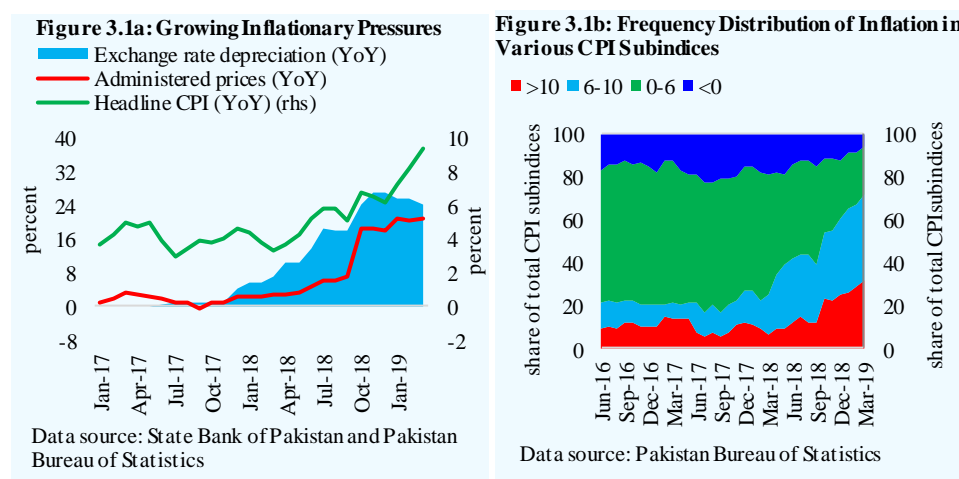


# 3 Inflation and Monetary Policy

## 3.1 Overview

Inflationary pressures strengthened further in Q3-FY19 in terms of both magnitude as well as dispersion (**Figure 3.1**). The headline CPI inflation surged steeply to 8.3 percent during Q3-FY19, compared to 6.5 in the preceding quarter, and only 3.8 percent recorded in the same quarter last year. Attributed primarily to cost-push triggers, and given the fact that the economy was already in stabilization phase for over a year, these pressures warranted careful management.



Four factors explained the recent surge in inflation. First, the needed stabilization measures induced the government to make upward adjustment in administered prices (of petrol, gas and electricity); not only did this inflate the energy (and by extension, transport services) component of the headline CPI, but also escalated businesses' energy expenses. Second, the lagged impact of PKR depreciation continued to seep through the broader economy via rising input costs and capital outlay, and also fed inflation expectations in the economy. Third, food inflation, which had remained benign over the past 5 years, began to creep up due to supply-side constraints (mainly meat and tomatoes), costly transportation and the PKR-led price increases in imported items (such as pulses and tea). And finally, house rents posted a sharp YoY increase during Q3-FY19 due to base effect – quarterly revisions in house rents were unusually modest in Q3-FY18.

The important concern from the monetary policy perspective was the likely continuation in these trends. Specifically, the persistence of large twin deficits entailed risks to overall macroeconomic stability as well as inflation outlook over the near-to-medium term. In addition to this, cost-push pressures on inflation were not expected to subside for the rest of FY19: the elevated level of the current account deficit and weak FX reserves position meant that near-term pressures on the exchange rate (and their spillover to domestic inflation) were still strong. Similarly, on the fiscal front, revenue shortfalls and more-than-expected security-related expenses had left little room for the government to absorb commodity price variations; a breach of the targeted deficit was imminent already. In the context of these concerns, even the lower-bound of the SBP's near-term inflation forecast range stayed above the 6 percent target. Therefore, preserving macroeconomic stability required continuation of tight monetary conditions.

Taking stock of these developments, the monetary policy committee (MPC) increased the policy rate further by aggregate 75 basis points in the two meetings held during Q3-FY19. With these increases, the cumulative adjustment in the policy rate since the beginning of the on-going tightening cycle, reached 500 bps by the end of Q3-FY19. Importantly, while the tight monetary policy gained support from other stabilization and regulatory measures in its efforts of reining in excess demand in the economy, its implementation was complicated by voluminous budgetary transactions in the banking system. The overnight repo market remained volatile, necessitating frequent interventions by the central bank (Table 3.1).

**Table 3.1: Liquidity Management Indicators**

		No. of OMOs	Recourse to SBP facility			Avg. outstanding OMO (billion Rs)	Avg. deviation b/w ONR & PR (bps)*
			No. of Visits	Ceiling (billion Rs)	Floor (billion Rs)		
Jan	2018	7	1	0	12.4	1135.8	-5
	2019	29	5	49.9	162	-1148.2	-16
Feb	2018	8	2	12.4	0	1338.3	-2
	2019	18	4	109.4	4.7	-183.6	-1
Mar	2018	9	4	47	47.8	917.3	+3
	2019	11	5	57.3	16.2	-547.3	0

Data source: State Bank of Pakistan; \* ONR=Overnight rate, PR= policy rate

The most important development was the record-high net retirements of government borrowing to commercial banks, and its replacement with the SBP debt. Specifically, over Rs 6.0 trillion worth of government debt (all T-bills) was scheduled to mature during Q3-FY19, only 60 percent of which was rolled over by banks – they were not willing to invest in government papers due to persistent

expectations of rising interest rates. The month of January 2019 was particularly challenging, as the government retired Rs 2.4 trillion to commercial banks on net basis; public agencies retired another Rs 69.0 billion. To absorb excess liquidity from the market, SBP had to conduct 29 OMOs during the month (almost every day). Although these mop-ups were largely helpful in diluting their impact on the interbank liquidity, the overnight rates remained on average 16 bps below the policy rate during January 2019. The situation improved in subsequent months as overnight rates remained close to the policy rate – in fact, for most days in March 2019, these remained higher than the policy rate (**Section 3.2**). However, in these two months as well, SBP had to intervene on average every second day to ensure stability in the market.

The entrenched liquidity surpluses in the interbank liquidity can be explained by weakening momentum of private sector credit on account of unfavorable macroeconomic conditions. Specifically, Q3-FY19 observed a sudden and sharp slowdown in the off-take of private credit, especially after its sizable expansion in the preceding quarter. The working capital component tumbled the most, as scheduled retirements by textiles and fertilizer manufacturers largely offset borrowings of sugar, dairy and beverages sectors. It may be recalled here that producers had borrowed heavily in the preceding quarter in the wake of rising export demand for value-added products, as well as a steep rise in cotton/yarn prices; the magnitude of their retirements in Q3-FY19 was particularly large. Among non-manufacturing sectors, power generating firms deleveraged, as their cash flows improved after the issuance of energy-related Sukuks by the government. A YoY decline in power generation during the quarter further subdued their financing requirements.

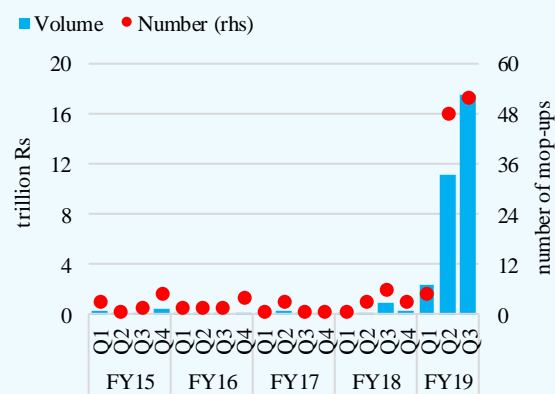
It is important to note here that businesses have been navigating through challenging times from the start of this fiscal year, as sharp depreciation of the PKR, rising input costs, flagging domestic demand, PSDP cutbacks, regulatory tightening, and unintended inventory accumulation, were all taking toll on industrial volumes. Contractions were visible in LSM right from the start of FY19, but rising input costs and cash flow constraints kept the credit growth intact till the end of the second quarter. However, deepening growth constraints have now started weighing on businesses' credit appetite, especially in view of elevated level of interest rates. As for the fixed investment loans, while most firms are reluctant to take a long-term view of the economy due to prevailing uncertainties, few large corporates have stuck to their planned capex, especially in the power sector.

### 3.2 SBP's Liquidity Management

Three factors primarily explained volatile liquidity conditions in the interbank market during Q3-FY19:

- (i) Persistent expectations of policy rate hikes by commercial banks that kept them away from investing in government papers. As a result, the government retired Rs 2.0 trillion to commercial banks during the quarter;
- (ii) Although banks invested Rs. 496.1 billion in PIB auctions (fixed and floating combined) during the quarter, these were partly offloaded to insurance companies and money market funds, bringing the liquidity back into the banking system; and
- (iii) A sharp slowdown in the offtake of private credit

**Figure 3.2: Volume and Number of Mop-ups**

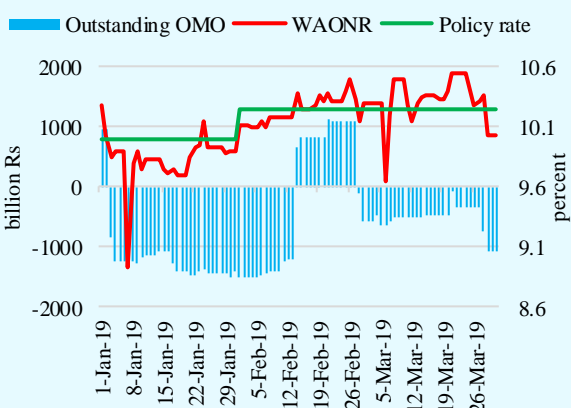


Data source: State Bank of Pakistan

Together, these developments more than offset the impact of a significant deceleration in commercial banks' deposits (non-government) during Q3-FY19. Consequently, the SBP continued to intervene regularly in the interbank market with an aim to maintain stability and ensure smooth implementation of monetary policy. Keeping in view the operational target, SBP conducted 52 open market operations to absorb surplus liquidity during the third quarter. The aggregate mop-up volumes in these operations were historic-highs (**Figure 3.2**). As a result, outstanding mop-ups at end-March stood at Rs 1.1 trillion compared to net injection of Rs 1.5 trillion at end-FY18.

Due to these heavy mop ups, liquidity conditions had relatively tightened from January 2019 through March 2019 (**Figure 3.3**). This is

**Figure 3.3: Key Liquidity Indicators**



Data source: State Bank of Pakistan

evident from the fact that the weighted average overnight rate (WAONR) remained above the policy rate in only 3 days in January 2019, whereas the frequency rose to 11 days and 21 days in February 2019 and March 2019, respectively.

**Table 3.2: Monetary Aggregates**

billion Rupees

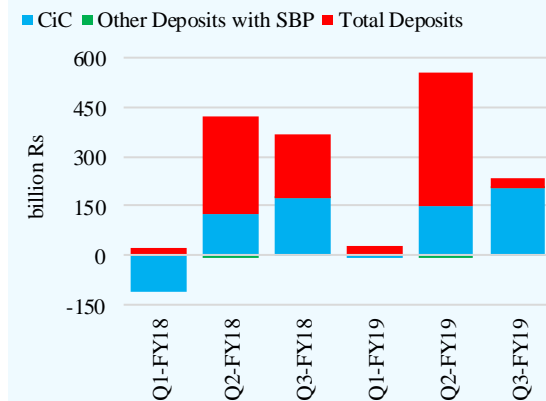
	FY18			FY19		
	H1	Q3	Jul-Mar	H1	Q3	Jul-Mar
<b>Money supply (M2)</b>	<b>336.4</b>	<b>366.0</b>	<b>702.4</b>	<b>577.3</b>	<b>235.6</b>	<b>812.9</b>
Net foreign assets	-174.4	-308.6	-483.1	-681.2	67.4	-613.7
Net domestic assets	510.8	674.7	1185.5	1,258.4	168.2	1,426.6
Net budgetary borrowing	313.2	457.4	770.6	650.6	178.2	828.8
SBP	-2.7	2,164.2	2,161.5	1257.1	2,187.8	3,444.9
Scheduled banks	315.9	-1,706.8	-1,390.9	-60;6.5	-2,009.6	-2,616.1
Credit to private sector	296.3	177.4	473.7	570.4	41.1	611.5
Credit to PSEs	66.0	107.6	173.6	145.1	165.1	310.2
Other items (net)	-152.5	-26.7	-179.3	-25.3	-135.1	-160.4
Currency in Circulation	15.6	171.6	187.3	143.3	206.4	349.7
<b>Total Deposits</b>	<b>320.8</b>	<b>194.0</b>	<b>514.8</b>	<b>433.8</b>	<b>29.0</b>	<b>462.8</b>

Data source: State Bank of Pakistan

### 3.3 Monetary Aggregates

After increasing sharply in the first half of the year, the pace of monetary expansion slowed down in Q3-FY19. This trend was attributed to a modest increase in overall budgetary borrowings from the banking system, as well as a subdued offtake in the credit to private sector. Therefore, a limited expansion was visible in net domestic assets (NDA) of the banking system (**Table 3.2**).

**Figure 3.4: Money Supply - Liability Side**



Data source: State Bank of Pakistan

Importantly, net foreign assets of the banking system posted an increase after falling consistently for the previous 4 quarters. This increase reflected the impact of official loans from bilateral resources, especially in March 2019, which allowed the government to partly retire its borrowings from the banking system.

3.1. On the liability side, the contribution of currency in circulation remained glaringly dominant against deposits during Q3-FY19 (**Figure 3.4**). Around 88

percent of the monetary expansion during the quarter was comprised of currency in circulation, and as a result, the currency to deposit ratio touched a level of 39.6 percent. This trend can partly be traced to an increase in the rates of return on NSS instruments, which attracted Rs 229.9 billion worth of net investments during Q3-FY19. Effective January 1<sup>st</sup> 2019, the profit rates on savings certificates were increased by more than 200 bps. On a cumulative basis, the returns on these instruments since the beginning of monetary tightening cycle have increased by over 500 bps, which compares favorably with only 277 bps increase in case of bank deposits. Possibly, some interest-sensitive deposit holders have shifted their savings from banks to NSS instruments.

Another reason behind a slower deposit mobilization was the expectation of further depreciation of the exchange rate. Anecdotal evidence suggests that general public resorted to dollar holdings in order to preserve their purchasing powers (as reflected from widening kerb premium – **Chapter 5**). It may be recalled here that back in April 2018, non-filers were barred from depositing cash dollars in their foreign currency accounts; therefore, for majority of public, the available option was to hold them in cash.

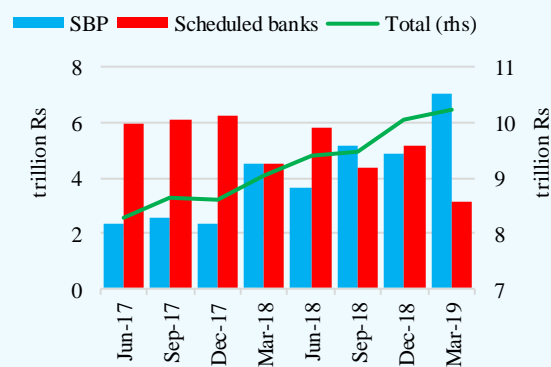
Thus, in order to reduce the cash orientation and informality in the economy, there is a need to take corrective measures that may encourage the use of formal savings channels. It may be highlighted here that the government has recently removed withholding tax (WHT) on cash withdrawals for filers; however, as documented in SBP Annual Report of 2016-17, the impact of this WHT on deposits mobilization was (statistically) insignificant. The major impact on currency growth and currency-to-deposits ratio was coming from WHT on non-cash banking transactions, which is still in place for non-filers.

### Government Budgetary Borrowings

Budgetary borrowings from the banking system slowed down during Q3-FY19 due to increased availability of non-bank and external funding.

Within the banking system, the government continued to borrow heavily from SBP, and made significant retirements to scheduled banks

**Figure 3.5: Budgetary Support from the Banking System (stocks)**



Data source: State Bank of Pakistan

(Figure 3.5).<sup>1</sup> This trend was attributed to the persistence of rate hike expectations in the interbank market, which kept banks away from rolling over debt maturities. Similar to trend in previous few quarters, the incremental investments in T-bills during Q3-FY19 were concentrated in 3-month tenor, which took the share of these instruments in entire T-bill stock to 99.9 percent.

**Table 3.3: Auction Profile of Government Securities (face value)**  
billion Rupees

	T-Bills			PIB -fixed rate			PIB -floating rate		
	Target	Offered*	Accepted	Target	Offered*	Accepted	Target	Offered*	Accepted
<i>In gross terms</i>									
Q1-FY18	3,900.0	4,511.2	4,406.3	300.0	104.1	55.6	-	-	-
Q2-FY18	3,600.0	4,586.5	3,601.2	200.0	54.3	0.0	-	-	-
Q3-FY18	5,375.0	5,396.5	4,214.7	200.0	55.7	0	-	-	-
Q1-FY19	5,450.0	5,119.0	4,687.0	150.0	64.1	20.6	150.0	151.5	108.3
Q2-FY19	4,600.0	5,779.7	5,431.4	150.0	45.3	22.5	150.0	93.4	0.0
Q3-FY19	6,050.0	3,775.6	3,690.6	200.0	945.5	397.9	250.0	232.6	98.2
<i>Net of maturity</i>									
Q1-FY18	218.5	829.7	724.8	-296.6	-492.5	-541.0	-	-	-
Q2-FY18	-5.0	981.5	-3.8	200.0	54.3	0.0	-	-	-
Q3-FY18	315.8	337.3	-844.5	-326.8	-471.1	-526.8	-	-	-
Q1-FY19	-210.6	-541.6	-973.6	-311.1	-397.1	-440.6	150.0	151.5	108.3
Q2-FY19	198.5	1,378.2	1,030.0	150.0	45.3	22.5	150.0	93.4	0.0
Q3-FY19	30.5	-2,243.9	-2,328.9	200.0	945.5	397.9	250.0	232.6	98.2

\* Offered amount excludes non-competitive bids

Data source: State Bank of Pakistan

An important development during the quarter was the market's renewed interest in long-term debt instruments (Table 3.3). This was potentially in the backdrop of a hike in the PIB cutoff rates in December 2018 auction. That in turn signaled the market regarding a shift in the government's strategy in favor of PIBs. During Q3-FY19, total offers for PIBs (both floating rate and fixed rate) soared to Rs 1.2 trillion against the target of Rs 450 billion. Of these, Rs 496.1 billion were accepted.

### Credit to PSEs and Commodity Financing

Credit to PSEs registered a significant increase during Q3-FY19 compared to the corresponding period last year. Almost the entire borrowing represented the investment of Islamic banks in Sukuk worth Rs 200 billion, issued by the Ministry of Energy. This amount was mobilized by the Ministry via Power Holding Private Ltd. (PHPL) in order to address liquidity constraints in the energy sector.

<sup>1</sup> Until H1-FY19, the overall volume of budgetary support from the banking system was more than twice that of last year.

Reportedly, PHPL has made its due payments to the IPPs and OMCs, which brought some improvement in their cash flows.

As for the commodity operations, higher net retirements were entirely driven by the repayment of loans for wheat procurement during Q3-FY19 (**Table 3.4**). Wheat sales within the country as well as exports enabled the procurement agencies to make significant loan retirements during the period.<sup>2</sup>

**Table 3.4: Commodity Financing**  
billion Rupees

	FY18			FY19		
	H1	Q3	Jul-Mar	H1	Q3	Jul-Mar
Wheat	-11.2	-44.3	-55.4	-91.8	-82.3	-174.1
Cotton	0.0	0.0	0.0	0.0	0.0	0.0
Rice	0.1	0.0	0.2	0.0	0.0	0.1
Sugar	-2.1	0.3	-1.8	2.1	0.6	2.7
Urea	-1.5	0.1	-1.4	4.2	0.9	5.1
Total	-14.6	-43.9	-58.4	-85.5	-80.7	-166.1

Data source: State Bank of Pakistan

### 3.4 Credit to Private Sector

The first 9-month position of private credit showed an encouraging picture, as the off-take rose to Rs 611.5 billion in Jul-Mar FY19, compared to Rs 473.7 billion recorded in the same period last year. However, focusing only on Q3-FY19, private credit moderated significantly as the offtake fell from Rs 177.4 billion in Q3-FY18 to only Rs 41.1 billion in Q3-FY19 (**Figure 3.6**). Textiles and fertilizer sectors, which had borrowed aggressively in H1-FY19, made heavy retirements during the quarter under review.

#### *Net retirements in textile, fertilizer and edible oil muted working capital loans*

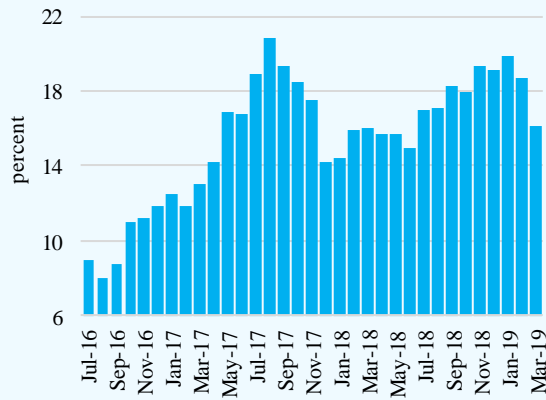
Export-led activity in the textile sector coupled with rising input costs drove up working capital borrowing in H1-FY19, during which the sector borrowed Rs 187.4 billion. Because the sector received 25.2 percent higher export revenues in PKR terms during the quarter, it retired Rs 32.5 billion of short-term loans in Q3-FY19, compared to borrowing of Rs 4.0 billion in the same period last year. Furthermore, it might have been challenging for some firms to roll over their bank debt, due to higher interest cost.

<sup>2</sup> During H1-FY19, 461.3 thousand MT wheat was exported as compared to 0.2 thousand MT in the same period last year, whereas in Q3-FY19, 96.2 thousand MT was exported compared to 307.2 thousand MT in Q3-FY18. Moreover, procurement agencies offloaded almost double the quantity of wheat during Q3-FY19 compared to Q3-FY18.



In the case of fertilizer, the net retirements of short-term loans was mainly due to longer than usual maintenance shutdown of plants of few major manufacturers in Q3-FY19. Fertilizer offtake during the quarter also contracted due to its higher prices, lower area under cultivation of major crops and low rainfall in the sowing season, all of which resulted in decline in production during Q3-FY19. Similarly, edible oil firms made seasonal retirement of Rs 6.9 billion in Q3-FY19, majority of which were loans taken for import financing purpose.

Figure 3.6: Credit to Private Sector (YoY growth)



Data source: State Bank of Pakistan

Table 3.5: Loans to Private Sector Businesses during Q3 (flow)

billion Rupees

	Total Loans		Working Capital*		Fixed Investment	
	FY18	FY19	FY18	FY19	FY18	FY19
<b>Private Sector Businesses</b>	<b>159.8</b>	<b>47.9</b>	<b>85.5</b>	<b>1.8</b>	<b>74.2</b>	<b>46.1</b>
Manufacturing	104.4	66.1	83.8	50.6	20.6	15.5
Sugar	93.3	94.3	86.4	83.1	6.9	11.2
Basic chemicals	-7.6	20.1	-5.2	11.3	-2.4	8.8
Dairy	12.4	11.0	2.1	10.9	10.4	0.1
Soft drinks & beverages	4.1	9.2	1.3	7.0	2.8	2.2
Cement	20.4	6.2	2.6	5.1	17.7	1.1
Iron & Steel	7.5	3.4	5.3	4.0	2.3	-0.6
Refined Petroleum	5.6	0.6	7.4	2.7	-1.8	-2.1
Edible oil and ghee	-2.3	-6.5	-2.2	-6.9	-0.1	0.4
Fertilizer	-27.8	-13.5	-19.2	-12.3	-8.6	-1.3
Textiles	-8.6	-28.6	4.0	-32.5	-12.6	3.9
Prod., trans. & dist. of electricity	46.2	10.7	26.0	-21.0	20.2	31.7
Mining and Quarrying	3.1	6.8	-0.7	4.5	3.7	2.4
Real estate & related	10.9	1.2	1.2	0.2	9.7	1.0
Commerce and Trade	-6.1	2.7	-13.4	-7.3	7.3	9.9
Construction	11.5	-5.6	8.2	2.4	3.2	-8.0
Transport, stor. & communication	2.3	-9.2	-6.2	-6.0	8.5	-3.2
Agriculture	-5.9	-10.7	-4.0	-7.6	-1.8	-3.1
Ship breaking etc.	-3.8	-14.0	-3.6	-14.0	-0.2	-0.1

\*includes trade financing

Data source: State Bank of Pakistan

***Higher input cost raised financing requirement in sugar***

Despite the fall in production of sugarcane on YoY basis, sugar sector borrowed at previous year's level during Q3-FY19.<sup>3</sup> However, unlike last year when most of the borrowing was activity-driven, the borrowings during Q3-FY19 period mainly reflected firms' liquidity constraints. It is important to recall here that a number of sugar manufacturing firms had defaulted on their bank loans in the preceding quarter, as prices remained depressed in the domestic market and the government was not able to make full payment of the export subsidy amount. An additional pressure in the third quarter was the increase in sugarcane prices by 16.6 percent YoY, compared to a decline of 4.2 percent last year. The liquidity constraints were also reflected in deposit withdrawals by the sector during Q3-FY19.

Besides sugar, other manufacturers also borrowed short term loans to finance their seasonal needs. These included dairy, soft drinks & beverages sectors, which borrowed a combined Rs 17.9 billion in Q3-FY19, compared to Rs 3.4 billion last year. However, their impact was diluted by the net retirements in textile, fertilizer and edible oil & ghee sectors. As a result, working capital loans in manufacturing grew only Rs 50.6 billion, compared to Rs 83.8 billion in the same period last year (**Table 3.5**).

***Capex in power transmission helped push fixed investment loans***

Unlike the first two quarters of FY19 when working capital dominated the increase in loans to private business, fixed investment loans constituted the major part of the increase in private credit. Sectors such as power generation, sugar and basic chemicals were the major beneficiaries. The major chunk of these loans was taken by power generation sector, as K-Electric (KE) is in the process of upgrading its power grids and the overall transmission network. It is pertinent to mention that the utility provider is investing heavily to strengthen power supply and improve operational efficiency.

***Consumer financing remained depressed***

Consumer financing rose Rs 43.0 billion in Jul-Mar FY19, compared to Rs 57.2 billion last year and consistently declined in all quarters. The major drag came from the segments such as auto and house financing. The decline in auto loans can be attributed to ban on non-filers from purchasing/registering cars, as well as rising markup cost. Moreover, house financing remained virtually stagnant in Q3-FY19, compared to Rs 2.7 billion increase in the same period last year (**Table 3.6**).

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<sup>3</sup> The second estimate for the Kharif season reveals a contraction in the production of sugarcane by 15.9 percent compared to the corresponding period last year.

**Table 3.6: Consumer Financing (flow)**  
billion Rupees

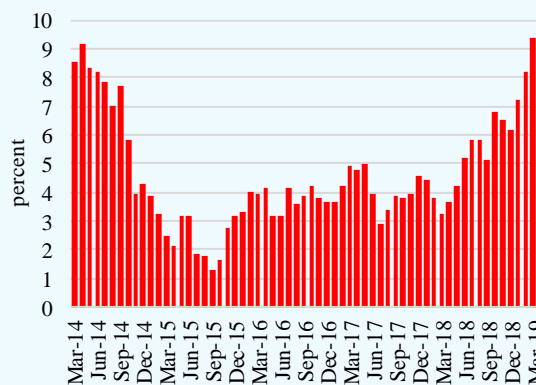
	Jul-Mar		Q1		Q2		Q3	
	FY18	FY19	FY18	FY19	FY18	FY19	FY18	FY19
<b>Total</b>	<b>57.2</b>	<b>43.0</b>	<b>18.4</b>	<b>15.3</b>	<b>17.1</b>	<b>14.5</b>	<b>21.7</b>	<b>13.2</b>
For Transport: Car	34.6	17.7	11.2	5.0	9.6	6.8	13.9	5.9
House building	15.1	8.3	6.3	5.4	6.1	2.9	2.7	0.0
Personal loans	1.8	9.8	0.8	3.5	-4.6	2.1	5.6	4.2
Credit cards	4.7	4.0	1.6	1.1	2.5	2.5	0.6	0.3
Consumer durables	1.0	3.2	-1.5	0.3	3.5	0.1	-1.1	2.8

Data source: State Bank of Pakistan

It may be noted that the SBP has introduced a policy for promoting low cost housing in March 2019 for lower income and special segments of the society, such as widows, children of martyrs, transgender people, and persons in areas severely affected by terrorism. The central bank has allowed certain regulatory relaxations to banks/DFIs. With 90:10 loan to value ratio, a housing unit/apartment having up to Rs 3 million value can be financed at a relatively low rate of 5 percent for up to 12.5 years.

The loans are refinanced by SBP and banks have been exempted from the exposure limit of 10 percent on real estate to the extent of exposure taken on low cost housing.

**Figure 3.7: Headline CPI Inflation (YoY)**



Data source: Pakistan Bureau of Statistics

### 3.5 Inflation

CPI inflation (YoY) consistently rose on a quarterly basis and reached 8.3 percent on average during Q3-FY19 (**Figure 3.7**). As a result, the average headline CPI inflation recorded highest third-quarter inflation since FY12 at 8.3 percent, compared to 3.8 percent during Q3-FY18 (**Table 3.7**).

**Table 3.7: Average CPI Inflation and Contribution during Q3**

growth in percent, contribution in percentage points

	Weight	Growth		Contribution	
		FY18	FY19	FY18	FY19
<b>Overall CPI</b>	<b>100.0</b>	<b>3.8</b>	<b>8.3</b>	<b>3.8</b>	<b>8.3</b>
<b>Food of which</b>	<b>37.5</b>	<b>2.0</b>	<b>5.2</b>	<b>0.8</b>	<b>2.1</b>
Meat	2.4	8.4	13.6	0.3	0.4
Cigarette	1.4	-19.8	14.5	-0.5	0.3
Tomatoes	0.4	-14.9	136.5	0.0	0.3
Milk	6.7	4.0	4.1	0.3	0.3
Sugar	1.0	-16.6	14.0	-0.2	0.1
<b>Energy of which</b>	<b>9.0</b>	<b>3.3</b>	<b>20.9</b>	<b>0.3</b>	<b>1.7</b>
Gas	1.6	0.0	85.3	0.0	1.0
Electricity	4.4	0.0	8.5	0.0	0.4
Fuel	3.0	12.9	14.9	0.3	0.3
<b>Non Food Non Energy of which</b>	<b>53.5</b>	<b>5.4</b>	<b>8.6</b>	<b>2.7</b>	<b>4.5</b>
House rent	21.8	5.4	8.2	1.0	1.6
Transport services	2.7	1.3	15.1	0.0	0.4
Education	3.9	14.0	8.7	0.6	0.4
Personal equipment	0.8	9.1	12.4	0.1	0.2
Footwear	1.6	0.6	7.9	0.0	0.1
Drug medicine	1.3	2.0	7.9	0.0	0.1
Construction input item	0.6	4.9	12.0	0.0	0.1
Motor vehicle	0.7	5.7	12.8	0.0	0.1

Data source: Pakistan Bureau of Statistics

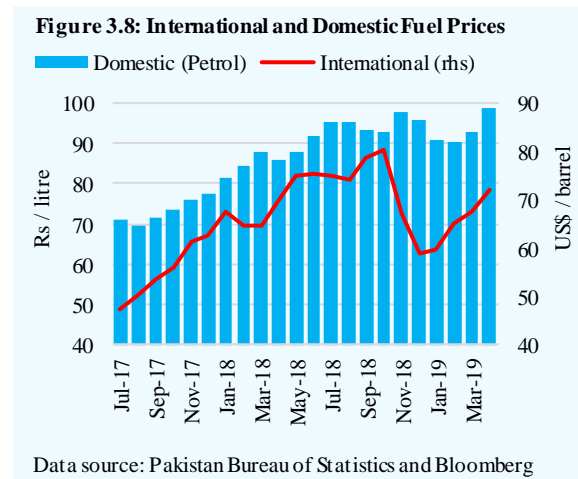
Major reasons for the rise in inflation included: (i) sustained pressures on twin deficits, which induced the government to adjust administered prices upwards and also impose regulatory duties on imported items; (ii) supply constraints of certain food items and imposition of FED on cigarettes; (iii) the second-round impact of rise in fuel prices and exchange rate depreciations; and (iv) a sharp YoY increase in house rents during Q3-FY19 due to base effect. As mentioned before, the inflationary pressures throughout FY19 have remained broad-based, as around 70 percent of the sub-indices showed more than 6 percent (target) inflation during Q3-FY19. Furthermore, around one-third of the sub-indices have grown by more than 10 percent.

#### **Government price adjustments steered energy inflation**

Administered prices, which primarily comprise of energy and important food items, posted a steep rise during Q3-FY19 (**Figure 3.8**). This increase was reflected in a high inflation in natural gas (85.3 percent), electricity (8.5 percent), and motor fuel (14.9 percent) during the third quarter. On aggregate, these contributed about 20 percent (1.7 percentage points) to the overall headline

inflation of 8.3 percent during the quarter. Last year, these CPI sub-indices had contributed only 7 percent to the headline inflation.

In particular, adjustments in domestic gas prices were necessary for the government to ease alleviate its current expenditures and also to bring down losses of gas distribution companies. It is important to recall here that the increase in natural gas tariffs was long due as gross underpricing of the commodity over the years has not just led to its overutilization but has also burdened the national exchequer significantly. While efficiency improvement at distribution level would help, it is important to reiterate that gas pricing needs to be much more competitive at the upstream level, in order to make bring online those gas fields that are presently commercially unviable.<sup>4</sup>



As for the motor fuel, it is important to mention here that after increasing consistently during FY18, domestic petrol prices have remained stable at an elevated level during Jul-Mar FY19.<sup>5</sup> This stability came on the back of a cut in sales tax on domestic motor fuel prices from July 2018 onwards, as well as a sharp decline in global crude prices in Q2-FY19. Although global crude prices surged again in Q3-FY19, their impact on domestic motor fuel prices did not materialize during the quarter.<sup>6</sup>

#### ***Food inflation began to surge***

Food inflation during Q3-FY19 more than doubled to 5.2 percent, compared to 2.0 percent during Q3-FY18. While this increase was broad-based, the rise in prices of tomatoes, sugar and cigarettes was particularly steep. The surge in prices of

<sup>4</sup> This would also encourage fresh exploration, which could increase total gas reserves in the country and alleviate pressure on retail price of gas over the medium term.

<sup>5</sup> Petrol prices had been increasing throughout during FY18, surging from Rs 72.8 per liter to Rs 92 per liter at end June 2018. In the first 9 months of FY19, the average petrol price stayed at Rs 93.8 per liter.

<sup>6</sup> This impact was materialized with a lag in May 2019, when the government increased the petrol prices by Rs 9.5 per liter, and HSD prices by Rs 4.9 per liter.

tomatoes was due to supply shortages emanating from lower domestic production, as well as tensions with India during the period that restricted its imports during Q3-FY19. In case of cigarettes, the imposition of federal excise duty from October 2018 onwards, resulted in a sharp rise in their prices.

The surge in sugar prices, which had stayed low and stable over the past couple of years, had been visible since the commencement of the current cane crushing season. By end-March 2019, sugar prices had soared to Rs 61.1 per kg in the domestic market from Rs 54/kg at the start of the year. It is also important to note here that sugar exports have already fallen this year in the absence of subsidies; compared to the export of 1 million ton of sugar in Jul-Mar FY18, only 123,000 tons was exported this year. However, the government is now mulling over banning the export of the commodity to keep domestic prices under check.

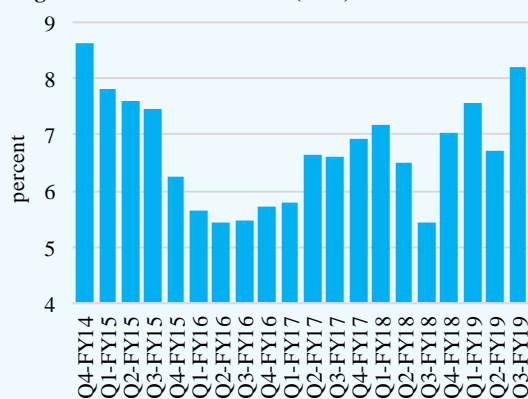
#### **Prices of non-food-non-energy items remained high**

House rent, second round impact of fuel prices, and multiple phases of exchange rate depreciation played a critical role in driving the NFNE inflation during Jul-Mar FY19. With the highest weight of 21.8 percent in the CPI, house rent contributes strongly to CPI inflation. During Q3-FY19, it added 1.6 percentage points to the headline CPI inflation against 1.0 percentage point contribution in Q3-FY18. Specifically, during Q3-FY19,

house rent (YoY) inflation rose by 8.2 percent, which is the highest level since Q4-FY14; it may be highlighted here that upward adjustments in house rent during Q3-FY18 were quite low compared to the trend observed during the last three years (**Figure 3.9**). City-wise segregated data shows that 9 out of 40 cities showed a double-digit rise in rents, while 23 cities observed increase in rent by more than 6 percent, which is the target rate set for the overall CPI.

Triggered by rise in fuel prices, transport services posted an inflation of 15.1 percent during Q3-FY19. Moreover, private courier services also hiked up their prices during Q3-FY19 following an increase in their transportation cost.

**Figure 3.9: House Rent Index (YoY)**



Data source: Pakistan Bureau of Statistics

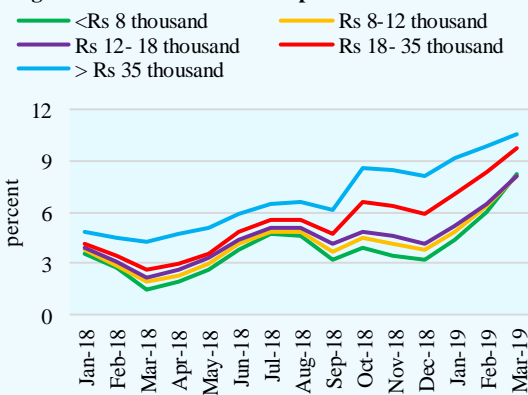
Additionally, some of those items that rely on imported inputs recorded higher inflation during Q3-FY19; these included motor vehicles (12.8 percent), motor vehicle accessories (10.3 percent), medicines (7.9 percent), medical equipment (6.3 percent) and telephone sets (9.8 percent). Resultantly, NFNE recorded an increase of 8.6 percent during Q3-FY19, compared to 5.4 percent during the same period last year.

### ***Income group-wise CPI Inflation***

Though inflationary pressures have accelerated since the beginning of FY19, their incidence on low-income groups (with incomes less than Rs 12,000) remained quite benign till the end of the second quarter (**Figure 3.10**). During Q3-FY19, however, inflation incidence on these income groups grew stronger, as the inflation doubled from around 4.0 percent YoY in December 2018 to slightly more than 8.0 percent YoY by

March 2019. Since consumption basket of low-income groups is mainly constituted of essential items, a broad-based rise in food prices have started to affect this group. Furthermore, the double-digit inflation in sensitive price index (which includes 53 essential items) during February and March 2019 also confirms that lower income groups have been more prone to rising inflationary pressures during Q3-FY19.

**Figure 3.10: CPI Income Group-Wise Inflation**



Data source: Pakistan Bureau of Statistics