5 Money and Credit

Introduction

Monetary policy as an important stabilizing tool ensures the sustainable economic growth as well as significantly influences the expectations about the future direction of economic activity and inflation through the channels of financial markets and bank-based intermediation. Therefore a stable financial system is a pre-requisite for stronger economic growth, as it enables the financial intermediation process to facilitate the smooth and efficient financial intermediation that allocate savings to profitable investment opportunities, and proper transmission of monetary policy, whose effective conduct and implementation in turn ensures price stability. Thus a strong and efficient financial system plays a vital role in improving the performance of the economy.

Global financial stability has improved during 2010-11 on the back of better macroeconomic performance and continued accommodative macroeconomic policies but improvement remain fragile as the health of financial institutions has not recovered in tandem with the overall economy. The challenge for governments remained un-addressed as to how the financial sector should intersect with the broader economy to avoid future crises. The confidence in the banking systems of many advanced economies has not been restored and continues to be a source of the sovereign risks in advance economies. There is a need to restore market confidence and reduce excessive reliance on central bank funding, considerable further strengthening of bank balance sheets and capital buffers will be necessary. Financial systems must enhance transparency through more rigorous and realistic stress tests and recapitalize, restructure, and even eliminate weaker institutions. Without these financial sector reforms funding difficulties may lead to another systemic liquidity episode.

Pakistan is living in a highly integrated world and a major turmoil of this magnitude certainly had implications for Pakistan economy. The ripple effects of this financial crisis had not hit with same intensity or severity as it had done to the developed world but still there are various channels through which the crisis had impacted financial sector in particular and Pakistan economy in general. Pakistan sensitively reacted to the structural changes in the financial space. The banking and the entire financial system is stronger after years of restructuring, de-regulation and improved supervision by SBP. Banking Companies Ordinance has been amended recently to enhance surveillance and vigilance mechanism of the SBP. Pakistan's financial institutions had not invested in derivatives that had exposure to risky investment bankers.

Pakistan's financial markets witnessed slowdown in the deposit mobilization and profitability in the sector, however, generally financial sector remained immune against contagion of the financial sector. Credit to private sector registered marked slowdown in the aftermath of the financial crisis but it is more to do with domestic peculiar economic conditions. The government sector remained the major client for the financial sector. Non-performing loans (NPLs) surged but still NPL-to-deposit or credit ratio remained competitive versus developing economies.

The drastic curtailment of external demand during the last two years has helped shaving off external demand, however, security and intensification of war on terror kept the government's demand for resources under pressure. On the other hand, lower than expected GDP growth, acute energy shortages and a high cost of doing business contributed to the revenue shortfall. Thereby, fiscal deficit sharply increased from 5.3 percent in fiscal year 2008-09 to 6.3 percent in fiscal year 2009-10. This kept monetary policy under enormous pressure to strike a balance between support to growth and keep inflation under check.

Monetary Policy Stance

Government's heavy reliance on SBP borrowing to finance the fiscal deficit has created a relentless increase in demand pressures. Consequently, inflationary pressures were quite severe in the beginning of fiscal year 2010-11 and become worse by the devastating floods. Moreover, the dried up external financing flows due to difficulties in IMF program and insufficient funds from non-bank sources raised the pressures on SBP borrowing to finance the fiscal deficit through most of first half of fiscal year 2010-11. A proactive policy response from the SBP to shave-off additional demand from the economy was required. To target the inflation and to contain the aggregate demand induced risks to macroeconomic stability, SBP raised the policy rate by 150 basis points (bps), staggered in three stages of 50 bps each, since July 2010. SBP raised the policy rate by 50 bps to 13 percent on 2nd August 2010. Soon after which country experienced an exogenous shock in the form of Floods. Consequently, the rate was further increased by cumulative 100 bps points to 14 percent up to 30th November 2010. While keeping in view the risks to inflation and economic growth, SBP has decided to keep the policy rate unchanged at 14 percent on 29th January 2011. Implementation of this policy stance entailed mopping up of liquidity while remaining aware of macroeconomic conditions affecting day to day availability of liquidity. Consequently the weighted average overnight money market repo rate has also increased by 124 bps on average, up till 27th January 2011, compared to the period when policy rate was kept unchanged.

Despite recent improvement in the external current account, restrained government borrowings from SBP and stable financial markets, the focus of both monetary and fiscal policy remained on addressing the structural fiscal weaknesses, reducing inflation for sustainable economic recovery and supporting revival of growth momentum in 2011-12.

Table-5.1: Policy Rate Changes

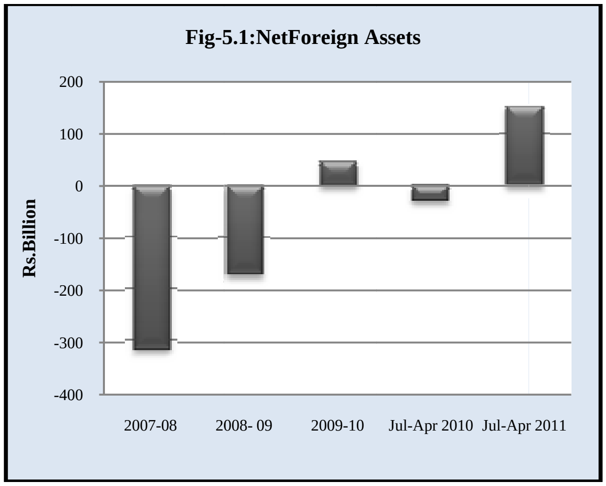
Effective Date	Policy Rate (%)
21-Apr-09	14
17-Aug-09	13
25-Nov-09	12.5
30-Jan-10	12.5
27-Mar-10	12.5
2-Aug-10	13
30-Sep-10	13.5
30-Nov-10 till date	14

Recent Monetary and Credit Developments

During first nine months of the current fiscal year (Jul-April 2010-11), broad money (M_2) has witnessed a robust growth underpinned by external sector buoyancy led increase in Net Foreign Assets (NFA) and government budgetary borrowing in NDA. Net expansion in M_2 increased by 9.6 percent during July- April, 2011 as compared to 8.1 percent during the same period last year.

Net Domestic Assets (NDA) during July-April 2011 reached at Rs 402.5 billion against Rs 446.1 billion during the same period last year. The expansion in NDA mainly attributed by a rise in demand for private sector credit and government borrowings.

On the other hand the NFA of the banking system during the period under review had increased by Rs 153.2 billion after registering a significant decline of Rs 31.3 billion during the same period of last year. The increase is due to record inflow of worker remittances worth $9 billion which are expected to cross historical $11 billion mark by the end of current fiscal year. The improvement in the current account deficit has played critical role in NFA improvement amidst sluggish inflows in the financial account. NFA witnessed a contraction in its stock which started in October 2009 continued during Jan-Apr 2010. The decline was mainly due to persistent pressures on external account as a result of lower than expected external inflows. Whereas in the remaining two month of fiscal year 2009-10, the expansion in scheduled banks' NFA came from a contraction in the current account deficit; due to robust inflows of workers' remittances and an improvement in the trade balance. The figure 5.1 presents the contraction and expansion trends of NFA.

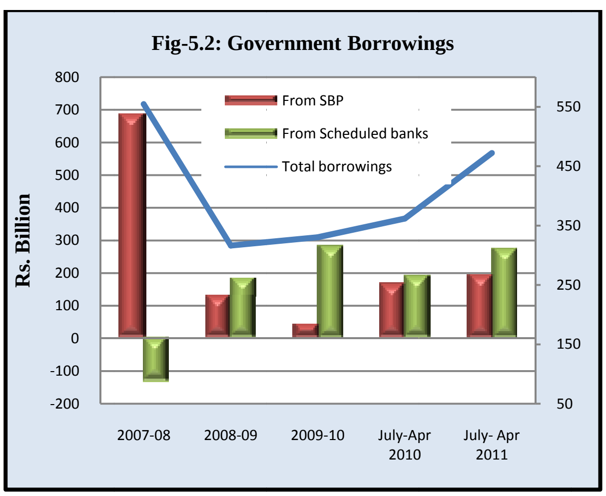


During July-April, 2011 Credit to private sector enterprises (PSEs) registered a sharp decline from Rs72.5 billion in 2009-10 to Rs 26.7 billion owing to the retirements by an oil refinery and a state owned oil marketing company . The table 5.2 reflects the profile of monetary indicators.

Table-5.2: Profile of Monetary Indicators **(Rs Billion)**

	Jul-April* 2009-10	Jul-April* 2010-11
1.Net government sector Borrowing(a+b+c)	**325.4**	**342.2**
a .Borrowing for budgetary support	361.8	472.2
b.Commodity operations	-35.6	-134.2
c.Others	-0.7	4.2
2.Credit to Non-government Sector (d+e+f+g)	**217.6**	**183.6**
d.Credit to Private Sector	144.2	156.7
e.Credit to Public Sector Enterprises (PSEs)	72.5	26.7
f. PSEs Special Account-Debt repayment with SBP	0.0	-0.2
g.Other Financial Institutions(SBP credit to NBFIs)	0.8	0.4
3.Other Items(net)	**-97.0**	**-23.3**
4.Net Domestic assets (NDA)	**446.1 (9.61%)**	**402.5 (7.69%)**
5.Net Foreign Assets (NFA)	**--31.3**	**153.2**
6.Monetary Assets(M2)	**414.8 (8.1%)**	**555.7 (9.62%)**

**Pertains to 30th April for FY10 & FY11* *Source: State Bank of Pakistan*



Government Bank Borrowing

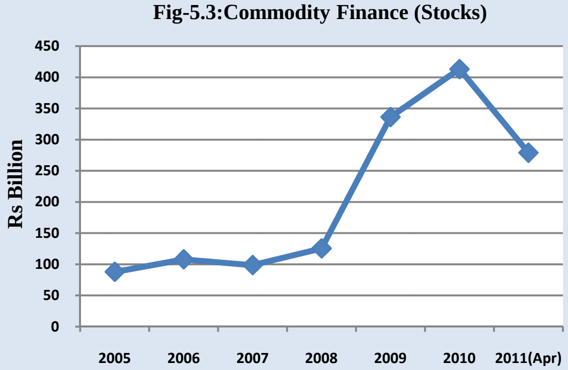
The government borrowing from the banking system for budgetary support and commodity operations stood at Rs342.2 billion during July-April, 2011 on account of weak fiscal position.

Government has borrowed Rs 196.3 billion from the State Bank of Pakistan (SBP) , while Rs 275.9 billion has been borrowed from the scheduled banks during July- April, 2011[See Fig-5.2]. Less than expected non-bank and external financing for budgetray support have compelled the government to borrow from the SBP and scheduled banks since October 2010. Within the banking system, the bulk of budgetary requirements durng July-April 2010-11 were met from scheduled banks. Nevertheless, the govervment was heavily dependant on SBP borrowing till November 2010, that has witnessed some respite in the later half of December 2010 when the government retired a large part of its debt to SBP. While on 5th May, 2011 the outstanding stock of government borrowing from SBP remained at Rs1434 billion, which is Rs144 billion higher than the agreed limit.

Commodity Finance

Commodity finance means advances provided either to the government, public sector corporations or private sector for the procurement of commodities such as cotton, rice, wheat, sugar, fertilizer etc. During July-April 2010-11 the retirement of loans under commodity financing picked up sharply and reached at Rs 134.2 billion on account of retirement of advances for wheat by provincial departments and Pakistan Storage and Supply Corporation (PAASCO) and other provincial procurement agencies as compared to Rs 35.6 billion during the same period last year. This was the result of the conscious decision of the Cabinet to allow wheat exports to capitalize upon higher international prices.

Fig-5.3:Commodity Finance (Stocks)

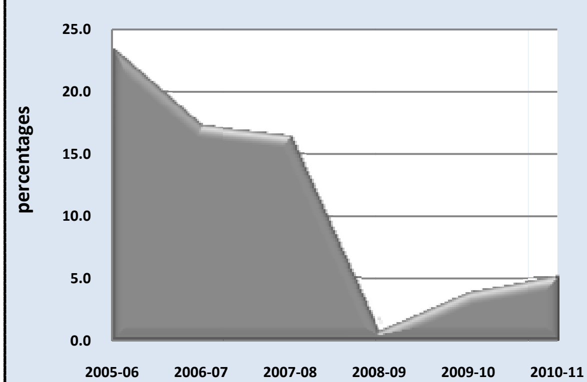


It is expected that government will avail an amount of Rs156 billion for the wheat procurement during the current season. Government procurement target is 6.57 million metric tons for 2011 season and support price is Rs950/40kg. At the same time government is expected to retire commodity credit further from continued wheat exports. Consequently, commodity financing is likely to remain zero in flow terms for the year 2011. However, even if government will depend only on rollover of the commodity financing, the expected outstanding amount close to Rs413 billion under commodity financing needs to be settled sooner than later by the end of June 2011.

Credit to Private Sector

The credit availed by the private sector during July-April, 2011 was Rs 156.7 billion compared to Rs 144.2 billion in the corresponding period last year. On the other hand, the year-on-year growth in private sector credit was 5.2 percent up till April, 2011. It is imperative to increase private sector's investment, as it plays a vital role in economic growth. Failure to which can be more challenging for the economy to generate sufficient revenues.

Fig 5.4 Growth of Private Sector Sector



A strong growth has been witnessed since January 2010 that was mainly due to an increase in seasonal demand for working capital. More than half of private sector credit went to the textile sector showing higher input prices, especially that of cotton. Sector wise breakup of private sector credit also shows that sugar and textile industries were the major drivers to this increase, which respectively availed credit of Rs 105.6 billion and Rs 62 billion during Jul-March 2011. During the same period, private sector credit increased by Rs 222.1 billion, higher by around Rs 74 billion than last year.

Table-5.3: Credit to Private sector (Rs Billion)

Sectors	July-March		Growth Rates	
	2009-10	2010-11	2009-10	2010-11
Overall Credit (1 to 5)	141.4	230.1	5.3	7.1
1. Loans[2/] to Private Sector Business	147.7	222.1	6.9	8.4
A. Agriculture	6.5	3.3	4.0	2.0
B. Mining and Quarrying	1.7	0.4	9.5	2.3
C. Manufacturing	95.0	205.3	7.7	16.2
Textiles	32.9	105.5	6.8	22.4
D. Electricity, gas and water supply	46.6	28.1	30.2	13.1
E. Construction	-2.0	-0.9	-2.8	-1.4
F. Commerce and Trade	-4.3	-18.1	-1.8	-7.9
G. Transport, storage and communications	6.4	-0.6	6.6	-0.6
H. Services	2.9	-6.3	6.9	-13.0
I. Other private business n.e.c	-3.8	3.6	-83.2	-80.9
2. Trust Funds and NPOs	0.8	3.4	6.4	25.7
3. Personal	-35.2	-17.6	-9.7	-5.5
4. Others	1.3	8.5	9.2	60.6
5. Investment in Security & Shares of Private Sector	26.9	13.6	23.8	9.4

1/ Credit is equivalent to "Advances plus Bills Purchased & Discounted plus Investments"

2/ Loans is equivalent to "Advances plus Bills Purchased & Discounted"

Table-5.4 Targets and Actual Disbursement of Agriculture Loans

Name Of Banks	Target		Actual Disbursement July-April	
			July-March	
	2009-10	2010-11	2009- 10	2010-11
5 Big Comm. Banks	124	132.4	85.2	93.3
ZTBL	80	81.8	49	37.4
DPBs	50	48.9	28.6	33.7
PPCBL	6	6.9	3.5	4.4
Total	**260**	**270**	**166.3**	**168.7**

Source: SBP

Manufacturing sector availed almost 92 percent (Rs205.3 billion) of total PSC followed by electricity, gas and water sector (13 percent), agriculture and other sectors (3 percent each). However, the impact of credit growth in these sectors was partly offset by credit contraction in commerce and trade sector (-8 percent).

The break-up of agri-credit disbursement shows that during the period under review five major banks disbursed Rs 93.3 billion against the target of Rs 132.4 billion. The low disbursement is mainly due to the devastating effect of floods which badly affected the performance of commercial banks in general and ZTBL in particular. Net decline in consumer financing during July-March 2010-11 stood at Rs 17.4 billion as compared to Rs 40.4 billion decrease in the same period last year, thereby, registered an increase of 7.1 percent against the decline of 9.0 percent in 2009-10. Loans for consumer durables witnessed a net expansion of 13.9 percent during July-March, 2010-11. However, a decline of 16.4 percent in net retirements of auto loans was witnessed that was mainly due to a significant increase in both cars and motorcycles followed by

12.2 percent negative growth in credit card financing, implying net retirement.

Table-5.5: Consumer Financing **(Rs Billion)**

Description	July-March		Growth(%)	
	2009-10	2010-11	2009-10	2010-11
Consumer Financing	-40.4	-17.4	-13.7	-7.1
1) For house building	-5.5	-5.4	-9.0	-10.0
2) For transport i.e. purchase of car	-9.1	-10.6	-11.6	-16.4
3) Credit cards	-6.2	-3.4	-17.4	-12.2
4) Consumers durable	-0.2	0.03	-41.4	13.9
5) Personal loans	-19.7	0.4	-17.0	0.4
6) Other	0.3	1.6	10.2	55.7

Source: SBP

Monetary Assets

The component of monetary assets (M_2) include: Currency in circulation, Demand Deposit, Time Deposits (Excluding IMF A/C, counterpart) and Resident's foreign currency.

Currency in Circulation

During July-April, 2010-11, currency in circulation increased to Rs 196.8 billion as compared to Rs 129.8 billion in the same period last year. Similarly the currency in circulation (CIC) as percent of money supply (M_2) has also increased by 23.5 percent in 2010-11 as against 23.1 percent during the same period in 2009-10.

Issuing of currency notes resulted in increased currency in circulation and broad money supply (M_2) in the economy. Broad money (M_2) grew by 9.6 percent during July-April 2010-11 against an increase of 8.1 percent during the same period last year. The increase in money supply is shared by both currency in circulation and deposit money.

Table-5.6 Monetary Aggregates **(Rs. Billion)**

Items	End June		July-Apr	
	2,009	2,010	2009-10	2010-11
A. Currency in Circulation	1,152.2	1,295.4	1,282.0	1,491.2
Deposit of which:				
B. Other Deposits with SBP	4.7	6.7	6.3	10.4
C. Total Demand &Time Deposits incl.RFCDs	3,980.4	4,475.2	4,263.6	4,831.3
of which RFCDs	280.4	345.4	334.2	368..2
Monetary Assets Stock (M2) A+B+C	5,137.2	5,777.2	5,552.0	6,332.9
Memorandum Items				
Currency/Money Ratio	22.4	22.4	23.1	23.5
Other Deposits/Money ratio	0.1	0.1	0.1	0.2
Total Deposits/Money ratio	77.5	77.5	76.8	76.3
RFCD/Money ratio	5.5	6.0	6.0	5.8
Income Velocity of Money	2.6	2.7	-	-

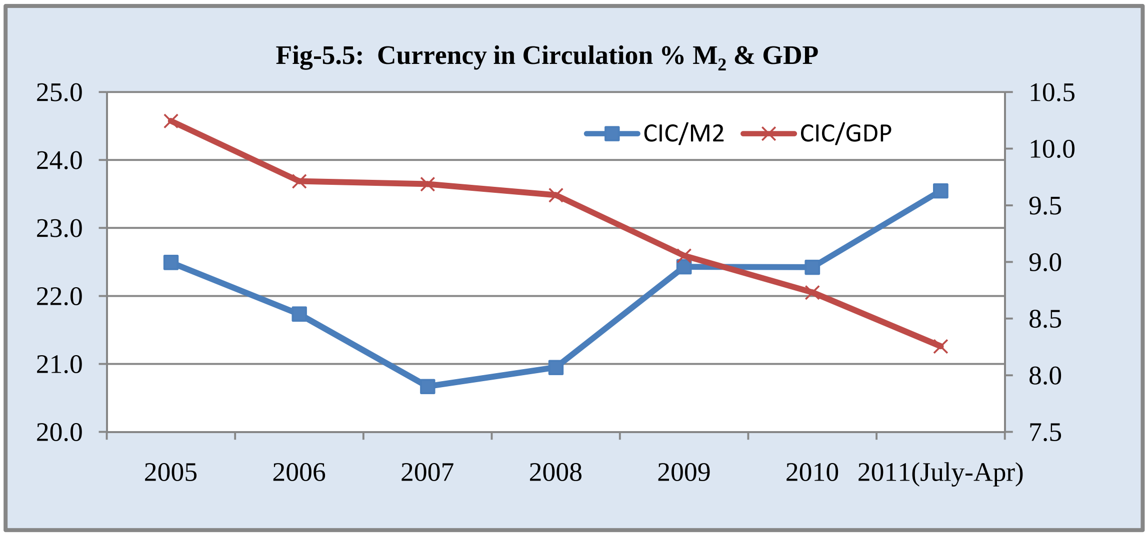
Source: SBP

Deposits

During July-April, 2011 demand and time deposits has increased by Rs 356.1 billion as compared to Rs 283.2 billion during the same period of 2009-10. Similarly Resident Foreign Currency Deposits (RFCDs) has increased by Rs 22.8 billion as compared to Rs 53.8 billion during the same period last year.

Monetary Management

Pakistan's economy has been slowed down since 2008, as the macroeconomic situation deteriorated significantly owing to multiple factors including security issues, rise in international food and oil prices, global financial turmoil, and energy crisis. Furthermore, recent unprecedented floods and heavy rains in the country to some extent have deepened the effects of an already fragile macroeconomic environment as the non-performing loans (NPLs) of the banking system increased by Rs 58 billion to reach Rs 517.9 billion by end-December 2010, against an increase of Rs 34.1 billion in the same period last year.



Liquidity conditions in the money market remained fairly comfortable during July-March 2010-11 underpinned by the reduced government borrowings from the SBP and growth in bank deposits. SBP drained this excess liquidity not only through auctions, but also mopped up a significant amount through open market operations (OMOs). The SBP mopped up Rs 540.2 billion during July-March 2010-11 against the injections of Rs 1032.3 billion whereas in the comparable period of last year absorption of Rs 242.1 billion against the injection of Rs 3352.5 billion has taken place.

Table -5.8: Summary of OMO's **(Rs. billion)**

	Injections		**Absorptions**	
	2009-10	**2010-11**	**2009- 10**	**2010-11**
July	50.0	75.1	153.6	20.5
August	250.9	165.1	-	-
September	206.0	196.6	-	54.4
October	546.7	36.9	-	171.5
November	415.2	67.6	8.0	102.5
December	648.8	34.1	6.3	128.6
January	553.2	106.9	59.9	11.5
February	316.5	119.4	-	51.2
March	365.2	230.9	14.3	-
Total	3,352.5	1,032.3	242.1	540.2

Source: SBP

The SBP accepted Rs 2527.5 billion from the primary market of T-bills during July-March 2010-11 as compared to Rs 999 billion in the same period last year. Market offered a total amount of Rs 4018.5 billion during the first nine months of 2010-11.

Table 5.9 Market Treasury bills Auctions **(Rs Billion)**

	JUL-JUN			Jul-March					
	2009-10			**Offered**		**Accepted**		**W.A.Rate***	
	Offered	**Accepted**	**W.A Rate***	**2009-10**	**2010-11**	**2009-10**	**2010-11**	**2009-10**	**2010-11**
3-Months	570.3	237.8	12.0	341.5	2479.5	131.3	1484.2	11.9	12.8
6-Months	865.9	404.5	12.0	532.9	1101.4	232.9	809.2	12.0	13
12-Months	1765.1	931.3	12.0	1188.2	437.6	634.8	234.1	12.0	13.2
Total	3201.3	1573.6	-	2062.6	4018.5	999.0	2527.5	-	-

Average of maximum and minimum rates

Source:SBP

With drying up of the external financing and fall in non-bank sources, government had left no choice but to borrow from the banking system. However, earlier in the year, when prospects of external financing were good, government had rejected all bids in auctions of longer tenure paper due to high rates demanded by banks.

On the other hand, banks were anticipating an increase in interest rates and therefore were more interested in shorter term papers. As it is evident that in the first six months of 2010-11 heavy investment was in 3-months T-bills which constituted almost 58.7 percent of the total accepted amount.

Fig- 5.7: Contribution of T-bills

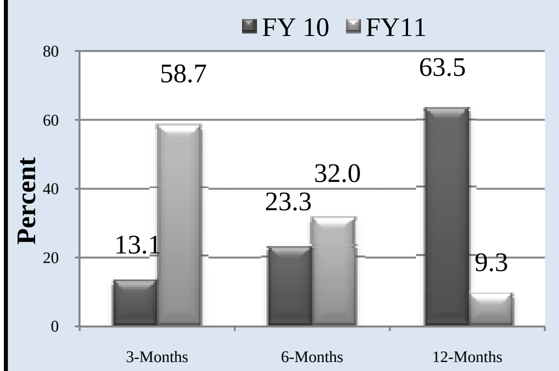
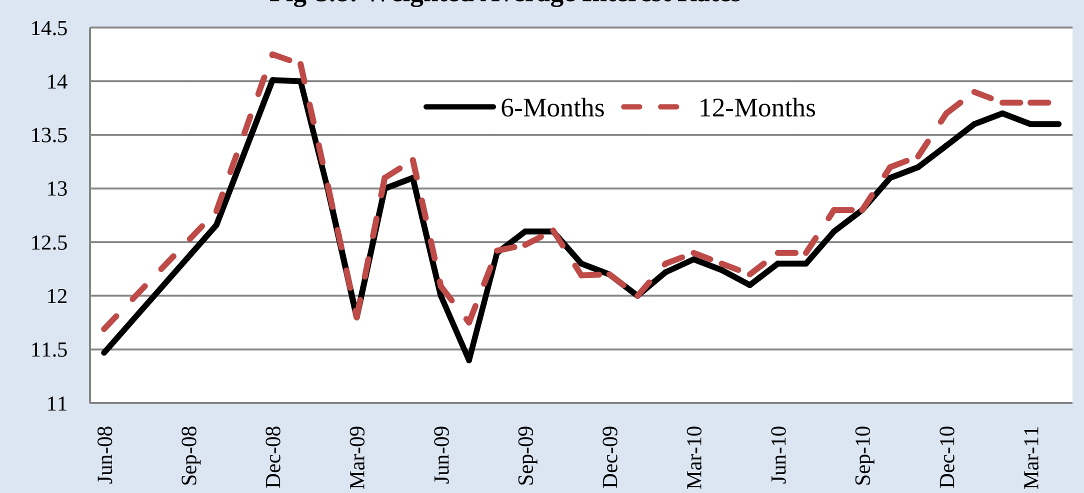


Fig-5.8: Weighted Average Interest Rates



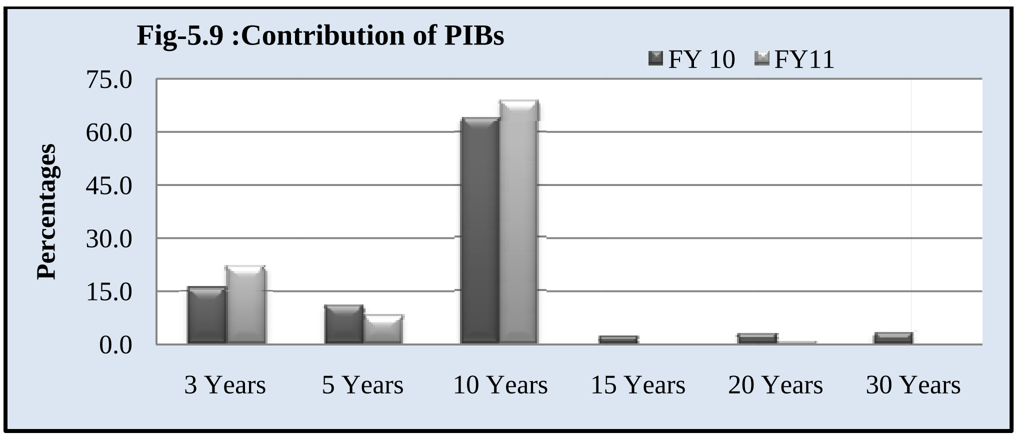
A PIB auction target of Rs 105 billion was set for Jul-February 2010-11 against maturities of Rs 27.4 billion. The government, however, rejected all bids in the first two auctions held in July and August 2010 due to high returns demanded by banks, as mentioned earlier.

Table-5.10: Pakistan Investment Bonds Auctions (Rs Billion)

PIBs	Offered	Accepted	*W.A Rate	Offered		Accepted		*W.A Rate	
	Jul-Jun			Jul-March					
	2009-10			2009- 10	2010-11	2009- 10	2010- 11	2009- 10	2010- 11
3 Years	21.2	11.6	12.30	16.9	42.2	8.2	18.7	12.3	14.0
5 Years	13.4	7.2	12.40	11.3	18.7	5.7	6.7	12.4	13.3
10 Years	69.8	39.4	12.60	57.8	111.2	32.7	57.5	12.6	14.1
15 Years	3.6	1.0	12.10	3.1	2.0	1.0	BR	12.9	Nil
20 Years	12.1	1.5	13.50	8.6	6.5	1.5	0.5	13.2	14.2
30 Years	14.6	1.8	13.60	11.5	11.1	1.8	BR	13.7	Nil
Total	**134.7**	**62.6**	-	**109.2**	**191.7**	**51.0**	**83.4**	-	-

Source:SBP

Although in subsequent auctions in an effort to retire SBP borrowings the government accepted Rs 53 billion, this was still lower than the target. The SBP mopped up Rs.83.4 billion from the primary market of PIBs during July-March 2010-11 as compared to Rs.51 billion in the same period of fiscal year 2009-10. Market offered a total amount of Rs 191.7 billion in the first nine months of 2010-11 as compared to Rs 109.2 billion in the same period of last year.



During the period under review heavy investment was in 10-years PIBs which constituted almost 69 percent of total accepted amount.

Weighted average lending rate (including zero mark-up) on outstanding loans stood at 13.6 percent while weighted average deposit rate (including zero mark-up) stood at 7.9 percent in March 2011, thus, resulted in a spread of 7.58 percent during March, 2011. Since September 2010, weighted average lending rates have increased due to tight monetary policy stance

During July-February 2010-11 in two *Sukuk* auctions Rs 89 billion were accepted against a target of Rs 80 billion. The government received offers of Rs 122.5 billion, showing a strong liquidity position of Islamic banks and their investment desire for this asset class.

Table-5.11: Lending & Deposit Rates(W.A)

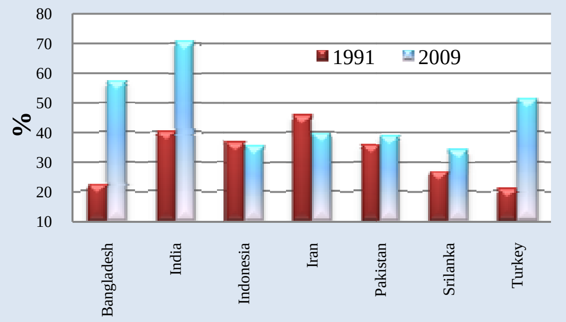
	LR*	DR*	Spread
Jan-10	13.35	6.10	7.25
Feb-10	13.38	6.07	7.31
Mar-10	13.40	6.10	7.3
Apr-10	13.42	6.03	7.39
May-10	13.4	6.05	7.35
Jun-10	13.39	5.79	7.6
Jul-10	13.35	5.84	7.51
Aug-10	13.38	5.82	7.56
Sep-10	13.34	5.77	7.57
Oct-10	13.32	5.83	7.49
Nov-10	13.42	5.88	7.54
Dec-10	13.52	5.91	7.61
Jan-11	13.62	6.02	7.6
Feb-11	13.55	6.04	7.51
Mar-11	13.55	5.97	7.58

**Lending Rate, Deposit Rate*

Box-1: Financial Development in Pakistan

Financial deepening refers to the increased provision of financial services with a wider choice of services geared to all levels of society. Financial deepening generally means an increased ratio of money supply to GDP. It refers to liquidity in the market in relation to size of the economy. High level of monetary expansion in relation to the size of the economy means, the more opportunities exist for continued growth. It reflects macro effects of financial deepening on the larger economy. Broad money (M_2) as percentage of GDP is one of the most commonly used indicator to measuring the financial deepening and level of access to financial services.

Fig-1: Comparision of M2-to-GDP Ratio



Financial deepening measures the volume of financial intervention by financial intermediaries in an economy. Considering M_2 as a proxy for the size of the financial sector, a rising M_2/GDP ratio indicates that in nominal terms the financial assets are growing faster than the non-financial assets. In contrast to the volatility in global financial markets since the beginning of the global financial crisis, the financial markets in Pakistan have continued to strengthen mainly because of the low integration with global financial markets, and in response to the ongoing reform process.

Table-1:.Key Indicators of Pakistan's Financial Development

Years	M2/GDP	DD+TD/M2
1999-00	36.9	74.6
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
July-Apr		
2009-10	36.5	70
2010-11	35.0	70

As it is evident from the Table 5.7, M_2/GDP has shown a rising trend since 1999-00 with growing economic activity and rose from 36.9 percent to 47 percent in 2006-07. However, since 2007-08 the ratio started to decline gradually and reached at 39.4 percent in 2009-10. During July-April 2010-11 M_2-to-GDP ratio has further weakened to 37.2 percent. On the other hand another significant ratio DD+TD/M_2 which also represents monetary depth has shown declining trend since 2004-05 by decreasing from 77.6 percent to 71.5 percent in 2009-10. This is the period when monetary policy stance changed from accommodating to tightening. Nevertheless, during July-April 2010-11 the ratio stood at 70 percent.

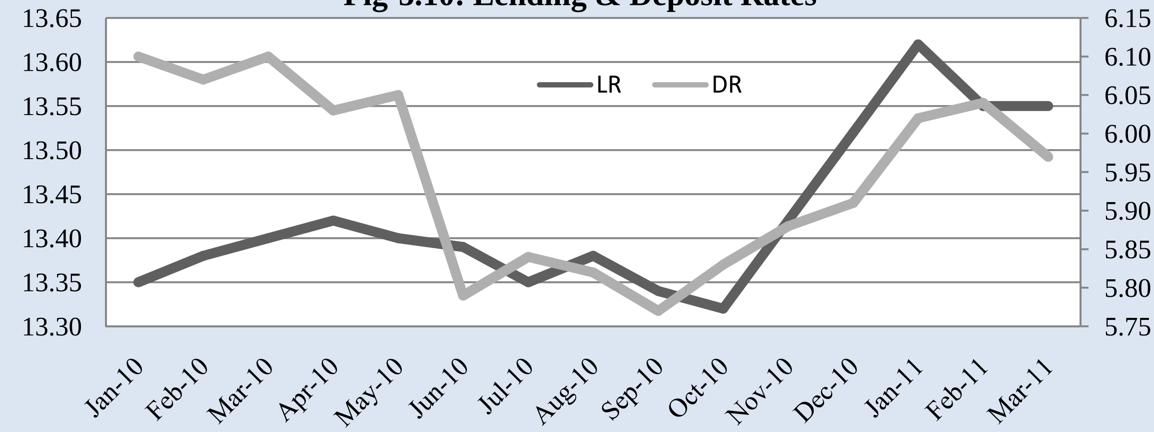
Financial deepening in Pakistan during 2007-2011 remained at lower level in contrast with the rest of the world. Slowdown in the economic activity has taking its toll on this very important indicator. The banking system remained risk averse and always prefers to provide financing for the fiscal deficit. With weakening economic activity the private sector shied away from the financial market and the government remained the only entity to provide support to monetary assets to GDP ratio. This also implies enormous idle capacity in the economy which financial sector is unable to cover. The financial market is captive to only a few instruments and prospering on highest spread in not only in the region but also among peer countries in all regions. The tight monetary policy stance of last six years has proved counter-productive as the private sector credit and capital formation witnessed inordinate shrinkage.

The falling ratio of broad money to GDP has important implications for financial stability and financial intermediation i.e, efficient allocation of resources. Under the proposed new legislation, the government will not recourse to the SBP financing and the government's commitment to lower fiscal deficit means releasing more resources for the private sector. This will impact positively to financial penetration and depth. However, it will not come ultimately as appropriate policies and incentives have to placed to use this for productive purposes.

Pakistan's Financial Sector

Financial sector is a crucial building block for the private sector development as it facilitates transactions and ensures the availability of credit and other financial products to consumers, businesses and other financial institutions. It includes banks, stock exchanges and insurer, credit unions, microfinance institutions and money lenders. It is important to have a sound and well functioning financial sector in order to support economic growth of a country.

Fig-5.10: Lending & Deposit Rates



Commercial Banks

The banking sector has recently witnessed a sharp growth in non-performing loans (NPLs) in particular during Jul-Dec 2011 on the backdrop of unprecedented floods that has intensified the effect of an already fragile economy. Thus it reflects the heightened credit risk. NPLs reached at Rs548 billion during Jul-Dec, 2011.

The asset base of the system grew by 3.8 percent during Jul-Dec, 2011 and reached at Rs 7,138 billion. Bank deposits during July-Sep 2011 witnessed a decline on account of the Ramadan and Eid related enhanced demand for currency in confluence with a slower growth in monetary aggregates. However, the situation reversed in following weeks with the replenishment of deposits forcing SBP to conduct mop- ups to check excess liquidity in the market. Hence, total deposits of all banks stood at Rs5,450 billion during July-December 2010.

Table-5.12a: Highlights of the Banking System **(Rs billion)**

	2005	2006	2007	2008	Sep-09	Dec-09	Jun-10	Sep-10	Dec-10
Total Assets	3,660	4,353	5,172	5,627	6,105	6,516	6,782	6,626	7,138
Investments (net)	800	833	1,276	1,080	1,593	1,737	1,893	1,873	2,142
Advances (net)	1,991	2,428	2,688	3,183	3,119	3,240	3,231	3,167	3,349
Deposits	2,832	3,255	3,854	4,217	4,483	4,786	5,128	5,021	5,450
Non-Performing Loans	177	177	218	359	422	446	460	494	548
Non-Performing Loans (net)	41	39	30	109	128	134	123	143	182
	Base-I					**Base-II**			
Capital Adequacy Ratio (all banks)	11.3	12.7	12.3	12.3	14.3	14.0	13.9	13.8	14.0

Source:SBP

During the first quarter of fiscal year 2010-11, the capital adequacy ratio stood at 13.8 percent against 14.3 percent during the same period last year, because the higher regulatory deductions from Tier-1 capital reduced the eligible capital as well as risk based capital adequacy ratio (CAR), which deteriorated to 13.8 percent. However, the contraction of the asset base mainly advances, led to a decline in size of the risk-weighted asset (RWA) over the quarter.

As on December 2010, total number of branches of banks stood at 9,908 as compared to 9,673 on 30 June 2010. Hence there is an increase of 235 branches in six months of 2010-11 [Table: 5.12b].

Assets of all banks showed a net expansion of Rs 355.4 billion during the first six months of 2010-11 and stood at Rs 7,137.7 billion. Hence, the asset base of the banking sector increased by 5.2 percent during July-December 2010.

Table - 5.12 b: Total Number of Branches of Schedule Banks

	30-Jun-10	31-Dec-10
1.No. of Branches	**9,673**	**9,908**
Public Sector Commercial Banks	1,777	1,791
Local Private Banks	7,292	7,511
Specialized Banks	544	546
Foreign Banks	**60**	**60**

Islamic Banking

A sustainable growth momentum has been maintained by the Islamic banks (IB) in the face of prevailing fragile economic condition. The Islamic banking assets, deposits and financing continued showing strong growth with total assets increasing to Rs 477 billion in 2010 from Rs 366.3 billion during the same period last year. The year-on year (YOY) growth in the assets was 30 percent.

Table- 5.13: Islamic Banks **(Rs Billion)**

	CY04	CY05	CY06	CY07	CY08	CY09	CY10*
Assets of the Islamic banks	44.1	71.5	119.3	205.9	276.0	366.3	477.0
Deposits of the Islamic Banks	30.2	49.9	83.7	147.4	201.6	282.6	390.1
Share in Banks Assets (%)	1.45	1.95	2.79	3.98	4.90	5.60	6.68
Share in Bank Deposits (%)	1.26	1.75	2.62	3.82	4.78	5.90	7.16

*Provisional data Islamic Banking Department, State Bank of Pakistan

Whereas the share in bank assets increased by 6.7 percent from 5.6 percent during the period under review. On the other hand, the total deposits of IB reached to Rs 390.1 billion from Rs 282.6 billion in CY09, thus it contributed to 7.2 percent in bank deposits as compared to 5.9 percent in CY09. The break-up of financing show that apart from *Murabah, Musharaka and Salam*, all other components of Islamic financing declined in CY10.

Table- 5.14: Financing Products by Islamic banks %age

Mode of Financing	CY04	CY05	CY06	CY07	CY08	CY09	CY10*
Murabaha	57.4	44.4	48.4	44.5	36.5	42.3	44.9
Ijara	24.8	29.7	29.7	24	22.1	14.2	12.7
Musharaka	1	0.5	0.8	1.6	2.1	1.8	2.9
Mudaraba	-	-	-	0.3	0.2	0.4	0.2
Diminishing Musharaka	5.9	12.8	14.8	25.6	28.9	30.4	29.5
Salam	0.7	0.6	1.9	1.4	1.8	1.2	1.4
Istisna	0.4	1.4	1.4	1	2.9	6.1	5.8
Others	9.8	12.1	3	1.6	5.4	3.6	2.6

*Provisional data *Source :SBP*

Microfinance

Government of Pakistan played an important role for sustainable development of the microfinance sector as an important part of the overall financial sector development strategy. As a result of strategic and regulatory initiatives, microfinance is now gradually mainstreaming into the formal banking system of Pakistan. The policy and regulatory environment is recognized as well developed. Most importantly, the sector's visibility has increased globally due to the launch of transformational branchless banking initiatives which leverage telecoms and postal networks and mobile phone technology to expand cost-efficient financial services to the unbanked population.

Despite the challenging macroeconomic and law & order situation, microfinance has achieved improvements in outreach, financial and operational performance. Overall, the sector (including MFIs) is currently serving more than 2.1 million active borrowers with a gross loan portfolio of Rs 25.5 billion as of 31st December 2010 .The deposit base increased by 45.5 percent during the year 2010. The microfinance sector saw significant growth in almost last three years as evident from the table below. Importantly, the deposits and loan portfolio saw a phenomenal growth in last three years.

Table-5.15: Micro-finance Industry Indicators

Indicators		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-07	MFBs	6	232	435,407	4,456,259	10,235	146,258	2,822,845
	MFIs	24	870	831,775	8,293,724	9,971	-	-
	Total	**30**	**1,102**	**1,267,182**	**12,749,983**	**10,062**	146,258	2,822,845
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**

Source: Investment Wing, Finance Division

The NPLs of MFBs exhibited negative trend as they crept up to a level of 5.3 percent at the end of March 2011 as against 1.6 percent last year. Nonetheless, the current level of NPLs is well below the estimates derived during the early damage assessment in face of heavy floods that triggered severe losses to life and property of millions during the 1st half of fiscal year 2010-11.

Channel diversification is critical to increase access to financial services in a cost-effective manner. A number of initiatives have been taken to facilitate following innovations in delivery channels:

a. The First Microfinance Bank (FMFB) entered into successful partnership with Pakistan Post (PP) to expand its lending operations in rural and remote regions using PP's network.

b. *Tameer* Microfinance Bank under its branchless banking model '*Easy Paisa*' has been facilitating the bills payment, domestic /home remittances, and m-wallets. At the end of March 2010, the volume of payments through *Easy Paisa* reached 2.25 million transactions transferring funds exceeding Rs. 8 billion.

c. United Bank Limited (UBL), a leading commercial bank is also operating its BB model by the name of 'Omni.' So far, UBL has developed a network of more than 2600 agents to provide payment services which have the potential to serve the financially excluded segment.

Private sector's commitment towards microfinance business appears promising for transformational change to attain large scale outreach through innovative business models. To sustain sector development and build on further, all microfinance institutions must assume primary responsibility for their own health and growth while the Government and donors may help bridging resource gaps by putting in place a mechanism of support/assistance which would support the long-term institutional building instead of covering institutions' operational inefficiencies and leakages.

Insurance Sector

The insurance industry in Pakistan is relatively small compared to developing countries and even the region but huge potential for expansion. In Pakistan, the insurance penetration stands at 0.7 percent of the GDP and insurance density is US$6.5 per capita. Efforts are being made to develop the insurance sector which has long been neglected.

The government encouraged liberalization and 100 percent foreign ownership and control of insurance companies was permitted by the government in 2007, with the condition of bringing in a minimum of US$2 million in foreign exchange from abroad and raising an equivalent amount from the local market. There are two dedicated foreign health insurance companies in the market, along with two foreign life and non-life insurance companies.

Despite its small size, the sector is supported by strong accounting and actuarial infrastructure. The leading listed insurance companies produce transparent financial statements. The reinsurance requirements for the sector are very stringent. A minimum of 80 percent treaty reinsurers must be A rated by internationally reputable rating agencies and only 20 percent can be BBB rated. The market has witnessed introduction of new products like health, crop and livestock insurance. New distribution channels such as Bancassurance, Websales and Telesales have also recently emerged.

Non-Life Sector

Currently there are 35 non-life insurance companies operating in the market including state-owned National Insurance Company Limited, which has a monopoly over government business including semi-autonomous entities. In non-life insurance business, 3 large private companies accounting for approximately 65 percent of the market share and approximately 93 percent stake belong to only 10 insurance companies. According to recent reports, the non-life private sector grew by 3.3 percent and the total premium revenue of the non-life insurance sector was approximately Rs. 43.6 billion. The main reason for this sluggish growth was worsening law and order situation and the resultant political instability. Additionally, the global recession also had an adverse impact on Pakistan's economy.

Life Insurance Sector

There are 7 life insurance companies in the market including state owned State Life Insurance Corporation, which enjoys 68 percent of the market share. According to latest reports, the private life insurance sector grew by 11 percent and the total premium stood at Rs. 41.9 billion.

Takaful Sector

There are 5 *takaful* operators in the market who have commenced their business operations in the recent past and are therefore still going through the initial phase of development. Out of the total, 3 general *takaful* operators are offering non-life insurance business and 3 family *takaful* operators are offering life insurance. In 2009, the total premium of the *takaful* sector was approximately Rs1.4 billion.

Reinsurance

A government-owned reinsurer, Pakistan Reinsurance Company Limited, continues to benefit from a mandatory minimum 35 percent share in the treaties of non-life companies.

Box-2: Way forward for Insurance Sector

- Revised solvency regulations shall be introduced in 2011, with an aim to reinforce the financial position of insurers over time and reduce the risk of volatility in the prices of certain assets (equities and properties) threatening their solvency.
- SECP is determined to create a transparent and enabling environment thereby increasing the insurance density by making insurance costs affordable to low-income people, and alleviation of poverty, by the development of regulatory framework for micro insurance.
- In order to ensure continued availability of comprehensive insurance cover for investment flow in the country and thus, to protect economic and financial sectors soundness, the SECP is working to develop a Terrorism Insurance Pool in Pakistan in line with international best practices and models in other jurisdictions.
- To eliminate the issuance of bogus motor third party compulsory insurance certificates by unauthorized persons/entities and to ensure that all vehicles on the country's roads have proper insurance cover issued by registered insurance/takaful companies, SECP, after detailed deliberations with the Insurance Association of Pakistan, had agreed on a comprehensive proposal..
- The Takaful Rules 2005 are being reviewed to remove the anomalies and addressing the areas which are silent in Takaful Rules, 2005. A new set of Takaful Rules 2011 is being formulated and will be issued shortly, repealing the 2005 Rules.

Source: Securities and Exchange Commission of Pakistan (SECP)