3 Inflation and Monetary Policy

3.1 Overview

Following a cumulative increase of 75 bps in the policy rate in H2-FY18, monetary policy continued to move along the adjustment path. In each of the two policy reviews during Q1-FY19, the monetary policy committee (MPC) raised the policy rate by 100 bps as external vulnerabilities, rising inflationary pressures and overall macroeconomic stress, all necessitated shoring up of the stabilization efforts (**Table 3.1**).

Table 3.1: Macroeconomic Indicators

		FY18				FY19
	Unit	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
CPI inflation*	percent	3.4	4.1	3.8	4.4	5.6
Core inflation-NFNE*	percent	5.5	5.4	5.4	7.0	7.7
Exchange rate (M2M) *	Rs/US$	105.4	106.5	111.2	116.8	124.4
Current account deficit	billion US$	3.7	4.6	4.3	6.3	3.6
Oil prices (Saudi Light)*	US$/barrel	50.4	59.8	65.7	73.2	75.9
Import cover (SBP) (end period)	months	3.3	3.2	2.6	2.1	1.8
Fiscal deficit	% of GDP	1.2	1.0	2.0	2.3	1.4

* Quarterly average
Data sources: State Bank of Pakistan, Pakistan Bureau of Statistics and Bloomberg

In its July meeting, the MPC particularly took stock of fiscal slippages in the second half of FY18, as these could potentially undermine SBP's efforts to contain demand pressures. By the time MPC met for the first time in July 2018, these pressures had already triggered a sense of policy urgency, as the current account deficit had reached an unsustainable level with no foreseeable respite in reserves drawdown. Moreover, a steady increase in core inflation since March 2018, growing cost push pressures stemming from PKR depreciation and global crude prices, and high inflation expectations increased the likelihood of headline inflation for FY19 surpassing the annual target of 6 percent. In fact, SBP's model-based range for average CPI inflation had increased to 6.0-7.0 percent for FY19 – a 50 bps increase from the earlier forecast. Thus, with the balance of risk shifting increasingly in favor of further tightening, the MPC raised the policy rate with a consensus vote count.

The considerations guiding the MPC's decision in September policy review were not different from the earlier ones. However, new challenges also emerged that required further consolidation of earlier policy decisions. For instance, estimates of output gap had increased further with inflationary pressures evident in both the food and non-food items. More importantly, SBP's inflation projections for FY19 increased further in the range of 6.5-7.5 percent. The following factors played a key role in this regard: (i) a higher than anticipated rise in international oil prices and its pass-through to domestic fuel prices; (ii) an upward revision in domestic gas prices; (iii) further increase in regulatory duties on imports in early September 2018; and (iv) a continued second-round impact of previous PKR depreciations.

Furthermore, although the non-energy imports posted a decline as early harvest projects under CPEC matured and edible oil prices softened, the payment pressure remained strong due to higher crude oil prices. The increase in import bill more than offset the improvement observed in workers' remittances and exports during the first two months of FY19; resultantly, pressure on the current account persisted. In addition to domestic developments, the MPC also took stock of global developments, especially the protectionist policies adopted by some of the advanced economies and the diversion of capital flows away from the emerging market economies. In view of all these developments, the MPC decided to raise the policy rate further by 100 bps.

It is pertinent to highlight here that SBP's stabilization efforts are getting increasing support from the fiscal policy, as evident from the cuts in development spending in Budget 2018-19, and a partial reversal of earlier tax relief measures.[1] Budgetary borrowings from the banking system remained subdued during Q1-FY19, as the fiscal deficit was funded predominantly by domestic non-bank sources as well as external borrowings. Within the banking system, the government borrowed extensively from SBP, primarily to repay a large volume of its maturing debt held by the commercial banks.

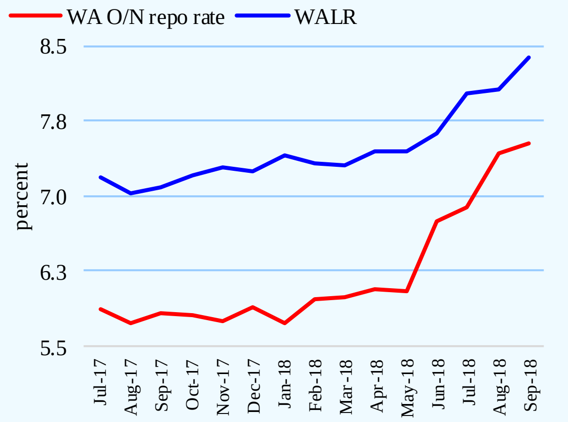
In overall terms, the government retired Rs 1.4 trillion held by commercial banks during Q1-FY19. Since this significant amount ran the risk of disrupting the interbank liquidity management and the levels of overnight rates, SBP had to unwind its earlier OMO injections substantially (to the tune of Rs 1.5 trillion). The net liquidity condition enabled the banks to cater to increased credit demand from both the private sector as well as PSEs during the quarter, without any unwarranted pressure on the overnight rates. A negative deviation of 8 bps on average between the overnight rates and the policy rate persisted nonetheless.

Easy liquidity conditions and a passive impact of the policy hike on the WALR (which increased by only 75 bps during the quarter) helped the private sector maintain its borrowing momentum in Q1-FY19 (**Figure 3.1**).

[1] PSDP spending declined from Rs 165.0 billion in Q1-FY18 to Rs 106.6 billion in Q1-FY19.

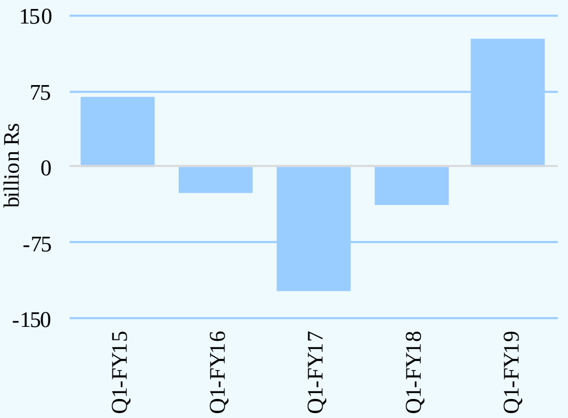
Against a seasonal decline witnessed in Q1-FY18, the overall offtake of private credit increased by Rs 127.9 billion in Q1-FY19 (**Figure 3.2**). The increase was evident primarily in working capital loans, as growth in fixed investment loans tapered during the quarter with maturing early harvest projects under the CPEC.

Figure 3.1: Trend in Key Interest Rates



Data source: State Bank of Pakistan

Figure 3.2: Credit to Private Sector- Flows



Data source: State Bank of Pakistan

Within working capital loans, borrowings by textiles and energy sector more than offset heavy retirements by sugar and rice processing firms. While the textile sector borrowings can be attributed to the higher export-driven activity as well as a sharp rise in cotton prices, the offtake by the energy sector mainly represented the price impact. In particular, rising crude prices increased the financing requirements of the petroleum refineries, while the higher furnace oil prices escalated the cost of thermal power generation; the overall activity in these two sectors remained weaker than last year. The impact of crude prices was also visible in the loans taken by the public sector enterprises (PSEs). Specifically, the increase in fuel cost further intensified the cash-flow related challenges (stemming from circular debt) in the energy sector value-chain.

Therefore, contrary to the developments in Q1-FY18, during which the entire growth in the net domestic assets (NDA) of the banking system had come from heavy public sector borrowings, the growth in Q1-FY19 has come from both the public sector and the private sector borrowings. However, the impact of NDA growth in overall money supply (M2) was partially offset by a net contraction in the net foreign assets (NFA) of the banking system, leading the M2 to post a net expansion of Rs 26.6 billion during Q1-FY19. This was unlike last year, when the impact of NDA growth on overall money supply was completely offset by a sharp contraction in NFA.

3.2 Monetary Aggregates

Broad money (M2) expanded by Rs 22.4 billion during Q1-FY19, as compared to a contraction of Rs 88.4 billion the same period last year. The entire increase stemmed from NDA of the banking system, as NFA continued to post net contractions during the period under review. In flow terms, SBP NFA recorded a smaller contraction compared to last year, which can be traced to the availability of external funding to the government during the quarter. Nevertheless, the outstanding stock of SBP NFA turned negative by the end of Q1-FY19 for the first time after February 2014, reflecting overall weaknesses in the country's external sector (**Table 3.2**).

Table 3.2: Monetary Aggregates
billion Rupees

	Flows		Stocks
	Q1-FY18	**Q1-FY19**	**end Sep18**
Government borrowing	333.1	73.5	10,273.2
Budgetary borrowings	369.9	84.9	9,477.6
From SBP	201.2	1,518.3	5,131.7
From scheduled banks	168.7	-1,433.7	4,345.8
For commodity operations	-36.3	-10.8	808.9
Credit to non-government	-32.2	189.2	7,222.8
Private sector	-37.4	127.9	6,100.8
PSEs	5.1	60.7	1,104.7
Other items (net)	-130.6	-91.8	-1,119.5
NDA	170.2	171.0	16,376.5
NFA	-258.6	-148.5	-357.0
SBP	-237.1	-92.2	-79.7
Scheduled banks	-21.5	-56.4	-277.2
Monetary assets (M2)	-88.4	22.4	16,019.6
Reserve money	-134.7	-31.0	5,453.7

Data source: State Bank of Pakistan

Credit to Public Sector Enterprises (PSEs)

Credit to the PSEs registered an increase of Rs 60.7 billion during Q1-FY19 compared to Rs 5.1 billion during the corresponding period last year. Importantly, a major share of PSE borrowings was attributed towards addressing liquidity constraints in the energy sector rather than investing in development projects to stimulate the real activity.

For instance, the bulk of the PSE credit was taken by Pakistan State Oil (PSO). The entity utilized these borrowings for payment settlements with its domestic and international debtors, which were pending for some time due to stuck-up receivables from different energy related enterprises, such as Gencos (mainly HUBCO and KAPCO), PIA and SNGPL. Similarly, additional borrowings by Power Holding Private Limited (PHPL) also contributed to this increase.

Commodity financing

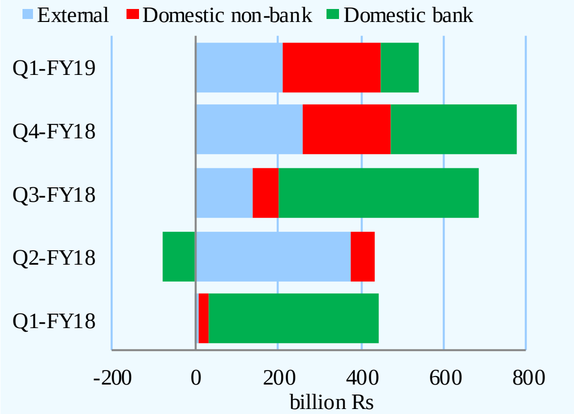
Procurement agencies, especially those involved in wheat related operations, had scaled up their bank borrowings to a 5-year high level during the fourth quarter of FY18. This represented not only strong commodity purchases but also cash flow problems faced by procurement agencies that emanated from their failure to offload a sizable portion of their stocks. However in Q1-FY19, these agencies were able to offload a significantly large amount of hypothecated stock compared to Q1-FY18,[2] primarily as export prospects became healthier on the back of recovery in global prices along with availability of heavy government subsidies.[3] However, as it turned out, there have been fewer seasonal retirements under commodity finance during Q1-FY19 compared to the same period last year.

This anomaly can be explained by the delayed interest payments by the procurement agencies on outstanding principals. In particular, responding to the policy rate hike, commercial banks had increased the mark-up amount due on the outstanding commodity loans, which impaired the repayment capacity of the procurement agencies. Resultantly, the agencies held up their scheduled repayments for some time and negotiated with banks for a better pricing. Furthermore, the expected improvement in the cash flow of agencies also did not materialize due to delays in subsidy payments by the government.

Budgetary borrowings

The overall budgetary borrowings from the banking system fell to a multi-year low during the first quarter of FY19. Although the overall fiscal deficit was higher in Q1-FY19 compared to the same quarter last year, its funding was skewed heavily towards non-bank domestic resources as well as external funding. In fact, banking system had financed 92.6 percent of fiscal deficit in Q1-FY18, but in Q1-FY19, its

Figure 3.3: Composition of Budgetary Finance



Data source: State Bank of Pakistan

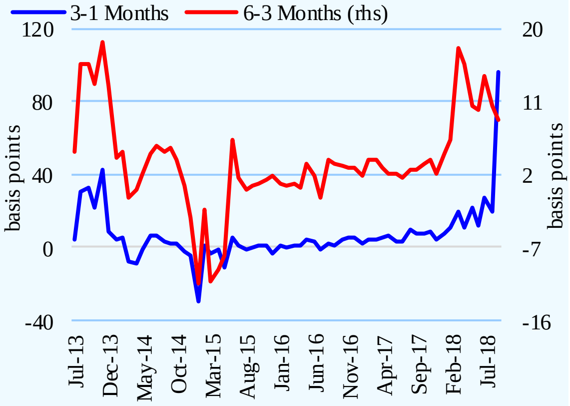
[2] During Q1-FY19, procurement agencies were able to offload 518.9 thousand MT of wheat. Last year, they could offload only 121.4 thousand MT.

[3] Global wheat prices were 12.7 percent higher on average during Jul-Sep 2018 compared to Jul-Sep 2017.

contribution in the same was only 17.1 percent (**Figure 3.3**).

Within the banking system, the reliance of the government on SBP financing increased considerably during the quarter, since scheduled banks' appetite for government securities remained muted because of expectations of a further increase in interest rates. These expectations are also reflected in the widening yield spreads in the secondary market between the 3-months and 1-month, as well as the yield spread between the 3-months and 6-months (**Figure 3.4**).

Figure 3.4: Yield Spreads in the Secondary Market



Data source: MUFAP

Therefore, the participation of the banks remained muted in most T-bill auctions (5 out of 7) during the quarter. The only two auctions where an active participation of banks could be seen were those held right after the July rate hike. In these two auctions, banks placed cumulative offers of Rs 4.4 trillion – all in 3m paper – against the maturities of Rs 2.0 trillion. As a result, the government was able to meet its pre-auction targets. However, in all other auctions, the government not only missed its pre-auction targets, but the net-of-maturity acceptances also remained negative. Importantly, 6m and 12m T-bills cumulatively failed to attract even one percent of the offers and acceptances in any auction held during the quarter.

Table 3.3: Auction Profile of Government Securities (face value)

billion Rupees

	T-Bills			PIBs -fixed rate			PIBs -floating rate		
	Target	Offered*	Accepted	Target	Offered	Accepted	Target	Offered	Accepted
In gross terms									
Q1-FY18	3,900.0	4,511.2	4,406.3	300.0	107.3	55.6	-	-	-
Q1-FY19	5,450.0	5,119.0	4,687.0	150.0	65.2	20.6	150.0	151.5	101.5
Net of maturity									
Q1-FY18	218.5	829.7	724.8	-296.6	-489.6	-541.0	-	-	-
Q1-FY19	-210.6	-541.6	-973.6	-311.1	-395.9	-440.6	150.0	151.5	101.5

*only MTB offered amount, excludes non-competitive bids

Data source: State Bank of Pakistan

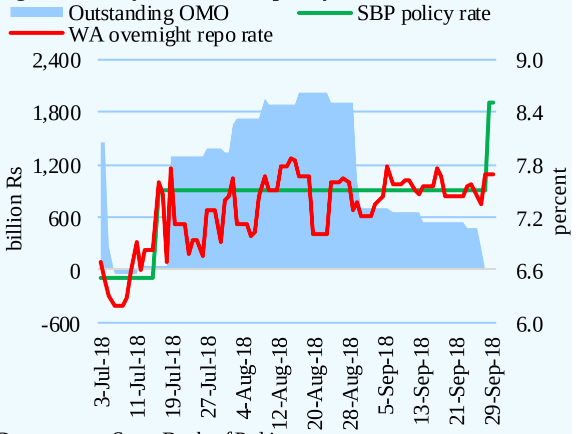
Likewise, fixed coupon PIBs demonstrated a similar trend where one out of three auctions was scrapped during the period under review. Moreover, the gross acceptances amounted to Rs 19.4 billion compared to maturities of Rs 461.1 billion. In contrast, floating rate PIBs remained the most favored instrument in the longer tenor bonds as the offered amount marginally exceeded the target compared to fixed rates where banks offered less than half of the target amount during Q1-FY19 (**Table 3.3**).

To sum up, the entire burden of sizable maturities of government papers as well as the additional government borrowing requirements was borne by the SBP. Resultantly, during Q1-FY19, government borrowings from the central bank soared to Rs 1.5 trillion.

3.3 Liquidity Conditions in the Interbank

The size of maturing government papers was sufficient for allowing banks to comfortably meet the liquidity demand emanating from: (i) higher credit off-take by private sector as well as PSEs; (ii) lower retirements by the government procurement agencies; (iii) uptick in FX injections; and (iv) a slowdown in the deposit growth.[4]

Figure 3.5: Key Interbank Liquidity Indicators

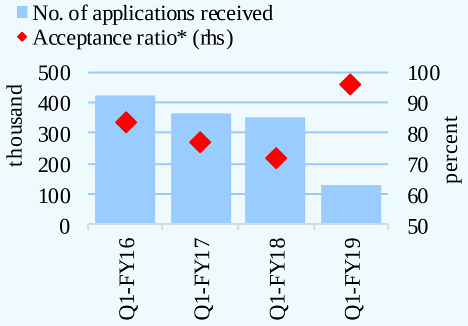


Data source: State Bank of Pakistan

Consequently, SBP rolled back the outstanding OMO injections to remove surplus liquidity from the market. The average outstanding OMO injections stepped down to Rs 1.0 trillion during Q1-FY19 compared to Rs 1.4 trillion last year (**Figure 3.5**). Despite the efforts, however, excess liquidity persisted in the interbank market, as evident from a negative 8 basis points deviation of overnight rates from the policy rate during Q1-FY19, compared to a 5 basis points positive deviation in Q1-FY18.

[4] Total deposits with commercial banks grew by 0.01 percent during Q1-FY19 compared to 0.37 percent last year.

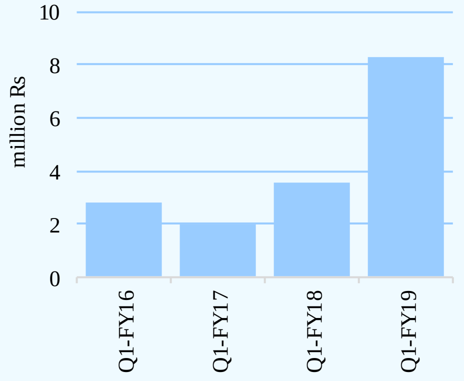
Figure 3.6a: Number of Loans Applications and Banks' Acceptances



* No. of loan applications accepted by banks divided by no. of loan applications received

Data source: State Bank of Pakistan

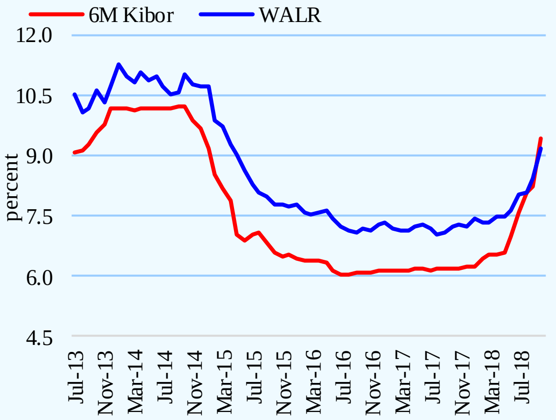
Figure 3.6b: Average Loan Size for Accepted Applications



Data source: State Bank of Pakistan

Thus as banks were not keen on investing in government papers, they focused solely on expanding private loan portfolios to park available liquidity. Although the credit demand conditions were not as upbeat as in the previous few quarters, partly due to higher interest rates and macroeconomic uncertainty, a strong competition persisted among banks for securing credible and financially viable projects. In fact, the number of loan applications that the banks received during the quarter posted a sharp decline during the quarter (**Figure 3.6a**). However, banks accepted most of these applications; the average loan size against accepted applications was also quite large (due to higher input prices) compared to the same quarter of preceding three years (**Figure 3.6b**). Their eagerness to expand loan portfolio is also reflected from the fact that the banks even lent at kibor to some of their prime customers, which almost wiped out the premium between 6-month kibor and the overall weighted average lending rates (**Figure 3.7**).

Figure 3.7: Trend in Lending Rates



Data source: State Bank of Pakistan

3.4 Credit to Private Sector

Credit to the private sector rose by Rs 127.9 billion in Q1-FY19, compared to a net retirement of Rs 37.4 billion in the same period last year. This healthy credit offtake indicates an encouraging start of FY19, as first quarter of fiscal year usually exhibits seasonal retirement of private credit. The credit developments during Q1-FY19 can be explained by (i) rising input costs (especially cotton and petroleum) which increased the demand for working capital loans; (ii) a sharp depreciation of PKR, which increased the rupee cost of imported inputs and machinery/equipment; and (iii) expedited work on planned investments in cement industry, which boosted its demand for long-term loans. Meanwhile, the pace of consumer financing slowed due to policy measures such as ban on non-filers from transactions in auto and house purchases/registration during Q1-FY19.

The growth in fixed investment loans tapered

The growth momentum in fixed investment loans weakened during Q1-FY19 (**Table 3.4**). The offtake by manufacturing sector was particularly subdued as the loan offtake more than halved compared to Q1-FY18. Within manufacturing, cement and sugar were the only two sectors where any noticeable activity was observed.

Long term borrowing in cement can be traced to expedited work on already planned investment of some projects. These projects had faced temporary slowdown last year due to regulatory constraints, however, work on these projects have now been resumed.[5]

As for the sugar sector, a higher credit offtake during Q1-FY19 represents liquidity constraints. Although firms were able to export a sizable quantity of sugar during the period, their cash flows did not improve considerably as the government did not make full payment of the export subsidy amount. Sugar manufacturers also blame the prevailing depressed prices in the domestic market for their liquidity problems. A number of firms have defaulted on their scheduled payments to the banks as the sector's outstanding non-performing loans (NPLs)

[5] For instance, Maple Leaf Cement temporarily held back work on its 7,300 tons per day project in Q2-FY18 due to an order issued by Punjab Environmental Protection Agency (EPA) in December 2017. Later in January 2018, the Lahore High Court put aside the EPA order in favor of the firm. Since then the firm resumed its expansion plan, which also progressed in Q1-FY19. Other firms borrowed to keep progress towards commencing operations of new plants according to their scheduled timelines. For instance, Cherat Cement borrowed for installation of Waste Heat Recovery for Line III, Kohat Cement for grey cement line of 7,800 tons per day capacity expansion, Pioneer Cement for 24 MW power plant, and Flying Cement for Waster Heat Recovery unit.

Table 3.4: Loans to Private Sector Businesses (Flows)

	Total Loans		Working Capital*		Fixed Investment	
billion Rupees	**FY18**	**FY19**	**FY18**	**FY19**	**FY18**	**FY19**
Private sector businesses	**-31.8**	**99.0**	**-85.9**	**64.1**	**54.0**	**34.9**
Manufacturing	-42.6	50.5	-87.3	30.2	44.7	20.3
Cement	0.5	17.4	-2.6	6.6	3.1	10.8
Textiles	-3.6	29.6	-18.0	29.4	14.5	0.2
Refined petroleum	-2.8	20.1	-1.9	22.0	-1.0	-1.9
Iron & steel	6.4	15.3	6.1	12.9	0.3	2.4
Edible oil and ghee	17.6	12.1	14.2	11.8	3.4	0.2
Motor vehicles	1.3	9.9	1.1	8.7	0.2	1.3
Fabricated metal products	1.1	5.1	0.0	4.3	1.1	0.8
Paper	-2.9	4.1	-4.4	5.1	1.5	-1.0
Fertilizer	-11.5	-7.4	-11.1	-2.9	-0.4	-4.5
Sugar	-31.5	-21.9	-39.9	-32.3	8.4	10.4
Rice processing	-12.7	-23.4	-13.0	-23.7	0.3	0.3
Electricity, gas and water supply	-4.5	35.2	-0.3	35.0	-4.1	0.2
Prod, trans and distribution of electricity	-4.2	36.1	0.6	35.7	-4.8	0.5
Prod, trans and distribution of gas	-0.3	-0.9	-1.0	-0.7	0.7	-0.2
Real estate & related	7.3	8.4	3.4	5.3	3.9	3.1
Transport, storage and communications	3.9	7.7	1.9	4.8	2.0	2.9
Construction	-1.1	5.7	-4.4	3.6	3.3	2.1
Mining and quarrying	2.6	2.0	-0.6	-2.4	3.2	4.3
Agriculture	9.3	-2.2	5.4	0.5	3.9	-2.8
Commerce and trade	5.3	-4.6	4.0	-5.5	1.3	0.9
Ship breaking	1.0	-10.4	1.0	-10.2	0.1	-0.2

*includes trade financing
Data source: State Bank of Pakistan

have grown by 41.6 percent during Q1-FY19.[6] So apparently, the sector's reliance on bank funding has increased to partially settle its dues with the banks; while some firms defaulted, others actually retired their short-term loans (working capital) by taking long-term loans (fixed investment). Given an uncertain liquidity position ahead, and the looming crushing season, these firms might also be finding it appropriate to lengthen their debt maturity profile.

Increased input costs raised the demand for working capital loans

Working capital rose by Rs 64.1 billion in Q1-FY19, compared to net retirements of Rs 85.9 billion in the same period last year. While the first

[6] The overall infection ratio of the sector has also increased from 5.2 percent at end June 2018 to 8.3 percent in September 2018.

quarter typically represents seasonal retirements in the working capital loans, the offtake remained higher this year due to a sharp rise in input/commodity prices. For example, the impact of higher prices of key inputs (stemming from both the global price increase as well as PKR depreciation) seems quite dominant in the increased borrowings by petroleum refineries and power generation units. These two sectors cumulatively borrowed Rs 57.7 billion in Q1-FY19 compared to only Rs 1.3 billion last year. However, if we adjust their borrowings with price trends in crude oil and thermal fuels (furnace oil, high speed diesel and coal), the increase in working capital loans during Q1-FY19 becomes quite marginal (**Table 3.5**).[7] This impact is also visible in relatively weak activity in these sectors: while the pace of thermal power generation slowed down in Q1-FY19, refining activities actually posted a contraction of 5.4 percent compared to the same period last year. Here it is also important to mention that the energy sector's reliance on the banking system on the whole is at elevated level due to the circular debt problem. This is especially true for petroleum refineries, as these firms typically generate sufficient amount of liquidity on their own when smoothly receive payments for the fuels sold.

Table 3.5: Working Capital Borrowings by POL and Power sectors in Q1 (Flows)
billion Rupees

	POL		Power	
	Nominal	Real*	Nominal	Real**
FY18	-1.9	-0.2	0.6	0.0
FY19	22.0	0.2	35.7	0.2

*Deflated using Saudi Arabian Light,
**Deflated using WPI index of furnace oil, coal and HSD
Data source: State Bank of Pakistan

As for the textiles, while the impact of 36.6 percent YoY increase in domestic cotton prices appears quite prominent in Q1-FY19, the activity in this sector (as reflected in higher export quantum) also explains a sharp increase in working capital loans. The overall working capital borrowing of textile firms increased by Rs 29.4 billion during Q1-FY19, in contrast to the net retirements of 18.0 billion that were observed during Q1-FY18. Since most of the activity in the sector was export-centric, around 39 percent of the borrowing was met from SBP's export refinance schemes, which were offered at a subsidized rate of 3.0 percent during Q1-FY19.

The fertilizer sector, on the other hand, retired its working capital loans in Q1-FY19. This was consistent with the decline in both the fertilizer offtake and production during the review period. Fertilizer off-take fell by 6.1 percent in Q1-FY19, compared to a rise of 1.2 percent in Q1-FY18 on a YoY basis, as a fall in area under cultivation of different Kharif crops was reported. Furthermore, two

[7] Arab light prices were 50.5 percent higher on average between Jul-Sep 2018 compared to Jul-Sep 2017.

out of three small units could not resume production due to non-availability of cheaper feedstock. This situation contributed to fertilizer sector's production falling by 4.8 percent during Q1-FY19, compared to a fall of 5.8 percent during the same period last year. [8]

Underserved segments such as SMEs need immediate attention of banks

Segment-wise analysis reveals that the corporate borrowers remained the major beneficiaries during Q1-FY19, while the share of SME advances continued to fall. The number of SME borrowers also declined in Q1-FY19 compared to the same period last year (**Table 3.6**). Most of this decline was evident in the big 5 banks, as the other banks increased their SME exposure by establishing hub branches in SME concentrated locations. However, their clientele growth too failed to pick up. This suggests that the focus of the banking industry is misplaced; instead of extending small loans to a large number of borrowers, they are focusing on expanding their aggregate loan portfolio.

Table 3.6: Major Indicators of SME Financing in Q1

flow in billion Rupees

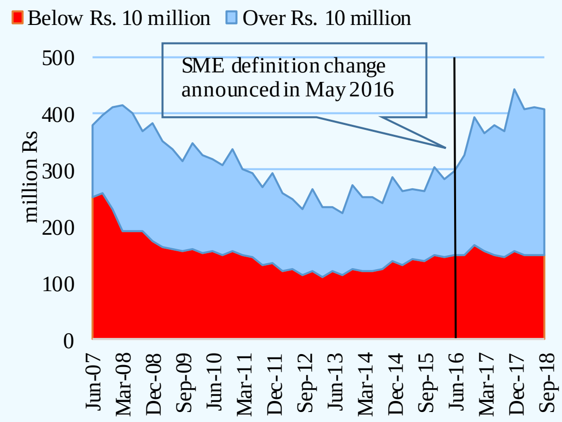
	FY17	FY18	FY19
SME finance	27.4	-10.8	-4.8
Big 5 banks	-3.9	-1.0	-6.8
*Other commercial banks**	31.1	-9.6	2.0
Share in advances (%)	6.3	6.0	5.4
Big 5 banks	4.5	4.9	4.3
*Other commercial banks**	7.9	6.9	6.3
No. of borrowers	164,585	173,785	172,899
Big 5 banks	31,425	43,848	46,494
*Other commercial banks**	95,140	91,986	88,561
NPLs ratio (%)	25.9	21.1	18.5

*excluding specialized

Data source: State Bank of Pakistan

Specifically, the existing SME portfolio is skewed towards big-ticket loans, as the share of loans over Rs 10 million has increased to 76.7 percent in the total SME advances at end-September, 2018, from 74.1 percent at end-September, 2017. Moreover, since March 2016, the overall rise in the SME loans is stemming from big-ticket loans only (**Figure 3.8**). It is important to note that this shift appeared after the

Figure 3.8: Composition of SME Loans by Size



Data source: State Bank of Pakistan

[8] Data source: National Fertilizer Development Centre (NFDC) and Pakistan Bureau of Statistics.

relaxation of SME definition in SBP's prudential regulations.[9] SBP has already undertaken various measures to improve credit availability across various sectors. In this regard, banks need to take advantage of the recent SME policy announced in FY18 to revive credit to this under-served sector on a priority basis.

Budgetary measures decelerated the pace of major consumer segment

After rising consistently for the last four quarters, the flow of consumer financing decelerated to Rs 15.3 billion in Q1-FY19 (**Table 3.7**). In particular, the offtake of car loans in Q1-FY19 more than halved compared to the same quarter last year, with banks also receiving much fewer applications for car loans in Q1-FY19 compared to the same quarter last year (**Figure 3.9**).[10] The government's decision of barring non-filers from purchasing/ registering vehicles mainly contributed to this slowdown, as complying with government directives, two of the three largest auto assemblers had suspended advanced car bookings for non-filers back in May 2018.

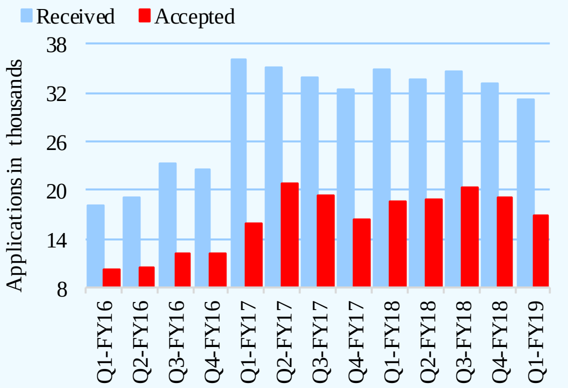
Table 3.7: Consumer Financing Q1 (flows)
billion Rupees

	FY18	FY19
Total	18.4	15.3
1) For house building	6.3	5.4
2) For transport i.e. purchase of car	11.2	5.0
3) Personal loans	0.8	3.5
4) Credit cards	1.6	1.1
5) Consumer durables	-1.5	0.3

Data source: State Bank of Pakistan

The decelerating impact of auto-finance on overall consumer financing was offset to a large extent by the Rs 3.5 billion rise in personal loans during Q1-FY19. Data suggests that some banks having high branch penetration and a large customer base of salaried class were able to push further in this segment during the quarter under review.

Figure 3.9: Trend in Applications Received and Accepted for Auto Loans



Data source: State Bank of Pakistan

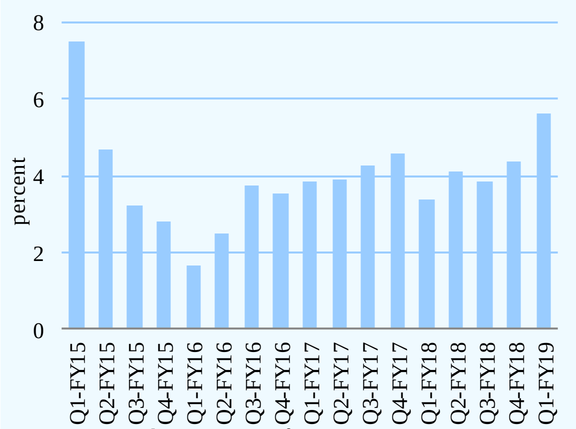
[9] IH&SMEFD Circular No. 02 of 2016, dated May 06, 2016 available at http://www.sbp.org.pk/smefd/circulars/2016/C2.htm

[10] PKR depreciated by 2.2 percent during Q1-FY19, compared to only 0.5 percent depreciation in the same period last year.

3.5 Inflation

Average headline CPI inflation increased to 5.6 percent during Q1-FY19 compared to 3.4 percent in Q1-FY18. This is the highest level of quarterly inflation observed since Q1-FY15 – the period from where global oil prices had begun to soften (**Figure 3.10**).

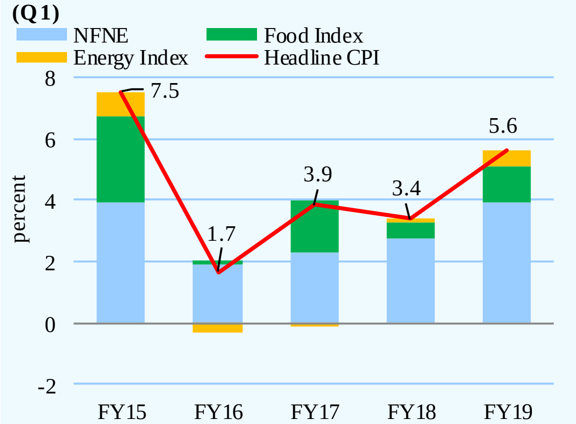
Figure 3.10: Average Headline CPI Inflation



Data source: Pakistan Bureau of Statistics

On the face of it, the most dominating push to headline CPI inflation during the quarter came from non-food-non-energy (NFNE) component, which typically represents the underlying demand pressures in the economy (**Figure 3.11**). However, it is important to highlight here that the increase in NFNE during Q1-FY19 also contained cost-push pressures, particularly the second round effects of higher oil prices as well as PKR depreciation.

Figure 3.11: Composition of Average Headline CPI Inflation (Q1)



Data source: Pakistan Bureau of Statistics

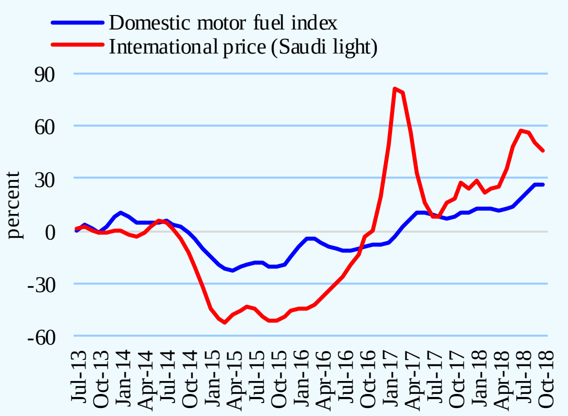
One such item within NFNE is transport services. Here, the entire impact can be attributed to the pass-through of increase in fuel prices (petrol, diesel and CNG). Similarly, motor vehicle prices have also increased by 10.7 percent during Q1-FY19, which the domestic auto assemblers have justified with PKR depreciation and the resultant increase in cost of imported CKDs/SKDs and other auto parts. Other items such as footwear and household equipment, where market supplies primarily contain imported items, also reflect some impact of PKR depreciation in addition to strong demand.

The direct impact of fuel prices on headline CPI inflation was also strong. These contributed nearly 18 percent to the *increase* in headline inflation in Q1-FY19 over the same period last year. Furthermore, food inflation also remained stronger than last year, as prices of major items such as wheat and sugar recovered from their depressed levels that had persisted throughout FY18. This recovery has come at a fiscal cost, since subsidy-led exports played an important role in offloading surpluses. Furthermore, the impact of fuel prices was also felt on most food items, as retailers passed on the impact of higher transportation costs to the consumers. This impact was more pronounced in the case of milk and meat.

Rising global and domestic oil prices

International oil prices continued on their upward trajectory during Q1-FY19. After increasing by 64.5 percent in FY18, price of Saudi Light increased by another 4.6 percent during Q1-FY19. Responding to this, the government has increased the petrol prices by only 1.5 percent (Rs 1.4 per liter) during Q1-FY19. This increase is quite subdued when we consider the following: (i) the government had only partially passed on the impact of increase in global crude prices that were observed in FY18, which suggests that a lagged pass-through of the earlier price increases was due; and (ii) Pak rupee posted a depreciation of 13.7 percent and 2.2 percent against the US dollar during FY18 and Q1-FY19 respectively; its impact on domestic petrol prices was also expected.

Figure 3.12: Changes in Global and Domestic Fuel Prices

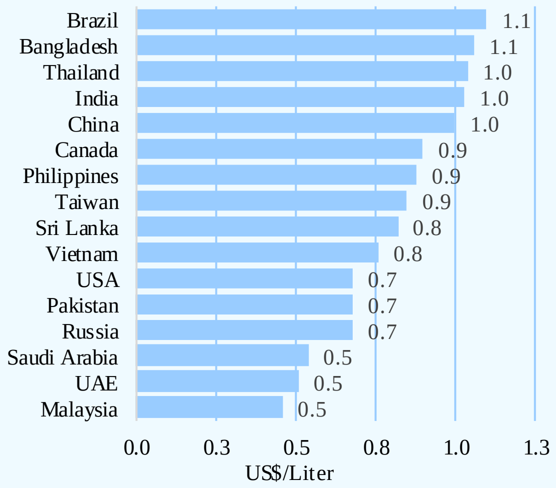


Data sources: PBS and Bloomberg

As shown in **Figure 3.12**, a one-to-one relationship between global and local fuel prices does not exist, especially as governments try to manage the volatility in the domestic fuel markets. That said, a contained increase in petrol prices recently may have also had some political considerations. Since 2018 was an election year, the outgoing government as well as the newly incumbent government, both were reluctant to raise the prices significantly to avoid public criticism. The outcome is that the current level of petrol prices in Pakistan continues to stay closer to the level that is observed across oil exporting countries (**Figure 3.13**). Not only does this entail fiscal burden but it also maintains the domestic petrol demand at an elevated level.

Nevertheless, the prices of transportation services were adjusted upward by 14.4 percent – a double-digit growth after an interval of 6 years. Items that contributed the most to transport inflation were train fares for short distances (less than 100 km), as well as fares of buses and air travel. Together, fuel and transport services contributed about 20 percent of the increase in non-food inflation during Q1-FY19, compared to their combined contribution of 3.4 percent during Q1-FY18.

Figure 3.13: Retail Petrol Prices (as of 14th Jan 2019)



Data source: www.globalpetrolprices.com

Table 3.8: Average CPI Inflation and Contribution from Different Items during Q1
growth in percent, contribution in percentage point

		Growth		Contribution	
	Weight	**FY18**	**FY19**	**FY18**	**FY19**
Overall CPI	**100.0**	**3.4**	**5.6**	**3.4**	**5.6**
Food *of which*	**37.5**	**1.2**	**2.7**	**0.5**	**1.1**
Cigarette	1.4	-16.4	0.6	-0.4	0.0
Wheat flour	4.2	-2.3	3.9	-0.1	0.2
Fresh vegetable	1.7	-5.7	4.0	-0.1	0.1
Tomatoes	0.4	-12.9	22.9	-0.1	0.1
Sugar	1.0	-17.5	-3.3	-0.2	0.0
Pulses	1.1	-17.5	-11.3	-0.3	-0.1
Meat	2.4	7.0	10.8	0.2	0.3
Milk	6.7	3.7	3.9	0.3	0.3
Non Food *of which*	**62.5**	**5.0**	**7.6**	**2.9**	**4.5**
Fuel	3.0	7.2	25.8	0.1	0.5
Transport services	2.7	0.1	14.4	0.0	0.3
Clothing & footwear	7.6	3.9	6.5	0.3	0.5
Education	3.9	10.1	13.7	0.4	0.6
Household equip	4.2	2.8	6.1	0.1	0.3
House rent	21.8	7.2	7.6	1.3	1.5
Recreation	2.0	0.3	6.7	0.0	0.1
Construction index	0.9	4.1	9.4	0.0	0.1
Motor vehicle	0.7	4.1	10.7	0.0	0.1
NFNE	**53.5**	**5.5**	**7.7**	**2.8**	**4.0**

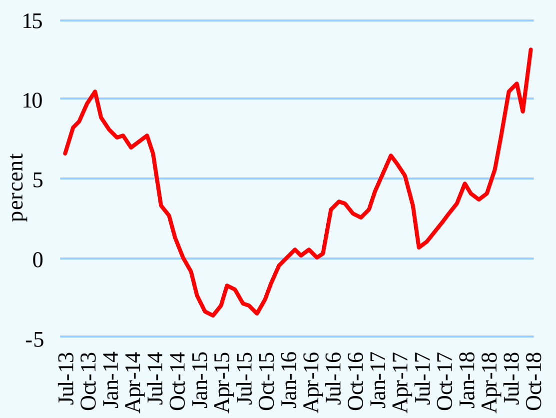
Data source: Pakistan Bureau of Statistics

Food prices normalized during the quarter
A slightly higher growth in food index was primarily due to the impact of cigarette prices. It may be recalled that the prices of cigarette uncharacteristically tumbled by 16.4 percent during Q1-FY18 due to a change in the duty structure by the government (**Table 3.8**).[11] This year, the prices remained more or less stable. Similarly, the prices of wheat flour, tomato and fresh vegetables also normalized in Q1-FY19 after witnessing a decline last year.

In addition, the prices of sugar and pulses continued to post negative growth during the period under review, although the downward drag was much contained compared to during Q1-FY18. In case of the former, a record sugarcane production and an excess availability had depressed its price last year; this year, increased sugar exports helped stabilize the price in the domestic market.

Cost-push pressures are increasing
With the surge in global commodity prices along with a sharp depreciation of Pak Rupee against the US Dollar, domestic prices of key raw-materials and capital goods have increased in recent months. These items are included in the wholesale price index (WPI), which has recorded a double-digit growth during Q1-FY19 – the first time in the last 7 years (**Figure 3.14**).

Figure 3.14: YoY Growth in WPI Index

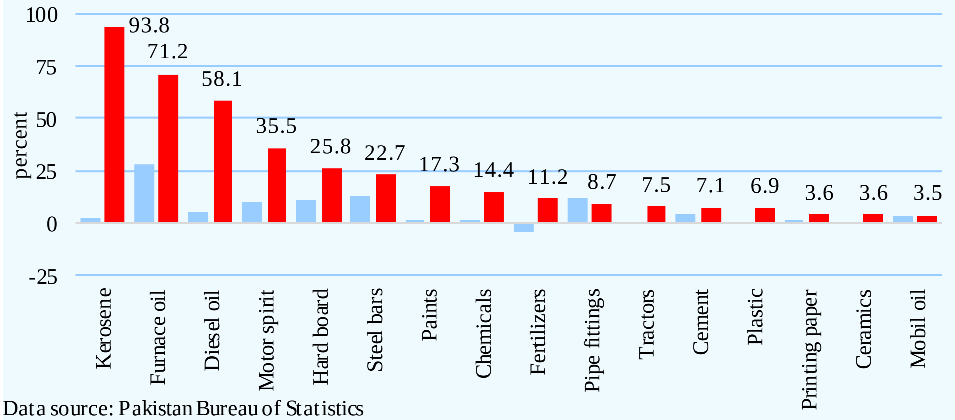


Data source: Pakistan Bureau of Statistics

It is important to note that although the inflation in petroleum products was the strongest (especially in the case of kerosene and furnace oil), non-oil products have also experienced a higher inflation compared to the same period last year. These mainly included (i) construction related items, such as cement, steel, pipe fittings etc.; (ii) agriculture inputs, such as tractors, fertilizers and pesticides; and (iii) other industrial inputs like metal and plastic products (**Figure 3.15**).

[11] For details, see SBP's First Quarterly Report of 2017-18 on The State of Pakistan's Economy,

Figure 3.15: Increasing Cost Push Pressures (Inflation in Key WPI Items during Q1)



Data source: Pakistan Bureau of Statistics

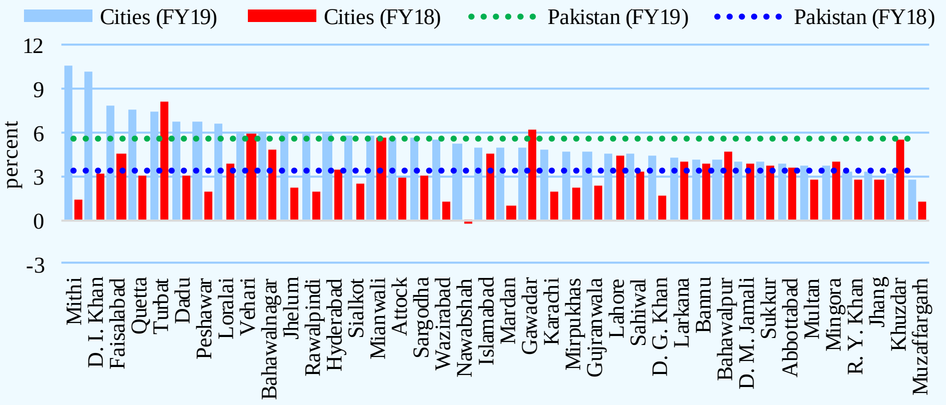
Education

As highlighted in previous quarterly and annual reports of SBP, the education index of CPI has increased by an average of more than 10 percent during the past few years, even when the overall inflation remained quite subdued. In Q1-FY19 also, education witnessed 13.7 percent inflation, whereas the index grew by 10.1 percent during Q1-FY18. Typically, the uptrend in education inflation was led by the private institutions, especially schools. However, in Q1-FY19, fee increase in public institutions was also a major contributing factor.

Skewed inflation rate across cities

Average headline CPI inflation during Q1-FY19 has varied across the 40 cities for which the data is compiled. While the average inflation during the quarter was 5.6

Figure 3.16: City-wise Inflation (Q1)



Data source: Pakistan Bureau of Statistics percent, the range of inflation amongst cities is 7.8 percentage point, with a maximum of 10.6 percent inflation in Mithi to a minimum of 2.8 percent in Muzzafargarh. The range is not different than last year; however, both the minimum and maximum of Q1-FY19 are higher than the same period of FY18.

Mithi and Dera Ismail Khan are the cities that stand out for Q1-FY19 in two ways. First, they have the highest inflation amongst the 40 cities within the CPI index during Q1-FY19 (**Figure 3.16**). Second, they are the top 2 cities that showed the highest *increase* in inflation during Q1-FY19 compared to Q1-FY18. At a disaggregated level, nearly all the sub-indices of these cities recorded higher inflation. It is necessary to highlight here that the CPI has equal weights for all the 40 cities. Therefore, inflation in small cities like Mithi and Dera Ismail Khan affects the overall inflation as much as a populous city like Karachi or Lahore. It has been the case that the inflation has been quite volatile (and sometimes higher) in smaller cities (probably due to supply related issues), which eventually translates into a generally high and volatile country-wide inflation as well.