4 Money and Banking

4.1 Overview

Q1-FY06 witnessed a monetary contraction, with M2 declining 0.35 percent in the period, in contrast to the 1.2 percent increase seen in Q1-FY05 (see **Figure 4.1**). This decline was dominated by a reduction in the NFA of the banking system, reflecting the increasing pressure on the country's external account, as NDA growth was relatively strong due to an increase in government borrowings for budgetary support and strong growth in private sector credit.

Figure 4.1: Money Supply during FY06-cumulative

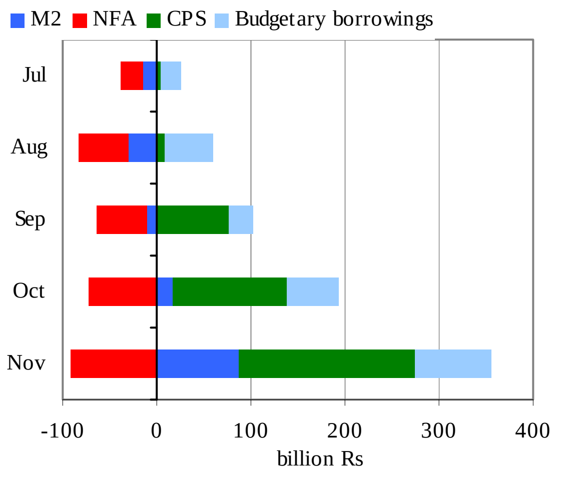
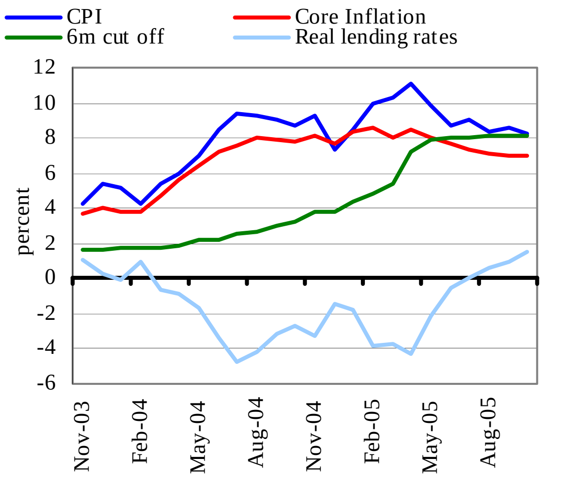
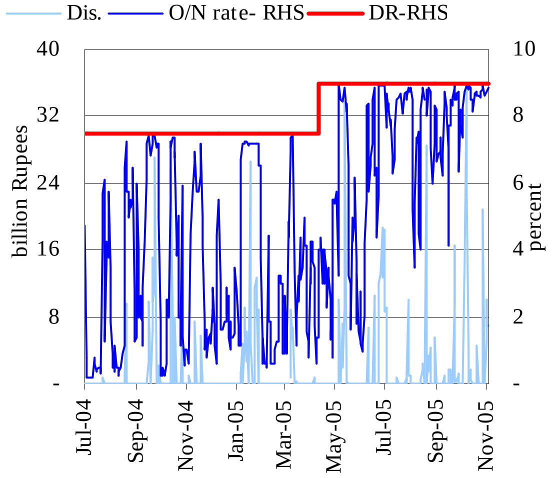


Figure 4.2: Monetary Policy Indicators



The lower growth in M2 together with the fall in CPI inflation from its 11.1 percent peak of April 2005 to 8.5 percent in September 2005, and the end of the steep uptrend in core inflation, together with the anticipated further lagged impact of earlier monetary tightening, were instrumental in SBP's decision to hold interest rates relatively unchanged through Q1-FY06 (see **Figure 4.2**). While keeping benchmark rates unchanged however, the SBP continued with the tight monetary posture by improving its inter-bank liquidity management (see **Figure 4.3**).

Figure 4.3: Overnight Rates and Discounting



Specifically, despite the negative growth in banks' deposit base and the absorption of Rupee liquidity on account of the substantial SBP forex interventions, the central bank continued with OMO operations to mop up any excess liquidity created as a result of the maturities of government securities.

However, the outlook of the monetary aggregates changed significantly from October 2005 onwards. In particular, private sector credit and government borrowing from the banking system both began rising strongly, with private sector credit expansion outpacing the monthly credit growth during the corresponding period of FY05[1]. As a result, during July-Nov FY06, the banking sector NDA registered a growth of 7.6 percent compared with the growth of 6.4 percent in the corresponding period of FY05. Indeed, the resulting increase in NDA offset the continuing decline in NFA, and therefore the money supply registered a sharp rise during Oct-Nov FY06, pushing the cumulative M2 growth during July-Nov FY06 to 3.0 percent as compared to the 5.5 percent rise in July-Nov FY05.

Given that the relatively subdued M2 growth in July-Nov FY06 is owed entirely to the sharp drawdown in the net foreign assets, (i.e. domestic demand has not slowed substantially), and the likelihood that this negative trend in NFA would halt or reverse in coming months (due to inflow of earthquake related foreign assistance), the SBP would need to be extremely careful to ensure that money supply growth remains consistent with long-term non-inflationary growth.

[1] During October and November 2005, private sector credit registered a growth of Rs 108.2 billion; compared with the growth of Rs 99.0 billion during October and November 2004.

4.2 Monetary Survey

The money supply recorded a growth of 3.0 percent during Jul-Nov FY06 compared with a robust growth of 5.5 percent in the corresponding period of FY05. This slow growth emanated entirely from a sharp decline in the NFA of the banking system that partially offset the robust growth in NDA during the period.

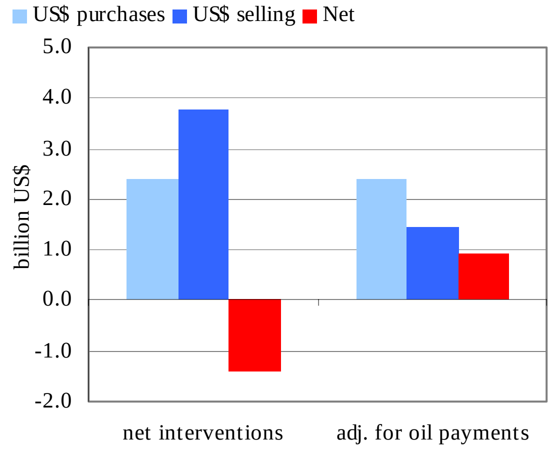
Table 4.1: Monetary Survey (Flows)
in billion Rupees

	Credit PlanFY06	Jul-Nov FY05	Jul-Nov FY06
Monetary assets	**380.0**	**137.2**	**88.2**
Net Foreign Assets (NFA)	**15.0**	**15.1**	**-90.5**
SBP		-62.6	-57.0
Scheduled Banks		77.7	-33.5
Net Domestic Assets (NDA)	**365.0**	**122.0**	**178.7**
SBP		161.9	121.3
Scheduled Banks		-39.8	57.4
of which			
Government borrowing	**120.0**	**45.7**	**65.3**
budgetary support	**98.0**	**42.8**	**81.6**
SBP		183.3	161.0
Scheduled Banks		-140.5	-79.4
Commodity operations	**20.0**	**1.3**	**-15.5**
Credit to non-govt sector	**320.0**	**146.7**	**182.6**
Private sector	330.0	164.7	185.8
PSEs	-10.0	-13.4	-1.6
Other Items (Net)	**-75.0**	**-70.3**	**-69.2**
SBP		-17.6	-38.1
Scheduled Banks		-52.7	-31.1

4.3 Net Foreign Assets

Unlike July-Nov FY05, when only the NFA of SBP had declined, the fall in the NFA of the banking system during July-Nov FY06 was visible in both the NFA of the SBP as well as that of the scheduled banks (see **Table 4.1**).

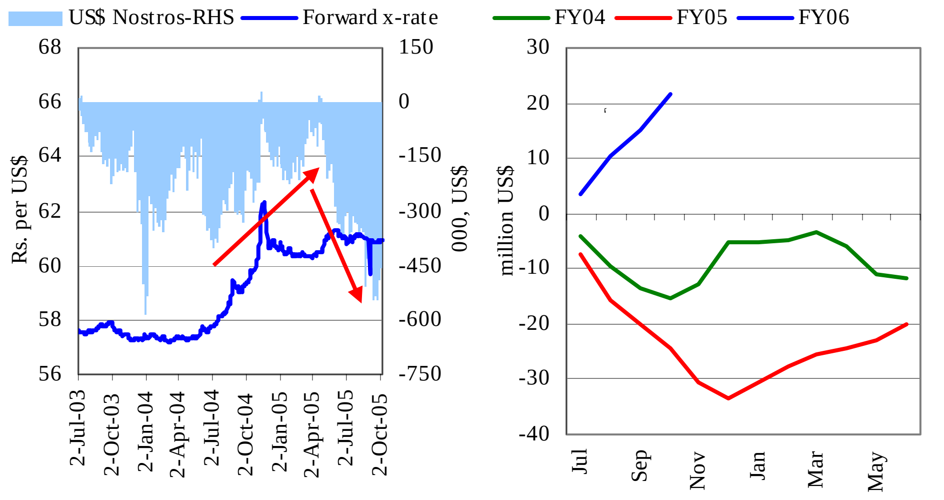
Figure 4.4: SBP's Interbank Interventions (Jul-Nov)



The decline in SBP NFA, in both periods, was mainly due to the continuation of the decision to provide foreign exchange to meet large outflows resulting from imports of some key commodities, so as to reduce market volatility. This can be seen from the fact that SBP sold US dollars worth Rs 141.4 billion in the inter bank market only for oil payments. Adjusting for these, it is seen that SBP has actually been a net purchaser of foreign exchange in the inter bank market (see **Figure 4.4**).

Ironically, the relatively stability of the exchange rate due to the SBP's interventions, may have contributed to the decline in the NFA of scheduled banks, by encouraging a sharp rise in foreign currency loans, even as continuing pressure of import payments led to a decline in banks' nostro balances (see **Figure 4.5**). In sharp contrast, during Jul-Nov FY05, the expectations of exchange rate appreciation had led to a rise in FE-25 deposits and had induced the retirement of foreign currency loans.

Figure 4.5: Exchange Rate Expectations



4.4 Net domestic assets-NDA

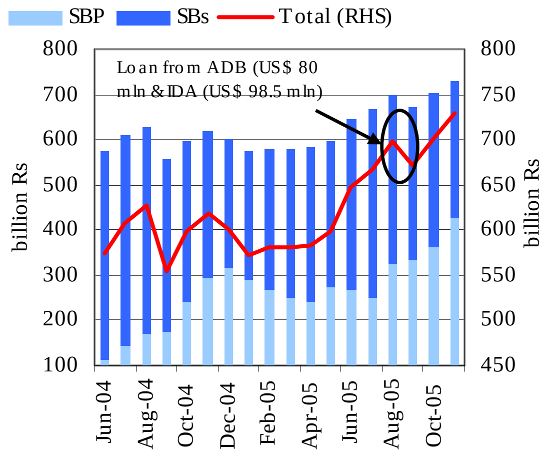
The NDA of the banking system increased by Rs 178.7 billion during Jul-Nov FY06 compared with an increase of Rs 122.0 billion in the corresponding period of FY05. As in FY05, the July-Nov FY06 NDA increase was driven principally by the rise in SBP NDA. This was because, through the first 5 months of FY06, the SBP had been lending directly to the government for its budgetary requirements and let the commercial banks cater to the financing needs of the private sector only. In fact, the rise of Rs 57.4 billion in the NDA of commercial banks is entirely due to their lending to the private sector.

Government sector borrowing

Government sector borrowing from the banking system during Jul-Nov FY06 increased by Rs 65.3 billion, as compared to the increase of Rs 45.7 billion during Jul-Nov FY05. This rise was entirely due to higher budgetary borrowings in the former period as the loans for commodity operations registered a net retirement.

Specifically, budgetary borrowings from the banking system increased by Rs 81.6 billion during Jul-Nov FY06 compared with an increase of Rs 42.8 billion in the corresponding period of FY05 (see **Figure 4.6**). These higher borrowings were the outcome of: (1) the higher budget deficit during Jul-Sep FY06 compared with Jul-Sep FY05 and; (2) lower availability of budgetary financing from other sources to the government during Jul-Sep FY06 (see **Table 4.2**).

Figure 4.6: Government Budgetary Borrowings



The composition of budgetary borrowings within the banking sector during Jul-Nov FY06 is similar to that of FY05. In both the periods, SBP solely funded the government budgetary requirements and commercial banks have registered net retirements.

Table 4.2: Deficit Financing (July-September) [1]
billion Rupees

	FY05	FY06
External	19.6	5.0
Non-bank	19.1	14.3
Privatization proceeds	6.1	3.5
Sub-total	*44.8*	*22.8*
Total financing requirement	**24.9**	**37.7**
Banking system	-19.9	14.8

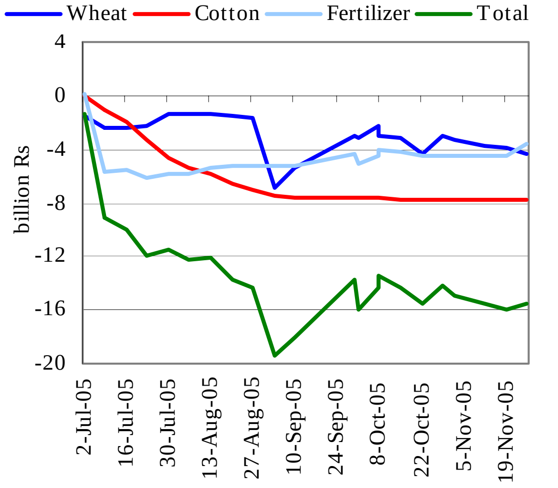
Source: Ministry of Finance (MoF), quarterly data.
[1] The MoF and SBP numbers differ due to differences in timings and definitions

Government loans for commodity operations declined by Rs 15.5 billion during Jul-Nov FY06 compared with an increase of Rs 1.3 billion in the corresponding period of FY05 (see **Figure 4.7**). Retirements were recorded in loans for cotton and fertilizer in addition to wheat. It should be noted that during Jul-Nov FY05, government increased its cotton procurement to stabilize the prevailing low domestic cotton prices arising out of a bumper crop. However, during Jul-Nov FY06, domestic cotton prices were already quite high and the TCP therefore continued retiring the loans borrowed in the previous season. The amount outstanding for commodity operations has declined substantially with the increase private sector role in commodity procurement, particularly for wheat.

4.5 Other items (net)

During Jul-Nov FY06, the accounting procedure for recording the OMO transactions has been changed and now these transactions will be reflected in the *other item net* (OIN) of the SBP and the scheduled banks. Specifically, prior to July 2005, the sale and purchase of government securities through OMOs used to result in the shift of claims on government between SBP and commercial banks.

Figure 4.7: Loans for Commodity Operations

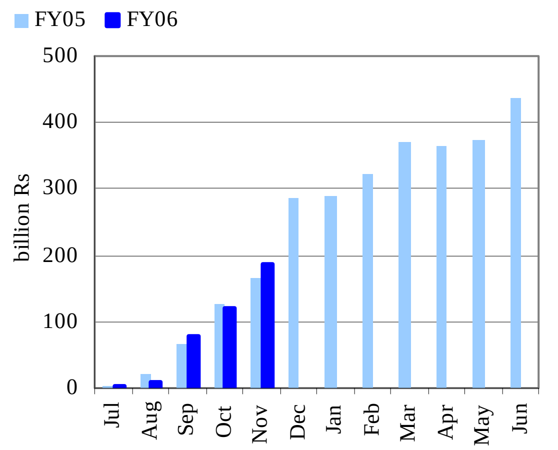


However, this standard has been changed from July 2005 onwards; now banks and SBP record the value of OMO transaction in their respective *other assets* and *other liabilities*. Consequently every transaction has an equal and opposite impact on the OIN of SBP and commercial banks, with no net impact on the OIN of the banking sector. This is an international practice that has been adopted to avoid frequent changes in the budgetary borrowing position of the government from State Bank and scheduled banks emanating from the OMO transactions.

4.6 Credit to private sector

Net credit to the private sector has increased by Rs 185.8 billion during Jul-Nov FY06 compared with the net growth of Rs 164.7 billion in the corresponding period of FY05 (see **Figure 4.8**). However, unlike the preceding three years, the credit to large scale manufacturing has seen a YoY decline, which appears to reflect a deceleration of growth in the sector in Q1-FY06.

Figure 4.8: Private Sector Credit



The expansion in credit to the private sector is a source of concern for two reasons: (1) the pace of credit growth indicates that the monetary tightening so far has succeeded marginally in reducing the private sector credit growth to 10.8 percent during the first five months of FY06 from 12.9 percent during the same period of FY05; and (2) sector wise data shows that corporate, SME and commodity finance are the major areas where most of the slowdown has been registered. In other words, agriculture and consumer loans are the major sectors driving the credit growth (see **Table 4.3**) in July-Nov FY06.

Table 4.3: Sectoral Distribution of Advances
billion Rupees

	Jul-Oct	
	FY05	**FY06**
(1) Private sector business	**87,112**	**78,317**
Agriculture	7,119	10,327
Mining and quarrying	2,143	140
Manufacturing	21,312	16,016
of which		
(1) Food products	(7,488)	(14,477)
edible oil and ghee	2,360	(1,020)
sugar	(3,693)	(3,670)
(2) Textiles	24,335	26,655
(3) Chemicals and products	6,326	4,724
fertilizer and nitrogen	4,560	4,397
(4) Cement	346	4,994
Construction	3,735	4,419
Commerce and trade	12,630	30,396
Transport and communications	9,075	2,509
Services	19,910	11,779
Other private business	10,497	1,664
(II) Personal	**15,922**	**32,418**
of which		
Consumer financing	13,382	32,197
i House building	5,422	4,870
ii. Auto finance	14,545	10,188
iii. Credit cards	1,778	5,255
iv. Consumer durables	656	588
v. Personal loans	(3,645)	11,471

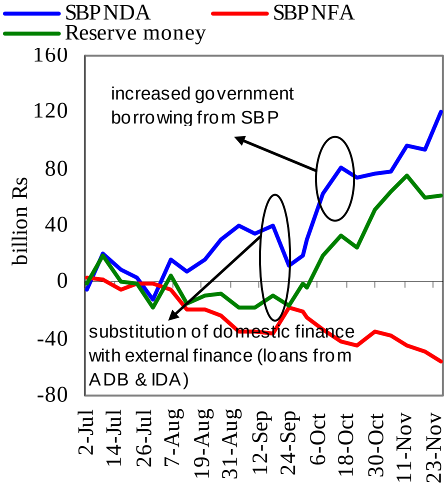
Source: Statistics Department, SBP

4.7 Reserve money

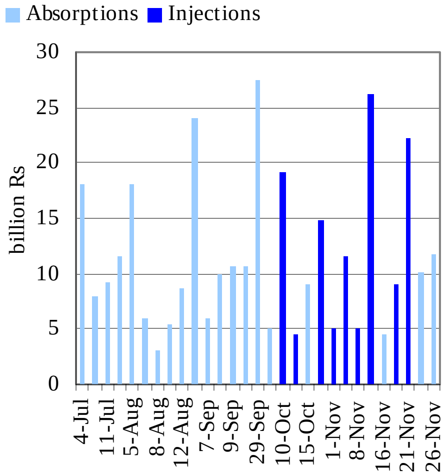
The reserve money growth during Jul-Nov FY06 is reflective of the SBP Rupee and dollar liquidity management in the inter bank market. In particular, during Jul-Sep FY06, reserve money registered negative growth. This was mainly due to SBP's huge inter bank dollar selling during the period that led to a sharp decline in SBP NFA. On the other hand, absorptions on account of OMOs compensated the increase in the NDA (by increasing '*other items net*', as explained earlier) arising from government borrowings (see **Figure 4.9**). As a result the reserve money showed negative growth during this period.

However, October onwards the inter bank market started facing severe liquidity shortages on account of (1) a robust growth in credit off take; and (2) net withdrawals in banks' deposit base on account of Ramadan and Eid. Therefore during October and November 2005, SBP had to make short-term liquidity injections in the inter bank market through OMOs. This along with a substantial increase in the government borrowings turned the hitherto negative growth in reserve money to positive. Although the reserve money growth increased sharply in Oct-Nov 2005 to record a Jul-Nov 06 cumulative growth of 6.8 percent, it remained substantially lower than the 13.5 percent increase recorded in the corresponding period of last year.

Figure 4.9: Reserve Money during FY06



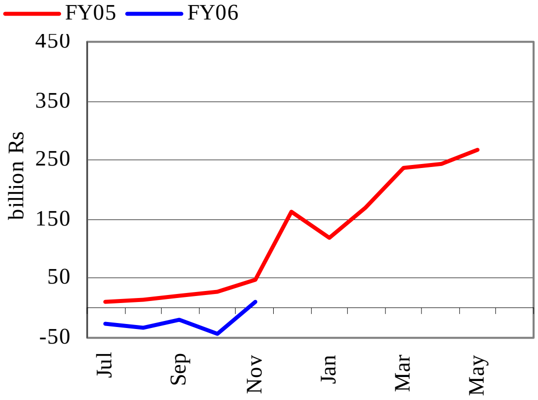
OMOs during FY06



4.8 Deposit mobilization

Deposit mobilization of the banks registered an increase of Rs 11.1 billion during Jul-Nov FY06 compared with an increase of Rs 47.1 billion in the corresponding period of FY05. Monthly data shows that during Jul-Oct FY06, there were net withdrawals from the banking system as a result of the net monetary contraction and the Ramadan effect. Subsequently, during November 2005, bank deposits registered an increase of Rs 54.5 billion (see **Figure 4.10**).

Figure 4.10: Cumulative Deposits



However, while analyzing the net withdrawals, the impact of changes in the format of data reporting by commercial banks to SBP cannot be ignored.

Specifically, in the older format, banks used to report some of the other liabilities in their respective deposit base; however the new format (adopted during July 2005) does not allow for such reporting and is hence a more accurate representation of the of volume of deposits. This change in the reporting mechanism caused a sharp decline of Rs 50 billion during July 2005 that had a cumulative impact on the overall deposit trend of Jul-Nov FY06.