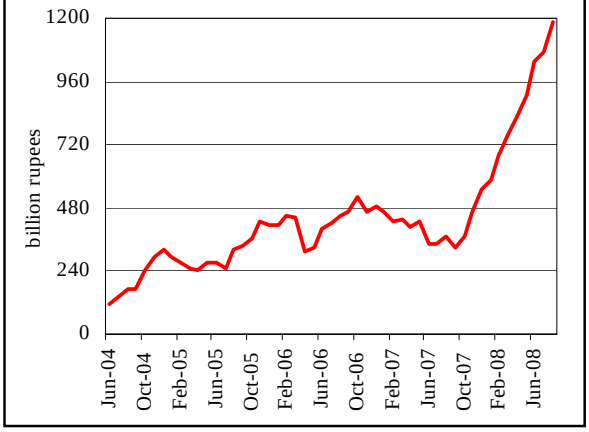
4 Money and Banking

4.1 Monetary Policy

Monetary policy environment was extremely challenging during FY08. The inflationary impact of weaker domestic production was exacerbated by an extraordinary rise in global commodity prices (particularly food and energy) and strong domestic demand. Consequently, despite repeated monetary tightening measures undertaken during the year, CPI inflation reached a three-decade high by June 2008, and has since continued to trend upwards (see **Table 4.1**).[1]

Figure 4.1: Stock of Net Budgetary Borrowings from SBP



The weaker domestic production was caused by both, adverse shocks (e.g., increased political noise and disappointing harvest of key major crops) and policy errors (e.g., inadequate increase in electricity generation capacity, late announcement of wheat support prices, etc). The relative weakness in real sector production, manifested Q2-FY08 onwards, led to high demand for imports with commodity prices continued to trend upwards (and accelerated in H2-FY08). The external imbalance was further worsened by the demand stimulus of the extraordinary increase in government borrowings from SBP, eroding the impact of earlier monetary tightening. In spite of repeated monetary policy tightening persistent increase in public spending contributed directly to the deteriorating fiscal and external imbalances fueling the already high inflationary pressures in the economy.

Despite an already blighted fiscal position, the government decided to continue with large subsidies through most of FY08. The resulting substantial rise in the fiscal burden, compounded by the increase in other expenditures, pushed up the fiscal deficit abruptly to 7.4 percent of GDP for FY08 against the budget estimate of 4.0 percent.

More worrying for SBP was the heavy monetization of fiscal deficit through a record rise in government borrowings from the central bank (see **Figure 4.1**), the most inflationary source of financing. During FY08, the government borrowed Rs 688.7 billion from SBP for budgetary support which were over 90 percent of the total financing requirement of the government for FY08. As a result, the stock of Market Treasury Bills for Replenishment (MRTBs) with SBP reached Rs 1,053 billion by end-June 2008 from Rs 452.1 billion at end-June 2007.

Table 4.2: Contribution to Growth in Reserve Money

percent

	Contribution to growth	
	FY07	**FY08**
Reserve money growth	**20.9**	**21.5**
Contribution from		
SBP NDA	-1.4	46.9
Government sector	-5.8	56.9
Non-government sector	5.3	-4.4
Other items	-0.8	-5.7
SBP NFA	22.2	-25.4

Thus the fiscal indiscipline complicated the monetary management by not only adding to aggregate demand pressures in the economy but also through contributing significantly to growth in reserve money. Consequently, despite continued monetary tightening,

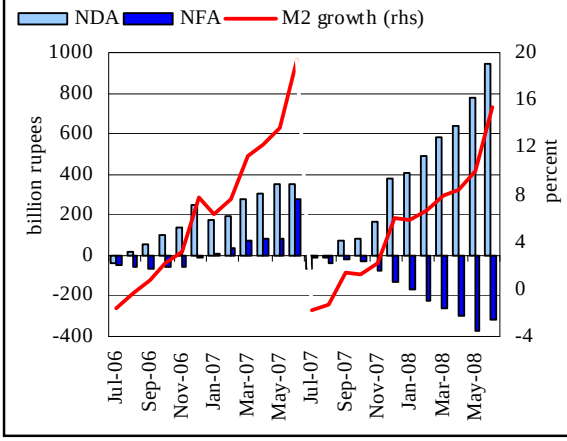
[1] The headline CPI inflation reached 21.5 percent (YoY basis) in June 2008 from 8.8 percent in December 2007.

Table 4.1: Monetary Policy Measures and Macroeconomic developments in FY08

Policy Measures	Macroeconomic developments
First Round Policy discount rate was raised by 50 bps to 10 percent effective from August 1, 2007	SBP policy neutralized the impact of monetary overhang created in June 2007 as evident from deceleration in M2 growth during Jul-Oct FY07. Government borrowing from SBP remain subdued; i.e. Rs.23.2 billion in the same period. However, government borrowed almost Rs .178 billion during Nov-Dec FY07 which led to softening of interest rate and acceleration in M2 growth. Rising global fuel and commodity prices adversely affected domestic inflation outlook. Fiscal burden increased as government decided not to pass-on the higher international oil prices to domestic consumers. Unabated domestic demand for oil exerted severe pressure on external account.
Second Round Policy discount rate was raised by 50 bps to 10.5 percent effective from February 1, 2008 Cash reserve requirement was increased by 100 bps to 8 percent for demand liabilities (including deposits of maturity up to one year).	Despite sustained high international commodity prices and the resulting increase in burden of subsidies, government kept the prices of key fuel items unchanged. Financing of subsidies was done through monetization which diluted the desirable impact of monetary tightening. Macroeconomic stress increased further as reflected in pressure on exchange rate and draw down of foreign exchange reserves. Head line CPI inflation rose sharply from 8.8 percent YoY in Dec-2007 to 17.2 percent in April -2008. Core inflation also increased to 14.1 percent YoY in April-2008 from 8.7 percent in Dec-2007.
Third Round Policy discount rate was raised by 150 bps to 12.0 percent effective from May 23, 2008. Cash reserve requirement was increased by 100 bps to 9 percent for demand liabilities (including deposits of up to one year maturity). Statutory liquidity requirement was raised by 100 bps to 19 percent	Government's heavy reliance on borrowing from SBP continued unabated with additional Rs. 149.8 billion during May 25 to June 30, 2008. During May–Jun 2008 external account deficit widened considerably and exchange rate came under severe pressure.

the reserve money growth reached 21.6 percent during FY08 compared to 20.9 percent in FY07 (see **Table 4.2**). Although growth in broad monetary aggregate (M2) decelerated during FY08, this conceals the continued pressure on monetary accounts due to widening external and fiscal accounts deficits (see **Figure 4.2**).[2] In particular, demand for domestic credit (both for the government and private sector) rose steeply to 29.3 percent during FY08 from 15.8 percent in FY07. Furthermore, liquidity injections from unpredictable government borrowings have weakened the transmission of policy rates to retail rates.

Figure 4.2: Break up of M2 Growth



The widening fiscal deficit together with the rising international commodity prices contributed to dramatic worsening of the external account position of the country, and provided a further impetus to domestic inflation as the rupee depreciated against major currencies. For example, due to

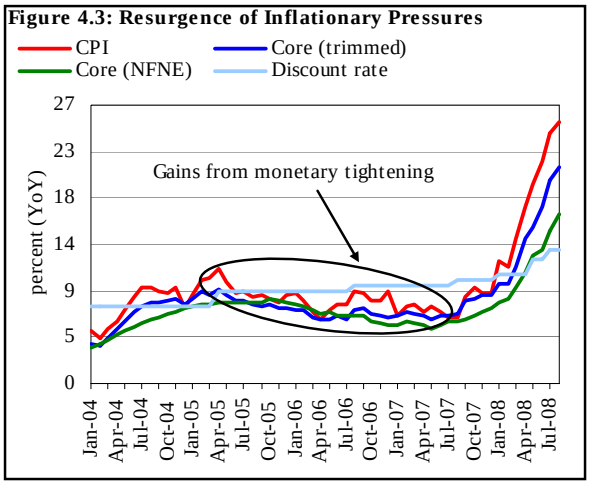
[2] It was the sharp contraction in NFA (reflecting severe pressure on external account) that led to deceleration in M2 growth.

considerable delays in phasing out fuel subsidies, the domestic consumption of POL products did not fall in line with rising prices in the international market, thereby putting pressures on external account. The current account deficit for FY08 jumped abruptly to 8.4 percent of the GDP from 4.8 percent deficit in FY07.

The effect of domestic demand pressures was also evident on private sector credit. Despite continued monetary tightening, growth in private sector credit gathered momentum after January 2008 and remained at 16.5 percent for FY08 – slightly lower than 17.3 percent rise witnessed in the previous year.

This persistent strong credit demand by the private sector can be explained by exceptionally high prices of commodities and raw material in both domestic and international markets. In some cases corporates needed more funding so that they could meet their growing export demand. Similarly capacity enhancements in some sectors have augmented their demand for working capital.

Figure 4.3: Resurgence of Inflationary Pressures



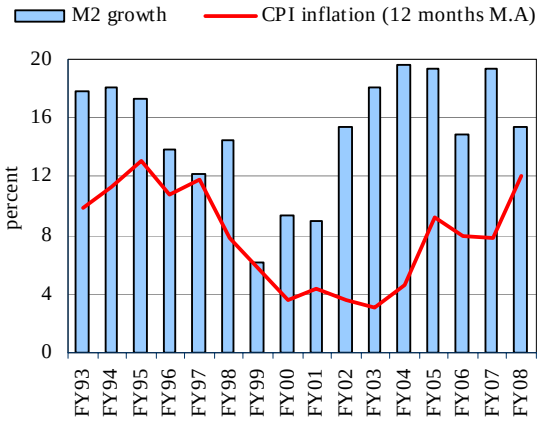
The desirable moderation in the credit demand did not materialize due to monetary tightening because of the availability of: (1) financing through non-bank sources, which is evident from growing participation of mutual funds and other non-bank financial institutions in corporate debt papers during FY08, and (2) interest rate risk hedging instrument. In the latter case, for example, availability of cross currency swaps, expectations of stable Rupee exchange rate and rising domestic interest rate encouraged corporates to substitute their Kibor-based interest obligations with Libor-based interest payments. As long as the Rupee exchange rate remained stable, corporates continued to gain from this derivative transaction to the extent of the difference in Kibor and Libor.

In sum, the exogenous shock in terms of rising oil and commodity prices in the international markets combined with a strong domestic demand led to acceleration in inflationary pressures. Inflation was exceptionally strong during H2-FY08 as the CPI inflation, year-on-year basis, reached 21.5 percent in June 2008 up from 8.8 percent in December 2007 (see **Figure 4.3**). More worryingly, core inflation – a measure that provides information about inflation outlook – rose to unprecedented levels. For example, the trimmed mean measure of core inflation sharply rose to 17.2 percent on year-on-year basis by June 2008 from 8.7 percent in December 2007.

The growing inflationary pressures and rising stresses on macroeconomic sustainability of the country continued to pose serious challenges for SBP (see **Monetary Policy Statement Jul-Dec 2008** for details). Consequently, a tight monetary policy remains the only way out.

Historical trends suggest that the monetary tightening had been successful in containing inflationary pressures in the economy. As evident from **Figure 4.4**, on average, monetary tightening has been followed by a slowdown in inflationary pressures, and vice versa. For example, during the past two years, the monetary tightening has been effective in reducing the CPI inflation from its previous peak of 11.1 percent in April 2005 to 6.2 percent in April 2006 – a fall of 4.9 percentage points in just one year.

Figure 4.4: M2 Growth and Inflation



The need for monetary tightening is not obviated by the fact that a part of the recent inflation spike stems from global price shock, which may be temporary and outside the control of SBP. This is because: 1) domestic inflation cannot be sustained without excessive domestic demand. 2) Even if recent price shocks were temporary, the sheer scale and magnitude of the rise in global commodity prices indicates that a monetary response is required to curb inflation expectation and limit the second round impacts. 3) the pass-through of these high global prices is expected to increase in months ahead both due to substantial depreciation of the rupee in recent months, and the government's bold decision to pass on to consumers the true cost of imported inputs in order to avoid allocation inefficiencies.[3] Lastly, a look at **Figure 4.5** clearly show that much of the rise in inflationary pressures occurred only in the final months of FY08. This explains why significant tightening measures had to be enacted in the later months of FY08 and July FY09.

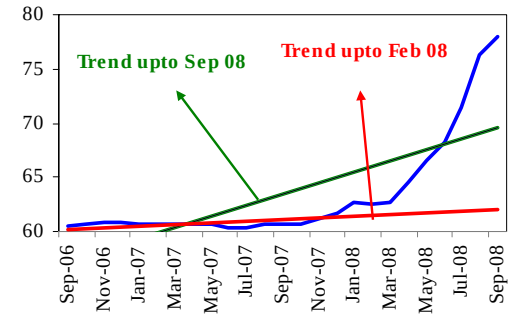
The tight monetary policy stance faced a major challenge during initial months of FY09, particularly due to exceptionally high pressures on Rupee liquidity in the inter-bank market. A combination of a number of developments led to this liquidity crunch. For example, (1) the overall monetary supply was facing contraction during initial months of FY09 mainly due to pressures on external account and its resulting impact on SBP's NFA; (2) the high inflation, relative lower interest rates and weak deposit mobilization efforts has led to slowdown in deposit growth rate and a rise in currency in circulation; (3) seasonal withdrawal of large sums from deposits due to increased demand for currency to meet expenses during Ramadan and Eid festival; and (4) sharp increase in withdrawal of deposits of some of the banks following rumors questioning the resilience of the banking system in Pakistan.

The pressure on Rupee liquidity in the inter-bank market increased further due to continued rising demand for credit from the private sector and public sector enterprises (mainly to finance mounting circular debt obligations). The market expectations that the Government is planning to pull out the public sector/Government deposits from the commercial banks also added to anxiety in the market from the liquidity perspective. As a result of these developments, interest rates in the inter-bank market rose sharply. In particular, the weighted average overnight call rate which was hovering in 10-14 percent range during Jul-mid Aug 2008 increased sharply to over 30 percent by first week of October 2008. However, following SBP several measures such as drastic reduction in reserve

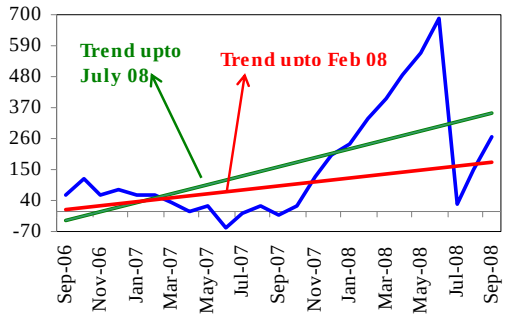
[3] The pass through has increase also because (a) domestic economy has become more integrated with global trends following the removal of administrative prices controls in recent years; and (b) like other developing countries, food and fuel have a significant share of 47.6 percent in the CPI basket, making CPI inflation more sensitive to changes in international prices.

Figure 4.5: Causes of High Inflation

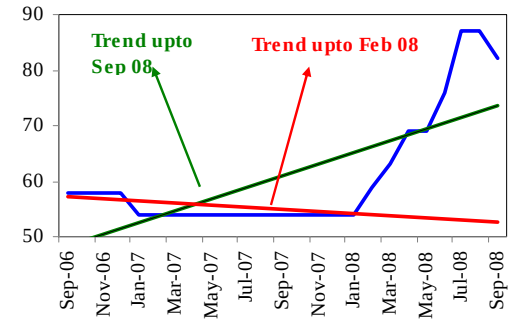
Exchange Rate (Rs/$)



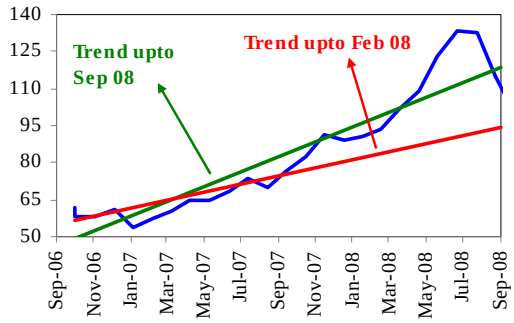
Government Expenditure (billion Rs)



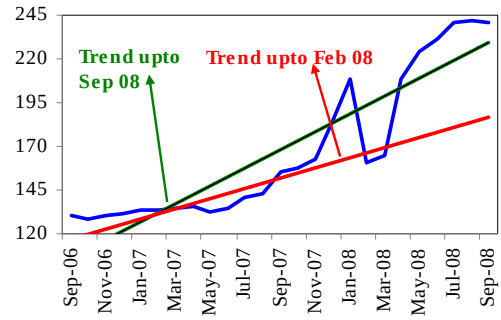
Petrol Prices (Rs per liter)



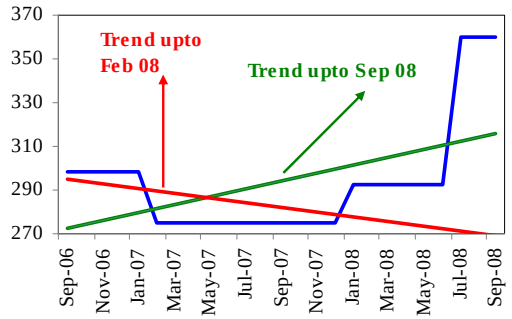
Crude Oil ($ per barrel)



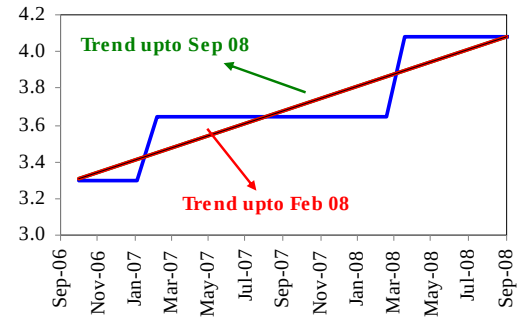
Wheat Flour (Rs per 10 kg)



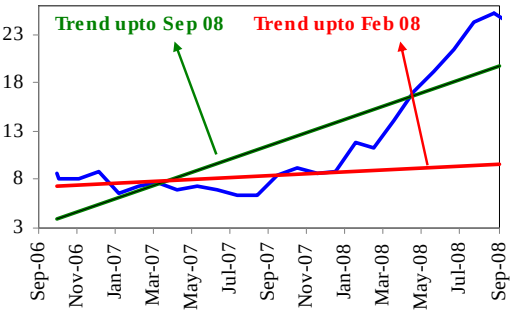
Gas (Rs per TU MMBTU)



Electricity (Rs per 101-300 Units)



CPI Inflation (YoY) (percent)



requirements,[4] liquidity injections through OMOs and discounting window, [5] and other,[6] the weighted average call rate fell to around 16 percent by end-October 2008. It may be worthwhile to mention here that these measures were taken only to effectively deal with the liquidity shortages and as such there is no change in the monetary policy stance of the central bank.

Table 4.3: Monetary Survey

	Flows (billion Rs)		Growth rate (%)	
	FY07	**FY08**	**FY07**	**FY08**
M2	658.2	624.0	19.3	15.3
NDA	383.7	941.4	14.2	30.6
Government borrowings	92.8	583.8	11.1	63
for budgetary support	102	554.5	14.4	68.5
from SBP	-58.6	688.7	-14.5	199.6
Scheduled banks	160.6	-134.2	52.7	-28.9
Commodity operation	-9.2	28.7	-8.5	29.1
Non-government sector	385.7	441.7	17.6	17.1
Private sector credit	365.7	408.4	17.3	16.5
PSEs	19.7	33	32.3	40.9
Total domestic credit	*478.5*	*1,025.30*	*15.8*	*29.3*
Other items (net)	-94.9	-84.1	28.9	19.9
NFA	274.6	-317.4	38.7	-32.2
SBP	222.7	-308.0	39.4	-39.1
Scheduled banks	51.8	-9.4	35.8	-4.8

4.2 Developments in Monetary Aggregates

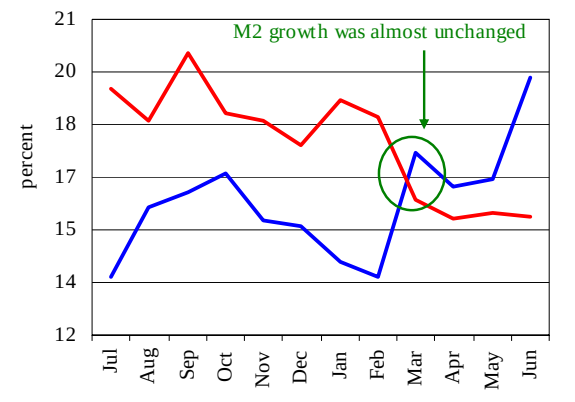
Growth in broad monetary aggregate remained at 15.3 percent during FY08, considerably lower than 19.3 percent witnessed in the previous year (see **Table 4.3**). This deceleration in M2 growth should however be interpreted with some care as:

(1) M2 growth is still higher than the indicative target of 13.5 percent for the year.

(2) Excluding the sharp jump in M2 in June 2007, YoY M2 growth during FY08 was 15.5 percent, slightly lower than 16.4 percent realized during the corresponding period last year (see **Figure 4.6**).

(3) More importantly, slowdown in M2 growth does not reflect any softening of domestic demand pressures.

Figure 4.6: YoY Growth in M2



The persistent strong domestic demand was evident from an exceptional rise in government borrowings from the central bank (meant for financing higher fiscal deficit) and continued credit demand from the private sector. Consequently, the net domestic assets of the banking system more than doubled to reach 30.5 percent in FY08 from 14.2 percent growth realized in FY07. During the preceding four years ending on FY07, the NDA has grown on average by 19.0 percent per annum.

[4] SBP has reduced the cash reserve requirement for all deposits up to one year maturity by a total of 300bps to 6 percent. There will another 100bps decline in CRR to 5 percent with effect from November 15, 2008. At the same time, SBP fully exempted the time deposits of 1 year tenor and above from Statutory Liquidity Requirements (SLR).

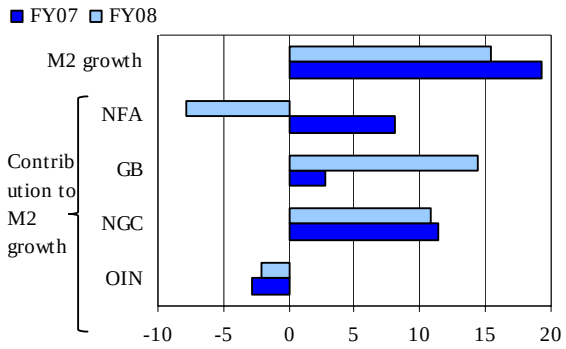
[5] Since mid August 2008, SBP has conducted 24 OMOs injections and have injected temporary liquidity in excess of PKR 440 billion and banks have been facilitated effectively on discount window.

[6] Now PIB's and TFCs to the extent of 10 percent of Time and Demand Liabilities (TDL) are eligible towards SLR. Previously this limit was 5 percent of TDL. Further, securities classified under "Held to Maturity" category were allowed to be used for borrowing under SBP repo facility (OMO)/ discount window.

The effect of strong domestic demand was also evident from worsening current account balance and the consequent drawdown of foreign exchange reserves. This in turn, led to a sharp reduction in NFA of the banking system.

Thus, it was the opposing effect of strong domestic demand on NDA and NFA of the banking system that helped in holding back the M2 growth during FY08 (see **Figure 4.7**).

Figure 4.7: Contribution to M2 Growth (%age points)

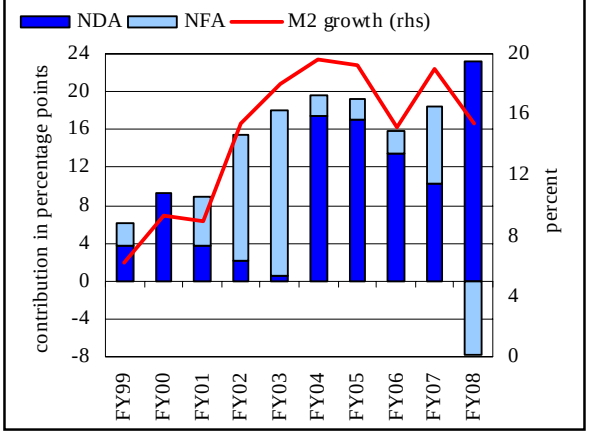


OIN=other item net, GB=government borrowing, NGC=non-govt credit, NFA=net foreign assets

4.2.1 Net Foreign Assets (NFA)

The sudden reversal in overall external balance (from a surplus of US$ 3.7 billion in FY07 to a huge deficit of US$ 5.8 billion) led to a sharp fall of Rs 317.4 billion in NFA of the banking system which was almost entirely concentrated in SBP's NFA (see **Table 4.3**). This was for the first time after 1998 that foreign assets of the banking system made a negative contribution to annual growth in monetary aggregates (see **Figure 4.8**).

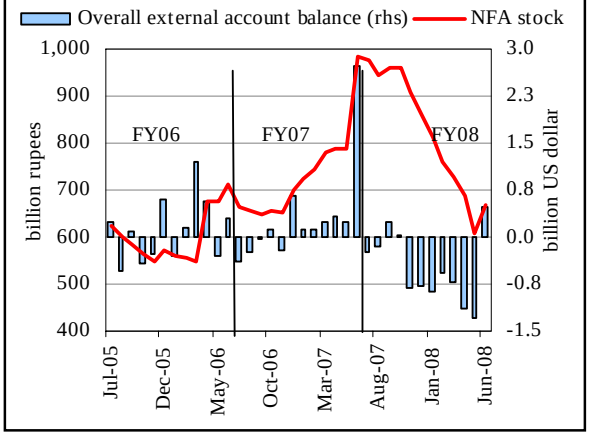
Figure 4.8: NFA Contraction and M2 Growth



The contraction in NFA flows was in contrast with the trends in recent year when substantial foreign exchange inflows were lessening the pressures on overall external balance, and in turn, reducing the perceived risks of the country. However, during FY08, not only the current account deficit widened sharply, inflows in the financial account also decelerated, putting severe stress on overall external balance.

Monthly trends show that NFA stock had remained more or less stable during the first four months of FY08. It was only after October 2007 that the demand pressures increased sharply which led to steeper fall in NFA in line with the pressure on external account (see **Figure 4.9**). Indeed, this fall in NFA has eaten into most of the buildup in foreign assets of the banking system observed during FY06 and FY07 (see **Figure 4.9**).[7]

Figure 4.9: Stock of NFA and Overall External Balance



A further analysis shows that the demand pressures were coming from both public and private sector. This was evident as slowdown in foreign exchange inflows of both the public sector as well as private sector contributed to NFA contraction. The available evidence show that external inflows for budgetary

[7] The NFA of the banking system had grown by a total of Rs 348 billion during FY06 and FY07.

financing has fallen short of the target set in the federal budget for FY08 (see **Figure 4.10**). At the same time, private sector foreign exchange outflows increased mainly due to import payments (particularly of POL) and disinvestments in equity markets (for details see **chapter on BoP**).

The challenge for monetary policy became more severe as the financial inflows (both investment and debt creating inflows[8]) necessary for financing the external current account deficit started drying up (see **Figure 4.11**). The resulting mounting up of pressures on overall external account led to drawdown of SBP's reserves and, thus, a fall of Rs 307 billion in NFA of SBP (see **Figure 4.12**).

Simultaneously, foreign assets of scheduled banks received some strength from the adjustments in rupee exchange rate against major currencies (see **Figure 4.13**) encouraging deposit growth and reduced interest in foreign currency loans. Specifically, the Rupee depreciation against major currencies made FE-25 deposits more attractive, thereby encouraging higher mobilization of foreign currency deposits during FY08. In overall terms, FE-25 deposits rose by US$ 412.4 million during FY08 compared to US$ 212.2 million in FY07.[9] The rise was more concentrated in Euro denominated deposits (see **Table 4.4**) as the rupee parity depreciated most against the euro during FY08.[10]

Sharp depreciation of the rupee against major currencies made foreign currency financing costlier, thus resulting into net retirement of FE-25 trade loans during FY08, and a corresponding rise in foreign assets of scheduled banks.[11] Despite the advantage from exchange rate depreciation, foreign assets of scheduled banks remained under pressure through most of FY08 (see **Figure**

Figure 4.10: External Financing

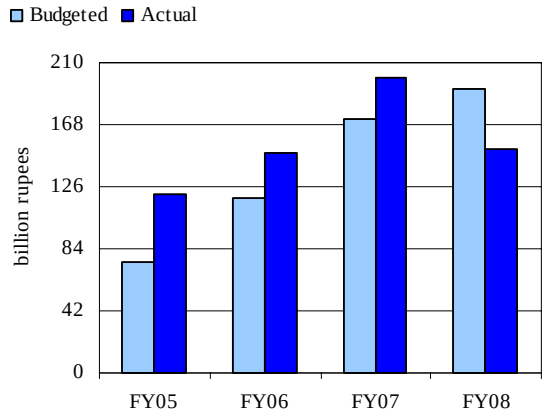


Figure 4.11: Key Foreign Exchange Inflows/Outflows

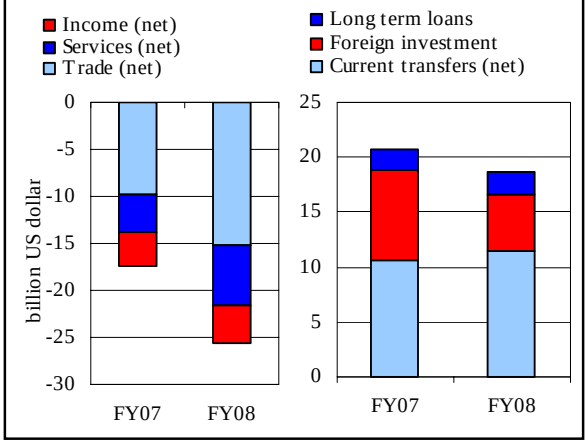
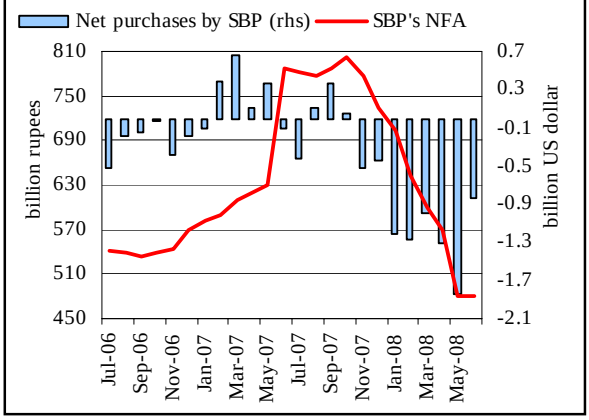


Figure 4.12: External Account Pressures and Contraction in SBP NFA



[8] The financial inflows during FY07 included GDRs and Eurobonds. These receipts were lower during FY08.
[9] While *non-resident* foreign currency deposits form a part of scheduled banks' NFA, only that portion of *resident* foreign currency deposits affect NFA which is placed outside Pakistan.
[10] The Rupee has depreciated by 24.1 percent against the Euro; 23.8 percent against JPY and 11.5 percent against the US Dollar.
[11] Since the foreign currency trade loans are the liability on resident of the country, these are considered a part of scheduled banks' *domestic* assets. A retirement of foreign currency loan converts this domestic asset into a foreign asset.

4.14). This probably showed the overall payment pressures on banks as reflected in depletion of their nostro balances during FY08.[12] Other source of the drain on foreign assets of scheduled banks was banks' swaps with SBP, which are treated a part of banks' domestic assets.

The sharp contraction in overall NFA of the banking system though helped in containing the M2 growth, the main concern for the monetary policy was the sustained domestic demand pressures which were one of the reasons for continued deterioration in current account balance and consequent reduction in NFA. The policy response was to focus on demand management through further monetary tightening.

Developments in NFA in the recent years underscore the complications faced by the central bank due to increased integration of the domestic economy with the rest of the world. Indeed the challenges for monetary policy have risen with the increased reliance on foreign exchange financial inflows, which are very sensitive to domestic developments. At the same time, monetary policy has to consider global developments that have a potential to significantly affect the transmission of monetary policy signals to domestic inflation and output .

Table 4.4: Currency-wise Break up of FE-25 Deposits

equivalent million US$

	Jun-07	Jun-08	change	
			absolute	percent
US$	3,033	3,128	95	3
Euro	275	516	241	88
GBP	444	522	77	17
JPY	4	2	-1	-39
Total	**3,755**	**4,168**	**412**	**11**

Figure 4.13: FE-25 Loans and Exchange Rate

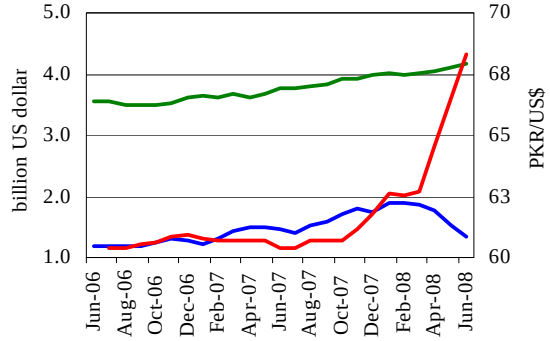
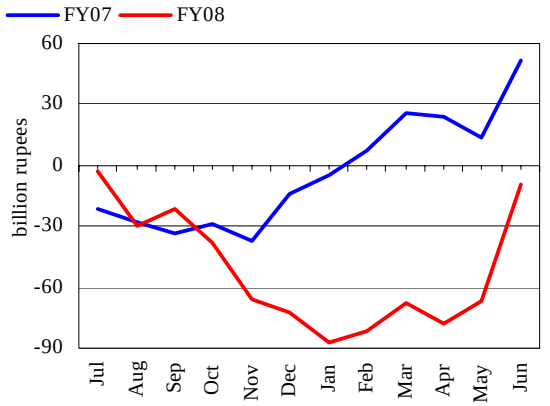


Figure 4.14: Cumulative Flows in NFA of Scheduled Banks



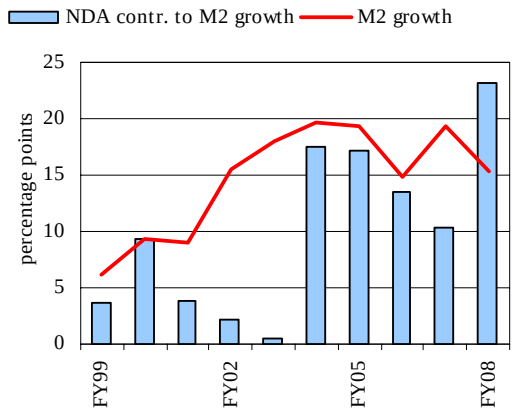
4.2.2 Net Domestic Assets

The strong domestic demand also doubled the growth in net domestic assets (NDA) of the banking system from 14.2 percent in FY07 to 30.5 percent in FY08. This not only reversed the downtrend in NDA growth witnessed during the past few years, but also sharply raised its contribution to M2 growth to an all time high (see **Figure 4.15**).

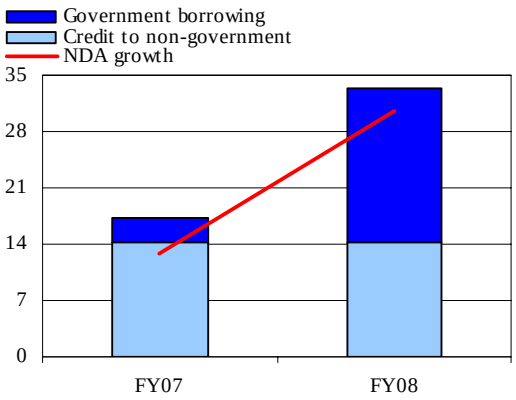
The continued strong demand for private sector credit, outpaced by sharp rise in government borrowings particularly from the central bank, led to acceleration in NDA growth.

[12] The trade nostro balances of scheduled banks fell by US$ 274 billion during FY08 compared to a rise of US$ 173 million in FY07.

Figure 4.15: Contribution of NDA in M2 Growth



Contribution of Govt Borrowings in NDA Growth



Government borrowings for budgetary support

Budgetary borrowings from the banking system increased five-fold to reach a record high of Rs 554.6 billion during FY08 compared to Rs 102 billion in the previous year (see **Figure 4.15**). More worrying was the increased reliance of the government on borrowings from the central bank as government had borrowed Rs 688.7 billion from SBP. This was in sharp contrast to the recommendations made in monetary policy framework for FY08 asking government to retire Rs 62.3 billion of its debt to the central bank. Indeed, it was the expansionary fiscal stance[13] of the government (see **Figure 4.16**) coupled with a shortfall in external financing that caused high budgetary borrowings from the central bank.

Figure 4.16: Exceptional Rise in Government Borrowings

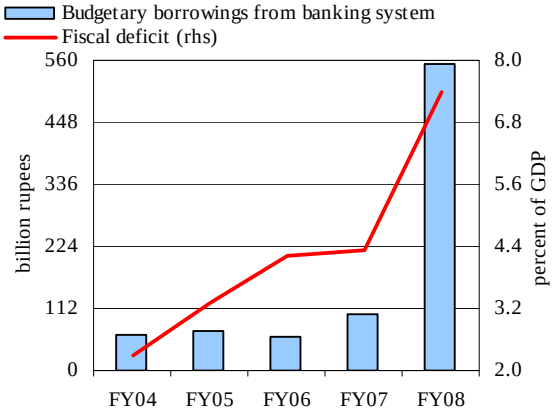
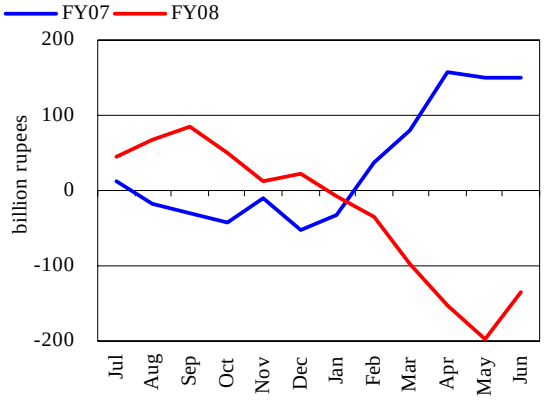


Figure 4.17: Government Borrowings from Scheduled Banks

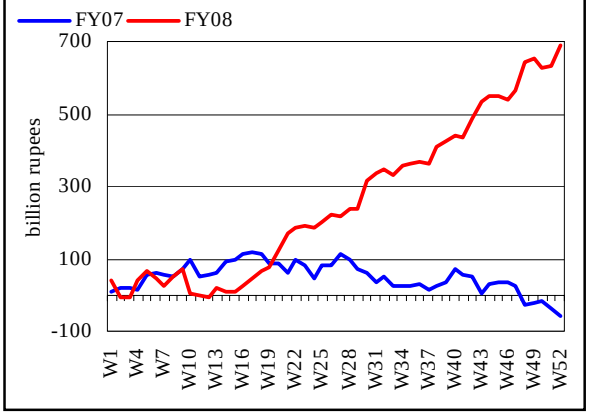


This heavy reliance on central bank borrowing is partly an outcome of scheduled banks' diminishing interest in government papers. The reluctance of banks to invest in government papers was mainly due to the fact that banks (a) were expecting higher interest rates on government papers in view of large financing needs of the government; (see section on **Money Market**) and (b) were already getting higher returns on credit extended to private sector. Thus, government was unable to mobilize substantial amounts in

[13] The widening fiscal deficit was mainly on account of government decision to delay the pass on the impact of rising international oil prices to domestic consumers and underestimation of current expenses.

treasury auctions, resulting into a net retirement of government debt to commercial banks (see **Figure 4.17**).

Figure 4.18: Cumulative Budgetary Borrowings from SBP



Thus, borrowings from the central bank increased sharply particularly after October 2007 (see **Figure 4.18**). Accordingly, the stock of outstanding Market Related Treasury Bills (MRTBs), an instrument through which government borrows from SBP on tap for replenishment, reached Rs 1,053 billion by end June 2008; more than double against the last year's level of Rs452.1 billion. It is worth mentioning that the creation of MRTBs entails minimal cost to the government since the interest paid on these T-bills is transferred back in the form of SBP's profits. Such high reliance on central bank borrowings has adverse implications for macroeconomy in general and monetary policy in particular. For example, (a) the liquidity injections due to borrowings made monetary management[14] more difficult as these diluted the effectiveness of the monetary policy by adding to overall demand in the economy and contributing to inflationary pressures, and (b) the spur in demand due to rising government expenditures also lead to severe burden on external account. (c) since the central bank borrowings are short term in nature, these adversely affect the maturity profile of the domestic public debt, etc (see **Box 4.1** for details).

Box 4.1: Implications of High Fiscal Deficit for Monetary Policy

High fiscal deficit has the ability to erode the effectiveness of monetary policy to control inflation. Not only the level but also the financing of budget deficit has implications for price stability. High absolute level of budget deficit has the potential to increase the general price level if more taxes are levied to bridge the resource gap while the financing from the domestic and international markets may directly impact the interest rate and money supply; thus, diluting the impact of monetary policy. Indirectly, high fiscal deficit may also lead to inflationary expectations – bringing inertia to the inflation levels. The key channels through which high fiscal deficits impact the monetary policy include:

1) Inflationary financing of government expenditures: A change in the fiscal deficit directly affects the stock of interest bearing government papers or/and the money supply required to finance this deficit. In the presence of a well established credit/debt market, the size of fiscal deficit might not directly impact the stock of money in the economy; but in countries with the absence of/underdeveloped markets, the government might require the central bank to monetize these deficits. In a rising inflation scenario, this may further add to the inflationary spiral in the economy by acting as a catalyst to the aggregate demand.

2) The stock of debt and the effectiveness of monetary policy: High fiscal deficits might raise the real interest rates in the economy over and above the GDP growth rate. A contractionary monetary policy to reduce inflation in this scenario can have even an opposing impact of actually increasing the price level. Given the level of fiscal deficit in an economy, a deceleration in the stock of money to reduce inflationary pressures will tend to increase the amount of government debt relative to the size of GDP. In this case, with bond finance replacing monetary finance, this will further raise the interest costs and the size of future fiscal deficit to the GDP, thus requiring more monetary growth in future.

3) Time inconsistency and public debt repudiation:

Repudiation (or denial) on the part of government to pay the public debt can take place if more taxes are levied to pay the existing debt or increase the general price level (results in low real stock of debt). Increase in taxes is considered to be inefficient due to the dead weight losses while decrease in real stock of debt by increasing inflation is an efficient way for the government to repudiate. If the central bank compromises on inflation to facilitate fiscal authorities, the real stock of government debt will go down but it will lead to dynamic time inconsistency problem for the central bank. The economic agents in the next period will anticipate that the central bank can deviate from the inflation target to facilitate government

[14] Although, during February 1 – May 22, SBP managed to keep the overnight rate in a desirable range on average, its volatility increased considerably as reflected from a significant rise in its coefficient of variation from 9.3 percent 16.4 percent.

and will incorporate these high expectations in their decisions making. Thus, the cost of this repudiation will transfer from the government to the central bank; hurting its credibility to fight inflation.

4) Indirect taxes and the price levels: To finance its fiscal deficits, the government might resort to increase indirect taxes that will directly translate into higher price levels. Specifically, one-off increase in these taxes will lead to the wage-price spiral and will contribute to high inflation and the inflationary expectations.

5) Fiscal deficits and the changes in inflationary expectations: Expectations of the economic agents regarding high fiscal deficits, stock of the existing government debt and resulting increase in the government sector borrowings might trigger a lack of confidence in the economic prospects of the country. These expectations; if translated to bonds and foreign exchange market, may lead to a credibility and capability crisis for the central bank's monetary policy.

It was in this context that SBP has recommended net retirement of Rs 84 billion for FY09 with quarterly retirement of Rs 21 billion. At the same time, SBP has urged the government to phase out its dependence on SBP borrowings over a period incorporating provisions in the Fiscal Responsibility and Debt Limitation Act, 2005.

The growth in the credit to the PSEs also increased sharply during most of FY08 mainly due to delays in settlement of oil price differential[15] claims of one public sector oil marketing company (OMC), and the credit extension to the electricity distribution companies. However, outstanding credit to PSEs abruptly dropped towards the end of June 2008 following the payment of OMC's claim by the government (see **Figure 4.19**). It may be pointed out that settlement of OMC claims coincides with a sharp rise in budgetary borrowings from the central bank.

Figure 4.19: Stock of Credit to PSEs

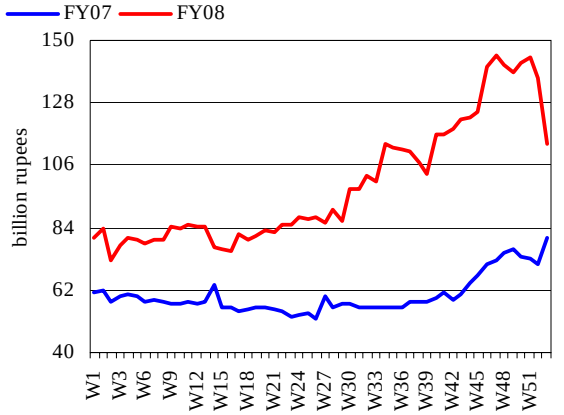


Figure 4.20: Private Sector Credit (Cumulative Growth)

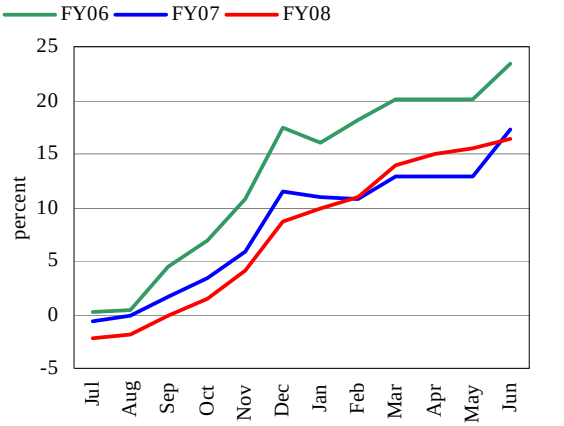
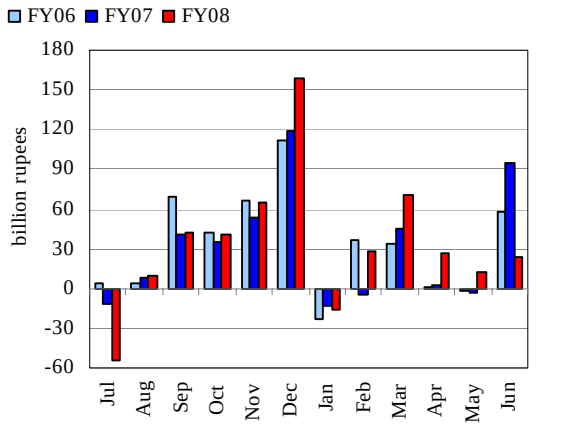


Figure 4.21: Credit to Private Sector (Incremental Flows)



Private Sector Credit (net)[16]

The demand for private sector credit gathered momentum after January 2008 and posted a strong growth of 16.5 percent for FY08 which was slightly lower than 17.3 percent rise

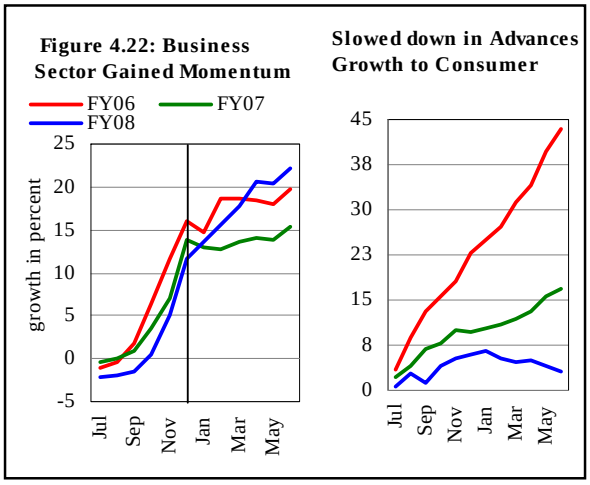
[15] Differential is between the international oil prices and the domestic consumer prices.
[16] Private sector credit comprises of banks' investments and advances to the corporate sector. The data on private sector credit is based on monetary survey of FY08.

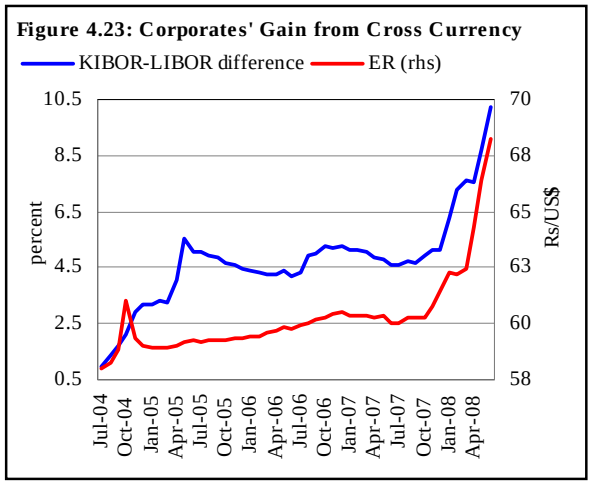
witnessed in the previous year (see **Figure 4.20**). The persistence in credit demand was notable given that

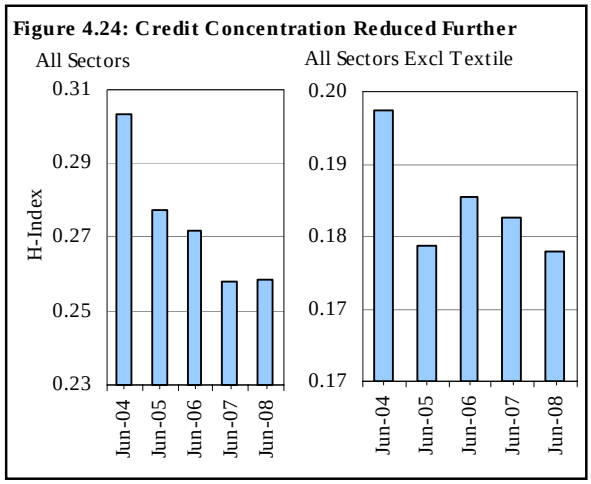
(1) There was an unusual slowdown in credit demand during June 2008. The private sector credit demand generally registers a steep rise in the month of June every year. But the credit expansion during June 2008 was remarkably low at Rs 24.1 billion (see **Figure 4.21**) compared to the average rise of Rs 58.9 billion for the month of June in the preceding five years.[17]

(2) A part of the credit demand was met through non-bank sources. This is evident from growing participation of mutual funds and other non-bank financial institutions in corporate debt papers during FY08. Indeed, a few corporates preferred to issue Sukuk and TFCs to (a) refinance expensive banks' advance, and (b) fund expansion related activities, for example in sectors such as chemical, fertilizer, real estate, shipyard, etc.[18]

(3) The demand for consumer credit has decelerated for the second consecutive year in FY08; in absolute terms increasing by Rs . 11.0 billion in FY08 as compared with Rs. 50.7 billion in FY07(**see Figure 4.22**).





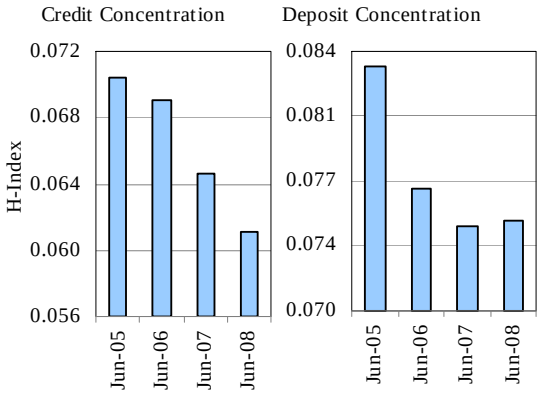


The expected moderation in credit demand did not materialize because of the availability of interest rate risk hedging instruments. Specifically, availability of cross currency swaps, expectations of stable rupee exchange rate and rising domestic interest rate encouraged corporates to substitute their Kibor-based interest rate obligations with Libor-based interest payments (see **Figure 4.23**). As long as the rupee exchange rate remained stable, corporates continued to gain from this derivative transaction to the extent of the difference in Kibor and Libor. As a result, the desirable moderation in the credit demand due to monetary tightening did not materialize.

[17] During Jul-May FY08, the private sector credit rose by 15.5 percent compared to 12.8 percent in the corresponding period of FY07.
[18] The impact of this is also evident from the weaker growth in fixed investment loans in the same period.

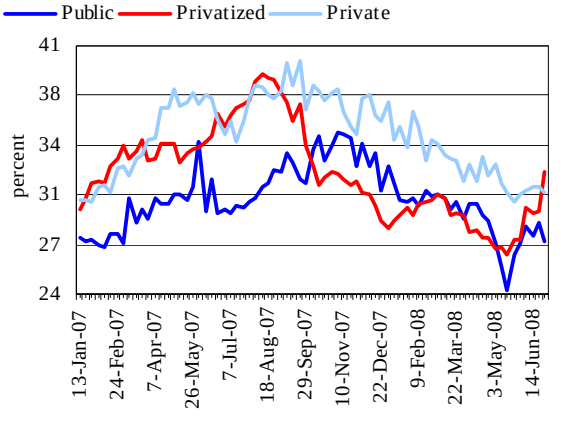
However, the recent sharp depreciation of the rupee against major currencies has not only wiped out the expected gains to corporates from these derivative deals, the expectation of further rupee depreciation is now encouraging corporates to fore-close such deals. Anecdotal evidence suggest that funding requirement for unwinding these transactions is also adding some pressures on credit demand.

Figure 4.25: Herfindahl Index Across Banks



The persistent strong credit demand by the private sector can also be explained by a number of other developments. For example, (1) in a few sectors such as agriculture, textile, edible oil, rice, basic iron & steel, higher input costs were contributing to a rise in credit demand; (2) since the financing need is also correlated with imports, a surge in import demand (particularly of raw cotton due to poor domestic harvest) added to financing requirements of importers; (3) similarly, exporters of cement and chemicals needed more funding to meet their growing export demand; and (4) capacity enhancements in some sectors (such as textile and cement) has also augmented their demand for working capital.

Figure 4.26: Liquidity Ratio of Domestic Banks



More importantly, the credit demand is broad based as more sectors have contributed to credit growth during FY08 compared to the previous year. Specifically, in addition to non-traditional sectors (such as power, cement, construction, commerce & trade), the credit demand from the textile sector (which generally has a relatively large share in overall banks' credit) also strengthened considerably during FY08.[19] The extent of credit diversification is well captured by the Herfindahl index (adjusted for the textile sector credit).[20] The falling index suggests that the credit growth during FY08 is more broad-based (see **Figure 4.24**).

Looking at the supply side, more banks have contributed in credit expansion during FY08. This is evident from a significant decline in bank-wise credit concentration during the period of analysis (see **Figure 4.25**) despite growing recovery issues on account of bad debts and write-off which had contained the lending ability of few banks during the period of analysis.

While the credit demand remained strong, the deposit growth of the banking system slowed down to 13.8 percent in FY08 from 18.7 percent in the preceding year.[21] However, banks' ability to lend aggressively to the private sector remained intact partly due to (a) fall in *effective* cash reserve

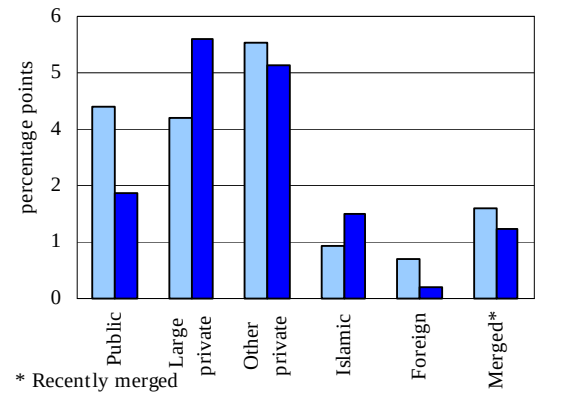
[19] The credit demand from the textile sector during FY08 rose sharply to 17.8 percent from only 0.4 percent in FY07.
[20] Since credit demand from the textile sector was considerably weak during FY07, we can exclude the textile sector for computing Herfindahl index for a more meaningful comparison.
[21] Even this deposit growth was mainly witnessed in the last month of FY08. As a result, average credit to deposit ratio of the banking industry which was 88.5 percent in May-2008 improved to 82.3 percent by June-2008.

requirements;[22] and (b) banks' unwillingness to rollover their investments in government papers. The latter was largely driven by a widening spread between the benchmark return on corporate lending and on government securities.

Nonetheless, a bank-wise analysis shows that the deposit growth during FY08 was concentrated in a few large privatized banks.[23] This is also visible from the Herfindahl index of deposit concentration across banks which remained unchanged from the last years' level (see **Figure 4.25**). This high concentration of deposit mobilization in banks viewed against strong credit demand, suggests that not all banks were equally comfortable in terms of their ability to extend credit.

In overall terms, banks are so far able to meet the strong private sector credit demand. However, the falling liquidity ratio[24] of banking industry points towards the shrinking space to accommodate more credit demand (see **Figure 4.26**). Even as increasing the deposit base is essential, banks would find this task more challenging given the attractive returns offered by the non-bank financial institution and rise in interest rate on national saving schemes.[25]

Figure 4.27: Banks' Contribution in Credit Expansion



Trend in bank-wise credit supply

Within the banking industry, most of the credit expansion in FY08 was seen from large privatized banks (see **Figure 4.27**). Indeed, this was largely due to robust growth in credit extended by one of the large privatized banks, which operated with maximum liquidity comfort throughout FY08.[26] Furthermore, another bank in this group lent aggressively, particularly during the last two months of FY08. This largely reflects the liquidity ease following its acquisition and settlement, by the government, of its advances to a public sector OMC.

Although the lending activities by small private banks gathered pace after March 2008, the contribution of this group in credit growth for FY08 still remained subdued. This was because one of the domestic private banks was going through the process of merger which prevented the entity from aggressive lending during the same period.

The fall in contribution of foreign banks in credit growth largely reflects soaring infected loans particularly in consumer loans category. This is also evident from their rising share of NPLs to advances ratio in FY08. The adverse effects of higher NPLs on foreign banks' lending activity were

[22] The effective CRR is computed after adjusting banks' total demand liabilities with the amount of export finance provided by banks from their own resources.

[23] Besides deposits, to sustain strong credit growth banks can use non-depositary sources; which mainly include banks' equity. In this perspective, the credit to deposit & capital ratio reached 73.6 percent by end Mar-2008 compared with 71.2 percent by end Mar- 2007 thus explain funding sources for credit expansion.

[24] Liquidity ratio is defined as total liquidity maintained by banks divided by the total time and demand liabilities. Effective from May 23, 2008, commercial banks are required to maintain 9 percent CRR on all deposits of upto one-year maturity and SLR of 19 percent of total demand and time liabilities.

[25] The government has increased the return on various NSS instruments in the range 190 to 350 bps effective from June 24, 2008. For instance, return on Defense Savings Certificate – on 10 year maturity – has been increased from 10.15 percent per annum to12.15 percent per annum.

[26] Interestingly, deposit growth during FY08 was also concentrated in privatized banks.

further compounded by a falling demand for consumer loans that generally form a large part of their loan portfolio.

Though the contribution of merged banks in credit growth has declined; their growth still remained strong at 9.6 percent during FY08 compared to 11.9 percent in FY07. The slowdown under this category was primarily due to rising NPLs in one of the recently merged banks. Excluding this bank, the net credit extension from this group increased substantially. Lastly, the lower credit expansion in public sector banks is explained by liquidity constraints as gauged by their falling share in incremental deposits during FY08.

Trend in Sectoral Advances[27]

Advances to the corporate sector, which had seen moderation in the preceding years, gathered momentum in FY08 by registering 21.1 percent growth (see **Figure 4.28**). The growth in advances was concentrated in the category of working loans and trade-related loans. The fixed investment loans on the other hand decelerated during FY08 (see **Figure 4.29**).

Fixed investment loans

Slowdown in fixed investment loans was expected during FY08 as advances under this category had posted a robust growth during the past few years particularly for expansion related activities in cement, construction and textile sectors. The slowdown in demand for fixed investment loans accentuated further due to (1) swap of advances with locally issued debt instruments, and (2) growing interest of private sector in TFCs & Sukuk to finance expansion related activities. Thus the growth in fixed investment loans (net) to the corporate sector fell sharply to 7.8 percent during FY08 from 25.6 percent growth in the previous year (see **Table 4.5**).

Figure 4.28: Private Sector Advances

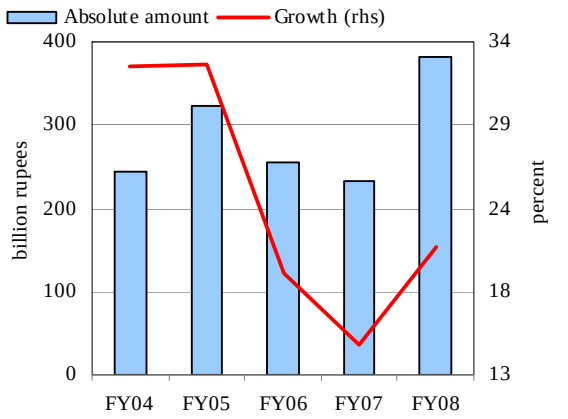


Figure 4.29: Accelerating Demand for Working Capital Loans

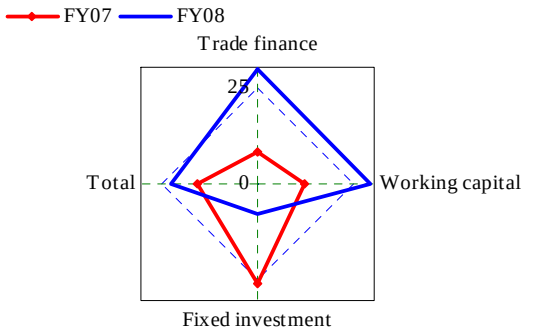
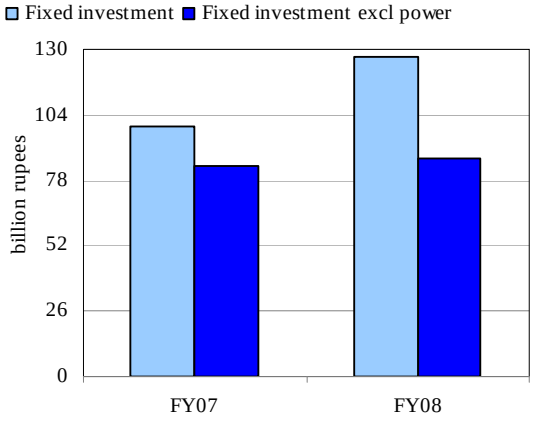


Figure 4.30: Fixed Investment Loans



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

Though disbursements under fixed investment loans recorded a substantial rise, this increase was concentrated in a few sectors. Specifically, after adjusting for advances to power sector, which explained a major part of the increase, disbursements under fixed investment loans increased marginally during FY08 (see **Figure 4.30**).

Working capital loans[28]

Although the moderating industrial activity has eased some pressures on credit demand, the overall demand for working capital loans in FY08 increased due to the rising input costs and a welcome export growth seen in H2-FY08. As a result, working capital loans depicted a robust growth of 29.1 percent in FY08 as compared to 11.4 percent during FY07.

Another prominent feature is the steep rise in working capital loans since January 2008 onwards (see **Figure 4.31**). Indeed, the decline in net credit expansion during the second half of the fiscal year had been a traditional feature of the credit cycle in past few years. This trend was clearly absent in FY08.

A closer look at the sectoral break-up of working capital demand during H2-FY08 reveals that the credit expansion remained broad based. Almost all industries witnessed a double digit credit growth, partly mirroring the inflationary pressures in the economy (see **Table 4.6**). It may be pertinent to note that the net decline in credit demand in H2-FY08 was seen in '*other business activities*', which mainly reflects banks' advances under continuous funding system (CFS) to the equity market, mirroring the setbacks in the local bourse performance in the same period.

A detailed purpose-wise analysis of the working capital loans provides useful insights:

Trade loans

After recording a deceleration for two

Table 4.5: Private Sector Advance

growth in percent

	Working capital		Fixed investment	
	FY07	**FY08**	**FY07**	**FY08**
Business sector	**11.4**	**29.1**	**25.6**	**7.8**
A.Agriculture, hunting and forestry	14.6	24.2	-0.6	-27.0
B.Manufacturing	10.7	26.8	13.1	5.6
a. Textile	-2.0	24.9	6.0	2.1
Spinning of fibers	-9.8	28.8	7.2	-12.4
b. Edible oil & gas	38.1	34.3	-43.4	86.9
c. Rice processing	5.4	39.7	-48.6	-22.8
d. Fertilizer	50.4	18.8	94.2	136.4
e. Cement	61.9	81.6	20.6	-23.3
C. Power	152.1	155.2	100.8	155.1
D. Construction	9.0	65.5	88.3	13.8
E. Commerce & trade	3.5	23.0	78.7	0.8
F. Transport, storage & communications	44.8	40.5	25.2	4.8

Figure 4.31: Unusual Rise in Working Capital Loans (Cumulative Flows)

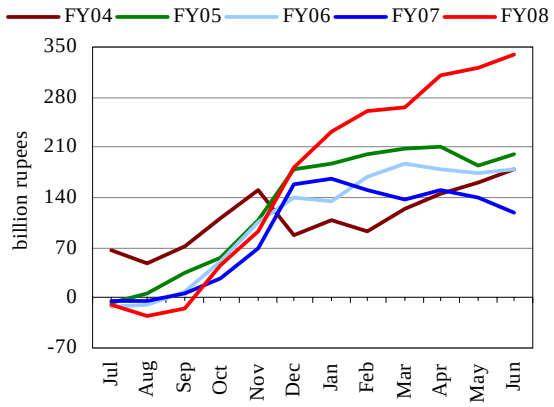


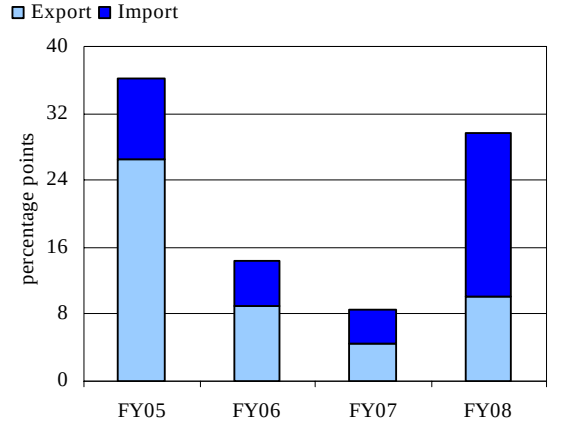
Table 4.6: Growth in Working Capital Loans During H2

	Growth		Contribution in growth	
	FY07	**FY08**	**FY07**	**FY08**
Working capital loans	**-3.2**	**11.7**		
Agriculture	-6.5	7.6	-0.6	0.7
Manufacturing	-4.0	10.2	-2.4	5.9
Power	84.5	67.0	0.8	1.7
Construction	-5.9	29.4	-0.2	0.9
Commerce and trade	-9.0	11.4	-1.5	1.7
Telecom	33.6	38.0	0.6	0.8
Other business activities	9.3	-22.1	0.4	-1.4
Other	-7.6	31.8	-0.4	1.4

[28]Working capital loans also includes trade related loans.

consecutive years, trade related loans depicted a significant growth of 29.7 percent during FY08 (see **Figure 4.32**). This acceleration was led by both import finance and export finance.

Figure 4.32: Contribution in Growth of Trade Finance

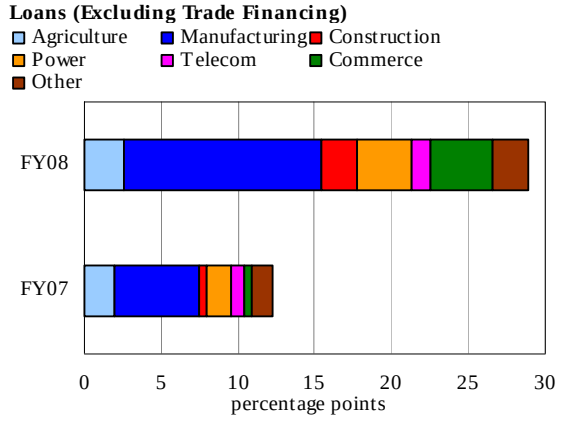


Within the import finance, most of the growth was visible in manufacturing, commerce & trade and power sector. While the growth in commerce & trade sector credit was mainly caused by increase in imports of primary and finished products, the rise in power sector credit demand was principally on account of import of power generation machinery. Most of the trade loans to textile sector were concentrated in cotton largely due to rising international price of raw cotton. Impact of hike in international commodity prices may also be visible in more credit to basic iron and steel industry, edible oil industry and cement sector.

Another important observation in import finance is the sharp decline in demand for foreign currency loans by domestic importers following the upward pressures on exchange rate in the second half of FY08.[29] As a result, FE-25 loans (importers only) witnessed a sharp drop to 1.4 percent during FY08 compared with growth of 92.3 percent in FY07.

Trend in export finance suggests that the loans under EFS recorded a growth of 7.9 percent in FY08 compared with 24.5 percent in FY07. On the other hand, FE-25 export loans registered a robust growth of 9.2 percent during FY08 in contrast to net decline in FY07. Most of the growth under EFS and FE-25 loans was seen in the H2-FY08 which was in line with the acceleration in country's export growth.

Figure 4.33: Contribution in Growth of Working Capital Loans (Excluding Trade Financing)



Other than trade loans

Credit demand from the corporate sector to meet their running expenses registered a robust growth of 28.9 percent during FY08 which is the highest growth in the preceding three years. It is evident from **Figure 4.33** that the net credit growth in FY08 was broad based and was recorded in all sectors. In particular, most of the acceleration was visible in manufacturing , commerce & trade,[30] construction and power sectors.

The advances to manufacturing sector recorded a robust growth of 24.7 percent despite the fact that industrial activity had remained subdued in response to severe energy shortages and weakness in domestic demand throughout FY08. Indeed, the increase in input cost partly explains the rise in

[29] A sharp depreciation of the Rupee in H2-FY08 made foreign currency loans costlier for domestic importers.
[30] Credit demand from the commerce and trade in FY08 was mainly caused by the domestic whole sales.

working capital requirements in few sectors including textile, rice processing, cement,[31] agriculture and construction. Apart from raw material prices, part of the increase in working capital requirements from the textile sector was expected, to an extent, as a result of capacity expansion in recent years.

Further, credit growth in refineries remained strong during FY08. However, it must be noted that the credit demand from this sub-sector mainly reflects the impact of delays in payment from WAPDA to IPPs.

The higher credit growth of 66.2 percent in the construction sector during FY08 was mainly caused by increased financing requirements for residential building related construction activities. Anecdotal evidence suggests a moderating housing demand; however, sharp growth in building material prices probably explains the higher credit demand in this sector. Furthermore, the rising development expenditures also contributed to the growth in credit to construction sector in the period of analysis.

Consumer loans

Growth in consumer loans continued to decelerate for second consecutive year and recorded a modest growth of 3.1 percent during FY08. Similar to FY07, the deceleration in consumer loans in FY08 was partly on account of rising interest rate adversely affecting the demand for consumer credit (see **Figure 4.34**). This deceleration in consumer loans together with a rise in gross NPLs in this category has led to a sharp rise in NPLs to advances ratio. (see **Figure 4.35**).[32]

The deceleration in consumer loans during FY08 was evident in all sub-categories (see **Table 4.7**). Most of the slowdown was visible in the auto finance. More importantly, the volume of auto finance also declined substantially in absolute terms in the same

Figure 4.34: Consumer Loans and Lending Rate

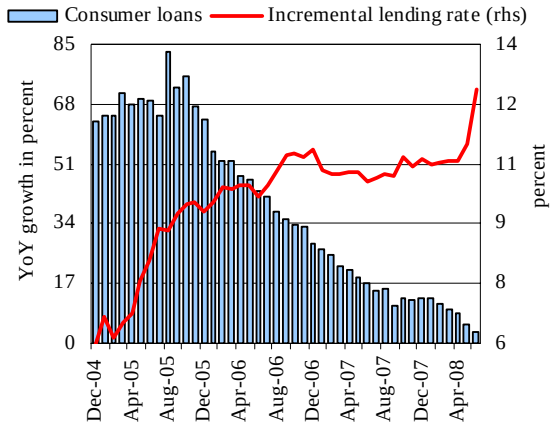


Figure 4.35: NPLs to Loan Ratio in Consumer Finance

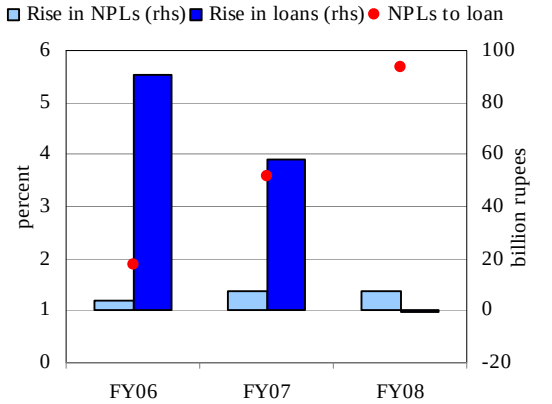
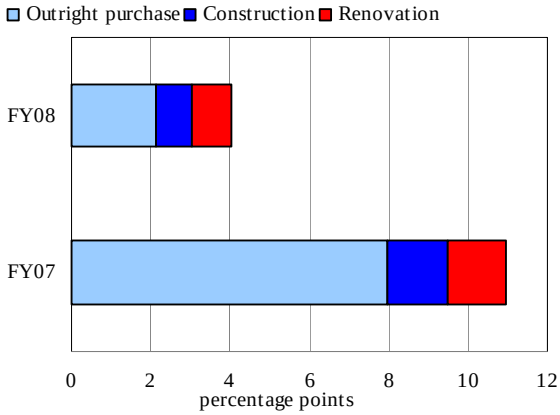


Figure 4.36: Contribution in Mortgage Finance Growth



[31] Although the local demand for cement witnessed slowed down, the growing international demand mainly explained this demand.

[32] It should however be noted that share gross NPLs in consumer loan are 8.9 percent of the overall NPLs of the banking industry (see section on ***Asset Quality***, for further discussion on NPLs).

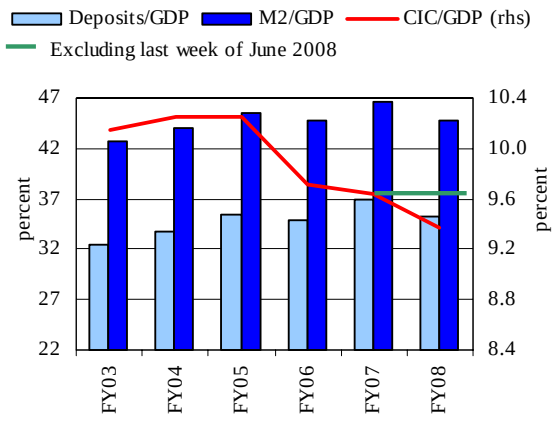
period. In addition to interest cost, increase in price of domestic cars as a result of higher manufacturing costs of automobile industry also moderated the demand for auto finance.[33] In case of mortgage finance, the slowdown was anticipated to an extent, on account of maturing house loans disbursed earlier. The impact of this on mortgage finance is further augmented by a sharp drop in disbursement growth during FY08 (see **Figure 4.36**).

Further analysis of disbursement data suggests that the contribution of outright purchases in mortgage finance slowed down significantly in FY08.

Table 4.7: Growth in Consumer Sector Loans

	Growth		Contribution in growth	
	FY07	**FY08**	**FY07**	**FY08**
Consumer loans	**17.0**	**3.1**		
Mortgage loans	26.5	21.7	3.9	3.4
Auto finance	7.8	-0.4	2.6	-0.1
Credit cards	27.7	3.7	3.1	0.5
Personal loans	18.1	-1.5	7.4	-0.6

Figure 4.37: Monetary Depth

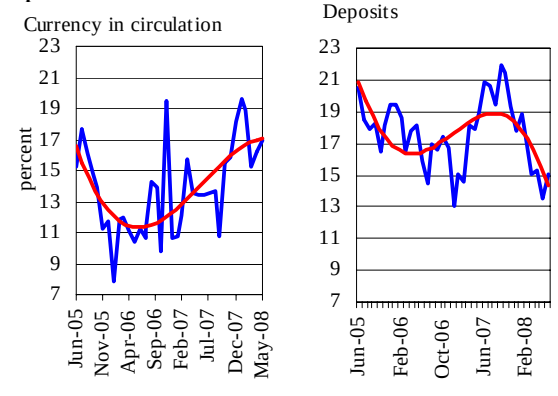


4.3 Monetary and Banking Indicators

4.3.1 Monetary Indicators

Considering M2 as a proxy for the size of the financial sector, M2/GDP ratio provides a broad measure of overall financial depth in an economy. As evident from **Figure 4.37**, this ratio has declined during FY08. A further breakup of this indicator reveals that the usage of both *deposits* and *currency in circulation* (CiC) in overall financial intermediation has fallen (in terms of GDP) during the year.

Figure 4.38: Growth in Currency in Circulation and Deposits



However, this fall in the degree of monetization as well as the change in the components of monetary liabilities should be interpreted carefully as:

1. The ratio increased sharply in FY07 largely due to significant jump in NFA in June 2007 which led to sharp jump in M2 growth for the year – which even exceeded the nominal GDP growth.

2. The fall in the ratio during FY08 also coincides with SBP's continued tight monetary policy and the resulting slowdown in M2 growth. Thus, from monetary policy perspective, a fall in M2/GDP ratio may reflect a reduction in the degree of monetary overhang in the economy.

3. Even the fall in CiC to GDP ratio is misleading as it was mainly driven by the sharp contraction in CiC during the last week of June 2008, probably reflecting payments of OMC claims by the

[33] Manufacturing cost increased on account of appreciation of yen and a substantial increase in aluminum and copper prices.

government during that period. Adjusting for this fall, the CiC/GDP ratio showed a marginal rise (see **Figure 4.37**)

More important for SBP is the qualitative change in the financial intermediation suggested by the substitution within monetary aggregates. Specifically, liquidity preference of economic agents has experienced some adjustments which led to a slowdown in deposit growth and acceleration in CiC growth during FY08 (see **Figure 4.38**). Perhaps the rising inflationary pressures and the growing competition with non-bank financial institutions (such as mutual funds) for saving mobilization led to diminishing role of banks in financial intermediation in relative terms. Consequently, *currency to deposit* ratio increased in FY08 after witnessing a falling trend since FY03 (see **Figure 4.39**).

While banks were facing low demand for deposits, the change in public preference to hold monetary assets in the form of currency has also weakened banks' ability to expand their deposit base during FY08. Indeed during FY08, the *deposit multiplier* measured as bank deposits to bank reserves ratio continued its downtrend (see **Figure 4.39**).[34]

Even though the growth in overall deposits decelerated, the foreign currency deposits became more attractive due to rising expectations of weakening rupee against major currencies. The resulting higher levels of dollarization in the economy are evident from both the rising share of foreign currency deposits (FCD) in total deposits, and in M2 (see **Figure 4.40**). Interestingly, euro has emerged as the preferred currency as people like to hold their savings more in euro denominated deposits.

With slowdown in overall deposit growth and continued strong credit demand, the *credit to deposit* ratio – a crude indicator to show the liquidity comfort with the banks –increased from end Jun-2007 level of 79.6 percent to

Figure 4.39: Liquidity Preference and Deposit Creation

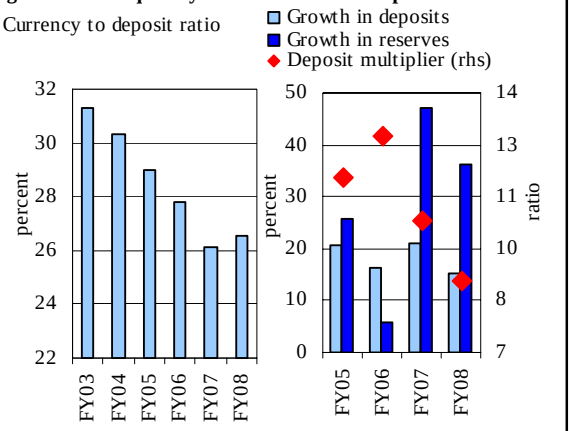


Figure 4.40: Dollarization in the Economy

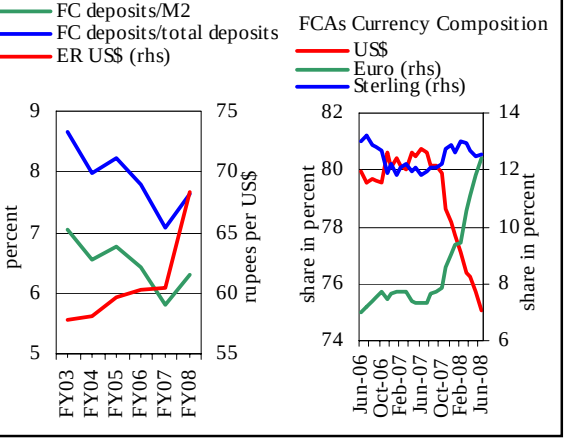
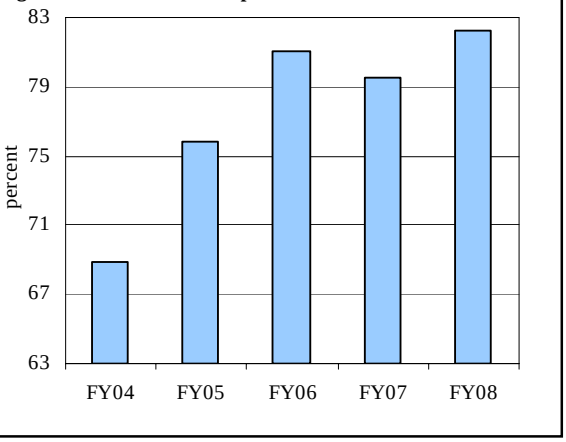
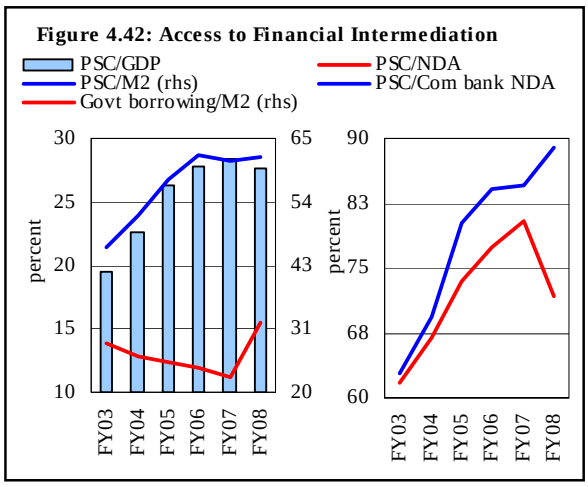


Figure 4.41: Credit to Deposit Ratio



[34] The fall in deposit multiplier was due to both the lower deposit growth as well as SBP's decision to increase cash reserve requirement (by 100 bps effective from February 1, 2008 and another 100 bps from May 23, 2008).

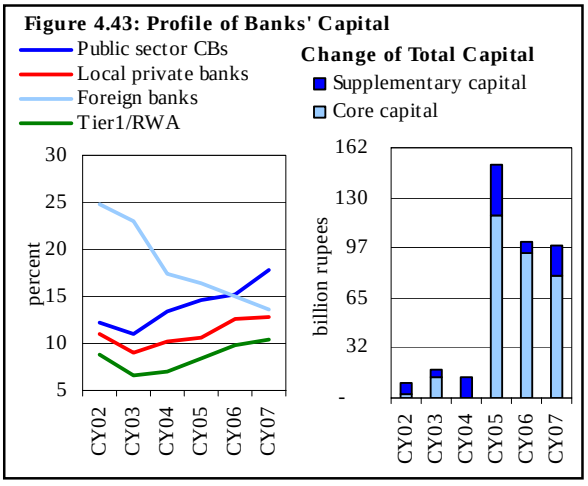
82.3 percent at end Jun-2008 (see **Figure 4.41**). Despite growing liquidity constraints, banks managed to finance the strong credit demand using their cash reserves with SBP and investments. Consequently, both reserve to deposit and investment to deposit ratios fell during FY08. [35]



The strong demand for credit from the private sector has led to rising share of PSC to commercial banks' NDA during FY08. With robust private sector credit demand and exceptionally high borrowing requirement of the government, banks were willing to provide financing to the government only at higher interest rates. Consequently, government resorted to more borrowings from the central bank (the most inflationary source) for financing its deficit. Thus, while the private sector has maintained its share in M2 at its last year's level, the *government borrowing to M2* ratio has increased sharply in FY08 – for the first time since FY03 (see **Figure 4.42**).

4.3.2 Banking Sector Soundness Indicators

Despite strong growth in capital base, a number of financial indicators of domestic banking industry struggled to maintain their pace of high growth set by them in the past. For example, rising interest rate affected the asset quality of banking industry as evident from high NPLs in corporate, SME and consumer sectors. At the same time, the provisioning expenses increased sharply, thereby lowering the profit of banking industry to Rs 73.3 billion from previous year's all time high of Rs 83.9 billion. The rise in provisioning expenses was due to more stringent provisioning requirements followings the withdrawal of benefits from forced sale value (FSV) of collateral while computing provision requirement against NPLs.[36]



Capital to risk weighted assets

The capital of banks that serves as front line defense against unexpected shocks in profitability strengthened further in CY07, recording another high growth of 27.1 percent, as against 38.1 percent witnessed in CY06. More importantly, the rise in the

[35] During FY08, reserve to deposit ratio fell to 9.1 percent from 9.5 percent in the previous year. The investment to deposit ratio declined to 26.8 percent from its previous level of 31.9 percent.

[36] In December 2007, SBP decided to completely withdraw the benefit of FSV collateral in order to make provisioning against NPLs more realistic. Since the amended prudential regulation of FSV has increased the provisioning expenses of banks for their *outstanding* loans, the expense burden grew sharply in CY07; this forced the total expenses to accelerate at twofold the pace of total income. For details, see BSD circular No. 7 of "Amendments in prudential regulations-provisioning for loans and advances" dated October 12, 2007.

capital adequacy ratio (CAR) was attained by increasing the risk base capital, not by decreasing the ratio of risk weighted assets in total assets.[37] Furthermore, despite a rise in minimum capital requirement (MCR), [38] number of banks falling short of MCR has declined during CY07 compared to CY06.

Out of the total increase of Rs 99.1 billion in banks' capital during CY07, the share of core capital was 79.3 percent, compared to 93.3 percent in CY06. This year, a sharp rise was observed in supplementary capital (see **Figure 4.43**) mainly reflecting the effect of fixed assets revaluation.

A comparison with peer countries shows that in a very short time, Pakistan seized position in the group of countries maintaining high capital adequacy ratio (see **Table 4.8**). More encouragingly, a bank-wise analysis shows that out of 36 banks, 28 are well capitalized, maintaining CAR above 10 percent.

Nonetheless, some banks are struggling to maintain their capital base. In CY07 two banks had their CAR falling below 8 percent mark (see **Table 4.9**) due to poor asset quality and low profits. In comparison, in each of the last three years, only one bank was unable to meet 8 percent CAR.

Table 4.8: Capital to Risk Weighted Assets (percent)

	2002	2003	2004	2005	2006	2007
Bangladesh	7.5	8.4	8.8	7.3	8.3	10.0 (Dec)
India	12.0	12.7	12.9	12.8	12.3	12.6 (June)
Pakistan	8.8	8.5	10.5	11.3	12.7	13.3 (June)
Malaysia	13.2	13.8	14.4	13.7	13.5	13.2 (Nov)
Thailand	13.0	13.4	12.4	13.2	13.6	14.6 (Sep)
Indonesia	20.1	22.3	19.4	19.3	21.3	21.3 (Sep)
Korea	11.2	11.1	12.1	13.0	12.8	12.7 (Sep)

Source: Global Financial Stability Report April 2008, IMF

Note: Parentheses represent the months for which 2007 data is available.

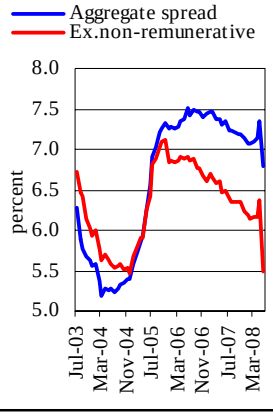
Table 4.9: No. of Banks Maintaining CAR Above 8 Percent Mark

	CY04	CY05	CY06	CY07
Public sector banks	4	4	4	4
Local private banks	25	24	24	24
Foreign banks	6	6	6	6
Sub total	*35*	*34*	*34*	*34*
Total banks in industry	35	35	35	36

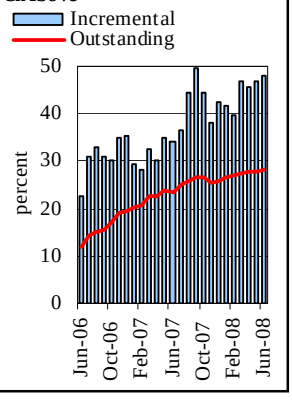
Note: Total no. of banks as per December 2007, specialized banks are not included.

Group wise position of banks is according to current definition

Figure 4.44: Banking Spread



Share of Deposits Mobilized at Eight Percent &Above



Banking Spread

SBP's efforts in the form of (1) time to time moral suasions to banks; (2) incentivizing banks to mobilize longer tenure deposits (through zero rating of CRR on term deposits of over 1 year maturity), and (3) imposition of 5 percent floor on saving deposits[39] played a key role in reducing banking spread[40] to 6.8 percentage points by end-June 2008. During FY08, the return on deposits improved by 120 bps, whereas the rise in lending rate was limited to 63 bps. Consequently, banking spread declined by 57 basis points – the biggest cut in the preceding three years (see **Figure 4.44**). The reduction in

[37] The growth of risk base capital remained 27.1 percent in CY07, whereas the growth of risk weighted assets was 20.2 percent. However, the share of risk weighted assets in total assets increased marginally to 68.1 percent from its last year level of 67.3 percent.

[38] The MCR, which is being raised in a gradual process, will be Rs 6 billion by the end of December 2009, increasing by Rs1 billion each year.

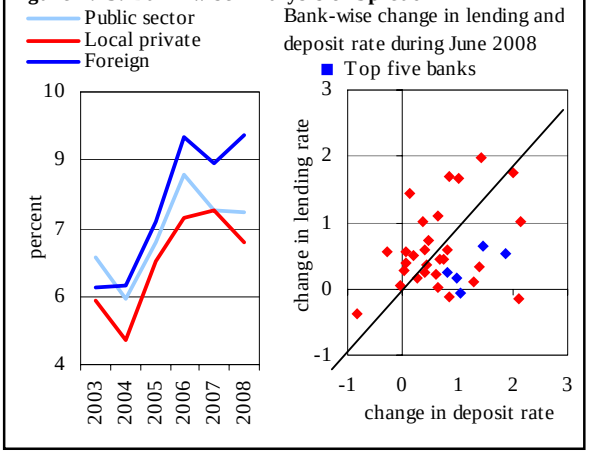
[39] On 23 May 2008, in its Interim Monetary Policy, SBP introduced a minimum profit rate of 5 percent per annum on all categories of saving/PLS saving deposit including any other profit bearing deposit with no fix maturity; this floor had been effective from 1 June 2008.

[40] It is measured by the difference between weighted average lending (WALR) and deposit rates (WADR). It is used to assess efficiency of the banking sector as an indicator.

spread is even more visible (i.e., 102 bps) when we exclude the effect of non-remunerative deposits from the WADR.

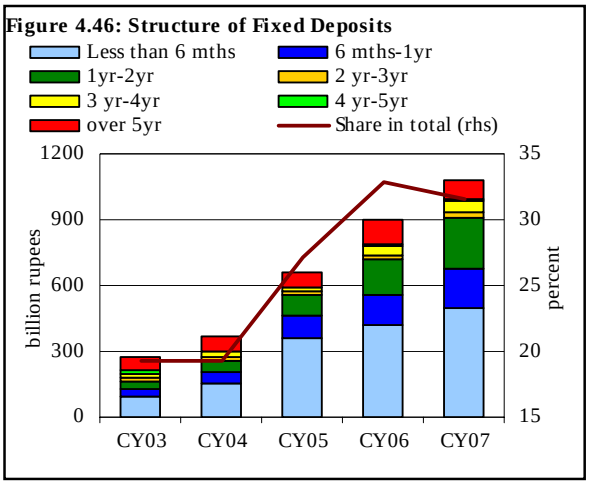
However, the bank-group wise analysis shows that while the local private banks have posted the largest fall in spread, interest margin charged by the foreign banks has actually increased (see **Figure 4.45**). Furthermore, there is a large variance in banks' response to introduction of 5 percent floor on saving deposits.[41] This dispersion may be explained by the share of saving deposits in their total deposits. At the same time, lending rates are also facing upward pressures. Thus, for majority of the banks, the interest rate spread squeezed as the rise in their deposit rates during June 2008 was more than the increase in their lending rates.

Figure 4.45: Bank-wise Analysis of Spread



Undoubtedly, introduction of 5 percent floor on deposits led to a sharp reduction in banking spread in June 2008. Nonetheless, SBP's policies to encourage longer term deposits also helped in improving the maturity profile of deposits. This is evident from the rising share of high yielding deposits in both incremental and outstanding deposits (see **Figure 4.46**). However, the share of fixed deposits in the total has experienced some decline during CY07 (see **Figure 4.46**). The fall is concentrated more in the deposit category of more than 5-year maturity.

Figure 4.46: Structure of Fixed Deposits



The mobilization of longer term deposits has also helped in reducing the maturity gap between assets and liabilities (see **Figure 4.47**).[42] It is expected that convergence in maturity profile of assets and liabilities at different tenures would also result in easing of liquidity constraints for banks.
The banks concentration in deposit mobilization, together with the growing competition for deposits, is compelling banks to offer attractive returns. Furthermore, banks are also facing intense competition from NSS and mutual funds. In this scenario, to attract fresh deposits and to make them compatible with high inflation; banks are bound to pay high returns, which can further put some pressure on spread as well as it may decrease the profits of banks.

[41] While a total of 20 commercial banks experienced narrowing of their spread, 15 banks recorded a rise in their margin.
[42] The maturity gap is measured by the difference between assets and liabilities for a given maturity adjusted by the total assets. Together with maturity gap, the sensitivity of banks' assets and liabilities to interest rate changes provides some sense of the movement in spread due to change in policy rate.

Asset Quality

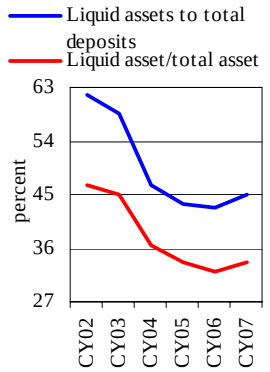
After years of improvements, asset quality of banking industry in CY07 started showing deterioration as the gross NPLs increased by Rs 54 billion with growth of 28.8 percent and reached Rs 241.3 billion (see **Figure 4.48**). The NPLs to advances ratio also weakened compared to previous year. However following the withdrawal of the benefits of forced sale value of the collateral, the provisioning and write-off increased by Rs 38.1 billion. Such stringent provisioning offset the effect of rising NPLs. Indeed, the net position of banking industry strengthened as evident in the improved ratio of Net NPLs to net advances (see **Figure 4.48**).

A further analysis shows that bad loans in corporate, SME and consumer sectors have contributed to the deteriorating asset quality. Of the total rise of Rs 54 billion in gross NPLs, corporate sector is contributing Rs 47.3 billion, mainly coming from high NPL ratios of textile, cement and automobile sectors.

Bad loans in consumer loan category increased by Rs 7.4 billion. The rising NPLs in consumer loans forced a few banks to hold back their lending during FY08 as the volume of consumer loans actually declined during FY08. Two of the local private banks who were active in aggressive lending to consumer sector, are facing high NPLs in auto, mortgage and personal loans.

The bad loans observed in SME depreciated the asset quality of banks mostly in the category of public and local private banks, forcing them to increase their provisioning expenses. The movements in NPLs shows minor increase of Rs 0.9 billion in cash recovery, mostly recorded in top five and in one specialized bank, compared with last fiscal year's Rs 3.3 billion. Moreover, while the volume of upgraded NPLs increased, the write off remained lower than the previous year (see **Figure 4.49**). More worryingly, the total addition in NPLs for FY08 was recorded Rs 130.6 billion quite higher than Rs 82.5 billion in previous year. But the increased level of provisioning not only improved the net position but also the

Figure 4.47: Liquidity Indicators



GAP (Assets-liabilities) as Percent of Total Assets

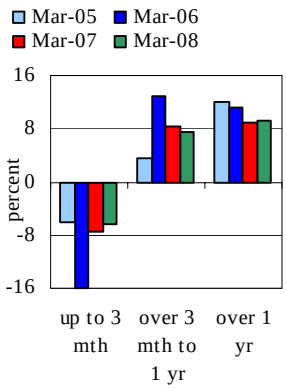


Figure 4.48: Asset Quality of Banks

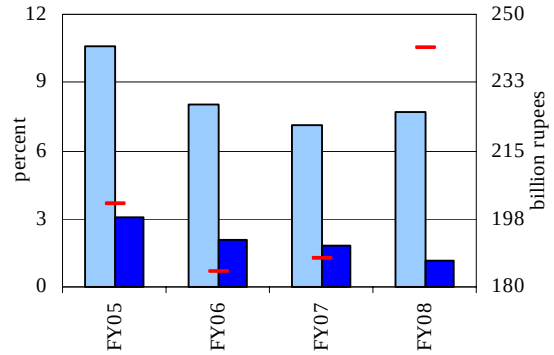
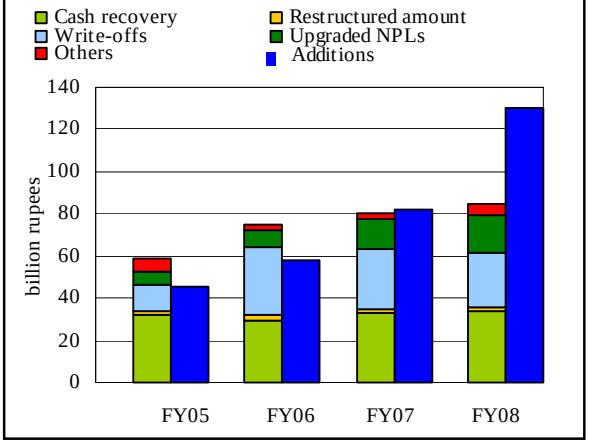


Figure 4.49: Movements in NPLs



coverage ratio[43] of NPLs which increased to 86.2 percent in June 2008 from 76.0 percent in June 2007.

Profitability

The profits of banks support them to cope with unexpected losses without disturbing their capital base. During CY07, banks posted a profit of Rs 73.3 billion, lower than previous year's all time high of Rs 83.9 billion. Even though the growth of total expenses remained lower than the previous year, the slowdown in income growth was far steeper (see **Figure 4.50**) thereby resulting in overall decline in profits of the banking industry.

Figure 4.50: Income and Expenses of Banking Sector

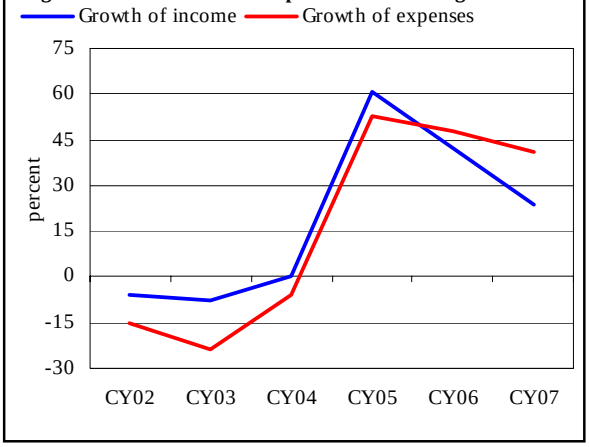


Table 4.10: Selected Indicators of Monetary Conditions

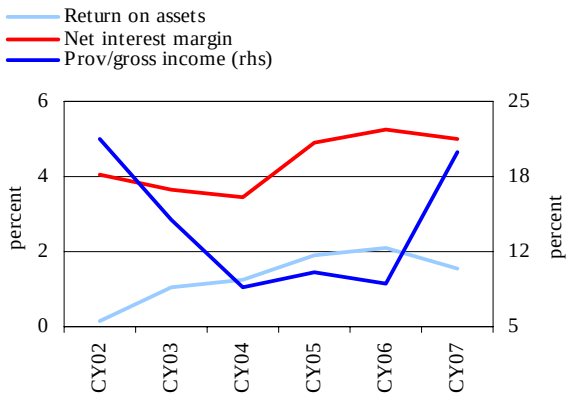
	unit	FY07	FY08
Discount rate (end-June)	percent	9.5	12.0
Cash reserve requirement	percent	7.0	9.0
Effective CRR[1]	percent	6.7	7.5
Statutory liquidity ratio	percent	18.0	19.0
Effective SLR[1]	percent	17.7	18.3
O/N repo rates (WA for June)	percent	7.49	10.86
Kibor (6-month offer rate) end-June	percent	10.02	14.19
Credit to deposit ratio	percent	74.2	88.9
WA interest rate on incremental lending	percent	10.3	12.8
Discounting per visit	billion Rs	9.6	14.5
Absorptions through OMOs	billion Rs	936	1,247
Injections through OMOs	billion Rs	72	232

[1.] After adjusting for banks' lending under EFS.

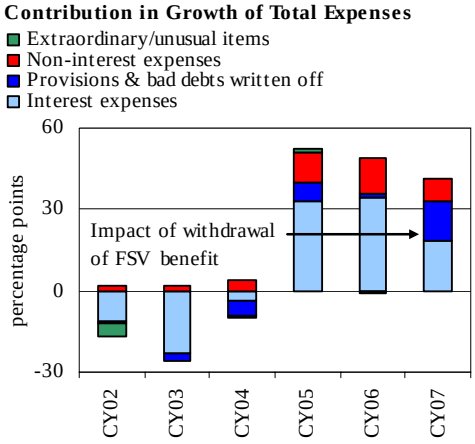
A further analysis of total expenses shows an exceptional rise in provisioning cost following withdrawal of benefits of forced sale value (FSV) (see **Figure 4.51**). The income increased by 23.6 percent in CY07, lower than the previous year's growth of 42.4 percent. Although the return on advances increased, the growth in gross advances slowed down to 11.7 percent in CY07 from 20.6 percent in CY06 which resulted in a decrease in growth of interest income from 45.7 percent in last year to 22.1 percent during CY07.

In contrast, non-interest income increased by 30.3 percent due to high growth in category of 'other income'.[44] Total profit after tax remained Rs 73.3 billion with 1.5 percent return on assets (after tax). But still it is in good shape while comparing

Figure 4.51: Earnings of the Banking Sector



Contribution in Growth of Total Expenses



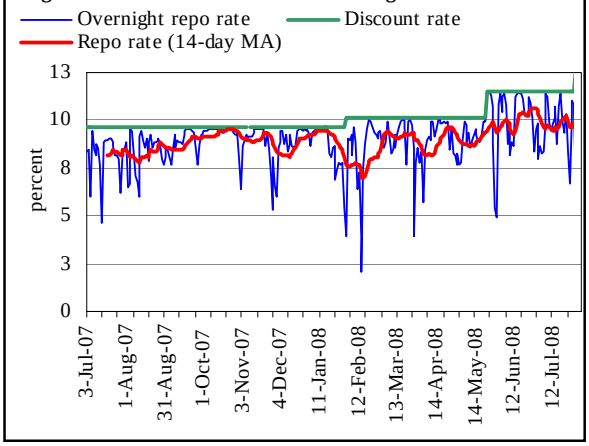
[43] It is the ratio of provisioning to gross NPLs that depicts the ability of banks to recover their bad loans with the help of their prudent provisioning.

with peer countries.

4.4 Money Market

Recognizing the need to reduce excess demand and the resulting inflationary pressure in the economy, SBP continued to drain excess rupee liquidity from the inter-bank market and kept the overnight repo rates close to the discount rate. As evident from **Table 4.10**, the liquidity conditions in the inter-bank became more restrictive in FY08 as a result of SBP's monetary management.

Figure 4.52: Movement in the Overnight Rates

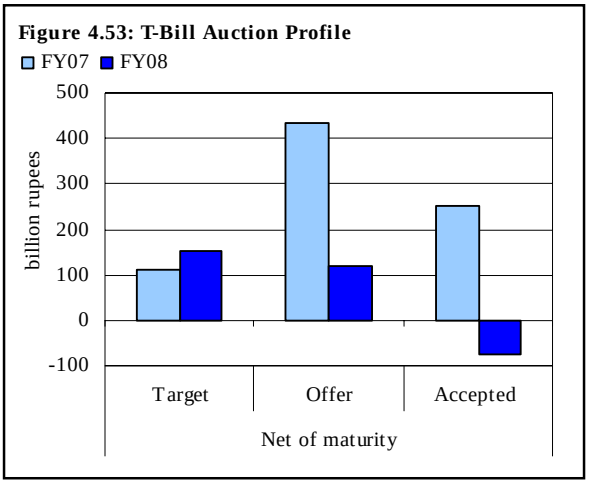


The task of liquidity management however remained quite challenging for SBP. On the one hand, sharp contraction in the net foreign assets (NFA) of the banking system drained out substantial liquidity from the money market. On the other hand, there were sizeable and unpredictable Rupee injections in the inter-bank money market as a result of excessive rise in government borrowings from the central bank. Consequently, the overnight repo rates remained volatile particularly after September 2007 as the government borrowings from the central bank picked up (see **Figure 4.52**). This even diluted the effect of tight monetary policy as the key interest rates started softening.

While the sharp rise in government borrowings was on account of large fiscal slippages, the shift on central bank financing was probably triggered by a very low participation of the scheduled banks in the auction of the government papers. This behavior was in contrast to trends during FY07 when the scheduled banks were investing heavily in the government papers due to ample liquidity in the money market and the expectations that the policy rate in the economy has peaked out.

Indeed, banks were bidding for higher cut-off rates in T-bill auctions because (1) the demand for financing from the government was extraordinarily high, (2) banks were already getting better return on their advances to the private sector, (3) market liquidity came under some stress due to slowdown in deposit growth as well as drains caused by payment pressures on external account. Even though SBP increased the cut-off rates in the T-bill auctions, these were still not aligned with market demands. As a result, scheduled banks were reluctant to invest in government papers.

Figure 4.53: T-Bill Auction Profile



This investment behavior by the scheduled banks had following implications: (1) SBP was not able to rollover the maturities coming

[44] Other income consists of the earnings from the rent or the sale of property/equipment.

from investments in the government papers;[45] (2) government borrowings from SBP increased significantly (see **Figure 4.53**). It was only after the SBP's decision to increase the discount rate and reserve requirements towards the end of FY08, when the scheduled banks started to invest in government papers to meet their new SLR requirements[46].

Table 4.11: PIB Auction Profile

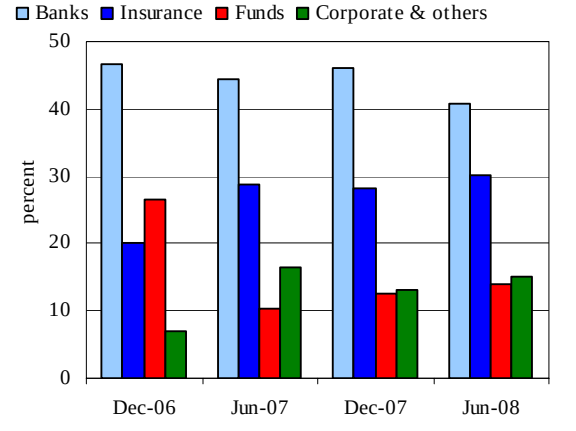
Tenor	FY07			FY08		
	Issued	Matured	Excess/ Deficit	Issued	Matured	Excess/ Deficit
3-Years	10.88	14.53	-3.65	4.9525	0.1	4.8525
5-Years	10.18	24.68	-14.5	10.7769	14.369	-3.5921
10-Years	30.21	-	30.21	23.0377	-	23.0377
15-Years	9.25	-	9.25	7.8006	-	7.8006
20-Years	11.25	-	11.25	7.85	-	7.85
30-Years	16.1	-	16.1	14.4	-	14.4
Total	**87.87**	**39.21**	**48.66**	**68.8177**	**14.469**	**54.3487**

Pakistan Investment Bonds

Developing domestic bond market has become a priority area in developing world. In fact, it is an answer to mitigate currency and maturity mismatch risks over the longer run. During FY08, government mobilized Rs 68.8 billion through PIB auctions less than Rs 87.87 billion mobilized during the preceding fiscal year (see **Table 4.11**). Less amount of PIB issuance during FY08 may reflect government's reluctance to lock-in its financing at high interest rates.

Ownership pattern of PIB suggests that along with banks, other sectors are continuously increasing their interest in PIB auctions (see **Figure 4.54**). This trend at one hand depicts non-banking sector's growing confidence on government securities while on the other hand it depicts banking sector's awareness about interest rate risk particularly on long term.

Figure 4.54: Ownership Pattern of PIBs



[45] During FY08, SBP couldn't roll over the maturities of more than Rs. 82.0 billion from T-bill auctions.
[46] SBP increased the discount rate and reserve requirements of the banking system by 150 bps and 100 bps respectively effective from 23rd May 2008.