

4 Monetary, Exchange Rate, and Reserve Management

4.1 Money and Debt Market

Efficient money and debt markets are an integral part of a vibrant financial system.

Improving the liquidity, depth, and efficiency of the money and debt markets has been one of the main strategic objectives of SBP. These markets play an essential role in promoting savings in the country, improving the financial intermediation process, and transmitting the monetary policy signals to impact inflation and economic growth. During FY13, SBP continued to progress in this direction and introduced a number of measures primarily aiming at strengthening monetary policy transmission mechanism, improving liquidity management and efficiency of intermediation by banks, and achieving diversification of investor base. In the following, we summarize the main steps taken by SBP during the fiscal year.

Amendments in Interest Rate Corridor Facilities

Since the introduction of interest rate corridor in August 2009, volatility in the short-term interest rates reduced significantly that has helped in strengthening the transmission mechanism of monetary policy. With the objective of improving the transmission mechanism by further reducing the volatility in the short-term interest rates, w.e.f. February 11, 2013, SBP decided to narrow the width of the interest rate corridor to 250bps from 300bps.

Moreover, in order to dissuade frequent access to the SBP overnight reverse repo and repo facilities by banks and to strengthen the liquidity management framework, effective from October 8, 2012, SBP announced that in case an eligible institution accesses either of SBP's reserve repo or SBP's repo facilities more than seven times during a given quarter, a spread of plus/minus 50bps will be applied over and above the applicable SBP overnight reverse repo and repo rates, respectively, for the remainder of the same quarter.

The above measure has significantly reduced the banks reliance on SBP interest rate corridor windows, and has improved the liquidity management of the banks by inducing the required change in their market behavior.

Mechanism on determining return on saving deposits

Most of the banks in Pakistan were used to pay profit to saving depositors on minimum monthly balances. To promote savings by rationalizing the deposit rates, and to reduce high banking spreads by bringing compatibility between the recovery of return on loans and the payment of profit on saving deposits; banks are now, effective from April 01, 2013, directed to pay profit to saving depositors on average monthly balances. Recently, SBP has also decided to link the minimum profit rate¹ with SBP's Repo rate (i.e. floor of the interest rate corridor). Specifically, with effect from October 01, 2013, the minimum profit rate to be paid on all Pak Rupee saving deposits will be 50 basis points below the prevailing SBP Repo rate.

Cash Reserve Requirements (CRR)

In order to provide banks more flexibility in their liquidity management and further reduce the volatility in the short term interest rates, SBP has rationalized the reserve maintenance requirements

¹ Since May 2008, SBP had placed a minimum rate of return of 5 percent for all savings accounts of the scheduled banks, which was later increased to 6 percent.

during FY13. With effect from October 12, 2012, the reserve maintenance period has been extended from one week to two weeks for the purpose of CRR. All banks have to maintain CRR at an average of 5 percent of Demand Liabilities (including time deposits with tenor of less than 1 year) during the reserve maintenance period. The daily minimum CRR has been reduced from 4 percent to 3 percent. Under the revised procedure, banks have been advised to maintain required reserves, during the period starting from Friday and ending on Thursday of subsequent week, by taking into account the Demand Liabilities as of close of business on Friday i.e. first day of reserve maintenance period.

Data on Bank-wise Access to SBP's Standing Facilities and Excess Cash Reserves

In addition to aforementioned measures for incentivizing banks for improving their liquidity management practices, in FY13, SBP has started publishing a quarterly report on its website showing bank-wise access to the overnight repo and reverse repo facilities of SBP. The report provides market with details the number of times individual institutions have accessed to SBP overnight standing facilities during the preceding quarter.

SBP has also started publishing bank-wise data on 'excess cash reserves' maintained by banks over and above CRR. The data is being published with a lag of about one month; and will help in differentiating between the relative performances of various banks in their money market operations. Excess cash reserve not only adversely impacts smooth functioning of the interest rate corridor but also has implications on banks' own liquidity management.

It is expected that the dissemination of this bank-wise information on use of central bank's standing facilities and maintenance of Excess Cash Reserve will bring more transparency and efficiency in the domestic money market.

Primary Dealer System

In order to improve effectiveness of Primary Dealer Primary (PD) System in broadening the investor base of Government securities, State Bank of Pakistan has further strengthened the rules governing PD system. In July 2012, revisions in the rules governing PD system have been made, whereby each PD is now required to:

- Provide complete information regarding processes, charges and forms required for investment in government securities, on their official websites.
- Disseminate and keep the service charges related to Investor Portfolio Securities (IPS) account activities, at a reasonable level.
- Display prices of government securities in their branches.
- Quote two-way prices on Electronic Bond Trading Platform (EBND) and generate at least 35 percent of its trading volume with other PDs on this platform.

In order to incentivize PDs to bring retail investment in Government securities (PIB, T-Bill) through non-competitive bids, a commission @ 10 paisa per rupees 100 was introduced. This commission is in addition to the under-writing commission already available for PIBs.

Recently in July 2013, a benchmark related to IPS accounts, has also been introduced against which performance of each PD will be evaluated at the end of a fiscal year. As per this benchmark each PD should have a minimum portfolio of 250 IPS accounts and shall ensure minimum 15 percent increase in its IPS accounts during a year. This measure will incentivize the primary dealers to market these accounts to retail investors through their branch network and will help in broadening the investor base of Government securities.

State Bank continued to recognize the efforts of PDs in the development of Government securities market, by announcing three best performing PDs for FY13 in the primary and secondary markets of Government securities. Faysal Bank Limited was declared best performing PD for FY13, followed by Habib Bank Limited and NIB Bank Limited.

Marketing Campaign of Government Securities

In coordination with Ministry of Finance a marketing campaign to create awareness about Government securities among the retail/small investors was launched, in October 2012, with following salient features:

- Advertisements were published in leading newspapers of the country to explain the salient features of government securities and operational details for investment therein.
- To further augment the impact of media advertisement, investor guides were also published for all government securities i.e. Market Treasury Bills, Pakistan Investment Bonds and GOP Ijara Sukuk. These guides were distributed through main branches of PDs and are also available at SBP website.² The investor guides provide complete information to the investors, both residents and non-residents, about features, investment procedure and benefits of investing in Government securities.

Online Auction of Government Securities

Since February 2013, the auction of MTBs and PIBs is being conducted online via Bloomberg Auction System. This decision to automate was taken by SBP to bring more efficiency in the Primary Auction process which has not only reduced operational risk in manual auction process but has also brought Pakistan at par with other countries that have already implemented an automated electronic auction system. The online auction system has been customized to the needs of Pakistan market, which has enabled SBP to implement the straight through processing of accepted bids in auction. Hence, the process of auction from bid submission to settlement of accepted bids has been completely automated.³

GOP Ijara Sukuk

In December 2011, Government of Pakistan launched GOP Ijara Sukuk with M2 Motorway as underlying asset for sale, purchase and lease through Pakistan Domestic Sukuk Company Limited (PDSCL). The maximum value of the asset under the said program of the Ijara Sukuk was Rs 234.6 billion, out of which GOP had issued Ijara Sukuk worth Rs 186.8 billion in four auctions held during FY12. The last auction of the series was conducted in Q1-FY13; in which Ijara Sukuk of Rs 47.0 billion were issued. In March, 2013, Government of Pakistan launched another series of GOP Ijara Sukuk with M-1 Motorway as an underlying asset. The maximum value of the asset was Rs 43.2 billion against which Sukuk worth Rs 43.02 billion were issued by the GOP in the auction held on March 26, 2013.

Since the start of issuance of GoP Ijara Sukuk in September 2008, Sukuk worth Rs 501.4 billion have been issued so far. As of June 30, 2013, the outstanding amount of GoP Ijara Sukuk was Rs 459.2 billion, out of which Sukuk worth Rs 381.7 billion are held by Islamic Banks/Branches.

² <http://www.sbp.org.pk/Guidelines/index2.asp>

³ Detailed instructions issued to PDs in this regard are available at <http://www.sbp.org.pk/dmmd/2013/C3.htm>

Trading of Government Securities at Stock Exchanges

A committee was formed in August 2013 to evaluate trading of Government securities⁴ on the stock exchanges of Pakistan consisting of all stakeholders i.e. SBP, SECP, KSE and CDC. Objective of the committee was to put up an appropriate regulatory and operational framework to launch the trading of Government securities on the stock exchanges by the end of January 2014. To broaden the investor base of Government securities, it was agreed that the trading of such securities at the stock exchanges will be an additional platform and will not replace the existing OTC market⁵. Accordingly, SBP has allowed trading of government securities on the stock exchanges of the country. Necessary instructions to primary dealers / banks were issued on January 28, 2014.

Foreign Exchange Market

The exchange rate policy in Pakistan primarily aims at ensuring smooth functioning of the foreign exchange market and managing the foreign currency reserves of the country. SBP continued to follow these broad objectives in FY13. Proactive approach of SBP to market regulation and management has not only led to stability in the foreign exchange market, but has also enhanced the depth of the market. Considering the increasing volume of transactions and enabling banks to manage large flows without adding excessive volatility in the market, SBP in its annual review during FY13 increased the overall Foreign Exchange Exposure Limit (FEEL) of the market by 9.7 percent. Moreover, with effect from April 15, 2013, cap on aggregate FEEL of an authorized dealer has been increased from Rs 2,500 million to Rs 3,500 million.

Regulations related to foreign currency accounts and trade loans under FE-25 scheme have also been improved during FY13. As per new instructions, issued in September 2012, Authorized Dealers (ADs) have been allowed to open foreign currency accounts and extend trade loans in US Dollar (USD), Pound Sterling (GBP), Euro (EUR), Japanese Yen (JPY), Canadian Dollar (CAD), UAE Dirham (AED), Saudi Riyal (SAR), Chinese Yuan (CNY), Swiss Franc (CHF) and Turkish Lira (TRY). Furthermore, the interbank placements and interbank swaps or any other source of foreign currency liquidity permitted under SBP regulations are now allowed to be used to extend trade loans in the above foreign currencies. However, currency of the trade loan should be the same as that of the underlying LC/ Firm Trade Contract. These changes in the regulation have not only facilitated the depositors and borrowers, but have also increased liquidity of all the concerned currencies in the foreign exchange market.

Table 4.1: Pak Rupee per US Dollar - Interbank Trends

	High	Low	Close	Average	Volatility C/C ²
FY10	85.58	81.40	85.51	83.89	3.02
FY11	86.50	83.93	85.97	85.56	2.40
FY12	94.69	85.79	94.55	89.27	2.48
FY13	99.80	93.70	99.66	96.85	1.67

² Reuters: Average close-to-close daily volatility (in percent)

During FY13, rupee exhibited a depreciation of 5.1 percent against US\$ in the interbank market, compared to a larger depreciation of 9.1 percent observed in FY12 (**Table 4.1**). This trend in the exchange rate was largely a reflection of demand and supply in the foreign exchange market. In FY13, external account showed a relatively lower deficit of US\$2.5 billion compared to US\$4.7 billion recorded in the previous fiscal year. Similarly, overall balance of payments also depicted a smaller deficit of US\$2.0 billion in FY13 against US\$3.3 billion recorded in FY12.

⁴ That is Market Treasury Bills, Pakistan Investment Bonds, and GOP Ijara Sukuk.

⁵ The OTC market (Bloomberg, Reuters and money market brokers) of Government securities will continue to function as usual and no changes will be made in the current OTC market.

The deficit in the balance of payment positions and repayment of IMF loans resulted into a fall in the foreign exchange reserves of the country from US\$15.3 billion at end-June 2012 to US\$11.0 billion by the end of FY13. However, due to proactive management of SBP, the decline in the reserves during the year has been gradual that helped avoiding any undue negative impact on the market sentiments.

42nd Meeting of ACU Board of Directors

SBP got the honor of hosting the 42nd meeting of the Board of Directors of Asian Clearing Union (ACU) in June 2013 in Islamabad⁶. The meeting was held in conjunction with the 26th SAARCFINANCE Group Meeting and 9th Governors' Symposium.

During the meeting, Governor State Bank of Pakistan assumed the Chairmanship of Board of Directors of the ACU for the year 2013. The meeting was attended by Governors of central banks/monetary authorities of Bhutan, India, Maldives, Myanmar, Nepal and Deputy Governors from Bangladesh, Iran and Sri Lanka. First Deputy Governor of Da Afghanistan Bank also attended the meeting as an observer.

In the inaugural address the Governor SBP highlighted the need for economic cooperation among the participants of the ACU member countries in current scenario. The expansion of intra-regional trade and cooperation on other fronts, among ACU member countries will help absorb any negative shocks in the global markets. With an increase in trade amongst ACU countries, and an integrated financial system that reduces the cost of trade, the countries of the ACU will be able to diversify their trade and tap into some of the fastest growing markets of the region.

During the meeting Secretary General ACU, Mrs. Lida Borhan-Azad presented the draft annual report on the operations of the ACU for FY12. Afterwards, Directors/Alternate Directors of ACU member countries delivered brief presentations about their countries highlighting respective economic developments during the FY12.

The meeting discussed over the issues related to promotion of intra regional trade among ACU member countries and to facilitate the importers and exporters by bringing more efficiency in the existing payments and settlement processes.

4.2 Foreign Exchange Reserve Management

The foreign exchange reserves of Pakistan are maintained for ensuring coverage of international payments obligation as well as the effective implementation of the foreign exchange policy.

The liquid foreign exchange reserves of country stood at \$11.0 billion at June 30, 2013 compared to \$15.3 billion as on June 30, 2012 (see **Table 4.2**).

Table 4.2: Month-end Foreign Exchange Reserves
(million US\$)

Month	SBP	Banks	Total
Jun-12	10,803	4,485	15,289
Jul-12	10,154	4,455	14,609
Aug-12	10,392	4,464	14,856
Sep-12	10,358	4,564	14,923
Oct-12	9,733	4,592	14,325
Nov-12	8,704	4,828	13,531
Dec-12	8,987	4,872	13,859
Jan-13	8,694	4,942	13,636
Feb-13	7,945	4,992	12,936
Mar-13	7,126	5,124	12,250
Apr-13	6,694	5,118	11,812
May-13	6,393	5,081	11,474
Jun-13	6,008	5,011	11,020

⁶ ACU is the multilateral organization comprising central banks of Bangladesh, Bhutan, India, Iran, Maldives, Myanmar, Nepal, Pakistan and Sri Lanka. Its main objective is to provide an efficient mechanism for payment and settlement among the member countries on a multilateral basis.

This decline by \$4.3 billion during FY13 represented current account deficit and the repayments to the IMF. The import coverage ratio was registered at 14.5 ‘weeks of imports’ by the end of FY13, down from 19.8 at the end of FY12.

Reserve Management Strategy

The global economy continued on the recovery path during FY13 as the markets responded to the financial and fiscal reforms undertaken in developed economies. Given the ongoing economic and financial developments in core investment markets, the Investment Strategy remained a key focus area for the reserve management function - leading to asset allocation and currency mix diversification initiatives. In-house reserve management capabilities were enhanced by augmenting the role of sovereign instruments in the in-house portfolio. The Agency Agreement signed between SBP and the People’s Bank of China, permitting SBP to conduct investment activity in the Chinese Interbank Bond Market, was the most significant development in Reserve Management area during FY13. This agreement represents the close collaboration between the State Bank of Pakistan and People’s Bank of China that has been built over time. The access to the Chinese Bond Market also provides integral flexibility to the State Bank of Pakistan for diversification and optimal management of foreign exchange reserves. It will help us meet SBP’s reserve management objectives while enhancing the overall profitability of invested reserves. Additional asset class and currency mix diversification initiatives are also planned to be phased-in upon assessment of favorable conditions in international foreign exchange and capital markets. Furthermore, a benchmark reassessment exercise was also conducted during FY13 resulting in reduction of credit exposure for Bank’s overall reserves portfolio - a key initiative given elevated uncertainty in Euro zone countries and rapidly changing global economic dynamics.

Reserve Outlook

SBP maintains a positive outlook for the foreign exchange reserves position for the upcoming year. While strong workers’ remittances continue to provide a buffer against an unfavorable trade balance, the Extended Fund Facility from IMF should allow for consolidation of the foreign exchange reserve position. The initiatives for enhancement of reserve management capabilities – implemented and planned – should allow for enhanced profitability while adhering to SBP’s pre-specified investment guidelines. The Investment Policy for foreign exchange reserves and any adjustments therein are formulated under the broad investment guidelines – of Security, Liquidity and optimal Returns – developed by the Central Board of the Bank.

4.3 Changes in Foreign Exchange Related Instructions

Instructions on the forward cover facility provided by the ADs against imports were further streamlined in terms of F.E. Circular No. 06 dated December 21, 2011. In this regard, certain queries were raised which were clarified vide Circular Letter No. 01 dated February 19, 2013. The said clarifications provide necessary guidelines on the facility. Further, the need for strict observance of applicable rules and regulations governing foreign currency accounts has been stressed upon the ADs vide Circular Letter No. 03 dated February 27, 2013. Besides, in case of any deposit of foreign currency notes of more than USD 10,000 (or equivalent in other currencies) in a single day, the account holders have been required to present the original receipt of acquisition.

4.4 Exchange Companies (ECs)

In consonance with the policy to organize and facilitate the exchange companies, SBP issued comprehensive network expansion policy for the ECs. Through this policy, ECs have been provided with detailed set of instructions regarding network expansion that has been linked with capital and compliance ratings of ECs. Further, in order to protect the interests of the buyers/sellers of foreign

exchange, SBP made it mandatory for ECs that the spread between buying and selling rates of foreign currencies should not exceed 25 paisas.

4.5 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 objectives of: (a) facilitating and supporting efficient flow of workers' remittances; and (b) to provide domestic investment opportunities to overseas Pakistanis. The establishment of PRI has contributed positively in enhancing the flow of remittances to Pakistan. More importantly, workers' remittances emerged as a major source to finance the trade deficit of the country. Remittances financed over two-third of Pakistan's trade deficit during FY13 compared to less than one-third of the trade deficit financed by the remittances during FY08. Among others, the introduction of instant account credit facility through inter-bank fund transfer (IBFT) was the major initiative of PRI in FY12. This product offers convenient and fast delivery of home remittance into beneficiaries' bank accounts within a maximum 30 minutes on 24/7 basis. It is hoped that this product will become popular amongst the remitters and beneficiaries.

Further, PRI is about to initiate a pre-departure briefing program for outbound Pakistani workers. The implementation strategy of pre-departure briefing program is under discussion between PRI and Emigration Bureau. Under this program, outbound Pakistani workers will be briefed about the sources and usage of sending and receiving home remittance through formal channels. They will also be provided facilities to open their own and their beneficiaries' bank accounts at the spot. Since over half million Pakistanis are going abroad annually through Emigration Bureau, this program is expected to increase remittances on sustainable basis.

4.6 Treasury Operations

During FY13, Treasury Operations Department continued to perform the treasury back-office and Nostro operations in addition to other functions such as accounting of outsourced portfolio/ execution of foreign currency payments; contributing significantly towards the achievement of the key objectives of SBP like prudent reserves management and financial stability. It ensured accurate & timely settlement, recording and reporting of traditional as well as advanced treasury products and FCY payments in automated environment, by developing skilled professionals of international caliber. Following are the major achievements:

- TOD successfully handled a complex and new treasury product under Currency SWAP Agreement (CSA) with Peoples Bank of China (PBC). Entire job was indigenously completed envisaging capacity building, technical analysis on substance of CSA, development of business process manual, opening of new accounts and their classification in GL as per accounting policy.
- As part of improving the efficiency and cost effectiveness of SBP's Treasury Operations, the account arrangements with foreign correspondents were reviewed, whereby certain nostros were rationalized and in a few instances terms and conditions of the nostros were re-negotiated.
- Developed program for auto loading of daily exchange rates directly into the Globus system through interface, without manual intervention.
- Capacity building of TOD's officers in treasury areas as well as Globus and Oracle Systems/ functionalities for improved efficiency.

- Enhanced the in-house capacity/skill set for independent valuation of the fixed income securities and derivative products held with foreign fund managers/custodians.
- Created interface with custodians' accounting platform and took initiatives for increased efficiency of their reporting on SBP portfolio for accounting, reconciliation and MIS.