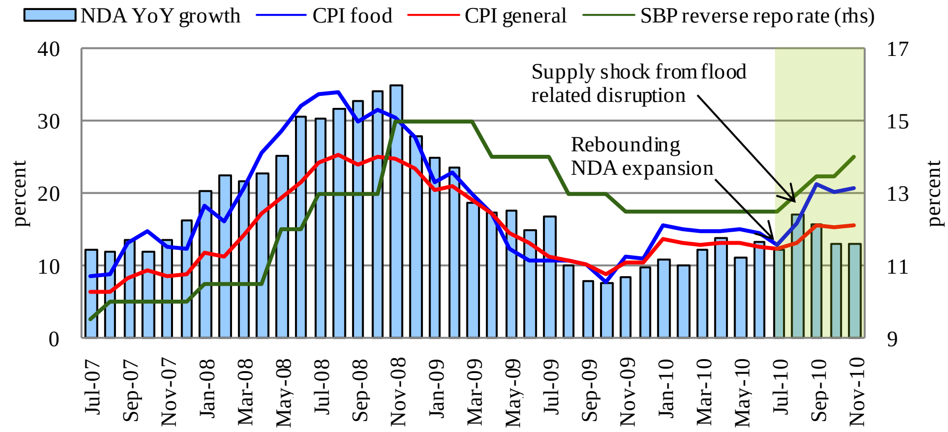
4 Money and Banking

4.1 Monetary Policy

While the SBP kept its policy rate on hold for most of FY10 to bolster a recovery in the domestic private sector, continued aggregate demand induced risks to price, and broader macro stability, prompted the central bank to raise its policy rate by 50 bps in each of the three policy rate decisions during H1-FY11 (see **Figure 4.1**).

Figure 4.1: Monetary Policy - Government led Monetary Expansion and Flood Supply Shock



Inflation persistence, risks to broader macroeconomic stability and tightening: **First Policy Meeting**. In addition to demand pressure emanating from increase in public sector wages, the inflation outlook for FY11 faced additional headwinds from upcoming upward revisions in power tariffs and the proposed Reformed General Sales Tax (RGST). An ambitious fiscal deficit target also called for caution in assessing risks to price stability. In addition to inflation, the pickup in domestic demand amid forecasts for higher international commodity prices could increase the import bill; the impact of any resulting deterioration in the current account on the country's overall external position would depend on timely realization of official foreign flows. In this backdrop, the SBP's monetary policy committee (MPC) unanimously voted for a 50 bps increase in the policy rate to contain aggregate demand induced risks to macroeconomic stability; taking it to 13 percent on August 2, 2010.

Growing fiscal pressure on monetary management and disruption from floods augmented risks to price and macroeconomic stability:

Second Policy Meeting. With monetary policy focused on limiting the demand-pull on domestic inflation, the monsoon flooding aggravated risks to price stability as well as the country's growth prospects. In particular, inflation rose to 13.2 percent in Aug 10, with a sharp rise in food inflation (see **Figure 4.1**). [1] Further, monetary implications of the fiscal response[2] to the crisis called for additional caution in assessing future inflation - particularly in the face of rising government recourse to central bank borrowings as highlighted below. In addition to inflation, risks to the external position from a higher import bill could be exacerbated if the expected improvement in export growth for FY11 failed to materialize due to flood related productivity losses. In this scenario, the SBP raised its policy rate by an additional 50 bps to 13.5 percent on September 29, 2010.

Third Policy Meeting. Continued government led monetary expansion - as a result of a weak fiscal position - continued to weigh heavily on macroeconomic stability. In particular, even as the temporary spike in food prices – from the flood related supply chain disruption- began to subside, rising government borrowings from the SBP kept inflationary pressures up. [3] Going forward the enactment of explicit limits on government borrowings from the SBP would help in addressing medium-term inflation expectations. In the meanwhile, pursuit of macro stability through monetary policy tools called for additional tightening in the central bank's policy stance. In light of a forecast resurgent in fiscal induced inflationary pressures - while cognizant of the implications for the private sector- the SBP raised its policy rate further by 50 bps, taking it to 14 percent on Nov 29, 2010.

[1] Month-on-month food inflation rose to 5.1 percent in Aug 10; this was considerably high even after taking in to account Ramadan seasonality. See **Monetary Policy Statement (MPS) Sep2010**.

[2] While it was expected that relief and reconstruction efforts would raise government expenditure, uncertainty remained over the timing and implementation of the RGST, elimination of power subsidies, as well as introduction of additional measures to raise revenue for flood relief efforts.

[3] While the sharp rise in month-on-month food inflation observed during Aug and Sep 2010 began to subside in Oct2010, overall inflation remained persistent; CPI inflation fell only marginally by 40 bps in Oct2010 to 15.3 percent from 15.7 in the previous month. See **Monetary Policy Statement (MPS) Nov2010**.

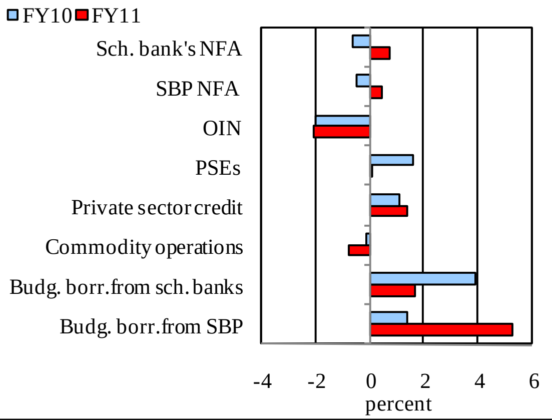
4.2 Developments in Monetary Aggregates[4]

Broad money (M2) growth accelerated to 6.9 percent during Jul-Dec FY11 from 4.7 percent in corresponding period last year (see **Table 4.1**). Almost all components show a trend reversal in their contribution to M2 growth during Jul-Dec FY11 compared to the corresponding period of FY10. In particular, government budgetary borrowings from the central bank provided the largest impetus to monetary expansion; as borrowings from scheduled banks slowed compared to last year (see**Figure4.2**). Meanwhile, an increase in the net foreign assets (NFA) of the banking system during Jul-Dec FY11 also supported M2 growth (see **Figure 4.2**).

Table 4.1: Monetary Aggregates (Jul-18th Dec)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	**FY11**	**FY10**	**FY11**
Broad Money (M2)	242.1	398.4	4.7	6.9
NFA	-55.3	69.0	-11.2	12.7
SBP	-25.4	27.8	-8.4	7.3
Scheduled banks	-30.0	41.2	-15.5	24.8
NDA	297.4	329.4	6.4	6.3
SBP	183.5	265.7	20.4	26.9
Scheduled banks	113.9	63.7	3.0	1.5

Figure 4.2: Contribution in Cumulative Growth of M2 (Jul-18th Dec)



4.2.1 Net Foreign Assets (NFA)

Reflecting the surplus in the country's external balance, NFA of the banking system expanded by Rs 69.0 billion during Jul-Dec FY11; compared with a fall of Rs 55.3 billion in the corresponding period last year. The improvement in overall NFA came from both, the central bank and scheduled banks.

Inflows from the IMF under the Emergency Natural Disaster Assistance (ENDA) in Sep 2010 reversed the fall in the central bank's NFA seen in the first two months of current fiscal year. In addition to institutional inflows and grants, net purchases of foreign exchange in the interbank market also contributed to the rise in SBP NFA during Jul-Oct FY11.

[4] This section is based on monetary survey data available up to Dec 18, 2010.

The expansion in scheduled banks' NFA came from a contraction in the current account deficit; due to robust inflows of workers' remittances and an improvement in the trade balance. As a result, commercial banks' NFA expanded despite considerably higher oil import payment pressure. [5]

4.2.2 Net Domestic Assets (NDA)

NDA of the banking system grew by 6.3 percent in Jul-Dec FY11 almost same as in the corresponding period last year. Two developments in NDA growth stand out:a) rising government budgetary borrowings from the banking system – in particular increased reliance on the central bank for financing, and b) retirements under commodity finance and a sharp deceleration in loans to public sector enterprises (PSEs) (see **Table 4.2**).

Table 4.2: Developments in NDA Components(Jul-18th Dec)

flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	**FY11**	**FY10**	**FY11**
Government borrowing	263.3	356.9	12.9	14.6
For budgetary support	272.2	400.3	16.2	19.9
SBP	72.8	304.5	6.3	25.2
Scheduled banks	199.3	95.8	38.6	11.9
Commodity operations	-7.2	-44.7	-2.1	-10.8
Non government sector	137.7	89.3	4.3	2.6
Credit to private sector	56.6	81.8	1.9	2.7
Credit to PSEs	81.9	6.8	30.7	1.9
Other items net	-103.7	-116.8	17.8	19.5

Government Borrowing for Budgetary Support

The government's reliance on the banking system was considerably higher during Jul-Dec FY11 compared to the same period last year. This was because of (a) large financing requirements of quasi-fiscal activities and defence outlays; interestingly, government spending does not appear to be led by flood relief and reconstruction activities (b) low external receipts; and (c) lower inflows in NSS during Q1-FY11 compared with the same period last year.[6]

The bulk of budgetary financing requirements during Jul-Dec FY11 were met by borrowings from the SBP[7], while borrowings from scheduled banks slowed (see **Table 4.2**). Lower borrowings from scheduled banks – and higher SBP borrowings - appear to reflect the rejection of bids by the government in the two PIB auctions held during Q1-FY11; however this was despite higher than targeted

[5] The SBP shifted oil payments to scheduled banks from Dec 14, 2009 onwards.

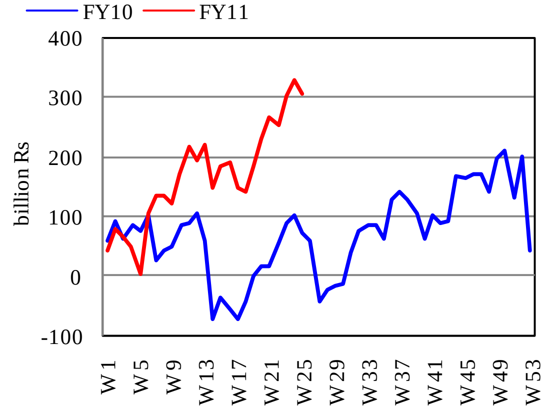
[6]The government mobilized Rs 34.8 billion through NSS in Q1-FY11 compared to Rs 53.0 billion in the same period last year.

[7] This is in contrast to last year when the government relied heavily on borrowings from scheduled banks to comply with the IMF's SBA program parameters.

acceptance from T-bill auctions and two Ijara Sukuk auctions held during this period.[8]

In fact, despite the materialization of IMF support funds in Sep 10, deficit monetization from the central bank still remained high (see **Figure 4.3**). The inflationary nature of such financing poses serious challenges for medium to long-term monetary management.

Figure 4.3: Budgetary Borrowings from SBP (Cumulative Flows)



Credit to Public Sector Enterprises

Borrowings of public sector enterprises (PSEs) decelerated considerably to Rs 6.8 billion during Jul-Dec FY11 compared with Rs 81.9 billion in the corresponding period last year. While the sharp rise in credit last year reflects the issuance of privately placed term finance certificates (PPTFCs), the slowdown in the current fiscal year is mainly the result of retirements by a power distribution company - probably due to partial payments of outstanding subsidy arrears owed by the government.

Commodity Finance

A key development in commodity finance during Jul-Dec FY11was a retirement of Rs44.7billion, compared with a fall of Rs7.2 billion in the same period last year. The bulk of the retirement was observed in wheat advances, whereas outstanding paddy advances also recorded a fall in Jul-Dec FY11. The outstanding stock of wheat loans was reduced by Rs 52.3billion. This was primarily due to a sharp retirement by the Punjab food agency during the last few weeks of the period under review as it off-loaded procured stocks in the market. In addition, by Dec 10, the TCP also reduced its loans to almost half the level of Jun10; this was made possible with the receipts of sales proceeds.[9] Meanwhile in paddy advances, PASSCO began retiring its loans by offloading previously

[8] See **4.6 Money Market**

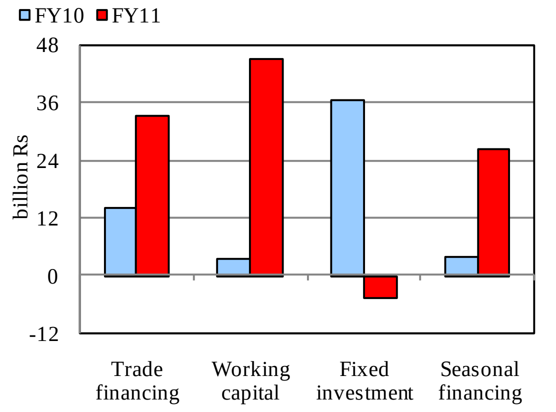
[9] During Jul-Nov FY09 the TCP obtained commodity financing from scheduled banks for wheat import. In Sep 2010 the agency retired Rs 13.2 billion against wheat advances; its outstanding stock now stands at Rs 11.9 billion (on Dec 18, 2010).

procured stock at a higher market price. However, despite the overall retirement in commodity financing, advances against sugar - mainly for import - were higher during Jul-Dec FY11 compared to the same period last year.

4.3 Credit to Private Sector (net)[10]

Net credit to the private sector expanded by Rs 81.8 billion during Jul-Dec FY11; this is encouraging when compared to a lower expansion of Rs 56.6 billion last year.

Figure 4.4: Trends in Different Types of Financing (Jul-Nov) Cumulative Flows



Detailed information for the available period Jul-Nov FY11 shows that the improvement in credit was mainly due to higher demand for seasonal and trade financing. Fixed investment loans declined during the period under review (see **Figure 4.4**). The bulk of demand for credit came from textile, retail trade, power, cement, and fabricated metals sectors.

Seasonal retirement of sugar financing lowered overall net credit demand:
A disaggregated analysis of advances shows that seasonal retirements from the sugar sector dragged down overall credit demand of the private sector (see **Table 4.3**). More specifically, private sector advances excluding sugar increased by Rs 104.1 billion during Jul-Nov FY11 compared with Rs 83.6 billion in the same period last year.

Seasonal retirements of sugar advances remained pronounced during FY11. This is explained by a higher credit off-take during the previous credit season[11] and strong profitability of sugar mills. However, a slowdown in the extent of retirement in Oct-Nov 2010 reflects the impact of fresh credit demand generated from the new crushing season which has already commenced in some areas; although some sugar mills have delayed crushing in anticipation of lower sugarcane prices.

---

[10] The discussion on net credit to the private sector is based on data available up to Dec 18, 2010.
[11] See Annual Report FY10

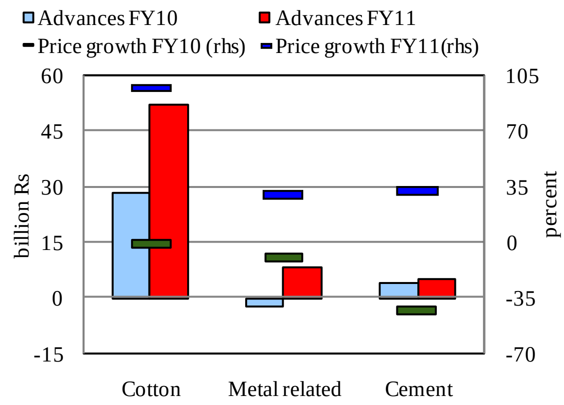
Higher raw material prices generated credit demand in some industries:
Higher domestic and international prices of raw materials provided an impetus to credit demand in some sectors such as textile, cement, iron & steel and fabricated metals.

Table 4.3: Working Capital Loans (Jul-Nov)
flows in billion Rs, growth in percent

	Flow		Growth	
	FY10	FY11	FY10	FY11
Business sector advances	3.7	45.0	0.3	4.1
Manufacturing	2.4	20.0	0.4	3.6
Rice Processing	1.5	8.2	5.6	31.9
Sugar	-29.3	-30.5	-60.0	-58.6
Textiles	35.3	47.5	17.2	26.1
a. Spinning	24.3	36.7	20.6	38.7
b. Weaving	6.6	5.8	24.8	20.7
Cement	0.4	-1.7	1.6	-6.9
Basic metals	-2.8	2.2	-16.1	14.0
Domestic appliances	-0.1	1.6	-1.2	32.9
Electricity, gas and water supply	-3.5	3.7	-7.4	6.6
Construction	-2.7	2.4	-5.9	6.0
Commerce and Trade	1.6	13.2	0.9	8.0
a. Retail trade	3.4	19.3	5.2	26.4

More specifically, with the onset of the procurement season, financing requirements of the spinning sector picked up in Oct 2010; after a net retirement during initial three months of FY11. Working capital loans formed the bulk of the increased financing requirements of the spinning sector, probably due to higher raw cotton prices. Moreover, on the back of a recovery in global demand for textile products, trade loans other than the EFS scheme also contributed to the increased credit off-take by the spinning sector.

Figure 4.5: Movement in Advances and Prices (Jul-Nov)



*working capital and trade advances

The increase in advances to the cement sector during Jul-Nov FY11came largely from import financing; anecdotal evidence suggests that the recent rise in international coal prices has translated into higher credit demand for import financing.[12] Similarly, fabricated metals and iron &

[12] Anecdotal evidence suggests that cost of raw material (coal) is 25-30 percent of the total costs of production of cement manufacturers.

steel industries also availed considerably higher import financing compared to last year on account of higher input prices in international markets (see **Figure 4.5**).

Demand led recovery also seen in a few sectors:
In addition to the rise in input prices, a higher credit off-take in certain sectors reflects growth in production. For instance, credit demand from the domestic appliances sector probably reflects increased production during Jul-Nov FY11; this can be substantiated by the positive contribution of consumer durables demand in overall consumer financing.

Similarly the recovery in global demand for textile products led to higher activity in the weaving sector. The sector expanded its production capacity, as shown by the increase in fixed investment loans during Jul-Nov FY11. It may be noted that in the 2010-11 budget the government offered an incentive to tax-paying companies undergoing balancing, modernization, and replacement (BMR) by extending a 10 percent tax credit. This also contributed to the rise in fixed investment loans.[13]

Furthermore, a revival in construction activities increased the working capital requirements of construction and allied industries. The commerce and trade sector also showed strong demand for credit during Jul-Nov FY11- particularly in the retail trade sector.

Consumer Loans
During Jul-Nov FY11, retirements in consumer loans were less than half the amount returned in the same period last year. All categories of consumer loans witnessed a slowdown in net retirements - notably personal loans. In fact, loans for consumer durables witnessed a net expansion during Jul-Nov FY11.

A deceleration in net retirements of auto loans during Jul-Nov FY11 was due to a significant increase in sales of both cars and motorcycles. This deceleration is purely demand-led since not only has the production and sale of locally manufactured cars and motorcycles increased during Jul-Nov FY11, the import of motor vehicles has also rebounded in the period under analysis (see **Table 4.4**).

[13] The tax credit concession is proposed for five years from FY11 to FY15 and the concession will be available in the same year in which the costs will be incurred.

Table 4.4: Production, Sales and Imports of the Auto Sector
Production and sales in units, imports in million US $

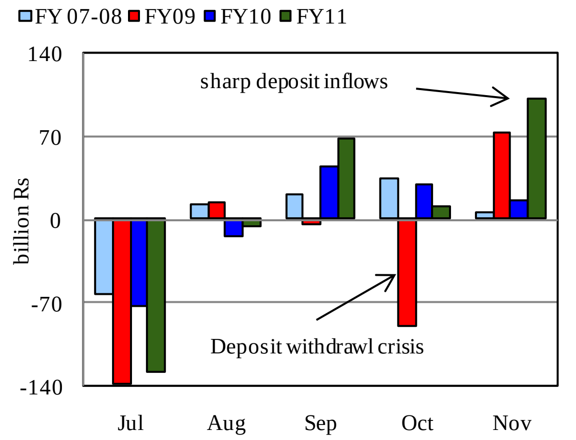
	Cars			Motor Cycles		
	FY10	**FY11**	**Growth (%)**	**FY10**	**FY11**	**Growth (%)**
Production	46,593	54,381	16.7	292,231	319,297	9.3
Sales	46,497	52,200	12.3	290,461	318,429	9.6
Imports*	192.8	231.6	20.1	24.4	31.8	30.2

*Imports of cars and motorcycles includes both completely built and knock down units (FBS Jul-Oct data)
Source: PAMA

4.4 Deposit Mobilization[14]

Banks' deposit base grew by 1.0 percent during Jul-Nov FY11 compared with a decline of 0.1 percent in the same period last year. However, this growth appears to be driven by an exceptionally sharp inflow in Nov 2010 (see **Figure 4.6)**.

Figure 4.6: Monthly Deposit Flows (Jul-Nov)



Indeed, excluding Nov, deposit performance for Jul-Oct FY11 shows a larger contraction than in the same period in previous years. [15] In fact, the slowdown in banks' deposit base in the last couple of years reflects a more general shift in agents' liquidity preferences away from bank deposits.

In addition, in the current fiscal year, government deposits witnessed a withdrawal during the period under review; net withdrawals of government deposits during Jul-Nov were unusual[16].

[14] The analysis presented in this section is based on customer deposits of the banking industry for the period Jul-Nov FY11; this does not include the deposits of financial institutions.
[15] During Jul-Oct FY11, deposits experienced a larger contraction of 1.2 percent compared with a decline of 0.3 percent in the same period last year; and growth of 0.1 percent for FY07-08.
[16] However, even excluding government deposits, banks' deposit base contracted by 1.0 percent during Jul-Oct FY11.

Shifting liquidity preferences: Both, the currency to deposit ratio, and M3 to M2 ratio, have been rising over the last couple of years; their rise represents a shift in agents' preferences away from bank deposits (see **Figure 4.7**). In particular, while a rising currency-to-deposit ratio reflects a shift in preferences towards currency holdings; the rise in M3 relative to M2 represents the rising competition banks face in deposit mobilization from non-bank sources, most notably National Savings Schemes (NSS).[17]

This shift in preferences away from bank deposits may be due to rising costs of using the banking system e.g., the withholding tax on financial transactions and negative real returns on bank deposits (see **Figure 4.8**).[18] Indeed, it appears that higher real returns, along with the security of investment in NSS instruments have provided strong competition to banks' time deposits in recent years (see **Figure 4.9).**

Figure 4.7: Shifting Liquidity Preferences

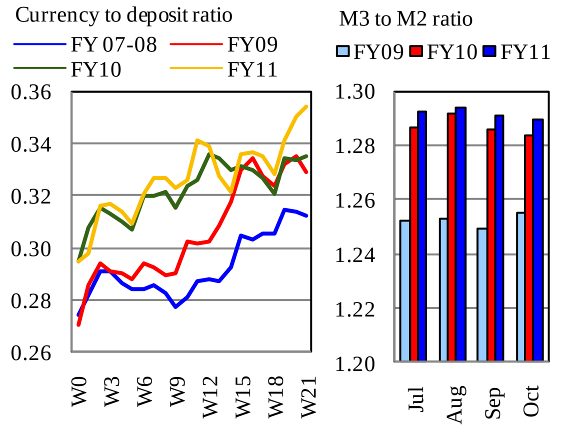
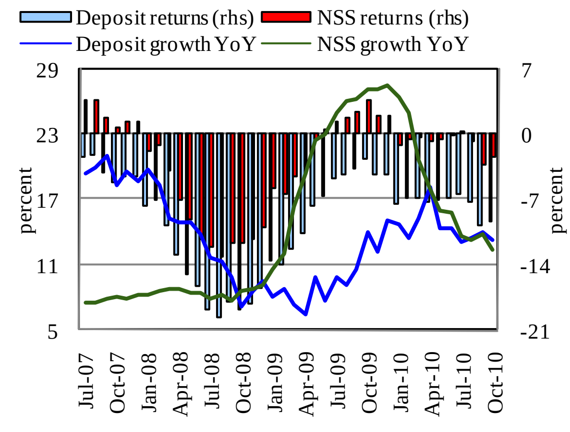


Figure 4.8: Bank Deposits & NSS: Real Returns and Growth



[17] It may be noted that institutional investments in NSS were re-allowed in Oct 2006, after a ban imposed in Mar 2000. For details see **First Quarterly Report FY07**.

[18] For FY11 the scope of the tax has been extended to include all bearer financial instruments. For a detailed analysis of the rising role of currency in monetary assets see **Annual Report FY10**.

Government Deposit withdrawals from a few large banks during Jul-Nov FY11: In addition to seasonality and the impact of shifting liquidity preferences, government deposits witnessed a net withdrawal of Rs 13.1 billion during Jul-Nov FY11.[19] This was in contrast to net inflows during the same period in previous years (see **Figure 4.10**). In line with the trend over the last couple of years, government deposit withdrawals appear to be concentrated in the industry's largest banks; three large banks account for the bulk of these withdrawals during Jul-Nov FY11.[20]

Figure 4.9: Banks' Time Deposits and NSS: YoY Growth

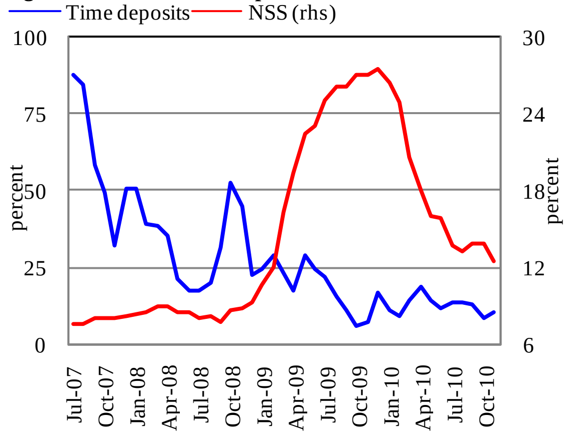
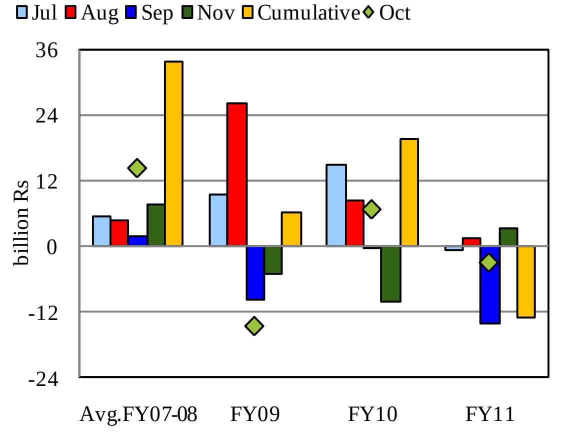


Figure 4.10: Government Deposit Flows (Jul-Nov)



4.5 Non-Performing Loans[21]

Commercial banks' asset quality metrics deteriorated further during Q1-FY11; gross NPLs increased by Rs 34.2 billion over June 2010, to reach Rs 494 billion. The increase in infected loans was considerably higher than in the four quarters of FY10. Further, advances also fell by Rs 49 billion; resulting in a worsening of the NPLs to loan ratio (see **Figure 4.11**).

The movement of NPLs shows that both the additions and reductions reflect deterioration during Q1-FY11 (see **Figure 4.12**). More specifically, total additions to NPLs were Rs 51.8 billion; considerably higher when compared to an

[19] Withdrawals occurred at both federal and provincial levels.
[20] These include a public sector bank and two local private banks.
[21] This section is based on quarterly data available up to Q1-FY11.

increase of Rs 43.9 billion during Q1-FY10. This deterioration in higher additions was primarily experienced by the corporate sector in both working capital and fixed investment loans during Q1-FY11 compared with the same period a year before.

Figure 4.11: Non Performing Loans

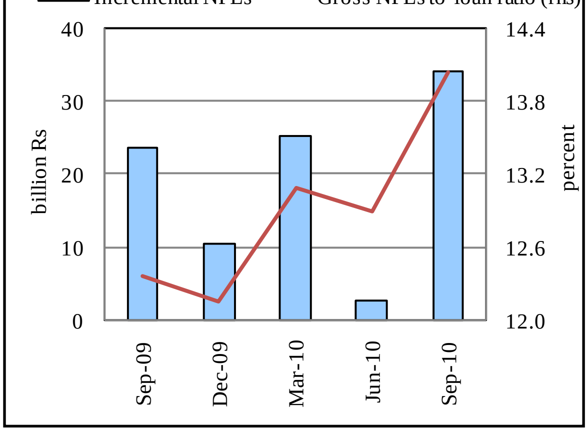
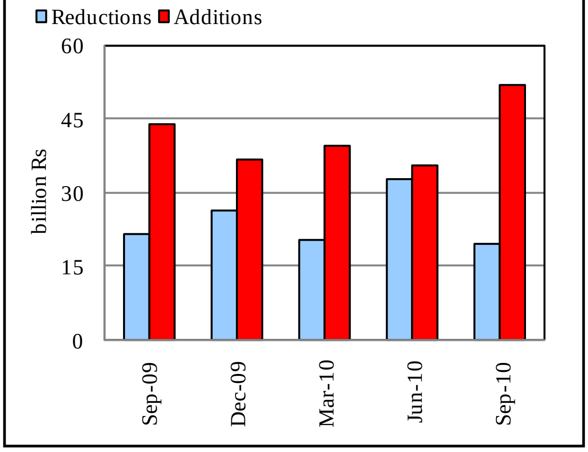


Figure 4.12: Movement in Non Performing Loans



4.6 Money Market[22]

Liquidity conditions in the money markets improved during H1-FY11 compared with the same period last year (see **Figure 4.13)**.

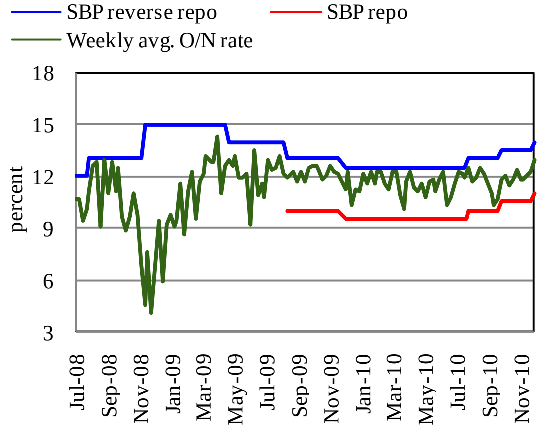
In the primary market, activity was dominated by T-bills and above target acceptance in the two Ijara Sukuk auctions; the government rejected all bids received in the first two Pakistan Investment Bond (PIB) auctions during H1-FY11, but accepted slightly above the target in the last auction. Further, T-bill auction results highlight considerable government appetite for borrowing and a shift in agent's bidding preferences towards shorter-tenor maturities; reflecting that the most recent increase in the SBP's policy rate in Nov 2010 was widely expected by the market.

[22] This section is based on data for the period Jul-Dec FY11.

4.6.1 Liquidity Management

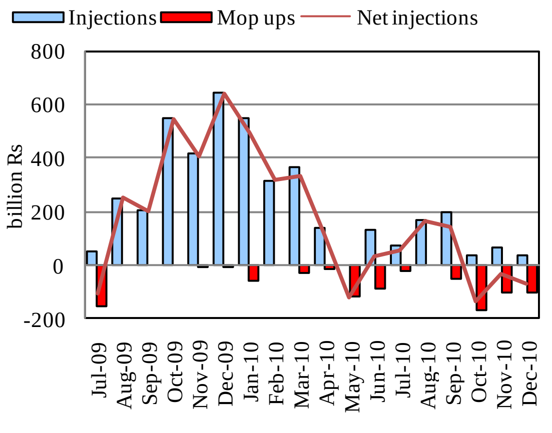
As liquidity conditions in the money markets improved, the SBP made a lower net injection of Rs 121.3 billion into the system through its Open Market Operations (OMOs) during H1-FY11, compared with Rs 1949.7 billion in the corresponding period last year (see **Figure 4.14**).

Figure 4.13: Trends in Overnight Repo Rates



Mop ups during Q1-FY11 were also considerably lower than the same quarter last year; perhaps due to banks' access to the SBP's Repo Facility to deposit their day-end funds with the central bank.[23] However, a considerable net absorption by the central bank during Q2-FY11 - in order to maintain consistency of the overnight repo rate with the policy stance - led to a higher mop up for the cumulative H1-FY11 period against the comparable period last year (see **Figure 4.14**).

Figure 4.14: Open Market Opertations (OMOs)



4.6.2 The Primary Market

Treasury Bills

Activity in the primary market for T-bills reflects considerable government appetite for borrowing. While the net target (adjusted for maturities) for H1-FY11was considerably lower compared with the same period last year, the government borrowed above target; Rs 199.6 billion were accepted net of maturities (see **Table 4.5**).

---

[23] The Repo Facility was introduced in Aug 2009 as part of the new liquidity management system. The facility allows banks to deposit their day-end surplus funds with the SBP at a rate 300 bps below the Reverse Repo rate. See **Monetary Policy Statement (MPS) Jul-Sep 2009**.

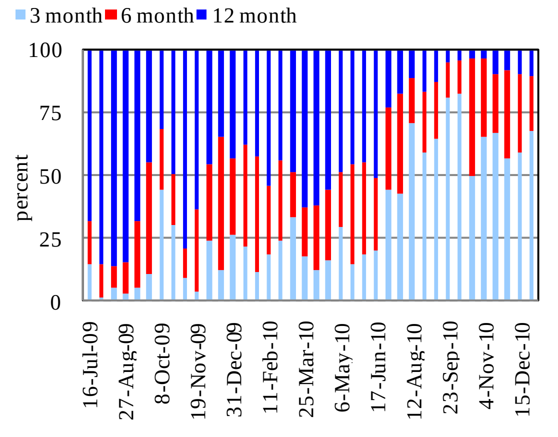
On the supply-side, while risk-averse banks[24] showed continued interest in government securities, the bid-to-cover ratio declined to 1.9 during H1- FY11, compared with 2.7 last year.[25] This may reflect the considerable roll-over of maturing securities, in the face of a gradual opening up of alternative asset allocation avenues for banks in the private sector[26] (see **Table 4.5)**. Further, the bulk of bids received in T-bill auctions were for 3 month maturities; as agents' preferences shifted towards the short-end of the yield curve in anticipation of the increase in the SBP's policy rate on Nov 29, 2010 (see **Figure 4.15**).

Table 4.5: Treasury Bills Auction Profile (H1-FY11)

billion Rs

	Maturities	Target	Offer	Accepted
FY09	720.7	855.0	1014.4	736.3
FY10	257.4	470.0	1290.3	531.0
FY11	1226.7	1220.0	2320.8	1426.3

Figure 4.15: Bidding Pattern in T-bill Auctions



Pakistan Investment Bonds

Four auctions of Pakistan Investment Bonds (PIBs) were scheduled for H1-FY11. While bids were received in all tenors, the government rejected all bids in the first two auctions. However, the last two auctions saw a pickup in acceptance of offers for long-term securities; the last auction in particular resulted in above targeted acceptance (see **Table 4.6)**. The rejection of bids for longer-term securities during Q1 FY11 reflects the government's reluctance to raise funds at higher rates. This may also explain the higher than targeted acceptance in T-bill auctions as

Table 4.6: PIB Auctions (H1-FY11)

billion Rs

Auction Date	Target	Offered	Accepted
22-Jul-10	20.0	19.9	0.0
18-Aug-10	25.0	15.6	0.0
13-Oct-10	20.0	17.1	7.9
22-Dec-10	20.0	33.1	21.1

[24] Banks' asset quality metrics deteriorated during Q1-FY11; see **4.5 Non-Performing Loans (NPLs)**.

[25] The bid-cover is defined as the ratio of the offered amount to the target. A higher ratio indicates aggressive bidding by participants and hence a successful auction.

[26] See **4.3 Private Sector Credit**

well as higher government borrowings from the central bank.[27]

Ijara Sukuk

In line with the announced calendar, two auctions of the 3-year Government of Pakistan Ijara Sukuk were held during Q2-FY11. Again, auction results highlight considerable government appetite for borrowing; not only was the target at Rs 40 billion for each auction considerably higher than previous auctions[28], the government accepted above target at Rs 89.0 billion from these auctions.

[27] See 4.2 Monetary Aggregates

[28] The target for each of the previous four auctions held between Sep 2008 and Sep 2009 was set at Rs 10 billion.

………………This page is left blank intentionally……………….