# 1 Overview

Pakistan's financial markets witnessed significant changes in FY04. Interest rates touched a historic low, the Rupee reached a 3½ year high and the capital market too witnessed a new all-time peak; all markets also saw improvements in depth and liquidity. These developments probably facilitated the economic recovery by catering the rising demand for financial services by the fast recovering economy.

**Table 1.1: Financial Market Indicators**

percent

| Money Market | | | | Capital Market | | | |
|---|---|---|---|---|---|---|---|
| | | FY03 | FY04 | | | FY03 | FY04 |
| *6 m Repo rates* | Highest | 6.7 | 3.9 | *KSE-100 Index* | Highest | 3,402.5 | 5,620.6 |
| | Lowest | 1.5 | 1.0 | | Lowest | 1,735.3 | 3,432.6 |
| | Average | 4.0 | 2.0 | | Average | 2,448.5 | 4,592.6 |
| *Cut-offs (6 m)* | Highest | 1.7 | 2.2 | *Mkt. Cap* | Value (bln Rs) | 755.8 | 1421.6 |
| | Lowest | 6.4 | 1.3 | | % of GDP | 15.7 | 26.0 |
| *Trading volumes/day (mln Rupees)* | Highest | 62.6 | 72.0 | *Turnover (mln share)* | High | 689.2 | 1,122.5 |
| | Lowest | 7.6 | 9.6 | | Low | 16.9 | 63.1 |
| | Average | 27.0 | 29.8 | | Average | 214.3 | 386.7 |

**Forex Market**

million US dollars

| | FY03 | FY04 | % Δ |
|---|---|---|---|
| Cash inflows | 25,239 | 25,644 | 1.6 |
| Cash outflows | 19,970 | 24,923 | 24.8 |
| Reserve accumulation | 11,667 | 12,389 | 6.2 |
| Exchange rate end-June (Rs/US$) | 57.8 | 58.17 | -0.64 |

In money market, the average repo rates in FY04 were almost one half of those prevailing in the preceding year and the trading volumes were much higher. Capital markets were buoyant this year as corporate earnings averaged 26.5 percent. Sixteen public offerings were floated in FY04 amounting to almost US$ 1 billion (Rs 55.6 billion). Most of the new offerings were oversubscribed. The investor base has also expanded due to the government's policy of attracting small retail investors to the sale of shares by public sector companies. The share of market capitalization in GDP also increased from 19.7 percent in FY03 to 26 percent in FY04 – an impressive outcome. The turnover was also much higher.

Subsequently, however, all markets also witnessed periods of volatility reflecting the changing fortunes of the Pakistan's external account and shifting expectations on interest rates. The changes in market expectations were particularly evident, directly or indirectly, during Q4-FY04 when upward movement in interest rates accelerated amidst rising inflation, the exchange rate suffered a net annual depreciation (for the first time in 2½ years), and the momentum of the two year old capital market rally finally faltered.

Inter-bank foreign exchange market witnessed a high level of activity in FY04. Both forex inflows and outflows were higher than the previous year. But the net flows were lower as imports of capital goods and raw material rose by 28.8 percent. In the last quarter, higher import of oil due to large price hike also exacerbated pressures on the forex market.

In fact, the volatility in the money and foreign currency market posed significant challenges to the SBP policy, as it sought to strike a balance between interest rate and exchange rate stability, containing inflation, and sustaining the growth momentum. On the positive side, the increased market volatility also led to an increased focus on risk management by domestic financial and non-financial corporates. This is evident in the considerable interest in the development of the financial derivatives market.

Another, particularly encouraging development in FY04 was the evident increased integration of the money and forex market, as the impact of interventions in one was clearly reflected in the other, indicating the improving efficiency in both markets. While the capital market is clearly not as closely linked to the other two, it too appears to be slowly reflecting these trends (e.g. recent interest rate hikes have had a discernable, albeit temporary, negative impact on the KSE-100).