4 Money and Credit

Q2-FY04 was a challenging period for the SBP as it strove to manage market expectations of a rise in rupee interest rates while simultaneously ensuring that the rupee remained on the path of a gradual appreciation in response to the still significant external account surpluses. The first challenge (task) was rendered particularly difficult by a confluence of factors that raised the demands on market liquidity in the face of a slowdown in supply.

In particular, the market expectations were guided by an anticipated tightening of market liquidity due to: (1) the evidently weakening remittance inflows through H1-FY04 (that implied a slowdown in liquidity injections by the SBP through forex purchases); (2) the exceptionally strong private sector credit demand that became very evident by October 2003 onwards; as well as, (3) the anticipated strong government demand[1] (driven by both, the increase in debt payments relative to FY03, and the very weak net investments in the National Savings Schemes). The impact of these market liquidity considerations was compounded by the acceleration in headline inflation through H1-FY04.

On the other hand, from the central bank's perspective, the fundamentals did not justify any *immediate* shift in the monetary stance. In the judgment of the SBP, the market liquidity was likely sufficient to accommodate the increasing demands from both, government and private sector, without significantly impacting domestic interest rates [2]. Thus, the arguments for a tightening of monetary policy hinged significantly on assessing the threat posed by the apparent rise in inflationary pressures. These reduced to two hypotheses:

(1) The evident inflationary pressures stemmed principally from the easy monetary stance of the SBP, and
(2) The threat posed by these inflationary pressures was sufficient to require an immediate tightening of the monetary stance.

The evidence does not strongly support both hypotheses. In particular, food inflation played a significant role in the acceleration in CPI inflation during H1-FY04, much of which stemmed from supply shocks rather than monetary policy. Moreover, SBP estimates suggest that food inflation was likely to decelerate in the

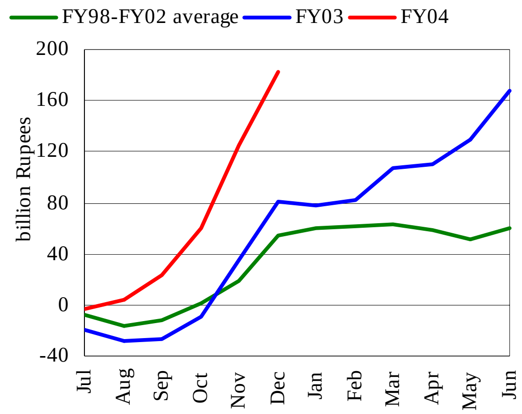
[1] The unexpected large PIB issue announced in September had an important impact on expectations, suggesting a rise in long-term interest rates, a consequent knock-on impact on short-term rates. The latter expectation was reinforced by the prevailing negative short-term real rates.
[2] In particular, a significant portion of increased government borrowings could potentially be met through privatization proceeds and external sector financing like Euro Bonds.

months ahead. Significantly, *non-food, non-oil* inflation remained quite subdued, ranging between 2.3 percent and 3.5 percent throughout H1-FY04 (see **Section** on **Prices** for details).

Similarly, SBP's perception that small acceleration in inflation was tolerable for the economy is based on the argument that inflation is, as yet, too low to cause serious damage. Another confounding element is that monetary pressures typically impact domestic inflation with considerable lags, and it is also likely that these lagged effects may be subdued due to the improved supply conditions. Furthermore, the lagged relationship between money growth and prices is further clouded by structural changes in Pakistan's financial sector, as mentioned in the *SBP's Annual Report for 2002-03*. The factors again counsel caution by the SBP in tightening monetary policy.

In light of these factors, the SBP considered it appropriate to maintain its monetary stance, to support the economy's progress towards a higher long-term growth trajectory.[3] Accordingly, SBP signaled its intentions by holding the acceptance cut-off unchanged in successive auctions for government paper. The consequent persistent low interest rates probably helped accelerated the momentum of private sector credit, taking the net credit growth during H1-FY04 to a mid-year all-time high [4](see **Figure 4.1**).

Figure 4.1: Private Sector Credit (flows)



While the exceptionally large net credit demand probably does owe to the strong economic recovery, it is important to note that the FY04 credit growth also represents a significant structural shift. This shift stems from the development of the consumer credit market, the entry of private commercial banks into the agri-credit market, as well as, (to a lesser extent) the reduction in the government's

[3] This said, the SBP has clarified that if inflation *does* accelerate it stands ready to move aggressively and adjust monetary policy accordingly.
[4] By end February 2004, the credit growth had reached approximately Rs 229.8 billion, the all-time high for any period of the fiscal year.

commodity market interventions. Thus, not only is the annual credit expansion likely to be significantly higher in FY04, but banks are unlikely to see the stabilization of net credit off take that was traditionally evident in the second half of a fiscal year.

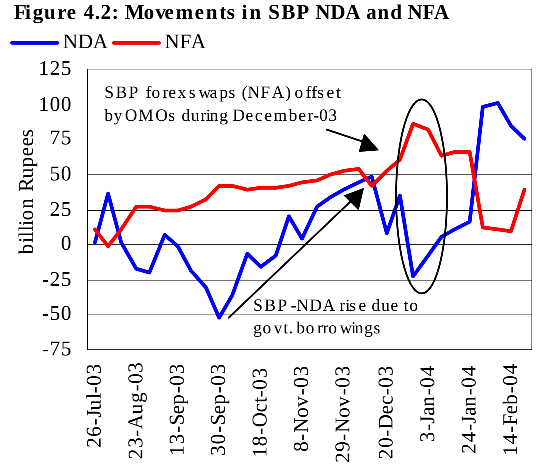
The exceptionally sharp jump in private sector credit, together with a lower retirement of government borrowings, meant that the growth in the Net Domestic Assets (NDA) jumped by Rs 116.1 billion during H1-FY04 as compared to a decline of Rs 13.5 billion during the corresponding period of FY03. Moreover, H1-FY04 also witnessed a reduction in net external inflows, reducing the growth in Net Foreign Assets (NFA) of the banking system relative to H1-FY03. Thus, in sharp contrast to the H1-FY03 monetary expansion of 8.6 percent, which was totally NFA driven, the 9.0 percent monetary expansion during H1-FY04 was largely a function of NDA growth (see **Table 4.1**).

Table 4.1: Share of NDA and NFA in Monetary Expansion

	H1-FY03	H1-FY04
Monetary expansion	152.1	187.5
Share of NDA		
Absolute (billion Rs)	-13.5	116.1
percent	-8.9	61.9
Share of NFA		
Absolute (billion Rs)	165.6	71.4
percent	108.9	38.1

A less welcome result of the SBP efforts to stabilize interest rates was the rise in the SBP NDA. This was because of lower acceptances in T-bill auctions, coupled with a decline in non-bank borrowings as well as net external receipts, led to increased government borrowings from the central bank. Ironically, as this awareness increased late in December 2003, it re-ignited speculation on interest rate hike, this time based largely on technical reasons – banks were now focusing on the likelihood of heavy SBP OMOs to contain its NDA within end-December 2003 targets (see **Figure 4.2**). While this demand did

Figure 4.2: Movements in SBP NDA and NFA



eventually emerge, it was significantly lower than anticipated[5], and finally led to the collapse of expectations of an interest rate hike, in the short-term, by January 2004.

Table 4.2: Monetary Survey of the Banking System (Flows during Jul-Dec)
billion Rupees

	FY04		FY03
	Credit Plan	**Actual**	**Actual**
Monetary expansion (I+II)	**191.7**	**187.5**	**152.1**
percent change	9.2	9.0	8.63
I. Net foreign assets	**34.2**	**71.4**	**165.6**
SBP	48.4	86.1	205.0
Scheduled Banks	-14.2	-14.8	-39.4
II. Net domestic assets (A+B+C)	**157.5**	**116.1**	**-13.5**
percent change	10.32	7.5	-0.88
SBP	13.4	-23.2	-144.4
Scheduled banks	144.1	139.2	130.9
A. Government sector	**46.1**	**-30.3**	**-55.1**
Net barrowing for budgetary support	53.1	-9.7	-34.0
SBP	5.9	-23.0	-161.8
Scheduled banks	47.2	13.3	127.8
Commodity operations	-7.0	-21.2	-21.0
Others		0.7	0.0
B. Non-Government sector	**106.5**	**152.8**	**68.5**
Private sector	103.8	182.0	81.0
(a) Commercial banks		186.6	77.2
of which: Export finance		20.3	-9.4
(b) Specialized banks		-4.6	3.8
Public sector enterprises	2.7	-24.9	-7.5
Autonomous bodies		-16.2	-2.1
Other PSEs		-8.2	-2.5
PSEs special debt-repayment a/c with SBP		-0.5	-2.9
SBP credit to NBFIs		-4.3	-5.1
C. Other items (net)	**5.0**	**-6.4**	**-26.9**

Source: Economic Policy Department

[5] As a matter of fact, this target could potentially be met even without conducting December 27, 2003 OMO but SBP did not take the risk because the increase in government deposits by end-quarter cannot be estimated perfectly.

The rise in the SBP NDA also contributed to the above target growth in reserve money despite a moderation in the growth of the SBP NFA. As a result, the 11.5 percent H1-FY04 growth in reserve money remains substantially above the end-December 2003 target.

4.1 Government Borrowings for Budgetary Support

The government's improved fiscal position during H1-FY04 reduced the financing requirement to only Rs 33.7 billion, almost half of the Rs 65.7 billion seen in H1-FY03. However, the aggregate availability of external financing, privatization proceeds as well as non-bank resource mobilization dropped by an even larger amount relative to H1-FY03. Therefore the amount of the net retirement to the banking system during H1-FY04 was lower than that in the corresponding period of FY03 (see **Table 4.3**)

Table 4.3: Deficit Financing *

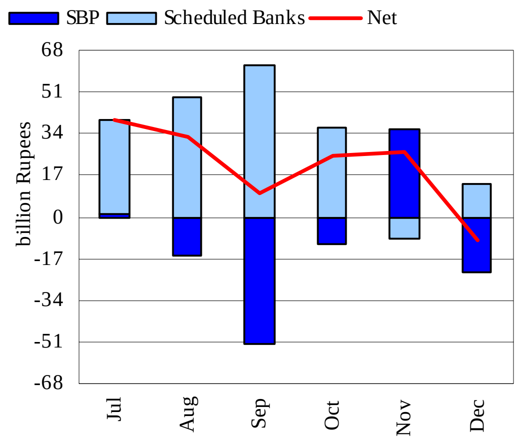
billion Rupees

	H1-FY03	H1-FY04
External	48.3	10.0
Non-bank	42.9	30.3
Privatization proceeds	8.5	1.7
Sub-total	*99.7*	*42.0*
Total financing requirement	**65.7**	**33.7**
Banking system	-34.0	-8.3

* The MoF and the SBP numbers may slightly differ due to mismatching of timings and definitions.
Source: Ministry of Finance

A striking development in the profile of government borrowings during H1-FY04 is the abrupt rise in borrowings from the SBP during November 2003. This is a reflection of the SBP efforts to contain a rise in interest rates (as discussed earlier). The subsequent substitution of the borrowings from the SBP with borrowings from scheduled banks mirrors the SBP efforts to meet credit plan NDA target through OMOs (see **Figure 4.3**).

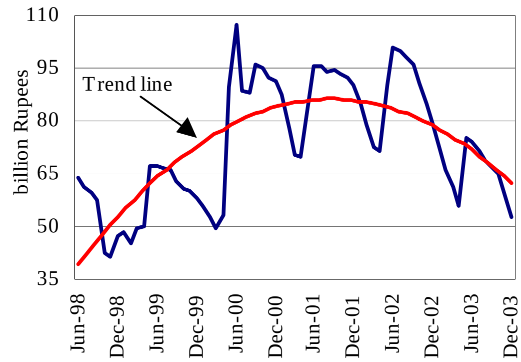
Figure 4.3: Net Budgetary Borrowings-FY04



4.2 Commodity Operations

The volume of public sector commodity procurement operations has been falling steadily since June 2002; even the seasonal increase during May-June 2003, was significantly lower than the levels witnessed in prior years.

Figure 4.4: Commodity Operations: Outstanding Credit



In absolute terms the net retirement of commodity loans totaled Rs 21.2 billion during H1-FY04, almost unchanged from H1-FY03, taking the aggregate stock of outstanding commodity operation loans at the end-December 2003 to Rs 52.8 billion, the lowest since May 1999 (see **Figure 4.4**).

4.3 Credit to the Private Sector

There was an unprecedented expansion of Rs 186.6 billion in the private sector credit during H1-FY04 that more than twice of the credit extended during H1-FY03. This extra ordinary growth not only reflects the widespread economic recovery but also the structural shift in the banking system that has increased the credit access to a larger portion of the economy.

In aggregate terms, there has been little change in the profile of the private sector credit growth (see **Table 4.4**):

1. Textile sector continue to dominate the net credit off-take, accounting 38.2 percent of the YoY growth. This growth appears consistent with high cotton prices and strong growth in textile exports.
2. Similarly, the growth of personal loans too remains strong.
3. An encouraging point in the credit profile is the sharp jump in the machinery loans (possibly construction) that suggests a pick up in the investment.
4. Another welcome development is the rise in the agri-credit; this probably reflects the improved returns in the sector and the increased confidence of farmers.

Table 4.4: Sectoral Distribution of Private Sector Credit during H1
billion Rupees

	Flows during		YoY change	
	FY03	**FY04^P**	**Absolute**	**Share in growth**
Overall Advances	**72.1**	**188.9**	**116.8**	**100.0**
I. Credit to Private Sector Business	**58.9**	**142.8**	**83.9**	**71.8**
A. Agriculture	3.6	10.7	7.1	6.1
1) Major crops	4.3	7.7	3.5	3.0
1) Minor crops	-0.6	0.1	0.7	0.6
1) Livestock	-0.2	1.7	1.9	1.7
B. Mining and quarrying	-0.6	6.7	7.4	6.3
C. Manufacturing	41.0	104.4	63.4	54.3
1) Food	1.6	-5.5	-7.1	-6.1
Sugar and preparation	-0.8	-7.4	-6.6	-5.6
2) Textiles group	31.4	76.0	44.3	38.2
Cotton	23.3	51.0	27.7	23.7
3) Non metallic mineral	0.5	4.0	3.5	3.0
Cement	-1.6	3.7	5.3	4.6
4) Fertilizer	-0.3	2.9	3.1	2.7
5) Machinery	-2.4	9.2	11.7	10.0
Agriculture, mining & construction	0.5	16.3	15.8	13.5
6) Miscellaneous	10.3	17.9	7.6	6.5
D. Ship breaking & waste	-0.7	1.0	1.7	1.5
E. Construction	1.0	2.8	1.8	1.5
F. Power, gas, water & sanitary	1.0	-0.6	-1.6	-1.3
G. Commerce	20.9	9.5	-11.3	-9.7
1) Whole sale & retail trade	18.6	5.0	-13.7	-11.7
2) Exporters	1.8	1.0	-0.8	-0.7
3) Importers	0.1	2.9	2.8	2.4
H. Transport, storage and communication	2.0	4.1	2.1	1.8
I. Services	7.7	4.5	-3.2	-2.7
J. Other private business	-16.8	-0.3	16.5	14.1
II. Credit to Trusts and NPOs	**1.2**	**6.0**	**4.7**	**4.0**
III. Personal Loans*	**11.9**	**40.1**	**28.2**	**24.1**

P: Provisional
* For break up of Personal loans, please see Section on Banking (credit expansion).
Source: Statistics Department, SBP.

4.4 Credit to Public Sector Enterprises (PSEs)

The net credit to the PSEs continued to decline during H1-FY04, which appears to reflect the success of the government's efforts towards their financial restructuring as well as improved management, in order to prepare for their privatization.[6]

In overall terms, Pakistan Steel Mills Corporation was the largest contributor in retiring commercial banks' debt followed by WAPDA and KESC (see **Table 4.5**).

Table 4.5: Credit to PSEs*
billion Rupees

	Stock s as on		Change during Jul-Dec.
	Jun-03	Dec-03	
PSMC	17.4	10.3	-7.1
WAPDA	17.2	10.7	-6.5
KESC	5.2	2.6	-2.6
PTCL	0.1	0.1	0.0
PIA	15.5	15.6	0.0
Other	32.4	24.2	-8.2
Total	**87.8**	**63.4**	**-24.4**

*Excluding the impact of PSEs special debt-repayment account with the SBP

4.5 Money Supply

The monetary expansion during H1-FY04 was marginally below than the credit plan target of 9.15 percent but slightly higher than that in H1-FY03. However, there was a structural shift in the composition of the growth in the two years. This year, monetary expansion is originating largely from net domestic assets in contrast to last year's expansion, which was principally through changes in net foreign assets. More importantly, it is the private sector, which is alone the source of the NDA rise as rest of the domestic sectors witnessed a net credit retirement.

Table 4.6: Components of Monetary Assets
billion Rupees

	Stocks as on		Growth during H1-FY04	
	30-Jun-03	31-Dec-03	Absolute	percent
Currency in circulation	494.6	567.5	72.9	14.7
Other deposit with SBP	3.5	3.5	0.0	-0.1
Cash in tills	30.4	30.3	-0.1	-0.5
Deposit of banks	141.0	145.2	4.2	3.0
Reserve money (M_0)	**669.5**	**746.5**	**77.0**	**11.5**
Demand deposits	608.2	698.3	91.5	15.0
Narrow money (M_1)	**1,106.2**	**1,270.7**	**164.5**	**14.9**
Time deposits	846.3	861.8	15.5	1.8
RFCDs	126.1	135.0	8.9	7.0
Total Deposits	1,580.6	1,695.2	114.6	7.3
Broad money (M_2)	**2,078.7**	**2,266.2**	**188.9**	**9.0**

Source: Economic Policy Department

The largest increase in money supply in both absolute and relative terms came in the form of demand deposits followed by currency in circulation. The cumulative

[6] The government is reportedly working on a *Financial Improvement Program* that would help in privatizing the PSEs after reducing their debt burden.

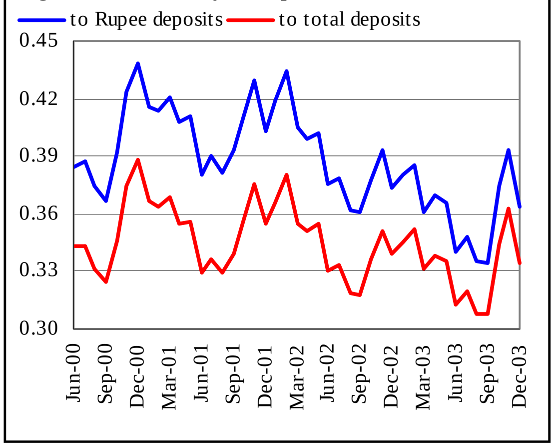
contribution of deposits in money supply was less than that of currency in circulation (see **Table 4.6**).

4.6 Monetary Indicators

Currency to Deposit Ratio (CDR)

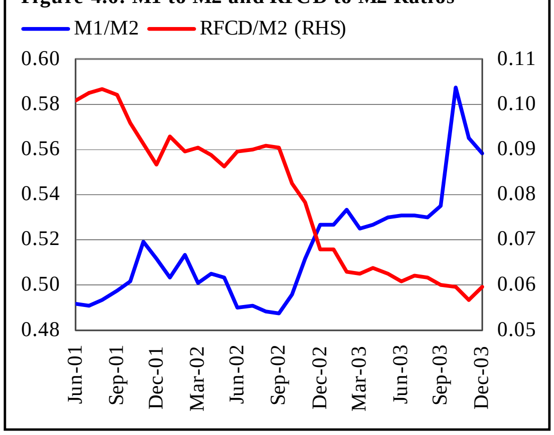
The steady decline of the CDR in recent years has been jolted in November 2003 by a surprisingly large rise in currency in circulation, which pushed the ratio to 0.36 up sharply from the 0.34 recorded in the preceding month. However, a closer look at the timings of the rise reveals that the unusually strong rise is probably due to the coincidence of cash withdrawals from banks associated with the Eid and last weekend of the month (when the monetary data for the month was recorded). This hypothesis is supported by the strong reversal in cash holdings during subsequent weeks (see **Figure 4.5**).

Figure 4.5: Currency to Deposit Ratios



This suggests that the cash holding preference in the economy has not changed significantly, and the strong rise in the currency in circulation (in rupee terms) from Rs 375.4 billion in June 2001 to Rs 568.5 billion at the end-December 2003, is simply proportional to the growth in money supply.

Figure 4.6: M1 to M2 and RFCD to M2 Ratios



Narrow to Broad Money Ratio (M1/M2)

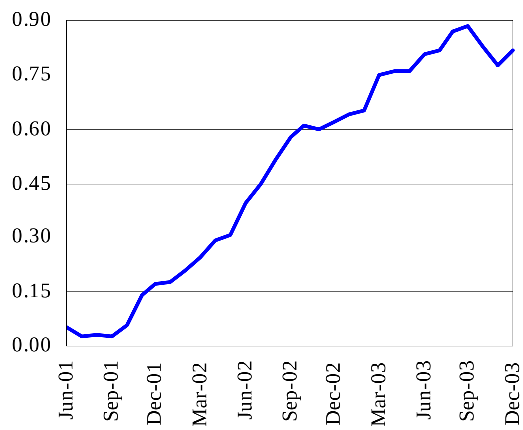
The liquidity preference in the economy, as proxied by the narrow money to broad money ratio (M1/M2), appears to increase dramatically since September 2002 (see **Figure 4.6**).

Given the fact that the CDR has not increased correspondingly during the period, the higher M1/M2 clearly suggests an increasing preference for demand deposits. The main reasons for this phenomenon appears to be: (1) conversion of resident foreign currency deposits into demand deposits (this was prominent in the H1-FY03 jump in the ratio); and, (2) temporary parking of corporate deposits due to the unwillingness of the institutions to lock-in their funds at the prevailing low-returns (this was particularly evident during H1-FY04). The October 2003 rise in M1/M2 was probably also incorporated the "1st Ramadan effect".[7]

NFA to RM Ratio

The backing of high-powered money by hard currency assets, which touched a high 88.3 percent in September 2003, slipped down to 81.9 percent by end-December 2003 because of slower growth in SBP-NFA compared to SBP-NDA during Q2-FY04 (see **Figure 4.7**). This was a function of an increase in government borrowings from the central bank as well as lower net forex inflows during Q2-FY04.

Figure 4.7: NFA to RM Ratio



[7] Since the last weekend of October 2003 and 1st Ramadan coincided, there was a massive shift of Rs 102.4 billion from time deposits to either currency in circulation or demand deposits.