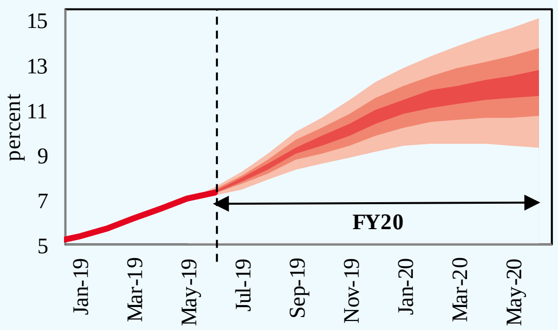
3 Inflation and Monetary Policy

3.1 Overview

By the start of FY20, the macroeconomic stabilization measures taken over the past year and a half had largely succeeded in reining in demand pressures in the economy. However, inflation proved difficult to deal with, especially given: (i) rising cost pressures emanating from the exchange rate depreciation and the rationalization of energy prices; (ii) a large fiscal deficit last year and its financing through central bank borrowing; and (iii) a steep rise in food inflation in the fourth quarter. Headline CPI inflation touched a higher plateau in every successive quarter of FY19, reaching 8.9 percent in April-June 2019. For FY20, the SBP's projections at the start of the year (July 2019) clocked in at an elevated range of 11-12 percent. Not only was this range higher than previously projected (**Figure 3.1**), but it was also in excess of the medium-term target of 5-7 percent.

Figure 3.1: CPI Inflation Projections (July 2019 forecast)
12-month moving average

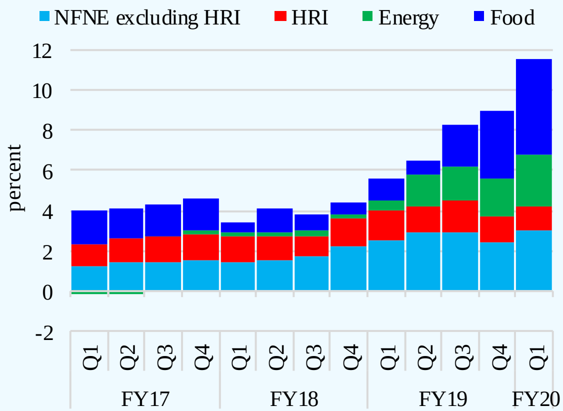


*Probability distribution of risks around the average forecast. Shades indicate various levels of confidence interval.
Data source: SBP staff estimates

These projections were premised entirely on the additional pressures emanating from: the OGRA's approval of up to a 168 percent hike in gas tariffs (effective from July 2019); several tax rationalization measures rolled out in the Budget 2019-20; and the expected pass-through of the exchange rate depreciation that took place towards the end of FY19. Although these measures were to bring about just a one-time surge in prices, these could also potentially reinforce inflation expectations. Moreover, further adjustment in the real interest rate was warranted to anchor the inflation expectations around the medium-term inflation target. Therefore, when the Monetary Policy Committee (MPC) met in July 2019, it raised the policy rate by 100 basis points.

As the quarter progressed, the upward pressures on inflation began to materialize. The steepest jump was recorded in the energy price index, reflecting the impact of a sharp increase in natural gas tariffs – this alone contributed 1.6 percentage points to the overall inflation during the quarter (**Figure 3.2**). The pass-through of the June 2019 exchange rate depreciation also had an impact. Not only did it push up fuel prices (and consequently transport fares), but it also reinforced the prevailing input cost pressures. Meanwhile, immediate price increases of a number of items was noted in the wake of tax rationalization measures: (i) the imposition of federal excise duty shored up retail prices of cigarettes, edible oil/ghee, cement, steel and cars; (ii) the end of zero-rating regime for the textile industry pushed up clothing prices, as producers passed on the impact of the applicable general sales tax (GST) to end-consumers; and (iii) the end of the reduced GST regime on sugar partially contributed to the increase in its retail prices. The impact of these budgetary adjustments was visible in a steep 2.3 percent month-on-month inflation recorded in July 2019.

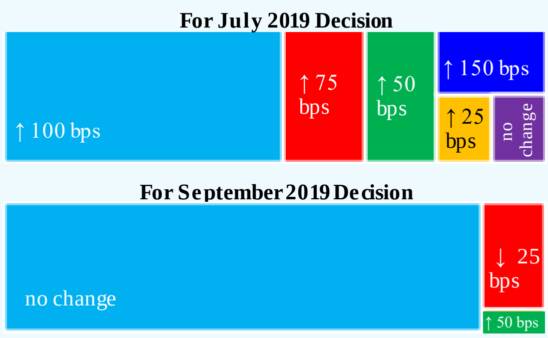
Figure 3.2: Composition of YoY CPI Inflation



Data source: Pakistan Bureau of Statistics

In subsequent months also, the course and the magnitude of headline inflation remained broadly in line with the SBP's earlier projections. Importantly, the improvement in the balance of payments (that led to stability in the market-based exchange rate), and the government's adherence to fiscal discipline, were both helpful in subduing the potential upside risks to inflation. As a result, the SBP's inflation projections in September 2019 remained more or less unchanged from July 2019. Keeping in view these developments, the MPC decided to keep the policy rate unchanged in its September 2019 decision.

Figure 3.3: Bloomberg Survey on Market Expectations*



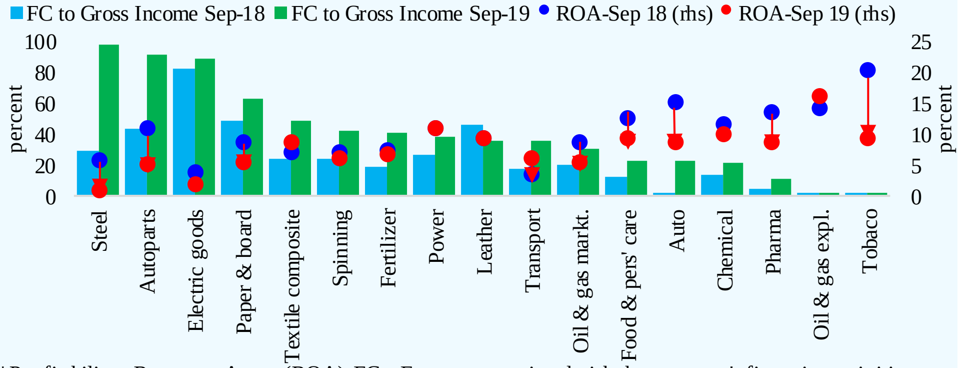
*The survey results are based on the views of economists at various brokerage houses, asset management companies and commercial banks in Pakistan

Data source: Bloomberg

The decision did not come as a surprise for the interbank market, as the expectations for further monetary tightening had subsided to a large extent after the July 2019 decision. Surveys of bank treasuries and fund managers explicitly reflected expectations that interest rates had peaked out (**Figure 3.3**). These expectations were also visible from the growing demand for longer tenor government papers in the primary market, and the yield spreads turning negative in the secondary market. In fact, banks were keenly observing the improvement in the fiscal position and the visible shift in the budgetary financing pattern away from banking sources (towards non-bank sources). Therefore, banks overbid in most auctions of government papers and locked in their available liquidity in long-term fixed-income assets.

As for private businesses, maintaining the interest rates at the elevated level meant they had to put up with the prevalent tight financial conditions. While credit demand was already weak due to thin activity in the manufacturing sector, most businesses avoided bank borrowing even to finance their short-term liquidity needs. Last year, cash flow constraints arising from inventory build-up and rising input costs had pushed many firms towards excessive leveraging; but with the weighted average lending rates hovering at 7 and a half year high levels in Q1-FY20, it had become difficult for firms (except for steel and car manufacturers) to viably meet their liquidity needs through bank borrowings. Financing cost had started eating up on firms' gross margins, which were already under stress owing to weak demand conditions (**Figure 3.4**). Therefore, a number of sectors preferred to deleverage; also, fewer requests were placed with banks for fresh working capital facility. In overall terms, Q1-FY20 saw net retirements of Rs 16.9

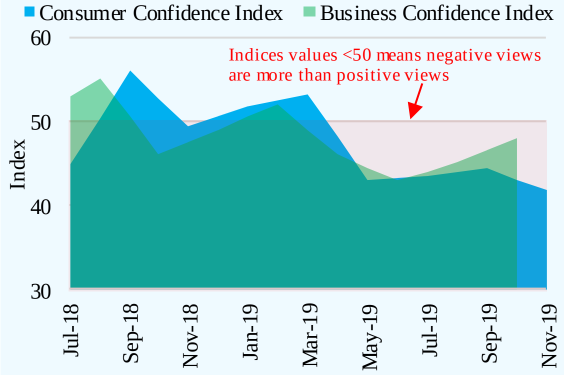
Figure 3.4: Financing Cost (FC) and Profitability of Non-Financial Firms



*Profitability= Return on Assets (ROA), FC = Expense associated with the company's financing activities, Gross income/loss = Net Sales + Other Operating Income - Cost of Goods Sold - Other Operating Expenses.
Data source: Bloomberg (financial data was available for 71 firms)

billion of private sector credit. Fixed investment also remained subdued as the overall confidence among businesses and consumers remained weak (**Figure 3.5**).

Figure 3.5: IBA-SBP Confidence Surveys



Source: IBA-SBP Consumer and Business Confidence Surveys

3.2 Monetary aggregates

Broad money expanded by Rs 105.2 billion during Q1-FY20, compared to Rs 22.4 billion last year (**Table 3.1**). Unlike the trend in the past 3 years, the entire increase this year stemmed from an improvement in net foreign assets (NFA) of the banking system, reflecting the improvement in the country's balance of payments and the receipt of the first tranche of the IMF's EFF program. Here, it is important to mention that this is the first time that the IMF's lending for balance of payments support will also be utilized by the government to finance its budget deficit (therefore, it will be treated as a liability of the government, not of the central bank).[1] In contrast to NFA, the net domestic assets (NDA) of the banking system contracted, as the increase in net budgetary borrowings (on accrual basis) was more than offset by credit retirement by the private sector and a sharp increase in the SBP's profit (which caused a decline in other items net).

Table 3.1: Monetary Aggregates in Q1 [P]

billion Rupees

	Abs. change in stocks		Growth rate in percent	
	FY19	**FY20**	**FY19**	**FY20**
M2 (A+B)	22.4	105.2	0.1	0.6
A. NFA*	-148.5	260.4	-71.3	17.3
B. NDA	171.0	-155.3	1.1	-0.8
Budgetary borrowing**	84.6	156.0	0.9	1.3
SBP	1,518.3	-1,586.9	42.0	-23.7
Scheduled banks	-1,433.7	1,742.9	-24.8	35.5
Commodity operations	-10.8	-15.6	-1.3	-2.1
Private sector	127.9	-16.9	2.1	-0.3
PSEs	60.7	-2.0	5.8	-0.1
Other items net	-91.8	-276.0	-8.9	-25.0
Reserve money	-31.0	-207.4	-0.6	-3.2

[P]: Provisional
* Outstanding stock at end June 2019 was Rs -1,507.1 billion and at end Sep 2019 was Rs -1,246.6 billion.
** These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in **Table 4.1.**
Data source: State Bank of Pakistan

[1] Hence, this amount will not be netted out from foreign exchange reserves to calculate the SBP's NFA.

On the liability side, currency in circulation grew at a five-quarter high rate of 5.8 percent during Q1-FY20. With commercial bank deposits falling by 1.4 percent, the overall currency-to-deposit ratio jumped to an all-time high of 42.0 percent (on average) during Q1-FY20. In addition to the prevailing high level of inflation, this trend can be attributed to growing apprehensions of businesses and households over increased financial scrutiny in the country. Over the past three years, businesses had already preferred out-of-bank settlements to avoid withholding taxes on banking transactions. But now, with increased use of data on deposits and banking transactions by tax authorities (to identify high net-worth individuals and unregistered businesses), the preference for cash-based settlements has grown even more. In addition, it also appears that tight financial conditions may have induced firms and households to tap their savings held in the form of bank deposits (**Table 3.2**).

Table 3.2: Change in Sector Wise Deposits in Q1*

	Percent	Rs billion	
	Share in June 2019	**FY19**	**FY20**
Total	100.0	1.6	-193.4
of which:			
I. Government	*14.8*	*-48.0*	*-88.9*
II. Non-financial PSEs	*6.1*	*24.8*	*42.0*
III. Non-bank FIs (NBFIs)	*3.2*	*13.8*	*27.1*
IV. Private sector	*21.5*	*-60.5*	*-135.6*
V. Personal	*49.2*	*106.0*	*-29.1*
a. Salaried persons	*12.4*	*34.2*	-29.3
b. Self employed	*21.4*	*11.1*	-14.6
c. Other personal	*15.5*	*60.8*	14.9
VI. Other	*0.5*	*-4.2*	*-30.3*

*From July 2019 onwards, SBP has adopted ISIC 4.0 classification, therefore, sectoral figures for FY19 and FY20 may not be fully comparable.
Data source: State Bank of Pakistan

Budgetary Borrowings

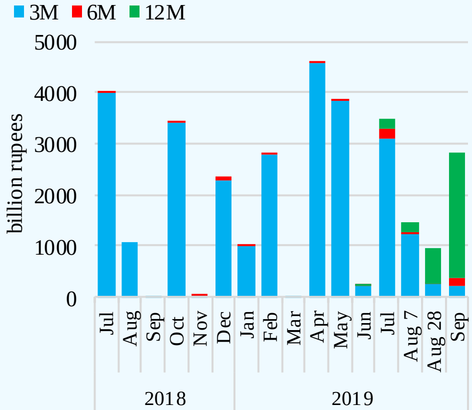
The fiscal deficit nearly halved during the quarter and there was an uptick in financing from non-bank sources. Therefore, the government's appetite for bank financing remained subdued compared to last year. Even though, on accrual basis, net budgetary borrowings from the banking system remained higher than last year, this was entirely on account of a sharp increase in the SBP's accrued interest income.[2] This increase was a result of: (i) higher stock of government borrowing at end-June 2019 compared to end-June 2018; (ii) higher level of interest rates; and (iii) the impact of term premium and a change in the interest payment cycle resulting from the debt re-profiling exercise at end-June 2019 (involving the

[2] Accrued interest income is a sub-component of budgetary borrowings in the monetary survey. However, when calculating budgetary borrowings on cash basis, the accrued income is not included. In Q1-FY20, the government's net retirements to the SBP stood at Rs 1.6 trillion on accrual basis and Rs 1.8 trillion on cash basis.

replacement of T-bills with long-term PIBs). Adjusting for the accrued interest income, the government's net retirements to SBP stood at Rs 1.8 trillion, which more than offset its Rs 1.7 trillion net borrowing from commercial banks. In overall terms, the government retired Rs 123.0 billion to the banking system in Q1-FY20 on cash basis.

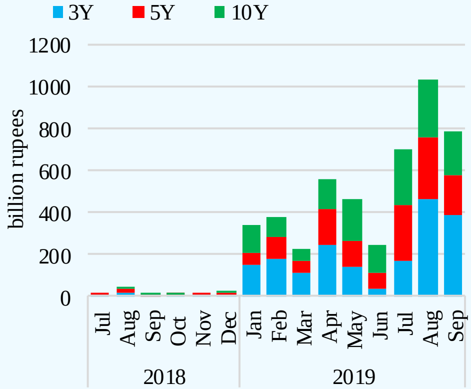
Within the banking system, a clear shift was observed in the source of the budgetary financing. Unlike last year, when the government had borrowed heavily from the SBP to retire commercial bank debt, it borrowed heavily from commercial banks this year to retire the SBP debt. This shift can be traced to two major factors. First, the government had committed not to borrow from the SBP to finance its deficit under the EFF program. This commitment was limited not just to achieving zero quarterly borrowings, but also to refrain from rolling over the maturing SBP debt. Second, the commercial banks' own appetite for investing in government papers remained strong. In particular, their expectations of interest rates had peaked out, which led them to lock available liquidity in longer tenor government securities. This change in the market's expectations was also quite visible in the bidding pattern in primary auctions, which clearly reflected banks' preference for longer tenor securities (**Figure 3.6a** and **b**).

Figure 3.6a: T-bill Bidding Pattern during Q1-FY20



Data source: State Bank of Pakistan

Figure 3.6b: PIB Bidding Pattern since Jul 2018



Data source: State Bank of Pakistan

Table 3.3: PIB Auction Summary (Fixed rate)

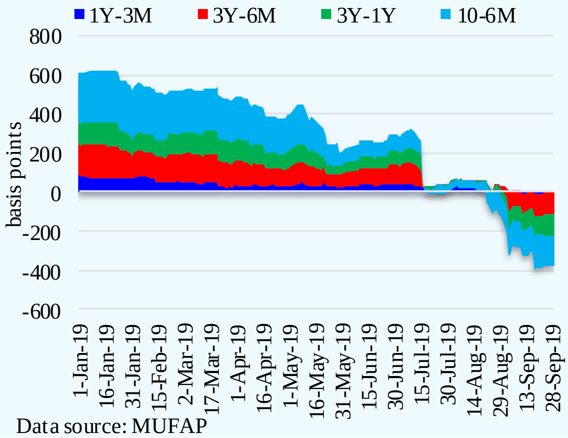
in billion rupees

	Target	Maturity	Offered*	Accepted
Fixed Rate				
Q1-FY20	**325.0**	**275.9**	**2,521.2**	**963.5**
Q1-FY19	150.0	461.1	65.2	20.6

Data source: State Bank of Pakistan

In case of PIBs, the banks' active participation was evident from the start of FY20. Since the first PIB auction was held after the 100 bps rate hike in July 2019, the market viewed that as the ideal time for placing funds in long-term bonds. In nearly all the subsequent auctions also, banks' offers widely surpassed the targets set by the government (**Table 3.3**); on aggregate, the offers in PIB auctions during the quarter stood at an all-time high. But relatively limited acceptances left nearly Rs 1.5 trillion worth of demand unmet.

Figure 3.7: Yield Spreads in the Secondary Market



Data source: MUFAP

Keeping in view such a high demand from scheduled banks, the government leveraged its position by slashing the cut-off rates by 75 bps, 130 bps and 145 bps for 3 year, 5 year and 10 year PIBs, respectively, during Q1-FY20. In the secondary market also, yield spreads turned negative, as the demand-supply gap of long-term bonds edged up (**Figure 3.7**). In addition to the market's view on interest rates, banks' expectations of subdued future supplies of long-term bonds, further strengthened the demand for these instruments. Specifically, with the improvement in tax collection and the overall fiscal position, along with estimates of higher external financing through the rest of the year, it was understandable for banks to anticipate a thin supply of PIBs in subsequent months.

A similar behavior was observed in T-bill auctions. Until the first auction of August 2019, banks bid for the shorter tenor securities, i.e., the 3m T-bill. However, banks' behavior changed in all the subsequent auctions, and they started bidding heavily in the 12m paper. In overall terms, the government mobilized Rs 1.8 trillion in excess of maturities from T-bills (**Table 3.4**).

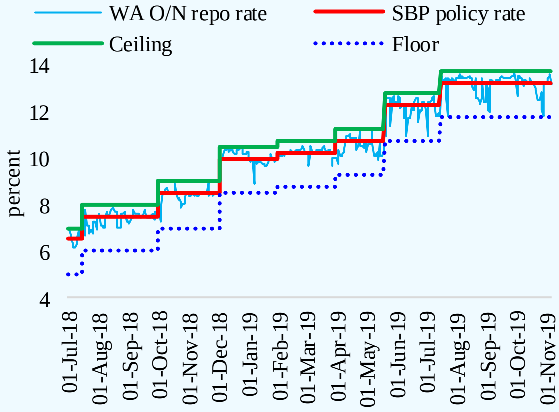
Table 3.4: T-bill Auction Summary

	Target	Offered	Accepted
in gross terms			
Q1-FY20	6,800.0	8,715.7	6,995.4
Q1-FY19	5,450.0	5,119.0	4,687.0
net of maturity			
Q1-FY20	1,620.4	3,536.1	1,815.8
Q1-FY19	-210.6	-541.6	-973.6

Data source: State Bank of Pakistan

With heavy bank participation in the auction of government securities amid deposit withdrawals, the interbank market witnessed bouts of liquidity drains during Q1-FY20. This strain was partially relieved by net retirements by the private sector, PSEs and the government's commodity procurement agencies. To further ease the liquidity conditions, the SBP scaled up its injections in the interbank market; the average outstanding OMO size soared to Rs 1.3 trillion during Q1-FY20, compared to Rs 1.0 trillion last year and *negative* Rs 247.4 billion (net absorption) in the preceding quarter.

Figure 3.8: Interest Rate Corridor



Data source: State Bank of Pakistan

At the same time, there were multiple instances where the average deviation of overnight rates plunged more than 100 basis points *below* the policy rate (**Figure 3.8**). This was primarily because the SBP refrained from conducting frequent mop-ups, and left the market to settle on its own, based on expected outflows. This increased the commercial banks' recourse to the floor facility, placing Rs 537.3 billion during Q1-FY20, compared to only Rs 146.5 billion a year earlier (**Table 3.5**).[3] As a result, the weighted average overnight rates plunged on multiple occasions.

Table 3.5: Summary of Repo Market

	Q1-FY19	Q1-FY20
Volume (in billion rupees)		
Mop up	-2,402.0	-308.8
Injections	12,825.9	19,673.1
Floor	-146.5	-537.3
Ceiling	491.9	515.0

Data source: State Bank of Pakistan

Commodity operations

Commodity operations recorded a relatively higher net retirement in Q1-FY20 than last year. This was mainly driven by wheat, as other commodities, such as fertilizer and sugar, recorded higher offtake during the quarter (**Table 3.6**). In case of wheat, better liquidity conditions of major procurement

Table 3.6: Commodity Financing in Q1
flow in billion rupees

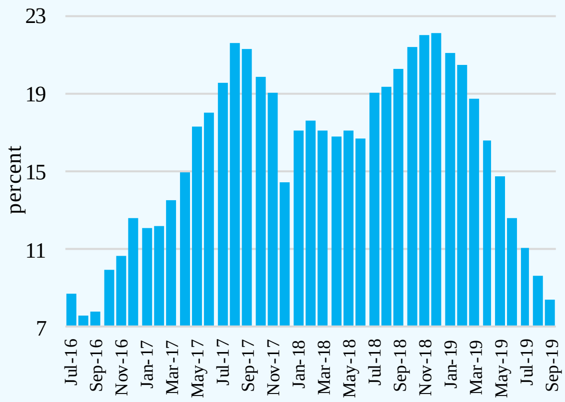
	FY19	FY20
Wheat	-12.4	-18.5
Rice	0.0	-0.8
Fertilizer	0.6	1.8
Sugar	0.9	1.9
Cotton	0.0	0.0
Total	**-10.8**	**-15.6**

Data source: State Bank of Pakistan

[3] During Q1-FY20, 46 counters had resorted to the SBP's floor facility, compared to only 17 during the same period last year.

agencies helped them retire a higher volume of bank debt. These agencies were able to scale up their releases of the commodities amid the prevailing shortages and price pressures in the market.

Figure 3.9: YoY Change in Stock of Loans to Private Sector Businesses



Data source: State Bank of Pakistan

3.3 Credit to Private Sector

The weakening in the private credit momentum, which had started from the third quarter of FY19, persisted in Q1-FY20. In overall terms, private businesses retired Rs 85.4 billion loans during the quarter, as compared to offtake of Rs 99.0 billion in Q1-FY19 (**Figure 3.9**).

The underlying dynamics of private sector credit were consistent with the overall macroeconomic situation. The downtrend in manufacturing activity, which constitutes the bulk of demand for bank credit, deepened further in Q1-FY20, as stabilization measures and regulatory changes weighed heavily. In particular, cost-push pressures, coupled with revenue-enhancing measures, led to price increases of various items, which induced consumers to reduce spending on luxuries (such as cars and appliances). This led to inventory build-ups and generated cash flow problems in the associated industries. Moreover, notwithstanding some recent improvement in the construction sector, the overall sentiment in the construction-allied industries remained downbeat. While firms had been facing tepid demand conditions since last year and initially managed their liquidity problems by further leveraging, the resultant increase in their financing costs and the rising trajectory of interest rates dissuaded them from pursuing this strategy in Q1-FY20.[4]

As a result, the overall demand for working capital loans remained subdued during the quarter. This was also reflected in a 6.5 percent YoY reduction in the number of applications received for working capital loans by banks.

[4] The incremental weighted average lending rate rose to 13.6 percent in Sep-2019 from 8.4 percent in Sep-2018.

Borrowing for fixed investment purposes increased

Fixed investment loans increased by Rs 14.6 billion during the quarter, as textiles and power sectors undertook capex and cellular firms borrowed long to pay for the renewal fees for GSM licenses.

Textile firms continued to position themselves to benefit from the market-based exchange rate regime, concessionary market access to the EU under the GSP-Plus, and lately, of imposition of tariffs on China's textile exports to the US (**Chapter 5**). The industry invested Rs 8.1 billion in importing machinery during the quarter; these purchases were financed primarily by the SBP's subsidized LTFF facility– LTFF constituted around 94 percent of the offtake during the quarter.

Table 3.7: Loans to Private Sector Businesses Q1*
flow in billion rupees

	Total Loans		Working Capital**		Fixed Investment	
	FY19	FY20	FY19	FY20	FY19	FY20
Private Sector Businesses	**99.0**	**-85.4**	**64.1**	**-100.0**	**34.9**	**14.6**
Manufacturing	50.5	-50.7	30.2	-46.5	20.3	-4.3
Sugar	-21.9	-42.7	-32.3	-36.9	10.4	-5.9
Rice processing	-23.4	-21.6	-23.7	-21.7	0.3	0.1
Vegetable and animal oils & fats	12.1	-12.8	11.8	-12.2	0.2	-0.5
Fertilizer	-7.4	-19.2	-2.9	-16.5	-4.5	-2.7
Paper & papers products	4.1	-4.8	5.1	-2.7	-1.0	-2.1
Electrical equipment	-7.3	-6.2	-9.1	-3.1	1.9	-3.1
Textiles	29.6	6.6	29.4	-2.0	0.2	8.6
Refined petroleum	20.1	-4.1	22.0	-2.9	-1.9	-1.1
Cement, lime and plaster	17.4	-1.8	6.6	1.4	10.8	-3.2
Other food manufacturers		17.2		15.7		1.5
Iron & steel	11.3	15.8	8.8	11.9	2.5	3.9
Motor vehicles	9.9	30.7	8.7	29.4	1.3	1.3
Power generation, transmission and distribution	36.1	9.6	35.7	3.8	0.5	5.8
Wholesale and retail trade	-4.9	-42.0	-5.1	-36.8	0.1	-5.3
Mining and quarrying	2.0	-5.0	-2.4	-5.8	4.3	0.9
Construction	5.7	-17.1	3.6	-19.0	2.1	1.9
Agriculture, forestry and fishing	-2.2	-0.8	0.5	0.6	-2.8	-1.3
Real estate activities	8.4	5.3	5.3	-0.2	3.1	5.6
Transportation and storage	6.0	4.6	2.2	5.4	4.0	-0.8
Telecom	1.5	24.4	2.7	-0.4	-1.0	24.8

* The sector wise numbers for FY19 and FY20 may not be fully comparable, as the flows for Q1-FY19 are based on ISIC 3.1 whereas the flows for Q1-FY20 are based on ISIC 4.0 classification.
**includes trade financing
Data source: State Bank of Pakistan

On the other hand, the increase in long-term loans in the power transmission and distribution segments reflected borrowing by CPEC-related coal-based projects.

In one case, the borrowing was to expedite work on a 660MW project, which is expected to commence operation by March 2021. In another case, a major IPP is in the process of growing its portfolio in various power projects; this raised its long-term financing requirement during the quarter.

In addition to these two sectors, some activity was also recorded in the steel sector. It is important to highlight that the existing south-based key players are focusing on increasing their footprint in the northern region of the country, apart from vying for market share in non-construction segments, such as the home appliance and the auto sectors. Steel firms are establishing dedicated service centers to capture the potential demand from these segments. Besides this, some firms are also investing in BMR activities, such as upgrading their furnaces.

Working capital loans recorded net retirements

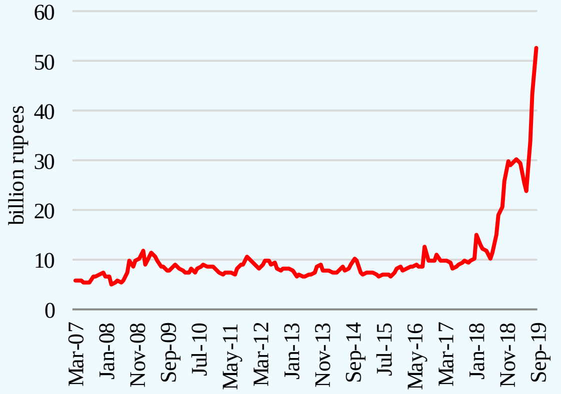
Working capital recorded a net retirement of Rs 100.0 billion in Q1-FY20, compared to an increase of Rs 64.1 billion last year (**Table 3.7**). The retirements were broad-based across major manufacturing sectors, such as refined petroleum, sugar, rice processing, fertilizers, and textiles. Here it is important to qualify that textile businesses retired Rs 2.0 billion of working capital loans, but a closer look into the data suggests that the export-oriented firms borrowed Rs 14.8 billion under the Export Finance Scheme.

Only three sectors took out more working capital loans during the quarter; these included FMCGs, automobiles and steel. In the case of FMCGs and steel, the impact of rising input costs and weakening demand put them in a tight spot. Liquidity concerns were more intense in the steel sector, as the subdued construction activity in the country did not allow firms to pass on the impact of costly imported steel scrap, high energy prices and rising transportation costs (due to axle load limits). Furthermore, anecdotal evidence suggests that firms were facing operational constraints, as their unregistered dealers had apprehensions with respect to the CNIC condition.

In case of automobiles, local assemblers had raised their prices several times since the beginning of FY19, citing the currency depreciation, the imposition of FED on various car models and additional customs duty on parts. However, the rising prices of cars, coupled with increasing cost of borrowing and maintenance, has priced out many buyers from purchasing vehicles and led to inventory build-up with dealers and assemblers. It is important to mention that car assemblers typically finance their working capital from customer prepayments and do not rely much on bank borrowing for operational needs; however, the inventory build-up has squeezed their cash flows and led them to borrow heavily from banks during

Q1-FY20 (**Figure 3.10**). In addition to carmakers, other segments of the industry, such as tractor, two/three wheeler and truck manufacturers, also took out short-term loans to manage their liquidity constraints.

Figure 3.10: Trend in Outstanding Working Capital Loans of Vehicle Manufacturers

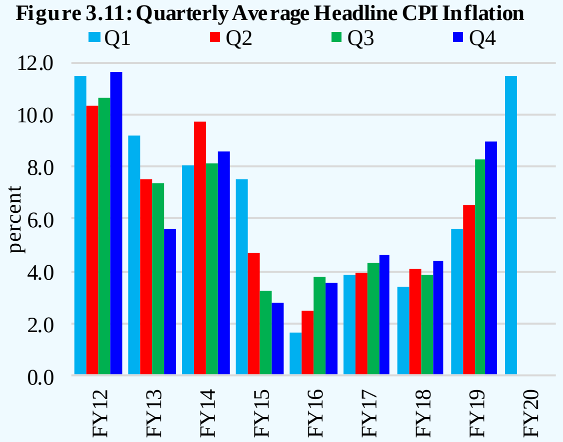


Data source: State bank of Pakistan

3.4 Inflation

Extending the steep upward trend persistent since the beginning of FY19, the average headline CPI inflation reached 11.5 percent in Q1-FY20. Not only this level was double the inflation observed in the same quarter last year, it was also the highest level of quarterly inflation since Q4-FY12 (**Figure 3.11**). In terms of dispersion, the increase in inflation was broad-based, as around 64 percent of the total items posted higher inflation during Q1-FY20 as compared to last year. Moreover, around 40 percent of the total items registered double-digit inflation during the quarter.

Figure 3.11: Quarterly Average Headline CPI Inflation



Data source: Pakistan Bureau of Statistics

Although the inflation during Q1-FY20 represents a sharp deviation from the medium-term target of 5-7 percent, it was not entirely unanticipated. First, the exchange rate depreciation towards the end of FY19 was expected to have a second-round impact on a number of items in Q1-FY20. Second, up to 168 percent increase in gas prices, as notified by Oil and Gas Regulatory Authority (OGRA), was expected to inflate energy prices from July 2019 onwards.[5] And

[5] According to the OGRA's notification, dated June 29, 2019, gas tariffs for slab using 201-300 mmbtu/month was raised up to 168 percent. For consumers using 51-100 and 101-200 mmbtu/month of gas, tariffs were raised by 136.2 and 109.5 percent respectively. Together, these three slabs constitute over half of the total gas consumption in domestic sector.

third, the revenue-led fiscal consolidation measures – including the imposition of FED, end of zero-rating regime for export-oriented industries and reduced GST regime for sugar – announced in Budget 2019-20 were anticipated to bring about a steep surge in retail prices of a number of food and non-food items (**Box 3.1**).

Box 3.1: Zero-rating Regime Ended for Export Oriented Industries

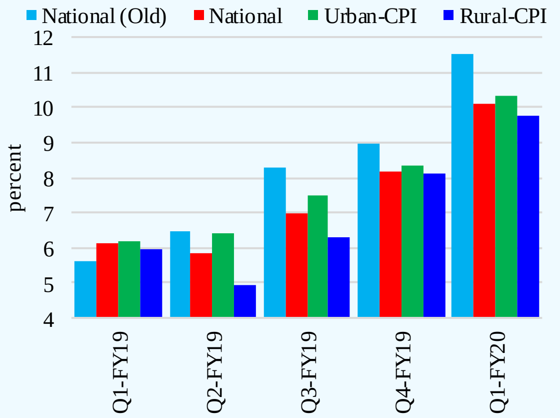
On 29th June, 2019, the zero-rated regime for the five major export-oriented sectors (textiles, carpets, leather, sports and surgical instruments) – granted under SRO 1125 dated 31st December 2011 – was rescinded after the issuance of SRO 694 (I)/2019. The government restored the standard GST rate of 17 percent on inputs and products of export-oriented sectors. The GST rate on local supplies of finished articles of textile and leather and finished fabric was also raised to 17 percent.

Previously, the industry players pertaining to these sectors were paying sales tax at zero-rate on 128 items to be used as industrial inputs. In addition, the SRO allowed registered manufacturers in these sectors to avail electricity and gas at zero percent sales tax. Furthermore, a tax of 5.0 percent was applicable if the produced items were sold to retailers or end-consumers domestically. Lastly, registered persons who were solely or otherwise engaged in retailing activities of these goods were paying 5.0 percent sales tax on their retail sales and were entitled to input tax adjustment.

However, according to the tax authorities, the provisions were at times being misused. In particular, the benefits were being availed by some manufacturers who sold a significant part of their finished products in the domestic market instead of exporting. Furthermore, the reduced rates were also hurting the government's revenue collection. This prompted the government to rescind the SRO 1125.

The strongest impact of these measures was visible on the food group, which was already struggling with rising transportation costs, crop damages, limited regional trade, hoarding practices and commodity-management issues. The other major contributor was the energy group, which recorded the highest level of inflation in at least a decade. Finally, the contribution of non-food-non-energy (NFNE) remained more or less at last year's level. This was despite the continued increase in input prices (including transportation cost), the pass through of the exchange rate depreciation, and the impact of revenue measures – especially in case of construction material and clothing. This signifies that the macroeconomic stabilization measures (including the increase in interest

Figure 3.12: Inflation-YoY(New Base)



Data source: Pakistan Bureau of Statistics rates and realignment of the exchange rate with fundamentals) that were taken to alleviate domestic demand pressures, have proved largely effective.

An important development during Q1-FY20 was the completion of the rebasing exercise of CPI by the Pakistan Bureau of Statistics (**Box 3.2**). While it will take some time to collect the price information at a granular level under the new base, preliminary assessment suggests that the trends are quite similar to those noted under the old base. For instance, national level inflation edged up to 11.4 percent in September 2019 on YoY basis as compared to 5.4 percent last year (**Figure 3.12**). In case of old base (2007-08=100), the (urban) inflation increased to 12.6 percent in September 2019 compared to 5.1 percent last year. Disaggregated analysis reveals that inflation in urban areas remained more pronounced as compared to rural areas, and was predominantly driven by highly volatile food inflation.

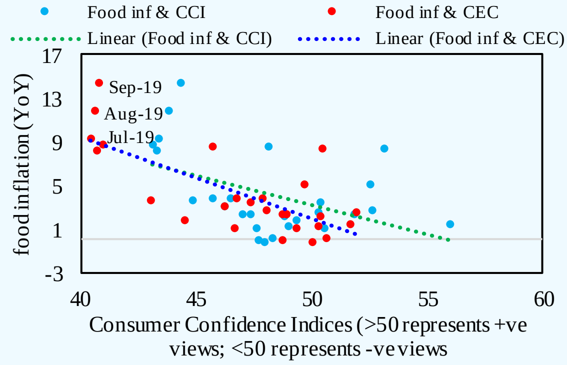
Table 3.8: Average CPI Inflation and Contribution - Q1
inflation in percent, contribution in percentage point

		Inflation		Contribution	
	Weight	**FY19**	**FY20**	**FY19**	**FY20**
Overall CPI	**100.0**	**5.6**	**11.5**	**5.6**	**11.5**
Food *of which*	**37.5**	**2.7**	**11.8**	**1.1**	**4.7**
Cigarette	1.4	0.6	37.9	0.0	0.7
Wheat flour	4.2	3.9	9.7	0.2	0.4
Chicken	1.4	-6.4	34.5	-0.1	0.3
Onion	0.5	-25.0	72.6	-0.2	0.4
Potato	0.5	-19.8	24.6	-0.1	0.1
Sugar	1.0	-3.3	33.5	0.0	0.3
Pulses	1.1	-11.3	19.2	-0.1	0.2
Vegetable ghee	2.1	3.0	13.6	0.0	0.2
Non Food *of which*	**62.5**	7.6	11.3	4.5	6.8
Fuel	3.0	25.7	23.1	0.5	0.6
Transport services	2.7	14.4	7.4	0.3	0.2
Clothing & footwear	7.6	6.5	8.2	0.5	0.7
Education	3.9	13.7	6.4	0.6	0.3
Household equipment	4.2	6.1	10.7	0.3	0.5
House rent	21.8	7.6	6.2	1.5	1.2
Recreation	2.0	6.7	8.0	0.1	0.1
Construction index	0.9	9.4	12.3	0.1	0.1
Motor vehicle	0.7	10.7	19.7	0.1	0.1
NFNE	**53.5**	**7.7**	8.0	**4.0**	4.2

Data source: Pakistan Bureau of Statistics

Food remained the dominant source of inflation
Food inflation, after rising steeply in H2-FY19, clocked in at 11.8 percent during Q1-FY20 (**Table 3.8**). This rise was a major factor contributing to weak

Figure 3.13: Food Inflation and Consumer Confidence (Jul 2017-Sep 2019)



CEC: Index of Current Economic Conditions, inf=inflation
Data source: IBA-SBP Consumer Confidence Survey, PBS

consumer confidence (**Figure 3.13**). In addition to the broad-based impact of increased transportation cost on account of fuel inflation and implementation of the axle load management policy, this pressure can be traced to:

<u>Revenue-enhancing fiscal measures</u>

As mentioned earlier, revenue measures in the Budget 2019-20 caused a significant increase in retail prices of a number of food items. For instance, upward revision in cigarette prices was attributed primarily to the imposition of FED in the Budget 2019-20.[6] It is important to note here that cigarettes single handedly contributed almost 0.7 percentage points to food inflation during the quarter.

Similarly, the increase in retail prices of edible oil and ghee products mainly reflected the increase in FED rate from 8.0 percent to 17.0 percent.[7] Edible oil refineries were also putting up with rising international prices of palm oil and soybean since the beginning of FY20: international palm oil prices were 6.8 percent higher in September 2019 as compared to June 2019, whereas prices of soybean increased by 4.3 percent in the same period.[8]

Moreover, double-digit inflation in sugar can partially be attributed to a steep rise in the rate of sales tax from 8 percent to 17 percent. In addition, anecdotal evidence suggests that rising sugar prices in the country, also reflect the persistence of collusive behavior and hoarding practices across the distribution chain. Official estimates of demand-supply conditions in the market support this view: the Ministry of Industries and Production has estimated available stocks in

[6] The FED was increased to Rs 5,200/1,000 sticks from Rs 4,500/1,000 sticks if the on-pack printed retail price exceeds Rs 5,960. Likewise, if the on-pack printed retail price is less than Rs 5,960, the FED was increased to Rs 1,650/1,000 sticks from Rs 1,840/1,000 sticks (for price between Rs 2,925 to Rs 4,500) and Rs 1,250/1,000 sticks (for on-pack printed prices less than 2,925). Source: SRO 608(I)/2019 dated 29th June 2019.

[7] In the budget FY20, it was proposed to increase the rate of FED to 17 percent on edible oils/ghee/cooking oil and do away with Rs 1 per kg tax in lieu of value addition tax and concessional rates on edible seeds.

[8] Data source: IMF

the country at over 2 million tons during the first week of October 2019; this seems sufficient, keeping in view the monthly demand of 0.4 million tons and given the expected start of the new crushing season from the next month.

Supply disruptions

Pressures on prices of some perishable food items emanated from supply disruptions in the form of crop damages, the impact of depreciation on imported food items, and non-tariff barriers on the import of vegetables and other food items. In particular, unfavorable weather this year has caused sizable losses in the minor crop sector. Therefore, reliance on imported food stuff increased, but at elevated prices due to the impact of Pak rupee depreciation. For instance, the double-digit inflation in pulses (barring gram), can be attributed to a production shortfall as well as a 12.2 percent increase in the rupee unit value of imports.[9] In case of chicken also, the impact of the Pak rupee depreciation appears strong, as it escalated imported feed prices. As per anecdotal evidence, poultry dealers were facing financial losses for some time as they were unable to completely pass on the impact of feed cost to their retail prices.

Furthermore, crop damages and supply constraints in regional economies (traditional suppliers) have also made it difficult to alleviate price pressures in the local market. For instance, heavy rains caused significant damages to onion harvest in Sindh, and delayed arrivals from Baluchistan. But similar damages were recorded in India also, which is one of the largest onion producers in the region. With supplies shrinking from India, most buyers (including Pakistan, Bangladesh and Nepal) started importing from China; naturally, an abrupt increase in demand pushed up prices of Chinese onions as well. It is worth noting that onion prices contributed 0.4 percentage points to the overall increase in food prices in Q1-FY20, and this trajectory is likely to stay north until the summer harvest arrives.

Also, in case of some food items, plugging the demand-supply gap via imports was itself difficult this year due to prevailing regulatory restrictions (non-tariff barriers). Commercial food importers have been complaining of delays in the issuance of import permits and valid phytosanitary certificates before they could place orders. Moreover, importers are also raising concerns with respect to lack of quarantine department staff at the borders to allow no-objection certificates for importing commodities into the country. These problems particularly affected the

[9] Pulses imports stood at 251.8 thousand MT in Q1-FY20 compared to 285.9 thousand MT in the same period last year.

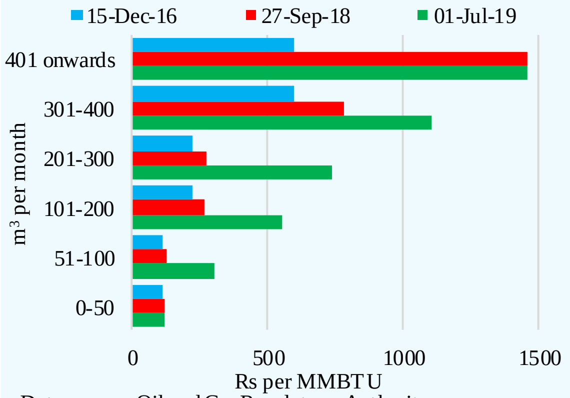
import of fresh vegetables in the country, which resulted in an 11.4 percent inflation during the quarter.

Commodity management
Wheat prices edged up further in Q1-FY20, after rising steeply in the fourth quarter of FY19. As mentioned in SBP's Annual Report for 2018-19, this increase predominantly reflects administrative weaknesses in commodity management, instead of just demand-supply dynamics.

Despite a good crop this year (though short of target) and carry-over stocks from previous years, the public procurement agencies were not able to control a consistent increase in wheat (and therefore, flour) prices. From time to time, procurement agencies were advised by the Economic Coordination Committee (ECC) to release sufficient amounts of wheat in the market to stabilize prices. It also imposed a ban on the commodity's exports during the quarter. However, these measures could not arrest the rising price trend, probably in the presence of hoarding practices in the open market.

Administered energy inflation continued with the upward trajectory
In an attempt to adhere to the objective of eliminating energy sector losses on a sustainable basis, the government has committed to increase administered fuel prices to reflect purchase prices.[10] The decision further escalated the underlying inflationary pressures in the economy as the energy index rose 32.5 percent during Q1-FY20, compared to a 6.5 percent increase recorded last year. Inflation in gas alone has contributed 1.6 percent to the headline inflation, constituting 59.0 percent of energy inflation. This was in response to a revision in natural gas prices by Oil and Gas Regulatory Authority (OGRA) for various consumers, effective from July 1, 2019 (**Figure 3.14**). This measure was taken to address the concern of

Figure 3.14: Slabs of Natural Gas Prices-Domestic Consumers



Data source: Oil and Gas Regulatory Authority

[10] The sector was advised to initiate a comprehensive pricing structure that was reflective of its costs, in order to eliminate the process of circular debt accumulation.

emerging arrears in the gas sector, coming mostly from delays in tariff notifications and rising technical losses. Moreover, certain amendments in the OGRA Act are on the cards, which are meant to ensure regular and timely notification of end-consumer tariffs.

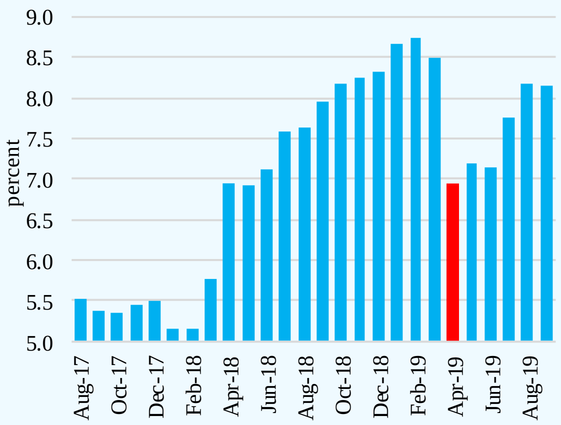
Motor fuel prices grew by 23.1 percent during the quarter under review. However, inflation in this segment was slightly contained as compared to last year on account of stable international oil prices.

Electricity inflation registered an 11.3 percent rise during the quarter, led by heavier rise in prices for slabs over 300 units. It is important to note that the government is committed to improving the pricing structure in the electricity sector by: aligning effective tariffs with those determined by Nepra; removing or minimizing delays in the tariff notifications; adequately budgeting the implicit subsidies provided by the government; and minimizing the technical and distribution losses. The government has already reduced the flow of circular debt by a significant margin during the quarter, and is expected to take the necessary actions to tackle all the major sources of power sector arrears.

Contribution of core inflation remains unchanged

The inflationary pressures in the NFNE component started bottoming out in April 2019 on YoY basis (**Figure 3.15**). However, the implementation of budgetary measures, such as imposition of direct taxes on multiple items, pushed up NFNE inflation during Q1-FY20.

Figure 3.15: NFNE Inflation-YoY



Data source: Pakistan Bureau of Statistics

For instance, in case of construction inputs (cement and steel), the impact may be attributed to the pass-through of increase in FED,[11] in addition to rise in energy tariffs. Similarly, motor

[11] In order to simplify the tax regime for steel sector, FED at 17 percent (in sales tax mode) was imposed on billets, ingots, bars, ship plates and other long profiles. Previously, steel sector was subject to fixed sales tax. Specifically, imported scrap was subject to sales tax at Rs 5,600 / MT whereas, for ship-plates obtained from breaking of ship, sales tax was Rs 9300 per MT. In contrast, for ship-breakers, ships imported for breaking was exempted from payment of sales tax. Further,

vehicle prices (in the CPI basket) also increased by 19.7 during the quarter, which the domestic assemblers justified with the imposition of FED on cars, increase in additional customs duties from 2 percent to 7 percent, and the lagged impact of the PKR depreciation.[12] In case of clothing and textiles also, the increase in prices can be attributed to the end of zero-rating regime of sales tax for the sector.[13]

Box 3.2: Rebasing of Price Indices

In August 2019, the Pakistan Bureau of Statistics (PBS) started publishing a new set of price indices with FY16 as the base year. The weights of consumer items in the new basket have been derived from the Family Budget Survey (FBS) conducted by the PBS in FY16, whereas consumption details have been taken from the Household Integrated Economic Survey (HIES). The salient features of new base data are given below:

Table 3.2.1: Comparison of New and Old Base

	Base year 2015-16	Base year 2007-08
	Urban	
No. of cities	35	40
No. of markets	68	76
No. of items	356	487
No. of commodities	94	89
No. of groups	12	12
	Rural	
No. of rural areas	27	Nil
No. of markets	27	Nil
No. of items	244	Nil

Data source: Pakistan Bureau of Statistics

- PBS introduced Rural Consumer Price Index (RCPI) and Urban Consumer Price Index (UCPI) for the first time.
- The National Consumer Price Index (NCPI) was also introduced (based on weighted average of RCPI and UCPI).
- The number of commodities included in the new CPI basket have been classified into 12 groups as per a scheme developed by the United Nations, i.e. "Classification of Individual Consumption According to Purpose.
- The total number of items has been reduced in the new base. This is despite the inclusion of some new items (**Table 3.2.1**).
- **The number of urban cities has also been reduced**. Jhelum, Wazirabad, Muzaffargarh, Mithi and Mardan have been excluded from the sample.
- In the new baskets, **weights have been changed** significantly for some categories. For instance, the overall food group's weight has been increased mainly on account of the rise in weight of *hotel and restaurant.* On the other hand, weight of the *housing group* has been decreased significantly (**Table 3.2.2)**
- Different weights are assigned to the urban and rural baskets along with different basket (**Table**

steel industry of tribal areas was also exempted from payment of sales tax. Whereas, FED on cement has been increased to Rs 2 per kg from Rs 1.5 per kg earlier.

[12] FED on the following slabs has been introduced: 2.5 percent for cars from 0 to 1,000 cc, 5 percent on cars from 1,001cc to 2,000 cc, and 7.5 percent on cars over 2,000 cc.

[13] The government restored the standard GST rate of 17 percent on inputs and products of export-oriented sectors, i.e. textile, leather, carpets, sports goods and surgical goods. The GST rate on local supplies of finished articles of textile and leather and finished fabric was also raised to 17 percent.

3.2.3).

- New indices are computed on the basis of **weighted geometric mean of prices,** as per best international practices; the old base was computed using the arithmetic mean.[14] [15]
- **Consumption quintiles have been introduced** instead of income quintiles, as it is difficult to extract income information from consumers.
- **Consumer-weighted approach has been introduced** to compute gas prices and electricity prices.
- **Electronic data collection** (Android based) has been introduced for the first time in the history of PBS.

Table 3.2.2: CPI Major Indices

		Old	**New**
	General (Overall)	100.0	100.0
1	*Food & non-alcoholic beverages.*	*34.8*	*34.6*
2	*Alcoholic beverages, tobacco*	*1.4*	*1.0*
3	Clothing & footwear	7.6	8.6
4	*Housing, water, gas & other fuel*	*29.4*	*23.6*
5	*Furnished household equipment & maintenance etc.*	*4.2*	*4.1*
6	Health	2.2	2.8
7	*Transport*	*7.2*	*5.9*
8	*Communication*	*3.2*	*2.2*
9	*Recreation & culture*	*2.0*	*1.6*
10	*Education*	*3.9*	*3.8*
11	Restaurants and hotels	1.2	6.9
12	Miscellaneous goods & services	2.8	4.9

Data source: Pakistan Bureau of Statistics

Table 3.2.3: Urban and Rural Indices

		Weights	
		Urban (94 indices)	**Rural (89 indices)**
1	Food and non-alcoholic beverages	30.42	40.87
2	Alcoholic beverages, tobacco	0.85	1.28
3	Clothing and footwear	8.01	9.48
4	Housing, water, electricity, gas	27.03	18.49
	House rent	19.26	8.61
	Gas charges	1.08	
5	Furnishing and household equipment	4.09	4.1
	Carpets	0.03	
	Household servant	0.77	
6	Health	2.31	3.51
	Therapeutic appliances & equipment	0.01	
7	Transport	6.14	5.56
8	Communication	2.35	1.99
9	Recreation and culture	1.73	1.38
10	Education	4.88	2.13
11	Restaurants and hotels	7.41	6.19
12	Misc. goods and services	4.77	5.02

Data source: Pakistan Bureau of Statistics

[14] As per the previous method, PBS used to collect 4 quotations for a commodity in a market and then take a simple average. Now, it collects 3 quotations in urban areas and 2 in rural in order to calculate the geometric mean.

[15] The geometric mean accounts for the economic substitution behavior of consumers relatively better. Consumers do, to some degree, insulate themselves from the impact of higher prices by adjusting their spending to relatively lower priced goods or services (Kenneth V. Dalton, John S. Greenlees, and Kenneth J. Stewart (1998), Incorporating A Geometric Mean Formula into the CPI, Monthly Labor Review, U.S. Bureau of Labor Statistics).