3 Inflation and Monetary Policy

Anticipating potential disruptions due to COVID-19, SBP cut the policy rate by a cumulative 225 bps during Q3-FY20 and took a number of measures to support businesses and healthcare facilities. Also, inflation softened towards the end of the quarter, as its medium-term outlook improved further given a noticeable slowdown in domestic demand, stabilizing food inflation, and the pass-through of record-low global oil prices to domestic consumers. Meanwhile, panic-driven foreign selling in the domestic debt market and amortization of bilateral and multilateral loans increased government's reliance on commercial bank borrowing. Private sector too scaled up its borrowings from banks as containment measures affected firms' liquidity position.

3.1 Monetary Policy

While the supply-driven inflationary pressures of the second quarter intensified further in January 2020, the real challenge to the macro economy emerged towards the end of Q3-FY20. The domestic and global spread of COVID-19 began to unleash outsized disruptions to the economy, as containment measures brought production and retail activities to a near-halt. The ensuing uncertainties, layoffs and negligible work opportunities for daily wage earners led to a noticeable slowdown in domestic demand. Financial markets were not spared either, as heightened global risk aversion triggered outflow of foreign capital from the domestic debt market and also put significant selling pressure on the local bourses. Under these circumstances, the burden of government borrowings will fall disproportionately on the domestic banking system, as massive healthcare needs and social transfers begin to put additional burden on the fiscal bottom line.

These challenging economic and financial conditions warranted a preemptive and aggressive monetary policy strategy. In particular, it was important to lend some resilience to domestic demand in the face of the virus-led contraction. Furthermore, a careful management was needed to respond to possible cash flow pressures for businesses stemming from supply-chain disruptions, avoid growing defaults and financial system constraints. Accordingly, the SBP reduced the policy rate by a cumulative 225 basis points during the third quarter. In its prescheduled meeting on 17th March, the Monetary Policy Committee lowered the policy rate by 75 basis points, but due to fast changing economic conditions both domestically and globally, it met again in a week's time and cut the policy rate by another 150 bps. [1]This off-schedule meeting and the decision highlighted – as was also spelled out clearly in the policy statement – that the MPC stands ready to take *whatever* measures it considers necessary in response to COVID-19 driven economic developments. Moreover, on the operations side, the MPC decided to make the interest rate corridor symmetric around the policy rate, in line with international best practices.

These decisions were supported by developments on the inflation front and a favorable medium-term price outlook. After plateauing in January 2020, overall inflation began to ease in the subsequent months, as perishables' prices responded positively to administrative supply-management measures. Even before the softening of food prices, the SBP had projected average headline inflation to fall in the target range of 5-7 percent over the medium term. These projections, premised on the transitory nature of supply shocks and contained inflation expectations, led the MPC to keep the policy rate unchanged in its January decision, despite consistently high inflation readings.

However, when the MPC met later in March 2020, it noted a qualitative improvement in the inflation forecast. Although the Committee noted temporary pressures on the exchange rate and escalated fiscal pressures in response to the COVID-19 shock, it gave more weight to the need to provide support to slowing economic activity. Furthermore, the overall inflation outlook appeared less of a concern in the context of a noticeable slowdown in domestic demand, softening food prices, and record-low global oil prices. Importantly also, the underlying trend in inflation appeared moderate as evident from relatively stable core inflation and a significant decline in inflation expectations. As a result of softening price pressures, the medium-term target range of 5-7 percent was now expected to be achieved somewhat earlier than previously forecast.

In addition to lowering the policy rate, the SBP also provided additional support to businesses by rolling out the Temporary Economic Refinancing Facility, which involved refinancing for bank lending for plant and machinery for new projects at a 7.0 percent fixed rate for 10 years. The SBP also announced a one-year extension in principal payments, doubled the period for rescheduling of loans from 90 to 180 days, and offered concessional financing to companies that do not lay off workers. All these measures are expected to alleviate cash flow pressures on local businesses as well as individual borrowers. The emergence of these pressures was already visible in the third quarter; the outstanding stock of non-

[1] This was followed by another 200 bps cut in mid-April 2020 and 100 bps each in May and June 2020, bringing the cumulative cut to date to 625 bps.

performing loans increased by 5.9 percent during the quarter taking the overall infection ratio to 9.1 percent at end March 2020, compared to 8.2 percent last year. Consequently, firms' reliance on banks to fulfill their liquidity needs remained on the higher side, especially exporters' who complained of cancellation of export orders post production and inventory build-up.

Table 3.1: Monetary Aggregates (provisional)
billion rupees

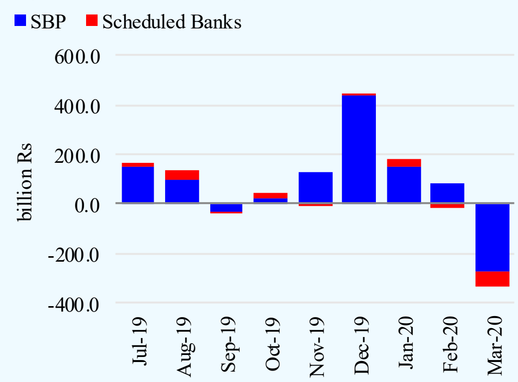
	Jul-Mar		Q3		Mar	
	FY19	**FY20**	**FY19**	**FY20**	**FY19**	**FY20**
M2 (a+b)	**812.9**	**1,520.0**	**235.6**	**602.7**	**327.6**	**639.4**
a. NFA	-613.7	797.1	67.4	-80.9	229.4	-329.9
b. NDA	1,426.6	722.9	168.2	683.6	98.2	969.3
Budgetary borrowings*	**828.8**	**966.5**	**178.2**	**779.8**	**-159.7**	**776.2**
SBP	3,444.9	-480.4	2,187.8	260.1	266.8	315.4
Scheduled banks	-2,616.1	1,446.9	-2,009.6	519.7	-426.5	460.7
Commodity operations	-166.1	-137.2	-80.7	-108.6	-25.6	-40.2
Private sector credit	**611.5**	**323.2**	**41.1**	**107.6**	**-4.4**	**73.2**
PSEs	310.2	3.5	165.1	5.8	194.3	12.3
Other items net	-160.4	-440.3	-135.1	-106.3	93.6	145.5

* These numbers are 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

3.2 Monetary Aggregates

The expansion in money supply (M2) more than doubled during Q3-FY20 over the same period last year (**Table 3.1**). On a cumulative basis, M2 expansion during Jul-Mar FY20 stood at Rs 1.5 trillion compared to Rs 812.9 billion last year. In contrast to the trend observed during the last two quarters, the expansion in Q3 mainly stemmed from a sharp increase in Net Domestic Assets (NDA), whereas Net Foreign Assets (NFA) posted a decline. Within NDA, the major increase came from the substantial growth in budgetary support from the banking system.

Figure 3.1: Monthly Change in Net Foreign Assets



Data source: State Bank of Pakistan

On the other hand, NFA fell by Rs 80.9 billion during Q3-

FY20 compared to an expansion of Rs 67.4 billion last year. However, monthly numbers show that NFA of the banking system continued to increase until February 2020, but posted a trend reversal in March (**Figure 3.1**).

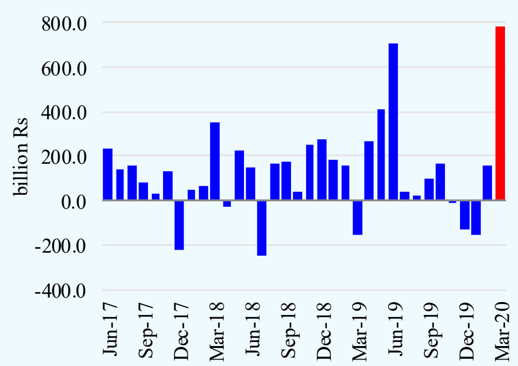
This reversal primarily represented the drawdown in the SBP's foreign exchange reserves following the large outflow of foreign capital from the domestic debt market. Additional hit to the banking system's NFA came from the Pak Rupee's depreciation during the month, which increased the rupee value of the existing stock of foreign liabilities.

On the liability side, the cash penetration in the economy remained strong. The growth in currency was approximately twice the growth in deposits during the quarter. As a result, the currency-to-deposit ratio jumped from an already elevated level of 39.4 percent in December 2019 to 41.7 percent in March 2020.[2]

Budgetary Borrowings

Despite a 23 percent lower fiscal deficit (in nominal terms) in Q3-FY20 compared to the same period last year, budgetary borrowings from the banking system rose sharply to Rs 779.8 billion in Q3-FY20 compared to only Rs 178.2 billion last year. These borrowings were largely concentrated in March, during which the government struggled with the COVID-led sharp slowdown in revenue mobilization as well as heavy financing burden (**Figure 3.2**). The latter stemmed from substantially large foreign selling pressure in the domestic debt market (equivalent to US$ 1.8 billion in March), as well as scheduled bilateral and multilateral repayments.[3]

Figure 3.2: Budgetary Borrowings from the Banking System



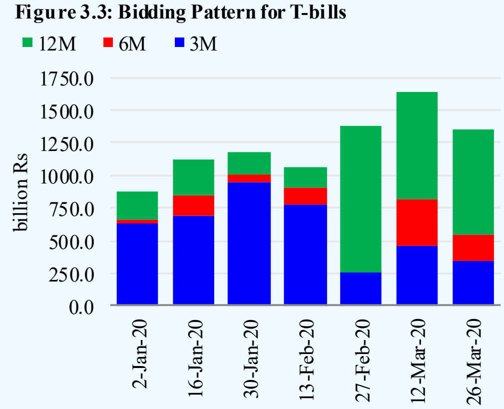
Data source: State Bank of Pakistan

The bulk of the budgetary requirements were financed by commercial banks,

[2] During March 1 to April 24, 2020, the currency-to-deposit ratio rose to an average of 42.8 percent. This was the highest increase in any eight-week period during the last 20 years.
[3] Of the total official loan amortization of US $1.4 billion in Q3-FY20, US$ 931 million was repaid in March 2020.

whereas the stock of borrowing from the SBP also increased by Rs 260.1 billion during Q3-FY20. This primarily reflected withdrawals from the government's cash buffers held with the SBP, as well as mark-up accruals. Importantly, the government adhered to its commitment of avoiding any fresh issuance of MRTBs from the central bank, in compliance with the SBP Act as well as the agreement with the IMF.

Figure 3.3: Bidding Pattern for T-bills



Data source: State Bank of Pakistan

As far as borrowings from commercial banks were concerned, these were mainly concentrated in T-bills, especially the 12-month paper in Q3. However, earlier in the quarter, the interbank market gave more weight to the rising inflation trend while bidding for government papers. Therefore, low expectations of a policy rate cut and an inverted yield curve resulted in the concentration of bids for 3-month T-bills (**Figure 3.3**). However, as sentiments shifted in favor of a rate cut in the March 2020 MPC meeting in response to February's soft inflation reading, fall in global oil prices, and weakening aggregate demand due to the intensifying COVID spread – the bidding pattern shifted in favor of 12-month paper.[4]

Table 3.2: T-bill Auction Summary during Q3-FY20
billion rupees

Tenor	Target	Maturity	Offered*	Accepted: *Gross*	Accepted: *Net of Maturity*
3M	1,000.0	2,100.9	4,104.1	1,866.7	-234.2
6M	750.0	290.0	927.6	337.2	47.2
12M	1,000.0	0.0	3,566.9	954.3	954.3
Total	2,750.0	2,390.9	8,598.5	3,158.3	767.4

*competitive bids only
Data source: State Bank of Pakistan

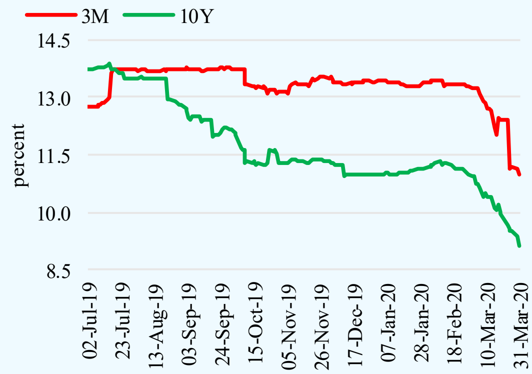
In overall terms, Rs 3,158.3 billion of T-bills were issued against the target of Rs 2,750.0 billion (**Table 3.2**). The short-term bond yields slid by 219 bps, 199 bps and 226 bps for 3-month, 6-month and 12-month T-bills respectively during the third quarter. Importantly, the cut-off rates remained broadly flat during the first five auctions of the quarter; it was

[4] A number of central banks announced rate cuts in response to the coronavirus outbreak during February and early March, including Thailand, China, Indonesia, Australia, and the US, etc.

in the last two auctions when the rates fell sharply.

The demand pattern was similar in case of PIBs. In the last auction of the quarter, strong expectations of a rate cut resulted in a spike in demand for PIBs, and hence gave an opportunity to the government to recalibrate the yields downward. Interestingly, in an attempt to extend the maturity profile, the government also accepted the bid for a 20-year bond; it was back in January 2015 when this instrument was last issued. Meanwhile, the early signs of a flattening of the yield curve emerged in response to the 150 bps policy rate cut on March 24, when the short-term yields fell sharply compared to the long-term bond yields (**Figure 3.4**).

Figure 3.4: Secondary Market Yields

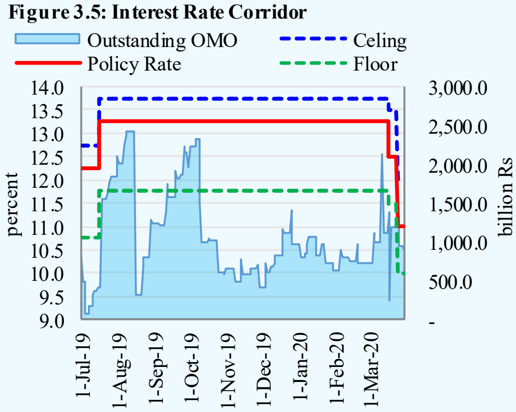


Data source: MUFAP

Interbank Liquidity

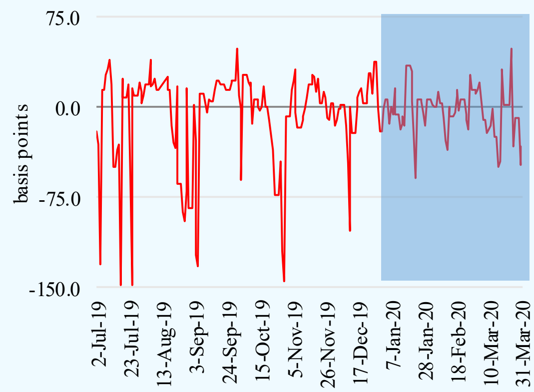
As in case of the primary market, the secondary market activity also witnessed some noteworthy developments during Q3-FY20. The quarter marked the end of the contractionary monetary policy stance that began in January 2018. At the same time, the MPC also announced aligning the interest rate corridor with international best practices by making it symmetrical around the policy rate (**Figure 3.5**).

Figure 3.5: Interest Rate Corridor



Data source: State Bank of Pakistan

Figure 3.6: Deviation of O/N Rate from the Policy Rate



Data source: State Bank of Pakistan

Encouragingly, the interbank market remained more stable during Q3-FY20 compared to the preceding two quarters of the ongoing fiscal year (**Figure 3.6**), though the monthly data shows that January and March were relatively more volatile than February.[5] In January, major liquidity pressures stemmed from a seasonal decline in deposits, which was partially offset by the SBP's foreign exchange purchases and retirements by the government and private sector. As a result, the average outstanding OMOs increased only slightly from Rs 845.8 billion in December 2019 to Rs 875.3 billion in January 2020. In February, the interbank market showed signs of stability, as the average outstanding OMOs fell to Rs 747.1 billion on the back of a recovery in deposit growth.

In March 2020, the volatility in the interbank market increased again due to financing pressure faced by the government. Importantly, capital outflows from the domestic debt market during the month had a dual impact on bank liquidity: on the one hand, the outflows strained rupee liquidity as commercial banks scaled up their investments in government securities; on the other hand, the SBP's foreign exchange injections to stabilize the exchange rate put additional pressure on the rupee liquidity. To keep the overnight rates close to the policy rate, the SBP stepped up its OMO injections to Rs 1,057.7 billion.

3.3 Credit to Private Sector

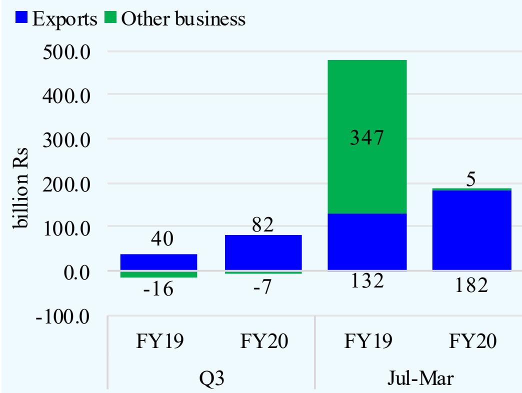
Loans to private businesses grew by Rs 187.3 billion during Jul-Mar FY20 – around one third of the Rs 554.7 billion increase recorded in the same period last year. However, the flow in Q3-FY20 was higher than the same period last year; as businesses aggressively took short-term loans to finance working capital needs. Importantly, a major part of the borrowing can be traced to industrial activity (e.g. textiles), which was consistent with the recovery in economy in the early part of

[5] The monthly average standard deviation of overnight rates in January, February and March amounted to 0.19 percent, 0.13 percent, and 0.21 percent respectively.

the quarter. But later on, the cash flows constraints also started to contribute towards the borrowing needs of businesses.

In particular, exporters complained of cancellation of export orders post production as advanced economies began to exercise containment measures. Therefore, almost the entire business sector borrowings during the quarter were concentrated in the export sector (**Figure 3.7**). In overall terms, the offtake of working capital loans by businesses stood at Rs 73.2 billion in March 2020, which was considerably large in comparison to Rs 55.5 billion in the preceding month, and net retirements of Rs 16.5 billion in March 2019.

Figure 3.7: Composition of Business Sector Loans

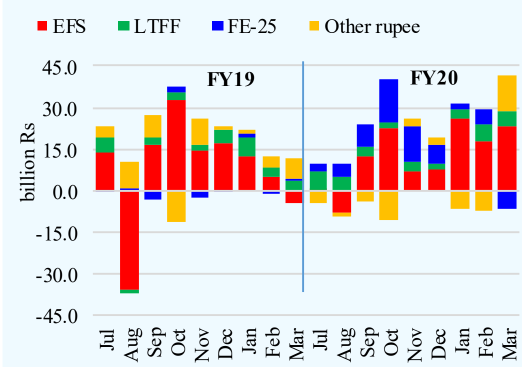


Data source: State Bank of Pakistan

Working capital loans to exporters increased further

Working capital loans posted net expansion of Rs 79.8 billion during Q3-FY20, much higher than the mere Rs 1.8 billion increase recorded during Q3-FY19. A noteworthy development within the working capital borrowings was a shift towards rupee-based borrowings by exporters during the quarter (**Figure 3.8**).

Figure 3.8: Composition of Export Loans (Monthly Flows)



Data source: State Bank of Pakistan

As noted in the Second Quarterly Report for FY20, exporters were more inclined towards foreign currency borrowings in the preceding quarter, especially those who were not eligible under SBP's refinancing scheme. Some supply-side constraints also contributed especially in case of those banks that had exhausted most of the limit assigned for EFS. However, from January 2020 onwards, SBP enhanced the aggregate limit for the EFS by Rs 100 billion. Therefore, the overall borrowing under the EFS increased significantly during the quarter. Foreign currency borrowings, on the other hand, slowed down in January and February 2020 and posted net retirement during the month of March 2020 – the latter reflects the impact of pressures in the foreign exchange market.

Table 3.3: Loans to Private Sector Businesses Jul-Mar*

flow in billion rupees

	Total loans		Working capital**		Fixed investment	
	FY19	**FY20**	**FY19**	**FY20**	**FY19**	**FY20**
Private Sector Businesses	**554.7**	**187.3**	**471.5**	**192.5**	**83.1**	**-5.2**
Manufacturing	452.0	237.7	400.4	218.6	51.6	19.1
Textile	173.9	191.5	154.9	165.3	19.0	26.2
Readymade garments	5.7	26.8	5.6	22.8	0.1	4.0
Sugar	34.9	49.4	20.8	52.8	14.1	-3.4
Rice Processing	41.4	19.1	41.3	18.9	0.1	0.2
Motor vehicles	22.6	19.3	19.8	17	2.8	2.3
Cement, lime and plaster	33.4	20.6	12.6	26.5	20.8	-5.9
Basic iron and steel	10.6	0.5	11.8	-2.7	-1.2	3.3
Paper & paper products	1.1	-10.7	1.0	-7.7	0.1	-3.1
Refined petroleum	33.6	-10.6	39.3	-9.2	-5.7	-1.4
Vegetable and animal oil/fats	19.4	-15.5	22.6	-16.7	-3.2	1.2
Fertilizers	3.5	-18.3	9.9	-13.4	-6.4	-4.9
Power gen., transmission and dist.	59.7	48.0	10.4	43.6	49.4	4.4
Transportation and storage	3.5	12.2	6.3	19.1	-2.7	-6.9
Telecommunications	-8.1	8.2	5.6	-6.2	-13.8	14.4
Real estate activities	22.1	2.7	12.5	3.5	9.6	-0.8
Health	1.0	0.8	0.4	-0.8	0.6	1.6
Mining and quarrying	12.6	7.9	6.9	3.2	5.6	4.7
Agriculture	-9.7	-15.2	-0.5	-7.5	-9.2	-7.7
Construction	-11.8	-29.4	9.0	-19.8	-20.7	-9.6
Wholesale and retail trade	55.5	-45.4	44.3	-37.1	11.2	-8.3

* The sector-wise data for FY19 and FY20 may not be fully comparable, as the flows for Jul-Mar FY19 are based on ISIC 3.1 whereas the flows for Jul-Mar FY20 are based on ISIC 4.0 classification.

**includes trade financing

Data source: State Bank of Pakistan

The textile sector recorded higher borrowing in Jul-Mar FY20 compared to last year, and comprised around 75 percent of manufacturers' loan offtake (**Table 3.3**). Encouragingly, the sector's borrowing was mainly activity-driven, as quantum apparel exports reached a record high during Q3-FY20 and inflation in cotton prices remained muted.[6] The sector benefited from the attractive rate of 3.0 percent on EFS, as more than half of the increase in working capital loans comprised of EFS loans during the quarter.

In the case of cement, some revival in construction activity was apparent as PSDP spending was higher during Q3-FY20 as compared to last year.[7] However, the financial position of most cement firms remained weak (evident from after-tax losses booked in the third quarter), as an overall economic slowdown did not allow them to pass on the impact of higher taxation and freight to end-consumers. As a result, the sector borrowed an additional Rs 13.7 billion during the quarter, taking the cumulative borrowing to Rs 20.6 billion in the Jul-Mar period. Similarly, the impact of COVID-19 related lockdowns seems to have amplified the already challenging environment for the petroleum refining sector. As the domestic demand for petroleum products plummeted in Q3-FY20 and OMCs were not picking products amid a lack of demand and to avoid inventory losses, refineries resorted to short-term bank borrowing to manage their cash crunch. Importantly, these businesses had retired loans in H1-FY20 to reduce their financing costs. However, as the fall in demand became severe during Q3-FY20, it led the sector to mobilize funds from banks once again. The sector borrowed Rs 5.1 billion in Q3-FY20, whereas it had retired Rs 14.3 billion in H1-FY20.

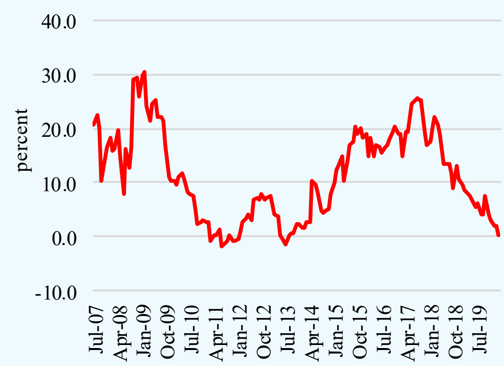
Among the non-manufacturing firms, the power sector's borrowing was noteworthy at Rs 43.6 billion during Jul-Mar FY20, compared to Rs 1.4 billion in the same period last year. Almost half of the increase in borrowing came in Q3-FY20, reflecting working capital requirements of coal-based power projects as well as other firms. Borrowings of coal-based power houses represented working capital needs as available data suggest that production from these plants significantly rose on YoY basis during Q3-FY20; quantum import of coal was higher in this period as well, which reflected the greater need for financing. In the case of other power producers, liquidity constraints apparently contributed to the short-term borrowing, as receivables soared during Q3-FY20 and the issuance of energy Sukuk II of Rs 200 billion got delayed.

[6] Given that cotton prices recorded a modest inflation in domestic markets but declined in international markets on YoY basis, activity dominated the price effect for inputs. Domestic cotton prices rose only 3.4 percent and international prices were 9.7 percent lower on YoY basis during Q3-FY20.
[7] PSDP recorded 6.2 percent increase in Q3-FY20, compared to decline of 39.2 percent in the same period last year on YoY basis.

Fixed investment loans declined in the second consecutive quarter

Fixed investment loans declined for the second consecutive quarter; in fact, these loans recorded net retirement for the first time in any Jul-Mar period since FY07. It seems that the recent investment cycle in many sectors had peaked out during FY18, and now these businesses are retiring their long-term loans as per schedule (**Figure 3.9**).

Figure 3.9: YoY Change in Fixed Investment Loans to Private Sector



Data source: State Bank of Pakistan

Despite the above dynamics, a silver lining was the expansion in long-term loans taken out by manufacturing businesses; these loans increased by Rs 19.1 billion during Jul-Mar FY20, as sectors such as textile and power continued to invest on long-term plans. The development was also consistent with the import of textile and power machinery, which rose by 8.7 and 13.8 percent YoY, respectively, in rupee terms during Jul-Mar FY20. Textile's borrowing was actually higher than last year (**Table 3.3**).

In the case of textile, firms are taking a variety of capital expenditures, which include balancing and modernizing of existing plants and equipment, and expansions. The sector continued to capitalize on attractive borrowing rates on the SBP's long-term financing schemes, such as LTFF. The expansion in the sector's fixed investment loans were fully financed from the LTFF during Jul-Mar FY20. This suggests that the policy measure of extending the limit of LTTF by Rs 100 billion in January 2020 was quite helpful.

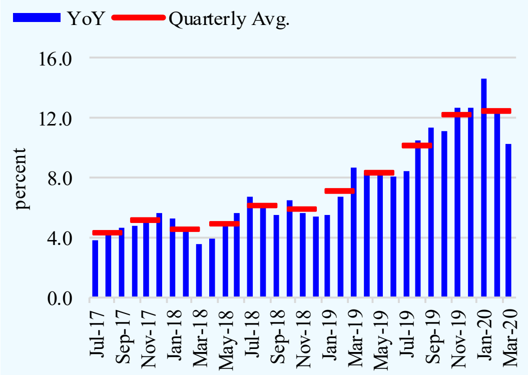
3.4 Inflation

After rising steeply for four consecutive quarters, the national CPI inflation was relatively stable during Q3-FY20. Rising slightly from 12.1 percent in the second quarter, the national CPI inflation clocked in at 12.4 percent during Q3-FY20 (**Figure 3.10**).

Notwithstanding the overall stability, the volatility in inflation across months rose considerably during the quarter. In January 2020, national CPI inflation touched

14.6 percent – the highest in any month since the availability of the index from July 2017. This level reflected a steep rise in food prices amid administrative weaknesses in the price control mechanism of essential items, such as wheat and sugar, as well as an increase in international prices of edible oil. Energy inflation also remained high due to fuel price adjustment in electricity prices during the month.

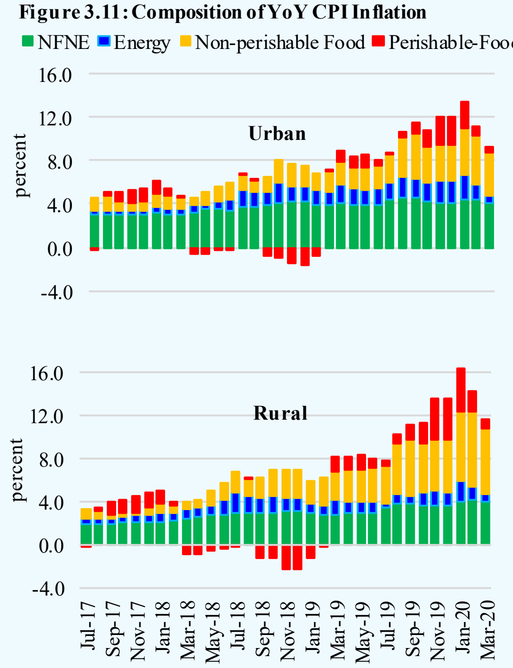
Figure 3.10: National CPI



Data source: Pakistan Bureau of Statistics

However, inflation softened in the subsequent months due to: (i) an effective crackdown on commodity hoarders, which led to improved supplies and an ease in non-perishables' prices; (ii) improved availability of important vegetables, which helped plug the demand-supply gap and softened prices; and (iii) the COVID-driven crash in the global crude oil market and the subsequent 6.2 percent drop in domestic fuel (petrol and diesel) index during March 2020. Energy inflation also softened from February onwards as an outcome of a delay in the fuel price adjustment (FPA) by the government. FPA was recorded zero for the months of February and March 2020, which resulted in a MoM decline in average cost of electricity for domestic consumers (**Figure 3.11**).

Figure 3.11: Composition of YoY CPI Inflation



Data source: Pakistan Bureau of Statistics

Finally, the underlying

inflationary pressures – as measured by the non-food-non-energy (NFNE) index – remained broadly stable during the quarter similar to the previous quarter. However, increase in a very few items (in January 2020) brought a small surge in the overall urban and rural NFNE in Q3-FY20.

Inflationary Pressure on Food Group Intensified in January

Contributed by both perishable and non-perishable items, food inflation surged during Q3-FY20. The impact of rural food prices was more pronounced with a 46.0 percent weight in the rural CPI basket compared to 36.8 percent weight in the urban CPI basket (**Figure 3.11**). However, it is important to note that after peaking out in January 2020, food inflation softened appreciably.

Non-perishable food items steered food inflation

In terms of contribution, the dominant push to non-perishable inflation came from

Table 3.4: Average CPI Inflation and Contribution

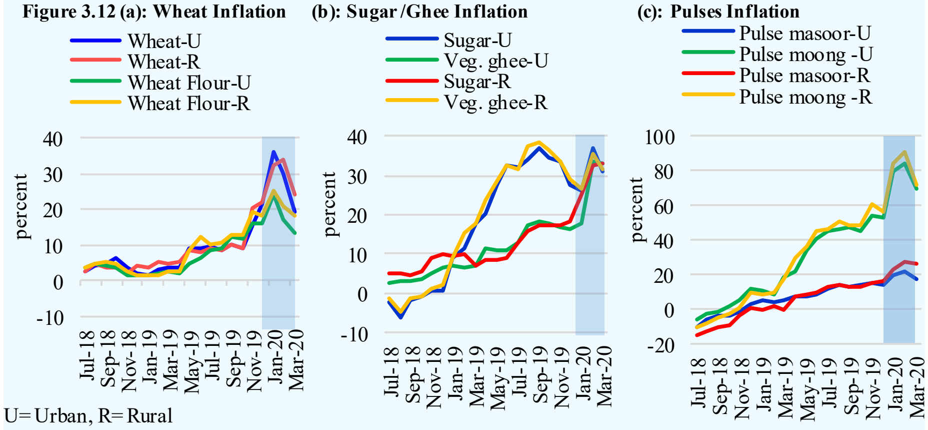
	Urban						Rural					
Items	Wt.*	Jul-Mar		Q3			Wt.*	Jul-Mar		Q3		
		FY19	FY20	FY19	FY20	Cont.*		FY19	FY20	FY19	FY20	Cont.*
CPI	100.0	6.7	11.1	7.4	11.3	11.3	100.0	5.7	12.2	6.3	14.0	14.0
Food & non-alcoh. bev.	30.4	2.9	15.7	5.7	17.3	5.0	40.9	2.7	17.2	5.0	20.5	8.1
Wheat	0.6	3.5	17.9	2.8	28.4	0.2	3.5	3.8	19.0	4.5	30.1	0.9
Wheat flour	3.0	2.8	14.3	1.9	18.3	0.5	3.4	3.1	16.5	1.8	21.3	0.6
Potato	0.4	-21.6	53.8	-19.4	92.4	0.3	0.7	-26.3	56.4	-23.2	113.1	0.6
Onions	0.6	-38.8	108.1	-27.3	104.9	0.4	0.9	-42.1	111.7	-31.5	109.3	0.6
Tomatoes	0.3	6.3	20.7	159.4	-30.9	-0.2	0.5	8.5	27.5	135.9	-19.1	-0.2
Fresh vegetables	1.5	-2.5	35.6	3.9	52.8	0.7	2.1	-3.7	39.4	-0.1	60.1	1.1
Sugar	1.1	2.9	32.5	12.6	31.3	0.3	2.0	4.0	33.1	14.2	31.0	0.5
Veg.ghee	1.0	5.0	20.5	6.9	28.0	0.3	2.4	7.3	21.1	8.9	30.2	0.7
Pulse moong	0.2	4.9	58.7	12.4	77.3	0.1	0.3	1.8	62.4	12.0	81.7	0.1
Clothing and ft.wear	8.0	5.4	9.1	6.2	9.5	0.8	9.5	7.7	9.8	7.0	11.1	1.1
Cotton cloth	2.2	5.5	12.9	6.4	12.7	0.3	2.8	10.5	12.4	10.3	14.7	0.5
Housing, Elec., Gas	27.0	8.3	8.2	9.2	7.2	2.0	18.5	8.1	5.3	7.3	6.8	1.3
Electricity charges	4.6	12.1	3.3	16.9	-1.9	-0.1	3.4	12.1	3.3	16.9	-1.9	-0.1
Gas charges	1.1	25.8	70.7	38.6	54.8	0.7	n.a	n.a	n.a	n.a	n.a	n.a
Health	2.3	6.1	11.4	5.9	11.8	0.3	3.5	6.5	12.2	6.9	12.4	0.5
Transport	6.1	16.6	17.2	11.5	17.1	1.1	5.6	14.8	15.0	9.7	15.1	0.9
Motor fuel	2.9	21.1	20.8	9.4	22.9	0.7	2.5	20.7	20.8	8.6	23.1	0.6
Communication	2.4	2.2	5.3	2.4	5.2	0.1	2.0	1.9	1.8	1.3	1.6	0.0
Restaurants and hotels	7.4	5.7	5.8	5.2	7.3	0.4	6.2	5.3	8.6	4.6	10.0	0.6

*wt. = weight and Cont.= Contribution for Q3
Data source: Pakistan Bureau of Statistics

wheat and wheat flour. Wheat inflation has been edging up consistently since April 2019, and prices of related items were following suit (**Table 3.4**). However, wheat prices rose by an exceptional 12.6 percent MoM in January 2020, which turned out to be the major contributor towards the acceleration in food inflation (**Figure 3.12a**). This crisis-like increase in prices from Q2-FY20 onwards stemmed from the following factors:

Despite low wheat production in the country compared to previous years and low carryover stocks with the procurement agencies, none of the procuring agencies met their procurement target for FY19.

Figure 3.12 (a): Wheat Inflation **(b): Sugar/Ghee Inflation** **(c): Pulses Inflation**



U=Urban, R=Rural
Data source: PBS

Official export of wheat and wheat products (*maida, suji,* etc.) was not banned 11th September 2019 and 29th November 2019, respectively.[8] Although the magnitude of exports was too low to make an impact, this created speculative pressures in the market.

Amid low stocks with procurement agencies, poultry feed mills were allowed to purchase huge quantities of wheat from the private sector, further creating supply-demand disequilibrium in the market.

The situation in January 2020 deteriorated further due to transportation disruptions following a 15-day strike by goods' transporters against the hefty rise in penalties on traffic rule violations on highways and motorways. Moreover, these constraints

[8] S.R.O 1044(I)/2019 and S.R.O 1481(I)/2019, Ministry of Commerce and Textiles, Commerce Division.

were also reflected in the bullish price outlook in the wholesale and retail markets, which encouraged hoarding of the commodity. Therefore, when these disruptions subsided, wheat prices began to ease in the market.[9] Importantly also, the government's decision to allow the import of wheat from February onwards, led to a significant drop in wheat prices. In February and March 2020, wheat prices declined by 3.5 and 8.4 percent on MoM basis, respectively.

The story in the sugar sector was not different either. While the surge in sugar prices in the initial months of the year stemmed from the end of concessional sales tax regime for the commodity, a sharper increase (5.1 percent MoM) was observed in January 2020 during the goods' transporters strike. In contrast to wheat, however, sugar prices continued to increase even after the strike ended. This increase primarily reflected expected low production of the commodity and the absence of a reliable stock position, which had activated speculative elements in the sugar market. Prices increased further in the month of February (8.4 percent MoM and 36.9 percent YoY), pushing the government to announce a ban on exports and allow the import of the commodity. In March 2020, sugar prices stabilized and dropped by 0.5 percent on MoM basis.

Inflation in edible oil remained in double digits during Q3-FY20. This increase was attributed to a sharp rise in international edible oil prices. Specifically, palm oil prices rose by 15.1 percent in Jul-Mar FY20, and by 25.6 percent in Q3-FY20, whereas soybean oil prices rose by 4.6 percent in Jul-Mar FY20, and 2.0 percent in Q3-FY20. Furthermore, the imposition of FED also put upward pressure on domestic cooking oil and ghee prices during the year.

The pulses price index rose by 33.7 percent in Q3-FY20 compared to 5.3 percent last year. Since the data on domestic production is not available, an analysis of demand-supply gap is not possible for the commodity; only the import data is available, which shows around 68 percent YoY increase in quantity imported during the quarter, as well as around 15.7 percent increase in unit prices of imports.[10] The international market for pulses had remained under pressure throughout Q3-FY20 due to wildfires in Australia (among top-3 global exporters) that severely damaged the red lentils crop, and drought-like situations in Thailand and Burma. The impact of international prices was further intensified when Australian prices rose on account of increased demand from India – one of the world's largest consumers as well as producers of pulses – which escalated its

[9] In the third and fourth week of January 2020, wheat flour prices declined by 1.3 percent and 1.8 percent on a week-on-week basis, respectively

[10] Pakistan (which is among the top 10 importers of pulses in the world) imported around 356,400 MT pulses in Q3-FY20 compared to 212,000 MT in Q3-FY19.

purchases to build up its food security in response to COVID-related uncertainties.

Inflation in perishable items decelerated

Inflation in perishables, though higher compared to same period last year, declined in Q3 as compared to Q2-FY20. Deflation in tomatoes amid imports from Iran as well as arrival of the domestic harvest in the market eased the overall inflationary pressures on this group (**Figure 3.13)**.

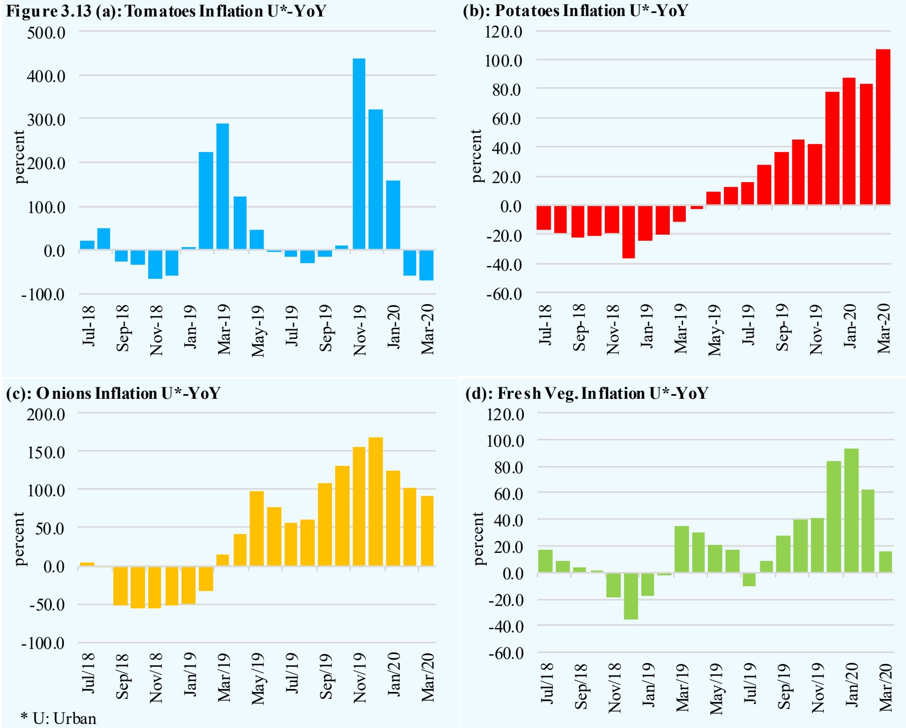


Figure 3.13 (a): Tomatoes Inflation U*-YoY

(b): Potatoes Inflation U*-YoY

(c): Onions Inflation U*-YoY

(d): Fresh Veg. Inflation U*-YoY

* U: Urban
Data source: Pakistan Bureau of Statistics

However, inflation in potato prices in Q3 remained significantly higher compared to both same period last year and previous quarter of the current year. Similarly, onions also registered inflation of 104.9 percent during Q3-FY20 on YoY basis, as compared to deflation of 27.3 percent last year. This year, local growers were getting relatively good prices from international buyers as supplies of a few critical perishable items (onions and potatoes) remained disrupted in regional countries (India and Bangladesh); therefore, Pakistan exported more than it usually does, creating a shortage in the local market despite a good harvest.[11]

In case of onions, the export ban announced by India (a major exporter in the region) was a major development in Q2-FY20. This created an opportunity for Pakistani traders to scale up onion supplies in the international market. This, together with the delayed crop arrival from Balochistan and restricted trade with India, caused a steep rise in domestic onion prices. The ECC, on the recommendation of the MNFSR, banned onion exports in March 2020 till 31st May to contain the pressure on domestic prices.

Core Inflation Rose Marginally

NFNE inflation, where stability was observed in Q2-FY20, posted an upward trend during Q3-FY20 in both urban and rural areas (**Figure 3.14**). House rent (with 19.26 weight) and marriage hall charges (with 1.75 weight) accelerated the NFNE inflation in urban areas in Q3-FY20, whereas house rent, clothing and miscellaneous goods and services caused rural inflation to surge during the quarter.

Other than these items, the overall NFNE index remained more or less unchanged during Q3-FY20, but recorded a moderate increase on a YoY basis. As documented in the First and Second Quarterly Reports for FY20, this increase was attributed to a rise in transport cost (on account of increase in motor fuel prices

Figure 3.14 (a): Composition of NFNE Inflation-Urban

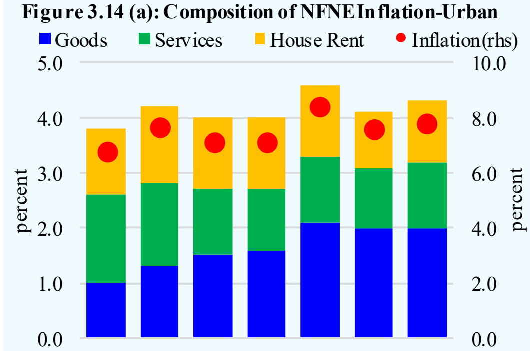
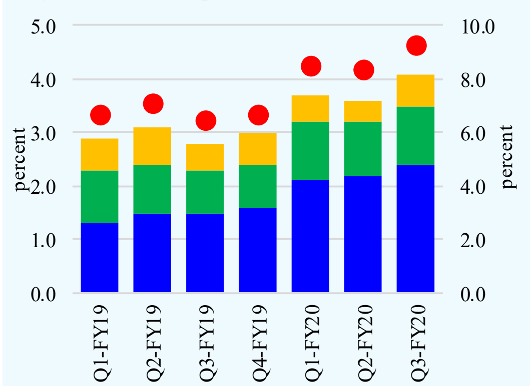


Figure 3.14(b): Composition of NFNE Inflation-Rural

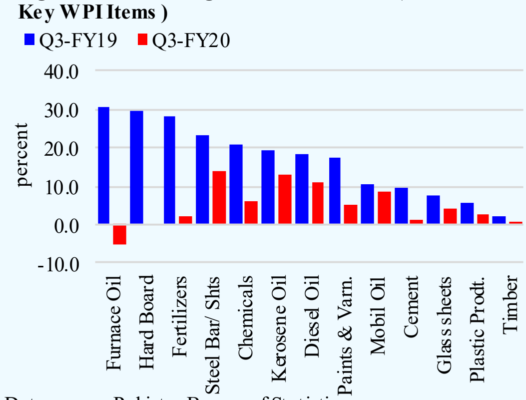


Data source: Pakistan Bureau of Statistics

[11] For a detailed analysis, see SBP Staff Note No 02/2020 "Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges".

and the axle load management), and revenue-enhancing measures taken in the budget 2019-20, including the elimination of zero-rating status of textiles and other export-oriented industries, increase of FED on cement, and the change in duty structure for the steel sector.

Figure 3.15: Declining Cost Push Pressures (Inflation in Key WPI Items)



Data source: Pakistan Bureau of Statistics

The overall moderation in prices of most items not only represented the impact of macroeconomic stabilization efforts, but also a considerable alleviation in cost push pressures in the economy. Notably, with the stability in global fuel prices along with the appreciation of the Pak rupee against the US dollar in H1-FY20, domestic prices of key raw materials stabilized in recent months. The wholesale price index (WPI), after plateauing in October 2018, recorded 22-month low inflation, on YoY basis, in March 2020. Disaggregated analysis suggests that the impact of declining raw material prices was visible on many items within the NFNE as well. The most evident impact could be observed in businesses' fuel costs. This was an outcome of a decline in global commodity prices, particularly fuel prices, on account of growth slowdown in major economies and government's decision to allow the pass-through of the falling oil prices to domestic consumers. However, a number of industries, including automobiles, construction and electronic appliances, experienced a slight increase in domestic prices of steel bars and sheets, cement and other important inputs (**Figure 3.15**).

Energy Inflation Registered Moderation

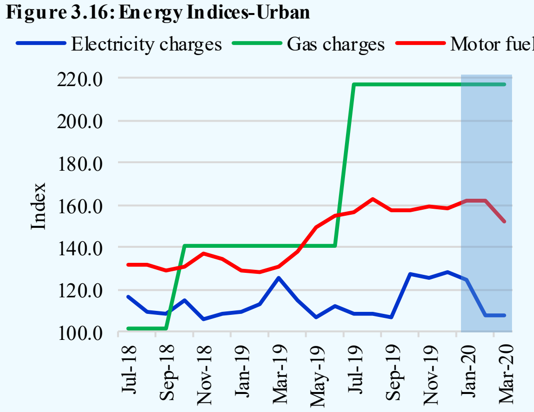
Stability in the administered prices of motor fuel, natural gas, electricity and CNG (indicative) remained instrumental in curtailing inflationary pressures in the energy group during Q3-FY20. However, the substantial ease in the overall energy inflation was observed on account of a decline in electricity inflation.

This decline primarily represented the postponement of fuel price adjustments (FPA) for November 2019 (and onwards), which was expected to be applicable in February 2020. However, Nepra deferred the decision following the government's plan to freeze the electricity tariff for the next six months. This decision also considered the request of the Central Power Purchasing Authority (CPPA) to introduce changes in the FPA mechanism. Thus in the absence of the FPA component in February 2020 (and also in March), the average cost of electricity posted a MoM decline.

It is important to note here that electricity prices have been inching up since FY19 in an attempt to rein in the growing circular debt by withdrawing the provision of subsidized power supply and passing on the impact of increased capacity payments, T&D losses, low recoveries and net hydel profits to end-consumers. A similar adjustment is also needed in the natural gas sector; but the government has delayed this decision to manage cost-push inflationary pressures in the economy.

In the case of motor fuels and gas charges, a higher inflation during Q3-FY20 represents 1.9 percent increase in motor fuel prices in the month of January 2020 on MoM basis. In addition, YoY increase also reflects previous petroleum price hikes (in July, September and November 2019) during the year. However, as mentioned earlier, motor fuel index dropped by 6.2 percent in March 2020 on MoM basis following the slump in global crude oil prices (**Figure 3.16**).

Figure 3.16: Energy Indices-Urban



Data source: Pakistan Bureau of Statistics