# 3 Monetary Policy and Inflation

*The SBP's Monetary Policy Committee decided to keep the policy rate unchanged at 7 percent during Q3-FY21. Further traction in the domestic economic recovery, uncertainty stemming from the third wave of Covid, along with anchored inflationary expectations mainly guided the policy decision. Economic activity indicators, including high frequency demand data, continued the recovery trend of FY21. Secondary market yields ticked up, amid relatively higher government borrowings from commercial banks. As for credit to the private sector, major private businesses retired their short-term loans during Q3-FY21, which moderated the overall private sector credit during the quarter. However, SBP's concessionary refinancing schemes, mainly TERF, drove up the offtake in fixed investment loans. On the inflation front, CPI inflation was volatile during Q3-FY21 on a YoY basis as both low and high readings were recorded during the quarter, partly due to the base effect. On an aggregate basis, nonetheless, CPI inflation weakened in Q3-FY21 on a YoY basis as well as over the preceding quarter. While core inflation remained broadly stable and energy inflation was higher, the decline in the headline number was mainly guided by deceleration in food inflation.*

## 3.1 Policy Review

The recovery in the domestic economy continued to gain traction in the third quarter of FY21. The supportive policy measures taken by the government and the SBP after the outbreak of Covid played an important role in this trend. Economic activity data at large and the SBP's consumer and business sentiment surveys registered an improvement on the whole.[1] Large-Scale Manufacturing (LSM) registered growth of 9.0 percent during Jul-Mar FY21, compared to 5.1 percent contraction during the same period last year. Also, a wide range of high frequency demand indicators, including sales of cement, POL, and automobiles, displayed a recovery trend.[2]

Overall financial conditions remained accommodative despite a slight uptick in lending rates. Due to continued pick-up in overall economic activity as well as in exports, private sector credit also registered an increase during Jul-Mar FY21 compared to the same period last year. A sizable expansion in fixed investment loans and consumer financing was witnessed, primarily due to the low interest rate environment as well as the SBP's subsidized refinancing schemes, especially LTFF and TERF. However, overall loans to private businesses moderated during Q3-FY21 compared to the corresponding period of last year as the offtake fell from Rs 75.4 billion in Q3-FY20 to Rs 60.5 billion in Q3-FY21. This is primarily due to increased working capital loan retirements by a few manufacturing businesses that had borrowed significantly

[1] Consumer Confidence Survey posted improvement till January 2021 wave, whereas it declined in March 2021. By contrast, Business Confidence Index registered continued improvement.

[2] Cement dispatches registered 23.0 percent YoY growth in Q3-FY21 compared to 4.4 percent growth last year. Also, car and POL sales registered 72.4 and 22.9 percent increase in Q3-FY21 compared to 53.4 and 21.9 percent decline, respectively, in Q3-FY20.

during H1-FY21.[3] On the other hand, fixed investment loans recorded an increase during Q3-FY21, compared to net retirements in the same period last year, as the textile sector benefitted from TERF – mainly to import textile machinery during the quarter.

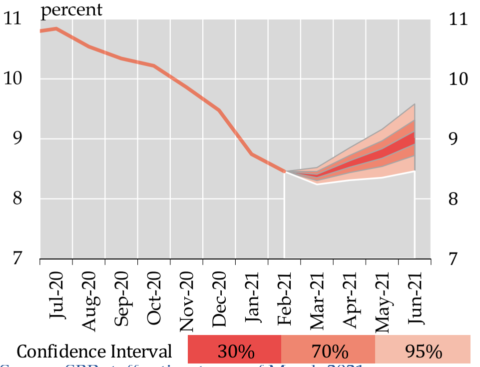
On the inflation front, the YoY inflation readings were volatile during the quarter. By the time the Monetary Policy Committee (MPC) met in January 2021, inflation outturns were encouraging. Inflation pressure eased in January 2021, mainly on account of waning supply-side pressures from the food group, base effect,[4] and stable core inflation amid existence of spare capacity in the economy. On a YoY basis, inflation fell to 5.7 percent in January 2021 (the lowest reading since January 2019) compared to 14.6 percent in the same period last year and 8.0 percent in December 2020. In the presence of excess capacity and well-anchored inflation expectations, second-round inflationary impacts of the expected rise in utility prices and any supply side shocks were unlikely to have a lasting inflationary impact. Therefore, average inflation was expected to be within the previously announced range of 7-9 percent in FY21. With the inflation outlook was relatively benign aside from the possibility of temporary supply-side shocks, the MPC felt that the existing accommodative stance of monetary policy remained appropriate to support the nascent recovery while keeping inflation expectations well-anchored and maintaining financial stability. As a result, the MPC decided to keep the policy rate unchanged.

While noting these favorable growth and inflation developments, the MPC stressed that considerable uncertainty remained around the outlook. In particular, the trajectory of the Covid pandemic was difficult to predict, given still-elevated global cases, the emergence of new strains, and lingering uncertainties about the roll-out of vaccines worldwide, all of which could slow the recovery. In light of such Covid-related uncertainties, the MPC felt it appropriate to provide, for the first time ever, some forward guidance on monetary policy to facilitate policy predictability and decision-making by economic agents. In the absence of unforeseen developments, the MPC noted that it expected monetary policy settings to remain unchanged in the near term. Further, as the recovery became more durable and the economy returned to full capacity, it expected any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates.

By the time the MPC met in March 2021, growth forecasts improved while inflation readings rose. On a YoY basis, headline inflation increased from 5.7 percent in January 2021 to 8.7 percent and 9.1 percent in February 2021 and March 2021 respectively. This rise was mainly attributed to increasing prices of electricity, sugar and wheat, whereas prices of perishable food items moderated during the period under review. Core

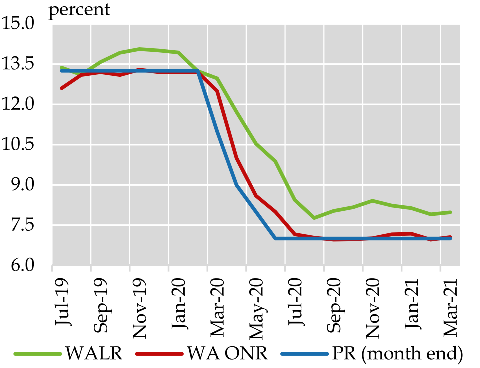
[3] Rice, fertilizer and refined petroleum sectors, which had borrowed significantly in H1-FY20, made heavy retirements during the quarter under review.
[4] On MoM basis, the inflation declined by only 0.2 percent in January 2021.

**Fan Chart-CPI Inflation(12mma)** **Figure 3.1**




Source: SBP staff estimates as of March 2021

**Trends in Major Interest Rates** **Figure 3.2**




Source: State Bank of Pakistan

inflation continued to remain relatively stable, in line with the negative output gap in the economy. [5] Given the rise in electricity tariffs that would continue to manifest in headline numbers in the coming months, inflation was expected to stay close to the upper end of the previously announced 7-9 percent range in FY21. However, uncertainty around the projection remained, with the summer's wage negotiations, any new tax measures in next year's budget, and higher international commodity prices associated with the global recovery posing upside risks (**Figure 3.1**).

In addition, the external sector position also strengthened, as the current account, on a cumulative basis, posted a surplus in the first seven months of FY21 on the back of record remittances and recovery in exports. Taking all these factors into consideration, the existing stance of monetary policy was deemed appropriate and the MPC, in its meeting held in March 2021, unanimously decided to keep the policy rate unchanged at 7 percent (**Figure 3.2**). Moreover, from the perspective of forward guidance, the MPC expressed the view that, in the absence of unforeseen developments, the monetary stance would remain broadly unchanged in the near-term and repeated the language from the January 2021 meeting related to future moves being measured and gradual.

## 3.2 Monetary Aggregates

The growth of money supply remained at an elevated level of 7.8 percent during Jul-Mar FY21.[6] It is important to recall here that, during Jul-Mar FY20, the money supply posted a multi-year high expansion of 8.5 percent as the budgetary support from the banking system picked-up the pace in the aftermath of the Covid

[5] For instance, in the auto sector, capacity utilization remained around 59.1 percent in cars, 43.5 percent in LCVs, 11.9 percent in buses, 11.7 percent in trucks and 76.8 percent in 2/3 wheelers, as per data taken from PAMA and Pakistan Economic Survey-FY20. In the cement sector, capacity utilization remained around 77.6 percent; whereas it was around 52.6 percent in the POL industry.
[6] The average broad money growth stood at 5.5 percent during Jul-Mar in FY15-FY19.

**Monetary Aggregates[P]** **Table 3.1**

billion Rupees

| | Q3 | | Jul-Mar | |
|---|---|---|---|---|
| | FY20 | FY21 | FY20 | FY21 |
| M2 (A+B) | 602.7 | 459.4 | 1,520.0 | 1,622.2 |
| A. NFA | -80.9 | 104.6 | 797.1 | 683.3 |
| B. NDA | 683.6 | 354.9 | 722.9 | 938.8 |
| Budgetary borrowing* | 779.8 | 304.8 | 966.5 | 742.1 |
| SBP | 260.1 | -664.8 | -480.4 | -1,250.7 |
| Scheduled banks | 519.7 | 969.7 | 1,446.9 | 1,992.8 |
| Commodity operations | -108.6 | -33.3 | -137.2 | -112.5 |
| Private sector | 107.6 | 156.0 | 323.2 | 499.6 |
| PSEs | 5.8 | 6.6 | 3.5 | -22.8 |
| Other items net | -106.3 | -87.1 | -440.3 | -180.0 |
| Reserve money | 259.1 | 244.6 | 424.4 | 256.3 |
| Currency in Circulation | 392.6 | 334.6 | 722.6 | 399.1 |
| Deposits | 209.9 | 125.9 | 797.3 | 1,207.7 |

[P]: Provisional

* These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in **Table 4.1.**

Source: State Bank of Pakistan

outbreak. On the asset-side, both Net Domestic Assets (NDA) and Net Foreign Assets (NFA) contributed towards the expansion of the broad money. Within the NDA, the main contributors to growth included continued government borrowings from the scheduled banks and a higher private credit off-take during Jul-Mar FY21 compared to the same period last year.[7] Meanwhile, the improvement in NFA continued on the back of favorable external sector developments, including growth in workers' remittances and exports, and realization of official inflows. During Q3-FY21 the NFA expanded by Rs 104.6 billion compared to a contraction of Rs 80.9 billion in the same period last year (**Table 3.1**).

On the liability side, the deposit mobilization decelerated to Rs 125.9 billion in Q3-FY21 compared to an increase of Rs 209.9 billion in Q3-FY20. This was mainly driven by an overall contraction in the remunerative deposits that, in turn, partly offset the growth in non-remunerative deposits.[8] The contraction in remunerative deposits reflects the impact of a sharp reduction in the interest rates compared to last year. Likewise, the expansion in the Currency in Circulation (CiC) also remained slightly lower during Q3-FY21 compared to the same period last year.

[7] Additionally, during Q3-FY21, both the government borrowings from the scheduled banks and private sector credit posted a higher expansion compared to the same period last year. However, as for the components of private sector credit, the loan to businesses moderated, whereas consumer finance recorded a sharp increase during Q3-FY21 compared to the same period last year.

[8] During Q3-FY21, the remunerative deposits fell by Rs 75.9 billion compared to an expansion of Rs 290.2 billion in the same period last year. In contrast, the non-remunerative deposits increased by Rs 165.7 billion in Q3-FY21 compared to a decrease of Rs 80.2 billion in the corresponding period last year.

However, given a lower expansion in deposits compared to CiC growth, the currency to deposit ratio further inched up to an average level of 42.4 percent during Q3-FY21 compared to 42.0 percent in Q3-FY20. This highlights the underlying preference of the public to make cash transactions.

As for the monetary base, the reserve money growth slowed to 3.3 percent during Jul-Mar FY21 compared to 6.5 percent in the corresponding period last year. This was despite greater expansion in the NDA of the SBP owing to the increased monetary stimulus via SBP's refinance schemes in the aftermath of the Covid outbreak. During Jul-Mar FY21, the expansionary impact of SBP's refinance schemes on reserve money amounted to Rs 328.1 billion compared to Rs 133.7 billion in the same period last year. The major drag on the SBP's NDA came from the increase in the government's deposits with the central bank and net retirements of the government debt held by the SBP. [9] This in turn more than offset the combined impact of SBP's subsidized lending schemes and Open Market Operations (OMOs).

### Budgetary Borrowings:

The government borrowed Rs 304.8 billion from the banking system during Q3-FY21 compared to Rs 779.8 billion in the corresponding period last year. It is pertinent to note here that last year, the budgetary support from the banking system spiked in the third quarter in response to the capital outflows and a slowdown in government's revenue collection due to the Covid fallout. Within the banking system, the government continued to borrow from the scheduled banks as it adhered to its commitment of zero borrowings from the SBP. Meanwhile, the government also shored up its deposits with the SBP during Q3-FY21.[10]

### Auctions

During Q3-FY21 the government announced a cumulative pre-auction target of Rs 4,910.0 billion – nearly Rs 1 trillion higher compared to the upcoming maturities during the quarter (**Table 3.2**). Keeping in view the objective of enhancing the maturity profile of the outstanding debt, on net-of-maturity basis majority of the targets were allocated to the medium to long term instruments. However, it is important to note here that compared to the preceding two quarters of FY21, the target for floating-rate PIBs (PFL) remained on the lower side and zero targets were allocated to 5Y, 10Y quarterly coupon PFL and 3Y, 10Y semiannual coupon PFL from February 2021 onwards. Though PFLs have played an instrumental role to enhance the maturity profile of the government especially during low interest rate environment, zero-targets were assigned to less liquid floaters. This was done with a view to support the development of secondary market of PFLs,

[9] The impact of budgetary support on the reserve money was Rs -1,250.7 billion during Jul-Mar FY21 and Rs -480.4 billion in the same period last year.

[10] During Q3-FY21, government deposits held with the SBP increased by Rs 624.2 billion compared to Rs 82.9 billion in the same period last year.

**Instrument-wise Auction Summary for Q3-FY21** **Table 3.2**

billion Rupees

| | Target | Maturity | Offered* | Accepted (all) |
|---|---|---|---|---|
| T-bills | 4,025.0 | 3,908.6 | 6,783.3 | 4,825.6 |
| 3M | 1,275.0 | 2,375.8 | 4,083.8 | 3,118.8 |
| 6M | 1,375.0 | 669.3 | 2,374.4 | 1,693.5 |
| 12M | 1,375.0 | 863.4 | 325.2 | 13.3 |
| PIBs (fixed) | 325.0 | - | 436.8 | 182.4 |
| 3Y | 110.0 | - | 74.7 | 48.9 |
| 5Y | 95.0 | - | 222.7 | 78.5 |
| 10Y | 50.0 | - | 133.9 | 53.4 |
| 15Y | 35.0 | - | 2.0 | - |
| 20Y | 20.0 | - | 3.5 | 1.5 |
| 30Y | 15.0 | - | - | - |
| PIBs (floater) | 510.0 | - | 206.8 | 112.2 |
| 2Y - Quarterly | 90.0 | - | 78.7 | 79.1 |
| 3Y - Quarterly | 150.0 | - | 65.1 | 33.1 |
| 5Y - Quarterly | 30.0 | - | - | - |
| 10Y - Quarterly | 30.0 | - | 21.0 | - |
| 3Y - SA | 30.0 | - | - | - |
| 5Y - SA | 150.0 | - | 42.0 | - |
| 10Y - SA | 30.0 | - | - | - |
| GIS - VRR | 35.0 | - | 89.5 | 66.6 |
| GIS - FRR | 15.0 | - | 8.8 | 8.3 |
| **Total** | **4,910.0** | **3,908.6** | **7,525.2** | **5,195.0** |

*competitive bids only

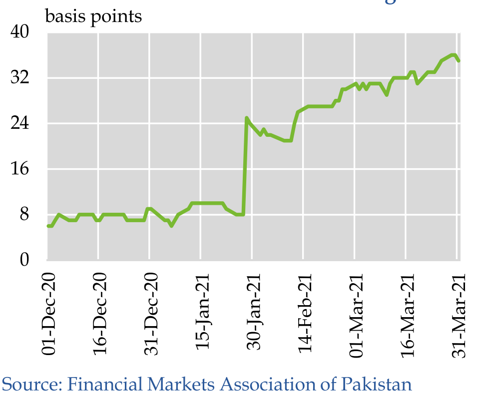
Source: State Bank of Pakistan

by continuing with fewer but most liquid issuances in the market.

### *Participation in Longer Tenor Securities Improved*

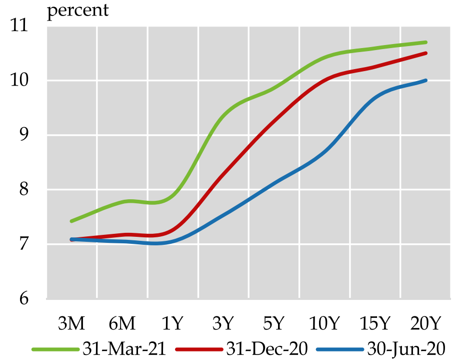
The market remained keen on investing in short-term papers, and with some adjustment in the term premium, the market's interest in 6M papers revived considerably (**Figure 3.3**). During Q3-FY21, the market placed competitive bids of Rs 2,374.4 billion for 6M papers compared to Rs 324.3 billion in Q2-FY21. Notwithstanding high offers, the cut-off rates for T-bills on-average remained 16 bps, 36 bps and 52 bps higher during Q3-FY21 compared to Q2-FY21 for the 3M, 6M and 12M T-bills respectively. This was primarily on the back of relatively strong expectations of an interest rate hike in six to twelve months period.

**6M-3M Yield** **Figure 3.3**



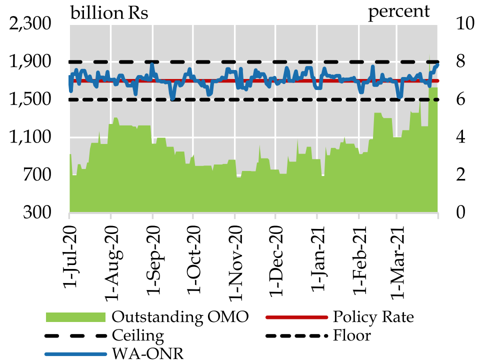

Source: Financial Markets Association of Pakistan

**Rising Secondary Market Yields** **Figure 3.4**




Source: Financial Markets Association of Pakistan

**Key Interbank Liquidity Indicators** **Figure 3.5**




Source: State Bank of Pakistan

Likewise, the offers for fixed rate PIBs also more than doubled compared to the preceding quarter. Though the participation was higher, the market demanded progressively higher yields. Consequently, medium to long term yields inched up, leading to an upward shift in the yield curve (**Figure 3.4**). The government made issuances amounting to Rs 182.4 billion of fixed coupon PIBs against a target of Rs 350.0 billion. In contrast, the market remained hesitant to invest in the floating rate PIBs as the offers fell to Rs 112.2 billion compared to Rs 1,970.4 billion and Rs 622.7 billion in Q1-FY21 and Q2-FY21 respectively.

As far as issuances of Shariah compliant instruments is concerned, only one auction took place during Q3-FY21. The government made issuances of Rs 66.6 billion of variable rental rate Sukuk and Rs 8.3 billion of fixed rental rate Sukuks against the target of Rs 35.0 billion and Rs 15.0 billion respectively. Importantly, since April 2020, the government was conducting auctions of Sukuk on a regular basis. This helped the government not only to diversify its outstanding debt, but also provided an avenue to raise financing at lower rates compared to conventional instruments.

### Interbank Liquidity:

The interbank liquidity conditions tightened as the government borrowing from the scheduled banks continued to rise. Meanwhile, with sluggish deposit mobilization, commercial banks were able to fund only a fraction of high additional liquidity needs. Therefore, in order to ensure a smooth monetary policy transmission, the SBP stepped up its OMO injections to an average level of Rs 1,158.0 billion in Q3-FY21 compared to Rs 896.6 billion in the corresponding period last year and 822.8 billion in the preceding quarter (**Figure 3.5**). In addition, the absolute deviation of overnight rates from the policy rate on average remained at 23 bps compared to 14 bps last year, reflecting a higher volatility in the overnight lending rates.

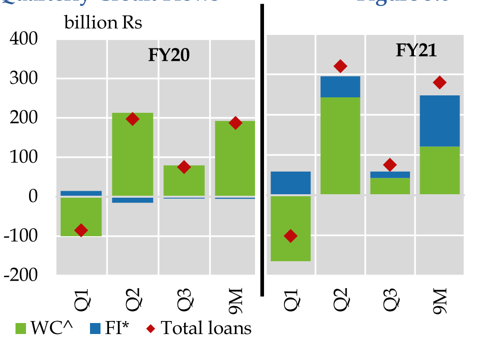
## 3.3 Credit to private sector

The first 9-month position of private credit showed an encouraging picture, as the loan off-take rose to Rs 280.0 billion in Jul-Mar FY21, compared to Rs 187.3 billion recorded in the same period last year. However, focusing only on Q3-FY21, private credit moderated, as the offtake fell from Rs 75.4 billion in Q3-FY20 to only Rs 60.5 billion in Q3-FY21 **(Figure 3.6).**

Some of the major sectors such as rice, fertilizer and refined petroleum, which had borrowed significantly in H1-FY20, made heavy retirements during Q3-FY21 (**Table 3.3**). Besides seasonal retirements by rice processing firms, a major part of these retirements can be traced to better liquidity conditions of mainly manufacturing businesses. This was consistent with higher export earnings in textile (especially of high value-added textile exports) and increased profitability in fertilizer and refined petroleum sectors.[11,12] In addition, higher sales tax refunds by the government provided further liquidity to the businesses for retiring their short-term loans.[13]

With a continued improvement in domestic demand, the overall business confidence also improved during the quarter. This, along with TERF, drove up the offtake in fixed investment loans to Rs 16.2 billion during Q3-FY21, compared to a net retirement of 4.4 billion last year.

**Quarterly Credit Flows** **Figure 3.6**




^ Working capital, *Fixed investment

Source: State Bank of Pakistan

### *Net retirements in rice and fertilizer muted working capital loans*

Rice processing sector made higher seasonal loan retirement of Rs 20.4 billion in Q3-FY21, majority of which were loans taken for harvesting needs during the preceding quarter.[14] The sector was able to retire its short-term loans on the back of higher export earnings.[15]

In case of fertilizer, the liquidity situation was relatively better this year, as the

[11] Around half of the short-term loan retirements in refined petroleum sector were made by two leading oil marketing companies that recorded net profit in Q3-FY21, compared to net loss in the same period last year.

[12] According to PBS data, exports of knitwear (33 percent), bedwear (19 percent) and towels (18 percent) posted a YoY increase in Rupee terms during Q3-FY21.

[13] Sales-tax refunds of Rs 57.0 billion were released during Q3-FY21, compared to Rs 32.9 billion during the same period last year.

[14] Third quarter is typically a period of seasonal retirements for rice processing sector. Importantly, during Q3-FY21, the sector's retirements remained on higher side compared to net retirement of Rs 7.2 billion, Rs 1.6 billion and Rs 7.7 billion during the corresponding periods in FY20, FY19 and FY18 respectively.

[15] In Rupee terms, rice exports grew by 8.1 percent during Q3-FY21, compared to a decline of 6.0 percent in the same period last year.

**Loans to Private Sector Businesses (Q3)** **Table 3.3**

(Flow in billion Rupees)

| | Total Loans* | | Working Capital** | | Fixed Investment | |
|---|---|---|---|---|---|---|
| | FY20 | FY21 | FY20 | FY21 | FY20 | FY21 |
| **Private Sector Businesses** | **75.4** | **60.5** | **79.8** | **42.2** | **-4.4** | **16.2** |
| Manufacturing | 115.0 | 80.1 | 111.1 | 55.4 | 3.9 | 23.0 |
| Sugar | 95.0 | 119.0 | 94.3 | 117.1 | 0.6 | 1.6 |
| Vegetable & animal oils and fats | -5.2 | 22.0 | -6.0 | 22.1 | 0.8 | -0.1 |
| Basic iron and steel | -9.9 | 12.2 | -5.7 | 9.8 | -4.1 | 2.3 |
| Basic pharmaceutical products | -5.2 | 1.2 | -5.0 | 2.5 | -0.3 | -1.2 |
| Paper & paper products | -4.2 | -1.3 | -3.2 | -1.1 | -1.1 | -0.2 |
| Motor vehicles | -19.2 | -0.8 | -19.2 | -4.2 | 0.1 | 3.4 |
| Cement, lime and plaster | 10.4 | -10.9 | 13.7 | -11.0 | -3.4 | 0.1 |
| Textile | 79.1 | 2.5 | 69.2 | -16.3 | 9.9 | 17.5 |
| Refined petroleum | 3.6 | -16.7 | 5.1 | -16.5 | -1.5 | -0.2 |
| Fertilizers | -18.2 | -23.1 | -12.7 | -17.2 | -5.5 | -5.9 |
| Rice processing | -7.5 | -20.5 | -7.2 | -20.4 | -0.3 | -0.1 |
| Power gen., trans., and dist. | 26.4 | 16.0 | 19.8 | 19.3 | 6.5 | -3.0 |
| Mining and quarrying | 6.8 | 5.0 | 5.5 | 3.7 | 1.3 | 1.3 |
| Construction | -3.2 | -6.8 | -0.6 | 1.0 | -2.7 | -3.2 |
| Transportation and storage | -5.0 | -0.4 | -2.8 | 0.8 | -2.2 | -1.1 |
| Real estate activities | -2.5 | 2.0 | -1.7 | 0.6 | -0.9 | 0.4 |
| Agriculture, forestry and fishing | -20.0 | -9.9 | -12.7 | -7.2 | -7.3 | -2.7 |
| Telecommunications | -4.9 | -5.4 | -3.3 | -7.6 | -1.6 | 2.2 |
| Wholesale and retail trade | -6.6 | -16.3 | -8.9 | -17.5 | 2.3 | 1.3 |

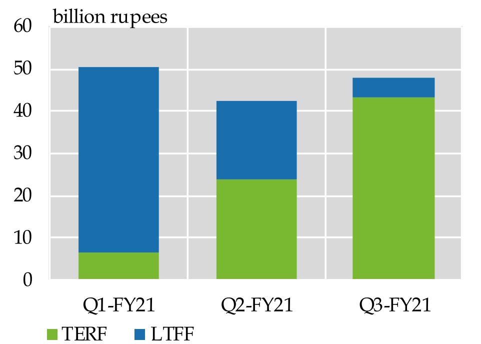
*Total loans in Q3-FY21 include Rs 2.2 billion of construction financing, as the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business (see IH&SMEFD Circular Letter No. 28 of 2020); ** working capital includes trade financing

Source: State Bank of Pakistan

sector's sales recovered in Q3-FY21, compared to the same period last year. In particular, urea offtake remained higher during the quarter. With this comfort, the sector retired Rs 17.2 billion in Q3-FY21, compared to a retirement of Rs 12.7 billion last year.

Refined petroleum retired short-term loans of Rs 16.5 billion during Q3- FY21, against an offtake of Rs 5.1 billion during Q3-FY20, when fall in domestic demand owing to the Covid-related lockdowns affected the liquidity positions of major Oil Marketing Companies (OMCs). This time around, with a revival in domestic demand for petroleum products, OMCs were able to retire their working capital loans. This is consistent with increased profitability of major OMCs during Q3-

**Gross disbursements under LTFF & TERF** **Figure 3.7**




Source: State Bank of Pakistan

FY21, which actually posted losses in Q3-FY20.

Textile firms retired their working capital loans in Q3-FY21 on the back of better liquidity position, as high value-added exports of the sector posted a YoY increase in both quantum and Rupee terms during the quarter **(Chapter 5)**. The loan retirements were despite rising input cost, as cotton prices (major input in textile) jumped by 25.1 percent during Q3-FY21, compared to an increase of 3.9 percent in Q3-FY20. Moreover, higher sales tax refunds during Q3-FY21 also supplemented the sector's liquidity position.

On the contrary, sugar sector borrowed working capital loans of Rs 117.1 billion during Q3-FY21, compared to an offtake of Rs 94.3 billion last year. The sector's borrowing need was mainly driven by relatively higher prices of sugarcane, as well as its increased production during the period under review.

Likewise, vegetable and animal oils and fats borrowed short-term loans of Rs 22.1 billion during Q3-FY21, compared to a net retirement of Rs 6.0 billion in the same period last year. This year's increase is primarily attributed to higher palm oil prices in the international market, which is mainly imported by the edible oil businesses in the country **(Section 3.4 – inflation).**

*Textile sector dominated fixed investment loans*

The borrowings under fixed investment loans were Rs 16.2 billion in Q3-FY21, compared to a net retirement of Rs 4.4 billion last year. Businesses took advantage of SBP's concessionary refinancing schemes, particularly TERF. Businesses took maximum advantage of this facility, raising the disbursements to Rs 43.3 billion in Q3-FY21 from Rs 24.0 billion during the preceding quarter **(Figure 3.7).**

Among both the manufacturing and non-manufacturing segments, textile dominated the overall fixed investment loans, as the sector borrowed Rs 17.5 billion during Q3-FY21, compared to an offtake of Rs 9.9 billion during the same period last year. While benefitting from the SBP's subsidized refinancing schemes, textile businesses borrowed long-term loans mainly to import textile machinery. This is consistent with the YoY growth in the import of textile machinery during the period under review.[16]

Apart from textile sector, automobile sector borrowed fixed investment loans of Rs 3.4 billion during Q3-FY21, compared to a marginal increase of 0.1 billion last year. The sector benefitted from TERF mainly for capacity expansion and BMR purpose.

*Consumer financing picked up the pace*

Consumer financing posted an offtake of Rs 47.1 billion in Q3-FY21, against an increase of Rs 1.5 billion last year **(Table 3.4).** While the overall loans were on an upward trajectory since the first quarter of this fiscal year, it was the hefty increase in auto finance that dominated banks'

[16] According to PBS, the import of textile machinery rose by 26.1 percent in Q3-FY21 compared to an increase of 4.9 percent in Q3-FY21.

**Consumer Financing** **Table 3.4**

(Flow in billion Rupees)

| | Q3 | | Jul-Mar | |
|---|---|---|---|---|
| | **FY20** | **FY21** | **FY20** | **FY21** |
| **Total** | **1.5** | **47.1** | **15.5** | **131.8** |
| Auto | 3.3 | 28.3 | 3.2 | 73.6 |
| Personal loans | 2.5 | 10.9 | 14.4 | 37.2 |
| House building | -2.3 | 7.4 | -5.6 | 13.8 |
| Credit cards | -2.5 | 1.5 | 2.4 | 10.0 |
| Consumer durables | 0.5 | -0.9 | 1.1 | -2.7 |

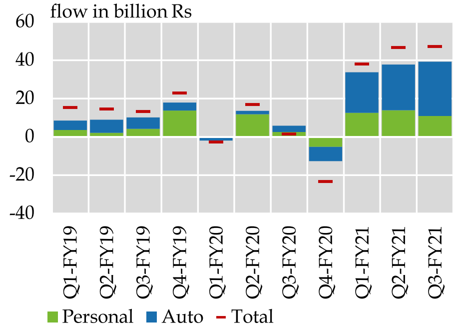
Source: State Bank of Pakistan

consumer portfolio during Jul-Mar FY21 **(Figure 3.8).**

The growth in auto finance during Q3-FY21 is mainly attributed to (i) low interest rates; (ii) rising prices of passenger cars, which affected the consumers' capacity to buy on cash; and (iii) new entrants in the automobile market, which provided wider options to the consumers. This is consistent with an across the board increase in the sales of auto assemblers during the period under review. In particular, cars in the category of below 1000cc and jeeps were in higher demand.[17]

Likewise, personal loans also picked up the pace during Q3-FY21. Besides the low interest rate environment, this increase may be viewed as the impact of Covid and the overall inflationary pressures in the economy, which might have affected the real incomes of consumers, especially the low-income group.[18]

**Consumer Financing (Quarterly flows)** **Figure 3.8**




Source: State Bank of Pakistan

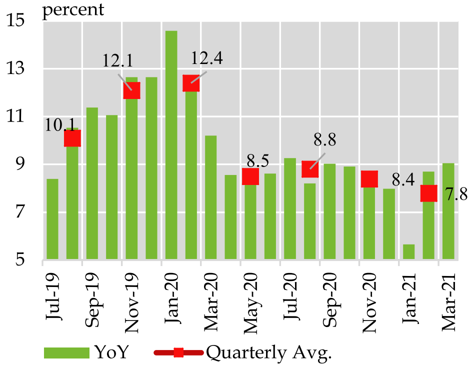
Apart from auto and personal loans, borrowings under housing finance also picked up the pace during the quarter under review. The increase is mainly driven by SBP's measures to promote housing and construction of buildings in the country. In particular, the SBP has assigned mandatory targets to banks in order to increase their housing and construction finance portfolios to at least 5 percent of their private sector credit by end-December 2021. So far (as of end-March 2021), the overall target has been achieved, as reflected by a persistent increase in the banks' housing and finance portfolio.[19]

## 3.4 Inflation

The inflationary pressures continued to ease in Jul-Mar FY21. In particular, national CPI inflation stood at 7.8 percent

[17] During Q3-FY21, the sales of below 1000cc cars more than doubled, and that of jeeps almost tripled, over the same period last year. (Source: Pakistan Automotive Manufacturers Association)
[18] On average, the index of low-end urban wages fell from 9.5 in Q3-FY20 to 5.9 in Q3-FY21. (Source: PBS)
[19] The outstanding stock of financing to the housing and construction sector increased from around Rs 149 billion in Q3-FY20 to Rs 202 billion in Q3-FY21. (Source: SBP press release, ERD/M&PRD/PR/01/2021-43, dated April 27, 2021)

**National Consumer Price Index** **Figure 3.9**



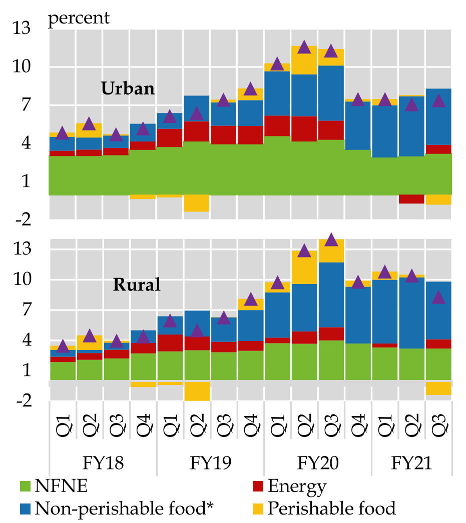

Source: Pakistan Bureau of Statistics

in Q3-FY21 compared to 12.4 percent in the same period last year and 8.4 percent in the preceding quarter. Notwithstanding the overall deceleration, CPI inflation remained volatile during the quarter as both low and high inflation outturns were registered (**Figure 3.9**). In fact, average inflation in Feb-Mar FY21 was 8.9 percent, higher than the preceding quarter.

In January 2021, national CPI inflation decelerated to 5.7 percent – the lowest in any month since January 2019. This level reflected a steep deceleration in the food group (**Figure 3.10**) and base effect. In particular, inflation in perishable food group declined amid improved availability of important vegetables such as tomatoes, potatoes and onions, which helped plug the demand-supply gap, resulting in softening in prices. In addition, inflation in poultry group also decelerated on account of the supply correction after witnessing a substantial rise in previous months on account of the demand-supply gap and rising feed prices.

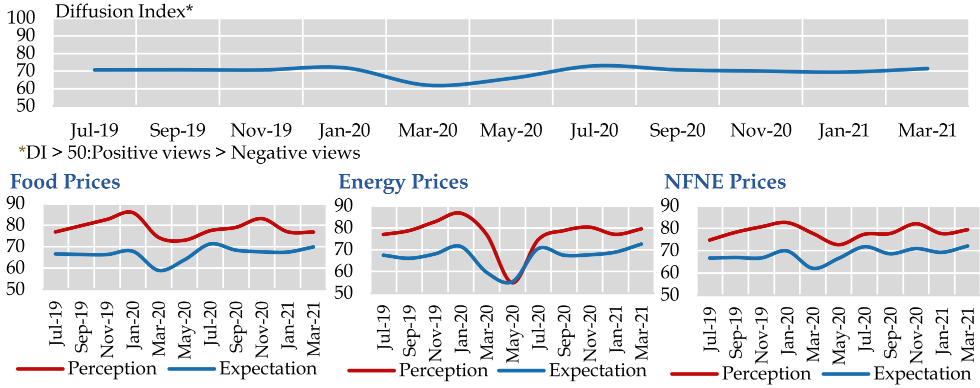
However, inflation picked-up in the subsequent months. Particularly in March 2021, inflation increased due to: (i) hike in electricity prices on account of the base tariff, quarterly adjustments and fuel charge adjustments; (ii) rise in sugar and edible oil prices; (iii) higher inflation in cotton-cloth and ready-made garments groups on account of the surge in input prices as domestic and global cotton prices have been on rising trajectory since the start of FY21; (iv) rise in the prices of foot-wear by local producers after keeping prices of some variants unchanged during previous year; and (v) surge in poultry inflation amid disrupted supply on the back of work related uncertainty of restaurants and marriage halls on account of the third wave of Covid and further rise in input prices. Also, the Wholesale Price Index (WPI) posted a 13-month high inflation in March 2021, indicating emerging cost-push inflationary pressures.

**Composition of YoY CPI Inflation** **Figure 3.10**




*Inclusive of alcohol beverages and readymade food
Source: Pakistan Bureau of Statistics

**Inflation Expectation Survey** **Figure 3.11**




Source: State Bank of Pakistan

Finally, the underlying inflationary pressures – measured by the non-food-non-energy (NFNE) index – remained broadly stable during the quarter, similar to Q2-FY21. However, increase in a few items (in February and March 2021) brought a marginal uptick in urban NFNE in Q3-FY21.

### *Surveys suggested broadly anchored inflation expectations*

The indicators of inflation expectations, gauged by the IBA-SBP Consumer Confidence Survey (CCS), presented a mixed picture during the quarter (**Figure 3.11**). The overall inflation expectations for the next six months subsided in January 2021 survey compared to previous iteration in November 2020 on account of the food and NFNE group. However, in March 2021, all the three categories (food, energy and NFNE) caused upward shift in the index, mainly reflecting surging electricity prices, after having experienced near stability in H1-FY21.

### *Inflationary pressure on food group subsided*

Food inflation softened significantly after posting consecutive double-digit inflation for the past six quarters. Specifically, it decelerated to 9.7 percent and 9.1 percent for urban and rural segments respectively in Q3-FY21, compared to 15.8 percent and 19.6 percent during the same period last year. Inflation in both non-perishable items and perishable items decelerated; however, deflation in perishable food group mainly arrested the inflationary pressures in the overall food group (**Figure 3.12**).

### *Inflation in non-perishable items decelerated*

In Q3-FY21, price of wheat continued its seventeen-month double-digit rising streak on a YoY basis ranging from 11.7 percent to 52.2 percent, albeit at a slightly slower pace.[20] Decelerating pace of inflation is attributed to narrowing supply-demand gap as around 3.6 MMT of wheat has been imported during Jul-Mar

[20] Leading the upward trend for a sixth month among major food items, the wheat price increased by around 26 percent year on year during Q3-FY21, both for urban and rural areas

**Inflation Heat-map-Urban (YoY)*** **Figure 3.12**

| | Mar-20 | Apr-20 | May-20 | Jun-20 | Jul-20 | Aug-20 | Sep-20 | Oct-20 | Nov-20 | Dec-20 | Jan-21 | Feb-21 | Mar-21 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Food & non-alcoholic Bev. | 13.7 | 10.7 | 10.9 | 13.8 | 16.9 | 11.9 | 13.3 | 14.9 | 13.7 | 13.1 | 6.7 | 10.5 | 11.9 |
| Wheat | 19.3 | 16.8 | 11.7 | 22.1 | 28.5 | 44.3 | 42.1 | 52.2 | 36.6 | 24.2 | 19.2 | 23.8 | 35.2 |
| Wheat flour | 13.5 | 14.8 | 13.0 | 24.5 | 18.5 | 23.4 | 20.2 | 24.7 | 13.3 | 13.4 | 7.2 | 13.5 | 18.9 |
| Chicken | 4.2 | -28.8 | 4.9 | 18.5 | 36.7 | -38.3 | -23.6 | 18.2 | 46.8 | 67.4 | 1.8 | 36.3 | 40.7 |
| Cooking oil | 26.7 | 22.2 | 20.7 | 20.2 | 17.3 | 11.4 | 11.1 | 11.4 | 10.1 | 10.6 | 13.7 | 15.4 | 15.2 |
| Potatoes | 107.5 | 92.3 | 96.9 | 72.0 | 63.0 | 62.4 | 67.2 | 53.1 | 56.1 | 38.3 | -4.6 | -4.6 | -5.8 |
| Onions | 92.2 | 40.7 | -21.2 | -35.6 | -19.6 | -33.0 | -30.8 | -8.3 | -6.6 | -24.4 | -30.4 | -29.7 | -49.2 |
| Tomatoes | -71.1 | -55.4 | -39.5 | -22.9 | 100.2 | -0.7 | 51.9 | 66.9 | -22.6 | -11.2 | -32.2 | -29.5 | -3.8 |
| Sugar | 30.9 | 27.8 | 20.1 | 14.7 | 17.0 | 28.0 | 25.4 | 33.0 | 35.8 | 15.3 | 25.9 | 17.2 | 23.5 |
| Clothing & footwear | 9.9 | 9.5 | 9.5 | 10.1 | 9.4 | 8.0 | 8.0 | 8.0 | 9.1 | 8.8 | 8.5 | 12.3 | 11.5 |
| Cotton cloth | 11.8 | 10.3 | 9.7 | 11.6 | 10.9 | 9.9 | 8.9 | 8.8 | 12.5 | 12.5 | 12.6 | 14.7 | 15.8 |
| Footware | 11.5 | 11.5 | 11.4 | 11.4 | 11.4 | 6.3 | 6.3 | 6.4 | 6.1 | 6.2 | 7.3 | 23.0 | 16.2 |
| Housing, water, Elec. | 5.1 | 5.1 | 6.5 | 5.6 | 3.6 | 5.4 | 5.5 | 2.3 | 2.2 | 2.8 | 2.9 | 10.0 | 8.2 |
| Electricity charges | -13.9 | -5.9 | 1.4 | -3.5 | -0.2 | 11.4 | 11.8 | -7.8 | -9.9 | -6.0 | -4.4 | 43.1 | 31.5 |
| Transport | 12.2 | 4.1 | -6.5 | -9.5 | -4.8 | -3.7 | -1.6 | -1.7 | -4.5 | -3.6 | -2.8 | -0.8 | 3.2 |
| Motor fuel | 16.3 | 0.4 | -19.5 | -28.0 | -9.8 | -10.3 | -7.1 | -7.1 | -9.5 | -8.8 | -6.6 | -5.3 | 1.0 |
| Readymade food | 8.2 | 7.7 | 7.4 | 8.0 | 7.0 | 8.8 | 8.7 | 9.4 | 9.7 | 10.6 | 10.8 | 9.5 | 10.1 |
| **Rural Inflation-YoY** | | | | | | | | | | | | | |
| Food & non-alcoholic Bev. | 15.8 | 12.8 | 13.7 | 15.5 | 18.7 | 14.0 | 16.4 | 18.4 | 16.7 | 13.5 | 6.6 | 8.9 | 11.2 |
| Wheat | 24.3 | 21.9 | 13.9 | 20.7 | 30.4 | 41.1 | 45.1 | 51.1 | 37.9 | 28.1 | 24.4 | 23.1 | 32.5 |
| Wheat flour | 18.0 | 18.1 | 14.9 | 23.2 | 21.6 | 26.2 | 26.7 | 29.4 | 19.6 | 15.8 | 13.7 | 16.6 | 20.8 |
| Chicken | -2.4 | -28.5 | 4.9 | 13.7 | 35.7 | -27.0 | -19.4 | 15.6 | 41.0 | 63.2 | 2.3 | 27.3 | 50.1 |
| Cooking oil | 29.6 | 26.8 | 24.6 | 23.5 | 17.6 | 14.0 | 13.5 | 14.1 | 15.2 | 15.8 | 15.5 | 18.9 | 20.5 |
| Potatoes | 120.7 | 103.5 | 126.6 | 100.6 | 88.1 | 65.1 | 71.3 | 61.0 | 78.5 | 47.0 | -7.9 | -10.1 | -6.3 |
| Onions | 100.9 | 38.9 | -13.7 | -36.3 | -20.9 | -38.7 | -36.2 | -2.6 | -8.8 | -27.6 | -32.6 | -30.2 | -50.5 |
| Tomatoes | -72.9 | -56.3 | -45.5 | -27.1 | 129.3 | 11.9 | 57.1 | 104.0 | -23.0 | -12.9 | -36.2 | -34.3 | -3.0 |
| Sugar | 31.4 | 24.5 | 19.3 | 14.0 | 16.6 | 25.5 | 25.3 | 33.4 | 42.5 | 12.8 | 23.5 | 15.1 | 22.7 |
| Clothing & footwear | 12.3 | 11.0 | 11.4 | 12.2 | 11.5 | 10.6 | 10.5 | 10.1 | 9.9 | 10.6 | 10.7 | 10.1 | 9.7 |
| Cotton cloth | 16.5 | 14.8 | 15.1 | 18.1 | 17.3 | 15.3 | 14.8 | 13.6 | 11.7 | 11.3 | 12.5 | 11.7 | 11.8 |
| Footware | 10.8 | 9.8 | 10.9 | 10.6 | 9.4 | 8.8 | 8.8 | 9.4 | 9.1 | 11.6 | 9.5 | 8.6 | 6.0 |
| Housing, water, Elec. | 4.6 | 5.2 | 6.0 | 4.9 | 5.5 | 7.2 | 7.4 | 3.7 | 3.6 | 4.9 | 4.5 | 12.2 | 10.1 |
| Electricity charges | -13.9 | -5.9 | 1.4 | -3.5 | -0.2 | 11.4 | 11.8 | -7.8 | -9.9 | -6.0 | -4.4 | 43.1 | 31.5 |
| Transport | 10.2 | 2.3 | -9.0 | -11.5 | -3.8 | -3.0 | -1.4 | -1.1 | -3.5 | -3.3 | -2.2 | -1.2 | 2.4 |
| Motor fuel | 15.7 | -0.9 | -21.5 | -30.1 | -10.0 | -10.5 | -7.2 | -7.2 | -9.9 | -9.2 | -6.8 | -5.4 | 1.4 |
| Readymade food | 11.5 | 11.0 | 12.1 | 12.4 | 12.0 | 11.6 | 13.1 | 14.0 | 14.1 | 14.6 | 14.4 | 12.5 | 11.9 |

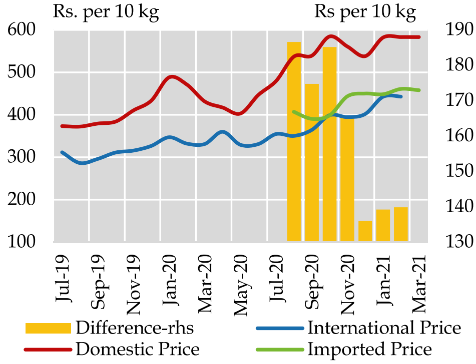
* lighter shades depict lower (and negative) inflation and darker shades indicate higher inflation on YoY basis.

Source: Pakistan Bureau of Statistics

FY21. However, the pace of imports decelerated in Q3-FY21 on account of the rising international prices of wheat, particularly in January 2021, and sufficient domestic availability of the grain (**Figure 3.13**). Similarly, despite sugar being a major contributor to the overall food inflation, its inflation decelerated both on YoY and QoQ basis as the commodity's price softened from November 2020 onwards, after the import of around 279,000 MT of sugar since July 2020.

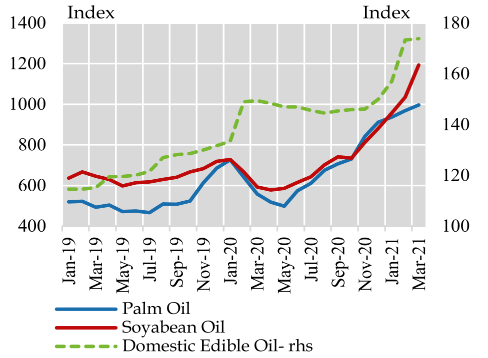
Inflation in pulses registered a significant deceleration during Q3-FY21 despite reduced import quantum during the review period and around 15.6 percent YoY rise in imported unit values.

**Wheat Prices** **Figure 3.13**




Source: World Bank, PBS

**Edible Oil** **Figure 3.14**




Source: IMF, PBS

Improved domestic production (Mash and Mung bean) provided respite to inflationary pressures in this group. [21]

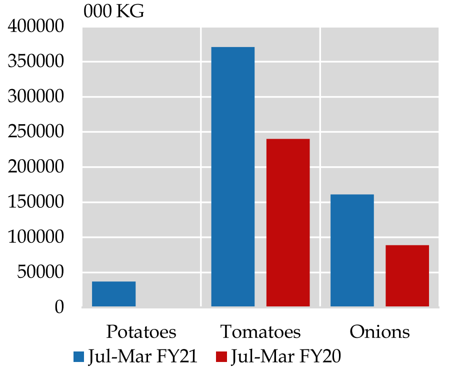
Some food items, on the other hand, posted rising inflation during the review period. For instance, condiments and spices remained one of the biggest contributors in food inflation during Q3-FY21 both in urban and rural areas. Disaggregated data reveals that red chilies powder dragged-up the overall index. Trade data shows that 162.5 thousand kg powder chilies were imported to fill in the supply demand gap during Jul-Mar FY21, compared to 0.4 thousand kg last year. As per Ministry of National Food Security & Research (MNFSR) recent estimates, both area and production reduced significantly for chilies crop in FY21 compared to last year.[22]

The persistent increase in the edible oil price index, observed since the start of FY21, was further strengthened by higher global inflation in palm and soybean. Rise in edible oil inflation was mainly cost-led as bullish international prices of palm oil and soybean significantly increased import cost. International palm oil prices have been on upward trajectory since June 2020 on account of the tight inventory levels in major exporting countries (**Figure 3.14**). In view of the rising cost, Economic Co-ordination Committee (ECC) also approved increase in subsidized ghee price of Rs 25 per kg at Utility Stores Corporation (USC) by end-February 2021. Unlike the overall slowdown in inflation in food group, inflation in readymade food surged to double-digits both in urban and rural areas in Q3-FY21. Rise in cooking oil, wheat and poultry prices fed into cooked food prices, escalating the second-round

[21] Imports of pulses declined by 1.9 percent during Jul-Mar FY21 compared to same period last year mainly due to 22.9 percent less imports in Q3-FY21 amid improved local production of pulses. However, in H1-FY21, imports rose by 13.0 percent compared to last year.

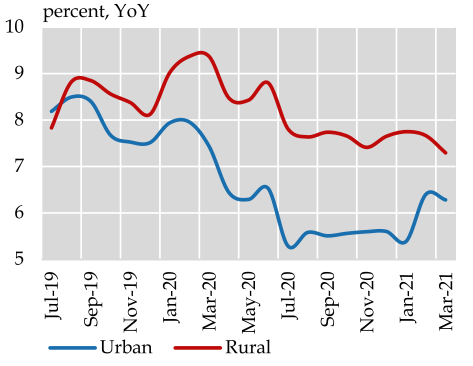
[22] Cultivated area of chilies declined by 24.8 percent, whereas total production was reduced by 26.7 percent.

**Prishable Items Import** **Figure 3.15**




Source: Pakistan Bureau of Statistics

**NFNE Growth** **Figure 3.16**




Source: Pakistan Bureau of Statistics

impact, which was stronger for readymade food segment within the inflation basket.

### *Perishable food items registered deflation*

The perishable-food index registered a 16.8 percent decline compared to 32.8 percent increase during same period last year. For instance, improved supplies of tomatoes kept the prices stable during the review period. Smooth local production of tomatoes[23] along with sufficient imports caused prices to remain stable, unlike the previous year where prices registered unprecedented hike amid delayed harvests, import barriers and structural weaknesses in the overall price control mechanism.[24]

Similarly, onion and potato prices remained stable in Q3-FY21. Sufficient local production along with imports have flushed the market with vegetables during the review period, causing deflation on a YoY basis (**Figure 3.15**).[25]

### NFNE inflation remained broadly stable

After staying within the range of 5.3 percent to 5.6 percent YoY throughout July 2020 to January 2021, core inflation for urban areas jumped by 100 basis points in February 2021 to 6.4 percent from 5.4 percent in January 2021 (**Figure 3.16**). In rural areas, on the other hand, NFNE inflation decelerated to 7.3 percent in March 2021 after staying within the range of 7.4 percent to 7.8 percent YoY throughout July 2020 to February 2021.[26]

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[23] Local production of tomatoes registered an increase of 12.8 percent in FY21.
[24] For details of last year's developments, see Chapter 3 of the SBP's Second Quarterly Report for FY20 on The State of Pakistan's Economy
[25] Local production of potato registered an increase of 2.8 percent during FY21.
[26] Rural NFNE has outpaced urban NFNE almost since the publication of separate indices. However, the gap significantly widened after January 2020. Analysis for the stated period suggests that house rent, construction inputs and wage rates, water supply, household furniture and miscellaneous goods and services registered significantly higher inflation in rural areas compared to urban areas. One of the

Broadly speaking, core inflation remained stable and has actually declined in rural areas in March 2021. Stability in the overall NFNE inflation (both urban and rural segments) can be attributed to: (i) existence of spare capacity in the economy; (ii) stable exchange rate environment; and (iii) muted fuel prices on a YoY basis. However, a few items caused NFNE to rise in urban basket.

Within urban NFNE, services index continued to decelerate in Q3-FY21; however, goods index registered rise in inflation owing to increase in clothing and footwear group during the review period. The price of cotton, an important industrial input for textiles, witnessed unabated spike during Q3-FY21 as its lower local production continued to widen the demand-supply gap. Due to increase in the prices of cotton yarn, the cotton cloth, readymade garments and hosiery items witnessed strong inflationary pressures. Also, footwear posted significant rise in inflation as two of the major producers increased prices of shoes and slippers for all three categories of gents, ladies and children after keeping prices unchanged for some variants last year.

In case of rural NFNE, both services and goods indices decelerated in Q3-FY21; however, the impact of the latter was more prominent. Prices for some components that fell sharply because of government relief and weak demand early in the pandemic have continued to hold down inflation. Examples include education fee, furniture prices, and hotel accommodation charges as well as transport charges. In addition to this, the group of construction inputs (cement, bricks, bajri and sand) registered deceleration mainly on account of the declining price of bricks. In personal items, deceleration is attributed to declining prices of gold in response to global trends on account of the weaker demand for the metal and low cost of imports.

In the perspective of stable inflation, post lockdown analysis, March 2020 onwards, suggests that prices of around 30 percent NFNE items remained almost unchanged (0 - 0.05 difference) at least for 6 of the last 12 months (**Figure 3.17**).[27] The unchanged indices reflect weak demand for those items, declining metal and fuel prices in international market as well as tax relief provided in budget FY20, such as motor vehicle tax etc.

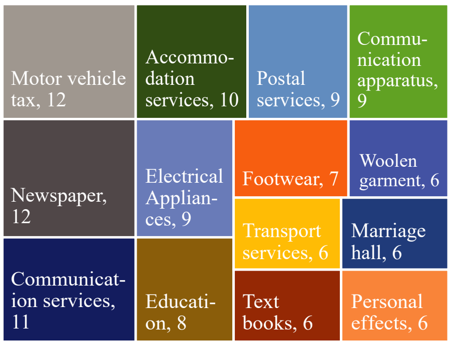
### Energy inflation resurged

Energy inflation remained muted in HI-FY21, both for the urban and rural segments. However, in Q3-FY21, the trends reversed as inflation bounced back after registering deflation for last two consecutive quarters. Disaggregated analysis reveals that the major increase in the energy index is attributed to upward

factors behind the difference in urban and rural core inflation is different consumption baskets (rural NFNE basket contains around 137 items whereas urban basket contains 236 items. In terms of mutually common items, only 124 number of items are common between urban-NFNE and rural-NFNE segments as around 13 items in rural basket are not part of urban NFNE basket) along with difference in weights.

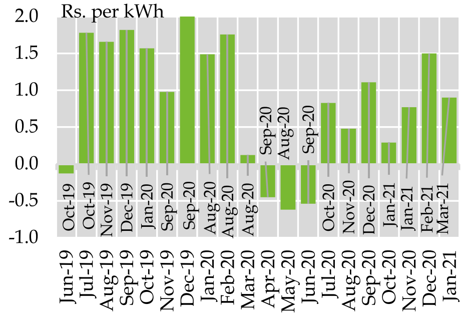
[27] Index of some items typically register less changes during the year like motor vehicle tax, postal services and newspapers etc. However, index of other items such as personal effects, electrical appliances and transport services changes frequently during the year.

**Unchanged NFNE Items** **Figure 3.17**




Source: Pakistan Bureau of Statistics

**Fuel Charge Adjustment** **Figure 3.18**




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

revision in electricity tariffs. Whereas, motor fuel and liquefied hydrocarbons indices continued to post deflation and gas index remained unchanged.

In case of electricity, a significant YoY inflation hike was observed during Q3-FY21 as authorities stepped-up their efforts to implement some critical policy measure to contain the accumulation of circular debt in the energy sector. These measures include: (i) increase in base tariff of Distribution Companies (Discos) as notified by National Electric Power Regulatory Authority (NEPRA) for all consumers (including life-line consumers consuming up to 50 units per month[28] and (ii) notification of the Q2-FY20 and Q3-FY20 quarterly tariff adjustments (QTAs) in December 2020 and Q4-FY20 QTA in February 2021. Moreover, monthly fuel charge adjustments also contributed to rise in inflation (**Figure 3.18**)

Domestic fuel prices, on the other hand, rose during the quarter under review in response to increase in global fuel prices.[29] However, the previous fall in fuel prices on account of the Covid-related sluggish global demand outlook continued to weigh on CPI inflation in Q3-FY21 on a YoY basis. Thus, the revised electricity tariffs, to address power sector issues, contributed to the rise in the overall energy inflation in Q3-FY21.

[28] The base tariff was raised by Rs 1.95/kWh.

[29] The recent rise in global oil prices reflects improved global growth prospects (with the arrival of vaccines) which could boost demand for oil-intensive activities. In addition to global recovery, cut in oil production by some OPEC countries also put pressure on prices.