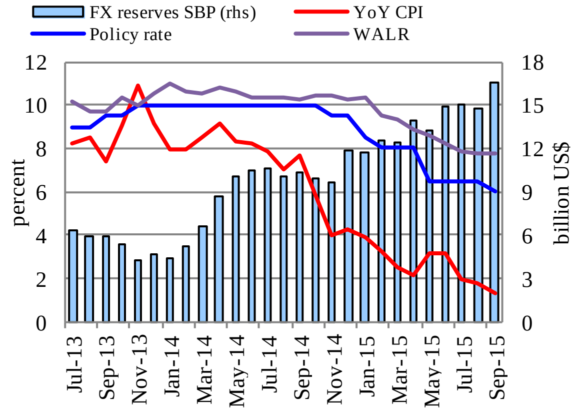
3 Inflation and Monetary Policy

3.1 Overview

Figure 3.1: Policy Environment - Key Indicators



Source: State Bank of Pakistan

Monetary easing, which was initiated last year, continued during the first quarter of FY16 as well. SBP slashed its policy rate by 50 bps to decades' low of 6.0 percent in September 2015, on top of a cumulative 350 bps reduction in FY15. Favorable macroeconomic environment was the key: a sharp fall in headline CPI inflation, together with subdued inflationary outlook; comfort on external front including all time high level of the country's FX reserves;[1] and contained budgetary deficit along with the continued shift in its financing away from SBP. In addition, elevated real cost of borrowing (inflation adjusted lending rates) and weak investment activity, called for a rate cut (**Figure 3.1**).[2]

Headline CPI inflation continued to decline in Q1-FY16. It fell from 7.5 percent in Q1-FY15, to only 1.7 percent in the quarter under review. Though prudent monetary management was a containing factor, primary impetus came from a continued fall in international oil and other commodity prices. Continuation of swift pass-through of a fall in international oil prices to domestic consumers in Q1-FY16 contained inflation both directly and indirectly. It led to 11.6 percent YoY deflation in *transport* group of CPI basket, and helped moderate inflation expectations of the households. Food inflation also receded due to lower commodity prices (wheat, rice & edible oil) and adequate supply of perishables. Controlling for the impact of these factors, core inflation comprising non-food and

[1] With an increase of US$ 1.4 billion during the quarter, Pakistan's liquid FX reserves surged to US$ 20.1 billion by end-September 2015. As of 23rd December 2015, the liquid reserves stood at US$ 21.1 billion. For detailed discussion, please see Chapter 5 on '**External Sector**'.

[2] CPI inflation adjusted weighted average lending rates stood at 5.2 percent in FY15, and 6.1 percent in Q1-FY16.

non-energy items, eased to 3.9 percent in Q1-FY16, compared with 8.0 percent during the same period last year.

However, recent developments have slightly enhanced upside risks to this low inflation. Specifically, the PKR has depreciated by 2.8 percent against US$ since end-June 2015 till 21st December 2015; petroleum prices have been revised upward from 1st November 2015; and higher growth in money supply, which may contribute to inflation by stimulating aggregate demand in the economy. Balancing the impact of these upside risks against the slump in international commodity prices, SBP projects average CPI inflation for FY16 to fall in the range of 3.5 to 4.5 percent; visibly lower than the inflation target of 6.0 percent for the year.

In addition to favorable impact on inflation, fall in international commodity prices continued to support Pakistan's external sector. The current account deficit for Q1-FY16, narrowed to only US$ 0.1 billion, which was comfortably financed by higher financial inflows: the issuance of Eurobond, commercial borrowing, and modest increase in FDI.

Impact of higher financial inflows is visible from changes in monetary aggregates. In absolute terms, net foreign assets of the banking system expanded by Rs 111.6 billion in Q1-FY16, against a net contraction of Rs 31.2 billion in Q1-FY15. Within the banking system, the expansion was entirely concentrated in SBP's NFA, reflecting official nature of financial inflows. This together with the expansionary impact of SBP's liquidity injections through open market operations, increased the reserve money by Rs 342.1 billion in Q1-FY16.

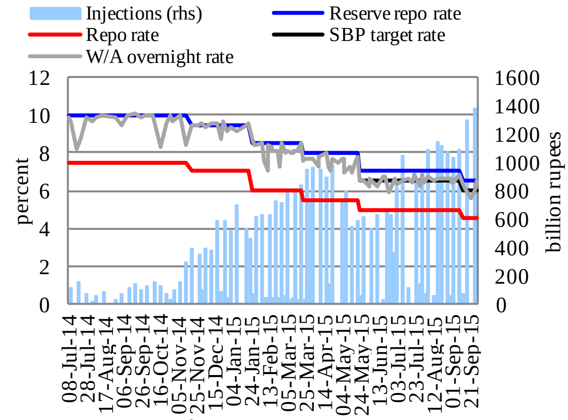
Despite a large increase in reserve money, the broad money supply (M2) expanded by only Rs 119.8 billion in Q1-FY16, due to net contractions in both NFA and NDA of scheduled banks. Specifically, change in NFA of scheduled banks reflects the monetary impact of an increase in trade financing against foreign currency (FE-25) deposits, which was largely financed by drawing down scheduled banks' assets held abroad.[3] The NDA of commercial banks, on the other hand, declined by Rs 197.0 billion in the quarter.

Within commercial banks' NDA, the private sector credit decreased by Rs 25.4 billion in Q1-FY16, compared with an increase of Rs 47.0 billion in Q1-FY15. These contrasting trends in CPS should be interpreted with caution because: (a)

[3] This led to a shift in scheduled banks' claim from foreigners (non-residents) to domestic (residents) borrowers.

gross disbursements of Rs 2,780.5 billion in Q1-FY16 were considerably higher than Rs 2,526.6 billion during the same period last year;[4] (b) fixed investment loans recorded a net increase of Rs 27.0. billion in Q1-FY16, against a net contraction of Rs 27.4 billion in the same period last year; (c) commodity prices, especially of cotton and rice are substantially lower in Q1-FY16, which have reduced working capital required for industrial raw materials; and (d) last year was an exception as the first quarter of the year is generally a period of retirement in credit cycle of Pakistan.[5]

Figure 3.2: SBP Liquidity Support via OMOs

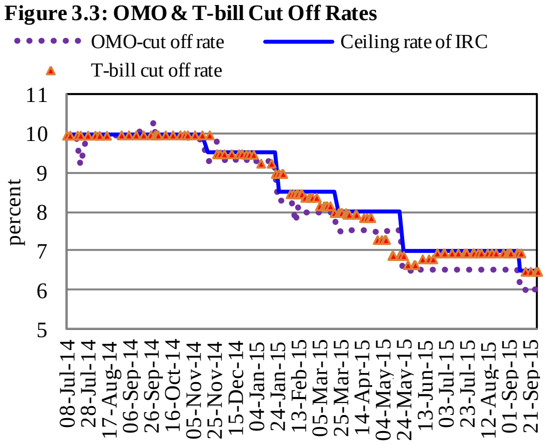


Source: State Bank of Pakistan

3.2 Money market developments

With the introduction of 'SBP policy rate' within the existing interest rate corridor (IRC) in May 2015, SBP ensures the overnight repo rate adjust according to the policy rate. As shown in **Figure 3.2**, SBP continued to inject liquidity through open market operations (OMOs) to keep the weighted average overnight repo rate close to the policy rate. This led to a substantial increase in the volume of OMOs, which peaked at Rs 1,374.0 billion in the last week of September 2015. In line with the revised IRC framework, SBP maintained OMO cut-off rates very close to the policy rate throughout the quarter (**Figure 3.3**). As a result, the acceptance to bid

Figure 3.3: OMO & T-bill Cut Off Rates



Source: State Bank of Pakistan

[4] The rise in gross disbursements was also reflected in healthy economic activity. LSM recorded a YoY growth of 3.9 percent in Q1-FY16, compared with a growth of 2.6 percent in Q1-FY15.

[5] Seasonal pattern was distorted by a sharp rise in trade financing in Q1-FY15, which overshadowed the seasonal retirements. Within trade financing, the expansion was primarily driven by higher imports of fertilizer, basic metals, petroleum products and edible oil.

ratio (on average) reached 92.8 percent in Q1-FY16, compared with 85.1 percent in the same period last year.

Despite huge liquidity injections, weighted average overnight rate generally fluctuated between the ceiling rate of IRC and the policy rate. Specifically, it was slightly above the policy rate for 44 of 59 working days during the quarter. However, the overnight rate was well below the IRC ceiling rate. This spread in money market interest rates, together with higher cut-off rates in T-bill auctions (close to the ceiling rate of IRC), created an opportunity for commercial banks to finance some of their investments in government securities by short term liquidity from SBP (**Figure 3.3**).

Table 3.1: Changes in Monetary Aggregates (Jul-Sep)
changes in billion rupees, growth in percent

	Change		Growth rate	
	FY15	**FY16**	**FY15**	**FY16**
Broad money (M2)	-6.0	119.8	-0.1	1.1
NFA	-31.2	111.6	-5.3	13.7
SBP	-8.2	150.9	-1.7	20.9
Scheduled banks	-23.0	-39.3	-20.7	-43.5
NDA	25.2	8.2	0.3	0.1
SBP	-66.9	205.2	-3.6	10.2
Scheduled banks	92.1	-197.0	1.2	-2.3
Government borrowing	97.1	157.2	1.6	2.3
For budgetary support (cash basis)	139.8	139.4	2.6	2.2
SBP	-39.0	-304.4	-1.7	-16.1
Scheduled banks	178.9	443.8	5.7	10.0
Commodity operations	-23.7	5.4	-4.8	0.9
Non government sector	46.5	-8.6	1.1	-0.2
Credit to private sector	47.0	-25.4	1.3	-0.6
Credit to PSEs	-0.4	17.2	-0.1	4.0
Other items net	-118.5	-140.4	15.7	16.0

Source: State Bank of Pakistan

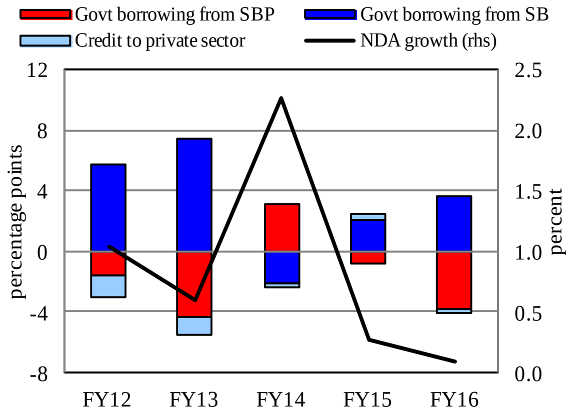
3.3 Developments in monetary aggregates

Broad money supply (M2) expanded by 1.1 percent in Q1-FY16, against a minor contraction of 0.1 percent during the corresponding period of FY15. Monetary expansion was largely driven by a visible improvement in external account, liquidity injections through OMOs, and government borrowing for budgetary finance. Within monetary aggregates, expansionary impact of these factors was partly offset by government's retirement to SBP and net contraction in credit to the private sector. In these setting, causative factors are briefly reviewed in the following discussion.

3.3.1 Net foreign assets (NFA)

Reflecting the monetary impact of favorable developments taking place on the external front, net foreign assets (NFA) of the banking system expanded by Rs 111.6 billion in Q1-FY16 against the contraction of Rs 31.2 billion in Q1-FY15. Within the banking system, the expansion was entirely concentrated in NFA of SBP, which increased by Rs 150.9 billion during the quarter. This was largely attributed to the issuance of Eurobond, commercial borrowing by the government, and CSF inflows.

Figure 3.4: Contribution to NDA Growth (Jul-Sep)



Source: State Bank of Pakistan

However, the expansionary impact of notable increase in SBP's NFA, was partly offset by Rs 39.3 billion contraction in NFA of commercial banks. A rise in trade financing against FE-25 deposits (US$ 152 million) was largely funded by withdrawing investments/ placement abroad, as the foreign currency deposits of commercial banks saw a net reduction in Q1-FY16.[6]

3.3.2 Net domestic assets (NDA)

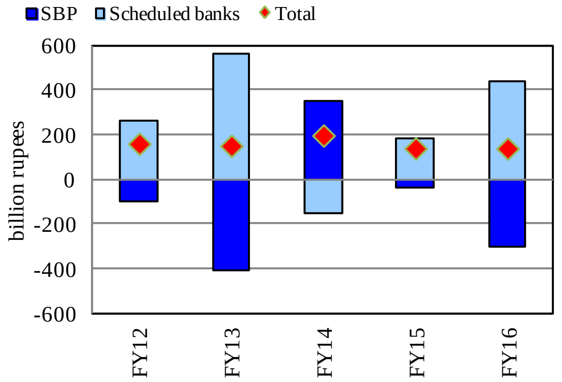
NDA of the banking system increased by only Rs 8.2 billion in Q1-FY16, compared with a rise of Rs 25.2 billion during the same period last year. This deceleration was attributed to net retirement in credit to the private sector, and increased liabilities of commercial banks (higher borrowing from SBP)(**Figure 3.4)**. These two factors largely contained the expansionary impact of government borrowing for budgetary finance during the quarter. Contributions of loans for commodity operations and credit to PSEs, were negligible in the overall NDA growth.

[6] With a net reduction of US$ 192 million during the quarter, FE-25 deposits of commercial banks stood at US$ 6,270 million by end-September 2015.

Government borrowing for budgetary support

On aggregate, the government's reliance on banking system for its budgetary support in Q1-FY16, was almost unchanged compared with the same period last year.[7] The pattern of borrowing also remained the same: net retirements to SBP, while borrowing from commercial banks. However, the volumes of net retirements to SBP and borrowing from commercial banks, were substantially higher in Q1-FY16, compared with Q1-FY15 (**Figure 3.5**).

Figure 3.5: Source of Budgetary Borrowings from the Banking System (Jul-Sep)



Source: State Bank of Pakistan

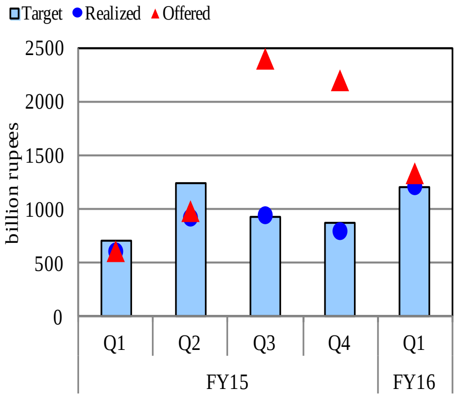
Specifically, the government borrowed Rs 443.8 billion (in net terms) from commercial banks in Q1-FY16, which was more than double the level of borrowing in Q1-FY15. This had notable implications for monetary management. On a positive note, the government retired Rs 304.4 billion (in net terms) to SBP during the quarter, which was more than seven times the level of retirement to SBP in the first quarter of last year. As a result, the government was able to contain its budgetary borrowing from SBP within the IMF target for end-September 2015. In addition, the government also met the quarterly limit of zero budgetary borrowing as prescribed in the SBP Act. Despite these favorable implications, it must be noted that heavy reliance on commercial bank funding may have reduced the scope for private sector credit.

Demand for government securities also remained high as commercial banks were eager to lock-in their funds in risk-free government securities in a declining interest rate scenario. Within government securities, PIBs were the preferred securities. The offered amount was four times of PIBs target in Q1-FY16, while the offered amount in T-bill auctions was close to the target (**Figure 3.6a & 3.6b**). This relatively higher demand for PIBs, allowed the government to realize the target amount at lower yields. Specifically, 3-year PIBs cut-off rate saw a reduction of 49 bps in the auction held in August 2015, indicating that the market

[7] In absolute term, the government borrowed Rs 139.4 billion for budgetary financing from the banking system in Q1-FY16, compared with Rs 139.8 billion in Q1-FY15.

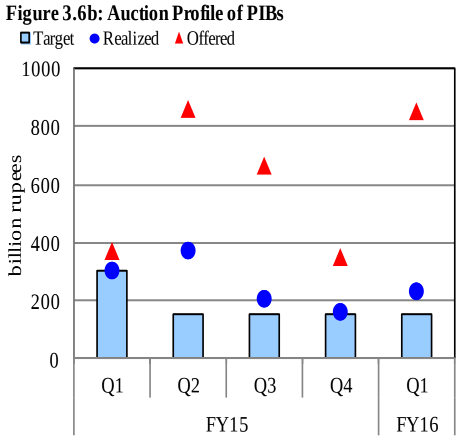
had factored in the 50 bps cut in the policy rate before the monetary policy announcement in September 2015.

Figure 3.6a: Auction Profile of T-Bills



Source: State Bank of Pakistan

Figure 3.6b: Auction Profile of PIBs



Source: State Bank of Pakistan

Commodity operations

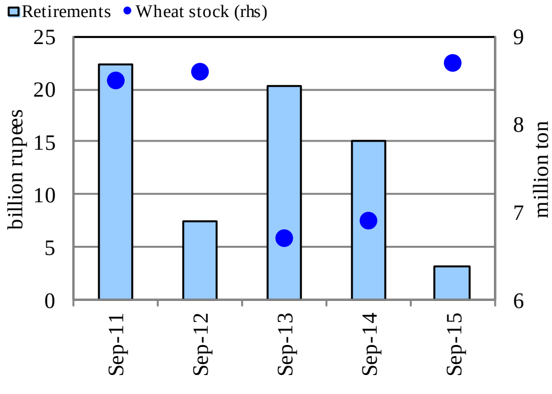
Despite being a period of seasonal retirement, loans for commodity operations saw a net increase of Rs 5.4 billion in Q1-FY16, against a net retirement of Rs 23.7 billion during the same period last year. This off-season rise was largely attributed to fresh borrowing for the procurement of sugar, fertilizer and rice, to stabilize domestic prices. Specifically, procurement agencies purchased sugar and rice from the domestic market.[8] Borrowing for these interventions contributed to pushing outstanding loans for commodity operations to Rs 569.8 billion by end-September 2015.

In addition to fresh borrowing, lower seasonal retirements also kept the outstanding level high. Specifically, loans for wheat procurement recorded a net retirement of only Rs 1.7 billion in Q1-FY16, which was one tenth of the amount retired during the same period last year. In fact, procurement agencies were unable to offload their last year's wheat stock, before the arrival of fresh crop (the procurement season). Wheat stock stood at 8.7 million ton by end-September 2015, compared with 7.0 million ton by end-September 2014. This impaired the

[8] The prices of sugar fell sharply in the international market, which incentivized the private sector to import 7.1 (000 MT) sugar during Jul-Sep FY16 compared with imports of 1.7 (000 MT) during Jul-Sep FY15. Specifically, the import unit value declined from 622US$/ton to only 401US$/ton. Similarly, 0.6 million MT of fertilizer was imported during the first quarter of FY16 compared with 0.4 million MT in Q1-FY15.

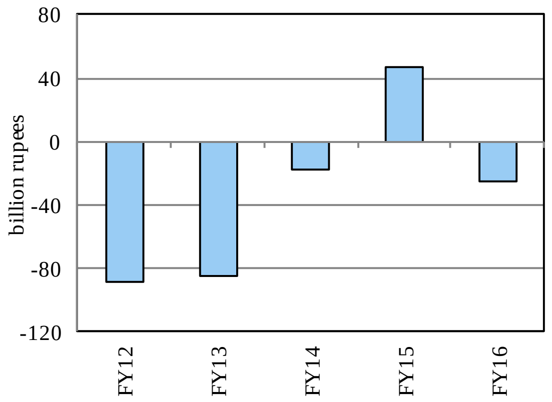
repayment capacity of the procurement agencies. As shown in **Figure 3.7,** higher wheat stocks accompanied by lower net retirement. Finally, the receivables on account of sale proceed (Rs 90.2 billion) and subsidies (Rs 182 billion) of the procurement agencies stood at Rs 272.2 billion by end September 2015. This has also undermined the ability of procurement agencies to retire some of their loans during the quarter.

Figure 3.7: Stock of Wheat Held by Procuring Agencies and Loan Retirements



Source: State Bank of Pakistan

Figure 3.8: Credit to the Private Sector (Jul-Sep)



Source: State Bank of Pakistan

3.4 Credit to private sector

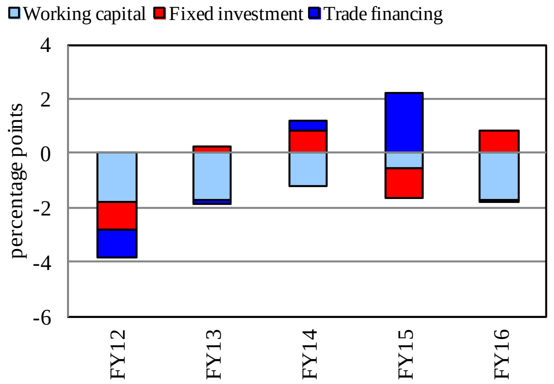
Credit to private sector recorded a net contraction of 0.6 percent in Q1-FY16, in contrast to an expansion of 1.3 percent during the same period last year. This must be interpreted with caution as: (a) the first quarter of the fiscal year is a period of seasonal retirement, and last year expansion was atypical of credit cycle (**Figure 3.8**);[9] (b) the net retirement in Q1-FY16 was much smaller than the average of last five years, i.e., Rs 33.9 billion; (c) gross disbursements were higher in Q1-FY16, compared with the same period last year; and (d) segment-wise distribution of loans to private business indicates that the net contraction in Q1-FY16 was entirely stemming from working capital and trade financing loans, which more than offset the rise in fixed investment loans (**Figure 3.9**). In addition, the sector specific developments also played a key role determining credit flows, which are briefly reviewed in the following discussion.

[9] Seasonal pattern was distorted by a sharp rise in trade financing in Q1-FY15, which overshadowed the seasonal retirements. Within trade financing, the expansion was primarily driven by higher imports of fertilizer, basic metals, petroleum products and edible oil.

Credit to agriculture sector

Loans to agriculture sector expanded by Rs 2.6 billion in Q1-FY16, which were one-fourth of the increase in Q1-FY15. Within major crops, credit need of rice crop was low due to fall in area under rice cultivation, and little incentive to invest on rice crop due to subdued price.[10] Cotton growers also faced similar challenges, with additional damages from heavy rains and pest attacks.[11] The use of input especially fertilizer recorded a decline during the period under review which also partially explains the slowdown in credit off-take. Lastly, accumulated wheat stocks with the procurement agencies (8.7 million tons as on 30 September 2015) and lower wheat price in international markets, suggest that credit for wheat crop is also likely to be low.[12]

Figure 3.9: Contribution to Private Sector Businesses Loans (Jul-Sep)



Source: State Bank of Pakistan

Credit to manufacturing sector

Loans to ***Food & beverage*** saw a net contraction of Rs 49.0 billion in Q1-FY16, which was more than double the amount retired in the same period last year (**Table 3.2**). The net retirement was concentrated in working capital and trade financing loans, while the fixed investment loans saw a modest increase during the quarter.

Within food sector, while the overall retirement by the ***rice*** mills was unchanged compared to the last year, there was a small increase in fixed investment loans in Q1-FY16. Anecdotal evidence suggests that some of the rice mills are investing in *rice bran oil extraction plants*.

[10] The price of rice fell by roughly 12.0 YoY percent during Q1-FY16.
[11] The production of cotton is estimated to fall from 13.96 million bales in FY15, to 10.86 million bales in FY16.
[12] Disbursements under relief package for agriculture, announced in September 2015, will have consequences on the credit cycle going forward.

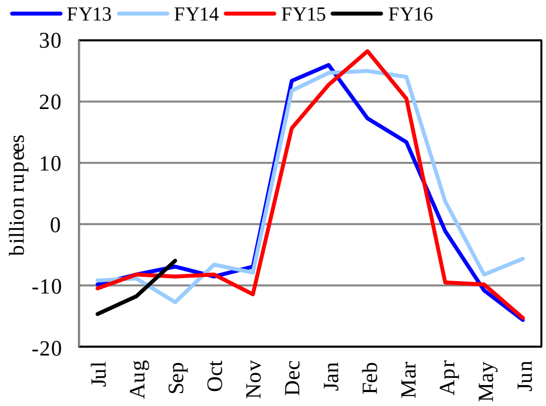
Table 3.2: Loans to Private Sector Businesses (Jul-Sep)

billion rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY15	FY16	FY15	FY16	FY15	FY16	FY15	FY16
Private sector business	13.6	-25.0	-16.9	-49.3	-27.4	27.0	57.9	-2.8
1) Agriculture	9.5	2.6	6.1	0.0	3.4	2.8	0.1	-0.1
2) Manufacturing	-14.7	-28.2	-46.6	-33.0	-9.4	7.7	41.2	-2.8
Food & beverages	-24.8	-49.0	-39.6	-50.9	0.4	2.7	14.5	-0.8
Rice	-11.5	-11.0	-12.3	-9.9	0.1	1.3	0.7	-2.4
Sugar	-27.2	-32.5	-35.1	-30.9	6.6	0.9	1.3	-2.4
Beverages	-3.3	-9.5	-4.1	-9.1	-0.1	-0.1	0.9	-0.3
Textile	-14.8	-8.7	-9.6	6.3	-6.5	-2.9	1.3	-12.1
Cement	2.8	0.9	2.8	-4.7	-1.2	5.2	1.3	0.4
3) Electricity	-2.1	-6.1	15.1	-8.8	-16.3	2.5	-0.8	0.1
4) Telecom	-0.6	-5.9	0.5	-7.4	-1.0	1.8	-0.2	-0.3
5) Ship breaking	8.0	-3.9	-0.1	-0.8	0.1	0.0	7.9	-3.2
6) Construction	-2.5	-2.5	-2.7	-2.3	0.0	0.9	0.2	-1.0
7) Real estate	8.8	6.8	5.0	2.2	1.5	2.6	2.2	2.0
8) Commerce & trade	1.3	-0.8	-2.6	-3.5	0.1	2.1	3.8	0.5
9) Land transport	0.1	6.7	0.1	0.0	-0.1	6.6	0.0	0.0
10) Others	5.9	6.3	8.2	4.3	-5.7	0.0	3.4	2.0

Source: State Bank of Pakistan

Figure 3.10: Sugar Credit Cycle (Monthly Flows)



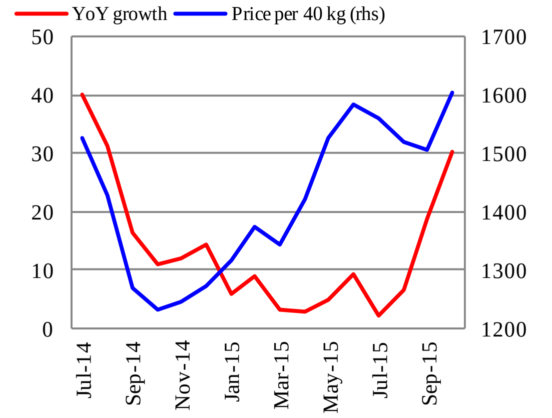
Source: State Bank of Pakistan

Sugar sector made slightly higher net retirements during Q1-FY16 compared to the same period last year (**Figure 3.10**). This was largely attributed to the fact that sugar mills were able to offload some of their stocks to the procurement agencies during the quarter.

The net retirements of ***textile*** in Q1-FY16 were almost half the amount retired in Q1-FY15. The composition of loans also changed drastically in Q1- FY16: working capital loans increased by Rs 6.3 billion during the quarter, in contrast with a decline of Rs 9.6 billion in Q1-

FY15. Although the production (quantum) of cotton is estimated to have declined from 13.9 million bales last year to 10.9 million bales in FY16, rise in cotton prices together with a modest increase in export of cotton, knitwear and towels, created demand for working capital loans during the quarter (**Figure 3.11**).

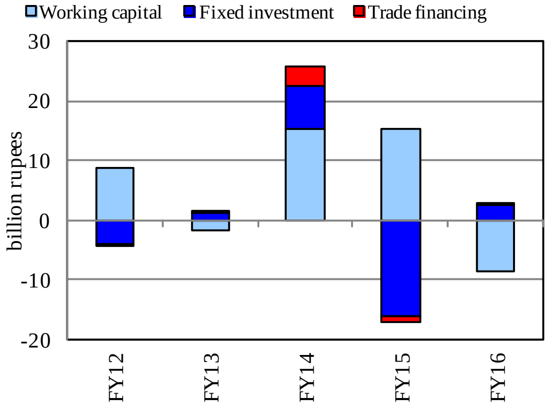
Figure 3.11: Cotton Seed Prices



Source: Pakistan Bureau of Statistics

Trade financing loans on the other hand recorded a net contraction of Rs 12.1 billion in Q1-FY16, in contrast with a net expansion of Rs 1.3 billion in Q1-FY15. This reversal was an outcome of deceleration of loans under the category of EFS. It must be recalled that in July 2014, EFS rate was cut from 8.4 percent to 7.5 percent after a gap of more than a year, which led to higher demand of EFS loans.[13] The rate was further reduced to 6.0 percent in February 2015. Since such loans had to be retired within 180 days; some of the loans availed in H2- FY15 were retired in Q1-FY16.

Figure 3.12: Distribution of Loans to Power Sector (Jul-Sep)



Source: State Bank of Pakistan

Eased liquidity conditions amid sharp fall of international oil prices bode well for producers and distributors of the ***power*** industry. Retirements made during Q1-FY16, were three times higher compared to the same period last year. Moreover, changes in composition of loans also differed from that of the last year. In Q1-FY16, retirement under the category of fixed investment loans was the major factor; this year

[13] It is pertinent to highlight that weaving and spinning mills are generally the biggest users of bank credit. However, knitwear and towel manufacturers were the major borrower in FY16.

retirements under the working capital loans pulled down the overall credit (**Figure 3.12**).

Loans for ***Land transport*** saw a notable expansion in Q1-FY16. This could be attributed to land transport for construction and road network, especially under China Pakistan Economic Corridor (CPEC).

Consumer financing

Consumer financing recorded a contraction of Rs 4.9 billion in Q1- FY16, against a rise of Rs 5.5 billion during the same period last year (**Table 3.3**). This decline in consumer financing is primarily attributed to personal loans, which concealed the increase recorded in auto financing.

Table 3.3: Consumer Financing

billion rupees, share in percent

	End September 2015		Change during Jul-Sep		
	Stock	**Share**	**FY14**	**FY15**	**FY16**
Consumer financing	268.9	100.0	13.6	5.5	-4.9
House building loans	41.7	15.5	-0.1	0.2	1.5
Auto loans	89.5	33.3	3.1	3.6	5.9
Credit cards	24.1	9.0	0.6	-0.1	0.2
Consumers durable	0.9	0.3	0.0	-0.1	0.5
Personal loans	112.7	41.9	10.1	1.9	-13.0

Source: State Bank of Pakistan

Within consumer financing, personal loans contracted by Rs 13.0 billion in Q1-FY16 against net expansions in the previous two years. As mentioned in earlier reports, a number of banks introduced innovative personal loan products such as Cash for Gold, Enhanced-Gold Schemes, especially designed to cater to the needs of the middle income group. As a result, personal loans saw a visible rise in the last two years. The retirement of such loans, along with lower fresh disbursements, dragged the overall consumer financing downwards.

Encouraging development in consumer financing is the successive rise in auto loans for the third year in a row, reflecting revival of auto financing. Quite similarly, house building loans also increased, which could be attributed to healthy construction activity.

3.5 Inflation

Headline inflation maintained its declining trajectory, and reached a 12-year low of 1.3 percent in September 2015. Average inflation for Q1-FY16 also plummeted to 1.7 percent, from 7.5 percent in the same period last year (**Table 3.4**). This deceleration was primarily driven by fall in international oil and commodity prices.[14] In addition, the prudent monetary management, and the favorable changes in the financing mix of budgetary deficit, also played their role in lowering inflation.

Table 3.4: CPI Inflation
percent

					Core inflation		
	Overall	Food	Non-Food	Energy	NFNE	Trimmed	RSC-CPI
FY15							
Q1	7.5	6.6	8.2	9.1	8.0	7.3	8.2
Q2	4.7	3.6	5.5	-2.5	7.1	5.5	7.4
Q3	3.2	1.9	5.5	-6.1	6.2	4.2	6.5
Q4	2.8	2.0	3.4	-5.0	4.9	3.6	5.2
FY16							
Q1	1.7	0.3	2.6	-4.0	3.9	2.8	4.3

Source: Pakistan Bureau of Statistics and State Bank of Pakistan

It is important to note that the decline in inflation was realized despite expected pressures from: (a) seasonal increase in prices due to Ramadan and Eid; (b) heavy rains in July 2015; and (c) upward adjustments in electricity and gas tariffs. Commodity-wise data indicates that rains in July did not have any significant impact on the prices of perishable items due to adequate supplies.[15] Similarly, upward adjustments in electricity and gas tariffs during the quarter, were more than offset by the fall in prices of petroleum products.

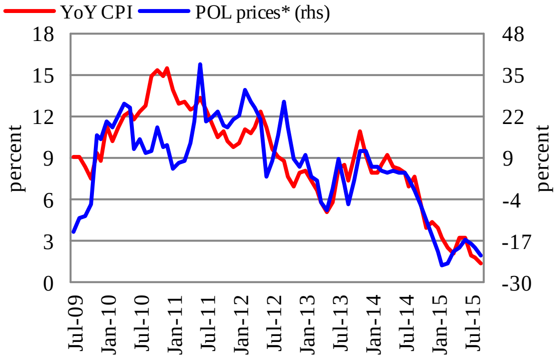
In fact, the government reduced the retail prices of POL products in two consecutive months (August and September 2015), which led to significant deflation of 11.6 percent in transport group of CPI basket in Q1-FY16 (**Figure 3.13**). In addition to this direct impact, the fall in oil prices also helped easing inflation expectations of households, and softening prices of other commodities in the CPI basket, through its spillover effects. The deflationary impact would have

[14] On YoY basis, there was a notable fall in international oil and commodity prices in Q1-FY16: crude oil (51%), sugar (30.1%), palm oil (10.7%), soybean (10.2%), cotton (2.5%), rice (7.8%) and wheat (3.6%). Source: Bloomberg

[15] Perishable items (fresh fruits, fresh vegetables, potatoes, onions and tomatoes) saw a deflation of 9.8 percent in Q1-FY16, compared with an inflation of 11.3 percent during same period last year. Imports from neighboring countries also helped check on prices of some perishable items such as tomatoes.

been much higher, had the government not increased the rate of sales tax on petrol from 20.0 to 25.5 percent in September 2015.

Figure 3.13: Headline Inflation and Change in POL Prices

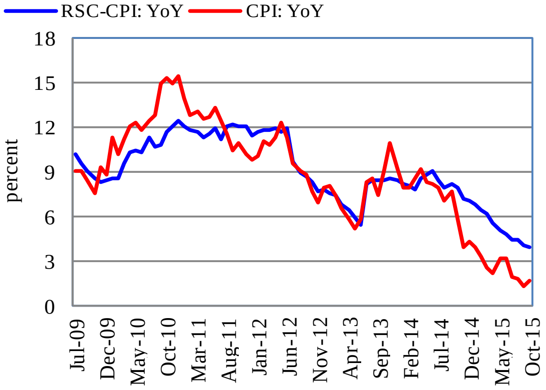


Source: Pakistan Bureau of Statistics

*YoY change of average price of super petrol, high speed diesel and CNG

Like transport, food and beverages group of the CPI basket also recorded a deflation of 0.7 percent in Q1-FY16, against an inflation of 5.8 percent in Q1-FY15. Within the group, a sharp fall in prices of potatoes, tomatoes, edible oil, wheat and rice offset the inflationary impact of higher prices of pulses, tea, milk, and onions.[16]

Figure 3.14: Overall CPI and Relative Stable Components of Inflation



Source: Pakistan Bureau of Statistics and State Bank of Pakistan

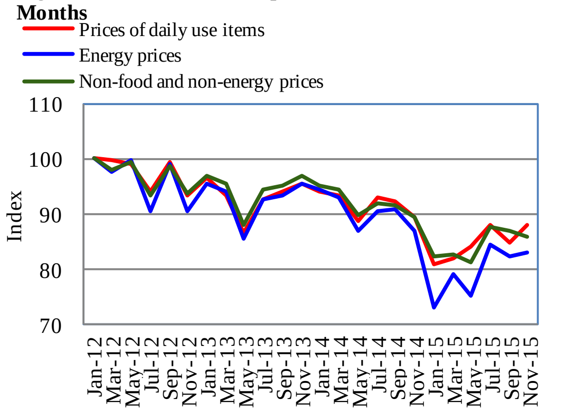
Controlling for commodities with volatile prices, different measures of core inflation for Q1-FY16 are in the range of 3 to 4 percent. It implies that prices of many items in the CPI basket, are either relatively stable or showing a gradual rise. Core inflation comprising of non-food and non-energy items, was 3.9 percent in Q1-FY16, compared with 8.0 percent during the same period last year. Similarly, RSC-CPI, an index based on relatively stable components of the CPI basket, registered 4.3 percent inflation in Q1-FY16, compared with 8.2 percent in the same period of last year (**Figure 3.14**).[17]

[16] Tea prices in international market increased due to a fall in production in Kenya. Tea prices in Pakistan simply followed. In case of pulses, fall in domestic production, contributed to price rise. Cognizant of this, the government allowed import of 50,000 tons of gram in September 2015, to manage the demand-supply gap.

[17] Detailed methodology of RSC-CPI and group wise items along their weights can be viewed at: http://www.sbp.org.pk/publications/wpapers/2013/wp66.pdf

Moreover, analysis of 89 composite commodities in the CPI basket from July 2009 to September 2015 revealed that 46 composite items including house rent have *always* recorded YoY inflation. These items have a combined weight of 56.4 percent in the CPI basket. This suggests that remaining items, which include most of the food and fuel related items, are responsible for volatility in inflation. Moreover, prices of many items in these two groups are administered by the government, reflecting its role in controlling inflation.

Figure 3.15: Consumers Expectations of Prices in Next Six Months

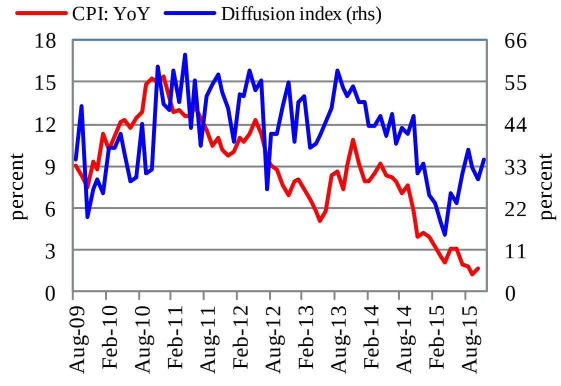


Source: State Bank of Pakistan

Inflation expectations

Inflation expectations measured by IBA-SBP Consumer Confidence Survey (CCS) conducted in July 2015, reported growing inflation expectations of households. This could be largely attributed to expected rise in electricity and gas tariffs, and taxation measures announced in the Federal budget. However, these expectations proved to be short lived due to a reduction in retail POL prices in July and August 2015. The CCS of September 2015 recorded lower inflation expectations for the next six months. The results indicate that households expect fall in prices of energy and non-food items in the next six months (**Figure 3.15**). However, the Consumer Confidence Survey for November 2015 recorded marginal upward revision in households' inflation expectations, as the government increased fuel prices in November 2015. Similarly, same inference can be drawn from the diffusion index developed by

Figure 3.16: Headline Inflation and Inflation Diffusion Index



Source: Pakistan Bureau of Statistics and State Bank of Pakistan

SBP (**Figure 3.16**).[18] Despite this, a financial market based measure of inflation expectations points towards low inflation, as long terms rates (10 years PIBs) fell by 58 bps between June and November 2015, against 50 bps cut in the policy rate in September 2015.

Going forward, inflation may slightly pick up from its existing low levels in the remaining months of FY16. Upward pressure is likely to come from: (i) depreciation of PKR against USD; (ii) second round effect of modest increase in electricity and gas tariffs; (iii) upward adjustment in domestic POL prices;[19] and (iv) historic low interest rates, which would stimulate demand. However these upside risks must be weighed against the continued slump in international oil and commodity prices.

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[18] For details, see http://www.sbp.org.pk/publications/Inflation_Monitor/index.htm

[19] Government increased price of petrol and diesel by Rs2.50 and Rs1.75, respectively in November 2015.