4 Money and Banking

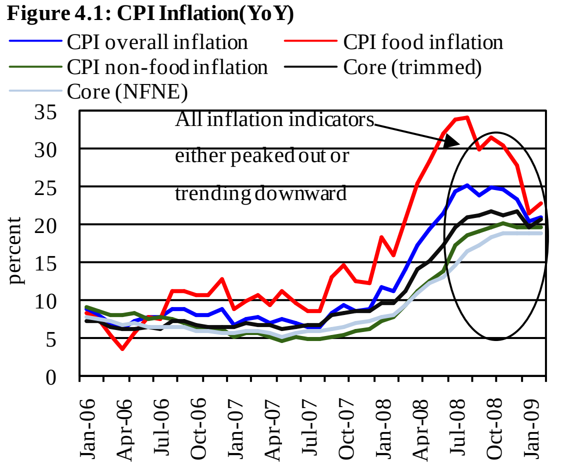
4.1 Monetary Policy

Faced with serious macroeconomic imbalances, [1]Pakistan initiated an aggressive macroeconomic stabilization program in early FY09. As a part of this stabilization effort, SBP further tightened its monetary policy. The discount rate was sharply raised by 200 bps on November 13, 2008, taking FY09 cumulative increase to 300 bps.[2]

The monetary measure was supported by constraints on deficit monetization, which in turn increased the consistency of the fiscal policy with the monetary stance. Furthermore, monetary policy received substantial support from the sharp adjustments in the exchange rate during Mar-Oct 2008 period.

These measures paid dividend as the persistent demand pressures in the economy finally started to ease somewhat in recent months (see **Table 4.1**). This was evident from a number of developments, for example:

Figure 4.1: CPI Inflation(YoY)



1. *Slowdown in inflation pressure*. Domestic CPI YoY inflation dropped sharply to 21.1 percent in February 2009 from its peak of 25.3 percent recorded in August 2008 (see **Figure 4.1**). Similarly the food component of CPI witnessed a sharp downtrend. Though the

[1] Inflation pressures were strong as YoY headline CPI inflation reached 25.0 percent and core inflation (20 percent weighted trimmed measure) touched 21.7 percent in October 2008. On the external front, robust growth in import bills resulted in worsening of current account deficit. Further, though fiscal deficit fell in Q1-FY09 as a result of reduction in oil subsidies and cut in developmental expenditure, the desirable impact on demand pressures was not materialize because of continuous monetization of deficit during Jul-Nov FY09 period.

[2] SBP had earlier increased its policy rate by 100 bps on 30th July 2008.

Table 4.1: Key Macroeconomic Indicators during FY09

YoY growth in percent

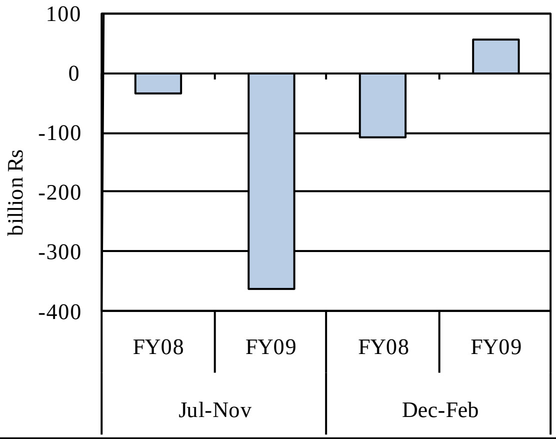
	Jul-Sep	Oct-Feb
Current account deficit	65.9	-42.1
Imports	34.2	-19.4
Non-food non-oil	10.1	-16.9
Oil	92.5	-29.4
Private sector credit*	20.3	9.1
Inflation*	23.9	21.1
Broad money*	13.5	9.9

* end period basis

non-food component showed some resilience till February 2009, this was essentially due to an uptrend in House Rent Index (HRI).[3] The sharp drop in global prices of key fuels and commodities had a significant role in moderating domestic inflationary pressures and it is expected that with economic slowdown, the downtrend in inflation would be steeper.

2. *Sharp drop in import demand particularly non-food non-oil imports.*[4] Sharp fall in imports translated into a lower current account deficit which, coupled with modest recovery in remittances and FDI flows during Dec-Feb FY09 significantly, reduced the depletion of the country's foreign exchange reserves, particularly of the central bank. In this perspective, it is encouraging that the SBP NFA even witnessed a net increase during Dec-Feb FY09 (see **Figure 4.2**).

Figure 4.2: Pressures on SBP NFA Started to Ease-off



3. *Deceleration in private sector credit growth.* The available data suggests that private sector credit grew by

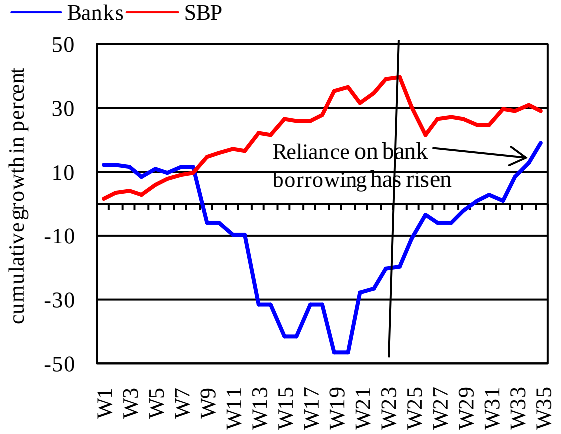
[3] HRI which constitute 23 percent of CPI or around 40 percent of CPI non-food inflation witnessed 18.5 percent YoY inflation in February 2009 compared with 15.0 percent in September 2008.

[4] The fall in import demand, both for oil and non-food non-oil imports, primarily reflects quantum effect partly due to rupee depreciation against major currencies and rising interest rates. Besides fall in import quantum, lower international oil prices also contributed to drop in import bill during the period under review. Please see chapter on **Trade accounts** for detail.

4.6 percent during Jul-Feb FY09 compared with strong growth of 11.7 percent in the corresponding period last year. While some of the banks were reluctant to lend to private sector due to concerns on credit quality,[5] credit demand from the private sector is also slowing down.[6] Besides falling imports, economic slowdown in US and EU markets and structural issues of textile industry which led to fall in textile exports, and lower input costs in few categories, such as cotton and steel bar, also explained part of the lower demand for credit.

4. *Weakening of demand stimulus due to improved fiscal discipline during H1-FY09.*[7] This is reflected in (1) fall in fiscal deficit to 1.9 percent of GDP in H1-FY09 compared with 3.4 percent in the corresponding period last year, and (2) pace of government borrowing from the central bank, which has been dampened since December 2008 -in line with the target set under the Stand-by Arrangement (see **Figure 4.3**). The government borrowed Rs 356.4 billion from SBP during Jul-Nov FY09, whereas during Dec-Feb FY09 period, net borrowings from the central bank were only Rs 56.9billion (see **Figure 4.4**).[8]

Figure 4.3: Budgetary Borrowings during FY09



The ease in demand pressures together with the associated improvement in macroeconomic variables also had implications for domestic liquidity particularly

[5] For detail see section on **Private sector credit**.

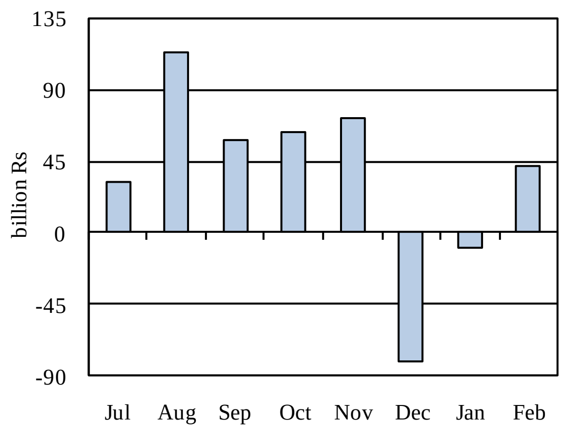
[6] Though the demand for fixed investment in various industries witnessed robust growth, lower demand for working capital loans put downward pressure on total credit demand from the private sector.

[7] Indeed, in the recent past besides contributing to demand pressures, the increased recourse to finance higher fiscal deficit from the central bank has diluted the impact of monetary tightening.

[8] The reduction in borrowing from SBP was concentrated in the month of December 2008. In absolute term, government retired Rs 133.6 billion to SBP in the same month.

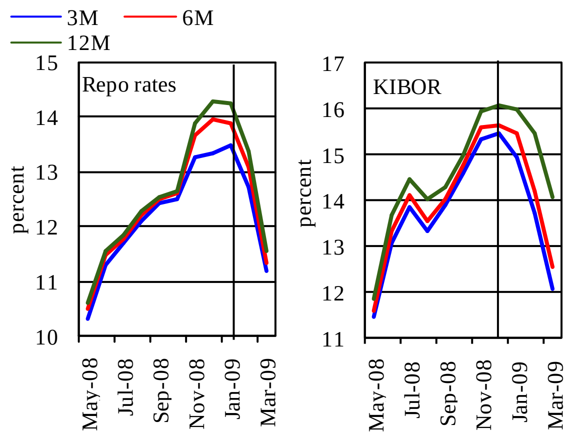
November 2008 onwards. A deceleration in credit demand from both the government as well as the private sector, along with a fall in pace of NFA depletion led to ample liquidity in the banking system.[9] The availability of the rupee liquidity in the interbank market, banks' changing preference in favor of risk-free debt instruments in view of increased concerns on credit quality, and market expectations that interest rates have peaked out , all encouraged a sharp rise in banks' investment in government papers during Dec-Feb FY09 period.[10] This in turn allowed the government to contain its borrowings from the central bank.

Figure 4.4: Creation of MRTBs during FY09



This liquidity situation was in stark contrast to October 2008. At that time, the banking system was facing severe liquidity crunch which was exacerbated by heavy withdrawals of deposits following rumor-fed concerns over the stability of local banks in the backdrop of the international financial crisis. SBP responded by providing extensive liquidity support to banks so that (a) their lending ability remained intact, (b) confidence on the banking system was restored quickly.

Figure 4.5: Market Interest Rates



The effect of SBP support to improve market liquidity, ease in demand pressures on rupee

[9] Net budgetary borrowing during Dec-Feb FY09 was Rs 102.8 billion compared with Rs 161 billion in the corresponding period last year.

[10] As a result, the stock of T-bill holding by commercial banks increased to Rs 629.1 billion by end February 2009 from a low level of Rs 483.9 billion in November 2008.

liquidity and lowering of inflation expectations have led to softening of market interest rates (see **Figure 4.5**).[11] This effectively means that the impact of the tight monetary policy stance of the central bank has eased considerably.

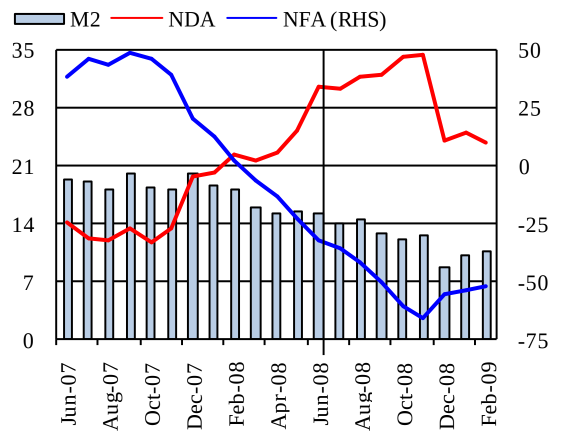
The definitive easing of the monetary policy is however constrained by the developments on the external account and the stubbornly high core inflation. Indeed, during Jul-Feb period, the gain from the lower import bill were somewhat offset by a slowdown in exports partly reflecting the effect of global slowdown which in turn have reduced the demand for country's exports. Furthermore, there are risks that future remittances and foreign investments flows may face slowdown in wake of deepening recession in major economies. In particular, the slowdown in Dubai may adversely affect remittance inflows.

Nonetheless, if the current down trend on demand pressure continues and external inflows do not dry up, this will provide SBP room to review its current monetary policy stance.

4.2 Developments in Monetary Aggregates

The YoY growth in broad money (M2) decelerated sharply to 9.9 percent as on 28th Feb FY09 compared to 17.9 percent in the corresponding period last year. The slowdown in M2 growth resulted from a strong contraction in net foreign assets (NFA) of the banking system. Net domestic assets (NDA) however increased by 23.0 percent on YoY basis on Feb 28, 2009. Interestingly, a closer look at the components of M2 shows a trend reversal in the sources of deceleration in M2 growth towards the end of November 2008 (see **Figure**

Figure 4.6: YoY Growth in Components of M2 (in percent)



[11] The effect of excess rupee liquidity in the market was particularly strong on auction cut off rates. This was because the auction process has undergone two major changes: (1) cut off rates in the primary auction are now being decided (as a debt management function) by the Ministry of Finance, instead of SBP, and (2) cut off decision is now based on target volume, i.e., the cut off rate will be the one at which the government realizes the auction target volume.

Table 4.2: Monetary Aggregates (flows)

billion Rs, growth in percent

	1 Jul to 1-Mar FY08	FY09		YoY growth	
		Jul- Nov	Dec- Feb	1 Jul-1 Mar FY08	1 Jul-28 Feb FY09
Broad money (M2)	**299.0**	**-10.8**	**116.6**	**17.9**	**9.9**
NFA	**-223.2**	**-356.3**	**54.1**	**2.7**	**-52.0**
SBP	-142.3	-363.0	57.7	8.4	-72.9
Scheduled banks	-80.9	6.7	-3.7	-20.8	64.4
NDA	**522.3**	**345.5**	**62.5**	**21.7**	**23.0**
SBP	337.4	292.4	-79.6	70.0	102.0
Scheduled banks	184.9	53.1	142.1	16.5	10.6
of which					
Govt sector	**287.6**	**270.9**	**102.8**	**36.3**	**55.2**
Net budgetary support	306.4	263.1	99.3	39.2	54.7
from SBP	359.3	356.4	-56.8	64.1	89.3
from scheduled banks	-52.9	-93.3	156.2	10.5	-4.5
Credit to PSEs	31.5	54.8	7.2	100.5	56.6
Credit to private sector	289.3	145.8	-12.7	17.8	9.1
Other items (net)	**-85.8**	**-126.0**	**-34.7**	**44.0**	**31.3**
Memorandum item					
Total domestic credit[1]	**608.1**	**471.5**	**97.2**	**24.1**	**24.0**
Reserve money	**136.2**	**-38.6**	**2.0**	**16.5**	**7.2**

[1] Sum of government and non-government credit

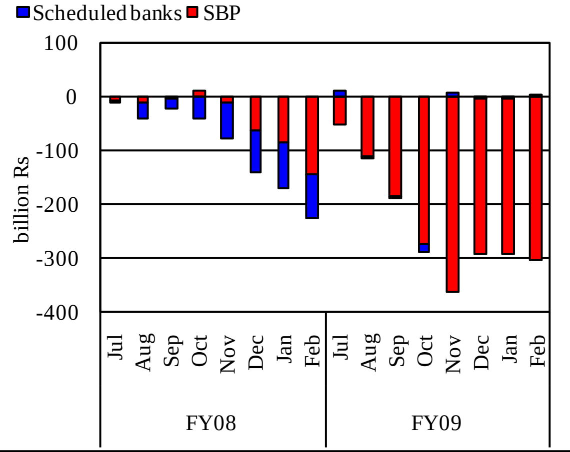
4.6). Specifically, with a visible improvement in the overall external balance, net foreign assets (NFA) of the banking system have expanded by Rs 54.1 billion during Dec-Feb FY09 compared to an exceptionally strong contraction of Rs 356.3 billion in Jul-Nov FY09 (see **Table 4.2**). In parallel, YoY NDA growth experienced a sharp slowdown after attaining an unusually high 34.5 percent growth as on November 29, 2008. As government borrowing from the banking system continues unabated, the decline in the growth of NDA November 2008 onwards reflects deceleration in credit to the non-government sector during Dec-Feb FY09.

Net Foreign Assets (NFA)

The Stand-By Arrangement (SBA) signed with the IMF towards the end of November 2008 helped restore calm in the foreign exchange market by ensuring funding of FY09 financing gap of the overall external account. While the receipts of the first tranche of the IMF loan does not have any direct impact on net foreign assets,[12] the depletion in NFA seen during Jul-Nov FY09 was arrested because of (1) a decline in trade deficit owing to sharp deceleration in import growth; (2) robust flows under workers' remittances, and (3) financial flows from other multilateral and bilateral sources received once the SBA was signed. Consequently, foreign exchange reserves of the country began to recover. The expansion of Rs 54.1 billion in net foreign assets of the banking system since 29 Nov FY09 reduced the contraction in net foreign assets of the banking system to Rs 302.2 billion during Jul-Feb FY09.

The Jul-Feb FY09 contraction in NFA of the banking system is heavily dominated by changes in SBP NFA (see **Figure 4.7**). Till November 2008, imports grew sharply due mainly to considerably large price effect of higher international commodity prices. The largest impact was from the steep rise in prices of petroleum products. The increased provision of foreign exchange liquidity to meet oil payments led to sharp depletion in SBP's reserves during Jul-Nov FY09. Pressures on SBP NFA mounted as external financing inflows slowed down. Hence, the net foreign assets of the SBP experienced an extraordinarily strong Rs 356.3 billion contraction during Jul-Nov FY09.

Figure 4.7: Net Foreign Assets (Cumulative Flows)



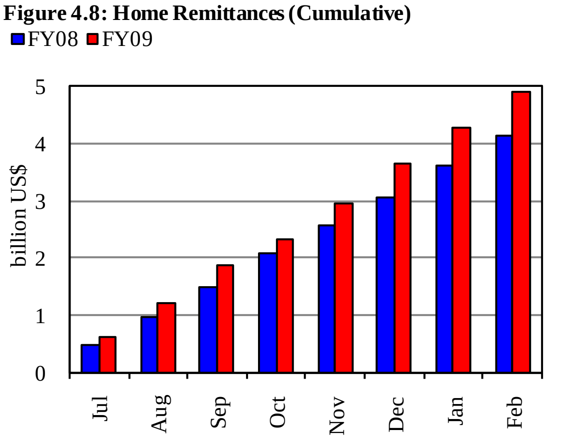
However, external financing inflows picked up from November 2008 onwards following the Stand-by Arrangement. In addition, the effect of decline in world oil prices on import growth started to get strength; in fact, the contribution of price effect in import growth turned negative since December 2008. Finally, the decision to partially meet foreign exchange requirement for payments of oil import from the interbank market effective February 2009 eased excessive pressure on

[12] This is because the IMF loan, which is essentially for balance of payment support, also creates a corresponding liability on the central bank.

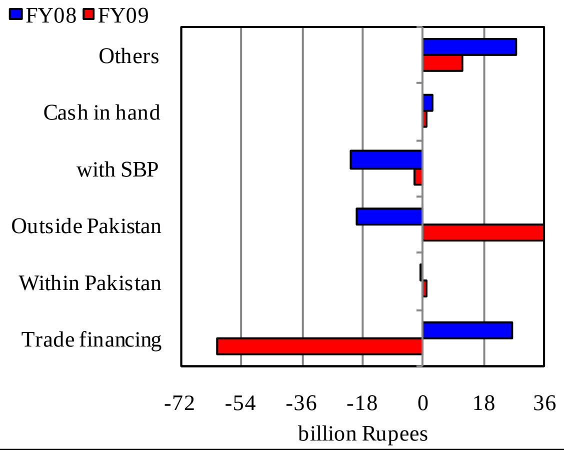
central bank's foreign exchange reserves.[13] For these reasons, SBP's NFA expanded by Rs 57.7 billion during Dec-Feb FY09.

Similarly, NFA of the scheduled banks registered a net expansion of Rs 3.0 billion during Jul-Feb FY09 compared to a contraction of Rs 80.9 billion during the corresponding period last year. Strong rise in workers' remittances and substantial retirement of foreign currency loans (see **Figure 4.8**) were the major factors responsible for the expansion in NFA of the scheduled banks during Jul-Feb FY09. The net impact of the above factors was strong enough to also offset the decline in net foreign investment during the period under review.

Figure 4.8: Home Remittances (Cumulative)



FE-25 Utilization (Jul-Feb)



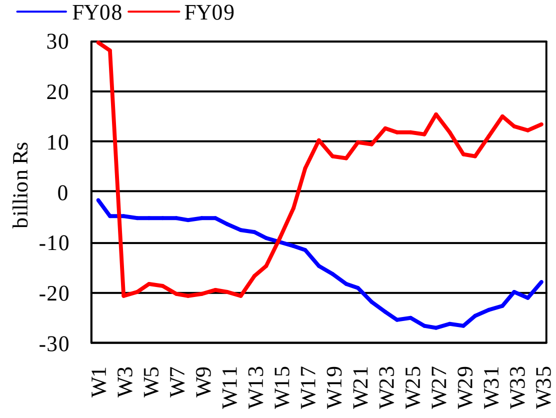
Net Domestic Assets (NDA)

After attaining an unusually high YoY growth of 34.5 percent in end-November 2008, the growth in NDA of the banking system decelerated sharply in subsequent months. Despite the deceleration, NDA of the banking sector registered a strong YoY growth of 23.0 percent during Jul-Feb FY09, slightly higher than the increase of 21.7 percent during the corresponding period of FY08. A surge in credit extended for commodity operations and persistently high government budgetary borrowing from the banking sector, contributed towards the strong growth in NDA of the banking sector during the

[13] Specifically, purchase of foreign exchange related to the import of furnace oil and POL related foreign exchange purchases made on specific form 'M' against approvals issued by Exchange Policy Department of the SBP are to be made from interbank market. For the rest, SBP will continue to provide foreign exchange to the banks.

period under review. The sharp increase in credit financing for commodity operations since mid October is caused by procurement of large quantities of wheat, rice and fertilizer. This is in contrast to persistent contraction in credit financing for commodity operations during the same period in FY08 (see **Figure 4.9**). Interestingly, after the spike seen in end October 2008, financing for commodity operations have lingered around the same level, perhaps due to delays in retirement of loans taken by PASSCO for financing of fertilizer procurement.

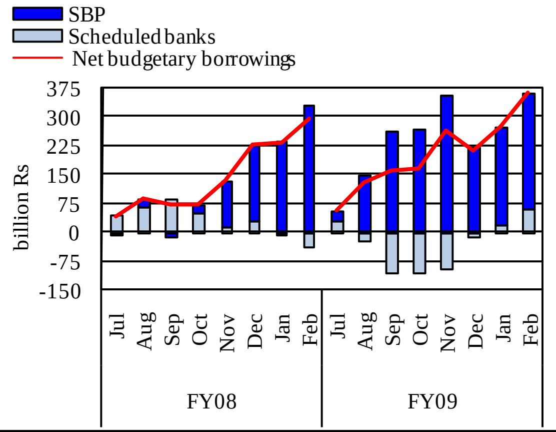
Figure 4.9: Financing for Commodity Operations (Weekly Cumulative Flows)



Demand for credit, both from public sector enterprise (PSEs) and the private sector, remained rather strong up till the end of October 2008. Since then, there is perceptible deceleration in the credit to the non-government.

Notwithstanding the continued pressure on the banking sector to finance the budget deficit, the composition of government borrowing from the banking system has changed significantly since mid- October 2008. The government retired some of its debt held by SBP and financed its borrowings needs from the scheduled banks. Consequently, SBP financing, as a share of net budgetary borrowing from the banking system, declined to 82.7 percent as on 28th Feb FY09 from a high of 207.1 percent as on 8th October FY09.

Figure 4.10: Budgetary Borrowings from Banking System (Cumulative)

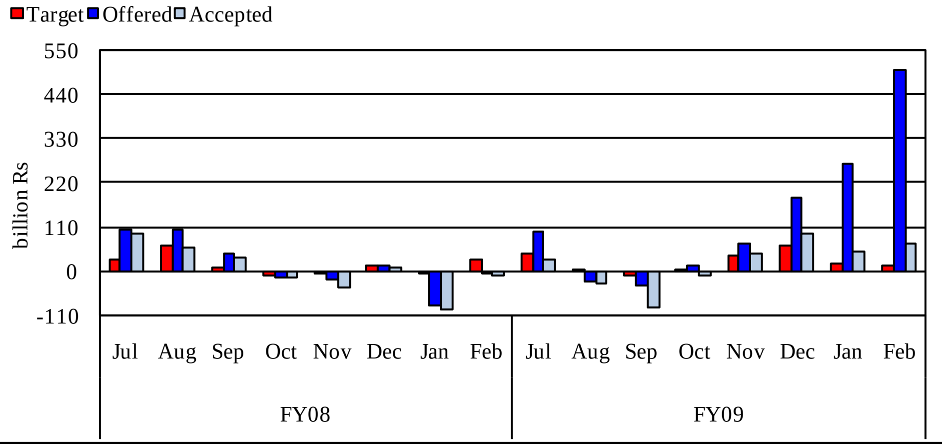


4.2.1 Government budgetary borrowings

The government's budgetary borrowing from the banking system during Jul-Feb FY09 rose by Rs 362.4 billion against an increase of Rs 306.4 billion in the corresponding period of FY08 (see **Figure 4.10**). The sharp rise in borrowing from the banking system is despite the fact that fiscal accounts for H1-FY09 suggest a considerably lower budget deficit, in line with FY09 annual budget target.[14] The apparent disconnect is explained by lesser availability of external financing,[15] and a contraction in domestic non-bank receipts which forced greater reliance on bank financing.

Importantly though, the government's reliance on budgetary borrowings from the SBP has declined since end November 2008. This was principally because: (1) in order to meet the end-December 2008 ceiling on borrowings from the central bank, the government used the proceeds from the transfer of SBP profits to retire its debt held by the SBP, (2) another Rs 22.7 billion worth of T-bills held by SBP were transferred to scheduled banks during Dec 26-31, 2008 under outright sale and OMOs (3) whereas external financing for H1-FY09 stands lower than the corresponding period last year, net external receipts to finance the deficit are larger than the Q1-FY09 inflows, and (4) banks' increased participation in the T-bill auctions in the wake of fading demand for credit by the private sector and concerns over growing NPLs. Consequently, stock of market related treasury bills (MRTBs) with SBP, which rose to Rs 1,393.4 billion by November 29, 2008, declined to Rs 1,345.2 billion as on 28th Feb 2009.

Figure 4.11: T-Bill Auction (Net of Maturities)

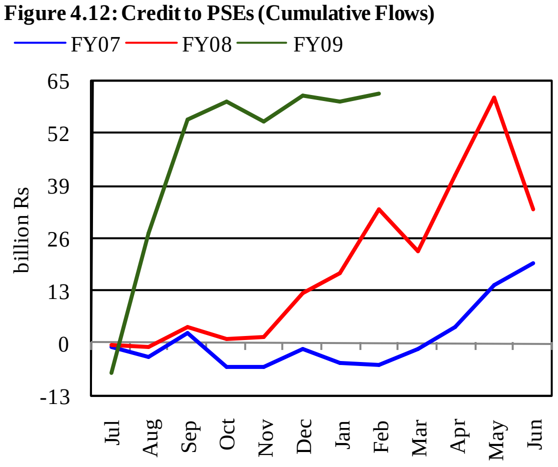


[14] The fiscal deficit for H1-FY09 was Rs 250.6 billion (or 1.9 percent of the projected GDP for FY09) lower than Rs 356.3 billion in H1-FY08 (or 3.4 percent of the FY08 GDP).
[15] The external financing during H1-FY09 was Rs 37.0 billion compared to net receipt of Rs 68.0 billion in H1-FY08.

During Jul-Nov FY09, scheduled banks were reluctant to provide financing to the government at the then prevailing auction cut off rates (see **Figure 4.11**). As a result, government was unable to even roll-over its maturing debt securities held by scheduled banks. This forced the government to retire Rs 93.3 billion of its budgetary borrowings from scheduled banks during Jul-Nov FY09. Since then, however, scheduled banks' financing to the government has expanded by Rs 156.2 billion. Slowing credit demand amidst a weakening economy and lower risk appetite of banks increased interest in government securities. Moreover, banks sought to lock in yields ahead of an expected fall in interest rate for the reasons: (a) private sector credit has contracted following slowdown in real economic activity and (b) their expectations that interest rates have peaked out. Consequently, scheduled banks provided, on cumulative basis, to the government Rs 62.9 billion as on 28th Feb 2009 against net retirement of Rs 52.9 billion in the corresponding period of FY08.

Another contribution to the higher acceptance was the change in the auction process for government papers. First, instead of SBP, Ministry of Finance decides the cut off rates in the primary auction. Moreover, cut off decision are now based on target volume, i.e., the cut off rate will be the one at which the government realizes the auction target volume rather than one set by the borrower. This means that going forward, the yields on government papers will be more sensitive to volume of government borrowings.

Figure 4.12: Credit to PSEs (Cumulative Flows)



The growth in the credit to the PSEs, which also contributed to Jul-Feb FY09 strong rise in NDA (see **Figure 4.12**), is attributable to continued delays in settlement of claims of one public sector oil marketing company (OMC) and the major power utility. Credit to PSEs rose by Rs 62.0 billion during Jul-Feb FY09 compared to an increase of Rs 31.5 billion in the corresponding period last year.

4.3 Credit to Private Sector (net)[16]

Corporate demand[17] for banks' credit could not maintain the robust YoY growth seen in the first three months of FY09 and it decelerated sharply in the succeeding period (see **Table 4.3**). Consequently, the cumulative private sector credit grew by 4.6 percent during Jul-Feb FY09 compared with strong growth of 11.7 percent in the corresponding period last year (see **Table 4.4**). Although the one-off credit demands, mainly from IPPs and OMCs, to fill the financing gap due to circular debt, somewhat inflated the credit growth in both fiscal years; the impact of this one-off demand on credit during FY09 was not as significant as in FY08.[18] Even adjusted for this phenomenon, it is seen that credit off-take, remains 6.1 percentage points lower in Jul-Feb FY09 than in the corresponding period last year (see **Table 4.4**).

Table 4.3: Trends in Private Sector Credit

YoY growth in percent

	FY08	FY09
Jul	15.4	17.3
Aug	15.3	16.6
Sep	15.2	20.3
Oct	15.6	18.6
Nov	15.6	16.1
Dec	15.9	12.8
Jan	17.0	11.2
Feb	17.8	9.1

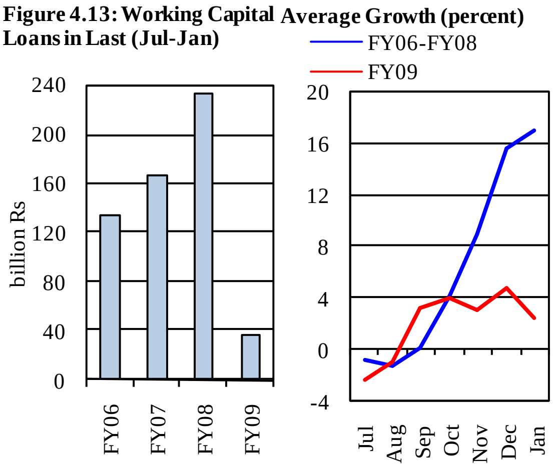
Table 4.4: Private Sector Credit (Jul-Feb)

Growth in percent

	FY08	FY09
Private Sector Credit	11.7	4.6
minus the impact of circular debt*	11.0	4.9

* Based on information collected from the sample corporates

Figure 4.13: Working Capital Loans in Last (Jul-Jan)



[16] The reported credit numbers comprises of banks' investments and advances to the corporate sector. This data is based on monetary survey, while the sector-wise discussion covers the period of Jul-Jan FY09.

[17] Credit demand from the businesses sector explains more than 85 percent of total private sector credit.

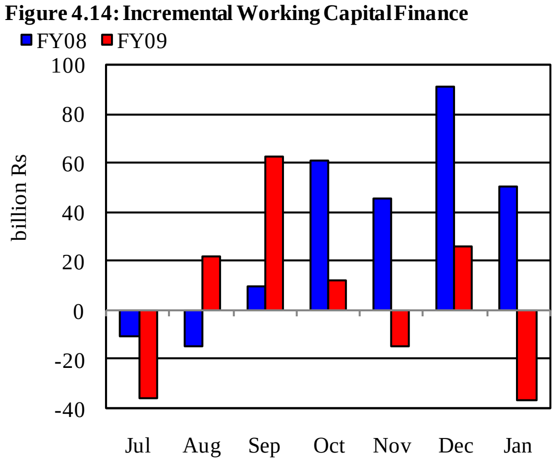
[18] This was partly explained by a lower base of June-2007.

The sharp slowdown in private sector credit during Jul-Jan FY09 was entirely explained by a significant deceleration in working capital loans which witnessed the lowest growth in the recent past (see **Figure 4.13**).

In contrast, the growth in long term loans, mainly for expansion activities in various industries, remained strong and was largely evident during Jul-Nov FY09; as the monthly trend saw a deceleration in each of the next two months. On face value, the growth in fixed investment loans would appear quite puzzling given that business slowdown is visible in various industries. The explanation is that a part of acceleration in demand for fixed investment loans particularly in the power, construction and fertilizer, sectors primarily reflects their financial closures in the last two years.[19]

A closer look at the working capital requirements indicates that credit demand was exceptionally strong during Aug-Sep FY09 .[20] However, it slowed significantly after October 2008, probably reflecting the liquidity strains in the banking industry which limited the lending ability of a few banks. In addition to this, a sharp fall in raw material prices has also lowered the working capital requirements from corporates.

Figure 4.14: Incremental Working Capital Finance



Though the liquidity pressures on the banking industry started to taper-off by end November 2008 due to number of measures undertaken by SBP,[21] credit off-take remains sluggish. In specific terms, January 2009 witnessed a net retirement under working capital loans. Although the slowdown under working capital loans in the month of January is a common factor, the net retirement in

[19] Financial closure broadly defines the project financing pattern of a company mainly through bank and non-bank sources (such as corporate papers, external financing). In case of bank finance, after signing the loan agreements with corproates, banks are bound to provide loan according to the terms and conditions mention in the contract.
[20] For detail see Q1-FY09.
[21] For detail see Q1-FY09.

January 2009 was exceptionally strong (see **Figure 4.14**).

Table 4.5: Possible Factors For Slowdown in Total Working Capital Loans (including Trade Finance)
YoY growth in percent

	FY08	FY09		
	Jul-Jan	Jul-Jan	Q1	Q2
Industrial production	5.6	-5.4	-6.2	-4.2
Imports	18.9	5.7	34.2	-6.6
Exports	5.6	7.6	18.0	1.8
WPI non-food*	12.7	11.6	35.2	11.7
Raw cotton	26.1	4.0	43.7	-1.9
Steel bar	30.3	14.4	53.9	28.8

*end period basis

Some of the reduction in demand for running finance since October 2008 was not unexpected as a few IPPs and OMCs had exhausted their credit limits with banks by end September 2008. The continued slowdown in economic activity however exacerbated the situation (see **Table 4.5**). The impact of former on working capital loans was further compounded by the retirement of banks' loan by some IPPs. Moreover, a decline in key asset markets reduced the speculative demand for credit. In addition, lower demand for credit was also explained by few sector specific issues.

For instance, economic slowdown in US and EU markets and structural issues of textile industry led to a fall in textile exports which in turn lowered the demand for working capital loans. Further, delays in settlement of textile export orders by importers resulted in piling up of stock of inventories.[22] This has also led to lower demand for fresh working capital loans. Likewise, deceleration in import demand[23] and lower input cost in few categories such as cotton and steel bar contributed to lower demand for working capital requirements.

Further, anecdotal evidence suggests that some corporates are also facing internal cash flow problems[24] in meeting their loan obligations. Besides liquidity squeeze in various industries, deterioration in interest coverage ratio[25] of a few corproates had also put significant downward pressure on credit demand (see **Table 4.6**).[26]

[22] For detail see section on **Trade Account**.
[23] Partly due to falling international oil prices and rupee depreciation against major currencies.
[24] Probably due to freeze on redemption of open end mutual fund in October 2008 and stock market crisis.
[25]Interest coverage ratio is defined as the ratio between the earnings before interest payment and taxes (EBIT) to interest expenses. This ratio evaluates a company's ability to pay the interest expenses on its debt from available earning sources. A higher interest coverage ratio means that the company's earnings is well above its interest requirements and thus company can withstand possible financial turmoil. By contrast, lower level of this ratio exhibits that the company barely manages to cover its interest costs and may easily fall into bankruptcy if its earnings suffer for even a single

A detailed analysis of selected sectors suggests that the lower interest coverage ratio in September 2008 was explained both by rising financial cost and fall in earnings before interest and tax (EBIT). It can be argued that part of private sector credit seems to be responding to interest rate channel of monetary policy. It may however be noted that a drop in EBIT of a few corproates reflects a mix of both fall in sale and increase in cost of goods sold.

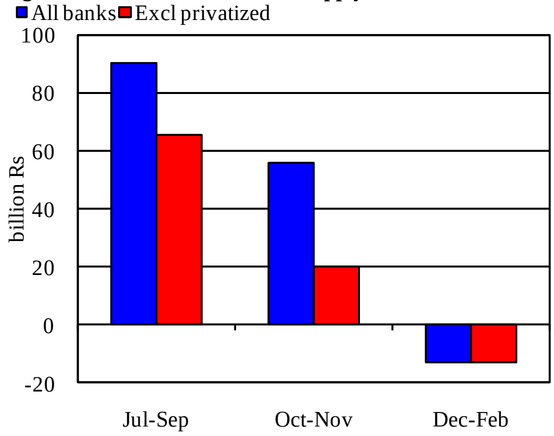
Table 4.6: Interest Coverage Ratio of Highly Leverage Selected Sectors*

	Sep-06	Sep-07	Sep-08
Textile	2.5	2.5	1.8
Fertilizer	7.4	6.2	4.5
Auto	16.9	40.1	2.7
Pharmaceuticals	350.7	144.0	73.4
Chemicals	9.0	30.9	6.8
Paper & Board	16.2	2.5	1.3
Leather & Tanners	3.5	9.2	13.3
Food and Personal Care Products	7.7	9.2	1.9
Power Generation and Distribution	-2.1	-1.5	-0.1
Overall	**7.1**	**7.9**	**2.7**

* This information is based on quarterly audited balance sheets of 23 listed companies.

Credit supply perspective suggests that during Jul-Sep FY09 banks had ample liquidity to fund credit demand as reflected in excess reserves with SBP over statutory requirements and maturing T-bill investments (see **Figure 4.15**).[27] However, a continuous fall in excess statutory reserves with SBP and sudden withdrawal of deposits in mid October 2008 exerted significant pressures on

Figure 4.15: Incremental Credit Supply-FY09



period. It may be noted here that financial cost is used instead of interest expenses to calculate this ratio for selected companies, which mainly includes markup on long term and short term loan, finance lease and bank charges.

[26] Resultantly, a few sectors also witnessed a relative increase in non-performing loans by end December 2008.

[27] Banks were reluctant to rollover their investment in government papers mainly due to exceptional demand for private sector credit in the same period.

liquidity available with banks. This prevented a few banks from aggressive lending during Oct-Nov FY09.

Although most of the banks were hit by the deposits withdrawal, the lending ability of the *large privatized banks*[28] remained intact, to an extent.[29] This was because, except one of the *large privatized banks*, mostly banks in this group (1) were not much affected by the liquidity crunch of October 2008 and (2) reverted to their pre-crisis deposit level by early November 2008.[30] On the other hand, the impact of deposit withdrawal was significant for some of the small private banks and thus their incremental lending fell sharply in Oct-Nov FY09[31].

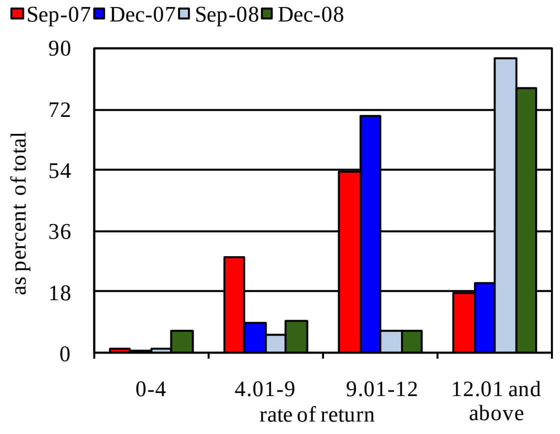
Table 4.7: Gross NPLs to Loan Ratio (in percent)

	Dec-08	Dec-09
Fixed investment	11.3	12.7
Working capital*	6.6	9.2

* Excluding trade related loans

As discussed earlier, though the SBP measures eased-off tight liquidity conditions, to an extent, in the inter-bank market since November 2008 onwards, the effect on bank's willingness to lend to private sector was weakened by number of factors such as rising concerns regarding deteriorating credit quality, delays in cash recoveries of loan proceeds and rising risk in sectors such as stock market and real estate. The concern regarding credit quality is also reflected by sharp increase in infection ratio particularly under working capital loans in December 2008 (see **Table 4.7**).

Figure 4.16: Banks' Lending Portfolio



Moreover, the structure of loan portfolio of the banks has also changed significantly as by end December 2008, 78.2 percent of the total bank advances were

[28] This category includes four banks namely; MCB, ABL, HBL, UBL.
[29] It may be noted here that the incremental credit from large privatized banks during Oct-Nov FY09 was Rs 35.7 billion compared with Rs 24.9 billion in the Q1 FY09.
[30] For detail see section on Deposits.
[31] As their deposit withdrawal was significant when compared with their total deposit base. For detail see Box 4.2 in Q1-FY09.

lent at the rate of 12 percent and above. In comparison same month last year 70 percent of aggregate bank advances were extended at rates between 9 to 12 percent (see **Figure 4.16**). Besides reflecting effect of monetary tightening, the change in banks' portfolio in terms of lending at a higher rate also indicates an increase in both the credit risk and return on government papers.

Table 4.8: Liquidity Position of Banking Industry during FY09
billion Rs

	Jul-Sep	Oct-Nov	Dec-Feb	Total
Net target	32.9	40.4	93.3	166.5
Net offered	33.1	80.8	951.8	1,065.7
Deposits	-129.0	-17.3	124.3	-22.3

In view of the rising NPLs, a few banks followed more stringent credit criteria. For instance, it is cited that banks are focusing to finance mostly those projects that have ability to generate cash flows. In recent past, banks mainly focused on the value of collateral such as inventories, amount receivable and fixed assets, and less emphasis was given to corporates' liquidity and cash flows. With rising default risks, banks are now also assessing the borrowers' income level and their current obligations to determine their ability to service debt. Further, banks are also reluctant to lend in those sectors which have seen significant increase in inventories.

On the other hand, government appetite to raise funds from the banking system provides an avenue for banks to put their funds in T-bills. In specific terms, till September 2008, commercial banks were reluctant to lend to government as credit demand was exceptionally strong and banks were expecting higher interest rates due to rising inflationary trend in the economy. However, since October 2008 onwards, banks' participation in T-bill auction increased significantly. Bank's greater interest in government paper was explainable by a number of reasons, including; (1) ample loanable funds with banks[32] (2) the interest rate differential between lending to private sector and to the government had narrowed[33] (3) changing banks' preference in favor of risk free instruments

Table 4.9: Structure of Bank Lending during FY09
billion Rs

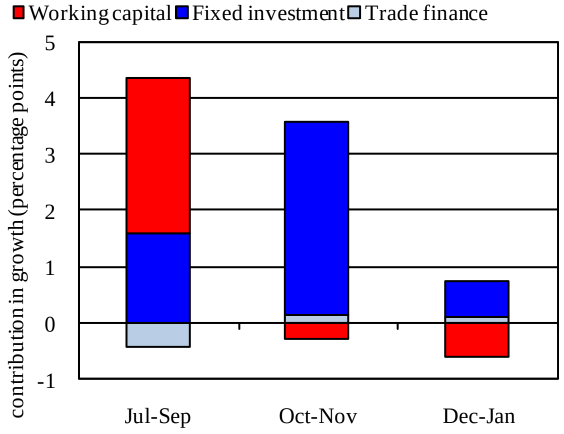
	Jul-Sep	Oct-Nov	Dec-Feb	Total
Private sector	90.3	55.5	-12.8	133.1
PSE	63.5	-8.7	7.2	62.0
Investment in GoP papers*	-99.6	30.6	191.6	122.6

*T-bill (net accepted)

[32] This is captured by banks' excessive bidding in T-bill auctions during Dec-Feb FY09 period (see **Table 4.8**).
[33] Difference between 6-month KIBOR and 6-month Repo rate declined from 152 basis points in September 2009 to 106 basis points in February 2009.

to avoid erosion of credit quality and (4) the market expectations that the overall interest rate in the economy have peaked out (see **Table 4.9**).

Figure 4.17: Breakup of Business Sector Advances -FY09



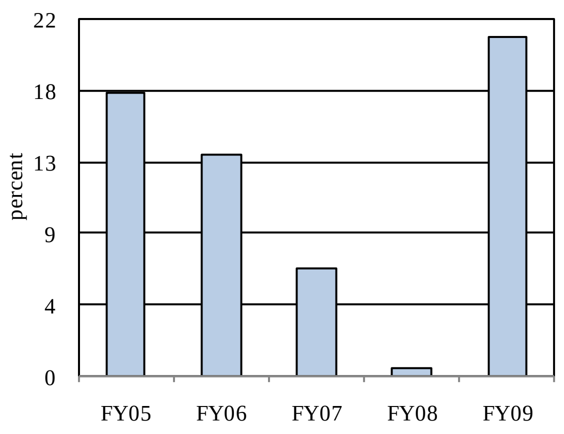
Trend in Business sector Advances

The growth momentum in business sector advances, which had witnessed strong growth in the last few years, slowed significantly, recording 7.6 percent growth during Jul-Jan FY09, i.e., 6.3 percentage points lower than the average growth in the preceding three years. Though fixed investment loans witnessed robust growth, a marked deceleration under working capital and trade loans had exerted significant downward pressure on overall demand for credit during Jul-Jan FY09.[34]

Factors explaining higher demand for fixed investment loans

In contrast to deceleration in fixed investment loans visible since last three years, Jul-Jan FY09 posted a robust growth of 21.0 percent (see **Figure 4.18**). Monthly trend depicts that this significant rise in fixed investment loans was largely concentrated in Jul-Nov period, whereas moderation in demand was seen in the months of December and January FY09 (see **Figure 4.19**). More

Figure 4.18: Growth in Fixed Investment Loans (Jul-Jan)



[34] It must, however, be noted that during Jul-Sep FY09, the contribution from working capital loans in advances growth was exceptional (see **Figure 4.17**).

importantly, demand for fixed investment remained broad-based as most of the sectors (such as fertilizer, power, commerce and trade, telecom and construction) recorded double digit growth.

It must, however, be noted that FY08 marginal growth was an exception; as most of the corporates were issuing private papers to both (1) finance their expansion projects, and (2) retire long-term loans in some cases.[35] Thus, the increase in demand under fixed investment loans for this year was expected to an extent, as corporate market saw no new issuance of corporate debt instrument in FY09. Further, it is also cited that disbursements in few sectors such as power, fertilizer and construction was anticipated as their financial closures were achieved in the last two years. In specific terms, while the fixed investment in power sector reflects expansion in power generating and distributing companies, demand in construction sector was principally for residential related projects by one large private construction company. In case of fertilizer sector, fixed investment demand was due to large fertilizer capacity expansion.

Figure 4.19: Fixed Investment Loans

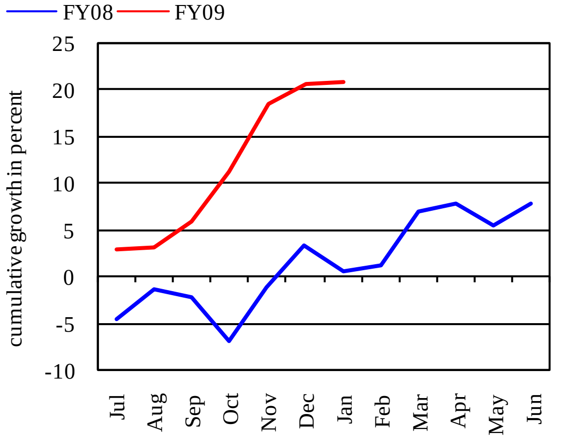
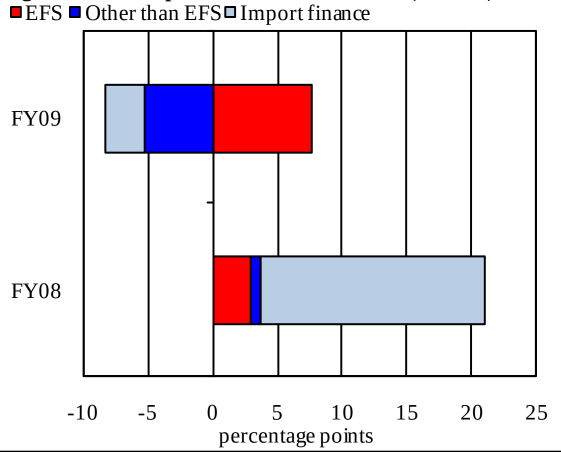


Figure 4.20: Composition of Trade Finance (Jul-Jan)



In addition, growth in fixed investment in telecom sector accelerated substantially from

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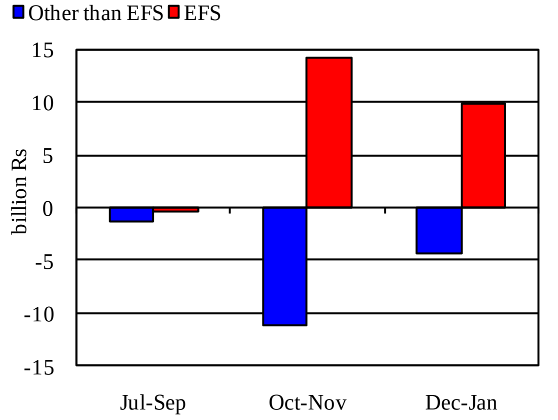
[35] For details see Q2-FY08

10.3 percent during Jul-Jan FY08 to 23.8 percent in Jul-Jan FY09. This was probably a reflection of expansion in the network of the wireless internet facility offered by different telecom companies.

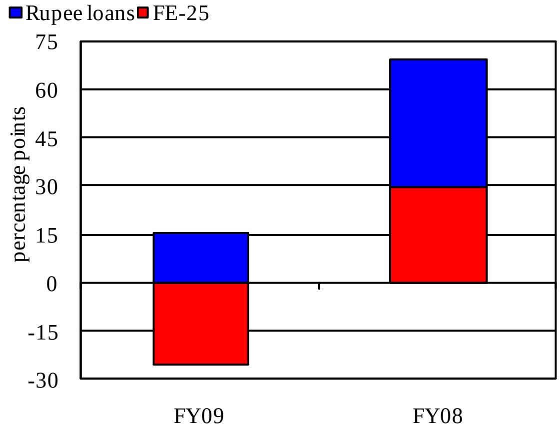
Figure 4.21: Substitution Between EFS and Other Than EFS-FY09



Factors explaining lower demand for trade related loans

The growth in trade related loans fell sharply to 0.9 percent in Jul-Jan FY09 compared to robust growth of 21.0 percent in the same period last year. This was despite the strong contribution of EFS loans in total trade loans (see **Figure 4.20**). Although the loans under EFS recorded a robust growth of 14.8 percent in Jul-Jan FY09 compared with 5.1 percent in the corresponding period last year, the export loans other than schemes (mainly against FE-25 loans) witnessed substantial net retirement which had diluted the impact of higher growth under EFS loans. Retirement under FE-25 loans was probably due to sharp depreciation of rupee against US dollar which had caused exporters to (1) substitute their FE-25 outstanding stock with EFS and (2) to meet their running finance requirement through EFS (see **Figure 4.21**).

Figure 4.22: Import Finance (Jul-Jan)



A commodity-wise break up shows that most of the increase in EFS is recorded in rice and textile related products such as towel, and cotton fabrics. In specific terms, increase in loans extended to rice traders is consistent with bumper crop and remarkable increase in rice exports. Likewise, higher loans under towel and cotton fabrics primarily reflects higher export quantum in these commodities.[36]

It must be noted here that to support exporters, SBP further enhanced the banks' limit under EFS and LTFF.[37] As a result of this measure, more liquidity will be available with banks to facilitate exporters at a highly concessional rate. Recently, SBP has also issued performance based mark-up rates under EFS to further lower the rates for exports.[38]

The fall in the import finance during Jul-Jan FY09 was visible in loans extended to importers against FE-25 and in local currency (sees **Figure 4.22**). While the drop in import finance was in line with the deceleration in country's import bills following a sharp fall in international oil prices, the upward pressure on exchange rate has further dragged down the demand for import finance.

Factors explaining lower demand for working capital loans
After recording robust growth in the past four years, demand for working capital loans decelerated substantially to 3.2 percent during Jul-Jan FY09, i.e., 18.6

Table 4.10: Advances for Working Capital Loans
growth in percent

	Jul-Jan		Oct-Jan	
	FY08	**FY09**	**FY08**	**FY09**
Business Sector	**19.6**	**3.2**	**24.8**	**-1.5**
A. Agriculture, hunting and forestry	14.2	1.1	7.5	1.0
B. Manufacturing	20.3	11.8	30.6	5.1
a. Textile	33.7	16.1	42.5	14.1
Spinning	42.1	24.4	52.9	19.2
b. Cement	46.6	22.3	25.7	5.2
c. Fertilizer	-39.0	38.7	-1.2	-24.6
C. Power	35.7	-1.4	36.1	-15.7
D. Construction	32.4	-14.1	31.6	-4.7
E. Commerce and Trade	17.3	-4.7	17.7	-5.2
F. Transport, storage and communications	3.8	-21.4	68.9	-27.2
G. Other business activities*	54.2	8.5	38.3	-12.2

* Mainly includes loans extended to stock brokers/trade under CFS

[36] For detail see section on Trade.
[37] In Jan-Mar 09 Monetary Policy Statement, SBP increased the banks' limit under EFS and LTFF by Rs. 35 billion. For detail see MPS Jan-Mar FY09.
[38] For details see SMFED circular # 06 dated March 09,2009.

percentage points lower than the average growth in the last four years. A detailed analysis of Jul-Jan period shows that the strong demand for working capital loans during Q1-FY09 begun to weaken sharply since October 2008 onwards. Thus, after witnessing exceptional growth in Q1-FY09, the growth under working capital loans dropped drastically in Oct-Jan FY09 (see **Table 4.10**).

A large number of sectors witnessed fall in demand for running finance requirements in Oct-Jan FY09 which is in stark contrast to previous year's trend. Besides, slowdown in economic activities, one of the major factors behind the significant slowdown in running finance requirements of corporates was a sharp fall in raw material prices in post Q1-FY09. For instance, drop in raw cotton prices since November 2008 onwards contributed to only 19.2 percent growth in demand for running finance in textile sector during Oct-Jan FY09 compared with strong growth of 52.9 percent in the corresponding period last year. Likewise, fall in credit extended to the construction sector partly recorded the impact of fall in steel bar prices during Oct-Jan FY09. The impact of this was further compounded by slowdown in domestic residential business activities as suggested by fall in real estate prices.

Further, freeze in stock market activity and resulting fall in valuation of shares lowered the incentives for stock brokers/agents to obtain advances under CFS. Resultantly, advances growth under loans to Stock Brokers/agents dropped drastically to 12.2 percent during Oct-Jan FY09 compared with 38.3 percent growth in Oct-Jan FY08.

Fall in demand from the power sector in Oct-Jan FY09 was partly due to retirement of bank loans by a few IPPs to avoid the rising financial expenses. The moderation in demand from power sector was further compounded by the fact that a few IPPs had already availed their credit limit till September 2008.

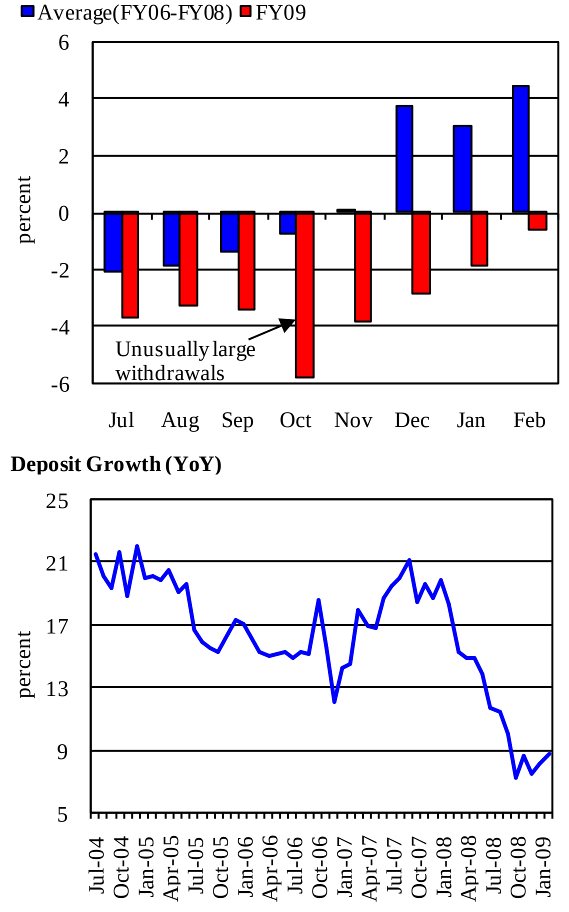
In case of fertilizer sector, though the credit demand was strong in Jul-Sep FY09, it decelerated sharply in the subsequent months. It may be pertinent to mention here that the higher demand from the fertilizer sector in Q1-FY09 was partly due to delays in settlement of DAP subsidy claims with the government.[39]

[39] In fact, to protect the farmers from hike in international DAP prices, government has been providing the DAP price differential (between the international DAP prices and the domestic DAP prices) to fertilizer companies. Since February 2008 the international DAP prices increased drastically and reaches to US$ 174.1 per mt in August 2008. Though government had raised the DAP subsidy in June 2008 from Rs 470/bag to Rs 1,000/bag which later on further increased to Rs

4.4 Deposit Mobilization[40]

Deposit mobilization by banks remained notably weak during Jul-Feb FY09 as overall deposits of the banking system declined by 0.6 percent on a cumulative basis.[41] This was in sharp contrast to deposit growth of 4.0 percent during the corresponding period of the previous year. The unusually large withdrawal in deposits during the first two weeks after *Eid-ul-Fitr* in response to depositors' concerns on stability of local banks, large scale redemptions by investors in mutual funds, shift in public preference away from deposits due to high inflation, high returns on NSS,effect of the slowdown in economic activity and continued external account pressures have contributed to the deceleration in deposit growth. Thus, the cumulative deposits growth, which generally attains positive levels around November each year, was still hovering in the negative range by February 2009 (see **Figure 4.23**).

Figure 4.23: Cumulative Deposit Growth



2,200/bag, however, delays in settlement of subsidy claims a few fertilizer companies had to borrow from the banking system to meet the financing gap.

[40] The discussion on deposits is based on total deposits of the banking system including government deposits.

[41] It must be noted here that a part of fall in overall deposit growth during Jul-Feb FY09 emanates from the exceptional seasonal withdrawal in deposits seen in July 2008.

Encouragingly, the recent trends suggest that the steep fall in YoY deposit growth seems to have bottomed out. Further, the banking system on overall basis has at least recovered from abrupt large erosion in deposit base during October 2008 (see **Figure 4.24**). Indeed, it took banks more than three months to re-build their deposits to levels prevailing in mid-September 2008 (well before the panic had struck the depositors). A slower recovery in banks' deposits was not surprising as depositors would take some time to overcome their concerns regarding the stability of local banks.

Figure 4.24: Weekly Trend in Stock of Deposits in FY09

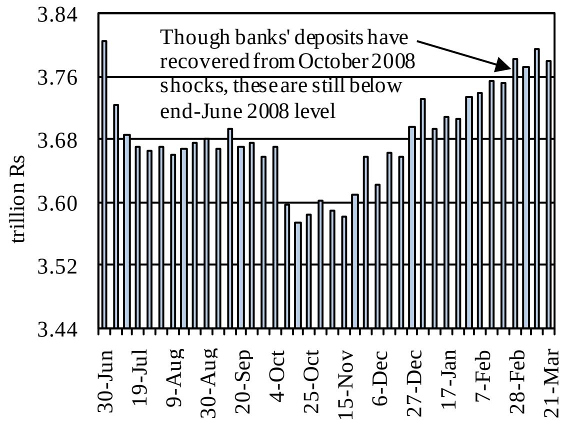
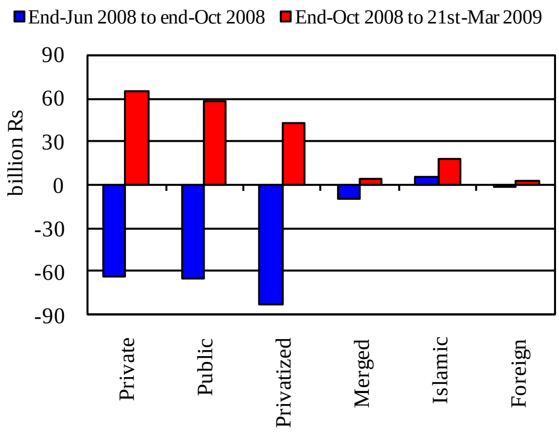


Figure 4.25: Deposit Mobilization

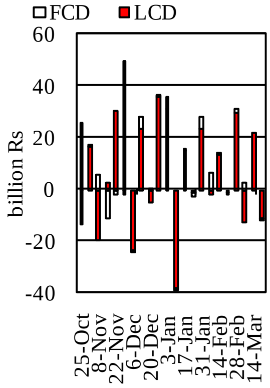


The recovery process is however not uniform across banks. While some of the banks recovered the loss in their deposit base rather quickly, other took more time, whereas a few of them are still struggling to recoup their deposits.

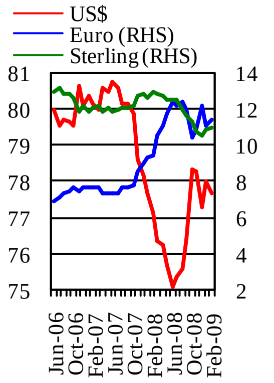
The bank-groupwise analysis of deposit growth after October 2008 suggests that both, public sector banks and private domestic banks have been able to recover most of the decline during June-October 2008 period in their stock of deposits (see **Figure 4.25**). Within public sector commercial banks, deposit growth is mainly concentrated in one large bank due to increase in deposits of government and public sector enterprises (PSEs). The growth in domestic private banks' deposits is on account of a rise in deposits of PSEs, corporate and telecom sectors.

On the other hand, recovery of deposits is slower in privatized banks. Some of the banks, which had recently merged, continued to face difficulty in mobilizing deposits even after October 2008. This was primarily because of the maturing deposits of companies in the telecom and refineries sectors. It is important to note that the merged banks are facing problems in deposit mobilization,despite the significant rise in return on deposits offered by these banks.

Figure 4.26: Currency Wise Movements of Weekly Deposits during Recovery



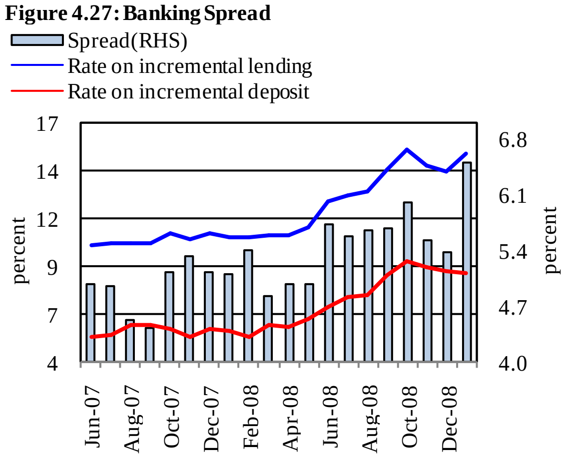
Share of US $ Denominated Deposits to Foreign Currency Deposits (in percent)



The foreign currency deposits, (particularly in US$ denominated deposits), which faced heavy withdrawal in October 2008, are again becoming attractive. The share of US$ denominated deposits is also improving (see **Figure 4.26**), mainly due to rise in resident FCD accounts.

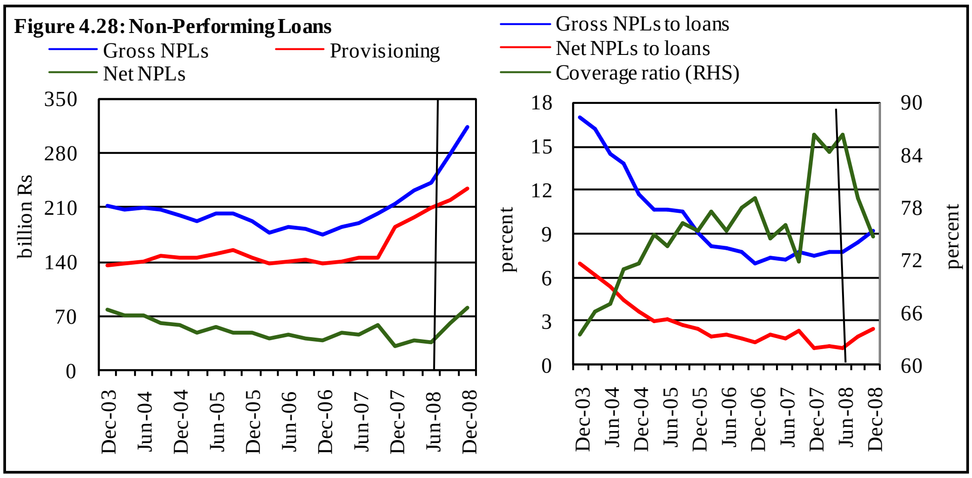
While almost all banks have increased return on their deposits, the interest rate spread for the banking industry rose by 100 basis points since June 2008, reaching 7.78 percentage points in January 09 – the highest level in recent years. It may be pointed out here spread had declined sharply in June 2008 following the introduction of 5 percent floor on savings/PLS deposits.

Figure 4.27: Banking Spread



During Jul-Oct 2008, though both the lending as well as deposit rates were increasing, the response of lending rates to liquidity shortages was more pronounced, thereby leading to a rise in banking spread. On the contrary, the massive liquidity support by SBP during October 2008 and onwards

Figure 4.28: Non-Performing Loans



probably eased the compulsion on banks to aggressively mobilize their deposit base. As a result, deposit rates softened whereas lending rates remained almost unchanged, leading to a further rise in banking spread (see **Figure 4.27**).

Table 4.11: Sector wise NPL to Loan Ratio

	Dec-07	Jun-08	Dec-08
Corporate sector	**7.14**	**7.58**	**8.88**
Chemical & pharma	11.07	8.75	7.69
Agribusiness	17.86	13.57	8.85
Textile	10.74	12.62	14.60
Cement	3.54	8.01	6.55
Sugar	7.12	4.99	9.06
Shoes & leather garments	10.05	17.36	8.63
Auto & trans equipment	6.05	6.31	7.49
SMEs sector	**9.25**	**11.22**	**15.79**
Agriculture sector	**18.68**	**16.55**	**15.77**
Consumer sector	**4.37**	**5.50**	**6.93**
Credit cards	3.52	4.81	5.50
Auto loans	4.63	5.88	5.93
Consumer durable	7.85	10.52	7.79
Mortgage loans	5.28	5.64	7.41
Commodity financing	**1.01**	**0.77**	**1.40**
Cotton	2.63	2.22	2.75
Rice	0.66	1.13	2.87
Sugarcane	0.00	0.14	0.30
Wheat	1.47	0.64	0.57
Total	**7.44**	**7.72**	**9.13**

4.5 Non-Performing Loans

The asset quality of the banking system has shown considerable deterioration during Jul-Dec 2008 as banks' total non-performing loans (NPLs) increased sharply by 30.0 percent (i.e., Rs 72.3 billion) over the June 2008 level to reach Rs 313.7 billion as on end-Dec 2008 (see **Figure 4.28**). In the meanwhile, the provisioning made by banks was relatively low partly because SBP allowed banks to avail the benefit of 30 percent of Forced Sale value (FSV) of collateral while calculating provisioning requirement. As a result, net NPLs more than doubled and the coverage ratio weakened sharply during Jul-Dec 2008. This increase in net NPLs together with slowdown in advances growth, also led to a steep rise in the net NPLs to net loan ratio.

A sector wise analysis shows that NPL to advances ratio has increased for all sectors except for the agribusiness (see **Table 4.11**). In the corporate sector, textile, sugar and auto are the sectors facing rising NPLs-advances ratio. The economic slowdown and the resulting stress on balance sheet of corporates are probably driving the rising trends in bad loans. On the other hand, the infection ratio in shoes and leather, cement and agribusiness has declined.

Although the NPLs in consumer finance continued to grow during Jul-Dec 2008, their share in overall NPLs has fallen during Jun-Dec 2008. Furthermore, rise in NPLs in consumer loans during Jun-Dec 2008 was mainly concentrated in one bank which contributed around 50 percent of the rise in NPLs under consumer loans. Within consumer credit, the extent of NPLs is rising for all categories, except for loans extended for consumer durables (see **Table 4.12**).

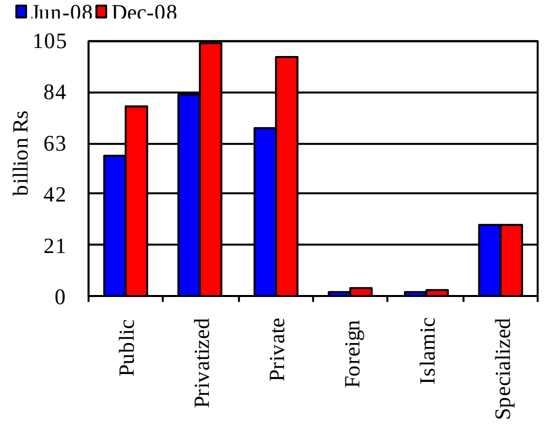
Table 4.12: Profile of Five Banks with Largest Increase in NPLs

	Dec07-Jun08	Jun08-Dec08
Percent share of 5 banks in		
Total NPLs	75	55
Total assets	32[1]	41[2]
Total advances	30[3]	42[4]

1. Assets as on Dec07 2. Assets as on Dec08
3. Advances as on Dec07 4. Advances as on Dec07

Banks' group-wise analysis shows that (1) both public and private banks are facing sharply increased burden of bad loans (see **Figure 4.29**).
(2) more of the banks are now facing rising NPLs. This is evident from the fact that five banks with largest increase in NPLs accounted for 55 percent of the total rise in NPLs of the banking system during second half of CY2008. During first half, around 75 percent of the incremental NPLs were

Figure 4.29: NPLs Stock by Bank-Group



concentrated in five banks (see **Table 4.12**). (3) It is the relatively larger banks that are now facing greater increase in NPLs during second half of CY2008. This is evident from their share in total assets and advances.