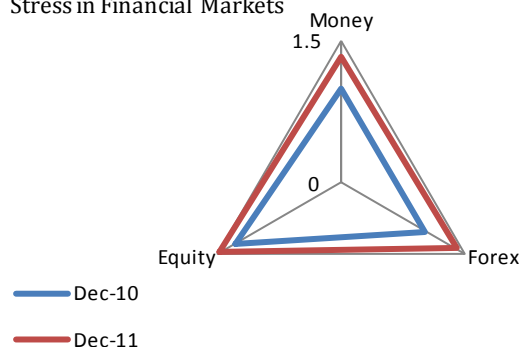


The second half of 2011 represents a stressful condition of the domestic financial markets as the macro-economy further weakens due to rising twin deficits. The money market liquidity showed stress as the central bank injected substantial liquidity in the banking system and yet the banks still providing the government an avenue to monetize its deficit. Similarly, adverse developments in the current account depreciated the USD/PKR parity by 4.6 percent while the import coverage ratio dropped as foreign exchange reserves depleted. Similarly, the equity market remained bearish as its benchmark index lost 9.2 percent and portfolio investment observed net outflow. Further, in line with general economic environment, listings in the equity and debt market remained low in H2CY11.

Financial markets remained under stress as economy further drowned into twin deficit.

Figure 5.1

Stress in Financial Markets



The key indicators of the financial markets exhibited a rising degree of pressure as soaring fiscal and current account deficits further dampened the economic growth. The stressed money market, depreciating exchange rate and bearish equity market contributed to strains in the financial markets (**Figure 5.1**).

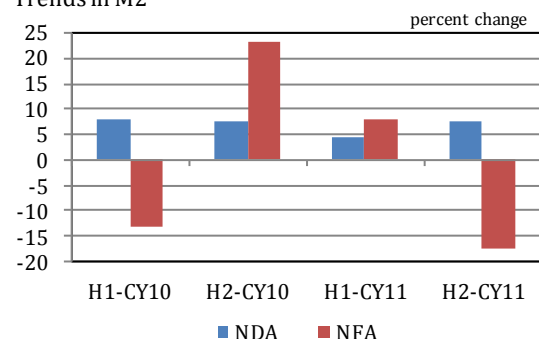
Despite monetary easing by 200 bps to 12 percent in H2-CY11, the short-term interest rate volatility remained high due to unpredictable yet persistent government borrowing from the banking system³⁶. Similarly, the uncertain financial inflows and widening of external account deficit in H2-CY11 also posed pressure on the USD/PKR exchange rate that depreciated by 4.6 percent during the period. Moreover, the uncertain political and social landscape coupled with unfavorable economic circumstances adversely affected the equity markets as the KSE-100 index which depleted by 9.2 percent during H2-CY11.

Liquidity stress in the money market further exacerbated in the last quarter....

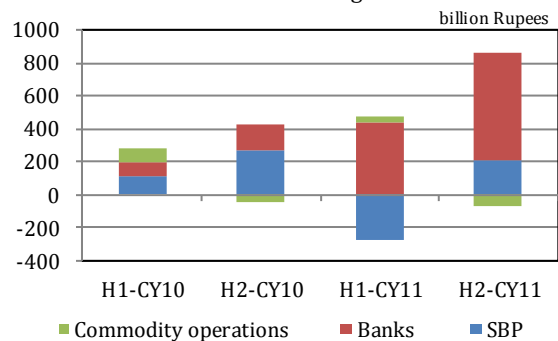
The developments in the financial markets also reflected in the skewed trend of the M2 growth (**Figure 5.2**). The mild liquidity strain that was felt in first half of 2011 and was largely contained by the Net Foreign Assets (NFA) reversed in the second half of CY11. Despite an increasing influx of remittances, the external account deficit increased mainly due to increasing oil import bill and

Figure 5.2

Trends in M2



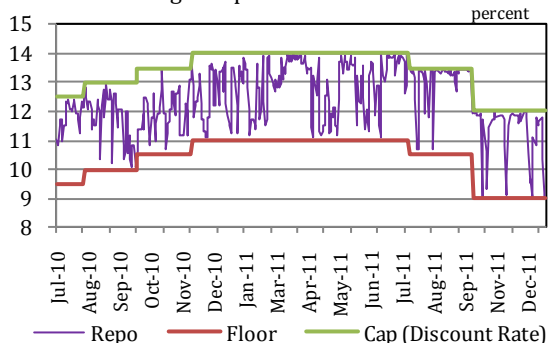
³⁶ The surge in government borrowings in second half was also due to partial settlement of the circular debt of Rs390.7 billion.

Figure 5.3**Pattern of Government Borrowings**

fertilizer imports, decline in portfolio investments and uncertainty regarding other financial inflows. As a result, the NFA declined drastically by 18 percent during H2-CY11 making the liquidity management a challenging proposition.

Similarly, in contrast to the first half, the second half of 2011 witnessed revival of monetization of fiscal deficit, in addition to continued government borrowing from the commercial banks. As a result, the Net Domestic Assets (NDA) grew by 9 percent as banks catered to increasing borrowing needs of the government (**Figure 5.3**).

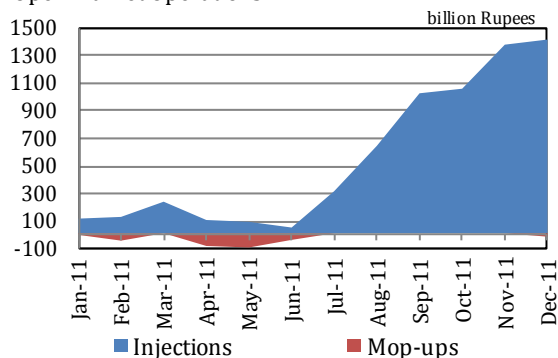
In wake of the above and rising Government's demand for credit, market liquidity remained stressed in the last quarter of CY11. Further, sluggish 4.6 percent growth in banks' deposits during second half as against 9.5 percent in the first half was not sufficient to meet the persistent public sector demand, let alone the private sector borrowers³⁷. Consequently, the short term overnight repo rates not only became more volatile but also remained largely close to the discount rate, particularly in the 4th quarter of CY11, reflecting the increased liquidity demand (**Figure 5.4**).

Figure 5.4**Trend of overnight Repo Rates**

Central bank increased liquidity through substantial open market operations (OMOs)

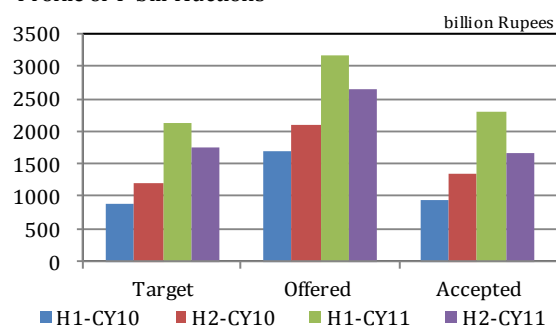
These liquidity shortages led banks increasingly approach the SBP discount window. To overcome the liquidity pressures, the central bank increased injection through frequent OMOs (**Figure 5.5**). However, as most of the bank funding continue to be channelized into Government securities, regular liquidity injection into the banking system tantamount to indirect monetization of debt.

Demand for longer tenor T-Bills remained high in expectation of cut in the policy rate...

Figure 5.5**Open Market Operations**

Analysis of the primary auctions of government securities reveals obvious trend; that banks' continued increased participation in T-bill auctions during the period under review. Owing to increasing credit risk, banks prefer to place the loanable pool of funds in risk-free government securities at relatively attractive interest rates. Hence, not only did the banks participate in high yielding and yet risk free short term government bills. Banks eagerness to invest in T-bills was visible from high offer ratio (i.e. ratio of offered amount

³⁷ The stock of bank deposits increased by Rs273 billion during the second half while the public sector lending increased to Rs654 billion.

Figure 5.6**Profile of T-bill Auctions**

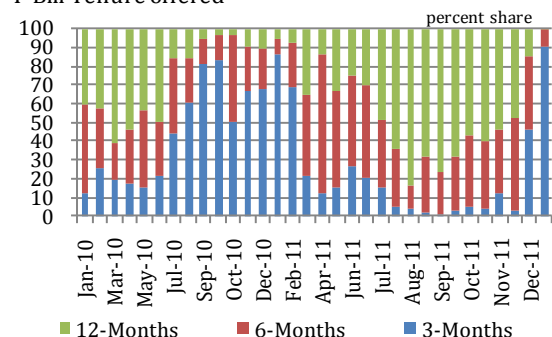
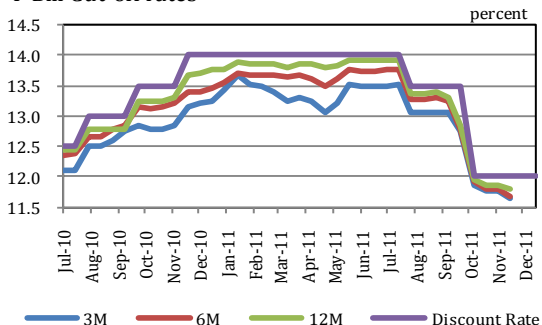
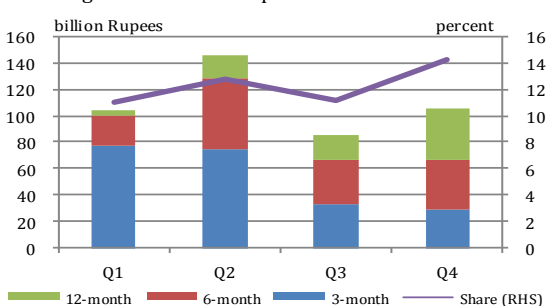
to target amount) of 150 percent during the period, though the acceptance ratio (i.e. ratio of accepted amount to target amount) remained stagnant to 100 percent (**Figure 5.6**).

Banks' preference to invest in longer-tenor T-bills started to emerge as policy rate was slashed by 50 bps in July 2011. The participation in 12-month T-bills remained above 60 percent of the total amount offered during most of the H2-CY11 due to expectations of a further cut in policy rate. The expectations further strengthened after a 150 bps discount rate cut in October 2011, consistent with the declining inflation rate (**Figure 5.7**). However, banks appetite for the government papers actually dried up by end of the year as bids made were far below the target and the government was unable to rollover the maturing T-bills. Eventually, the accepted T-bills (Rs1,690 billion) fell short of the government target of Rs1,775 billion in H2CY11.

The cut-off rates reveal the preferences of the borrowers and lenders. Consistent with the offering pattern, the 12-month cut-off rate remained close to the discount rate and rather less volatile than the 3-month rate. With the gradual cut in discount rate, the T-bills rate also followed the same path while the 3-month rate was more responsive to rate cuts as banks opted for longer maturities (**Figure 5.8**).

The share of NCBs increased in overall participation

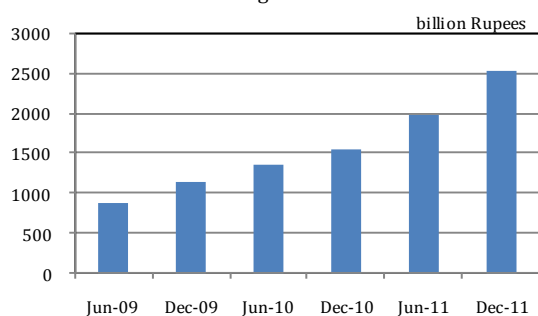
In addition to banks and other financial institutions, households and businesses also participate in the MTB / PIB auctions through Investor Portfolio Securities (IPS) accounts maintained with banks. The measure aims at diversifying investors' base in government auctions, along with instilling competition in the bidding process and encouraging small investors to invest in government securities. Under this approach, banks submit non-competitive bids (NCB)³⁸ on behalf of interested investors for consideration in the auctions. As a result, participation of institutions and individuals in T-bills auctions increased over the year. During CY11, the share of NCBs accepted towards total acceptance has increased from 11.1 percent during Q1-CY11 to 14.3 percent in Q4-CY11 (**Figure 5.9**).

Figure 5.7**T-Bill Tenure offered****Figure 5.8****T-Bill Cut-off rates****Figure 5.9****Growing share of Non-Competitive Bids in CY11**

³⁸ SBP increased the ratio of Non-Competitive Bids (NCB) from 10 percent in Jul FY03 to 15 percent in July FY10.

Figure 5.10

Stock of T-bills outstanding

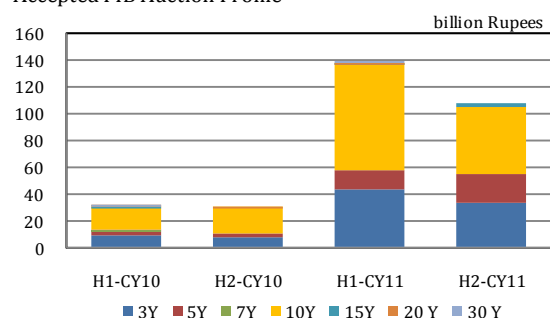


Increasing investments in T-Bills squeezed the flow of banks' credit to private sector

With increasing investment of commercial banks in government securities, the maturing amount of T-bills has been growing by more than 60 percent per year since FY09 (**Figure 5.10**). Against required rollover of Rs 1.5 trillion T-bills in CY10, the amount increased to Rs 2.5 trillion in CY11. The sharp rise has implications not just for the fiscal account, but also for the private sector as higher rollovers served to squeeze the available liquidity for the private sector.

Figure 5.11

Accepted PIB Auction Profile

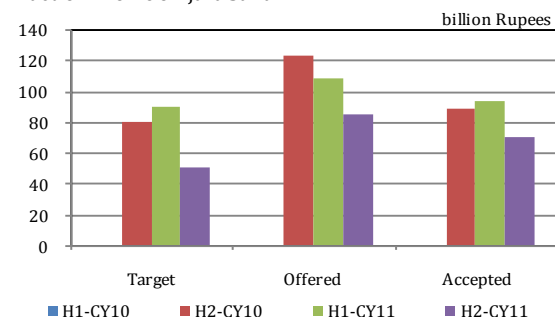


Banks' interest in PIBs off-set by rate cut and liquidity constraints

The regular auction profile of the PIBs exhibited declining trend of banks' investment in longer term maturities (**Figure 5.11**). Furthermore, the PIB auction offerings also reduced significantly in the second half of 2011 reflecting banks' concern for liquidity management and rate cuts.³⁹

Figure 5.12

Auction Profile of Ijara Sukuk

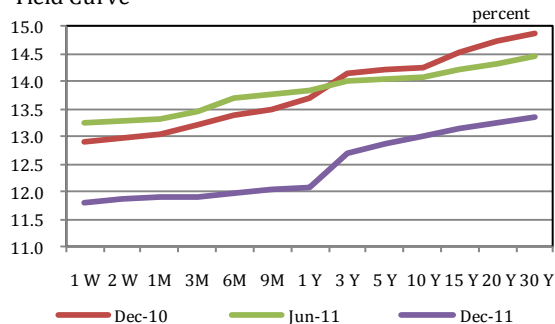


In terms of Islamic money market instruments, the floatation of a GoP Ijara Sukuk offering in H2-CY11 provided much needed investment instrument for the Islamic banks (**Figure 5.12**). The Government issued Ijara Sukuk of Rs 70 billion far in excess of the target of Rs 50 billion. Not only it helped government in generating funds for itself but it also helped the Islamic banks to invest excess liquidity and earn risk free return and improve their stability outlook.

Monetary stance shifted the yield curve downwards with steepening over medium to long term horizon.

Figure 5.13

Yield Curve

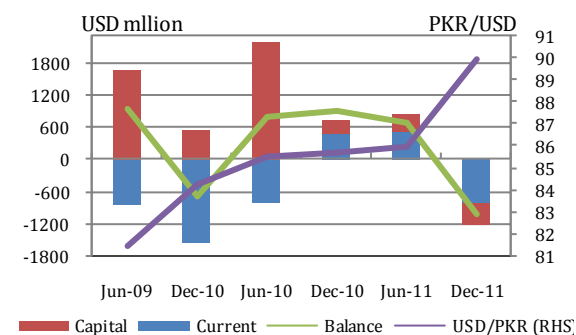


The 200 bps reduction in the discount rate impacted the overall interest rates as the Yield Curve shifted downwards. The short-term rates in expectations of the further rate cut flattened by end Dec-11 (**Figure 5.13**). While medium and long term part of the Yield curve steepened due to inflationary expectations and overall economic situation. Additionally, the government converted the inter circular corporate circular debt and subsidies on commodity finance through issuance of Government securities to the tune of Rs 391 billion including issuance of 50 percent PIBs of 5 year maturity. This increased supply of long-term government securities apparently declined banks' demand for additional securities, resulting in increase of the secondary market yields on these securities and steepening of the yield curve.

³⁹ The banks offered Rs232 billion for a target of Rs95 billion in the first half 2011 out of which Rs137 billion were accepted. Meanwhile, for a target of similar Rs95 billion, the banks offered Rs170 billion out of which Rs107 billion were accepted.

Figure 5.14

Developments in External Account

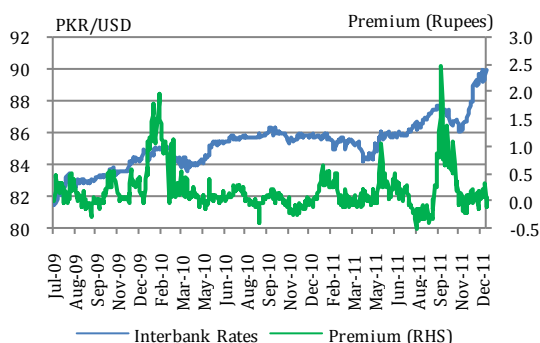


Stress prevailed in the foreign exchange market and on the domestic currency as external account deteriorated.

While central bank's operations kept the liquidity stress in the money market under check, the foreign exchange market faced stresses of its own –partially due to exogenous factors like rising international fuel and commodity prices, international investors' risk appetite, and uncertainties surrounding global economic recovery. In addition domestic business affected by prevailing energy shortages, and law and order situation also hampered exports that decelerated by 9.1 percent during H2-CY11 while imports increased by 9.3 percent (**Figure 5.14**).

Figure 5.15

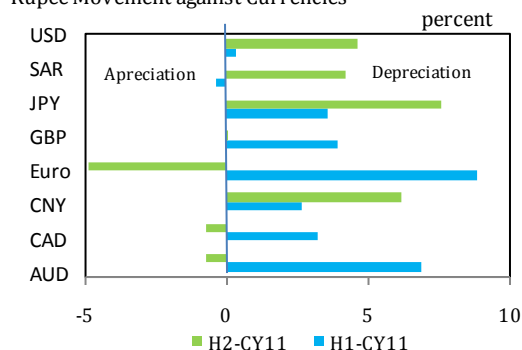
Exchange Rate and KERB Market Premium



As a result, the current account deficit surged to USD 2.3 billion in H2-CY11 against surplus in the corresponding period of the last year. The financial account flows also presented dismal picture. Foreign Direct Investment (FDI) declined by 36 percent, while foreign portfolio investment (FPI) turned negative. The developments in external account resulted in exerting pressure on the value of Pak rupee that depreciated by 4.62 percent against US Dollar in H2-2011, compared to marginal depreciation of 0.38 percent in the first half. Much of the depreciation took place in last two months of H2 on account of rising oil import payments.

Figure 5.16

Rupee Movement against Currencies

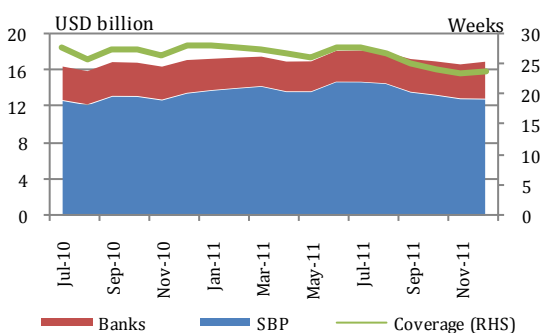


With the depreciation of Pak Rupee, the maximum KERB market premium (difference between exchange companies /market and interbank exchange rates) was Rs2.46 per US Dollar during H2-CY11 (**Figure 5.15**). This also led to a buying spree among the speculators in anticipation of further depreciation.

In addition to depreciation against the USD, Pak Rupee also depreciated against all other major currencies except Euro (**Figure 5.16**). As a result the NEER (Nominal Effective Exchange Rate) depreciated by 0.7 percent. However, the inflation adjusted Real Effective Exchange rate (REER) appreciated by 3 percent indicating a likely reduction in country's external competitiveness.

Figure 5.17

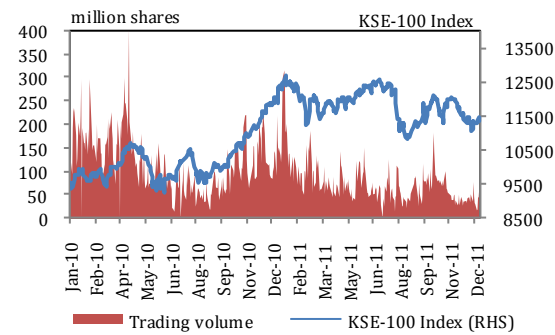
Foreign Exchange Reserves and Import Coverage



External account deficit kept pressure on FX reserves and on import coverage ratio

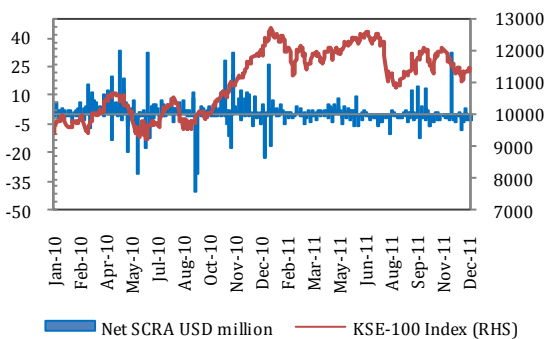
The external account deficit also depleted reserves held by the central bank by USD 1.9 billion in H2-CY11 as against an improvement of USD 1.2 billion in the first half. Accordingly, the import coverage also reduced to 24 weeks of import in H2 against 28 weeks in the H1 (**Figure 5.17**).

Downward pressure on Pak Rupee also led to an increase in the foreign currency deposits (FCD), held by commercial banks, by US

Figure 5.18**KSE-100 Index and Trading Volumes****Table 5.1: Profile of Capital Market**

	2009	2010	2011
Listed Companies	651	644	638
Listed Capital	814.5	919.2	1,048.4
Capitalization	2,705.9	3,268.9	2,945.8
GDP Ratio	23.6	23.7	17.9
KSE-100	9386.9	12022.5	11347.7
New Companies	4	6	4
New Equity Capital	8.8	33.4	16.0
New Debt	1	4	6
New Debt Capital	3.0	5.7	14.8

Listed Capital, Capitalization, New Equity Capital and New Debt Capital are in Rs. Billions. GDP Ratio in percent and Equity volume in million shares

Figure 5.19**Net SCRA Flows and KSE Performance**

Dollar 690 million. Though, a considerable rise in the FCD may highlight the risk of dollarization of the economy, however, with maximum FCD⁴⁰ limits placed on a Commercial Bank, the risk remain contained. On the positive side, increase in deposits provided funds to the banks for financing trade, thereby limiting pressure on the Pak Rupee and reserves.

Equity indices severely affected by fragile macro-economy and prevailing political environment

Similar to the money and FX market, the equity and capital markets also faced stresses during H2-CY11. The benchmark KSE-100 index depleted by 9.2 percent to 11,347 points on account of weak macroeconomic fundamentals and political issues both locally and internationally (**Table 5.1**). In addition, the prevailing law and order situation also repulsed the foreign investors and the KSE witnessed foreign portfolio investment outflows.

Though healthy financial performance of leading corporate was expected to revive the market outlook and activity as measured by the turnover, uncertainties in the international relations kept the market in the bearish sentiment. The average turnover further decreased to 58 million shares per day in H2CY11 as against 97 million in the first half (**Figure 5.18**).

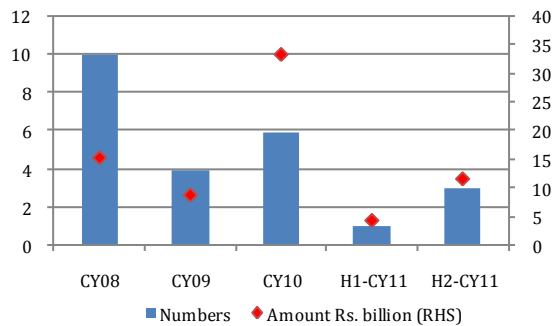
The portfolio investment measured by Special Convertible Rupee Account (SCRA) also witnessed limited market participation throughout the second half (**Figure 5.19**). Actually, portfolio investment is generally short-lived and in volatile markets, the investors book gains and flee as soon as reasonable profits accumulate. The local investors following the herd behavior also led to panic selling in some instances and add to deterioration in the equity indices. Similarly, in wake of the uncertainties facing the economy, the SCRA witnessed a net outflow of USD 209 million during H2-CY11 compared to a net inflow of USD 237 million in FY11. Most of the outflows were limited to equity securities due to bearish stock market. The equity market failed to pick up albeit positive corporate results; while declining outflow of FPI further contributed to downtrend.

⁴⁰ In terms of Regulation O-5 of the Prudential Regulation for Corporate Commercial Banking, Foreign Currency deposits should not at any point exceed twenty percent of the local currency deposits of the banks at the close of business on the last working day of the preceding quarter.

Listings in Equity and debt market remained low

Figure 5.20

Equity Listings in KSE



The listings in the equity market though revived in H2-CY11 but still remain small in number and value. A total of 3 companies were listed that augmented the listed capital by Rs11.6 billion (**Figure 5.20**). However, the corporate debt market remained quite inactive in terms of listing during the period under review. Only one instrument worth Rs1.5 billion was listed in the debt market in H2-CY11 against listing of five instruments worth Rs13.2 billion in the first half (**Figure 5.21**). Generally, the corporate that require long-term debt for project finance tend to borrow from the corporate debt market. However, under the prevailing economic scenario and sluggish business activity, majority of the corporates borrowed from banking sources for their working capital needs only.

Figure 5.21

Corporate Debt Market Performance

