4 Money and Banking

4.1 Overview

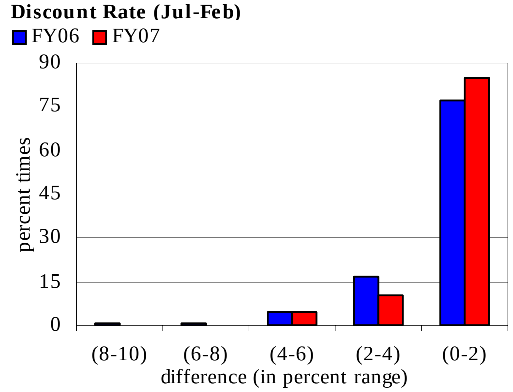
Although decelerating, CPI inflation remained high through Jul-Feb FY07 and therefore, in line with its policy bias towards maintaining price stability, SBP continued to focus on moderating the excess demand pressures in the economy by retaining its tight monetary policy throughout the period. However, at the same time, SBP was also mindful of the need to ensure the availability of credit for exporters and industrial investment in the textile sector to sustain long term economic growth. This was necessary to address recent slowdown in export growth and the resulting pressures on the external account.

Table 4.1: Key Monetary Aggregates

	Units	FY06	FY07
Reserve money growth (24th Feb)	percent	9.6	15.3
Credit to deposit ratio (average Jul-Feb)	percent	82.3	85.2
Overnight rates volatility (Jul-28th Feb)		0.16	0.14
Liquidity ratio	percent	30.3	30.1
Absorptions through OMOs (Jul-Feb)	number	44	46
Injections through OMOs (Jul-Feb)	number	18	4

Consistent with its objective of maintaining price stability, SBP not only raised reserve requirements for banks with effect from July 22, 2006 but also increased the discount rate by 50 bps to 9.5 percent a week later. In addition, SBP continued further with its frequent open market operations (OMOs) to drain excess liquidity from the inter-bank market (see **Table 4.1**). This is evident from a persistent narrow spread between the discount rate and overnight rate throughout Jul-Feb FY07 period (see **Figure 4.1**).[1] Finally, in order to improve liquidity management in the inter bank market, SBP raised the daily minimum reserve requirements for banks effective from January 18th 2007.[2]

Figure 4.1: Deviation of Overnight Rates from Discount Rate (Jul-Feb)



[1] It may be noted that due to increase in discount rate in July 2006, volatility in overnight rates computed as coefficient of variation is not directly comparable. The **Figure 4.1** clearly shows that

Table 4.2: Composition of Money Supply (Jul-24th Feb)

	Growth (in percent)		Contribution to M2 growth	
	FY06	FY07	FY06	FY07
NDA	14.5	8.2	11.4	6.5
Non-government credit	17.4	10.1	10.5	6.5
Government borrowing	15.7	5.1	4.0	1.2
Other items (net)	-44.1	13.6	-3.1	-1.2
NFA	-12.7	6.0	-2.7	1.2
M2	**8.7**	**7.7**	**8.7**	**7.7**

At the same time, SBP was also concerned about the recent slowdown in export growth and growing long-term investment needs in textile industry. Accordingly, SBP first lowered the export refinance rate in July 2006, thereby reducing the cost of financing to industry to around 300 bps below market rates.[3] This is in addition to the long term financing for export oriented projects (LTF-EOP) which is extended at 4-5 percent or 600-700 bps below market rates for 3-7 years.[4] Later in September 2006, SBP offered a debt swap option to textile sector to convert its fixed investment loans into relatively cheaper LTF-EOP facility.[5] Not only these measures led to additional liquidity injections into the economy, these also resulted in negative real lending rates on EFS and LTF-EOP.

Despite the liquidity injections, M2 growth has slowed, indicating that monetary policy has been effective (see **Table 4.2**). Specifically, M2 growth decelerated to 7.7 percent during Jul-Feb FY07 period compared to 8.7 percent during the corresponding period of previous year. This slowdown primarily stemmed from lower growth in non-government sector credit. Private sector credit growth remained strong despite structural constraints (see **Section** on **Credit to Private Sector** for details). On the other hand, the government borrowings from the banking system during Jul-Feb FY07 were also low, this was mainly on account of greater availability of external financing. The impact of this on reserve money was offset by a rise in net foreign assets (NFA) of the banking system.

the overnight rate has remained within a close range (0 - 2 percent) to the discount rate more of the times during Jul-Feb FY07 compared to the corresponding period of FY06.

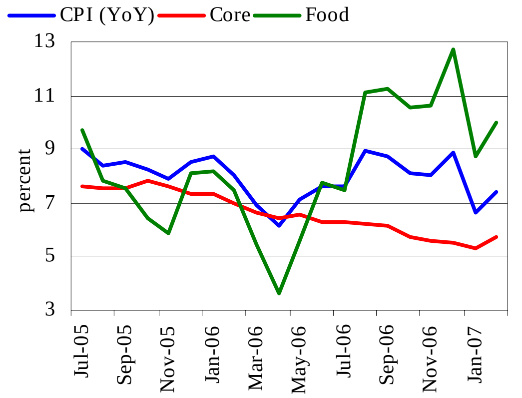
[2] SBP increased the daily minimum requirements to 2 percent and 6 percent for time and demand liabilities (from earlier levels of 1 percent and 4 percent) respectively.

[3] SBP also capped the maximum margin/spread of banks at 1 percentage point from 1.5 percentage points earlier.

[4] In July 2006, the maximum margin/spread for banks/DFIs on loans under LTF-EOP was reduced from 3 percent per annum to 2 percent per annum.

[5] Textile sector received bulk of the outstanding export refinancing of Rs 134 billion and all of the LTF-EOP amounting to Rs 43.5 billion (as of February 2007). Of the total credit provided to textile sector during Jul-Feb FY07, 37 percent is concessional; excluding spinning (which is not eligible for EFS and LTF-EOP), the share of concessional financing rises to 83 percent.

Figure 4.2: Inflation Trends



SBP's continued focus on maintaining price stability has also resulted in a further moderation in inflationary expectations as evident from a continued downtrend in core inflation that has slowed to 5.7 percent YoY in February 2007 from 7.0 percent YoY in February 2006 (see **Figure 4.2**).

More importantly, this slowdown in inflationary pressures has been achieved without significantly affecting the growth momentum. Current SBP estimates suggest that the GDP growth will be higher than the FY06 level of 6.5 percent which is well above the long term growth trajectory.[6]

Indeed, it is important that SBP's monetary policy continue to focus on price stability if the high growth trend is to be sustained. This is because the high inflation has economic and social cost as it (1) negatively affects investment activities in the economy by creating uncertainty about the future output and input prices and profitability; (2) undermines confidence in the domestic currency; (3) diverts activities from efficient management and production towards maneuvering and speculation to benefit from inflation; (4) discourages long term contracts as resources are wasted on frequent negotiations; and (5) and exerts negative effect on consumer spending by reducing the real value of consumer wealth. Thus, the focus of the Central Bank should be on maintaining price stability. However, in doing so, it should be vigilant to a number of key risks and challenges to the monetary policy.

The *foremost* concern for the Central Bank is the overall CPI inflation that has remained stubbornly high throughout Jul-Feb FY07 and was increasing through most of the period. As a result, the overall CPI for FY07 is expected to be higher than the 6.5 percent target for the year.

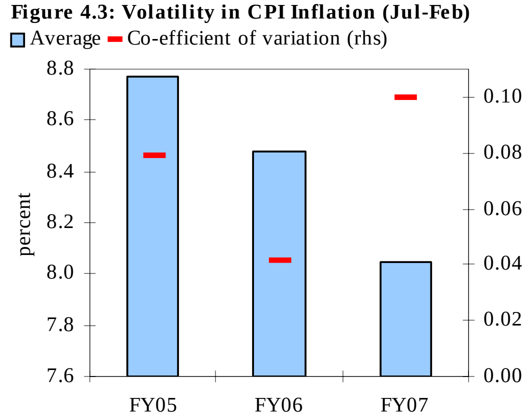
It is important to note that these inflationary pressures were mainly driven by persistently high food inflation reflecting supply shortages. This is evident from a

[6] The average growth rate for the period FY1951-2006 has been 5 percent.

sharp 4.0 percentage point decline in food inflation in January 2007 over January 2006. This clearly shows that to the extent inflationary pressures are emerging from high food prices, overall CPI will be less responsive to monetary policy changes.

This suggests that if SBP had firmly aimed at containing the overall CPI inflation to its target for the year, this would have required excessive monetary tightening, with a further rise in discount rate. This would have risked economic growth prospects particularly when the core inflation (that represents underlying excess demand pressures in the overall economy) has been showing steady decline. Further, it was expected that the lagged transmission of monetary tightening pursued in previous year as well as tightening measures taken in early FY07 will be sufficient in eliminating excessive demand pressures from the economy.

Figure 4.3: Volatility in CPI Inflation (Jul-Feb)



Nonetheless, SBP still remains concerned about high and volatile trends in overall CPI (even if it is driven by pressures stemming from supply-side disturbances) as this could potentially serve as a constraint in aligning inflation expectations with the Central Bank policy signal (see **Figure 4.3**).

A *second* concern for SBP's monetary policy is the sharp rise of 15.3 percent in reserve money during Jul-Feb FY07 compared to 9.6 percent growth realized during the corresponding period of the previous year (see **Table 4.3**). This high growth in reserve money does not bode well as it dilutes the Central Bank's monetary tightening even though it is not yet translated into a surge in overall M2 growth. The argument rests on the notion

Table 4.3: Reserve Money Growth (Jul-Feb)

	billion Rs		% share in change	
	FY06	**FY07**	**FY06**	**FY07**
Government sector	178.2	25.9	19.6	2.6
Private sector	-0.7	58.0	-0.1	5.8
NFA	-42.5	25.3	-4.7	2.5
Other items net	-45.9	45.9	-5.1	4.6
Others	-1.9	-1.8	-0.2	-0.2
Reserve money	**87.2**	**153.2**	**9.6**	**15.3**

that the reserve money is the most inflationary source of monetary growth that potentially weakens the expectations channel of monetary policy transmission.[7]

Ironically, a significant part of the reserve money growth during Jul-Feb FY07 was caused by debt swap facility offered by SBP to the textile sector that only resulted in liquidity injection in the banking system to the tune of Rs 36.5 billion.[8] Further as explained earlier, in addition to debt swap, SBP is also providing fresh concessional financing under LTF-EOP and export refinance facility.

It is important to note that these incentives provided by SBP have significant impact on reserve money growth. In fact, unless neutralized by SBP through its open market operations. The impact of loans extended under LTF-EOP scheme on reserve money would persist for some years as these loans have a maturity of 3-7 years. Similarly, although the EFS loans are short term in nature focusing on working capital requirements, their outstanding stock may remain high due to considerable interest rate differential between the prevailing market rates and the rates on these schemes.

Table 4.4: Deficit Financing[1]

billion Rupees

	Jul-Dec FY06	Budgetary estimates FY07	Jul-Dec FY07
External	39.8	171	96.2
Non-bank	-6.7	8	25.3
Privatization proceeds	18.7	75	15.9
Sub-total	**51.8**	**254**	**137.5**
Total financing	**136.7**	**285**	**169.0**
Banking system	84.9	120	31.5

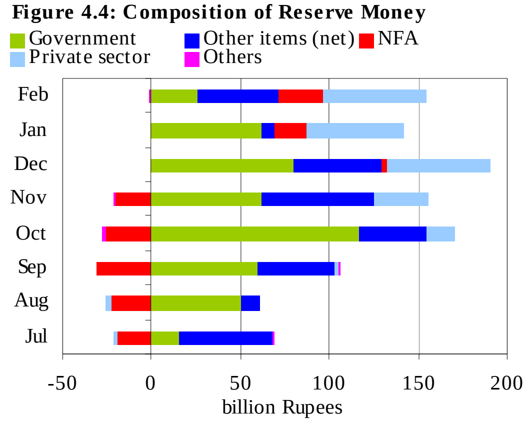
Source: Ministry of Finance (MoF), quarterly data.
[1] The MoF and SBP numbers differ due to differences in timings and definitions

[7] In the inflation expectation channels, credibility of the Central Bank plays the key role managing expectations regarding inflation. If economic agents believe on the Central Bank and are confident that inflation will be kept low in future, they will adjust the wages and salaries upwards only moderately. In addition, firms will consider the prevailing increase in costs as temporary and will maintain the prices stable. In this manner, expectations of low inflation can help central bank achieve price stability objective.

[8] In order to provide a relief to textile sector that was facing high financing cost on its earlier outstanding loans, SBP allowed a one time opportunity to refinance its market based fixed term loans availed from banks/DFIs for import of plant & machinery with loans under SBP's LTF-EOP scheme. The mark-up under LTF-EOP scheme remains fixed for the tenor of the loan and is significantly lower than the market rate. SBP provided banks the entire amount of the outstanding loans eligible under this facility at subsidized rates of LTF-EOP. As a result, banks received liquidity which they had locked in their long term loans to the textile sector.

Another major contributor to reserve money growth is the government borrowing from the Central Bank and external sector. As explained earlier, the budgetary borrowings from the SBP is markedly low during Jul-Feb FY07 compared to the corresponding period of previous year.

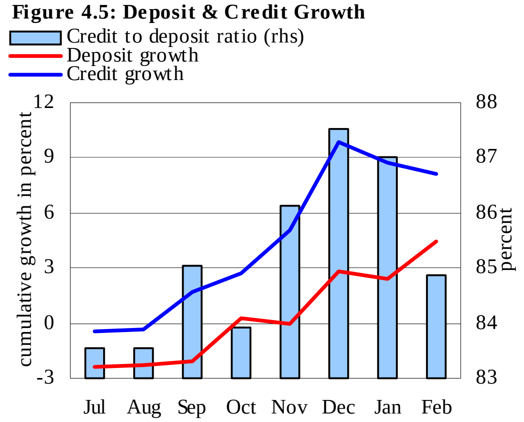
Figure 4.4: Composition of Reserve Money



This was possible mainly due to greater availability of financing from external and non-bank sources (see **Table 4.4**).[9] Thus, though the government has retired part of its earlier borrowings from the SBP during the year, to the extent the retirements were caused by external inflows, the reserve money growth would change only in its composition (see **Figure 4.4**).

The SBP sterilized a substantial part of reserve money growth during Jul-Feb FY07, but it could not do so more aggressively because of the need to accommodate private sector credit growth demand, which had significantly outpaced the deposit growth during the period.

Figure 4.5: Deposit & Credit Growth

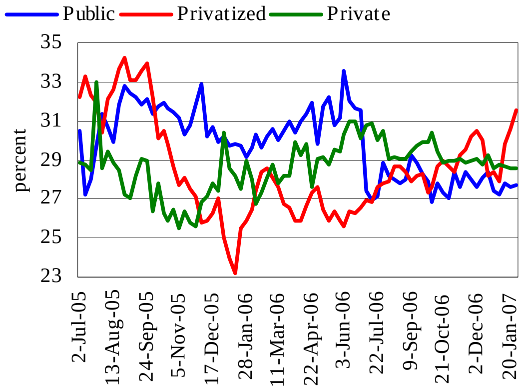


As seen in **Figure 4.5**, the credit to deposit ratio has remained quite large during the period and in some cases

[9] This is because (1) the government has sought to increase its non-bank borrowings through allowing institutions invest in NSS instruments and issuing PIBs; (2) government was able to retire part of the SBP debt by using Central Bank's profit transferred to the government during this period, and (3) as evident from **Table 4.4**, the availability of external financing during Jul-Dec FY07 is far greater than that in the corresponding period of the previous year.

went beyond 100 percent,[10] Further, liquidity ratio of smaller domestic banks and some foreign banks has declined despite the increased reserve requirements during the period (see **Figure 4.6**).

Figure 4.6: Liquidity Ratio of Domestic Banks

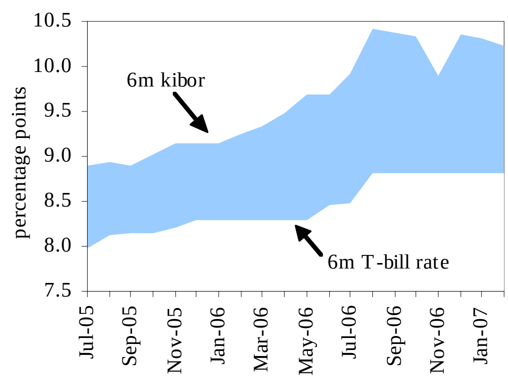


Liquidity ratio is calculated as total liquidity maintained by banks divided by the total demand and time liabilities.

The strong private sector credit demand and consequent availability of lending avenues suggest that a further rise in discount rate would have required to make banks' investment in government papers more attractive (thereby reducing the reserve money growth).

At the current rate, banks had limited incentives to lend to the government given (1) a widening spread between benchmark rates for corporate lending and the repo rate on government securities (see **Figure 4.7**); (2) absence of major risks on quality of private sector credit as evident from a decline in net NPLs to net loans ratio, and (3) more than required capital adequacy of banks[11] (see **Table 4.5**).[12] Certainly,

Figure 4.7: Spread Between Rates for Government and Corporate Lending



[10] At end-January 2007, five banks were operating with credit to deposit ratio above 100 percent.
[11] If the private sector credit runs the sufficient risk of default, the risk averse banks revert to investments in government paper at the cost of higher yields. Likewise, the increase in risk weighted assets of banks goes beyond the standard minimum capital, banks have to switch assets from private credit to government credit.
[12] In fact, limited interest of banks in government paper was the reason why at first place government had to borrow excessively from the SBP throughout Jul-Nov FY07 to finance its deficits.

given the need to support private sector credit demand, rise in discount rate and further tightening of the market liquidity was not desirable.

Going forward, the large foreign exchange inflow since November 2006 is an emerging challenge to SBP. In addition to making country's balance of payments outlook positive for FY07, the expected strength in H2-FY07 foreign currency inflows would also exert upward pressures on reserve money growth.

Table 4.5: Asset Quality of Banks

	Net NPLs to net loans	
	Dec-05	**Dec-06**
Public sector commercial banks	1.2	1.5
Local private banks	1.8	1.0
Foreign banks	-0.6	-1.0
Commercial banks	***1.5***	***1.0***
Specialized banks	28.5	19.5
All banks	**2.4**	**1.5**

Interestingly, both the government and the private sector are expected to benefit from these foreign currency inflows, and in a situation where the reserve money growth is already considerably high, strong inflows would make liquidity management by the Central Bank more challenging.

One obvious policy response from Central Bank would be the sterilization of monetary impact of such inflows. The government has already reduced its reliance on SBP borrowings, and this direction needs to continue and the stock of SBP borrowing further reduced. This implies that counterpart funding should not be used to *increase* expenditures.

On the positive side, SBP is also expecting an increase in liquidity in the inter-bank market during H2-FY07 as the demand for private sector credit slows down in line with the credit cycle. The expected lower demand for private sector credit, recent rise in deposits growth,[13] and Rupee counterpart of the expected foreign exchange inflows are likely to improve liquidity position of banks, and thereby inducing them to invest more in government papers. This in turn will allow SBP to mop up excess liquidity without necessarily raising the discount rate.[14]

[13] Although the deposit growth during Jul-Feb FY07 slowed down to 4.8 percent from 5.9 percent during the corresponding period of FY06, monthly data suggest that the deposit growth is gaining pace since October 2006 onward (see **Figure 4.19a**).
[14] It may be pointed out that banks are already showing interest in T-bills as evident from net offer (i.e., offers net of maturity) of Rs 180.2 billion by banks in the last four auctions held during Jan-Mar FY07 against Rs 75.1 billion offered net of maturity in the preceding 15 auctions during Jul-Feb FY07 period. This renewed interest of commercial banks in T-bills has allowed government to retire its debt held by the Central Bank. This process is effectively transferring T-bill holdings from Central Bank to the commercial banks, thereby helping in containing reserve money growth.

4.2 Monetary Survey

Growth in money supply (M2) during Jul-Feb FY07 slowed to 7.7 percent from 8.7 percent during the same period of FY06 (see **Table 4.6**).

Contrary to the Jul-Feb FY06, when the monetary growth was entirely due to net domestic assets (NDA) as net foreign assets (NFA) were showing a contraction; the expansion in M2 during Jul-Feb FY07 was contributed by the increases in both NDA and NFA.

However, the *slowdown* in monetary growth during Jul-Feb FY07 stemmed entirely from the NDA. The NFA, on the other hand, has registered a slight increase during Jul-Feb FY07.

Net Foreign Assets (NFA)

The NFA of the banking system registered an expansion of Rs 41.1 billion Jul-Feb FY07 compared to the contraction of Rs 80.9 billion during the corresponding period of the preceding year.

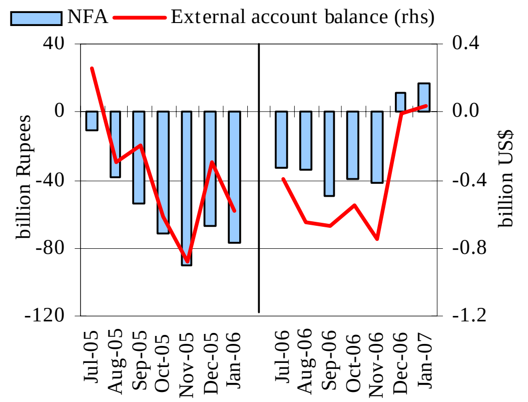
This is reflective of the improvements in country's balance of payments (see **Figure 4.8**). While the

Table 4.6: Monetary Survey (Flows)

billion Rupees

	Credit Plan FY07	Jul-Feb FY06	Jul-Feb FY07
Money Supply (M2)	**459.9**	257.5	264.3
Growth rate (in percent)		8.8	7.7
NFA	**9.8**	-80.9	41.1
SBP		-42.5	25.3
Scheduled banks		-38.4	15.8
NDA	**450.1**	338.4	223.2
SBP		130.4	70.0
Scheduled banks		208.0	153.3
A. Government borrowing	**130.1**	118.3	42.6
Budgetary support	**120.1**	148.8	78.1
SBP		178.2	25.9
Scheduled banks		-29.5	52.3
Commodity operations	**10**	-29.2	-33.6
B. Credit to non-govt. sector	**395**	310.8	222.2
Private sector	390	310.6	227.1
PSEs	5	1.5	-5.2
C. Other Items (net)	**-75**	-90.7	-41.6
SBP		-45.9	46.0
Scheduled banks		-44.8	-87.5

Figure 4.8: Cumulative Flows in NFA



current account deficit continued to rise during Jul-Feb FY07, Pakistan has seen large financial account surplus during the period, which has resulted in an expansion of the NFA of the banking system.

The major factors responsible for large foreign exchange inflows included a relatively higher growth in workers' remittances and foreign investments (both FDI and portfolio), foreign inflows through Global Depository Receipts (GDRs)[15] and relatively slower increase in trade-related foreign currency loans.

Within the banking sector, the improvement in the NFA is explained by the improvements in the NFA of both the SBP and scheduled banks. It is interesting to see that the SBP NFA registered a growth of 4.5 percent, despite larger volumes of foreign exchange interventions during FY07 compared with the preceding year (see **Figure 4.9**). This phenomenon is explained by large inflows under external financing (mainly through Asian Development Bank), logistic support and GDRs that more than offset the impact of forex interventions.[16]

Figure 4.9: SBP Forex Interventions (Jul-Jan)

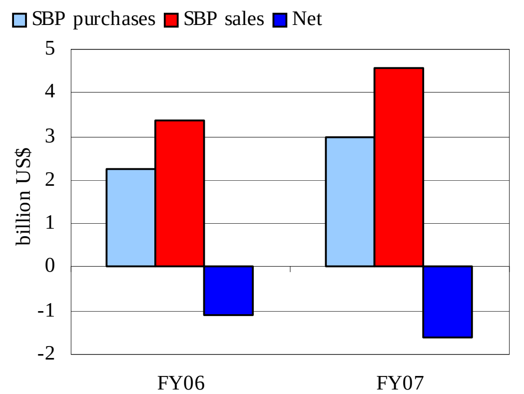
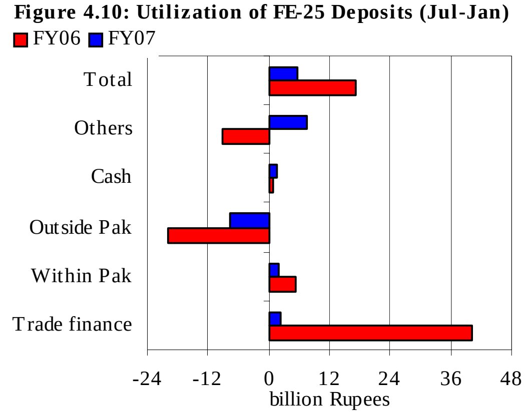


Figure 4.10: Utilization of FE-25 Deposits (Jul-Jan)



The NFA of the commercial banks, on the other hand, showed a net expansion of Rs 15.8 billion during Jul-Feb FY07 against a net contraction of Rs 38.4 billon during Jul-Feb FY06. The

[15] US$ 731 million were mobilized through issuing GDRs of OGDCL.
[16] See Section on **Balance of Payments** for details.

increase in NFA during Jul-Feb FY07 was on the back of slow growth in FE-25 trade loans and a higher increase in banks' nostros and placements outside Pakistan[17] during the period (see **Figure 4.10**).[18]

Net Domestic Assets (NDA)

The growth in the net domestic assets (NDA) of the banking system slowed during Jul-Feb FY07, contributed by the slowdown in NDA of both the SBP and the scheduled banks. The slowdown in SBP NDA stemmed entirely from relatively low budgetary borrowings from the SBP; part of which was offset by an increase in OIN and SBP claims on the scheduled banks. On the other hand, a deceleration in private sector credit and higher contraction in OIN contributed to the slowdown of scheduled banks' NDA.

Figure 4.11: Compositional Shift in Budgetary Finance

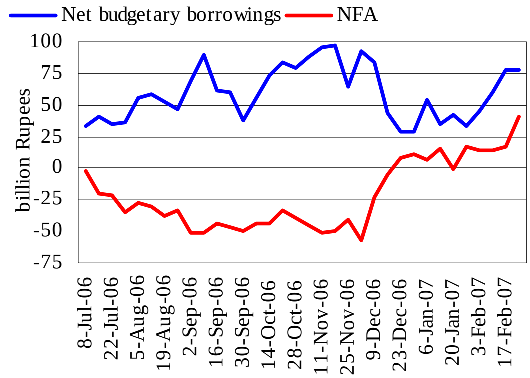
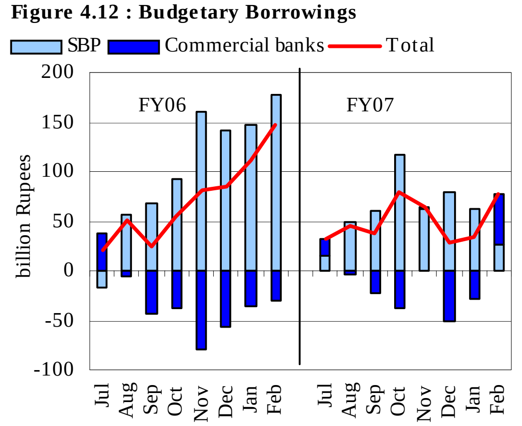


Figure 4.12 : Budgetary Borrowings



Government Borrowings

Although the government was running larger budget deficit during Jul-Feb FY07, the budgetary borrowings from the banking sector during Jul-Feb FY07 were less than half of the same during the preceding year.[19,20]

[17] In the absence of domestic demand for trade related loans, banks have to place foreign currency under FE-25 deposits either in their nostros or make investment in foreign securities.

[18] Please see section of **Private sector credit** for details.

[19] It may be recalled that the budgetary borrowings during Jul-Nov FY07 were smaller than Jul-Nov FY06, only slightly.

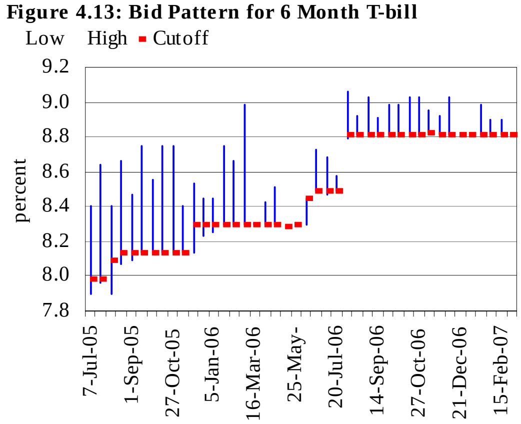
The lower borrowings were attributed mainly to an increase in the government's reliance on external financing post-November 2006 (see **Figure 4.11**).

The composition of the budgetary borrowings within the banking industry during Jul-Feb FY07 is in contrast with the preceding year. Although the Central Bank borrowings still constitute the bulk of the total, the borrowings from scheduled banks have also registered some increase (see **Figure 4.12**).

The increase in government borrowings from scheduled banks mainly reflects the shift in market expectations regarding changes in interest rates. In specific terms, during Jul-Feb FY06 banks, in anticipation of a rise in interest rates, were bidding at excessively high rates in T-bill auctions. Therefore, the government was borrowing directly from the SBP.

However, August 2007 onwards the market expectations of interest rate increases died out following the increase in reserve requirements and discount rate during July 2007 (see **Figure 4.13**). As a result, government's retirements to the scheduled banks registered a slowdown during Jul-Feb FY07 and even turned positive during February 2007.

Figure 4.13: Bid Pattern for 6 Month T-bill



Credit to Private Sector

Growth in credit to private sector decelerated during Jul-Feb FY07, rising by 10.7 percent YoY compared with the growth of 18.1 percent during the same period last year.

A close analysis of the data shows that the slowdown primarily stems from a deceleration in fixed investment loans (particularly in the textile sector), as the working capital requirements have actually accelerated. Excluding the textile

[20] SBP also transferred its profit of Rs 60 billion to the government in the month of November, which is showing a decline in net claims to the government.

sector, the growth in aggregate business sector advances has also seemed to have increased (see **Table 4.7**).

Table 4.7: Growth in Advances

percent

	Working capital		Fixed investment		Total	
	FY06	**FY07**	**FY06**	**FY07**	**FY06**	**FY07**
Business sector	15.4	15.8	13.7	6.7	14.8	13.0
Textiles	23.7	15.7	3.3	-10.5	17.2	8.1
Business excluding textiles	12.0	15.8	18.8	13.8	13.8	15.1

Working capital includes trade financing

It seems that the deceleration in demand for fixed investment loans is mainly due to structural problems in the real sector of the economy that reduced its ability to absorb additional credit at the same pace as in the past two years[21]. Furthermore, delays in initiation of major infrastructure projects, e.g., power projects, led to subdued demand for fixed investment loans. Credit growth is expected to accelerate as structural factors are resolved and the infrastructure projects come online.

4.8: Private Sector Advances (Jul-Jan)

	Absolute flows		% Growth	
billion Rupees	**FY06**	**FY07**	**FY06**	**FY07**
1. Private sector businesses	181.9	193.8	14.6	13.0
A. Agriculture	6.9	9.7	5.3	7.2
Major crops	5.2	16.3	7.1	20.4
B. Manufacturing	93.3	115.7	12.3	12.9
Sugar	2.2	-6.4	6.6	-11.8
Textiles	64.7	35.4	17.2	8.1
Paper and products	1.4	5.2	18.3	55.6
Coke and refined petroleum products	-1.2	5.7	-8.8	71.9
Cement	13.0	9.2	39.8	14.6
C. Electricity, gas and water	1.7	12.1	11.0	63.9
D. Construction	7.4	10.2	23.5	24.2
E. Commerce and trade	43.0	21.0	29.7	11.0
F. Transport, storage & communications	6.5	10.8	12.9	17.3
G. Other private business	5.5	5.1	17.6	15.5
2. Personal	53.9	34.3	21.7	10.0
Consumer financing	51.6	31.1	24.9	10.4

The impact of this on aggregate growth of advances was also compounded by the recent mergers /acquisitions in the banking sector, and consequent slowdown in credit operations. This was most evident in the agriculture and consumer credit market segments. Further, the lending capacities

[21] For instance, the installed capacity in textiles and cement sector has already increased sizably in the past few years; therefore, the demand for fixed investment loans in these sectors has slowed down.

of banks also constrained as some of the banks are trying to improve their risk management practices.

Sectoral analysis

A sectoral analysis of the data shows that within business sector, the major slowdown came from the commerce and trade sector, the growth of which was only one third of the growth in the preceding year[22]. Further the growth in personal sector advances during Jul-Jan FY07 was almost half the growth during Jul-Jan FY06 (see **Table 4.8**)[23].

Within personal loans, all the consumer financing products registered slowdown, with loans for consumer durables showing net retirements (see **Figure 4.14**). The maturing of earlier consumer loans means that deceleration in net growth in consumer credit was to be expected. But the magnitude of the deceleration in FY07 suggests that the overall consumer credit demand has also moderated somewhat. Auto loans during Jul-Jan FY07 were less than half that during Jul-Jan FY06 attributed mainly to increase in interest rates.[24]

Figure 4.14: Change in Consumer Finance (Jul-Jan)

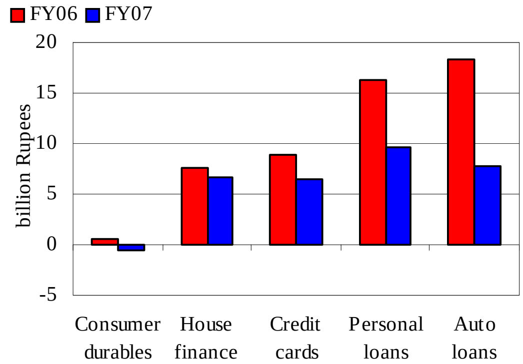
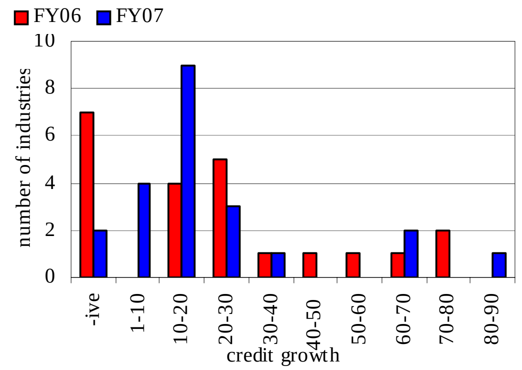


Figure 4.15 : Frequency Distribution of Credit Growth in Manufacturing Units (Jul-Jan)

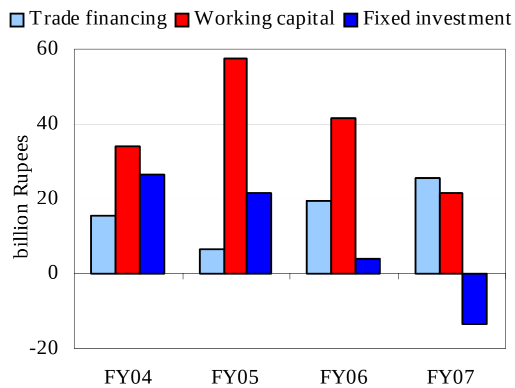


[22] The sector wise data on advances does not include banks' investments in shares and bonds of private corporate sector. The same is included in monetary survey data on private sector credit.
[23] Sector wise distribution of private sector credit is available for Jul-Jan FY07.
[24] The slowdown in auto loans is also reflected in a deceleration in production and imports of automobiles during the same period.

Encouragingly, the advances to manufacturing sector witnessed a higher growth during Jul-Jan FY07 compared to the preceding year. Number of sectors showing net retirements during Jul-Jan FY06 has declined during Jul-Jan FY07. Advances to most of the industries in manufacturing sector were showing a respectable growth (see **Figure 4.15**).[25]

Within the manufacturing sector, advances to textile industry registered major slowdown during Jul-Jan FY07 attributed mainly to certain industry specific factors. Most importantly demand for fixed investment loans fell sharply after exceptional growth in recent years when the industry was preparing for post MFA competition. The impact of this decline was compounded by a number of other factors that included; (1) the overall decline in the demand for Pakistani textile products from its major trading partners due to price and quality related issues; (2) increased prices of raw cotton due to a significant decline in cotton production; and (3) increase in cost of financing.

Figure 4.16: Credit to Textile Sector (Jul-Jan)



Interestingly, the trade related financing under textiles showed an increasing trend during Jul-Feb FY07 attributed mainly to a decline in EFS rates by 100 basis points during July 2006 and a decline in banks' margin by a 50 basis points (see **Figure 4.16**).

Sugar manufacturers showed a relatively net retirement of Rs 6.4 billion during Jul-Jan FY07 from an extension of Rs 2.2 billion advances during the same period last year. The major factors causing this slowdown were the decline in the sugar prices in the international market and sharp increase in sugarcane production domestically.[26]

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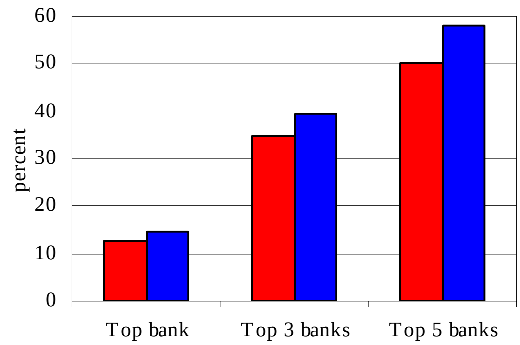
[25] While there were 9 industries showing growth in advances in the range of 5 to 30 percent during Jul-Jan FY06; this number increased to 15 during Jul-Jan FY07.

[26] Therefore, the demand for working capital loans remained low.

However, the strong advances growth in food products (especially rice processing), wearing apparel, fertilizer, basic metals, domestic appliance, electrical machinery, paper board & products industry, coke & refined petroleum products and steel industries more than offset the impact of slowdown in advances to textile and sugar.

The strongest growth in advances was seen in the telecommunication sector where net advances expanded by 17 percent during Jul-Jan FY07 compared to the growth of 13 percent during the same period last year. This was mainly because of the continuing need of operators to expand cell-phone networks due to competitive pressures.[27]

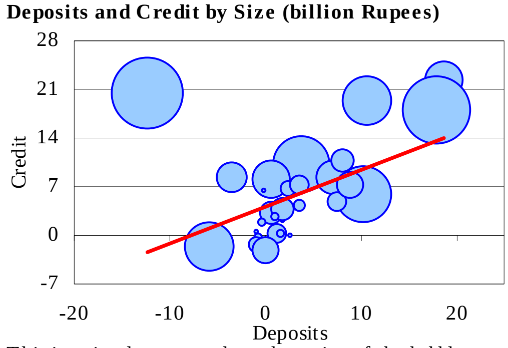
Figure 4.17: Bank Concentration in Credit Expansion (Jul-Jan)



Within the banking sector, it is interesting to note that the credit concentration was skewed towards banks with very large deposit bases. As shown in **Figure 4.17**, the credit concentration among banks during Jul-Jan FY07 was higher compared with the preceding year.

Further disaggregated data shows that a few large and medium sized banks (in terms of deposit base), have registered a higher credit expansion compared with the other domestic and foreign banks. Moreover, the lower credit growth by smaller

Figure 4.18: Scatter Plot of Increases in Banks' Deposits and Credit by Size (billion Rupees)



This is a simple scatter plot; where size of the bubble shows size of the bank

[27] The higher growth in credit to telecommunication sector is in addition to US$ 250 million worth International Bonds issued by Mobilink during Jul-Feb FY07.

banks was caused mainly by slow deposit mobilization; particularly during the period of seasonal off-take (see **Figure 4.18**).

Deposit Mobilization

The deposit growth during Jul-Feb FY07 slowed down to 4.8 percent from 5.9 percent during Jul-Feb FY06 (see **Figure 4.19a**). Encouragingly however, the currency to deposit ratio during the former period has mostly remained high throughout the period. However, the only exception was the month of December, explained primarily by the fall of Eid during the last week of the month (see **Figure 4.19b**).

Figure 4.19 (a): Cumulative Deposit

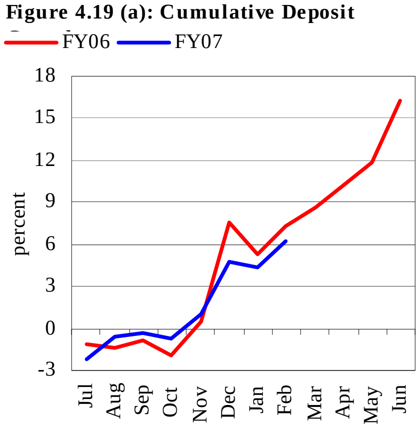


Figure 4.19 (b): Currency to Deposit Ratio

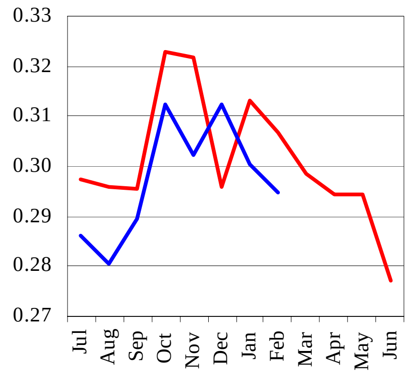


Figure 4.20 (a): Spread Between Returns on Rupee Deposits & FCAs

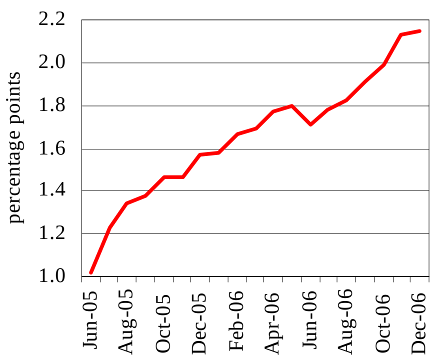
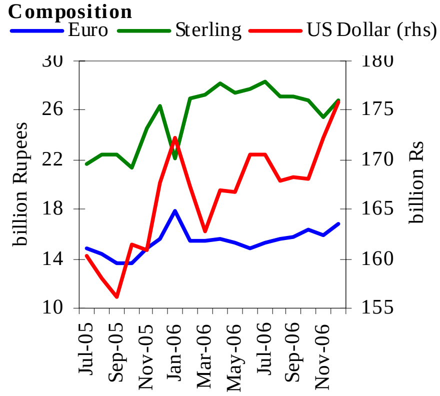


Figure 4.20 (b): FCA's Currency Composition



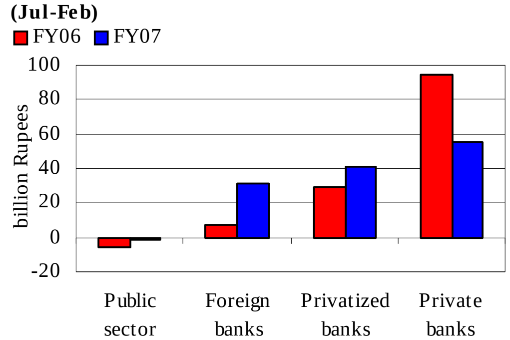
The currency composition of the deposits shows that the share of foreign currency deposits continued to decline in total deposits given the expectations of a stable exchange rate. Further the spread between interest rates on Rupee deposits and foreign currency accounts also widened during FY07 (see **Figure 4.20a**).

Within foreign currency deposits, Sterling and Yen deposits registered net withdrawals while the US dollar and Euro deposits almost halved compared with Jul-Feb FY06 (see **Figure 4.20b**).

A disaggregation of deposit mobilization within banking groups shows that most of the slowdown was registered in domestic private banks. The deposit mobilization of foreign banks and the large privatized banks, on the other hand, has remained higher during Jul-Feb FY07 compared with the preceding year (see **Figure 4.21**).

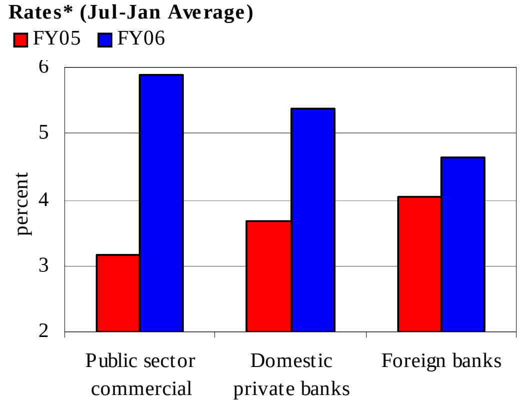
It is interesting to see the returns offered by PSCBs on deposits which were the lowest during Jul-Feb FY06 among banking groups. During Jul-Feb FY07, these banks raised deposit rates by 256 basis points and are now operating with the highest deposit rates (see **Figure 4.22**). Despite this sharp increase in deposit rates, the deposits of public sector

Figure 4.21: Group-wise Deposit Mobilization (Jul-Feb)



In both years, Standard Chartered Bank Pakistan Ltd. and Habib Bank AG Zurich Bank are included in Private banks.

Figure 4.22: Group-wise Incremental Deposit Rates* (Jul-Jan Average)



* Incremental deposit rate is the weighted average rate at which deposits are mobilized during a month.

banks registered net withdrawals. This phenomenon is explained mainly by the net withdrawals from deposits of public sector enterprises (PSEs) (see **Table 4.9**).

Encouragingly, the impact of monetary tightening has started appearing on banks' deposit rates. As mentioned earlier, the credit to deposit ratio during Jul-Feb FY07 has remained quite high thus creating liquidity constraints for the banks. Therefore, the banks have started mobilizing deposits at higher returns especially during the period of seasonal credit off-take (see **Figure 4.23**). Hence, a healthy competition has emerged within the banking sector as evident from aggressive advertising campaigns of banks' saving products.

Table 4.9: Sector-wise Deposit Growth
in percent

	FY06	FY07
Government	4.3	3.7
PSEs	22.3	-6.0
NBFIs	85.8	28.7
Private business	-1.3	2.3
Manufacturing	-6.2	-4.0
Telecommunications	39.2	136.7
Personal	5.1	4.6

It is important to note that the increase in outstanding amount in national saving scheme (NSS) during Jul-Dec FY07 has so far been due to inflows in *Pensioners' saving accounts* and *Behbood Savings Certificate*. This suggests that the government's decision to allow institutional investment in national saving schemes (NSS) in September 2006 has so far not diverted savings from the banking system to the NSS. In other words, as funds flow into these schemes, the competition for deposits could intensify in months ahead benefiting depositors further.

Figure 4.23: Share of Deposits Mobilized Over 8 Percent Rate of Return in Total Stock