4 Money and Banking

4.1 Overview

Although monetary tightening helped in reducing inflationary pressures in the economy during FY06, aggregate demand was still high as indicated by the strong growth in real GDP (that increased by 6.6 percent during FY06 despite losses relating to October 2005 earthquake and higher international oil prices), the high growth in private sector credit, sluggish decline in core inflation and large external account deficit. The FY07 monetary environment was rendered even more challenging by the need to balance the targeted rise in real GDP growth (i.e., 7 percent for FY07) and a further deceleration in inflation (from 7.9 percent in FY06 to 6.5 percent target for FY07).

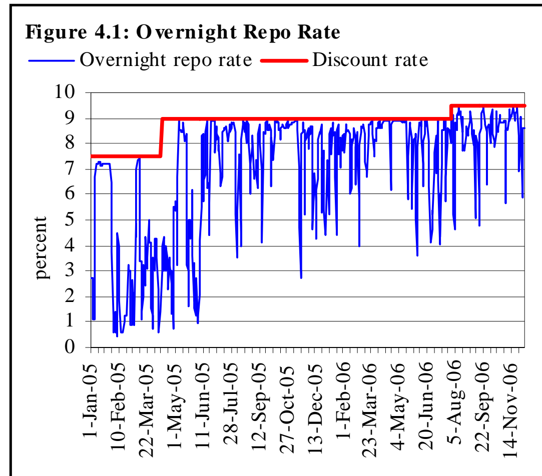
The monetary policy also had to respond to the challenges posed by the expansionary fiscal policy and the continued pressures on the external account. In this regard, the use of exchange rate policy to address external imbalances was deemed unhelpful due to the pass through of exchange rate adjustments on domestic prices.[1] Thus, the charge of addressing macroeconomic imbalance fell disproportionately more on the monetary policy instruments. In this background, the Credit Plan for FY07 envisaged a slowdown in monetary expansion (M2) from 15.2 percent in FY06 to 13.5 percent in FY07; this target M2 growth was slightly lower than the nominal GDP growth target (14.0 percent for FY07), which would reduce excessive aggregate demand pressures in the economy while continuing to support the growth objective.

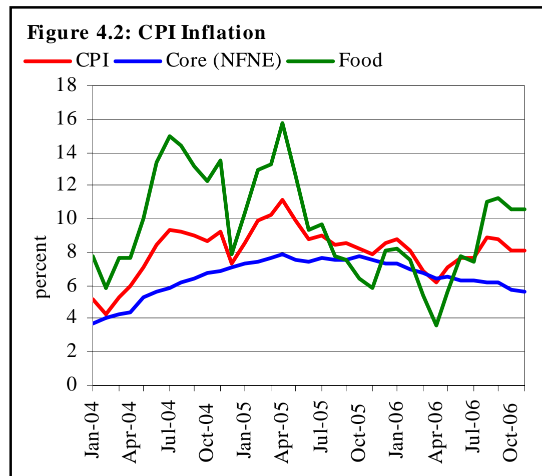
Consistent with this objective, SBP further tightened its monetary policy in FY07 by first raising the cash reserve requirements for banks on 22nd July 2006, and then increasing the discount rate by 50 basis points to 9.5 percent a week later. At the same time, SBP continued to drain excess liquidity from the inter-bank market. This combination of OMOs and increase in reserve requirement has exerted upward pressures on the overnight rates. Specifically, the overnight rates remained persistently close to the discount rate throughout H1-FY07.

[1] Given that the large external imbalance was due to sharp increase in imports, there are reasons to believe that the use of exchange rate policy to address external imbalances may not be desirable as a large share of imports comprises of raw material and capital goods, which are needed for capacity expansion and removing supply bottlenecks.

This is reflected in reduced volatility as the coefficient of variation for overnight rates has declined to 0.12 during Jul-Dec FY07 as compared to 0.16 during the same period last year. As shown in **Figure 4.1**, the overnight repo rate has been moving very close to the discount rate.

The impact of monetary tightening pursued in FY06 as well as the policy signals through the FY07 changes, is already evident in the slowdown in private sector credit growth, which has dropped to 5.9 percent during Jul-Nov FY07[2] against the 10.9 percent growth witnessed in the corresponding period of FY06. Moreover, core inflation, as measured by non-food non-energy (NFNE) inflation has slowed to 5.6 percent YoY in November 2006 from 7.6 percent YoY in November 2005 (see **Figure 4.2**).[3]





However, the growth in monetary aggregates during Jul-Nov FY07 remained strong (see **Figure 4.3**). This is because:

(1) the government borrowings showed a marginal deceleration, compared to the slowdown in the private sector credit; and

[2] Jul-Nov FY07 pertains to the period beginning from July 2006 to last Saturday of November (i.e., 25th Nov 2006).

[3] Both estimates of core inflation (i.e., non-food non energy as well trimmed) are showing deceleration, but the slowdown in the latter is relatively gradual.

(2) the contraction in NFA during Jul-Nov FY07 has been much lower than that in FY06.

While Jul-Nov FY06 figures show that *government borrowings* from the banking system have decelerated marginally (see **Table 4.1**), this reflects an exceptional receipts in this month. Adjusting for this, the borrowings are clearly higher, and volatile (see **Figure 4.4**). A large part of the variation in government borrowings from the banking system is a result of the uncertainty in the availability of budgetary financing from other sources (i.e., from external and non-bank).[4]

Although, the government may be able to remain within the budgetary borrowing target of Rs 120 billion from the banking system for FY07, excessive borrowing during the course of the year is a source of concern for monetary policy as this adds to the aggregate demand and in turn to the

Figure 4.3: Growth in Monetary Aggregates

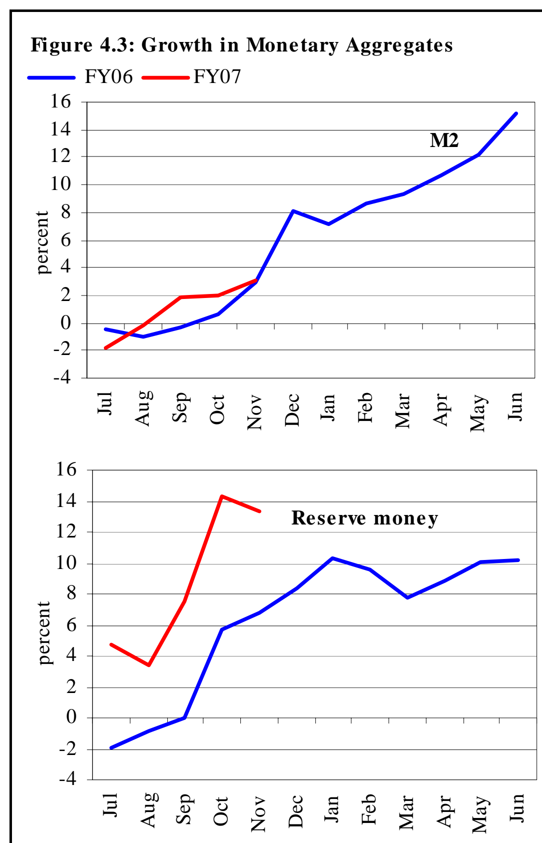


Table 4.1: Contribution to M2 Growth (Jul-Nov)

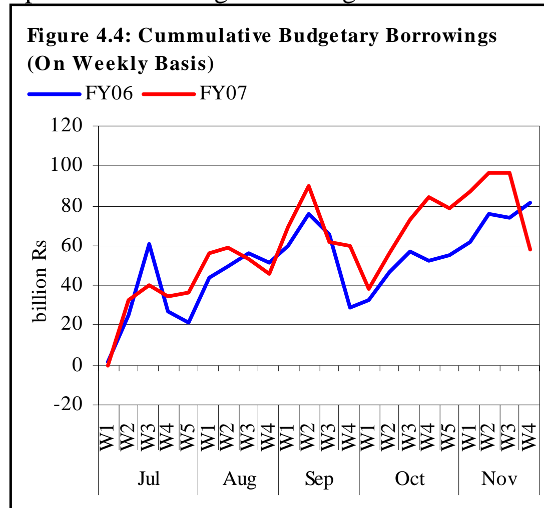
	Growth (percent)		Contribution to Growth (percent)	
	FY06	**FY07**	**FY06**	**FY07**
NDA	7.7	5.4	6.0	4.3
Credit to non-government	*10.2*	*5.5*	*6.2*	*3.5*
Government borrowing	*8.7*	*6.3*	*2.2*	*1.6*
Other items (net)	*33.7*	*8.6*	*-2.3*	*-0.8*
NFA	-14.2	-6.2	-3.1	-1.2
M2	**3.0**	**3.0**	**3.0**	**3.0**

[4] In April FY06, the government retired a large proportion of bank borrowing using the external receipts through privatization proceeds and Eurobond issue. Similarly, the sharp reduction in budgetary borrowing during the last week of November 2006 is largely the result of retirement of government debt owed to the banking sector through using proceeds from central bank's profits which were credited to the government account.

inflationary pressures in the economy.[5]

This is particularly unwelcome because the government borrowing is entirely from the central bank, which is the most inflationary in nature as it contributes to reserve money growth. Specifically, the reserve money sharply increased by 13.4 percent during Jul-Nov FY07 against 6.8 percent growth witnessed during the corresponding period of the previous year.[6] Given that SBP is targeting to bring down M2 growth to 13.5 percent in FY07 from 15.2 percent in the preceding year, this sharp increase in the reserve money is undesirable. The high government borrowing and the resulting rise in reserve money has a potential of re-igniting the inflationary pressures in the economy. If this happens, the time path for achieving a stable low inflation could be extended, as in the absence of low stable inflation, the central bank would have to keep interest rates high for a longer duration.

Figure 4.4: Cummulative Budgetary Borrowings (On Weekly Basis)



Realizing the need to reduce reliance on bank borrowing (especially from SBP), the government has sought to increase its non-bank borrowings. Unfortunately, instead of raising these incremental funds entirely through PIB issues, the government has also re-allowed institutional investment in National Saving Schemes (NSS). While the latter decision would, in theory, allow institutional

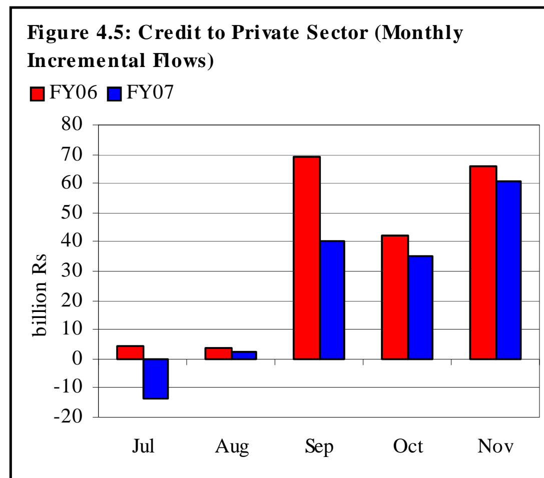
[5] The extent of the impact of government borrowing on inflation will depend on the sources of funding (i.e., SBP or commercial banks) and response of the central bank. The government borrowings from the commercial banks would lead to increase in M2 without expanding the monetary base (i.e., reserve money) through multiplier effect. This in turn will add to inflationary pressures in the economy. The borrowings from the central bank on the other hand would result into an increase in the reserve money and in turn to a rise in M2 which will be in addition to the increase in M2 through the multiplier effect. Thus, unless this impact on reserve money is neutralized by central bank through open market operations (OMOs), borrowings from the central bank are most inflationary in nature.

[6] Scheduled banks' deposits with SBP (which are part of the reserve money) saw an increase of Rs 42.6 billion in the month of July 2006 in which SBP raised the cash reserve requirement (CRR) for banks. Adjusting for this rise in deposits, the reserve money still shows an increase of 9.1 percent during Jul-Nov FY07.

investors to rollover large NSS maturities, this major policy reversal is likely to have significant negative implications for the development of the domestic debt market, and raise interest rate risk for the government (see **Special section on NSS**).

In contrast to government borrowings, the private sector credit seems to be responding to interest rate signals from the central bank. Specifically, growth in private sector credit during Jul-Nov FY07 has slowed down to 5.9 percent compared to 10.9 percent rise witnessed during the corresponding period of the previous year. However, so far, this slowdown in private sector credit growth is *not* a source of disquiet for SBP for the following reasons:

Figure 4.5: Credit to Private Sector (Monthly Incremental Flows)



- The YoY growth in private sector credit remains very strong at 18.0 percent by 25th Nov 2006, although down from 31.9 percent last year.

- A review of monthly trends in private sector credit shows that the slowdown is largely concentrated in the month of September 2006. In fact, trends during October and November 2006 indicate presence of strong demand for private sector credit in the economy (see **Figure 4.5**).

- The available evidence suggests that the slowdown in private sector credit is not broad-based as (1) the increased *net* retirement, particularly by the sugar manufacturers[7] and cotton spinning sector during Jul-Oct FY07 contained the

[7] With a view to discourage hoarding of sugar and to ensure stability in its prices, SBP on June 9, 2006 directed all banks to ensure that all advances against the security of sugar stock are fully adjusted latest by 31st October 2006. Further, all renewals/fresh disbursements were made subject to 50 percent cash margin requirement with the instruction that such advances are made only after a clean up period of at least one month. These restrictions were however withdrawn on 27th October 2006 (see BPRD Circulars # 4, 10, and 15 of 2006).

growth in private sector credit;[8] and (2) deceleration in bank credit against equities (see Section on **Private sector credit** for more details).

- More importantly, while the nominal lending rates are rising, the real lending rates are still very low (see **Figure 4.6**). The real lending rates under export finance facility are even negative.[9] The trade-related loaning activity is still very strong (see **Figure 4.7**).

- Further in order to help the textile sector that previously borrowed and at the floating KIBOR rates and are now feeling the pain of sharp rise in KIBOR due to monetary tightening, SBP announced debt swap option under Long Term Finance- Export Oriented Project (LTF-EOP) on September 04 2006. Interest rates on LTF-EOP facility is considerably lower than the weighted average rates of the

Figure 4.6: Lending Rates on Incremental Loans

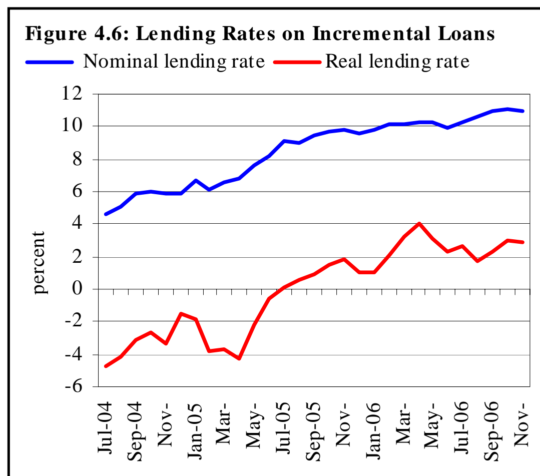
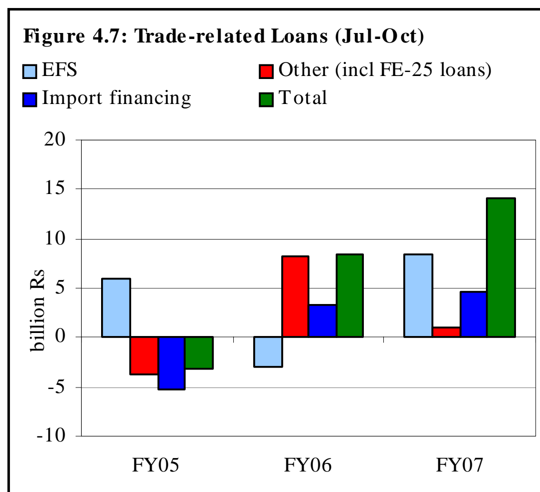


Figure 4.7: Trade-related Loans (Jul-Oct)



[8] The *net retirement* by sugar manufacturers increased to Rs 18.3 billion during Jul-Nov FY07 period from Rs 1.8 billion during the corresponding period of FY06. The credit growth in cotton spinning sector remained sluggish at 2.8 percent during Jul-Nov FY07 period against the growth of 57.7 percent during the corresponding period of FY06.

[9] Refinance under EFS is being offered at 6.5 percent, i.e., 4-4.5 percent below the 6-month KIBOR.

benchmark instruments,[10] thus leading to an efective subsidy in the range of 4.6-5.4 percent.[11]

In sum, though the overall demand for credit by the private sector has decelerated, the slowdown is not broad-based. This suggests that monetary policy needs to remain tight.

However, while the transmission of the monetary policy on lending rates has improved over the last year, the impact on deposit rates has been less than desired, contributing to an unhealthy high banking spread (see **Figure 4.8**).

A part of the rise in the spread is explained by the changing maturity and risk profile of banks' assets and liabilities, and therefore SBP encouraged banks to mobilize longer term deposits by reducing cash reserve requirement on their time liabilities in July 2006. Encouragingly, the available evidence shows that banks are mobilizing deposits offering higher returns to customers and the share of such deposits has been rising (see **Figure 4.9**).

Figure 4.8: Banking Spread

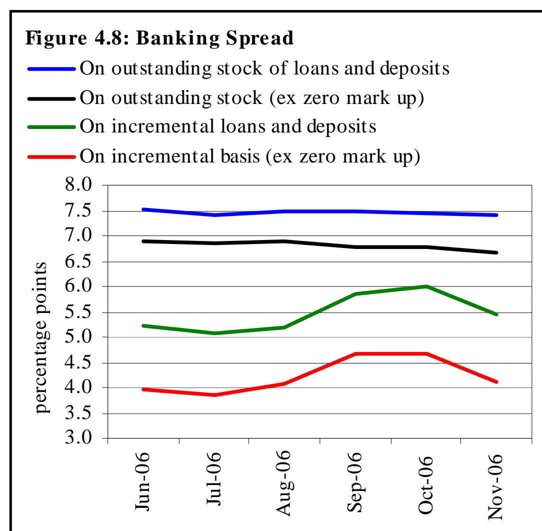


Table 4.2: Distribution of Banks in terms of Banking Spread

	Percentage of banks			
	Dec-05	**Mar-06**	**Jun-06**	**Oct-06**
Spread range	*On incremental basis*			
1-3 percent	19	24	21	23
3-5 percent	11	16	18	18
5-7 percent	28	24	23	18
7-9 percent	25	24	26	28
More than 9 percent	17	11	13	13
Spread range	***On incremental basis excl. zero mark up***			
1-3 percent	25	35	31	26
3-5 percent	19	19	23	23
5-7 percent	28	22	23	36
7-9 percent	14	16	18	10
More than 9 percent	14	8	5	5

[10] 12-month T-bills, 3-year PIBs and 5-year PIBs are used as benchmark instrument depending upon the tenor of financing.
[11] See **Box 5.7** in *SBP's Annual Report* for FY06.

Since the mobilizations of long-term deposits lower the maturity mismatch for banks and reduce liquidity risks, it was expected that the banking spread would decline. But in the meanwhile, lending rates have also risen thereby leading to a sharp rise in banking spread (calculated on the basis of incremental loans and deposits) in recent months (see **Figure 4.8**).

Further, as evident from **Table 4.2**, while the concentration of banks earning more than 7 percent spread (on incremental basis excluding zero mark up deposits and advances) has declined from 28 percent in December 2005 to 15 percent in October 2006, 59 percent of banks are still charging spread in the range of 3-7 percent, which is quite high. Such a large spread can have a dampening effect on economic growth by discouraging savings.

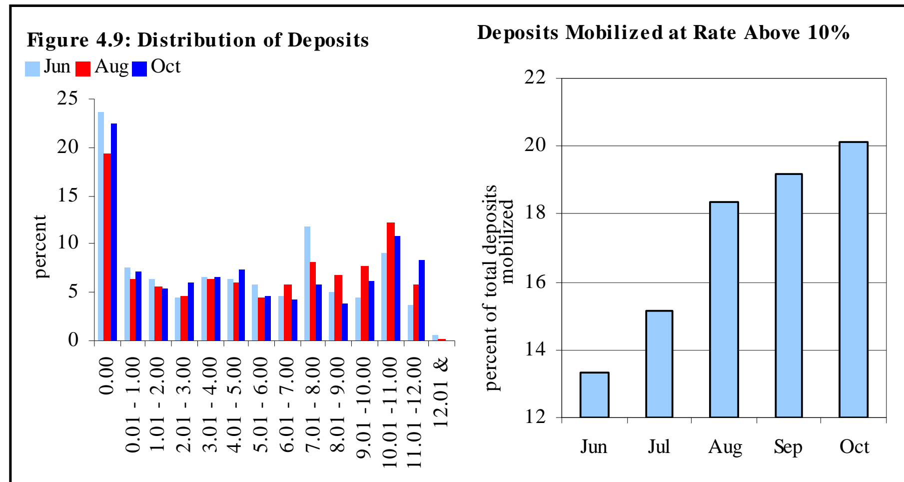


Figure 4.9: Distribution of Deposits

4.2 Monetary Survey

The broad monetary aggregate (i.e., M2) registered a growth of 3.0 percent during Jul-Nov FY07 period which was the same as achieved during the corresponding period of FY06 (see **Table 4.3**). As in the previous year, the expansion in money supply during Jul-Nov FY07 has been entirely contributed by the increase in net domestic assets (NDA) of the banking system as the net foreign assets (NFA) showed a contraction during the period, reflecting the continued pressures on country's external account.

Table 4.3: Monetary Survey (Flows)

billion Rupees

	Credit Plan	Jul-Nov[1]	
	FY07	FY06	FY07
M2	**459.9**	**88.2**	**103.5**
	13.5%	*3.0%*	*3.0%*
NFA	**9.8**	**-90.5**	**-42.6**
SBP		-57.0	-20.4
Scheduled banks		-33.5	-22.2
NDA	**450.1**	**178.7**	**146.1**
	16.5%		
SBP		121.3	124.3
Scheduled banks		57.4	21.8
of which			
Government borrowing	**130.1**	**65.3**	**53.1**
For budgetary support	***120.1***	*81.6*	*57.6*
SBP		161.0	62.0
Scheduled banks		-79.4	-4.4
Commodity operations	**10.0**	**-15.5**	**-3.3**
Credit to non-govt sector	**395.0**	**182.6**	**119.4**
Private sector	390.0	185.8	125.4
PSEs	5.0	-1.6	-6.2
Other items (net)	**-75.0**	**-69.2**	**-26.4**
SBP		-38.1	63.4
Scheduled banks		-31.1	-89.9

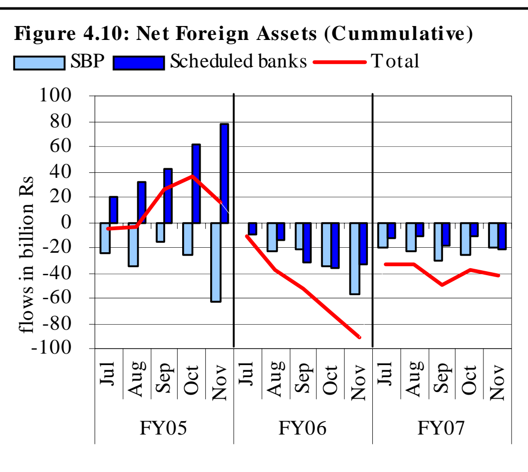
[1] Beginning of July to last Saturday of November (25 Nov 2006)

Given that SBP is targeting to contain FY07 M2 growth at 13.5 percent against the actual growth of 15.2 percent in the preceding year, the acceleration in M2 during Jul-Nov FY07 is quite unwelcome and reinforces the need for a tight monetary stance.

4.2.1 Net Foreign Assets

The impact of continued pressures on the external account was evident on the NFA of the banking system that showed a contraction of Rs 41.1 billion during Jul- Nov FY07, almost equally distributed between SBP and

Figure 4.10: Net Foreign Assets (Cummulative)



commercial banks (see **Figure 4.10**).

However, it is important to note that the contraction in the NFA of the banking system during Jul-Nov FY07 was considerably lower than the sizeable reduction of Rs 90.7 billion witnessed during Jul-Nov FY06.

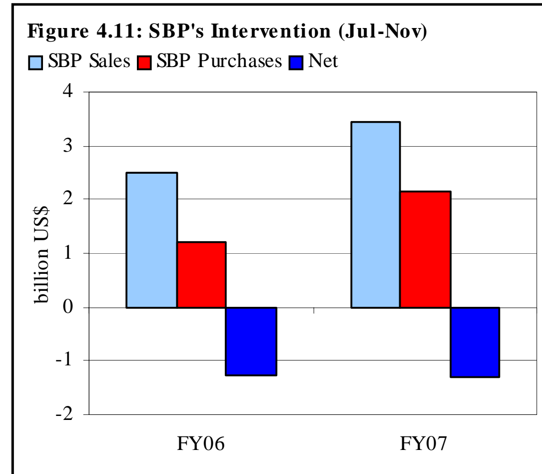


Figure 4.11: SBP's Intervention (Jul-Nov)

As in the previous year, the fall in SBP NFA during Jul-Nov FY07 reflected the worsening external account and SBP's decision to support foreign exchange market by providing foreign exchange to meet lumpy payments (see **Figure 4.11**) so that the extent of volatility in exchange rate could be contained. However, the lower depletion in SBP's NFA during Jul-Nov FY07 was on account of higher inflows (such as such privatization receipts of PTCL) during this period.

Table 4.4: FE-25 Loans (Jul-Nov)
million US Dollar

	FY06	FY07
Total FE-25 Loans	**491.9**	**120.6**
To exporters	306.7	-16.4
To importers	185.2	137.0

The depletion in commercial banks' NFA during Jul-Nov FY07 was low compared to the corresponding period of previous year. This mainly reflects the subdued demand of the foreign currency loans, which rose by only US$ 88 million during Jul-Nov FY07 against US$ 453.3 million during Jul-Nov FY06.[12] In particular, the foreign currency loans have become unattractive for exporters due to narrowing down of the differential between the EFS rate and the benchmark LIBOR rates, as well the increase in perceived exchange risk due to continuing pressures on the external account.

[12] The commercial banks may use the foreign currency funds mobilized under FE-25 deposit scheme either for placement outside Pakistan (in which case these foreign currency funds would add to the NFA of commercial banks) or for extending loans to exporters & importers (in such case, this would add to the NDA of the commercial banks as these loans are converted into Rupee and become liability of the domestic residents). Thus, with a given pool of FE-25 deposits, any increase in foreign currency loans, would lead to a corresponding decline in commercial banks' NFA and increase in its NDA. The opposite would happen when a foreign currency loan is retired or matures.

Since importers cannot take advantage of subsidized EFS loans, they are still interested in availing foreign currency loans due to the higher cost of the Rupee borrowing (see **Table 4.4**).

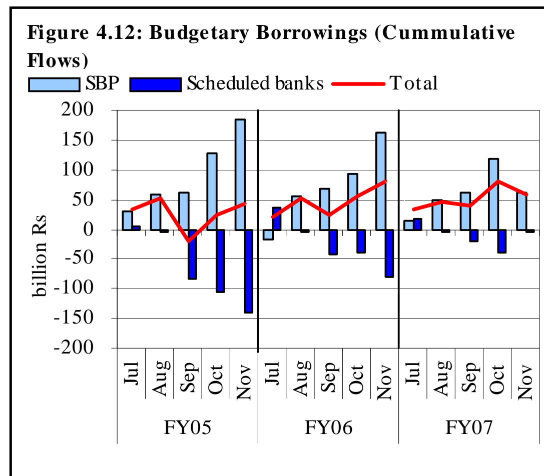
4.2.2 Net Domestic Assets

During Jul-Nov FY07, the growth in net domestic assets (NDA) of the banking system slowed down to 5.4 percent from 7.5 percent realized during the corresponding period of the previous year. The deceleration is evident in all major components of NDA viz. *government borrowing*, *credit to non-government sector*, and *other items (net)*.

Government sector borrowings

The government borrowings from the banking system decelerated to 6.3 percent during Jul-Nov FY07 from 8.1 percent during the corresponding period of FY06. However, this improved performance was the result of retirement of Rs 32.7 billion to the banking system in the last week of November 2006. The volatility in budgetary borrowing makes SBP's liquidity management more difficult.

Figure 4.12: Budgetary Borrowings (Cummulative Flows)



The high budgetary borrowing was mainly due to increased estimated budget deficit in FY07 (see **Table 4.5**). It is expected that the reliance of the budgetary borrowing on the banking system may fall following the recent decision of re-allowing institutional investment in National Saving Schemes since September 2006 and expected external flows on account of floatation of GDR.

Table 4.5: Deficit Financing (Jul-Sep)

billion Rs

	FY06	FY07
Deficit	**37.7**	**86.7**
External	5.0	27.8
Domestic	32.6	58.9
Non-bank	14.3	24.4
Bank	14.8	34.5

Unfortunately, share of the government's borrowing from the central bank has been rising steadily over time (see **Figure 4.13**). A key contributor to this rising trend has been the absence of any sizeable PIB issue in recent years. Certainly, such borrowings are the most inflationary in nature.

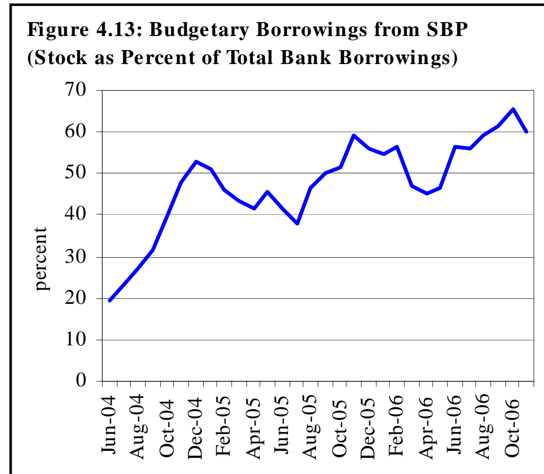


Figure 4.13: Budgetary Borrowings from SBP (Stock as Percent of Total Bank Borrowings)

Borrowings from commercial banks which had been witnessing net retirement during the Jul-Nov period of last two years also turned positive during FY07.

However, the credit under commodity operations slowed as the credit extended to Trading Corporation of Pakistan (TCP) during Jul-Nov FY07 for sugar-procurement related operations was offset by retirements on account of loans related to wheat, cotton and rice procurement operations (see **Figure 4.14**).

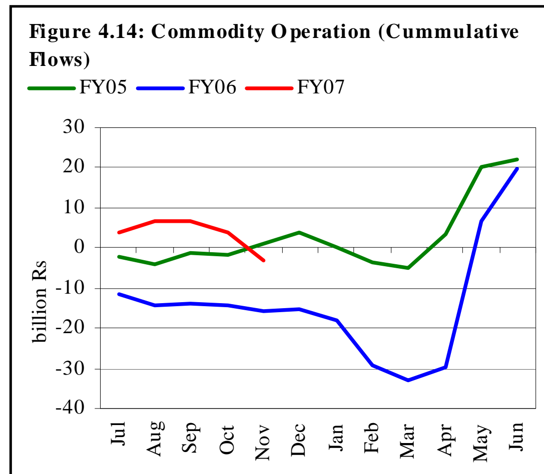


Figure 4.14: Commodity Operation (Cummulative Flows)

Credit to private sector

The private sector lending witnessed a sharp slowdown during Jul-Nov FY07, growing at 5.9 percent compared to the 10.9 percent growth realized during the corresponding period of last year. A close analysis of the data shows that this slowdown is concentrated in a few sectors:

Table 4.6: Private Sector Credit (Jul-Nov)

(billion Rupees)	Absolute flows FY06	Absolute flows FY07	% Growth FY06	% Growth FY07
1. Private sector businesses	**144.0**	**106.2**	**11.6**	**7.1**
A. Agriculture	**9.5**	**11.7**	**7.3**	**8.7**
B. Manufacturing	**71.1**	**51.1**	**9.4**	**5.7**
Sugar	-1.8	-18.3	-5.5	-33.5
Textiles	59.2	33.3	15.7	7.6
Of which cotton	44.6	-5.0	18.3	-1.7
Coke and refined petro products	-2.5	5.0	-19.0	62.9
Chemicals and products	4.3	1.0	7.9	1.4
Non-metallic minerals	8.4	3.3	20.9	4.5
Of which cement	8.5	-3.2	26.1	-5.1
Basic metals	0.2	4.4	1.6	24.3
Machinery and equipments	2.0	3.6	19.7	32.2
C. Electricity, gas and water	**0.3**	**3.6**	**1.7**	**19.3**
D. Construction	**5.0**	**6.0**	**16.0**	**14.3**
E. Commerce and trade	**34.3**	**10.2**	**23.7**	**5.3**
F. Transport, storage & communications	**3.1**	**10.2**	**6.2**	**16.2**
G. Services	**16.0**	**5.8**	**22.4**	**6.2**
Of which other business activity	3.6	-0.2	63.0	-2.0
2. Personal	**38.7**	**32.1**	**15.6**	**9.4**
Of which consumer financing	37.9	29.6	18.3	9.9
Business + Personal	**182.8**	**138.3**	**12.2**	**7.5**

1. The sugar manufacturer witnessed a sharp increase of 33.5 percent in *net retirement* from Rs 5.5 billion during Jul-Nov FY06 to Rs 18.3 billion in Jul-Nov FY07. This probably reflects the impact of the SBP's directive to banks to ensure that all advances against the security of sugar stock are fully adjusted latest by 31st October 2006. The resulting increase in net retirement pulled down the overall growth in private sector credit.

2. *Other business activities* witnessed a sharp drop in credit from Rs 14.5 billion in Jul-Nov FY06 to the retirement of Rs 1.6 billion during Jul-Nov FY07. This head includes bank advances under continuous funding system (CFS) to equity market which is closely related to performance of the stock market. During Jul-Nov FY07, the KSE-100 Index increased by 6.3 percent, sharply lower than 21.2 percent growth realized Jul-Nov FY06.

3. The credit to the cotton sector during Jul-Nov Fy07 was low at Rs 4.8 billion compared to the Rs 89.5 billion extended during the corresponding period last year. The slowdown is largely concentrated in cotton spinning sector.

As evident from **Table 4.7**, there is considerably higher retirement of Rs 23.5 billion in *agriculture machinery and equipment purchase* and *manufacturing of sugar* during Jul-Nov FY07 that contributed in slowing down the private sector credit. The lower credit to *other business activities* (mostly for CFS), *wholesale and commission trade* (that also includes part of FE-25 loans) and *cement manufacturer* further decelerated the growth in private sector credit.

Table 4.7: Profile of Credit to Private Sector Business (Jul-Nov)

	No of Sectors			Amount in Rs billion		
	FY05	**FY06**	**FY07**	**FY05**	**FY06**	**FY07**
Retirement of more than Rs 5 billion	1[1]	0	2[2]	-5.5	0.0	-23.5
Between Rs 3 to 5 billion	0	0	1	0.0	0.0	-3.0
Between Rs 1 to 3 billion	8	7	4	-15.2	-10.0	-6.2
up to Rs 1 billion	52	52	42	-16.1	-13.9	-7.7
Credit up to Rs 1 billion	68	69	77	25.4	18.0	20.3
Between Rs 1 to 3 billion	11	11	17	18.2	18.1	29.7
Between Rs 3 to 5 billion	7	6	7	28.8	22.5	27.7
Between Rs 5 to 10 billion	2	4[3]	1[4]	12.6	27.4	5.8
More than Rs 10 billion	4	3[5]	2[6]	143.2	114.5	29.1

1. Manufacturers of sugar
2. Agriculture machinery & equipment, and manufacturers of sugar
3. Major crop sector, auto sector (sales, maintenance and repair), and manufacturers of cement, domestic and wholesale
4. Manufacturers of refined petroleum and products
5. Cotton spinning sector, exports of finished products, other business activities
6. Major crop sector and post & telecommunication

Credit to agriculture sector increased by 9.1 percent during Jul-Nov FY07 mainly due to growing of major crops that showed an increase of 20.4 percent (Rs 16.3 billion) during the period. The rise in agri-credit was despite the retirement of Rs 5.21 billion (15.7 percent) under purchase of agricultural machinery and equipments.

While there is no doubt that the extraordinary growth in private sector credit (net) during the previous two years (largely reflecting the impact of historical low interest rates in the economy) has been receding, the credit demand is still quite strong. This is apparent in a strong 18.0 percent YoY growth in private sector credit by November 25, 2006.

Other items (net)

During Jul-Nov FY07, the *other items net* (OIN) had a contractionary impact on M2 growth. Most of the decline in OIN came from scheduled banks, which was partially offset by a fall in SBP other liabilities. The decline in SBP's liabilities was on account of reversal of the repo transactions and the allocation of SBP's profit.