

## Monetary Policy and Inflation

*Domestic supply shocks, particularly the hike in administered prices, alongside chronic structural issues and second round effects of commodity price shocks, kept the National CPI inflation elevated during H1-FY24. While global commodity prices witnessed a downtrend, PKR depreciation partially neutralized its impact on imported inflation during H1-FY24. Moreover, core inflation plateaued at elevated level, reflecting second round effects of higher food and energy prices, increase in minimum wages and high inflation expectations. Hence, to keep the real interest rate positive on a forward-looking basis and to bring inflation down to the medium-term target range, the Monetary Policy Committee maintained tight monetary policy stance and kept the policy rate unchanged at 22 percent during H1-FY24. Amid the contractionary policy environment and sluggish domestic demand, private sector credit uptake slowed down during the first half of FY24. However, the government's continued reliance on commercial banks for budgetary support contributed to expansion in Net Domestic Assets of the banking system. This, along with the expansion in the Net Foreign Assets of the SBP, led to acceleration in broad money growth in H1-FY24.*





## 3 Monetary Policy and Inflation

### 3.1 Policy Review

The Monetary Policy Committee (MPC) maintained tight monetary policy stance by keeping the policy rate unchanged at 22 percent during H1-FY24. Although inflationary pressures eased in H1-FY24 relative to H2-FY23 with some improvement in food supply amid administrative actions against illegal activities, such as hoarding and smuggling, and increase in agriculture output, the headline inflation remained higher compared to H1-FY23.

The sentiments about the country's macroeconomic environment had fairly improved at the start of FY24. Importantly, the country managed to secure a US\$ 3.0 billion Stand-by Arrangement (SBA) from the IMF in June 2023 that lowered near-term risks to the external account outlook. In terms of real economic activity, the domestic demand indicators in June 2023, continued to show policy-driven slowdown, whereas the YoY National CPI (NCPI) inflation came down by about ten percentage points, after peaking in May 2023.

These developments reflected positively on inflation outlook when the MPC met in July 2023. Taking into account these considerations alongside the lagged impact of the cumulative monetary tightening, budgeted fiscal consolidation, benign outlook for global commodity prices and the high base effect, the MPC projected the average NCPI inflation to fall in the range of 20.0 – 22.0 percent in FY24.<sup>1</sup> The

volatility in global commodity prices and domestic and external supply shocks presented significant upside risks to these projections.

The MPC also projected a moderate recovery in economic activity in FY24, mainly on account of expected rebound in agriculture output. While the withdrawal of import prioritisation measures in June 2023 ameliorated the outlook of industry, the continued contractionary monetary and fiscal policies were expected to keep the real GDP growth in the range of 2.0 – 3.0 percent in FY24.

With the policy-induced compression in domestic demand, the MPC projected current account deficit in the range of 0.5 – 1.5 percent of GDP in FY24. Furthermore, the MPC stressed the importance of continued fiscal prudence by expanding tax net, containing un-targeted subsidies and expediting reforms in loss-making Public Sector Enterprises (PSEs). These measures are seen as necessary conditions for achieving macroeconomic stability and bringing down inflation to the medium-term target range.<sup>2</sup>

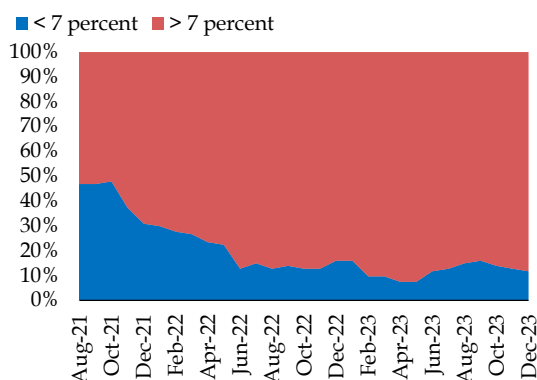
The broad macroeconomic trends remained mostly in line with the MPC's projections during H1-FY24. In particular, according to the provisional estimates, real GDP grew by 2.1 percent in Q1-FY24, against a 1.0 percent growth in the same period last year.<sup>3</sup> Similarly, the domestic demand indicators also started to show

<sup>1</sup> SBP revised the inflation projection range for FY24 to 23.0 – 25.0 percent in its January 2024 Monetary Policy Review.

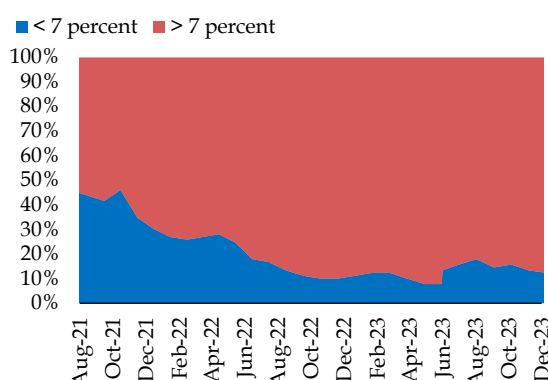
<sup>2</sup> The government has announced its medium-term inflation range of 5 to 7 percent. Sources: Ministry of Finance (2020). Medium Term Budget Strategy Paper (2020-2023).

<sup>3</sup> According to the National Income Accounts data released in March 2024, the real GDP grew by 1.7 percent in H1-FY24, against 1.6 percent growth in the same period last year.

**Frequency Distribution of Urban CPI Basket**



**Figure 3.1 a Frequency Distribution of Rural CPI Basket**



Source: Pakistan Bureau of Statistics

early signs of bottoming out from September 2023 onwards. With the recovery in economic activity and the withdrawal of guidance on import prioritisation in June 2023, current account balance slipped into deficit during Jul-Nov FY24, after showing surpluses during the last four months of FY23.

The fiscal outcome was also broadly in line with the consolidation envisaged in FY24 budget. The contractionary policy environment and subdued domestic demand underpinned slowdown in private sector credit during H1-FY24. However, the NCPI inflation during H1-FY24 surpassed the level seen in the same period last year.

A greater-than-expected hike in administered prices of gas, as well as pervasive distortions in the commodities' market, had a large bearing on inflation during H1-FY24. Meanwhile, reflecting the impact of decreasing – but still elevated – costs, second round effects of commodity

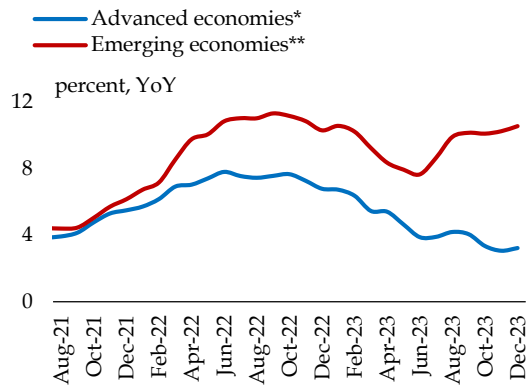
price shocks, and increase in minimum wage, the core inflation also remained sticky at a higher level. Moreover, the items exceeding the upper bound of medium-term inflation target dominated the distribution of CPI basket across urban and rural segments (**Figures 3.1a and 3.1b**).

Taking stock of these developments, and to keep inflation expectations anchored, the MPC continued with the tight monetary policy stance in all of its meetings held during H1-FY24.<sup>4</sup> In view of the lagged impact of monetary tightening in the past two years, budgeted fiscal consolidation, ease in global commodity prices and a favourable base effect, the MPC anticipated headline inflation to follow a downward trajectory in the second half of FY24. The MPC noted that with the real interest rates in positive territory on 12-month forward looking basis, the monetary policy stance was appropriate to bring down inflation to the medium-term target range of 5.0 – 7.0 percent by the end of FY25.<sup>5</sup>

<sup>4</sup> MPC convened four meetings during H1-FY24.

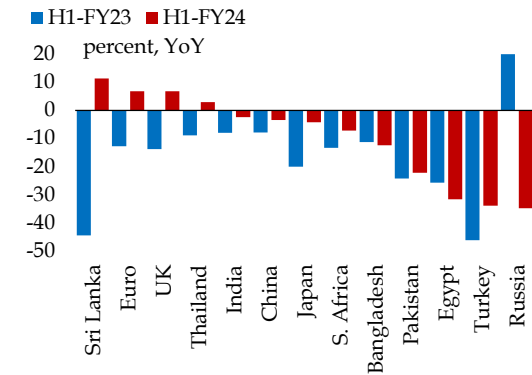
<sup>5</sup> In its March 2024 meeting, the MPC revised this timeline to September 2025.

**Headline CPI Inflation** Figure 3.2



\* include G7 countries; \*\*based on 51 EMDEs  
Source: Haver Analytics

**Appreciation (+) / Depreciation (-) of Currencies across Advanced and Emerging Economies** Figure 3.3



Source: Haver Analytics

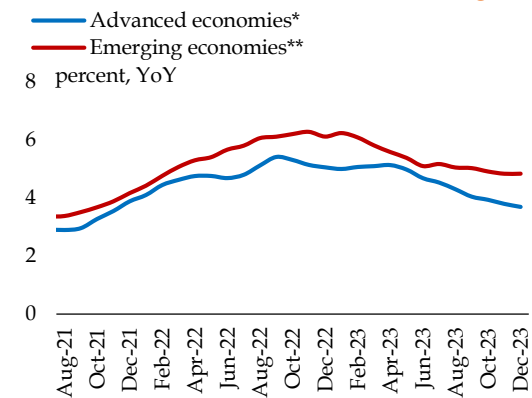
### 3.2 Global Inflation and Monetary Policy Responses

Global inflation saw diverging trends in H1-FY24. While the Advanced Economies (AEs) witnessed continuation of disinflationary trends that started towards the end of 2022, inflationary pressures resurfaced in Emerging and Developing Economies (EMDEs) during H1-FY24, after witnessing a downtrend in the second half of FY23 (**Figure 3.2**).

The ease in supply chain disruptions, decline in global commodity prices and a general slowdown in economic activity supported disinflation in AEs.<sup>6</sup> In addition, relatively lower currency depreciations, as well as stronger and credible monetary policy frameworks, aided in continued moderation of headline inflation in these economies (**Figure 3.3**).<sup>7</sup>

On the other hand, food supply disruptions, mostly due to climate change, restrictions on food exports from some of the large exporting countries, domestic supply shocks, and rising import costs contributed to spikes in food prices in a number of emerging economies.<sup>8,9</sup>

**Core Inflation** Figure 3.4



\* include G7 countries; \*\* based on 51 economies  
Source: Haver Analytics

<sup>6</sup> See Chapter 5 for details.

<sup>7</sup> IMF, World Economic Outlook (2023)

<sup>8</sup> In East Asia (Republic of Korea and Taipei, China), food prices edged up amid weather-related uncertainties.

<sup>9</sup> Rice prices, a staple food commodity for most of developing Asia, rose to a 15-year high in November 2023, as India expanded ban on its rice exports. Source: Asian Development Outlook, December 2023

**Number of Emerging Market Economies announcing Policy Rate Decisions**

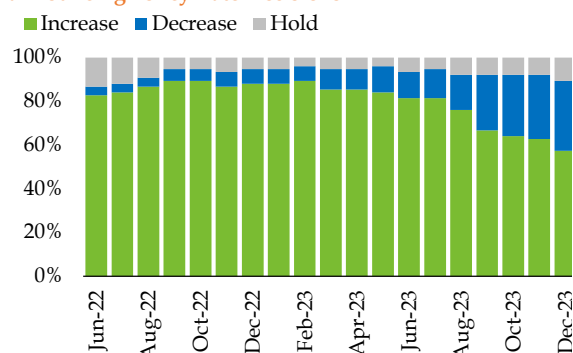


Figure 3.5 a

**Number of Advanced Economies\* announcing Policy Rate Decisions**

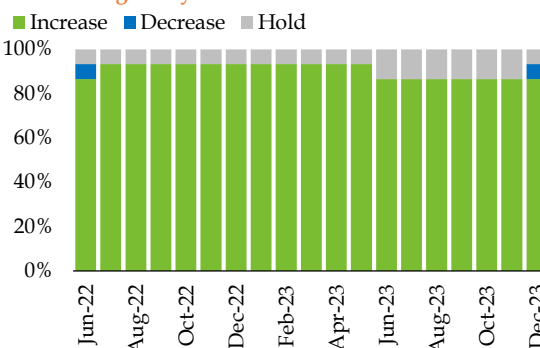


Figure 3.5 b

Note: The increase/decrease is calculated for 75 Emerging Market Economies.

Source: Haver Analytics

\*15 Advanced economies

However, the core inflation declined only gradually in both AEs and EMDEs (Figure 3.4). The underlying inflationary pressures, primarily emanating from tight labor markets, increase in wages to compensate for escalating cost-of-living, and pass-through of higher energy prices, explain these trends.<sup>10</sup>

In view of the stubborn core and above target headline inflation, most central banks in AEs and EMDEs maintained tight monetary policy stance (Figure 3.5). Similarly, in view of sustained inflationary pressures, Pakistan kept the policy rate unchanged during the review period.

### 3.3 Pakistan's Monetary Aggregates

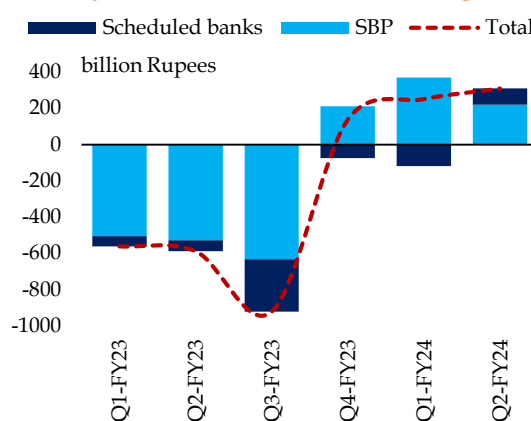
Despite a continued contractionary monetary policy stance, the broad money (M2) growth accelerated to 4.5 percent in H1-FY24, compared to 1.2 percent in the same period last year. Expansion in both Net Domestic Assets (NDA) and Net Foreign Assets (NFA) contributed to

acceleration in M2 growth (Table 3.1). The increase in NDA was largely on account of higher budgetary borrowings by the government from commercial banks, while expansion in NFA, specifically of the SBP, reflects improvement in external account (Figure 3.6).

Notwithstanding improved availability of external finance, the government relied heavily on budgetary borrowings from the commercial banks during H1-FY24. In

Quarterly Flows of NFA

Figure 3.6



Source: State Bank of Pakistan

<sup>10</sup> IMF (2023). World Economic Outlook (October 2023)

**Monetary Aggregates (H1)**

flows in billion Rupees, growth in percent

Table 3.1

	Change in Stock		Growth		Contribution to M2 Growth	
	FY23	FY24	FY23	FY24	FY23	FY24
Broad money (M2)	340.2	1,412.5	1.2	4.5	1.2	4.5
NFA	-1,150.4	561.7	N/A	N/A	-4.2	1.8
NDA	1,490.6	850.8	5.3	2.5	5.4	2.7
Budgetary borrowing	458.5	2,084.2	2.5	9.4	1.7	6.6
SBP	147.4	-1,744.0	2.9	-33.2	0.5	-5.5
Scheduled banks	311.1	3,828.2	2.3	22.5	1.1	12.1
Commodity operations	5.2	-229.2	0.5	-15.4	0.0	-0.7
Credit to private sector	584.5	385.0	6.5	4.2	2.1	1.2
Credit to PSEs	80.8	22.9	5.9	1.4	0.3	0.1
Other items net	32.3	-1,381.5	-	-	0.1	-4.4
Reserve money	-23.4	-747.5	-0.3	-6.5	-	-
Currency in circulation	114.7	-697.1	1.5	-7.6	0.4	-2.2
Deposits	218.3	2,102.3	1.1	9.4	0.8	6.7

Source: State Bank of Pakistan

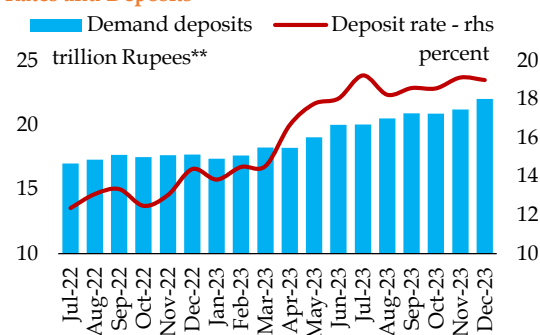
addition to a large fiscal deficit, this was because of net retirement to the non-banking sector, particularly in T-bills and National Saving Schemes (**Chapter 4**). However, net retirements in commodity operations financing, lower credit offtake by the private sector and a steep contraction in the Other Items Net (OIN), partially diluted the impact of the surge in government budgetary borrowing on NDA.<sup>11</sup>

On the other hand, expansion in the SBP's NFA was the outcome of a sizeable increase in external financing inflows during H1-FY24. Successful negotiation for IMF's SBA in June 2023 was instrumental in reviving the confidence of multilateral and bilateral lenders, leading to significant increase in inflows during H1-FY24. Furthermore, the repayment of external debt was lower in H1-FY24 compared to last year (**Chapter 5**).

On the liability side, currency in circulation (CiC) declined by 7.6 percent during H1-FY24, compared to an increase of 1.5 percent in the corresponding period of last year. The decline in CiC was entirely concentrated in Q1-FY24. According to anecdotal evidence, besides lucrative interest rates offered by banks on saving accounts, as shown in **Figure 3.7**, the crackdown on smuggling and hoarding of US dollars, amid rumors of

Weighted Average Deposit Rates and Deposits\*

Figure 3.7



\* excluding zero mark-up and inter financial institutions

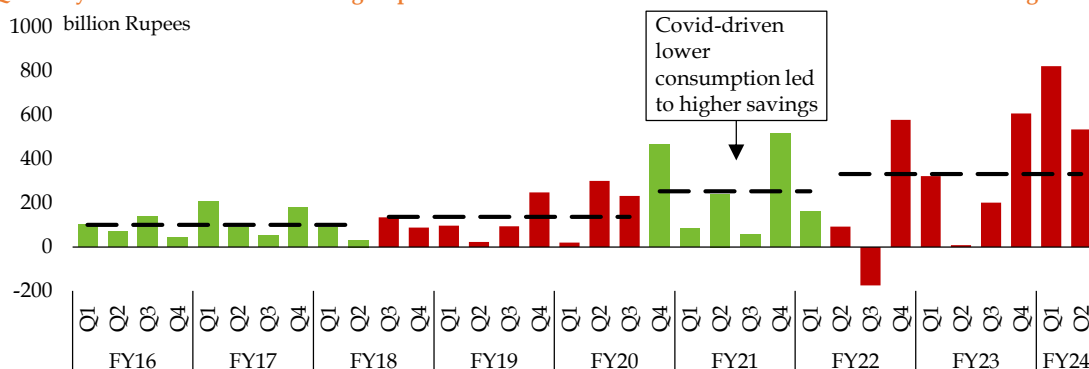
\*\* outstanding stock position

Source: State Bank of Pakistan

<sup>11</sup> To facilitate their liquidity management, SBP has allowed Development Finance Institutions (DFIs) to participate in Open Market Operations (OMOs) since June 2022. The entries of these OMOs in monetary aggregates mainly resulted in a sizeable change of Rs 1.4 trillion in the stock of OIN during the review period.

Quarterly Flows of Customers' Saving Deposits\*

Figure 3.8



\* Red bars indicate flows in times of tight monetary policy, & vice versa for green bars; Dotted line shows average flows during monetary loosening/tightening episodes

Source: State Bank of Pakistan and SBP staff estimates

demonetization of Rs 5,000 banknote also contributed to reduction in CiC.<sup>12</sup>

This is also reflected in a 9.4 percent growth in bank deposits during H1-FY24, compared to an increase of 1.1 percent last year. In addition, as anticipated, high interest rate environment also encouraged individuals to save, as shown by quarterly flows of saving deposits (Figure 3.8).

### Commodity Financing

Financing for commodity operations posted a net retirement of Rs 229.2 billion during H1-FY24, compared to an offtake of Rs 5.2 billion last year (Table 3.2). This was entirely driven by retirement of loans availed for wheat procurement. The provincial governments undertake commodity operations to ensure food security and to maintain stability in prices of food grains, particularly wheat. The procurement agencies purchase wheat at

an announced support price, and then release at subsidized rates for public consumption. To avoid strain on fiscal resources, the provincial governments rely on bank financing for purchase of wheat.

However, due to lack of adequate financial resources, the delay in payment of subsidy has led to a persistent increase in the stock of commodity debt over the years. To address this issue, the government made partial repayment of overdue subsidies to provincial food departments, which enabled them to make retirements during H1-FY24.<sup>13,14</sup> In addition, timely release of wheat stocks also helped the procurement

Commodity Financing flows in billion Rupees Table 3.2

	H1-FY23	H1-FY24
Total	5.2	-229.2
Wheat	-54.7	-278.1
Sugar	16.5	-6.7
Cotton	0.1	0.2
Fertilizer	43.3	57.2

Source: State Bank of Pakistan

<sup>12</sup> Source: Senate of Pakistan document, dated November 17, 2023, available at: [www.senate.gov.pk/uploads/documents/1700217467\\_224.pdf](http://www.senate.gov.pk/uploads/documents/1700217467_224.pdf)

<sup>13</sup> Source: Punjab Debt Bulletin, September 30, 2023, Government of Punjab

<sup>14</sup> The Punjab Government has released Rs 395 billion to Food Department by end-September 2023. Source: Debt Bulletin Jul-Sep 2023.

agencies to make loan retirements during the review period.<sup>15</sup>

### Government Borrowings

The net budgetary borrowings from the banking system grew sharply by 9.4 percent in H1-FY24, compared to 2.5 percent increase in the same period last year. Besides higher fiscal deficit, scheduled repayment to the SBP, a sizeable decline in non-bank financing and buildup of the government deposits with the SBP were the major factors that spurred the government borrowing from the commercial banks during the review period (Figure 3.9).<sup>16</sup>

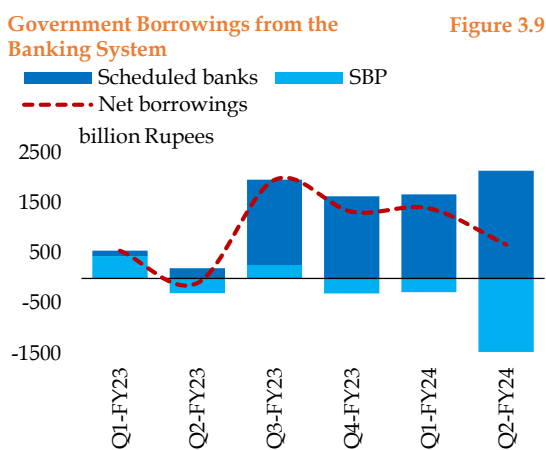
The government met most of its deficit financing requirements through floating rate PIBs (PFLs) during H1-FY24 (Table 3.3). To reduce the roll-over risk, the government kept the auction targets for T-bills slightly lower than the respective

maturities and assigned most of the targets to PFLs and Ijara Sukuk. Amid stubborn inflationary pressures, the cut-off rates on government securities increased during Q1-FY24. However, the spreads between the policy rate and the auction cut-off yields dropped significantly by December 2023.

Anticipating downward inflation trajectory in the second half of FY24, the MPC kept the policy rate unchanged in all of its meetings held during H1-FY24. The market also started to price in anticipated reduction in the policy rates going forward, as reflected by declining cut-off rates and secondary market yields. Correspondingly, market's tenor preferences for the government securities, as reflected in auction participation, also contrasted in the two quarters.

Anticipating interest rate hike, the market was increasingly keen in investing in 3-month T-bills during Q1-FY24. Later on, with the change in expectations about the interest rate path, the market started to lock in funds in longer-tenor bills during Q2-FY24 (Figure 3.10).

Similar trends were visible in longer-tenor government securities. Specifically, the market increased its offer-to-target ratio for fixed-rate PIBs to 3.2 times in Q2-FY24, from 1.5 times in the first quarter. However, in view of the elevated cost for the longer-tenor, the government accepted



Source: State Bank of Pakistan

<sup>15</sup> The growth in hypothecated wheat stocks decelerated from 13.2 percent in H1-FY23 to 1.7 percent in H1-FY24.

<sup>16</sup> The fiscal deficit as percent of GDP increased from 2.0 percent in H1-FY23 to 2.3 percent in H1-FY24. Further, non-bank financing posted a net retirement of Rs 251.6 billion in H1-FY24, compared to an increase of Rs 1.6 trillion last year.

## State Bank of Pakistan Half Year Report 2023-2024

## Auction Summary during Jul-Dec FY24

Table 3.3

billion Rupees

	Target	Maturity	Offered*	Accepted
<b>Treasury Bills</b>				
3-month	5,445.0	16,604.3	19,725.5	9,979.6
6-month	5,445.0	127.2	3,755.5	496.3
12-month	5,445.0	971.5	15,872.6	7,106.0
<b>Total</b>	<b>16,335.0</b>	<b>17,703.0</b>	<b>39,353.6</b>	<b>17,581.9</b>
<b>Pakistan Investment Bonds</b>				
<i>Fixed rate</i>				
3-year	370.0	519.8	1,560.9	684.6
5-year	280.0	337.0	339.1	92.7
10-year	250.0	-	461.2	175.3
15-year	30.0	2.9	-	-
20-year	30.0	-	-	-
30-year	30.0	-	-	-
<b>Total</b>	<b>990.0</b>	<b>859.7</b>	<b>2,361.3</b>	<b>952.7</b>
<i>Floating rate</i>				
2Y-Quarterly	1,030.0	1,111.8	969.6	576.1
3Y-Quarterly	1,030.0	876.2	1,679.5	788.1
5Y-Semi annual	790.0	-	5,460.3	2,943.0
10Y-Semi annual	790.0	-	1,273.3	861.0
<b>Total</b>	<b>3,640.0</b>	<b>1,988.0</b>	<b>9,382.7</b>	<b>5,168.1</b>
<b>Ijarah Sukuk</b>				
GIS-VRR	740.0	-	1,797.2	734.6
GIS-FRR	480.0	-	1,194.7	503.6
<b>Total</b>	<b>1,220.0</b>	<b>-</b>	<b>2,991.9</b>	<b>1,238.2</b>

\*Competitive bids only

Source: State Bank of Pakistan

amount close to the overall target of these fixed rate securities during H1-FY24.

The PFLs remained the preferred mode of investment throughout the first half. Given the expectation of the policy rate to have peaked, markets' appetite for bonds with semi-annual coupon re-set feature rose significantly relative to the auction targets during Q2-FY24 (**Figure 3.11**).<sup>17</sup> In line with the market's interest, the

government fulfilled most of its financing requirements through these securities.

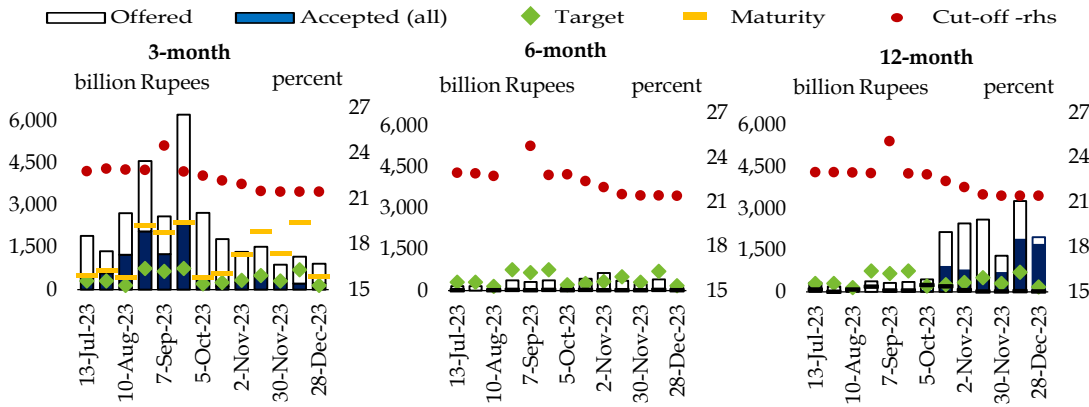
Regarding the GoP Ijarah Sukuk, the market found the Variable Rental Rate (VRR) lucrative in an increasing interest rate environment during Q1-FY24. However, with the anticipation of monetary easing in Q2-FY24, the market's interest shifted towards Fixed Rental Rate (FRR).<sup>18</sup> In the secondary market, the short-term yields dropped by December 2023,

<sup>17</sup> The coupon of 2-year PFL is reset on fortnightly basis (Source: DMMD Circular No. 23 of 2020, dated October 16, 2020).

<sup>18</sup> The offer-to-target ratio for FRR rose from 1.4 in Q1-FY24 to 3.2 in Q2-FY24. In the case of VRR, the ratio slightly declined from 2.7 in Q1-FY24 to 2.5 in Q2-FY24.

**Auction Summary of T-bills during H1-FY24**

**Figure 3.10**



Source: State Bank of Pakistan

after remaining elevated until September 2023, which reflects market's expectations of decline in inflation in the near future (Figure 3.12).

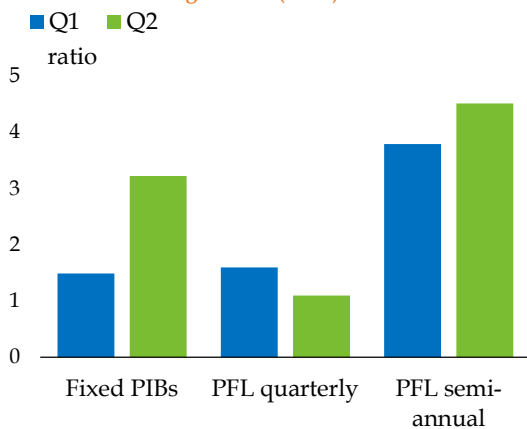
**Interbank Liquidity**

Amid increased reliance on commercial banks to finance the fiscal deficit, the liquidity requirements of the interbank market increased in H1-FY24, compared to

the corresponding period of last year (Figure 3.13). The increase in liquidity requirements in Q1-FY24 was despite retirement in loans for commodity operations, as well as a sizeable increase in bank deposits. In Q2-FY24, a marginal growth in currency in circulation, along with sustained increase in government's budgetary borrowing from scheduled banks, put further drain on the interbank liquidity.<sup>19</sup>

**PIBs: Offer-to-Target Ratio (FY24)**

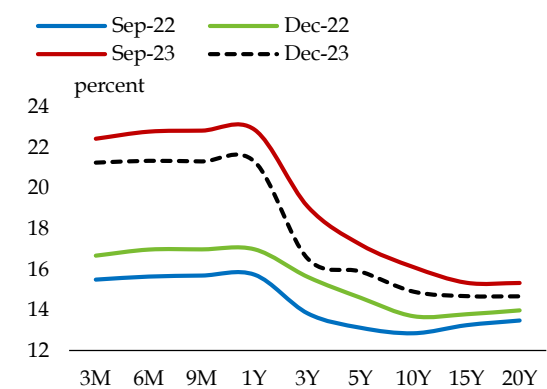
**Figure 3.11**



Source: State Bank of Pakistan

**Yield Curve\***

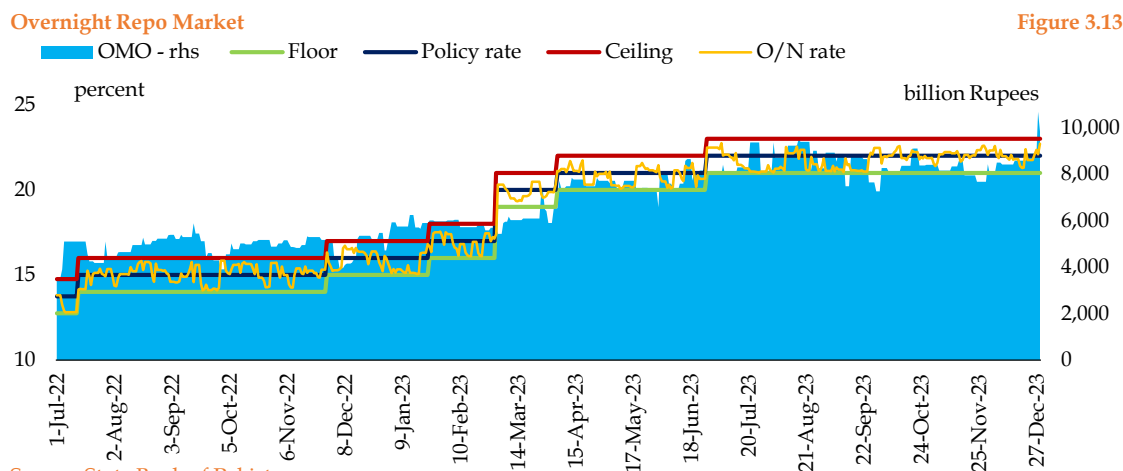
**Figure 3.12**



\* end-period PKRV rates

Source: Financial Market Association of Pakistan

<sup>19</sup> Currency in circulation declined by 9.4 percent during Q1-FY24, followed by an increase of 2.0 percent in Q2-FY24.



Source: State Bank of Pakistan

**Average Outstanding OMO Stock** Table 3.4

billion Rupees		
	FY23	FY24
Q1	4,839.1	8,580.3
Q2	4,938.3	8,409.5
H1	4,888.7	8,494.9

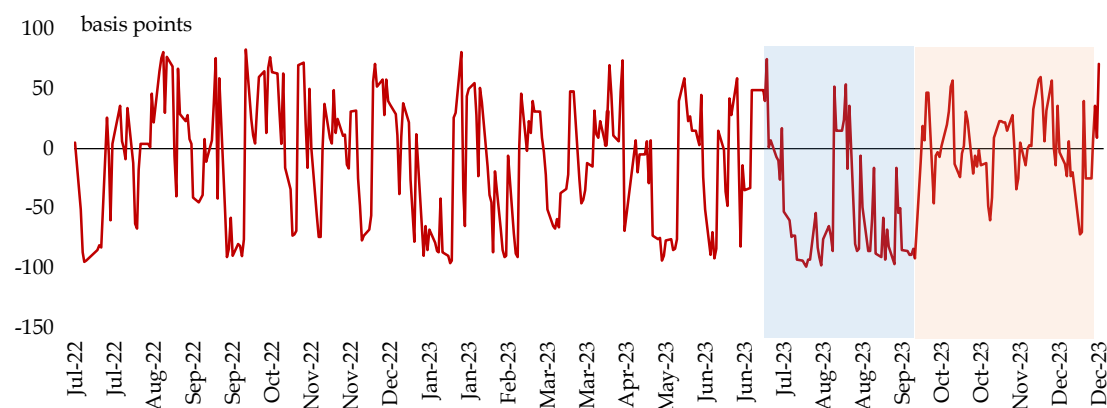
Source: State Bank of Pakistan

average outstanding OMOs stock during the review period compared to the same period last year (**Table 3.4**).

Given significant liquidity pressures and market's anticipation of interest rate hikes during Q1-FY24, the SBP provided bulk of the liquidity through longer-tenor OMOs, i.e., having maturity period of 60 days and above.<sup>20</sup>

**Deviation of Average Daily ONR from the Policy Rate**

Figure 3.14



Source: State Bank of Pakistan

<sup>20</sup> Out of the total OMO injections of Rs 12.0 trillion in Q1-FY24, about 76 percent or Rs 9.1 trillion were having maturity period of 60 days and above, including 60, 63, 70, 73, 74, 77 and 82 days.

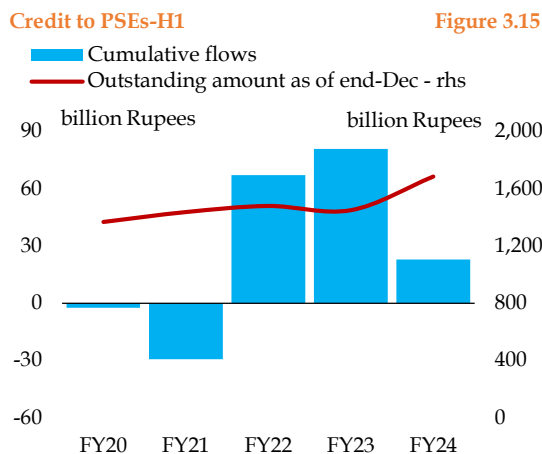
However, the market sentiments changed in the second quarter, as it viewed the interest rates to have peaked-out, and expected monetary easing going forward. With the shift in market’s sentiments, the SBP provided liquidity through shorter-tenor OMOs (mostly having a maturity of 7, 14 and 28 days) during Q2-FY24. In line with this shift, the O/N rate moved relatively closer to the policy (target) rate in Q2-FY24 (**Figure 3.14**).

### Credit to Public Sector Enterprises (PSEs)

Credit uptake by the PSEs moderated to Rs 22.9 billion in H1-FY24, compared to Rs 80.0 billion in the first half of the previous year (**Figure 3.15**). While Sui Northern Gas Pipelines Ltd. (SNGPL), Sui Southern Gas Co. Ltd. (SSGC) and Pakistan International Airline (PIA) continued to borrow, large retirements by Pakistan State Oil (PSO) reduced overall credit to the PSEs during H1-FY24.

Borrowing by the PSEs from banks has experienced a significant increase over the past few years. Chronic structural issues primarily explain this increased borrowing by the PSEs, particularly by those related to energy sector. A number of factors including subsidized power tariffs, delayed release of (tariff differential) subsidies by the government and accumulation of sales tax refunds has undermined the ability of power and gas companies to clear outstanding dues to PSO on account of LNG imports. Hence, for the settlement of these payables, these companies resorted to borrowing from commercial banks during H1-FY24.

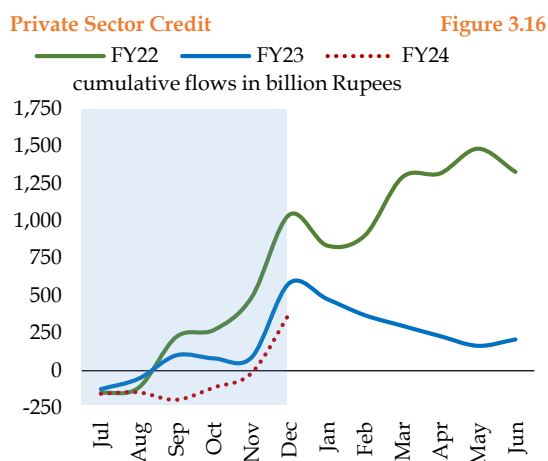
Likewise, continued liquidity constraints due to lingering structural inefficiencies led the PIA to approach banks during H1-FY24 to settle fuel payments to the PSO. On the other hand, as opposed to same period last year, PSO retired a part of its outstanding debt in H1-FY24 with improvement in its sales and hence cash flow position.<sup>21</sup>



### 3.4 Credit to Private Sector

Private sector credit continued to remain subdued, increasing by 4.2 percent during H1-FY24 compared to 6.5 percent in the same period last year. After remaining depressed in Q1-FY24, credit demand picked up slightly during the second quarter, with most of the increase being concentrated in December 2023 (**Figure 3.16**). Disaggregated data indicates a broad-based expansion in working capital

<sup>21</sup> PSO witnessed unprecedented sales during Q1-FY24 on account of effective business strategies, as per first quarter financial report (September 30, 2023).

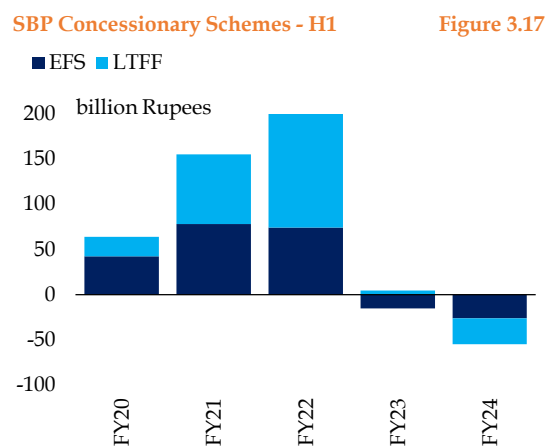


Source: State Bank of Pakistan

requirements in Q2-FY24, whereas demand for fixed investment loans and construction finance stayed muted throughout the first half of FY24.

Several factors contributed to the slowdown in credit demand during the review period. Persistently elevated cost of borrowing and fiscal consolidation during H1-FY24 were instrumental in dampening credit demand.<sup>22</sup> Meanwhile, political and economic uncertainty weighed on fixed investment loans. In addition, the start of a gradual phasing-out of the SBP concessionary financing schemes (EFS and LTFF) to Export-Import Bank also affected advances under these schemes (Figure 3.17).<sup>23,24</sup>

Apart from these factors, slight moderation in the cost of production as indicated by WPI (Wholesale Price Index) inflation, reduced working capital requirements of a



Source: State Bank of Pakistan

number of industries, despite a relatively lower contraction in LSM output (Table 3.5). This is with the exception to gas prices, which were revised upward from November 2023 onwards.

Meanwhile, improved profitability and liquidity indicators (except textiles), also reduced borrowing requirements of the

**Input Prices - H1** Table 3.5  
growth in percent

	FY23	FY24
WPI inflation	34.1	25.4
Coal	79.4	39.5
Electrical energy	48.8	27.7
Motor spirit	77.3	25.3
Diesel oil	94.0	7.7
Furnace oil	42.9	22.6
Construction inputs	28.3	24.9
Liquefied hydrocarbons	23.8	14.0
Global commodity index	19.6	-22.8

Source: Pakistan Bureau of Statistics, International Monetary fund

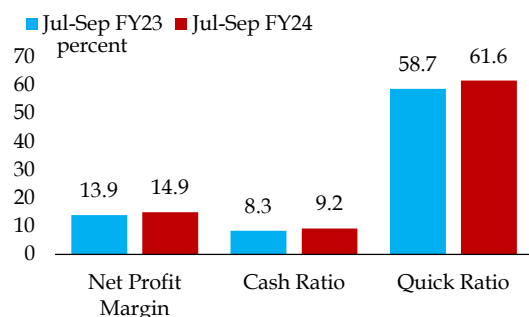
<sup>22</sup> Federal PSDP declined by 4.4 percent in H1-FY24, whereas provincial PSDP slowed down in H1-FY24. Primary surplus stood at 1.7 percent of GDP in H1-FY24 as compared to 1.1 percent in H1-FY23.

<sup>23</sup> As part of IMF conditionality, the SBP's operational involvement in the two largest refinancing schemes (EFS and LTFF) is set to cease at the end of a five-year transition period beginning from July 2023.

<sup>24</sup> SBP plans to reduce the portfolio under EFS and LTFF schemes by 10 percent during FY24.

### Financial Ratios of Non-Financial Firms\*

Figure 3.18



\* excluding textile sector

Source: SBP - Quarterly financial statement analysis of selected non-financial listed companies, SBP staff calculation

firms (Figure 3.18).<sup>25</sup> A decrease in the cost of goods sold and improvement in sales values led to a notable increase in gross margins. This also improved the liquidity position of the firms.

Nonetheless, slight improvement in economic activity during Q2-FY24, as seen from increase in LSM output and capacity utilization in some of the industries, somewhat revived demand for private sector credit.<sup>26,27</sup> In addition, deteriorating financial indicators of the key borrowing sector, i.e., textiles, as well as rising raw material cost in some industries, contrary to the slight slowdown in the overall cost in various industries as mentioned earlier, also drove the demand for bank credit (Table 3.6).

### Improved liquidity conditions and seasonal pattern led to retirement in few sectors

Fertilizer sector made retirements during H1-FY24 compared to substantial borrowings in the same period last year.<sup>28</sup> Retirements can be attributed to healthy fertilizer offtake in Q1-FY24, particularly of DAP, due to better crop conditions. In addition, relatively strong financial position also reduced borrowing requirement of the sector. In anticipation of hike in gas tariffs, fertilizer companies had increased prices in the beginning of the year. Hence, the delay in announcement of the hike in gas tariff till November 2023, significantly improved financial position of the sector. The improved operating margins and better liquidity conditions aided the fertilizer companies to reduce reliance on bank credit.

Similarly, cement producers also posted significant increase in operating margins. Upward adjustment in prices despite deceleration in the pace of production cost, as well as cost-efficient initiatives, improved profitability of the cement sector.<sup>29,30</sup> Meanwhile, higher export volumes and a notable decline in inventories strengthened liquidity position

<sup>25</sup> Inventory levels of the firms registered significant deceleration in Q1-FY24 as compared to the same period last year (Source: SBP-Quarterly financial statement analysis of selected non-financial companies, SBP staff calculation).

<sup>26</sup> LSM registered an increase of 0.5 percent during Q2-FY24 as compared to 1.9 percent contraction last year same period.

<sup>27</sup> Capacity utilization of firms registered notable improvement in Q2 after posting decline in Q1, compared to last year (SBP's Business Confidence Survey).

<sup>28</sup> Cash flow constraints stemming from both domestic and global factors induced many firms to leverage last year.

<sup>29</sup> International coal prices declined by 62.1 percent in H1-FY24 as compared to 103.6 percent increase last year. Source: International Monetary Fund.

<sup>30</sup> Energy mix was shifted towards coal in order to gain price benefit.

## State Bank of Pakistan Half Year Report 2023-2024

## Loans to Private Sector Businesses

Table 3.6

flow in Rs billion

	Total*		Working Capital		Fixed Investment		Total Loans	
	FY23	FY24	H1		FY23	FY24	Q1	Q2
			FY23	FY24			FY24	
<b>Total</b>	574.5	442.6	370.1	369.3	205.4	76	-78.6	521.2
Manufacturing	503.1	307.3	343.2	279.7	161.1	29.5	-116.5	423.8
Textile	188.2	106.8	137.3	95	51.8	10.9	84.3	22.5
Cement & plaster	45.8	-18	23.6	-16.3	22.3	-1.4	-15.1	-3
Refined petroleum	42.6	-5.1	37.2	-12.3	5.4	7.2	-26.8	21.8
Paper industry	20.8	16	9.5	10.4	11.3	5.6	2.6	13.4
Basic iron & steel	7.4	33.6	4.2	37.5	3.3	-3.8	0.2	33.4
Motor vehicles	14.4	15.3	13.8	14.9	0.6	0.3	-3.8	19
Basic pharma.	10.8	6.1	9.2	-0.9	1.9	7.2	4.1	2
Fertilizers	53.7	-33.5	45.7	-32.5	8.1	-1	-47.3	13.8
Veg. & animal oils	3.2	18.9	2.6	19.1	0.6	0.1	8.6	10.3
Rice processing	67.9	82.9	68	82.3	-0.1	0.6	-19.9	102.8
Sugar	-64.6	-49.4	-59.7	-41.2	-4.9	-8.2	-120.9	71.5
Telecommunication	35	11	3.4	-3	31.6	14.1	6.7	4.4
Construction	11	10	7.5	7	1.6	-3.7	3.2	6.8
Agri. & fishing	23.5	73	9.7	28.4	13.9	44.7	30.4	42.6
Mining & quarrying	1.2	2.2	3.5	4.2	-2.3	-2	-7.3	9.6
Real estate activities	0.6	-4.7	0.2	-1	0.3	-1.2	-2.1	-2.6
Transport. & storage	-5.9	7.2	-2.2	7.2	-3.7	0.1	-0.3	7.5
Power gen. & dist.	2.7	-54.2	0.2	-27.7	2.6	-26.4	-33.1	-21.1
Wholesale & retail trade	-6.5	84.2	-2.2	73.5	-4.3	11	41.4	42.9

\* Total amount may not sum up as it also includes construction finance. In terms of IH&SMEFD Circular Letter No. 28 of 2020, the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business.

Source: State Bank of Pakistan

of the cement companies, leading to retirement of loans.<sup>31</sup>

Power generation also made retirement during H1-FY24. The Central Power Purchasing Authority (CPPA) made partial payment of the overdue subsidies to the Independent Power Producers (IPPs) under the Circular Debt Management Plan (CDMP) FY24. This shored up their cash

flow position, enabling power generation and distribution entities to retire their bank debt during the review period.<sup>32</sup>

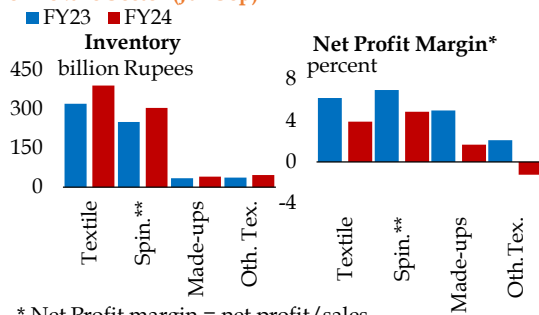
In addition, sugar sector saw seasonal retirements during H1-FY24, albeit at a slower pace compared to the same period last year. This relatively lower retirement can be traced to significantly higher than seasonal credit demand in December 2023

<sup>31</sup> Cement exports posted growth of 99.7 percent in H1-FY24 compared to 56.3 percent contraction last year. Source: Pakistan Bureau of Statistics.

<sup>32</sup> The government adopted revised CDMP for FY24 in August 2023. This plan aims at addressing the issues contributing to accumulation of circular debt (CD) in the energy sector through various measures, including continued timely adjustment of power tariffs, expediting energy sector reforms and CD stock payments to IPPs and government power producers (GPPs). IMF Country Report 24/17

**Selected Financial Indicators of Textile Sector (Jul-Sep)**

**Figure 3.19**



\* Net Profit margin = net profit/ sales

\*\* Spinning, weaving and finishing

Source: SBP-Quarterly financial statement analysis of selected non-financial listed companies, SBP staff calculations

due to increase in prices of sugarcane, the main raw material of the industry.<sup>33</sup>

***Elevated cost of production and challenging business environment impacted credit uptake in few sectors***

A relatively less favorable business environment constrained textile production during H1-FY24, leading to slowdown in credit demand of the sector. Importantly, the discontinuation of the concessionary energy tariffs since the start of FY24 and surge in raw material prices inflated cost of production during H1-FY24.<sup>34</sup>

Rising operational costs and piling up inventories created liquidity issues, driving textile firms to resort to bank finance (Figure 3.19). However, as mentioned above, declining production volumes in

the textile sector pared the overall credit demand relative to last year.

As regards iron and steel group, demand for working capital increased during H1-FY24. PKR depreciation and rise in international prices fueled increase in the cost of production, raising working capital requirements of the industry during the review period.<sup>35</sup>

***Strong agriculture production boosted credit offtake in related industries***

Rice processing dominated credit uptake in food group. Amid a rebound in production and increased export demand, rice milling saw a sizeable increase in credit uptake during the review period.

Similarly, working capital requirement of the textile industry increased for procurement of cotton during FY24.

***Consumer financing remained downbeat***

Consumer financing continued to shrink with a pronounced retirement in auto financing during H1-FY24. However, credit cards maintained the rising trend witnessed for the past couple of years, whereas house building edged down after showing a rising trend since FY21 (Figure 3.20).

The impact of stabilization measures implemented over the course of last two years, including increased cost of

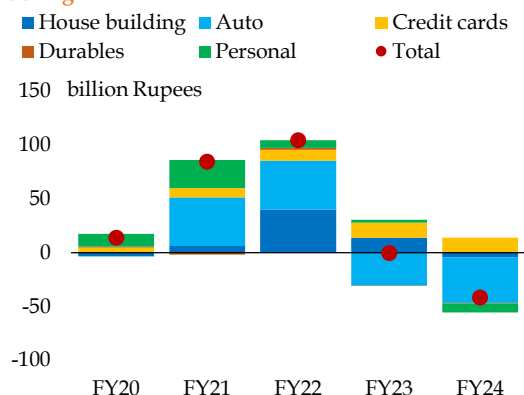
<sup>33</sup> Sugarcane prices rose by 53.5 percent during H1-FY24 as compared to 18.8 percent last year. (PBS)

<sup>34</sup> Wholesale price indices for woven fabrics, cotton fabrics and dyeing material rose by 24.1 percent, 40.9 percent and 50.7 percent during H1-FY24 as compared to 11.9 percent, 15.2 percent and 0.0 percent, respectively, same period last year.

<sup>35</sup> According to LSM production data, iron and steel category recorded 440 (MT) production in H1-FY24 compared to 447 (MT) last year.

**Consumer Financing: Flows during H1**

**Figure 3.20**



Source: State Bank of Pakistan

borrowing and tightened prudential regulations continued to dampen auto financing. Car sales plunged significantly despite lowering of car prices by some of the key assemblers, on relative basis, during H1-FY24.<sup>36</sup> Overall constrained economic activity and increased borrowing cost has not only affected the demand for automobiles but also led to contraction in demand for house building, personal and durable goods loans.

On the other hand, increasing use of digital technologies by consumers due to ease and convenience in making payments, has played a major role in significant credit uptick against credit cards. In addition, financial difficulties amid increase in the cost of living also might have compelled consumers to make purchases on credit.

### 3.5 Inflation

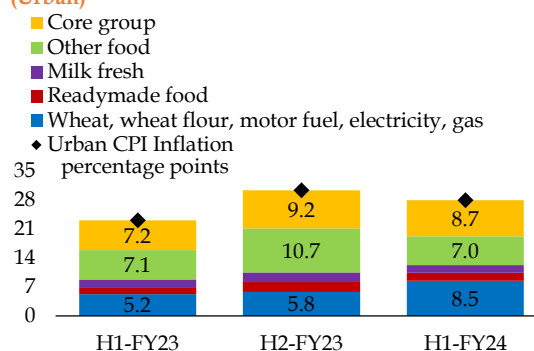
The NCPI inflation rose to 28.8 percent in H1-FY24 as compared to 25.0 percent in

the same period last year. Although domestic demand remained subdued amid continued contractionary policies, a range of domestic structural factors, supply shocks and their second round effects via elevated input costs and wages exacerbated the inflation outcomes. In addition, PKR depreciation, which partly offset the respite provided by the declining global commodity prices, also contributed to inflation.

Hike in energy tariffs and a significant uptick in the minimum support price (MSP) of wheat, in particular, weighed heavily on inflation during H1-FY24. Similarly, domestic market imperfections that manifested in hoarding and smuggling of food commodities (particularly wheat), created artificial shortages. To put things in the perspective, the increase in prices of wheat and energy alone contributed nearly one-third to urban inflation during H1-FY24 (Figure 3.21).

**Major Contributors to Inflation (Urban)**

**Figure 3.21**



The blue bars show the contribution of items affected from the administered prices.

Source: Pakistan Bureau of Statistics

<sup>36</sup> Some auto manufacturers announced reduction in car prices of some variants in October 2023, whereas some manufacturers offered other incentives, such as reduction in car registration charges and after-sales service packages.

**Average CPI Inflation**

**Table 3.7**

Items	percent							
	Wt.*	Average Inflation during			Contribution			H1-FY24
		H1-FY23	H2-FY23	H1-FY24	H1-FY23	H2-FY23	H1-FY24	
<b>NCPI</b>	<b>100</b>	<b>25.0</b>	<b>33.0</b>	<b>28.8</b>	<b>25.0</b>	<b>33.0</b>	<b>28.8</b>	
<b>Urban CPI</b>	<b>100.0</b>	<b>23.1</b>	<b>30.4</b>	<b>28.0</b>	<b>23.1</b>	<b>30.4</b>	<b>28.0</b>	
<b>Food</b>	<b>36.8</b>	<b>30.7</b>	<b>44</b>	<b>33.2</b>	<b>11.8</b>	<b>17.0</b>	<b>13.5</b>	
Perishable	4.4	48.3	36.0	7.5	2.1	1.6	0.4	
Non-perishable	32.4	28.5	45.0	37	9.7	15.4	13.1	
<b>NFNE (Core inflation)</b>	<b>53.7</b>	<b>14.1</b>	<b>18.2</b>	<b>18.4</b>	<b>7.2</b>	<b>9.2</b>	<b>8.7</b>	
<b>Energy</b>	<b>9.5</b>	<b>38.8</b>	<b>38.0</b>	<b>47.9</b>	<b>4.2</b>	<b>4.2</b>	<b>5.8</b>	
<b>Rural CPI</b>	<b>100.0</b>	<b>27.9</b>	<b>37.0</b>	<b>30.0</b>	<b>27.9</b>	<b>37.0</b>	<b>30.0</b>	
<b>Food</b>	<b>45.9</b>	<b>33.6</b>	<b>48.0</b>	<b>33.7</b>	<b>16.0</b>	<b>23.0</b>	<b>16.8</b>	
Perishable	5.7	52.0	41.3	7.7	2.9	2.3	0.5	
Non-perishable	40.3	31.3	<b>48.9</b>	<b>37.8</b>	<b>13.1</b>	<b>20.7</b>	<b>16.3</b>	
<b>NFNE (Core inflation)</b>	<b>42.6</b>	<b>17.4</b>	<b>23.5</b>	<b>25.9</b>	<b>7.1</b>	<b>9.4</b>	<b>3.5</b>	
<b>Energy</b>	<b>11.4</b>	<b>41</b>	<b>37.4</b>	<b>27.2</b>	<b>4.8</b>	<b>4.6</b>	<b>9.6</b>	

\*wt. = weight, Cont.= Contribution

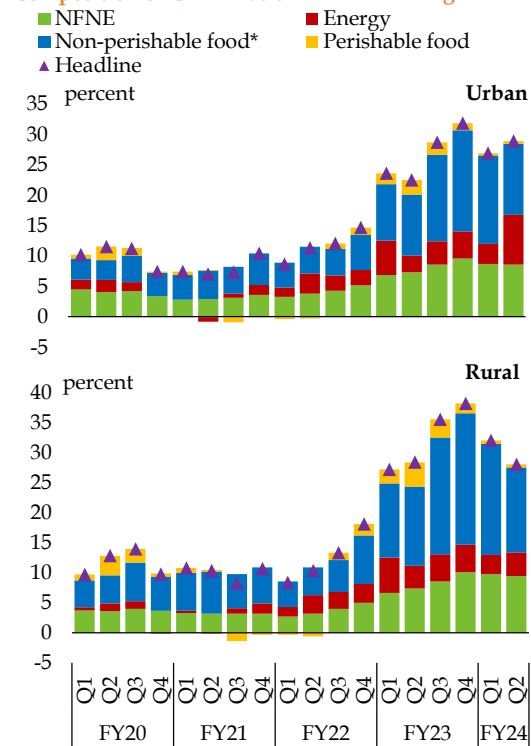
Source: Pakistan Bureau of Statistics

In overall terms, non-perishable food was the largest contributor to the headline inflation, followed by Non-Food Non-Energy (NFNE) and energy (Table 3.7). However, the government’s administrative actions, as well as improved supply situation of some food items (especially wheat), somewhat eased price pressures during H1-FY24 relative to H2-FY23 (Figure 3.22).<sup>37</sup>

**Higher MSP along with market imperfections kept wheat prices elevated in H1-FY24**

Wheat and wheat products were the largest contributors in the urban and rural inflation during H1-FY24. The climate change, heatwaves experienced in Mar-Apr 2022 and flash floods during Jul-Aug 2023, had raised concerns about inadequate wheat availability and caused an uptrend in wheat prices since January

**Composition of CPI Inflation** Figure 3.22



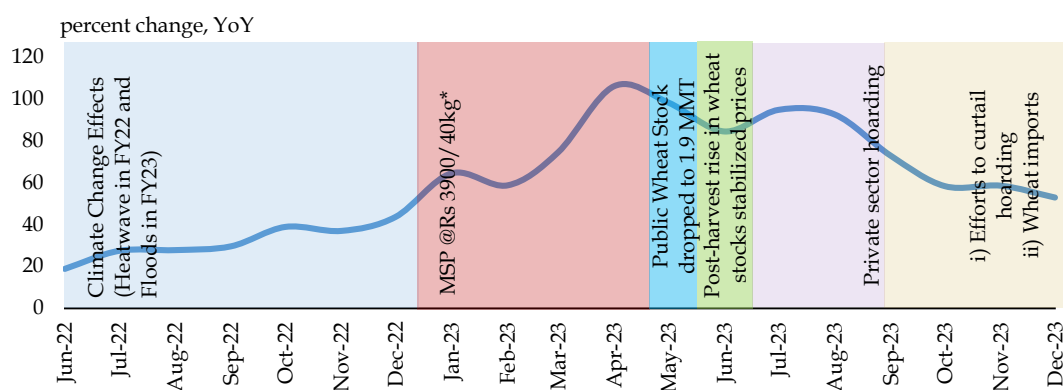
\* inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

<sup>37</sup> The average MoM inflation declined from 2.4 percent in H2-FY23 to 1.9 percent in H1-FY24.

Wheat Prices (Urban)

Figure 3.23



\* Punjab MSP-Rs 3,900/40 kg and Sindh MSP-Rs 4,000/40kg

Source: PBS, Finance Division

2023. To encourage wheat production amid rising input costs, the government announced a large increase in the MSP for the crop in FY23 that further augmented the price pressures (Figure 3.23).<sup>38</sup>

Although wheat production rose by 7.5 percent in FY23, it was slightly lower than the production target.<sup>39</sup> On the other hand, to meet unforeseen exigencies, the government had scaled up the target for commodity's strategic reserves.<sup>40</sup> Hence, despite improved production a sizeable demand-supply gap existed, which led to illegal profiteering activities such as

hoarding. This, together with smuggling to neighboring countries, created artificial shortage of wheat, thus pushing up its prices in the domestic market.<sup>41</sup>

To address these challenges, the government stepped up its administrative efforts against hoarding, smuggling and price manipulation.<sup>42,43</sup> In addition, the government, together with the private sector, imported the commodity to ease supply situation.<sup>44</sup> Moreover, low international prices of wheat partly eased pressure on domestic prices.<sup>45,46</sup>

<sup>38</sup> Minimum support price set for FY23 was Rs 3,900 per 40 kg as compared to Rs 2,200 in FY22.

<sup>39</sup> The actual wheat production (28.18 MMT) was slightly less than the target of 28.37 MMT. Source: Ministry of National Food Security and Research (2023). Year Book 2022-23. Islamabad: MNFSR

<sup>40</sup> The target for strategic reserves was also increased for 2023 from one MMT to two MMT in view of unforeseen circumstances. Source: Ministry of National Food Security and Research (2023). Year Book 2022-23. Islamabad: MNFSR

<sup>41</sup> Source: Press Release: Second session of the 5th APEX committee of SIFC on September 9, 2023

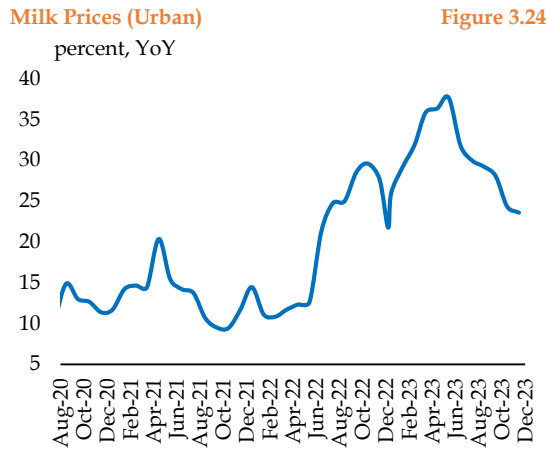
<sup>42</sup> FBR issued notification on November 7, 2023 stated the prevention of smuggling of essential commodities in Baluchistan and KP. Source: SRO 152(1)/2023

<sup>43</sup> Source: Monthly Report September 2023 (www.finance.gov.pk)

<sup>44</sup> Wheat imports during H1-FY24 stood at 1.4 million tons, compared to 1.5 million tons in the same period last year. Source: PBS

<sup>45</sup> On average, global wheat price was considerably lower at around Rs 87.0 per kg, relative to domestic price of Rs 124.6 per kg during Jul-Dec FY24. Sources: World Bank and Pakistan Bureau of Statistics

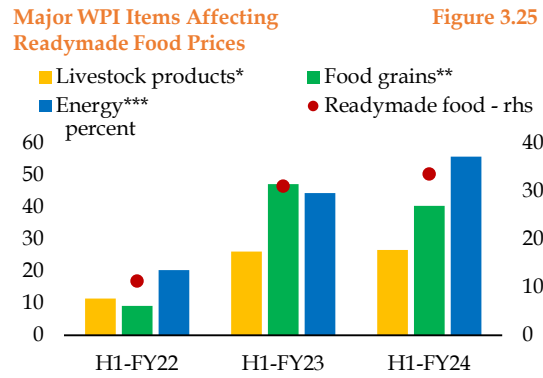
<sup>46</sup> The government allowed import of 1.0 MMT of milling wheat for the year 2023-24, through Trade Corporation of Pakistan to maintain the strategic reserves. (Finance Division's Press Release No. 478 issued on October 23, 2023).



***Amid widening demand-supply gap, fresh milk remained one of the top five contributors to inflation***

Continuing the trend seen in the past few years, milk prices saw a double-digit increase in H1-FY24 (**Figure 3.24**). While soaring livestock feed cost and reduced availability of imported feed fanned increase in milk prices during FY23, the persistently elevated prices of milk also reflect longstanding structural issues in the supply chain leading to widening supply-demand gap.

This is important to mention that fresh milk is included in the list of essential commodities, subject to the government’s announced administered prices. However, on account of the myriad structural issues, milk prices do not follow the official rate list. Nevertheless, the provincial governments ensured stringent implementation of milk prices at official rates, which eased milk prices during H1-FY24.



***Ready-made food prices emulated the increase in food and energy prices***

Following the uptrend in prices of livestock and dairy items such as fresh milk, meat, chicken, food grains (wheat and rice), condiments and spices, sugar, and tea, the prices of ready-made food also swelled significantly. Moreover, with substantial upward revision in gas tariffs, the operational cost also soared, which further added to the price pressures in the packaged food group (**Figure 3.25**).

***The hike in gas charges fanned energy inflation***

Gas charges were the second largest contributor to the average headline CPI inflation in urban areas in H1-FY24. To stem the accumulation of circular debt, the government announced a large increase in variable gas charges in November 2023, in addition to increase in January 2023, primarily including the non-protected category (**Table 3.8**).

**Changes in Gas Charges (Domestic sector) during H1 FY24** Table 3.8

	Jan-23	Nov-23	Absolute change
<b>Variable charges (Rs/MMBTU)</b>			
<i>Protected category (PC) slabs (in hm<sup>3</sup>)</i>			
Up to 0.25	121	121	
Up to 0.5	150	150	No change
Up to 0.6	200	200	
Up to 0.9	250	250	
<i>Non-protected category (NPC) slabs (in hm<sup>3</sup>)</i>			
Up to 0.25	200	300	100
Up to 0.6	300	600	300
Up to 1	400	1,000	600
Up to 1.5	600	1,200	600
Up to 2	800	1,600	800
Up to 3	1,100	3,000	1,900
Up to 4	2,000	3,500	1,500
Above 4	3,100	4,000	900
<b>Fixed charges (Rs/MMBTU)</b>			
PC	10	400	390
NPC	1,000 (<=1.5 hm <sup>3</sup> )		540
	2,000 (>1.5 hm <sup>3</sup> )		1,540

\* cubic hectometer refers to hundred cubic meters.

Source: Oil & Gas Regulatory Authority

Similarly, the monthly fixed charges were also increased substantially for both protected and non-protected consumers.<sup>47</sup> Moreover, the gas charges for the non-domestic sector, including commercial users, captive exporting units, and CNG, almost doubled from the earlier rates.

### Electricity charges rose sharply amid periodic annual and quarterly adjustments

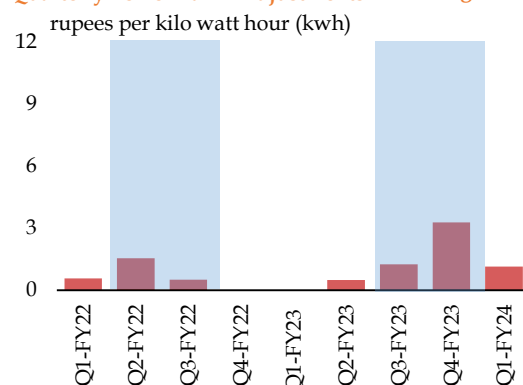
The annual adjustments, along with relatively higher quarterly adjustments and the fuel charge adjustments (FCAs), escalated electricity prices in H1-FY24. Effective from July 1, 2023, the government introduced an annual adjustment of Rs 5.75 per unit, on average, to variable electricity charges, across all consumer slabs.<sup>48</sup> Furthermore, two quarterly adjustments were also announced in the

<sup>47</sup> Protected consumers are domestic consumers, with gas consumption less than or equal to 0.9 hm<sup>3</sup> for the last 4 winters (Nov-Feb). The non-protected category refers to the gas usage exceeding 0.9 hm<sup>3</sup>

<sup>48</sup> IMF (2024). First Review under Stand-By Arrangement, published in January 2024.

<sup>49</sup> Source: Notification No. NEPRA/TRF-IO0/MFPA/ 13/4933-43. NEPRA

**Quarterly Power Tariff Adjustments** Figure 3.26



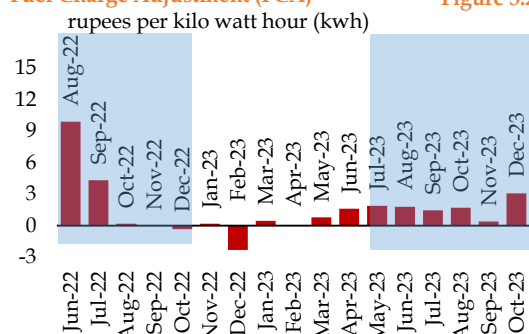
The labels show the time period of the tariff adjustment.

Source: National Electric Power Regulatory Authority

months of July and October 2023 for a period of three and six months, respectively (Figure 3.26).

Furthermore, FCA also increased during H1-FY24 on account of collection of the deferred payments of the flood related subsidy for the months of August and September 2022 (Figure 3.27). These postponed FCAs were collected during March-October 2023.<sup>49</sup> Moreover, the rise

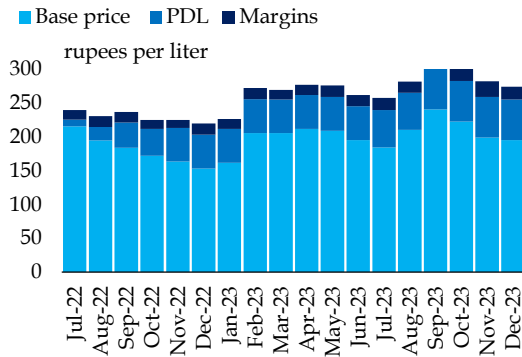
**Fuel Charge Adjustment (FCA)** Figure 3.27



Note: x-axis indicates months for which FCA was charged; indicative months around the bars are months in which FCA was actually billed. FCA is collected with a one-month lag.

Source: National Electric Power Regulatory Authority

**Composition of Motor Fuel Prices** Figure 3.28



Note: The effect of subsidies and sales tax remained zero during the review period

Source: Oil & Gas Regulatory Authority

in FCAs partly depicted the impact of weaker local currency that increased the fuel cost despite declining global oil prices in H1-FY24.<sup>50</sup>

**Motor fuel prices increased despite a decline in global oil prices**

Three factors explain double-digit increase in motor fuel prices during H1-FY24 (Figure 3.28). First, the government increased the Petroleum Development Levy from Rs 50/litre in June 2023 to Rs 55/litre during July-August 2023 and further to Rs 60/litre in September-December 2023. Second, starting from September 2023, the government also allowed increase in margins of dealers and oil marketing companies (OMCs).<sup>51</sup> Lastly, the PKR depreciation compared to H1-FY23 partly neutralized the impact of

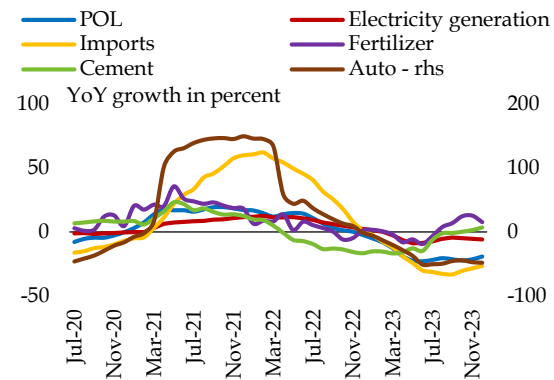
moderating global oil prices, leading to increase in the base price of fuels.<sup>52</sup>

**Second round effects of increase in food and energy prices drove core inflation**

Although lower than the multi decade peak reached in May 2023, core inflation stayed persistently elevated during H1-FY24. This was despite a sluggish pace of domestic demand amid continued contractionary policies (Figure 3.29).

A host of factors were behind the stubborn underlying inflationary pressures during H1-FY24. These included: increase in tax rates and minimum wages; PKR depreciation and second round-effects of successive supply shocks and adjustments in administered price.<sup>53,54</sup> These factors have resulted in plateauing of core

**High Frequency Indicators (3MMA)** Figure 3.29



Note: Except electricity gen. and imports, other indicators show sales.

Sources: PBS, PAMA, NEPRA, APCMA, OCAC

<sup>50</sup> The PKR depreciated by 22.2 percent during H1-FY24, against 24.1 percent depreciation in H1-FY23.

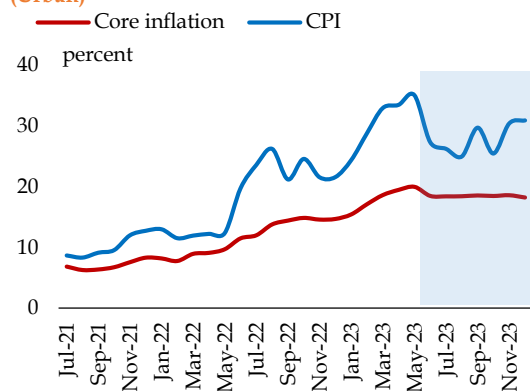
<sup>51</sup> Source: Various issues of petrol price composition, available at [www.ogra.org.pk/e-10-gasoline-prices](http://www.ogra.org.pk/e-10-gasoline-prices)

<sup>52</sup> Despite the decline in global oil prices, the import unit prices of petroleum crude and products in rupee terms rose 12.7 percent and 17.4 percent in H1-FY24.

<sup>53</sup> Labor and Human Resource Department of Punjab, Government of Punjab, September 9<sup>th</sup>, 2023

<sup>54</sup> FBR Finance Supplementary Act (2023); FBR SRO No. 297(I)/2023, dated March 08, 2023, available at [www.download1.fbr.gov.pk/SROs/2023382232741774SRO-297-OF2023.pdf](http://www.download1.fbr.gov.pk/SROs/2023382232741774SRO-297-OF2023.pdf); and FBR Finance Act 2023

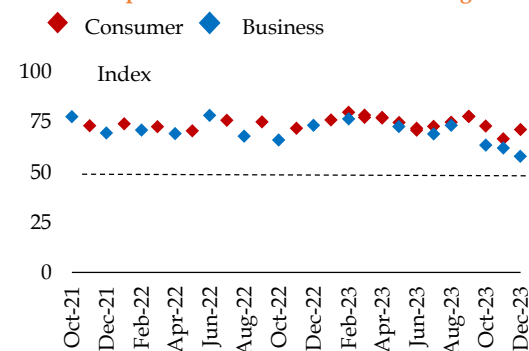
**Trends in Headline and Core Inflation (Urban)** Figure 3.30



Source: Pakistan Bureau of Statistics

inflation at an elevated level notwithstanding ease in headline inflation (Figure 3.30).<sup>55,56</sup> The shocks to food and energy prices seep to the core and headline inflation through multiple channels. The intensity and length of these second round effects, however, varies with different structural characteristics of the economies,

**Inflation Expectations** Figure 3.31



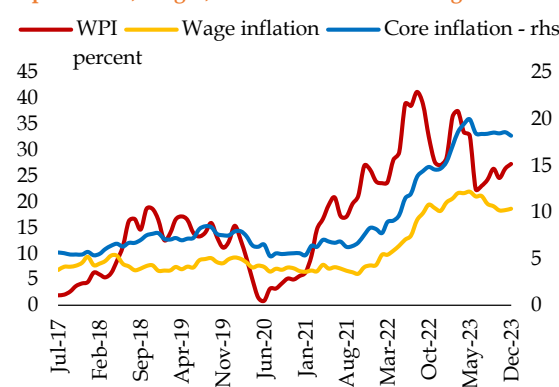
The values exceeding 50 indicates that high inflation views are more than low inflation views.

Source: State Bank of Pakistan

and types of shocks, i.e. food versus energy (Box 3.1).

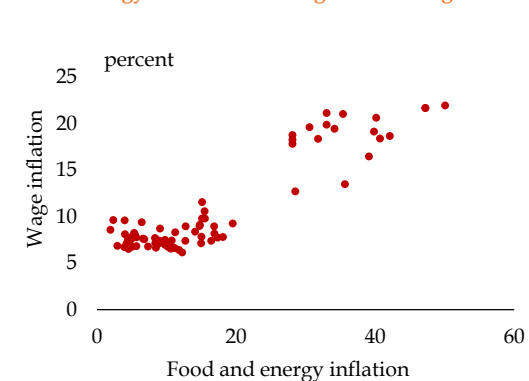
Amid increasing food and energy prices and a general inflationary environment, the inflation expectations of households and businesses remained high during H1-FY24 (Figure 3.31). As rising inflation

**Inputs Costs, Wages, and Core Inflation** Figure 3.32a



Source: Pakistan Bureau of Statistics

**Food & Energy Inflation and Wages** Figure 3.32b



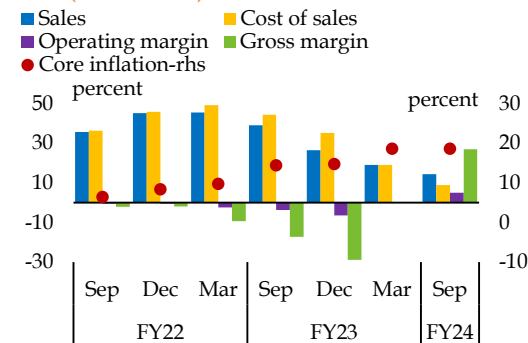
Note: In figure 3.32b, the data points range from Jul-17 till Dec-23

<sup>55</sup> Persistent increase in headline inflation in response to rising food and energy inflation, indicates sequential shocks to food and energy prices or presence of second round effects emanating from rising inflation expectations and wages. S. Cecchetti, G. & Moessner, R. (2008). Commodity prices and inflation dynamics. BIS Quarterly Review, December 2008

<sup>56</sup> Khaliq, F. (2023). An intermediate target for the SBP: Headline or Core Inflation? *International Journal of Contemporary Issues in Social Sciences*. ISSN(E) 2959-3808,2(4),1277-1287. Retrieved from <http://ijciss.org/index.php/ijciss/article/view/428>

**Financial Indicators of Non-Financial Firms (YoY Growth)**

**Figure 3.33**



Source: SBP - Quarterly financial statement analysis of selected non-financial listed companies, SBP staff calculation; Pakistan Bureau of Statistics

dampened purchasing power of households, they demanded higher wages to preserve their real incomes. The resulting increase in wages further added

to cost and hence inflation (Figures 3.32a & 3.32b).<sup>57</sup>

Moreover, as indicated by the consistent rise in prices of core goods basket, the increase in profit margins of non-financial corporate sector, also hint at rising markups (Figure 3.33).<sup>58,59</sup> Amid a confluence of domestic and global supply shocks, the corporate sector faced a significant spike in input costs in the past two years, which squeezed profitability as companies opted to partly absorb the cost increases by lowering profit margins (Figure 3.33). However, during H1-FY24 firms increased profit margins despite a slowdown in the cost of production, which may also have contributed to core inflation.

### Box 3.1: Understanding Second-Round Effects of Shocks to Food and Energy Prices

The shocks to food and energy prices are transmitted to the core and headline inflation through both direct and indirect channels. The magnitude of direct transmission varies according to the respective weights of food and energy components in the CPI basket. The literature identifies numerous conduits through which, the indirect – second-round – effects are propagated to core and overall inflation. These channels, along with a host of other economic factors that impact the transmission of commodity price shocks to inflation, are discussed in the following.

*Shocks to non-core prices engender second-round effects via demand-pull and cost-push dynamics* through elevated inflation expectations and rising input costs.<sup>60</sup> If the workers perceive the spike in commodity prices as permanent, they demand higher wages to offset the impact on their purchasing power. The ensuing increase in marginal cost of businesses and expansion in consumption transmits to core and hence overall inflation.<sup>61</sup> In the same vein, a hike in food and energy prices inflates input costs of the firms, driving increase in prices of other goods and services, if firms decide to retain profit margins.

<sup>57</sup> Given the unavailability of data on wages for all economic sectors, Figures 3.32 a and b are showing data for the wages related to tailoring, cleaning and laundering, construction, garbage collection, house help, doctor clinic fees, dental and other hospital services, mechanical, and personal grooming services.

<sup>58</sup> Core goods baskets constitute items such as packaged consumer goods, automobiles, constructions input items (cement and steel), appliances, and personal and cleaning items (washing powder, face cream). Inflation in core goods basket rose from 21.5 percent in H1-FY23 to 31.4 percent in H1-FY24.

<sup>59</sup> Markup refers to the difference between selling price and cost.

<sup>60</sup> Rangasamy. (2011). Food inflation in South Africa: some implications for economic policy, *South African Journal of Economics* 79(2), pp 184–201;

<sup>61</sup> Ruch, F. & Plessis, S. (2015). Second-Round Effects from Food and Energy Prices: an SBVAR approach. South African Reserve Bank Working Paper Series WP/15/05

**Certain structural characteristics of the economies are more prone to spawn pervasive second round effects.** First, countries with lower oil intensities tend to have relatively mild impact of spikes in global commodity prices on inflation. Second, countries with higher governance score and autonomy of central banks experience lower spillover of commodity price shocks. Third, greater uncertainty about inflation path amplifies the second-round effects of international food price shocks.<sup>62,63</sup> Lastly, commodity price shocks weigh more strongly on inflation expectations in emerging economies due to less-anchored expectations, given weaker monetary policy frameworks in these economies.<sup>64</sup>

**The shocks to food prices feed much stronger second-round effects into core inflation** than the hike in energy prices, because of higher weight in the consumption basket and non-availability of close substitutes.<sup>65</sup> Specifically, in the case of low income economies, food prices tend to have stronger, more volatile and persistent swings, which lead to stronger transmission to non-food prices.<sup>66,67</sup>

**Oil price increases also impact food inflation.** The surge in oil prices inflates cost of production and transportation, leading to smaller but significant spillover of oil price shock to food and core inflation.<sup>68</sup>

**Commodity price shocks produce non-linear, lagged effects.** The swings in commodity prices impact the overall inflation with lags. The lagged effect may arise due to contractual nature of retail prices, unlike the commodity prices, which are determined in more competitive markets.<sup>69</sup> The impact of shocks to commodity prices produces asymmetric effects. While an increase in prices is relatively quickly transmitted to consumer prices, price declines may only be transmitted partially. This non-linearity may arise on account of various factors including government interventions, non-competitive behavior of the market and asymmetric information.<sup>70</sup>

<sup>62</sup> Better governance structure entails higher public sector efficiency. Similarly, central bank independence is associated with higher credibility, which is instrumental in anchoring inflation expectations.

<sup>63</sup> Gelo, G. & Ustyugova, Y. (2012). Inflation responses to commodity price shocks – how and why do countries differ? IMF Working Paper, WP 12/225.

<sup>64</sup> IMF World Economic Outlook (2011).

<sup>65</sup> De Gregorio, J. (2012). Commodity prices, monetary policy, and inflation, IMF Economic Review 60(4), pp 600–633.

<sup>66</sup> Walsh, J. P. (2011). Reconsidering the role of food prices in inflation. International Monetary Fund.

<sup>67</sup> Hanif, M. N. (2012). A note on food inflation in Pakistan. *Pakistan Economic and Social Review*, 183-206.

<sup>68</sup> Alp, H., Klepacz, M., & Saxena, A. (2023). Second-Round Effects of Oil Prices on Inflation in the Advanced Foreign Economies, published on December 15<sup>th</sup> 2023 in FEDS Notes. Available at (<https://www.federalreserve.gov/econres/notes/feds-notes/second-round-effects-of-oil-prices-on-inflation-in-the-advanced-foreign-economies-20231215.html>)

<sup>69</sup> Ferrucci et al. (2012). Food Price Pass-Through in the Euro Area: Non-Linearities and the Role of the Common Agricultural Policy. *International Journal of Central Banking*, 8(1), 179-218.

<sup>70</sup> Alnour et al. (2023). Unveiling the asymmetric response of global food prices to the energy prices shocks and economic policy uncertainty. *World Development Sustainability*, 100083