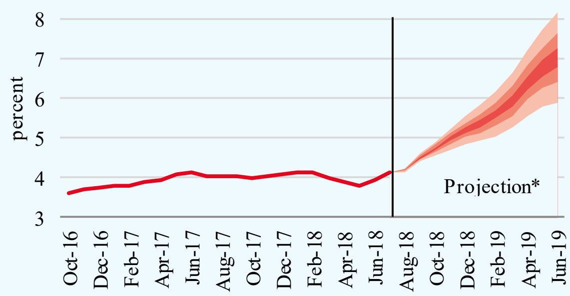
3 Monetary Policy and Inflation

3.1 Overview

The monetary policy environment remained challenging throughout FY19, as macroeconomic stress – manifested in rising core and headline inflation, low level of foreign exchange reserves and large twin deficits – continued to persist despite policy measures taken last year. While the economy was already bracing for a policy-led slowdown along with a more flexible exchange rate regime, it also had to put up with speculations with respect to the decision on the IMF program. Moreover, to comply with international regulatory standards and also to broaden the tax base, the government scaled up its documentation efforts and tightened financial scrutiny. All of this weakened the confidence of businesses and consumers, which sparked volatility in currency and equity markets, increased cash penetration in the economy, and slowed down deposit mobilization in the banking system.[1] While the ongoing structural measures will take some time to settle down before financial markets and businesses could stabilize and firmly reposition, the SBP continued to maintain tight monetary conditions to manage demand and anchor inflation expectations. The SBP's monetary policy committee (MPC) increased the policy rate in all six decisions during the year, by a cumulative 575 bps.

The foremost concern was the steady increase in headline inflation. Here, the impact of demand overhang was exacerbated by rising cost pressures in the economy, as the government pushed up administered energy prices in an attempt to limit its current expenses amid growing fiscal constraints. Not only did this escalate inflation in the energy and transport components of the CPI basket, but it also had a spillover impact on other food and non-food items. A similar pressure came from the pass-through of the ongoing, as well as the earlier, depreciation of Pak rupee on prices of imported goods, and goods with heavy imported content. Making things worse, food inflation rose steeply during the 4th quarter, which reflected weaknesses in the intervention mechanism and monitoring system in wheat and sugar markets, and the absence of an immediate contingency plan to cope with crop damages and disruptions in the distribution chains. As a result, the inflation outlook, which already projected a higher-than-target outcome at the start of the year (**Figure 3.1**), became more challenging through the course of it. The persistence of large twin deficits did not help either; in fact, this triggered significant upside risks to the near-to-medium term inflation outlook.

Figure 3.1: CPI Inflation Projections at the Start of FY19
(12 Months Moving Average Inflation)



*Probability distribution of risks around the average point forecast of 6.8 pecent. Shades indicate various levels of confidence interval.
Data source: SBP projections (July 2018)

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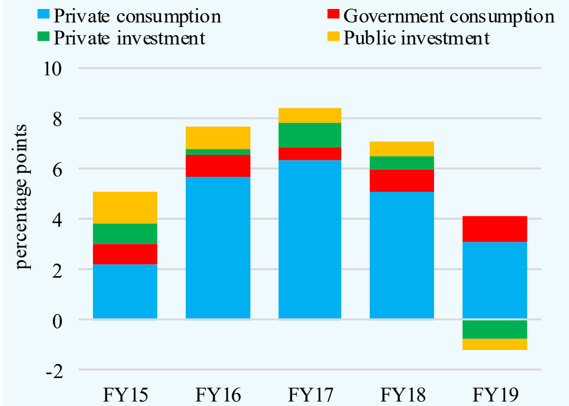
[1] The overall deposit growth had weakened to 3.9 percent in the first 11 months of FY19, compared to 4.8 percent in the same period last year. However, in the month of June 2019, a steep rise in deposits was observed, when the government announced the withdrawal of Rs 40,000 bearer prize bond (latest by March 31, 2020). These bonds can be converted into Premium Prize bonds, replaced with Special Saving Certificates (SSC)/Defence Savings Certificates (DSC), or encashed at face value through bank accounts. Under this scheme, Rs 64.8 billion worth of Rs 40,000 bonds were encashed in June 2019, with some of the corresponding Rupee value placed with banks as deposits. Excluding the impact of June 2019, the average currency-to-deposit ratio remained at an elevated level of 39.4 percent, compared to 36.8 percent in FY18.

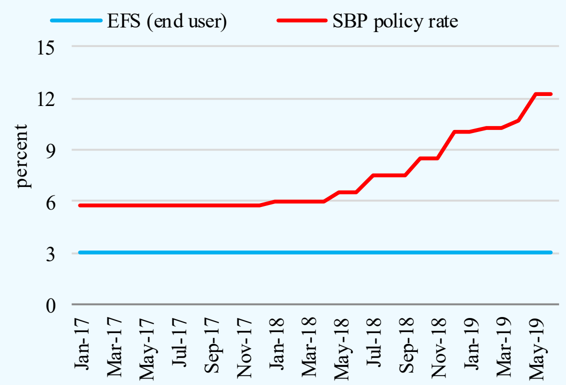
Specifically, although import compression measures helped bring down FX payment pressure in the economy, the official foreign exchange reserves remained below the standard adequacy level (3-month import cover). This led the Pak rupee to depreciate at frequent intervals. On the fiscal front, a sharp rise in current spending and a slowdown in revenue collection more than offset the impact of the cut in PSDP. The resultant higher deficit ran the risk of diluting the impact of consolidation efforts, especially when its financing was increasingly made by borrowings from the SBP. Nonetheless, the combined impact of a decline in PSDP spending, the depreciation of Pak rupee, and other regulatory and administrative measures was significantly noted on private consumption and investment (**Figure 3.2**). The efforts specifically dented activities in the industrial sector, which typically generates nearly 61 percent of businesses' credit demand.

Figure 3.2: Composition of Growth in Domestic Demand



Data source: Pakistan Bureau of Statistics

Figure 3.3: Trend in SBP Policy Rate and End-user Rate of Export Finance Scheme (EFS)



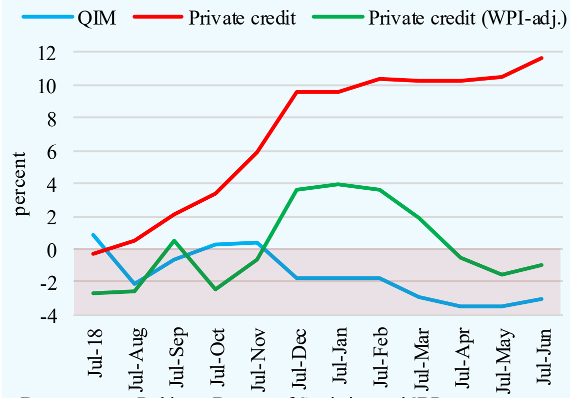
Data source: State Bank of Pakistan

Surprisingly though, the offtake of private credit was quite upbeat in the first half of the year, despite the fact that the LSM activity had begun to fall since the beginning of FY19. This trend can be explained by heavy borrowings by export-oriented industries for working capital during the period, as interest rates under the SBP's subsidized loan schemes (already at historic low levels) have been kept unchanged (**Figure 3.3**). Around 25 percent of manufacturing loans were taken under these schemes during the year. However, it is important to note that while export quantums of these industries posted improvement over the last year (especially value-added textiles, basmati rice and leather footwear), a sharp increase in raw material prices also had a major role in escalating their borrowing requirements. For instance, rice and cotton were available in the domestic wholesale market at prices 11.2 percent and 25.2 percent higher than last year. Similarly, the depreciation of the Pak rupee had also increased the cost of imported inputs, such as dyes and chemicals. Non-exporting industries, too, faced the brunt of the rising cost of both energy and non-energy components (such as iron and steel bars).

Another important aspect of private credit was the slowdown in fixed investment loans. Three factors contributed to this trend: (i) as PSDP spending fell and early-harvest projects under the CPEC approached completion, the investment activity in the energy and transport sectors weakened; (ii) this impact was reinforced by the expected end to the recent capex cycle in the manufacturing sector, and the scheduled repayments associated with earlier capex in energy, manufacturing and construction sectors; and (iii) a general wait-and-see approach observed across the business community in response to steep movements in exchange rate and interest rates; moreover, there have been general apprehensions about growing emphasis on documentation and tax efforts. Nonetheless, as was the case in working capital loans, the depreciation of the Pak rupee also escalated the cost of imported machinery, which was reflected in higher offtake of fixed investment loans by textiles, sugar and power generation and distribution sectors.

Although cost pressures persisted in the later months of the year, the overall credit momentum weakened significantly as the economic slowdown deepened and steadily spread across a number of sectors. For the full year, the private credit offtake posted a growth of 11.6 percent in FY19 compared to 14.9 percent last year. However, after adjusting with movements in the WPI index, the offtake in overall private credit this year was much subdued (**Figure 3.4**).

Figure 3.4: Cumulative Trend in Manufacturing Index and WPI-adjusted Private Credit



Data sources: Pakistan Bureau of Statistics and SBP

With the cost-driven momentum in private credit and heavy fiscal borrowings, the overall growth in money supply in FY19 was higher than last year. Furthermore, the composition of M2 growth remained heavily skewed towards public sector borrowings, which implies that fiscal discipline needs to be maintained to enhance effectiveness of monetary policy tightening. This is going to be a complex task going forward, given the fact that the outsized stock of government's domestic debt has already been repriced following the steep rise in the policy rate: in FY20, the government has estimated its mark-up expense to increase by 45.5 percent compared to FY19, eating up more than half of the FBR's estimated tax revenues. Under these circumstances, effective implementation of monetary policy will hinge upon management of the primary balance, and commercial banks' portfolio choice. As for the government, it has set a much lower target for the primary deficit next year under the IMF program; committed not to take additional budgetary financing from SBP; and devised a plan to gradually reduce the existing outstanding stock of debt held by the central bank.[2] Furthermore, to address unwarranted liquidity requirements, the government has recently approved the Cash Management and Single Treasury Account Policy 2019-2029.[3] These measures are expected to contribute positively towards monetary policy transmission going forward.

While these improvements are welcome, fresh challenges have emerged with respect to the formulation and effectiveness of monetary policy, and the overall stability of the financial sector. First, the administrative measures to control the level and volatility in food prices have had been sub-optimal during the year, to say the least. In case of important commodities such as wheat and sugar, the surge in prices during Q4-FY19 seems to be an outcome of the absence of an effective mechanism of measuring available stocks in the country, delayed decisions with respect to managing demand conditions, and also weak administrative control over collusive behavior and hoarding practices across the distribution chain. Furthermore, to ensure smooth availability of minor crops (fruits and vegetables), the country seems to be lacking a contingency plan in case damages are done to domestic crops and/or geopolitical factors constrain timely import from immediate neighbors. The increase in food inflation, if it persists, can prove counterproductive to disinflationary measures taken by the SBP.

The second challenge pertains to the growing cash penetration in the economy. The currency-to-deposit ratio, which has been on an increasing trend ever since the government imposed withholding

[2] To this end, the stock of mostly short-term government debt held by the SBP has already been re-profiled into PIBs of various maturities by end-June 2019.
[3] This policy is aimed at ensuring an efficient and integrated cash management system to restrain deficit monetization.

tax on non-cash based transactions, increased further in FY19 to 39.4 percent against last year's average ratio of 36.8 percent. Importantly, the regulatory environment is getting even more challenging for deposit growth in the country, especially in the light of apprehensions regarding sharing of depositors' data with tax authorities; tightening of the noose around tax evasion and short-filing; stiff competition from alternative savings instruments; and intense monitoring with respect to money laundering and terror financing. As mentioned before, these concerns would linger for some time before banks and the general public would get attuned to increased financial scrutiny and implementation of international regulatory standards. In the meantime, it is important to ward off any unwarranted pressure on bank deposits; one recommendation is to remove the withholding tax on non-cash transactions for all customers. Moreover, banks also need to effectively engage with their customers to address their due concerns, and step up efforts to provide convenient and lucrative solutions for their savings needs.

Finally, the macroeconomic challenges have raised some concerns with respect to banks' asset quality. Specifically, the banks' non-performing loans (NPLs), which began to creep up since Q2-FY19, continued to increase through the rest of the year. On a yearly basis, gross NPLs posted a growth of 23.2 percent, which is the highest growth observed since FY11. Importantly, the impairment in asset quality was observed in both gross and net terms, even though banks have provided for most of the delinquencies.[4]

3.2 Monetary Aggregates

The broad money grew by Rs 1.8 trillion in FY19 compared to Rs 1.4 trillion last year. Though the contraction in the NFA was significantly higher compared to last year, the overall increase in the NDA – due to sizable budgetary borrowings – more than offset the decline in NFA.

Within NFA of the banking system, the SBP's NFA shrunk by Rs 1.1 trillion, whereas that of scheduled banks' recorded a net contraction of Rs 159 billion. In case of the central bank, this fall was mainly on the back of borrowings from other countries and international organizations in order to provide a support to FX reserves amidst challenges on the external front. As for the NDA, the higher growth in FY19 represented a steep rise in budgetary borrowings and credit to public sector enterprises, which more than offset the lower offtake in credit to the private sector as compared to last year (**Table 3.1**).

Table 3.1: Monetary Aggregates ^{P}
billion rupees

	Abs. change in stocks		Growth rate in percent	
	FY18	FY19	FY18	FY19
M2 (A+B)	1,416.3	1,801.3	9.7	11.3
A. NFA	-810.5	-1,298.7	-134.6	-623.1*
B. NDA	2,226.8	3,100.0	15.9	19.1
Government borrowing	1,244.1	2,137.9	13.9	21.0
Budgetary borrowing	1,110.9	2,204.4	13.4	23.5
SBP	1,263.3	3,079.3	53.8	85.2
Scheduled banks	-152.4	-875.0	-2.6	-15.1
Commodity operations	133.2	-63.3	19.4	-7.7
Non-government borrowing	1,022.3	1,021.7	17.0	14.5
Private sector	775.5	693.5	14.9	11.6
PSEs	245.4	326.0	30.7	31.2
Reserve money	616.7	1,088.8	12.7	19.9

^{P}: Provisional
* Outstanding stock at end June 2018 was Rs -208.4 billion and at end June 2019 was Rs -1,507.1 billion.
Data source: State Bank of Pakistan

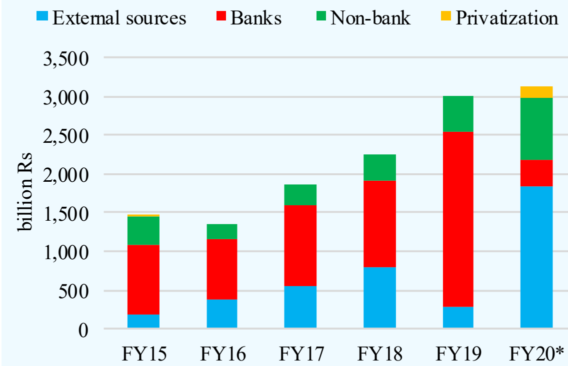
Government budgetary borrowings

The government's budgetary borrowings from the banking system doubled during FY19 compared to last year. This increase represented: (i) a large fiscal deficit, an outcome of a shortfall in revenue collection and higher than budgeted interest payments and defense expenditures; and (ii) a sharp decline in the availability of external financing during the year, which largely offset the impact of higher debt mobilized via NSS instruments and money market funds (**Figure 3.5**).

[4] While gross NPLs as percent of total loans have increased from 7.9 percent at end-June 2018 to 8.8 percent by end-June 2019, net NPLs to loan ratio has increased from 1.1 percent to 2.1 percent during the same period.

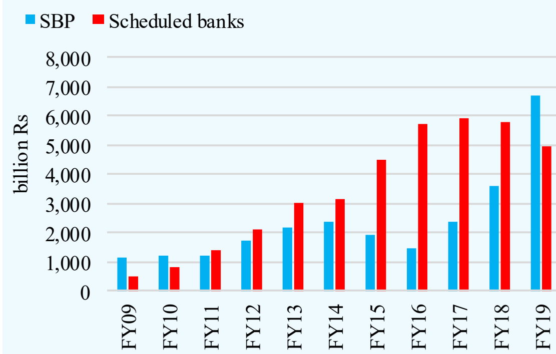
Within the banking system, the government borrowing remained heavily skewed towards the central bank. Borrowing an all-time-high of Rs 3.1 trillion from the SBP to bridge fiscal imbalances, the government retired Rs 875.0 billion debt held by commercial banks. It appears that in the wake of growing fiscal constraints, the government gave more weight to cost-effective mobilization while managing public debt. Consequently, the outstanding budgetary support from the central bank surpassed the outstanding level of government borrowings from scheduled banks for the first time since FY11 (**Figure 3.6**). While these borrowings were in clear violation of the SBP Act, which stipulates zero quarterly borrowing from the central bank, it also fueled growth in reserve money, risking additional inflation in the economy.

Figure 3.5: Financing of Fiscal Deficit



* budgeted
Data source: State Bank of Pakistan

Figure 3.6: Outstanding Stock of Budgetary Borrowings from the Banking System



Data source: State Bank of Pakistan

T-bill auctions

In gross terms, banks offered Rs 23.3 trillion in T-bill auctions against the cumulative target of 19.5 trillion. These large volumes mainly represented repeated rollovers of 3-m papers during the 26 auctions held during the year. If maturities are netted out, the banks' total offers fall to Rs 4.1 trillion, of which the government's acceptances stood at a *negative* Rs 307.3 billion.

Scheduled banks had been expecting an upward interest rate trajectory almost throughout the year, keeping in view the trend in inflation and the growing BoP stress (**Table 3.2**). Since the monetary policy committee was meeting every two months, and banks were expecting a rate increase in nearly all the decisions, their perceived duration risk for all the tenors was quite sizable (certainly, it was less in case of 3-m paper).[5] Importantly, this risk was embedded in their bids in T-bill auctions, which were held every fortnight. Therefore, the banks preferred to bid only in 3-m paper: their combined offered volume in 6-m and 12-m papers was not even 1.0 percent of the total offers. And even in case of 3-m paper, it was observed that the deviation of the maximum bid from the cut-off was fairly large, especially in auctions that were held during the first half of the year.

In contrast, the government was already struggling with a large carryover stock of public debt and mark-up payments and was, therefore, defying market expectations of rate hikes. Thus, while the banks priced in their expectations of future interest rate increases in their bids, the government was only passing on previous policy rate increases to the auction cut-off rates. As a result, in nearly half of the T-bill auctions held during the year, the net-of-maturity acceptances by the government remained negative. By the end of October 2018, almost the entire stock of 6-month and 12-month paper was matured and banks were left with only 3-month paper in their fixed-income portfolio. This

[5] Duration is the sensitivity of the price of a bond to changes in interest rates.

trend had negative implications for the government in terms of the heightened roll-over risk amid frequent voluminous maturities.

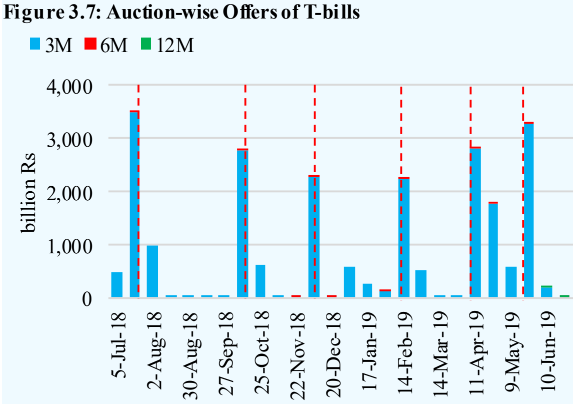
Table 3.2: Monetary Policy - Market Expectations

Month	Expectations of Policy Direction (Majority)	Details of Voting (SBP MPC Market Pulse)	Bloomberg Survey
Jul-18	Increase	61 percent ⇨ 50 bps hike 22 percent ⇨ 100 bps hike 17 percent ⇨ 25 bps hike	48 percent ⇨ 50 bps hike 43 percent ⇨ 100 bps hike 10 percent ⇨ 150 bps hike
Sep-18	Increase	50 percent ⇨ 50 bps hike 32 percent ⇨ 100 bps hike 18 percent ⇨ no change	56 percent ⇨ 50 bps hike 30 percent ⇨ 100 bps hike 7 percent ⇨ no change 7 percent ⇨ 75 bps hike
Nov-18	Increase	78 percent ⇨ 100 bps hike 11 percent ⇨ 150 bps hike 11 percent ⇨ no change	74 percent ⇨ 100 bps hike 19 percent ⇨ 50 bps hike 3 percent ⇨ 75 bps hike 3 percent ⇨ 200 bps hike
Jan-19	No Change	71 percent ⇨ no change 29 percent ⇨ 50 bps hike	83 percent ⇨ no change 13 percent ⇨ 50 bps hike 3 percent ⇨ 100 bps hike
Mar-19	Increase	47 percent ⇨ 50 bps hike 26 percent ⇨ 25 bps hike 16 percent ⇨ 100 bps hike 11 percent ⇨ no change	42 percent ⇨ 50 bps hike 42 percent ⇨ 25 bps hike 10 percent ⇨ 75 bps hike 3 percent ⇨ no change 3 percent ⇨ 100 bps hike
May-19	Increase	47 percent ⇨ 50 bps hike 47 percent ⇨ 100 bps hike 6 percent ⇨ 75 bps hike	52 percent ⇨ 100 bps hike 17 percent ⇨ 125 bps hike 14 percent ⇨ 150 bps hike 10 percent ⇨ 50 bps hike 7 percent ⇨ 75 bps hike

Data source: State Bank of Pakistan and Bloomberg

A common trend witnessed across all T-bill auctions was that the banks' participation remained upbeat in the auctions (for 3-month paper only) held right after the announcement of monetary policy; in subsequent auctions, their participation lessened (**Figure 3.7**). In its place, banks increasingly used OMOs as an alternative avenue to temporarily park their funds until the announcement of the next monetary policy. This strategy was convenient from the banks' perspective, since the SBP had been regularly conducting these OMOs to keep the overnight rates close to the target rates.

Figure 3.7: Auction-wise Offers of T-bills

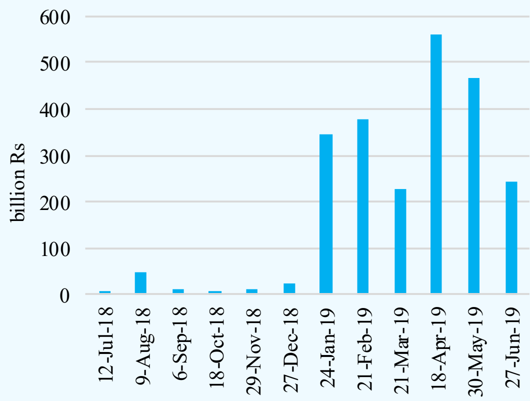


* red dotted lines represent MPC meeting dates
Data source: State Bank of Pakistan

PIB Auctions

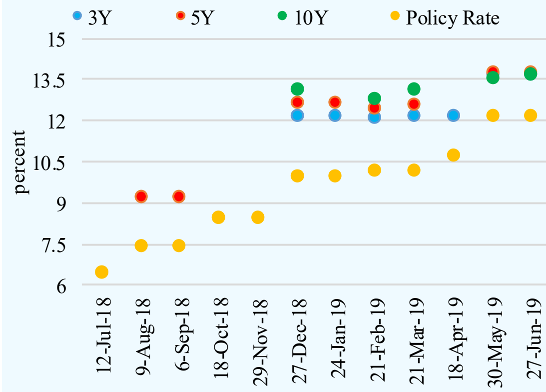
In case of PIBs, while the duration risk perception of commercial banks was the same as for T-bills, the government followed a different strategy. After observing the banks' lackluster participation in PIB auctions during the first 5 months of FY19, the government gave a steep rise in the cutoff yield in the auction held in December 2018. Although the banks did not participate actively in this auction as well, the signal they got for subsequent auctions was important. From January 2019 onwards, the participation in PIB auctions gained momentum, as the market found the prevailing cutoff yield lucrative enough to lock funds for the long term (**Figure 3.8a** and **b**). Furthermore, based on a visible moderation in domestic demand, flattening core inflation and improvement in the current account balance, interest rates were perceived to have neared plateau. Importantly, in the last two auctions of fixed rate PIBs of FY19, the highest amount of offers were placed in the 10-year paper: around 44.1 percent (May 2019) and 52.8 percent (June 2019) of the total bids were received for the 10-year paper.

Figure 3.8a: Auction-wise offers for Fixed Rate PIBs



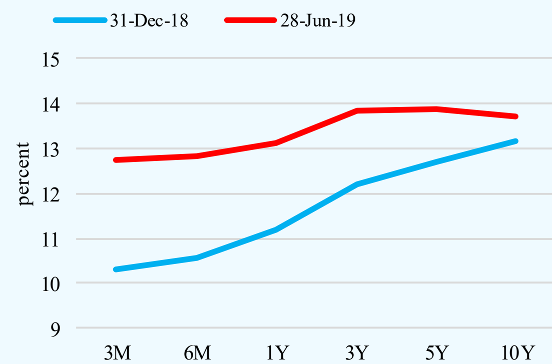
Data source: State Bank of Pakistan

Figure 3.8b: Narrowing of Spread between Policy rate and PIB cut-off rates



The yield curve also validates these expectations, as after showing a steep upward trend at the beginning (and by the middle) of this year, it flattened by the end of FY19. Importantly, the spread between 10-year and 3-year paper also turned negative in June 2019, thereby leading to a slight inversion at the longer end of the yield curve (**Figure 3.9**). Going forward, such developments will help the government increase the average maturity of its outstanding debt.

Figure 3.9: Yield Curve



Data source: MUFAP

On the other hand, the market for floating rate PIBs is developing gradually. Against the target of Rs 850 billion, offers amounting Rs 706.3 billion were received (**Table 3.3**). However, a majority of these offers were made at a higher margin relative to the prevailing rate. Eventually, on the very last auction of the fiscal year, the government opted to increase the margin of floating rate PIBs by 5 bps since none of the bids were received at the previous cut-off margin. It is important to recall here that this was the second instance when the margin of this security was increased since its first issuance in May 2018. Last time, it was increased by 20 bps in August 2018 to 70 bps.

The margin serves as the compensation for the term and liquidity premium for this bond. Since this is a relatively new instrument in the market, the associated liquidity risk is a bit on the higher side, which is primarily the reason the market is demanding a higher cut-off. Nonetheless, such frequent changes in the margin are not desirable for the development of the secondary market for this particular bond. An important development that came towards the close of the fiscal year was the amendment in the determination of coupon. Previously, it was linked only to the weighted average yield of the latest successful 6-month T-bill auction; but as per the new instructions, in case the latest 6M T-bill auction was either scrapped or there was no participation from the market, the PKRV rates would be used as an alternative benchmark.[6] The new method will help mitigate the risks associated with excessive reliance on the primary auction rates.

Table 3.3: PIB Auction Summary

billion Rupees

	Target	Maturity	Offers	Accepted
Fixed Coupon				
FY17	800.0	1,427.3	1,757.9	894.0
FY18	900.0	1,123.4	347.5	101.7
FY19	800.0	843.6	2,350.9	873.5
Floating –Rate				
FY18	100.0	-	296.1	43.1
FY19	850.0	-	706.3	311.7

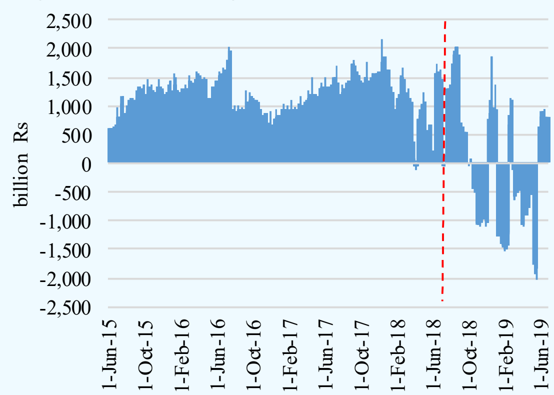
Data source: State Bank of Pakistan

Liquidity Management

In terms of the frequency and volume of central bank interventions, FY19 emerged as a unique year. The interbank money market witnessed several episodes of outsized liquidity swings that required massive interventions in both directions (**Figure 3.10**). The year also witnessed the highest level of net absorption (Rs 2.0 trillion) at one point, ever since the corridor facility was put in place.

The entrenched liquidity problems in the interbank market were associated primarily with developments in the primary government bond market (as detailed in section 3.2). Moreover, a strong momentum in private credit

Figure 3.10: Outstanding OMOs



Data source: State Bank of Pakistan

Table 3.4: Snapshot of Open Market Operations

		FY16	FY17	FY18	FY19
Interventions	No. of Mop-up	10	6	13	91
	No. of Injections	92	78	77	39
	Vol of OMO Mop-up (billion Rs)	546.4	415.4	1,397.4	40,108.3
	Vol of OMO Injections (billion Rs)	67,599.7	58,420.6	66,534.8	27,307.9
Discount Window	No. of visits on Discount Window	73	58	47	88
	No. of visits Ceiling	52	35	37	54
	No. of visits Floor	21	23	10	34
	Vol of Discount Window Operations	3,285.1	1,301.0	1,018.4	3,325.0
	Vol Ceiling (billion Rs)	2,754.8	935.7	838.9	2,491.9
	Vol Floor (billion Rs)	530.4	365.4	179.5	833.2
	No. of Banks on Ceiling	167	70	79	124
	No. of Banks on Floor	69	40	18	67
Overall	No. of Days when outstanding OMO was -ve	0	0	12	189
	No. of Days when outstanding OMO was +ve	366	365	353	167

Data source: State Bank of Pakistan

[6] DMMD Circular No. 16 of 2019 dated June 25, 2019

during H1-FY19 and its abrupt weakening in the second half, also undermined liquidity management and forecasting for bank treasuries. Therefore, the SBP had to scale up the frequency and volume of its open market operations in order to stabilize the money market rates close to the policy rate (**Table 3.4**). However, despite this elevated level of interventions, the commercial banks' resort to the discount window facility was quite frequent. In particular, the banks' recourse to the discount window coincided with open market operations on 41 instances; of these, on nearly half the days, the direction of intervention and discount window operation was identical. This highlights the prevailing inefficiencies in the money market, which makes it challenging for the banks to: a) accurately forecast their overnight cash flow needs; and b) place their surplus funds or meet their borrowing needs without relying on the SBP.

Commodity Operations

Commodity operations recorded a net retirement of Rs 63.3 billion during FY19 compared to an increase of Rs 133.2 billion last year (**Table 3.5**). These retirements mainly reflected the ease in cash flow of wheat procuring agencies, which were able to pay back Rs 73.1 billion to the banking system during FY19.

Table 3.5: Commodity Financing

Flow in billion Rupees

	FY18	FY19
Wheat	135.1	-73.1
Cotton	0.0	0.0
Rice	0.2	-0.4
Sugar	-1.0	4.5
Fertilizer	-1.1	5.7
Total	**133.2**	**-63.3**

Data source: State Bank of Pakistan

It is important to note that during the previous 7 consecutive years, wheat procurement agencies were accumulating debt, as back-to-back bumper crops and depressed prices in the international market made it hard for them to offload a sizable amount of their procured stocks. Markup payments too added to their cost of operations. Last year also, procurement agencies were unable to pay off bank liabilities despite a sharp increase in subsidy-led exports, and their debt accumulation reached a 5-year high. In FY19, however, the procurement agencies were able to sizably cut their hypothecated stocks.[7] Crop damages and price management efforts mainly explained this trend.

Specifically, wheat prices in the wholesale market, after declining consistently in the last four years, began to surge from the start of the year. This movement represented the demand-supply mismatch in the market stemming from weak issuances from the government godowns amid heavy export of the commodity (both formal and informal). However, market conditions aggravated in Q4-FY19, when heavy rains and hailstorm in the peak harvest season sparked fears of commodity shortage in the domestic market. The WPI wheat prices rose steeply by 9.8 percent and 11.3 percent YoY in May and June 2019. Thus, to bring stability in the market and keep prices under control, the government scaled up its issuances.

Another factor that improved the cash flow situation for procurement agencies and helped retire wheat-related loans, was the payment of Rs 21.0 billion subsidy to Passco by the federal government during FY19. This subsidy was due from the government under the procurement agencies' contribution towards strategic reserves and the World Food Program.

Credit to PSEs

The overall PSE debt, which had already touched 4 percent of GDP by end-June 2018, increased further in FY19, as the power generation and distribution sector continued to rely heavily on the domestic banking system for smooth functioning. This year, banks lent another Rs 326.0 billion to PSEs, the bulk of which ended up with the energy sector. These primarily comprised banks' investments in Sukuk issued by the Power Holding Private Limited – the entity in which over Rs 700

[7] There was a 3.1 million MT reduction in hypothecated stock during FY19, compared to an increase of 0.1 million MT last year.

billion of the circular debt of energy sector is parked.[8] It is important to note that though such efforts can help reduce the immediate liquidity crunch in the energy-related firms, structural problems have persisted in the country's energy supply chain that do not allow the sector to run on a sustainable basis. The issues of energy mispricing, low recoveries, large transmission and distribution losses, managerial and technical inefficiencies at Discos' level, have all remained unaddressed for long, and the stopgap measures taken in the past could fix institutional liquidity problems only temporarily.[9]

In the recently approved Extended Fund Facility program, the IMF has assigned structural benchmark on the elimination of circular debt. The fund requires an effective tariff structure that reflects true costs. This will help contain the buildup of circular debt as new capacity comes online. Following the required prior actions, the government has already raised power and gas tariffs in July 2019 and another adjustment is expected in the coming months. Besides, amendments are planned in the Nepra Act to fully adopt a mechanism of automatic adjustment on tariffs on a quarterly basis. Furthermore, the government is required to prepare a detailed plan to reduce the circular debt through improving collection, efficiency gains and good governance.

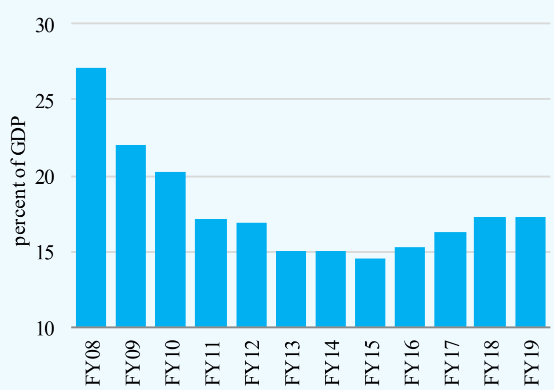
Importantly, similar reforms have been entrusted in the gas sector, where besides the tariff rationalization, the government has to prepare a comprehensive plan to reduce losses, increase private sector participation in gas sector through two distribution companies, and amend OGRA Act to notify end-consumer tariffs in a regular and timely manner. To minimize the impact of annual increase in power tariff, consumers with 300 units/month are exempted; for this purpose, the government has to allocate a new subsidy equal to 0.1 to 0.2 percent of GDP.

3.3 Credit to Private Sector

With the moderation in the economy and a decline in the industrial activity, the momentum in private credit weakened: private sector credit expanded by Rs 693.5 billion during FY19, compared to Rs 775.5 billion last year. Resultantly, the credit to GDP ratio remained stagnant at 17.3 percent in FY19 (**Figure 3.11**).

The development that differed markedly during FY19 from last year was the dominant role of higher input prices arising from the stabilization measures (e.g. regulatory duties, exchange rate depreciation) and increase in administered energy prices, which intensified the financing needs of the businesses (**Figure 3.12**). In real terms (deflated by non-food WPI), credit to private sector declined by 4.9 percent in FY19, compared to a growth of 9.7 percent last year. Moreover, the expansion in loans for fixed investment more than halved compared to FY18, as businesses' sentiments faltered in response to a slowdown in the overall economic activity; completion of the early-harvest CPEC projects; significant reduction in PSDP expenditures; and continuation of import compression measures that contributed to lower imports of capital goods.

Figure 3.11: Private Sector Credit



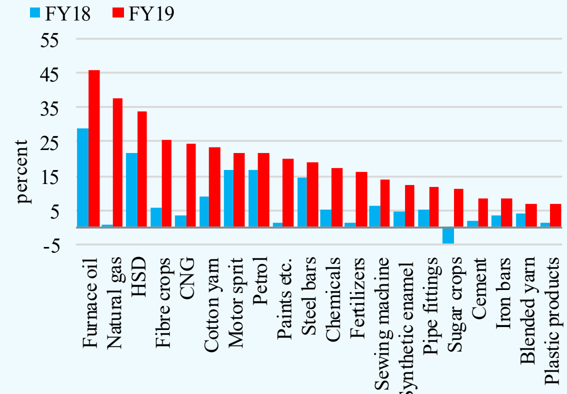
Data source: State Bank of Pakistan and Pakistan Bureau of Statistics

[8] The government mobilized Rs 200 billion via the Pakistan Energy Sukuk-I in March 2019 and made payments to IPPs and a few OMCs that eased liquidity constraints in the energy supply chain.
[9] Earlier in November 2011, the government swapped Rs 313.0 billion of sovereign securities for PHPL's liabilities. Similarly, the government once again settled Rs 322.0 billion of circular debt by issuing PIBs in June 2013. However, in FY19, the credit to PSEs, especially PHPL, surged again due to settlement of IPPs' dues. By end-June 2019, PSEs' debt had reached 5.3 percent of GDP, from 4.0 percent in June 2018.

Fixed investment loans lost traction

Fixed investment loans had recorded a consistent increase since FY14 in response to higher PSDP expenditures and progress on CPEC-related infrastructure projects. A number of industries, including cement, iron & steel and power generation spent on capex and BMR activity, and resorted to bank financing for the import of machinery and equipment. In FY19, however, long-term loans grew only Rs 82.9 billion – less than half of the Rs 203.9 billion increase recorded in FY18.

Figure 3.12: Inflation in Key Inputs



Data source: Pakistan Bureau of Statistics

Importantly, by end-FY19, it was expected that the capex cycle in construction-allied industries would begin to stall due to: (i) a number of early-harvest CPEC projects nearing completion, and lack of clarity through most of the year with respect to the expected initiation of new projects under the phase II; (ii) new political regime taking over that took some time to settle in before initiating spending on public works and announcing new mega projects; and (iii) stringent regulations on private real estate market and an expected slowdown in the housing sector. Moreover, export prospects for these industries were also not upbeat enough to encourage manufacturers to pursue additional capacity expansions.

This phenomenon was most prominent in the case of cement. It may be recalled that the sector was increasingly borrowing in long-term to finance its expansion cycle from FY14 onwards. Now that many projects have already achieved their commissioning stage and some are in trial running stage, several firms started retiring their loans from Q3-FY19 onwards. Resultantly, the sector's fixed investments increased by Rs 17.5 billion in FY19, lower than Rs 36.9 billion rise noted last year.

In case of other manufacturers, only textile and sugar increased their long-term borrowings in FY19, albeit at a slower pace than last year (**Table 3.6**). In the case of textiles, though the import of machinery declined in dollar terms, the depreciation of local currency raised the financing requirements of the firms. Textile businesses continued to position themselves to take advantage of the GSP Plus and to capitalize on opportunities arising from the trade war between the US and China. While the market interest rates were on an increasing trend during FY19, the subsidized end-user rate of 5 percent to textile businesses provided them a cushion to continue long-term borrowing – LTFF loans constituted more than 100 percent to the overall expansion in fixed investment loans in FY19, which suggested that except for the export-oriented industries, businesses deleveraged during FY19.

As far as the sugar sector was concerned, the liquidity situation appeared to be difficult during FY19. Mills blamed the recent prolonged episode of low domestic as well as international prices and a double-digit increase in sugarcane's wholesale prices during FY19 for their cash flow constraints. Since the sector relies heavily on bank financing, some mills may have considered it prudent to lengthen the maturity profile of their loans by borrowing long-term and retiring short-term loans in FY19.

Apart from the manufacturing sector, the power sector's borrowing momentum was the most prominent in FY19, as the increase was highest since FY14 when the overall fixed investment started rising. A deeper look into the data reveals that major variation was due to the KE and few CPEC-

Table 3.6: Loans to Private Sector Businesses
billion rupees

	Total Loans		Working Capital*		Fixed Investment	
	FY18	FY19	FY18	FY19	FY18	FY19
Private Sector Businesses	**657.9**	**574.6**	**454.0**	**491.6**	**203.9**	**82.9**
Manufacturing	419.7	411.6	295.7	362.1	124.0	49.5
Textiles	117.8	132.0	87.5	105.9	30.4	26.1
Refined petroleum	9.9	36.9	10.2	42.3	-0.3	-5.4
Cement	54.7	33.1	17.7	15.5	36.9	17.5
Edible oil and ghee	27.4	30.4	21.0	34.6	6.4	-4.2
Rice processing	13.4	26.5	12.7	26.0	0.7	0.5
Fertilizer	-43.5	23.7	-33.1	32.3	-10.4	-8.5
Iron & steel	30.1	22.5	29.8	20.4	0.3	2.1
Motor vehicles	2.5	20.5	1.9	14.5	0.5	6.0
Sugar	35.7	-19.6	20.8	-31.0	14.9	11.4
Production, transmission & distribution of electricity	46.1	95.6	45.8	47.0	0.2	48.6
Commerce and trade	69.0	65.6	52.1	42.8	17.0	22.8
Mining and quarrying	2.5	22.2	-0.5	14.7	2.9	7.5
Real estate & related	36.1	20.3	20.6	10.3	15.4	10.0
Agriculture	8.0	-5.6	-0.3	5.8	8.3	-11.4
Transport, storage and communication	23.4	-2.1	7.4	21.8	16.0	-23.9
Construction	27.6	-12.8	11.2	6.6	16.4	-19.4
Ship breaking etc.	24.3	-32.7	24.9	-34.3	-0.7	1.6

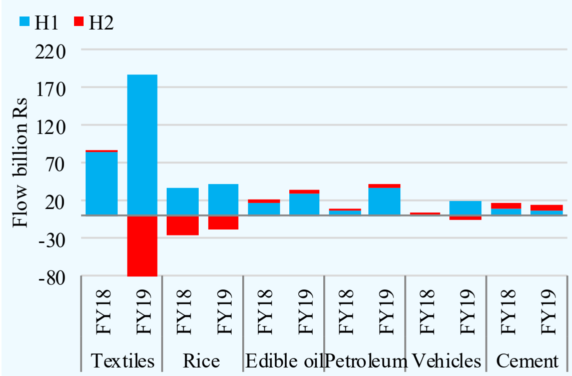
*includes trade financing
Data source: State Bank of Pakistan

related projects. KE took investment loans primarily to improve its transmission network. As per industry sources, such investments in the past have brought significant improvement in the company's transmission network and helped reduce its T&D losses. Traditionally, the distribution and transmission sector has suffered due to lack of investment; the issue has been highlighted several times in various SBP reports on the State of the Economy. Besides KE, a Karachi-based IPP leveraged in FY19 to finance an increase in its stake in various projects. Similarly, another coal-based IPP also borrowed from commercial banks to complete its project during FY19; the project started commercial operations in July 2019.

Exports and cost-driven demand pushed up working capital loans

Private businesses took Rs 491.6 billion in working capital loans during FY19, compared to Rs 454.0 billion last year. Within manufacturing, the sectors that drove the credit expansion included textiles, rice processing, petroleum refining, edible oil & ghee and motor vehicles (**Figure 3.13**). Although the flow for FY19 was higher than last year, the demand for working capital did not appear vibrant as banks actually received around 14 percent fewer applications for working capital loans as compared to last year. Several sector-specific factors influenced the demand for working capital loans during FY19.

Figure 3.13: Working Capital Loans in Selected Manufacturing Sectors



Data source: State Bank of Pakistan

Export-oriented activity and subsidized loan products drove up working capital loans in textiles and rice

Financing requirements of the textile sector remained high in FY19 due to an increase in export-led activity. The sector borrowed Rs 105.9 billion from banks during FY19, which was a 13-year high. Most of the borrowing activity was concentrated in H1, as the sector retired some of its loans in the second half of the year. It is important to highlight that despite a considerable increase in the SBP's policy rate, the end-user rate on EFS scheme was kept unchanged at 3.0 percent, which made it very lucrative for export-oriented businesses to borrow under such schemes. Of the total working capital borrowing by the textile sector, which is traditionally a major beneficiary of subsidized loans, around 44 percent was taken under the EFS scheme. In addition to export activity, higher cotton prices (25.2 percent up YoY) in the domestic market further raised the financing requirements of textile businesses.

Rice was another beneficiary of EFS loans, as around 30 percent of working capital taken by rice processors was under this scheme. Similar to textiles, higher financing requirement of rice processors was due to a better performance of exports during FY19, especially basmati varieties that recorded a double-digit increase. Importantly, Pakistani basmati has been able to penetrate in European markets in recent years as the Indian basmati was banned in these markets due to excessive use of certain pesticides. To capitalize on these opportunities, rice processors borrowed Rs 26.0 billion in FY19, compared to Rs 12.7 billion last year.

PKR depreciation raised financing requirement in import-dependent sectors

With regards to import-dependent industries such as edible oil & ghee manufacturers and refined petroleum, the depreciation in the Pak rupee jacked up firms' short-term financing requirements. In case of edible oil & ghee, the impact of depreciation was strong enough to offset the benefit from a double-digit decline in global prices of palm oil (**Table 3.6**). In the petroleum refining industry, the cost-push impact was exacerbated by regulatory measures which led to a build-up of inventories. Specifically, the government's decision to reduce dependence on furnace oil in the overall energy mix resulted in a slowdown in overall POL consumption in the country, which did not allow refineries to offload their produce.

The problem of inventory build-up was also observed in the car assembling industry. This issue propped up because of three reasons: (i) the government had barred non-filers from purchasing/registering cars till March 2019 (only cars up to 1300 cc engine capacity were exempted); (ii) as assemblers passed on the impact of additional duties and PKR depreciation on their prices, the demand for cars weakened; and (iii) a rise in interest rates may have priced out some potential buyers from purchasing cars using bank loans. Facing liquidity shortages, local manufacturers had to increase their short-term borrowing by around Rs 15.1 billion in FY19. It is important to mention that car manufacturers typically finance their requirements from customers' prepayments, but weaker sales pushed them to borrow from banks.

Budgetary measures and economic slowdown affected construction-allied industries

The overall construction activity in the country declined by 7.6 percent during FY19, compared to 8.2 percent growth seen last year, and 10 percent growth on average during the preceding 3 years. This weakening was felt heavily on cement and steel manufacturing. For instance, cement domestic dispatches declined during FY19, and production was also down by 3.0 percent, compared to growth of 11.1 percent last year. Though cost push pressures should have contributed to increased borrowing in these sectors, the slowdown in construction activities was quite severe in containing their borrowing requirements.

Among non-manufacturing concerns, the power sector was the biggest user of working capital loans. Although prices of primary fuel supplies (such as crude and FO) rose substantially during the year which contributed to higher financing needs, some liquidity comfort to the sector came from the issuance of Rs 200 billion worth of Sukuk in March 2019 and subsequent payments to various entities in the energy supply chain. Consequently, due to a relatively better cash flow situation, the sector's borrowing increased only marginally during FY19, compared to last year. Moreover, a policy shift away from furnace oil translated into significant decline in thermal power generation from furnace oil during the FY19. However, the impact was much severe in H1-FY19 and contained the short term financing requirement of the sector.

Tough year for consumer financing

After consistently growing for the last six years, consumer financing lost pace and rose by Rs 57.3 billion in FY19, compared to Rs 86.5 billion last year. The major drag came from auto and house financing segments, which suffered due to the government's ban on non-filers from purchasing/ registering assets such as cars and residential properties (above Rs 5 million), several price hikes of cars, and rising interest rates. The anticipation of new product launches and phasing out one popular model also played their part, as some customers may have adopted a wait-and-see approach. Furthermore, anecdotal evidence suggest that since interest rates were on an upward trajectory, the substantial increase in installment amount compelled borrowers to either opt for high equity participation ratio or avoid bank financing altogether. Apart from these factors, the popularity of ride hailing services, which itself was an early contributing factor to the rise in auto financing, also seemed to have reached its saturation level, thereby negatively contributing to the growth in advances. Due to the interplay of these factors, commercial banks received 9.5 percent lower number of applications for auto financing during FY19, compared to last year and the segment could only increase by Rs 22.2 billion in FY19 – around half the expansion witnessed during FY18 (**Table 3.7**).

Table 3.7: Consumer Financing
billion rupees

	FY18	FY19
Total	**86.5**	**57.3**
For transport e.g. cars	43.3	22.2
Personal loans	12.5	13.9
Housing	22.3	10.4
Credit cards	7.4	7.0
Consumer durables	1.1	3.7

Data source: State Bank of Pakistan

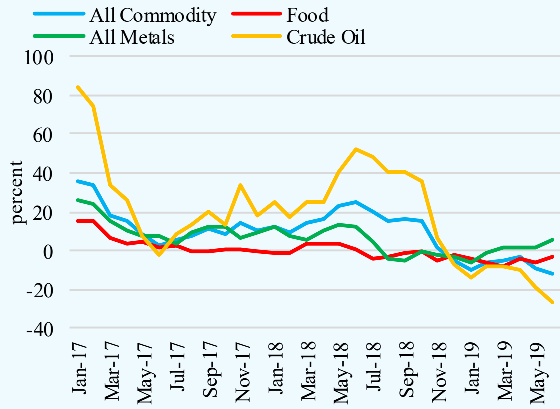
On the other hand, housing finance also suffered in FY19 and rose only by Rs 10.4 billion, compared to Rs 22.3 billion rise last year. In terms of outstanding portfolio, Islamic banks were able to keep their share intact at around 46 percent as of June 2019. However, in flow terms, the increase stemmed mainly from conventional banks where medium-sized players dominated. Nonetheless, the ban on non-filers on purchasing property (above Rs. 5.0 million) kept this segment suppressed during the year. As per industry sources, the increased price levels also eroded the capacity of many households to afford residential units in close vicinity of urban centers. Moreover, as per anecdotal evidence, consistent interest rate hikes during the year significantly raised the installment amount for potential borrowers, many of whom stand disqualified due to the breach of the maximum required debt-burden-ratio.

Compared to other segments, personal loans and consumer durables performed better (**Table 3.7**). The flow of FY19 for consumer durables was historically highest, but price impact mainly explained this phenomenon, as there was more than double-digit inflation in consumer durables during the year. The argument also gets support from the fact that while banks received around 20 percent lower applications, the average loan size of accepted applications more than doubled to Rs 2.8 million in FY19 from Rs 1.2 million last year.

3.4 Inflation

With the moderation in global economic growth – attributed to intensifying trade-related tensions between China and the US, Brexit negotiations, and tight financial conditions across advanced and emerging market economies – commodity prices began to lose steam in FY19. The overall commodity price index (IMF) that remained 16.6 percent higher between July and October 2018, posted a YoY deflation of 6.4 percent between November and June 2019 (**Figure 3.14**). This weakening led to a moderation in consumer price inflation (CPI) across advanced and emerging market economies (EMs) during FY19 (**Table 3.8**). The glaring exception were the countries struggling with BoP stress and pressures on domestic currencies. Pakistan belonged to this league; however, the pressure on inflation here was less severe as compared to that in Turkey, Argentina and Egypt (**Table 3.8**).

Figure 3.14: Global Commodity Price Index



Data source: IMF

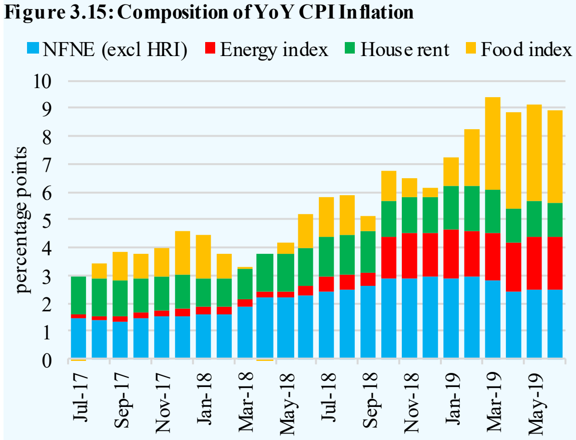
Table 3.8: Inflation and Currency Depreciation in Emerging and Developing Economies

	Depreciation (Avg.)		CPI Avg. Inflation			Depreciation (Avg.)		CPI Avg. Inflation	
	FY18	FY19	FY18	FY19		FY18	FY19	FY18	FY19
Pakistan	-4.8	-19.3	3.9	7.3	Russia	3.2	-10.1	2.6	4.3
Egypt	-16.5	0.7	20.9	13.9	South Africa	5.8	-9.4	4.3	4.6
Turkey	-12.7	-30.8	11.5	19.9	Brazil	-2.7	-14.2	2.9	4.2
India	2.1	-7.8	4.2	3.0	Sri Lanka	-3.7	-10.6	5.3	2.0
Bangladesh	-3.7	-2.3	5.8	5.5	China	4.7	-4.6	1.7	2.2
Malaysia	5.3	-1.3	2.6	0.3	Iran	-12.9	-12.9	8.2	37.6
Indonesia	-2.5	-5.9	3.5	3.0	Thailand	7.6	0.6	0.8	1.0
Philippines	-4.7	-2.6	3.6	4.7	Argentina	-20.8	-48.8	19.6	48.3

Data source: Haver Analytics

Compared to double-digit inflation recorded in these economies, the headline CPI inflation in Pakistan was recorded at 7.3 percent during FY19 compared to 3.9 percent last year. This outcome was within range of forecast made by SBP (**Figure 3.1**). That said, it was the first time in 5 years that inflation surpassed the annual target of 6.0 percent set by the government. Importantly, inflation continued to trend up throughout the year before it plateaued in March 2019 (**Figure 3.15)**. Although core inflation predominantly explained the continuously rising trend in inflation during the first 4 months of the year, it was the steep rise in food and energy inflation that deepened inflationary pressures in subsequent months (**Table 3.9**). In terms of dispersion, for the full year, inflation increase was broad based as a majority of the sub-indices (72 out of 89- with about 81 percent share in CPI) posted

Figure 3.15: Composition of YoY CPI Inflation



Data source: Pakistan Bureau of Statistics

higher inflation during FY19 compared to last year. Meanwhile, in terms of distribution, around 41 percent of the items registered inflation in the range of 5-10 percent (**Figure 3.16**), depicting the presence of underlying demand as well as cost push pressures in the economy.

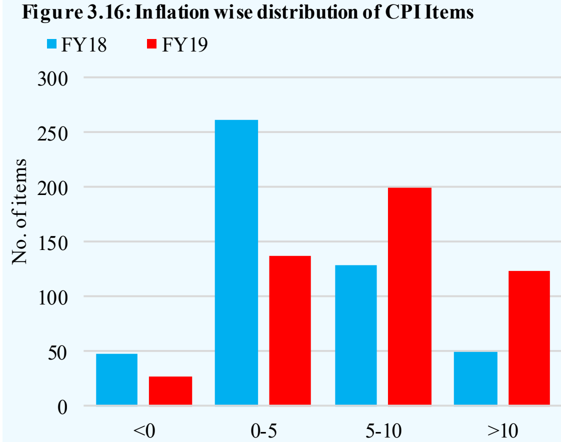
Table 3.9: Average CPI Inflation and Contribution

		Avg. Inflation						Contribution	
	Wt.	H1-FY18	H2-FY18	FY18	H1-FY19	H2-FY19	FY19	FY18	FY19
General	**100**	**3.8**	**4.1**	**3.9**	**6.0**	**8.6**	**7.3**	**3.9**	**7.3**
A. Food	**37.5**	**3.0**	**2.6**	**1.8**	**1.8**	**6.5**	**4.6**	**0.7**	**1.8**
Cigarette	1.4	-16.8	-17.8	-17.3	6.3	16.1	11.2	-0.4	0.2
Wheat flour	4.2	-1.6	-0.4	-1.0	3.1	3.6	3.3	0.0	0.1
Sugar	1.0	-18.9	-13.2	-16.2	-0.9	20.7	9.6	-0.2	0.1
Fresh vegetable	1.7	-3.6	-4.2	-3.9	-4.1	11.6	3.0	-0.1	0.1
Meat/chicken	3.8	5.6	11.3	8.5	11.1	7.1	9.0	0.4	0.4
Milk fresh	6.7	3.8	3.9	3.8	3.8	4.1	3.9	0.3	0.3
Tomatoes	0.4	27.7	-16.9	8.3	-21.9	91.8	16.1	0.0	0.1
Cooking oil	1.8	3.3	2.1	2.7	3.1	7.2	5.2	0.0	0.1
Vegetable ghee	2.1	3.8	1.7	2.7	3.8	7.4	5.6	0.0	0.1
B. Non-food	**62.5**	**5.0**	**5.8**	**5.4**	**8.7**	**9.8**	**9.2**	**3.2**	**5.5**
House rent	21.8	6.8	6.2	6.5	7.1	7.3	7.2	1.2	1.4
Education	3.9	11.1	13.5	12.4	12.1	7.1	9.5	0.5	0.5
Clothing & footwear	7.6	3.8	5.7	4.8	6.9	6.5	6.7	0.4	0.6
Health	2.2	11.4	5.0	8.1	7.4	8.3	7.9	0.2	0.2
Motor fuel	3.0	9.1	13.2	11.2	26.4	19.1	22.5	0.2	0.5
Furnished H.H	4.2	3.0	5.2	4.1	6.9	8.9	7.9	0.2	0.4
Transport services	2.7	0.2	3.2	1.7	15.8	13.4	14.6	0.0	0.4
Motor Vehicle	0.7	3.9	6.5	5.2	12.4	12.4	12.4	0.0	0.1
Misc. goods services	2.8	5.4	6.8	6.1	7.7	9.1	8.4	0.2	0.3
Core (NFNE)	**53.5**	**5.5**	**6.2**	**5.8**	**8.0**	**7.8**	**7.9**	**3.0**	**4.1**

Data source: Pakistan Bureau of Statistics and SBP calculations

Inflationary pressures during the year can be traced to:

Figure 3.16: Inflation wise distribution of CPI Items



Data source: Pakistan Bureau of Statistics

1. Surge in energy prices: Fiscal constraints and the impact of depreciation

A sharp increase in administered prices of motor fuel, natural gas, electricity and CNG (indicative) remained instrumental in strengthening inflationary pressures in the economy during FY19. These adjustments had become almost inevitable for the government in view of growing fiscal constraints (on account of revenue gaps and escalated current expenses) amid heavy depreciation of the Pak rupee. Furthermore, unit values of imported coal also posted a sharp increase of 15.2 percent YoY in rupee terms (**Figure 3.17**).

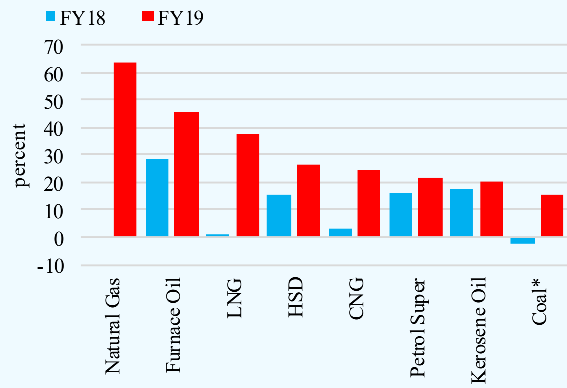
The largest direct impact came from adjustments in natural gas tariffs, as this alone contributed 0.7 percentage points to the headline inflation during the year. The Oil and Gas Regulatory Authority (OGRA) increased the retail prices of natural gas for various slabs, particularly the slab for which usage is over 500 MMBTU/month, in order to minimize the subsidy element and lower the gap between prescribed and notified tariffs for gas consumption. It is important to note that prices of natural gas were kept unchanged since September 2015, despite significant movement in crude oil prices, which serves as a benchmark for setting the natural gas tariffs. The differential in prescribed price (as per the guaranteed returns to gas distribution companies) and the notified price added quite a burden to the fiscal accounts – the government has accrued payments worth Rs 56.8 billion only to SNGPL during the financial year 2018. Likewise, CNG prices also increased by 24.4 percent during FY19 compared to 3.4 percent rise last year in response to the upward revision of the sale price of natural gas. [10]

Meanwhile, the electricity price index also registered 4.2 percent inflation during FY19, after staying stable last year. This was an outcome of various price adjustments by Nepra during the year for consumers utilizing more than 300 units. These adjustments were meant to rein in the growing circular debt in the sector by withdrawing the provision of subsidized power supply and passing on the impact of increased capacity payments, T&D losses, low recoveries and net hydel profits.

In case of motor fuels, the trend in global oil prices, exchange rate movement and frequent revisions in the sales tax structure during the year, determined the direction and magnitude of changes in domestic petrol and high speed diesel (HSD) prices (**Table 3.10**). In overall terms, the motor fuel index posted 22.5 percent inflation during FY19, contributing 0.5 percentage points to the overall inflation. However, it is important to note that despite this increase, petrol price in Pakistan is at a level observed in some major net oil exporting countries (**Figure 3.18**).

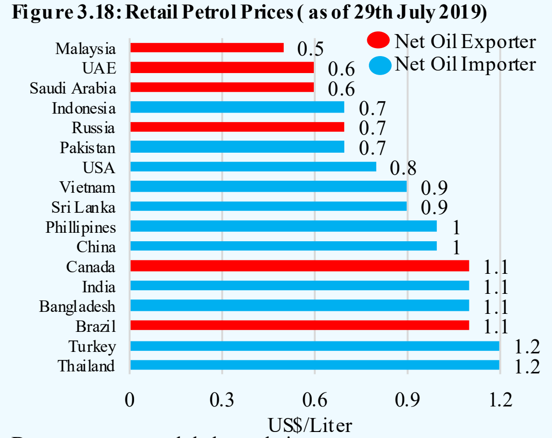
Here, it is important to note that while the direct impact of energy prices in overall inflation was almost 20 percent during the year, its indirect impact was also significant. As shown in **Table 3.11**, 65.1 percent of the commercial and 37.1 percent of the industrial activities are fueled by natural gas, which had shown 64.0 percent CPI-inflation (and 37.4 percent in WPI) during the year. It is possible that due to a significant moderation in domestic

Figure 3.17: Energy Inflation



*unit value of imports
Data source: Pakistan Bureau of Statistics

Figure 3.18: Retail Petrol Prices (as of 29th July 2019)



Data source: www.globalpetrolprices.com

Table 3.10: Fuel Prices- Percent Growth (FY19)

(End Period)	Q1	Q2	Q3	Q4
Saudi Light	5.3	-33.6	26.1	-1.7
PKR depreciation	2.2	10.5	1.4	12.0
Sales Tax-petrol (level)	9.5	8	17	13
Domestic petrol prices	1.5	2.7	-3.1	21.3

Data source: FBR, SBP, PBS and Bloomberg

Table 3.11: Share of Different Fuels in Total Energy Consumption (by Sector) in FY18
percent

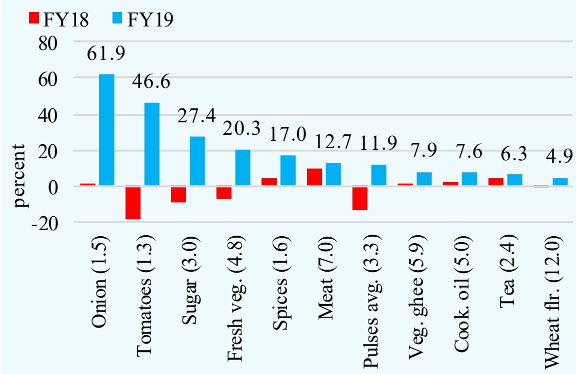
	Commercial	Industry	Agriculture	Transport
Electricity	34.9	10.9	98.2	-
Gas	65.1	37.1	-	8.8
Coal	-	43.4	-	-
Oil	-	8.7	1.8	91.2
Total	100	100	100	100

Data source: Pakistan Energy Year Book 2018

[10] The sale price was increased to 980 per MMBTU via SRO (I) dated 4th October 2018, from 700 per MMBTU (SRO (I) dated 30th December 2016).

demand, traders, manufacturers and transporters might not have been able to completely pass on the impact of high gas prices to their consumers; therefore, the broad-based increase in CPI indicates at least a partial transmission. Transportation costs have certainly gone up, and a pressure on those commodities is clearly visible where supplies are ensured on a daily basis (such as meat, milk and perishable food items). Here, it is important to reiterate that although the overall economic and political cost of energy inflation is quite large, price rationalization is extremely important in this sector not just to run energy-related entities on a sustainable basis, but also to ensure a competitive environment for productive investments.

Figure 3.19: Major Drivers in Food Inflation in 4th Quarter



Note: weights in parenthesis
Data source: Pakistan Bureau of Statistics

2. Surge in food inflation: Supply disruptions and weak price controls

Food inflation remained stable during H1-FY19 on account of steady growth in prices of perishable food items amid sufficient supplies, and a subdued inflation in sugar and pulses amid the presence of abundant stocks in the market. However, food inflation recorded a steady and broad-based increase from January 2019 onwards, and clocked in at 8.5 percent during the 4th quarter (**Figure 3.19**). While the impact of increased transportation cost was clearly visible, other factors also played an important role. These included:

a. *Supply disruptions and Ramazan effect*:
For some perishable food items, pressures on prices emanated from supply shortages. For instance, in case of tomatoes, damages to the local crop and imposition of a ban on import of (disease prone) Indian varieties restricted its supplies in the domestic market, particularly during the last 2 quarters of the year. Pakistan significantly scaled up its imports from Afghanistan, but this did not prove sufficient to pacify the market. Similarly, prices of onions soared during the 4th quarter, primarily on account of some rain-led damages to the summer crop in Balochistan, which accounts for over 27 percent of the total onion production in the country.[11] While supplies remained constrained during the quarter, demand was met through imports.

In case of other perishables, it appears that the seasonal impact of Ramzan on CPI prices was more pronounced in FY19, as compared to last year. Although there should be no significant impact of a seasonal variable on a YoY basis, the timing of price collection data by the PBS seems to have factored in. A case in point is inflation in fruit prices. Prices of fruits typically increase sharply during the first 15 days of Ramazan. This year, these days coincided with the data collection period by PBS surveyors. Last year, the Ramazan-related peak in prices had come during the 3rd week of the holy month; by then, the process of price collection was completed for the month of May.

b. *The impact of depreciation of Pak rupee*:
A higher inflation in some food items emanated from the indirect impact of the depreciation of the Pak rupee. For instance, the inflation in edible oil and ghee is linked directly to the depreciation of the rupee, as international prices of soybean and palm oil hovered around a level throughout the year which was 12.9 and 19.9 percent lower respectively compared to last year. Similarly, the pressure on domestic tea prices has also emanated from the depreciation, as international prices of tea remained

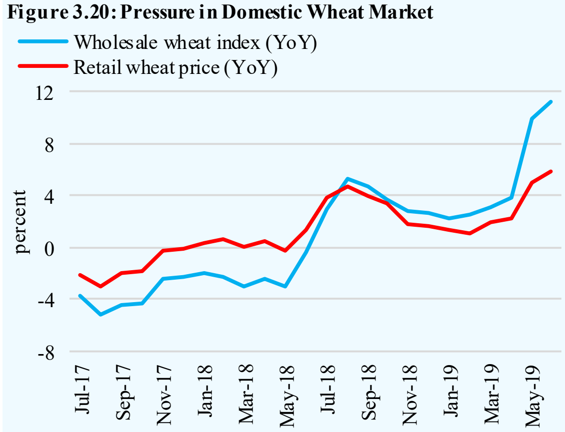
[11] It is important to recall here that Balochistan's crop arrives in the market around May, two months after the harvesting season in Sindh. Data Source: Agriculture Marketing Information Service, Directorate of Agriculture (Economics & Marketing) Punjab, Lahore

18.2 percent lower compared to the last year. Furthermore, higher inflation in pulses and dry fruits can also be attributed to the same factor.

c. *Weak administrative mechanism for controlling wheat and sugar prices*:
After staying stable over the past couple of years, wheat prices started to increase by the beginning of FY19. In the first quarter of the year, the demand for wheat remained unusually high due to heavy buying by exporters: wheat exports through formal channels touched 441,000 MT, equivalent to 64.5 percent of the full-year's exports. Reportedly, the size of informal exports was also considerably high during this period. Nonetheless, the size of these exports was not large enough to put pressure on domestic prices, given the available volume of wheat reserves in the country. It appears that the pressure observed in the commodity's wholesale prices was triggered by late intimation of sale price and delayed issuance by the procurement agencies, which created a temporary demand-supply gap in the market.

Later, the impact was further intensified in Q4-FY19, when untimely rains and hailstorms in the peak harvest period sparked concerns about significant crop damages, particularly in southern Punjab. Moreover, the Sindh government lowered its procurement targets for the year in lieu of estimated available stocks, rising financial cost and limited storage capacity of provincial procurement agencies. Importantly, estimates of country-wide carryover stocks are based on the data provided by the procurement agencies as well as estimates of fresh harvest – decisions about export depend upon the deviation of these stocks from the estimated demand. As it turned out, damages to Punjab's crop were higher than expected, which, together with lower procurement targets by the Sindh government and increased sales in the market, resulted in some depletion of wheat stocks held by the procurement agencies. On aggregate, the government agencies procured 33.0 percent less wheat during 2019 compared to last year, and their interventions in the market were not sufficient to stabilize prices. As a result, the wholesale price of wheat remained 8.3 percent higher in Q4-FY19 on YoY basis, which ultimately exerted pressure on the retail price of wheat flour (**Figure 3.20**). To alleviate these pressures, the Economic Coordination Committee (ECC) decided to impose a ban on wheat exports in its meeting held in July 2019. However, in the same meeting, the committee observed that the stock of wheat in the country, at 28 million tons, looked adequate in comparison to the estimated demand of 25.8 million tons. It appears that hoarding practices and/or price collusive behavior in the wholesale market may also have contributed to pressure on wheat prices. Besides, the government also needs to rein in commodity purchases for informal exports.

Figure 3.20: Pressure in Domestic Wheat Market



Data source: Pakistan Bureau of Statistics

The story in the sugar market was not different either; here also, the agencies responsible for price controls were not able to manage the market despite sufficient availability of stocks. The difference is that whereas wheat stocks are held by the government's own procurement agencies, in case of sugar, private mills maintain the stock and inform the government about their inventories. Although the reported volumes suggest that the country's available stocks were sufficient till the arrival of FY20 crop, prices came under tremendous pressure in both the wholesale and retail markets since the commencement of cane crushing season. If estimates of carryover stocks are accurate, then this pressure probably represents the emergence of hoarding opportunities amid lower availability of cane in the market, delayed crushing and anticipation of a decline in sugar production during the season.

This impact was more pronounced in the month of June, when the government announced an increase in GST from 8 percent to 17 percent under the federal budget 2020; the expected increase in prices from July 2019 onwards might have encouraged (non-registered) traders to hoard the commodity. Sugar prices posted 33.5 percent increase during June 2019 on a YoY basis, and 6.2 percent increase on a month-on-month basis. Going forward, for price stability, there is a dire need for an effective mechanism for government agencies to monitor the stocks and ex-factory, prices, and take action against manufacturers' collusive behavior and hoarding practices across the distribution chain.

d. *Regulatory measures*:
For cigarettes, a double digit inflation was recorded in FY19 compared to a sharp deflation last year. Lower base effect amid a change in the duty structure last year predominantly brought higher inflation this year, as the prices of cigarettes normalized (**Table 3.12**).

Table 3.12: Change in FED Structure on Locally Produced Cigarettes

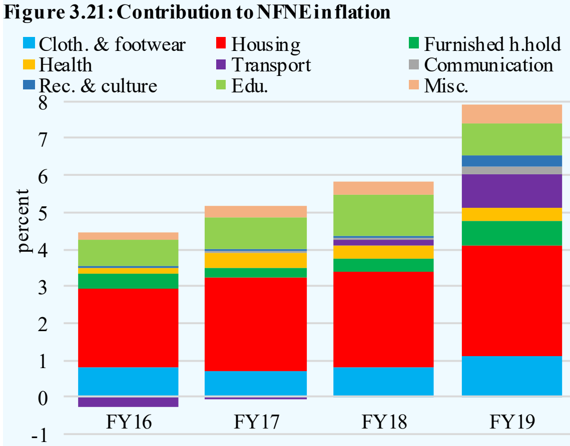
FY18*		FY19**		FY19***	
Price description per 1,000 piece	**Rate of duty/1000 pc**	**Price description per 1,000 piece**	**Rate of duty/1000 pc**	**Price description per 1,000 piece**	**Rate of duty/1000 pc**
If the on-pack printed retail price exceeds Rs 4,500	Rs 3,740	If the on-pack printed retail price exceeds Rs 4,500	Rs 4,500	If the on-pack printed retail price exceeds Rs 5,960	Rs 5,200
If the on-pack printed retail price exceeds Rs 2,925, but less than Rs 4,500	Rs 1,670	If the on-pack printed retail price exceeds Rs 2,925, but less than Rs 4,500	Rs 1,840	If the on-pack printed retail price is less than Rs 5,960	Rs 1,650
If the on-pack printed retail price does not exceed Rs 2,925	Rs 800	If the on-pack printed retail price does not exceed Rs 2,925	Rs 1,250		

*SRO 407(I)/2017 dated 29th May 2017, ** SRO 1150(I)/2018 dated 18th September 2018,*** SRO 608(I)/2019 dated 11th June 2019
Data Source: Federal Board of Revenue

Core inflation: Cost-push pressures dominate

The core inflation component, measured by NFNE, continued its upward trajectory during FY19, indicating underlying demand pressures in the economy. However, component-wise analysis suggests that cost-push pressures also played a substantial role in driving up the NFNE inflation. As shown in **Figure 3.21**, the increase in NFNE came mainly from house rents, transportation services, clothing and footwear, and furnished household equipment.

Figure 3.21: Contribution to NFNE inflation



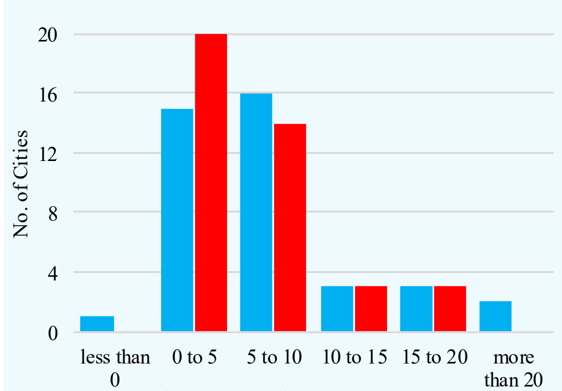
Data source: Pakistan Bureau of Statistics

Non-fuel transport items registered 12.4 percent inflation in FY19 compared to 2.3 percent last year. Items where inflationary pressures were most pronounced included transport services, mainly railway and bus fares, locally assembled cars, and tyres and tubes. In case of transport services, the increase in bus and train fares can be attributed to higher transport fuel prices. Since bus fares are determined by private transporters, their increase was more pronounced (up 28.4 percent). As for the train fares, it appears that the government only partly passed on the impact of higher transport fuel prices, as the fares increased by 16.2 percent on average for various categories.

In case of cars, prices of different variants increased in the range of 10 – 22 percent during the year. Domestic auto assemblers have justified these price hikes with the depreciation of the Pak rupee and the increase in regulatory duties on completely- and semi-knocked down kits and other auto parts (including tyres). It is important to mention here that the demand for cars remained weak throughout FY19, and therefore could not contribute to inflation in this segment.

House rents continued to remain a major contributor to the rising core inflation. In FY19 also, around one third of non-food-non-energy inflation came from house rent. Although the average inflation in house rents for the country increased from 6.5 percent in FY18 to 7.2 percent, city-wise data shows that the vibrancy was observed only in a few cities, as in nearly half of the cities the inflation in house rents was less than last year. Furthermore, 24 out of 40 cities recorded inflation of less than 7.2 percent in their house rents. Importantly, 8 out of 40 cities posted double-digit inflation, among which, D.I. Khan and Turbat registered over 20 percent increase during the year (**Figure 3.22**).

Figure 3.22: Distribution of House Rent Inflation



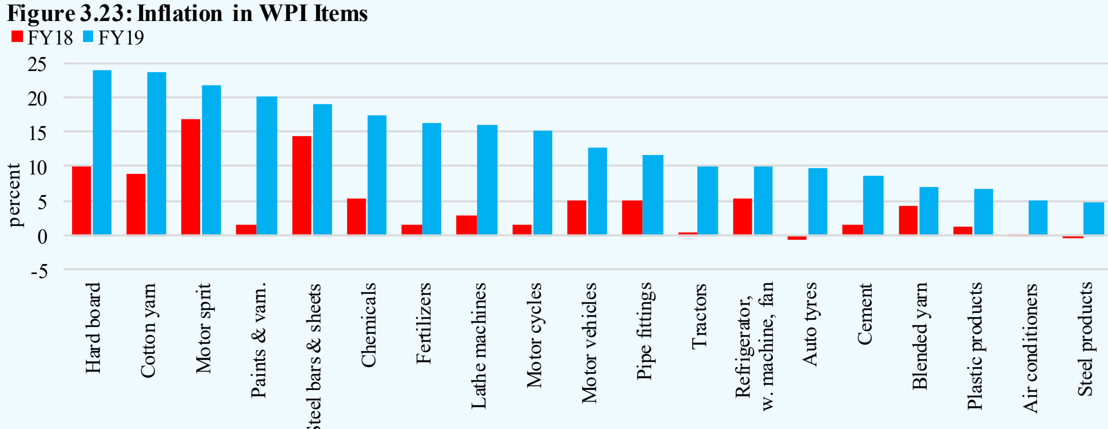
Data source: Pakistan Bureau of Statistics

Other items

In case of other items within the NFNE basket, the impact of increase in raw material prices played an important role. For instance, the cost of production for the textile industry increased during the year due to a sharp rise in cotton and yarn prices, as well as higher rupee cost of imported machinery, chemicals and other inputs (due to exchange rate depreciation). Similarly, the inflation in footwear also remained higher than last year. This increase was evident in both the imported as well as locally produced footwear (which use imported plastic and rubber). In overall terms, the clothing and footwear group posted an inflation of 6.7 percent, contributing 13.8 percent to the core inflation.

In addition to this sub-group, the impact of rising raw material prices was felt on other items within the NFNE as well. The most glaring impact could be seen on businesses' fuel and transportation costs. Besides, a number of industries, including automobiles, construction and electronic appliances, had to bear with a double-digit increase in domestic prices of steel bars and sheets. This increase was an outcome of both an increase in unit values of imported steel products, as well as the impact of the exchange rate movement. Similarly, a large number of industries were impacted by elevated prices of

Figure 3.23: Inflation in WPI Items



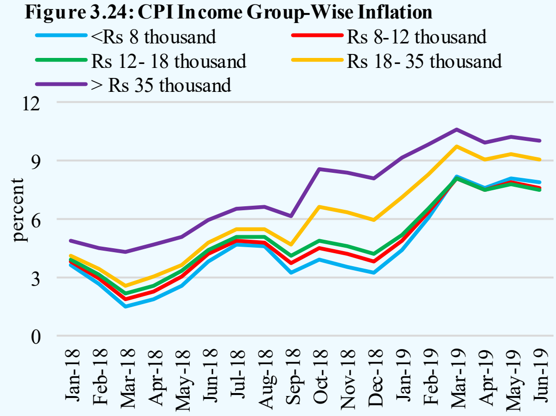
Data source: Pakistan Bureau of Statistics

various chemicals. Pakistan mostly relies on imported chemicals that are used in local industries, including textiles, pharmaceuticals, steel melting, personal care items, washing soaps and detergent, and plastic products. In overall terms, the impact of higher input prices was captured by the wholesale price index, which recorded a 12.0 percent increase during FY19, up from the 3.5 percent level last year (**Figure 3.23**). On a YoY basis, WPI inflation remained in double digits during the year – for the first time since November 2013.

Incidence of inflation

After registering a steady behavior up till H1-FY19, inflation incidence on low income groups grew stronger in Q3-FY19, as the inflation doubled from around 3.2 percent YoY in December 2018 to 8.2 percent YoY by March 2019. Since the contribution of food inflation was dominant during H2-FY19, the incidence of inflation fell disproportionately on the low income groups (**Figure 3.24**).

Figure 3.24: CPI Income Group-Wise Inflation



Data source: Pakistan Bureau of Statistics