4 Money and Credit

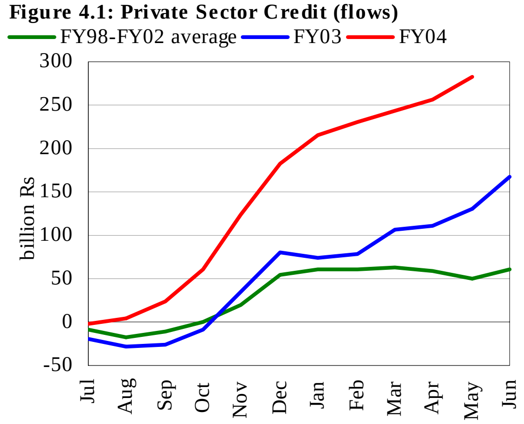
As in the preceding quarter, the SBP continued to face significant challenges to its efforts to moderate the expectations of a sharp rise in both, the interest rate and the exchange rate, during Q3-FY04. Market expectations in turn, were driven by a visible narrowing of the external account surplus as well as an anticipated jump in government borrowings from the banking system.

Indeed, the fall in the external account surplus led the SBP to hold down its forex purchases from the inter-bank market (to mitigate pressures on the exchange rate), and consequently the pace of net rupee injections into the economy declined. Simultaneously, the market anticipated higher government borrowings from the inter-bank rupee market due to: (1) the absence of financing from the Saudi Oil Facility; (2) a YoY decline in other external economic assistance; (3) lower availability of non-bank financing from inflows into the NSS; and (4) the need to fund the pre-payment of expensive external debt. The impact of these rupee market liquidity factors on interest rate expectations was compounded by the steady rise in domestic inflation (which was driving real interest rates further into negative territory) as well as the rise in global interest rates.

In practice, however, the pace of the rise in cut-off yields in T-bill auctions by the SBP during Q3-FY04 was slower than demanded by the market, and the government's increased appetite for banking system borrowings was therefore met entirely by the central bank (borrowings from commercial banks actually witnessed a net decline during the period). The SBP decision to allow only small increases in T-bill yields owed principally to an expectation that inflationary pressures (especially *non-food non-oil* inflation) would remain benign throughout FY04, facilitating stronger growth in credit demand.

In fact, the easy monetary policy of the central bank probably helped accelerate the momentum of private sector credit significantly, taking the net credit growth during Jul-May FY04 to Rs 283.6 billion, an all-time high for this period of the fiscal year (see **Figure 4.1**). This probably contributed to major positive developments in the

Figure 4.1: Private Sector Credit (flows)



economy, such as higher utilization of capacity in the manufacturing sector, continued BMR in textile sector, the development of the consumer credit market, an increased focus of private commercial banks on the agri-credit market, as well as the increased participation of the private sector in the domestic commodity markets.

The exceptionally sharp jump in private sector credit, together with substantial government borrowings, resulted in rapid growth in the Net Domestic Assets (NDA) of the banking system during the first eleven months of FY04, in contrast to a significant decline seen during the corresponding period of FY03. Moreover, current fiscal year also witnessed a reduction in net external inflows, slowing the increase in Net Foreign Assets (NFA) of the banking system relative to FY03. Thus, in sharp contrast to the July-May FY03 monetary expansion of 14.7 percent, which was totally NFA driven, the 15.9 percent monetary expansion during July-May FY04 was largely a function of NDA growth (see **Table 4.1**).

Table 4.1: Monetary Expansion-Share of NDA and NFA

	Jul-May	
	FY03	**FY04**
Monetary expansion	258.3	329.7
Share of NDA		
Absolute (billion Rs)	-30.3	270.2
percent	-17.1	82.0
Share of NFA		
Absolute (billion Rs)	288.5	59.5
percent	117.1	18.0

Source: Economic Policy Department

It is important to note that by May 2004 monetary policy induced inflationary pressures were still relatively low, but it seemed likely that inflation would accelerate in future given the increasing capacity utilization evident in many segments of the economy and rising international commodity prices. It was this concern that led the SBP to act a little more aggressively to contain demand pressures through accelerated adjustments in the interest rates by May 2004.

While the SBP remains focused on the need to contain inflationary expectations to sustainable levels, it must also tread carefully when raising interest rates given: (1) the structural changes evident in the credit cycle and the relative ignorance of the transmission mechanism between credit off-take and inflation; and, (2) the fact that much of the credit growth during FY04 has been on floating rates (imply that a hike in rates could, at least initially, add impetus to cost-push pressures).

Table 4.2: Monetary Survey of the Banking System (flows during July-May)
billion Rupees

	FY04		FY03
	Credit Plan[1]	**Actual**	**Actual**
Monetary expansion (I+II)	**221.3**	**329.7**	**258.3**
percent change	10.6	15.9	14.7
I. Net foreign assets	**94.9**	**59.5**	**288.5**
SBP	86.5	51.4	318.5
Scheduled Banks	8.4	8.1	-30.0
II. Net domestic assets (A+B+C)	**126.4**	**270.2**	**-30.3**
percent change	8.3	17.6	-2.0
SBP	-10.5	39.9	-204.3
Scheduled banks	136.9	230.3	174.0
A. Government sector	**15.2**	**54.9**	**-80.9**
Net barrowing for budgetary support	20.2	64.8	-59.9
SBP	-28.8	56.3	-230.0
Scheduled banks	49.0	8.5	170.1
Commodity operations	-5.0	-11.7	-25.2
Others		1.8	4.2
B. Non-Government sector	**106.2**	**246.7**	**114.7**
Private sector	100.2	283.6	130.9
(a) Commercial banks		292.8	128.9
of which: Export finance		28.3	-2.0
(b) Specialized banks		-9.2	2.0
Public sector enterprises	6.0	-30.6	-9.1
Autonomous bodies		-19.6	6.0
Other PSEs		-8.1	-11.7
PSEs special debt-repayment a/c with SBP		-2.9	-3.4
SBP credit to NBFIs	0	-6.3	-7.1
C. Other items (net)	**5.0**	**-31.4**	**-64.0**

[1]End-June
Source: Economic Policy Department

4.1 Government Borrowings for Budgetary Support

The government's deficit financing requirement has declined by 17.6 percent YoY during July-March FY04. However, due to a large decline in the availability of domestic non-bank funds and net negative receipts of external financing;[1] the aggregate availability of *other than banking system* financing dropped to only Rs 17.6 billion during the period. Therefore, in contrast to the net retirement of banking system borrowings during July-March FY03, the corresponding period of

[1] Largely, this was due to early retirement of ADB loan.

FY04 witnessed an increase in net borrowing from the banking system (see **Table 4.3**).[2]

Table 4.3: Deficit Financing during Jul-Mar *
billion Rupees

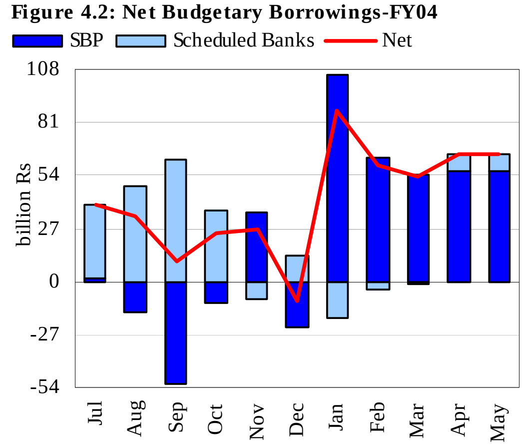
	FY03	FY04
External	64.2	-25.2
Non-bank	66.2	34.3
Privatization proceeds	8.5	8.5
Sub-total	*138.9*	*17.6*
Total financing requirement	**86.4**	**71.2**
Banking system	-52.5	53.6
SBP	-224.2	54.4
Scheduled banks	171.7	-0.8

* The MoF and the SBP numbers may slightly differ due to mismatching of timings and definitions.
Source: Ministry of Finance

Moreover, the profile of the FY04 banking system borrowings also presents a sharp contrast to that of the preceding year. While FY03 essentially saw a shifting of SBP's holdings of government debt to the commercial banks (as the central bank sought to partially *sterilize* an exceptionally large NFA-driven growth in reserve money), the FY04 net government borrowings were entirely from the SBP (*accelerating* reserve money growth).

As elaborated earlier, this change in the profile of government borrowings stems principally from the SBP's efforts to contain the rise in interest rates in the face of market expectations to the contrary. In fact, the rise in the SBP NDA would have been even sharper if not for a US$ 500 million February 2004 sovereign Eurobond issue. The proceeds of the Eurobond significantly offset the rupee borrowing requirements stemming from a US$ 1.1 billion pre-payment of expensive external debt[3] (see **Figure 4.2**).

Figure 4.2: Net Budgetary Borrowings-FY04

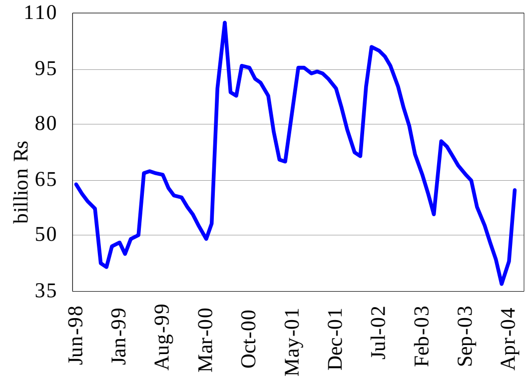


[2] This section is based on end-quarter data due to non-availability of the corresponding MoF figures.
[3] At the end-December 2003, it was two OMO's that temporarily shifted the government SBP borrowings to scheduled banks, which mirrors the SBP efforts to meet credit plan NDA target.

4.2 Commodity Operations

Figure 4.3 shows that the volume of public sector commodity procurement operations was falling steadily since June 2002. Even the seasonal increase during May-Jun FY03, was significantly lower than in prior years. In particular, loans for wheat procurement, which has the largest share in commodity procurement operations, has come down to Rs 16.4 billion at the end-March 2004 from end-June 2003 level of Rs 51.1 billion. This is a reflection of the rising role of the private sector in wheat procurement operations since FY03.[4]

Figure 4.3: Commodity Operation Credit-Stocks



In aggregate, the volume of retirement of commodity operation loans was Rs 36.8 billion during Jul-Mar FY04, nearly equivalent to the retirement of these loans (of Rs 39.4 billion) during the corresponding period of FY03. As a result, the outstanding stock of commodity operation loans at the end-March 2004 was Rs 37.2 billion – the lowest level since May 1999.

Thereafter, however, the government sought to wheat procurement in order to build reserves to contain inappropriate speculative hoardings by some traders. This resulted in an up tick in the stock of commodity operation loans by April 2004.

4.3 Credit to the Private Sector

The net credit to the private sector, which started climbing in Feb-Mar FY03, had yet to see an appreciable slowdown by end-May 2004. As a result, the Jul-May FY04 period recorded an unprecedented expansion of Rs 292.8 billion in the

[4] Because of this shifting, the government has lost its control over wheat supply that resulted in acute wheat shortages across the country. Consequently, the prices of wheat and wheat based products shot up substantially (see also the **Section** on **Prices**).

private sector net credit from the commercial banks;[5] this is more than twice of the net credit extended during the same period of FY03.[6]

Table 4.4: Private Sector Credit-Sectoral Distribution
billion Rupees

	Flows during Jul-Mar		YoY change	
	FY03	**FY04**	**Absolute**	**Share in growth (%)**
Overall advances	**87.0**	**222.2**	**135.2**	**100.0**
I. Credit to private sector business	**68.3**	**167.0**	**98.8**	**73.0**
A. Agriculture	3.9	11.5	7.6	5.6
1) Major crops	4.3	6.4	2.1	1.6
2) Minor crops	-0.4	0.8	1.2	0.9
B. Mining and quarrying	-0.2	6.2	6.4	4.7
C. Manufacturing	61.7	126.4	64.6	47.8
1) Food & beverages	6.0	40.0	34.0	25.2
i. Sugar & preparation	2.2	-1.1	(3.4)	-2.5
ii. Edible oil & ghee	0.4	2.1	1.7	1.2
2) Textiles	32.1	77.0	45.0	33.3
i. Cotton	30.5	52.5	22.0	16.3
ii. Synthetic yarn	0.7	5.7	5.0	3.7
3) Textile products	11.1	22.1	11.0	8.1
4) Leather & products	2.3	6.4	4.1	3.0
5) Non metallic mineral	0.4	6.1	5.6	4.2
i. Cement	-1.7	5.0	6.7	5.0
7) Chemical & products	0.2	7.7	7.6	5.6
8) Fertilizer	-9.3	-1.1	8.2	6.1
11) Electronic equipments	0.7	-4.4	(5.1)	-3.7
12) Machinery	-3.1	-10.3	(7.2)	-5.3
14) Miscellaneous	21.3	-17.2	(38.5)	-28.5
D. Ship breaking & waste	-1.7	1.0	2.6	2.0
E. Construction	2.0	1.5	(0.5)	-0.4
F. Power, gas &water, & sanitary purposes	2.9	0.9	(1.9)	-1.4
G. Commerce	18.2	8.3	(10.0)	-7.4
H. Transport, storage and communication	-1.6	5.1	6.7	5.0
I. Services	0.0	28.1	28.2	20.8
J. Other private business	-17.0	-21.9	(4.9)	-3.6
II. Credit to Trusts and NPOs	**-0.3**	**5.1**	**5.4**	**4.0**
III. Personal Loans	**19.0**	**50.1**	**31.0**	**23.0**

Source: Statistics Department, SBP.

[5] Specialized banks saw a net retirement of Rs 9.2 billion during July-May FY04 compared to a net credit expansion of Rs 2.0 billion in the same period of FY03. This probably reflects the entry of commercial banks in the agri-credit market.
[6] FY03 credit expansion was already above the FY98-FY02 average.

This extra ordinary credit growth so far has been broad based, showing higher credit utilization in most sectors. The broad based credit expansion reflects widespread economic activity. A further probe into the broad composition of private sector credit expansion shows that 56 percent accrued to manufacturing, 18 percent to services (including commerce, transport and communication), and 27 percent to agriculture and consumer loans (see **Table 4.4**).

1. Within the *manufacturing* sector, a large portion of the credit was taken by the *textile* sector (including *textile products*) which probably reflects continued BMR activities in the industry, a sharp rise in working capital requirements (particularly due to high cotton prices and increased capacity utilization), and strong export-led demand.
2. The loans for *food and beverages* have almost a quarter share in YoY growth.
3. Similarly, *personal* loans, that include auto, mortgage, credit cards, etc. continued to grow strongly in Q3-FY04,
4. The share of *services* sector has substantially increased.

4.4 Credit to Public Sector Enterprises (PSEs)

The PSEs (including large corporations as well as small enterprises) continued to retire commercial bank credit during Q3-FY04; taking the cumulative retirement during July-May FY04 to Rs 28.0 billion (see **Table 4.5**). This phenomenon appears to suggest that government has met with substantial success in its efforts towards the financial restructuring of PSEs as well as improving management of these institutions in preparation for their privatization.

Taken as a whole, Water and Power Development Authority and Pakistan Steel Mills Corporation were the largest contributors in retiring debt from commercial banks followed by Karachi Electric Supply Corporation.

Table 4.5: Credit to PSEs*
billion Rupees

	Stocks as on		Change during Jul-
	Jun-03	May-04	
PSMC	17.4	9.6	-7.7
WAPDA	17.2	9.0	-8.2
KESC	5.2	0.9	-4.3
PTCL	0.1	1.2	1.1
PIA	15.5	14.8	-0.7
Other	32.4	24.3	-8.1
Total	**87.8**	**59.8**	**-28.0**

*Excluding the impact of PSEs special debt-repayment account with SBP.

4.5 Broad Money

The largest increase in components of money supply during Jul-May FY04 in both absolute and relative terms was seen by demand deposits followed by currency in circulation. However, the cumulative contribution of deposits to growth in money supply was less than that of currency in circulation because of relatively smaller growth in both, time deposits and residents' foreign currency deposits (see **Table 4.6**). In aggregate, broad money (M2) rose sharply by 15.9 percent during Jul-May FY04 as against a 14.7 percent increase in the corresponding period of FY03.

Table 4.6: Components of Monetary Assets

billion Rupees

	Stocks as on		Growth during Jul-May FY04	
	30-Jun-03	29-May-04	Absolute	percent
Currency in circulation	494.6	587.4	92.8	18.8
Other deposit with SBP	3.5	2.1	-1.4	-40.0
Cash in tills	30.4	30.0	-0.4	-1.3
Deposit of banks	141.0	152.5	11.5	8.2
Reserve money (M_0)	**669.5**	**772.0**	102.5	**15.3**
Demand deposits	608.2	748.4	140.2	23.1
Narrow money (M_1)	**1,106.2**	**1,299.7**	193.5	**17.5**
Time deposits	846.3	929.1	82.8	9.8
RFCDs	126.1	141.5	15.4	12.2
Total Deposits	1,580.6	1,818.9	238.3	15.1
Broad money (M_2)	**2,078.7**	**2,408.4**	92.8	**15.9**

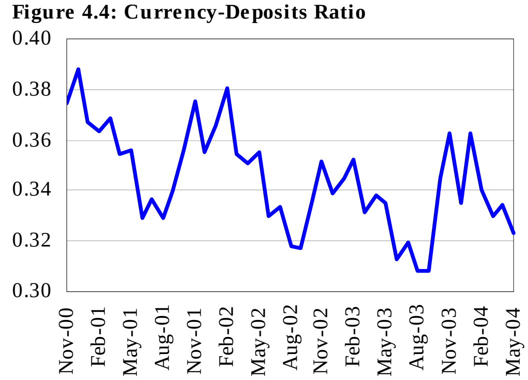
Source: Economic Policy Department

4.6 Monetary Indicators

Currency Deposit Ratio (CDR)

The higher seasonal CDR at the end-December 2003 came down to 0.3229 at end-May-2004 after another seasonal upward jump in January 2004. This pattern is consistent with trends in the preceding two years, which depict heavy withdrawals at ahead of the Eid festivals (see **Figure 4.4**).

Figure 4.4: Currency-Deposits Ratio

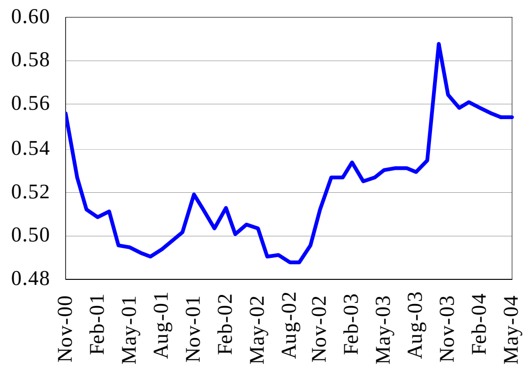


While the absolute volume of currency in circulation has reached an all-time high of Rs 587.4 billion by end-May 2004, this was simply a seasonal rise and remains almost proportional to the substantial growth in money supply.

Narrow to Broad Money Ratio (M1/M2)

The liquidity preference in the economy,[7] which had increased sharply in October 2003, came down during Nov-May FY04 (see **Figure 4.5**).[8] This downward trend is merely a reversal of the temporary rise in currency in circulation and demand deposits.

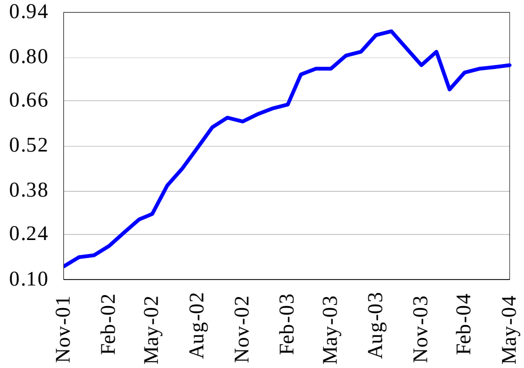
Figure 4.5: M1 to M2 Ratio



NFA to RM Ratio

The coverage of high-powered money by net foreign assets, which touched a high of 88.3 percent in September 2003, slipped to 77.6 percent by end-May 2004. This reflects, (1) the lowering current account surpluses, (2) the one-time payment of expensive external debt in January 2004, and (3) mounting government SBP borrowings (see **Figure 4.6**).

Figure 4.6: NFA to RM Ratio



[7] As proxied by narrow to broad money ratio (M1/M2).
[8] Please also see *Second Quarterly Report for FY04* for details.