6 Exchange Markets and Reserve Management

6.1 Money and Debt Market

Improving the depth, liquidity, and efficiency of the money and debt markets in Pakistan is one of the prime strategic objectives of the State Bank. SBP took various initiatives, during the year, to further develop the marketable government securities debt market in Pakistan with special focus on broadening the investor base. Moreover, SBP's management of market liquidity and sentiments helped effectively implementing monetary policy stance and anchoring inflation expectations. It also helped ensuring smooth functioning of these markets complemented with increased trade volumes, and improving maturity profile of government domestic debt.

Pakistan Investment Bonds

Debt Management Strategy of the Government of Pakistan, supplemented with an appropriate monetary policy stance and its implementation, has facilitated a shift in market's interest from Treasury Bills (T-bills) to Pakistan Investment Bonds (PIBs). During FY14, the government raised Rs. 2,037.0 billion against the offered and targeted amount of Rs. 2,232.5 billion and Rs 780 billion, respectively. With this shift in market interest towards longer tenor government securities, maturity profile of the government debt has improved and roll-over risk for the government has reduced. Share of PIBs in overall domestic debt of government has increased from 13.9 percent at end-June 2013 to 29.6 percent by end-June 2014.

Ijara Sukuk

In coordination with SBP, Government of Pakistan successfully issued GOP Ijara Sukuk (GIS) in the domestic market in June 2014, after a gap of around fifteen months. Market's aggressive participation in GIS auction helped the government raise Rs.49.5 billion at 200 bps below the benchmark rate. The issuance of Ijara Sukuk has helped Islamic Banks/Islamic Bank Branches to invest a part of their surplus liquidity. As of June 30, 2014, total outstanding amount of GIS was PKR 326.36 billion, out of which, GIS worth PKR 290.4 billion are held by Islamic Banks/Branches.

Introduction of International Securities Identification Numbers (ISIN) for Government Securities

To facilitate international investors and to further broaden the investor base of Government securities, the State Bank of Pakistan has started issuing International Securities Identification Number (ISIN), from April 24, 2014, to all outstanding Government Securities; including Market Treasury Bills, Pakistan Investment Bonds, Government Ijara Sukuk and treasury bills issued through Outright OMO Sale. The issuance of ISIN for government securities will harmonize the Pakistan debt market with international debt markets through availability of information on these securities in line with the international standards.

Code of Conduct for Treasuries of Banks, DFIs, and Primary Dealers (PDs)

In January 2014, State Bank of Pakistan issued "Code of Conduct" for the treasuries of Banks, DFIs and PDs with the objective to foster high standard of business conduct, adopt professional market practices, and ensure equitable and healthy relationships among market participants. It will promote ethical behavior and standards of conduct; affirming the use of sound dealing practices and procedures; supporting robust and efficient front and back office operations; and mitigating risks from the point of execution to settlement. All Banks, DFIs and PDs have been advised to implement this Code of Conduct in their treasuries and ensure its compliance. Further, Risk and Compliance

Department of the each bank/DFI/PD, has been advised to submit a quarterly report to their senior management regarding compliance to this 'Code of Conduct', which should be discussed and documented along with all exceptions and breaches.

Trading of Government Securities on the Stock Exchanges
To further broaden the investor base, State Bank of Pakistan decided, to allow trading of Government Securities (Market Treasury Bills, Pakistan Investment Bonds & GOP Ijara Sukuk) on the Stock Exchanges in January 2014. SBP has also allowed all Primary Dealers (PDs) of Government securities for proprietary trading of Government Securities on the stock exchanges. However, the current OTC market of Government Securities and all its associated platforms will continue to work as usual.

6.2 Foreign Exchange Market

During the year under review, SBP focused on enhancing capacity of the domestic foreign exchange market to manage large trade volumes, ensuring smooth functioning of the market, and building foreign exchange reserves of the central bank. Considering the rising external trade volumes, SBP further increased overall Foreign Exchange Exposure Limit (FEEL) of the market by 2.4 percent in FY14; enabling the market to better manage larger flows without having any undue impact on volatility in exchange rate. Moreover, the maximum cap on FEEL of an Authorized Dealer has been increased from PKR 2,500 million to PKR 3,500 million.

Improved balance of payment position, especially during second half of FY14, helped SBP to accumulate foreign exchange reserves; which increased to US$9.1 billion by the end of FY14 from US$ 6.0 billion at end-June 2013. PKR-US$ parity, though showed significant volatility, recorded an appreciation of 0.9 percent during the year (see **Table 6.1**).

Table 6.1: Pak Rupee per US Dollar Interbank Trends

	High	Low	Close	Average	Volatility C/C[2]
FY11	86.50	83.93	85.97	85.56	2.40
FY12	94.69	85.79	94.55	89.27	2.48
FY13	99.80	93.70	99.66	96.85	1.67
FY14	110.5	95.75	98.80	102.88	4.07

[2] Reuters: Average close-to-close daily volatility (in percent)

However, during most of the first half of the year, Pakistan's balance of payment position remained weak, foreign exchange reserves continued to fall, and the exchange rate depreciated by 5.4 percent. Weak capital and financial inflows that were insufficient to finance even a relatively low current account deficit and large debt repayments primarily related to repayment of IMF-SBA facility resulted in a drain in the foreign exchange reserves and had fueled the negative sentiments of the market reflecting depreciation of the exchange rate. SBP adopted cautious policy and closely managed the domestic foreign exchange markets to ensure its smooth functioning. Further, to quell any speculative tendencies and calm the sentiments in the foreign exchange markets, Governor SBP along with the Finance Minister held meetings with financial sector players, corporate leaders, and representatives of exchange companies to take them into confidence on the measures taken and improved outlook of the overall economy in general and Pakistan's external sector in particular.

During second half of the fiscal year, overall balance of payment improved significantly. While the external current account deficit remained low, increased inflows in the form of CSF money, 3G license fee, receipts of Euro bonds and loans and grants from multilateral and bilateral sources considerably turned the balance of payment position into surplus and helped SBP build its foreign exchange reserves (see **Table 6.2**). SBP remained vigilant and kept a check on the excessive volatility in the exchange rate.

6.3 Foreign Exchange Reserve Management

Reserve Management Strategy

FY14 was a mixed year for major financial markets due to uncertain interest rate outlook. The easing bias of the major central banks in FY13 ensured that interest rates remained depressed throughout the major economies. The gradual shifting of the easing stance with the US tapering announcement in FY14 led to considerable uncertainty in the markets regarding the future direction of interest rates. The priority of the central banks in such an uncertain scenario remained safety, closely followed by liquidity. SBP's reserve management strategy for FY14 was also shaped around this view, ensuring the security and liquidity of Foreign Exchange Reserves. The approach helped SBP in managing its debt obligations despite sharp deterioration of reserve position at the start of FY14. Foreign Exchange Reserves have bounced back from the middle of the year and are expected to improve further in FY15.

Table 6.2: Month-wise Foreign Exchange Reserves
(in million US$)

Month end	SBP	Banks	Total
Jul-13	5,203.8	5,082.9	10,286.7
Aug-13	4,824.1	5,170.7	9,994.8
Sep, 13	4,693.5	5,123.5	9,817.0
Oct, 13	4,229.7	5,295.1	9,524.8
Nov, 13	3,048.2	5,198.6	8,246.8
Dec, 13	3,479.3	4,834.2	8,313.5
Jan, 14	3,180.3	4,808.0	7,988.3
Feb,14	3,918.6	4825.0	8,743.6
Mar,14	5,364.6	4,709.7	10,074.3
Apr,14	7,414.2	4,768.6	12,182.8
May, 14	8,682.9	4,782.9	13,465.8
Jun, 14	9,095.7	5,043.6	14,139.3

The world economy has continued on its moderate recovery path in FY14. The US economy and the UK economy are fast approaching their pre-financial crisis levels. The recovery in EU remains slow, but it is expected to gain momentum in FY15. SBP has continued to invest in the Chinese domestic bond market after its agreement with the People's Bank of China in FY13. The access to the Chinese bond market has been a vital source of diversification for SBP and has become an important part of SBP's reserve management strategy. With substantial increase in reserves, diversification into new instruments and asset classes will come under consideration subject to suitable global environment. Foreign exchange reserves yielded a gross return of more than 1.3 percent during FY-14 which is considerably high under the prevailing zero yield levels in the global financial markets.

6.4 Meeting of Standing Technical Committee of Asian Clearing Union (ACU)

State Bank of Pakistan hosted a meeting of Standing Technical Committee (STC) of Asian Clearing Union (ACU) in April 2014. Senior officials and experts from central banks of Bangladesh, Bhutan, India, Iran, Nepal, Myanmar and Sri Lanka represented their countries. The meeting was held in continuation of the efforts to enhance intra regional trade among ACU member countries and to bring efficiency in the existing payments and settlement processes under ACU.

6.5 Exchange Companies

To strengthen AML/KYC, new instructions were introduced; all sale and outward transactions of US$ 35,000 or above (or equivalent in other currencies) are required to be conducted by the exchange companies through crossed cheque/DD/PO issued from the personal account of the customer and instrument number and issuing bank's name would be mentioned on the transaction receipt along with CNIC number of the customer. Further, exchange companies are required to get and retain copy of the identification document of all transactions of US$ 2,500 or above (or equivalent in other currencies); the earlier threshold level was US$ 5,000 (or equivalent in other currencies). Minimum paid-up capital requirement of all new and existing exchange companies has been enhanced from Rs. 100 million to Rs. 200 million; the companies are required to maintain 25 percent of paid up capital as SLR with SBP.

6.6 Pakistan Remittance Initiative (PRI)

State Bank of Pakistan, Ministry of Overseas Pakistanis and Ministry of Finance launched this joint initiative in April 2009. The establishment of PRI has contributed positively in enhancing the flow of remittances to Pakistan. Home remittances rose to US$ 15.83 billion in FY14, witnessing a growth of 13.7 percent compared with US$ 13.92 billion in FY13. This rise is mainly attributed to: (i) a record number of workers went abroad in the preceding year, (ii) Interbank Fund Transfer (IBFT) facility in home remittances increased efficiency in the delivery channels and convenience for the beneficiaries; and (iii) release of a record amount of Rs. 10.46 billion by the Government on account of TT charges on home remittances. The latter was particularly instrumental to ease capital position of overseas tie-ups and thus motivate them to undertake marketing campaigns for Pakistani corridor.

6.7 Treasury Operations

Nostro operations, SWIFT business side and other related functions such as accounting and reporting of outsourced reserves portfolio entrusted to foreign fund managers and execution of FCY payments of SBP & GOP; reserves management and financial stability were handled efficiently. Accurate and timely processing and settlement of trades, recording and reporting of traditional as well as advanced treasury products and execution of FCY payments in automated environment were ensured. Further, to broaden the foreign investment avenues and diversify the currency mix, SBP opened a new offshore RMB Nostro account in Hong Kong.

6.8 Risk Management and Compliance

SBP has strengthened its risk monitoring framework through designing and implementing credit and market risk frameworks covering all reserve management operations. Such a framework has enabled SBP to actively monitor the health of bank’s foreign exchange portfolio on daily basis and under various scenarios. In addition, the Bank has taken several initiatives in collaboration with relevant stakeholders to review existing risk management policies/framework to bring them in conformity with the changing dynamics of the financial markets and associated risks and to support SBP reserve management operations to comply with its broader objectives of safety, liquidity, and return while conducting reserve management activities.

On operational risk front, SBP has introduced various controls at policy and operational levels to minimize the operational risk in SBP reserve management activities. Some of the key tasks that were completed during the year are: Implementation of credit and market risk framework for in-house and outsourced reserve management activities; further harmonization of internal and external data sources of in-house and outsourced portfolios to address issues related to data validation and authenticity; laying down the necessary infrastructure for tactical investment in fixed income portfolio management.