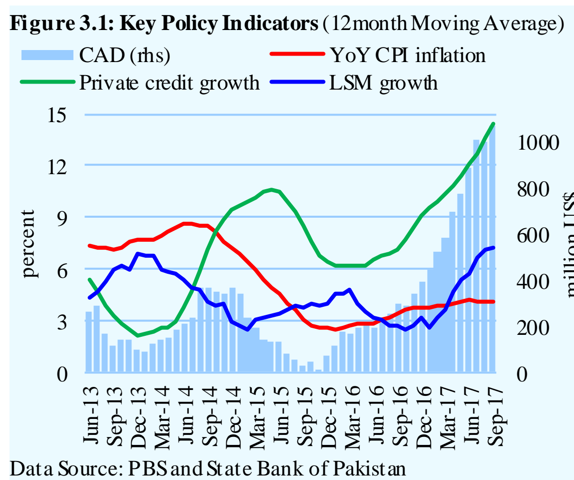
3 Inflation and Monetary Policy

3.1 Policy review

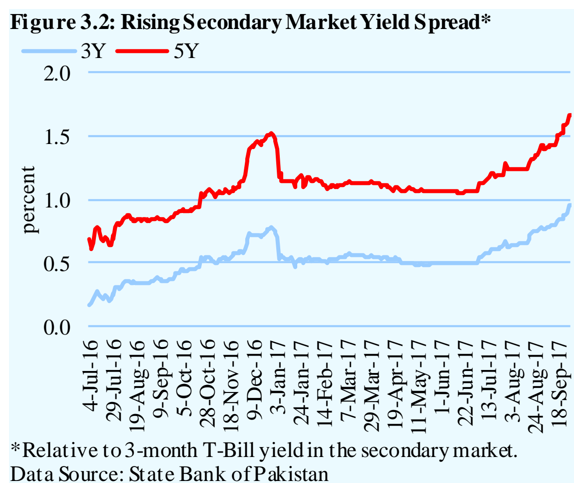
Aggregate demand seems to have consolidated further during the first quarter of FY18, with a pick-up in key macroeconomic indicators, including LSM, private credit disbursements, imports, and exports (**Figure 3.1**). However, headline inflation remained stable, as an improvement in food supplies and adjustments in duty structure helped deflect the impact of demand-driven pressures, as well as those emanating from a trend reversal in global commodity prices.[1]

Figure 3.1: Key Policy Indicators (12month Moving Average)



Data Source: PBS and State Bank of Pakistan

Figure 3.2: Rising Secondary Market Yield Spread*



*Relative to 3-month T-Bill yield in the secondary market.
Data Source: State Bank of Pakistan

However, such comfort was not available in the external sector, as despite recovering from a year-long slump, the combined volume of exports and remittances was not sufficient to finance imports. Consequently, the current account deficit widened further, which along with insufficient financial inflows, resulted in reserves drawdown. These dynamics were instrumental in firming up expectations of an interest rate hike in the interbank market (**Figure 3.2**). The Monetary Policy

[1] According to the World Bank, global energy and non-energy prices remained 13.6 and 3.2 percent (respectively) higher in Q1-FY18 compared to Q1-FY17. Despite the trend reversal, price levels of many commodities are still low compared to those in Q1-FY15, when the prices began to slide.

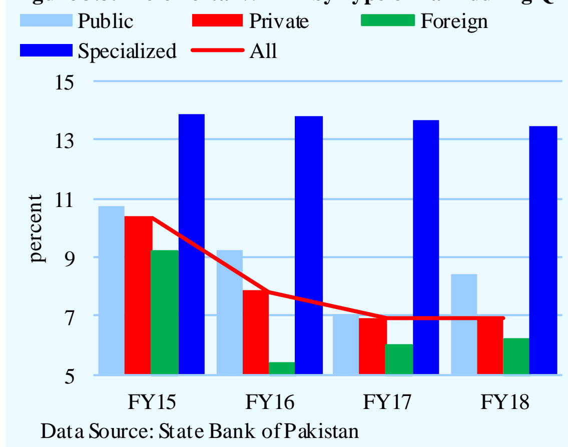
Committee (MPC) also deliberated upon these risks, and decided to keep the policy rate unchanged at 5.75 percent in both the meetings held during the quarter.

From the MPC's standpoint, this cautiously accommodative stance was meant to ensure the persistence of the favorable investment climate in the country. Comfort on the inflation front also factored in the MPC's decisions, as SBP's in-house projections implied a below-target outcome of headline CPI for the fourth consecutive year in FY18. On the external front, although BoP concerns were increasing, the government's increased engagements with commercial and official lenders, as well as its plans to further tap into the international capital markets, provided some reassurance. Moreover, a gradual recovery in exports, remittances and FDI also brought forth a source of optimism (**Chapter 5**).

On its part, SBP continued to proactively manage interbank liquidity to keep the overnight rates close to the policy rate. The spread between the policy and actual overnight rates squeezed further to 5 basis points (on average) during Q1-FY18, from 9 basis points a year earlier.[2] Banks' recourse to SBP's discount window facility was also limited. This outcome was despite the fact that barring SBP's interventions, liquidity conditions in the interbank market were relatively tight during Q1-FY18, as compared to the same period last year.

Specifically in Q1-FY17, banks had sizable volume of liquidity at their disposal due to credit retirements by both the government as well as the private sector. However in Q1-FY18, not only were there fewer retirements by private sector, the government also ended up taking fresh budgetary support of Rs 197.9 billion from scheduled banks. To counter the pressures on overnight rates, SBP deepened its interventions via open

Figure 3.3: Incremental WALR by Type of Bank during Q1



Data Source: State Bank of Pakistan

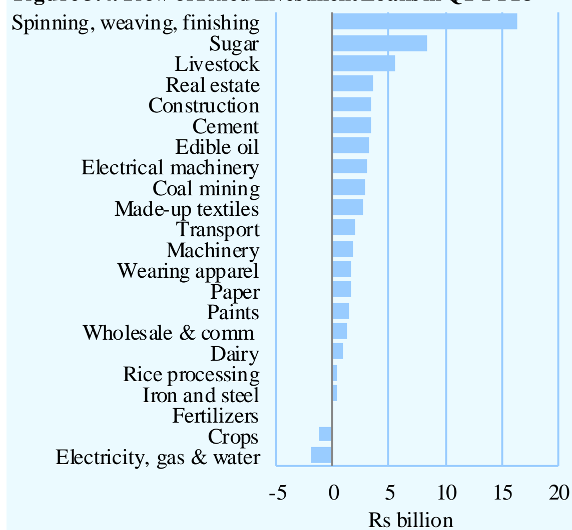
[2] For reference, the spread between the policy rate and overnight rates was 5 basis points in the preceding quarter (i.e. Q4-FY17) as well.

market operations (OMOs): the average outstanding level of OMO injections rose to Rs 1.4 trillion in Q1-FY18 as compared to Rs 1.1 trillion during the same period last year.

Thus with relative stability in money market rates within the interest rate corridor, banks (especially domestic private banks) were able to offer financing products to their customers at even lower rates (**Figure 3.3**). Weighted average lending rates were 4 basis points lower than Q1-FY17, which helped keep the lending momentum going. Gross disbursements grew 19.0 percent during the quarter, which scaled down the level of net retirements compared to Q1-FY17. Fixed investment loans, in particular, continued to grow at a robust pace, reflecting the ongoing capital expenditures in a number of industrial and services concerns. For instance, a number of food processing firms in sugar, edible oil and dairy sectors are investing in vertical integration and cost-efficient processing, vying for a greater share in a growing consumer market.

Similarly, optimism prevails among exporters because of a steady recovery in some economies of the EU and in the US. In particular, consistent positive readings coming out in business and consumer surveys in these economies are quite encouraging (**Chapter 5**). Therefore, many textile firms continued to borrow long-term loans using SBP's subsidized schemes (**Figure 3.4**); this naturally led to a sharp increase in the import of textile machinery during the quarter.[3]

Figure 3.4: Flow of Fixed Investment Loans in Q1-FY18



Data Source: State Bank of Pakistan

Furthermore, taking a cue from tangible progress in infrastructure development under PSDP as well as CPEC, private investors remained bullish over medium-term business conditions in allied sectors. Corporate firms in cement, steel,

[3] On YoY basis, textile machinery imports rose 27.3 percent in Q1-FY18, as compared to 7.6 percent increase recorded in Q1-FY17.

power, construction, and allied sectors all leveraged further to gear up for strong demand down the road (**Figure 3.4**).[4]

Nonetheless, higher public spending (along with lower mobilization of budgetary funding from other sources) also put financing pressure on the banking system. Not only did the government increase its budgetary borrowings from the banking system, but for the completion of certain projects, public sector enterprises also took consortium financing directly from banks. As a result, the overall net domestic assets (NDA) of the banking system expanded at a rapid pace. However, the overall money supply (M2) fell by 0.6 percent in quarter under review, as the increase in NDA was more than offset by a sharp contraction in net foreign assets (NFA) of the banking system.

3.2 Liquidity conditions in the interbank

Although deposit mobilization by the banking system improved slightly over last year, liquidity conditions in the interbank market were not as smooth as they were in Q1-FY17.[5] Overnight rates inched up close to the ceiling of the interest rate corridor on more than one occasion, necessitating intervention by the central bank. The liquidity pressures primarily emanated from: (i) substantial budgetary borrowing from scheduled banks; (ii) FX operations; and (iii) seasonal impact of cash withdrawals around Eid-ul-Adha.[6]

Specifically, the major PKR liquidity pressure in July 2017 emanated from FX operations, which was only partly offset by net retirements by the government and private sector. SBP support came in the form of OMOs, the average size of which remained around Rs 1.3 trillion during the month. Despite the interventions, the relative strain in the interbank during the month was reflected in overnight rates, which remained 11 basis points above the policy rate (on average).[7]

During August, the government switched its borrowing pattern by retiring a significant portion of the central bank's debt using funds mobilized from scheduled banks.[8] This, along with a pick-up in private credit off-take (of Rs 35.5

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[4] The effect of these upbeat construction activities is also reflected in an uptick in construction-related inflation (**Section 3.5**).

[5] Bank deposits grew by 0.2 percent during Q1-FY18, compared to 0.1 percent in Q1-FY17.

[6] Eid-ul-Adha fell during 2nd - 4th September 2017.

[7] In July 2016, overnight rates had remained 8 basis points above the policy rate on average. Taking the maturity of PIBs worth Rs 1.2 trillion into consideration, SBP had not rolled over maturing OMO injections amounting to Rs 1.1 trillion on the same day (18th July, 2016). For details, see SBP's 'The State of Pakistan's Economy' First Quarterly Report for 2016-17.

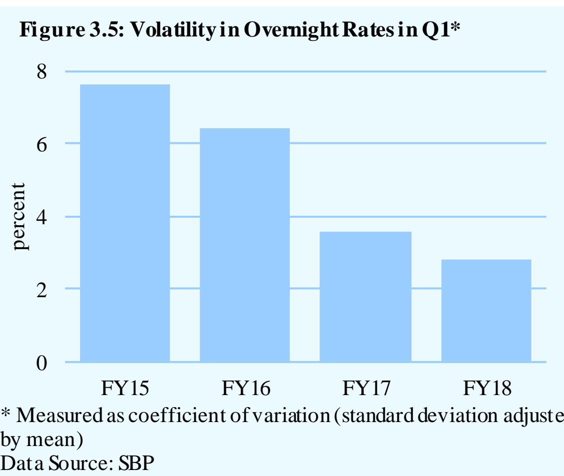
[8] On cash basis, the government retired Rs 228.0 billion of its SBP debt and borrowed Rs 379.7 billion from scheduled banks during August 2017.

billion) during the month, resulted in some tightening of liquidity at commercial banks' disposal. SBP responded by stepping up OMO injections, the mean outstanding stock of which rose to Rs 1.4 trillion during the month. This helped contain the deviation in weighted average overnight rates to 2 basis points below the policy rate during the month.

Finally, September witnessed the reemergence of liquidity pressures due to Eid-related withdrawals as well as Rs 34.5 billion off-take by private sector. While the net retirements of Rs 48.5 billion by the government provided only minimal liquidity support to commercial banks, SBP further scaled up the average size of outstanding OMO injections to Rs 1.6 trillion.

In a nutshell, OMOs served as a counterbalance against liquidity pressures, with the aim to minimize the deviation of overnight rates from the policy rate. These also helped smoothen the functioning of the money market, as reflected in fewer occasions of banks' recourse to SBP's discount window facility.[9] With more effective implementation of the policy rate, SBP has been particularly successful in reducing the volatility of weighted average overnight rates more recently (**Figure 3.5**), thereby ensuring stability in the long term rates (this is especially reflected in 6 month KIBOR, which remained fairly stable at around 6.2 percent during Q1-FY18).

Figure 3.5: Volatility in Overnight Rates in Q1*



* Measured as coefficient of variation (standard deviation adjusted by mean)
Data Source: SBP

3.3 Monetary Aggregates

The expansion in NDA was fairly large in Q1-FY18 as compared to the same period last year. Higher budgetary borrowing, along with lower net retirements from the private sector, resulted in a much larger expansion of NDA during Q1-FY18 compared to same period of last year (**Table 3.1**). On the other hand, NFA of the banking system witnessed a contraction, which more than offset the expansion in NDA, eventually leading to contraction of broad money.

[9] Commercial banks borrowed Rs 85.8 billion in 7 visits to SBP's discount window during Q1-FY18, compared to Rs 503.9 billion in 10 visits during Q1-FY17.

Table 3.1: Changes in Monetary Aggregates (Jul-Sep)
flow in billion Rupees

	FY17	FY18
Reserve Money	237.5	-134.7
M2	29.6	-88.4
NFA	-8.4	-258.6
SBP	38.0	-237.1
Scheduled banks	-46.4	-21.5
NDA	38.1	170.2
Budgetary Borrowing*	299.6	408.2
SBP	567.7	210.3
Scheduled Banks	-268.1	197.9
Commodity operations	-30.7	-36.3
Private Sector Credit	-124.1	-37.4
PSE Credit	24.5	5.1
Other items net	-152.7	-130.6

* on cash basis
Source: State Bank of Pakistan

With financing needs arising from the current account deficit and official debt servicing payments, there was a more pronounced fall in the NFA of the central bank than scheduled banks.[10] At the same time, NFA of scheduled banks also declined. This was largely due to a significant increase in foreign liabilities of commercial banks; this reflected their efforts to reduce the FX gap arising out of higher import payments.

Budgetary borrowings

The overall budgetary borrowings surpassed the last year's historic-high level towards the end of September. This was due to lower financing available from external and domestic non-bank sources, which created additional funding pressure on the banking system (**Chapter 4**).[11]

Within the banking system, the financing burden was distributed almost equally among SBP and scheduled banks. Importantly, the entire mobilization from scheduled banks was against T-bills, as the market was convinced that interest rates had bottomed out (**Table 3.2**). Even within T-bills, the market preferred the 3-month instrument – accounting for over 3/4th of offers against all tenors – which reflected a very short timeframe within which it was expecting a policy reversal.

Meanwhile, PIBs remained out of favor. While the government itself set negative net-of-maturity pre-auction targets for the quarter, scheduled banks' appetite for longer tenor instruments was muted in light of the interest rate expectations. Therefore, participation by scheduled banks in the August and September PIB auctions was low, and as such no funding was mobilized.

[10] The current account deficit during Q1-FY18 rose to US$ 3.6 billion as compared to US$ 1.6 billion last year.
[11] The government borrowed Rs 7.9 billion from external sources in Q1-FY18, compared to net mobilization of Rs 68.8 billion in Q1-FY17 (see Chapter 4 on **Fiscal Policy and Public Debt**).

Table 3.2: Auction Profile of Government Securities*
billion Rupees

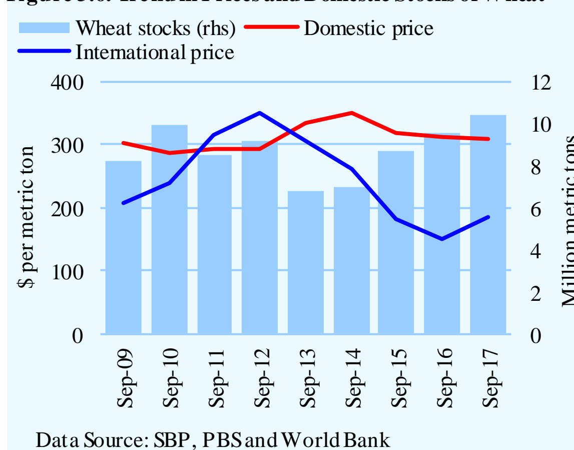
	T-Bills			PIBs		
	Target	Offered	Accepted	Target	Offered	Accepted
In gross terms						
Q1-FY17	1450.0	3066.0	1763.9	300.0	995.4	646.3
Q1-FY18	3900.0	4511.2	4406.3	300.0	107.3	55.6
Net of maturity						
Q1-FY17	272.0	1887.9	585.9	-1127.3	-431.9	-748.8
Q1-FY18	218.5	829.7	724.8	-296.6	-489.6	-541.0

*includes non-competitive and special auction (in face value)
Source: State Bank of Pakistan

Borrowing by public agencies (PSEs Credit and Commodity Operations)
Credit to public sector enterprises (PSE) rose by only Rs 5.1 billion during Q1-FY18 compared to Rs 24.5 billion last year. This deceleration basically represents heavy retirements (of Rs 47.5 billion) by Pakistan State Oil (PSO) mainly on the back of its maturing PIB holdings during the quarter.

Here, it is important to mention that the retirements by PSO do not indicate any significant improvement in its liquidity concerns. Circular debt continued to complicate cash management for the entity, reflected in further increase in its outstanding receivables (from energy sector and aviation) by Rs 4.9 billion during the quarter; at end-September 2017, PSO's receivables totaled Rs 282.0 billion. Borrowings by other energy-related PSEs also continued to remain strong, rising by Rs 10.4 billion during the quarter.

Figure 3.6: Trend in Prices and Domestic Stocks of Wheat



Data Source: SBP, PBS and World Bank

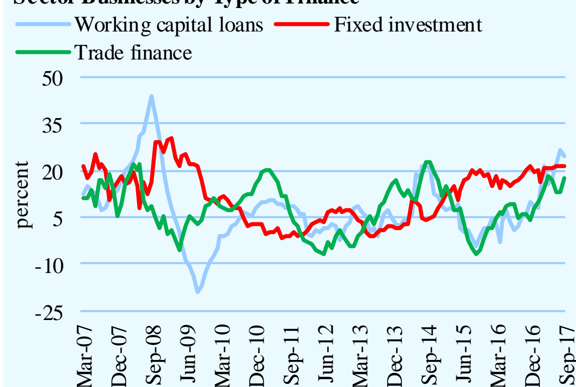
Meanwhile, there were higher retirements of commodity loans – mainly wheat – during Q1-FY18 as compared to last year. This basically suggests that wheat procurement agencies were able to offload higher quantities compared to last year – the impact of which was also reflected in a continuous fall in the commodity price (**Section 3.5**). Notwithstanding this, however, the outstanding wheat stock with these agencies continued to increase; FY17 was the 4th straight year of a

bumper crop and despite various measures taken by the government, the country has not been able to export the commodity.[12] During Q1-FY18, the magnitude of exports was not even 1 percent of the outstanding wheat stock as of end-June 2017.[13] Essentially, the policy of support prices is maintaining a sizeable differential between domestic and international prices, thereby limiting the export prospects of wheat held by procurement agencies.

3.4 Credit to Private Sector

Credit to private sector kept its growth momentum in Q1-FY18, as gross disbursements increased by 19.0 percent over the same period last year. Due to this, coupled with the fact that a large chunk of credit off-take last year was long-term in nature, the magnitude of seasonal retirements during the quarter was quite low (**Figure 3.7**).[14] In particular, banks' portfolio of fixed investment loans continued to expand, reflecting favorable policy stance, as well as positive business sentiments over the medium term.[15]

Figure 3.7: YoY growth in Outstanding Loans to Private Sector Businesses by Type of Finance



Data Source: State Bank of Pakistan

Growing consumer base in the country has been the major pull factor encouraging domestic players to reposition, especially in the food and FMCG sectors. Edible oil, poultry and sugar manufacturers are all working towards gaining efficiency, attaining modern technology and reducing their production costs. Moreover, the

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[12] The government has also retained the 60 percent regulatory duty on import of wheat (first imposed in FY17) to avoid build-up of excess wheat stocks. Furthermore, the government, vide Notification No. 4-12/2014/DFSC-II/Wheat Export dated September 26, 2017, has approved export of wheat/wheat products beyond August 31, till October 30, 2017.

[13] According to customs record, Pakistan exported only 1,086 MT of wheat during Jul-Sep 2017. The stock of wheat with provincial governments and various procurement agencies at end June 2017 was over 9.5 million MT.

[14] The net retirements were more than one third at Rs 37.4 billion in Q1-FY18, compared to Rs 124.1 billion observed in the same period last year, according to monthly monetary survey data.

[15] These sentiments were captured in the OICCI's Business Confidence Index Survey (Wave 15). The overall business confidence index score increased from 13 percent in the May 2017 surveys to 21 percent in the November 2017 iteration, with sentiment among the retail and wholesale trade sector posting the greatest improvement.

government's continued focus on bridging the infrastructure gap has attracted investments and reinvestments in allied industries such as cement, transport and iron and steel. For these industries, the steady progress on CPEC has been quite reassuring. Finally, relatively upbeat sentiments in advanced economies, particularly the US and EU, have encouraged capital expenditures in export-oriented industries such as textiles.

Within textiles, the spinning and weaving segments continued to be the main beneficiaries of fixed investment loans under the LTFF schemes, which were offered at very attractive rates. Made-up (value-added) sector also borrowed long-term loans, as export orders firmed up (**Chapter 5**).

Similarly, the financing needs of some edible oil manufacturers for installation of extraction plants (from raw seeds) contributed to the borrowing for fixed investment purpose. The cement sector also went for further capital expenditure as the ongoing construction activities boosted demand, and capacity utilization exceeded 90 percent during Q1-FY18. The sugar sector too borrowed for fixed investment; anecdotal evidence suggests that some of the manufacturers are diverting to energy-efficient processes to reduce operating costs.

Within working capital category, sugar and fertilizers made heavy retirements. Both the industries faced glut-like situation during the quarter, as existing stocks exceeded domestic demand. It may be recalled here that sugar mills had borrowed excessively last year to procure the record-high sugarcane crop; therefore, a high level of retirement was expected during Q1-FY18. In case of fertilizers, urea manufacturers cut back production from H2-FY17 onwards on account of large inventories as well as lower gas supply. The government has already allowed export of both the commodities and even announced subsidy to help traders offload the stock; however, these measures apparently have not proved very effective. In contrast, edible oil and ghee manufacturers took additional working capital financing during the quarter, as expected price hikes in the international market encouraged them to stockpile palm oil inventories (**Chapter 5**).

Among non-manufacturing sectors, agriculture, electricity, mining, ship-breaking and transport increased their borrowings for both fixed as well as working capital purposes (**Table 3.3**). Agriculture figured more prominently as long-term borrowings reflect increased penetration of corporate poultry farming in the country. Firms are particularly investing in automation of business processes, as well as installing environmentally controlled sheds.

Table 3.3: Loans to Private Sector Businesses in Jul-Sep (flow in Rs Billion)

	Total loans		Working capital		Fixed Investment		Trade finance	
	FY17	FY18	FY17	FY18	FY17	FY18	FY17	FY18
Private Sector Businesses	**-115.1**	**-20.8**	**-136.5**	**-60.5**	**39.6**	**56.7**	**-18.3**	**-17.1**
Manufacturing	-108.6	-43.4	-125.4	-64.8	32.9	46.2	-16.1	-24.8
Textiles	-26.8	1.4	-20.6	-2.8	3.5	18.5	-9.7	-14.2
Made-up textile articles	-6.0	10.6	-1.5	3.5	-1.0	2.7	-3.5	4.4
Spinning, weaving, finishing	-20.1	-4.8	-18.2	-1.3	4.6	16.5	-6.5	-20.1
Iron and Steel	-2.9	6.4	-4.2	4.9	1.0	0.3	0.2	1.1
Machinery and equipment	0.8	3.1	0.3	2.4	0.6	1.8	-0.1	-1.1
Cement	-3.2	0.5	-4.6	1.3	-0.5	3.4	1.9	-4.2
Fertilizers	4.1	-11.5	-14.2	-8.6	17.1	-0.2	1.2	-2.7
Food products	-67.4	-31.6	-64.5	-50.9	4.4	11.6	-7.3	7.7
Edible oil and ghee	-6.9	17.7	-6.5	5.2	0.6	3.2	-1.0	9.3
Rice Processing	-24.4	-12.7	-23.5	-13.6	-0.2	0.3	-0.8	0.6
Sugar	-39.7	-31.5	-40.3	-39.1	3.5	8.4	-3.0	-0.7
Agriculture and forestry	12.0	9.3	11.0	4.7	2.1	3.8	-1.2	0.8
Electricity, gas and water	0.2	6.3	-7.7	3.3	7.4	-1.9	0.5	4.9
Commerce and Trade	-0.9	5.1	4.5	-0.2	-1.6	1.4	-3.8	3.9
Transport and communications	-5.3	3.7	-5.3	1.6	0.5	2.0	-0.5	0.0
Construction	-4.8	-1.1	-4.4	-5.2	0.6	3.4	-1.0	0.7

Data Source: State Bank of Pakistan

Consumer financing

While the increase in mortgages during Q1-FY18 was three times the increase observed last year, it was the hefty increase in auto finance that dominated banks' consumer portfolio during Q1-FY18 (**Table 3.4**).

Table 3.4: Trend in Consumer financing in Q1
(flows in Rs billion)

	FY15	FY16	FY17	FY18
Total	**6.0**	**-5.1**	**20.3**	**18.4**
House finance	0.2	1.5	1.8	6.3
Auto	4.1	5.7	5.7	11.2
Credit cards	-0.1	0.2	1.5	1.6
Durable	-0.1	0.5	-0.1	-1.5
Personal loans	1.9	-13.0	11.4	0.8

Data Source: State Bank of Pakistan

Increased availability of cheaper financing facilities contributed significantly to higher car sales in the country (**Chapter 2**). Anecdotal evidence suggests that some customers are using bank-financed cars to sign up for ride-hailing service providers. Industry estimates suggest that the magnitude of car financing could have been even higher if not for delayed delivery of vehicles by local assemblers. Islamic financing products are particularly affected as these require physical possession of the vehicle at the time of disbursement. To address this concern, more aggressive banks are using their demand projections to pre-book cars in bulk with wholesale importers. Moreover, some banks are providing

financing for semi-commercial vehicles like Bolan and Ravi under various subsidized loan schemes announced by the government.

Within banks, the Islamic segment kept on consolidating its share in outstanding auto financing loans in the quarter. Some Islamic banks are now more inclined towards diminishing musharka as opposed to car ijarah, which used to be the more popular Islamic auto financing product. This was primarily to avoid all the associated risks and cost (registration; maintenance; insurance premiums; etc.) of retaining the ownership throughout the tenure of ijarah. In case of diminishing musharka, since the ownership splits from the day one between the borrower and the bank, risks and rewards are also shared.

3.5 Inflation

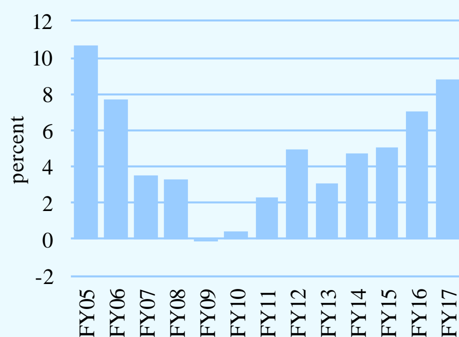
Although some impetus has been building around inflation over the past few months following a recovery in global commodity prices as well as consolidating domestic demand (**Figure 3.8**), the headline CPI inflation has moderated to 3.4 percent in Q1-FY18 from 3.9 percent in Q1-FY17, and 4.6 percent in Q4-FY17. Much of this subdued outcome is attributed to easing food inflation, which more than compensated for the steady increase in non-food inflation (**Table 3.5**). While prices of pulses, fresh vegetables, tomatoes, sugar and wheat remained lower, it was the change in FED structure for cigarettes which contributed the most to falling headline numbers. Excluding this item alone increases the CPI inflation from 3.5 percent last year to 3.8 percent during Q1-FY18.

Table 3.5: Average CPI Inflation and Contribution during Q1

		Growth		**Contribution**	
	Weight	**FY17**	**FY18**	**FY17**	**FY18**
Overall CPI	**100.0**	**3.9**	**3.4**	**3.9**	**3.4**
Food *of which*	**37.5**	**4.0**	**1.2**	**1.7**	**0.5**
Tobacco	1.4	17.7	-16.1	0.4	-0.4
Food and beverages	34.8	3.2	2.2	1.2	0.8
Pulses	1.1	23.8	-17.5	0.3	-0.3
Sugar	1.0	7.1	-17.5	0.1	-0.2
Fresh vegetables	1.7	19.5	-5.7	0.4	-0.1
Tomato	0.4	21.1	-12.9	0.1	-0.1
Onion	0.5	-31.6	63.6	-0.2	0.3
Non Food *of which*	**62.5**	**3.7**	**5.0**	**2.2**	**2.9**
House rent	21.8	5.8	7.2	1.1	1.3
Education	3.9	8.3	10.1	0.3	0.4
Health	2.2	5.9	12.4	0.1	0.2
Transport	7.2	-4.1	3.0	-0.3	0.2
NFNE (excluding HR)	**31.7**	**4.0**	**4.5**	**1.3**	**1.4**

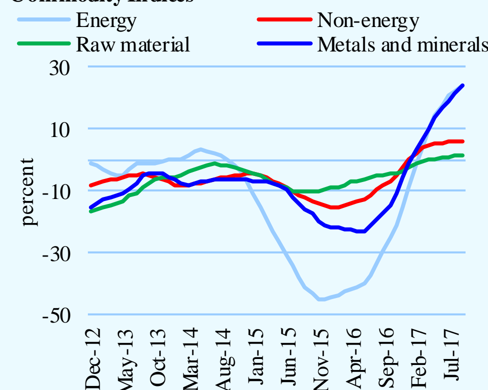
Data Source: Pakistan Bureau of Statistics and SBP Calculations

Figure 3.8a: Growth in Domestic Demand (Constant prices)*



* Domestic demand is total of consumption, investment and government expenditures

Figure 3.8b: YoY Change in World Bank Commodity Indices *



* 12-months moving average

Figure 3.8c: YoY Inflation in Metal Products and Machinery Equipments (WPI)

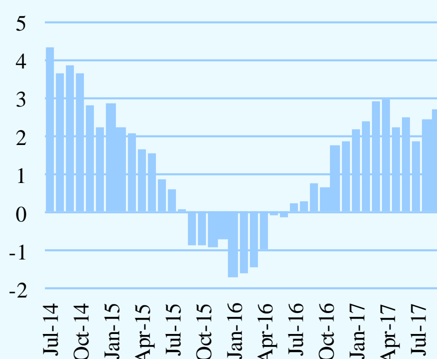
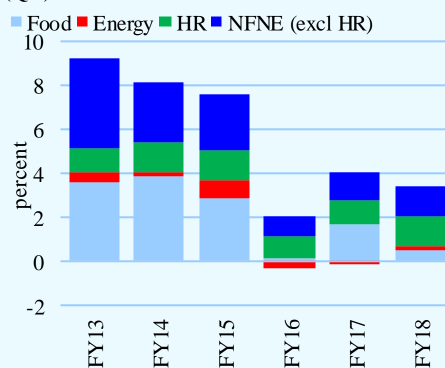


Figure 3.8d: Contribution in Average CPI Inflation (Q1)



Data Source: PBS and World Bank

Cigarettes

In a bid to reduce the influx and sale of non-duty paid cigarettes in the country, law enforcing agencies have recently intensified their country-wide crackdown against smuggled and counterfeit brands. Moreover, to discourage tax evasion, FBR has changed the federal excise duty structure on various tiers in the budget 2017-18. While FED on premium brands (with price exceeding Rs 2,925/1,000 pieces) has been increased, a new tier has been introduced at the lowest-end, with a much reduced rate of duty (**Table 3.6**).

In the CPI basket, there are 4 brands representing cigarette consumption, out of which 3 fall under this lowest tier. Therefore, the impact of this adjustment has been largely positive for CPI inflation, with aggregate cigarette prices recording a

fall of 16.4 percent in Q1-FY18. This fall is certainly exceptional as cigarette prices are always adjusted upwards. In fact, anti-tobacco activists have criticized this move claiming that this will increase tobacco consumption in the country. Nonetheless, from the perspective of domestic cigarette production in the formal sector, which has more than doubled compared to last year, this measure seems effective. Still, it remains to be seen to what extent the FBR is able to increase revenue collection from the product.

Table 3.6: Change in FED Structure on Locally Produced Cigarettes

Old Structure*		New Structure**	
Price description per 1,000 piece	**Rate of duty/1000 pc**	**Price description per 1,000 piece**	**Rate of duty/1000 pc**
If the on-pack printed retail price exceeds Rs 4,000	Rs 3,436	If the on-pack printed retail price exceeds Rs 4,500	Rs 3,740
If the on-pack printed retail price does not exceed Rs 4,000	Rs 1,534	If the on-pack printed retail price exceeds Rs 2,925, but less than Rs 4,500	Rs 1,670
		If the on-pack printed retail price does not exceed Rs 2,925	Rs 800

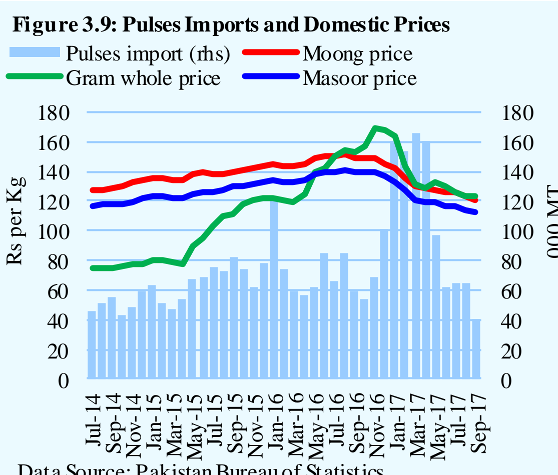
*SRO 473(I)/2016 dated 3rd June 2016; **SRO 407(I)/2017 dated 29th May 2017

Data Source: Federal Board of Revenue

Food supplies

In case of pulses, a fall in local production over the past couple of years, had led to a steady increase in prices throughout FY16 and initial months of FY17. Although traders had been trying to fill the demand-supply gap via imports, these could not alleviate price pressures in the domestic market. In H2-FY17, record-high levels of pulses were imported to ease supplies, especially anticipating a rise in Ramadan-related demand; instantly, prices of most pulses began to taper, and in Q1-FY18, a 17.5 percent fall in prices was recorded over the same period last year (**Figure 3.9**). Pakistan's reliance on imported pulses has increased significantly in recent years; imported varieties now constitute around 63 percent of total pulses supply in the country.

Figure 3.9: Pulses Imports and Domestic Prices

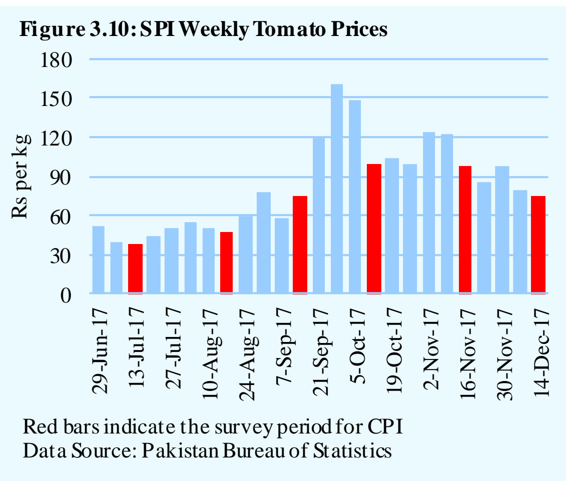


Data Source: Pakistan Bureau of Statistics

In case of fresh vegetables, it may be recalled that the average prices of these items showed 19.5 percent growth in the first quarter of FY17 due to supply disruptions in the wake of crop damages and strict border controls. Although security checks are still stringent, these do not seem to be disrupting the trade of perishables anymore. As a result, prices normalized and recorded a YoY decline of 5.7 percent during Q1-FY18.

Similarly, tomatoes were also sold at lower prices through most of Q1-FY18 as compared to Q1-FY17. However, a blip was observed during the last week of September 2017, when prices shot up to an unprecedented Rs 160 per kg. While this increase is visible in weekly SPI data, it was not captured in CPI because PBS collects the prices of CPI food items through their surveys during 11th-14th of each month – the window where prices were generally stable during September (**Figure 3.10**). In fact, the unusually higher prices did not reflect in the next month's CPI also, as the hike was subsided to a large extent, before the October 2017 survey was conducted.

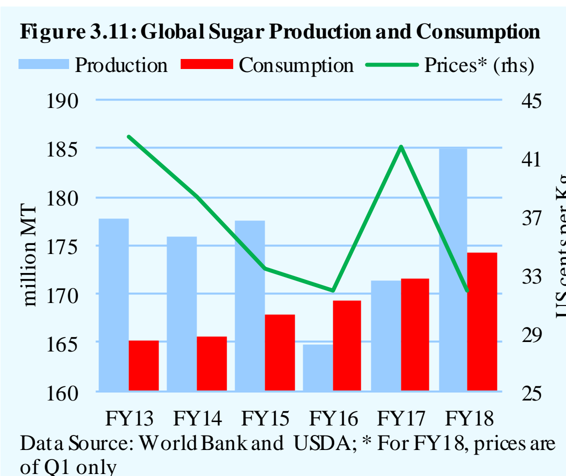
Figure 3.10: SPI Weekly Tomato Prices



Red bars indicate the survey period for CPI
Data Source: Pakistan Bureau of Statistics

In case of sugar, high global production along with a stable domestic demand led to a rise in its surplus stock in FY17 (**Figure 3.11**).[16] This glut resulted in a decline in both international and domestic sugar prices from November 2016 onwards. Particularly for Pakistan, the production of sugarcane during FY17

Figure 3.11: Global Sugar Production and Consumption



Data Source: World Bank and USDA; * For FY18, prices are of Q1 only

[16] Source: USDA report, "Sugar: World Markets and Trade" released in May and November 2017.

exceeded 73.6 million MT, recording a growth of 12.4 percent compared to 4.2 percent during the previous year. Consequently, prices of sugar dropped by 17.5 percent in Q1-FY18; this would be the first time since FY13 that sugar prices fell in the first quarter of any fiscal year.

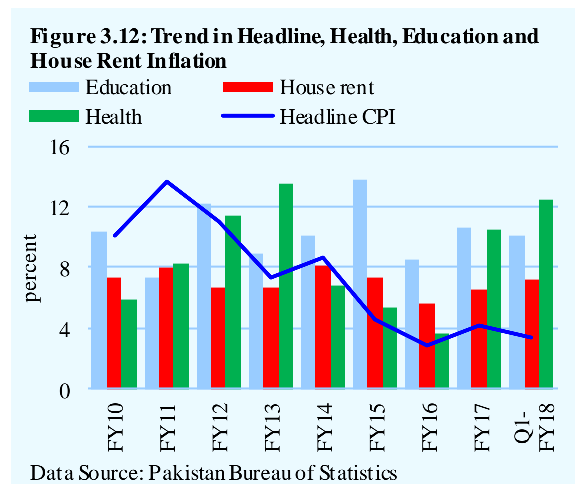
Energy prices

As shown in **Figure 3.8b**, global commodity indices clearly show signs of recovery since 2016. That said, the pass-through of international oil prices to domestic consumers has lately been moderate and comes with a time lag. This lagged impact may help explain the government's decision to cut the petrol and high speed diesel prices during July and August 2017, before raising them in September 2017.[17] As a result, inflation in petroleum, diesel, CNG, and gas cylinders remained higher during Q1-FY18 as compared to deflation recorded in Q1-FY17. However, transport fares largely remained unchanged during the quarter.

Education and health

Within core inflation, while house rent continued to have a major share, it was the double-digit inflation in education and health that actually contributed the most to NFNE inflation (**Figure 3.12**).

Figure 3.12: Trend in Headline, Health, Education and House Rent Inflation



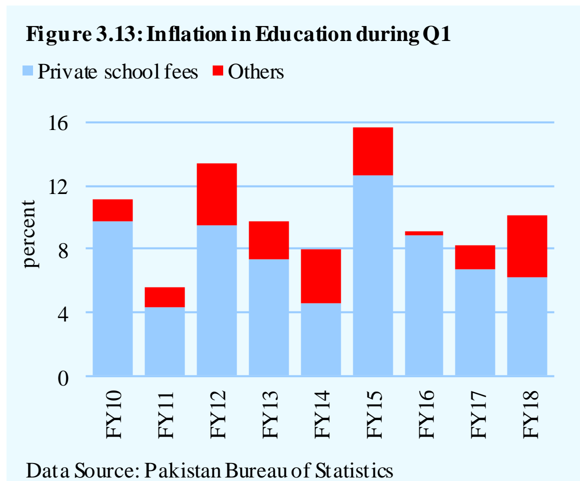
Data Source: Pakistan Bureau of Statistics

At its core, the issue of a persistent increase in education and healthcare services in the country can be traced to the inability of the public sector to ensure adequate provision of these services to a major part of the population. Therefore, the penetration of private facilities has increased in both sectors over the past few years. Although from a quality perspective, private services may be considered superior to public ones, this has created an issue of affordability for a large segment of the population.

[17] The government cut petrol price by Rs 1.5 and Rs 1.8 per liter in July and August, before raising it by Rs 2 per liter in September 2017. Similarly, it cut HSD price by Rs 1.5 and Rs 2.5 per liter in July and August, and left it unchanged in September 2017.

For instance, average increase in education index has persistently remained close to 10 percent between FY10 and Q1-FY18, despite the fact that the overall inflation has declined and averaged 7.3 percent. Importantly, the education component of CPI has doubled in just a span of 7 years, representing the need to maintain checks and balances on private institutions. While this trend is visible in nearly all the sub-components of education, private school fee has been contributing the most (**Figure 3.13).** In explaining the Q1-FY18 education-related inflation also, private school fee played a dominant role, though a strong contribution also came from rising tuition fees in government professional colleges and universities.

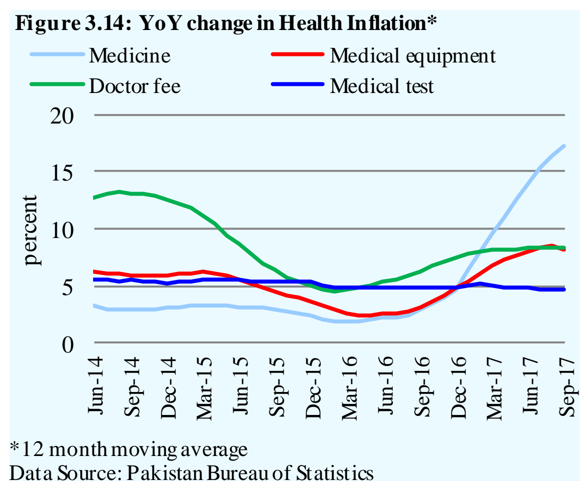
Figure 3.13: Inflation in Education during Q1



Data Source: Pakistan Bureau of Statistics

Similarly, healthcare costs have also been increasing over the past few years with contributions coming from both medicines as well as service charges (**Figure 3.14**). In Q1-FY18, however, while service charges have continued to post a steady increase, drug prices have depicted a substantive increase of 18.6 percent in Q1-FY18. This increase is more than three times the 5.0 percent increase seen in Q1-FY17, and 5.3 percent observed in the first quarter of past 8 years. This increase was despite the fact that the Drug Regulatory Authority of Pakistan (DRAP) had mandated price revisions primarily on the basis of trend in the overall CPI index (though exceptions were to be granted on a case to case basis). As it turned out, prices of many medicines reported in CPI were increased more than the benchmark set for them. This situation basically warrants tighter administrative checks on

Figure 3.14: YoY change in Health Inflation*



*12 month moving average
Data Source: Pakistan Bureau of Statistics

pharmaceuticals retailing, in order to arrest the rising healthcare costs in the country.

Construction-related prices

With booming construction activity in the country, an upward pressure on associated prices was to be expected. As shown in **Figure 3.15,** the WPI construction index – which includes items related to cement, steel, bricks, glass sheets, paints and varnishes, pig iron, pipe fittings, timber, ceramics and sanitary, and concrete mixer – has been rallying since the 2nd quarter of FY17, and clocked in at 6.6 percent in Q1-FY18 (**Chapter 5**). The situation is similar for construction-related items included in the CPI basket, where the construction index has started to inch up on the back of a rise in wages of construction labor (6.3 percent YoY in Q1-FY18). The rise in wages would probably be higher had the demand for construction labor from Gulf countries been at levels observed in the past 5 years.

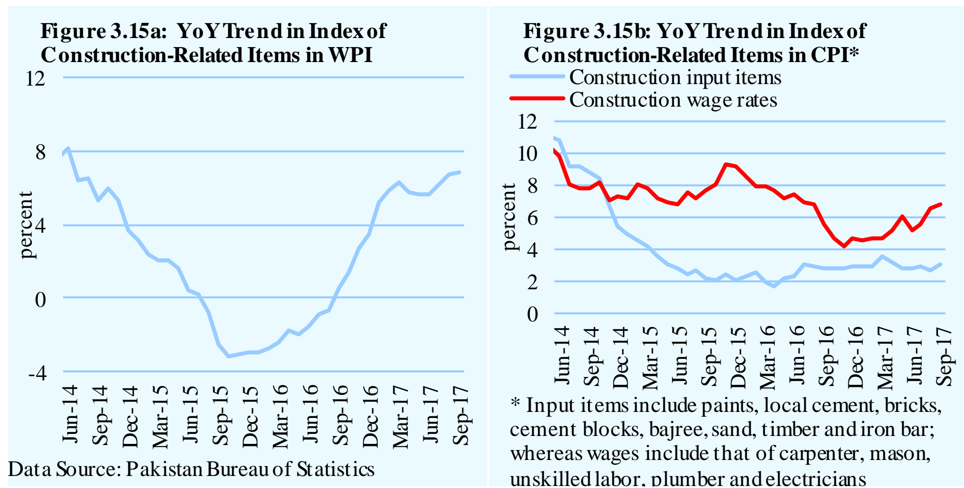


Figure 3.15a: YoY Trend in Index of Construction-Related Items in WPI

Data Source: Pakistan Bureau of Statistics

Figure 3.15b: YoY Trend in Index of Construction-Related Items in CPI*

* Input items include paints, local cement, bricks, cement blocks, bajree, sand, timber and iron bar; whereas wages include that of carpenter, mason, unskilled labor, plumber and electricians