A Primer on Pakistan’s Inflationary Trajectory

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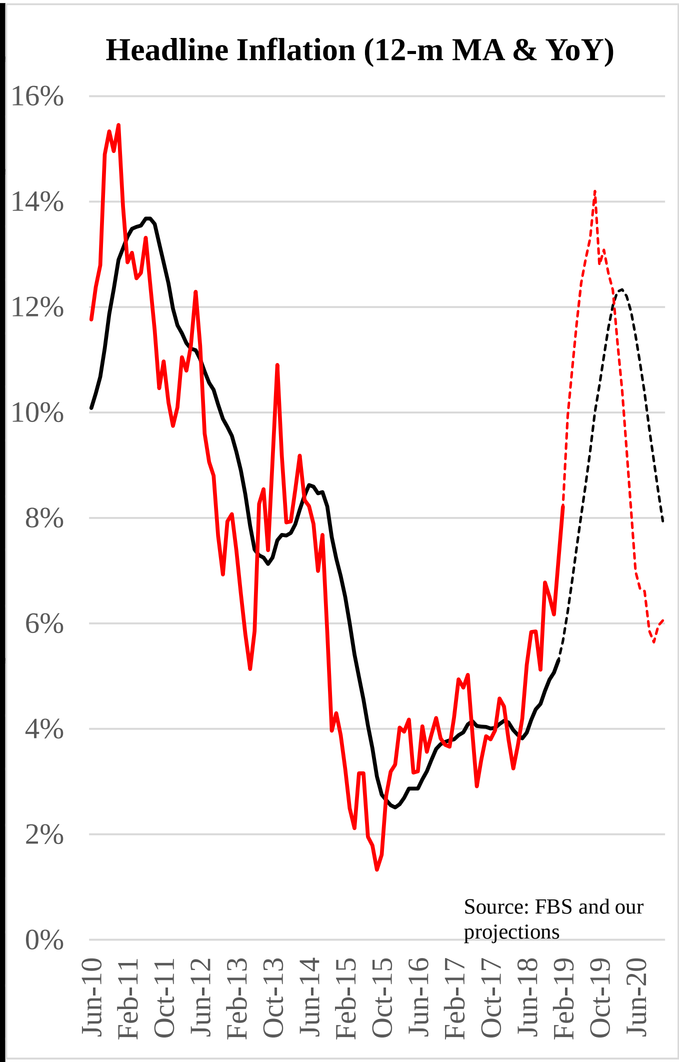
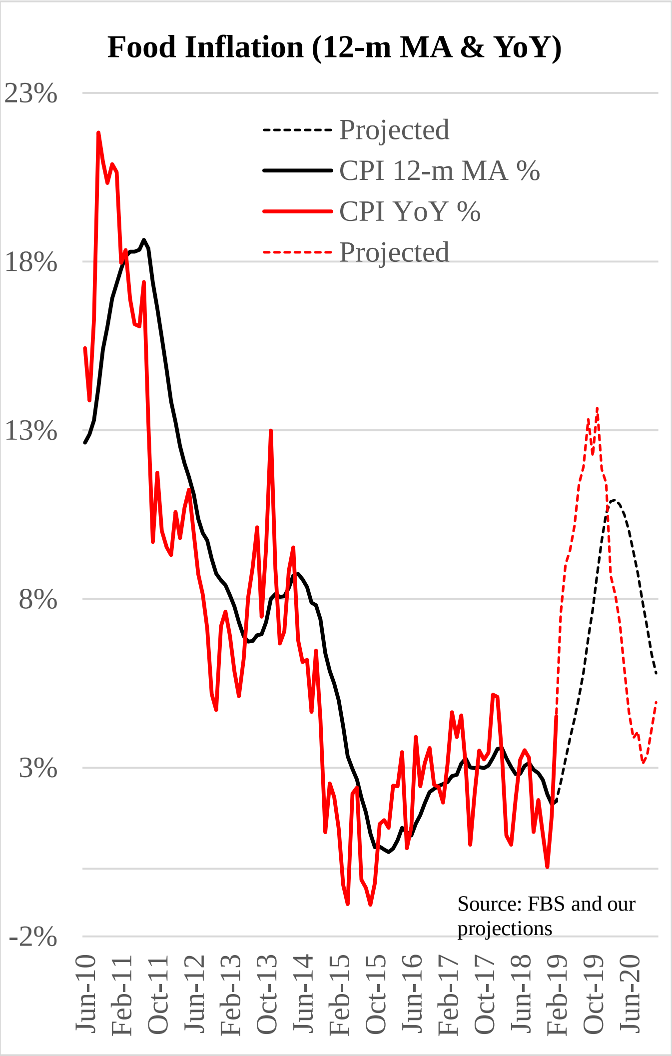
Inflation is back – π

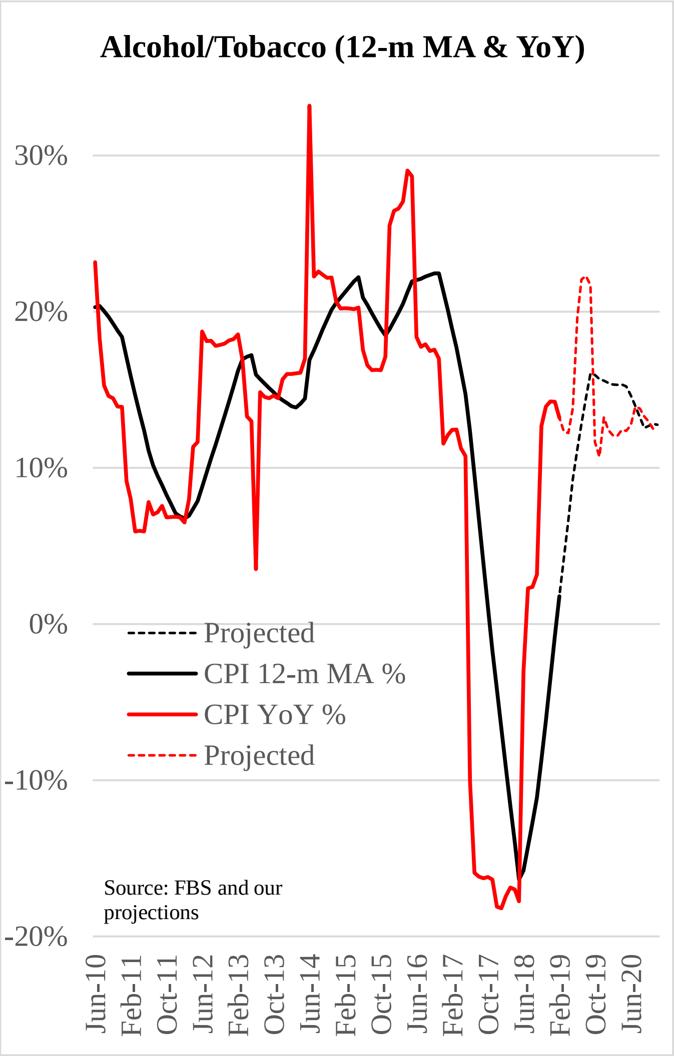
Table 1: Price Shocks		
	Month end	Fuel/ltr (Rs)
	PKR/$	Super
Jul-18	121.6337	99.50
Aug-18	124.2460	95.24
Sep-18	124.2374	92.83
Oct-18	132.5482	92.83
Nov-18	140.2686	97.83
Dec-18	138.7922	95.83
Jan-19	138.2553	90.97
Feb-19	139.0557	90.38
Mar-19	145.9457	92.89
Apr-19	149.0557	97.27
May-19	153.2457	99.31
Jun-19	156.1257	101.20
Jul-19	156.1357	103.77
Aug-19	156.8157	103.77
Sep-19	160.7457	104.46
Oct-19	160.0957	106.90
Nov-19	159.4157	106.90
Dec-19	157.5287	106.90



- **Table 1** shows price adjustments to stabilize economy;
- We focus on *supply-push* factors that drive inflation;
- This will manifest in *food*, *utilities* & *transportation* (71% of CPI basket);
- Latent inflationary forces already exist in the system;
- By end-June 2019:
  - YoY π could be 12.4%;
  - M. Avg π could be 8.0%.
- By these price shocks:
  - YoY could max at 13.9% in September 2019; &
  - Avg inflation could max at 12.0% by Feb 2020.
- Inflation between mid-2014 & mid-2018 was *abnormally* low (oil price collapse). With large twin deficits, inflation should run higher (say 7 - 9%).

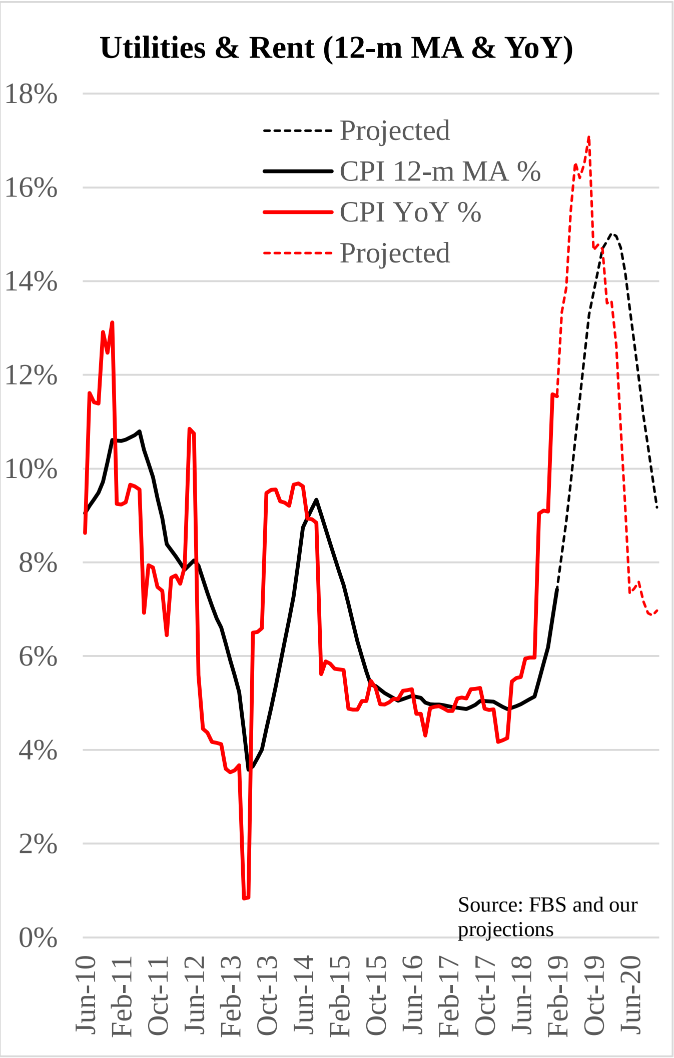
Food inflation

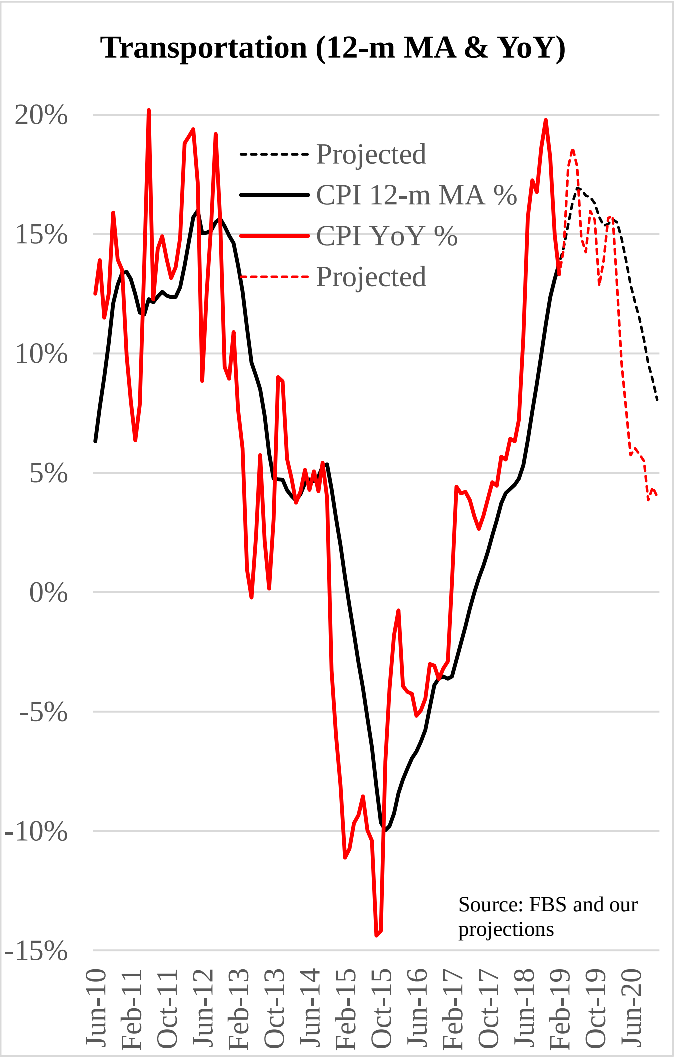




- Food accounts for 34.8% of the CPI basket, and Alcohol/Tobacco only 1.4%;
- Food prices are impacted by retail fuel prices & devaluations;
- Hence the sharp fall in 2014, which is reversing;
- YoY inflation will hit double digits from June to January 2020;
- But this is not unprecedented;
  - YoY inflation exceeded 20% in 4Q-2010;
  - Avg inflation exceeded 18% between March and August 2011.
- GoP will have to manage public sentiments as this will not be an easy period.

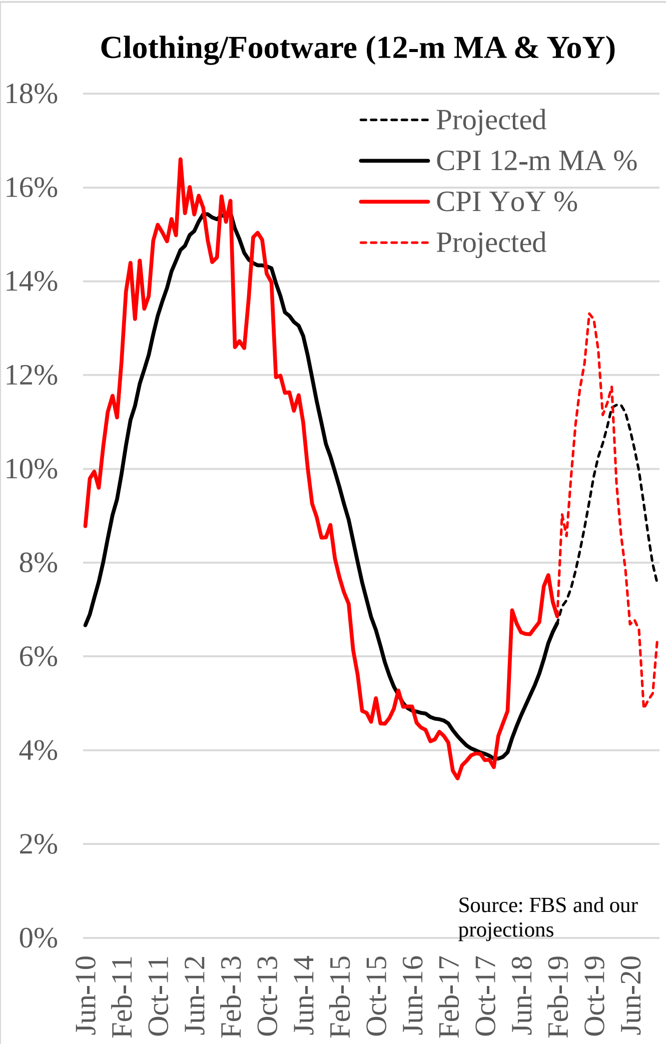
π in utilities & transportation

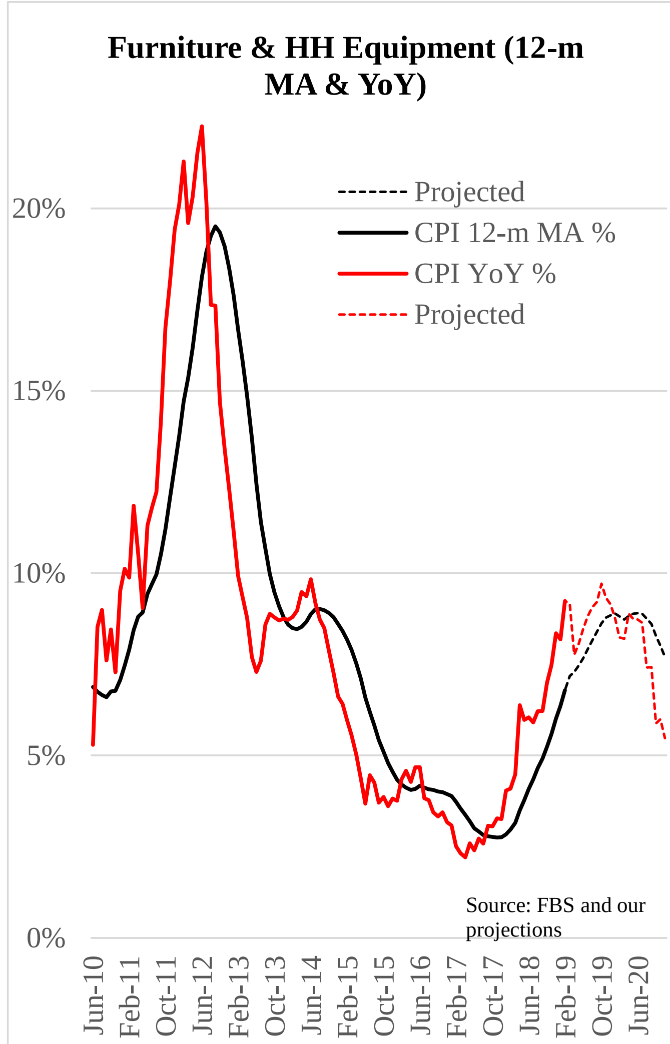




- Utilities (29.4% of CPI) and Transport (7.2%) are directly impacted by PKR/$ and PoL;
- Projections are not that extreme when one looks at realized inflation (solid lines);
- Utility costs will increase as part of the IMF program;
- Urgent need to contain circular debt, reduce PSE losses, and curb imports (weaker PKR). This means we cannot escape this source of inflation;
- We assume global oil prices in the range of $60-70/b in 2019, and softer in 2020.

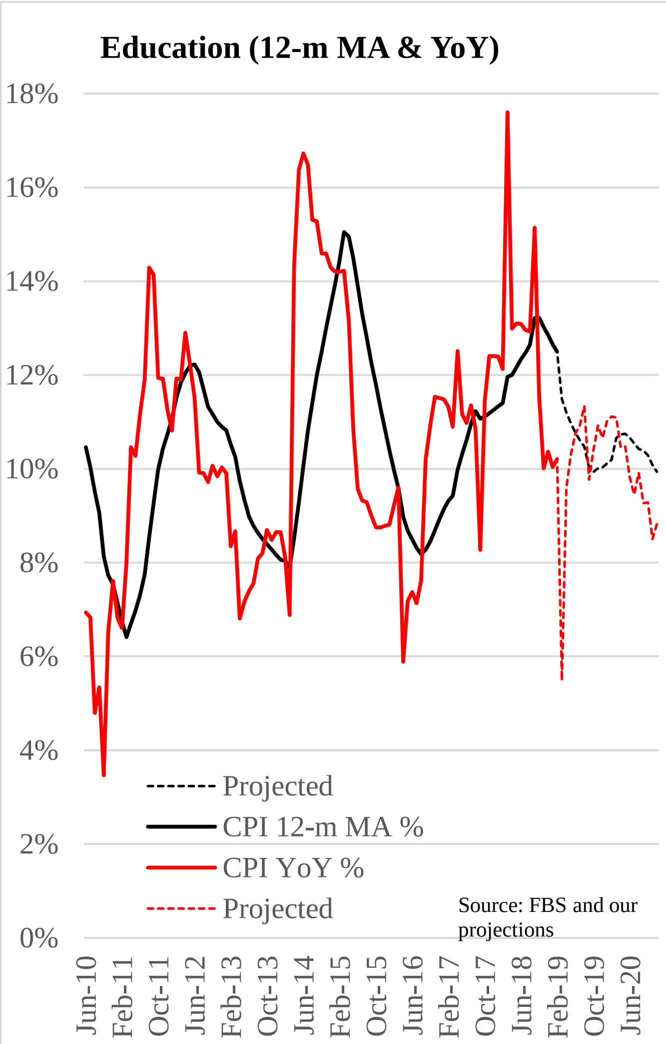
π in Clothing & Household items

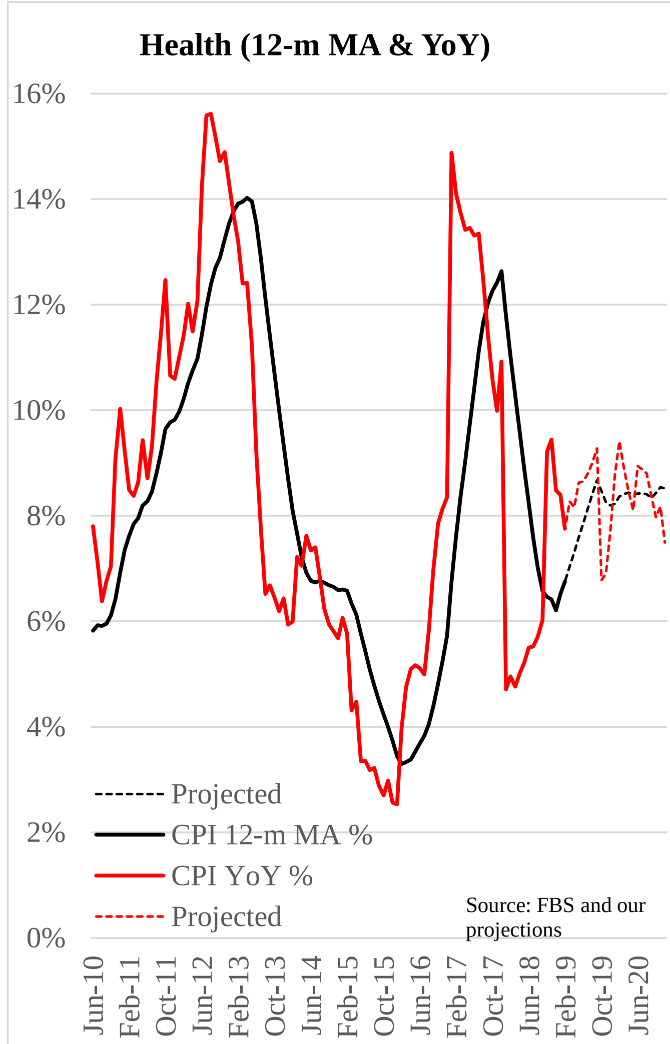




- Clothing (7.6% of CPI) and Household items (4.2%) are significant in the avg household budget;
- Significant share of clothing/footware is imported from China (final products and raw materials);
- Inflationary momentum is already obvious (solid lines);
- With economic slowdown, demand will ease for household equipment & furniture;
- We expect these sub-indices to stabilize in the range of 7 - 9% in 2020.

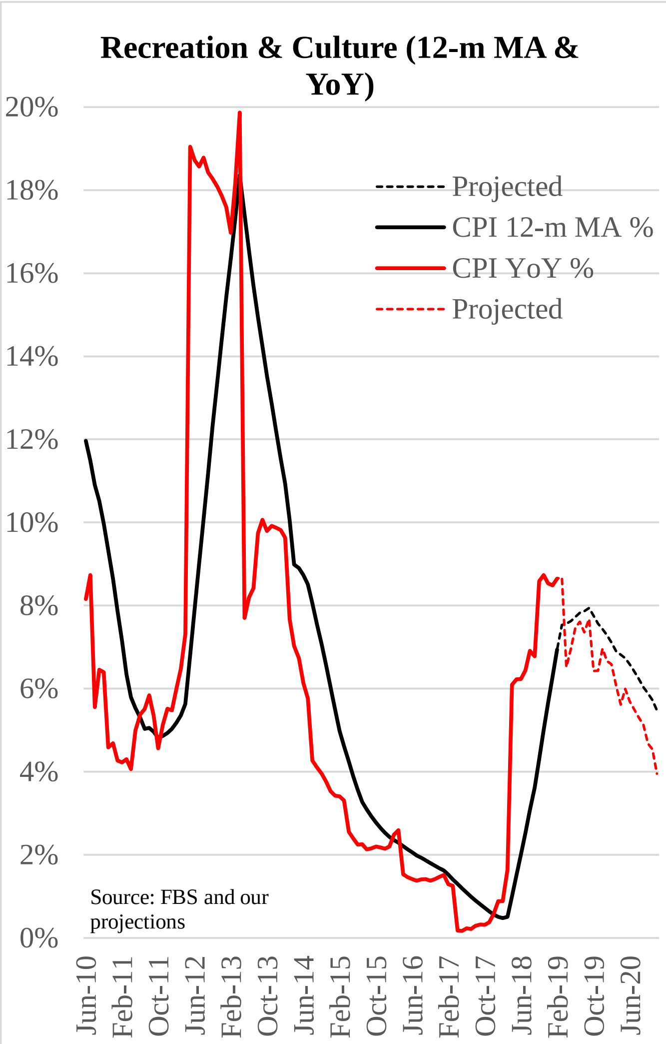
π in Education & Health

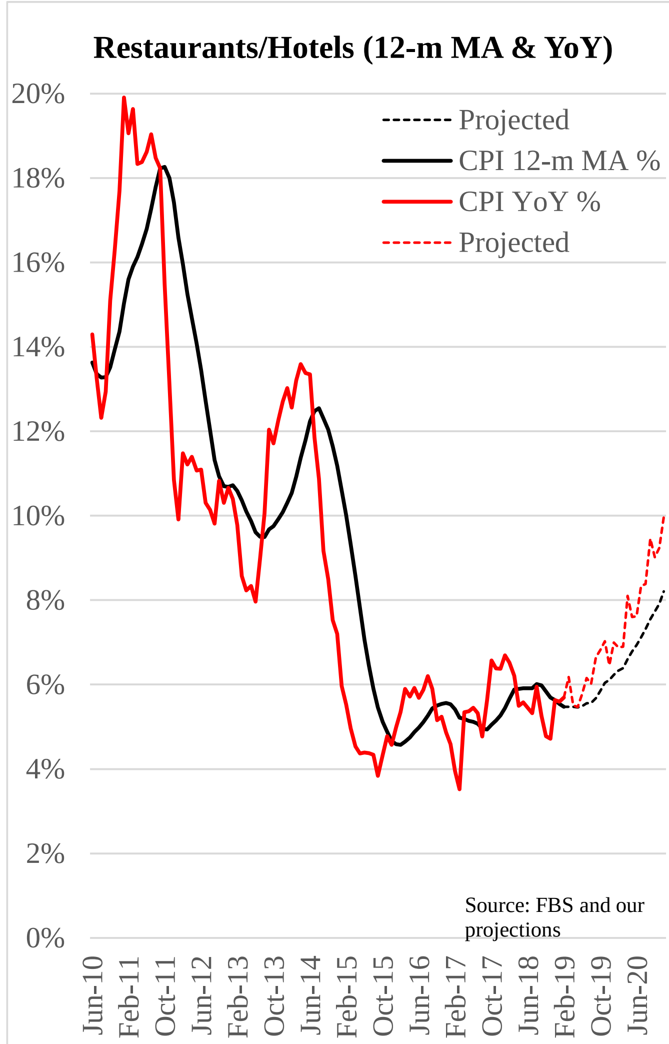




- Education (3.9% of CPI) and Health (2.2%) are also important;
- These are necessary services, & are impacted by stabilization (raw materials for medicines);
- Education inflation is erratic, but this is heading down (see dotted black line);
- Both could stabilize around 8 - 10%, which will hurt the middle-class;
- This means consumer spending (not on essentials) will take a hit in 2019 and 2020;
- GoP should have a proper narrative for this.

π in Recreation & Restaurants





- Recreation (2.0% of CPI) and Restaurants (1.2%) could show diverging trends;
- Recreation is likely to be hit by lower discretionary spending;
- Restaurants & Hotels are for the middle class, and their costing is driven by food and utility costs;
- The squeeze on consumer spending is already being felt and will get worse;
- We expect belt-tightening across the board.

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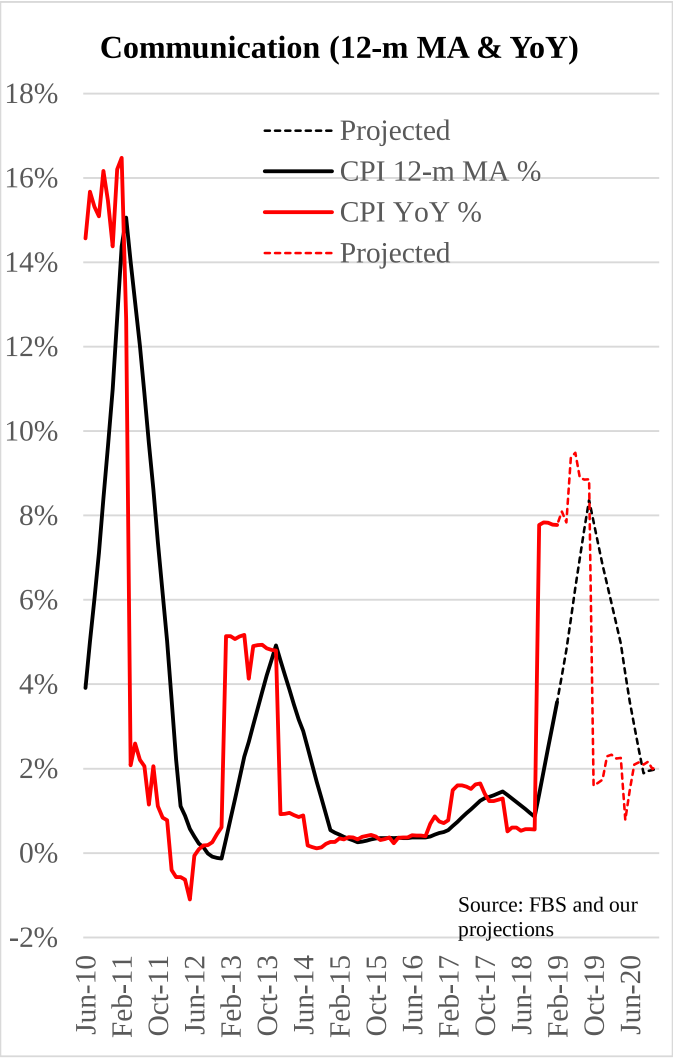
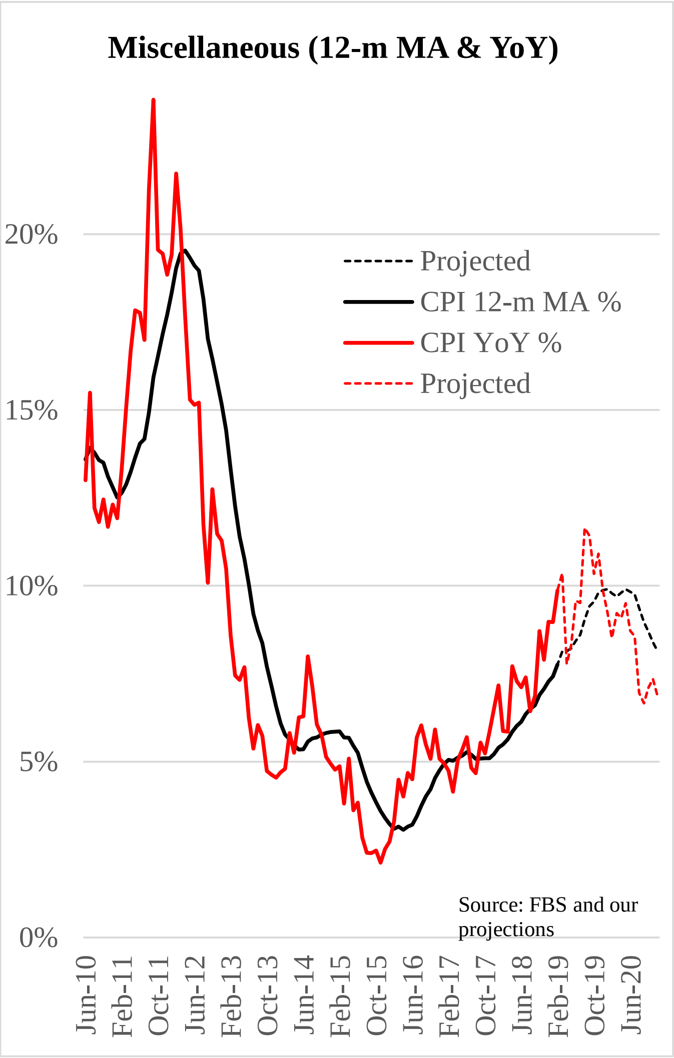
π in Communication & Misc costs





- Communications (3.2% of CPI) and miscellaneous costs (2.8%) are hard to call;
- Cell phone charges have pulled down YoY inflation to less than 1½ % since Jan 2014;
- Then there was a 7.2% MoM increase in the sub-index in October 2018;
- Communication costs will not be a source of inflation;
- Miscellaneous costs could capture demand pressures, which we show to be tapering by mid-2019.

Conclusion

- Our projections are based on the price adjustments shown in Table 1:
  - Inflation will be lower if PKR is not devalued as much, or if fuel prices are not increased to the levels shown (& vice versa);
  - Big moves & currency volatility are perhaps now required to change sentiments in the FX market, or else the trade deficit will continue to haunt policymakers;
  - We think GoP should commit to hard stabilization, even if this means an increase in inflation.
- Inflation will continue to rise in 2019:
  - The inflationary momentum in the various sub-indices is already obvious;
  - For policy-setting however, we should focus on the 12-month moving average inflation rate;
  - Average inflation in FY19 will be around 8% (with YoY inflation in double digits);
  - IMF stabilization program will stoke the inflationary trend.
- The real issue is what happens to interest rates:
  - If avg inflation remains around 8% in FY19, SBP may not be compelled to increase interest rates;
  - The real issue is Pakistan's domestic debt, which urgently needs to be re-profiled;
  - But this requires an end to the monetary tightening cycle, which is hard to justify with inflation rising.
- Policy trade-off is near impossible: **policy orthodoxy** vs. **actual stabilization**:
  - Stabilize the fiscal sector (i.e. manage debt servicing); increase the maturity of domestic debt (i.e. move banks into PIBs); shift GoP borrowing away from SBP (i.e. convince banks that tightening cycle has ended); protect banks' balance sheets (i.e. avoid possible defaults on consumer loans) **OR** keep increasing interest rates as inflation rises;
  - If GoP (& IMF) opts for stabilization, then the policy narrative will have to change substantially.