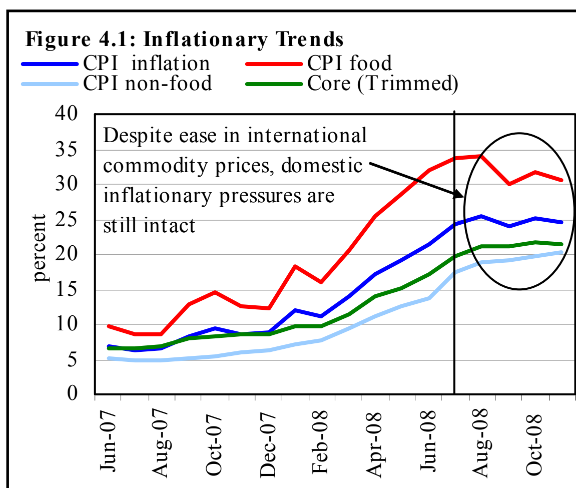
4 Money and Banking

4.1 Monetary Policy

SBP undertook more aggressive monetary tightening during FY09 as it further increased the policy rate by 300 bps in two rounds. On cumulative basis, this meant a 550 bps rise during the last 18 months. These policy measures were in response to carryover of macroeconomic stresses of the preceding year, which had grown in size during the current year.



The monetary tightening of FY09 became unavoidable given the acceleration in inflationary pressures during the year. The YoY CPI inflation reached a record high of 25.3 percent in August 2008, with food inflation touching as high as 34.1 percent. Although down from its peak, domestic inflation has remained high. While food prices have retreated somewhat, non-food inflation shows little effect of the sharp decline in international commodity prices (see **Figure 4.1**). One explanation could be that the businesses are taking advantage of strong domestic demand to support their margins.

Another allied concern for the monetary policy was the rising external current account deficit, which was mainly reflecting domestic demand pressures.[1] This together with slowdown in external financing flows, led to a sharp depletion in country's foreign exchange reserves and steep depreciation of the domestic currency. Indeed, with import coverage of reserves falling to low levels (see

[1] The external current deficit is largely explained by strong growth in import demand both for oil as well as non-oil products (see Section on ***Foreign Trade*** in ***Chapter 6***).

Figure 4.2), such continuing high pressures on external account were unsustainable even in the short-term.[2]

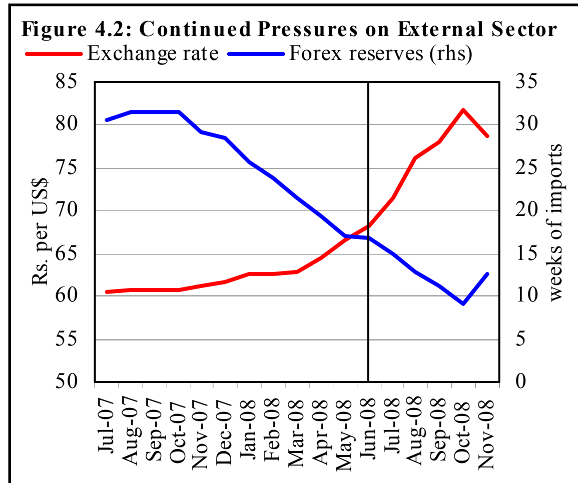


Figure 4.2: Continued Pressures on External Sector

Despite the anticipated relief in overall import bill for the country due to recent broad-based decline in international commodity prices, there is still a risk that external account pressures will persist. This is because the substantial slowdown in major economies may weaken Pakistan's exports and remittance inflows. It is therefore critical to achieve a sustained decline in overall import through demand management policies, and thus bring the external current account deficit to manageable levels.

In order to do so, it is imperative to reduce the domestic demand stimulus from continuing monetization of the deficit, which has greatly diluted the impact of earlier monetary tightening. Government budgetary borrowings from the central bank during Jul-Nov FY09 reached Rs 356.4 billion, as compared to Rs 169.5 billion in the same period last year. The stock of market related treasury bills (MRTBs) with SBP has reached Rs 1,393.4 billion by end-November 2008 (see **Figure 4.3**).

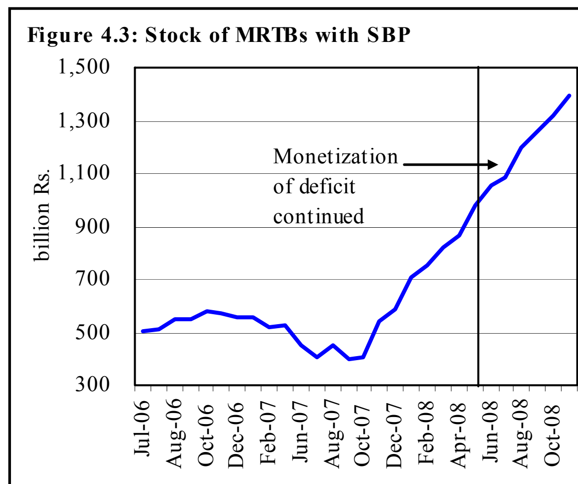


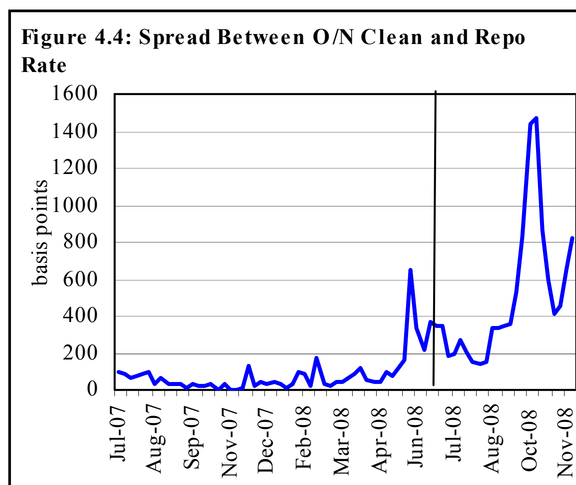
Figure 4.3: Stock of MRTBs with SBP

This undesirable rise in borrowings from the central bank during FY09 was despite an explicit commitment by the government (in the Budget for 2008-2009), for a net zero

[2] Current account deficit reached US$ 6.9 billion during Jul-Nov FY09 compared to US$ 4.7 billion in the corresponding period of preceding year.

budgetary borrowings from the central bank for FY09. This strong growth led the SBP in its Monetary Policy Statement for July-December 2008, to recommend that the government retire Rs 21 billion of borrowings to the central bank in each quarter.

Figure 4.4: Spread Between O/N Clean and Repo Rate



The available indicators suggest that the continued excessive borrowings from the central bank are mainly due to (a) a relative decline in financing receipts during the first quarter of FY09, both from non-bank sources and from external sector, and (b) scheduled banks' reluctance to invest in government papers at the prevailing interest rates through Jul-Oct FY09. SBP in the past has repeatedly highlighted the difficulties in liquidity management and increased risk to inflation outlook due to continued monetization of budget deficit. Monetary tightening was therefore essential (a) to reduce the burden on central bank for government financing, and (b) to contain excess demand which was stressing the external account and putting pressures on exchange rate and foreign exchange reserves.

Indeed, the steep fall in foreign exchange reserves and sharp depreciation of the exchange rate (both driven by external account pressures) led to a substantial drain of the rupee liquidity from the inter-bank market by October 2008, and contributed to inability of the government to raise more funds from the scheduled banks.

The resulting decline in banks' liquidity and lower T-bill holdings with scheduled banks, both led to a sharp jump in call rates in the inter-bank market. Thus, the spread between call and repo rose to exceptionally high levels (see **Figure 4.4**).

The liquidity crunch became severe following a heavy withdrawal of deposits owing to seasonal cash demand around Eid. In October 2008, banking system also experienced rumor-induced panic withdrawal of deposits.[3] SBP responded by

[3] See ensuing section on '***Deposit mobilization***' in this chapter.

introducing a number of temporary measures aimed at accommodating extraordinary liquidity shortages in the banking system.[4]

As a result of SBP's timely response, the liquidity concerns have considerably subsided. There is, however, a need to continue policy focus on addressing macroeconomic imbalances, namely high inflation, exceptional pressures on external account and continued reliance of government on borrowings from the central bank. Recognizing this, the government and SBP have already developed a macroeconomic stabilization program, which is being currently implemented. The Stand-By Arrangement for 23 months agreed with International Monetary Fund, is one key element of this entire package which will also help in mobilizing resources from other International Financial Institutions (IFIs). Not surprisingly, the program agreed with the Fund also aims to bring down inflation, protect country's reserve

Table 4.1: Inflation and Interest Rates

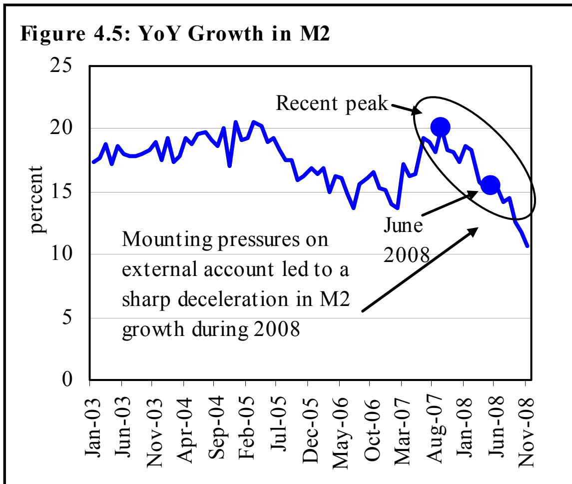
percent

	Inflation YoY		Policy Rate		
	Nov-07	Nov-08	Previous	Current	w.e.f
USA	3.5 *	3.7	1.0	0.25	Dec 08
UK	2.1 *	4.5	3.0	2.0	Dec 08
Eurozone	3.1	2.1	3.3	2.5	Dec 08
Canada	2.4 *	2.6	2.3	1.5	Dec 08
Australia	1.9 #	5.0	5.3	4.3	Dec 08
Japan	0.3 *	1.7	0.5	0.3	Oct 08
China	6.9	2.4	6.7	5.6	Nov 08
S. Korea	3.5	4.5	4.0	3.0	Dec 08
Malaysia	1.9 *	7.6	3.8	3.3	Nov 08
Thailand	3.0	2.2	3.8	2.8	Dec 08
Philippines	3.2	9.9	5.8	6.0	Aug 08
India	5.5 *	10.4	7.5	6.0	Dec 08
Pakistan	8.7	24.7	13.0	15.0	Nov 08
Sri Lanka	18.2 *	20.2	10.0	10.5	Oct 08
Vietnam	10.0	24.2	13.0	12.0	Oct 08
Indonesia	5.6	11.7	9.3	9.5	Oct 08

* data pertains to October # Quarterly data

Source: Bloomberg, The Economist

Figure 4.5: YoY Growth in M2



[4] See SBP document '***Interim Monetary Policy Measure, November 2008***'.

position, and eliminate SBP financing of the government.

It is also important to recognize that the economic stresses faced by Pakistan are quite different from what other countries in the region, and across the globe, are facing following unfolding of the international financial crisis. Thus, one should expect wide variance in policy response in Pakistan and other countries. While macroeconomic situation in Pakistan requires continued monetary tightening (well supported by fiscal measures), other countries are facing the risk of economic recession, which is reflected in their monetary policy responses (see **Table 4.1**).

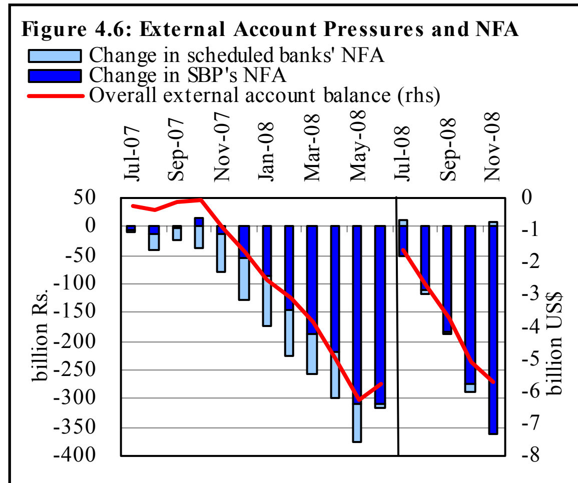
Table 4.2: Monetary Aggregates (from end June till Nov 29)

	Flows in billion rupees		YoY growth (%) in stocks	
	FY08	**FY09**	**FY08**	**FY09**
Broad money (M2)	171.4	-10.8	19.3	10.4
NFA	-99.9	-356.3	38.5	-64.8
SBP	-34.5	-363.0	42.9	-84.5
Scheduled banks	-65.4	6.7	17.7	47.7
NDA	271.3	345.5	15.1	30.3
SBP	153.6	292.4	-10.6	250.2
Scheduled banks	117.7	53.1	18.5	8.3
of which				
Govt sector	168.0	270.9	18.4	62.7
Net budgetary support	191.3	263.1	24.3	62.5
from SBP	169.5	356.4	2.4	170.2
from scheduled banks	21.9	-93.3	60.4	-51.2
Credit to PSEs	4.5	54.8	61.2	97.9
Credit to private sector	133.9	145.8	15.6	16.1
Memorandum item				
Total domestic credit[1]	306.7	471.5	17.1	31.2
Reserve money	76.1	-38.6	14.9	12.0

[1] Sum of government and non-government credit.

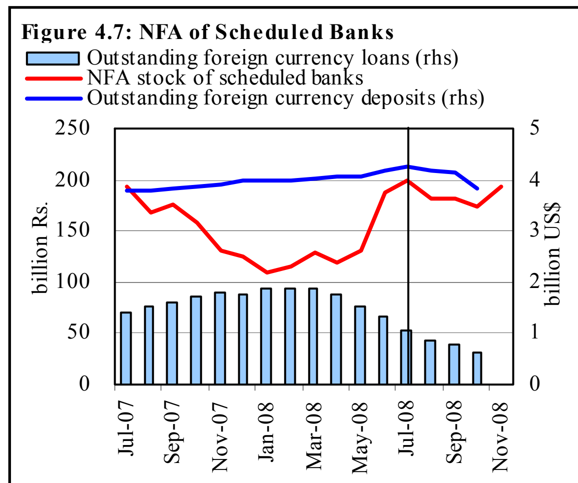
4.2 Developments in Monetary Aggregates

An extraordinarily strong contraction in net foreign assets (NFA) of the banking system led to a net drain of Rs 10.8 billion in broad money aggregate (M2) from the system during Jul -Nov FY09. The contraction in NFA was partially offset by a sharp rise in government borrowings form the central bank (see **Table 4.2**). Nonetheless, M2 growth YoY decelerated steeply to 10.7 percent by end November 2008 (see **Figure 4.5**) – the lowest growth seen during the last seven years.



Given that the contraction in NFA owes to strong demand for imports, and that domestic credit growth (both for public as well as private credit) remains robust, the slowdown in M2 during Jul-Nov FY09 should not be misconstrued as a weakness in domestic aggregate demand. Indeed the exceptional rise in government borrowings from the central bank is aggravating already high demand pressures in the economy.[5] Such pressures are well evident in an unusual rise in total domestic credit that has grown by 31.2 percent on YoY basis by end November 2008 compared to 17.1 percent increase an year earlier.

Net Foreign Assets (NFA)



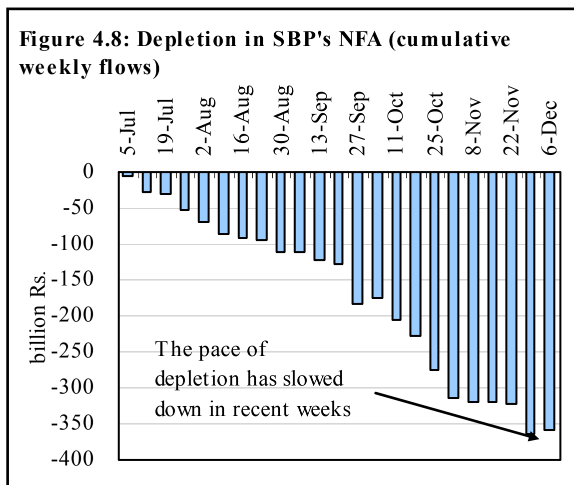
The contraction of Rs 356.3 billion in net foreign assets of the banking system during Jul-Nov FY09 was even higher than the decline of Rs 317.4 billion recorded in NFA during the *entire* fiscal year of 2007-2008 (see **Figure 4.6**). The pressure on NFA of the banking system mirrors the sharp worsening of external account position of the country.

The considerably high growth of 21.6 percent in imports during Jul-Nov FY09 (mainly due to rising oil bill) lead to sharp increase in the external current account deficit over the corresponding

[5] When government borrows from scheduled banks, this leads to diversion of resources from private sector to government (that causes shifting of demand from one segment of economy to other). The budgetary borrowings from SBP on the other hand are most inflationary as this means injection of *fresh* funding in the economy (with no curtailment in resources available to private sector).

period of FY08. Payment pressures compounded as external financing inflows slowed down, thus accelerating the depletion of foreign exchange reserves, particularly of the central bank.[6] Indeed, during Jul-Nov FY08, SBP's support for oil payments were US$ 6.1 billion – more than twice the US$ 2.9 billion provided during the corresponding period of previous year. This implies that the contraction was far greater in NFA of the central bank.

Figure 4.8: Depletion in SBP's NFA (cumulative weekly flows)



Pressures on NFA of scheduled banks during Jul-Nov FY09 were relatively moderate compared to corresponding period of FY08. During initial months of FY08, NFA of scheduled banks came under pressures following a rise in foreign currency loans which were encouraged by both (a) expectations of relatively stable Pak rupee exchange rate, and (b) higher interest rate differential between the rupee-based borrowings and foreign currency borrowings.

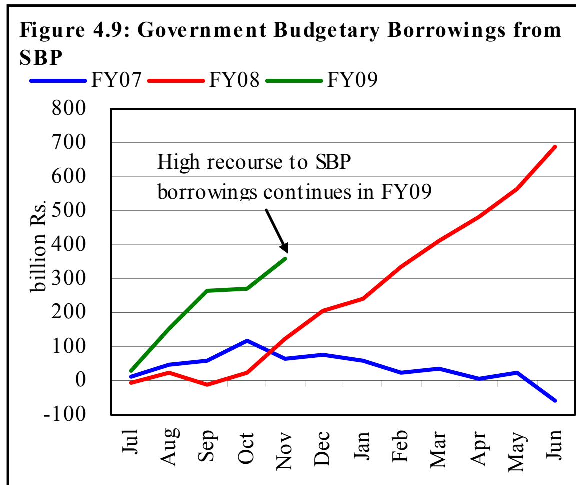
During FY09, though the interest rate differential widened, depreciation of rupee against major currencies made foreign currency loans costlier and riskier. This prompted traders to retire their foreign currency obligation.[7] The resulting rise in banks' foreign assets even helped in moderating the strong downward pressures on NFA following heavy withdrawals of foreign currency deposits towards the end of September and early October 2008 (see **Figure 4.7**).

[6] The drain on foreign exchange reserves was pronounced during FY09 as the government could not mobilize external financing for the budget. This was because Pakistan's ability to tap international capital markets was constrained due to worsening global financial condition as well as domestic economic uncertainties that led to downward adjustments in country's sovereign credit rating. The heightened risk also accelerated foreign exchange outflows (particularly portfolio investment flows) and forced importers to advance their demands for payments in foreign currency.

[7] Since foreign currency loans are banks' liability on residents, these are treated as a part of banks' domestic assets in monetary accounts. Thus foreign currency loans lead to switching of banks foreign assets (which for example, were placed abroad) with their domestic assets, and vice versa when a foreign currency loan is retired.

A review of the latest weekly trends in SBP's NFA indicates that the pressures on country's external account have already started to show some signs of ease (see **Figure 4.8**). This is mainly on account of recent decline in oil and other commodity prices in the international markets, relative calm in sentiments of the exchange market following various measures taken by the central bank (including the monetary tightening) and inception of stabilization program with IMF support.

Figure 4.9: Government Budgetary Borrowings from SBP



It is expected that the Stand-By Arrangement (SBA) negotiated with the IMF and the implementation of macroeconomic stabilization package would help in restoring confidence on Pakistan's economy and pave the way for more financial assistance from other multilateral and bilateral sources. This, in turn would strengthen the forex reserves position of the country.[8] Nonetheless, a sustained decline in overall import demand is critical to avoid any further loss in reserves, particularly when weakening global economies could lead to a slowdown in both, export growth and remittance inflows.

Net Domestic Assets (NDA)

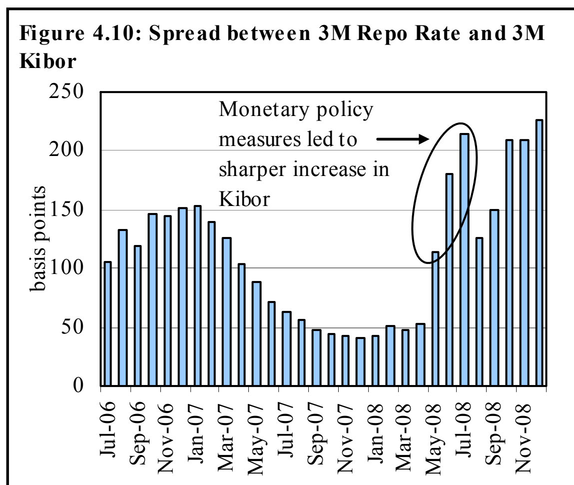
The YoY growth in NDA which was unusually high at 30.6 percent during FY08 remained strong at 30.3 percent even during Jul-Nov FY09. Persistently high government budgetary borrowings from the central bank and the strong demand for credit, both from public sector enterprise (PSEs) and private sector; all acted to further increase the NDA growth during the period under review. The government's high recourse to the central bank financing and retirement of its obligations to scheduled banks made SBP the main contributor to NDA growth.

[8] Pakistan has already received the first tranche of US$ 3.1 billion from the IMF on November 26, 2008 which raised SBP's reserves to US$ 6.2 billion. It should however be noted that the net foreign assets of SBP (and the money supply) remained unchanged on receipt of IMF tranche. This is because the IMF loan, which is essentially for balance of payment support, also creates a corresponding liability on the central bank.

Government budgetary borrowings

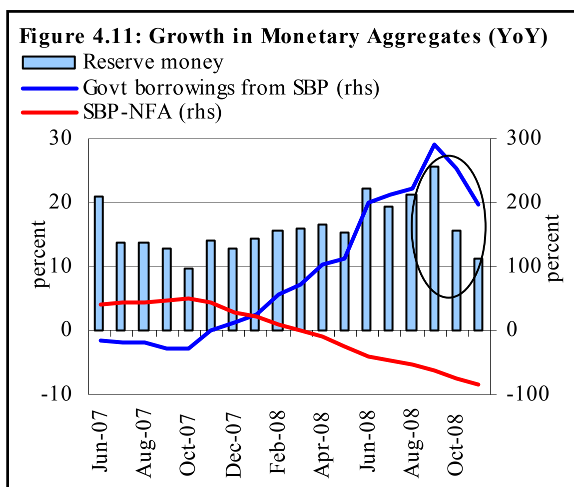
Government budgetary borrowings from the SBP continued unabated during FY09, reaching Rs. 356.4 billion during Jul-Nov FY09 (see **Figure 4.9**). Consequently, stock of market related treasury bills (MRTBs) with SBP increased to Rs 1393.4 billion by November 29, 2008 compared to Rs 1053 billion at end-June 2008.

Figure 4.10: Spread between 3M Repo Rate and 3M Kibor



So far, the emerging trends in fiscal account for FY09 are in line with the government's commitment to bring down its budgetary deficit to 4.2 percent of GDP for FY09.[9] It was therefore the decline in external financing,[10] and inability of the government to raise funding from non-SBP sources, that explain the higher reliance on borrowings from the central bank.

Figure 4.11: Growth in Monetary Aggregates (YoY)



The financing burden fell on the central bank as scheduled banks were reluctant to provide financing to the government through Jul-Oct FY09 at the then; prevailing auction cut off rates. This was largely because (a) the private sector credit (that was growing quite strongly) was offering higher returns to banks (see **Figure 4.10**), and (b) expectations that very high inflation would soon lead to higher rates. This tendency was heightened by

[9] The fiscal deficit for Q1-FY09 was Rs 139.5 billion (or 1 percent of the projected GDP for FY09) lower than Rs 158.1 billion in Q1-FY08 (or 1.5 percent of the GDP).
[10] The external financing during Q1-FY09 was almost zero compared to net receipt of Rs 36.8 billion in Q1-FY08.

liquidity crunch in October 2008. As a result, government was unable to even roll-over its maturing debt securities held by scheduled banks.[11] Thus, government has made retirement of Rs 69.0 billion to scheduled banks during Jul-Nov FY09.

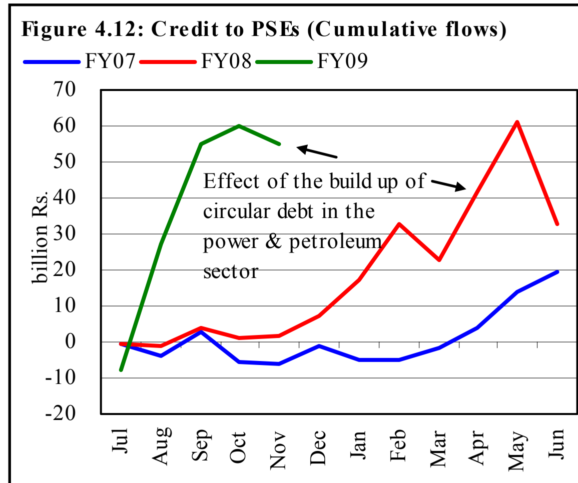


Figure 4.12: Credit to PSEs (Cumulative flows)

Besides adding to the already high inflationary pressures in the economy, continued borrowings from central bank posed various challenges to SBP. For example, the unpredictable and large borrowings made liquidity management more difficult and weakened the transmission of monetary policy signals to retail rates. The task of liquidity management became daunting as the falling stock of T-bills with scheduled banks (as banks were not much interested in rolling over their investments in government papers) constrained their ability to raise funds in the repo market.[12] This had two implications: (1) banks had to meet their funding needs more from the call market (thereby adding to volatility in overnight inter-bank call rates).[13] (2) SBP's ability to address liquidity shortages in the inter-bank market (through OMOs and discount window) was also impaired.

The extent of difficulty in monetary management by SBP is also reflected in continued high growth in reserve money during FY09. As evident from **Figure 4.11**, the slowdown in reserve money growth in recent months was realized only when the pace of government borrowings from SBP slowed down in relative terms.

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[11] During Jul-Dec 2007, after adjusting for auction maturities, government was able to mobilize Rs 137.0 billion through T-bill auctions. In comparison, during Jul-Dec 2008, total acceptance in auctions fell short of maturities by Rs 18.9 billion.
[12] Government papers are liquid assets which the banks use as collateral while accessing SBP's discount window, raising funds in inter-bank repo market. These papers are also used in open market operations (OMOs).
[13] Some banks, which were holding low volume of liquid assets, had to face abnormally high call rates in the inter-bank market.

In view of complications due to government borrowings from the central bank, it is essential that sources of budgetary financing are diversified. In this regard, government has already phased out most subsidies and increased interest rates on National Saving Schemes. The outstanding credit to PSEs increased sharply during Jul-Nov FY09 (see **Figure 4.12**) as continuing delays in settlement of claims by the government has pushed the major power utility and the oil marketing company in public sector to seek finance from scheduled banks. In addition, banks have also extended credit to the airline operating in public sector.

Table 4.3: Growth in Private Sector Credit
percent

	Jul-Nov	
	FY08	**FY09**
Private sector credit	**5.4**	**5.1**
Business sector	**5.0**	**7.1**
of which:		
Fixed investment	-1.1	17.2
Working capital	4.9	4.4
Trade finance	18.1	-1.7

4.3 Credit to Private Sector[14]
Growth in private sector credit remained strong at 5.1 percent during Jul-Nov FY09; slightly lower than that in the corresponding period last year. This was despite negative contribution from trade financing during the period under review (see **Table 4.3**). Demand for working capital and fixed investment, on the other hand, remained strong.

There are a number of factors that explain this rise in private sector credit during Jul-Nov FY09. For example,

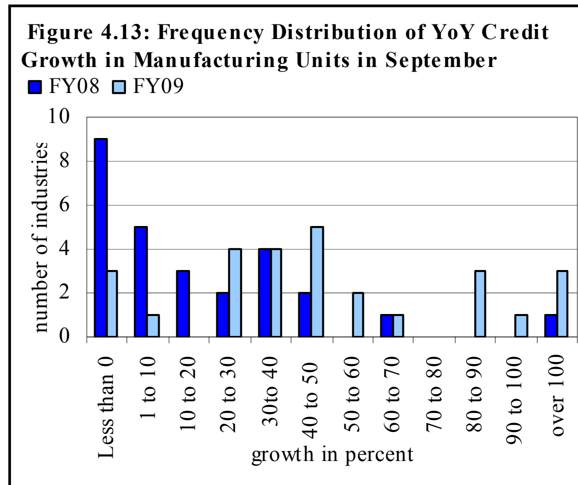
(1) Non-availability of other non-bank sources of financing. As mentioned in earlier SBP reports that during FY08 part of the credit demand was met through non-banks' investments in corporate debt papers (i.e., Sukuk and TFCs).[15] In the absence of any new issuances of these instruments during FY09, credit demand from the bank sources were understandably higher.

(2) Similar to last year, the working capital requirements of Independent Power Projects (IPPs) and Oil Marketing Companies (OMCs) continued to rise

[14] The reported credit numbers comprises of banks' investments and advances to the corporate sector. This data is based on monetary survey, while the sector-wise discussion covers the period of Jul-Oct FY09.
[15] During FY08, a few corporates preferred to issue Sukuk and TFCs to refinance expensive banks' credit and in some cases to fund expansion related activities.

unabatedly in FY09.[16] In addition to price differential claims with the government, the delay in settlement of furnace oil and natural gas claims with WAPDA led to an upward pressure on credit demand during initial months of FY09 (see **Box 4.1**). The magnitude of the inter-corporate debt can be gauged from the fact that till September 2008, a few IPPs and OMCs had exhausted their prescribed credit limits with the domestic banking system. The resulting credit constraints could possibly explain the lower credit extension during October 2008.

Figure 4.13: Frequency Distribution of YoY Credit Growth in Manufacturing Units in September



(3) It must also be noted that the regulatory measures taken by the SBP to contain the forex market pressures evident in the initial months of FY09 also added some pressures on the credit demand. Anecdotal evidence suggests that temporarily suspension of forward cover against all types of imports in July 2008[17] led to higher demand for rupee financing by a few importers to hedge their exchange rate exposure.[18]

(4) A sharp depreciation of rupee against US dollar in the initial months of FY09 made derivate instruments, such as cross currency swaps, unattractive for corporates.[19] As a result, a large number of such deals un-winded during the period of Jul-Oct FY09. Anecdotal evidence suggests that a few banks, having significant exposure in CCS, arranged rupee funding for their client to unwind such deals.

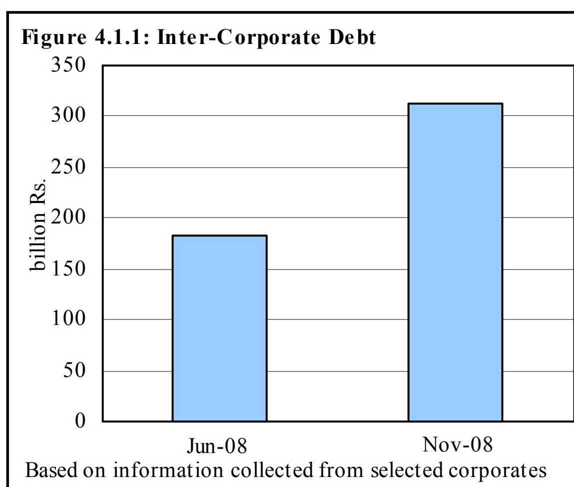
[16] Indeed, in FY08 OMCs had borrowed from the banking system (against government guarantee) in wake of delays in price differential claims between the international oil prices and the domestic consumer prices. However, government had settled a large amount against OMCs by end June 2008.
[17] For detail see Foreign Exchange Circular No.08 of 2008.
[18] It is cited that in expectation of further depreciation of rupee a few importers borrowed rupee from the banking system to buy dollar to hedge against exchange rate losses.
[19] In view of stable exchange rate and rising domestic interest rates in the recent pasts, a few corproates preferred to engage in cross currency swaps by switching their Kibor-based interest payments with Libor-based loans.

The confluence of above mentioned factors was particularly strong during September 2008. Though the credit off-take season generally begins in September every year, the credit growth during September 2008 was exceptionally strong.[20] Further analysis shows that this credit growth was driven mainly by increased demand for running financing, largely coming from manufacturing, power, construction, commerce & trade

Box 4.1: Circular Debt

The issue of inter-corporate debt[21] which emerged in FY08, became larger and more complex during initial months of the current fiscal year.

Figure 4.1.1: Inter-Corporate Debt



Based on information collected from selected corporates

Looking retrospectively, the issue of inter-corporate debt during FY08 rose mainly as the government was providing subsidy on fuel prices to domestic consumers and power utilities faced losses. The delays in the settlement of oil price differential[22] claims by the government and the utilities forced a few OMCs to borrow from the banking system (against government guarantees) in FY08. Although the government was also subsidizing electricity throughout FY08, this did not enlarge the outstanding amount of circular debt in the power and petroleum sector. This was because (1) the volume of price differential claims of the major power utility in public sector remained low,[23] and (2) Independent Power Projects (IPPs) had sufficient cash to meet payments to their creditors.

During the initial months of FY09, circular debt situation worsened despite the fact that government has phased out subsidy on fuel prices. The exceptional increase in outstanding debt held by OMCs and IPPs this year (see **Figure 4.1.1**) is because of sharp rise in differential claims against a state owned power company. Indeed, the public sector

[20] The credit expansion during September 2008 was exceptionally high at Rs 111.8 billion compared to the average rise of Rs 49 billion for the same month in the last four years.

[21] Inter-corporate debt is a situation where a company withheld payments to its suppliers thereby resulting into a situation where suppliers also stop making payments to their creditors.

[22] This refers to the differential between the international oil prices and the domestic consumer prices.

[23] This was probably due to the fact that in the budget for that year, government had earmarked financing amount for the subsidy on electricity.

power companies have developed large payable to (1) IPPs for the electricity purchased for distribution purpose; and (2) fuel supply companies for furnace oil and natural gas used in production of electricity. Ironically, IPPs in turn are also facing difficulties in making payments to their fuel suppliers.

Thus, facing pressures on their cash flows, IPPs, OMCs and public sector gas distribution entities too stopped clearing payments to their creditors and thus leading to build up of inter-corporate debt.

and telecom sectors. Within manufacturing sector a large number of industries had seen credit growth in the vicinity of 20 to 50 percent during September 2008 (see **Figure 4.13**).

There was, however, an unusual break in credit cycle this year; unlike previous year, credit growth could not maintain its momentum after September 2008 (see **Figure 4.14**).[24]

This slowdown in credit growth, which was mainly visible under working capital loans, was probably due to liquidity crunch in the banking system and the consequent rise in the lending rates. In the meanwhile, a relative fall in raw material prices in recent months[25] has also lowered the working capital requirements from

Figure 4.14: Cumulative Growth in Private Sector Credit

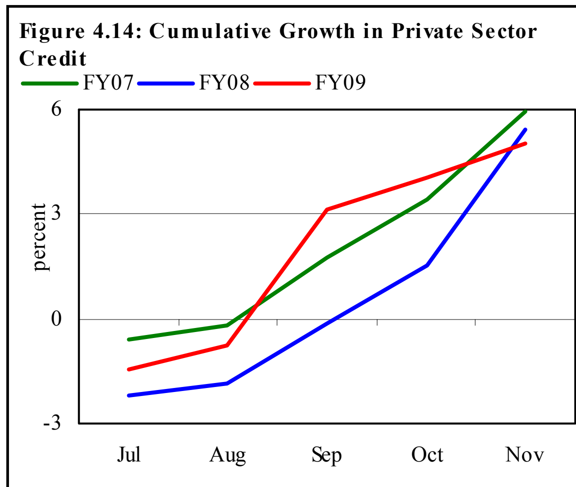
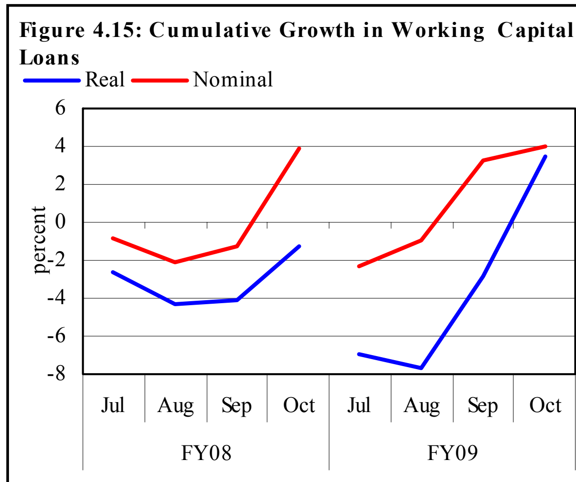


Figure 4.15: Cumulative Growth in Working Capital Loans



[24] The private sector credit during Oct-Nov FY09 saw an increase of Rs 55.5 billion compared to Rs 136.8 billon in the corresponding period of previous year.

[25] The YoY growth in WPI index for non-food group dropped sharply to 25.2 percent and 12.8 percent in October and November 2008 respectively compared with 37.4 percent YoY rise in August 2008.

corporates.[26] This impact is evident from the lower variance between real[27] and nominal demand for working capital loans during Jul-Oct FY09 (see **Figure 4.15**). It can be argued that though the impact of liquidity crunch on private sector credit would disappear after some time, slowdown in credit demand owing to falling prices of raw material may persist going forward.

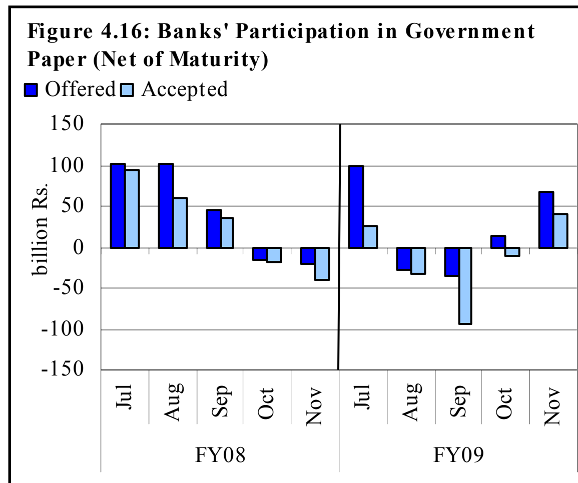


Figure 4.16: Banks' Participation in Government Paper (Net of Maturity)

Banks' participation in credit supply

Banks were able to comfortably fund the strong credit demand particularly during September 2008. This was because (a) banks were using their excess statutory reserves with SBP, and (b) the government has been retiring its borrowings from scheduled banks.

As discussed earlier, the latter point also reflects banks' unwillingness to invest in government papers, partly due to expectations of higher interest rate as inflationary pressures were rising, and partly on account of exceptionally strong credit demand during Aug-Sep 2008. Thus, banks were not willing to rollover their investment in maturing T-bills (see **Figure 4.16**).[28]

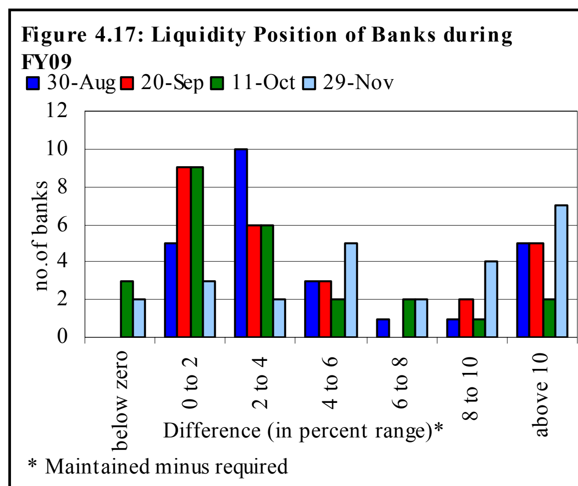
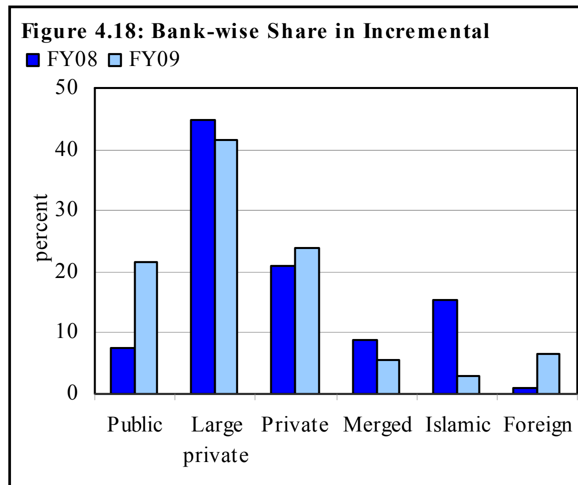


Figure 4.17: Liquidity Position of Banks during FY09

[26] Since July 2007, working capital requirements from corporates rose markedly due to unprecedented hike in raw material prices (both in the domestic and global markets).
[27] The stock of total working capital loans has been deflated by the WPI index for non-food group.
[28] Typically, low private sector credit demand (before the start of credit cycle) allows government to mobilize substantial amount through treasury auctions. During Aug-Sep 2008, however total

Banks, however, started facing stress on their rupee liquidity holding with the fall in their excess statutory reserves with SBP. This liquidity condition tightened further following a rumor-induced, abrupt and sizeable withdrawal of deposits in mid-October 2008 (see **Figure 4.17**).[29] Following a series of measures undertaken by SBP,[30] the liquidity strains of banks have averted to an extent. This can be viewed from the large number of banks having excess liquidity ratio[31] over 4 percent by end-November 2008 compared with the mid-October 2008 position (see **Figure 4.17**). Notwithstanding SBP's temporary liquidity support, banks now have to put greater focus on deposit mobilization so as to meet private sector credit demand.

Figure 4.18: Bank-wise Share in Incremental



The bank-wise data on credit shows that more banks have contributed in credit expansion during Jul-Nov 2008 (see **Figure 4.18**). In particular, small private banks, which traditionally have lower share in credit supply, lent more aggressively to private sector during the initial months of FY09. This largely stemmed from two banks in this category.[32] It must however be noted that the

Table 4.4: Break-up of Growth in Advances

percent

	Jul-Oct		Aug-Sep
	FY08	**FY09**	**FY09**
Business sector of which:	**0.5**	**6.1**	**4.9**
Fixed investment	-6.9	11.4	2.9
Working capital	0.5	5.2	7.0
Trade financing	16.0	-0.4	0.9
Consumer financing	**4.1**	**-6.0**	**-2.8**

acceptance in T-bill auctions fell short of maturity by Rs 125.6 billion compared with the average net acceptance of Rs 94.9 billion in the corresponding months last years.

[29] See section on **Deposit Mobilization** for more details.

[30] These mainly include reduction in reserve requirements, liquidity injection through OMOs and discount window. For details see ***Interim Monetary Policy Measure***, November 2008.

[31] Excess liquidity ratio is computed as the difference between the actual and required liquidity maintained by banks divided by the total time and demand liabilities.

[32] Interestingly, these banks witnessed marginal increase in deposit during Aug-Sep FY09.

liquidity crunch of October 2008 affected some small banks more severely. As a result, their share in incremental credit dropped sharply during Oct-Nov 2008 period.

Trend in Private Sector Advances

Growth in advances to the business sector rose by 6.1 percent during Jul-Oct FY09, compared to nominal growth of 0.5 percent during the corresponding period previous year.[33] As evident from **Table 4.4**, most of the demand for business sector advance has been for fixed investment and working capital loans. Trade related loans, on the other hand, registered a net retirement.

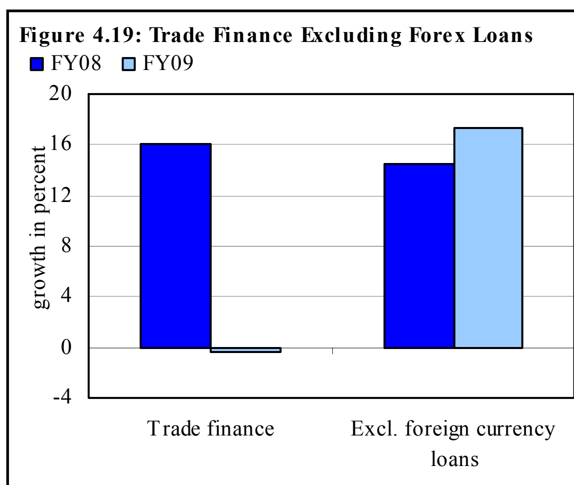


Figure 4.19: Trade Finance Excluding Forex Loans

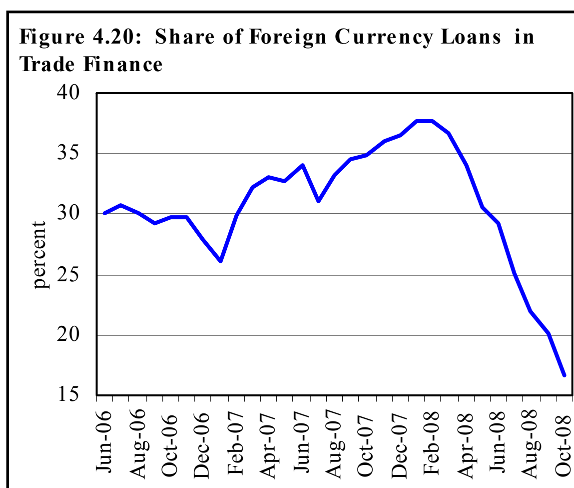


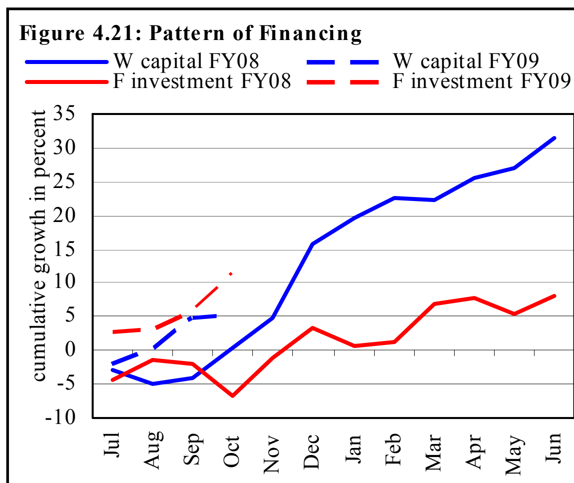
Figure 4.20: Share of Foreign Currency Loans in Trade Finance

The fall in trade finance during Jul-Oct FY09 was primarily due to sharp decline in demand for foreign currency loans (mainly by importers) following a sharp depreciation of the rupee against US dollar. Thus, excluding the net retirements under the foreign currency loans, advances for trade finance depict a stronger growth of 17.4 percent in Jul-Oct FY09, which is in line with the acceleration in growth of aggregate trade volume in the same period (see **Figure 4.19**).[34] Resultantly, the share of foreign currency loans in total trade

[33] The consumer loans, on the other hand, witnessed a sharp slowdown during Jul-Oct FY09 as compared to net lending in the corresponding period last year.
[34] Within rupee trade loans, the disbursement under EFS loans increased to Rs 147.5 billion in Jul-Oct FY09 compared with Rs 135 billion in the corresponding period last year.

finance dropped steeply from 37.8 percent in January 2008 to 16.6 percent in October 2008 (see **Figure 4.20**). A monthly analysis shows that, unlike previous year, pickup in demand for fixed investment and working capital loans was unusually high since August 2008 (see **Figure 4.21**). For example, the growth in advances for working capital loans (which rose by 5.2 percent during Jul-Oct FY09 compared with 0.5 percent in Jul-Oct FY08) is mainly concentrated in the month of August and September 2008. Indeed, it was a deceleration in working capital loans in the month of October 2008 that had actually restricted the cumulative growth to 5.2 percent during Jul-Oct FY09.

Figure 4.21: Pattern of Financing



A sectoral breakup of working capital loans during Aug-Sep FY09 suggests that the demand for these loans stemmed primarily from the manufacturing sector (see **Table 4.5**). Apart from this, acceleration in demand from the power sector was expected, to an extent, mainly due to non-payment of dues by the government entities to IPPs.

Table 4.5: Breakup of Working Capital Loans during Aug-Sep

(amount in billion Rs, growth in percent)

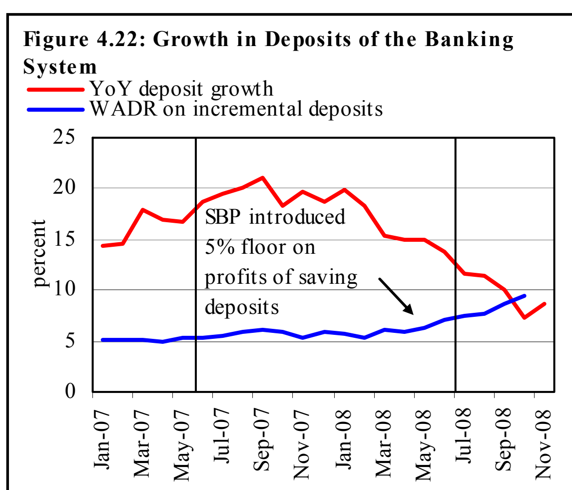
	Absolute increase		Growth	
	FY08	FY09	FY08	FY09
Working capital loans	**-12.4**	**82.1**	**-1.4**	**7.0**
A. Agriculture	**4.9**	**0.2**	**4.8**	**0.1**
B. Manufacturing	**-13.4**	**59.5**	**-3.0**	**10.3**
a. Textile	4.0	12.1	2.4	5.3
Spinning of fibers	0.5	14.1	0.5	11.6
b. Refined petroleum products	0.3	11.0	2.7	94.4
c. Chemicals and chemical products	-4.3	19.0	-10.6	33.8
d. Manufacture of machinery &equipment	0.7	3.1	7.0	26.7
C. Power	**2.8**	**11.7**	**14.7**	**20.4**
D. Transport & communications	**-7.6**	**1.6**	**-32.8**	**4.2**
E. Other business activities	**1.9**	**9.5**	**4.0**	**15.3**
F. Other	**-1.1**	**-0.4**	**-1.1**	**-0.1**

Within the manufacturing sector, the advances grew by 10.3 percent during Aug-Sep FY09 compared with net retirement in the same period last year. This growth

mainly came from the textile spinning, fertilizer and refined petroleum product industries.

The demand for fixed investment loans remained strong throughout the period of Jul-Oct FY09 and posted a growth of 11.4 percent in contrast with a fall in the corresponding period last year. Major sectors that registered an increase in fixed investment loans were power, fertilizer, telecom and construction. The rise in fixed investment demand in power sector is the outcome of continued expansion related activities by power companies. It must be noted that in FY08, fertilizer sector mainly finance their expansion plans through non-bank sources such as Sukuk, TFCs and rights issue. In absence of any new issuances of these instruments in Jul-Oct FY09, dependence on bank's advances for meeting fixed investment demand was expected in this sector.

Figure 4.22: Growth in Deposits of the Banking System

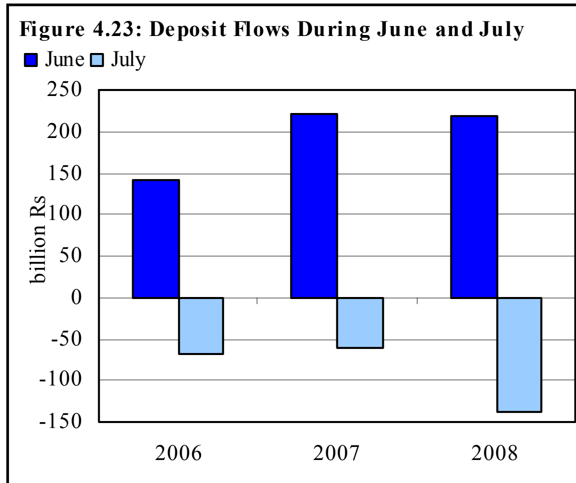


4.4 Deposit Mobilization

The pressures on deposit mobilization by the banking industry intensified further during FY09 as the YoY deposit growth weakened to 8.7 percent by November 2008 from 13.8 percent in June 2008 and 19.7 percent in November 2007 (see **Figure 4.22**). This deceleration in deposit growth was despite a relatively steep rise in weighted average return on deposits.

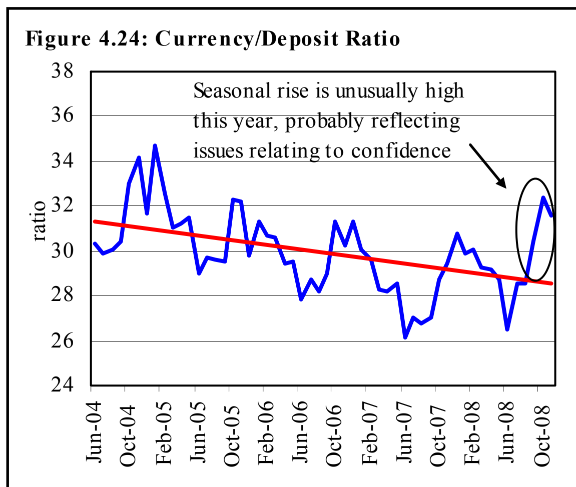
Though a number of factors explain the slowdown in deposit growth, it was the abrupt withdrawal of Rs 96.5 billion in deposits during the first two weeks after Eid-ul-Fitr that took a heavy toll on deposit mobilization efforts of banks. Indeed, seasonal deposit withdrawals (around Ramadan and Eid) were exacerbated this year by rumor-fed concerns over the stability of local banks in the backdrop of the international financial crisis (see **Box 4.2** for more details).

Other factors that explain the slowdown in deposit growth include the following:



1. The banking sector in Pakistan generally experiences a sharp jump in deposits during June each year, which is followed by withdrawal during subsequent months. In July 2008, the deposit withdrawal was exceptionally high (see **Figure 4.23**)

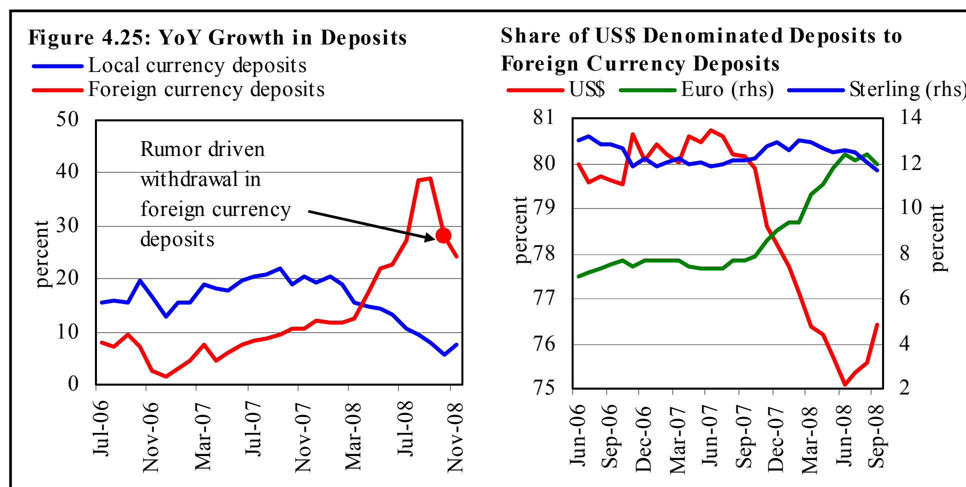
2. There is also a significant shift in public preference away from deposits. Probably reflecting the effect of rising inflationary pressures, this has also led to a decline in deposit multiplier and thus weakening deposit growth (see **Figure 4.24**).



3. The significant rise in external account outflows also acted to contain the deposit growth.[35] This is because the central bank was providing the foreign currency to meet the net external outflows. The equivalent Rupee payment eventually hit deposits of the banking system.

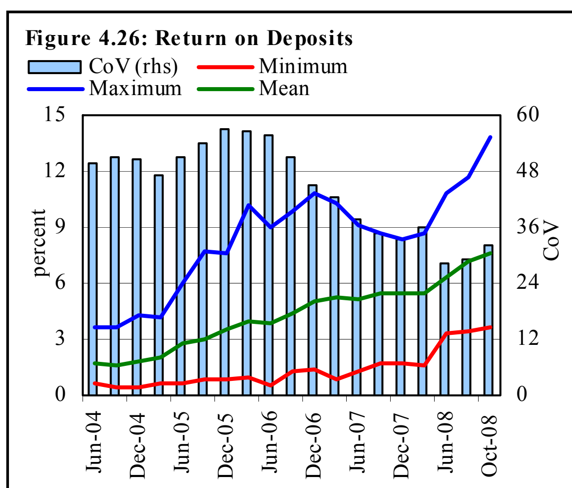
4. Finally, with the relative slowdown in GDP growth and attendant ease

[35] The overall external account balance for Jul-Nov FY09 is showing a huge deficit of US$ 5.7 billion compared to a deficit of US$ 908 million during the corresponding period of 2007.



in economic activities some deceleration in deposit growth was to be expected.[36]

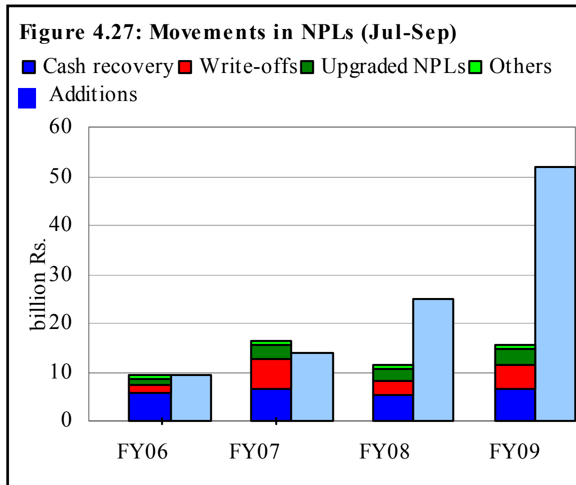
The currency-wise composition of deposits suggests that despite continued slowdown in rupee deposits growth, the foreign currency deposits increased sharply particularly after March 2008. This was mainly due to expectations of exchange gains from weakening local currency.[37] The growth momentum in foreign currency deposits remained intact until October 2008 when bank deposit withdrawals also affected the foreign currency accounts.



Within the foreign currency deposits, the growth was more pronounced in US dollar denominated accounts. As a result, the share of dollar deposits increased strongly since June 2008 onwards (see **Figure 4.25**).

[36] GDP growth for FY09 is projected to slowdown to 3.5-4.5 percent from 5.8 percent in FY08 (see Chapter 1).

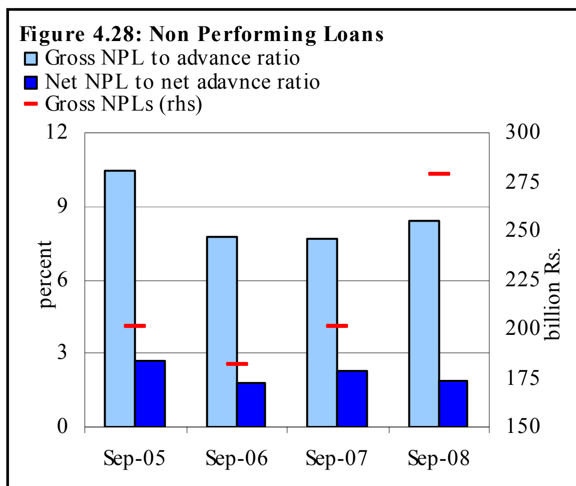
[37] The monthly average exchange rate of the rupee depreciated from Rs 62.7 per US$ in March 2008 to Rs 81.6 per US$ in October 2008.



The rise in rate of return on deposits is relatively steeper during FY09. Besides SBP's decision to impose a minimum 5 percent floor on saving deposits, the recent squeeze in rupee liquidity in the inter-bank market has led to higher return on deposit. As evident from **Figure 4.26**, in addition to minimum interest rates on deposits, the maximum return offered by banking industry has increased quite sharply in recent month. The impact on weighted average return on deposits was, however, muted due to considerably large share of low (or zero) remunerative deposits in the banking system.

4.5 Non Performing Loans

The gross non-performing loans (NPLs) reached Rs 278.1 billion by end-September 2008 from Rs 241.3 billion at end-June 2008. Further analysis shows that NPLs for Q1-FY08 recorded an addition of Rs 51.7 billion which was partially offset by cash recoveries, upgraded NPLs and write offs (see **Figure 4.27**). Moreover, sector-wise analysis shows that bad loans in corporate, SME, agriculture and consumer sectors have contributed to the deteriorating asset quality during the quarter under review.



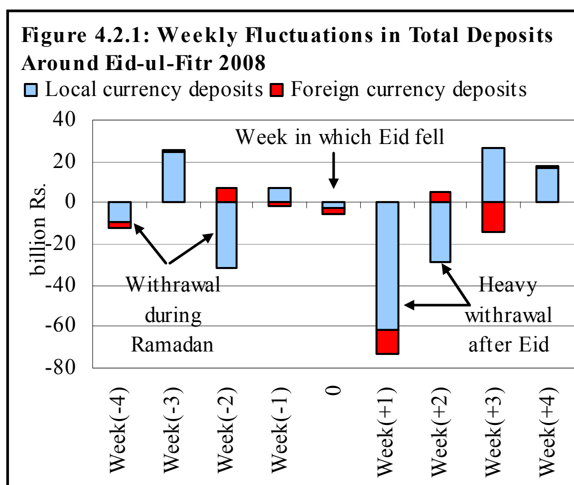
Despite the stress on loan portfolio, the overall banking sector is quite resilient as the infection ratio currently stands at 8.4 percent of advances, which further falls to as low as 1.9 percent once an adjustment is made for amount of provisions held against NPLs (see **Figure 4.28**).[38]

Box 4.2: Stress on Banking Sector Deposits in October 2008

The banking sector which had been struggling over the last 1¼ years to enhance deposit growth, suffered a major setback in October 2008 when there was an abrupt withdrawal of Rs 96.5 billion from the banking system in just two-week period immediately following the Eid-ul-Fitr.

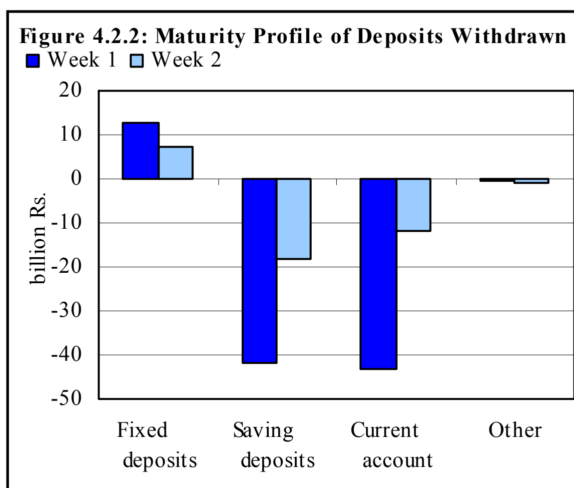
As evident from **Figure 4.2.1**, deposits of the banking system were already under stress during the month of Ramdan. These pressures intensified after Eid. Several events contributed to this pressure on deposits.

Figure 4.2.1: Weekly Fluctuations in Total Deposits Around Eid-ul-Fitr 2008



For example, there were some concerns among depositors about the likely impact of the global financial crisis on domestic banking system. Such worries deepened following the freeze on issuance and redemption of open-end mutual funds (with direct exposure to equity securities) in early October. At the same time, call rates in the money market jumped to exceptionally high levels for some banks which were falling short in their holding of liquid assets. In the foreign exchange market, the rupee also came under severe pressure and depreciated sharply from Rs 78.04 per US$ at end-

Figure 4.2.2: Maturity Profile of Deposits Withdrawn

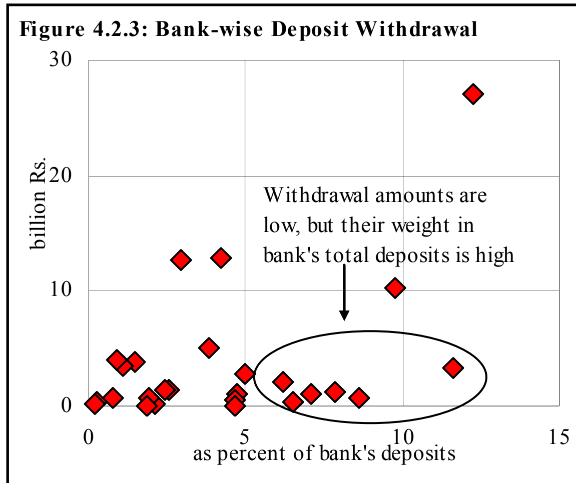


[38] Infection ratio is NPLs as percent of loans and advances.

September 2008 to Rs 83.5 by mid-October, 2008. All these adverse developments provided an ideal breeding ground for spate of rumors, ranging from freezing of foreign currency account and sealing of lockers to stories focusing on some of the local private banks.

In this situation, some depositors became nervous and rushed to take out their deposits. In the beginning, both local currency as well as foreign currency deposits experienced substantial withdrawals (see **Figure 4.2.1**).

Figure 4.2.3: Bank-wise Deposit Withdrawal



A further break up of deposits withdrawal during the first two weeks after Eid gives following insights:

1. Though the deposit withdrawal affected almost all banks, some of the banks experienced substantial run on their deposits. To put this in perspective, over 70 percent of the deposit withdrawal during October 4-8, 2008 took place in only 5 banks.

2. As expected, the withdrawal pressures were mainly savings and current accounts (see **Figure 4.2.2**).

3. The complexity of this near run on deposits was greater for central bank. This was because for some of the small private sector banks, though the volume of deposit withdrawal was low in absolute terms, this was still significant when compared to their total deposits (see **Figure 4.2.3**). This highlights the need for quick liquidity support by the central bank to stem the run on sound banks.