# 4 Money and Banking

## 4.1 Overview

As in the case of many regional economies (see **Box 1**), Pakistan's central bank has maintained a tight monetary policy throughout FY06 in order to contain inflationary pressures in the economy. However, in a departure from most Asian central banks (and SBP's own past) practices, the monetary tightening in Pakistan was not achieved through raising the policy rate; the discount rate remained unchanged through FY06, and even the auction yields on the benchmark 6-month T-bill rate was almost unchanged, witnessing a rise of only 50 basis points during the period. Instead, the SBP focused on draining excess liquidity from the inter-bank market through very frequent OMOs'. As a result, the short-term inter bank interest rates remained fairly close to the discount rate and contributed to an increase of 202 basis points in weighted average lending rates during Jul-May FY06 (see **Figure 4.1**).

**Figure 4.1: Key Domestic Interest Rates**

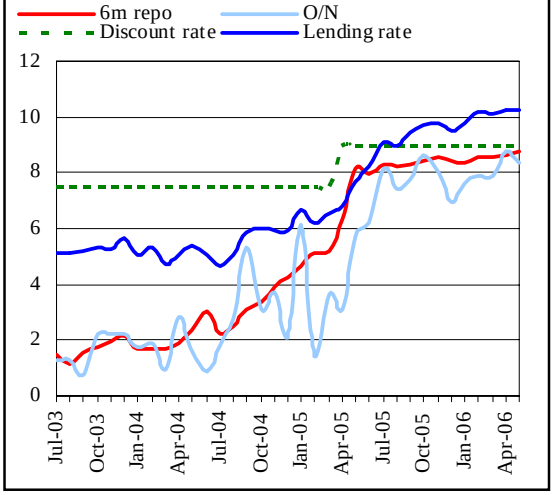
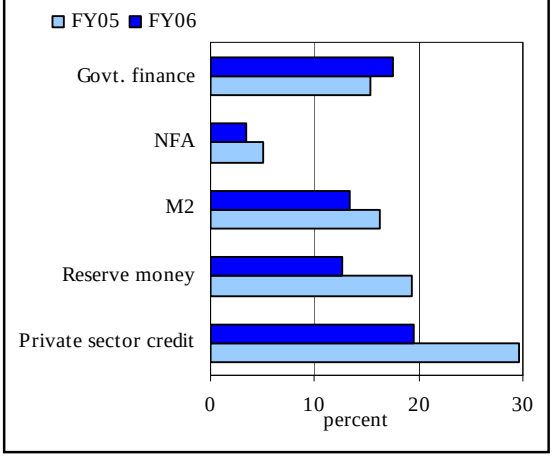



**Figure 4.2: Growth in Monetary Aggregates (Jul-Jun 10, FY06)**




The rise in interest rates had a visible impact on credit growth. Consequently, by June 10 FY06, the major monetary aggregates have been showing significant weakening compared with FY05. The growth in money supply-M2 decelerated to 13.3 percent during July-June 10 FY06 compared with the 16.2 percent in the same period of FY05 (see **Figure 4.2**).

**Box 4.1: Monetary tightening in Asian Economies Jul-Apr FY06**

The inflationary concerns arising out of higher energy prices and a continuous increase in asset prices during 2004 have deepened further during 2005 through most of the Asian region (see **Table B.1**). As a response, many central banks have been pursuing a tight monetary posture by revising upwards the policy rates during 2005 and 2006.

**Table B.1: CPI Inflation in Major Asian Economies (calendar year averages)**

| | 2004 | 2005 | 2006* | Apr-06** |
|---|---|---|---|---|
| India | 3.8 | 4.2 | 4.8 | 4.9 |
| Indonesia | 6.1 | 10.5 | 14.2 | 15.4 |
| Korea | 3.6 | 2.7 | 2.5 | 2.0 |
| Malaysia | 1.4 | 3.0 | 3.1 | 4.5 |
| Pakistan | 7.4 | 9.1 | 8.4 | 6.2 |
| Philippines | 6.0 | 7.6 | 7.4 | 7.1 |
| Thailand | 2.8 | 4.5 | 3.6 | 6.0 |

Source: World Economic Outlook Apr 2006; *2006 estimated
**YoY growth; Source: International Financial Statistics-IFS

For instance, Bank of Thailand that executes its monetary stance by influencing the short-term money market rates through changes in its policy rate the 14 day repurchase rate; has made seven upward revisions in its policy rate taking it from 2.5 at end June 2005 to 4.75 at end April 2006 (a cumulative increase of 225 basis points during the period Jul-Apr FY06). The Central Bank of Philippines has made three revisions during Jul-Apr FY06 in its policy rate (the overnight repurchase rate) raising it from 9.25 percent to 9.75 percent at end April 2006. The Bank Negara Malaysia influences the money market rates through changes in its overnight policy rate (OPR). During Jul-Apr FY06, BNM made three revisions in OPR to bring in a cumulative increase of 80 basis points. In Indonesia, the BI rate is used as a policy rate by Bank Indonesia and is a reference rate to conduct open market operations. During Jul-Apr FY06, the BI rate has been revised in five occasions bringing in a cumulative increase of 425 basis points. Finally, the Reserve Bank of India has increased its policy rate by 75 basis points during Jul-Apr FY06.

This slowdown was driven primarily by the deceleration in private sector credit. While the growth in private sector credit during July-June 10 FY06 was slightly higher than the estimate in the Annual Credit Plan for the year, it was markedly lower than that in the corresponding period of FY05. As shown in **Table 4.1**, while the aggregate contribution of government sector borrowings and the NFA to M2 growth during Jul-June 10 FY06 saw a little change from that in the

**Table 4.1: Contribution to M2 growth**
in percentage points

| | Jul-Feb | | 1 Jul-10 Jun | |
|---|---|---|---|---|
| | FY05 | FY06 | FY05 | FY06 |
| Credit to non-govt sector | 12.3 | 10.5 | 14.3 | 11.3 |
| Government borrowing | 0.1 | 3.9 | 4.1 | 4.4 |
| NFA | 1.7 | -2.7 | 1.2 | 0.8 |
| Sub total | 1.9 | 1.2 | 5.3 | 5.2 |
| OIN | -3.2 | -3.1 | -3.4 | -2.9 |
| **M2** | **10.9** | **8.6** | **16.2** | **13.3** |

preceding year, the lower contribution by non-government credit continued to dominate the slowdown in overall M2 growth during Jul-Jun 10 FY06.

Clearly, monetary tightening has started generating some dividends and the implied fall in aggregate demand has begun to ease inflationary pressures. May 2006 data shows significant improvement, with headline CPI inflation decelerating to 7.1 percent YoY compared with 9.8 percent YoY during May 2005. However, besides the tight monetary posture pursued since H2-FY05, improved domestic food supplies, and a decline in major international commodity prices played a significant role in bringing the headline inflation down. While core inflation also decelerated, it still remained high throughout the period. Thus, from SBP's perspective, a discontinuation of tightening remained far from consideration. Moreover, continuity of monetary tightening is also vital to achieve the moderate inflation target of 6.5 percent in FY07, especially given the need to reduce aggregate demand in the economy in the face of an expansionary stance of the FY07 budget, and the projected widening of the current account deficit.

## 4.2 Monetary survey

The growth in the broad money supply slowed to 13.3 percent during Jul-Jun 10 FY06 compared with the 16.2 percent during the corresponding period of FY05. As a result monetary growth may be very close to the rise in nominal GDP for the first time in four years. This deceleration in M2 growth was contributed by both, Net Domestic Assets (NDA) as well as the Net Foreign Assets (NFA), of the banking system (see **Table 4.2**). While the former was attributable to weakening growth in private sector credit; the slower growth in the latter is explained by deterioration in the country's balance of payments during the period.

**Table 4.2: Monetary Survey – Flows (July-June 10 FY06)**
in billion Rupees

| | Credit Plan FY06 | FY05 | FY06 |
|---|---|---|---|
| **M2** | **380.0** | **402.4** | **395.5** |
| *growth in percent* | | *16.2* | *13.3* |
| **Reserve money** | | **149.7** | **114.5** |
| *growth in percent* | | *19.4* | *12.6* |
| **NFA** | **15.0** | **30.0** | **22.4** |
| SBP | | -30.3 | 46.7 |
| Scheduled Banks | | 60.3 | -24.3 |
| **NDA** | **365.0** | **372.4** | **373.1** |
| SBP | | 162.7 | 58.4 |
| Scheduled Banks | | 209.7 | 314.7 |
| **Government borrowing** | **120.0** | **101.1** | **131.9** |
| **for budgetary support** | **98.0** | **77.2** | **120.4** |
| SBP | | 188.1 | 112.3 |
| Scheduled Banks | | -110.9 | 8.1 |
| **Commodity operations** | **20.0** | **22.1** | **11.4** |
| **Credit to non-govt sector** | **320.0** | **355.5** | **335.1** |
| Private sector | 330.0 | 378.0 | 333.7 |
| PSEs | -10.0 | -16.4 | 2.7 |
| **OIN** | **-75.0** | **-84.2** | **-93.9** |
| SBP | | -19.9 | -53.1 |
| Scheduled Banks | | -64.4 | -40.7 |

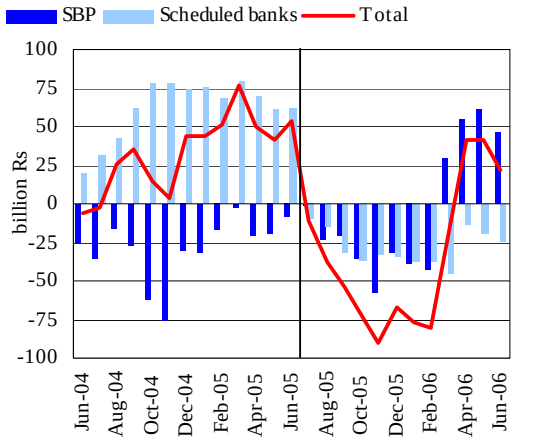
**Net foreign assets-NFA**

The decline in the NFA of the banking system during most of Jul-Jun 10 FY06 derived from two apparently contradictory developments – the sharp widening of the country's current account deficit, and the firming expectations of exchange rate stability.

In the preceding year, the re-emergence (and widening) of a current account deficit after a gap of three years had raised the risk of large exchange rate adjustment. This had led to a rise in FE-25 deposits as well as the retirement of FE-25 loans, both of which improved scheduled banks' NFA. However, the SBP NFA had deteriorated, reflecting mainly the SBP decision to provide foreign exchange for imports of some key commodities (mainly oil).

This support continued into FY06, and the SBP NFA therefore continued to decline, through most of the period (see **Figure 4.3**). However, the expectations of relative stability in the rupee due to this SBP liquidity support, led to slower growth in banks' forex deposits and, together with rising rupee interest rates, led to a rise in forex loans. These two developments meant that banks' NFA also declined in FY06, in contrast to the FY05 picture.

**Figure 4.3: Net Foreign Assets**




However after having declined by Rs 80.8 billion during Jul-Feb FY06, NFA of the banking sector took a sharp (but an expected) upturn during March 2006 mainly on the back of (1) long waited receipts of privatization proceeds of PTCL and (2) receipts against the issuance of Euro bond. These flows propped up the SBP NFA by Rs 71.8 billion during the month and also offset the continued weakness in NFA of commercial banks. As a result, the NFA of the banking system witnessed a net increase of Rs 22.4 billion during July-June 10 FY06.

**Net Domestic Assets (NDA)**

The NDA of the banking system increased by Rs 373.1 billion (growth of 16.0 percent) during Jul-Jun 10 FY06 compared with the increase of Rs 372.4 billion

(or 19.6 percent) during the same period of FY05. As in the previous year, the Jul-Jun 10 FY06 increase in NDA was driven principally by the growth in credit to the non-government sector.

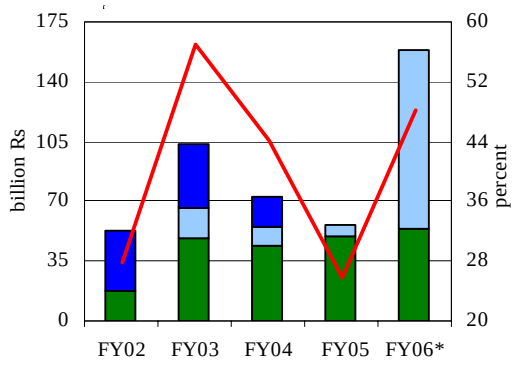
**Government Budgetary Borrowings**

By end-February 2006, government borrowing for budgetary support from the banking sector had exceeded the Rs 98.0 billion FY06 annual target by over 50 percent principally due to substantial borrowings from SBP.

However, the inflows under PTCL privatization and the issuance of Euro bonds during March 2006 allowed the government to retire a large part of these borrowings. As a result, the cumulative government borrowings from the banking sector dropped to Rs 120 billion during Jul-June10 FY06.

As shown in **Figure 4.4**, the volume of one-off flows during Jul-May FY06 is the largest in last five years and the share of these has reached over 48 percent of the budget deficit. Since such inflows effectively provide 'costless financing' to the government; their increased volume is a source of disquiet as this might undermine the need for the government to adhere strictly to the fiscal discipline.[1]

**Figure 4.4: Size of One-off External Payments**



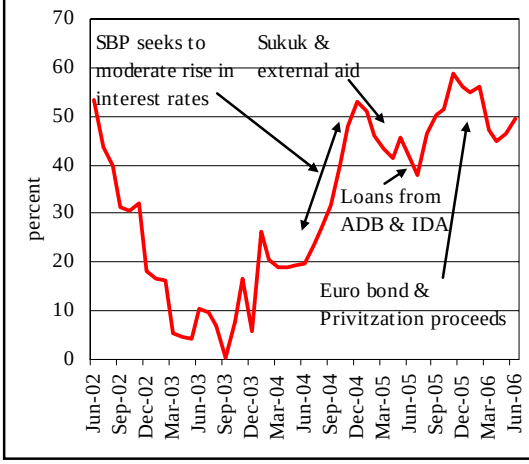

*One-off paymnets are till Jul-May, FY06; and the budget deficit is annual estimate for FY06

Stepping back, the composition of bank borrowings during Jul-Jun 10 FY06 was similar to the preceding year as SBP continued to finance a significant part of government requirements. Commercial banks, on the other hand, provided only 6.7 percent of the total budgetary finance. However, the share of borrowings

[1] In addition, such one-off inflows increase the non-structural supply of foreign exchange in the economy thereby masking the possible needs for exchange rate adjustments.

from SBP in total budgetary bank borrowings receded sharply during April 2006 after touching a 46-month peak during Q2-FY06 (see **Figure 4.5**) as the government retired a large proportion of SBP debt using the external receipts though privatization proceeds and Eurobond issue. Had these receipts not been realized, government borrowing for budgetary support from SBP would have stood at Rs 222.1 billion during Jul-June 10, FY06.

**Figure 4.5: Share of Borrowings from SBP**

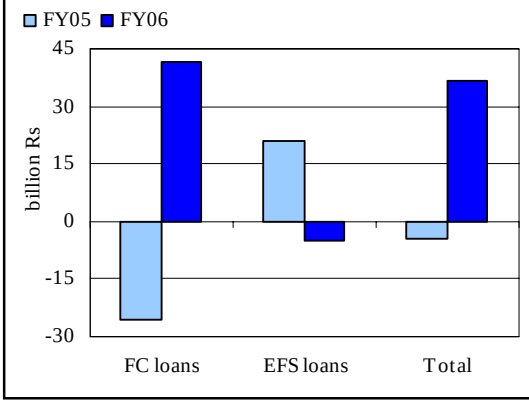



**Credit to Private Sector**

The increase of Rs 333.7 billion in private sector credit during Jul-Jun 10 FY06 was a little higher than the annual (credit plan) estimate for FY06, but was significantly lower than the increase during the same period of FY05. This slowdown is despite the larger increases in trade related loans and the private sector commodity finance during Jul-May FY06 compared with the preceding year.

Specifically, the trade related loans (including both FE-25 loans and the loans under export finance scheme) during Jul-Mar FY06 increased by Rs 36.5 billion compared with the net retirements registered in the preceding year (see **Figure 4.6**).[2] This said, the slowdown in activities in the credit market appears to be driven by both demand and supply side factors.

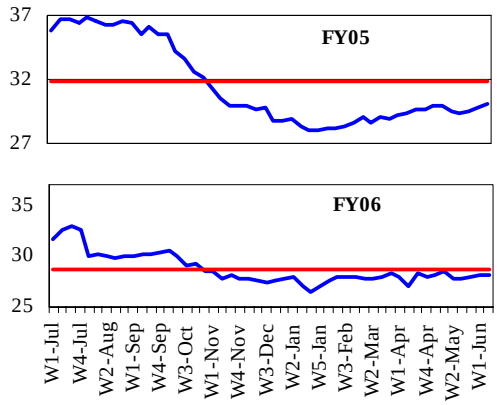
**Figure 4.6: Trade Related Loans (Jul-Mar)**




[2] The data for EFS volume is reported on quarterly basis.

From the demand side, major factors causing the credit slowdown were; (1) a rise in real lending rates that not only slowed down the demand for productive loans but have also lessened the arbitrage opportunities prevailing as a result of negative real lending rates; and (2) a slowdown in credit off take by domestic synthetic textile and telecommunication industries.[3]

**Figure 4.7: Deviations in Liquidity Ratio**




From the supply side, tighter liquidity conditions in the inter bank market as a result of the SBP tightening measures probably contributed to the slowdown in private sector credit. During the Jul-Jun 10 FY06, not only the average liquidity ratio[4] was slightly lower than that in the same period of FY05, the deviations from average were also thin (see **Figure 4.7**).

A sectoral distribution of credit shows that the retirements in agriculture sector[5] loans and a slowdown in credit off-take by textiles and telecommunications sectors contributed most to the weakening credit growth during Jul-May FY06 (see **Table 4.3**). While the slowdown in textile credit is attributed mainly to the rising import of synthetic textiles and the slowdown in fixed investment loans in the

**Table 4.3: Private sector advances (Jul-Apr)**
in billion Rupees

| | FY05 | FY06 |
|---|---|---|
| Agriculture | 16.2 | -0.5 |
| Manufacturing | 146.8 | 131.1 |
| sugar | 4.7 | 15.8 |
| *textiles* | 94.7 | 68.8 |
| *non-metallic minerals* | 15.1 | 16.4 |
| Construction | 9.6 | 9.4 |
| Commerce and trade | 36.9 | 49.8 |
| Transport and communications | 21.4 | 8.4 |
| Consumer finance | 66.0 | 70.7 |
| **Total (business + personal)** | **332.4** | **303.7** |

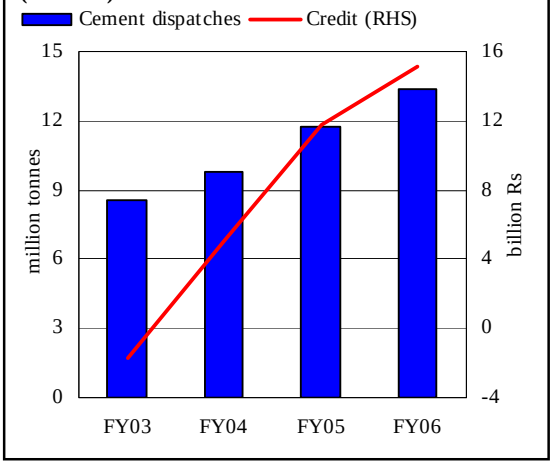
Source: Statistics Department

[3] For details, please see *SBP's Second Quarterly Report for FY06*.
[4] Liquidity ratio is defined as required reserves (CRR and SLR) plus excess reserves as percent of demand and time liabilities of banks net of inter bank time and demand liabilities and FE-25 deposits.
[5] The net retirements are shown mainly because the ZTBL wrote-off loans worth over Rs 13 billion during the period.

sector;[6] the slowdown in telecommunication credit reflects only the absence of fixed investment loans during Jul-Apr FY06.[7]

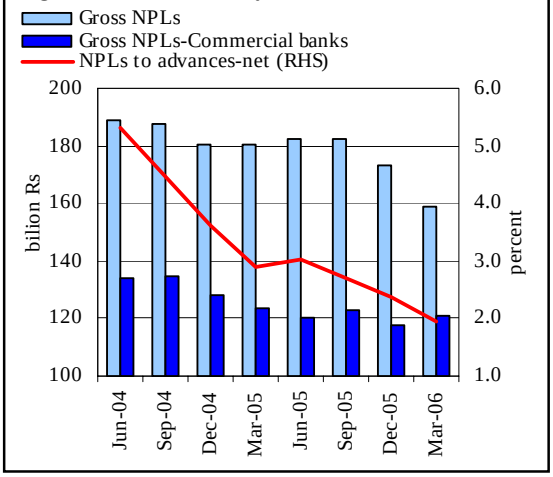
Credit to the cement sector registered higher increases during Jul-Apr FY06 mainly on the back of continued public as well as private sector construction activities (see **Figure 4.8**). Similarly, the credit for *commerce and trade* sector also registered higher increase during Jul-Apr FY06 mainly due to a sharp rise in trade related loans (in foreign currency). Finally, the increase in consumer credit during Jul-Apr FY06 was only slightly higher compared with Jul-Apr FY05. Within consumer finance, credit card financing increased with a growth of 177 percent over Jul-Apr FY05; whereas auto loans, housing finance and personal loans registered slowdown.

**Figure 4.8: Cement Industry: Credit and Dispatches (Jul-Mar)**




From the financial stability perspective, however, there were two interesting developments during FY06. First, it is important to see that the 50 percent of the total *increase* in outstanding advances during Jul-Dec FY06 was extended against real estate as collateral. A continuation of this trend would not be a welcome development as a high level of concentration in collaterals

**Figure 4.9: Asset Quality of Banks**




[6] The import of textile machinery registered a negative growth of 5 percent.
[7] For details, please see *SBP' Second Quarterly Report for FY06.*

could prove detrimental for banks' soundness at the time of financial distress (see **Box 4.2**).

Second, it should be noted that the gross non-performing loans (domestic operations) of the banking industry though declined significantly by Rs 23.3 billion during Jul-Mar FY06; however this decline was attributed entirely to the decline in the NPLs of ZTBL. In fact, gross NPLs of commercial banks have registered a slight increase of Rs 1 billion during Jul-Mar FY06 compared with a decline of Rs 13.9 billion during Jul-Mar FY05 (see **Figure 4.9**). This again is not *yet* a source of concern, mainly reflecting (1) the low fresh NPLs, and (2) the fact that banks probably done with the loan write-off that had led to decline in their NPL in previous years. It may also be noted that NPLs as percent of net advances are at very low level.

It should be noted that NPLs of most of the domestic private banks (other than large five banks) have increased during the period; whereas NPLs of all the large five banks have registered a net decline.

**Box 4.2: Exposure in Real Estate: Risks to the Banking Sector & the Countries' Experiences**

The exposure of banking sector to real estate can take any form including,[1] (1) holdings of real estate assets in banks' portfolios; (2) lending to customers for real estate purchases; (3) financing of real estate developers and construction companies; (4) lending to NBFIs especially housing finance companies; (5) relying on real estate to collateralize other kind of lending. In any case, risks to the banking sector is clear; if the property price falls, the value of collateral starts declining and the risk of banks increases. This decline in prices forbids banks to finance real estate purchases which further reduce the demand and thus price of real estate. Hence, higher the exposure of banks in real estate worse the impact of any price falls.

In this regard, East Asian crisis (1997) gives a clear indication of banks' exposure to the real estate sector resulting in severe financial crisis once the property prices start declining. **Table B1** shows the magnitude and duration of the price falls in selected countries. On average, prices of the residential property declined by 35 percent and those of commercial property fell by 45 percent. In most countries, property prices peaked on average 2-3 years while the price fall was a gradual process taking3 to 8 years on average.

**Table B1: Length & Magnitude of Real Estate Price Falls**

| | Price Fall | | Length of bust period | |
|---|---|---|---|---|
| | RRE | CRE | RRE | CRE |
| | percent | | years | |
| Canada | -21 | -30 | 3 | 5 |
| Finland | -47 | -53 | 4 | 4 |
| Ireland | -28 | NA | 7 | NA |
| Japan | -33 | -72 | 8 | 8 |
| Malaysia | -15 | -5 | 2 (on gog) | 1 |
| Mexico 1 | -81 | NA | 6 | NA |
| Mexico 2 | -10 | NA | 1 | NA |
| Netherlands | -48 | NA | 7 | NA |
| Spain | -32 | NA | 4 | NA |
| Sweden | -26 | -42 | 3 | 3 |
| Thailand | -45 | -69 | 6 | 8 |
| Average | -35 | -45 | 4.6 | 4.8 |

RRE: Residential Real Estate CRE: Commercial Real Estate
Source: IMF Working Paper WP/01/129 (full citation in ***references***)

In Thailand, during 1994-96, credit from finance companies to real estate and construction sector reached to 30 percent of total loans. Banks' exposure to real estate sector reached to 30 to 40 percent of the total assets. Therefore, with the burst in asset price bubble there, non-performing loans surged to 25 percent of total assets of the banking sector (see **Table B2**).

In Sweden and Finland, real estate prices increased significantly during 1980s as a result of growth in real income and credit. This price boom ended abruptly during 1990 with the beginning of worldwide economic slowdown and rising housing units, finance companies experienced major losses and they borrowed heavily from banks to remain sound. A systemic financial crisis occurred in both the countries in 1991-92.

The Japanese banking crisis was also caused by banks' heavy exposure in the real estate. The direct exposure of banks in real estate even reached to 18 percent of the outstanding loans during 1991. During 1991-92, property prices began to fall and this was accompanied by a sharp contraction in private sector credit.

**Table 2: Exposure of East Asian Countries' Banking Sector to Real Estate**

in percent of assets at end 1997

| | Property Exposure | Collateral Valuation | Non-performing loans | |
|---|---|---|---|---|
| | in percent of assets at end 1997 | | | |
| | | 1997 | 1997 | 1998 |
| Korea | 15-25 | 80-100 | 16 | 22.5 |
| Indonesia | 25-30 | 80-100 | 11 | 20 |
| Malaysia | 30-40 | 80-100 | 7.5 | 15 |
| Philippines | 15-20 | 70-80 | 5.5 | 7 |
| Thailand | 30-40 | 80-100 | 15 | 25 |
| Hong Kong | 40-55 | 50-70 | 1.5 | 3 |
| Singapore | 30-40 | 70-80 | 2 | 3.5 |

Source: IMF Working Paper WP/02/20 (full citation in ***references***)

Contrary, there are some cases where the asset price bubble and bust appeared but no banking crisis occurred. In case of Singapore, real estate prices more than doubled during 1994-97 and the banks' exposure in the real estate and construction was even more than 35 percent of outstanding loans during 1990s. During 1996-97, property prices began to fall and the non-performing loans to total loans reached to 12 percent at end 1999 from 3 percent a year earlier. Although profitability of banks hampered significantly but their capital adequacy remained well above the minimum target. This shows that with well supervised and well capitalized banks, swings in the real estate market might not cause any severe financial distress in the economy.

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