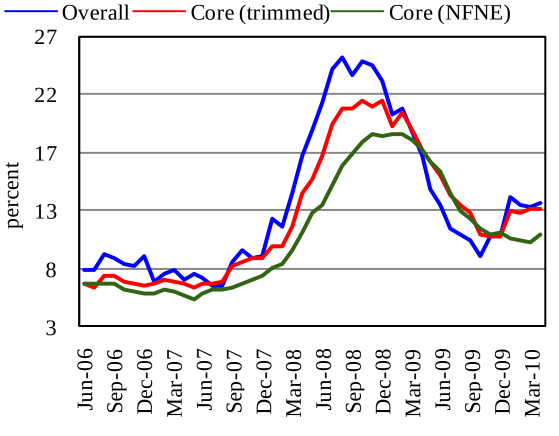
4 Money and Banking[1]

4.1 Monetary Policy

Figure 4.1: CPI Inflation (YoY)



The key challenge for the SBP in the last 12 months has been to support the recovery in economic growth while curbing inflationary pressures. Easing of inflation from an average of over 20.8 percent in FY09 to about 10.3 percent in H1-FY10 allowed the SBP to cut its policy rate by 150 basis points during the first six months of the current fiscal year. However, resurgence in inflationary pressures in Q3-FY10 (with an average of 13.2 percent during the quarter) along with an expansionary fiscal stance and weakening external receipts, all militated against a further easing of monetary policy. Consequently, the SBP decided to keep the policy rate unchanged at 12.5 percent in two consecutive monetary policy announcements (i.e. January and March 2010).

Despite a sustained rise in LSM production during Q3-FY10 over the same period last year,[2] contribution of domestic supply-side pressures to inflation remained limited due to the prevailing excess capacity in a number of industries.[3] This is also evident from a gradual decline in core inflation - as measured by NFNE (non-food, non-energy) –to single digit (i.e. 9.9 percent) by March 2010.[4] However, NFNE bounced back to 10.6 percent in April, 2010. The trend reversal in NFNE in April 2010 indicates strengthening inflationary pressures, possibly due to second round effects of persistently high food and energy inflation (see **Figure 4.1**). Though a part of the rise in inflation was expected on account of upward revisions in electricity tariffs, increases in prices of key international commodities

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[1] The money and banking analysis is based on data available up to April 2010.
[2] During Q3-FY10 LSM growth was 9.6 percent compared with a fall of 12.0 percent in the same period last year.
[3] For detail, see section 2.2: Large Scale Manufacturing.
[4] NFNE YoY inflation dropped to 9.9 percent by end-March 2010, compared with 18.5 percent in March 2009.

such as crude oil, pulses, metal and cotton compounded the inflationary pressures. While CPI YoY inflation in April 2010 has been substantially low when compared with 17.2 percent in April 2009, it exhibits persistence and thus carries the potential to fuel the inflation expectations in the economy.[5]

An allied concern is the persistent upwards pressure on the external account. Though the current account deficit dropped to US$ 3.0 billion during Jul-Apr FY10[6] – the lowest deficit in the last four years - compared with US$ 9.0 billion in Jul-Apr FY09, the continued fall in capital and financial inflows has exerted considerable pressure on the overall external account balance. Putting this in perspective, financing of even a small current account deficit became increasingly challenging given the uncertainty on realization of promised external inflows, particularly the Tokyo pledges.

The problems attached with timely realization of external inflows were worsened by rising fiscal spending and low tax receipts, pushing the fiscal deficit upward.[7] This situation coupled with lingering quasi-fiscal activities such as continued borrowing of energy sector due to circular debt and lower than expected retirement by procurement agencies and food departments for commodity operations led to a buildup of pressures on banking system liquidity. As a result, it appears that financing costs for the government may go up considerably. The sharp increase in government borrowing costs has implications not just for the fiscal account, but also exerts upward pressure on the corporate sector lending rate. Anecdotal evidence suggests that banks are benchmarking corporate sector rate equivalent to the high government rate.

In the face of lower than anticipated external inflows (mainly the third IMF tranche) the financing mix of the fiscal deficit in Q3-FY10 is likely to skew towards the banking system.[8] Specifically, the

Table 4.1: Breakup of NDA Contribution in FY10
percentage points

	Jul-Apr	Q1	Q2	Q3
NDA growth (percent)	**9.8**	**0.1**	**7.2**	**0.4**
Government	7.1	0.8	1.9	**1.0**
Non-government	2.7	-0.7	5.3	-0.6

[5] More importantly, core inflation measured by trimmed mean has also shown resilience in recent months.
[6] It must be noted here that the recent increase in imports were largely offset by the receipts against logistic supports and high worker remittances.
[7] It may be noted here that fiscal deficit in H1-FY10 was Rs 403.3 billion much higher compared with Rs 249.5 billion in H1-FY09. Even though the IMF also provided relaxation in the target of fiscal deficit for Q2-FY10. For detail, see Chapter 5: Fiscal Developments.
[8] Data for Q3-FY10 was not available. However, anecdotal evidence suggests that government borrowing from the banking system has increased substantially.

government exceeded its quarterly limits of deficit monetization agreed with IMF for end March 2010. Government borrowing from the SBP was in addition to the government financing requirement for heavy maturities of T-bills; though these have been rolled over by scheduled banks as the seasonal credit off-take remained low during the period of analysis.

Consequently, most of the contribution in NDA of the banking system came from government related financing in Jul-Apr FY10 (see **Table 4.1**). Thus, unlike last year, M2 growth is largely explained by NDA expansion during Jul-Apr FY10.

4.2 Developments in Monetary Aggregates

Growth in broad money aggregates (M2) increased sharply to 8.1 percent during Jul-Apr FY10, despite a steep contraction of Rs 56 billion in Jan-23 Apr FY10 (see **Table 4.2**). Indeed the cumulative growth in M2 was 5.5 percent during Jul-

Table 4.2: Monetary Aggregates

flows in billion Rupees, growth in percent

	Flows				Growth	
	Jul-Apr		Jan-Apr		Jul-Apr	
	FY09	FY10	FY09	FY10	FY09	FY10
Broad money (M2)	114.1	414.0	11.4	74.4	2.4	8.1
NFA	-226.9	-37.5	65.0	-41.5	-34.0	-7.2
SBP	-246.9	-12.2	47.0	-32.4	-51.4	-3.8
Scheduled banks	20.0	-25.3	18.0	-9.1	10.7	-13.1
NDA	341.0	451.5	-53.6	115.9	8.5	9.8
SBP	157.1	121.6	-56.8	12.8	20.3	13.8
Scheduled banks	184.0	329.9	3.2	103.1	5.7	8.8
of which						
Government borrowing	315.2	325.0	95.7	203.5	20.9	16.0
For budgetary support	250.3	361.4	40.0	230.6	18.3	21.5
SBP	124.4	168.5	-98.4	231.2	12.0	14.5
Scheduled banks	125.9	192.9	138.4	-0.6	38.0	37.3
Commodity operations	66.7	-35.6	55.8	-27.6	52.4	-10.6
Non-government sector	185.3	217.7	-79.1	0.9	6.1	6.8
Credit to private sector	43.4	144.3	-159.89	19.7	1.5	5.0
Credit to PSEs	142.1	72.5	80.7	-20.5	125.0	27.2
Other items net	-159.5	-91.1	-70.2	-88.5	31.5	15.1

23^{rd} Apr FY10. The large impetus to M2 growth in the last week of April 2010 came from a continued increase in government financing requirement for budgetary borrowing [9]and rise in net foreign assets (NFA) of the banking system.[10,11]

It may be noted here that though government recourse to bank financing remained substantially higher during FY10 so far than the increase seen in the corresponding period of last year,[12] the impact of this on M2 growth was partly offset by a contraction in NFA of the banking system.

Figure 4.2: Contribution to M2 Growth (Jan-Apr)

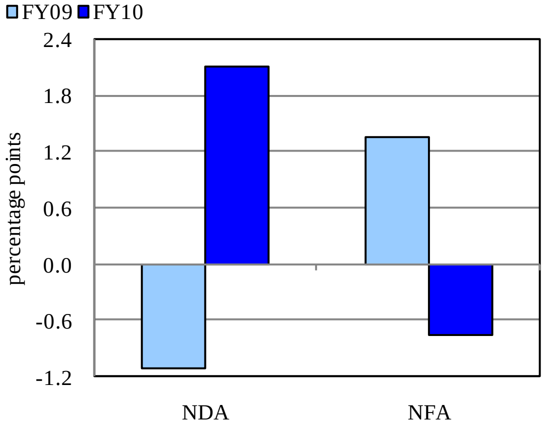
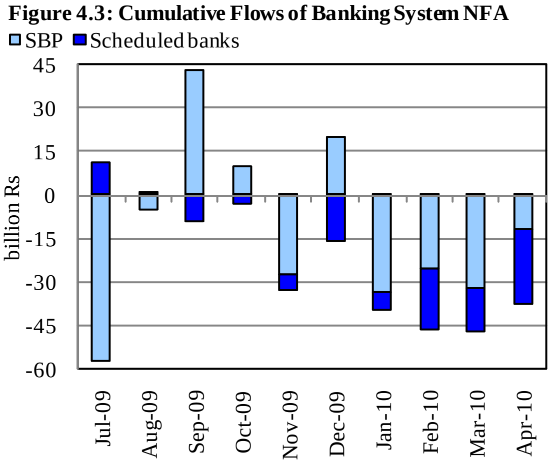


Figure 4.3: Cumulative Flows of Banking System NFA



Net Foreign Assets (NFA)

The contraction in the stock of NFA of the banking system which began in October 2009 continued in Jan-Apr FY10 as well; as pressures on external account persisted largely on account of lower than anticipated external inflows (see **Figure 4.3**). Putting this in perspective, had these expected external inflows realized, NFA of the banking system would have witnessed a net inflow during the period of analysis. Similar to Q2-FY10, the depletion in NFA of the banking system during Jan-Apr FY10 was mainly evident in the SBP NFA due to the retirement of official loans;

[9] During the last week of April 2010 government borrowed Rs 75.0 billion from the banking system compared to Rs 155.6 billion during Jan-23rd Apr FY10.

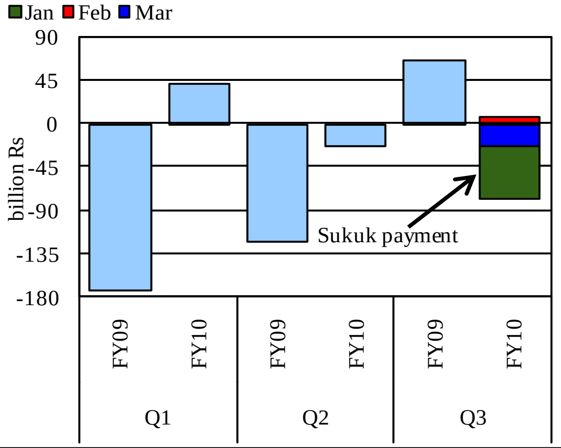
[10] Consequently, growth in M2 during Jan-Apr FY10 is mainly driven by NDA, which is in contrast to Jan-Apr FY09, when NFA was mainly responsible for M2 growth (see **Figure 4.2**).

[11] During the last week of Apr FY10, NFA of the banking system rose sharply mainly on account of inflows of logistic support funds of US$188 million.

[12] In particular, government borrowing from SBP exceeded its quarterly ceiling by end Mar 2010. The outstanding stock of government borrowing from SBP on cash basis reached Rs 1,193.7 billion by end March 2010, Rs 63.7 billion higher than the quarterly target ceiling.

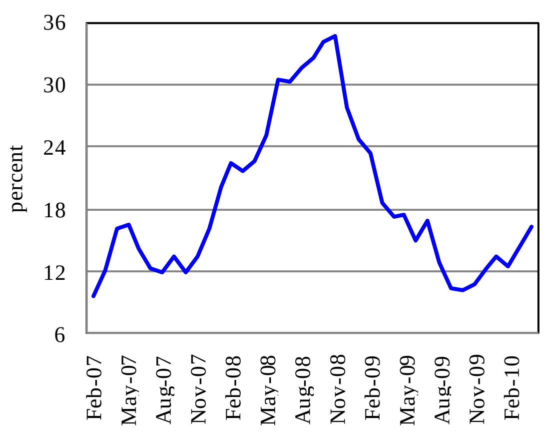
particularly the Sukuk bond payment in the month of January 2010 (see **Figure 4.4**).[13] These payment pressures on SBP NFA were compounded by (a) SBP net forex interventions in the interbank market January 2010 onwards, and (b) non-materialization of IMF third tranche of US$ 338 million in March 2010. The impact of these factors overshadowed the inflows of official grants and coalition support funds.[14]

Figure 4.4: Quarterly Trends in NFA of SBP



NFA of the scheduled banks witnessed a depletion of Rs 25.3 billion during Jul-Apr FY10 compared to a net expansion of Rs 20 billion in the corresponding period last year. Substantial retirement of foreign currency loans by the traders last year, mainly explained the net expansion in NFA of the scheduled banks. However, these retirements remained significantly lower during Jul-Apr FY10. This coupled with high payments of oil imports, a fall in foreign investments and lower inflows under net foreign private loans exerted considerable pressure on NFA of the scheduled banks during the period under review.

Figure 4.5: YoY Growth in NDA of the Banking System



Net Domestic Assets (NDA)

After hitting a 32- month low YoY growth in end-October 2009 (10.2 percent), the YoY growth in NDA accelerated in the following months (see **Figure 4.5**). Resultantly, NDA of the banking system grew by 9.8 percent in Jul-Apr FY10; slightly higher than the growth (8.5 percent) recorded in the

[13] Besides Sukuk bonds, other official payments include IDB and World Bank.
[14] The country received US$ 184.9 million official grants and US$ 537.4 million as logistic support during Jan-Apr FY10.

same period last year. Two developments make the Jul-Apr FY10 NDA growth particularly significant: persistently high governement borrowing from the banking system, and lower than expected retirement under commodity finance.

Government Borrowing for Budgetary Support

The government's borrowing from the banking system during Jul-Apr FY10 rose by Rs 361.4 billion compared to Rs 250.3 billion in the corresponding period last year. Half of this cumulative increase in government borrowing during Jul-Apr FY10 was visible January 2010 onwards.[15] A considerably high reliance on the banking system by the government for budgetary borrowing during Jan-Apr FY10 was caused mainly by (a) a continued increase in fiscal spending; (b) lower than anticipated external flows; and (c) low inflows in NSS during Q3-FY10 compared with the same period last year.

Within the banking system, the central bank provided the bulk of budgetary finance during Jan-Apr FY10. It may,however, be noted that this incremental budgetary borrowing from the SBP does not include the government's funding requirements related with maturing T-bills that were rolled over by commercial banks. The government borrowed above its auction target (net of maturity) in Q3-FY10 (see **Table 4.3**), and exceeded the quaterly limits for deficit monetization agreed with IMF by end-March 2010. Interestingly, the later was despite the transfer of non-tax reciepts in the month of March 2010. This suggests that the available room for the government's borrowing from SBP in the final quarter of FY10 would be lower given the end-June 2010 target. In addition, uncertainty attached with the realization of committed external flows and funds mobilized through non-bank sources suggests high recourse to the scheduled banks in months ahead.

Table 4.3: T-bills Auction Analysis during FY10

billion Rupees

	Jul-Apr	Q1	Q2	Jan-Apr
Net targets	248.3	144.2	70.1	34.0
Net offer	1,667.4	596.7	438.0	632.7
Net acceptance	376.4	188.7	86.6	101.1
Auction maturities	796.7	180.8	74.9	541.0

Commodity Finance

The outstanding stock of commodity finance declined by Rs 35.6 billion during Jul-Apr FY10, compared with net increase of Rs 66.7 billion in the same period last year. Most of this retirement was recorded in wheat finance and is visible in Jan-Apr FY10. In particular, the stock of wheat loans declined by Rs16.3 billion

[15] During Jan-Apr FY10, government borrowing increased by Rs 203.5 billion – substnatially higher when comapred with a rise of Rs 95.7 billion in the same period last year.

during Jan-Apr FY10 to reach Rs 220.3 billion by end April 2010; still higher than Rs 149.9 billion in April 2009.

With less than the expected retirement under wheat finance by the government agencies, additional bank finance for the procurement of the 2010 wheat crop will exert pressures on banks' liquidity. In this enviroment, it appears that financing rates for commodity operations may go up considerably as banks are pricing liquidity and maturity risks associated with commodity operations.[16] Further, given the limited funding resources available to the government, the pricing power of banks appears to have increased in recent months.

Public Sector Enterprises (PSE)

The cumulative growth in PSE borrowing was 27.2 percent in Jul-Apr FY10 compared with a robust growth of 125.0 percent in the same period last year. Retirements by a few POL related PSEs, and low credit disbursement to a public sector steel mill in Jan-Apr FY10 has limited the net expansion of PSEs borrowing during FY10 so far.[17]

This public sector steel mill is unable to open LCs for raw material imports despite strong demand as banks are reluctant to disburse incremental loans on account of huge net losses of the entity.

Despite the lingering issue of circular debt in the energy sector, a few POL related PSEs showed retirement during Jan-Apr FY10 on account of their receipts from the suppliers in the month of March 2010.

4.3 Private Sector Credit

Credit to the private sector expanded in Q3-FY10 by Rs 22.6 billion compared with a sharp contraction of Rs 127.1 billion in the same period last year (see **Figure 4.6**).

Table 4.4: Flows in Advances to Private Sector

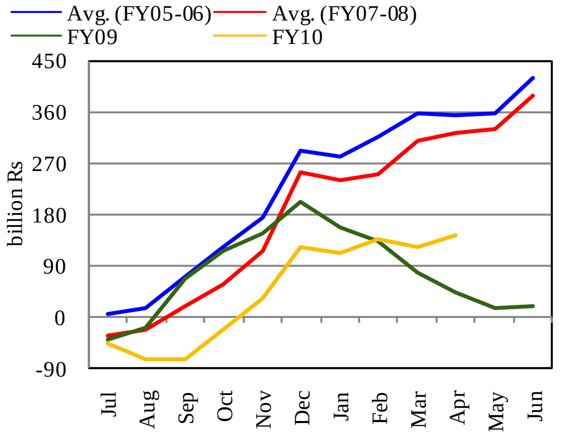
billion Rupees

	Jul-Dec		Jan-Mar	
	FY09	**FY10**	**FY09**	**FY10**
Credit to private sector	203.1	124.6	-127.1	22.6
Business sector advances	194.1	124.7	-93.6	23.0
Working capital	74.0	58.6	-109.3	2.8
Fixed investment	122.0	46.0	15.1	21.6
Trade financing	-1.3	19.6	0.5	-0.8

[16] For instance, banks are charging around KIBOR plus 2.5 to 2.75 percent on commodity operation loans at present, which is considerably high when compared with KIBOR plus 2.0 in June 2009.

[17] High PSE borrowing in Q3-FY09 was on account of issuance of PPTFCs by a public sector entity to settle part of circular debt claims.

Figure 4.6: Cumulative Flows in Private Sector Credit



The deceleration in credit was largely explained by exceptionally low demand for working capital loans during the period under review (see **Table 4.4**). The decline was broad-based, as a large number of industries witnessed retirement; except a few industries (see **Table 4.5**). For instance, the seasonal credit demand in sugar sector was Rs 47 billion in Q3-FY10- exceptionally high- compared with an average increase of Rs 18.7 billion during the last four years. Interestingly, this increase in credit demand was despite the decline seen in the sugar production. This apparent anomaly is explained by high sugarcane prices in response to supply shortages as a result of a poor 2010 crop.

In contrast, demand for fixed investment loans witnessed a rise in Q3-FY10, largely visible in a few sectors such as power, telecoms, and textile. Borrowing by few corporates in the telecommunications sector was largely to finance import LCs. Further, a rise in textile machinery imports as a result of incentives announced by the government and the SBP[18] partly explain credit demand for long-term loans under the long term financing facility (LTFF) during the period of analysis.

Since most industries are still operating under capacity, demand for additional financing for capital expenditure is likely to remain limited in the months ahead.

[18] In September 2009, import duty on textile machinery was completely eliminated, compared to 5 percent previously. Further, SBP has extended the refinancing of second hand machinery under the LTFF scheme up-to June 30, 2010. For detail, see SMEFD Circular Letter No. 3 of 2010.

Further, it is worth mentioning that renewed interest by banks' towards consumer financing – primarily auto finance - was observed January 2010 onwards. Recovery in this segment reflects a strong performance of the automobile industry coupled with significantly increased efforts by banks. Anecdotal evidence suggests that banks campaigns –e.g. partnerships with automakers to facilitate the financing procedure for clients and offering specific car brands on reduced mark ups – supported credit off-take observed during the period under review.

Table 4.5: Break-up of Working Capital Loans (Jan-Mar)
billion Rupees

	FY09	FY10
Working capital loans	-109.3	2.8
Excluding advances to sugar sector	-131.0	-44.2
A. Agriculture	-0.9	-1.6
B. Manufacturing	-51.7	16.8
a. Food products and beverages	10.7	43.4
Rice processing	-4.0	-2.1
Edible oil and ghee	-3.6	0.0
Sugar	21.6	47.0
b. Textiles	-30.8	-16.1
Spinning of fibers	-17.6	-12.9
c. Coke, refined petroleum products	-1.4	2.2
d. Chemicals	-13.1	-6.9
Fertilizers and nitrogen compounds	-6.2	-3.7
e. Non-metallic mineral products	-4.4	0.5
Cement	-2.7	0.0
C. Electricity, gas and water supply	-26.8	2.0
Production, transmission, distribution of power	-25.7	2.2
D. Construction	-2.0	-1.4
E. Commerce and trade	-9.5	-9.8
F. Transport, storage, and communications	-5.4	2.0
Telecommunications	-5.4	1.6
G. Real estate, renting, and business activities	-7.5	-1.5
Other business activities	-7.1	-0.3

4.4 Deposit Mobilization[19]

The gradual pickup in the deposit base which began in September 2009 continued in the subsequent months. Resultantly, deposits of the banking industry recorded robust growth of 8.6 percent during Jul-Apr FY10, in stark contrast to a contraction of 0.2 percent in the corresponding period of FY09.[20] While monetary expansion supported deposit growth in Q2-FY10, growth during Q3-FY10- despite a contraction in M2- largely reflects the absorption of currency in circulation into the banking system. [21]

The acceleration in deposit growth during Jul-Apr FY10 is particularly significant because of:

[19] The analysis is based on total deposits of the banking industry, including government deposits.
[20] It may be noted that average growth for the Jul-Apr period for FY07-08 stood at 7.7 percent.
[21] The currency-to-deposit ratio declined to 31.3 percent by end-April 2010, from 34.1 percent in November 2009. However, it remained higher than the average of 29.8 percent for Apr FY08-09.

(1) A phenomenal rise in government deposits, and
(2) Shift in the maturity profile of large privatized banks' incremental deposits towards lower cost funding.

Sectoral analysis suggests that although deposit growth during Jul-Apr FY10 was visible in all sectors, almost half of this increase is explained by a strong rise in government and public sector deposits (see **Table 4.6**).

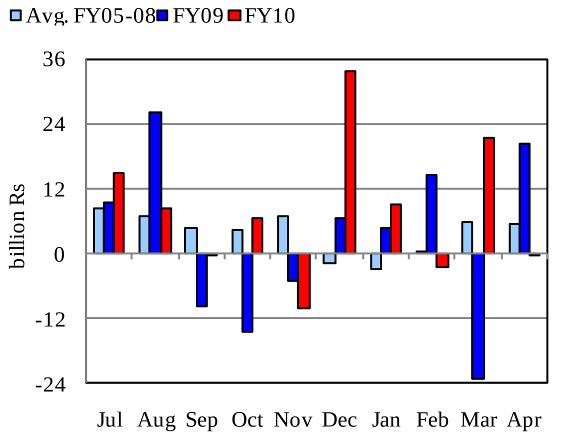
Table 4.6: Selected Sector-wise Deposit Flows (Jul-Apr)
billion Rupees

	Avg.FY06-08	FY09	FY10
Government	36.8	29.0	80.3
PSEs	22.7	-16.1	59.5
Private sector business	28.0	9.9	59.9
of which			
Textiles	-2.2	-2.9	0.2
Electricity, gas & water	-3.0	-0.5	23.3
Motor vehicles	-3.4	-3.9	5.9
Construction	-4.6	-2.7	3.9

Government deposits witnessed a sharp increase during Jul-Apr FY10 which was unusually high compared to the same period last year, as well as the average for Jul-Apr FY05-08.

This seems quite surprising given the substantially high government borrowings from bank and non-bank sources. Further analysis shows that while government deposits recorded a rise throughout FY10 so far-except withdrawals in a few months-the steep increase was largely concentrated in the month of December 2009 and March 2010 (see **Figure 4.7**).[22]

Figure 4.7: Monthly Flow of Government Deposits



Though both federal and provincial government organizations contributed in deposit growth, the major increase in deposits came from three federal government agencies.[23] Government

[22] The incremental government deposits in these two months were substantially higher when compared with the average increase in the same months in preceding years. However, considerable government deposit inflows were received in April 2010 in contrast to marginal withdrawals during April 2009.
[23] These agencies contributed over half of total government deposit inflows during Jul-Apr FY10.

deposits were not only concentrated in a few agencies, but also in a few banks. Specifically, more than half of incremental government deposits in Jul-Apr FY10 were recorded in three public sector banks.[24]

Table 4.7: Maturity-wise Contribution to Deposit Growth (Jul-Apr)
percentage points

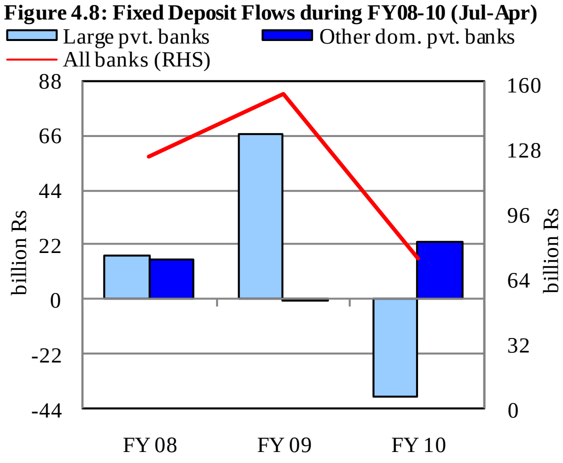
	Avg.FY07-08	FY09	FY10
Fixed	5.3	4.1	1.8
Savings	1.3	-0.9	4.1
Current	1.1	-3.3	2.7
Total growth (percent)	**7.7**	**-0.2**	**8.6**

* includes all current and other categories

Similar to government deposits, public sector enterprises (PSEs) recorded buoyant deposit inflows during the current fiscal year compared to net withdrawals during Jul-Apr FY09. Interestingly, PSE deposit inflows were also visible mainly in the months of December 2009 – led by a few power sector entities – and April 2010.[25]

In terms of *maturity profile*, incremental deposits of the banking system shifted sharply towards shorter tenors during Jul-Apr FY10 compared to previous years[26]. In particular, inflows under the fixed category slowed; as banks mobilized nearly half of their deposits under the savings category (see **Table 4.7**).

Figure 4.8: Fixed Deposit Flows during FY08-10 (Jul-Apr)



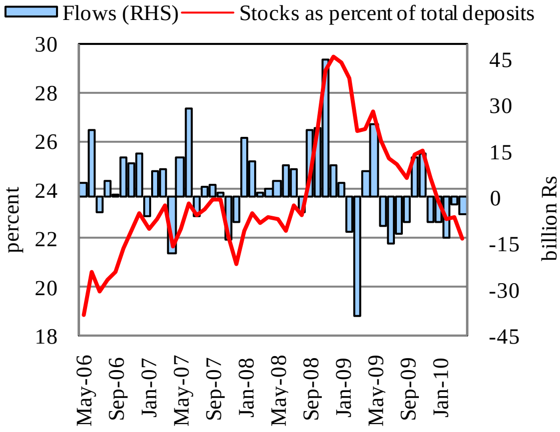
The lower contribution of fixed deposits[27] in total deposit growth during Jul-Apr FY10 mainly reflects considerable

[24] It may be noted that one large public sector bank alone accounted for over half of the total increase in government deposits over Jul-Apr FY10 period.
[25] PSE deposit inflows of Rs 30.1 billion were registered in Dec 2009, with one enterprise accounting for one-third of the inflow. Further inflows of Rs 36.7 billion received in April 2010 with one entity contributing almost half of this.
[26] It may be noted that during FY09, large privatized banks provided a significant impetus to fixed deposit growth.
[27] It may be noted that the contribution of fixed deposits to total deposit growth for Jul-Feb FY10 is almost half of that for the Jul-Apr period – this reflects significant government current withdrawals in a large public sector bank, and subsequent placement under the fixed category in March 2010.

fixed deposit withdrawals in the *large privatized banks*[28] during Q1 and Q3. These withdrawals were strong enough to offset the increase seen under the same category in o*ther domestic private banks* [29] (see **Figure 4.8**).

However, fixed deposit withdrawals in large privatized banks, must be seen in the context of the extraordinary surge in the same category due to the rumor driven deposit withdrawal during the period of Sep-Oct 08. Last year, these banks faced considerable withdrawals in shorter tenor deposits, and responded by increasing their fixed deposit base.[30] Therefore, fixed deposit withdrawals during Jul-Apr FY10 possibly reflect a strategic shift by these banks to lower the interest burden associated with longer-tenor time liabilities. Consequently, these withdrawals brought the share of fixed deposits in their total deposit base close to its pre-crisis level by end-April 2010 (see **Figure 4.9**).

Figure 4.9: Large Privatized Banks' Fixed Deposits



Nonetheless, total deposits of large privatized banks increased by Rs 56.5 billion, on account of mobilizing shorter tenor individual and corporate deposits during Jul-Apr FY10; compared with a net withdrawal of Rs 11.5 billion in the same

Table 4.8: Bank Group Deposit Flows (Jul-Apr)

billion Rupees

	FY09	FY10
Public sector	38.7	113.1
Large privatized	-11.5	56.5
Other domestic private	-3.3	99.6
Merged	6.1	30.6
Islamic	28.9	41.0
Foreign	15.0	10.7
All banks*	**-5.9**	**351.6**

*includes specialized banks

[28] Large privatized banks faced fixed deposit withdrawals of Rs 39.3 billion during Jul-Apr FY10. However, it may be noted that in contrast to other large privatized banks, one bank in the group increased its fixed deposit base during this period.
[29] This group comprises domestic private banks that are not in the merged or Islamic category.
[30] To put this in perspective, Rs 66.6 billion was mobilized under the fixed category by these banks during Jul-Apr FY09. This was exceptionally high compared to an average increase of Rs 23.5 billion for Jul-Apr FY 07-08.

period last year (see **Table 4.8**)[31].

On the other hand, *other domestic private banks* witnessed a sharp increase in their fixed and saving deposits during Jul-Apr FY10 compared with the same period last year. These banks attracted longer-tenor deposits by offering competitive returns, as well as a wide range of savings products. Thus, the total deposit base of other domestic private banks increased by Rs 99.6 billion during Jul-Apr FY10 compared with Rs 3.3 billion in the corresponding period last year.

A disaggregated analysis highlights two banks from this group that received almost one-fourth of the banking industry's fixed and saving deposit inflows for Jul-Apr FY10. While one bank received considerable government deposits during this period, the other bank achieved this mainly by mobilizing private individual deposits.

[31] It may be noted that Islamic banks recorded significant deposit growth during Jul-Apr FY10 as well as in the corresponding period in previous years. Anecdotal evidence suggests this significant increase in the deposit base enabled these banks to actively participate in Shariah compliant interbank placements in an environment of liquidity pressures facing the banking industry.