Chapter 3
Monetary Policy and Inflation

Coordinated stabilization efforts, coupled with realignment of the exchange rate with market fundamentals, led to a visible improvement in twin deficits in the first eight months of FY20. Non-food-non-energy inflation also remained relatively stable, though one-off and seasonal factors kept headline inflation under pressure throughout this period. The improvement in macro fundamentals was also reflected in a steady improvement in consumer and business confidence, which paved the way for a sustainable recovery in economic growth. However, just when initial signs of this recovery became visible, the domestic and global spread of the coronavirus and the needed containment measures significantly disrupted economic activity. Businesses' supply chains were hit hard, as manufacturing and retail activities came to a near-halt. To handle the ensuing financial constraints, businesses turned to more lean operational practices and pulled the available cost-cutting levers, including optimizing inventory purchases and laying off workers. SBP responded swiftly to the emerging economic, financial, and social challenges, and introduced a series of measures aimed to alleviate financing constraints of households and businesses, protect work opportunities for the country's labor force, and extend support to the health sector. The Monetary Policy Committee (MPC) held multiple emergency meetings to review the evolving situation and cut interest rates by a cumulative 625 bps within almost 3 months, among the largest rate cuts in the world. This historically unprecedented cut was made possible by a commensurate fall in inflation and monetary policy shifting appropriately toward supporting growth in the wake of the Covid outbreak.

3 Monetary Policy and Inflation

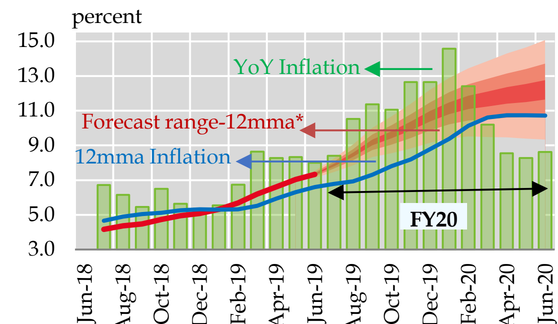
3.1 Policy Review

Following the increase of 575 bps in the policy interest rate and the realignment of the exchange rate with market fundamentals, the macroeconomic stabilization efforts to address the twin deficits had reached a mature stage at the start of FY20. These efforts had helped rein in demand pressures in the economy and strengthened the country's external position. However, headline inflation was elevated, and the forecast for the incoming year was much higher than the medium-term target. This unfavorable inflation outlook, coupled with a weak fiscal position, meant that the policy focus during FY20 would continue to center on consolidating macroeconomic stability. In fact, stabilization efforts were expected to gather momentum with the initiation of the economic reform program supported by the IMF's Extended Fund Facility from July 2019 onwards, the government's commitment to avoid deficit monetization, and comprehensive fiscal consolidation measures announced in the 2019-20 budget.

In its first meeting in July 2019, the Monetary Policy Committee (MPC) decided to raise the policy rate by 100 bps. The decision took into account upside inflationary pressures from previous depreciation of the exchange rate and a likely increase in near-term inflation from the one-off impact of adjustments in utility prices and other revenue enhancing measures announced in the FY20 budget. The SBP's CPI projections at the start of the year (July 2019) were at an elevated range of 11-12 percent, which was in excess of the medium-term target of 5-7 percent **(Figure 3.1)**. Although the cumulative change in the policy rate later proved successful in taming demand-side pressures (as reflected in consistent stability in the core inflation), the economy faced a fresh set of challenges as the year progressed.

The foremost concern was the steep surge in food inflation stemming from higher taxes (sugar, cigarettes and edible oil and ghee), increase in transportation costs, and temporary supply disruptions (fresh vegetables, wheat and sugar). However, SBP expected inflation to fall considerably in FY21, with the dissipation of one-off inflationary factors. Therefore, despite the higher inflation outturns in subsequent months, the MPC kept the policy rate unchanged in subsequent meetings. Nonetheless, a careful observation of inflation trends was necessary because if entrenched, the surge in food inflation could further damage consumer confidence, strengthen inflation expectations, and potentially spill over to non-food items in the CPI basket.

CPI Inflation Projections in July 2019 and Actual Outcome — **Figure 3.1**

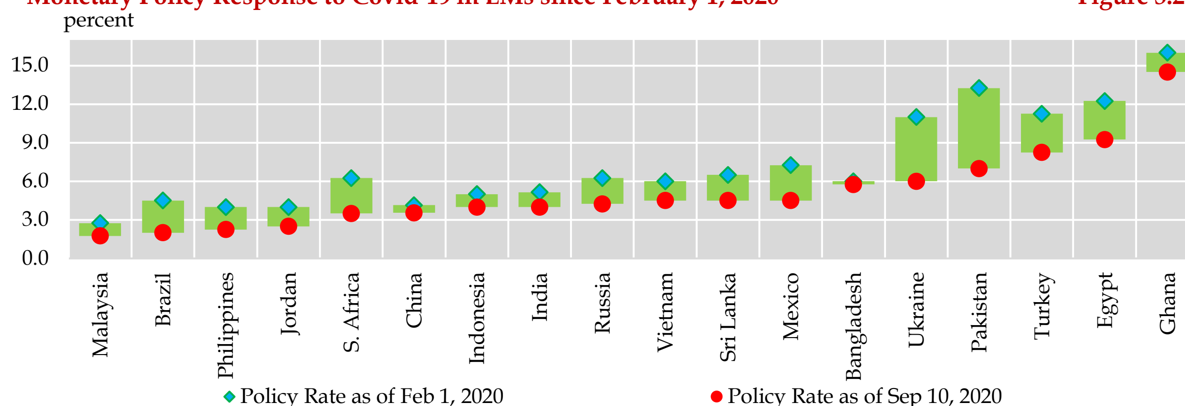


* Probability distribution of risks around the average forecast. Shades indicate various levels of confidence interval.

Source: PBS and SBP staff estimates

These price pressures kept intensifying till January 2020, but began to ease in February, as perishables' prices responded positively to administrative supply-management measures (including crackdown on speculative elements) and resumption of seasonal supplies. Inflation fell further in March when international oil prices declined significantly, following rising worldwide Covid infections and weakening global demand. But around this time, domestic infections also began to increase substantially. The domestic and global spread of the virus and the needed containment measures began unleashing disruptions of an unprecedented magnitude to

Monetary Policy Response to Covid-19 in EMs since February 1, 2020 **Figure 3.2**



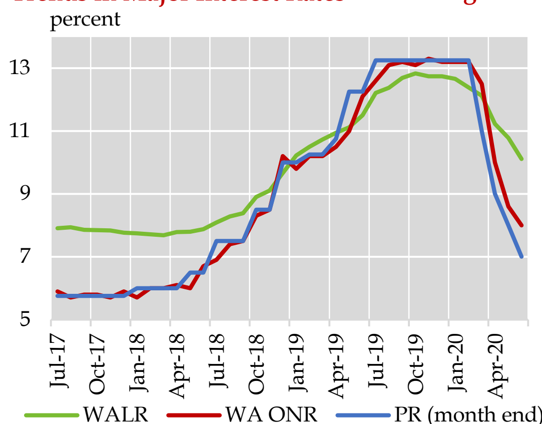
* The green bars show the magnitude of reduction in the policy rates.
Source:tradingeconomics.com; cbrates.com

the economy. Businesses' supply chains were hard hit, as manufacturing and retail activities came to a near-halt. To handle the ensuing financial constraints, firms began to adopt lean operational practices while pulling hard on multiple cost-cutting levers, including optimizing inventory purchases, laying off workers, and freezing further hiring. While profitable and cash-rich firms were expected to hold up against the crisis, solvency fears emerged for more illiquid firms – especially as the health crisis and its economic fallout worsened.

These disruptions, along with uncertainties associated with the duration of containment measures, led to a noticeable slowdown in domestic demand and weakening in consumer and business confidence. The SBP was also concerned with developments in the financial markets, as foreign fund managers pulled capital from a number of emerging market economies including Pakistan; this triggered significant selling pressure in domestic debt and equity markets. From the stability standpoint also, the evolving financial position of the corporate sector posed risk for the asset quality of the banking system. Finally, the fiscal position was also expected to deteriorate (Chapter 4), keeping in view heavy spending requirements to cover healthcare needs, social transfers, contact tracing, data management, and handling of returning migrants.

Therefore, it was imperative for SBP to respond preemptively and forcefully to handle these challenges before they morphed into an economic crisis. To cope with the challenge, SBP took comprehensive policy and regulatory measures to allay the cash-flow constraints of households and businesses, protect work opportunities for the country's labor force, and extend support to the health sector. The MPC held multiple off-schedule meetings to review the evolving situation and, leveraging the policy space available as inflation declined sharply, cut interest rates by a cumulative 625 bps within almost 3 months – the largest rate cut among the EM economies **(Figure 3.2 and Figure 3.3)**. In all these policy reviews, the MPC noted a marked reduction in inflation momentum amid a noticeable slowdown in domestic demand, softening food prices, decades low global oil prices, and a significant decline in inflation expectations. Given these factors, SBP projected the medium-term target inflation range of 5-7

Trends in Major Interest Rates **Figure 3.3**



Source: State Bank of Pakistan

percent to be achieved somewhat earlier than previously forecast. Moreover, although temporary pressures were visible on the exchange rate as well as the fiscal account, the MPC considered policy rate cuts crucial to provide cushion against slowing economic activity. This was particularly needed to make debt financing viable for firms whose interest coverage had weakened considerably during the recent monetary tightening cycle, and were therefore being priced out of the credit market.

Importantly, SBP also introduced a concessional financing scheme for businesses committing to retain their workers. To encourage banks to lend to small and medium-sized entities under this Rozgar Scheme, the SBP and the government later introduced a risk-sharing facility on first loss basis for SMEs and small corporates – 60 percent and 40 percent risk-sharing for entities with annual turnover not exceeding Rs 0.8 billion and Rs 2.0 billion, respectively. Furthermore, to provide temporary liquidity support to otherwise solvent firms and entrepreneurs, SBP allowed banks to extend the principal repayments on loans. Also, in an attempt to support investment activity in the country in these uncertain times, the central bank announced the Temporary Economic Refinance Facility to provide concessionary refinance facility for setting up new industrial units which was later extended for BMR activities as well. For the health sector, SBP introduced a refinance scheme to provide concessional credit to hospitals and other medical facilities seeking to build facilities to care for Covid-19 patients, and eased restrictions on import of medical supplies and equipment.

In the process, however, multiple structural weaknesses gained prominence, especially in the design and outreach of these measures, which necessitated scaling up the implementation efforts. In particular, the overall weak credit penetration in the economy made it challenging for SBP to achieve the desired level of policy outreach. While firms having an established relationship with banks could get financial support in these challenging times, it was feared that many financially excluded micro, small and medium-sized firms might struggle to manage their cash problems. Moreover, the informal sector, which employs over 71 percent of the country's non-agriculture labor force, was also hard to reach. The SBP took up these concerns head-on. SME tracing, aggressive marketing, frequent stock-taking, and grievance redressal became cornerstones of the implementation framework for the incentive schemes. To achieve this, the SBP worked closely with its field offices (BSC), business chambers, and commercial banks to address regulatory and operational constraints with respect to the credit offtake under these schemes. Policies were readjusted where necessary, whereas corrective actions were taken if a loan was rejected despite eligibility or when banks asked for higher than required collateral (especially under risk-sharing facilities).

The effective implementation of these measures helped alleviate the financial stress of myriad businesses, households and health-related institutions. By end-June 2020, around which the MPC held its third emergency meeting, over 1.3 million businesses had their principal payments worth over Rs 810 billion either deferred (for up to one year) or restructured. Similarly, over 2,784 businesses took financing help to pay salaries to 1.3 million employees. These developments notwithstanding, the downside risks to growth continued to remain high, as reflected in the contraction recorded in most high-frequency indicators of economic activity, including LSM, cement dispatches, petroleum sales, etc. Furthermore, consumer and business confidence remained in negative zones, as uncertainty prevailed with respect to the Covid trajectory, and the expected duration of smart lockdowns. Therefore, with demand-side inflation risks receding further and the external sector outlook becoming stable, the MPC brought down the policy rate further to 7 percent. With this decline in the policy rate, based on which an outstanding amount of Rs 3.3 trillion in loans were to be repriced by early July 2020, the cumulative potential cash flow impact to households and businesses from the SBP's collective measures reached approximately 4.0 percent of GDP.

3.2 Monetary Aggregates

The broad money (M2) grew by 17.5 percent during FY20 as compared to 11.3 percent last year. This higher expansion came on the back of a strong turnaround in net foreign assets (NFA) of the banking system. The Net Domestic Assets (NDA) also rose sharply, but their increase was lower than last year (**Table 3.1**).

Moreover, the sharp increase in SBP profits led to a fall in other items net.

These trends reversed completely after the spread of Covid-19: the NFA a posted net contraction, whereas the NDA recorded a steep rise. In case of NFA, two developments were important. First, foreign investors pulled their capital from the domestic market, which led to some pressures on the country's foreign exchange reserves. And second, because of these capital outflows, the Pak Rupee depreciated against the US dollar, which significantly inflated the outstanding stock of foreign liabilities (in Rupee terms) of the banking system. Foreign assets were also revalued, but given an outsized volume of foreign liabilities, the net impact was negative. This is evident from the fact that around 31 percent of the contraction in NFA during Mar-Jun 2020 stemmed from a 9 percent depreciation of the Pak Rupee. In the case of NDA, the key factor behind the expansion was a spike in the government's budgetary borrowings from the scheduled banks. This spike is explained by (i) banks' secondary market investments in government paper as foreign investors pulled out; and (ii) additional borrowing requirements of the government to handle Covid-related spending amid tapering revenue collection.

Monetary Aggregates (provisional) — **Table 3.1**

billion Rupees

	Jul-Feb		Mar-Jun		Fiscal Year	
	FY19	FY20	FY19	FY20	FY19	FY20
M2 (a+b)	**485.3**	**880.5**	**1,316.0**	**2,228.8**	**1,801.3**	**3,109.3**
a. NFA	-843.2	1,127.0	-455.5	-134.8	-1,298.7	992.2
b. NDA	1,328.5	-246.4	1,771.5	2,363.6	3,100.0	2,117.1
Budgetary borrowings*	**988.5**	**190.3**	**1,215.0**	**1,979.8**	**2,203.5**	**2,170.0**
SBP	3,178.1	-795.8	-99.6	660.9	3,078.5	-134.9
Scheduled banks	-2,189.6	986.1	1,314.7	1,318.8	-875.0	2,304.9
Commodity operations	-140.5	-96.9	77.2	153.9	-63.3	57.0
Private sector credit	**615.9**	**250.0**	**77.7**	**-53.7**	**693.5**	**196.4**
PSEs	115.9	-8.8	210.2	105.1	326.0	96.3
Other items net	**-254.0**	**-585.8**	**177.8**	**178.9**	**-76.2**	**-406.8**
Liability-side:						
Currency in Circulation	311.7	473.3	250.6	718.7	562.2	1,192.0
Total Deposits with Banks	166.0	407.6	1,066.5	1,502.4	1,232.4	1,909.9
Reserve Money	757.3	25.6	331.5	1,080.6	1,088.8	1,106.2

* These numbers are on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in Figure 3.4 and Table 4.1.

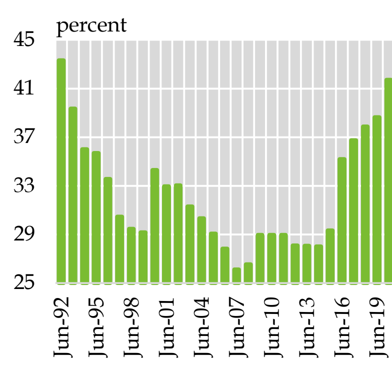
Source: State Bank of Pakistan

To have a clear understanding of the monetary sector developments during FY20, it is important to split the year into before and after the Covid shock. During the first eight months, the NFA remained the key driver of the overall growth in monetary base, reflecting an improvement in the current account, IFI support and foreign capital inflows in the domestic debt market. Here, it is important to recall that for the first time, the IMF's lending for balance of payments support under the ongoing program was also utilized by the government to finance its budget deficit (therefore, it was treated as a foreign liability of the government, not of the central bank). The NDA of the banking system during this period posted contraction, as foreign investment in domestic debt instruments lowered the government's appetite for bank funding. Private sector credit also weakened, as domestic industrial activity decelerated.

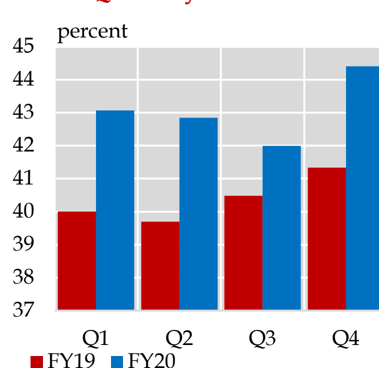
Developments on the liability side were not favorable either. As also highlighted in previous reports, the economy's cash preference has increased manifold in recent years, especially relative to the increase in bank deposits, since the imposition of withholding tax on banking cash and non-cash transactions. However, in FY20, additional challenges emerged which encouraged firms and individuals to keep more cash, as reflected in a higher currency to deposit ratio in all the quarters over last year (**Figure 3.4b**). At end-June 2020, this ratio touched 41.7 percent – a level last seen in FY92 (**Figure 3.4a**).

In the pre-Covid period, the increase in this ratio represented the impact of prevailing high levels of inflation (especially food inflation) and the resulting weak consumer confidence, as tight financial conditions may have induced firms and households to tap their savings held in the form of bank deposits, and also carry more cash. In addition to this, apprehensions of individuals and businesses with respect to the increased financial scrutiny in the country, intense monitoring against short-filing and tax evasion, and the increasing use of data on bank deposits and banking transactions (to identify high net-worth individuals and unregistered businesses) by tax authorities, also led to an increase in out-of-bank settlement for commercial and personal transactions.

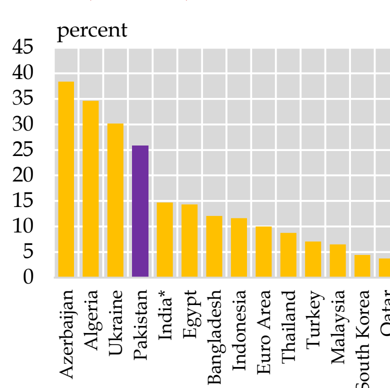
Currency to Deposit Ratio - Annual **Figure 3.4a**



Currency to Deposit Ratio - Quarterly **Figure 3.4b**



Currency in Circulation to M2 (Jun 2020) **Figure 3.4c**



*the ratio for India is calculated using monetary survey of RBI for Jun 19, 2020
Source: SBP, IMF and RBI

While these challenges persisted in the period after the Covid-19 spread as well, the uncertainties with respect to mobility restrictions triggered increased cash penetration in the economy. On average, the overall currency to deposit ratio hovered around 43.8 percent during Mar-Jun 2020. It appears that despite the SBP's proactive efforts to promote digital payments and uninterrupted banking operations, customers preferred cash holding for precautionary purposes. Probably this represents their attempt to minimize visits to banks amid reduced banking hours and restricted mobility. However, it is also important to note that this period (Mar-Jun) also included the month of Ramazan, when customers typically withdraw their deposits to avoid Zakat deductions and for Eid-related spending.[1] Meanwhile, the increase in currency in circulation may also reflect the impact of cash disbursements under the government's Ehsaas Emergency Cash program (to the tune of around Rs 150 billion up to June 30) to support families facing extreme financial hardship.

Nonetheless, the steady increase in cash penetration in the economy is concerning as, compared to other emerging market economies, it is already on the higher side in Pakistan. As shown in **Figure 3.4c**, the currency to deposit ratio in Pakistan is significantly higher compared to India and Egypt, almost double as compared to

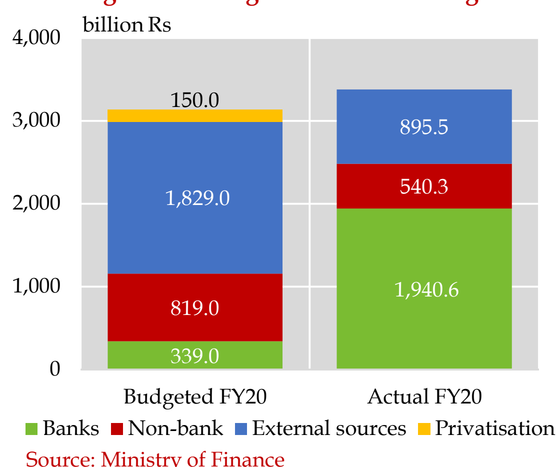
[1] In the initial weeks of May 2020, the currency to deposit ratio had touched 46.6 percent.

Bangladesh, Indonesia and Turkey, and over 4-times the ratio in Malaysia and South Korea. Although the impact of Covid-related uncertainties may dissipate going forward, the prevailing concerns with respect to financial scrutiny might linger for some time. That said, serious measures are needed to reduce informality from the economy and ensure inclusivity in the provision of financial services, if the cash penetration is to be reduced sizably.

Government Borrowings

Budgetary support from the banking system remained at an elevated level for the second consecutive year, although it witnessed a slight deceleration on a YoY basis.[2] As mentioned earlier, the government resorted to the domestic banking system mainly in the Mar-Jun period, when foreign investors divested from the debt market amid a sharp rise in the government's spending needs. In the earlier months of the year, budgetary borrowings from the banking system were quite contained as the government adhered to the fiscal targets laid out in the budget, and sufficient funding was available from external and domestic non-bank sources. Nonetheless, on a full-year basis, the financing outturns witnessed a tangible deviation from the budgeted estimates (**Figure 3.5**).

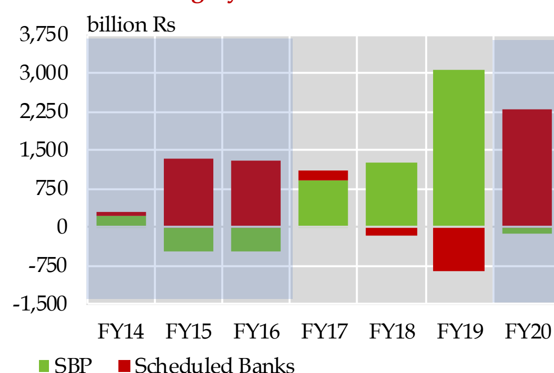
Financing Mix of Budget Deficit **Figure 3.5**



Source: Ministry of Finance

As opposed to the budgeted financing requirement of only Rs 339 billion from the domestic banking system, the government ended-up borrowing Rs 1.9 trillion (on-cash basis) during FY20. Within the banking system, the entire burden of the budgetary support fell on scheduled banks, as the government adhered to its commitment of refraining from deficit monetization, and at the same time avoided rolling over the maturing securities held by the central bank.[3] It is important to recall here that a similar trend was observed back in FY14-FY16 when the government had completely avoided central bank borrowing (**Figure 3.6**). But in all the years in between, including last year, borrowing from the central bank had constituted a major proportion of deficit financing.

Composition of Budgetary Support from the Banking System* **Figure 3.6**



*Highlighted area indicates IMF programs

Source: State Bank of Pakistan

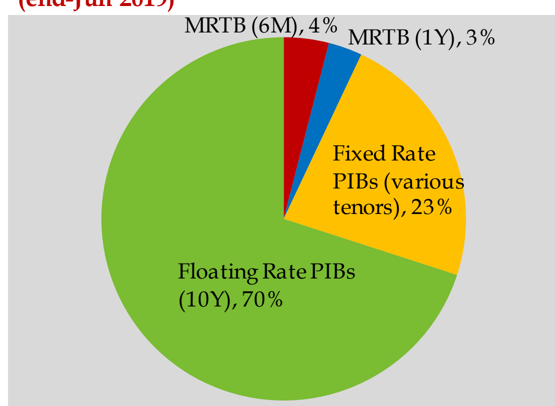
However, it is also important to recall here that at end-June FY19, the government had carried out major re-profiling of the SBP debt, when the entire outstanding portfolio of MRTBs was rescheduled. Nearly 70 percent of the SBP debt stock was converted into 10-Year Floating Rate PIBs (FR-PIBs). Also, towards the start of FY20, the government had built cash buffers (to the tune of Rs 1 trillion) to mitigate temporary cash flow problems that could possibly arise in the absence of fresh SBP funding. Together, these measures implied that (i) there will be no additional

[2] The budgetary borrowings from the banking system grew by 18.0 percent in FY20 as compared to 23.5 percent last year.

[3] During FY20, the government retired Rs 569 billion worth of securities that were held by the SBP.

financing pressure on the government to amortize the maturing SBP debt, as 93 percent of the SBP debt had a maturity greater than one year (only 7 percent of the stock held in 6- and 12-month T-bill was to mature before June 2020) (**Figure 3.7**); and (ii) the government could draw on cash buffers in case significant pressures emerged on secondary market yields.

Reprofiling of MRTBs (end-Jun 2019) **Figure 3.7**



Source: State Bank of Pakistan

Thus, at the start of the year, the interbank market knew that the supply of government bonds will remain contained despite the non-availability of SBP funding. This view was reinforced by the fiscal consolidation measures announced by the government in the FY20, and its adherence to these measures as the year progressed. On the other hand, the demand for government bonds remained strong, as market expectations of interest rates plateauing began to take hold, especially after the MPC's July decision. This encouraged banks to offer higher-than-target liquidity volumes against longer tenor instruments in primary auctions. In response, the government adhered to the targets set in the auctions, leveraged this demand-supply gap to slash the cut-off rates, and substituted its short-term debt with long-term papers. As a result, not only did the yields remain suppressed in the secondary market, but the overall maturity profile of the government domestic debt also improved. On net basis, the government's borrowings against PIBs (Rs 1.9 trillion net) were more than double than those against T-bills (Rs 738.9 billion) during FY20.

Further details on primary auctions of government securities and the behavior of market participants are presented below.

Primary auctions and market behavior

Investments via T-bills remained higher than last year on net-of-maturity basis, with competitive offers at a significantly higher level compared to the preceding years (**Table 3.2**). Importantly, a clear preference was observed for longer tenor instruments. The net-of-maturity offers for 12-month T-bills rose to an all-time high of Rs 14 trillion. This was on the back of expectations of plateauing interest rates and plunging yields from August 2020 onwards that drove the first round of shift in market's preference of 12- and 6-month T-bills over 3-month paper. However, the high inflation numbers in December and January 2020, and an inverted yield curve, resulted in a temporary reversal in the trend that persisted from mid-December to mid-February; again, 3-month T-bill offers constituted more than 50 percent of the entire competitive T-bill bids. Then after the Covid-19 outbreak, market's expectations for interest rate cuts again took hold and the demand for 12- and 6-month papers increased. On a full-year basis, the outstanding stock of 3-month paper witnessed a sharp decline of Rs 4.4 trillion, whereas an increase of Rs 0.9 and Rs 4.6 trillion in 6- and 12-month papers, respectively, was observed.

T-bill Auction Summary **Table 3.2**

billion Rupees

Tenor	Target	Maturity	Offered*	Accepted
FY20	15,050.0	13,986.3	32,354.2	15,167.1
FY19	19,500.0	19,183.7	23,343.2	18,875.9
FY18	16,925.0	16,388.0	21,105.2	17,550.6

*competitive bids only

Source: State Bank of Pakistan

In case of PIBs, the acceptances of both fixed and floating rate instruments remained at an elevated level during FY20 (**Table 3.3**). The government raised a cumulative Rs 1.97 trillion from PIBs in FY20 compared to only Rs 0.34 trillion in FY19 on net of maturity basis. This is indicative of a clear shift in the government's debt management strategy. Encouragingly, in an effort to increase the

range of long-term and medium-term bonds for the market, the government reintroduced the 15-year fixed-coupon PIB in April 2020 (that were last issued in August 2011), and new 3-year and 5-year floating rate PIBs in June 2020 to fill the gap of a medium-term floating rate instrument in the market. Along the same lines, in March 2020, the government accepted bids for 20-yr PIBs after a gap of more than 5 years.

PIB Auction Summary **Table 3.3**

billion Rupees

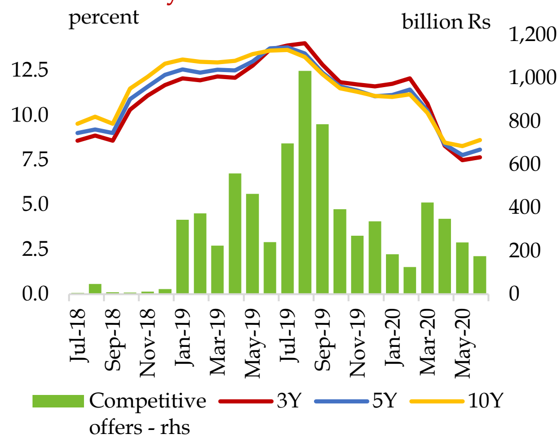
Tenor	Target	Maturity	Offered*	Accepted
Fixed coupon				
FY20	1,255.0	920.3	5,027.0	2,070.7
FY19	800.0	843.6	2,320.5	873.5
FY18	900.0	1123.4	338.5	101.7
Floating coupon				
FY20	950	-	1,578.1	818.3
FY19	850	-	706.3	311.7
FY18	100	-	296.1	43.1

*competitive bids only

Source: State Bank of Pakistan

On the demand-side, the competitive offers more than doubled compared to the preceding year, given the market's willingness to take more exposure on the long-term instruments, keeping in view the high level of long-term rates. Initially at the start of FY20, the volume of offers remained high but bids for PIBs dipped subsequently as the yields started declining and with inflation in double-digits (until March 2020). With the onset of Covid-19, the market's expectations of rate cuts increased, and in turn, resulted in a renewed interest for PIBs – though not as high as was observed during Q1-FY20 (**Figure 3.8**).

Bidding Pattern of Fixed Rate PIBs and Secondary Market Yields **Figure 3.8**

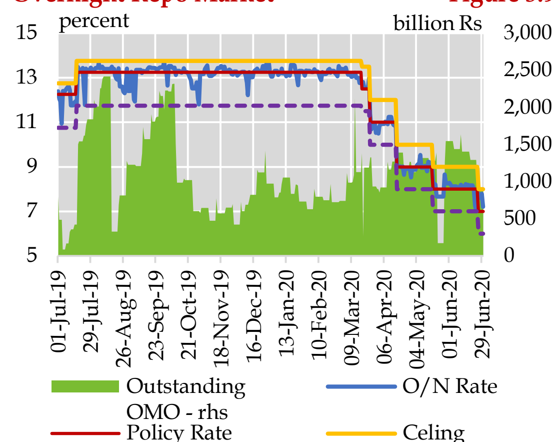


Source: State Bank of Pakistan and MUFAP

Sukuk issuance amid Covid-19

Keeping in view the surge in the fiscal deficit after the Covid-19 outbreak, along with outflow of foreign portfolio investment from local debt securities, the government responded by expanding the domestic investor base by issuing Shariah-complaint debt instruments. In Q4, Rs 198.2 billion worth of 5-year variable rental rate Sukuk were issued, against the target of Rs 300 billion. It was in June 2017 when the government had last issued Sukuk to finance its budgetary needs. The timely issuance this year was not only helpful in increasing Islamic banks' share in the government securities portfolio, but also provided them an opportunity to invest in risk-free Islamic government debt instruments. Importantly, comparing the auction results of 5-year floating rate (FR) PIB (auction held on June 17, 2020) and the Government Ijara Sukuk-Variable Rental Rate (GIS-VRR) of the same tenor (auction held on June 18, 2020) reveals that the cutoff margin for FR-PIB was +49 bps, whereas it was -10 bps for GIS-VRR – i.e. the Sukuk was almost 59 bps cheaper.

Overnight Repo Market **Figure 3.9**



Source: State Bank of Pakistan

Liquidity Management

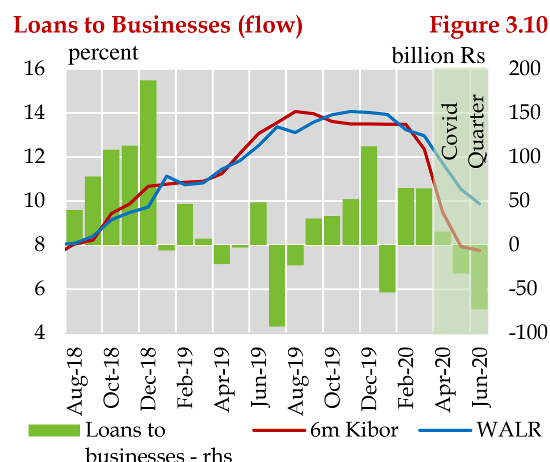
During FY20, the domestic interbank market remained relatively less volatile as compared to the large liquidity swings observed last year. This stability was achieved on the back

of a shift in the government's debt management strategy to increase the maturity profile, which was also supported by renewed market interest in the long-term sovereign debt instruments. This resulted in less voluminous maturities in each subsequent auction as opposed to the situation last year. The stability gains from this gradual increase in average time-to-maturity of the government debt portfolio continued to unfold throughout the year. This can be gauged from the fact that the overnight rates remained less volatile during H2-FY20 as compared to H1-FY20 (**Figure 3.9**). Nonetheless, the SBP stepped up OMO injections in the Mar-Jun 2020 period, in response to the increase in the government's borrowing requirements from the scheduled banks, and to adjust the overnight rates close to the steeply reduced policy rate.

3.3 Credit to Private Sector

The momentum in private sector credit weakened significantly during FY20, as the overall offtake stood at only Rs 196.4 billion, as compared to Rs 693.5 billion last year. This primarily represented subdued industrial production (mainly LSM) during the year – initially on account of stabilization measures and regulatory changes announced in the FY20 budget, and later due to factory closures amid the Covid-related lockdowns. It is important to recall here that the cash flow constraints stemming from inventory build-ups and rising cost pressures in the country had induced many firms to leverage excessively last year. However, as the interest rates rose steadily and stayed at double-digits till March 2020, additional bank financing became less viable for many firms. In the first 8 months of FY20 also, businesses struggled with weak interest coverage, and in some industries, such as technology and communication, electric goods, food and personal care, cement, textile, the finance cost was more than 70 percent of the operating income (for steel, power, leather it was over 39 percent during the quarter ending March 2020). Although credit demand gained some strength during the third quarter amid decent export activity, the credit numbers plummeted again in the fourth quarter as businesses retired Rs 90 billion (**Figure 3.10**). Importantly, this net retirement was despite the steep cut in policy rates and the relief measures announced by the SBP, whereby firms could request for deferral of principal component of installment for a one-year period at no fee or increase in mark-up. Furthermore, borrowers who were unable to even service the mark-up amount or needed deferment exceeding one year, could get their financing rescheduled or restructured. In addition, a large number of firms also applied to avail the "Rozgar Scheme" announced by the SBP to provide concessionary loans to cover the salary component of firms' expenditures. The SBP also introduced the Temporary Economic Refinance Facility (TERF) and the Refinance Facility for Combating Covid-19 to incentivize fresh investment activity and cover health-related expenditures, respectively. Under these favorable dynamics in the credit market, some recovery in credit offtake was expected.

Loans to Businesses (flow) **Figure 3.10**



Source: State Bank of Pakistan

Three factors primarily explain the subdued credit offtake during the fourth quarter. First, while a large amount of loans was approved under the Rozgar Scheme, actual disbursements remained low up till end-June 2020. Against the total approval of Rs 119.1 billion by June 26, actual disbursements stood at Rs 51.1 billion. The outstanding amount of credit will eventually increase when banks will disburse the approved funding. Second, anecdotal evidence suggests that some firms have been retiring their previously taken bank loans against conventional facilities, through

Loans to Private Sector Businesses* **Table 3.4**

(Flow in billion Rupees)

	Total Loans		Working Capital**		Fixed Investment	
	FY19	FY20	FY19	FY20	FY19	FY20
Private Sector Businesses	574.6	97.3	491.6	60.3	82.9	37.0
Manufacturing	411.6	162.5	362.1	111.0	49.5	51.5
Textile	132.0	170.0	105.9	127.1	26.1	43.0
Cement, lime and plaster	33.1	26.2	15.5	26.3	17.5	-0.2
Sugar	-19.6	15.1	-31.0	12.8	11.4	2.2
Basic iron and steel	11.3	17.6	10.7	11.6	0.6	6.0
Motor vehicles	20.5	14.6	14.5	11.3	6.0	3.3
Rice Processing	26.5	-1.4	26.0	-1.7	0.5	0.3
Paper & paper products	2.8	-7.1	2.8	-5.0	0.0	-2.2
Vegetable and animal oils and fats	30.4	-11.1	34.6	-12.8	-4.2	1.7
Refined petroleum	36.9	-20.4	42.3	-18.9	-5.4	-1.4
Fertilizers	23.7	-31.9	32.3	-26.6	-8.6	-5.3
Telecommunications	-6.4	25.5	11.7	-8.0	-18.1	33.5
Mining and quarrying	22.2	15.0	14.7	7.7	7.5	7.3
Real estate activities	8.6	2.6	3.9	3.7	4.7	-1.1
Power generation, transmission and distribution	95.6	9.0	47.0	15.1	48.6	-6.0
Administrative and support service activities	-	-14.7	-	-7.6	-	-7.1
Transportation and storage	3.4	12.9	8.7	22.9	-5.4	-9.9
Agriculture, forestry and fishing	-5.1	-21.3	6.2	-10.4	-11.3	-10.9
Construction	-12.8	-27.5	6.6	-17.2	-19.4	-10.3
Wholesale and retail trade	62.8	-46.2	42.2	-42.7	20.6	-3.5

*The sector-wise data for FY19 and FY20 may not be fully comparable, as the flows for FY19 are based on ISIC 3.1 whereas the flows for FY20 are based on ISIC 4.0 classification.
**includes trade financing

Source: State Bank of Pakistan

borrowing under recently announced concessionary funding facilities. Therefore, the net addition in the outstanding credit may not be large. Third, anecdotal evidence also suggests that due to uncertainties prevailing with respect to the Covid trajectory and the duration of the containment measures, firms with sufficient liquidity on-hand preferred to repay their outstanding loans and postponed additional borrowing plans.

Working capital loans

Private businesses took only Rs 60.3 billion in working capital loans in FY20, as compared to Rs 491.6 billion last year (**Table 3.4**). The demand for working capital did not appear vibrant, as banks actually received 10 percent fewer applications for working capital loans during FY20 on YoY basis. With higher borrowing cost, export-oriented firms, especially in the textile sector, managed to avail financing under the SBP's concessional Export Finance Scheme (EFS), thus increasing the overall borrowing under EFS to Rs 114.8 billion in FY20 from Rs 87.2 billion in FY19. This means that excluding EFS, firms actually retired previously taken working capital loans during the year. Around 58 percent of the increase in EFS loans came in Q3-FY20, as from January 2020 onwards, the SBP had enhanced the aggregate limit for the scheme by Rs 100 billion to facilitate export-oriented sectors and promote export growth.

Similar to textiles, the cement sector's borrowings were also concentrated in the second and third quarters, with higher PSDP spending leading to some revival in construction activity in the country. At the same time, however, the financial position of most cement firms remained weak (as evident from the after-tax losses booked in Q3), as the overall economic slowdown did not allow them to pass on the impact of higher taxation and freight to end-consumers.

Developments in the sugar sector were not different either. Short-term borrowings by the sector in Q3 alone were enough to dilute the impact of loan retirements in the other

quarters of the year. With the goods' transporters strike in January 2020, sugar prices rose sharply, and continued to increase even after the strike ended. In the absence of a reliable stock position, the government announced a ban on exports and allowed the import of sugar. As a result, the sector borrowed Rs 93.4 billion during Q3, taking its cumulative borrowing to Rs 12.8 billion in FY20.

In contrast, oil refineries opted to deleverage to shield their profit margins from getting further eroded by high borrowing cost, decreased demand for fuels due to reduced industrial activity coupled with shut down of factories, complete halt of public transport, and interprovincial movement during country-wide lockdown. The refining sector was already facing serious cash flow constraints stemming from regulatory changes for furnace oil-based power generation, and import-led compression in the commercial transport activity in the country.

Among the non-manufacturing firms, the transport sector's borrowing was noteworthy at Rs 22.9 billion in FY20, compared to Rs 8.7 billion last year. Almost the entire increase in the offtake came in H1-FY20, reflecting borrowing by a deep seaport operator that is upgrading its operations.

Fixed investment loans

Over the past couple of years, fixed investment loans recorded a consistent increase on the back of higher PSDP expenditures and progress on CPEC-related infrastructure projects. A number of sectors, including cement and power generation, had spent on capex and resorted to bank financing for the import of machinery and equipment. In FY20, however, long-term loans grew by only Rs 37 billion – less than a half of the Rs 82.9 billion increase recorded in FY19. It seems that the recent investment cycle in many sectors had peaked out, and now these businesses are retiring their long-term loans. Furthermore, firms may not be expected to take a long-term view of the economy with macroeconomic stabilization policies in place and overall weak business confidence. In particular, frequent increases in interest rates last year had raised the investment finance cost substantially. This coupled with market perception of exchange rate risk – stemming from frequent exchange rate adjustments as the country moved towards adopting a market-based exchange rate system – might have made it challenging in the short term to carry out robust project evaluations and feasibility studies for industrial investment.

Three sectors, that recorded some fixed investment activity during FY20 included telecom, textile, and iron & steel. Textile firms continued to position themselves to take advantage of the improved market opportunity in the key export destinations and the pricing edge stemming from the exchange rate realignment. The sector also enjoyed concessional rates under the SBP's Long Term Financing Facility (LTFF) for export-oriented projects, as LTFF loans constituted around 84 percent of the textile sector's overall fixed investment borrowing during FY20, and a full 100 percent during Q4. This suggests that the policy measure of extending the limit of LTTF by Rs 100 billion in January 2020 was quite helpful.

The telecom sector borrowed Rs 24.8 billion in Q1-FY20 to pay for the submission of renewal fees to the government for GSM licenses – also an important source of non-tax revenue for the government (Chapter 4). In addition, the sector borrowed another Rs 19.1 billion in Q4-FY20 for network expansion plans. Encouragingly, in May 2020, a leading cellular firm operating in Pakistan announced a partnership with a multinational payment technology company to strengthen the payments ecosystem for merchants and customers in Pakistan, and is expected to invest accordingly.

In addition to these two sectors, some activity was also recorded in the steel sector. It is important to highlight that the existing south-based key players are focusing on increasing their footprint in the northern region of the country, apart from vying for market share in non-construction segments, such as the home appliance and the auto sectors.

Consumer financing

After growing in the last couple of years, consumer financing lost pace and fell into the negative territory in FY20 (**Table 3.5**). Consumer financing posted a net retirement of Rs 6.4 billion, as compared to an increase of Rs 57.3 billion last year. Consumers perceived this year to be challenging to borrow from banks to finance their spending on house building, car purchases and other consumer items, as interest rates remained in double-digits through most of the period. The overall consumer confidence also remained weak amid high inflation and weak economic activity.

Consumer Financing **Table 3.5**

flow in billion Rupees

	FY18	FY19	FY20
Total	**86.5**	**57.3**	**-6.4**
Personal loans	12.5	13.9	7.3
Consumers durable	1.1	3.7	1.3
Credit cards	7.4	7.0	-1.3
Transport e.g. cars	43.3	22.2	-4.3
Housing	22.3	10.4	-9.3

Source: State Bank of Pakistan

The major drag came from housing and auto financing segments, which posted negative growths of 9.3 percent and 4.3 percent, respectively. These segments also struggled to perform because the government had placed a ban on non-filers from purchasing/ registering assets, such as cars and residential properties (above Rs 5 million). In case of auto finance, consumers faced additional challenges, as car assemblers raised their ex-factory prices several times since the beginning of FY19 (citing the impact of the currency depreciation). On top of that, regulatory measures, including the imposition of FED on various car models, and additional customs duty on auto part imports, further escalated retail prices. This, coupled with high interest rates, significantly increased the volume of monthly installments of car financing products. As a result, many customers were priced out.

In order to promote and develop housing finance in the country, the SBP has decided to set mandatory targets for banks to extend mortgage loans and financing for developers and builders. Banks will be required to increase their housing and construction of building loan portfolios to at least 5 percent of their private sector credit by end December 2021. The SBP is gearing up efforts for housing projects in the light of the government's plan to build low-cost housing projects for low-income people.

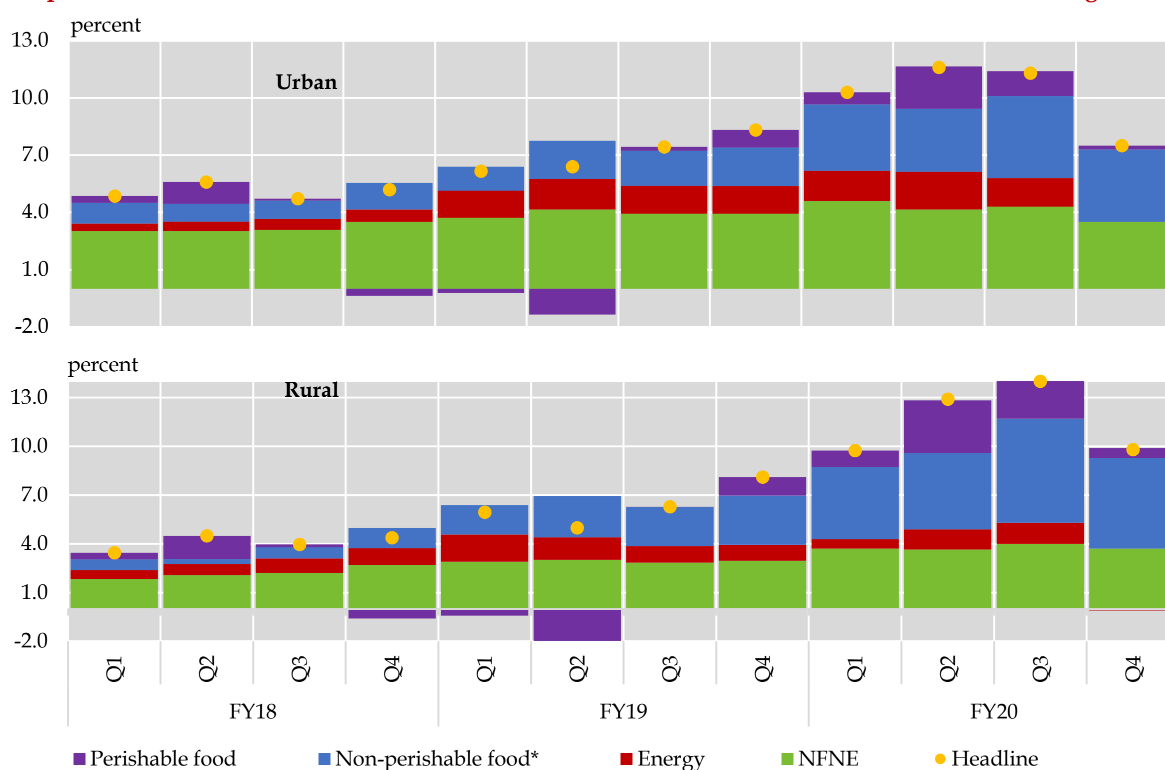
3.4 Inflation[4]

While keeping the policy rate aligned with the medium-term inflation target, SBP was able to keep the underlying inflationary pressures in the economy in check during FY20. This was reflected in the stability in the non-food-non-energy (NFNE) component of CPI (**Figure 3.11**). Nonetheless, multiple factors of a temporary and seasonal nature kept the overall level of inflation high during the year. These included: (i) supply disruptions in major food items stemming from delayed crop arrivals, speculative activities and weak commodity management; (ii) duties and taxes levied/ increased in the Budget 2019-20 on multiple food items including sugar, cigarettes, edible oil and ghee; (iii) price adjustments on account of exchange rate depreciation that took place towards the end of FY19; (iv) tighter border management by custom authorities; and (v) higher transportation costs following the increase in fuel prices as well as the implementation of the axle-load policy. As a result, headline inflation posted a sharp increase and clocked in at 10.7 percent in FY20 as compared to 6.8 percent in FY19.

It is important to note that though higher than last year, FY20's inflation outcome was lower than the SBP's projection of 11-12 percent at the start of the year. This outcome should be viewed in the context of a shift in regulatory and policy dynamics in the country through

[4] In August 2019, the Pakistan Bureau of Statistics (PBS) started publishing a new set of price indices with FY16 as the base year. For details see *Box 3.2: Rebasing of Price Indices* in the State of Pakistan's Economy Report for Q1-FY20.

Composition of YoY CPI Inflation **Figure 3.11**



*Inclusive of alcohal beverages and readymade food
Source: Pakistan Bureau of Statistics

the course of the year. Specifically, at the start of the year, temporary pressures on inflation were envisaged on account of revenue-enhancing budgetary measures, the approval of up to 168 percent rise in gas tariffs, higher transportation cost, and the absorption of recent exchange rate depreciation. While these pressures materialized as the year progressed, fresh challenges emerged in the form of crop damages (leading to profiteering and speculative activities in the domestic food market), which persisted up till January 2020. Furthermore, although the full-year average for energy inflation remained lower than last year, the administrative prices of energy items increased steadily during Jul-Jan FY20, as the government passed on the impact of energy sector arrears to end-consumers (in both gas and electricity segments). As a result, headline inflation increased to 14.6 percent YoY in January 2020, taking the year-to-date average inflation to 11.6 percent.

However, the situation in both food and energy sectors changed significantly from February 2020 onwards. In the food market, while some improvement was attributed to seasonal resumption of perishables' supplies and imports, major support came from the government's effective crackdown on speculative elements in the non-perishable market. Similarly, in the energy sector, Nepra postponed the fuel price adjustment applicable in February 2020, following the government's decision to freeze electricity prices till June 2020. This regulatory decision was crucial to stabilize energy prices in the country. This was reinforced by a sharp decline in global crude oil prices in early March 2020, the impact of which was immediately passed on to domestic fuel prices. In addition, the overall weak demand conditions following the Covid-related containment measures between March and June 2020, also pushed core inflation down. As a result of these developments, the headline inflation dropped from 14.6 percent in January 2020 to 8.2 percent in May 2020 and 8.6 percent in June 2020.

In terms of dispersion, for the complete year, the higher level of inflation was wide-ranging,

Average CPI Inflation and Contribution **Table 3.6**
(percent)

Items	Urban						Rural					
	Wt.*	FY20		FY			Wt.*	FY20		FY		
		H1	H2	FY19	FY20	Cont.*		H1	H2	FY19	FY20	Cont.*
CPI	100.	11.0	9.4	7.1	10.2	10.2	100.0	11.3	11.9	6.3	11.6	11.6
Food & non-alcoh. bev.	30.4	14.8	14.5	4.4	14.6	4.2	40.9	15.5	17.2	4.4	16.4	6.5
Clothing and ft.wear	8.0	8.9	9.6	5.7	9.2	0.7	9.5	9.1	11.3	7.4	10.2	1.0
Housing, Elec., Gas	27.0	8.7	6.5	8.2	7.6	2.1	18.5	4.5	6.1	7.4	5.3	1.0
Electricity charges	4.6	6.0	-2.3	11.5	1.8	0.1	3.4	6.0	-2.3	11.5	1.8	0.1
Gas charges	1.1	79.9	54.8	29.0	66.4	0.8	n.a	n.a	n.a	n.a	n.a	n.a
Furnish. & H.H equip.	4.1	11.8	9.0	7.9	10.4	0.4	4.1	10.1	10.2	7.0	10.1	0.4
Health	2.3	11.2	10.3	6.7	10.8	0.3	3.5	12.1	11.6	7.1	11.8	0.4
Transport	6.1	17.2	6.1	16.6	11.5	0.7	5.6	14.9	4.0	15.0	9.3	0.6
Motor fuel	2.9	19.8	2.0	20.7	10.7	0.4	2.5	19.7	1.1	20.5	10.2	0.3
Communication	2.4	5.4	3.7	3.0	4.5	0.1	2.0	1.9	1.2	2.0	1.5	0.0
Education	4.9	6.6	4.4	9.5	5.5	0.3	2.1	5.2	4.2	5.9	4.7	0.1
Restaurants and hotels	7.4	5.1	7.3	5.5	6.2	0.5	6.2	7.9	10.5	4.9	9.2	0.6
Misc. goods & services	4.8	11.6	10.7	8.6	11.1	0.5	5.0	12.7	13.2	7.4	13.0	0.7
NFNE	53.7	8.0	7.1	7.2	7.5	4.1	42.6	8.4	8.9	6.8	8.7	3.8

*wt. = weight and Cont.= Contribution for FY20
Source: Pakistan Bureau of Statistics

as a majority of the sub-indices (67 out of 94, with around 71 percent share in urban CPI indices) posted higher inflation during FY20 as compared to last year.

Food remained the dominant source of inflation

Food inflation not only surged significantly during FY20, but was also the major contributor to the overall rise in inflation (**Table 3.6**). Both perishable and non-perishable food items registered double-digit inflation, but the impact of the latter was more pronounced and persistent (**Figure 3.12**).

Non-perishables

Among the non-perishable food items, the major concern emerged from wheat and wheat flour. A crisis-like increase in their prices was observed from Q2 onwards, which stemmed from production shortfall compared to its target and lower procurement of the crop in the previous season by procurement agencies (as pointed out in detail in the SBP's Third Quarterly Report of FY20).

While these developments triggered speculative activity in the wheat market, the situation deteriorated further in January 2020 due to transportation disruptions following a 15-day strike by goods' transporters against the heavy rise in penalties over violation of traffic rules on highways and motorways. These constraints were also reflected in the strong momentum in the wholesale and retail prices, which appeared to have encouraged stockpiling of the commodity. Therefore, when the transporters' strike ended and the government allowed import of wheat from February 2020 onwards, a significant drop in wheat prices was observed in February (down 3.5 percent MoM) and March (down 8.4 percent MoM), as shown in **Figure 3.13**. Nonetheless, after falling for nearly 4 months in a row, prices surged again towards the end of May 2020, when the Pakistan Flour Mills Association announced a hike in the prices of flour by Rs 20 per 20kg bag, and wheat-grinding operations in Punjab, Khyber Pakhtunkhwa and Balochistan shut down as millers were unable to purchase wheat from either the open market or the government food authorities.

Other than wheat, prices of cigarettes, sugar, edible oil and ghee, and pulses also came under pressure during the year. In case of cigarette, the significant revision in FED pushed up prices. Similarly, in case of edible oil and ghee products, the increase in FED rate

Heat Map - YoY Urban Inflation (Food) **Figure 3.12 a**

	Wt.	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Food Index	36.8	7.5	7.9	11.9	15.0	13.7	16.6	16.7	19.5	15.2	13.0	10.4	10.6	12.9
Perishable food	4.5	14.3	5.4	13.3	27.2	35.9	66.0	76.4	68.8	25.2	12.9	9.2	1.5	4.2
Non-perishables	26.0	6.5	8.1	12.5	14.4	11.1	10.8	10.8	15.2	14.9	13.9	11.0	12.9	15.7
Poultry(Chicken,Egg)	1.9	-12.4	-6.6	50.0	52.0	-0.3	-13.0	-11.5	21.0	6.7	3.1	-13.8	7.9	24.5
Pulses	0.7	15.1	16.9	18.6	18.7	19.0	22.8	21.7	34.9	35.8	30.4	50.7	41.9	35.2
Fresh fruits	1.4	0.6	9.7	8.2	6.7	5.4	7.9	9.1	8.5	1.8	3.1	3.0	-3.6	4.3
Condiments & spices	1.3	20.3	18.9	21.9	20.5	18.1	19.2	17.6	24.4	25.6	27.0	23.2	24.7	29.8
Vigetables	2.9	23.3	2.1	13.3	34.5	47.5	92.5	118.3	105.6	34.5	14.5	11.2	3.7	3.2
Grains	4.9	6.0	7.7	7.9	9.8	9.2	12.9	13.9	21.0	16.5	12.9	13.4	11.3	19.4
Edible oil	2.2	12.4	13.9	18.4	19.3	18.0	16.0	16.5	16.4	30.0	29.7	24.2	23.0	22.4
Readymade Food	5.5	5.2	6.1	5.8	6.3	6.2	6.6	6.2	6.9	8.6	8.2	7.7	7.4	8.0
Meat (Meat, Fish)	2.4	11.1	11.8	12.2	12.6	13.5	13.2	13.5	13.2	12.7	11.4	11.3	9.1	8.2

Heat Map - YoY Rural Inflation (Food) **Figure 3.12 b**

	Wt.	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Food Index	45.9	9.1	9.3	12.6	15.0	14.6	19.3	19.7	23.8	19.7	15.5	12.9	13.7	15.2
Perishable food	5.8	14.7	12.1	17.3	26.1	34.3	73.9	89.3	90.3	41.2	18.2	13.5	11.4	10.9
Non-perishables	35.1	8.0	8.2	11.4	12.3	10.6	12.0	12.0	17.0	17.6	14.5	11.8	13.4	15.5
Poultry(Chicken,Egg)	2.0	-6.4	-9.3	37.3	42.1	4.4	-10.4	-13.9	16.5	13.0	-2.6	-16.0	7.6	16.9
Pulses	1.1	16.3	17.8	19.9	18.1	19.5	23.9	23.7	35.4	38.5	34.8	47.2	44.9	40.1
Fresh fruits	1.5	3.6	15.9	14.7	10.7	6.7	13.2	21.5	12.5	10.4	7.1	3.9	8.2	5.2
Condiments & spices	1.5	15.2	11.5	13.4	13.7	11.1	14.7	22.1	27.0	34.6	34.0	43.9	53.3	59.1
Vigetables	4.2	20.8	10.0	16.7	29.8	41.3	93.0	115.5	123.3	50.0	19.7	16.1	11.4	12.7
Grains	8.5	9.9	9.4	9.2	10.7	10.5	17.4	17.8	24.5	23.6	18.8	18.3	13.8	19.9
Edible oil	3.0	9.7	14.0	16.8	17.9	17.8	17.5	19.1	26.0	32.1	32.1	28.9	27.7	26.2
Readymade food	3.8	4.6	7.0	7.8	7.8	7.7	8.4	8.1	8.7	11.0	11.5	11.0	12.1	12.4
Meat (Meat, Fish)	2.0	13.0	12.5	11.3	12.1	12.7	12.0	12.2	11.6	9.0	9.6	8.3	8.6	7.7

* lighter shades depict lower (and negative) inflation and darker shades indicate higher inflation on YoY basis.

Source: Pakistan Bureau of Statistics

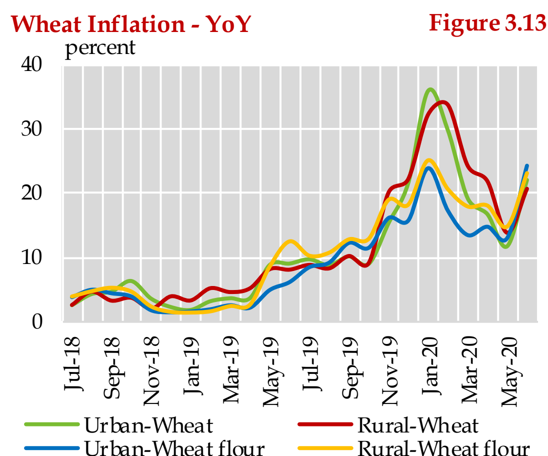
from 8.0 percent to 17.0 percent primarily contributed to the higher inflation. Edible oil refineries were also struggling with rising international prices of palm oil and soybean almost since the beginning of Q2-FY20, which they passed on to end-consumers.[5] Furthermore, the double-digit inflation in sugar can also be at least partially attributed to a steep rise in the rate of sales tax from 8.0 percent to 17.0 percent. In addition to budgetary measures, the price hike also reflected the expected low production of the commodity and the absence of a reliable stock position, which had activated speculative behavior in the sugar market. In March 2020, the government announced a ban on exports and allowed the import of the commodity to release the price pressures.

In case of pulses, however, inflationary pressures were largely imported. Wildfires in Australia (among the top-3 global exporters) and drought-like conditions in Thailand and Burma, have affected the global pulses production. Moreover, prices also rose on account of increased demand from India, which is one of the world's largest consumers as well as producers of pulses. In fact, there had been a general push by India in the second half of the year to shore up food security by making huge purchases in response to Covid-related uncertainties. Pakistan saw approximately 15 percent increase in unit values of imported pulses in

[5] International palm oil prices rose by 13.8 percent in FY20 as compared to a 19.9 percent deflation in FY19, and prices of soybean increased by 2.6 percent during FY20 compared to a 12.9 percent decline last year.

FY20 as compared to last year, which was passed on to prices in the domestic retail market.

Wheat Inflation - YoY **Figure 3.13**



Source: Pakistan Bureau of Statistics

Perishables

FY20 remained quite a challenging year in terms of managing perishable food prices, especially of vegetables (**Figure 3.14**). High temperatures and untimely rains disrupted crop cycles this year, as delayed arrivals exerted temporary price pressures in the market. It is important to mention here that the rise in perishable food prices was not just a domestic phenomenon, but also emerged as a regional concern in the second half of 2019. Specifically, unfavorable weather damaged crops in India, which is the largest producer and exporter of onion, tomatoes and potatoes in the region. India not only explicitly banned the export of onions and tomatoes in September 2019, but it also imported onions to bridge the supply-demand gap, which escalated regional prices. For Pakistan, the situation got much worse because while regional prices were not helpful, the import procedures were not smooth due to the prevailing regulatory restrictions (non-tariff barriers).[6] Delays in the issuance of import permits and valid phytosanitary certificates, and lack of quarantine department staff at the borders to allow no-objection certificates, affected imports of various vegetables and created temporary shortages in the domestic market.[7]

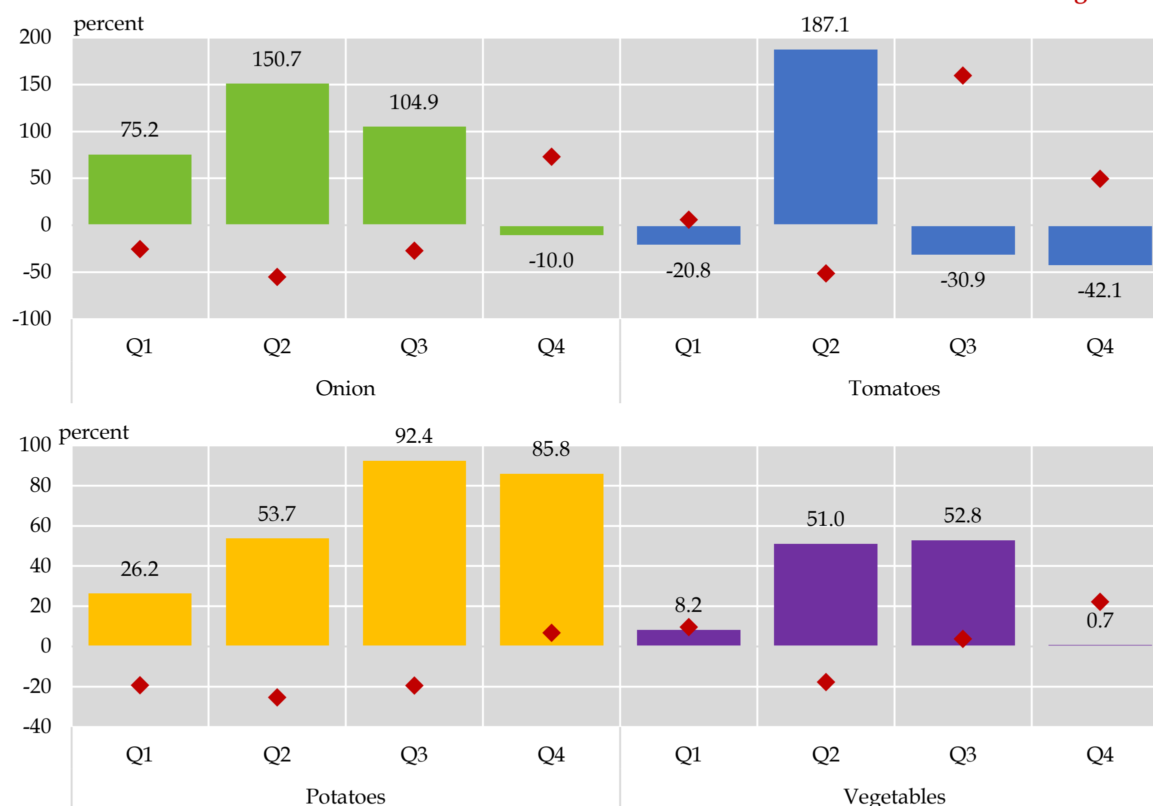
Core inflation somewhat stabilized in urban regions, while it rose marginally in rural areas

According to the 12-month-moving-averge of non-food-non-energy (NFNE) index, the inflationary pressures stabilized during FY20, especially for urban areas (**Figure 3.15**). This moderation primarily represented the impact of macroeconomic stabilization efforts, especially the high level of interest rates, which were needed to bring the headline inflation down to the medium-term target of 5-7 percent. The considerable alleviation in cost push pressures in the economy during the year was also a factor. Notably, with the stability in global fuel prices along with the appreciation of the Pak Rupee against the US dollar in H1-FY20, domestic prices of key raw materials stabilized in recent months. The wholesale price index (WPI), after plateauing in October 2018 with 18.7 percent rise, recorded inflation as low as 0.9 percent YoY, in June 2020. Furthermore, the last quarter saw a significant decline in core inflation in urban areas, which represented a noticeable weakening in the demand on account of Covid-related containment measures.

Within NFNE, the goods' index posted a double-digit inflation during FY20. It appears that this increase partially represents the impact of overall increased transport costs amid higher motor fuel prices than last year, and the implementation of the axle load policy. Furthermore, revenue-enhancing measures taken in the FY20 budget have also affected goods' prices: (i) inflation in the clothing and footwear group can be attributed to the impact of ending of the zero-rating regime (effectively, an imposition of 17 percent GST); (ii) the rise in steel prices can partly be explained by the imposition of 17

[6] For details, see A. Khalid and Sabahat (2020). *Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges*. SBP Staff Note 2/20. Karachi: State Bank of Pakistan (http://www.sbp.org.pk/publications/staffNotes.htm)
[7] For details, see SBP's State of Economy Report for Q2-FY20.

Inflation in Perishable Food Items - YoY **Figure 3.14**



* bars denote FY20 and dots denote FY19
Source: Pakistan Bureau of Statistics

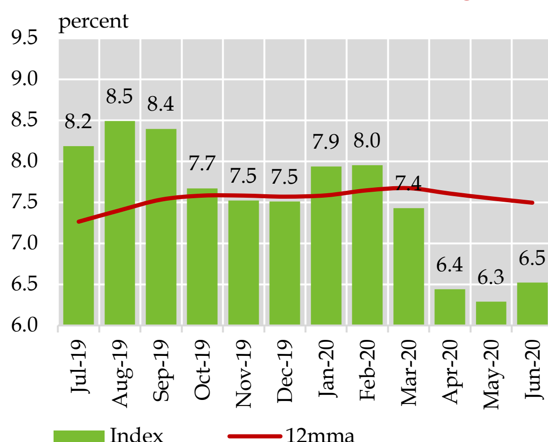
percent federal excise duty on various steel products; and (iii) the increase in cement prices reflects the impact of the increase in FED this year.

In contrast, inflation in services items remained on the lower side as compared to FY19. Component-wise analysis suggests that house rent and education played a significant role in driving down the overall services inflation for urban areas. In education, the decline in inflation came from private school fees following the Supreme Court's decision.

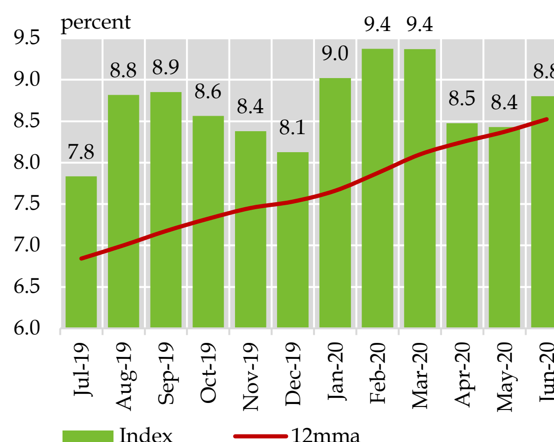
However, within services, upward pressure on low-end wages and service charges was registered, especially in the urban areas. The index of low-end urban wages and service charges (with 3.4 percent weight in overall CPI) – incorporating services such as household servants, cleaning & laundering, tailoring, garbage collection, motor cycle tyre puncture, car service, carpenter, mason, plumber and electrician – posted 8.9 percent inflation, on average, during FY20, as compared to 7.2 percent last year. This possibly reflects the impact of the overall inflationary pressures in important food items and rise in the transportation cost, which had affected real incomes of the low-income group the most in Q2-FY20. However, the inflationary pressures subsided visibly from March 2020 onwards in the same group, which can be attributed to restricted mobility and limited work opportunities amid weak demand for such services.

In this context, it is not surprising to see the overall NFNE softening in the fourth quarter, specifically in the months of April and May 2020. Around 70 percent of the NFNE indices registered no change in prices (33 out of 47 indices) in April 2020 and around 38 percent registered no change in May 2020 (**Figure**

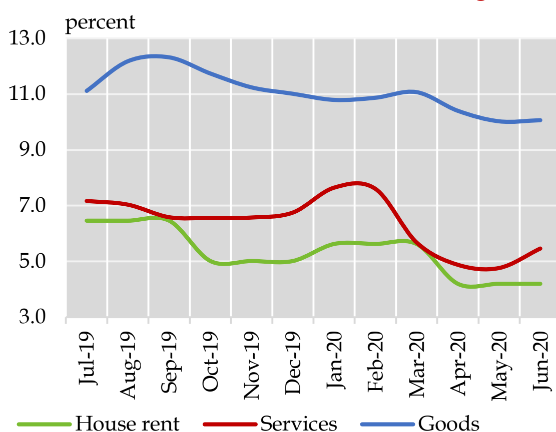
Urban NFNE - YoY Growth **Figure 3.15a**



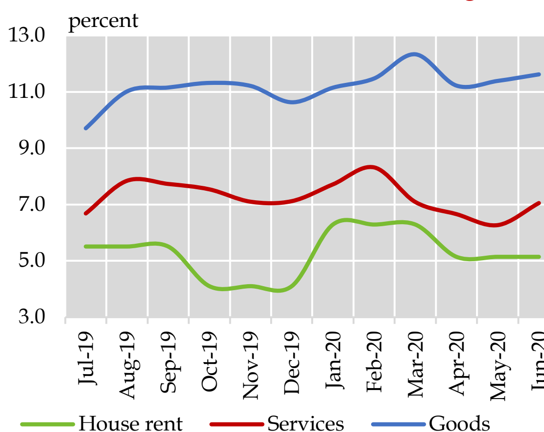
Rural NFNE - YoY Growth **Figure 3.15b**



Urban NFNE - YoY Growth **Figure 3.15c**



Rural NFNE - YoY Growth **Figure 3.15d**



Source: Pakistan Bureau of Statistics

3.16).[8] As mobility remained restricted and a number of retail centers were not operational, the Pakistan Bureau of Statistics (which collects countrywide prices and computes the price indices) kept prices of various items unchanged while constructing the inflation index for April 2020. Particularly, prices of clothing and footwear, various household items, auto parts and services, healthcare, recreation services, personal grooming services and marriage hall charges exhibited no change during the month.

Energy inflation decelerated

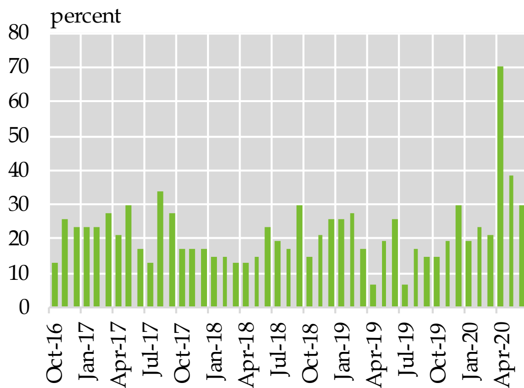
The energy index posted 12.7 percent increase during FY20, compared to 16.3 percent previous year. This relative softening was contributed primarily by a fall in prices (deflation) of motor fuel and electricity during the last quarter of FY20.

In case of motor fuel, the price index remained stable at an elevated level during the first eight months. However, from March 2020 onwards, the motor fuel index dropped significantly, both on MoM and YoY basis, following the slump in global crude oil prices on account of the Covid-19 pandemic. On a cumulative basis, the index posted a 31.4 percent decline during March and June 2020.

Substantial ease in the electricity inflation was observed during FY20, as it rose by only 1.8 percent compared to significant rise of 11.5 percent during FY19, both for urban and rural areas. During the first seven months, the index rose by 7.2 percent on average compared to

[8] In terms of composition, urban NFNE index comprises almost half of the sub-indices. i.e. 47 out of the total 95.

Indices with No Change - Core Group **Figure 3.16**



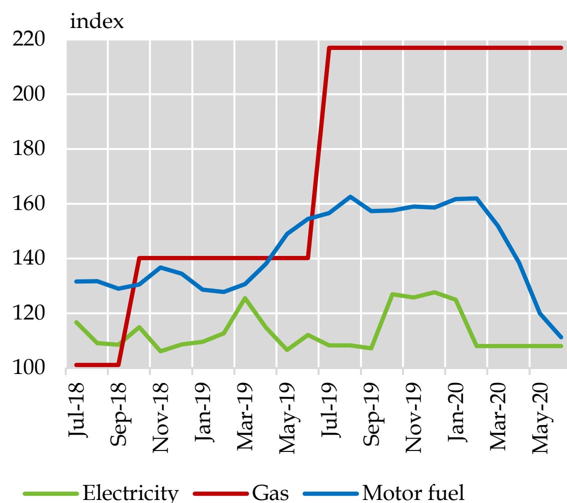
Source: Pakistan Bureau of Statistics

same period last year. This reflected the impact of passing on the impact of increased capacity payments, T&D losses and low recoveries, in an attempt to rein in the growing circular debt, improve the energy sector's viability, and tackle the rising arrears. However, the electricity inflation declined by 5.5 percent on average during the last five months of FY20 on YoY basis. This decline primarily came from the postponement of fuel price adjustments (FPA) for November 2019 (and onwards), which was expected to become applicable in February 2020. This reversed a positive trend observed in the electricity index since the beginning of the year. Also, Nepra deferred the subsequent FPA decisions following the government's plan to freeze the electricity tariff for the next six months. This decision also considered the request of the Central Power Purchasing Authority (CPPA) to introduce changes in the FPA mechanism. Thus, in the absence of the FPA component from February 2020 onwards, on cumulative basis, the electricity index posted 13.5 percent decline in June 2020, as compared to February 2020.

In contrast to fuel and electricity, the urban gas prices witnessed the highest rise in the energy group during FY20, contributing 0.8 percentage points alone to the total inflation and accounting for around 64 percent of the energy inflation. This was in response to the revision in natural gas prices by the Oil and Gas Regulatory Authority (OGRA) for various consumers, effective from July 1, 2019. According to OGRA's notification, dated June 29, 2019, gas tariffs for consumers using 201-300 mmbtu/month were raised by up to 168 percent. For consumers using 51-100 and 101-200 mmbtu/month of gas, tariffs were raised by 136.2 and 109.5 percent, respectively.

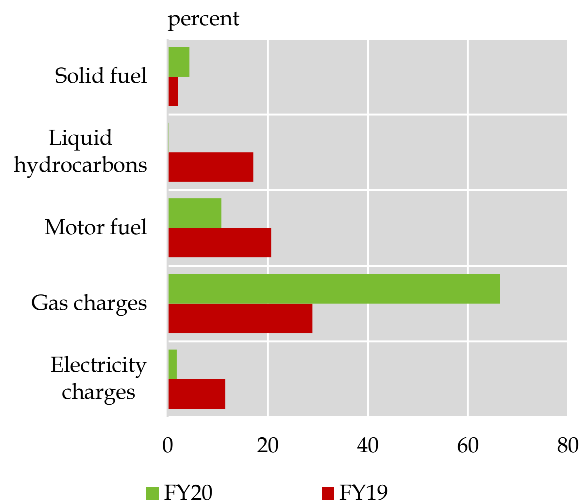
Together, these three slabs constitute over half of the total gas consumption in domestic sector. This measure was taken to address the concern of emerging arrears in the gas sector, coming mostly from delays in tariff notifications and rising technical losses. In addition to revising the tariff structure for

Energy Indices - Urban **Figure 3.17a**



Source: Pakistan Bureau of Statistics

Energy Inflation - Urban **Figure 3.17b**



reducing the unaccounted for gas (UFG) losses, improvements in infrastructure, rehabilitation of networks, and theft control are also part of the plan. However, for the rest of the year, the index posted no change, reflecting stable prices (**Figure 3.17**).