

# 2

## Financial Markets' Behavior

*The average volatility in domestic financial markets remained slightly higher in CY25, mainly driven by an upbeat equity market. Bullish sentiment continued to drive up equity prices; however, trade tariff uncertainty and geopolitical tensions had a material but short-lived impact on investors' confidence. Foreign investors continued to be net sellers while mutual funds and individuals absorbed most of the selling pressure. FX market conditions remained broadly stable owing to a contained current account deficit and noticeable improvement in SBP's FX reserves resulting in stability of rupee-dollar parity. Money market continued to function in an orderly manner under the effective SBP monetary management. Monetary policy stance further eased amid ebbing inflationary pressures. Liquidity conditions, however, varied during the year: overnight Repo Rate largely remained above policy rate, suggesting elevated liquidity pressures.*





## 2 Financial Markets' Behavior

### *Global financial markets manifested resilience against trade tariffs shock....*

Global financial markets witnessed abrupt risk pricing amid historic hike in trade tariffs by the US across all trading partners on April 02, 2025.<sup>1</sup> Risk appetite in equity markets fell, sovereign bonds yields dropped, corporate bonds spreads widened, and emerging markets currencies came under stress.<sup>2</sup> Nonetheless, the volatility proved short-lived as markets appeared to shrug off the potential macroeconomic implications of tariffs owing to the evolving nature of tariffs policy. The exceptionally strong optimism in equity markets – prevailing over much of CY25 – was reinforced by continued dovish stance of major central banks.<sup>3</sup>

It is noteworthy that longer-term bond yields in advanced economies – despite monetary easing – remained elevated<sup>4</sup> due to concerns over fiscal sustainability and price stability (see **Chapter 1**).<sup>5</sup>

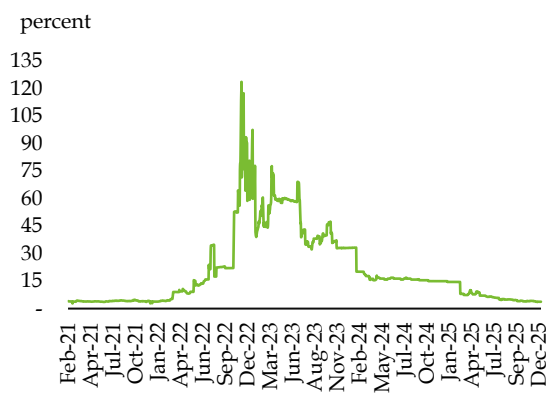
### *Domestic macro financial conditions improved further...*

Macro-financial conditions further improved during CY25 as manifested by several indicators, such as growing economic activity, healthy current account position, enhanced SBP's FX reserves, improved fiscal balance, reduced inflationary pressures, further cuts in

policy rate, receding country's risk premium (**Figure 2.1**) and improved country's credit ratings.<sup>6</sup> Particularly, achievement of various targets and benchmarks under IMF's Extended Fund Facility (EFF) as well as Resilience and Sustainability Facility (RSF) strengthened macroeconomic fundamentals, thus putting the economy on a sustainable growth trajectory.<sup>7</sup>

Pakistan's 5 year CDS

Figure 2.1



Source: Bloomberg

### *Nonetheless, volatility in financial markets edged a bit up...*

The average volatility in domestic financial markets remained slightly higher during CY25, mainly driven by equity market (**Figure 2.2 & 2.3**). The risk-on sentiment continued throughout CY25, driving KSE-100 index up by 51.2 percent to 174,054 (84.3 percent growth in

<sup>1</sup> Effective tariffs rate surged to above 20 percent, a level not seen in a century.

<sup>2</sup> IMF (2025). Global Financial Stability Review. *October*

<sup>3</sup> Federal Reserve and ECB delivered three cuts, by 25 bps each time, during CY25. Also, Bank of England and Bank of Canada reduced interest rates by 100 bps through four cuts during CY25.

<sup>4</sup> BIS (2025). Quarterly Review: International banking and financial market developments. *September*

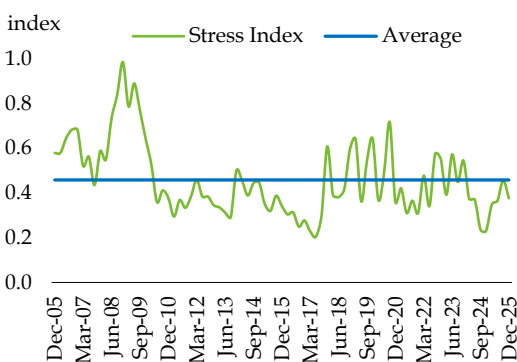
<sup>5</sup> The Economist. (2025, December 21). The five biggest market developments of 2025.

<sup>6</sup> Fitch, S&P Global, and Moody's upgraded Pakistan's credit rating respectively in April 2025, July 2025, and August 2025; Broadly, these agencies changed the credit rating due to sustained progress over fiscal consolidation, implementation of structural reforms, contained external liquidity risks, and recovery in international reserves.

<sup>7</sup> Real GDP growth increased by 3.1 percent in FY25 from 2.6 percent in FY24, the momentum continued from June 2025 onwards, as the economy grew by 3.8 percent in H1FY26; Current account deficit stood at US\$ 0.45 billion; SBP's FX net reserves increased to US\$ 16.1 billion at end December 2025 from US\$ 11.7 billion in December 2024. Fiscal deficit (percent of GDP) reduced to 5.4 percent in FY25 from 6.8 percent in FY24; In H1FY26, fiscal balance turned into surplus of 0.4 percent; 12MMA inflation declined to 3.6 percent in December 2025 from 12.6 percent in December 2024; Policy rate was further reduced by 250 bps to 10.5 percent in CY25.

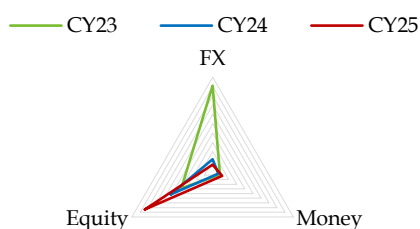
CY24). Nevertheless, short-lived episodes of stress – emanating from external factors such as US trade tariffs policy and heightened geopolitical tensions on regional and domestic fronts – momentarily undermined investors’ confidence. The FX market, on the other hand, continued to witness lower stress amid benign current account position and build-up of FX reserves. Money market continued to function in an orderly manner due to SBP’s effective monetary operations to ensure that the policy rate remains within the corridor.

**Financial Markets Stress Index** **Figure 2.2**



Source: SBP Staff Calculations

**Financial Markets Stability Map** **Figure 2.3**



Note: Volatility in the respective markets is calculated using Exponential Weighted Moving Average (EWMA) method. Daily Overnight repo rate, KSE-100 index and Interbank PKR/USD Exchange Rate are used as indicators for the money, equity and foreign exchange markets, respectively.

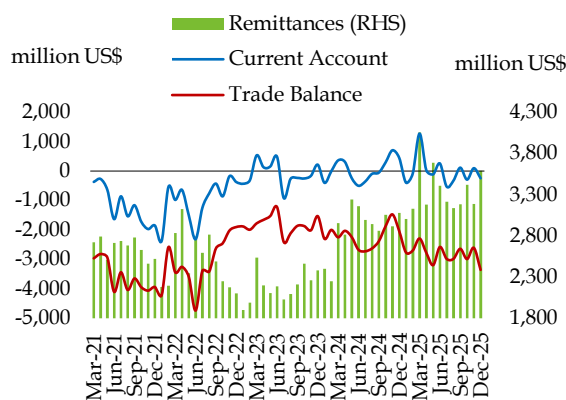
Source: State Bank of Pakistan

## 2.1 FX Market

*Contained current account deficit along with higher financial inflows supported FX liquidity conditions...*

FX market witnessed muted volatility amid broader positive developments. Current account balance turned slightly negative in CY25 as compared to a surplus in CY24. This was despite a noticeable rise of 27.5 percent in trade deficit of goods & services. Imports of goods & services grew by 11.5 percent – amid improving economic activity – while exports of goods & services registered a marginal growth of 0.8 percent in CY25.<sup>8</sup> Nonetheless, robust growth in workers’ remittances cushioned the impact of widened trade deficit and kept current account balance in check (**Figure 2.4**).<sup>9</sup> The relatively higher financial inflows and favorable global commodity prices also supported external account balance.<sup>10</sup>

**Trend in Current Account Balance** **Figure 2.4**



Source: State Bank of Pakistan

Importantly, successful IMF reviews under EFF and RSF programs during CY25 delivered US\$ 2.2 billion of inflows, resulting in improved FX

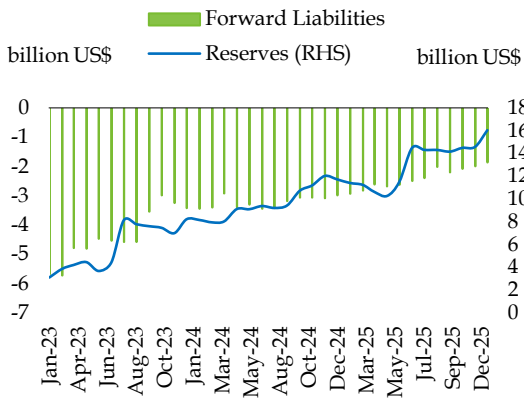
<sup>8</sup> Trade deficits in goods and services amounted to US\$ 34.0 billion in CY25 against US\$ 26.7 billion in CY24.

<sup>9</sup> Workers’ remittances increased to US\$ 40.2 billion in CY25 from US\$ 34.7 billion in CY24.

<sup>10</sup> Net financial inflows amounted to US\$ 2.4 billion in CY25 against US\$ 1.1 billion in CY24. Global commodity price index averaged 167 in CY25 against 165 in CY24

liquidity, strengthening of market confidence, and reinforcing macroeconomic stability.<sup>11</sup> In the wake of benign current account dynamics, SBP kept building FX reserves. SBP's net reserves increased by 37.1 percent to US\$ 16.1 billion in CY25. Although official inflows supported build-up of FX reserves, the accumulation in FX buffers has been largely driven by strategic purchases.<sup>12</sup> It is noteworthy that SBP has been consistently reducing its forward liabilities over the last three years; a manifestation of strengthened FX reserves (Figure 2.5). In CY25, SBP reduced forward liabilities further by US\$ 1.1 billion.

SBP's FX Reserves and Forward Liabilities Figure 2.5

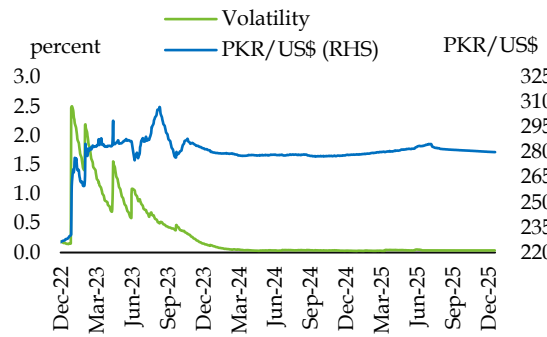


Source: State Bank of Pakistan

Rising FX buffers kept Rupee-Dollar parity stable ...

Amid rising FX reserves, exchange rate volatility remained subdued and rupee-dollar parity averaged at Rs 281.2, showing a mild depreciation of 0.9 percent in CY25 (Figure 2.6). The movement in exchange rate remained range-bound, which reflected orderly conditions in the FX market. Also, nominal broad US\$ index, on average, didn't change much during CY25, suggesting stronger domestic macroeconomic fundamentals in determining rupee strength.<sup>13</sup>

Exchange Rate and its Volatility\* Figure 2.6

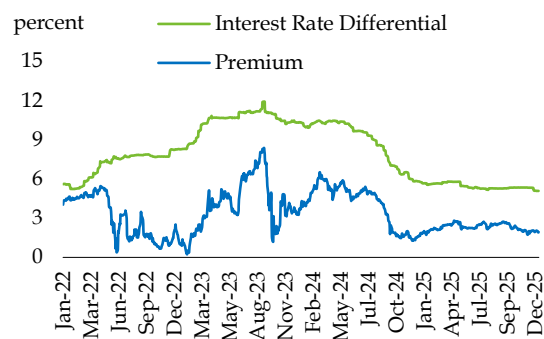


\*Volatility is measured using Exponential Weighted Moving Average Method based on daily data.

Source: State Bank of Pakistan

The improved liquidity conditions coupled with narrowing interest rate differentials – due to subsiding inflationary pressures in domestic economy – kept forward premium at a lower level in the year reviewed (Figure 2.7). On average, 6M forward premium compressed to 2.3 percent in CY25 from 4.1 percent in CY24. In addition, fluctuations in premium between open- and interbank-market exchange rates remained within a confined range, indicating FX market stability during CY25 (Figure 2.8). The open market premium averaged Rs 1.0 in CY25, slightly above Rs 0.6 witnessed in CY24. The structural reforms in Exchange Companies

Trend in 6M Forward Premium Figure 2.7



Note: Interest rates differential represent 6M KIBOR minus 6M SOFR.

Source: State Bank of Pakistan

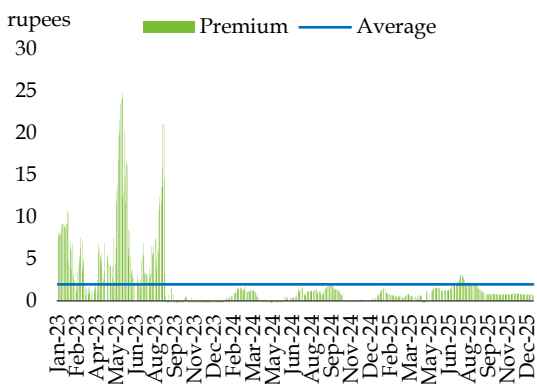
<sup>11</sup> First two reviews of EFF were successfully completed in May 2025 and December 2025, respectively. Also, first review of RSF was completed in December 2025.

<sup>12</sup> SBP's interbank FX purchases amounted to US\$ 6.9 billion in CY25.

<sup>13</sup> US Dollar index against major global currencies averaged 123.1 in CY25 against 123.2 in CY24.

(ECs) initiated during H2CY23 continued to play a vital role in bringing improved market discipline, strengthening FX reserves by enhancing remittances inflows through formal channels and curbing speculative trading.

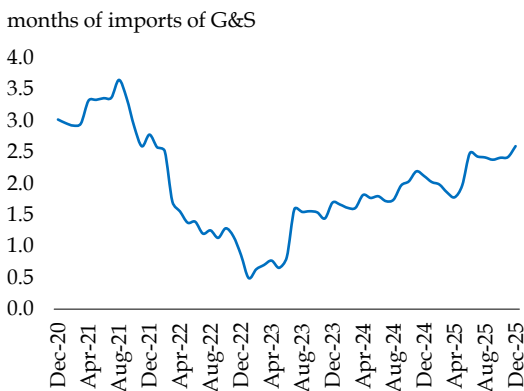
**Trend in Open Market Premium** Figure 2.8



Source: State Bank of Pakistan

With rising external account buffers, imports cover steadily improved to 2.2 months from 1.8 months in CY24 and 1.0 months in CY23, on average (Figure 2.9). The growing imports capacity manifests enhanced macroeconomic resilience of the domestic economy against external shocks.

**Import Coverage Ratio** Figure 2.9

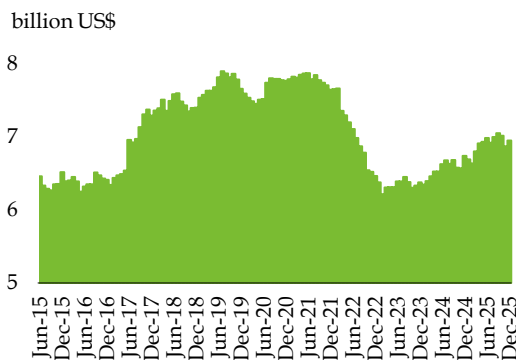


Source: State Bank of Pakistan

*The steady revival in FE-25 deposits continued*

Foreign currency deposits (FCD) kept rising – albeit gradually – for another year (Figure 2.10). These deposits averaged US\$ 6.9 billion in CY25, higher than US\$ 6.6 billion in CY24 and US\$ 6.3 billion in CY23. The gradual rise in FE-25 deposits appears to indicate improved confidence among market participants. Encouragingly, with a limited exposure to FX risks, the results of sensitivity (stress testing) analysis show that even after a severe 30 percent hypothetical depreciation of rupee against USD, all banks remain compliant with the requirement of minimum CAR.

**Trend in FE-25 Deposits** Figure 2.10



Source: State Bank of Pakistan

**2.2 Money Market**

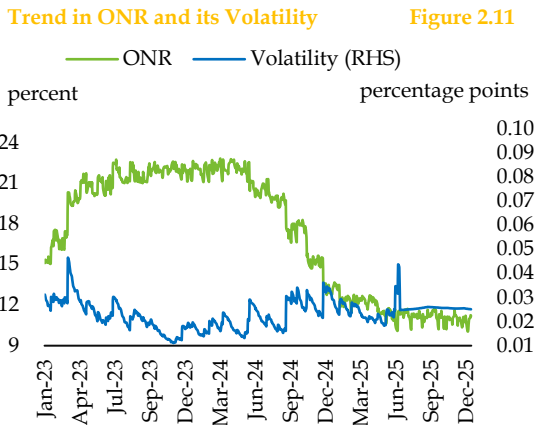
*Monetary policy was further eased amid dissipating inflationary pressures...*

The disinflation trend continued during CY25 owing to coordinated and prudent monetary and fiscal policies. The inflation based on National CPI (12MMA) declined to 3.6 percent in December 2025 from 12.6 percent in December 2024. Resultantly, SBP further reduced policy rate cumulatively by 250 basis points to 10.5 percent in CY25.<sup>14</sup>

<sup>14</sup> Policy rate was reduced by 100 bps each on January 27 and May 05. On December 15, 2025, it observed another 50 bps cut bringing cumulative reduction to 250 bps in CY25

*Money market volatility remained subdued...*

Overnight Repo Rate (ONR) continued to move within the interest rate corridor and witnessed muted average volatility in CY25 (**Figure 2.11**).<sup>15</sup>

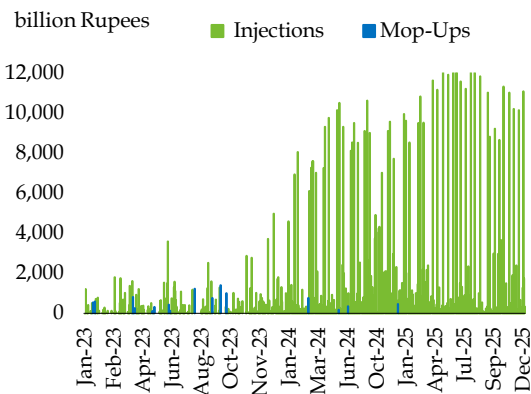


Source: State Bank of Pakistan

Money market dynamics reveals that liquidity pressures remained elevated in CY25, as implied by a smaller but positive average gap between ONR and policy rate (19 basis points in CY25 vs. 12 basis points in CY24). There were 187 positive instances of a positive gap versus 61 negative ones.<sup>16</sup>

Further analysis reveals that despite strong deposits inflow during CY25, more than two-fold increase in government budgetary borrowing from the banking sector along with decent credit demand appears to feed tight liquidity conditions, thereby maintaining slightly upward pressure on ONR.<sup>17</sup> This was evident from higher OMOs injections by SBP during the year under review. The average

injection size increased to Rs 1,964 billion from 1,662 billion in CY24 (**Figure 2.12**). However, tenors of injections have noticeably declined over the course of previous two years.<sup>18</sup> In addition to higher OMOs injections, liquidity assistance provided to the banks through SBP's ceiling facility also increased in CY25. On average, banks availed liquidity assistance worth Rs 137.1 billion as compared to Rs 109.6 billion in CY24. Nonetheless, the year under review also witnessed some periods of eased liquidity conditions (e.g., 61 instances of negative gap between ONR and policy rate).

**OMOs Injections and Mop-ups** **Figure 2.12**

Source: State Bank of Pakistan

*Secondary market yields on government securities continued to fall across all maturities...*

Yields on government securities in the secondary market not only further lowered across short and long-ends, but yield curve also nearly flattened in CY25 (**Figure 2.13**).<sup>19</sup> Moreover, the decline in average yields was higher in CY25 as compared to previous year.

<sup>15</sup> ONR volatility averaged at 2.5 bps in CY25 as compared to 2.2 bps in CY24.

<sup>16</sup> A positive deviation of ONR from SBP policy rate may imply relatively tight liquidity conditions in money market and vice versa

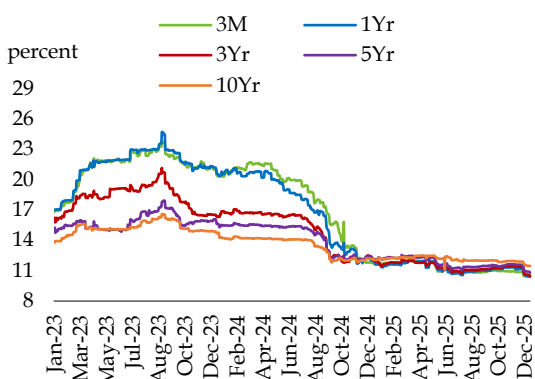
<sup>17</sup> Deposits showed an increase of 24.7 percent in CY25. However, such high growth was partially due to base effect as deposits mobilization remained noticeably weak in Q4CY24 due to ADR linked tax policy, which was later abolished. Deposits increased by 19.5 percent during Mar-25 to Dec-25. Government budgetary borrowing, on cash basis, increased by Rs 7,555 billion in CY25 against Rs 2,729 billion in CY24. Advances contracted by 6.0 percent in CY25, reflecting the strong base effect, as banks sharply expanded lending during Q4CY24. However, during March 2025 to December 2025, advances witnessed 12.9 percent growth due to economic recovery and easing financial conditions.

<sup>18</sup> In CY23, average tenor was 29 days which declined to 13 and 10 days, respectively, in CY24 and CY25

<sup>19</sup> Average yields on 3M, 6M, and 1Y securities fell by 7.6 percent, 7.4 percent and 6.8 percent respectively in CY25. Average yields on 4Y, 3Y, and 10Y securities fell by 4.0 percent, 2.8 percent, and 1.5 percent respectively in CY25.

The analysis reveals that during CY25, the fall in yields was more pronounced at the short end (e.g., less than one year) suggesting improved anchoring of inflation expectations – in line with eased monetary policy stance. The transition of yield curve from inversion in CY24 to flattening reflects market’s confidence on marked progress on key macroeconomic challenges resulting in improved economic prospects.<sup>20</sup>

**Yields on Government Securities** Figure 2.13



Source: Mutual Funds Association of Pakistan

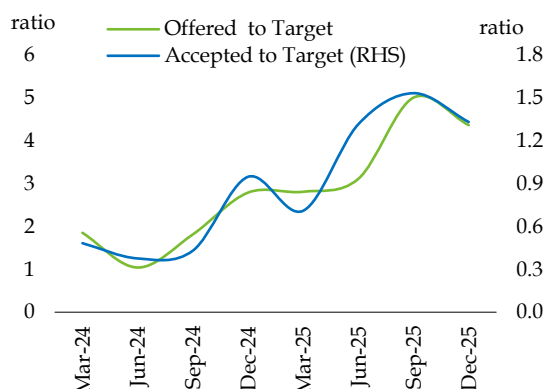
With further decline in yields, revaluation surplus of the banking sector on government securities surged to Rs 623.7 billion in CY25 from Rs 306.7 billion in CY24 (see Chapter 3).<sup>21</sup>

*Driven by government’s preference, banks’ investments were concentrated in longer-tenor securities...*

Banks’ investments in federal government securities increased by Rs 9.2 trillion to Rs 37.0 trillion in CY25. Around 70 percent increase in investments came from PIBs followed by Sukuk and MTBs.<sup>22</sup> It appears that – to further improve

debt maturity profile – the government capitalized yield curve flattening by shifting debt from MTBs to PIBs and Sukuk. For instance, acceptance to target ratio in MTBs auctions declined to 0.8 in CY25 from 1.0 in CY24. On the contrary, the ratio increased to 1.2 from 0.6 in case of fixed rate PIBs (Figure 2.14). Similarly, government acceptance remained higher in floating rate PIBs (semiannual) during CY25.<sup>23</sup>

**Offered and Acceptance Ratio of Fixed Rate PIBs** Figure 2.14



Source: State Bank of Pakistan

Banks’ bidding behavior in the debt auctions for MTBs reveals that even though banks offered higher than the government target, offered to target ratio declined during CY25 compared to past year.<sup>24</sup> Moreover, within MTBs, banks preferred to invest in 1M and 12M treasury bills (Figure 2.15).<sup>25</sup> In case of fixed rate PIBs, banks offered to target ratio increased to 3.9 from 2.0 in CY24. Within fixed rate PIBs, 65 percent of the total funds offered for PIBs, pertained to 5 years and above tenors (Figure 2.16). Amid the accommodative stance of monetary policy,

<sup>20</sup> Mehl, A. (2009). The yield curve as a predictor and emerging economies. *Open Economies Review*, 20(5), 683-716.

<sup>21</sup> The Fair Value through Other Comprehensive Income (FVOCI) and Fair Value Through Profit and Loss (FVTPL) categories of government securities, which form more than 90 percent of the government securities of banks, are subject to mark-to-market adjustments.

<sup>22</sup> Investments in Sukuk and MTBs comprised 15.9 percent and 8.6 percent, respectively, of the total increases in federal government securities in CY25.

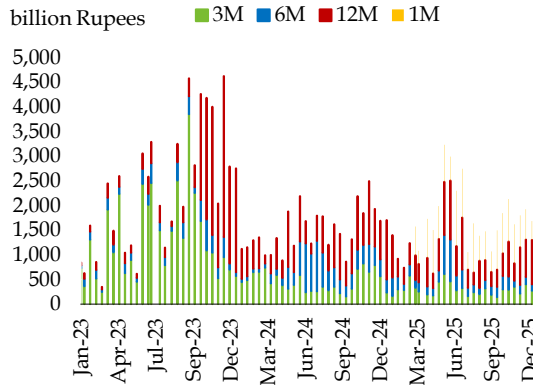
<sup>23</sup> Acceptance to target ratio increased to 1.2 in CY25 from 1.0 in CY24

<sup>24</sup> Offered to target ratio declined to 2.6 in CY25 from 3.1 in CY24

<sup>25</sup> Banks preferred to invest around 70 percent (in 1M and 12M treasury bills) of the total funds offered for treasury bills during CY25

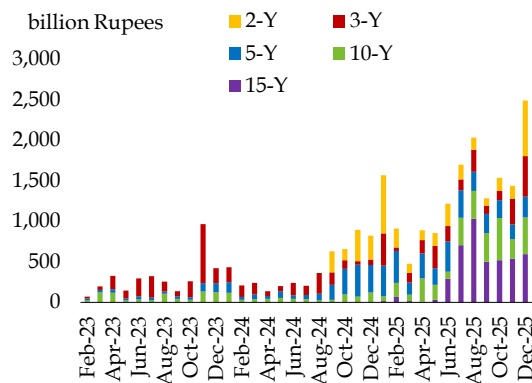
banks' interest in floating rate PIBs remained noticeably higher in CY25.<sup>26</sup>

**Bidding Behavior in T-bills Auctions** Figure 2.15



Source: State Bank of Pakistan

**Banks' Bidding for Fixed Rate PIBs** Figure 2.16

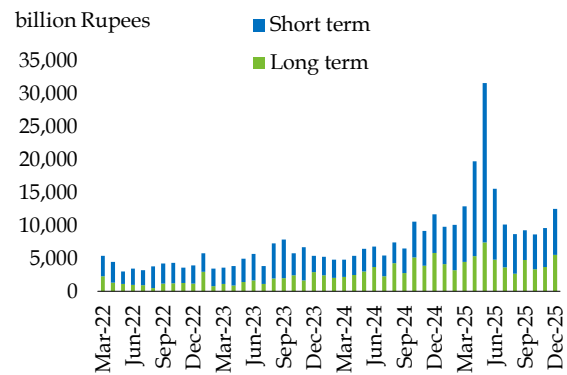


Source: State Bank of Pakistan

In the secondary market, trading volume of government securities surged to 88.2 percent in CY25 as compared to 31.3 percent in CY24. It suggests substantial interest of market in government securities. The trading, however, remained tilted towards short-tenor securities (66 percent share in total trading value vs. 52 percent in CY24) (Figure 2.17).

**Secondary Market Trading**

Figure 2.17



Source: State Bank of Pakistan

*Latest stress testing results suggest resilience of banking sector to market shocks...*

The results of sensitivity (stress testing) analysis show that under the most severe shock scenario, i.e. a parallel upward shift in the yield curve by 300 basis points, all banks remain compliant with the requirement of minimum CAR (for detail see Market Risk section in Chapter 3).

### 2.3 Equity Market

*Risk-on sentiment continued during CY25...*

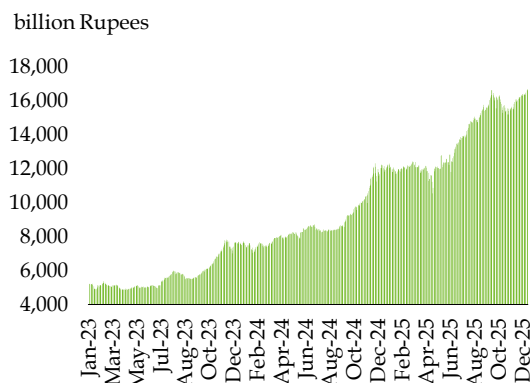
Bullish sentiments prevailed in stock market throughout CY25. The KSE-100 index – with 51.2 percent growth – surged to 174,054 by end of CY25 (84.3 percent growth in CY24) and remained one of the best performers in the world.<sup>27</sup> Accordingly, market capitalization of the top 100 listed companies increased by 38.4 percent to Rs 16,639 billion in the year under review (Figure 2.18).

The continued bullish momentum was driven by improved macroeconomic prospects. Significant progress on inflation, lower interest rates, sustained improvement in fiscal balance, currency stability, and external account

<sup>26</sup> Offered to target ratio increased to 4.3 from 2.5 in CY24

<sup>27</sup> [Pakistan Set for Up to 16 IPOs as Three-Year Stock Rally Tops 300%](#)

**Market Capitalization of KSE-100 Index** Figure 2.18



Source: Bloomberg

resilience backed by coordinated macroeconomic policies propelled investor confidence. Particularly, manifested discipline under EFF IMF program underpinned market optimism during CY25. The material transition from large macroeconomic imbalances to credible growth trajectory was also reflected in the upgrades of country's credit ratings by international rating agencies.<sup>28</sup>

In this backdrop, Price to Earning (P/E) ratio continued trending upward, averaging 7.6 in CY25 from 5.1 in CY24 (Figure 2.19). Also, average trading volume of KSE-100 increased to

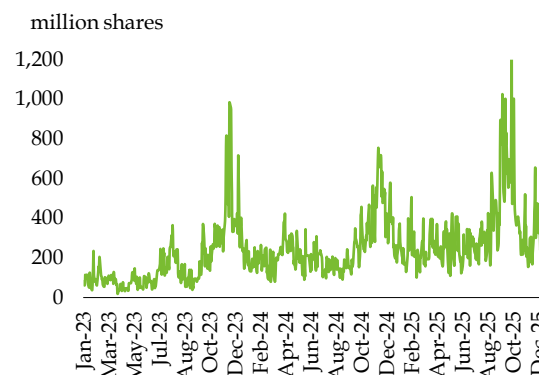
**Price to Earning Ratio** Figure 2.19



Source: Bloomberg

331 million shares from 250 million shares in CY24 (Figure 2.20).

**Daily Trading Volume of KSE-100** Figure 2.20



Source: Bloomberg

Nonetheless, the market experienced short-lived bouts of heightened volatility...

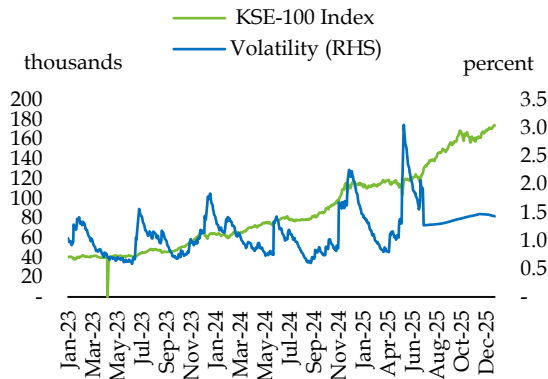
In the first half of CY25, KSE-100 index increased by 9.1 percent while the second half witnessed an impressive growth of 38.5 percent. The lackluster performance in H1CY25 was due to the unprecedented uncertainty around US trade tariffs policy as well as domestic and regional geopolitical tensions that led to some short-lived stress episodes (Figure 2.21). For instance, on April 07, 2025 the index declined by 3.3 percent owing to elevated concerns on trade tariffs policy. Also, domestic geopolitical tensions dented investor confidence, leading to 12.6 percent decline in the index between April 22 and May 08, 2025. However, market rebounded significantly afterwards, driven by ease in the conflict, successful completion of first review under EFF as well as approval of financing arrangement under RSF.<sup>29</sup> The stress re-surfaced – between June 12 and June 23, 2025 – due to another regional conflict involving a neighboring country, which caused the index to drop by 6.4 percent. However, volatility receded as the tensions receded.

<sup>28</sup> Fitch, S&P Global, and Moody's upgraded Pakistan's credit rating respectively in April 2025, July 2025, and August 2025. Broadly, these agencies changed the credit rating due to sustained progress over fiscal deficit, implementation of structural reforms, contained external liquidity risks, and recovery in international reserves

<sup>29</sup> KSE-100 index shot-up by 13.3 percent within just two days after May 08, 2025

In H2CY25, investor confidence continued to surge, broadly due to a persistent improvement in macroeconomic indicators, reduction in tariff rate, and improved geopolitical leverage.<sup>30, 31</sup>

**KSE-100 Index and its Volatility** Figure 2.21

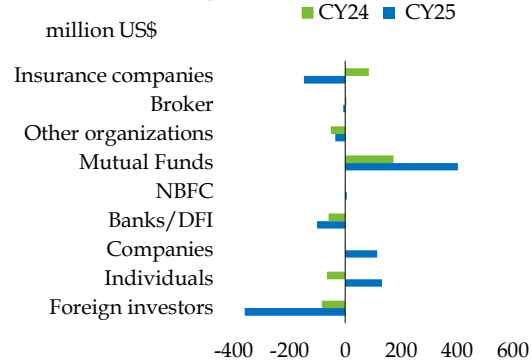


Source: State Bank of Pakistan

*Mutual funds and individual investors were largest net buyers in CY25...*

Mutual funds continued to be the largest net buyers of equities for another year followed by individual investors (Figure 2.22). The ebbing interest rates and attractive returns on stocks have been driving mutual funds to increase their exposure to equities. With 54.7 percent increase in investments towards equities during CY25, mutual funds exposure in stocks (as percent of their total assets) increased to 14.3 percent from 9.5 percent in CY24 and 9.1 percent in CY23. Money market and income funds continued to be top priority asset classes for mutual funds in the year under review (see Chapter 6.2).<sup>32</sup>

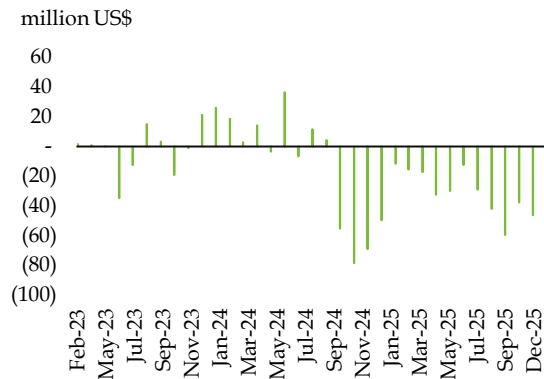
**Mutual Funds and Individuals were Prominent Net Buyers** Figure 2.22



Source: National Clearing Company of Pakistan Limited

It is noteworthy that foreign investors continue to be net sellers. (Figure 2.23). This could possibly be due to profit taking behavior amid robust returns delivered by equity market.

**Foreign Portfolio Investment (Net)** Figure 2.23



Source: State Bank of Pakistan

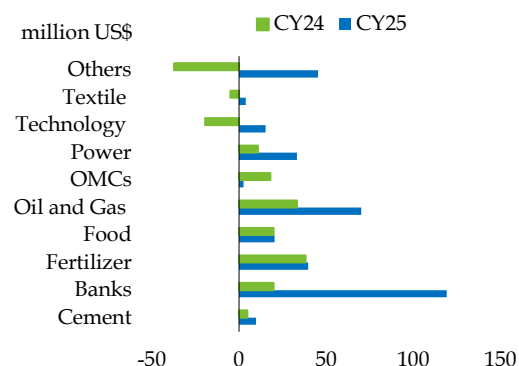
Sector-wise analysis reveals that the local investors' exposure was highest in banks' stocks followed by Oil and Gas, and fertilizer (Figure 2.24).

<sup>30</sup> Against 29 percent tariff on Pakistan's goods exports to US announced on April 02, 2025, the rate was reduced to 19 percent on August 01, 2025.

<sup>31</sup> On September 17, 2025, Pakistan and Kingdom of Saudia Arabia signed a Strategic Mutual Defense Agreement

<sup>32</sup> Money market and income funds represented 43.4 percent and 23.2 percent, respectively, of the total assets of mutual funds in CY25

Net Buying was Highest in Banks Stocks Figure 2.24



Source: National Clearing Company of Pakistan Limited

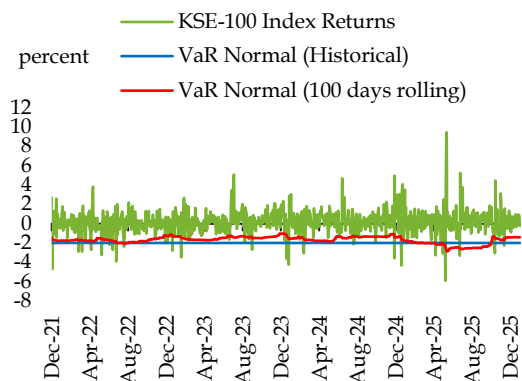
It is noteworthy that due to conservative regulatory regime of SBP, banks maintain a limited exposure to the equity market, which makes them less sensitive to volatility in the market. This is evident from banks' investment in equities, which stood at a meager 2.5 percent of banks' regulatory capital at end December 2025.

In addition, the latest sensitivity analysis (stress testing) results also suggest that even in a shock scenario of 36.1 percent decline in equity prices (KSE-100 index), which is equal to historically highest quarterly decline in the index, banks remain CAR compliant.

Risks in equity market normalized after increasing momentarily...

The analysis of a 100 days rolling Value at Risk (VaR) suggests that average magnitude of decline in equity prices was higher in CY25 as compared to previous two years. Moreover, within CY25, downward movement in stocks' prices sharply increased during second quarter, reflecting the impact of uncertainty on trade tariffs and geopolitical tensions. However, risks gradually normalized afterward (Figure 2.25). Moreover, daily returns of KSE-100 index breached Value at Risk (VaR) normal seven times as compared to fifteen times in CY24.

Value at Risk of KSE-100 Index Returns Figure 2.25



Source: Pakistan Stock Exchange and SBP Staff Estimates