPEC front will lift up the FDI as well as

<sup>172</sup> Finally, US Fed raised its policy rate by 25 bps in December 2015.

<sup>173</sup> As of end December 2015, foreign exchange reserves has import coverage ratio to around 28 weeks; much higher than the 3 months which is considered the minimum bench mark for reserve adequacy.

exports from Pakistan – more permanent sources of foreign exchange inflows. However, worker remittance inflows may decelerate further from oil producing countries if oil prices continue their current declining trend and development spending in these countries subsides.

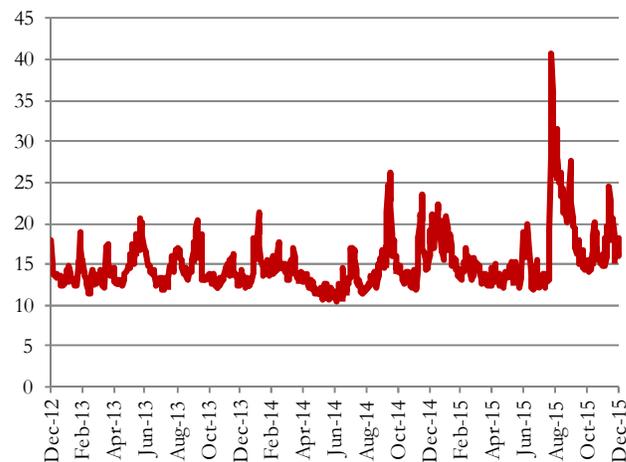
## Capital Market

### Global Equity markets remained volatile in CY15...

Marked with global uncertainty, the reviewed year observed accelerated pace of market corrections in equity markets across the globe. The net selling and capital flight from emerging economies prompted high scale of volatility as gauged by Chicago Board Options Exchange (CBOE) Volatility Index<sup>174</sup> (Figure 7.15).

**Figure 7.15**  
CY15 observed large correction in global equity markets

Chicago Board Options Exchange (CBOE) Volatility Index



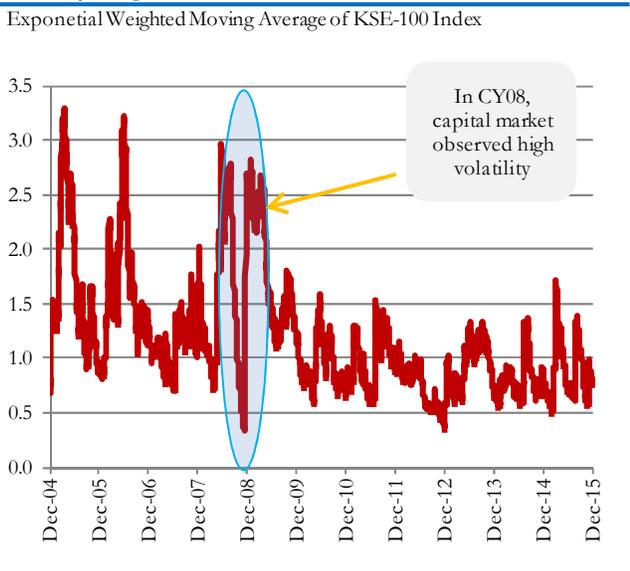
Source: Chicago Board Options Exchange (CBOE)

<sup>174</sup> CBOE index is a popular measure of the implied volatility of S&P 500 index options. VIX is a ticker symbol of CBOE index (<https://en.wikipedia.org/wiki/VIX>)

*Higher but manageable volatility in domestic equity market...*

A little bit higher volatility in the equity market of Pakistan during CY15 compared to CY14 was a natural outcome owing to spillover transmitted from the stress in international markets. However, it remained within a range not threatening to the stability of the market. In fact, the volatility was significantly lesser than the extreme levels seen during the 2008 and 2009 stressed years (**Figure 7.16**).

**Figure 7.16**  
Volatility in capital market increased



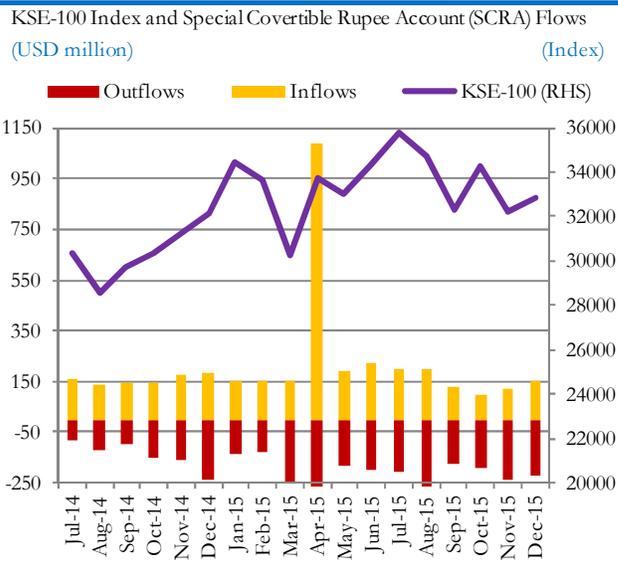
Source: Pakistan Stock Exchange

*Positive sentiments of domestic investors shield the equity market...*

Despite net selling by foreign investors in Pakistan in the second half of CY15 (**Figure 7.17**), a host of factors resisted freefall in equity markets: (a) optimistic sentiments of domestic investors based on positive economic outlook and improved economic fundamentals, (b) corporate profitability in fertilizer, auto and cement sectors and (c) positive impacts of low commodity prices on the economy

in general and inflation in particular. On aggregate basis, KSE-100 index moved up by 2.1 percent during CY15 (27 percent in CY14) to reach 32,816 as of end, December 2015.

**Figure 7.17**  
SCRA observed relatively higher outflows during CY15



Source: S&DWH, SBP and Pakistan Stock Exchange

The overall market capitalization, however, declined by 5.9 percent during CY15 to reach PKR 6.9 trillion as of end December, 2015 against PKR 7.4 trillion as of end December, 2014 (**Table 7.2**).

*In comparison to trends in other emerging economies, equity market fared relatively better ...*

More fragility was seen in equity markets during second half of CY15 (**Table 7.3**). However, the post Yuan devaluation impact was lesser in Pakistan than many other emerging economies. During this stressed period, KSE-100 index observed 5 percent decline as against 18 percent fall in MSCI index of emerging economies.

**Table 7.2****Progress of Capital Markets in Pakistan during CY15**

	Million PKR except companies, index and bond data	
	31-12-2014	31-12-2015
Total No. of Listed Companies	557	554
Total Listed Capital - PKR	1,168,485	1,269,703
<b>Total Market Capitalisation - PKR</b>	<b>7,380,532</b>	<b>6,928,497</b>
<b>KSE-100™ Index</b>	<b>32,131</b>	<b>32,811</b>
KSE-30™ Index	20,772	19,309
KSE Meezin Index (KMI-30)	50,735	55,647
KSE All Share Index	23,398	22,868
New Companies Listed during the year	6	8
Listed Capital of New Companies - PKR	26,973	29,941
New Debt Instruments Listed during the year	6	2
Listed Capital of New Debt Instruments - PKR	15,000	25,000
Average Daily Turnover - Shares in million	219	258
Average value of daily turnover - Rs.	9,402	11,465
Average Daily Turnover (Future™) YTD	24	36
Average Value of Daily Turnover - YTD	2,205	3,142

Source: Pakistan Stock Exchange

*Shariah compliant equity instruments outperform the market...*

The Shariah compliant equity instruments performed relatively better than overall market as reflected through 9.6 percent growth in KMI-30 (i.e. KSE Meezan Index) during CY15 (though growth decelerated compared to CY14: 19.6 percent).

*KSE-100's performance is being acknowledged globally...*

Based on progress witnessed in market liquidity, framework and regulations, recently, MSCI Inc. - a US-based provider of equity, fixed income, and hedge fund stock market indices – is considering to reclassify the MSCI Pakistan Index from 'Frontier Markets' to 'Emerging Markets' in 2016.

**Table 7.3****World Equity Market Indices**

	Dec-14	Jun-15	Dec-15	Change in CY15	Change Jun-Dec, 2015
	indices			percent	
USA (DJIA)	13,823	17,620	17,425	26.1	(1.1)
Euro (Euro Stoxx)	319	354	345	8.2	(2.5)
Japan (Nikkei)	17,451	20,236	19,034	9.1	(5.9)
France (CAC)	4,272	4,790	4,637	8.5	(3.2)
Germany (DAX)	9,805	10,945	10,743	9.6	(1.8)
China (SSEA)	3,234	4,273	3,539	9.4	(17.2)
India (BSE)	27,499	27,781	26,118	(5.0)	(6.0)
Pakistan (KSE)	32,131	34,399	32,816	2.1	(4.6)
Britain (FTSE)	6,566	6,521	6,242	(4.9)	(4.3)
Brazil (BVSP)	50,007	53,081	43,350	(13.3)	(18.3)
MSCI World	417	423	399	(4.3)	(5.7)
MSCI Developed	1,709	1,735	1,662	(2.8)	(4.2)
MSCI Emerging	954	972	794	(16.8)	(18.3)

Source: Bloomberg

Going forward, the overall improvement in domestic economy is expected to reflect in terms of resurgence in equity market.

