4 Exchange Rate and Reserve Management

4.1 Overview

The first two quarters of FY09 saw internal and external shocks carrying-over from FY08, complicating market & reserve management. State Bank of Pakistan, cognizant of these multifaceted challenges introduced a number of measures to cope with the rapidly changing market situation, and to ensure smooth functioning of the financial markets. These measures helped strengthen the market mechanism, curtailed excessive short-term volatility and calmed down the turbulent sentiments, making sailing a bit smooth through these testing times.

The most disturbing factor during the year was the steep rise in international oil prices reaching unprecedented levels (see **Table 4.1**), and putting immense pressure on the country's foreign exchange reserves. The deteriorating external account triggered excessive volatility in the FX market during the first quarter of the year (see **Figure 4.1** and **Table 4.2**). SBP took a number of proactive measures in the first quarter to curb undesirable excessive short term volatility. At the same time, SBP continued its efforts to complement the governments' strategy to shore up country's FX Reserves. The success of this strategy culminated in the resumption of the IMF program which provided the much needed support to the country's Foreign Exchange Reserves. The subsequent turnaround in international oil prices also helped in restoring market's confidence to a large extent. Thus after observing a volatile period during Jul-Oct08 the market gradually normalized, and the rest of the year witnessed gradual weakening of the rupee with healthy volatility.

4.2 Interbank Market

As the year started, current account balance further deteriorated and the decline in rupee's value kept gathering pace. To encourage foreign exchange inflows and calm down market sentiments, SBP took a number of

Table 4.1: Daily Arabian Light Crude Closing Prices

in US dollar, change in percent

ARL-OSP-A quote	Highest quote	Lowest Quote	Average daily close	YoY change*
FY03	33.1	22.6	27.2	-
FY04	37.7	24.9	30.2	11.0
FY05	55	32.5	41.2	36.4
FY06	69.9	49.9	58.7	42.5
FY07	73.8	48.5	61.2	4.3
FY08	140.6	66.1	92.6	51.3
FY09	**143.6**	**32.7**	**67.1**	**-27.5**

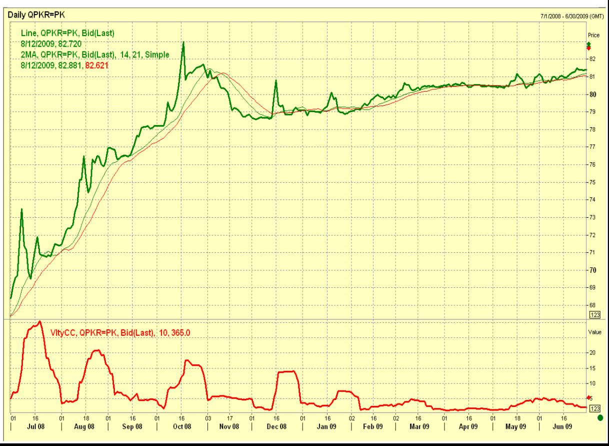
*=YoY change in average close prices

Table 4.2: Percent Change in PKR/USD Parity in FY09

change in percent

Month end	Closing rate	Monthly change	Change since Jun 08
Jul	71.46	-4.48	-4.48
Aug	76.48	-7.02	-11.82
Sep	78.16	-2.20	-14.27
Oct	81.47	-4.23	-19.11
Nov	78.83	3.24	-15.25
Dec	79.10	-0.34	-15.65
Jan	79.10	0.00	-15.65
Feb	80.00	-1.14	-16.96
Mar	80.51	-0.64	-17.71
Apr	80.53	-0.02	-17.74
May	81.17	-0.79	-18.67
Jun	81.46	-0.36	-19.10

Figure 4.1 USD/PKR Exchange Rate Movement during FY09



measures early in FY09. These included suspension of forward booking of foreign exchange against imports, SBP support for all types of POL payments, reduction in trading time for interbank foreign exchange transactions, Cash Margin on LC's, and reduction in advance payments against imports from 50 percent to 25 percent. Moreover, SBP issued instructions for exporters to submit their overdue export proceeds. As a result of the campaign for realization of overdue export bills, stock of outstanding export bills held by exporters declined significantly during Jul-Nov08. With sharp decline in international oil prices and Pakistan's entry into the IMF program, the situation in the FX market improved. The investigations into operations of exchange companies, involved in illegal transfers of foreign currencies, also helped curbing the speculative tendencies and reducing the pressure on rupee.

Table 4.3: Exchange Rate Trend

volatility and change in percent

Year	High	Low	Close	Average	Volty C/C	change
FY05	61.60	57.55	59.64	59.35	2.6	-3.2
FY06	60.45	59.57	60.22	59.87	0.9	-1.0
FY07	61.01	60.18	60.37	60.65	1.0	-0.3
FY08	69.75	60.30	68.40	62.68	4.0	-13.3
FY09	84.08	68.47	81.46	78.65	6.8	-19.1

Source: DMMD Transactional Reporting & Reuters

On yearly basis, the USD/PKR exchange rate incurred depreciation of approximately 19 percent during FY09 compared with 13 percent in FY08 (see **Table 4.3**). The depreciation was more pronounced during the Jul-Oct period when the Exchange Rate showed an average monthly depreciation of 4.8 percent. However, after the announcement of IMF program in Nov08, rupee recovered some of its earlier losses and posted a recovery of 3.2 percent. For the rest of FY09, exchange rate remained relatively stable while registering gradual depreciation reflecting the demand and supply conditions in the market. The average interbank USD/PKR exchange rate during the year remained PKR 78.65 with high and low levels of Rs84.08 and Rs68.47 which were traded during the months of July-Oct 2008.

One major development during the year was the gradual transfer of POL payments back to the interbank market. A phased program has been announced to the market according to which SBP will cease to provide foreign exchange for oil imports by December 2009. As a first step of this phased strategy, SBP allowed banks to cover Furnace oil and specific 'M' form payments from the interbank market in Feb 2009. Unlike the past experience, the transition was successful as the banks comfortably covered these outflows without any excessive movements in the exchange rate. The remaining categories of POL payments are scheduled to be diverted to interbank market in Aug09 and Dec09.

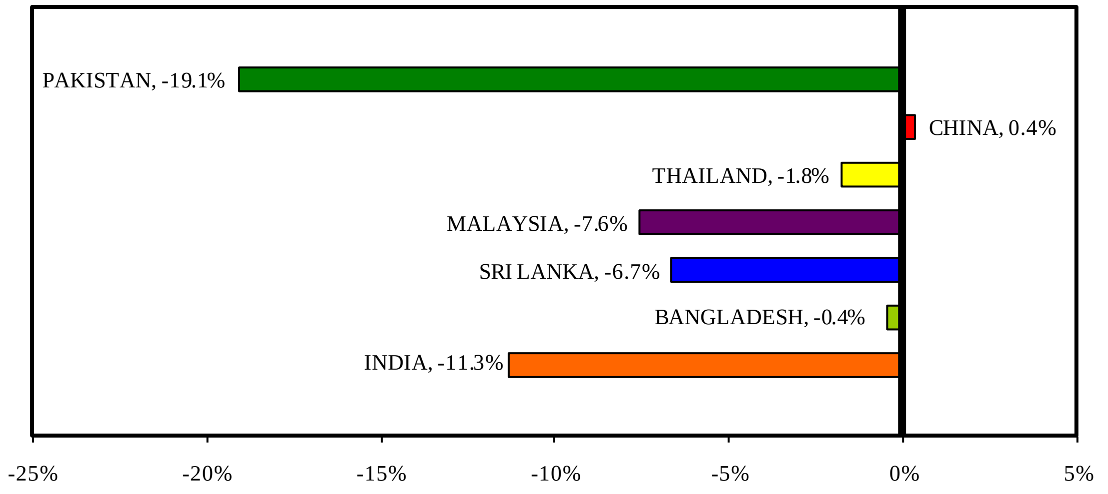
While diverting the POL payments back to the market, SBP took the initiative of enhancing the market's capacity to handle large volume transactions on its own. SBP increased the Foreign Exchange Exposure Limits (FEEL) of the Banks from 15 percent of their Paid-up Capital to 20 percent of Paid-up Capital (Free of Losses) in Jun09. This measure increased the market's overall FEEL by 26 percent from approximately US$297million to US$374 million.. The determination process of FEEL allocation was also improved with incentivizing banks that utilize their FEEL limits more effectively.

As the foreign exchange market stabilized, SBP removed the restrictions on the trading hours for customer and interbank foreign exchange transactions. Also the margin restrictions on Import letters of Credit have also been removed.

4.3 Regional Perspective

The global economic slowdown had its toll on many other regional currencies which showed declining trend in their value against the US dollar. However, the most significant depreciation was witnessed in Pak rupee and Indian rupee which depreciated by about 19.1 percent and 11.3 percent (see **Figure 4.2**). Malaysian ringgit and Lankan rupee also faced depreciating pressure to the tune of 7.6 percent and 6.7 percent. On the other hand, depreciation was relatively low in Thai baht and Bangladesh taka. The Chinese currency was perhaps the only exception in the region that showed slight improvement against the US dollar.

Figure 4.2: Regional Currencies Performance Against UD$ during FY09



4.4 Support for POL Payments

Unprecedented increase in oil prices in international market at the end of FY08 kept upward pressure on oil bill at the start of FY 09. Oil bill for the first quarter of the year remained significantly higher as payments made during this period accounted for 42 percent of the total oil bill of FY09. Impact of decline in oil prices became visible only after the end of the first quarter.

During F09, SBP provided a total of $9,233 million to banks for POL payments which were about 90 percent of the total oil bill. This amount was $281 million higher than the support provided in FY08 which was approximately $8,952 million (see **Table 4.4**).

Table 4.4: POL Payments during FY08-FY09

million US dollar

	FY09				FY08		
Month	**SBP's share**	**Banks' share**	**Total**	**Month**	**SBP's share**	**Banks' share**	**Total**
Jul-08	1,141	105	1,246	Jul-07	786	66	852
Aug-08	1,498	0	1,498	Aug-07	480	139	619
Sep-08	1,554	0	1,554	Sep-07	425	141	566
Oct-09	1,170	0	1,170	Oct-07	512	159	671
Nov-08	740	0	740	Nov-07	702	215	917
Dec-08	690	0	690	Dec-07	824	109	933
Jan-09	503	0	503	Jan-08	602	260	862
Feb-09	328	133	461	Feb-08	728	132	860
Mar-09	294	182	476	Mar-08	740	154	894
Apr-09	368	179	547	Apr-08	924	301	1225
May-09	366	167	533	May-08	1,266	195	1461
Jun-09	581	233	814	Jun-08	963	211	1174
Total	**9,233**	**999**	**10,232**	**Total**	**8,952**	**2,082**	**11,034**

4.5 Foreign Exchange Reserve Management

The financial turbulence that first surfaced in August 2007, reached full swing in March 2008, and was going strong at the onset of FY09. The precipitous fall in housing markets led to drying up of liquidity in that market leading to severe decline in prices of related assets and mortgaged backed securities. With ABS and MBS markets freezing up, asset prices declined and financial institutions, primarily in the West, underwent declining profitability and received sizeable knocks to their balance sheets. This subsequently led to a bout of bankruptcies and ensuing tightening of the lending standards – initiating a secondary phase of activity slowdown. The programs initiated by central banks, globally, to ease the credit markets and return liquidity to the financial markets became one of the most expansive and synchronized effort globally to beat a global activity downturn. The actions of the Federal Reserve, European Central Bank, the Bank of England, and Bank of Japan were particularly important. These included aggressive easing of policy rates, asset purchase programs and fiscal stimulus packages to ease credit markets and to re-invigorate consumption which had been severely impacted from the wealth destruction in home and capital markets.

At the onset of FY09, the challenges that the State Bank of Pakistan encountered included the high import bill. Oil prices had peaked in July and remained above $100 benchmark, throughout Q1 F-Y09. Given the slowdown in home remittances, dwindling exports, coupled with high import obligation in shape of POL support, took a heavy toll on the current account deficit and the balance of payments. The reserves reached a low of $6 billion in Q1 FY09. In response to need for liquid currency for balance of payments needs and cash flow management in a highly stressed market, a decision was made to partially disinvest Externally Managed Fixed Income Portfolio. In Q2 FY09, a portion of the reserves was disinvested from External Fixed Income Portfolio to cash in the Q2 FY09. The initial cost was anticipated to the tune of 3.0 percent+ due to financial market turmoil and overall liquidity conditions, however, it was brought down to 2.1 percent through active management of the disinvestment process. This in itself is a commendable achievement considering the global financial conditions and credit spreads prevailing towards end of Q1 FY09. In late November 2008, the IMF provided support in shape of a Stand-By Arrangement for Pakistan which resulted in additional cash inflow of $3.1 billion to help bolster the reserves to $9.1 billion by 2008 year end. In Q2 FY09 oil prices dropped from $100 and were expected to stabilize at a lower range given the weakening global economy providing hope for the restoration of the Bank’s foreign reserves.

Despite the global financial turmoil and depleting reserves, the capacity building measures continued at departmental and cluster levels, with skill enhancements through arranging web-based fixed income training modules, self-study and encouraging individuals to take-up professional certifications relevant to the business. Resultantly 90 percent of staff members have registered for professional certifications of international repute including CFA and FRM. Additionally, sourcing competent professionals at junior level was also carried out to fill open slots for these extremely specialized functions.

Substantial value was added to the Bank’s profitability through active management of investment portfolio in FY09. The gross return in FY09 on the overall reserves was 2.31 percent, slightly better than its benchmark. While, return was lower than 4.9 percent in FY08, considering zero interest rate environments prevailing globally in FY09, the returns earned are a significant achievement and were only possible due to enhanced team capabilities achieved through Cluster based structure. Given the inflow of foreign currency through multinational programs, and a moderation in POL support payments, the central bank foreign reserves should see growth in the upcoming year. With the reserve position stabilizing, the strategic allocation of assets will be re-evaluated internally through Cluster resources and optimally re-positioned taking into account global conditions to improve returns while managing an appropriate risk profile.

4.6 Home Remittances

The efforts undertaken by SBP in consultation with other stakeholders have resulted in total remittances to reach historic high level of USD 7.8 billion in FY09, registering a growth of 21 percent over FY08.

Another breakthrough related to the remittances was launching of the historic Pakistan Remittance Initiative (PRI) by the federal government and the State Bank of Pakistan. This will hopefully bring a fundamental change in country’s remittance regime to boost and facilitate the flow of remittances sent home by non-resident Pakistanis. The insufficient presence of Pakistani banks in overseas jurisdictions and lack of marketing efforts are some of the major impediments to the flow of remittances. In this backdrop, a financial incentive scheme is being launched for overseas entities whereby they will be supported in their marketing efforts. The scheme is performance based and rests on the basic premise of offering financial incentives against mobilization of additional remittances. Such incentives shall start from bringing at least US$ 100 million from one particular jurisdiction in one year. To provide for a remittance structure whereby ownership of remittance to Pakistan could be placed, PRI is established wherein:

- State Bank of Pakistan shall deploy a team of senior officials and other support required to implement and execute the objective.
- Ministry of Finance through SBP will make available the requisite funds required to enable the Pakistan Remittance Initiative to commence its operations and take all necessary actions to enhance the flow of remittances.
- There will be an Advisory Group which will, in consultation with other stake holders, formulate the strategy to achieve the objective of Pakistan Remittance Initiative.
- An independent organization shall be established which will take the initiative and continue the work which the Pakistan Remittance Initiative would have already undertaken.

To provide a reliable and immediate contact, 24 hours 7 days a week, call centre has been established which is now operational. All overseas Pakistanis and their families can inquire about the remittance services of banks and lodge their complaints with the call centre. PRI is working to provide such services toll free for overseas Pakistanis living in various regions of the world. However, at the moment, toll free services are currently available to Pakistanis living in North America. In addition, a comprehensive website, i.e., **www.pri.gov.pk** has been established to provide maximum information about the processes involved in the remittance transactions. Further, to facilitate the remitters in identifying the places near to them to route remittances through banking channels, a locator has been placed.

In the initial phase, PRI formed a focused group of five large banks and these banks in consultation with SBP have finalized all related arrangements to instantly credit the bank account of the beneficiary once they receive the funds. Similarly these banks have completed their arrangements for instant payments of cash over the counter.

Similarly, to address the issue of delay in interbank settlement of remittance transactions, SBP has put in place a mechanism whereby banks would inform twice a day each other about the bank accounts to be credited with the remittances received while the funds shall route through RTGS simultaneously with the exchange of information.

SBP has also introduced a mechanism for compensation to remittance beneficiaries for delay by the banks and a comprehensive ‘Complaint Handling Mechanism’ has also been put in place. Similarly, SBP is encouraging the enhanced role of technology in offering remittance services.

4.7 Exchange Companies

In FY09, to initiate action against Hundi/Hawala operators and people involved in illegal foreign exchange business, State Bank of Pakistan requested Ministry of Interior to take law enforcement action against illegal operators. Accordingly, FIA launched a special campaign and apprehended a number of foreign exchange operators involved in illegal activities. While analyzing the results of FIA action, the data reveals that remittances earlier being transmitted through undocumented channels had started to divert to formal channels. During FY09, SBP took the following measures:

Reemphasized to Maintain AML / KYC Standards and Proper Documentation. SBP reemphasized to the Exchange Companies, the importance of documentation and exercising utmost diligence while dealing with their customers in terms of maintaining KYC standards, establishing bonafides and satisfying themselves with the beneficial ownership of transactions routed through them. It was also reiterated that in case any Exchange Company was found involved in violation of any SBP Rules & Regulations in general and any undocumented transactions in particular, strict action leading towards suspension or cancellation of the license would be taken against the company involved.

Certificates regarding Compliance Status of each Business Location. Exchange Companies were advised to revisit the compliance status of each of its business location including branches, CEBs, franchises, payment booths with respect to documentation of transactions and adherence to SBP rules and regulations through all available means including on-site visits of business locations. The Exchange Companies were advised to submit certificates to this effect by October 31, 2008, signed by CEO and all Directors of the company.

Additional Requirements w.r.t. Export of Permissible FCYs. Exchange Companies were advised that; (I) all the currency carriers must be employees of the Exchange Company; and (ii) it would be compulsory for ECs to finalize the deal with overseas entity before the shipment of each export consignment. The system generated deal ticket (specifying consignee name, address, contract details, amount, exchange rate, etc.) must be accompanied with each request for exporting permissible FCYs.

Changes in Foreign Exchange Regime taken place during the year FY09

Advance Payments against imports on L/C Basis. The facility of 100 percent advance payment against irrevocable L/Cs and firm registered contracts was restricted to 50 percent. The advance payment facility against imports has been further reduced to 25 percent of the FOB or CFR value of the goods against letters of credit only.

Forward Cover Facility. Authorized Dealers were 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. The said facility for all types of imports has been temporarily suspended since July 2008.

Payments against POL Products. Authorized Dealers were allowed to make all purchases of foreign exchange from interbank market related to the import of Furnace Oil and remittances against which specific approvals were granted by the Exchange Policy Department, SBP. Effective August 1, 2009, in addition to the above, all purchases of foreign exchange related to import of Diesel and other refined products are being made by the banks from the interbank market. SBP will, however, continue to provide foreign exchange to the banks for import of crude oil only.

Enhancement in the Limit of Retention of Export Proceeds for Exporters of Pharmaceutical Products. The limit of retention of export proceeds for exports of Pharmaceutical products has been enhanced from 10 to 15 percent.

Asian Clearing Union (ACU) Mechanism. ACU Euro has been included as the second ACU currency along with ACU dollar w.e.f. January1, 2009. The ACU Euro would be equivalent in value to one Euro. Accordingly, transactions under ACU Mechanism, in addition to ACU dollar (ACUD), may also be denominated and settled in ACU Euro (ACUE) effective January1, 2009.

Further, to encourage the banks to maintain reasonable/sufficient balances in their accounts to ensure timely payments, the Authorized Dealers have been permitted to pay/receive interest, at their discretion, on ACUD and ACUE accounts as per mutually agreed terms and conditions.