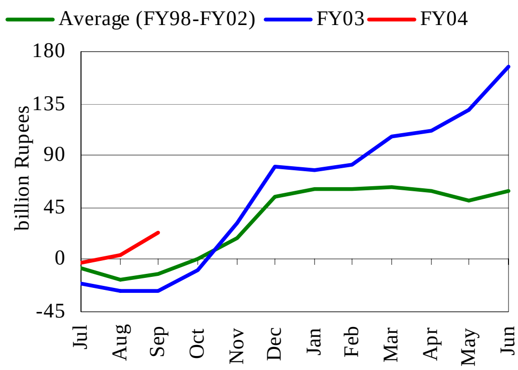
4 Money and Credit

The initial quarter of FY04 proved to be quite eventful, witnessing a number of significant changes. Not only was there quite a robust increase in net private sector credit (in contrast to the net retirement traditionally seen in the period), but the benchmark interest rates too inched up, ending a 1183 basis point slide initiated 26 months ago. Moreover, due to a lower availability of external funding and the net negative accumulation from the NSS, the net government budgetary borrowings from the banking system increased in contrast to the declines witnessed in each of the preceding 8 quarters. Finally, while 2.1 percent M2 growth rate for Q1-FY04 was practically unchanged from Q1-FY03, it was not entirely due to NFA growth (reversing the trend observed through most of FY03).

The most significant of these was the divergence in the movement of net private sector credit. While the trade financing continued to move on traditional patterns, recording a decline in net credit, the aggregate private sector credit rose sharply during Q1-FY04. This is in stark contrast to the trends in the preceding years (see **Figure 4.1**), and appears to be caused by:

Figure 4.1: Private Sector Credit



(1) A surge in consumer credit

The exceptional credit growth is primarily a function of the SBP's easy monetary posture, as low interest rates catalyzed the substantial development of the consumer finance market.

(2) Increased cotton financing

Not only did an anticipated shortfall in cotton production induce the early initiation of cotton purchases, the net credit requirements were also inflated due to a sharp jump in cotton prices (relative to FY03).

In this context, it is instructive to note that until mid-September 2003, market interest rates did not move up in response to the exceptional credit expansion, as the interbank market remained substantially liquid. However, market sentiment was increasingly pre-disposed to a rise in interest rates.

Table 4.1: Sterilization during Q1
billion Rupees

	FY03	FY04
SBP foreign currency transactions	76.0	23.6
Sterilization (overall)	77.6	34.2
Change in reserve money	-1.6	-10.6

In particular, a temporary forex liquidity shortage prompted a sharp fall in SBP forex purchases (see **Table 4.1**). This lower injection of Rupees, together with the rising government demand, especially through unexpected PIB auctions, (due to lower availability of external finance and a visible fall in net NSS receipts) the narrowing spread between Rupee and US Dollar interest rates, as well as the negative real yields on short-term T-bills had, by September 2003, led the market to expect a rise in interest rates.

Therefore, while the aggressive SBP interventions to support interest rates during July-August 2003 did not induce a major market reaction, the September 2003 measures[1] fetched a more than proportionate response, in terms of sharply higher bids in subsequent auctions. As a result, the SBP was eventually forced to lower the volume of accepted bids in successive auctions in order to prevent an unwarranted sharp rise in interest rates.

From the central bank's perspective: (1) the Rupee liquidity shortage was potentially only a short-term phenomenon caused by an unseasonal credit demand, and, as such, it would not warrant a shift in monetary stance; (2) similarly, it was unclear whether the sterilization of interbank forex market injections would continue into the months ahead; and (3) a temporary increase in the government funding demand could, at least in theory be met by a mixture of privatization receipts and SBP borrowings. In essence, all these arguments reduced to a simple choice between containing inflationary pressures and supporting acceleration in growth.

Given that inflation remained low (albeit rising) and that economic recovery was incipient with growth still below the targeted long-term trajectory, the balance of risk for the SBP tilted towards the continuation of the current monetary stance.

The SBP objective of keeping the interest rates stable could be witnessed by SBP interventions of maintaining market liquidity through the OMOs during Q1-FY04.

4.1 Government Borrowings for Budgetary Support

Although the government revenues were higher in Q1-FY04, a matching increase in expenditures left the funding requirement almost unchanged from Q1-FY03.

[1] Unscheduled T-bill auctions, a small hike in yields in September 4, 2003 auction, as well as continuing OMOs.

Thus the net decline in the availability of non-discretionary flows increased the reliance on bank borrowings for budgetary support to Rs 9.9 billion during Q1-FY04, in contrast to a net *retirement* of Rs 12.7 billion in the corresponding quarter of FY03 (see **Table 4.2** and **Table 4.3**).

Table 4.2: Monetary Survey of the Banking System (Flows) during Q1

billion Rupees

	FY03	FY04	
	Actual	**IMF projections**	**Actual**
Monetary assets (M2)	37.6	44.0	43.2
percent change	2.1	2.1	2.1
I. Net foreign assets	107.2	13.2	42.0
SBP	127.9	12.6	41.5
Scheduled banks	-20.7	0.6	0.5
II. Net domestic assets	-69.5	30.8	1.2
percent change	-4.5	2.0	0.1
SBP	-109.5	-4.0	-52.6
Scheduled banks	40.0	34.8	53.8
A. Government sector (net)	-16.0	41.5	5.7
a) Net bank barrowing for budgetary support	-12.7	43.5	9.9
SBP	-128.1	-16.8	-51.8
Scheduled banks	115.3	60.3	61.7
b) Commodity operations	-4.8	-2.0	-7.5
c) Others	1.5		3.3
B. Non-government sector (net)	-36.0	-15.7	6.1
a) Credit to private sector	-26.8	-16.6	23.1
i) Commercial banks	-28.2		21.0
of which EFS	-7.7		7.6
ii) Specialized banks	1.5		2.1
b) Credit to PSEs	-4.1	1.0	-15.7
i) Autonomous bodies	-4.6		-8.2
ii) Other PSEs	0.7		-7.3
iii) PSEs special debt-repayment a/c with SBP	-0.2		-0.1
c) Other financial institutions	-5.1	0.0	-1.3
C. Other items (net)	-17.6	5.0	-10.6
SBP	22.4	5.0	-2.9
Scheduled banks	-39.9	0.0	-7.9

Source: Economic Policy Department, SBP.

The structure of the bank borrowings, however, remained unchanged with higher commercial bank borrowings and a decline in borrowings from the SBP.

As a result, the government's net SBP borrowings dropped for a third consecutive year, reaching an all-time low of only Rs 1.1 billion by end-September 2003. Significantly, this development has increased the government's ability to fund deficits in the remaining months of FY04 through the SBP, without breaching the annual credit plan limits.

Table 4.3: Deficit Financing during Q1 [1]

billion Rupees

	FY03	FY04
External	34.6	4.9
Non-bank	19.7	24.1
Privatization proceeds	0.8	2.0
Sub-total	*55.1*	*31.0*
Total financing requirement	41.0	40.9
Banking system	-14.1	9.9

Source: Ministry of Finance

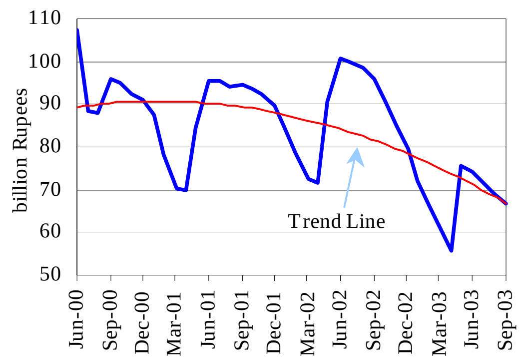
[1] The MoF and SBP numbers may slightly differ due to differences in timings and definitions.

More importantly, the SBP holdings of government paper also declined to a low of Rs 64.1 billion. However, as mentioned in earlier reports, the low stock of government paper held by the SBP does not present a meaningful restriction in the central bank's ability to sterilize reserve money growth, given its stated intention of issuance of certificates of deposit (if required).

4.2 Commodity Operations

The outstanding stock of commodity operation loans continued its declining trend, falling by Rs 7.5 billion during Q1-FY04 compared to a retirement of Rs 4.8 billion in Q1-FY03 (see **Figure 4.2**). The Q1-FY04 retirement reduced the outstanding stock of these loans to Rs 66.6 billion (which split almost equally between federal and provincial government).

Figure 4.2: Commodity Operations-Outstanding Credit



4.3 Credit to Private Sector

The monetary survey data shows that net credit to the private sector during Q1-FY04 showed a stunning expansion of Rs 23.1 billion. This represents a clear deviation from the "normal" credit cycle, which witnesses a net retirement during the first quarter of the fiscal year (in fact, Q1-FY03 had seen a net retirement of Rs 26.8 billion).

Quite encouragingly, the FY04 improvement appears to reflect a broad based recovery in economic activity[2]. As evident from **Table 4.4**[3] the net expansion of Rs 34.6 billion compared to a net retirement of Rs 25.3 billion was mainly attributed to:

Table 4.4: Private Sector Credit during Q1-Sectoral Distribution

billion Rupees

	FY03	FY04	YoY change	
			Absolute	Share in growth
Overall advances	-25.3	34.6	59.9	100.0
I. Credit to private sector business	-28.8	10.8	39.6	66.1
A. Agriculture	2.4	8.7	6.3	10.5
Major crops	2.5	6.8	4.3	7.2
B. Mining and quarrying	0.2	1.2	1	1.7
C. Manufacturing	-26.7	-2.5	24.2	40.4
1) Textiles	-17	-2.3	14.7	24.5
Cotton	-15.9	0.9	16.8	28.0
2) Leather & products	-0.3	1.7	2	3.3
3) Non metallic mineral	-0.6	2.4	3	5.0
Cement	-1.8	1.3	3.1	5.2
4) Petroleum refining	-5.3	-2.3	3	5.0
5) Fertilizer	0.7	2.1	1.4	2.3
6) Miscellaneous	-4.1	-4.3	-0.2	-0.3
D. Ship breaking & waste	-1.4	0.8	2.2	3.7
E. Construction	0.4	1	0.6	1.0
F. Power, gas & water, & sanitary	-0.2	-1.3	-1.1	-1.8
G. Commerce	4.1	2.1	-2	-3.3
1) Whole sale & retail trade	8.8	4	-4.8	-8.0
2) Exporters	-1.9	-4.8	-2.9	-4.8
3) Importers	-3.5	2.3	5.8	9.7
H. Transport, storage & communication	-1	3.1	4.1	6.8
I. Services	0.3	2.7	2.4	4.0
J. Other private business	-7	-5	2	3.3
II. Credit to trusts and NPOs	1.1	0.8	-0.3	-0.5
III. Personal loans	2.4	23	20.6	34.4

Source: Statistics Department, SBP

[2] The expectation of an increase in interest rates could have also induced businesses to seek loans even ahead of the normal demand cycle.

[3] This data on the sectoral distribution of net advances does not match closely with the monetary survey net private sector credit data due to differences in the definition.

1. Approximately 40 percent of the net private sector credit growth is accounted for by the manufacturing sector. Within this, the most prominent contribution is from cotton financing;

2. Another significant boost was evident from *personal loans* that accounted for approximately a third of the rise in the private sector credit;

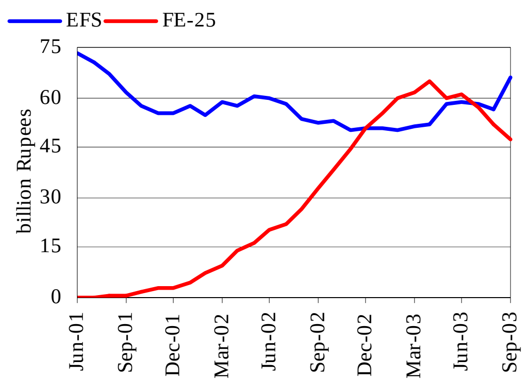
3. Agricultural loans too have witnessed significant growth, accounted for 10.5 percent of the increased credit extended in Q1-FY04.

While the acyclical rise in cotton financing represents a non-repeating shock, the increase in personal loans appears to be a structural shift, which would be expected to permanently alter the dynamics of the domestic credit cycle. Traditionally, given the credit constrained economy, banks had not focused on the development and marketing of consumer finance products. However, this picture had changed following the exceptional liquidity influx since FY01. The resulting availability of consumer finance products, easing of regulations, development of banks' infrastructure, changes in legal framework,[4] and above all, significant improvement in consumer awareness, is expected to support the growth of this market segment even if interest rates would rise.

Trade Related Loans

Although the trade volume during Q1-FY04 was significantly higher than in Q1-FY03, the volume of trade related loans did not see a corresponding increase; a marginal rise in the use of Rupee export finance was more than offset by a decline in the foreign currency denominated loans against FE-25 deposits. Foreign currency loans, which were increasing since June 2001, have steadily declined since May 2003 (see **Figure 4.3**). This trend reversal in foreign currency trade related loans is mainly attributed to: (1) market expectation of the relative stability (or minor

Figure 4.3: EFS and FE-25 Loans



[4] For example, making the bouncing cheque a criminal offense, permitting re-possession of property without costly (and time consuming) recourse to courts, etc.

depreciation) of the Rupee; and (2) fact that the export finance scheme became more attractive following by SBP decisions to reduce the rate for advances under this scheme.

4.4 Credit to Public Sector Enterprises

The net credit to public sector enterprises both to six autonomous bodies and other PSEs declined during Q1-FY04. This simply reflects the government's focus, in recent years, on improving the balance sheets of all PSEs. The biggest contribution to the quarterly improvement was from the higher profitability of Pakistan Steel Mills that enabled it to retire commercial banks' debt totaling Rs 7.1 billion.

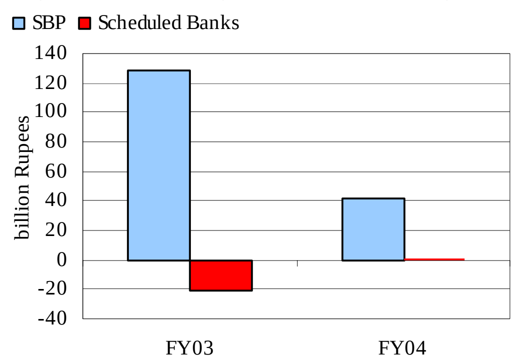
4.5 Net Domestic Assets (NDA)

Compared to a net contraction of Rs 69.5 billion during July-September, 2002, there was a net expansion of Rs 1.2 billion during the same period of the current fiscal year. This significant change was a reflection of lesser contraction in SBP NDA whereas scheduled banks NDA expanded. This represents the lesser sterilization by SBP during Q1-FY04.

4.6 Net Foreign Assets (NFA)

The growth in the banking system NFA slowed to Rs 42.0 billion during Q1-FY04 relative to the Rs 107.2 billion during Q1-FY03, reflecting lower external account surpluses.

Figure 4.4: Net Foreign Assets (flows) during Q1

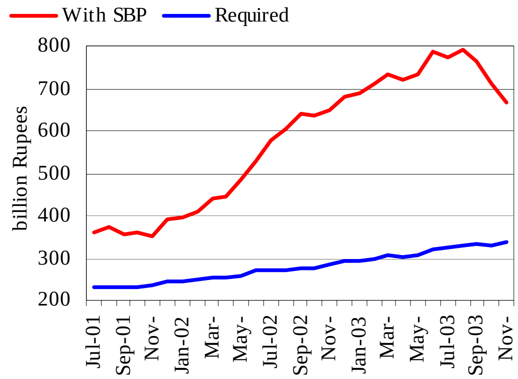


As evident from **Figure 4.4**, the YoY deceleration in NFA growth is primarily visible in the SBP NFA, due to the fall in purchases from the interbank market. In contrast, the NFA of the scheduled banks has witnessed a reversal, from a decline of Rs 20.7 billion in Q1-FY03 to a small rise (Rs 0.5 billion) in Q1-FY04. The latter shift essentially reflects the decline in FE-25 loans (see **Section 9.5** for details) as well as the marginal rise in FE-25 deposits during Q1-FY04.

4.7 Reserve Money

Reserve money witnessed the usual seasonal decline during Q1-FY04, falling by 1.6 percent primarily because of two T-bills auctions that mopped up Rs 17.1 billion (net of maturity) in August 2003.

Figure 4.5: Total and Required Reserves of the Banks with SBP

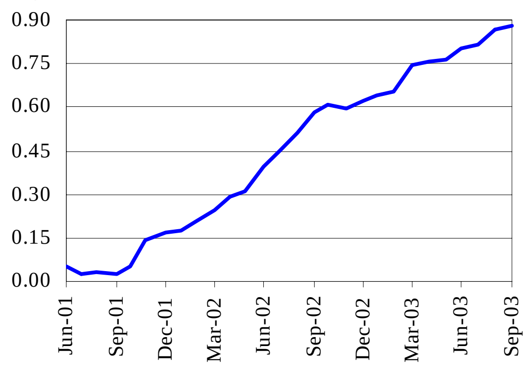


During the same period, the currency in circulation increased by Rs 4.4 billion, whereas banks' reserves (including banks' deposits with SBP and cash in the tills of the commercial banks) decreased sharply by Rs 15.0 billion reversing the trend that had been evident since Q2-FY02 (see **Figure 4.5**).

4.8 Money Supply

The 2.1 percent monetary expansion during Q1-FY04 was in line with the credit plan target, though the composition deviated from the plan. The NDA of the banking system expanded by only Rs 1.2 billion, well short of the target of Rs 30.8 billion. This was because of lower than targeted net credit utilization by the government and net credit retirement by the PSEs (compared to a Rs 1.0 billion growth envisaged in the credit plan), which could not be offset by higher than the targeted net credit expansion by the private sector. On the other hand, the increase in the SBP NFA was greater than that envisaged under the plan.

Figure 4.6: NFA to RM Ratio

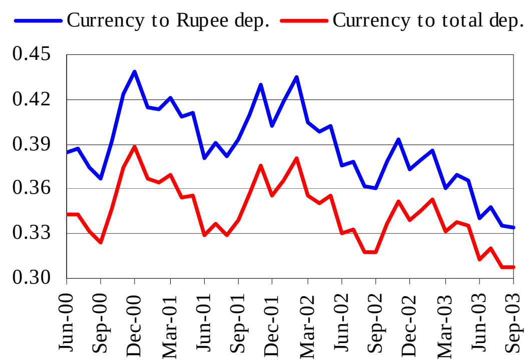


4.9 Monetary Indicators

An encouraging trend, visible over the last two years, has been the increasing NFA to RM ratio. The growth of both, NFA and RM contributed almost equally to this improvement. On the one hand, increasing SBP forex purchases helped in swelling NFA, while on the other, the continuing sterilization reduced SBP holdings of Rupee assets (primarily government papers). Therefore the NFA to RM ratio reached to 88.3 percent at end-September 2003 from 2.7 percent at end-July 2001. If this trend continues, the high-powered Rupee stock could be fully backed by hard currency assets in the near future (see **Figure 4.6**).

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 (CDR), which suggests the growing intermediation by the banking system. This decline in the CDR, largely contributed by the increase in growth rate of deposits has continued in Q1-FY04 (see **Figure 4.7**).

Figure 4.7: Currency to Deposit Ratios



M1 to M2 ratio, which measures liquidity preference, has increased in Q1-FY04. This is almost entirely due to the relative increase in demand deposits (currency in circulation was almost unchanged during the quarter). A possible explanation for the gradual rise in the contribution of demand deposits in M2 is that many corporations deposited their funds temporarily in these deposits instead of locking in *(low)* fixed returns in anticipation of a rise in the interest rates (see **Figure 4.8**).

Figure 4.8: M1 to M2 Ratio