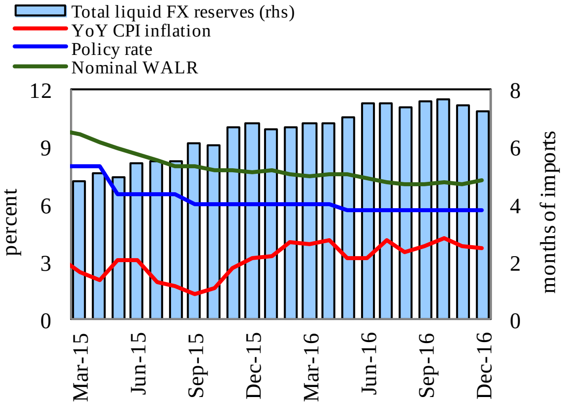
3 Inflation and Monetary Policy

3.1 Policy review

With the uptick in global commodity prices amid healthy domestic demand, some of the macroeconomic indicators began to change course. Import payments have particularly been rising with the start of FY17, which resulted in the near-doubling of the current account deficit during the first half.[1] The average CPI inflation also remained higher in H1-FY17 compared to the same period last year, as the impact of the commodity slump gradually fizzled out (**Figure 3.1**).[2] Nonetheless, the inflation has been stable over the past one year, oscillating within a narrow range. Finally, aside from good performances by few sectors, the overall LSM growth remained low during the initial months of FY17.[3]

Figure 3.1: Key Policy Indicators



Source: State Bank of Pakistan

These divergent trends in important indicators were challenging for monetary policy decision-making – especially for the one due in November 2016. A rate cut could have supported the sluggish activity in the LSM – the fact that external pressures had been (and still seem) manageable and the increase in CPI inflation subdued, this policy option could not be disregarded altogether.[4] However, from the macroeconomic stability standpoint, it seemed prudent not to discount the emerging import pressures while pushing for higher growth. Thus, with a close

[1] The current account deficit increased from US$ 1.9 billion in H1-FY16 to US$ 3.6 billion in H1-FY17.

[2] The average IMF commodity price index during Oct-Dec 2016 was 12.9 percent higher than the same period last year. In contrast, this index had posted a decline of 33.2 percent YoY during Oct-Dec 2015.

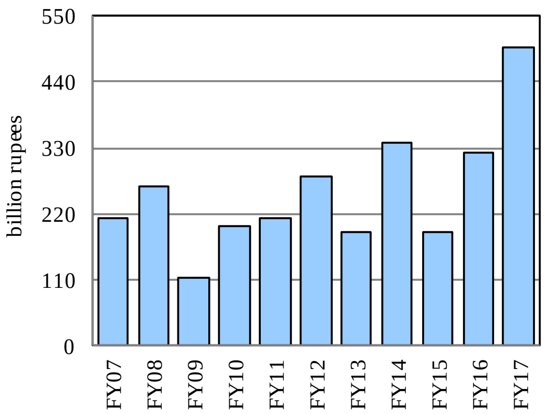
[3] Here it is important to point out that after recording a low growth during Jul-Oct 2016 (2.0 percent YoY), LSM rebounded strongly by an average 7.7 percent during Nov-Dec 2016 on YoY basis.

[4] Despite a significant increase in the current account deficit during H1-FY17, pressures on the overall external sector are contained, as there were sufficient volume of FX loans and FDI.

voting of 6:4 in favor of status quo, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 5.75 percent.[5]

The MPC's decision basically prolonged the spell of historic-low interest rates in the country.[6] It also signaled the committee's comfort over the short-term macroeconomic outlook. The outcome was naturally positive. Corporate customers, positioning earlier in response to favorable business environment only gradually, borrowed aggressively in the months of November and December 2016, prompted by the initiation of fresh credit cycle with the arrival of *kharif* crops. Consumer loans also picked up as banks strategized to readjust their asset portfolios in favor of high-earning segments.

Figure 3.2: Credit to Private Sector (Oct-Dec)



Source: State Bank of Pakistan

As a result, the overall credit to private sector posted an unprecedented increase of Rs 499.3 billion during Q2-FY17 (**Figure 3.2**); even after adjusting for the price level, this flow was a ten-year high. In addition to favorable policy environment, this also represented: (i) higher cotton prices and recovery in value-added textile exports YoY in Q2-FY17, which increased working capital requirements of textile firms (**Chapter 5**);[7] (ii) high PSDP expenditures that triggered activity in cement, real estate and construction sectors;[8] and (iii) the uptick in CPEC-related activity in the energy sector. Therefore, it was not surprising to see a fairly large volume of loans extended under both the fixed investment as well as working capital categories (**Section 3.3**).

[5] SBP's last policy rate cut (of 25 bps in May 2016) brought the cumulative decline in interest rates from November 2014 onwards to 425 bps. By the time for next policy decision (i.e., in March 2017), this would be one of the longer time periods during which SBP has kept the policy rate unchanged.
[6] Prior to the ongoing spell of low interest rates in the country, one has to go back to before May 1972 to identify a period where the policy rate was maintained below 6 percent.
[7] Global cotton prices rose 13.6 percent in Q2-FY17, compared to 1.2 percent in Q2-FY16. Similarly, domestic cotton prices rose 15.3 percent YoY during Q2-FY17.
[8] PSDP expenditures stood at Rs 445.7 billion in H1-FY17, representing an increase of 17.9 percent over the same period last year.

This unusually large volume of private credit off-take constituted the bulk (over 80 percent) of monetary expansion during Q2-FY17 (**Table 3.1**). The rest was mostly contributed by budgetary borrowings, the volume of which was quite modest in comparison to the preceding quarter. Not only was the overall deficit slightly lower during the quarter, but the higher availability of external financing moderated funding pressure on the banking sector.[9] Within the banking sector, the government continued with its Q1-FY17 borrowing mix; i.e., mobilizing funds only from SBP and making retirements to commercial banks. Its impact on the reserve money growth was neutralized by unwinding of outstanding OMO injections (**Section 3.2**). Some downward pressure on reserve money also came from a fall in SBP's NFA during the quarter.

Table 3.1: Monetary Aggregates

flows in billion Rupees

	FY16			FY17			Jan-Dec	
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**	**2015**	**2016**
Reserve Money	342.1	-7.8	334.3	237.5	26.5	264.1	696.5	761.3
M2	119.8	360.0	479.7	29.6	616.2	645.9	1,352.4	1,708.8
NFA	111.6	39.0	150.6	-8.4	-12.2	-20.6	321.5	23.7
SBP	150.9	28.8	179.7	38.0	-3.4	34.6	353.9	165.5
Scheduled banks	-39.3	10.2	-29.1	-46.4	-8.7	-55.2	-32.4	-141.8
NDA	8.2	321.0	329.2	38.1	628.4	666.5	1,031.0	1,685.1
Budgetary borrowings*	139.4	43.9	183.3	299.6	107.5	407.1	872.6	1,010.9
SBP	-304.4	-124.8	-429.2	567.7	324.9	892.6	-450.1	847.0
Scheduled banks	443.8	168.7	612.5	-268.1	-217.4	-485.5	1,322.6	164.0
Credit to Private sector	-25.7	321.4	295.7	-115.6	499.3	383.7	261.2	534.4
Other items (net)	-140.1	22.9	-117.2	-152.7	10.4	-142.4	-152.5	-95.3

* on cash basis

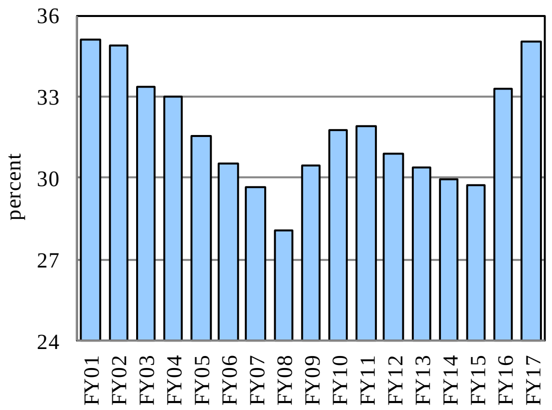
Source: State Bank of Pakistan

Therefore, the reserve money growth was only 0.6 percent in Q2-FY17, helping contain the cumulative growth in H1-FY17 to 6.6 percent – much lower than the 10.6 percent growth realized in H1-FY16. The overall M2 growth still fell short, despite a sizable expansion in the second quarter. The money multiplier continued its downward trajectory throughout H1-FY17, as public preference tilted further towards cash holding. As shown in **Figure 3.3**, the currency-to-deposit ratio, which spiked right after the imposition of withholding tax on banking transactions

[9] The overall fiscal deficit during Q2-FY17 was Rs 361.2 billion, which was 17.5 percent lower than the deficit incurred in Q1-FY17. While external resources financed only 15.7 percent of the deficit in Q1-FY17, these were sufficient to make up for 47.6 percent of the total deficit in Q2-FY17.

in early FY16, reached to a 16-year high during H1-FY17 – close to the level last seen in H1-FY01.[10]

Figure 3.3: Average Currency-to-Deposit Ratio (July-Dec)

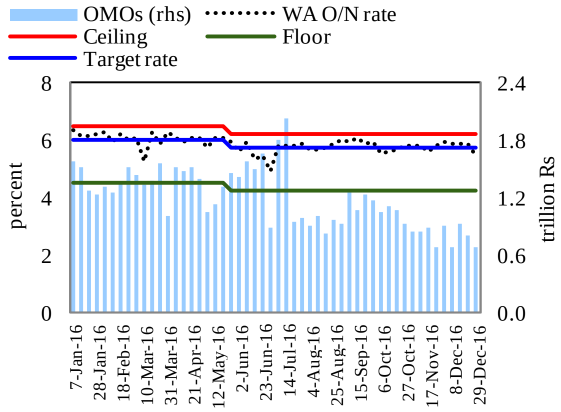


Source: State Bank of Pakistan

3.2 Money market developments

The policy rate remained unchanged throughout H1-FY17, and liquidity conditions in the interbank market eased further as the government continued to borrow from SBP. These were particularly helpful in the second quarter that marks the initiation of the credit cycle. The ease in liquidity conditions was reflected in multiple indicators: (i) the decline in overnight rates, which stayed on average just 1 basis point above the target rate during Q2-FY17 (**Figure 3.4**);[11] (ii) a steady fall in the outstanding level of OMO injections, which declined from Rs 1,147 billion at end-September to Rs 800 billion by end-December 2016; and (iii) limited use of the SBP's reverse repo facility by commercial banks.[12] Furthermore, with respect to long term rates, the 6-month KIBOR remained fairly stable – at around 6.1 percent – during H1-FY17.

Figure 3.4: SBP Interest Rate Corridor and OMOs



Source: State Bank of Pakistan

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[10] Specifically, the average currency-to-deposit ratio during H1-FY17 rose to 35.0 percent.
[11] This compares to an upward deviation of 10 bps of the overnight rate from the target rate during the preceding quarter.
[12] Banks availed SBP's reverse repo facility only 6 days during Q2-FY17, compared to 10 days in the previous quarter. In terms of volume, commercial banks' borrowing from the SBP window amounted to Rs 65.6 billion during Q2-FY17, against Rs 503.9 billion during the previous quarter.

Notwithstanding this comfort in the interbank market, commercial banks' participation in the auctions of government papers was subdued during Q2-FY17 (**Table 3.2**). Unlike the first quarter, when the government (in gross terms) raised more than twice the combined targeted amount of Rs 300 billion, all PIB auctions during Q2 were scrapped. Not only were the offered volumes quite modest in comparison to targets, the rates quoted by commercial banks were also on a higher side. Given these conditions, and the fact that the government had sufficient funding available from other resources (SBP, external and domestic non-bank), the government rejected all the bids for PIBs during the quarter.

Table 3.2: Auction Profile of Government Securities*

billion Rupees

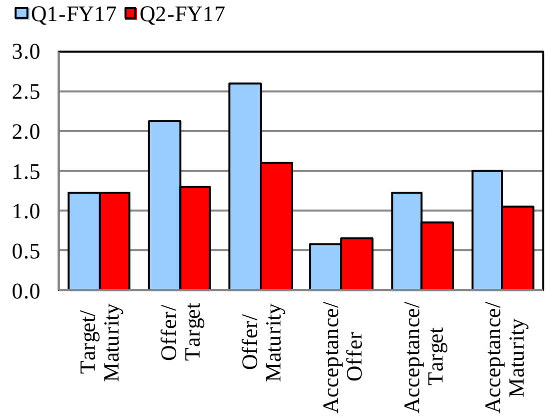
	T-bills			PIBs		
	Target	Offered	Accepted	Target	Offered	Accepted
Gross						
Q1-FY16	1,200.0	1,387.0	1,321.2	200.0	808.2	218.3
Q2-FY16	1,225.0	2,060.9	1,014.0	150.0	447.0	182.9
Q1-FY17	1,450.0	3,066.0	1,763.9	300.0	995.3	678.5
Q2-FY17	1,300.0	1,695.8	1,099.6	200.0	234.6	-
Net of maturities						
Q1-FY16	337.4	524.4	458.6	36.7	644.9	55.0
Q2-FY16	78.6	914.5	-132.4	150.0	447.0	182.9
Q1-FY17	272.0	1,887.9	585.9	-1,127.3	-431.9	-748.8
Q2-FY17	241.6	637.4	41.2	200.0	234.6	-

*includes non-competitive and special auction (in face value)

Source: State Bank of Pakistan

The pattern of low participation and high bid rates witnessed in PIB auctions was mirrored in T-bill auctions as well. Commercial banks placed bids amounting to 1.3 times the government's target in Q2-FY17, compared to more than double the target in the previous quarter (**Figure 3.5**). That said, unlike PIB auctions, the government met about 85 percent of the T-bill auction targets.

Figure 3.5: Key Ratios of T-bills Auction



Source: State Bank of Pakistan

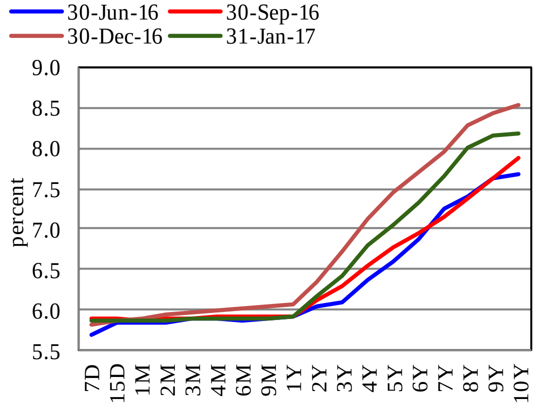


Figure 3.6: PKRV Yield Curve

Source: State Bank of Pakistan

The first outcome of the PIB and T-bill auctions was a collective funding shortfall of about Rs 400 billion for the government, which it duly plugged via borrowings from SBP.[13] The second notable impact was a steepening of the longer segment of the yield curve (> 1 year maturity), especially between end-September and end-December (**Figure 3.6**).[14] This indicated the market's anticipation of a rise in inflation, and a possible bottoming out of policy rate – thereby increasing the term premium. Commercial banks' bidding behavior in the auctions of government papers – i.e., relatively greater inclination for T-bills over PIBs – is consistent with this line of reasoning. Nonetheless, as the actual inflation consistently turned out to be lower than market expectations (especially in November and December 2016), some correction in the longer segment of the yield curve was observed during January 2017.

3.3 Monetary aggregates

While most of the developments in monetary aggregates have already been discussed in **Section 3.1**, a few additional insights are being presented here:

(i) NFA of the banking system declined for the second consecutive quarter in FY17, which is in sharp contrast to the rise observed in the comparable quarters of FY16. Importantly, the stock of NFA of scheduled banks that turned negative back in May 2016, continued to decline further. This mainly represented higher FX liabilities incurred by some of the foreign banks operating in the country;

(ii) Credit to public sector enterprises (PSEs) increased by Rs 60.0 billion during H1-FY17. This increase is mainly attributed to financing raised for the completion of Neelum-Jhelum Power Project; back in June 2016 also,

[13] The government borrowed Rs 893 billion from SBP during H1-FY17, of which Rs 325 billion was during Q2-FY17.

[14] PKRV interest rates of less than one year tenor did not shift because these are more sensitive to changes in policy rate and overnight rate: the policy rate remained unchanged, and the overnight rate remained close to the target rate in the period under consideration.

the company had issued Rs 100 billion sukuk to get around financial constraints in the timely completion of the project;

(iii) The retirements under commodity loans in H1-FY17 were more than double the same in H1-FY16.[15] Higher retirements were primarily evident in two commodities: fertilizer and wheat. In the case of fertilizer, the government's subsidy program led to a higher off-take of both urea and DAP during *kharif* 2016; this enabled the Trading Corporation of Pakistan to settle its dues with commercial banks.

As for wheat, although the procurement agencies were able to retire more to commercial banks compared to last year, the outstanding stock of loans as well as the unsold stocks of wheat still remains high. Given the surplus availability of wheat in the country, the government (while maintaining the wheat support price at Rs 1,300 per 40 kg) took certain measures in FY17 to do away with the high level of unsold stocks. Firstly, it gave an extension (up to March 15, 2017) on the subsidy of US$ 120 per tons on the export of wheat, and increased the limit of export under the scheme by 400,000 tons to 1.3 million tones. Secondly, it raised the regulatory duty on wheat import further to 60 percent in H1-FY17, to avoid the building up of a glut-like situation in the market.[16]

3.4 Credit to private sector

The business climate in the country has been favorable for the last few years, on the back of stable macroeconomic environment, better energy and security conditions, and the initiation of mega projects in the country. While this continued to have a positive bearing on credit off-take in H1-FY17, further impetus to credit demand came from: (i) lagged impact of reduction in policy rate in May 2016; (ii) higher PSDP expenditures and CPEC related investments in the country, which triggered activity in construction and transport industries; and (iii) a recovery in input prices – especially cotton and coal – which supplemented the demand for working capital loans in sectors like textile and cement.

However, the swing factor in Q2-FY17 was the favorable supply-side conditions, as the government continued to make retirements to commercial banks, leaving them with sufficient resources to meet the funding needs of the private sector. In addition, deposit growth also remained slightly higher than last year; during Q2-

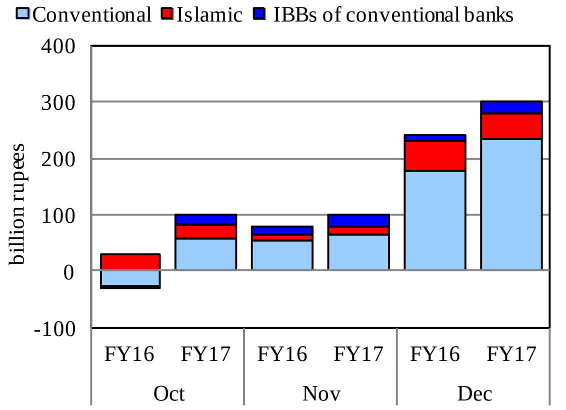
[15] Specifically, net retirements during H1-FY17 amounted to Rs 82.8 billion, compared to net retirements worth Rs 41.8 billion during H1-FY16.

[16] Back in Q4-FY16 also, the government had increased the regulatory duty from 25 percent to 40 percent.

FY17, total deposits with banks grew by 6.0 percent, compared to 5.3 percent in the comparable quarter last year.

The net result of these demand- and supply-factors was the significant increase in private sector borrowing during Q2-FY17. The increase in credit was evident in both working capital and fixed investment categories, and originated primarily from conventional banks (**Figure 3.7**).[17] The increase was particularly strong in the last week of December, when banks reported to have lent out Rs 229.9 billion to the private sector. However, the caveat came in the *first week* of January 2017, when Rs 111.5 billion was subsequently retired.[18]

Figure 3.7: Credit to Private Sector (Flows, by Type of Bank)



Source: State Bank of Pakistan

Manufacturing credit picked up despite slowdown in LSM

Within loans to private sector businesses, manufacturing firms accounted for 68.5 percent of the credit availed during Q2-FY17 (**Table 3.3)**. As is customary, textile units were amongst the large borrowers, with demand driven primarily by a pickup in cotton prices as well as an increase in textile exports – both in terms of quantum and value.[19]

By contrast, rising volumes – rather than prices – helps explain the higher credit demand by the sugar sector. The area dedicated to the sugarcane crop, as well as subsequent production – particularly in Punjab – exceeded the annual target for

[17] Particularly, energy and construction sectors continued to have high share in credit for fixed investment in FY17; moreover, cement, textile and food products & beverages also followed suit in the year despite having marginal credit availed for this purpose in FY16.

[18] Some commercial banks seem inclined to make temporary placements in the form of credit during the last week of the calendar and fiscal year – promptly followed by substantial retirements the next week.

To be precise, the first week refers here to the week extending from 30-Dec-16 to 6-Jan-17.

[19] Domestic cotton prices rose 15.3 percent YoY during Q2-FY17. For details of increase in quantum and value of textile exports during Q2-FY17, please see **Chapter 5**.

FY17.[20] As a result, demand for credit during the crushing season was also higher compared to last year.

Table 3.3: Loans to Private Sector Businesses (flows during Q2)
billion Rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY16	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**
Total loans to private businesses	255.7	420.2	149.9	279.3	56.4	94.3	49.4	46.6
1) Manufacturing	192.5	287.9	125.6	195.9	12.7	50.3	54.2	41.6
a) Textiles	91.3	123.0	66.2	84.5	4.3	19.5	20.8	19.0
Spinning, weaving, finishing	70.0	104.3	52.7	74.3	2.9	18.7	14.4	11.2
b) Food products & beverages	53.9	91.7	31.6	67.8	5.8	13.6	16.6	10.3
Rice processing	27.4	39.7	17.3	32.3	0.9	0.6	9.2	6.8
Sugar	10.4	39.8	3.9	26.9	5.2	8.1	1.3	4.8
c) Cement	0.7	14.1	1.4	5.4	-2.2	6.2	1.5	2.6
d) Chemicals	17.1	10.0	14.6	11.6	-0.1	-0.3	2.5	-1.2
Man-made fibers, other products	0.9	5.1	1.0	2.2	-0.1	2.6	0.0	0.3
Fertilizer	4.3	-3.4	6.7	5.3	-4.8	-5.8	2.4	-2.9
2) Electricity, gas & water supply	26.5	38.0	12.0	25.4	16.2	11.8	-1.7	0.9
3) Commerce and trade	23.2	28.1	24.3	23.2	-1.5	2.9	0.4	2.0
Retail trade	11.2	13.8	14.2	9.9	-4.1	1.9	1.1	2.0
Wholesale and commission trade	10.8	14.5	9.4	13.7	2.1	1.1	-0.6	-0.3
4) Construction	23.2	16.9	8.2	6.3	11.6	10.8	3.5	-0.1
5) Real estate, renting, business activity	8.8	12.1	6.7	7.2	2.4	5.6	-0.3	-0.6
6) Transport, storage/communication	12.8	2.5	-0.8	1.4	14.0	1.5	-0.3	-0.4
7) Agriculture	15.1	-6.5	14.2	-2.5	0.2	-4.5	0.7	0.6

Source: State Bank of Pakistan

Working capital demand from the cement sector traces its origin to higher production and local dispatches, on account of increased domestic construction activity as mentioned earlier. In addition, anecdotal evidence indicates that some major cement manufacturers are also gearing up for expansion, which explains the demand for fixed investment loans by the sector.

To sum up, sectors like sugar and cement availed significantly higher credit in the current period; this uptick is consistent with their stronger, individual contributions within LSM.[21]

[20] The frequent distress faced by cotton crop in past seasons and high support prices for sugarcane fixed by the government over the past several years made sugarcane a safer and more remunerative option for growers, leading to an increase in the area under the crop. For details, see **Chapter 2** in SBP's First Quarterly Report for FY17 on The State of Pakistan's Economy.

Energy sector's borrowing saw a shift in composition

While the borrowing for power projects last year had primarily been composed of long-term loans (classified as fixed investment), H1-FY17 saw a shift towards short-term (working capital) borrowing.[22]

Table 3.4: Consumer Financing
flows in billion Rupees

	Full-year		Jul-Dec		
	FY15	**FY16**	**FY15**	**FY16**	**FY17**
Total	32.0	25.5	13.1	9.9	37.6
Auto	21.0	26.8	8.2	11.8	15.7
Personal	9.1	-11.3	4.9	-6.0	13.7
House building	0.9	7.9	0.2	2.7	4.7
Credit cards	1.1	1.7	-0.1	0.8	2.8
Consumer durables	-0.1	0.4	-0.1	0.5	0.7

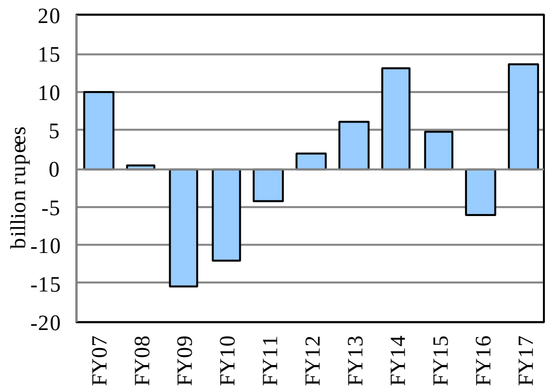
Source: State Bank of Pakistan

It is also worth mentioning that import of power generating and electrical machinery amounted to Rs 276.3 billion during H1-FY17, while gross disbursement of fixed investment loans to the energy sector amounted to only Rs 101.2 billion in the same period. This implies that a large portion of machinery imports are not being financed by bank credit.[23] By contrast, the demand for working capital credit from energy firms appears to have increased on account of rising operational costs (purchase of various fuels), since the machinery already imported last year would now be in use.

Consumer financing remained strong

Consumer financing posted an increase of Rs 37.6 billion during H1-FY17 (**Table 3.4**). Auto finance continued to be the dominant segment, while personal loans showed a pickup. The net credit off-take of Rs 13.7 billion of personal loans witnessed in H1-FY17 is the highest half-year figure in about a decade (**Figure 3.8**).

Figure 3.8: Personal Loans (Flows during H1)



Source: State Bank of Pakistan

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[21] LSM grew by 3.9 percent during H1-FY17, as compared to the same growth witnessed in the H1-FY16 (see **Chapter 2 on Real Sector**).

[22] Specifically, fixed investment net credit off-take for electricity, gas and water supply was Rs 18.7 billion during H1-FY16, compared to Rs 22.5 billion in H1-FY17, whereas the corresponding working capital off-take rose from Rs 3.2 billion in H1-FY16 to Rs 17.7 billion in H1-FY17. Thus, despite the marginally higher fixed investment off-take in the current period in Rupee terms, the share of these long-term loans in total credit off-take declined considerably.

[23] For further discussion on machinery imports data, see **Box 5.1** in **Chapter 5**.

3.5 Inflation

Average CPI inflation rose to 3.9 percent in H1-FY17, from 2.1 percent in H1-FY16 (**Table 3.5**). This rise was mainly due to (i) fewer supplies of fresh vegetables;[24] (ii) a visible recovery in global prices of food commodities such as palm oil, rice and sugar;[25] (iii) the impact of taxation measures in Federal Budget for 2016-17 on various items such as cigarettes, powdered milk, stationery items and cement; and (iv) gradual build-up of domestic demand as evident in rising core inflation, especially non-food-non-energy (NFNE).

Table 3.5: CPI Inflation
percent

					Core	
	Overall	**Food**	**Non-Food**	**Energy**	**NFNE**	**Trimmed**
FY16						
Q1	1.7	0.3	2.7	-3.7	3.9	2.8
Q2	2.5	1.8	3.0	-1.2	3.8	2.8
H1	2.1	1.0	2.9	-2.5	3.8	2.8
Q3	3.8	3.3	4.1	1.7	4.5	3.5
Q4	3.5	3.0	3.9	0.1	4.5	3.7
FY17						
Q1	3.9	4.0	3.7	-1.6	4.6	3.6
Q2	3.9	3.6	4.1	-2.1	5.2	3.8
H1	3.9	3.8	3.9	-1.8	4.9	3.7

Source: Pakistan Bureau of Statistics and State Bank of Pakistan

Importantly, the combined impact of these factors on overall CPI would have been higher if not for the continued YoY fall in prices of motor fuel and transport services in the quarter.[26] Moreover, stability in the PKR in Q2-FY17 also played a role in taming inflation. The H1 inflation of 3.9 percent YoY is quite below the target of 6.0 percent set in the Annual Plan for 2016-17.

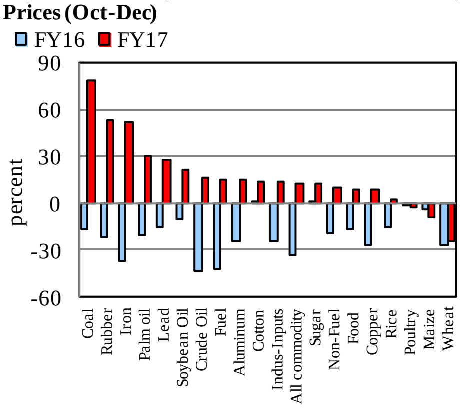
Stepping back, the prices of fresh vegetables remained high in both the quarters of H1-FY17; it posted the highest increase of 19.2 percent in Q2-FY17 among the 20 heaviest items in the CPI basket. This is in comparison with only 1.9 percent increase during the same period last year. Not only did the dry weather affect the domestic production of certain vegetables (especially garlic and turnip), but the crackdown on informal trade also disrupted imported supplies.[27] Nonetheless,

[24] Fresh vegetables mainly include peas, chilies, garlic, ginger, carrots, cucumbers, turnips, cauliflower, spinach, lemon/limes, etc. These do not include potatoes, tomatoes and onions, the price data for which is reported separately.
[25] The rise may also be attributed to the base effect, as the price of few heavy weight items in CPI that fell sharply last year, either increased during Q2-FY17 (cooking oil/ghee, and rice) or posted a marginal decline (motor fuel) during Q2-FY17.
[26] These two have a combined weight of 5.7 percent in the overall CPI.
[27] For instance, cauliflower, spinach, and lemon & limes imports dropped to 1.9, 0.2, and 2.6 metric ton in Jul-Oct FY17, from 2.1, 1.0 & 5.1 metric ton, respectively in the same period last year.

compared to Q1-FY17, when the increase in vegetable prices was broad-based, it was concentrated in few items during Q2-FY17.[28]

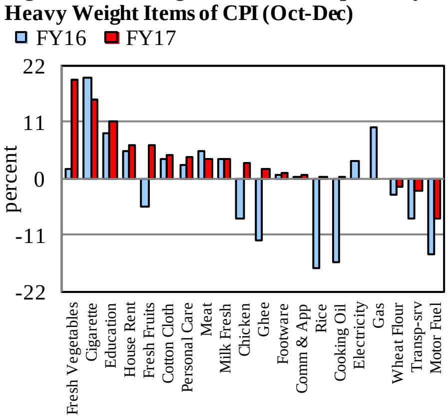
Meanwhile, global prices of a number of edible commodities recovered in Q2-FY17 (**Figure 3.9**), and have recently started influencing domestic inflation **(Figure 3.10**). Specifically, the trend of falling domestic prices of rice, cooking oil, ghee, and sugar till Q1-FY17, reversed during Q2-FY17. Moreover, due to imposition/enhancement of taxes in the Federal Budget for 2016-17, many consumer items (such as cigarettes, powdered milk, and stationary items) also contributed to pushing up inflation.[29] Cement prices also increased as the government changed the modalities in duty structure.[30]

Figure 3.9: Changes in Selected Global Commodity Prices (Oct-Dec)



Source: International Monitoring Fund

Figure 3.10: Changes in Prices of Top Twenty Heavy Weight Items of CPI (Oct-Dec)



Source: Pakistan Bureau of Statistics

Apart from these items, prices of health and education services recorded significant increases of 8.1 and 11.3 percent in Q2-FY17, compared with only 2.7 and 8.8 percent respectively in Q2-FY16. Price of health services and related items rose mainly due to upward revision in medicine prices following the approval of Drug Regulatory Authority of Pakistan (DRAP).[31] In case of

[28] In Q1-FY17, most of the fresh vegetables like brinjal, bottle gourd, okra, tinda, turai, karaila, chilies (green) and garlic recorded more than 20 percent inflation. However, in Q2-FY17, a number of vegetables recorded a sharp fall in prices like bottle gourd, lady finger/okra, peas, tinda, turai, karaila, arvi, carrot and ginger, whereas garlic and turnip recorded 66.5 and 22.3 percent inflation, respectively.

[29] For instance cigarettes and cement recorded inflation of 15.3 and 5.2 percent in Q2-FY17, compared with 19.8 and -1.2 percent in Q2-FY16, respectively.

[30] For details see **Chapter 3** in SBP's First Quarterly Report for FY17.

[31] Via S.R.O. 628 (I)/2016 dated July 22, 2016, DRAP, Ministry of National Health Services, Regulations and Coordination.

education, the increase mostly represents an early revision of educational fees in FY17 compared to FY16.[32] These changes also fed into the steady rise in core inflation: NFNE rose to 5.2 percent in Q2-FY17 compared to an average of 4.5 percent in the previous three quarters.

The only group whose prices fell in Q2-FY17 was transport.[33] This represented the lagged impact of the fuel price cuts announced by the government in Jan-Mar 2016.[34] However, the seven-month stability in POL prices came to an end when the government eventually lifted petrol and diesel prices in December 2016.[35] Its impact on CPI inflation will be reflected in subsequent months.

Outlook

The OPEC agreement to cut output in the later part of Q2-FY17 caused a rising trend in crude oil prices, as these have recovered by 25.0 percent between November 2016 and February 2017.[36] As anticipated, the government has partially passed on its impact to domestic consumers from mid-January 2017 onwards.[37]

The following factors may contribute to domestic inflation during the remaining months of FY17:

i) Global commodity and oil prices are expected to move in upward direction, which will be affecting domestic inflation.
ii) The construction component of WPI is showing a robust increase recently, which may transmit to wages and prices of construction items in CPI. [38] Moreover, as construction cost is reflected in house rent, an upward revision

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[32] In FY16, education fees were revised upward in Q3, whereas in FY17, these were increased in Q2.
[33] Transport group prices fell by 3.3 percent for Q2-FY17, compared with 8.6 percent in Q2-FY16.
[34] The government had slashed petrol and diesel prices by a cumulative Rs 13.5 and 12.5 per liter, respectively during Jan-Mar 2016.
[35] In December 2016, the government announced Rs 2 and Rs 2.70 per liter increase in prices of petrol and high speed diesel, respectively – this is the first increase since April 2016. A month earlier, OMCs had increased the price of HOBC following the deregulation of the market of this fuel.
[36] Saudi Arabian light oil was traded at US$ 43 and US$ 45.4 per barrel on the eve of US elections on November 8, 2016, and November 30, 2016 – the day OPEC agreed on the production cut. On March 6, 2017, its trading was averaged at US$ 54.2 per barrel.
[37] From mid January to 1st March 2017, the government has increased petrol and high speed diesel prices on four occasions, cumulatively by Rs 6.7 per liter and Rs 6.8 per liter, respectively. Furthermore, price of CNG has also gone up by Rs 1.7 per kg during Jan-Feb 2017, following the deregulation of CNG sector in December 2016 (vide Ministry of Petroleum and Natural Resources notification no. CNG-7(9)/16-Price, dated December 16, 2016).
[38] Construction input items of WPI include glass sheets, other glass articles, ceramics & sanitary, bricks blocks & tiles, cement, steel bars & sheet and pipe fittings.

in house rent index – the largest component of CPI, may also put upward pressure in the CPI inflation.

iii) On the flip side, recent rains will likely improve supply conditions of wheat and perishables food items, which will help mitigate inflationary pressures.

Thus, on balance, we expect the annual CPI inflation to remain close to 4 percent during FY17.