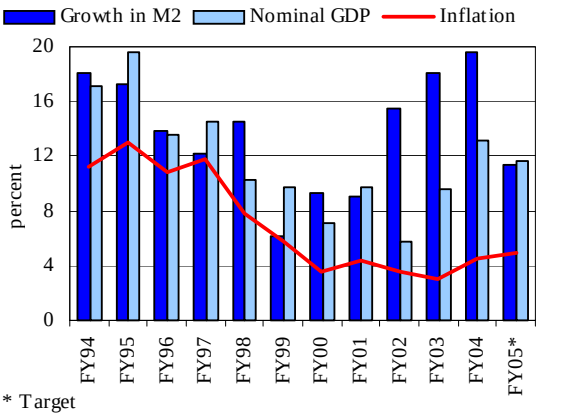
5 Money and Banking

5.1 Monetary Policy

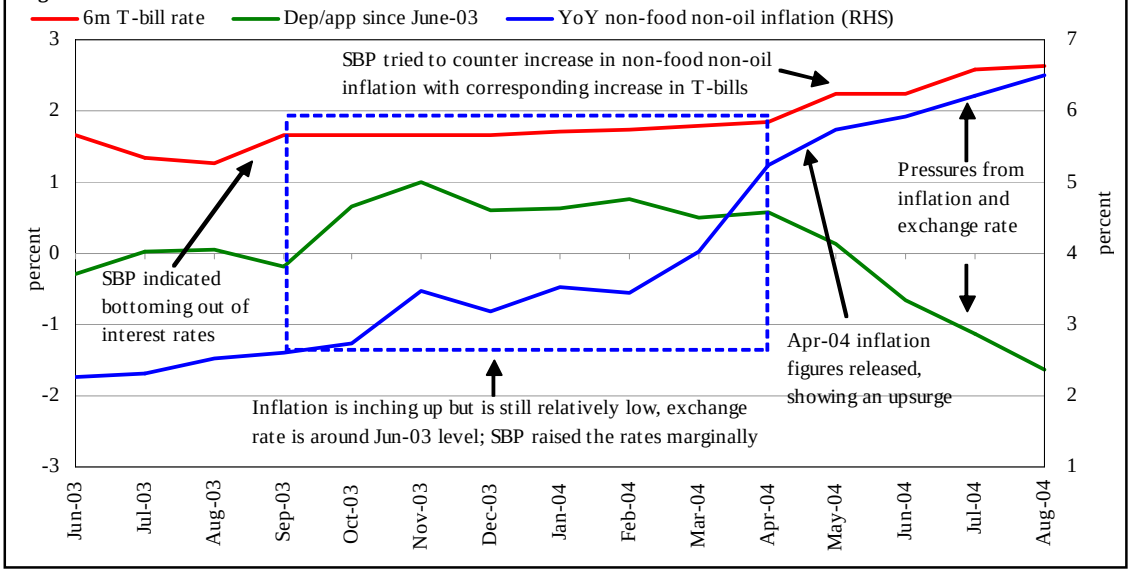
For the third successive year, the growth in monetary assets in FY04 outstripped the rise in nominal GDP. In fact, the 19.6 percent growth in M2 during FY04 was the highest in the last 12 years. This easy monetary stance, adopted to kick start a stagnant economy in absence of fiscal stimulus was successful in inducing a massive increase in aggregate demand leading to increased capacity utilization in the economy, especially in the manufacturing sector, and driving real GDP growth over 6 percent for the first time since FY96. Not surprisingly, however, the very success of this monetary posture also contributed to rising inflationary pressures (see **Figure 5.1**).

Figure 5.1: Money, GDP Growth and Inflation



Thus, FY04 witnessed a gradual shift in monetary policy, as rising inflation became a source of concern. While the SBP signaled the bottoming out of Rupee interest rates as early as August 2003 T-bill auction, it was not too concerned at the *initial* FY04 inflation numbers. This is because most of the inflationary pressures appeared to come from (1) rising food prices and (2) a jump in international oil prices (see **Box 5.1**). In both cases the monetary policy induced pressures were relatively low and thus did not merit a revision in the SBP's monetary posture. However, this relatively benign picture changed significantly by end-Q3-FY04 as it became clear that both inflation and exchange rate pressures were increasing,[1] and therefore the SBP began moving interest rates steadily upwards (see **Figure 5.2**).

Figure 5.2: Movements in Nominal Anchors



[1] Headline as well as (non-food non oil) inflation.

In addition, a few other factors also influenced the country's monetary environment. These include:

1. *Higher government financing needs*

   Despite a fall in the absolute size of the fiscal deficit relative to that in FY03, the government borrowings from the banking system substantially increased during FY04. This was because of a decline in funding from other sources (1) lower '*net*' external economic assistance, (2) the end of the Saudi Oil Facility (SOF), (3) the decline in the net availability of domestic non-bank funding and (4) prepayment of expensive external debt. Market expectations of an increase in banking system borrowings by the government began firming post-October 2003, and were subsequently confirmed in March 2004 by reports of the termination of the Saudi Oil Facility (that had been worth Rs 15.8 billion in H1-FY04).[2] In order to contain these expectations, the SBP rejected most bids in the T-bill auctions during H1-FY04.

   Although the rejection of bids did lead to a rise in the SBP NDA (as it was forced to fund the government requirements), it is instructive to note that the inter-bank market remained relatively stable in January-April 2004 period despite heavy government borrowings.

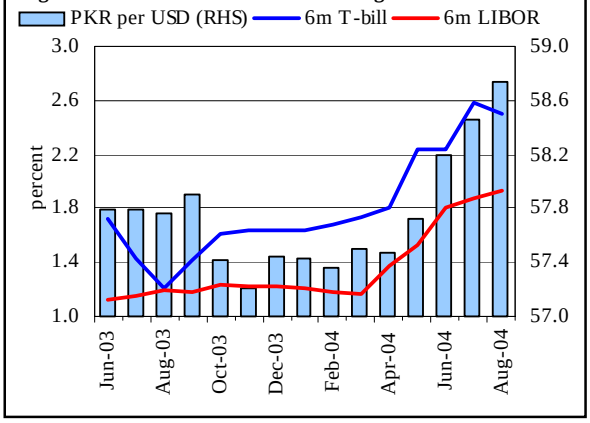
2. *Narrowing external account surplus*

   The visible narrowing of external account surplus due to the declining current account surplus (the trade deficit, in particular, rose sharply in H2-FY04)[3] and pre-payment of external debt brought the domestic currency under pressure. As a result, in a bid to moderate the pace of Rupee depreciation, the SBP gradually reduced its forex purchases from the interbank market during first three quarters of FY04 and subsequently was a net seller in the market. Accordingly, the corresponding net Rupee injections into the interbank market first narrowed and then partially reversed. Not surprisingly, this was an important driver of expectations of a rise in interest rates through most of FY04, and particularly after Q3-FY04.

3. *Rise in international interest rates*[4]

   As the Rupee-US dollar interest rate spread narrowed, and as expectations of a Rupee depreciation took hold there was a shift in domestic borrowings away from US$ loans towards Rupee loans. The resulting drain on US$ liquidity in the inter-bank market pressured the Rupee/US$ exchange rate, and consequently raised pressures for a rise in Rupee interest rates (see **Figure 5.3**). The narrowing interest rate differential significantly impacted the conduct of domestic monetary policy in August

Figure 5.3: Interest Rate and Exchange Rates



[2] Also see **Section 5.1.7**.

[3] While remittance inflows had slowed temporarily in September-November 2004, these rebounded sharply thereafter. Thus, sustained pressure on the current account emerged only in H2-FY04 under the twin shocks of the loss of the SOF and acceleration in imports (especially in the oil bill).

[4] Interest rates in Pakistan had become *relatively* insensitive to international interest rates following the freeze on private forex accounts in May 1998. However, the link between PKR and USD interest rates was strengthened considerably FY01 onwards, following the large jump in the disbursement of USD loans taken by Pakistani traders, and the consequent ability of borrowers to switch from PKR to forex loans to take advantage of interest rate arbitrage opportunities.

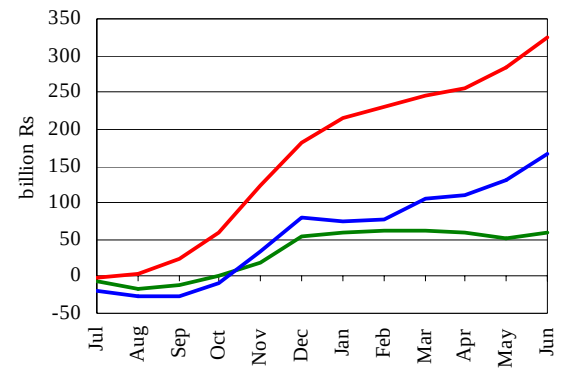
2003 (when a temporary pressure was relieved by a small adjustment in Rupee yields) and then post-March 2004 (when the sustained pressure on the external account led to continued pressure for an upward movement in Rupee interest rates).

The SBP efforts towards meeting the sometimes conflicting objectives of (1) striking the balance between inflation and growth, (2) moderating pressure on the exchange rate while simultaneously containing sharp movements in PKR interest rates, (3) conducting the auctions of government securities, and (4) short-term management of market liquidity probably did, at times, blur the clarity of monetary signals, but these episode were quite temporary. On aggregate, the SBP has consistently indicated its desire to use monetary policy to stimulate economic activity in the country, and its willingness to accept some modest rise in inflationary pressures as a cost for accelerating economic growth.

In the event, the SBP's accommodative monetary stance proved to be extremely successful, with FY04 witnessing a record growth in net private sector credit of Rs 325.2 billion (see **Figure 5.4**).[5] The resulting increase in domestic aggregate demand complemented the rising external demand to spur a broad recovery in the economy (in general) and by large-scale manufacturing, in particular. Thus it seems that expansionary monetary policy pursued for the last few years finally started yielding dividends in FY04.

In addition to the increased credit demand, FY04 also saw a structural shift in the credit cycle. Traditionally, the bulk of the net credit growth during the year was concentrated in the September-December period. These loans were typically short-term (3-6 months) working capital loans, and therefore net credit growth during the second half of a fiscal year often saw a flattening of the net credit growth as loan retirements partially offset fresh disbursements, culminating in the net retirement of credit during the initial months of the succeeding fiscal year.

Figure 5.4: Private Sector Credit (cumulative flows)



This pattern, which is clearly evident in the preceding years, changed substantially towards the end of FY03 and particularly in FY04 (see **Figure 5.4**). Specifically, the growing volume of consumer finance, increasing agri-credit, and the rising private sector participation in commodity procurement meant that much of the lending was no longer concentrated in the second quarter of the fiscal year.[6]

The easy monetary stance of the central bank has also contributed in increasing the access of small scale borrowers to the banking system credit, which is evident in higher number of (individual) borrowers. This was made possible because of persistent low interest rates during the last two years (and negative real rates on small deposits), which diverted the individuals towards banking sector credit utilization instead of savings in terms of deposits (see **Section 5.1.3** for details).

There is also evidence indicating that a significant proportion of the longer tenor private sector credit was on floating rates. This development was also an important factor in determining conservative

[5] To put this in perspective, this was larger than cumulative net credit expansion in the preceding four years.
[6] In fact, the credit extended through credit cards has a sustainable outstanding credit level on roll over basis, not necessarily showing a visible cyclical pattern in monthly data. Moreover, the loans for durables, auto and housing as well as personal loans are of longer maturity in general.

SBP response to the rise in inflationary pressures in H2-FY04. From the central bank's perspective, there was a risk that a more aggressive rise in interest rate may generate larger retrenchment of aggregate demand than seen traditionally, and therefore it was probably desirable to move cautiously so as not to risk the growth momentum of the economy.

This said, it should be noted that the central bank's ability to hold a conservative stance on raising interest rates depends crucially on both, the movements in international interest rates as well relatively subdued growth in domestic inflationary pressures derived from monetary policy.[7] If core inflation (proxied by non-food non oil inflation) accelerates, central banks have to respond, as was evident in Q4-FY04, and the initial months of FY05.

The central bank is likely to continue balancing between the objectives of sustaining the growth momentum, managing the pressures on the exchange rate and containing inflation through FY05, but FY05 monetary policy is unlikely to be as accommodative as in FY04. This is implicit in the SBP's monetary policy statement, which clearly indicates the SBP's concerns over the monetary overhang in the economy, and states that the SBP would only seek to avoid a "significant" weakening of the economy.

5.1.1 Monetary Survey

While monetary expansion witnessed acceleration in FY04, even over the strong growth in the preceding year, there were significant differences in the structure of the growth in the two years. The FY03 monetary expansion of 18.0 percent was almost totally caused by a rise in NFA (due to rising external account surpluses), while the 19.6 percent FY04 monetary expansion was caused principally by a growth in NDA with only a small contribution from NFA growth (see **Table 5.1**).

The major determinant of FY04 NDA growth was an exceptional rise in private sector credit in response to the SBP's easy monetary policy. The impact of this on the NDA of the banking system was further strengthened by a rise in government borrowings from the banking system to finance the fiscal deficit as well as the pre-payment of expensive external debt. In contrast, during FY03, NDA growth had been smaller because the rise in private sector credit had been largely offset by the net retirement of public sector credit. *Other items net* (OIN) of the banking system continued to shrink in FY04 but the decline was much smaller than during FY03

In contrast to the NDA picture, growth in the Net Foreign Assets (NFA) of the banking system was subdued during FY04, since the external account surplus was squeezed on account of prepayment of external debt and increase in the trade deficit.

5.1.2 Credit Plan FY04

The monetary expansion targeted in the FY04 Credit Plan was Rs 230.0 billion, of which Rs 130.0 billion were envisaged to be through the NFA and the rest was through domestic credit creation. However, the eventual outcome saw significant variation in all of the components, including NFA of the banking system. The major reasons behind these variations were:

1. Government borrowings for the pre-payment of Asian Development Bank's debt in January 2004, which were not incorporated in the original budget estimates for FY04.
2. Pakistan's sovereign Eurobond issue in February 2004, which partially reduced the government borrowing from the banking system.
3. Changes in the credit cycle that led to private sector credit growth in H2-FY04, in sharp contrast to the traditional stagnation in net credit off-take during the second half of a fiscal

[7] Please see **Sections 3.1** for additional discussion.

year (the actual FY04 private sector net credit growth during the whole FY04 was more than three times the initial estimate).

Table 5.1: Monetary Survey of the Banking System (Flows)
billion Rupees

	FY03	FY04	FY04
	Actual	Credit plan	Actual
Monetary assets (M2)	**317.4**	**230.0**	**407.9**
percent change	*18.0*	*11.0*	*19.6*
I. Net foreign assets	**308.9**	**130.0**	**43.5**
SBP	328.3		50.5
Scheduled banks	-19.4		-7.0
II. Net domestic assets	**8.4**	**100.0**	**364.3**
percent change	*0.6*	*6.5*	*23.7*
SBP	-228.2		37.5
Scheduled banks	236.7		326.8
A. Government sector	-78.4	10.6	58.1
a) Net bank barrowing for budgetary support	-56.0	15.0	63.7
SBP	-249.2		60.0
Scheduled banks	193.3		3.7
b) Commodity operations	-26.6	-6.0	-8.2
c) Others	4.2	1.6	2.6
B. Non-government sector	148.5	91.0	315.4
a) Credit to private sector	167.7	85.0	325.2
i) Commercial banks	163.2		333.5
of which EFS	*-1.6*		30.0
ii) Specialized banks	4.4		-8.2
b) Credit to PSEs	-11.6	6.0	-2.9
i) Autonomous bodies	-4.8		-21.1
ii) Others	-3.2		21.5
iii) PSEs special debt-repayment account with SBP	-3.6		-3.3
c) Other financial institutions	-7.6		-6.9
C. Other Items (Net)	-61.7	-1.6	-9.2
SBP	28.1		-14.9
Scheduled banks	-89.8		5.7

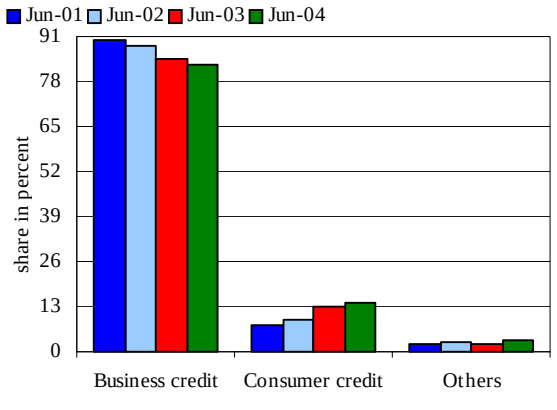
Source: Economic Policy Department, SBP.

As a result, the FY04 monetary growth significantly exceeded the target growth (by 8.6 percentage points), taking the cumulative monetary expansion during the period to Rs 407.9 billion.

5.1.3 Credit to the Private Sector

The decline in interest rates to record lows amidst a considerable increase in deposit growth, particularly in FY03 and FY04, spurred demand for credit by the private sector as corporates tried to restructure their balance sheets, expanded their capacity or utilized it at higher levels and new avenues such as consumer finance and agriculture were explored by the commercial banks.

Figure 5.5: Structure of Scheduled Banks Advances



The impact of these changes is clearly evident in the FY04 private sector net credit off-take. While credit to businesses continues to account for the bulk of the total, over the years

its share has declined gradually (see **Figure 5.5**).

A break up of private sector business credit (scheduled banks) reveals that the bulk is accounted for by the manufacturing sector, which is consistent with the acceleration in the LSM production during the year (see **Table 5.2)**. Moreover, the large share of textile industries within it, is explained not only by the sectors growing working capital requirements (especially due to a large jump in cotton prices) during FY04, but also by the increasing investment in the industry for capacity enhancement as well as BMR under the *Textile Vision 2005* plan (see **Table 5.3**).

Another positive impact of SBP's easy monetary stance, which became increasingly apparent in FY04, is the increasing access of small borrowers to the banking system credit. The commercial banks, which have traditionally catered to businesses needs only, entered into consumer credit market by introducing many financial products especially designed for small borrowers. Not surprisingly, the number of small borrowers increased substantially in FY04.

Consumer Financing

Net consumer credit grew strongly in FY04, rising by Rs 75.6 billion, compared to Rs 48.6 billion in the preceding year. Among the consumer sector, although automobiles and personal loans registered major increase in absolute terms, highest growth was observed in financing for consumer durables during FY04 (see **Figure 5.6**).

These rising consumer loans had a second order effect on demand for corporate loans. As the demand for automobiles and consumer durables (particularly electronic items) increased significantly, the corporates' borrowings also expanded for increasing production in these sectors. This is reflected in robust growth in LSM, especially in automobiles and electronics during FY04.

Trade Related Loans

During much of FY03, traders had preferred to obtain foreign currency loans; not only were

Table 5.2: Distribution of Private Sector Business Credit (scheduled banks)

billion Rupees

	FY04 flow	
	Absolute	**Share**
Overall	234.8	100.0
Agriculture	17.5	7.5
Commerce	31.2	13.3
Services	19.9	8.5
Manufacturing	145.5	61.9
Food & beverages	36.1	24.8
Textiles & textile products	84.3	58.0
Leather & products	3.5	2.4
Non metallic mineral	5.4	3.7
Basic metal industries	3.0	2.1
Machinery	-11.2	-7.7
Automobiles, transport machinery	3.5	2.4
Miscellaneous	20.9	14.4
Others	20.7	8.8

Source: Statistics Department, SBP.

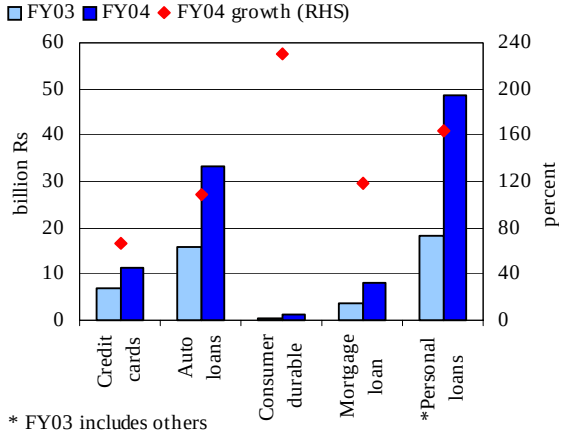
Table 5.3: Investment Finance under Textile Vision 2005

billion Rupees

	FY02	**FY03**	**FY04**
Value added	5.4	7.8	8.9
Stitching	0.5	1.7	1.4
Knitting	1.4	1.1	1.5
Finishing	0.1	0.1	1.3
Knit processing	0.6	0.9	1.4
Woven processing	2.8	4.1	3.4
Traditional sectors	24.5	26.5	27.9
Weaving	0.4	0.2	0.4
Spinning	18.7	14.8	19.4
Polyester fiber	2.9	3.0	0.8
Others	0.0	0.5	2.3
Total	29.9	34.2	36.8

Source: Banking Supervision Department, SBP.

Figure 5.6: Consumer Financing



these loans cheaper than those under the *Export Finance Scheme*, but the effective cost could be further reduced due to the appreciation of the Rupee, and the loans carried a relatively smaller documentation burden. Thus while the stock of the EFS saw little change, the volume of FE-25 loans climbed sharply. However, this scenario changed as the market began anticipating a weakening of Rupee by March 2004.

The resulting shift away from FE-25 loans then strengthened as EFS rates dipped below that of FE-25 loans (see **Figure 5.7**). The impact on FE-25 loans of any rise in expectation of a weaker Rupee is particularly evident during July-October 2003 and March 2004 onwards. As a result, the increase in EFS loans during FY04 was at the expense of FE-25 loans.

Figure 5.7: Trade Related Loans

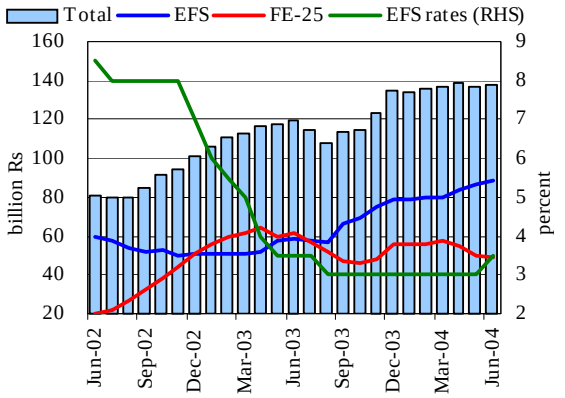


Table 5.4: Share of NDA and NFA in Reserve Money

	FY03	FY04
Reserve money growth		
absolute (billion Rupees)	84.9	103.4
percent	14.5	15.4
Share of NDA		
absolute (billion Rupees)	-243.4	52.9
percent	-286.7	51.2
Share of NFA		
absolute (billion Rupees)	328.3	50.5
percent	386.7	48.9

Source: Economic Policy Department, SBP.

5.1.4 Reserve Money

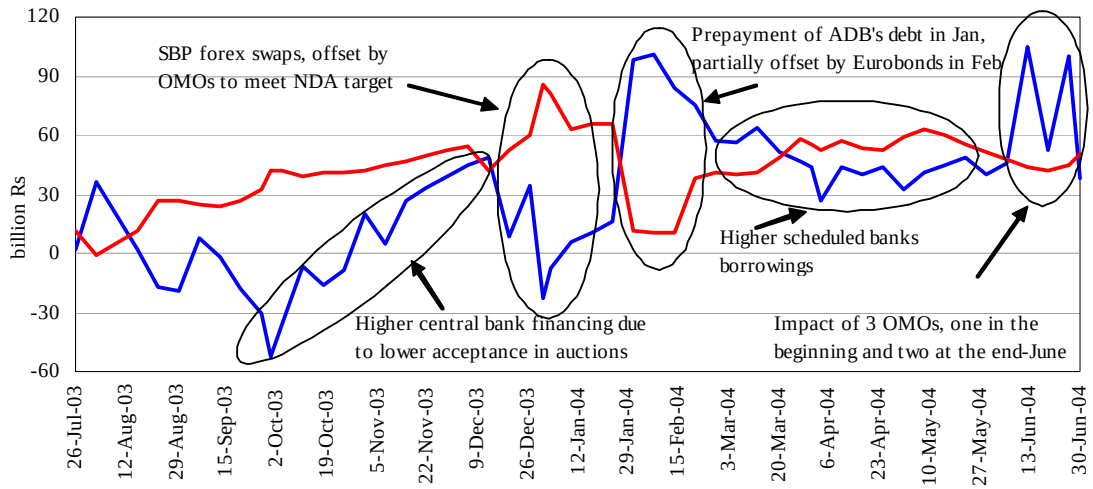
During FY04, reserve money growth witnessed acceleration, rising by 15.4 percent YoY, even over the strong 14.5 percent rise seen in FY03. However, the profile of the growth changed markedly over the two years in tandem with broad money growth (see **Table 5.4**).

The rise in the reserve money in FY03 was driven entirely by the growth in the SBP NFA. This, in turn, was *principally* driven by the SBP's forex purchases as it strove to moderate the appreciation of the Rupee in the face of a substantial external account surpluses;[8] the resulting rise in SBP NFA was only partially sterilized by the retirement of SBP T-bill holdings (lowering SBP NDA) amidst exceptional growth in commercial bank lending to the government.

In contrast, the RM growth during FY04 was almost equally contributed by SBP NFA and NDA (government borrowings from the central bank). While the former was simply a reflection of the decline in the external account surpluses, the latter was driven by the government's increased reliance on bank borrowings to finance the deficit (see **Section 5.1.6** for details) as well as to fund the prepayment of expensive external debt. While the government's increased borrowings could, in theory, have been accommodated from the commercial banks thereby restraining the RM growth, this was unfortunately precluded by prevailing market expectations of a sharp rise in interest rates. As the SBP desired a modest increase in interest rates, it had little option but to temper these expectations by funding the government requirements directly instead of adding to the demand in the interbank market, as is evident from **Figure 5.8**.

[8] Net aid flows to the government also added to the SBP NFA.

Figure 5.8: Movements in SBP NDA and NFA

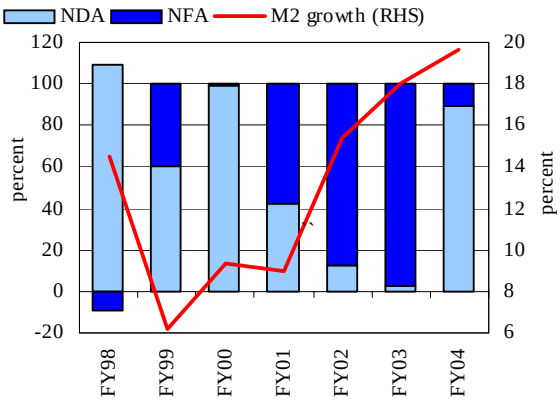


In any case, the increasing central bank lending to the government led to higher than credit plan SBP-NDA and, in fact, this forced the SBP to conduct OMOs during December 2003[9] and June 2004 in order to meet the corresponding limits on the SBP NDA.[10]

5.1.5 Monetary Assets

As explained earlier, the sources of growth in monetary assets varied sharply in the last two fiscal years. While the FY03 monetary expansion of 18.0 percent came from NFA growth, (which offset the *decline* in NDA of the banking system), almost 90.0 percent of the monetary growth in FY04 (19.6 percent YoY) was driven by a rise in the NDA of the banking system (see **Figure 5.9**).

Figure 5.9: Share of NDA and NFA in M2 Growth



5.1.6 Government Borrowings for Budgetary Support

The government's overall budgetary deficit continued to decline during FY04 (both, as a percentage of GDP as well as in absolute terms), but its borrowings from the banking system increased.

Table 5.5: Deficit Financing[1]
billion Rupees

	FY02	FY03	FY04
External	82.8	87.5	15.8
Non-bank	85.0	141.6	73.0
Privatization proceeds	8.4	11.3	11.0
Sub-total	176.2	240.4	99.8
Total financing requirement	**189.1**	**184.6**	**173.9**
Banking system	12.9	-55.9	74.0

Source: Ministry of Finance

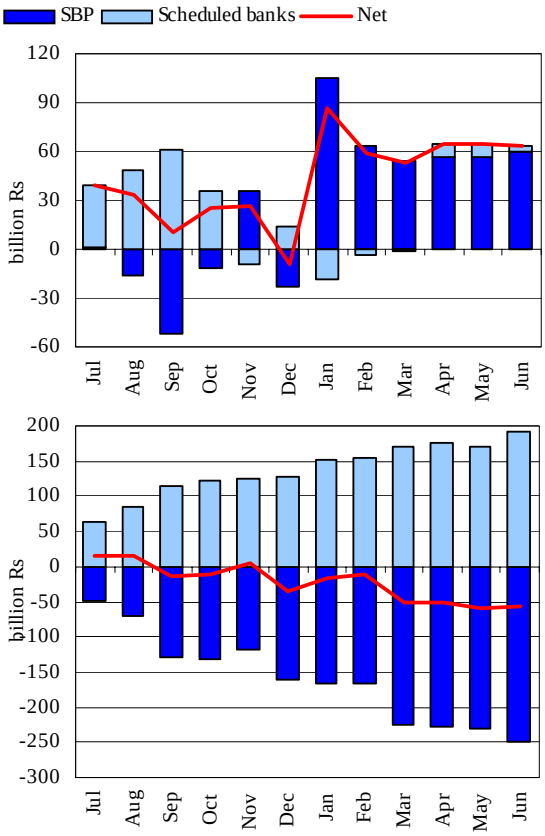
[1] The MoF and SBP numbers may differ slightly due to differences in timings and definitions

This apparent disconnect is explained by a decline in government receipts from external sources (net) as well as from non-bank funding during the year (see **Table 5.5**). In particular, the government needed to borrow Rupee funds in order to pay its expensive forex loans (which was

[9] For details, see ***Second Quarterly Report FY04***.
[10] During the last three days of June 2004, the SBP conducted 2 OMOs, absorbing Rs 62.8 billion in order to meet SBP-NDA target.

not taken into account at the time of the Federal Budget 2003-04). The resulting increase in the government's borrowing requirements from the banking system in FY04 was, in fact, almost entirely met by the central bank in sharp contrast to that in FY03, when the SBP was trying to sterilize the reserve money growth caused by its interbank forex purchases. The extraordinary addition to interbank Rupee liquidity due to SBP forex interventions in FY03 had allowed a massive Rs 193.3 billion government borrowing from the scheduled banks without impacting interest rates, and the effective switching of government debt from the books of the SBP to that of the commercial banks (see **Figure 5.10**).

Figure 5.10: Net Budgetary Borrowings during FY04



One significant development in this respect was the announcement of large PIB auctions by the MoF at various occasions during FY04. The impact of the large auctions significantly complicated the management of monetary policy. While the long term bonds were clearly not used to signal monetary policy, the surprise announcements (in terms of the large size as well as the timings of the issues) did influence the yield curve.

5.1.7 Commodity Operations

The credit demand for commodity operations continued to decline for the forth successive year in FY04. While the Rs 8.2 billion decline during FY04 is lower than Rs 26.6 billion fall seen in FY03, this is simply proportionate to small stock of outstanding loans; the aggregate stock of commodity financing loans has declined from its peak of Rs 107.4 billion in June 2000 to Rs 65.9 billion by the end-June 2004 (see **Figure 5.11**).

Figure 5.11: Commodity Operation Credit (stocks)

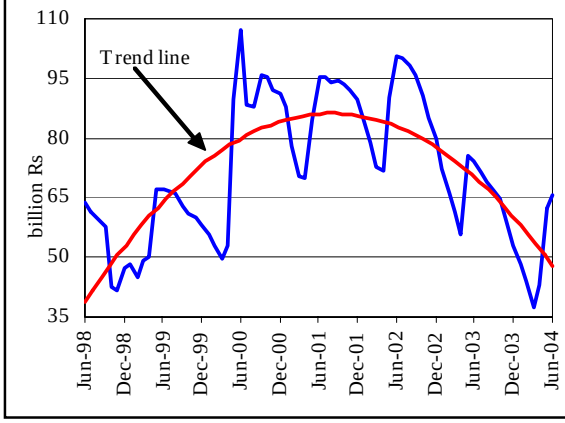


Figure 5.12 shows that commodity operation credit is highly correlated to loans for wheat purchases. Increasing wheat exports and higher private sector participation in the wholesale wheat market explains a decline in the fresh borrowing requirements for commodity operations loans by the government during FY03, which continued in FY04 until March 2004. The subsequent trend reversal probably reflects the government's efforts to aggressively build up wheat reserves through market purchase from the FY04 harvest in order to increase its ability to intervene in the market against speculative pressures.

5.1.8 Monetary Indicators

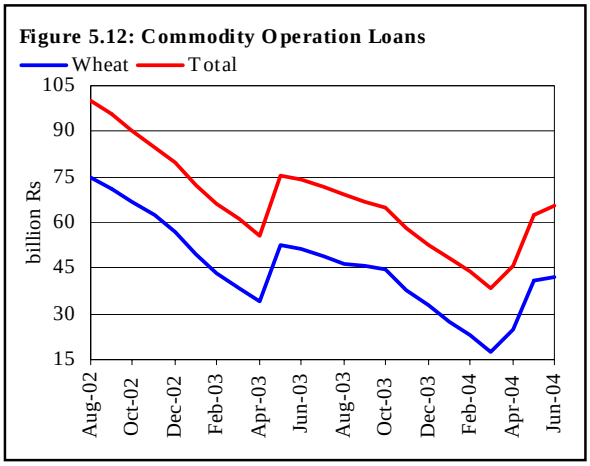


Figure 5.12: Commodity Operation Loans

Currency-Deposit Ratio (CDR)

As mentioned in the ***State Bank of Pakistan Annual Report for 2002-03***, a striking development evident over the last few years is the gradual decline in the *currency to deposit* ratio, which suggests the growing intermediation through the banking system (see **Figure 5.13**).

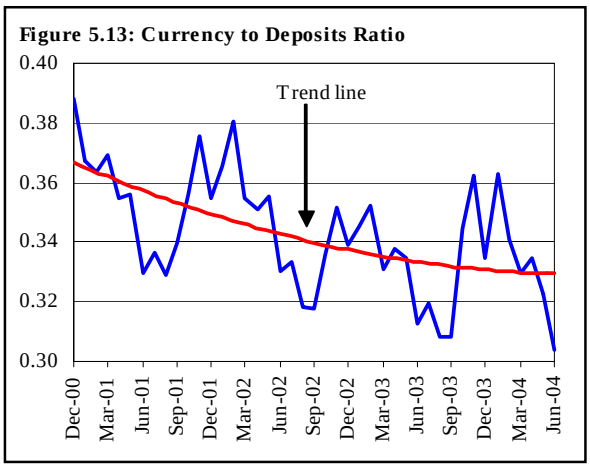


Figure 5.13: Currency to Deposits Ratio

The decline in the CDR appears to reflect the robust deposit growth since FY01, largely due to substantial remittances as well as acceleration in domestic economic activities.[11] Besides financial innovations such as ATM, credit and debit cards, online banking etc. reduced the need for cash holdings. Further, increasing availability of consumer credit enhanced the clientele of banking system resulting in higher intermediation and hence low cash holdings.

This steady decline of the CDR was disturbed in November 2003 and January 2004 by a large rise in currency in circulation, which pushed the ratio to 0.36, up sharply from the preceding months. However, a closer look at the timings of the rise reveals that the unusually strong rises were due to the coincidence of cash withdrawals from banks associated with the Eid and last weekend of the month (when the monetary data for the month is recorded). The hypothesis is supported by the strong reversal in cash holdings during subsequent weeks.

While the absolute volume of currency in circulation reached an all-time high of Rs 587.4 billion by end-May 2004 (which marginally declined by end-June) from Rs 375.4 billion in June 2001, the CDR is declining steadily over the period. This suggests that the strong rise in the currency in circulation (in Rupee terms), is simply proportional to the growth in money supply, and does not indicate an increase in the cash preference in the economy. Moreover, the seasonal fluctuations in CDR are in line with past trends. It is important to note that the CDR at end-June 2004 was 0.30, which is the lowest since September 1999.

M1 to M2 Ratio

The liquidity preference of the economy, as measured by the *M1 to M2* ratio, which had been on the rise since September 2002, rose even sharply during October-November 2003; however, it started declining afterwards.

[11] Data also suggests that banks that are more involved in credit activities were able to mobilize greater deposits as well because borrowers usually place funds with the lending banks.

Given the fact that the CDR was on a steady declining path during FY03, the higher M1/M2 clearly suggests an increasing preference for demand deposits (see **Figure 5.14**).[12] The rise in M1/M2 during October-January FY04 period represents Ramadan and Eid effects; the downtrend afterwards is simply a reversal of the temporary rise in currency in circulation and demand deposits.[13]

NFA to RM Ratio

The backing of high-powered money by hard currency assets (which is visible through the share of NFA in RM) was on the rise during FY03 and reached to its peak by September 2003 (88.3 percent) before slipping down in the following months (see **Figure 5.15**). Up to September 2003, the RM growth was driven entirely by SBP NFA, together with partial sterilization through SBP NDA, which resulted in rise in NFA to RM ratio. The decline afterwards was primarily due to slowing down in the growth of SBP NFA on account of lowering current account surpluses as well as rising capital account deficit.

M2 to GDP Ratio

A welcome development recorded during the last few years is the increasing M2 to GDP ratio (see **Figure 5.16**). The higher monetary expansion during this period (which was principally driven by the acceleration in NFA growth) coupled with low inflation, reflects higher monetization of the economy and suggests increasing financial sector intermediation of economic activities.

5.2 Money Market[14]

During FY04 the thrust of monetary management was towards aligning the market expectations with monetary policy stance. Initially during FY04 when interest rates were under downward pressure, it was important to indicate to the market that the interest rates

Figure 5.14: Liquidity Preferences

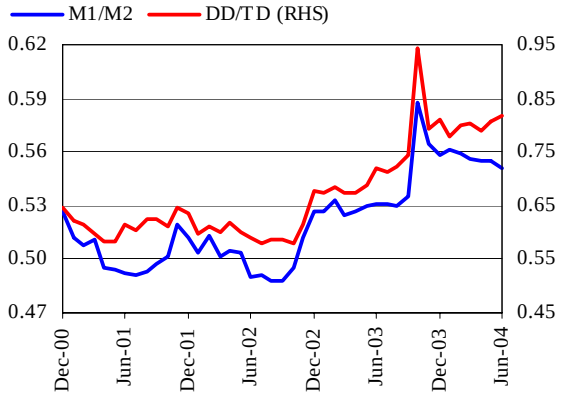


Figure 5.15: NFA to Reserve Money Ratio

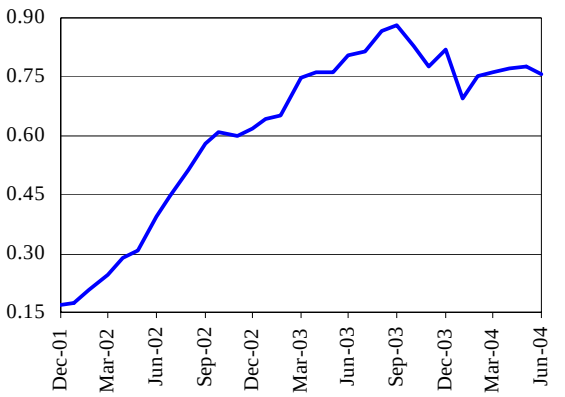
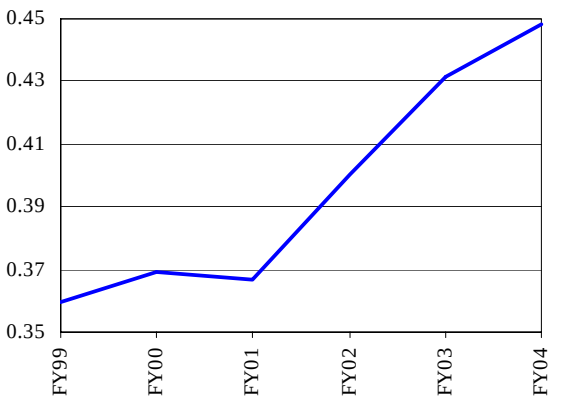


Figure 5.16: M2 to GDP Ratio



[12] The main reasons for this phenomenon appear to be: (1) conversion of resident foreign currency deposits into demand deposits (this was prominent in the H1-FY03 jump in the ratio); and, (2) temporary parking of corporate deposits due to the unwillingness of the institutions to lock-in their funds at the currently prevailing low-returns. As the retirement of forex deposits eased by Mach 2003, the M1 to M2 ratio stabilized during Q4-FY03.

[13] Since the last weekend of October 2003 and 1st Ramadan coincided, the reported data for the month of October shows a massive shift of Rs 102.4 billion from time deposits to either currency in circulation or demand deposits.

[14] Detailed discussion on the Money Market operations can be found in the SBP's new publication: ***The Financial Market Review***. This section gives a brief overview of the money market activity during FY04.

had bottomed out while in the later part of the year, especially towards end, SBP tried to calm the expectations of a sharp rise in the interest rates.

5.2.1 Treasury Bills Auction

Although the acceptance to offer ratio was higher in FY04, the Rs. 515.0 billion accepted in T-bills during FY04 was relatively lower than Rs 642.6 billion realized in FY03 (see **Table 5.6**). It was only in the 3-month tenor that both amount offered and accepted were higher in FY04. In order to contain the market expectations of a sharp rise in interest rates, SBP not only rejected the higher bids but also rejected the entire auctions on two occasions. As most of the rejected bids were in auction for 6-month T-bills, the outstanding stock of these fell sharply during the year.

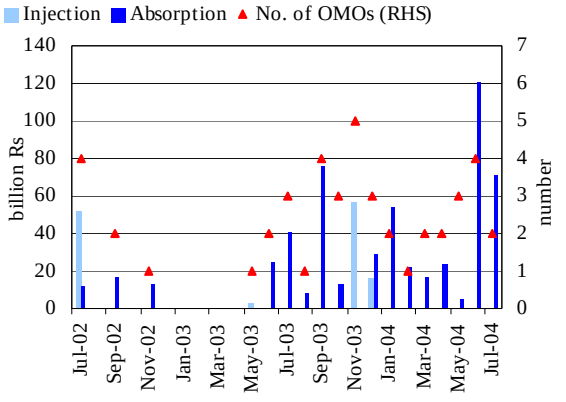
Table 5.6: Treasury bill Auctions Summary (billion Rupees)

Instrument	Year	Amount		Percent
		offered	accepted	accepted
Three-month	FY03	109.1	29.2	26.8
	FY04	216.6	115.6	53.3
Six-month	FY03	747.0	349.0	46.7
	FY04	329.0	158.4	48.2
Twelve-month	FY03	694.9	264.4	38.1
	FY04	476.7	241.0	50.6
Combined	FY03	1,551.0	642.6	41.4
	FY04	1,022.3	515.0	50.4

5.2.2 Open Market Operations (OMOs)

As the central bank was trying to stabilize the interest rates during most of FY04, more frequent interventions were required compared to the previous year.[15] Accordingly, SBP not only made more frequent OMOs but also the amounts injected and absorbed was greater than in FY03 (see **Figure 5.17**). While in net terms, focus of SBP interventions were to mop-up the excess liquidity, SBP also injected Rs 76.6 billion through OMOs during Q2-FY04.

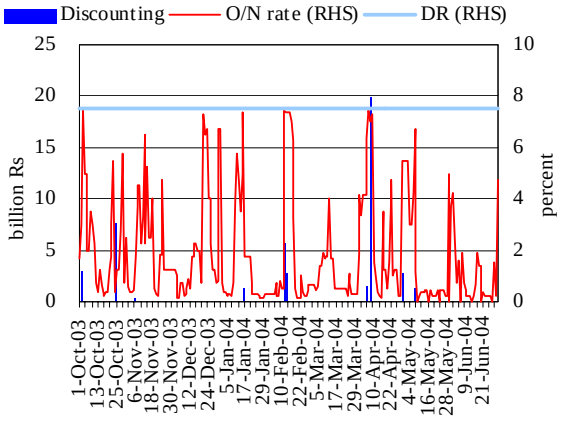
Figure 5.17: Open Market Operations



5.2.3 Overnight Rates and SBP Discount Window

During FY04, the overnight rates remained low and stable compared to the previous year, barring a few occasions when there was seasonal demand of liquidity or when SBP mopped up excess liquidity from the market (see **Figure 5.18**).[16] This is also evident from both lower amount of discounting and number of visits by the banks to the SBP discount window during FY04 as compared to FY03 (see **Table 5.7**).

Figure 5.18: Discounting and Overnight Rates



5.2.4 Pakistan Investment Bonds (PIBs)

In FY04, GoP borrowed Rs 107.7 billion from market as against Rs 74.8 billion in FY03. The important features of PIB auctions in FY04 were firstly the launch of Jumbo Issues and secondly, the issue of 15 and 20 year PIBs, thereby extending the yield curve (see **Table 5.8**).

[15] During FY03, falling interest rates were largely consistent with SBP easy monetary policy.
[16] Especially, when SBP had to meet half-yearly NDA targets.

5.3 Banking System

The tremendous improvement in the banking sector during FY03 was further consolidated during FY04. Bank deposits and credit witnessed strong increases during FY04 on the back of robust economic recovery (see **Table 5.9**). This performance was helped by both, the falling burden of outstanding non-performing loans as well as low increases in fresh NPLs.

Table 5.7: Activities at Discount Window
billion Rupees

	No. of visit to discount window	Total amount of discounting	Average per visit
FY03	60.0	618.7	10.3
FY04	11.0	46.5	4.2

Table 5.8: Pakistan Investment Bonds Auction Summary
billion Rupees

Instrument	Year	Combined target*	Amount offered	Amount accepted	Average yield (%)	Average coupon (%)
Three-year	**FY03**	66.0	26.1	9.7	5.5	8.0
	FY04	90.0	38.5	14.5	4.0	6.0
Five-year	**FY03**	66.0	45.6	14.4	6.5	9.1
	FY04	90.0	58.5	27.8	5.1	7.0
Ten-year	**FY03**	66.0	140.3	50.8	6.8	10.0
	FY04	90.0	93.0	51.6	6.4	8.0
Fifteen-year	**FY03**	-	-	-	-	-
	FY04	36.0	14.3	7.0	8.3	9.0
Twenty-year	**FY03**	-	-	-	-	-
	FY04	36.0	16.6	6.8	9.3	10.0
Combined	**FY03**	66.0	212.0	74.8	-	-
	FY04	126.0	221.0	107.7	-	-

* Targets combined separately for 3, 5 & 10 years and 15 & 20 years.

5.3.1 Credit Expansion

With the surging raw material prices, growing economic activity especially in LSM and international trade, rising consumer loans and agri-finance and finance to SME sector, total credit to the economy grew by 26 percent YoY against 13.3 percent during FY03. Although largest share remained with the corporate sector but in growth terms, consumer sector outpaced other sectors. Certainly, one of the significant factors driving the higher credit demand from the various sectors of the economy were the exceptionally low lending rates.

Table 5.9: Changes in Selected Banking Sector Indicators
billion Rupees

	FY02	FY03	FY04
Deposit mobilization	173.5	275.1	353.4
Net credit expansion	41.7	133.2	297.4
Credit to private sector	32.3	167.7	325.2
Stock of NPLs	11.1	-9.5	1.5
W.A. lending rates (basis points)	-185	-454	-253
W.A. deposit rates (basis points)	-83	-227	-69

Note: Negative sign indicates decline over the previous

Within the banking sector, around 50.0 percent of the credit during FY04 was extended by the big five banks that only had a share of 13.2 percent in FY03. This is because of two reason; (1) in FY03, there were heavy net retirements of public sector loans (especially in commodity operation loans) that were in the books of these banks; and (2) big five banks have entered the business of consumer finance with innovative products and strong marketing campaigns that has increased their share in total consumer financing from 26.0 percent in FY03 to 34.8 percent in FY04. Other domestic commercial banks, with a share of 32.7 percent in total outstanding credit, outpaced other groups by extending Rs 168.5 billion in the economy during the year that constitute around 56.7 percent of the annual credit flow. This is the result of the expansion of their branch network, improved marketing practices and better customer services.

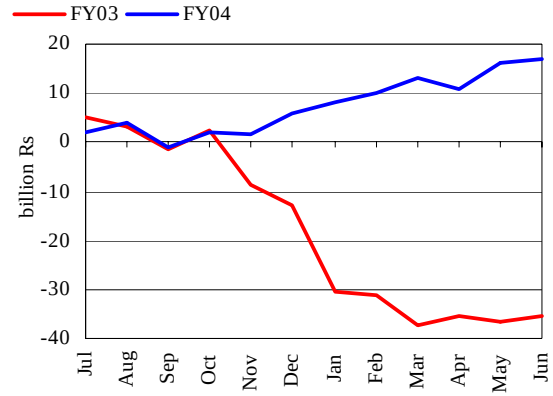
Looking ahead, the supply side of the credit growth looks positive keeping in view the enhanced capital requirements, rising asset prices, prevailing liquidity through deposits, declining burden of NPLs and faster cash recoveries (see **Box 5.2** for details).

On the other hand, the demand side of the credit growth looks relatively imprecise. Since the robust growth of corporate sector credit is partially the upshot of rising consumer loans, it is imperative to see how long the consumer financing can remain attractive. A question arises whether banks will be able to attract customers in future when the interest rates are expected to rise in short to medium term. This is crucial because one of the major factors behind the success and popularity of consumer financing since last two years, has been the low interest rate environment. Mortgage and auto loans are usually sensitive to interest rate hikes and it will be prudent for the banks to extend new loans to borrowers who can absorb the impact of these hikes without any difficulty.

5.3.2 Deposit Mobilization

Despite already high base during FY03 and negative real returns on deposits, banking sector recorded 20.9 percent growth in deposit mobilization during FY04. In fact this is the third consecutive year when there has been a double-digit deposit growth. This impressive performance was driven by continued inflows of workers' remittances and acceleration in domestic economic activities.

Figure 5.19: FCDs (cumulative flows)



Currency Composition

While Rupee deposits continued to dominate the net mobilization during FY04, the distinct feature of deposit mobilization was a trend reversal in foreign currency deposits (FCDs). After registering a decline of Rs 35.0 billion during FY03 as the Rupee appreciated, FCDs increased by Rs 16.8 billion during FY04 (see **Figure 5.19**). The rise in FCDs during FY04 was initially seen in Euro and Sterling deposits (as the US$ was weakening against these currencies) while US dollar deposits continued to decline. However, Q2-FY04 onwards, the US dollar deposits also began rising following the appreciation of the currency against Rupee.

5.3.3 Non-Performing Loans (NPLs)

The distinct features with regard to non-performing loans in FY04 were; (1) lower additions in fresh NPLs; (2) higher write-offs during FY04; and (3) better restructuring/rescheduling of old NPLs. Of these, however, the most encouraging was the lower additions in fresh NPLs despite a robust increase in lending activities of banks.

After adjusting FY02 and FY03 data in the light of changes in the reporting and considering only the domestic operations of the banks (see **Box 5.3** for details), NPLs of commercial banks declined by Rs 7.7 billion in FY04. However, on the whole, for all scheduled banks the NPLs showed an increase of Rs 1.5 billion. This is due to high incidence of NPLs in specialized banks, which comprise around 29.0 percent of the total NPLs. Commercial banks are thus exhibiting continuous improvement in credit assessment as their NPLs show a continuous declining trend (see **Table 5.10**).

This improvement in NPLs growth by commercial banks since the last two years is due to several reasons: (1) low lending rates that positively effected the repayment capacity of the borrowers, (2) higher earnings of the corporate sector that enabled them to service their liabilities, (3) the depreciation of dollar against Rupee that had a positive impact on the repayment capacity of borrowers availing foreign currency loans, (4) better credit appraisal practiced by banks, (5) improved restructuring policies of banks which increased the coordination between bank and the borrowers, (6) better credit culture in the consumer sector as suggested by anecdotal evidence, (7) with CIB, data check and credit rating agencies in place, it is easier for banks to evaluate the borrower in terms of their available credit history.

Table 5.10: NPLs-Domestic Operations and Current Accounting Practices

billion Rupees

	FY02	FY03	FY04
PSCBs	45.2	41.7	42.7
LPBs	100.2	96.2	88.2
FBs	4.0	3.6	2.8
SBs	47.2	45.6	54.8
All Banks	196.6	187.1	188.6
Commercial Banks	149.4	141.5	133.8

Box 5.3: Accounting of Non-performing Loans

Banks in Pakistan till Q1-FY04 were required to report NPLs by summing up both principal and mark-up of the classified asset. This practice, of adding up accrued mark-up in the outstanding NPLs, used to result in a continuous upward movement in NPLs even if every single new loan was serviced completely.

This can be seen through a 27.8 percent share of mark-up in total outstanding NPLs at end September 2003, especially in the case of specialized banks where it is 37.6 percent. In fact this definitional issue had a significant impact in the exceptionally high growth of NPLs in the past, especially in the years when the lending rates were high.

On the other hand, quarterly statement of NPLs only used to cover the assets related to banks' domestic activities. This used to underestimate the exact estimates of NPLs that were required to make adequate provisioning.

Therefore, in order to achieve consistency and uniformity in accounting practices and also to adapt best international practices, SBP issued various guidelines to banks[1]. These include; (a) accrued mark up, both in income account and suspense account, should only be shown under 'other assets" of banks and will not be the part of NPLs, and (b) banks will report NPLs by including their domestic and overseas activities both.

[1] BSD Circular No. 9 dated November 12, 2003

Box 5.1: Cost Push Inflation and Central Banks: A Theoretical Perspective

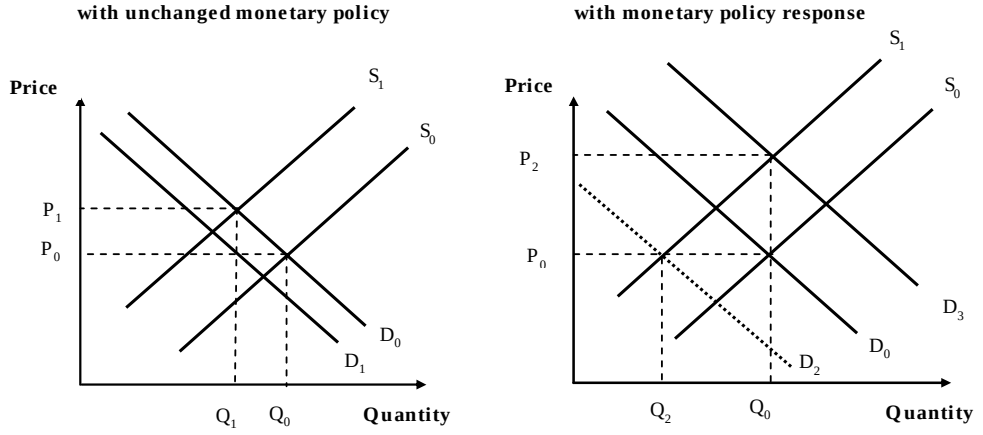
The sharp rise in international oil prices threatened to significantly push up global inflation while simultaneously putting at risk the growth momentum.

This raises the question: should the central banks, which principally manage demand, react in response to a supply side shock? The answer however, is neither simple nor clear-cut. The complication arises due to the outcome of the supply side shock: on one hand, it pushes the inflation rate up; while on the other it dampens the growth (employment). The central banks that typically have dual objectives (of prices stability and economic growth) face a dilemma whether to address inflation or unemployment. There are two major considerations, which may affect the policy response: (1) the seriousness of the price shock and whether it is a temporary or permanent; and (2) the cyclical position of the economy at the time of shock. The theoretical impact of an oil price shock is analyzed here in this background.

An increase in the price of oil (which is an important production input as well as a part of consumers' energy budget) is significant enough to show typically in the headline inflation at least initially. First, in a standard demand-supply diagram (see **Figure 5.1.1**), this will shift the supply curve to S_1 from S_0 and the equilibrium price and quantity to P_1 and Q_1 from P_0 and Q_0 respectively. Second, it may also hit the aggregate demand due to a cut in consumers' spending as their purchasing power is eroded, this is similar to the case when a rise in sales tax on oil is passed on to the consumers; also the extent of decrease in demand would be higher as the income of oil importing country would be transferred to oil producing country, which would squeeze the overall spending of the oil importing country. These factors will shift the aggregate demand curve to D_1 from D_0.

The economy therefore endures simultaneous negative shocks, both in supply and demand. These two shocks will reduce the aggregate output from Q_0 to Q_1. The impact on prices however will be ambiguous. Theoretically it could go up or down, depending on size of the leftward shift in both supply and demand as well as on the slopes of these curves. One can argue that the impact on demand would be higher than supply, and therefore could lead to a deflation (which may require a cut in interest rates); however, this has not happened in the past.[1]

Figure 5.1.1: The Impact of Higher Oil Prices



In this situation, the monetary policy response has a critical role in actual outcome of inflation and unemployment. Assuming the oil price shock is permanent, at one extreme, the central bank could focus exclusively on neutralizing the initial inflationary impact of oil price hike, i.e. by tightening of monetary policy to curtail aggregate demand. This may be effective in controlling inflation but only at the cost of loss of output (and employment). Such an action may shift the demand curve further to left (D_2) at P_0 equilibrium price and Q_2 new output level. On the other extreme, the monetary managers might focus absolutely on demand reducing effects of higher oil prices, and try to stabilize growth. This means, the central bank will opt for an easy monetary policy (that might be complemented by expansionary fiscal policy to further boost the demand). This will shift the demand curve to D_3, bringing the equilibrium output to Q_0 (the initial output level), simultaneously pushing the prices further up to P_2. In fact, during 1970s oil shock, similar policy initiatives were taken by the Fed.

The risk from this policy is that the prices would have risen by full amount implied by the oil shock, and more dangerously could pass through into wage-price competition across the economy. Precisely, the initial oil price rise could probably be taken by the economic agents as a temporary phenomenon however; an expansionary monetary policy at that point of time could generate the expectations of a permanent rise in prices. If this is the case, the economic agents would incorporate increase in prices in their wage contracts, which would push further the cost of production. As a result, the inflationary potential from the initial oil shock would probably be maximized. Once the expectations of rise in inflation have taken the roots, any attempt by the central banks to curtail higher and persistent inflation rate through monetary tightening could lead to a sharp and larger increase in interest rates, which could cause a deeper recession.

Having learnt from the past experiences, the SBP has been monitoring carefully the recent up trend in domestic inflation. The nature of oil price hike seems to be permanent as the recent price increase is largely due to strong demand for oil because of a booming global economy, especially in China and United States. As discussed earlier, this situation requires a tightening of monetary policy. However, given the fact that the economy has just started to grow and probably still has some excess capacity, there is limited danger of building a price-wage-price spiral. It is this perception that has made SBP very cautious about the extent and timing of its monetary tightening. It is important to note that a rise in interest rates does not necessarily imply a tightening of policy in case of cost push inflation, since the central banks typically then need to raise interest rates simply to keep real interest rates steady.

Note: The above discussion is based on the article: The crude art of policymaking, published in June 10th 2004 edition of *The Economist*.

1 See brief article: Response to oil shocks: is the cure worse than the disease?-Business Review (Federal Reserve Bank of Philadelphia) spring, 2002 by Sylrian Leduc and Keith Sill.
Remarks by Governor Edward M. Gramilch at Annual Economic Luncheon, Federal Reserve Bank of Kansas City, Sept 16, 2004

Box 5.2: Credit Supply Looks Positive

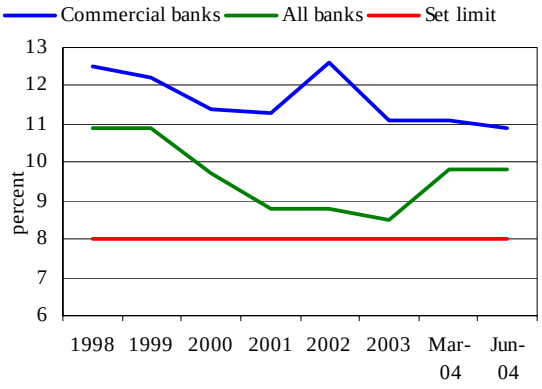
(a) Government borrowings from scheduled banks

In the Credit Plan for FY05, government sector borrowings are set at Rs 47 billion which is significantly lower than actual borrowings of Rs 58.1 billion during FY04. FY05 data till October 02, 2004 shows that within net budgetary borrowings from the banking system, borrowings from SBP have increased substantially, while the scheduled banks are showing net retirements. On the other hand, net credit to private sector during the same period shows no letup, increasing by Rs 64.5 billion against Rs 31.8 billion in FY04. The government's retirement in tandem with increased borrowing by the private sector from schedule banks suggests that central bank is not willing to impede the ongoing momentum of credit growth by creating liquidity shortages in the banking system.

(b) Enhanced capital requirements

Capital adequacy ratio of the banks has declined sharply during last two years due to increase in loan to asset ratio of banks. However, this ratio is still above the required level especially for the commercial banks (see **Figure 5.2.1**). Data also suggests that the banks that are more active in credit expansion have sufficient room to keep on with the current credit growth momentum.

Figure 5.2.1: Capital Adequacy Ratio

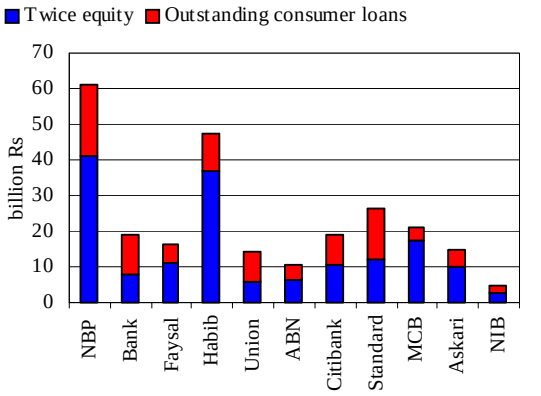


Besides, SBP has increased the minimum paid-up capital requirements for banks from Rs 1 billion to Rs 1.5 billion till end December 2004 and Rs 2 billion till end December 2005. Banks that are currently operating with low capital base now have to make efforts to raise their capital. This increase in capital will provide them a leeway to further increase their risk weighted assets.

(c)Available scope within regulatory framework

Sufficient scope is available for banks to finance the recently explored areas like consumer sector, agriculture and Small and Medium Enterprises (SMEs). In fact, according to SBP regulations, banks can extend their consumer financing activities up to 2 and 4 times of their equity in their first and second year of the business. **Figure 5.2.2** shows that banks that are most active in consumer lending are still far behind this prescribed limit and thus have space to lend more.

Figure 5.2.2: Scope for Consumer Finance



Similarly, for SME finance, no limitation is in place for banks rated AA or above; for the rest, the limit is twice the equity of the bank. For agriculture finance, annual targets are being set by Agriculture Credit Department (ACD) of SBP, which the banks are successfully meeting for the last two years.
Moreover, most of the banks are extending credit beyond the target which shows their willingness to invest in this sector.

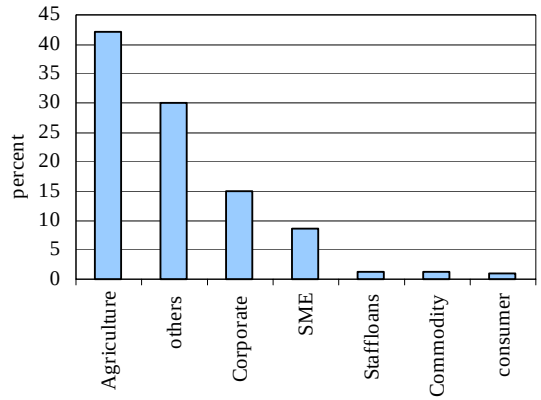
d. Lower NPLs, more cash recoveries

Another comfort that the banks have in meeting the financing requirements of the growing economy is the declining level of stuck up loans (more details to come later). Especially, cash recoveries have been very impressive that added Rs 57.9 billion in the banking system liquidity during last two years, i.e., FY03 and FY04. Further, declining burden of NPLs has also enabled banks to operate with lower spread.

e. Lower NPL ratio in non-traditional sectors

One of the major concerns of banking industry, in providing loans to SME and consumer finance sector, is the absence of information regarding the creditworthiness of the borrowers. However, data shows that the ratio of non-performing loans is not yet a problem in lending to these sectors (see **Figure 5.3.3**).

Figure 5.2.3: NPLs to Loan Ratio



f. Rising asset prices

Real estate prices are increasing rapidly since last two years and registered year on year growth of 23.4 percent in June 2004. On the other hand, at end December 2003, the share of advances against real estate increased to 23.5 percent of total advances, from 21.9 and 22.8 percent in 2002 and 2001 respectively. If the above trends continue, credit growth is expected to remain strong as the financial history suggests a strong positive correlation of real asset prices and the credit to private sector.

The conceptual framework of interactions between the real estate market and banks' lending behavior is well explained in a Paper "Bubbles in real estate markets" by Herring and Wachter 2002. According to this paper, the amount lent to the real estate sector relative to capital will be greater if the expected returns are higher relative to the opportunity cost of funds and vice versa. "First, lending to the real estate is attractive when it is expected to be profitable. Promised returns are often higher than rates available on corporate loans. Rising real estate prices may directly encourage greater lending to the real estate sector in two ways. First to the extent the bank's own holdings of real estate rise in value and the economic value to bank's capital increases. Second, to the extent that the market value of collateral on outstanding real estate loans increases, the risk of loss on the existing portfolio of loans declines and it is possible to lend more without increasing the probability of bankruptcy".

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