4 Money and Banking

4.1 Monetary Policy

Substantial improvements in many key macroeconomic indicators, including a very sharp drop in headline inflation (see **Table 4.1**), allowed SBP to continue gradually easing its monetary policy during FY10. A policy rate cut of 100 basis points in August 2009 was followed by another 50 basis point reduction in November 2009, representing a cumulative fall of 250 basis points in the policy discount rate since the current monetary easing cycle was initiated in April 2009.[1]

Table 4.1: Key Macroeconomic Indicators

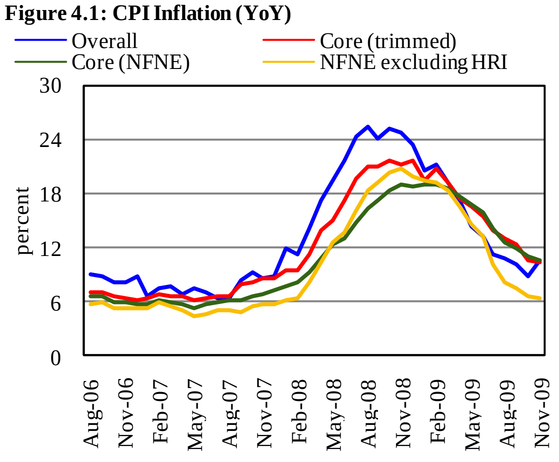
YoY growth (percent)

	Jul-Nov	
	FY09	**FY10**
Current a/c deficit	56.1	81.4
Imports	*25.6*	*-21.2*
LSM[2]	-5.0	0.7
Private sector credit[1]	4.4	0.9
Money supply (M2)[1]	0.6	4.2
CPI inflation (YoY)	24.7	10.5
Tax receipts[3]	27.7	0.6

[1]Jul-5th Dec; [2] Jul-Oct; [3] Jul-Sep

The scale and speed of the decline in headline inflation, from 24.7 percent in November 2008 to 10.5 percent in November 2009,[2] suggests that the tight monetary policy and constrained monetization of the fiscal deficit have significantly eased excess demand pressures that had bedeviled the economy in the past three years. The disinflationary impact of this was probably also aided by

Figure 4.1: CPI Inflation (YoY)



[1] SBP had decreased its policy rate by 100 bps in April 2009.
[2] At the same time, demand pull inflationary pressures as captured in core inflation both non-food non-energy (NFNE) and 20 percent trimmed mean, though decelerating, remained in double digits and higher than that of overall inflation (see **Figure 4.1**). This was essentially due to House Rent Index (HRI), which being computed as a 24 month geometric mean, changes very gradually.

the lower impact of imported inflation (due to a relatively stable rupee in FY10 and relatively low international commodity prices) and improved domestic production of key staples.

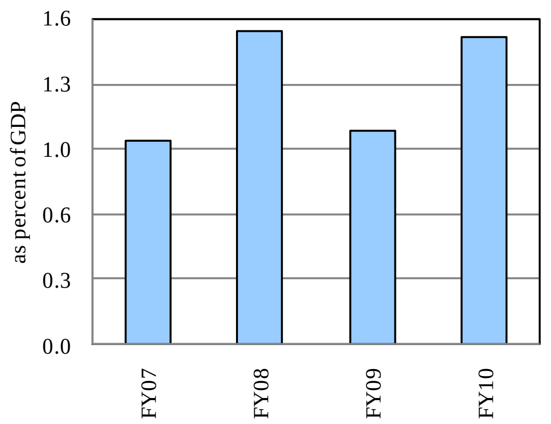
The moderation in demand pressures is evident from the persistent YoY fall in imports (particularly the negative growth in import volumes during Jul-Nov FY10) that led to a sharp contraction in the current account deficit, and also in the lower growth of private sector credit in the same period. The weaker credit demand, tight liquidity conditions[3] and risk averseness of banks further kept monetary expansion in check during the period under review (see **Table 4.2**).[4]

The 14.2 percentage point decline in inflation over the last 12 months and evidence of a contemporary weakness in the domestic economy, as suggested by indicators such as low growth in monetary aggregates, stagnancy in tax receipts, weakness of large scale manufacturing, declining exports, etc., have all led to calls for a much more accommodative monetary posture.

However, from the SBP perspective, room for aggressive monetary easing is constrained by number of factors:

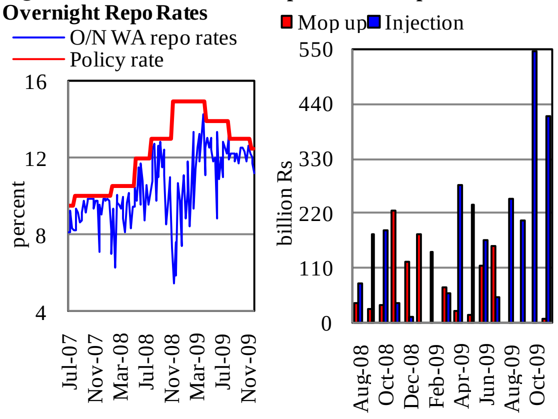
Fiscal and quasi-fiscal activities are adding to upward pressures on rates
The fiscal deficit rose to 1.5 percent of GDP during Q1-FY10 compared with 1.1 percent of GDP in Q1-FY09, representing a 62.4 percent increase in rupee terms (see **Figure 4.2**). While this did not lead to a sharp rise in budgetary borrowings from SBP, in line with the quarterly target agreed with the IMF, the higher deficit did have some negative connotations:

Figure 4.2: Fiscal Deficit



[3] As banks' fund are locked due to credit extended for both circular debt and commodity procurement.
[4] For detail, see section on **Private Sector Credit**.

Figure 4.3: Trends in Overnight Repo Rates **Open Market Operations**



1. A part of the deficit was financed through an IMF bridge finance loan, the inflationary impact of which is similar to that of deficit monetization.
2. The large jump in the rupee value of the deficit, and lower recourse to SBP finance meant that government borrowings from commercial banks increased substantially. Net budgetary borrowing from scheduled banks, was Rs 166.0 billion during Jul-5th Dec FY10 compared with a net retirement of Rs 67.0 billion in the corresponding period last year. This was despite better availability (i.e., Rs 107.6 billion in Jul-Sep FY10) from non-bank sources.
3. The high government sector demand, and low deposit growth is now constraining banks' ability and willingness to take additional exposure in the private sector, and risking the crowding out of private investment.

The problems emanating from expansionary fiscal policy are compounded by a significant increase in quasi-fiscal activities such as financing of the energy sector circular debt and borrowings by various procurement agencies and provincial food departments for commodity operations.[5] For instance, delays in realization of subsidies from federal government made it difficult for procurement agencies and food departments to retire bank loans in time.[6] This has not only caused pressure on banks' liquidity but also lowered banks' willingness to lend for procurement of fresh crops.

In response to these liquidity shortages, SBP provided extensive liquidity support through OMOs during Jul-Nov FY10 (see **Figure 4.3**). The timely support of SBP to improve market liquidity and continued expectation of lowering inflation kept the overnight repo rate within the interest rate corridor.

[5] Procurement agencies and provincial food departments obtained bank finance to procure different commodities such as wheat, rice, fertilizer, etc., to stabilize the market price and to build-up strategic reserves to ensure smooth domestic supply.
[6] This impact was further compounded by buildup of receivables from different government organizations.

Possible slippages in fiscal account can add demand pressures

Moreover, there are concerns that fiscal account will show some weakness in FY10. For example, the on-going anti-terrorist operations could significantly add to budgetary expenditures through the year. Similarly, there are risks of shortfalls in revenues (due to the weaker economy). The increase in the fiscal deficit would potentially be exacerbated by lower than planned external financing flows. This would add to pressures on the domestic banks, and raise inflationary pressures.

Imported inflation could re-emerge

Another allied risk for aggressive monetary easing is the possible increase in external current account deficit. It may be kept in mind that imports have already started to indicate some upward pressures since October 2009 partly reflecting recent resurgence in international commodity prices. Even small domestic recovery may further add pressures on the import bill in coming months. Given the concerns on resumption of external inflows, financing of current account deficit would remain challenging. The concerns on uncertain external flows can be viewed from the fact that even in Q1-FY10, official inflows other than IMF short-term bridge financing was much lower than anticipated. Moreover, the pass-through of high global prices is also expected to translate into greater exchange rate volatility which will likely add further pressure on the external account.

Table 4.2: Monetary Aggregates (Jul-5th Dec)

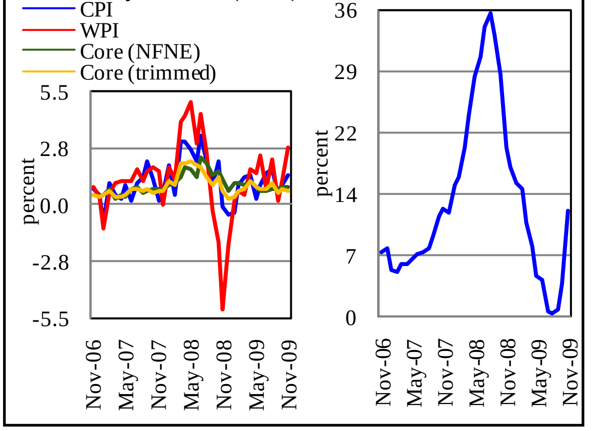
flows in billion rupees, growth in percent

	Flows		Growth rates	
	FY09	**FY10**	**FY09**	**FY10**
Broad money (M2)	**29.7**	**215.8**	**0.6**	**4.2**
NFA	**-357.9**	**58.0**	**-53.6**	**11.2**
SBP	-357.8	65.9	-74.5	20.3
Scheduled banks	-0.1	-7.9	-0.04	-4.1
NDA	**387.6**	**157.8**	**9.6**	**3.4**
SBP	315.7	114.3	40.8	13.0
Scheduled banks	71.9	43.5	2.2	1.2
of which				
Government borrowing	350.4	250.4	23.1	12.3
For budgetary support	338.2	254.9	24.8	15.2
SBP	405.2	88.9	39.2	7.6
Scheduled banks	-67.0	166.0	-20.2	32.2
Commodity operations	13.7	-2.8	10.1	-0.8
Non-government sector	182.8	101.4	6.1	3.2
Credit to private sector	127.3	27.1	4.4	0.9
Credit to PSEs	55.6	75.1	48.9	28.2
Other items net	-145.7	-194.1	28.7	32.1

Inflationary pressures may already be building up

The persistent rise in month-over-month (MoM) inflation in all price indices since February 2009 suggests that inflationary pressures are rebounding (see **Figure 4.4**). In specific terms, on MoM basis all inflation indices witnessed positive growth in the last consecutive ten months. Making things worse, recent uptrend in imported inflation – international crude oil prices in particular– have started to show up in WPI index.[7] Specifically, WPI inflation after witnessing downtrend since September 2008 has again gained some momentum from September 2009; even recording YoY sharp rise of 12.5 percent in the month of November 2009 compared with an average rise of 1.3 percent in the first four months of FY10.

Figure 4.4: Resurgence of Inflationary Pressures (MoM)



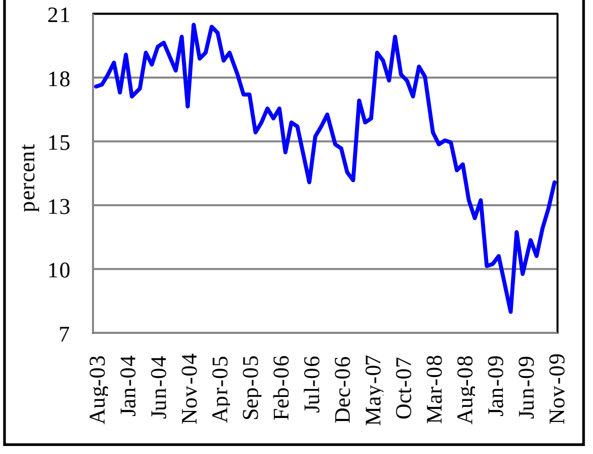
Though the contribution of global commodity prices in WPI is still low, however, it may gain more strength in months ahead, if international prices continue to show resilience.[8] Moreover, planned adjustments in electricity tariff rate are likely to add upward pressures on WPI and thus overall inflation.

4.2 Developments in Monetary Aggregates

The YoY growth in broad money (M2) after witnessing the lowest level of 8.0 percent in April 2009 during the last eight years, reached 13.4 percent by December 5, 2009 (see **Figure 4.5**).

This rise resulted entirely from YoY increase in net foreign assets (NFA) of the banking system as growth in net domestic assets (NDA) of the banking system slowed markedly to 8.4 percent YoY basis by December 5, 2009.

Figure 4.5: YoY Growth in M2



[7] Apart from commodity prices, the uptrend in WPI was also contributed by sugarcane and cotton prices in domestic market. For details, see **Chapter 3** on **Prices**.
[8] It may be noted here that a few commodities in WPI such as crude oil, motor spirit, etc., are directly influenced by movement in international prices.

It is worth mentioning here that in August 2009, IMF has increased the SDR quota allocation for all of its member countries.[9] Though the amount disbursed under SDRs does not have any impact on M2, and reserve money; it has changed the composition of M2 growth. More specifically, NFA of the SBP increased by Rs 99 billion whereas the other items net (OIN) of the SBP fell by the same amount thus resulting in weakening of NDA of the SBP (see **Table 4.3**).

Table 4.3: Impact of SDRs Allocation
billion Rupees

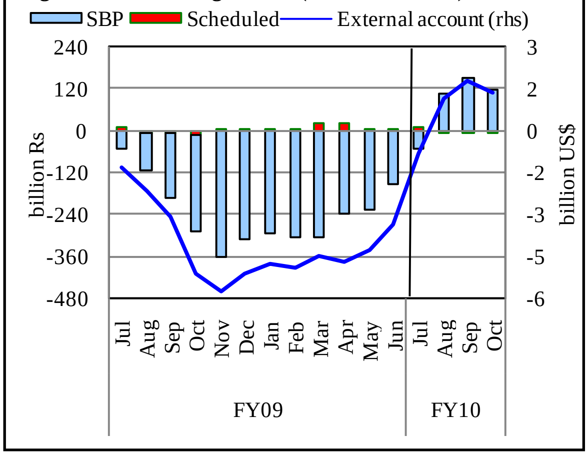
	Jul-5th Dec	
	FY09	**FY10**
NFA	-357.9	58.0
Adjusted for SDRs	-357.9	-41.0
SBP NFA	-357.8	65.9
Adjusted for SDRs	-357.8	-33.1
NDA	387.6	157.8
Adjusted for SDRs	387.6	256.8
SBP NDA	315.7	114.3
Adjusted for SDRs	315.7	213.3

Net Foreign Assets (NFA)[10]

The NFA of the banking system registered a lower contraction of Rs 41.0 billion during Jul-5th Dec FY10 compared with an extraordinary decline of Rs 357.9 billion in the corresponding period last year (see **Table 4.3**).

The sharp unexpected rise in portfolio investments, persistent increase in workers' remittances and substantial inflows from multilateral agencies were major factors responsible for a low contraction in NFA. Persistent contraction in trade deficit also lowered the payment pressures on NFA of the banking system during the period of analysis (see **Figure 4.6**).

Figure 4.6: Net Foreign Assets (cumulative flows)

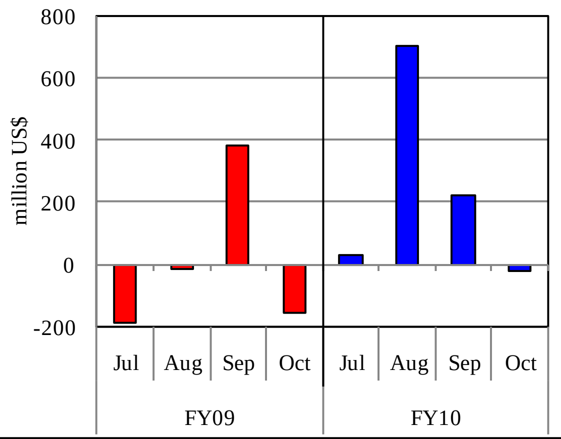


Similar to FY09, the contraction in NFA of the banking system during Jul-5th Dec FY10 was mainly contributed by SBP's NFA; though the pace of contraction in

[9] On August 29, 2009 IMF increased SDR quota allocation for its member countries in primary response to global financial crises. The main purpose of this increased allocation is to provide significant unconditional financial resources to liquidity constrained countries.
[10] The discussion here onwards is based on NFA and NDA adjusted for SDRs.

NFA of SBP declined sharply in the period of analysis. More specifically, the availability of external resources for budgetary finance; particularly short-term bridge finance from IMF lower the pace of contraction in NFA of the SBP (see **Figure 4.7**). Had this inflow not materialized, SBP NFA would have witnessed an even higher decline.[11]

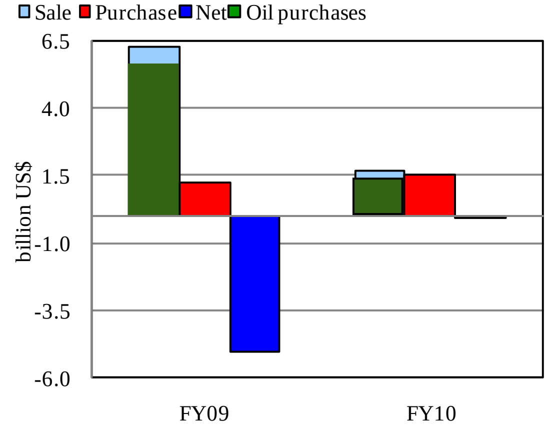
Figure 4.7: Net Foreign Exchange Official Inflows



The pressure on SBP NFA was further eased by gradual shifting of oil imports financing towards interbank market.[12] Resultantly, SBP's net intervention in the inter-bank foreign exchange market remained significantly lower in Jul-Oct FY10 compared with the same period last year (see **Figure 4.8**).

Net contraction in commercial banks' NFA was limited to Rs 7.9 billion during Jul-5th Dec FY10 as against Rs 0.1 billion in the corresponding period FY09 (see **Table 4.2**). The higher contraction is partly explained by oil import payments. However, uptrend in deposit base, in the wake of net private inflows, of the scheduled banks partly offset the oil payment pressures

Figure 4.8: SBP Forex Intervention (Jul-Oct)

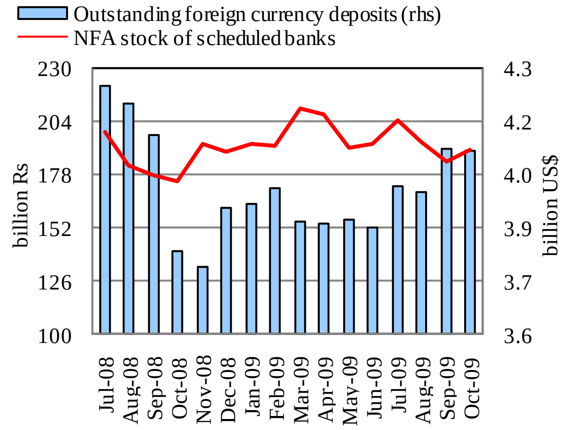


[11] Excluding IMF loan, SBP NFA recorded a decline of Rs 42.1 billion during Jul-5th Dec FY10.
[12] SBP has gradually shifted the burden of foreign exchange purchases for import of POL products on scheduled banks. In the first step, from February 2009 SBP directed scheduled banks to finance the import of furnace oil, whereas import of diesel and other refined products were still financed by SBP. Further, from August 2009, purchase of diesel and other POL products were also shifted to scheduled banks, and thus SBP financed only crude oil purchases. Finally, by mid-December 2009, all purchases of oil products are shifted to the inter-bank market.

(see **Figure 4.9**).

Net Domestic Assets
The contraction in domestic demand kept the growth in NDA of the banking system to 5.6 percent during Jul-5th Dec FY10 compared with a strong growth of 9.6 percent in the same period of the previous year. More specifically, it was the weakened demand for private sector credit, low budgetary borrowing and sluggish credit off-take under commodity finance that had limited the net expansion in NDA during the period under analysis.

Figure 4.9: Scheduled Banks' NFA



Government Borrowing for Budgetary Support
Government budgetary borrowing from the banking system during Jul-5th Dec FY10 remained lower compared to the corresponding period of FY09. This was despite a rise in total budgetary finance in Q1-FY10 as deficit increased to Rs 223.7 billion compared with Rs 137.7 billion in the same quarter last year. A disaggregated analysis suggests that a substantial increase in receipts of external budgetary flows as well as rise in non-bank finance especially from NSS made it possible to arrest the borrowings from the banking system (see **Table 4.4**).[13]

Table 4.4: Deficit Financing (Jul-Sep)
billion Rupees

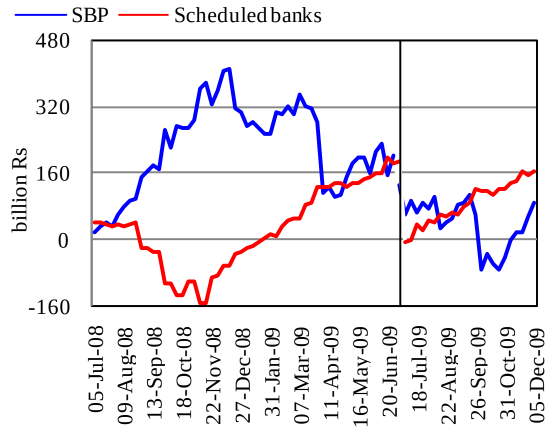
	FY09	FY10
Deficit	137.7	223.7
External	6.2	77.1
Domestic	131.7	146.6
Non-bank	27.1	107.6
Bank	104.6	39.0

While the exceptional financing burden in Jul-6th Dec FY09 entirely fell on the central bank, the expansion in budgetary borrowing from the banking system during Jul-5th Dec FY10 mainly stemmed from commercial banks as borrowings from the central bank remained low (see **Figure 4.10**). It may be recalled that

[13] Within non-bank borrowing, government mobilized Rs 53.0 billion through NSS in Q1-FY10 compared to Rs 20.9 billion in the same period last year.

during the first four months of FY09, deficit monetization was substantially higher. Indeed, it was only after the implementation of macroeconomic stabilization program in November 2008 that contained the government borrowings from the central bank.

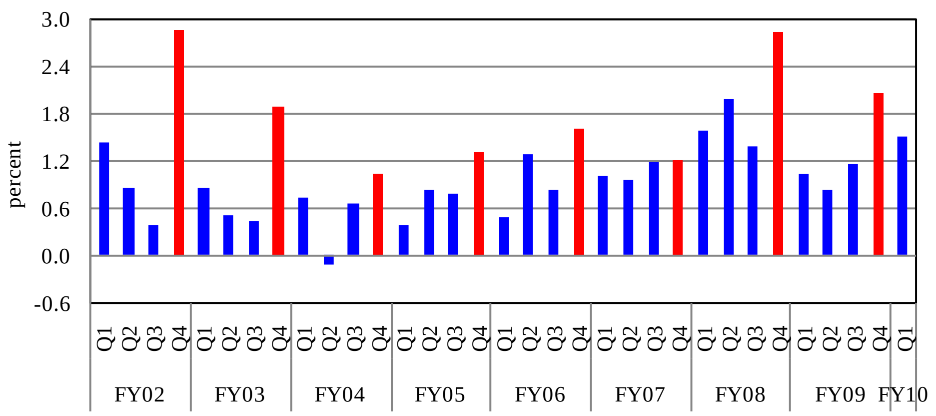
Figrue 4.10: Composition of Budgetary Borrowings



A detailed data suggests that by end-September 2009, government retired its debt with SBP by: a) using the proceeds from the transfer of SBP profits to government accounts, and b) borrowings from commercial banks by issuing Rs 40.5 billion worth of T-bills in the same month. Resultantly, stock of MRTBs with SBP declined to Rs 1010.8 billion by end-September 2009 compared to Rs 1256.9 billion at end-September 2008. On the other hand, borrowing from the commercial banks remained intact as: a) banks are still reluctant to lend aggressively to the private sector, and b) credit demand from private sector also remained sluggish.

Nonetheless, the monetary implication of current fiscal trend appears worrisome. The fiscal deficit for Q1-FY10 reached 1.5 percent of GDP, which is high relative to the full year target of 4.9 percent of GDP. To put this in perspective, the normal pattern in quarterly fiscal deficit shows that it would jump sharply in the final quarter of the year (see **Figure 4.11**). This suggests the risk of high recourses from the banking system in months ahead in case of delays in materialization of committed external flows, particularly given the uncertainty attached with funds mobilized through NSS.

Figure 4.11: Fiscal Deficit to GDP (Quarterly Trend)



Further, public sector enterprises (PSEs) borrowings from the commercial banks continued unabated in FY10, rising Rs 75.1 billion during Jul-5th Dec FY10, compared with Rs 55.6 billion in the corresponding period last year. Similar to last year, credit requirements from a few PSEs mainly came on account of delays in settlement of energy claims with the government. This impact was further compounded by credit demand from the newly established power holding company in September 2009. The power holding company issued a government backed privately placed term finance certificates (PPTFCs),[14] which was meant to reduce significant part of banks' claim on a few PSEs and private entities.[15,16] Though with the issuance of PPTFCs, a few PSEs had settled some of their loan obligations with the banks, however, it was observed that they had again acquired more advances from banks as they got cushion for fresh borrowing.

Commodity Finance[17]

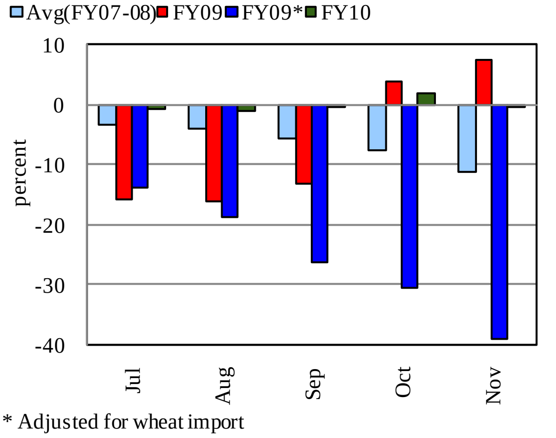
A prominent feature in the FY10 commodity finance is the absence of customary seasonal retirements during the initial four months of the fiscal year. Indeed, the first few months of each fiscal year usually coincides with repayment of commodity loans particularly rice, fertilizer and sugar.[18] However, retirements under these commodities were exceptionally low in FY10 (so far) given the

[14] For detail see **Chapter 4** on **Money and Banking,** SBP Annual Report FY09.
[15] These claims rose as some of the PSEs used banks' credit to finance their cash flows due to buildup of inter-corporate debt.
[16] This was a second major efforts made by the government to resolve circular debt issues. For detail see **Annual Report** for **FY09**.
[17] Different procurement agencies and provincial food departments availed bank loans for procurement of different commodities such as wheat, rice, fertilizer, etc., to: a) stabilize the market price and b) to build up strategic reserves to ensure domestic supply on sustained basis.

substantial borrowings seen in the previous year (see **Figure 4.12**). This was probably due to delays in settlement of price differential claims with the government that have adversely affected the repayment capacity of few public entities (see **Box 4.1**).[19]

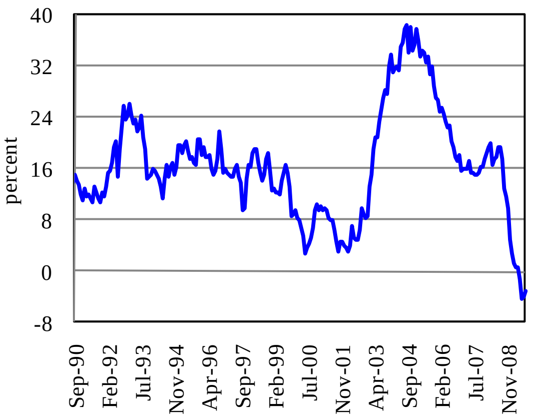
In addition, demand for wheat from government stocks remained weak due to substantially higher issue price relative to international prices.[20] Resultantly, commodity finance recorded a decline of Rs 2.8 billion in Jul-5th Dec FY10 compared with a rise of Rs 13.7 billion in the corresponding period last year. It may be pointed out that higher borrowings during Jul-6th Dec FY09 mainly reflects credit requirement by TCP for wheat import.[21]

Figure 4.12: Commodity Finance (cumulative growth)



* Adjusted for wheat import

Figrue 4.13: YoY Growth in Private Sector Credit



Box 4.1: Accumulation of Bank Loans for Commodity Operations

In the last two years, increasing fiscal constraints led to delays in the disbursement of accrued payables by the government. In particular, the government has been consistently failing to release subsidy payments to domestic institutions on time, and the unpaid arrears have cascaded through the economy, as affected firms were then unable to make payments to supplier and/or repay loans taken

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[18] Rice procurement starts mostly from month of November, whereas procurement of wheat lasts for April to June of each year.

[19] However, in the month of October 2009, a slight increase in demand was seen for procurement of new crops (i.e., rice and sugar) and also for fertilizer import.

[20] Anecdotal evidence indicates inward smuggling of wheat.

[21] During Jul-6th Dec FY09, TCP obtained Rs 53.3 billion from scheduled banks for wheat import. Excluding this, the commodity finance seen a net retirement of Rs 39.6 billion in the same period.

from the financial system. The most visible example of this is the circular debt problems reported in the energy sector. A lesser known example is the recent emergence of another pool of claims unpaid by the government (and government entities), resulting from the government's commodity operations, which is potentially as large and intractable.

The commodity operations of government are typically due to its desire to either:
(1) ensure "good" (above market) prices for farmers/producers,
(2) provide subsidies to economic agents,
(3) ensure the availability of buffer stock of some commodity to smooth out excessive volatility in its price.

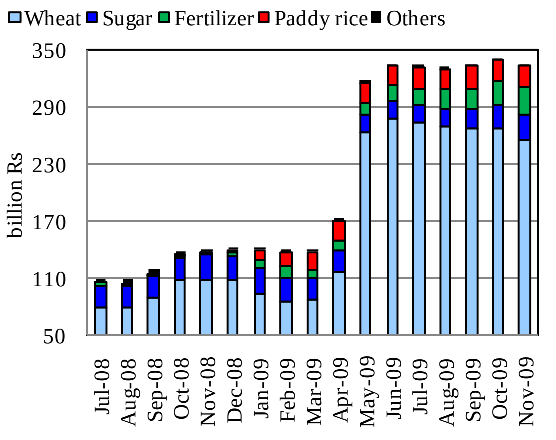
These operations are generally conducted through the Federal and/or provincial government entities and are funded by loans from banks. These loans, that typically carry an implicit government guarantee, are largely expected to be self-liquidating. For example, loans taken to ensure the availability of government wheat stocks to forestall speculative price hikes by hoarders, would be expected to wind-down as the stocks are gradually issued (sold) to millers, and the proceeds used to repay loans. Thus, there is often a seasonal variation in the stock of commodity operation loans.

These commodity operations do entail some fiscal cost for the government, as stocks are often sold at rates below market rates; the difference between the cost of the commodity operations (procurement, storage losses, financial charges, etc.) and the sale proceeds being covered by budgetary allocations. However, if the government defers payments of the differential claims, these loans cannot be retired on time, leading to liquidity issues for lending institutions from the unanticipated (and involuntary) lengthening of loan maturities. In the long term, this can also add to fiscal costs for government due to greater loan period, increase in interest cost as financial institutions account for liquidity risk, adverse changes in prices of stocked commodities, etc.

Recent emergence of rising stock of commodity loans over last 12 months
The volume of subsidy claims had not been significant in recent years as traditional borrowing for commodity operation remained low.[22] However, in FY09, a combination of heavy interventions in a number of commodities (particularly wheat), increasing fiscal constraints, and adverse commodity prices movements led to a sharp rise in outstanding commodity financing. By end-November 2009, outstanding bank loan for commodity procurement reached Rs 334.9 billion as the federal and provincial governments were unable to release required funds to procurement agencies (i.e., TCP, PASSCO) and provincial food departments, respectively (see **Figure 4.1.1**).

The sharp accumulation in borrowing was largely visible

Figure 4.1.1: Outstanding Stock of Commodity Finance



[22] The stock of borrowing for commodity operation had remained around Rs 100.0 billion on end-June basis historically.

during the last quarter of FY09. These loans were mainly acquired for wheat procurement, with smaller amounts for rice and fertilizer. The interventions followed bumper domestic crops of rice and wheat. A commodity–wise breakup indicates that price differential claims were substantially high under wheat procurement compared with other commodities. More specifically, the government had announced the high wheat support price prior to sowing season in 2008 which not only resulted into record wheat crop, but also increased the bank credit requirements by the procurement agencies. While both tiers of the government contributed in wheat procurement, the major rise came from provincial food departments, particularly, the Punjab.[23]

The difference between procurement & storage cost and the issue price continues to rise with time. At the same time, the provincial food departments have been unable to aggressively offload their stocks of wheat in domestic market in recent months which demand a lower price.[24] Another cost driver was the Punjab government's provision of wheat at a very subsidized rate in the month of Ramadan.[25] All these factors led to build-up of huge price differential claims towards the government. Since these claims have not been paid by the government, provincial food departments faced liquidity shortages in settling bank loans. The liquidity condition may even get worse in coming months given the seeming weak ability of procurement agencies to off-load the existing wheat stock. Specifically, around 9.0 million ton of wheat was procured in 2009 and on the face of surplus wheat in the market, it is unlikely that procurement agencies will be able to off-load the entire stock before March 2010 when procurement of the next (2010) harvest is expected to begin.

In case of rice, PASSCO had procured 432,534.9 M tons of rice in the previous year at the minimum guaranteed price ranging from 700 to 1500 per 40 kg. Anecdotal evidence suggests that PASSCO could not able to offload the significant portion of procured stock in the domestic market as traders offered substantially low price to purchase rice. The low tender price could be partly attributed to the ample domestic stock from the 2008 crop in the market, weakness in international prices at least till October 2009, and arrival of new crop in the market. More importantly, PASSCO is also not willing to sell the product at very low price in anticipation of delays in the realization of price differential claims by the government. Likewise, the price differential claims[26] of Trading Corporation of Pakistan (TCP) for fertilizer, rice and sugar also contributed in the outstanding banks' exposure in commodity finance.[27] Apart from price claims by the government, TCP receivables from a few public entities including utility stores and food departments have also built up in recent months.

The discussion above clearly shows that non-realization of price differential claims by the government did not allow procuring agencies to settle bank debts. Moreover, it is also expected that in coming months a large volume of bank debts would remain unsettled, as in addition to a domestic supply glut, the low international prices (particularly of wheat) have made it difficult to export surplus commodities. This has several implications:

Banks became reluctant to extend incremental loans in light of existing large exposure

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[23] Over 9.0 million ton of total wheat procurement in 2008 around 6.0 million ton is procured by the provinces.

[24] Issue price is the price at which mill owner purchase wheat from procured agencies. Presently, government fixed issue price at Rs 975/40 kg. Anecdotal evidence suggests that the reason for weaker demand from private sector for the wheat held by the government is an inward smuggling of wheat in the country from Central Asian Republics due to lower international prices.

[25] Anecdotal evidence suggests that during Ramadan the wheat was sold at Rs 304/40 kg.

[26] This refers to differential between the procurement & storage cost and the issue price.

[27] TCP is the only agency which import fertilizer, particularly urea, and sugar.

A bank-wise analysis suggests that the loan extended for the commodity operation by end-November 2009 was mainly concentrated in five largest banks. This has not only exerted pressures on banks' liquidity but also explained banks' reluctance to extend incremental loans to these entities for 2010 crop procurement.[28]

Commodity operations may crowd out the private sector, and distort price signals
Procuring agencies and provincial food departments seems unable to repay bank loans unless government releases subsidy amount. This suggests that bank funds may remain stuck for some times. Till Q1-FY10, private sector credit remained weak which did not highlight these liquidity constraints so far. October 2009 onwards developments, however, indicate that the stuck-up loans in commodity finance may even crowd out private sector credit. These developments include: (a) a rise in private sector credit October 2009 onwards, (b) a relatively muted deposit growth during the same period, and (c) a sharp increase in government budgetary borrowings from commercial banks.

Possible burden on the fiscal account
If government would disburse the subsidy to different agencies then this will lead to increase in fiscal burden and thereby resulting into higher financing requirements. Moreover, if procurement agencies could not start the timely procurement of new crops then it may distort price signals in the market and would impact prospects for 2011 crops.

To sum up, a prompt settlement of price differential claims is essential to ease-off banks funds. The current situation signifies just one problem associated with government providing subsidies in various sectors of the economy. Not only have such subsidies distorted relative prices in the economy and caused demand pressures; the fluctuating domestic and international prices of key commodities have caused problems in assessing the required fiscal spending.

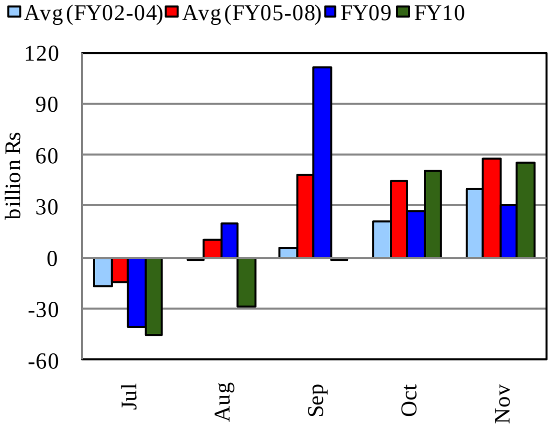
4.3 Credit to Private Sector (net)[29]

The steep contraction in corporate demand[30] for bank credit which began in the second half of FY09 further intensified in the initial months of FY10. Resultantly, the private sector credit witnessed the worst performance in twenty three years; with YoY growth recording net retirement of 2.7 percent by December 05, 2009 (see **Figure 4.13**).

On cumulative basis, a low level of 0.9 percent growth in private sector credit during Jul-5th Dec FY10 stemmed entirely from net retirement in working capital loans. This was despite of some signs of revival in a few industries. The anomaly is perhaps due to the fact that in FY09 a number of industries[31] were piling up inventories in anticipation of both high domestic demand and rise in raw material prices (both in global and domestic markets). However, the said behavior from

[28] It was one of the large public sector banks that had actually explained the incremental credit demand for commodity operation during the month of October 2009.
[29] The reported credit numbers comprise of banks' investments and advances to the corporate sector. This data is based on Monetary Survey which is available till 5th December 2009; whereas, sector-wise discussion covers Jul-Oct period.
[30] More than 85.0 percent of total private sector credit is extended to the corporate sector.
[31] For instance, refineries, edible oil and steel.

Figrue 4.14: Net Credit to Private Sector (Monthly Flows)



those industries reversed in Jul-5th Dec FY10; thus the incremental credit demand to build up inventories during the period under review was not as significant as in Jul-6th Dec FY09. Moreover, a number of factors such as: a) some export-based industries (e.g., cement[32]) were capable of generating cash flows from their export earnings of last year, b) a number of companies had reported closures in H2-FY09[33], particularly in textile sector, and c) a steep fall in raw material prices in few categories such as raw cotton and iron & steel bar prices in the domestic market had put lower pressures on incremental demand for credit during the period of analysis.

On the other hand, demand for long-term loans remained persistently higher compared with working capital requirement. Similar to last year, the power, fertilizer, cement and construction sectors were few main sectors accounting for continuing higher demand for fixed investment loans. Disbursements in power and fertilizer sectors, in particular, seems quite surprising given that a number of companies had already drawn significant amount of assigned limits with banks in FY09. This was probably due to commencement of a few projects which had actually accelerated the incremental demand for credit. Moreover, exchange rate fluctuations in recent past have also made LC commitment costlier for some corporates.[34] As a result, number of companies arranged rupee funding from banks to fulfill their additional requirements in the period of analysis.

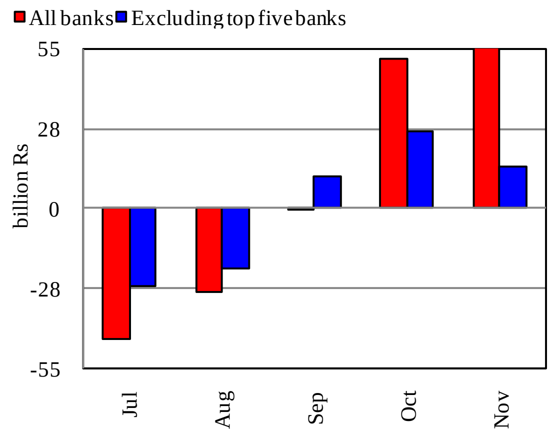
The commencement of long-term projects, particularly power and fertilizer, will increase the running finance requirements in months ahead. In fact, a few banks

[32] It may be recalled that in FY09 cement export grew by 97.7 percent during Jul-Oct; though lower from 105.5 percent rise in the corresponding period of FY08.
[33] Anecdotal evidence suggests that industrial recovery during Q1-FY10 is concentrated in a few large companies.
[34] SBP temporarily suspended the forward foreign exchange cover against all types of imports since July 8, 2008. For details, see EPD FE Circular No. 08 of 2008. The forward cover was earlier allowed to authorize dealers so they could hedge against exchange rate risk in import payments.

have already committed the running finance limits to their clients in above mentioned sectors. Besides working capital loans, resilience in demand for fixed investment may also continue as commencement of new projects in few sectors such as real estate, refineries[35] and rental power will boost the project financing need from corporates. Therefore, it is quite possible that the visible fall in private sector credit in the recent past may not continue going forward.

Indeed, it is obvious from **Figure 4.14**, that October 2009 witnessed a pickup in credit demand which is unusually higher than the average increase in the same month preceding years. [36]

Figure 4.15: Incremental Credit Supply-FY10



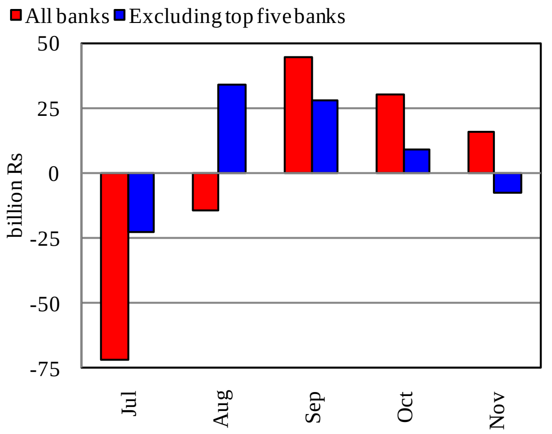
The supply side perspective suggests that banks' risk-averse lending which was seen in FY09 consequent to rise in non-performing loans of corporates, continued in the initial few months of FY10 as well. As a result, banks were remained conservative in their lending to the private sector.

Though, the growth in gross NPLs, corporate sector loans in particular, slowed down during Q1-FY10, stringent credit assessment in a number of banks resulted in limited supply of funds.[37] At the same time, a number of banks also witnessed increase in cash recoveries against NPLs.[38] While, the lower increase in gross NPLs was partly anticipated as net credit fell sharply since January 2009, high cash recoveries reflect banks' greater efforts.

[35] In most of the refineries the desulphurization projects are in progress, as to ensure compliance with the government's requirement of reducing sulphur content in HSD, to 500 parts sulphur per million till calendar year 2012.
[36] Month of July is an exception which usually coincides with seasonal retirement each year.
[37] In contrast to the same period last year, a sharp increase in gross NPLs of corporate sector loans was largely explained by working capital; however, the contribution of working capital NPLs in gross NPLs of corporate sector in Q1-FY10 was significantly low.
[38] For detail, see section on NPLs.

This said, net credit growth may not attain the same growth momentum, as seen over the preceding few years[39], as banks are now increasingly focused to finance certain projects that have sound cash flows. This is in contrast to the practice in the boom years when bank finance was provided mainly depending upon the collateral value; including inventories, fixed assets and receivables with much less consideration on cash flows of businesses. Thus the conservative approach is likely to contain the growth of private sector credit.

Figure 4.16: Incremental Deposits - FY10



The bank-wise incremental credit distribution suggests that top five banks, which traditionally have had the largest share in credit supply, recorded higher contraction in their lending activities compared with the remaining banking groups, particularly during Jul-Sep FY10 (see **Figure 4.15**). An in-depth analysis suggests that significant exposure of the top five banks in PSE credit and commodity finance in the recent months probably resulted in lower loanable funds for private sector. To make things worse, deposit growth in the top five banks also remained significantly lower compared with other banks, particularly in the first three months of FY10 (see **Figure 4.16**). Apart from liquidity concerns, high net budgetary borrowing of government also constrained banks' ability to extend funds to private sector during the period under review (see **Table 4.5**).

Private Sector Advances

While demand for consumer loans has been falling from last year, a sharp contraction in business sector advances led to a marked drop in private sector advances during Jul-Oct FY10.

The business sector advances contracted by 0.6 percent in Jul-Oct FY10 as compared to an average growth of over 5.0 percent in the same period during last five years. As evident from **Figure 4.17**, net retirement under

[39] Excluding last year, on average private sector credit grew by 24.6 percent during FY04-FY08.

working capital loans explained the entire decline in advances growth. Demand for fixed investment and trade loans, though slowed down markedly, still had positive contribution in advances growth.

Table 4.5: Banks' participation in T-bills Auctions

billion rupees

	FY09		FY10
	Jan-Mar	**Apr-Jun**	**Jul-Oct**
Maturity	514.8	250.5	205.9
Net target	50.2	99.5	174.1
Net offered	1011.7	462.6	704.2
Net accepted	169.4	108.4	162.5

The monthly trend suggests that the contraction in advances was mainly concentrated in the first three months of FY09 whereas slight recovery in advances demand was seen in the month of October 2009 (see **Table 4.6**). More specifically, pickup in credit demand in October 2009 is partly a reflection of seasonal running finance requirement; particularly for cotton procurement. Moreover, in sugar sector, the seasonal demand was absent during the period under review. This was due to the fact that manufacturers have delayed sugarcane crushing and a number of industries are repaying loans availed last year.

Apart from seasonal finance, power sector witnessed acceleration in demand for working capital loans in October 2009; though it showed net retirement during Jul-Oct FY10 period. In fact, the settlement of loans by a few IPPs on account of PPTFCs issuances in September 2009 provided them room to borrow in the following month. The need for additional borrowing stemmed from the fact that circular debt issue has not been resolved yet.

Table 4.6: Break-up of Working Capital Loans during FY10

billion rupees

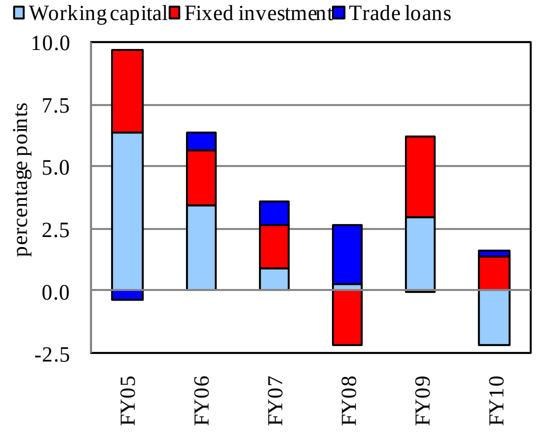
	Jul-Oct		Oct
	FY09	**FY10**	**FY10**
Working capital loans	**62.6**	**-46.3**	**30.4**
A. Agriculture	**2.8**	**0.9**	**-0.8**
B. Manufacturing	**54.1**	**-33.1**	**14.4**
a. Rice processing	-5.4	-8.7	0.2
b. Manufacture of sugar	-10.8	-25.8	-4.6
c. Textile	21.9	13.0	24.1
Spinning of fibers	18.7	9.0	18.6
b. Refined petroleum products	11.2	-1.8	-1.6
c. basic metal	2.4	-3.6	-0.1
c. Chemicals and chemical products	14.3	-0.2	-3.5
d. Manufacture of machinery	2.0	-0.9	-0.8
C. Power	**1.1**	**-8.7**	**7.9**
D. Construction	**-5.6**	**-3.5**	**1.0**
E. Commerce & trade	**8.7**	**-7.0**	**3.6**
D. Transport & communications	**-1.0**	**2.1**	**-0.3**
E. Other business activities	**9.7**	**1.0**	**0.5**

Finally, an increase in demand from commerce and trade during the month of October 2009 probably reflects slight improvement in industrial performance and rising trade volume.

Consumer loans

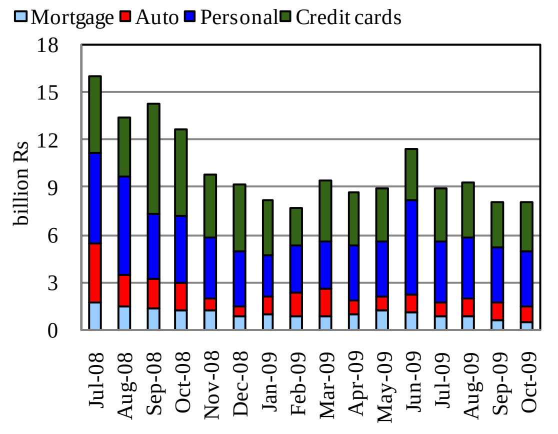
The growing number of bad loans in consumer sector, emanated partly from rise in borrowing cost and fall in real income of borrowers, hampered adversely banks' willingness as well as ability to lend aggressively during the last two years. Resultantly, consumer loans which had been decelerating since December 2006, witnessed a net contraction of 6.0 percent in Jul-Oct FY09 and further 7.6 percent during Jul-Oct FY10. Similar to previous year, the contraction in consumer loan is visible in all categories.

Figure 4.17: Composition of Growth in Business Sector Loans



The auto loans, in particular, continued to fall during Jul-Oct FY10 despite a recent increase in local car sales.[40] This is because the recent demand for automobiles was largely financed by customers' equity rather than bank loans. This said, a number of banks have seen an upsurge in demand for auto finance in recent months. Therefore, it is likely that auto finance may increase somewhat in coming months; though banks will likely be more conservative while making consumer loans.

Figure 4.18: Monthly Disbursements under Consumer Loans



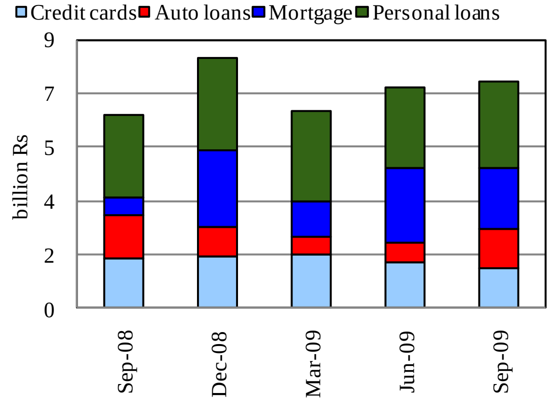
[40] In fact, anecdotal evidence suggests that consumer demand for automobiles is directly influenced by the auto finance availed from banks. However, increase in borrowing cost and banks' cautious lending following rise in NPLs, made banks loans more expensive for borrowers.

Viewed from disbursement side, a significant portion of consumer loans still comprises personal loans followed by credit cards-the most risky lending as it is largely uncollateralized (see **Figure 4.18**). This was despite a sharp rise in total addition in NPLs under these categories in recent past (see **Figure 4.19**). A detailed analysis suggests that these loans are concentrated in few banks which are mainly focusing on lending to clients with whom they have long established relationships. For example, some banks are offering these loans mainly to those borrowers whose salary accounts are maintained with them. This not only ensures the regular income streams of borrower but also provide authority to banks to debit the account of customer when payments become due.

4.4 Deposit Mobilization[41]

Deposit mobilization by banks shows some recovery as YoY deposit growth witnessed an uptrend since May 2009 reaching 12.2 percent by end-November 2009 (see **Figure 4.20**). However, given a considerable increase in country's foreign exchange reserves in the recent past, the current level of YoY deposit growth is still low (see **Figure 4.20**). In recent years, increases in total forex reserves were a very important contributor to deposit growth in the domestic banks. However, this linkage now seem to have weakened.

Figrue 4.19: Break-up of Total Addition in NPLs of Consumer Loans

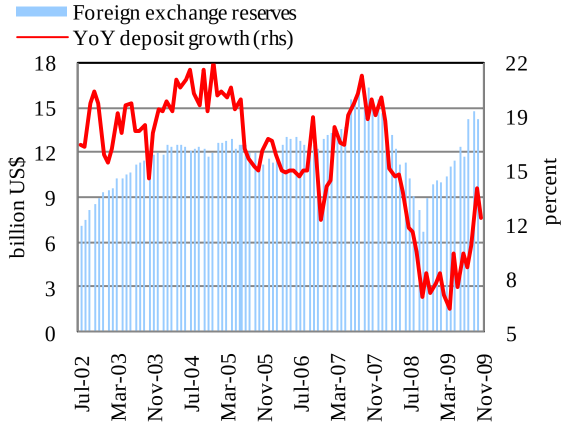


During FY09, the dollar liquidity for imports was increasingly being funded by forex purchases from the central bank, with a commensurate fall in rupee deposits (amid a contraction of broad money). However, the subsequent recovery in SBP forex reserves was not through market purchases (which would have re-injected liquidity into the system) but rather largely through IMF loans (which do not impact market liquidity or broad money growth).

[41] The discussion on deposits is based on total deposits of the banking industry including government deposits.

Another reason for the relatively low YoY deposits growth in Jul-Nov FY10 is the much reduced monetization of the fiscal deficit. More specifically, the cumulative net budgetary borrowing from central bank witnessed lower rise of Rs 88.9 billion in Jul-5th Dec FY10 as against substantial borrowing of Rs 405.2 billion in the corresponding period last year.

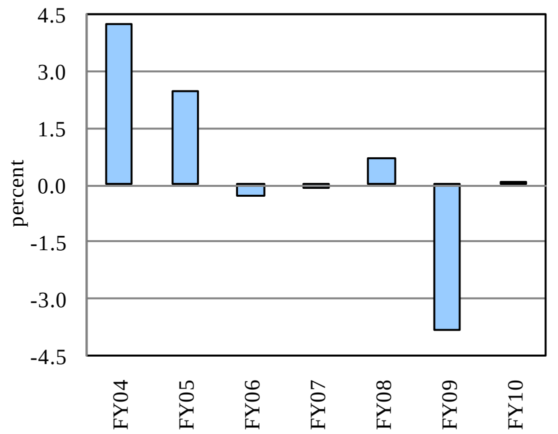
Figure 4.20: Foreign Exchange Reserves & Deposit Growth



Nonetheless, on cumulative basis deposits of the banking system recorded a growth of 0.1 percent during Jul-Nov FY10 in sharp contrast to same period of previous year when deposit base contracted by 3.8 percent (see **Figrue 4.21**).

More encouraging is the fact that this improvement in deposits was borad-based as a large number of banks have witnessed rise in their deposit. A further analysis suggests that a number of factors explains this growth in deposit during Jul-Nov FY10. For example:

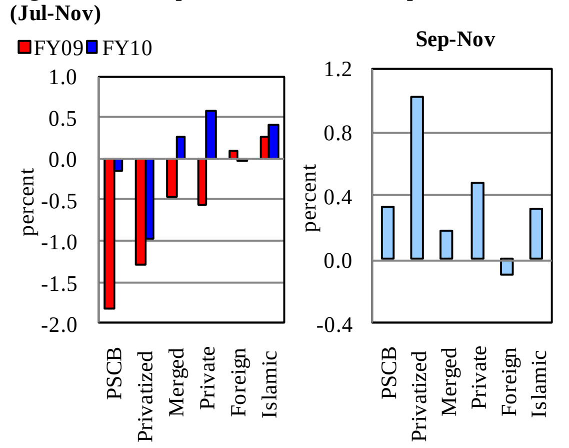
Figure 4.21: Cumulative Deposit Growth (Jul-Nov)



1. Ease in external account pressures has started to show some positive impact on deposit growth. More specifically, external account balance for Jul-Nov FY10 witnessed a surplus of US$ 0.9 billion compared to a deficit of US$ 5.6 billion in the corresponding period last year. Therefore, the resulting rupee liquidity eventually contributed into deposit growth, and

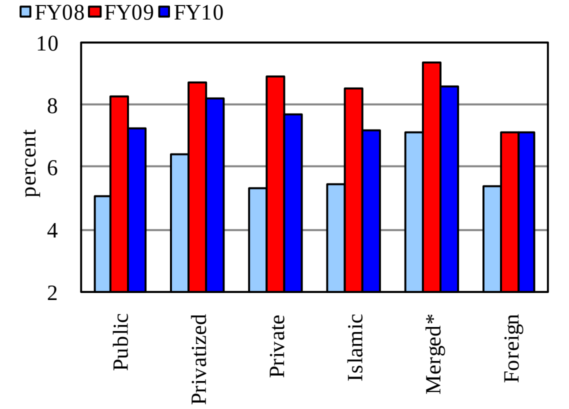
2. Sign of revival in a few industries, particularly wholesale and retail trade, power and automobile, also explains part of growth in deposits. In particular, the deposit growth under motor vehicles possibly reflects increased sales of locally manufactured cars.

Figure 4.22: Group-wise Contribution in Deposit Growth (Jul-Nov)



A bank-group wise analysis suggests that except *large privatized banks* deposits of other remaining banks depicts increase in their deposit base over June 2009 (see **Figure 4.22**).[42] More specifically, it was one of the *large privatized banks* that had mainly contained the deposit growth in this group. Excluding this, deposits of *large privatized banks* also depicts a small rise of 0.1 percent.[43]

Figure 4.23: Incremental Deposit Rates (average Jul-Oct)



*merged during last five years

The large erosion in the deposit of one *large privatized bank* mainly stemmed from massive withdrawals from its fixed deposits. In fact, squeezed profit margins in the wake of high provisioning expenses forced the bank to reduce the stock of expensive deposits by not encouraging the depositors to reinvest in long-term deposits. Besides privatized banks, public sector deposits also witnessed net withdrawal

[42] Even withdrawals from large privatized banks are mainly concentrated in first two months of FY10 as their deposits witnessed an increase in the following months (see **Figure 4.22**). Sep-Nov data pertains to FY10.

[43] Total deposit base adjusted for this large privatized bank depicts 1.3 percent growth in Jul-Nov FY10.

during Jul-Nov FY10; though the fall in deposit growth is much lower than the corresponding period last year.

On the other hand, other banks witnessed an increase in their deposits during Jul-Nov FY10. More specifically, a rise in deposits of merged banks was because a number of banks in this group offered impressive incremental returns relative to the remaining banks (see **Figure 4.23**).

Figure 4.24: Currency-wise YoY Deposit Growth

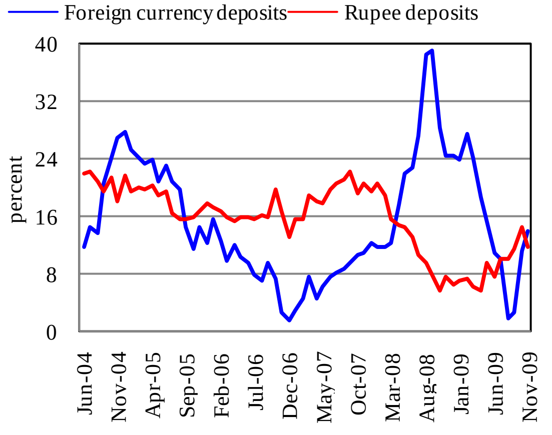
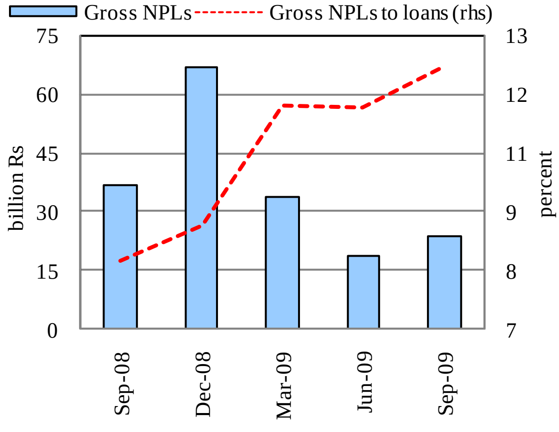


Figure 4.25: Non Performing Loans



The currency wise composition of deposits depicts that the YoY growth in foreign currency deposits after witnessing steep fall since October 2008, started gaining momentum reaching 14.0 percent by end-November 2009 (see **Figure 4.24**).

Within the foreign currency deposits, the major increase came from US dollar denominated accounts mainly from deposits of PSEs.

4.5 Non Performing Loans

Asset quality of the banking system shows some weakness in Q1-FY10 as gross NPLs increased by Rs 23.7 billion over June 2009 and reached Rs 421.6 billion;

though this increase was considerably lower than the sharp rise seen in the first three quarters of FY09 (see **Figure 4.25**).[44]

The movement in NPLs depicts that both, total additions and reductions, in NPLs for Q1-FY10 reflects some improvement (see **Figure 4.26**). More specifically, total addition in NPLs during Q1-FY10 was limited to Rs 43.9 billion, much lower than a rise of Rs 51.7 billion recorded in Q1-FY09. This improvement was evident mainly in lower rise seen in corporate sector loans during Q1-FY10 compared with the same period a year earlier when most of the addition came from this segment (see **Figure 4.27**). On the other hand, not only the reduction in NPLs during Q1-FY10 was higher than the corresponding period last year, the composition also showed improvement over last year. In particularly, the recent reduction in NPLs constituted mainly of cash recoveries[45] and upgraded NPLs compared with Q1-FY09 when the volume of cash recoveries and upgraded NPLs was low. Further analysis shows that although the contribution from corporate sector loans remained high in the gross NPLs growth, the credit quality of consumer and agriculture loans seem to have worsened more (see **Figure 4.27**). More

Figure 4.26: Movements in NPLs

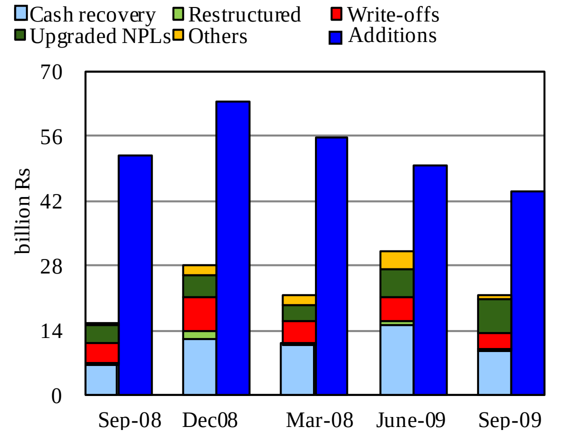
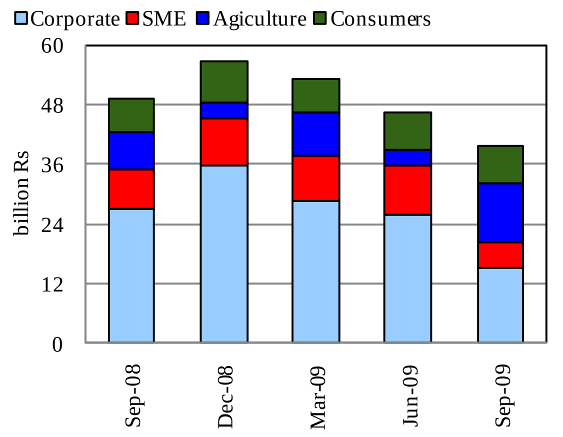


Figure 4.27: Segment-wise Break-up of Additions in NPLs



[44] Continued rise in NPLs to loan ratio in September 2009 may be read with some caution as net credit extended from banks declined sharply since January 2009.
[45] Anecdotal evidence suggests that cash recoveries mainly stemmed from working capital in construction sector, sugar and textile industry, and commerce & trade sector.

specifically, the increase in gross NPLs of agriculture sector in Q1-FY10 was almost double than the rise seen in Q1-FY09 (see **Table 4.7**). It may, however, be noted here that this increase was mainly concentrated in one of large public sector banks. In consumer loans, the increase was witnessed in all categories largely reflecting continued worsening in purchasing power of individuals.

Table 4.7: Break-up of Increase in Gross NPLs (Jul-Sep)

billion rupees

Segments	FY09	FY10
Corporate	20.5	12.7
Agriculture	4.5	7.6
SME	8.5	-1.5
Consumer	2.0	4.2
Others	1.3	0.7
Total increase	36.8	23.7