7 Activities of Financial Markets

7.1 Performance of Money Market during FY04

During FY04, the money market experienced three distinct phases of interest rate changes;

- The first phase represents a declining trend that took the interest rate to historic low levels in July-August 2003. This was primarily brought about by the continued pressure of excess liquidity in the money market and persistent declining trend, which began in July 2001. Expectations of a further decline in interest rates were still ripe in the market during the first phase despite the extremely low level of prevailing interest rates.

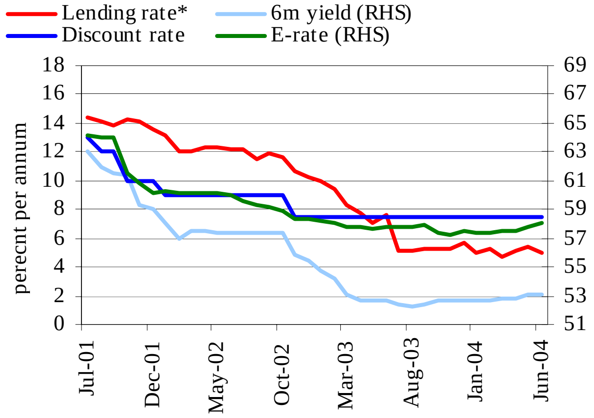
- The second phase depicts a period of relative stability in interest rates from September 2003 to March 2004. SBP's cut-off rate in T-bill auctions, which signalled a bottoming out of interest rates, became a precursor to this stability. However expectations of trend reversal in interest rates also started to take shape in this period due mainly to the announcement of an unexpectedly large *Jumbo* issue of PIBs in September 2003. These expectations were reinforced by the continued decline in mobilization of NSS and expected payments of the expensive external debt liabilities. However SBP managed these expectations by rejecting a large part of the PIB offering in the October 2003 auction, thereby containing the rising trend.

- The third phase shows a period of visibly rising expectations about interest rates that were formed during April-June 2004. The rising inflationary trend made these expectations more credible. SBP also took cognizance of the rapidly expanding monetary aggregates and indicated a tightening of monetary policy.

However, it is important to mention that the tightening of monetary policy requires utmost care as any sharp adjustment in interest rates has the potential to negatively impact the growth prospects. In fact, despite market perceptions of a sharp increase in interest rates, SBP's response has been that of a moderate transition keeping medium term growth and inflation outlook in view. SBP's Monetary Policy Statement clearly mentions that

"….it will modulate swift policy changes if the inflation accelerates in the coming months or any unanticipated events takes place or if the differential with international interest rates widen significantly.[1]*"*

Figure 7.1: Key Interest Rates



* Since July 2003, these also inculde inter-bank transactions

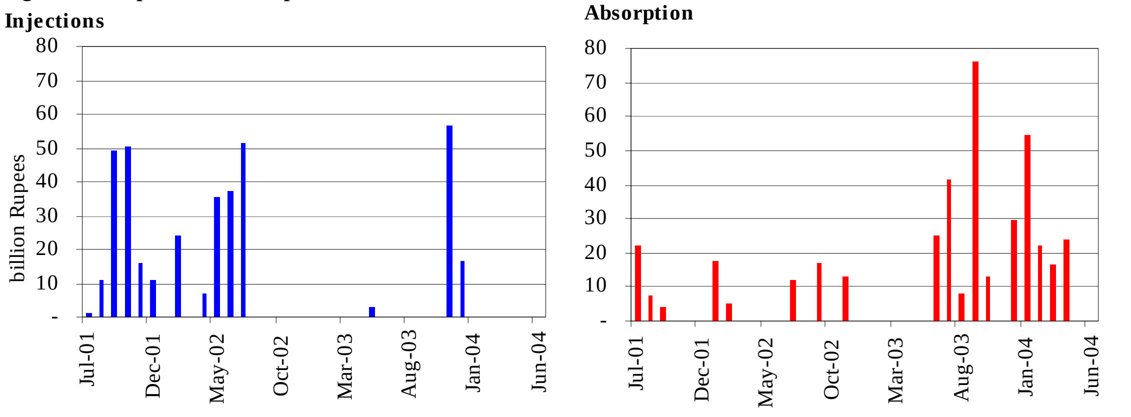
As shown in **Figure 7.1**, the easy monetary policy stance resulted in a steep decline in lending rates during the larger part of FY02-FY04 until a reversal in April 2004. Importantly, the large current account surpluses and subsequent SBP Forex purchases helped achieve exchange rate stability in the corresponding period. However, a sharp fall in current account surplus and external debt prepayments during second half of FY04 resulted in depreciation of Rupee and reinforced the need to increase domestic interest rates to stem any sharp depreciation of Rupee.

[1] SBP, Monetary Policy Statement, January-June 2004. This stance is supported by the newly issued Monetary Policy Statement, July-December 2004.

7.1.1 SBP Interventions and Treasury bill Auctions

As shown in **Figure 7.2**, the direction of rupee interventions through OMOs shows a stark difference in FY04 compared with the preceding two years. In specific terms, against a net injection of Rs185.1 billion in FY02, and mere Rs12.2 billion net absorption in FY03, FY04 witnessed a net absorption of a substantial Rs 211.9 billion. A larger part of these OMOs (Jan-Apr 2004) were geared to stem the excessive growth in monetary aggregates (M2 and reserve money), and to dampen the rising inflationary pressure.

Figure 7.2: Open Market Operations



As shown in **Table 7.1**, barring very few episodes of discounting the market remained relatively more liquid during FY04 compared with the preceding two years. This excess liquidity in the inter-bank money market was helped by better cash management and decreased reliance of commercial banks on the discount window.

Table 7.1: SBP Discount Window

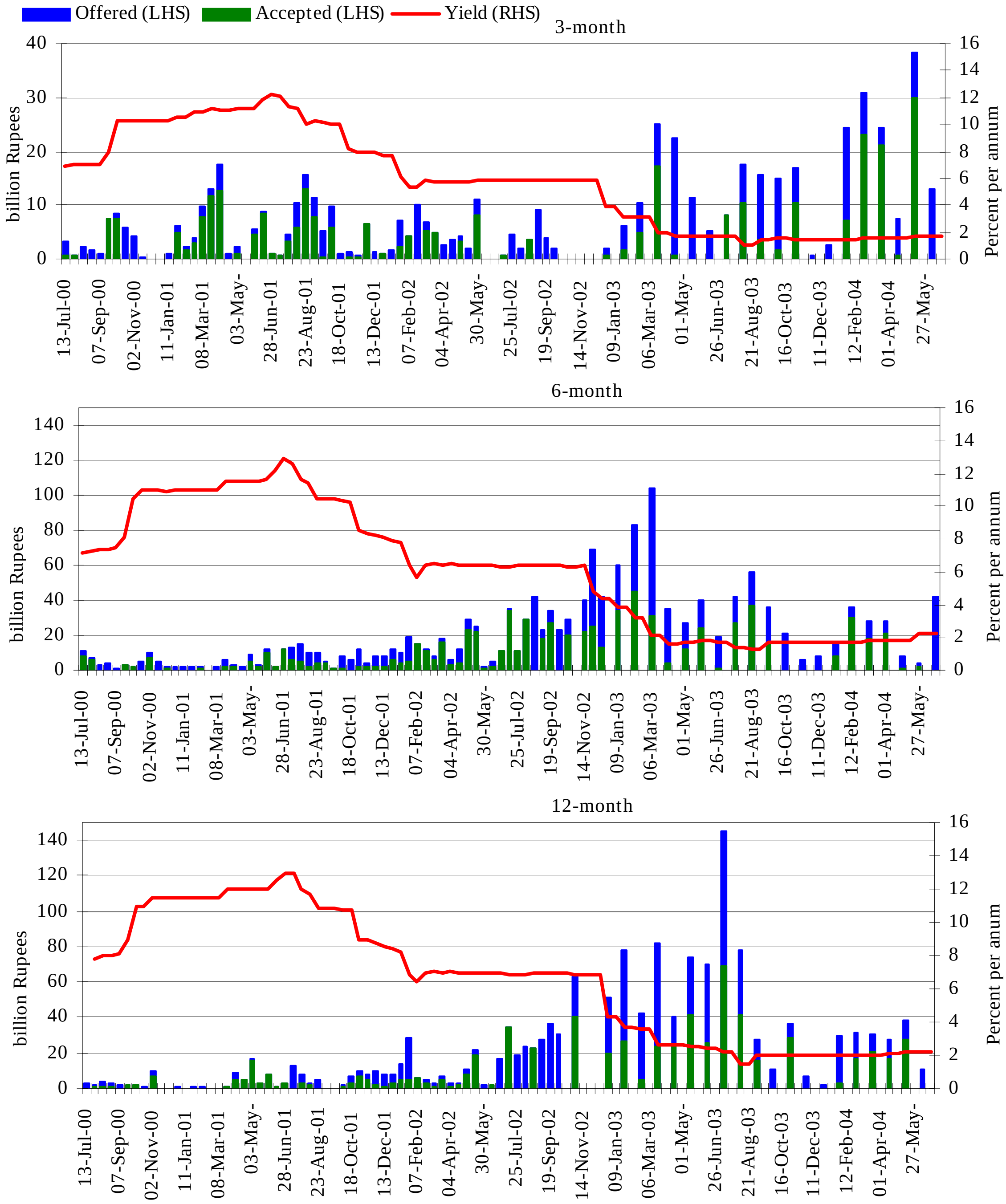
billion Rupees

	No. of days NIL dis.	No. of visits	Total discounting	Average per day
FY02	233	132	828.4	2.3
FY03	305	60	618.7	1.7
FY04	358	7	21.8	0.1

Table 7.2: Treasury bill Auctions Summary

Instrument	Year	No. of Auctions		No. of Bids		Amount (billion Rupees)		Percent	Spread (in percent)		W.A.
		Held	Scrap.	Received	Accepted	Offered	Accepted	Accepted	Simple	% of Yield	Yield
Three-month	FY02	26	8	177	61	128.4	72.9	56.8	0.60	7.22	8.3
	FY03	16	7	105	18	109.1	29.2	26.8	0.36	9.83	3.6
	FY04	13	3	204	64	216.6	115.6	53.3	0.51	34.57	1.5
Six-month	FY02	26	3	647	285	284.5	160.4	56.4	0.58	7.13	8.2
	FY03	18	1	1095	371	747.0	349.0	46.7	0.59	13.00	4.5
	FY04	13	2	530	186	329.0	158.4	48.2	0.47	28.29	1.6
Twelve-month	FY02	26	1	585	201	202.4	84.0	41.5	0.69	8.12	8.6
	FY03	16	5	1288	366	694.9	264.4	38.1	0.63	14.80	4.2
	FY04	13	2	668	230	476.7	241.0	50.6	0.86	43.67	2.0
Combined	FY02	26	12	1409	547	615.3	317.2	51.6	-	-	-
	FY03	26	13	2488	755	1551.0	642.6	41.4	-	-	-
	FY04	26	7	1402	480	1022.3	515.0	50.4	-	-	-

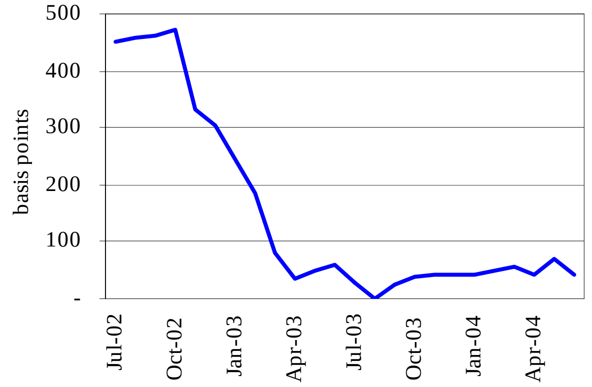
Figure 7.3: T-Bill Auctions Summary



As detailed in **Table 7.2**, the amount offered in T-bill auctions declined by 34.1 percent in FY04 in comparison to a phenomenal rise of 152.1 percent in FY03. These lower offerings in FY04 could be explained by: (1) phenomenal (and historic) rise in credit to private sector, (2) the reversal in interest rates in the latter half of FY04 prompted the market players to invest less in anticipation of getting a higher interest rate in subsequent auctions, and (3) a higher supply of long-term government bonds especially in the first half of FY04. In addition, SBP rupee injection through its Forex purchases also slowed down considerably during FY04.

The movements in Treasury bill rates of different tenors show the phases of monetary policy contraction and expansion during the past four years (see **Figure 7.3**). An important development related to short-term interest rates also took place during the past two years. As depicted in **Figure 7.4**, with the recent decline in interest rates, the differential between T-bill rates and LIBOR narrowed considerably (almost vanishing in August 2003). This convergence of domestic interest rates towards international interest rates is likely to prevail in future given the comfortable level of foreign exchange reserves of the country.[2] This implies that the domestic interest rates would follow the broader trends in international capital markets, and are less likely to increase to the levels that were observed before their fall.

Figure 7.4: Interest rate Differential (6-momth T-bill and 6-month LIBOR)



7.1.2 Secondary Market Activity in Government Securities

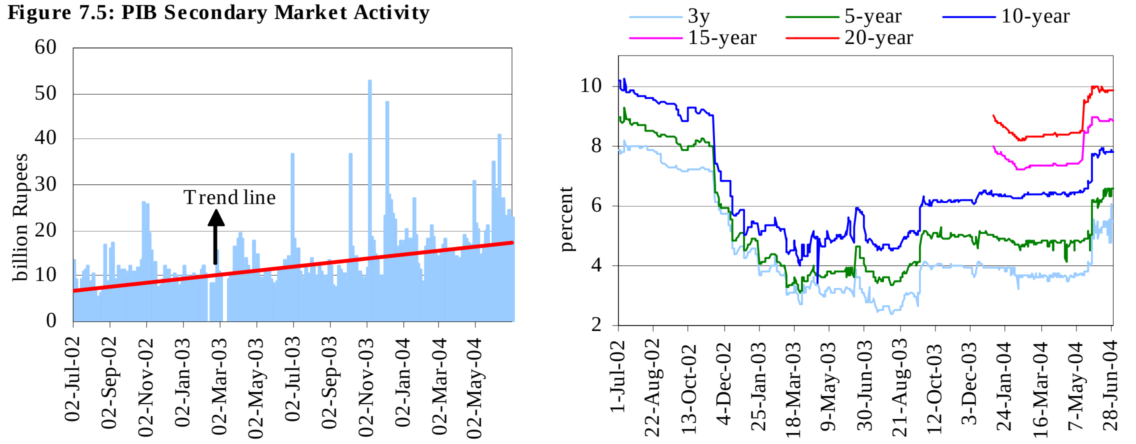
As reported in **Table 7.3**, the secondary market activity in government securities maintained a respectable level in the last two fiscal years; increasing by almost twice the total and average level of FY02. This increase is not surprising given the increase in issuances in both the T-bills and PIBs. However, the composition of trading has changed during FY04 compared to the last year with larger volumes dominated by PIBs and a sharp fall in the 6-month T-bill trading.

Table 7.3: Secondary Market Trading
billion Rupees

	3-month	6-month	1-year	PIB	All tenors
		FY03			
Total	13.1	2,480.6	2,704.7	2,773.8	7,972.2
Average	0.0	8.4	9.1	9.6	17.6
Max	3.6	33.1	48.5	36.9	62.6
		FY04			
	228.4	851.8	3,419.5	4,299.6	8,799.4
Average	0.8	2.9	11.7	14.8	30.2
Max	9.2	52.9	39.8	52.7	81.4

The probable reason for higher trading in the long-term bond is the increase in size (the outstanding stock of PIB has increased from Rs228.7 billion in June 2003 to Rs331.6 billion in June 2004). As shown in **Figure 7.5**, the PIB trading shows

Figure 7.5: PIB Secondary Market Activity



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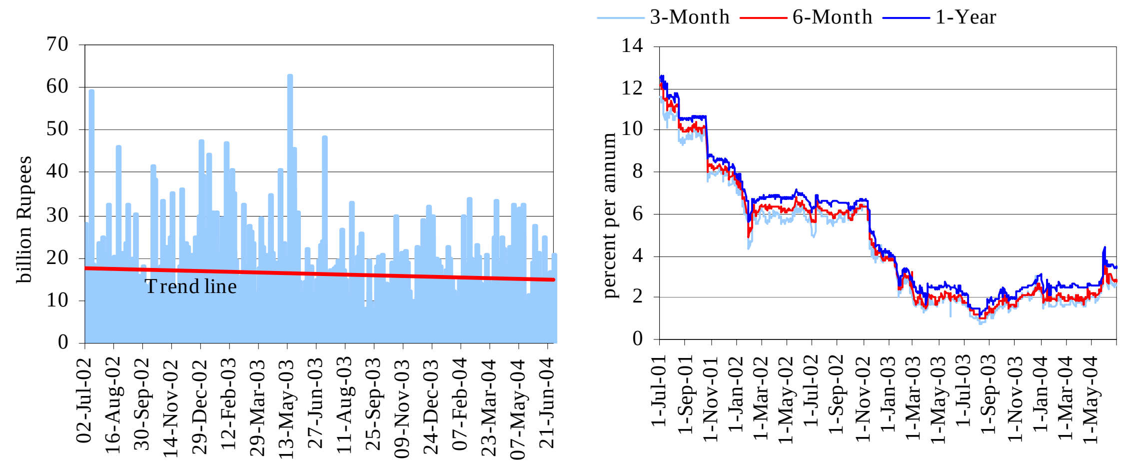
[2] The soaring level of domestic interest rates in 1990s also mirrored the need to attract foreign exchange through the foreign currency accounts.

a clear upward shift since October 2003. And, since almost half of the total trading occurred in PIBs there was an overall higher trading activity. The disallowing of pass-through bids (in PD rules) may also helped in a surge in long-term trading activity as the clients have to rely more on the secondary market for getting a reasonable price. The decline in activity in the 6-month paper could be due to the lesser volume of the 6-month T-bills issued in this period.

As shown in **Figure 7.5**, the long-term interest rates bottomed out in August 2003, after a period of decline (since July 2001) that led to a negative real yields on 3- & 5-year PIBs. Afterwards, announcements of unexpected and large PIB auction targets in September 2003 and April 2004 resulted in a sharp rise in long-term interest rates, though remaining fairly stable during the period between the two announcements. The stability of the long-term rates was owed, in part, to the lack of large PIB auctions, which lowered pressure on PIB prices and complemented the SBP's policy of raising short-term rates only very gradually. An important development during FY04 was the successful inaugural issuance of the 15- and 20-year PIBs in January 2004.

The short-term interest rates also bottomed out in August 2003, with the market expecting a reversal in domestic interest rates. On the other hand, SBP scaled down the market expectations by rejecting a T-bill auction and accepting less than the target in the PIB auction during October 2003. Nonetheless, a rising inflationary trend (especially when core inflation also started to register an upward trend in the last quarter of FY04) coupled with pressures on exchange rate resulted in tightening of monetary policy by the end of FY04 (see **Figure 7.6**).

Figure 7.6: Treasury Bills Trading



7.1.3 Government Bond Market

The outstanding stock of PIBs has increased from Rs228.7 billion in June 2003 to Rs331.6 billion in June 2004, representing a rise of 37.5 percent. This effectively increased the size of the government bond market beside increasing the liquidity for the money market players (as reflected by the surge in trading activity in PIB). However, some weaknesses remain to be addressed with respect to the auction schedule and size of the individual auctions, which tend to distort market expectations of future interest rates, for example:

(1) The announcement of an unexpected and large auction of a Jumbo issue in September 2003 (apart from other factors cited earlier) created strong market expectation of reversal in interest rates, and subsequently SBP had to scale down these expectations by rejecting bids in 6-month and 12-month T-bill and accepting lower amount in PIB auctions in October 2003.

(2) Another announcement of a large and unexpected auction in April 2004 has pushed interest rates sharply upward. This led to a rejection of both T-bill auctions in June by SBP to manage the interest rate expectations of the market players.

In essence, these developments clearly highlight the importance of a greater coordination between SBP (which sets targets for T-bills auctions) and the Finance Ministry (which sets targets and timing for PIBs) in managing the interest rate structure and associated expectation in the economy. This becomes even more important given the fact that the net government market borrowings through PIBs have been significantly higher than through T-bills during FY04. Nonetheless, the introduction of Jumbo issues resolved the problems in pricing and liquidity of different issues. Moreover the introduction of 15- and 20-year bonds effectively provided benchmarks for mortgage financing.

As reported in **Table 7.4**, Rs107.7 billion worth of PIB were sold during FY04 compared with only Rs74.8 billion in FY03. This increase in PIB issuance could be explained by a reduction in other sources of financing, like NSS and external finance during FY04 in comparison with FY03.

Table 7.4: Pakistan Investment Bonds Auction Summary

billion Rupees

Instrument	Year	Combined Target*	Amount offered	Amount Accepted	Percent Accepted	Average Yield (%)	Average Coupon(%)
	FY02	93.0	46.1	24.8	53.8	9.8	10.4
Three-year	FY03	66.0	26.1	9.7	37.0	5.5	8.0
	FY04	90.0	38.5	14.5		4.0	6.0
	FY02	93.0	47.3	24.7	52.1	10.6	10.9
Five-year	FY03	66.0	45.6	14.4	31.5	6.5	9.1
	FY04	90.0	58.5	27.8	47.4	5.1	7.0
	FY02	93.0	144.9	58.2	40.2	11.6	12.0
Ten-year	FY03	66.0	140.3	50.8	36.2	6.8	10.0
	FY04	90.0	93.0	51.6	55.5	6.4	8.0
	FY02	-	-	-	-	-	-
Fifteen-year	FY03	-	-	-	-	-	-
	FY04	36.0	14.3	7.0	48.9	8.3	9.0
	FY02	-	-	-	-	-	-
Twenty-year	FY03	-	-	-	-	-	-
	FY04	36.0	16.6	6.8	40.8	9.3	10.0
	FY02	93.0	238.4	107.7	45.2	-	-
Combined	FY03	66.0	212.0	74.8	35.3	-	-
	FY04	126.0	221.0	107.7	48.7	-	-

** Targets combined separately for 3, 5 & 10 years and 15 & 20 years*

All in all, PIB auctions proved successful in terms of auctions held, number of bids received and accepted compared with the last years (see **Table 7.5**). However, the overall acceptance fell short of combined targets for the first time in FY04 primarily due to the rejection of bids (at higher interest rates) in auctions held towards the end of the fiscal year.

Table 7.5: PIB Auction Performance

	No. of Auctions		No. of Bids	
	Held	Scrap.	Received	Accepted
FY01	6	0	261	182
FY02	13	1	1,374	486
FY03	7	0	1,595	323
FY04*	7	0	1,273	626

** Including two jumbo issues of three and two openings respectively*

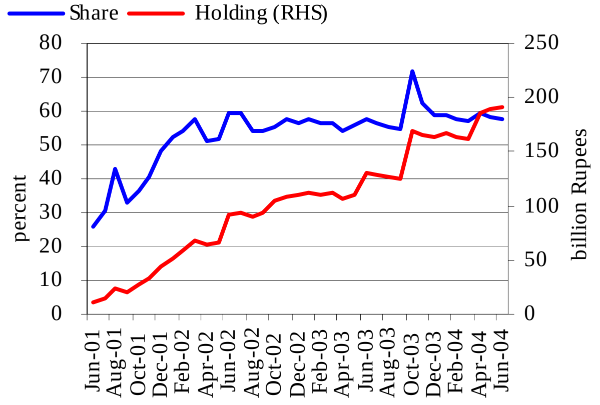
The changes in PIB coupon rates are given in **Table 7.6**. In line with the easy monetary policy stance the coupon rates for 3, 5 and 10-year PIBs were reduced by 100 bps in October 2003. However, given the already exorbitant premiums embedded in market prices the lower coupon rate resulted only in mildly reducing these premiums while the yields shifted upwards.

Table 7.6: Changes in PIB Coupon Rates

Effective	3-year	5-year	10-year	15-year	20-year
14-Dec-00	12.5	13.0	14.0	-	-
22-Aug-01	11.8	12.2	13.0	-	-
22-Nov-01	10.5	11.0	12.0	-	-
28-Feb-02	9.0	10.0	11.0	-	-
31-Dec-02	7.0	8.0	9.0	-	-
6-Oct-03	6.0	7.0	8.0	-	-
20-Jan-03	-	-	-	9.0	10.0

As shown in **Figure 7.7**, the commercial banks' share in outstanding PIBs declined in the period Jan-Jun 2004. Although, there is no significant decline in banks' holding, fall in share reflects that fresh issues during the Jan-June 2004 period largely went to the corporate sector. The lower interest of banks in fresh issues resulted from lower targets in 3- and 5-year bonds amidst an expectation of interest rate rise. It is worth mentioning that in a scenario of interest rate rise banks would prefer to invest in shorter tenors and wait for interest rates to rise in order to book assets later at a higher yield. In addition, the reversal in interest rates in the latter half of FY04 kept the corporate clients largely away from getting new supply of PIBs as they waited for interest rates to stabilize (corporate sector tends to hold these bonds till maturity and is risk averse especially when there is uncertainty in future interest rate outlook).

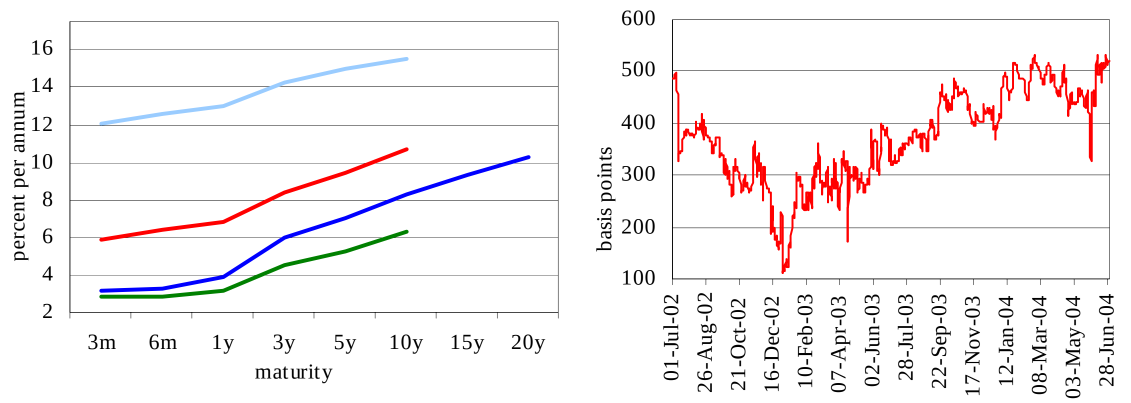
Figure 7.7: Banks' Holdings of PIBs



7.1.4 Developments in Yield Curve

As shown in **Figure 7.8**, the yield curve shifted downwards considerably in FY04 compared with FY01, however the monetary policy tightening since May 2004 resulted in a slight upward shift. In addition, the slope of the yield curve has gradually become steeper since January 2003; initially the steepness was due to a relatively sharper decline in short-term interest rates and in the latter half of FY04 due to a sharper rise in the long-term interest rates.

Figure 7.8 : Yield Curves (end-June)

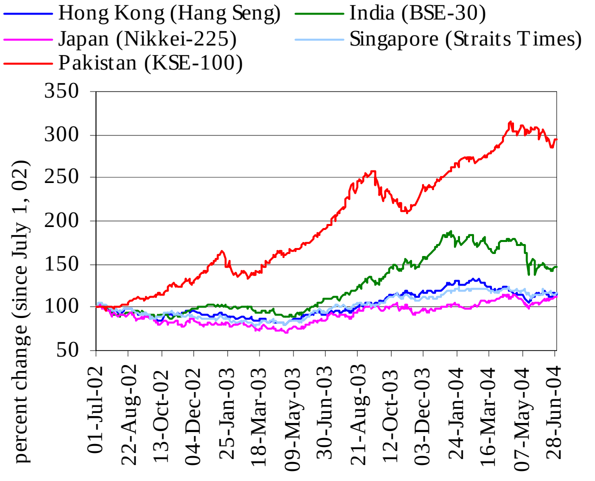


7.2 Capital Markets

Capital Markets in Pakistan witnessed a significant growth in the past few years due to the phenomenal surge in external account surpluses that resulted in a massive growth in domestic liquidity. In addition, the relatively low returns on fixed income securities (like NSS) and lucrative valuations in the equity market and improvements in other macroeconomic fundamentals paved the way for equity markets in Pakistan to surpass all the previous records of index level and turnover of shares.

As seen in **Table 7.7** the equity market showed a growth of 59.9 percent in market capitalization during CY03; while in first 6-months of CY04 it further grew by 55.0 percent. Also, the similar trend is visible in other equity market indicators like total turnover, average turnover and, most importantly, in terms of new floatations. However, the corporate debt market witnessed a decline in new floatations during last 18 months primarily due to easy availability of cheaper finance from the commercial banks.

Figure 7.9: Regional Markets v/s KSE-100



The Pakistani stocks also performed favorably in comparison with other regional markets. As seen in **Figure7.9**, KSE-100 index witnessed much higher growth in last two fiscal years compared with the other regional markets stock indices.

Table 7.7: Overview of Capital Market (KSE)

million Rupees

	CY00	CY01	CY02	CY03	CY04*
			Equities		
Listed companies	741	747	711	701	666
Listed capital	236458.5	235683.2	291240.85	313267.23	376221.86
Market capitalization	382,730.40	296,143.70	595,205.63	951,446.50	1,474,625.18
New companies listed	3	3	4	6	12
New listed capital	2,035.00	2,884.70	6,318.30	4,562.60	55,473.26
Bonus issue listed	5,210.55	4,187.49	3,273.43	4,773.52	4,163.77
Right issues listed	3,387.15	1,531.45	13,639.38	9,393.15	3,445.65
			Debt Instruments		
New debts instruments listed	3	5	16	6	2
Listed capital	647.5	5,658.30	8,655.70	2,749.00	1,050.00
			KSE – 100 Index (Base Nov 01,1991)		
High	2,054.43	1,550.42	2701.42	4604.02	5620.66
Low	1,276.05	1075.16	1322.07	2356.48	4473.03
Range	778.38	475.26	1,379.35	2,247.54	1,147.63
			Turnover		
Total shares (in - million)	46,157.66	23,069.71	41,627.20	76,380.08	51,413.60
Avg/Day (in million)	186.9	96.91	167.1	308.81	414.8

** As on July 09, 2004*

Source: KSE website (www.kse.net.pk)

7.2.1 Supervisory Role of Securities of SECP

SECP continued to improve the regulatory framework of capital markets during FY03. In addition to the earlier reforms in the areas of rationalization of trading practices, risk management and enhancement of corporate governance, the following reforms are currently under process:

Risk Mitigation Measures

The Carry-Over Trade (COT) system was rationalized and it was specified that COT should be for a minimum period of 10 days with the financee having the option to release it after one day. Efforts are underway to gradually phase out COT and replace it with margin financing/futures. In addition the COT transactions were limited to only thirty eligible scrips.

Finally, in late June and early July 2004, SECP and State Bank of Pakistan, issued *The Margin Trading Rules, 2004* and *Regulations for Margin Financing by banks/DFIs* respectively. Applicable from July 2004, these rules and regulations would strengthen the market integrity, and reduce the risk of recurrent crises. However, margin financing and existing COT would run parallel till COT is abolished completely in December 2004.

Demutualization and integration of Stock Exchanges

The SECP has constituted an Expert Committee comprising of national and international securities market experts with the objective of formulating a comprehensive plan for demutualization and integration of stock exchanges.

Cooperation with Regional Regulators

To provide comfort to foreign portfolio investors and regulators the SECP has entered into the process of finalizing Memorandum of Understandings (MOU) with its counterparts in various jurisdictions. SECP executed a MOU with the Securities and Exchange Commission of Sri Lanka and are initiating similar MOU with India, Indonesia and the Philippines. SECP also intends to initiate MOU with the US, the UK and Japan.

Steps to enhance Accounting Standards

Highest standards of accounting, disclosure and transparency are a prerequisite for efficient working of the capital market. The SECP has taken several steps in this regard including rotation of auditors by listed companies after every five years, restriction on auditors to provide non-audit services to their listed audit clients and enhancement of penalties on auditors in case of professional misconduct.

Institutional strengthening of SECP

The SECP has an excellent work force comprising of professional accountants, business managers, economists, lawyers, IT specialists etc. Proper incentives are being put in place to provide a sustainable work environment, which include staff training and development programs, the provision of market based compensation packages and career advancement options. These steps will go a long way in capacity building of the regulator.

Extension of the Code of Corporate Governance

The Code of Corporate Governance requires directors to discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent, and timely manner. The SECP intends to extend the Code to unlisted public companies and government corporations.

Enhancement of legal and regulatory framework

The SECP intends to set up a corporate laws review commission to harmonize the legal and regulatory framework in order to make it more efficient and cost effective.

Corporate tax rationalization
The SECP intends to work in close conjunction with the Central Board of Revenue to incentivize corporatization, ensure the progressive development and graduation of corporates and to provide the necessary incentives for the development of the capital market and insurance sector

Institute of Corporate Governance
An Institute of Corporate Governance is in the process of being established to provide an enabling environment for the implementation of the recently promulgated Code of Corporate governance, by corporates. The SBP has also published a handbook of corporate governance (see **Box 7.1**)

In addition, the SECP has directed each stock exchange to set up a monitoring and surveillance wing to check market abuse. Also, SECP intends to promote Corporate Social Responsibility (CSR) and Socially Responsible Investing (SRI), so that companies can contribute to sustainable economic development by running their businesses to achieve economic growth, but at the same time, ensure environmental protection and protect consumer and other stakeholder interests.

Box 7.1: SBP guidelines on corporate governance
In September 2003, State Bank of Pakistan issued a Handbook of Corporate Governance with a view to reinforcing the importance of adopting good corporate governance and to assist bankers, auditors and public at large to understand the subject. The SBP has strong interest in ensuring sound corporate governance in banks, it will make the work of supervisor relatively easier.
Some basic tools for sound corporate governance include:

- Appointment of key personnel after ensuring that they pass the fit and proper test,
- Promote corporate values, ethics, code of conduct for appropriate behavior and institution of a system to ensure compliance,
- Articulation of corporate strategy against which success of overall enterprise and the contribution of individuals can be measured,
- Assignment of a clear-cut responsibilities and decision making authorities, and outlining chain of required approvals from individuals to the board of directors,
- Institution of a forum interfacing the board of directors, senior management and the auditors,
- Putting in place sound internal control system, including internal and external audit functions, risk management, independent of business line,
- Special monitoring of situations where conflict of interest arises, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the bank,
- Offer of incentives (monetary and otherwise) to management (senior, business line) and employees in the form of compensation, promotion and other recognition, and
- Channeling the flow of information both within and outside the organization (the public).

7.2.2 Performance of Stock Exchanges
The performance of three stock exchanges in Pakistan during FY04 continued to show signs of improvement in various stock market indicators reflecting the: (1) good corporate earnings, (2) restoration of investors' confidence due to improvement in macroeconomic environment, (3) restoration of political ties with neighboring countries, and (4) the expectations of political stability and continuity of economic policies.

As shown in **Table 7.8**, the KSE (biggest stock exchange of country) increased in size (market capitalization) and liquidity (trading volume and turnover ratio). More importantly, IPOs during FY04 are almost twice the figure for FY02-FY03 combined.

Table 7.8: Profile of Karachi Stock Exchange

	FY02	FY03	FY04
Total number of listed companies	725	705	685
Total listed capital (Rs billion)	260.6	300.9	374.3
KSE-100 index	1,770.1	3,402.5	5,279.2
KSE all share index	1,118.8	2,168.5	3,480.2
SBP General index of Prices	106.7	204.9	
Initial public offering (IPO)	4	3	13
New debt instrument listed	10	21	6
Trade volume during the year (million shares)	28,852	52,741	96,585
Market capitalization (Rs billion)	411.6	755.8	1428.1
Value of shares traded (Rs billion)	804	2,271	4,926
Average daily turnover (million shares)	120.9	214.3	387.9
Trading days	241	246	249
Turnover Ratio	2.2	4.1	0.3

Source: Karachi Stock Exchange & Statistics Department, SBP

As shown in **Figure 7.10**, there is a visible surge in KSE-100 index and turnover of shares since July 2002, barring a few technical corrections.

Similarly, the LSE and ISE also followed the trends in the KSE, and showed growth in market capitalization and turnover (see **Table 7.9**).

Table 7.9: Performance of LSE and ISE

billion Rupees, shares in million

	LSE			ISE		
	Listed companies	Turn over	Paid up capital	Listed companies	Turn over	Paid up capital
FY02	581	18,281.2	246.3	279	1,657.9	180.6
FY03	561	28,191.6	280.1	261	1,606.0	232.7
FY04	534	19,900.0	361.53	260	1,320.8	320.6

As seen in **Table 7.10**, FY04 witnessed 17 floatations (including IPOs) compared with 4 each for FY02 and FY03. This surge in floatations is not surprising given the historic bullish trends seen in last two years and over-subscription.

Figure 7.10: KSE-100 Index and Turnover

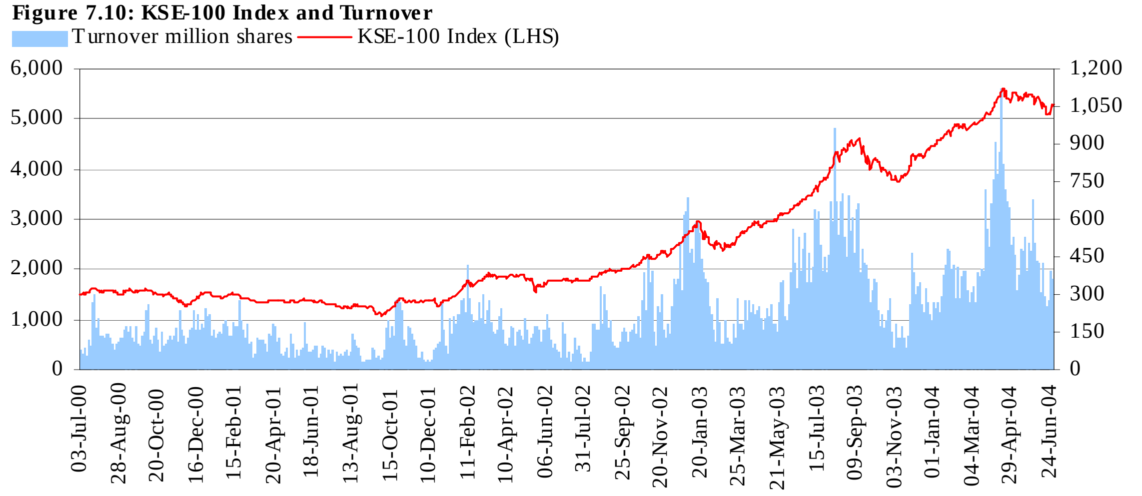


Table 7.10: New Floatation at KSE

million Rupees

	Company	Date of Listing	Total Paid up capital	Offered amount	Subscribed
			FY02		
1	Fayzan Manufacturing Modarba	Dec-01	900.0	540.0	6.1
2	WorldCall Multimedia	Jan-02	530.0	132.0	21.4
3	National Bank	Feb-02	3730.4	373.0	1033.2
4	Attock cement	Jun-02	680.3	100.0	31.1
			FY03		
1	Fayzan Manufacturing Modarba	Dec-01	2095.5	16.5	544.7
2	WorldCall Multimedia	Jan-02	2349.6	-91.4	653.4
3	National Bank	Feb-02	2603.8	-199.3	762.1
4	Attock cement	Jun-02	2857.9	-307.2	870.8
			FY04		
1	TRG	Jul-03	600.0	200.0	1,121.9
2	Pakistan Containers Terminal	Aug-03	638.0	160.0	1,340.7
3	National Bank of Pakistan		Already Listed	604.0	1222.3
4	First National Bank Modaraba	-	250.0	100.0	121.1
5	OGDCL	Jan-04	43,009.3	6,881.5	28,100.0
6	Worlcall Broadband Limited	Feb-04	1,500.0	300.0	1,976.1
7	ABAMCO Stock Market Fund	Mar-04	500.0	without public offering	
8	Pakistan Capital Market Fund	Mar-04	1,500.0	375.0	2,030.7
9	SSGC		Already Listed	1,747.0	13,000.0
10	Bank Alflah Limited	May-04	2,000.0	1,200.0	11,801.2
11	Macpac	Apr-04	389.0	150.0	473.6
12	ABAMCO Capital Fund	Jun-04	1,193.8	without public offering	
13	ABAMCO Composite Fund	Jun-04	3,000.0	1,000.0	73.5
14	Callmate Telips Telecom Limited	Jun-04	502.5	150.0	589.8
15	Southern Networks Limited	Jun-04	594.6	150.0	137.9
16	PIA		Already Listed	1,150.7	1,329.3
17	PICIC Investment Fund	Jun-04		without public offering	

New floatations are likely to get a further boost due to privatization of some of public sectors corporations.

Table 7.11 shows the top performing sectors in the KSE during FY04 in term of liquidity (traded value). The *oil and gas exploration* sector topped the list both in terms of size and liquidity; the sector includes the current market leader in OGDCL. It was followed by the relatively low sized very liquid *cement* sector whose stocks remained attractive to the investors due to higher profitability and enhanced production capacities in companies like DG Khan cement. Other major sectors in terms of liquidity include the *oil and gas marketing* sector (including market leaders like PSO and Shell), *technology and communication* (including the market heavy-weight like PTCL with a second highest market capitalization for a individual company).

Figure 7.11: COT(Badla Market)

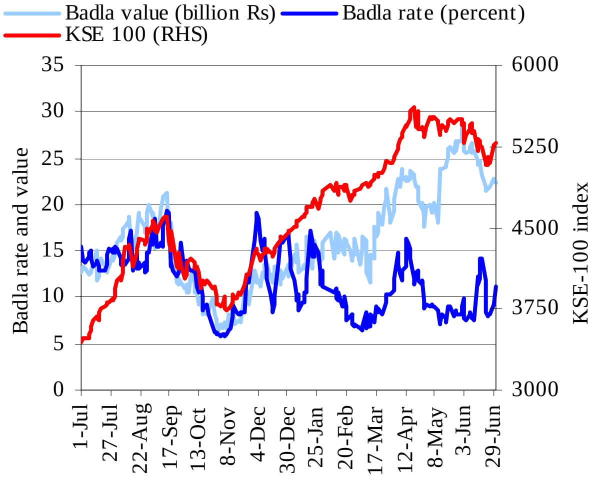


Table 7.11: Top performing sectors of KSE during FY04

billion Rupees

	Sector	Market Capitalisation Total	Share (%)	Cum. Share	Traded value Total	Share (%)	Cum. Share
1	Oil & gas exploration companies	307.9	21.7	21.7	473.1	19.9	19.9
2	Cement	68.8	4.8	26.5	430.7	18.1	38.0
3	Oil & gas marketing companies	111.8	7.9	34.4	313.8	13.2	51.2
4	Transport	28.4	2.0	36.4	226.7	9.5	60.7
5	Commercial banks	116.4	8.2	44.5	218.6	9.2	69.9
6	Technology & communication	168.6	11.9	56.4	160.1	6.7	76.6
7	Investment banks/cos./securities	34.1	2.4	58.8	111.2	4.7	81.3
8	Fertilizer	75.6	5.3	64.1	108.7	4.6	85.9
9	Power generation & distribution	64.2	4.5	68.6	73.6	3.1	89.0
10	Textile composite	34.1	2.4	71.0	68.3	2.9	91.8
11	Insurance	29.6	2.1	73.1	46.6	2.0	93.8
12	Synthetic & rayon	33.3	2.3	75.5	42.6	1.8	95.6
13	Close-end mutual funds	18.8	1.3	76.8	38.0	1.6	97.2
14	Chemicals	52.4	3.7	80.5	25.2	1.1	98.2
15	Automobile assembler	33.7	2.4	82.9	13.8	0.6	98.8

As shown in **Figure 7.11**, the badla financing played an important role in stock market movements. In fact, the rise in KSE-100 index closely mirrored the badla value and market corrections also resulted from high leverage position of the investors amidst rising badla rates.

7.2.3 Corporate Debt Market

The corporate debt market witnessed a decline of 69.4 percent in new issues worth Rs. 3.3 billion during FY04 (see **Table 7.12**). As shown in **Figure 7.12**, there was a sharp decline in issues during FY04, more importantly the upward trend of previous three years (FY01-FY03) was reversed. The surge in corporate debt issues during FY02-FY03 occurred due to a phenomenal decline in domestic interest rate. While the interest rates remained low, availability of easy and cheaper finance from the commercial banks declined the growth of TFC in FY04, however, the reversal in interest rates in second half of FY04 may result in revival of TFC issues as the corporates may tap finance opportunity at still cheap rates that are likely to get expensive.

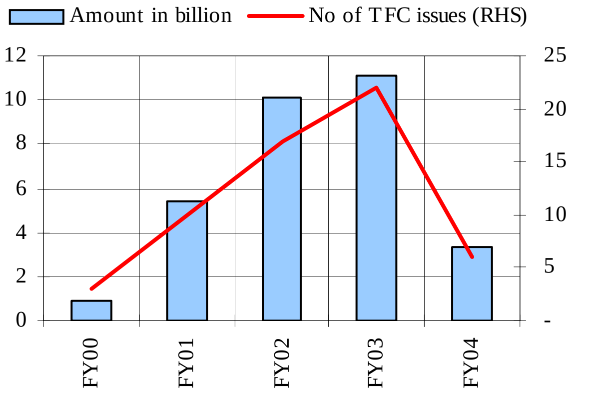
Table 7.12: Corporate Debt Profile

Amount in Rupees million

Company	Issue Date	Coupon Rate	Tenor Years	Amount	Listed at
		FY03			
Engro Chemical Pak. 2	Jul-02	W.A. last 3 cut-off 5yrs PIB+1.15% Floor 11.00% Cap 15.00%	5.0	1,000.0	KSE
Maple Leaf Cement	Jul-02	5 Years PIB Rate + 2.50% Floor 15.25%, Cap 17.75%	4.0	250.0	KSE
Orix Leasing 2	Jul-02	SBP Dis. Rate + 2 Floor 10%, Cap 13%	4.0	746.8	KSE
Dawood Leasing 2	Jul-02	SBP Dis. Rate + 1.75% Floor 12.25% , Cap 16.25%	5.0	250.0	LSE
Muslim Commercial Bank	Aug-02	Cut-off yield of 5 yrs PIB + 1.50% Floor 11.75% , Cap 15.75%	5.6	1,600.0	KSE
Crescent Leasing Corp.2	Sep-02	Base Rate+ 2% p.a. floor of 12.00% and cap of 15.75% where base rate is the cut-off yield on the last successful SBP auction of 5-year PIBs.	5.0	250.0	KSE
World Call	Sep-02	SBP Dis. Rate + 1.75% Floor 12.25%, Cap 16.25%	5.0	350.0	KSE
Shakarganj Mills 2	Sep-02	SBP Dis. Rate + 2%, Floor 12.25%, Cap 15.75	4.0	200.0	LSE
Quetta Textile Mills Ltd.	Oct-02	SBP Dis. Rate +2.50% with a floor of 13% and a cap of 18%	5.0	750.0	KSE
Union Bank	Dec-02	Cut-off yield of 5 yrs PIB + 2.25% Floor 11.00%, Cap 15.50%	5.5	750.0	KSE
Bank Al-Falah	Dec-02	Cut-off yield of 5 yrs PIB + 1.35% Floor 10.00%, Cap 15.00%	6.0	650.0	LSE
Security Leasing 2	Jan-03	SBP Dis Rate +2.25 1st Year Floor: 11.50%, Cap15.50% 2-4 years Floor11.00%, Cap 15.50%	4.0	299.0	KSE
KASB Leasing (Pak Apex Lease)	Jan-03	W.A. of last 3 cut-off of 5 years PIB+2.25 Floor 11.50%, Cap 14.50%	5.0	200.0	KSE
Gulistan Textile Mills Ltd	Jan-03	SBP Dis. Rate + 2.25% Floor 11.00% , Cap 17.00%	5.0	400.0	LSE
Gulshan Spinning Mills	Jan-03	SBP Dis. Rate + 2.25% Floor 11.00% , Cap 17.00%	5.0	400.0	LSE
Paramount Spinning Mills	Jan-03	SBP Dis. Rate + 2.00% Floor 10.90% , Cap 17.00%	5.0	200.0	LSE
Paramount Leasing Ltd.2	Feb-03	SBP Dis. Rate + 2.50% Floor 11.50% , Cap 14.50%	4.0	325.0	LSE
Paktel	Mar-03	SBP Dis. Rate +2.0% for 1st Year, floor of 12% and a cap of 16% For 2-3 Years, floor of 11.50% and a cap of 16%	3.0	840.0	LSE
JS & Co.	Apr-03	Cut-off yield of 5 yrs PIB + 1.50% Floor 7.50%, Cap 13.00%	5.0	900.0	LSE
Trust Lease	Jun-03	SBP Dis. Rate +2.0% Floor 9%, Cap 14%	5.0	250.0	KSE
Ittehad Chemicals Ltd	Jun-03	SBP Dis. Rate + 2.50% Floor 11.00%, Cap 15.00%	5.0	250.0	KSE
Total FY03				**10,860.8**	
		FY04			
Pacific Leasing	Jul-03	SBP Dis. Rate + 2.0% Floor10.50%, Cap 13.50%	4.0	320.0	LSE
First Oil & Gas (OPI)	Sep-03	SBP Dis. Rate + 2.5% Floor10.50%, Cap 14.50%	3.3	1,000.0	KSE
Pharmagen Limited	Oct-03	W.A. yield of 5 yrs PIB + 2.50% Floor 8.50% , Cap 11.50%	5.0	300.0	LSE
Pakistan Services Ltd.	Nov-03	SBP Dis. Rate + 2.5% Floor 9.75%, Cap 13.75%	5.0	700.0	KSE
Al-Zamin Leasing Modaraba	Dec-03	Expected Minimum 8%, P&L based	5.0	250.0	KSE
Union Bank II	Nov-03	Cut-off Yield of 5 yrs PIB + 0.75% Floor 5.0%, Cap 10.75%	6.0	749.0	KSE
Total FY04				**3,319.0**	

An important development during FY04 was the issuance of guidelines on Commercial Paper (CP) in order to facilitate the development and growth of commercial paper in Pakistan.[3] The step is expected to encourage banks/DFIs to initiate development of primary and secondary market of CPs. Only a few commercial papers were floated in FY04, and the size of the market is very small for any secondary market activity to initiate. Nonetheless, the corporate sector especially the textile and sugar concerns are interested in floating commercial paper. Given the stringent rating requirements the demand for CP is also positive.

Figure 7.12: Growth in TFC Market



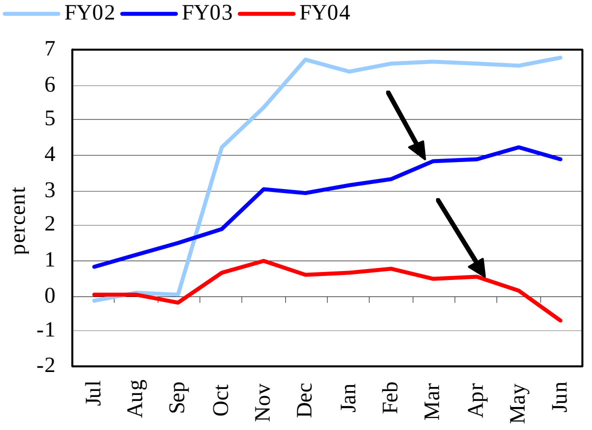
The major hindrance in development of CP market is the unfavorable taxation (stamp duty), availability of cheaper finance from the commercial banks and buy-and-hold strategy of participants. However, the recent reversal in interest rates (with gradual tightening of monetary policy) could help spur CP issuances in future.

7.3 Foreign Exchange Market

7.3.1 Interbank market

An abrupt but *beneficial* turnaround in the external accounts balance in FY02 strengthened further in FY03. However, net forex flows did not sustain and faced deterioration in FY04 due to enlarged outflows despite moderate forex inflows. Consequently, in contrast to the sharp appreciation in FY02 and FY03, Rupee depreciated marginally in FY04 (see **Figure 7.13**).

Figure 7.13: Cumulative App/Dep Since June



The positive developments in FY02 and FY03 allowed SBP to take proactive measures aimed at establishing relatively more resilient, competitive and liberalized foreign exchange market[4]. The notable outcome of these measures included an unprecedented stability, enhanced market capacity for lumpy payments, room for prepayment of expensive external debt and establishment of exchange companies.

More specifically, SBP, while responding to huge external flows in FY03, mopped up surplus forex liquidity from the inter-bank market through net purchases; this welcome policy stance, particularly for exporters, was geared towards moderating the rate of Rupee appreciation and also brought about positive externalities in the form of massive foreign exchange reserves[5] and availability of cheap

[3] State bank of Pakistan circular, BPD Circular No. 28 dated August 23, 2003
[4] For details please see Reforms Matrix (**Annex**).
[5] Generally, higher foreign exchange reserves act as a cushion against a speculation drive and more importantly set aside market expectations about major fluctuations in the exchange rate.

Rupee financing due to a low interest rate environment[6].

Despite stronger market fundamentals[7] in FY03 compared to FY02, largely due to remittance inflows and export receipts, SBP followed a cautious policy of foreign exchange management and opted for gradual appreciation in FY03 (see **Table 7.13**). In fact, like other central banks, SBP faced difficulty in distinguishing the extent of transitory and permanent flows i.e. those, which resulted from 'reverse capital flight' and 'structural flows'. Therefore a rational policy of gradual appreciation was adopted considering the uncertainty associated with dominant forex flows, as these were likely to taper off (or at least moderate) once the economy absorbed the positive shock of September 11 2001. SBP's efforts in stabilizing the exchange rate can be gauged from the fact that the rate of appreciation[8] was kept in check through heavy SBP net purchases in FY03. In fact, net SBP purchases from interbank market in FY03 were almost doubled relative to FY02.

Table 7.13: Major Forex Flows and Exchange Rate Management

Amount in US$ million and Rate in percent

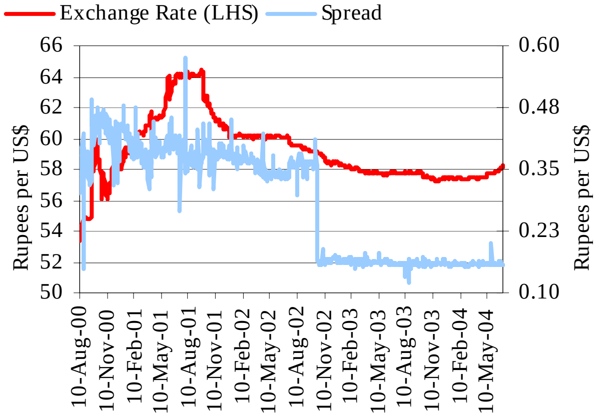
	FY01	FY02	FY03	FY04[1]
Current Account Balance	326	2833	4203	1931
Adjusted CAB	-2514	-27	2513	875.8
Remittances	1087	2390	4237	3517
Trade Deficit[2]	-1269	-294	-444	-1066
FE-25 Deposit	1543	2098	2296	2671
FE-25 Loans	1.4	340	1056	864.5
Exchange Rate (Rupees per US$)	64.1	60	57.8	58.2
Appreciation (+) /Depreciation (-)	-18.6	6.8	3.9	-0.8
SBP net Purchases	-1126	2483	4546	897
SBP Reserves (Flows)	685.9	2657	5192	1029
T-bills Rate (6-month)	12.87	6.28	1.66	2.23
Discount Rate	14	9	7.5	7.5

[1] July-May 2004 period for BOP Data

[2] Based on exchange records

As a result of SBP's forex market operations, dominantly in the forward market, SBP's foreign exchange reserves crossed US$ 9.9 billion and also lowered the cost of financing as the Rupee interest rate declined to historic lows at the end of FY03. To capitalize on the positive developments at play, SBP prudently initiated certain measures for the development of the market and liberalization of the foreign exchange regime. Specifically, in order to protect the interest of small exporters and to harness price efficiency in the foreign exchange market through increased competition, SBP reduced the permissible spread margin between buying and selling rates to 20 paisas per US Dollar in October 2002 for ready and forward transactions (see **Figure 7.14**). Moreover, an added incentive of *foreign currency loans* against FE-25 deposits further facilitated market activities. In fact, the marked difference in the market activities of FY02 and FY03 was the increasing role of forex loans in shaping the direction of Rupee vis-à-vis Dollar as forex loans augmented the forex liquidity in the market in Rupee appreciating environment.

Figure 7.14: Daily Exchange Rate Movement



Given the comfortable level of foreign exchange reserves and the prospects of positive current account balance, the market

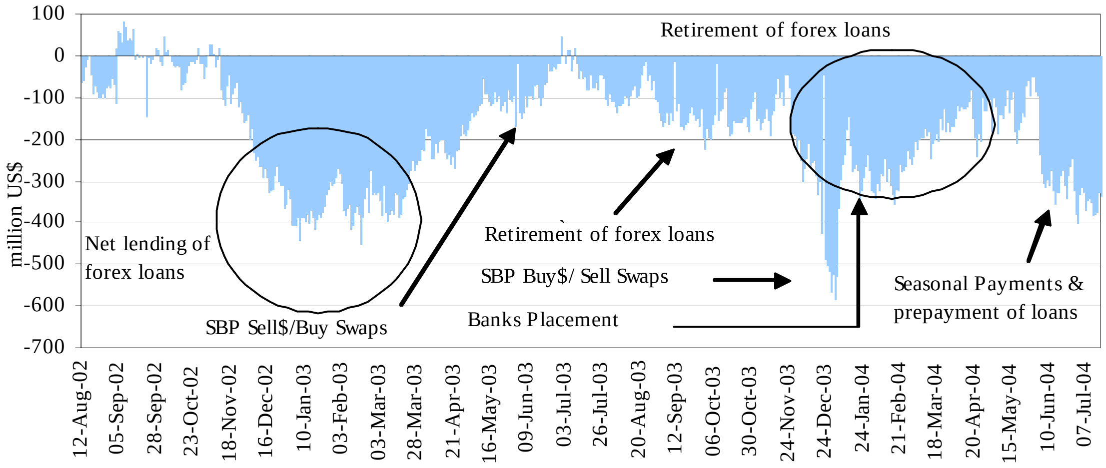
[6] The heavy SBP net purchases implied net injection of Rupee liquidity in the inter-bank market, which generally has consequences in terms of lowering interest rates and inflationary expectations in the economy. Although SBP had been partially sterilizing the Rupee liquidity injected through SBP forex net purchases however the quantum of liquidity was large enough to exert a downward pressures on the interest rate.

[7] Adjusted current account balance (excluding non-structural inflows) improved sharply from *negative* US$ 0.06 billion in FY02 to US$ 2.5 billion in FY03.

[8] As against appreciation of 6.8 percent in FY02, Rupee managed to appreciate by only 3.9 percent in FY03.

expectations for Rupee appreciation became stronger in FY03. With this view, exporters started selling the proceeds heavily in the forward market. As a result, forward points significantly fell and turned into discount by FY03. To stabilize forward premiums, SBP introduced a 'Swap Desk' in September 2002 aimed at facilitating exporters in the forward market.. This tool not only helped in containing a further reduction of the forward points but also influenced the Rupee liquidity. Moreover, the availability of the swap desk allowed banks to effectively manage their Nostro balances that had been volatile due to foreign currency lending (see **Figure 7.15**).

Figure 7.15: Aggregate Nostro



Given the fact that inflows were continuing and SBP's capacity to sterilize these flows was gradually weakening due to the decline in its T-bills holdings, there was a need to introduce other policy measures for better utilizations of forex flows. Therefore, policies of import liberalization and prepayments of expensive debt were followed, which had a major contribution in the net decline in forex flows during FY04. More specifically, the overall external balance in FY04 was reduced only to one-third of FY03. Importantly, although market inflows in FY04 were still substantial, as reflected in higher exports and moderated remittances, the main drain in the liquidity came from greater outflows due to stunning increase in imports, prepayment of government and foreign private loans[9] and retirement of forex loans. Encouragingly, the higher imports were due to machinery, chemicals and other raw materials, which bode well for industrial activity as reflected in growth of large scale manufacturing sector.

As a result of the net decline in forex liquidity, rise in domestic and international interest rates and increasing inflationary pressures fueled market expectations of a weakening Rupee in H2-FY04. This was clearly reflected in the net open position (NOP) of the inter-bank market, which fell significantly in Q4-FY04 and resulted into enormous downward pressures on the Rupee Dollar parity by end of FY04. SBP in its attempt to avoid further deterioration in forex liquidity deficit and also to compose market expectations has been injecting Dollars through net sales since Q4-FY04.

Although the pace of foreign exchange accumulation slowed down due to lower net purchases in FY04 compared to FY03, this policy also helped in containing reserve money in an inflationary environment.

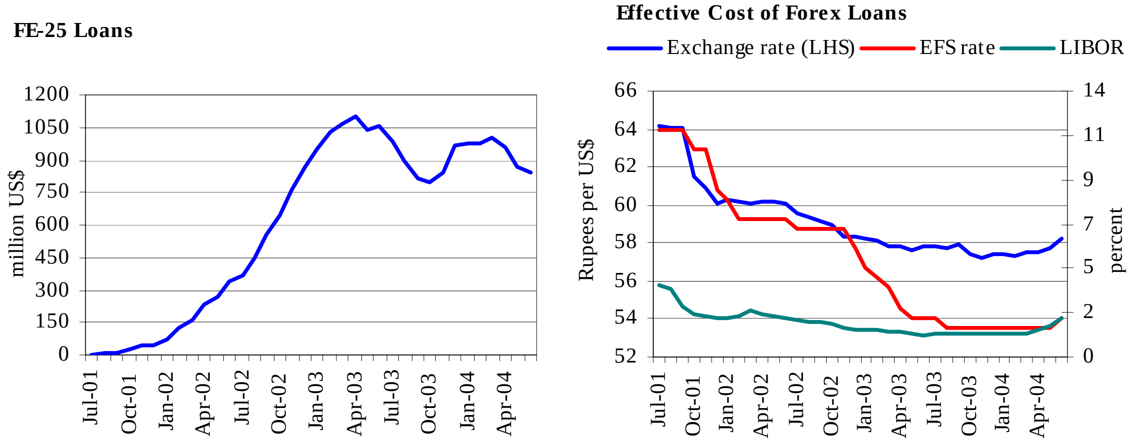
[9] Although SBP permitted premature retirement of private loans in December 2002, however the bulk of prepayments were made in FY04. Most notable payments were (1) US$ 1.17 billion prepayment to ADB made from a sinking fund (US$920 million) developed separately from SBP net purchases, and (2) PARCO prepayment of US$ 385 million to JBIC through a swap transaction with consortium of banks.

Foreign Currency Loans

With a view to stabilizing the returns, and to protect the interest of depositors in a low interest rate environment as well as to facilitate exporters, Banks had been allowed to utilize FE-25 Deposits for trade financing since March 2001. However, the real impetus in foreign currency lending came from the rising demand of exporters as expectations of Rupee appreciation became stronger. In addition, wider interest rate differentials between the EFS rate and LIBOR rate kept the cost of foreign currency loans lower than the EFS scheme. From banks' perspective, foreign currency lending was profitable because it gives relatively higher earning on the FE-25 deposit portfolio[10]. More specifically, these loans started benefiting both banks and exporters by giving ample arbitrage opportunity to the latter and more importantly significant exchange gains to the former. This encouraging environment resulted in a phenomenal growth of the foreign currency loans in FY03, substituting credit share in favor of FE-25 loans from the historically popular EFS scheme (see **Figure 7.16**).

Besides the advantage of a better effective rate of return, foreign currency lending was preferred due to less documentation and clear guidance from SBP[11] (see **Box 7.2** for comparison of schemes). In fact, interest in FE-25 loans can be gauged from the fact that until April 2003, almost 50 percent of FE-25 deposits were utilized in trade financing. Moreover, the consumption of the Forex loans was more pronounced in case of exporters than importers[12] (see **Figure 7.16**).

Figure 7.16: Foreign Currency Loans (against FE-25 deposits)



However with the fading expectations of Rupee appreciation and diminishing arbitrage possibility in the face of a narrowing interest rate differential, FE-25 loans lost their appeal in FY04 as compared to FY03 (see **Figure 7.17**).

[10] Earlier banks were only investing FE-25 Deposits in US T-bills.

[11] More detailed regulations pertaining to FE-25 Loans were issued on 23rd August 2002. Especially, rules regarding premature repayment brought these loans in limelight.

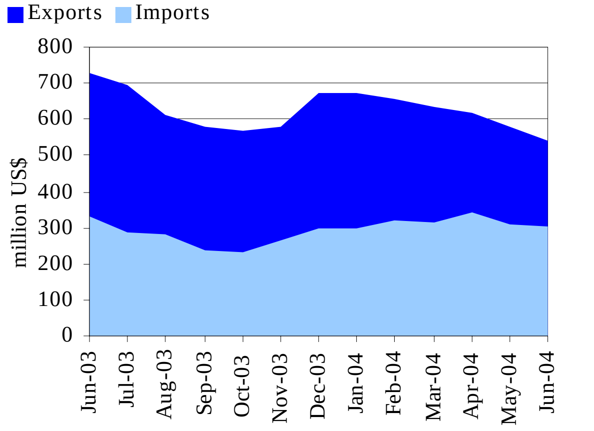
[12] Outstanding Forex loans to exporters are adjusted from export proceeds at the exchange rate on which original financing was allowed. On the other hand, for the repayment of loan by importers, AD are allowed to purchase foreign currency to the extent of loan from inter-bank market at the prevailing exchange rate on the date of repayment in order to adjust foreign currency loan outstanding against such importer.

Box 7.2: Comparison of Schemes for Financing Exports			
Salient Feature	**EFS**	**FCEF Facility**	**FE-25 lending**
Inception	Export Finance Scheme has been operating since 1973.	SBP issued instructions for introduction of this facility on 28th March 2001. However, due to lack of interest from the exporters resulting in under utilization, the scheme stands terminated w.e.f 17th April 2003.	Since the introduction of new foreign currency accounts, i.e. FE-25 deposits, SBP allowed trade-financing facilities against these deposits; however, the real impetus came when SBP issued guidelines for this facility in August 2002.
Target Market	Export finance facilities made available to Direct Exporters, Indirect Exporters (input suppliers to direct exporter) and Small, Medium and Emerging Exporters (who reports exported up to US$ 2.5 Million in the preceding year) and Trading companies (who are not the manufacturers).	Small and Medium sized Enterprises (with annual exports up to US$ 2.5 Million), Large/Traditional Direct Exporters (up to 50% of total facility), and Emerging New Exporters, In direct Exporters, Registered Importers and Common bonded warehouse.	Established Exporters and Importers.
Exposure	SBP extending the loan against the collateral of exports/imports documents.	GoP negotiated a loan in US Dollar with the Asian Development Bank for the purpose of providing a Foreign Currency Export Finance Facility.	Traders and Authorized Dealers are at exposure by utilizing the FE-25 deposits for the purpose of lending.
Criteria	The finance is given on pre as well as post shipment on eligible commodities. Facility is provided on case-to-case basis after scrutinizing the documents.	Exporter may avail the export finance *limit*, based on his last year's export performance in respect of eligible commodities. The limit is based on revolving basis.	As such no criteria is set by SBP. However, commercial bank internal underwriting of credit worthiness is usually evaluated.
Rate	Financing rate is determined on the basis of weighted average yield of 6 months T-bill, and subject to revision on monthly basis.	Rate of mark-up charged by SBP is Libor based and floating depending upon the cost of funds to Government.	Rate is market determined depending on the Libor. Since the commercial banks are independent of determining the rate therefore the rate charged to the customers vary across the banks.
Coverage	100 percent of the Export order/Contract/LC.	80 percent of the Export order/Contract/LC.	At the discretion of commercial bank.
Penalty	Penalty of different slabs for not meeting the target is directed by SBP.	As such no penalty is set by SBP.	No instructions of penalty for later payment are directed by SBP. However, most commercial banks have been charging extra in case of pre and late payments.
Documentations	*Direct Exporter* Application/ Undertaking on Form "B". Demand Promissory Note (D.P Note) from exporter (on prescribed form). Copy of Export Order/LC	*Direct Exporter* Contract between the exporter and buyer. Firm Export Order Letter of Credit	*Direct Exporter* Contract between the exporter and buyer. Firm Export Order Letter of Credit
	Indirect Exporter Application Undertaking on Form "C". In land letter of Credit/ Standardized Purchase Order (ILC/SPO). Showing the supply of inputs and the amount involved by the Indirect Exporter to execute a specific export order. Demand Promissory Note (D.P Note) on prescribed form.	*Indirect Exporter* Inland Letter of Credit opened on the strength of L/C of Direct Exporter or Standardized Purchase Order.	*Indirect Exporter* Inland Letter of Credit opened on the strength of L/C of Direct Exporter or Standardized Purchase Order.

FE-25 Loans and Forex Liquidity

The major impact of Forex loans on the inter-bank market can be explained from their lending mechanism. In practice in a Rupee appreciating environment, banks extend forex loans against trading documents, which are self-liquated from export proceeds. Generally traders immediately sell Forex funds (financed from FE-25 deposits) to inter bank market for generating Rupee liquidity. Therefore, forex loans augment the liquidity in the inter bank market as they expedite the supply of Dollars in the market that are otherwise realized in future when export bills payments materialize. Similarly, they also delay the demand of Dollars by importers until the maturity of loans.

Figure 7.17: Composition of Forex Loans

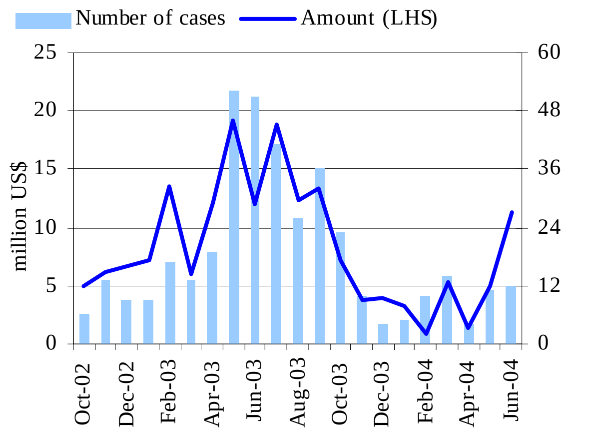


The remarkable growth of forex loans in FY03 compounded liquidity in the market, which consequently escalated the pressures on Rupee appreciation. However, with the change in market players' perception due to a depreciating Rupee in FY04, market players' retired the forex loans that adversely impacted the liquidity. Much of the reduction in liquidity came from importers who purchase Dollars from the inter-bank market at the prevailing rate for repayment of the loans. As market players generally get caught in heavy prior period adjustments of forex loans with the change in perception of the Rupee, which could lead to a forex liquidity crunch. Looking at **Figure 7.18**, foreign currency adjustments increased in periods of Rupee Depreciation. Surprisingly, forex loans adjustments were relatively more pronounced in FY03 than FY04 as market players were taking advantage of Rupee appreciation therefore SBP started strict scrutiny of the loan adjustments cases from then[13].

FE-25 Loans and Foreign Exchange Reserves

With the emergence of foreign currency loans the composition of foreign exchange reserves also changed. In fact, banks finance foreign currency loans from their reserves i.e. FE-25 deposits and the amount lent to the traders is sold in the inter-bank market. Specifically, this amount escalates the inter-bank forex liquidity and eventually purchased by the SBP for stabilizing exchange rate. In this way, the foreign currency loans financed from FE-25 deposits also become part of SBP reserves and result in overstating foreign exchange reserves. Therefore, in order to draw a more accurate picture of foreign exchange reserves, it was decided to subtract the forex loans from commercial banks' reserves in December 2002. As a result, share of SBP reserves in overall reserves increased further.

Figure 7.18: Forex Loans Prior Maturity Adjustment

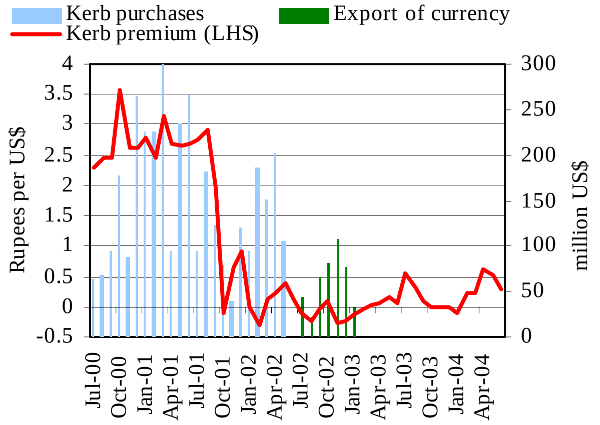


13 For prior period adjustments of forex loans, banks are subject to take permission from SBP.

7.3.2 Kerb Market

Pakistan has a long history of external imbalances with a heavy reliance on kerb purchases[14] to finance the forex liquidity deficit and to stabilize the disorderly forex market conditions. September 11, 2001 brought in major structural changes in Pakistan's economy. The collapse of the kerb premium in FY02 was one of the main features of these structural changes and had positive spillover effects on the performance of Pakistan's external sector since then. Specifically, the narrowing difference between the kerb and inter-bank exchange rate diverted the foreign exchange flows to the official channels and eventually enabled SBP to stop purchasing from the kerb market since June 2002.

Figure 7.19: Kerb Premium and Kerb Purchases



As SBP was effectively the largest buyer[15] of hard currency from the kerb market, this step further restrained the upward movement of the kerb rate and diluted the powers[16] of moneychangers that were consistently active in exacerbating the speculation regarding a rising exchange rate (see **Figure 7.19**).

Amidst the declining trend, there were few small hiccups, otherwise the kerb premium persistently remained below Rs.0.50/US$. Specifically, a temporary rise was seen in July 2003 because moneychangers were under reporting 'export of currencies[17]' proceeds. In order to curb these activities, SBP took stringent actions against those moneychangers who were unnecessarily fuelling the kerb rate. Similarly, a hike was also visible in April 2004 due to transient factors such as speculative buying and growing demand of Dollars by gold merchants. This increase was immediately subsided after SBP took aggressive action against moneychangers.

These few episodes of small rebound in kerb premium did not result in diversion of flows back to informal channels because such risks were mitigated by SBP's proactive measures[18]. Consequently, the inter bank market continued to dominate the kerb market as the remittances that flushed the inter-bank market in FY03 only fell by small extent in FY04. These flows are likely to increase overtime through official channels because moneychangers have been transformed into exchange companies from end June 2004 as per SBP regulations, which marks the closure of moneychanger business in Pakistan.

Exchange Companies

The favorable developments in the kerb market provided an opportunity for the removal of market segmentation and allowed to take measures for unifying the exchange rate.

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[14] SBP had purchased US$ 5.654 billion from the kerb market from FY99 to FY02.

[15] The largest buyer of hard currency from the kerb market is for self-financing of imports. These forex flows are used for the import of consumption goods that are smuggled into Pakistan.

[16] Major reasons for the dominance of kerb market were efficient delivery, cost effectiveness, exchange rate gains (difference between inter-bank rate and the kerb market), and tapping the unofficial flows due to undocumented nature of business.

[17] Initially, SBP had been purchasing US dollars repatriated against the export of unauthorized currencies (known as kachara in kerb market) from moneychangers. Since July 2002 moneychangers were directed to sell proceeds of 'export of currencies' to nationalized banks, which were finally purchased by SBP. However, finally in March 2003, 'export of currencies' operations were transferred to few authorized exchange companies in order to ensure effective monitoring.

[18] SBP has been consistently monitoring the kerb rate and talked-down the premium.

This overriding objective stemmed from the need to develop a mechanism so as to capitalize on the ongoing developments.

Policy Environment

The promulgation of ordinance no XXX (30) of 2002 on July 30, 2002 opened a new chapter in the history of foreign exchange liberalization. The amendment in Foreign Exchange Regulation Act, 1947 initiated the formulation of foreign exchange companies, aiming at documenting the moneychanger business and to harness the corporate culture through a well-documented and proper regulatory system[19]. To formalize these objectives, SBP issued complete guidelines of rules and regulations pertaining to an Exchange Companies (EC)[20]. In order to further facilitate this transformation, on February 12, 2004 moneychangers were also allowed to enter into a franchise arrangement with independent exchange companies. However, after facing reluctance from moneychangers in complete transformation, SBP also allowed moneychangers to set up exchange companies in "B" category with much lower paid up capital requirement[21]. However a restriction was also imposed that at least 5 moneychangers must collaborate to form an exchange company in "B" category. Therefore, three options were available to Authorized Money Changers (AMCs) for transformation: (1) to form an exchange company (2) have a franchise with an exchange company and (3) set up a 'B' category exchange company.

Structure of Exchange Companies

Since the issuance of the above-mentioned ordinance, a total of 18 exchange companies and 33 exchange companies (B) have been issued licenses.
Out of these, 17 EC and 24 EC (B) were in operation as end of June 2004[22], with branches/booths across Pakistan for efficient and easy access to customers[23]. Moreover, 83 authorized moneychangers 'AMCs' and 38 'non-AMCs' have formed franchises with EC (see **Table 7.14**). Although the business activities of Exchange companies vary across both categories, however, the structure is heavily dominated by category 'B'[24].

More encouragingly, with the introduction of category 'B' in June 2004, almost 89 percent of moneychangers have come under the ambit of exchange companies' regulations, before the deadline on June 2004[25] (see **Table 7.15**).

Table 7.14: Structure of Exchange Companies during FY04

	Category	
	(A)	**(B)**
Licenses Issued and Business Commenced	17	24
Licenses Issued and Business Not Commenced	1	9
Branches/Booths	*52*	*214*
Franchises with E. C (A)		
AMCs	83	-
Non-AMCs	38	-

Table 7.15: Status of Moneychangers Transformation at the end June 2004

	Number	Percent
AMCs accommodated in E.C. (B)	210	56
AMCs accommodated in E.C. (A)	19	5
AMCs accommodated in Hotels	21	6
AMCs accommodated in Franchises with EC (A)	83	22
Total AMCs so far Accommodated	*333*	*89*
Less AMCs not interested in continuation of Business	15	4
AMCs not responded	27	7
Total AMCs Operating Before surrender	375	100

[19] Although SBP listed a set of criteria for eligibility and formulated a code of conduct for moneychangers (375 at present), however, they were not subject to audit from SBP approved auditors and were not required to submit their transactions details to SBP.
[20] For details see *Financial Sector Assessment 2001-02*.
[21] Unlike the minimum paid-up capital of Rs. 100 million for exchange companies "A", exchange companies "B" may operate with a minimum capital of Rs. 25 million only.
[22] Only 5 E.C were formed till the end of June 2003.
[23] These companies have a broad branch network. In fact, registered Head Offices of 15 companies are located in Karachi, 7 in Lahore, 6 in Islamabad/ Rawalpindi, 2 in Quetta and 1 each in Gujranwala, Hyderabad and Kharian.
[24] Exchange Company (B) has been granted a limited scope of operation and is only allowed to operate in sale and purchase of currency.
[25] All moneychangers, who were earlier authorized to transact exchange business under licenses from SBP have ceased to function from the close of business on 30th June 2004.

In relative terms, out of the total number of moneychangers, a dominant number of moneychangers are operating as E.C (B) followed by those having franchise agreements with EC (A). The successful transformation of a vast majority of moneychangers business will help in effective monitoring of unofficial activities. Since exchange company shall be subject to the internationally 'Know Your Customer' policy and identification of suspicious transitions. In this way, they are also expected to initiate efforts against money laundering.

Transactions of Exchange Companies (A)

Exchange companies invariably prefer to conduct business in terms of hard currency due to the nature of the business and very importantly because it also gives them leeway to capture the flows from unofficial channels. In order to curb these unofficial activities, proper documentation of these transactions was made mandatory. Therefore, exchange companies were directed to ensure that major transaction should be routed through their Nostro account[26]. Nonetheless, as **Figure 7.20** reveals, transactions through cash are still higher than Nostro transactions. Much of this wedge was due to the 'export of currency' that has been physically shifted by moneychangers to the Gulf region against which US Dollar was brought back in hard cash[27].

Figure7.20: Exchange Companies (A) Transactions

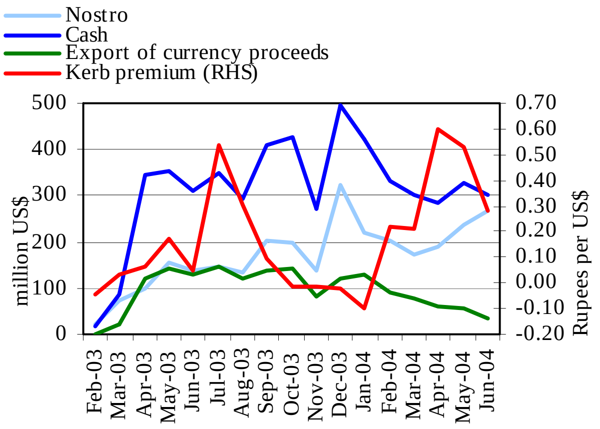
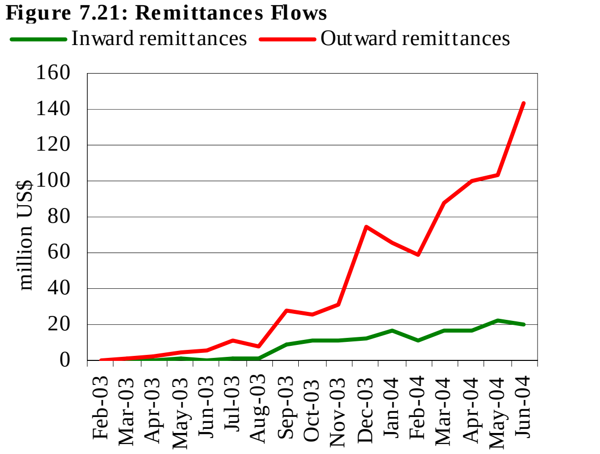


Figure 7.21: Remittances Flows



While the transactions in both Nostro and Cash have similar trends, a sharp transitory jump was witnessed in December 2003 due to speculative trading of Iraqi Dinnar and also because of the year-end payments impact. However, a SBP cautionary note to public pertaining to trading in Iraqi Dinnar helped to dilute such speculations.

One of the objectives of the formation of exchange companies is to capture the remittances flows. Interestingly, although both inward and outward remittances increased over time, the exceptional growth in outward remittances outpaced the growth in inward remittances in FY04 (see **Figure 7.21)**. This gap in the inward and outward remittances is financed through purchase of foreign currency in cash over-the-counter.

The exceptional growth in outward remittances was mainly due to travel payments. In fact, the integration of moneychangers into exchange companies increased the outflow of travel related

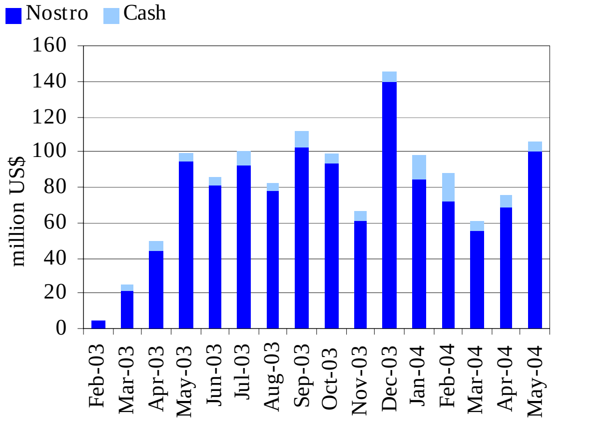
[26] Many Exchange Companies are operating without Nostro Accounts and using FE-25 deposit for these purposes.

[27] Since some moneychangers were involved in malpractices while bringing back proceeds of 'exporting of foreign currency' into Pakistan. This caused forex shortages in the market and led to higher kerb premium. Therefore, in order to curb these activities, SBP allowed 'export of foreign currency' business to limited authorized exchange companies and remaining exchange companies are required to surrender their 'export of foreign currency' to these Authorized exchange companies**.** This was reflected in lower receipts of export of currency that showed declining trend since February 2004

expenditure in external accounts, as travel expenses are largely financed through the exchange companies[28]. On the other hand, the growth in inward remittances was on the back of 'home remittances'.

The lower forex inflows into exchange companies are also evident in **Figure 7.22**, representing lower sales to Authorized Dealers since February 2004[29]. The lower sales to authorized dealers also reduced the supply of additional forex flows and helped in increasing the pressures on exchange rate in latter months of FY04.

Figure7.22: Sales to Authorized Dealers



Although SBP has taken various policy measures in liberalizing the regime, the exchange companies have to go a long way in meeting the *real* objective of formation of exchange companies i.e. unification of the exchange rate.

[28] Earlier, moneychangers were not subject to submit statements regarding travel transactions and these were therefore not reported to SBP.

[29] Exchange Companies are required to sell the surplus funds to banks.