

"liquidity management via interest rate corridor in pakistan- and experience of o...

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STATE BANK OF PAKISTAN SUMMER INTERNSHIP PROJECT REPORT 2011 “

Liquidity Management via Interest Rate Corridor in Pakistan- and Experience of Other Countries’ Emerging Markets” Submitted to: Sir Mubarak By: Tooba Sarfaraz Rafia Parvez Sumbul Masood Introduction to State Bank of Pakistan: State Bank of Pakistan, the central bank of the country was established in July 1948 i. e. , within one year after Pakistan gained independence.

Being the central bank, it regulates the monetary policy and the credit system of the country to foster its growth in the best national interest with a view to secure monetary stability and to fully utilize the productive resources of the country. The bank’s operations also include preserving the value as well as maintaining stability in the Banking system. Vision: “ To transform the SBP into a modern and dynamic central bank, highly professional and efficient, fully equipped to play a meaningful role in sustainable basis in the economic and social development of Pakistan. ” Mission: To promote monetary and financial stability and foster a sound and dynamic financial system, so as to achieve, sustained and equitable economic growth and prosperity. ” Introduction to Domestic markets and monetary management department (DMMD): Domestic Markets and monetary management department was created in Sept 2006 as a result of comprehensive restructuring within State Bank of Pakistan with the objective of transforming the central bank into a dynamic institution more responsive to the growing sophistication in the financial markets. DMMD is an offshoot of the previous Exchange and Debt Management

Department (EDMD), which was established in Feb 2000. Vision: “ To

illustrate a proactive, professional and planned approach for effective

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management of exchange and debt markets so as to contribute towards accomplishment of exchange and monetary policy objectives. " Mission: DMMD strives to set performance benchmark within SBP and Pakistan's financial markets. Departmental goals: The core objective of DMMD is to implement the monetary policy objective of the State bank of Pakistan by using the available tools in both the money and foreign exchange markets.

Departmental objectives: * Monetary Policy Implementation: a. Maintenance of stable interest rates in inter-bank money market through proactive management of money market liquidity. b. Raising short term government debt and developing yield curve through auction of market treasury bills c. Proactive management of money market liquidity through open market operations d. Liquidity management through interest rate corridor system. * Exchange Rate Policy Management: a. Stable exchange rates and Forward premiums at appropriate /sustainable levels b.

Sale and purchase of third currencies at optimum prices c. Smooth and sufficiently liquid foreign exchange markets d. Optimal accumulation of foreign exchange reserves and forward portfolio * Reserve Management: a. Optimal utilization of reserve portfolio and maximum returns on investment of surplus reserves. Hiring of investment consultants and fund managers for optimizing returns. * Debt Management a. Domestic debt i. Developing the markets for government securities ii. Coordination between monetary and fiscal policies iii. Raising short term and long term domestic debt for the government v. Data base management of permanent and floating debts. b. External debt i. Monitoring and ensuring prompt payment of external debt

installments through state bank of Pakistan and commercial banks.

Introduction of an Interest Rate Corridor In order to reduce the volatility in short term interest rates and to bring more transparency in the implementation of monetary policy, State Bank of Pakistan has decided to introduce an interest rate corridor for the money market overnight repo rates. The corridor will operate through standing overnight repo / reverse-repo facilities (i. . floor & ceiling), setting a formal corridor for the money market overnight repo rates consistent with the monetary policy of State Bank of Pakistan. The salient features of the interest rate corridor are as follows: 1. The interest rate corridor will consist of two end-of-day Standing facilities offered by State Bank of Pakistan: Existing SBP 3-day Repo Facility will be renamed as SBP Overnight Reverse-Repo Facility, which will become the ' Ceiling'; and a new SBP Overnight Repo Facility to absorb excess funds from the market will serve as the ' Floor' of the corridor. . The procedure for availing the end-of-day financing facility from State Bank of Pakistan at the ' Ceiling' rate in case the market is short of funds will continue to be in accordance with the existing practices and instructions issued by State Bank of Pakistan from time to time in reference to the ' SBP 3 day Repo Facility (now renamed as SBP Overnight Reverse-Repo Facility) against Government of Pakistan Market Treasury Bills and Federal/Pakistan Investment Bonds. 3.

The overnight end-of-day standing repo facility at the ' Floor' rate will be available to scheduled banks and primary dealers which are left with excess funds in the interbank market. These funds can be placed with State Bank of Pakistan in the form of an overnight repo against Treasury Bills at the ??'Floor' rate. Some of the operational details are as under: a. Only

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scheduled banks and primary dealers will be eligible to place the funds at the ' Floor' rate with State Bank of Pakistan . This facility will only be available at the end of the day, when it can be ascertained that the market has excess funds. c. The time for intimating this amount to the State Bank of Pakistan will be between 2: 30pm to 3. 30pm from Monday to Friday and between 12: 00pm to 1. 00pm on Saturday. (Specimen format is enclosed). d. The minimum amount for the Overnight Repo/Reverse Repo Facility will be PKR. 100 million, and in multiples of PKR. 50 million thereof. e.

The Treasury Bills acquired under the Standing Overnight Repo facility from State Bank of Pakistan will be SLR eligible. 4. The ' Floor' and the ' Ceiling' rates (and the width of the corridor) will be advised by the State Bank of Pakistan from time to time as deemed necessary. 5. State Bank of Pakistan will continue to conduct term Open Market Operations (OMOs) in the form of repos/ reverse-repos as per current practice in addition to these standing facilities. 6. The interest rate corridor will be applicable from 17Aug, 2009. i.

MONETARY POLICY: Monetary policy is the mechanism or the process through which the government, the central bank or the monetary authority of any country controls or determines the (a) supply of money, (b) the availability of money, (c) the cost of money or the interest rate, keeping in mind the broad strategic objectives of the state regarding price level, growth and stability in an economy and the overall policies that supports or under which people would want to start businesses and provide employment.

When the incident of 9/11 happened, the overall economic environment of the world was affected very seriously and an impact of tightening monetary

policy also falls. After the incident the foreign investment shoot up and flow of money continuously increased, although the value of money was stabilized but it causes inflation in many countries as well as in Pakistan. The inflow of foreign remittances resulted in inflationary pressure.

In 2001, SBP revised its policy to control the flow of money. Since 2004, SBP in continuously issuing monetary policy statement biannually from Jan-June and second from July-Dec. TOOLS FOR IMPLEMENTING MONETARY POPLICY:

To implement its objectives , some tools are required: 1. Direct Instruments
2. Indirect Instruments DIRECT INSTRUMENTS: * Cash Reserve Requirements (CRR) * Statutory Liquidity Requirements (SLR) CASH RESEVE REQUIREMENTS (CRR):