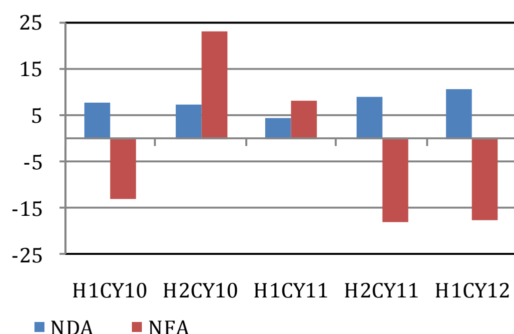
Chapter 5 Financial Markets

The high fiscal deficit and uncertain financial inflows maintained stress on the money and foreign exchange markets. However, the bullish equity markets led to a considerable improvement in stock indices during the period under review. The liquidity pressures in the money market remained, though lower than the previous half, due to persistent reliance of the Government on financial institutions for bridging the fiscal gap, for which the central bank made substantial injection for easing out the market liquidity. Meanwhile, with the depletion in foreign exchange reserves due to multilateral repayments, unfavorable terms of trade and market sentiments, PKR depreciated by 5.2 percent against the USD.

Stress prevailed in the financial markets despite modest recovery in the macroeconomic indicators and revival of equity market.

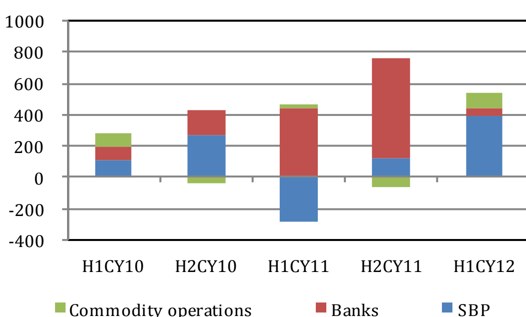
The rising degree of stress and vulnerability faced by the domestic financial markets carried over from the previous half year. The money market activities were largely driven by high government borrowing needs to bridge the revenues and expenditures gap. The foreign exchange market also remained volatile on account of modest yet growing current account deficit, limited financial inflows and market sentiments. However, the highlight of the financial markets during the first half of CY12 remained the robust growth in the equity market index that witnessed a sharp increase of 21.6 percent during the first half of CY12 (against a decline of 9.2 percent during H2-CY11).

Figure 5.1
Trends in M2 (percent change)



The trends in the money supply (M2) reflected the persistence of stress in the domestic money markets and the external sector. The surge in government borrowings for financing the budgetary needs and increase in lending to public sector enterprises (PSE) augmented the Net Domestic Assets (NDA) of the banking system by 10.6 percent during HI-CY12 compared to 8.8 percent in the second half of CY11 (**Figure 5.1**). Similarly, the sharp deterioration in foreign exchange reserves in response to growing current account deficit dampened the Net Foreign Assets (NFA) by 17.8 percent.

Figure 5.2
Pattern of Government Borrowings - Half-Yealy Flows (Rs. billion)



The prevailing high budgetary borrowings from the financial sector in general and banks in particular affected the macroeconomic recovery prospects due to persistent decline in private investments.[45] The share of public sector credit in total assets, which declined to 21 percent in CY08, again surged to 40 percent in Jun-12; around 3 times increase in absolute terms. This rising share of Government exposure on banks not only

[45] The investment to GDP ratio has fallen from 22 percent in FY08 to 13 percent in FY12.

Figure 5.3

Trend of overnight Repo Rates (percent)

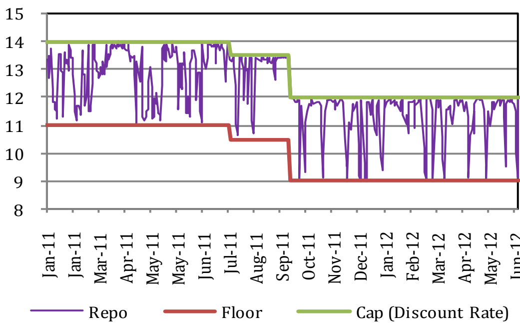


Figure 5.4

Open Market Operations (Rs. billion)

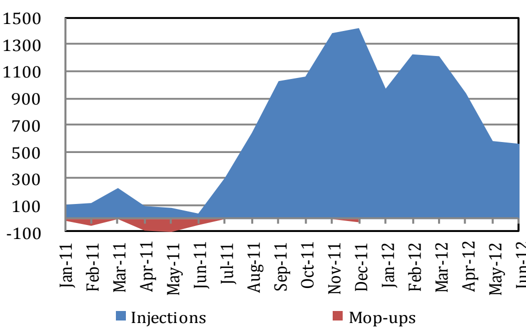


Figure 5.5

Stock of T-bills, PIBs and Sukuks outstanding (Rs. billion)

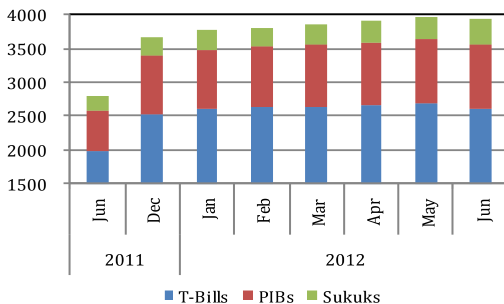
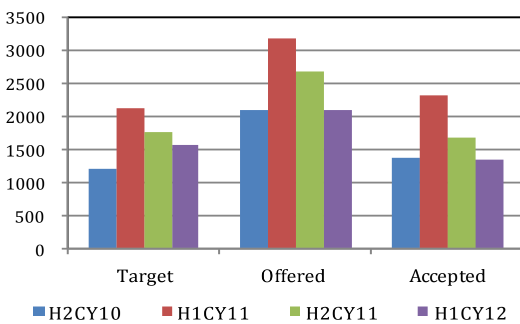


Figure 5.6

Profile of T-bill Auctions (Rs. billion)



limited the availability of credit to private sector but also surpassed the share of private sector credit in total assets.

The surge in bank credit during H1-CY12 mainly resulted from increased demand for loans from the PSEs and higher level of commodity finance for wheat procurement[46] and fertilizer import, which curtailed the availability of liquidity for incremental budgetary borrowing from the banks during the period. As a result, the monetization of fiscal deficit increased, enhancing central bank borrowings by 29.4 percent during H1-CY12 compared to 6.3 percent growth in the previous half (**Figure 5.2**).

Persistent fiscal borrowings maintained stress on short-term money market rates

Decreasing foreign financial inflows and higher public sector credit demand constrained the market liquidity, despite the fact that banks mobilized significant amount of deposits during the period under review. Accordingly, short-term overnight rates remained quite volatile and most of the time remained near the upper bound of the interest rate corridor (**Figure 5.3**).

To ease out the market liquidity, the central bank continued heavy injections through frequent OMOs, though quantum remained below the level of injections made in second Half of 2011 (**Figure 5.4**). However, such heavy injections did not affect the short-term rates, indicating the depth of fiscal needs. It also reflected the risk averse behavior of banks, which continued to fund the government directly from deposits mobilized as well as through channeling most of the repo borrowings from the central bank into Government securities.

The stock of T-Bills, PIBs and Sukuks saw a considerable increase due to persistently large fiscal deficit over the last few years. The trend continued during the period under review, however in sharp contrast with the behavior of last few years, most of the increase took place in long term PIBs and Sukuks (**Figure 5.5**). The participation in the most of the securities continued to generate high interest, though lower than those observed in H2-CY11. In case of T-Bills, the government preferred to match the maturities (F**igure 5.6**), while the acceptance ratio remained quite high in case of PIBs and Sukuks.

[46] In FY12, the government not only increased the wheat support price from Rs 950 to Rs 1050 per 40 kg, but also announced a higher procurement target of 7.7 million tons, compared to the actual procurement of 6.2 million tons last year.

Figure 5.7

T-Bill Tenure offered (percent share)

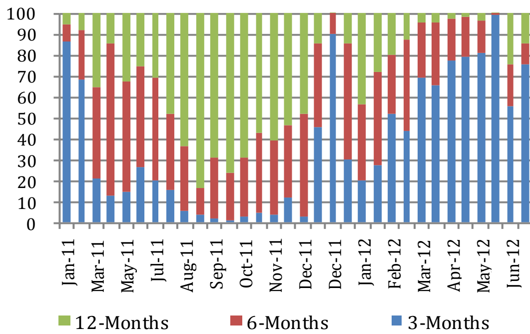


Figure 5.8

Growing share of Non-Competitive Bids

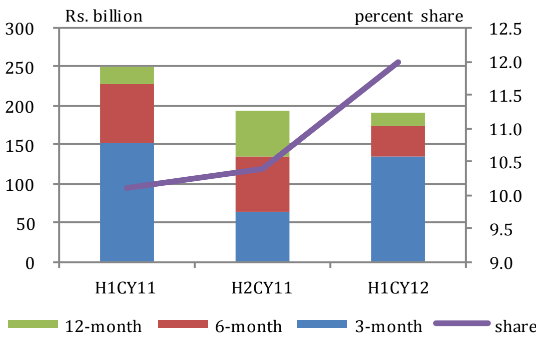


Figure 5.9

Accepted PIB Auction Profile (Rs. billion)

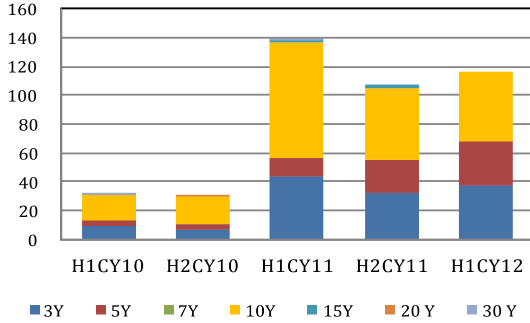
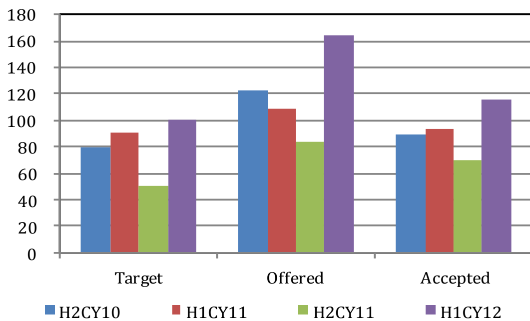


Figure 5.10

Auction Profile of Ijara Sukuk (Rs. billion)



Tenor wise flow into T-bills shows that banks preferred investments in longer tenor T-Bills in the initial months of CY12. However, as the expectations for changes in discount rate subsided, the banks' preference tilted to shorter tenor T-Bills. Accordingly, the share of amount offered for 3-month T-bills improved to 60 percent of the total offered amount during the first half while the share of 6-month securities remained 27 percent (**Figure 5.7**). This is in stark contrast to H2-CY11 during which the interest rates were slashed by 200 bps, which kept the share of amount offered for 3-month T-bill to just 17 percent of total offerings.

In addition to banks and other financial institutions, households and businesses also participated 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) on behalf of interested investors for consideration in the auctions. The government has placed heavy emphasis in promoting the IPS scheme among the masses in order to attract more investors. As a result, the share of institutions and individuals in T-bills auctions increased over the year. During H1-CY12, the share of NCBs accepted towards total acceptance has increased to 12 percent from 10.2 percent in second half of CY11 **(Figure 5.8).**

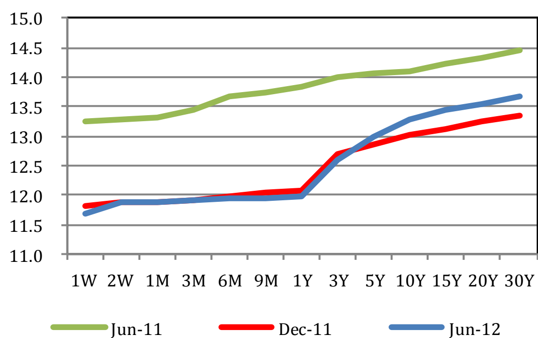
Borrowings in long-term debt instruments further boosted

In contrast to the T-bill auction profile in which the accepted amount was less than the offered by market participants, the government borrowed heavily in the long-term securities market - PIBs and Sukuks. Against the target of Rs. 90 billion, it accepted Rs. 118 billion of PIBs, a rise of 14.5 percent in acceptance during the first half. Similar to previous subscriptions, much of the interest remained in 10 years, 3 years and 5 years maturities respectively. The share of 10 year PIBs though declining remained 42 percent of subscribed PIBs that was earlier 46 percent during H2-CY11 (**Figure 5.9**).

Similar to the PIBs, the auction profile of Ijarah Sukuk also showed an encouraging trend of renewed interest in the long term Islamic debt instruments. Against the target of Rs. 100 billion, the government subscribed Rs. 116 billion during the period (**Figure 5.10**). A higher acceptance against the targeted amount has not only helped the government to generate funds,

Figure 5.11

Yield Curve (percent)



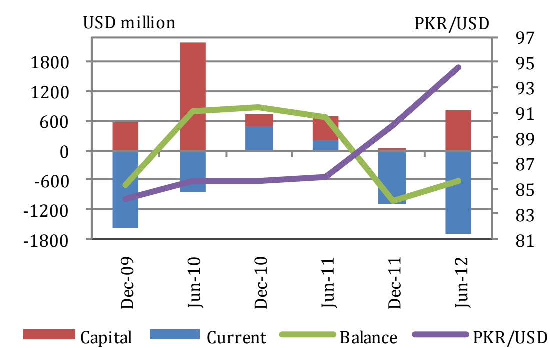
but also provided Islamic banks an avenue to utilize its surplus liquidity in a depressed lending environment.

The stickiness of policy rate at 12 percent throughout the first half of CY12 has kept the short-term interest rates close to the Dec-11 level. However, the subsequent higher acceptance to target ratios of long–term instruments (PIBs and sukuks) has slightly pushed the long-term rates by an average of 20bps during the first half (**Figure 5.11**).

Deteriorating current account balance imposed stress on foreign exchange market

Figure 5.12

Developments in External Account

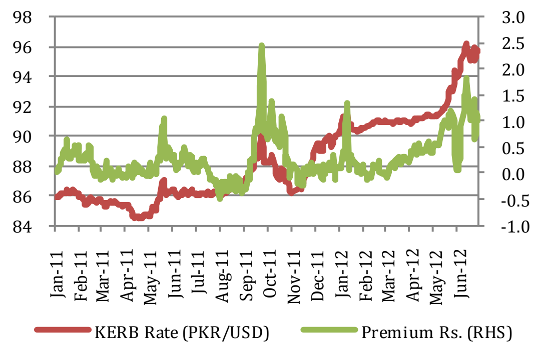


The foreign exchange market remained under stress during first half of CY12 as the demand for foreign exchange amplified in wake of rising current account deficit. The depleting foreign exchange reserves due to financing of trade and services deficit and repayment of IMF loan coupled with the dried-up foreign inflows, both non-debt (FDI and FPI) and debt (loans) buildup pressure in the foreign exchange market (**Figure 5.12**).

Accordingly, the PKR observed gradual depreciation through most of the half year under review. Likewise, the market sentiments also responded to a combination of factors like the IMF repayments and depreciation of the of USD against other regional currencies in the second quarter of the CY12, the PKR depreciated by 389 and 468 paisas in the interbank and Kerb market leading to a 5.2 percent depreciation against the USD in the first half of CY12 (9.1 percent for FY12 and 0.6 percent for FY11).

Figure 5.13

KERB Exchange Rate and Premium



The trade deficit resulting from decline in exports by 2.8 percent and a price-driven rise in the import bill by 11.6 percent during FY12 was mainly responsible for deterioration in the current account. Though the high influx of workers' remittances of USD 13.1 billion significantly off-set the trade deficit, the overall current account deficit augmented to USD 1.6 billion in first half of CY12.

The rising degree of stress and volatility in foreign exchange market also reflected in increased premium between the KERB and the interbank rates. With constant depreciation of the domestic currency, the demand for foreign currency amplified among the households and businesses that further enhanced the KERB premium. The KERB premium increased from an average of Rs. 0.21 during H2-CY11 to Rs. 0.45 during H1-CY12 as

Figure 5.14

Foreign Exchange Reserves and Import Coverage

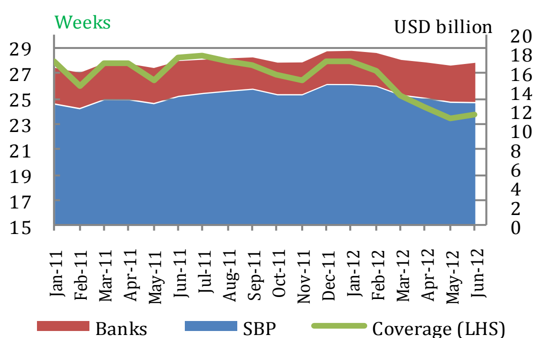


Figure 5.15

KSE-100 Index and Trading Volumes

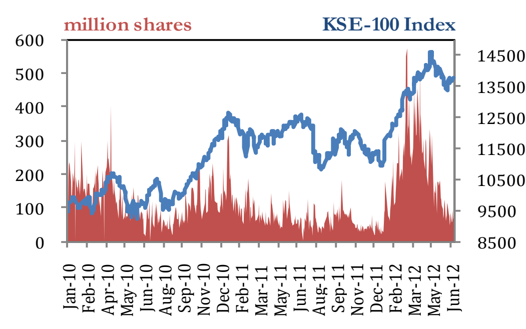


Table 5.1

Comparision of Equity Markets Performance

	27 Jun CY12	4 Jan CY12	29 Jun CY11	%Δ-CY12
USA (DJIA)	12,627	12,418	12,261	1.7
China (SSEA)	2,322	2,273	2,858	2.1
Japan (Nikkei)	8,731	8,560	9,797	2.0
Britian (FTSE)	5,524	5,669	5,856	-2.6
Turkey (ISE)	61,184	51,533	63,003	18.7
India (BSE)	16,968	15,883	18,694	6.8
Indonesia (JSE)	3,935	3,907	3,803	0.7
Malaysia (KLSE)	1,602	1,504	1,575	6.5
Pakistan (KSE)	13,799	11,362	12,423	21.4
Singapore (STI)	2,842	2,711	3,080	4.8
Thailand (SET)	1,166	1,036	1,033	12.5
Brazil (BVSP)	53,109	59,365	62,334	-10.5
MSCI Developed	1,202	1,204	1,314	-0.2
MSCI Emerging	913	938	1,133	-2.6
MSCI World	304	305	338	-0.5

demand for foreign currency increased in the KERB market[47] (**Figure 5.13**).

Import coverage ratio also worsened as imports rise and reserves fall.

With a decline in liquid foreign exchange reserves held with the central bank (to USD 10.8 billion on account of rise in the import bill and repayment of IMF installments), the import coverage ratio also deteriorated to 19 weeks in June-12 from 24 weeks coverage in Dec-11 (**Figure 5.14**).

As a result of the depreciation of PKR against USD, the foreign currency deposits (FCD) held with the banks grew by 10.6 percent during the period. Such an increase in the deposit, within the regulatory limits, provided for improving the total FX reserves as well as funding to banks for financing trade, thereby limiting pressure on the PKR and reserves. On the contrary, a rise in the FC deposits from KERB market purchases further imposed stress on the exchange rate and KERB premium.

Equity market boosted on healthy corporate announcements and renewed buying spree

In contrast to money and foreign exchange markets, the KSE witnessed bullish trend during H1-CY12. The benchmark KSE-100 index with a 21.6 percent surge closed at 13,801.4 level (**Figure 5.15**). Stock market in Pakistan actually outperformed the other leading advanced and emerging markets' stock markets during the first half of CY12 (**Table 5.1**). Much of the improvement in the index resulted from favorable corporate announcements, healthy payouts, promulgation of Capital Gains Tax Ordinance[48] and renewed institutional buying. Importantly, surge in the index came despite a number of negative events on political and geo political front.

Despite healthy gains, the stock market failed to attract sizable new equity listings in the first half. In fact, the number of listed firms of KSE decreased substantially from 638 in Dec-11 to 590 in Jun-12[49] (**Table 5.2**), on account of liquidation and breach of the listing regulations of the KSE. Moreover, one new company was listed in the equity market during the first half, while no new debt issue took place due to limited demand for funds as well as

[47] Despite an increase in average premium, the maximum KERB premium declined from Rs. 2.46 to Rs. 1.83 during the first half. Though the premium exceeded by 100 paisas during 21 days of FX trading as against 8 times in the second half CY11.
[48] The ordinance to amend certain fiscal law (Ordinance III of 2012) was promulgated in April 2012 that later became the part of Finance Bill 2012.
[49] The listing Regulation 30 enables the KSE to suspend, delist or place companies in defaulters' segment if the companies are found in the breach the regulations. The recent decline in the number of companies resulted mainly from application of this regulation.

Table 5.2

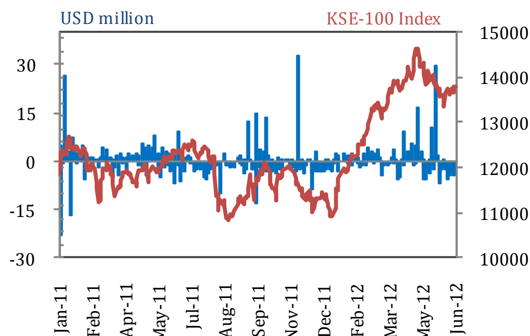
Profile of Capital Market

	2009	2010	2011	H1-CY12
Listed Companies	651	644	638	590
Listed Capital	814.5	919.2	1,048.4	1,069.8
Capitalization	2,705.9	3,268.9	2,945.8	3,518.1
GDP Ratio	23.6	23.7	17.9	16.6
KSE-100	9386.9	12022.5	11347.7	13,801.4
New Companies	4	6	4	1
New Equity Capital	8.8	33.4	16.0	0.0
New Debt	1	4	6	0.0
New Debt Capital	3.0	5.7	14.8	0.0

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

Figure 5.16

Net SCRA Flows and KSE Performance



lack of willingness from the firms and corporate for taking further exposure in the prevailing business and economic environment.

The trading volumes at KSE improved from an average of 58 million shares during H2-CY11 to 177 million shares in H1CY12 Increased trading however remained limited to few sector including banking telecom, energy and fertilizer. The trading concentration improved during the first half as share of top three companies in total trading decreased from 21 percent to 19 percent while the concentration of top 10 companies decreased from 54 percent to 43 percent during the period.

Due to recovery in the equity markets, KSE was able to attract potential investors. However, foreign portfolio investment (FPI) continued its downward trend, though recovery in the market limited the size of outflow. Moreover, change in investors' appetite to quality of capital in wake of the prevailing financial distress in advanced countries also restrained flows of foreign capital despite substantial uptick in the equity markets. Accordingly FPI and SCRA investment in the KSE witnessed a decline of USD 20 million and USD 50 million respectively during the first half of CY12 (**Figure 5.16**).