4 Money and Banking

4.1 Overview

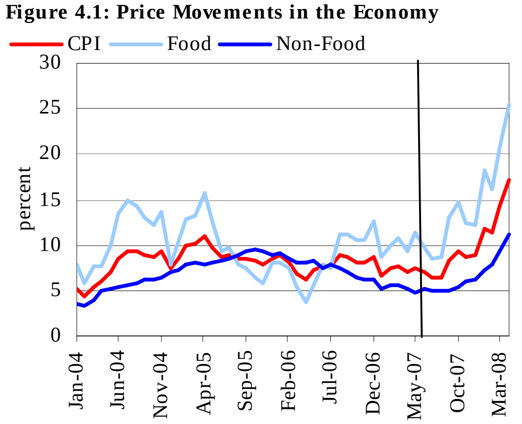
The SBP has continued with the tight monetary policy stance during FY08, raising the discount rate and increasing the reserve requirements of the banking system.[1] Other changes were also implemented to improve the transmission of policy signals, reduce the growth of reserve money, and drain liquidity from the market.[2] As a result, the overnight rates remained close to the discount rate and excess liquidity in the money market declined significantly (see **Table 4.1**).

Table 4.1: Liquidity Conditions in the Money Market (Jul-21st May)

	unit	FY07	FY08
Overnight rates (average)	percent	8.4	8.9
Volatility	percent	12	14
Credit/deposit ratio (end Apr)	percent	84.3	90.8
Credit/deposit ratio (end Apr, marginal)	percent	72.4	227.1
Discounting per visit	billion Rs	8.9	15.2
Absorptions through OMOs	billion Rs	789.3	1035.8
Injections through OMOs	billion Rs	72	190.6
WALR (end March, marginal)	percent	10.6	10.9

Despite sustained monetary tightening, inflationary pressures have persisted in the economy throughout Jul-Apr FY08 (see **Figure 4.1**). Specifically, the overall CPI reached a record high of 17.2 percent in April 2008 more than double from 6.4 percent recorded in July 2007. This was due to a number of factors, including supply shocks and continuing strong demand. The former was driven by disappointing harvests of key domestic crops, and a sustained increase in global commodity prices (including unprecedented hikes in food and energy costs). The demand pressures, on the

Figure 4.1: Price Movements in the Economy



[1] SBP increased its policy rate by 50 bps to 10 percent effective from August 1, 2007. To curb the aggregate demand pressures further, SBP again increased its policy rate by 50 bps to 10.5 percent and CRR by 100 bps effective from February 1, 2008. **Since the finalization of report SBP further raised its policy rate by 150 bps and reserve requirements by 100 bps.**
[2] See SBP's Monetary Policy Statements for Jul-Dec 2007 and Jan-Jun 2008 for details.

other hand, are reflected in a sharp rise in the fiscal deficit that was largely monetized through a record increase in government borrowings from the central bank. The impact of both supply and demand side factors was also reflected in the sharp widening of the current account deficit seen November 2007 onwards.

Thus, the conduct of monetary policy has become increasingly challenging for SBP as the fiscal year has progressed, and inflationary pressures appear to be gaining further strength.

Pass-through of international prices is increasing
Historic high prices of some of the key commodities in the international market (such as petroleum products, rice, wheat, palm and soybean oil etc) are exerting an upward pressure on domestic prices. This pass through is significant (see **Table 4.2**), and has increased in recent years as prices of many commodities in the domestic market are now more reflective of trends in the global markets (especially in fuel commodities, iron, selected food items, fertilizer sectors etc).[3] The impact on domestic inflation has recently become more pronounced as the government began to gradually pass-on the rise in cost of key fuel (petrol and diesel), which had earlier been frozen, to the domestic consumers.

Inflation expectations are becoming stronger
Since longer term structural price changes[4] are the major contributor to global inflation, the impact on inflationary expectations is likely to be more lasting. There are evidences that the erosion in purchasing power and squeeze in profit margins due to sustained increase in food and commodity prices are contributing to second round of inflationary pressures. The core inflation measures, which are reflective of underlying inflationary pressures in the economy, reached their historic highs in April 2008. Further, there is increasing risk that without continued monetary tightening, the inflationary pressures may turn into a wage-price spiral.

[3] It is important to note that the pass through of international prices to domestic consumers is not limited to imported goods only. In the case of exportables, higher prices in global markets will induce producers to sell their produce to foreign consumers, thereby exerting pressures on the local prices as well. The recent sharp increase in the prices of rice is the case in point where pressures on international prices were transmitted to domestic markets.
[4] Rising bio-fuels production in the US and EU accounts for almost half of the increase in consumption of major food crops in the past year. Growth in per capita income in emerging economies has brought robust demand growth. Higher energy and fertilizer costs have also contributed to higher prices for all agricultural commodities. Most of these factors are likely to be permanent (source: IMF Survey Magazine, March 2008).

Table 4.2: Empirical studies on impact of international prices on domestic inflation in Pakistan

Author	Data	Results
Khan and Qasim (1996)	1971-12 to 1994-95	One percent increase in import prices increase general price level of 0.46 percent.
Khan, Bukhari and Ahmed (2007)	1972-73 to 2005-06	One percent increase in import prices increases domestic inflation by 0.12 percent
Akbari and Rankaduwa (2005)	Quarterly 1992-2004	One percent increase in import prices increases the CPI inflation by 0.26 percent in the long run while increases the WPI inflation by 0.25 percent
Ahmad and Ali (1999)	1982-II to 1986-IV	One percent increase in import prices leads to 0.15 percent increase in domestic inflation
Hasan et al (1995)	1972-73 to 1994-95	One percent increase in external prices increases the manufacturing prices by 0.25 percent and raw material prices by 0.50 percent.
Ahmad and Ram (1991)	1960-61 to 1987-88	One percent increase in import prices leads to 0.20 percent increase in WPI and 0.14 percent in CPI respectively
Hyder, Zulfiqar and Sardar Shah (2004)	Jan 1988-Sep 2003	The exchange rate pass through is more pronounced in the case of WPI compared to CPI. The long-run pass through coefficient is 14.86 percent for WPI and 11.43 percent for CPI, whereas, short-run coefficient for WPI is 15.85 and for CPI is 10.27.

References:

Khan,A.H and M.A.Qasim (1996). "Inflation in Pakistan Revisited". *The Pakistan Development Review* 35:4 pp.747-757

Khan.A.A, Bukhari.K.H and Ahmad.Q.M. (2007). "Determinants of Recent Inflation in Pakistan". SPDC Research Report No. 66

Akbari.A.H and Rankaduwa.W (2006). "Inflation Targeting in Small Emerging Market Economy: The Case of Pakistan". *SBP Research Bulletin* 2:1 pp. 169-190

Ahmad.E and Ali.S.A. (1999). "Exchange Rate and Inflation Dynamics." *The Pakistan Development Review* 38:3 pp. 235-51

Hasan.A.M, Ashfaque K.H, Pasha.H.A and Rasheed.A. (1995)."What Explains the Current High Rate of Inflation in Pakistan?" *The Pakistan Development Review* 34:4 pp. 927-943

Ahmad.E and H.Ram (1991). "Foreign Price Shocks and Inflation in Pakistan: A Monetarist Approach" *Pakistan Social and Economic Review* 29:1 pp.1-20

Hyder, Zulfiqar and Sardar Shah (2004). "Exchange Rate Pass-Through to Domestic Prices in Pakistan." SBP Working Paper Series No.05

Weak fiscal space will inhibit government's ability to cushion impact

As the current higher prices in international markets are forecast to persist well above their historical averages for the foreseeable future, any effort by the government to absorb pass through of rising global prices to domestic consumers, would soon become unsustainable due to limited fiscal space. For Pakistan, the problem is compounded by the already high fiscal deficit.[5] Furthermore, the government is relying more on borrowings from the central bank, which is the most inflationary source of financing. To put this in perspective, as of May 10, 2008, the government budgetary borrowings from SBP have grown, by Rs 551.0 billion during the current fiscal year which has almost doubled the stock of

[5] The mounting-up of the fiscal deficit can contribute to the overall CPI inflation through two different channels: (1) rise in fiscal deficit due to high expenditures growth adds to the aggregate demand pressures in the economy, and (2) the composition of deficit financing also matters for the price stability.

MRTBs to Rs 940.6 billion. This fiscal indiscipline has complicated the monetary management. As evident from **Table 4.3**, the government sector has made significant contribution to overall M2 and aggregate demand pressures in the economy. Further, the liquidity injections from unpredictable government borrowings have weakened the transmission of policy rates to retail rates.

External current account deficit is also widening sharply

The impact of both the rising international commodity prices as well as the widening of fiscal deficit is being reflected in the overall worsening of balance of payments accounts.[6] This deterioration of the external account has implications for the monetary management because (1) it has put an upward pressure on the exchange rate of Pak rupee against major currencies that may add to the pass-through of imported inflation to the domestic economy;[7] (2) as a part of deterioration in external account is due to delays in the availability of external financing, it has resulted into increased reliance of the government sector borrowings on the central bank which is adding to the inflationary pressures; and (3) it has the potential to adversely impact the overall macroeconomic stability and economic growth.[8]

Table 4.3: Composition of M2 Growth by Sectors (Jul-Apr)

percent

	Contribution to M2 growth	
	FY07	**FY08**
NFA	**2.3**	**-7.3**
NFA govt.	4.2	4.1
NFA non-govt.	-1.9	-11.4
NDA	**9.9**	**15.7**
NDA govt.	3.5	8.9
NDA non-govt.	6.3	6.9
M2	**12.2**	**8.5**
Total govt. contribution	7.7	13.0
Total non-govt. contribution	4.5	-4.6

Given the mounting inflationary pressures, and the rising risk to macroeconomic stability and long-term growth, it was critical that the policy response be urgently formulated and implemented.

A survey of the monetary policy of various central banks clearly indicate that high global energy, food and commodity prices have substantially increased the upside risks to inflation for developing countries. Central banks of such economies

[6] During Jul-Apr FY08, balance of payments account turned into deficit of US$ 5.1 billion compared to the surplus of US$ 0.8 billion during the same period last year.

[7] By increasing the Rupee cost of imported goods, the exchange rate depreciation encourages more spending on domestic goods and services. Thus, in turn adds to demand pressure on domestic goods.

[8] The balance of payments problems severely hamper the growth prospects of an economy in the long-run through restraining the import demand which is essential for growth.

have decided either to further tighten their monetary policy or to maintain a status quo (despite clear indication of weakening aggregate demand – see **Box 4.1** and **Annexure 1**).

Box 4.1: Response of Selected Central Banks to Rising Fuel & Commodity Prices

A survey of monetary policy response of selected central banks to rising fuel and commodity prices reveals some interesting trends (see **Annexure 1** for details):

- In developing countries where the economic growth is strong, and risks to inflation and inflation expectations have increased considerably, the central banks have responded with more tightening (examples, India, China).
- In developing countries where the economic growth is strong, and domestic inflationary pressures are currently at low level, the central banks have kept their policy rate unchanged (example Malaysia).
- In developing countries where the aggregate demand is weakening, the central banks have kept their policy stance unchanged on anticipation that either disinflation would offset the pass through of higher international fuel and commodity prices (example, Turkey, Indonesia) or the inflation pressures would moderate with the slowdown in global economy (examples, Thailand, Philippines).

In the case of developed economies, the dominant response is the reduction in policy rate because (1) the recent tightening of credit conditions has considerably increased the downside risks to economic growth, and (2) the pass through of higher prices of food commodities is limited because of lower share of food items in the consumption basket. In Australia, which is commodity exporter, the improvement in terms of trade due to rising global commodity prices could potentially lead pressures on domestic spending. In view of rising risks to inflation, central bank further tightened its monetary policy.

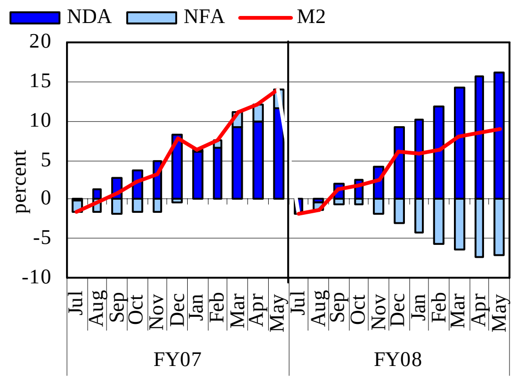
4.2 Developments in Monetary Aggregates

Growth in broad money (M2) decelerated during Jul-10th May FY08 due to contraction in the net foreign assets (NFA) of the banking system; net domestic assets (NDA) of the banking system, on the other hand, expanded sharply during this period (see **Figure 4.2**). The YoY growth in M2 as on 10th May FY08 remained at 14.0 percent –still higher than FY08 target of 13.7 percent (see **Table 4.4**).

Table 4.4: Monetary Survey (as on 10th May)
flows in billion Rs and growth in percent

	Absolute flows since end-June		YoY Growth in Stock	
	FY07	**FY08**	**FY07**	**FY08**
Government borrowing	185.8	423.0	24.9	32.4
For budgetary support	212.4	362.1	27.8	27.3
SBP	34.8	551.0	28.9	104.4
Scheduled banks	177.5	-188.9	26.8	-42.7
Commodity operations	-26.4	60.9	3.1	96.0
Credit to Non-Govt Sector	274.0	414.4	15.9	21.3
Private sector	263.4	369.8	15.9	19.9
Credit to PSEs	10.2	44.3	21.1	75.6
OIN	-64.3	-180.7	31.2	53.9
SBP	44.3	-101.7	25.0	101.4
Scheduled banks	-108.6	-79.0	35.4	23.7
NDA	395.5	656.7	17.0	20.9
SBP	79.2	449.6	30.0	102.3
Scheduled banks	316.3	207.1	15.7	12.2
NFA	84.6	-289.8	16.8	-12.6
SBP	61.5	-221.7	11.3	-9.7
Scheduled banks	23.1	-68.1	42.7	-23.4
M2	480.1	366.9	16.9	14.0

Figure 4.2: Contribution to M2 Growth (Jul-10th May)



Net Foreign Assets (NFA)

Contraction in NFA of banking system has been the result of widening trade deficit and lower net receipts of external financing.

Within the banking system, contraction in SBP's NFA has been higher compared to that of scheduled banks (see **Figure 4.3**). Higher SBP market support for oil payments, lower inflows on account of delays in privatization/ disinvestment transactions (including GDRs), and delays in logistic support receipts are the factors that explain most of the current decline in SBP's NFA (see **Figure 4.4**).

The contraction in scheduled

banks' NFA[9] during Jul-10th May FY08 was due to a decline in foreign investments,[10] and lower receipts in foreign private loans.[11]

While the trade financing availed by importers (due to a rising interest rate differential between the Rupee and foreign currency loans) led to a sharp decline in the scheduled bank's NFA,[12] this was partially offset by a rise in resident foreign currency deposits during the period.[13]

Net Domestic Assets (NDA)
The sharp acceleration in NDA growth of the banking system is a source of concern for monetary policy. The SBP has contributed the most to the overall NDA expansion mainly due to strong growth in the government borrowings from central bank (see **Figure 4.5**). In the case of scheduled banks' NDA,

Figure 4.3: Net Foreign Assets (Cumulative Flows-Jul-10th May)

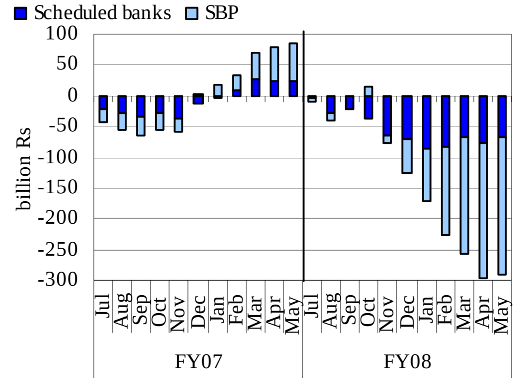
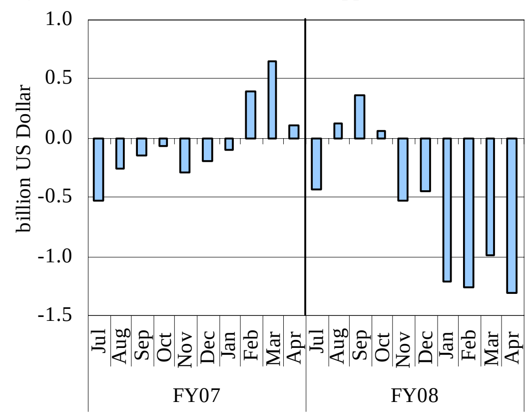


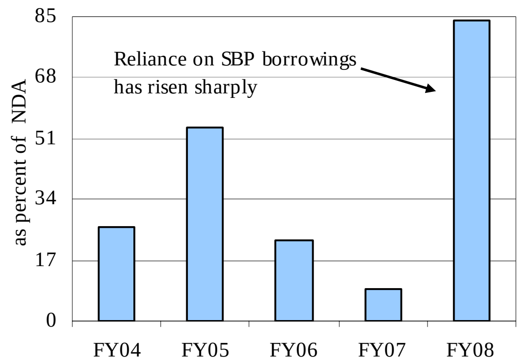
Figure 4.4: SBP's Forex Market Support (Net)



[9] This depletion in scheduled banks' NFA was despite a substantial rise of US$ 5.3 billion in workers' remittances during Jul-Apr FY08 compared to US$ 4.5 billion during the corresponding period last year. Foreign currency deposits also increased by Rs 19.0 billion during Jul-Apr FY08 compared to Rs 4.9 billion during the corresponding period last year.
[10] Foreign investment slowed down to US$ 3.6 billion during Jul-Apr FY08 compared to US$ 5.9 billion during the same period last year.
[11] Foreign private loans registered a major slowdown as the economy received net inflow of US$ 271 million only during Jul-Apr FY08 compared to US$ 465 million during the same period last year.
[12] Specifically, during Jul-Apr FY08, trade sector availed Rs 26.1 billion worth foreign currency loans compared to Rs 19.3 billion during the Jul-Apr FY07.
[13] Resident Foreign Currency Deposits witnessed an increase of Rs 21.2 billion during Jul-Apr FY08 against the increase of just Rs 2.8 billion during the same period last year.

the impact of expansion in private sector credit was partially offset by government's net retirement of borrowings from scheduled banks.

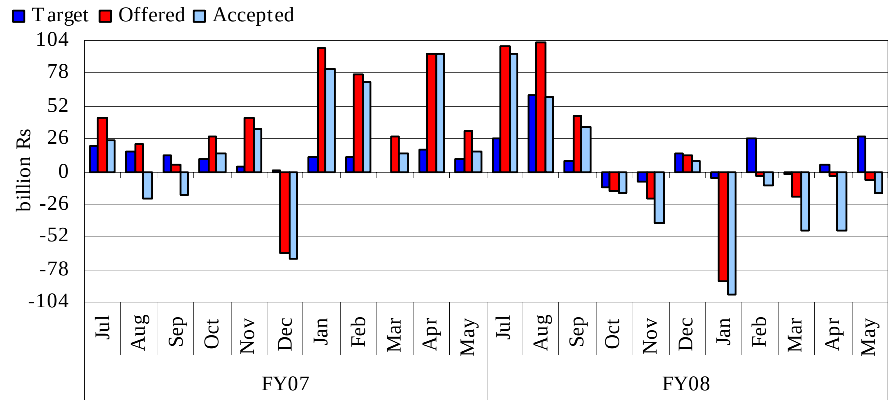
Figure 4.5: Budgetary Borrowings from SBP (Jul-10th May)



Government budgetary borrowings

On cumulative basis, as on May 10, 2008, government has borrowed Rs 551 billion from SBP during the current fiscal year, which has almost doubled the stock of MRTBs with SBP to Rs 940.6 billion. To put this in perspective, the Jul-10th May FY08 borrowings are twice the net borrowings seen during the preceding three years. The exceptional borrowings reflect more than budgeted expansion in the fiscal deficit against a slower growth in revenue mobilization and a shortfall in external financing receipts.

Figure 4.6: T-bill Auctions (Net of Maturities)

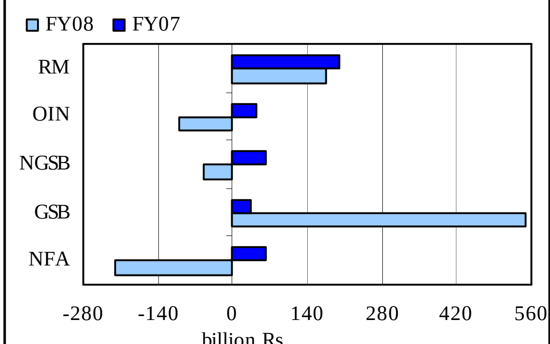


The reliance on central bank borrowing is partly an outcome of scheduled banks' reduced interest in government papers. This is because of tight liquidity conditions in the inter-bank market and strong credit demand from the private sector (which offers greater return). As a result, government is unable to mobilize substantial amounts in treasury auctions. In fact, there is a net retirement of government debt to commercial banks (see **Figure 4.6**).

The growth in the credit to the PSEs, which also contributed to the current rise in NDA, is attributable to delays in settlement of oil price differential[14] claims of one public sector oil marketing company (OMC), and the credit extension to the electricity distribution companies.

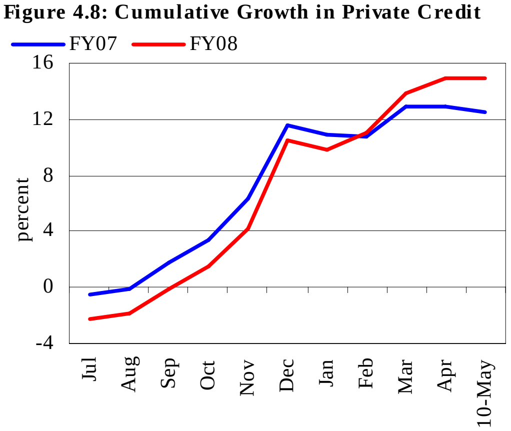
Despite substantially high government sector borrowings from the central bank, growth in the reserve money has slowed down in recent months (see **Figure 4.7**). This reflects (1) the contraction in NFA, net retirement in the amount of refinance provided by SBP,[15] and (3) open market operations.

Figure 4.7: Composition of Reserve Money (Jul-10th May)



RM=Reserve Money, OIN=Other Items Net, NGSB=Non-govt sector borrowings, GSB=Govt sector borrowings

Figure 4.8: Cumulative Growth in Private Credit



Private Sector Credit (net)[16]

Following a sharp rise since January 2008, the cumulative growth in private sector credit for the current fiscal year accelerated to 14.9 percent – 2.5 percentage points higher than that in corresponding period last year (see **Figure 4.8**).

[14] Differential is between the international oil prices and the domestic consumer prices.

[15] In order to contain excessive growth in reserve money, SBP capped the amount of export refinance for FY08 at 70 percent of the end-June 2007 level. This measure has led to net reduction in outstanding volume of export refinance.

[16] Private sector credit comprises of banks' investments and advances to the corporate sector. The data on private sector credit is based on monetary survey covering the period of Jul-10th May FY08.

The private sector credit, which had been growing at a slower pace till January 2008 compared to previous year, gathered momentum thereafter.

The key factors contributing to this recent acceleration in private sector credit growth were (1) rise in working capital requirements due to higher input costs; (2) the need for bridge financing to settle price differential claims of OMCs and IPPs; and (3) the higher fixed investment (visible in a few sectors, e.g. textile, refineries and power) in the month of March 2008 (see **Table 4.5**).

Credit demand is stong

The acceleration in private sector credit growth during Jul-Mar FY08 was mainly reflected in credit extended to corporates. The overall credit demand is strong despite a significant slowdown in credit growth to consumers during the same period (see **Figure 4.9**).

At least, a part of the rise in credit demand is explained by continued strong surge in raw material prices in sectors such as agriculture, textile, commerce and trade. This suggests that the credit demand would have been even higher had energy shortages and operational

Table 4.5: Break-up of Private Sector Credit (FY08)
cumulative growth in percent

	Dec	Jan	Feb	Mar
Private sector credit	10.5	9.9	11.0	13.9
Of which:				
Fixed	3.4	0.5	1.3	7.0
Working capital	15.6	19.9	22.2	22.8

Figure 4.9: Contribution to Growth in Private Credit (Jul-Mar)

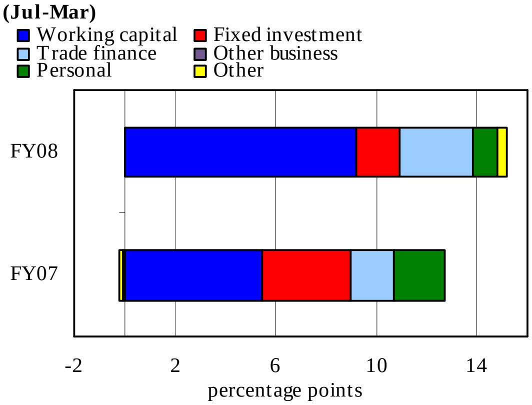
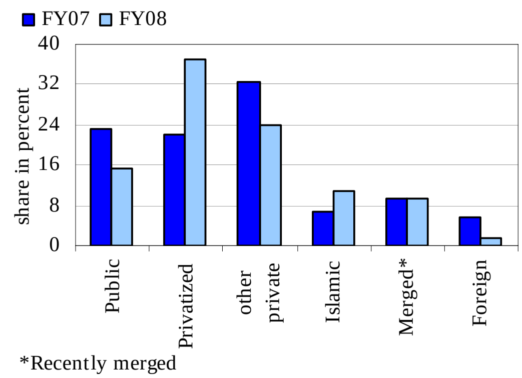


Figure 4.10: Skewed Incremental Credit Distribution (Jul-10th May)



bottlenecks in major industries not have constrained the industrial growth during Jul-Mar FY08.

Bank's concentration in lending has risen amid supply side issues

The institutional concentration in the incremental lending activities increased during Jul-10th May FY08, compared to last year (see **Figure 4.10**). This was mainly due to a sharp rise in lending activity of one of the large privatized banks, which interestingly also experienced a higher deposit mobilization, particularly during the period of seasonal credit off-take.

The rising share of Islamic banks in incremental credit during Jul-10th May FY08 is reflective of the growing interest of public in the Islamic banking industry. Islamic banks are generating a healthy competition as they have been able to attract a significant share of credit demand from conventional banks.

The lower credit expansion in the remaining banking groups during the period under review stems from following reasons: (1) the process of merger in one of the domestic private bank (under the category of small domestic private banks) has prevented the entity from aggressive lending; and (2) deterioration in the quality of banks' assets, particularly in the category of consumer loans may have restrained a few banks to contribute significantly in the lending activities (see **Table 4.6**). The impact of the latter is more evident in foreign banks, since a large portfolio of foreign banks' credit comprises of consumer loans. Therefore, the lower demand for consumer loans and rising NPLs in this category has caused slowdown in foreign banks' credit expansion (see **Table 4.7**).

Table 4.6: Credit Quality Indicators (end Mar)

percent

	Mar-07	Mar-08
NPLs / loan (gross)	7.2	7.7
of which: Corporate	6.7	7.8
SME	9.2	8.9
Agriculture	23.7	19.8
Consumers	3.2	4.8

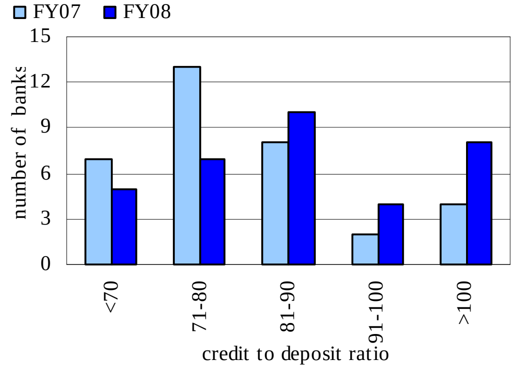
Lastly, the lower credit expansion in few banks is also explained by the liquidity constraints as gauged by their falling share in incremental deposit during Jul-Apr FY08. It may be noted that the average credit to deposit ratio

Table 4.7: Deceleration in Foreign Banks' Credit (Jul-Mar)

	FY07		FY08	
	Growth	**Share***	**Growth**	**Share***
Consumer credit	24.8	5.7	-7.8	-2.3
Business credit	13.9	10.7	13.1	9.2
Total	**16.4**	-	**6.9**	-

*Contribution to credit growth of foreign banks in percentage points of the banking system reached to 108.4 percent by end-April 2008 compared with 86.1percent by end-April 2007. This shows banks' increasing inability to lend aggressively (**Figure 4.11**).[17]

Figure 4.11: Dwindling Banks' Ability to Extend Credit (Jul-Apr)



In this perspective, creating room for extending more credit is essential. But this is demanding as deposit growth of the banking sector has already moderated in recent months partly due to growing competition from non-bank financial institutions (NBFIs).

Table 4.8: Private Sector Advances Growth (Jul-Mar)
percent

	Trade financing		Working capital		Fixed investment	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Business sector	**13.5**	**24.7**	**13**	**22.3**	**15.5**	**7**
A. Agriculture, hunting and forestry	-85.1	130	14.2	17.3	2	-12.2
B. Manufacturing	14.6	26.9	16.8	22.6	6.8	9.3
a. Textile	10.6	21.4	3.9	27.4	1.3	13.7
Spinning of fibers	21.8	32.5	5.1	29.6	-1.4	3.1
b. Sugar	-38.6	4.4	29.9	4.6	15.4	10.9
c. Fertilizer	273.3	18	34.2	10.2	57.5	41.8
d. Cement	139	138	30.5	78	13.2	-20.3
C. Electricity, gas and water	33	391	60.8	89.5	70	85
D. Construction	-36	297	17.6	35.5	49.6	3.7
E. Commerce and trade	8.2	9.1	5.5	19.8	38.9	-11.9
F. Transport, storage & communications	123.4	-53	34.5	2.8	19.4	8.3

Moreover, expanding credit growth remains challenging for banks as corporates are increasingly relying on private debt papers (Sukuk and TFCs), instead of

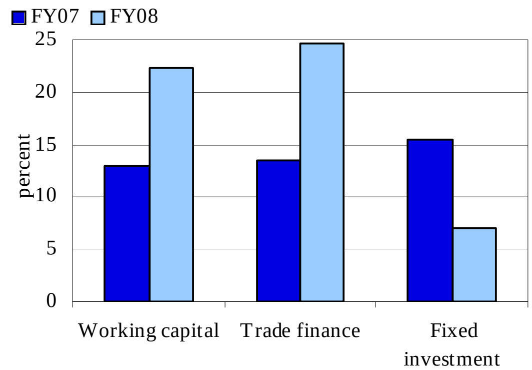
[17] Indeed, number of banks having credit to deposit ratio over 91 percent has increased substantially in Jul-Apr FY08.

raising finance through bank loans.[18] The level of substitution between bank and non-bank finance may increase further as these private debt instruments are traded informally in the secondary market. Indeed, selling of TFCs/Sukuks in secondary market by banks would depress the credit growth of the banking sector.[19]

Trend analysis of Sectoral Advances[20]

The growth in advances to the business sector accelerated to 17.7 percent during Jul-Mar FY08 from 13.6 percent in the corresponding period last year (see **Table 4.8**). A major contribution to this higher growth came from working and trade-related loans, whereas the growth in fixed investment demand has decelerated (see **Figure 4.12**). The personal sector loan on the other hand witnessed a slowdown during Jul-Mar FY08.

Figure 4.12: Growth in Private Sector Advances (Jul-Mar)



Lower demand for fixed investment does not reflect concerns for the economy

The substitution of expensive banks' advances with locally issued private papers (Sukuk and TFCs) resulted in deceleration in fixed investment loans during Jul-Mar FY08. In addition to substituting banks' loan, corporates are also increasingly using debt instruments to finance expansion activates (for example, in the chemical, cement, real estate and ship yard). Further, the slowdown in the fixed investment loans was anticipated to an extent, since few industries (e.g. cement, construction and textile) had expanded their capacities in recent years.

[18] As discussed in Q2-FY08, most of the private papers, especially Sukuk, were issued to refinance banks' debt. To the extent NBFIs investment in Sukuk is being used to substitute bank loans, this would depress the overall credit demand from the banking system.

[19] In case of liquidity shortages in the inter-bank market, banks may even choose to substitute their private debt paper holdings with the advances to the private sector.

[20] This section in based on data on private sector loans as per the classification under International Standard Industrial Classification and is available up to March 2008. The said data will not tally with the credit data reported in monetary survey as the latter includes banks' investments in equities of private business sector as well.

At the same time, higher demand for fixed investment loans from power, fertilizer and textile sectors is encouraging. It must be noted that a few power companies and refineries are in phase of finalizing their financial closures to undertake the expansion activities. Thus, banks are expecting higher credit demand in the next fiscal year.

Demand for trade related loans is high

Growth in trade related loans during Jul-Mar FY08 stemmed primarily from the import finance, which is in line with the rising import payments of the country during the period under review. The trade financing availed by the exporters on the other hand decelerated during Jul-Mar FY08 compared to that in corresponding period last year.

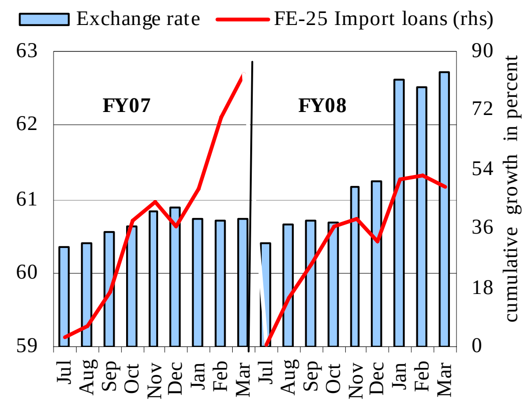
A further analysis of financing availed by the exporters depicts that it was the fall in growth of EFS that explains the slowdown in credit to exporters (see **Table 4.9**). Indeed, during FY07 exporters substituted their outstanding stock of FE-25 loans with that of EFS.[21] Interestingly, however, the gross disbursement under EFS recorded Rs 273 billion during Jul-Mar FY08 – slightly higher than the disbursement level of corresponding period.

Table 4.9: Export Finance Availed by Exporters (Jul-Mar)

	FY07		FY08	
	Growth	**Share***	**Growth**	**Share***
EFS	25.5	15.0	2.9	2.0
FE-25 Loans	-1.1	-0.3	23.1	6.0
Total	**9.6**		**7.6**	

*Contribution to growth in percentage points

Figure 4.13: Import Finance Against FE-25 Loans



The foreign currency loans, which had remained attractive for domestic importers during H1-FY08 largely due to stable exchange rate, became costlier following a depreciation of the Rupee in the latter half of FY08. This led to a slowdown in the demand for FE-25 loans by importers (see **Figure 4.13**).

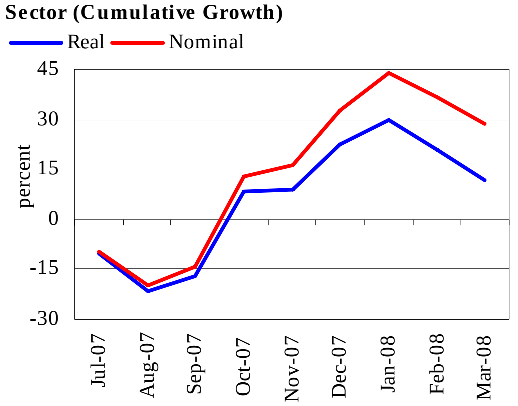
[21] This was because of increase in subsidy provided under EFS in July 2006.

Strong demand for working capital loans is despite lower industrial activity

The demand for working capital loans during Jul-Mar FY08 remained strong at 22.3 percent – the highest growth for Jul-Mar period in the last two years. Major contribution to growth came from the manufacturing sector, commerce and trade, power and other private business (see **Table 4.8**).[22]

The higher working capital advances to manufacturing sector[23] was remarkable given that the operational bottlenecks and supply-side concerns had caused a deceleration in the industrial growth during the said period. The sectoral analysis suggests that the sectors where the credit demand accelerated (such as cotton, rice processing, and construction) are also experiencing a surge in their raw material prices.

Figure 4.14: Working Capital Loans to Spinning Sector (Cumulative Growth)



For example, higher advances to the spinning industry were caused mainly by increased raw cotton prices during Jul-Mar FY08. The impact of this was more visible in the lower real demand for working capital loans in this sector (see **Figure 4.14**). Likewise, in the construction sector, the demand for working capital witnessed substantial growth mainly due to rising prices of building raw material.

In the cement sector, a part of the demand for working capital loans during Jul-Mar FY08 was attributed to rising exports. Similarly, higher trade related activity, specifically in Q3-FY08, explains demand for working capital loans in commerce and trade.

The demand for working capital increased also due to some industry specific

[22] Growth in other private business reflects bank advances under continuous funding system (CFS) to equity market largely mirroring the performance of local bourse.
[23] Unlike the previous year, working capital requirement from the manufacturing sector was concentrated in the textile sector during Jul-Mar FY08. This impact is more evident from 19.6 percent growth in working capital demand of manufacturing (excluding textiles) during FY08 compared with a strong growth of 27.5 percent in the corresponding period last year.

factors. For example, delays in settlement of claims with OMCs probably led to growth in working capital advances to refining petroleum products during Jul-Mar FY08. Similarly, the rising credit demand in the power sector was caused by the impact of delays in payment from WAPDA to IPPs.

<u>Consumer loans are responding to rising interest rate</u>

The increase in interest rate played a pivotal role in restricting the demand for consumer loans during Jul-Mar FY08. Besides this, rising NPLs to loans ratio in almost all categories of consumer loans (see **Table 4.10**) caused banks to become more vigilant while extending consumer credit. The impact of this restraint is more evident in auto loans, as one of the banks has even suspended the auto finance scheme.

Resultantly, growth in consumer loans decelerated to 4.8 percent during Jul-Mar FY08 compared with 11.8 percent in the corresponding period last year. More importantly, consumer credit recorded net retirement in Q3-FY08.

Table 4.10: NPLs to Loan (Gross)
(end-Mar position in percent)

	Mar-07	Mar-08
Consumers	**3.2**	**4.8**
Credit cards	3.7	3.7
Auto loans	2.6	5.9
Durables	3.2	14.8
Mortgage	2.3	4.2
Personal loans	4.0	4.5

Figure 4.15: Contribution to Growth in Consumer Finance (Jul-Mar)

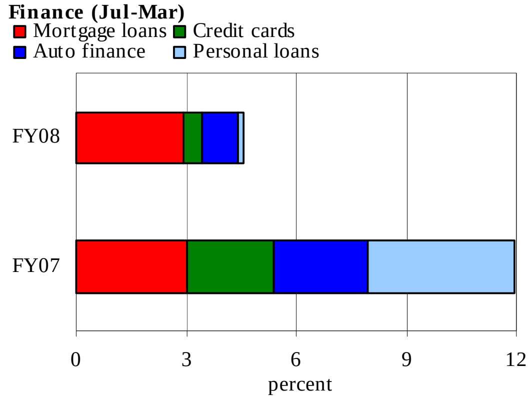
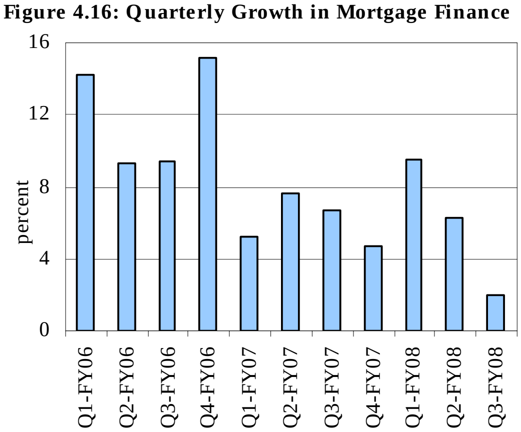
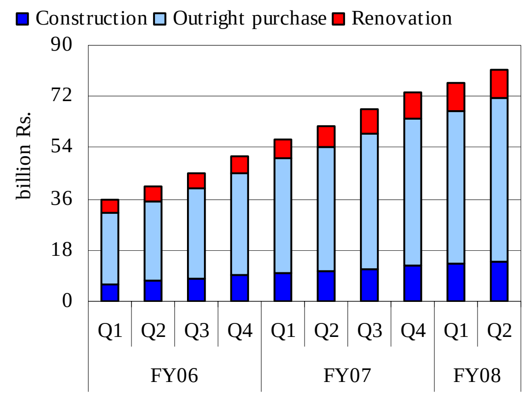


Figure 4.16: Quarterly Growth in Mortgage Finance



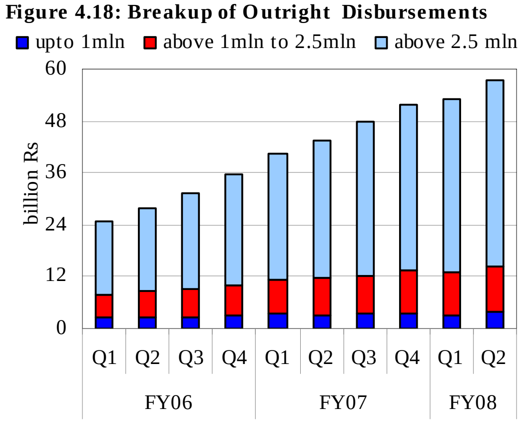
It is also worth noting that the share of consumer loans in the overall loans to private sector fell to 14.4 percent by end Mar 2008 compared to 15.4 percent in the corresponding period last year. This fact probably kept WALR from increasing sharply during Jul-Mar FY08, since consumer loans are high yielding advances.

Figure 4.17: Disbursement of Mortgage Finance



The slowdown visible in the consumer loans was broad-based as almost all categories, except mortgage finance, witnessed substantial deceleration, during Jul-Mar FY08 compared with the corresponding period last year (see **Figure 4.15**). The growth in mortgage finance also decelerated, but this still remains strong at 18.6 percent in Jul-Mar FY08. While the uptrend in mortgage finance appears to have tapered-off in recent quarters (see **Figrue 4.16**), this is mainly attributed to maturing of loans disbursed earlier. The quaterly disbursements, especially under outright purchase, are showing rising trend during the period of analysis (see **Figrue 4.17**).

Figure 4.18: Breakup of Outright Disbursements



Within outright purchase, a substantial portion of loans were disbursed under the loan category of above Rs 2.5 million (see **Figure 4.18**), which is probably reflecting the impact of rising real estate prices during the period under review.

Deposit Mobilization

The deposits growth of the banking system slowed to 5.9 percent during Jul-Apr FY08 from 9.4 percent during the corresponding period of last year (see **Figure 4.19**). A number of factors were responsible for this deceleration, such as:

(1) a sharp increase in current account deficit and the resulting foreign exchange outflows hold back the growth in deposit mobilization;

(2) the build-up of price differential claims of IPPs and OMCs led to downward pressures on their deposits; [24]

(3) a higher deposit base of FY07 due to one-off rise in foreign currency deposits of some commercial banks for import of machinery and network enhancement in the telecom sector. Not only such inflows were absent in FY08, the subsequent withdrawal of these funds restrained the growth in deposits base during the current period;

(4) an evident slowdown in the GDP growth from previous year; and

(5) a higher returns on investments in mutual funds that made deposits an inferior choice in the investment portfolio.

Figure 4.19: Cumulative Deposit Growth

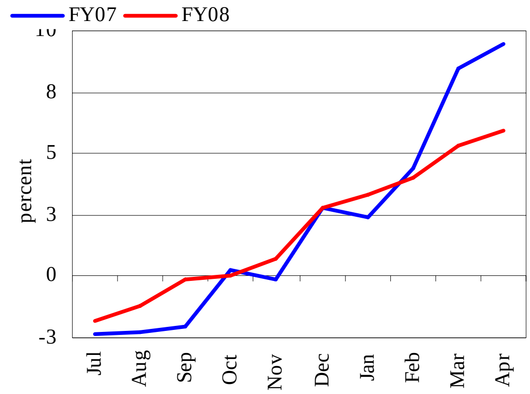


Table 4.11: Sector wise Deposit Growth and Contribution (Jul-Mar)

growth in percent; contribution in percentage points

	FY07		FY08	
	Growth	**Share**	**Growth**	**Share**
Total	**8.5**	**--**	**5.4**	**--**
of which				
Government	9.7	1.0	13.1	1.4
PSEs	-2.1	-0.2	7.5	0.6
NBFIs	50.4	0.9	14.3	0.4
Private sector	12.5	3.5	-3.4	-1.0
of which				
Textile	*-4.1*	*-0.1*	*-1.3*	*-0.01*
Construction	*-2.4*	*-0.04*	*-27.3*	*-0.5*
Telecom	*286.6*	*1.9*	*-53.9*	*-1.2*
Personal	7.8	3.1	7.2	2.8

A sector-wise analysis shows government as a significant contributor to overall deposit growth during Jul-Mar FY08 (see **Table 4.11**), which is quite surprising given the substantially high government borrowings from SBP and non-bank sources. The slowdown in deposits growth is due to net withdrawal in deposit

[24] Although the government provided guarantee on bank financing to settle a part of the claims of some OMCs, pressures on cash flows was hindering deposits mobilization.

base of the private sector. The deposit withdrawal in telecom sector largely due to payments for capital imports made significant contribution to contraction in the deposit base.

The currency-wise composition shows rising contribution of foreign currency deposits in overall deposit growth. This suggests that depositors, anticipating pressures on the Pak-Rupee, are preferring foreign currency deposits to local currency deposits (see **Figure 4.20**).

Within foreign currency deposits, the share of US Dollar deposits has witnessed a steep decline during FY08 (see **Figure 4.21**). This is predominantly because of weakening US Dollar against major currencies in the international markets.

Figure 4.20: Contribution to Deposit Growth

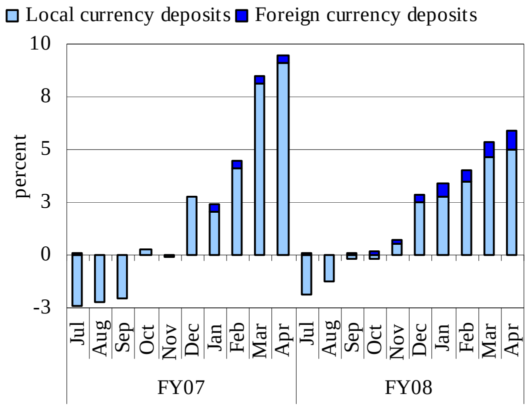
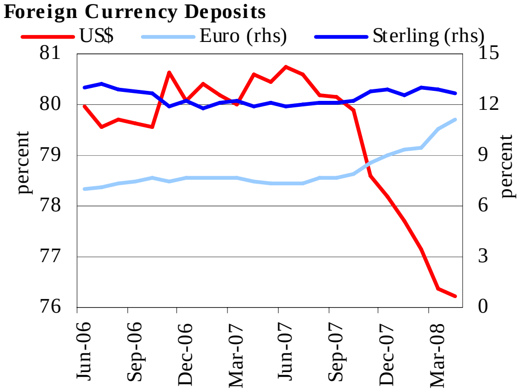


Figure 4.21: Share of US$ Denominated Deposits to Foreign Currency Deposits



Bank-wise distribution of deposits

Bank-wise distribution of deposits suggests that except for Islamic banks, all the banking groups have registered a slowdown in their deposit growth during Jul-Apr FY08 compared to the same period last year (see **Figure 4.22**). This decelerating deposit growth of these banking groups is inspite of an increased offered rates on deposits compared to the similar period of FY07 (see **Figure 4.23**).

It is expected that continued monetary tightening (which has led to a fall in excess reserves of commercial banks) and slowdown in deposit growth, would force banks to further raise their offered rates on deposits in order to meet continued strong growth in credit demand. At the same time, SBP is providing incentive in

Figure 4.22: Contribution in Deposit Growth (Jul-Apr)

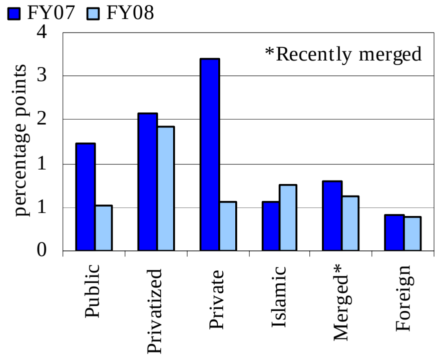
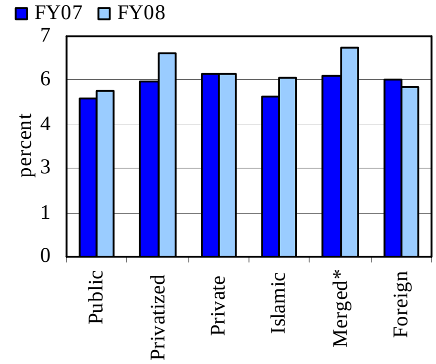


Figure 4.23: Incremental Deposit Rates (Avg Jul-Mar)



the form of zero rated CRR on term deposits of over one year maturity. It may be noted that deposits of one year and higher maturity are growing at a much faster pace compared to demand deposits. As a result, their share in total deposits has risen by 4.0 percentage points to 10.3 percent during August 4-May 10, FY08.

Annexure Table: How Various Central Banks Have Responded to Recent Rise in Fuel and Commodity Prices? – A Survey of Recent Policy Decisions (Updated on May 22, 2008)

Overall policy stance	Recent trends in inflation	Most recent policy change	Risk assessment by respective central banks
India The liquidity management assumes priority in the conduct of monetary policy. Since March 2004, the repo rate has risen by 175 bps to 7.75%, whereas the cash reserve requirement (CRR) has increased by 375 bps to 8.25%	Year-on-year WPI inflation, which was 3.83% on January 12, 2008, *i.e.*, at the time of the announcement of Third Quarter Review, increased to 7.41% on March 29, 2008 and rose further to 7.83% for the week ended May 03, 2008.	• On April 17, 2008, India increased CRR by 50 bps to 8% which would be effective in two stages, i.e., 25 bps on 26th April and another 25 bps from May 10, 2008. • The CRR was further increased to 8.25% effective from May 24, 2008. • **Last meeting:** April 29, 2008	• The recent rise in inflation has mainly emanated from supply-side pressures such as the one-off increase in domestic petrol and diesel prices to partially offset the global crude oil price increase over the year; continuous hardening of prices of petroleum products that are not administered, rising prices of wheat and oilseeds and the adjustment in steel prices in March 2008 due to the surge in international prices. • The upsurge in inflation in India has occurred at a time when global commodity prices have been volatile at historically elevated levels and central banks in mature and emerging economies alike have been articulating heightened inflation concerns. • There are concerns that demand pressures, which have been reasonably contained so far, are being coupled with supply-side factors which, if not temporary, could impact domestic inflation significantly.
Indonesia During the initial six months following the adoption of inflation targeting regime in July 2005, Bank Indonesia raised its policy rate by 425 bps. However, subdued inflation and growing economy allowed BI to reduce its policy rate by 475 bps on cumulative basis since April 2006.	Year-on-year inflation, which was 6.52% in Mar 2007, increased to 8.96% in Apr 2008.	• In December 2007, the BI rate was lowered by 25 bps to 8%. However, on May 6, 2008, central bank decided to raise the BI rate by 25 bps to 8.25%. • **Last meeting:** May 06, 2008	• The government commitment to ensure smooth distribution of foods and especially of staple goods considerably helped BI in achieving inflation targets during the past 2 years. The resulting downtrend in inflation together with steady improvement in economic growth allowed BI to cut its policy rate in December 2007. • The latest review of monetary policy suggests that the outlook for macroeconomic stability will face considerable challenges if the high level of international commodity prices and risk of global economic slowdown continue unabated. • The central bank will closely monitor economic developments and particularly any surge in inflationary pressure through identification of emerging sources of inflationary pressure. Bank Indonesia is resolutely committed to controlling inflation through more effective, simultaneous use of monetary instruments.

Malaysia The continued benign inflationary pressures have so far allowed the central bank to pursue growth supporting monetary policy stance.	The overall CPI inflation is moderate but rising. Year-on-year CPI inflation, which was 1.4% in Jun 2007, increased to 2.8% in Mar 2008. The YoY food inflation rose from 2.3% to 4.9% during the same period.	• Overnight policy rate unchanged at 3.5% since April 2006. • **Last meeting:** April 29, 2008	• While the slower external demand will have some moderating impact on the Malaysian economy, growth continues to be supported by an expansion in domestic demand. • Global energy and food prices have recently risen sharply from their already high levels. A major uncertainty at this stage is the extent of the moderation in global economic activity and the impact it will have in reducing global price pressures. • Domestic food prices have risen in response to the increase in global prices. The increase in food prices reflect a structural phenomenon requiring measures that ensure the adequacy of supply, create appropriate incentive structures that promote higher food production, and enhance the efficiency of the production and distribution chain. • The upside risks to inflation projection of 2.5-3% would be dependent on the degree to which (1) the increase in global prices have an impact on domestic prices and (2) administered prices are adjusted. • After evaluating the evidence on the downside risks to growth and the upside risks to inflation, the Bank has decided to maintain the current stance of monetary policy.
Thailand The central bank adopted inflation targeting in May 2000. The central bank considers the 0 - 3.5% target range for core inflation to be appropriate for the economy	Year-on-year CPI inflation, which was 1.8% in Apr 2007, increased to 6.2% in Apr 2008. The YoY food inflation also rose from 3.3% to 9.8%. However, the YoY core inflation rose marginally from 1.2% to 2.1% during this period.	• The last policy rate cut occurred in July 2007 when the rate was lowered by 25 bps to 3.25%. Since then, the rate is unchanged. • **Last meeting:** May 21, 2008	• While the Thai economy continued to grow strongly, exports have begun to show signs of moderation consistent with the slowdown in the global economy. In addition, rising costs of production and higher inflation could affect confidence and private spending going forward. • Risks to inflation increased markedly recently. Headline inflation accelerated as a result of the significant increase in energy and raw food prices. Core inflation rose by more than expected, mainly as a result of higher pass through of production costs, which could result in higher core inflation going forward. • The central bank realized that the risks to economic growth and inflationary pressures had risen. Though, the MPC decided to keep the policy interest rate, it would stand ready to adjust the monetary policy stance should inflation continue to accelerate.

Philippines A significant ease in inflation outlook and moderate demand-side pressure allowed the central bank to pursue monetary easing during second half of 2007. The average inflation of 2.8% for 2007 stood lower than 6.2% inflation realized in previous year and the target range of 4.0-5.0 %	Year-on-year CPI inflation, which was 2.3% in Apr 2007, increased to 8.3% in Apr 2008. This was the highest level since May 2005. The YoY inflation of food, beverage and tobacco rose from 8.2% in Mar 2008 to 11.4% in Apr 2008.	• The central bank gradually lowered the policy rate by 250 bps to 5 % during Jul 2007 to Jan 2008 period. • Since January 2008, the policy rate is unchanged. • **Last meeting:** April 24, 2008 • **Next meeting**: June 05, 2008	• The monetary policy admits that the balance of risks to the inflation outlook is tilted to the upside. Core inflation has drifted upward, with the March 2008 reading at its highest level since November 2006. The pending requests for wage and transport fare adjustments could raise the upside risks to inflation coming from demand-side pressures. • However, the offsetting factors include (1) relative appreciation of the peso that cushioned the impact of rising fuel and commodity process on domestic inflation; (2) oil import tariff reduction scheme would partially alleviate inflationary pressures stemming from possible continued surge in crude oil prices; and (3) weakness in global economic growth and its likely moderating impact on inflationary pressures in the international markets. • The central bank therefore decided to maintain the policy rate unchanged.
Turkey The target defined as the annual percentage change of the CPI has been set at 4% for 2008 (as well as for 2009 and 2010) with a symmetrical uncertainty band of 2 percentage points in both directions around the point target. The central bank failed to meet its inflation target in 2006 and 2007.	The Apr 2008 CPI inflation was 9.66% - more than double the year-end target.	• Following a strong monetary tightening of the past, a measured rate cut cycle was initiated in September 2007. The overnight borrowing rate was gradually lowered by 225 bps in total to 15.25% in Feb 2008. • The rate was however increased again by 25 bps to 15.75% in mid-May 2008. • **Last meeting:** May 15, 2008	• Lagged pass-through impact of the exchange rate movements and rising energy and processed food prices may lead to a temporary rise in inflation in the short term. • Difficulties in international credit markets continue to restrain the domestic demand, while external demand remains strong. • Overall, aggregate demand conditions will continue to support disinflation. • In the forthcoming period, monetary policy decisions will be geared towards keeping inflation close to these forecasts. Therefore, it is important that economic agents align their expectations with the Central Bank forecasts. The central bank will continue to take the necessary measures to prevent the potential second-round effects of the adverse developments in food and energy prices. Thus, the central bank will consider the possibility of a further measured rate hike in the next meeting.

Australia Under the inflation targeting framework, the RBA maintains CPI inflation between 2 and 3% range, on average, over the cycle.	The YoY CPI inflation rose to 4.2% in Mar 2008 from 2.4% in Mar 2007. The trimmed mean CPI also increased from 2.7% in Mar 2007 to 4.1% in Mar 2008.	• Since May 2002, RBA has been pursuing tight monetary policy. Until Mar 2008, the policy rate gradually increased by 300 bps to 7.25 percent. Since then the rate is unchanged. • **Last meeting:** May 06, 2008	• While domestic sources of inflationary pressure have clearly increased over the past year, the rise in inflation has been partly a result of global factors, notably a general increase in commodity prices. • There are evidences that the growth of domestic demand had moderated significantly. However, the prospects for growth and inflation are highly uncertain. On the one hand, the slowdown in the developed economies, the ongoing strains in world financial markets and tight domestic financial conditions were working to slow demand. On the other hand, there is the larger-than-expected stimulus to domestic incomes from the rising terms of trade. • Given the substantial tightening in financial conditions since mid 2007, and the extent of uncertainty surrounding the outlook, the RBA decided that it was appropriate to allow the current setting of monetary policy more time to work.
Korea BOK is following inflation targeting since May 1998. For 2007-9 period, CPI inflation of 3% with uncertainty band of 0.5% in both directions is the target for monetary policy.	The YoY CPI in March increased to 4.1% which is above the target range for the year and is the fastest pace in almost 4 years.	• Since October 2004, the BOK has been gradually raising its policy rate. During October 2004 to August 2007 period, the policy rate has risen by 175 bps. Since then, the central bank has maintained the policy rate at 5%. • **Last meeting:** May 08, 2008	• Despite some signs of adjustment in the pace of expansion in the domestic economy, the future economic performance faces a high degree of uncertainty largely due to international financial market turmoil and the US economic slowdown. • In the meanwhile, higher oil prices continued to push CPI inflation. • BOK therefore maintained its policy rate at 5%.

England BoE follows inflation targeting, aiming at 2% inflation without creating undue instability in the economy.	While the YoY CPI reached 3% in Apr 2008 from 2.5% in March. The RPI increased to YoY 4.2% in Apr 2008 from 3.8% in preceding month. .	• Towards the end of 2007, there were signs that growth has begun to slow, spending were expected to moderate, and credit market conditions had considerably tightened. These factors increased downside risks to the outlook for both output and inflation further ahead. In response, from Dec 2007 to Apr 2008, the BoE has reduced the policy rate by 75 bps to 5%. Since then the rate is unchanged. • **Last meeting:** May 08, 2008	• The Bank expects that increases in energy and import prices would push CPI inflation further above the target this year. However, trying to bring inflation to the target within this period would result in an undesirable degree of volatility in output. The central projection in the May *Inflation Report* implied that inflation would return to around the 2% target after two years. • The Bank continued to balance the upside and downside risks to inflation at this horizon. On the downside, a sharp slowing in the economy associated with weak growth of real disposable income and the tightening supply of credit could pull inflation below the target. The upside risk to the inflation outlook over the forecast period was that the period of above target inflation in the near term would, by affecting the expectations of those setting prices and wages, have a greater tendency to persist than had been assumed in the central projection. • In overall terms, though economic activity was likely to slow, the Bank had judged that some slowing in the growth rate of output was likely to be necessary for inflation to settle close to the target around two years ahead. A further reduction in policy rate this month could create the impression that the Bank was trying to stabilize output growth rather than maintaining its focus on the inflation target.