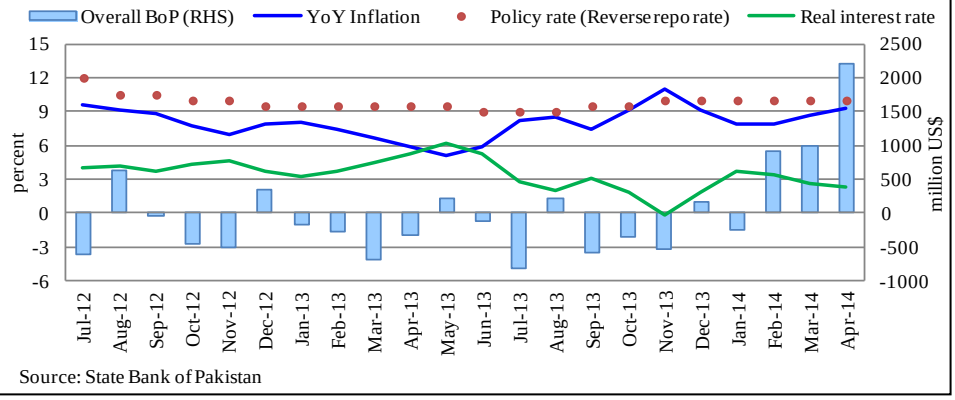
3 Inflation and Monetary Policy

3.1 Overview

The gradual monetary tightening pursued during the first half of the year, was put on hold in Q3-FY14, as the risks associated with the inflationary pressures and external sector dissipated to some extent.[1] More specifically, SBP kept the policy rate unchanged at 10 percent in its monetary policy decisions of January and March 2014. Broadly speaking, following factors were key: (i) higher-than-anticipated financial inflows coupled with the appreciation of PKR; (ii) an encouraging trend towards fiscal consolidation; and (iii) a lower-than-expected increase in inflation (**Figure 3.1**). Although developments in the external and fiscal sectors signaled further improvement as the government successfully mobilized US$ 2.0 billion from Eurobonds and generated US$ 1.1 billion from the long awaited auction of 3G/4G spectrum licenses, the comfort on inflation slightly waned as YoY inflation for April 2014 turned out to be higher (at 9.2 percent) than expected. Keeping in view the sustainability of external sector developments and stability in key macro variables, SBP adopted a cautious approach in its monetary policy decision on May 17, 2014, by maintaining its policy rate at 10 percent.

Figure 3.1: Policy Rate, Inflation and Overall External Account Balance



Source: State Bank of Pakistan

[1] The external sector weaknesses and building up of inflationary expectations at the beginning of FY14, forced SBP to make a shift in its monetary policy stance from accommodative to gradual tightening. Specifically, SBP increased the policy rate by 50 bps each in its monetary policy decisions announced in September and November 2013.

In fact, as shown in **Figure 3.1**, the somewhat erratic pattern of YoY inflation during Jul-Apr FY14, which was largely driven by excessive volatility in perishable food items and adjustments in administered prices, complicated the task of formulating the inflation outlook for FY14. The average inflation for FY14 was initially projected at 11.0 to 12.0 percent, which was considerably higher than the average inflation of 7.4 percent for FY13.[2] As the year progressed, inflation did pick up and reached double-digit (10.9 percent) in November 2013. However, this was followed by a decline in YoY inflation in December 2013 and January 2014. This, along with the softening of inflationary expectations, led to a downward revision in projected inflation to 10.0 to 11.0 percent.[3] In fact, SBP now expects average inflation for FY14 to fall in the range of 8.0 to 9.0 percent due to: (a) the appreciation of exchange rate; (b) relative stability in oil prices in both international and domestic markets; (c) government efforts to shift its borrowing away from SBP; (d) deceleration in money growth; and (e) the easing inflationary expectations as indicated by SBP-IBA Consumer Confidence Survey in May 2014.

Monetary expansion, which is often considered to be one of the leading indicators of inflation, decelerated to 5.9 percent during Jul-Mar FY14, compared with 9.0 percent during the same period last year. This deceleration was expected due to the quantitative limits on SBP's NDA, and limits on government borrowing from SBP.

The government was able to contain its borrowing from SBP within the limit agreed with the IMF for end-March 2014. In fact, the large inflows into the Pakistan Development Fund in Q3-FY14, received as a capital grant from a friendly country, helped reduce government borrowing from SBP (in net terms) quite significantly.[4] Despite this, SBP's NDA target was missed by a small margin.

On a cash basis, the government borrowed Rs 436.9 billion for budgetary financing from the banking system during Jul-Mar FY14, which was almost half the amount borrowed during the same period in FY13. This sharp deceleration

[2] Inflation was projected to increase due to: (a) the government's decision for upwards adjustment in electricity and gas prices; (b) an increase in GST rate; (c) removal of certain exemptions to contain subsidies; and (d) inflationary expectations built on upward adjustment in prices of petroleum products, and depreciation of exchange rate. For details, see Monetary Policy Statement of September 2013.

[3] Monetary Policy Statement of January 2013.

[4] Government borrowing from SBP has been the prime source of changes in SBP's NDA in recent years.

can be attributed to government efforts to contain its overall budgetary deficit, and the availability of non-bank funding.

The reduction in government borrowing, forced commercial banks to shift their focus towards the private sector. This was made easier with the improvement in power and gas availability; higher business and consumer confidence; and relatively low real cost of borrowing, which created demand for bank credit. Both the demand and supply side factors resulted in healthy growth in credit to the private sector after a gap of five years. Specifically, private sector credit expanded by 10.0 percent during Jul-Mar FY14, which was more than double the growth realized during the same period last year. Moreover, the growth was seen in all the three segments, i.e., working capital, trade financing, and fixed investment loans.

3.2 Liquidity condition

Money market liquidity posted considerable volatility during Jul-Mar FY14, which was largely driven by: (i) a pickup in private sector credit; (ii) a sharp reduction in government borrowing; (iii) the unplanned substitution of short-term debt (T-bills) with the medium to long term instruments (PIBs); (iv) the unexpected external inflows; (v) unanticipated exchange rate developments; and (vi) the market view about interest rate. Not only did the money market rate move outside the normal interest rate corridor (IRC) at times, the OMO cut-off rate were also higher than the SBP's reverse repo rate, which is the upper limit of the IRC.

For a meaningful analysis, liquidity conditions and the behavior of money market rates during Jul-Mar FY14, should be bifurcated into two periods, i.e., the periods before and after the monetary policy decision of November 2013. **Figure 3.2** shows that excess liquidity prevailed in the market prior to the November 2013 decision as the weighted average overnight rate was hovering near the middle of the IRC; SBP was conducting open market operations (OMOs) to drain liquidity from the market;[5] and individual banks were frequently placing their funds with SBP at the floor rate.[6]

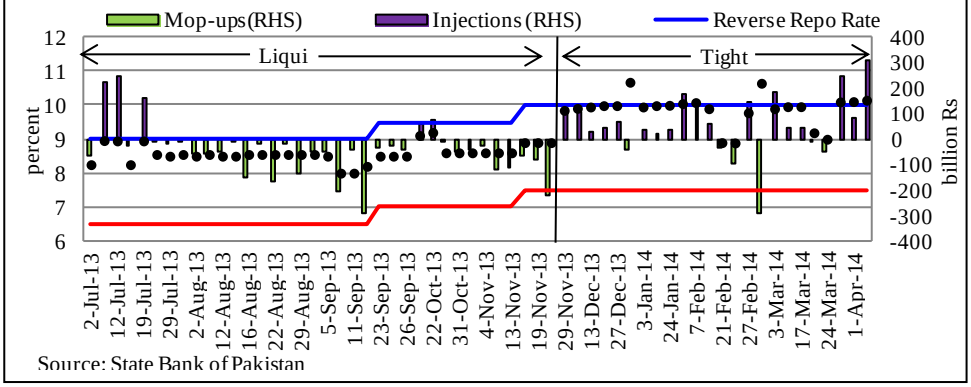
Following the increase in the policy rate in November 2013 (which followed up the 50 bps rise in September), banks started to participate aggressively in T-bill

[5] As mentioned in the First Quarterly Report for FY14, the banks' reluctance to reinvest their maturing T-bills holdings due to expected increase in interest rates, and SBP's net foreign exchange purchases to comply with the prior actions required for the IMF program, created excess liquidity in the market.

[6] IRC activity indicates that banks placed their funds with SBP at 79 times during first quarter of the year.

auctions. At the same time, the government accepted huge amounts in these auctions to retire its borrowing from SBP to meet end-December targets. This pushed the cut-off rates for all tenors almost to the policy rate, creating a very flat yield curve up to one year maturity.[7] The overnight money market rate also exceeded the policy rate (reverse repo rate) on various occasions, as SBP provided limited liquidity through OMOs in a market where commercial banks had overcommitted in the primary auctions. Even the OMO cut-off rate was higher than the policy rate on many occasions, as the SBP consciously kept the money market tight, keeping in view external sector developments.[8]

Figure 3.2: Liquidity Conditions



Source: State Bank of Pakistan

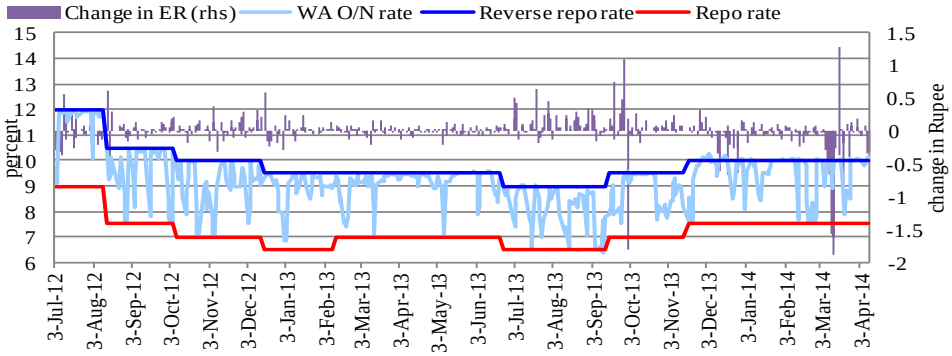
Besides getting liquidity through OMOs, the utilization of SBP's overnight repo (floor) and reverse repo (ceiling) facilities shows that banks approached SBP for liquidity 113 times during Q3-FY14 (they borrowed an average of Rs 13.8 billion per visit), but placed liquidity only 32 times (with an average of Rs 7.5 billion). Moreover, fifteen commercial banks, including three of big 5 banks, used SBP's reverse repo facility at least 4 times to secure liquidity during the quarter. This shows that money market rates remained elevated during the quarter.

[7] Specifically, the government accepted Rs 1,413.9 billion (excluding non-competitive bids) in three T-bill auctions held after the change in policy rate in November 2013, compared with the pre-auction (cumulative) target of Rs 875.0 billion and maturity of Rs 1,125.1 billion.

[8] Interest Rate Corridor (IRC) was introduced with effect from August 17, 2009, with a width of 300 bps between the ceiling (reverse repo) and the floor (repo). The width of IRC was subsequently reduced to 250 bps. Moreover, to make the IRC more effective, SBP explicitly discouraged frequent use of the standing facilities by introducing a spread of 50 bps (plus/minus) for all those institutions visiting either the reverse repo/repo facilities more than 7 times during a quarter. This amendment effectively widened the width of IRC from 250 to 350 bps for all those banks, which have already accessed the SBP facility for 7 times during a quarter.

Elevated money market rates helped stabilize exchange rate by increasing the cost of Rupee liquidity **(Figure 3.3)**. This not only discouraged speculative activity in the FX market, but also kept the interest rate differential between the rupee and foreign currency loans high. The demand for FX loans to finance oil payments also factored in during the period when SBP's FX reserves were falling. Specifically, trade financing against FE-25 deposits increased by US$ 940 million during Jul-Mar FY14, against a net retirement of US$ 431 million during the same period in FY13. Appreciation of the PKR in March 2014, also contributed to this increase, as the effective cost of foreign currency borrowing depends on expected depreciation/appreciation of the PKR, and the interest rate differential between domestic and international markets (LIBOR). With a large interest rate differential and an appreciating PKR, foreign currency loans became very attractive.

Figure 3.3: Changes in exchange rate and money market rates



Source: State Bank of Pakistan

In addition to the exchange rate, notable developments at the very short-end of the yield curve (up to 12 months), also impacted the term premium, and the market's participation in government securities. Specifically, elevated interest rates, and the fall in inflation from December 2013 onwards, in the presence of healthy term premiums on medium to long term government securities, sharply changed banks' interest in PIBs. The government received bids of Rs 1,030.0 billion in three PIB auctions held during Q3-FY14, against the pre-auction cumulative target of Rs 180 billion. The government accepted most of these bids (Rs 985.1 billion), which sharply increased the average maturity of bank holdings of government securities; this is good for the banking industry and also for the government's maturity profile.

The bid pattern of T-bill auctions, especially in March 2014, also indicates that banks were expecting a rate cut in the near future. Specifically, commercial banks offered money in 6 &12 month T-bills, in sharp contrast to the pattern observed during H1-FY14. Similarly, banks offered record volume of Rs 542.9 billion in PIB auction held on 26th March 2014, against the target of Rs 60.0 billion. This aggressive bidding to lock in their funds for longer maturities (i.e., PIBs), even when there was a liquidity shortage at the time of settlement, is an indication of the interest rate outlook of the banks. SBP injected Rs 250 billion just after the settlement day through an OMO with a cut-off rate at 10.1 percent. While these developments helped increase the maturity profile of government debt, liquidity management for both SBP and banks became more challenging due to the unplanned and sudden nature of these developments.

3.3 Developments in monetary aggregates

Broad money supply (M2) increased by Rs 526.6 billion during Jul-Mar FY14, compared with an expansion of Rs 686.4 billion during Jul-Mar FY13 (**Table 3.1**). It is encouraging to note that the deceleration in monetary expansion was primarily driven by lower government borrowing, which overshadowed the healthy 10 percent growth in private sector credit during this period. Moreover, external sector developments, especially the inflow of US$ 1.5 billion into the Pakistan Development Fund in Q3-FY14, have favorably impacted the composition of broad money supply during Jul-Mar FY14.

Table 3.1: Monetary Aggregates during Jul-Mar

billion Rupees

	Cumulative Flows		Quarterly Flows (FY14)		
	FY13	**FY14**	**Q1**	**Q2**	**Q3**
Broad money (M2)	**686.4**	**526.6**	21.5	506.4	-1.3
NFA	-161.2	-103.2	-173.2	-42.0	112.0
SBP	-163.0	-59.0	-146.1	-83.7	170.8
Scheduled banks	1.8	-44.2	-27.1	41.7	-58.9
NDA	847.6	629.8	194.6	548.4	-113.2
SBP	387.0	178.0	174.2	161.2	-157.5
Scheduled banks	460.6	451.8	20.4	387.2	44.2

Source: State Bank of Pakistan

Quarterly data of monetary aggregates shows that almost the entire improvement in the composition of M2 came in Q3-FY14. In sharp contrast to the net contraction of Rs 215.2 billion during the first half of the year, net foreign assets (NFA) of the banking system expanded by Rs 112.0 billion during Q3-FY14 (**Table 3.1**). However, the expansionary impact on money supply was completely

offset by the net contraction of Rs 113.2 billion in NDA of the banking sector, leaving broad money supply almost unchanged during the quarter.

Fall in government borrowing

Following a prolonged period of excessive government borrowing from the banking system, a visible deceleration was observed during the third quarter of the year. Both the lower fiscal deficit, and availability of non-bank funding, helped reduce government reliance on the banking system.

Besides the overall fall in government borrowing, government efforts to shift its borrowing away from SBP towards commercial banks is also clearly visible during Jul-Mar FY14 (**Table 3.2**). The government relied heavily on SBP funding during the first quarter of FY14 as commercial banks were reluctant to invest in government securities.

Table 3.2: Net Budgetary Borrowing during Jul-Mar (Cash-basis)

billion Rupees

	Cumulative Flows		Quarterly Flows (FY14)		
	FY13	**FY14**	**Q1**	**Q2**	**Q3**
From Banking System	**856.7**	**436.9**	198.1	285.2	-46.4
From SBP	-25.7	58.8	352.9	90.3	-384.3
From Scheduled Banks	882.4	378.1	-154.8	195.0	337.9

Source: State Bank of Pakistan

As mentioned earlier, commercial bank offered huge amount in primary auctions of government securities after the change in policy rate, especially of November 2013. This allowed the government to contain its borrowing from SBP. The situation further improved in Q3-FY14, as net government borrowing from SBP saw a net reduction of Rs 384.3 billion. It is important to highlight here that net reduction in borrowing from SBP was primarily attributed to an inflow of US$ 1.5 billion into the Pakistan Development Fund (PDF). In fact, these inflows pushed government deposit with SBP from Rs 96.3 billion at the beginning of the year, to Rs 309.9 billion by end-Q3-FY14.

Commodity operations[9]

With a net retirement of Rs 133.8 billion during Jul-Mar FY14, outstanding loans for commodity operations reached Rs 336.0 billion by end March-2014. Like the previous year, this net retirement was entirely driven by the repayment of loans for

[9] The numbers discussed in this section will not match with the data from the monetary survey as the latter does not include the financing availed from Pak Oman Inv. Co, Pak Libya Holding Co. and Saudi Pak Industrial & Agricultural Investment Co.

wheat procurement, which more than offset the increase in loans for the procurement of sugar and fertilizers during the period of analysis (**Table 3.3**).

Table 3.3: Loans for Commodity Operations - Cumulative flows (Jul-Mar)

billion Rupees

	FY13	FY14
Wheat	-145.4	-146.1
Sugar	14.5	3.0
Fertilizer	17.9	9.3
Total	-113.0	-133.8

Source: State Bank of Pakistan

Despite a pickup in domestic production, net borrowing for the import of fertilizer saw an expansion of Rs 9.3 billion during Jul-Mar FY14. In fact, the government decision to import fertilizer for the Rabi season (October-December) created demand for credit, while the unexpected availability of gas contributed to higher domestic production.[10] However, the relatively lower increase in credit compared to Jul-Mar FY13, is also because of the realization of subsidy payments from the government.[11]

Borrowing for sugar procurement increased by only Rs 3.0 billion during Jul-Mar FY14, compared with a rise of Rs 14.5 billion the year before. The nominal increase during Jul-Mar FY14 was primarily attributable to sugar procurement by TCP before the commencement of crushing season.[12]

Finally, the accumulated receivables of procurement agencies (on account of sale proceeds and subsidies) continued to impair their repayment capacity. As of end March 2014, the volume of receivables stood at Rs 282.2 billion, which was 84.2 percent of the outstanding loans for commodity operations. This implies that speedy settlement of these receivables would help procurement agencies repay their loans. Within receivables, subsidy payments due from the government declined by Rs 3.7 billion during Jul-Mar FY14, to Rs 172.4 billion (**Box 3.1**). As highlighted in previous SBP Annual and Quarterly Reports, there is an urgent need to settle these subsidies, as this will also be cost effective for the government.

[10] In fact, gas supplied to Guddu thermal power plant was diverted towards the fertilizer sector, as the plant was temporarily shut down for the maintenance.
[11] The amount of subsidy receivable (for fertilizer) decreased from Rs 57.2 billion as of end June 2013 to Rs 53.0 billion as of end March 2014.
[12] In Jul-Mar FY13, the government intervened in sugar sector at a large scale to stabilize the domestic price.

Box 3.1: Subsidies Receivable for Commodity Operations

Procurement agencies aim at stabilizing commodity prices through the crop cycle by ensuring adequate supply in the market. Their commodity operations are financed by the government-guaranteed bank loans, and should be self- liquidating in nature. If the release price is less than procurement price (including cost of storage and waste), it implies that the government is subsidizing that commodity. To keep these commodity operations sustainable, federal and provincial governments allocate specific amount of subsidies in their respective budgets for these institutions.

Despite this self liquidating nature of commodity operations, delays in the realization of receivables (sale proceeds and subsidies) impair the repayment capacity of these institutions, which keeps outstanding borrowing from scheduled banks high. As of end March 2014, the amount of receivable subsidies stood at Rs 172.4 billion, despite decline of Rs 3.7 billion during Jul-Mar FY14.

Budget documents reveal that the federal government has been allocating subsidy for TCP and PASSCO over the years. However, the amount allocated in the budgets has been lower than the amount of subsidies receivable by these institutions (**Table 3.1.1**). Consequently, the amount of subsidies receivables stood at Rs 17.3 billion and Rs 56.1 billion for PASSCO and TCP respectively.

Table 3.1.1: Subsidy Allocation viz-a-viz Receivables in Commodity Operations^

billion Rupees

	FY10	FY11	FY12	FY13	FY14
Allocation in Fed budget (for TCP & PASSCO)	30.2	20.0	4.0	5.2	9.0
Receivable of TCP & PASSCO	50.6	53.3	43.7	89.2	73.4*
Allocation in Punjab Budget (overall)	26.7	21.0	30.0	34.0	36.0
Receivable of Punjab Food Department	38.0	53.2	42.9	68.8	80.8*
Allocation in Sindh Budget (overall)	n.a	1.6	1.5	3.0	3.0
Receivable of Sindh Food Department	0.0	8.7	13.9	18.1	18.1*

^: In case of both Khyber Pakhtunkhwa and Balochistan, the food departments do not have any outstanding receivables of subsidies towards their respective governments.
*: As of end March
Source: State Bank of Pakistan; Ministry of Finance; Annual Budget Statements of respective provinces

Although overall receivable subsidies have declined by Rs 3.7 billion during Jul-Mar FY14, there is a need to settle this pending liability. As repeatedly highlighted in SBP Annual and Quarterly Reports, this will not only help improve fiscal transparency, but also be cost effective for the government, as these are funded by commercial borrowings.

Credit to PSEs

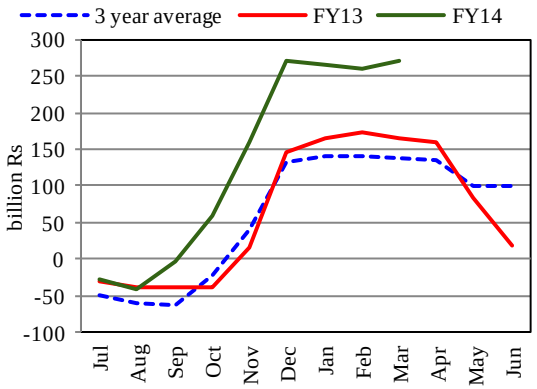
Credit to PSEs expanded by Rs 74.3 billion during Jul-Mar FY14, compared to an increase of Rs 44.9 billion during the same period last year. The entity-wise breakup shows that higher demand came primarily from energy-related PSEs,

which were facing liquidity problems due to re-accumulation of inter-agency receivables, albeit at a lower levels than the previous years.[13]

Credit to private sector

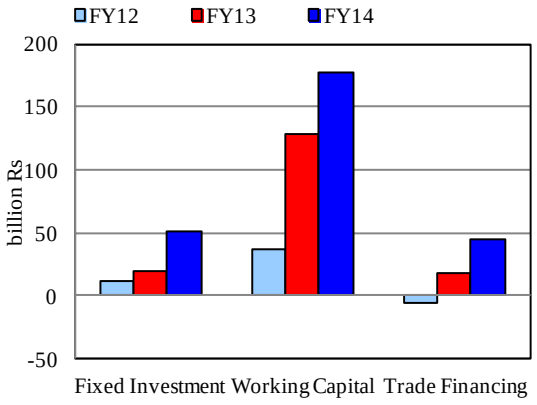
Following five years of low growth, credit to the private sector expanded by Rs 335.8 billion during Jul-Mar FY14, compared with Rs 139.8 billion during same period last year (**Figure 3.4**). Within total credit to the private sector, healthy growth was largely driven by loans to private businesses, which is an indication of the revival of industrial activities. As mentioned earlier, both demand and supply side factors contributed to the growth. The pickup in consumer financing also bodes well as it supports manufacturing activity by creating demand. However, it must be realized that overall credit to the private sector in Jul-Mar FY13 was understated by retirement of Rs 76.3 billion in credit to NBFCs, this contractionary impact was limited during Jul-Mar FY14, as net retirement by NBFCs stood at only Rs 7.6 billion (**Table 3.4**).[14]

Figure 3.4: Loans to Private Sector-Cumulative Flows



Source: State Bank of Pakistan

Figure 3.5: Trend in Type of Financing (Jul-Mar)



Source: State Bank of Pakistan

[13] Specifically, Pakistan State Oil Company (PSO) borrowed Rs 86.8 billion in net terms for import financing and to meet its working capital requirements during Jul-Mar FY14. Similarly, credit to Pak Arab Refinery Ltd (PARCO) increased by Rs 19.4 billion, of which Rs 17.4 were for import financing. WAPDA borrowed Rs 14.3 billion in net terms, which were primarily used to meet the working capital needs.

[14] Banks' investment in NBFCs increased significantly during FY12 due to tax incentive on the investments in NBFCs, especially of mutual funds. However, the government announced the partial withdrawal of tax incentive in a phased manner in June 2012. Consequently, the banks are restraining their investments in NBFCs.

Credit distribution by types of financing reveals that growth was visible in all three categories during Jul-Mar FY14 (**Figure 3.5**).

Table 3.4: Change in Credit to Private Sector
billion Rupees

	FY13				FY14			
	Q1	**Q2**	**Q3**	**Jul-Mar**	**Q1**	**Q2**	**Q3**	**Jul-Mar**
Overall	-84.9	189.5	35.2	139.8	-17.4	338.7	14.5	335.8
of which								
Loans to private business	-39.6	186.1	18.6	165.1	-3.0	274.8	0.0	271.7
Investments in private stocks	-1.1	12.3	4.4	15.6	1.4	5.2	8.3	14.8
Consumer financing	-1.8	8.4	1.9	8.5	13.4	4.7	3.4	21.5
Credit to NBFCs.	-65.7	-12.6	2.0	-76.3	-16.2	2.9	5.7	-7.6

Source: State Bank of Pakistan

Trade financing witnessed a significant increase during Jul-Mar FY14, largely driven by export financing.[15] Both the bumper rice crop (which contributed to the exportable surplus),[16] and a modest increase in textile exports, also contributed to the increase in trade financing. Moreover, the increased import of petroleum products, for power generation and shortage of CNG in the winter, also added to the volume of import financing.

The distribution of private sector credit indicates that sector specific developments influenced lending during the period under review.

Food products and beverages:

- Credit expansion to the *sugar* sector benefited from strong growth in production, which came about because of the healthy sugarcane crop.[17] Besides working capital, fixed investment loans were availed by sugar mills investing to generate electricity from bagasse, and for capacity enhancement (**Table 3.5**). Large carry-over stocks from the previous season, also added to the credit requirements of the sugar sector.
- Capacity expansion and product diversification by suppliers of drinking water and soft drinks, continued to create credit demand from the *beverages* sector.[18]

[15] It is important to note here that massive rise in foreign currency loans (against FE-25 deposits) for import financing should not be confused with trade financing to private businesses discussed here.
[16] Rice production reached 6.8 million tons during FY14, which is not only more than the last year's production of 5.5 million tons, but also higher than the target of 6.2 million tons.
[17] Sugar production grew by 7.8 percent during Jul-Mar FY14, compared with 3.0 percent in the same period last year.
[18] Beverages sector has been performing well for last couple of years due to rising demand. Three Greenfield production plants have also been established. FDI inflows to beverages sector stood at

- Another notable development during Jul-Mar FY14, was the significant volume of working capital availed by manufacturing units that produce feed stuff for animals. However, credit expansion was largely concentrated in Q3-FY14, on account of liquidity pressures caused by rising prices of raw material (maize and soybean).

Table 3.5: Net Change in Loans to Private Sector Businesses during Jul-Mar
billion Rupees, share in percent

	Share-End	Overall Loans		Trade Financing		Working Capital		Fixed Investment	
	Mar FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Private. Business	100.0	165.1	271.7	17.3	44.4	128.6	177.0	19.1	50.3
a) Manufacturing	60.8	145.5	215.1	17.5	35.4	112.5	143.4	15.5	36.4
Of which									
Food & beverages	15.0	60.4	95.2	10.5	8.6	40.1	71.0	9.8	15.6
Of which									
Animal feed	0.7	2.5	5.9	0.8	-1.4	1.2	6.8	0.5	0.5
Sugar	6.5	39.9	49.7	2.9	0.6	30.6	38.8	6.5	10.3
Beverages	1.1	1.8	13.1	0.7	0.5	3.7	12.5	-2.6	0.0
Textiles	21.3	74.9	68.6	10.1	13.6	56.8	53.7	8.1	1.3
Of which									
Spinning	9.0	34.0	32.6	-2.9	9.1	35.4	29.8	1.5	-6.3
Weaving	3.9	10.7	16.5	3.5	1.3	6.3	11.7	0.9	3.5
Finishing	3.6	11.8	13.1	-0.8	7.7	7.5	10.0	5.1	-4.6
Fertilizer	3.5	-3.3	-1.8	-2.8	0.3	3.5	0.4	-4.0	-2.6
Appliances	0.7	4.1	6.7	0.9	0.0	2.8	6.2	0.4	0.5
b) Energy	9.3	-0.8	26.8	1.3	-0.4	11.6	8.0	-13.6	19.2
c) Others*	29.9	20.4	29.8	-1.4	9.4	4.5	25.7	18.5	-5.3

*Agriculture, fishing, mining, ship breaking, construction, hotel, transport, real estate, education, health, etc.
Source: State Bank of Pakistan

Textile *sector:* Following growth in credit to the textile sector during the first half of the year (especially from September to December),[19] Q3-FY14 recorded a net retirement of Rs 31.4 billion. Segment-wise data indicates that loans for fixed investments fell as a number of textile firms were retiring credit that had been utilized for alternate energy sources and BMR (balancing, modernization and replacement) in the recent past.[20]

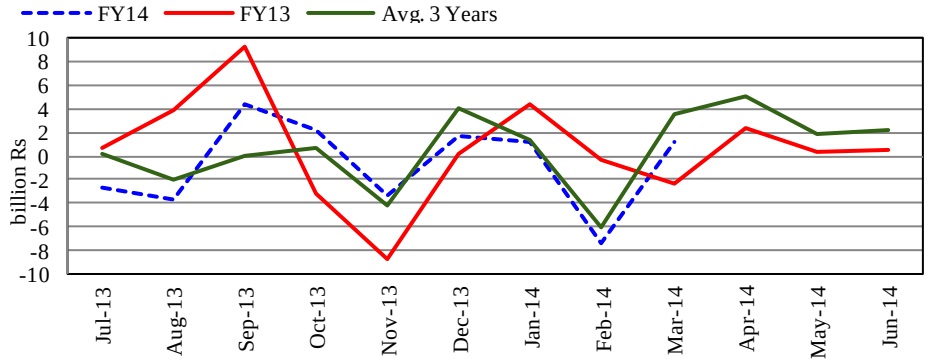
US$ 23.5 million during Jul-Mar FY14, compared to an outflow of US$ 7.5 million during the same period last year.

[19] Credit to textile sector expanded by Rs 100.0 billion during H1-FY14, compared with Rs 65.2 billion during H1-FY13.

[20] Fixed investment loans recorded a net retirement of Rs 4.3 billion during Q3-FY14, while the textile sector borrowed Rs 6.8 billion (in net terms) in previous 4 quarters (Q3-FY13 to Q2-FY14) for the BMR.

The *fertilizer* sector continued to retire its fixed investment loans utilized for capacity expansion a few years back (**Table 3.5**). However, quarterly data indicates that there was some improvement in working capital loans during Q3-FY14, especially in the month of March (**Figure 3.6**). This was largely due to the pickup in domestic production and a decline in fertilizer off-take during Q3. Furthermore, import payments for phosphoric acid (main raw material in DAP production) led to a nominal increase in trade financing during Jul-Mar FY14.

Figure 3.6: Working Capital of Fertilizer Sector-Cumulative Flows



Source: State Bank of Pakistan

Energy Sector, which accounted for 9.3 percent of outstanding loans to the private sector as of end Mar 2014, availed fixed investment loans worth Rs 19.2 billion during Jul-Mar FY14, in sharp contrast to the net retirement seen during the same period last year. These loans were primarily used to set up small projects and rehabilitation of existing power plants.[21] The modest increase in working capital availed by energy sector, can be traced to liquidity problems facing power companies.

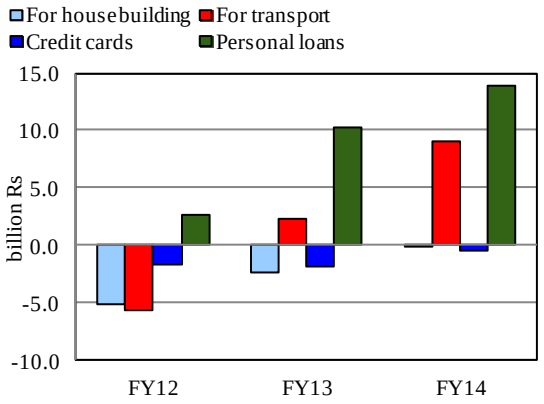
Manufacture of appliances: Credit to appliance manufacturers witnessed a notable improvement during Jul-Mar FY14. A leading manufacturer of electronic products heavily borrowed to shore up its production facilities in the wake of reviving consumer demand, and for product diversification.[22]

[21] Imports of power generating machinery reached $507.4 million during Jul-Mar FY14, compared to $385.9 million same period last year.

[22] The results of SBP-IBA Consumer Confidence Survey indicate improving consumer and business confidence. The latest survey (May 2014) also suggests that an increasing number of consumers are planning to purchase consumer durables in next six months, and they expect financial conditions to improve in coming months.

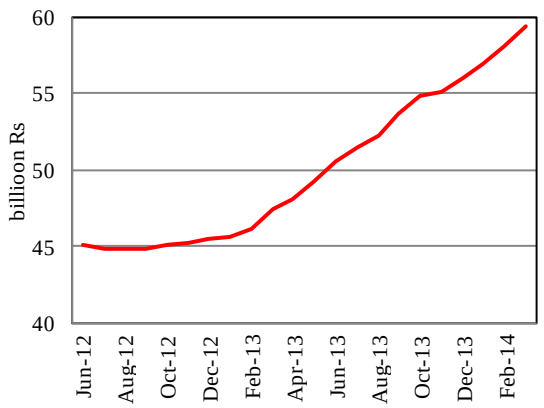
Finally, *consumer financing* that recorded a modest increase in September 2012 after a prolonged period of net retirement, continued to gain momentum during Jul-Mar FY14. The recovery is primarily driven by personal loans and auto financing, while other categories of consumer financing are yet to show much of an improvement (**Figure 3.7**). Bank-wise data indicate that the growth in personal loans can be traced to one public sector commercial bank, which accounted for 89.1 percent of the increase during Jul-Mar FY14. In contrast to personal loans, the increase in auto financing is driven by one private sector bank, which aggressively followed its segmented marketing strategy (**Figure 3.8**).[23]

Figure 3.7: Consumer Financing- Jul-Mar



Source: State Bank of Pakistan

Figure 3.8: Auto Financing



Source: State Bank of Pakistan

3.4 Inflation

Average inflation during the period Jul-Mar FY14 was 8.6 percent, compared with 8.0 percent during the same period last year. However, quarterly data shows that inflationary pressures declined in Q3 after rising in Q2 (**Figure 3.9**). Interestingly, the same factors, which pushed Q2 inflation upward, contributed to bringing it down in Q3, i.e.:

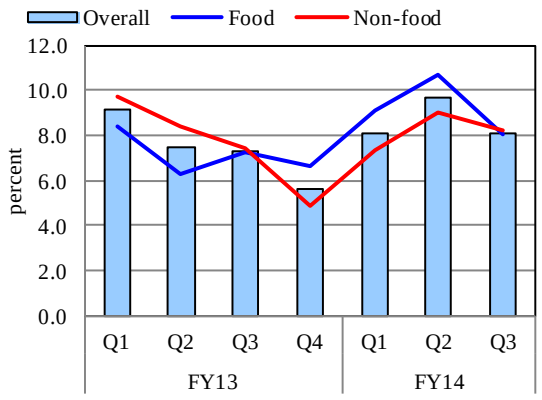
(a) Wheat and perishable food inflation declined significantly after December 2013 (as discussed later);

[23] Bank-wise loans for auto financing indicate that 25.6 percent of increase in auto financing during Jul-Mar FY14 came from one commercial bank.

(b) Global petroleum prices that were rising since June 2013, stabilized after October 2013.[24] Some of this price benefit was transferred to consumers by reducing retail POL prices in November, 2013. There was another major reduction in March 2013.

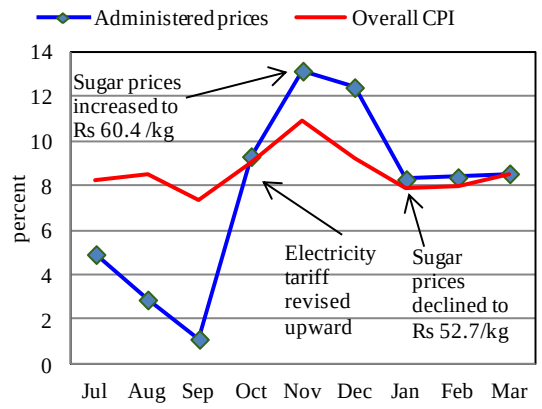
(c) Exchange rate, which was depreciating during the first half of FY14, appreciated sharply in Q3.[25] The PKR appreciation, along with stability in POL prices has dampened inflationary expectations.

Figure 3.9: YoY Inflation in FY14



Source: Pakistan Bureau of Statistics

Figure 3.10: YoY Change in Administred Prices



Source: Pakistan Bureau of Statistics

In addition to wheat and POL prices, inflation in some other items that are regulated by the government also moderated during the third quarter. YoY inflation in an index of these items (Administered Price Index) declined significantly in Q3.[26] As shown in **Figure 3.10**, the overall CPI inflation has been following the changes in Administered Price Index during the year. In fact, headline inflation was driven largely by supply side factors and administrative prices during this period.

[24] IMF Crude Oil Index (average of Brent, West Texas, and Dubai Fateh) increased from 187.68 in June 2013 to 204.58 in September, 2013 and then declined to 192.56 in January 2014.
[25] Exchange rate depreciated from Rs 99.66 per US$ on end June 2013 to Rs 105.32 on end December 2013, and then appreciated to Rs 98.53 on end March 2014.
[26] Administered price index includes wheat, sugar, electricity, gas charge, kerosene oil, petrol super, high speed diesel, CNG, Gas cylinder (LPG), car tax (800 cc – 1300 cc), train fares, platform tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.

Having said this, monetary policy that has been tight since September 2013, also contributed to reining-in inflationary pressures. Core inflation (measured both by NFNE and Trimmed mean) came down during Q3 (see **Table 3.7** at the end of this section for a snapshot of inflation).

Major contributors to inflation

It is interesting to note that price inflation in the heaviest 10 items in the CPI basket, which explain more than 60 percent of the overall CPI inflation during Q3, either remained stable or declined during the quarter **(Table 3.6).** House rent index (HRI), which typically has the highest contribution due to its large weight in the CPI basket, showed stable inflation during this period.[27] Similar is the case with fresh milk, which has the second highest weight, i.e., 6.68 percent in the CPI basket.

Table 3.6: Top 10 Contributors to Inflation

		% Contri-bution *	YoY Inflation		
			Q1	Q2	Q3
1	House Rent	17.4	8.2	7.9	8.0
2	Wheat & its products	10.9	24.5	26.0	16.8
3	Electricity	9.6	0.0	15.8	15.8
4	Milk Fresh	6.7	7.4	6.7	6.5
5	Fresh Vegetable	3.4	17.6	16.5	18.1
6	Education	3.4	8.0	8.6	7.9
7	Cigarette	3	14.7	15.1	16.2
8	Chicken	2.7	12.6	10.5	16.4
9	Cotton Cloth	2.6	15.0	13.9	13.3
10	Potatoes	2.5	13.0	70.2	51.2
	Overall Inflation		8.1	9.7	8.1

*: These items are selected according to their contribution to Q3 inflation.

Source: Pakistan Bureau of Statistics

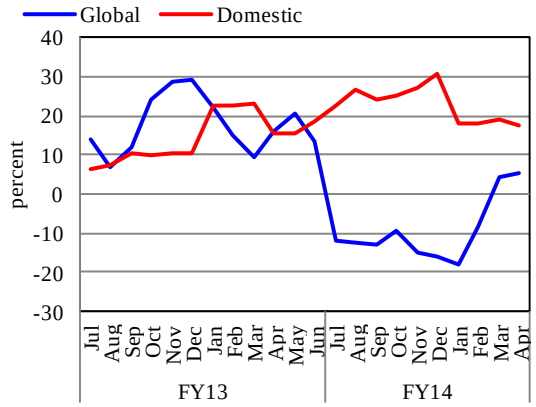
Within this group of top 10 contributors, two notable items which have shown considerably lower inflation in Q3 compared to the previous quarter, are wheat and potato.

Wheat prices have been rising since June 2013, mainly due to short supply in the domestic market as a result of below target production in the last season. However, the pace of increase eased in Q3, as supply improved with higher wheat releases by the government and the private sector.[28] Moreover, the high base effect also kept YoY wheat price inflation lower in Q3, than the previous quarter.[29]

[27] HRI weight in the CPI basket is 21.81 percent.
[28] Anecdotal evidence suggests that the private sector had built its stock by local purchases at the time of harvest, and imports during Aug-Dec, 2013. After December, it increased wheat supply to the market, in an anticipation of forthcoming bumper crop.
[29] Wheat prices increased by more than 20 percent in January 2013.

Global wheat prices, on the other hand, rebounded in February 2014 after a declining trend since July 2013 (**Figure 3.11**). Adverse weather condition in the U.S. and South America, and concerns about possible wheat supply disruption due to Ukraine-Russia stand-off, contributed to the recent increase in global prices. However, with an expected 8.5 percent growth in global wheat production in 2013-14, the recent pressure on global prices is likely to recede.[30] Similarly, in Pakistan, wheat prices are expected to remain stable with above target production during this year.

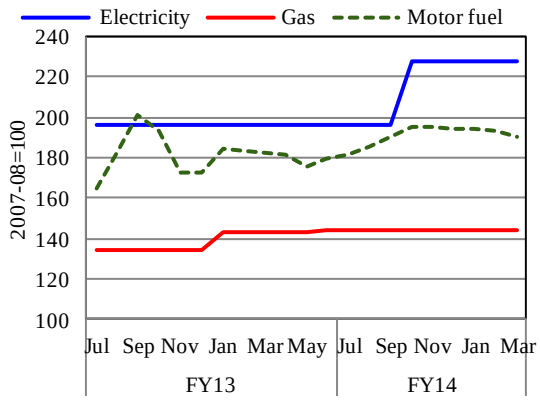
Figure 3.11: Wheat Inflation (% YoY)



Source: Pakistan Bureau of Statistics

Within perishable items, potato prices have fluctuated throughout the period (Jul-Mar). While, the average price came down from Rs 48.4 per kg in Q2 to less than Rs 28.4 in February 2014, it again increased sharply in March 2014 with a MoM change of 39.2 percent. The fluctuations in potato prices were mainly due to issues with the crop, which was affected by inadequate weather. In addition to low production, retail potato prices also saw pressure due to the increase in exports to the Middle East, Russia and other central Asian states.[31]

Figure 3.12: Index of Energy Prices



Source: Pakistan Bureau of Statistics

Energy prices

Energy prices impact inflation directly, as well as indirectly through second round impact. During the quarter, energy prices

[30] Global Economic Prospects (April 2014): Commodity Markets Outlook.
[31] Pakistan's potato export was US$ 20.9 million during July-March FY14 compared with US$ 14.2 million during the same period last year.

remained stable, as discussed below:

- Electricity price has remained unchanged since October 2013, when it was increased by 15 to 24 percent for different user slabs (**Figure 3.12**);
- Gas prices for households were increased in January 2013 by around 6 percent, with a slight upward adjustment in June 2013. Since then, there is no change;
- A major upward adjustment in CNG prices (by 21.2 percent) was made in January 2013. With this high base, YoY inflation in Q3 was significantly lower compared with previous quarters; and
- Motor fuel prices (which have an important role in shaping inflationary expectations) were gradually increased during the first half of the fiscal year, but as shown in **Figure 3.12**, the downward adjustment during Q3 (tracking the trend in international prices), has dampened the inflationary outlook.[32]

Inflation outlook

While we foresee no broad based pressure on consumer prices in the coming months, individual items and one off factors may keep headline inflation at its current level. For example, CPI inflation increased sharply in April 2014 due to just two items: one from perishable food group (potato), which showed MoM inflation of 42.1 percent in the month; and the second is education (mainly fees for private English medium schools), which increased by 9.7 percent. On the flip side, we expect some softening in wheat prices as the new crop enters the market, and some pass through emanating from stable exchange rate. Moreover, SBP-IBA Consumer Confidence Survey (for May 2014) also indicates lower inflationary expectations for months ahead. In effect, SBP projects average inflation to remain in the range of 8 to 9 percent during FY14.

[32] For example, price of petrol was increased gradually from Rs 100.63 per liter in June 2013 to Rs 113.26 in October. It was reduced to Rs 112.76 in November 2013 and then to Rs 110.03 in March 2014. Similar adjustments were also made in the prices of high speed diesel.

Table 3.7: Inflationary Trends

		Food			Non-Food			Core Inflation		
	CPI General	Wheat & its products	Perishable	Food Overall	Energy	HRI	Non-food Overall	NFNE	Trimmed	Administered price index *
YoY inflation										
Jun-FY13	5.9	19.8	15.1	7.9	-10.6	7.1	4.4	7.8	6.8	-8.7
Jul-FY14	8.3	23.2	20.9	9.2	4.3	8.2	7.6	8.2	7.8	4.9
Aug-FY14	8.5	26.9	18.0	10.3	1.2	8.2	7.3	8.5	7.9	2.9
Sep-FY14	7.4	23.5	6.6	7.9	-1.1	8.2	7.0	8.7	7.6	1.1
Oct-FY14	9.1	24.3	18.5	9.8	9.5	7.9	8.6	8.4	9.0	9.3
Nov-FY14	10.9	26.4	43.1	13.0	13.7	7.9	9.4	8.5	9.2	13.2
Dec-FY14	9.2	27.2	14.4	9.3	13.6	7.9	9.1	8.2	8.7	12.4
Jan-FY14	7.9	15.8	8.6	7.2	10.2	8.0	8.4	8.1	8.2	8.3
Feb-FY14	7.9	16.6	8.0	7.5	10.2	8.0	8.2	7.8	8.1	8.4
Mar-FY14	8.5	18.1	11.8	9.2	9.9	8.0	8.0	7.6	8.1	8.5
MoM Inflation										
Jan-2014	0.5	0.0	-4.4	0.0	0.0	2.1	0.9	1.0	0.6	-0.4
Feb-2014	-0.3	0.6	-6.6	-1.0	-0.1	0.0	0.2	0.2	0.2	-0.2
Mar-2014	1.0	1.0	10.8	2.1	-0.5	0.0	0.2	0.3	0.3	0.0
Average inflation										
FY12	11.0	2.7	6.6	11.0	13.0	6.7	11.0	10.6	11.5	8.6
FY13	7.4	13.6	1.8	7.1	-2.1	6.7	7.5	9.6	9.0	-3.6
Q1-FY14	8.1	24.5	15.0	9.1	1.4	8.2	7.3	8.5	7.8	2.9
Q2-FY14	9.7	26.0	25.4	10.7	12.2	7.9	9.0	8.4	9.0	11.6
Q3-FY14	8.1	16.8	9.5	8.0	10.1	8.0	8.2	7.8	8.2	8.4
Jul-Mar FY13	8.0	12.3	-1.0	7.3	0.9	6.6	8.5	10.1	9.5	-1.8
Jul-Mar FY14	8.6	22.2	16.8	9.3	7.9	8.0	8.2	8.2	8.4	7.6

* API is a weighted index, compiled by Research Department of SBP on the basis of prices data of PBS. It includes wheat, sugar, electricity, gas, kerosene oil, petrol, HSD, CNG, gas cylinder (LPG), car tax (800 cc – 1300 cc), train fares, platform tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.