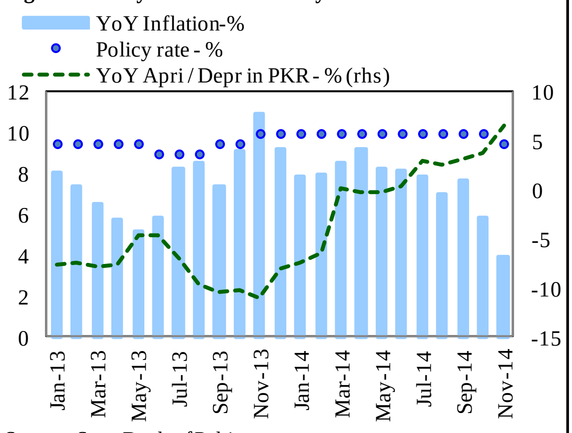
3 Monetary Policy and Inflation

3.1 Overview

SBP kept its monetary policy stance unchanged during the first quarter of the year (**Figure 3.1**). In effect, SBP had to weigh the comfort from declining inflation; lower government borrowing from the banking system; and stability in the FX market, against the potential impact of the August 2014 floods on food inflation in subsequent months, and the activity on the political front. In addition, the widening trade deficit, coupled with the delay in 4th Review of the IMF program, contributed to uncertainty about the outlook for FX inflows. Keeping a watchful eye on these developments, SBP maintained its policy rate at 10 percent in its policy decisions of July and September 2014. Furthermore, liquidity in the money market was cautiously kept tight to avoid any unnecessary pressure on the exchange rate, and to ensure sustainability.

However, risks to inflationary outlook dissipated as the economy entered the second quarter of the year. Not only was the impact of floods on perishable food items limited, but softening global commodity prices, and the lagged impact of monetary tightening, helped improve the inflation outlook. YoY inflation in November 2014 has already declined to 13-year low of 4.0 percent.

Figure 3.1: Key Indicators of Policy Environment



Source: State Bank of Pakistan

Concerns about the external sector also eased with the successful completion of discussions for the 5th Review of the IMF program, which subsequently paved the way for the combined release of the 4th and 5th tranches (amounting to US$ 1.1 billion) in December 2014. Moreover, the government was able to issue Sukuks worth US$ 1.0 billion in the international market[1], which will reduce government reliance on domestic sources of funding, and help improve the external position.

[1] Against the target of US$ 500 million, total bids worth US$ 2.3 billion were received.

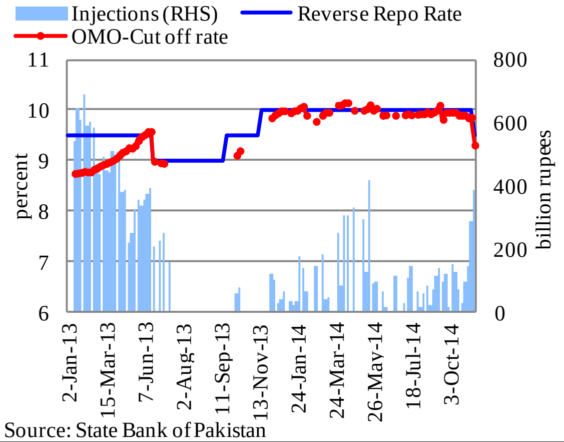
This positive outlook on the external sector, along with the government efforts to contain the budget deficit, created some room to support weak economic activity. Hence, SBP decided to reduce the policy rate by 50 bps to 9.5 percent in its monetary policy decision of November 2014, and by 100 bps to 8.5 percent in monetary policy decision of January 2015. This reduction will help the private sector, as the month of November marks the period of seasonal credit offtake. The first quarter, which is a period of seasonal retirement in the credit cycle, saw a net expansion of Rs 59.6 billion YoY (1.6 percent) in Q1-FY15, against a net contraction of Rs 17.4 billion in Q1-FY14. This unexpected increase was primarily driven by a healthy growth in trade volumes, and a pick-up in consumer financing.[2]

The expansionary impact of the increase in credit to the private sector and the government, on money supply, was more than offset by the undesirable but contractionary impact of a fall in foreign exchange reserve and SBP's money market intervention for liquidity management. As a result, the M2 witnessed a small contraction of Rs 6.0 billion in Q1-FY15, against an expansion of Rs 21.5 billion during the same period last year.

3.2 Money Market Developments

Cognizant of the developments taking place in the FX market, and the decline in government borrowing from the banking sector, SBP had to be careful in managing liquidity in the money market. The hard earned stability in the FX market faced some challenges in August 2014, following political events in Islamabad. The situation was further complicated by the sharp increase in current account deficit, and the potential delay in the official FX inflows (**Chapter 5**).[3] As a result, the PKR depreciated by 2.8 percent and SBP's FX reserves fell by US$ 558.4 million in

Figure 3.2: SBP Liquidity Support: OMOs



Source: State Bank of Pakistan

[2] Loans for import financing saw a net expansion of Rs 49.5 billion during Q1-FY15, which were 2.7 times of the increase in Q1-FY14. Similarly, consumer financing benefited from a healthy demand for auto loans (for details, see **Section 3.4**).

[3] Balance of payment data for July was released in the third week of August 2014.

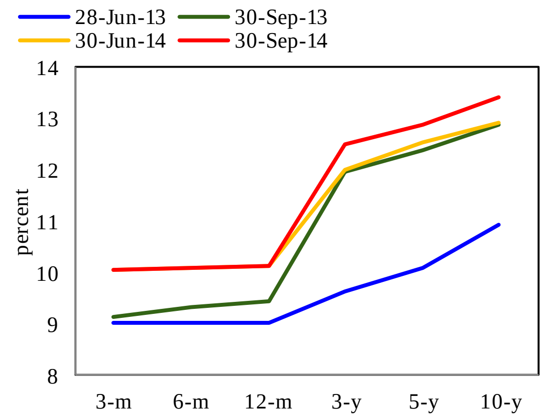
the month of August 2014 (**Figure 3.1**).[4]

In this situation, SBP kept rupee liquidity tight in the money market, to avoid pressure on the exchange rate, and to further contain depletion in its FX reserves. The weighted average overnight rate was maintained very close to the upper limit of the interest rate corridor (IRC), by providing limited liquidity through open market operations (**Figure 3.2**). Not only were OMO cut-off rates very close to the upper limit of the IRC, but the acceptance-to-bid ratio (84.9 percent for the quarter), was lower than the preceding quarter (Q4-FY14). Moreover, the utilization of SBP's window for liquidity management, indicates that commercial banks visited the window 98 times during the quarter to borrow a total of Rs 693.3 billion, compared with only 17 visits to place funds amounting to Rs 163.4 billion.

While proactive liquidity management helped maintain stability in the FX market, it impacted bank participation in government securities, and increased the demand for foreign currency loans. Specifically, trade financing (loans for both imports and exports) against foreign currency deposits, increased by US$ 439.1 million during the quarter, to reach all time high of US$ 2.1 billion by end-September 2014. In our view, the impetus came from importers who borrowed heavily to benefit from the prevailing interest rate differential. In addition to this, exchange rate movements also played an important role in determining the effective cost of borrowing in foreign currency.

Elevated domestic interest rates rendered the short-end of the yield curve (up to one year) almost flat (**Figure 3.3**). Specifically, the term premium between the 3-month and 12-month T-bills, was only 8 to 15 bps during the quarter. During the same period, term premium between the 12-month T-bills and 3-year PIBs was huge ranging between 216 to 245 bps. This disconnect in the yield curve, stoked the

Figure 3.3: Secondary Market Yields



Source: State Bank of Pakistan

[4] Although SBP's FX reserves saw an increase of US$ 224.3 million in September 2014, the end-September target of Net International Reserves under the IMF program was missed on account of non realization of OGDCL privatization inflow.

market appetite for PIBs. As a result, the government was able to mobilize Rs 303.7 billion from three PIB auctions held during the quarter against a combined target of Rs 300.0 billion. However, SBP had to inject liquidity into the market to facilitate the settlement of these auctions, as a number of banks were over-bidding. This is a common practice, as investing banks can fund their lucrative investments by borrowing from the money market or from SBP.

3.3 Monetary Aggregates

Money supply posted a small contraction of 0.1 percent during Q1-FY15, compared to a net expansion of 0.2 percent in the corresponding period last year. However, it is encouraging to note this reduction did not come from credit to private sector, which expanded by 1.6 percent during the quarter. In effect, major contributions came from lower government borrowing, and an undesirably higher external deficit that reduced NFA of the banking system.

Table 3.1: Monetary Aggregates

billion Rupees

	Stock as of		Absolute changes	
	Jun-14	**Sep-14**	**FY14**	**FY15**
Money Supply (M2)	9,968.0	9,962.0	21.5	-6.0
NDA	9,367.0	9,392.1	194.6	25.0
SBP	1,871.6	1,804.5	174.2	-67.1
Comm. Banks	7,495.5	7,587.6	20.4	92.1
NFA	601.0	570.0	-173.2	-31.0
SBP	489.6	481.6	-146.1	-8.0
Comm. Banks	111.4	88.3	-27.1	-23.0

Source: State Bank of Pakistan

Net Foreign Assets (NFA) of the Banking System

Contraction in NFA of the banking system reflects the pressure on the external account: sharp increase in the current account deficit, and a decline in both debt and non-debt inflows.[5] However, this contraction was much lower compared to Q1-FY14, when the country had to make lumpy repayments to the IMF (**Table 3.1**).

Within the banking system, the decline in commercial banks' NFA was more pronounced. In effect, SBP's FX support in the interbank market remained fairly limited, because of quarterly targets on its net international reserves (NIR) under the IMF program. As a result, the burden of financing lumpy import payments fell on commercial banks, which is visible from both the contraction in their NFA, and an all-time high volume of import financing against FE-25 deposits.[6] Since net

[5] For details, please see **Chapter 5** on External Sector.

[6] Specifically, import financing (loans for imports only) against FE-25 deposits surged by US$ 615.5 million during the quarter, to all time high level of US$ 1,266.6 million.

mobilization of FE-25 deposits was quite low compared to the demand for FX loans, commercial banks had to draw down their FX investments/placements abroad. This shift in commercial banks' claims (assets) from foreign to domestic residents, led to a contraction in their NFA.

Net Domestic Assets (NDA) of the Banking System

The *growth* in NDA of the banking system, declined from 2.3 percent in Q1-FY14, to only 0.3 percent in Q1-FY15. As mentioned before, this deceleration was entirely driven by lower government borrowing, as credit to non-government sector grew at a higher pace during the quarter. Within the banking system, SBP's NDA saw a net contraction of Rs 67.1 billion during the quarter. Despite this, SBP's NDA target for end-September 2014, agreed with the IMF, was not met primarily on account of non-realization of OGDCL privatization inflows.

Government Borrowing for Budgetary finance[7]

The availability of higher NSS funding during the quarter, reduced the government's reliance on bank financing for budgetary support. Government borrowing from the banking system during Q1-FY15, was around 70 percent of the amount borrowed during the corresponding period last year. Moreover, lower borrowings came with a favorable change in the source of funding within the banking system: unlike heavy reliance on SBP in the previous year, the government actually retired Rs 39.0 billion to the SBP during Q1-FY15 (**Table 3.2**). While this retirement helped the government meet its quarterly limit of zero budgetary borrowing from SBP (as prescribed in SBP Act 1956), it was not enough to meet the end-September target under the IMF program. Delay in issuance of Sukuk and non-realization of OGDCL privatizations proceeds explains this breach of the target. Specifically, the stock of government borrowing from SBP stood at Rs 2,288.7 billion at end-September 2014, against the IMF target of Rs 2,070 billion.

Table 3.2: Net Budgetary Borrowing during the First Quarter
cash basis, billion rupees

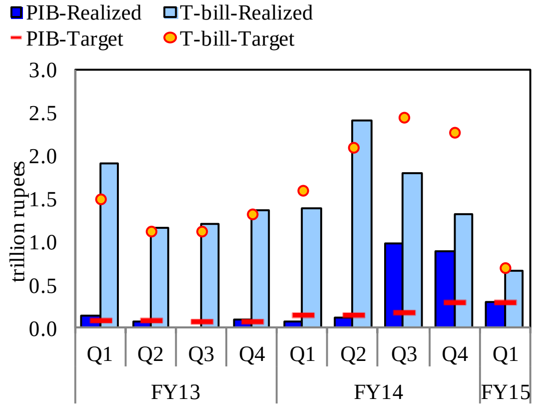
	FY13	FY14	FY15
Banking System	151.5	198.0	139.9
SBP	-412.1	352.8	-39.0
Scheduled banks	563.6	-154.8	178.9

Source: State Bank of Pakistan

[7] Numbers discussed in this section are on cash basis, which will differ from that of Monetary Survey.

The pattern of government borrowing from commercial banks in Q1-FY15, is exactly the opposite to what was realized in Q1-FY14. The government borrowed Rs 178.9 billion from commercial banks in Q1-FY15, compared to net retirement of Rs 154.8 billion seen in Q1-FY14 (**Table 3.2**). This turnaround is primarily because of a change in market expectations of future interest rates, and subsequent banks interest in government papers.

Table 3.4: Auction Profile



Source: State Bank of Pakistan

Unlike Q1-FY14, when banks were anticipating an increase in interest rates and refrained from actively participating in T-bills auctions, they were expecting a policy status quo throughout Q1-FY15, with some probability of a rate cut. In this scenario, commercial banks were eager to lock-in funds in risk-free government securities at prevailing interest rates.[8] This facilitated government's efforts to meet its funding requirements from the market largely as planned. Specifically, the government realized Rs 303.7 billion in primary auctions of PIBs, against the pre-auction (accumulated) target of Rs 300.0 billion for the quarter. In case of T-bills, the government mobilized Rs 658.0 billion, against the quarterly target of Rs 700.0 billion (**Figure 3.4**).

This pattern of government borrowing helped improve the maturity profile of its domestic debt, and also mitigated re-pricing and roll-over risks.[9] Commercial banks were also happy to place their funds in PIBs, as the disconnect between T-bills and PIBs yields (which emerged during Q1-FY14), remained in place throughout Q1-FY15 (**Figure 3.3)**.

[8] Market expectations of interest rate cut materialized during second quarter of the year, when the SBP cut the policy rate by 50 bps to 9.5 percent in its monetary policy decision of November 2014.
[9] For details, please section on **Domestic Debt.**

Commodity Operations

In addition to budgetary support, the government also borrows from the banking sector to finance its commodity operations. Loans for commodity operations saw a net reduction of Rs 23.7 billion during the quarter, to reach Rs 468.7 billion at end-September 2014. Moreover, commodity-wise distribution shows three major commodities saw a net retirement during the quarter, with a dominating role of wheat financing (**Table 3.3**).[10]

Table 3.3: Commodity Operations
billion rupees

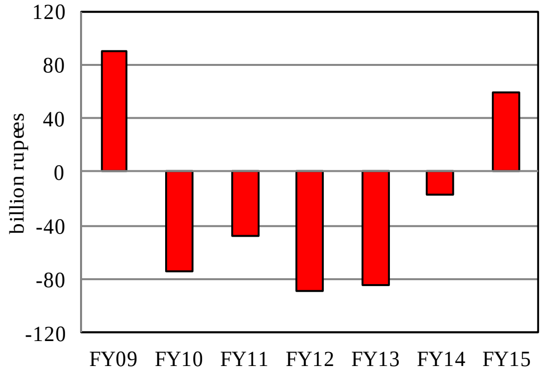
	Stock as of		Absolute change	
	Jun-14	**Sep-14**	**Q1-FY14**	**Q1-FY15**
Wheat	386.2	371.2	-20.2	-15.0
Sugar	46.8	44.7	-5.7	-2.1
Fertilizer	58.4	51.8	3.9	-6.7
Rice	1.0	1.0	0.0	0.0
Total	492.4	468.7	-22.0	-23.7

Source: State Bank of Pakistan

3.4 Credit to Private Sector

Credit to private sector recorded a YoY growth of 1.6 percent during Q1-FY15 – positive growth after a gap of five years (**Figure 3.5**). However, detailed data suggests that the increase came primarily from a rise in import financing during the period (**Table 3.4**).

Figure 3.5: Credit (net flows) to the Private Sector in the First Quarter



Source: State Bank of Pakistan

Working capital and fixed investment loans posted net retirements during the quarter (**Table 3.1**). It must be noted that seasonal retirements of working capital loans from sugar and textile industries, remained stronger than last year. However, this was more than offset by higher credit offtake by petroleum refineries and cement manufacturers. As a result, overall working capital loans show lower retirements than last year.

[10] Following the end of wheat procumbent season (March-June), procurement agencies generally start retiring their loans against wheat from July onwards.

Similar to the trend in previous years, heavy bank investments in government papers reduced the supply of loanable funds for the private sector. Since the start of 2014, banks have been actively placing funds in PIBs, which carry much higher returns than the WALR banks get from the manufacturing sector (**Table 3.5**). Given market expectations that the policy rate is unlikely to be increased in the near future, the incentive to invest in government securities is likely to continue. In addition, anecdotal evidence suggests that banks are presently lending only to blue-chip customers, whereas other borrowers have largely been priced out from the market.

Table 3.4: Changes in credit to private sector
billion rupee

	FY14	FY15
Credit to private sector (MS)	-17.4	59.6
of which		
A) Credit to NBFIs	-16.2	-14.0
B) Private sector business	-3.0	13.6
of which		
Working Capital	-31.3	-16.9
Fixed Investment	19.4	-27.4
Export Financing	-9.5	8.4
Import Financing	18.4	49.5
C) Consumer financing	13.4	5.1
of which		
Personal Loans	10.0	1.9
Auto Loans	3.1	3.6

Source: State Bank of Pakistan; MS: Monetary Survey

<u>Borrowing by type of financing</u>

Import financing increased by Rs 49.5 billion in Q1-FY15, compared with an increase of Rs 18.3 billion in Q1-FY14. This expansion was driven by higher imports of fertilizer, basic metals, petroleum products and edible oil. Import financing for *edible oil & ghee* doubled compared to last year amid higher quantum. As mentioned earlier, it was also beneficial for importers to borrow in US$ to avail the wedge between PKR and US$ loans, especially given a stable outlook for the PKR (**Chapter 5**).

Table 3.5: Rate of return on credit to manufacturing sector; T-Bills; and PIBs
percent

	WALR manufacturing	PIBs*	T-bills*	KIBOR
Dec-11	12.18	12.45	11.83	11.94
Jun-12	11.93	12.75	11.92	11.97
Dec-12	10.90	10.40	9.28	9.40
Jun-13	10.66	9.70	9.09	9.41
Dec-13	10.29	12.10	9.93	10.06
Jun-14	10.50	12.10	9.96	10.17
Sep-14	N.A	12.59	9.95	10.18

* Monthly average cut-off rates of 3-M T-bills & 3 year PIBs
Source: State Bank of Pakistan

Fixed investment loans recorded net retirement of Rs 27.4 billion during Q1-FY15, in contrast with an expansion of Rs 19.4 billion during the same period last year. Sector-wise information indicates that major retirements were made by the energy and textile sectors (Rs 16.3 and Rs 6.5 billion, respectively) (**Table 3.6**). Both sectors availed fixed investment loans last year for capacity expansion and

BMR, respectively.

Table 3.6: Credit to private sector businesses
changes in billion rupees

	Abs. Change		Working capital		Fixed		Trade financing	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Private sector	-3.0	13.6	-31.3	-16.9	19.4	-27.4	8.8	57.9
1) Agriculture	7.7	9.5	8.0	6.1	-0.7	3.4	0.4	0.1
2) Manufacturing	-26.7	-14.7	-37.8	-46.6	14.2	-9.4	-3.2	41.2
Food & beverages	-46.3	-24.8	-40.9	-39.6	-0.9	0.4	-4.5	14.5
Rice	-8.3	-11.5	-6.9	-12.3	0.0	0.1	-1.4	0.7
Sugar	-31.0	-27.2	-28.3	-35.1	1.4	6.6	-4.1	1.3
Beverages	5.5	-3.3	4.5	-4.1	-0.2	-0.1	1.2	0.9
Edible oil & Ghee	4.4	9.4	-0.2	2.2	0.0	-1.9	4.6	9.1
Feeding stuff animals	-0.2	7.9	1.7	3.9	-0.3	0.2	-1.6	3.9
Textile	0.3	-14.8	9.7	-9.6	-0.9	-6.5	-8.5	1.3
Cement	-1.3	2.8	-4.9	2.8	4.3	-1.2	-0.8	1.3
Petroleum Products	14.0	18.9	2.6	10.0	10.8	1.4	0.6	7.5
Basic Metals	9.0	6.6	3.2	1.3	1.0	-3.0	4.8	8.3
3) Electricity	25.6	-2.1	15.4	15.1	6.9	-16.3	3.2	-0.8
4) Telecom	-7.1	-0.6	-2.9	0.5	-5.1	-1.0	1.0	-0.2
5) Commerce & Trade	-4.8	1.3	-8.3	-2.6	1.1	0.1	2.3	3.8
6) Construction	-3.2	-2.5	-4.2	-2.7	1.1	0.0	0.0	0.2
7) Mining & Quarrying	1.5	2.2	0.6	0.4	2.2	-0.3	-1.3	2.0
8) Ship breaking	3.4	8.0	0.4	-0.1	-0.6	0.1	3.7	7.9
9) Real estate	0.4	8.8	-2.1	5.0	0.1	1.5	2.3	2.2
10) Others*	0.2	3.8	-0.4	7.9	0.2	-5.6	0.4	1.4

*Fishing, hotel, transport, education, health, etc.
Source: State Bank of Pakistan

Working capital loans that mature within a year, generally reflect procurement of raw material by manufacturing firms and seasonality in cash flows. These recorded a contraction of Rs 16.9 billion during Q1-FY15, compared to a decline of Rs 31.3 billion during the same period last year. Retirement by sugar, textile and rice processing industries were particularly strong. In view of the trend in global commodity prices, it appears the working capital requirement for manufacturing during FY15, will remain lower than last year (**Chapter 2**).

As far as working capital loans are concern, sugar firms retired Rs 6.8 billion *more* in Q1-FY15, than in Q1-FY14. As discussed in Chapter 2, sugar manufacturers were facing liquidity problems last year, due to excessive carry-over stocks and strong production, which forced them to borrow heavily from banks. As usual, the bulk of retirement took place in the first quarter.

Textile sector, with a share of 20 percent of loans to private businesses, retired Rs 14.8 billion during Q1-FY15, in contrast with a negligible expansion of Rs 0.3 billion during Q1-FY14. This contraction was expected, as textile manufacturers had to borrow more last year, keeping in view a sharp rise in cotton prices (**Chapter 2**). Furthermore, after gaining GSP plus status in FY14, many large exporting firms expanded and revamped their operations using fixed investment loans. These loans were scheduled to be retired in the first quarter.

Consumer Financing

Consumer financing recorded a YoY growth of 2.3 percent during Q1-FY15, compared with a growth of 6.5 percent during the same period last year. Within consumer financing, relatively low-risk auto financing increased by 5.6 percent, against 6.2 percent growth recorded last year. This consistent growth in auto financing was further boosted in FY15, due to an amendment in car financing regulations; banks can now finance cars up to 9 years old.[11] In addition, the launch of the long awaited new model of Toyota Corolla, also seems to have played a part in higher demand for auto loans in FY15.

3.5 Inflation

Headline YoY inflation remained in single-digits during the first quarter of FY15 – a trend witnessed since July 2012.[12] During Q1-FY15, the average CPI inflation came down to 7.5 percent, compared to 8.1 percent in the corresponding quarter last year (**Table 3.7**). Furthermore, year-on-year inflation remained low in Q1-FY15, and continued to edge lower.

Table 3.7: Quarterly Averages of YoY Inflation

percent

		CPI	Food	NFNE	Trimmed
FY14	Jul-Sep	8.1	9.1	8.5	7.8
	Oct-Dec	9.7	10.7	8.4	9.0
	Jan-Mar	8.1	8.0	7.8	8.2
	Apr-Jun	8.6	8.2	8.6	8.4
FY15	Jul-Sep	7.5	6.6	8.0	7.3

Source: Pakistan Bureau of Statistics

The ease in inflationary pressures was realized despite significant upside risks to inflation. Specifically, while it was feared that floods might impact the availability of perishable food throughout the country, seasonal price hikes on

[11] BPRD Circular No. 07 of 2014, dated July 23, 2014. According to which, banks/DFIs desirous of financing the purchase of used cars shall prepare uniform guidelines for determining the value of the used vehicles. In no case the bank/DFI shall finance the cars older than nine years.

[12] The only exception was the month of November 2013, when the YoY inflation touched 10.9 percent.

account of Ramadan and Eid were expected to make things worse.[13] In addition to this, an increase in power tariffs was widely anticipated, which would have pushed inflation further up.

As things played out, the floods in 2014, did not impact food prices to the same extent as in the past, mainly because floods were not as severe it was expected (**Chapter 5**). As far as the Ramadan effect was concerned, it must be noted that inflation for common use items like fresh fruits, onions, tomatoes, potatoes and fresh vegetables, *did* increase on a quarter-on-quarter basis, but this was more than offset by *deflation* in heavier items like wheat, edible oil and ghee.[14] Finally, the government did increase power tariff during the quarter, but the increase was less than expected.

Compared to Q1-FY14, decline in inflation this fiscal year was driven by: (i) improved grain supplies; (ii) soft oil prices; (iii) reported delays in the increase in power tariffs; and (iv) the cut in retail POL prices. The disinflation in food was more pronounced, due to favorable supply-side factors, mentioned above. Both measures of core inflation have also softened (**Table 3.7**).

Improved food supplies

If we look at the 20 heaviest items in the CPI basket, most of the disinflation in Q1-FY15 was evident in wheat flour, rice and fresh vegetables (**Figure 3.6**). This improvement was driven primarily by improved stocks in the country, thanks to better production, and timely imports in August and September 2014.[15] Similarly, more rice was available in the domestic market this year, as traders preferred to hold back exports due to depressed international prices (**Chapter 5**). As far as fresh vegetables are concerned, their supply remained smooth due to timely imports. Furthermore, prices of onions and tomatoes were lower than last year, due to better demand-supply management.[16]

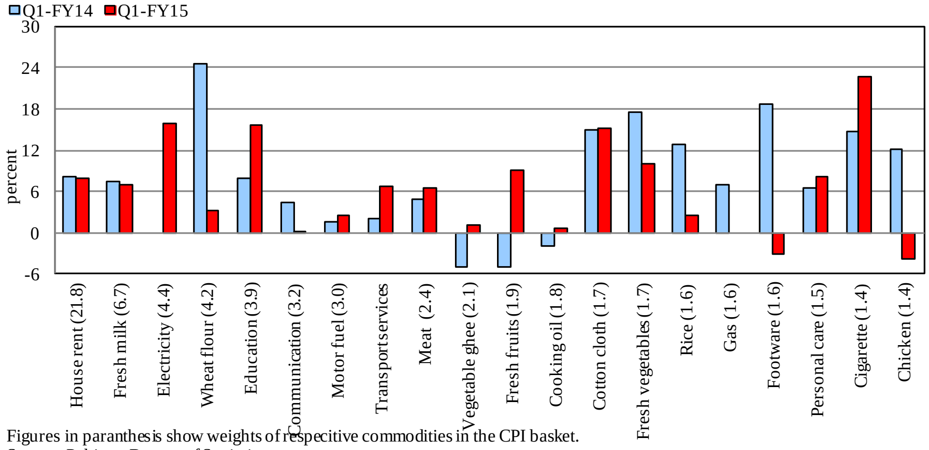
[13] Increase in prices, especially of perishable food items, during the month of Ramadan is a common phenomenon, and is observed almost every year.

[14] Wheat prices had started to decline with the arrival of new crop. During Apr-Jun, the price of wheat remained 11.7 percent lower on average, than the preceding quarter. This trend continued into Jul-Sep, when price of wheat posted a further quarter-on-quarter decline of 0.5 percent. As far as edible oil and ghee is concerned, their prices are directly linked with global prices. In the international market, palm oil prices started to decline from April 2014 onwards: the commodity was being traded at US$ 850 per MT in March 2014, which declined to US$ 758.5 in June, and further to only US$ 657 during September.

[15] Wheat production in Rabi 2014 had increased by 4.4 percent YoY. Furthermore, the country imported 275,000 MT of wheat during August and September 2014.

[16] In Q1-FY14, Pakistan had doubled its onion exports, mainly to compensate for the damage to Indian crop. This had caused a demand-supply gap in local market, which put upward pressures on

Figure 3.6: Inflation Trends in 20 Heaviest Items in the CPI Basket

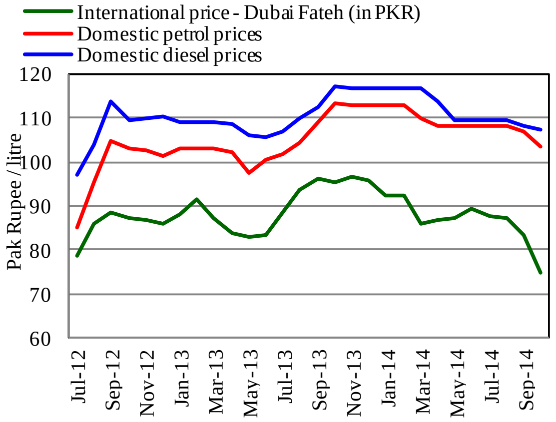


Figures in paranthesis show weights of respecitive commodities in the CPI basket.
Source: Pakistan Bureau of Statistics

Administered prices continue to influence headline inflation

The government increased electricity tariffs on various consumption slabs, by an average of 16 percent in October 2013. This increase alone contributed 0.7 percentage points to inflation during Q1-FY15. This contribution would have been more pronounced, if the government had increased the tariffs further, as committed.

Figure 3.7: Comparison of International Oil Prices and Domestic Fuel Prices



Source: Pakistan Bureau of Statistics; IMF and SBP (for exchange rate data)

In case of motor fuel, despite a significant easing in the international prices of crude oil, there was only a nominal reduction in the domestic fuel prices during Q1-FY15 (**Figure 3.7**). However, in October, the government further reduced oil prices (by Rs 3.3 per litre), and a much more significant reduction at end-November 2014.

---

its price. In case of tomatoes, local crop had suffered damages in Q1-FY14. Although the government increased its imports from India, but quantities were not sufficient to fill the demand-supply gap.

It is interesting to note that some consumer items like kerosene oil, cigarettes, soft drinks etc. are selling at above their retail prices either fixed by the government or manufacturers. Provincial Supply and Prices Departments as well as their 'Bureau of Supplies and Prices' are entrusted by the federal government to check this practice under the relevant laws[17].

Increases in cigarette prices
The 2014-15 Budget did not specifically increase federal excise duties on cigarettes, but its imposition at the wholesale and retail level was simplified and re-structured. More specifically, from three-slabs based on a composite formula, the duty is now levied on two-slabs based on a specific rate. This simplification resulted in higher retail prices of cigarettes (an increase of 13.5 - 27.6 percent for different brands). Cigarettes alone contributed 0.4 percentage points to overall CPI inflation during Q1-FY15.

Going forward
In November 2014, the CPI inflation has come down to a 13-year low of 4.0 percent, reflecting the impact of downward revision in domestic fuel prices announced at end-October, 2014, and ease in food supplies. This softening has been more broad-based, as it was contributed by food items, as well as housing, water, electricity, gas group.[18] Various factors that feed into our assessment on inflation through rest of the year are listed below: [19]

- Another large downward revision in POL prices announced at end-November 2014, is expected to reduce the motor fuel inflation through its direct effect on CPI inflation as well as through cost-push inflation in other items;

- With falling international oil prices, the government has now the comfort to defer the decision to increase power tariffs further;

- According to IBA-SBP consumer confidence survey of November 2014, inflation expectations remain soft for the next six months. The major fall

[17] Price Control and Prevention of Profiteering and Hoarding Act, 1977.
[18] The contribution of these items in overall CPI inflation declined to 2.2 percentage points and 1.4 percentage points as compared to contribution of 2.8 and 2.2 percentage points respectively in average quarterly inflation Q1-FY15.
[19] Through two separate notifications, the federal government had imposed 52 paisa per unit and Rs1.50 per unit equalization surcharges on electricity consumers.

is expected in energy inflation (an outcome of lower oil prices), followed by the food inflation;

- Since fuel prices are correlated with inflation expectations of households, falling domestic POL prices are expected to positively influence their inflation expectations; and

- The stable PKR against the US dollar will further agument the positive impact of falling international commodity prices, especially crude oil and food, on domestic inflation. [20]

- However, the likely imposition of gas infrastructure development cess (GIDC) in January 2015, could positively impact inflation.

[20] The inflow of US$ 2.1 billion in December 2014 on account of International Sukuk, and 4th & 5th tranche of EFF from the IMF, has brought stability to the PKR.