3 Monetary Policy and Inflation

In response to the recovery in domestic demand, emerging inflationary pressures, and a widening current account deficit, SBP increased the policy rate by 25 basis points to 7.25 percent in Q1-FY22. This proactive policy approach was aimed at ensuring the sustainability of growth and keeping inflation expectations anchored. Meanwhile, credit to the private sector increased during Q1-FY22, compared to net retirements during the same period last year. Despite seasonal loan retirements in sugar and rice processing sectors, the overall demand for working capital loans increased, mainly due to the rising input costs, revival in economic activity and recovery in business confidence. Furthermore, SBP's TERF scheme drove up fixed investment loans, whereas consumer financing continued to accelerate with major impetus from automobile and housing segments. On the inflation front, YoY CPI inflation that was declining since May 2021, inched up by end-Q1-FY22, though on aggregate basis, it weakened slightly in Q1-FY22 over Q1-FY21. While core inflation remained broadly stable and energy inflation was higher, the ease in the headline number was mainly due to stable food inflation. Inflation expectations, which were broadly anchored in July 2021, drifted up in September 2021.

3.1 Policy Review

Monetary policy in Pakistan shifted gears in Q1-FY22. With an increase in the policy rate of 25 basis points, the 14-month long spell of unchanged monetary policy settings ended during the review period. Though the outlook at the start of the fiscal year appeared encouraging, pressures emerged on various fronts by the end of the quarter. In particular, rising domestic demand, external sector vulnerabilities and upside risks to inflation had become more prominent. Higher inflation outturns were also expected later in the fiscal year mainly due to higher imported inflation driven by rising global commodity prices.

By the start of FY22, the macroeconomic rebound from the Covid-led downturn strengthened further. High-frequency demand indicators continued to show robust growth. For instance, sales of Fast Moving Consumer Goods (FMCGs) and domestic cement sales registered significant increase in FY21 as compared to the last year.[1,2] Similarly, import and local production of steel also increased. Energy demand also remained strong, reflecting the continued recovery in economic activity.[3] Similarly, large-scale manufacturing (LSM) continued to maintain strong growth, reflective of the ongoing positive momentum in the economic activity.[4]

By the time MPC met in July 2021, inflation, although at an elevated level, had declined from 11.1 percent in April 2021 to 9.7 percent in June 2021. For the first time in June 2021, since January 2021, food prices fell on account of the government's administrative measures and relatively better production of wheat and sugar. Moreover, core inflation remained stable in both urban and rural areas, indicating that the energy and food-driven inflation had not seeped into general

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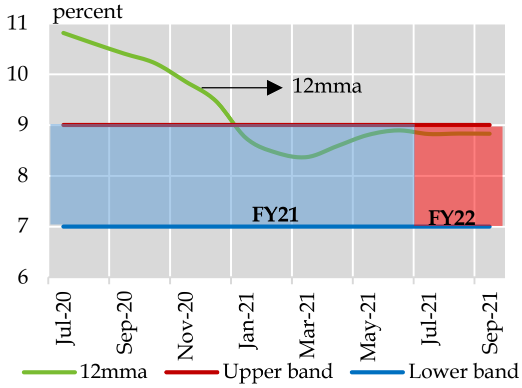
[1] The cumulative sales of 26 listed FMCG companies grew by 22.7 percent in FY21 compared to 6.8 percent a year ago.
[2] Cement sales rose by 20.4 percent in FY21 compared to 0.9 percent decline last year.
[3] POL sales registered an increase of 16.3 percent during FY21 compared to 11.7 percent decline last year.
[4] LSM rose by 14.9 percent in FY21 compared to 9.8 percent decline last year.

CPI Inflation Projection and 12MMA **Figure 3.1**



Source: Pakistan Bureau of Statistics and State Bank of Pakistan staff estimates

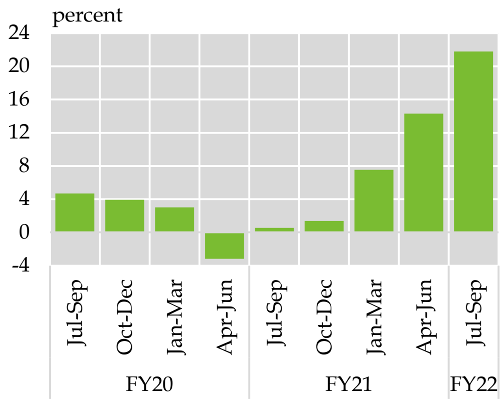
prices. In addition, inflation expectations fell in July 2021. Keeping in view these developments, the inflation forecast was announced at 7-9 percent for FY22, subject to both downward and upward risks (**Figure 3.1**).[5] Moreover, despite the surge in international oil prices, downward adjustments in the Petroleum Development Levy (PDL) by the government helped arrest the domestic pass-through.

In view of the continued domestic recovery and improved inflation outlook following the decline in food and core inflation, the MPC decided to keep the policy rate unchanged at 7 percent in its July 2021 decision. However, the MPC stated that monetary policy would begin to normalize if signs of demand-led pressures on inflation or vulnerabilities in the current account appeared.

As the quarter progressed, the pressures on current account deficit and inflation began to emerge, causing a reassessment of the outlook and also the policy stance, by the time MPC met in September 2021. Two factors particularly fed into the decision to raise interest rates: (i) current account deficit increased to US$ 0.8 billion and US$ 1.5 billion in July 2021 and August 2021 respectively, mirroring both increasing domestic demand and elevated global commodity prices; (ii) though YoY inflation declined in July 2021 and August 2021, the momentum of rising prices remained relatively higher with month-on-month rise of 1.3 percent and 0.6 percent respectively. Moreover, inflation expectations of both households and businesses had inched-up compared to the earlier survey iteration. In addition, wage inflation also picked up in July 2021 as the economic recovery strengthened. Going forward, higher inflation outturns were expected on account of imported inflation amid pass through of global commodity prices into domestic prices, particularly of energy, and the path of domestic demand (**Figure 3.2**).

With the changed economic outlook, the MPC unanimously decided to increase the

Growth in Unit Value Index of Imports **Figure 3.2**



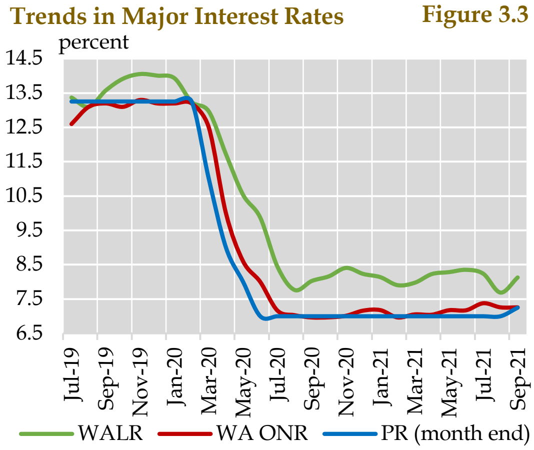
Source: Pakistan Bureau of Statistics

[5] The downside risk was associated with resurgence of Covid-19, whereas the upside risks include higher than expected increase in international commodity prices, rise in domestic energy tariffs, unfavorable exchange rate movement and unexpected fiscal expansion.

policy rate by 25 bps, to 7.25 percent. Nonetheless, as noted in the Monetary Policy Statement (MPS), the stance of monetary policy was still appropriate to support growth. In addition, it was reiterated that a greater emphasis was required on the appropriate policy mix to safeguard the durability of growth, keep inflation expectations anchored, and slow the growth in the current account deficit given reduced pandemic-related uncertainty in the economy.

Notwithstanding the policy decision of raising the rate took place by end-September 2021, an accommodative policy environment had persisted for most of the quarter: real interest rates remained negative on forward-looking basis and the availability of SBP's usual concessionary refinance schemes (LTFF, TERF) kept funding costs low reflecting conducive financial conditions for businesses (**Figure 3.3**). Consequently, overall private sector credit increased during Q1-FY22 despite the fact that first quarter of the year normally registers retirements on account of seasonal retirements by sugar and

Trends in Major Interest Rates **Figure 3.3**



Source: State Bank of Pakistan

rice sectors. The accommodative policy environment and rebound in the economic activities, both domestic and exports, drove up fixed investment loans (under TERF), working capital requirements and consumer financing. In addition to the overall rise in economic activity and improvement in business confidence,[6] rising input costs (especially cotton and edible oil) also escalated the demand for working capital loans.

3.2 Monetary Aggregates

Broad money growth slowed to 0.6 percent during Q1-FY22 compared to an expansion of 1.2 percent during the same period last year. This expansion emanated from growth in the Net Domestic Assets (NDA) of the banking system, which was partly offset by the contraction in the Net Foreign Assets (NFA). Last year, conversely, money supply growth was driven entirely by the NFA's expansion (**Table 3.1**).

Monetary Aggregates (Q1)[P] **Table 3.1**

billion Rupees; growth in percent

	Change in Stock		Growth	
	FY21	**FY22**	**FY21**	**FY22**
M2 (A+B)	260.5	149.5	1.2	0.6
A. NFA	307.3	-32.9	59.5	-4.5
B. NDA	-46.8	182.4	-0.2	0.8
Bud. borrowing*	285.2	-33.5	2.1	-0.2
SBP	-281.9	-322.9	-4.3	-6.0
Sch. banks	567.1	289.5	7.9	2.9
Com. operations	-59.9	9.5	-7.4	1.1
Pvt. sector credit	-76.6	226.4	-1.1	3.0
PSEs	-11.9	11.6	-0.8	0.8
Other items net	-184.9	-31.3	-12.3	-1.7
Reserve money	-149.0	-195.9	-1.9	-2.3

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 in Chapter 4.
Source: State Bank of Pakistan

[6] Please see Figure 3.8 for detailed analysis.

On the asset side, the NDA registered growth on the back of high private sector credit off-take, and increased lending to public sector enterprises and government commodity procurement agencies. Despite being a period of seasonal retirements, private sector credit recorded a sizable expansion of Rs 226.4 billion during Q1-FY21 compared to net retirements of Rs 76.6 billion in the same period last year. In contrast, there were net budgetary retirements to the banking system, mainly due to retirements made to the SBP.

With regards to NFA, amid ongoing increase in international commodity prices and as domestic economic recovery gained traction, rising imports put pressure on external sector. The main impact came from the contraction in the NFA of SBP. Debt servicing and FX operations combined more than offset the impact of inflows from issuance of Eurobonds and funds received through Roshan digital accounts during Q1-FY22. Meanwhile, the allocation of SDRs amounting to US$ 2.75 billion under IMF's general SDR allocation had no effect on the NFA of SBP. As a result, NFA of the banking system contracted Rs 32.9 billion, after expanding Rs 307.3 billion last year.

On the liability side, currency in circulation grew by 1.6 percent during Q1-FY22, compared to a decline of 0.7 percent during Q1-FY21, whereas deposit mobilization slowed to only 0.2 percent from 2.0 percent in the same period last year. This slowdown in deposit growth was partly due to high base effect of deposits at end-June 2021. [7] Besides this, private business deposits contracted by Rs 101.4 billion compared to an increase of Rs 104.8 billion in the same period last year. This reflects high liquidity needs of businesses on account of high input costs and a visible pick-up in domestic economic activity which were partly financed by deposit withdrawals.

Government Borrowings

Meanwhile, the government made net budgetary retirements of Rs 33.5 billion to the banking system during Q1-FY22, compared to borrowings of Rs 285.2 billion during Q1-FY21. A lower budget deficit compared to last year, availability of sizable external financing (higher than the budget deficit itself), and higher mobilization from the non-bank sector, cumulatively helped reduce the government's reliance on the domestic banking system for financing during Q1. Instead, the government made net-retirements to SBP to the tune of Rs 322.9 billion, adhering to its commitment of zero-borrowings from the central bank. Meanwhile, fresh borrowings of Rs 289.5 billion were made from commercial banks.

Primary Auctions

The government's pre-auction target remained skewed towards T-bills and floating rate PIBs on net-of-maturity basis. For fixed rate PIBs, the target for Q1-FY22 was Rs 603.0 billion less than the maturities due during the quarter, in anticipation of mobilizing higher funds from floaters and T-bills (**Table 3.2)**.

For T-bills, market participation relative to targets remained high. Especially for 3M and 6M T-bills, the offer-to-target ratio was 2.5 times and 3.0 times respectively. In comparison, the 12M paper attracted only half the amount of offers relative to the target

[7] During June 2021, the deposits increased by Rs 1.45 trillion on MoM basis compared to an increase of Rs 1.04 trillion in June 2020.

Auction Summary **Table 3.2**

billion Rupees

	Target	Maturity	Offered*	Accepted
Treasury bills				
Q1-FY22	4,700.0	4,174.6	9,335.2	4,425.4
Q1-FY21	1,800.0	2,703.8	5,112.4	2,047.3
Pakistan Investment Bonds				
Fixed Rate				
Q1-FY22	450.0	1,053.0	943.9	399.6
Q1-FY21	420.0	101.4	448.9	249.2
Floating Rate				
Q1-FY22	525.0	0.0	1,330.6	916.8
Q1-FY21	830.0	0.0	1,970.4	870.6

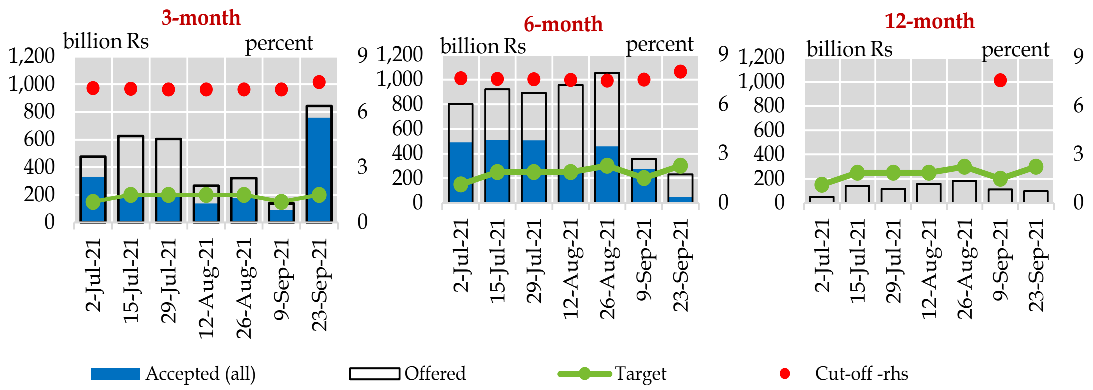
*competitive bids only

Source: State Bank of Pakistan

for Q1-FY22, indicating market's expectation of bottoming out of interest rates. In six auctions that were held before the policy rate hike, the government remained keen on not increasing the cut-off rates. In fact, the cut-off rates fell by 9 bps, 10 bps and 7 bps for 3M, 6M and 12M papers respectively from the last auction of June 2021 and before the announcement of the September 2021 monetary policy. The trend reversed in the last auction of the quarter, when the cut-off rates were increased subsequent to the MPC's announcement of a 25 bps increase in the policy rate (**Figure 3.4**).[8] As a result, the government was not able to meet the target assigned for T-bills. Additionally, the secondary market yields also followed a similar trend, and the yield curve shifted upwards only after the hike in the interest rates (**Figure 3.5**). Thereby indicating little or no expectations of a rate hike in the September 2021's monetary policy decision.

Within long-term bonds, the government remained inclined towards allocating higher targets to floating rate debt instruments. On net-of-maturity basis, the cumulative targets for floaters stood at Rs 525.0 billion, against net retirements of Rs 603.0 billion envisaged for fixed rate PIBs. Market offers for fixed rate PIBs stood at Rs 943.9 billion while for floaters the market offered Rs 1,330.6 billion. Keeping in view higher yields demanded by the market compared to the prevailing cut-offs, the government accepted only Rs 399.6 billion from fixed coupon PIBs. In this

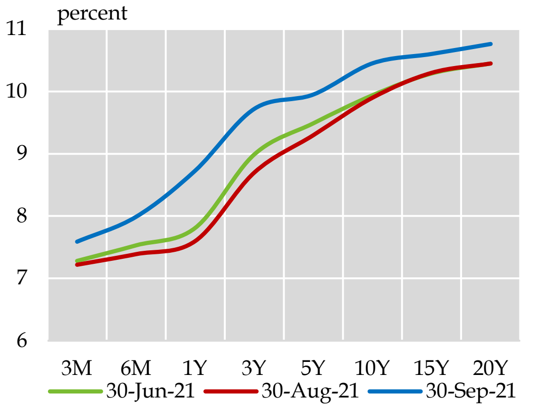
Bidding Pattern in T-bill Auctions during Q1-FY22 **Figure 3.4**



Source: State Bank of Pakistan

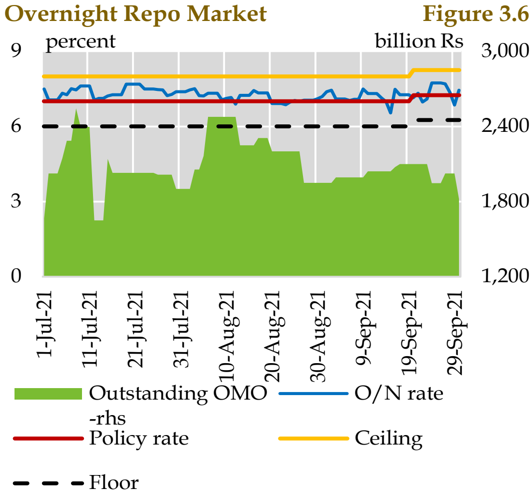
[8] In response to policy rate hike of 25 bps, the cut-off rates for 3M and 6M rose by 40 bps and 49 bps respectively.

Secondary Market Yields **Figure 3.5**



Source: Financial Markets Association of Pakistan

Overnight Repo Market **Figure 3.6**



Source: State Bank of Pakistan

backdrop, floaters helped the government to raise medium-to-long term debt while providing an alternative to the market to avoid building additional duration risk on their books.[9] Given these favorable traits of floaters, the government was able to raise Rs 916.8 billion via issuances of floating rate PIBs. Moreover, 3Y quarterly coupon PIBs remained the market's most favored instrument floaters.

Interbank Liquidity

Sizable private sector credit off-take, fresh budgetary borrowings from scheduled banks, and SBP's foreign exchange operations cumulatively augmented the Rupee liquidity requirements of commercial banks. Meanwhile, deposit mobilization was not sufficient to bridge this short-term liquidity gap. Keeping in view these pressures, the SBP stepped up its OMO injections (**Figure 3.6**). The outstanding net injections rose to an average of Rs 2.1 trillion during Q1-FY22 compared to Rs 1.1 trillion during the same period last year. On 80 days intermittingly the overnight rates remained higher than the policy rate, against 54 days during the same period last year. Moreover, the upside deviation of overnight rates from the policy rate also inched up. During these instances, the overnight rates remained on average 34 bps above the policy rate compared to 24 bps in the Q1-FY21.

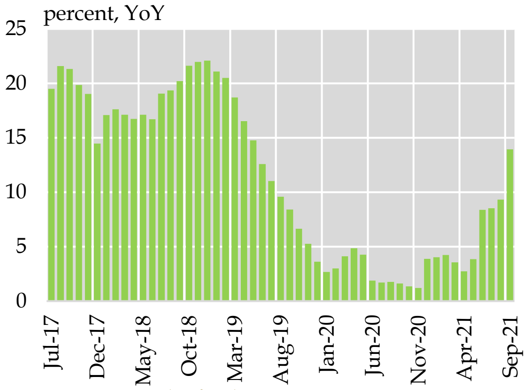
3.3 Credit to private sector

During most of Q1-FY22, the accommodative policy environment continued to prevail. Notably, low interest rates and SBP's concessionary financing schemes (mainly TERF) persisted during the quarter. Loans to private sector businesses rose by Rs 177.4 billion, compared to a net retirement of Rs 101.4 billion last year.

Usually the first quarter of fiscal year exhibits seasonal loan retirements, credit to private sector businesses posted net borrowings during Q1-FY22 **(Figure 3.7).**

[9] Duration is a measure of the sensitivity of a bond's price to changes in interest rates. Duration risk is simply the risk of a potential change in the value of debt instruments to a given change in the interest rates.

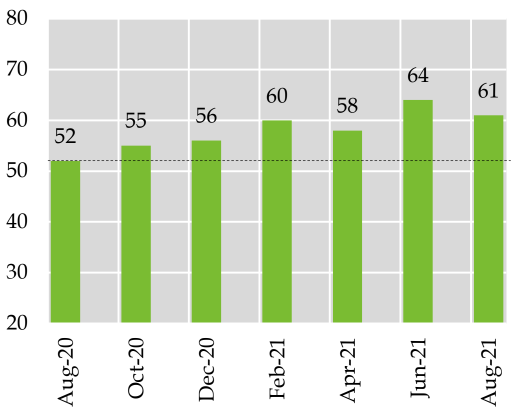
Change in Stock of Loans to Private Sector Businesses **Figure 3.7**



Source: State Bank of Pakistan

Besides, low interest rates and SBP's concessionary financing schemes, the credit increase can also be attributed to three main factors. First, the industrial activity gained further momentum, as LSM grew by 5.1 percent during Q1-FY22, compared to a growth of 4.5 percent last year. Second, the rising input costs (especially cotton and edible oil) led to an increase in the demand for working capital loans **(Box 3.1).** Finally, the overall business confidence improved during the quarter, as reflected by increase in the Business Confidence Index in August 2021, compared to August 2020. However, compared to the preceding survey in June 2021, the index slightly decelerated (**Figure 3.8).** Increase in inflationary pressures and PKR depreciation may have played a role in weakening some of the earlier optimism in the industrial sector (**Chapter 2**). Meanwhile, consumer financing continued to accelerate, owing to low interest rates, with major impetus from automobile and housing loans during the period under review.

Business Confidence Index **Figure 3.8**



Source: State Bank of Pakistan

Higher input costs raised the demand for working capital loans

Working capital loans rose by Rs 63.3 billion in Q1-FY22, compared to a net retirement of Rs 165.6 billion in the same period last year **(Table 3.3)**. Despite some seasonal retirements by sectors such as sugar and rice processing, the overall offtake remained higher this year, mainly due to a sharp rise in input prices. For instance, the impact of higher prices of key inputs (reflecting the global price trends) seems quite dominant in the increased borrowings by textile and edible oil businesses.

With regards to the textile, the 55 percent YoY increase in domestic cotton prices,[10] as well as continued strong export performance **(Chapter 5)**, both increased firms' demand for working capital loans, which grew by Rs 113.6 billion during Q1- FY22, in contrast to the net retirements of Rs 41.7 billion last year. Since most of the activity in the sector was export-centric, around a quarter of the borrowing was met from SBP's Export

[10] Source: Karachi Cotton Association

Loans to Private Sector Businesses (Q1) **Table 3.3**

(Flow in Rs billion)	Total loans*		Working Capital**		Fixed Investment	
	FY21	FY22	FY21	FY22	FY21	FY22
Private Sector Businesses	**-101.4**	**177.4**	**-165.6**	**63.3**	**59.6**	**89.2**
Manufacturing	-156.4	109.7	-196.0	60.2	39.3	44.9
Textile	-27.5	139.5	-41.7	113.6	14.2	23.5
Vegetable and animal oils and fats	-6.0	23.6	-8.3	21.5	2.3	2.1
Refined petroleum	-6.6	17.3	-6.7	14.3	0.0	3.0
Paper & paper products	2.0	9.6	-1.4	7.5	3.4	2.1
Motor vehicles	-16.5	4.1	-16.8	2.1	0.3	2.0
Basic iron and steel	2.8	3.8	2.5	1.9	0.3	1.9
Cement, lime & plaster	-10.3	2.5	-11.5	1.2	1.2	1.3
Basic pharmaceutical products	17.4	-7.8	3.6	-6.8	13.8	-1.3
Rice processing	-15.2	-13.7	-15.8	-15.1	0.5	1.3
Fertilizers	9.3	-16.0	12.8	-23.9	-3.5	7.9
Sugar	-82.3	-94.1	-82.7	-92.9	0.4	-1.3
Telecommunications	1.7	19.4	5.1	-9.6	-3.4	29.0
Power gen, trans & dist.	9.1	8.8	-9.3	-5.0	18.4	13.8
Mining & quarrying	-3.3	-5.7	-3.4	-8.6	0.1	2.9
Wholesale & retail trade	17.9	18.8	15.6	15.6	2.3	2.2
Agriculture, forestry & fishing	3.7	8.0	6.1	5.7	-2.4	1.3
Transportation & storage	0.6	4.4	3.1	4.0	-2.6	0.2
Real estate activities	1.1	0.9	-1.1	0.8	0.4	-0.9
Construction	2.3	8.7	1.5	0.2	-0.3	-5.4

*Total loans in Q1-FY21 and Q1-FY22 include construction financing of Rs 4.6 billion and Rs 24.9 billion, as the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business (see IH&SMEFD Circular Letter No. 28 of 2020). ** Working capital includes trade financing.

Source: State Bank of Pakistan

Finance Scheme (EFS), offered at a subsidized rate of 3.0 percent. [11]

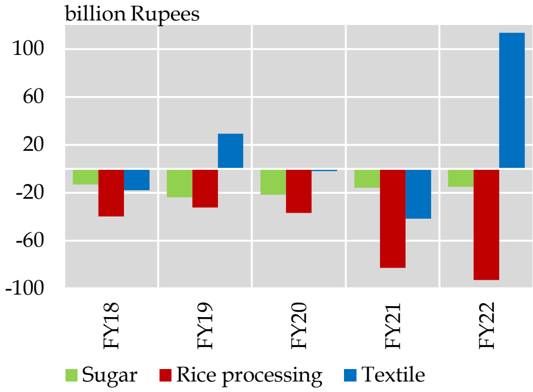
In addition to textile, vegetable oil and animal fats also took out short-term loans in Q1-FY22, compared to net retirements last year. The increase can be attributed to higher edible oil prices in the international market, which drove up the working capital needs of these firms. For instance, with a 60 percent YoY jump in international palm oil prices during Q1-FY22, its imports rose by 58 percent YoY during the review period, in rupee terms.

Meanwhile, the refined petroleum sector borrowed Rs 14.3 billion in Q1-FY22, compared to a net retirement of Rs 6.7 billion in the same period last year. Major oil refineries borrowed short-term loans mainly to meet the rising fuel demand amid accelerating economic activities in the country. This is in line with 17.9 percent YoY growth in POL sales during the review period.

In contrast, sugar and rice processing firms made seasonal loan retirements during Q1-

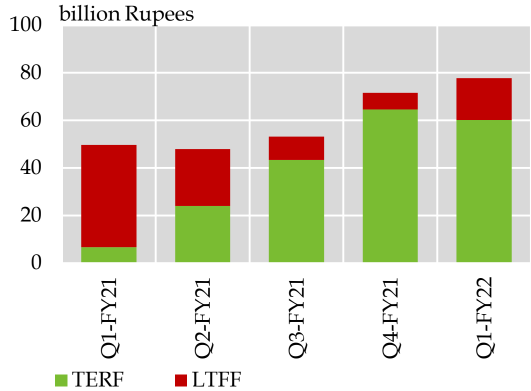
[11] Within working capital loans, export financing increased to Rs 33.7 billion during Q1-FY22, from Rs 5.1 billion last year.

Flow of Working Capital Loans to Major Sectors (Q1) **Figure 3.9**



Source: State Bank of Pakistan

Gross Disbursements under LTFF & TERF **Figure 3.10**



Source: State Bank of Pakistan

FY22, as shown in **Figure 3.9**. It is pertinent to mention that the second quarter of the fiscal year is typically a period of seasonal borrowings for both the *Kharif* crops (rice and sugarcane).[12] In case of fertilizer, better liquidity situation helped firms pay back their loans during the period. This is consistent with increased sales revenues of the sector during Q1-FY22 over last year, as reflected in the financial statements of major listed fertilizer businesses. With this comfort, the sector retired Rs 23.9 billion in Q1-FY22, compared to an increase of Rs 12.8 billion last year.

TERF drove up fixed investment loans

The borrowings under fixed investment loans were Rs 89.2 billion in Q1-FY22, compared to Rs 59.6 billion last year. Businesses took advantage of SBP concessionary financing schemes, particularly TERF. Out of the total approved amount of Rs 434.7 billion, Rs 198.8 billion (46 percent) have been cumulatively disbursed by end-September 2021. During Q1 specifically, TERF disbursements increased to Rs 60.2 billion, compared to only Rs 6.7 billion in the same period last year **(Figure 3.10).**

Within manufacturing segments, textile dominated the overall fixed investment loans with the sector borrowing Rs 23.5 billion during Q1-FY22, compared to Rs 14.2 billion last year. While benefitting from the SBP's subsidized financing schemes, textile businesses borrowed long-term loans mainly to import textile machinery and for capacity expansions. This is also consistent with the YoY growth in the import of textile machinery during the period under review.[13]

Meanwhile, fertilizer businesses borrowed Rs 7.9 billion in the long-term loans during Q1-FY22, compared to a net retirement of Rs 3.5 billion last year. As per the financial statements of a leading fertilizer manufacturer, it resorted to bank financing

[12] For details on seasonal borrowings and retirements, see Chapter 3 in the SBP's Second Quarterly Report for FY21 on the State of Pakistan's Economy.
[13] According to PBS, the import of textile machinery rose by 141.1 percent in Q1-FY22 compared to a decline of 20.9 percent in Q1-FY21.

mainly for the acquisition of majority shares in a renewable energy business.

Among non-manufacturing segments, borrowings by the telecommunications and electric power sectors were prominent. Telecom sector borrowed Rs 29.0 billion during Q1-FY22, compared to a net retirement of Rs 3.4 billion last year. Major telecom businesses borrowed fixed investment loans for capacity expansion and network upgradation. Meanwhile, power sector's borrowing increased, albeit lower than last year. This mainly represents borrowing by a major utility company in order to partially settle the parent company's loan owing to change of ownership.

Automobile and housing loans dominated consumer financing

Consumer financing picked up further and posted an increase of Rs 58.5 billion in Q1-FY22, compared to Rs 38.1 billion last year. Automobile loans continued to dominate banks' consumer portfolio, which is in line with 80.6 percent YoY growth in the sales of passenger cars and 132.6 percent YoY growth in the sales of jeeps during Q1-FY22.[14] Moreover, launching of new variants in passenger cars (1,300cc and above) by some auto assemblers played a significant role in driving up the demand for auto-financing.

Apart from auto loans, the expansion in consumer lending is largely explained by house building loans, which increased by Rs 14.9 billion, compared to only Rs 0.9 billion last year **(Table 3.4).** This increase is primarily attributed to the measures taken by government and SBP to promote housing and construction financing in the country. Notably, in July 2020, SBP mandated banks

Consumer Financing (Q1) **Table 3.4**

(Flow in Rs billion)	FY21	FY22
Total Consumer Financing	**38.1**	**58.5**
Automobile loans	21.3	30.1
House building	0.9	14.9
Personal loans	12.5	7.4
Credit cards	6.1	3.8
Consumers durable	-2.6	2.3

Source: State Bank of Pakistan

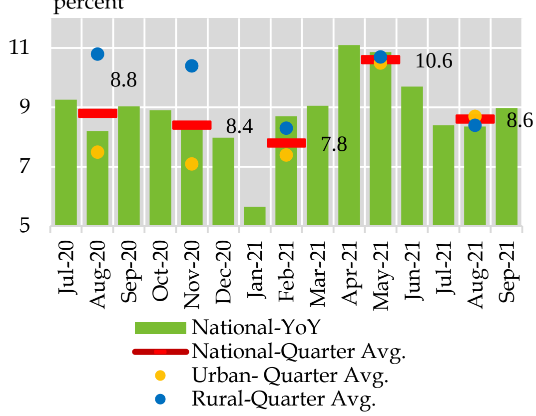
to increase their housing and construction finance portfolio to at least 5 percent of their domestic private sector advances by December 2021. Around 94 percent of the overall quarterly target set by SBP for September 30, 2021 has been met. As for the low cost housing finance, banks approved financing of Rs 72 billion under *Mera Pakistan Mera Ghar* (MPMG) as of September 30, 2021, out of which Rs 16.97 billion were disbursed. As a result, the outstanding stock of banks' housing and construction finance portfolio had increased to Rs 305 billion by end-September 2021, from Rs 166 billion a year earlier.

3.4 Inflation

National headline inflation remained 8.6 percent in Q1-FY22 compared to 8.8 percent in same period last year (**Figure 3.11**). The group-wise breakdown indicates that food inflation, non-perishable items in particular, remained the major contributor to headline inflation, followed by the Non Food Non Energy (NFNE) group (**Figure 3.12**). Although inflation remained stable on 12mma basis, the ongoing rise in international commodity prices (**Box 3.1**), revival in domestic demand and lagged impact of exchange rate depreciation contributed to buildup in price pressures in various sub-groups of core basket.

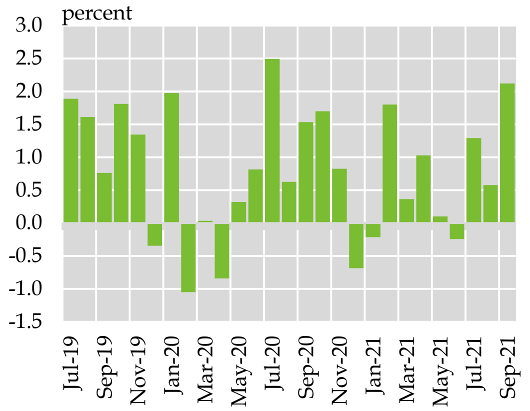
[14] Source: Pakistan Automotive Manufacturers Association.

Consumer Price Index **Figure 3.11**



Source: Pakistan Bureau of Statistics

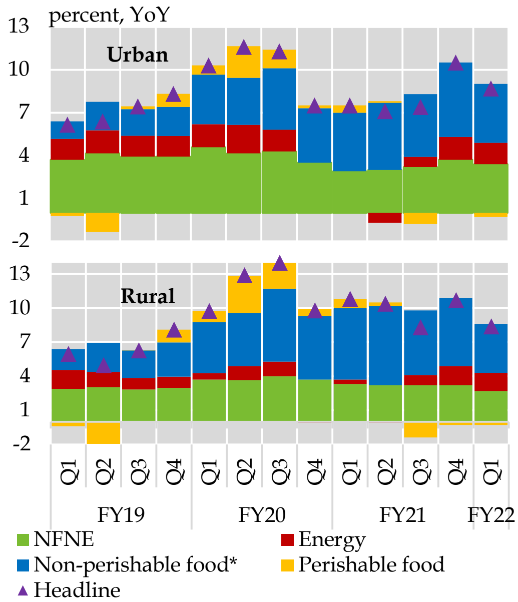
National CPI -MoM **Figure 3.13**



Source: Pakistan Bureau of Statistics

Meanwhile, contribution of energy inflation to overall inflation also surged on account of rising domestic fuel prices on the back of rising global prices. Moreover, the Wholesale Price Index (WPI) continued its upward trajectory, indicating persistent cost-push inflationary pressures in the economy.

Composition of CPI Inflation **Figure 3.12**



*Inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

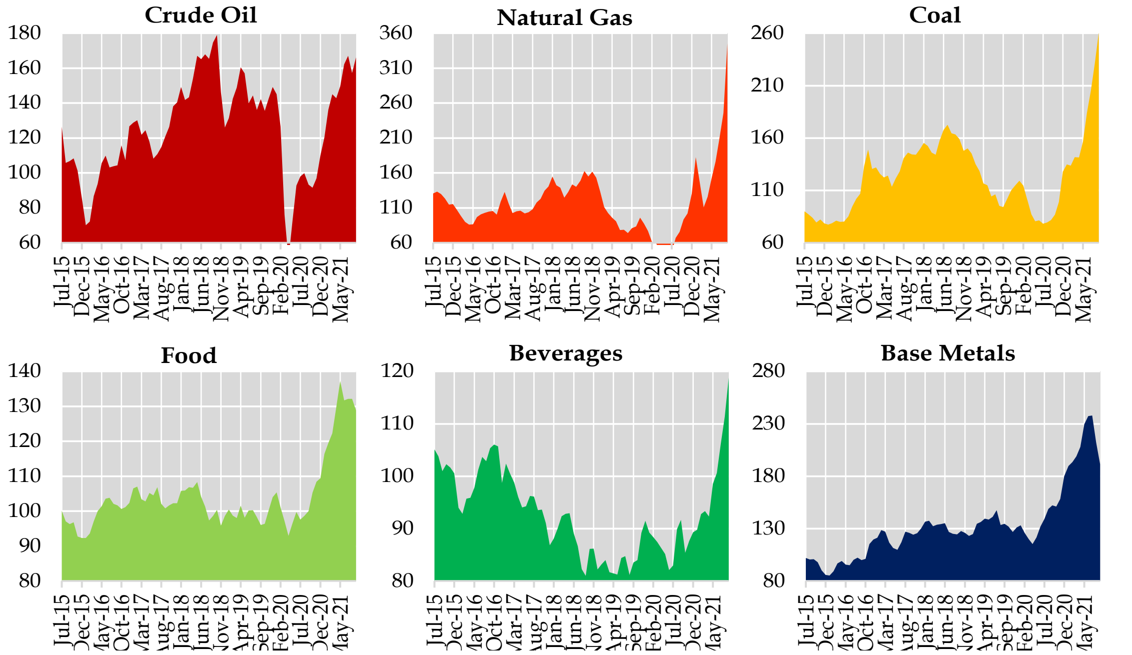
Monthly disaggregated data reveals that inflation outturns that were declining since May 2021, inched up in September 2021 at 9.0 percent, against 8.4 percent in both July 2021 and August 2021. Month-on-month readings also depicted intensifying inflationary pressures by end-quarter (**Figure 3.13**).

Box 3.1: Drivers of the Sharply Rising Global Commodity Prices: Shortages and Supply Constraints

Commodity prices have been surging globally since July 2020, amid revival in demand as economies started reopening in various parts of the world after easing of covid-related restrictions. However, these price pressures intensified since May 2021(**Figure 3.1.1**). In this backdrop, preliminary analysis of the drivers of global price hike highlights that, while demand for goods was already strong, multi-faceted supply-side limitations are also contributing significantly to the price pressures. Additional issues emanating from global logistics, transportation congestion in particular, are adding further stress to already swelling prices.

International Commodity Markets

International Commodity Indicies **Figure 3.1.1**



Source: International Monetary Fund

Most of the commodity prices in 2021 rose to or exceeded levels last seen in the commodity price spike witnessed back in 2011. Unfavorable weather conditions worsened the supply dynamics of many commodities, in addition to demand pick-up as well as supply chain disruptions amid Covid pandemic.

Energy Sector

Crude oil: Crude oil prices have increased sharply in Q1-FY22 on account of revival in demand, weather-related supply disturbances, and controlled production by OPEC+.[15] Oil production in the US was impacted by Hurricane Ida while OPEC and its partners produced below the committed quota due to maintenance and supply outages.[16] In addition, oil price hike have also been supported by higher natural gas prices, being the close substitute of the commodity.

Natural Gas: IMF index for natural gas rose by 324 percent during Q1-FY22. This surge is attributed to extreme weather conditions as extended drought state in Brazil forced it to shift from hydro to natural gas for power generation. At the same time, the global coal market experienced significant supply constraints. Consequently, natural gas demand rose for being substitutable commodity in some cases. Meanwhile, Europe faced drawdown in natural gas stocks on account of severe 2020-21 winter, which caused unusual stock building.

Coal: IMF's coal index rose by around 191 percent during Q1-FY22. Increase was primarily driven by strong demand from China as unfavorable weather conditions (a drought like situation earlier this year in

[15] Blogs.worldbank.com
[16] https://www.iea.org/reports/oil-market-report-september-2021

southern China) drained hydroelectric dams and increased demand for coal. Meanwhile, on the supply front, output from Indonesia was affected by unexpected rainfalls, while transportation bottlenecks delayed shipments. At the same time, price pressures further intensified when some firms in Japan and Europe started switching to coal amid increasing natural gas prices.

Metals and Cotton Market

Base Metals: Pick-up in demand due to reopening of economies, i.e. ease in travel restrictions, rebound in manufacturing industries as well as the release of pent-up demand from last year with some supply side constraints put upward pressure on metal prices, in general.

Steel and Aluminum: Steel prices started rising on account of China's decision to reduce steel production as it plans to reduce carbon emission from steel plants.[17] Similarly, aluminum prices has witnessed significant rise over uncertainty after a military takeover in Guinea, the world's second-largest producer of the ore, and a major supplier to China.

Cotton: Cotton prices increased by 44.6 percent during Q1-FY22, hitting almost 10-year high level. Squeezed global supplies are contributing to rising trend in prices as extreme weather conditions have affected cotton production in US significantly, one of the major exporters of the commodity. Meanwhile, demand for cotton from major textile exporters including China and Pakistan, was also quite strong.

Food and Beverages Group

Global food prices rose nearly 33 percent during Q1-FY22 over last year, hitting the highest level in over a decade. Robust demand and supply shortages, extreme weather conditions and supply chain disruptions are constantly pushing the prices.

Wheat: Tightening export availability amidst strong world demand contributed to higher wheat prices. Meanwhile, contraction in production, predominantly due to the prolonged drought conditions in North America as well as adverse weather in Kazakhstan and the Russian Federation, kept prices elevated (**Table 3.1.1**).[18]

Production by Major Producers **Table 3.1.1**

Million metric tons

	2020-21 (Preliminary Estimates)	2021-22 (Projection as of November 2021)
Wheat		
Russia	85.4	74.5
US	49.7	44.8
Sugar		
Brazil	42.1	36.0
Cotton		
China	29.5	26.7

Source: United States Department of Agriculture

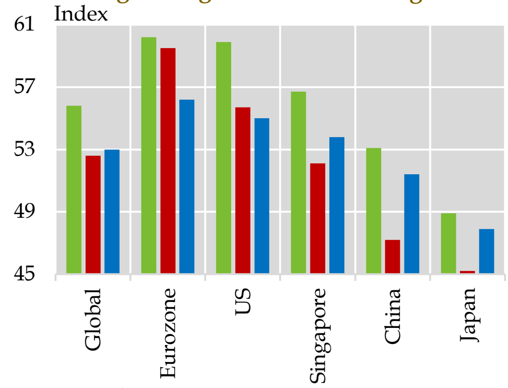
Sugar: Concerns over reduced output in Brazil, the world's largest sugar exporter, due to prolonged dry and freezing weather conditions, continued to strengthen the increase in world sugar prices.

Edible Oil: Price index of edible oil crops has grown significantly since March 2020 over growing demand for biodiesel and unsupportive weather patterns. Also, concerns over below-potential production of palm oil in Malaysia due to persisting migrant labor shortages are keeping the prices historically high.

Coffee: Coffee prices registered increase, sparked by the concerns over supply due to climate conditions in major producing countries and increasing freight costs. Concerns over the Brazilian crop, affected by the recent frosty weather, have led to high prices.

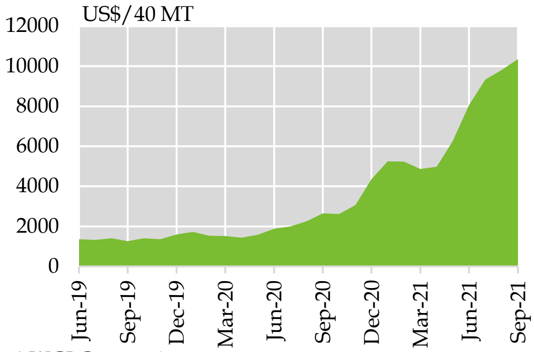
[17] Commodity Markets Outlook-October 2021 (World Bank)
[18] FAO Food Price Index-September 2021

Purchasing Managers' Index **Figure 3.1.2**



Source:tradingeconomies.com

Container Freight Benchmark Rate* **Figure 3.1.3**



* WCI Composite
Source: Bloomberg

Supply Chain Challenges

In addition to commodity related demand and supply dynamics, supply chain bottlenecks have further intensified price pressures that continued to seep into commodity prices and stoke inflation.[19] Freight charges, in particular, registered significant spike during Q1-FY22.

With the rapid recovery in world trade after the pandemic and reopening of economies following strict lockdowns, significant disruption to supply chains, with high congestion at ports, were experienced.[20] In addition to capacity constraints at ports, labor shortages continued to hamper routine operations. These supply chain challenges have led to lags in delivery times, particularly in sectors experiencing raw-material issues. This, in turn, affected economic activities for many economies as indicated by Purchasing Managers Index (PMI)[21] during Q1-FY22 (**Figure 3.1.2**). On average, suppliers' delivery times, a sub-index of PMI,[22] lengthened across the four major economies.[23] Consequently, freight rates accelerated significantly (**Figure 3.1.3**).

In short, soaring commodity prices amid surge in demand and weather-related supply constraints, in combination with rising transportation cost have intensified global price pressures during Q1-FY22 and elevated global inflation outturn.

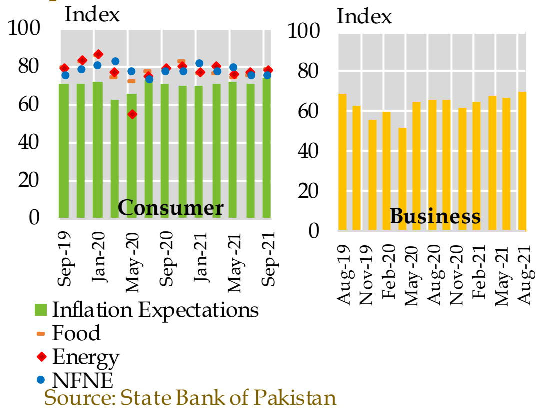
Inflation expectations posed mixed picture

Taken together, the evidence from SBP-IBA Consumer Confidence Survey (CCS) conducted in the first half of July 2021 and Business Confidence Survey (BCS) in the second half of June 2021, inflation expectations appeared to be reasonably anchored at the start of FY22 as the results showed that both consumer and business

[19] IMF World Economic Outlook-October 2021
[20] According to industry experts, worst affected were the US west coast ports of Long Beach and Los Angeles, and Chinese terminals at Shanghai and Ningbo.
[21] PMI indicates prevailing direction of economic trends in manufacturing and services.
22 A widely used indicator of supply delays, capacity constraints and price pressures
[23] The US reported the highest degree of supply chain lengthening, followed closely by the UK and the Eurozone.

inflation expectations index declined. However, in September 2021, inflation expectations of both households and businesses drifted up (**Figure 3.14**). Increase in consumer inflation expectation index was observed on account of rise in all three categories (food, energy and NFNE); however, rising food prices played a major role in the overall increase in inflation expectations.

Inflation Expectations **Figure 3.14**

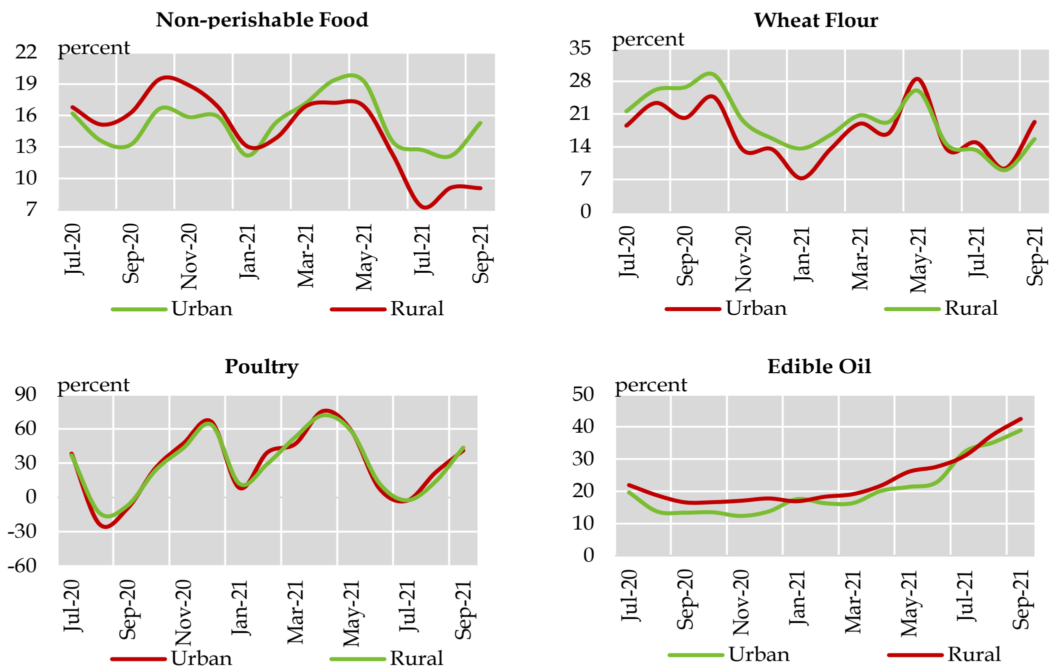


Source: State Bank of Pakistan

Food inflation remained major contributor to headline inflation

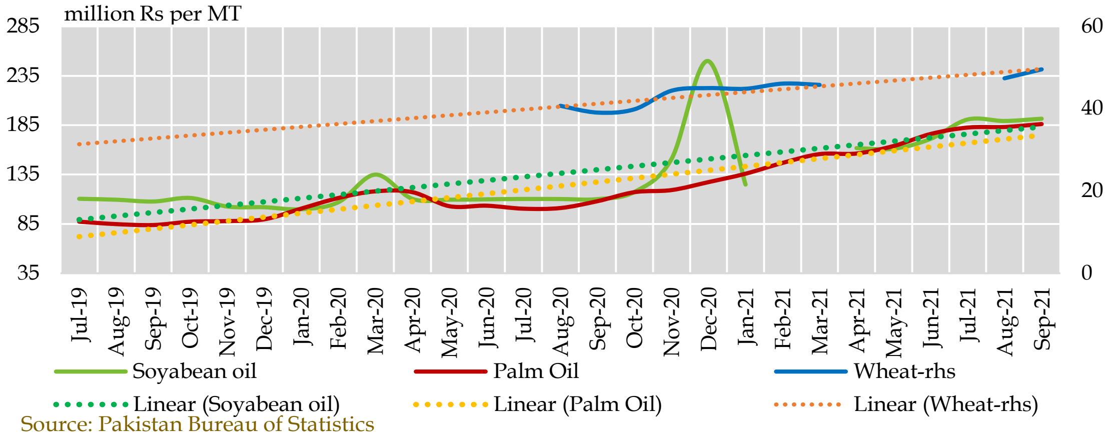
Food index rose by 10.1 percent and 8.5 percent in urban and rural areas respectively during Q1-FY22, compared to 12.9 percent and 15.7 percent increase in the same period last year. Despite decline in the pace, food group remained the major contributor to the overall inflation. Persistent increase in international food prices, in addition to lagged impact of exchange rate depreciation, continued to put upward pressures on food prices (**Figure 3.15**).

Non-Perishable Food Group Inflation **Figure 3.15**



Source: Pakistan Bureau of Statistics

Unit Value of Imports **Figure 3.16**



Source: Pakistan Bureau of Statistics

Item wise analysis suggests that inflation in edible oil and poultry segments rose significantly compared to the same period last year. In case of edible oil and ghee products, manufacturers has been struggling with rising international prices of palm oil and soybean since July 2020 (**Figure 3.16**). Unit prices of soybean and palm imports have risen more than 70 percent in Q1-FY22.

The poultry index (both for urban and rural areas) rose by around 14 percent during Q1-FY22 compared to decline in the same period last year. Rise in inflation mainly reflects price recovery, as chicken prices had crashed amid low demand after the imposition of strict as well as partial lockdowns last year.

Readymade food group (cooked chicken, beef, biryani, bread and tea) prices recorded double-digit inflation during Q1-FY22. This reflects indirect rise in the prices of inputs, such as wheat, edible oil, chicken and transportation cost.

Although wheat inflation remained limited during the review period amid relatively better production (**Figure 3.17**), adequate wheat procurement (**Figure 3.18**) and imports,[24] inflation in wheat flour still remained elevated. Anecdotal evidence suggests that the increase can be attributed to rise in the minimum support price (MSP);[25] increase in wheat issue price by procuring agencies to flourmills;[26] and delay in announcement of release price as well as release of stocks by the procurement agencies by end-quarter.

For sugar, double-digit inflation was registered partially reflecting increase in the MSP for sugarcane in FY21.[27] However,

---

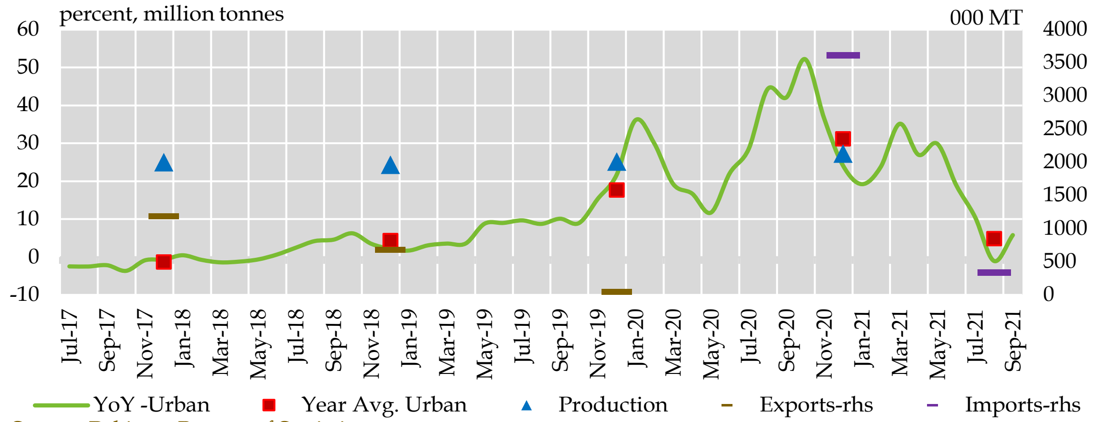
[24] Total availability of wheat was reported at 28.231 MMT by end-September 2021. This included production of 27.5 MMT and leftover stock of 0.731 MMT as compared to the national requirement of 30.27 MMT.

[25] The Economic Coordination Committee enhanced the MSP of wheat crop FY21 to Rs 1,800 per 40 Kg from 1400 per 40 kg previously. Sindh unilaterally increased it to Rs 2,000 per 40 Kg.

[26] Minimum release price was increased by 32 percent, from Rs 1,475 to Rs 1,950, in an attempt to withdraw subsidies.

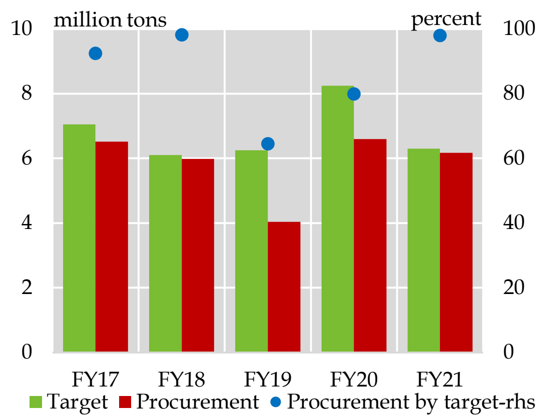
[27] MSP was increased by Rs 10 to Rs 200 per 40 kg in Punjab, and to Rs 202 per 40kg in Sindh in FY21.

Wheat Inflation **Figure 3.17**



Source: Pakistan Bureau of Statistics

Public Sector Wheat Procurement **Figure 3.18**



Source: Provincial Food Departments

slowdown was observed compared to last year, which can be attributed to increased sugarcane production in FY21 along with higher imports during Q1-FY22.[28]

Some food items, on the other hand, registered a slowdown in inflation during the review period. For instance, in the case of pulses, improved production of various categories along with higher imports kept prices stable during the review period, despite a rise in unit prices of imported pulses on YoY basis.

In case of condiments and spices, inflationary pressures declined significantly compared to the same period last year, despite the rise in unit prices of imports. This can be attributed to improved domestic production, as target of chilies crop production was increased by around 4 percent for FY22.

Supply of perishable food items have been largely adequate since October 2020. Resultantly, inflation in this group comprising fresh vegetables, fruits, tomatoes, potatoes and onions, is on declining trajectory since then. Improved local production and higher imports have kept the supply-demand gap in check at large during the review period.

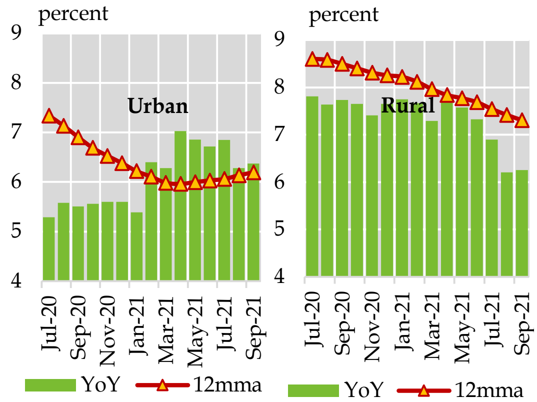
Underlying inflation remained broadly stable

Moving average trend suggest that the course of NFNE inflation is broadly stable

[28] Sugarcane production rose to 81.0 million MT in FY21, compared to 66.4 million MT in FY20. Pakistan imported 157,800 MT of sugar in Q1-FY22, against minimal imports of 30,100 MT in the same period last year.

NFNE-YoY Growth

Figure 3.19



Source: Pakistan Bureau of Statistics

(Figure 3.19). However, on YoY basis, it increased marginally in July 2021 for urban segment led by all three groups of house rent, goods and services. Similarly, quarter average rose by 100 basis points compared to last year same period.

The YoY increase in core inflation is attributed to multiple factors. They include: i) rise in domestic demand, as reflected by high frequency demand indicators; ii) rise in transportation cost amidst higher fuel prices; iii) revision in government service/tax charges for vehicles and postal services (which were kept unchanged in the previous budget on account of Covid-related relief); iv) ongoing adverse impact of the rise in the international metal prices; and v) lagged impact of exchange rate depreciation.

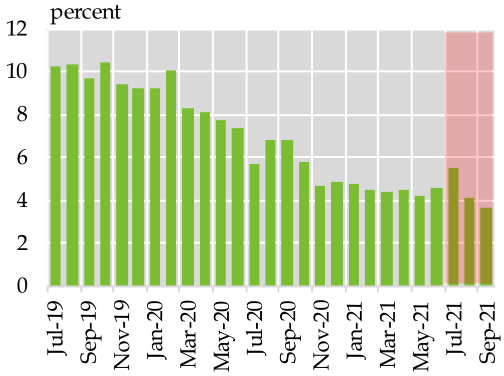
While core inflation picked up in urban areas, price pressures were more concentrated among goods as compared to services. Across goods, significant price raises were observed in clothing and footwear over last year. Prices of cotton, an important input for textile industry, observed unabated spike during Q1-FY22 as decline in production in FY21 continued to widen the demand-supply gap and were met via higher priced imports. Consequently, inflationary pressures remained high in cotton cloth and readymade garments.

Inflation in construction inputs rose significantly during Q1-FY22. Rise in iron bar prices, in particular, pushed-up the overall construction input index. In addition to rising construction activities, soaring international metal prices also contributed to the rising inflation.

Inflation of very few sub-groups, on the other hand, registered slowdown. For instance, inflation in motor vehicles group was influenced by the government's decision to reduce taxes on lower end cars. FED was eliminated on up to 850cc cars, whereas sales tax was reduced from 17 percent to 12.5 percent for up to 850cc cars. These taxation changes arrested the rising inflation trend in motor vehicle group. Also, deflation was recorded in personal use items, as gold; the precious metal's prices declined owing to decrease in international prices over revival in global activities.

In the services group, some of the rise in inflation reflects base effect, as prices are compared against the low levels that prevailed last year amid Covid-related relief provided by the government in the FY21 budget. For instance, motor vehicle tax and postal services fall in this particular category. In transport services, inflation grew amid high fuel prices, as previously transport fares were affected by low fuel cost amidst lower global oil prices last year. The impact of the re-opening of economy was also visible in recreation and cultural services, as inflation increased in the group. Pace of inflation also rose in house rents during the review period

YoY Inflation in Urban Construction Wages **Figure 3.20**



Source: Pakistan Bureau of Statistics

which was subdued last year after the onset of the pandemic.

Wage pressures remained contained during the quarter on YoY basis owing to higher base effect. However, monthly YoY data depicts building wage pressures since the start of FY22, as the inflation in construction wage rate inched up by 5.5 percent in July 2021 compared to full year average of 5.1 percent in FY21 reflecting wage recovery from last year's low level (**Figure 3.20**).

In contrast, NFNE inflation is declining on YoY basis in rural areas since the beginning of FY22, primarily reflecting base effect, [29] difference in imported inflation for rural segments, and basket differential.

Disaggregated data of goods category indicates that deceleration in inflation was concentrated in a few sub-groups, particularly on account of difference in consumption basket of rural areas and urban areas. For instance, a marked decline in inflation was observed in cotton cloth, footwear, household textiles and furniture and furnishing. Some branded and imported items in clothing and footwear category kept the inflation on higher side in the urban basket; whereas, the absence of such items in the rural basket kept rural inflation subdued.

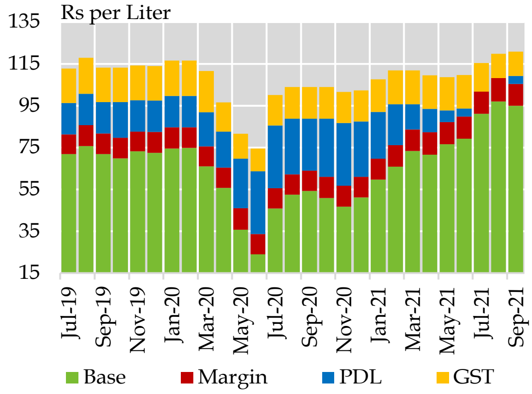
Energy inflation rose significantly

Energy inflation registered significant increase in both urban and rural areas in Q1-FY22. Barring gas index, all other sub-indices of the energy group rose sharply during the quarter.

In case of motor fuel, average inflation inched up by more than 15 percent during Q1-FY22 both in the urban and rural segments, compared to deflation in the same period last year. This was despite the government's decision to reduce the Petroleum Development Levy (PDL) and sales tax on petroleum products in order to contain the pass on of higher international prices to consumers (**Figure 3.21**). In fact, the surge in energy inflation is attributed to sustained increase in global oil prices, which climbed above USD 80 a barrel in September 2021, hitting their highest level in three years. (**Figure 3.22**).

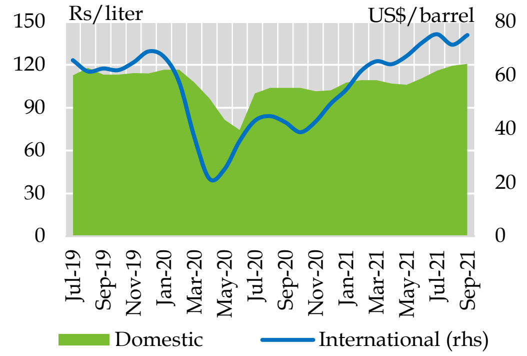
[29] Last year, rural core inflation was high in response to lower impact on economic activities in rural areas as compared to urban areas amid lockdowns. As Asian Development Bank survey suggests that at least one family member had returned from urban or other areas to rural areas after lockdowns. Meanwhile, urban core inflation had declined amid restricted economic activities and related subdued demand. Since April 2021, mobility data from Google for transit and station supports elevated activity in major cities, indicating increased movements from rural to urban areas. This implies a rebound in economic activities in urban areas, which is commensurate with the uptick in urban inflation. In contrast, inflation in rural areas decelerated.

Composition of Petrol Price **Figure 3.21**



Source: Oil and Gas Regulatory Authority

Fuel Prices **Figure 3.22**

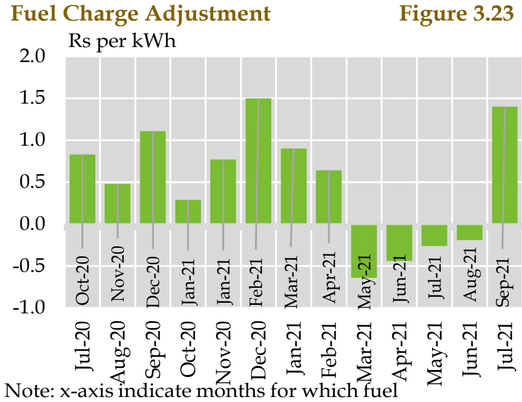


Source:Pakistan Bureau of Statistics; State Bank of Pakistan and Bloomberg

Similarly, electricity charges inflation posted double-digit increase after witnessing moderate rise during the same period last year. This rise reflects increase in base tariff of Rs 1.95 per kWh of distribution companies (Discos) in February 2021 to address the circular debt, along with monthly fuel charge adjustments charged during Q1-FY22 (**Figure 3.23**).

In addition, category of Liquefied Hydrocarbons (LPG) remained a major contributor to the overall rise in energy inflation. Following the rising trend in international prices of propane and butane, major imported content, domestic LPG prices are under pressure since July 2021.

Fuel Charge Adjustment **Figure 3.23**



Note: x-axis indicate months for which fuel charge adjustment was charged
Source: National Electric Power Regulatory Authority