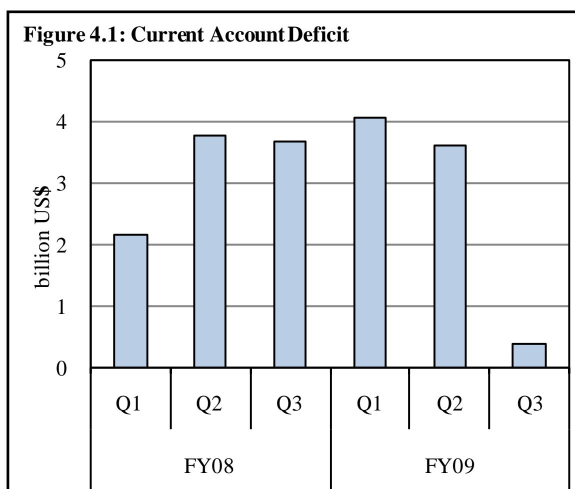
4 Money and Banking[1]

4.1 Monetary Policy

Domestic demand has been visibly declining since November 2008. This was particularly noticeable in: (1) a downtrend in the country's imports that, over time, helped substantially narrow the current account deficit; (2) a deceleration in private sector credit growth; as well as (3) the moderation of demand stimulus as fiscal discipline improved, and incremental monetization of the fiscal deficit was constrained. The *pace* of the improvement, however, was initially unclear, and there were lingering risks on the external account as well as in the relative resilience in core inflation. These risks precluded an immediate definitive easing of monetary policy, and accordingly the January 2009 Monetary Policy Statement (MPS) kept the policy rate unchanged.

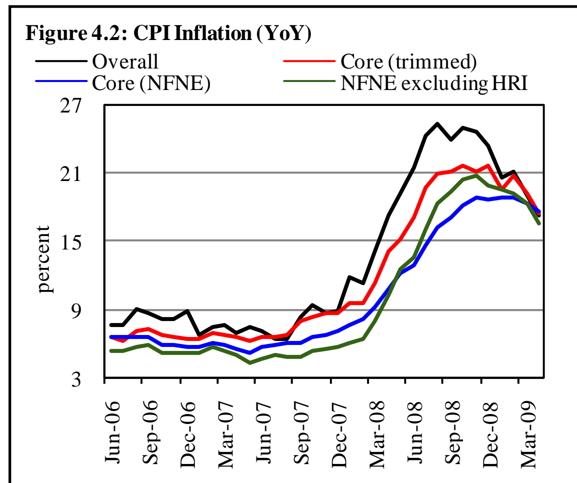
Notwithstanding this, the measures introduced in the wake of the liquidity shock in October 2008 meant that KIBOR eased, particularly in the wake of the non-enforcement of implicit interest rate corridor by SBP, which effectively diluted the impact of the policy stance on the already stressed domestic economy. Further, in order to support industry, and particularly the export-oriented sectors, that were pressured by the impact of the global recession, by easing access to concessional financing schemes, and lengthening maturities.

By April 2009, the trend improvement had accelerated, allowing the central bank to signal a definitive easing of monetary policy through a 100 bps reduction of the policy rate, bringing it to 14 percent effective from April 21, 2009. The risks emanating from the external account and stubbornly high core inflation have both lessened substantially. The current account deficit has fallen very sharply (see **Figure**



[1] This section covers data till last week of April 2009.

4.1), and the CPI inflation has also declined.



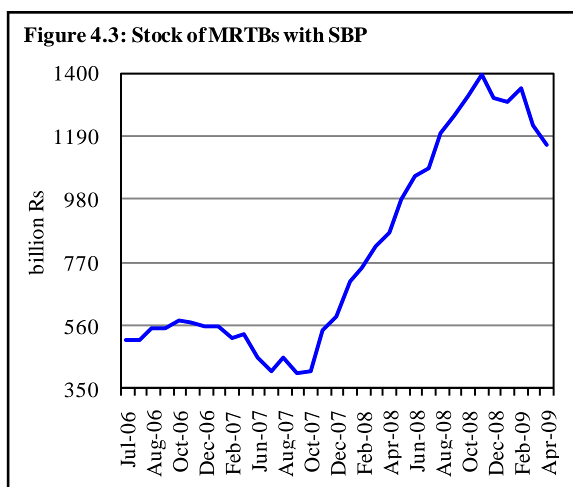
While inflation has been quite persistent over the last 6 months, this appears to be changing, as evident in the declining trend in the year-on-year figures for CPI inflation as well as both core inflation measures (see **Figure 4.2**).[2] SBP forecasts indicate that disinflationary trends will accelerate in months ahead, with the emerging steep downtrend in CPI inflation being followed by a sharp decline in core inflation. A leading indication of the expected decline in core inflation is seen in the behavior of NFNE core measure excluding HRI, which has dipped sharply in recent months.

Similalry, recent available information on the external account indicates a strengthening of the country's balance of payments position. The incremental rise in the current account deficit during Q3-FY09 was only US$ 396 million, substantially lower than the deficit of US$ 3.7 billion during the corresponding period of FY08 (see **Figure 4.1**). Indeed, the current account posted a surplus of US$ 128 million in February 2009. This improvement in external current account, together with foreign exchange inflows from International Financial Institutions (IFIs) led to a significant increase in SBP's foreign exchange reserves, which rose to US$ 7.8 billion at end-April 2009 from its low level of US$ 3.5 billion by end-October 2008. Recognizing lowering of risk to external sector position, SBP has revised downward its FY09 forecast for the external current account deficit.[3]

Meanwhile, the recent pronounced weakening of excess demand pressures continued in Q3-FY09 as well. In particular, the YoY growth in imports further dropped to 36.4 percent in Q3-FY09 due to both sharp YoY fall in import prices

[2] The YoY headline CPI dropped to 17.2 percent in April 2009 compared with its peak of 25.3 percent recorded in August 2008. Likewise, core inflation (20 percent weighted trimmed measures) reached to 17.6 percent in April 2009 compared with 21.7 percent in October 2008.
[3] It may be noted here that SBP has lowered its projection of current account deficit as percent of GDP which was in the range of 5.8-6.2 to 5.2-5.6 for FY09.

and quantum.[4] Moreover, the private sector credit growth continued to show deceleration as it recorded net retirement of Rs 127.1 billion in Jan-Mar FY09 compared with net lending of Rs 203.1 billion in H1-FY09.[5] The deceleration in credit growth was a reflection of both lower demand and banks' reluctance to lend to private sector in wake of deteriorating credit quality.



Likewise, on the fiscal side the government's reliance on central bank borrowing has further declined by end March 2009. Specifically, the government has retired Rs 218.1 billion to SBP in March 2009 to meet the quantitative ceilings on borrowing from SBP envisaged in the Stand By Arrangement (SBA).[6] Resultantly, the cumulative government budgetary borrowing from SBP reduced to Rs 81.5 billion during Jul-Apr FY09; significantly lower than Rs 404.8 billion in the corresponding period last year.

The domestic liquidity condition, as a result of slowdown in domestic credit requirements by the government and private sector and sharp fall in pace of depletion of Net Foreign Assets (NFA) of the banking system have continued, so far, remained relatively easy.[7] The impact of improvement in demand pressures on rupee liquidity is quite visible from the softening of market interest rates since January 2009 (see **Figure 4.4**).

It has been argued that the substantial improvement in macroeconomic indicators, should have allowed for a sharper reduction in the policy rate, particularly the

[4] For detail please see chapter on **Trade Account**.
[5] The cumulative increase in private sector credit during Jul-25th April FY09 was only Rs 48.6 billion compared with Rs 371.3 billion in the corresponding period of the last year.
[6] The stock of Market Related Treasury Bills (MRTBs) has lowered to Rs 1158.2 billion by end April, 2009 from a peak of Rs 1429.5 billion on December 3rd, 2008 (see **Figure 4.3**).
[7] While, in the month of October and November 2008 the continued decline in deposit growth exerted downward pressures on rupee liquidity, an abrupt and heavy withdrawal of deposits from the banking system further aggravated the situation. However, the SBP proactive liquidity management ensured the smooth functioning of inter-bank market.

growth indicators show a substantial slowdown in the economy, and inflation is projected to fall sharply. Indeed, the market had already envisaged the possible cut in the policy rate, ahead of the April 2009, in wake of lower inflationary pressures in the economy, as evident from the downtrend in the market rates since January 2009.

Such a measure would indeed be possible were it not for the risks attached to the current macroeconomic situation, including anticipated shortfalls in fiscal receipts, the uncertain international environment which adds uncertainty to Pakistan's ability to finance even a narrower current account deficit, as well as the fact that the accelerated decline in inflation is, so far, more an expectation than a fact.

Ironically, risks to monetary easing may emerge from a much-desired revival of credit demand from the private sector; if the government's financing demands on the banking system remain at current levels. It must be kept in mind that the government's success in financing its fiscal deficits post-November 2008 from commercial banks, without sparking upward pressure on

Figure 4.4: Key Market Interest Rates

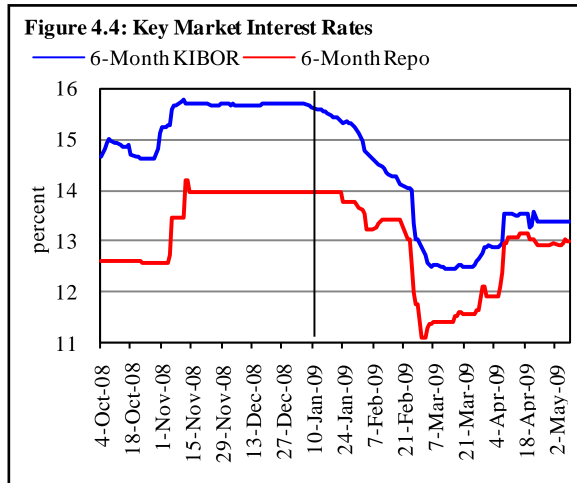


Table 4.1: Monetary Aggregates (Jul-Apr)

flows in billion Rupees and growth in percent

	Absolute flows since end-June		Growth	
	FY08	**FY09**	**FY08**	**FY09**
Broad money (M2)	**341.2**	**88.4**	**8.4**	**1.9**
YoY growth			*15.3*	*8.4*
NFA	**-297.7**	**-236.9**	**-30.2**	**-35.5**
YoY growth			*-12.9*	*-37.3*
SBP	-219.9	-237.3	-27.9	-49.4
Scheduled banks	-77.8	0.4	-39.5	0.2
NDA	**638.9**	**325.3**	**20.7**	**8.1**
YoY growth			*22.6*	*16.9*
SBP	407.2	114.7	270.2	14.8
Scheduled banks	231.7	210.5	7.9	6.5
of which				
Govt sector borrowing	**360.0**	**303.2**	**38.9**	**20.1**
Net budgetary support	333.2	259.9	41.1	19.0
SBP	484.9	105.3	140.6	10.2
Scheduled banks	-151.7	154.5	-32.6	46.7
Credit to PSEs	**41.7**	**142.1**	**51.7**	**125.0**
Credit to private sector	**371.3**	**48.6**	**15.0**	**1.7**
Other items (net)	**-134.3**	**-168.5**	**31.8**	**33.3**
Memorandum item				
Total domestic credit[1]	754.1	464.5	22.1	10.9
Reserve money	**133.5**	**-50.6**	**11.0**	**-3.4**

[1] Sum of government and non-government credit.

market rates was because of weak private sector demand, as much as bank's increase risk averseness in the face of rising NPLs. A hint of this is already evident in April 2009 uptrend in the market rates that was possibly an indication of short-term liquidity stress arising mainly in wake of advance taxation payments.[8] Notably, the rise in T-bills cut-off rates in the auction held on April 08, 2009, was not mirrored in the last Pakistan Investment Bond (PIB) auction held on April 15, 2009. As a matter of fact, in this auction banks' not only offered higher amount i.e. Rs 49.3 billion against a target of Rs 20 billion but the yield had also declined markedly, reflecting that the market continued to anticipate lower long term inflation (and therefore lower benchmark rates).

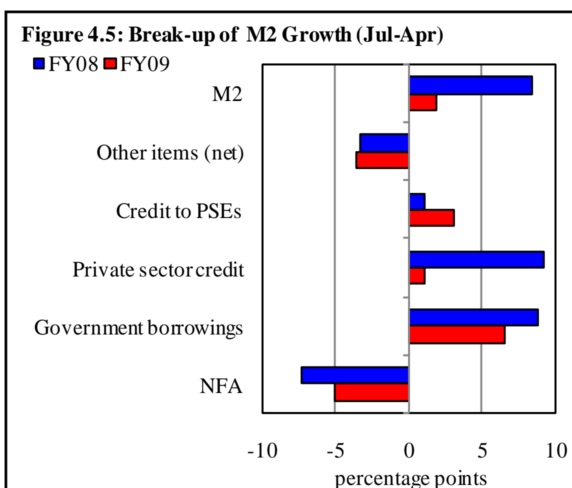
It is this balance of risks that held back a sharper adjustment in the policy rate in April 2009; the reduction was thus a pro-active measure taken ahead of the *projected* sharp decline in inflation, as the SBP strove to strike a balance between its twin objects of containing inflation, while supporting growth in the economy.

4.2 Developments in Monetary Aggregates

Growth in broad money (M2) decelerated sharply during Jul-Apr FY09 even as the depletion in net foreign assets (NFA) of the banking system was checked following the improvement in overall balance of payments account since November 2008. The YoY growth in M2 as on April 25, 2009 dropped to 8.4 percent from 15.3 percent a year earlier (see **Table 4.1**).

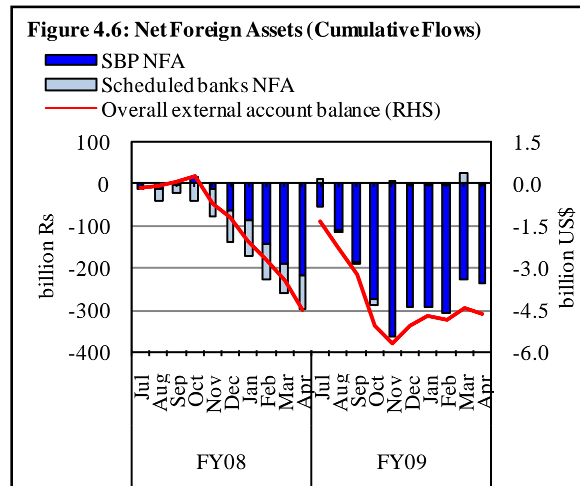
A look at the causative factors of M2 growth during Jul-Apr FY09 reveals that the sharp deceleration resulted from declines in the contribution to the stock of broad money by government borrowings and credit to private sector (see **Figure 4.5**). While the contraction in the stock of NFA lessened and credit to public sector enterprises (PSEs) expanded significantly, these were not large enough to arrest the deceleration in M2 growth.

Figure 4.5: Break-up of M2 Growth (Jul-Apr)



[8] SBP responded to ease the liquidity pressures by injecting Rs 276.8 billion in the month of April 2009.

Given reduced credit requirements by the government as well as the private sector, and the fact that the improvement in NFA owes partially to weaker import demand, the slowdown in the growth of M2 points to a possible weakening of domestic aggregate demand. This is also indicated by a deceleration in the growth of total domestic credit.



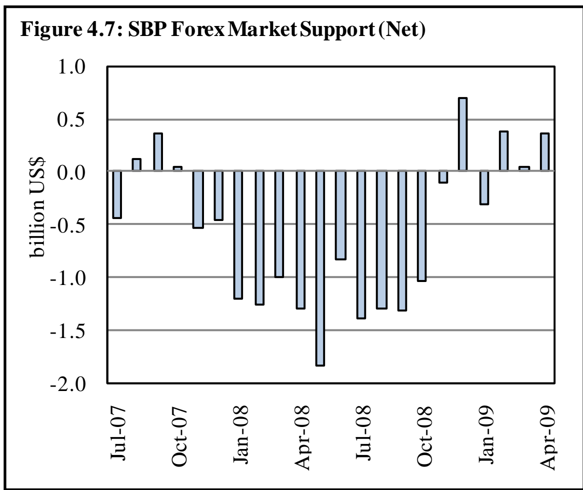
Net Foreign Assets (NFA)

Following the upturn in country's external account, contraction in NFA of the banking system has eased gradually since December 2008 (see **Figure 4.6**). Even so, the cumulative contraction in NFA of the banking system stood at Rs 236.9 billion as on April 25, 2009. The improvement in external account and hence the NFA of the banking system owed to: (1) decline in current account deficit as trade balance improved and workers' remittances remained strong; (2) external financial inflows strengthened from multilateral and bilateral sources; and (3) substantial retirement of foreign currency loans to commercial banks.

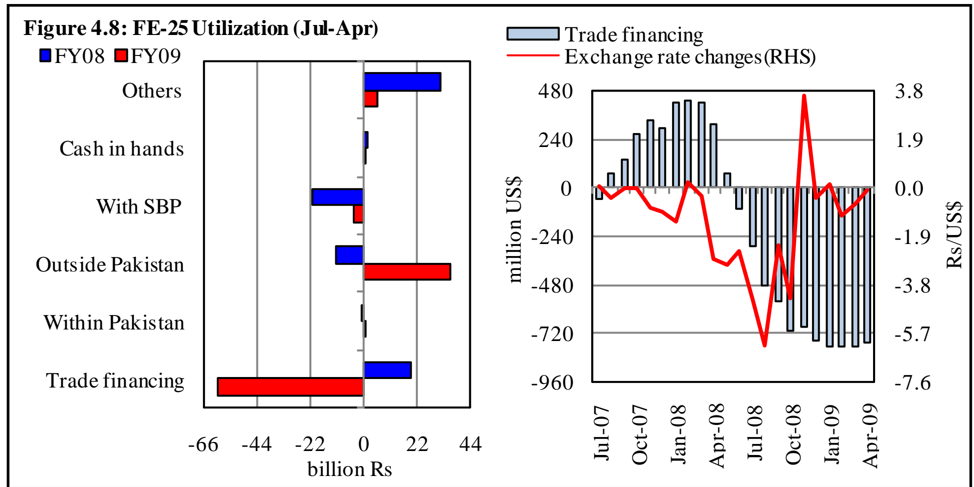
Within the banking system, the extraordinary strong contraction in SBP NFA seen in the intitial months of FY09 eased out as major trends in balance of payments reversed in the subsequent months. First, the SBA helped the government in acquiring external budgetary financing inflows from other mutilateral and bilateral sources. Specifically, the government received US$ 500 million each from the World Bank and the Government of China and another US$ 100 million in logisitc support during the third quarter of the current fiscal year. The resulting build-up of foreign exchange reserves and the decision to partially meet foreign exchange requirement for payments of oil import from the interbank market explain the current position of SBP intervention in foreign exchange market (see **Figure 4.7**). Second, improts witnessed a large contraction during Jul-Apr FY09 resulting in quantitative improvement in trade balance, despite a complete standstill in export growth.

NFA of the scheduled banks registered a net expansion of Rs 0.4 billion during Jul-25th Apr FY09 compared to a contraction of Rs 77.8 billion during the

corresponding period last year. This reversal is mainly explained by strong rise in workers' remittances and substaintial retirement of foreign currency loans by the business sector following large depreciation of rupee against major currencies (see **Figure 4.8**).



Net Domestic Assets (NDA)
NDA of the banking system registered a YoY growth of 16.9 percent during Jul-25th Apr FY09 compared to the YoY growth of 22.6 percent in the corresponding period of FY08. The sharp deceleration in NDA growth of the banking system was contributed by declines in government borrowings as well as credit to non-government sector during Jul-Apr FY09. As a result, the growth



in NDA of both the SBP and of the scheduled banks experienced significant slowdown.

While the decline in the growth of SBP NDA is a direct result of quantitative ceilings on budgetary borrowings from SBP under SBA, the deceleration in the growth of scheduled banks' NDA reflects the financial and economic risks faced by the country. With weak deposit growth and rising non-performing loans, banks

have gradually shied away from extending credit to the private sector. On its part, the credit demand from the private sector also shrank owing to (1) slowdown in economic activity exacerbated by power shortages, decline in external demand due to global recession, and (2) aggressive monetary tightening by SBP over the last 12 months. Thus, credit to private sector fell to merely Rs 48.6 billion during Jul-25th Apr FY09 compared to Rs 371.3 billion in the corresponding period last year.

However, the impact of decline in credit to private sector was partially offset by the increase in banks' investment in risk-free government securities and loans to the public sector enterprises.

4.2.1 Government Budgetary Borrowings

The increase in government's budgetary borrowing from the banking system fell off sharply towards the end of March 2009. On cumulative basis, government's budgetary borrowing from the banking system rose by Rs 259.9 billion during Jul-25th Apr FY09, which is significantly lower than Rs 333.2 billion rise in the corresponding period of FY08.

Figure 4.9: Cumulative Budgetary Borrowings during FY09

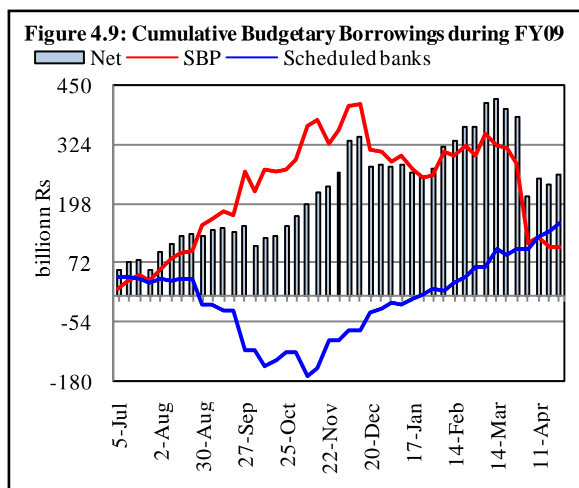
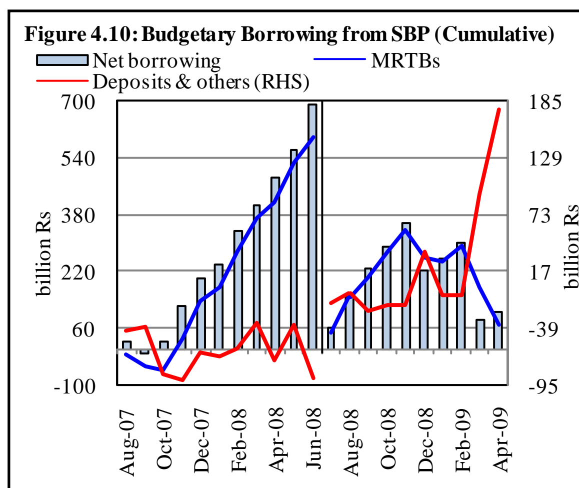


Figure 4.10: Budgetary Borrowing from SBP (Cumulative)



The commitment to contain the fiscal deficit to Rs 562.0 billion for FY09 under SBA and considerable external budgetary inflows in the third quarter of the current fiscal year have resulted in reduced reliance of the government on banking sector financing.

What is more important for the monetary policy is the welcome shift in the composition of government budgetary

borrowing from the banking sector. The government has retired some of its debt to the SBP and financed its additional borrowing needs from the scheduled banks. As a matter of fact, scheduled banks now finance major portion of government's budgetary requirements (see **Figure 4.9**).

Even though the government retired a portion of MRTBs held by SBP, the sharp decline in budgetary borrowing from SBP towards the end of March 2009 mainly reflects build up of government deposits at SBP (see **Figure 4.10**). Major reasons for this rise in government deposits at SBP include (1) receipts of US$ 500 million from World Bank, and (2) transfer of Rs 63.3 billion SBP profits to the government. It is interesting to note that the cumulative transfer of SBP profits to the government reached Rs 135.3 billion for the first nine months of FY09, against Rs 87.3 billion for the whole FY08.

Scheduled banks, on the other hand, showed renewed interest in extending budgetary financing to the government (see **Figure 4.11**). Consequently, the government was able to raise Rs 137.2 billion during Jul-Apr FY09 from the scheduled banks against net retirement of Rs 100.4 billion in the corresponding period of FY08.

Banks' greater interest in government paper was due to a number of factors, including (1) demand for bank credit from private sector declined due to domestic and external shocks to the economy; (2) increased risk averseness of the banks consequent to the rise in non-performing loans; and (3) banks' expectations that interest

Figure 4.11: T-bill Auctions (Net of Maturities)

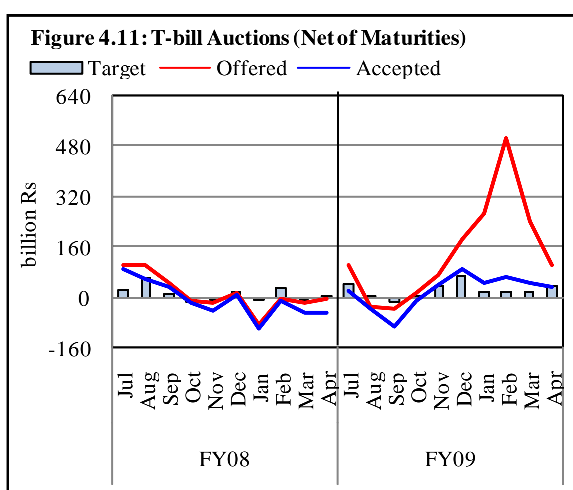
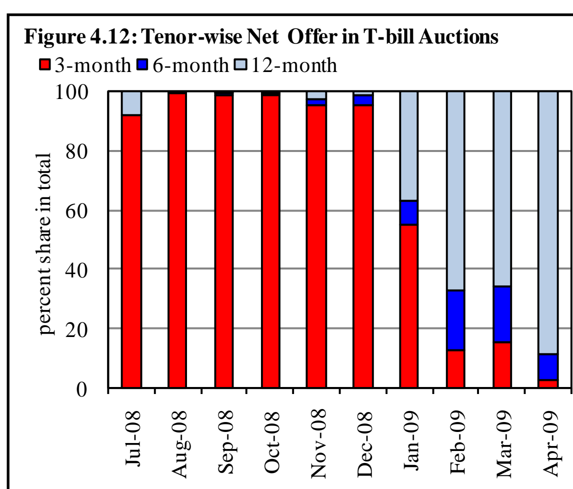
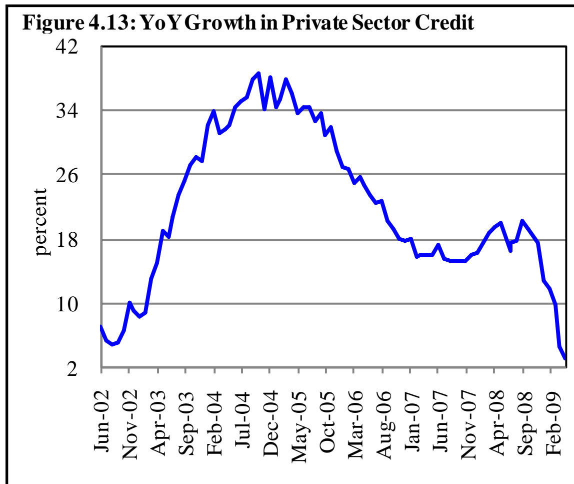


Figure 4.12: Tenor-wise Net Offer in T-bill Auctions

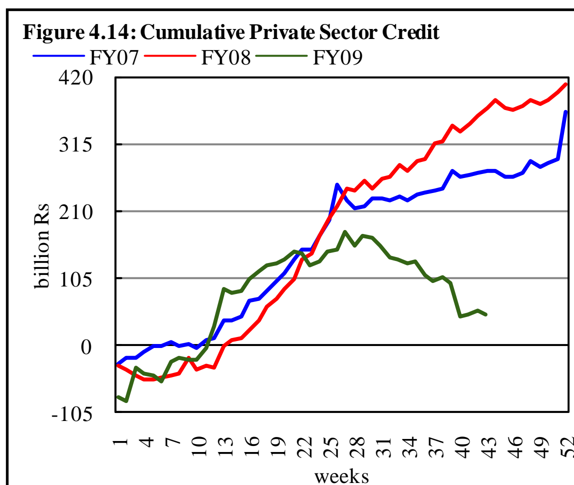


rates have peaked out, as reflected in shift to more offering in 12-month tenor in T-bills auctions (see **Figure 4.12**). The fact that banks started locking into longer tenor since January 2009 reflects that the market anticipated a cut in SBP policy rate and incorporated it into their bid decisions for T-bill auctions well before the announcement of Monetary Policy Statement by the SBP.



4.3 Private Sector Credit (net)[9]

The slowdown in private sector credit which started in October 2008, due to temporary liquidity crunch with banks, persisted in the following months of FY09 as well. Resultantly, the YoY growth in private sector credit reached to a six-year low of 3.0 percent by end April 2009 (see **Figure 4.13**). In absolute terms, the increase in private sector credit was only Rs 48.6 billion in Jul-Apr FY09 compared with remarkable surge of Rs 371.3 billion in the corresponding period of the previous year. The deceleration in credit growth was a little exaggerated as a few Independent Power Projects (IPPs) settled some of their loans obligations with banks (see **Figure 4.14**).[10] Nonetheless, even after adjusting for this one-off



[9] The reported credit numbers comprise banks' investments and advances to the private sector. This data is based on monetary survey. The sector-wise advances discussion covers the period of Jul-Mar FY09.

[10] Some of the corporates used banks' funding to smooth out their cash flows due to buildup of inter-corporate debt. To resolve part of circular debt issue, government has recently issued Term Finance Certificate (TFC) of worth Rs 80 billion. It may be noted here that banks' investment in this TFC

impact for bank finance, the credit off-take for Jul-Mar FY09 period remained significantly low at Rs 105.8 billion compared with Rs 332.0 billion in the same period of the previous year.

The slowdown in private sector credit was mainly explained by exceptionally low demand for working capital. This reflects a number of developments, such as (1) slowdown in domestic economic activities on account of acute power shortages, (2) a sharp fall in raw material prices in the international and domestic markets, (3) rising interest cost and (4) contraction in trade volume partly due to the global recession etc.

The demand for fixed investment loans in contrast remained quite resilient. The growth in long-term loans was because a few industries such as power, fertilizer and construction, utilized their credit lines committed with banks in the last two years. This reliance is likely to persist as the commencement of new private sector projects particularly in cement, fertilizer, power and sugar industries would continue to sustain the demand for long-term loans in the coming months.

Lending Behavior of Banks

During the initial months of FY09, not only the demand for private sector was strong, banks were also willing to extend credit to the private sector (see **Table 4.2**). Thereafter, a number of inter-related developments completely changed the credit environment for banks. For example, (1) with continued decline in deposit growth, rupee liquidity in the inter-bank market started drying up – this was also reflected in falling banks' excess reserve with SBP, (2) liquidity conditions worsened further following an abrupt and heavy withdrawal of deposits from the banking system and (3) concerns on quality of credit began to surface.

Table 4.2: Banks' Lending Business

billion Rupees

	Jul-Apr		FY09	
	FY08	FY09	Jul-Sep	Oct-Apr
Private sector	371.3	48.6	90.3	-41.7
PSE	41.7	142.1	63.5	78.6
Investment in GoP papers*	-30.7	268.5	-96.4	364.9

*PIBs & T-bills (net accepted)

will have an offsetting impact on short-term banks' advances extended to the private sector (particularly the power sector) and a few public sector enterprises.

While the liquidity concerns were addressed to an extent by the SBP's timely measures in November 2008, the apprehensions on credit quality continued with banks limiting their exposure on the private sector. Resultantly, banks' credit to the private sector dropped drastically September 2008 onwards.

The resulting availability of loanable funds with banks permitted the government to sharply increase its financing of the deficit through scheduled banks. Thus, banks' investment in government papers has expanded by Rs 375.5 billion since November 2008.[11] Besides this, a few banks have also invested in recently issued government TFCs of worth Rs 80 billion for settlement of a part of inter-corporate debt which had emerged in the previous year. This has an offsetting impact on short-term banks' advances extended to the private sector (particularly the power sector) and a few public sector enterprises.

Table 4.3: Bank-wise Advances Supply in FY09

billion Rupees

	Jul-Sep	Oct-Mar	Jul-Mar
Domestic private banks	80.9	-10.5	70.4
Large privatized	34.2	18.2	52.5
Other private	46.7	-28.7	17.9
Public banks	2.4	20.1	22.5
Foreign banks	5.9	1.8	7.8

Figure 4.15: Sectoral Break-up of Loans Extended from Domestic Private Banks

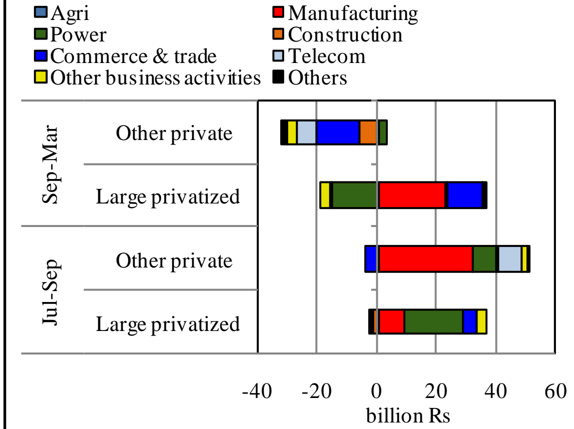


Table 4.4: NPLs to Loan Ratio in Textile Sector

percent

	Dec-08	Dec-09
Large privatized	10.9	12.7
Other private	6.0	11.3
Public	23.2	28.0
Foreign	2.2	5.5

The group-wise analysis of incremental advances by banks suggests that the slowdown in private sector credit since September 2008 remained broad based as most of the banks had limited their lending activity.[12] Although, the advances

[11] During Jul-Sep FY09, government retired Rs 99.6 billion to scheduled banks.
[12] Advances to the private sector explain more than 85 percent of total private sector credit.

from the public banks in the same period increased significantly, this was essentially due to one of *large public banks* in this group (see **Table 4.3**).

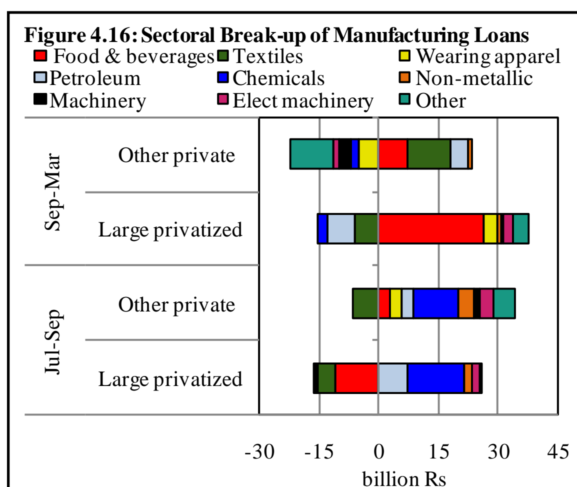


Figure 4.16: Sectoral Break-up of Manufacturing Loans

Within domestic private banks, the fall in advances of large privatized banks[13] in March 2009 is partly explained by retirement of loans by a few IPPs (see **Figure 4.15**). Excluding this impact, the lending activity of large privatized banks showed improvement in Sep-Mar FY09. Notably, this improvement was concentrated in two of *large privatized banks*, and was visible in manufacturing and commerce & trade sectors (see **Figure 4.15**). Within manufacturing sector food & beverages sub-sector was the major recipient of advances (see **Figure 4.16**).

Further, except for a few small banks, most of the banks seem to be unwilling to extend funds to the textile sector during Jul-Mar FY09.[14] Besides lower credit demand, deteriorating credit quality in this sector partly explains banks' reluctance to extend credit. The concern on textile sector's ability to repay loans was highlighted due to a sharp increase in NPLs to Loans ratio of this sector during the year 2008 (see **Table 4.4**).

Recognizing the credit quality concerns, most of the banks have acted cautiously, to prevent their balance sheets from further worsening, by implementing more stringent lending criteria. In this regard, banks are now gauging the debt servicing ability of corporates by focusing on their current income streams or liquidity position. Indeed, in recent past, banks used to assess collateral value more, which includes inventories and fixed assets, and less importance was given to the cash flows of corproates.

[13] This category includes four banks namely; MCB, ABL, HBL, UBL.
[14] Traditionally textile sector has the largest share in total private sector advances.

Trends in Sectoral Advances

Growth in the private sector advances during Jul-Mar FY09 was limited to only 1.0 percent compared with robust growth of 15.1 percent in the corresponding period last year. While growth in consumer finance has been decelerating since FY07, recent marked deceleration in business sector advances stifled the growth in private sector advances.

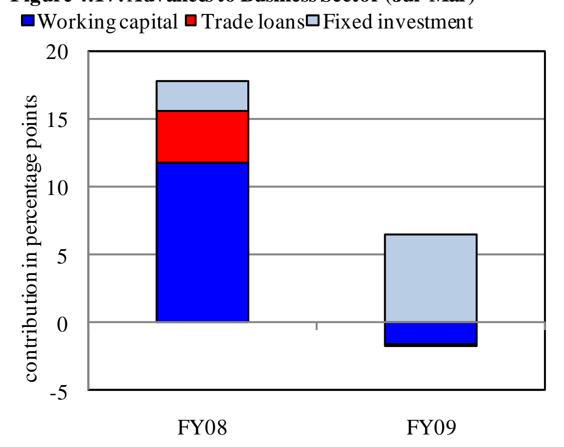
Table 4.5: Growth in Private Sector Advances (Jul-Mar)

	Change			
	percent		billion Rupees	
	FY08	**FY09**	**FY08**	**FY09**
1.Business sector	17.7	4.8	304.7	100.5
A. Agriculture & forestry	8.2	5.4	12.1	8.5
B. Manufacturing	19.2	7.3	193.1	88.4
a. Manufacture of food products	13.8	17.5	23.4	33.5
Rice processing	*68.7*	*34.6*	*19.8*	*13.7*
Sugar	*6.4*	*26.2*	*4.0*	*17.2*
b. Manufacture of textiles	21.5	0.3	94.2	1.4
Spinning of fibers	*20.3*	*0.5*	*71.8*	*2.0*
c. Manufacture of basic metals	13.8	-9.0	3.8	-3.3
d. Manufacture of domestic appliances	27.2	4.2	3.0	0.6
e. Manufacture of refined petroleum	152.0	28.9	15.6	5.5
f. Fertilizers and nitrogen compounds	25.0	45.3	7.1	22.2
g. Cement	2.8	10.1	2.3	8.1
C. Power	88.0	20.0	37.3	22.7
D. Construction	27.3	-8.6	15.0	-6.8
E. Transportation & telecommunication	5.0	2.6	4.0	2.4
Telecommunication	*0.6*	*3.7*	*0.4*	*2.6*
F. Commerce & trade	13.7	-3.0	28.5	-7.5
G. Other business activities*	11.7	-3.1	8.1	-2.7
2.Personal loans	5.3	-11.2	21.2	-47.1

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

The slowdown in business sector advances stemmed essentially from the fall in working and trade related loans (see **Figure 4.17**). Indeed, the extent of deceleration in total working capital loans was strong enough to offset the high growth in fixed investment loans. A disaggregated analysis reveals that the slowdown in the business sector advances was visible in various sectors including manufacturing, construction, telecom, commerce and trade sectors and other business services (see **Table 4.5**).

Figure 4.17: Advances to Business Sector (Jul-Mar)



The trade related loans exhibited a fall of 0.3 percent during Jul-Mar FY09 compared with strong growth of 24.7 percent in the corresponding period last year. The slowdown was contributed by both the import finance and export loans other than scheme (mainly

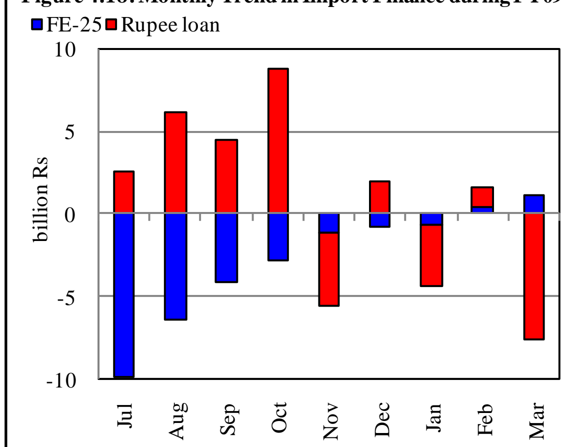
against FE-25). Only the contribution from Export Finance Scheme (EFS) in total trade loans remained robust (see **Table 4.6**). The drop in export loans other than EFS was partly due to sharp fall in rupee value against US dollar in the initial few months. Resultantly, most of the exporters had substituted their FE-25 outstanding stock with EFS. Furthermore, fall in country's exports has also exerted downward pressure on overall demand for export loans.

Table 4.6: Contribution in Growth of Trade Finance
percentage points

	Import finance	EFS	Other than scheme
FY08	19.0	3.7	2.0
FY09	-4.6	10.0	-5.6

On the other hand, the monthly trend in import finance suggests that the stability in rupee value against US dollar since December 2008 has somewhat eased the downward pressure on import finance against FE-25 loans.

Figure 4.18: Monthly Trend in Import Finance during FY09



However, the continued deceleration in country's import bills November 2008 onwards, partly due to fall in international oil prices and slowdown in economic activity explains the overall fall in demand for loans extended to the importers (see **Figure 4.18**).

Manufacturing Sector

Advances growth to the manufacturing sector decelerated drastically to 7.3 percent during Jul-Mar FY09 compared with robust growth of 19.2 percent in the same period last year (see **Table 4.5**). Monthly trend depicts that after recording strong growth in the initial few months of FY09, there was an unusual drop in advances demand November 2008 onwards, even during Jan-Mar FY09 a number of sectors had seen net retirement which is unlike to previous years.[15] A closer

[15] Although deceleration in credit growth during Jan-Mar period is a common factor in preceding few years-reflecting credit cycles; the decline in credit growth during Q3-FY09 was stronger.

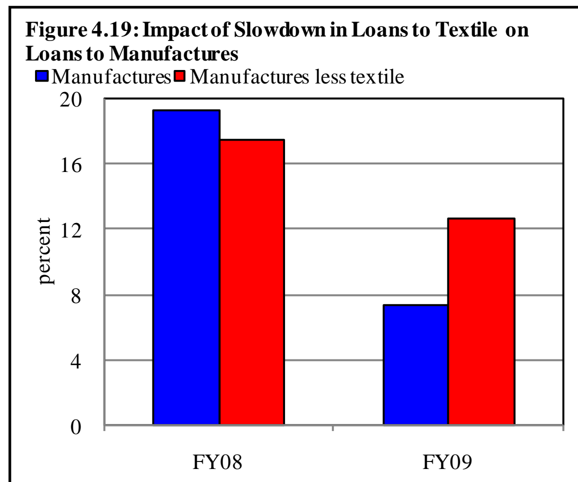
look at the manufacturing sector suggests that this deceleration mainly came from lower running finance requirements (see **Table 4.7**). In general, the growing severity of energy shortages and continued slump in economic activity has adversely affected the production activity in a number of industries which in turn lowered the demand for working capital loans. Furthermore, fall in prices of raw materials in a few sectors has also lowered the additional demand for running finance in Jul-Mar FY09.

Table 4.7: Growth in Manufacturing Sector Loans (Jul-Mar)
percent

	FY08	FY09
Trade finance	26.9	-0.3
Working capital	22.6	5.1
Fixed investment	9.3	17.2

The demand for fixed investment loans, however, remained strong in the same period. A part of the increase in fixed investment loans is probably a reflection of the earlier commitment in some industries.

Figure 4.19: Impact of Slowdown in Loans to Textile on Loans to Manufactures



Within manufacturing sector, the major deceleration in the period of analysis came from the textile sector (see **Figure 4.19**). Excluding this, the growth in manufacturing sector increased to 12.6 percent in Jul-Mar FY09, though still lower than the same period of the previous year. Besides textile, refinery, basic metal and domestic appliance also dragged down the demand for bank loans in the manufacturing sector.

The slowdown in *textile sub-sector* was visible in both working capital loans and fixed investment loans, only advances extended under EFS registered a significant growth.[16] However, the strong impact of EFS was more than diluted by a sharp drop in import finance and other than EFS loans to textile sector.

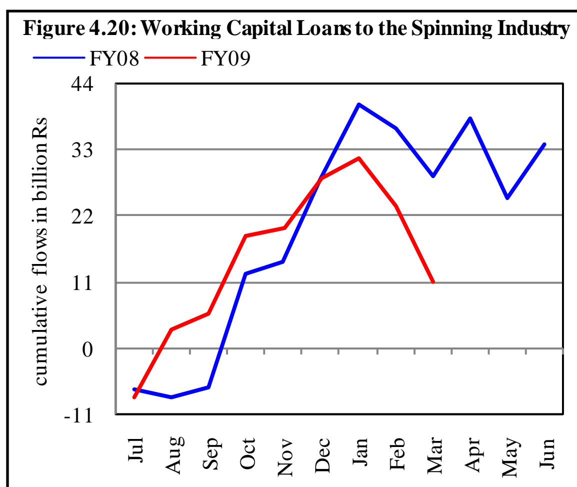
[16] During Jul-Mar FY09 EFS loans to textile sector recorded 21.0 percent growth compared with 3.0 percent rise in the corresponding period of the last year.

Table 4.8: Advances for Working Capital Loans
growth in percent

	Jan-Mar		Jul-Mar	
	FY08	FY09	FY08	FY09
Manufacturing	7.4	-7.5	22.6	5.1
a. Manufacture of food products	13.6	7.6	10.7	18.6
Rice processing	*0.2*	*-9.6*	*86.2*	*41.7*
Sugar	*54.3*	*60.1*	*4.6*	*32.1*
b. Manufacture of textiles	3.3	-11.5	27.4	1.0
Spinning of fibers	*0.6*	*-11.2*	*29.6*	*8.3*
c. Manufacture of basic metals	-16.5	-22.5	-18.4	-21.0
d. Manufacture of domestic appliances	-7.8	-6.4	27.1	-8.7
e. Manufacture of refined petroleum	18.2	-6.9	119.4	6.1
f. Fertilizers and nitrogen compounds	69.0	-22.9	10.2	28.9

Within *textile sector*, most of the slowdown in running finance requirements emanates from the *spinning sector* (see **Table 4.8**). Monthly trend reveals that the credit-off take in this sector was strong in the initial few months of FY09; partly a reflection of commodity financing for cotton availed by the private sector (see **Figure 4.20**).[17] However, in the following months of FY09, the loans to the spinning industry could not maintain the growth momentum and dropped drastically.[18]

Figure 4.20: Working Capital Loans to the Spinning Industry



Though a part of the fall in textile loans was anticipated, in view of continued global slowdown and the resulting

[17] It may be noted here that the private sector availed Rs 13.7 billion during Jul-Dec FY09 for procurement of cotton compared with net retirement of Rs 0.6 billion in the corresponding period last year.

[18] Decline in net advances in the second half of the fiscal year had been a traditional feature of credit cycle in past few years, however, FY08 was an exception probably on account of higher cotton prices.

drop in exports, the huge stock of inventories on account of delays in export order settlement further aggravated the situation. Furthermore, a few spinning industries have closed down their production operations in the recent months on account of acute power shortages, structural impediments in the industry and rising inability to service bank obligations. All these factors have led to lower the additional demand for running finance in this sector in the period of analysis.

Loans to the *refinery industry* registered a growth of 28.9 percent in Jul-Mar FY09 compared with triple digit growth during Jul-Mar FY08. Most of the deceleration was evident in running finance requirement mainly on account of lower crude oil imports due to financial constraints in some refineries.

Loans extended to the *basic metal industry* fell by 9.0 percent during Jul-Mar FY09 in contrast with a robust growth of 13.8 percent in the corresponding period last year. This was due to inventory accumulation and downward rigidity in steel import prices that lowered the country's import, thus decreasing the trade finance requirements of the sector.[19]

Finally, advances to the *machinery and equipment* dropped by 3.9 percent during Jul-Mar FY09 compared with a strong growth of 20.3 percent in the same period preceding year. This mainly stemmed from the domestic appliances industry. Indeed, persistent inflation in the economy has curbed the purchasing power of households which led to fall in demand for the domestic appliances. This impact was further compounded by the fact that the industrial activity in this sector has also declined partly due to lower demand, power shortages and pilling up of inventories. All these factors probably led to lower the running finance requirement from this sector.

This said, a few sectors mainly food & beverages, cement and fertilizer saw *high growth* in advances.

Loans to the *food & beverages* sub-sector registered a rise of 17.5 percent during Jul-Mar FY09 compared with 13.8 percent growth in Jul-Mar FY08. This was mainly visible in rice processing and sugar industries (see **Table 4.5**). The advances to former came from working capital loans in wake of bumper crop and significant increase in rice exports. The advances to sugar sector stemmed from running finance requirement for procurement of sugarcane.[20] Moreover, sugar

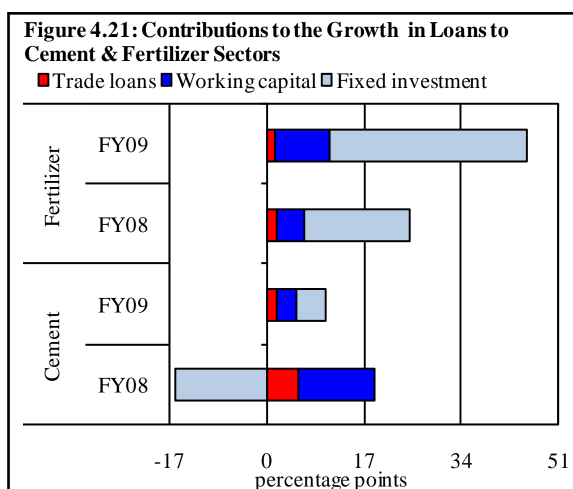
[19] Please see chapter on **Trade Account** for detail.

[20] In FY08 manufactures had delayed sugarcane crushing, primarily due to carry over stocks which led to subdued demand for working capital loans.

sector may seen higher demand for fixed investment loans in the months ahead as the government has recently allowed a few industrialists to setup new sugar mills.

Growth in advances extended to the *cement sub-sector* came mainly from the fixed investment loans due to a few ongoing capacity augmentation projects in this industry (see **Figure 4.21**).[21] Moreover, a few cement industries are also focusing on initiating power generation projects through waste heat recovery process.[22] This indicates that the demand for fixed investment loans in this sector is likely to continue in the upcoming months as well. In contrast, the demand for working capital loans decelerated sharply to 11.0 percent during Jul-Mar FY09 compared with strong growth of 78.0 percent in the corresponding period last year.

Figure 4.21: Contributions to the Growth in Loans to Cement & Fertilizer Sectors



Indeed, the cement industry has expanded its installed capacity significantly in the recent past in expectation of higher domestic demand in wake of government spending on construction of dams and other developmental projects. Unfortunately, the current domestic consumption of cement has reduced partly due to reduction in developmental expenditures and private construction activates. Moreover, though the global economic recession has also adversely affected the cement demand in UAE, the export demand is still strong in the Africa, India and Middle East. Resultantly, cement export though decelerated, exhibited a strong growth of 59.8 percent in Jul-Mar FY09. Furthermore, one of the major cement producers has issued right shares to repay part of their expensive bank loans. All these factors therefore aptly explain the lower demand for working capital loans in the cement industry during the period of analysis. This said, the monthly trend of local cement

[21] During FY08 a few corporates of cement sector issued TFCs to finance expansions and in some cases to retire their long term bank obligations.

[22] A few cement industries are focusing on recycling the steam generated during cement production to produce power for the industry.

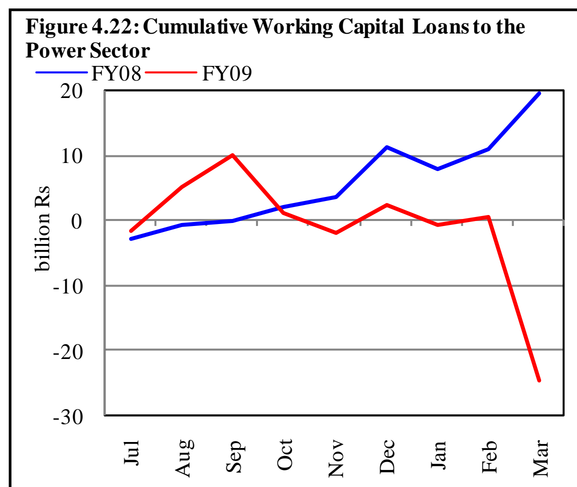
dispatches suggests some sign of recovery in the recent months which in turn may slightly increase the working capital demand, going forward.[23]

Fertilizer was another sub-sector where the high demand for bank advances during Jul-Mar FY09 was mainly driven by a few large capacity expansion projects (see **Figure 4.21**). The higher demand for working capital loans in the initial few months of FY09 was partly due to short-term bridge finance by a few companies in this sector to meet the financing gap arising due to delays in settlement of DAP subsidy claims from the government.[24] This exceptionally high borrowing, however, fell in the following months of FY09 as one of the major companies had retired its bank loan on account of settlement of subsidy claims.

Power

Growth in advances to the power sector remained robust at 20.0 percent during Jul-Mar FY09, although it decelerated sharply from a strong growth of 88.0 percent in the corresponding period last year (see **Table 4.5**). It must, however, be noted that FY08 strong growth, mainly under working capital loans, was partly attributed to high borrowing by some IPPs to fill the financing gap due to delays in settlement of circular debt claims. Though, the credit demand from those IPPs was still strong in Jul-Sep FY09, it however, decelerated in the following months of FY09. This was initially due to retirement of bank loans by some of the IPPs to avoid the rising financial cost. This was further compounded by a sharp fall seen in March 2009 in wake of partial settlement of circular debt claims (see **Figure 4.22**). Resultantly, the cumulative growth in working capital loans dropped sharply. In case of fixed investment loans, increase in advances was anticipated on account of expansions in power generating and distribution

Figure 4.22: Cumulative Working Capital Loans to the Power Sector



[23] Given the fact that a significant portion of raw material such as coal and fuel in the cement production is imported internationally, the recent fall in the price of coal and fuel in the international market would offset some of the impact of additional demand for working capital.

[24] For detail see Q2-FY09.

companies. Furthermore, the credit demand is likely to increase further in months ahead as a few banks are expecting more financial closures in this industry.

Construction

Loans extended to the construction sector fell drastically to 8.6 percent in Jul-Mar FY09 compared with exceptional growth of 27.3 percent during Jul-Mar FY08. This was caused by both lower financing requirements for building and infrastructure related construction activities (see **Figure 4.23**). This was partly due to fall in steel bar prices since October 2008 and slowdown in construction activities both in public and private sector. Indeed, the latter factor not only lowered the credit demand in this sector but has also impacted adversely the credit demand in other related industries such as cement and basic iron & steals industries in the period of analysis.

Figure 4.23: Loans to Construction Sector

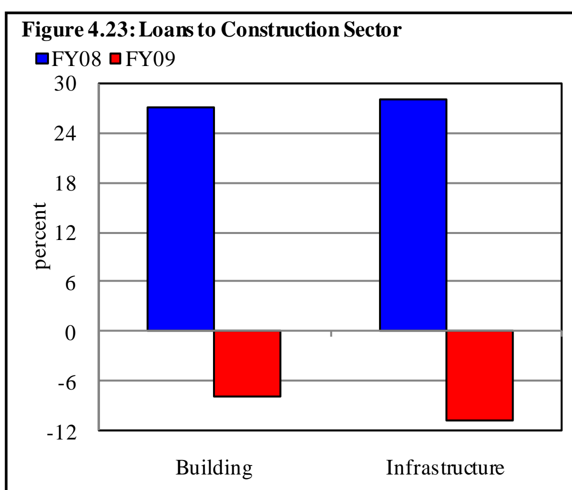
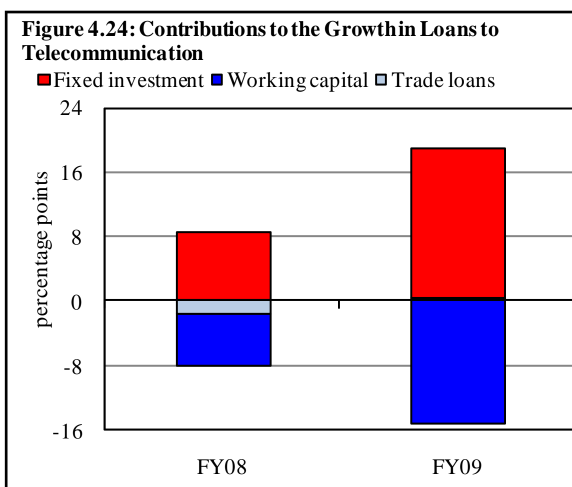


Figure 4.24: Contributions to the Growth in Loans to Telecommunication



Telecommunication

Growth in advances to the telecommunication sector witnessed strong growth of 3.7 percent during Jul-Mar FY09 compared with 0.6 percent rise in the corresponding period of previous year. While the growth in working capital loans dropped sharply, the higher demand for long-term finance largely explains the growth in this sector (see **Figure 4.24**). The former was probably a reflection of slowdown in business activity in this sector on account of lower consumer demand

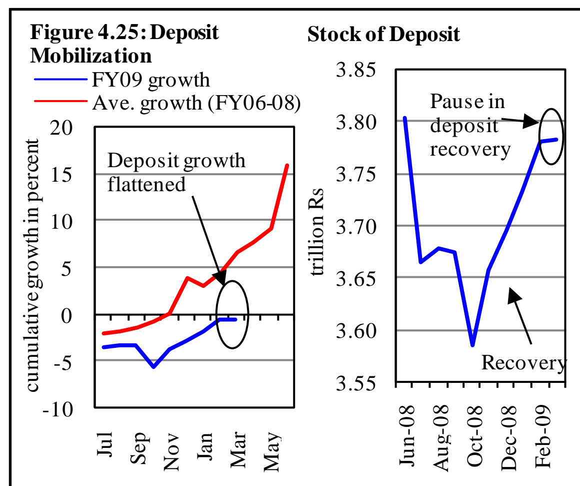
due to increased taxes and saturation of the urban markets.[25] The lower consumer demand is also visible from fall in imports of mobile sets in Jul-Mar FY09 compared with Jul-Mar FY08.[26]

The demand for fixed investment loans was mainly for expansions in some telecom companies to increase the coverage of network in remote areas and also to provide the wireless internet facility.

Given the fact, that the cellular mobile subscribers has already crossed 88 million mark indicating that the market is on saturated stage, the demand for fixed investment loans from this sector probably may not increase significantly in the upcoming months.[27] Nevertheless, mobile banking[28] can be an attractive unexplored area for the telecom industry. In this regards, one of the major telecom industry has already taken step to initiate such projects.

Advances growth in *commerce and trade* exhibited a fall of 3.0 percent during Jul-Mar FY09 compared with strong growth of 13.7 percent in Jul-Mar FY08. The main contribution came from lower running finance requirements primarily in the wake of deceleration in trade volume. Lastly, though freeze on the stock market activity has been removed in December 2008, advances demand from the stock broker/agents did not pick up. This probably indicates banks' reluctance to take additional exposure in

Figure 4.25: Deposit Mobilization



[25] In the current budget of FY09, the rate of GST on telecom sector rose from 15 percent to 16 percent along with the imposition of custom duty of Rs 500 per mobile set. Source PTA.
[26] During Jul-Mar FY09 mobile phone imports witnessed a significant fall of 76 percent compared with a dropped of 12 percent in Jul-Mar FY08.
[27] For detail see PTA annual report 2007-08.
[28] Mobile banking is a phenomenon used for performing balance checks, account transactions and payments etc.via a mobile device such as a mobile phone. The first phase of mobile banking brings with it services of bank account maintenance which will leads to the second phase of facilities such as paper/plastic-free money transactions, money transfer, mobile sales, auctions, and brokerage etc.

stock market activity. Thus, the advances growth under this head fell by 3.1 percent during Jul-Mar FY09 compared with impressive growth of 11.7 percent in the same period last year.

Table 4.9: Factors Impeding Deposit Growth
percent

	Jul-Mar	
	FY08	**FY09**
Reserve money	10.4	-2.1
Private sector credit	13.9	3.4
Receipts under national saving schemes	7.1	17.2

4.4 Deposit Mobilization[29]

The overall deposit growth of the banking system continued to remain low (see **Figure 4.25**). This was despite a considerable ease in external current account pressures which was a significant source of erosion in deposit-base.[30]

Table 4.10: Deposit Growth by Banks' Category (Jul-Mar)

	Change in FY08		Change in FY09	
	Abs Δ billion Rupees	**Cont. to growth in %**	**Abs Δ billion Rupees**	**Cont. to growth in %**
Public banks	22.0	0.66	-6.6	-0.17
Privatized banks	68.1	2.04	-43.3	-1.14
Merged banks[1]	31.8	0.95	-1.7	-0.05
Private banks	9.7	0.29	-3.2	-0.08
Foreign banks	16.9	0.51	12.3	0.32
Islamic banks	30.7	0.92	23.8	0.63
All banks	**179.1**	**5.36**	**-21.5**	**-0.57**

[1]Includes banks which have merged during the previous 5 years
Note: Specialized banks are included in all banks

Although banks have well withstood the severe withdrawal pressures of October 2008, there are other developments which have acted to hold back deposit growth. These include (1) the slowdown in economic activities as evident from deceleration in private sector credit growth; (2) lower liquidity injections from SBP into banks following lower budgetary borrowings from the central bank; (3) increased competition from National Saving Scheme (NSS) – see **Table 4.9**; and (4) decline in weighted average return on deposits. Thus, on cumulative basis, deposits of the banking system recorded contraction of 0.6 percent in Jul-Mar FY09.

The slowdown in deposit growth during March 2009 should, however, be interpreted carefully, as it was the net withdrawal in government deposits with banks and in foreign currency deposits largely on account of import payments by a few corporates that offset the effect of a rise in personal and business deposits during the month.

[29] The discussion on deposits is based on total deposits of the banking system including government deposits.
[30] The foreign exchange remittance inflows, which are an important contributor to deposit growth, have shown a rise of 19.7 percent during Jul-Mar FY09.

The deceleration in deposit growth affected almost all banks. The YoY growth in deposits of top five banks[31] (in terms of deposit base) has declined from 16.4 percent in June 2008 to 8.2 percent in March 2009.

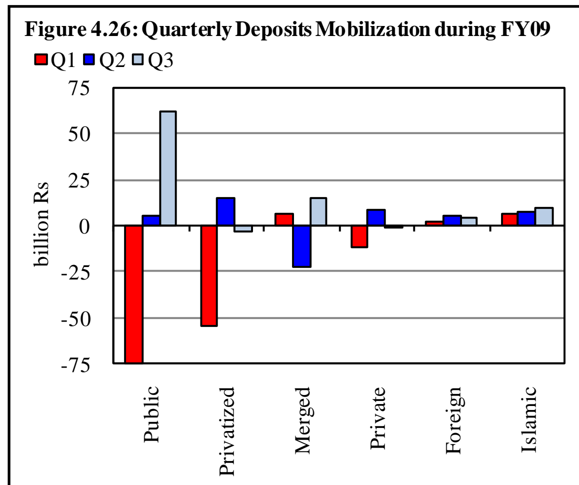


Figure 4.26: Quarterly Deposits Mobilization during FY09

A group-wise analysis shows that deposits in both public and private sector banks are yet to regain their end-June 2008 level. The privatized banks in particular are experiencing relatively large erosion in their deposit base (see **Table 4.10**). The public sector banks experienced a notable recovery during the third quarter of FY09 (see **Figure 4.26**).

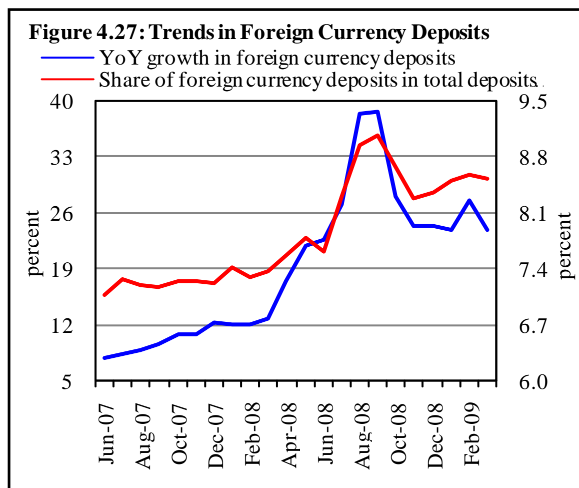


Figure 4.27: Trends in Foreign Currency Deposits

Islamic banks and foreign banks are showing rather decent performance as there is a net increase in their deposit-base over June 2008; but the deposit growth is still lower compared to the previous year.

In terms of currency composition, the post-October 2008 gradual rise in the share of foreign currency deposits seem to have peaked out as YoY growth of foreign currency deposits decelerated in March 2009 (see **Figure 4.27**). The net withdrawal of US$ 86 million in foreign currency deposits of the banking system during March 2009 was in US dollar and Euro denominated deposits.

[31] These banks contribute 51.8 percent of the total deposits of the banking system.

The slowdown in overall deposit growth is associated with a decline in average return on deposits. In particular, the maximum weighted average return on deposits has fallen from a near peak of 9.5 percent in October 2008 to 8.0 percent in March 2009. This was probably due to (1) perverse impact of SBP liquidity support and (2) market expectations that interest rate have peaked out. In former case, the massive liquidity support by SBP, to ensure stability of domestic banking system, during October 2008 and onwards probably eased the compulsion on banks to increase their deposit base. At the same time, growth in private sector credit decelerated. Thus, it was not surprising that the share of high yielding deposits in the total deposits has also started to decline in recent months (see **Figure 4.28**).

Figure 4.28: Return on Deposits

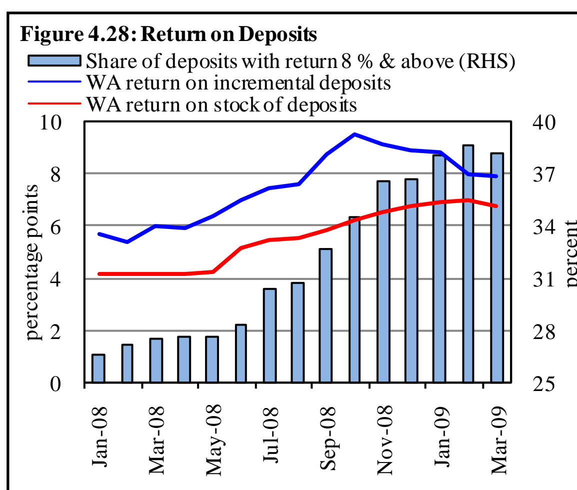
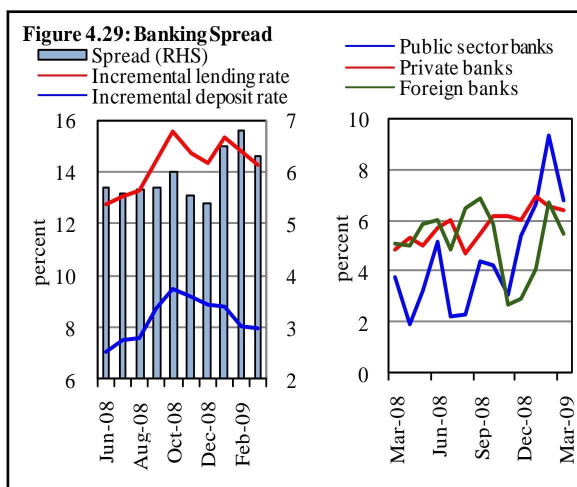


Figure 4.29: Banking Spread



Despite recent softening of the deposit rates, the banking spread showed marginal contraction in March 2009 because of relatively large decline in lending rates (see **Figure 4.29**). Nonetheless, compared to June 2008, the banking spread shows an increase of 60 bps. This increase was mainly contributed by public sector and foreign banks.