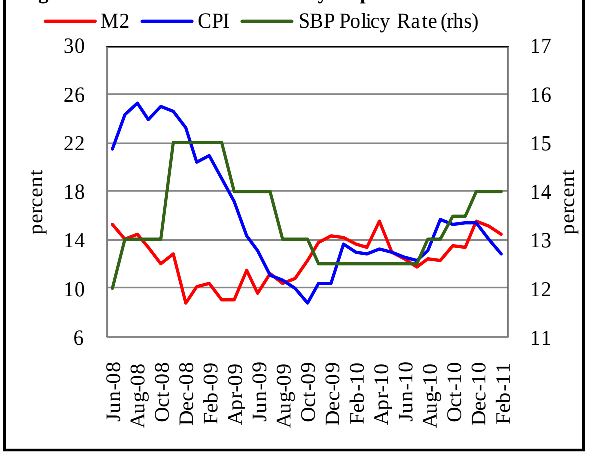
4 Money and Banking[1]

4.1 Overview

Fall in non-bank and external financing led government to rely increasingly on the borrowing from the banking system, particularly SBP through most of H1-FY11. Reluctance of the government to take politically difficult decisions to curtail the fiscal deficit, laid the responsibility of managing the difficult economic situation disproportionally on SBP.

The persistent increase in demand pressures from monetization (of the fiscal deficit) called for a proactive policy response from the SBP. Hence, SBP announced three successive 50 bps hike in the policy rate during H1-FY11. Subsequently, however, restrained exercised by the government in curtailing its borrowings from the SBP and accompanied improvement in the external accounts allowed SBP to keep the policy rate unchanged in the next two policy announcement (see **Figure 4.1**).

Figure 4.1: Inflation and Monetary Expansion - YoY



Although the government has kept its borrowing from SBP in check so far, it has only been partially successful in undertaking necessary revenue generation and expenditure reduction measures. These measures are not only important for curtailing the fiscal deficit, but also crucial for the resumption of the suspended IMF program. The importance of the IMF program is clear; it is vital not only in terms of its implications for balance of payments, but also for resumption of external financing from other multilateral agencies. In the absence of this external

[1] The analysis in this chapter is based on monetary survey data up to 26th Feb 2010; monthly data on advances and loans available until Jan 2010; quarterly data on Non-Performing Loans (NPLs) up to the quarter ended Dec 2010; and money market data up to end-Feb 2010, unless otherwise specified.

financing, the government may resort to monetize its deficit, which would fuel inflation and force SP to raise rates.

4.2 Monetary Aggregates

Expansion in broad money (M2) accelerated with a growth of 7.7 percent during the first eight months of the current fiscal year compared to 5.7 percent in the same period last year (see **Table 4.1**).

Table 4.1:Monetary Aggregates (Jul-Feb 2011)
flows in billion rupees, growth in percent

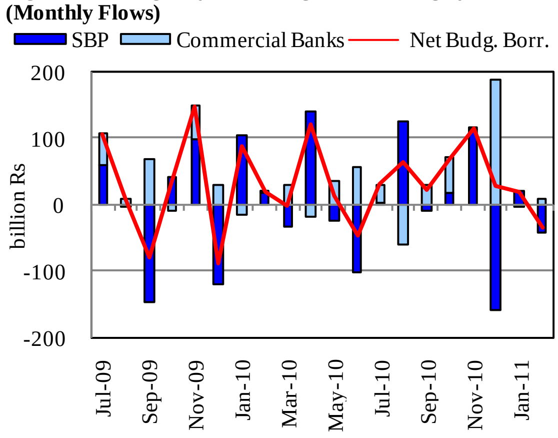
	Flows		Growth rates	
	FY10	**FY11**	**FY10**	**FY11**
Broad Money (M2)	294.7	444.6	5.7	7.7
NFA	-45.9	146.2	-9.3	26.8
SBP	-25.6	147.1	-8.4	38.8
Scheduled banks	-20.4	-0.9	-10.6	-0.5
NDA	340.6	298.5	7.3	5.7
SBP	168.0	92.2	18.6	9.3
Scheduled banks	172.6	206.2	4.6	4.9
of which				
Government borrowing	186.6	233.3	9.2	9.6
For budgetary support	240.1	325.2	14.3	16.2
SBP	60.1	71.8	5.2	5.9
Scheduled banks	179.2	253.4	34.7	31.6
Commodity operations	-52.1	-94.7	-15.5	-22.9
Non government sector	226.9	230.6	7.1	6.8
Credit to private sector	137.9	208.8	4.7	6.9
Credit to PSEs	89.2	21.5	33.5	6.1
Other items net	-72.9	-165.4	-12.5	-27.7

Both the net domestic assets (NDA) and net foreign assets (NFA) of the banking system contributed to this growth. The growth in NFA reflects an improvement in the country's external accounts, while the expansion in NDA shows a pickup in demand for private sector credit and a rise in government borrowings.[2]

Government borrowing for budgetary support

Government borrowing from the banking system increased 16.2 percent during Jul-Feb FY11. As stated earlier, a fall in non-bank and external financing was primarily responsible (see **Figure 4.2**).

Figure 4.2: Budgetary Borrowing from Banking System (Monthly Flows)



Within the banking system, the bulk of budgetary financing during Jul-Feb

[2] For details on factors contributing to the improvement in the net foreign assets, please see chapter 6 on balance of payments.

FY11 were met from scheduled banks. A disaggregated analysis, however, shows that the government was relying more on SBP borrowing till November 2010, and it was only in the latter half of December 2010 that the government retired a large part of its debt to SBP. In addition, the government became more aggressive in T-bill auctions, accepting amounts in excess of announced targets.

Credit to public sector enterprises

Credit to public sector enterprises (PSEs) declined sharply during Jul-Feb FY11 to Rs 21.5 billion from Rs 89.2 billion last year.[3] This was due to retirements by an oil refinery and a state owned oil marketing company amid lackluster overall demand.

Commodity operations

Overall commodity loans fell by Rs 94.7 billion during Jul-Feb FY11, which was on account of retirement of advances for wheat procurement. The cabinet decision to allow wheat exports facilitated this retirement and a contraction in wheat advances can be expected to continue for the next few weeks.[4] Although overall commodity loans registered a fall, financing was extended for sugar imports via TCP.

4.3 Private Sector Credit

Private demand for credit picked-up during Jul-Feb FY11. The outstanding stock of loans to the private sector increased by Rs 208.8 billion compared to Rs 137.9 billion in the same period last year. This was largely due to an increase in seasonal demand for working capital and trade related loans. More than half of private sector credit went to the textile sector (see **Table 4.2**) reflecting higher input prices, especially that of raw cotton.

Table 4.2: Private Sector Advances - Flows (Jul-Jan)

billion rupees

	FY10	FY11
Manufacturing	**84.1**	**177.1**
Textiles	45.9	116.3
Rice	19.5	22.0
Edible oil	-5.4	9.9
Cement	2.1	6.3
Basic metals	-1.0	3.3
Fabricated metals	0.8	0.3
Sugar	0.3	15.7
Fertilizer	5.8	-5.1

In addition to textiles, the impact of rising input prices on credit demand was also visible in other industries such as sugar, rice and basic metals.

[3] The sharp rise in credit off-take last year reflects the issuance of privately placed term finance certificates (PPTFCs).

[4] For details see First Quarterly Report of FY11.

4.4 Non-Performing Loans

Asset quality of the banking system deteriorated further during the first half of the fiscal year. Gross NPLs increased by Rs 58.0 billion to reach Rs 517.9 billion by end-Dec 2010, compared with an increase of Rs 34.1 billion in the same period last year. Not surprisingly, over one-third of this increase in NPLs came from the textile and energy sectors.

Nevertheless, NPLs to loan (infection) ratios for the textile and agri-business recorded improvement over the start of the fiscal year, as well as the previous quarter (see **Table 4.3)**. The improvement in the ratio for the textile sector is attributed to an increase in advances to sector during Q2-FY11. In addition, improvement in textile exporters' margins on account of increase in export prices, also enhanced their ability to retire some of their loans. On the other hand, the improvement in the ratio for agri-business reflects better repayment capacity following the rise in agricultural incomes due to the increase produce prices (e.g. cotton, sugarcane).

Table 4.3: NPLs to Advances Ratio: Selected Sectors

percent

	Jun-10	Sep-10	Dec-10
Chemicals	6.5	7.8	7.6
Agribusiness	7.5	8.4	6.4
Textile	23.2	25.2	22.2
Cement	15.7	15.3	16.0
Sugar	15.6	21.9	16.9
Shoes & Leather	12.9	13.3	12.5
Automobile	19.0	22.1	23.5
Electronic & Transmission	7.7	7.9	9.0

In contrast to textiles and agri-business, the infection ratio deteriorated for the auto sector primarily due to net retirement of loans during the period under review (see **Table 4.3**).

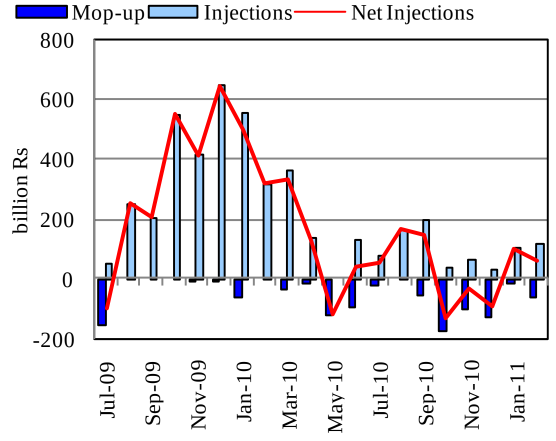
4.5 Money Markets

Liquidity Management

Liquidity conditions in the money market remained fairly comfortable during Jul-Feb FY11 on account of government borrowings from SBP and growth in bank deposits. Concerned about the consistency of market liquidity and SBP monetary policy stance, the central bank drained this excess liquidity not only through auctions, but also mopped up a significant amount through open market operations (OMOs) and repos.

To keep the interbank money market liquidity condition in line with the monetary policy stance, SBP moped up Rs 540.2 billion during Jul-Feb FY11 compared with Rs 227.8 billion during the same period last year; whereas injections in the market by SBP remained low (see **Figure 4.3**). Moreover, commercial banks deposited Rs 673.2 billion with SBP under overnight repo facility (floor for interest rate corridor) compared to Rs226.7 billion during the corresponding period last year.

Figure 4.3: Open Market Operations (OMOs)



Primary Market

Treasury Bills

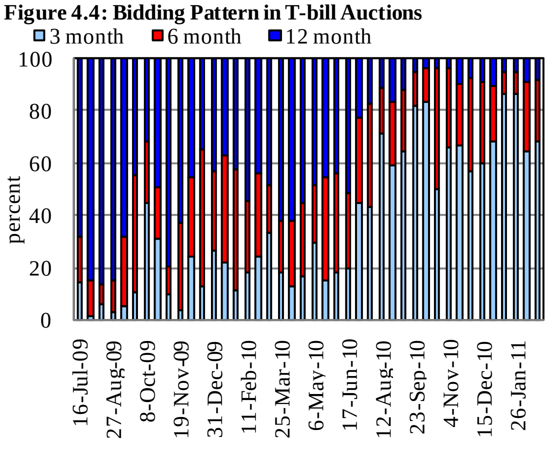
The government accepted Rs 180.8 billion (net of maturities) during Jul-Feb FY11 against a net target of Rs 89.5 billion (see **Table 4.4**). With drying up external financing and the fall in non-bank sources, government was left with little option but to borrow heavily from the banking system. Earlier in the fiscal year, when prospects of external financing were good, government had rejected all bids in auctions of longer tenure PIBs due to high rates demanded by banks.[5] Banks on the other hand, were

Table 4.4: Treasury Bills Auction Profile (Jul-Feb)

billion rupees

	Maturities	Target	Offer	Accepted
FY09	1161.3	1320.0	2219.1	1276.0
FY10	512.3	740.0	1763.1	789.8
FY11	1790.5	1880.0	3204.0	1971.3

Figure 4.4: Bidding Pattern in T-bill Auctions



[5] The rejection of these bids was despite higher than target offers by banks; they offered Rs 138.1 billion in the five PIB auctions held during Jul-Feb FY11.

anticipating an increase in interest rates and therefore were more interested in shorter term T-bills (see **Figure 4.4**).

Pakistan Investment Bonds

A PIB auction target of Rs 105.0 billion was set for Jul-Feb FY11 against maturities of Rs 27.4 billion. The government, however, rejected all bids in the first two auctions (July and August 2010) due to high returns demanded by banks. In subsequent auctions, in an effort to retire SBP borrowings, the government accepted Rs 53.0 billion, but this was still lower than target.

GOP Ijara Sukuk

Against a target of Rs 80.0 billion for the two Sukuk auctions held in the Jul-Feb FY11 period,[6] Rs 89.0 billion were accepted. The government received offers of Rs 122.5 billion, which reflects strong liquidity position of Islamic banks and their investment appetite for this asset class.

[6] The auctions were held in Nov and Dec 2010.