5 Money and Credit

5.1 Overview

Although the year ended on a better note compared to FY00, it was a difficult period in terms of the challenges faced by Pakistan's monetary managers. Structural changes in the exchange rate regime, the need to increase liquid foreign exchange reserves, and hard targets to ensure that government borrowing from SBP was strictly monitored, kept the money and foreign exchange markets edgy throughout the year. The decision to float the Rupee in July 2000 had tremendous implications for SBP's monetary policy. The timing of this decision was part of the policy steps needed to enhance Pakistan's commitment to reform its external sector.

The market initially criticized the abrupt changes in SBP's monetary policy, but the underlying reason for this course of action became obvious with time. With the dismantling of the Rupee/Dollar band that was in place during FY00, coupled with the need to ensure that liquid reserves were able to meet quarterly targets, SBP's monetary policy became the first line of defense to calm the foreign exchange market. The harsh measures that SBP was compelled to take in October 2000, following the sharp depreciation of the Rupee, signaled the successful transition to a new nominal anchor. These measures did prove successful not only to check the slide of the Rupee, but also to shift government borrowing to commercial banks. However, to balance off the negative implications of rising T-bill rates (e.g. higher debt servicing pressures, linking EFS rates to T-bills, and trying to provide some comfort to private sector investors), SBP was concerned about the increase in interest rates.

This concern was partially mitigated, as private sector credit expanded sharply during Q2-FY01 despite the higher interest rate structure; commercial bank credit to the private sector increased from Rs 15.4 billion last year to Rs 54.2 billion in FY01. Although this growth in credit is encouraging, it is important to realize that banks were meeting this peak credit demand during a quarter of unprecedented liquidity shortage. If this had not been the case, it is plausible that growth in private sector credit could have been much higher.

In aggregate terms, the growth in money supply was lower this year as compared to FY00. What is encouraging is the fact that the growth of currency in circulation started to taper in the second half of the year, but the growth and changing composition of bank deposits are not as auspicious. Although the year ended well (but not necessarily for the right reasons – Rupee deposits increased by Rs 55.0 billion in the last two months of the year), banks' inability or unwillingness to mobilize Rupee deposits continues to undermine the deepening of the banking system. The *real* stagnation of Rupee generating deposits and the growing spread between lending and deposit rates, still needs to be addressed on an urgent basis. It is hoped that the strategy to reform the banking system will help tackle these problems.

5.2 Credit Plan

The Credit Plan for FY01 was revised and brought in line with the thrust of the SBA; as expected, the main changes focused on government borrowing for budgetary support and net foreign assets (NFA – see **Table 5.1**). However, the aggregate change in monetary growth was nominal; M2 growth was only brought down by Rs 2.7 billion in the revised Credit Plan.

As mentioned before, developments this year were more encouraging as compared to FY00, when government borrowing from the banking system increased by Rs 40.0 billion instead of a planned contraction of Rs 14.5 billion. During FY01, the resumption of external finance (Rs 128.8 billion during the year) coupled with stronger non-bank borrowing following the successful launch of the

Pakistan Investment Bond (PIB), allowed the government to retire Rs 33.0 billion to the banking system, which exceeded the targeted amount (see **Table 5.1**).

The central bank's NFA also showed a marked improvement, and in doing so exceeded the targeted level. This was primarily because of the availability of external financing from the IFIs, long-term foreign exchange swaps conducted with banks and concerted efforts to step up kerb purchases. In aggregate terms, money supply increased by Rs 125.4 billion during FY01, which was Rs 18.9 billion less than the revised Credit Plan target for the year.

Table 5.1: Credit Plan and Actual Outcome FY01

billion Rupees

		Credit plan FY01		Actual outcome	
		Original	Revised	FY01 [1]	FY00
A.	**Government sector borrowing (net)**	**-2.2**	**-14.5**	**-46.9**	**78.0**
	Gross budgetary borrowing	*29.8*	*40.4*	*1.6*	*104.2*
	Special account-debt repayment	*-32.0*	*-54.9*	*-34.5*	*-64.3*
1.	Net budgetary borrowing	-2.2	-14.5	-33.0	40.0
	From SBP		-1.8	-31.6	135.0
	From scheduled banks		-12.7	-1.4	-95.0
2.	Commodity operations			-12.5	40.1
3.	Net effect of zakat fund/privatization proceeds			-1.9	-1.8
4.	Others (credit to NHA & CAA)			0.5	-0.2
B.	**Non-government sector borrowing**	**89.2**	**105.0**	**68.7**	**26.2**
1.	Autonomous bodies[1]	4.0	11.5	7.4	3.1
2.	Net credit to private sector and PSCEs	85.2	93.5	61.3	23.1
	Commercial banks			70.6	25.1
	PSCEs other than B(1)		12.0	16.5	9.7
	Private sector			54.2	15.4
	of which export refinance			*0.8*	*-8.4*
	Specialized banks			1.7	2.9
	Other financial institutions			-7.7	0.4
	PSCEs special account-debt repayment with SBP	-14.6	-10.5	-3.3	-5.2
C.	**Other items (net)**	**0.0**	**-2.0**	**30.9**	**14.4**
D.	**Net domestic assets of the banking system**	**87.0**	**88.6**	**52.7**	**118.7**
		(6.0%)	(6.1%)	(3.6%)	(8.9%)
E.	**Net foreign assets of the banking system**	**60.0**	**55.6**	**72.7**	**1.4**
F.	**Monetary assets (M2)**	**147.0**	**144.3**	**125.4**	**120.1**
		(10.5%)	(10.3%)	(8.9%)	(9.4%)

[P] Provisional

[1] WAPDA, OGDC, PTC, SSGC, SNGPL, KESC & PR

Source: SBP

5.3 Government Borrowing

Gross budgetary borrowing in FY01 was only Rs 1.6 billion as compared to Rs 104.2 billion in FY00, while net borrowing this year was negative Rs 33.0 billions (see **Figure 5.4**). What is far more insightful is to look at the breakdown of government borrowing from banks and the central bank. [1]

Despite end-year differences, FY01 started on a similar note on which FY00 had ended. Although the fiscal deficit this year was smaller than in FY00, sources for financing this deficit were initially scarce, as external financing had all but dried up since the last IMF program was effectively

[1] The quantum and composition of government borrowing from the banking system (both SBP and commercial banks) during the year, were monitored as part of the stabilization program.

Figure 5.1: Net Domestic Assets

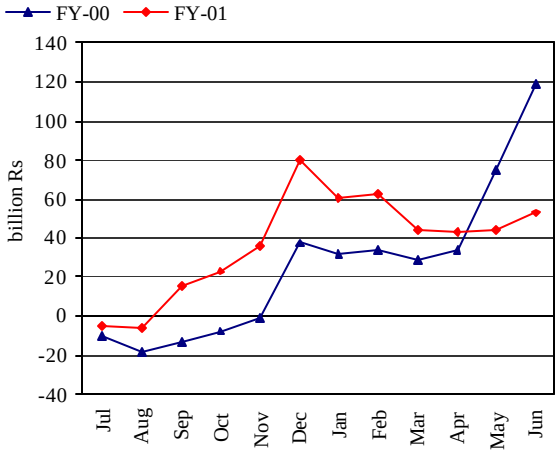


Figure 5.2: Monetary Assets

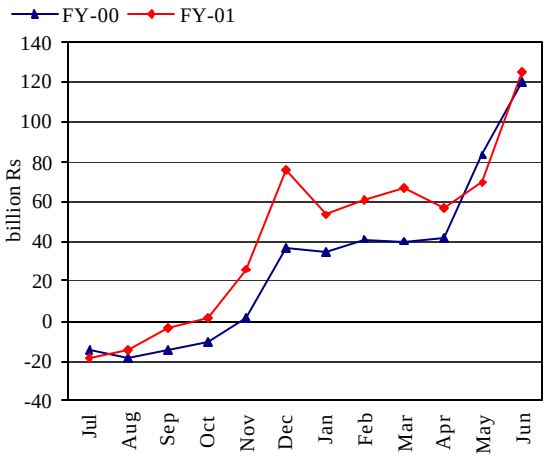


Figure 5.3: Govt. Borrowings for Commodity Operations

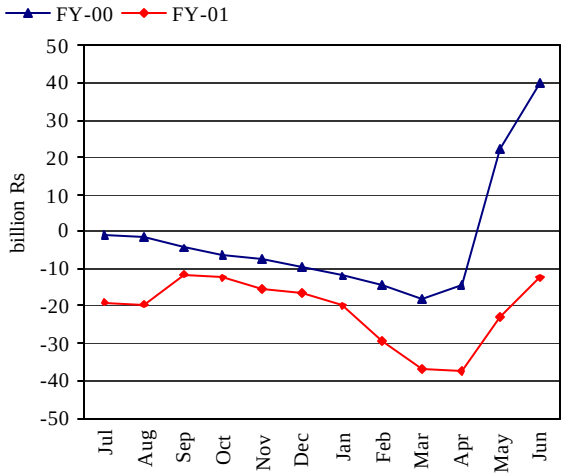


Figure 5.4: Budgetary Borrowing

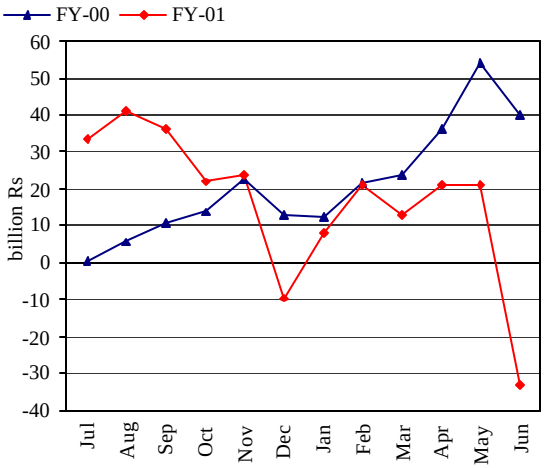


Figure 5.5: Borrowings By Autonomous Bodies

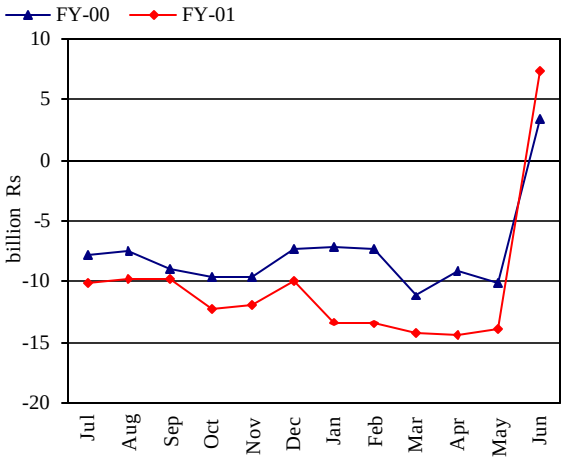
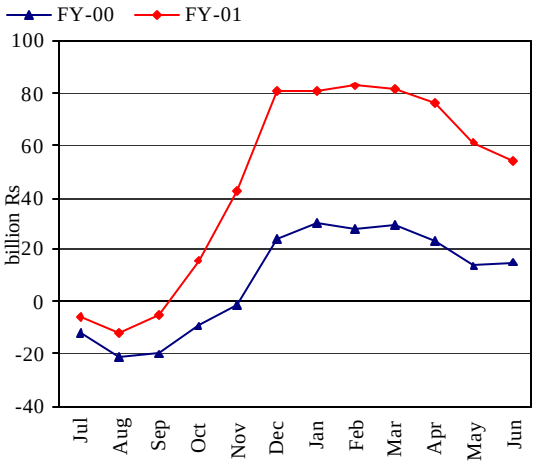


Figure 5.6: Credit to Private Sector

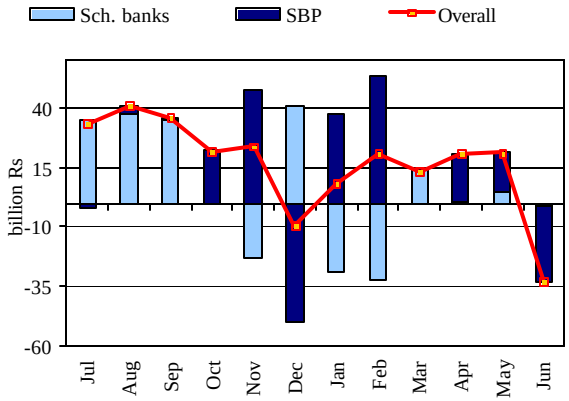


suspended in March/April 1999. Furthermore, the quantum of external finance that was flowing in on account of the conversion of frozen FCAs into Special US Dollar bonds in FY99 (and to some extent in FY00) was not forthcoming this year.

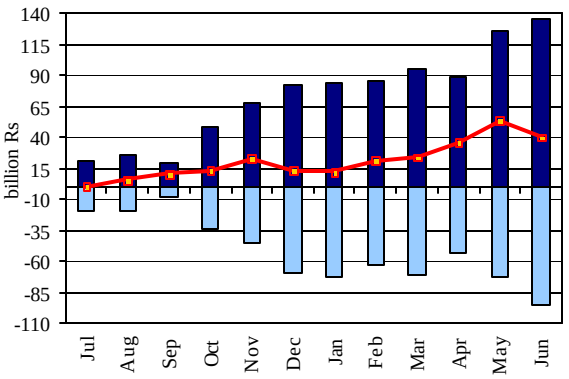
In terms of internal sources, the decision to ban institutional investment in the National Savings Scheme (NSS) in March 2000, coupled with the series of cuts in returns that preceded this decision, could not allow the government to rely as much on non-bank sources to finance the fiscal deficit. Furthermore, since fresh issues of the Federal Investment Bonds (FIBs) had stopped in June 23, 1998, there was no long-term government bond in the market. Hence, one of the largest sources of long-term savings in Pakistan (institutional investors like insurance companies, mutual funds and pension funds) was not available to the government at the beginning of FY01.[2] In effect, with limited availability of external and non-bank financing at the beginning of the year, the original Credit Plan target that GOP would actually *retire* its debt to the banking system by Rs 2.2 billion was clearly misplaced.

This became obvious in the early part of FY01; with few avenues to finance the government's on-going expenditures, GOP had no option but to turn to the banking system. As shown in **Figure 5.7**, in just the first quarter of FY01, the government had already borrowed Rs 36.0 billion compared to Rs 10.9 billion in the first quarter of FY00. However, unlike FY00, the authorities were careful to ensure that the bulk of this burden fell on commercial banks, since the central bank could not afford to add to the tremendous burden created by the Rs 135 billion borrowed from SBP during FY00 alone.

Figure 5.7: Borrowing for Budgetary Support (FY01)



Borrowing for Budgetary Support (FY00)



With the additional responsibility imposed on monetary policy to defend the Rupee/Dollar parity under a free-floating exchange rate regime, there was a very sharp reversal in the composition of government borrowing between SBP and commercial banks in October (see **Figure 5.7**). This is because of the huge volume of discounting needed to comply with SBP's decision to increase cash reserve requirements by 2 percent on October 7, 2000. This move may have caught the market by surprise, but this tightening of monetary policy followed two discrete increases in the discount rate (from 12 to13 and then to 14 percent, on September 19 and October 5, respectively) and a 2.8 percentage increase in 12-month T-bill rates during the period September 7 to October 5. A cursory glance at **Figure 9.15** will provide the rationale for this abrupt change in monetary policy. It will also be observed that the slide in the

[2] Although the PIB was launched in December 2000, at the beginning of FY01, it was not clear when the long-term bond would be floated.

Rupee was successfully interrupted when the discount rate was twice increased; this signaling devise was also used to good effect in June 2001.

By October, the picture of government borrowing began to change. By end-November/early-December, despite the sharp tightening of monetary policy, government borrowings had all but shifted to SBP's portfolio (see **Figure 5.7**).[3] For the central bank, these were very difficult times; the SBA was in place and the IMF's Performance Criteria to reduce the volume of SBP's net domestic assets (NDA) by end-December, basically meant the central bank had to shift a large volume of government debt to commercial banks by year end. In this regard, the second quarter of FY01 was perhaps the most hectic and challenging period for Pakistan's monetary managers: (1) the quarter started with an unprecedented shortage of liquidity in the banking system, (2) this was a period of peak demand for private sector credit, and (3) the end-December NDA target required a shift of almost Rs 90 billion of government debt to commercial banks in a little over two weeks.

The turnaround in the government's borrowing profile witnessed in end-December 2000, was also repeated in end-March and end-June 2001 (see **Figure 5.7**). However, the latter two end-quarter targets were comfortably met without having to resort to exceptional steps as had been the case in end-December. Part of the reason was the availability of external financing, while the liquidity shortage in the banking system eased as seasonal demand for private sector credit fell in the second half of the year. Furthermore, the successful launch of the Pakistan Investment Bonds (PIBs) in December alleviated the pressure on the banking system.

To summarize, the pattern of government borrowing from the banking system in FY00 and FY01, suggests a clear trend; the government has a tendency to retire its debt to commercial banks while increasing its reliance on the State Bank of Pakistan. This could be because banks have not been able to grow their Rupee deposits since the nuclear tests, or the fact that the government's debt management system needs to be improved. Also, the abrupt changes (tightening) of monetary policy during FY01 may have discouraged banks from investing in fresh government paper.

5.3.1 Commodity Operations

FY00 witnessed a bumper wheat crop, which resulted in record financing from commercial banks for this purpose. It should be noted that the bulk of commodity financing is for the procurement of wheat (around 60.0 percent of the total credit), followed by rice (23.0 percent), edible oil seeds (11.1 percent) and sugar (3.5 percent).[4] However, given the stagnant (and in some cases decreasing) financing to crops other than wheat, commodity financing is dominated by the size of the wheat crop and its seasonality.

Although drought conditions reduced the size of wheat crop by 9.9 percent during FY01, the amount procured was about half what had been bought last year. Hence, commodity operation resulted in net retirement of Rs 12.5 billion exceeding the projected zero impact on monetary growth this year.

5.4 Credit to Private Sector

In sharp contrast to FY00, credit disbursed to the private sector posted robust growth; against a net increase of only Rs 15.4 billion during FY00, this year the private sector increased its net borrowing by Rs 54.2 billion. The primary reasons for this rebound can be traced to certain developments last

[3] Theoretically speaking, if the central bank were to tighten monetary policy in an environment where the government is dependent on the banking system, it should result in a shift in the government's debt from the central bank to commercial banks. However, with the acute liquidity shortage in the banking system, the sheer volume of discounting in the month of October clearly overshadowed this effect, with the result that banks had to repo a large volume of government securities with SBP, with the result that government debt actually shifted from commercial banks to the central bank.

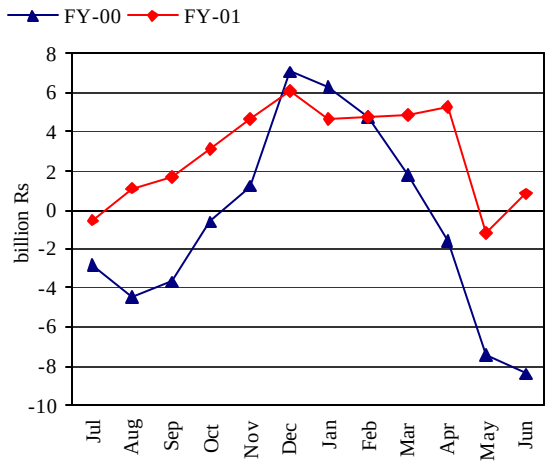
[4] These figures are based on monthly averages for commodity financing during FY00 and FY01.

year that kept borrowers away; there was a great deal of self financing of cotton as prices were quite low and profit margins were very high. Furthermore, with the change in government in October 1999, the strong emphasis on accountability with a specific focus on loan recovery and the documentation drive, created an atmosphere of uncertainty during most of FY00.

If we compare this scenario with FY01, the situation has changed and is beginning to reverse itself. Domestic prices of cotton lint were 35 percent higher than the previous year, which fueled demand for credit by the ginning industry. The accountability drive is still on, but the tempo faltered with the first tax amnesty scheme, which ended in June 2000 (see **Chapter 4**). Furthermore, with the government's revival strategy announced in December 1999 and successful negotiations with the IMF in November, sentiments in the private sector did improve somewhat. Although the incentives provided to certain non-traditional sectors like IT and small & medium size enterprises, did not solicit the degree of activity the government was hoping for, there was selective growth in credit demand by Pakistan's traditional industries like textiles and sugar (see **Figure 5.6).**

Gross disbursements under the export finance scheme (EFS) were lower in FY01 as compared to the year before. Stricter eligibility criteria and maturing loans (which were disbursed in FY99) resulted in net contraction at the end of FY00. Despite these issues, credit disbursed under EFS shows net expansion of Rs 0.8 billion in FY01. There are two interesting observations in this regard: one pertains to the fact that banks tend to retain the amount of refinance obtained from SBP (as deposits in their books) even after the loan is retired by exporters (see **Box 5.1**). In this regard, SBP took sharp notice and issued an explicit warning to banks to return these amounts to SBP within three days of receipt.[5] In the following week, Rs 3.2 billion was returned to SBP, and by the month's end, banks had returned Rs 6.4 billion (see **Figure 5.8**). The second observation refers to the surge in export finance in the month of June 2001. Since EFS rates have been revised upwards since early 2000, in an effort to link them to T-bill rates (this linking was formally stated in our understanding with the IMF in the Letter of Intent (LOI), exporters front-loaded their credit demand fearing another increase in EFS rates in the near future.

Figure 5.8: Export Refinance



5.4.1 Sector-wise Distribution of Private Sector Credit

As shown in **Table 5.2**, the pattern of private sector borrowing from commercial banks did not change much in FY01. The dominance of manufacturing, with a focus on working capital loans (especially for the textile sector) was maintained this year. Although lack of disaggregated data does not allow for rigorous analysis, discussions with banks have highlighted the view that the textile sector's fixed investment for balancing, modernization, and replacement (BMR) has fallen during FY01. Nevertheless, with lower profitability in the textile sector this year, a larger share of this financing was availed from banks as opposed to reinvested profits. There is also anecdotal evidence that fixed investment in textiles has shifted away from BMR to the purchase of capital equipment for the garment sector.

[5] This was done via BSD circular letter No. 7, which was issued on April 30, 2001.

The break-up of working capital for manufacturing reveals that textiles accounted for 63.5 percent of the growth in this category. Despite a larger cotton crop during FY00, the textile sector relied more on self-financing due to windfall gains earned through lower cotton prices. Lending during this period in FY01, returned to normal as textile profits shrank and the hesitation of banks withered away. During the course of the year, the months of November and December *alone* witnessed net disbursements Rs 23.4 billion. As shown in **Figure 9.8**, input prices in general, and lint cotton prices in particular, were much higher in FY01, especially during September-December 2000. This factor, coupled with the fact that lower credit was disbursed during FY00 (which meant lower retirement in FY01), explains the larger figure this year.

The sugar sector also utilized more working capital during FY01, on account of higher domestic prices of sugarcane. This price rise was driven by lower production of sugarcane, which forced sugar mills to import raw sugar, which itself added to the demand for credit. During February and March 2001, this sector borrowed over Rs 3.9 billion. The demand for credit by the automobile sector was derived by higher demand for motorcycles (resulting from increased purchasing power in rural areas)

Box 5.1: Export Finance Scheme (EFS)

Export Finance Scheme (EFS) was introduced in 1973 to provide concessionary export finance for the promotion of non-traditional and newly emerging commodities. Subsequently the scope of the scheme was widened and all manufactured goods were included. However, there is a negative list comprising of items not eligible under EFS. This list is revised from time to time and consists of items such as raw cotton, wool, hides and skins etc. The scheme further witnessed a major operational change in October 1977 when it was divided in two parts. Namely; Part-I and Part-II. An exporter is eligible under both parts of the scheme as long as the facility availed under Part-I is not duplication of facility availed in Part-II. Further both the facilities are available for direct as well as indirect exporters.

Under Part-I of the scheme, the commercial banks provide concessional finance both on pre-shipment and / or post-shipment basis against firm export order/ irrevocable letter of credit. The exporters are under obligation to produce relevant shipping documents within the prescribed period, failing which fine is levied as prescribed under the scheme for non-shipment. However, an exporter can substitute old contract or letter with a new one and export same or other eligible goods.

Under Part-II of the scheme an exporter can avail finance up to 50 percent of the value of exports made by him in the preceding financial year. The limit is available to the exporter on revolving basis like a cash credit account wherein outstanding amount at any time should not exceed the exporter's entitlement. For the purpose of monitoring the export performance, an exporter is required to realize export proceeds from eligible commodities (excluding those earned through Part-I) equal to twice the amount of his daily average borrowing during the mentioned period.

Recent Changes in the Export Finance Scheme

As part of the conditionality of the Trade Export Industry Program Loan (TEIPL) provided by Asian Development Bank in 1998, EFS has witnessed considerable modifications and improvements in its working. These include; i) more stress on availability of financing facilities under the scheme to small medium and emerging enterprises (SMEs) and indirect exporters, ii) Provision of financing facility for 180 days, across the board as against two tier system of 150 days and 180 days, iii) Introduction of foreign currency export finance facility (FCEF). It's a dollar denominated window for providing financing facility to exporters for import of foreign inputs required for execution of export orders, iv) setting up of Pakistan Pre-shipment Export Finance Guarantee Agency (PEFGA) with the view to resolve the collateral problems of SME exporters in particular, v) reduction in reliance on interest subsidy.

Further in order to resolve the problems of the exporters relating to the export finance scheme, an Export Cell has been created in the SBP, besides appointment of a Complaint Officer. State Bank has also established the Credit Advisory Committees (CAC) at its local Offices. These CAC play pivotal role in resolving various issues in consultation with representatives of banks and exporters.

At present banks are getting refinances from SBP as per limits fixed by the SBP in their favor for the FY01. Rate of export finance charged by commercial banks is 13 percent as of July 1, 2001 while SBP refinance rate is 11.5 percent.

and the urban outreach by banks and leasing companies in terms of the availability of consumer financing (see **Chapter 2**).

Lower input prices of furnace oil and the switching over to gas of certain cement factories, has revived sentiments in the cement sector. Profitability during the year was also higher on account of higher domestic retail prices, as the cement cartel once more came into existence. As a result, credit demand by this sector was lower in FY01 as compared to FY00.

Other manufacturers, which include edible oil, beverages, leather, chemicals, etc., have shown growth in the last two years. However, owing to higher profits in FY01 and a larger volume of disbursements last year, net credit off-take by these sectors has been lower in FY01 relative to the year before. With a large weight attached to chemicals, the relative slowdown in the textile sector this year also impact this head since many of the largest items in chemicals are used as inputs by the textile sector. This largely explains the lower off-take of working capital by this sector.

Table 5.2: Scheduled Banks Credit to Private Sector (selected)

billion Rupees

	Flows during	
	FY01	**FY00**
A. Advances & bills	**61.6**	**29.9**
1. Export financing	4.3	-4.7
a. Export finance scheme	-0.9	-4.3
b. Others	5.2	-0.4
2. Government self employment scheme	-1.0	-1.2
a. Unemployed persons	-0.7	0.1
b. Public transport	-0.3	-1.2
3. Small loans	-0.1	2.8
a. Agriculture	2.1	1.5
b. Business	1.0	0.7
c. Industry	-3.2	0.6
Fixed investment	-3.2	0.7
Working capital	0.0	-0.2
4. Agriculture[1]	2.4	4.0
5. Manufacturing	29.7	21.5
a. Locally manufactured machinery	-1.1	-0.8
b. Manufactured-other than LMM and small loans for industry	30.8	22.4
For fixed investment	4.5	3.1
For working capital	26.3	19.3
Automobile manufactures	0.5	-2.4
Cement manufactures	0.2	1.4
Fertilizer manufactures	-0.6	-0.1
Sugar manufactures	4.5	-2.6
Textile manufactures	16.7	12.8
Other manufactures	5.0	10.1
6. Wholesale & retail trade[1]	6.9	2.3
7. Import financing	4.8	-3.8
8. Other activities not described above	14.6	9.0
B. Investment	**5.1**	**2.6**
Total (A+B)	**66.7**	**32.6**

[1] Excluding small loans

5.5 Autonomous Bodies

In terms of net credit disbursed to autonomous state owned enterprises during the year, this almost doubled over the year before. However, from **Figure 5.5**, it is clear that the developments in June 2001 are not representative of what has happened during the course of the year. Furthermore, with the suspension of IFI assistance last year, WAPDA could not avail Rs 5.5 billion that had been earmarked. Accounting for this, lending during FY00 *itself* is not indicative of the actual credit needs of the autonomous bodies.

The main users of credit in FY01 were KESC and WAPDA, which together availed Rs 12.1 billion. This exceeded their combined limit of 7.5 billion for the year, but the excess could be accommodated by scaling back PTCL's borrowing limit in view of its continuous retirement during the year; by year end, PTCL retired 3.5 billion against its targeted expansion of Rs 1 billion. As shown in **Figure 5.5**, as of end-May 2001, autonomous bodies (with the exception of KESC) had retired 14.0 billion. However by end-June, total borrowing was Rs 7.4 billion. Of this Rs 21 billion expansion in the month of June, at least Rs 8.5 billion can be traced to the government's account. The remaining amount is part of the seasonal increase in borrowing at the year-end to secure credit allocations for the next year. After crossing the year, this credit is returned to the banks.

5.6 Specialized Banks

As regards credit disbursed by specialized banks, there is a slight improvement in FY01 over the year before (see **Table 5.1**). However, what is distinct about this year is the increasing role of IDBP and the decrease in the share of ADBP. The decrease in ADBP's share is mainly due to concerted efforts to improve the loan recovery drive, and does not signal a fall in gross lending by this institution. On the contrary, ADBP has been quite proactive in providing funds to small farmers during the year, to alleviate the problems caused by the severe drought (see **Chapter 2**). As discussed earlier, ADBP's loan recoveries were greater than gross disbursements during the course of the year. This was motivated by the need to improve the operational efficiency of ADBP and also to reduce the dependency of such institutions on the central bank for their funding. As part of the reform process in the financial sector, in October 2000, SBP discontinued concessional financing to both ADBP and FBC. The growth posted by IDBP on the other hand, which is the highest in the last five years, is part of the government effort to revive sick industrial units. More specifically, the increase shown in credit disbursed (around Rs 2.4 billion) is primarily on account of the accrual of mark-up on existing loans, which reflects efforts to revive the loans that have financed these industrial units.

Credit disbursed by *other financial institutions* show a contraction of Rs 7.7 billion during FY01. This contraction may seem out of place, since as a norm, these institutions play a very marginal role in overall credit expansion. However, this contraction reflects the closure of certain foreign currency swaps conducted with some NBFIs in 1998, whereby these institutions paid Rupees into SBP to purchase hard currency at year-end FY01.

5.7 Other Items (net)

Other items net ended the year increasing liquidity by Rs 30.9 billion against a targeted contraction of Rs 2 billion. Changes in this head are often concentrated in the last month of the fiscal year, largely on account of the fact that SBP books its profits/losses in this month. Net profits have a contractionary impact, while losses increase domestic liquidity. During the year, SBP's revenues were largely neutralized by several one-off adjustments due to the switch over to a new international accounting standard. The net profit of SBP amounted to Rs 21.3 billion compared to Rs 36.1 billion last year.

5.8 Net Foreign Assets (NFA) of the Banking System

NFA of the banking system refers to the stock of foreign assets (less liabilities) held by both scheduled banks and the central bank. As shown in **Table 5.1**, NFA of the banking system increased by Rs 72.6 billion during the course of the year. This sharp increase compared to the mild rise in FY00, is a clear indication of the successful implementation of the stabilization program. This can be seen in **Figure 5.9**, where the build up in SBP's NFA is sharpest at quarter ends, especially in June 2001. In overall terms, the expansion in NFA was shared almost equally between SBP (Rs 37.7 billion) and scheduled banks (Rs 35.0 billion). As shown, the increase realized during the course of the year exceeded both the original and revised targets contained in the Credit Plan for the year.

The main items on the assets side of SBP's NFA are gold and foreign currency holdings, while the main head on the liability side is IMF funding.[6] While all foreign exchange entering Pakistan through proper channels (except foreign currency accounts via FE-25) ends up in SBP's reserves, not all these inflows are categorized as the central bank's liabilities. Only tranches received from the IMF count as the central bank's liability, and as such, have no impact on SBP's NFA. The sharp increase in NFA during May and June 2001 reflects concerted efforts to increase liquid reserves through kerb

[6] Other assistance from the IFIs, where the GOP realizes the Rupee equivalent, is not considered SBP's forex liability, since the government must provide Rupees to the central bank when the loans are to be repaid.

purchases and foreign exchange swaps conducted in June. This effort was helped by inflows of US$ 445.6 million from the World Bank and the Asian Development Bank.

In terms of commercial banks, the asset component of NFA includes balances held abroad and foreign exchange bills discounted; whereas on the liability side, the main item is non-resident foreign currency accounts (FCAs). Until the freeze, all fresh inflows of FCAs were surrendered to SBP in exchange for a Rupee equivalent. In effect, such inflows increased SBP reserves and the Rupee deposit base of banks. On the liability side, non-resident FCA's were treated as forex liabilities and netted off in the NFA. This very convenient relationship lasted till end-May 1998. The only problem was that over time, the government spent all the hard currency and only had Rupees to pay back. The FCA scheme was consequently revised a number of times, and banks are no longer given the option of depositing their mobilized FCAs to SBP. The slight upward movement in NFA witnessed after December 2000, is on account of the actual payment of non-resident FCAs (FE 45), which reduces commercial banks' foreign liabilities.

Figure 5.9: Net Foreign Assets of SBP

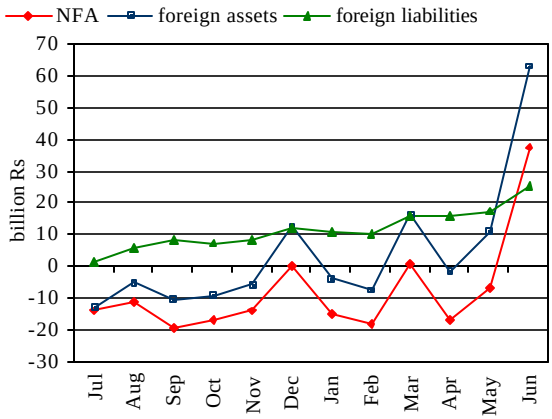
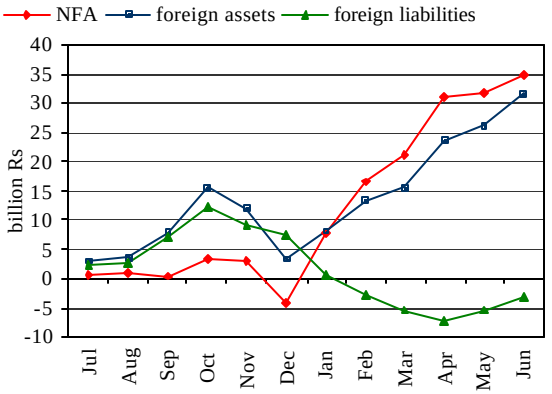


Figure 5.10: Net Foreign Assets of Schedule Banks

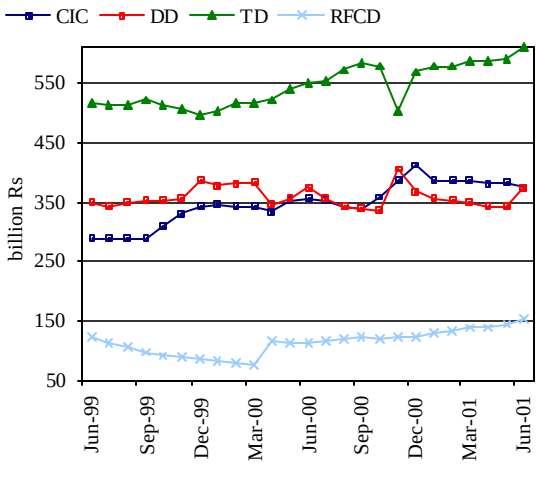


5.9 Components of Monetary Expansion

Although monetary growth was lower during FY01, what is more important is the compositional change compared to last year. Currency in circulation only posted growth of 5.6 percent (against 23.6 percent in FY00), while term deposits in the banking system grew by 11.1 percent (against 6.3 percent in FY00). Also, volatile demand deposits actually fell in nominal terms this year, compared to growth of 7.5 percent during FY00 (see **Table 5.3**).

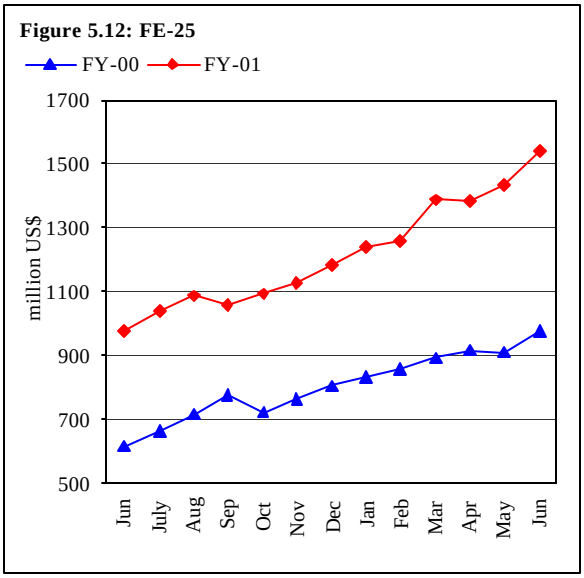
However, a more detailed analysis does not reveal as positive a picture as the end year numbers would suggest. First, the increase in term deposits was effectively realized in the last two months, while deposit rates have remained largely stagnant. Also, most of the increase in the last month was on account of demand deposits (see **Figure 5.11**). Although this is a seasonal increase witnessed at the end of the year (a degree of window dressing by

Figure 5.11: Components of Monetary Assets



banks), the retirement of Dollar swaps (in Rupees) with banks and NBFIs in June, and fresh long-term swaps of US$ 126 million conducted in the month, implies that SBP injected Rupee liquidity of almost 10.8 billion in June 2001 (the remaining Rs 7.9 billion was paid off in the form of T-bills). Second, for the first time since the freeze of FCAs in end-May 1998, the outstanding volume of resident FCAs actually increased. As highlighted in past *Quarterly Reports*, almost all fresh FCAs are now being routed into the FE-25 Scheme, and this mobilization has picked up in the last quarter of FY01 (see **Figure 5.12**). Since these FCAs do not create a Rupee equivalent (even when banks had the opportunity to place the mobilized hard currency with SBP), such mobilization does increase the banks' total deposits, but it does not help them generate Rupee liquidity.

Figure 5.12: FE-25



In terms of currency in circulation, a combination of factors was responsible for the sharp increase in demand for currency notes in the second quarter: (1) the UN sanctions against Afghanistan resulted in some hoarding of Rupee by traders as precautionary demand, (2) fears about the questions asked in the tax survey forms that were distributed widely in the large cities, and (3) the month of Ramzan started in mid-November 2000, which results in a seasonal increase in currency demand. In contrast to FY01, currency in circulation was edging up in the last quarter of FY00, as concerns about the accountability of Rupee deposits were being played out. This did not happen in FY01.

Table 5.3: Components of Monetary Assets

million Rupees

	30-06-1997	30-6-1998	30-06-1999	30-06-2000	30-06-2001
Stocks					
Currency in circulation	244,141	272,922	287,716	355,677	375,442
Demand deposits with banks	192,274	200,997	349, 115	375,397	374,987
Time deposits with banks	386,801	447,433	516,586	549,124	610,138
Other deposits with SBP	7,135	6,412	6,212	7,959	11,292
R.F.C. deposits with banks	222,882	278,556	120,917	112,475	154,154
Total domestic liquidity	**1,053,233**	**1,206,320**	**1,280,546**	**1,400,632**	**1,526,014**
Growth					
Currency in circulation	4.3%	11.8%	5.4%	23.6%	5.6%
Demand deposits with banks	-7.2%	4.5%	73.7%	7.5%	-0.1%
Time deposits with banks	12.2%	15.7%	15.5%	6.3%	11.1%
Other deposits with SBP	5.1%	-10.1%	-3.1%	28.1%	41.9%
R.F.C. deposits with banks	52.7%	25.0%	-56.6%	-7.0%	37.1%
Total domestic liquidity	**12.2%**	**14.5%**	**6.2%**	**9.4%**	**9.0%**
Percentage share in M2					
Currency in circulation	23.2%	22.6%	22.5%	25.4%	24.6%
Demand deposits with banks	18.3%	16.7%	27.3%	26.8%	24.6%
Time deposits with banks	36.7%	37.1%	40.3%	39.2%	40.0%
Other deposits with SBP	0.7%	0.5%	0.5%	0.6%	0.7%
R.F.C. deposits with banks	21.2%	23.1%	9.4%	8.0%	10.1%

To summarize, *Rupee* deposits only increased by 6.2 percent in FY01 (see **Table 5.4**). Accounting for inflation and real growth during the year, it is clear that as a fraction of GDP, Pakistan's Rupee deposit base is shrinking. In contrast, total Rupee deposits (total deposits less the resident component of FE-25) increased by 8.8 percent in FY00. In effect, the problems facing the banking system still remain, and will require a concerted strategy on the part of banks to rectify the gradual dis-intermediation that has been taking place since the freeze of FCAs.

Table 5.4: Impact of FE-25 on M2

billion Rupees

	Rupee Deposits (DD+TD)	Resident FCA (RFCD)	M2	FE-25	Excluding FE-25		Growth in M2	
					(DD+TD)	(RFCD)	Incl. FE-25	Excl. FE-25
30-06-99	865.7	120.9	1280.5	24.5	865.7	96.4	6.4%	4.4%
30-06-00	924.5	112.5	1400.6	34.4	924.5	78.1	9.4%	8.8%
30-06-01	985.1	154.2	1526.0	75.2	985.1	79.0	9.0%	6.2%

5.10 Money Market

With fundamental changes in the foreign exchange regime and strict targets attached to the stabilization program, the money market had to face the brunt of this adjustment. More specifically, the need to increase liquid reserves, coupled with the persistent need to reduce GOP's dependency on central bank financing, could have resulted in a continuous increase in T-bill rates and conscious efforts to keep the money market very tight. Although such conditions were orchestrated at certain times in the latter half of FY01, SBP was able to relax its tighter monetary stance when subsequent targets were eased and banks became more comfortable with the new paradigm.[7] Policy changes to this effect are still being implemented in FY02.

Although the first two months of FY01 were relatively calm, developments in the forex market in the third week of August and the second week of September, forced SBP to act. In August, SBP intervened by selling hard currency to signal the market; however in mid-September, a shift in strategy took place. With this transition, the currency almost witnessed a free fall in mid-September, as SBP could not commit to use sufficient reserves to defend the Rupee. Another reason for the period of transition was the mind-set in the market and the system of monetary management. The new paradigm of managing the foreign exchange market required SBP to have an independent way of influencing short-term domestic liquidity without signaling a change in its monetary stance or a change in T-bill rates.[8]

It is important to mention here, that in countries with market based monetary management, the distinction between managing daily fluctuations in market liquidity and the central bank's monetary stance is very clear. Hence, unanticipated changes in market liquidity are rectified by conducting open market operations (OMOs) to ensure that this liquidity is managed within certain limits. In more sophisticated financial systems, to achieve the desired level of market liquidity, central banks are in

[7] The time taken to implement these changes reflect the caution needed to ensure that both the central bank and players in the money market are aware of how the system is changing. It was also done to ensure that the transition period did not witness excessive volatility in T-bill rates and the Rupee/Dollar parity.

[8] With strict targets on SBP's NDA since December 2000, the central bank could not afford to keep the money market too tight since this would have almost surely required SBP to increase cut-off rates in its open market operations (OMOs). If this were to happen, it would have been used as a signal that SBP is contemplating an increase in T-bill rates. In effect, subsequent primary auctions could have seen an increase in T-bill rates.

the practice of conducting OMOs (both to inject and absorb liquidity) daily or even three times a day. In effect, banks are less dependent on the discount window of the central bank.

This is not the case in our system, where frequent cash accommodation occurs through SBP's 3-day Repo facility, causing overnight rates to go up sharply during periods of shortage, and fall drastically when market eases. The resulting variation in overnight rates sends confusing signals to market participants, which are sometimes misconstrued as changes in SBP's monetary stance. The fixed schedule of bi-weekly OMOs, unwittingly, also reinforced conflicting signals.[9] As mentioned before, it was only in August 2001 that SBP replaced the system of pre-determined OMOs with discretionary OMOs depending on conditions prevailing in the money market and its implications for the inter-bank foreign exchange market. This proactive management of short-term liquidity could also explain the relative calm in the foreign exchange market in FY02.

Although rising T-bill rates are common in any stabilization program, given the dominant role of domestic debt servicing in government expenditures, coupled with the fact that the most difficult target was to contain the size of the fiscal deficit, SBP had to be very conscious of the level of T-bill rates.

5.10.1 Open Market Operations

Table 5.5 reveals that SBP mainly concentrated on moping up liquidity from the market in FY01, a sharp contrast to the year before. In fact, it was only during the period of acute shortage of market liquidity (the second quarter of FY01), when SBP strategically injected liquidity to ease the problem facing the banks, within the context of the end-December NDA target.

Table 5.5: Open Market Operations
million Rupees

	Injection			Absorption		
	FY99	**FY00**	**FY01**	**FY99**	**FY00**	**FY01**
July	-	4,750	-	10,150	-	7,700
August	-	-	-	40,950	21,550	17,150
September	-	-	-	64,420	28,180	13,900
October	-	18,230	-	-	-	-
November	-	4,350	9,400	10,150	5,500	-
December	-	24,500	22,425	40,095	5,000	-
January	-	35,610	13,550	-	-	-
February	-	27,600	-	23,975	3,400	27,850
March	-	1,800	-	-	-	22,400
April	4,810	-	-	-	12,450	4,900
May	6,050	9,330	-	-	-	9,100
June	-	11,700	-	9,950	-	-
Total	**10,860**	**137,870**	**45,375**	**199,690**	**76,080**	**103,000**

Although the distinction between OMOs and primary auctions was only formalized in early FY02, SBP had already started signaling the difference. It was only in the first 5 OMOs in FY01, that SBP sold government papers on an *outright* basis at maturities greater than 4 months; this practice, however, stopped for the remainder of the year. This factor could also explain the consistency in the direction of cash flows during the year; in months when the market was liquid, SBP did not inject liquidity, and vice versa. This was not the case in FY00, when SBP both injected and absorbed market liquidity during the months of November, December and February (see **Table 5.5**).

After the steps taken during the month of December were reversed (see **Figure 5.13**), and seasonal demand for private sector credit had eased, SBP was conscientious of the need to ensure that surplus

[9] The reason for the market's view that OMO rates are indicative of likely T-bill rates needs to be explained. In this regard, the blame partly rests with SBP; OMOs were scheduled for every alternate Thursday (the interim Wednesdays were Primary Actions) and as such were viewed as *mini* (or short-term) auctions. The rationale for this fixed system of OMOs, can be traced to the fact that managing market liquidity on a daily basis was not given due importance in the past. Since the induced stability of the Rupee during FY00 did not create a link between existing market liquidity and the interbank value of the Rupee, pre-determined OMOs were effectively used as a way for the central bank to gauge market sentiments on a regular basis.

liquidity was not allowed to stay in the market. As shown in **Table 5.5,**, the months of February and March witnessed heavy absorption to help support the Rupee/Dollar parity.

5.10.2 Discounting of government securities by banks

As shown in **Figure 5.13**, the almost continuous discounting by banks during the second quarter of FY01, reflects the unprecedented shortage of liquidity during this period. For the year as a whole, banks discounted more than twice as much compared to the year before. More specifically, Rs 1,556.7 billion worth of discounting took place in FY01, against Rs 737.6 billion in FY00. Although the crunch was more concentrated last year, FY01 still saw an increase in the number of visits to the discount window, and larger average discounting per visit (see **Table 5.6**). Given the acute shortage of liquidity at the end of calendar 2000, on account of the NDA target and peak private sector credit demand, it is not surprising that the record volume of discounting occurred around the turn of the year; for the consecutive working days between December 30 to January 4 (where December 31 and January 1 were holidays), the total volume of discounting was Rs 43.1 billion, followed by Rs 71.2, Rs 55.7 and Rs 42.7 billion, respectively.

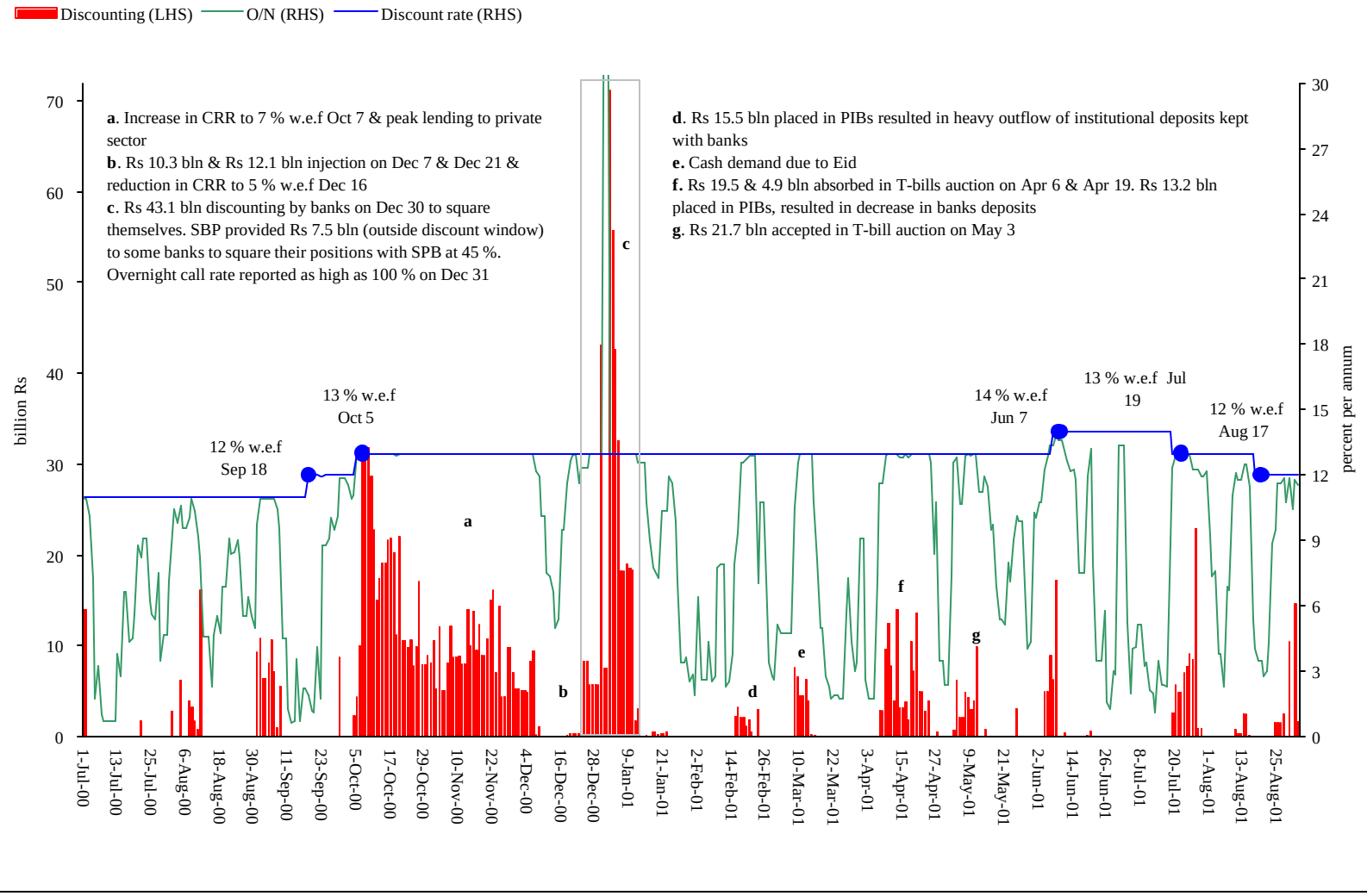
Table 5.6: Activities at Discount Window

million Rupees

	No. of visit to discount window (no. of days)			Total amount of discounting			Average per visit		
	FY99	**FY00**	**FY01**	**FY99**	**FY00**	**FY01**	**FY99**	**FY00**	**FY01**
July	10	15	3	17,458	33,585	29,776	1,746	2,239	9,925
August	5	8	8	6,944	28,150	44,034	1,389	3,519	5,504
September	2	3	9	900	7,805	64,924	450	2,602	7,214
October	23	13	28	85,799	29,455	438,180	3,730	2,266	15,649
November	-	2	29	-	28,230	282,664	-	14,115	9,747
December	-	12	22	-	62,283	138,921	-	5,190	6,315
January	23	10	19	152,399	106,855	309,448	6,626	10,686	16,287
February	9	4	8	18,350	12,654	16,186	2,039	3,164	2,023
March	5	14	9	37,400	42,609	33,853	7,480	3,044	3,761
April	26	4	19	117,742	19,120	114,117	4,529	4,780	6,006
May	16	10	11	40,511	49,197	41,060	2,532	4,920	3,733
June	-	30	8	-	317,697	43,528	-	10,590	5,441
Annual	**119**	**125**	**173**	**477,547**	**737,625**	**1,556,691**	**4,013**	**5,901**	**8,998**

During the second half of FY01, or more specifically after mid-January, the market remained fairly liquid when compared with the preceding half. This is especially noteworthy at the end of the third and fourth quarter of FY01, when despite end-quarter NDA targets, overnight rates were low which allowed banks to find cheap liquidity and not have to approach SBP for discounting. As shown in **Figure 5.13**, the episodes when banks required discounting during the second half of FY01, were on account of unanticipated events or exogenous factors. For example, large investments in PIBs were seen in February and April, Eid demand for currency notes materialized in March, and SBP had to tighten monetary policy in June 2001 because of unexpected pressure on the Rupee/Dollar parity (see **Figure 5.13**).

Figure 5.13: Discounting and Over Night Rates



5.10.3 T-bills Auction

Before discussing movements in T-bill rates during FY01, it is important to have some perspective on developments before the year started. As mentioned earlier, during most of FY00, GOP was able to increase its borrowing from the banking system and still edge T-bill rates down (see **Figure 5.14**). This was because the government was retiring its debt to commercial banks and borrowing heavily from SBP instead.

As shown in **Figure 5.15**, after the 2.9 percentage point increase in 6-month T-bill rates (from September 21 to October 19), interest rates remained calm till mid-March. In fact, even the increase witnessed in March 22, was more a correction of the slight inversion in 3 and 6-month rates that had been carried forward from the March 8 auction. The increase in rates also shows a degree of self-fulfillment of bank expectations, as the end-March NDA target was looming. Although this target was eased following discussions with the IMF, the bid patterns in the primary auctions were beginning to incorporate the anticipated increase in T-bills. Although SBP was comfortable in terms of being able to meet this target without having to increase T-bill rates, the bid pattern in the March 8 auction effectively compelled SBP to increase the cut off rates. Needless to say, this increase allowed the central bank to accept a larger volume of bids, which helped meet the end-March target by a comfortable margin.

The stability of 6-month T-bill rates (around 11.5 percent) would have remained for the rest of the year, had it not been for the pressure on the Rupee/Dollar parity in the first week of June 2001. Furthermore, if the central bank had absorbed short-term liquidity at high rates in the OMO, there was a fear within SBP that such a course of action would have resulted in a very sharp hike in T-bill rates just to meet the end-June NDA target. Other than the pressure this would have put on future debt servicing, one must realize that the export finance scheme (EFS) was to shift the benchmarking of its pricing to the 6-month T-bill rate by end-June; this increase in T-bill rates would have been inconsistent with the government's overall strategy to increase exports in FY02. The compromise solution was to increase the discount rate on June 7, 2001, which succeeded in calming the foreign exchange market. With this increase in the discount rate, T-bill rates also had to be raised. Nevertheless, as shown in **Figure 5.15**, this did not signal a shift in SBP's monetary stance, as rates were brought down to May 2000 levels within two auctions. This downward trajectory has persisted in the first quarter of FY02.

To summarize this sub-section, in overall terms, commercial banks offered only Rs 259.4 billion in FY01 against Rs 469.2 billion in FY00. Despite rising interest rates and long periods of stability during the year, the volumes offered by banks declined on account of the liquidity crunch in the first half of the year. However, during the second half of FY01, with the improvement of market liquidity and the stability in T-bill rates, banks were more forthcoming in the primary auctions (see **Figure 5.15**). Another indication of this comfort can be gauged by the fact that the percentage of total bids that were accepted in the primary auctions was quite high in the second half of FY01.

5.10.4 Pakistan Investment Bonds (PIBs)

After fresh issues of the Federal Investment Bonds (FIBs) were stopped on June 23, 1998, there were no long-term government securities that could meet the investment needs of banks, NBFIs, insurance companies, pension funds and corporate bodies. With the attractiveness of NSS rates and no bar on institutional investment, this vacuum was not even felt. However, in the interest of developing the longer end of the government debt market by creating a yield curve, and to boost the corporate debt

Figure 5.14: Auction Summary of MTBs

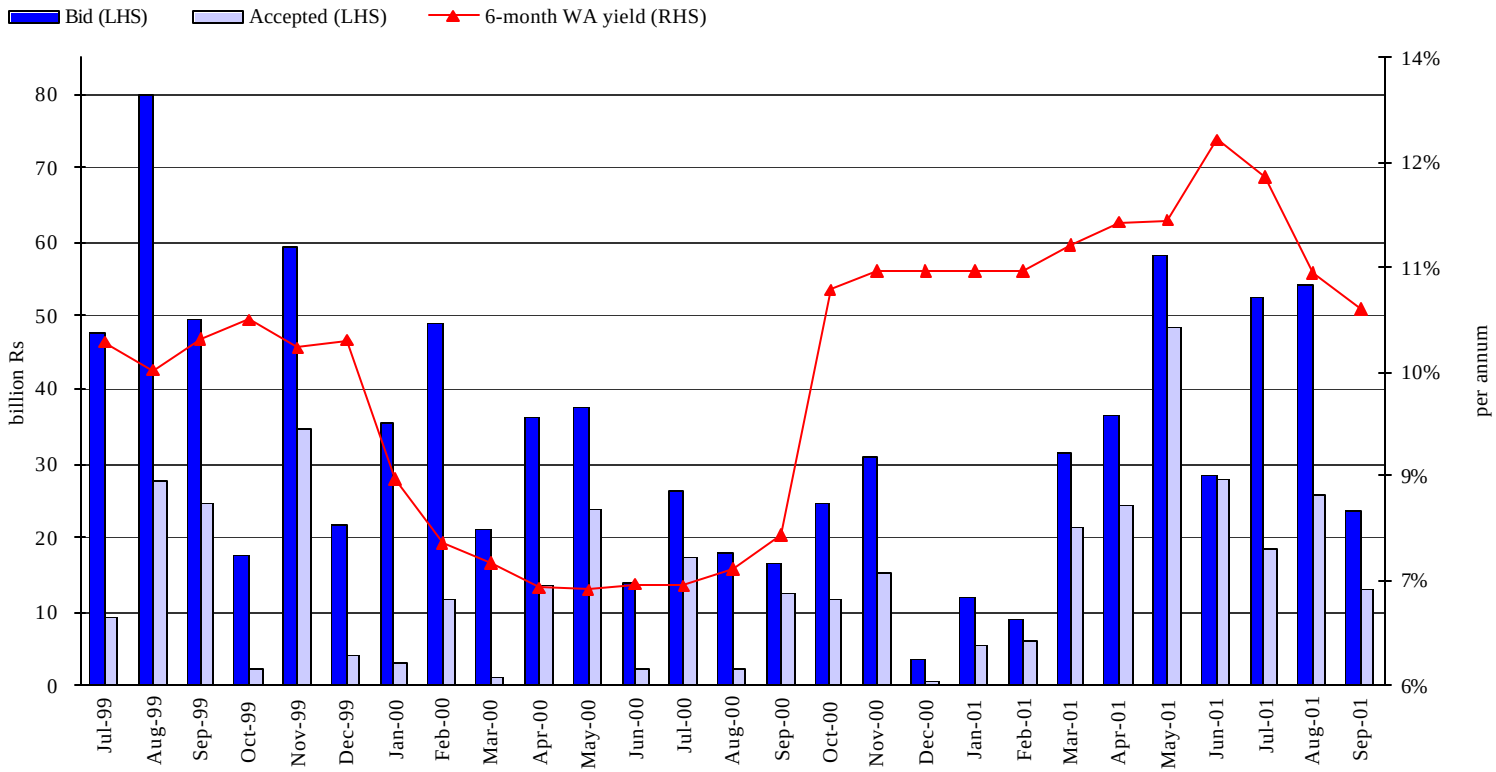


Figure 5.15: Auction Summary of MTBs

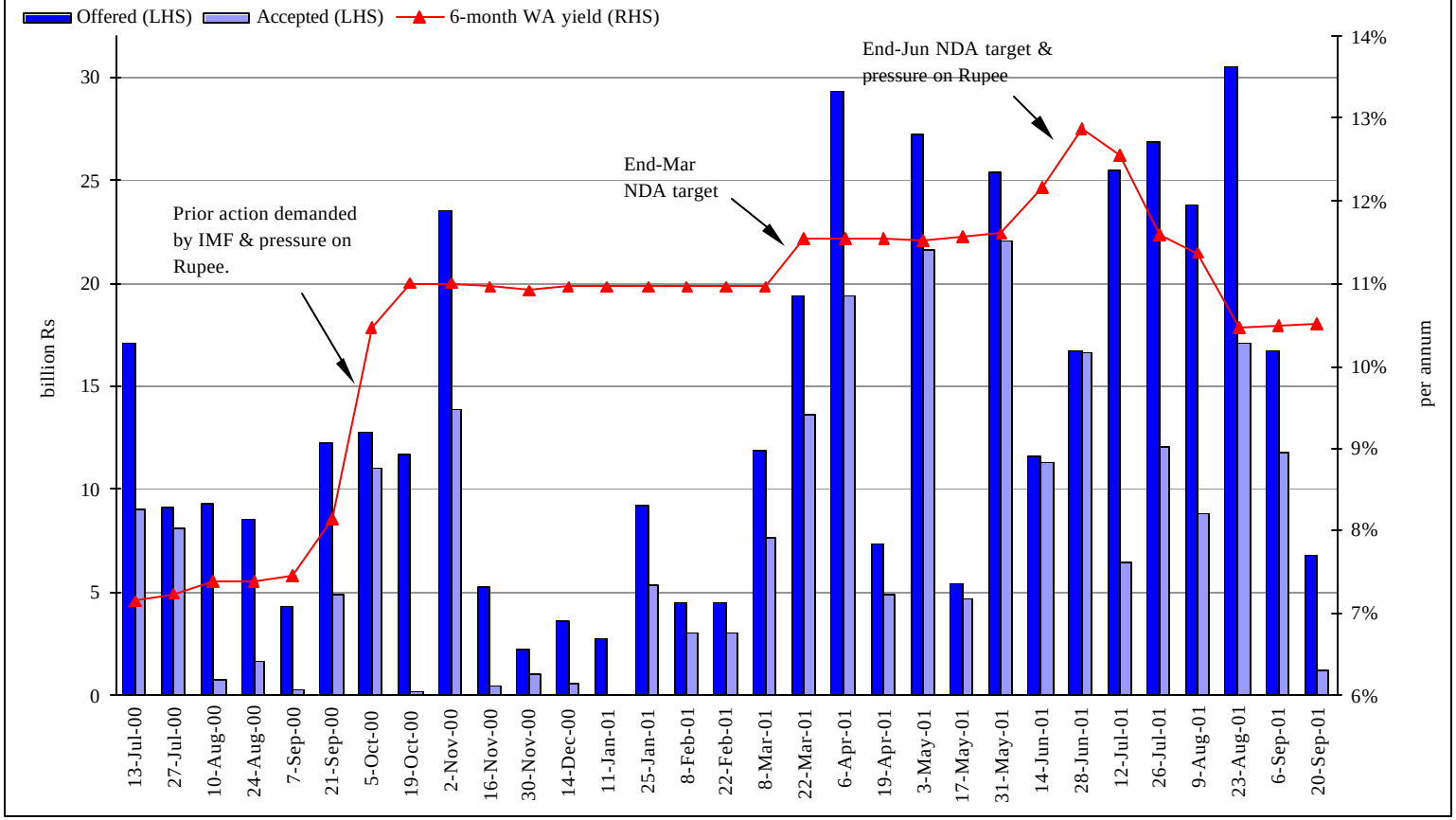


Table 5.7: PIB Auctions - Summary of Results

million Rupees

	Tenor	Target	Coupon rate % p.a.	Amount offered	Range of price offered/Rs 100	Amount accepted	W. A. % p.a.	% accepted of tot. accpt.
1st Dec 14, 00	3 Years		12.50	4,056	98.50--100.35	1,999	12.4507	45.08
	5 Years		13.00	1,031	99.90--100.35	213	12.9490	4.80
	10 Years		14.00	4,562	99.50--100.35	2,222	13.9667	50.11
	Total	**4,000**	-	**9,649**	-	**4,434**	-	**100.00**
2nd Dec 30, 00	3 Years		12.50	2,027	99.00--100.11	507	12.4823	5.20
	5 Years		13.00	3,066	99.90--100.11	3,059	12.9997	31.41
	10 Years		14.00	7,406	99.50--100.18	6,174	13.9783	63.39
	Total	**10,000**	-	**12,499**	-	**9,740**	-	**100.00**
3rd Feb 14, 01	3 Years		12.50	1,309	100.00--100.35	1,209	12.4270	7.79
	5 Years		13.00	953	100.00--100.30	452	12.9457	2.91
	10 Years		14.00	15,575	100.00--100.36	13,846	13.9551	89.29
	Total	**8,000**	-	**17,837**	-	**15,506**	-	**100.00**
4th Apr 18, 01	3 Years		12.50	665	100.00--100.15	534	12.4719	4.75
	5 Years		13.00	1,124	100.00--100.20	1,124	12.9913	10.00
	10 Years		14.00	11,431	99.50--100.11	9,581	13.9960	85.25
	Total	**12,000**	-	**13,220**	-	**11,239**	-	**100.00**
5th May 21, 01	3 Years		12.50	479	99.75--100.11	429	12.4859	47.75
	5 Years		13.00	499	99.75--100.10	469	12.9934	52.25
	10 Years		-	-	-	-	-	-
	Total	**3,000**	-	**978**	-	**898**	-	**100.00**
6th Jun 16, 01	3 Years		-	-	-	-	-	-
	5 Years		-	-	-	-	-	-
	10 Years		14.00	4,632	98.00--100.10	4,307	14.0042	100.00
	Total	**12,000**	-	**4,632**	-	**4,307**	-	-
Grand total		**49,000**		**58,815**		**46,123**		

market, the government decided to launch the PIBs in December 2000, with subsequent auctions every two months.[10] With price auctioning of the PIBs, certain requirements on the short-listed Primary Dealers (to develop a vibrant secondary market), and the institutional ban on investing in NSS in March 2000, it was hoped that there would be sufficient demand for this instrument.

Although there is strong market demand for the PIBs, gauging market demand for this instrument still remains elusive. The reason is straightforward; although there are select institutions that have the largest appetite for the PIBs, their past investment patterns in NSS instruments does not allow the market to gauge their monthly or annual appetite. Furthermore, the on-tap nature and ease of investing in NSS, did not force large institutional investors to upgrade their asset management systems. Furthermore, as part of the agreement with the PDs, these banks advise SBP about the market demand before each auction, which is used to set the auction target. Also, SBP has an understanding with the PDs that these targets will not be exceeded to keep a limit on the total supply of PIBs in the market. Barring exceptional developments in February 2001 when SBP accepted almost twice the target amount, SBP has limited the supply of the PIBs, but PDs still have the incentive to underestimate market demand. This is on account of the underwriting commitment of the

[10] The decision to hold two auctions in December 2000, was two fold: (1) with PIB rates to anchor returns on Defence Savings Certificates (DSCs) from January 1, 2001 (as part of our commitment to the IMF), it was felt that two auction would provide a more accurate picture of long-term interest rates, and (2) the first auction was heavily over-subscribed. Needless to say, this raising of debt from non-banks, also helped in meeting the tough end-December NDA target.

PDs, whereby each PD must buy at least 3.5 percent of the annual auction target. However, since there are only 7 PDs, and the PIB auctions are generally over-subscribed, this commitment is not binding; nevertheless, PDs are still on the cautious side.

As shown in **Table 5.7**, of the six auctions conducted during FY01, four were over-subscribed. The last auction that took place on June 20, was heavily under-subscribed following the unanticipated increase in the discount rate on June 7. Since the target for this auction was discussed and formalized before the increase in the discount rate, this market response was expected. The fifth auction on May 20, took place under comfortable money market conditions, but was under-subscribed on account of the limited appetite for 3 and 5-year PIBs. In April 2001, SBP decided to break up the auction system into a monthly schedule, whereby the auction of 3 and 5-year PIBs would be held in one month followed by the auction of the 10-year instrument (see **Table 5.7**). This decision was taken on the recommendation of the PDs, which felt that the combined auction (every two months) created cash flow problems for them.

With the passage of time, target setting is becoming more accurate and the central bank's commitment not to exceed the target has also been honored. Although the secondary market is still very thin, as the PIB matures, both in terms of secondary market trading and asset management by institutional investors, the future of the PIB is quite promising. In a difficult 7-month existence of the PIB, this instrument has already mobilized Rs 46.1 billion; looking ahead, this figure is likely to be much higher during FY02.