4 Money and Credit

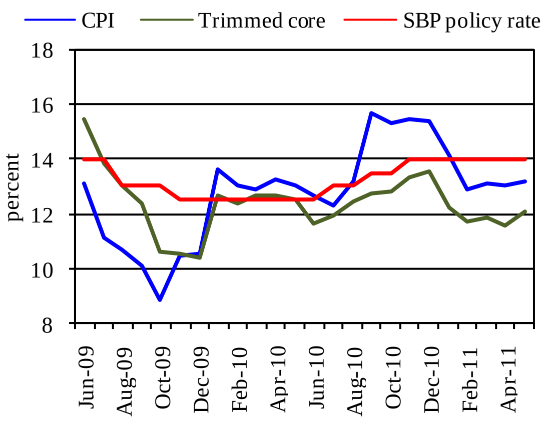
4.1 Overview

The improvement in the external account, and some let-up in government borrowing from SBP, allowed SBP to keep its policy rate unchanged at 14.0 percent in the last three policy announcements (January, March and May 2011). These decisions reveal a shift in monetary policy when compared to a cumulative increase of 150 bps in the policy rate during H1-FY11.

The key challenges for monetary policy included weak domestic economic activity, double-digit inflation, risks of reversal in the external account and a large fiscal deficit that requires on-going domestic financing. Although the impact of the floods on domestic prices has clearly dissipated, inflationary pressures remain (see **Figure 4.1**). More disturbingly, as discussed in the previous chapter, the outlook for inflation is not encouraging.

Another key concern for monetary policy could stem from the possible reversal in the external account. Specifically, any pressure on the external sector would impact Rupee liquidity in the interbank money market, thereby complicating the implementation of monetary policy.

Figure 4.1: Policy Rate & Inflation



On the fiscal side, the government is currently working with a revised deficit target of 5.5 percent of GDP. However, since the budget deficit during Jul-Mar 2011 has already reached 4.5 percent of GDP, meeting the annual target will be challenging.

Despite these fiscal pressures, the government has kept its commitment to SBP, and broadly contained borrowings from the central bank at end-September 2010 levels. In fact, during Q3-FY11, the government retired Rs 107.3 billion to SBP. This containment, along with significant improvement in external account, is the key reason for an unchanged policy rate during H2-FY11.

However, the recent increase in government borrowing from SBP to pay-off the quasi-fiscal expense in the energy sector (the circular debt), appears to be a departure from its commitment. In our view, this surge in government borrowing is temporary, and we hope this will converge to the end-September 2010 level by the end of the current fiscal year as committed by the government.

4.2 Monetary Aggregates

According to available information, both the net foreign assets (NFA) and net domestic assets (NDA) of the banking system contributed to monetary expansion during Jul 1st - May 28th 2011 (see **Table 4.1**). While NFA of the banking system showed an expansion of Rs 170.8 billion (mirroring the comfort in the external account[1]) during this period, NDA increased sharply by Rs 507.1 billion.

Table 4.1: Monetary Aggregates (Jul 1st - May 28th, 2011)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	FY11	FY10	FY11
Broad money (M2)	463.6	677.8	9.0	11.7
NFA	-22.3	170.8	-4.5	31.3
SBP	2.9	147.4	0.9	38.9
Scheduled banks	-25.2	23.3	-13.1	14.0
NDA	485.9	507.1	10.5	9.7
SBP	155.4	113.4	17.2	11.5
Scheduled banks	330.5	393.6	8.8	9.3

Major components affecting NDA of the banking sector are briefly reviewed in the following discussion.

Table 4.2: Major Components of NDA (Jul 1st -May 28th, 2011)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	FY11	FY10	FY11
Government borrowing	422.2	563.5	20.8	23.1
For budgetary support	371.1	608.3	22.1	30.2
SBP	142.6	129.5	12.2	10.7
Scheduled banks	228.5	478.8	44.3	59.6
Commodity operations	52.0	-49.0	15.5	-11.9
Non government sector	173.3	121.1	5.4	3.6
Credit to private sector	103.5	102.5	3.6	3.4
Credit to PSEs	68.9	18.1	25.9	5.1

Government borrowing for budgetary support

Fiscal slippages and inadequate external funding led to over 30 percent increase in government borrowing for budgetary support during Jul 1st - May 28th 2011 (see **Table 4.2**). This accounts for 89.7 percent of the expansion in broad money.

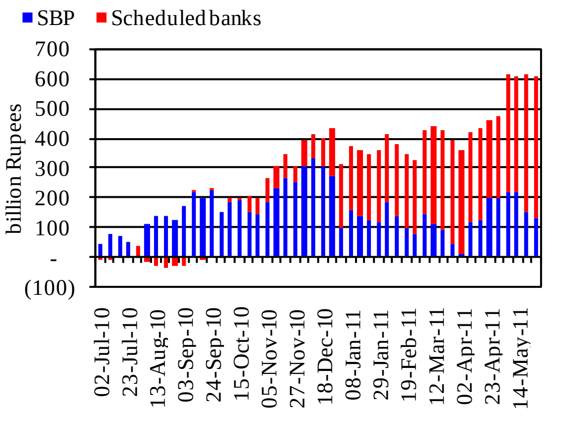
Government borrowing for budgetary support can be viewed in three distinct phases. In the first phase that runs till mid-December 2010, the government relied

[1] The external accounts indicate a current account *surplus* of US$ 748 million during Jul-Apr 2011 against a current account *deficit* of US$ 3,456 million over the same period last year (for details, please see Chapter 6 on **External Sector**).

primarily on SBP borrowings. Thus, from July to mid-December 2010, the government borrowed Rs 413.5 billion from the banking system; of which Rs 328.6 billion was from SBP.

The second phase starts from mid-December 2010 till end-March 2011. During this period, the government was able to contain its borrowings from the banking system. More importantly, the government even replaced some SBP debt by borrowings from commercial banks. This helped the government contain its borrowings from SBP at end-September 2010 levels. Hence, in net terms, the government retired Rs 286.1 billion to SBP (see **Figure 4.2**). The containment of government borrowings from SBP was facilitated by two developments:

Figure 4.2: Cumulative Government Borrowing



1. The National Saving Scheme (NSS) witnessed net inflows of Rs 87.2 billion in Q3-FY11, which was substantially higher compared to the first two quarters.

2. Increase in bank deposits, seasonally low demand for private sector credit, retirement of commodity finance loans, and the rupee liquidity stemming from a buildup in FX reserves, helped banks to finance the government without putting pressure on interest rates. Cut-off rates in T-bill auctions witnessed a slight decrease over the same period.

The third phase starts from April 2011 onwards. From April 2nd till mid-May 2011, the government borrowed Rs 207.9 billion from SBP. A large part of this borrowing was meant to pay-off the growing circular debt in the energy sector. In other words, this borrowing is actually financing the *carry-over* of quasi-fiscal deficits from previous years. More importantly, SBP expects government borrowings will soon converge to end-September 2010 levels. In fact, a portion of this borrowing has already been shifted to commercial banks through an outright sale of government securities into open market.

Credit to PSEs

Net credit to public sector enterprises declined to Rs 18.1 billion during Jul 1st – May 28th 2011 compared to Rs 68.9 billion over the same period a year ago. This slowdown primarily reflects improvement in the cash flow of PSEs as the government decided to gradually increase electricity tariffs and pass on changes in international oil prices to domestic consumers. However, the outstanding loans to PSEs are still hovering around Rs 350 billion.

Government borrowing for Commodity Operations

The much awaited government decision to export surplus wheat in Q3-FY11, is an important step towards dealing with the growing problems in commodity operations. This measure accelerated the retirement of wheat financing loans by the government and created much needed room for wheat procurement before arrival of the fresh crop (in the last week of March 2011).

Nonetheless, outstanding commodity operations loans as of May 28th 2011 stood at Rs 364.2 billion. Of this, Rs 205.1 billion is on account of borrowings for commodity operations in previous years.[2] This includes subsidy 'receivable' from the federal and provincial governments, which amounts to Rs 118.5 billion as of May 28th 2011. In a sense, this is another example of a quasi-fiscal operation that the government needs to internalize in the forthcoming year.[3]

Credit to Private Sector[4]

While private sector business continued to utilize bank credit, there is hardly any credit demand for new investment activities in the economy. Specifically, the growth of credit to private sector was slightly lower at 3.4 percent during Jul-May 28th 2011 compared to 3.6 percent over the same period in FY10.

Working capital loans during Jul-Apr 2011 jumped to Rs 144.7 billion against Rs 47.4 billion in the corresponding period of FY10 (see **Figure 4.3**). This three-fold increase in demand for working capital loans is due to the rise in raw material prices, especially of cotton, sugarcane and edible oil. Both textile and sugar

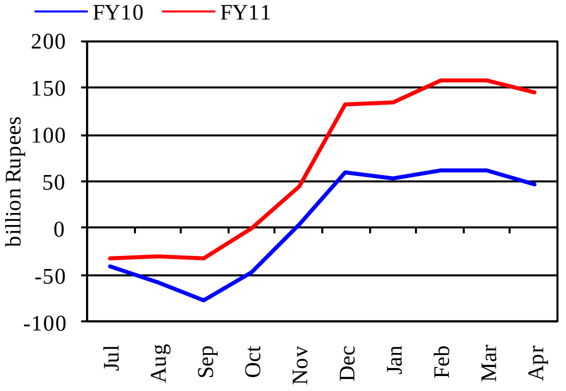
[2] It also shows that the government commodity operations are not self liquidating as they are generally envisaged.

[3] Any decision to settle these subsidies will have no monetary implications since the government agencies have already borrowed from the banking system. Furthermore, the government stands to gain from recognizing quasi-fiscal expenses because: (a) it will render fiscal accounts more transparent; and (b) the government will be able to substitute expensive commodity operations loans with relatively less expensive market based borrowing.

[4] While the overall credit numbers are based on monetary survey data, the detailed discussion in this section relies on loans to private sector businesses.

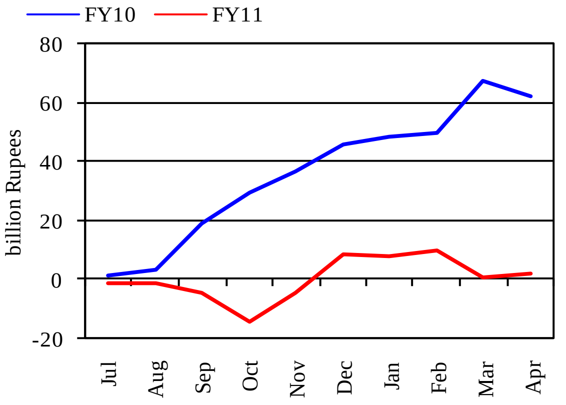
sectors accounted for 68.5 percent of the rise in working capital loans over the period of analysis.

Figure 4.3: Changes in Working Capital Loans



The surge in exports increased the demand for trade loans. These loans increased by Rs 68.0 billion during Jul-Apr 2011 compared to Rs 21.0 billion in the previous year. The sectoral distribution of trade loans reflects the dominance of the textile sector, which accounts for 71.6 percent of the rise.[5]

Figure 4.4: Changes in Fixed Investment Loans



Compared to the significant increase in working capital and trade loans, the fixed investment component saw a nominal increase of only Rs 1.7 billion against an expansion of Rs 62.0 billion over the same period last year (see **Figure 4.4**). Monthly data indicate net retirement of investment loans in 6 out of 10 months of this fiscal year. This does not bode well for the economy.

Compared to slow growth in credit for businesses, consumer loans witnessed net retirement for a third year in succession. The share of consumer financing in private sector loans has declined to 7.7 percent in April 2011, as compared to 9.1 percent as of end-June 2010. In absolute terms, these loans witnessed net retirement of Rs 21.8 billion in Jul-Apr 2011 against Rs 44.4 billion in the previous year. This slowdown in net retirement is largely because banks are reluctant to provide fresh loans, while outstanding loans continue to be paid-off.

[5] Unsurprisingly, textile related exports accounts for 55.3 percent of total exports over the period of analysis.

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