6 Exchange Markets and Reserve Management

6.1 Money and Debt Market

A well-developed financial market plays a key role in effective implementation of monetary policy. During FY15, SBP has made further progress towards improving the depth, liquidity, and efficiency of the money, debt, and foreign exchange markets in Pakistan, which is one of the prime objectives of the Bank. During the year, SBP took the following initiatives which helped in the effective implementation of monetary policy stance and ensured smooth functioning of financial markets to achieve SBP's objective of anchoring expectations and maintaining low inflation.

6.1.1 Improvement in the Interest Rate Corridor Framework

To enhance the effectiveness of monetary policy and better manage liquidity in the interbank market, SBP improved the structure of its Interest Rate Corridor (IRC) framework. The main feature of this improved framework is the introduction of the 'SBP target rate' for the money market overnight repo rate as the new and main Policy Rate of SBP. This step aligned SBP's operational target with the new Policy Rate set within IRC, i.e., 50 basis points below the ceiling rate. The main objective of adopting an improved IRC by SBP was to stabilize short-tenor interest rates around the 'Policy Rate' for smooth transmission of monetary policy. To keep the interest rate close to the target rate, SBP conducted more frequent and larger volume Open Market Operations (OMOs) to meet liquidity needs of the market. As a result, in the period since May 2015 monetary policy statement, the overnight repo rate remained (on average) close to the new SBP target rate (Policy Rate) of 6.50 percent, indicating successful implementation of monetary policy stance.

6.1.2 Introduction of Liquidity Management Instruments for IBIs

Islamic banking industry in Pakistan has progressed significantly in recent years. However, due to limited availability of Shariah compliant instruments in the domestic market, IBIs were facing problems in managing their liquidity. The liquidity management for IBIs became more challenging due to lack of fresh issuances of GoP Ijara Sukuk (GIS) and maturing stock of already issued GIS.

To facilitate IBIs in their liquidity management and to improve the effectiveness of monetary policy transmission, SBP introduced OMOs for IBIs in October 2014. Under these OMOs, SBP can purchase or sell GIS either on deferred payment basis (Bai-Muajjal) or on ready payment basis, using multiple price competitive bidding auction process. These OMOs provided SBP a tool to manage liquidity available in this segment of the market and facilitated IBIs in better management of their surplus funds, particularly in the absence of new Sukuk issuances by the GoP.

6.1.3 Development and implementation of Derivative Transactions Reporting System (DTRS)

The Over-the-Counter (OTC) derivatives market in the country operates under the regulatory framework of SBP. Banks execute derivative transactions permitted by SBP and report the transactions detail on monthly basis. In the past, data from these reports was manually processed to get market-wide scenario. To closely monitor the activities of derivatives market, SBP introduced the Derivative Transaction Reporting System (DTRS) to capture all derivative transactions executed by banks operating in Pakistan.

DTRS, introduced in April 2015, is developed on the same lines as FXCRS and MMCRS which capture FX and money market transactions, respectively. DTRS requires all banks dealing in financial derivatives to report derivative transactions, including cross currency swaps, interest rate swaps, foreign currency options, and Forward Rate Agreements (FRAs) on weekly basis. Banks send details of their derivative transactions using client-end forms developed and supplied by SBP. The data received by SBP is loaded in DTRS and reports are generated using available tools for monitoring and analysis.

6.2 Foreign Exchange Market

A stable and vibrant foreign exchange market is immensely important for the functioning of financial sector and overall economy. SBP continued to focus on smooth functioning of the domestic foreign exchange market and building its foreign exchange reserves. During FY15, Pakistan's foreign exchange reserves increased by US$ 4.6 billion to 18.7 billion by June 30, 2015.

4.2.1 Establishment of Cross Border CNY settlement System in Pakistan

SBP signed a Currency Swap Agreement with the People's Bank of China (PBoC) in 2011 with the objective of promoting bilateral trade and financing direct investment between the two countries in their respective local currencies. Further to encourage trade with China in CNY, SBP has recently allowed ICBC Pakistan to establish a local CNY settlement and clearing setup in Pakistan. This is a part of series of steps taken by SBP to encourage trade with China in CNY such as allowing banks to accept CNY deposits and extend CNY loans to importers/exporters. Key elements of the CNY Settlement Initiative are as follows:

(1) ICBC Pakistan branches are allowed to open CNY accounts of the banks operating in Pakistan to facilitate settlement of CNY based transactions such as remittance to/from China.
(2) ICBC Pakistan branches can provide CNY liquidity to the interbank market for the settlement of CNY based transactions.

Keeping in view the recent local and global economic developments, SBP expects this initiative to yield long term benefits to China-Pakistan relationship in general, and Pakistan's economy and banking system in particular.

6.3 Foreign Exchange Reserve Management

6.3.1 Global Economic Outlook

The year started with a declining trend in oil prices driven by excess supply. OPEC did not reduce supply to preserve market share in face of increased supply by non-OPEC especially North American shale oil producers. The oil price was projected to provide a boost to household consumption in US. The oil price also reduced the US inflation and brought it close to zero. However, the Fed attributed it to transitory factors. The US economy grew strongly with a GDP growth of 2.4 percent for 2014. Fed indicated that the monetary policy tightening would commence once data confirmed that economy is on a growth trajectory. In contrast the European economies struggled during the year with France growing by 0.2 percent, Italy with a negative GDP growth of 0.4 percent, Portugal with a GDP growth of 0.9 percent, Spain 1.4 percent and Germany growing at 1.6 percent.

The heightened volatility in the bond and FX markets due to uncertain economic data, policy actions and political events saw sudden and sharp FX movements. During FY'15 US Dollar appreciated against GBP by 8.91 percent, EUR by 22.92 percent, JPY by 20.89 percent, AUD by 22.39 percent and CAD by 17.08 percent. In short, all major currencies have lost ground to the strengthening US Dollar during the year. The major events which caused this extreme volatility include European Central Bank's (ECB) launch of quantitative easing (QE) program of EUR 1.1 trillion; easing of monetary policy by central banks globally; Greek exit fear from eurozone, decoupling of the monetary policy of Federal Reserve Bank & ECB and fall of commodity prices. The prevailing economic conditions and the allied policy actions taken by the monetary authorities dragged sovereign yields to extremely low levels and in some cases into negative territory.

Although the long drawn out negotiations between the new government and the troika, i.e., ECB, IMF, and European Commission, over the terms of the new bailout package were successful in the end, they caused great uncertainty and stress in the financial market. The Chinese economy was able to meet its growth target over FY15, providing some respite to global growth. In addition to monetary measures, Chinese policy makers also focused on supporting the economy by advancing its reforms agenda for its State Owned Enterprises (SOEs). The Chinese economy is likely to benefit from the internationalization of Renminbi – which includes gradually opening up of Chinese capital markets to foreign investors and promoting the global use of Renminbi for cross-border trade settlement.

6.3.2 SBP Reserve Management Strategy

SBP is continuing with its strategy of adhering to the overall risk parameters and ensuring that the foreign reserve portfolio provides an optimal return keeping in view the safety and liquidity needs of the SBP. The reserves have grown during the year and are expected to continue with this trend benefiting from the recent decrease in global oil prices. The investment in the Chinese bond market continued in FY15 and was expanded during the year. The Chinese bond portfolio continues to play an important role in the SBP's overall reserve portfolio mix and offers a vital source of risk diversification and yield enhancement.

6.4 Foreign Exchange Regime

Major changes made in foreign exchange regime during FY15 are as under:

- With a view to cater to their genuine small import needs, importers were allowed advance payment up to US$ 10,000/- or equivalent foreign exchange per invoice for import of all eligible items without requirement of Letter of Credit or Bank Guarantee.
- In order to facilitate resident Pakistanis to meet their individual foreign exchange needs, SBP has simplified its instructions/procedure regarding remittances/release of foreign exchange related to medical treatment and studies abroad.
- To improve supervision and monitoring of foreign exchange transactions by Hotels having restricted authorization to deal in foreign currencies, reporting requirements were revised as per International Statistical Standards.
- To further facilitate exchange companies, duration of the renewed licenses of exchange companies (category A) was increased from three to five years from the date of expiry of the license subject to completion of SBP required formalities.
- The exchange companies have been encouraged to increase their capital by simplifying the regulatory approval process.
- To broaden the scope of exchange companies, they were allowed to conduct branchless banking activities as agents of authorized financial institutions.

6.5 Home Remittances

Workers' remittances increased to US$ 18.7 billion during FY15, registering a growth of 18.2 percent over the preceding year. They made up for nearly 45 percent of the country's import and are 6.5 percent of GDP.

Pakistan Remittance Initiative (PRI) (a joint initiative of SBP, Ministry of Finance, & Ministry of Overseas Pakistanis) has contributed significantly in enhancing the flow of remittances through formal channels. In the recent times, following major steps have been taken, under the auspices of PRI, to facilitate the flow of remittances:

- Introduction of innovative products by financial institutions for both remitters and beneficiaries
- Enhanced overseas market coverage of financial institutions
- Efforts to enhance awareness amongst the overseas Pakistanis in coordination with other stakeholders
- Country-wide workshops as a preparatory work to launch pre-departure briefing program
- Establishment of PRI dedicated call center to cater queries and complaints of customers regarding delay in home remittance payments

In order to encourage overseas Pakistanis to remit money to the country through formal banking channels, GoP had introduced 'Reimbursement of TT charges Scheme on Home Remittance' in October 1985. In order to rationalize the scheme, the reimbursement rate of SAR 25/- has been reduced to SAR 20/- for each eligible remittance transaction. The minimum amount of remittance to qualify for reimbursement of TT charges has been increased from US$ 100/- to US$ 200/- or equivalent to other currency.

6.6 Treasury Operations

A mechanism for compiling the data/disclosures relating to FCY investments and FX trades, for IAS compliant financial statements, has been developed and implemented. Further, settlement modalities and procedures were finalized and applied for the first time for internally managed fixed income securities investment initiated by the front office. This successful exercise has built internal HR capacity at back office and would greatly help in diversification of internally managed portfolio in future. In order to strengthen the SWIFT system operations, database recovery software has been procured and installed. On the core business side, accurate and timely settlement of trades, recording and reporting of traditional as well as advanced treasury transactions and execution of FCY payments were ensured.