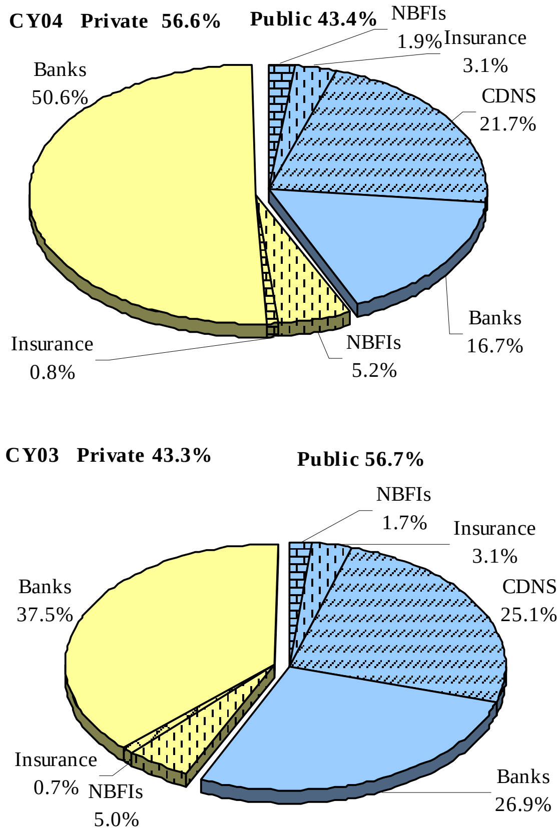
Executive Summary

Structure and Performance of the Financial Sector

Benefiting from on-going financial sector reforms and a significant improvement in the macroeconomic environment of the country, the financial sector has not only recorded visible changes in its size and ownership structure, but also in its key performance indicators. The overall size of the financial sector (measured by assets) increased to Rs 4.5 trillion with an impressive rise of Rs 569.1 billion during CY04.

The institutional composition of the financial sector indicates that this notable rise in financial sector assets was not equally shared by the major groups of financial institutions. Over 80 percent of the rise in assets came from the banking sector, which further increased its dominance in the overall financial sector (see **Figure E.1**). Another notable development in the institutional structure is the 3.4 percentage points decline in the share of CDNS. Besides a commendable growth of competing financial institutions, this decline primarily stems from a net outflow from national savings schemes, which has happened for the first time since 1972.

Figure E.1: Ownership and Institutional Structure

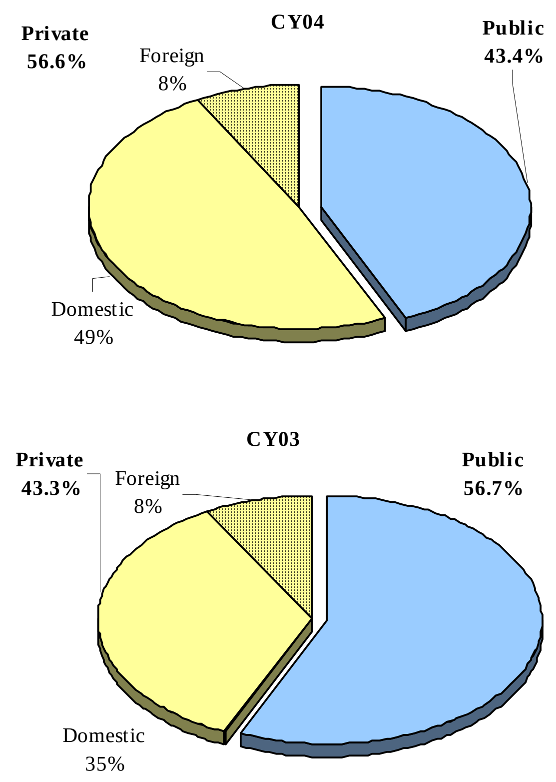


Similar to the changes in the institutional structure of the financial sector, ownership structure in terms of the public and private sector has also undergone substantial changes during CY04. The share of the private sector increased to 56.6 percent – this is for the first time that the share has exceeded 50 percent since the nationalization of financial institutions in 1974. Furthermore, if we exclude CDNS, the financial sector is now primarily owned and managed by the private sector. These changes in the ownership structure of the financial sector clearly reflect the efforts of the government to promote the role of the private sector in the economy not only by providing an enabling business environment, but also by divesting its investment holdings in financial institutions through the ongoing process of privatization.

The bifurcation of the private sector into domestic private financial institutions and foreign institutions highlights another notable development. The share of the former has reached almost 86 percent by end-CY04 as compared to 67.2 percent at end-CY00. This changing pattern of market shares clearly indicates that the domestic private sector now has a leading role in the financial sector (see **Figure E.2**).

Key performance indicators of the financial sector clearly reflect its resilience to both internal and external shocks. Specifically, the risk absorption capacity of the financial sector has increased considerably, as the equity to liability ratio has increased to 8.5 percent by end-CY04 compared to 7.6 percent at end-CY03. Moreover, the narrowing average spread and net interest margin along with increased profitability (return on average assets after tax), signifies the increasing efficiency of the financial sector. Specifically, the financial sector was able to channel funds from the surplus sectors of the economy to the deficit sectors at a lower cost of intermediation.

Figure E2: Ownership Structure of Financial Sector



Financial Infrastructure

An efficiently functioning financial sector requires the support of an adequate regulatory and legal framework. Both SECP and SBP have continued their proactive surveillance of the changing market dynamics with an increasingly sound performance of the economy, and issue directives as and when required.

SBP has undertaken a comprehensive revision of the Prudential Regulations' framework given the changing risk profile of the banking sector in terms of diversification of their asset portfolio and has issued separate sets of Prudential Regulations for Corporate / Commercial lending, SMEs and Consumer Financing, whereas Prudential Regulations for Agriculture Financing will be issued soon. During the year under assessment, some of the important revisions pertained to revaluation reserves, reserve building, minimum capital requirements, revaluation surplus / deficit, housing finance and the maximum credit limit for clean lending.

Detailed Financial Derivatives Business Regulations were also issued during the year. Additionally, State Bank has also started the process of implementation of Basel II by outlining a roadmap for its execution in consultation with the stakeholders.

Given the increased exposure of banks on consumer financing, the role of the Credit Information Bureau (CIB) has become even more significant. The scope of coverage of SBP's CIB database is now being enhanced to cover all loans amounts. Developments such as these are in the process of being implemented.

SBP has also issued specific Prudential Regulations for the conduct of Microfinance Institutions (MFIs) which detail the various requirements for a prudent operational framework for an MFI. In addition, Guidelines for Infrastructure Project Financing have also been notified by SBP which facilitate banks to develop relevant expertise in providing non-recourse financing based on the assessment of the future income streams of the borrower. The guidelines have been categorized in line with the various phases associated with Infrastructure Projects given their long gestation period. SBP has also developed an Institutional Risk Assessment Framework (IRAF) which is in the process of being implemented. Moreover, in the last few years, SBP has taken various steps and measures towards the improvement of the payment and settlement systems in the country.

In addition to regulatory requirements, an appropriate and sound legal framework gives banks the requisite support in conducting their business. In this respect the Financial Institutions (Recovery of Finances) Ordinance, 2001 has greatly facilitated the recovery of outstanding dues.

Moreover, with an increased emphasis on the significance of Payment Systems and the need for a uniform regulatory approach especially towards e-based payments, SBP has posted a (draft) Payment Systems and Electronic Funds Transfer Act on its website, which will be formalized soon, in line with comments and suggestions from the stakeholders. This Act provides a legal framework to supervise and regulate payment systems and electronic funds transfers in Pakistan, and to protect the rights of both the financial institutions and customers involved in any transaction related to electronic funds transfer.

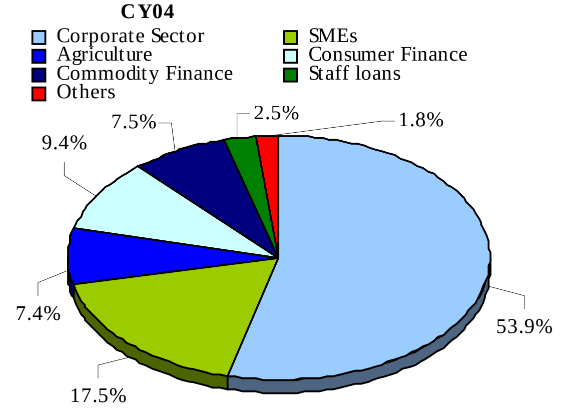
In order to promote Private Pension schemes, SECP has introduced a set of rules called the Voluntary Pension System Rules which authorize a Life Insurance company or an Asset Management company to register themselves as Pension Fund Managers to manage the contributions made by or on behalf of participants in pension funds.

Bank Credit

During CY04, banks have disbursed an incremental credit amount of Rs 415 billion, taking the outstanding credit volume to Rs 1.62 trillion at end CY04, exhibiting a growth of 34.4 percent over March CY04. This was largely an outcome of continued implementation of banking sector reforms, surplus liquidity with banks, and a growth-oriented monetary policy. In particular, the easy availability of agriculture credit, increased regulatory focus on SME finance and the changing pattern of consumer expenditures are some of the factors which gave the economy a demand-pull stimulus.

A sector-wise distribution of credit shows that the corporate sector still absorbs the largest share of total bank credit, at 53.9 percent at end-CY04 (see **Figure E.3**). SME finance also has a sizable share at 17.5 percent. Agriculture and commodity finance together captured a substantial share 14.9 percent, whereas consumer finance and staff loans jointly contributed 11.9 percent to total bank credit.

Figure E.3: Sectoral Distribution of Bank Credit at end CY04

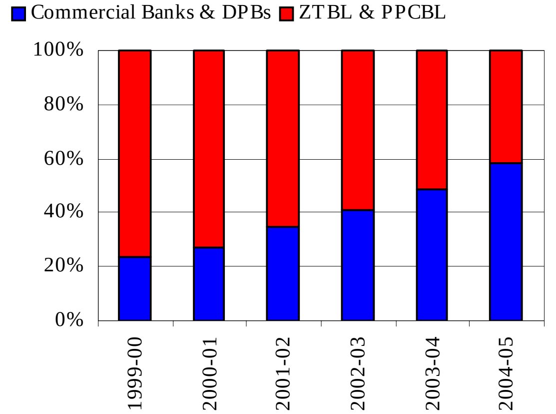


Within corporate sector credit, the largest share is that of fixed investment loans which exhibited a growth of 32.3 percent over March CY04. In particular, cement, automobiles, electronics, power generation and petroleum refining are some industries which have taken fixed investment loans from banks for the purchase of plant and equipments and for BMR activities.

With respect to the SME sector, the outstanding volume of SME finance reached Rs 284.0 billion at end-CY04, registering a growth of 26.1 percent over March CY04. In its efforts to promote SME financing, SBP has also established a new SME department which is responsible for devising appropriate policies and strategies in order to promote the growth of this sector keeping in view its role in employment generation and poverty alleviation in the economy. Most of the SME lending during CY04 has been for the working capital requirements of the existing units. SMEDA, which provides a number of services to SMEs including business plan development service, technical and financial advisory service, policy planning and legal services, also has a major role in this area.

Agriculture is another sector which has been given prime importance in credit distribution in recognition of its significance in the growth of the economy. SBP has provided an enabling environment to encourage commercial banks to provide financial resources to this sector and as a result, recent years have seen a major institutional shift in the provision of agriculture credit from ZTBL and Cooperatives to commercial banks (see **Figure E.4**). The scope of the Agriculture Credit Scheme which was previously limited to production loans for inputs has been broadened to the whole value chain of the agriculture sector.

Figure E.4: Share in Disbursement



Consumer finance has also increased significantly and reached Rs 152.6 billion at end-CY04, a growth of 83.9 percent over March CY04. Within the categories of consumer finance, the largest share belongs to personal finance at 46.2 percent. Housing finance exhibited a growth of a remarkable 205.4 percent during the year, mainly due to the fact that banks have designed their respective mortgage finance products at competitive rates and a simplified eligibility criteria. Auto loans have also increased substantially and reached Rs 49.6 billion at end-CY04, with a growth of 79.9 percent over March CY04.

An increased emphasis has also been given to Microfinance as a tool for poverty alleviation as it provides financial resources to under privileged people who do not have access to formal bank financing. During CY04, the outreach of the existing Microfinance Institutions increased considerably mainly due to a sharp rise in the number of branches of Khushali Bank. The number of borrowers has reached over 177,000 at end-CY04 compared with only 95,000 at end-CY03, mainly because of First Microfinance Bank whose number of borrowers almost doubled during the year. Outstanding advances have more than doubled during CY04, at Rs 1.5 billion. Majority of these advances, around 86.5 percent, have been extended by Khushali Bank.

On an overall basis, with the increased exposure of banks to the various sectors of the economy, the risk profile of banks has also changed considerably, especially given the rapidly growing economy. This has also resulted in a rise in inflationary pressures and subsequently, interest rates in the economy. By adopting a more forward looking approach, i.e. by evaluating borrowers on the basis of their expected future income streams in line with future business forecasts, banks can maintain the asset quality of their loan portfolio. Repayment capacity of the borrowers can be assessed further with the help of the credit information services of CIB and other such institutions in the private sector which maintain a centralized database on credit facilities.

Islamic Financial Services

Islamic Financial Services in Pakistan include Islamic Banking, Islamic Non-Banking Financial Institutions (NBFIs), such as Modarabas and Mutual Funds, and a *Takaful* (Islamic Insurance) company, which was launched recently.

With the introduction of SBP's three-pronged strategy for the growth of Islamic Banking in Pakistan, Islamic banking activities have recorded a noteworthy progress during the year, with an asset base of Rs 44 billion and deposits of over Rs. 30 billion by end-CY04. The share of Islamic Banking in the total banking sector assets and deposits remains small, but given the rapid growth in the industry, it is expected that this share will grow considerably in the near future.

Various regulatory and policy developments have taken place in the recent past, an important feature of which is SBP's role in improving the awareness of market players and the general public about Islamic Banking. Other developments include the finalization of accounting standards for Murabaha and Ijarah, development of Shariah Compliant Inspection expertise at SBP etc.

By end-CY04, 25 licenses were issued for Islamic Banking branches of 9 conventional banks, out of which 21 branches of 7 conventional banks started operation in 2004. In addition two more full fledged Islamic Banks were issued licenses by SBP during the year.

The asset base of Islamic Banks is strongly skewed towards corporate financing, in addition to a significant exposure on SME and Consumer financing, with a relatively small share of Agriculture financing. Moreover SBP has also introduced an Islamic Export Refinance Scheme in order to support the operations of eligible exporters on the basis of Islamic modes of financing. Assets of Islamic NBFIs, which include modaraba companies and Islamic Mutual Funds, have also grown by 22.3 percent during the year.

A lot of activity has been observed in Islamic Capital Markets on both the local and international front with respect to the issuance of Islamic Bonds i.e. *Sukuks*. The government of Pakistan issued a Shariah Compliant Ijarah Sukuk of US $ 600 million in January 2005. Moreover, Islamic capital market issuers and investors are rapidly increasing in number and the niche is showing signs of becoming a permanent and sizable industry, as opposed to a temporary phenomenon.

In May 2005, Pak Kuwait Investment Company launched the first Islamic Insurance company in Pakistan as a joint venture with a Malaysian based company called Takaful National. The company intends to focus on General *Takaful* in its initial phase of operations and introduce Family *Takaful* at a later point.

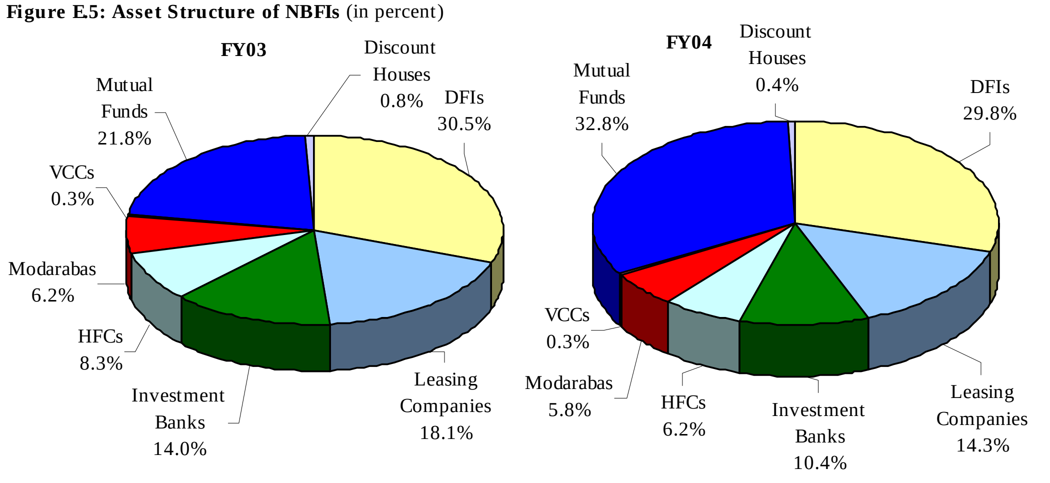
In terms of future prospects and challenges, one of the major challenges for SBP is the development of shariah compliant liquidity instruments in order for Islamic banks to manage their SLR requirements. Increase in the size and volume of Islamic capital markets also depends on the existence of a secondary market for trading in Sukuks, which is still to be developed even on an international level.

Banking Sector

The Banking sector recorded a strong performance during CY04. Not only was it able to expand its core business activities, but it also strengthened its capital base, improved asset quality as well as profitability during the year. While a massive rise in banking sector advances increased the underlying risks to banking sector, the risk absorption capacity of the banking sector also witnessed a significant improvement, which actually outpaced the increase in risks. Specifically, the risk weighted capital adequacy ratio increased to 10.5 percent against the minimum requirement of 8.0 percent, and the actual level of 8.5 percent in CY03. Moreover, asset quality of the banking sector, measured on the basis of the non-performing loans (NPLs) to total loans ratio improved, as the ratio edged down to 11.6 percent as compared to 17.0 percent for the previous year. Return on assets (ROA) after tax also increased by 10 bps to reach 1.2 percent during CY04. Importantly, this growth in profitability of the banking sector was also accompanied with a narrowing average spread and net interest margin. These developments clearly reflect the increased competition among banks and improvement in the efficiency of the banking sector.

A detailed analysis of the dynamics of banking sector deposits (liabilities), loans and advances and investments (assets), together with the risk absorption capacity of the banking sector and SBP's regulatory profile indicates that the banking sector is well equipped with various policy tools to prudently manage its risks. As the banking sector does not operate in a vacuum, a regression analysis suggests that adverse movements in real GDP growth, interest rates and inflation can affect the asset quality of the banking sector. As the economy is now at a high growth trajectory and its trickle down effects are likely to create more business activities in the future, the banking sector will continue to receive the requisite vital support from the macroeconomic environment. Given these dynamics, the strong banking sector performance is likely to sustain in the foreseeable future.

Figure E.5: Asset Structure of NBFIs (in percent)



Financial Performance of NBFIs

The NBFIs sector, which includes DFIs, Modarabas and Non-Banking Finance Companies (NBFCs), has undergone considerable structural changes in recent years under the regulatory purview of the Securities and Exchange Commission (SECP). With particular reference to the year 2004, NBFIs have shown a remarkable resilience to the changing market dynamics, with increased competition from the banking sector. The total assets base of the NBFIs increased by 21.6 percent during the year which is marginally less than the growth rate of 21.2 percent of the previous year. The share of NBFIs' assets in the total assets of the financial sector is 7.1 percent at end-FY04, as against 6.7 percent in the previous year. While the share has increased since the previous year, the most interesting feature to note is the pace of increased activities in the Mutual Funds industry which has undergone a drastic change in terms of ownership of assets from the public to the private sector in 2004, in addition to the mushrooming of a number of new funds during the year. A comparative position of the shares for various categories for FY03 and FY04 is shown in **Figure E.5**.

DFIs have maintained a dominant position in the NBFIs sector in terms of their scope of business, their large capital base and their share of assets and deposits. Being single-product entities in the past, these institutions are now trying to diversify and expand their business activities. The year under assessment has been a significant year for DFIs. Not only have they extended their capital base in line with SBP's minimum paid-up requirements, their assets have also grown by around 19 percent, and advances by almost 61 percent. On an overall basis, DFIs seem to have re-aligned their business strategy with their core business functions and are more strongly focused on diversifying their business activities.

The size of the Investment Banking Industry, on the other hand, continues to shrink given that a few Investment banks have either merged into commercial banks, or have opted for voluntary liquidation. With a strong concentration on leasing business, most of these institutions are now competing with leasing companies, modarabas and commercial banks, with only a few organizations focusing on providing investment finance services. Total Assets of Investment Banks have decreased by 9.4 percent in FY04, as compared to a growth of over 59 percent in FY03. While the earning assets to total assets ratio continues to gain strength, a break-up of earning assets shows that over 86 percent of these assets constitute of lease finance and investments. This composition of the asset portfolio has strong bearings on the future earnings, profitability and business focus of the industry.

As opposed to other NBFCs which have expanded operations in other areas in the ambit of the NBFC framework, the leasing sector is single-mindedly focused on their function of providing lease financing. Lease finance constitutes 85 percent of the total earning assets, with the rest consisting of investments. Overall, leasing companies have performed well in terms of facing up to the challenges in their operating environment. However it has to be borne in mind that a complete focus on only one product area is not a feasible long-term business strategy given the increasing emphasis on universal banking and an increasingly competitive environment along with rising interest rates.

Modarabas provide a Shariah compliant mode of financing and investment, and have played a vital role in the development and growth of the economy and capital markets since their inception. The Modaraba sector continues to be the largest group among the NBFIs in terms of the number of companies, which currently stand at 35, whereas their share in total assets has decreased to 5.82 percent in comparison with 6.2 percent in FY03. The sector is inundated with a number of small entities, so much so that almost half of the companies have a share of less than 1.0 percent (each) of total assets, and only 2 modaraba companies have a share of more than 10 percent each. Increased activities in the Modaraba sector during the year led their assets to grow by 13.7 percent, with a growth in advances of 11.7 percent. Modarabas are strongly focused on leasing business, and lease finance constitutes more than 62 percent of total earning assets, whereas Musharika and Morabaha finance have a share of 18.6 percent. Investments on the other hand have increased to 17.3 percent as a percentage of total earning assets as compared to 15.9 percent in FY03.

Modarabas have considerable potential to carve out a niche for themselves in the corporate sector of the country. However instead of having numerous organizations with a low share in total business activities, the Modaraba sector should, in consultation with the regulators, work in the direction of increasing their market share by joining hands with each other in order to emerge as stronger entities.

The Housing Finance sector is primarily dominated by House Building Finance Corporation (HBFC) with a 97 percent share in total assets. Despite the immense competition by commercial banks, HFCs successfully maintained their share in core operational activities of housing finance as witnessed by an increase in housing finance outstanding by an amount of Rs 895 million to reach 12.04 billion. It has to be noted that HFCs have exhibited a remarkable resilience to changing market dynamics given the adequate level of capitalization, and a competitive level of growth in advances given the significant growth in their core business.

The Mutual Funds sector in Pakistan has undergone a dramatic change in recent years, both in terms of a change in ownership and increased activities due to a booming stock market. Where previously institutions like ICP and NIT used to be the pre-dominant players in the areas of closed-end and open-end funds respectively, previous years has seen an active role of Asset Management Companies in the private sector to the extent that the share of the public sector, as in the rest of the financial sector as well as in the economy, has gradually decreased over time.

The impact of this trend is more visible in closed-end mutual funds where the public sector's share has been completely taken over by the private sector. The main reason behind this is the privatization of ICP's funds during 2004 through an open competitive bidding process, as a result of which the various funds were amalgamated and taken over by ABAMCO Asset Management and PICIC. Net Assets of the Mutual Funds on a consolidated basis, have increased by 83.7 percent in FY04. It is interesting to note that while the share of the public sector shows a declining trend in open-end Mutual Funds, NIT (the sole public sector player) continues to have a dominant share at 73.3 percent of total open-end funds.

Discount houses serve the purpose of meeting short-term liquidity needs of the financial and corporate sector, by discounting a wide variety of instruments such as bonds, bills receivables etc. Given the fact that banks also provide discounting facilities, and the bond market in Pakistan is still in the process of development, the scope of activities for Discount Houses has generally been limited. Venture Capital is another area which has generally seen limited activities. Since most of the companies in this sector have started operations in the recent past, a better assessment of their performance can be made over a period of time.

Banks and NBFIs are now largely operating on a uniform platform in terms of providing an array of services to their clients. In order to remain commercially viable entities, NBFIs in general need to re-align their business strategies, focus on their core business functions, diversify their product base, and devise new methodologies of mobilizing savings to fund their business activities by reducing their reliance on borrowings. This is especially important in a rising interest rate environment which translates into a higher cost of doing business.

Financial Savings and Interest Rate Structure

The structure of financial savings plays a crucial role in the development of an economy, given that it determines the nature of savings. Financial savings grew by 13.6 percent in FY04. In comparison with the growth in nominal GDP, the growth of financial savings during FY02 and FY03 was significantly higher whereas in FY04 the growth was smaller than the nominal GDP growth rate. While the former was due to low inflation, which resulted in low growth in nominal GDP, the latter was due to the strong economic performance, which also had an inflationary impact on the economy. Consequently, financial savings as a percent of GDP inched up from 60.3 percent at the end of FY01 to 66.8 percent by end-FY04. The strong growth in financial savings was largely due to the growth in deposits of scheduled banks. This is reflected in the increased share of the stock of deposits in nominal GDP which reached 35.7 percent at the end of FY04 from 30.4 percent at end-FY01, whereas the share of mutual funds increased from 0.9 percent in FY03 to 1.5 percent in FY04.

Specifically, developments in the areas of banking and finance, and the inflow of a substantial amount of remittances have had a significant impact on financial savings. The financial savings rate has shown an increasing trend since FY01, with the exception of FY04. A similar trend is true for

National Savings, and is largely attributed to the more than proportionate increase in nominal GDP. In FY04, the extent of withdrawal of funds from CDNS does not reflect a corresponding growth of bank deposits, the primary reason for which is the diversion of funds into the stock market due to the opportunity of making phenomenal gains on the back of an exceptional performance of the stock market during the year.

Successful financial liberalization also depends on a well developed contractual savings sector. Contractual savings are the financial assets of contractual savings institutions (e.g. pension funds, life insurance companies etc.). Contractual savings institutions imply a higher level of professional specialization in the market, more funding for riskier (and higher yielding) projects, improved economies of scale and scope, reduced transaction costs, innovations in financial engineering and improved corporate governance and information disclosure. Contractual Savings Institutions in Pakistan include CDNS, Insurance and Social Protection Funds, such as Employees Old Age Benefits Fund, Worker's Welfare Fund, Worker's Participation Fund and the GP Fund. In addition an increased emphasis is also being given to the promotion of Private Pension Schemes.

The structure of interest rates prevalent in an economy is also of vital importance for economic decision making. A wide variation among interest rates, if not explainable by the difference in the term and risk profile of different instruments, is generally not desirable. This is because it creates arbitrage opportunities and promotes speculative activities, which may have negative implications on the real economic activities in a country. It is therefore crucial to have some degree of convergence in various interest rates and the difference should reflect the term and risk premium.

The interest rate structure of Pakistan's economy mainly consists of rates on banks' deposits and lending schemes; yields on government securities (T-bills, PIBs and profit rates on national saving schemes); interest rates charged and offered by NBFIs and rates of return on term finance certificates (TFCs).

The single most notable component in the structure of interest rates, until the recent past, was the rate of return on NSS instruments. The high and rigid profit rates on NSS had strong negative implications for the pricing of term finance certificates. Specifically, in order to make TFCs an attractive mode of investment, all the corporate debt instruments had to be priced significantly higher than the profit rates on comparable NSS instruments, which carry a zero risk of default. Moreover, during the second half of the 1990s, the higher profit rates on NSS diverted the flow of funds from the banking sector towards NSS instruments. Due to measures taken by the government in the last few years, especially with respect to linking NSS rates with the rates of return on PIBs, interest rate distortion due to NSS has reduced considerably.

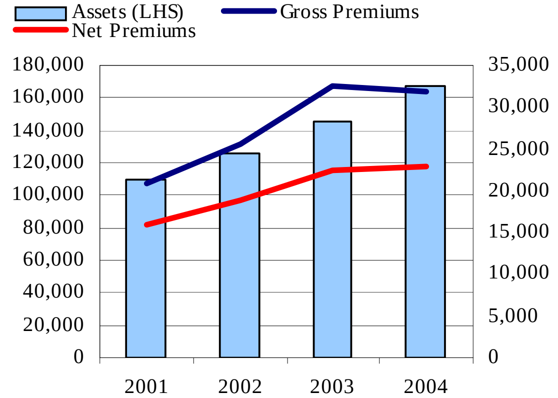
Banking spread, the difference between weighted average lending and deposit rates, can be termed as a crude measure of the cost of intermediation in the banking industry. In general terms, higher banking spreads are unfavorable as these depict institutional inefficiencies. Banking spread has been declining since FY03, especially as the competition among banks has increased substantially in the subsequent years.

Insurance Sector

The performance of the insurance industry showed a positive correlation with the consistently improved performance of the economy in CY04, as emphasized by its increasing share in financial assets and profitability. The assets of the insurance industry increased by 15.4 percent in CY04 over CY03. The non-life insurance sector has shown a faster growth of 18.0 percent whereas the life insurance industry grew by 14.6 percent in CY04. Moreover, the assets of the country's only reinsurance company showed an improvement of 6.1 percent in CY04. A comparison of total assets, gross and net premiums of the industry is shown in **Figure E.6**.

The non-life industry showed improvements in its asset size and profitability which increased by 60.1 percent in CY04. This subsequently increased the share of earnings from non-core operations in total earnings from 26.3 percent in CY03 to 30.5 percent in CY04.

Figure E.6: Summary Statistics of the Insurance Industry (million rupees)



Similarly, the development process of the life insurance industry also continued in CY04. On the regulatory front, introduction of Voluntary Pension System Rules and Takaful (Islamic insurance) rules will further facilitate the growth of the life insurance industry. The combined gross premiums of life insurance companies has been growing at an annual average rate of 19.1 percent to reach Rs. 14.6 billion in CY04 from Rs.8.2 billion in CY01. State Life Insurance Corporation (SLIC) continues to dominate the life insurance industry, however, the market share of life insurance companies excluding SLIC has also been increasing gradually.

The total assets of the life insurance sector increased to Rs 123.7 billion in CY04 from Rs 107.9 billion in CY03. These assets are largely allocated in the form of investments in government securities and listed equities.

Performance of Financial Markets

Strong economic performance has helped Pakistan's financial markets to grow rapidly during the last couple of years; both the size and depth of the markets have increased substantially. The improved inter-linkages, both at the domestic and international level, which provided opportunities for the development of domestic financial markets are not free of cost and the risk exposure of players in the financial markets has increased as well. It has become increasingly important for both market participants and regulators, to adopt a more proactive risk management framework. Developments during FY05 have also re-enforced the need for giving serious consideration to improved risks management practices on a priority basis.

During most of FY05, developments in the money market were largely due to the divergent views between the market and SBP on the pace of the upward adjustment in the benchmark interest rates. Specifically, while the market was expecting a sharp increase in the interest rates, SBP opted for a gradual rise. However, SBP followed the approach of striking a balance between supporting economic activities while abating the rising inflationary pressures. During Q2-FY05, the banks continued to bid (during auctions) at very high interest rates, which led to the acceptance of very low amounts in the auction. In fact, during this period the accepted amount in the T-bills auctions was well below the maturities of earlier auctions and it was imperative for SBP to mop-up this liquidity to effectively transmit the tightening monetary policy signal. Accordingly, SBP substantially increased the number of OMOs and remained focused on draining the excess liquidity from the market. Moreover, as no sign of deceleration in core inflation was observed until March FY05 and given that the economic growth was likely to exceed its target without difficulty, SBP sent a strong signal to the market in April FY05 by raising the discount rate by 150 basis points to 9.0 percent. Also, the subsequent T-bills auctions during the month saw a strong rise in cut-off rates.

In the forex market, the depreciation pressures on the Rupee started in the last quarter of FY04 and continued during the first four months of FY05. The Rupee value declined steadily against the US$, reaching a four-year low of Rs 61.4 per US$ by end-October FY05. The expectations of further depreciation of the Rupee induced importers to opt for forward bookings, and also a strategy to import sooner than later. Similarly, these developments created incentives for exporters to delay export proceeds. The combined impact of these elements resulted in an unusually large current account deficit on a monthly basis, and a sharp depreciation of the Rupee in October FY05 which also threatened to cause a run on the Rupee. This potential risk led SBP to make a formal commitment to supply foreign exchange for oil imports. Accordingly, from November FY05, SBP started to absorb a significant portion of the foreign exchange demand in the market. Moreover, SBP also introduced some temporary restrictions in forex market transactions to overcome speculative activities. As a result of these steps, the Rupee started gaining strength and stabilized at around Rs 59.7 per US$ by end-June FY05.

With respect to the performance of the equity markets, the extended rally at the Karachi Stock Exchange which started in FY03, accelerated in FY05. This was particularly true especially from December 2004 to mid-March 2005, when the KSE index saw an unprecedented sharp growth and touched a record high level of 10,303 points. However, only a part of this improvement can be supported by the improvement in economic fundamentals. A comparison of regional price earning ratios suggests that by mid-March, the KSE-100 was clearly quite expensive, even when compared to the better-rated markets in the region. The index saw a massive correction in the second half of March 2005 and plunged by 2,706 points in just 13 sessions. Several factors, including withdrawal of funds by COT financiers, the *lock-in* effects of circuit breakers, excessive buying in the ready market and selling in the futures market by certain operators, altogether contributed significantly to the mid-March 2005 market decline.

Macroeconomic and Financial Sector Comparison with SAARC and ASEAN Countries

Two distinct regional associations, SAARC and ASEAN, comprise over seventeen different economies of Asia. These economies differ from each other in terms of their age, size and economic performance. However, some comparisons can be drawn between these intra-regional economies on the basis of economic and financial performance for a uniform period of observation, spanning from 1990 to 2003, on the basis of which Pakistan's performance has been assessed in comparison with financial sector indicators of the SAARC and ASEAN countries under the framework of macroeconomic performance.

The indicators of financial liberalization and financial depth show that the economy of Pakistan tops the list of SAARC economies. Although both the degree of financial liberalization and financial depth are relatively higher in the case of India, but the degree of volatility is less in the case of Pakistan. Similarly, it is also observed that the degree of financial depth (M2/GDP) in Pakistan is lower on average relative to the ASEAN countries but the level of financial liberalization is compatible with the economy of Singapore. It is concluded that the increased and stable pace of liberalization of the financial system in Pakistan has the potential to further enhance the financial depth and support sustainable economic growth in future.