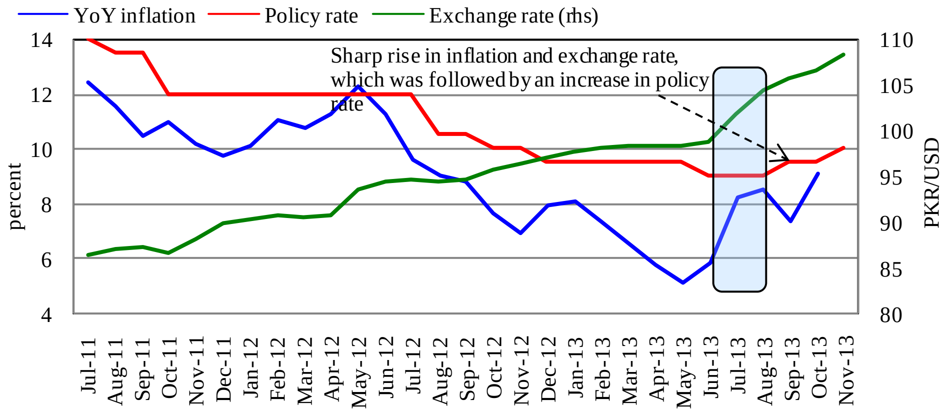
3 Inflation and Monetary Policy

3.1 Overview

Q1-FY14 saw an end to the accommodative monetary policy pursued over the previous two years: SBP increased the policy rate by 50 bps to 9.5 percent in September 2013, after reducing it by a cumulative 500 bps in FY12 and FY13 (**Figure 3.1**).[1,2] This policy shift was needed to: (i) support the PKR, which depreciated more in Q1-FY14 than any quarter in the past 5 years;[3,4] (ii) respond to the increase in inflation, along with the revival of inflationary expectations; and (iii) shift government borrowing away from SBP. In overall terms, SBP's monetary policy reflected the need to support the IMF stabilization program that Pakistan entered in September 2013.

Figure 3.1: Policy Rate and YoY Inflation



Source: State Bank of Pakistan

The depreciation in the PKR was particularly unsettling, as it not only increased the repayment burden of the country's external debt and liabilities, but was partially responsible for reversing the inflation trend and stoking inflationary

[1] After keeping the policy rate unchanged at 14.0 percent during November 2010-July 2012, SBP reduced it by 50 basis points on 31st July 2012. Since then, policy rates had declined by a cumulative 500 basis points, to only 9.0 percent by end August 2013.
[2] This was followed by another 50 bps increase in the policy rate in November 2013, taking the cumulative rise in policy rate to 100 bps during first half of the year.
[3] This large depreciation was driven by an increase in external deficit; SBP's FX purchases from the interbank; and speculative market sentiments, ahead of the new IMF program (**Chapter 5**).
[4] The rising external deficit caused a decline in country's foreign exchange reserves by US$ 1.2 billion during the quarter.

expectations during the quarter. Overall CPI inflation increased to 8.1 percent in Q1-FY14, compared to only 5.6 percent a quarter earlier. In addition to the PKR weakness, the increase in inflation was driven by a modest rise in global commodity prices; an increase in power tariffs; supply constraints in essential food items; and, the increase in GST rate. The increase in retail prices of petrol and wheat not only trigger cost-push inflation and higher wages, but also *anchor* household and business inflation expectations (**Section 3.4**).

Although the recent surge in inflation appears to be a cost-push phenomenon, it requires a policy response from SBP to avoid its second-round impact. More specifically, while monetary policy cannot contain supply-driven food inflation, it can avoid its spread across commodities by managing inflation expectations. Furthermore, constant nominal interest rates in an environment of increasing inflation could trigger pressures if borrowings by the private sector begin to heat up.

The trend in monetary aggregates during Q1-FY14 was not helpful either. Government borrowing from SBP increased by 17.1 percent during Q1-FY14, compared to net retirements in Q1-FY13.[5] This increased reliance on SBP can be traced to a number of factors like the net loan retirements to external creditors; a decline in investment in NSS instruments following the reduction in profit rates; and banks' cautious participation in primary auctions in anticipation of a tighter monetary policy (**Section 3.2**).

While the government was able to contain its borrowing from SBP within the limit set in IMF program for the quarter, it could not avoid the breach of the zero quarterly limit on central bank borrowings by the federal government, prescribed in the SBP Act 1956. Nonetheless, the expansionary impact of this surge in budgetary borrowings on broad money supply (M2), was largely offset by a contraction in the NFA of the banking sector. In effect, broad money supply increased by only Rs 21.5 billion (0.2 percent) during Q1-FY14, which is less than half the increase seen in Q1-FY13 (**Table 3.1**).

As far as private sector credit is concerned, the first quarter typically records net retirement of working capital loans. However, during Q1-FY14, net retirements were visibly lower than the previous year, as disbursements were relatively strong.[6]

[5] More specifically, the government borrowed Rs 379.2 billion from SBP, whereas budgetary borrowings from scheduled banks declined by Rs 179.1 billion during the quarter.
[6] Net retirements in private sector credit were only Rs 17.4 billion, compared to Rs 84.9 billion in the same quarter last year.

Table 3.1: Monetary Aggregates – Q1
stocks and flows in billion Rupees, growth in percent

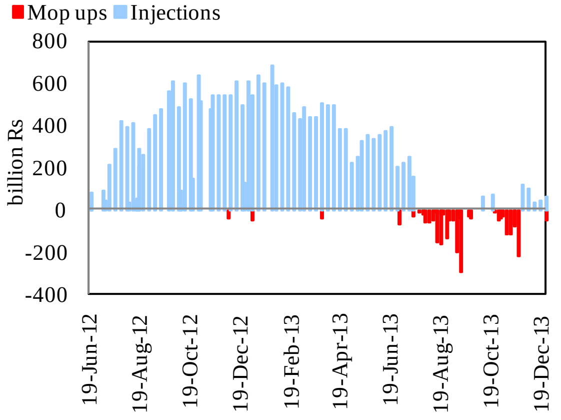
	Stock as on		Absolute change in stocks		Percent growth in stocks	
	Jun-13	**Sep-13**	**FY13**	**FY14**	**FY13**	**FY14**
Broad money (M2)	8857.8	8879.3	54.0	21.5	0.7	0.2
NFA	268.8	95.7	11.8	-173.2	2.2	-64.4
SBP	132.9	-13.1	-4.3	-146.1	-1.1	-109.9
Scheduled banks	135.9	108.8	16.0	-27.1	11.6	-19.9
NDA	8589.0	8783.6	42.2	194.6	0.6	2.3
SBP	1954.0	2128.2	101.7	174.2	6.8	8.9
Scheduled banks	6635.0	6655.4	-59.4	20.4	-1.1	0.3
of which						
(i) Government borrowing	5737.1	5913.8	159.0	176.7	3.7	3.1
For budgetary support	5246.4	5446.4	152.5	200.0*	4.0	3.8
SBP	2212.9	2592.1	-399.4	379.2	-23.4	17.1
Scheduled banks	3033.5	2854.3	551.9	-179.1	26.4	-5.9
Commodity operations	467.7	445.7	9.0	-22	2.1	-4.7
(ii) Non government sector	3664.0	3681.6	-69.4	17.6	-1.9	0.5
Credit to private sector	3357.4	3340.0	-84.9	-17.4	-2.5	-0.5
Credit to PSEs	288.1	323.1	15.5	35.1	6.0	12.2
(iii) Other items net	-812.1	-811.8	-47.4	0.3	5.9	0.0

*Budgetary borrowing from the banking system reported in monetary survey is slightly different than the financing numbers provided by the Ministry of Finance (reported in **Table 4.1**). Please see Data Explanatory note No. 5 for details.

Source: State Bank of Pakistan

The higher off-take of fresh loans can be traced to excess liquidity in the interbank market, as well as a recovery in local manufacturing. Specifically, the banks' reluctance to reinvest in maturing T-bills, coupled with SBP's net FX purchases from the interbank,[7] created excess Rupee liquidity in the market. This quantum of liquidity even caused a direction reversal in SBP's open market operations;

Figure 3.2: Open Market Operations



Source: State Bank of Pakistan

[7] One of the prior actions for IMF program was to purchase US$ 125 million from the interbank market during Jul-Aug 2013, to contain reduction in country's foreign exchange reserves.

compared to net OMO *injections* of Rs 208 billion by end-June 2013, SBP's net *mop-ups* stood at Rs 40 billion by end-September 2013 (**Figure 3.2**). Going forward, it is important to note that monetary expansion is capped by the quantitative ceilings on the NDA of SBP; limits on net government borrowing from SBP; and, a floor on SBP's net FX reserves. This contained monetary expansion, coupled with a partial reversal in PKR parity in Q2-FY14, may be helpful in curbing inflation expectations. The sharp deflation in perishable food items has already eased YoY inflation pressure in December 2013 and January 2014.[8] For the full FY14, SBP's inflation forecast would be in the range of 10.0 – 11.0 percent (**Section 3.4**).

3.2 Monetary Aggregates

Broad money supply (M2) during Q1-FY14 increased by only 0.2 percent in Q1-FY14, compared to a rise of 0.7 percent in the corresponding quarter last year (**Table 3.1**). This slowdown in M2 growth can be traced to a decline of 64.4 percent in the NFA of the banking system, which more than offset a 2.3 percent growth in the NDA during the quarter.

Net Foreign Assets (NFA)

Net foreign assets (NFA) of the banking system declined by Rs 173.2 billion during Q1-FY14, compared to an increase of Rs 11.8 billion in Q1-FY13. A rise in the external deficit during Q1-FY14 – led by debt servicing, was responsible for this decline, which caused a US$ 1.2 billion reduction in the country's liquid FX reserves (**Chapter 5**).[9] Most of the decline was evident in SBP's NFA, as external debt servicing is financed directly by SBP. However, NFA of the scheduled banks also fell during the quarter, as current account related payments were large, and SBP FX support was not available. Furthermore, commercial banks increased their borrowings from financial institutions abroad (usually in the form of overdraft on their trade nostros) during the quarter, to bridge the gap between FX payments and receipts, which further pulled down their NFA.[10]

Net Domestic Assets

The NDA of the banking system posted a growth of 2.3 percent in Q1-FY14, compared to a modest rise of 0.6 percent in Q1-FY13. This increase was driven

[8] After increasing to 10.9 percent YoY in November 2013, CPI inflation has come down to 9.2 percent YoY in December 2013, and further to 7.9 percent YoY in January 2014. This decline was driven mainly by a sharp fall in food inflation from 13.0 percent YoY in November 2013 to only 8.9 percent and 6.7 percent YoY in December 2013 and January 2014, respectively.

[9] External debt servicing (including short-term loans) totaled US$ 1.8 billion during Q1-FY14.

[10] While calculating NFA, liabilities from external sources are netted out from foreign assets.

by a rise in budgetary borrowings from the banking system, higher credit off take by PSEs, and lower retirements from the private sector.

Budgetary borrowings from the banking system increased by Rs 200.0 billion in Q1-FY14, compared to Rs 152.5 billion in Q1-FY13. This increase can be traced to a decline in financing from external sector and NSS instruments. More specifically, external debt repayments continued to surpass fresh disbursements during Q1-FY14. This increased the actual financing requirements from Rs 286.9 billion, to Rs 314.1 billion.[11] On the other hand, net mobilization via NSS instruments during Q1-FY14 were less than the previous year, due to a reduction in profit rates on January and July 2013 (**Chapter 4**). Consequently, government had little choice but to resort to the banking system to finance the budget deficit.

Within the banking system, there was a shift in government borrowings from commercial banks, to SBP: the government borrowed Rs 379.2 billion from the SBP during Q1-FY14, whereas it retired Rs 179.1 billion to the scheduled banks (**Table 3.1**). This shift to SBP was due to increased market uncertainty regarding the future course of interest rates, and the delay in monetary policy announcement in September, which kept commercial banks away from actively participating in the T-bill auctions.

Table 3.2: Summary of T-bill Auctions in Q1-FY14

billion Rupees

	Pre- auction target	Maturity	Offered (competitive)	Accepted (all)	Accepted (competitive)	Accepted net of maturity
11-Jul-13	300.0	345.2	229.3	240.3	226.4	-104.9
25-Jul-13	300.0	457.7	279.2	275.5	264.7	-182.2
8-Aug-13	300.0	332.6	184.7	195.7	182.6	-136.9
22-Aug-13	200.0	34.4	31.1	33.1	25.5	-1.3
5-Sep-13	250.0	214.4	87.9	88.3	82.1	-126.1
19-Sep-13	250.0	210.3	634.3	515.9	495.4	305.6
Q1-FY14	**1600.0**	**1594.6**	**1446.6**	**1348.9**	**1276.7**	**-245.7**

Source: State Bank of Pakistan

Data on the T-bill auctions reveal that the amount realized by the government was substantially lower than auction targets, and also much below maturing T-bills, during the period (**Table 3.2**). Outcomes of auctions held on 22nd August and 5th September were particularly insightful: against a cumulative target of Rs 450 billion and maturing amount of Rs 248.8 billion, the market offered only Rs 119.0

[11] Fiscal deficit during Q1-FY14 was Rs 286.9 billion; however, if we add back net decline in external financing of Rs 27.2 billion, the effective financing requirement increases to Rs 314.1 billion.

billion. As expected, most of this amount was offered in 3-month T-bills – not a single bid was offered in 6-month and 12-month T-bills in the auction held on 5th September.[12] Clearly, the market did not want to lock-in funds in longer term instruments when they expected interest rates to rise.

PIB auctions during the quarter also met a similar fate – the government could realize only 43.1 percent of the targeted amount (Rs 150 billion). Facing this situation, the government had no other option but to borrow from SBP. Despite this, borrowings from SBP remained within the quantitative target agreed with the IMF: against the target of Rs 2,690 agreed with the IMF, net government borrowings from SBP was Rs 2,521 billion by end-September 2013. However, the government was unable to meet the limit of zero quarterly borrowing (on net terms) prescribed in the SBP Act.[13]

Commodity Operations

The outstanding volume of loans for commodity operations declined by Rs 22.0 billion during Q1-FY14, compared to an increase of Rs 9.0 billion during Q1-FY13. The data on commodity-wise loans indicate that net retirement during the quarter was primarily driven by repayment on wheat and sugar loans. In fact, PASSCO and the Food Department of Punjab offloaded their wheat stocks at a rapid pace during the quarter, to meet domestic demand for wheat and stabilize flour prices.[14] This helped these procurement agencies to retire their borrowings during the quarter (**Table 3.3**).

Table 3.3: Change in Outstanding Loans and Stock of Wheat (end-Q1)

	PASSCO		Punjab Food Department	
	FY13	FY14	FY13	FY14
Quantity (stocks in 000 MT)	163.2	-264.3	-78.8	-454.4
Outstanding loans (billion Rupees)	-1.0	-5.8	-1.0	-15.6

Source: State Bank of Pakistan

Further details reveal that the receivables of both PASSCO and the Food Department of Punjab on account of wheat, stood at Rs 294.8 billion as of end-

[12] However, the situation substantially changed following the Monetary Policy announcement on 13th September 2013. The market offered Rs 634.3 billion against the target of Rs 250 billion in T-bill auction held on 19th September 2013. The government realized Rs 515.9 billion from this auction, which helped contain government borrowing from SBP to an extent.

[13] Besides statuary requirements, rise in government borrowing has strong implications for the debt and monetary management. Specifically, the government's increasing reliance on T-bills has increased the re-pricing and rollover risks for the government. In an increasing interest rate scenario, the re-pricing risk could undermine the government efforts to consolidate the fiscal deficit.

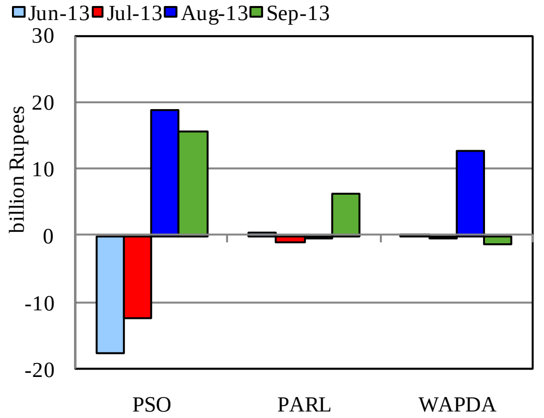
[14] However, this proved insufficient, as wheat and flour prices continued to increase throughout the quarter (**Section 3.4**).

September 2013, of which Rs 65.6 billion was on account of receivable subsidies. Moreover, total receivables of procurement agencies stood at Rs 486.4 billion as of end Q1-FY14, including Rs 155.3 billion of receivable subsidies. The payment of these subsidies by the respective governments, would allow the procurement agencies to retire 34.8 percent of their costly borrowing from commercial banks.

Credit to PSEs

Credit to PSEs recorded a YoY growth of 12.2 percent during Q1-FY14, compared to a growth of 6.0 percent during the same period last year. The demand for credit originated from energy-related PSEs, which can be traced to their cash flow problems.

Figure 3.3: Monthly Changes in Credit to PSEs



Source: State Bank of Pakistan

Specifically, most of the PSEs retired their loans in June and July 2013, following the settlement of the circular debt by the government. However, as structural issues continued to persist in the energy sector, the circular debt started to build up in subsequent months, causing a rise in PSE's demand for bank loans (**Figure 3.3**).

3.3 Credit to Private Sector

Net retirement of private sector credit remained significantly lower in Q1-FY14, compared to the previous year (**Table 3.4**). Private businesses and non-bank finance companies (NBFCs) were mainly responsible for lower retirements this year, as consumer financing posted an increase of Rs 13.4 billion.

Table 3.4: Change in Credit to Private Sector during Q1

billion Rupees

	FY12	FY13	FY14
Overall	-88.7	-84.9	-17.4
of which			
Loans to private business	-95.3	-39.6	-3.0
Investments in private stocks	2.9	-1.1	1.4
Consumer financing	-4.5	-1.8	13.4
Credit to NBFCs	6.3	-65.7	-16.2

Source: State Bank of Pakistan

Credit to NBFCs continued to show net retirements during Q1-FY14. This was mainly because the government had reduced tax incentives on investments in mutual funds from July 2012 onwards.[15,16] Therefore commercial banks, who were routing some of their investments in government securities through NBFCs, are now gradually disinvesting from these institutions. With a reduction of Rs 16.2 billion in Q1-FY14, the credit to NBFCs has largely reverted to its trend prevailed before June 2011.

Table 3.5: Net Change in Loans to Private Sector Businesses during Q1
billion Rupees

	% share	Overall loans		Trade financing		Working capital		Fixed investment	
	in stock	**FY13**	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**
Private sector business		-39.7	-3.0	-2.2	8.9	-43.2	-31.3	5.6	19.4
Of which									
a) Elec.& gas distribution	10.3	-0.5	25.6	0.0	3.2	-1.8	15.4	1.2	6.9
b) Petroleum refining	1.8	0.2	14.0	0.0	0.6	-2.2	2.6	2.3	10.8
c) Other manufacturing	55.9	-47.6	-40.7	-1.7	-3.8	-43.9	-40.4	-1.8	3.4
Textiles	20.9	-25.0	0.3	-2.6	-8.5	-16.2	9.7	-6.1	-0.9
Food & beverages	11.0	-42.1	-46.3	-3.9	-4.5	-42.6	-40.9	4.5	-0.9
Sugar	3.9	-24.7	-31.0	0.8	-4.1	-28.5	-28.3	2.9	1.4
Bakery	0.6	-1.2	1.6	0.3	0.0	-0.8	2.3	-0.6	-0.7
Beverages	0.9	-0.1	5.5	0.4	1.2	-2.3	4.5	1.7	-0.2
Paper & paper board	1.2	1.1	0.3	0.2	0.3	1.9	-1.8	-1.0	1.8
Fertilizers	3.9	7.7	-1.2	-1.0	0.0	10.1	1.6	-1.3	-2.8
Rubber & plastics	1.0	4.8	-0.4	2.0	1.0	0.3	-0.6	2.5	-0.8
Electrical machinery	2.1	2.0	3.7	1.2	1.0	-0.9	0.8	-0.1	2.0
Cement	2.1	-3.2	-1.3	-1.9	-0.8	-0.7	-4.9	-0.5	4.3

*Category of *Government self employment schemes*, which constitutes around 0.01-0.03 percent of total outstanding loans, is excluded from private sector business's total loans.
Source: State Bank of Pakistan

Loans to private businesses posted net retirement of only Rs 3.0 billion in Q1-FY14, compared to Rs 39.7 billion in Q1-FY13 (**Table 3.5**). Export-led buying of cotton and yarn, and the re-accumulation of circular debt in the energy sector (which increased bank borrowings by refineries and IPPs), were mainly

[15] The Gazette of Pakistan dated June 27th, 2012 noted that " ….dividend income from Money Market Mutual Funds and Income Funds shall be taxed at the rate of 25 percent for tax year 2013 and at the rate of 35 percent for tax years 2014 onwards". It is pertinent to mention here that standard income tax rate for the corporate sector is 35 percent.

[16] Banks' investment in NBFIs substantially increased due to tax incentive on the investments of NBFCs, especially of mutual funds. The scheduled bank took advantage of this opportunity by routing some of their investments in government securities through NBFIs. As a result, banks' investment in NBFCs saw a 2.4 time increase in just one year (i.e., FY12), and reached historic high of Rs 231.0 billion by end November 2012. However, the government announced the withdrawal of tax incentive in a phased manner in June 2012. Consequently, the banks are containing their investments in NBFCs.

responsible for the increase in fresh loans. Moreover, fixed investment loans also posted a modest increase especially in the energy sector, including power distribution and petroleum refining. This increase largely offset seasonal retirements, as well as bulky repayments by the cement and fertilizer sectors.

Loans to the energy sector – including refineries and electricity and gas distribution companies, increased by Rs 39.6 billion during Q1-FY14, compared to a decline of only Rs 0.3 billion in the corresponding quarter of FY13. This increase took place despite a retirement of Rs 58.1 billion (related to the circular debt settlement) during the month of June 2013. However, as mentioned before, the circular debt piled up again in August and September, which caused a rise in bank borrowings by refineries, OMCs and IPPs. In addition to this, anecdotal evidence suggests that a few private power plants, which were closed in the previous year due to financial constraints, had started operating in Q1-FY14 – this generated additional demand for working capital loans to purchase furnace oil.

Loans to the *textile sector,* which is one of the biggest users of bank loans, recorded an increase of Rs 0.3 billion in Q1-FY14, compared to a net reduction of Rs 25.0 billion in Q1-FY13 (**Table 3.5**). A rise in procurement of raw cotton, and cotton yarn by the exporters, increased credit demand of the textile sector**.**[17]

Loans to *food and beverages* saw a net contraction of Rs 46.3 billion in Q1-FY14, due to seasonal retirements from the sugar sector.[18] Among other food industries, working capital loans to the FMCG sector increased by Rs 2.3 billion during Q1-FY14, due to higher grain prices.[19] In contrast, the rise in loans to *beverages* can be traced to the construction of three new greenfield bottling plants in the country.

As far as cement and fertilizer are concerned, these sectors continued to retire loans in Q1-FY14. While cement benefited from strong profitability and improved cash flows,[20] fertilizer continued to retire long-term loans that were taken to finance capacity expansion a few years back. Encouragingly, there has also been some increase in the fixed investment activity in the cement sector, in the form of new local plants, and a joint-venture to set-up a plant in Africa.

[17] According to PBS, total cotton yarn exports stood 193.7 thousand MT during Q1-FY14 compared to 181.5 thousand MT during Q1-FY13, raw cotton exports stood 36.9 thousand MT during Q1-FY14 compared to 14.5 thousand MT during Q1-FY13.
[18] First quarter of the year is a retirement period for the sugar sector.
[19] Price of wheat and corn surged by 25.0 percent each in Q1-FY14, over the previous year.
[20] Profits of cement manufacturers remained strong due to declining international coal prices, and better margins.

However, investment in fertilizer is at standstill due to uncertainties related with gas availability and contract enforcement.[21]

Finally, *consumer financing* is finally showing some signs of improvement after a long period of net retirements**.** Details indicate that expansion in consumer financing is largely stemming from personal loans, which have picked up since November 2012, as the National Bank of Pakistan revised the limit on its salary loan scheme for government employees (**Table 3.6**).[22] Moreover, *Cash and Gold Scheme* (ready cash against gold) of NBP is also contributing to the personal loans. There is also some increase in consumer financing by other commercial banks as well during Q1-FY14, mainly in the car loan segment.

Table 3.6: Loans to Consumer Sector during Q1
billion Rupees

	FY12	FY13	FY14
Consumer financing	**-4.7**	**-1.7**	**13.6**
of which			
House building	-1.9	-1.1	-0.1
Auto loans	-2.3	-0.2	3.1
Credit cards	-1.0	1.3	0.6
Personal loans	0.6	-1.7	10.1

Source: State Bank of Pakistan

3.4 Inflation

After receding throughout FY13, inflationary concerns resurfaced with the start of FY14: headline inflation increased to 8.1 percent YoY in Q1-FY14, compared to only 5.6 percent in the preceding quarter (**Table 3.7**). This increase in inflation was driven by multiple factors, including: (i) a modest rise in global commodity prices; (ii) a sharp depreciation in PKR; (iii) trend reversal in administered prices; (iv) supply constraints in essential food items; and (v) a rise in standard GST rate by one percentage point.

Table 3.7: Quarterly Averages of YoY Inflation
percent

		CPI	Food	NFNE	Trimmed
FY13	Jul-Sep	9.1	8.4	10.9	10.6
	Oct-Dec	7.5	6.3	9.9	9.2
	Jan-Mar	7.3	7.3	9.5	9.2
	Apr-Jun	5.6	6.6	8.2	7.0
FY14	Jul-Sep	8.1	9.1	8.5	7.8

Source: Pakistan Bureau of Statistics

While all these factors indicate supply-side forces at work – and food inflation taking the lead, both the measures of core inflation (i.e., NFNE and trimmed) have also edged up (**Table 3.7**). However, this increase does not necessarily imply demand pressures in the economy; it can be seen as a second-round impact of

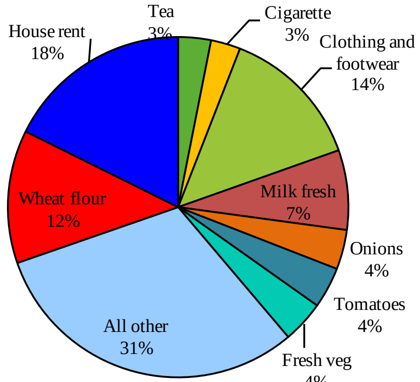
[21] As mentioned in **Chapter 2**, the increase in gas supplies to fertilizer sector in Q1-FY14 was a temporary arrangement.
[22] Personal loans account for around 50 percent of consumer financing.

price increases in key items like petrol and wheat, which not only trigger cost-push inflation and higher wages, but also *anchor* inflation expectations of households. In addition, movements in the Dollar-PKR parity directly influence price setting by private sector businesses. Therefore, to arrest the spread of inflation across commodities, and to stabilize real interest rates, supply-side inflationary pressures required a timely policy response (**Section 3.1**).[23]

Composition of inflation

A commodity-wise break up of CPI inflation shows that wheat and house-rent alone added 2.4 percentage points to Q1-FY14 inflation (**Figure 3.4**). Contributions from clothing & footwear, fresh milk, tea, cigarettes and vegetables were also large. The remaining items contributed nearly 30 percent of Q1-FY14 inflation. Although the number of items showing double-digit inflation is still low, a large number of items in the CPI basket are posting price increases during the quarter (**Table 3.8**).

Figure 3.4: Composition of YoY CPI Inflation - Q1-FY14



Source: Pakistan Bureau of Statistics

Table 3.8: Distribution of CPI Items as per Inflation Outcome

number of items

	Q1-FY13	Q2-FY13	Q3-FY13	Q4-FY13	Q1-FY14
Deflation	41	45	48	60	44
No change	26	30	28	40	48
1 - 5 % inflation	60	69	71	107	86
5 - 10 % inflation	95	111	129	139	156
Above 10% inflation	255	224	194	132	143

Source: Pakistan Bureau of Statistics

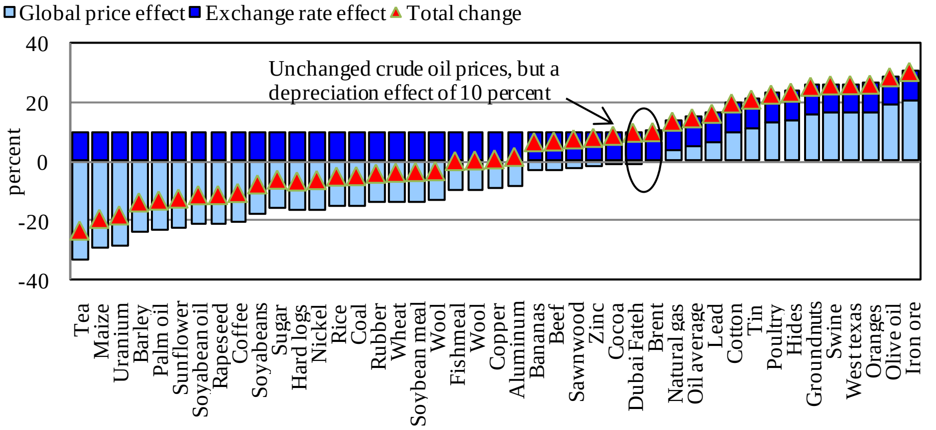
[23] It is important to mention here that monetary measures are not taken to reduce food inflation, but to contain inflationary expectations, and preventing the diffusion of food inflation into a wider range of commodities. In reducing food inflation, administrative actions are more effective, which include correcting market structure by addressing collusive behavior of producers and distributors; and also managing strategic reserves of key commodities. To achieve this, the government should aim to assess accurate estimates of production and available stocks, before taking important decisions of exporting essential commodities. Time and again, food inflation surges due to ineffective management, and central bank has to respond to avoid its second-round impact.

Disentangling the trend in global prices and PKR depreciation

Compared to a decline of 4.8 percent in Q1-FY13, global commodity prices showed a modest rise of 0.7 percent during Q1-FY14. Most of the increase was seen in the month of July 2013, when crude oil prices soared in response to escalating tensions in Iraq, Syria and Libya. However, as the global economy continued to weaken, and oil production was completely restored in Libya, prices have receded. Furthermore, prices of a number of commodities have declined in Q1-FY14, e.g., palm and soybean oil, wheat, rice, coal, and nickel.

The effect of global prices on domestic inflation was intensified by the PKR depreciation during the quarter. As shown in **Figure 3.5**, while the increase in dollar prices of key commodities was marginal, the real concern was the trend in PKR prices. For instance, if we look at the price of crude oil (both Dubai Fateh and Brent), its dollar price has remained more or less unchanged, but its PKR price shows a 9.9 percent increase during the period. This increase was translated into higher domestic petrol prices, which in turn, forced up prices of fresh milk, and other food items where transportation costs are significant.[24]

Figure 3.5: Composition of Change in Global PKR Prices of Primary Commodities



Source: IMF

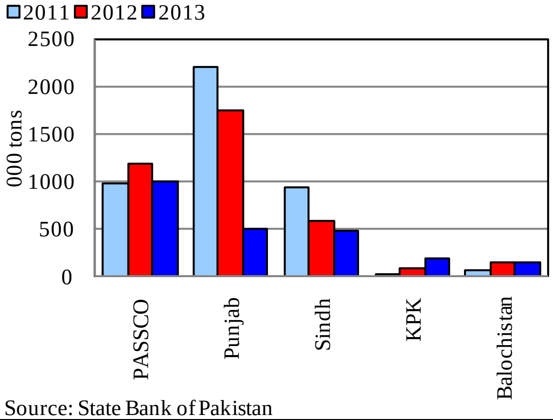
Increase in energy tariffs

During Q1-FY13, the government had significantly reduced the price of piped gas, which pulled down headline inflation. This deflationary effect had held back inflation numbers throughout FY13, but this has been reversed, as FY14 began. In fact, the government increased gas tariffs in January 2013 by 6.1 percent, and later in June 2013 by 1.0 percent.

[24] Domestic price of petrol super increased by 10.6 percent YoY in Q1-FY14.

Similar to gas, electricity tariffs also show no respite: the government has already increased these tariffs on various consumption slabs by an average of 16 percent in October 2013. The increase in these tariffs will push CPI inflation both through its direct contribution to the index, as well as through cost-push inflation in other items.

Figure 3.6: Carry-over Stock of Wheat at the Start of Harvest



Source: State Bank of Pakistan

Lower stocks drove wheat flour prices

Despite a 3.5 percent fall in global wheat prices, domestic wheat prices increased by 25.0 percent in Q1-FY14. This increase is largely driven by the lower-than-target crop in the previous season, and export of wheat flour, which has reduced the carry-over stock (**Figure 3.6**).[25] In fact, the country imported 143.9 thousand MT of wheat during Q1-FY14, but this was not enough to make up for the prevailing demand-supply gap.

Budgetary measures increases cigarette and tea prices

While the increase in GST in Federal Budget 2013-14, has added to inflation across commodities, the impact of certain budgetary measures on cigarettes and tea was more pronounced. More specifically, the government had reduced sales tax on tea from 16 percent to only 5 percent back in April 2012, to contain smuggling. However, in the 2013-14 Budget, this relaxation was withdrawn, and the sales tax on tea was increased to 17 percent in one go. In case of cigarettes, the government increased federal excise duty from 2.0 percent last year, to 3.0 percent in the 2013-14 Budget.

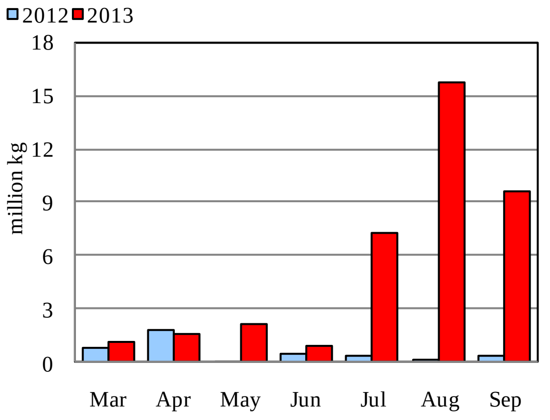
Onion and tomatoes: trade didn't help

Pakistan almost doubled onion export during Q1-FY14 compared to the previous year, primarily to compensate for the damage to Indian crop (**Figure 3.7**). However, this increase was at the direct cost of higher domestic prices, which increased by 50.7 percent YoY during the quarter.

[25] Pakistan exported 185.7 thousand MT of wheat flour during Q1-FY14.

As far as tomatoes are concerned, its price posted an increase of 80.3 percent during the quarter, as bad weather damaged the crop in Balochistan and parts of Sindh. In response, Pakistan increased the import of tomatoes from India to 98.0 million kg in Jul-Sep 2013, from only 57.1 million kg in the previous year.[26] However, this quantum of import was not sufficient, as domestic prices rose consistently throughout the quarter. Inflation in tomato prices has increased further in the second quarter to 101.6 percent YoY, as supplies from India suffered a setback due to unseasonal rainfall in tomato growing areas.

Figure 3.7: Onion Exports by Pakistan



Source: Pakistan Bureau of Statistics

Going forward

The CPI Inflation in Q1-FY14 was driven mainly by PKR depreciation; higher petrol prices; increase in GST; and an increase in energy tariffs. These factors were also manifested in consumer confidence surveys, which showed increase in inflation expectations of households and businesses. However, some of the factors that drove inflation in Q1-FY14, have eased – or reversed in recent months. More specifically, unexpected appreciation of PKR in December is containing price pressures; domestic petrol prices, in particular, have not changed for months. This relative price stability may soften inflationary expectations going forward. However, some upside pressures still persist in the form of a large external gap; recent trend in commodity prices;[27] and the need to further reduce energy subsidies as part of the IMF program.[28] On balance, SBP's inflation forecast for FY14 is in the range of 10.0 – 11.0 percent.

[26] Source: Pakistan Bureau of Statistics
[27] Price of Brent crude oil increased from US$ 108.1 per barrel in November 2013, to US$ 110.6 per barrel in December 2013, showing a growth of 2.4 percent.
[28] The recent increase in gas infrastructure development cess (GIDC) on industrial and power sectors, may also trigger cost push inflation (**Chapter 4**).