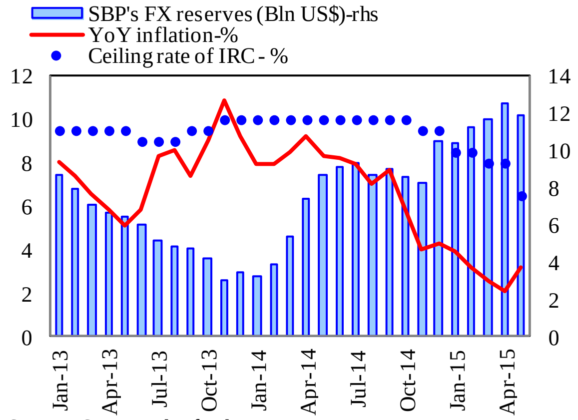
3 Inflation and Monetary Policy

3.1 Overview

With a notable improvement in macroeconomic environment, monetary easing initiated in November 2014, gained momentum during the second half of the year. SBP cut the ceiling rate of interest rate corridor (IRC) by a cumulative 250 bps in its monetary policy decisions during Jan-May 2015 (**Figure 3.1**).[1] In aggregate, the ceiling rate saw a reduction of 300 bps in four consecutive monetary policy announcements to reach a historic low of 7.0 percent by end-May 2015. The key drivers were: (a) a sharp decline in inflation along with the improved inflationary outlook; (b) the growing ease on external front; and (c) the relatively contained budgetary deficit, with a shift in its' financing away from SBP. The underlying reasons were both the prudent economic management and good fortune.

Figure 3.1: Key Indicators



Source: State Bank of Pakistan

Sharp fall in international oil prices along with inflows from a robust growth in workers' remittances, a successful issuance of Sukuk in the international market and disbursements under the IMF program (driven by policy initiatives), helped improve the external sector during Jul-Mar FY15. The net impact is amply visible from: (a) SBP's liquid foreign exchange reserves, which surged to US$ 11.6 billion by end-March 2015, more than double the level seen a year ago (**Figure 3.1**);[2] and (b) the exchange rate (PKR parity with US Dollar), which depreciated only by 3.1 percent during Jul-Mar FY15.

The stability in PKR, the government decision to pass-on the benefit of fall in international oil prices to domestic consumers, and the lagged impact of prudent

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[1] Please see footnote number 5 for developments related to IRC.
[2] SBP also comfortably met the target on net international reserves (NIR) for end-March 2015 under the IMF program.

monetary policy, eased both inflation and inflationary expectations. While headline YoY inflation plunged to a decade's low of 2.5 percent in March 2015, the period average (Jul-Mar FY15) declined to 5.1 percent compared to 8.6 percent during the same period last year.[3] This disinflation is broad-based, as all measures of inflation (food, non-food, non-food-non-energy, trimmed, and Relatively Stable Component of CPI[4]) registered noticeable declines during the period of analysis.

Low inflationary environment is also benefiting from favorable changes in the composition of deficit financing, especially from the banking system. Although government borrowing from the banking system in absolute terms was slightly higher than that in the corresponding period last year, it carries substantially different implications for the monetary expansion in the economy. Specifically, the government borrowed Rs 58.8 billion from SBP in Jul-Mar FY14, which had an expansionary impact on the reserve money. In sharp contrast to this, the government made net retirement of Rs 674.4 billion to SBP during Jul-Mar FY15, which has contracted the reserve money. This net retirement not only helped the government contain its borrowing from SBP within the ceiling agreed with the IMF for end-Mar 2015, but also comfortably meet the limit of zero quarterly borrowing prescribed in SBP Act, 1956.

This contractionary impact of retirements to SBP together with the beginning of monetary easing in November 2014, complicated the liquidity management. SBP stepped up its liquidity injections through open market operations (OMOs), which pushed up the volumes of OMOs to near Rs 1.0 trillion by end-March 2015. **Figure 3.2** shows that higher volumes were also required to reduce the OMO cut-off rate to the desired level, which was kept around 50 bps lower than SBP reverse repo rate (ceiling of interest rate corridor) from mid-Feb 2015 onwards. This marked shift in OMO cut-off rates from its past trend was a harbinger of potential changes in interest rate corridor framework, which were implemented on May 25, 2015.[5]

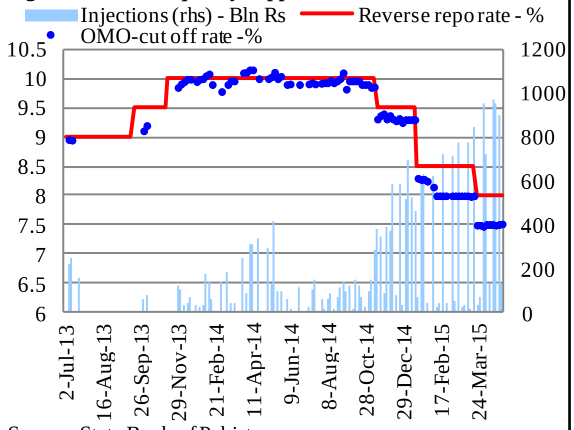
[3] Average CPI inflation for FY15 decelerated to 4.5 percent, which is substantially lower than the target of 8.0 percent for the year, and the average inflation of 8.6 percent in FY14.

[4] Relatively Stable Component of CPI is a new measure of core inflation. It permanently excludes the relatively volatile commodities from the CPI basket. However, it includes both food and non-food commodities, indicating persistent price behavior in Pakistan. For details, see Inflation Monitor for Mar 2015 on http://www.sbp.org.pk/publications/Inflation_Monitor/2015/Mar/IM_Mar_2015.pdf

[5] Specifically, SBP press release dated 24th February 2015 reveals that the bank is in process of revisiting its interest rate corridor by introducing 'SBP Target Rate' for money market overnight repo rate. Maintaining an almost fixed spread between the OMO cut-off rates and the ceiling of interest rate corridor indicate that SBP has implicitly implemented the potential changes well before the May 25, 2015, for smooth transition to new IRC framework.

As for the effect of SBP liquidity injections on money supply is concerned, this must be seen in macro perspective. Despite increasing volumes of OMOs, the reserve money grew by only 4.9 percent during Jul-Mar FY15, compared with 8.0 percent during the same period last year. Moreover, this modest increase was entirely driven by notable improvement in external accounts, while NDA of SBP saw a net contraction of Rs 22.1 billion (0.9 percent) during the period.

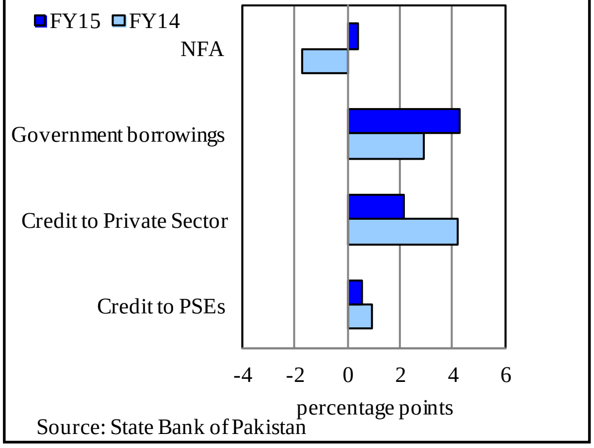
Figure 3.2: SBP Liquidity Support: OMOs



Source: State Bank of Pakistan

Like reserve money, broad money supply also grew at a slightly lower rate of 5.7 percent during Jul-Mar FY15, compared with 5.9 percent during the same period last year. On the face of it, this lower growth in broad money supply is at odds with the easy monetary policy stance of SBP. To put this in perspective, one must note that: (a) SBP has been very active in providing liquidity to keep the interest rate at the desired level; and (b) deceleration in credit to private sector could be attributed to soft commodity prices. In fact, a sharp decline in international commodity prices (oil, cotton, rice, edible oil, mettles, etc.); healthy corporate profits; and excess capacity with the corporate sector, have reduced the demand for bank credit in nominal terms.

Figure 3.3: Contribution to Broad Money Growth



Source: State Bank of Pakistan

3.2 Developments in monetary aggregates

Unlike the previous year when monetary tightening and a sharp contraction in NFA helped contain monetary expansion; an unwarranted deceleration during Jul-Mar FY15 was entirely driven by a slowdown in NDA of the banking system (**Table 3.1**). Within NDA, expansionary impact of government sector borrowing was more than offset by lower credit expansion to the private sector and public sector enterprises (**Figure 3.3**).

Table 3.1: Monetary Aggregates (Jul-Mar)

flow in billion Rupees; growth in percent

	Absolute Changes since end June		YoY growth in stocks	
	FY14	FY15	FY14	FY15
Money Supply (M2)	526.6	568.1	5.9	5.7
NDA	629.8	433.6	7.3	4.6
SBP	178.0	-21.1	9.1	-1.1
Scheduled Banks	451.8	454.8	6.8	6.1
NFA	-103.2	134.4	-38.4	22.4
SBP	-59.0	160.9	-44.3	32.9
Scheduled Banks	-44.2	-26.5	-32.5	-23.8

Source: State Bank of Pakistan

3.2.1 Net Foreign Assets

Growing ease on external front has significantly improved the net foreign assets (NFA) of the banking system. In absolute terms, NFA expanded by Rs 134.4 billion during Jul-Mar FY15, compared with the contraction of Rs 103.2 billion during the same period last year. Institutional breakup shows that the expansion was largely driven by NFA of SBP, reflecting the monetary impact of pick up in multilateral /bilateral inflows (other than the IMF) and the issuance of a Sukuk bond.

Moreover, contraction in NFA of scheduled banks was relatively (Rs 26.5 billion) low during Jul-Mar FY15, as compared with the same period last year. This marginal improvement was attributed to increase in scheduled banks' assets held abroad, which increased by Rs 18.5 billion during Jul-Mar FY15, against a net decline of Rs 0.9 billion during the same period last year. Net retirement in trade financing against FE-25 deposits, also helped banks increase their balances abroad.[6] The foreign liabilities of scheduled banks also reduced, as borrowing from banks abroad was lower than last year.

3.2.2 Net domestic assets

Net domestic assets (NDA) of the banking system expanded by Rs 433.6 billion during Jul-Mar FY15 compared with Rs 629.8 billion during the same period last year. This relatively small expansion can be traced to a slowdown in credit to the private sector, which overshadowed the growth in government sector borrowing. Institutional break up shows that SBP's NDA recorded a contraction of Rs 21.1 billion in Jul-Mar FY15, against an expansion of Rs 178.0 billion during the same

[6] Trade financing against FE-25 deposits was US$ 940 million during Jul-Mar FY14, in contrast with retirements of US$ 192 million during Jul-Mar FY15.

period last year. This contraction was entirely driven by huge net retirements by the fiscal authorities.

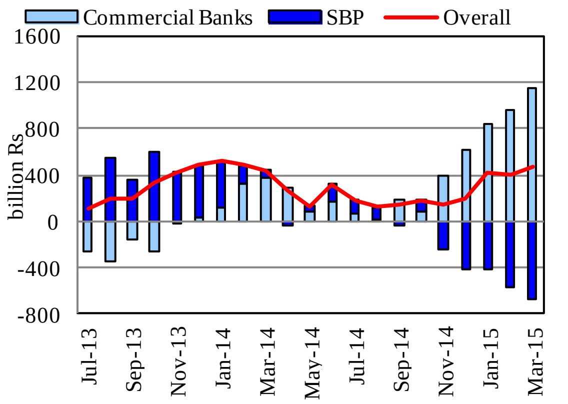
Although NDA of scheduled banks remained almost unchanged during the period of analysis, there were notable changes in contributory factors compared to the last year. Specifically, government borrowing from scheduled banks was three times higher than the level seen in Jul-Mar FY14, while credit extended by commercial banks to the private sector and public sector enterprises was almost half of the last year's level. Subsequent discussion, explore these two issues in details.

Government borrowing for budgetary support[7]

In aggregate, there was a small increase in government borrowing from the banking sector during Jul-Mar FY15, compared with the same period of last year. However, the composition of government borrowing during Jul-Mar FY15 differed substantially from that of the last year.

As shown in **Figure 3.4**, government borrowing from SBP saw a massive retirement during Jul-Mar FY15, compared with small borrowing during the same period last year. This retirement helped the government contain its budgetary borrowing from SBP within the ceiling agreed with the IMF for end-Mar 2015, and to meet the quarterly limit of zero borrowing under the SBP Act, 1956.

Figure 3.4: Net Budgetary Borrowing- Cumulative Flows



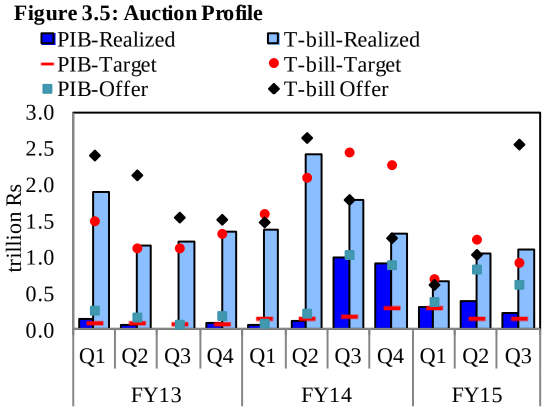
Source: State Bank of Pakistan

This net retirement to SBP was partially financed by government borrowing from commercial banks. Specifically, the government borrowed Rs 1,143.8 billion from commercial banks during Jul-Mar 2015, compared with Rs 378.1 billion during the same period last year.

[7] It may be noted that government borrowing data mentioned in this section is on cash basis, which may not match data from Monetary Survey compiled on accrual basis.

A brief review of auctions for government securities reveals that not only the government was willing to borrow, commercial banks were also keen to invest in *risk free* government securities during the period of analysis. As shown in **Figure 3.5**, commercial banks aggressively participated in primary auctions for government securities to lock-in their funds at prevailing higher interest rates as monetary easing was on the cards after Q1-FY15.[8]

Figure 3.5: Auction Profile



Source: State Bank of Pakistan

Within government securities, 3-year PIB was the most preferred instrument for commercial banks. In fact, a disconnect between T-bill and PIB segments of the yield curve prevailed, especially before the change in monetary policy stance in November 2014.[9] Banks exploited this opportunity by aggressively participating in PIB auctions, which was quite rewarding as the government accepted well above the pre-auction targets to improve maturity profile of its domestic debt. For example, banks offered Rs 828.6 billion in PIB auctions during Q2-FY15 against the cumulative target of only Rs 150.0 billion, and the government realized Rs 354.3 billion from these auctions (more than double the target).

Bid pattern in the auctions for government securities during Q3-FY15 indicates that commercial banks appetite for PIBs has peaked, and the demand for T-bills has revived to some extent (**Figure 3.5**). Unlike the first and the second quarters of the year, commercial banks were aggressively bidding in T-bills auctions during Q3-FY15. As a result, the government was able to generate Rs 1,107.2

[8] It must be recalled that SBP kept its monetary policy stance unchanged during the first quarter of the year due to potential impact of August 2014 floods on food inflation; unfavorable activity on political front; and delay in the 4th Review of the IMF program. Furthermore, liquidity in the money market was cautiously kept tight to avoid any unnecessary pressure on the exchange rate, and to facilitate stabilization under the IMF program.

[9] Specifically, average term premium between 3-year PIBs and 6-month T-bills was 229 bps during Q1-FY15, which reduced to 117 bps during Q2-FY15 and eventually narrowed to 11 bps during Jan-Feb FY15.

billion from these auctions, which was double the maturing amount and well above the cumulative target of Rs 925.0 billion for the quarter.[10]

Commodity operations

The outstanding loans for commodity operations declined to Rs 436.8 billion by end-March 2015, compared to Rs 492.4 billion as of end-June 2014. However, this net retirement of Rs 55.7 billion during Jul-Mar FY15 was much lower compared to the retirement of Rs 133.7 billion during the same period last year (**Table 3.2**). This was primarily on account of wheat financing, as procurement agencies were unable to off-load their wheat stocks before the arrival of fresh crop, which undermined their ability to retire back credit during Jul-Mar FY15.

Table 3.2: Loans for commodity operations (Jul-Mar)

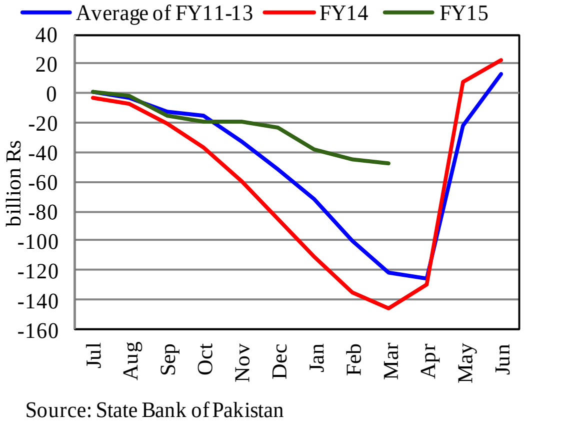
billion Rupees

	FY14	FY15
Wheat	-146.1	-47.6
Sugar	3.0	-0.8
Urea	9.3	-8.9
Rice	0.1	0.1
Cotton	0.0	1.5
Overall	-133.7	-55.7

Source: State Bank of Pakistan

The real issue is the relatively high wheat prices in domestic market as compared to the international market. To benefit from this price differential, the private sector imported 0.7 million tons of wheat during Jul-Mar FY15. This additional wheat supply in the market as well as the issue of wheat support price, made it difficult for procurement agencies to make seasonal retirements. Moreover, it must be recalled that FY14 was relatively an exceptional year as heavy retirements were made during that period (**Figure 3.6**).

Figure 3.6: Net Cummulative Flows - Wheat Financing



Source: State Bank of Pakistan

As pointed out in earlier SBP reports, receivables on account

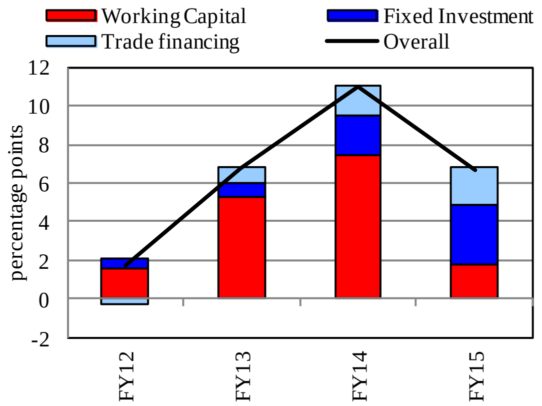
[10] These investments of commercial banks in government securities were partially financed by short term borrowing from the central bank.

of subsidies and sales proceeds constitute around 50 percent of outstanding loans for commodity operations. Smooth settlement of these receivables is imperative for improving fiscal transparency, and containing financial cost of commodity operations.

3.3 Credit to private sector

In absolute terms, credit to private sector expanded by Rs 204.9 billion during Jul-Mar FY15, compared with an expansion of Rs 335.8 billion during the same period last year. Although this slowdown is attributed to both demand and supply side factors, the role of the former seems to be more pronounced. Specifically, sharp fall in commodity prices, healthy corporate profits, excess capacity with the industrial sector, continuation of energy shortages, and higher real cost of borrowing, have reduced the demand for bank credit. On the other hand, although banks eagerness to invest in *risk free* government securities reduced supply of loanable funds for the private sector, this should not be a major constraining factor in the presence of huge liquidity injections by SBP and visible fall in interest rates.[11]

Figure 3.7: Contribution in Credit to Private Sector



Source: State Bank of Pakistan

Distribution of credit by type shows that the deceleration was entirely stemming from lower working capital loans to private businesses (**Figure 3.7**). Among other factors, sharp fall in commodity prices seems to be a major reason. Working capital loans, adjusted for the fall in wholesale prices, indicate a growth of 8.9 percent during Jul-Mar FY15, compared with 7.5 percent during the same period last year. Moreover, fixed investment loans expanded by Rs 84.4 billion during Jul-Mar FY15 (1.7 times of the expansion seen in Jul-Mar FY14) (**Table 3.3**).

[11] The average volume of OMOs for liquidity injection stood at Rs 78.4 billion, Rs 217.4 billion and Rs 390.3 billion during the first, second and third quarter of FY15, respectively.

In addition to macroeconomic factors, sector specific developments also impacted credit expansion during the period of analysis, which are briefly reviewed in the discussion to follow.

Table 3.3: Credit to private sector businesses (Jul-Mar)

Flows in billion rupees

	Total Credit		Working capital		Fixed investment		Trade financing	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Private sector business	271.7	185.1	177.0	50.6	50.7	84.4	44.1	50.2
1) Agriculture	16.6	14.3	11.1	11.1	4.7	8.2	0.8	-5.0
2) Manufacturing	215.1	104.6	143.4	26.7	36.4	44.0	35.4	34.0
Food & beverages	95.2	56.8	71.0	24.2	15.6	17.2	8.6	15.4
Rice	36.9	10.1	25.4	0.0	2.3	5.0	9.3	5.1
Sugar	49.7	40.1	38.8	19.7	10.3	17.2	0.6	3.2
Beverages	13.1	6.1	12.5	3.4	0.0	1.5	0.5	1.3
Textile	68.6	29.5	53.7	15.9	1.3	1.8	13.6	11.8
Cement	-7.2	-1.6	-5.8	-1.7	-1.6	0.5	0.1	-0.4
3) Electricity	26.8	-3.2	8.0	1.0	19.2	-6.0	-0.4	1.9
4) Telecom	-7.9	10.2	2.3	8.3	-11.3	1.0	1.2	0.9
5) Others*	51.2	60.9	38.4	-19.0	9.1	52.7	3.8	27.2

*Fishing, hotel, transport, petroleum, edible oil, education, commerce & trade, construction, mining & quarrying, ship breaking, real estate, health, etc.

Source: State Bank of Pakistan

Food & beverages sector

Within manufacturing sector, net credit expansion to food & beverages sector during Jul-Mar FY15 was almost half the amount seen in Jul-Mar FY14. Decline in commodity prices was the major contributory factors as:

- Price of paddy fell from Rs 2400-2500/40kg during FY14 to only Rs 1500-1600/40kg during the period of analysis, which reduced credit needs of rice processing mills.
- Credit availed by sugar industry during Jul-MarFY15 was slightly lower than the last year, which can be traced to a decline in production. Sugarcane crop posted a decline from 67.5 million tons in FY14 to 62.6 million tons during the current season.
- Credit expansion to beverages sector was less than half the increase seen during Jul-Mar FY14. Lower demand for working capital loans seems to be

major contributory factor, as fixed investment loans increased during Jul-Mar FY15.[12]

Textile sector

Decline in cotton prices and weak external demand, were the main factors that led to lower credit off take by the textile sector. In addition, most of the textile firms were retiring their fixed investment loans during the first half of FY15. Had these retirements not been made, the overall credit off take have been marginally higher as demand for fixed investment loans increased during Q3-FY15.

Energy sector

In contrast to net credit expansion of Rs 26.8 billion during Jul-Mar FY14, energy related enterprises retired Rs 3.2 billion during Jul-Mar FY15. While working capital loans remained lower than the last year's level, fixed investment loans posted a net retirement of Rs 6.0 billion during Jul-Mar FY15. Among other factors, these developments are also linked to the settlement of inter-agency receivables in the energy sector at the onset of FY14, which helped generate electricity. This resumption and expansion of operations, created demand for working capital and fixed investment loans during that period. However, retirement of fixed investment loans and lower working capital requirements reversed the trend during Jul-Mar FY15.[13]

Telecom sector

Against a net retirement of Rs 7.9 billion during Jul-Mar FY14, credit to the telecom sector expanded by Rs 10.2 billion during the review period. Both working capital and fixed investment loans increased following the launch of 3G/4G spectrums in April 2014. Lately, the purchase of equipments related to bio-metric verification by cellular firms and the launch of 4G LTE in December 2014 by one of the leading cellular companies, also contributed to healthy credit off-take.

Consumer financing

Consumer financing saw an expansion of Rs 16.0 billion during Jul-Mar FY15, compared to an increase of Rs 21.5 billion in Jul-Mar FY14 (**Table 3.4**). This deceleration was primarily a function of small increase in personal loans, especially compared to the last year. Relatively high base effect along with the

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[12] As mentioned in previous quarterly reports, one of the leading producers is in the process of establishing three green-field production plants in the country, which is contributing to higher fixed investment loans.

[13] Re-emergence of inter-agency receivables, which have reached the level of Rs 280 billion, constrained the efficient functioning of the energy sector.

retirements of loans availed during past two years, and heavy utilization of the well known personal loans schemes, appears to be the contributory factors.

Table 3.4: Consumer Financing (Jul-Mar)

billion Rupees

	FY12	FY13	FY14	FY15
Overall	-17.4	8.5	21.5	16.0
For house building	-5.4	-2.4	-0.1	0.1
For transport i.e. purchase of car etc	-10.6	2.3	9.0	12.7
Credit cards	-3.4	-1.9	-0.5	-0.5
Consumers durable	0.0	-0.1	0.2	-0.1
Personal loans	0.4	10.2	13.9	4.9

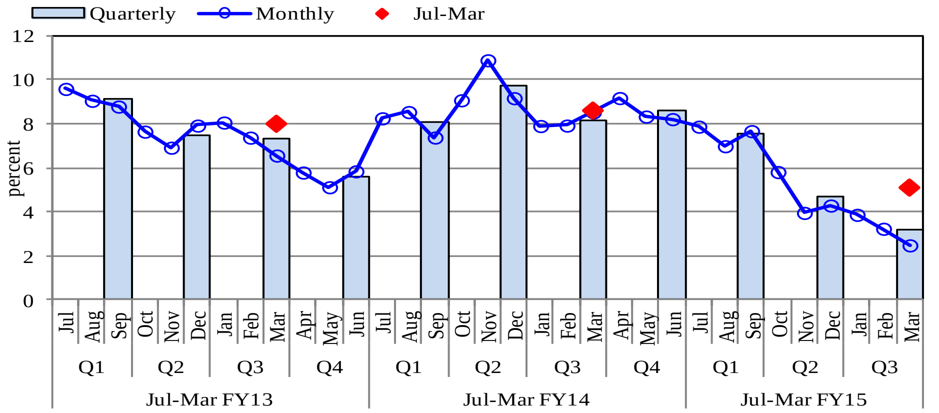
Source: State Bank of Pakistan

Auto financing, with 30 percent share in consumer financing, posted a healthy growth of 11.6 percent during Jul-Mar 2015. Change in regulatory requirement, which allowed banks to finance used cars up to 9 years old, and the launch of new locally assembled sedan, seems to be the major contributory factors.

3.4 Inflation

CPI inflation continued to decline in the third quarter of the year, and reached a decade low of 2.5 percent in March 2015. The average inflation during the first nine months of FY15 was 5.1 percent, which was more than 3.5 percentage points lower than the same period last year (**Figure 3.8**). This sharp reduction in

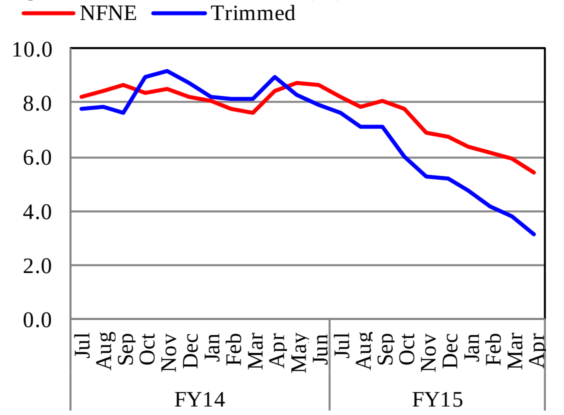
Figure 3.8: CPI Inflation (YoY)



Source: Pakistan Bureau of Statistics

inflation was mainly due to steep fall in international oil prices, which was passed on to domestic consumers, and low commodity prices in the global markets.[14] Additional support also came from stable exchange rate, and the lagged impact of tight monetary policy prevailed during FY14 and initial months of FY15.

Figure 3.9: YoY Core Ionflation (%)



Source: Pakistan Bureau of Statistics

As YoY inflation in both the food and non-food groups declined sharply during this period, the core inflation also showed significant reduction (**Figure 3.9**). Particularly, the core inflation measured by trimmed mean, which excludes extreme price changes, showed a more pronounced decline. In fact, prices of around one fourth items in the CPI basket either declined or stayed unchanged during the third quarter of the year, compared with the 16 percent during the same period last year.

All the commodity groups showed single digits inflation in Q3-FY15, except tobacco and education (which includes fees charged by private school and colleges). The real driving factor was the transport group, which showed a price decline of 10 percent during the quarter (**Table 3.5**). However, it is pertinent to note that within the transport group, fares saw a reduction of only 4.8 percent.

The impact of reduction in fuel prices was also visible from the Administered Price Index (API) – a sub-index of items, prices of which are administered by the government. The API showed an inflation of 0.6 percent during Jul-Mar FY15, substantially lower than 7.4 percent recorded in the corresponding period last year. Although the government increased electricity charges by 1.8 percent in November 2014, its impact was more than compensated by reduction in fuel prices. Moreover, average wheat prices also declined by 5.6 percent during Jul-

[14] IMF's Commodity Price Index (overall) witnessed 20.1 percent decline during Jul-Mar 2015 over the same period last year, while sub-index of food prices declined by 9.7 percent during this period.

Mar FY15 compared with the same period last year, which contained not only administered price inflation, but also general CPI inflation.[15]

Table 3.5: YoY Inflation in Consumer Price Index
(percent)

	FY14				FY15			Jul-Mar	Jul-Mar
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	FY14	FY15
Food Group	**9.1**	**10.7**	**8.0**	**8.2**	**6.6**	**3.6**	**1.9**	**9.3**	**4.0**
Food & beverages	8.8	10.5	7.5	7.5	5.8	2.7	0.9	8.9	3.1
Tobacco	14.6	14.9	16.0	22.2	22.4	21.7	20.2	15.2	21.4
Non- food Group	**7.3**	**9.0**	**8.2**	**8.9**	**8.2**	**5.5**	**4.2**	**8.2**	**5.9**
Clothing & Footwear	15.0	13.4	11.7	11.3	9.4	8.6	7.7	13.3	8.6
Housing:	6.5	9.5	9.3	9.7	8.9	5.8	5.7	8.5	6.8
House rent	8.2	7.9	8.0	8.6	7.8	7.6	7.5	8.0	7.6
Electricity charges	0.0	15.8	15.8	15.8	15.8	1.2	1.8	10.5	5.8
Gas charges	7.0	7.0	0.9	0.6	0.0	0.0	0.0	4.9	0.0
Labor wages *	10.8	11.0	10.1	10.0	7.8	7.4	7.6	10.6	7.6
Other housings **	8.0	9.8	10.0	9.3	7.4	4.9	2.9	9.3	5.0
Furnishing & maintenance	8.4	8.7	8.8	9.6	8.8	7.2	6.0	8.6	7.3
Health	7.0	6.4	6.4	7.3	6.8	5.8	5.4	6.6	6.0
Transport	2.6	6.9	4.7	4.5	4.9	-1.8	-10.0	4.7	-2.4
Communication	4.9	4.8	0.9	0.9	0.2	0.2	0.3	3.5	0.2
Recreation & Culture	9.4	9.9	9.0	6.6	4.7	3.7	3.4	9.4	3.9
Education	8.0	8.6	7.9	15.8	15.7	14.5	14.2	8.1	14.8
Restaurant & Hotels	10.4	12.2	12.9	13.4	10.6	7.7	5.5	11.9	7.9
Miscellaneous	5.7	4.6	5.1	5.9	7.1	5.3	4.5	5.1	5.6
Overall CPI	**8.1**	**9.7**	**8.1**	**8.6**	**7.5**	**4.7**	**3.2**	**8.6**	**5.1**

*: Includes wages of un-skilled labor, carpenter, mason, plumber, and electrician.
**: Includes cement, bricks, blocks, paints, bajri, sand, iron bar, timber, firewood, kerosene oil, and water charges.

Inflation expectations

Although international oil price seems to have bottomed out, it is still way below the June 2014 level. It implies that fuel inflation in the remaining months of FY15 will have a dampening effect on average headline inflation. Moreover, stable PKR (due to comfortable balance of patment position and foreign exchange reserves) and shift in government borrowing from SBP to commercial banks, will also keep inflation expections at low level.

The survey-based inflation expectations indicator, as measured by the IBA-SBP Consumer Confidence Survey (CCS) conducted in March 2015, also indicates lower inflation expectations for the rest of this fiscal year and early part of the next fiscal year. Medium-term inflation expectations (6-months-ahead inflation),

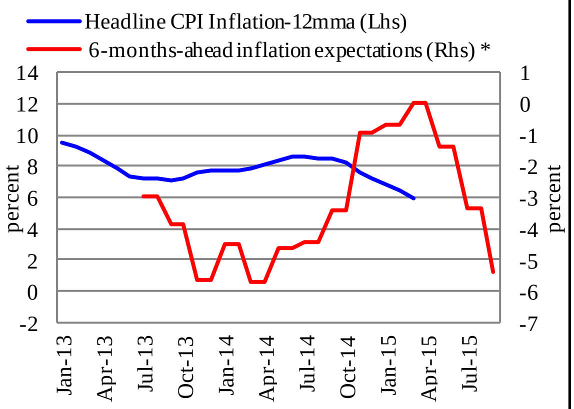
[15] The role of wheat prices in affecting overall inflation in the short to medium term in Pakistan has been well documented by Khan, M. S. and Schimmelpfennig, Axel (2006), Inflation in Pakistan: Money or Wheat?; SBP-Research Bulletin Volume 2, Number 1, 2006.

gauged from one of the survey question, has improved in a third consecutive survey conducted in March 2015.

In line with the survey-based indicator, a Financial Market measure of inflation expectations also improved further during Q3-FY15 as shown by a 209 bps fall in long-term interest rates (on 10-year PIBs) since end-December, 2014.[16] In aggregate, 10-year PIB yield has declined by 410 bps from September 2014 to end-March 2015.

As shown in **Figure 3.10**, the 6-months-ahead inflation expectations (a measure from IBA-SBP CCS) has been leading a moderation in the headline CPI inflation since the inception of the IBA-SBP CCS in January 2012. On the basis of future trajectory of this indicator coupled with a contained government borrowing from SBP and the stability in the exchange rate, it is expected that average headline CPI inflation may drop further from its current level despite an uptick in crude oil prices in the international market.

Figure 3.10: Inflation Expectations vs. Headline CPI



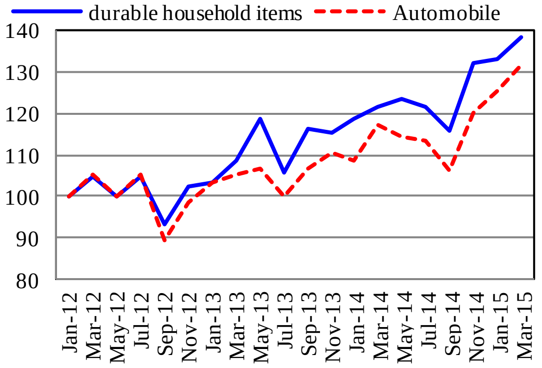
*: This line shows YoY changes in the moving average of one of the indices of IBA-SBP CCS survey measuring overall inflation expectations for next 6-months.
Source: State Bank of Pakistan.

Nonetheless, the recent trends of crude oil futures market suggest that international oil prices are likely to stay lower over the next two years, mainly driven by the prospects of a stronger US dollar and higher Iranian crude oil supplies after the potential lifting of sanctions.

[16] While in the survey-based measure of inflation expectations, the respondents are directly asked about the expected inflation, a Financial Market measure of inflation expectations involves inferring medium to long-term inflation expectations from the yield curve. Specifically, money market interest rates on the long-term government bonds reflect a compensation for expected inflation over the time horizon of the bonds, besides showing a reward for postponing current consumption and a liquidity premium.

In the light of the prolong softening of the international oil prices and an accommodative monetary policy stance by the SBP, the IBA-SBP Consumer Confidence Index (CCI) further rose to 156.8 in the survey conducted in March 2015.[17] Meanwhile, the responses of the IBA-SBP CCS respondents about durable goods purchases over the next six months also portray the brighter prospects for Pakistan's economy (**Figure 3.11**).

Figure 3.11: The IBA-SBP CCS: Next six months for purchasing



Source: State Bank of Pakistan

[17] The highest level this index has reached since its creation.