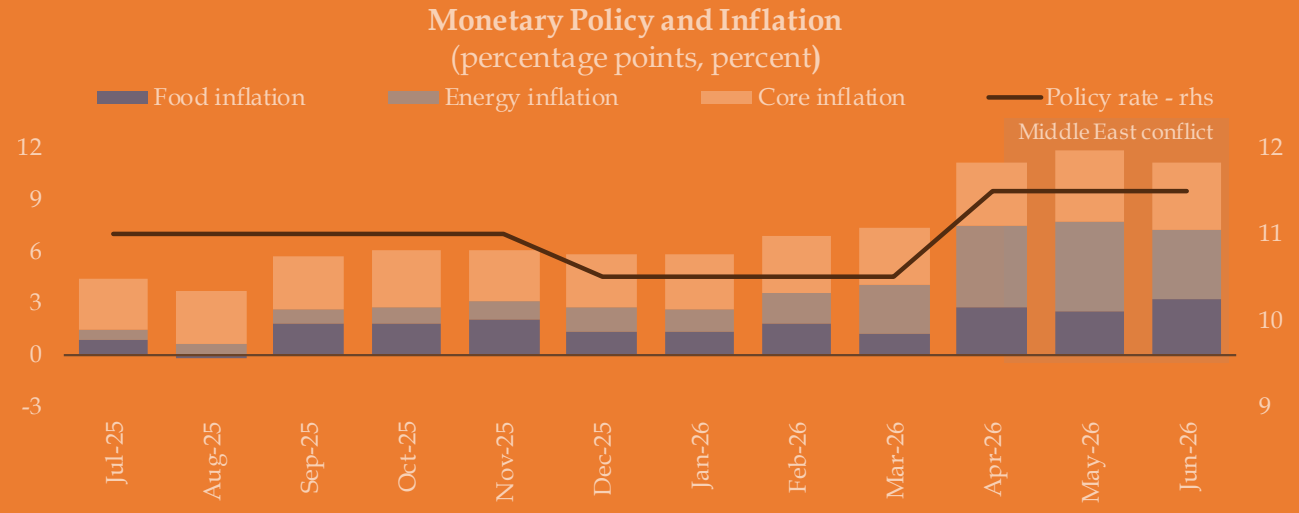


3

Monetary Policy and Inflation

The average NCPI inflation rose to 7.1 percent in FY26, compared with 4.5 percent in the previous year. Inflation remained relatively contained for most of the year, supported by coordinated monetary tightening and fiscal consolidation that kept domestic demand in check, benign global commodity prices, and favourable adjustments in electricity prices. Year-on-year inflation remained within the medium-term target range during Jul–Feb FY26. Inflationary pressures, however, intensified later in the year, as the outbreak of the Middle East conflict triggered a surge in global oil prices, pushing inflation into double digits from April 2026 onward. At the same time, the inflation outlook became more uncertain amid risks from unanticipated adjustments in energy prices, domestic floods, volatility in global commodity prices, and uncertainty surrounding global trade tariffs. In response, the MPC maintained a prudently cautious approach throughout FY26. Meanwhile, in line with the easing domestic financial conditions, reflecting the transmission of reduction in policy rate in the previous year, and a gradual recovery in economic activity, private sector credit growth also increased. Additionally, higher government's budgetary borrowing from scheduled banks, and expansion in credit to PSEs, underpinned increase in net domestic assets of the banking system. This, together with continued increase in net foreign assets of SBP led to higher growth in money supply in FY26.



3 Monetary Policy and Inflation

3.1 Policy Review

The monetary policy committee (MPC) continued with a prudently cautious stance amid uncertainty surrounding the inflation outlook. The MPC reduced the policy rate by 50 basis points (bps) in December 2025 as inflation was assessed to remain within the target range owing to benign global commodity prices and anchored inflation expectations. Subsequently, the MPC kept the policy rate unchanged in January and March 2026, before raising it by 100 bps to 11.5 percent in April 2026 as the Middle East conflict clouded the inflation outlook. This measured approach throughout the year kept the average national CPI (NCPI) inflation around the upper bound of the medium-term target range of 5.0 – 7.0 percent, i.e. at 7.1 percent, during FY26, despite global oil price shock and supply chain disruptions.

At the start of FY26, the MPC expected year-on-year inflation to remain mostly within the target range, with temporary deviations in a few months towards end of the fiscal year. This assessment was based on an adequately positive real policy rate, continued fiscal consolidation, improved external account position supporting exchange rate stability, and a generally favourable global commodity price outlook. However, this outlook was subject to risks emanating from higher-than-anticipated adjustments in the administered energy prices, possible flood-related supply disruptions, frictions in wheat market, volatile global commodity prices and the uncertainty surrounding global trade policies.

The MPC also initially projected real GDP growth in the range of 3.25 - 4.25 percent for FY26. The combined impact of earlier monetary easing, improving business sentiments and anticipated recovery in agriculture were expected to support the momentum in growth. While the expansion in economic activity was likely to result in a concomitant increase in imports, slower global growth was expected to weigh on exports outlook. Nonetheless, workers' remittances were projected to remain strong and help contain the current account deficit in the range of 0 - 1.0 percent of GDP in FY26.

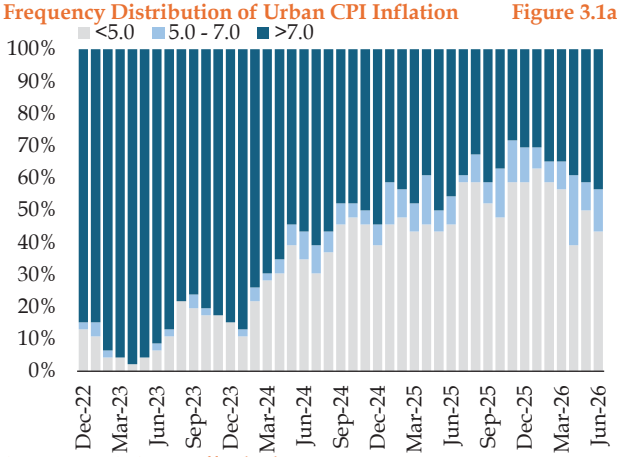
Although inflation remained below the lower bound of the medium-term target range during June-August 2025, the committee assessed that the near-term inflation outlook was clouded by elevated uncertainty stemming from both domestic and global factors. Expected adjustments in gas and electricity tariffs also posed upside risks to energy inflation. The floods during Aug-Sep FY26 further added to uncertainty, although their impact remained limited compared to the 2022 floods.

Moreover, rising sales of automobiles, cement, fertilizers and POL, alongside a broad-based private sector credit (PSC) growth pointed to stronger economic activity. Lower borrowing costs and reduced government's recourse to bank financing supported credit expansion. Moreover, large scale manufacturing (LSM) production showed a notable increase in Jul-Aug FY26, against a contraction in the same period last year.

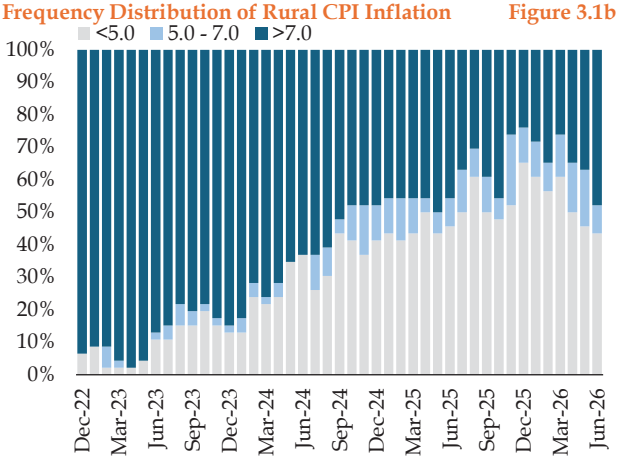
By October 2025, the growth outlook had further improved. However, persistent core inflation, uncertainty around food and global commodity prices, and the unfolding impact of the earlier policy-rate reductions warranted continued caution. Accordingly, the MPC kept the policy rate unchanged at 11.0 percent in its July, September and October 2025 meetings.

By December 2025, the balance of risks had improved, as inflation remained within the target range and its outlook improved, global commodity prices softened, and economic activity strengthened without creating excessive inflationary and current account pressures. Foreign exchange reserves also increased despite sizeable external debt repayments. These developments, particularly the improved inflation

Frequency Distribution of Urban CPI Inflation **Figure 3.1a**



Frequency Distribution of Rural CPI Inflation **Figure 3.1b**



Sources: PBS; SBP staff calculations

outlook, provided room for a measured 50 bps reduction in the policy rate to 10.5 percent, while maintaining an adequately positive real policy rate. The MPC subsequently maintained the policy rate in January 2026 amid persistent core inflation and stronger-than-anticipated economic activity leading to upward revision in FY26 growth projection by 0.5 percentage points to 3.75 - 4.75 percent. Meanwhile, SBP reversed the average Cash Reserve Requirement (CRR) for banks from 6 percent to 5 percent in line with improvement in economic fundamentals.[1]

However, outbreak of the Middle East conflict in late February 2026 posed significant upside risks to inflation outlook. Global fuel prices and freight and insurance costs rose sharply, while trade and transport routes were also disrupted. Given heightened uncertainty over the duration and intensity of the conflict, and increased risks to inflation, growth and the external account, the MPC maintained the policy rate at 10.5 percent in March 2026.

As the conflict prolonged, its inflationary impact became larger and more widespread. Global energy prices rose considerably above the pre-conflict levels, and the government also passed the increase to domestic consumers. As a result, NCPI inflation saw a broad-based increase reaching double digits by April 2026. Core inflation also increased, and inflation expectations and confidence of consumers and businesses deteriorated.

The breadth of inflation was particularly indicated by increase in prices of a large number of CPI items, which exceeded the upper bound of the medium-term target range in the last quarter of FY26 (**Figure 3.1**). The MPC assessed the year-on-year inflation to remain in double digits and exceed the upper bound of the target range for most of FY27. The committee therefore increased the policy rate by 100 bps to 11.5 percent in April 2026 to limit the potential second-round effects of the oil price shock and keep the inflation expectations anchored (**Box 3.1 & 3.2**).

The MPC also underscored the urgent need for comprehensive structural reforms to reduce external sector vulnerability to global supply shocks. The committee reiterated that combining steady fiscal consolidation with structural reforms is imperative to insulate the domestic economy from supply-side disruptions and prevent the entrenchment of second-round effects of the supply shocks.

3.2 Monetary Aggregates

Amidst ease in financial conditions, the broad money (M2) growth edged up to 14.7 percent in FY26 from 12.9 percent in FY25. This increase was

[1] In November 2021, SBP increased the average CRR from 5 percent to 6 percent and daily minimum requirement from 3 percent to 4 percent, to contain domestic demand.

Monetary Aggregates - FY26 **Table 3.1**

billion Rupees, growth in percent

	Stocks end-period		Change in stock		Growth (YoY)	
	FY25	FY26	FY25	FY26	FY25	FY26
Broad money (M2)	40,506.3	46,460.1	4,624.5	5,953.8	12.9	14.7
NFA	464.9	2,138.5	1,602.8	1,673.7	-140.8	360.0
NDA	40,041.5	44,321.6	3,021.7	4,280.1	8.2	10.7
Budgetary borrowing	34,078.3	36,325.6	4,354.4	2,247.2	14.6	6.6
SBP	3,836.2	590.7	-691.5	-3,245.5	-15.3	-84.6
Scheduled banks	30,242.2	35,734.8	5,045.9	5,492.7	20.0	18.2
Commodity operations	1,066.5	1,008.6	-311.8	-58.0	-22.6	-5.4
Credit to private sector	9,948.7	11,412.0	1,081.9	1,463.3	12.2	14.7
Credit to PSEs	2,104.4	2,338.7	-87.1	234.3	-4.0	11.1
Other items net	-8,089.5	-7,419.9	-2,487.0	669.6	44.4	-8.3
Currency in circulation	10,634.5	11,941.5	1,481.4	1,307.0	16.2	12.3
Deposits	34,590.5	39,810.0	4,408.8	5,219.5	14.6	15.6
Reserve money	12,970.6	14,474.6	1,357.8	1,503.9	11.7	11.6

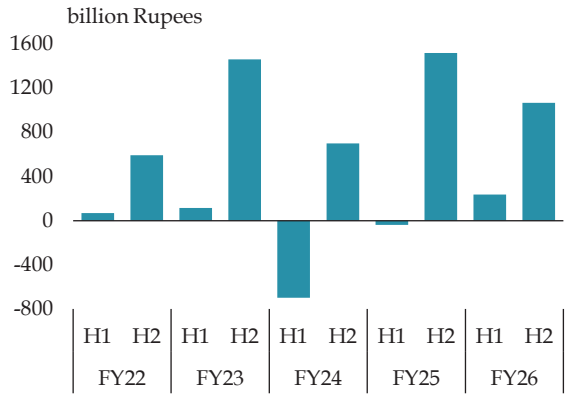
Source: SBP

largely contributed by expansion in Net Domestic Assets (NDA), while Net Foreign Assets (NFA) of the banking system also increased (**Table 3.1**). Sizeable budgetary borrowing, though lower compared to the previous year, together with increased credit to private sector and public sector enterprises (PSEs) underpinned the expansion in NDA. Moreover, build-up of foreign exchange reserves through significant FX purchases,[2] valuation gains on the SBP's gold holdings on account of surge in international gold prices, and repayment of foreign liabilities expanded NFA of the banking system.

On the liability side, currency in circulation (CiC) increased by Rs 1.3 trillion during FY26, lower than Rs 1.5 trillion expansion in FY25 (**Figure 3.2**). In terms of GDP, however, CiC remained almost unchanged around 9 percent. This moderation could be attributed to positive real interest rates. Despite this slight moderation during the full fiscal year, currency demand increased considerably in H2-FY26 amid Ramadan and Eid, higher remittance inflows[3] and improving economic activity. Heightened regional geopolitical uncertainty may also have contributed to higher precautionary cash holding in H2-FY26.

The bank deposits rose by Rs 5.2 trillion during FY26, compared to Rs 4.4 trillion increase recorded in FY25. By deposit type, the remunerative deposits made a slightly larger contribution than current deposits. Further, the pattern as well as underlying factors of the change in deposits also varied during the year. In H1-FY26, deposits increased by Rs 2.0 trillion, with

Currency in Circulation - Flows **Figure 3.2**



Source: SBP

[2] During FY26, SBP made net foreign exchange purchases of US$ 8.1 billion from the interbank FX market, compared to US$ 7.7 billion during FY25.

[3] Empirical literature identifies remittances as a major factor influencing currency in circulation in Pakistan, due to its positive impact on income and hence transaction demand for currency; Ejaz et al. (2019). The conundrum of rising demand for currency in Pakistan. SBP staff notes 1/20. SBP.

growth in remunerative deposits more than offsetting a slight decline in current deposits. In H2-FY26, deposits expanded by Rs 3.2 trillion (**Figure 3.3**), led mainly by current deposits. Following the seasonal trend, most of the increase was concentrated in Q4-FY26, particularly in June 2026.

Credit to Public Sector Enterprises

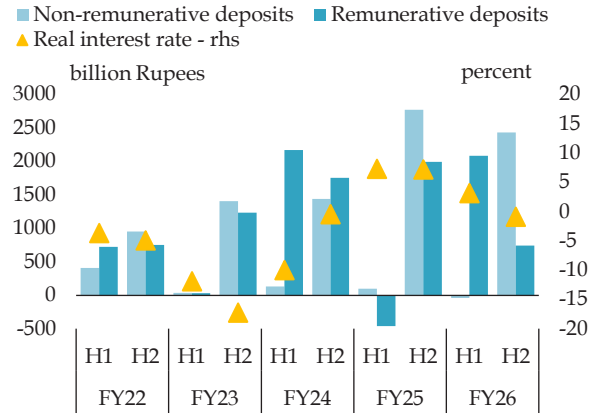
Credit to PSEs expanded by Rs 234.3 billion during FY26, after recording net retirements in the preceding two years (**Table 3.1**). The increase was largely concentrated in a few entities, including Central Power Purchasing Agency (CPPA), Pakistan State Oil (PSO), Pakistan National Shipping Corporation (PNSC) and Pakistan International Airlines Holding Company.

The rise in borrowing by the CPPA, under the government's arrangement with scheduled banks, was meant to clear accumulated payables in the power sector.[4] In addition, PSO relied on short-term borrowing to manage cash flows due to its large receivables.[5] Meanwhile, PNSC borrowed to finance purchase of new tankers,[6] and PIA Holding Company borrowed to meet finance costs on existing debt.[7]

Commodity Operations Financing

In line with the shift in government policy to encourage private sector to procure and manage wheat stock, commodity operations financing saw a net retirement for the third consecutive year in FY26. The Sindh government partly retired its outstanding debt after releasing wheat stocks during FY26.[8] Pakistan Agricultural Storage & Services Corporation (PASSCO) also reduced its outstanding commodity debt during the year, while Punjab government fully retired its debt

Bank Deposits - Flows **Figure 3.3**



Source: SBP

stock, in line with the shift toward market-based commodity operations.[9]

Budgetary Borrowing

Net government budgetary borrowing from the banking system almost halved to Rs 2.2 trillion in FY26 from Rs 4.4 trillion in FY25. Although the government increased its borrowing from scheduled banks, large retirements to the SBP partially offset this increase.

The government accelerated repayments of SBP debt to smooth its domestic debt maturity profile. A large portion of this debt was scheduled to mature in FY29.[10] By retiring part of the debt ahead of the maturity, the government reduced the prospective refinancing burden and distributed repayments more evenly. Further, to extend the maturity profile of domestic debt and benefit from the reduced interest rates, the government set the targets for Treasury Bills (T-bills) around the maturities, while setting higher targets for Pakistan Investment Bonds (PIBs) during FY26 (**Table 3.2**).

[4] Press release no. 264, available at: https://pid.gov.pk/site/press_detail/30458.
[5] PSO (2026). Un-audited condensed interim financial statements for the nine months. Pakistan State Oil Company.
[6] PNSC (2026). Consolidated condensed interim financial statements for the nine months. Pakistan National Shipping Corporation.
[7] PIAHCL (2026). Financial results for the third quarter. PIA Holding Company Limited.
[8] Source: https://cm.sindh.gov.pk/news/sn-abyna-palysy-oharyn-la-srynr-palysy-mlazmn-ky-rygyolr-r-maholyaty-thfth-yn-ahm-sarn-jy-mnthory-ey-y.
[9] GOPb (2025). Punjab Debt Bulletin, Government of Punjab.
[10] IMF (2025). Pakistan: Second Review Under the Extended Arrangement Under the Extended Fund Facility. International Monetary Fund.

Auction Summary - FY26 **Table 3.2**

billion Rupees, ratio

	Target	Acceptance	Acceptance (net of maturity)	Target-to-Maturity	Offer-to-Target	Acceptance-to-Maturity
			Treasury Bills			
Q1-FY26	2,975.0	3,549.2	515.5	0.9	3.2	1.2
Q2-FY26	5,250.0	5,776.2	321.3	0.9	2.4	1.1
Q3-FY26	3,900.0	4,832.7	875.1	0.9	2.6	1.2
Q4-FY26	7,400.0	8,494.7	1,389.6	1.0	3.1	1.2
Total	**19,475.0**	**22,652.9**	**3,101.6**	**1.0**	**2.8**	**1.2**
			Pakistan Investment Bonds			
Fixed Rate						
Q1-FY26	1,000.0	1,635.5	1,050.6	1.7	5.0	2.8
Q2-FY26	1,250.0	1,744.4	1,092.8	1.9	4.4	2.7
Q3-FY26	1,300.0	1,563.5	1,563.5	-	3.6	-
Q4-FY26	1,000.0	1,300.3	1,142.5	6.3	4.0	8.2
Total	**4,550**	**6,243.8**	**4,849.4**	**3.3**	**4.2**	**4.5**
Floating Rate						
Q1-FY26	1,850.0	1,556.7	674.2	2.1	4.7	1.8
Q2-FY26	-	-	-90.5	-	-	-
Q3-FY26	650.0	402.9	-114.9	1.3	12.9	0.8
Q4-FY26	-	-	-1,213.6	-	-	-
Total	**2,500**	**1,959.6**	**-744.7**	**0.9**	**6.8**	**0.7**

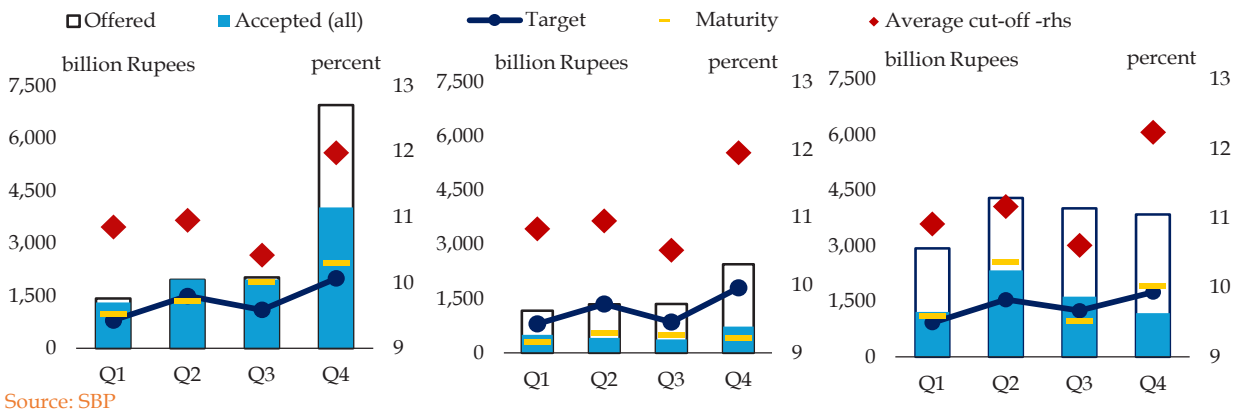
Note: Data shows face values of all securities. Acceptance includes both Competitive and Non-Competitive Bids (NCBs). For PIBs, acceptance also includes Short Sale.

Source: SBP

In T-bill auctions, investors' demand for 12-month bills was relatively higher. However, as geopolitical tensions and the associated uncertainty increased later in the year, market preferences shifted toward shorter-tenor bills, particularly 1-month and 3-month T-bills (**Figure 3.4 and 3.5**).

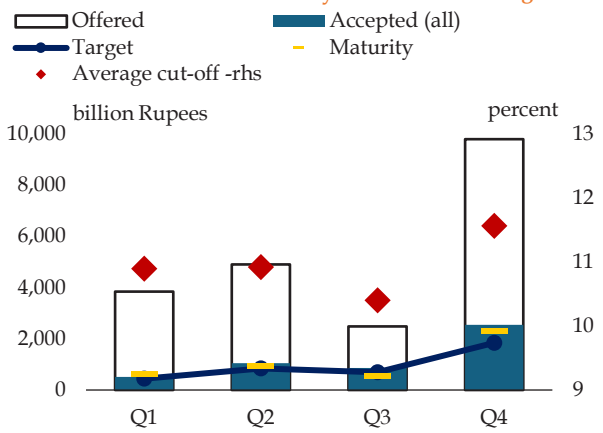
The cut-off rates in T-bill auctions moved closer to the policy rate during H1-FY26 (**Figure 3.6**). Following the policy rate reduction in December 2025, market participants initially expected the SBP to lower the policy rate further in January 2026. However, the outbreak of the Middle East conflict pushed up inflation expectations and led to a shift in market sentiments toward tighter monetary conditions. Accordingly, the market bid for higher returns in subsequent auctions. Furthermore, rising fiscal financing needs during H2-FY26 exerted additional upward pressure on cut-off rates. This pushed the cut-off rates above the policy rate, besides inducing increased volatility. However, as the market uncertainty began to ease, cut-off rates moved closer to the policy rate in June 2026.

T-Bill Auction Summary - FY26 **Figure 3.4**



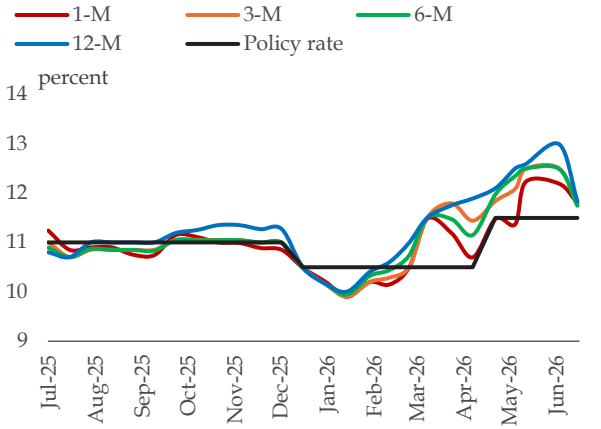
Source: SBP

1-Month T-Bill Auction Summary - FY26 **Figure 3.5**



Source: SBP

Cut-Off Rates **Figure 3.6**



Source: SBP

Overall, the government recorded net borrowing through T-bills, with most of the increase seen during the second half of FY26. As upside risks to inflation and uncertainty over the policy rate increased, investors demanded higher yields on longer-term fixed-rate instruments. In response, the government mobilised more funds, specifically during Q4, through shorter-tenor T-bills. This approach allowed the government to meet immediate funding requirements at relatively lower cost.

Investors' demand for PIBs also remained robust during FY26, though offers softened somewhat during H2 as uncertainty increased. Demand remained particularly strong for 15-year zero coupon PIBs and 10-year semi-annual PFLs, which attracted the highest offers (**Table 3.3**). In H2-FY26, investors also demanded higher yields. The government responded by accepting smaller amounts and, in some auctions, rejecting all bids to avoid borrowing at relatively elevated rates.[11]

Auctions of Pakistan Investment Bonds **Table 3.3**

ratio

	Offer-to-target		Acceptance-to-target	
	FY25	FY26	FY25	FY26
2Y- Zero coupon	2.8	2.4	0.8	0.6
3Y- Fixed	3.1	3.6	0.9	1.1
5Y- Fixed	3.6	3.5	1.3	1.4
10Y- Fixed	2.1	2.9	1.2	1.2
15Y- Zero coupon	1.4	11.6	1.0	3.3
2Y - PFL Semi-Annual	1.6	-	0.03	-
5Y- PFL Semi-Annual	1.9	-	0.7	-
10Y- PFL Semi-Annual	3.5	6.8	1.6	0.8

Source: SBP

PIB auctions reflected a notable change in the government's long-term borrowing strategy during FY26. In FY25, semi-annual floating-rate instruments had dominated conventional long-term issuance. In FY26, however, the government shifted its borrowing toward fixed-rate and zero-coupon PIBs (**Table 3.3**). This strategy reduced interest rate risk and increased predictability in future debt-servicing costs.

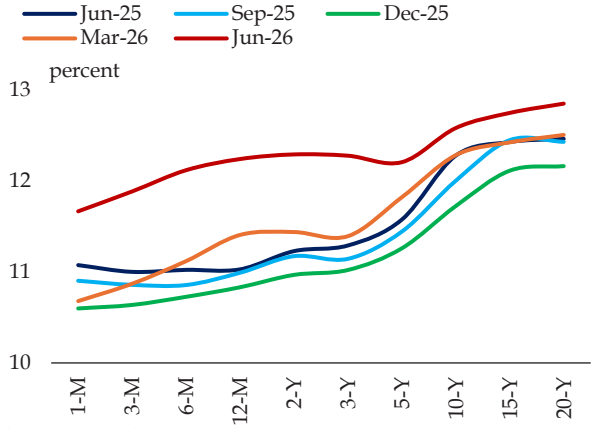
The secondary market yields declined during H1-FY26, broadly reflecting the reduction in the policy rate and expectations of further monetary easing. However, yields began to rise from March 2026 onward amid rising uncertainty (**Figure 3.7**). The yield curve, nevertheless, retained a positive slope, reflecting optimism about future economic growth and inflation as well as elevated uncertainty.

Interbank Liquidity

Interbank liquidity remained under pressure during FY26, mainly due to increased government borrowing from scheduled banks, expansion in PSC, and lending to PSEs. These pressures were partly offset by stronger deposit growth,

[11] For instance, the government rejected all bids in the fixed-rate PIB auction of April 28, 2026, and in several other auctions including the 15-year and 10-year PIBs-fixed and the 10-year PFLs.

Secondary Market Yield Curve **Figure 3.7**



Source: MUFAP

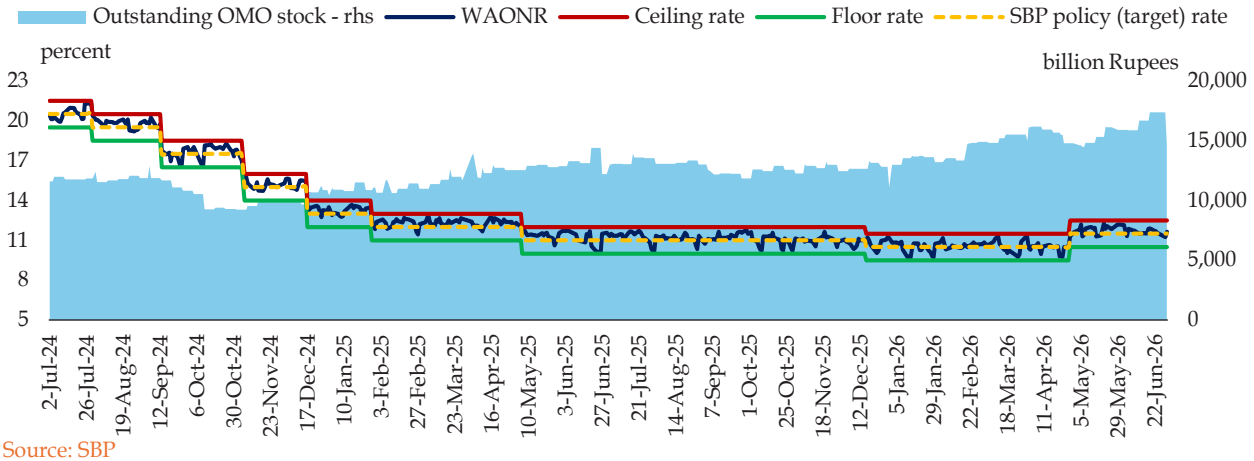
reduction in cash reserve requirement, SBP's net FX purchases, retirements in commodity operations financing and moderation in CiC.

SBP's liquidity operations effectively managed these pressures. As a result, the average outstanding Open Market Operations (OMOs) stock increased to Rs 13.9 trillion in FY26, compared to Rs 11.4 trillion in FY25, with market interventions primarily concentrated in 7-day and 14-day tenors. Liquidity operations remained closely aligned with market conditions, helping to anchor overnight rates around the policy rate (**Figure 3.8**). The weighted average overnight repo rate (WAONR) remained 9.4 basis points above the policy rate, on average, during FY26, compared with 23.4 basis points in FY25 (**Figure 3.9**).

Despite the prevailing liquidity pressures, banks' recourse to the ceiling facility moderated during FY26. Usage of the ceiling facility declined from 167 to 142 days, while the average number of borrowing banks fell from three to two and the average amount borrowed per visit decreased from Rs 193.2 billion to Rs 158.1 billion, indicating that regular OMOs largely met banks' liquidity requirements and reduced the need for overnight borrowing from SBP. Similarly, the use of floor facility fell by 33 percent to a three-year low of 164 days. The average number of participating banks also declined from three to two per operation, while the average placement dropped sharply from Rs 267.9 billion in FY25 to Rs 72 billion in FY26.

Liquidity requirements of the Islamic banks continued to be met through Shariah-compliant OMOs. The average volume of liquidity injections through Shariah-compliant OMOs declined to Rs 205.1 billion during FY26 from Rs 234.6 billion in the previous year. Consistent with this, recourse to the Islamic ceiling facility also moderated.[12]

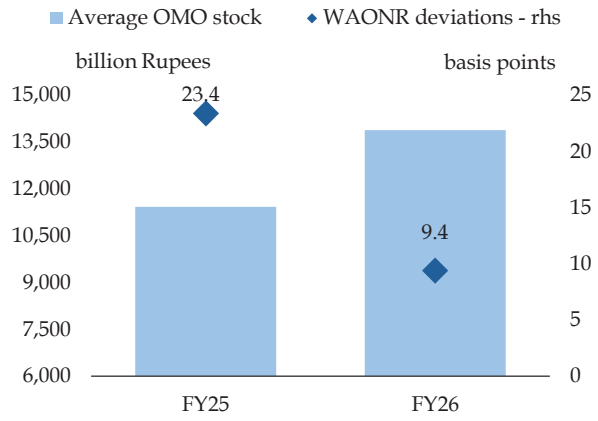
Interbank Liquidity Indicators **Figure 3.8**



Source: SBP

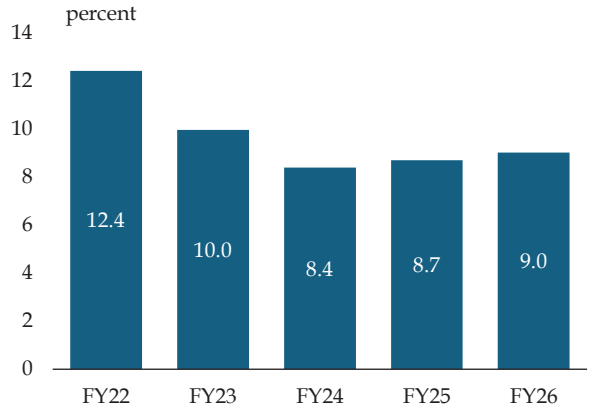
[12] The frequency of access to the Islamic ceiling facility declined from 115 days in FY25 to 95 days in FY26, while the average amount of collateral pledged decreased from Rs 6,495.7 billion to Rs 5,599.1 billion.

Average WAONR Deviations from Policy Rate **Figure 3.9**



Source: SBP

Private Sector Credit-to-GDP Ratio **Figure 3.10**



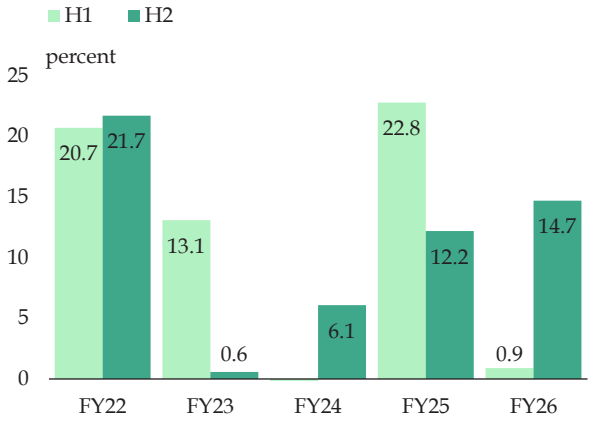
Source: SBP

3.3 Private Sector Credit

Private sector credit grew by 14.7 percent in FY26 compared to 12.2 percent in FY25. With this, credit-to-GDP ratio increased to 9.0 percent from 8.7 percent last year **(Figure 3.10)**.[13] Most of the increase in PSC was concentrated in H2-FY26, as credit growth remained sluggish in H1-FY26 because of high base effect stemming from banks' increased lending to avoid ADR-based tax in the previous year **(Figure 3.11)**.[14]

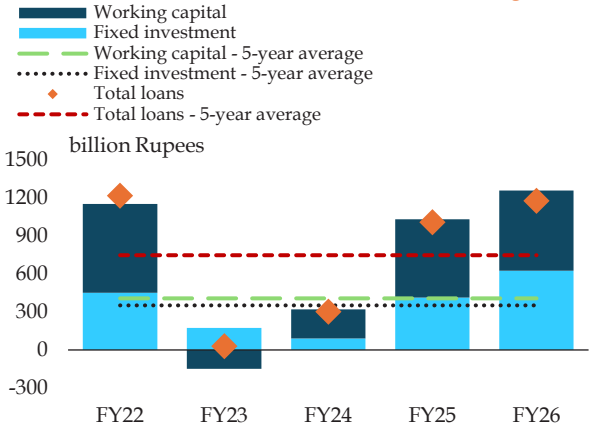
The loans to private sector businesses (PSBs), which constitute around 84.0 percent of total PSC,[15] expanded by Rs 1.2 trillion in FY26 compared to an expansion of around Rs 1.0 trillion in FY25. This increase was contributed by working capital and fixed investment loans, both surpassing levels observed in the previous year, as well as their past five-year averages **(Figure 3.12)**. Nonetheless, the contribution of fixed investment loans was noticeably higher in FY26 compared to FY25.

Private Sector Credit Growth **Figure 3.11**



Source: SBP

Credit to Private Sector Businesses - Flows **Figure 3.12**



Source: SBP

[13] Credit-to-GDP ratio in FY26 was still lower compared to its average of 10.3 percent during last five years (FY21-FY25).
[14] The increase in tax rate linked to ADR in FY25, particularly on bank income from government securities incentivized banks to improve ADR and increase loan portfolio. As a result, bank lending to private sector surged (for further details, **Chapter 3** of FSR (2024)).
[15] Private sector credit has two components: (i) investments in securities and shares of private sector; and (ii) loans to private sector. Loans to private sector are further classified into four components comprising of loans to private sector businesses, loans to trust funds and non-profit organizations, personal loans and others.

Underlying factors of Private Sector Credit **Table 3.4**
growth in percent, diffusion index

	H1-FY25	H2-FY25	FY25	H1-FY26	H2-FY26	FY26
Global commodity prices	-4.1	-5.2	-4.7	-7.6	18.6	5.3
Global energy prices	-8.3	-9.9	-9.1	-12.8	25.7	5.9
Exchange rate (average) (+app/dep, %)	3.3	-0.6	1.3	-1.2	0.5	-0.4
Weighted average lending rate*	17.1	12.7	14.9	12.2	12.2	12.2
WPI	4.4	-0.5	1.9	0.3	7.5	3.9
Motor spirit	-10.9	-7.6	-9.3	3.8	28.1	15.9
Diesel	-15.3	-7.3	-11.5	6.7	43.6	25.1
Electricity	7.9	-17.3	-5.6	-15.4	-0.7	-8.5
Natural gas liquified	37.8	-0.3	15.7	6.3	8.5	7.4
Economic activity						
LSM	-1.8	0.3	-0.7	4.8	5.1	5.0
Product demand**	59.1	64.2	61.6	62.7	69.2	65.9
Purchasing managers index**	49.9	56.7	53.3	54.9	52.5	53.7

*Average during the period, ** Average of diffusion indices
Sources: SBP; PBS; WB

The expansion in credit to PSBs was supported by both demand- and supply-side factors. On the demand side, improving real economic activity and increase in consumer demand, evidenced by sustained growth in LSM and high-frequency demand indicators, stimulated credit demand. Furthermore, increased raw material procurement by PSBs increased working capital requirement. The surge in global energy prices in H2-FY26, which raised input cost, further increased working capital requirements of PSBs **(Table 3.4)**.

In addition, consumer financing also increased, led by auto financing and house building loans. Meanwhile, stable macroeconomic conditions together with lower financial costs drove expansion in the fixed investment loans.

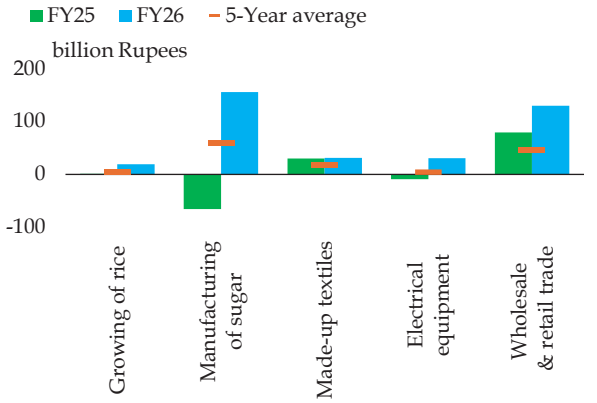
On supply side, reduction in CRR from 6 percent to 5 percent in January 2026 injected additional liquidity into the banking system. This, combined with a robust growth in bank deposits, significantly enhanced the capacity of commercial banks to extend credit to private sector.

Economic activity influenced demand for working capital loans

The PSBs borrowed Rs 629.1 billion for working capital purposes in FY26 compared to Rs 617.3 billion in FY25. The major sectors availing short-term financing included manufacturing of motor vehicles; cement lime & plaster; sugar; textiles; electrical equipment; and wholesale & retail trade **(Table 3.5 and Figure 3.13)**.

Manufacturing of cement, lime & plaster more than doubled its short-term borrowing compared to last year. This can be attributed to increased demand amid recovery in construction activity in both private and public sectors driven by increase in overall PSDP spending and the government's low-cost housing scheme specifically, Wazir-e-Azam Apna Ghar Program (**Economic Growth, Chapter 2**).[16,17] Likewise, higher uptake of working capital loans by manufacturing of motor vehicles reflects strong automobile sales and

Major Sub-Sectors Availing Working Capital Loans - Flows **Figure 3.13**



Source: SBP

[16] PSDP expenditures as a percent of GDP increased to 2.7 percent in FY26 compared to 2.6 percent last year.
[17] Coal prices decreased by 1.6 percent in FY26 compared to an increase of 16.7 percent in FY25.

Loans to Private Sector Businesses **Table 3.5**

flows in billion Rupees

	Total Loans*						Working Capital**		Fixed Investment	
	FY25			FY26						
	H1	H2	FY	H1	H2	FY	FY25	FY26	FY25	FY26
Total	**1,915.7**	**-909.1**	**1,006.6**	**867.2**	**306.0**	**1,173.2**	**617.3**	**629.1**	**413.8**	**625.3**
A. Agriculture, forestry & fishing	59.9	34.0	93.9	123.1	53.2	176.3	42.8	81.7	51.1	94.5
Of which: growing of wheat	28.6	16.9	45.4	20.3	-16.8	3.5	36.6	-9.0	8.8	12.5
B. Mining and quarrying	16.3	-16.9	-0.6	-3.5	-8.0	-11.5	-4.9	-10.9	4.3	-0.5
C. Manufacturing: off which	1,401.0	-884.9	516.1	501.6	155.1	656.6	409.9	379.7	109.5	286.9
Textile	504.8	-267.9	237.0	112.8	-60.1	52.7	237.2	15.9	2.5	39.6
Wearing apparel	106.3	-51.4	54.9	23.6	-15.2	8.5	53.1	2.2	2.0	6.7
Rice processing	92.1	-57.8	34.3	106.1	-56.3	49.8	30.3	46.2	4.0	3.7
Sugar	-26.7	-16.4	-43.2	-39.6	200.9	161.3	-65.8	155.9	20.5	8.0
Vegetable & animal oils	17.6	-6.7	10.9	-28.1	0.8	-27.3	12.3	-25.3	-1.4	-2.0
Cement & plaster	107.1	-126.6	-19.5	5.4	27.5	32.9	8.2	21.1	-27.5	11.9
Fertilizers	45.8	2.5	48.4	37.6	36.0	73.6	28.1	-5.4	20.2	79.0
Refined petroleum	42.7	-11.0	31.7	26.9	-44.4	-17.5	5.1	-2.3	26.5	-15.2
Motor vehicles	27.9	-19.4	8.6	68.9	-38.9	30.0	11.5	15.9	-3.0	14.1
Basic iron & steel	18.2	-2.7	15.5	6.1	3.1	9.2	1.1	-9.0	13.2	19.5
Paper and paper products	14.4	8.1	22.5	5.7	2.6	8.3	7.6	5.7	14.9	2.6
D. Electricity, gas, steam & AC supply	-24.8	-3.0	-27.8	-84.2	21.0	-63.2	0.1	-18.0	-27.4	-45.5
E. Water supply; sewerage, waste management	7.2	1.1	8.3	13.4	-1.2	12.2	-1.9	1.2	10.2	11.0
F. Construction	25.9	-8.4	17.5	9.0	16.8	25.8	11.7	19.2	24.1	47.2
G. Wholesale and retail trade^	91.7	45.5	137.2	155.7	52.7	208.4	79.2	130.0	60.6	92.0
H. Transport. & storage	-14.8	20.7	5.9	27.6	47.2	74.9	-17.3	13.5	20.0	58.1
I. Accommodation & food service	43.0	-0.8	42.2	13.1	4.3	17.4	-1.1	9.6	43.6	9.8
J. Information and communication	133.9	11.5	145.4	59.8	-16.6	43.2	42.6	17.7	102.5	25.8
Others	176.4	-107.8	68.5	51.5	-18.5	29.4	56.3	5.4	15.5	45.9

^ includes repair of motor vehicles and motorcycles

* Total amount also includes construction finance. In terms of IH&SMEFD Circular Letter No. 28 of 2020, the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business.

** includes trade finance

Source: SBP

production amid lower interest rates and reduced tariffs on the import of auto parts.[18]

The increase in working capital loans availed by manufacturing of electrical equipment can be linked to rise in production of electric fans and transformers driven by government policy measures, besides improvement in overall demand in the economy.[19] Similarly, in line with the increase in sugarcane production and its price, the working capital needs of sugar manufacturers increased in FY26.

Conversely, demand for working capital loans by the textiles declined. This was primarily due to contraction in domestic cotton output and subdued international demand, which collectively suppressed short-term credit utilisation by the low value-added textiles. [20]

Profitability shaped working capital requirements of some sectors

Manufacturing of coke and refined petroleum products and growing of wheat are other major sectors that retired working capital loans in FY26, against an expansion in the previous year. Specifically, petroleum and coke refining sector reduced its reliance on short-term financing. Improved liquidity—driven by strong sales volumes, price increases, and better profit margins—effectively lowered overall working capital requirements, signalling their improved cash flow.[21]

[18] Source: FBR S.R.O. 1151 (l)12025, S.R.O 1152(2025).

[19] Source: Prime Minister Fan Replacement Program, available at: https://www.sbp.org.pk/circulars/shsfd-circular-no-01-of-2026

[20] Feroz1888 Mills LTD (2026). Condensed Interim Financial statement for Q3-FY26.

[21] Attock petroleum Limited (2026). Interim Report & Financial Statement, March 2026.

Similarly, wheat growers retired working capital loans despite a 4.5 percent increase in crop area. This retirement underscored an improvement in farmers' cash position, driven primarily by a sharp increase in domestic wheat prices and targeted government support that enhanced farmers' liquidity.[22] In contrast, short-term borrowing by rice processing units increased due to lower exports, amid growing global competition that impacted liquidity of rice millers.[23]

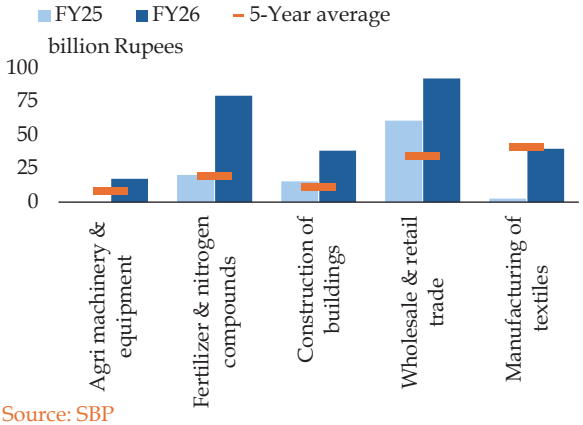
Stable macroeconomic environment encouraged fixed investment loans

Fixed investment loans rose by Rs 625.3 billion in FY26, compared to Rs 413.8 billion in FY25. This expansion was driven by favourable macroeconomic environment, specifically increased capacity utilisation (on average basis during the FY26), lower interest rate, and the government's EXIM bank administered Long Term Financing Facility (E-LTFF) for plant and machinery.[24] Notwithstanding this improvement, fixed investment loans have been on decline in terms of GDP (**Box 3.3**).

Major sectors that availed long-term financing during FY26 included agriculture machinery & equipment, fertilizers and nitrogen compounds, construction of buildings and manufacturing of textiles **(Figure 3.14).** Textiles manufacturers scaled up financing for fixed investment to enhance capacity, specifically major textile firms invested in solarisation to reduce production cost and improve production efficiency.[25]

Higher offtake of fixed investment loans by agriculture sector can be linked to solarisation, besides increased imports of agricultural machinery and implements. Similarly, the increased uptake of fixed investment loans by

Major Sub-Sectors Availing Fixed Investment Loans - Flows **Figure 3.14**



Source: SBP

construction sector was meant for import of construction machinery. Fertilizer & nitrogen compounds sector availed long-term loans to improve operational efficiency of plants by investing in alternative gas supply lines.

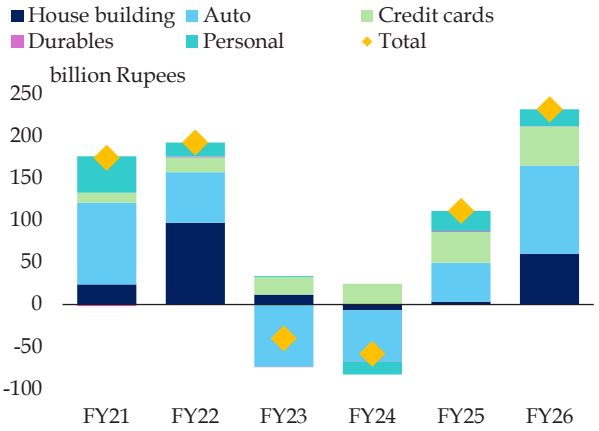
Consumer Financing

Consumer financing expanded by Rs 231.8 billion in FY26 more than twice the increase of Rs 111.2 billion in FY25. The increase was mainly driven by recovery in auto financing, followed by house building loans and credit cards (**Figure 3.15**) amid lower borrowing costs, easing inflation during most of the year, and a gradual recovery in household demand.

The expansion in auto loans was supported by lower lending rates (**Box 3.4**). This was in line with the trends in automobile sales and production.[26] Housebuilding finance also increased, aided by the lower lending rates, moderation in construction input prices and the launch of subsidised housing schemes (**Figure 3.16**).[27] Meanwhile, credit card financing maintained its upward trajectory, supported by higher card

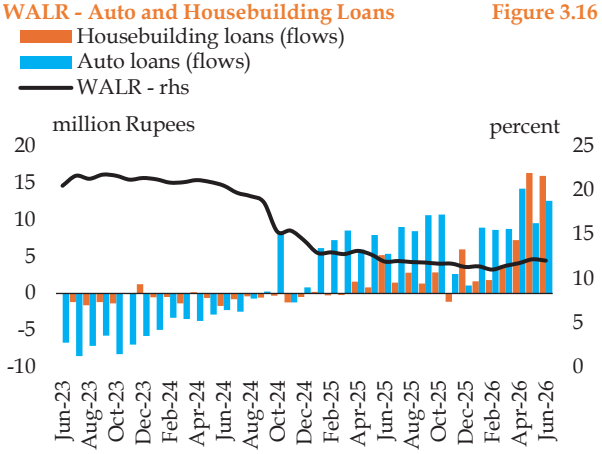
[22] Engro Holdings (2026). Quarterly Report, March 2026.
[23] Matco Foods Limited (2026). Third Quarterly Report, Reaching New Heights, 2026.
[24] Under E-LTFF, a limit of Rs 110 billion of fresh financing was made available during FY26. Out of which, around Rs 58 billion were disbursed by the commercial banks. This financing was available to businesses at concessional rate, 3 percent below the policy rate, available at: https://eximbank.gov.pk/long-term-financing/
[25] Stylers International Limited (2026). Quarterly Report, March 2026; Interloop Limited (2026). Quarterly Report, March 2026.
[26] For further discussion see **Chapter 2**.
[27] Mera Ghar Mera Ashiana later renamed the Wazir-e-Azam's Apna Ghar Program was introduced to promote affordable housing at subsidised markup rates. Source: SH&SFD Circular No.3. SBP

Consumer Financing - Flows **Figure 3.15**



Source: SBP

WALR - Auto and Housebuilding Loans **Figure 3.16**



Source: SBP

issuance and increased transaction volumes and sales.[28, 29]

Advances to priority sectors increased

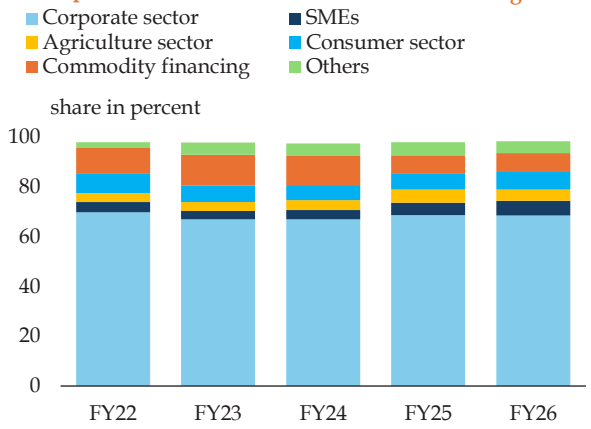
The share of advances to SMEs in total advances slightly increased in FY26 compared to the previous year **(Figure 3.17)**. This expansion was driven by targeted government and SBP initiatives, notably the Risk Coverage Scheme for Small Farmers,[30] the Prime Minister's Youth Business and Agriculture Loans, and Revised Prudential Regulations for SMEs.[31] Furthermore, SBP and the government's credit guarantee scheme for small farmers (Zarkhez-e), together with government's Kissan Card initiative, also contributed to increase in advances to agriculture sector.

3.4 Inflation

The average NCPI inflation in FY26 rose to 7.1 percent, up from 4.5 percent in the previous year (**Table 3.6**). Monthly trends show that year-on-year inflation remained within the medium-term target range during Jul-Feb FY26, before accelerating in the final months of the fiscal year, pushing up the average inflation slightly above the upper bound of the medium-term target range.

In overall terms, the increase in inflation was driven by supply-side pressures within energy

Breakup of Banks' Gross Advances - Stocks **Figure 3.17**



Source: SBP

[28] In FY26, credit card issuances have been higher in volume than the comparable period in FY25. Source: Payment Systems Annual Review. SBP.

[29] Anecdotal evidence suggests that card issuances increased substantially in Q1-FY26 amid special cards being offered under several agricultural schemes.

[30] Risk Coverage Scheme was announced on August 20, 2025, to extend financing for small and marginalized farmers, further details are available at https://www.sbp.org.pk/circulars/acfid-circular-no-02-of-2025

[31] The key measures included revision in SME financing limit from Rs 25 million to Rs 100 million, and for Medium Enterprises from Rs 100 million to Rs 500 million; enhancement in regulatory retail portfolio from Rs 180 million to Rs 300 million; simplification of loan application for SMEs; digital supply chain financing; incentives for export-based SMEs; EFS enhancement plan; and Exim bank administered long term financing facility for plant and machinery (Source: Revised Prudential Regulations for SMEs available at) https://www.sbp.org.pk/assets/documents/laws_regulations/Updated_Prudential_Regulations_for_SME_Financing-July_16_2026.pdf

Average CPI Inflation **Table 3.6**

growth in percent, contribution in percentage points

Items	Weight	Average Inflation			Contribution		
		H1-FY26	H2-FY26	FY26	H1-FY26	H2-FY26	FY26
NCPI	**100**	**5.1**	**9.0**	**7.1**	**5.1**	**9.0**	**7.1**
Urban CPI	**100**	**5.2**	**9.0**	**7.1**	**5.2**	**9.0**	**7.1**
Food	**36.8**	**3.1**	**5.4**	**4.2**	**1.2**	**2.1**	**1.7**
Perishable	4.4	-8.7	-0.4	-5.1	-0.4	0.0	-0.2
Non-perishable	32.4	4.8	6.0	5.4	1.7	2.1	1.9
NFNE (Core inflation)	**53.7**	7.0	7.9	7.4	3.1	3.6	3.3
Energy	**9.5**	5.6	22.0	13.5	0.9	3.3	2.1
Rural CPI	**100**	**5.0**	**8.9**	**7.0**	**5.0**	**8.9**	**7.0**
Food	**45.9**	**3.9**	**6.9**	**5.4**	**1.9**	**3.3**	**2.6**
Perishable	5.7	-8.8	-4.3	-7.1	-0.6	-0.2	-0.4
Non-perishable	40.3	5.9	8.2	7.0	2.5	3.5	3.0
NFNE (Core inflation)	**42.6**	**8.1**	**8.3**	**8.2**	**3.1**	**3.3**	**3.2**
Energy	**11.4**	**-0.3**	**19.1**	**9.2**	**0.0**	**2.3**	**1.1**

Sources: PBS; SBP staff calculations

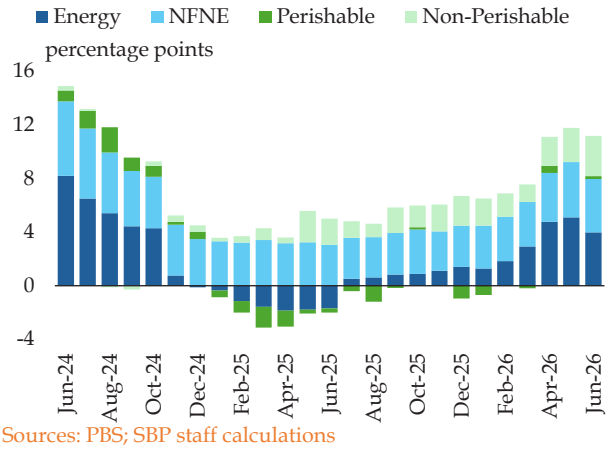
and food groups. Supply frictions and higher transportation costs, alongside crop losses caused by floods, exacerbated food inflation throughout the year. Moreover, the pass-through of elevated global energy prices to domestic prices – following the outbreak of the Middle East conflict – compounded inflationary pressures from March 2026 onward.

The surge in global energy prices drove increases in domestic fuel, electricity and transport prices, impacting both energy and non-energy segments. While core inflation moderated during FY26, it remained the primary contributor to headline inflation, accounting for roughly half of average inflation in urban and rural baskets. However, the composition of inflation shifted during the year, with the contribution of energy rising from one-fifth in Jul-Feb FY26 to about 40 percent in Mar-Jun FY26 in urban regions (**Figure 3.18**).[32]

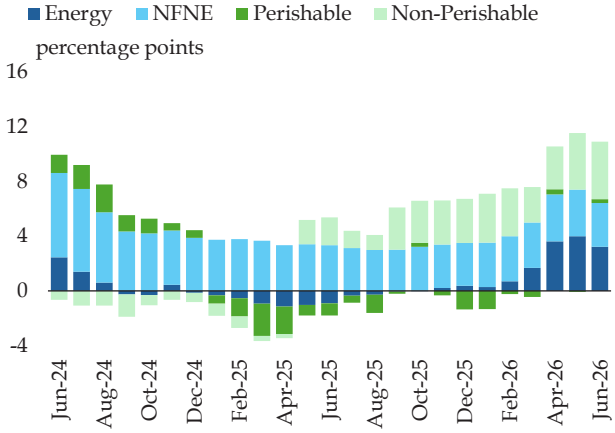
Supply chain disruptions contributed to food inflation in FY26

Food inflation was driven by non-perishable food items, in both urban and rural regions. The prices of perishable food items, on the other hand, declined owing to improved domestic supply of fresh vegetables including potatoes.[33] While production of tomatoes and onions decreased, the closure of the western border improved domestic availability, leading to easing price trends. Within the non-perishable food items, wheat and wheat

Urban CPI Inflation Composition **Figure 3.18a**



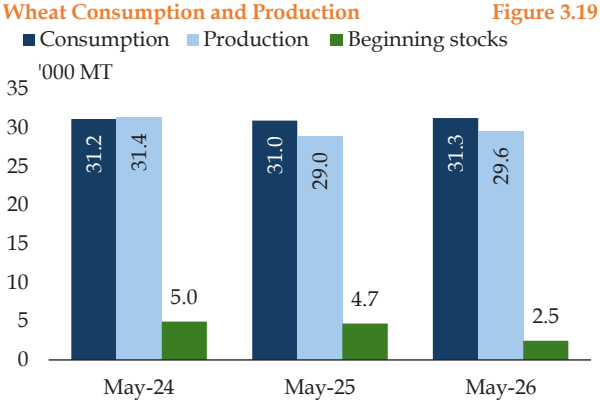
Rural CPI Inflation Composition **Figure 3.18b**



Sources: PBS; SBP staff calculations

[32] Likewise, contribution of energy in the rural basket rose from one-tenth in Jul-Feb FY26 to 31 percent in Mar-Jun FY26.
[33] Potato production increased by 27.6 percent in FY26. Source: MoF (2026). Pakistan Economic Survey 2025-26, Ministry of Finance.

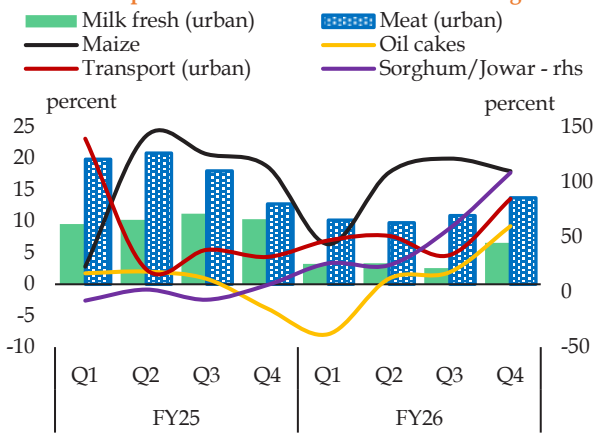
Wheat Consumption and Production **Figure 3.19**



* Stocks are shown as of May which marks the start of the wheat market year

Source: USDA

Growth in Input Prices **Figure 3.20**



Source: PBS

flour prices accounted for the bulk of the increase in food inflation. Prices of other food items, including milk, meat, and sugar also contributed to the food inflation.

Several factors were responsible for increase in prices of wheat and its products in FY26. First, the transitional impact of government's withdrawal from large-scale public procurement in FY25 and delays in operationalising private-sector-led wheat procurement arrangements created market uncertainty.[34] Second, decline in crop production in FY25 reduced overall supply. Third, flood-related losses further intensified price pressures due to concerns over supply shortages, resulting in reduced beginning stocks at the start of the year (**Figure 3.19**).[35] Fourth, global energy price shock, which led to higher transport costs, further added to wheat price increase from April 2026 onward.

Similarly, the spike in electricity and fuel costs also pushed up meat and fresh milk prices in the last quarter of FY26 (**Figure 3.20**). This impact was further reinforced by seasonal spike in demand due to Eid ul-Adha in May 2026.

Sugar prices also saw upward pressure due to domestic market frictions and supply concerns. A drop in sugarcane output in FY25 created sentiments about shortages in FY26.[36] This resulted in emergency imports by the government during Sep-Nov FY26,[37] which added to the market perception regarding a shortfall in domestic production. This resulted in speculative behaviour by some market players, leading to higher sugar prices in FY26.[38]

The Middle East conflict fuelled energy inflation

Energy inflation accelerated in FY26, after dropping to multi-year low in the preceding year. While benign global commodity prices and power sector reforms helped ease energy prices during most of the year, supply shock caused by the Middle East conflict reversed the trend from March 2026 onwards.

In H1-FY26, energy inflation remained contained despite a sizeable increase in gas charges, as lower global crude oil prices and downward adjustments in electricity tariffs partly offset the impact of administered gas-price revisions. The hike in gas charges primarily reflected ongoing energy-sector reforms aimed at improving cost recovery and containing circular debt accumulation.[39] Overall, increase in fixed monthly charges raised gas prices for households by 23

[34] Source: USDA (2026). Grain and Feed Update, September 2026, Report No. PK2026-0012.
[35] Source: USDA (2025). Grain and Feed Update, September 2025, Report No. PK2025-0011.
[36] FY25 saw a production shortfall of 3500 MT in sugar. This fed into expectations of a projected shortfall in FY26. Source: USDA.
[37] The volume of sugar imports stood around 308,404 MT in H1-FY26. Source: PBS
[38] Press Release date July 31st, 2025. Ministry of National Food Security and Research.
[39] Pakistan: Third Review under the Extended Fund Facility. May 2026. IMF Staff Report

percent in FY26,[40] making it the largest contributor to energy inflation during the year (**Figure 3.21a and b**).[41]

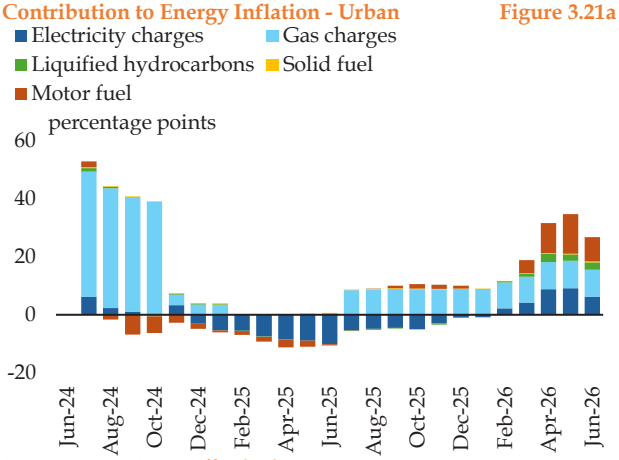
Moreover, after remaining subdued in H1-FY26, electricity charges also experienced a double-digit increase in H2-FY26. During the first half, a negative Quarterly Tariff Adjustment (QTA) provided temporary relief to consumers. However, an upward adjustment to the QTA in December 2025 drove energy costs higher for the remainder of the year.[42] Further increase came from annual rebasing, which was deferred from July 2025 to January 2026 following the shift in NEPRA's rebasing timeline.[43]

Nonetheless, power sector reforms effectively mitigated a more severe spike in the QTA. Most notably, integration of industrial consumers into the national grid—under the *Off-the-Grid (Captive Power Plants) Levy Act, 2025*—coupled with a moderate uptick in economic activity, stimulated electricity demand. This successfully reduced capacity payments, which comprised a significant portion of the QTA. Moreover, the surge in international crude oil prices impacted retail electricity prices through positive Fuel Cost Adjustments (FCA) due to elevated generation costs from March 2026 onward.[44]

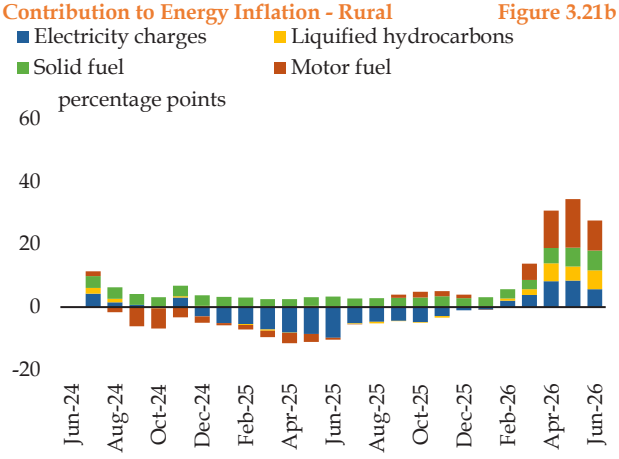
The pass-through of the energy price shock was most pronounced in motor fuels and liquified hydrocarbons. Motor fuel prices were already on a steady increase since the start of the year due to upward adjustments in the Petroleum Development Levy (PDL) and the implementation of the Climate Support Levy from July 2025. This uptrend intensified following the surge in global energy prices (**Figure 3.22**). In view of high volatility in global commodity prices, the government shortened the fuel price adjustment cycle from fortnightly to weekly revisions by March 2026 to keep domestic demand in check.[45] The decision has implications for inflation dynamics (**Box 3.5)**.

Although the government temporarily reduced PDL for April and May 2026 to provide relief to consumers, following the reduction in ex-depot prices, the levy was raised again in June 2026.

Contribution to Energy Inflation - Urban **Figure 3.21a**



Contribution to Energy Inflation - Rural **Figure 3.21b**

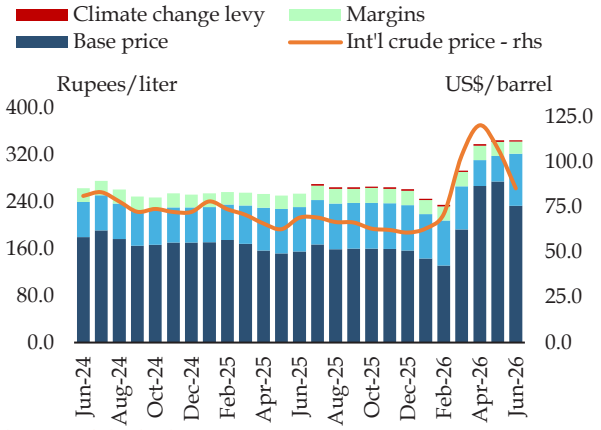


Sources: PBS; SBP staff calculations

[40] Source: OGRA notification dated June 09, 2025
[41] Gas charges contributed more than half of the increase in urban energy inflation in FY26.
[42] QTA is adjusted after every three months, it does not only capture fuel-cost variation; but also adjusts for changes in capacity payments, transmission and distribution costs, variable O&M, use-of-system charges, and other approved cost components faced by DISCOs. Source: NEPRA
[43] PR No. 150. January 17th, 2025. Ministry of Information and Broadcasting. Government of Pakistan
[44] FCA is a monthly fuel-cost pass-through mechanism and is therefore more directly linked to the changes in generation fuel mix, exchange rate movements and international fuel prices. Source: NEPRA
[45] OGRA Notification dated 1st March 2026.

Likewise, the global energy price volatility also affected liquified hydrocarbon prices - LNG and RLNG, which saw the largest increase compared to other domestic energy sector components.[46] Importantly, the incidence of the direct pass-through of the global energy shock to domestic prices fell more on consumers in high consumption baskets (**Box 3.6**).

Composition of Motor Fuel Prices **Figure 3.22**



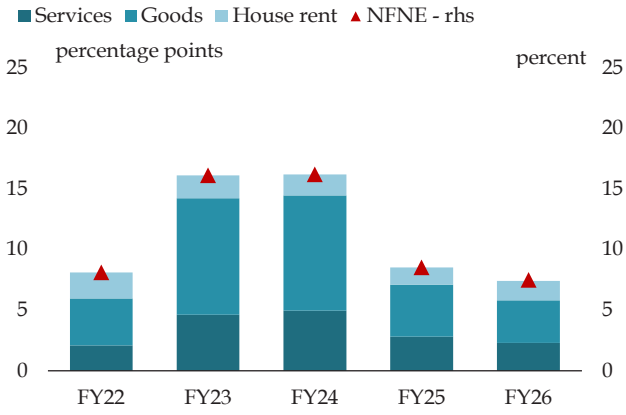
Sources: OGRA; WB

Core inflation eased in FY26, but underlying price pressures remained

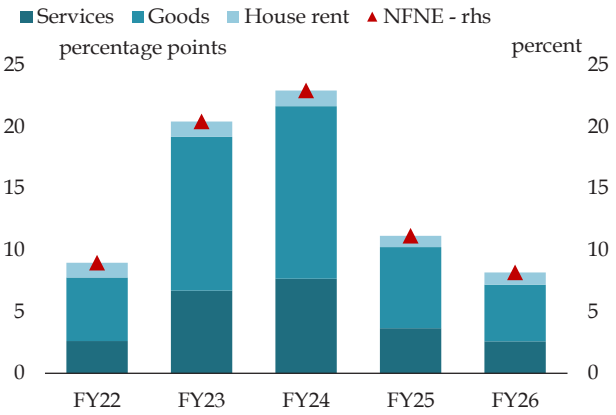
Continuing the disinflationary trend observed in FY25, core inflation eased further in FY26 across urban and rural baskets (**Figure 3.23a and b**).[47] The moderation, more evident during H1-FY26, was supported by coordinated monetary and fiscal tightening, which prevented unwarranted expansion in domestic demand, and benign global commodity prices. However, the disinflationary process reversed in H2-FY26.

The moderation in core inflation was initially driven by easing price pressures across core goods and services, particularly recreation and culture, footwear and cotton cloth (**Figure 3.24**). Lower import prices and subdued demand from textile mills helped ease price pressures in cotton cloth.[48] Additionally, tax rate relaxations and high base effect from previous year explained softening prices of recreation and culture and footwear, respectively.[49,50] These gains, however, were partly offset by around 40 percent increase in prices of personal effects. Personal effects contributed nearly one-fifth to core inflation in FY26, significantly higher than the historical average of 5 percent.[51] This sharp increase in the contribution of personal effects was largely driven by rising gold and silver prices amid heightened global uncertainty. However, the outbreak of the

Contribution to Core Inflation - Urban **Figure 3.23a**



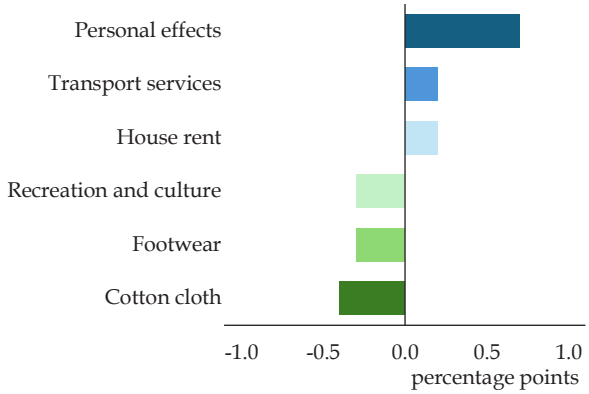
Contribution to Core Inflation - Rural **Figure 3.23b**



Source: PBS

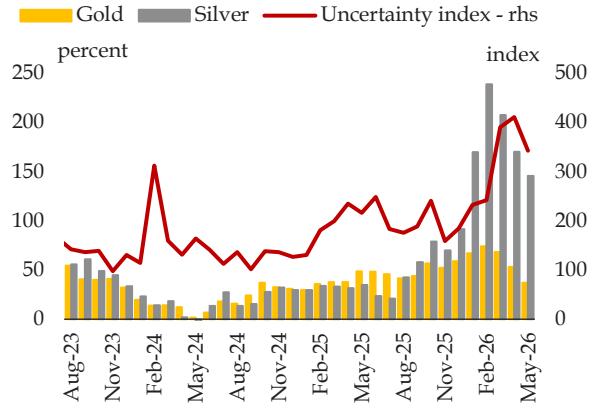
[46] MoF (2026) Pakistan Economic Survey 2025-26, Ministry of Finance.
[47] Urban core inflation declined to 7.4 percent in FY26 from 8.5 percent in FY25. Excluding personal effects, which largely capture movements in gold prices, core inflation fell more sharply to 6.3 percent from 8.3 percent.
[48] Source: Monthly Cotton Review June 2026 – Pakistan Central Cotton Committee
[49] Lower customs valuations for imported laptops and reduced GST on cable TV services in Sindh supported the moderation in recreation and culture. Source: Valuation Ruling No. 2000/2025, Directorate General of Customs Valuations.
[50] Source: Sindh Finance Act (2025).
[51] The average contribution of personal effects category to core inflation during FY17-FY25 was 5 percent.

Top Contributors to Core Inflation - Urban FY26 **Figure 3.24**



Source: PBS

Uncertainty and Precious Metal Prices **Figure 3.25**



Sources: PBS; Fed US

Middle East conflict led to some moderation in precious metal prices as demand for liquidity increased (**Figure 3.25**).[52]

The disinflationary trend in core inflation reversed in the latter months of FY26, especially in the aftermath of the Middle East conflict. This trend was largely attributed to a pickup in services inflation during the final quarter of FY26.[53] Specifically, transport services contributed the most, as higher fuel costs – stemming from the global energy price shock – directly increased bus, rail, and auto-rickshaw fares, alongside a sharp spike in airfares during April and May 2026.[54] Postal services also added to inflationary pressures as courier charges increased during the year.

Moreover, house rent maintained a gradual upward trend throughout FY26, underpinned by persistent structural imbalances in the housing market. Pakistan faces an estimated shortage of around 10 million housing units, with the deficit concentrated largely among low- and middle-income households.[55] Consistent with these supply constraints, house rent increases were more pronounced for smaller units in major urban centres.[56]

While core inflation declined during FY26, it remained persistently higher than the upper bound of the medium-term range for most of the year. This indicates that underlying inflationary pressures have yet to fully dissipate (**Box 3.7**).

Box 3.1: Monetary Policy Response to Energy Price Shocks

Energy price shocks pose a challenge for calibrating monetary policy because the initial inflationary impulse originates from the supply side, while monetary policy is for demand management. Further, monetary tightening to mitigate the impact of energy price spikes on headline inflation may result in output contraction [Bodenstein et al. (2008)]. The case for a response, however, arises when the initial shock begins to propagate to a broader set of prices through production costs, wages, price-setting behaviour and inflation expectations. Such a situation raises the risk of turning a temporary energy-led spike in inflation into a persistent and broad-based one. Therefore, no monetary policy response or a delayed response can result in de-anchoring of inflation expectations. Against this backdrop, this

[52] Gold and silver prices reached their peak in February 2026. During the same month, the personal effects' n.e.c. category accounted for 28.8 percent of core inflation. In FY26, gold prices increased by 54.4 percent, compared with a five-year average increase of 26.8 percent. Gold and silver account for almost half of the personal effect`s n.e.c. category in the CPI basket.
[53] The contribution of services to urban core inflation remained broadly stable at around 0.9 percentage points during the first three quarters before increasing to 1.5 percentage points in the final quarter.
[54] Bus fares, which account for nearly half of the transport services basket, increased by an average of 34.3 percent during FY26.
[55] Source: SME, Housing & Sustainable Finance Department, SBP.
[56] Source: Zameen Property Index

box explores the relevant literature and responses of major central banks to draw lessons for an appropriate monetary policy response to mitigate the impact of these shocks on inflation.

Literature suggests that monetary policy should respond to persistence rather than the relative-price shock alone. For an oil price shock, central banks should respond to the second-round effects that cause expected inflation to deviate from the target [Carare et.al. (2021)]. This is particularly important for emerging economies like Pakistan, where second-round impact on food inflation is higher due to sheer weight of food in CPI [Gelos & Ustyugova, (2012)]. The case for monetary tightening becomes stronger when the shock persists and begins to influence wages, expectations and broader price-setting behaviour.

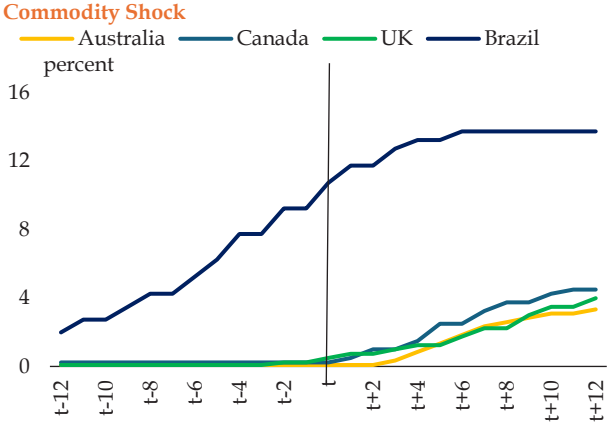
The recent country experiences show that different central banks have responded differently to energy price shocks. The Bank of Canada held its policy rate in March 2026 noting that inflation was close to target and core pressures remained limited, explicitly indicating that it would look through the immediate oil-price effect while monitoring whether higher costs spread to other goods and services and become persistent [BoC (2026)]. Similarly, the ECB kept its policy rate unchanged in March 2026 as inflation was close to target and longer-term inflation expectations remained anchored [ECB (2026)]. The US Federal Reserve also maintained its policy rate in March 2026 and April 2026, noting that higher energy prices though raised short-term inflation expectations, longer-term expectations remained broadly anchored [Fed (2026)]. On the contrary, the Reserve Bank of Australia raised its policy rate in March 2026 and May 2026. This was because higher energy prices coincided with pre-existing excess demand, elevated underlying inflation, and higher short-term inflation expectations which increased the risk of external shock leading to more persistent inflation [RBA (2026)].

Based on the preceding discussion, an appropriate response should take into account following considerations.

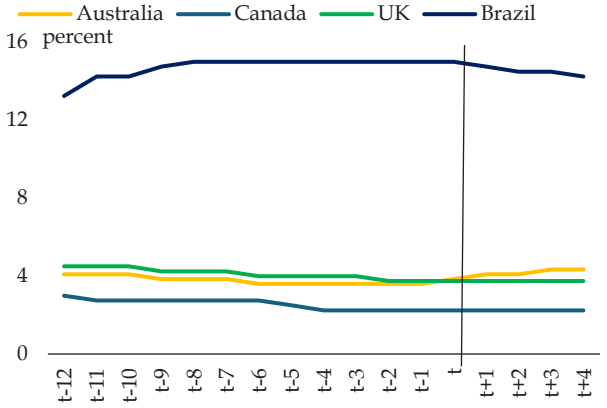
First, it is critical to distinguish between a transitory shock or the one that develops into persistent one. Prolonged energy-price increases often lead to higher costs feeding into wages and firms' pricing decisions – wage-price spiral. Labour-market conditions are also important, since greater slack can reduce both workers' bargaining power and firms' ability to pass higher costs to final prices. Much of this evidence, however, emerges with a lag.

Second, assessing second-round effects is central to calibrating the monetary policy response. Inflation targeting central banks, like the Bank of England, distinguish between the direct impact of higher energy prices on fuel and utilities and the subsequent propagation of the shock, noting that policy would generally look through the direct effects [BoE (2026)].[57] Rather than relying solely on headline inflation, it is more instructive to monitor whether the energy shock is becoming broad-based, the distribution and breadth of price increases, firms price expectations and

Monetary Policy Response Post 2022-23 Commodity Shock **Figure 3.1.1a**



Monetary Policy Response Post Middle East Conflict **Figure 3.1.1b**



Source: Haver Analytics

[57] Out of a sample of thirty-eight central banks, thirty-three held their rates three months post-shock. Source: Bank of International Settlements Data Portal.

cost pass-through, realised and expected wage growth, household and market inflation expectations, and firms' profit margins [BoE (2026)].

Third, the initial conditions also matter for policy calibration. This is most prominent when comparing policy decisions during the recent energy price shock and the 2022-23 commodity shock due to the Ukraine-Russia war. Most central banks raised rates post 2022-23 shock because it compounded with the post-pandemic shock (**Figure 3.1.1**), resulting in high and persistent core inflation. The Middle East conflict in comparison has caused volatility in global energy prices, however, the impact of the shock on core commodities is yet to be seen.

In sum, the policy response depends on the nature, duration and persistence of the energy shock and the economy's initial inflation and demand conditions. A temporary increase in energy prices with anchored expectations and contained underlying inflation provides greater scope to look through its direct, and potentially some indirect effects. Conversely, a persistent shock that increases wages and inflation expectations may require tightening to prevent inflation from becoming entrenched.

**The contribution of Mehreen Tariq Ghani and Hafiza Bismah Qadoos is acknowledged in writing this box.*

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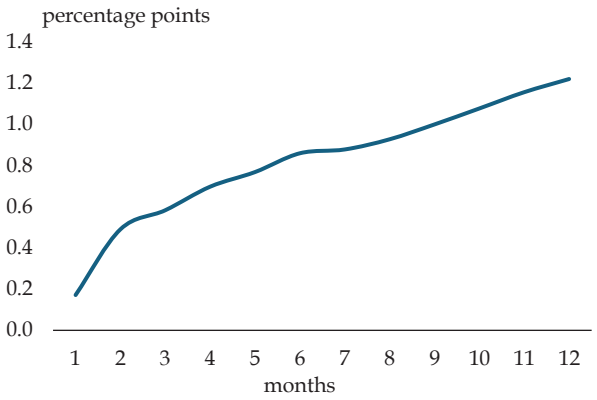
Box 3.2: Assessing Second Round Effects of Global Energy Price Shock in Pakistan

Global energy price shocks raise inflation both directly via increase in utility and fuel costs, and indirectly through second-round pressures from subsequent adjustments in wages and costs, and inflation expectations. Ruch and Du Plessis (2015) highlight that second round effects emerge through both the cost channel—higher input costs raising firms' output prices—and the expectations channel, where households and workers demand wage increases anticipating higher future prices, and fuel wage-price spirals. Literature shows that energy price shocks produce significant second-round effects on inflation expectations and core inflation [Allon-Pineda et al. (2025), Alp et al. (2023)].

Assessment of the second-round effects of energy price shock is necessary as these remain embedded in inflation for an extended period. It is particularly important in the context of calibrating an appropriate monetary policy response. In this backdrop, this box attempts to quantify second round effects of oil price shock in case of Pakistan. For this purpose, we estimate Structural VAR on monthly data from January 2004 to June 2026.[58] The variables include global

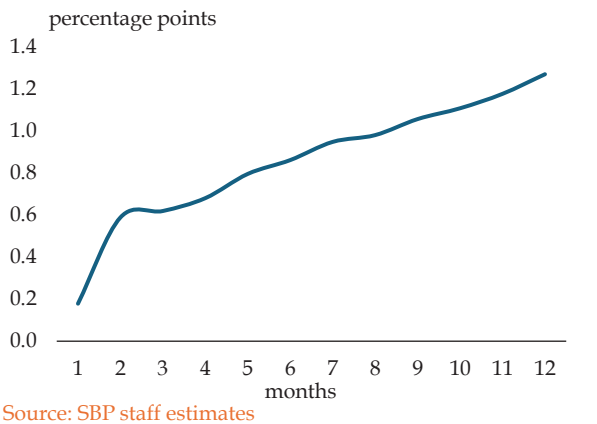
[58] Variables were recursively ordered using Cholesky decomposition.

Cumulative Response of CPI Inflation to a 10 percent Shock to Global Energy Price **Figure 3.2.1**



Source: SBP staff estimates

Cumulative Response of Food Inflation to a 10 percent Shock to Global Energy Price **Figure 3.2.2**



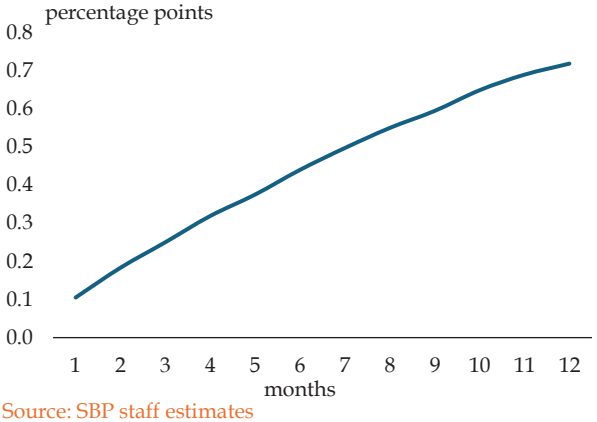
Source: SBP staff estimates

energy price index,[59] nominal exchange rate, CPI inflation, policy rate, large-scale manufacturing index, food inflation, expected inflation, and core inflation.[60,61]

The results show that a 10 percent increase in global energy prices raises CPI inflation by 1.2 percentage points after one year from the shock, with effects persisting for two years **(Figure 3.2.1)**. Food inflation increases by 1.3 percentage points after one year **(Figure 3.2.2),** while core inflation increases by 0.7 percentage points **(Figure 3.2.3)**. These estimates are in line with the findings of Ruch and Du Plessis (2015), Christine J. et al (2024),[62] Alp et al. (2023), Baba, C. & Lee, M. J. (2022) and Conflitti, C. & Luciani, M. (2017).[63]

In view of the above results, central bank should tighten monetary policy to address the potential second round effects of global energy price shock. Literature suggests that a timely and appropriate response minimizes uncertainty regarding their magnitude and helps in anchoring of inflation expectations to prevent them from becoming entrenched [Soderstrom (2002)]. Conversely, ignoring these effects risks entrenching inflation expectations, which later necessitates more aggressive tightening and results in a higher output loss to restore price stability.

Cumulative Response of Core Inflation to a 10 percent Shock to Global Energy Price **Figure 3.2.3**



Source: SBP staff estimates

**The contribution of Abdul Basit Alias Shahzad is acknowledged in writing this box.*

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[59] Global energy price is a composite index and comprises three key components including crude oil, natural gas and coal prices. Source: Pink Sheet available at https://www.worldbank.org/en/research/commodity-markets
[60] All the variables were non-stationary in levels.
[61] AIC criteria showed six lags were optimal for SVAR.
[62] The authors estimated that a 10 percent increase in Dubai crude prices leads to a combined (direct & indirect) effect on core and non-core which persists for 18 months and reaches its peak at 0.28 percentage points in 13th month.
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Box 3.3: Drivers of Fixed Investment Loans

Fixed investment loans in Pakistan grew by 8.3 percent in FY10 compared to 19.0 percent in FY26. Yet, their share in terms of GDP fell from 5.0 percent in FY10 to 2.9 percent in FY26 (**Figure 3.3.1**). This decline has implications for long-term growth potential, export competitiveness and job creation. This box analyses key drivers of fixed investment loans. The literature identifies policy uncertainty, real interest rates, capacity utilisation and operating profits as important determinants of fixed investment loans. Each of these is analysed in the context of Pakistan in the following.

Economic policy uncertainty

High economic policy uncertainty discourages firms from committing long-term debt (**Figure 3.3.2**). Latif & Siddiqi (2025) and Quddus et al. (2022) found significant negative effects of economic policy uncertainty on corporate investment. Addressing this issue requires ensuring predictability in the economy. This involves adopting credible fiscal frameworks, predictable energy policy, strengthening infrastructure, and ensuring stable macroeconomic environment.

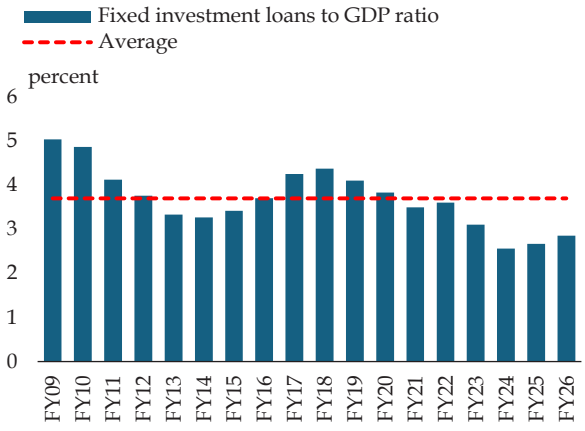
Borrowing cost

Increased borrowing cost is one of the factors impacting firm's long-term investment. Zahid et al. (2026) found that higher real interest rates reduce capital investment, especially during recessions **(Figure 3.3.3)**. In this regard, ensuring monetary policy credibility supports anchored inflation expectations and reduces the necessity for aggressive interest rate hikes. Furthermore, targeted government support for micro, small, and medium enterprises (MSMEs) can effectively lower borrowing costs for industrial sector.

Capacity utilisation

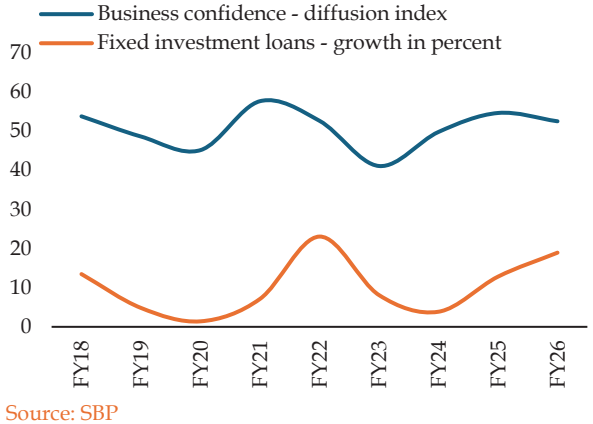
Lower capacity utilisation of manufacturing firms weakens investment demand, and vice versa [Artica (2023)]. Firms borrow to expand capital when utilization of existing plant is high, and demand is growing in the economy. Further, low-capacity utilisation also implies that firms are producing output at higher cost which constrains the profitability

Fixed Investment Loans to GDP Ratio **Figure 3.3.1**



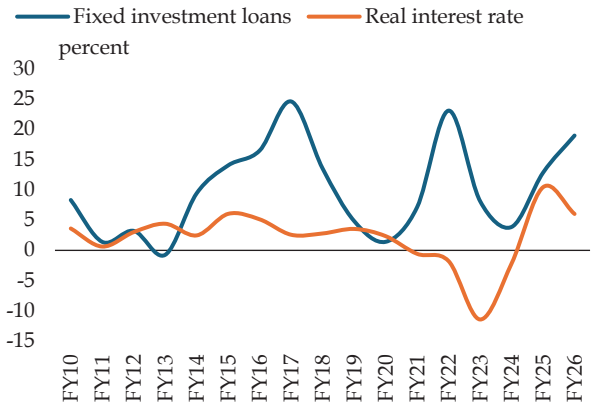
Source: SBP

Fixed Investment Loans and Business Confidence **Figure 3.3.2**



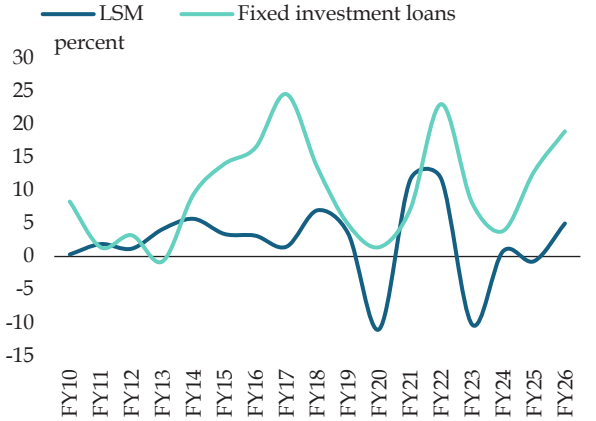
Source: SBP

Fixed Investment Loans and Real Interest Rate **Figure 3.3.3**



Source: SBP

Fixed Investment Loans and LSM Growth **Figure 3.3.4**



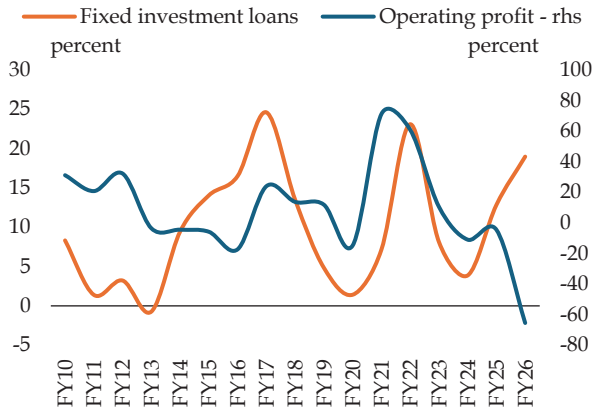
Source: SBP

and creditworthiness besides reducing their ability to service debt **(Figure 3.3.4)**. A stable macroeconomic environment, reliable infrastructure and greater export access can help provide stable environment for promoting sustained growth and exploiting the potential of the economy.

Operating profit

Increase in profitability positively influences businesses decision to invest for capacity expansion (**Figure 3.3.5)**. Moreover, increase in operating profit strengthens balance sheet of firms by enhancing their ability to pay long term loans. Larger capital-intensive firms with increased operating profits receive long-term debt at favourable terms compared to smaller firms [Saif-Alyousfi, A. Y. et al (2025)]. A stable macroeconomic environment that entails maintaining low and stable inflation, encouraging research and development and adoption of green technologies is likely to improve the operational performance of firms.

Fixed Investment Loans and Operating Profit **Figure 3.3.5**



Source: SBP

Conclusion

Reviving business fixed investment in Pakistan requires addressing core economic fundamentals. Key priorities include enhancing the credibility of macroeconomic policies, ensuring long-term macroeconomic stability, rationalizing taxes, and expanding capacity utilisation through infrastructure development and export promotion.

**The contribution of Abdul Basit Alias Shahzad is acknowledged in writing this box.*

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Box 3.4: Tracing the Auto Sector's Response to Monetary Policy

Globally, consumer credit is found to be sensitive to interest rate movements. The automobile sector provides a useful context for examining this important transmission channel, as auto loans make up more than one-third of consumer credit in Pakistan. Economic literature supports this view. Johnson et al. (2014) found that credit conditions are a significant determinant of vehicle purchases, with households more dependent on credit being particularly sensitive to financing conditions. Ustabaş & Buyun (2024) also confirm the sensitivity of automobile demand to financing conditions. **Figure 3.4.1** shows close movement between growth of real auto finance and automobile sales in Pakistan. Auto finance tends to weaken during tighter monetary conditions and recover when financing conditions ease (**Figure 3.4.2**). Against this background, this box examines whether changes in real auto finance are associated with subsequent changes in automobile sales in Pakistan. The analysis controls for vehicle availability through Completely Knocked Down (CKD) imports, workers' remittances (WR) and other relevant variables.

To assess this relationship, an Auto Regressive Distributed Lag (ARDL) model is estimated using monthly data from November 2008 to June 2026 (**Table 3.4.1**). The coefficient of real auto finance is found positive and weakly statistically significant, implying a one percentage point acceleration in real auto finance growth is associated with an increase in auto sales growth by about 3.2 percentage points. This provides evidence that auto finance is a relevant channel through which monetary conditions are transmitted to consumer demand. Remittances also impact sales positively, confirming that remittance-funded demand operates alongside financing. In addition, CKD imports affect sales with lags, especially at the fourth lag, suggesting that imported-kit availability matters for production, inventory and delivery of vehicles.

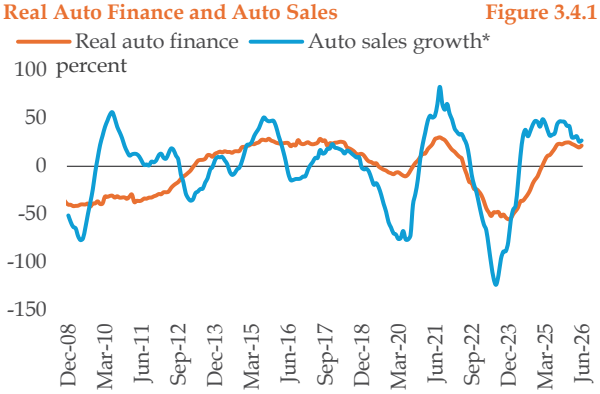
The role of CKD imports also underscores the importance of localisation. Since a large share of the value of each vehicle sold is imported, changes in auto financing are likely to be accompanied by changes in vehicle imports. Greater localisation would reduce the imported content of each vehicle and thereby weaken this link, allowing shifts

ARDL Results (Dep. Variable Automobile Sales) **Table 3.4.1**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Real auto finance	3.2	1.9	1.7	0.09
CKD imports	0.0	0.1	-0.2	0.86
CKD imports (-1)	0.3	0.1	3.0	0.00
CKD imports (-2)	0.1	0.1	0.5	0.61
CKD imports (-3)	-0.4	0.1	-3.7	0.00
CKD imports (-4)	1.0	0.1	10.5	0.00
WR	0.6	0.3	1.9	0.06
YOY_sales(-1)	0.1	0.1	2.6	0.01
YOY_sales(-2)	-0.1	0.1	-2.5	0.01
C	-12.2	6.0	-2.0	0.04
COVID_SHOCK_DUMMY	-233.2	41.6	-5.6	0.00
Adj R-squared	0.6			
F-statistic	34.4		Prob(F-stat)	0.00

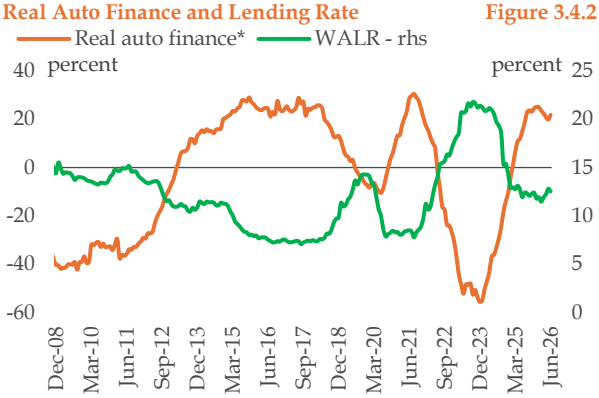
Note: All coefficients were tested for statistical significance at the 10% level.
CKD terms are jointly significant (Wald F = 30.2, p < 0.01).
LM test indicates no serial correlation.
Source: SBP staff estimates

Real Auto Finance and Auto Sales **Figure 3.4.1**



* Auto sales growth is measured as the six-month moving average of the growth rate in automobile unit sales.
Sources: SBP; PAMA

Real Auto Finance and Lending Rate **Figure 3.4.2**



* Real auto finance is calculated by adjusting auto finance for inflation.
Sources: SBP; PAMA

in financing conditions to influence domestic demand with less accompanying movement in the external account.

**The contribution of Muhammad Zuhaib is acknowledged in writing this box.*

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Box 3.5: Daily Fuel Price Adjustments and its Pass-through to Inflation

The government has progressively shortened the petroleum-pricing cycle during 2026 amid heightened global oil-price volatility, moving from fortnightly to weekly reviews in March, and then daily on July 17, 2026. The first single-day notification applied on July 21, after which OGRA began publishing daily ex-depot prices. The step shortened the administrative lag between changes in international costs and domestic prices and increased the frequency with which the pricing formula incorporates changes in market-linked costs.[64]

Daily pricing does not imply one-for-one indexation to the latest international quote. In fact, for motor fuel, OGRA uses seven-working-day averages of Platts Arab Gulf product prices and the PKR/USD exchange rate, alongside import costs, IFEM, regulated margins, levies and taxes.[65] OGRA determines and publishes the resulting ex-depot price without routine federal approval, while the government retains control over taxes, levies and regulated components. The system is therefore more market-linked but remains distinct from full retail deregulation.[66]

Why adjustment frequency matters for inflation?

Higher international energy prices first affect inflation directly through increase in fuel prices; depending on the duration and magnitude of the shock, higher fuel prices may subsequently pass-through to transport and production costs and, ultimately, food and other non-energy prices. More frequent adjustments change the speed and timing of pass-through from international fuel prices and the exchange rate movement to domestic pump prices.

Cross-country evidence indicates that the domestic pricing regime is an important determinant of fuel-price pass-through. Under the daily framework, overlapping seven-day averages allow changes in external costs to enter domestic fuel prices more promptly than under fortnightly pricing. Coady et al. (2012) show that automatic pricing formulas can preserve pass-through, while moving-average mechanisms smoothen short-term fluctuations. Daily pricing therefore reduces the administrative lag in first-stage transmission without implying one-for-one adjustment to daily international prices. Using data for 109 developing economies over 2000–2014, Kpodar and Imam (2020) find that pass-through is higher under more flexible pricing mechanisms, when international price movements are relatively moderate and less volatile.

Implications for inflation

For CPI inflation, however, a shorter transmission lag should be distinguished from the cumulative inflationary effect of the external shock. More frequent adjustment limits the accumulation of unpassed costs and, consequently, the need for relatively large discrete corrections in domestic fuel prices. Coady et al. (2012) show that automatic pricing mechanisms with smoothing can avoid prolonged periods of unchanged domestic prices associated with ad hoc pricing and the relatively large adjustments that may subsequently become necessary.

[64] Government of Pakistan, Petroleum Division, notifications for March 14, 21 and 28, 2026; Cabinet-approved revised pricing guidelines dated July 17, 2026; Petroleum Division, 'Petroleum Minister Consults Industry on Daily Pricing Reform,' July 18, 2026. The first single-day price applied on July 21, 2026.

[65] The HSD pricing framework was revised in August 2026 to benchmark prices to Dubai crude plus a diesel crack spread capped at US$ 41.89 per barrel, limiting the pass-through of exceptionally high international refining margins. The framework remains under review, including rules-based interventions for exceptional price shocks. Source: Petroleum Division

[66] OGRA, daily petrol and HSD price build-ups; Government of Pakistan, revised pricing guidelines, July 17, 2026. The Cabinet instructions specify seven working-day Platts averages and no routine federal or prime-ministerial approval; OGRA price sheets provide the detailed build-up.

More frequent adjustment also reduces discretion over the timing of formula-based price changes. Delaying pass-through does not eliminate the cost of an external shock; it may instead appear through foregone fuel-tax revenues, explicit or implicit subsidies, supplier balances, or larger subsequent price adjustments. A consistent pricing rule instead allows market-driven cost changes to pass-through in both directions and makes any decision to cushion their impact an explicit fiscal policy choice. This is particularly relevant when higher international energy prices require domestic demand to adjust to the adverse terms-of-trade shock.

Therefore, daily price adjustments impact the timing of the pass-through of the external shock to domestic prices rather than the underlying size of the external shock. The eventual impact on CPI impact, however, depends on the persistence of the shock and the strength of indirect and second-round effects.

**The contribution of Syed Hamza Ali and Mehreen Tariq Ghani is acknowledged in writing this box.*

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Box 3.6: Household Exposure to Energy Price Shock

The effects of Middle East conflict transmitted rapidly to domestic energy prices, raising energy inflation during Apr–Jun FY26 to around 31 percent in both urban and rural areas. The welfare consequences of such a shock, however, cannot be inferred from aggregate inflation alone. A common price shock can impose very different burdens across households because the level and composition of energy consumption vary with income, access to commercial fuels, transport use, location and other household characteristics. International evidence shows that differences in consumption baskets can generate substantial variation in households' exposure to energy shocks, although the incidence across income groups depends on country-specific consumption patterns and households' capacity to adjust expenditure (Battistini et al., 2023; OECD, 2023).

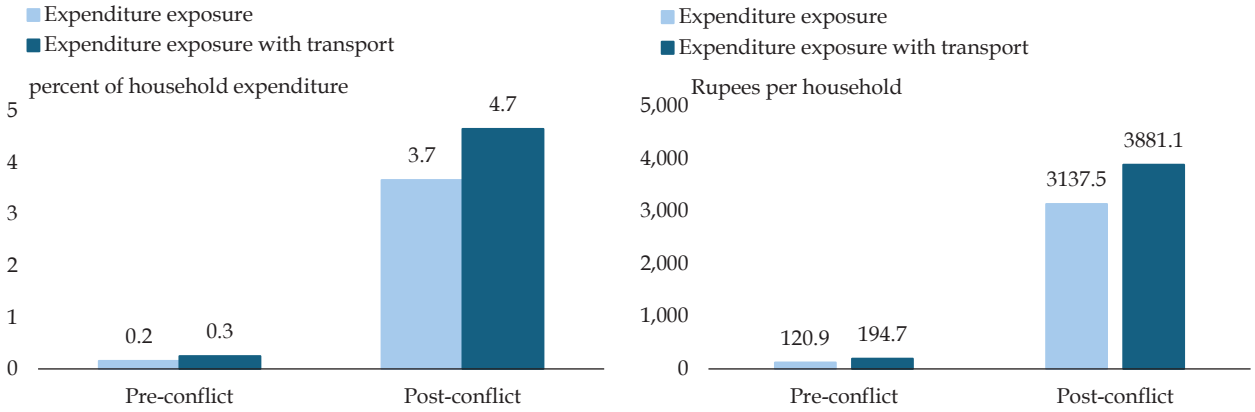
Against this backdrop, this box examines the distributional incidence of the recent energy price shock in Pakistan. It estimates the additional household expenditure required to maintain the pre-shock consumption bundle and examines how this expenditure burden varies across the consumption distribution and energy sources. The analysis identifies how the energy types, including electricity, motor fuel, natural gas, LPG and kerosene, and solid fuels, to the overall expenditure burden as well as the share of households facing relatively high exposure. In doing so, it complements aggregate inflation analysis with an assessment of the immediate purchasing-power implications of higher energy prices for households.

Methodology

The analysis combines channel-specific urban and rural CPI price changes with microdata for 30,123 households from HIES 2024-25. For each household, expenditure on electricity, natural gas, LPG and kerosene, solid fuels, and motor fuel is multiplied by the corresponding price change. The resulting increase in monthly expenditure is expressed as a share of the household's total monthly consumption expenditure to obtain a measure of direct household expenditure exposure. A broader measure adds purchased transport expenditure, assuming full pass-through of motor-fuel price increases to transport costs.

This methodology follows the household-budget approach used by Causa et al. (2022) and Hua and Shi (2024), which combines household-specific expenditure shares with category-level price changes to estimate the first-round distributional effects of price shocks. The estimates capture first-round expenditure exposure, and does not account for substitution across fuels, reductions in energy consumption, household-specific tariff slabs, income responses, transfers, or indirect pass-through to other goods and services.

Household Exposure to Energy Price Shocks **Figure 3.6.1**



Source: PBS; SBP staff estimates

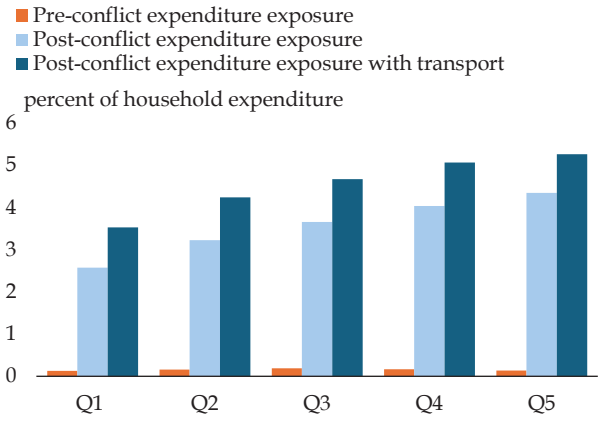
Results

The energy price shock substantially increased the expenditure required for households to maintain their pre-shock consumption bundle. On average, the additional expenditure for first consumption quintile rose from 0.15 percent of household consumption expenditure before the shock to 3.67 percent after the shock, equivalent to an increase from Rs 121 to Rs 3,137 per household per month. Including purchased transport raises the post-shock expenditure requirement to 4.65 percent of household consumption, or Rs 3,881 per month (**Figure 3.6.1**).

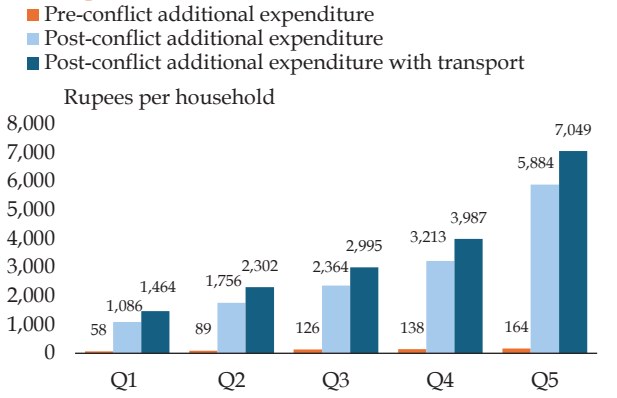
The expenditure burden increases along the consumption distribution. Post-conflict direct exposure rises from 2.57 percent for the first consumption quintile to 4.34 percent for the fifth consumption quintile; including transport increases the corresponding burden to 3.53 and 5.27 percent (**Figure 3.6.2a and 3.6.2b**). The difference is considerably larger in rupee terms: the additional monthly expenditure required to maintain the same consumption bundle increases from Rs 1,086 in the first consumption quintile to Rs 5,884 in the fifth consumption quintile. Thus, households in the fifth consumption quintile incur around 5.4 times the rupee loss of those in the first consumption quintile, compared with about 1.7 times their proportional exposure.[67]

The rising expenditure burden across the consumption distribution differs from the regressivity of energy shocks often documented in advanced economies, where lower-income households typically allocate larger budget shares to utilities and heating (Battistini, Bobasu and Gareis, 2023; Causa et al., 2022). For Pakistan, the result points to differences in commercial-energy consumption across the expenditure distribution. Higher-consumption households

Energy Exposure by Consumption **Figure 3.6.2a**



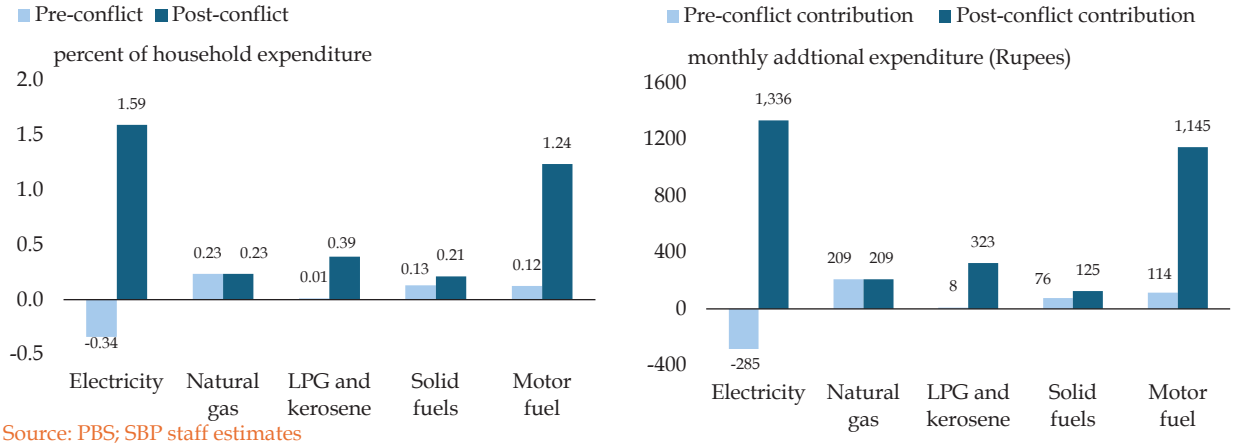
Monthly Cost of Energy Price Shocks by Consumption Quintile **Figure 3.6.2b**



Source: PBS; SBP staff estimates

[67] When measured against reported household income, the additional post-conflict expenditure equals around 5 percent for Q1 and 18 percent for Q5, indicating the greater commercial-energy use of higher-consumption households.

Household Energy Exposure by Source Figure 3.6.3



Source: PBS; SBP staff estimates

tend to have greater access to commercial energy, higher appliance ownership and greater private mobility, increasing their expenditure on electricity, gas and motor fuel. Lower-consumption households may consume less commercial energy or rely more on non-purchased fuels, which lowers their measured direct exposure.[68]

The composition of the shock further explains the distributional pattern. Electricity and motor fuel dominate household exposure, contributing 1.59 and 1.24 percentage points, respectively, to the post-conflict direct expenditure burden. Together, they account for about 77 percent of the estimated proportional exposure and nearly four-fifths of the additional monthly expenditure. LPG and kerosene contribute 0.39 percentage point, while natural gas and solid fuels add 0.23 and 0.21 percentage point, respectively (**Figure 3.6.3**).

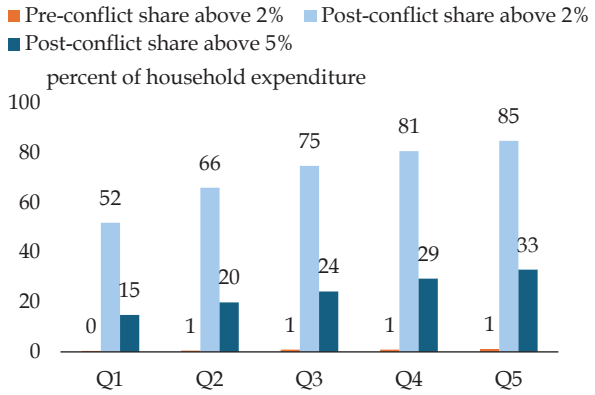
Average exposure by consumption quintile, however, conceals substantial dispersion within each group. Before the shock, no more than around 1 percent of households in any consumption quintile had direct expenditure exposure above 2 percent of household consumption. In post-shock, this share rises from 52 percent in the first consumption quintile to 85 percent in the fifth consumption quintile. More severe exposure, above 5 percent of household consumption, affects 15 percent of households in the first consumption quintile and 33 percent in the fifth consumption quintile (**Figure 3.6.4**).[69]

Policy implications

The government policy decision to fully pass on the increase in global energy prices to domestic prices was intended to curb energy demand and limit the fiscal burden associated with suppressing prices. This was particularly relevant for higher-consumption households, who account for greater energy consumption and, as the results show, face substantially larger expenditure increases following the shock. Higher prices therefore place greater incentives for demand adjustment where energy consumption is relatively high.

At the lower-end of the consumption distribution, however, lower measured exposure does not imply a greater capacity to absorb the shock. Lower-income

Share of Households with High Energy Exposure Figure 3.6.4



Source: PBS; SBP staff estimates

[68] The result should not be interpreted as evidence that poorer households are better able to absorb the shock. Direct exposure measures the size of the price exposure, not savings, liquidity, food security or access to coping mechanisms.

[69] These figures are not comparisons of a quintile average with a threshold. Each of the 30,123 sampled households is first classified using its own energy spending and total consumption; the chart then reports the survey-weighted share crossing the threshold within each quintile.

households have less room to accommodate higher energy costs and may have to reduce energy use or compress expenditure on other essential goods and services. This strengthens the case for targeted support rather than generalised price suppression, allowing vulnerable households to be protected while preserving price signals and the intended demand response among higher-consuming households. The government's move toward targeted subsidies is also supported by earlier evidence that generalised electricity subsidies disproportionately accrue to better-off households (Trimble et al., 2011; Walker et al., 2017). At the same time, the presence of highly exposed households even in the lower consumption quintiles suggests that targeting based solely on consumption levels may overlook vulnerable households; incorporating energy exposure could further improve the incidence of support.

**The contribution of Syed Hamza Ali is acknowledged in writing this box.*

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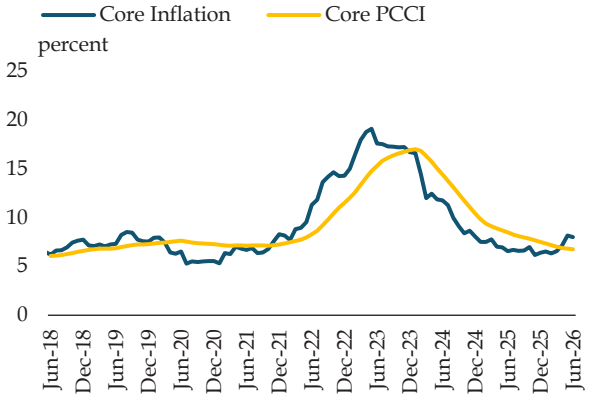
Box 3.7: Decomposition of Core Inflation into Common and Transitory Components

The literature on core inflation emphasizes the need to separate persistent economy-wide inflation from relative-price movements and other transitory item-specific disturbances (Bryan and Cecchetti, 1994; Quah and Vahey, 1995; Stock and Watson, 2016). This distinction is important for monetary policy conduct because persistent inflation driven by common factors is more relevant for assessing underlying inflationary pressures than temporary movements arising from changes in price of an individual item.

To achieve and maintain price stability, a central bank generally responds to economy-wide shocks that affect a broad range of goods and services and hence the general price level rather than temporary movements in individual prices due to sector-specific factors. The common inflation component is intended to capture price changes attributable to economy-wide factors, including capacity utilisation, movements in non-labour input costs such as commodity prices, and changes in the prices of imported goods and services. This box estimates the persistent and common component of core inflation (Core-PCCI) in Pakistan during FY20–26 from monthly item-level core CPI inflation using Principal Component Analysis (PCA), following the framework of Bańbura and Bobeica (2020).

The measure summarises the common movement across core items and retains its persistent part. The estimation results are shown in **Figure 3.7.1**. The difference between core inflation and Core-PCCI represents idiosyncratic components. During FY20 and FY21, before the inflation surge, observed core inflation and Core-PCCI remained broadly close, although short-lived differences emerged. This narrow gap suggests that observed movements in core inflation were largely explained by changes in the common component, with only a limited role for item-specific factors. During FY22 and FY23, observed core inflation rose above Core-PCCI. This divergence indicated that sector specific factors had a greater influence on core inflation during this period.

Core Inflation vs Persistent Component of Core Inflation **Figure 3.7.1**



Source: SBP staff estimates

From FY24 through FY26, observed core inflation declined more rapidly than Core-PCCI, causing the persistent common component to remain above conventional core inflation for much of this period. This widening gap suggests that favourable item-specific movements contributed more to observed disinflation, while persistent economy-wide price pressures eased more gradually due to the lingering impact of earlier shocks on production costs and price-setting behaviour. The gap subsequently reversed towards the end of FY26 as core inflation picked up, while Core-PCCI continued to ease, suggesting that the recent increase was largely associated with item-specific rather than common price pressures.

Overall, the persistence of the common component above observed core inflation for much of FY24–FY26 suggests that underlying price pressures receded more gradually than indicated by conventional core inflation. Core-PCCI can therefore provide a useful complementary gauge of underlying inflation by filtering out item-specific movements and focusing on price changes that are common across the core basket and persistent over time.

**The contribution of Syed Hamza Ali is acknowledged in writing this box.*

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