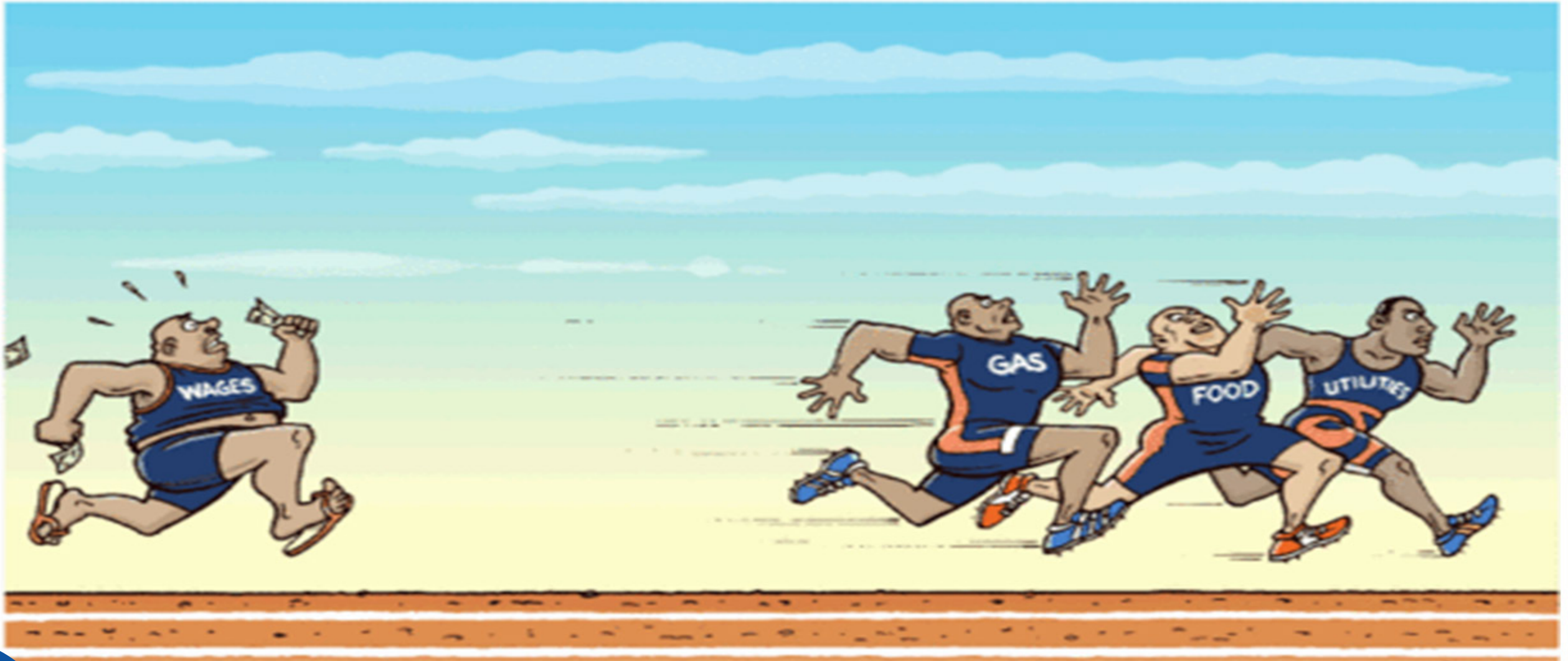


# Inflation

September, 2019



# Inflation

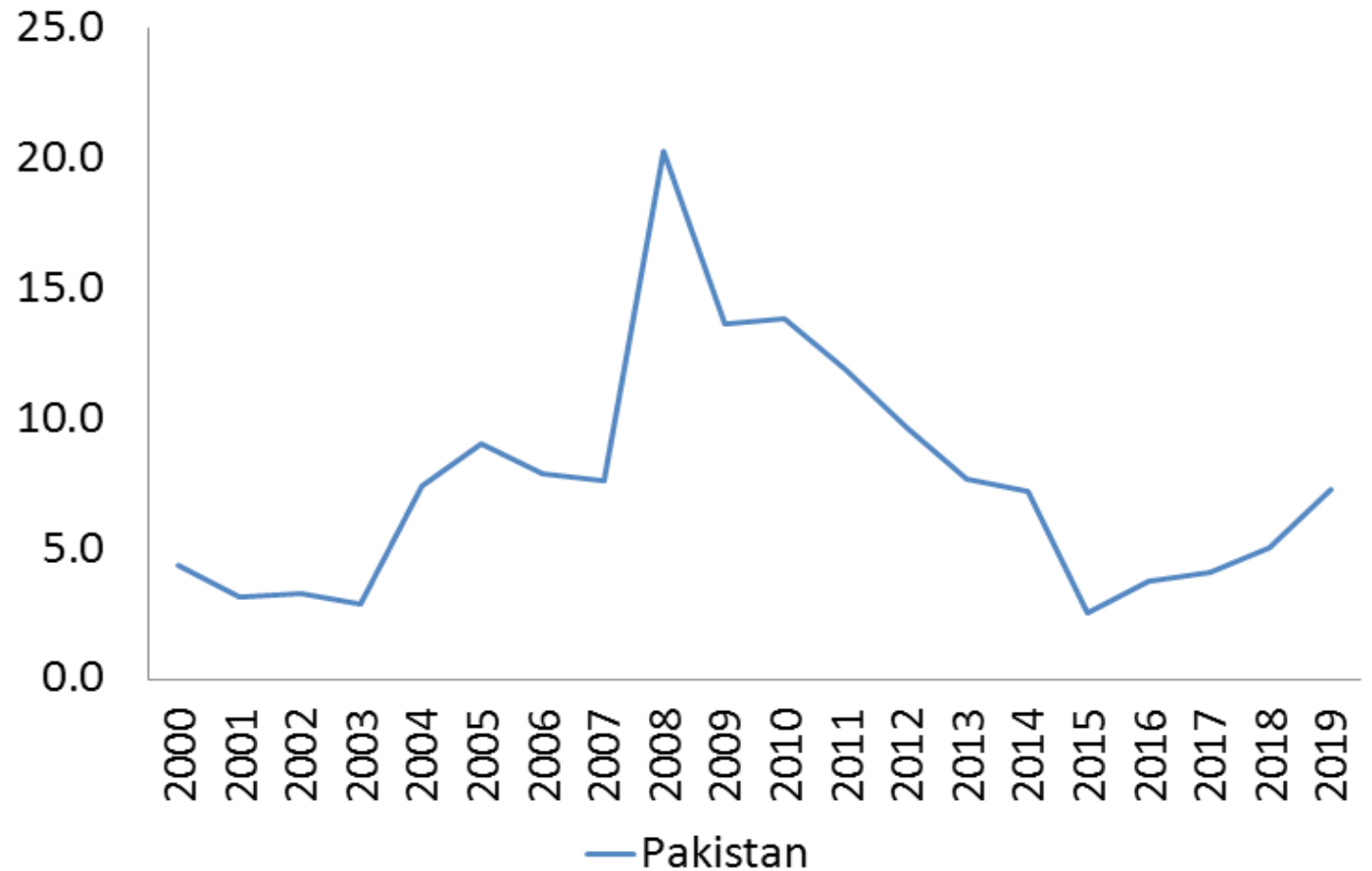
According to IMF, **Inflation** is the rate of increase in prices over a period of time.

According to SBP, **Core Inflation** is a measure which excludes transitory or temporary prices volatility as in the case of some commodities such as food and energy prices.

## Drivers of inflation

- Demand-pull inflation
- Cost-push inflation

## Historical Trend of Pakistan's Inflation



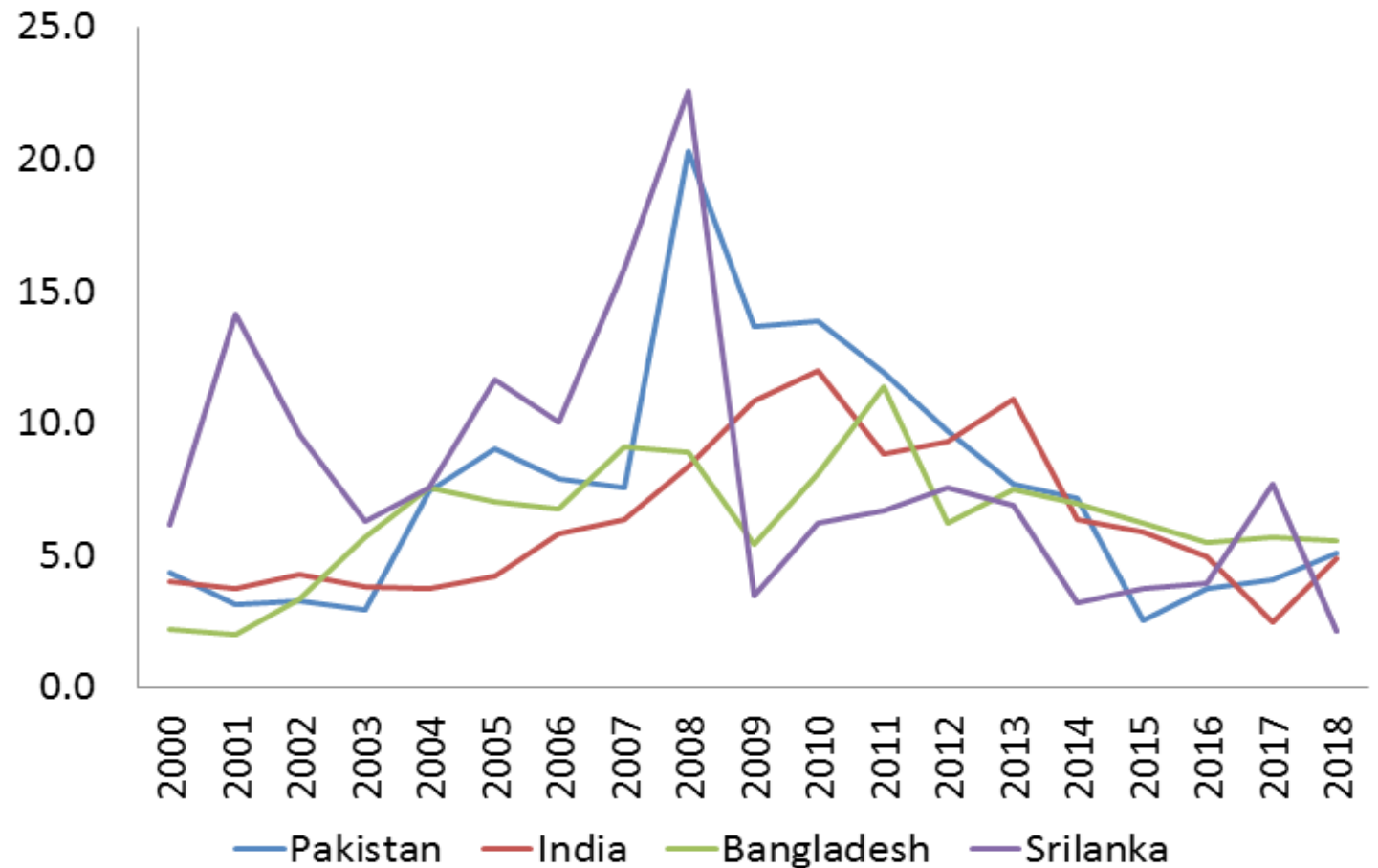
## Types of Inflation Indexes used in Pakistan

**Consumer Price Index (CPI)** tracks changes in the price of a basket of goods and services consumed by a typical household.

**Sensitive Price Index (SPI)** is a weekly inflationary indicator that measures the change in the cost of a fixed basket of goods and services purchased by the households in the country.

**Wholesale Price Index (WPI)** is an index showing changes in price levels of manufactured goods before the retail level.

### Peer Comparison



## Rebasing and Weight Changes of Key Components of the Consumer Basket

	Old base 2007/08
	% Weights
Non-perishable food items	29.8
Perishable food items	5.0
<b>Food and non-alcoholic beverages</b>	<b>34.8</b>
Alcoholic beverages, tobacco	1.4
Clothing and footwear	7.6
Housing, water, electricity, gas & fuels	29.4
Furnishing and household equipment maintenance	4.2
Health	2.2
Transport	7.2
Communication	3.2
Recreation and culture	2.0
Education	3.9
Restaurants and hotels	1.2
Misc. goods and services	2.8
<b>Total</b>	<b>100.0</b>

## Rebasing and Weight Changes of Key Components of the Consumer Basket

Pakistan Bureau Statistics has recently re-stated the CPI base year from 2006-2007 to 2015-2016, along with some important changes made to the weights of key components of the consumer basket, which are as following:

- CPI now measures urban and rural inflation separately. Previously, 487 products prices were collected from 76 markets of 40 cities. The new methodology has a classification of Urban and Rural CPI, with Urban covering 35 cities for 356 items; whereas Rural covers 27 towns for 244 items.
- Weightages of housing and transport in the consumer basket have reduced.
- PBS has linked few items directly to oil prices, under the new methodology. For example, electricity inflation now covers the fuel adjustment, previously it use to cover base tariff only.
- PBS has decided to axe the old method for electricity consumption by measuring simple averages. Under the new methodology, PBS will measure inflation via weighted average of electricity consumption.

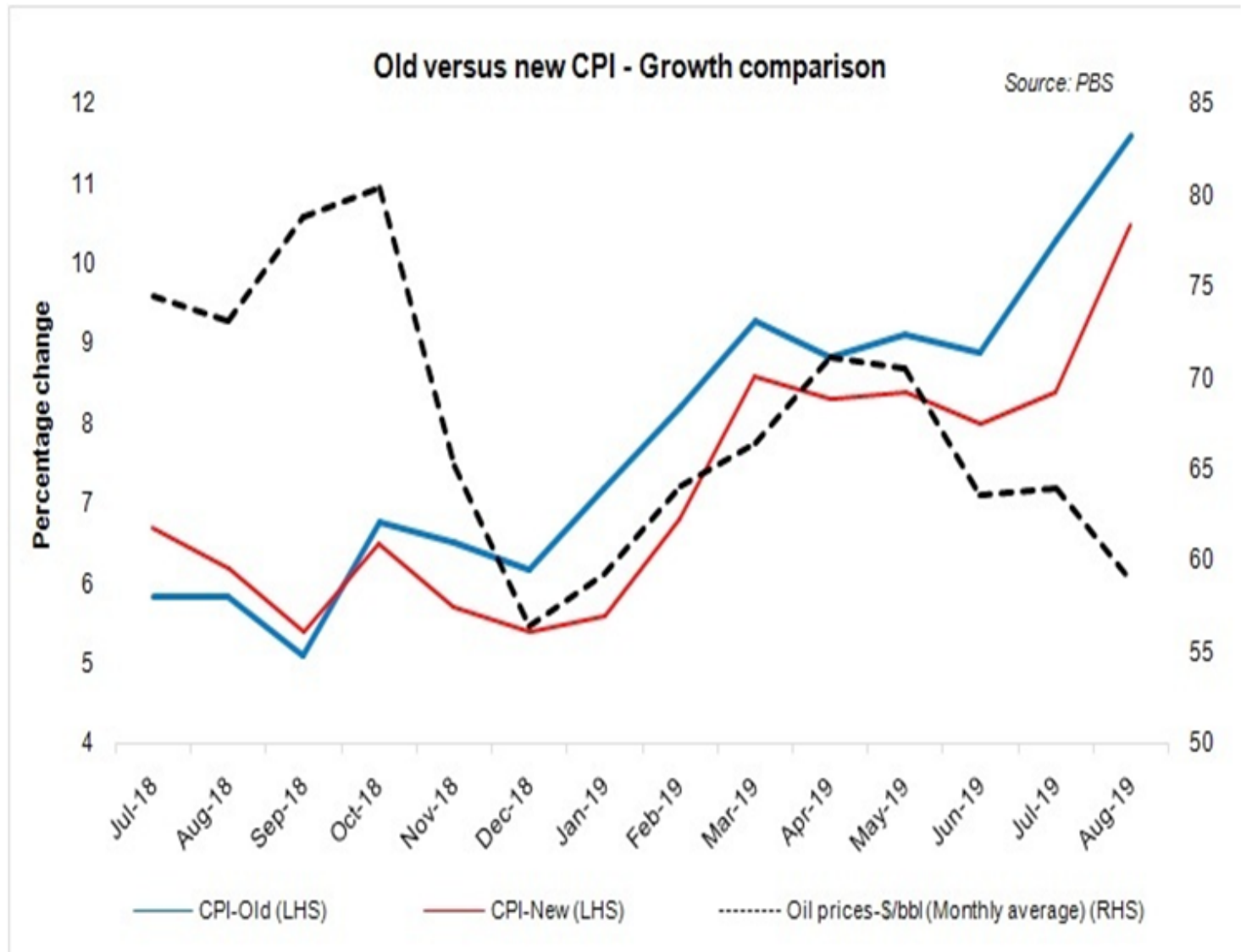
## Rebasing and Weight Changes of Key Components of the Consumer Basket

	Old base 2007/08	New base 2015/16		Urban CPI	Rural CPI
	% Weights				
Non-perishable food items	29.8	29.6	(0.2)	-	-
Perishable food items	5.0	5.0	-	-	-
<b>Food and non-alcoholic beverages</b>	<b>34.8</b>	<b>34.6</b>	<b>(0.2)</b>	<b>52.9</b>	<b>47.1</b>
Alcoholic beverages, tobacco	1.4	1.0	(0.4)	50.2	49.8
Clothing and footwear	7.6	8.6	1.0	56.0	44.0
Housing, water, electricity, gas & fuels	29.4	23.6	(5.8)	68.8	31.2
Furnishing and household equipment maintenance	4.2	4.1	(0.1)	60.1	39.9
Health	2.2	2.8	0.6	49.8	50.2
Transport	7.2	5.9	(1.3)	62.5	37.5
Communication	3.2	2.2	(1.0)	64.0	36.0
Recreation and culture	2	1.6	(0.4)	65.5	34.5
Education	3.9	3.8	(0.1)	77.5	22.5
Restaurants and hotels	1.2	6.9	5.7	65.1	34.9
Misc. goods and services	2.8	4.9	2.1	58.9	41.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>		<b>60.1</b>	<b>39.9</b>

## Comparison of Old versus new CPI

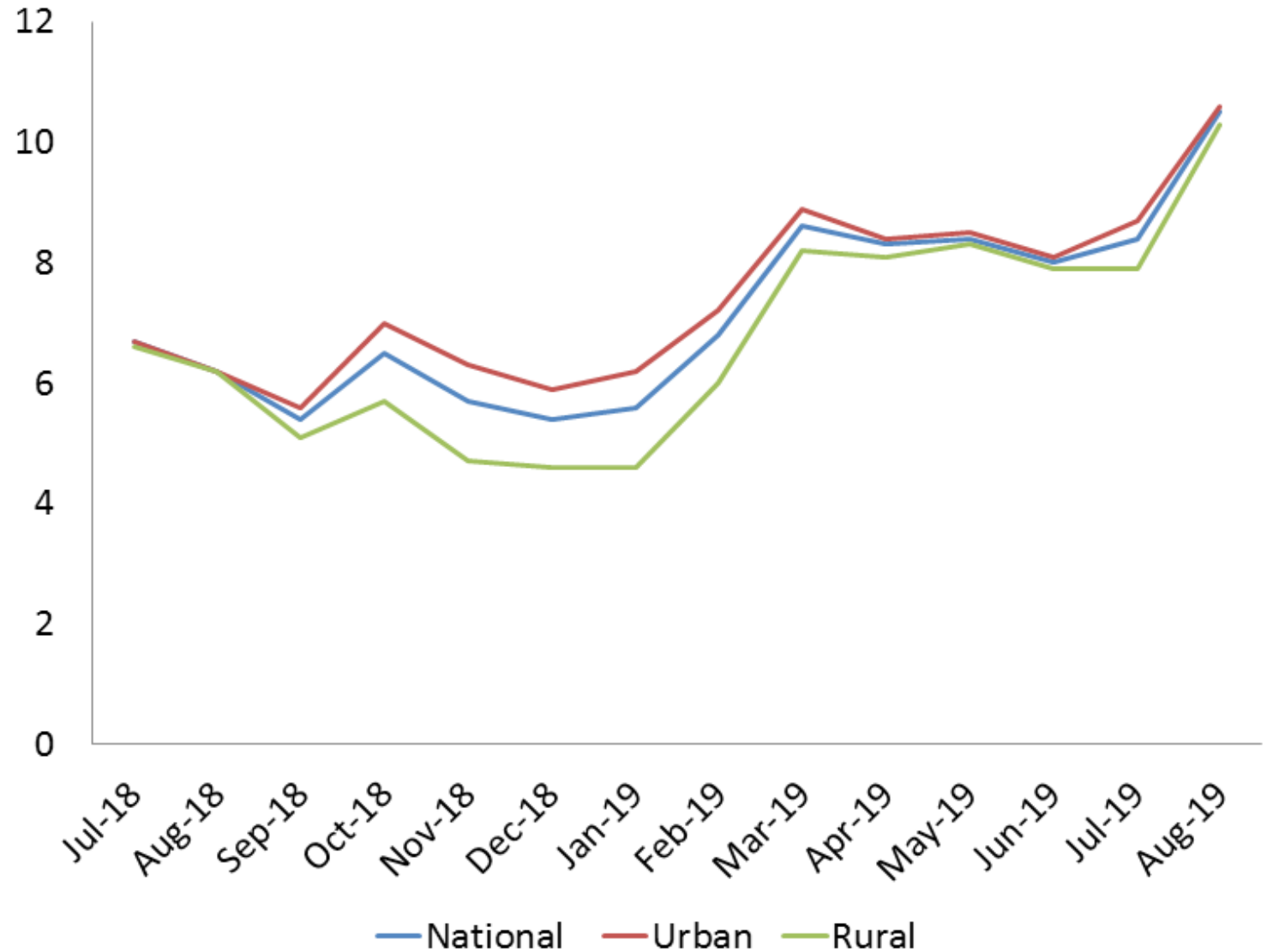
The new CPI is comparatively on the lower side since mid Sep-18 in relation to old CPI. This is due to rebasing of CPI from 2007-2008 to 2015-2016 coupled with Urban and Rural Classification.

Despite oil price declines since Apr-19 CPI has trended upwards. This is because of devaluation, higher energy (electricity and gas) and food inflation.



## Urban and Rural Classification

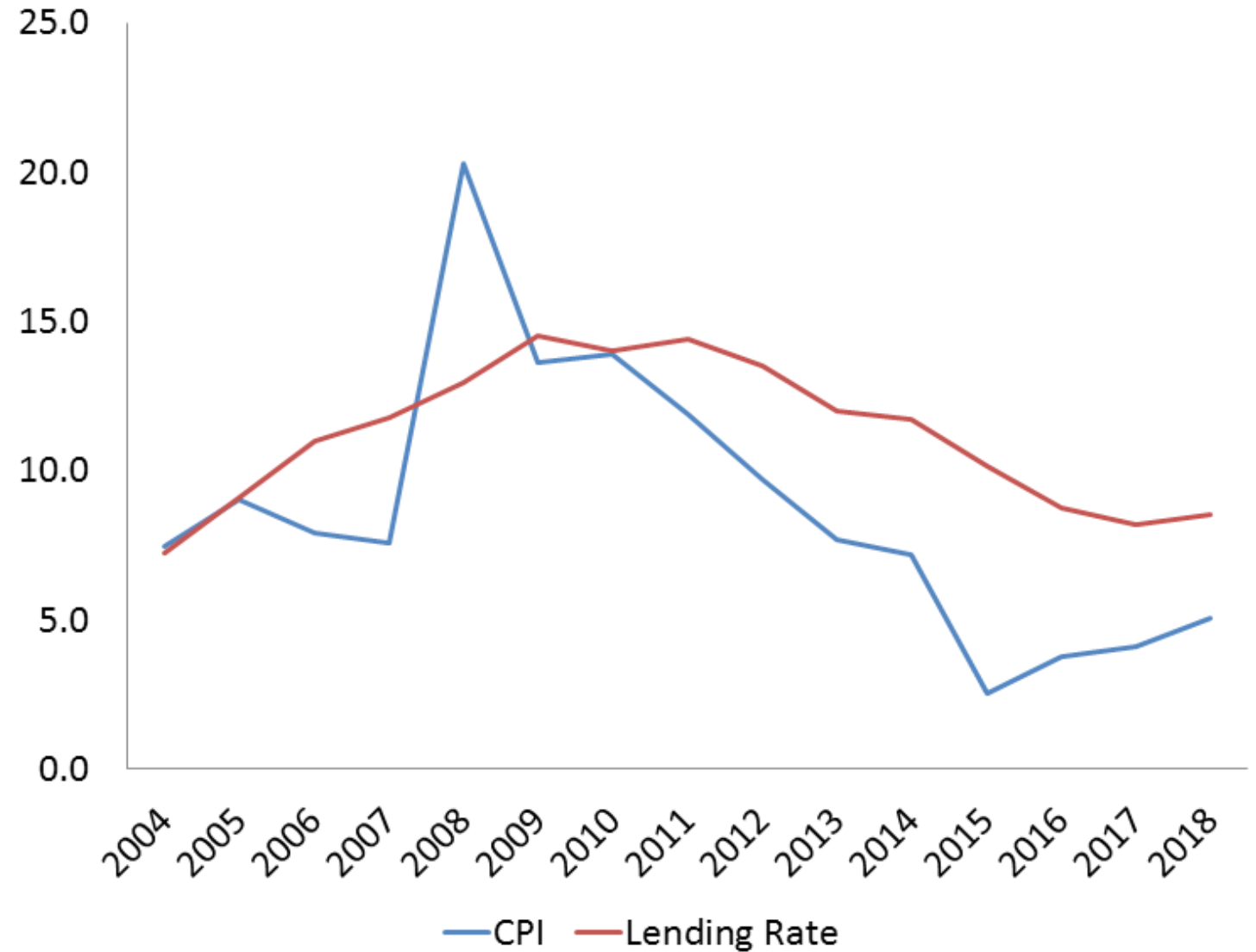
With the urban and rural classification, urban inflation is pushing the national inflation upwards and rural is exerting downward pressure. So overall the new methodology is showing a more realistic inflation number vis-à-vis old methodology





## CPI and Policy Rate Relationship

Real Interest Rates is the difference between policy rate and inflation. In Pakistan, real interest rates have historically remained positive barring 2008.



## CPI and Policy Rate Relationship

During FY09, CPI averaged 20.8% while the discount rate peaked at 15% translating into negative real interest rates.

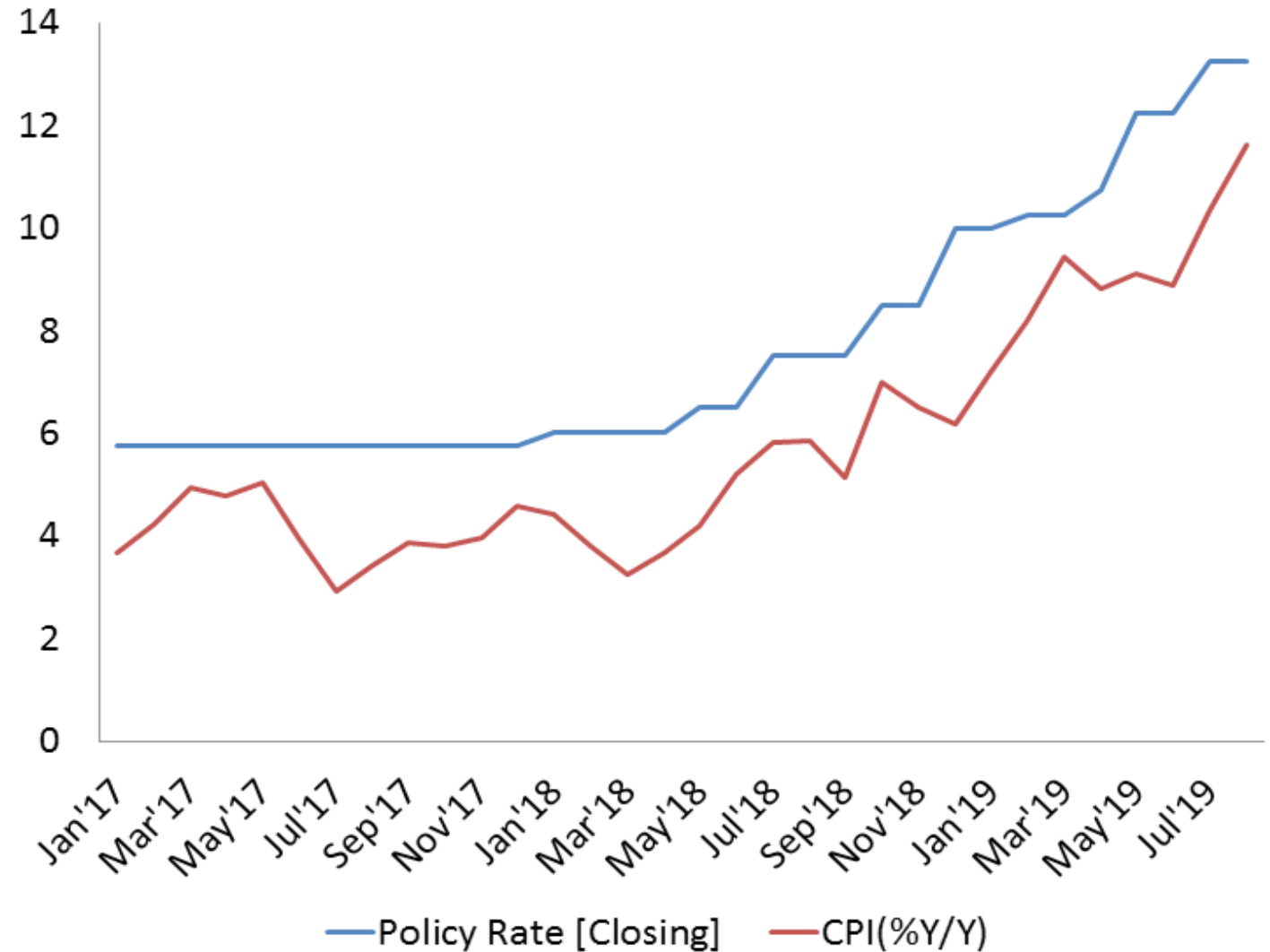


## CPI and Policy Rate Relationship

Post exchange rate devaluation starting from Dec'17, CPI readings have depicted an increasing trend although with a lagged impact. Resultantly, policy rate has continued to increase.

Real Interest Rates based on past 12 month CPI numbers are around 5%. Real Interest Rates are positive at around 2% based on SBP expected inflation of 11.5%.

IMF is projecting that inflation will be around 13% during FY20 and will eventually slow down. (FY21: 8.3%; FY22: 6%; FY23: 5%)



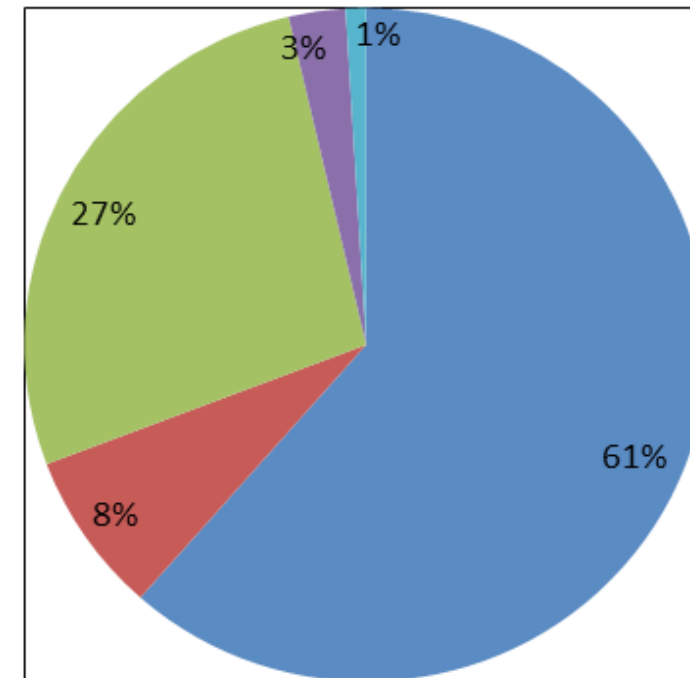
## Efficacy of increasing interest rates to curb aggregate demand

Government plans to curtail the inflation rate by increasing interest rate. However, the quantum of consumer financing in relation to total borrowing is low. Government remains the largest borrower.

Working Capital as a proportion of loans to private sector accounts for 55.2%, while the remainder is associated with fixed investment. With economic slowdown, stocks levels are increasing for majority of the companies, therefore increasing the working capital needs.

### Credit Loan Classification for June 19

- Credit to Government Sector
- Loans to Private Sector
- Others
- Credit to PSEs
- Consumer Financing



## Hot Money and Carry Trades

Higher interest rates could facilitate SBP to increase foreign currency flows in government debt instruments. **Carry Trade** means borrowing in a low interest rate currency and converting the borrowed amount into another high interest rate currency.

### **Advantages of the Carry Trade:**

- Brings stability in external account.
- Generally the Debt Market of Pakistan is small, with a major proportion of government debt funded by commercial banks. With foreign inflows, debt capital market is expected to grow and will make way for other instruments.
- 

### **Downsides of Carry Trade:**

- Carry Trade is a risky strategy, as interest rates are deliberately kept higher to attract hot money, which is easy to attract but outflows can be swift.
- Government might be losing out in the longer run, as the cost of the borrowing is significantly higher.

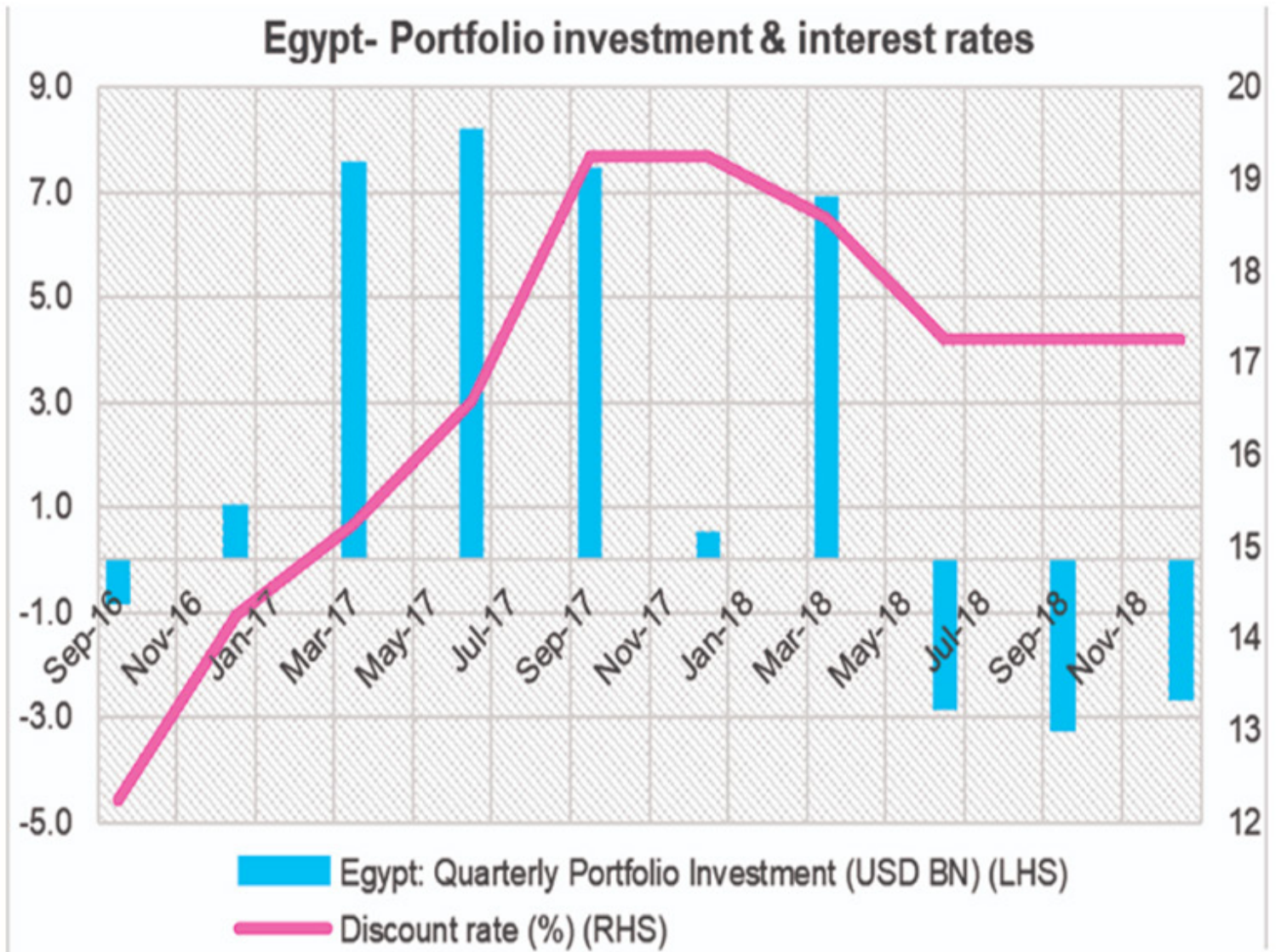
### **Quantum of inflows will depend on the following:**

- Outcome of FATF meeting in October
- Whether inflows are ring-fenced as was the case with Egypt
- Expectation of future currency movement which will depend on receipt of projected foreign currency inflows

## Egypt's Carry Trade

After steep currency devaluation in Nov'16 coupled with increasing interest rates. Egypt saw an influx of portfolio money, an inflow of \$30.7 billion net-flow during Jan17-Mar18 (majority of it in government securities). However, the net portfolio flows became negative with easing monetary policy with an outflow of \$8.7 billion during April18-Dec18.

Unlike Pakistan, Egypt has sizeable foreign currency flows from gas exports and tourism



## Future Outlook

Inflation numbers for the next three to four months would set the direction for policy rate. Inflation numbers are dependent on the following :

- Quantum of quarterly electricity and gas tariff adjustment
- Impact of recent increase in international oil prices
- Fiscal slippages could lead to inflationary pressures
- Market expects interest rates to decline over the next 6 months. This is evident from the latest PIB auction which has resulted in further inversion of the yield curve. This is because 3 years PIBs are currently trading at 12.95% (5 year PIB: 12.5%; 10 year PIB: 12.25%)

## Sources

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