Chapter 5

Money and Credit

Pakistan's monetary policy aims at stabilizing economic growth through a number of channels. It influences the future expectations of economic activity and inflation. A sound fiscal position is important for achieving macroeconomic stability. This occurs through efficient resource allocation and the mobilization of domestic savings. Because of this, the central bank through its monetary policy and strategies plays an influential role.

The global financial crisis that erupted in late 2007 not only produced the severe worldwide economic contraction, it has also hampered the ability of central banks to successfully manage the economy. In reaction to the crisis, markets of developed economies responded in a variety of ways, such as creating measures aimed at specific sectors, as well as more general stimulus packages aimed at keeping financial institutions buoyant. On the other hand, economic activity in emerging and developing economies remained relatively vigorous on account of strong internal demand. The global economic activity rebounded in 2010 on the back of better macroeconomic performance and continued accommodative macroeconomic policies. Unfortunately, performance slowed later in the year because countries with large public and private debt burdens faced serious problems accessing sovereign debt markets. Consequently, heightened concerns about long term debt sustainability in various parts of the world have posed additional risks, not only to financial stability, but also for the ability to access safe assets.

Box 1
High Demand for Safe Assets

There is a potential threat to global financial stability due to high demand for safe assets. The threat has been driven up on account of heightened uncertainty, regulatory reforms and the extraordinary post-crisis responses of central banks in the advance economies. The supply of safe assets has contracted as the ability of the public and the private sectors to produce such assets has declined. Similarly, the number of countries whose debt is considered safe has fallen. Lack of safe asset scarcity will increase the price of safety and compel investors to move down the safety scale. It will also lead to more short-term spikes in volatility, and shortages of high-grade collateral.

There is a need for flexibility in policy design and implementation for a smooth adjustment in the markets for safe assets. Hence policy makers should strike a balance between the desire to ensure the soundness of financial institutions and the costs associated with potential overly rapid acquisitions of safe assets to meet such goals.

Global Financial Stability Report, April 2012. IMF.

Pakistan's financial sector has not witnessed a direct impact of the global financial crisis due to its limited exposure in international financial markets. However, high inflationary pressures, heightened security risks, power shortages and a high cost of doing business posed numerous challenges for Pakistan's economy. Consequently, all these factors along with the global financial crisis caused a deceleration in the investment rate, a rise in unemployment and poverty, an increase in the debt burden, and a sharp fall in foreign exchange reserves. Moreover, the dearth of financial inflows resulted in a sharp diversion of credit away from the private sector. As a consequence, monetary policy remained under enormous pressure to strike a balance between supporting growth and keeping inflation under watch.

The devastating floods in 2010 and heavy rains in Sindh in 2011 once again brought on a plethora of challenges. The government's efforts to contain the fiscal deficit were undermined by the significant rise in federal and provincial government's expenditures in favor of rehabilitation and reconstruction activities. Moreover, the less than expected external inflows intensified fiscal stress. In addition, changes in key export and import prices in the international markets and the fragile global economic recovery are also affecting domestic economic conditions. Despite the challenges faced by the economy due to flood and security related issues Pakistan holds enormous potential and resilience. This was evident when the fiscal deficit remained within reasonable limits, (i.e 5.9 percent of GDP in 2010-11). The year to year CPI inflation was also recorded at 10.8 percent in March 2012 against 13 percent in the same period of the previous year.

Table 5.1: Policy Rate

Effective from Date	
21-Apr-09	14.0
17-Aug-09	13.0
25-Nov-09	12.5
30-Jan-10	12.5
27-Mar-10	12.5
02-Aug-10	13.0
30-Sep-10	13.5
30-Nov-10	14.0
01-Aug-11	13.5
10-Oct-11	12.0
30-Nov-11 until date	12.0

Source: State Bank of Pakistan

Monetary Policy Stance

The continuation of sound monetary management is central to taking on the multifaceted challenges faced by any economy as it deals with major issues of price stability, control of money supply and rationalization of administered interest rate. In Pakistan, monetary management has mainly focused on controlling inflation. Inflation has persistently remained in double digits in the last few years on account of difficult domestic and external economic environment. Similarly, the heavy reliance on domestic borrowings in the absence of diversified and sustainable financing sources has constricted the availability of credit to the private sector. Furthermore, dried up external financing and insufficient funds from non-bank sources resulted in short-term borrowing from the banking system. Consequently, the banking sector's exposure to government papers has increased significantly.

Given the difficult economic situation, the State Bank of Pakistan (SBP) followed a proactive policy response to shave-off additional demand from the economy. It has also accommodated the fiscal deficit. The SBP adopted an expansionary monetary policy during the fiscal year 2011-12. It slashed the discount rate by 50 bps points to 13.5 percent from 14 percent on the back of an improved fiscal position. The decision continued to show progress, as the consumer price index (CPI) and government borrowings from the Central Bank remained lower than its level at the end of June. However, the rate was further reduced by 150 bps points to 12 percent on October 8th, 2011, in order to boost to private sector credit and investment. Similarly, for a smooth functioning of a payment system and financial stability, SBP has injected substantial short term liquidity in the system.

Nevertheless, risks to macroeconomic stability due to fiscal weakness and decline in foreign inflows have not retreated. The power crisis and the precarious law and order situation are still an impediment to provide an environment conducive for productive activities. Hence, there is a need for a cautious approach to keep the inflation expectations around the medium term targets of 9.5 percent for fiscal year 2012-13 and 8 percent for fiscal year 2013-14. On the other hand increase in government borrowing to finance the budget deficit is adversely affecting the inflation outlook. Keeping the overall macroeconomic situation in view, the SBP has decided to keep the policy rate unchanged at 12 percent w.e.f. April 13, 2012.

Recent Monetary and Credit Development

During the first eleven months of the current fiscal year, July – 11th May 2012 broad money (M2), or money and close substitutes for money, witnessed an expansion of 9.09 percent as compared to 11.47 percent during the same period in 2010-11. The deceleration in money supply is primarily driven by the significant fall in the Net Foreign Assets of the banking system, along with increased government borrowing and a one-off settlement of circular debt. During the first half of the fiscal year 2011-12, a significant decline in capital financial account inflows resulted in depletion of SBP foreign exchange reserves to finance the major part of current account deficit. The profile of monetary indicators for fiscal year 2010-11 and 2011-12 is demonstrated in Table 5.2.

Table 5.2: Profile of Monetary Indicators Rs. Billion

	Jul-14May 2010-11	**Jul-11May 2011-12**
1. Net government sector Borrowing(a+b+c)	506.5	1,003.3
a. Borrowing for budgetary support	603.3	1,084.4
b. Commodity operations	-101.1	-81.6
c. Others	4.2	0.5
2. Credit to Non-government Sector (d+e+f+g)	118.7	92.9
d. Credit to Private Sector	107.8	234.8
e. Credit to Public Sector Enterprises (PSEs)	10.6	-142.6
f. PSEs Special Account-Debt repayment with SBP	-0.2	0.0
g. Other Financial Institutions(SBP credit to NBFIs)	0.5	0.7
3.Other Items(net)	-143.6	-215.3
4.Net Domestic assets (NDA)	481.6 (9.20%)	880.9 (14.89%)
5.Net Foreign Assets (NFA)	181.1	-272.2
6.Monetary Assets(M2)	662.6 (11.47%)	608.7 (9.09%)

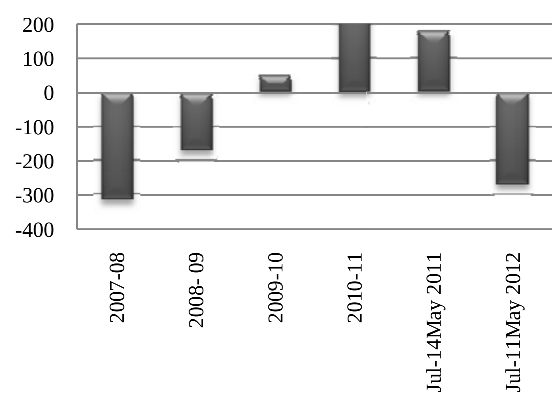
Source: State Bank of Pakistan

Net Domestic Assets (NDA) from July – 11th May 2012 stood at Rs. 880.9 billion against Rs. 481.6 billion during the same period last year, reflecting an increase of 14.9 percent over the last year. The expansion in NDA is mainly due to a rise in demand for private sector credit and government borrowings.

Conversely, Net Foreign Assets (NFA) witnessed a significant contraction on account of reduction in SBP's foreign exchange reserves that arose from the widening current account deficit and deteriorating capital and financial account surpluses. NFA of the banking system during the period under review declined to Rs. 272.2 billion as compared to an increase of Rs. 181.1 billion in the same period of 2010-11.

During July – 11th May 2012, credit to public sector enterprises (PSEs) registered a sharp decline from Rs. 10.6 billion in 2010-11 to Rs. 142.6 billion. Credit to PSEs was mostly concentrated in electricity generation companies, however in November 2011 in order to partially resolve the circular debt issue the government borrowed Rs. 391 billion from commercial banks through 12-month treasury bills and 5-year Pakistan Investment Bonds.

Figure-5.1: Net Foreign Assets

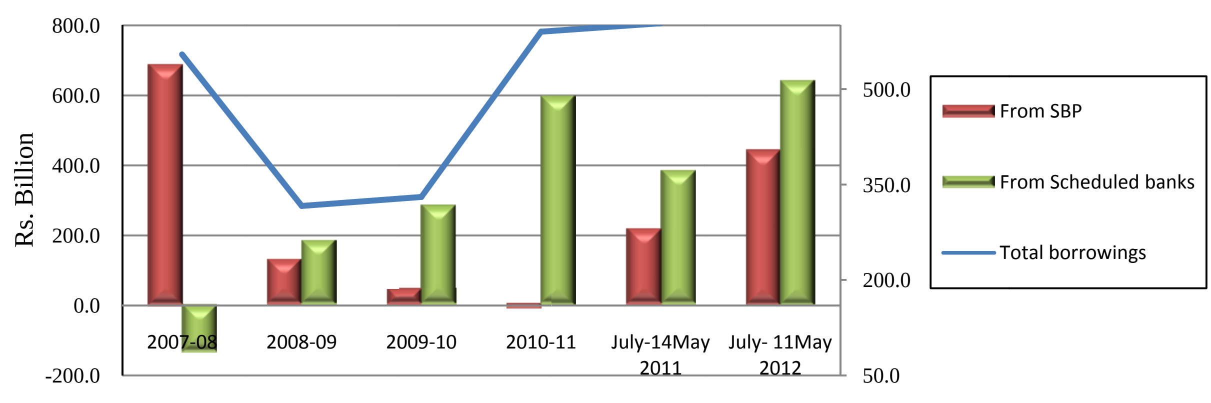


Government Bank Borrowing

The government borrowing from the banking system for budgetary support and commodity operations stood at Rs. 1,003.3 billion during July

– 11th May 2012 on account of rising subsidy on commodities, public sector enterprises' losses and less than target revenue collection. Government borrowing for budgetary support alone stood at Rs 1,084.4 billion as compared to Rs. 603.3 billion in the same period of the last year. The SBP financing has increased to Rs. 442.3 billion as compared to Rs. 217.7 billion. Financing from scheduled banks witnessed a net increase of Rs. 642.1 billion during the period under review against Rs. 385.6 billion last year. Non-bank and external financing for budgetary support was less than expected, compelling the government to borrow from the SBP and scheduled banks.

Figure 5.2: Government Borrowings



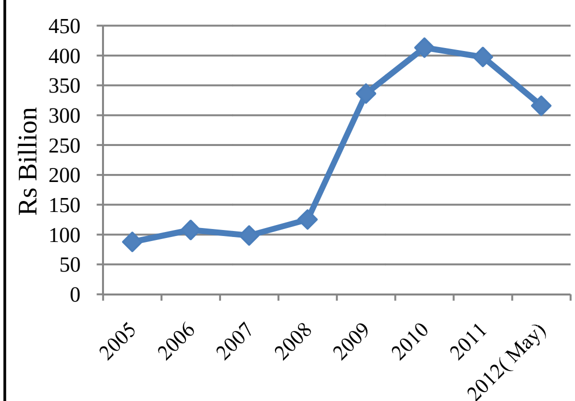
The heavy reliance on the borrowing requirement of the government from the banking system has also led to the sluggish growth in the private sector, under the crowding out effect. According to the recent SBP Amendment Act, 2012, the government borrowing from the SBP is required to be repaid at the end of each quarter and the existing stock is to be retired within eight years.

Commodity Finance

Commodity finance aims to provide short term advances either to the government, public sector corporations or private sector for the procurement of the commodities such as cotton, wheat, rice, sugar and fertilizer.

During July – 11th May 2012, loans for commodity financing registered a net retirement of Rs. 81.6 billion against the retirement of Rs. 101.1 billion in the same period of fiscal year 2010-11. The retirement was primarily concentrated in the second quarter of fiscal year 2012 as the government released Rs. 78 billion to procurement agencies for the settlement of accumulated subsidies. On 11th May, 2012 the stock of government borrowings for commodity operations stood at Rs 315.9 billion (Figure 5.3).

Figure 5.3: Commodity Finance



The government procurement target is 7.72 million tons (MT) of wheat this year, and the support price has been raised to Rs. 1050 per 40 kg for the forthcoming wheat crop. Additionally, decline in international wheat prices has reduced the incentive for its export by the private sector. Therefore, a considerable rise in the credit requirement for wheat procurement is expected during the rest of the months of current fiscal year 2011-12.

Credit to Private Sector

The credit availed by the private sector during July-11th May, 2011-12 stood at Rs 234.8 billion as compared to Rs 107.8 billion in the same period last year. On the other hand year to year growth in private sector credit was 7.5 percent up until 11 May, 2012. There is a strong relationship between private sector credit and economic growth. However, heavy borrowing from the banking system has restricted the credit expansion to the private sector.

The private sector witnessed the highest flow of credit in the second quarter of fiscal year 2011-12 standing at Rs. 282.2 billion. Despite the substantial credit flow, the cumulative private sector credit (PSC) expansion during July – 11th May 2012 was limited to Rs 234.8 billion because of more than usual seasonal retirements in the first quarter of fiscal year 2012.

Credit to Private Sector (Sectoral Analysis)

The revival of private investment in the economy was one of the main concerns for SBP to ease the monetary policy stance in 2011-12. However, the desired boost in private investment demand could not take place due to energy shortages and an unfavorable law and order situation. Additionally, substantial government borrowing has crowded out the private sector from receiving credit. This has limited the availability of credit. Similarly, due to rising non-performing loans (NPLs) banks preferred to invest in liquid assets rather than extending credit to the private sector.

Fig-5.4 : Growth of Private Sector

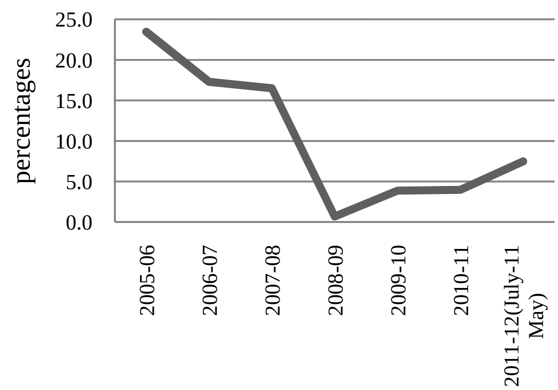


Table 5. 3: Credit to Private Sector Rs Billion

Sectors	End June Stocks		July-March (Flows)		Growth Rates	
	Jun-10	Jun-11	2010-11	2011-12	2010-11	2011-12
Overall Credit (1 to 5)	2,749.3	2,918.2	228.3	41.6	8.3	1.4
1. Loans to Private Sector Business	2,258.5	2,431.8	222.1	42.9	9.8	1.8
A. Agriculture	169.5	180.5	3.3	10.5	2.0	5.8
B. Mining and Quarrying	17.5	17.9	0.4	-2.8	2.3	-15.7
C. Manufacturing	1,263.6	1,385.4	205.3	65.0	16.2	4.7
Textiles	470.2	514.7	105.5	16.4	22.4	3.2
D. Electricity, gas and water supply	215.5	269.4	28.1	-12.2	13.1	-4.5
E. Construction	67.1	67.7	-0.9	-9.5	-1.4	-14.0
F. Commerce and Trade	229.7	213.7	-18.1	-4.3	-7.9	-2.0
G. Transport, storage and communications	105.1	106.2	-0.6	-2.5	-0.6	-2.3
I. Other private business n.e.c	23.6	29.4	3.6	-1.4	15.1	-4.8
2. Trust Funds and NPOs	13.1	18.0	3.4	-1.0	25.7	-5.4
3. Personal	321.5	294.0	-17.6	-7.8	-5.5	-2.6
4. Others	11.1	16.4	6.7	-0.1	60.6	-0.6
5. Investment in Security & Shares of Private Sector	145.1	158.0	13.6	7.5	9.4	4.7

Source: State Bank of Pakistan

Sector wise growth in credit to the private sector shows that loans to private sector businesses registered a sharp decline. In flow terms, the credit expansion during the period under review stood at Rs. 42.9 billion against Rs. 222.1 billion in July—

March 2011. However, the stocks reached Rs 2474.7 billion in March 2011-12 against the end June stock of Rs 2431.8 billion, reflecting an increase of only 1.8 percent. All of the major sectors, excluding agriculture, registered a decline in credit when compared to last year. Particularly, loans to textile sector are significantly lower than last year. The ample profitability of textile sector in 2010-11, along with subsequent decline in cotton prices in 2011-12 explains the relatively lower requirement for credit during July - May 2012.

The manufacturing sector advanced over 100 percent (Rs 65.0 billion) of total PSC, followed by textiles (38.2 percent), and agriculture (24.5 percent). On the other hand, credit to trade and construction declined by 14 percent, followed by electricity, gas and water supply (4.5 percent), and then commerce and trade (2 percent).

In agriculture, overall credit disbursement by five major commercial banks[1] stood at Rs. 107.6 billion in July—March 2012 as compared to Rs. 93.3 billion in July—March 2011 posting an increase of Rs. 14.4 billion or 15.4 percent. Total credit disbursement to agriculture sector during July-March 2012 surged by 17 percent on year to year basis to Rs. 197.4 billion against total disbursement of Rs. 168.7 billion in the same period of fiscal year 2010-11.

Net decline in consumer financing during July - March 2012 stood at Rs8.5 billion as compared to the decline of Rs 17.4 billion in the comparable period of 2010-11 , thereby registered a decline of 3.9 percent as compared to the decline of 7.1 percent during the period under review.

Table 5.4: Consumer Financing Rs. Billion

Description	July-March		Growth (%)	
	2010-11	2011-12	2010-11	2011-12
Consumer Financing	-17.40	-8.50	-7.10	-3.90
1) For house building	-5.40	-5.20	-10.00	-10.90
2) For transport i.e. purchase of car	-10.60	-5.60	-16.40	-11.00
3) Credit cards	-3.40	-1.70	-12.20	-7.00
4) Consumers durable	0.03	0.10	13.90	37.10
5) Personal loans	0.40	2.70	0.40	3.00
6) Other	1.60	1.20	55.70	27.00

Source: State Bank of Pakistan

Loans for consumer durables witnessed a net expansion of 37.1 percent during July 2011 - March 2012 against 13.9 percent in the same period last year. However, auto loans, mortgages, credit cards and personal loans have consistently been on the decline since January 2008 on account of multiple factors (e.g. fragile economic conditions, rising cost of credit and increasing default). The stock of consumer finance reduced to Rs. 209.1billion in March 2012 from its peak of Rs. 371.3 billion exactly four years earlier.

Each category within the consumer finance segment has registered a persistent increase in the loan infection ratio for the last three years. This increase has been a combination of rising NPLs and declining credit to each category with the exception of consumer durables.

Monetary Assets

The component of monetary assets (M2) include: currency in circulation, demand deposit, time deposits (excluding IMF A/C, counterpart), and resident's foreign currency.

[1] Allied Bank, Habib Bank Limited, MCB Bank Limited, National Bank of Pakistan and United Bank Limited

Table-5.5 Monetary Aggregates (Rs Million)

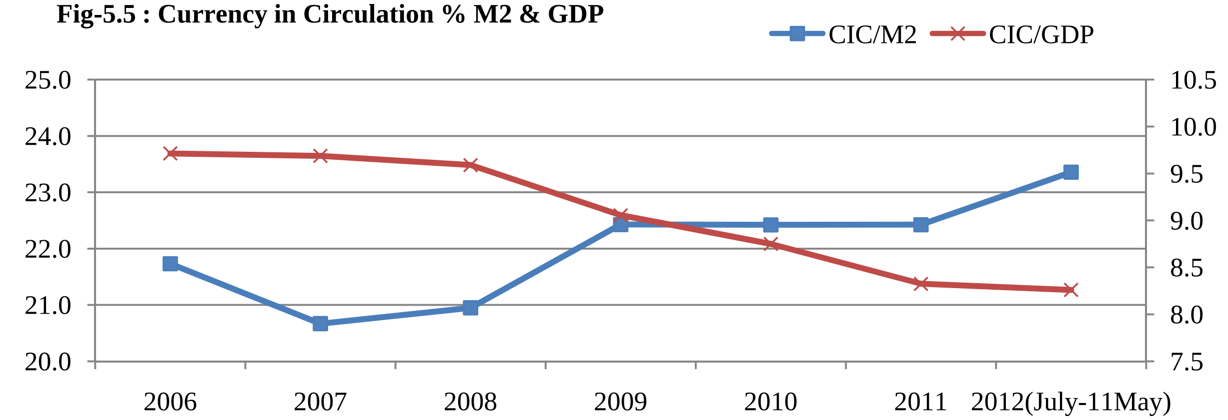
Items	End June		July-11May	
	2010	2011	2010-11	2011-12
A.Currency in Circulation	1,295,385	1,501,409	1,550,840	1,705,749
Deposit of which:				
B. Other Deposits with SBP	6,663	10,145	10,359	11,924
C.Total Demand &Time Deposits incl.RFCDs	4,475,186	5,183,640	4,878,666	5,586,202
of which RFCDs	345,438	374,945	368,012	416,962
Monetary Assets Stock (M2) A+B+C	5,777,234	6,695,194	6,439,864	7,303,874
Memorandum Items				
Currency/Money Ratio	22.4	22.4	24.1	23.4
Other Deposits/Money ratio	0.1	0.2	0.2	0.1
Total Deposits/Money ratio	77.5	77.4	75.8	76.5
RFCD/Money ratio	6.0	5.6	5.7	5.7
Income Velocity of Money	2.7	2.9	2.7	2.7

Source: State Bank of Pakistan

Currency in Circulation

During July – 11th May 2012, currency in circulation (CIC), in flow terms, stood at Rs. 204.3 billion as compared to Rs. 255.5 billion in the same period last year. Similarly, the currency in circulation as percent of money supply (M2) has declined to 23.4 percent in 2011-12 as against 24.1 percent during the same period in 2010-11.

Fig-5.5 : Currency in Circulation % M2 & GDP



Broad money (M2) grew by 9.09 percent during July – 11th May 2012, as compared to an increase of 11.47 percent during the same period last year. The decline in broad money (M2) came from the decline in both currency in circulation and deposit money.

Deposits

During July – 11th May 2012, demand and time deposits stood at Rs. 402.6 billion as against Rs 403.5 billion during the same period last year. Hence the decline in currency in circulation is offset by the increase in demand and time deposits. Similarly, resident foreign currency deposits (RFCDs) have increased to Rs. 42.0 billion as compared to Rs. 22.6 billion during the same period last year.

Monetary Management

Efficient monetary management is crucial in providing a sound and secure financial environment that is favorable for the attainment of both macroeconomic stability and growth. Moreover, a well-developed financial system facilitates the exchange of goods and services by providing payment services. It also allocates society's savings to its most productive use by acquiring and processing the information about enterprises and finds possible investment projects. Finally, it helps diversify and reduce liquidity and inter-temporal risk. A stable financial system is essential for an efficient, deep and liquid market.

The strains on the financial sector and the credit crunch in the aftermath of the global financial crisis led to the closing of many credit lines and erosion various of financial mechanisms. Pakistan's financial markets witnessed a slowdown in deposit mobilization and profitability in the sector. Conversely, the financial sector remained generally immune to the contagion of the unstable financial sector.

Table 5.6: Summary of OMO's Rs. billion

	Injections		Absorptions	
	2010-11	**2011-12**	**2010- 11**	**2011-12**
July	75.05	408.45	20.50	-
August	165.05	640.35	-	-
September	196.55	1025.10	54.40	-
October	36.85	1058.65	171.50	-
November	67.55	1381.45	102.50	-
December	34.10	1418.90	128.55	24.00
January	106.85	969.15	11.50	-
February	119.40	1244.40	51.20	-
March	230.85	1210.90	-	3.00
Total	1,032.25	9357.35	540.15	27.00

Source: State Bank of Pakistan

During the first half of fiscal year 2011-12 reliance on the banking system to fund the government's finances created further challenges to striking a balance between cautious liquidity operations and payment system stability. Furthermore, the excess volatility in short term interest rates increased the challenges of monetary management, mainly due to a sharper deterioration in the external current account deficit, a declining trend of foreign inflows, and a higher currency to deposit ratio. However, other market interest rates, such as KIBOR and the weighted average lending rate (WALR), have largely followed the policy rate reductions. The average spread between the policy rate and the 6 month KIBOR has narrowed to 12 bps after the cumulative 200 bps reduction in the policy rate.

Table 5.7: Market Treasury Bills Auctions Rs. Million

	JUL-JUN			Jul-March					
	FY2010-11			Offered		Accepted		W.A.Rate*	
	Offered	Accepted	W.A Rate*	FY11	FY12	FY11	FY12	FY11	FY12
3-Months	2,837,276	1,668,408	12.8	2,479,501	671,490	1,484,235	363,478	12.8	12.5
6-Months	2,226,878	1,614,552	13.0	1,101,412	1,501,433	809,208	883,012	13.0	12.7
12-Months	908,194	599,015	13.2	437,602	2,086,003	234,144	1,239,758	13.2	12.8
Total	5,972,348	3,881,975		4,018,515	4,258,926	2,527,587	2,486,247		

Source: State Bank of Pakistan
Average of maximum and minimum rates

The SBP accepted Rs. 2486.2 billion from the primary market of T-bills during July 2011 - March 2012 as compared to Rs. 2527.6 billion during the same period of fiscal year 2010-11. The market offered a total amount of Rs. 4259 billion during the first nine months of current fiscal year 2011-12.

In an anticipation of a further cut in the policy rate in October 2011 and onwards investment in longer tenure papers increased. During the first nine months of 2011-12 months T-bills, accounted for 49.9 percent of the total accepted amount followed by 35.5 percent in 6 months T-bills

Figure-5.6: Contribution of T-bills

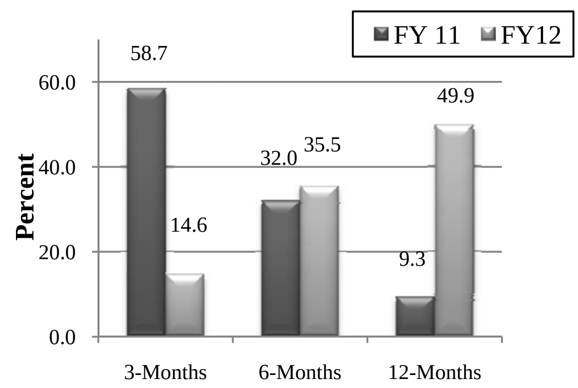


Fig-5.7: Weighted Average Interest Rates

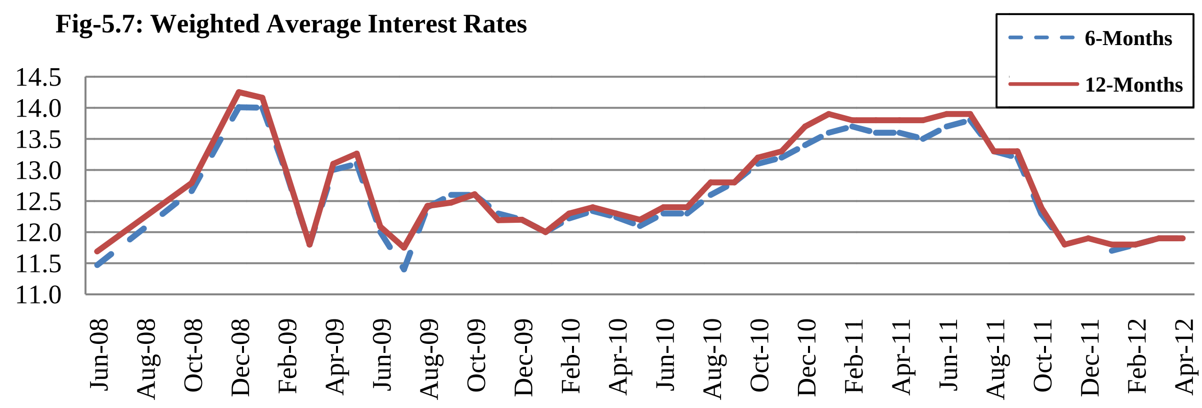
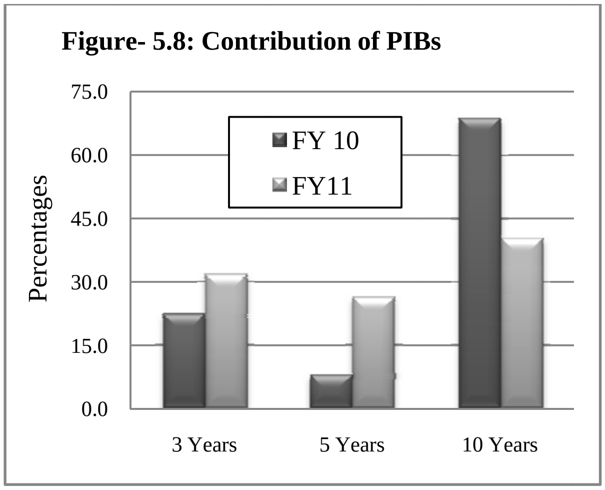


Table 5.8: Pakistan Investment Bonds Auctions — Rs. Million

PIBs	Offered	Accepted	*W.A Rate	Offered		Accepted		*W.A Rate	
	Jul-Jun			Jul-March					
	FY 2010-11			FY 11	FY12	FY 11	FY 12	FY 11	FY 12
3 Years	81,960	49,712	14.0	42,227	74,171	18,684	50,607	14.0	12.8
5 Years	33,306	16,668	13.3	18,662	57,277	6,674	41,938	13.3	12.6
10 Years	176,840	101,355	14.1	111,246	108,032	57,537	64,370	14.1	12.8
15 Years	2,966	460	14.1	2,031	2,446	BR	2,262	Nil	13.5
20 Years	7,875	875	14.2	6,500	200	525	0	14.2	0.0
30 Years	12,413	225	14.2	11,113	210	BR	0	Nil	0.0
Total	315,360	169,295		191,779	242,336	83,420	159,177		

Source:SBP
* : Average of Minimum and Maximum rates

During 2011-12, the SBP rose up to Rs. 159.2 billion from the primary market of Pakistan Investment Bonds (PIBs) as compared to Rs. 83.4 billion in the same period last year. The market offered a total amount of Rs. 242.3 billion in the first nine months of the fiscal year 2011-12 against Rs. 191.8 billion in 2010-11.



During the period under review, heavy investment occurred in 10 years PIBs which constituted almost 40.4 percent of the total accepted amount.

Table 5.9: Lending and Deposit Rates Weighted Average (W.A.)

	LR	DR	Spread
Dec-10	14.20	7.41	6.79
Jan-11	14.22	7.20	7.02
Feb-11	14.19	6.99	7.20
Mar-11	14.24	7.09	7.15
Apr-11	14.37	7.35	7.02
May-11	14.21	7.45	6.76
Jun-11	14.25	7.22	7.03
Jul-11	14.62	7.46	7.16
Aug-11	14.22	7.40	6.82
Sep-11	14.28	8.40	5.88
Oct-11	13.97	8.03	5.94
Nov-11	13.58	7.48	6.10
Dec-11	13.23	7.06	6.17
Jan-12	13.18	7.12	6.06
Feb-12	13.14	7.03	6.11
Mar-12	12.80	6.98	5.82

Source: State Bank of Pakistan

The weighted average lending rate (including zero mark-up) on outstanding loans stood at 12.80 percent while the weighted average deposit rate (including zero mark-up) stood at 6.98 percent in March 2012. This resulted in a spread of 5.82 percent. The decline in the weighted average lending rate is due to the lag involved in contracting fresh loans in the new declining interest rate environment and the decline in banks return on government securities.

It is pertinent to mention that since the Central Bank was following a tight monetary policy until August 2011 and the interest rates were moving up, the banking spread remained high. Consequently, there was a lackluster movement in deposit rates.

Pakistan's Financial Sector

A well-developed financial sector plays an important role in overall economic development, as it mobilizes savings for productive investment, facilitates capital inflows and remittances from abroad, and stimulates investment in both physical and human capital. It includes banks, stock exchanges, credit unions, insurance companies, microfinance institutions and money lenders. Hence a sound and stable financial sector contributes to economic and social development.

Commercial Banks

The asset base of the banking system and its key elements posted a strong growth trend, particularly in terms of the deposit base. However, the asset mix of the banking system shifted further toward investment, as banks continued to invest in government papers and bonds of public sector enterprises (PSEs). On a Year to year basis the asset base of the banking system registered an increase of 15 percent and stood at Rs. 8207 billion in December 2011 as compared to Rs. 7138 billion in December 2010.

Table 5.10: Highlights of the Banking System **Rs billion**

	CY*05	CY06	CY07	CY08	CY09	Dec-10	Sep-11	Dec-11
Total Assets	3,660	4,353	5,172	5,628	6,516	7,138	7,763	8,207
Investments (net)	800	833	1,276	1,087	1,737	2,142	2,845	3,053
Advances (net)	1,991	2,428	2,688	3,173	3,240	3,349	3,263	3,341
Deposits	2,832	3,255	3,854	4,218	4,786	5,450	5,769	6,238
Equity	292	402	544	563	660	697	753	784
Profit Before Tax (PBT)	94	124	107	63	81	111	116	170

Table 5.10: Highlights of the Banking System — Rs billion

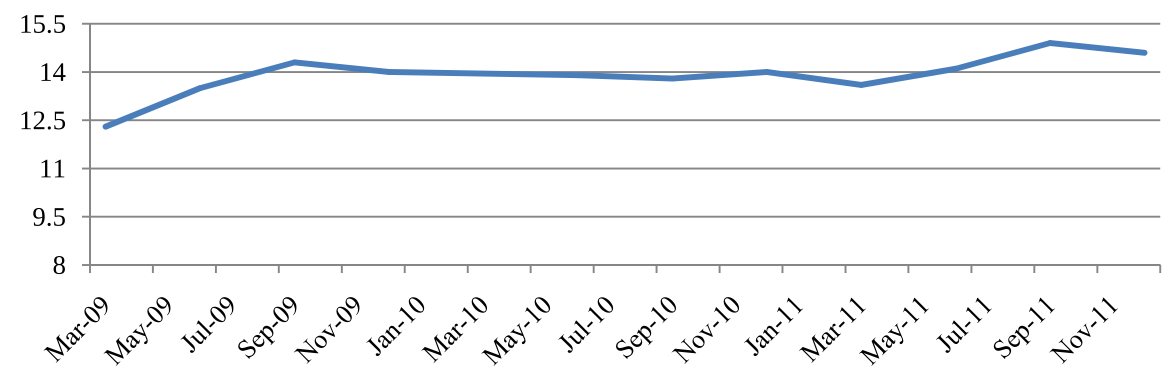
	CY*05	CY06	CY07	CY08	CY09	Dec-10	Sep-11	Dec-11
Profit After Tax (PAT)	63	84	73	43	54	65	76	110
Non-Performing Loans	177	177	218	359	446	548	613	607
Non-Performing Loans (net)	41	39	30	109	134	182	210	202
	Base-I		Base-II					
Capital Adequacy Ratio (all banks)	11.3	12.7	12.3	12.3	14.0	14.0	14.9	14.6

Source: State Bank of Pakistan
* Calendar year

The deposits of the banking system increased to Rs. 6238 billion in December 2011 from Rs. 5450 billion in December 2010 thus posted a growth of 14.4 percent year to year basis.

With continuous growth in the non-performing loans (NPLs) since CY07, credit risk has been a major challenge for banks. NPLs reached Rs. 607 billion in December 2011 against Rs. 548 billion recorded in December 2010. The capital adequacy ratio also increased to 14.6 percent from 14 percent during the period under review (Table 5.9).

Fig-5.9: Capital Adequacy Ratio (percent)



BOX-2
Financial Development

Financial development in reference to the increase in the ratio of money supply to GDP suggests that the more liquid money is available in the economy, the more opportunities exist in economy for sustainable economic growth. Therefore, the development of the financial system (financial deepening) is interlinked with the economic development of any country.

Considering M2 as a proxy for the size of the financial sector, increase in M2/GDP ratio reveals that in nominal terms the financial assets are growing faster than the non financial assets. In case of Pakistan, the financial market has shown great resilience in the wake of global financial crisis due to low integration with global financial markets.

Table5.11: Key Indicators of Pakistan's Financial Development

Years	M2/GDP	DD+TD/M2
2000-01	36.7	75.4
2001-02	40.0	75.4
2002-03	43.1	76.2
2003-04	44.9	76.8
2004-05	45.1	77.6
2005-06	45.0	72.5
2006-07	46.6	74.1
2007-08	44.7	73.3
2008-09	39.2	72.0
2009-10	39.4	71.5
2010-11	37.1	71.8
July-May		
2010-11	35.0	70.0
2011-12	34.9	70.1

Table 5.11 suggests that the M2 to GDP ratio has shown a rising trend since 2000-01 with growing economic activity and rose from 36.7 percent to 47 percent in 2006-07. The ratio

started to decline gradually and stood at 37.1 percent in 2010-11. During July —May 2012 M2 to GDP ratio has declined further to 34.9 percent as compared to 35 percent in the same period last year on account of the pressure to the liquidity profile of the financial markets mainly due to the rising government's borrowing needs. On the other hand another significant ratio DD + TD/M2, which represents monetary depth, has also shown the declining trend since 2004-05 by decreasing from 77.6 percent to 71.8 percent in 2010-11. This is the period when the monetary policy stance changed from accommodating to tightening. However, reduced policy rate by 200 bps to 12 percent during the current fiscal year 2011-12, resulted in a slight increase of 70.1 percent during July 2011—May 2012 from 70 percent during the same period last year.

In an effort to improve financial deepening and competition in the banking system, SBP is already encouraging depositors to put their savings in government securities through Investor's Portfolio Securities (IPS) accounts which may lead to better returns on deposits over time. Moreover, in May 2008, SBP introduced a minimum percent floor on all categories of Savings/PLS Saving Products. Consequently, average deposit rate of all saving related products increased from 2.1 percent to 5.25 percent, with no significant change thereafter. The saving deposits category now account for 38 percent of all bank deposits and 52 percent of total number of deposit accounts.[1]

Islamic Banking

The Islamic banking industry in Pakistan has maintained a strong and sustainable growth momentum in the wake of fragile economic conditions. Over the past six years it has witnessed an average growth of 30 percent.

Table 5.12: Islamic Banks Rs. Billion

	CY05	CY06	CY07	CY08	CY09	Dec-10	Dec-11
Assets of the Islamic banks	71.5	119.3	205.9	276.0	366.3	477.0	641.0
Deposits of the Islamic Banks	49.9	83.7	147.4	201.6	282.6	390.1	521.0
Share in Banks Assets	1.95%	2.79%	3.98%	4.90%	5.60%	6.68%	7.80%
Share in Bank Deposits	1.75%	2.62%	3.82%	4.78%	5.90%	7.16%	8.40%

Source: Islamic Banking Department, State Bank of Pakistan
*Provisional data

The asset base of the industry reached Rs. 641 billion reflecting 34 percent Year to year (YOY) growth, while the share in bank assets increased to 7.8 percent from 6.7 percent during the period under review. The growth in assets is mainly attributed to financing and investment that together grew by 40 percent year to year basis. On the other hand deposits reached to Rs. 521 billion depicting YOY growth of 34 percent by end of Dec 2011. Thus it contributed 8.4 percent in banks deposits against 7.2 percent in Dec 2010. Similarly operating performance indicators also witnessed encouraging performance in 2011, as non-performing financing (NPFs) declined while return on assets (ROA) and return on equity (ROE) both remained higher than that of overall banking industry average.

The breakup of financing in CY11 indicates that Murabaha dominates followed by Diminishing Musharaka and Ijara with all other modes constituting a relatively small share.

Microfinance

The Government of Pakistan and the SBP remain committed to promoting microfinance as a long term strategy to broaden access to financial services by the low income segments, thus improving their livelihood and income generating opportunities.

[1] Monetary Policy statement, April, 2011-12

Table 5.13: Financing Products by Islamic banks							%age
Mode of Financing	**CY05**	**CY06**	**CY07**	**CY08**	**CY09**	**CY10**	**CY11**
Murabaha	44.4	48.4	44.5	36.5	42.3	44.9	43.8
Ijara	29.7	29.7	24.0	22.1	14.2	12.7	10.4
Musharaka	0.5	0.8	1.6	2.1	1.8	2.9	2.4
Mudaraba			0.3	0.2	0.4	0.2	0.1
Diminishing Muskaraka	12.8	14.8	25.6	28.9	30.4	29.5	32.0
Salam	0.6	1.9	1.4	1.8	1.2	1.4	2.4
Istisna	1.4	1.4	1.0	2.9	6.1	5.8	4.4
Others	12.1	3.0	1.6	5.4	3.6	2.6	4.4

Source : State Bank of Pakistan

The overall microfinance sector witnessed loan portfolio growth of 13 percent over the year. Its gross loan portfolio stood at Rs. 28.84 billion as the quarter ended in December 2011 with 2.07 million active borrowers. On the deposit side, the number of depositors of Micro Finance Banks (MFBS) increased to 1.44 million with a deposit base of Rs. 13.6 billion as of March 31, 2012.

The overall performance of the sector remained positive in spite of the various challenges including the heavy floods/rains that adversely affected various parts of the country especially Sindh, for the second consecutive year. The loan portfolio growth is attributable to the recent microfinance sector strategy that stresses the need for microfinance providers to diversify portfolio in different economic and geographic segments. The NPLs of microfinance banks have also dropped to two (2) percent as the quarter ended in March 2012 against 5.29 percent in March 2011 depicting effectiveness of the credit process. The sector was able to expand its retail network to 1,739 business locations across the country.

Table 5.14: Microfinance Industry Indicators

Year	Institution	Number of MFBs	Number of Branches	Total No. of Borrowers	Gross loan portfolio (Rs. In '000)	Average Loan Size (Rs)	Total No. of Depositors	Deposits (Rs. In '000)
Dec-08	MFBs	7	271	542,641	6,461,462	11,907	254,381	4,115,667
	MFIs	20	1,186	1,190,238	11,952,000	14,940	-	-
	Total	27	1,457	1,732,879	18,413,462	10,626	254,381	4,115,667
Dec-09	MFBs	8	284	703,044	9,004,000	13,576	459,024	7,099,206
	MFIs	21	1,159	1,123,001	12,719,000	11,326	-	-
	Total	29	1,443	1,826,045	21,723,000	12,131	459,024	7,099,206
Dec-10	MFBs	8	284	717,141	10,528,000	20,151	780,294	10,289,000
	MFIs	21	1,252	1,342,395	14,966,000	17,180	-	-
	Total	29	1,536	2,059,536	25,494,000	18,385	780,294	10,289,000
Dec-11	MFBs	9	303	733,931	14,650,000	19,691	1,362,202	13,927,066
	MFIs	23	1,436	1,339,140	14,195,000	10,600	-	-
	Total	32	1,739	2,073,071	28,845,000	13,914	1,362,202	13,927,066

Source: State Bank of Pakistan

Microfinance Policy Initiatives

The policy framework for microfinance has evolved in tandem with sector growth. It encourages private sector participation by supporting a multi-institutional approach. The regulatory instructions are developed in view of the present market situation and MFBs' preparedness allowing adequate room for further innovation and market development. During the past two consecutive years Pakistan was globally ranked first by the "Economist Intelligence Unit" (EIU) of the Economist magazine, in terms of microfinance regulatory framework via its reports released in 2010 and 2011.

In September, 2011 the Waseela Microfinance Bank was granted a license under the "Microfinance Institutions Ordinance, 2001" to operate nationwide. In addition, the Auriga Group acquired the district wide Network Microfinance Bank with the intent of upscaling its operations as a nation wise MFB. Also in the same month, the general provisioning requirement for MFBs was withdrawn in cases where loans were backed by liquid securities, gold, or other cash collateral with appropriate margin. However, in case of all other loans, microfinance banks shall maintain general provision of 1%.

In March 2012, the State Bank has revised Prudential Regulations No. 10 and 11 for MFBs to facilitate lending to microenterprise segment. For these purposes, the term microenterprise shall mean projects or businesses in trading, manufacturing, services, and agriculture sectors that lead to livelihood improvement and income generation. Microenterprises are undertaken by micro-entrepreneurs who are either self-employed or employ few individuals; these businesses do not exceed 10 employees and they excluded seasonal labor.

The revisions will facilitate lending of up to Rs. 500,000 to eligible microenterprises. Moreover, MFBs that previously were unable to tap the microenterprise market constraints of lending up to Rs. 150,000 under the general loans category will now be able to upscale their credit operations.

Box-3
Program's initiatives:

SBP is playing a pivotal role in promoting inclusive finance through implementation of government and donor funded programs. These programs are managed with the objective of enhancing the provision of financial services to unbanked segments especially to the poor and marginalized population through sustainable models. The updates on government programs and SBP market interventions are as follows:

1. Financial Inclusion Program (FIP):

FIP is implemented with grant assistance of 50 million pounds from the UK Government's Department for International Development (DfID). SBP has successfully launched a number of market interventions under FIP since 2008. Progress under each of these interventions is as follows:

a. The Institutional Strengthening Fund (ISF) was launched to strengthen institutional and human resource capacity of MFB is in order to enhance scale and sustainability of microfinance services. So far funding support of Rs. 819 million has been approved for 19 microfinance providers including top and middle tier MFBs and MFIs as well as the Pakistan Microfinance Network. The grant covers 22 projects addressing institutional strengthening needs of the grantee institutions for capacity building/ HR training, IT development, business plan/ strategic reviews, market research, branchless banking, corporate governance, credit ratings, remittances, and treasury functions, and others.

b. Microfinance Credit Guarantee Facility (MCGF) was launched to mobilize wholesale commercial funding for microfinance providers through partial guarantees to commercial banks. So far, fourteen (14) guarantees with a total exposure of Rs. 957 million have been issued for mobilizing Rs. 3,275million.

c. Credit Guarantee Scheme (CGS) for Small and Rural Enterprises aims to facilitate credit to small and rural businesses through partial guarantees. So far partner banks have booked guarantees of Rs. 1,107 billion against sanctioned loans of Rs. 2.711 billion for 3,846 small and rural enterprises by the end of March 2012.

d. Financial Innovation Challenge Fund (FICF): was launched in May 2011. It aims to foster innovations and test new markets, lower cost of delivery, enable systems and procedures to be more efficient and provide new ways of meeting the unmet demand for financial services. A number of applications were received under the 1st round and the selected applicants will be announced after due process.

2. Improving Access to Financial Services Fund (IAFSF)

The following interventions have been taken under IAFSF:

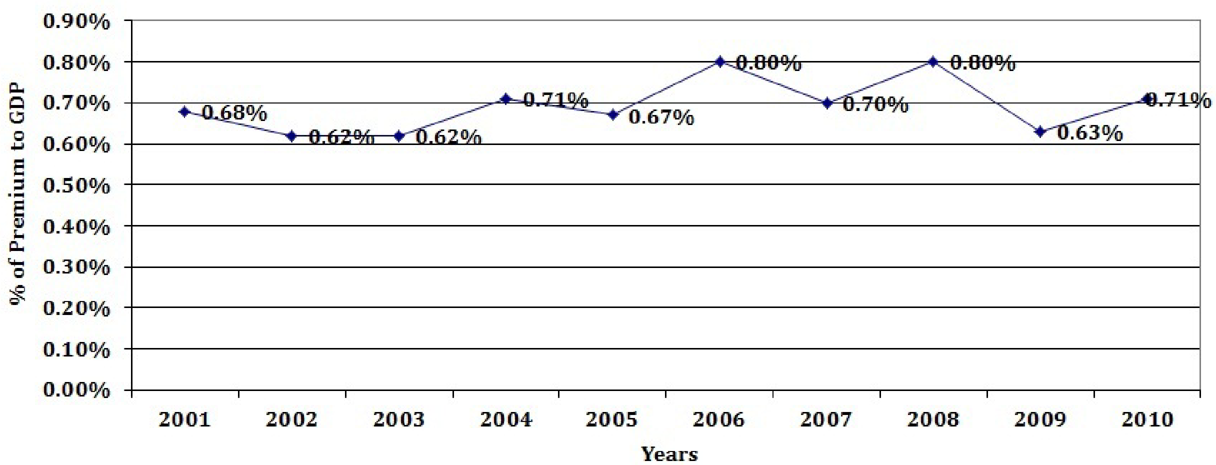
a. Nationwide Financial Literacy Program has been launched in January 2012 to disseminate basic education about financial concepts, products and services to the masses.

b. Grass Root Level Training Programs on Microfinance is a series of 40 individual training programs expected to benefit 1000 participants from various microfinance providers. So far 12 training Programs have been organized.

Insurance Sector

The insurance industry in Pakistan is relatively small compared to its counterparts in the region. The insurance penetration and density remained modest as compared to other jurisdictions while the insurance sector remained underdeveloped relative to its potential. As of December 2010, the industry's total premium revenue stands at Rs. 100.58 billion.

Fig-5.10: Insurance Penetration in Pakistan



Box-4
Way Forward

1. **Development of New Insurance Law:** SECP is considering embarking upon the initiative of revamping of insurance laws in Pakistan. The derived benefits will include a new regulatory and supervisory framework encompassing enhanced reserves and capital requirements, insurance industry's risk-focused surveillance mechanisms, training and capacity building to support the implementation of the improvised insurance regulatory framework. Under this new regime, certain new regulations will also be introduced where no such framework exists currently such as regulations for reinsurance, regulations for insurance & reinsurance brokers, regulations for alternate distribution channels, regulations for disclosure requirements and consumer protection, regulations for Takaful Investment Products, and others.

2. **Voluntary Pension Schemes by Insurance companies:** Although there are already nine (9) Pension Funds

operating under the Voluntary Pension System Rules, 2005, none of the insurers have so far ventured in this area while registering itself under these rules. The SECP intends to make the existing Rules more conducive and equally attractive for insurers by initiating a consultative process with the relevant stakeholders and encouraging the insurance companies to offer voluntary pension products.

3. Development of Crop Insurance in Pakistan: The agriculture sector contributes approximately 21 percent to Pakistan's GDP and generates about 45 percent of employment. It also contributes to the economic growth of the country by supplying raw materials to the industry as well as for export purposes. With the proliferation of numerous initiatives launched by the public and private sector, including the access to financial services in rural areas, it has become imperative that measures be taken to mitigate risks to which farmers are exposed. It is a known fact that agricultural production can increase if the vagaries of nature and the risks associated with it can be better managed. While, the majority of areas of our agricultural economy are exposed to adverse weather events such as floods and droughts, crop diseases and other disasters, the immediate need is to provide it with a carefully designed tool to mitigate such inherent risks. As the apex regulator of the insurance industry, it is the endeavor of SECP to develop and promote the agricultural insurance in order to ensure the well-being of the economy. Also, while augmenting the efforts of government whereby it formed a crop insurance scheme in year 2008 and the recent interest to develop a scheme available to all farmers of the country involved in the cultivation of the major crops, there is a need of bringing all stakeholders, including SECP, State Bank of Pakistan, insurance industry, agriculture and livestock development departments/ agencies, together to articulate the development of crop insurance in Pakistan. SECP will be working to help in building a market-based approach in the design and pricing of crop insurance products.

Conclusion

Pakistan’s financial institutions are doing the utmost to continue to respond to the global economic and financial volatility. Although Pakistan was not heavily affected by the financial crisis of 2007, it is taking every precaution in how it moves forward to support growth and monitor inflation. Efforts continue in avoiding high inflationary pressures, mitigating heightened security risks, eliminating power shortages and providing a lower cost of doing business, in order to boost Pakistan’s economy. With evidence of its past resilience in rough economic times, the future roles of money and credit in Pakistan remain optimistic.