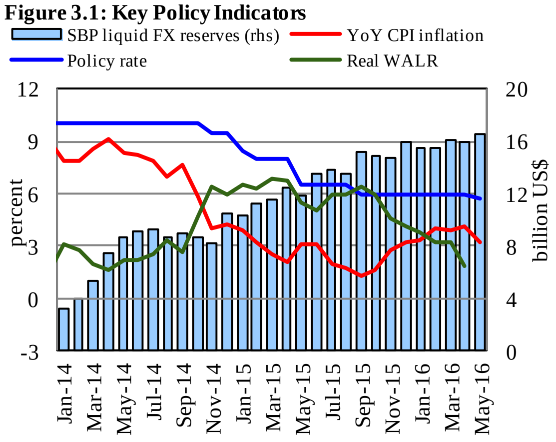
3 Inflation and Monetary Policy

3.1 Overview

Following a 50 bps cut in the policy rate to historic low level of 6 percent in September 2015, SBP kept the rate unchanged in the subsequent monetary policy reviews up to March 2016 (**Figure 3.1**). In these reviews, SBP primarily considered two policy options: either a small rate cut or status quo.[1] In effect, critical evaluation of key developments in macroeconomic environment along with the outlook during these reviews suggested that the benefits of further rate cut were balanced out by the associated risks.[2] However, in the recent monetary policy review of May 2016, SBP cut the policy rate by 25 bps to all time low level of 5.75 percent.[3]

Figure 3.1: Key Policy Indicators



Source: State Bank of Pakistan

During Jul-Mar FY16, average headline CPI inflation was 2.6 percent, compared to 5.1 percent during same period last year.[4] However, despite significant reduction in domestic fuel prices in the third quarter of this fiscal year, the falling trend in inflation has reversed. Average CPI inflation for Q3-FY16 reached 3.8 percent, compared with only 1.7 percent in the first quarter of the year and 3.2

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[1] Minutes of Monetary Policy Committee meeting held on 9th April 2016 shows that 5 votes each were in favor of the 25 bps reduction in the policy rate and for maintaining status quo. In view of the tie, the Chairman exercised his casting vote in favor of no change in the policy rate. For details, see the minutes of the MPC. http://www.sbp.org.pk/m_policy/index.asp.

[2] The risks identified in these reviews included increase in inflationary expectations; pick up in aggregate demand; negative growth in exports; and subdued increase in remittances.

[3] With this cut, the policy rate has seen a cumulative reduction of 425 bps from 10 percent in October 2014, which will impact economic activity through transmission mechanism going forward.

[4] This relatively low average inflation is largely driven by lower commodity prices, relatively stable exchange rate, swift pass-through of lower oil prices to domestic consumers and subdued monetary expansion.

percent in Q3-FY15. This rise of inflation is largely driven by imposition of regulatory/custom duties, and increase in prices of few non-perishable food items.

Consumer Confidence Survey of IBA-SBP for May 2016 also revealed expectations of higher inflation in overall, food, non-food and energy groups for May-Oct 2016, primarily reflecting the impact of the inching up of inflation in recent months, and an upward adjustment in domestic petroleum prices in April 2016.[5]

Gradual rise in inflation together with the fall in weighted average lending rates (WALR) have reduced the real cost of borrowing. Specifically, inflation adjusted WALR during Jul-Mar FY16 stood at 4.8 percent, compared with the average of 5.0 percent in the same period last year. The lagged impact of this monetary easing, together with favorable developments in macroeconomic environment, created demand for bank loans. On the other hand, supply of funds benefited from SBP liquidity injections through open market operations to maintain the overnight repo rate close to the target rate. Both the interplay of demand and supply side factors led to healthy growth in credit to the private sector.

In absolute terms, credit to private sector expanded by Rs 323.4 billion during Jul-Mar FY16, against an expansion of Rs 216.5 billion during the same period last year. The expansion was broad-based as credit to a large number of sectors increased, which included manufacturing (especially textiles, food and beverages, and chemicals); electricity, gas and water; construction; and transport and communication.

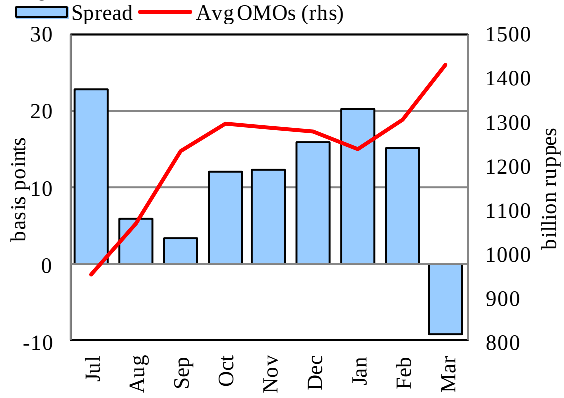
Pick up in credit to the private sector, and rise in government borrowing from the banking system were the major causative factors of monetary expansion during Jul-Mar FY16. The role of net foreign assets in monetary expansion, however, remained subdued in Jul-Mar FY16. On the liability side, currency in circulation emerged as the major contributor, while the increase in bank deposits remained low. As a result, currency to deposit ratio increased by 441 basis points to 33.7, which led to 25 basis points reduction in money multiplier to 3.3 during Jul-Mar FY16.[6]

[5] The results are in contrast to March 2016 survey, which were primarily driven by the impact of the substantial declines in petroleum prices during February and March 2016.
[6] Changes in money multiplier affect the central banks' ability to control the broad money supply by influencing the reserve money.

3.2 Money market developments

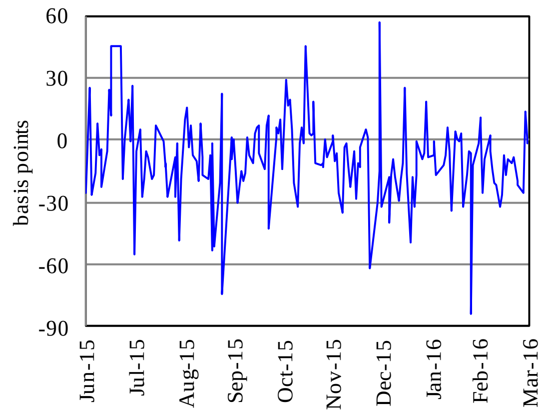
Pick up in credit to the private sector, continuation of government borrowing from scheduled banks, higher cash holding of public and subdued growth in bank deposits kept interbank cash liquidity under pressure during the review period. In this situation, SBP stepped-up its liquidity injections to maintain overnight repo rate close to the target rate. The outstanding level of net OMO injections increased significantly to an average of Rs 1,302 billion during the period from September 2015 (when the policy rate was cut) to end Q3-FY16.[7] These higher interventions by SBP led to reduction of the spread between overnight repo rate and the policy rate to only 3 bps since the monetary policy review of 30th January 2016 (**Figure 3.2**).[8]

Figure 3.2 : Spread of Overnight Repo Rate with SBP Target Rate and OMOs



Source: State Bank of Pakistan

Figure 3.3: Spread between Call and Overnight Repo Rate



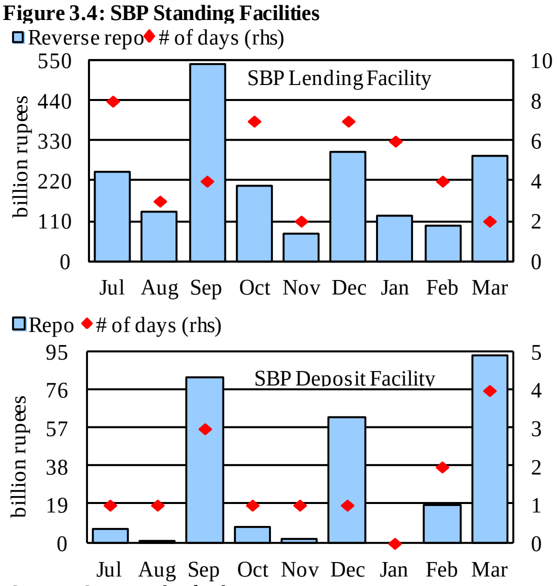
Source: State Bank of Pakistan

Interestingly, the overnight call rate has shown relatively small deviations from the policy rate as compared to the overnight repo rate.[9] As shown in **Figure 3.3**, there was a negative spread between the overnight repo and call rate in 127 out of 182 working days in Jul-Mar FY16. However, its impact on overall money market activity is quite limited as the volume of call transactions was only 3.4

[7] The OMOs stayed on average at Rs 902 billion during the monetary policy of May 2015 and September 2015.
[8] The spread was 13 bps during the maintenance period (i.e., the period from last cut in the policy rate in September 2015 to January 2016 monetary policy).
[9] The average spread of call rate with SBP target rate was negative 5 basis points as compared to positive 13 basis points spread of repo rate with the target rate.

percent of overall money market transactions (call and repo) during Jul-Mar FY16.

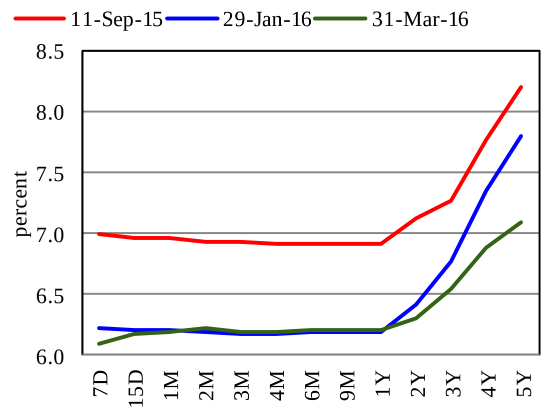
Figure 3.4: SBP Standing Facilities



Source: State Bank of Pakistan

Both availability of liquidity in the call market and SBP's proactive liquidity management have reduced activity on SBP standing facilities. The commercial banks—both in terms of amount borrowed from SBP and number of visits—have shown lower reliance on standing lending facility in Q3-FY16 as compared to the previous quarters (**Figure 3.4**). Similarly, the deposit facility has also shown higher activity in Q3-FY16. This indicates that gap of demand and supply of liquidity was comparatively narrower in the quarter.

Figure 3.5: Secondary Market Yield Curve

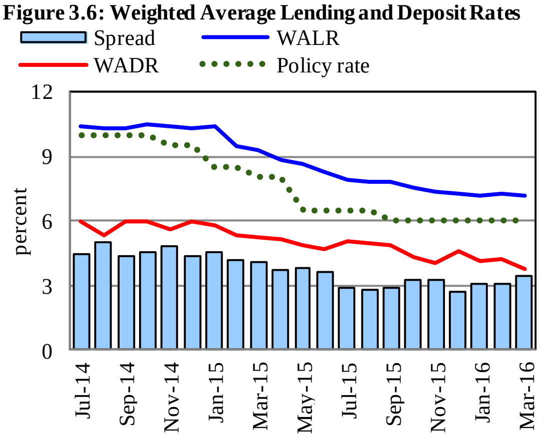


Source: State Bank of Pakistan

The improved liquidity conditions together with a decline in overnight repo rate have impacted market and banks' retail rates through the transmission mechanism. Secondary market yield curve has shifted downward since the last cut in the policy rate in September 2015 (**Figure 3.5**). Noteworthy is the high tilt on the right end of the yield curve at the last working day of monetary policy review of January 2016; this shows that the reaction of longer term rates was a bit milder. Despite no change in the policy rate in January 2016, better liquidity conditions and decline in short-term rates aligned market expectations towards lower long term rates; resulting in a commensurate fall in tenors longer than 1-year in the yield curve. The positive slope of the yield curve may hint at expectations of higher growth and modest inflation going forward.

The ease in secondary market yield has led to lower weighted average lending rates of commercial banks, reflecting the pass-through of change in the policy rate to banks' retail rates. Specifically, the lending rates have slowly and steadily crept down by more than the cut in policy rate since September 2015 (**Figure 3.6**). It reflects lower cost of borrowing for the private businesses, which led to relatively higher monetary expansion.

Figure 3.6: Weighted Average Lending and Deposit Rates



Source: State Bank of Pakistan

3.3 Developments in monetary aggregates

Broad money has shown marginally higher growth of 6.0 percent during Jul-Mar FY16, largely due to expansion in the net domestic assets, compared to 5.7 percent increase in the same period last year (**Table 3.1**). The role of external sector development in the monetary expansion in Jul-Mar FY16 remained subdued because SBP foreign exchange reserves have stabilized.

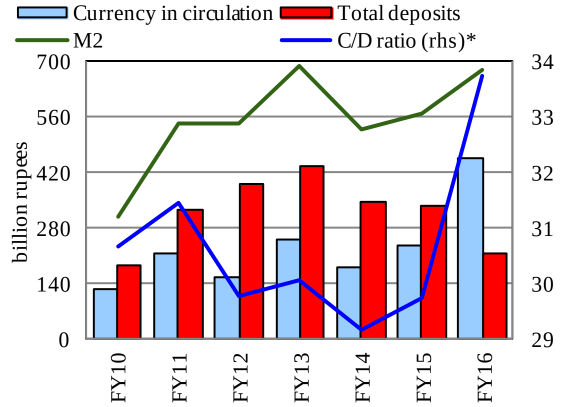
Table 3.1: Monetary Aggregates (Jul-Mar)
flow in billion rupees; contribution in percent

	Flow since end June		Contribution to M2 growth	
	FY15	**FY16**	**FY15**	**FY16**
Money supply (M2) (A+B)	568.1	677.6	5.7	6.0
Reserve money	138.9	433.6	1.4	3.8
Liability side				
A. Currency in circulation	233.5	458.1	2.3	4.1
B. Bank deposits	334.6	219.5	3.4	1.9
Asset side				
A. NDA	432.2	593.8	4.3	5.3
SBP	-22.6	270.1	-0.2	2.4
Scheduled banks	454.8	323.6	4.6	2.9
B. NFA	135.9	83.8	1.4	0.7
SBP	162.4	141.4	1.6	1.3
Scheduled banks	-26.5	-57.6	-0.3	-0.5

Source: State Bank of Pakistan

On the asset side, the main contributions to higher growth came from pickup in credit to the private sector, and continuation of government borrowing from scheduled banks. On the liability side, the currency in circulation increased by Rs 458 billion, that is about twice the rise seen in the same period of last fiscal year

Figure 3.7: Broad Money (Flows during Jul-Mar)



Source: State Bank of Pakistan; * Currency to deposit ratio

(**Figure 3.7**). On the other hand, total deposits showed lower growth in the aforementioned period.

The private sector deposits, which account for 93.9 percent of total deposits, saw a cumulative flow of Rs 149.4 billion during Jul-Mar FY16, which was lower than half the flow observed in the same period of FY15. This is the lowest increase in total deposits since FY11. Moreover, it is the first time since FY10 that the contribution of total deposits in M2 is lower than that of currency in circulation. As a result, currency to deposit ratio increased from an average of 30.1 during FY10-FY15 to 33.7 by end Q3-FY16.

A major reason of this high currency in circulation and lower growth in bank deposits, as highlighted in previous reports, could be the imposition of withholding tax on all transactions exceeding Rs 50,000 for non-filers. Sharp rise in prize bonds, which increased by Rs 94.1 billion during Jul-Mar FY16 compared to Rs 49.8 billion in the same period of FY15, also lends credence to this assertion. Moreover, gradual decline in weighted average deposit rates since FY10 could be another contributory factor. Regardless of the reason, this situation does not bode well for financial deepening and effectiveness of the monetary policy.

<u>Net foreign assets</u>

The net foreign assets (NFA) of the banking system, reflecting the monetary impact of developments in the external sector, expanded by Rs 83.8 billion during Jul-Mar FY16 as compared to Rs 135.9 billion in the same period of FY15. Quarterly changes indicate that a notable decline of Rs 66.7 billion in NFA of the banking system in Q3-FY16 contained a healthy expansion seen during earlier quarters of the year. The NFA of both SBP and commercial banks contracted in Q3-FY16. Despite slowdown, SBP successfully met the performance criteria of tenth IMF review for end-March 2016 regarding net foreign currency swaps/forward position and net international reserves.

There was a relatively smaller increase in NFA of SBP during Q3-FY16; whereas higher contraction in NFA of scheduled banks is attributed to a fall in their balances held abroad during the same period. FE-25 deposits of scheduled banks declined by US$ 8.2 million during Jul-Mar FY16. Nonetheless, trade financing against FE-25 deposits increased by US$ 362.1 million during the same period. This trade financing was largely funded by banks through reducing their placements outside Pakistan.

Net domestic assets

Net domestic assets (NDA) of the banking system expanded by Rs 593.8 billion during Jul-Mar FY16 compared to Rs 432.2 billion in the comparable period of FY15. The relatively high expansion was entirely concentrated in third quarter of the year.[10]

Within the banking system, SBP's NDA saw a notable expansion of Rs 270.1 billion during Jul-Mar FY16, in sharp contrast to a contraction of Rs 22.6 billion in the same period last year. This was entirely attributed to *other items net* (Rs 804.6 billion), which primary reflects the impact of the central bank's liquidity management. The expansionary impact of SBP's liquidity management on its balance sheet was strong enough to overshadow the retirement in budgetary borrowing of Rs 525.5 billion to SBP. Despite this expansion, SBP was able to meet the NDA target for end-March 2016 set by the IMF, due to space created earlier.

On the other hand, NDA of scheduled banks showed lower cumulative flows during Jul-Mar FY16 against the same period of last year. The expansionary impact of pickup in credit to private sector was more than offset by comparatively lower government borrowing from the commercial banks and commodity operations.

Government budgetary borrowing

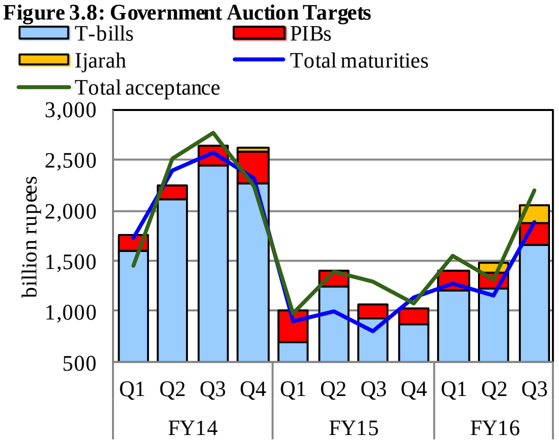
In absolute terms, the government borrowed Rs 538.0 billion for its budgetary finance from the banking system (on cash basis) during Jul-Mar FY16 as compared to Rs 469.4 billion during the same period of FY15. Composition of borrowing suggests that the government continued to retire its SBP debt in order to honor its obligations under the IMF program. However, the retirement was much lower at Rs 96.3 billion during Q3-FY16 against Rs 261.0 billion in Q3-FY15. Cumulatively, government retired Rs 525.5 billion during Jul-Mar FY16,

[10] NDA of the banking system expanded by Rs 264.6 billion in Q3-FY16 as compared to a mere Rs 38.1 billion in the same period last year.

compared to Rs 674.4 billion in the same period last year. This allowed the government to successfully keep the borrowing from SBP under the ceiling set by the IMF for end-March 2016.[11]

Given the fact that the government is running a deficit, the net retirement to SBP was funded mainly through borrowings from the scheduled banks and other resources, including non-bank and external (see **Chapter 4**). As shown in **Figure 3.8**, quarterly targets for the auction of government securities have gradually risen from about Rs 1 trillion in Q1-FY15 to a bit more than Rs 2 trillion in Q3-FY16.

Figure 3.8: Government Auction Targets



Source: State Bank of Pakistan

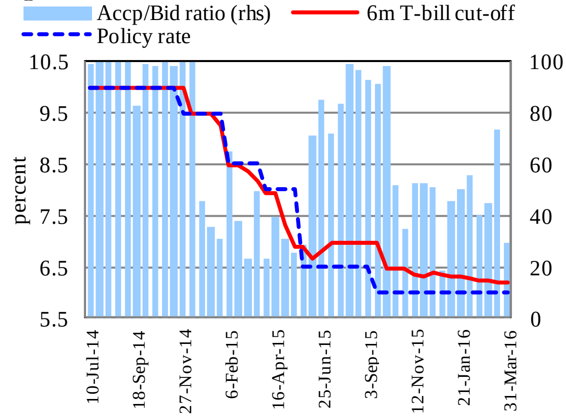
The results of the primary auction during the last few months show the government's inclination towards long-term borrowing. Specifically, the government long-term borrowing through PIBs and Ijara Sukuk (in gross terms) accounted for 26.3 percent of the realized amount from primary auctions in Q3-FY16, compared with 14.2 percent in the first quarter of the year.

The government borrowed Rs 1,063.5 billion from scheduled banks during Jul-Mar FY16, which was Rs 80.2 billion lower than the borrowing in the same period of FY15. A significant portion of the borrowing worth Rs 152.3 billion (net of maturity) came from Ijara Sukuk during Q3-FY16. The auction of Sukuk was conducted after a gap of 18 months in December 2015. Given that the government did not conduct any such auctions during June 2014 up to December 2015, the successful implementation of 3 auctions during Dec-Mar FY16 is a welcome development and a step in the right direction. Similarly, government accepted high amount (Rs 125.2 billion net of maturity) in PIB auction during Q3-FY16 despite high maturities and coupon payments in the quarter.

[11] It may be noted that the outstanding level of SBP injections increased by Rs 1 trillion during end-October 2013 to end-Mar 2016, as compared to Rs 1.4 trillion retirement of government borrowing to SBP in the same period.

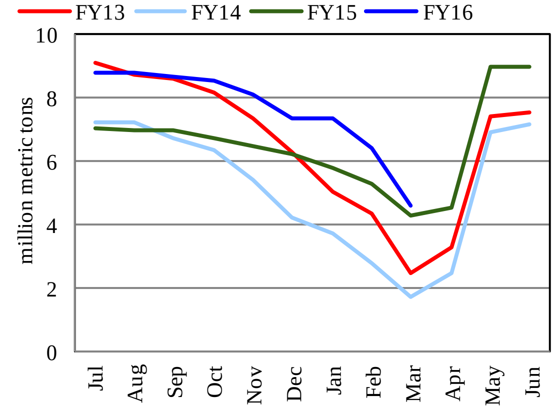
Though the breakup of auction targets indicates that T-bills (having maturity of up to one year) account for more than 80 percent of the combined targets, the government borrowing (net of target) has fallen since Q1-FY13. The demand for T-bills however is still evident from low accepted to bid ratio of auctions and declining T-bill cut-off rates decided by the government (**Figure 3.9**). It may either be a deliberate effort by government to avoid short-term tenor securities or better liquidity situation of the government during the recent months (due to successful Sukuk auctions). [12]

Figure 3.9: T-bills Auction



Source: State Bank of Pakistan

Figure 3.10: Stock of Wheat with Procurement Agencies



Source: State Bank of Pakistan

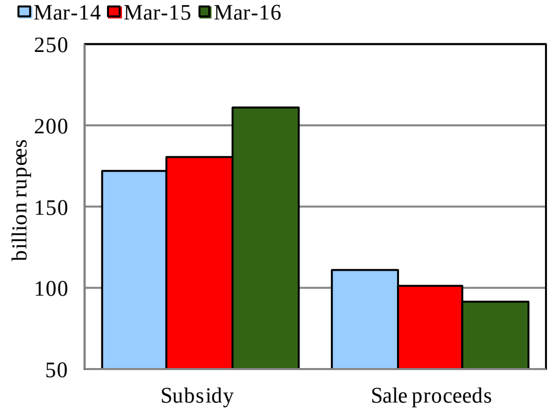
<u>Commodity operations</u>

Despite higher net retirements in Jul-Mar FY16 compared to the same period last year, the outstanding loans for commodity operations stood at Rs 464.2 billion by end-Mar 2016, compared with Rs 436.8 billion at the same period last year. In absolute terms, the net retirement of Rs 100.3 billion during Jul-Mar FY16, is almost twice as high as the retirement in comparable period of FY15. In effect, there was an abnormally low retirement in FY15 because procurement agencies could not offload their wheat stocks before the arrival of fresh crop leading to their inability to retire credit.

[12] Excessive reliance on short term borrowing not only exposes the government towards rollover and re-pricing risks, but also complicates the liquidity management.

The persistence of relatively high domestic prices of wheat compared to international market undermined the government's ability to offload wheat stock in FY15 and to some extent in FY16. As shown in **Figure 3.10**, the wheat stock with procurement agencies during FY16 has remained higher as compared to past three years. The government has set the wheat procurement target of 7.1 million tons for FY16. The realization of this target would possibly push the wheat stock with the government to all time high level. Given the limited storage capacity of government departments and procurement agencies, managing the wheat stock would entail the risk of relatively high wastage.

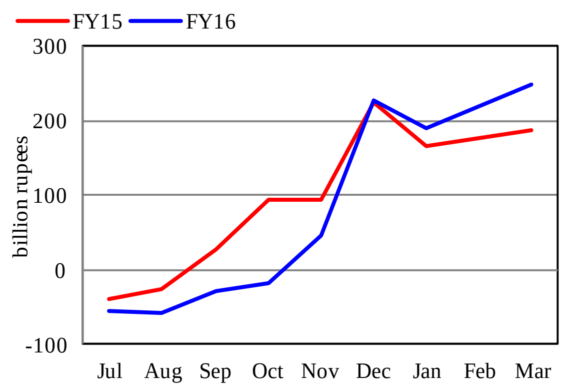
Figure 3.11: Total Receivables of Procurement Agencies



Source: State Bank of Pakistan

Another important factor, which affects the repayment capacity of the procurement agencies, is the outstanding receivables on account of subsidies and sale proceeds. As shown in **Figure 3.11**, receivable subsidies have increased since FY14, while the sale proceeds have declined. This shows that smooth settlement of subsidies would help procurement agencies to retire some of their outstanding borrowing.

Figure 3.12: Credit to Private Sector Businesses (Cumulative flows)



Source: State Bank of Pakistan

3.4 Credit to private sector

Credit to private sector expanded by Rs 323.4 billion during Jul-Mar FY16, compared with Rs 216.5 billion during the same period last year. Private sector businesses availed a majority of this credit, i.e. Rs 249.0 billion, which is higher than Rs 187.6 billion for the same period of FY15 (**Figure 3.12**). As evident in the figure, the cumulative credit disbursement was at par as on end-December. However, credit to private sector increased sharply during Q3-FY16 as compared with Q3-FY15. Increased optimism regarding the business environment, low energy prices, improving aggregate demand (e.g., LSM), investments in CPEC-related projects, and relatively low cost of borrowing contributed to demand for bank credit.[13] On the supply side, SBP continued to inject liquidity into the market via OMOs, which supported the ability of commercial banks to extend credit to the private sector.

Table 3.2: Loans to Private Sector Businesses (Jul-Mar)
billion rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Total	187.6	249.0	48.7	65.4	85.2	140.3	53.7	43.3
Of which								
1) Agriculture	14.3	-1.4	6.8	-7.4	8.2	6.1	-0.8	-0.1
2) Manufacturing	104.6	206.4	26.7	116.5	44.0	34.1	34.0	55.7
Food & beverages	56.8	68.7	24.2	42.9	17.2	11.9	15.4	13.9
Textiles	29.5	82.5	15.9	58.0	1.8	9.3	11.8	15.1
Electrical machinery	-3.4	9.2	-5.1	-4.8	1.3	6.0	0.4	8.1
Fabricated metal products	-0.9	4.4	-2.3	3.2	0.1	1.6	1.3	-0.4
Chemicals	1.9	33.1	-8.1	22.1	11.4	7.5	-1.4	3.5
3) Electricity, gas & water	-3.2	39.8	1.0	13.0	-6.0	31.9	1.9	-5.1
4) Construction	11.0	26.7	-2.0	-2.6	11.3	28.1	1.7	1.3
5) Commerce and trade	11.1	11.3	-0.4	4.0	7.8	7.1	3.7	0.1
6) Transport, storage & communications	9.9	20.9	7.1	-9.2	2.6	30.1	0.1	-0.0
7) Real estate	17.8	7.1	6.3	3.2	11.7	1.0	-0.2	3.0

Source: State Bank of Pakistan

Moreover, improvement in credit off-take was fairly broad-based, as it was spread over a number of sectors including manufacturing; electricity, gas and water; construction; and transport, storage and communication (**Table 3.2**).[14] These sectors collectively availed Rs 293.9 billion of the total credit availed by private sector businesses during Jul-Mar FY16.

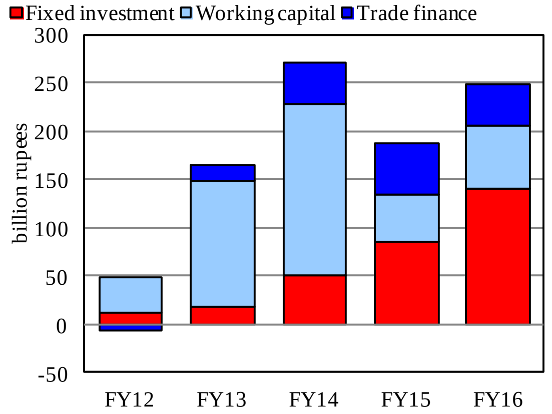
[13] According to the OICCI (Overseas Investors Chamber of Commerce and Industry) Business Confidence Index survey Wave 12 results, released in May 2016, business confidence was at a high of 36 percent, up from 22 percent in November 2015. Meanwhile, the weighted average lending rate (nominal, excluding interbank) was 7.8 percent for Jul-Mar FY16, compared to 10.5 percent in comparable period last year.

[14] Meanwhile, sectors/sub-sectors characterized by net retirement in Q3-FY16 included: agriculture, hunting and forestry; mining and quarrying; commerce and trade; real estate, renting and business activities; and some manufacturing concerns (such as producers of grain, chemicals, and coke and refined petroleum products).

Distribution of credit, by type

With regard to the nature of credit availed, the larger magnitude of fixed investment loans in a number of sectors during Jul-Mar FY16, compared to similar period in FY15, is a promising development (**Figure 3.13**).[15] It suggests that a number of firms took advantage of lower cost of funding to expand their operations.

Figure 3.13: Credit to Private Sector Businesses (Jul-Mar)



Source: State Bank of Pakistan

Meanwhile, working capital loans also increased by Rs 65.4 billion during Jul-Mar FY16 as compared to Rs 48.7 billion in the same period of FY15.[16] The higher flow is attributed to manufacturing sector, by showing cumulative flow of Rs 116.5 billion during Jul-Mar FY16 after an unusually low flow of Rs 26.7 billion in the same period of FY15.[17] In general, working capital credit uptake tended to be associated with higher production. The fertilizer sector is a case in point: with reference to large scale manufacturing (LSM), this sector posted 15.9 percent growth in Jul-Mar FY16, compared to 1.0 percent in comparable period of FY15, in tandem with high uptake of working capital loans.

Finally, trade finance slightly declined, showing a cumulative flow of Rs 43.3 billion, in Jul-Mar FY16, compared to Rs 53.7 billion registered in Jul-Mar FY15. In specific terms, flows on account of export financing scheme (EFS) amounted to Rs 25.8 billion in Jul-Mar FY16 – much lower compared to credit off-take of Rs 38.4 billion in comparable period of FY15. This does not come as a surprise, since exports on the whole showed a YoY decline of 9.3 percent in Jul-Mar FY16, on the back of both a decline in price and quantum (see **Chapter 5**).

[15] Specifically, a significant portion of such credit was availed by livestock; food and beverages (especially meat production, processing and preservation units); textile finishing units (excluding woolen); made-up textiles (excluding bed-wear); fertilizers; plastic products; electrical machinery and apparatus; production, transmission and distribution of electricity; construction; retail trade; road transport; and telecommunications.

[16] Gross disbursements amounted to Rs 7.2 trillion during Jul-Mar FY16, as compared to Rs 6.1 trillion in Jul-Mar FY15.

[17] The following sectors availed relatively large sums of working capital financing in Jul-Mar FY16: manufacturers of sugar; textile units involved in spinning, weaving and finishing; fertilizers; and production, transmission and distribution of electricity.

On the other hand, import financing rose during the period, from an average of around Rs 17.3 billion in each of the reference periods for FY14 and FY15, to Rs 20.9 billion in Jul-Mar FY16.[18] Rise in import financing concurs with a 10.2 percent YoY increase in non-oil imports during Jul-Mar FY16.[19]

Sectoral distribution of credit

*Agriculture***:** There was a net retirement of Rs 1.4 billion in credit to agriculture sector during Jul-Mar FY16, against a net expansion of Rs 14.3 billion in comparable period of FY15. In effect, net credit expansion of Rs 8.7 billion to the livestock sector in Jul-Mar FY16, was overshadowed by a net contraction of Rs 9.9 billion in credit to crop-growers.

Possible explanations for a decline in credit to crop-growers may be found in the below-par performance of major crops, cotton being the most notable example. Pest outbreaks (including pink bollworm and white fly attacks), untimely rainfall, and depressed prices resulted in losses for major crop growers. Poor performance of crops may, in turn, have reduced the appetite of farmers to take on more loans, reflecting weakness on the demand side.

On the other hand, the livestock sector was characterized by credit off-take for fixed investment in particular, with the greatest portions availed for cattle and dairy farming (Rs 4.7 billion), and poultry and related activities (Rs 2.1 billion) during Jul-Mar FY16. Investment in livestock occurred with concurrent emergence of a host of new brands offering related products, such as packaged milk and processed meat. Thus, it appears that value addition and development along the supply chain fuelled growth within the livestock sector.

Manufacturing: Net credit expansion to manufacturing sector amounted to Rs 206.4 billion in Jul-Mar FY16, compared to Rs 104.6 billion in comparable period of FY15. Textiles and chemicals were the largest beneficiaries. For textiles, spinning, weaving and finishing units in particular availed the largest portion of credit throughout the period. Working capital was the most dominant form of credit availed, followed by trade financing and fixed investment. Appetite for fixed investment appeared to remain subdued in light of lackluster exports.

[18] Sectors which availed significant portion of import financing included refined petroleum and related manufactures; electricity distribution and control apparatus; cotton spinning units; manufacturers of edible oil and ghee; and fertilizer. Notable net retirement of import financing was witnessed in the following sectors: ship-breaking; production, transmission and distribution of electricity; and wholesale and commission trade.

[19] Import demand for power-generating machinery, fertilizers, textile machinery, and CKD/SKD automobiles has remained particularly strong during Jul-Mar FY16.

Meanwhile, credit availed by the chemicals sector amounted to Rs 33.1 billion in Jul-Mar FY16, which represents a marked increase from Rs 1.9 billion of credit availed in comparable period last year. This could be attributed to growing activity in the chemical sector.[20]

Finally, for cement sector, there was net credit expansion of Rs 70.4 million for fixed investment during Jul-Mar FY16, reflecting the ambitions of some industry players to avail financing for further expansion of installed capacity. While dispatches to local market was the sole driver of demand during H1-FY16, the third quarter was marked by a positive turnaround in dispatches to export markets, most notably in March 2016, which enabled the sector to achieve over 94 percent utilization of total installed capacity.

Other private sector businesses: Construction-related businesses availed Rs 54.7 billion of credit in Jul-Mar FY16, compared to Rs 38.7 billion in the first three quarters of FY15.[21] Encouragingly, fixed investment component was the predominant type of credit availed, with funds diverted to development of roads and construction of residential and non-residential buildings.

Similarly, production, transmission and distribution of electricity, was another sector with higher proportion of fixed investment loans. This sector availed Rs 37.8 billion worth of credit during Jul-Mar FY16, comparing favorably to Rs. 3.3 billion taken up in Jul-Mar FY15. More crucially, Rs 30.1 billion of the credit in current fiscal year was intended for fixed investment.

It is likely that fixed investments in both construction- and electricity-related activities have taken off in response to infrastructure projects.[22] In addition, construction of residential buildings may be tied to ongoing mega housing projects, particularly in bigger cities. Finally, development spending also picked up, growing 32.6 percent during H1-FY16, while PSDP expenditure rose by 40.3 percent, providing a stimulus to infrastructure development and construction.

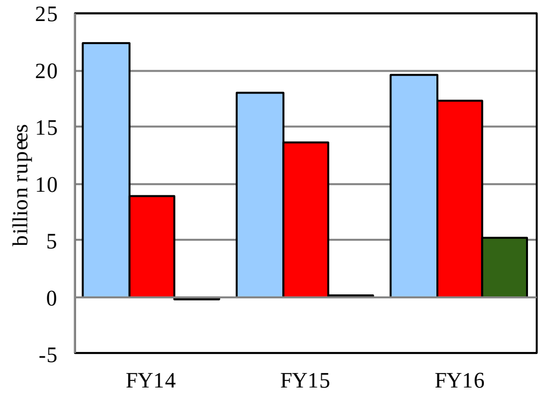
Consumer financing: On a cumulative basis, consumer financing amounted to Rs 19.6 billion in Jul-Mar FY16, compared to Rs 18.1 billion in Jul-Mar FY15

[20] Specifically, LSM figures for Jul-Mar FY16 indicate that chemicals sector grew 10.0 percent in the period, compared to 6.7 percent in Jul-Mar FY15.
[21] Construction-related sectors have been classified as an amalgamation of the following categories: construction; transport, storage and communications; and real estate.
[22] Under China-Pakistan Economic Corridor (CPEC), FDI from China for Jul-Mar FY16 amounted to US$ 515.9 million, compared to US$ 193.5 million in comparable period last year.

(**Figure 3.14**). The uptick was primarily on the back of auto-financing and house-building loans.

Credit expansion in both auto-financing and house-building appears to be a direct reflection of low interest rates adopted by the central bank. In addition, improvement in overall economic activity appears to have stimulated bank lending, on account of lowered credit risk.[23]

Figure 3.14: Consumer Financing (Jul-Mar)



Source: State Bank of Pakistan

Table 3.3: CPI Inflation (percent)

					Core		
	Overall	Food	Non-Food	Energy	NFNE	Trimmed	RSC-CPI*
FY15:							
Q1	7.5	6.6	8.2	9.1	8.0	7.3	8.2
Q2	4.7	3.6	5.5	-2.5	7.1	5.5	7.4
Q3	3.2	1.9	4.2	-6.1	6.2	4.2	6.5
Jul-Mar	5.1	4.0	5.9	-0.1	7.1	5.7	7.3
FY16:							
Q1	1.7	0.3	2.7	-3.5	3.9	2.9	4.3
Q2	2.5	1.8	3.0	-1.2	3.8	2.8	4.4
Q3	3.8	3.3	4.1	1.7	4.5	3.4	5.1
Jul-Mar	2.6	1.8	3.3	-1.1	4.1	3.0	4.6

*Relatively Stable Component of CPI, its detailed methodology and group-wise items along with their weights can be viewed at: http://www.sbp.org.pk/publications/wpapers/2013/wp66.pdf
Source: Pakistan Bureau of Statistics, State Bank of Pakistan

3.5 Inflation

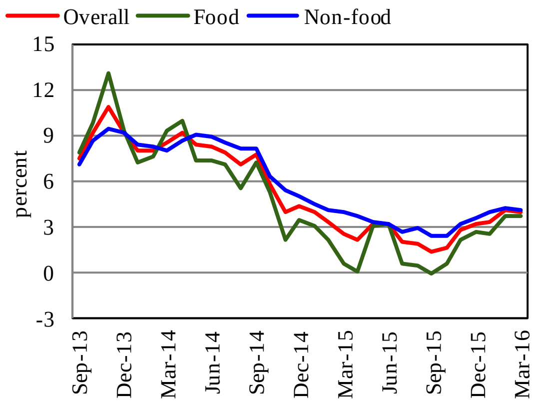
Low global oil and commodity prices, contained monetary expansion, stable exchange rate, and most importantly the swift pass-through of falling oil prices to domestic consumers,[24] contributed to lower the headline inflation to an average of 2.6 percent in Jul-Mar FY16, compared with 5.1 percent during same period last year, and annual target of 6.0 percent for FY16. However, this comparison of

[23] NPLs in housing finance declined by 5.9 percent, from Rs 14.12 billion in September 2015 to Rs 13.28 billion in December 2015, according to the SBP Quarterly Housing Finance Review for December 2015.
[24] For details see **Box 3.2** on **The Economics of Oil prices pass-through in Pakistan** in SBP Second Quarterly Report for FY16 on The State of Pakistan's Economy.

average inflation conceals a key development: the gradual rise in YoY CPI inflation since October 2015. In other words, inflation in Pakistan is inching up from it decades' low to a more moderate level. Specifically, average CPI inflation for Q3-FY16 was 3.8 percent, which is higher than the first two quarters of this year, and the corresponding quarter of the last year (**Table 3.3**).

The gradual rise in overall inflation is largely attributed to: (i) the imposition of regulatory duties on a wide range of luxury and non-luxury items, and a one percentage point increase in custom duties; (ii) the rise in electricity and gas prices on YoY basis; [25] and (iii) increase in prices of few non-perishable food items. Despite this gradual rise, the overall inflation for the year still remains subdued.

Figure 3.15: CPI Headline Inflation



Source: Pakistan Bureau of Statistics

Food group, being more than one-third of the CPI basket, saw a notable rise in YoY inflation since September 2015 to 3.7 percent in March 2016 (**Figure 3.15**).[26] Within food group, upward pressure came mostly from cigarettes, fresh milk, tea, sugar, pulses, and meat. Meanwhile, the sizeable fall in prices of potatoes and tomatoes contained inflation in perishable food items.[27,28] Non-food inflation, which has been consistently higher than food inflation in recent times, also witnessed gradual rise since September 2015 onwards. Within non-food, services (including housing) and clothing items significantly contributed to non-food inflation in Q3-FY16.

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[25] Electricity inflation rose by 2.8 percent and gas by 9.9 percent during Q3-FY16, compared to 1.8 percent and no change respectively, in Q3-FY15.

[26] It posted YoY inflation of 4.7 percent in April 2016.

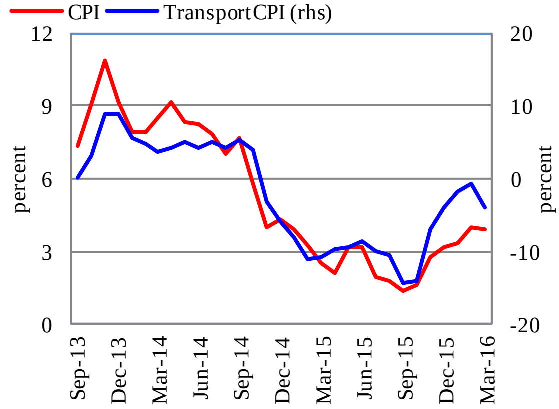
[27] Due to ample supplies, prices of potatoes and tomatoes declined to an average of Rs 19 and 33 respectively in Q3-FY16, compared to Rs 25 and 53 in the same period last year.

[28] Perishable food items, having 4.99 percent weight in CPI basket, include fresh fruits, fresh vegetables, potatoes, tomatoes and onions (Source: Pakistan Bureau of Statistics). Perishable food items saw YoY inflation of 0.7 percent during Q3-FY16, compared with 0.8 percent in Q3-FY15. Within perishables, prices of onions and fresh fruits recorded 65.4 percent and 2.5 percent inflation respectively, in Q3-FY16.

Housing group, which is the second biggest group of CPI basket (after food), recorded 5.1 percent inflation in Q3-FY16 compared with 5.7 percent in Q3-FY15.[29] Other major sub-indices of CPI, except transport group, also recorded positive inflation in Q3-FY16. Thanks to downward adjustment in prices of petroleum products, transport group saw a deflation of 2.2 percent in Q3-FY16, compared with a significant fall of 10 percent in the same period last year (**Figure 3.16**).[30]

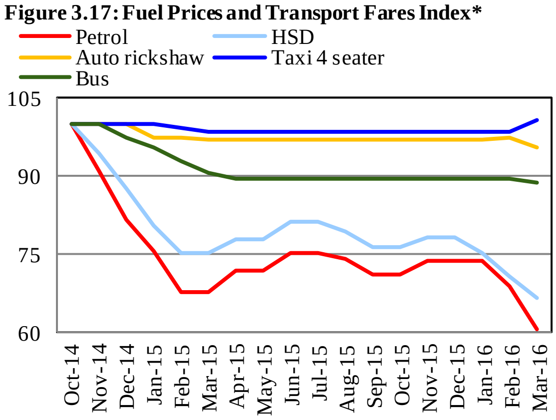
Though prices of petrol and high speed diesel fell considerably from October 2014 to March 2016, there was hardly any notable decline in fares of public transportation. As evident from **Figure 3.17**, taxi and rickshaw fares remained largely unchanged, while there was a small reduction in bus fares (within city).

Figure 3.16: Headline and Transport CPI Inflation



Source: Pakistan Bureau of Statistics, State Bank of Pakistan

Figure 3.17: Fuel Prices and Transport Fares Index*



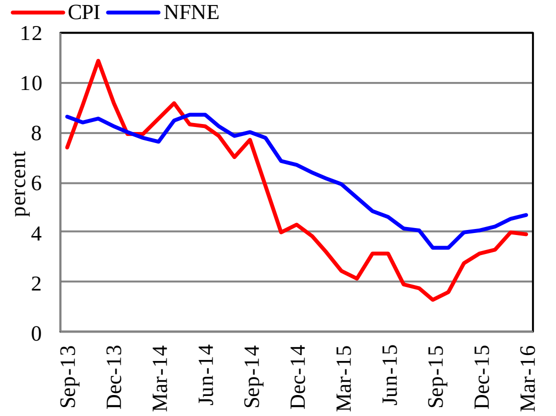
*All variables are indexed to their respective Oct 2014 level.
Source: Pakistan Bureau of Statistics. State Bank of Pakistan

This downward rigidity in fares could be mainly attributed to weak regulatory structure in transport sector along with rise in operating cost of vehicles due to: (i)

[29] Housing group, carrying a weight of 29.41 percent in the CPI basket, includes house rent, electricity, gas, water, kerosene oil, firewood, construction items and construction-related wage rate.
[30] Petrol prices were reduced by Rs 5 per liter in February 2016 and Rs 8.48 per liter in March 2016, while that of high speed diesel were reduced by Rs 3, 5 and 4.53 per liter in January, February and March 2016 respectively.

increase in prices of motor vehicles and accessories;[31] (ii) rise in mechanical service charges; (iii) downward rigidity in motor vehicle tax; and (iv) a rise in compensation of transport staff (based on anecdotes). All these factors added to operating cost of vehicles, which largely offset the potential impact of fall in fuel prices on fares of public transportation.

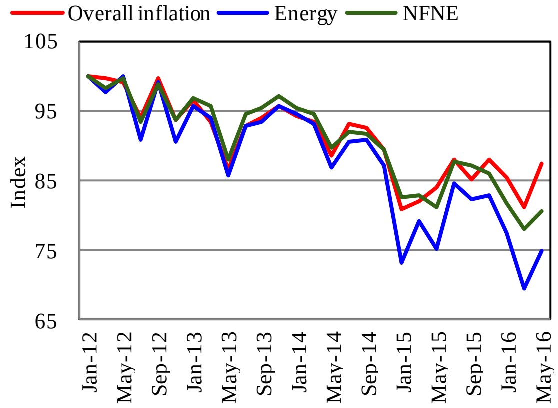
Figure 3.18: Overall and NFNE Inflation



Source: Pakistan Bureau of Statistics

Controlling for the volatile items in the CPI, different measures of core inflation such as NFNE, trimmed measure and RSC-CPI also inched up in recent months. Moreover, core inflation indicators (NFNE and RSC-CPI) showed higher inflation than the headline CPI (**Figure 3.18**), indicating the role of volatile items in keeping the headline inflation low.[32] Furthernore, relatively higher core inflation also reflect the impact of rise in aggregate demand.

Figure 3.19: Consumers Expectations of Prices in Next Six Months



Source: Pakistan Bureau of Statistics

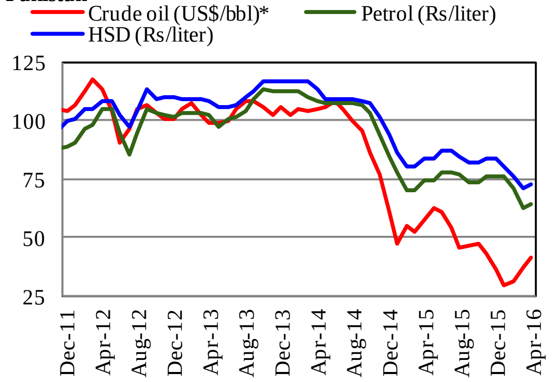
Due to gradual rise in inflation, households' inflation expectations measured by Consumer Confidence Survey of IBA-SBP changed in May 2016 as compared to March 2016. The households expect higher inflation in overall, food, non-food and energy groups for the following six months (**Figure 3.19**). This may reflect the impact of rise in petroleum prices during

[31] In motor vehicles, prices of only 70 cc motor cycles (reported in CPI index) fell, while in auto parts, only prices of tyres fell in the period October 2014 to March 2016.

[32] Core inflation measured by Relatively Stable Component of CPI (RSC-CPI) clocked in at 5.1 percent in Q3-FY16, compared to 6.5 in Q3-FY15.

April 2016.[33] Moreover, further risk to inflation expectations could emerge from international oil prices, which have recovered lately in Q3-FY16 (**Figure 3.20**).[34]

Figure 3.20: Global Oil Prices vs Petrol and HSD prices in Pakistan



*Average price of WTI, Brent and Dubai Fateh
Source: IFS, Pakistan Bureau of Statistics

Going forward, while the ample supply of major food items will keep downward pressure on overall inflation, an opposing upward pressure is likely to be created by few factors. These include: (i) expected pickup in aggregate demand due to low interest rates; (ii) seasonal factors such as impact of price rise in Ramzan; (iii) taxation measures in the federal budget for the next fiscal year and; (iv) continued recovery in global oil and several commodity prices. However, overall inflation for FY16 still remains well below the annual target of 6.0 percent for the year.

[33] Petrol and high speed diesel oil prices rose by Rs 1.4 and Rs 1.2 per liter, respectively, in April 2016. Domestic fuel prices are one of the major driving factors of the households' inflation expectations (source: Abbas H., Baig S. and Choudhary M. A. (2015) "Inflation Expectations and Economic Perceptions in a Developing Country Setting" available at http://dsqx.sbp.org.pk/ccs/survey%20information/paper.pdf).
[34] Global oil prices recorded modest recovery from February 11, 2016 onwards due to weak dollar and efforts of major OPEC and non-OPEC producers for an output freeze deal. Further, according to World Bank, the oversupply also began to diminish. World Bank forecasted the average crude price for 2016 to be US$ 41 per barrel (Source: World Bank, Commodity markets outlook, April 2016).