Box 3: US Dollar Liquidity Remains an Important Aspect of Inter-Connectedness and Financial Markets Behavior during CY18

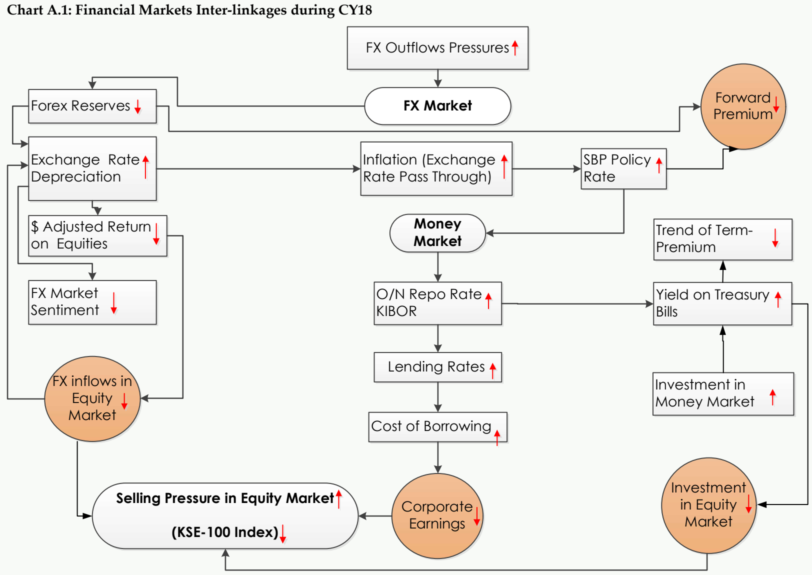
In CY18, US dollar liquidity has remained one of the important aspects of connectivity in domestic financial markets. Forex market developments have affected equity market through lower dollar adjusted returns[113] on foreign investment and rising inflation (exchange rate pass-through impact). Lower dollar adjusted returns have resulted in net outflow of foreign portfolio investment exerting pressure on equity market and exchange rate (**Chart A1**).[114] With rising inflation, SBP increased its policy rate, which in turn translated into higher lending rates thereby increasing cost of borrowing for the corporate sector. Resultantly, increased financial expenses undermined corporate earnings and added to selling pressure in the equity market.

Also, rising yield in money market instruments (treasury bills) concomitant with falling stocks prices have triggered investment flows towards money market funds from the equity market.

The link between forex and money market is also reflected through forward premium. Rising interest rates in the domestic market –relative to the interest rates in foreign markets—should make up higher forward premium in forex swap transactions. However, despite notably higher interest rate spread, forward premium during H2CY18 has remained squeezed due to the dearth of dollar liquidity coupled with expectations of PKR depreciation in the domestic market.

To conclude, US dollar liquidity has played vital role in explaining the behavior and inter-connectedness of financial markets during CY18.

Chart A.1: Financial Markets Inter-linkages during CY18



Note: Colored boxes represent market stress.

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113 Exchange rate depreciation results into lower dollar adjusted returns as foreign investment return on equity is measured in PKR. Therefore, returns deliver back less dollars in case of domestic currency depreciation.

114 During CY18, except the month of January, equity market has observed consistent net foreign investment outflow.