3 Monetary Policy and Inflation

On account of rising inflation and current account deficits during most of the H1-FY22 fueled by the sharp rise in global commodity prices, SBP raised the policy rate cumulatively by 275 basis points to 9.75 percent. To contain the monetary expansion, SBP also took targeted measures by increasing the cash reserve requirements for commercial banks by 100 bps, further tightening the regulatory regime for consumer financing and imposing cash margin requirements on import of additional 114 items. Growth in money supply, though at an elevated level, slightly moderated in the H1-FY22, owing to a decline in the NFA of the banking system. Credit to private sector, however, registered a strong off-take during the period. This was mainly because of high commodity prices that increased the borrowing needs of some business sectors such as textile, iron and steel. In addition, uptick in production and trading activity and SBP's concessionary financing schemes (LTFF and TERF) also drove the demand for credit. National CPI inflation, in the meantime, followed an upward trajectory in the H1-FY22, with both urban and rural baskets accelerating the national CPI in the Q2-FY22. While the food group, non-perishable food items in particular, remained the main contributor, the steep rise in energy prices along with increased core inflation also intensified the inflationary pressures during Q2-FY22.

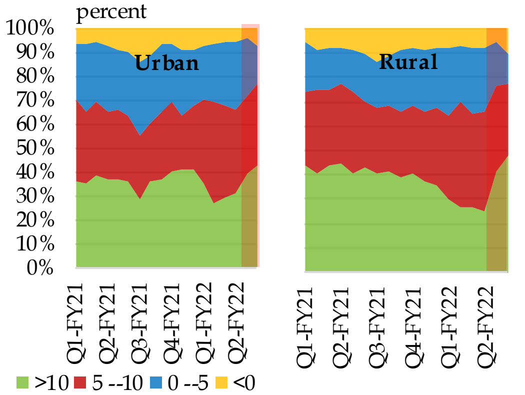
3.1 Policy Review

Global commodity prices super-cycle characterized by post-pandemic rise in demand, particularly the increase in petroleum prices, impacted domestic inflation out-turns and worsened current account deficit in H1-FY22. These increasing pressures, therefore, warranted vigilant policy actions.

With respect to the balance of payments, persistently high international commodity prices together with increased domestic economic activity continued to widen the current account deficit. On the other hand, headline inflation rose to 9.8 percent in H1-FY22 compared to 8.6 percent in year-ago period largely stemming from the strengthening of inflationary pressures in Q2-FY22 both in terms of magnitude and in terms of dispersion. Number of items with double digit started increasing Q1-FY22 onwards (**Figure 3.1**).

In particular, disaggregated analysis suggests that inflation not only was higher on a YoY basis during Q2-FY22, but MoM outturns also remained high on a sequential basis, indicating significantly rising inflation momentum. Three factors largely explained the surge in inflation. First, in response to rising global commodity prices, administered prices (of petrol, electricity and LPG) were adjusted upwards; not only did this inflate the energy component of the CPI, but it also escalated transport services expenses. The rise in electricity tariffs also reflected upward adjustments under the government's circular debt management plan. In addition, rising global commodity prices also built inflationary pressures in imported edible items (such as edible oils, pulses etc.) as well

Frequency Distribution of Inflation **Figure 3.1**



Source: PBS

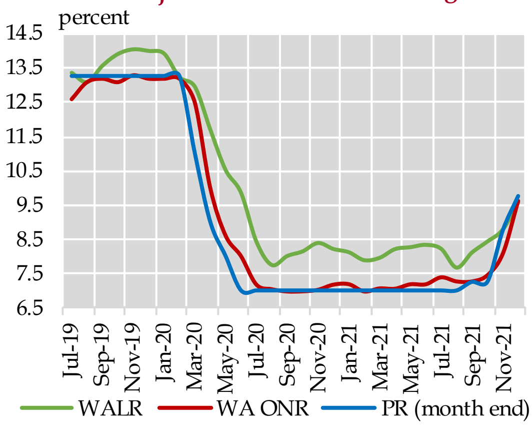
as industrial inputs (such as metals, cotton, paper etc.). Second, core inflation, which had previously remained within the range of 6 to 7 percent, began to rise, reflecting domestic demand pressures. Finally, house rents posted a significant YoY increase during Q2-FY22 due to base effect, which increased H1-FY22 house rent to 6.3 percent. With the given broad-based inflationary pressures, the inflation forecast range for FY22 was also revised upward from 7-9 percent to 9-11 percent.

In the same vein, another important concern from the monetary policy perspective was the deterioration in the current account deficit despite strong exports and workers' remittances. The current account deficit numbers had been larger than expectations in October 2021 and November 2021, stemming mainly due to the sharp rise in global commodity prices together with increased domestic demand.

Meanwhile, domestic economy activity continued its momentum in the Q1-FY22. High-frequency demand indicators, including electricity generation, cement dispatches, sales of FMCGs and petroleum products registered positive growth.[1] Similarly, large-scale manufacturing (LSM) continued to gain further traction, reflective of the ongoing positive momentum in the economic activity.[2] However, with the ongoing economic activity, real money supply growth remained at an elevated level, although slightly less than last year and decelerating sharply in Q2.

Taking stock of these developments, in particular the faster than expected shift in risks away from growth toward inflation and the current account, the Monetary Policy Committee (MPC) increased the policy rate by cumulative 275 bps in H1-FY22. Following the beginning of the tightening cycle in September 2021 with rate increase of 25 basis points, the policy rate was increased further by 150 bps in November 2021 and by 100 bps in December 2021 (**Figure 3.3**). The MPC was of the view that this would achieve sustainable economic growth, by countering inflationary pressures and ensuring sustainability of the current account. Importantly, Pakistan was not an exception as major central banks also tightened monetary policy during the second half of 2021 to keep the inflation expectations anchored (**Box 3.1**). However, Pakistan was among the countries that proactively opted to normalize the Monetary Policy to contain inflation and anchor expectations. In addition, in November's meeting, it was

Trends in Major Interest Rates **Figure 3.2**



Source: State Bank of Pakistan

[1] The cumulative sales of 23 listed FMCG companies grew by 19.9 percent in H1-FY22 compared to 20.3 percent same period a year ago. POL sales registered an increase of 12.1 percent during H1-FY22 over and above 11.0 percent growth last year, whereas cement sales maintained last year's multiyear high level of domestic dispatches of around 24.1 million tons during H1-FY22.

[2] LSM rose by 7.4 percent in H1-FY22 compared to 1.5 percent same period last year.

decided to increase the frequency of monetary policy reviews from six to eight times a year in continuation of efforts to make the process of monetary policy formulation more predictable and transparent in line with international best practices.

In addition to changes in the policy rate, some other specific measures were also taken to counter emerging demand pressures. First, the average Cash Reserve Requirement (CRR), to be maintained during a period of two weeks by scheduled banks, was increased from 5 percent to 6 percent and minimum CRR to be maintained each day from 3 percent to 4 percent. Second, Prudential Regulations (PRs) for consumer financing were tightened. Third, 100 percent cash margin requirement was imposed on the import of additional 114 items, leading to slower import growth and thus supporting the balance of payments position.[3]

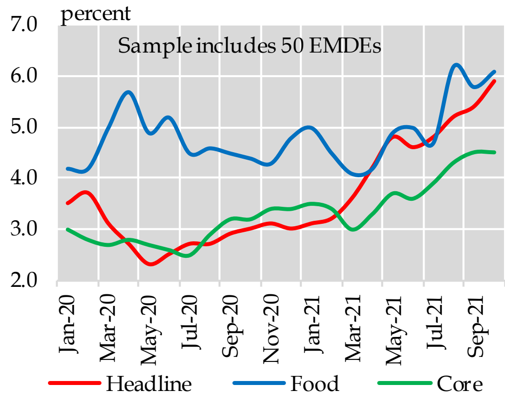
Thus, with the increase in the policy rate during H1-FY22, weighted average overnight rates as well as weighted average lending rates registered an increase of almost the same magnitude; however, the impact was more pronounced in Q2-FY22. Consequently, in response to both policy rate and revised PRs, consumer financing registered 16.2 percent decline in Q2-FY22 compared to Q1-FY22 particularly on account of auto, personal and consumer durable groups. However, overall credit to the private sector registered strong off-take during the quarter primarily because of a rise in working capital demand stemming from higher commodity prices. In addition to cost pressures, uptick in activity in some sectors such as textiles also raised working capital requirements.

Box 3.1: Inflation and Monetary Policy Response in EMDEs

Inflationary pressures across the globe have strengthened at a faster than expected pace during the past few months. Emerging market and developing economies (EMDEs) have observed broad-based increases in inflation since mid-2020, however, the rise has been steeper since July 2021 (**Figure 3.1.1**). Generally, rising inflation is attributed to pandemic-related supply-demand gaps and higher commodity prices and pick-up in demand compared to last year.[4] In some economies, exchange rate depreciation also led to higher prices of imported products.

Increase in inflation has been broad based across countries as well as components. For instance, around four fifths of EMDEs—mainly in Europe and

Inflation in EMDEs **Figure 3.1.1**



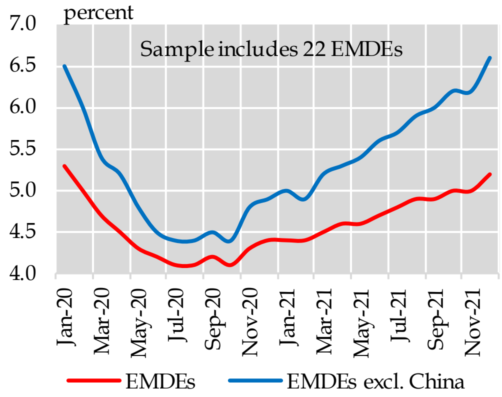
Source: World Bank

[3] The changes in the PRs effectively prohibit financing for imported vehicles. They also tightened regulatory requirements for financing domestically manufactured/ assembled vehicles of more than 1000 cc engine capacity and other Consumer Finance facilities like personal loans and credit cards.
[4] "World Economic Outlook", October 2021, International Monetary Fund.

Central Asia (ECA), Latin America and the Caribbean (LAC), and Sub-Saharan Africa (SSA) registered higher inflation in 2021. In terms of components, a rise in inflation was registered across food, energy and core groups (**Figure 3.1.1**). In particular, around one third of EMDEs observed double-digit food inflation in 2021.[5]

In order to address inflationary pressures and ensure that inflation expectations remain anchored, multiple EMDEs have tightened monetary policies in recent months (**Figure 3.1.2**) after a substantial amount of fiscal support and monetary stimulus provided to combat pandemic-related challenges.

Policy Rate in EMDEs **Figure 3.1.2**



Source: World Bank

3.2 Monetary Aggregates

The broad money growth slowed to 4.3 percent during H1-FY22 compared to 5.6 percent during the same period last year. The entire growth in the money supply came on the back of the expansion in the net domestic assets of the banking system that posted an increase of Rs 1,274.9 billion during H1-FY22 compared to an expansion of Rs 584.0 billion in the same period last year. Meanwhile, part of this impact was offset by a Rs 227.5 billion contraction in the Net Foreign Assets (NFA) in comparison to an increase of Rs 578.8 billion during H1-FY21 (**Table 3.1**).

Within NDA, the bulk of the increase came from the private credit off-take that clocked in at Rs 1,043.1 billion during H1-FY22 compared to an increase of Rs 343.5 billion in the corresponding period last year. This was mainly driven by high input prices and elevated levels of domestic economic activities. Other factors that contributed towards expansion of the NDA include higher credit offtake by PSEs compared to the same period last year and lower retirements by the commodity procurement agencies. Cumulatively all of these factors more than offset the impact of deceleration in the government budgetary borrowings from the banking system which fell to Rs 246.8 billion in H1-FY22 compared to 437.3 billion in H1-FY21.

Meanwhile, NFA of the banking system posted a contraction in the two consecutive quarters of FY22. Cumulatively, during the H1-FY22 the NFA fell by Rs 227.5 billion compared to an expansion of Rs 578.8 billion in the same period last year. This contraction was mainly on account of SBP's NFA that fell by Rs 219.6 billion during H1-FY22 against an increase of Rs 345.5 billion in H1-FY21. This reflects the impact of the deterioration in the current account balance owing to the widening trade deficit. Likewise, the NFA of commercial banks also fell slightly by Rs 8.0 billion compared to an increase of Rs 233.3 billion in the corresponding period last year.

On the liability side, currency in circulation increased by Rs 69.7 billion in H1-FY22 compared to an increase of Rs 64.5 billion in H1-FY21, while the commercial bank

[5] "Global Economic Prospects", January 2022, World Bank.

Monetary Aggregates[P] **Table 3.1**

flow in billion Rupees

	FY21			FY22		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
M2 (A+B)	260.5	902.3	1,162.7	149.5	897.9	1,047.3
A. NFA	307.3	271.5	578.8	-32.8	-194.7	-227.5
B. NDA	-46.8	630.8	584.0	182.3	1,092.6	1,274.9
Budgetary borrowing*	285.2	152.1	437.3	76.7	170.0	246.8
SBP	-281.9	-304.0	-585.9	-212.7	185.1	-27.6
Scheduled banks	567.1	456.0	1,023.2	289.5	-15.1	274.4
Commodity operations	-59.9	-19.4	-79.3	9.5	-24.1	-14.6
Private sector credit	-76.6	420.1	343.5	226.4	816.7	1,043.1
PSEs	-11.9	-17.4	-29.3	11.6	55.5	67.1
Other items net	-184.7	91.7	-92.9	-141.5	70.8	-70.7
Reserve money	-149.0	160.8	11.7	-195.9	236.7	40.8
Currency in circulation	-40.4	104.9	64.5	111.6	-41.9	69.7
Deposits	289.3	792.5	1,081.8	35.6	924.0	959.6

P: provisional

Source: State Bank of Pakistan

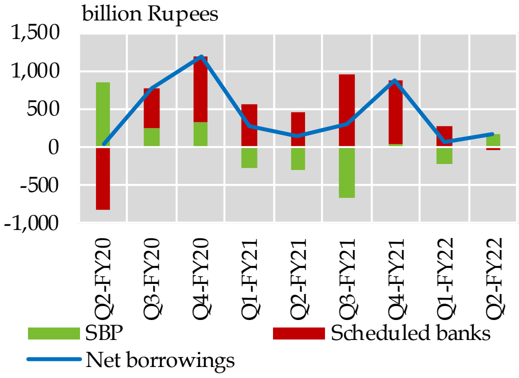
deposits increased by Rs 959.9 billion during H1-FY22 compared to an increase of Rs 1,081.8 billion in the same period last year. This brought the currency to deposit ratio down to 38.2 percent – the lowest level since December 2018. This uptick in the deposit mobilization can be attributed to a cumulative 275 bps increase in the policy rate during H1-FY22 and removal of the withholding tax on the banking transactions for persons not appearing in the active taxpayers' list as well with effect from July 1 2021. This was also reflected in the composition of customer deposits. Remunerative deposits of customers increased by Rs 861.6 billion during H1-FY22 compared to Rs 603.4 billion in the same period last year. Meanwhile, with an increased opportunity cost of holding cash in non-remunerative accounts, the customers' non-remunerative deposits increased by Rs 222.2 billion in H1-FY22 compared to Rs 333.0 billion last year.

Government borrowings

The budgetary borrowings from the banking system fell to Rs 247.0 billion during H1-FY22 compared to Rs 437.3 billion in the same period last year. On quarterly basis, the slowdown in budgetary support from the banking system mainly came on the back of significantly lower borrowings during Q1-FY22; in the subsequent quarter however, it inched up slightly compared to the same period last year (**Figure 3.3**). During the quarter, the government borrowed Rs 185.1 billion from the central bank while it made retirements amounting to Rs 15.1 billion to the scheduled banks. The borrowings from the central bank rose mainly on the back of on-lending to the government against the IMF SDR allocation.[6] Besides this, the government deposits held by the central bank also fell during Q2-FY22, which also inched up the overall borrowings from SBP.

[6] The SBP issued a loan to the government of Pakistan amounting to Rs 474.9 billion in Q2-FY22.

Government Borrowings from the Banking System **Figure 3.3**



Source: State Bank of Pakistan

Primary Auctions

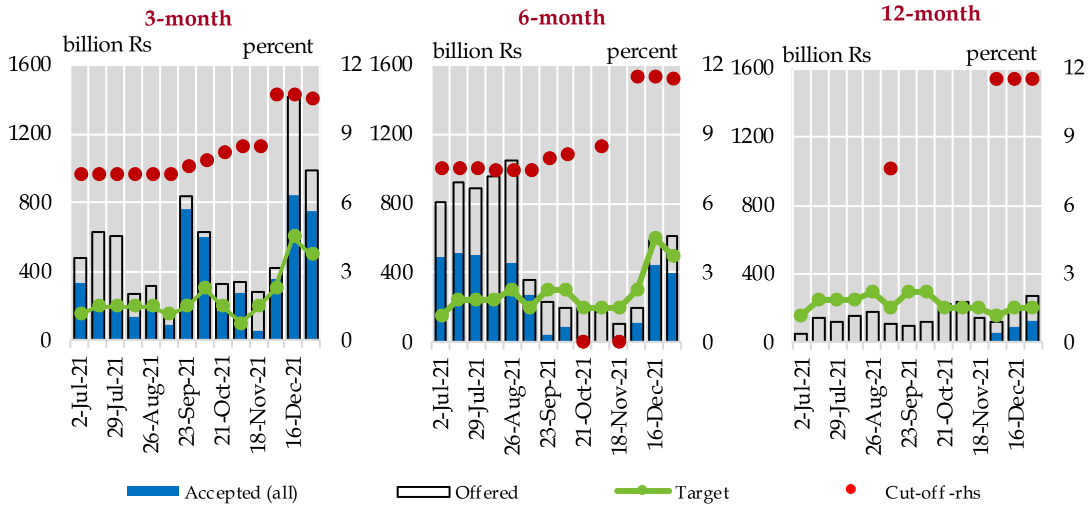
Since the start of the fiscal year, the market's interest in shorter duration instruments remained intact. This was primarily driven by the expectations of the interest rate path. Prior to the reversal of the interest rate cycle, the government did not increase the cut-off rates in the primary market to keep the yields low, at the cost of slightly missing the cumulative targets of T-bills and fixed coupon PIBs. In September 2021, after the first rate hike of the fiscal year, the market's expectations of further rate increase became stronger.

In this backdrop, the government assigned higher targets to floating rate PIBs on net of maturity basis compared to fixed rate bonds, as floaters provide variable return and have medium to long-term maturities. Around 42 percent of the targets on net of maturity basis were assigned to floating rate PIBs, followed by around 26 percent to Ijarah Sukuk.

In case of T-bills, the market remained keen on investing in 3M papers. The offered to target ratio for 3M T-bills stood at 2.0 times compared to 0.9 times for both 6M and 12M bills. The government, while striking a balance between increasing cut-off rates and maintaining the maturity profile, made the highest acceptances (net of maturity) for 3M bills relative to the other zero-coupon bonds (**Figure 3.4**).

In the secondary market, the short-term yields rose faster than the long-term yields,

Auction Summary of T-bills during H1-FY22 **Figure 3.4**



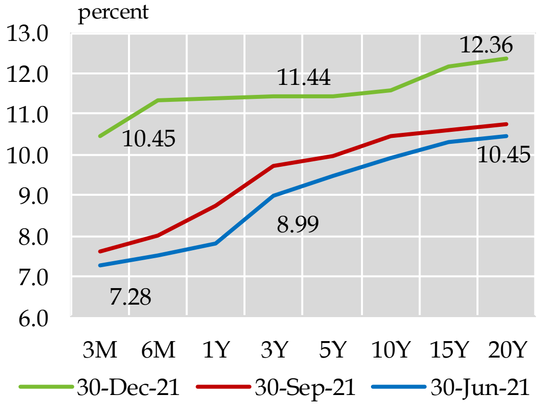
Source: State Bank of Pakistan

highlighting increased expectations of interest rate hikes in the near term. In response to a 250 bps hike in the policy rate during Q2-FY22, 3-month yields rose by 276 bps, while for 6M they picked up by 331 bps. In contrast, on the longer end of the curve, the increase in yields for 3-year, 5-year and 10-year bonds was 170 bps, 151 bps and 117 bps, respectively **(Figure 3.5)**.

With the flattening of the yield curve, the government also made close-to-target acceptances of fixed rate PIBs. Though the rates currently stand at a high level which will increase the government's borrowing cost, this will also help the government in maintaining the maturity profile and diversify its outstanding stock of sovereign bonds. For 5-year bonds, the acceptances remained more than twice the targets. Cumulatively, the government made acceptances amounting to Rs 287.6 billion of fixed coupon PIBs against the target of Rs 300.0 billion.

For floaters, the rising interest rate scenario made investment more favorable.

Secondary Market Yields **Figure 3.5**



Source: Financial Market Association of Pakistan

Auction Summary **Table 3.2**

billion Rupees

	Target	Maturity	Offered*	Accepted
Treasury bills	**5,950.0**	**5,702.8**	**7,821.3**	**4,375.4**
3-month	2,200.0	2,148.1	4,400.4	3,059.8
6-month	2,300.0	3,467.1	2,088.9	1,042.3
12-month	1,450.0	87.6	1,332.1	273.3
Pakistan Investment Bonds				
Fixed Rate	**300.0**	**54.8**	**990.1**	**287.6**
3-year	90.0		281.6	64.9
5-year	75.0	54.8	366.9	167.0
10-year	60.0		331.4	55.7
15-year	45.0		5.2	0.0
20-year	15.0		5.0	0.0
30-year	15.0		0.0	0.0
Floating Rate	**650.0**	**-**	**1,004.5**	**606.2**
2Y-Qtrly	175.0		575.2	459.9
3Y-Qtrly	175.0		281.5	146.3
5Y-Semi annual	175.0		104.6	0.0
10Y-Semi annual	125.0		43.2	0.0
Ijarah Sukuk	400.0	-	794.6	587.9
GIS-VRR	300.0		586.4	507.2
GIS-FRR	100.0		208.1	80.7

*competitive bids only

Source: State Bank of Pakistan

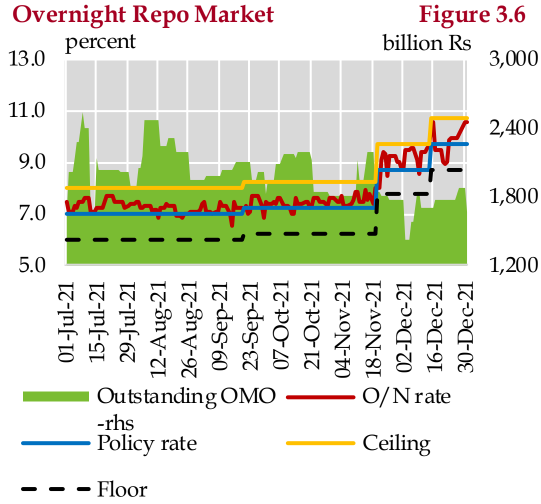
The 2-year quarterly coupon floater stood out as the most favored variable rate bond. The acceptances were in excess of the pre-auction target. This is because a 2-year floating rate PIB carries a duration risk of only 14 days, making it the lowest duration bond available in the primary market.[7]

Besides that, the government also resumed the auction of Sukuk which remained suspended since Jan 2021. Like the trend observed in conventional instruments, the market's interest remained skewed towards Variable Rental Rate Sukuk (GIS-VRR). The government made a cumulative issuance of Rs 507.2 billion of GIS-VRR compared to a target of Rs 300.0 billion for Q2-FY22. In comparison, the acceptances for fixed rental rate Sukuk stood at Rs 80.7 billion against the target of Rs 100.0 billion (**Table 3.2**).

Interbank liquidity

The money market showed signs of liquidity pressures throughout Q1-FY22 that continued to persist until October 2021.[8] From November 2021 onwards, as the deposit mobilization gained momentum and the government borrowings from commercial banks remained muted, the market's reliance on OMO injections started to ease out. High private credit offtake and increase in the cash reserve requirement, on the other hand, partly offset these liquidity inflows in the system. On quarterly basis, the average outstanding OMO injections fell to Rs 1,875.0 billion in Q2-FY22 compared to Rs 2,092.4 billion in the preceding quarter (**Figure 3.6**).

Overnight Repo Market **Figure 3.6**

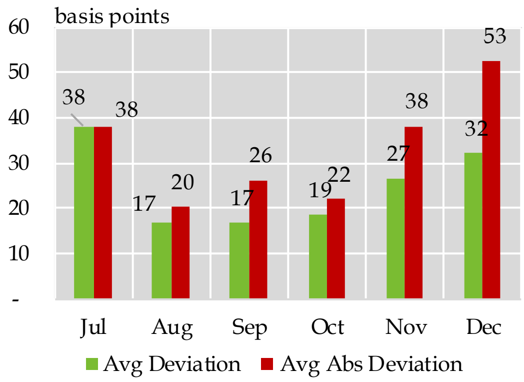


Source: State Bank of Pakistan

As far as the volatility is concerned, the overnight money market remained more volatile during Q2-FY22. The average absolute deviation of overnight rates from the policy rate increased to 38 bps during Q2-FY22 compared to 28 bps in the preceding quarter (**Figure 3.7**). Importantly, in November 2021 the SBP also increased the Cash Reserve Requirement (CRR) with an objective to contain the expansion of money supply. Consequently, this partly had an offsetting impact on the liquidity inflows coming into the banking system in the form of deposits and net retirements from the government. That said, in the long-term this will provide an incentive for banks to mobilize longer tenor deposits.[9] Additionally, the overnight market remained more volatile during the quarter on the back of two rate hike decisions by the MPC. In

[7] The coupon for 2-year floating rate PIB is paid quarterly; however, it resets on fortnightly basis making its duration even lower than that of a 3-month T-bill, which has a maturity of 84 days.
[8] For details refer to Chapter 3 of SBP's First Quarterly Report on the State of Pakistan's Economy for FY22.
[9] CRR is applicable on demand and time liabilities of banks with tenor of less than a year.

Deviation of Overnight Rates from the Policy Rate **Figure 3.7**



Source: State Bank of Pakistan

order to ease out heightened volatility and to further enhance the forward guidance given in December 2021's policy, three *63-day OMO* injections took place in the month of December following the MPC announcement.

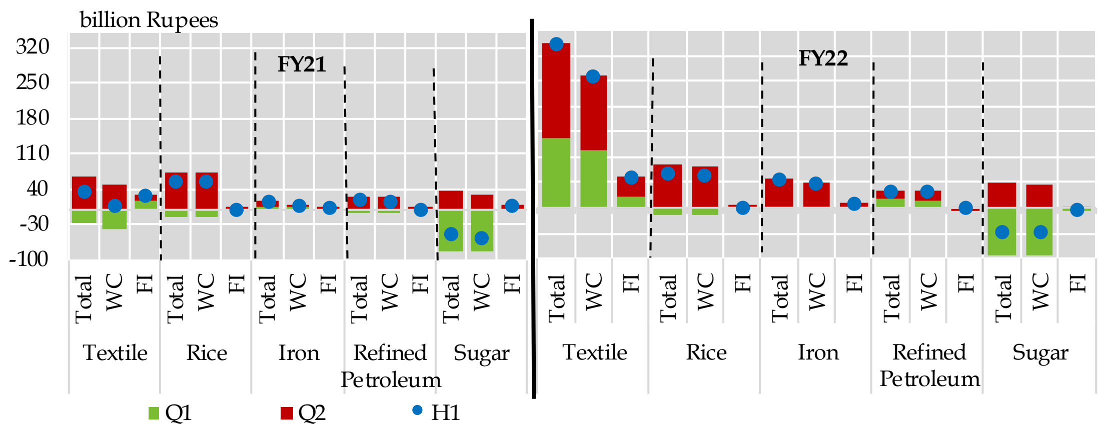
3.3 Credit to Private Sector

The H1-FY22 can be seen as a transition from the last year's favorable environment to relatively tighter monetary conditions for private sector businesses this year, mainly due to two factors. First, the policy environment was less accommodative, with the policy rate up by 275 basis points from 7.0 percent in end-June 2021 to 9.75 percent in end-December 2021 (**Figure 3.2**). Second, there was a persistent increase in the global commodity prices, which increased the input cost for private sector businesses. Despite these factors, the expansion in economic activities continued during the review period, as the policy reversal is expected to have a lagged impact on the overall economic activity.

With a sharp increase in credit offtake during Q2-FY22, loans to private businesses almost quadrupled in the H1-FY22 over the same period last year**.** The increase mainly came from working capital loans, concentrated in the Q2-FY22 (**Figure 3.8**).

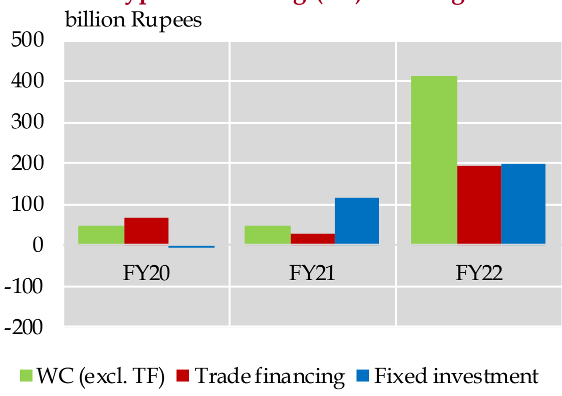
The higher credit offtake can be attributed to: (i) higher input prices (especially of cotton, and basic metals) which increased the borrowing needs of textile and iron and steel; (ii) improved production in sectors such as iron and steel, and paper and paper products; and (iii) vibrancy in trading

Loan Offtake by Major Sectors (flow) **Figure 3.8**

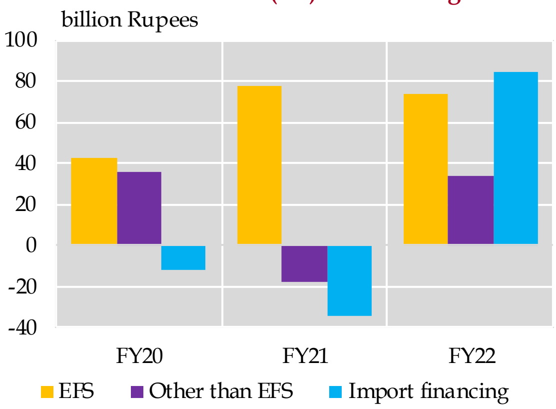


Source: State Bank of Pakistan

Trend in Type of Financing (H1) **Figure 3.9a**



Flows in Trade Finance (H1) **Figure 3.9b**



Source: State Bank of Pakistan

activity also contributed to the higher demand for loans, as reflected by a broad-based expansion in trade financing (both import financing and export financing) during the review period **(Figure 3.9).** The overall improved demand for loans is in line with 27.2 percent higher loan applications received during H1-FY22, over last year.

Working Capital Loans

Working capital loans rose by Rs 607.7 billion in H1-FY22, compared to Rs 73.7 billion in the same period last year (**Table 3.3**). Higher demand for short-term loans by businesses is attributed to some sector-specific developments.

The textile sector dominated the overall borrowing with an offtake of Rs 260.1 billion during H1 FY22, compared to only Rs 8.4 billion in the same period last year. Two main factors explain this increase. First, higher cotton prices raised the borrowing needs of textile businesses. This is consistent with the 56.8 percent YoY jump in the domestic cotton prices during H1-FY22.[10] Second, textile businesses also availed short-term financing to scale up their exports, as reflected by higher quantum exports of major textile products during H1-FY22 **(Chapter 5).**

Likewise, higher prices of base metals in the international market resulted in a five-fold increase in borrowings by the basic iron and steel sector.[11] The overall working capital borrowing of iron and steel firms increased by Rs 49.6 billion during H1-FY22, compared to an increase of Rs 9.5 billion during the same period last year. Apart from managing the input price pressure, the sector's borrowing attributes 18.4 percent growth in the production of iron and steel products during H1-FY22, compared to a marginal increase of 1.2 percent last year. This is in line with buoyant construction activity in the country during H1-FY22, reflected in 40.2 percent growth in PSDP spending during H1-FY22, compared to a decline of 11.8 percent last year.

[10] Source: Emerging Textiles.
[11] During H1-FY22, the prices of base metals rose by around 30 percent in the international market. (Source: IMF)

Loans to Private Sector Businesses (H1) **Table 3.3**

(Flow in billion Rupees)	Total Loans*		Working Capital**		Fixed Investment	
	FY21	**FY22**	**FY21**	**FY22**	**FY21**	**FY22**
Private Sector Businesses	**219.5**	**860.2**	**73.7**	**607.7**	**115.7**	**199.8**
Manufacturing	83.7	670.9	10.3	527.4	72.2	136.3
Textile	35.4	326.5	8.4	260.1	26.5	63.3
Rice Processing	57.2	70.5	55.8	67.4	1.3	2.9
Basic iron and steel	15.3	57.8	9.5	49.6	5.8	8.2
Refined petroleum	18.9	35.9	17.7	34.4	1.3	1.5
Paper & paper products	-1.8	24.8	-5.5	17.6	3.7	7.2
Vegetable and animal oils and fats	-10.3	17.4	-13.7	15.4	3.4	1.7
Cement, lime and plaster	-0.6	11.6	-4.1	10.0	3.5	1.6
Motor vehicles	-17.4	13.5	-19.6	6.9	2.2	6.6
Fertilizers	27.7	5.9	24.5	-5.6	3.2	11.5
Sugar	-46.0	-45.9	-54.0	-45.3	8.1	-0.6
Telecommunications	5.1	20.8	10.0	-13.2	-4.9	34.0
Power gen., trans., and dist.	40.4	27.4	-4.7	7.6	45.2	19.9
Agriculture, forestry and fishing	11.5	30.6	13.7	23.9	-2.2	5.6
Transportation and storage	0.2	11.4	-0.3	8.6	0.5	2.2
Wholesale and retail trade	25.2	49.3	19.0	46.9	5.8	1.2
Mining and quarrying	-3.4	-0.9	-7.3	-2.0	3.9	1.2
Real estate activities	-4.6	3.8	-1.5	1.0	-6.0	-0.5
Construction	15.7	31.1	3.7	0.3	-9.1	-3.6

*Total loans in H1-FY21 and H1-FY22 include construction financing of Rs 30.1 billion and Rs 52.7 billion, as the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business (see IH&SMEFD Circular Letter No. 28 of 2020); ** working capital includes trade financing

Source: State Bank of Pakistan

Borrowings by the refined petroleum sector almost doubled to Rs 34.4 billion in H1-FY22, compared to an offtake of Rs 17.7 billion in the same period last year. The increase primarily came from Q1-FY22, as major oil refineries availed bank financing to meet the rising fuel demand, which is consistent with 17.9 percent YoY growth in POL sales during the Q1-FY22.

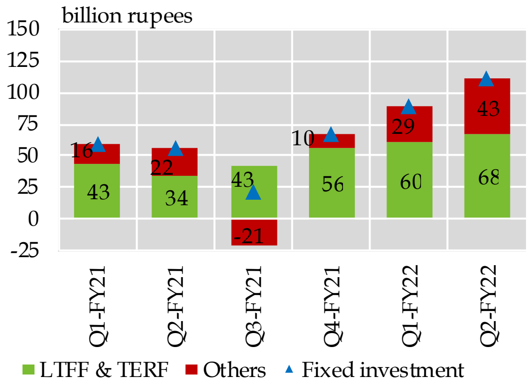
The paper and paper products sector borrowed Rs 17.6 billion during H1-FY22, compared to a net retirement of Rs 5.5 billion last year. The higher borrowings came on the back of 8.3 percent YoY growth in the production of paper products during H1-FY22.

In addition to the refined petroleum and paper, vegetable and animal oils and fats sector also increased its short-term borrowings. The sector borrowed Rs 15.4 billion during H1-FY22, compared to a net retirement of Rs 13.7 billion during the same period last year. The entire increase was concentrated in the Q1-FY22, when higher edible oil prices in the international market drove up the working capital needs of these firms.

Rice processing firms borrowed Rs 67.4 billion during H1-FY22, compared to an offtake of Rs 55.8 billion last year. After the usual seasonal loan retirement in Q1-FY22, the sector availed higher loans in the subsequent quarter, to scale-up its exports. This is supported by 11.7 percent YoY growth in quantum exports of rice during Q2-FY22. On the other hand, after posting significantly higher loan retirements by the sugar sector during Q1-FY22, it increased the offtake in Q2-FY22 over last year, owing to higher sugarcane prices and the start of crushing season **(Figure 3.8)**.[12] On a cumulative basis, sugar sector retired Rs 45.3 billion during H1-FY22, compared to a net retirement of Rs 54.0 billion last year.

Among non-manufacturing sector, wholesale and retail trade availed short-term loans of Rs 46.9 billion during H1-FY22, compared to an offtake of Rs 19.0 billion last year. This reflects borrowings by major oil marketing companies (OMCs) to finance the import of petroleum products. This is supported by 29 percent YoY growth in quantum imports of petroleum products during H1-FY22. Notably, some of the major OMCs benefitted from the exemption of customs duty on imports of petroleum products from China under the China-Pakistan Free Trade Agreement.[13] Consequently, Pakistan's share of petrol (motor spirit) imports from China jumped from 7 percent during H1-FY21 to around 33 percent during H1-FY22.[14]

Fixed Investment Loans (net flows) **Figure 3.10**



Source: State Bank of Pakistan

Fixed Investment Loans

The borrowings under fixed investment loans were Rs 199.8 billion in H1-FY22, compared to an offtake of Rs 115.7 billion last year. Private sector businesses availed SBP's concessionary financing schemes (LTFF and TERF) for machinery imports and capacity expansion. This is supported by higher disbursements under LTFF and TERF during Q2-FY22 **(Figure 3.10).** It is pertinent to mention that out of the total approved amount of Rs 436 billion under TERF, Rs 269 billion (around 62 percent) were disbursed by end-December 2021.

Within the manufacturing sector, textile businesses dominated by borrowing Rs 63.4 billion during H1-FY22, compared to an offtake of Rs 26.5 billion last year. Benefitting from LTFF and TERF, the textile sector borrowed long-term loans to import textile machinery, which corresponds to 89.0 percent YoY growth in the import of textile machinery during H1-FY22.[15] In addition, the anecdotal evidence suggests that some textile firms having spinning segment availed long-term financing for adding finishing units in order to enhance their production capacity. Besides textile, fertilizer was the second biggest user of fixed investment loans in the manufacturing sector, as it increased its borrowings by Rs 11.5 billion during H1-FY22, compared to Rs 3.2 billion last year. Most of the increase was concentrated in Q1-FY22, as a major listed fertilizer firm resorted

[12] Sugarcane prices jumped by 19.8 percent YoY during Q2-FY22 (Source: Pakistan Bureau of Statistics).
[13] Source: FBR SRO 1640(I)/2019, dated December 31, 2019.
[14] Source: PBS
[15] Source: PBS

to bank financing for the acquisition of majority shares in a renewable energy business.[16]

Among non-manufacturing entities, the telecommunications sector availed higher fixed investment loans. The sector borrowed Rs 34.0 billion during H1-FY22, compared to a net retirement of Rs 4.9 billion last year. The increase represents syndicate financing facility availed by a major cellular firm during the Q1-FY22 to finance the acquisition of a 4G license.[17] Meanwhile, power sector also availed bank financing, albeit lower than last year. The sector borrowed Rs 19.9 billion during H1-FY22, compared to an offtake of 45.2 billion last year. Bulk of the increase came in the Q1-FY22, as a major utility company borrowed in order to partially settle the parent company's loan owing to change of ownership.

Consumer Financing **Table 3.4**

flow in billion Rupees

	Q1		Q2		H1	
	FY21	FY22	FY21	FY22	FY21	FY22
Total loans	**38.1**	**58.5**	**46.6**	**49.0**	**84.7**	**107.5**
Auto loans	21.3	30.1	24.0	15.5	45.3	45.5
House building	0.9	14.9	5.5	25.3	6.4	40.2
Credit cards	6.1	3.8	2.3	6.3	8.4	10.1
Personal loans	12.5	7.4	13.8	2.6	26.3	9.9
Consumers durable	-2.6	2.3	0.9	-0.6	-1.7	1.7

Source: State Bank of Pakistan

Consumer Financing

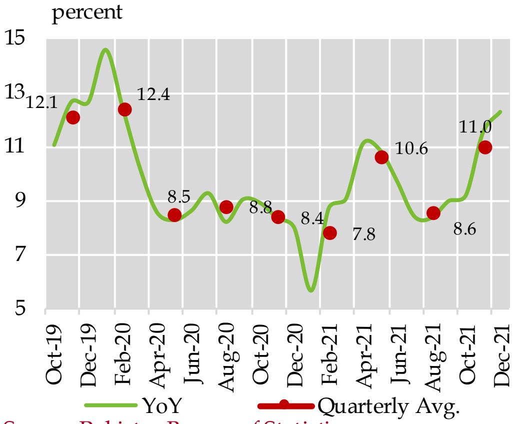
Unlike the favorable conditions for consumer financing during last year, H1-FY22 witnessed some macro-prudential measures aimed at moderating the demand growth in the economy to support the country's balance of payments.[18] The impact of these regulatory measures was visible on consumer financing, as the total loans to consumers moderated in the Q2-FY22. Consumer financing increased by Rs 49.0 billion during Q2-FY22, slightly higher than the same period last year. More importantly, the financing under the transportation segment slowed down to Rs 15.5 billion during Q2-FY22 from Rs 24.0 billion a year earlier.

On a cumulative basis, consumer financing reported a flow of Rs 107.5 billion in H1-FY21 as compared to Rs 84.7 billion a year earlier (**Table 3.4**). Apart from auto loans, the increase is attributed to house building loans during the review period.

A significant increase in house building loans offset the slowdown in auto loans during H1-FY22. The house building segment borrowed Rs 40.2 billion during H1-FY22, compared to an increase of Rs 6.4 billion last year. This is reflected by an increase in the outstanding stock of housing and construction finance by Rs 175 billion in December 2021, over last year. The increase was on the back of mandatory targets set by SBP for banks to

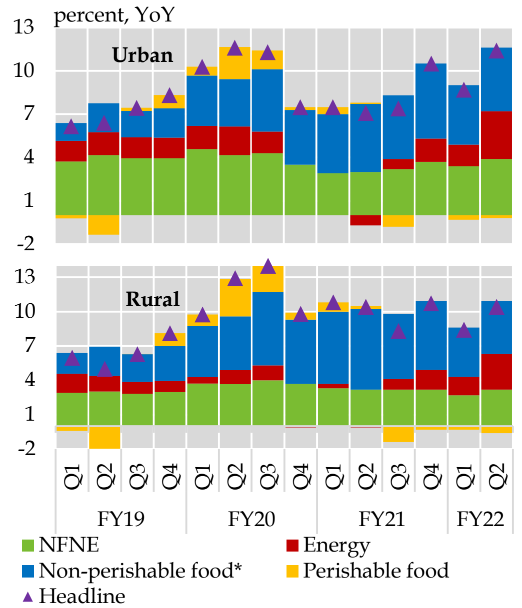
[16] Source: Pakistan Stock Exchange, available at: www.psx.com.pk/psx/files-attachment/?file=168789.pdf
[17] Source: Pakistan Telecommunication Authority, press release, dated September 15, 2021
[18] As per revised regulations, the maximum tenure of the auto finance facility was reduced from seven years to five years. In addition, the overall auto financing limits availed by one person from all banks/DFIs, in aggregate, will not exceed Rs 3 million at any point in time; and the minimum down payment for auto financing was increased from 15 percent to 30 percent. (Source: SBP press release, dated September 23, 2021).

National CPI **Figure 3.11**



Source: Pakistan Bureau of Statistics

Composition of CPI Inflation **Figure 3.12**



*Inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

increase their housing and construction loans to 5 percent of their overall private sector credit portfolio by December 31, 2021.[19]

3.4 Inflation

Inflationary pressures continued to strengthen throughout the H1-FY22 on account of persistently rising global prices of energy, food and metal group along with elevated domestic demand and weakening of domestic currency. In particular, National CPI (NCPI) inflation stood at 11.0 percent in Q2-FY22 compared to 8.4 percent during the same period last year and 8.6 percent in the preceding quarter (**Figure 3.11**).

While the food group remained the main contributor, the steep rise in energy prices along with increased core inflation also contributed to inflationary pressures during H1-FY22. (**Figure 3.12**). In terms of dispersion, particularly for Q2-FY22, the inflation increase was registered in around half of the sub-indices both in urban and rural areas.[20]

Inflation expectations drifted up

Taken together, the evidence from SBP-IBA Consumer Confidence Survey (CCS) and Business Confidence Survey (BCS)[21] indicates that inflation expectations drifted up during H1-FY22. In particular, the results of survey conducted in Q2-FY22 depicted that the consumer inflation expectation index remained elevated almost up to the mark of the previous iteration and the business inflation expectations index increased

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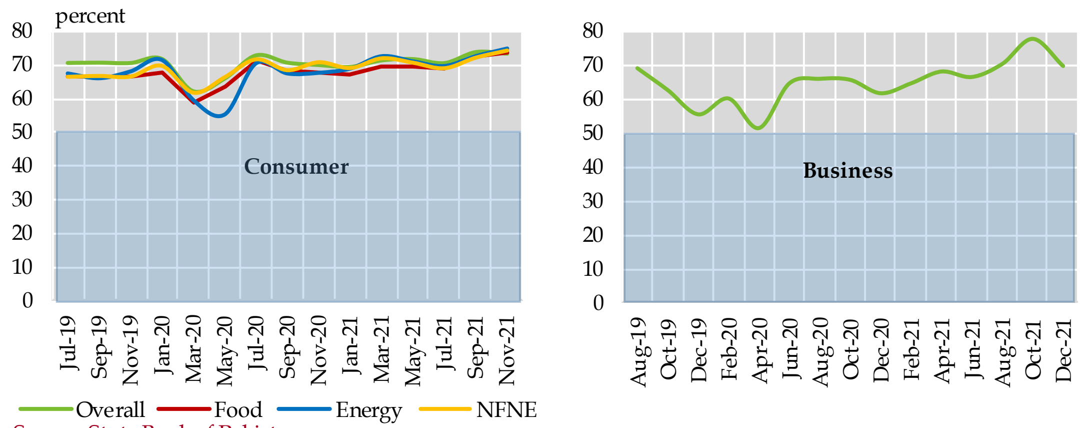
[19] For details, see SBP circular: IH&SMEFD Circular No. 10 of 2020 of 15 July 2020 and subsequent circulars on the subject.

[20] 49 out of 94 items (with about 52 percent share in urban CPI) and 43 out of 89 items (with about 48 percent share in rural CPI) posted higher inflation during Q2-FY22.

[21] CCS was conducted in July 2021, September 2021 and November 2021, whereas BCS was conducted in October 2021 and December 2021.

Inflation Expectations **Figure 3.13**



Source: State Bank of Pakistan

significantly. Elevated consumer inflation expectation index was observed on account of rise in all three categories (food, energy and NFNE); however, rising energy and NFNE prices played a major role in the overall increase in inflation expectations. However, in December 2021, inflation expectations of businesses declined compared to the earlier survey results (**Figure 3.13**).

Food continued to remain the dominant contributor to overall inflation

Food group remained the major contributor to overall inflation in H1-FY22. Particularly, during Q2-FY22, it registered 11.0 percent and 8.3 percent inflation in urban and rural areas respectively during Q2-FY22, compared to 13.2 percent and 15.7 percent increase in the same period last year. Though the pace of food inflation declined on a YoY basis, it accelerated over Q1-FY22. Rising global food prices and supply-demand gaps in some commodities continued to put upward pressures on food prices. (**Table 3.5**).

Rising global commodity prices amid supply disruptions and production prospects

Elevated global food prices remained one of the major reasons behind double-digit inflation in the food group. Around 1.3 percentage point was contributed by imported contents in the food group (cooking oil, tea, pulses) to total inflation of urban areas in Q2-FY22. For instance, the highest direct impact of increasing international commodity prices to food inflation came from edible oils. Palm oil and soybean prices have been on a steep rising trajectory since June 2020 due to growing demand for biodiesel and unsupportive weather patterns in major crop growing areas. Throughout H1-FY22, price pressures reflect concerns over reduction in exports from Indonesia, the world's top palm oil exporter, along with subdued production in major palm oil producing countries.[22]

Similarly, prices of tea, which has 2.3 percent share in urban food basket, also remained elevated during the Q2-FY22 owing to an increase in the unit value of imports.

[22] FAO Food Price Index-January 2022

Average CPI Inflation and Contribution **Table 3.5**

percent

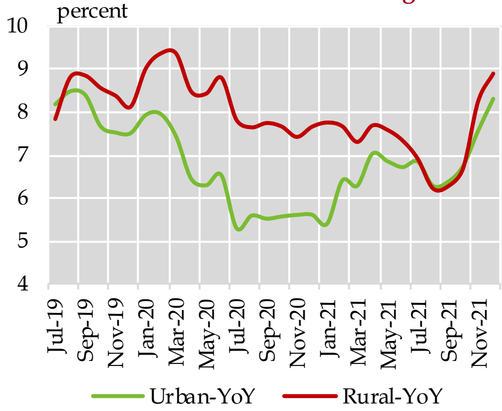
Items	Urban						Rural					
	Wt.*	H1		Q2			Wt.*	H1		Q2		
		FY21	FY22	FY21	FY22	Cont.*		FY21	FY22	FY21	FY22	Cont.*
Headline		7.3	10.1	7.1	11.4			10.6	9.4	10.4	10.4	
Food & non-alcoholic. beverage	30.4	14.0	10.7	13.9	11.1	3.6	40.9	16.2	8.4	16.2	8.2	3.6
Wheat	0.6	37.7	7.4	37.1	9.7	0.1	3.5	38.7	5.0	38.5	5.5	0.2
Wheat flour	3.0	18.8	15.8	17.0	17.0	0.5	3.4	23.1	14.3	21.5	15.9	0.5
Cooking Oil	1.1	11.9	42.9	10.7	51.0	0.6	0.6	15.0	46.3	15.0	52.9	0.3
Vegetable ghee	1.0	17.0	44.5	16.0	52.6	0.6	2.38	18.9	43.6	17.7	50.7	1.4
Fresh Fruits	1.4	-1.2	9.4	-5.0	22.4	0.2	1.5	-2.6	7.1	-5.4	16.5	0.2
Pulse masoor	0.2	18.9	16.6	16.8	24.5	0.0	0.2	26.9	14.4	25.5	20.3	0.0
Gram whole	0.1	3.7	11.3	2.6	15.8	0.0	0.1	-1.2	16.8	-2.2	21.8	0.0
Non-perishable food	26.0	15.2	14.0	16.1	14.7	3.9	35.1	17.2	11.4	18.4	11.9	4.3
Perishable food items	4.5	8.1	-6.1	4.3	-6.4	-0.4	5.8	10.2	-7.2	6.4	-9.8	-0.7
Tea	0.8	3.4	4.7	0.3	8.3	0.1	1.3	4.0	4.0	1.1	7.4	0.1
Alcoholic beverage, Tobacco.	0.9	5.9	2.5	6.5	2.0	0.0	1.3	5.6	1.7	5.4	1.7	0.0
Clothing and footwear	8.0	8.5	10.4	8.6	10.6	0.8	9.5	10.5	8.9	10.2	9.5	0.9
Housing, Electricity, Gas	27.0	3.6	10.8	2.5	13.3	3.5	18.5	5.3	13.8	4.0	16.9	2.8
Furniture & household equipment	4.1	6.3	9.8	6.4	10.1	0.4	4.1	9.9	10.6	9.9	11.3	0.4
Health	2.3	6.9	9.2	7.3	9.3	0.2	3.5	8.8	7.8	8.4	8.0	0.3
Transport	6.1	-3.3	15.9	-3.2	21.9	1.3	5.6	-2.7	13.7	-2.6	19.4	1.0
Communication	2.4	0.4	3.6	0.5	3.5	0.1	2.0	0.3	0.9	0.4	0.9	0.0
Recreation and culture	1.7	3.0	6.7	3.1	7.7	0.1	1.4	5.7	7.5	6.1	7.4	0.1
Education	4.9	1.0	2.2	1.1	2.2	0.1	2.1	1.6	3.8	2.1	3.3	0.1
Restaurants and hotels	7.4	8.5	9.8	9.4	11.1	0.8	6.2	8.8	8.3	9.3	9.8	0.6
Misc. goods & services	4.8	10.7	8.9	10.3	10.0	0.5	5.0	14.3	8.3	14.1	9.4	0.5
NFNE	53.7	5.5	7.0	5.6	7.5	3.9	42.6	7.7	7.2	7.6	7.9	3.2

*wt. = weight and Cont.= Contribution for Q2

Source: Pakistan Bureau of Statistics

Globally, prices are under pressure on the back of improved demand and a government backed reserve price initiated by Kenya to safeguard small farmers (**Table 3.5**).

NFNE-YoY Trends **Figure 3.14**

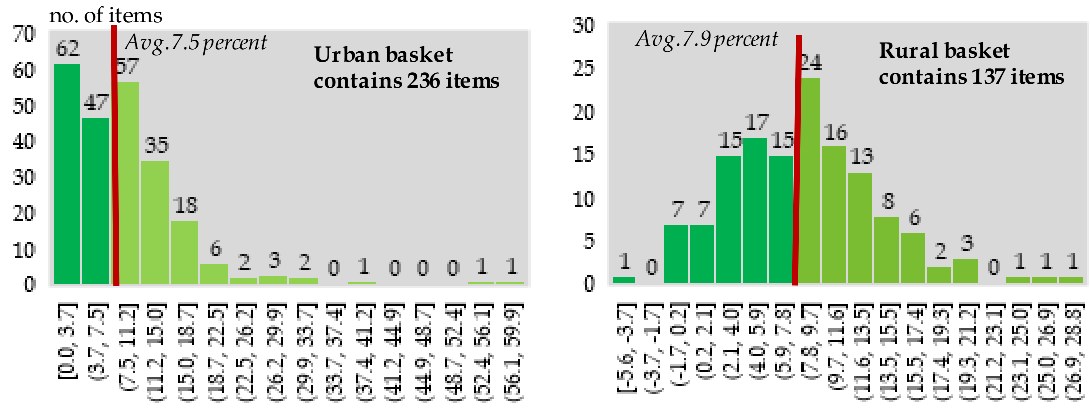


Source: Pakistan Bureau of Statistics

Supply-demand gaps and indirect cost

Pressures on prices of some food items emanated from supply disruptions on imported food items during H1-FY22. For instance, during Q2-FY22, inflation in few pulses remained high. Particularly, pulse masoor and gram whole registered double-digit inflation. Shortfall in domestic

Frequency Distribution NFNE Items **Figure 3.15**



Source: Pakistan Bureau of Statistics

production of various pulses and increase in unit values of imported pulses caused inflationary pressures in this food group.

Though overall perishable food group registered deflation during H1-FY22, a trend persisting since Q3-FY21 on account of sufficient domestic supplies and adequate imports, inflation in fresh fruits and vegetables remained high compared to the same period last year. Relatively lower imports of some fruits created supply-demand gaps in the market, causing high inflation in this group.
Double-digit inflation in ready-made food group was observed during H1-FY22 on account of indirect rise in the prices of inputs, such as wheat, edible oil, chicken and transportation cost.

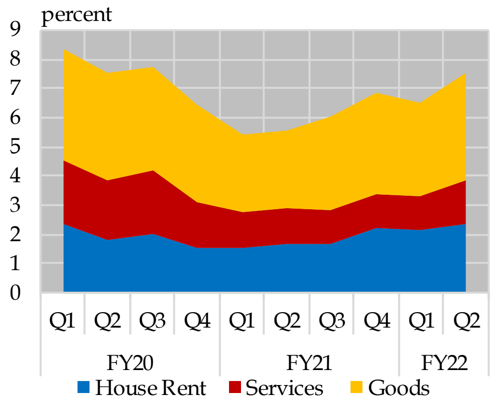
Although wheat inflation remained limited during H1-FY22 both on MoM basis and YoY basis amid relatively better availability of the produce (good crop and imports), inflation in wheat flour remained elevated on a YoY basis amid the increase in wheat issue price by procuring agencies to flour mills.[23]

NFNE inflation started intensifying

The inflationary pressures in the non-food-non-energy (NFNE) group increased in H1-FY22. In particular, NFNE inflation intensified in Q2 compared to both Q1-FY22 as well as the same quarter last year for both urban and rural areas (**Figure 3.14).** In terms of dispersion, more than half of the sub-indices registered higher inflation compared to the same period last year in Q2-FY22.[24] Item-wise commodity basket of urban and rural areas reveals that more than half of the items posted above average NFNE inflation during the quarter (**Figure 3.15**). Acceleration in NFNE inflation reflected increased domestic demand in the economy. In addition, aggravating cost-push pressures on account of increasing international commodity prices and revision in some service charges in Budget FY2021-22 also contributed to rising NFNE inflation.

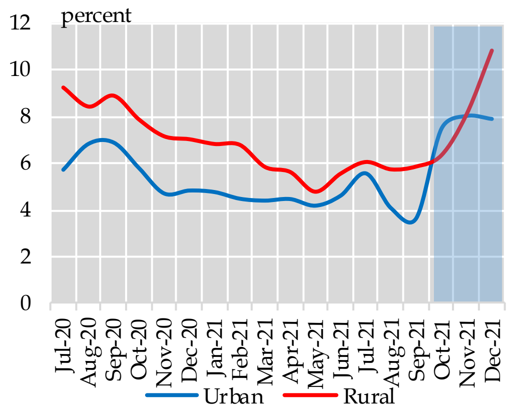
[23] Minimum release price was raised from Rs 1,475 to Rs 1,950, in an attempt to withdraw subsidies.
[24] Around 62 percent and 55 percent of the sub-indices registered higher inflation in urban and rural areas respectively.

NFNE Inflation-Contribution **Figure 3.16**



Source: Pakistan Bureau of Statistics

Construction Wage Rates **Figure 3.17**



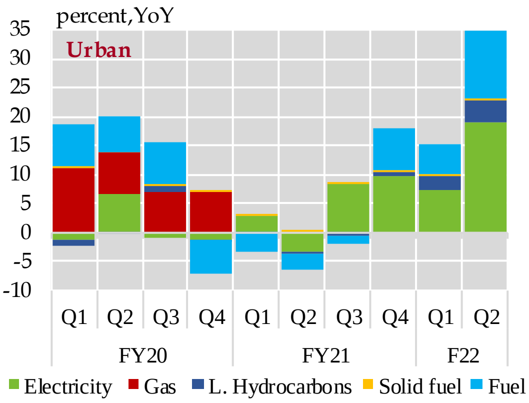
Source: Pakistan Bureau of Statistics

Within the urban as well as rural NFNE, both the services and goods indices accelerated in H1-FY22; however, the impact and contribution of the latter remained more pronounced (**Figure 3.16**). House rent also registered significant rise in inflation. Across goods, particularly in Q2-FY22, significant price rise was observed in clothing and footwear, plastic products, household equipment and textbooks during Q2-FY22 over last year amid rising cost of imported inputs as well as improved demand.[25] Similarly, rise in iron bar prices, in particular, pushed-up the overall construction input index reflecting both rising demand and global prices.[26]

Motor vehicles group, which posted significant deceleration in inflation in Q1-FY22 after reduction in FED by the government in budget FY22, registered significant rise in the inflation during Q2-FY22. This reflects upward price revisions by auto manufacturers over passing on the impact of duties on some variants.

In the services group, some of the rise in inflation reflects base effect, as prices are higher compared to the low levels that prevailed last year amid Covid-related relief provided by the government in the FY21 budget.[27] Also, wage pressures remained

Composition of Energy Inflation **Figure 3.18**



Source: Pakistan Bureau of Statistics

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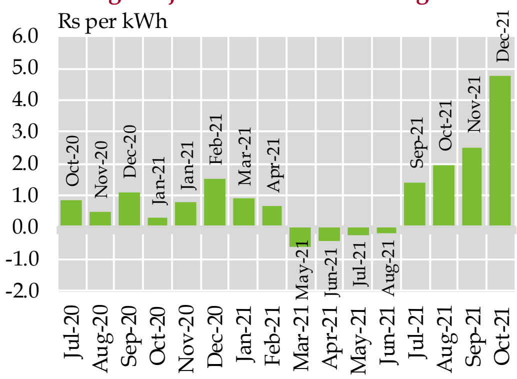
[25] International cotton, plastic and paper prices are on rising trajectory amid disruption in the global supply chains.
[26] IMF index of base metals rose by 15.5 percent in Q2-FY22 compared to last year.
[27] For instance, tax on motor vehicles and charges of postal services were raised in FY22 budget.

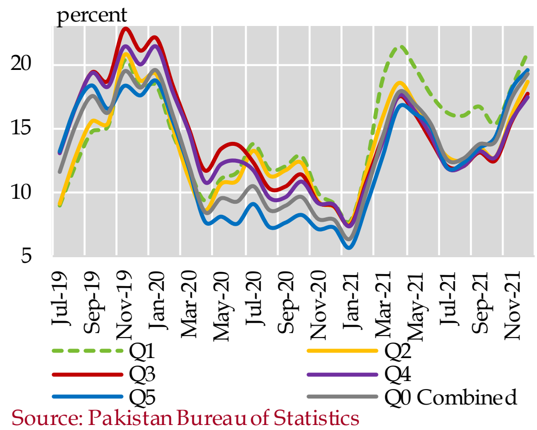
Fuel Charge Adjustment **Figure 3.19**



Note: x-axis indicate months for which fuel charge adjustment was charged

Source: National Electric Power Regulatory Authority

Inflation-Consumption Quintile **Figure 3.20**



Source: Pakistan Bureau of Statistics

elevated during Q2-FY22 on YoY basis owing to lower base effect as well as rising construction activities and may be construed as the impact of overall inflationary pressures in the economy, which have affected real incomes of the low-income group the most (**Figure 3.17**).

Energy inflation continued to surge

A sharp increase in administered prices of motor fuel, electricity and LPG remained instrumental in strengthening inflationary pressures in the economy during H1-FY22 (**Figure 3.18**). These adjustments reflect measures taken under the circular debt management plan and rising international fuel prices.

The largest direct impact came from adjustments in electricity tariffs, as this alone contributed 1.2 percentage points to the headline inflation during H1-FY22 and 1.8 percentage points in Q2-FY22, particularly. Significant upward revision in Fuel Cost Adjustment (FCA) contributed to major rise in inflation in this group (**Figure 3.19**).

In the case of motor fuels, the trend in global oil prices and frequent revisions in the sales tax and PDL structure during the H1-FY22 determined the direction and magnitude of changes in domestic petrol and high-speed diesel (HSD) prices. In overall terms, the motor fuel index posted more than 25 percent inflation during H1-FY22 both in urban and rural areas, contributing around 0.8 percentage points to the overall inflation.

Consumers of the lowest consumption basket were hit-hard

The incidence of increasing inflationary pressures on low-consumption group (with consumption up to Rs 17,732) remained quite elevated throughout H1-FY22, the impact was more pronounced during Q2-FY22 as compared to other consumption quintiles (**Figure 3.20**). Since the consumption basket consists of the Sensitive Price Index (SPI),[28] a broad-based rise in food prices, electricity tariffs, and fuel charges has affected this group severely as compared to other groups.

[28] Sensitive Price Index includes 51 essential items.