2

Financial Markets' Behavior

The domestic financial markets witnessed lower volatility during CY24 in the wake of persistent improvement in macroeconomic conditions, receding policy uncertainty, and successful arrangements with IMF. This, along with improvement in current account position, and FX market sentiments, translated into stable rupee-dollar parity throughout the year. Money market continued to function orderly under the effective SBP monetary management. Monetary policy stance reversed its course following the increased disinflation momentum. Though liquidity conditions varied over the year, Overnight Repo Rate largely remained above policy rate suggesting elevated liquidity pressures. Equity prices continued to surge backed by supportive macroeconomic environment and better economic prospects. KSE-100 outperformed peer markets for another year. Mutual funds and insurance sector were largest net buyers in CY24.

2 Financial Markets' Behavior

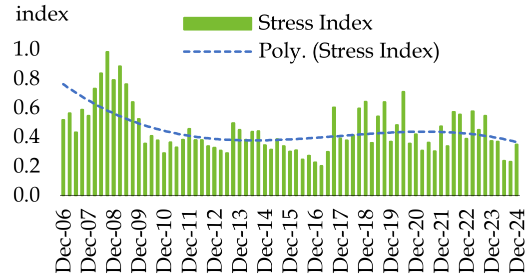
Global financial markets continued to follow a steady trajectory….

Global financial markets manifested relatively contained volatility and continued to operate smoothly during CY24. Equity and currency markets witnessed a short-lived high volatility in the first week of August-2024 owing to an increase in interest rate by Bank of Japan—highest since 2008[1]—and the news about weak labor market conditions in the US.[2] Nevertheless, global financial conditions broadly remained favorable, however, resurgence in trade policy uncertainty has affected the stocks and currencies in emerging markets.[3] Moreover, the term-premium in the US—after remaining negative for few years—turned into positive in September 2024, reflecting the projections of elevated net issuance of US treasuries in future due to anticipated increase in fiscal deficit.[4]

Domestic financial markets witnessed abated stress owing to improving economic conditions and upbeat market sentiment…

The overall volatility in the domestic financial markets trended downward during CY24 (**Figure 2.1**) reflecting the impact of persistent improvement in macroeconomic fundamentals, lower policy uncertainty, and successful conclusion of IMF SBA program along with entry into Extended Fund Facility (EFF) program.[5] Moreover, Moody's and Fitch upgraded Pakistan's credit rating, reflecting better external liquidity position.[6] Consequently, country's risk premium as well as economic policy uncertainty declined in CY24 (**Figure 2.2 and Figure 2.3**).

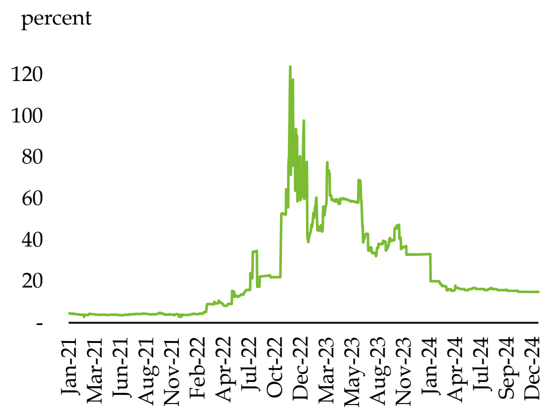
Financial Markets Stress Index **Figure 2.1**



Note: Stress index is calculated using Exponential Weighted Moving Average (EWMA) method. Daily Overnight repo rate, KSE-100 index and Exchange Rate (PKR/US$) are used as indicators for the money, equity and foreign exchange markets, respectively

Source: SBP Staff Calculations

Pakistan's 5 year CDS **Figure 2.2**



Source: Bloomberg

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[1] BoJ raised short-term interest rates to 0.25 percent from 0.10 percent on July 31-2024. Previously, the overnight call rate was at 0.3 percent in 2008 that subsequently moved to 0 percent in 2010 and further into negative territory in 2016.

[2] Aquilina, M., Lombardi, M. J., Schrimpf, A., & Sushko, V. (2024). *The market turbulence and carry trade unwind of August 2024* (No. 90). Bank for International Settlements. The unwinding of yen leveraged positions, including carry trades, amplified short-lived bouts of extreme equity market volatility and exchange rate movements in early August

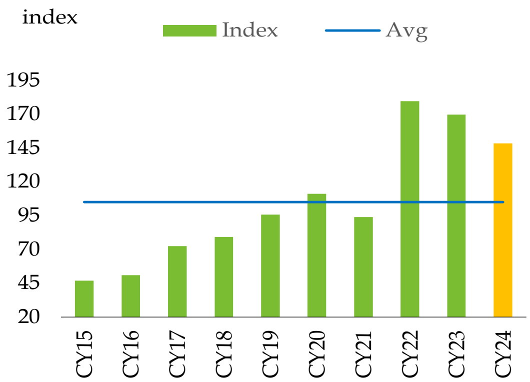
[3] IMF. (2025). World Economic Outlook Update. *January*

[4] IMF. (2024). Global Financial Stability Report. *October*

[5] https://www.imf.org/en/News/Articles/2024/09/27/pr-24343-pakistan-imf-concludes-2024-aiv-consultation-pakistan-approves-37-mo-extended-arr

[6] Fitch upgraded the credit rating from CCC to CCC+ in July-2024. Moody's upgraded the credit rating to Caa2 from Caa3 in August 2024.

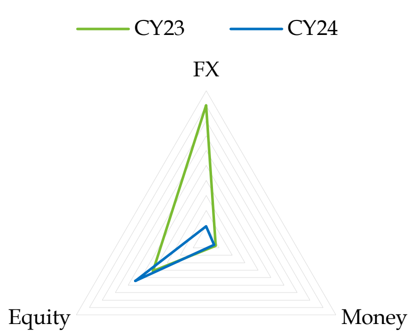
Economic Policy Uncertainty Index **Figure 2.3**



Source: State Bank of Pakistan

The lower stress in financial markets was almost exclusively contributed by FX market, manifesting rupee stability as SBP's net FX reserves increased by 42.5 percent to US$ 12.0 billion at end CY24 (**Figure 2.4).** Equity market, however, witnessed higher volatility in the wake of rapid increase in the KSE-100 index which surged by 84.3 percent in CY24. Money market continued to function in an orderly manner due to SBP's effective monetary operations to ensure adequate liquidity and keep the interest rates within the corridor around policy rate.

Financial Markets Stability Map **Figure 2.4**



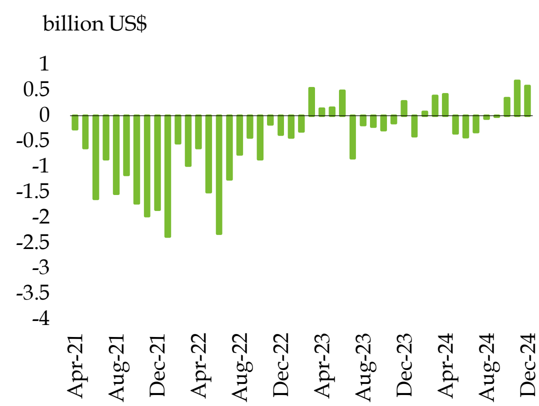
Source: State Bank of Pakistan

2.1 FX Market

Current account surplus and IMF program kept Rupee-Dollar parity largely stable …

Current account balance further improved by turning into a *surplus* of US$ 0.8 billion during CY24 from a *deficit* of US$ 0.8 billion in CY23 (US$ – 12.2 billion in CY22) (**Figure 2.5)**. In the wake of revival in economic activity, stable exchange rate, and ease in restrictions, imports grew by 15.2 percent in CY24 compared to a contraction of 24.3 percent in last year. Nonetheless, SBP's net purchases in the FX market[7], robust increase in workers' remittances—aided by incentives and regulatory reforms—and strong exports performance[8] helped build FX buffers despite weak official FX inflows and debt repayments.[9] In addition, stable global commodity prices[10] supported external account dynamics during CY24.

Trend in Current Account Balance **Figure 2.5**



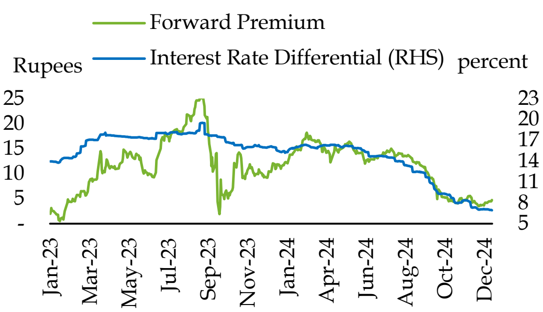
Source: State Bank of Pakistan

A critical factor behind the FX market stability was the successful completion of Stand-By Arrangement (SBA) with the IMF in April-2024 coupled with fresh Extended Fund Facility (EFF) program worth around US$ 7 billion in

[7] SBP' net purchases amounted to US$ 4.9 billion during June2024 to November 2024.
[8] Workers' remittances grew by 31.5 percent to US$ 35.0 billion in CY24 against 11.8 percent contraction in CY23. Exports grew by 10.7 percent in CY24 as compared to 6.8 percent contraction in CY23
[9] Pakistan witnessed US$ 1.0 billion net financial inflows in CY24 against US$ 5.0 billion in CY23. External debt re-payments (only principal) amounted to US$ 7.0 billion in CY24 against US$ 9.0 billion in CY23
[10] Global commodity price index averaged at 165 in CY24 almost similar level of 166 in CY23

September 2024. Resultantly, FX liquidity and prospects for planned external inflows improved, augmenting the market confidence as well as the macroeconomic stability. This was also reflected in the 6-month forward premium which lowered[11] over CY24 and largely remained consistent with the interest rate differentials – unlike last year's relatively higher deviations from the differentials – indicating muted market's apprehensions about macroeconomic fragilities **(Figure 2.6)**. For instance, in H1CY24, 6M forward premium averaged at Rs14.3 while it declined to Rs 8.5 in the second half of CY24, reflecting narrowing interest rate differential amid significant monetary easing in domestic market.

Trend in 6M Forward Premium **Figure 2.6**

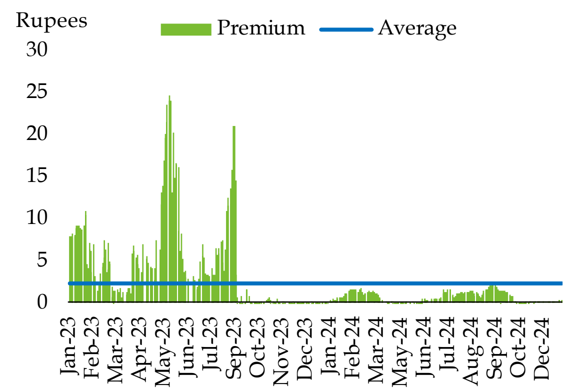


Note: Interest rates differential represent difference between 6M KIBOR and 6M Secured Overnight Financing Rate (SOFR)

Source: State Bank of Pakistan

Besides, fluctuations in premium between open and interbank market exchange rate remained within a confined range, reflecting improved sentiment in the FX market during CY24 (**Figure 2.7)**. The premium averaged at Rs 0.5 against Rs 4.3 in CY23. The narrowing open market premium has been due to SBP's policy reforms in Exchange Companies (ECs) as well as administrative measures by the government taken in the second half of CY23.[12] The changing dynamics of the open market proved encouraging by playing an instrumental role in helping improve FX liquidity through an impressive increase in workers' remittances.

Trend in Open Market Premium **Figure 2.7**



Source: State Bank of Pakistan

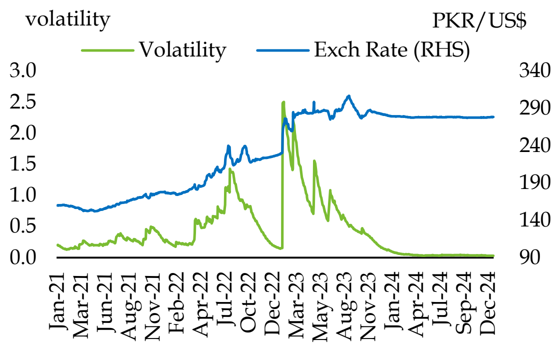
In this backdrop, volatility in FX market was placid and the rupee maintained its parity against US$ at Rs.278.5, on average, showing an appreciation of 0.7 percent in CY24 against a significant depreciation of 26.9 percent in CY23 (**Figure 2.8)**. Although US$ continued to appreciate against major global currencies during CY24, improved external account position and stable domestic macroeconomic conditions provided support to the local currency.[13]

[11] On average, the premium was Rs.11.3 in CY24 against Rs.11.5 in CY23

[12] SBP suspended operations of a number of exchange companies in H2CY23. SBP also initiated several structural reforms including providing the ECs-B the option of converting into full-fledged ECs, and increase in minimum paid-up capital to Rs.500 million (free of losses) from Rs.200 million. Please see relevant circular available at https://www.sbp.org.pk/epd/2023/FEC3.htm

[13] US$ index against major global currencies increased, on average, to 123 in CY24 from 121 in CY23

Exchange Rate and its Volatility* **Figure 2.8**



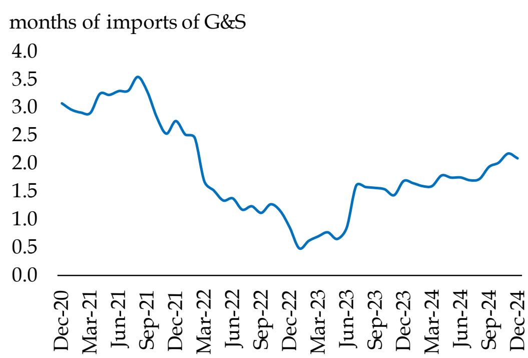
*Volatility is measured using Exponential Weighted Moving Average Method based on daily data

Source: State Bank of Pakistan

With an increase in FX reserves, imports coverage ratio improved…

SBP's net FX reserves witnessed a consistent improvement during the reviewed year. The FX reserves increased by 42.5 percent to US$ 12.0 billion at end CY24. Consequently, despite growth in imports, the imports coverage ratio (ICR) improved to 2.1 months from 1.7 months in December-2023 (0.9 months in December-2022) (**Figure 2.9**). Enhanced liquidity conditions were also manifested by SBP's move to reduce its forward liabilities by around US$ 431 million to US$ 3.0 billion in December-2024 compared to December 2023 (US$ 5.3 billion in December 2022).

Import Coverage Ratio **Figure 2.9**

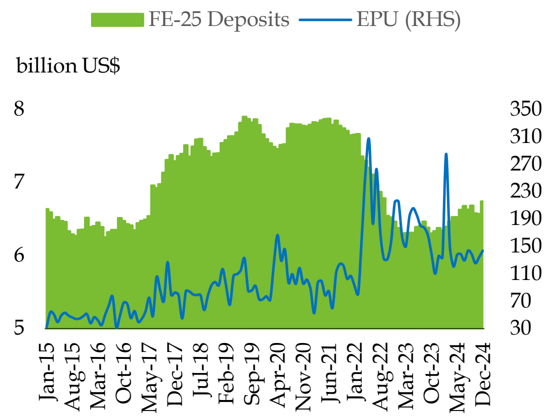


Source: State Bank of Pakistan

FE-25 deposits witnessed a modest revival after remaining under pressures for a couple of years …

The trajectory of FE-25 deposits trended downward during CY22 and CY23 amid heightened macroeconomic uncertainty.[14] However, current year witnessed a consistent recovery in the foreign currency deposits, which averaged at US$ 6.6 billion, slightly up from US$ 6.4 billion in previous year (**Figure 2.10**). It might reflect a receding but elevated economic uncertainty.[15]

Trend in FE-25 Deposits **Figure 2.10**



Source: State Bank of Pakistan

2.2 Money Market

Monetary policy reversed its course following the increased disinflation momentum…

The monetary policy stance reversed its course during 2024. In the wake of continued monetary tightening complemented by fiscal consolidation, National CPI (YoY) decelerated sharply after January-2024, subsiding to 4.1 percent in December-2024 from a high of 29.7 percent a year earlier.

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[14] FE-25 deposits averaged at US$ 6.4 billion and US$ 7.0 billion in CY23 and CY22 respectively (US$ 7.8 billion in CY21).

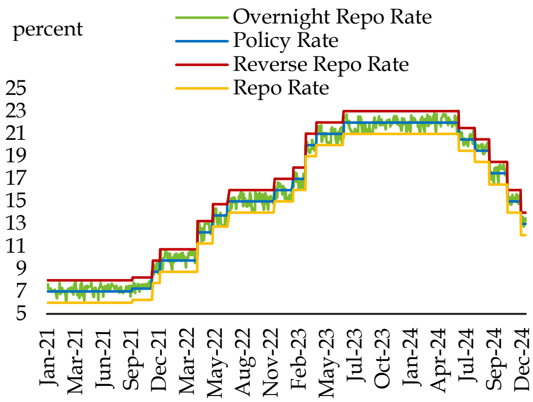
[15] The economic policy uncertainty index averaged at 149 in CY24, down from 170 in CY23 but still higher than the average of 105 during CY15-CY24.

Accordingly, SBP moved to lower its policy rate in early June-2024, and followed up with consistent relaxation in monetary stance subsequently. The policy rate was reduced to 13.0 percent by December-2024 from 22.0 percent in June-2024.[16]

Volatility in Overnight Repo Rate (ONR) continued at a lower level…

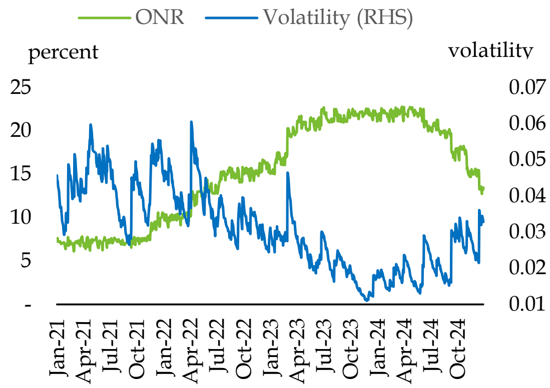
ONR continued to oscillate within the interest rate corridor during CY24, manifesting the effectiveness of SBP's monetary operations (**Figure 2.11)**. Moreover, ONR volatility, on average, continued to remain at a lower level.[17] Nonetheless, a few spikes in ONR volatility were observed post-May 2024, which in turn was driven by successive and significant cuts in policy rate (**Figure 2.12)**.

Interest Rate Corridor **Figure 2.11**



Source: State Bank of Pakistan

Trend in ONR and its Volatility **Figure 2.12**



Source: State Bank of Pakistan

The average gap between SBP Policy rate and ONR remained positive[18] (0. 12 in CY24 vs. -0.24 in CY23), with 156 positive and 88 negative instances. Within the year, the gap increased to 0.18 in H2CY24 from 0.05 in the first half of CY24.

The upward pressure on ONR, particularly in the second half, reflected a number of factors. First, advances of the banking sector increased by Rs 3.7 trillion while deposits declined by Rs 746 billion, in H2CY24 broadly reflecting the impact of easing financial conditions and banks 'efforts to meet the advances-to-deposit ratio (ADR) thresholds to avoid taxes. Second, although government's budgetary borrowing from the banking sector witnessed a deceleration in CY24, it still remained elevated, reinforcing liquidity pressures in money market.[19] In H2CY24, government budgetary borrowing increased by 26.9 percent—compared to 40.8 percent in the first half of reviewed year. Third, the average size of OMOs injections[20] increased indicating higher liquidity pressures (**Figure 2.13)**. This is also corroborated by the fact that banks availed

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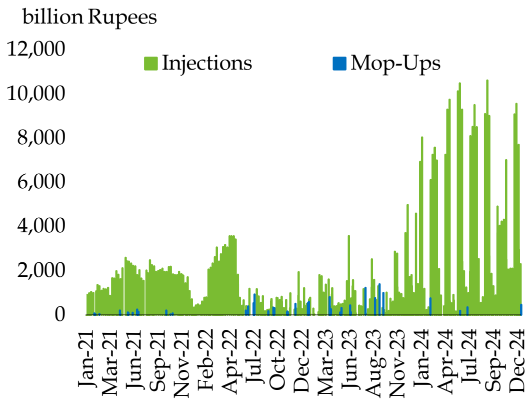
[16] Policy rate remained at 22.0 percent until June 10, 2024. It was reduced to 20.5 percent on June 11,2024
[17] On average, volatility in ONR turned 0.022 in CY24 against 0.023 in CY23.
[18] A positive gap may imply relatively higher liquidity pressures in money market and vice versa
[19] On average, year on year increase in government borrowing was recorded at 33.9 percent in CY24 against 39.5 percent in CY23
[20] Average OMOs injections amounted to Rs 1.7 trillion in CY24 against Rs 483 billion in CY23. Within CY24, average injections increased to Rs 2.0 trillion in H2 from Rs 1.4 trillion in H1.

SBP's ceiling facility with a higher frequency[21] particularly in H2CY24 requiring increased liquidity assistance.[22]

OMOs Injections and Mop-ups **Figure 2.13**



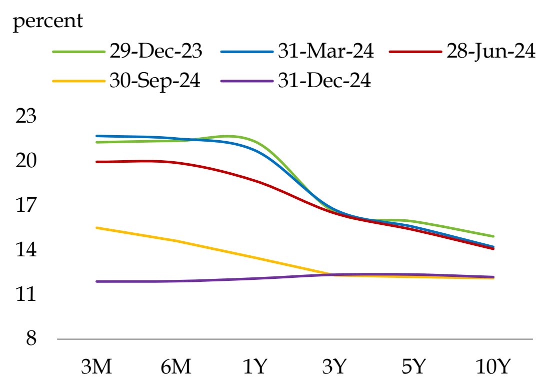
Source: State Bank of Pakistan

Similarly, during the periods of easy liquidity conditions, i.e., 88 instances of negative gap, banks availed SBP's floor facilities to park their excess liquidity temporarily.[23] A few banks, with excess liquidity, deployed their funds with central bank in view of declining trajectory of interest rates.

Yield curve shifted downward mirroring reversal in monetary policy course…

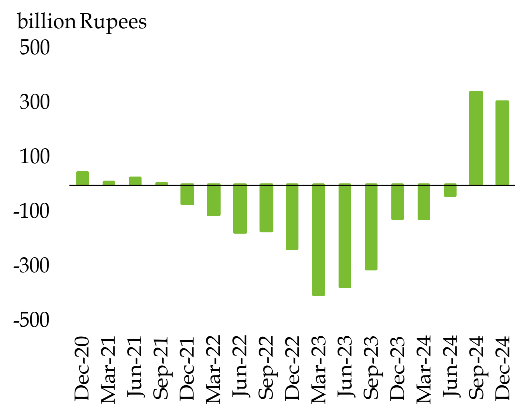
In line with softening of monetary policy stance, yield curve continued to shift downward since June 2024 (**Figure 2.14).** The Fair Value through Other Comprehensive Income (FVOCI) and Fair Value Through Profit and Loss (FVTPL) categories of government securities, which form more than 90 percent of the government securities of banks, are subject to mark-to-market adjustments. Banks had been incurring persistent revaluation deficit on these portfolios since December 2021. However, with a significant decline in yields (PKRV rates), value of government securities rose and total revaluation surplus of the banking sector reached Rs 307 billion in CY24 compared to a deficit of Rs 127 billion in CY23 (**Figure 2.15)**. Likewise, banks recorded gain on sale of government securities in FVTPL category, which increased to Rs 94.0 billion in CY24 as compared from Rs.6.0 billion in CY23.

Yield Curve **Figure 2.14**



Source: Mutual Funds Association of Pakistan

Surplus/Deficit on Revaluation of Securities **Figure 2.15**



Source: State Bank of Pakistan

[21] Banks availed liquidity assistance by 224 times in CY24—higher than 173 times in previous year. Within CY24, banks approached SBP 135 times in H2 against 89 times in H1.

[22] The average liquidity assistance amounted to Rs 111 billion against Rs 95 billion in CY23. Within CY24, the average liquidity assistance increased to Rs 119 billion in H2 from Rs 103 billion in H1.

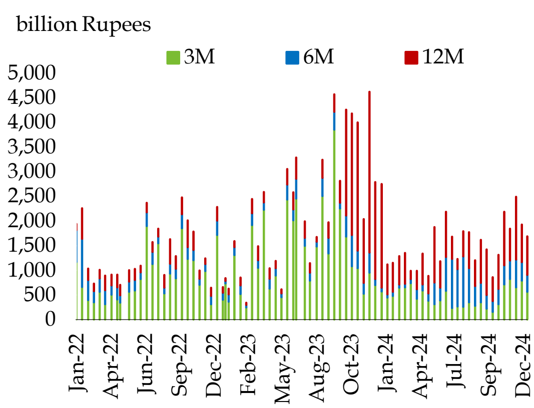
[23] The banks availed floor facility 246 times in CY24 (236 times in CY23) and parked, on average, Rs 273 billion with SBP against Rs 215 billion in CY23.

Accordingly, banks' interest tilted towards longer-tenure securities….

Though the securities with shorter repricing tenors, i.e. MTBs and floating rate PIBs and Sukuk, constituted substantial part of banks' investment portfolio, banking sector strategized to lock more of its funds in longer-tenure securities in order to preserve profitability in a declining interest rate environment. The government also had set a significantly lower target of financing to raise through MTBs in CY24.[24] Moreover, the government retired around Rs 1.3 trillion of Treasury bills through various buybacks in H2CY24, and mobilized resources through floating rate PIBs, especially semi-annual coupon bonds.

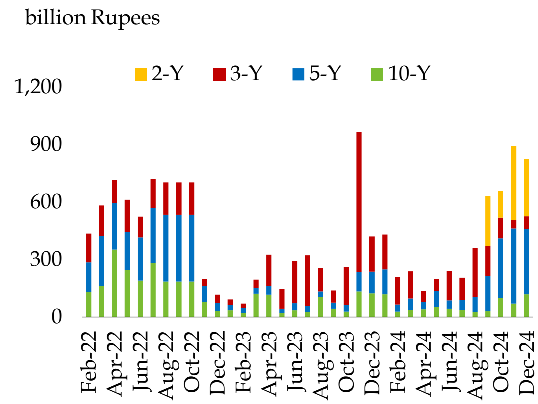
Banks' behavior in auctions shows that their preference for 6M and 12M treasury securities increased[25] in CY24 (**Figure 2.16).** Moreover, in case of fixed rate PIBs, banks offered increased funds in CY24 as compared to CY23 (**Figure 2.17).** In addition, banks took a significant interest in floating rate PIBs (semiannual) during the period under review as the government's target and acceptance for floating rate PIBs remained noticeably lower in CY24.[26]

Bidding Behavior in T-bills Auctions **Figure 2.16**



Source: Sate Bank of Pakistan

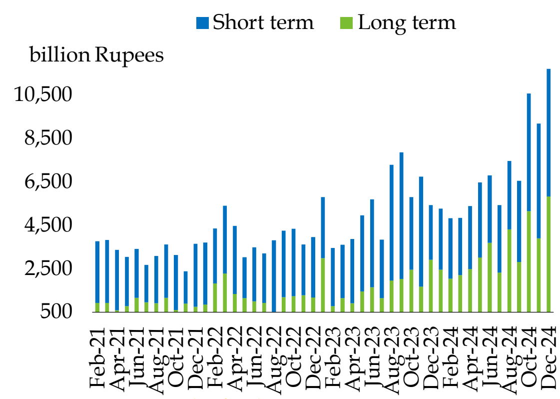
Banks' Bidding for Fixed Rate PIBs **Figure 2.17**



Source: State Bank of Pakistan

The secondary market dynamics remained in sync with primary market developments as the market participants increasingly traded longer-tenure securities. The total trading volume of government securities increased by 31.3 percent to Rs 85.0 trillion in CY24. The share of longer-tenor securities in total trading volume increased to 47.6 percent in CY24 from 32.8 percent in CY23 (**Figure 2.18).**

Secondary Market Trading **Figure 2.18**



Source: State Bank of Pakistan

[24] In CY24, total target for MTBs was Rs 12 trillion against Rs 30 trillion in CY23.

[25] In CY23, banks' offering in 3M treasury bills was 60 percent of the total funds offered for treasury bills auctions. In CY24, banks offered 30 percent of the total funds offered for treasury bills auctions. However, banks offered 23 percent (10 percent in CY23) and 47 percent (30 percent in CY23) of the total funds for 6M and 12M treasury bills in CY24.

[26] In case of semiannual PIBs, banks offered Rs 17 trillion against government target of Rs 7 trillion in CY24. The government accepted Rs 7.4 trillion. However, for quarterly PIBs, the target was Rs 1.5 trillion and the government accepted just Rs.61 billion.

Latest stress testing results suggest resilience of banking sector to market shocks

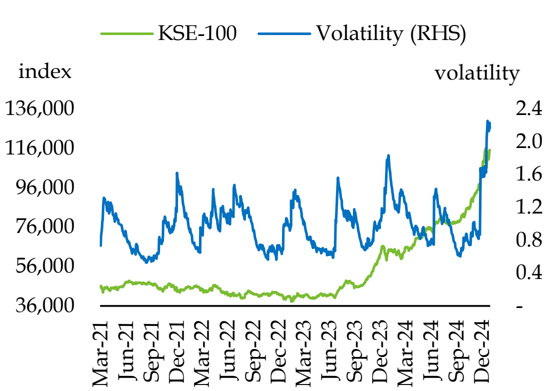
The results of sensitivity (stress testing) analysis show that under the most severe shock scenario (i.e. a parallel upward shift in the yield curve by 300 basis points), the CAR of the banks remains well above the minimum requirement (**for detail see the section on Market Risk in Chapter 3 on Banking Sector**).

2.3 Equity Market

KSE-100 index continued to rise with impressive momentum…

The surge in KSE-100 index which commenced in the second half of CY23 continued into the year under review, setting new records, albeit with elevated volatility (**Figure 2.19)**. The index witnessed a staggering growth of 84.4 percent, reaching at 115,127 level by end of the CY24 (54.5 percent growth in CY23).

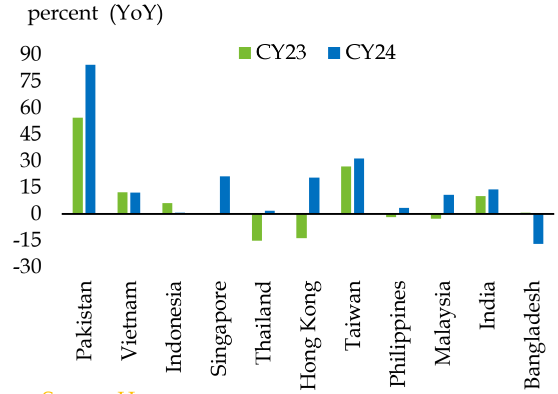
KSE-100 Index and its Volatility **Figure 2.19**



Source: State Bank of Pakistan

Accordingly, market capitalization increased by 59.9 percent (39.4 percent growth in CY23) to Rs 14.5 trillion at end December 2024. Within the year, the index averaged at 68,489 and 88,417, respectively, in H1 and H2 of the reviewed year. Moreover, domestic equity market continued to outperform regional peers for another year **(Figure 2.20).**

Regional Countries Equity Markets Performance **Figure 2.20**

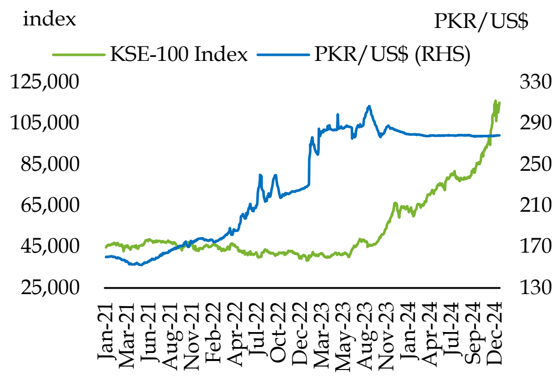


Source: Haver

In the first half of CY24, lower policy uncertainty, sharply receding inflationary pressures, and successful conclusion of IMF-SBA program largely triggered positive sentiments in the equity market. Particularly, the index jumped to 78,802 from 72,797 within a week (between June 12 –20, 2024), reflecting, inter alia, the first cut in policy rate after a period of prolonged monetary tightening.

In the second half, the rising investors' confidence was mainly driven by continued cycle of monetary easing amid increased disinflation momentum, securing fresh IMF program and improvement in the country's credit rating by Fitch and Moody's. In addition, stable rupee-dollar parity (**Figure 2.21),** backed by favorable external account position, remained crucial factors behind equity market performance throughout the year.

KSE-100 Index and Exchange Rate **Figure 2.21**



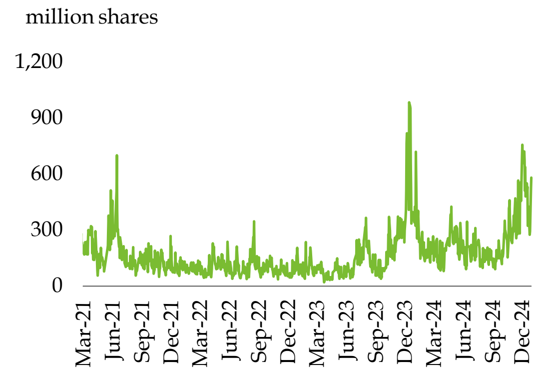
Source: State Bank of Pakistan

The renewed optimism in market sentiments was also reflected in the turnaround in Price to Earnings Ratio (P/E), which kept declining during previous years (**Figure 2.22**). P/E ratio averaged at 5.0 in CY24 compared to 4.2 in CY23 and 4.6 in CY22. With increased risk appetite, equity market witnessed higher trading during the year under review (**Figure 2.23**).[27]

Price to Earnings Ratio **Figure 2.22**

Source: Bloomberg

Trading Volume of KSE-100 **Figure 2.23**

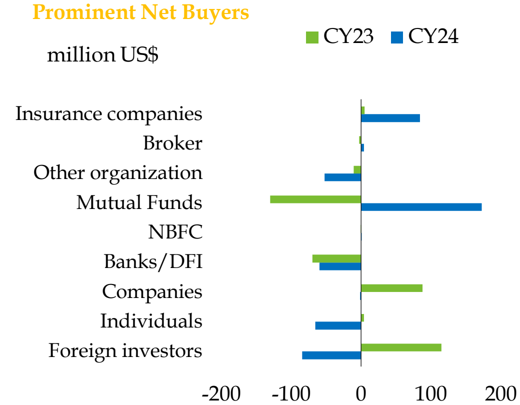


Source: Pakistan Stock Exchange

Mutual funds and insurance firms were the largest net buyers …

Mutual funds and insurance sector were largest net buyers of equities during CY24., (**Figure 2.24**). Amid declining interest rates and attractive stocks' valuations, mutual funds' investments in equities increased by 107.2 percent in CY24. However, their exposure in equities (as percent of their total assets) slightly increased to 9.5 percent from 9.1 percent in CY23, as a major chunk of mutual funds' assets (75.5 percent) was still concentrated in money market and income funds during CY24.

Mutual Funds and Insurance were Prominent Net Buyers **Figure 2.24**



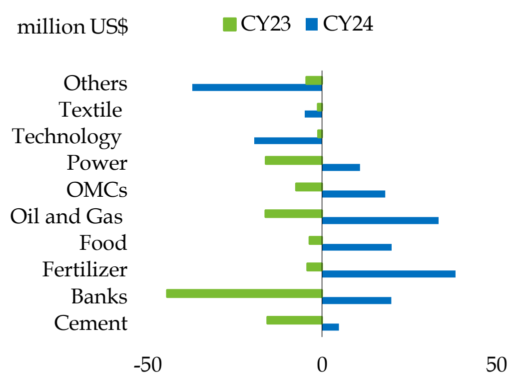
Source: National Clearing Company of Pakistan Limited

[27] Average daily trading volume increased to 252 million shares in CY24 from 164 million shares in CY23.

It is noteworthy that foreign investors were net sellers reducing their exposure worth US$ 84 million in the equity market despite improving macroeconomic conditions particularly amid stable Rupee-dollar parity. It was, as market reports suggests, on account of repositioning of a major foreign investor due to reclassification of Pakistan from secondary emerging to frontier market.[28]

Sector-wise analysis indicates that local investors took highest exposure in fertilizer sector followed by Oil & Gas and Oil Marketing Companies (OMCs) during CY24 (**Figure 2.25).**

Net Buying was Highest in Fertilizer Stocks **Figure 2.25**

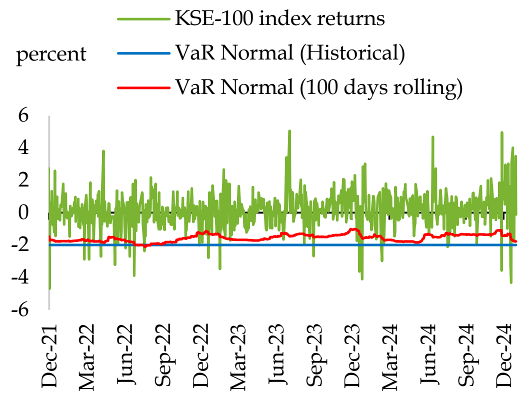


Source: National Clearing Company of Pakistan Limited

The risks in equity market remained at a relatively lower level….

Despite remarkable surge in equity prices, risks remained at a relatively lower level, in the context of historical average,[29] during CY24. The Value at Risk (VaR) analysis suggests that daily returns of KSE-100 index breached VaR Normal (100 days rolling) 15 times as compared to 13 times in CY23 (**Figure 2.26).**

Value at Risk of KSE-100 Index Returns **Figure 2.26**



Source: Pakistan Stock Exchange and SBP Staff

It is noteworthy that in the backdrop of a conservative regulatory regime of SBP, banks are maintaining a limited exposure to the equity market, which makes them less sensitive to volatility in equity market. Investment in equities stood at 3.4 percent of banks' regulatory capital at end December 2024 (6.8 percent in CY23). The latest sensitivity analysis (stress testing) results also suggest that even with a hypothetical shock scenario of 36.1 percent decline in equity prices (KSE-100 index), which is equal to historically highest quarterly decline in the index, most of the banks remain CAR compliant.

Going forward, the performance and stability dynamics of domestic financial markets will largely hinge on strength of economic recovery, political stability, government's ability to pursue the IMF EFF program and implement crucial economic reforms.

[28] On July 03, 2024, FTSE Russell announced reclassification of Pakistan from Secondary Emerging to Frontier Market status with effect from September 23, 2024 as Pakistan was unsuccessful in meeting the criteria of stock count. Please read the relevant article available at https://www.brecorder.com/news/40333204

[29] For the period CY01-CY24, the breach average is 16.