

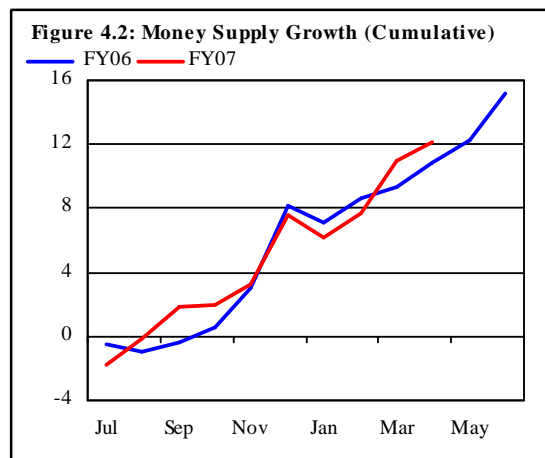
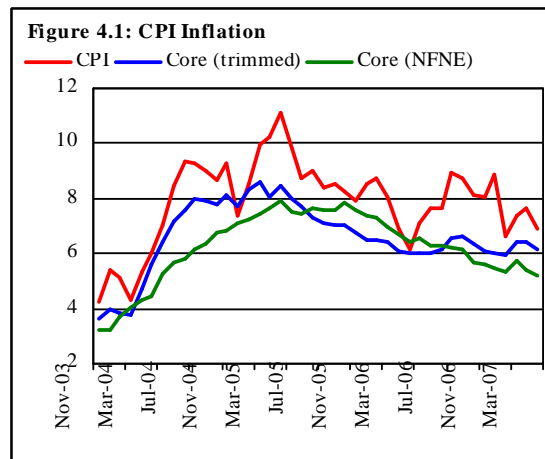
# 4 Money and Banking

## 4.1 Overview

The key challenge for SBP monetary policy during FY07 has been to maintain a balance between sustaining strong economic growth and low and stable inflation. The recent available economic indicators suggest that while the economic growth momentum remains intact, the headline CPI inflation has been stubbornly high at an average of 7.9 percent during Jul-Apr FY07<sup>1</sup> (see **Figure 4.1**) and is projected to remain in the 7.5-7.8 percent range by end FY07.

The task of monetary management became more difficult in recent months with a sharp monetary expansion which accelerated to 12.1 percent during Jul-Apr FY07, exceeding the 10.8 percent growth realized during the corresponding period of FY06 (see **Figure 4.2**). More importantly, it is likely that the FY07 M2 growth would exceed the 13.5 percent growth target for the year.

Clearly, with (1) economic growth still substantially above the long term average, (2) the headline inflation, despite some decline, remaining persistently higher



<sup>1</sup> This is calculated as percentage change in average CPI for Jul-Apr FY07 over Jul-Apr FY06.

than the FY07 target, (3) the recent acceleration in M2 growth threatening to add to the inflationary pressures, and (4) so far, the slowdown in credit off-take essentially being visible mainly in textile units and consumer credit; the existing tight monetary stance appears appropriate.

While the headline CPI inflation is high, this is mainly due to continuing pressures on food inflation, as the expected slowdown in food inflation in the second half of FY07 did not materialize. Nonetheless, the demand-pull inflationary pressures as reflected in core inflation are weakening. Specifically the YoY core inflation (Non-Food Non-Energy – NFNE) has come down to as low as 5.2 percent in April 2007 from 6.4 percent in April 2006 and a local peak of 7.8 percent in October 2005. Similarly, core inflation measured by the trimmed mean has also decelerated, although not as sharply as in the first measure.

SBP recognizes that food inflation is typically less responsive to monetary tightening and therefore the monetary policy should not respond aggressively to temporary shocks in food prices. At the same time, it is also clear that a continuing focus on tight monetary policy is needed so that the *second-round* impacts of these shocks from high food inflation do not permeate to underlying inflationary pressures in the economy. As a result, SBP depends more on market dynamics and government's administrative measures to contain food inflation while retaining a tightening bias to ensure that inflationary expectations are contained.

In this perspective, the surge in M2 expansion in H2-FY07 is a more challenging development given that this has the potential to cause a resurgence in excess demand pressures in the economy. Unfortunately, the underlying causes of the recent M2 growth (i.e., strong government borrowings and rise in net foreign assets – see **Figure 4.3** and **Table 4.1**)<sup>2</sup> leave the central bank with a dilemma.

The budgetary borrowings from the banking system are largely a function of (1) the overall fiscal position of the government<sup>4</sup>, and (2) availability of financing from other sources (external and domestic non-bank).

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<sup>2</sup> These together contributed 3.6 percent to the total rise of 4.0 percent in M2 growth during Mar-Apr FY07.

<sup>4</sup> It is also argued that the changes in government borrowings depend on the lead and lags in various payments and receipts of the government, which also induce unpredictability to the overall volume of budgetary borrowings from the banking system. For example, to the extent the recent sharp rise in government budgetary borrowings reflects lower external financing, it is expected that the forthcoming sovereign bond issue will enable the government to retire a part of its outstanding debt with the domestic banking system.

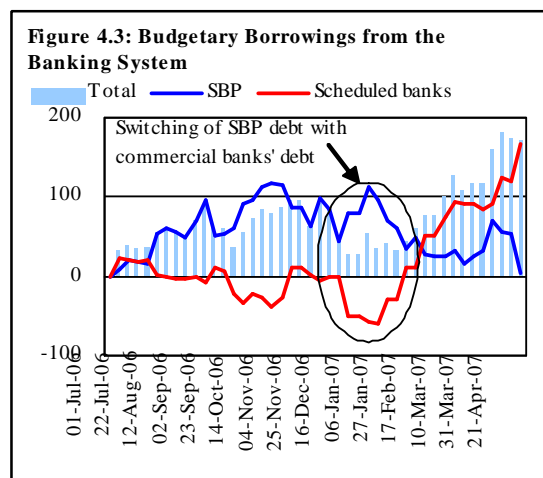
**Table 4.1: Causative Factors for M2 Growth**

in percent	Jul-Apr		Jul-Feb		Mar-Apr	
	FY06	FY07	FY06	FY07	FY06	FY07
<b>M2 growth</b>	10.8	12.1	8.7	7.7	2.0	4.0
<i>Contribution from</i>						
<b>NFA</b>	1.3	2.4	-2.7	1.2	3.7	1.1
<b>NDA</b>	9.5	9.7	11.4	6.5	-1.7	2.9
<b>Government borrowing</b>	0.7	3.5	4.0	1.2	-3.0	2.1
For budgetary support	1.7	5.0	5.0	2.3	-3.0	2.5
<b>Credit to non-govt sector</b>	11.7	8.1	10.5	6.5	1.1	1.5
Private sector	11.6	8.0	10.5	6.6	1.1	1.3
<b>Other items (net)</b>	-2.8	-2.0	-3.1	-1.2	0.2	-0.7

Given the government's commitment to increase development spending, and the fact that the monetary policy has already been successful in reducing excess aggregate demand, a further increase in policy rate raised the risk that an increase in government expenditures could seriously crowd out private investment.

This raises two points: (1) the government needs to retire borrowings from the banking

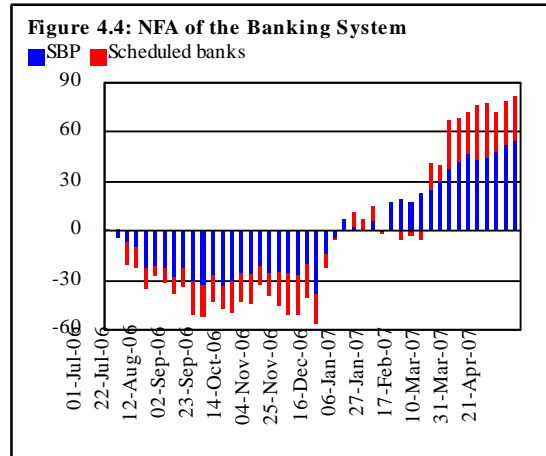
system, particularly from central bank. In particular, going forward, any rise in government receipts from external and non-bank sources must be mirrored by corresponding retirement of government debt with SBP in order to contain the reserve money growth; and (2) It is important that the fiscal deficit be contained in years ahead to reduce the risk of crowding out of the private investment.



The second major source of expansion in money supply during Mar-Apr FY07 is the large foreign exchange inflow (both in the government and the private sector) that has led to a significant increase in NFA of the banking system (see **Figure 4.4**). If excessive foreign exchange inflows are not mopped up, this would force the Rupee to appreciate against the foreign currency with adverse economic consequences. On the other hand, if the SBP seeks to purchase the foreign

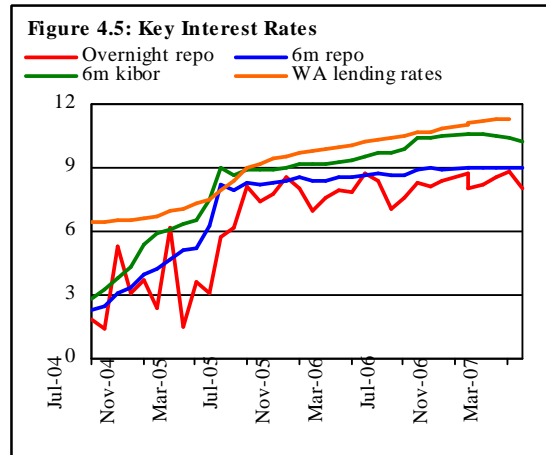
exchange in order to defend the Rupee appreciation; this could potentially further spur undesirable growth in reserve money.

It must also be recognized that the increasing integration of the domestic financial market with international markets may render further interest rate hikes counter-productive. In other words, if the SBP attempts to sterilize the liquidity, the resultant rise in interest rates could lead to further foreign exchange inflows.



In light of the above, rather than raising the policy rate, the SBP focused on effective liquidity management. Indeed, the surplus liquidity in the inter-bank market (stemming from M2 expansion) could potentially stimulate the multiplier process by putting downward pressures on interest rates in coming months. This indeed was not desirable because, given the persistence of supply side pressures, a further increase in aggregate demand could only have exacerbated the inflationary pressures in the economy. To avoid this, the SBP has been monitoring closely the liquidity in the inter-bank market and has been intervening as and when required.<sup>5</sup>

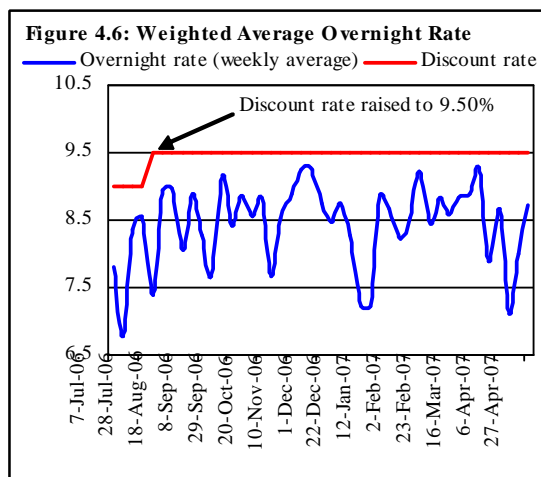
The effectiveness of liquidity



<sup>5</sup> The FY07 liquidity management was not only focused on the desired quantum of liquidity available in the inter bank but also took into account the efficient allocation of financial resources. In particular, the SBP has been directing banks on several occasions to closely monitor the use of the funds provided by them. This was done to ensure that the bank credit is not used to finance speculative activities in the economy.

management can be gauged from the fact that although the robust growth in deposit mobilization and the increased SBP purchases of US dollar from the inter-bank market added the Rupee liquidity in the banking system, there does not appear to be pressures for the softening of the weighted average lending rates (see **Figure 4.5**). Although the weighted average lending rates on gross disbursements (during the month) registered some decline in January and February 2007, this owed mainly to the impact of low interest rates applied on inter-bank lending (see **Box 4.1**).

It is true that the excess liquidity in the inter-bank market led to some temporary dips in the inter-bank overnight repo rate which resulted in large deviations from the discount rate. However, it is important to mention here that these deviations were of short duration (see **Figure 4.6**) and mainly reflect the unexpected inflows (especially from the external sector and government sector) that



hamper the proactive conduct of liquidity management. More importantly, these deviations were inconsequential as the credit demand remained subdued throughout the period and given that despite the decline in kibor,<sup>6</sup> the lending rates kept following a rising trend.

The persistently high lending rates throughout Jul-Apr FY07 were instrumental in containing the aggregate excess demand in the economy. The impact of this on private sector credit growth was compounded by (1) the increase in credit from NBFIs; (2) more conservative credit assessments by banks given the expanded borrowers' data available through Credit Information Bureau (CIB); (3) internal restructuring as well as mergers and acquisitions in the banking industry; and (4) increase in capacity installations in manufacturing sector in recent years and delays in initiation of major infrastructure projects that led to subdued demand for fixed investment loans.

<sup>6</sup> The decline in Kibor is merely a rationalization of credit spreads over collateralized rates to historical norms, which had widened post reserve requirement and discount rate changes.

As a result, growth in private sector credit slowed to 13.0 percent during Jul-Apr FY07 compared to 20.2 percent during the corresponding period of FY06.

#### 4.2 Monetary Survey

The growth in money supply (M2) during Jul-Apr FY07 accelerated to reach 12.1 percent compared with 10.8 percent during Jul-Apr FY06. The high monetary growth during Jul-Apr FY07 was caused mainly by a sharp increase in net foreign assets (NFA) of the banking system as the growth in net domestic assets (NDA) of the banking system strong, as in the previous year (see **Table 4.2**). While the increase in NFA reflects higher foreign exchange inflows, the strong growth in NDA was caused entirely by a sharp increase in government sector borrowings for budgetary support that more than offset the deceleration in the credit to non-government sector.

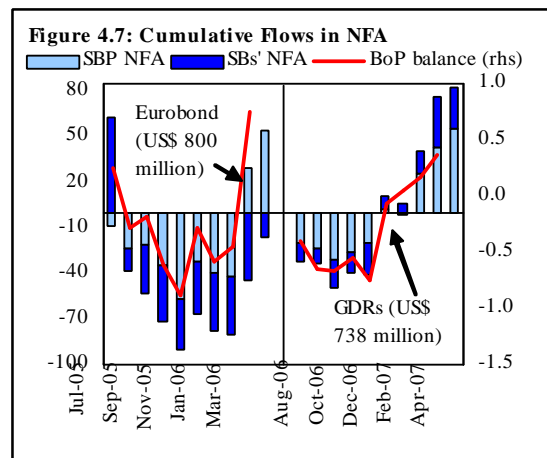
#### Net Foreign Assets

Following the slight improvement in the country's external account, the NFA of the banking system registered an expansion of Rs 82.2 billion during Jul-Apr FY07 (see **Figure 4.7**). This increase in NFA looks particularly high especially when compared with the Rs 9.8 billion initial estimates in the Credit Plan for FY07 and

**Table 4.2: Monetary Survey (Flows)**  
billion Rupees

	Credit Plan FY07	Jul-Apr	
		FY06	FY07
<b>Money supply (M2)</b>	<b>459.9</b>	<b>320.8</b>	<b>412.2</b>
		(10.8)	(12.1)
<b>NFA</b>	<b>9.8</b>	<b>38.7</b>	<b>82.2</b>
		(6.1)	(11.9)
SBP		54.7	55.1
Scheduled banks		-16.0	27.1
<b>NDA</b>	<b>450.1</b>	<b>282.1</b>	<b>330.0</b>
		(12.11)	(12.10)
SBP		10.8	33.9
Scheduled banks		271.3	296.0
<b>A. Government borrowing</b>	<b>130.1</b>	<b>20.1</b>	<b>120.4</b>
<b>Budgetary support</b>	<b>120.1</b>	49.9	170.6
SBP		43.2	3.1
Scheduled banks		6.6	167.6
<b>Commodity operations</b>	<b>10</b>	-29.7	-50.4
<b>B. Credit to non-govt. sector</b>	<b>395</b>	<b>346.6</b>	<b>278.0</b>
Private sector	390	345.3	273.8
		(20.2)	(13.0)
PSEs	5	2.5	3.8
<b>C. OIN</b>	<b>-75</b>	<b>-84.5</b>	<b>-68.4</b>
SBP		-31.6	30.6
Scheduled banks		-52.9	-99.0

Note: Figures in parenthesis are growth rates



the low expansion of Rs 38.7 billion during the same period of FY06.

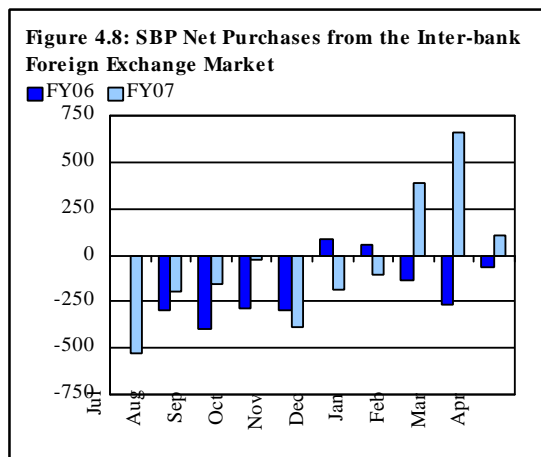
Major factors responsible for the current expansion in NFA include, influx of foreign exchange mainly through GDRs, a relatively high foreign investment (both FDI and Portfolio), foreign private loans and increase in loan disbursements from Asian Development Bank.<sup>7</sup>

Within the banking system, so far, the growth in NFA stemmed mainly from scheduled banks' NFA where most of the private sector foreign exchange flows were directed. The increase in SBP NFA of Rs 55.1 billion during Jul-Apr FY07 was only a little higher than the increase of Rs 54.7 billion in Jul-Apr FY06, despite the relatively lower government sector external inflows in the former period.

The major factors responsible for a slowdown in government sector inflows were: (1) delays in sovereign bond issuance during FY07; these had replenished the SBP NFA by US \$ 799.0 million in Jul-Apr FY06; (2) lesser inflows under privatization proceeds (even after including inflows of foreign exchange through floatation of GDRs); and (3) relatively low logistic support receipts.

However, the impact of the slowdown in public sector external inflows on SBP's NFA was more than offset by the increase in the central bank's net US\$ purchases from the inter-bank foreign exchange market during February and March 2007 (see **Figure 4.8**).<sup>8</sup>

Going forward, the expected issuance of a sovereign bond by the Government of Pakistan, and disbursements of loans from Asian Development Bank and Islamic Development Bank, are expected to result in a



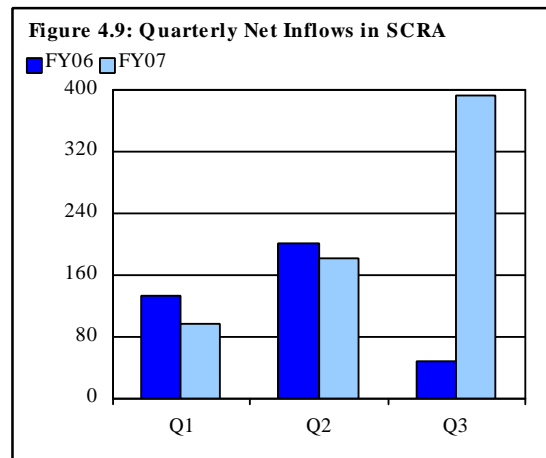
<sup>7</sup> Net of total servicing, the ADB disbursed US\$ 720.5 million during Jul-Mar FY07 compared with US\$ 369.9 million in Jul-Mar FY06.

<sup>8</sup> As a result, the cumulative net selling reached to US\$ 433.1 million (or Rs 26.3 billion) during Jul-Apr FY07; almost one-third of net selling of US\$ 1.6 billion (or Rs 98.5 billion) in Jul-Apr FY06.

further rise in SBP's NFA during the remaining months of FY07.<sup>9</sup>

The NFA of the scheduled banks showed an expansion of Rs 27.1 billion during Jul-Apr FY07 compared to the net contraction of Rs 16.0 billion during Jul-Apr FY06.

This higher expansion is mainly explained by large foreign investment (both direct and portfolio), a relatively weak demand for FE-25 loans by the business sector<sup>10</sup> and significantly higher inflows of workers' remittances during Jul-Apr FY07.<sup>11</sup>



It is interesting to see that most of the increase in scheduled banks' NFA came during the Q3-FY07 when the overall external account balance turned into a surplus. In addition to a narrowing trade deficit and an increase in foreign direct investment, a noticeable increase was also observed in Special Convertible Rupee Accounts (SCRA) balances during Q3-FY07 which was even higher than the combined increase in SCRA during Q1 and Q2-FY07 (see **Figure 4.9**). Although SBP purchased a major part of foreign exchange from the inter-bank market during Q3-FY07, the volume of purchases was not sufficient to offset the impact of these inflows on scheduled banks' NFA.

Going forward, the expansion in NFA of the banking system is expected to continue apace and SBP forecasts suggest a cumulative expansion of Rs 220 billion by end-June FY07 (see **Figure 4.10**). The inflows in private sector are expected to continue, but their magnitude remains uncertain. In the wake of high

<sup>9</sup> Issuance of sovereign bonds worth US\$ 500 million was projected in FY07 initial budget estimates.

<sup>10</sup> Business sector availed only US\$ 309.2 million from FE-25 deposits during Jul-Apr FY07 compared to US\$ 610.4 million during the same period last year. This relatively weak demand for foreign currency loans reflects the narrow spread between the cost of FE-25 loans and EFS loans, thereby making FE-25 loans unattractive for exporters. Importers on the other hand continued to avail the FE-25 loans which were cheaper compared to the rupee funding rate.

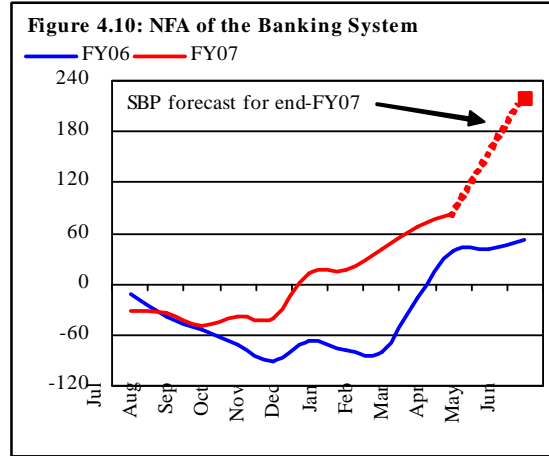
<sup>11</sup> During Jul-Apr FY07, workers' remittances grew by 22.6 percent compared to 5.2 percent during the same period last year.

inflation and reserve money growth pressures in the economy, sterilizing these huge foreign exchange inflows to minimize their impact on overall M2 growth will continue to be a challenge for SBP.

**Net Domestic Assets**

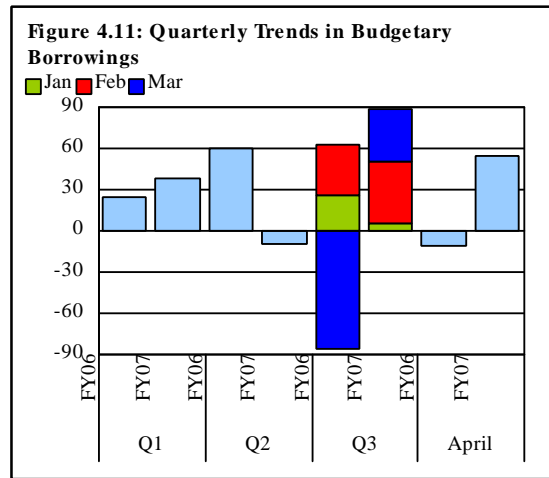
Growth in Net Domestic Assets (NDA) has remained more or less unchanged from the previous year during Jul-Apr FY07 to reach 12.1

percent. This was because the slowdown in credit to the non-government sector (from 19.4 percent in Jul-Apr FY06 to 12.7 percent in Jul-Apr FY07) offset the acceleration in credit to the government sector (from 2.7 percent in Jul-Apr FY06 to 14.3 percent in Jul-Apr FY07).



**Government Borrowings for Budgetary Support**

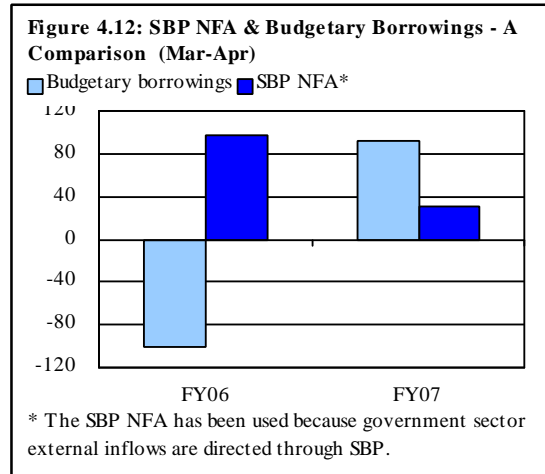
The increase in government's budgetary borrowings from the banking system during Jul-Apr FY07 was more than twice of that in Jul-Apr FY06. In specific terms, the budgetary borrowings recorded an increase of Rs 170.6 billion during Jul-Apr FY07 compared with Rs 49.9 billion in Jul-Apr FY06, despite the substantially large inflows in NSS.<sup>12</sup> The higher growth in the former period was caused mainly by (1) a rise in financing requirements; and (2) a relatively subdued financing



<sup>12</sup> The government mobilized Rs 42.1 billion through NSS during Jul-Mar FY07 compared with Rs 8.9 billion during Jul-Mar FY06. As a result, domestic non-bank borrowings reached to Rs 73.9 billion compared with net retirements of Rs 12.7 billion in corresponding period of previous year.

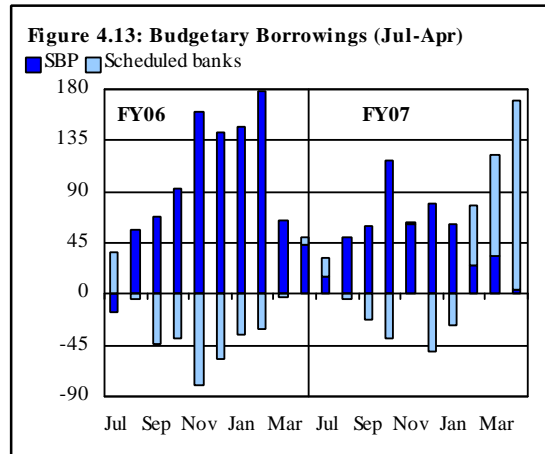
from external sector compared with Jul-Apr FY06.

It is interesting to note that the budgetary borrowings from banking sector, during Jul-Feb FY07, were less than half of that in the corresponding period last year. It was only March 2007 onwards that this picture changed completely and the budgetary borrowings exceeded those in the previous year (see **Figure 4.11**). This change stemmed mainly from a sharp difference in the volume of external financing in the two periods.



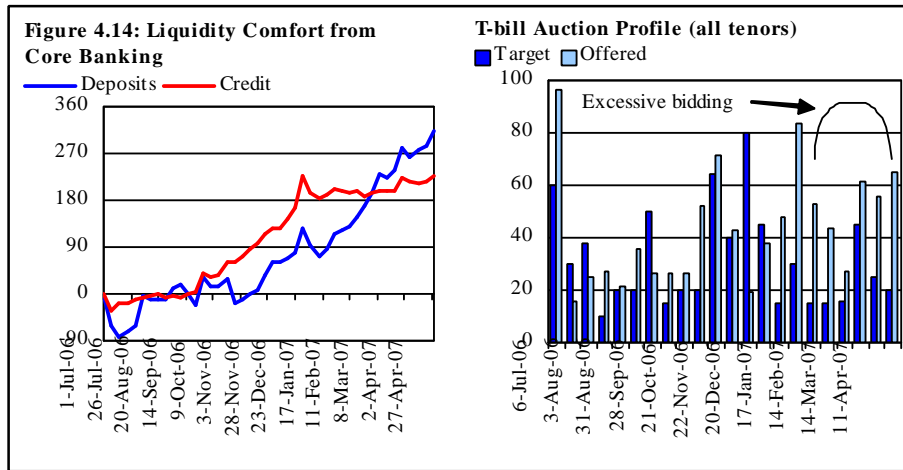
Specifically, during Mar-Apr FY06, the realization of Euro bond issuance and PTCL privatization proceeds had enabled the government to retire most of budgetary borrowings from the domestic banking system during the period (see **Figure 4.12**). As these external inflows were not available to the government in Mar-Apr FY07, government financed its budgetary requirements through domestic bank borrowings.

Nevertheless, it is worth mentioning that in Mar-Apr FY06, the net increase in budgetary borrowings was quite minimal as the government used the entire volume of external flows to retire domestic debt. In this perspective, the *increase* in budgetary borrowings of Rs 92.5 billion during Mar-Apr FY07 looks more disturbing.



Within the banking sector, the scheduled banks provided the bulk of budgetary finance during Jul-Apr FY07.

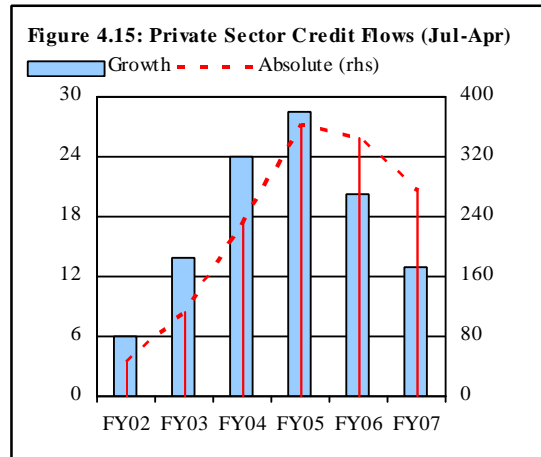
This is sharply in contrast with Jul-Apr FY06 when the SBP was directly financing the budgetary needs. The monthly break up of the data, however, shows that up to the end-January 2007, the government was retiring the borrowings from scheduled banks (see **Figure 4.13**).



This trend discontinued February 2007 onwards when the scheduled banks started investing heavily in government papers following the increase in Rupee liquidity at their disposal<sup>13</sup> (see **Figure 4.14**). The increase in offered amounts (net of maturity) in T-bill auctions, coupled with bid rates very close to the cut-off rates in previous auctions, provided government an opportunity to mobilize Rs 195.7 billion from scheduled banks during Feb-Apr FY07 and retire Rs 58.4 billion to the SBP in the same period. This helped SBP to contain the reserve money growth, in addition to absorbing additional liquidity from the inter bank market.

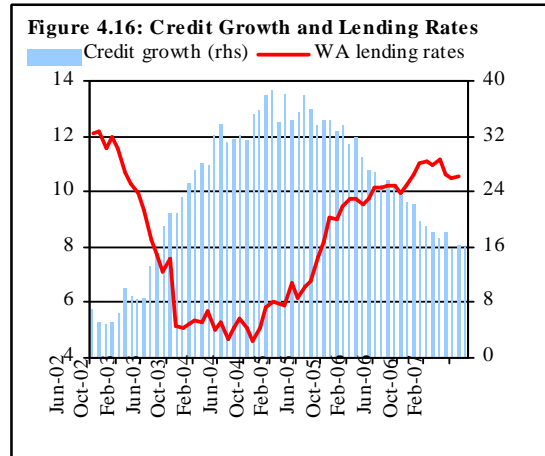
#### Private Sector Credit

Growth in credit to private sector slowed from 20.2

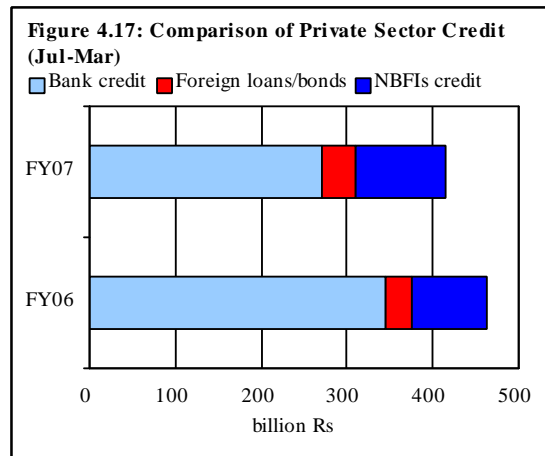


<sup>13</sup> The increase in liquidity stemmed mainly from a strong deposit growth, a slowdown in credit off-take and SBP's large US\$ purchases from inter bank.

percent during Jul-Apr FY06 to 12.9 percent during Jul-Apr FY07; the lowest credit growth for Jul-Apr period in the last five years (see **Figure 4.15**). More specifically, the volume of credit also declined substantially in Rupee terms in the said period showing that monetary policy has been reasonably successful in reducing excess demand in the economy (see **Figure 4.16**).



Besides interest rates increase, other contributory factors to the slowdown in private sector credit (net) could include: (1) the greater availability of non-bank finance to the private sector, including credit from NBFIs, increase in foreign private loans and issuance of corporate bonds in international market by the private sector companies (see **Figure 4.17**); (2) banks following more conservative credit assessments given the expanded borrowers' data available through CIB and slightly increasing non-performing loans; (3) restructuring as well as mergers and acquisitions in the banking industry;<sup>14</sup> (4) the SBP's continuous emphasis on monitoring of the personal loans as well as under other schemes to ensure the minimum use of bank credit to finance speculative activities; and (5) large volume of loan write-offs during Jul-Mar FY07 compared with the Jul-Mar FY06.<sup>15</sup>



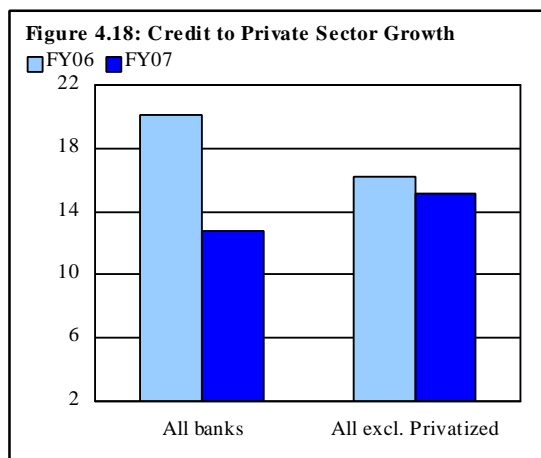
<sup>14</sup> The banks that merged during Jul-Apr FY07 registered an expansion of Rs 14.0 billion compared with Rs 30.1 billion in the corresponding period of previous year.

<sup>15</sup> In specific terms, loans amounting to Rs 16.1 billion were written off during Jul-Mar FY07 by commercial banks compared with Rs 6.9 billion in the same period of FY06.

In fact, a significant contribution to the realized FY07 credit growth was due to the provision of concessional facilities by the SBP. Excluding this, the credit growth drops to 10.1 percent in Jul-Apr FY07 from 19.3 percent in Jul-Apr FY06.

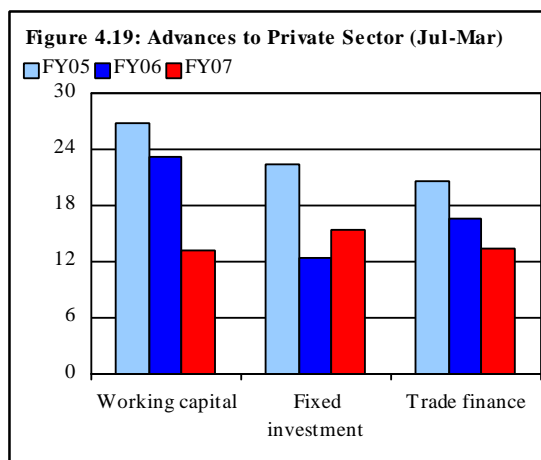
Nevertheless, the disaggregated data shows that the slowdown in private sector credit during Jul-Apr FY07 was not only

concentrated in few sectors; but was concentrated in only a few banks as well. Specifically, while the major slowdown was registered in textiles, cement industries and commerce sector (within business sector) as well as in personal loans; the bank-wise data shows that excluding the privatized banks,<sup>16</sup> the credit to private sector has decelerated only slightly (see **Figure 4.18**).



*Business sector loans<sup>17</sup>*

The growth in aggregate business sector loans decelerated to 13.6 percent during Jul-Mar FY07 compared with 18.5 percent growth in the corresponding period of the previous year. A major contribution to this deceleration was from working capital loans and trade financing. In contrast, fixed investment loans registered a higher growth,

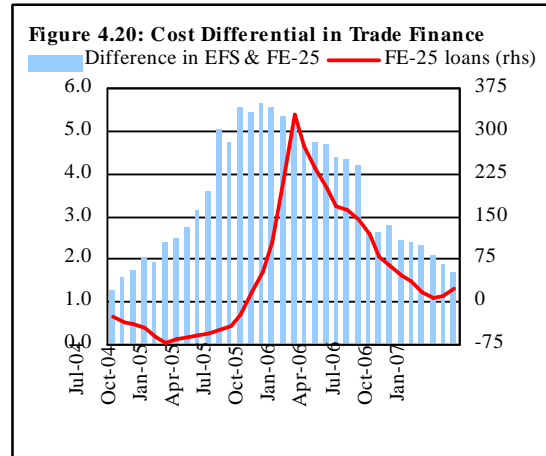


<sup>16</sup> Privatized banks include HBL, MCB, ABL and UBL. Together, these banks constitute 35 percent in outstanding credit to private sector at end April 2007 (and 36.5 percent at end April 2006).

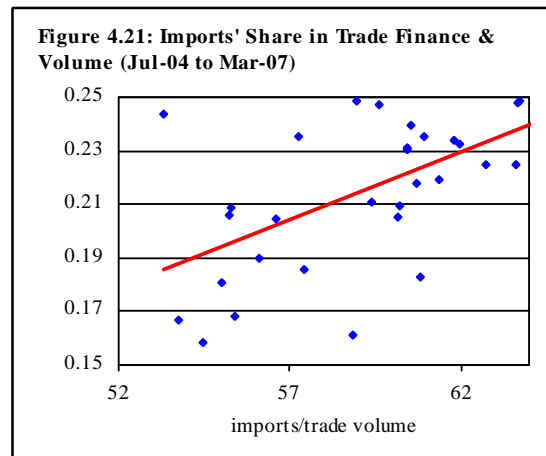
<sup>17</sup> Following sub-sections are based on data on private sector loans as per the classification under International Standard Industrial Classification and is available up to March 2007. The said data will not tally with the credit data reported in monetary survey as the latter includes banks' investments in equities of private business sector as well.

mainly to the telecommunication and power sectors (see **Figure 4.19**).

The slowdown in trade financing during Jul-Mar FY07 is in line with the deceleration in the growth of aggregate trade volumes from 21.9 percent during Jul-Mar FY06 to 7.9 percent in Jul-Mar FY07. However, the composition of trade finance during Jul-Mar FY07 is in stark contrast with Jul-Mar FY06. In specific terms, the EFS loans, that had registered a mere 0.7 percent growth during Jul-Mar FY06 constituted 71.3 percent of the increase in total trade finance during Jul-Mar FY07. This mainly reflected a decline of 150 basis points in the cost of such loans even as benchmark interest rates in the economy rose.<sup>18</sup>



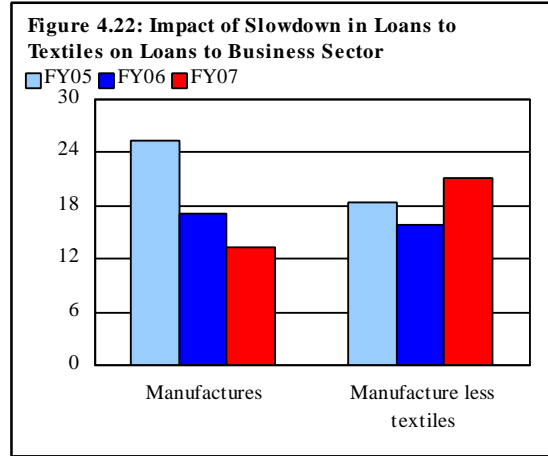
Foreign currency loans, on the other hand, lost their attractiveness for domestic exporters because of the dwindling spread between the cost of FE-25 loans and EFS loans (see **Figure 4.20**). However, it is interesting to see that the FE-25 loans for import financing and the share of import finance to total trade financing has increased substantially. This is a function of the relatively lower cost of FE-25 loans, as Rupee funding rate rose (see **Figure 4.21**).



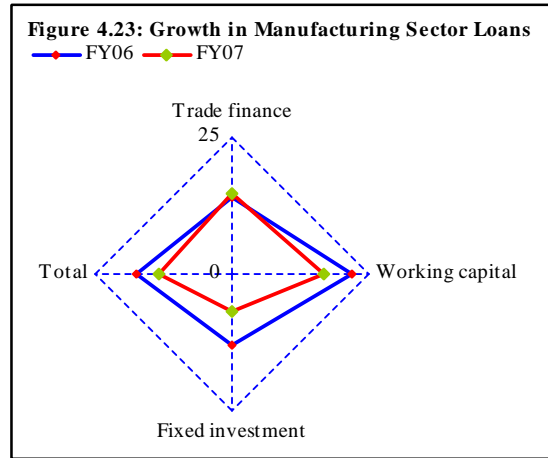
<sup>18</sup> The SBP reduced the rate of refinance from 7.5 percent to 6.5 percent during July 2006. In addition, the SBP also capped the maximum margin/spread of banks at 1 percentage point from 1.5 percentage points earlier.

Manufacturing sub-sector

Growth in advances to the manufacturing sector decelerated to 13.2 percent during Jul-Mar FY07, compared with 17.1 percent rise in the corresponding period of FY06. However, it is pertinent to mention here that excluding the textile industry, the growth in advances to manufacturing sector has actually accelerated (see **Figure 4.22**).



The slowdown was visible in both fixed investment loans and the loans for working capital (see **Figure 4.23**). Only trade financing registered a slight acceleration. A part of the slowdown in fixed investment loans is probably because many industries have already substantially increased their production capacities in recent years and have not borrowed aggressively in FY07. Moreover, delays in initiation of major infrastructure projects, e.g., power projects, have also led to subdued demand for fixed investment loans.



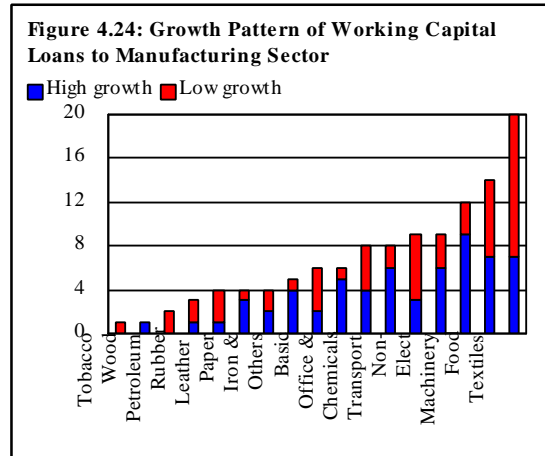
However, it must be noted that the growth in working capital loans to manufacturing sector, though decelerated, has remained strong at 16.8 percent during Jul-Mar FY07.

In addition, a mixed trend in working capital loans was evident across various industries. Specifically, more than half of the manufacturing units registered a

higher growth in off-take of working capital loans in Jul-Mar FY07 while others observed slower growth, compared with Jul-Mar FY06 (see **Figure 4.24**).

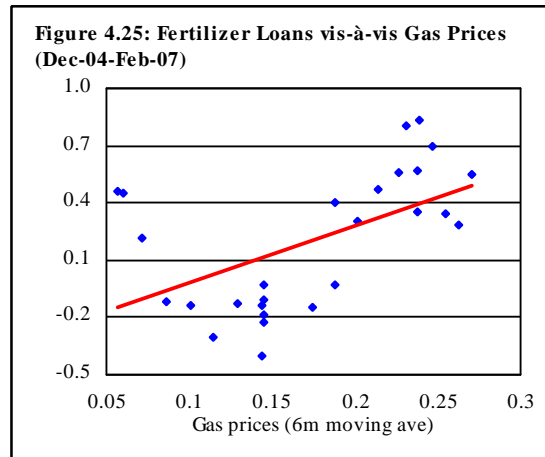
*(1) Sectors registering high growth in advances*

In most of the units that registered higher growth in advances during Jul-Mar FY07, the increase in raw material prices (both domestic and foreign) played an important role in raising the working capital requirements.



For example, advances to rice processing industries recorded a sharp growth of 26.8 percent during Jul-Mar FY07 compared with 6.1 percent growth during Jul-Mar FY06 (see **Table 4.3**). This growth was caused mainly by a surge in domestic prices of rice amidst rising international prices.<sup>19</sup> This, coupled with the higher demand for Pakistani rice in international market, increased the working capital requirements of the rice processing companies.<sup>20</sup>

Similarly, loans to the manufacture of electrical machinery and appliances registered a robust growth during Jul-Mar FY07 contributed mainly by domestic appliance industry and the manufactures of insulated wires and cables.



<sup>19</sup> The production of rice has dropped to 4.5 million tons in FY07 compared with 5.1 million tons in the preceding year. As a result, retail price of rice in the local market was increased from Rs 1100 per 40 kg in FY06 to Rs 1200 per 40kg in FY07.

<sup>20</sup> The demand for Pakistani rice in international market was due to a short supply of basmati rice caused by a sharp decline of 15 percent in the production of Indian rice.

While the growth in loans to former reflects a substantial growth of 30.6 percent in the unit prices of imported electrical machinery and apparatus during Jul-Mar FY07, the growth in latter is caused mainly by continued fixed investments in the telecommunication sector.

Fertilizer was another sector where the high growth in advances was driven entirely by increase in raw material prices. Specifically, the high growth in advances to fertilizer sector, despite a sharp slowdown in production, is explained mainly by a significant rise of 27.0 percent YoY in natural gas prices July 2006 onwards compared with a 14.5 percent rise in the same period last year (see **Figure 4.25**).<sup>21</sup>

Loans to the manufactures of wearing apparel registered a robust growth of 27.8 percent in Jul-Mar FY07 compared with only 5.1 percent growth during Jul-Mar FY06. Most of the increase was seen in trade financing as also evident in the 13.8 percent growth in exports of readymade garments, even over an already high growth of 24.8 percent during Jul-Mar FY06.

Finally, loans to basic metal industries registered a sharp growth during Jul-Mar FY07, compared with the preceding year. This was mainly due to a substantial rise in the international prices of pig iron and iron ores that increased the domestic

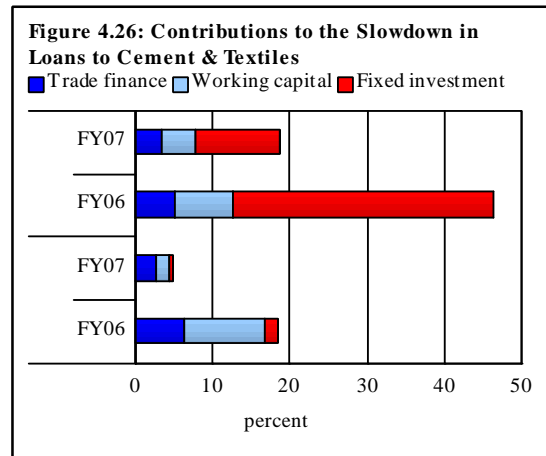
**Table 4.3: Growth in Private Sector Credit (Jul-Mar)**

	Change			
	percent		billion Rs	
	FY06	FY07	FY06	FY07
<b>1. Private business</b>	<b>18.5</b>	<b>13.6</b>	<b>230.9</b>	<b>203.2</b>
<i>of which</i>				
<b>A. Agriculture and forestry</b>	<b>-1.1</b>	<b>7.8</b>	<b>-1.4</b>	<b>10.5</b>
<b>B. Manufacturing</b>	<b>17.1</b>	<b>13.2</b>	<b>129.9</b>	<b>119.0</b>
<i>of which</i>				
a. Manufacture of food products	13.8	20.9	16.9	30.1
<i>Rice processing</i>	6.1	26.8	2.0	7.6
<i>Feeding stuff for animals</i>	70.6	395.8	1.3	9.9
<i>Sugar</i>	47.6	20.4	15.8	11.1
b. Manufacture of textiles	18.5	5.0	69.5	21.6
<i>Spinning of fibers</i>	15.6	5.4	31.7	11.8
c. Manufacture of wearing apparel,	5.1	27.8	1.4	8.0
d. Manufacture of refined petroleum	-2.0	69.7	-0.2	5.4
e. Fertilizers and nitrogen compounds	28.6	48.0	3.6	8.2
f. Cement	46.4	18.8	15.1	11.9
g. Manufacture of basic metals	23.1	43.7	3.4	7.9
<i>Manufacture of iron &amp; steel</i>	23.7	64.6	2.2	7.9
h. Manufacture domestic appliances	21.6	85.6	1.4	6.9
i. Manufacture electrical machinery	12.6	29.4	1.7	4.4
<i>Manufacture of electric motors</i>	-4.6	3.6	-0.1	0.1
<b>C. Electricity, gas and water supply</b>	<b>15.4</b>	<b>65.3</b>	<b>2.4</b>	<b>12.3</b>
<b>D. Construction</b>	<b>28.7</b>	<b>24.6</b>	<b>9.0</b>	<b>10.3</b>
<b>E. Transport and communications</b>	<b>11.3</b>	<b>22.2</b>	<b>5.7</b>	<b>13.9</b>
<i>Telecommunications</i>	19.6	39.6	6.0	17.0
<b>2. Personal loans</b>	<b>27.0</b>	<b>11.3</b>	<b>67.2</b>	<b>38.8</b>

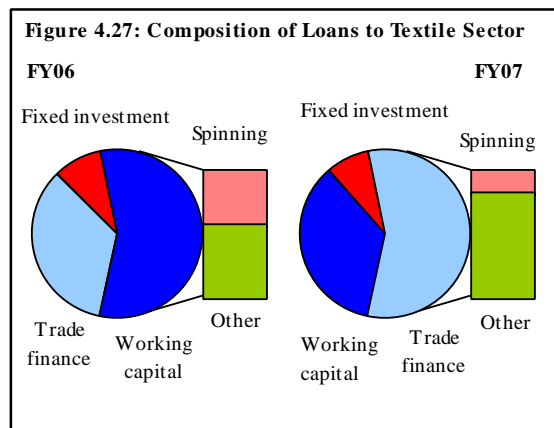
<sup>21</sup> However, the gas prices have been revised downwards January 2007 onwards.

prices of raw material of iron and steel industry, thus increasing the working capital requirements of the sector.

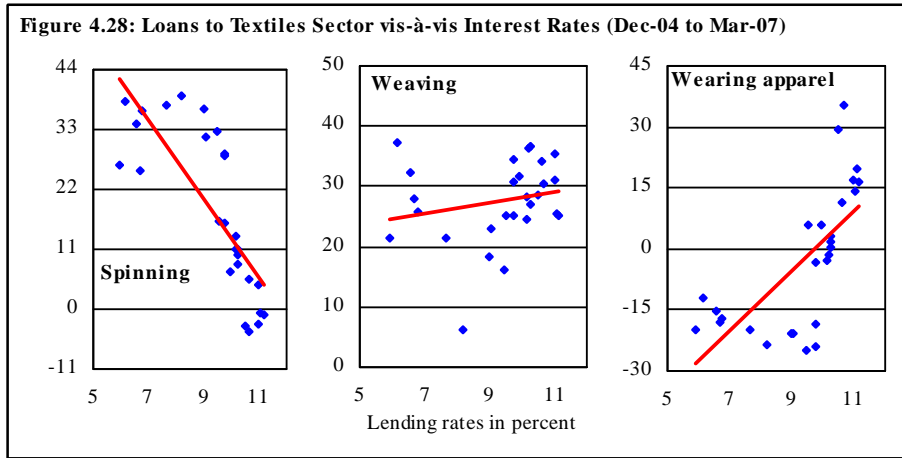
(2) *Sectors registering low growth in advances*  
Spinning, weaving and finishing of textiles, manufacture of knit wear and cement sectors were the major industries exhibiting a low growth in net advances. While the slowdown in textiles sector loans stemmed mainly from the sharp deceleration in working capital loans, the major contribution in slowdown in loans to the cement industry was from fixed investment loans (see **Figure 4.26**).



Within textiles, most of the slowdown in credit off-take was evident in the spinning of cotton and synthetic fiber industries (see **Figure 4.27**). Major reasons for this slowdown were: (1) a deceleration in export growth; (2) a relatively stable cotton prices through FY07; and (3) increase in financing costs. It must be noted that due to the availability of concessionary export finance scheme to weaving of textiles and the manufactures of wearing apparel, growth in advances to these sub-sectors remained strong (see **Figure 4.28**).



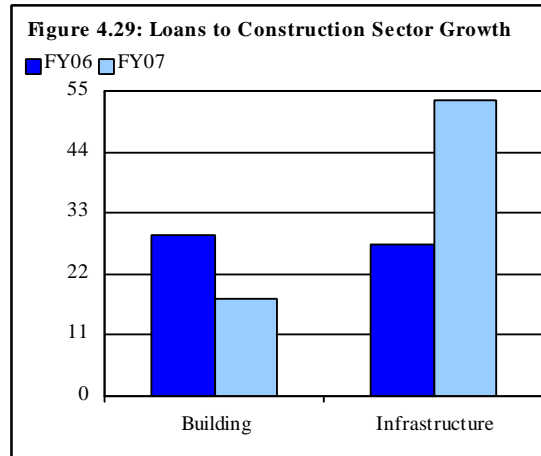
The slowdown in fixed investment loans to the textile sector was caused mainly by (1) substantial installation of new capacity in recent years (especially under Textile Vision 2005); and possibly (2) delayed off-take by industrialists in anticipation of textile sector relief package.



Likewise, the slowdown in credit extended to the cement sector was caused mainly by the sharp fall in demand for fixed investment loans, following the huge capacity augmentations in the cement industry during the last five years.<sup>22</sup> In contrast, the working capital loans in cement industry, though decelerated, exhibited a robust growth of 30.5 percent during Jul-Mar FY07 as reflected in rising demand in domestic and external markets.

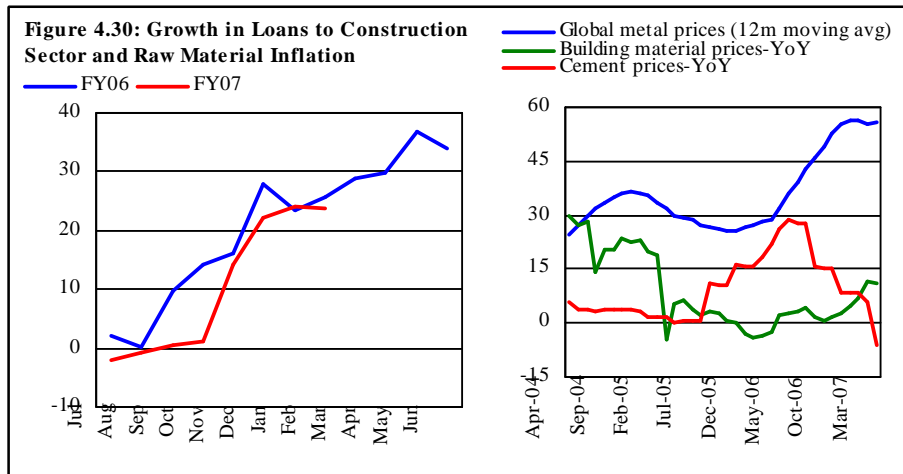
Construction sub-sector

Growth in advances to the construction sector remained strong at 24.6 percent during Jul-Mar FY07, although a little lower than 28.7 percent in Jul-Mar FY06 (see **Figure 4.29**). This was caused primarily by the increased financing needs for infrastructure related construction activities.



In addition, the rise in raw material prices, especially the international metal prices, have also led to an increase in financing needs of the construction sector (see **Figure 4.30**).

<sup>22</sup> From FY02 to FY06, the installed capacity in cement industry increased by 41.9 percent.



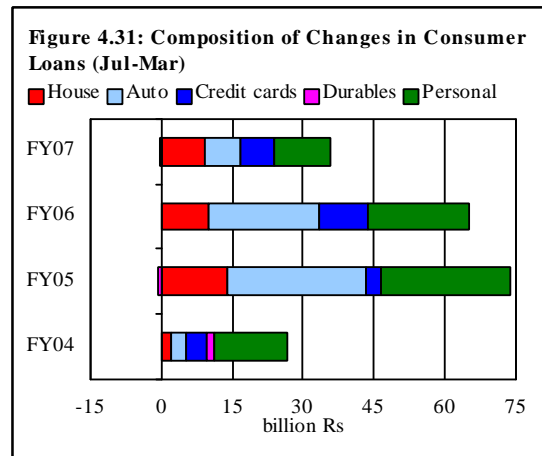
*Consumer Loans*

After registering an extraordinary growth of 70.5 percent in Jul-Mar FY05, the growth in consumer loans has been decelerating, dropping to 31.6 percent in Jul-Mar FY06 and further to 11.9 percent in Jul-Mar FY07 (see **Figure 4.31**).

While the Jul-Mar FY06 slowdown also incorporated the impact of higher base of FY05; the slowdown in Jul-Mar FY07 was caused primarily by the increase in interest rates as well as more restrained lending by banks.

The deceleration in auto loans, in particular, has the largest contribution of 8.7 percentage points in the total 19.7 percentage points decline in the growth rate.

The deceleration in the growth of auto loans is attributable to four major factors: (1) the increase in interest rate; (2) low demand for automobiles as a result of increase in prices of domestic cars and low interest of consumers in imported cars (see **Figure 4.32**); (3) high insurance charges that have increased the effective cost

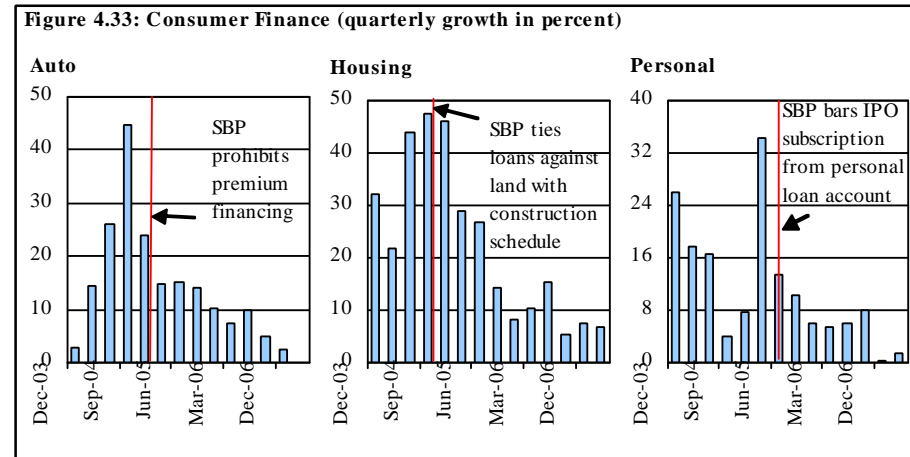
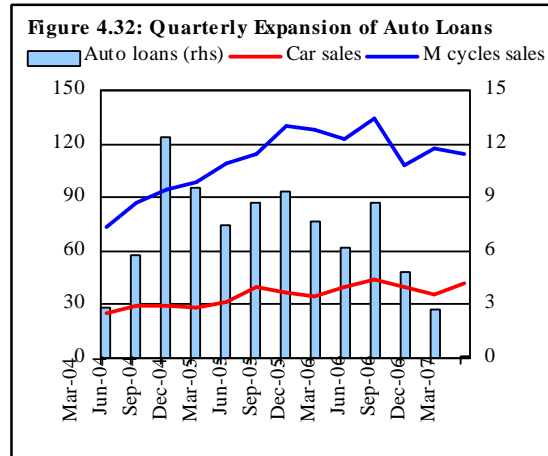


of automobile financing;<sup>23</sup> and (4) increased number of bad debts due to interest rates increases that resulted in a relatively more cautious lending by banks.

Growth in other personal loans witnessed a significant deceleration during Jul-Mar FY07. In addition to the increased cost of financing, the mandatory use of Credit Information Bureau (CIB) data by banks is also cited as a major reason in this slowdown. In specific terms, earlier banks were only required to set the credit limit to a certain borrower depending upon the aggregate take-home income.

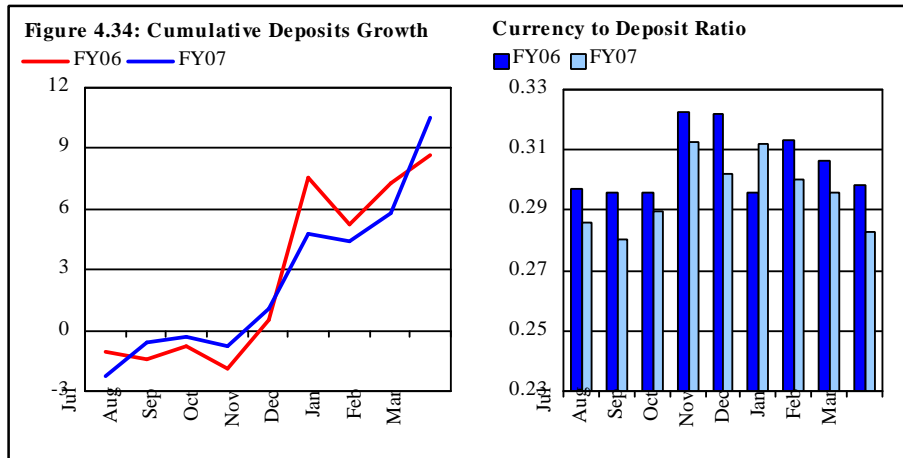
However, 2006 onwards, banks are required to set these limits after netting the aggregate take-home income by total financing already availed from other commercial banks.

In addition, the SBP has given much emphasis on the need to ensure closed



<sup>23</sup> Insurance is compulsory for auto financing from banks. Most of the car insurance companies have made it compulsory for the insurance holders to use costly car tracking devices.

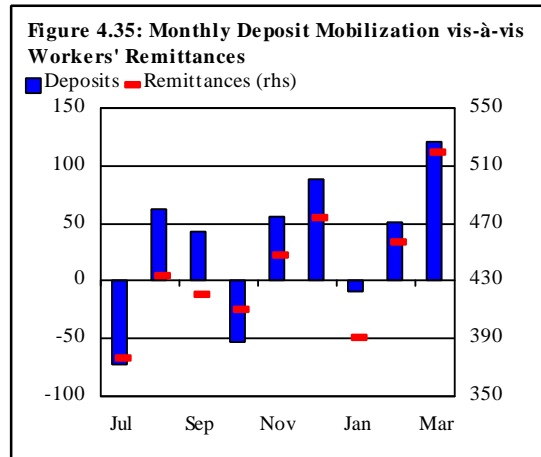
monitoring of personal loans so that these loans are not utilized for speculative activities (see **Figure 4.33**). Housing finance, though decelerated, recorded a robust growth of 20.9 percent during Jul-Mar FY07.



**Deposit Mobilization**

The deposit base of the banking industry during Jul-Apr FY07 registered a growth of 11.7 percent, slightly higher than the 10.5 percent seen during Jul-Apr FY06 (see **Figure 4.34**). Despite a sharp rise in investments in NSS instruments and increase in deposits of non-bank financial institutions (NBFIs), including aggressive retailing from mutual funds, the double digit growth in bank deposits is impressive.

More importantly, the currency to deposit ratio has remained low throughout Jul-Apr FY07 compared to the same period in the preceding year reflecting the increased



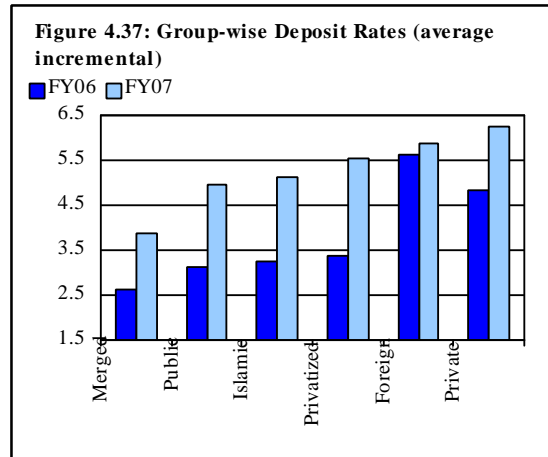
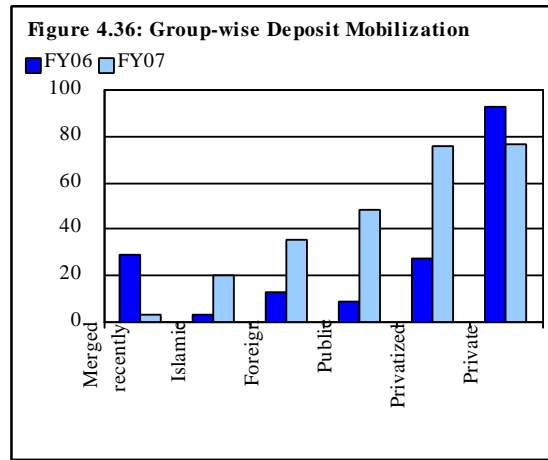
intermediation of the banking sector.

The higher growth in the deposits during Jul-Apr FY07 was caused mainly by a high growth in workers' remittances (see **Figure 4.35**), more aggressive marketing of deposit products by banks, increase in weighted average deposit rates, and the expansion in the network and usage of Automated Tellers Machines (ATMs) (which limits precautionary cash holdings).<sup>25</sup>

*Private Banks Continued to Lead*

Within the banking sector, the domestic private banks (excluding large privatized banks and also those banks that merged during FY07) continued to outperform other banking groups in deposit mobilization, although their deposit growth slowed somewhat from the previous year. However, due to a low growth base, the share of private banks in total increase in bank deposits slightly declined during Jul-Apr FY07 compared with Jul-Apr FY06 (see **Figure 4.36**).<sup>26</sup> The high returns offered by domestic private banks are the key contributors in high deposit mobilization of these banks (see **Figure 4.37**).

Further, as a result of SBP efforts to raise the rate of returns on deposits, the



<sup>25</sup> The increased use of electronic transactions, especially for cash withdrawals and funds transfer implies that the deposits remain within the banking system for longer periods.

<sup>26</sup> The Figure includes all customer deposits including government deposits. As such, this will not tally with the deposits reported in monetary survey since the latter excludes government deposits.

deposit rates of rest of the banking industry rose sharply during Jul-Mar FY07 compared with Jul-Mar FY06.<sup>27</sup> The only exception to this was the recently merged banks where the deposit mobilization decelerated during Jul-Mar FY07.

The currency wise decomposition of the deposits shows that within the overall deposits of the banking system, the share of foreign currency deposits is declining mainly due to expectations of a stable exchange rate stemming from continued massive forex inflows in the economy.

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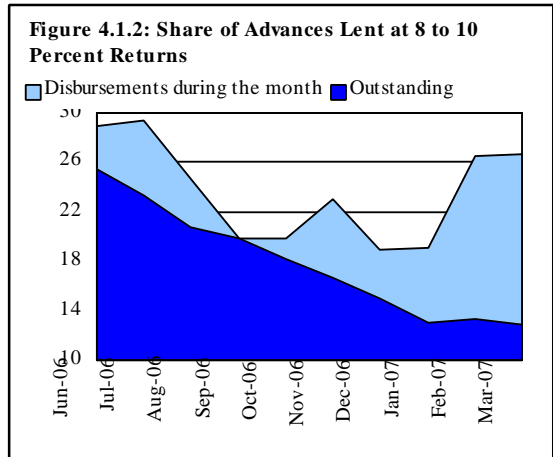
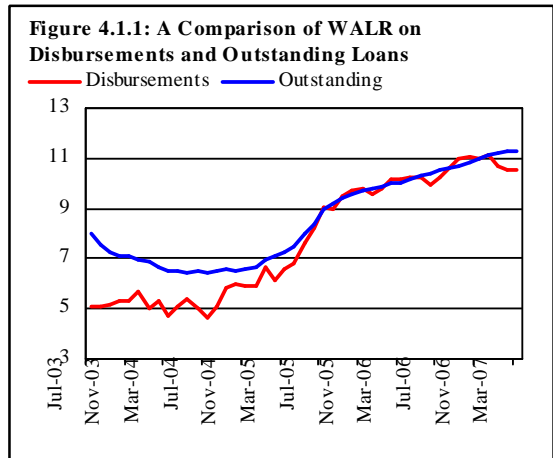
<sup>27</sup> The data on weighted average deposit rates is available up till March 207.

**Box 4.1: Factors Providing a Downward Bias to Weighted Average Lending Rates**

It may be important to mention that the weighted average lending rates include the returns applied on inter-bank lending as well. Since the volume of these lending is usually quite substantial; their impact on overall lending rates is also quite significant. Thus, when overnight rates are high, these provide an upward bias to weighted average lending rates and vice versa. However, as the maturity of inter-bank lending is usually quite short (for overnight, for instance), the impact of the returns applied on these lending gets diluted in outstanding data. Therefore, while the weighted average lending rates on gross disbursements (during the month) show a dip January 2007 onwards; the weighted average lending rates on outstanding loans continued the increasing trend (see **Figure 4.1.1**).

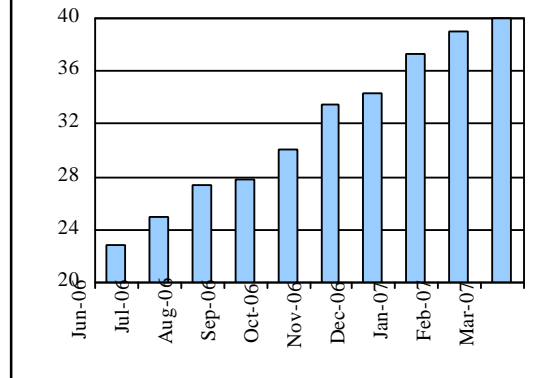
Since the decomposition of data on weighted average lending rate is not available with respect to the kind of transactions (i.e., customer lending and inter-bank lending); the impact of rates applied on inter-bank transactions can not be gauged. However, the advances given at returns between 8 percent to 10 percent can be used as a crude proxy for inter-bank lending. A look at the share of these advances in gross disbursements (during a month) and outstanding advances seconds the view that the impact of inter-bank lending is relatively lower in outstanding data (see **Figure 4.1.2**).

Therefore, to check whether the lending rates in the economy have actually increased, it will be more meaningful to analyze the share of loans extended at various rates of return. The advances extended at returns 12 percent and above has increased tremendously during Jul-Feb FY07 registering a robust growth of 85 percent (see **Figure 4.1.3**). As such, the share of these advances in total advances also increased tremendously from 22.8 percent at end-June 2006 to 39.1 percent at end February 2007. The data on gross disbursements during the month, however, shows that the average share of high cost loans during Jul-Feb FY07 period has been 28.6 percent.



In addition to inter-bank lending rates, a sharp increase in private sector lending on subsidized rates has also provided a downward bias to the weighted average lending rates. In particular, a sharp rise in loans under EFS and conversion of fixed investment loans on market based returns to subsidized LTF-EOP scheme has increased the share of low return lending in total lending. This is evident from a sharp growth of 89 percent in the share of loans extended at the rate 7.01-8.00 percent during Jul-Feb FY07 with an absolute increase of Rs 59.9 billion.

**Figure 4.1.3: Share of Outstanding Loans Disbursed at 12 Percent & Above**



**Box 4.2: SBP Measures to Increase the Supply of Bank Credit**

At first, the SBP, on the suggestion of Pakistan Banks' Association (PBA) removed the cap on aggregate exposure of banks against all their clean facilities with the amount of their equity.<sup>1</sup> The existing instructions require the banks to restrict their *Aggregate Clean Exposure* at the level of their equity. However, banks have now been advised that they may take higher exposure on unsecured basis provided the SBP is satisfied with the level of their risk management processes, loan default ratio and other allied factors.

Moreover, during April 2007, the SBP amended the Regulation R-17 of Prudential Regulations for Consumer Financing with which the banks restricted to cap their *housing exposure* at 10% of their total net advances. However, this restriction was withdrawn to enable the banks to expand the housing portfolio reasonably.<sup>1</sup>

Further, the SBP changed the definition of subordinated loans during FY07. Specifically, the borrowers are allowed to include sub-ordinated loan in their equity, which consequently enable them to have higher exposure limit (borrowing limit) from the financial institutions. However, the borrowers were earlier allowed to include only those sub-ordinated debts in their equity, which were taken from the sponsors of the borrowing companies, i.e. the borrowers enjoyed restricted choice to generate subordinated debts. However, with the amendment in March 2007, the companies can also generate subordinated loans from other than the sponsors. This amendment will enable the companies to have larger number of avenues to generate subordinated debts, that will consequently enable them to avail higher financing limits from the financial institutions.<sup>1</sup>

<sup>1</sup> See BPD Circular NO. 02 dated June 02, 2006 for details.

<sup>1</sup> See BPRD Circular Letter No. 14 dated April 21, 2007 for details.

<sup>1</sup> See BPRD Circular Letter NO. 09 dated March 26, 2007 for details.