

4 Money and Banking

4.1 Overview

Monetary policy remained tight throughout July-Feb FY06; while the benchmark 6-month T-bill rate was kept almost unchanged, SBP increased its interventions during the period to ensure that short-term inter-bank market rates remain close to the discount rate (see **Table 4.1**).

Table 4.1: Open Market Operations (OMOs)

	Jul-Feb	
	FY05	FY06
Number of OMOs	26	63
Number of injections	3	18
Number of absorptions	23	45
Average over-night repo rate	3.3	7.8
SBP repo (discount) rate	7.5	9.0
Coefficient of variation (overnight rates)	79	16

The higher inter-bank rates, amidst declining market liquidity and rising credit-deposit ratio of the banking sector, contributed significantly to the 196 basis point increase in the weighted average lending rate¹ during July-Feb FY06, and a consequent relative deceleration in non-government credit growth. Although credit growth remained strong at 18.1 percent during Jul-Feb FY06, it was substantially lower than the very high growth of 25.3 percent during Jul-Feb FY05. Thus, the lower monetary expansion during the period was contributed principally by the slowdown in non-government credit growth, and depletion in banking system NFA (see **Table 4.2**).

Table 4.2: Composition of Money Supply (Jul-Feb)

	Flows (billion Rs)		Contribution to M2 growth	
	FY05	FY06	FY05	FY06
1. Credit to non-government sector	305.6	310.8	12.3	10.5
2. Government borrowing	2.7	116.7	0.1	3.9
3. NFA	43.5	-80.8	1.8	-2.7
Sub total(2+3)	46.2	35.9	1.9	1.2
4. OIN	-80.3	-90.6	-3.2	-3.1
5. M2	271.5	256.1		

It should be noted that while there is a very large jump in government borrowings during the period significantly raising the impact on M2 growth relative to FY05, this was partly due to the relief spending needs of the earthquake affected areas, retirement of long-term government paper (PIBs and FIBs), and less than

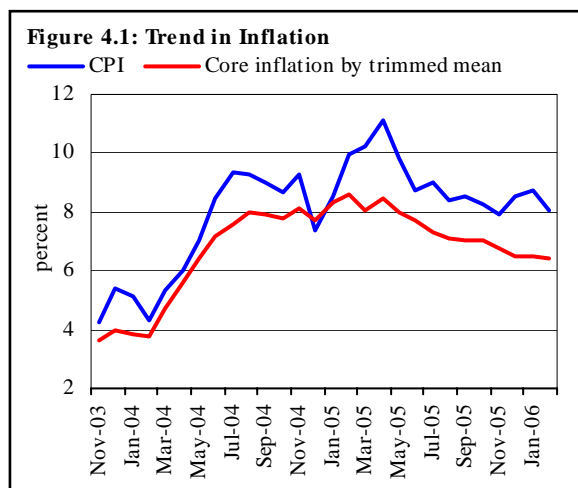
¹ One contribution to this will also be from changes in the profile of the credit growth. For example the increasing share of more expensive loans e.g. personal loans, agri-loans, etc. in total fresh disbursements would also push the weighted average lending rate for the period.

anticipated receipts from NSS instruments. All of the government borrowings for budgetary support were from the SBP.²

However, as seen in **Table 4.2**, the net contribution of government borrowings and changes in the NFA on M2 growth is little changed from the previous year. Moreover, as anticipated external receipts materialize, a part of the decline in NFA of the banking system caused by the external account deficits will reverse, and there will also be an offsetting fall in government borrowings from the banking system. Such a development would thus not have a material change on overall M2 growth for the full year.

Thus, it is anticipated that the dominant impact on the projected slowdown in overall FY06 M2 growth, from 19.3 percent in FY05 to an estimated 14.3 percent in FY06,³ will emerge from a relative slowdown in non-government (and particularly, private sector) credit. As a consequence, the FY06 money growth is projected to be slightly below the rise in nominal GDP for the first time since FY02.

Despite evidence of the slowdown in credit off-take relative to last year (which saw exceptionally high growth in net credit off-take) and a visible weakening in manufacturing growth, the SBP monetary policy stance has come under debate. Ironically, this centers on a very welcome weakness in inflationary pressures, and particularly the deceleration in core inflation (see **Figure 4.1**). On the one hand, some stakeholders (including manufacturers and exporters) point to the fall in inflation and stress the need to immediately lower interest rates to reduce the cost of production and investment in order to strengthen growth. On the other hand, the SBP is also exhorted by other stakeholders to tighten its monetary posture even further, by increasing rates immediately. It is argued that



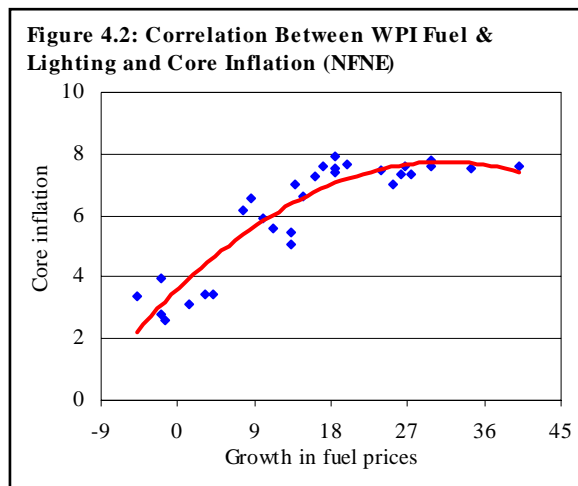
² A part of the higher borrowings from the banking system may also reflect lags in the realization of anticipated external receipts.

³ SBP projections

this is needed to reduce inflation to the low single digits, support long-term growth, and curb speculative pressures (alleging that asset bubbles have been created and need to be pricked), even at the risk of substantially depressing economic activities in the short-term. Both arguments merit some consideration.

The problem with the first argument is simply that despite the decline, domestic inflation rates remain relatively high and, while slowing, FY06 real GDP growth is also expected to remain strong, at over 6 percent. At present, it can be argued that given the monetary overhang of the preceding years, a premature easing of monetary policy runs the risk of reversing the downtrend in inflation, and that any financial savings as a result of lower interest rates could therefore be quickly eaten up by a rise in the cost of inputs. It must also be remembered that deposit growth (and indeed, the national savings rate) have already weakened in FY05 and FY06.⁴ In light of the above, and the emerging competition for deposits, it therefore seems prudent for the central bank to retain its tight monetary stance until inflationary pressures decline further.

The argument against a *further* immediate increase in interest rates is more nuanced, and the answers are less clear. A seemingly obvious answer would be that interest rates need not to be raised further given that inflation has fallen, and the trend seems likely to continue for some months ahead. However: (1) the resurgence in the CPI inflation during Dec-Jan FY06 was largely on account of the supply side factors and base affect, as the non-food non-energy inflation registered further deceleration during Jul-Feb FY06⁵. During February 2006, however, both the food and non-food inflation registered a downtrend and the overall CPI inflation declined to 8.05 percent; (2) although the core inflation has declined marginally from its peak level of 7.9 percent witnessed in April 2005 to 7.3 percent in



⁴ This means that the country will be hard pressed to meet its growing investment requirements through domestic savings, with attendant costs in terms of a widening current account deficit, slower growth, and eventually, higher inflation.

⁵ See SBP publication "Inflation Monitor" February 2006 for further details.

January 2006, this seems to be the result of lagged pass through of higher fuel prices on the core inflation. It may be pointed out that, although the core inflation excludes energy and food components, it shows strong correlation with fuel components in both the CPI and WPI (see **Figure 4.2**). Since domestic fuel prices have not changed since last few months it is likely that core inflation will show a more significant decline going forward, *ceteris paribus*.

However, given the potential for reigniting inflation (particularly as increasing trade and fiscal imbalance, as well as the persistent high fuel prices may not allow inflationary expectations to weaken significantly), and the potential buildup of asset bubbles, a decision to sustain the current monetary stance must center on the SBP's statutory responsibility to sustain both, price stability *and* growth, in the economy. Indeed, while there is some evidence of a slowdown in the commodity-producing sectors, and particularly large-scale manufacturing, this seems to be driven more by factors other than a very substantially slowdown in demand (e.g. capacity constraints). Finally, on the risk of asset bubbles, it must be recognized that these are notoriously hard to define *ex-ante*, and there is also a considerable controversy in economic literature on the appropriate policy response.⁶

On balance, based on the above discussion there seems to be little room for a reduction in the interest rates through the remaining months of FY06, and indeed there is some support for a policy bias towards a further tightening of the monetary stance. In accordance with the Monetary Policy Statement for Jan-Jul FY06, the SBP will therefore continue to monitor economic developments, particularly the trends in inflation, with a view to containing inflationary pressures without significant prejudice to growth.

4.2 Monetary Survey

Money supply registered an increase of Rs 256.1 billion during Jul-Feb FY06 compared with an increase of Rs 271.5 billion in the corresponding period of FY05 (see **Table 4.3**). The entire Jul-Feb FY06 increase was attributed to a strong growth of Rs 336.9 billion in the banking sector NDA as the NFA registered a net decline of Rs 80.8 billion due to rising trade imbalances and delay in external finance receipts

4.2.1 Net Domestic Assets

Net domestic assets registered a robust growth of 14.46 percent during Jul-Feb FY06 compared with the growth of 11.98 percent during Jul-Feb FY05 mainly due to a sharp rise in government sector borrowing. Expansion in credit to private

⁶ This is particularly true if the bubbles are restricted to small components of the economy.

sector (Rs 310.6 billion) was only slightly lower than Rs 322.5 billion witnessed in the corresponding Jul-Feb FY05.

Government Borrowing for Budgetary Support

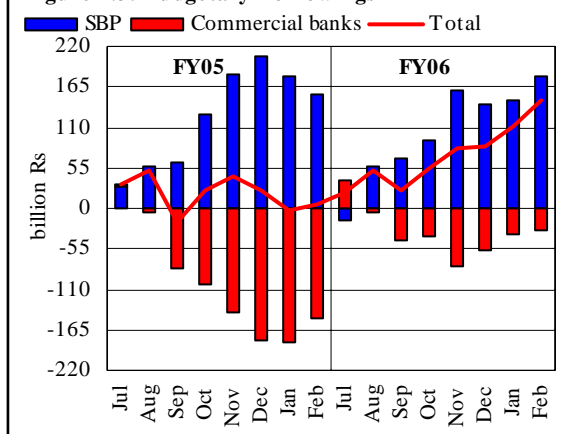
Government borrowing for budgetary support registered an increase of Rs 147.2 billion during Jul-Feb FY06 compared with an increase of Rs 5.0 billion in the corresponding period of the previous year (see **Figure 4.3**). The larger FY06 borrowings are explained mainly by: (1) increased government expenses on account of earthquake relief related activities; and (2) the shift in composition of budgetary finance.

Specifically, 54.2 percent of the full FY05 estimates of external finance were realized during H1-FY05 as the disbursements of loans from ADB and IDB and the receipts against the issuance of *sukuk* were realized during the period. This allowed the government to retire banking sector borrowings (see **Table 4.4**). In contrast, during H1-FY06 external finance receipts have been quite low, with 32.7 percent of the full year estimates being realized. As a result, the government borrowings from the banking sector have increased sharply, breaching the full year target by end-February 2006.

Table 4.3: Monetary Survey (Flows During Jul-Feb)
billion Rs

	Credit plan for FY06		
	FY06	FY05	FY06
M2 (I+II)	380.0	271.5	256.1
<i>growth in percent</i>		10.9	8.6
Reserve money	118.8	87.2	
<i>growth in percent</i>		15.4	9.6
I. NDA (A+B+C)	365.0	228.0	336.9
SBP		138.5	130.4
Scheduled Banks		89.5	206.5
<i>of which</i>			
A. Government borrowing	120.0	2.7	116.7
(i) Budgetary support	98.0	5.0	147.2
SBP		155.0	178.2
Scheduled Banks		-150.0	-31.0
(ii) Commodity operations	20.0	-3.5	-29.2
B. Credit to non-govt sector	320.0	305.6	310.8
Private sector	330.0	322.5	310.6
PSEs	-10.0	-10.8	1.4
C. OIN	-75.0	-80.3	-90.6
SBP		-10.8	-45.9
Scheduled Banks		-69.5	-44.7
II. NFA	15.0	43.5	-80.8
SBP		-31.7	-42.5
Scheduled Banks		75.2	-38.3

Figure 4.3: Budgetary Borrowings



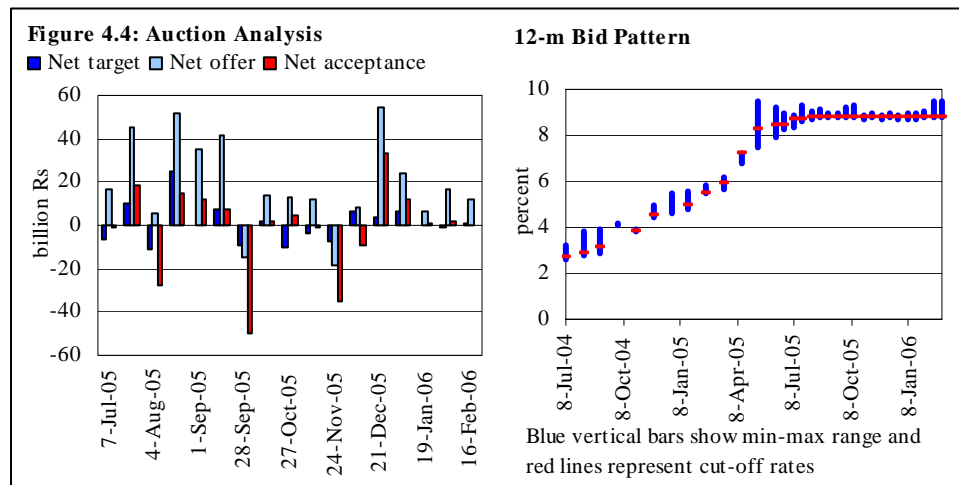
Going forward, however, the government sector borrowing from the banking sector is likely to witness some retirements as the external finance receipts are expected to rise sharply. As a result, government borrowing from the banking sector is likely to fall to the annual FY06 target by the year-end.

Table 4.4: Deficit Financing (Jul-Dec)¹

billion Rs	Budgetary		
	FY05	Est.FY06	FY06
External	40.4	121.6	39.8
Non-bank	15.7	55.4	-6.7
Privatization proceeds	6.8	20.0	18.7
Sub-total	62.8	197.0	51.8
Total financing requirement	79.6	285.0	136.7
Banking system	16.8	88.0	84.9

Source: Ministry of Finance (MoF), quarterly data.

¹ The MoF and SBP numbers differ due to differences in timings and definitions



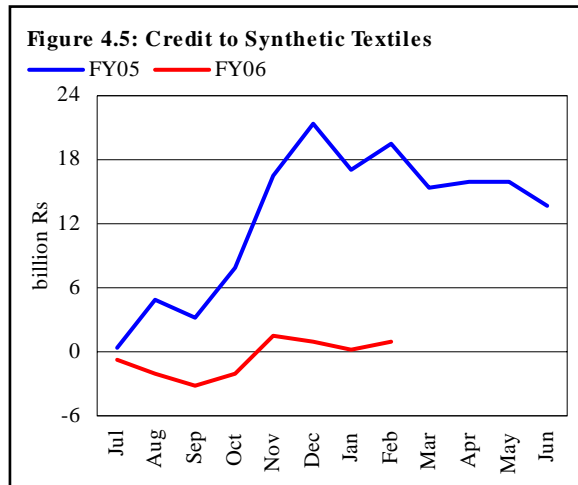
The composition of budgetary borrowings from banking system during Jul-Feb FY06 was similar to that of Jul-Feb FY05⁷. In both the periods, commercial banks registered net retirements, and the government’s budgetary requirements were funded by the SBP (see **Figure 4.4**).

Private Sector Credit

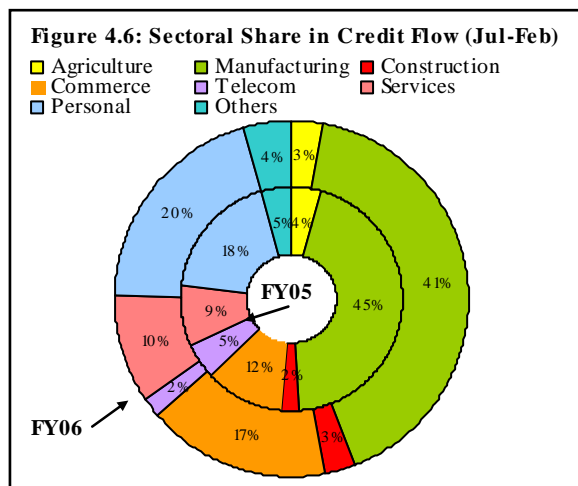
Private sector credit witnessed a deceleration during Jul-Feb FY06, increasing by Rs 310.8 billion (18.1 percent YTD) compared with Rs 322.5 billion (25.3 percent YTD) in the corresponding period of FY05.

⁷ However, it is imperative to mention here that the accounting practice of OMO transactions has been different during the two periods, i.e., Jul-Feb FY05 and FY06. In specific terms, in the older format, the OMO transactions used to shift the claims between SBP and commercial banks. However, from July 2005, these transactions are reflected only in other items net.

This slowdown looks a natural outcome of the constrained liquidity with the banks and the rising lending rates. However, some industry-specific factors also had a significant contribution. In specific terms, slowdown in credit growth was also contributed by; (1) the slowdown in credit off take by the local synthetics textile industry during Jul-Feb FY06 compared with Jul-Feb FY05 (see **Figure 4.5**)⁸. This was



because, during FY06, government reduced customs duties on fibers and man-made/blended yarns to promote the growth in textile industry⁹. As a result, imports of these products displaced local production¹⁰. This translated into a lower demand for credit by the domestic industry. (2) Slower growth in credit to telecommunication industry. This was because a multinational cellular company borrowed heavily from the banking sector during FY05 for fixed investment purposes to start its operations in Pakistan. With these one-off credit requirements absent in FY06, net credit disbursements to the telecommunication sector were understandably lower.



The sectoral distribution of the credit shows that personal and the commerce sector saw large increases in their respective share in incremental credit during Jul-Jan FY06 compared with that

⁸ January figures are the latest available.

⁹ Custom duties declined to 6.5 percent on fibers (from 10-20 percent on various categories) and 14 percent on fabrics of all man made yarns and blended yarns from 25 percent.

¹⁰ The import of synthetic fiber and synthetic yarn witnessed a growth of 64.3 and 55.0 percent during Jul-Jan FY06 over Jul-Jan FY05.

in the corresponding period of FY05 (see **Figure 4.6**).

While credit to commerce sector is reflective of the increase in trade related activities, the growth in consumer finance shows: (1) a weak responsiveness of consumer credit demand to interest rates; and (2) banks' interest in lending to this sector because of higher margins and a relatively low probability of default. Specifically, consumer loans have, at present, one of the smallest infection ratios as only 1.2 percent of total consumer credit portfolio is non-performing (see **Table 4.5**).

Although the manufacturing sector had the largest share in incremental credit in both the periods, its share has declined significantly during FY06.

The share of the construction industry has doubled in the incremental credit during FY06 reflecting the continuous growth in construction related activities in the country. Within the consumer finance sector, the major increases in incremental credit were registered in the credit cards and personal loans (see **Table 4.6**).

Similarly, while auto loans constituted the largest portion in the incremental consumer credit during Jul-Feb FY06, it registered a negative growth over Jul-Feb FY05. This slowdown seems partially the outcome of SBP's directive to banks (during January 2005) not to finance the premiums¹¹, and partially the impact of rise in lending rates. Interestingly, however, auto sales do not show any

Table 4.5: Segment-wise NPLs to Loan Ratio (percent)

	Sep-04	Dec-04	Mar05	Jun-05	Sep-05	Dec-05
Corporate	14.0	10.9	9.9	8.9	8.9	7.0
SME	10.9	10.6	10.2	13.1	13.1	11.6
Agriculture	38.1	38.2	34.3	37	33.3	31.1
Consumers	0.8	0.9	0.8	0.9	1.0	1.2
Credit cards	2.1	2.2	1.5	1.4	0.9	0.8
Auto loans	0.6	0.9	0.7	0.7	0.9	0.9
Durables	7.9	6.2	6.4	6.2	5.2	7.8
Mortgage	0.4	0.4	0.5	0.3	0.3	0.6
Personal	0.6	0.7	0.6	1	1.2	1.7
Commodity financing	1.0	1.1	1.3	1.2	1.3	1.2
Staff	1.4	1.4	1.4	1.4	1.3	1.0
Others	19.1	20.0	13.4	16.9	15.4	23.5

Table 4.6: Consumer Finance During Jul-Feb

	Increase (billion Rs)		
	FY04	FY05	FY06
House building	1.6	11.4	8.3
Auto finance	1.6	29.1	20.8
Credit cards	4.0	2.6	9.4
Consumer durables	1.0	-0.7	0.5
Personal loans	14.0	17.7	17.7
Others	6.5	-9.1	-0.1
Total	28.7	51.1	56.6

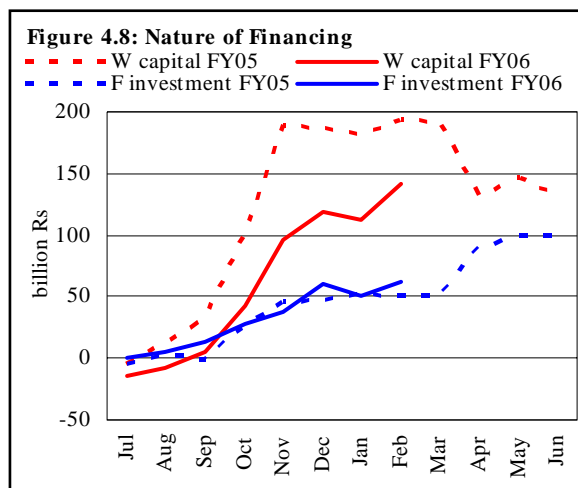
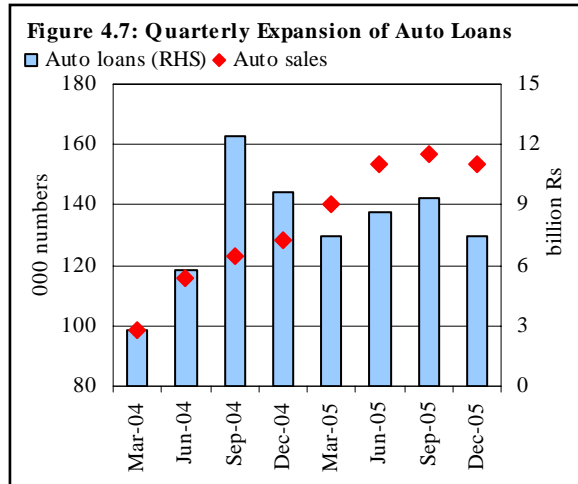
¹¹ This view perhaps can be strengthened by a sharp decline in incremental average auto loan size (increase in number of loans divided by increase in number of accounts) from Rs 1.31 million during Jul-Dec FY05 to 0.39 million during Jan-Jun FY05.

slowdown, possibly indicating a switch to cash purchases and increased car financing by NBFIs and other institutions (see **Figure 4.7**).

Most of the business sector credit growth has been for working capital requirements (see **Figure 4.8**). Indeed, it was the decline in working capital requirements, mainly of the synthetic textile industries that contributed to the lower rise in overall private sector credit growth during July-Feb FY06. The increase in fixed investment loans, on the other hand, was slightly larger than the corresponding period last year. Major sectors that registered an increase in fixed investment loans were cotton, woolen and made up textiles, sugar, cement, and domestic appliances industries.

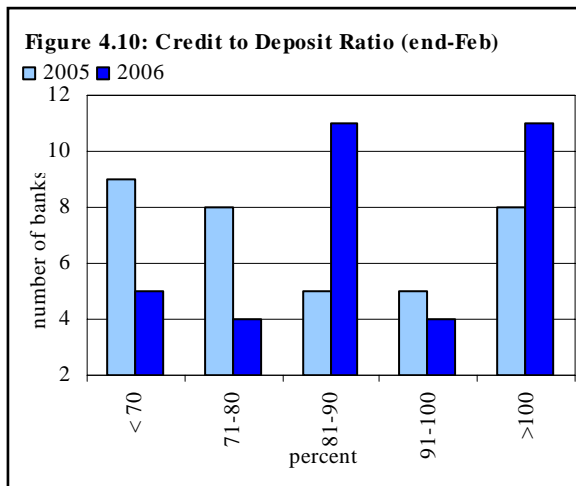
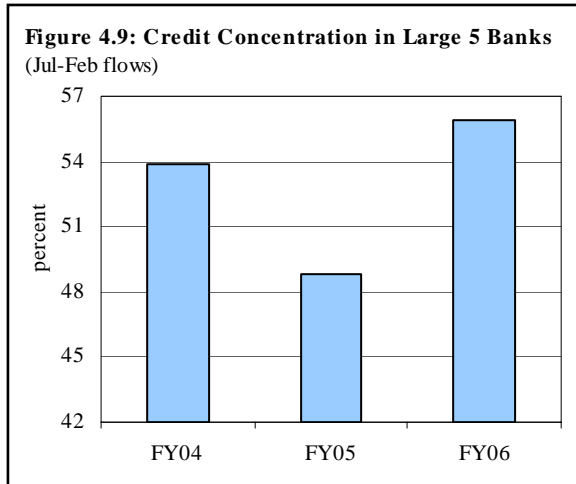
Banks' Concentration

Bank wise data shows that the share of the large five banks in the incremental credit has increased from 48.8 percent during Jul-Feb FY05 to 55.9 percent during FY06 (see **Figure 4.9**). As a result, the institutional concentration in lending activities has increased. This can be attributed to: (1) rising credit to deposit ratio, especially of the private sector banks and (2) the banks' response to capital requirements. Specifically, due to strong, sustained credit growth, the average credit to deposit ratio¹² of the banking industry has risen substantially in the preceding three years. The trend has



¹² Credit includes; (1) private sector credit; (2) private sector investment (banks' investment in stocks and private sector bonds); (3) loans for commodity operations; and (4) loans to PSEs and autonomous bodies. Whereas deposits include all bank deposits including the government sector deposits.

continued into Jul-Feb FY06 also, with the ratio rising to 82.0 percent on average. This translates into a weakening of banks' ability to lend aggressively, and is most evident in domestic private banks, some of which have credit to deposit ratio in excess of 100 percent (see **Figure 4.10**). While the credit to deposit ratio of the big five banks is still relatively lower, it should be noted that it too has also increased sharply during FY06 and, for the first time in last five years, is now close to the industry's average (see **Figure 4.11**).



In addition to the liquidity constraints, more stringent capital adequacy requirement might also have curtailed the ability of the smaller banks to contribute significantly in the credit expansion. In fact, as per the new requirements, banks have to maintain

capital to risk weighted assets between 8 to 14 percent depending upon their IRAF¹³ rating; and one approach to achieve the capital adequacy standards is to bring down the share of credit in total assets.

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¹³ Institutional Risk Assessment Framework.

Credit Quality

It should be noted that despite the aggressive lending to the private sector, there is little evidence of the deterioration in the quality of banks' assets (see **Table 4.7**). The ratio of non-performing loans to total advances has declined to 2.4 percent at end December 2005 compared with 3.0 percent as at end June 2005 and 3.6 percent as at end December 2004, possibly

suggesting the impact of better credit appraisal practices by the banks and favorable economic conditions.

4.2.2 Net Foreign Assets

The NFA of the banking system registered a decline of Rs 80.8 billion during Jul-Feb FY06 compared with the net increase of Rs 43.5 billion in the corresponding period of FY05. The FY06 decline in NFA has been the result of the widening trade deficit, that resulted in massive outflows of foreign assets from the domestic economy (see **Figure 4.12**), as well as the lower net receipts of external financing.

Within the banking system, both the SBP and the scheduled banks contributed to the overall decline in NFA.

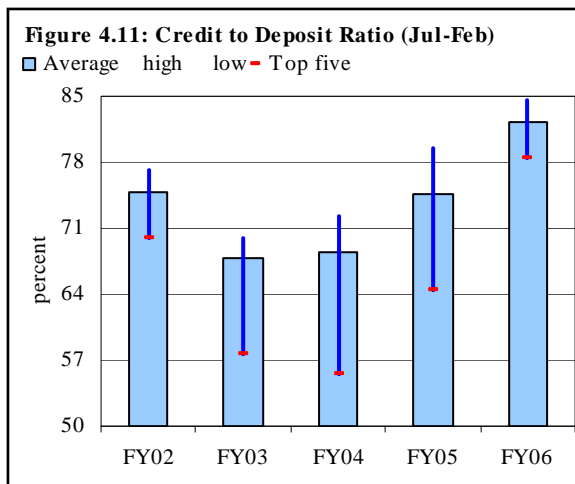
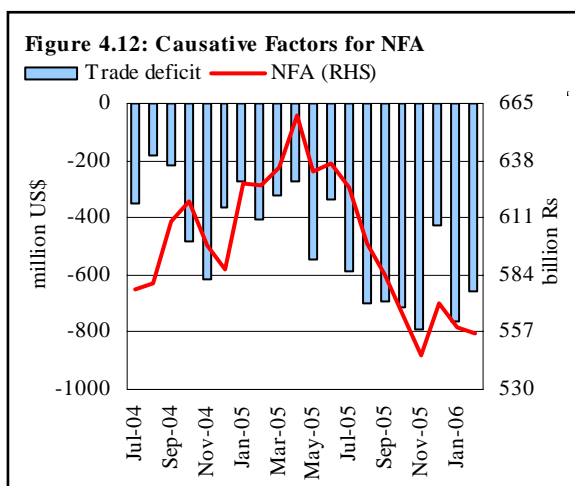


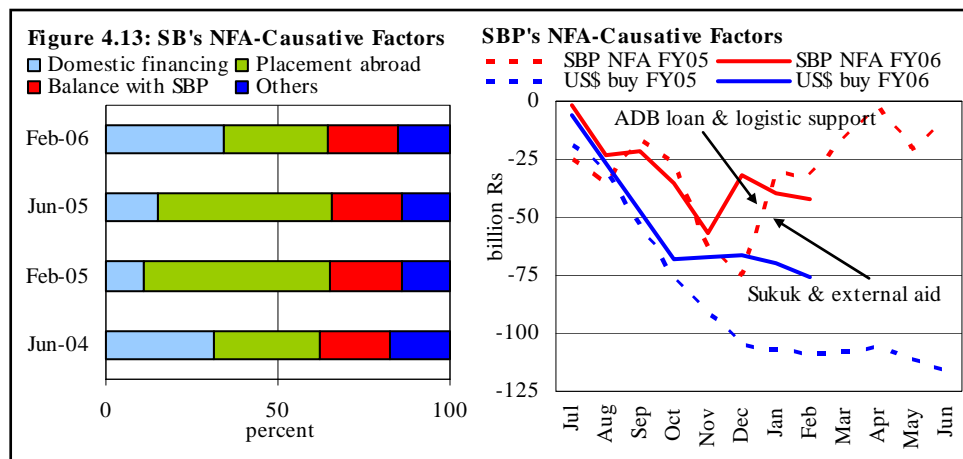
Table 4.7: Credit Quality Indicators (end-Dec)

	NPLs / loan (gross)		NPLs / loans (net*)	
	Dec-04	Dec-05	Dec-04	Dec-05
All banks	11.6	9.0	3.6	2.4
Commercial banks	9.1	6.7	2.7	1.5
Public sector banks	13.5	9.8	3.6	1.2
Private sector banks	9.0	6.5	2.8	1.8
Foreign banks	1.6	1.4	0.0	-0.6
Specialized banks	52.9	53.2	26.3	28.5

* net of provisioning



The decline in SBP NFA is quite in line with the volume of its interventions in the forex market to reduce exchange rate volatility, while the decline in scheduled banks' NFA is the outcome of the expectations of a stable exchange rate that resulted in a robust growth in trade related lending against FE-25 deposits (see **Figure 4.13**).



4.3 Reserve Money

Reserve money growth registered significant deceleration during FY06 and increased by Rs 87.2 billion (9.59 percent) during Jul-Feb FY06 compared with an increase of Rs 118.7 billion (15.37 percent) during Jul-Feb FY05. This deceleration is attributed to a slowdown in both SBP NDA and SBP NFA during the latter period.

In particular, the decline in SBP NFA during Jul-Feb FY06 was considerably larger than decline during Jul-Feb FY05. This was on account of lower inflows under program loans (mainly from ADB and World Bank) during Jul-Feb FY06 compared with Jul-Feb FY05. The slowdown in SBP NDA, despite higher government borrowings from SBP during Jul-Feb FY06, was attributed to a sharp decline in SBP OIN during Jul-Feb FY06 compared with Jul-Feb FY05.

4.4 Components of Money Supply

The slowdown in M2 during Jul-Feb FY06 is reflected in its components as the growth in total deposits of the banking sector and the currency in circulation has registered a slowdown during Jul-Feb FY06 compared with Jul-Feb FY05.

However, it is encouraging to see that the currency to deposit ratio has remained lower during the former period reflecting partially the increase in weighted

average deposit rates (from 1.6 percent on average during Jul-Feb FY05 to 3.9 percent during Jul-Feb FY06) (see **Figure 4.14**).

The slowdown in deposit growth was entirely due to the deceleration in growth of foreign currency deposits. Specifically, during most of Jul-Feb FY05, the upward pressures on exchange rate (on account of increased oil payments) and the

expectations of the Rupee depreciation made foreign currency deposits-FCDs rather attractive. Therefore, around 20.4 percent of total mobilization was comprised of FCDs during that period. However, during Jul-Feb FY06, FCDs constitute 8.3 percent of total deposit mobilization reflecting the expectations of exchange rate stability. Within the FCDs, the growth in deposits denominated in US dollars registered major slowdown whereas those denominated in Euro witnessed a sharp growth.

