Chapter 3
Monetary Policy and Inflation

Keeping in view the need to nurture the recovery, the supply-side and concentrated nature of inflation and uncertainties posed by the pandemic, the Monetary Policy Committee (MPC) considered it appropriate to continue with the accommodative stance throughout FY21. To provide necessary support to the ongoing recovery process, the policy rate was kept unchanged at 7 percent amid well-anchored inflation expectations and subdued underlying inflationary pressures. As economic activity indicators started to show signs of recovery, consumer and business confidence improved. This was also reflected in the credit off-take by businesses and households. Private sector credit recorded double-digit growth in FY21 with a significant increase in fixed investment loans, as businesses benefitted from SBP's concessionary financing schemes, mainly Long Term Financing Facility (LTFF) and Temporary Economic Refinance Facility (TERF). Further, the low interest rate environment led to a visible expansion in consumer financing, mainly in automobile, personal and housing loan segments. National CPI, on the other hand, decelerated in FY21 on the back of relatively contained demand-side pressures that in turn helped to offset the inflationary impact of temporary supply-shocks. Also, headline CPI remained within the SBP's projection range of 7-9 percent. Core inflation, measuring underlying inflationary pressures, remained lower compared to the previous year on account of contained cost-push factors such as low fuel price, favorable exchange rate conditions and spare capacity in the economy.

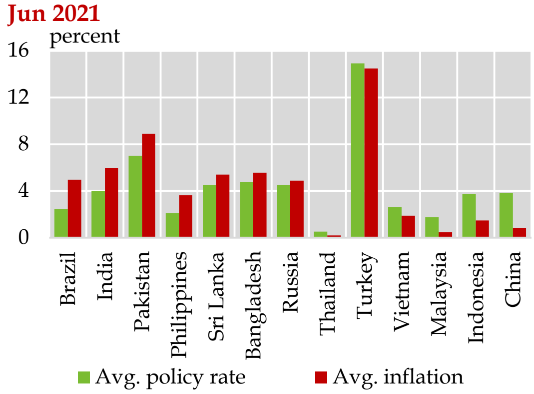
3.1 Policy Review

The Monetary Policy Committee (MPC) continued with the accommodative stance during FY21 to counter the impact of Covid-19 fallout and support the economic recovery. The policy decision was mainly supported by well-anchored inflation expectations, subdued inflationary pressures, improvement in the current account balance, adequate availability of external financing and improvement in foreign exchange reserves position. Taking all these factors into consideration, and heightened uncertainty created by the pandemic, the MPC deemed it appropriate to continue its emphasis on reviving economic growth. Therefore, the policy rate was kept unchanged at 7 percent in all its meetings held in FY21.

Recall that the MPC had announced the rate cuts of 625 basis points in a series of meetings during March-June 2020. Adjusting for inflation, Pakistan's monetary policy stance remained on the lower spectrum in comparison to many emerging economies during Jul 2020 – Jun 2021 (**Figure 3.1**), thereby providing a conducive environment for a revival in the economic activity. To further incentivize economic growth, SBP also announced extensions and relaxations for some of the refinance schemes launched after the outbreak of the pandemic in FY20.

The government also laid more emphasis on promoting housing and construction sector activities. In line with this, in July 2020, SBP mandated banks to increase their housing and construction finance portfolio to at least 5 percent of their private sector advances by December 2021. In addition, to minimize the economic impact and to protect businesses and daily wagers, the government adopted a more targeted strategy and remained inclined towards intermittent smart lockdowns instead of complete closure of businesses that was

Average Inflation and Policy Rate in Emerging Markets during Jul 2020 - Jun 2021 **Figure 3.1**



Source: Haver Analytics

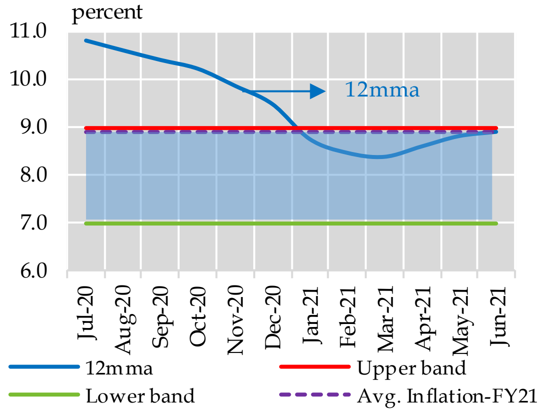
implemented during the first wave of the pandemic in FY20.

Consequently, with the favorable policies, economic recovery gained momentum as the year progressed. High frequency demand indicators like FMCG sales, POL sales, power generation, cement and auto sales posted a significant recovery during the year.[1] Coordinated fiscal and monetary policy efforts were instrumental to this turnaround. SBP's concessionary financing schemes and accommodative monetary policy stance helped to contain debt financing and debt servicing costs for firms and households. On the fiscal side, targeted support was made in the form of tax concessions, disbursement of pending refunds, and subsidies. These measures enabled firms to meet the growing demand for industrial raw materials and consumer goods.

The supportive policies resulted in a significant improvement in the Business Confidence Index. With a pick-up in the economic activity, the private sector credit also registered an increase of 11.2 percent in FY21 compared to an increase of 2.9 percent last year. This recovery in credit offtake was mostly driven by the expansion in fixed investment loans and consumer finance. Also,

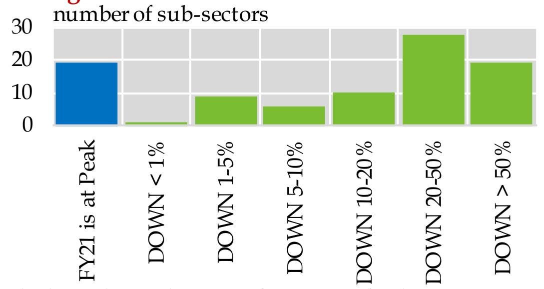
[1] During FY21, the domestic cement dispatches, car sales, power generation and POL sales grew by 20.4, 56.7, 6.9, and 14.3 percent respectively.

CPI Inflation Projection and 12MMA **Figure 3.2**



Source: PBS and SBP staff estimates

Comparison of Sub-sectors of QIM with their Peak Production Level during FY15-FY20 **Figure 3.3**



*the bars show relative performance of sub-sectors in FY21 compared to their peak performance during FY15-FY20. The y-axis reflects number of sub-sectors that fall in respective categories on the x-axis.

Source: Pakistan Bureau of Statistics

working capital loans increased mainly due to higher borrowings by the non-manufacturing sectors. In contrast, some of the major manufacturing businesses, such as textile, cement and motor vehicles retired their loans during FY21 on the back of improved cash flow position of the firms due to pick-up in domestic sales and higher tax refunds. Meanwhile, SBP's concessionary schemes particularly TERF and enhanced LTFF during Covid supported the growth in fixed investment loans.[2] During FY21, the fixed investment loans grew by 11.4 percent compared to a decline of 1.5 percent last year. Meanwhile, a renewed interest in auto and housing finance was behind the uptick in the consumer finance.

Both headline and core inflation moderated in FY21. Headline inflation eased to 8.9 percent during FY21 compared to 10.7 percent last year. Likewise, urban core inflation fell to 6.0 percent compared to 7.5 percent a year ago. The SBP's CPI projections at the start of the year (July 2020) were in the range of 7-9 percent, lower than FY20's forecast of 11-12 (**Figure 3.2**). The range for FY21 reflected improved outlook on account of low fuel prices, inflation neutral budget (with no additional taxes and some relief to construction industry) and relatively contained demand-side pressures. The inflation forecast was subject to many upside and downside risks as well throughout the year. The upside risks included rise in the prices of important food items, extreme weather conditions and adjustments in fuel and utility tariffs; whereas, the downside risks comprised second and third waves of the pandemic and related deceleration in demand.

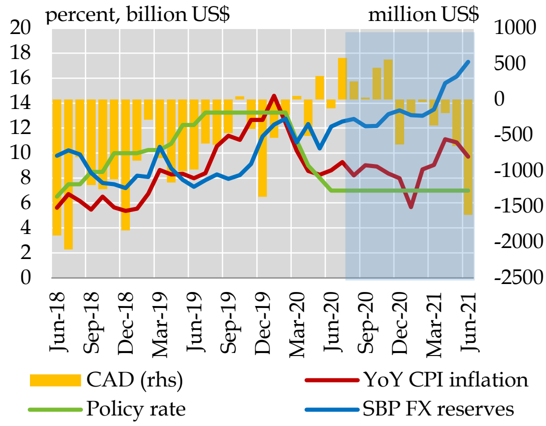
As the year progressed, core inflation remained benign, given continued spare capacity in the economy.[3] Moreover, as a proxy indicator of spare capacity, analysis reflects that a large majority of sub-sectors of LSM were still operating below their previous peak levels that were attained during FY15-FY20 (**Figure 3.3**).[4] However, pressure on headline inflation persisted due to supply side disruptions, especially in food group, and administrative adjustments in electricity tariffs. YoY inflation readings also displayed volatile trends during the year. It ranged from a trough of 5.7 percent in January 2021, amid waning supply-side pressures from the food group and base effect, to a peak of 11.1 percent in April 2021 amid revised electricity tariffs, upward pressure on domestic fuel prices (on MoM basis) and high inflation in poultry group. Importantly, in the last quarter of FY21, the headline inflation decelerated from

[2] In FY21, gross disbursements under TERF amounted to Rs 138.6 billion, which did not exist last year, as the disbursements started in FY21

[3] Capacity utilization data of various sectors such as Cement, POL, Auto (LTV, LCV, HCV) reveals that the activity is still less than the levels observed during FY16 and FY17.

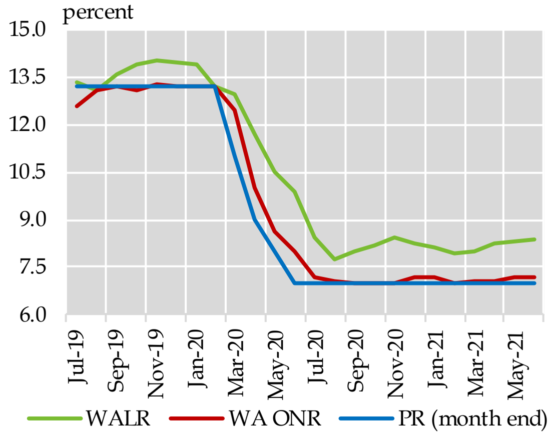
[4] 73 out of the 92 sub-sectors of the LSM were below their peak levels attained since FY15.

Trend in Key Policy Indicators **Figure 3.4**



Source: SBP, PBS

Trends in Major Interest Rates **Figure 3.5**



Source: State Bank of Pakistan

11.1 percent in April 2021 to 9.7 percent in June 2021. This trend also supported the MPC's prior stance that recent price pressures were mostly supply-driven and temporary. Consequently, the average inflation in FY21 was in line with the SBP's forecast range of 7-9 percent announced in May 2020.

Country's external sector position during FY21 was strongest in several years (**Figure 3.4**). The current account deficit fell to a 10-year low level. This was supported by an improvement in the trade balance and record high remittances, primarily due to supportive policy measures and increased use of formal channels. These favorable developments, consequently, bolstered foreign exchange buffers.

With heightened uncertainty due to Covid, the MPC for the first time also provided forward guidance on monetary policy in its January 2021 meeting (**Box 3.1.1**). Moreover, in the subsequent monetary policy decisions during the fiscal year, the MPC reinforced its commitment by maintaining the existing level of policy rate. It also reiterated its expectations to continue with an accommodative interest rate environment in the near term, with any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates over time.

In a nutshell, with the aforementioned favorable macroeconomic environment, the MPC felt that the existing accommodative stance of the monetary policy was appropriate to support the nascent recovery (**Figure 3.5).**

Box3.1: Managing Interest Rate Expectations using Forward Guidance

The central bank communication is an important aspect of the monetary policy that aims to reduce economic and financial uncertainty. During unusual economic conditions, some central banks also communicate the future monetary policy stance which is referred to as forward guidance. It is an unconventional monetary policy tool that is used by the central banks to minimize interest rate volatility and to manage interest rate expectations. This could take various forms such as qualitative forward guidance, quantitative forward guidance, or guidance conditional on specific economic developments and/or for a given duration. In 1999, forward guidance was first adopted by the Bank of Japan in line with its zero interest rate policy. Subsequently, during the global financial crisis forward guidance became more prominent among developed economies as the interest rates in some developed countries touched the zero lower bound.

In the aftermath of Covid-19 outbreak, some developed and emerging market central banks adopted this approach to give confidence to investors and other economic agents in the forward-looking decisions given heightened uncertainties (**Table 3.1.1**).

Forward Guidance by Central Banks in the aftermath of Covid-19 Outbreak **Table 3.1.1**

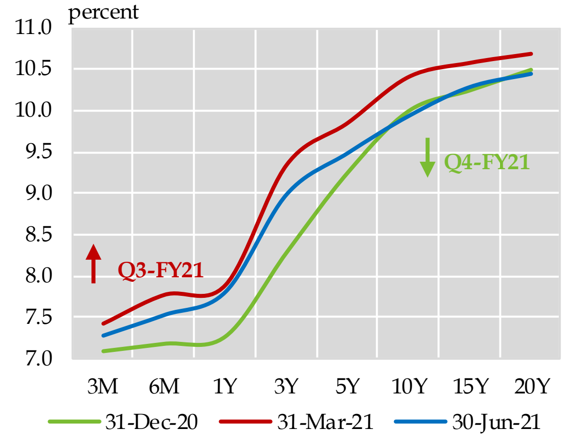
Central Bank	First Forward Guidance Communication after Covid-19 Outbreak	Most Recent Stance
State Bank of Pakistan	"In the absence of unforeseen developments, the MPC expects monetary policy settings to remain unchanged in the near term. As the recovery becomes more durable and the economy returns to full capacity, the MPC expects any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates." (Jan 22, 2021)	"Looking ahead, in the absence of unforeseen circumstances, the MPC expects monetary policy to remain accommodative in the near term, and any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates over time." (Jul 27, 2021)
Reserve Bank of Australia (RBA)	"The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band." (Mar 19, 2020)	"The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The central scenario for the economy is that this condition will not be met before 2024." (Aug 3, 2021)
Bank of Canada	"The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved." (Jul 15, 2020)	"We remain committed to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In the Bank's July projection, this happens sometime in the second half of 2022." (Jul 14, 2021)
US Federal Reserve	"The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals" (Mar 15, 2020)	"The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time" (Jul 28, 2021)
Reserve Bank of India	"The MPC also decided to continue with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year – to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward." (Oct 09, 2020)	"The MPC also decided to continue with the accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward." (August 6, 2021)
Sri Lanka	"The Board observed the stronger than expected growth performance towards the end of 2020 and underscored the need for maintaining the prevailing low interest rate structure to support the sustained economic recovery in the period ahead." (Apr 03, 2021)	-
Brazil	"the Copom does not foresee reductions in the monetary stimulus unless inflation expectations, as well as its baseline scenario inflation projections, are currently close to the inflation target at the relevant horizon for monetary policy, 2021 and, to a lesser extent, 2022. This intention is conditional on the maintenance of the current fiscal regime and on the anchoring of long-term inflation expectations." (Aug 05, 2020)	"For the next meeting, the Committee foresees another adjustment of the same magnitude [interest rate was increased by 100 bps]. The Copom emphasizes that its future policy steps could be adjusted to ensure the achievement of the inflation target and will depend on the evolution of economic activity, on the balance of risks, and on inflation expectations and projections for the relevant horizon for monetary policy." (Aug 04, 2021)

Source: Central bank (respective) press releases

In Pakistan, the MPC started to provide forward guidance from January 2021, with an objective to reinforce the commitment of continuing accommodative monetary policy stance and to facilitate policy predictability and decision-making by economic agents. It was for the first time that the SBP explicitly mentioned that the interest rates will remain unchanged until the near term. The MPC leveraged a low probability of demand-side inflation and well-anchored inflation expectations to provide forward guidance to the market.

The secondary market (PKRV) yields on GoP debt securities were on the rising trend since the start of FY21 and it continued throughout the third quarter. Given the negative real rates, and with inflation edging-up, market showed somewhat delayed response to the guidance given by the MPC regarding the near-term interest rate path. However, the market gained confidence after the announcement of subsequent monetary policy in March 2021. From Q4-FY21 the yields eased out, with a relatively larger impact on the longer end of the curve (Figure 3.1.1). Meanwhile, guidance on future interest rate path also helped in increasing the market's participation in medium to long term instruments. The competitive bids for fixed rate PIBs increased to Rs 1,468 billion in Q4-FY21 compared to Rs 437 billion and Rs 186 billion in Q3-FY21 and Q2-FY21 respectively.

Secondary Market Yeilds **Figure 3.1.1**



Source: Financial Markets Association of Pakistan

Other countries also benefitted by providing forward guidance during the crisis period. For instance, according to Reserve Bank of India (RBI) forward guidance helped in boosting market sentiments and eliminating 'illiquidity fears'.[5] It also complemented other unconventional monetary policy tools used during the pandemic. On a similar note, a study conducted by Federal Reserve Bank of Cleveland shows that forward guidance communicated by FOMC during Covid19 was effective in managing public's expectations about the interest rate path in case it was accompanied by Summary of Economic Projections (SEP) - a report that provides forecasts of economic variables. However, it does not have an impact on altering expectations regarding economic fundamentals.[6]

3.2 Monetary Aggregates

Broad money expansion posted a growth of 16.2 percent during FY21 compared to 17.5 percent in the preceding year **(Table 3.1)**. However, it is important to mention here that it is still at an elevated level compared to the growth recorded in previous years. On the asset-side, both Net Domestic Assets (NDA) as well as Net Foreign Assets (NFA) posted expansion, with a higher contribution of the NDA of the banking system. On YoY basis, the growth in NDA moderated slightly mainly on account of lower net budgetary borrowings from the banking system and net retirements made by Pubic Sector Enterprises (PSEs) compared to borrowings last year. The combined impact of these two developments more than offset the impact of a solid turnaround in the credit to private sector. Meanwhile, continuous improvement in the external position and buildup of FX reserves supported the growth in the NFA. This was on the back of a contained current account deficit, due to record high exports and workers' remittances, and other official inflows. On quarterly basis, the fourth quarter recorded highest FX inflows in comparison to the first three quarters. These include fresh issuances of multi-tranche Eurobonds and green Eurobonds issued by WAPDA, inflows from multilateral agencies and other commercial loans.

On the liability side, the growth in currency in circulation nearly halved to 12.5 percent in FY21 compared to 24.1 percent in FY20, while deposits growth increased to 17.6 percent in FY21 compared to 14.9 percent a year ago. However, weekly data shows that the currency to deposit ratio remained at an elevated level during FY21 as the public's preference for holding cash and out of bank settlements continued to remain high.[7] Several factors were behind this trend: (i) the demand

[5] www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=20141
[6] www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2020-economic-commentaries/ec-202027-forward-guidance-during-the-pandemic.aspx
[7] On a weekly basis, the currency to deposit ratio remained on average at 43.1 percent during FY21 compared to 43.1 percent in FY20 and 40.4 in FY19.

Monetary Aggregates[P] **Table 3.1**

billion Rupees

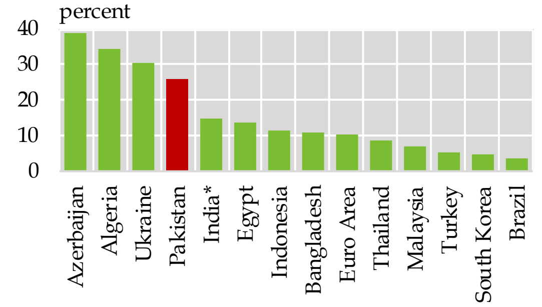
	Abs. change in stock		Growth rate in percent	
	FY20	FY21	FY20	FY21
M2 (A+B)	3,109.5	3,389.7	17.5	16.2
A. NFA	990.9	1,241.0	65.8	240.4
B. NDA	2,118.6	2,148.7	11.0	10.0
Budgetary borrowing*	2,151.8	1,712.4	18.6	12.5
SBP	(153.1)	(1,119.0)	-2.3	-17.1
Scheduled banks	2,304.9	2,831.5	47.0	39.3
Commodity operations	57.0	90.6	7.5	11.1
Private sector	196.4	766.2	2.9	11.2
PSEs	96.3	(53.8)	7.0	-3.7
Other items net	(391.6)	(376.3)	-35.5	-25.2
Reserve money	1,106.4	983.6	16.8	12.8
Currency in circulation	1,192.0	767.9	24.1	12.5
Total deposit with banks	1,909.9	2,595.0	14.9	17.6

[P]: Provisional
* These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented
Source: State Bank of Pakistan

for cash increased multiple folds in aftermath of the Covid outbreak. Though a sizable chunk of this high level of currency in circulation posted a reversal in Q1-FY21, the demand for holding cash remained on the higher side; (ii) reduced opportunity cost of holding cash as a result of low interest rates; and (iii) impact of cash transfers by the government via Ehsaas program.

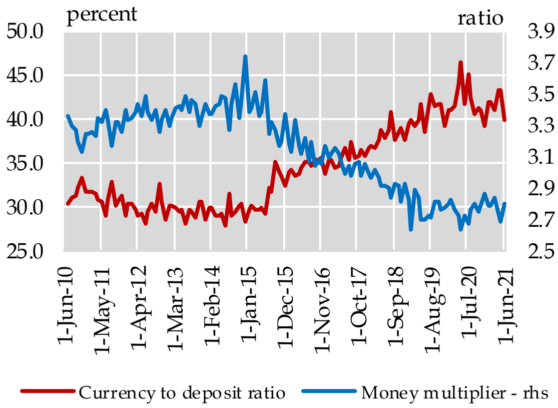
Importantly, despite several initiatives taken by the State Bank of Pakistan to encourage the use of digital banking channels, the cash penetration in the economy is still hovering at a high level both in comparison to the historical trend and also compared to other countries (**Figure 3.6**). Pakistan's currency to money supply is significantly higher compared to other regional economies like India, Egypt, Bangladesh, Turkey, etc. The recent surge in cash usage in the economy as well as issues such as withholding taxes on banking transactions for non-filers and increased scrutiny of financial transactions have also hurt deposit growth over past few years.[8] Consequently, the credit creation capacity of financial intermediaries has been negatively affected as captured by a fall in the money multiplier (**Figure 3.7**).

Currency in Circulation to Broad Money (Jun 2021) **Figure 3.6**



* for India the ratio is calculated as CiC/M3
for Algeria, Egypt, Indonesia, Bangladesh and Thailand latest available figures were used as data for Jun 2021 is not available.
Source: Haver Analytics

Impact of High Cash Penetration in the Economy on Financial Intermediation **Figure 3.7**



Source: State Bank of Pakistan

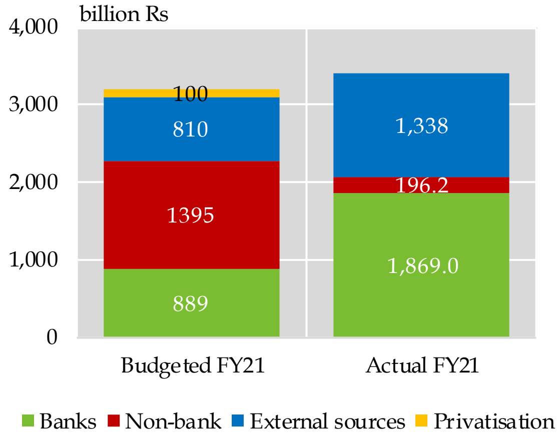
[8] In the finance bill of FY22, the withholding tax on banking transactions for non-filers has been removed and its impact on the components of money supply may unfold in the coming months. On the other hand, the State Bank of Pakistan has reinstated the interbank funds transfer fee that remained suspended since the start of the pandemic in Mach 2020.

Government borrowings

Despite a slight increase in the fiscal deficit in absolute terms, the banking system's budgetary support (on cash-basis) marginally fell to Rs 1,869.0 billion in FY21 compared to Rs 1,925.2 billion in FY20. This was on the back of higher than budgeted financing from external sources. That said, the reliance on the banking system remained on higher side and was more than twice than was budgeted for FY21 (**Figure 3.8**). The main driver behind higher than estimated borrowings from banks was a sharp fall in the mobilization of funds from non-bank sources. The government was only able to raise Rs 196.2 billion from non-bank sources compared to the budgeted amount of Rs 1395.0 billion. This was because: (i) limited availability of NSS (due to limited availability of CDNS outlets due to lockdowns in the initial months of FY21 and institutional investors were barred from investing in NSS w.e.f July 01, 2020); (ii) low profit rates on NSS instruments; (iii) withdrawal of Rs 25,000, Rs 15,000 and Rs 7,500 denomination prize bonds during FY21; and (iv) nonbank investment in GoP securities was on the lower side compared to last year.

Within the banking system, the government mobilized Rs 2,831.5 billion in FY21 from the scheduled banks compared to Rs 2,304.9 billion in the preceding year. Meanwhile, the government adhered to its commitment of zero borrowings from the SBP. On net basis including the impact of government deposits, the government made sizable retirements to the SBP. During FY21, the federal government added around Rs 647.8 billion to its cash buffers maintained with the banking system. As a result the gross financing from commercial banks also increased. Importantly, this is for the second consecutive year that the government borrowing from central bank has remained zero, despite higher fiscal outlays to tackle the fall out of the pandemic. Had the crisis period coincided with a budgetary support from the central bank, it may have fueled inflationary pressures. Also, zero borrowing from the central bank over the past two years has also enabled improved liquidity management by the SBP. This in turn leads to a smoother transmission of monetary policy and helps in anchoring inflation expectations.

Financing Mix of Budget Deficit **Figure 3.8**



Source: Ministry of Finance

Auctions

The government's pre-auction targets remained aligned with its objective of enhancing the maturity profile of the outstanding marketable securities. The net of maturity target for T-bills stood at negative Rs 1,165.8 billion for FY21 compared to Rs 1,163.7 in FY20 (**Table 3.2**). In contrast for fixed rate PIBs, the government increased the net-of-maturity targets to Rs 1,121.6 billion compared to only Rs 379.7 billion in the preceding year. Likewise, the government's target for floaters, that provide longer maturity with flexible rates, also remained on the higher side. The pre-auction target allocation to floaters was more than three times in FY21 compared to that of the last fiscal year. Additionally, the government, in Q2-FY21, also introduced new floating rate bonds of medium to long term maturities with multiple coupon frequencies.[9]

As far as the market participation is concerned, somewhat contrasting trend was observed during the first and second half of the fiscal year. During H1-FY21, the market remained inclined towards short term instruments and floaters. This was primarily on the back of the then relatively strong

[9] In October 2020, the government introduced new floating rate PIBs of multiple tenors i.e. 3Y, 5Y and 10Y with quarterly coupon resetting and a 2Y floater with fortnightly coupon reset.

Instrument-wise Auction Summary **Table 3.2**

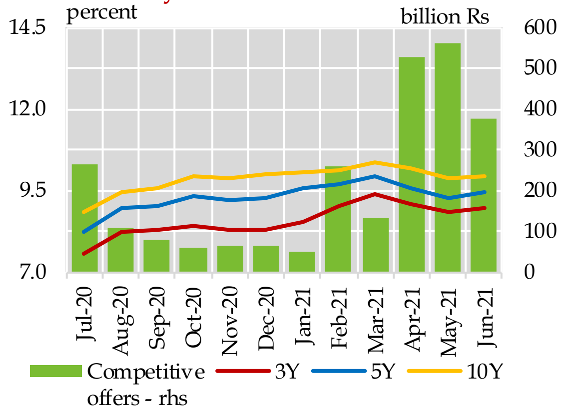
billion Rupees

	Target		Maturity		Offered*		Accepted (all)	
	FY21	FY20	FY21	FY20	FY21	FY20	FY21	FY20
T-bills	12,975.0	15,150.0	14,140.8	13,986.3	26,765.8	32,354.2	14,865.3	15,167.4
3M			7,674.9	13,186.00	14,594.3	14,225.50	8,698.5	8,811.9
6M			1,816.2	799.8	9,733.7	4,157.30	5,585.9	1,705.8
12M			4,649.7	0.5	2,437.8	13,971.40	580.9	4,649.7
PIBs (fixed)	1,510.0	1,300.0	388.4	920.3	2,539.7	5,027.0	1,056.3	2,070.7
3Y	530.0	520.0			1,115.3	2,262.0	479.3	1,102.2
5Y	430.0	395.0			815.9	1,530.8	301.2	612.8
10Y	300.0	265.0			439.9	1,188.7	149.7	332.8
15Y	140.0	30.0			96.5	22.9	64.0	16.8
20Y	80.0	90.0			72.1	22.6	62.1	6.1
30Y	30.0	-			-	-	-	-
PIBs (floater)	2,725.0	850.0	-	-	3,171.2	1,578.1	1,632.5	818.5
2Y - Qtrly	285.0	-	-	-	213.4	-	175.7	-
3Y - Qtrly	450.0	-	-	-	365.9	-	229.0	-
5Y - Qtrly	150.0	-	-	-	107.6	-	90.5	-
10Y - Qtrly	150.0	-	-	-	130.1	-	98.5	-
3Y - SA	550.0	50.0	-	-	1,193.3	84.1	624.8	60.6
5Y - SA	770.0	50.0	-	-	776.8	48.5	306.3	34.5
10Y - SA	370.0	750.0	-	-	384.1	1,445.5	107.8	723.4
GIS - VRR	230.0	300.0			605.2	597.0	385.2	198.2
GIS - FRR	120.0	-			83.2	-	52.8	-
Total	17,560.0	17,600.0	14,529.2	14,906.6	33,165.1	39,556.3	17,992.1	18,254.8

*competitive bids only

Source: State Bank of Pakistan

Bidding Pattern of Fixed Rate PIBs and Secondary Market Yields **Figure 3.9**



Source: State Bank of Pakistan and FMAP

market expectations of an interest rate hike in six to twelve months period. However, after the January 2021's meeting of the MPC in which the SBP issued the forward guidance, and at the same time the term premium of 6M T-bills ticked up in comparison to 3M T-bills, the market's appetite for 6M T-bill increased.

Likewise, for fixed rate PIBs the market's participation started to revive in the third quarter (**Figure 3.9**). Subsequently, as the SBP maintained the accommodative monetary stance and restated the forward guidance in successive monetary policy statements, the market's participation for fixed rate PIBs improved further in the fourth quarter of FY21. Besides this, in February 2021 the SBP also withdrew the upper limit on investments in PIBs that can be counted towards maintenance of Statutory Liquidity Requirements (SLR) for banks and development finance institutions.[10] This also helped in strengthening market's interest in longer tenor government securities.

With market's renewed interest in 6M T-bills and also fixed rate PIBs in the second half,

[10] SBP DMMD Circular No. 04 of 2021

government leveraged the opportunity by increasing the acceptances. The cutoff rates slid by 47 bps for 3M T-bills and ticked up by 10 bps and 31 bps for 6M and 12M papers respectively. For fixed rate PIBs, the yields initially increased until Q3-FY21, but eventually eased out during Q4-FY21 (**Figure 3.9**). Meanwhile, the issuances of floating rate PIBs almost doubled compared to the preceding year. Bulk of the issuances for these instruments were made during H1-FY21. In H2-FY21, the issuances for floaters witnessed a marked slowdown owing thin market participation and lower acceptances by the government.

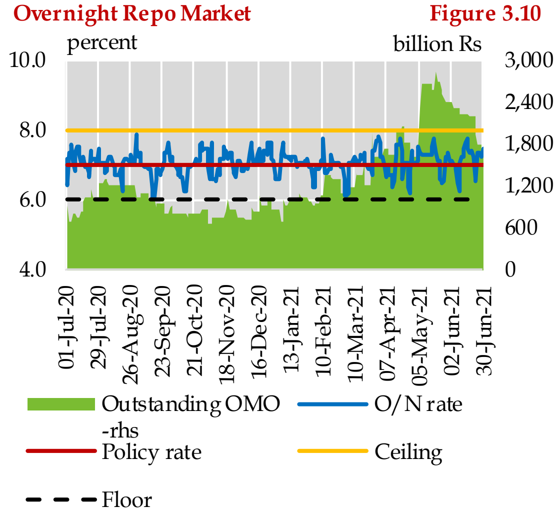
For Shariah compliant instruments, the market's appetite remained intact. The cumulative issuances of variable rental rate and fixed rental rate Sukuk more than doubled during FY21 compared to last year. However, since January 2021 the government has not conducted any Sukuk auction. It is important to recall here that the government had successfully conducted auctions of Shariah compliant instruments since April 2020 on regular basis and have benefitted from the lower yields they offer compared to conventional domestic debt instruments. Besides that, Sukuk issuances have also helped the government to diversify its outstanding debt. Therefore, it is crucial to ensure their timely and uninterrupted auctions.

Interbank Liquidity

The interbank repo market remained relatively liquid at the start of the fiscal year and required lower interventions. As the year progressed, liquidity pressures started to emerge. SBP proactively managed these pressures via its open market operations as reflected by the increase in outstanding OMOs towards the later part of the fiscal year (**Figure 3.10**). During H1-FY21 deposit mobilization coupled with other factors such as SBP's FX management, retirements from Public Sector Enterprises and government procurement agencies helped in easing out liquidity pressures in the overnight repo market. As a result of these inflows, the market required lower SBP's support. The average outstanding OMO injections fell down to Rs 936.0 billion in H1-FY21 compared to Rs 1,125.2 billion in the same period last year.

In contrast, during H2-FY21 the liquidity conditions started to tighten as the government borrowings from the commercial banks continued to increase alongside an uptick in the private credit offtake. In particular during Q4-FY21, the liquidity pressures increased further and required higher volume of OMO injections. Therefore, average outstanding OMO increased to Rs 2.1 trillion in Q4-FY21 compared to Rs 1.0 trillion, Rs 0.8 trillion and 1.2 trillion in Q1, Q2 and Q3 of FY21 respectively. These pressures were mainly on the back of high government borrowings in Q4-FY21, outflows from the banking system in the form of tax payments, and seasonal withdrawals of deposits during the month of Ramzan and Eid. These liquidity outflows also resulted in more frequent and sporadic visits at SBP's discount window. Not only did the market require higher interventions, the volatility in the weighted average overnight rates rate also remained on the higher side compared to the preceding quarters. During Q4-FY21, the average absolute deviation of overnight repo rates from the policy rate increased to 33 bps compared to 24 bps, 26 bps and 23 bps in Q1, Q2 and Q3 of FY21 respectively.

Overnight Repo Market **Figure 3.10**

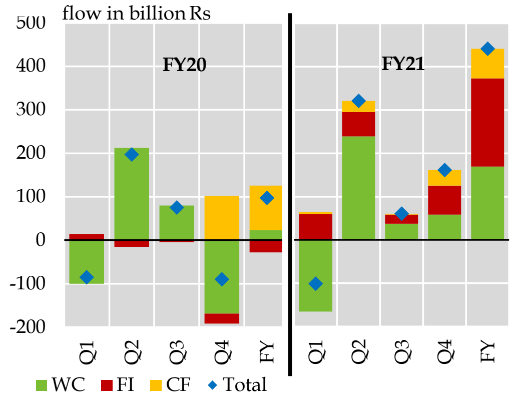


Source: State Bank of Pakistan

3.3 Credit to Private Sector

Credit to private sector grew by 11.2 percent in FY21, compared to an increase of 2.9 percent last year. This year's growth was led by fixed investment loans and consumer financing.[11] The overall credit offtake during FY21 was driven by three main factors. First, a better domestic demand along with an improved business confidence during the year compared to subdued demand last year,[12] particularly during the fourth quarter of FY20 due to Covid-related lockdowns **(Figure 3.11).** Second, in contrast to FY20, the low interest rate environment further augmented the overall credit offtake during FY21. Third, SBP's concessional financing schemes, mainly enhanced LTFF during Covid and TERF drove up the fixed investment loans during the period under review.

Loans to Businesses | Figure 3.11



Note: WC: Working Capital; FI: Fixed investment; CF: Construction financing
Source: State Bank of Pakistan

Higher borrowings by non-manufacturing sector pushed up working capital loans

Private businesses took Rs 169.5 billion in working capital loans during FY21, as compared to Rs 23.3 billion last year. The demand for these did not appear vibrant, as some of the major sectors such as textile, cement and motor vehicles that borrowed during FY20, retired their short-term loans this year (**Table 3.3**). This is consistent with the fact that banks actually received 8 percent fewer loan applications during FY21 on YoY basis. Although manufacturing businesses continued to dominate, the sevenfold increase in offtake during FY21 is mainly attributed to higher borrowings by non-manufacturing sectors, which posted net retirements last year.

Within manufacturing, bulk of the demand came from fertilizers, vegetable and animal oils and fats, and rice processing businesses. In the case of fertilizer, higher production raised the sector's short-term borrowings to Rs 41.0 billion in FY21, compared to a net retirement of Rs 26.6 billion last year.[13] The increase was more pronounced in Q4-FY21, when a 221.6 percent YoY growth in fertilizer imports had raised the manufacturers' short-term borrowing needs.

In addition to fertilizer industry, vegetable and animal oils and fats also raised their short-term borrowings this year, compared to net retirements last year. The increase was on the back of higher edible oil prices in the international market, which is mainly imported by the edible oil businesses in the country.[14]

Likewise, the overall working capital loans of both the rice processing and sugar sector remained on the higher side than last year. Due to the seasonality factor, these businesses usually require short-term financing during the second quarter of a fiscal year, which coincides with the harvesting season of rice and sugarcane crops.[15]

Higher offtake by the rice processing firms more than offset net retirements during rest of

[11] Credit to the private sector mainly comprises loans to private sector businesses (84 percent of total private sector credit) and consumer financing (10 percent).
[12] LSM grew by 14.9 percent during FY21, compared to a decline of 10.2 percent last year. Further, the Business Confidence Index improved significantly from 39 in June 2020 to 64 in June 2021.
[13] Fertilizer production rose by 7.0 percent during Jul-May FY21, against an increase of 5.6 percent last year.
[14] During FY21, the import of soy bean oil rose by 261 percent (against 65 percent decline in FY20), and that of palm oil increased by 65 percent (compared to an increase of 12 percent in FY20), in rupee terms. (PBS)
[15] For details, see SBP's second quarterly report on the State of Pakistan's Economy for FY21.

Loans to Private Sector Businesses **Table 3.3**

(flow in billion Rupees)

	Total Loans*		Working Capital**		Fixed Investment	
	FY20	FY21	FY20	FY21	FY20	FY21
Private Sector Businesses	**97.6**	**441.4**	**23.3**	**169.5**	**-27.9**	**203.5**
Manufacturing	161.4	258.2	109.8	111.1	48.3	141.5
Fertilizers	-31.9	37.6	-26.6	41.0	-5.3	-3.4
Vegetable and animal oils and fats	-11.1	34.8	-12.8	29.2	1.7	5.6
Rice Processing	-1.4	28.0	-1.7	26.7	0.3	1.3
Sugar	15.1	24.1	12.8	16.0	2.0	7.9
Refined petroleum	-20.4	13.7	-18.9	13.1	-1.4	0.5
Basic pharmaceutical products	7.9	18.5	5.0	6.2	2.8	12.3
Paper & paper products	-7.1	6.4	-5.0	2.3	-2.2	4.1
Cement, lime and plaster	26.2	0.2	26.4	-8.0	-1.2	7.8
Motor vehicles	14.6	-15.8	11.3	-23.7	3.3	7.9
Textile	168.8	26.3	125.9	-42.6	42.9	66.0
Non-manufacturing	-63.8	183.2	-86.5	58.4	-76.2	62
Electric power gen., trans., and distribution	9.0	66.5	15.1	7.2	-7.4	59.7
Telecommunications	25.5	21.8	-8.0	9.3	33.5	12.4
Wholesale and retail trade	-46.4	16.6	-43.4	7.5	-5.5	8.4
Transportation and storage	13.0	-5.9	22.8	-5.9	-10.1	-0.1
Accommodation	-3.7	4.1	-1.5	0.2	-8.3	-0.9
Mining and quarrying	15.0	-15.8	7.7	-13.4	7.3	-2.4
Real estate activities	1.1	1.5	-2.4	-1.0	-11.7	-2.7
Agriculture, forestry and fishing	-21.3	12.1	-10.4	17.0	-11.0	-5.0
Construction	-24.1	24.9	-46.0	3.0	-46.3	-16.7

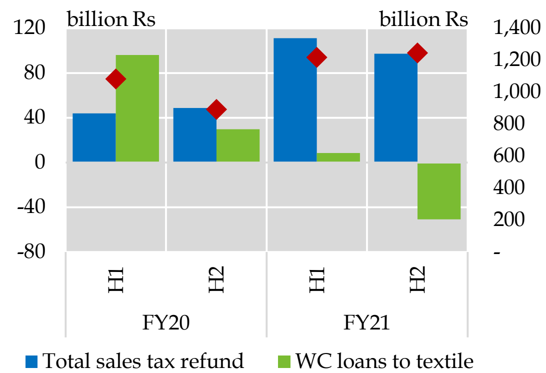
*Total loans include construction financing of Rs 102.2 billion in FY20 and Rs 68.4 billion in FY21, as the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business (see IH&SMEFD Circular Letter No. 28 of 2020). Therefore, the loans data by type of finance for FY20 and FY21 may not be fully comparable; ** working capital includes trade financing

Source: State Bank of Pakistan

the year. On the other hand, besides seasonal offtake during Q2-FY21, sugar sector also borrowed in the subsequent quarter to cover higher sugarcane prices during Q3-FY21.

On the contrary, with a better liquidity position, some of the sectors managed to retire their loans, such as textile, motor vehicles and cement. Textile businesses posted a net retirement of Rs 42.6 billion in FY21, compared to an offtake of Rs 125.9 billion last year. Beside increased sales tax refunds by the government, higher export proceeds helped the sector in retiring its short-term loans **(Figure 3.12).**[16] This is consistent with a 25 percent growth in textile exports during FY21, compared to an increase of 8.7 percent last year, in rupee terms. Despite higher cotton prices (major input in textile) that grew by over 18 percent in FY21, compared to an increase of 1.1 percent last year, textile sector comfortably managed to retire its loans, as the sector had a better cash flow position in FY21, over last year. This is supported by the sector's profit after tax of Rs 35.6 billion during Jul-Mar FY21, compared to Rs 12.9 billion during the same period last year.[17]

Working Capital Loans to Textile **Figure 3.12**



Source SBP, FBR, PBS

[16] As per the provisional estimates, sales tax refunds of over Rs 200 billion were released in FY21, compared to Rs 158 billion last year.

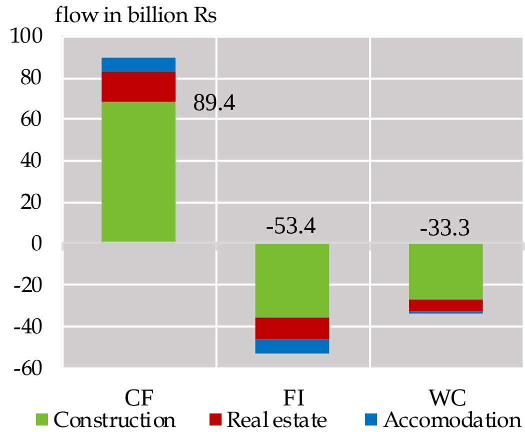
[17] www.sbp.org.pk/departments/stats/pdf/FSA-Q.xlsx

With a better liquidity position, the automobile sector was also able to pay back its loans amounting to Rs 23.7 billion in FY21, compared to an offtake of 11.3 billion last year. The sector's overall profitability jumped to Rs 16.4 billion during Jul-Mar FY21 from Rs 52.0 million last year. This is also in line with 56.7 percent YoY growth in passenger car sales during the year. Likewise, cement manufacturing businesses were able to retire short-term loans of Rs 8.0 billion in FY21, compared to an offtake of Rs 26.4 billion last year. With the housing and construction activities gaining momentum, cement domestic dispatches rose by 20.4 percent during FY21, compared to a marginal decline of 0.9 percent last year. This mainly helped the sector in retiring its loans during the year.

In FY21, almost the entire increase in working capital loans was driven by the non-manufacturing sector, which posted an increase of Rs 58.4 billion in FY21, compared to a net retirement of 86.5 billion last year. Notably, loans to agriculture sector were prominent in FY21, which were entirely driven by lending to the farm sector. The increase in offtake can be traced to seasonal borrowings by rice and wheat growers. For instance, growers of rice increased their borrowings during Q2-FY21 (which coincides with the *Kharif* season); whereas, the wheat growers mainly resorted to bank financing during Q4-FY21 (*Rabi* season). Along with the seasonal factor, both the rice and wheat growers have borrowed working capital loans mainly to scale-up their production levels during FY21 **(Chapter 2)**.[18] Moreover, wholesale and retail trade sector borrowed Rs 7.5 billion in FY21, compared to a net retirement of Rs 43.4 billion a year earlier. This year's increase mainly came from wholesale of fertilizers, which was concentrated in the fourth quarter of FY21, as a significant rise in the international DAP prices during the quarter increased the borrowing needs of wholesalers.[19]

Further, last year's higher loan retirements mainly in construction sector dragged down the overall loans to non-manufacturing sector in FY20. It is important to note that with an inter-sectoral adjustment in credit to the private sector, banks have been separately reporting the data on credit/loans under construction financing since June 2020.[20] So, the loans for construction purposes have been shifted from working capital and fixed investment categories to a separate category for construction financing. As shown in **Figure 3.13**, loans to sectors, such as construction, real estate activities and accommodation were reclassified into construction financing. The sole purpose of this separate reporting is to monitor the progress on housing and construction finance in the country. This was consistent with an offtake of Rs 68.4 billion under construction financing.

Intersectoral Adjustment (June 2020) Figure 3.13



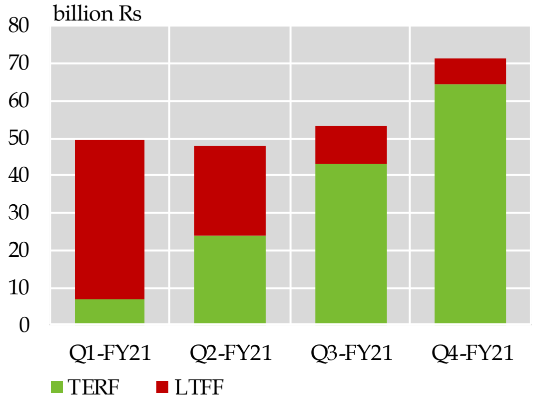
Source: State Bank of Pakistan

LTFF and TERF drove up fixed investment loans

Fixed investment loans posted a significant increase of Rs 203.5 billion in FY21, compared to a net retirement of Rs 27.9 billion last year. The higher offtake in long-term loans was mainly on the back of SBP's concessionary financing schemes, mainly LTFF during the first half of FY21, and TERF afterwards **(Figure 3.14).**

[18] During FY21, the production of wheat crop rose by 8.1 percent YoY, and that of rice grew by 13.6 percent over last year.
[19] Average DAP prices in the international market grew by 110.6 percent YoY during Q4-FY21 (Haver Analytics).
[20] SBP IH&SMEFD Circular Letter No. 28 of 2020

Gross Disbursements under LTFF & TERF **Figure 3.14**



Source: State Bank of Pakistan

SBP launched TERF in March 2020 to counter the impact of Covid-19 pandemic through promoting industrial activity in the country. The scheme was valid for one year (till March 2021). By end-June 2021, a total financing of Rs 434.7 billion was approved under the scheme, out of which, Rs 138.6 billion (32 percent) were actually disbursed. Textile sector was the major beneficiary of the scheme, followed by construction, automobile, and food and beverages, as shown in **Figure 3.15.**

Textile sector dominated the overall fixed investment loans with a 54 percent YoY increase in the loan offtake during FY21. Benefitting from SBP's concessionary financing schemes, the sector availed long-term financing mainly to import textile machinery. This is consistent with a 52.8 percent growth in textile machinery imports (in rupee terms) during FY21, compared to a decline of 21.5 percent last year.

Other than textile, pharmaceutical sector borrowed long-term loan of Rs 12.3 billion in FY21, compared to an increase of only Rs 2.8 billion in the same period last year. This mainly represents the acquisition of a chemical manufacturing business by a renowned pharmaceutical firm in the country during Q1-FY21.[21]

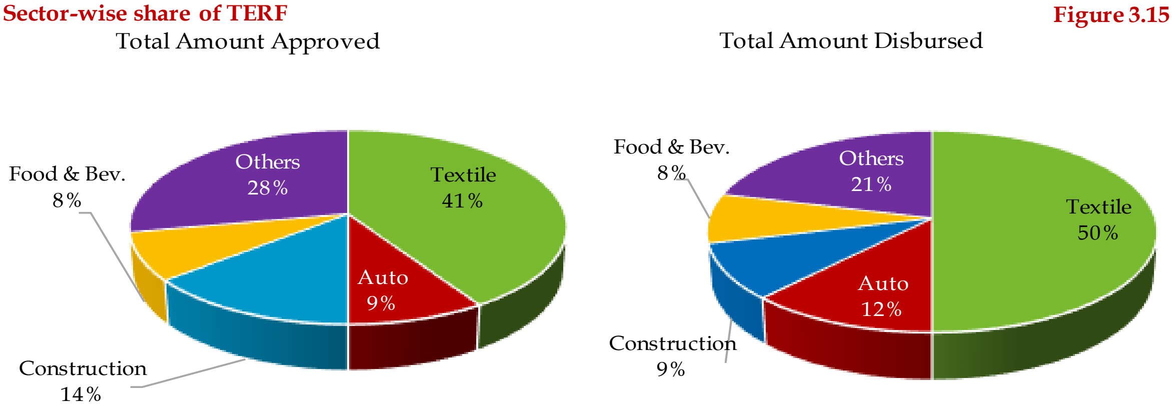
In the case of non-manufacturers, power sector was prominent with an offtake of Rs 59.7 billion in FY21, compared to a net retirement of Rs 7.4 billion last year. The sector availed long-term financing mainly to spend on capacity expansion, as well as to import machinery, as reflected by a 39.3 percent jump in the import of power generating machinery in FY21, compared to an increase of 8.7 percent last year.[22]

Telecom sector also increased its long-term borrowings in FY21, albeit at a slower pace than last year. The sector's borrowings were mainly concentrated in the last quarter of FY21, when two of the leading cellular firms operating in the country borrowed long-term loans for their network expansion.

Consumer loans recorded significant expansion

Given the low interest rate environment during the year, consumer loans increased by

Sector-wise share of TERF **Figure 3.15**



Source: State Bank of Pakistan

[21] For details, see SBP's first quarterly report on the State of Pakistan's Economy for FY21.
[22] PBS.

Rs 174.0 billion in FY21, compared to a retirement of Rs 7.9 billion in FY20. This increase mainly emanated from auto financing, which held 55.7 percent share in consumer financing during the year. Besides lower interest rates, the introduction of new variants of passenger cars by some auto assemblers and pent-up demand from delayed purchases last year played a significant role in driving up the auto-financing. Rest of the expansion in consumer lending is largely explained by financing in segments like personal and housing loans, which increased by Rs 43.0 billion and Rs 23.8 billion, respectively **(Table 3.4)**.

The impetus to housing finance came from the measures taken by the government and SBP during FY21 in order to promote housing and construction financing in the country. For instance, in July 2020, SBP mandated banks to increase their housing and finance construction portfolio to at least 5 percent of their private sector advances by December 2021. Around 92 percent of the overall target set by SBP for June 30, 2021 has been achieved. Furthermore, the Government Markup Subsidy Scheme (G-MSS) was introduced in October 2020, commonly known as *Mera Pakistan Mera Ghar*, for low to middle income segments of the society. Later in March 2021, some of the features of G-MSS were revised to expand its outreach to the individuals and households who do not own a house.[23] As a result of these measures, the banks' housing and construction finance portfolio has increased to Rs 249 billion by end-June 2021 from Rs 148 billion a year earlier.

Consumer Financing **Table 3.4**

flow in billion Rupees

	FY19	FY20	FY21
Total	**65.8**	**-7.9**	**174.0**
Auto loans	22.2	-4.3	97.0
Personal loans	13.9	9.2	43.0
House building	10.4	-12.8	23.8
Credit cards	7.0	-1.3	12.0
Consumers durable	3.7	1.3	-1.8

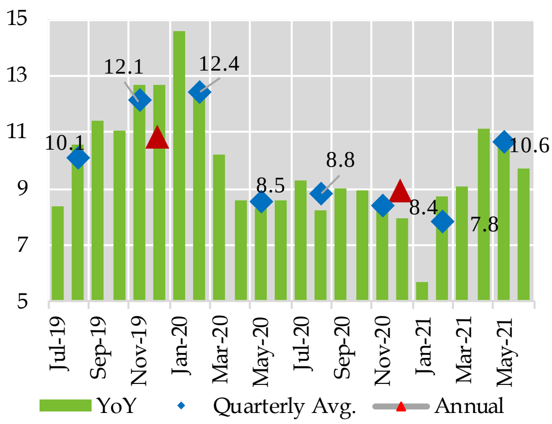
Source: State Bank of Pakistan

3.4 Inflation

National CPI inflation decelerated to 8.9 percent in FY21 compared to 10.8 percent last year, in line with the SBP forecast range for inflation announced in May 2020. Also, NFNE inflation, measuring underlying inflationary pressures, remained low and almost stable throughout the year. Broadly, five set of factors contributed to overall slowdown in inflation observed during the year. First, cost-push inflation remained contained as domestic fuel prices have fallen from a relatively higher level a year ago and are below their pre-pandemic levels. This sharp fall in energy prices, which fed to household energy bills and motor fuel prices, were still weighing on overall inflation. Second, the overall demand-side pressures remained contained despite revival in the demand indicators, partly owing to the existence of spare capacity in the economy. Also, significant decline in the prices of some services like transport fares, fee of government institutions, tax on services etc., having relatively higher weight in core consumption basket, kept the underlying inflation in check. Third, tax relief measures in the wake of Covid-related situation in the Budget 2020-21 have proved largely effective. Fourth, favorable exchange rate environment during FY21 on account of improved current account deficit also helped pacify the underlying inflationary pressures. Also, it facilitated absorbing some of the increase in international commodity prices. Fifth, supply-side situation remained favorable in case of perishable food items that helped decelerating the inflation significantly in the said category. Notwithstanding the overall slowdown, inflation remained volatile during the year. Therefore, the full year inflation outcome should be analyzed in the context of volatile readings, particularly during H2-FY21 (**Figure 3.16**). With the start of the year, particularly in Q1-FY21, inflation continued to stabilize around single digit, a trend observed since April 2020, after experiencing double-digit inflation in FY20. In overall terms, with the exception of non-perishables food group, Covid-induced fall in the international fuel prices along with spare capacity in the economy largely helped to rein in inflationary

[23] SBP IH&SMEFD, SBP Circular No. 03 of 2021, dated March 25, 2021.

National CPI-Inflation **Figure 3.16**



Source: Pakistan Bureau of Statistics

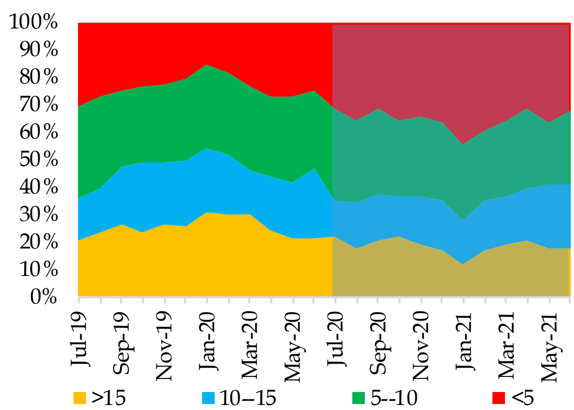
trends in the economy. While the inflation outturns were relatively low, further comfort to the pace of inflation came from decline in energy inflation and ease in prices of perishable food items in the second quarter of FY21.

With the start of H2-FY21, inflation further decelerated in January 2021 to lowest level (5.7 percent) on YoY basis since January 2019. Notwithstanding overall slowdown in Q3-FY21, CPI remained quite volatile during the quarter as inflation started inching-up from March 2021 onwards primarily on account of revision in electricity tariffs and rising fuel prices (on MoM basis). During first nine months of FY21, average inflation was 8.3 percent, however, high inflation in the last quarter (10.6 percent) dragged the average inflation to the higher end of the SBP forecast range. Meanwhile, food group, being the major contributor to overall inflation, persistently registered double-digit inflation throughout the year mainly on account of non-perishable food items.

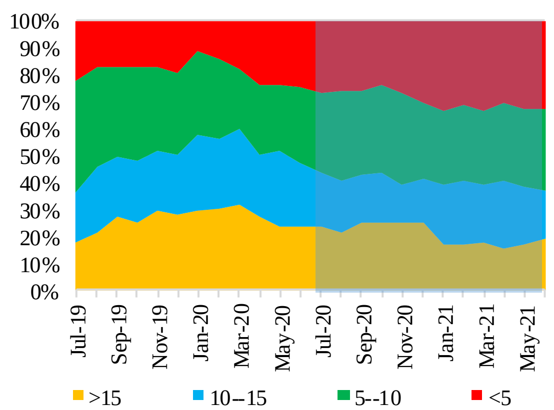
In terms of dispersion, for the year under review, the inflation decline was concentrated in half of the sub-indices compared to the broad-based rise last year.[24] Meanwhile, in terms of both distribution and magnitude, the trends reversed during FY21 compared to last year. The number of items posting double-digit inflation during the first nine months of the FY20 started to shift toward the less than 5 percent bracket, depicting subsiding inflationary pressures in the economy (**Figure 3.17**).

The category-wise breakdown suggests that food inflation remained the major contributor to headline inflation in both urban and rural areas, whereas underlying inflationary pressures (reflected in NFNE) were largely stable (**Figure 3.18**). Item-wise analysis reveals that around 75 percent of the inflation was concentrated in handful of commodities pertaining to energy and food groups (**Figure 3.19**).

Frequency Distribution of Urban CPI **Figure 3.17a**



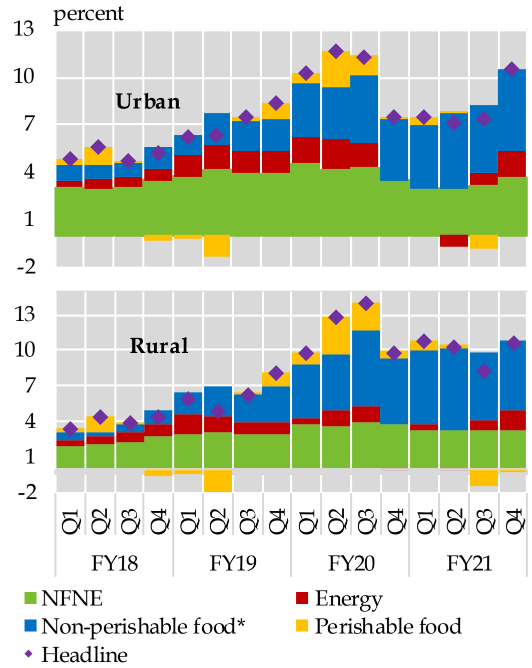
Frequency Distribution of Rural CPI **Figure 3.17b**



Source: Pakistan Bureau of Statistics

[24] 53 out of 94-with around 56 percent share in CPI in urban indices and 49 out of 89-with around 55 percent share in CPI in rural indices.

Composition of YoY CPI Inflation **Figure 3.18**



*Inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

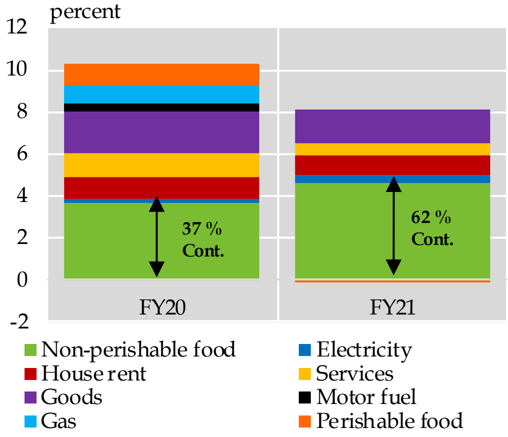
Inflation Expectations have been Broadly Stable and Remain Well Anchored

Inflation expectations, measured by IBA-SBP Consumer Confidence Survey (CCS), represented almost stable trends throughout FY21 (**Figure 3.20**). Notwithstanding overall stability, expectations readings remained somewhat elevated during second-half of the year. During first half, inflation expectations declined slightly on account of ease in food price expectations as non-perishable food prices registered significant decline. In H2-FY21, all the three categories (food, energy and NFNE), energy index in particular on account of revision in electricity tariffs, pushed the index slightly upwards. Broadly, overall inflation expectations remained anchored during the review period.

Food Remained the Dominant Source of Inflation

Though in double digits (12.4 percent) and main contributor to overall inflation (around 56 percent contribution), food inflation decelerated slightly in FY21 compared to FY20 (13.6 percent) on account of significant slowdown in perishable food items group (**Figure 3.21**).

Inflation Contribution-Urban **Figure 3.19**

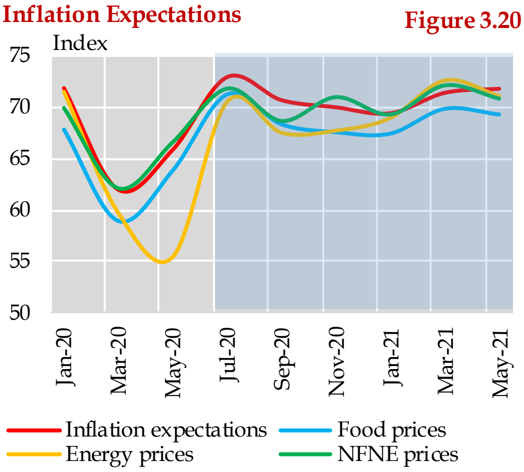


Source: Pakistan Bureau of Statistics

Non-Perishable Food Items Registered Higher Inflation

After witnessing double-digit inflation in FY20, non-perishable food inflation further accelerated in FY21, contributing around 87 percent in total food inflation. Following factors led to further strengthening in inflation pace, (i) commodity management issues (wheat, sugar), (ii) rising international food prices on account of disrupted supply-chains owing to Covid situation across the globe and extreme weather-related unfavorable production prospects impacted domestic inflation directly and indirectly to a great extent, and (iii) Covid-related uncertainty regarding lockdowns gave rise to poultry inflation along with rising feed prices.

Inflation Expectations **Figure 3.20**



Source: State Bank of Pakistan

Heat Map- YoY Urban Inflation (Food Group) **Figure 3.21**

	Wt.	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21
Food Index	36.8	15.1	11.3	12.4	13.9	13.0	12.6	7.3	10.3	11.5	15.7	15.3	11.0
Non-perishable food	26.0	16.2	13.6	13.2	16.7	15.9	15.9	12.2	15.4	17.2	19.4	19.3	13.5
Perishable food items	4.5	20.8	3.8	13.7	7.3	5.0	0.4	-18.9	-15.7	-15.6	4.6	-0.2	-2.5
Wheat	0.6	28.5	44.3	42.1	52.2	36.6	24.2	19.2	23.8	35.2	27.0	29.9	19.0
Wheat flour	3.0	18.5	23.4	20.2	24.7	13.3	13.4	7.2	13.5	18.9	16.9	28.5	13.4
Sugar	1.1	17.0	28.0	25.4	33.0	35.8	15.3	25.9	17.2	23.5	18.2	21.6	21.5
Condiments and Spices	1.3	39.5	38.9	40.9	36.6	37.6	47.4	27.2	31.1	28.7	31.6	26.7	23.3
Pulses	0.7	25.5	20.9	22.9	23.3	16.1	14.2	1.6	3.5	8.1	-7.4	-5.6	-4.3
Poultry (Egg, Chicken)	1.9	38.4	-23.3	-9.4	25.8	47.4	66.3	8.5	39.5	47.0	75.8	58.5	8.1
Edible Oil(Oil & Ghee)	2.1	19.7	13.8	13.4	13.5	12.4	13.8	17.6	16.3	16.4	20.1	21.4	22.9

Heat Map- YoY Rural Inflation (Food Group)

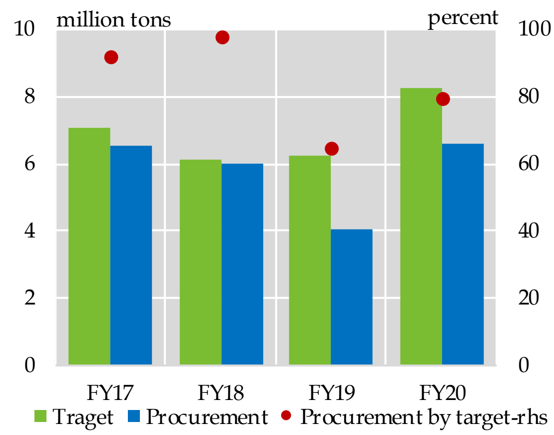
	Wt.	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21
Food Index	45.9	17.8	13.5	15.8	17.7	16.1	13.4	7.2	9.1	11.1	14.1	12.8	9.8
Non-perishable food	35.1	16.8	15.1	16.3	19.5	18.9	16.8	13.1	13.9	16.9	17.2	16.9	12.2
Perishable food items	5.8	25.4	3.7	16.9	13.4	7.4	-1.6	-23.7	-19.3	-19.4	0.5	-8.2	-5.5
Wheat	3.5	30.4	41.1	45.1	51.1	37.9	28.1	24.4	23.1	32.5	24.5	27.7	20.1
Wheat flour	3.4	21.6	26.2	26.7	29.4	19.6	15.8	13.7	16.6	20.8	19.3	26.0	14.4
Sugar	2.0	16.6	25.5	25.3	33.4	42.5	12.8	23.5	15.1	22.7	16.5	21.7	20.7
Condiments and Spices	1.5	59.6	48.8	57.8	53.7	53.7	49.6	31.4	24.2	23.3	13.7	4.0	-1.9
Pulses	1.1	28.4	20.8	25.2	23.5	16.4	13.2	3.2	2.4	6.8	-4.5	-5.9	-7.3
Poultry (Egg, Chicken)	2.0	37.0	-13.5	-7.1	23.7	43.3	63.7	12.0	29.4	52.9	71.9	58.0	12.6
Edible Oil(Oil & Ghee)	3.0	21.9	18.8	16.6	16.6	17.1	17.8	16.9	18.3	19.1	21.8	26.1	27.6

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

Source: Pakistan Bureau of Statistics

In the case of wheat, despite significant imports during the year, multiple factors kept the inflation on the higher side.[25] First, for the year 2020, wheat crop put upward pressures on prices because of low production (crop size of 25.25 MMT against a target of 27.03 MMT). Second, from the perspective of government's commodity operations, relevant agencies missed the procurement targets almost for the second consecutive year (**Figure 3.22**). One possible reason for this could be the increasing difference between the support price and the wholesale price of wheat at the time of procurement.[26] Also, timely release of stocks by the procurement agencies plays an important part in managing the price pressure which was somehow mismanaged during the first half of the year. Third, the import process seemed to be slow at the start of the year which could not fill the supply-demand gaps in the market as ECC allowed wheat import

Public Sector Wheat Procurement **Figure 3.22**



Source: Provincial Food Departments

by end- June 2020 whereas first shipment arrived in August 2020. Also, relatively high international wheat price seems to have discouraged the private dealers in aggressive participation in imports. Fourth, speculative activities also have played a central role in

[25] 3,613 thousand MT of wheat was imported during FY21.

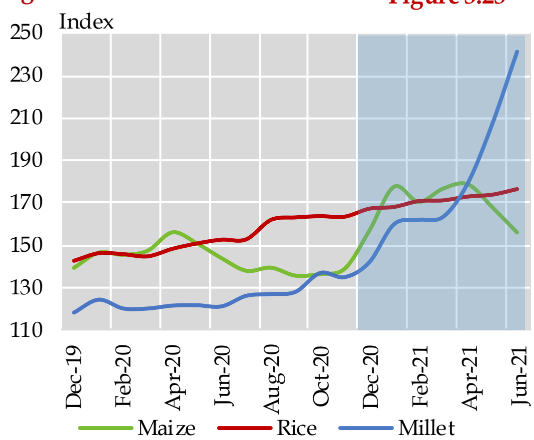
[26] See Chapter 3, SBP's first quarterly report on the State of Pakistan's Economy for FY21.

price increase as government was persistently warning for strict action against those found involved in hoarding.

Inflation outturns for sugar also remained on the higher side during FY21. Price pressures persisted despite the significant imports during the year.[27] The double-digit inflation in sugar can be explained by the following factors. (i) decline in sugar stocks to 5.3 MMT in FY20 from 6.7 MMT in FY19 [28] on account of low sugarcane production in FY20,[29] (ii) absence of information about reliable stock position and anti-competitive activities by the industry as noted by Competition Commission of Pakistan's enquiry report (October, 2020) and (iii) increase in Minimum Support Price (MSP) for sugarcane in FY21.

Poultry group posted double-digit inflation during the year, contributing around 12 percent and 14 percent to total food inflation of urban and rural areas, respectively. While consumers were struggling with supply- and demand-related price pressures amid Covid-related lockdowns and uncertainty, poultry feed prices also surged, following the trend of international prices (**Figure 3.23**). As per industrial experts, poultry feed is around three-fourth of the total input cost of producing chicken and egg, while imported ingredients constitute major part of the poultry feed.

Agriculture Wholesale Index **Figure 3.23**



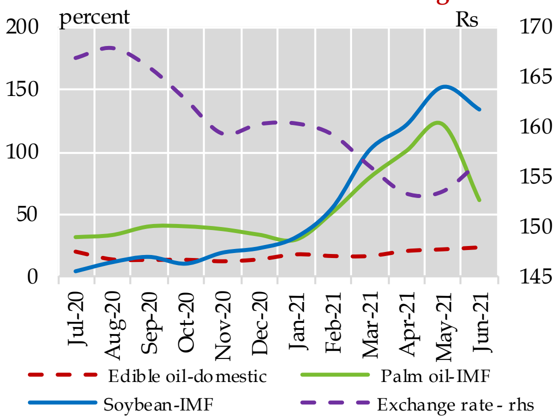
Source: Pakistan Bureau of Statistics

In case of condiments and spices, inflation surged significantly during the review period. Disaggregated information reveals that red chili powder dragged-up the overall index of condiments and spices. Production and area under cultivation of red chilies, both declined significantly during FY21.[30] Price pressures persisted despite significant imports made in order to fill the supply-demand gap.[31]

The increase in edible oil prices observed since the beginning of the year, persisted throughout the year, keeping the inflation at the higher side. Three sets of factors led to increase in inflation in this group. First, international palm oil and soybean prices started increasing with the reopening of the economies and release of pent-up demand. Second, supply-chain constraints due to labor shortages resulting from a decline in the number of migrant workers including shipping bottlenecks, pushed-up the prices of edible oil (**Box 3.2**)[32]. Third, tight inventory levels in major exporting countries due to weather-related concerns in the major producing areas put upward pressure on edible oil prices. Though inflation in the edible oil group, having higher imported content, was high amid rising international food prices, favorable exchange rate conditions absorbed much of the intensifying impact (**Figure 3.24**).

[27] 3597 thousand MT of sugar was imported during FY21 compared to 282 thousand MT last year.
[28] Competition Commission of Pakistan, Enquiry Report October, 2020.
[28] In FY20, 66.37 million tons of sugarcane was produced compared to 67.17 million tons in FY19. In FY21, 81.00 million tons of sugarcane has been produced.
[30] Production registered 26.7 percent decline during FY21, while, area under cultivation reduced by 24.8 percent.
[31] 198.5 thousand kg red chilies were imported during FY21 compared to 0.4 thousand kg last year.
[32] Palm oil harvesting and processing operations have been increasingly affected by labor force reduction, especially in Malaysia, where several plantations were suffering from acute shortages of migrant laborers triggered by policies to curtail the spread of Covid.

Inflation in Edible Oil **Figure 3.24**

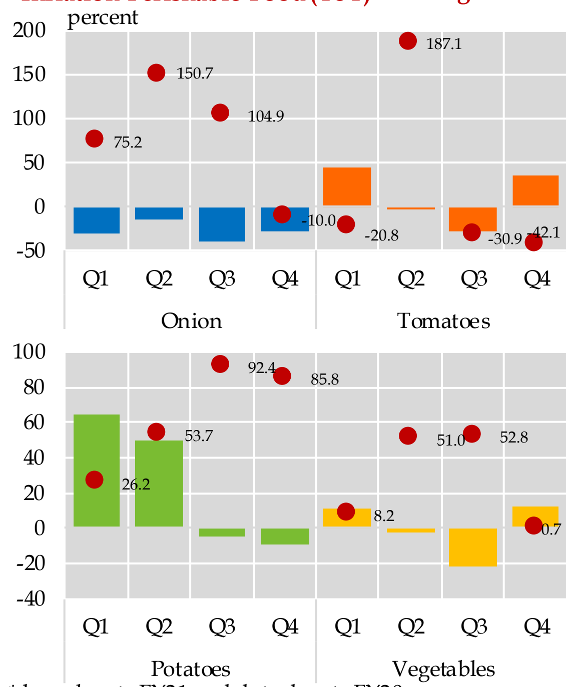


Source: PBS, IMF

Inflation in Perishable Food Items Decelerated Significantly

After witnessing high inflation in FY20, perishable food group, consisting of fresh vegetables, fruits, tomatoes, potatoes and onions, registered significant deceleration in FY21.[33] For instance, in the case of tomatoes, improved local production and higher imports caused prices to remain low and stable.[34] Similarly, price of onions averaged around Rs 47 in urban areas this year compared to Rs 66 last year. Both better domestic crop and adequate imports caused decline in onion prices in FY21 (**Figure 3.25**).[35]

Inflation-Perishable Food (YoY) **Figure 3.25**



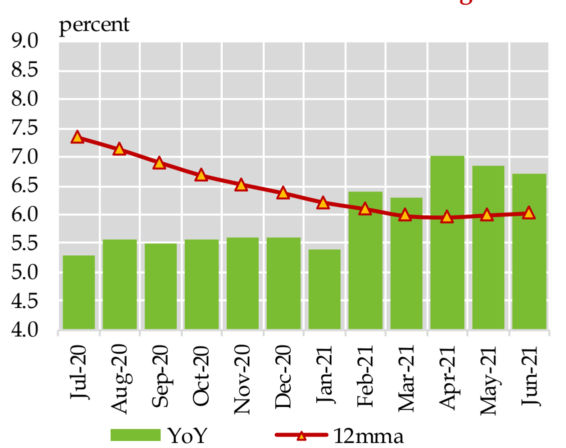
* bars denote FY21 and dots denote FY20

Source: Pakistan Bureau of Statistics

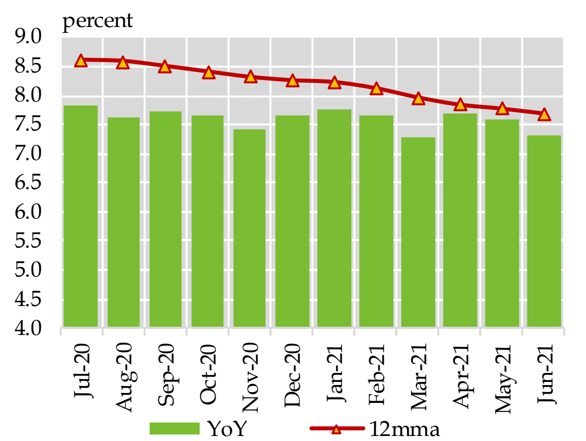
NFNE Remained Broadly Low and Stable

NFNE inflation decelerated for both urban and rural segment during FY21 compared to last year (**Figure 3.26**). Broadly speaking, slowdown implies that ease in cost-push pressures on account of muted fuel prices and

Urban NFNE - YoY Growth **Figure 3.26a**



Rural NFNE - YoY Growth **Figure 3.26b**



Source: Pakistan Bureau of Statistics

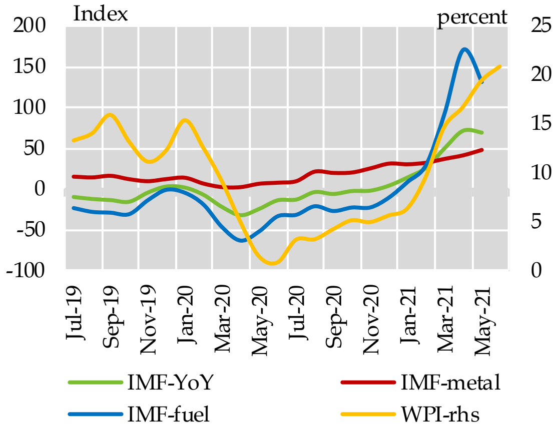
---

33 High temperatures, untimely rains and hurdles in issuance of import permits affected imports of various vegetables and created temporary shortages in the domestic market, exerting temporary price pressures in FY20.

34 Local production of tomatoes increased by 12.8 percent during FY21, whereas, imports rose by around 55 percent during FY21.

35 Local production of onions remained almost at FY20 level; imports rose by around 82 percent during FY21.

WPI and Global Commodities **Figure 3.27**



Source: Pakistan Bureau of Statistics and IMF

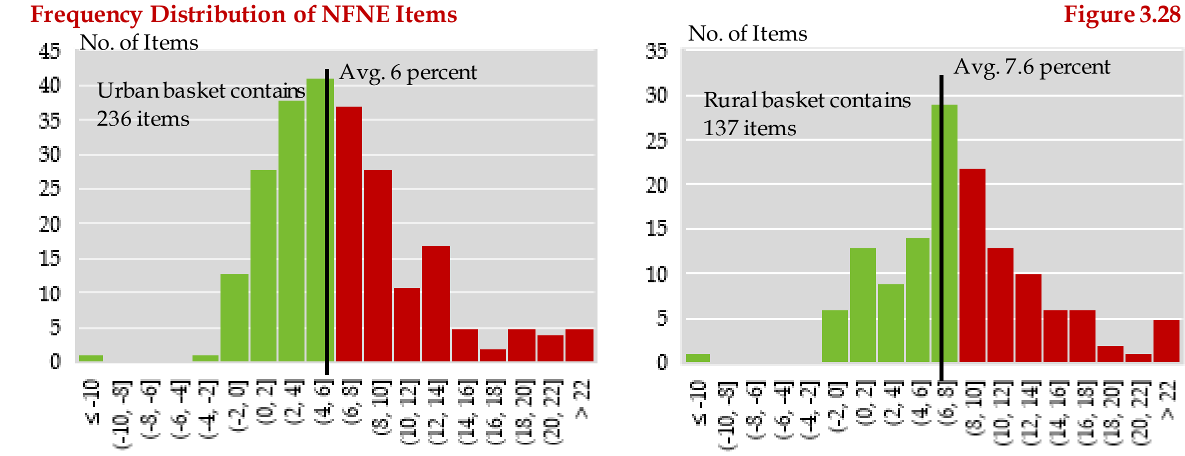
non-inflationary Budget 2020-21 have proved largely effective in arresting the pace of core inflation (**Figure 3.27**). Moreover, the presence of spare capacity in the economy (negative output gap) and favorable exchange rate conditions during the year also facilitated in containing the underlying inflationary pressures.

In the case of urban and rural areas, pace of inflation in both goods and services declined significantly, however, the impact of the latter was more pronounced. House rent inflation, on the other hand, remained almost at the same level observed last year. Indices-wise information (for goods group) reveals that barring few categories (clothing and footwear, furniture and household equipment and therapeutic appliances and equipment), broad-based deceleration was registered. Disaggregated analysis reveals that downward pressure on prices of construction related items has been registered, especially in cement, crushed stone (bajri) and iron bars. The FED on portland cement, aluminous cement, slag cement, super sulphate cement and similar hydraulic cements has been reduced in Budget 2020-21 from Rs 2/kg to Rs 1.75/kg in the wake of Covid.

For services group, on the other hand, deceleration is concentrated in around one third of the indices in urban areas and around half of the indices in rural areas. Component-wise analysis, both for urban and rural areas, shows that this has been driven by a combination of Covid-related factors. For instance, no change in motor vehicle tax, subdued construction wages and education fee played a significant role in driving down the overall services inflation. In education sector, the decline came from both private and public school/college fees. This can be attributed to: (a) concession in tuition fees as provided in the Sindh Covid Emergency Relief Ordinance, 2020, as well as The Punjab Private Educational Institutions Ordinance, 2020; and (b) withdrawal of collection of advance tax on tuition fee by some educational institutions, in addition to the Supreme Court's decision taken earlier in FY20 to restore school fees to the 2017 level, on which it fixed the maximum increase in fees at 5 percent a year. In addition, motor vehicle taxes posted no change in inflation on account of no new taxes imposed by the government in order to provide Covid related relief to the masses.

Item-wise commodity basket of urban and rural areas reveals that around half of the

Frequency Distribution of NFNE Items **Figure 3.28**



Source: Pakistan Bureau of Statistics

items posted above the average NFNE inflation during the year. Heavy-tail distribution hints towards the fact that inflation deceleration in the commodities having relatively higher weight in the overall NFNE basket is likely to have played a role in overall decelerating inflationary pressures (**Figure 3.28**).[36] For instance, items like fee of government institutes, transport fares, newspapers and service taxes have played substantial role in slowing down NFNE inflation.

Energy Inflation Posted Deceleration

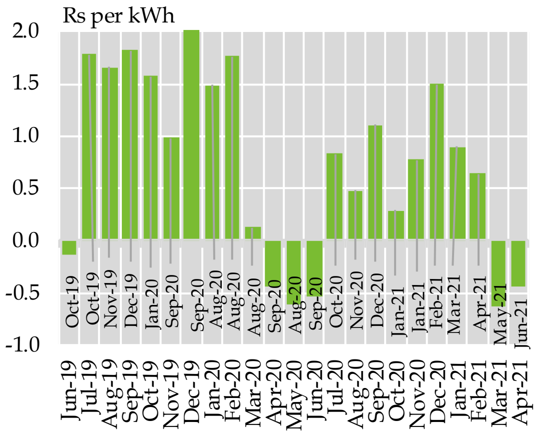
Energy inflation registered significant deceleration for urban areas in FY21 compared to last year, however, it rose marginally for rural areas during the same period compared to FY20. Notwithstanding overall deceleration in energy inflation for urban community in FY21, inflation remained volatile, particularly during the second half of the year. Barring gas index, all other sub-indices of energy group rose sharply during the last quarter.

Disaggregated analysis for full year, in case of urban segment, shows that double digit inflation in electricity prices was more than offset by deflation in fuel prices and liquefied hydrocarbon. For rural areas, though fuel and liquefied hydrocarbons registered deflation on YoY basis, rise in electricity tariffs and solid fuel predominantly dragged-up the energy inflation.

In the case of motor fuel, the prices remained stable, however, on YoY basis it posted deflation during the first eight months. However, from March 2021 onwards, the motor fuel prices rose significantly, dragging YoY inflation on higher level, following the gain in global crude oil prices on account of improved global growth prospects with the arrival of vaccines and increased demand for oil-intensive activities such as transport and aviation.[37] On a cumulative basis, urban inflation rose by 17.2 percent during March and June 2021.

For electricity inflation, after posting 1.3 percent decline during Jul-Jan FY21, significant YoY rise was recorded from February 2021 onwards as government enhanced its efforts to address energy sector issues pertaining to circular debt. Measures included i) increase in base tariff of Rs 1.95/kWh of Distribution Companies (Discos)- including life-line consumers consuming up to 50 units per month and ii) notification of the Q2-FY20 and Q3-FY20 quarterly tariff adjustments (QTAs) in December 2020 and Q4-FY20 QTA in February2021. Also, monthly fuel charge adjustments added to surge in inflation (**Figure 3.29**)

Fuel Charge Adjustment **Figure 3.29**



Source: NEPRA

Box: 3.2 Global Inflation Behavior after Covid-19

The Covid-19 pandemic posed significant challenges to global economy led by slowdown in demand, rising poverty levels amid loss of businesses and employment, disruption in supply chains, increasing financing need to meet Covid management spending, etc. In this backdrop, preliminary analysis of the global inflation behavior,

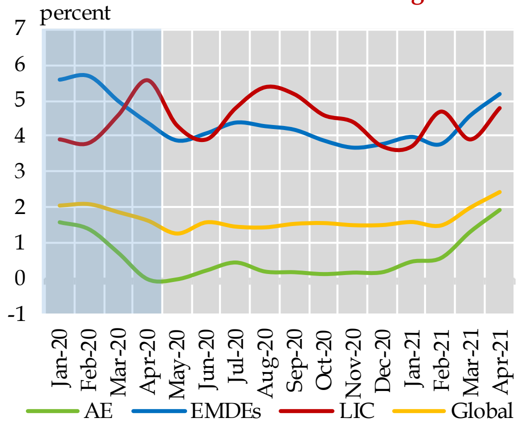
---

[36] Urban frequency distribution shows that around ***49 percent items*** remained in the group showing more than 6 percent average inflation whereas Around ***7 percent items*** posted inflation equal or less than zero. Rural frequency distribution shows that around ***51 percent items*** remained in the group showing more than 7.6 average percent inflation whereas around ***5 percent items*** posted inflation equal or less than zero.

[37] In addition to improved demand for crude oil, decision of cut in oil production by some OPEC countries also put upward pressures on oil prices.

especially in emerging economies highlights that dampened demand pulled down inflation levels in the initial months after the pandemic outbreak across countries. However, from May 2020, with a global shift towards smart lockdowns and the consequent pickup in economic activity, international commodity and fuel prices has started to rise. The trend further strengthened in April 2021, with the global availability of Covid vaccine. A persistence increase in these price pressures, may lead central banks to reverse the expansionary policy stance which may restrict the pace of economic recovery.

Headline Inflation **Figure 3.2.1**

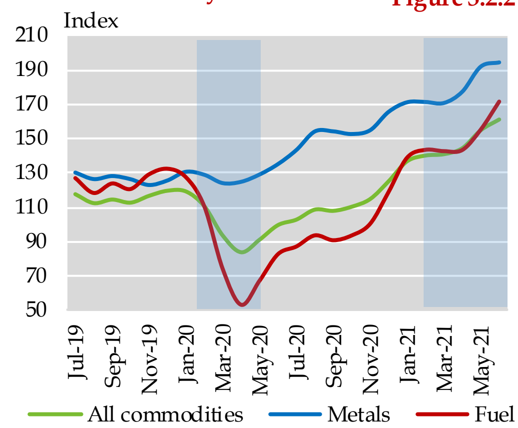


Source: World Bank

Waning inflationary pressures during January 2020 to May 2020- global scenario:

With the start of the pandemic, global inflation declined by 0.8 percentage points, during four months i.e., from January 2020 to May 2020. Similarly, the Emerging Markets and Developing Economies (EMDEs) and advanced-economies inflation also witnessed 1.2 and 1.6 percentage points declines in inflation respectively, during this period (**Figure 3.2.1**).

Global Commodity Index **Figure 3.2.2**



Source: IMF

Demand-side factors put downward pressure on global inflation

Subdued aggregate demand: Worldwide strict lockdowns along with weaker consumer confidence negatively affected the aggregate demand. Depressed economic activities along with weakened demand put downward pressure on prices.[38]

Decline in global fuel prices: Oil prices dropped significantly after the onset of pandemic as lockdowns disrupted the transport and travel services that account for around two thirds of global energy consumption (**Figure 3.2.2**).[39] Reduced demand for fuel affected prices and contained the pace of inflation.

But few supply-side factors put upward pressure on prices

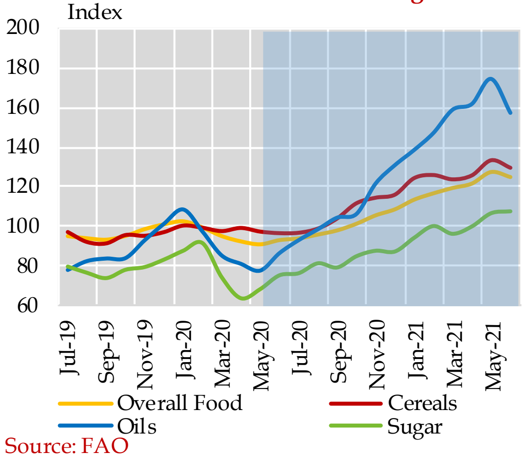
Supply-chain disruptions: Supply chain disruptions have been a major challenge since the outbreak of pandemic. Strict lockdowns at the start of Covid-19 interrupted economic activity, especially the services sector, as restrictions were imposed on dealings that required in-person collaboration. Likewise, labor shortages resulting from a decline in the number of migrant workers disrupted production. In addition, hoarding practices by some countries, increased border controls and customs regulations resulting in longer wait times affected the smooth supplies of goods and put upward pressure on prices of commodities.[40]

[38] A.C. Dunn, K. K. Hood, and A. Driessen (2020). *Measuring the Effects of the COVID-19 Pandemic on Consumer Spending Using Card Transaction Data.* Bureau of Economic Analysis Working Paper 2020–5. Washington D.C.: U.S. Department of Commerce
[39] C.M. Wheeler, J. Baffes, A. Kabundi, G. Kindberg-Hanlon, P. S. Nagle and F. Ohnsorge (2020). *Adding Fuel to the Fire: Cheap Oil during the COVID-19 Pandemic.* Policy Research Working Paper 9320. Washington, D.C.: WB
[40] According to the WTO, around 80 countries and customs territories introduced prohibitions or export restrictions as a result of the COVID-19 pandemic (IMF Research-September 2020)

Currency depreciations: In EMDEs, weakening of currency during the pandemic was one of the factors behind rising inflationary pressures, as around one fifth of EMDEs ended 2020 with weaker exchange rates than at the start of the year.[41]

Food supply disruptions: Market and trade restrictions, discussed earlier, affected domestic food supply chains in some countries. Supply disruptions in agriculture products due to labor shortages also caused price pressures.[42] Similarly, the value chain for fruits, the most perishable items which require labor-intensive handling and rapid (often airborne) transport, was also affected.[43] Thus, rising wholesale and retail markups and non-availability of the products contributed to rising food price inflation.[44]

Food Prices Indices **Figure 3.2.3**



Source: FAO

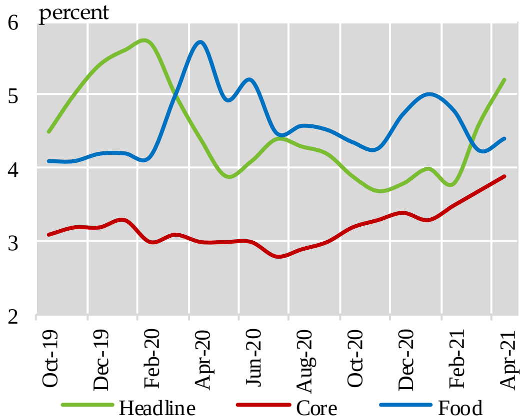
The significant dip in the global inflation reflects that the impact of demand-side factors more than offset the impact of supply-side factors during the initial four to five months.

Resurgence in global inflation – May 2020 onwards:

In May 2020, however, global inflation started to gain upward momentum, although it remained low by historical standards. With the revival in activity and demand on account of imposition of smart lockdowns, consumption shift from in-person to online transactions, prices of fuel and metal started rising. In addition to this, food prices started to surge as well (**Figure 3.2.3**). While the supply-chain disruptions were already developing rising food inflation expectations with the beginning of the Covid containment phase, weather related supply shocks further spiraled the food inflation. For instance, prices of edible oil increased most due to supply shortfalls (**Figure 3.2.3**). Similarly, wheat prices posted significant rise in prices reflecting strong global demand and unfavorable growing conditions in major parts of the wheat growing regions (for details see Box 3.1 of First Quarterly Report FY21 on the State of the Pakistan's Economy).

By April 2021, global inflation further picked up its pace and rose above pre-pandemic levels, especially in EMDEs. Improved global recovery prospects[45] with the rolling-out of vaccines, recovery in fuel prices and ever-rising global food prices accelerated the rising pace of inflation. Food group, in particular, witnessed surging inflation on account of Covid-related supply chain bottlenecks,[46] shipping delays, elevated transport costs and weather uncertainties. Consequently, in EMDEs, both headline and core has surpassed the pre-pandemic levels, however, the pace of latter is steeper (**Figure 3.3.4**).

EMDEs Inflation **Figure 3.2.4**



Source: World Bank

[41] Global Economic Prospects-June 2021, World Bank
[42] Palm oil harvesting and processing operations were affected by labor force reduction, especially in Malaysia, where several plantations suffered from acute shortages of migrant laborers triggered by policies to curtail the spread of Covid.
[43] FAO price indices for oilseeds, vegetable oils and oil meals, October 2020
[44] J. Swinnen, and J. McDermott (eds.) (2020). *COVID-19 and Global Food Security*. Washington, D.C.: IFPRI
[45] World economy is projected to grow by 5.6 percent in 2021 (WB).
[46] Covid-related congestion at North European and Asian terminals interrupted trade plans by end FY21 (Institute of Export & International Trade-UK).

Rising inflation in EMDEs and low-income countries (LICs), particularly, may compound challenges for the policy makers. With the pandemic still a major risk on account of new emerging virus variants and a number of economies in some sort of lockdown, the disruption in supply chains still remains a concern. Supply chain issues from multiple waves of the pandemic, as well as weather-related subdued production prospects for some cereal crops have built price pressures. Consequently, higher inflation for food group, which accounts for about half of consumption in LICs and a large portion in EMDEs, may further add to inflationary pressures in these economies. From the policy perspective, a fleeting rise in inflation may not merit a monetary policy response. However, if rising price pressures persist and potential second-round impact emerges, EMDEs central banks may re-consider to change their accommodative monetary policy stance sooner than expected. For EMDEs particularly, inflation forecasts indicate towards rise in inflation in 2021 that may exceed their target bands.[47]

[47] Global Economic Prospects-June 2021, Washington D.C.: WB.