4 Exchange Rate and Reserve Management

4.1 Over view

Buffeted by a combination of external and internal shocks, reserve management turned out to be quite an act of tight rope walking in FY08. International credit crunch, soaring commodity prices and slackening domestic economy have put immense downward pressure on the reserves. To make situation worse, speculators tried to create panic in the forex market. SBP, cognizant of its responsibilities put in place innovative policy measures to calm down this rather turbulent phase and reduce forex market imperfections.

4.2 Foreign Exchange Market

Deteriorating external account position combined with political uncertainties increased pressure on the exchange rate considerably during FY08. Compared with FY07, exchange rate showed higher volatility with a more pronounced reflection of the prevailing demand and supply conditions. The volumes traded in the market also increased in line with the growth in country's trade volume. Although SBP continued to allow the market forces to play their due role in determining the exchange rates, managing it was a challenge as the investor sentiments and speculative tendencies introduced spikes in exchange rate during the year. To curb the pressures and calm the sentiments in the domestic foreign exchange market, SBP introduced two rounds of administrative and regulatory measures that helped calm the exchange markets.

Figure 4.1 PKR/US$ Exchange Rate during FY08

After experiencing a high degree of exchange rate stability for almost five years, rupee- dollar parity depreciated cumulatively in FY08 by 13.3[1] percent in nominal terms. However, depreciation in the real effective exchange rate was only 2.3 percent due to high domestic inflation relative to inflation in the trading partner countries. Exchange rate dipped to lows of Rs69.75 per US$ compared to an average of Rs62.73 per US$ during FY08. To curb the pressures and calm the sentiments in the domestic foreign exchange market, SBP introduced a number of administrative and regulatory measures that helped restore a degree of foreign exchange rate stability (See **Figure 4.1**, PKR/USD exchange rate during FY08).

The year started with SBP's decision to partially divert the POL payments back to the market sources. In July '07, SBP issued instructions allowing the banks to cover POL payments against specific 'M' Form approvals and furnace oil from the interbank market. Though this was a major step by the SBP, the market sentiments remained calm without any sharp change in Exchange parity. In general, market participants took SBP's move on a positive note.

During the first quarter FY08, exchange rate remained stable with a gradual weakening of the rupee. SBP was able to comfortably buy back most of the POL support provided to the banks. However, the

[1] Figures relating to exchange rate movements may differ from those given in Balance of Payment chapter of VOL.I of this report due to difference in computation methodology.

sequence of political events happening subsequently drastically changed the market scenario. After keeping a stable posture till Oct '07, the pace of rupee depreciation increased sharply in the backdrop of heightened political uncertainty. The parity registered depreciation of only 0.6 percent during Jul-Oct '07 period; however during Nov-Jun period, the exchange rate showed depreciation of 12.7 percent, increasing the overall depreciation during FY08 to about 13.3 percent (see **Table4.1**).

Table 4.1: Percent Change in PKR/USD Parity

Month End	Closing rate	Monthly change (%)	Change since Jun '07 (%)
Jul '07	60.40	-0.05	0.05
Aug '07	60.62	-0.36	0.41
Sep '07	60.69	-0.12	0.53
Oct '07	60.73	-0.07	0.60
Nov '07	61.24	-0.84	1.44
Dec '07	62.00	-1.24	2.70
Jan '08	62.64	-1.03	3.76
Feb '08	62.45	0.30	3.45
Mar '08	62.73	-0.45	3.91
Apr '08	64.60	-2.98	7.01
May '08	66.37	-2.74	9.94
Jun '08	68.40	-3.06	13.30

Specifically, after the events of Dec 27 pressure on exchange rate mounted significantly. The rupee continued to lose ground amid thin supply conditions. Many suppliers selling forward withheld their sales in anticipation of further rupee depreciation. Whereas the demand side showed a rising trend due to higher POL payments, SCRA outflows and forward bookings by importers.

Market uncertainty further escalated during the month of February as elections came closer. The parity touched the peak of Rs. 63.15 per US$ just a day before the election date. However, after the peaceful electoral process, market reacted favorably by a significant rise in rupee's value. This reaction was more of a perception based than real improvement in demand/supply conditions. Some institutions also took advantage of the drop in parity and made heavy forward bookings to hedge their future obligations. Resultantly the exchange rate again started rising and gradually reverted back to the high of Rs. 62.75 per US$ by March '08. During April' 08 weakening trend in rupee value continued and exchange rate gradually moved up to Rs. 64.60 per US$ by the month end.

Table 4.2: Exchange Rate Trend

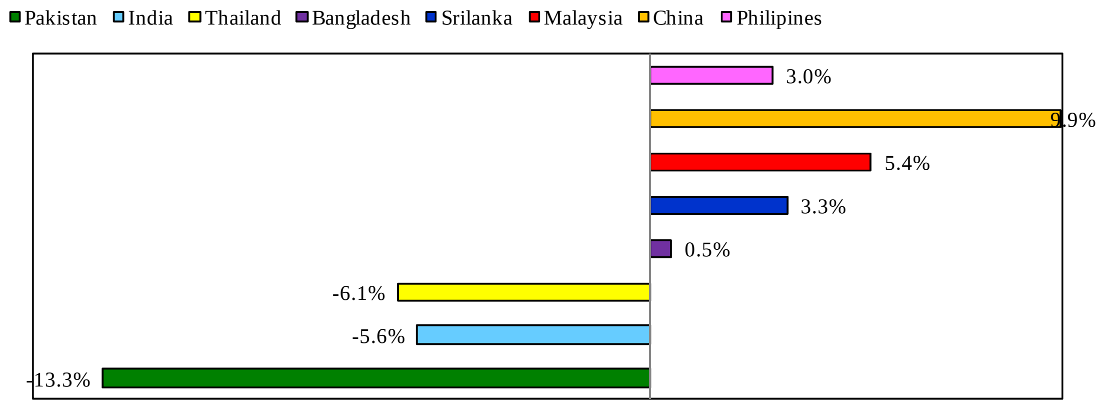
Year	High	Low	Close	Average	Volty C/C	Percent change
FY05	61.6	57.55	59.64	59.35	2.57	-3.21
FY06	60.45	59.57	60.22	59.87	0.92	-0.97
FY07	61.01	60.18	60.37	60.65	0.96	-0.26
FY08	69.75	60.3	68.4	62.73	0.04	-13.30

Source: REUTERS

The month of May proved volatile for the interbank foreign exchange market as the exchange rate depreciated by around 6 percent in the first two weeks of the month and touched the high of Rs. 69.75 per US$. However, SBP's timely administrative measures helped in restoring market's sentiments and stabilized the parity around PKR 67 by the month end. During the month of June rupee continued the depreciating trend; however the slide was more gradual without any sharp spike in the exchange rate. This was mainly due to SBP's administrative measures and market's expectations of higher inflows expected to realize before year end. The year ended on a stable note with PKR/USD rate trading around Rs. 68.40 per US$ in the interbank market (see **Table 4.2**).

From a regional perspective, PKR was among the few currencies which showed depreciation against US Dollar during FY08 (see **Figure 4.2**). Besides Pak Rupee, Indian Rupee and Thai Baht also depreciated against the US currency. In nominal terms, the depreciation in PKR was more pronounced compared with other regional currencies. At the same time there were several regional currencies which showed significant appreciation against the US Dollar. These included Chinese Yuan, Malaysian Ringgit, Sri Lankan Rupee, Philippines Peso, etc. with the Chinese Yuan gaining the most strength against the US Dollar with over 9 percent appreciation during the year.

Figure 4.2: Regional Currencies Performance against US$ during FY08



During FY08, SBP continued its support for POL payments. However this year SBP diverted about 25 percent of the total POL payments to the market sources. As a result, SBP provided a total of $8,951.2 million to banks against POL payments during FY08 compared with $7,473 million in the preceding year. At the same time banks arranged about $2,080 million from their own sources to fund the oil payments during FY08 (see **Table 4.3**).

Table 4.3: POL Payments during FY07-FY08

(million US dollar)

FY08				FY07	
MONTH	SBP's Share	Banks' Share[1]	TOTAL	MONTH	SBP
July '07	786	66	853	July '06	805
Aug '07	480	139	619	Aug '06	704
Sep '07	425	141	566	Sep '06	636
Oct '07	512	159	671	Oct '06	631
Nov '07	702	215	916	Nov '06	542
Dec '07	824	109	934	Dec '06	524
Jan '08	602	260	862	Jan '07	557
Feb '08	728	132	860	Feb '07	552
Mar '08	740	154	893	Mar '07	572
Apr '08	924	301	1,224	Apr '07	554
May '08	1,266	195	1,461	May '07	671
June '08	963	211	1,174	June '07	725
	8,951	2,080	11,031		7,473

[1]During FY06-07 SBP provided support for all types of POL payments. However on July 13th 07, POL payments against Furnace Oil and specific 'M' form approvals were shifted to Banks

Despite this the total quantum of POL support provided by SBP increased by 20 percent from the previous year. Especially in the last quarter of the year (see **Figure 4.3**), the oil support volume increased significantly when SBP provided $3,153 million of oil support compared with $1,950 million during the corresponding period in the previous year. This was mainly because of the unprecedented rise in international oil prices which increased by over 100 percent during the year. The Arabian Light Crude which was trading around $66/barrel at the start of the year escalated to over $130/barrel by the end of the year with an average price of $92/barrel (see **Figure 4.4**). The higher oil bill had its implications on the country's foreign exchange reserves which after reaching a historic high level of $16.5 billion, started showing a declining trend. The reduced inflow volumes in the interbank market also hampered SBP's ability to buy-back the POL support provided earlier, exacerbating the pressure on the country's FX reserves.

4.3 Reserve Management

FY08 year will be remembered as one of the most difficult years for financial markets across the globe. Sub-prime crisis triggered by housing mortgage defaults resulted in liquidity turmoil. Federal

Reserve Board, Bank of England and European Central Bank took drastic steps to bail out financial sector from this crisis. It is, however, still early to say that the crisis is over, and there is already a debate about second round effects. The initial reaction to the subprime problems was a global re-pricing of risk, with all commonly accepted expensive assets classes impacted. Thus all credit sectors were affected and we saw a general widening of credit spreads.

Figure 4.3: Share of SBP in POL Payments

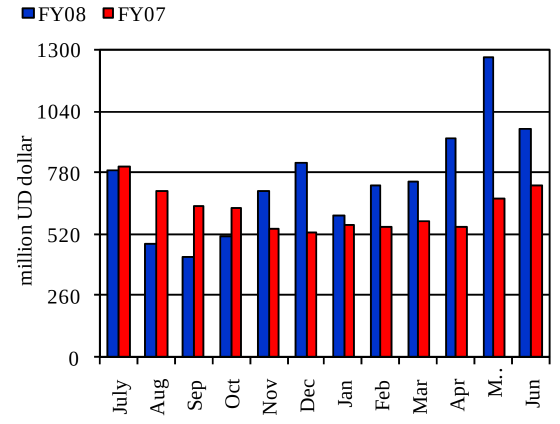


Figure 4.4: Oil Price Trend

While our reserves are not directly exposed to sub-prime, the effects of widening of spreads are not limited to sub-prime sector only, and our reserves are no exception. It can be safely said that the institutional reforms undertaken by SBP last year to strengthen the reserve management capabilities had started to show results with reasonable returns in very difficult market conditions. During FY08 substantial value has been added to bank's profitability through active management of investment portfolio. On gross return basis, SBP managed to earn a return of 4.9 percent which was close to its benchmark and in line with the returns in past three years. A comprehensive Strategic Asset allocation exercise is underway to examine the current asset mix and develop a new asset mix taking into account the global economic conditions to improve returns while keeping the risk at acceptable level.

Sharp increase in current account deficit arising from higher oil bill and reduced inflow in interbank market, resulted in declining trend in country's foreign exchange reserves from October 2007. The overall reserves of the country stood at US$ 11.2 billion at the end June 2008; down by US$ 5.2 billion from the peak of US$ 16.4 billion in Oct 2007. Declining trend in foreign exchange reserves and drastic increase in import bill has adversely affected reserve adequacy i.e. import coverage ratio declined to 16.8 weeks from 30.6 weeks in June FY07.

Pressures on SBP reserves are likely to ease in the coming months due to rise in the inflows and financial assistance from multilateral agencies.

4.4 Changes in Foreign Exchange Regime

From foreign exchange policy perspective, FY08 has been a year of higher turbulence and volatility especially the second half. This was driven mainly by political uncertainty and worsening current account deficit. However, in the first half of FY08, SBP continued with its approach of gradual liberalization of foreign exchange regulations and took various measures which included:

4.4.1 Payments against POL Products: Due to growth in foreign exchange flows in the interbank market and increase in foreign exchange exposure limits, banks were allowed to purchase foreign exchange from the interbank market against import of all categories of furnace oil. All other POL related foreign currency purchases, made on the basis of specific form ‘M’ approvals by SBP, were also allowed to the banks from the interbank market.

4.4.2 Advance Payments against Imports: To facilitate importers, SBP allowed advance payments against letters of credit and firm registered contracts up to 100 percent of the FOB or CFR value of the imported goods subject to certain precautionary measures.

4.4.3 Remittance of Surplus Funds by Foreign Airlines To facilitate Foreign Airlines in Pakistan, these were allowed to submit BSP sales statement provided by the International Air Transport Association (IATA) instead of detailed reporting on prescribed form. Further, Airlines in Pakistan have been allowed to issue tickets to Saudi Arabia or its adjoining countries during the Hajj season i.e. from 10th Shawal to 10th Zilhaj which were forbidden earlier.

The exchange rate depreciation accelerated in second half of FY08 due to of political uncertainty and worsening current account deficit. This resulted in the emergence of destabilizing speculative trading activities; consequently SBP had to intervene with certain administrative steps with focus not only on market stabilization but also to curb speculative trends. Accordingly SBP took a number of steps during the second half of FY08, which included:

4.4.4 Advance Payments against Imports on L/C Basis: The facility of 100 percent advance payment against irrevocable letters of credit and firm registered contracts up to 100 percent of the FOB or CFR value of the goods was restricted to 50 percent. Further in case of import on contract basis importers were also required to arrange bank guarantee from the foreign supplier and to obtain SBP’s prior approval. Subsequently, in July 2008, the advance payment facility against imports has been further reduced to 25 percent of the FOB or CFR value of the goods.

4.4.5 Advance Payment up to US$ 10,000: Facility of advance payment up to US$ 10,000/- without L/C or contract which was earlier permissible against all import by manufacturers / commercial exporters was restricted to import of raw material/spare parts by the industrial users for their own use.

4.4.6 Forward Cover Facility: With a view to curb speculation, the forward cover facility of less than one month tenor was disallowed. Consequently, ADs were only permitted to provide forward cover for a period of not less than one month and up to a maximum period of one year on a roll over basis. Subsequently, in July 2008, the forward cover facility for imports has been temporarily suspended altogether.

4.4.7 Payment against POL: To address sharp volatility in the exchange rate it was decided in July 2008 that State Bank of Pakistan would continue to provide foreign exchange to banks for the import of all POL products including all categories of furnace oil.

4.5 Home Remittances

In FY08, SBP continued to pay special attention to enhance the flows of workers’ remittances through formal channels by following a comprehensive strategy. The main components of the strategy included: (i) increased level of commitment by the financial sector to provide remittance related services (ii) adoption of consultative role by SBP (iii) collection and sharing of best practices (iv) SBP support in product development and utilization of innovative tools (v) operational level assistance, and (vi) establishing an efficient feedback system. The efforts undertaken by SBP in consultation with other stakeholders have resulted in total remittances to reach historic high level of USD 6.45 billion in the FY08, registering a growth of 17.4 percent over FY07.

4.6 Exchange Companies

In FY08 State Bank of Pakistan initiated reform process in the Exchange Companies sector with a view to bring better market discipline through enhanced transparency, disclosure, strong monitoring, supervision and enforcement. The most important has been a change in SBP's approach from 'bringing financial discipline and corporate culture' to 'ensuring discipline, strict compliance and proper corporate governance'.

Like in the interbank market, SBP took the following administrative measures to check the speculative trends in the Exchange Companies market.

4.6.1 Discontinuation of Nostro Accounts of Exchange Companies: To enhance off-site surveillance of Exchange Companies, it was decided that all permissible inflows/ outflows of Exchange Companies are to be routed only through FCY Accounts maintained with commercial banks in Pakistan. The Exchange Companies, therefore, were advised to close all their existing Nostro accounts with banks abroad and bring back the balances held in those accounts into their FCY A/Cs in Pakistan latest by May 31, 2008.

4.6.2 Enhanced Surrendering Requirements in the Interbank Market: Exchange Companies were earlier required to surrender 10 percent of foreign currencies received by them on account of inward home remittances in the interbank. With a view to bring more inflows in the interbank, this requirement was enhanced to 15 percent.

4.6.3 Restriction on Export of certain Currencies: With a view to curbing speculative trends and to ensure that three major cash currencies namely UK Pound Sterling, Euro & UAE Dirham remain available with the banks to the extent required. Exchange Companies were debarred from exporting cash in these currencies. The companies were advised to deposit these currencies with the banks in Pakistan. Further, banks were allowed to surrender these currencies to SBP.

4.6.4 Linking of Outward Remittances with Inward Remittances: One of the major activities of Exchange Companies is to (i) mobilize workers' remittances from overseas with special focus on jurisdictions where non-resident Pakistanis (NRP) face difficulty in effecting their remittances back home and (ii) distribute remittances in far-flung areas where these services are either non-existent or hard to procure. In this respect as a motivating factor for Exchange Companies to mobilize additional remittances, these were allowed to effect outwards remittances on behalf of bona fide customers for permissible transactions only to the extent of 75 percent of the home remittances mobilized by the company during the preceding month.

4.6.5 Mandatory Withdrawal in Cash US Dollars from Export Proceeds: With a view to enhance the cash liquidity of US dollar with exchange companies, it was made mandatory for all Exchange Companies to withdraw in cash US Dollar at least 15 percent of the proceeds of the FCY exported by them from their FCY accounts maintained by them with banks in Pakistan.

4.6.6 Enhancement of Reporting Requirements: The reporting requirements for Exchange Companies were enhanced. The companies are required to report all their major activities i.e. sale/ purchase over the counter, inward remittances, and outward remittances on daily basis on the prescribed formats. Similarly the periodicity of certain reports has also been reduced.

4.6.7 Approval Requirement for Effecting Major Transactions: In July 2008, Exchange Companies were advised to take prior approval of SBP for all transactions of US $ 50,000 or above (or equivalent in other foreign currencies) on account of outward remittances or sale of foreign currencies to the customers. However, this requirement has not been made applicable on sale of foreign currency to the banks/exchange companies.

4.7 Export of Permissible FCYs by Exchange Companies through Lahore Airport

In order to further facilitate Exchange Companies and monitor export of cash FCYs, State Bank of Pakistan operationalised SBP-Customs Joint Booth at Allama Iqbal International Airport, Lahore in July 2008. The said facility is already available at Jinnah International Airport, Karachi.