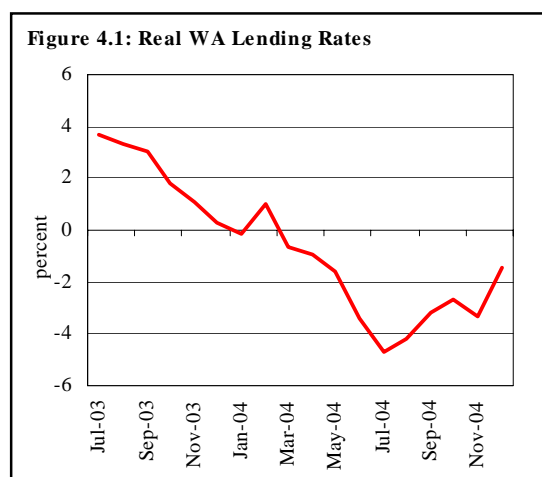


4 Money and Banking

Overview

Although the SBP raised interest rates steadily through the first 8 months of FY05, continuing the uptrend initiated in Q3-FY04, monetary policy largely remained accommodative; the weighted average lending rates remained negative in real terms (see **Figure 4.1**) and private sector credit rose by a record Rs 291.4 billion during the period.¹ More tellingly, core inflation also continued its steady rise throughout the period.

While monetary policy can provide a potent stimulus to the economy, a sustained rise in money supply higher than the nominal growth rate of GDP can add to inflationary pressures. On the other hand, when the economy is undergoing structural changes, the relationship between money supply and inflation, the time lags involved and the magnitude are not clear. This implies some constraints in modulating the monetary policy.



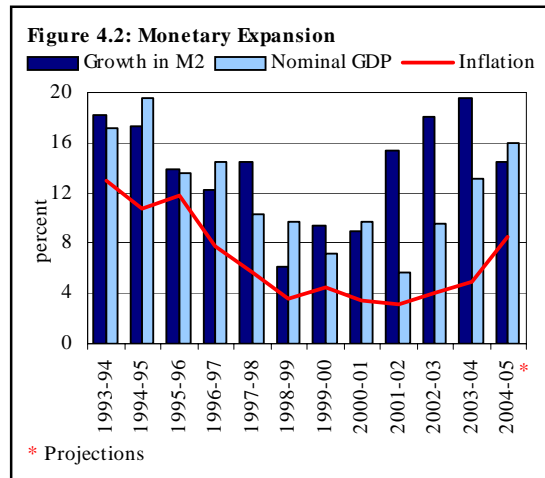
Thus, in the preceding three years, when inflation was relatively low, SBP sought to accelerate growth in the economy² by allowing a monetary overhang with M2 growth outstripping GDP growth by 6 to 9 percentage points (see **Figure 4.2**). But thereafter, as the economy gained momentum, and inflationary pressures gathered pace by Q3-FY04, it initiated a measured increase in interest rates,

¹ Original full year target for credit expansion were set at Rs 200 billion. By second week of February credit expansion was Rs 291.5 billion compared to Rs 227.8 billion in the corresponding period last year.

² In fact, the low interest rate environment for the last three years has provided benefits to the economy by allowing restructuring of balance sheets (through re-pricing of debt at more favorable rates), an increase in investments (driven by higher earnings due to lower financial costs) and also a rise in consumption of household sector (raising demand and bolstering business confidence).

seeking to strike a balance between containing inflation while avoiding a significant weakening in the growth momentum.

This increased bias towards a relatively tighter monetary posture is also evident in the revised Credit Plan for FY05 presented in February 2005, wherein M2 growth is envisaged at 14.5 percent, roughly in line with the then-expected growth in nominal GDP. More recent estimates³ suggest that the actual growth in money supply during FY05 may remain below the eventual nominal GDP growth.



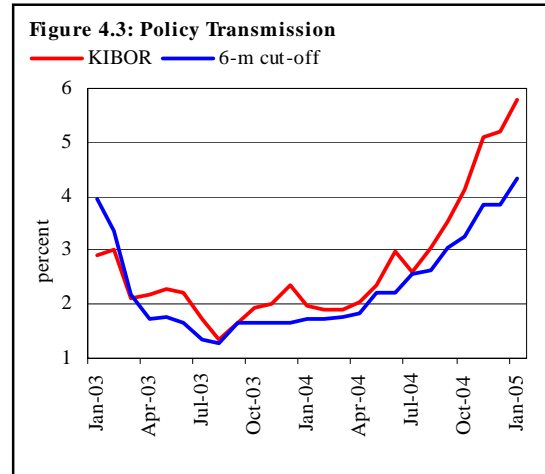
While there now appears to be a broad market consensus on the desirability of a tighter monetary posture in order to contain inflationary pressures, the pace and the extent of the tightening needed is still unclear.

So far, the SBP has opted for a strategy of steadily raising interest rates. Specifically, since July 2004 the SBP has raised the benchmark 6-month T-bill interest rate by almost 300 basis points to approximately 5.20 percent by March 2, 2005, and furthermore has more frequently conducted OMOs in order to improve the transmission of the policy signal on to lending rates (see **Figure 4.3**). However, so far, CPI inflation has weakened only slightly and core inflation has continued to trend higher. This would suggest that monetary policy needs to be tightened further.

In particular, it is important to note that even if the Credit Plan targets are achieved, this does not mean that inflationary pressures in the economy will be contained immediately. For example, it is likely that FY05 inflation will continue to be fed by the lagged impact of the monetary overhang developed in the preceding three years. Also, it will take some time to reverse inflationary expectations that have strengthened in recent month in light of inflation trends.

³ SBP forecast.

Ironically, even a sustained *gradual* increase in interest rates threatens to raise liquidity in the inter-bank markets. On the one hand, the widening differential between Rupee and US Dollar interest rates is reviving interest in FE-25 foreign currency loans. This could generate a positive cycle of additional forex liquidity strengthening the rupee (making these loans even more attractive by reducing effective interest costs), and effectively adding liquidity to the inter-bank rupee market as well.⁴ This suggests that if higher rupee rates do initiate this cycle, the SBP would also need to mop up this incremental liquidity to ensure improved transmission of a monetary tightening.



4.1 Credit Plan 2004-2005 Revisited

The developments during H1FY05, not only with regard to credit expansion but also with regard to growth and inflation, especially after government's decision to pass on the impact of increase in the international oil prices, made it necessary to revisit the Credit Plan chalked out at the beginning of the year. Inflation and GDP growth are now expected to be more than 7 percent up from 5 and 6.6 percent respectively. In view of the expected higher GDP and inflation, monetary expansion has also been revised upwards from 11.3 percent to 14.5 percent.

Notwithstanding the impact of other items net, which are now expected to exert a contractionary impact of Rs 65.0 billion against an expansionary impact of Rs 13.0 billion in the original plan, the monetary expansion target has been increased by Rs 158.0 billion. After adjusting for *other items*, this is almost an increase of 60.0 percent over the initial targets. While the non-government sector will be entitled to an additional Rs 140 billion, government sector will have an extra scope of Rs 18 billion. No changes have been made in the targets of net foreign assets (see **Table 4.1** for details).

⁴ For details please see the SBP *State of Pakistan's Economy Report for Q1-FY05*.

Table 4.1: Monetary Survey of the Banking System (till 12th February)
billion Rupees

| | Credit Plan | | Flows | |
|---------------------------------|-------------|------------|--------------|--------------|
| | Original | Revised | FY05 | FY04 |
| Government borrowing | 47 | 65 | -3.9 | 57.6 |
| Net budgetary borrowing | 45 | 60 | -4.4 | 84.8 |
| SBP | | | 168.0 | 85.6 |
| Scheduled banks | | | -172.4 | -0.8 |
| For commodity operations | 5 | 5 | -0.4 | -27.6 |
| Others | -3 | 0 | 0.9 | 0.5 |
| Non-government borrowing | 190 | 330 | 274.4 | 187.4 |
| Credit to private sector | 200 | 350 | 291.4 | 221.2 |
| (a) Commercial banks | | | 291.6 | 227.8 |
| Of which : | | | | |
| <i>Export finance</i> | | | 18.1 | 20.5 |
| (b) Specialized banks | | | -0.1 | -6.6 |
| Credit to PSEs | -5 | -15 | -11.1 | -29.4 |
| Other financial institutions | -5 | -5 | -5.9 | -4.3 |
| Other items (net) | 13 | -65 | -72.5 | -11.8 |
| SBP | | | -14.0 | 3.8 |
| Scheduled Banks | | | -58.4 | -15.6 |
| Net domestic assets | 250 | 330 | 197.9 | 233.2 |
| SBP | | | 148.1 | 84.0 |
| Scheduled banks | | | 49.8 | 149.1 |
| Net foreign assets | 30 | 30 | 45.3 | 3.1 |
| SBP | | | -33.2 | 10.1 |
| Scheduled banks | | | 78.6 | -7.0 |
| M2 | 280 | 360 | 243.3 | 236.4 |
| (in percent growth) | | | 9.79 | 11.37 |

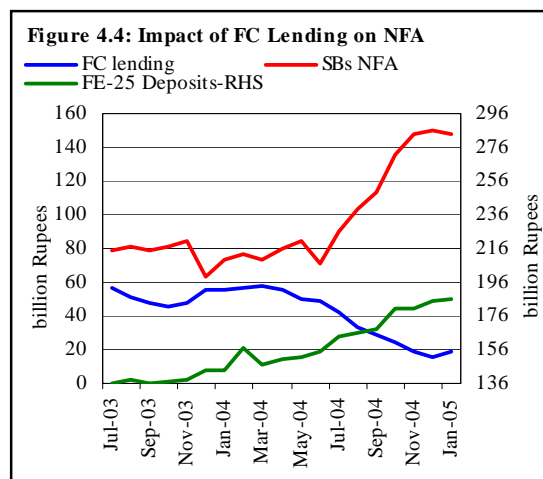
4.2 Monetary Survey⁵

Monetary expansion during Jul-Feb FY05 continued to register significant growth and has increased by Rs 243.3 billion compared with Rs 236.4 billion in the corresponding period of FY04 (see **Table 4.1**). While both, NDA and NFA contributed to the expansion, the contribution of the former was larger.

⁵ Discussion in this section is based on Monetary Survey of February 12, 2005.

4.3 Net Foreign Assets (NFA)

The NFA of the banking system grew by Rs 45.3 billion during Jul-Feb FY05, sharply higher than the mere Rs 3.1 billion rise during the corresponding period of FY04. This larger increase owes entirely to a Rs 78.6 billion rise in the NFA of commercial banks which more than offset a 33.2 billion decline in the SBP NFA.



The large rise in the NFA of commercial banks, in turn, is explained mainly by the retirement of trade-related foreign currency loans and the increase in FE-25 deposits⁶ (see **Figure 4.4**). Both of these movements are explained by the movements in the Rupee/US\$ parity; the strengthening expectations of a weaker Rupee, encouraged a rise in FE-25 forex deposits, and led traders switch away from US\$ denominated loans. This led to a sharp rise in banks NFA until end-October 2004. Thereafter, as the Rupee regained strength,⁷ both of these trends weakened, and the rise in banks' NFA halted.

Interestingly, in January 2005, FE-25 loans have once again started to rise after declining for the preceding 9 months. This reflects both a stronger Rupee post-October 2004 as well as higher rupee interest rates (reducing the effective cost of forex loans).⁸ This suggests that if FE-25 lending continues to gather pace, banks' NFA could once again decline in the months ahead.

The decline in the NFA of SBP however, simply reflects the worsening external account, and, in particular, the central bank's decision to support the Rupee in the

⁶ Specifically, when a foreign currency deposit is mobilized, this adds to the NFA of commercial banks if invested outside Pakistan. On the other hand, when these funds are loaned to the domestic economy, these enter the inter-bank market and in order to avoid double counting of these funds in the country's reserves, the NFA of banks is deducted by an amount equal to the loan (and replaced by an equivalent increase in the NDA). Thus, when the loans are retired, the deduction is reversed and banks' NFA rises accordingly (while the NDA declines).

⁷ This was due to a shift in SBP policy (see **Section on BOP** for details).

⁸ For example, the export finance rate has risen by 2.0 percentage points during Jul-Feb FY05 against 1.0 percentage point increase in LIBOR.

inter-bank market in order to reduce excessive volatility. Indeed, in contrast to the trend for NFA of commercial banks, the NFA of SBP declined by Rs 33.2 billion during Jul-Feb FY05 against a rise of Rs 10.1 billion in the same period of FY04. This is mainly explained by increased SBP's net forex selling in the inter bank.⁹

4.4 Net Domestic Assets

The growth of Rs 197.9 billion in the NDA of the banking system during Jul-Feb FY05 was much lower than the Rs 233.2 billion rise in the corresponding period of FY04. SBP NDA inflated by government borrowing was the main contributor to this growth. The smaller contribution of commercial banks in the FY05 NDA growth is because of the heavy net retirement of government borrowings, and contraction in *Other items (net)* of commercial banks, which offset most of the impact of the record growth in net credit to the private sector. In contrast Jul-Feb FY04 growth in the NDA of banking system was mainly driven by the private sector propelled growth in the NDA of scheduled banks (see **Table 4.1**).

4.5 Government Borrowings

Interestingly, by mid-February 2005 government borrowings for budgetary support witnessed a net *retirement* of Rs 4.4 billion (compared to a massive increase of Rs 84.8 billion in the corresponding period of FY04), even though the fiscal deficit in the FY05 period is substantially higher.¹⁰ This discrepancy is explained by the shift in the profile of government debt over the two periods. During FY04, the government's rupee borrowings had been inflated by the substitution of expensive external debt, while in the corresponding period of FY05, a substantial increase in external debt paved the way for the retirement of rupee borrowings.¹¹

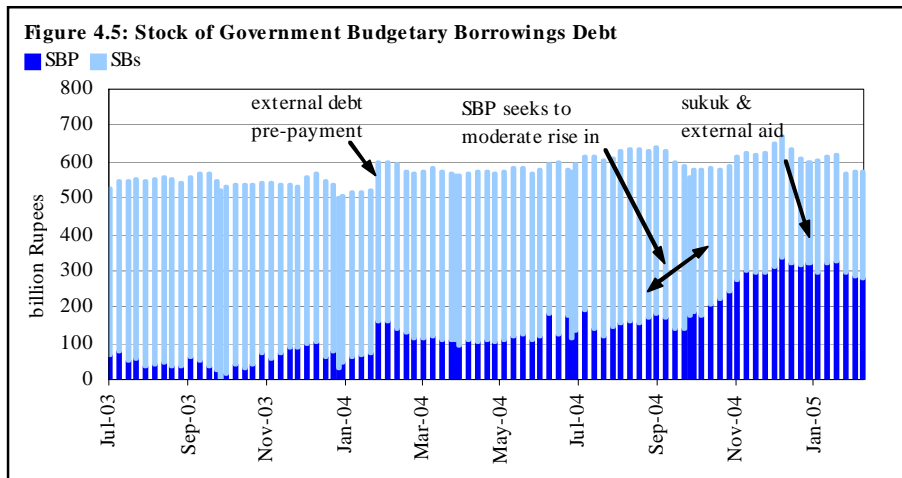
Another important development during Jul-Feb FY05 was the rise in the share of borrowings from the SBP in the total stock of government borrowing for budgetary support (see **Figure 4.5**). This was a consequence of the differing views of the SBP and commercial banks on T-bill yields. While the SBP sought to raise interest rates only gradually, banks were bidding aggressively for higher yields. As a result, acceptances in T-bill auctions fell sharply even below the

⁹ Net selling during Jul-Feb FY05 was Rs 117.5 billion against Rs 67.7 billion in the same period last year. However, most of its impact was offset by a rise in SBP NFA during last week of January due to realization of *Sukuk* receipts.

¹⁰ In rupee terms, the H1-FY05 budgetary deficits reached Rs 79 billion, as compared to a deficit of Rs 33 billion in H1-FY04.

¹¹ Specifically, the last week of January 2005 saw a large jump in net external receipts (mainly representing the inflow of US \$ 600 million due to the sovereign *Sukuk* issue, as well as large external aid disbursements).

maturing amounts, leading the SBP to fund the government requirements, and thereby raising its share of government T-bill debt.

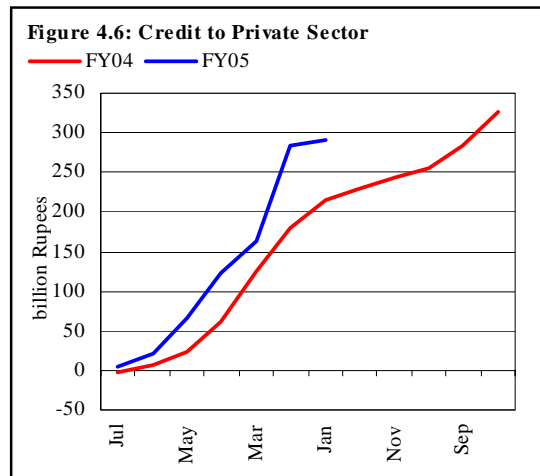


4.6 Commodity Operations

Credit for commodity operations shows a slight decline of Rs 0.4 billion during Jul-Feb FY05 compared to a substantial retirement of Rs 27.6 billion in the corresponding period of FY04. The bulk of the retirement in Jul-Feb FY04 was on account of repayment of wheat related loans. In Jul-Feb FY05, however, these retirements were more than offset by extension of credit to Trading Corporation of Pakistan for cotton related operations.

4.7 Private Sector Credit

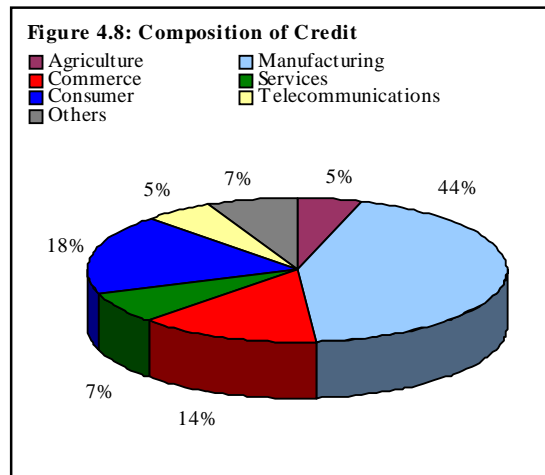
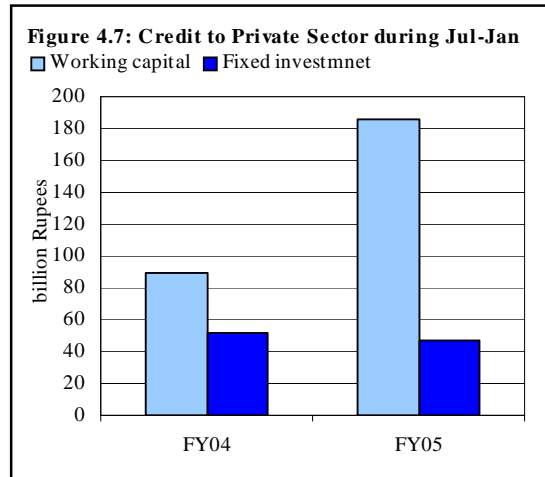
Private sector credit increased by Rs 291.4 billion during Jul-Feb FY05, sharply higher compared even to the exceptional growth of Rs 221.2 billion seen in the same period of FY04 (see **Figure 4.6**). It should be noted that this increase is despite a gradual rise in interest rates throughout Jul-Feb FY05 period, which testifies to the growth momentum of the



economy. In fact, the increased business confidence is also evident in the continuing strength in credit extended for both fixed investment and working capital (see **Figure 4.7**).

The credit extended for fixed investment during Jul-Jan FY05 was only a little lower than in the corresponding period of FY04.¹² The textile sector, which covers 33 percent of LSM, accounted for the bulk of this credit off-take. This reflects the industry's efforts to benefit from the post ATC regime by actively pursuing the transformation into integrated units in order to become increasingly competitive. In addition, substantial fixed investment loans have also been extended to the cement, construction, transport and telecommunications sectors.

The sharp 108.3 percent YoY rise in working capital requirements reflects both increased capacity utilization and the impact of addition new capacities.¹³ In particular, a significant part of the increase in working capital credit has been from sectors that had not participated significantly in credit off-take during the preceding years. This



¹² The distribution of credit by sector is available only with significant lags. While February 2005 data is not yet available, the trend is not expected to differ significantly from the January data.

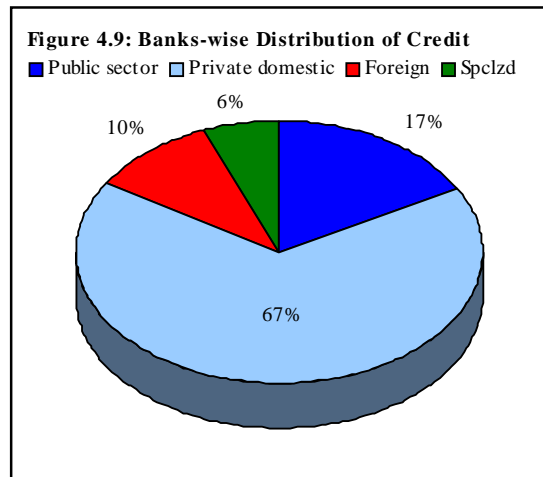
¹³ Increase in capacity utilization ranges from 1.4 to 33.3 percentage points in various industries (see **Section 2.2 of Real Sector on Industry**).

appears to suggest that the acceleration in economic activities is now broadening.

As far as the broad distribution of credit is concerned, the manufacturing sector was the major recipient of the credit receiving 44 percent of the net credit expansion during Jul-Feb FY05 followed by the consumer sector (see **Figure 4.8**). Within the consumer sector automobile and housing finance were the major beneficiaries.

A bank-wise distribution of credit show that most of the credit requirements were financed through private domestic banks (see **Figure 4.9**). Within this group, big privatized banks extended the major chunk of the credit as these banks were enjoying relatively better liquidity position during the period.

In particular, at end-January 2005 domestic banks (other than the big 5) were operating with 86.3 percent credit to deposit ratio compared with 70.3 percent for the 5 largest banks.



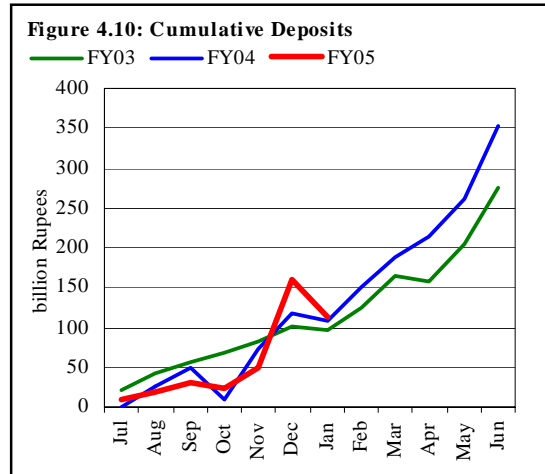
4.8 Other Items (Net)

OIN of the banking system registered a sharp decline of Rs 72.5 billion during Jul-Feb FY05 compared with a decline of Rs 11.8 billion in the corresponding period of FY04. Most of this decline came from the scheduled banks and is mainly explained by a rise of Rs 40.4 billion in their paid-up capital and reserves; (see **Box 4.1**). It may be recalled that SBP revised regulations on minimum paid up capital, required banks to increase their paid up capital to Rs 1.5 billion till end December 2004 and, further to Rs 2.0 billion till end December 2005.

4.9 Deposit Mobilization

Total deposits (including government deposits) increased by Rs 113.4 billion (5.56 percent) during Jul-Jan FY05 compared with Rs 108.2 billion (6.41 percent) during the corresponding period of FY04 (see **Figure 4.10**).

In the first 5 months of FY05, aggregate deposit growth in the banking system was much slower than in the preceding two years. This trend, however, changed in December 2004, when there was an expansion of cumulative Rs 110.7 billion (i.e. 68.6 percent of the July-Dec FY05 deposit growth). While a part of this unusual spike reversed in January 2005, the customary seasonal return of liquidity to the banking sector, and the increased pressure on bank to raise deposits rates,¹⁴ suggests that deposits growth will be relatively stronger February 2005 onwards.



Although, the Rupee deposits continued to contribute the larger part of Jul-Jan FY05 deposit mobilization, foreign currency deposits also showed a sizeable uptrend, rising by Rs 29.8 billion (see **Table 4.2**).

Table 4.2: Deposit Mobilization During Jul-Jan
billion Rupees

| | LCDs | | FCDs | | Total Deposits | |
|------------------|--------------|-------------|------------|-------------|----------------|--------------|
| | FY04 | FY05 | FY04 | FY05 | FY04 | FY05 |
| Big Five Banks | 21.9 | -0.5 | 2.4 | 10.3 | 24.3 | 9.7 |
| Domestic Banks | 77.6 | 63.2 | 3.5 | 14.6 | 81.1 | 77.8 |
| FBs | 1.3 | 22.1 | 1.6 | 4.9 | 3.0 | 27.1 |
| SBs | -0.2 | -1.2 | 0.0 | 0.0 | -0.2 | -1.2 |
| All Banks | 100.8 | 83.6 | 7.5 | 29.8 | 108.2 | 113.4 |

While the 5 largest banks have witnessed a decline in their net deposit mobilization (mainly because of net retirement of credit by PSEs), the aggregate deposits of the remaining (smaller) banks increased. In aggregate, foreign banks have registered an impressive performance in terms of expanding their deposit base.

¹⁴ The credit to deposit ratio has surged to 79.5 percent at end January 2005, from 72.2 percent and 69.4 percent at end -January 2004 and end-January 2003, respectively. Given the evident increase in net interest margins, banks are increasingly likely to focus on deposit mobilization by offering higher returns. Anecdotal evidence indicates that this trend is indeed gathering pace.

Box 4.1: Other Items Net (OIN): An Explanatory Note

Basically, the OIN is calculated on a net basis (**other assets minus other liabilities**). It includes a range of items including fixed assets of banks (other asset), capital and reserves (other liabilities), profit or loss, revaluation of assets (other liabilities) and all the other items that have neither classified in credit to government sector nor in credit to non-government sector.

Technically, the value of OIN will be zero if all the *other assets* are fully backed by *other liabilities*. Or in other words, the corresponding entry of any other liability is made in other assets. In practice however, this is not the case. It is possible that a counter asset side entry of any *other liability* is made under some other classified head (credit to government or non-government sector). Some examples of such entries are given below;

- 1) One such adjustment could be in the form of write-off of loans. For instance, a bank write-offs loan amounting Rupees say 10 billion. In balance sheet, the liability entry would be a decline of equivalent amount in bank's equity; and on the asset side, bank's advances will register a similar decline. In monetary survey, this entry will make changes in OIN. Since equity is included in *other liabilities*, the decline in equity will increase OIN. However, its counter entry is not made in *other assets* (had this been the case there would have been no change in OIN); rather, credit to non-government sector will decline by the same amount. Therefore, a rise in OIN is offset by the decline in credit to non-government sector. There is no change in NDA.
- 2) One of the common causative factors of a change in OIN is the rise in banks' equity either in form of capital injection by central bank or capital built-up through floating shares. For instance if a bank raises its paid up capital, OIN will decline since capital is the part of *other liabilities*. This is because, the asset entry will not be made in *other assets* as the cash holding of banks is not included in *other assets* (again, had this been included in *other assets*, there would have no change in OIN). Now this decline in OIN is represented by a decline in currency in circulation as currency in circulation is calculated by netting cash holdings of the banks.
- 3) As interest rates fall and the prices of (government) securities go up. Given that banks are required to revalue their assets on mark to market basis every week, this rise in the securities' value will immediately be reflected in banks' balance sheets. On the liability side, surplus on this revaluation will be taken to the equity; and on the asset side, value of banks' investment in these securities will go up. This rise in revaluation account means an increase in *other liabilities* and hence a decline in OIN. The counter entry on asset side will appear as increase in claims on government, although the rise in value of securities should only be relevant for secondary market trading and not for increase in claims on government.