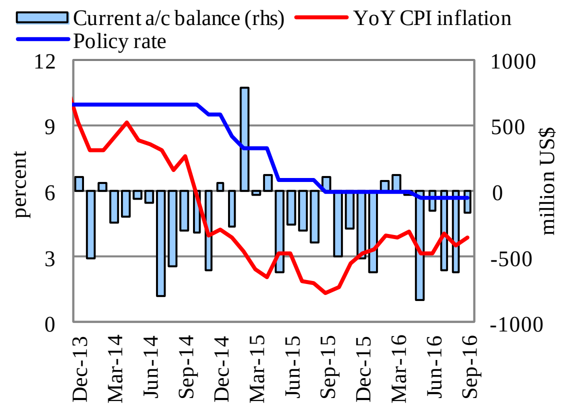
3 Inflation and Monetary Policy

3.1 Policy review

While FY16 had ended with all-around stability in key macroeconomic indicators, SBP adopted a cautious monetary policy stance during Q1-FY17. Two considerations particularly guided SBP's decision: first, CPI inflation began to increase – albeit very slowly – on the back of measures to control informal trade on both the eastern and western borders of the country, stability in global commodity prices, and hike in taxes by the government (**Section 3.5**). Second, notwithstanding the welcome accumulation of FX reserves for the 8th quarter in a row, current account deficit increased with decline in exports and increase in imports. Moreover, workers' remittances also did not pick up.

Keeping in view the above developments, SBP decided to keep the policy rate unchanged in both of its monetary policy reviews in July and September 2016 (**Figure 3.1**). However, SBP continued to actively manage liquidity conditions in the interbank market to make sure that despite liquidity swings – stemming from maturing PIBs and Eid-related cash withdrawals – the overnight rates did not deviate much from the target rate.

Figure 3.1: Key Policy Indicators

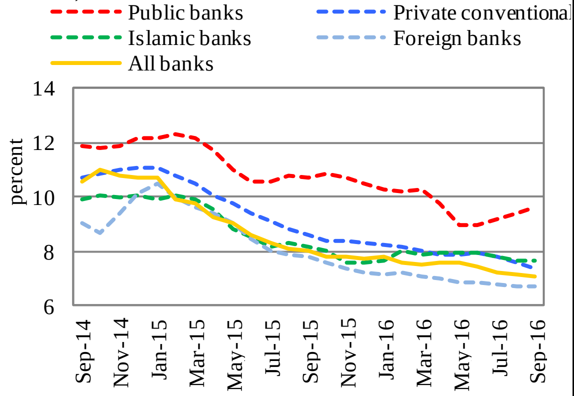


Source: State Bank of Pakistan

Therefore, the interbank market functioned smoothly during the quarter as the average deviation in overnight rates from the target rate remained lower than last year (**Section 3.2**). Moreover, banks' visits over the SBP's overnight facilities in Q1-FY17 were also fewer. Importantly, retail lending rates continued to decline during the quarter (except for public sector banks) despite no change in the policy rate (**Figure 3.2**).

One reason behind the downward trend in lending rates was the private sector's low appetite for bank credit. While heavy retirements observed **in** the quarter are very much seasonal in nature, large corporate clients have sufficient liquidity at their disposal, which kept them away from leveraging further, despite historic-low interest rates in the country (as also noted in the Annual Report for 2015-16). However, some activity was visible in fixed investment loans, which mainly represented vibrancy in the energy sector and energy-related capital expenditures in the manufacturing sector. In other sectors of the economy, the activity remained subdued, though some firms had reportedly been re-pricing their existing debt.

Figure 3.2: Weighted Average Lending Rates (by Type of Banks)



Source: State Bank of Pakistan

Under these circumstances, banks were parking their excess liquidity in government papers. However, their overall exposure to the government declined by Rs 268.1 billion during Q1-FY17.[1] This was due to two factors: *first*, unusually large volume of PIBs matured during the quarter, which was not rolled over by the government.[2] *Second*, in order to finance increased budgetary requirements, the government scaled up its borrowings from SBP during the quarter (by Rs 567.7 billion).[3]

Typically, the increase in government borrowings from SBP is considered inflationary via its direct impact on reserve money growth. However, in this period, the impact of government borrowings on reserve money growth was offset by the roll-back of equivalent volume of OMO injections from the interbank market. In effect, the increase in net claims on government was offset by a proportionate fall in other items net.[4] Further, CPI inflation is already very low, and likely to remain within the target.

[1] On cash basis, the government retired Rs 268.1 billion to commercial banks during Q1-FY17, compared to net mobilization of Rs 443.8 billion during Q1-FY16. This included the impact of maturity of PIBs worth Rs 1.4 trillion during the quarter.
[2] The government targeted to raise Rs 300 billion from PIB auctions during Q1-FY17, against the retirement of Rs 1.4 trillion worth of PIBs in the same period.
[3] The fiscal deficit was Rs 437.9 billion in Q1-FY17, compared with Rs 328.2 billion in the same period last year.
[4] The growth in SBP's NDA fell from 10.2 in Q1-FY16 to 7.5 percent in Q1-FY17. This coupled with a slowdown in SBP's NFA, led to a decline in growth of overall reserve money from 10.9 percent in Q1-FY16 to only 6.0 percent in Q1-FY17.

As a result, the money supply (M2) growth remained subdued during the quarter (**Table 3.1**). Higher government borrowings from the banking system were largely offset by net retirements by the private sector, as well as a fall in the other items net. Moreover, the contraction in net foreign assets of the banking system during the quarter further pulled down the M2 growth.[5]

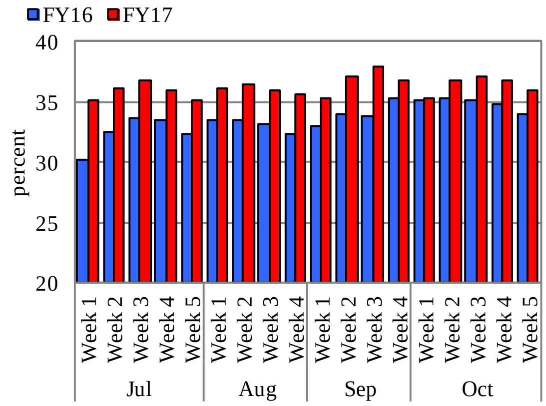
Another reason behind low monetary expansion during Q1-FY17 was high currency-to-deposit ratio, which has led to a lower money multiplier. In this context, increasing the penetration of formal banking services in the economy – as explicitly laid out in the National Financial Inclusion Strategy – has lately become more important.

Table 3.1: Changes in Monetary Aggregates (Jul-Sep)
billion Rupees

			Growth rate (%)	
	FY16	**FY17**	**FY16**	**FY17**
Reserve money	342.1	237.6	10.9	6.0
Broad money (M2)	119.8	29.6	1.1	0.2
Net foreign assets	111.6	-8.4	13.7	-0.8
Net domestic assets	8.2	38.1	0.1	0.3
Net claims on govt.	157.2	288.8	2.3	3.7
Net claims on non govt.	-8.9	-98.0	-0.2	-2.0
Other items (net)	-140.1	-152.7	N/A	N/A

Source: State Bank of Pakistan

Figure 3.3: Currency to Deposit Ratio



Source: State Bank of Pakistan

3.2 Money market developments

Though the policy rate remained unchanged, some volatility in interbank liquidity was expected due to: (i) unprecedented retirement of PIBs worth Rs 1.4 trillion; (ii) all-time high seasonal retirement of private credit; and (iii) fall of two Eids during the quarter and the associated cash withdrawals. Under these circumstances, the central bank had to manage the liquidity to ensure the stability of the payment system, without compromising the level of the operating target of monetary policy.

[5] The NFA of scheduled banks, which was already negative as on end-June 2016, declined further (by Rs 46.4 billion) in Q1-FY17. This decline more than offset the Rs 39.4 billion increase in SBP's NFA. In the same period last year, the NFA of scheduled banks declined by Rs 39.3 billion, but SBP's NFA increased by a higher amount of Rs 150.9 billion.

The maturity of PIBs was falling due in the month of July 2016. As it turned out, these retirements did not have a significant impact on interbank liquidity, as these were almost entirely offset by lowering OMO injections.[6] Meanwhile, retirements of private sector credit created liquidity buffers for commercial banks to make up for cash withdrawals related to Eid-ul-Fitr. Therefore, overnight rates hovered comfortably within the prescribed corridor throughout the month; these rates did exhibit some inter-day volatility in the first two weeks of the month, but stabilized thereafter (**Figure 3.4**).

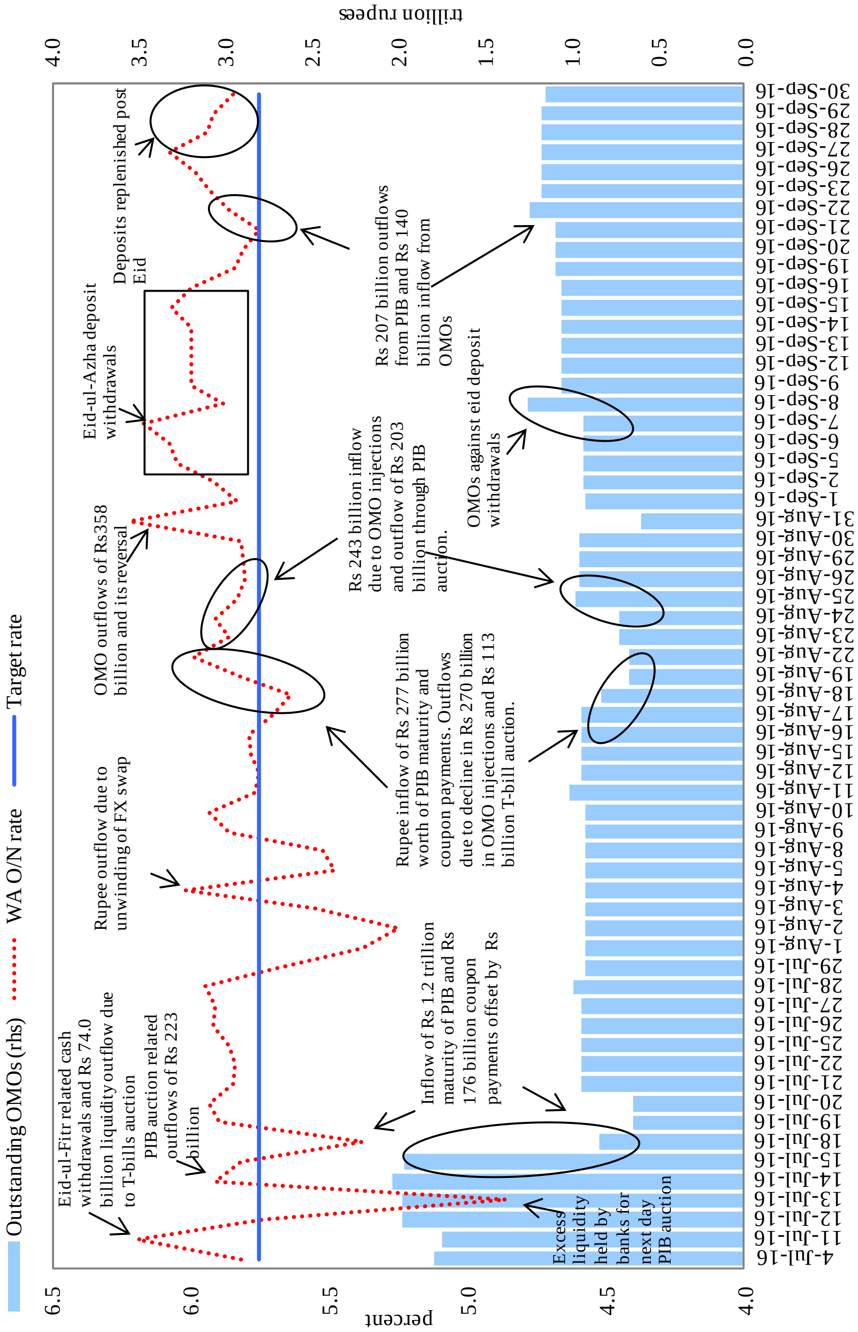
This stability remained intact throughout the month of August, in which the overnight rates stayed closer to the target rate. However, upward pressures started to build during September with the fall of Eid-ul-Azha and a pick up in the demand for private credit. Nonetheless, for the full quarter, the overnight rates showed an average deviation of just 9 basis points from the target rate. Moreover, the banks accessed the SBP window for only 12 working days in the same period of FY17 compared to 20 days in Q1-FY16. As for the long-term rates, the 6-month KIBOR remained almost flat at around 6 percent throughout the quarter.[7] No major shifts were visible in secondary market yield curve either.

This liquidity comfort allowed banks to actively participate in the auctions of government papers during the quarter. For instance, in T-bill auctions, the government set a net-of-maturity target of Rs 272.0 billion during Q1-FY17 (**Table 3.2**). Against this, banks offered Rs 1.9 trillion (net-of-maturity). This allowed the government to mobilize Rs 585.9 billion via T-bills – nearly double the target, without raising the weighted average yield of the auctions.[8]

In case of PIBs, the government conducted three auctions in Q1-FY17 with the combined target of Rs 300 billion. With offers of Rs 1.0 trillion, the government raised more than twice the targeted amount (**Table 3.2**). However, in comparison to the maturities of Rs 1.4 trillion, the government had made net retirement of Rs 748.8 billion to the market, which it met via raising SBP debt.

[6] Maturity of PIBs worth Rs 1,171 billion was due on 18th July 2016. The same day, maturity of Rs 1,133 billion worth of OMO injections was also due, which SBP decided not to roll over.
[7] With no change in policy rate, stability in KIBOR helps the decision-making of both scheduled banks as well as private sector in credit market.
[8] The interest of scheduled banks for T-bills were mainly for 6-month tenors (50 percent), followed by 12-month.

Figure 3.4: Overnight Rate, Liquidity Flows and OMOs



Source: State Bank of Pakistan

Table 3.2: Auction Profile of Government Securities*
billion Rupees

	T-bills			PIBs		
	Target	Offered	Accepted	Target	Offered	Accepted
In gross terms						
Q1-FY16	1,200.0	1,387.0	1,321.2	200.0	808.2	218.3
Q1-FY17	1,450.0	3,066.0	1,763.9	300.0	995.3	678.5
Net of maturity						
Q1-FY16	337.4	524.4	458.6	36.7	644.9	55.0
Q1-FY17	272.0	1,887.9	585.9	-1,127.3	-431.9	-748.8

Source: State Bank of Pakistan; *includes non-competitive and special auction (in face value)

3.3 Monetary aggregates

Broad money expanded by Rs 29.6 billion in Q1-FY17 as compared to Rs 119.8 billion in the same period of FY16. The lower monetary expansion was mainly due to contraction in net foreign assets (NFA). While net domestic assets (NDA) of the banking system increased, the contraction in the NFA more than offset the expansion in the NDA.

Higher fiscal deficit during Q1-FY17 was primarily responsible for a larger NDA expansion of the banking system. Nearly 68 percent of the total fiscal deficit in Q1-FY17 was financed via banking system; the government borrowed Rs 567.7 billion from SBP, and retired Rs 268.1 billion to scheduled banks. This pattern was different than the last year (i.e., Q1-FY16), when the government was raising funds from scheduled banks and retiring SBP debt.

The main reason behind the government resorting to SBP was to meet its additional budgetary requirements and repay large volume of maturing PIBs. It may be recalled that SBP and the government had taken several steps to promote interbank activity of government securities by offering homogenized securities in a span of several PIB auctions. However, auctions of such securities during FY11-FY13 – and the government's mobilization in excess of targets – had led to highest ever retirement of PIBs in a single quarter (Rs 1,427.3 billion) in Q1-FY17.[9]

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[9] During FY14, the government conducted a series of 12 PIB auctions with the exact specification (that is, similar coupon rate and year to maturity). The 3-year bonds sold in that year were scheduled to mature in July 2016, which amounted to Rs 1,170.8 billion. Similarly, the 5-year bonds sold in a similar manner in FY11 were also retiring in August 2016, worth a total amount of Rs 254.3 billion.

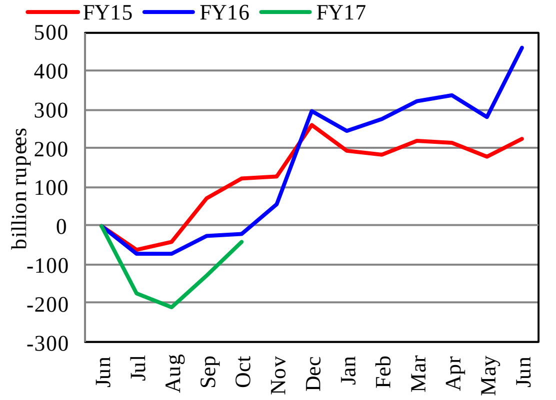
3.4 Credit to private sector

Q1-FY17 was characterized by net retirements, in line with the credit cycle observed in previous years.[10] The relatively large net retirements during the quarter can be attributed to exceptionally high credit off-take in the month of June 2016.

This had led to *a priori* anticipation that net retirements in the next month would also be comparatively higher – which actually happened in July 2016 (**Figure 3.5)**.

Also, while it is tempting to identify a silver lining in the higher September 2016 off-take compared to the last year, it would be premature to read too much into the data as the nature of the fresh credit cycle would be much clearer once half-yearly figures are in (**Table 3.3**).[11]

Figure 3.5: Credit to Private Sector (cumulative flows)



Source: State Bank of Pakistan

Table 3.3: Private Credit during the month of September

billion Rupees

			Growth (%)	
	2015	2016	2015	2016
Total credit to private sector	47.0	81.5	1.2	2.3
Total loans to private businesses	29.0	45.4	1.0	1.4
of which				
Working capital	-7.0	17.8	-0.5	1.2
Fixed investment	15.9	26.7	1.5	2.2
Trade finance	20.1	1.0	4.5	0.2

Source: State Bank of Pakistan

<u>Fixed investment trend holds promise</u>

Encouragingly, credit demand for fixed investment purposes increased during Q1-FY17 (**Table 3.4**).[12] This occurred in tandem with a strong growth in machinery imports during the quarter.[13] This activity mainly represents BMR in existing

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[10] Net retirement in credit to private sector during Q1-FY17 amounted to Rs 115.6 billion, compared to Rs 25.7 billion in Q1-FY16.

[11] An encouraging aspect of credit off take during Q1-FY17 was the revival of SME financing. After staying subdued over the past 8 years, the outstanding volume of SME finance posted a YoY growth of 24.6 percent in September 2016.

[12] Unlike other components of private sector credit, loans for fixed investments do not follow a seasonal pattern.

[13] As per customs sources, Rs 285.4 billion worth of machinery was imported in the country during Q1-FY17. The expansion in the outstanding stock of fixed investment loans stood at only Rs 43.2 billion during the quarter. This suggests that only a small fraction of machinery imports was

manufacturing units, as well as progress in energy and infrastructure related projects under the CPEC.

Table 3.4: Loans to Private Sector Businesses (Jul-Sep)
billion Rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY16	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**
Total loans to private businesses	-29.8	-102.7	-56.7	-127.6	28.6	43.2	-1.6	-18.3
Of which (o/w)								
1) Manufacturing	-28.2	-108.6	-33.0	-125.4	7.7	32.9	-2.9	-16.1
a) Food products & beverages	-49.0	-67.4	-50.9	-64.6	2.7	4.4	-0.8	-7.3
o/w Sugar	-32.5	-39.7	-30.9	-40.3	0.9	3.5	-2.4	-3.0
b) Textiles	-8.7	-26.8	6.3	-20.6	-2.9	3.5	-12.1	-9.7
o/w Spinning, weaving, finish.	-21.0	-20.1	1.3	-18.2	-6.4	4.6	-15.9	-6.5
c) Basic and fabricated metal	0.2	-4.8	1.0	-5.6	-1.7	1.0	0.9	-0.2
d) Rubber, plastics and paper	-0.8	-3.8	-1.0	-4.3	1.3	0.1	-1.1	0.5
e) Cement	0.9	-3.2	-4.7	-4.6	5.2	-0.5	0.4	1.9
f) Electrical equipment	1.2	-2.8	0.2	-0.4	0.8	1.9	0.2	-4.4
g) Chemicals	23.8	-0.7	13.9	-16.7	6.8	17.7	3.0	-1.8
o/w Fertilizer	25.9	4.1	14.9	-14.2	7.6	17.1	3.4	1.2
2) Education	1.2	-5.9	0.2	-0.6	1.0	-5.3	0.0	0.0
3) Transport, storage/communication	0.4	-5.3	-6.2	-5.6	7.0	0.8	-0.3	-0.5
4) Construction	-2.5	-4.8	-2.3	-4.4	0.9	0.6	-1.0	-1.0
5) Electricity, gas & water supply	-6.1	3.5	-8.8	-7.7	2.5	10.7	0.1	0.5
6) Real estate & renting activity	6.8	4.3	2.2	-1.7	2.6	0.5	2.0	5.5
7) Agriculture	2.6	16.0	0.0	15.1	2.8	2.1	-0.1	-1.2

Source: State Bank of Pakistan

Fertilizer manufacturers borrowed the most; some entities are reportedly setting up coal-based power plants, and are also investing to switch from natural gas to coal as their major fuel source. In fact, it is not just fertilizer, but sugar manufacturers are also borrowing from banks to diversify into bagasse-fired cogeneration power plants. Similar positions have been taken by certain textile conglomerates in the country as well.

In the case of energy, it appears that the CPEC-related activity has provided a notable boost – especially as most projects are backed by the government. Within energy, anecdotal evidence indicates that green-field investments in power generation may have peaked, but transmission and distribution sector still holds

financed via bank loans. The same phenomenon was observed in FY16 when machinery imports totaled Rs 894.5 billion, but the increase in outstanding stock of fixed investment loans was only Rs 171.7 billion during the year.

promise. While a large portion of the funding is expected to come from outside Pakistan, especially for CPEC related projects, the indirect impact – i.e., a pickup in construction, trading and business activity in general – might spur credit demand.

Banks continued looking for quality projects

In terms of retail rates, anecdotal evidence indicates that the stiff competition among banks witnessed last year – especially between Islamic and conventional banks – continued in the first quarter of FY17. However, while the weighted average lending rates (WALRs) of Islamic banks were, on average, lower than conventional banks during Q1-FY16, this dynamic has reversed in Q1-FY17. Moreover, it was prompted primarily by reduction in WALRs of conventional banks, which were flush with liquidity on account of large PIB maturities and unprecedented volume of retirements from private businesses during July 2016. Under these circumstances, the uptick in consumer financing – especially for car purchases and mortgages – during the quarter was much welcome (**Table 3.5**).

Table 3.5: Consumer Financing (Flows)

billion Rupees

	Full-year		Jul-Sep		
	FY15	**FY16**	**FY15**	**FY16**	**FY17**
Consumer financing	32.0	33.2	5.0	-5.1	7.8
Auto	21.0	26.8	3.1	5.7	5.7
House building	0.9	7.9	0.2	1.5	1.8
Credit cards	1.1	1.7	-0.1	0.2	1.5
Consumer durables	-0.1	0.4	-0.1	0.5	-0.1
Personal	9.1	-3.7	1.9	-13.0	-1.1

Source: State Bank of Pakistan

3.5 Inflation

Average headline CPI inflation clocked in at 3.9 percent YoY in Q1-FY17 compared with 1.7 percent in the same period last year (**Table 3.6**). This increase is primarily attributed to a number of seasonal and supply-side factors: (i) buoyancy in food prices as both the Eids fell during the quarter; (ii) supply shortages of fresh vegetables that exacerbated the seasonal impact on their prices; (iii) subsiding global deflation in key commodities (like crude oil and industrial inputs) along with a recovery in prices of major food items (palm oil and rice) during the quarter;[14] (iv) increase in regulatory duties on few import items in Federal Budget 2016-17 (e.g., powder milk); and (v) other fiscal measures to increase tax mobilization.[15] Furthermore, the PKR, on average,

[14] Though these commodities are still showing deflation in the domestic market, the magnitude is much smaller compared to the previous year. For example, rice and cooking oil prices fell 7.8 and 4.9 percent YoY in Q1-FY17 after declining by 11.5 and 13.2 percent, respectively, in Q1-FY16.

[15] The government changed the duty structure by: (a) replacing 5 percent FED with fixed rate of Rs 1 per kg of cement; (b) increasing FED on cigarettes; (c) enhancing FED on beverages from 10.5 to 11.5 percent; (d) imposing regulatory duty on powdered milk; and (e) increasing the rate of sales tax on certain ingredients of poultry feed from 5 to 10 percent. Following these changes, prices of

depreciated by 1.7 percent against the US Dollar in Q1-FY17 compared to Q1-FY16; this further pushed up the overall inflation in the country.

Supply disruptions due to crop damages in India and strict border controls

While seasonal (Eid-related) demand remained strong, the supply of fresh vegetables remained disrupted throughout the quarter. Heavy rains during July and August reportedly damaged crop harvest in India, which reduced both the formal as well as informal import of fresh vegetables in Pakistan.[16] Additional supply constraints came from stricter payment controls for cross-border trade.[17] Anecdotal evidence suggests that this move obstructed clearance of a number of consignments, particularly at western borders of Taftan and Chaman; trade of fresh fruits, vegetables and other perishable items with Iran and Afghanistan has reportedly been adversely affected. As a result, prices of fresh vegetables posted an increase of 19.5 percent in Q1-FY17 compared with a fall of 0.2 percent in the same period last year.[18] Among the top-20 items in the CPI basket (by weight), the inflation in fresh vegetables was the most prominent (**Figure 3.6**).

Table 3.6: CPI inflation

percent					Core	
	Overall	Food	Non-Food	Energy*	NFNE	Trimmed
Q1-FY16	1.7	0.3	2.7	-3.7	3.9	2.9
Q2-FY16	2.5	1.8	3.0	-1.2	3.8	2.8
Q3-FY16	3.8	3.3	4.1	1.7	4.5	3.5
Q4-FY16	3.5	3.0	3.9	0.1	4.5	3.7
Q1-FY17	3.9	4.0	3.7	-1.6	4.6	3.6

Source: Pakistan Bureau of Statistics; *SBP calculations

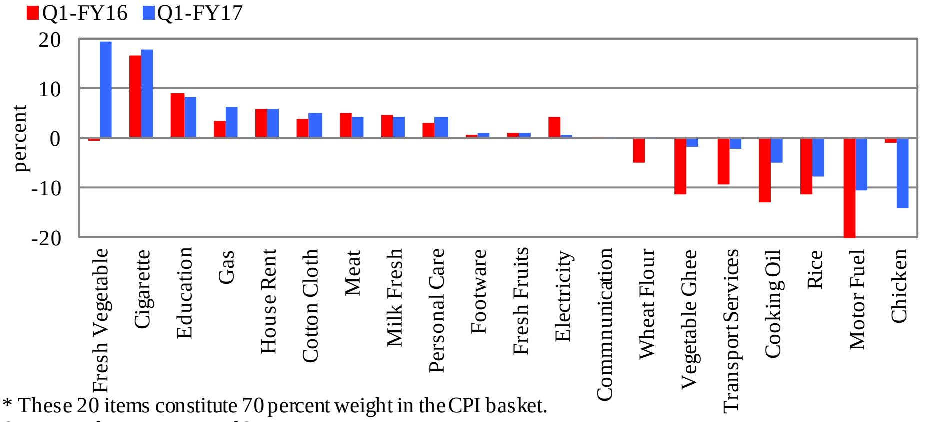
cigarettes and cement rose by 17.5 and 5.8 percent in Q1-FY17, compared with 16.3 and -0.9 percent, respectively in Q1-FY16.

[16] Customs data suggests that besides tomatoes, potatoes and onions, Pakistan imports a number of fresh vegetables such as garlic, cauliflower, cabbage, cucumber, peas, carrots and spinach. A sizeable quantum of these items is imported from India. Supplies can get disrupted if harvests fall or tensions arise across the working boundary.

[17] In order to strengthen payment systems and facilitate stakeholders, the customs authorities and SBP jointly introduced the system of Electronic Import Form (EIF) as an integral part of the goods clearance system (for details, see FE Circular No. 05 of 2016, dated August 09, 2016). In order to import goods into Pakistan, all importers shall be required to submit EIF request through their Web-based-one-customs (WeBOC) User ID to any authorized dealer of their choice in Pakistan. As per new requirements, no consignment without the proper filing of the EIF form will be processed. This move will also help curb informal and illegal transfer of FX across border: since transactions used to get processed manually earlier and it was not possible to keep record of all transactions, there was a possibility of using informal payment modes to their settlement.

[18] Within perishable food items, a notable increase in prices of fresh vegetables and potatoes was observed. In addition to the impact of season and rains, efforts to export the surplus stock of potatoes also contributed to its price increase in the domestic market.

Figure 3.6: Changes in Prices of Top 20 Weightiest Items of CPI*

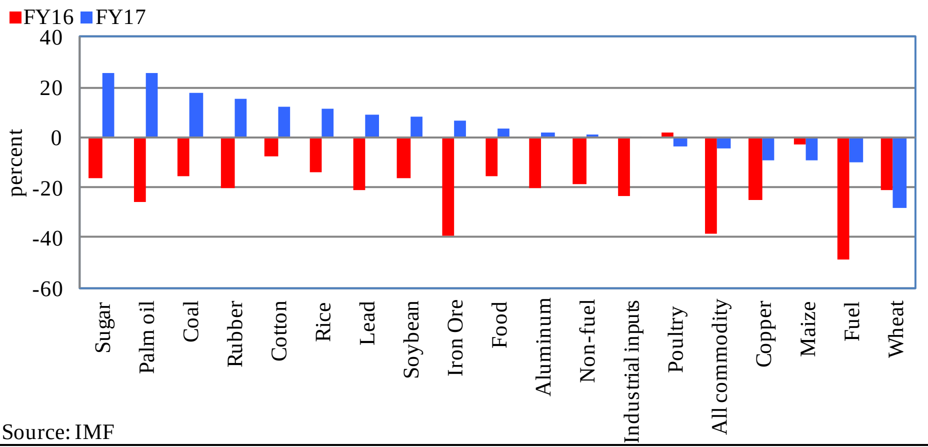


* These 20 items constitute 70 percent weight in the CPI basket.
Source: Pakistan Bureau of Statistics

Global commodity trends

The deflation in global commodity prices is receding fast, and prices of some commodities have lately inched up (**Figure 3.7**).[19] During Jul-Sep 2016, prices of a number of commodities like palm and soybean oil, rice, cotton and coal posted YoY inflation. However, prices of crude oil continued to fall during the quarter, whereas prices of industrial inputs and wheat are still to bottom out.

Figure 3.7: Changes in Selected Global Commodity Prices (Jul-Sep)



Source: IMF

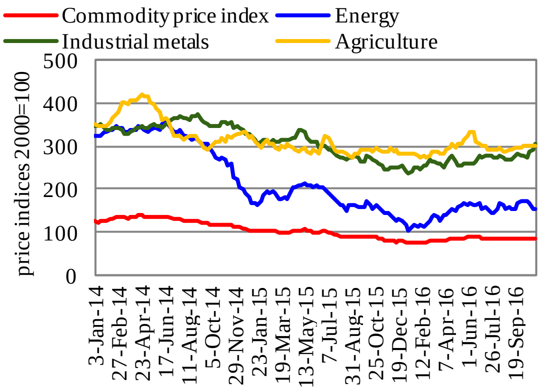
[19] The overall IMF commodity price index has posted a decline of 4.7 percent in Jul-Sep 2016, compared to a 38.6 percent drop in Jul-Sep 2015. Prices of certain food items like palm oil and rice have posted a YoY increase of 25.7 and 11.8 percent during Jul-Sep 2016.

So far, the impact of global prices on domestic inflation has been mixed. For instance, prices of palm oil and rice have increased in the international market, but in the domestic market their prices continued to decline during Q1-FY17.[20] By contrast, domestic price of petrol and diesel fell in tandem with global crude.[21] This fall in domestic fuel prices, in turn, led to 2.0 percent YoY decline in prices of transport services in Q1-FY17; bus fares declined by an average of 5.1 percent YoY during the quarter.

Outlook

The ongoing rebalancing in China, the ultimate outcome on Brexit, and the change in political regime in the US, will have a strong influence over the direction of the global economy and commodity prices. There has been a partial recovery in commodity prices from January 2016 onwards, but this has been patchy and is seemingly susceptible to exogenous shocks at best (**Figure 3.8**).

Figure 3.8: Global Commodity Price Indices



Source: Bloomberg and S&P

Two developments that took place at end-November 2016 will be crucial in determining the inflation path: first, the government ended the 7-month long spell of stability in petrol prices in the country, and allowed an increase of Rs 2 per liter, effective from 1st December 2016. Second, on the global front, the OPEC was able to strike an agreement to cut crude production – for the first time in 8 years.[22] Just the signal that this cartel – which controls over a third of the global crude – is alive, was enough to send jitters across the commodity market; price of Saudi Arabian Light oil increased by over 9 percent right after the announcement.

[20] Price of rice in domestic market has fallen by 7.8 percent YoY in Q1-FY17, whereas prices of edible oil and ghee have declined by 4.9 and 1.8 percent YoY, respectively.
[21] Price of petrol and diesel fell by 15 and 13.9 percent YoY in Q1-FY17 compared to declines of 29.3 and 22.3 percent in Q1-FY16, respectively.
[22] Some of the non-OPEC members, especially Russia, also agreed to participate in the production cuts.

While this immediate oil rally is likely to fizzle out soon, the actual impact of planned production cuts would not be evident in the short term: these are not deep enough to immediately clear the existing glut in the market. More importantly, the impact on Pakistan's CPI inflation will be influenced by when, and how much of the increase in global prices the government is willing to pass on to consumers.

Nonetheless, border controls and trade links with neighboring countries will contribute in setting the path of food inflation – especially perishables – in the country for some time. As for the staple food, current stocks of wheat seem sufficient, which will help keep the overall inflation in check. On balance, therefore, we expect average CPI inflation in FY17 to remain lower than the target of 6 percent set by the government – the Jul-Nov average CPI inflation stood at only 3.9 percent. SBP would monitor global and regional developments closely to remain prudent in its monetary stance.