4 Money and Banking

4.1 Overview

The monetary tightening followed throughout FY07 was successful in significantly reducing non-food inflation in Pakistan, but its pass through on headline CPI inflation was offset by the impact of the sustained increases in global food and energy commodity prices. More worryingly, towards the end of FY07 evidence was emerging that the impact of these rising prices was beginning to seep into the broader economy. This was captured by the May 2007 reversal of the FY07 downtrend in core inflation[1] (see **Figure 4.1**).

Concerned by the emerging uptrend in core inflation, as well as the risk of an inflationary upsurge from an exceptional rise in monetary aggregates towards the end of FY07, the SBP proactively further tightened its monetary stance in early August 2007. It raised the policy rate (the discount rate) by 50bps, and continued to drain excess liquidity from the domestic inter-bank market. It also implemented other, non-monetary, measures to contain the rise in the monetary aggregates, asking the government to limit its borrowings from the central bank, and capping the re-financing of concessional loans

Figure 4.1: Interest Rates and Inflation

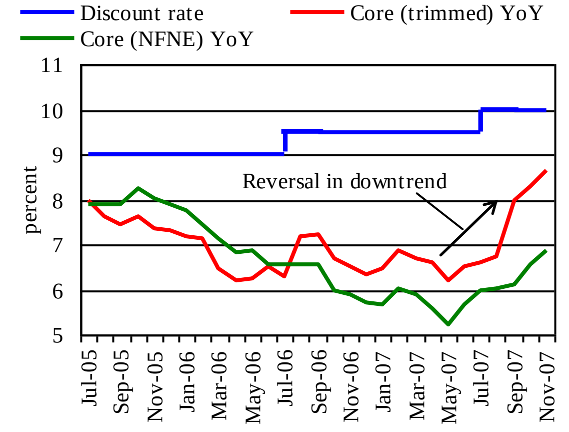


Table 4.1: Key Monetary Aggregates (Jul- 1st Dec)

	Units	FY05	FY06	FY07	FY08
RM growth	percent	12.9	6.5	11.8	6.3
M2 growth	percent	6.4	3.4	4.2	4.2
O/N rates volatility	percent	0.81	0.14	0.13	0.12
Discounting (Avg per visit)	billion Rs	6.4	6.2	9.8	12.3

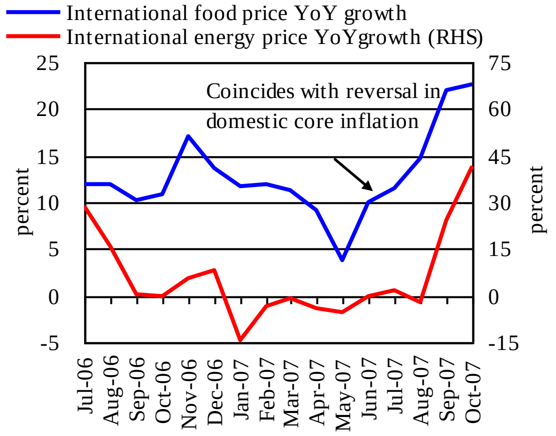
Figures for the December correspond to 1st week every year.

[1] After reaching 5.2 percent in May 2007, the non-food non-energy (NFNE) core inflation reached 6.9 percent in November 2007. Similarly the trimmed mean core inflation measure also reached a trough at 6.2 percent YoY in May 2007 before climbing to 8.6 percent YoY in November 2007.

to exporters.[2] As seen in **Table 4.1**, these policy measures substantially reduced the growth in the reserve money during Jul-1st December FY08 period, and tightened liquidity in the inter-bank market.

In the meanwhile, the impact of rising global commodity prices was becoming more visible on domestic inflation.[3] The headline CPI inflation continued to rise, reaching a 29-month high of 9.3 percent by October 2007 due to the exceptionally strong 14.7 percent growth in food inflation.[4] The impact on core inflation also appears to be related to the recent rise in international commodity prices, particularly of food and oil (see **Figure 4.2**).[5]

Figure 4.2: International Food and Energy Prices



Data source: IMF Primary Commodity Prices

Although overall CPI inflation slowed down to 8.7 percent in November 2007 over the preceding month, the two measures of core inflation, i.e., NFNE and trimmed mean, are still trending upward. This means that pressures on CPI food inflation are now influencing the prices of a broader range of the CPI basket. Further, though the food prices are volatile and short lived in nature, global inflationary pressures on some of the food commodities are likely to be sustained going forward. Finally, the inflationary pressures could rise further, if the government decides to pass on the impact of the recent oil prices to domestic consumers. It is therefore important for SBP to continue with its current tight monetary policy stance.

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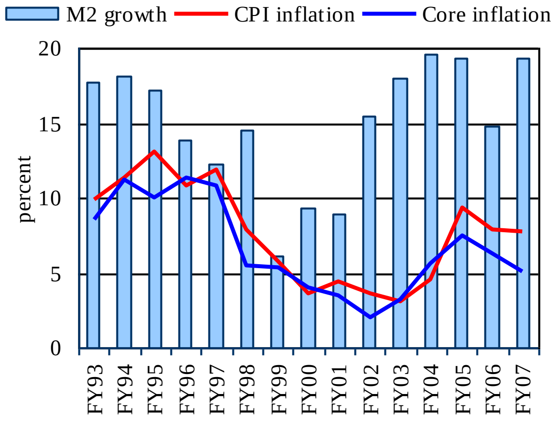
[2] Export refinance from SBP was capped at 70 percent of the end-June 2007 level.
[3] Empirical evidence also points out that prices of imported goods have a significant role in determining the domestic prices (see Naseem, Anjum, "Determinants of Inflation in Pakistan", State Bank of Pakistan, 1995).
[4] The impact of imported inflation was compounded by domestic supply shortages particularly in wheat.
[5] While it is true that the government has so far not passed on the impact of sharp rise in international oil prices of key fuels to domestic consumers, the prices of a number of petroleum products (not regulated by the government) are rising along with international trend.

Figure 4.3: M2 Growth and Inflation



As inflationary pressures mount despite continued monetary tightening, debates on effectiveness of monetary policy on inflation have been triggered afresh. While acknowledging that the *direct* impact of supply-side factors may be less amenable to monetary tightening, economic literature and historical trends in Pakistan clearly indicate that inflationary pressures are indeed responsive to changes in monetary policy. As evident from **Figure 4.3**, on average, monetary tightening has been followed by a slowdown in inflationary pressures, and vice versa. Similarly, the empirical literature on the relationship between money supply and inflation in Pakistan supports the view that the monetary policy has a strong causal *long run* impact on inflation (see **Table 4.2**). Thus clearly, had SBP not tightened its monetary policy, inflation would have been even higher than the current levels.

Indeed, as explained in the Monetary Policy Statement issued in July 2007, the current tight monetary stance is also important to (1) curb the inflationary expectations, and (2) limit the second round impact of rising food prices to the rest of the economy.[6] Addressing inflation expectations is essential given the inflation persistence in Pakistan. **Figure 4.4** shows that the inflation rate has a long memory as it has significant impact on future inflation levels.[7,8]

Given the need to contain inflationary expectations, the acceleration in M2 growth, particularly in November 2007, is a concern. Specifically, despite

[6] For further details on the second round impact of food inflation, see **Box 5.1**, SBP Annual Report for FY07, p.59.
[7] The economic literature suggests various sources of inflation inertia including rigidities particularly in the labor market (due to wage indexation) and the nature and persistence of monetary policy shocks.
[8] The correlogram is for CPI inflation (on YoY basis) based on monthly data from July 1990 to October 2007. This is the graphical presentation of the correlation between observations at different distances apart. The fact that the correlation of CPI inflation with its past values approaches zero for very large values of lag shows the persistence in inflationary trend.

Table 4.2: Recent Empirical Evidence on the Relationship Between Money Supply and Inflation

	Study	Data Coverage	Results
1	**Aleem et al. (2006)**	1972-73 to 2005-06	Private sector credit and adaptive expectations are the most important contributors to inflation in Pakistan. Tight monetary policy is one of the important options for price control.
2	**Kemal. M. Ali (2007)**	1975:1 to 2003:4	Inflation is essentially a monetary phenomenon in Pakistan however; money supply starts impacting inflation after a lag of 9 months and takes rather long to converge to equilibrium if there is a shock to GDP, money supply or prices.
3	**Khan and Schimmelpfennig (2006)**	1998:01 to 2005:6	Monetary factors have an important role in price level determination and affect inflation with a lag of about one year in Pakistan. However, changes in the wheat support price influence inflation in the short run but not in the long run. Furthermore, wheat support price matters only over the medium term if accommodated by monetary policy.
4	**Qayyum (2006)**	1960-2005	There is strong positive relationship between money supply and inflation in Pakistan and the excess money supply has always contributed to the rising price level. Furthermore, sufficient monetary tightening is the most effective tool for controlling inflation in Pakistan.
5	**Husain and Abbas (2000)**	1949-50 to 1998-99	There is a two way relationship between money supply and inflation in Pakistan. Not only the increase in money supply raises the general price level but also increases the demand for money which results in further expansion in the money supply.
6	**Chaudhry and Ahmad (1995)**	1973-1992	Financing of the budget deficit from the banking system is inflationary in the long run because it adds to the money supply growth. Furthermore, governments should reduce the size of its budget deficit to control inflationary pressures from the economy.

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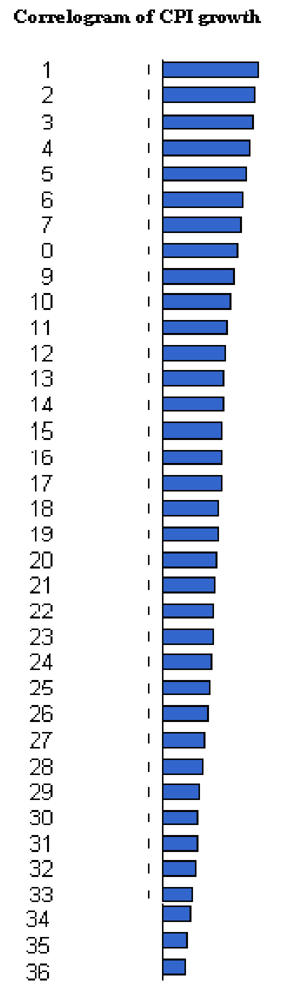
showing relatively subdued growth in the initial months of FY08, the M2 growth during Jul-1st Dec FY08 is almost unchanged from that in the corresponding period of FY08. Though the monetary tightening has been successful in moderating the private sector credit growth during Jul-1st Dec FY08 period, its impact on M2 growth was more than offset by continued strong budgetary borrowings from the banking system (see **Table 4.3**).

Figure 4.4 inflation inertia in Pakistan



These higher borrowings were despite greater mobilization under National Savings Schemes and Pakistan Investment Bonds, and higher receipts from external sources. Indeed, these higher borrowings are reflective of the sharp rise in the budget deficit (see **Table 4.4**).

What is more worrying is the fact that during the recent weeks, the government is relying heavily on borrowings from the central bank,[9] which directly adds to the reserve money growth. The impact of borrowings from the central bank on reserve money growth was however partly offset by significant retirements under export refinance.[10] Thus, despite the fact that the substantial rise in government borrowings from the central bank added to SBP NDA, the reserve money growth during Jul-Dec 1st FY08 remained substantially lower than that in the corresponding period of FY07 (see **Figure 4.5**).

The net credit to the private sector registered a deceleration during Jul-1st Dec FY08, increasing by 5.4 percent compared to 7.0 percent in the corresponding period of FY07. This shows that the exceptional rises in private sector credit growth seen in past years

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[9] The total government borrowings from the SBP during Jul-1st Dec FY08 were Rs 169.5 billion. However, during 20th Oct 20 to 1st Dec 2007 period, government borrowed Rs 158.5 billion from the central bank.
[10] As a result of modifications made in the export finance scheme on Jul 31, 2007, scheduled banks are required to gradually reduce their end-June 2007 level of refinance from SBP. By end-January 2008 the outstanding refinance should be lowered by 15 percent, and by end-June 2008 the outstanding refinance should reach 70 percent of the outstanding level as on end-June 2007.

are converging to long term trends.

The private sector credit demand is still robust as the rise in net credit after September 22, 2007 is sharper than that in the previous year. It must also be kept in mind that the credit extended by the banking sector is also being supplemented by other sources of financing. In particular, there is evidence that some of the private entities are issuing TFCs/Sukuk bonds to refinance the borrowings from the scheduled banks.[11]

Table 4.3: Contribution to M2 Growth

percent

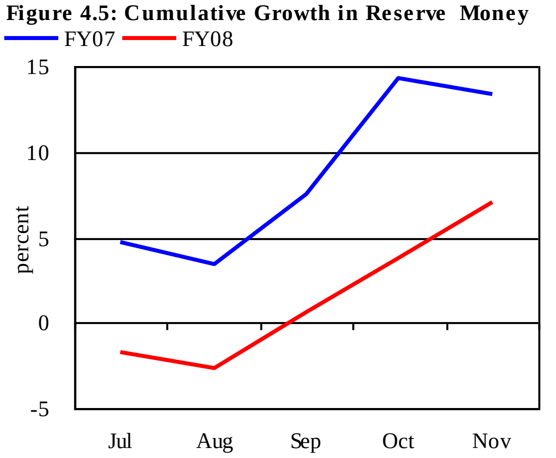
	Jul-Nov	
	FY07	FY08
NFA	-2.1	-2.46
NDA	6.3	6.68
Government borrowings	2.66	4.14
Credit to non govt. sector	4.1	3.41
Private sector credit	4.34	3.3
Other items (net)	-0.46	-0.87
M2	**4.20**	**4.22**

Table 4.4: Deficit Financing (Jul-Sep)

billion Rs

	FY07	FY08
Deficit	**86.7**	**158.1**
External	27.8	36.8
Domestic	58.9	121.3
Non-bank	10.0	51.4
Bank	34.5	69.9
Privatization proceeds	14.4	0.0

Figure 4.5: Cumulative Growth in Reserve Money



The private sector credit growth during rest of FY08 is expected to gain further momentum because: (1) the commencement of financing private sector IPIs project will provide adequate boost to private sector credit growth, (2) companies which met their demand from external borrowings in earlier periods are likely to revert to domestic markets given the widening of spreads overseas, and (3) performance of banks that had slowed credit activities due to merger and acquisition activity would regain momentum.

[11] To the extent these TFCs/Sukuk bonds are held by the non-bank financial institutions, this would depress the net credit extended by the scheduled banks.

4.2 Monetary Survey

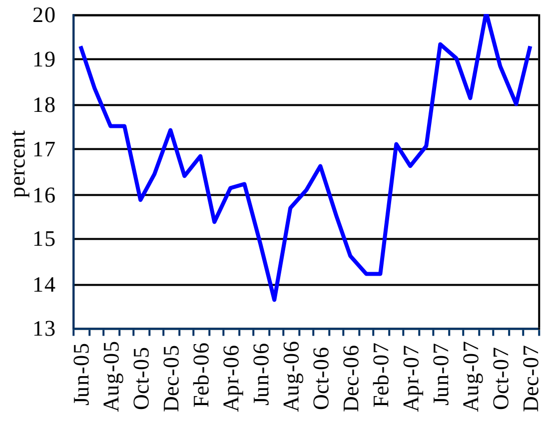
The growth in broad monetary aggregate (M2) remained at 4.22 percent during Jul-1st Dec FY08; almost at the same level as during the corresponding period of FY07. The FY08 expansion in M2 is entirely attributable to a rise in net domestic assets (NDA) of the banking system, as the net foreign assets (NFA) registered a contraction during the period (see **Table 4.5**)

Table 4.5: Monetary Survey (in billion Rupees)

	Flows		% change	
	FY07	**FY08**	**FY07**	**FY08**
M2	143.0	171.4	4.2	4.2
Reserve money	117.9	76.1	11.8	6.3
NFA	-71.4	-99.9	-10.1	-10.1
SBP	-38.1	-34.5	-6.7	-4.4
Scheduled Banks	-33.3	-65.4	-23.0	-33.2
NDA	214.5	271.3	8.0	8.8
SBP	123.0	153.6	56.5	101.9
Scheduled Banks	91.5	117.7	3.7	4.0
of which				
Government borrowing	90.4	168.0	10.8	18.1
For budgetary support	97.6	*191.3*	*13.8*	*23.6*
SBP	98.6	169.5	24.4	49.1
Scheduled Banks	-1.0	21.9	-0.3	4.7
Commodity operations	-5.9	-22.0	-5.5	-22.4
Credit to non-govt sector	139.8	138.7	6.4	5.4
Private sector	147.7	133.9	7.0	5.4
PSEs	-8.2	4.5	-13.4	5.5
Other items (net)	-15.7	-35.4	4.8	8.4

(*) pertains to 1st Dec for FY08 and 2nd Dec for FY07

Figure 4.6: M2 Growth on YoY Basis

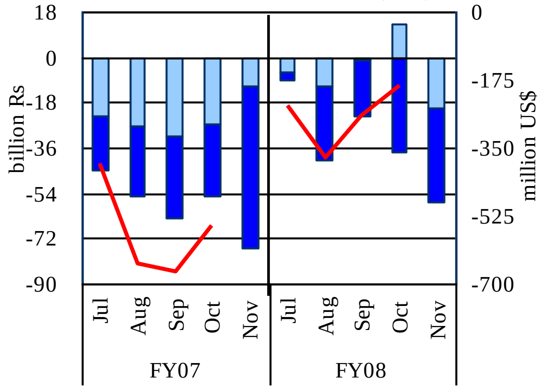


Given the risks of renewed inflationary pressures in the economy, the continued strength in M2 growth rate is a source of concern for the central bank. The monetary tightening has been successful in moderating the exceptional rise in private sector credit growth seen in past years to levels consistent with its long term trends. However, the impact of this desirable moderation in private sector credit growth on M2 growth was more than offset by continued strong budgetary borrowings from the banking system during Jul-1st Dec FY08 period.

The YoY growth in M2 currently stands at 19.3 percent, exactly the same as on 30th June 2007. Also as evident from **Figure 4.6**, the YoY M2 growth trend is quite volatile, requiring more vigilance from SBP to achieve 13.5 percent M2 growth target for FY08.

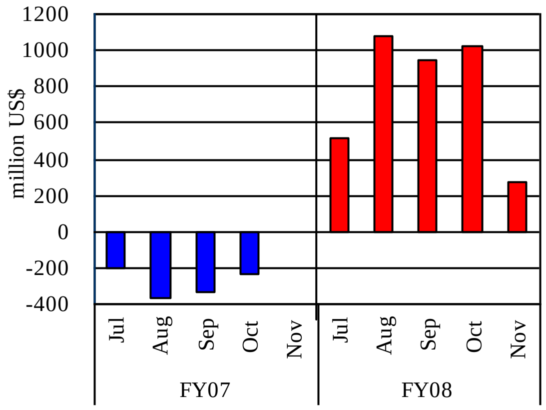
Net Foreign Assets (NFA)
The NFA of the banking system witnessed a higher depletion of Rs 99.9 billion during Jul-1st Dec FY08 compared to Rs 71.5 billion during the corresponding period of previous year. Furthermore, similar to previous year, the NFA of both the scheduled banks and SBP witnessed a reduction (see **Figure 4.7**). However, the depletion is concentrated more in scheduled banks' NFA.

Figure 4.7: Net Foreign Assets (Cumulative Flows)



The SBP's NFA witnessed a contraction of Rs 34.5 billion during Jul-1st Dec, FY08 compared to Rs 38.1 billion in the corresponding period of FY07. The lower depletion in central bank's NFA, in turn, is contributed by net foreign exchange loan inflows (mainly from IDA and ADB) totaling US$ 1127 million during Jul-Nov FY08 compared to US$ 267 million in the corresponding period of FY07 (see **Figure 4.8**).

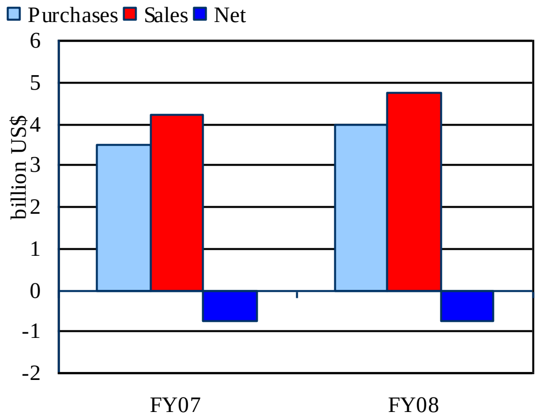
Figure 4.8: Net Foreign Exchange Inflows from ADB & IDB



It may however be pointed out that despite the gradual shifting of financing of the oil import bill (furnace oil) to the interbank market, the SBP continues to finance a part of oil payments in order to avoid excessive market volatility. This dynamic is an important contributor to the depletion of SBP's NFA, particularly as international oil price rise (see **Figure 4.9**).

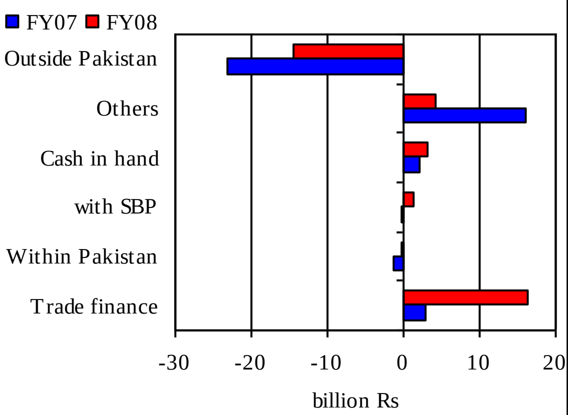
The depletion in scheduled banks' NFA is mainly due to the sharp rise in foreign currency loans to traders owing to expectations of relative stability of Pak rupee exchange rate as well as the interest rate differential between the Rupee and the US Dollar. Specifically, during Jul-Oct FY08 traders availed Rs 16.22 billion as foreign currency loans compared to just Rs 2.99 billion in the corresponding period of FY07. To meet this demand, there has been an almost proportional withdrawal from scheduled banks' placements abroad (see **Figure 4.10**) that contributed to a net contraction in their NFA.

Figure 4.9: SBP's Forex Intervention (Jul-Oct)



This depletion in scheduled banks' NFA is despite an increase of Rs 12.9 billion in resident foreign currency deposits (RFCDs) during Jul-1st Dec FY08 against a net withdrawal of Rs 2.0 billion during the corresponding period of FY07. Had this growth in RFCDs not taken place, scheduled banks' NFA would have shown an even larger contraction.

Figure 4.10: Utilization of FE-25 Deposits (Jul-Oct)



Net Domestic Assets

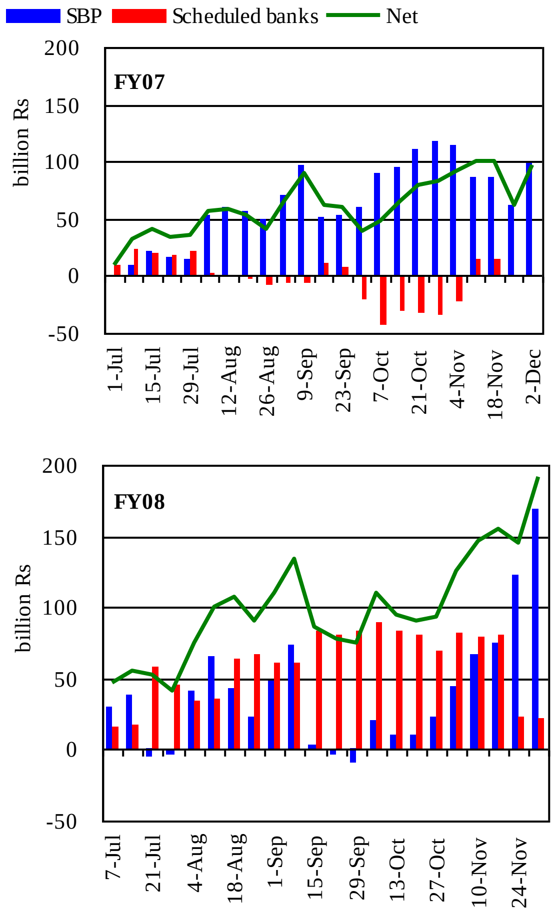
NDA of the banking system registered a growth of 8.8 percent during Jul-1st Dec FY08, compared to the growth of 8.0 percent during the corresponding period of FY07. While private sector credit recorded moderate growth, the government borrowings from the banking system continued to grow strongly despite substantial credit retirement under commodity operations.

The NDA growth during Jul-1st Dec FY08 was evident mostly in the sharp rise in SBP NDA, mainly explained by continued government borrowings from the central bank. As the government was also borrowing from scheduled banks, this inflated their NDA growth during Jul-Dec FY08, even offsetting the impact of slowdown in private sector credit growth.

Government Budgetary Borrowings

The government's budgetary borrowings from the banking system during Jul-1st Dec FY08 rose by Rs 191.3 billion compared to a rise of Rs 97.6 billion in the corresponding period of FY07. The sharp increase in borrowings was despite substantial resource mobilization through PIBs and National Saving Schemes (NSS), and larger inflows under external financing.[12]

Figure 4.11: Cumulative Budgetary Borrowings



As evident from **Figure 4.11**, during Jul-Nov FY08, the government has been relying on borrowings both from scheduled banks as well as from SBP. This is in sharp contrast to Jul-Dec FY07 when the government borrowed heavily from SBP to retire its obligations to scheduled banks.

Banks' greater interest in government paper (particularly in longer tenor) was due to a

[12] Government mobilized Rs 36 billion (net of maturities) from PIBs auction during Jul-Oct FY08 compared to a mobilization of Rs 0.12 billion in the corresponding period of previous year. Furthermore, mobilization through NSS increased by Rs 24.3 billion (in net terms) during Jul-Oct FY08 compared to Rs 17.6 billion during Jul-Oct FY07.

number of reasons, including: (1) their expectations that interest rates have peaked out,[13] and (2) the interest rate differential between lending to private sector and to the government had narrowed.[14] This allowed banks to offer Rs 210.7 billion (net of maturities) in various auctions of government papers during Jul-Nov FY08 compared to Rs 139.8 billion in the corresponding period of FY07 (see **Figure 4.12**). Thus the government was successful in mobilizing Rs 93.2 billion through debt auctions to commercial banks during Jul-Nov FY08 compared to the retirement of Rs 24.0 billion in the corresponding period of FY07.

Figure 4.12: Auction Analysis (Net of Maturities)

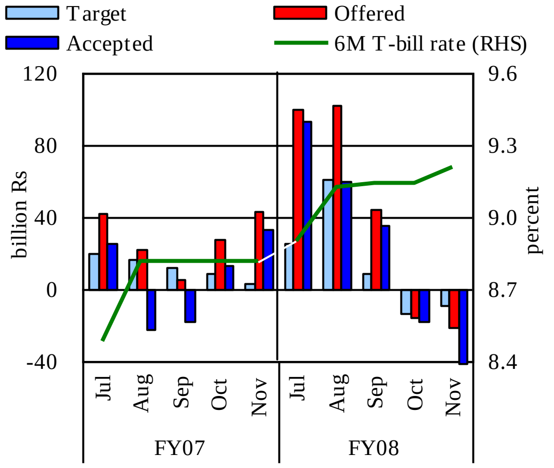
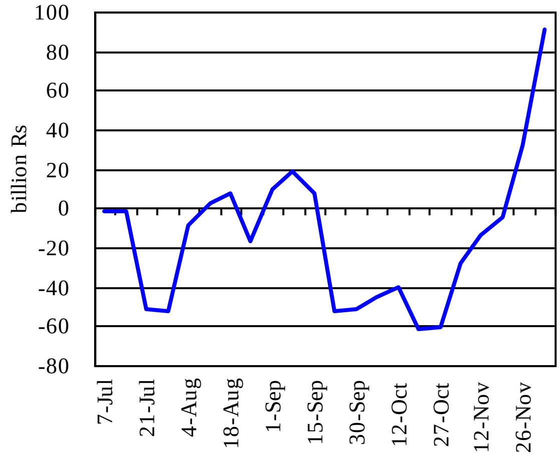


Figure 4.13: Cumulative Change in MRTBs (FY08)



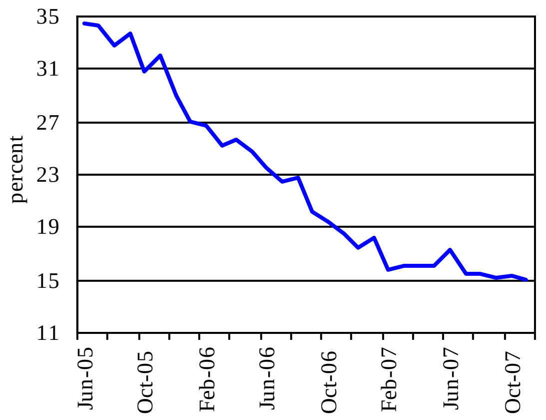
However, despite a visible rise in borrowings from the scheduled banks, pressures on SBP to finance budgetary requirements continued to remain high. This is evident from the fact during the first quarter of FY08 borrowings from the central bank touched the peak of Rs 73.2 billion by September 8, 2007. Nonetheless, the quarterly ceiling on borrowings from the central bank was met as

[13] This is evident from banks' interest in 12-months papers during auctions conducted in FY08. Of the total offered amount of Rs 352.5 billion, 93.3 percent were in 12-month T-bills.

[14] The difference between 6-month KIBOR and 6-month market repo rate declined from 77 bps at end-June 2007 to 27 bps at end-November 2007.

the government used the proceeds from the transfer of the central bank's profit to retire its debt held by the SBP.[15]

Figure 4.14: YoY Growth in Private Sector Credit

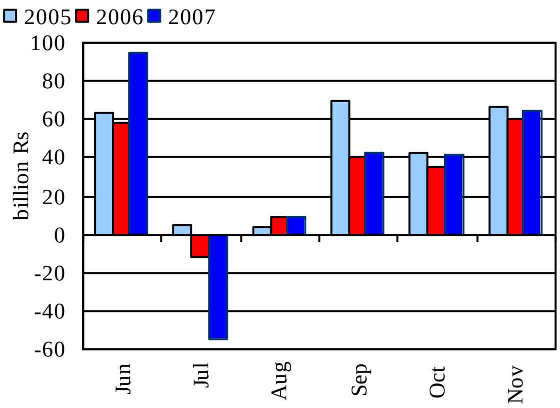


The government however continued to borrow from central bank during the second quarter (see **Figure 4.13**). This abrupt increase in government borrowings from SBP poses difficulties in monetary management, and will make it difficult for the government to adhere to the quarterly/annual ceilings prescribed by the central bank.[16]

Credit to Private Sector (net)[17]

Net credit to the private sector registered a deceleration during Jul-1st Dec FY08, increasing by Rs 133.9 billion (5.4 percent) as compared with Rs 147.7 billion (7.0 percent) in the corresponding period of FY07. However, two points are significant:

Figure 4.15: Credit to Private Sector (Monthly Incremental)



(1) On an year-on-year basis, the growth in the net credit to the private sector appears stabilizing at around 15 percent (see **Figure 4.14**).

(2) A significant contribution to the slower FY08 growth is from the

[15] SBP's profits of Rs 47.3 billion were transferred to the government in mid–September, 2007.
[16] Government borrowings from the central bank add to the aggregate demand pressures in the economy and are the most inflationary in nature.
[17] The reported private sector credit data is based on monetary survey, while the sector-wise discussion covers the period of Jul-Oct FY08.

exceptional seasonal retirement seen in July 2007. Excluding this, the net credit growth sees a small rise (see **Figure 4.15**). In other words, the aggregate slowdown in private sector credit during Jul-1st Dec FY08 is overstated due to the *reversal* of exceptional growth in end-June 2007 seasonal credit.

It must also be kept in mind that the credit by the banking sector is also being supplemented by other sources of financing. The private sector is using non-bank finances, thus shifting part of the credit demand away from the banking sources. In particular,

(a) Besides banks, non-bank financial institutions are meeting the financing demand of the private sector through their investment in debt instruments (TFCs and Sukuk). It may be pertinent to note that most of the private sectors' TFCs and Sukuks have been used to refinance banks' credit.

(b) Availability of foreign investment and loans has also played an important role in softening the demand for the bank credit in some of the sectors, particularly in telecommunication.[18]

Slower demand for fixed investment loans had been anticipated, as industries such as textiles and cement would be expected to consolidate after significant expansions in recent years. However, the impact of this slowdown on overall credit was probably compounded by delays in initiation of major infrastructure projects in the power sector.

The commencement of financing private sector power projects will provide a boost to private sector credit growth. It is also likely that companies which met their demand from external borrowings in earlier periods would revert to domestic markets given the expected widening of spreads overseas. Thus, it is possible that the apparent deceleration in private sector credit growth during FY08 may not persist at current levels for long. In fact, as evident from **Figure 4.16**, after Sep 22, 2007, the rise in private sector credit is steeper than that in the corresponding year.[19]

[18] During Jul-Oct FY08 telecom sector received US$ 425.9 million FDI as compared to US$ 345.3 million in corresponding period of FY07.

[19] The private sector credit has already picked up since Sep 22, 2007 as there is an increase of Rs 170.4 billion during Sep 22 to Dec 1, 2007 period compared to Rs 138.7 billion in the corresponding period of previous year.

Looking from the supply side, some of the banks have adopted a more cautious lending approach following a rise in non-performing loans, particularly in consumer financing, SME and corporate. In overall terms, while SBP is ensuring adequate liquidity in the market to meet private sector credit requirements, banks also have sufficient room to extend credit as evident from lower loan to deposit ratio (see **Figure 4.17**).[20]

A detailed bank-wise analysis shows that the growth in private sector lending is visible only in privatized banks and Islamic banks (see **Figure 4.18**). The increase in credit supply from the latter source was expected following the expansion in the Islamic banking industry in the recent past. The increase in privatized banks' credit was mainly due to higher demand

Figure 4.16 : Cumulative Flows in Private Sector Credit

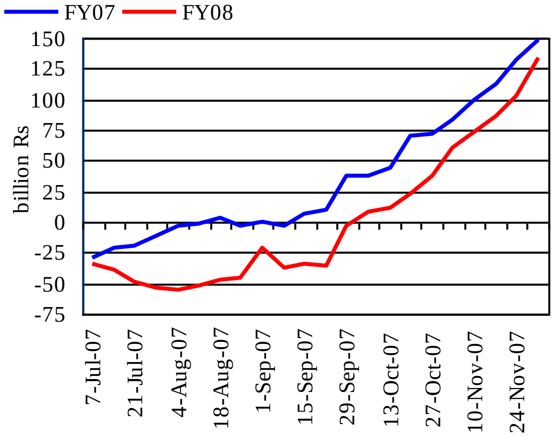
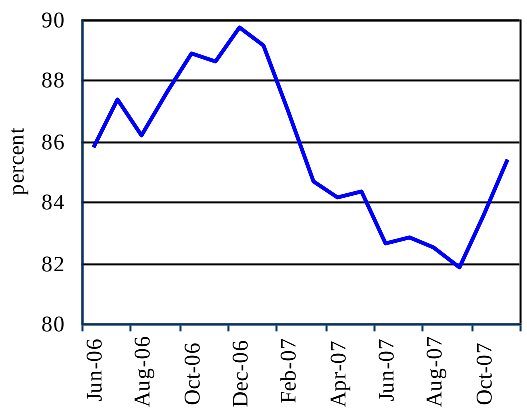


Figure 4.17: Credit to Deposit Ratio

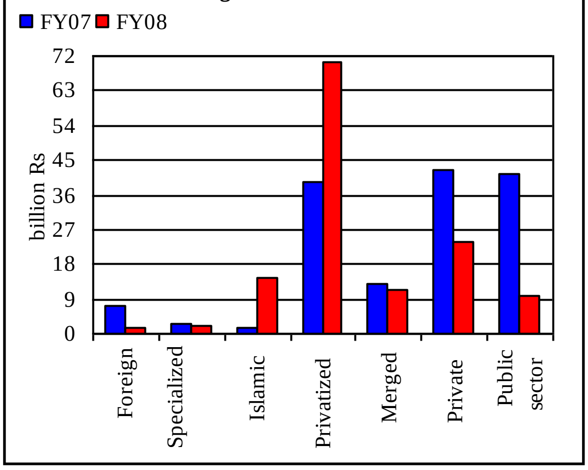


[20]It is pertinent to note that effective CRR is falling since August 2007, primarily due to (1) banks have been allowed to deduct the component of the export credit provided by banks under the Export Finance Scheme - EFS (from their own sources) from the sum total of the demand liabilities determined for the purpose of computation of CRR, (2) CRR for all deposits and liabilities of one-year and above maturity has been reduced to zero; whereas for other demand and time liabilities, the CRR is 7 percent. Prior to this, banks were required to hold 3 percent CRR for time liabilities including deposits of 6 month and higher maturity and 7 percent for the other demand and time liabilities. This implies that in new setup, CRR on banks' time deposits of six month and above but less than one year has been increased from 3 to 7 percent; while CRR on one year and higher maturity time deposits has been reduced to zero from 3 percent earlier. Thus, banks now have more loan-able funds.

for consumer and SME loans. This higher growth in this group was despite larger NPLs in one of the large privatized bank that restrained the entity from lending aggressively.

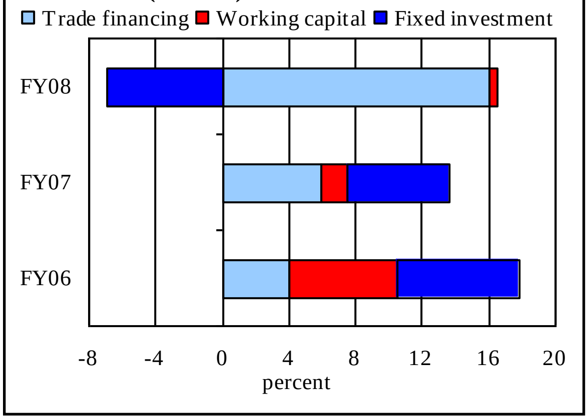
The credit slowdown in public sector banks could be due to higher NPLs in one large public sector bank. Moreover, high credit to deposit ratio may have also restricted few private banks from aggressive lending during the period under review.

Figure 4.18: Bankwise Breakup of Private Sector Lending



The visible slowdown under the category of merged banks[21] principally incorporates the impact of NPLs in one of the recently merged bank. Adjusting for this bank, the merged banks in aggregate have registered substantial rise in net credit growth. This suggests that the banks merged in the past few years are regaining momentum in their lending activities.

Figure 4.19: Growth in Business Sector Loans (Jul-Oct)



Business sector loans[22]

The growth in aggregate credit to business sector registered a nominal rise of 0.5 percent during Jul-Oct FY08 compared with 3.6 percent growth in the corresponding period of FY07.

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[21]This category includes four banks merged during FY07.

[22] 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 October 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.

The purpose-wise breakup of business sector credit shows that the deceleration mainly stemmed from the net retirement in the fixed investment loans and a slowdown in working capital requirement. In contrast, demand for trade related loans recorded an acceleration during the period of analysis (see **Figure 4.19**).

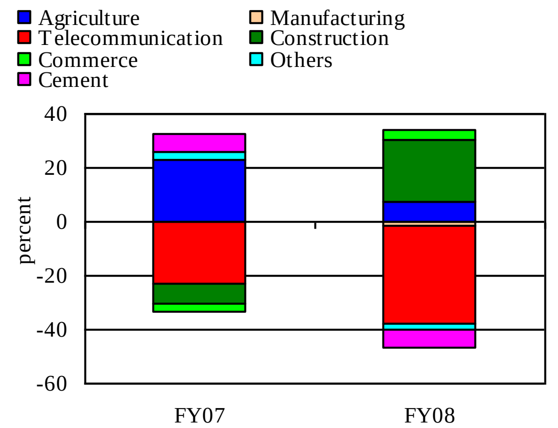
Table 4.6: Private Sector Advances (Jul-Oct)
billion Rs

	Trade financing		Working capital		Fixed investment	
	FY07	FY08	FY07	FY08	FY07	FY08
Business sector	**14.1**	**41.3**	**12.9**	**4.6**	**26.6**	**-37.7**
1. Agriculture, hunting and forestry	-0.19	0.07	19.68	7.85	-7.26	-0.59
2. Manufacturing	8.92	31.77	-1.56	-6.33	0.21	-19.17
a. Textile	2.31	9.96	-3.94	18.21	4.61	-11.13
Spinning of fibers	4.8	2.6	-11.92	12.26	2.82	-16.19
b. Sugar	-1.85	0.16	-13.98	-13.19	0.96	-1.14
c. Fertilizer	1.20	0.94	4.73	-3.13	-2.99	-2.13
d. Cement	0.29	1.76	0.59	-0.89	-2.22	-1.23
3. Electricity, gas and water	-0.14	0.18	-0.35	2.10	4.24	3.21
4. Construction	-0.16	-0.16	-2.08	7.34	2.70	-2.03
5. Commerce and trade	6.24	1.25	-4.88	4.64	6.10	-3.49
6. Transport, storage & communications	0.04	0.81	-1.81	-5.39	11.60	1.16
Telecommunications	0.08	0.64	-2.41	-5.39	13.13	0.64
7. Other private business (n.e.c)	1.35	0.62	0.42	-15.28	2.91	-1.81
8. Other sectors	-1.9	6.8	3.5	9.6	6.1	-14.9

Working Capital

The private sector advances for working capital rose by 0.5 percent during Jul-Oct FY08 compared with a 1.6 percent increase in the corresponding period of FY07. It may be pertinent to note that the slowdown in the demand for working capital does not suggest moderating economic activity as:

Figure 4.20: Growth in Working Capital Loans

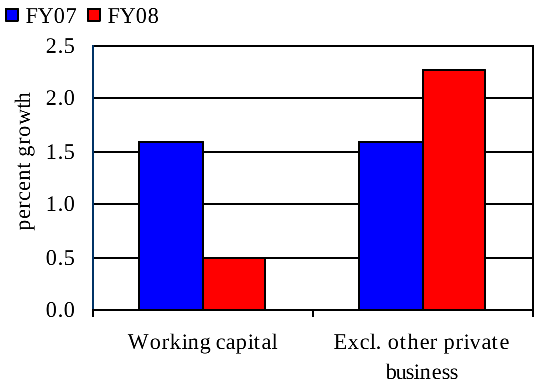


(1) It was concentrated in few sectors including sugar, fertilizer, telecom and other private business (see **Figure 4.20** &

Table 4.6). In fact excluding the net retirement under the head of *other personal business*,[23] which explained a substantial part of slowdown, credit for working capital requirements depicts a stronger growth of 2.3 percent in Jul-Oct FY08 (see **Figure 4.21**).

(2) Though the credit slowdown appears in telecom, fertilizer and sugar; this was due to sector specific reasons. For example, in the telecom sector, the lower demand for working capital loans during Jul-Oct FY08 was probably the result of the availability of funds in the form of external borrowings and foreign investment flows.

Figure 4.21: Working Capital Loans Excluding Other Private Business (n.e.c)



The slowdown in advances to the fertilizer sector, despite a rise in domestic production, appears largely a reflection of lower prices of raw material during Jul-Oct FY08 (see **Table 4.7**). Moreover, in sugar sector, manufactures have delayed sugarcane crushing, primarily due to carry over stocks, thus have led to subdued demand for working capital loans.[24]

Table 4.7: Impact of Fall in Natural Gas Prices on Fertilizer Sector Credit

amount in billion Rupee

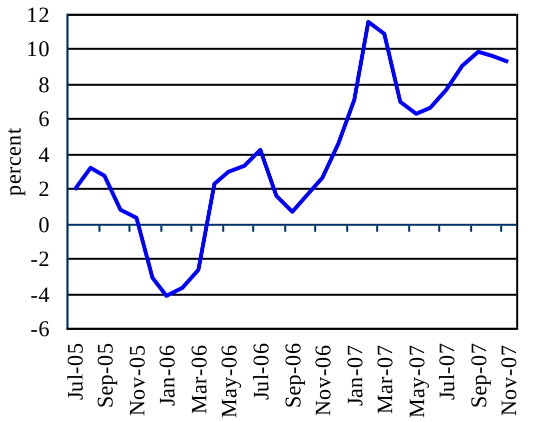
	% change in gas prices	Loans extended to fertilizer
FY07	27.0	4.7
FY08	-10.0	-3.1

In contrast, the acceleration in demand for working capital loans in few industries partly reflects impact of rise in raw material prices in the domestic market. For instance, advances to the construction sector, particularly in construction related

[23] This head includes business loans which are not classified elsewhere.
[24] In fact, industrialists borrow from commercial banks to procure sugarcane.

activities, recorded a net expansion of Rs 7.3 billion during Jul-Oct FY08 compared with a net retirement of Rs 2.1 billion in the corresponding period last year. This was mainly caused by the rise in building material prices in the domestic market and rising housing demand (sees **Figure 4.22**). The latter is also substantiated by the relatively high growth in mortgage finance during Jul-Oct FY08. In addition, bank advances under continuous funding system (CFS) to the equity market has remained high, particularly in the month of October 2007, largely mirroring the performance of the local bourse in this month.

Figure 4.22: Building Material Prices YoY Change



Within the textile sector, stronger demand for working capital, visible in the spinning of cotton and synthetic fiber, mainly reflects the impact of an increase in cotton prices during Jul-Oct FY08.[25] Furthermore, the purchase of cotton bales by the ginning industry in the month of October 2007 has also led to the higher demand in the cotton sector.

Fixed Investment Loans

The fixed investment loans to the business sector recorded net retirement during Jul-Oct FY08 compared with a net expansion in the corresponding period of FY07.

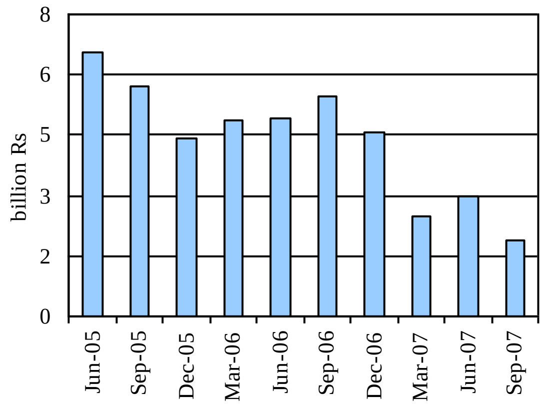
The major deceleration in fixed investment loans during Jul-Oct FY08 was recorded in the spinning sector. In fact, during the last few years textile sector has borrowed substantially under the textile vision 2005 thus the net retirement in Jul-Oct FY08 principally reflects the scheduled repayments (see **Figure 4.23**). Similarly, in the telecom sector, the current slowdown is also primarily a reflection of scheduled retirement of loans disbursed during the past few years.

[25] The domestic prices of raw cotton depict a YoY rise of 18.8 percent till October 2007 compared with 4.8 percent increase in the corresponding period last year.

Interestingly, a few fertilizer industries are financing their expansion related activities through internal cash generation and other sources (such as a rights issue and Sukuk). This probably suggests lower dependence on banks' credit for meeting fixed investment demand in this sector.

Though the deceleration in fixed investment is visible in most of the sectors during Jul-Oct FY08, banks are expecting acceleration in demand for fixed investment loans going forward particularly in power and telecom sector. For example, in the telecom sector one of the large mobile companies has a large expansion plan underway which is expected to be met through banks' finance. Similarly the credit demand from power sector is likely to increase as private power projects are initiated.

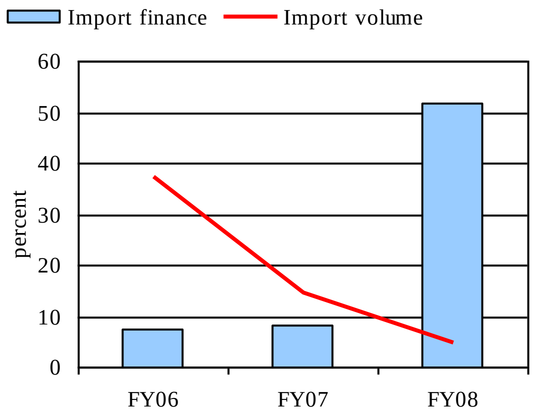
Figure 4.23: Quarterly Disbursement of Fixed Investment Loans to Textile Sector



Trade Finance

The aggregate trade loans to the business sector accelerated sharply to 16.0 percent during Jul-Oct FY08 compared with 6.0 percent growth in the corresponding period FY07. The disaggregated data depicts that the growth in trade finance stemmed primarily from the import finance. This seems quite puzzling as the growth in import volume continued to decelerate to 4.6 percent in Jul-Oct FY08 from 14.5 percent during Jul-Oct FY07 (see **Figure 4.24**).

Figure 4.24: Growth in Import Finance (Jul-Oct)



To correct this anomaly, sectoral data was analyzed which suggests that the sectors where import finance accelerated (such as cotton, basic iron and steel and chemical) are also experiencing acceleration in their import demand.

Besides higher import demand in a few commodities, a relative rise in raw material prices has also caused an increase in import finance. For instance, an increase in raw material prices of cotton explains higher growth in trade-related loans under the spinning sector, particularly under cotton spinning (see **Figure 4.25**).

Figure 4.25: Cotton Outlook 'A' Index

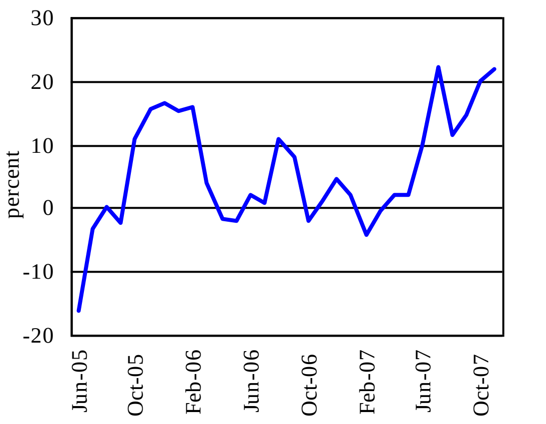
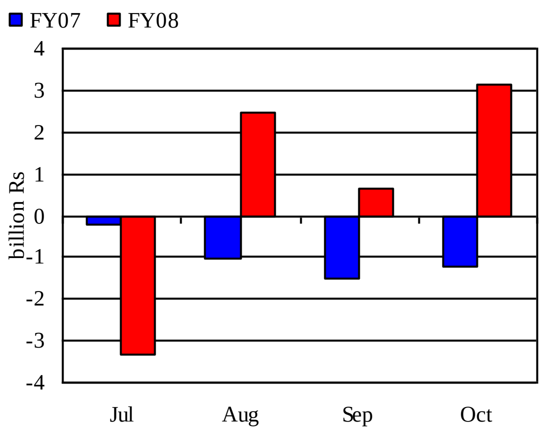


Figure 4.26: Export Finance Against FE-25 Loans



The acceleration is also visible in export finance against FE-25 loans that registered a net lending of Rs 2.9 billion in Jul-Oct FY08 in contrast with net retirement of Rs 4.0 billion in the corresponding period previous year (see **Figure 4.26**). The export loans under EFS depict substantial net retirements that more than offset the rise in loans under FE-25. The disbursement under EFS however increased significantly to Rs 133 billion during Jul-Oct FY08, approximately Rs 6.2 billion higher from the disbursements in the corresponding period of the preceding year.

Consumer Loans

The reported data depicts that the growth in consumer loans decelerated to 4.1 percent during Jul-Oct FY08 compared to a growth of 7.8 percent in Jul-Oct FY07. Except auto and mortgage finance, all other categories under consumer finance registered a slowdown, and personal loans even depict a net retirement during Jul-Oct FY08 (see **Figure 4.27**). The slowdown in consumer finance was expected primarily on account of maturing earlier loans and rising interest rates. Interestingly, however, the impact of latter is not broad based, as auto and mortgage finance registered substantial growth of 6.6 percent and 10.2 percent respectively during Jul-Oct FY08.

Growth in auto loans during Jul-Oct FY08 was mainly attributable to remarkable increase in sales of motorcycles, whereas car sales experienced a slowdown during this period. Though the production and sale of locally manufactured cars have declined during Jul-Sep FY08, the trade data depicts triple digit growth in imported cars as compared to double digit growth in the corresponding period of FY07.

Figure 4.27: Composition of Changes in Consumer Finance (Jul-Oct)