4 Money and Banking

4.1 Overview

In the light of FY08 targets for inflation and GDP growth, and the risks identified in the Monetary Policy Statement for Jul-Dec 2007, SBP further tightened its monetary policy effective from 1st August 2007 (see **Box 4.1**). However, the impact of these policy measures was swiftly eroded by (1) sustained increase in food commodity prices, (2) impact of rising costs of oil products, and (3) a stimulus from expansionary fiscal policies. As a result, during the first half of FY08, inflationary pressures not only gained further strength, but the risks to macroeconomic stability also increased substantially. These risks were particularly evident from higher fiscal and external current account deficits, which turned out to be considerably higher than those envisaged in the monetary policy framework. The worsening of macroeconomic imbalance points to the continued and strong aggregate demand in the economy.

Box 4.1: Key Risks to Monetary Policy in FY08 and SBP's Response

In line with FY08 targets for GDP growth and inflation (i.e., 7.2 percent and 6.5 percent, respectively), the monetary policy framework envisaged the M2 growth of 13.7 percent for the year. In addition, the Monetary Policy Statement for Jul-Dec 2007 pointed out following key risks and challenges to the monetary policy:

- high and volatile domestic food inflation and its possible second round impact on the broader economy,
- continued strength in international oil prices and its likely pass through on the domestic inflation,
- possible monetization of fiscal deficit in case of delays in external financing receipts, and
- impact of an exceptional rise of 19.3 percent in M2 growth during FY07.

In response, SBP took several monetary and other measures, for example,

- raising the policy rate by 50 bps to 10 percent effective from August 1, 2007,
- recommending the government to retire borrowings from the SBP by Rs 62.3 billion during FY08, and
- capping the refinancing of concessional loans to exporters.

The sheer magnitude of the increase in commodity prices has been particularly unexpected and a disconcerting feature of inflationary pressures in FY08, particularly post-Q1-FY08. Prices of number of commodities (e.g., oil, copper, aluminum, wheat, palm oil, DAP) reached historic highs in FY08.

The impact on rising food inflation in particular has increased inflationary stresses throughout the economy, due to its large share in the consumption basket.

Similarly, the expected strength[1] in international oil prices significantly added to domestic inflation.[2]

Rise in food prices, due to supply problems and/or market inefficiencies, can clearly be better tackled through fiscal and administrative measures. However, given evidence that the steep rise in food prices was driving a second round inflationary cycle, continued monetary tightening was essential. It is important to note that without the sustained monetary tightening, it is likely that headline inflation would be considerably higher.

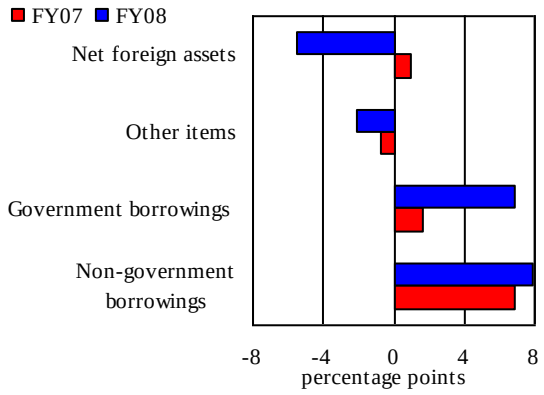
Table 4.1: Deficit Financing (Jul-Dec)

billion Rupees

	FY07	FY08
Deficit	169.0	356.3
Financing		
External	96.2	68.0
Domestic	72.7	288.3
Non-bank	25.3	58.0
Bank	31.5	228.6
Privatization proceeds	15.9	1.7

The rising fiscal deficit and its financing also posed severe complications for the Monetary Policy Framework for FY08.[3] Besides adding to aggregate demand pressures in the economy, the increased financing of the fiscal deficit from domestic sources has led to a sharp rise in budgetary borrowings from the central bank–the most inflationary in nature. The borrowings from SBP reached Rs 359.3 billion

Figure 4.1: Contribution to M2 Growth (Jul-1st Mar FY08)



[1] Although the monetary framework anticipated pressures on oil prices in the global markets, the extent of the rise in oil prices was far beyond expectations.

[2] While the government insulated the economy from a part of the rise in international oil prices, by freezing domestic prices of some products (diesel and petrol), the prices of most petroleum products and derivatives were unregulated.

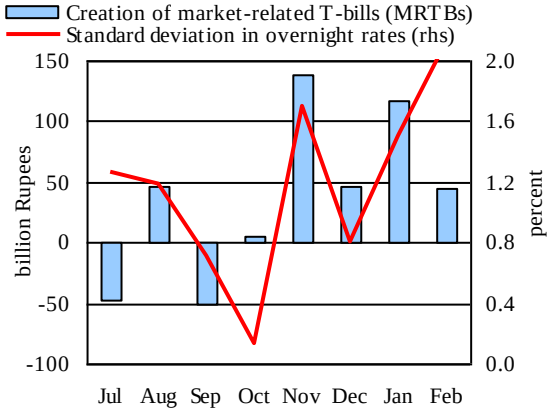
[3] The fiscal deficit during Jul-Dec FY08 was significantly higher than that in the corresponding period of the preceding year (see **Table 4.1**), and if current trends continue, the full-year fiscal deficit would breach the target for FY08 (i.e., 4.0 percent of GDP).

during Jul-1st Mar FY08, instead of the net retirement of Rs 62.3 billion recommended in the Monetary Policy Statement for Jul-Dec FY08. The sharp rise in budgetary borrowings was major driving force behind the high annualized M2 growth of 17.6 percent YoY as on 1st Mar 2008 (see **Figure 4.1**). This is a source of concern for SBP as it has the potential to add to the demand pressures in the economy going forward.

One major reason for excessive government borrowings is the shortfall in external financing flows.[4] However, it is important to note that (a) the rise in budgetary borrowings from central bank was greater than the decline in external financing receipts, and therefore (b) even if the projected external financing is realized and the government uses these to retire its budgetary borrowings from the central bank, this would not reduce the monetary overhang created by monetization of the high budget deficit.[5] In other words, it is important for the government to reduce its fiscal deficit, if monetary growth is to be contained.

These excessive borrowings from the central bank also posed difficulty in liquidity management by SBP (as reflected in higher volatility of overnight rates (see **Figure 4.2**).[6] The liquidity injections from unpredictable government borrowings weakened the transmission of the rise in policy rate to the retail rates (as reflected in softening of KIBOR).[7]
The widening fiscal deficit

Figure 4.2: MRTBs Creation and Overnight Rates



[4] In particular, uncertainties due to domestic political noise and the adverse impact of sub-prime mortgage crisis on global financial markets led to delays in privatization (through GDRs etc.)
[5] In case, if the government retires central bank's borrowings using external finance receipts, this will simply result into a substitution of SBP's NDA with SBP's NFA, with no impact on the reserve money. Thus, the monetary impact of the budgetary financing from the central bank and from external sources is identical.
[6] Although the fall in effective CRR during Jul-Feb FY08 was also adding to the market liquidity, the excessive government borrowings from the central bank was the dominant factor that even offset the impact of (a) a deceleration in the non-government deposit growth, (b) liquidity absorption through export refinance, (c) net foreign exchange outflows reflecting rising current account deficit, (d) SBP's market support, and (e) strong private sector credit demand.
[7] During Aug-Dec FY08, 6-month KIBOR declined by 26 bps.

coincided with the growing current account gap.[8] This unexpected worsening of country's external account was challenging for SBP because the evidence of high aggregate demand pressures evident in the persistent rise in current account deficit and its financing raises questions on the macroeconomic sustainability. And if not responded adequately, these could adversely impact growth outlook of the economy.[9] The impact of external account deficit on exchange rate may even add to inflationary pressures and expectations in the economy.

The available evidences suggest that the external account stress is not likely to ease in the short-term,[10] and therefore a prompt policy response, aiming at reducing expenditures through a mix of monetary and fiscal policies, is essential.[11] But with expansionary fiscal policy being one of the sources for higher current account deficit,[12] responsiblity of containing external account pressures falls disproportionately on the monetary policy.[13]

Rising macroeconomic imbalances clearly risked further stoking inflationary pressures in the economy (as seen in the steady increase in core inflation), raising a threat to Pakistan's economic growth prospects in medium to long-term. Thus, SBP responded aggressively by further raising its policy discount rate by 50 bps to

[8] Current account deficit increased sharply by 47.1 percent during Jul-Jan FY08 on YoY basis. In terms of GDP, this stands at 4.8 percent during Jul-Jan FY08 period, significantly higher than 3.6 percent during the corresponding period of previous year.

[9] The balance of payments difficulties may even constrain long run economic growth. For example, as the rise in export growth is the major sustainable mean to finance higher import demand, unsustainable deficit in the balance of payments constrains economic growth through restraining import demand (resulting from expansion in domestic economic activity).

[10] While the imminent slowdown in the US economy and its spillover to other export markets as well as the impact of domestic power shortages will hold back growth in exports, the continued strength of commodity prices in the global markets would likely to keep the import bill inflated.

[11] Since the monetary and fiscal policies are significant determinants of the current account balance, (see **Box 7.2** in *SBP Annual Report for FY07*), the monetary tightening aimed at correcting current account deficit should be accompanied by improved fiscal discipline.

[12] The government's decision to prevent *direct* pass through of higher international oil prices to domestic consumers had two major implications: (1) domestic demand for petroleum products remained intact, thus making their imports relatively less responsive to rising prices in the international markets, and (2) the government's decision to prevent *direct* pass through of higher international oil prices to domestic consumers has made import demand of POL products relatively less responsive to rising prices in the international markets, thereby maintaining pressures on aggregate demand in the economy.

[13] It is expected that (a) the reduction in domestic demand pressures following the monetary tightening would help easing pressures on import demand, (b) moderation in inflationary pressures would improve international price competitiveness of exports, and (c) commitment for achieving macroeconomic stability would reduce perceived risks to the economy and improve credit worthiness, thus easing external financing constraints.

10.5 percent and the cash reserve requirement of the banking system by 100 bps on current deposits effective from 1st February 2008.

The monetary policy can best contribute to long run economic growth by creating an environment with a stable price level or a low and predictable rate of inflation (see **Box 4.2**).[14] In the medium-term, stable prices also help in moderating the fluctuations in output. Addressing widening macroeconomic imbalances becomes essential as these not only add to inflationary pressures, but also harm economic growth prospects.

Box 4.2: Price Stability and Economic Growth

Price stability not only complements the GDP growth and employment generation in the long-run but also moderates the fluctuations in output and employment in the medium-run. This is because:

Firstly, low and stable price level provides the corporate sector with an environment where the economic agents can make their decisions without the fear of unexpected fluctuations in the purchasing power of the domestic currency. High and fluctuating price level distorts the market signals emitting out of the price mechanism by confusing both the producers and the consumers in differentiating between the changes in prices due to supply and demand conditions or due to changes in the general inflation. Thus, the increase in *noise* attached with the high levels of inflation oppresses the effectiveness of the market economy thereby making the incentive structures for the economic agents complicated where more resources are diverted towards hedging the risks associated with high levels of inflation.

Secondly, some recent empirical studies have concluded that low and stable level of general price level not only contributes to the economic growth and employment but also ensures greater stability in output and employment in the short to medium-run.[15] Moreover, price stability for a long period leads to low, stable and well anchored inflation expectations by the economic agents-granting freedom to the central bank to fix different disorders in the broader economy.

Thirdly, interest rate movements in an economy generally respond to the changes in inflation expectations because the lenders incorporate the costs associated with the loss in purchasing power of the principal amount in their lending decisions. When inflationary expectations are low, the rental cost of money will automatically go down due to low rate of purchasing power erosion-leading the real interest rates in the economy to go down. Moreover, with stable prices, not only the risks associated with holding long-term bonds and securities will be lower but will also reduce the premium on bearing that risk by the lender. It will lead to a declining interest rate scenario ensuring greater scope for the private sector to invest.

The importance of low and stable inflation in achieving high long-run growth also provides a cornerstone for monetary and fiscal policy coordination. It is therefore essential that government improves its fiscal discipline and retire its borrowings from the central bank as recommended in the monetary policy framework.

[14] For example, the resulting strength of pricing signals contributes towards a better resource allocation in the economy.

[15] For further details, see Bernanke, B.S (2006) "Benefits of Price Stability" Center for economic policy studies, Princeton University, Princeton.

Otherwise, the time path for achieving a stable and low inflation would be extended, thus raising the cost of adjustment for other economic agents.

Limiting government borrowings is also important. Otherwise, more aggressive SBP's efforts to contain M2 growth to its indicative target of 13.7 percent for FY08 would crowd out the private sector credit. So far this has been avoided. Available data suggests that the private sector credit has grown by 11.7 percent during Jul-1st Mar FY08; slightly higher than the corresponding period last year. The demand for working capital is on the rise as (1) delays in the settlement of price differential claims led IPPs and OMCs to resort to financing from bank sources for their working capital requirements, and (2) a sharp surge in raw material prices, both in the domestic and global markets, had pushed up the credit demand from the corporate sector.

Although the demand for fixed investment loans moderated in a number of industries, this is more a reflection of the fact that some industries had already expanded their activities in recent years, whereas others are using foreign currency loans & investments and floatation of debt instruments in the domestic market.

Table 4.2: Monetary Survey (Jul-1st Mar)

billion Rupees

	Absolute flows		Growth	
	FY07	**FY08**	**FY07**	**FY08**
Government borrowing	57.3	277.7	6.8	30.0
For budgetary support	94.0	296.6	13.1	36.6
SBP	25.6	359.3	6.4	104.2
Scheduled banks	68.4	-62.8	21.8	-13.5
Commodity operations	-36.5	-18.2	-33.9	-18.4
Credit to non-govt sector	232.3	320.5	10.6	12.4
Private sector	237.0	289.3	11.2	11.7
Credit to PSEs	-5.0	31.5	-8.3	39.1
Other items (net)	-25.2	-86.0	8.3	20.3
SBP	44.2	-21.0	-22.5	10.2
Scheduled banks	-69.4	-65.0	63.4	29.9
NDA	264.3	512.3	9.7	16.6
SBP	69.6	337.4	32.0	223.9
Scheduled banks	194.7	174.9	7.8	6.0
NFA	31.4	-223.4	4.6	-22.7
SBP	30.1	-142.4	5.3	-18.1
Scheduled banks	1.3	-81.1	1.1	-41.2
M2	295.8	288.8	8.7	7.1
YoY M2 growth			14.0	17.6

4.2 Monetary Survey

Growth in broad monetary aggregate (M2) slowed to 7.1 percent during Jul-1st Mar FY08 compared to 8.7 percent during the corresponding period of FY07 (see **Table 4.2**). This M2 growth stemmed entirely from a sharp rise in Net Domestic Assets (NDA) of the banking system due to high government borrowings. Net Foreign Assets (NFA) of the banking system registered a net contraction mainly reflecting weakness in country's external account.

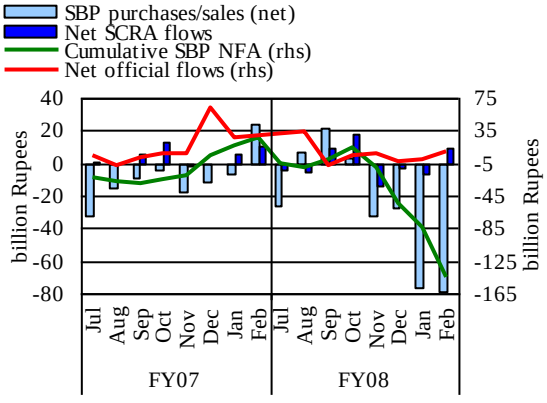
The YoY M2 growth as on 1st March 2008 however remained higher at 17.6 percent compared to 14.0 percent YoY growth as on 3rd March 2007. This suggests that meeting the indicative target of 13.7 percent for M2 during FY08 would be a major challenge for the central bank.

4.2.1 Net Foreign Assets (NFA)

NFA of the banking system registered a net contraction of Rs 223.4 billion during Jul-1st Mar FY08 compared to an expansion of Rs 31.4 billion during the corresponding period previous year. This contraction in NFA is attributable to domestic political unrest, pressures on commodity prices in the international markets and the global implications of the sub-prime mortgage crisis in the US economy.[16]

Within the banking system, contraction in SBP's NFA was higher compared to the scheduled banks. Delays in issuance of GDRs, lower logistic support receipts and SBP's decision to provide foreign exchange to support a part of oil payments (even when the oil prices are at their historic high levels) explain the current decline in SBP's NFA (see **Figure 4.3**).[17]

Figure 4.3: Monthly Causative Factors in SBP NFA (Jul-Feb)



Similarly, scheduled banks' NFA registered a net decline of Rs 81.1 billion during Jul-1st Mar FY08 compared to an expansion of Rs 1.3 billion during the corresponding period last year. Despite substantial rise in the workers' remittances,[18] decline in the net foreign

[16] The domestic political problems have led to a slowdown in exports, outflow of foreign assets from the country, and delays in the privatization. The liquidity problems in the international financial markets following sub-prime mortgage crisis in the US economy has made external financing more difficult. At the same time, the economic slowdown in key markets has reduced the demand for Pakistan's exports.

[17] The SBP NFA for Jul-Feb period of FY07 included US$ 731 million mobilized through issuing OGDCLs GDRs.

[18] Workers' remittances increased by US$ 4.1 billion during Jul-Feb FY08 compared to US$ 3.4 billion during the same period FY07.

investment (see **Figure 4.4 (a)**) and slowdown in foreign private loans[19] are the major factors responsible for contraction in scheduled banks' NFA.[20]

Furthermore, the trade financing availed by importers due to a rising interest rate differential between the Rupee and foreign currency loans led to a sharp decline in the scheduled bank's NFA (see **Figure 4.4 (b)**). More specifically, during Jul-Feb FY08, trade sector availed Rs 26.7 billion worth foreign currency loans compared to Rs 7.9 billion during the Jul-Feb FY07. It is important to note that this decline in scheduled banks' NFA was despite an increase of Rs 25.3 billion in Resident Foreign Currency Deposits (RFCDs) during Jul-1st Mar FY08 against the increase of just Rs 1.7 billion during the same period last year. Had this increase in RFCDs not taken place, scheduled banks' NFA would have shown an even larger contraction.

Figure 4.4a: Foreign Investment (Jul-Jan)

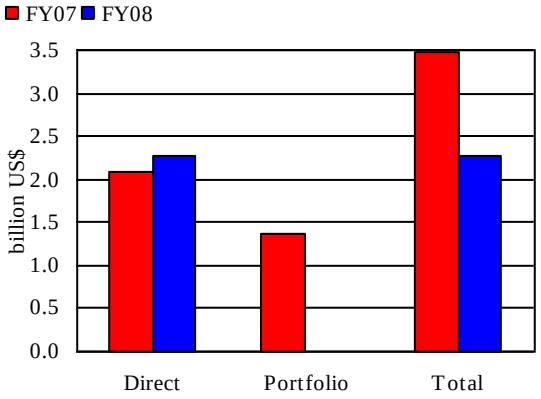
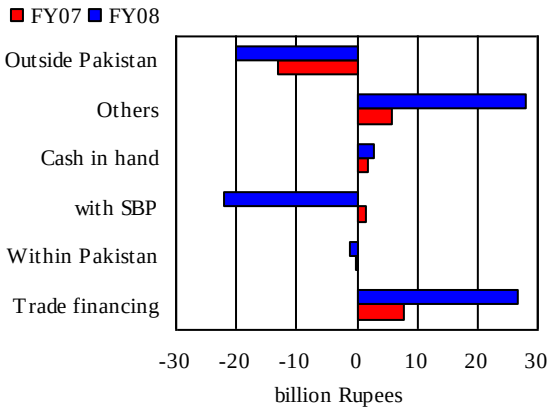


Figure 4.4b: FE-25 Utilization (Jul-Feb)



4.2.2 Net Domestic Assets (NDA)

Due to a phenomenal rise in government sector borrowings from the banking system, net domestic assets of the banking system registered a strong growth of

[19] Foreign private loans witnessed a sharp slowdown as economy received only US$ 127 million during Jul-Jan FY08 in this category compared to US$ 191 million during the same period last year.
[20] The scheduled banks NFA for Jul-Feb FY07 included the impact of GDR issued by one of the private banks as well of foreign currency bond issued by one of the corporates in the Telecom sector.

16.6 percent during Jul-1st Mar FY08 compared to the growth of 9.7 percent during corresponding period of FY07. Growth in private sector credit however remained at 11.7 percent during Jul-1st Mar FY08, only slightly higher than 11.2 percent growth during the corresponding period last year.

Credit to the public sector enterprises also contributed to the current rise in NDA by registering a growth of 39.1 percent during Jul-1st Mar FY08 in contrast to the negative growth of 8.3 percent during the corresponding period last year. This growth in the credit to the PSEs is attributable to delays in settlement of oil price differential[21] claims of one public sector oil marketing company (OMC), and the credit extension to the electricity distribution companies.

Figure 4.5: Government Financing Mix (Jul-Dec)

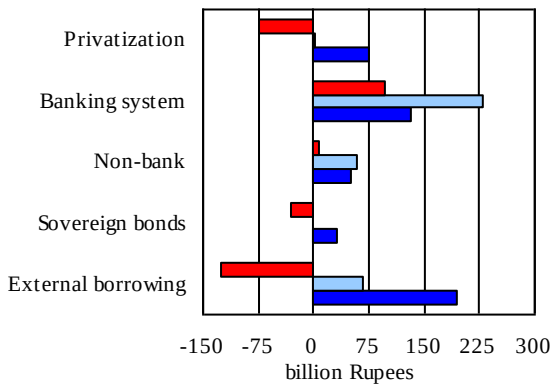
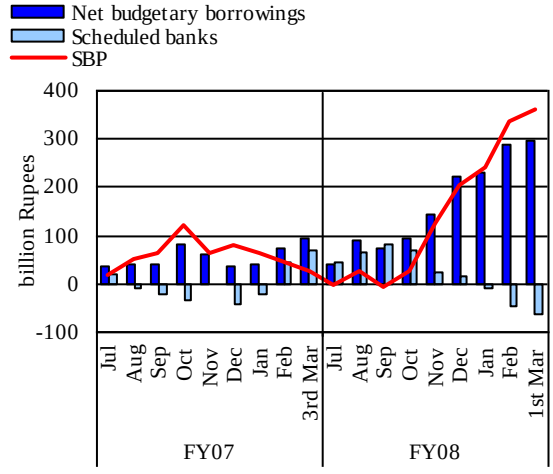


Figure 4.6: Net Budgetary Borrowings from the Banking System (cumulative)



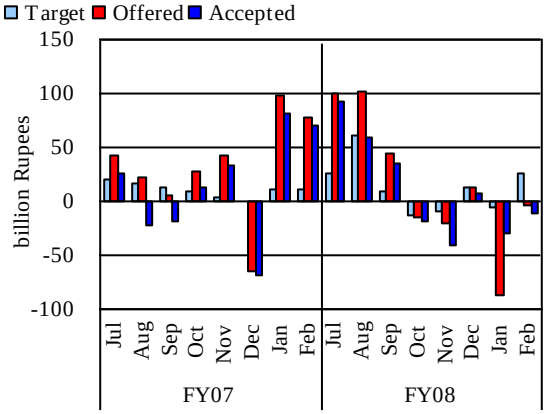
Government Budgetary Borrowings

Government budgetary borrowings from the banking system rose sharply by Rs 296.6 billion during Jul-1st Mar FY08 against Rs 94.0 billion during the corresponding period last year. It indicates that during first eight months of the current fiscal year, government has borrowed Rs 165.6 billion in excess of its full year banking sector borrowings target of Rs 131.0 billion.

[21] Differential is between the international oil prices and the domestic consumer prices.

The above target government sector borrowings from the banking system are the result of multiple factors. These include, (1) slower growth in tax revenues, (2) a higher growth in government expenses, (3) less than expected external inflows for budgetary finance, and finally (4) the fall in the receipts of logistic support funds.[22] As a result, government borrowings rose substantially from both the bank and the non-bank sources (see **Figure 4.5**).

Figure 4.7: T-bill Auctions (net of maturities)



However, what is more worrying for the monetary policy is the fact that the government has relied heavily on borrowings from SBP. This, being the most inflationary, may further worsen inflationary expectations.

Table 4.3: SBP Open Market Operations (Jul-Feb)

	Injection	Absorption
FY07	47.0	658.4
FY08	68.4	718.4

On the other hand, government has retired Rs 62.8 billion to commercial banks during Jul-1st Mar FY08 (see **Figure 4.6**).

It may be pointed out that the government had borrowed substantially from the scheduled banks during Q1-FY08. This trend however changed completely second quarter and onwards when scheduled banks showed little interest in the T-bill auctions.[23] This probably reflect strong seasonal demand for private sector credit (as well as attractive returns on private sector loans) and lower growth of non-governemnt deposits. In addition, the expectations regarding changes in discount rate in the monetary policy statement for H2-FY08 also limitied the

[22] Pakistan has received US$ 281.7 million under logistic support during Jul-Feb FY08 compared to US$ 722.0 million received during the corresponding period of FY07.
[23] SBP did not increase the cut-off rates significantly from September FY08 onwards because of the narrowing differential between T-bill cut off rates and the discount rate.

scheduled banks' participation in the auctions of the government securities (see **Figure 4.7**).[24]

Figure 4.8a: Reserve Money Flows (cumulative Jul-1st Mar FY08)

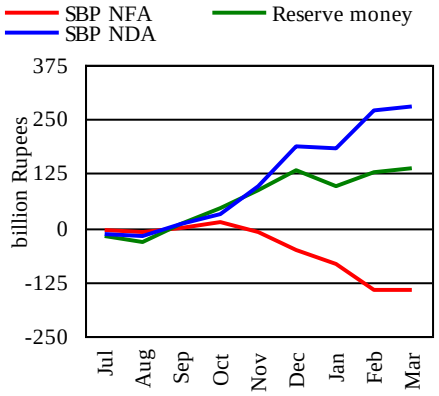
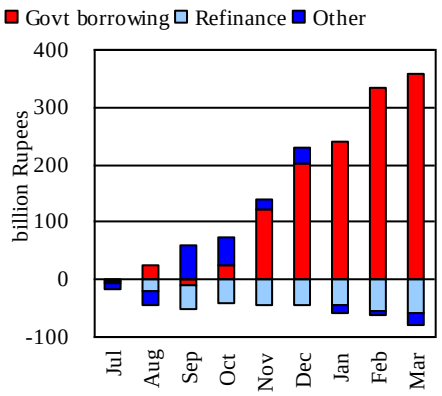


Figure 4.8b: Composition of SBP NDA (cumulative Jul-1st Mar FY08)



As a result, scheduled banks did not choose even to rollover their investments in the T-bills during Q2-FY08.

Despite exceptional rise in government borrowings from the central bank, the reserve money growth fell 11.3 percent during Jul-1st Mar FY08, compared to the exorbitant 15.5 percent during the corresponding period of FY07 (see **Figure 4.8**). This was possible due to the net retirement under the refinance facility, a sharp decline in SBP NFA and net higher absorprion by SBP in open makret operations (see **Table 4.3**).

Table 4.4: Growth in Private Sector Credit

percent

	FY07	FY08
Private sector credit	11.2	11.7
minus the impact of circular debt	11.2	11.2
Business sector advances*	13.0	13.7
Working capital	14.6	19.6
Fixed investment	6.7	0.5
Trade loans	19.9	21.0

*pertains to Jul-Jan period

Private Sector Credit (net)[25]

Private sector credit growth remained slightly higher during Jul-1st Mar FY08

[24] It is important to note that the government deposits with scheduled banks have reached Rs 26.2 billion by 1st March 2008. Since the budgetary borrowings from the banking system are reported in net terms, these deposits have actually depressed overall budgetary borrowings accordingly.

[25] Private sector credit comprises of banks' investments and advances to the corporate sector. The data on private sector credit is based on monetary survey covering the period of Jul-1st Mar FY08.

compared with corresponding period of the previous year (see **Table 4.4**). Although delays in settlement of price differential claims of OMCs[26] and IPPs[27] have somewhat inflated the demand for working capital. The adjusted credit off-take remains strong at 11.2 percent during Jul-1st Mar FY08.[28]

A look on advances to private sector suggests that a part of resilience in private sector credit is due to a sharp surge in raw material prices (both in the domestic and global markets) that has pushed up the credit demand from the corporate sector. This is evident from higher growth of working capital loans[29] during Jul-Jan FY08 in a number of industries (such as edible oil, cement, rice processing and construction) for Jul-Jan FY07 period. The impact of higher raw material

Figure 4.9: Cumulative Growth in Working Capital Loans

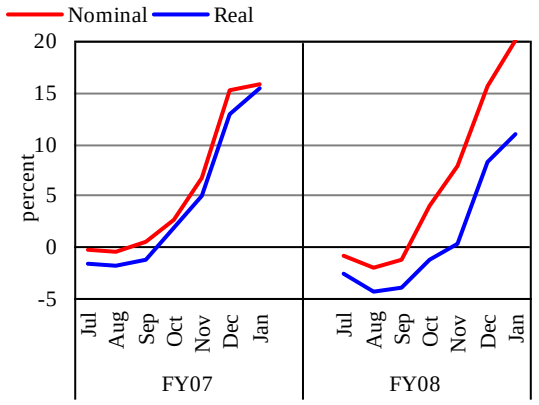
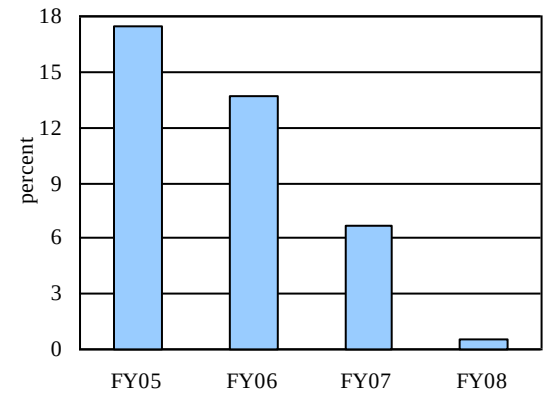


Figure 4.10: Growth in Fixed Investment Loans (Jul-Jan)



[26] The government has been providing the oil price differential (between the international oil prices and the domestic consumer prices) to OMCs. However, in recent months, following cash flow problems due to delays in settlement of price differential claims, OMCs had to borrow (against the government guarantee) from the banking system. Out of total amount disbursed to OMCs (i.e., Rs 33.0 billion), Rs 27.0 billion was disbursed to a public sector entity which is not included in the reported private sector credit data.

[27] In case of IPPs, delays in settlement of claims with WAPDA led to an increase in their demand for working capital.

[28] Anecdotal evidence suggests that delays in settlement of claims with WAPDA also had subsequent effect on higher demand for credit by few refineries. However, this rise in working capital demand by refineries could not be adjusted due to data limitations.

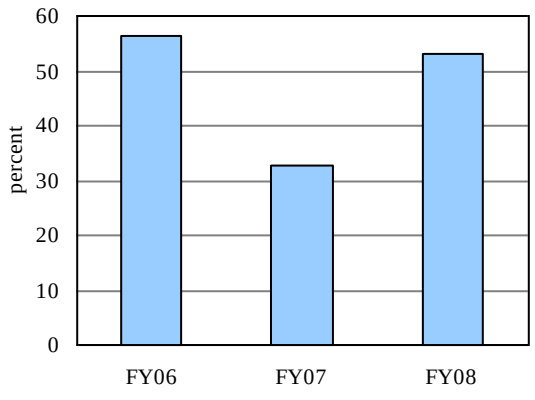
[29] This includes trade financing and working capital loans.

prices on private sector credit demand is also captured in the large variance between real and nominal demand for working capital loans during Jul-Jan FY08 (see **Figure 4.9**).[30]

It appears that demand for fixed investment loans has moderated in a number of industries (see **Figure 4.10**). However, this does not necessarily suggest a slowdown in economic activities as (a) the moderation in fixed investment demand in *cement, construction* and *textile* is more of a reflection of the fact that these industries had already expanded their capacities in recent years; and (b) some of the industries are financing their expansion projects through other sources, such as foreign currency loans (e.g., telecom), foreign investments (telecom, chemical) and floatation of debt instruments (e.g., chemical, cement, real estate and ship yard) in the domestic market. Further, the demand for fixed investment is expected to grow substantially in the power and refinery sector.[31]

It is encouraging that the private sector is issuing more debt instruments (e.g., privately placed Sukuks and TFCs). Anecdotal evidence suggests that apart from supplementing the total credit availability to the private sector, the financing from NBFIs, in some of the cases, is substituting the bank loans. The latter has an offsetting impact on the overall credit from the banking system.

Figure 4.11: Credit Concentration in Top Five Banks (Jul-1st Mar)



Another interesting observation is the higher concentration of lending activities within a few banks, as reflected in the rising share of large five banks in the incremental credit extended during Jul-1st Mar FY08 (see **Figure 4.11**).[32] This probably reflects the lower credit to deposit ratio, particularly of the large banks, that provided them room to extend more credit. On the other hand, some of the banks have become more vigilant while extending loans probably due to (1) rising

[30] The stock of working capital loans has been deflated by the WPI index for non-food group.
[31] It is expected that financial closure of more power projects would realize in the next fiscal year, and some of the refineries would raise funds from banking sector to undertake their expansion activities.
[32] Banks have been classified according to their asset size.

recovery issues as a result of bad debts and write-off, especially in consumer loans, and (2) limits on capital requirements (a few smaller banks have curtailed aggressive lending to remain within their capital adequacy limits).

Private Sector Advances (net)[33]

Private sector advances witnessed a growth of 11.9 percent during Jul-Jan FY08, almost unchanged from the corresponding period last year (see **Table 4.5**). *Manufacturing*, *power* and *other private business* made major contribution in the net advances growth. In contrast, contribution from *telecom*, *construction*, *personal* and *others* was significantly lower during Jul-Jan FY08 compared to the corresponding period of FY07 (see **Figure 4.12**).[34]

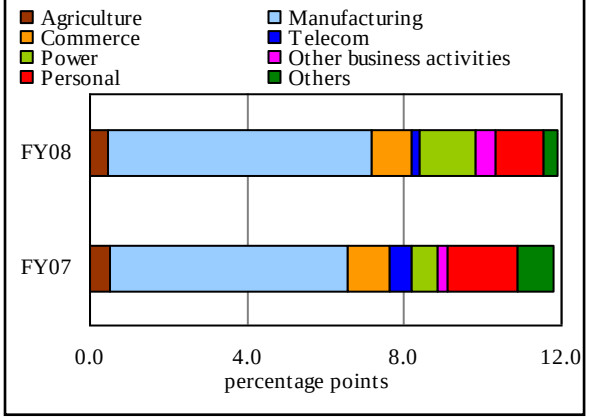
In the *power sector*, the demand for advances (both for working capital and fixed investment) was significantly higher during Jul-Jan FY08.

Table 4.5: Private Sector Advances (Jul-Jan)

growth in percent

	FY07	FY08
1. Private sector businesses	**13.0**	**13.7**
A. Agriculture	**7.2**	**6.9**
B. Manufacturing	**12.9**	**14.7**
Textiles	8.1	19.1
Paper and products	55.6	20.0
Fertilizer	20.8	-0.8
Cement	14.6	3.2
Edible oil	7.5	8.5
Basic iron & steel	56.7	26.0
Rice processing	26.4	74.9
C. Electricity, gas and water supply	**63.9**	**73.9**
D. Construction	**24.2**	**19.4**
E. Commerce and trade	**11.0**	**10.8**
F. Transport, storage & communications	**17.3**	**5.7**
G. Real estate, renting and business activities	**6.6**	**11.8**
F. Other private business n.e.c	**15.5**	**-20.4**
2. Personal	**10.0**	**6.7**
Consumer financing	10.4	6.6
Private sector advances	**11.8**	**11.9**

Figure 4.12: Contribution to Growth in Private Sector Advances

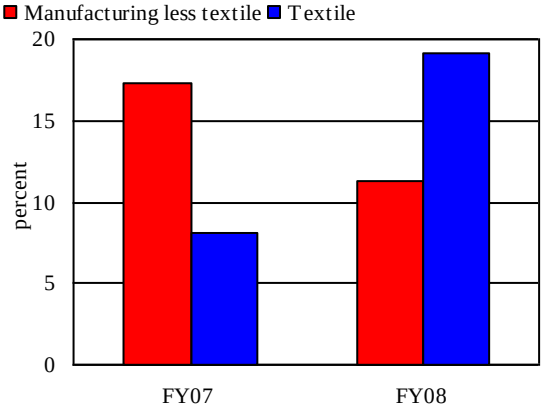


[33] This section in based on data on private sector loans as per the classification under International Standard Industrial Classification and is available up to January 2008. The said data will not tally with the credit data reported in monetary survey as the latter includes banks' investments in equities of private business sector as well.

[34] *Other sectors* mainly include business sector loans which are not specified elsewhere. As some of the loans included in the category were reclassified, this led to a sharp reduction during Jul-Jan FY08.

Indeed, the rise in working capital loans incorporated the impact of delays in payment from WAPDA to IPPs, whereas growth in fixed investment loans reflects the impact of capacity expansion in private sector power projects.

Figure 4.13: Growth in Manufacturing Sector Loans



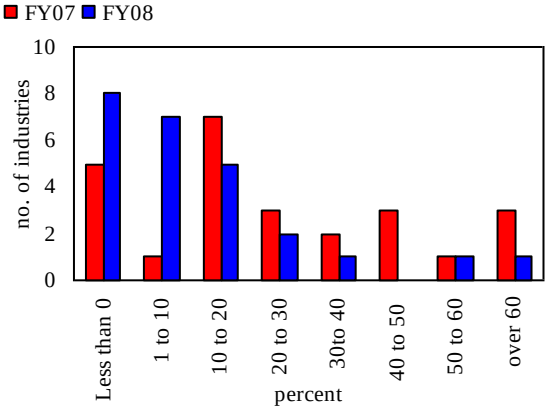
Manufacturing

Growth in advances to the manufacturing sector rose to 14.7 percent during Jul-Jan FY08 from 12.9 percent in Jul-Jan FY07. This higher growth was mainly driven by higher advances to the textile sector; excluding the textile industry, the growth in advances to manufacturing sector has decelerated (see **Figure 4.13**).

Advances to non-textile sector

Slowdown in advances to non-textile sub-sector is broad-based and mainly came from lower demand for fixed investment loans and for working capital loans (see **Figure 4.15**).[35] The growth in trade-related loans to non-textile sectors (particularly in *basic chemicals, cement and fertilizer sectors*) however accelerated during Jul-Jan FY08, reflecting increased trade activity during the period under review.

Figure 4.14: Credit Growth in Non-Textile Sector



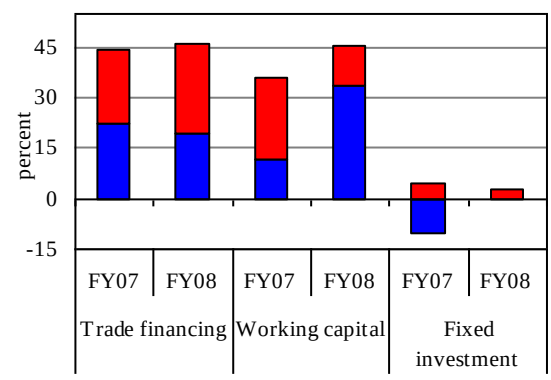
[35] The number of industries showing net retirement has increased in Jul-Jan FY08 (see **Figure 4.14**).

Slowdown in working capital loans in *edible oil,*[36] *basic iron and steel, machinery of domestic appliances* and *weaving apparel* reflects mainly the dismal industrial activities in these sectors during Jul-Jan FY08. In the fertilizer sector, the deceleration in the working capital loans was largely due to lower prices of natural gas.[37]

Growth in working capital advances to *refining petroleum products* also decelerated, but this still remains strong at 87.0 percent during Jul-Jan FY08, probably due to delays in settlement of claims with the OMCs. Demand for working capital loans however rose in a number of industries, for example *rice processing, medicinal and pharmaceutical products, electrical distribution and control apparatus, cement, and paper industry*. In the case of rice processing, the rising demand for working capital was mainly due to increased domestic prices of rice.[38] Higher demand from the pharmaceutical industries was primarily a reflection of increased production on account of measures taken by the government in form of duty slash on raw material imports.[39]

In case of fixed investment loans, deceleration in many industries partly reflects (1) large repayments in some sectors (e.g., following a substantial disbursement for capacity enhancement in past few years, net retirement in cement sector was to be expected) and (2) substitution of expensive bank loans with local bond issuances (e.g., a swap of banks' credit with a debt instrument by one of the large paper manufacturer).

Figure 4.15: Purpose-wise Growth in Manufacturing Sector Loans



[36] As Pakistan imports a substantial quantity of edible oil, the domestic industry is sensitive to international prices of edible oil.
[37] The gas prices during Jul-Jan FY08 fell by 9.3 percent compared to a rise of 24.2 percent last year.
[38] On average, retail rice prices increased within a range of 42-58 percent under different categories during Jul-Jan FY08.
[39] For details, see **section 2.2** on **Large Scale Manufacturing**.

Advances to textile sector
Growth in advances during Jul-Jan FY08 was largely visible in working capital loans, mainly to the spinning industry.[40]

Specifically, the advances to the spinning industry (see **Figure 4.16**) registered a robust growth of 42.1 percent during Jul-Jan FY08 compared with 9.8 percent increase in Jul-Jan FY07, reflecting a rise in domestic raw cotton prices (see **Table 4.6**).

Figure 4.16: Advances to Textile Sector

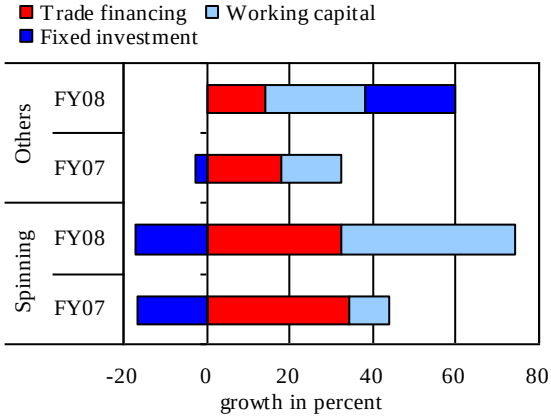


Table 4.6: Impact of Rise in Cotton Prices on Cotton Credit (Jul-Jan)

amount in billion Rupees; production in billion bales

	% change in raw cotton prices	Production of raw cotton	Loans extended to spinning of cotton
FY07	4.3	13.0	7.3
FY08	26.1	12.8	33.4

Fixed investment loans to the textile sector witnessed a retirement, probably of loans disbursed under the Textile Vision 2005. Monthly trends however show a rise in demand for fixed investment loans during November and December 2007 that interestingly coincides with the rise in import demand for textile machinery during these months.

Growth in trade related loans to the textile sector decelerated to 19.3 percent during Jul-Jan FY08 compared with 22.4 percent rise in the corresponding period of FY07. In fact, it was the anemic advance growth in weaving industry that had caused the slowdown in overall demand for trade-related loans; excluding the weaving sub-sectors, credit for trade financing depicts a strong growth of 24.2 percent in Jul-Jan FY08 as against 15.7 percent growth during Jul-Jan FY07.

Construction
Growth in advances to *construction* sector decelerated to 19.4 percent during Jul-

[40] The increase was recorded despite the dismal performances of textile industry mainly driven by lower export demand.

Jan FY08 compared with 24.2 percent growth in the corresponding period last year. The issuance of privately placed Sukuks for financing new projects probably explains lower demand for fixed investment loans from this sector.

On the contrary, the working capital requirements depict robust growth of 32.4 percent in Jul-Jan FY08 compared with 20.5 percent rise during Jul-Jan FY07. Besides rising housing demand, the increase in domestic raw material prices for construction mainly explains the higher demand for working capital requirement in this sector during Jul-Jan FY08.

Table 4.7: Growth in Consumer Loans (Jul-Jan)

percent

	FY07	FY08
Mortgage loans	15.5	17.6
Credit cards	19.2	6.9
Auto finance	8.0	6.0
Personal loans	7.9	3.0
Consumer loans	**10.4**	**6.6**

Consumer loans

Growth in consumer loans slowed to 6.6 percent during Jul-Jan FY08 from 10.4 percent in the preceding year (see **Table 4.7**). The deceleration in consumer loans is evident in all categories (except mortgage finance).[41] In particular, deceleration in the growth of auto finance was attributed to (1) lower demand for automobiles due to increase in prices of locally produced cars, and (2) risk aversions of banks following recovery issues (e.g., one of the banks has even suspended auto finance scheme). On the contrary, mortgage finance depicts a robust growth of 17.6 percent as compared to 15.5 percent rise in the corresponding period last year.

Table 4.8: Issuances of Privately Placed Listed Sukuk (Jul-Jan FY08)

million Rupees

		Purpose	
Sectors	**Amount**	**Repayment**	**Project Finance**
Electronic	2,550	√	
Paper	3,500	√	
Sugar	500	√	
Chemical	9,500	√	√
Cement	10,500	√	√
Textile	650	√	
Real estate	3,000		√
Oil & gas	5,000	√	
WAPDA*	8,000		√
Shipping	4,000		√

Source: Banks and beneficiaries

Banks' Investments in Privately Placed Sukuk

In addition to providing advances, banks are also

[41] The mandatory use of Credit Information Bureau (CIB) data by banks is also cited as a major reason of slowdown in consumer loans.

investing in debt instruments issued by the private sector. As evident from **Table 4.8**, approximately Rs 47 billion of privately placed Sukuk have been issued from July 2007 onwards.[42] This suggests that while the overall demand for credit is still intact, there is now a lower dependence on banks' advances.

It must be noted here that though the substantial portion of investment in debt instruments came from banks, non-bank financial institutions are also investing in these papers.

Table 4.9: Incremental Credit to Deposit ratio (Jul-1st Mar)

billion Rupees

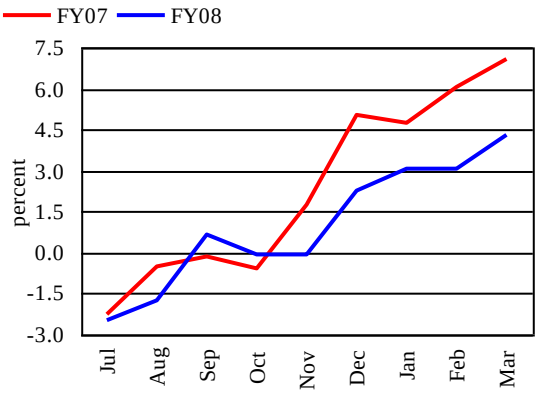
	Increase		
	Credit	**Deposits**	**Ratio (%)**
FY06	294.7	183.7	160.6
FY07	195.5	188.6	103.7
FY08	302.7	137.1	220.8

Furthermore, despite the attractiveness of Sukuk for Islamic banks (as these are Shariah-based instruments), the share of Islamic banks in the primary debt issuances is small compard with traditional banks.

Source of Credit Finance[43]

A quick look at the **Table 4.9** shows that the lower growth in deposit during Jul-1st Mar FY08 has led to a rise in the incremental credit-deposit ratio (see also **Figure 4.17**). Thus, in order to sustain strong credit growth, banks have used non-depositary sources.[44] In this regard, the fall in effective CRR during the period under review, and banks' unwillingness to

Figure 4.17: Cumulative Deposit Growth (Jul-1st Mar)



[42] This information set should be read with some caution due to its possible *partial* coverage. This is because: (a) privately placed Sukuks are currently not recorded by any regulatory institution, thus there is a chance that some of the issues are not covered; and (b) the information has been collected from banks who were acting as arrangers for these transactions, thus, a Sukuk arranged by any NBFI, has not been captured in this dataset.

[43] This section is based on monetary survey deposits which excludes government deposits.

[44] Theoretically, banks' equity is the most common form of non-deposit resources. Besides this, banks can also liquidate their investment in government and private papers; and draw down excess reserves held with the central bank.

invest in government papers[45] explain funding sources for credit expansion.

Deposit Mobilization[46]

The overall deposit growth slowed from 6.4 percent during Jul-Feb FY07 to 4.2 percent in Jul-Feb FY08 (see **Table 4.10**). It was the fall in growth of *other*[47] deposits that explains the slowdown in deposit mobilization.

Table 4.10: Sector wise Deposit Growth (Jul-Feb)

	FY07		FY08	
	Growth	**Share***	**Growth**	**Share***
Customer	4.4	4.2	4.1	3.8
NBFIs	50.6	0.4	18.6	0.3
Others	41.1	1.8	3.6	0.2
Total	**6.4**		**4.2**	

*Contribution in growth in percentage points

Figure 4.18a: Exchange Rate Movement

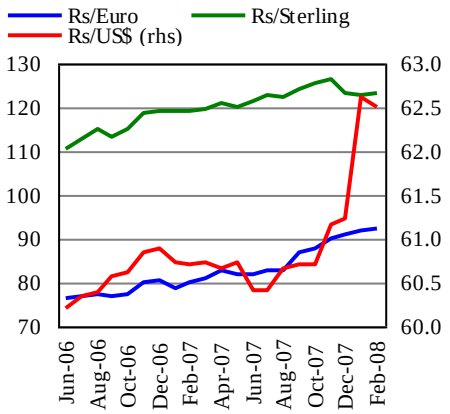
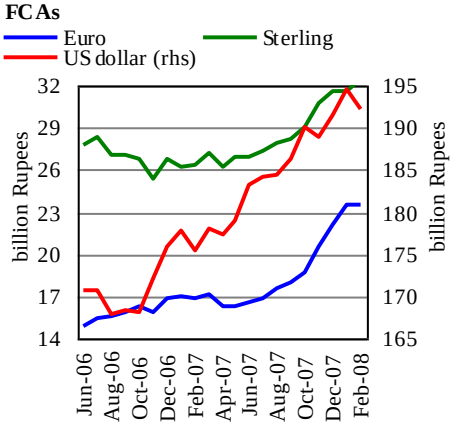


Figure 4.18b: Currency Composition of FCAs



The currency-wise break-up of the customers' deposits reflect that a sharp depreciation in the value of the Rupee against major currencies during Jul-Feb FY08, made foreign currency deposits more attractive to the customers (see **Figure 4.18**). Thus, within foreign currency deposits, Sterling, Euro and US-dollar denominated deposits registered a robust growth during Jul-Feb FY08 over Jul-Feb FY07.

[45] The consequent rise in government borrowings from central bank has added to available liquidity with banks.

[46] The section includes all customer deposits including government deposits and thus will not tally with the deposits reported in the sub-section of "*Source of Credit Finance*".

[47] Others deposits mainly includes margin or LCs, margin on guarantees, unclaimed dividend/ dividend payable, security deposit accounts and any other miscellaneous liabilities.

Further, a bank-wise deposit distribution shows that except public sector banks and Islamic banks, all other banking groups recorded a substantial decline in the deposit mobilization during Jul-Feb FY08 compared to the corresponding period of FY07 (see **Figure 4.19**). This decline was recorded despite a rise in deposit rates by most of the banks (see **Figure 4.20)**. Moreover, the slowdown in deposits of one of the domestic private banks (under the category of small domestic private banks), is mainly explained by the net withdrawals from the deposits of PSEs and corporate sector.

On the contrary, the sharp rise in deposits of public sector banks was on account of a sizeable increase in deposits of government and public sector enterprises (PSEs) in one large bank within this category.

Figure 4.19: Group-wise Deposit Mobilization (Jul-Feb)

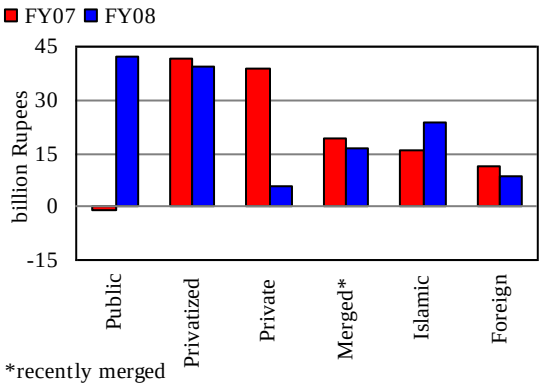


Figure 4.20: Group-wise Deposit Rates during Jul-Jan (average incremental)