3 Monetary Policy and Inflation

The SBP's Monetary Policy Committee decided to keep the policy rate unchanged at 7 percent during Q2-FY21. Further traction in the domestic recovery and well-anchored and contained inflationary expectations mainly guided the policy decision. Economic activity indicators, including high frequency demand-side data, posted recovery, whereas consumer and business sentiments strengthened as Covid-related uncertainty receded somewhat. Meanwhile, deposit mobilization remained strong, which, in turn, offset the liquidity pressures in the interbank market. Also, credit to the private sector posted an encouraging recovery amid the revival in economic activity and the availability of SBP's concessionary refinancing schemes. CPI inflation, on the other hand, weakened in Q2-FY21 on YoY basis as well as over the preceding quarter. While the measure of core inflation has remained broadly stable and energy inflation declined, the headline number was driven mainly by stronger food inflation in the non-perishable group.

3.1 Policy Review

Domestic economic activity gained traction throughout the first half of FY21. In particular, industrial activity gathered momentum, as large-scale manufacturing (LSM) posted a broad-based growth, especially in Q2-FY21. Also, high frequency demand indicators, such as auto sales, cement dispatches, POL sales, and electricity consumption, indicated a sustained recovery (**Figure 1.1 in Chapter 1**). The external and fiscal sector indicators continued to improve during the period under review, as both the current account and the primary balance posted surpluses. In the meantime, owing to stability in core inflation and the decline in energy components, the national CPI inflation softened (**Table 1.1**).

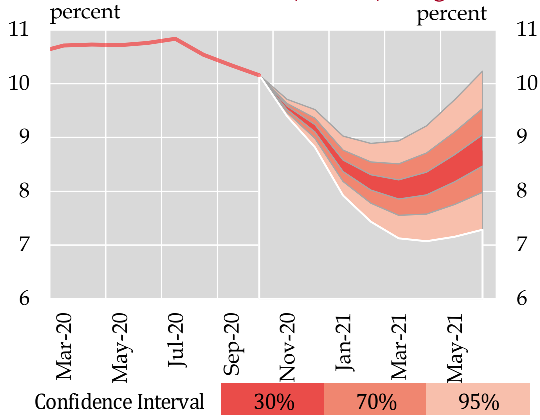
Due to the pick-up in overall economic activity as well as exports, the private sector credit posted a positive growth in Q2-FY21 after displaying a persistent negative trend since the third quarter of FY19. The uptick is mainly driven by a broad-based rise in working capital loans, largely supported by the SBP's concessionary refinancing schemes.

Notwithstanding the positive momentum in the economy, particularly during the second quarter of FY21, the overall demand-side inflationary pressures remained contained, partly owing to the existence of spare capacity in the economy.[1] Core inflation remained stable during the first half of the year (both in Q1 and Q2), whereas headline inflation decelerated. In particular, in Q2-FY21, headline inflation decelerated to 8.4 percent from 8.8 percent in Q1-FY21.

The YoY trend depicts that national headline inflation fell from 8.9 percent in October 2020 to 8.0 percent in December 2020 - the lowest rate since June 2019. This decline is mainly attributed to decreasing inflation in perishable food items and deflation in energy prices. Meanwhile, a significant increase in food prices was

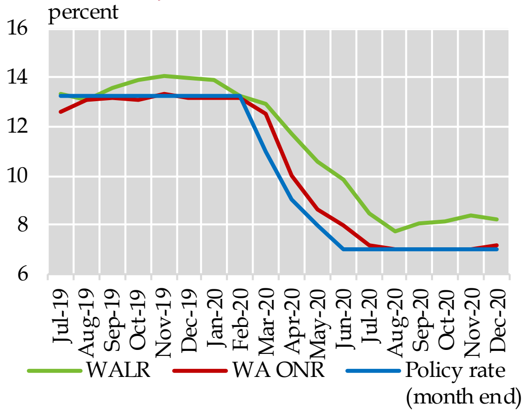
[1] For instance, in the auto sector, capacity utilization remained around 51.7 percent in cars, 40.1 percent in LCVs, 11.9 percent in buses, 10.9 percent in trucks and 76 percent in 2/3 wheelers, as per data taken from PAMA and Pakistan Economic Survey. In the cement sector, capacity utilization remained around 77 percent, whereas it was around 60 percent in the POL industry.

Fan Chart-CPI Inflation (12mma) Figure 3.1



Source: SBP staff estimates as of November,2020

Trends in Major Interest Rates Figure 3.2



Source: State Bank of Pakistan

recorded in October 2020 and November 2020 (on YoY basis) on account of non-perishable food items.

Nonetheless, the inflation projection for FY21 remained unchanged at 7-9 percent during the period, with the consideration of the favorable base effect and spare capacity in the economy. However, the range was subject to several risks. The upside risks included a potential increase in the food and energy prices, whereas the downward risks were associated with the second wave of the pandemic (**Figure 3.1**).

In view of the broadly unchanged outlook for growth and inflation during the period under review, the existing stance of monetary policy was deemed appropriate to keep the recovery on-track, as inflation expectations remained well-anchored. Therefore, the Monetary Policy Committee (MPC), in its meeting held in November 2020, decided to keep the policy rate unchanged at 7 percent (**Figure 3.**2).

3.2 Monetary Aggregates

The broad money grew by 5.6 percent during H1-FY21, compared to a slightly lower growth of 5.2 percent in the corresponding period last year. During Q2-FY21, both the Net Foreign Assets (NFA) and Net Domestic Assets (NDA) posted an expansion, unlike the trend observed in the preceding quarter where the entire increase in the money supply was driven by the NFA (**Table 3.1**).

Importantly, after a gap of 31 months, the NFA of the banking system turned positive in December 2020. This was on the back of an improvement in the current account balance and also due to a shift in the foreign liabilities from the SBP to the government, which in turn positively impacted the SBP's NFA.

During Q2-FY21, the NFA of the banking system expanded by Rs 271.5 billion, compared to an increase of Rs 618.4 billion during the same period last year. Bulk of this increase came from the improvement in the SBP's FX reserves position (**Figure 3.3**). In case of the NDA, the sharp increase in private credit offtake, along with higher government budgetary borrowings from the banking system

Monetary Aggregates[P] **Table 3.1**

billion Rupees

	FY20			FY21		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
M2 (A+B)	105.2	812.1	917.3	260.5	902.3	1,162.7
A. NFA	259.6	618.4	878.0	307.3	271.5	578.8
B. NDA	-154.4	193.7	39.3	-46.8	630.8	584.0
Budgetary borrowing*	156.0	30.6	186.6	285.2	152.1	437.3
SBP	-1,586.9	846.4	-740.5	-281.9	-304.0	-585.9
Scheduled banks	1,742.9	-815.7	927.1	567.1	456.0	1,023.2
Commodity operations	-15.6	-12.9	-28.5	-59.9	-19.4	-79.3
Private sector credit	-16.9	232.5	215.6	-76.6	420.1	343.5
PSEs	-2.0	-0.3	-2.4	-11.9	-17.4	-29.3
Other items net	-275.2	-58.8	-334.0	-184.7	91.7	-92.9
Reserve money	-207.4	372.6	165.3	-149.0	160.8	11.7
Currency in Circulation	289.1	40.8	330.0	-40.4	104.9	64.5
Deposits	-184.9	772.3	587.4	289.3	792.5	1,081.8

[P]: Provisional

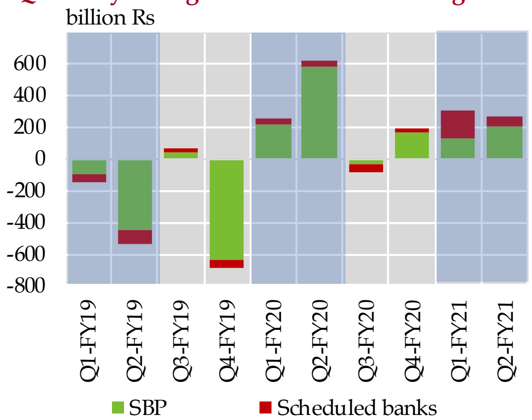
* These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in **Table 4.1 in Chapter 4.**

Source: State Bank of Pakistan

during Q2-FY21, were the main drivers of the domestic assets of the banking system.

As far as the liability side of the broad money is concerned, the growth in currency in circulation re-emerged in Q2-FY21, as it recorded an expansion of Rs 104.9 billion, against a contraction of Rs 40.4 billion in the preceding quarter and an increase of Rs 40.8 billion in the corresponding period last year. On a cumulative basis, during H1-FY21, the deposits with the commercial banks grew by Rs 1,081.8 billion, compared to Rs 587.4 billion in the same period last year.[2] Despite the improvement in deposit mobilization, the overall currency to deposit ratio remained at an elevated level of 41.6 percent on average during H1-FY21, as compared to 41.5 percent in the same period last year.

Quarterly Change in the NFA **Figure 3.3**



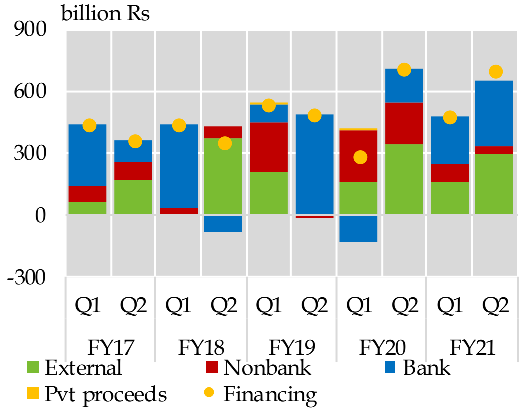
Source: State Bank of Pakistan

[2] Most of this YoY increase in deposits during H1-FY21 had originated in Q1 (Rs 289.3 billion), whereas mobilization had decreased by Rs 184.9 billion in the corresponding period last year. In Q2-FY21, the deposits expanded only slightly on YoY basis.

Government Borrowings

The government's borrowings from the banking system more than doubled during H1-FY21. This was partly due to an increase in the fiscal deficit in nominal terms, and also due to lower mobilization from non-bank sources (**Figure 3.4**).[3] In addition, given the government's commitment of zero deficit monetization, the reliance on commercial banks for budgetary support remained high.

Sources of Fiscal Deficit Financing **Figure 3.4**



Source: Ministry of Finance

During Q2-FY21, the government continued to set higher net-of-maturity targets for longer tenor bonds as compared to T-bills. Keeping in view the relatively low level of interest rates, the targets for floating rate PIBs were more than double that of fixed rate PIBs. Not only the pre-auction target for floaters were on the higher side, but the government also introduced new PIBs-Floating rate (PFL), with quarterly coupons (**Box 3.1**).

Box 3.1: A Recap of Recent Changes in the Floating-rate Bond Market in Pakistan

In May 2018, Pakistan's first floating rate government bonds were introduced. This 10-year instrument was launched primarily to provide an avenue to the market to invest in long-term bonds without taking exposure of the duration risk. Subsequently in June 2020, in a low interest rate environment, the government added new medium-term floaters, with maturities of 3 years and 5 years to its existing offering of floating rate bonds. Moreover, the coupon structure remained similar for all the maturities, i.e. a semi-annual coupon with the benchmark rate linked to 6-month T-bill yields and an additional margin (reflecting the term and liquidity premium of the bond).

To further exploit the untapped potential of the floating rate bonds, the government introduced the new PFLs with more favorable features for the market in October 2020. This time around, however, not only a new maturity was added, but new coupon structures were also offered. The instruments with 3, 5 and 10-year maturities were now also offered with quarterly coupon and quarterly resets linked with the yields of the 3-month T-bill. Additionally, a 2-yr PFL was also introduced, with a unique coupon feature of fortnightly resets and coupon payments

List of Floating Rate PIBs **Table 3.1.1**

Coupon Frequency	Coupon Reset	Maturity	Benchmark*
Quarterly	Fortnightly	2-Year	3M T-bill
Quarterly	Quarterly	3-Years	3M T-bill
Quarterly	Quarterly	5-Years	3M T-bill
Quarterly	Quarterly	10-Years	3M T-bill
Semi-annual	Semi-annual	3-Years	6M T-bill
Semi-annual	Semi-annual	5-Years	6M T-bill
Semi-annual	Semi-annual	10-Years	6M T-bill

*benchmark is the weighted average yield of the most recent auction (near coupon reset date) of the respective security.

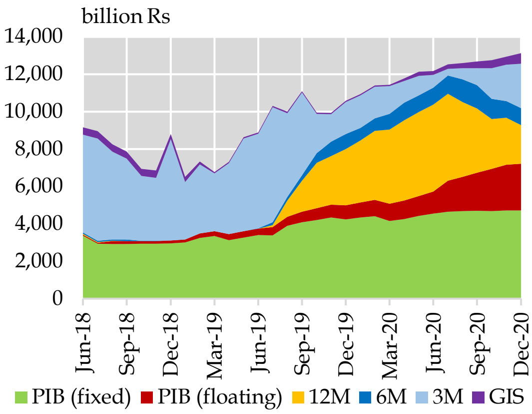
Source: State Bank of Pakistan

[3] The nonbank financing fell to Rs 132.2 billion during H1-FY21 from Rs 439.4 billion and Rs 234.4 billion in H1-FY20 and H1-FY19 respectively.

on quarterly basis. In a nutshell, there are currently seven floaters available in the market, with maturities ranging from 2-yrs to 10-yrs. On the flipside, having a wide range of instruments is to some extent leading to an element of confusion in the market and is also disadvantageous in terms of improving liquidity of the floaters.

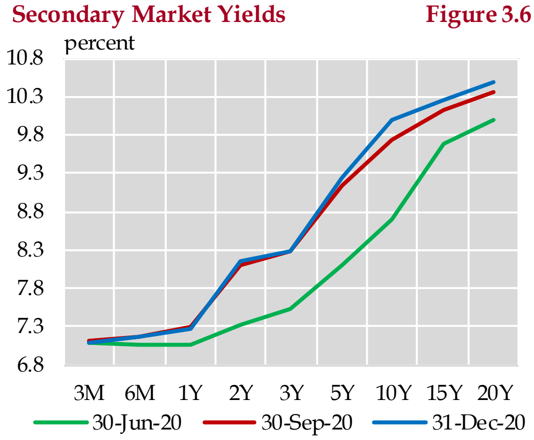
Besides this, in Q2-FY21, the government also made changes in the auction structure of the floating rate PIBs, with the objective to simplify and standardize the pricing of floaters. From October 16, 2020 onwards, in the fresh issuances of PFL, the primary dealers were directed to bid in terms of prices instead of margins; this effectively brought down margins to zero. However, the total return may have remained the same, with a compensatory adjustment in prices. From the secondary market's perspective, this change will make the price of the floaters more standardized, unlike previously, when prices also used to reflect the underlying quoted margin of the security. Meanwhile, the auctions for the floating rate PIBs have moved to a multiple price competitive bidding framework (from October 16, 2020 onwards) from a uniform price competitive bidding structure. This change should help the government take advantage of the bids offered below the cutoff rates and economize the debt servicing cost.

Outstanding Marketable Securities **Figure 3.5**



Source: State Bank of Pakistan

Secondary Market Yields **Figure 3.6**



Source: MUFAP

With the government's consistent efforts, the outstanding stock of government securities has not only become more diversified, but the average time to maturity has also improved (**Figure 3.5**). It is important to recall here that throughout FY20, the interest rate expectations presented favorable conditions for the government's objective of extending the maturity profile.[4] In the current scenario, however, the interest rate expectations are acting as a headwind. With a gradual steepening of the yield curve, it may become more challenging for the government to maintain a favorable maturity profile of marketable securities (**Figure 3.6**).

This is also evident from the increasing preference of the market for 3-month T-

[4] As the interest rates peaked out at 13.25 percent at the start of FY20 and the market's expectations of further rate hikes subsided after the July 2019 MPC decision, the longer tenor bonds became more attractive for the market (for more details, see Chapter 3 of the SBP's First Quarterly Report of FY20).

bills. As a result, the share of 3-month papers in the outstanding stock of government securities has started to increase – not in line with the government's borrowing targets. With no change in interest rates during H1-FY21, the market is concentrating its offers in the 3-month T-bills. Around 90 percent of the total competitive offers (for T-bills) received during Q2-FY21 were for the 3-month paper, against 45 percent in the preceding quarter. As a result, the total issuances of T-bills remained nearly Rs 500 billion higher as compared to the pre-auction target during Q2-FY21 (**Table 3.2**).

Meanwhile, the market's interest for fixed and floating rate PIBs remained on the lower side. The offers were not only lower compared to the preceding quarter, but also fell short of the government's pre-auction targets. In case of fixed rate PIBs, the government also remained reluctant to accept higher cut-offs; therefore, it was able to meet only 11 percent of the target for Q2-FY21. With a tough situation in mobilizing financing for longer tenor at fixed rates, the PFLs – with the unique variable coupon feature – remained a relatively important instrument for the government to maintain its maturity profile.

In order to further leverage on the favorable structure of the PFLs, the government introduced new floaters in Q2-FY21. The market also responded positively to the newly launched quarterly coupon (quarterly reset) PFL, to the extent that it nearly dried up all the offers for the

Instrument-wise Auction Summary for Q2-FY21 **Table 3.2**

billion Rupees

	Target	Maturity	Offered*	Accepted
T-bills	**2,750.0**	**3,493.9**	**4,725.1**	**3,249.4**
3M	950.0	1,457.5	4,231.8	2,920.4
6M	950.0	577.1	324.3	241.4
12M	850.0	1,459.3	169.0	87.6
PIBs (fixed)	**390.0**	**-**	**186.1**	**42.4**
3Y	150.0	-	32.1	4.8
5Y	110.0	-	53.8	-
10Y	85.0	-	48.2	-
15Y	30.0	-	25.5	15.0
20Y	15.0	-	26.6	22.6
PIBs (floater)	**930.0**	**-**	**622.7**	**455.1**
2Y – Quarterly	100.0	-	41.3	7.2
3Y – Quarterly	120.0	-	222.6	160.7
5Y – Quarterly	120.0	-	107.6	90.5
10Y – Quarterly	120.0	-	109.1	98.5
3Y – Semi Annual	170.0	-	85.6	64.2
5Y – Semi Annual	160.0	-	27.0	18.0
10Y – Semi Annual	140.0	-	29.5	16.0
GIS – VRR	**105.0**	**-**	**300.3**	**201.2**
GIS - FRR	**45.0**	**-**	**18.5**	**-**
Total	**4,220.0**	**3,493.9**	**5,852.7**	**3,948.1**

*competitive bids only

Source: State Bank of Pakistan

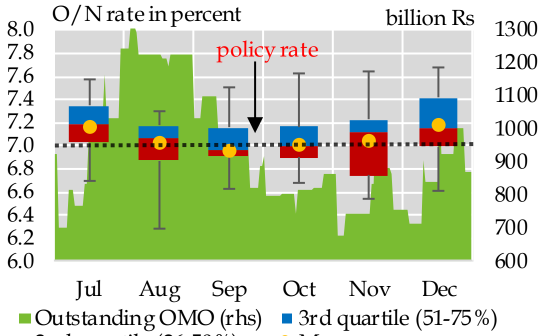
semi-annual PFLs. In contrast, the market's interest for another new addition of 2-year quarterly coupon PFL with fortnightly coupon reset remained dull. This was despite the fact that this instrument offers the lowest interest rate risk exposure as compared to other securities. Anecdotal evidence suggests that the relatively new structure of this bond is leading to lower participation. Going forward, once the back-end systems of market participants are upgraded, this may potentially become a useful asset for financial institutions to match their short-term liabilities.

Likewise, the government also continued to raise financing via Shariah-compliant instruments. The market also remained keen on investing in variable rental Sukuks by making cumulative offers nearly three-times the amount of the auction targets. In contrast, the participation remained muted in the fixed rental Sukuk. Moreover, the government also did not issue the fixed rental instruments, keeping in view the demand for higher cut-offs from the market with low bid volumes. Instead, higher issuances amounting to Rs 201.2 billion were made for variable rental Sukuks, as compared to the target of Rs 105.0 billion during Q2-FY21.

Interbank Liquidity

The interbank liquidity conditions required lower SBP support during H1-FY21 as compared to the same period last year. On QoQ basis, liquidity conditions eased up further in Q2-FY21 (**Figure 3.7**). The average OMO size fell to Rs 822.8 billion from Rs 1,048.3 billion in the preceding quarter and Rs 912.8 billion in the corresponding period last year. Deposit mobilization played a key role in stabilizing the liquidity pressures. Besides this, the SBP's FX management, together with retirements made by Public Sector Enterprises (PSEs) and government procurement agencies, also provided additional liquidity support to the system.

Interbank Liquidity Indicators **Figure 3.7**



* the box and whisker plots daily movements in the overnight rates (excluding outliers).

Source: State Bank of Pakistan

The liquidity conditions initially improved during the first two months of the quarter, while pressures reemerged towards the end of the quarter. During October 2020, the government's borrowing needs from the commercial banks were lower, whereas pressures from the private credit offtake were also minimal. Moreover, the weekly deposit mobilization inflows and the SBP's FX management provided additional liquidity support. Consequently, the outstanding OMO injections decreased. In addition, higher activity on the corridor's floor compared to the ceiling also indicates comfortable liquidity conditions in the interbank market. Meanwhile, the average absolute deviation of overnight rates during October remained the lowest at 25 bps, relative to the other two months in Q2-FY21.

In November 2020, the OMO injections reduced further to an average level of Rs 787.8 billion. The commercial banks utilized the SBP's repo facility on five occasions, compared to only one instance when banks had borrowed using the SBP's reverse repo facility. Meanwhile, the absolute deviation of overnight rates from the policy rate increased to 28 bps - up by 3 bps compared to October.

In contrast, during December 2020, the overnight rates were at a higher level, with liquidity pressures emanating from continued government borrowings from banks and an acceleration in the private credit offtake. For 18 days intermittingly, the overnight rates remained higher than the policy rate, with an absolute average deviation of 26 bps during the month. As a result, the SBP scaled up the OMO injections to Rs 860.4 billion.

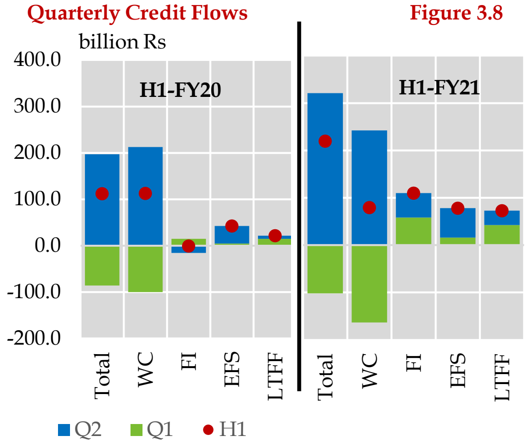
3.3 Credit to Private Sector

With a sharp increase in credit offtake during Q2-FY21, loans to private businesses almost doubled in the first half of FY21 on YoY basis. The higher offtake in Q2-FY21 more than offset the net loan retirements in the first quarter **(Figure 3.8).**

The rise in overall credit was primarily driven by working capital loans, particularly in Q2-FY21. This may be attributed to: (i) the pickup in industrial production as the year progressed; (ii) increased export-related activity in textiles and non-basmati rice; and (iii) utilization of the SBP's refinance facilities. Notably, around a quarter of the increase in the working capital loans during Q2-FY21 was contributed by the Export Finance Scheme (EFS).[5]

While the aforementioned favorable conditions prevailed during Q1-FY21 as well, credit did not pick-up during the quarter. This may be explained by the availability of surplus carry-over stocks, which had suppressed firms' working capital needs in the quarter.[6] In Q2, the uptick in working capital mainly owes to the seasonal demand in rice and sugar sectors, and inventory depletion in Q1 in some sectors such as textile, steel and footwear, which necessitated restocking activity and therefore increased the firms' credit needs.

Quarterly Credit Flows **Figure 3.8**



WC: Working Capital Loans; FI: Fixed Investment Loans; EFS: Export Finance Scheme; LTFF: Long Term Financing Facility
Source: State Bank of Pakistan

[5] Out of Rs 62.3 billion EFS loans in Q2-FY21, textile and rice processing sectors availed Rs 25.8 billion and Rs 19.7 billion, respectively.
[6] For details, see Chapter 3 in the SBP's First Quarterly Report for FY21 on the State of Pakistan's Economy.

Loans to Private Sector Businesses (H1) **Table 3.3**

(flow in billion Rupees)

	Total Loans*		Working Capital**		Fixed Investment	
	FY20	FY21	FY20	FY21	FY20	FY21
Private Sector Businesses	**111.9**	**219.5**	**112.8**	**79.4**	**-0.8**	**110.0**
o/w: EFS	42.5	78.2	42.5	78.2	-	-
LTFF (incl. TERF)	21.6	72.9	-	-	21.6	72.9
Manufacturing	122.7	83.7	107.5	14.9	15.1	67.6
Rice processing	26.6	57.2	26.1	55.8	0.6	1.3
Fertilizers	-0.1	23.3	-0.7	24.5	0.6	3.2
Refined petroleum	-14.2	18.4	-14.3	17.7	0.1	1.3
Textile	112.4	35.4	96.1	11.1	16.3	23.8
Basic iron and steel	10.4	15.3	3.0	9.5	7.4	5.8
Cement, lime and plaster	10.2	-0.6	12.8	-4.1	-2.6	3.5
Paper & paper products	-6.5	-3.4	-4.5	-5.5	-2.0	3.7
Vegetable and animal oils and fats	-10.3	-10.3	-10.7	-13.0	0.4	2.7
Motor vehicles	38.4	-17.4	36.2	-19.6	2.2	2.2
Sugar	-45.6	-46.0	-41.5	-54.0	-4.1	8.1
Power gen., trans., and dist.	21.6	40.4	23.8	-4.7	-2.2	45.2
Wholesale and retail trade	-38.8	25.2	-28.1	19.0	-10.7	5.8
Mining and quarrying	1.2	-3.4	-2.3	-7.3	3.4	3.9
Transportation and storage	17.2	0.2	21.9	-0.3	-4.7	0.5
Agriculture, forestry and fishing	4.8	11.5	5.2	13.7	-0.4	-2.2
Telecommunications	13.1	5.1	-2.9	10.0	15.9	-4.9
Real estate activities	5.2	-3.6	5.1	-1.5	0.0	-6.0
Construction	-26.1	13.4	-19.2	3.5	-6.9	-9.7

*Total loans in H1-FY21 include Rs 30.0 billion in construction financing after the revision in data on credit/loans from June 2020 onwards due to the inter-sectoral adjustment in private sector business. See IH&SMEFD Circular Letter No. 28 of 2020 for details. **Working capital includes trade financing

Source: State Bank of Pakistan

Fixed investment loans, on the other hand, increased by Rs 115.0 billion in H1-FY21, compared to a net retirement of Rs 0.8 billion in the corresponding period last year. Benefitting from the SBP's concessionary financing schemes, the power and textile sectors mainly borrowed long-term loans of Rs 45.2 billion and Rs 23.8 billion, respectively, during the period under review.

Working Capital Loans

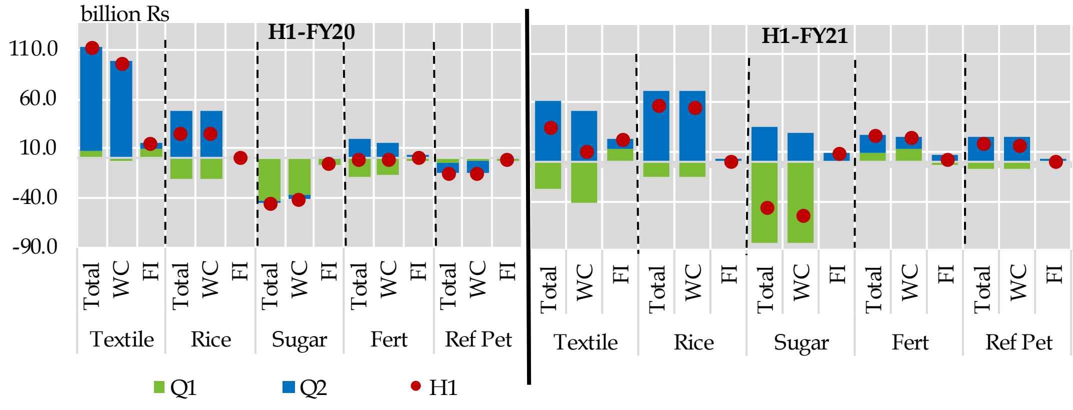
The increase in working capital loans during Q2-FY21 more than offset the net retirements in the preceding quarter.

Cumulatively, working capital loans rose by Rs 79.4 billion in H1-FY21, lower than an increase of Rs 112.8 billion in H1-FY20 **(Table 3.3).**

The higher demand for short-term loans during Q2-FY21 is explained by the broad-based growth in the LSM, seasonal credit offtake by rice processing and sugar businesses, and increased export-related activity in textile and non-basmati rice. The export-oriented sectors borrowed primarily from the SBP's concessionary Export Finance Scheme (EFS).

Rice and sugar businesses usually retire their short-term loans during the first

Loan Offtake by Major Sectors **Figure 3.9**



Source: State Bank of Pakistan

quarter and borrow in the second quarter, mainly to procure the raw material, as rice and sugarcane (being *Kharif* crops) are usually harvested during the second quarter of the fiscal year. In Q2-FY21, rice processing firms benefitted from the subsidized export refinance scheme and scaled up their exports, as reflected by an increase in exports of non-basmati rice during the quarter – both in terms of quantum and value (see **Chapter 5** for details).

Likewise, the sugar sector's short-term borrowings rose in Q2-FY21 after posting seasonal retirements in Q1. The increase in offtake during Q2 was consistent with the growth in sugar production, along with higher domestic prices. However, net retirements in Q1 overshadowed the borrowings in Q2 (**Figure 3.9**). Therefore, on a cumulative basis, the sector posted a net retirement of Rs 54.0 billion in H1-FY21, compared to a lower net retirement of Rs 41.5 billion last year.

In addition to the seasonal demand factor, inventory depletion in a few sectors in Q1 had increased the need for working capital loans in the subsequent quarter. After rising until June 2020, the inventory levels of a few sectors (such as textiles, steel, apparel, footwear and accessories design) declined in Q1-FY21.[7]

Meanwhile, the textile sector also benefitted from the EFS and borrowed short-term loans to scale up its exports (**Chapter 5**). Around half of the increase in working capital loans of the textile sector during Q2-FY21 came from the EFS.

In case of fertilizer, the revival in production raised the sector's short-term borrowings to Rs 24.5 billion in H1-FY21, compared to a marginal net retirement of Rs 0.7 billion last year.[8] The increase was more pronounced in Q1, when a 23.8 percent YoY growth in fertilizer imports had raised the manufacturers' short-term borrowing needs. However, in Q2, a 45.3

[7] On QoQ basis, inventories of *textiles*, *steel*, and *apparel, footwear & accessories design* segments declined by 12.5 percent, 35.6 percent and 16.9 percent respectively during Q1-FY21 (source: Bloomberg).
[8] Fertilizer production rose by 8.4 percent in H1-FY21, against an increase of 4.9 percent in H1-FY20.

percent YoY decline in fertilizer imports suppressed the working capital needs of the sector.

Refined petroleum borrowed Rs 17.7 billion in H1-FY21, compared to a net retirement of Rs 14.3 billion in the same period last year. The entire increase in offtake was concentrated in Q2, as major oil marketing companies in the country continued to borrow short-term loans mainly to meet the rising fuel demand amid accelerating economic activities in the country. This is in line with the 11.5 percent YoY growth in POL sales during Q2. On the other hand, wholesale and retail trade borrowed Rs 19.0 billion in H1-FY21, compared to a net retirement of Rs 28.1 billion last year. The increase was mainly concentrated in Q1, as sales of fuels inched up with the revival of economic activities in the country following the ease in lockdown restrictions.[9]

Fixed Investment Loans

The borrowings under fixed investment loans were Rs 110.0 billion in H1-FY21, compared to a net retirement of Rs 0.8 billion last year. The private sector took advantage of the LTFF and TERF schemes. In particular, disbursements under TERF were quite substantial during the second quarter, increasing to Rs 26.1 billion from Rs 4.5 billion in Q1-FY21.

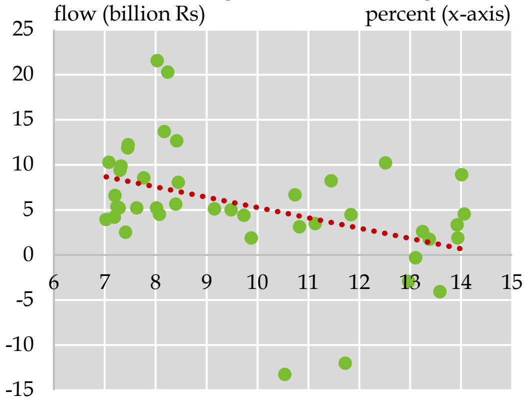
Within the manufacturing sector, textile businesses borrowed Rs 23.8 billion during H1-FY21, compared to an offtake of Rs 16.3 billion last year. By utilizing the concessional financing schemes, the textile sector borrowed long-term loans mainly to import textile machinery. This behavior was also consistent with the YoY growth in the import of textile machinery, particularly in Q2-FY21.[10]

Among non-manufacturing entities, power generation, transmission and distribution was the only major sector that availed higher fixed investment loans. Power firms mainly borrowed fixed investment loans for capacity expansion and to import power generating machinery.[11]

Consumer Financing

Consumer financing reported a cumulative flow of Rs 84.7 billion in H1-FY21 as compared to Rs 14.0 billion in the same period last year. The uptick in Q1-

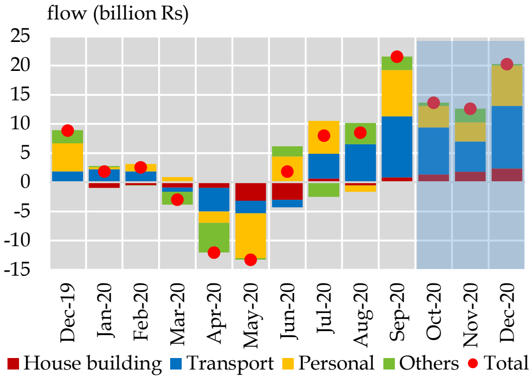
Consumer Financing & WALR* **Figure 3.10**



* July 2017 - December 2020
Source: State Bank of Pakistan

[9] For details, see Chapter 3 in the SBP's First Quarterly Report for FY21 on the State of Pakistan's Economy.
[10] According to PBS, the import of textile machinery rose by 33.1 percent in Q2-FY21 compared to a decline of 13.1 percent in Q2-FY20.
[11] Power generation machinery imports rose by 31.8 percent in H1-FY21, compared to an increase of 19.1 percent in H1-FY20, as per PBS data.

Consumer Financing **Figure 3.11**



Source: State Bank of Pakistan

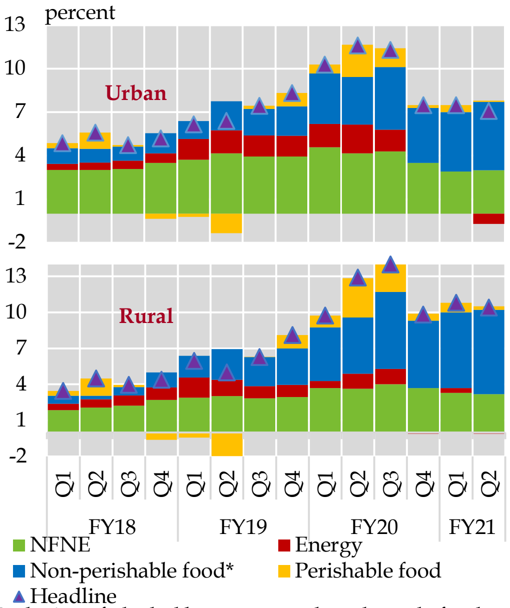
FY21 further gained momentum in the second quarter, when credit to consumers grew by Rs 46.6 billion, as compared to Rs 16.7 billion in Q2-FY20. The improvement is mainly attributed to auto and personal loans, as consumers took advantage of lower bank lending rates in H1-FY21 (**Figure 3.10**).

Also, there was a noticeable improvement in house building loans during the second quarter of this fiscal year (**Figure 3.11**). This is likely due to the mandatory targets set by the SBP for banks to increase their housing and construction loans to 5 percent of their overall private sector credit portfolio by December 31, 2021.

3.4 Inflation

The inflationary pressures continued to ease throughout the first half of FY21. In particular, national CPI inflation stood at 8.4 percent in Q2-FY21, compared to 8.8 percent in Q1-FY21 and 12.1 percent in Q2-FY20. The non-food non-energy (NFNE) inflation remained stable on account of spare capacity in the economy, and benign cost-push factors. Food inflation, however, remained high in both quarters

Composition of YoY CPI Inflation **Figure 3.12**

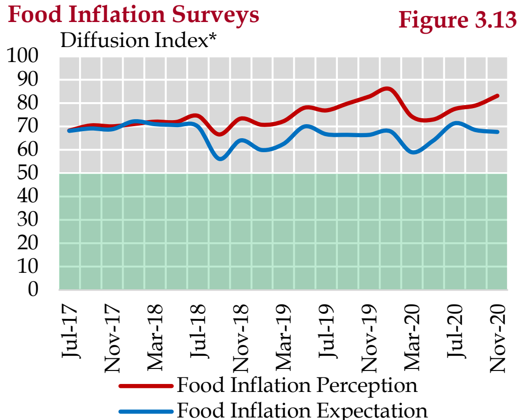


*Inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

of FY21 compared to the preceding quarter due to non-perishable food items, whereas inflation in perishable food group eased (**Figure 3.12**). Stable prices of administered energy items during the quarter, on the other hand, slowed down the overall pace of inflation on a YoY basis,

Food Inflation Surveys **Figure 3.13**



*DI > 50:Positive views > Negative views

Source: State Bank of Pakistan

Average CPI Inflation and Contribution **Table 3.4**

Items	Urban						Rural					
	Wt.*	H1		Q2			Wgt.*	H1		Q2		
		FY20	FY21	FY20	FY21	Cont.*		FY20	FY21	FY20	FY21	Cont.*
Headline		11.0	7.3	11.6	7.1			11.3	10.6	12.9	10.4	
Food & non-alcoh. bev.	30.4	14.8	14.0	17.4	13.9	4.2	40.9	15.5	16.2	18.7	16.2	6.7
Wheat	0.6	12.5	37.7	15.3	37.1	0.2	3.5	13.3	38.7	17.2	38.5	1.2
Wheat flour	3.0	12.2	18.8	14.5	17.0	0.5	3.4	14.1	23.1	16.8	21.5	0.7
Chicken	1.4	12.2	12.5	-11.6	43.0	0.5	1.5	8.9	14.8	-9.2	39.0	0.5
Eggs	0.5	-2.4	45.2	-0.8	52.3	0.3	0.6	-3.3	44.7	-2.1	52.9	0.3
Non-perishable food	26.0	11.3	15.2	10.9	16.1	4.0	35.1	11.1	17.2	11.5	18.4	6.2
Perishable food items	4.5	34.9	8.1	57.6	4.3	0.2	5.8	40.1	10.2	62.9	6.4	0.5
Sugar	1.1	33.1	25.8	32.0	28.2	0.3	2.0	34.2	26.1	32.7	29.7	0.5
Condiments & spices	1.3	19.4	40.2	18.3	40.6	0.6	1.5	14.4	53.8	15.9	52.3	0.8
Alcoholic Bev., Tob.	0.9	22.6	5.9	17.3	6.5	0.1	1.3	25.9	5.6	21.2	5.4	0.1
Clothing and ft.wear	8.0	8.9	8.5	9.2	8.6	0.7	9.5	9.1	10.5	9.8	10.2	1.0
Housing, Elec., Gas	27.0	8.7	3.6	9.1	2.5	0.7	18.5	4.5	5.3	6.1	4.0	0.7
Furn' & HH equip.	4.1	11.8	6.3	11.3	6.4	0.3	4.1	10.1	9.9	10.2	9.9	0.4
Health	2.3	11.2	6.9	10.9	7.3	0.2	3.5	12.1	8.8	12.3	8.4	0.3
Transport	6.1	17.2	-3.3	16.0	-3.2	-0.2	5.6	14.9	-2.7	13.3	-2.6	-0.2
Communication	2.4	5.4	0.4	5.2	0.5	0.0	2.0	1.9	0.3	1.8	0.4	0.0
Recreation and culture	1.7	6.9	3.0	6.5	3.1	0.0	1.4	7.9	5.7	7.9	6.1	0.1
Education	4.9	6.6	1.0	6.3	1.1	0.1	2.1	5.2	1.6	5.2	2.1	0.0
Restaurants and hotels	7.4	5.1	8.5	5.0	9.4	0.7	6.2	7.9	8.8	8.3	9.3	0.6
Misc. goods & services	4.8	11.6	10.7	11.0	10.3	0.5	5.0	12.7	14.3	12.6	14.1	0.7
NFNE	53.7	8.0	5.5	7.6	5.6	3.0	42.6	8.4	7.7	8.4	7.6	3.2

*wgt. = weight and Cont.= Contribution for Q2
Source: Pakistan Bureau of Statistics

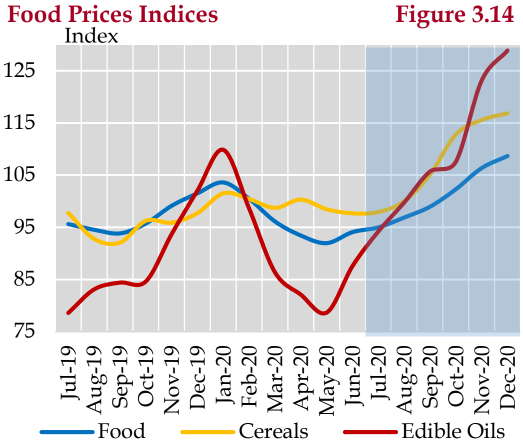
whereas other components of inflation remained almost unchanged during the second quarter. This trend suggests that inflation during this period was an outcome of supply-side issues as well as rising global food prices.

Nonetheless, with a considerably high share in the consumption basket, rising food prices kept the index of households' perception of food prices (which represents how they view current food prices compared to the previous 6 months) highly elevated as compared to previous waves. This represents elevated prices of mostly non-perishable items, whereas the index of households' expectation of food prices (which represents how they view food prices in the next six months compared to today) have remained broadly stable, as prices of wheat and sugar started to stabilize from November 2020 onwards (**Figure 3.13**).

Food continued to remain the major source of inflation

With around 37 percent weight in the urban CPI basket and 46 percent weight in the rural CPI basket, the increase in food prices, largely of non-perishable food items, in H1-FY21 remained a major challenge (**Table 3.4**). Among the non-perishable food items, particularly in Q2-FY21, the main pressure came from the

Food Prices Indices **Figure 3.14**



Source: FAO

poultry group (chicken and eggs), followed by the staple group (wheat and wheat flour and edible oil). Trends in agriculture and poultry production, supply-side issues and higher global food prices mainly led to higher prices in domestic markets (**Figure 3.14**).

The poultry index (both for urban and rural areas) rose by more than 40 percent during Q2-FY21 compared to declines recorded in the same period last year (**Figure 3.15**). In addition to a low base effect,[12] multiple factors contributed to this rise. For instance, demand for chicken rose significantly post-lockdowns, after the government allowed marriage halls and restaurants to reopen. Meanwhile, additional demand from the wedding season also emerged. On the other side, supply dipped, as many producers who had suffered lockdown-related losses over the previous few months did not replenish their sheds.[13] In addition to losses, uncertainty related to the second wave of Covid-19 also prevailed. While consumers were struggling with supply- and demand-related price pressures, poultry feed prices also surged, following the trend of international prices. As per industrial experts, poultry feed is around 70 to 75 percent of the total input cost of producing chicken and egg, while

Heat-map of Non-perishable Food Items (YoY Inflation) **Figure 3.15**

	Wt.	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20
Wheat-U	0.6	21.7	36.1	30.0	19.3	16.8	11.7	22.1	28.5	44.3	42.1	52.2	36.6	24.2
Wheat-R	3.5	22.2	32.2	33.7	24.3	21.9	13.9	20.7	30.4	41.1	45.1	51.1	37.9	28.1
Wheat flour -U	3.0	15.8	24.1	17.4	13.5	14.8	13.0	24.5	18.5	23.4	20.2	24.7	13.3	13.4
Wheat flour -R	3.4	18.3	25.2	20.7	18.0	18.1	14.9	23.2	21.6	26.2	26.7	29.4	19.6	15.8
Edible Oil-U	2.2	16.5	16.4	30.0	29.7	24.2	23.0	22.4	19.7	13.8	13.4	13.5	12.4	13.8
Edible Oil-R	3.0	19.1	26.0	32.1	32.1	28.9	27.7	26.2	21.9	18.8	16.6	16.6	17.1	17.8
Chicken -U	1.4	-17.2	22.6	14.5	4.2	-28.8	4.9	18.5	36.7	-38.3	-23.6	18.2	46.8	67.4
Chicken -R	1.5	-19.0	18.5	21.3	-2.4	-28.5	4.9	13.7	35.7	-27.0	-19.4	15.6	41.0	63.2
Eggs -U	0.5	2.0	18.1	-10.3	-0.1	44.2	19.6	44.9	43.1	28.6	38.6	43.3	48.7	64.4
Eggs -R	0.6	-1.3	12.7	-5.3	-3.1	29.3	17.5	28.0	41.1	30.4	33.2	43.7	49.3	65.3

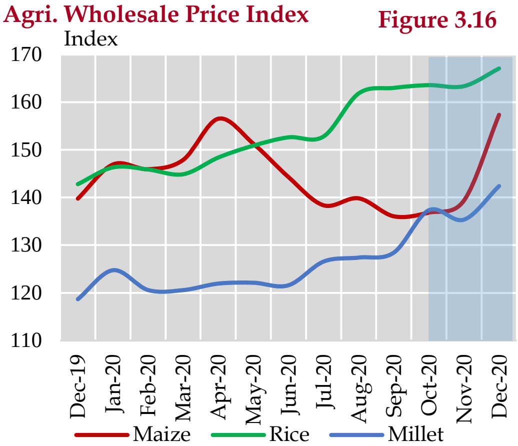
*Lighter shades depict lower and negative inflation and darker shades indicate higher inflation on YoY basis

Source: Pakistan Bureau of Statistics

[12] Prices had declined in Q2-FY20 amid supply correction after witnessing significant increase in Q1-FY20 due to suspension in production by some poultry farmers on account of rising input prices.
[13] Chicken prices had crashed significantly following the imposition of strict lockdowns in March 2020.

imported ingredients cost about 50-55 percent of the poultry feed.[14] Prices of most of the feed items increased in the Q2-FY21 (**Figure 3.16**).

Agri. Wholesale Price Index **Figure 3.16**



Source: Pakistan Bureau of Statistics

Wheat prices rose by more than 37 percent during Q2-FY21 both for the urban and the rural segments, whereas rural wheat flour inflation outpaced urban wheat flour inflation during the period under review. While analyzing the wheat flour index, the composition of the basket was identified as one of the reasons behind the inflation differential during the period,[15] in addition to the difference in weight of baskets and the impact of transportation cost on account of distance from point of retail markets/production to end-consumers (for details, see the SBP's Second Quarterly Report for FY20).

The quarter started with the elevated level of wheat prices, on account of the wheat crisis that had originated in the preceding months due to a shortfall in production as compared to the target as well as the constrained stock position with the public sector procurement agencies.[16] However, prices started to decline from November 2020 onwards as imported wheat landed at the ports, supplementing the domestic reserves as well as filling the current demand gap.[17] Wheat imports by the public sector (via Trading Corporation of Pakistan) and private sector, along with the government's efforts to timely release the wheat in the provinces by the procurement agencies to ensure steady supply, and provisioning of the commodity via utility stores and fair shops, all managed to assuage price pressures.

Similarly, despite sugar being a major contributor to the overall food inflation,

[14] Maize, soybean meal, rice tips, canola meal, sunflower meal and wheat bran are mostly used as poultry feed.

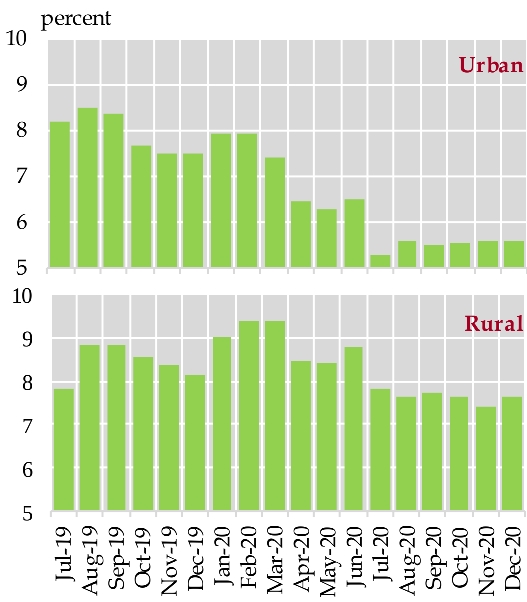
[15] The wheat flour index for urban areas comprises w*heat flour (fine/superior quality), wheat flour (average quality)* and *wheat flour bag.* The index for rural areas consists of *wheat flour (average quality)* and *wheat flour bag*. There were minor differences in inflation in the common commodities, i.e. *wheat flour (average quality)* and *wheat flour bag* in the urban and rural segments; however, inflation in *wheat flour (fine/superior quality)* in the urban basket was different. For some other food items as well, rural inflation was running much higher than urban inflation and differences in the consumption basket have been identified as one of the reasons behind the stark disparity.

[16] For details, see Chapter 3 in the SBP's First Quarterly Report for FY21 on the State of Pakistan's Economy.

[17] Around 0.9 million MT of wheat was imported by the end of October 2020, whereas around 2.1 million MT was imported during Q2-FY21. This import was made against the initial estimates of shortfall of 1.6 million MT for consumption requirement during FY21.

the commodity's price softened from November 2020 onwards, after the import of around 250,000 MT of sugar during Q2-FY21. Meanwhile, edible oil also contributed significantly to the food inflation, following the rising trend in international prices. Palm oil and soybean prices have been on a steep rising trajectory since June 2020, amid sharp contractions in global inventory levels due to weather-related concerns in the major producing areas.

NFNE - YoY Growth **Figure 3.17**



Source: Pakistan Bureau of Statistics

NFNE inflation continued to remain soft and stable

The inflationary pressures in the non-food-non-energy (NFNE) group, a measure to capture the underlying inflationary pressures, moderated in the first half of the year. In particular, NFNE remained stable in Q2-FY21 as compared to Q1, whereas it slowed down as compared to the same quarter last year for urban and rural areas (**Figure 3.17**). Almost half of the indices within urban NFNE registered lower inflation in Q2-FY21 as compared to the same period last year. This signifies that alleviation in cost-push pressures on account of muted fuel prices and tax relief measures announced for the construction industry in the Budget 2020-21 have proved largely effective. Moreover, the presence of spare capacity in the economy and orderly exchange rate conditions also helped pacify the underlying inflationary pressures.

Within the urban NFNE, both the services and goods indices decelerated in Q2-FY21; however, the impact of the latter was more pronounced. Motor vehicles, construction inputs,[18] text books, newspapers and stationery mainly caused the decline in the overall goods index.

Within rural NFNE, both services and goods indices decelerated in Q2-FY21; however, the impact of the former was more pronounced. Marriage hall charges, motor vehicle tax (Covid-related relief in the budget by imposing no additional taxes) and education index (Covid-related concession by Sindh and Punjab

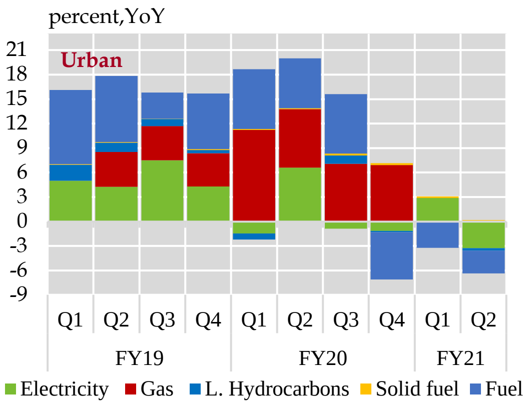
[18] The FED on Portland cement, aluminous cement, slag cement, super sulphate cement and similar hydraulic cements was reduced in the Budget 2020-21 from Rs 2/kg to Rs 1.75/kg in the wake of the Covid-19 outbreak.

governments in private sector fee) mainly slowed down the pace of inflation.[19]

Energy inflation continued to decline

Energy inflation remained subdued in H1-FY21, both for the urban and rural segments. Particularly in Q2, the urban energy index registered a 6.2 percent decline, whereas the rural index declined by 0.6 percent in the same period. Disaggregated analysis suggests that the largest impact on the urban energy index came from low domestic fuel prices, followed by electricity prices, on YoY basis (**Figure 3.18**).

Composition of Energy Inflation **Figure 3.18**



Source: Pakistan Bureau of Statistics

In case of motor fuels, prices remained almost stable, on average, during Q2-FY21 as compared to Q1-FY21. The MoM increase in fuel prices (0.2 percent and 0.7 percent in October 2020 and December 2020, respectively) was more than offset by the MoM dip of 1.8 percent in November 2020. However, deflation was registered on YoY basis in Q2-FY21. Soft international oil prices on YoY basis over the Covid-related sluggish global demand outlook and a stable domestic currency helped contain the inflationary impact in the motor fuel group.

In case of electricity prices, both the urban and rural areas posted slight increase during the quarter compared to previous quarter; however, 7.9 percent decline was observed on YoY basis in Q2-FY21. The rise in inflation during the quarter represented the impact of quarterly tariff as well as fuel cost adjustments to cover the cost of rising capacity payments and the sector's losses. It is important to recall here that these quarterly adjustments are part of the government's plan to address the issues pertaining to the accumulation of power sector arrears.

[19] For details, see Chapter 3 in the SBP's First Quarterly Report of FY21 on the State of Pakistan's Economy.