3 Inflation and Monetary Policy

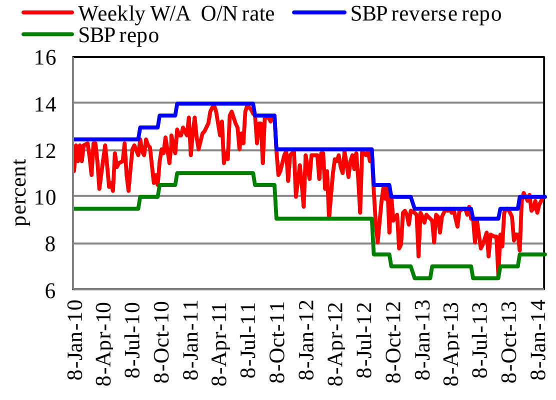
3.1 Overview

One of the most notable developments during the first half of the year, was the shift in SBP's monetary policy stance from accommodative to gradual tightening. SBP increased the policy rate by 50 bps each in its monetary policy decisions announced in September and November 2013 (**Figure 3.1**).[1] This change in the policy stance was primarily driven by: (i) growing inflationary expectations; and (ii) to calm the FX market against the backdrop of a widening external deficit.

There was some improvement as the economy moved towards the end of H1-FY14. Pressure from Pakistan's external sector eased in December 2013, and is likely to remain benign in the second half of the year, as the large repayments to the IMF have been met during H1-FY14. This, along with the improvement in the inflation outlook and stability (and recent appreciation) in the exchange rate allowed the central bank to keep the policy rate unchanged at 10.0 percent in its monetary policy decisions announced in January and March 2014.

Headline YoY inflation, which had been increasing since early FY14, entered double digits in November 2013, before softening to 9.2 percent in December 2013. This increase in the inflationary pressures during H1-FY14 can be traced to: (i) excessive volatility in perishable food prices due to supply constraints; (ii) a sharp increase in the price of wheat and its related products; (iii) increase in GST rate; and (iv) the reduction in subsidies on fuel and electricity, which pushed up administered prices of energy. Inflation expectations also gathered pace as the households and

Figure 3.1: SBP Policy Rate



Source: State Bank of Pakistan

[1] It is pertinent to note that the policy rate saw a cumulative reduction of 500 bps during FY12 and FY13.

businesses *anchor* their expectations on the prices of wheat and petroleum products, and movements of exchange rate.

However, inflationary pressures have weakened since December 2013, as the prices of perishable food items retreated after an ease in supply constraints.[2] Furthermore, the pressures on PKR parity have also eased since December 2013, and the government is trying to reduce its inflationary borrowing from SBP. Hence, average inflation for the year is likely to fall in the range of 8.5 to 9.5 percent.

In addition to inflation, continuation of government borrowing from the banking sector and the on-going external sector weakness significantly impacted the monetary sector during H1-FY14. These two factors were pushing money supply in opposite directions, i.e. government borrowing was contributing to monetary expansion, while deterioration in external accounts had a contractionary impact. In net terms, broad money supply (M2) grew by only 6.0 percent during H1-FY14, compared with 8.0 percent during the same period last year.

Government borrowing target was missed in the second quarter
Causative factors of monetary expansion showed that government borrowing for budgetary finance decreased from Rs 518.1 billion in H1-FY13, to Rs 471.7 billion during H1-FY14 (**Table 3.1**). Nonetheless, the government was unable to meet the end-December 2013 target on its borrowing from SBP, as agreed with the IMF.[3] Furthermore, the government could not limit its borrowing from SBP to zero by end of both quarters, as prescribed in the SBP Act.[4] In net terms, the government borrowed Rs 83.7 billion from SBP in the second quarter of the year, in addition to the Rs 379.2 billion borrowed in Q1-FY14.

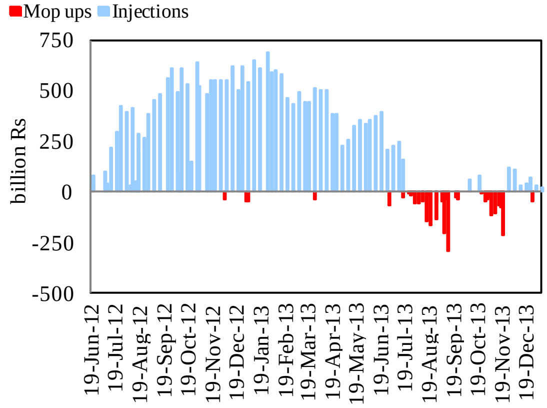
SBP begins to mop-up liquidity after a prolonged phase of monetary injections
SBP's purchases from the FX market to support falling FX reserves in Q1; the government's increasing reliance on SBP funding till September 2013; and commercial banks' reluctance to invest in short-term government securities, created excess liquidity in the interbank market.[5] These developments not only

[2] With the arrival of fresh crops, month-on-month prices of perishable food items declined by 25.6 percent in December 2013.
[3] Outstanding stock of net budgetary borrowing from the central bank (on cash basis) stood at Rs 2,611.1 billion as on end-December 2013, compared to the IMF target of Rs 2,560 billion.
[4] With the bilateral external inflows in February and March 2014, and other external inflows expected in H2-FY14, it will be easier to meet these targets going forward.
[5] It may be noted that banks were reluctant to re-invest their maturing T-bills at prevailing rates in anticipation of an increase in interest rates. Specifically, before the announcement of monetary

ended the prolonged period of SBP's injections seen in FY12 & FY13, but also forced SBP to mop-up liquidity to maintain money market rates within the interest rate corridor (**Figure 3.2**).

The increase in SBP's policy rate in September 2013, facilitated the government to shift some of its borrowing from SBP towards commercial banks. Resultantly, net budgetary borrowing from commercial banks during Q2-FY14 reached Rs 188.1 billion, against a net retirement of Rs 179.1 billion in the first quarter of the year.

Figure 3.2: Open Market Operations



Source: State Bank of Pakistan

In addition to the government borrowing, credit to the private sector also picked up during H1-FY14. The private sector borrowed Rs 321.3 billion during H1-FY14, which was three times the credit expansion seen in H1-FY13. Major contributions to this increase came from healthy growth in large scale manufacturing sector, seasonal credit off-take, and the demand for trade financing. Finally, consumer financing also grew by 8.3 percent during H1-FY14, compared to 3.2 percent in H1-FY13.

3.2 Monetary Aggregates

Broad money supply (M2) expanded by Rs 527.9 billion during H1-FY14, compared to 612.4 billion in H1-FY13. This deceleration in M2 was primarily driven by the net contraction of the NFA of the banking system, which partially offset the expansionary impact of net domestic assets (**Table 3.1**).

3.2.1 Net foreign assets (NFA)

In absolute terms, the NFA of the banking system recorded a sharp contraction of Rs 215.2 billion during H1-FY14, in contrast to a rise of Rs 17.2 billion during the same period last year. Within the banking system, the contraction was entirely

policy decision in September 2013, commercial banks offered only Rs 812.3 billion in five T-bills auctions held during Q1-FY14, against the maturity of Rs 1,384.34 billion and the target of Rs 1,350 billion.

stemming from SBP's NFA, as the onus of financing the external deficit fell largely on the central bank. In fact, the drying up of financial inflows in recent

Table 3.1: Monetary Aggregates during H1
flows in billion Rupees, growth in percent

	Cumulative Flows		Quarterly Flows (FY14)		Growth during H1	
	FY13	**FY14**	**Q1**	**Q2**	**FY13**	**FY14**
Broad money (M2)	**612.4**	**527.9**	**21.5**	**506.4**	**8.0**	**6.0**
NFA	17.2	-215.2	-173.2	-42.0	3.2	-80.0
SBP	-59.9	-229.8	-146.1	-83.7	-15.2	-172.9
Scheduled banks	77.1	14.6	-27.1	41.7	55.8	10.8
NDA	595.3	743.0	194.6	548.4	8.4	8.7
SBP	272.3	335.5	174.2	161.2	18.1	17.2
Scheduled banks	323.0	407.6	20.4	387.2	5.8	6.1
Major components of NDA						
Government sector borrowing	478.3	380.5	176.7	203.7	11.2	6.6
For budgetary support*	518.1	471.7	200.0	271.7	13.6	9.0
SBP	-216.2	462.8	379.2	83.7	-12.7	20.9
Scheduled banks	734.3	8.9	-179.1	188.1	35.1	0.3
Commodity operations	-38.8	-89.4	-22.0	-67.4	-8.9	-19.1
Non government sector	144.8	375.4	17.6	357.9	4.0	10.2
Credit to private sector	104.5	321.3	-17.4	338.7	3.1	9.6
Credit to PSEs	40.3	54.3	35.1	19.3	15.7	18.9
Other items net	-27.9	-12.9	0.3	-13.2	3.5	1.6

*These numbers will not match with the financing numbers provided by MoF on its website. This is because MoF reports government borrowing on *cash basis*, while SBP's monetary survey is compiled in *accrual basis*.
Source: State Bank of Pakistan

years has finally pushed the stock of SBP's NFA into negative territory for the first time since October 2001.[6] Temporal changes in the NFA indicate that a major contraction took place in the first quarter of the year, whereas CSF inflows worth US$ 322.0 million in the second quarter helped contain the overall deterioration in the NFA of the banking system (**Table 3.2**).

3.2.2. Net Domestic Assets (NDA)

In sharp contrast to the net contraction in NFA, net domestic assets (NDA) of the banking system expanded by Rs 743.0 billion during H1-FY14, compared to a rise of Rs

Table 3.2: NFA and CSF
billion Rupees

	NFA	**CSF**	**NFA excl. CSF**
Q1-FY13	11.8	104.1	-92.3
Q2-FY13	5.4	66.1	-60.7
Q3-FY13	-178.3	0.0	-178.3
Q4-FY13	-102.1	0.0	-102.1
Q1-FY14	-173.2	0.0	-173.2
Q2-FY14	-42.0	31.9	-73.9

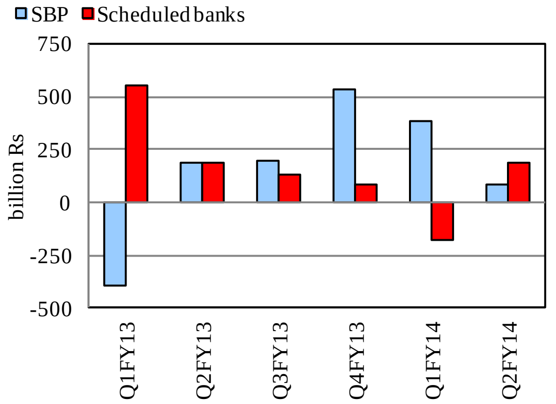
Source: State Bank of Pakistan

[6] It implies that SBP's foreign liabilities have exceeded its holding of foreign assets.

595.3 billion during H1-FY13 (**Table 3.1**). The rise in NDA during H1-FY14 can be traced to government borrowing for budgetary finance, and pickup in credit to the private sector, with the impact of the former being the greater.

The government borrowed Rs 271.7 billion from the banking system in Q2-FY14, in addition to Rs 200.0 billion borrowing in the first quarter of the year. Within banking system, the government heavily relied on SBP funding. Specifically, it borrowed Rs 462.8 billion from SBP, which was 98.1 percent of the total government borrowing from the banking sector in H1-FY14.

Figure 3.3: Government Borrowing for Budgetary Support



Source: State Bank of Pakistan

Within the banking system, there was a change in the source of deficit financing in the second quarter of the year. While the fiscal authorities extensively relied on the central bank in Q1-FY14 and retired some of the borrowing from commercial banks, this trend reversed in Q2-FY14 (**Figure 3.3**). This was primarily facilitated by the shift in SBP's monetary policy stance. Specifically, the 50 bps increase in the policy rate in September 2013 revived commercial bank interest in government securities, which helped fiscal authority to contain its borrowing from the central bank.[7] However, the government could not limit its quarterly borrowing to zero as prescribed in the SBP Act. As stated earlier, the government was also unable to contain its borrowing from SBP within the limit agreed with IMF.

Commodity Operations[8]

With a net retirement of Rs 89.4 billion during first half of the year, the outstanding stock of loans for commodity operations reached Rs 378.3 billion by end-December 2013. This is encouraging to note that the net retirement in H1-FY14 was more than double the amount retired in the same period last year.

[7] Commercial banks offered Rs 3,225.6 billion in T-bill auctions held after the change in monetary stance from 13th September 2013 to 31st December 2013, against the cumulative target of Rs 2,350.0 billion. Please, see foot note 4 also.
[8] Discussion in this section is based on domestic public sector commodity operations.

Moreover, unlike the previous year when retirement was entirely driven by the repayment of wheat loans, the net retirement in H1-FY14 was broad based (**Table 3.3**).

Loans for wheat procurement, which accounted for 72.8 percent of commodity financing as of end-December 2013, saw a net retirement of Rs 86.2 billion during H1-FY14, compared to Rs 66.3 billion in H1-FY13 (**Table 3.3**). This was largely attributed to aggressive off loading of wheat stocks by the provincial food departments to stabilize wheat price in Q2-FY14.[9] This, along with the lower carry forward stocks from the previous year, has pushed down the country's wheat stocks as of end-December 2013, to the levels observed by end-February, i.e., before the arrival of the new crop.[10] However, it is important to emphasize here that the country still has comfortable level of wheat stocks to meet domestic requirements.

Table 3.3: Loans for Commodity Operations
billion Rupees

	As of end Dec-2013	Share (%)	Cumulative Flows H1 FY13	Cumulative Flows H1 FY14
Wheat	275.3	72.8	-66.3	-86.2
Sugar	42.4	11.2	5.2	-3.0
Fertilizer	59.7	15.8	22.3	-0.3
Rice	1.0	0.3	-0.1	0.0
Total	378.3	100.0	-38.8	-89.4

Source: State Bank of Pakistan

In the case of fertilizer, lower imports due to an increase in domestic production reduced the borrowing requirements of TCP.[11] Similarly, loans for sugar procurement also witnessed net retirement during H1-FY14, as TCP aggressively off loaded its sugar stock.

Despite these favorable developments, the ability of procurement agencies to retire costly borrowing from the commercial banks is undermined by accumulated receivables. As of end December 2013, total receivables stood at Rs 267.7 billion, of which Rs 173.4 billion was on account of subsidy payments due from the government. In overall terms, these receivables account for 70.7 percent of outstanding commodity financing as of end H1-FY14. It implies that speedy realization of receivables would help retire outstanding loans for commodity operations. However, given the fiscal pressures, this seems unlikely. It implies

[9] Wheat prices increased by 27.8 percent YoY during Q2-FY14 compared to 24.5 percent in the first quarter of the year.
[10] See **Figure 3.9**.
[11] Fertilizer imports during H1-FY14 stood at US$ 427.6 million, compared to US$ 478.3 million in H1- FY13. Within fertilizer, the share of DAP imports was 61.5 percent in H1-FY14, compared to 43.0 percent in H1-FY13.

that procurement agencies may struggle to retire their debt. As repeatedly highlighted in SBP's Annual and Quarterly Reports, timely payment of subsidies will not only help improve fiscal transparency, but also be cost effective for the government.

Table 3.4: Credit to PSEs in FY14
billion Rupees

	Q1	Q2	H1
PARCO	5.2	12.2	17.3
PSO	22.1	31.7	53.7
WAPDA	11.1	2.1	13.2

Source: State Bank of Pakistan

Credit to PSEs

The net lending to PSEs increased by Rs 54.3 billion during H1-FY14, compared to Rs 40.3 billion during the same period last year. The institutional breakup shows that energy sector PSEs borrowed from the banking sector due to re-accumulation of receivables (**Table 3.4**).

3.3 Credit to Private Sector

Credit to the private sector expanded by Rs 321.3 billion in H1-FY14, compared to only Rs 104.5 billion in H1-FY13 (**Table 3.5**). This significant increase can be traced to: (i) lower cost of borrowing in real terms;[12] (ii) some improvement in power and gas availability, which supported credit demand by the LSM sector; and (iii) higher business confidence due to the government's focus on industrial activity. In addition to these macro factors, sector specific developments like expansions in production capacities, product diversification, investment in alternate energy sources, etc., also contributed to the healthy growth in credit to the private sector.

Table 3.5: Change in Credit to Private Sector
billion Rupees

	FY13			FY14		
	Q1	Q2	H1	Q1	Q2	H1
Overall	-84.9	189.5	104.5	-17.4	338.7	321.3
of which						
Loans to private business	-39.6	186.1	146.5	-3.0	274.8	271.8
Investments in private stocks	-1.1	12.3	11.2	1.4	5.2	6.5
Consumer financing	-1.8	8.4	6.6	13.4	4.7	18.1
Credit to NBFCs.	-65.7	-12.6	-78.3	-16.2	2.9	-13.3

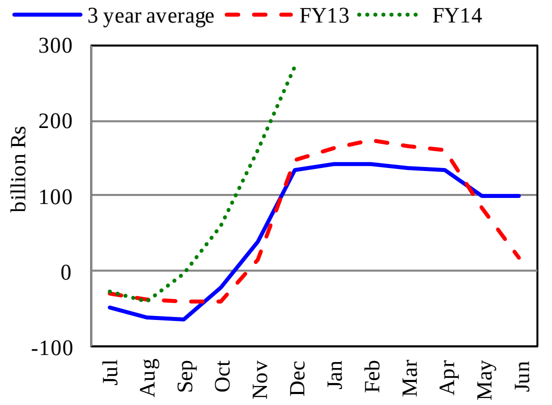
Source: State Bank of Pakistan

Within private sector credit, loans to private sector businesses during H1-FY14, increased by Rs 271.8 billion compared to Rs 146.5 billion in H1-FY13 (**Figure**

[12] YoY inflation adjusted lending rates on fresh loans for H1-FY14 averaged at 1.2 percent, compared with 3.5 percent for the same period of the previous year.

3.4). Apart from the usual seasonal demand for the procurement of rice and cotton, loans to other sectors also gathered pace during H1-FY14.[13]

Figure 3.4: Loans to Private Sector - Cumulative Flows



Source: State Bank of Pakistan

The sectoral distribution of loans clearly indicates that credit expansion is broad based as a large number of sectors and sub-sectors recorded an increase in credit off-take. Moreover, distribution of loans to private businesses by type also indicates that all three categories (namely trade financing, fixed investment and working capital) witnessed an increase during H1-FY14 (**Figure 3.5a**).

Seasonal credit off-take explained part of the rise in working capital

- The rice processing units availed Rs 30 billion of working capital during H1-FY14, compared to Rs 17.6 billion during H1-FY13. This significant rise in credit was primarily attributed to increased rice production and healthy growth

Figure 3.5a: Trend in Type of Financing (H1)

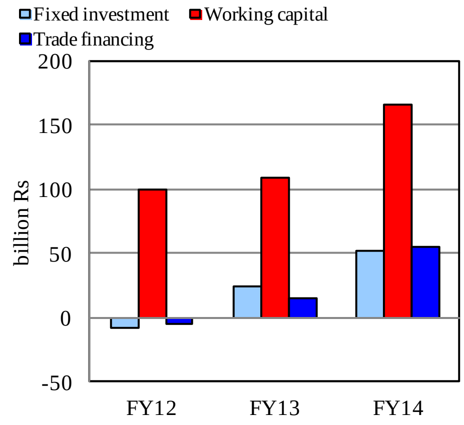
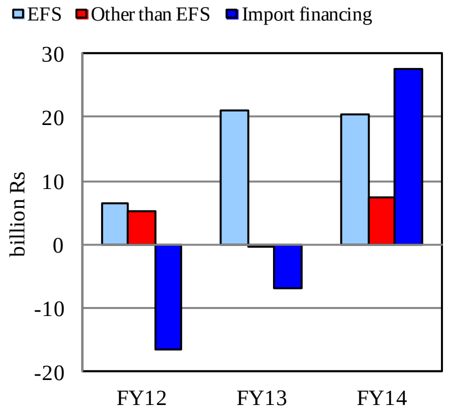


Figure 3.5b: Flows in Trade Finance (H1)



Source: State Bank of Pakistan

[13] Following the seasonal pattern of credit to the private sector, credit expansion was concentrated in the second quarter of the year, while the Q1-FY14 saw a net retirement of Rs 17.4 billion.

in rice exports.[14]

- Credit demand for *cotton* procurement from spinning, weaving and finishing industries, remained strong due to: (i) early cotton arrival in the market;[15] (ii) increased cotton buying by the textile mills to meet the anticipated demand from the European market after attaining GSP plus; and (iii) rise in demand by cotton exporters.

Table 3.6: Net Change in Loans to Private Sector Businesses during H1[1]

billion Rupees

	Share-End H1-FY14	Overall Loans		Trade Financing		Working Capital		Fixed Investment	
		FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Private. business	100.0	146.5	271.8	14.1	55.1	108.7	165.4	23.7	51.4
a) Manufacturing	58.9	94.0	165.0	11.0	30.5	70.8	96.0	12.1	38.5
Of which									
Food & beverages	12.3	3.7	20.9	6.4	7.8	-11.7	2.3	9.0	10.8
Of which									
Edible oil	1.5	-9.7	7.5	-4.3	6.2	-5.6	1.2	0.1	0.1
Rice	3.0	23.7	40.8	6.0	9.8	17.6	30.0	0.1	0.9
Sugar	3.8	-16.8	-23.9	2.9	-2.4	-23.8	-28.0	4.1	6.5
Bakery	0.6	1.1	3.9	0.3	-0.3	0.8	4.1	0.0	0.1
Beverages	0.8	0.6	3.9	0.7	-0.2	-0.3	4.5	0.2	-0.4
Textiles	22.5	65.2	100.0	5.7	13.9	55.6	80.5	3.9	5.6
Of which									
Spinning	9.6	39.4	49.2	5.0	0.0	35.7	51.9	-1.2	-2.8
Weaving	4.0	6.2	21.0	1.2	2.0	3.9	13.2	1.1	5.7
Finishing	3.8	10.9	19.3	-1.6	5.3	8.3	10.3	4.2	3.7
Cement	2.0	-7.8	0.4	-3.0	-0.9	-2.1	-5.2	-2.7	6.4
b) Power	9.5	9.6	31.5	0.6	2.4	5.4	22.3	3.6	6.8
c) Commerce	8.8	12.4	34.1	-0.4	12.2	9.3	22.5	3.5	-0.6
d) Others*	22.8	30.5	41.3	2.9	10.0	23.2	24.6	4.5	6.7

[1]Numbers may not add up exactly due to separate rounding off.
*Agriculture, Fishing, Mining, Ship Breaking, Construction, Hotel, Transport, Real Estate, Education, Health, Community, Others.
Source: State Bank of Pakistan

- Higher working capital requirements by the *fast moving consumer goods* (FMCGs) sector also contributed to the rise in credit demand;[16]

[14] Rice production reached 6.4 million tons during FY14, which not only exceeded the target of 6.2 million tons for the year, but was also significantly higher than the last year's production of 5.5 million tons. Moreover, rice exports sharply increased to US$ 966.6 million during H1-FY14, compared to US$ 749.3 million in H1-FY13 (Source: PBS).

[15]Early arrival of cotton due to changing seasonal pattern, especially in Punjab, caused improved cotton arrivals in the market.

[16] Manufacturers of *soft drinks* and *other beverages* showed significant rise in working capital requirement on account of increased demand from a leading beverages company which availed bank

- Working capital loans to the *power sector* increased by Rs 22.3 billion in H1-FY14, compared to Rs 5.4 billion in H1-FY13 (**Table 3.6**). This significant increase was largely attributed to higher capacity utilization by the power sector following the settlement of circular debt by end FY13, which opened up space to lend to the power sector.[17] Interestingly enough, the re-accumulation of receivables in subsequent months, again created appetite to borrow from banks.
- Working capital loans to c*ommerce and trade* also increased during H1-FY14, due to an increase in trading activities, and growing business of retailing outlets.[18]

Broad based expansion in trade financing: Within trade financing, the expansion was largely driven by loans for import financing (**Figure 3.5b**). Increased demand for various imported goods, and depreciation of PKR, were the major contributory factors. Specifically, the private sector heavily borrowed to import *electrical machinery* and for *commerce & trade* during Q2-FY14.[19] The import of petroleum products picked up for power generation, and to meet the acute CNG shortage during the winter season.[20]

In addition to imports, loans for export financing also increased by Rs 27.6 billion during H1-FY14, compared to Rs 21.1 billion in H1-FY13. Major contribution came from concessional EFS loans, which saw an expansion of Rs 20.3 billion during the period under review. Further details indicate that exporters borrowed under EFS for rice, cotton and textile made-ups. As stated earlier, this was driven by better rice production and cotton demand from China.

Improvement in fixed investment loans: Within credit to the private sector, increase in the fixed investment loans (loans for more than one year maturity),

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finance to expand its operations. Moreover, increasing demand for bakery products and rise in corn prices, also contributed to credit expansion during H1-FY14.

[17] It is important to note the credit expansion was concentrated during the first quarter of the year; in Q2-FY14, loans to the energy sector declined, as a number of power plants could not sustain their operations due to gas shortages during the winter season.

[18] With the opening of mega retailing stores in big cities, there is a visible change in retail trading. Moreover, these outlets are well integrated with the banking sector due to increasing use of debit and credit cards as a means of payments. This increased interaction with the banking system, help retailing stores utilize bank financing for expanding their business.

[19] Imports of electrical machinery (refrigerators, freezers, generators, washing machines etc) reached US$ 535.4 million during H1-FY14, compared to US$ 403.1 million in the same period last year (Source: PBS).

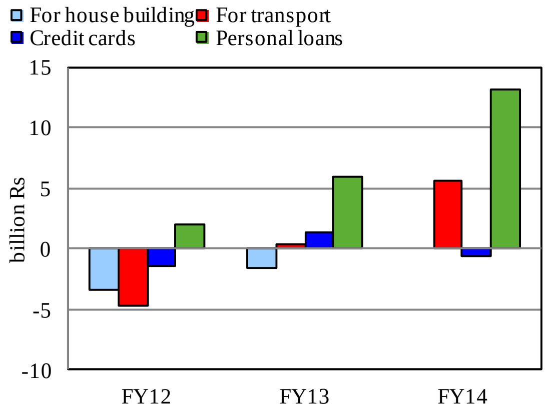
[20] Imports of petroleum products rose to 6.7 million MT during H1-FY14, compared to 6.2 million MT during the same period last year (Source: PBS).

during the first half of the year, is a welcome development. More importantly, this increase in fixed investment loans is broad based:[21]

- Major players in the dairy sector borrowed in Q2-FY14, for product diversification, investment in alternate energy sources, and for enhancing their existing production capacity;[22]
- The cement sector availed fixed investment loans as some of the leading cement companies are expanding their production capacity;[23]
- Loans to the *paper and board* industry increased during Q2-FY14, as this sector is investing in alternate fuel plants/boilers to cope with the persistent energy crisis.[24]
- A number of sugar mills availed fixed investment loans for power generation from sugarcane bagasse during H1-FY14.
- Textile weaving utilized fixed investment loans for BMR (balancing, modernization and replacement) to benefit from preferential access to EU market (GSP plus status).
- Power sector utilized fixed investment loans for setting up new power projects, and for the up gradation of old units.

Following a prolonged period of net retirement, ***consumer financing*** has picked up since November 2012; this trend continued during H1-FY14 (**Figure 3.6**). Composition of consumer finance indicates that the recovery was largely driven by personal loans, which saw an expansion of Rs 13.0 billion during H1-FY14. Further

Figure 3.6: Consumer Financing-H1



Source: State Bank of Pakistan

[21] Dairy, Paper and Board, cement, Iron and steel, weaving and finishing of textiles and electrical equipment posted modest rise in fixed investment loans compared to the same period last year.
[22] Engro food entered in the loose milk market in Karachi with the launch of its brand, "Mubrook". It also opened few retail outlets in the city. Nestle, on the other hand, is on its way to increase production capacity.
[23] For instance, Askari Cement and Lucky Cement.
[24] Century papers and Packages have installed coal based boilers for drying purposes in paper production. It is interesting to note that import of boilers reached US$ 34.7 million during H1-FY14, compared to US$ 9.2 million during the same period last year.

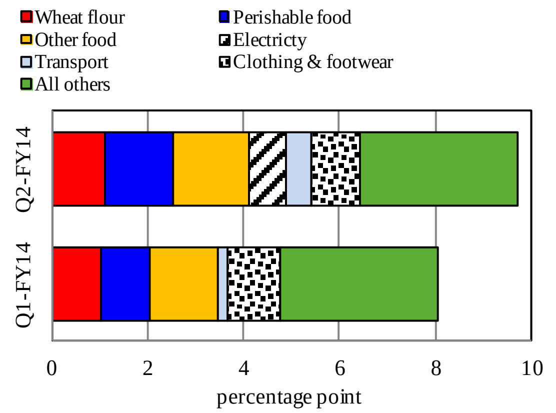
details indicate that the one of the public sector commercial banks marketed its *Salary Loan* scheme and *Cash and Gold* scheme, which was the swing factor in personal loans. In addition to personal loans, auto financing also picked up in recent months, as one of the private sector banks actively marketed its auto finance facility. More specifically, the bank followed a segmented marketing approach, which turned out to be quite a success.[25]

3.4 Inflation

Headline inflation continued to increase in Q2-FY14, reaching an average of 9.7 percent in the quarter, from 8.1 percent in Q1-FY14. In overall terms it rose to 8.9 percent during H1-FY14 compared to 8.3 percent in H1-FY13. The quarterly analysis indicates that as witnessed during Q1-FY14, the rise in wheat flour prices, and the increase in GST rate, continued to fuel headline inflation in the second quarter. Pressures were compounded in Q2-FY14 due to the increase in power tariffs and fuel prices, and worsening supplies of perishable food items. In fact, the combined share of inflation contributed by perishable food items, electricity prices and transport group, rose to 28.3 percent in the second quarter from 15.1 percent in Q1-FY14 (**Figure 3.7**). The role of perishable foods in H1-FY14 can be seen in **Table 3.7**.

Both the measures of core inflation (trimmed as well as NFNE) showed stability in 'underlying inflation' around 8.4 percent during H1-FY14. It is significantly lower than the core inflation observed during H1-FY13. However, trimmed core inflation increased to 9.0 percent in Q2-FY14, compared to 7.8 percent in Q1-FY14 (**Table 3.7**). This is due to the fact that trimmed inflation for Q2-FY14 included electricity prices, which were absent in the trimmed CPI basket during Q1-FY14 (**Table**

Figure 3.7: Composition of Inflation



Source: Pakistan Bureau of Statistics

[25] Bank-wise loans for auto financing indicate that 30.0 percent of increase in auto financing during H1-FY14 came from that bank.

3.7).[26] However, core inflation measured by NFNE remained almost stable during Q2-FY14, compared to the preceding quarter.

Table 3.7: CPI Inflation (YoY)
percent

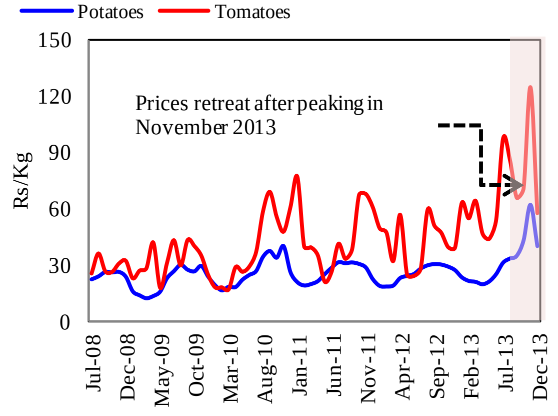
			CPI			
			Food Inflation		Core Inflation	
		CPI	Overall	Perishable	NFNE	Trimmed
FY13	Q1	9.1	8.4	9.7	10.9	10.6
	Q2	7.5	6.3	-7.3	9.9	9.2
	H1	8.3	7.3	1.2	10.4	9.9
	Q3	7.3	7.3	-4.6	9.5	9.2
	Q4	5.6	6.6	9.6	8.2	7.0
	H2	6.5	6.9	2.5	8.9	8.1
FY14	Q1	8.1	9.1	15.2	8.5	7.8
	Q2	9.7	10.7	25.4	8.4	9.0
	H1	8.9	9.9	20.3	8.4	8.4

Source: Pakistan Bureau of Statistics

Inflation in perishable food items

Inflationary pressures from perishable food items (specifically onions, tomatoes and fresh vegetables) intensified further in the second quarter, when prices of potatoes recorded a sharp increase.[27] In fact, the retail price of potatoes and tomatoes hit an all-time high in November 2013 (**Figure 3.8**).[28] The sharp rise in the prices of

Figure 3.8: CPI Prices



Source: Pakistan Bureau of Statistics

[26] Trimmed mean core inflation is computed by excluding items from the CPI basket, showing highest and lowest inflation with cumulative weight of 10 percent. This means, the trimmed CPI basket changes every month.
[27] The increase in the consumer prices of onions, tomatoes, fresh vegetables and potatoes had a 14.7 percent contribution in the headline YoY inflation during Q2-FY14, compared to 12.6 percent in the preceding quarter.
[28] The consumer prices of potatoes reached Rs 62.3 per kg in November 2013.

potatoes was because of harvest delays, particularly in Punjab.[29] Similarly, the supply of tomatoes worsened in the second quarter due to a slowdown in imports from India.[30]

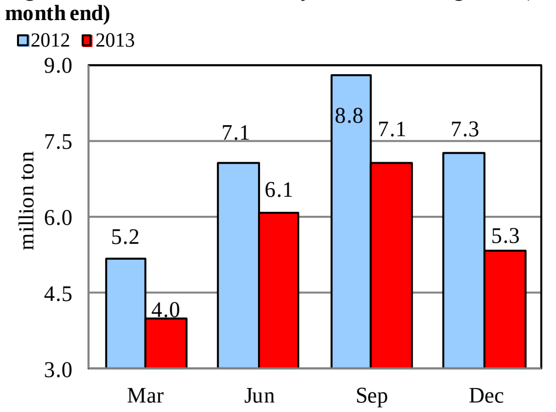
However, this situation eased in December 2013, following the arrival of fresh crops, which pulled down headline YoY inflation to 9.2 percent in December 2013, after touching double digits in November 2013.[31]

Increase in wheat and wheat flour prices

The wheat flour inflation recorded a sharp increase of 25.3 percent in H1-FY14, compared to 8.3 percent in the corresponding period last year. Wheat flour alone contributed 1.1 percentage points to headline inflation in Q2-FY14, which is 11.6 percent of the total increase. This was despite a falling trend in global wheat prices.[32]

The increase in the price of wheat, wheat flour and allied products during H1-FY14, can be traced to below target wheat production last year, and the resulting decline in stocks held by the government (**Figure 3.9**). Furthermore, there are fears the government may not be able to achieve the wheat procurement target this season (to build its stocks) as support prices are deemed unattractive for farmers.[33] In

Figure 3.9: Wheat Stocks Held by Procurement Agencies (at month end)



Source: State Bank of Pakistan

[29] Due to unfavorable weather this year, the cultivation of potatoes could not start on time. This led to delays in its harvesting, and in turn, caused supply shortages in the market.
[30] A sharp increase in the prices of tomatoes in India following the unseasonal rainfalls discouraged its exports to Pakistan.
[31] The arrival of fresh crops resulted in 25.6 percent decline in the prices of perishable food items during December 2013, compared to the preceding month. Had the prices of perishable food items not declined in December 2013, the Q2-FY14 average YoY headline inflation would have increased to 10.4 percent, rather than the actual 9.7 percent.
[32] Global wheat prices reached their four-year low of US $207 per metric ton in mid-January 2014.
[33] The federal governments have maintained the Wheat Support Price (WSP) at last year's level of Rs 1,200 per 40 kg, whereas its current market price is around Rs 1,600 per 40 kg. This gives little

this regard, the empirical evidence suggests that the rise in wheat and wheat flour inflation could trigger cost push inflation because of an increase in wages.[34]

Rise in administered prices

As a part of the fiscal consolidation undertaken by the government, power tariffs for household consumers were revised upwards by 15.8 percent during October 2013.[35] As anticipated, this increase fuelled headline inflation during Q2 -FY14 – just this accounted for an 8.1 percent increase in inflation during the second quarter.

Furthermore, the government also increased electricity tariffs for commercial and industrial users by 23.7 percent in August 2013. This too has filtered down to an increase in general price levels within the quarter.[36]

In addition to power tariffs, petrol and diesel prices were also revised upwards in October 2013. This, along with a low base because of the decline in CNG tariffs in November 2012, resulted in a sharp uptick in fuel price inflation in Q2-FY14.[37]

Global commodity prices remain subdued

On a positive note, global commodity prices remained soft almost throughout H1-FY14. As a matter of fact, international commodity prices fell slightly in Q2-FY14 compared to a marginal increase in Q1-FY14. Furthermore, the second quarter of FY14 witnessed a 0.7 percent appreciation in PKR against US Dollar after posting a 6.0 percent depreciation in Q1-FY14. With a stable PKR and

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incentive to farmers to sell their crop to the government, which may cause difficulties for government to build wheat reserves after arrival of crop.

[34] Labor cost constitutes around one-quarter of the total cost of production in the manufacturing and services sectors of the economy [Source: Choudhary, A., Naeem, S., Faheem, A., Hanif, N., and Pasha, F. (2011), "Formal Sector Price Discoveries: Preliminary Results, from a Developing Country," SBP Working Paper No. 42].

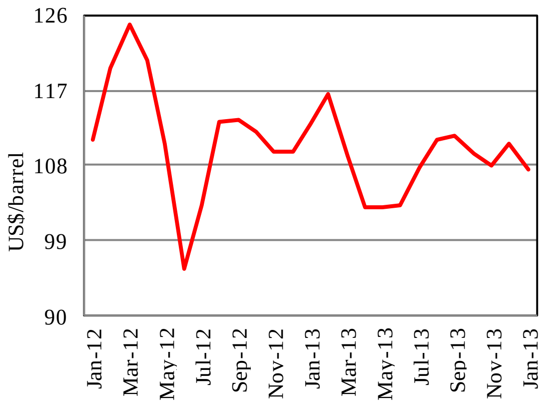
[35] Electricity tariffs were increased in the range of 15.5 to 23.8 percent for domestic users with monthly consumption above 200 kWh. In the prices data published by PBS, the same rate has been applied (with an average of 15.82) to all cities in the CPI basket effective from October 2013. However, KE (formerly KESC) is showing the pre-October 2013 tariffs on the bills to its customers in Karachi. This suggests that the increased tariff rate should have been incorporated in the city-wise prices data excluding Karachi.

[36] These findings are also confirmed by a price setting survey of formal (manufacturing and services) sector firms by SBP, which confirms that the increase in energy prices becomes part of output prices within a period of 3 to 9 months. Choudhary, A., Naeem, S., Faheem, A., Hanif, N., and Pasha, F. (2011), "Formal Sector Price Discoveries: Preliminary Results, from a Developing Country," SBP Working Paper No. 42.

[37] Fall in the prices of CNG drove the overall inflation down in November 2012, following the Supreme Court order that disputed the then mechanism for setting CNG prices.

subdued global prices, the impact of imported inflation and exchange rate pass through, is likely to be favorable going forward (**Figure 3.10**).

Figure 3.10: International Price - Brent Crude



Source: International Monetary Fund

Inflation Outlook

Some of the factors driving inflation in the first half of FY14 have started to ease. For instance, the pressure on PKR has eased, while perishable food items and global commodity prices should add to the muted inflation outlook. Furthermore, the latest 'SBP-IBA Consumer Confidence and Inflation Expectations Survey' suggests softening of inflationary expectations on account of stability in administered prices, in particular retail oil prices, and PKR against US Dollar.[38] The stability in food inflation pulled down headline YoY inflation to 7.9 percent in January 2014, from 9.2 percent in December 2013. Based on these factors, we project inflation to fall in the range of 8.5 to 9.5 percent during FY14. There are, however, risks that the government may announce an increase in gas tariffs, which had been anticipated in January 2014. The needed upward revision in gas tariffs would put pressure on inflation, as household gas tariffs figure prominently in the CPI basket.

[38] For details, see SBP's Annual Report for FY13 Special Section 4.1