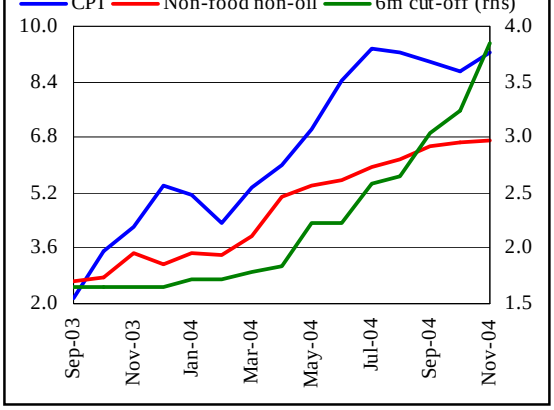
4 Money and Banking

Overview

The pressures for higher interest rates that emerged in May 2004 continued to mount in the initial months of FY05. On the one hand, domestic CPI inflation rose substantially above the annual target, while on the other the Rupee too came under some pressure following persistent weakness in the external account.

While the domestic economy is now considerably more sensitive to changes in international interest rates than in earlier years,[1] a rising external account deficit means that monetary policy would play only a limited role in stabilizing the exchange rate. Of greater relevance to monetary policy therefore was the steady increase in core (monetary policy induced) inflation since March 2004.

Figure 4.1: YoY Inflation and T-bill Rates (percent)



While the pace of the rise in core inflation (as proxied by *non-food non-oil* inflation) has certainly weakened significantly in recent months (see **Figure 4.1**), a number of strong arguments can be presented for the continuation (and even acceleration) of the monetary tightening initiated by SBP. These include:

1. the fact that headline CPI inflation remains significantly higher than core inflation (and may therefore be helping cement inflationary expectations). Moreover, the persistence of real negative lending rates would be expected to provide arbitrage opportunities for borrowings and encourage speculative activity in the economy.

2. the continued rise in monetary aggregates may be adding to inflationary pressures that will manifest after significant lags. This would indicate the

[1] For detailed discussion see SBP *Financial Markets Review for FY04*

need to contain the rise in monetary aggregates in order to restrain the rise in future inflation.

However, from the central bank's perspective, the case for shift from its policy of measured tightening to a sharp, immediate increase in interest rates is far from clear.

1. CPI inflation, while high at present appears to be trending downwards (see **Figure 4.1**),[2] and barring unforeseen shocks, it may even decelerate in H2-FY05. Thus, even a measured increase in interest rates coupled with a fall in inflation could bring average real lending rates back into the positive territory in a few months. It is also worth noting that the increased government vigilance in preventing supply-side pressures in key commodities could help avert inflationary spirals in these commodities.[3]

2. The rise in monetary aggregates, and reserve money in particular, offers a stronger argument for a sharper rise in domestic interest rates, as evident in the steady rise in core inflation. This is also implicitly acknowledged in the rising acceptance cut-offs in auctions for the benchmark 6-month T-bills; as against an aggregate rise of 57 basis points during H2-FY04, July-November 2004 saw it rise by 161 basis points (see **Table 4.1**). Also, the SBP has sought to improve the transmission of this change into KIBOR through increased resort to OMOs during the period.

Table 4.1: YoY Inflation and T-bill Rates

Rise in basis points	**Jul-Dec FY04**	**Jul-Nov FY05**
CPI	348	81
Non-food non-oil	69	112
Cut off rate (6m)	57	161

Fortunately, while the reserve money growth of 13.5 percent during July-November 2004 was only marginally lower than the RM growth of corresponding period of 2003, the source of the increase and likely future trend of RM suggests that the FY05 impact of money multiplier on M2 growth (and inflation) will be lower (and indeed, the 5.7 percent monetary expansion during July-November FY05 is considerably lower than the 7.9 percent expansion in the corresponding period of FY04). Firstly, since a significant part of the FY05 RM growth stems from the rise in FE-25 deposits which will not contribute to expansion in domestic credit and M2

[2] The November increase in CPI inflation is a seasonal jump due to Ramadan.
[3] The government up till now has not transferred the impact of higher oil prices to the consumers; also, government is making efforts to build wheat stocks through imports to control wheat prices.

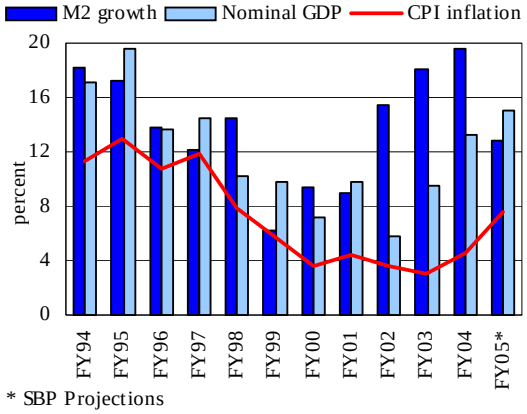
(unless, ironically, rupee interest rate were to rise faster than US$ interest rates raising interest in FE-25 foreign currency loans)[4]. Secondly, the SBP's policy of providing foreign currency to meet oil payments from its forex reserves will reduce the SBP NFA (and hence moderate the aggregate rise in RM).

Finally, the debate over the desirable objectives - single or multiple - of the central bank in a developing economy is unsettled and answers are still unclear. However, in an economy where a fiscal stimulus may not be desirable due to a large debt burden *and* persistent fiscal deficits there is little option but to resort to a monetary stimulus to kick-start the economy.

There appears little doubt that the easy monetary posture played a central role in stimulating growth and investment in Pakistan's economy in recent years and particularly in FY04 (see **Figure 4.2**). Moreover, while fiscal policy is gradually becoming more important in supporting growth, this role of monetary policy continues to be vital in FY05 – the net credit expansion (to the private sector) of Rs 163.2 billion during July-November FY05 is even higher than the exceptionally large net credit expansion of Rs 124.8 billion during the corresponding period of FY04.

A degree of caution in raising interest rates sharply may also be desirable given the presence of structural changes in the credit cycle as well as imminent (and potentially destabilizing) changes in the textile exports markets. However, economic history also shows that the caution can very easily be overdone. Moreover, there is strong empirical evidence that the trade-off between growth and inflation exists only in the short-run. The

Figure 4.2: Money, GDP Growth and Inflation



[4] Entire 20 percent reserve requirement (CRR plus SLR) on foreign currency deposits is held with SBP, vis-à-vis only 5 percent CRR for rupee deposits, therefore an increase in foreign currency deposits results in a higher increase in RM.

SBP will therefore closely monitor available data by January 2005 in order to assess if the balance of risks requires an acceleration of current measured tightening of monetary policy. This assessment will be incorporated in the forthcoming *Monetary Policy Statement for January-June 2005*.

4.1 Monetary Survey

The monetary expansion continued to record considerable growth during July-November FY05, contributed almost entirely by NDA (due to substantial private sector credit as well as significant government net budgetary borrowings). In

Table 4.2: Monetary Survey of the Banking System (flows during July-November)

billion Rupees

	FY04	FY05
Monetary expansion (I+II)	**164.4**	**142.7**
percent change	7.91	5.74
I. Net foreign assets	**58.5**	**14.4**
SBP	52.3	-62.6
Scheduled banks	6.3	77.1
II. Net domestic assets (A+B+C)	**105.9**	**128.3**
percent change	6.88	6.74
SBP	39.2	161.9
Scheduled banks	66.7	-33.7
A. Government sector	**7.7**	**51.0**
Net barrowing for budgetary support	22.8	48.1
SBP	35.4	183.3
Scheduled banks	-12.7	-135.2
Commodity operations	-16.1	1.3
Others	0.9	1.6
B. Non-Government sector	**95.9**	**146.7**
Private sector	124.8	163.2
(a) Commercial banks	133.8	161.6
of which: Export finance	*16.4*	*8.7*
(b) Specialized banks	-9.0	1.6
Public sector enterprises	-27.6	-11.9
Autonomous bodies	-16.3	-0.8
Other PSEs	-11.0	-10.4
PSEs special debt-repayment a/c with SBP	-0.3	-0.7
SBP credit to NBFIs	-1.3	-4.6
C. Other items (net)	**2.4**	**-69.39**

Source: Economic Policy Department, SBP

comparison, the corresponding period of FY04 had witnessed a significant contribution of both NDA and NFA (principally because of large private sector credit, considerable government net budgetary borrowings, and significant external account surpluses).

In particular, the July-November FY05 period witnessed a substantial increase in commercial banks NFA which was largely subdued by a decline in SBP NFA. In contrast, during the corresponding period of FY04, NFA growth was principally led by SBP NFA. While the latter represents SBP forex net purchases to restrain the rupee appreciation, the former indicates: (1) the SBP support to interbank forex market (to smooth volatility and take care of lumpy payments), and (2) significant growth in foreign currency deposits as well as substantial retirement of foreign currency loans.

In NDA growth, the comparison between July-November periods of FY04 and FY05 shows that the contribution of both government net budgetary borrowings and private sector credit increased significantly during FY05. This was partially offset by a substantial decline in *other items net* of the banking system during July-November FY05 compared to same period of FY04 (see **Table 4.2**). This includes a Rs 17.6 billion decline reflecting the impact of higher SBP profitability (from the revaluation of its forex reserves, and increasing income from T-bill holdings).

4.2 Government Borrowings for Budgetary Support

The improved fiscal position due to better fiscal management during Q1-FY05 reduced the government financing needs compared to Q1-FY04 from Rs 40.9 billion to Rs 24.9 billion. This smaller requirement was comfortably met by a rise in external financing, a big jump in privatization proceeds, as well as substantial non-bank borrowings during the 3 quarter, allowing a net *retirement* of banking system debt (see **Table 4.3**)[5].

Table 4.3: Deficit Financing (Jul-Sep) [1]
billion Rupees

	FY04	FY05
External	4.9	19.6
Non-bank	24.1	19.1
Privatization proceeds	0.8	6.1
Sub-total	*31.0*	*44.8*
Total financing requirement	**40.9**	**24.9**
Banking system	9.9	-19.9

Source: Ministry of Finance (MoF), quarterly data.
[1] The MoF and SBP numbers may differ slightly due to differences in timings and definitions

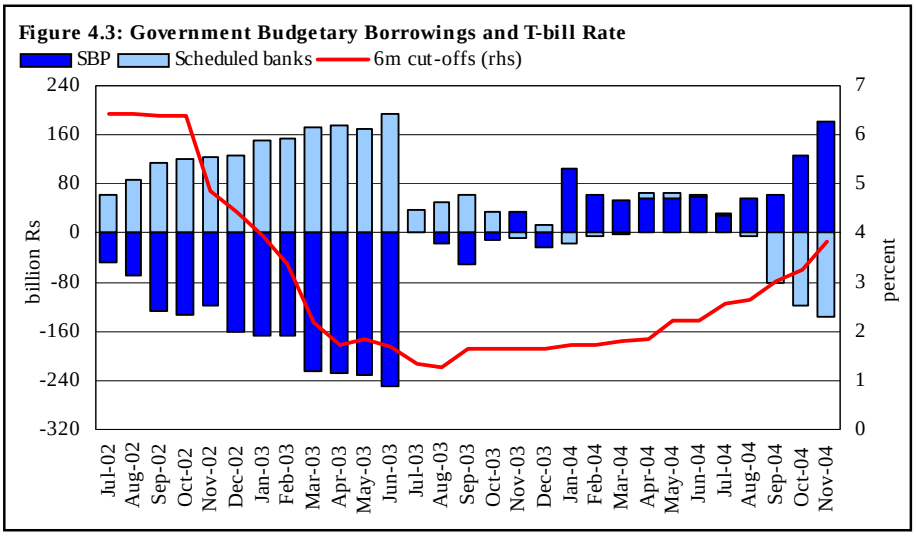
However there was a sharp rise in the net budgetary

[5] This is a result of the shift of PIB holdings from banking sector to the corporate sector.

borrowings from the banking system during October-November 2004, reversing the Q1-FY05 position from net retirement to net borrowings for cumulative July-November FY05 period. In particular, on account of government budgetary support, July-November FY05 observed net borrowings of Rs 48.1 billion, which was substantially larger than net borrowings of Rs 22.8 billion, recorded during July-November FY04. There is also a visible shift in the profile of the government borrowings from the banking system, with increased reliance on SBP borrowings more than offsetting retirement from the scheduled banks.

In fact, as evident from **Figure 4.3**, the government's increasing reliance on SBP financing began as early as Q2-FY04, reflecting the authorities' desire to moderate pressures for a rise in domestic interest rates.

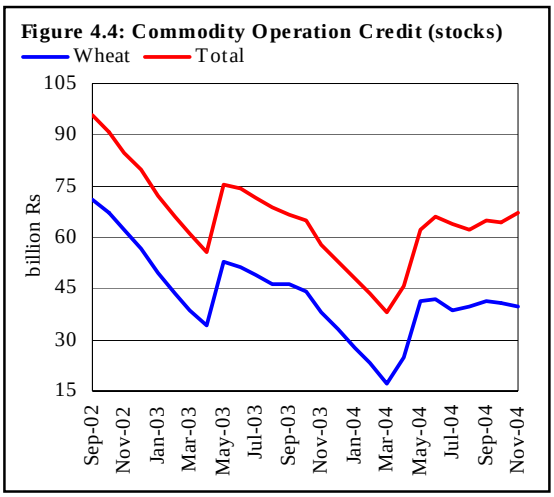
Figure 4.3: Government Budgetary Borrowings and T-bill Rate



4.3 Public Sector Commodity Operations Credit

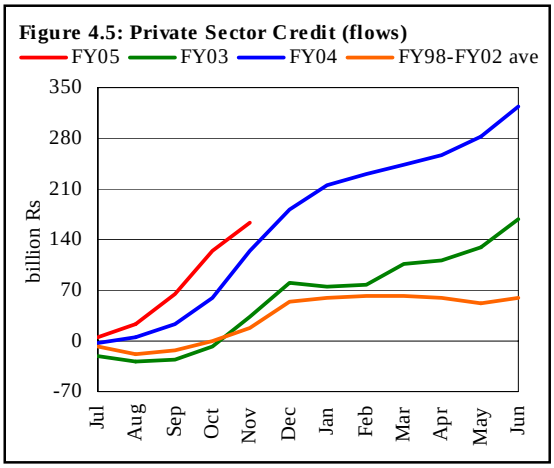
As already explained in previous SBP reports, the volume of public sector commodity procurement operations has been falling steadily since June 2002. However, the credit for commodity operations, which is highly correlated with wheat procurement by the government, saw a larger seasonal increase during April-June 2004 than in the corresponding period of FY03. This reflects a deliberate government move to build up its wheat reserves, in order to ensure its ability to intervene in the market and avoid any disruption (such as witnessed in FY04).

In aggregate, compared to a net retirement of Rs 16.1 billion during July-November FY04, July-November FY05 witnessed a net borrowing of Rs 1.3 billion. As a result, the outstanding stock of commodity operation loans at the end-November 2004 increased marginally to Rs 67.2 billion (see **Figure 4.4**).



4.4 Private Sector Credit

Despite a steady increase in interest rates, net credit to the private sector continued to grow apace during July-November FY05, recording an expansion of Rs 163.2 billion in the period, well above even the exceptional Rs 124.8 billion growth recorded in the corresponding period of FY04.[6]



As evident in **Figure 4.5**, the structural shift in the credit cycle that was a prominent feature of the credit growth in FY04, is also evident in the initial months of FY05. In particular, the decline (or at best stagnation) in net credit expansion during the first quarter, that had been a traditional feature of the credit cycle in past years, was clearly absent in FY05.[7]

[6] The net credit to the private sector during FY04 was exceptionally high; it was not only nearly twice the FY03 but also more than cumulative net credit expansion in the preceding four years.

[7] The decline had been a function of the fact that in earlier years the larger portion of credit expansion in a fiscal year had traditionally constituted working capital business loans, the bulk of which were seasonally retired in the first quarter of the next fiscal year. As the volume of retired loans was usually greater than the fresh disbursements during the first quarter, the period typically recorded a decline in the net credit outstanding. During FY04 however, a large non-seasonal credit

The sectoral break-down of the net credit expansion during July-Oct FY05[8] shows that the aggregate demand remains strong and the credit expansion remained broad based, mirroring the general improvement in the economy. In particular:

- *textiles and textile products* sector remained the largest borrower. This probably reflects the growing working capital requirements due to capacity additions as well as the good cotton harvest;

- *transport, communication, & storage* group recorded significantly larger credit expansion during FY05 compared to FY04 possibly because of increasing investments in road transport and telecommunication; and

- consumer credit grew strongly, largely on account of loans for automobiles, construction as well as through the increasing in personal loans.

4.5 Reserve Money (RM)

While the strong growth of reserve money continued during July-November 2004, its profile was totally different from the July-November 2003 RM growth (see **Table 4.4**). While the latter was largely because of SBP NFA accumulation representing SBP forex purchases from interbank forex surpluses (to moderate the rupee appreciation); the former was due to huge government borrowings from the central bank (to restrain the rise in domestic interest rates), which was partially subdued by a decline in SBP NFA (to support the domestic currency in the inter-bank market).

Table 4.4: Share of NDA and NFA in Reserve Money (Jul-Nov)

	FY04	FY05
Reserve Money Growth		
absolute (billion Rs)	102.5	104.3
percent	15.3	13.5
Share of NDA		
absolute (billion Rs)	50.3	166.9
percent	49.0	160.0
Share of NFA		
absolute (billion Rs)	52.3	-62.6
percent	51.0	-60.0

Source: Economic Policy Department, SBP.

Arguably the current addition in the stock of reserve money may lead to increasing inflationary expectations. However, the SBP estimates suggest that: (1) according to the seasonal pattern, the

demand from diverse sectors emerged (e.g. for long term investments, consumer financing, etc.). As a result not only has the volume of credit disbursed increased, the net credit growth is strengthened by the fact that these loans are often not retired in the short-term (therefore do not depress net credit growth).

[8] SBP Statistics Department: Monthly data on credit by borrowers for October 2004.

growth of reserve money would be declining in coming months; and (2) the additional reserve money would have less intermediation because of a change in its composition. As a result, the broad money growth rate in FY05 is likely to be lower than the monetary expansion seen in FY04.[9]

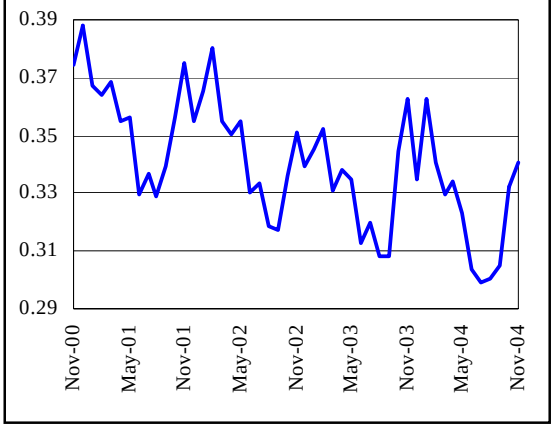
4.6 Monetary Indicators

Currency-Deposit Ratio (CDR)

The gradual decline in *currency to deposit* ratio has continued for the last four years, which represents increasing intermediation of transactions by the banking system (see **Figure 4.6**).

It is interesting to note that the CDR ratio has invariably declined in Pakistan whenever the banking sector was able to capture a greater share of current transfers into the economy. The first episode of a downtrend in the CDR was in the 1990s, on the back of rising private forex deposits. Similarly, the current downtrend appears to reflect the shift of current transfers from the informal to the formal markets since Q3-FY01.

Figure 4.6: Currency-Deposit Ratio



In fact, the decline from the peak of 0.3649 at the end-January 2004 level to 0.2993 at end-July 2004 was not only larger than past trend decline, but also the end-July 2004 level was the lowest since September 1999.

As discussed in SBP's earlier reports, while increasing use of ATMs, credit and debit cards, online banking etc. reduced the need for cash holdings, the expanding commercial banks' credit frontier (including agri credit and consumer finance) enhanced the customers' base of the banking system, resulting in higher intermediation and hence lower cash balances.

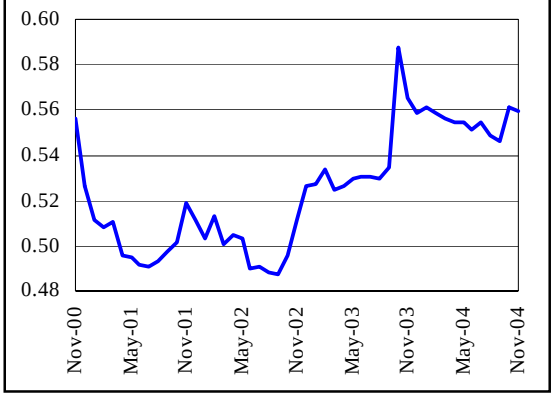
[9] For details, see **Box 4.1**.

In fact, the August-October 2004 period witnessed a seasonal increase in CDR, which was smaller in magnitude compare to the FY04 seasonal hike. A further analysis of this rise suggests that the rise principally came in October 2004, which was due to the cash withdrawals from the banks associated with Ramadan and the Eid festival. Assuming that this phenomenon will remain consistent with trends in the preceding years, it indicates that the CDR would decline in the months ahead (barring a jump in January 2005 ahead of the *Eid-ul-Adha* festival.

M1 to M2 Ratio

The liquidity preference of the economy as measured by the *M1 to M2* ratio declined during Q1-FY05, though it showed a seasonal upward movement during October 2004 (see **Figure 4.7**). This rise in the *M1 to M2* ratio represents Ramadan and Eid effects and the ratio is likely to remain high up to the coming Eid festival (January 2005). It would probably see a reversal afterwards as the temporary rise in currency in circulation and demand deposits would be expected to fall.

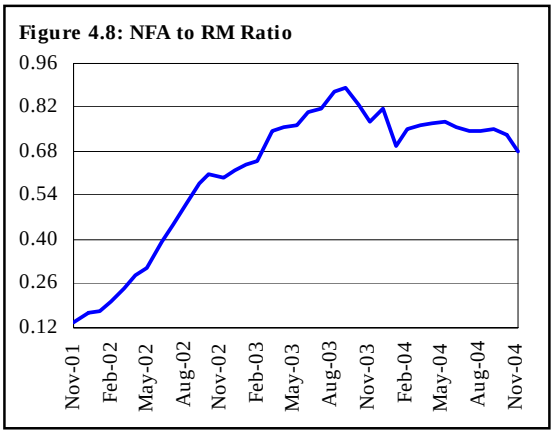
Figure 4.7: M1 to M2 Ratio



NFA to RM Ratio

The backing of high-powered money by hard currency assets (which is visible through the share of NFA in RM) has been declining slowly since June 2004 (see **Figure 4.8**). The decline was due to (1) slowdown in the growth of NFA of the banking system as the inter-bank forex surpluses turned into deficit, which was partially offset by increasing RFCDs; (2) continued higher

Figure 4.8: NFA to RM Ratio



growth of reserve money through SBP NDA because of increased government borrowings from the central bank.

4.7 Money Market Developments

The developments in the money market are reflective of the SBP monetary stance of containing a sharp rise in the interest rates in the face of market expectations of a larger increase. This is evident from the bidding pattern of banks and the SBP cut off rates (see **Figure 4.9**).

Till end-August, there was ample liquidity in the market due to higher maturities and relatively lower seasonal credit demand. This is obvious from the fact that although banks were offering substantial amounts in auctions, SBP was also conducting OMOs during this period to mop up liquidity (see **Figure 4.10**).

However, concerned over the slow impact of monetary policy tightening on macro variables, SBP not only mopped up Rs 58 billion through OMO but also accepted higher than the targeted amounts in two auctions in August. This

Figure 4.9: 6m T-bill Bidding Pattern
Low, high and cut-offs

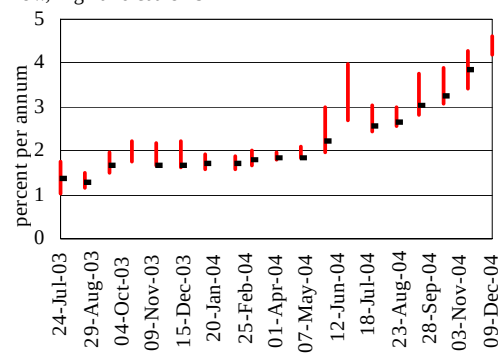


Figure 4.10: Open Market Operations

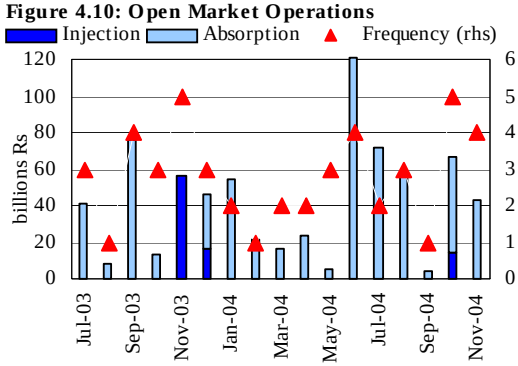
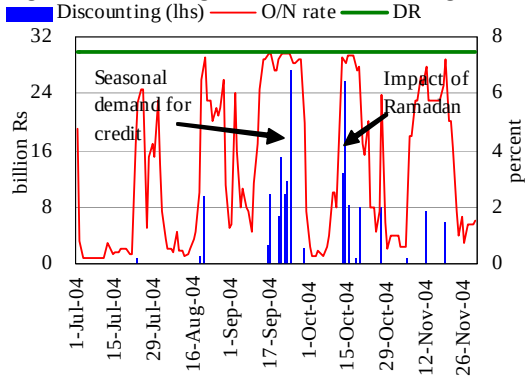
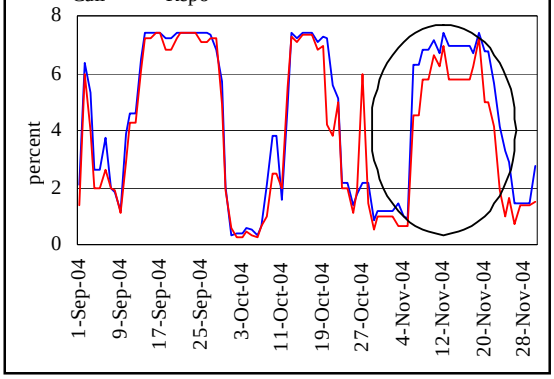


Figure 4.11: Overnight Rates and Discounting



along with seasonal pick up in credit demand in September 2004 left the market short and banks had to resort to discounting (see **Figure 4.11**).

Figure 4.12: Call vs Repo Rate



In the ensuing months of October and November 2004 an unprecedented credit demand resulted in lower offerings by banks in the T-bill auctions, consequently pushing the interest rates upwards. However the SBP preferred a more gradual increase. Resultantly, while the banks were offering less and less amounts against the targets, SBP was accepting even lower amounts, leading to net retirement of T-bill holding by the commercial banks and a corresponding increase in government borrowings from SBP.

As a result of this shifted, commercial banks' holding of T-bills eroded to uncomfortably low level (especially that of smaller banks). The impact of depleting stock of government securities of scheduled banks is evident from the increased differential between Call and Repo rates (see **Figure 4.12**). This suggests that the banks may be willing to bid relatively more aggressively in forthcoming T-bill auctions.

Table 4.5: Change in Banking Aggregates (Jul-Sep)

billion Rupees

	FY04	FY05
Deposits	**48.9**	**31.4**
Rupee deposits	49.8	20.4
Foreign currency deposits	-0.9	10.98
Total Credit	**0.8**	**52.7**
Foreign currency loans	-13.6	-20
Rupee loans	14.4	72.7
Private sector	23.0	65.7
Public sector	-22.2	-13.0
NPLs (domestic)		
Gross NPLs	5.7	-1.3
Net NPLs	-0.8	-8.6

4.8 Banking Developments[10]

The sharp deceleration in M2 growth in the initial months of FY05 as well as the expectations of large rupee depreciation is reflected in the deceleration in the deposit growth of commercial banks, as well as a shift in the currency profile of the

[10] This section covers the analysis of the data from July to September only.

deposit growth (see **Table 4.5**).

Currency composition of the deposit mobilization during Q1-FY05 is in sharp contrast with FY04. Resident foreign currency deposits (RFCDs) that were exhibiting withdrawals last year not only stabilized but also registered a strong uptrend following the continuous appreciation of dollar during the period. In fact, RFCDs increase of Rs 11 billion during Q1-FY05 is the highest quarterly increase in last 13 quarters. This exceptional growth can be explained by the interfunction of a number of factors:

1) rupee was depreciating during the period;

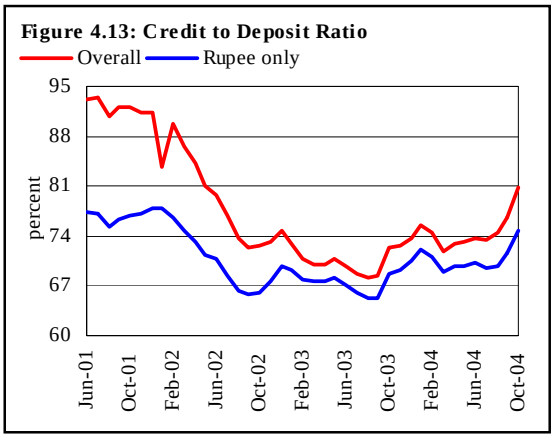
2) a sharp rise in headline inflation and the worsening real deposit rate induced shift from Rupee deposits; and

3) higher LIBOR raised the effective rate of returns on RFCDs.

On the other hand, Rupee deposits that were registering a mushroom growth since last two years could only register a marginal growth during Q1-FY05 compared with Q1-FY04.

In contrast to foreign currency deposits, foreign currency loans have lost their appeal due to rising value of dollar.[11] Although, the EFS rates have started inching up since Q4-FY04, the interest rate differential was still not sufficient to make foreign currency loans attractive. This has resulted in the increased demand for Rupee loans from all the sectors. Therefore the banks do not have the similar liquidity ease as was seen in Q1-FY04 because the foreign currency deposits that they mobilize can not be utilized for financing Rupee loans.

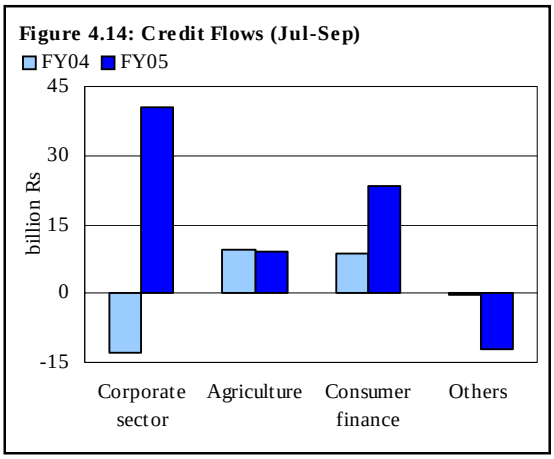
Figure 4.13: Credit to Deposit Ratio



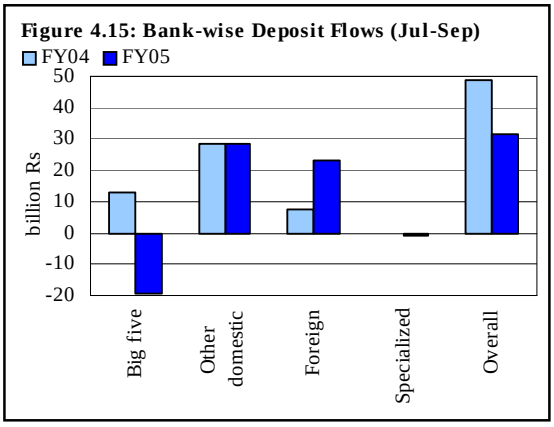
[11] Although, foreign currency loans had registered net retirements during Q1-FY04 as well, however, (1) the volume of net withdrawals are Rs 6.4 billion higher in Q1-FY05; and (2) given the continuous appreciation of dollar during this period, the retirements of foreign currency loans are expected to continue in coming months.

This liquidity discomfort is also visible from the rising credit to deposit ratio (see **Figure 4.13**).

Stepping back, the heavy net credit expansion of Rs 52.7 billion against Rs 0.8 billion in Q1-FY04 is due to a sharp rise of Rs 65.7 billion in credit to private sector that overshadowed the net retirements of Rs 13 billion from the public sector. This increase in credit to private sector appears to be a result of: (1) lower retirements from corporate sector during Q1-FY05 compared with Q1-FY04 (which is consistent with the larger share of fixed investment in total credit during FY04); and (2) a continuing increase in financing to the consumer and agriculture segments.



The corporate sector was major recipient of credit during Q1-FY05 (see **Figure 4.14**), and encouragingly, 66 percent of this credit was utilized for fixed investment. This was followed by consumer financing that registered an increase of Rs 23.2 billion against Rs 8.7 billion in Q1-FY04. In consumer loans, auto loans as usual formed the bulk of financing. Moreover, the trend in mortgage loans is in contrast with that in the preceding year; against net retirement of 0.4 billion during Q1-FY04, Rs 11 billion were extended during Q1-FY05.



4.8.1 Banks' Contribution

Domestic banks (other than the big five), which predominantly cater to the private sector, extended around 76 percent of the total net credit extended during Q1-FY05. The big five banks, with around 17.4

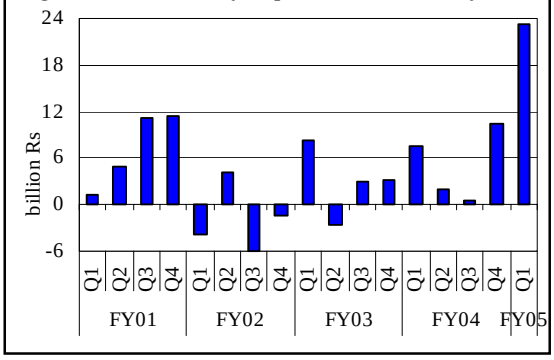
percent of outstanding credit to public sector, registered an increase of Rs 2 billion during Q1 FY05 against a huge net retirement of Rs 20 billion in Q1-FY04.

While the aggregate deposit growth of the smaller domestic banks remained strong (as in FY04), the Q1-FY05 growth was less broad-based, with approximately 51 percent of the rise coming from only two banks in this group (see **Figure 4.15**).

By contrast, the big five banks witnessed net withdrawals during Q1-FY05; though here too, around 57.5 percent of the withdrawals came from only one bank, which was on account of significant net retirements by the public sector (including both government loans for commodity operations and loans to PSEs).

Foreign banks exhibited an impressive performance during Q1-FY05. The deposits mobilized by this group were not only the highest in past seventeen quarters (see **Figure 4.16**); they were larger than the annual mobilization by these banks in last three years. Foreign currency deposits used to constitute around 40 percent of the deposit portfolio of the foreign banks till FY00. However, the imposition of limits on these deposits by SBP [12] and subsequent appreciation of the domestic currency had significantly impaired the ability of the foreign banks to mobilize deposits forcing them to devise innovative schemes to lure Rupee deposits.

Figure 4.16: Quarterly Deposit Mobilization by FBs

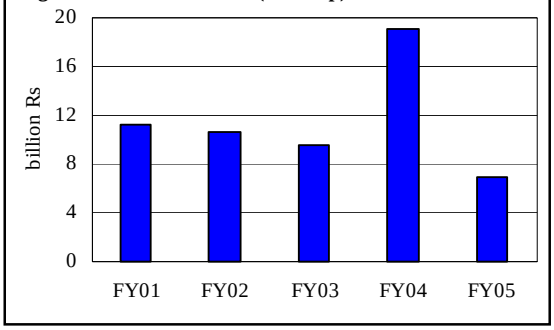


Although the share of foreign currency deposits in overall deposits of foreign banks is rising again (20.05 percent at the end of November 2004, up from 19.9 percent at the end of November 2003) foreign banks are likely to continue their efforts to mobilize Rupee deposits. For example, during September 2004, the rate on fresh deposits offered by foreign banks were 117 and 52 basis points higher than that offered by *big five banks* and *other domestic private banks* respectively.

[12] *BSD circular No. 02, dated January 01, 2002.*

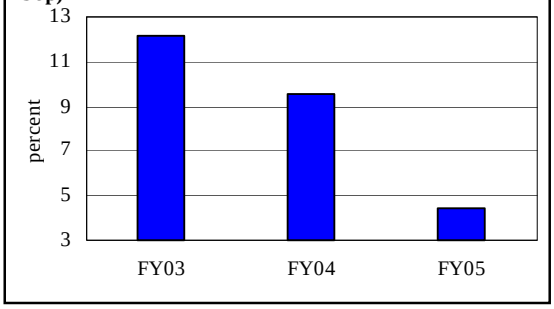
4.8.2 Non-Performing Loans (NPLs) Outstanding NPLs of the banking industry declined further to reach Rs 206.7 billion at end Q1-FY05. This is because during the quarter reductions in NPLs outpaced additions in NPLs. In fact, the first quarter fresh NPLs for FY05 are the lowest in the last five years (see **Figure 4.17**). Although the NPLs of domestic commercial banks increased slightly, this increase was more than offset by the decline in the NPLs of foreign and specialized banks.

Figure 4.17: Fresh NPLs (Jul-Sep)



The burden of NPLs has also declined sharply as net NPLs are only 4.5 percent of net advances at end Q1-FY05 against 9.5 percent in Q1-FY04 (see **Figure 4.18**). This is because of both decline in outstanding gross NPLs and increased provisioning by banks.

Figure 4.18: Net NPLs to Net Advances Ratio (end-Sep)



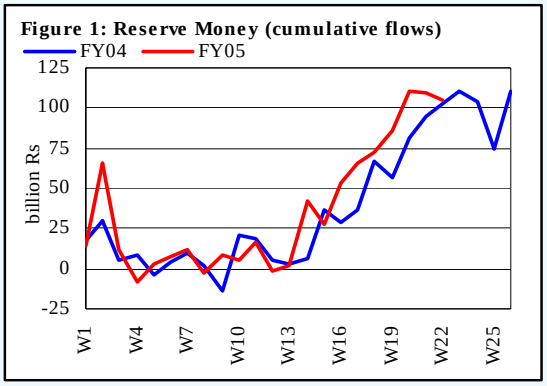
Box 4.1: An Analysis of Reserve Money Growth[1]

During July-November FY05, Reserve Money (RM) saw a cumulative increase of Rs 104.3 billion against Rs 102.5 billion recorded in the same period last year (see **Figure 1**). As the Money Supply (M2) growth target for FY05 (11.26 percent) is lower than the actual outcome of M2 growth (19.6 percent) in FY04, this high RM might be a source of concern. This section analyzes various sources of the growth in RM to evaluate its impact on M2.

Causative Factors of RM

Looking at the causative factors of the RM, the 13.5 percent growth in it during July-November FY05 is primarily attributed to substantial increase in the government borrowings from the SBP, amounting to Rs.183.3 billion. This has been the result of SBP policy of not allowing the interest rates to increase too sharply and therefore all the government borrowings from the banking sector have been through SBP.

Figure 1: Reserve Money (cumulative flows)



Components of RM

Form the components side, currency in circulation (CiC) and banks deposits with SBP are the major sources of increase in RM contributing Rs.89.7 and Rs. 14.0 billion respectively. The 15.5 percent YoY growth in CiC recorded during July-November FY05 is relatively smaller than the 20.7 percent YoY increase seen in the corresponding period of FY04. However, most of this is explained by seasonal trend which sees a decline in CiC shortly after the Eid festival. In FY04 the Eid festival had taken place two weeks later than in FY05 and therefore the decline in CiC seen in November 2004 is not visible in the preceding year. In other words, there does not appear to be any significant underlying difference in the growth of CiC during the two years.

However, the FY05 profile of the RM growth through deposits appears to be very different from that in the preceding year. Firstly, there is a cumulative increase of Rs 14.0 billion in *Banks' Deposits* with SBP during the first five months of FY05 against a decline of Rs 1.3 billion in the same period of the preceding year. Secondly, the rise in *Banks' Deposits* with SBP in FY05 mainly reflects the growth in resident foreign currency deposits (RFCDs) of banks – as the entire 20 percent reserve requirement (CRR plus SLR) on foreign currency deposits is held with SBP, vis-à-vis only 5 percent CRR for rupee deposits, an increase in RFCDs results in a higher increase in RM than a corresponding increase in rupee deposits. In FY04, although rupee deposits saw a large jump, the impact on RM growth was negated by a relative small decline in RFCDs (see **Figure 2**).

Impact of RM on M2

Despite being high RM growth during July-November FY05 did not have the same impact on the growth of broad money (M2) as it had in the same period of FY04 (see **Table 1**). This basically suggests that the change in money multiplier during July-November FY05 was lower than in the same period last year. This is because:

[1] Analysis is based on the provisional data of 27-Nov-2004

First, the commercial banks saw a higher increase in RFCDs during FY05. In the absence of foreign currency lending this would reduce the value of money multiplier.[1] In addition, large retirement of foreign currency loans during FY05 means that value of money multiplier will decrease. This is because now a larger portion of deposits is not being used for credit extension.

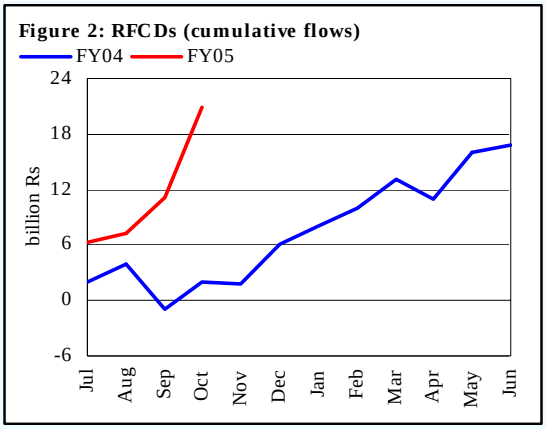


Table 1: Impact of the Money Multiplier (Jul-Nov)

	FY04	FY05
Reserve Money (billion Rs)	15.3	13.5
Money Supply (billion Rs)	7.9	5.7
Change in Money Multiplier	-0.06	-0.18

Another important point to note is that after October 2003 the foreign currency loans started to increase as Rupee started appreciating. The reversal of foreign currency lending in coming months of FY05 is unlikely until the expectations for exchange rate depreciation changes or the gap between Rupee and Dollar interest rates increase to a very significant level. This suggests that if deposit growth during rest of FY05 continues to be driven by RFCDs and/or if banks are unable to deploy these deposits through foreign currency loans domestically; the money multiplier will further decrease.[2]

Another factor that can slow the RM growth going forward is the commitment that the SBP has made to use its forex reserves to support lumpy oil payments, assuming these payments are US$ 250-300 million monthly, this would significantly reduce the NFA of the SBP and thus the reserve money.

The lower money multiplier as well as possible slowdown in RM growth going forward, suggests that present RM growth is less likely to translate its self into high M2 growth as was witnessed in the previous year.

[1] The fall during July to November FY04 was again due to slight downward (depreciation) pressure on Rupee.

[2] The impact of rupee interest rates on the demand for foreign currency loans from local businesses also carries interesting monetary policy connotations. As stated above, currently, it is the relatively low rupee interest rates and the expectations of a rupee depreciation that is rendering the foreign currency loans unattractive for domestic businesses. Conceivably, a substantial increase in rupee interest rates could render foreign currency loans attractive to local corporate and businesses. This would re-inject the RFCDs into the domestic economy, and raise the money multiplier effect. In other words, efforts to tighten monetary policy could promptly be reversed through rising liquidity. This clearly shows that as the economy becomes more open and integrated with the global economy, monetary management will become increasingly challenging.