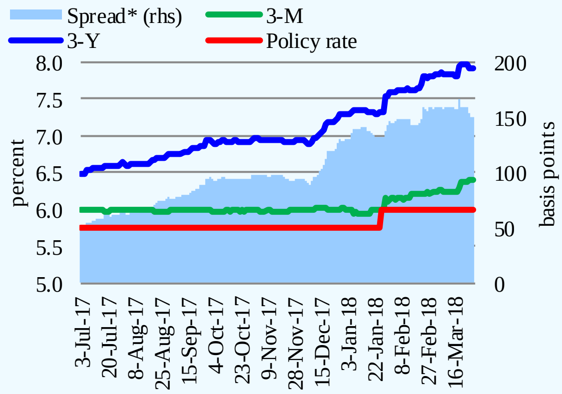
3 Inflation and Monetary Policy

3.1 Overview

The thirteen-quarter long spell of monetary easing that led to a historic low policy rate in the country, came to a close in Q3-FY18.[1] Market players had been anticipating a reversal in monetary policy stance for some time already, as indicated by their subdued participation in auctions of government securities except for the 3-month paper, and the rising secondary market yield spread (**Figure 3.1**).

Figure 3.1: Policy Rate and Secondary Market Yields



*between 3-M and 3-Y secondary market yields
Data source: State Bank of Pakistan

For the MPC, four key developments motivated the January 2018 decision to raise the policy rate by 25 bps: (i) PKR depreciation of nearly 5 percent in December 2017; (ii) rising international oil prices; (iii) monetary tightening by other central banks (particularly Fed and Bank of England), with its concomitant impact on PKR interest rate differential; and (iv) an overheating of the economy as indicated by increased capacity utilization in a number of industries. Thus, in view of the expected rising trend in inflation and aggregate demand, the committee overwhelmingly voted in favor of increasing the policy rate to 6 percent.[2]

The policy rate was kept unchanged when the MPC met again in March 2018. The status quo was considered prudent to allow more time for the full impact of the January rate hike and other policy measures taken by the government and SBP to play out. While inflation forecast was still on a higher side, some comfort came

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[1] Monetary easing began in November 2014, when SBP cut the policy rate by 50 bps to 9.5 percent. The historic low policy rate of 5.75 percent was set in May 2016.

[2] MPC's concerns turned out to well-grounded as core inflation did surge to 5.8 percent in March and 6.9 percent in April 2018, even though headline CPI inflation still remained on track to fall within the annual target. The spike in core inflation may have been triggered in part by the two episodes of exchange rate depreciation, as prices of a number of non-food items (particularly those with an import component, like motor vehicles) rose sharply.

from moderation in core inflation from its 5.5 percent average in H1-FY18, to 5.2 percent in Jan-Feb 2018. Moreover, it was expected that the combined impact of the two depreciations on the trade balance would become fully apparent over the next few months, since exchange rate movements tend to be accompanied by a lagged impact and second round effects.

As for the interbank market, it appears that banks had already priced in the expected policy reversal on lending rates offered to their customers. Specifically, weighted average lending rate (WALR) that started inching up from October 2017 onwards, had shown a cumulative increase of 16 bps by end December 2017. Thus, when the policy rate was increased by 25 bps in January 2018, it attracted a muted response from banks; if anything, WALR shed 10 bps (on average) in February and March 2018. This softening of retail rates stemmed from ample liquidity that was available to banks, primarily on account of sizeable maturity of government securities, which they were not keen to roll over in a perceived rising interest rate scenario.[3] To a lesser extent, deposit mobilization during the third quarter was also higher than it had been during Q3-FY17. Importantly, this liquidity comfort played a part in pushing the average deviation of overnight rates from the policy rate into the negative territory (i.e. minus 3 bps) during Q3-FY18.

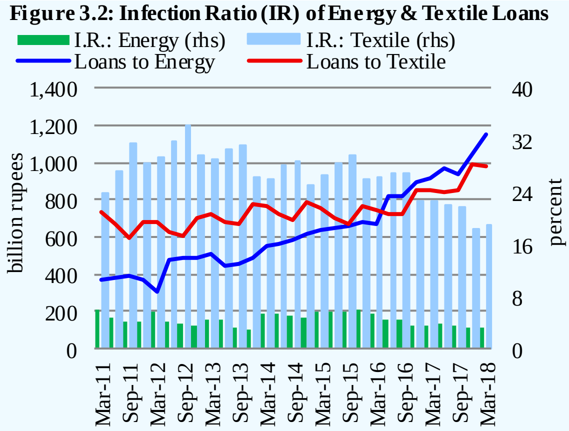
Thus, with virtually unchanged financing cost for the private sector, credit expansion continued unabated during the third quarter. In fact, growth in private credit during Q3-FY18 was twice that of last year.[4] While borrowing for working capital by the textiles sector was the largest in terms of volume during the quarter, the revival of fixed investment loans was the highlight of the period under review. A number of sectors – manufacturing and non-manufacturing alike – seemed to shrug off some of the hesitancy that appeared to have slightly held back long-term borrowing during the preceding quarter.

Other than interest rates, the steady continuation of economic activity – reflected by promising LSM numbers throughout the quarter – kept the credit demand strong. Additionally, the exchange rate adjustment in December 2017 may have helped ease the perception of an overvalued rupee among certain quarters, especially firms considering long-term fixed investment. Furthermore, the active decision-making by the government also helped subdue the element of uncertainty that had earlier put some businesses in a wait-and-see mode.

[3] Banks' reduced lending to the government ultimately prompted the highest-ever quarterly budgetary borrowing from the central bank.
[4] Credit to private sector grew by 3.2 percent in Q3-FY18 on QoQ basis, compared to 1.6 percent in the same period last year.

A key supporting factor that encouraged banks to cater to financing requirements of the private sector was a steady improvement in perceived credit quality. The overall non-performing loans declined as percent of outstanding loans from 9.9 percent as of March 2017 to 8.3 percent at end-March 2018. The infection ratio was particularly reassuring in the energy sector (under 4 percent, private and public entities combined), where banks' exposure is growing the most.[5] As shown in **Figure 3.2**, the credit quality in energy sector looks much favorable especially when compared with the traditionally largest recipient of bank loans: textiles.

Figure 3.2: Infection Ratio (IR) of Energy & Textile Loans



Data source: Financial Soundness Indicators, SBP

3.2 Liquidity Conditions in the Interbank Market

Liquidity conditions eased up considerably during Q3-FY18. In addition to the downward deviation of overnight rates from the policy rate mentioned earlier, another indicator of liquidity comfort was the reduced need for commercial banks to approach the central bank for support. During Q3-FY18, commercial banks utilized SBP's reverse repo facility on just four occasions, to borrow Rs 59.4 billion; in contrast, eight such instances were documented in the third quarter a year ago that had led to borrowings four times as high (Rs 160.8 billion to be precise).

The easy liquidity conditions mainly stemmed from lower investment in government securities by scheduled banks. While there were sizeable maturities of PIBs and T-bills in the third quarter, scheduled banks' participation in auctions of government securities remained sparse, except for the 3-month paper (**Section 3.4**).[6] The government, therefore, relied on SBP for budgetary borrowings. This was a reversal from the earlier pattern in H1-FY18, when commercial banks had funded budgetary borrowings and the government had retired its SBP debt. To a

[5] Admittedly, a significant portion of this borrowing has been directed towards productive capacity enhancements and increased running costs of operating new power plants. At the same time, some portion of energy sector loans was meant to fulfill liquidity shortages stemming from rising circular debt.

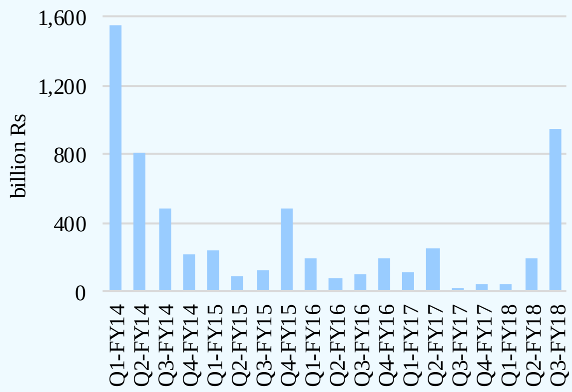
[6] Maturities of government securities amounted to Rs 5.6 trillion during Q3-FY18, comprising Rs 5.1 trillion for T-bills and Rs 526.8 billion for PIBs (principal only; excluding coupon).

lesser extent, some liquidity cushion also came from a minor uptick in deposit generation during the third quarter.[7]

These developments more than offset the liquidity pressure that may have emanated from FX interventions in the interbank, particularly in the aftermath of the December 2017 exchange rate adjustment. Such interventions during Q3-FY18 exceeded the amount observed in the earlier two quarters of the fiscal year. Specifically, the volume of FX injections in January 2018 was the highest monthly injection of FY18 thus far, though it subsequently subsided to an extent in February and March.

In view of the excess liquidity and in keeping with SBP's operational target, the central bank gradually unwound its outstanding stock of OMO injections in the third quarter.[8] The average outstanding OMO position fell to Rs 1.1 trillion during Q3-FY18, from Rs 1.5 trillion in the previous quarter.[9] In fact, the outstanding OMO position was negative Rs 36 billion as of end-March, in sharp contrast to the historic high of Rs 2 trillion that had been touched in Q2-FY18. Furthermore, repo (mop-ups) featured prominently during the third quarter, on a scale not witnessed since Q1-FY14 (**Figure 3.3**).

Figure 3.3: Repo (Mop-up) Acceptances



Data source: State Bank of Pakistan

3.3 Monetary Aggregates

While broad money growth had been subdued during H1-FY18 compared to a year earlier, it picked up during the third quarter (**Table 3.1**). This was due to an increase in net domestic assets (NDA) of the banking system, with the impetus

7 Total deposits with banks grew by 1.8 percent during Q3-FY18, compared to 0.3 percent in Q3-FY17. That said, deposit generation of 4.8 percent for Jul-Mar FY18 remained lower than the 6.4 percent growth seen in Jul-Mar FY17.

8 SBP's operational target is to maintain the weekly weighted average overnight repo rate close to the policy rate.

9 The average outstanding level of OMO injections was Rs 961 billion in Q3-FY17. However, in this instance, Q2-FY18 serves as a better reference point, particularly since the outstanding stock had briefly touched a historic high of Rs 2 trillion in just the previous quarter.

coming from higher budgetary borrowing and private sector credit during Q3-FY18 compared to the third quarter last year.

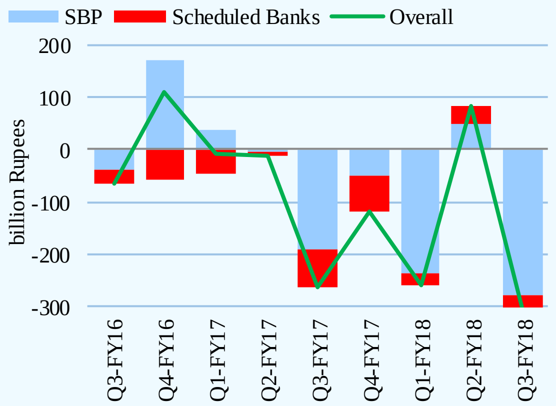
Table 3.1: Monetary Aggregates
flows in billion Rupees

	Q3		Jul-Mar	
	FY17	**FY18**	**FY17**	**FY18**
M2	110.2	366.0	756.1	702.4
NFA	-264.2	-308.6	-284.8	-483.1
SBP	-189.7	-277.8	-155.2	-464.3
Scheduled banks	-74.5	-30.8	-129.7	-18.7
NDA	374.4	674.7	1,040.9	1,185.5
Budgetary borrowing*	287.6	481.8	694.7	813.5
SBP	-100.5	2,162.5	792.2	2,159.9
Scheduled banks	388.0	-1,680.8	-97.5	-1,346.3
Private sector credit	77.9	177.4	438.6	473.7
PSE credit	114.0	107.6	197.0	173.6
Commodity operations	-55.1	-43.9	-137.9	-58.4
Reserve money	50.3	181.6	314.3	198.4
Other items (net) - SBP	337.2	-1,714.7	-432.1	-1,573.5
Reverse repo	298.7	-1,628.5	-408.4	-1,516.4

*On cash basis
Data source: State Bank of Pakistan

At the same time, the net foreign assets (NFA) of the banking system declined. Following a brief respite in Q2-FY18, when the NFA of SBP and scheduled banks had both registered minor recoveries, the indicator fell in the third quarter (**Figure 3.4**). This was because the positive flow in NFA of SBP in the previous quarter owed to a one-off development (i.e. issuance of Eurobond and Sukuk in the international capital market) rather than a sustained trend reversal.

Figure 3.4: Quarterly Flows in Net Foreign Assets



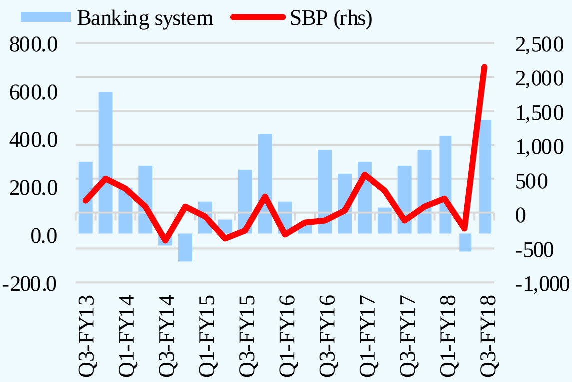
Data source: State Bank of Pakistan

As for reserve money, its growth picked up during the third quarter, primarily because of the elevated budgetary borrowing from SBP.[10] That said, reserve money growth would have been even larger in proportion to the scale of budgetary borrowings from the central bank had it not been partially neutralized by the unwinding of outstanding OMO injections (**Table 3.1**). To a lesser extent, the declining NFA of SBP also contributed to a much contained increase in reserve money.

3.4 Budgetary Borrowings

The government's budgetary borrowings from the banking system took their cue from fiscal developments. During H1-FY18, the fiscal deficit was relatively contained, and sizable external financing was also available in Q2; thus, budgetary borrowings from the banking system during the half as a whole were lower compared to last year. However, as fiscal slippages began to emerge in the third quarter and the buffer provided by Eurobond and Sukuk issuances subsided, the government increasingly tapped the banking system to bridge the shortfall. Moreover, the onus to provide financing fell squarely on SBP (**Figure 3.5**). The central bank lent nearly Rs 2.2 trillion to the government during the third quarter. Not only did this amount represent the highest quarterly borrowing from SBP ever, it also meant that the limit of zero quarterly borrowing from central bank – laid out in SBP Act – was not met.

Figure 3.5: Quarterly Budgetary Borrowing (Flows)
billion Rupees



Data source: State Bank of Pakistan

As mentioned earlier, the government's heavy reliance on SBP borrowing in the third quarter may be attributed in part to banks' lackluster participation in auctions of government securities. The March 2018 PIB auction was the 8th successive such auction to be scrapped amidst low participation by scheduled banks. Furthermore, the disinterest in 6- and 12-month T-bills which had surfaced in the previous quarter continued in Q3-FY18, with either no bid received for these tenors in a majority of the auctions, or the bids placed being rejected since they were on the higher side.

[10] Reserve money grew 3.7 percent in Q3-FY18, compared to 1.2 percent growth in Q3-FY17.

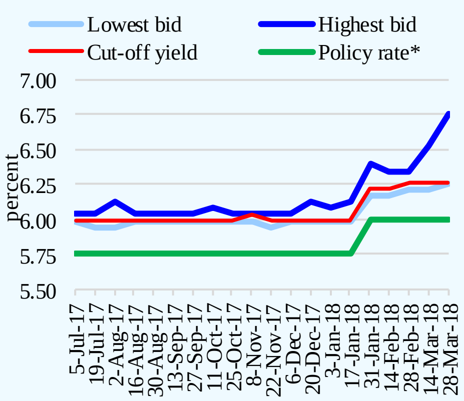
Table 3.2: Tenor-wise Offers and Acceptance in T-Bill Auctions* (Gross)
in billion Rupees

	3-month			6-month			12-month		
	Mat.	Off.	Acc.	Mat.	Off.	Acc.	Mat.	Off.	Acc.
Q1-FY17	267.1	814.5	410.5	400.6	1,378.4	863.4	510.3	873.1	490.1
Q2-FY17	389.7	1,086.2	827.1	441.2	497.2	216.1	227.5	127.3	56.3
Q3-FY17	841.7	1,748.7	1,203.8	863.4	1,972.1	1,391.0	817.1	599.0	369.6
Q4-FY17	1,189.2	1,479.9	1,383.2	216.1	698.2	502.7	266.7	76.4	20.6
Q1-FY18	1,800.4	3,501.6	3,463.1	1,391.0	942.8	895.5	490.1	66.8	47.7
Q2-FY18	3,045.9	4,284.7	3,298.4	502.7	296.8	302.8**	56.3	5.0	0.0
Q3-FY18	3,794.1	5,311.0	4,214.7	895.5	80.3	0.0	369.6	5.3	0.0

* In face value. Mat.= Maturity; Off.= Offered; Acc.= Accepted
Offered columns contain competitive bids only; Accepted columns contain all acceptances
** Consists of Rs 291.8 billion competitive and Rs 11.1 billion non-competitive bids
Data source: State Bank of Pakistan

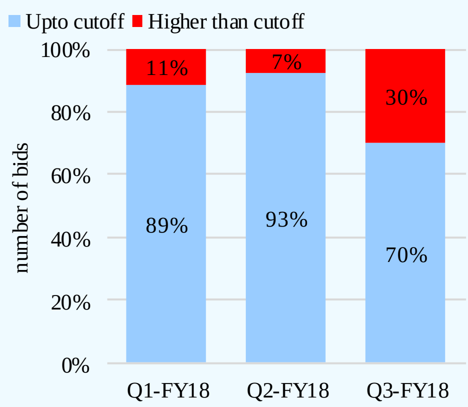
The pattern of offers and acceptances for the 3-month T-bill also presented a striking picture (**Table 3.2**). The gap between net-of-maturity offers and acceptances of the 3-month tenor, which had widened considerably in the second quarter, remained close to Rs 1 trillion even in Q3-FY18. During Q3 in particular, higher bid rates motivated the relatively low acceptance against the shortest tenor (**Figure 3.6**).

Figure 3.6a: Bidding Pattern for 3-month T-Bill



Data source: State Bank of Pakistan

Fig 3.6b: Composition of Bids for 3-m T-bills



Data source: State Bank of Paksitan

Commodity Operations

Commodity financing posted lower retirements during Q3-FY18 compared to the same period last year (**Table 3.3**). This was primarily driven by developments in wheat, which constitutes around 80 percent of the overall lending under commodity operations.

By contrast, sugar and fertilizer witnessed a modest credit expansion during Q3-FY18 compared to the same period last year. This marginal increase was mainly related to finance cost of the outstanding loans against pending subsidies and the commodities procured earlier. In case of sugar, local suppliers demonstrated their reluctance to participate in a tender issued by TCP in January 2018, mainly because of differences over payment terms.

Table 3.3: Commodity Operations
flow in billion Rupees

	Q3		Jul-Mar	
	FY17	FY18	FY17	FY18
Wheat	-56.52	-44.28	-134.33	-55.43
Sugar	0.78	0.30	4.25	-1.82
Fertilizer	0.60	0.08	-5.99	-1.40
Cotton	0.99	1.05	-1.88	0.06
Rice	0.02	0.02	0.06	0.15
Total	-55.11	-43.86	-137.90	-58.44

Data source: State Bank of Pakistan

3.5 PSE Credit

While credit to PSEs experienced a slowdown during Q3-FY18 on YoY basis, its subcomponent of loans remained higher compared to the same period last year (**Table 3.4**). Energy-related PSEs (like PSO, Power Holding Private Limited - PHPL, WAPDA) continued to dominate this segment.

Table 3.4: Credit to PSEs
flow in billion Rupees

	Q3		**Jul-Mar**	
	FY17	**FY18**	**FY17**	**FY18**
Credit	114.0	107.6	197.0	173.6
Loans	76.1	110.4	111.5	212.3
Of which				
Energy related PSEs	51.6	115.7	70.9	166.6
Investment	37.9	-2.8	85.5	-38.7

Data source: State Bank of Pakistan

During the third quarter, WAPDA settled Rs 150 billion outstanding dues of net hydel profit to the governments of Punjab and KP – part of which was financed through borrowings from commercial banks. The government also raised funds through PHPL to settle its dues to IPPs and PSO. Meanwhile, PSO was able to reduce its outstanding receivables from Rs 313 billion to Rs 304 billion during Q3-FY18, mainly on the back of funds received as part of circular debt settlement.[11]

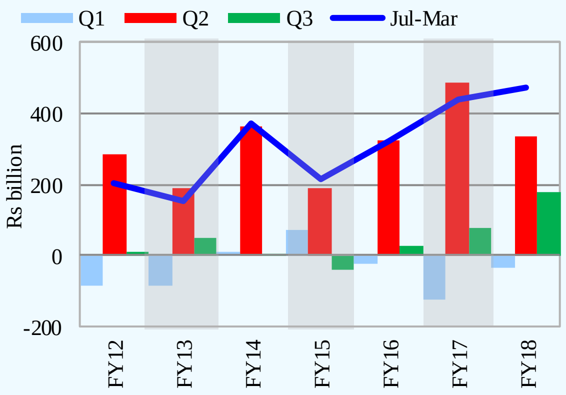
3.6 Credit to Private Sector

The third quarter marked a pickup in fixed investment loans, which was instrumental in pushing overall flows of credit to private sector during the Jul-Mar period beyond the level seen last year (**Figure 3.7**). Specifically, the Rs 77.2

[11] Having said that, PSO's financial woes are still a matter of concern and it is imperative for the company to negotiate with key stakeholders, both on the asset as well as the liability side, in order to smoothly manage payments related to FO and LNG.

billion flow of fixed investment during Q3-FY18 was the highest quarterly flow of the ongoing fiscal year.[12] More broadly, the Jul-Mar FY18 fixed investment lending represented a 12-year high.

Figure 3.7: Quaterly Flows of Credit to Private Sector



Data source: State Bank of Pakistan

The textile sector was the single largest group accounting for long-term loans during Jul-Mar FY18, having taken advantage of SBP's refinance schemes.[13] This development was consistent with the sector's improved performance, as export-oriented firms in particular continued to benefit from the government's export package, as well as a recovery in major markets like the EU to which Pakistan has favorable access via the GSP plus regime.[14]

Apart from textiles, the cement sector also registered noteworthy fixed investment borrowing during Jul-Mar FY18. In fact, the sector's fixed investment loan uptake in the third quarter alone amounted to Rs 16.9 billion, amid reports that some key players remained keen on capacity expansions. Domestic dispatches grew at a robust pace, increasing by nearly 17.9 percent to 31.3 million tons during Jul-Mar FY18.

Meanwhile, the power sector's fixed investment appetite recovered in the third quarter, after a relatively modest offtake in H1-FY18.[15] This included financing for: a gas-fired power plant being developed in the public-private partnership mode in Sindh; a coal-based CPEC power project in Hub; and wind energy projects being set up in Jhimpir by two textile firms.

[12] Fixed investment loans had risen by Rs 56.7 billion and Rs 41.8 billion in Q1-FY18 and Q2-FY18.
[13] Nearly 63 percent of the textile sector's fixed investment borrowing was facilitated by SBP's Long Term Finance Facility during Jul-Mar FY18. To a lesser extent, one-third of the sector's flow of working capital was also financed through the Export Finance Scheme.
[14] For further discussion of the textile sector's borrowing, refer to SBP's Second Quarterly Report for FY18.
[15] The power sector borrowed long-term loans worth Rs 25.3 billion in Q3-FY18, compared to net retirement of Rs 8.9 billion in H1-FY18.

Table 3.5: Loans to Private Sector Businesses in Jul-Mar (Flow, in billion Rupees)

	Total Loans		Working Capital*		Fixed Investment	
	FY17	FY18	FY17	FY18	FY17	FY18
Private Sector Businesses	**382.2**	**417.7**	**221.3**	**242.0**	**160.9**	**175.7**
Manufacturing	259.7	244.1	161.9	158.3	97.8	85.8
of which						
Textiles	87.0	124.2	60.8	89.8	26.2	34.3
Cement	11.7	35.9	2.9	12.5	8.7	23.4
Rice processing	9.4	31.1	8.4	30.3	1.0	0.8
Electrical machinery	6.5	28.2	5.0	25.6	1.5	2.6
Sugar	101.1	25.2	85.5	15.1	15.5	10.1
Edible oil and ghee	-4.5	16.4	-5.0	14.4	0.5	2.0
Iron and steel	0.5	13.9	-0.6	14.9	1.1	-1.0
Bakery etc	0.6	12.9	0.1	9.1	0.5	3.7
Basic chemicals	0.8	12.1	-1.3	9.8	2.2	2.2
Domestic appliances	6.2	10.1	4.8	5.7	1.3	4.4
Fertilizer	-14.7	-69.2	-25.6	-56.1	10.9	-13.1
Electricity, gas and water supply	44.9	66.1	24.1	43.0	20.9	23.1
Production., transmission and distribution of electricity (power sector)	46.1	60.8	24.4	44.4	21.7	16.4
Manufacture of gas; distribution of gaseous fuels through mains	0.7	5.2	1.6	-1.3	-0.9	6.6
Commerce and trade	20.1	38.5	20.3	24.9	-0.3	13.6
Real estate, renting and business activity	7.6	24.3	1.2	9.5	6.4	14.8
Transport, storage and communications	-0.3	19.5	-9.1	-3.5	8.8	22.9
Construction	22.4	13.6	6.6	7.7	15.8	5.8

*includes trade financing

Data source: State Bank of Pakistan

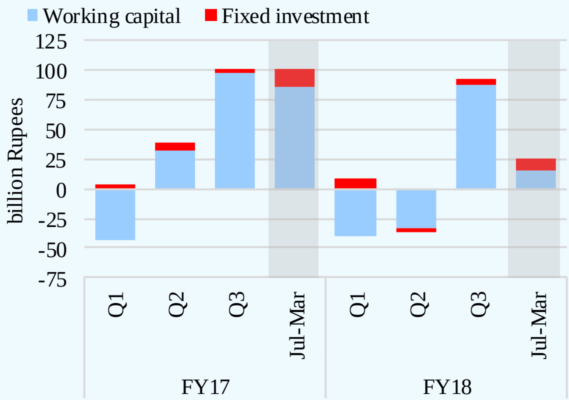
Moving on to working capital loans, the textile sector again accounted for the bulk of these borrowings during Jul-Mar FY18, which were relatively higher compared to last year. This may be attributed to rising export quantums and increased procurement of cotton pushing up the requirement for short-term loans, even though domestic cotton prices continued to remain soft compared to a year earlier.[16] Other sectors that registered notable working capital borrowing during Jul-Mar FY18 included: (i) the power sector, where projects coming online pushed up the financing requirement for fuel purchases; and (ii) rice processing, which saw double digit growth in exports.

That said, during the third quarter only, it was the sugar sector which overwhelmingly drove the off-take for working capital loans. It would appear that

[16] The wholesale price of cotton grew by 5.3 percent in Jul-Mar FY18, compared to 24.3 percent in Jul-Mar FY17.

the delayed onset of the sugarcane crushing season this year primarily explains the disruption in timing of the related credit flows, particularly during Q2 and Q3-FY18 (**Figure 3.8**). While crushing typically gets underway in November, this year a majority of mills delayed crushing by around 15-30 days. Hence, it is possible that the borrowing cycle may overflow into the fourth quarter as well, such that full year flows to the sugar sector would normalize by the year end. Given that there was a record production of sugarcane this season, there is little reason to suspect that working capital borrowing by the sector would be significantly lower as compared to last year.

Figure 3.8: Loans to Sugar Sector



Data source: State Bank of Pakistan

In contrast, there was no recovery in borrowing activity by the fertilizer sector – neither in terms of short or long-term borrowing, nor in any of the three individual quarters of FY18. In the backdrop was the continuing decline in production, which spilled over to Q3-FY18 as a number of small units remained closed due to unavailability of cheap gas feedstock.[17]

Consumer financing

Consumer financing kept up its growing momentum and rose by Rs 57.2 billion in Jul-Mar FY18, compared to Rs 50.1 billion last year. This is the highest flow in the last 12 years in any Jul-Mar period, and was driven primarily by auto and housing finance (**Table 3.6**).

Table 3.6: Consumer Financing in Jul-Mar
flows in billion Rupees

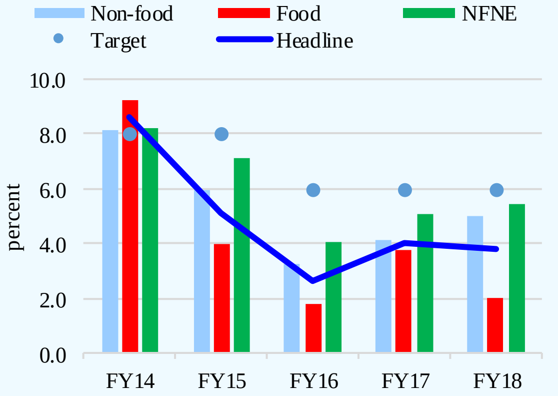
	FY17	FY18
Total	**50.1**	**57.2**
Auto financing	26.2	34.6
House building	8.2	15.1
Credit cards	3.0	4.7
Consumer durables	0.8	1.0
Personal loans	11.9	1.8

Data source: State Bank of Pakistan

[17] Small fertilizer producers could only achieve 9 percent capacity utilization during Jul-Mar FY18, compared to 69 percent utilization in Jul-Mar FY17. In contrast, large fertilizer producers' capacity utilization was around 100 percent in both periods.

That said, it is worth noting that merely eight banks have accounted for around 70 percent of the outstanding auto and housing loans over the last couple of years. The credit card segment is even more concentrated, with only five banks holding nearly 78 percent market share. Given that the per capita income has increased in recent years, banks may benefit by diversifying into these largely untapped segments.

Figure 3.9: Average CPI Inflation (Jul-Mar)



Data source: Pakistan Bureau of Statistics

3.7 Inflation

Rising global commodity prices and strong domestic demand played a key role in determining the trend of domestic prices during Jul-Mar FY18. This was particularly true for non-food inflation, which rose by just under one percentage point YoY; however, its impact was more than offset by a decline in food inflation (**Figure 3.9**). On aggregate, the headline inflation remained lower than last year.

Table 3.7: Average CPI Inflation and Contribution during Jul-Mar

		Growth		Contribution	
	Wt	**FY17**	**FY18**	**FY17**	**FY18**
Headline	**100**	**4.0**	**3.8**	**4.0**	**3.8**
Food	**37.5**	**3.8**	**2.0**	**1.6**	**0.8**
Cigarettes	1.4	15.1	-17.8	0.3	-0.4
Fresh vegetables	1.7	17.9	-3.0	0.3	-0.1
Sugar	1.0	8.3	-18.2	0.1	-0.2
Pulses	1.1	11.9	-17.9	0.2	-0.3
Onion	0.5	-38.1	90.2	-0.3	0.4
Meat & chicken	3.8	2.0	7.4	0.1	0.3
Rice	1.6	-0.6	14.3	0.0	0.2
Milk Fresh	6.7	3.8	3.9	0.3	0.3
Non-food	**62.5**	**4.2**	**5.0**	**2.4**	**3.0**
House rent	21.8	6.4	6.4	1.2	1.2
Education	3.9	10.3	12.1	0.4	0.5
Clothing, shoes	7.6	4.3	4.1	0.4	0.3
Motor Fuel	3.0	-5.7	10.4	-0.1	0.2

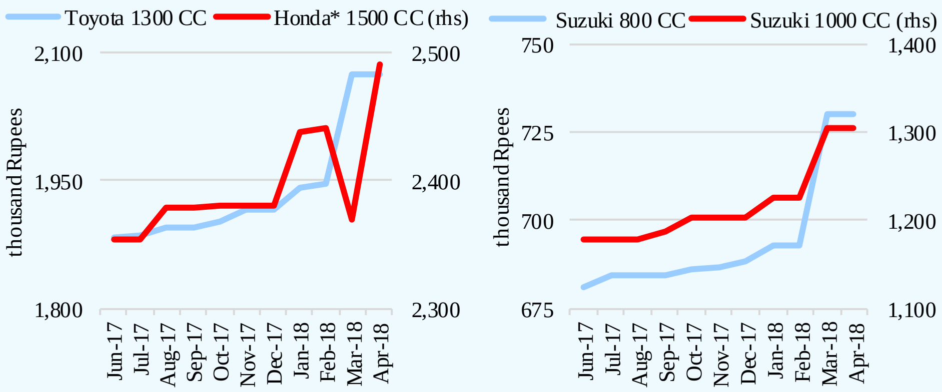
Data source: Pakistan Bureau of Statistics

Commodities that showed lower inflation during Jul-Mar FY18 were (a) cigarettes; (b) fresh vegetables; (c) sugar; and (d) pulses (**Table 3.7**). Here, it is important to mention that developments related to these items were actually triggered in Q1-FY18, but continued to subdue CPI inflation until the third quarter. These included: (a) fall in cigarette prices due to a change in the regulatory duty structure; (b) normalization of fresh vegetable prices as their supplies eased in FY18; and (c) excess supply of sugar and pulses in the country.

Motor vehicle prices spiked during Q3-FY18

Regulatory duty on car imports and a rising Japanese Yen against PKR during Jul-Mar FY18 had a significant impact on car prices in the CPI basket.[18] Car manufacturers raised the prices of several variants that are part of the CPI, and have an import-related component (**Figure 3.10**). Resultantly, the motor vehicle index rose by 5.7 percent during Q3-FY18 against 4.3 percent during the same period last year.

Figure 3.10: Spike in Car Prices



* Civic

Data source: Pakistan Bureau of Statistics

Pass-through of change in global oil prices to domestic POL

Demand and supply-related factors drove up global oil prices at a brisk pace.[19] Resultantly, the government raised domestic fuel prices quite frequently during Jul-Mar FY18 in order to keep them aligned with international prices (**Figure 3.11**). Cumulatively, petroleum prices rose from their lowest level recorded in CPI (in August 2017) to Rs 88.1 per litre, a growth of 26.7 percent.[20] Consequently, the motor fuel index rose by 10.4 percent during Jul-Mar FY18, after declining for previous three consecutive years in the same 9-month period. The impact of this rise also started to spill over to transport services, as the index

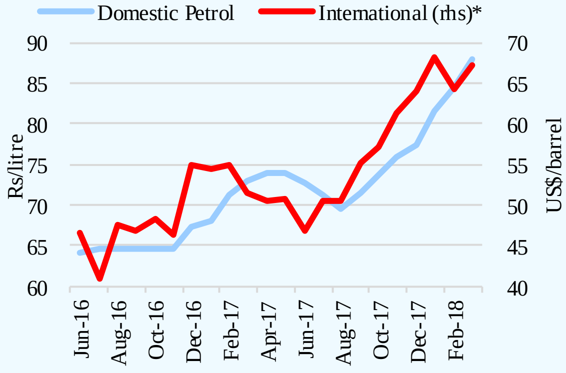
[18] The PKR depreciated by 13.5 percent against Japanese Yen during Jul-Mar FY18.
[19] Average prices of WTI, Brent, Dubai Spot and Saudi Arabian Light increased by 43.1 percent during Jul-Mar FY18. For details, see **Chapter 5**.
[20] Diesel prices were also adjusted, rising by just over 27 percent during the same period. In comparison, international oil prices (average of WTI, Brent, Dubai Spot and Arabia light Spot) increased from its recent trough by registering a 43 percent increase during Jul-Mar FY18.

rose by 1.3 percent during Q3-FY18 against declines in the same periods of FY15-FY17.

Rice prices on a rise despite sufficient supply

In case of rice, its prices have been steadily rising since the beginning of FY18. First, during Jul-Mar FY18, the quantum of rice export rose by about 16.8 percent compared to the same period of FY17. Second, the mid-December 2018 exchange rate depreciation appeared to boost the foreign demand of Pakistani rice. By extension, this enhanced external demand may have played an important role in maintaining the upward trajectory of rice prices.

Figure 3.11: Domestic and International Oil Prices



* Average of WTI, Brent, Dubai Spot and S Arabia Light
Data source: Bloomberg and Pakistan Bureau of Statistics

Regulatory duties affected various CPI items

Alteration in the structure of regulatory duties of cigarettes had prompted an unintended, abrupt fall in prices of cigarette items in the CPI during Q1-FY18.[21] In the third quarter, it was betel nut prices that felt a direct impact of regulatory duties; these prices rose by over five times during Q3-FY18.[22] This can be attributed to three factors, one of which was the FBR's decision to increase the regulatory duty on import of the commodity from 25 percent to 55 percent.[23] Second, attempts to illegally import betel nuts, and that too without proper medical certificate, had been made unsuccessful by customs authorities.[24] Third, there was a crackdown on the sale of the commodity in some parts of the country.[25]

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[21] For a detailed analysis of how the altered regulatory duties affected cigarette prices, please refer to SBP's First Quarterly Report on The State of Pakistan's Economy, 2017-18.

[22] While the weight of betel nuts in the CPI is negligible (0.02 percent), such an exponential increase in prices is worth highlighting.

[23] Through S.R.O.1035 (I)/2017.

[24] The Ministry of Commerce requires valid import permit as well as phytosanitary (health) certificate for the import of many food items (Ministry of Commerce, S.R.O. 1076).

[25] For instance, the Punjab Food Authority gave an ultimatum to retailers and wholesalers to stop selling betel nuts and close their respective businesses by 30th April, 2018, before legal action was taken against them.

In addition, regulatory duty of 30 percent imposed on maize in October 2017 had an indirect impact on chicken prices. According to the Pakistan Poultry Association (PPA), maize is the key ingredient of poultry feed, having about 60 percent weight. Given that domestic production of maize also remained low, the association holds that regulatory duty on maize has brought about a significant increase in input costs for the poultry producers. In the meantime, these developments appear to have contributed to an 18.4 percent increase in prices of chicken during Q3-FY18; in comparison, they had remained on the lower side during Jul-Mar FY15, FY16 and FY17.

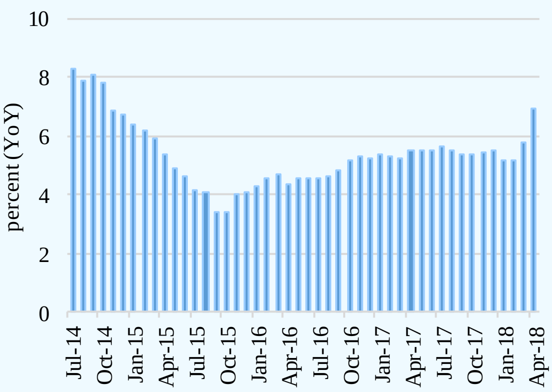
More broadly, the export quantum of meat grew by 3.4 percent during Q3-FY18, compared to a decline of 29.9 percent in Q3-FY17. Thus, the relatively lower supply in the domestic market may partially explain a rise in meat prices, which was the highest during Jul-Mar FY18 compared to similar periods since FY14.[26] Specifically, in case of beef and mutton, the growth in prices almost doubled during the period compared to Jul-Mar FY17.

Core inflation picked up

The non-food non-energy (NFNE) inflation displayed stable YoY growth during H1-FY18 (**Figure 3.12**). It even moderated somewhat in January and February 2018, as: (a) the house rent index witnessed the lowest YoY growth since FY10 in the first 2 months of 2018, and (b) the health index maintained single-digit (less than 5 percent) growth during the same period, compared to more than 12 percent average YoY growth during 2017.[27] [28]

However, during March and April 2018, the core index rose to its highest level in 36 months, due to rapid growth in an overwhelming majority of its components.[29] Two points

Figure 3.12: Non-Food Non-Energy Index



Data source: Pakistan Bureau of Statistics

[26] Meat (mutton and beef) and chicken have a combined CPI share of 3.8 percent.
[27] The house rent index is NFNE's heaviest component, with a 40 percent share.
[28] Average YoY growth in the health index was 8.7 percent during Jan-Apr FY18, compared to 9.9 percent in the comparable period a year earlier.
[29] CPI includes clothing and footwear, construction related indices, motor vehicle and its accessories, mechanical services and education.

are worth highlighting. First, the education index showed a YoY growth of 17.6 percent during March 2018, which is the highest ever since the rebasing of CPI; courtesy of majority of items in the index that showed double-digit growth.[30] Second, due to two rounds of exchange rate depreciation in December 2017 and March 2018, the higher cost of imported items evidently led to a broad-based impact on non-food CPI items.

[30] The items include the fee charged by educational institutions in both the public sector (average increase of 25 percent) and private sector (average increase of 15 percent).