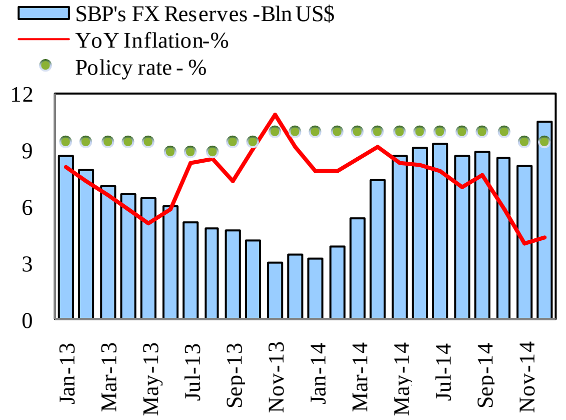
3 Inflation and Monetary Policy

3.1 Overview

The second quarter of the year marked the beginning of monetary easing, as SBP cut the policy rate by 50 bps to 9.5 percent in mid-November 2014 (**Figure 3.1**).[1] This change in monetary policy stance was primarily driven by a visible improvement in both inflation and inflationary outlook; the growing comfort on external front; and some positive developments vis-à-vis the government efforts towards fiscal consolidation.

Figure 3.1: Key Indicators of Policy Environment



Source: State Bank of Pakistan

These developments gained further momentum in subsequent period. Specifically, Pakistan successfully launched a five-year dollar-denominated Sukuk in international market by end-November 2014[2]; the successful completion of the 5th review of the IMF program resulted in the disbursement of US$ 1.1 billion in December 2014; and the current account recorded a surplus of US$ 76.0 million during the month of December 2014, largely due to a contraction in the trade deficit and stronger remittances. These improvements, coupled with a decline in inflation and lower government borrowing from the banking system, allowed the central bank to ease its monetary policy. The policy rate was further cut by a cumulative 150 bps to a ten-year low of 8.0 percent in the monetary policy decisions of January and March 2015.

Prior to the change in policy stance, SBP not only held up the policy rate unchanged during the initial months of the year, but also kept liquidity tight in

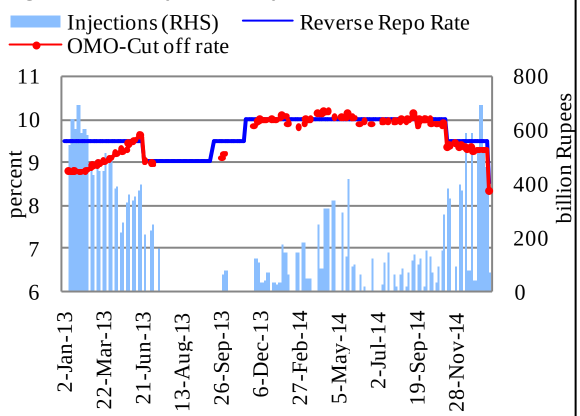
[1] After a cumulative 100 bps increase in the policy rate during Jul-Nov 2013, it was kept unchanged for a full year till November 2014.
[2] Against the target of US$ 500 million, total bids worth US$ 2.3 billion were received.

money market. This was considered necessary to ensure stability in foreign exchange market, and to contain relatively higher non-food inflation.

However, the fall in global oil prices, softening commodity prices, stability in exchange rate, limited impact of floods on food inflation, and lagged impact of monetary tightening, contained inflation.[3] Specifically, inflation declined sharply from September 2014 onwards, and reached a decade-low of 2.5 percent in March 2015.

Among other factors, sharp fall in commodity prices has also impacted bank credit in H1-FY15.[4] So far net credit to the private sector has expanded by Rs 222.3 billion in H1-FY15, compared with Rs 321.3 billion during the same period last year. This, together with lower government borrowing from the banking sector, contained money supply during the period under review. Specifically, broad money supply (M2) grew by only 4.4 percent during H1-FY15, compared with 6.0 percent during the same period last year.

Figure 3.2: Money Market Dynamics



Source: State Bank of Pakistan

3.2 Liquidity conditions

With the comfort on the external front, coupled with the change in monetary policy stance to ensure smooth flow of bank credit to the private sector, SBP stepped up liquidity injections from November 2014 through its open market operations (OMOs) (**Figure 3.2**). The volume of OMOs increased sharply and

[3] It is important to mention here that risks to inflationary outlook dissipated only in the second quarter of the year. Initially it was feared that floods would have a serious impact on the prices of perishable items, while non-food inflation was expected to increase due to planned increase in electricity tariff.

[4] On the one hand, a sharp fall in inflation increased the real cost of borrowing during the period under review: inflation adjusted weighted average lending rate (WALR) during H1-FY15 stood at 5.2 percent, compared with 1.9 percent during the same period last year (the WALR used to calculate the real cost of borrowing does not include zero-markup and inter-bank loans). On the other hand, fall in commodity prices (especially of oil, cotton, and rice) reduced demand for bank credit.

crossed Rs 500 billion in December 2014. The OMO cut-off rate also decreased, as SBP was willing to accept more bids. In this context, following points are worth noting.

1. During 15th Nov-31st Dec 2014, the *acceptance to bid* ratio in OMOs stood at 97.9 percent, compared with 90.7 percent in OMOs held during 1st Jul-14th Nov 2014;
2. Average volume of liquidity injection through OMOs also increased from Rs 94.2 billion during 1st Jul-14th Nov 2014, to Rs 319.3 billion during 15th Nov-31st Dec 2014; and
3. The OMO cut-off rate also reflected SBP willingness to provide liquidity, as it was kept visibly *lower* than the policy rate (**Figure 3.2**).

The above points indicate that overall liquidity was at ease after the change in monetary policy stance. However, despite this improvement, bank-specific liquidity problems continued to persist during the second quarter of the year. Specifically, banks borrowed Rs 1,170.4 billion from SBP in 118 visits during Q2-FY15, against Rs 693.3 billion in 98 visits during Q1-FY15.

3.3 Monetary aggregates

Broad money supply increased by 4.4 percent during H1-FY15, compared with 6.0 percent during the same period last year. This deceleration was primarily due to lower government borrowing and subdued growth in credit to the private sector. These factors helped contain growth in NDA of the banking sector, especially of SBP's NDA (**Table 3.1**).

3.3.1 Net foreign assets (NFA)

NFA of the banking sector saw a net expansion of Rs 47.6 billion during H1-FY15, in sharp contrast to a net contraction of Rs 215.2 billion during the same period last year. Quarterly bifurcation of data indicates that the expansionary impact was entirely concentrated in second quarter of the year: a reflection of visible improvement on the external front.

Within the banking sector, NFA of SBP expanded by Rs 65.4 billion during H1-FY15, against a net contraction of Rs 229.8 billion during the same period last year. This sharp reversal was largely attributed to issuance of a Sukuk bond, and other multilateral inflows (excluding IMF).

On the other hand, NFA of scheduled banks contracted by Rs 17.7 billion during H1-FY15 against the net expansion of Rs 14.6 billion during the same period last year. This contraction stemmed primarily from a rise of US$ 425 million in import financing (against FE-25 deposits) during H1-FY15.[5] Since overall FE-25 deposits increased only by US$ 65 million, commercial banks had to withdraw their placements/balances held abroad to finance these loans. This caused a reduction in their NFA.[6]

Table 3.1: Absolute changes Monetary Aggregates (Jul-Dec)

billion Rupees

	FY14			FY15		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Money Supply (M2)	21.5	506.4	527.9	-6.0	448.8	442.8
NDA	194.6	548.4	743.0	25.0	370.1	395.2
SBP	174.2	161.2	335.5	-67.1	-139.1	-206.1
Commercial Banks	20.4	387.2	407.6	92.1	509.2	601.3
NFA	-173.2	-42.0	-215.2	-31.1	78.7	47.6
SBP	-146.1	-83.7	-229.8	-8.0	73.4	65.4
Commercial Banks	-27.1	41.7	14.6	-23.0	5.3	-17.7

Source: State Bank of Pakistan

3.3.2 Net domestic assets (NDA)

H1-FY15 expansion in NDA of the banking system was almost half the increase seen during the same period last year. The institutional break up shows that sharp deceleration was entirely stemming from a huge contraction of Rs 206.1 billion in the NDA of SBP. This contraction was on cards as the government was required to contain its budgetary borrowing from SBP within the limit agreed with the IMF (under the program) for end December 2014, especially after missing the target for end September 2014.[7] It is encouraging to note that the contraction was large enough to facilitate SBP in meeting the IMF ceiling on its NDA for end December 2014.

[5] The increase in import financing was much larger compared to an overall increase in FE-25 deposits (US$ 65 million) during this period.

[6] Banks' placements/investments abroad are effectively a claim on foreigners (included in NFA), whereas trade financing is a claim on domestic exporters/importers (included in NDA).

[7] IMF ceiling on net budgetary borrowing from SBP for end-December 2014 was Rs 2,000 billion, compared with Rs 2,328 billion for end June 2014. This indicates a net retirement of Rs 328 billion during H1-FY15.

One of the key factors behind net contraction in NDA of SBP was the government efforts to switch its borrowing away from SBP to commercial banks (more on this later). The impact of change in sources of government borrowing was also amply visible from sharp increase in NDA of the commercial banks. Specifically, despite subdued growth in credit expansion, NDA of commercial banks expanded by Rs 601.3 billion during H1-FY15, against an increase of Rs 407.6 billion during the same period last year.

Table 3.2: Net Budgetary Borrowing

billion Rupees

	FY14			FY15		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Banking System	198.0	285.3	483.3	139.9	59.1	199.0
SBP	352.8	90.3	443.1	-39.0	-374.4	-413.4
Scheduled banks	-154.8	195.0	40.1	178.9	433.5	612.4

Source: State Bank of Pakistan

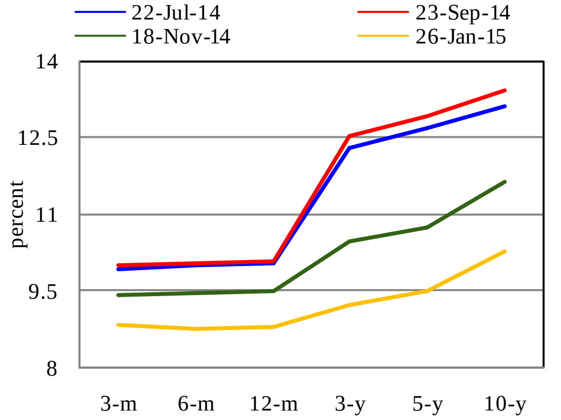
***Government borrowing*[8]**

On a positive note, government borrowing from the banking system in H1-FY15 was less than half the amount that government borrowed during the same period last year. Moreover, the government was not only able to meet the limit on its borrowing from central bank under the SBP Act 1956, it was also able to contain its borrowing from SBP within the ceiling agreed with the IMF for end December 2014.[9] Specifically, the government retired Rs 374.4 billion to SBP during second quarter of the year, taking the cumulative retirement to Rs 413.4 billion during H1-FY15. This was almost the mirror image of the pattern of government borrowing from SBP in H1-FY14: an increase of Rs 443.1 billion (**Table 3.2**).

Further details on government borrowing indicate that massive (net) retirement to SBP was partially funded by government borrowing from commercial banks. Specifically, the government borrowed Rs 612.4 billion (in net terms) from commercial banks during first half of the year, compared with only Rs 40.1 billion during the same period last year.

[8] Discussion in this section is based on government borrowing data on cash basis, which will not match with the Monetary Survey data compiled on accrual basis.
[9] It is pertinent to mentioned here that the government missed the IMF ceiling on budgetary borrowing from SBP for end September 2014.

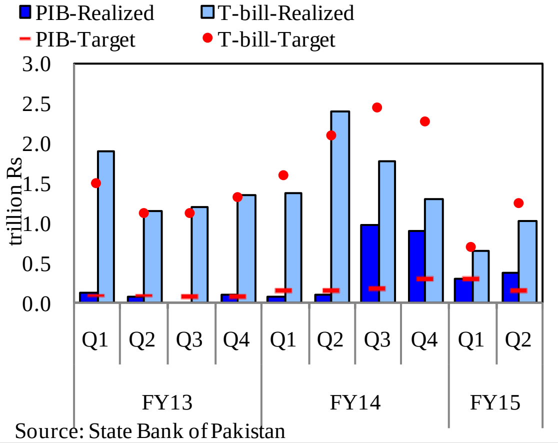
Figure 3.3: Secondary Market Yields



Source: State Bank of Pakistan

In fact, while the government was switching its borrowing away from SBP to commercial banks in a bid to meet the IMF targets, the commercial banks were also aggressively participating in primary auctions of government securities to lock-in their funds at higher interest rates in anticipation of a cut in the policy rate. Specifically, commercial banks offered Rs 832.9 billion in PIB auctions during Q2-FY15 against the cumulative target of only Rs 150.0 billion.[10] In fact, banks were eager to exploit the disconnect between the short (up to one year) and medium to long end of yields, before the change in monetary policy (**Figure 3.3**).

Figure 3.4: Auction Profile



Source: State Bank of Pakistan

For the same reason, T-bills became less attractive: commercial banks offered much less than the target in nearly all the auctions held during this period.[11] In net terms, the government accepted Rs 969.7 billion in these auctions, which was less than the maturing amount (**Figure 3.4**). However, banks' appetite for T-bills has revived as the disconnect between the T-bills and PIB segments of the yield curve vanished following the monetary policy decision of January 2015 (**Figure 3.3**). The swift pass-through of cut in the policy rate to secondary market yield of

[10] This allowed the government to realize Rs 372.7 billion from PIB auctions, despite reducing the cut-off rate even before the cut in policy rates.
[11] Against the cumulative target of Rs 1,245 billion, commercial banks offered Rs 1,035.5 billion during Q2-FY15.

government securities is also visible from the yield curves. Data indicates that 50 bps cut in the policy rate in November 2014 was reflected in the yields of MTBs and PIBs, which fell by 49 and 158 bps respectively.[12]

Commodity operations

Being a period of seasonal retirement, loans for commodity operations recorded a net contraction of Rs 25.6 billion during H1-FY15. However, this retirement was substantially lower than the net reduction of Rs 88.5 billion during the same period last year (**Table 3.3**). Within commodity finance, wheat financing showed less retirements during H1-FY15, compared with the same period last year. This was because despite the available stocks with public procurement agencies, private sector imported 0.7 million tons to benefit from lower global prices. Therefore, these agencies were unable to offload their stocks and could not make seasonal retirements to commercial banks (**Chapter 2**). Moreover, higher retirement in the last year was largely attributed to aggressive off loading of wheat stocks by the provincial food departments to stabilize wheat prices, especially in Q2-FY14.

Table 3.3: Loans for commodity operations (Jul-Dec)

billion Rupees

	FY14	FY15
Wheat	-85.3	-23.1
Sugar	-3.0	-2.0
Fertilizer	-0.3	-0.5
Rice	0.0	0.1
Total	-88.5	-25.6

Source: State Bank of Pakistan

In aggregate, outstanding loans for commodity operations stood at Rs 466.8 billion as of end December 2014, compared with Rs 381.2 billion at the same time a year before. Further details indicate that around 50 percent of these loans are backed by commodity stocks, while the rest of the amount is receivables on account of subsidies and sales proceeds. This entails unfavorable implications for fiscal operations. Specifically, receivable subsidies of Rs 186.1 billion are a pending liability of the government, and the potential revaluation losses of hypothecated wheat stocks could also be a burden on scarce fiscal resources. As repeatedly highlighted in SBP's Annual and Quarterly Reports, timely settlement of such receivables will not only help improve fiscal transparency, but also be cost effective for the government.

[12] It is pertinent to mention here that while short term interest rates were moving in line with the policy rate, long term interest rates fell sharply, in anticipation of a further rate cut.

3.4 Credit to private sector

Credit to private sector recorded a YoY growth of 6.0 percent during H1-FY15 compared with 9.6 percent during the same period last year. Both demand and supply factors contributed to this slowdown. On the supply side, a rise in government borrowing from commercial banks and subdued growth in banks deposit, reduced available funds for the private sector during the period under review. On the demand side, softening commodity prices (especially of cotton, rice and sugarcane), persistent energy shortages, and healthy profitability, curtailed the demand for bank credit. Gross disbursements data also shows that average disbursements (Rs 867 billion) during H1-FY15 remained lower than (Rs 1024 billion) in H1-FY14.

Table 3.4: Changes in credit to private sector (Jul-Dec)
billion Rupees

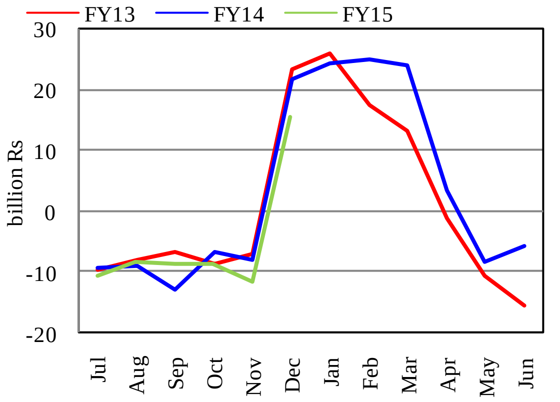
	FY14	FY15
Credit to private sector (MS)	321.3	222.3
of which		
A) Credit to NBFIs	-13.3	-13.0
B) Private sector business	271.8	207.6
of which		
Working Capital	165.4	84.5
Fixed Investment	51.4	36.9
Export Financing	27.6	44.6
Import Financing	27.5	41.5
C) Consumer financing	18.1	11.4
of which		
Personal Loans	13.0	4.9
Auto Loans	5.6	7.4

Source: State Bank of Pakistan; MS: Monetary Survey

Credit demand from private businesses

Within private businesses, the deceleration in credit off take can be traced to lower demand from the manufacturing sector, as the agriculture sector borrowing remained at the level seen in H1-FY14. Specifically, loans to manufacturing sector expanded by Rs 114.6 billion during H1-FY15, compared with an increase of Rs 165.0 billion during the same period last year (**Table 3.5**). This slowdown was largely coming from the food, textile and energy sectors.

Figure 3.5: Credit Cycle of Sugar Industry



Source:State Bank of Pakistan

Textiles: Credit to the textile sector was almost half the increase seen in H1-FY14, as lower cotton prices and a subdued international demand for cotton yarn, contained the working capital requirement. Furthermore, textile industry retired fixed investment loans, which were availed last year to expand and upgrade their capacities to optimize benefits of GSP plus status in the EU.

Table 3.5: Credit to private sector businesses (Jul-Dec)
changes in billion rupees

	Abs. Change		Working capital		Fixed Investment		Trade financing	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Private sector business	271.8	207.6	165.4	84.5	51.4	36.9	55.0	86.1
1) Agriculture	17.1	18.3	13.8	11.1	2.4	7.5	0.9	-0.3
2) Manufacturing	165.0	114.6	96.0	27.1	38.5	19.8	30.5	67.7
Food & beverages	20.9	15.0	2.3	-17.1	10.8	9.5	7.8	22.6
Rice	40.8	26.7	30.0	16.3	0.9	2.0	9.8	8.4
Sugar	-23.9	-31.2	-28.0	-43.9	6.5	12.2	-2.4	0.5
Beverages	3.9	4.7	4.5	-2.9	-0.4	6.2	-0.2	1.4
Edible oil & Ghee	40.8	26.7	1.2	7.5	0.1	-3.8	39.5	23.0
Feeding stuff animals	1.9	7.2	3.7	4.6	0.1	0.1	-1.9	2.4
Textile	100.0	57.7	80.5	34.8	5.6	-1.4	13.9	24.4
Cement	0.4	4.8	-5.2	3.1	6.4	-0.8	-0.9	2.5
Petroleum Products	11.9	14.4	-4.8	7.3	10.3	5.7	6.4	1.3
Basic Metals	8.2	5.7	6.3	-0.1	2.2	-0.9	-0.3	6.6
3) Electricity	31.5	-4.4	22.3	6.5	6.8	-9.5	2.4	-1.4
4) Telecom	-4.6	10.8	1.2	11.5	-6.6	-0.6	0.8	-0.1
5) Others*	86.4	85.2	49.1	27.4	13.4	27.4	23.9	30.5

*Fishing, hotel, transport, education, commerce & trade, construction, mining & quarrying, ship breaking, real estate, health, etc.
Source: State Bank of Pakistan

Food & beverages: loans to food & beverages sector increased by Rs 15.0 billion during H1-FY15, compared with a rise of Rs 20.9 billion during the same period last year. Within food group, major slowdown was seen in the category of loans for rice processing. Given the recent decline in rice prices, the demand for working capital loans was expected to remain subdued.[13]

In line with the typical credit cycle, sugar firms retired bank loans in H1-FY15 (**Figure 3.5**).[14] However, retirements were higher this season as pricing issues delayed cane crushing (**Chapter 2**).[15] In contrast, credit to beverage firms

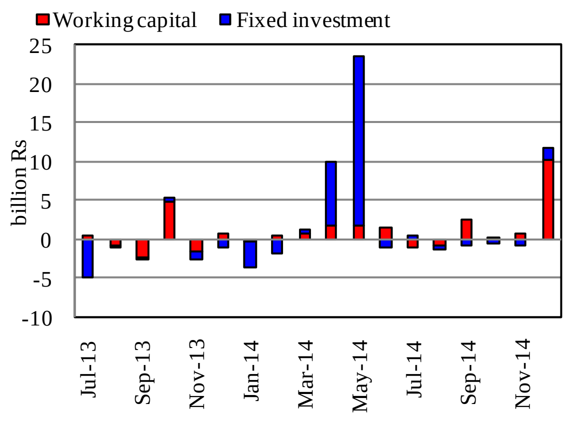
[13] Anecdotal evidences suggests that price of paddy is ranging between Rs 1,500-1,600/40 kg in FY15, compared with Rs 2400-2500/40 kg in FY14.
[14] Sugar industry's credit cycle indicates that the bulk of the retirement takes place during the first quarter of a year, after which credit off-take increases as cane crushing generally starts in early November
[15] Impact of prolonged problem is clearly visible from data on sugar production. Specifically, sugar production in November 2014 stood at 11.6 thousand tonnes, compared with 61.1 thousand tonnes in November 2013.

increased marginally, particularly in the category of fixed investment loans. One of the leading producers is in the process of establishing three green-field production plants.[16]

Energy: electricity-related enterprises retired Rs 4.4 billion during H1-FY15, in contrast with a net expansion of Rs 31.5 billion in H1-FY14. It is important to recall here that government had settled outstanding receivables in the power sector during June and July 2013. As a result, a few private power plants restarted their operations, which generated additional demand for working capital loans in H1-FY14. This impact was missing in H1-FY15. Moreover, smooth settlement of Tariff Differential Subsidies (TDS) by the government, also helped contain liquidity problems of the energy sector.

Telecom: telecom was one of the few sectors in which credit off-take remained higher than last year. Specifically, in contrast to a net retirement of Rs 4.6 billion during H1-FY14, credit to cellular companies expanded by Rs 10.8 billion during H1-FY15. The appetite for working capital loans has increased since the launch of 3G/4G in April 2014 (**Figure 3.6**). Furthermore, this may also reflect purchasing of equipments by cellular firms related to bio-metric verification.

Figure 3.6: Credit Availed by Telecom Sector



Petroleum: credit to petroleum sector expanded by Rs 14.4 billion during H1-FY15, compared with a rise of Rs 11.9 billion during the same period last year. This increase in credit was primarily driven by liquidity requirements of refineries, to finance their day to day production activities.[17] Most importantly, increasing inter-agency receivables and delays in naphtha exports (due to lower price at

[16] Beverages sector has been performing well from the last three years due to rising demand and resultant capacity expansion by firms. FDI inflows to beverage sector stood at US$ 14.2 million during H1-FY15.
[17] Production of petroleum products increased by 2.7 percent during Jul-Dec FY15, compared with 8.3 percent during the same period last year.

international level, refineries followed the policy of wait and see), also created demand for working capital loans.[18]

Deceleration in consumer financing

Consumer financing increased by Rs 11.4 billion during H1-FY15, compared with a rise of Rs 18.1 billion during H1-FY14. Within consumer financing, personal loans saw a deceleration during the period under review, while the auto loans continued to increase. Amendment in regulations for car financing, which allowed banks to finance cars up to 9 years old, and high demand for the new model of Toyota Corolla, seem to be the contributory factors.[19] The deceleration in personal loans is primarily due to high base impact. A number of banks introduced innovative personal loan products, especially designed to cater to the needs of the middle and high income groups in previous years.[20]

3.5 Inflation

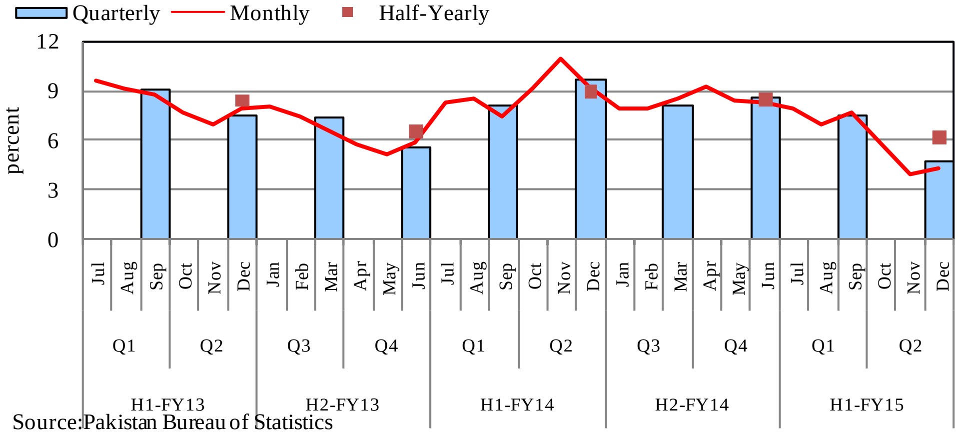
A sharp decline in global oil prices since July 2014, has pushed CPI inflation down to 6.1 percent in H1-FY15, from 8.9 percent during the same period last year (**Figure 3.7)**. This decline was more pronounced in the second quarter of the year, when global oil prices fell more sharply, and the government swiftly passed this on to domestic consumers. In addition, softening global prices of other commodities (like cotton, wheat, edible oil, sugar, etc.);[21] the lagged impact of tight monetary policy prevailed during Jul-2013 to Nov-2014; improved food supplies; and appreciation in the PKR; were among other factors contributing to low inflation during the quarter.

The decline in food and energy inflation had a spill-over impact on other consumer goods, which is evident from a sharp reduction in core inflation – as measure by trimmed mean (**Table 3.6**).[22] NFNE, another measure of the core inflation, also declined during the quarter.

While inflation in all commodity groups declined in recent months, a sharp reduction was seen in *transport* group, which showed a deflation of 1.8 percent in Q2-FY15, compared with an inflation of 6.9 percent in the corresponding period

[18] Exports of naphtha declined by 59.5 percent (in real terms) during Jul-Dec FY15.
[19] 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.
[20] Cash for Gold, Enhanced-Gold Schemes, etc., are some of the examples.
[21] IMF's Commodity Prices Index (overall) witnessed a more than 20 percent decline during Oct-Dec 2014. Commodity food index declined by 4.8 percent during this period.
[22] Trimmed mean core inflation is computed by excluding highly volatile items from the CPI basket.

Figure 3.7: CPI Inflation (YoY)



Source:Pakistan Bureau of Statistics

last year. However, within the *transport* group, fares of buses and taxi services declined only marginally, in contrast to a sharp reduction in the prices of petrol and diesel (**Figure 3.8**).[23]

Table 3.6: CPI Inflation
(percent)

	Overall	Food	Non-Food	Energy	Core NFNE	Core Trimmed
FY14:						
Q1	8.1	9.1	7.3	1.4	8.5	7.8
Q2	9.7	10.7	9.0	12.2	8.4	9.0
Q3	8.1	8.0	8.2	10.1	7.8	8.2
Q4	8.6	8.2	8.9	10.1	8.6	8.4
FY15:						
Q1	7.5	6.6	8.2	9.1	8.0	7.3
Q2	4.7	3.5	5.5	-2.5	7.1	5.4
H1-FY14	8.9	9.9	8.2	6.8	8.4	8.4
H1-FY15	6.1	5.0	6.8	3.0	7.6	6.4

Source: PBS

Reduction in domestic fuel prices also led to deflation in Administered Price Index – a sub-index of CPI, which declined by 0.2 percent in Q2-FY15, compared with an increase of 11.6 percent in Q2-FY14.[24] Although a few items in this index showed higher inflation than last year (like electricity charges for certain slabs, CNG prices, and motor vehicle tax), these were more than offset by a drastic cut in prices of POL and gas cylinder.

[23] The benefits of low fuel prices to consumers could have been even higher if the provincial governments have timely activated the district-level price control committees for fixing, monitoring and enforcing controls on transport fares and prices of other items. Serious and effective administrative measures are needed under the Price Control and Prevention of Profiteering and Hoarding Act, 1977, to manage prices of essential items.

[24] Administered price index is prepared by SBP's Research Department on the basis of commodity-wise PBS data. It has a weight of 12.22 percent in overall CPI, and 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.

During Q2-FY15 prices of perishable food items declined significantly due to adequate supply and likely savings in farm-to-market transport cost (**Figure 3.9**).[25] The overall index of perishable food items declined by 1.9 percent in Q2-FY15 – in sharp contrast to Q2-FY14, when this index witnessed an increase of 25.5 percent.

Figure 3.8: Fuel Prices Vs Transport Fares

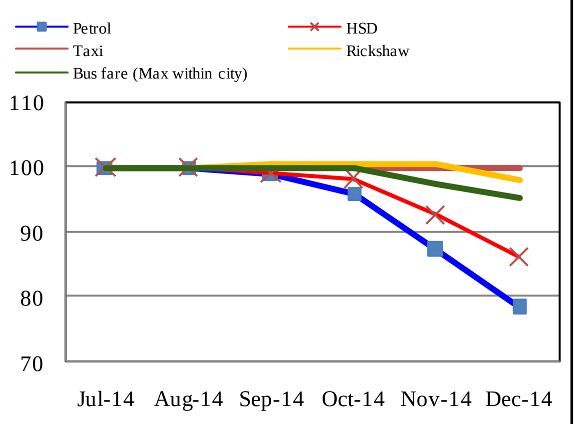
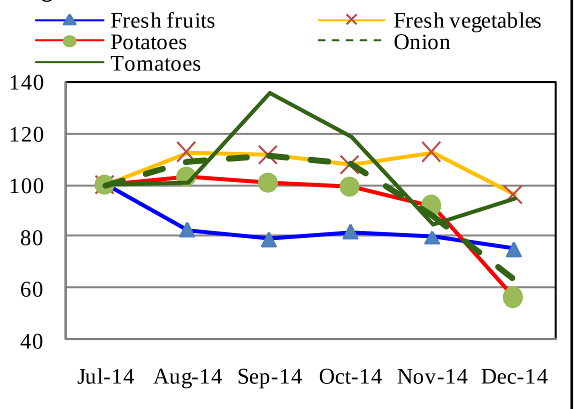


Figure 3.9: Movements in Prices of Perishable Food Items



Inflation expectations

Both POL prices and PKR exchange rate anchor inflation expectations of households and businesses.[26] Successive downward revisions in POL prices and a stable PKR along with subdued global commodity prices are, therefore, expected to keep inflation low in months ahead.

In addition, the survey-based inflation expectations indicator of January 2015, as measured by the IBA-SBP Consumer Confidence Survey (CCS), shows benign inflation expectations. Specifically, the index number measuring the medium-term inflation expectations (6-months-ahead inflation), gauged from one of the survey questions, has recorded an improvement of 1.4 and 3.4 percent in the two consecutive surveys conducted during November 2014 and January 2015, respectively. Similarly, a Financial Market measure of inflation expectations also

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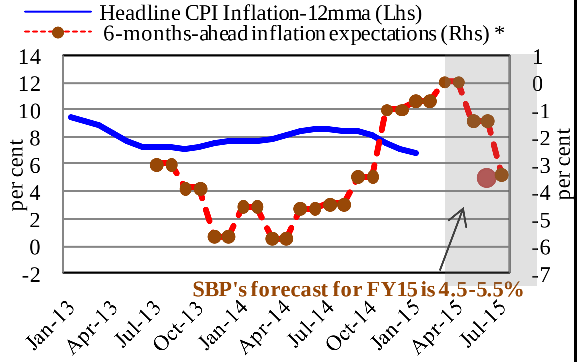
[25] Perishable food items include: fresh fruits, potatoes, onion, tomatoes and fresh vegetables.
[26] See Special Section 4.1: The Expectations Channel in Determining Inflation; by Dr. Ali Choudhary and Dr. Mushtaq Khan; SBP Annual Report, FY13, PP 68-70.

improved during last few months, as suggested by a 200 bps fall in long-term interest rates (on 10-years PIBs) since mid-November, 2014.[27]

As shown in **Figure 3.10**, the 6-months-ahead inflation expectations (a measure from IBA-SBP CCS) is one of the leading indicators of the headline CPI inflation. The improvement in both survey-based and market-based inflation expectations measures, coupled with the recent reduction in domestic oil prices, may lead to a sustained fall in CPI inflation in the medium-term.

Fig 3.10: Inflation Expectations vs. Headline CPI Inflation



*: This line shows YoY changes in the moving average of one of the indices of IBA-SBP CCS survey measuring overall inflation expectations for next 6-months.

Nevertheless, how long the inflation will remain at low trajectory will depend upon the behavior of global oil prices going forward. The recent trend of crude oil futures market suggests that the international oil prices have bottomed out, as shown by the upward movement of US$7 in the forward contract from the 6-years low prices of US$ 45.2 witnessed in the last week of January 2015.[28] The International Energy Agency (IEA) has projected that the average oil prices will stay around $55 per barrel in 2015. The future market trends also indicate that the average oil price will stay around US$66 till 2017.

The expected medium-term persistence of the lower international oil prices and some improvement in the energy shortages, might benefit Pakistan's economic growth to some extent in this fiscal year and a year after. Meanwhile, the IBA-SBP Consumer Confidence Index (CCI) also indicates the better economic conditions in the next 6-months as the CCI has recorded an improvement of 12.4 percent from 137.6 to 154.6 in the survey conducted in January 2015 over

[27] While in the survey-based measure of inflation expectations, the respondents are directly asked about the expected inflation, a Financial Market measure of inflation expectations involves inferring medium to long-term inflation expectations from the yield curve. Specifically, money market interest rates on the long-term government bonds reflect a compensation for expected inflation over the time horizon of the bonds, besides showing a reward for postponing current consumption and a liquidity premium.

[28] See http://quotes.ino.com/exchanges/contracts.html?r=NYMEX_CL for detail.

November, 2014.[29] In line with these improved general economic conditions, the respondents of the IBA-SBP Consumer Confidence Survey also consider this time as a good time for making durable goods purchases.

[29] This was the highest level this index has reached since its creation.