4 Exchange Rate and Reserve Management

4.1 Debt Market

State Bank of Pakistan has broad objectives of improving the liquidity in the debt & capital markets, channelizing savings to debt instruments and bringing efficiency to bank intermediation in order to increase deposit rates and lower the cost of borrowing for Government of Pakistan (GOP). In this context diversification of investor base of Government securities is an important task. SBP has taken several steps to broaden the investor base of Government Securities, especially in the context of retail investors. Brief snapshots of some steps taken in this regard are as follows:

- In order to facilitate non-qualified and retail investors, rules governing Primary Dealer (PD) system were amended to facilitate small investors. Now PDs are allowed to accept non-competitive bids for treasury bills in addition to PIBs.
- SBP has simplified the account opening process for individuals who want to open Investors Portfolio of Securities (IPS) account with banks for Govt. securities PKR account with them. Furthermore, reporting requirement has also been strengthened.
- With persistent follow up with FBR, the 10 percent withholding tax (WHT) deducted on "all Federal Government securities" is now the full and final settlement of the income tax liability for individuals. This results synchronization of tax treatment on Govt. securities with bank deposits & NSS instruments for retail investors.

As a result of the above efforts, the share of non-bank investors in Treasury Bills has increased from 7.8 percent in Jun 2009 to 21.5 percent in Aug 2011; increase of over Rs 410 billion.

Statutory Liquidity Requirements (SLR) for Islamic Banks/Islamic Bank Branches

Islamic Banks (IBs) and Islamic Bank Branches (IBBs) were required to maintain Statutory Liquidity Requirement (SLR) equivalent to 9.0 percent of their Time and Demand Liabilities (TDL). This low rate of SLR for IBs/IBBs as compared to conventional banks was due to non-availability of Shariah compliant securities. However, regular issuance of GOP Ijara Sukuk during FY11 provided sufficient supply of Shariah compliant securities and consequently the outstanding amount of GOP Ijara Sukuk was increased to Rs 225 billion as of Jun 30, 2011 from Rs 42 billion as of Jun 30, 2010. It is important to apply same liquidity standards across all banks; hence, the SLR of IBs/IBBs was raised to 19.0 percent of TDL in two phases (5.0 percent in each phase) to bring IBs/IBBs at par with conventional banks.

Authorized Derivative Dealers

Habib Bank Limited (HBL) was appointed Authorized Derivatives Dealer (ADD) by the SBP in June 2011. Appointment of HBL has been made as per criteria defined in Financial Derivatives Business Regulations issued by SBP. With the appointment of HBL, now there are five banks which are working as ADD. SBP has also initiated a process of reviewing the performance of ADDs to ensure that these banks continue to abide by the directives specified by the central bank.

Currency Swap Arrangements

During FY11 SBP has developed a framework of executing bilateral currency swap arrangements (CSA) with the regional central banks in the respective local currencies with the objective of boosting bilateral trade and investment in local currencies.

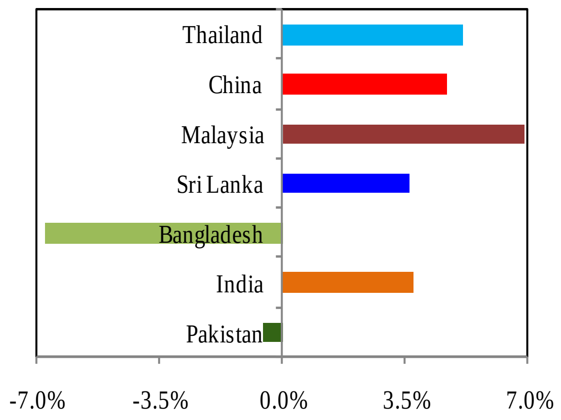
As a result a bilateral CSA was concluded on 1st Nov 2011 between SBP and central bank of the Republic of Turkey (CBRT) in Pakistan Rupee / Turkish Lira with size amounting to US$ 1 billion, in equivalent local currencies. Tenor of the agreement is for 3 years. Core objective of the Currency Swap Arrangement is to finance bilateral trade in respective local currencies of the two countries.

Exchange Rate & Reserves Management

In addition to the economic factors, SBP's proactive approach also facilitated smooth functioning of the market. SBP's strategy remained focused on facilitating market forces to play their due role in determination of exchange rate. The approach helped in building up capacity amongst the participants to quickly adjust with changing market conditions. In line with this strategy, SBP further increased the maximum cap on aggregate Foreign Exchange Exposure Limit of banks to PKR 2,500 million. This measure significantly enhanced the banks' capacity to smoothly handle large volume transactions without putting any undue pressure on the exchange rate. Consequently, Pak Rupee showed healthy volatility during the year with movement in both directions reflective of the prevalent demand and supply conditions.

On an annual basis, Rupee showed slight weakness against the US Dollar with a point-to-point nominal depreciation of about 0.5 percent compared to a weakening of 5 percent in FY10. Pak Rupee was amongst the few currencies in the region which weakened during the year as a number of other regional currencies such as Indian Rupee, Malaysian Ringgit atnd Chinese Yuan gained strength during the same period (see **Figure 4.1**).

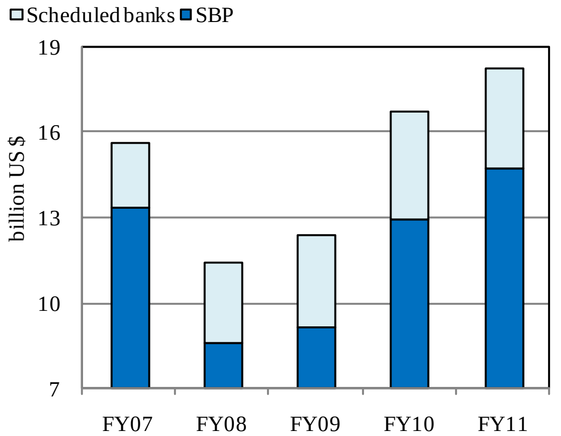
Figure 4.1: US$ Against Different Currencies in FY11



4.2 Foreign Exchange Reserve Management

Foreign exchange reserves showed a healthy growth of 8.9 percent during FY11, increasing to US$18.2 billion at June 30, 2011 (see **Figure 4.2**). Comfortable supply of foreign exchange allowed SBP to make purchases from the inter-bank market and build up its reserves, which recorded a growth of 14.1 percent. As against SBP, banking sector's foreign currency reserves showed a decline of 8.7 percent. The overall strong position of reserves can be attributed to a surplus in current account on the back of record remittances of US$11.2 billion and healthy growth in exports during FY11. Going forward, forex reserves of the country are expected to post further growth given anticipation of strong remittances, subdued oil prices, and continued support from international donor agencies.

Figure 4.2: Foreign Exchange Reserves



Substantial value was added to the SBP's profitability through active management of investment portfolio in FY11. The gross return in FY11 on the overall reserves was 3.1 percent, significantly better than its benchmark despite difficult interest rate environment and volatility in asset and currency markets. The reserve management strategy - adopted at the onset of the global financial crises - of tilting allocations towards high rated global government debt has paid dividends given the flight to quality in the global markets and ensuing reductions in yields. Going forward, the reserve management team foresees a normalization of markets in the medium term and is exploring the optimal deployment of reserves under the cautious risk parameters and economic outlook.

In an effort to enhance the reserve management function, capacity building measures are being undertaken. Team members are encouraged to attend interactive web-based seminars, international conferences and professional certifications to keep abreast of markets trends and views. Personnel in specialized functions have also been trained through attachments programs with international firms with global repute to bring systems and practices at SBP in line with global best practices.

4.3 Changes in Foreign Exchange Regime FY11

In order to meet the genuine business needs of importers, effective March 22, 2011, the forward cover facility against imports was restored subject to compliance with the terms and conditions. Previously, forward booking against all types of imports was temporarily suspended.

4.4 Pakistan Remittance Initiative (PRI)

In order to provide an ownership structure in Pakistan for remittance facilitation, State Bank of Pakistan, Ministry of Overseas Pakistanis and Ministry of Finance launched a joint initiative called Pakistan Remittance Initiative (PRI) in April, 2009. This initiative has been taken to achieve the objective of (a) facilitating and supporting efficient flow of remittances and (b) to provide investment opportunities in Pakistan for overseas Pakistanis. PRI has been quite successful in its endeavors and its efforts have been recognized globally. International Association of Money Transfer Networks (IAMTN) has awarded Pakistan Remittance Initiative (PRI) Money Transfer Award 2011 for the category of ‘Asia Pacific including South Asia’. The award was conferred in recognition of PRI’s efforts to facilitate the flow of remittances through formal channels in Pakistan. Some of the major contributions of PRI are as below

- Since the launch of the scheme, the number of PRI member banks has increased significantly.
- Banks are being encouraged to enhance their outreach worldwide through new remittance-specific related arrangements such as: bilateral arrangements, global MTOs like Western Union, MoneyGram, Express Money, and penetration through International Association of Money Transfer Network.
- Now the beneficiaries can receive funds in cash over the counters even without having bank accounts as per related KYC procedures and identification requirements.
- A number of innovative remittance products have been developed by PRI participating banks such as: (a) Pardes Cards, offering beneficiaries ease of withdrawing their funds 24x7 from any ATM across the country; (b) Inter Bank Funds Transfer (IBFT) which provides a unique opportunity to member banks for speeding up Inward Remittance Delivery to the beneficiary’s accounts; (c) Home Remittance Center/Booth wherein payments can be made beneficiaries via cash, demand drafts and pay orders.
- SBP has already taken initiative to develop Payment Systems Architecture of the country which after completion would help in achieving the objectives of instant delivery of home remittances in beneficiary account/ (over the counter); generating confirmation SMS to the beneficiary; development of robust and reliable ATM Network to offer an option to beneficiary of home remittances to withdraw cash even after banking hours and during holidays, and development of integrated and secured payment system infrastructure of Alternate Delivery Channels (ATM, POS, IVR, Call Centre, Mobile Banking) offering option to beneficiary of home remittances to make Person to Person (P2P) payments.

- A Complaints Handling and Feedback Mechanism: All overseas Pakistanis and their families can inquire about the remittance services of banks and lodge their complaints with the call centre (0092-21-111-222-774).
- Monetary Penalty on Delay in Remittance: In case the amount of remittance is not credited/ paid to the beneficiary as per stipulated instruction, the beneficiary shall be entitled to a return of sixty five (65) paisa per thousand rupees per day from the concerned bank for the number of days credit/payment on account of remittance was delayed.
- PRI also have organized various training programs on Home Remittance Business Roles & Responsibilities. More than 600 participants comprising Branch Managers of remittance rich areas of Khyber Pukhton Khawa, Regional Chiefs of banks, and bank officers dealing in Foreign Exchange and Call agents attended the Workshops.

4.5 Exchange Companies

In order to address the concerns of Foreign Exchange Companies effective January 19, 2011, the SBP allowed Exchange Companies to export all types of FCYs other than US Dollars as per prescribed procedure through designated airports. The Exchange Companies shall, however, ensure to receive the equivalent US Dollars against exported currencies in their foreign currency accounts maintained with banks in Pakistan within 3 working days. In 2008, State Bank had prohibited Exchange Companies to export cash in U.K Pound Sterling, Euro and UAE Dirhams in addition to US Dollars.

***Re-alignment of Offsite Monitoring, Supervision and Compliance Functions*:** With a view to strengthen monitoring of Exchange Companies, the offsite monitoring, supervision, compliance, enforcement and related functions have been transferred to Offsite Supervision & Enforcement Department (OSED) which is well equipped to carry out such a specialized task. Moreover, airport affairs have also been transferred to Foreign Exchange Operations Department, SBP, BSC (Bank). From on-site inspection perspective, a new department has been created for the inspection of exchange companies and DFIs.