

3 Prices

3.1 Overview

All price indices depicted a substantial fall in inflation during FY10 compared with the record levels seen in the preceding year (see **Table 3.1**), but even these relatively lower levels of inflation were quite high. In particular, while annual average CPI inflation fell to 11.7 percent during FY10, which was much lower than the 20.8 percent for FY09, it remained significantly higher than the 9.0 percent target for the year. This makes the fourth successive year since FY06 in which inflation target could not be achieved (see **Figure 3.1**). The trend for other inflation measures during FY10 was similar to that for CPI inflation - inflation measured by Wholesale Price Index (WPI), Sensitive Price Indicator (SPI), and GDP deflator¹ all showed significant deceleration during the year, but remained in double digits.

A break-up of headline Consumer Price Index (CPI) reveals that while inflationary pressures eased during the first half of FY10, they resurged January 2010 onwards.² Thereafter, during the second half of the fiscal year, inflationary pressures persistently moved in a narrow range of 12.7 to 13.7 percent (see **Figure 3.2**). The downtrend in the first half of FY10 was due to the combined impact of: (a) continuation of tight monetary stance; (b) fiscal consolidation in FY09 relative to FY08, which resulted in a net retirement in the budgetary borrowings from the central bank; (c) a sharp decline in international commodity prices, as well as, (d) massive improvement in domestic supply of most of the food commodities on the back of better harvests.³ However, not only did most of these factors reverse in the second half of FY10, inflationary expectations strengthened due to reductions in energy-related subsidies during the year.

Table 3.1: Inflation Trends (percent)

	Annual average				YoY*		
	GDP deflator	CPI	WPI	SPI	CPI	WPI	SPI
FY05	7.0	9.3	6.8	11.1	8.7	6.2	9.4
FY06	10.5	7.9	10.1	7.8	7.6	9.0	8.7
FY07	7.7	7.8	6.9	9.4	7.0	7.3	8.0
FY08	16.2	12.0	16.4	14.2	21.5	30.6	26.3
FY09	20.3	20.8	18.2	22.7	13.1	4.1	10.8
FY10	10.1	11.7	12.6	13.2	12.7	17.6	16.5

*June

Figure 3.1: Inflation Actuals vs. Targets

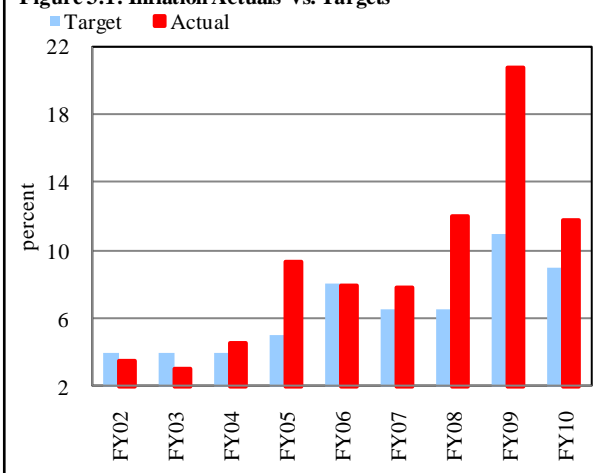
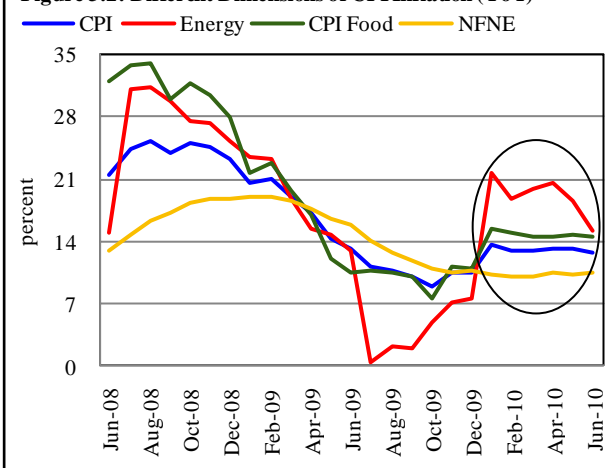


Figure 3.2: Different Dimensions of CPI Inflation (YoY)



¹ GDP deflator is the broadest measure of inflation. This is the ratio of nominal GDP and real GDP. Percent change of GDP deflators for two periods provides inflation for this measure.

² Average CPI inflation was 10.3 percent in H1-FY10 and 13.1 percent during H2-FY10.

³ Major crops grew by 7.3 percent in FY09.

For example, impact of upward revision in electricity tariffs, was further compounded by the government decision to pass-through the impact of rise in international oil prices. Higher production and transportation costs with their attendant impact on prices of food items, pressures on exchange rate in January 2010 when SBP passed on all oil import payments to the market, and reversal in fiscal stance with monetization of deficit, were also important contributing factors to relatively high inflation in H2 FY10.

The impact of rising cost of energy and fuels was more evident in surge in core inflation measured by 20 percent trimmed mean in H2-FY10 compared with a stable trend of core inflation measured by non-food non-energy (NFNE) in this period. It is important to note that both headline CPI and core inflation moved in a narrow range in H2-FY10. However, a decline in core inflation measured by trimmed mean in June 2010 and a rise in NFNE means that inflationary pressures, though eased somewhat, are more broad based. Movements in core inflation point toward persistence in inflationary pressures in months ahead.

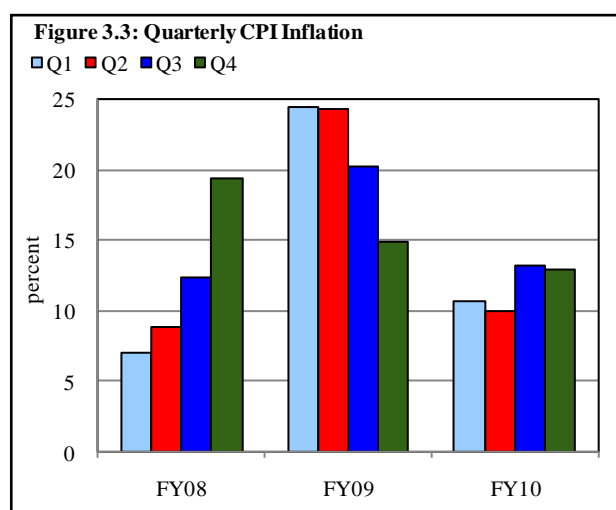
It is important to note that the expansionary fiscal policy during FY10⁴ augmented demand-pull inflation, even as a reduction in energy related subsidies generated cost-push inflation in the economy. The combined impact contributed to the resilience in inflationary pressures in recent months. Furthermore, expected upward adjustments in electricity tariffs, and potentially higher imported inflation as well as a substantial rise in public sector salaries (and attendant rise in demand pressures) had already stoked concerns over the inflation outlook for FY11. In this backdrop, the central bank raised discount rate by 50 basis points to 13.0 percent effective from August 2, 2010.

Inflationary expectations have now been strengthened further by the emerging impact of the unprecedented floods in Pakistan. The resurgence of food inflation could be significant, at least in the short run, following considerable damage to crops, farm machinery, seed stocks, etc. At the same time, the havoc on infrastructure means disruptions in supplies for some months.

Much of the impact of the floods on food inflation is likely to be temporary; e.g. vegetable prices will decline as fresh crops are harvested, and some losses made up through imports. More persistent pressures will come from structural issues and trends in international commodity prices. For example, drought in Russia and Ukraine drove, otherwise subdued, international wheat prices to almost equivalent to domestic prices (excluding transportation costs). Similarly, international edible oil prices also registered gains in recent months. Incorporating these developments, SBP forecasts suggest that annual average CPI inflation is likely to be in the range of 13.5 – 14.5 percent during FY11.⁵

3.2 Consumer Price Index

Overall CPI inflation (YoY) for FY10 was significantly lower compared to the preceding year. It declined during the first quarter reaching its lowest level of 8.9 percent during October 2009. However, after upward adjustment of administered fuel prices, inflationary pressures resurged during the third quarter onwards. CPI inflation moved in a narrow range during FY10 compared to the preceding two years which is also evident in



⁴ Fiscal deficit rose from 5.3 percent of GDP in FY09 to 6.3 percent of GDP in FY10.

⁵ Up from earlier estimates of 11 – 12 percent for FY11 (for details see **Monetary Policy Statement July 2010**).

low standard deviation of CPI during this period (see **Figure 3.3**).⁶

CPI inflation (YoY) was 13.1 percent in June 2009, and was slightly lower at 12.7 percent in June 2010. This persistence in headline inflation was largely attributed to fiscal slippages including monetization of fiscal deficit, and upward adjustment in administered prices, depreciation of rupee, and rising international prices of sugar, cotton, and oil. It is interesting to note that most of the volatility in CPI inflation stemmed from food component. CPI food inflation dropped to 7.5 percent in October 2009 – the lowest level since July 2006, but resurged from there onwards. This rise in CPI food inflation was also reflected in higher number of items registering double digit increases in recent months. Items recording double digit or higher inflation declined in earlier months of FY10, a trend which was reversed in later months (see **Figure 3.4**).

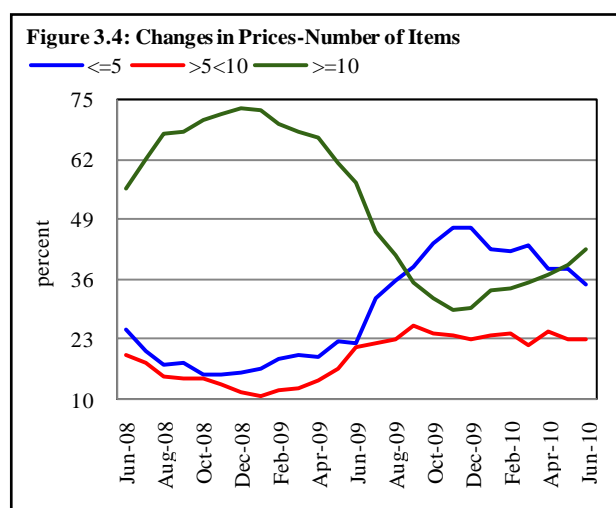
In contrast, non-food inflation was relatively stable throughout FY10 (see **Table 3.2**). This resilience and a slight increase in non-food inflation, despite a continued decline in HRI inflation, is mainly a reflection of rising prices of fuels, energy, transportation, clothing, etc.

3.2.1 CPI Food Inflation

Since non-food inflation moved in a narrow range throughout FY10, the variation in headline CPI inflation mainly came from movements in CPI food inflation during the year (see **Figure 3.5**). It is notable that CPI food inflation was declining till October 2009, then was resurging till January 2010, and finally stayed in the range of 14.5 – 14.9 percent during Feb-Jun FY10. A trend reversal in CPI food inflation after October 2009 was mainly an indirect impact of rise in the prices of key fuels, particularly diesel (up by 8.7 percent [MoM] from November 1, 2009). The impact of increased cost of transportation on prices of food commodities was further compounded by a rise in the prices of imported food items such as pulses, sugar amid (a) depreciation of rupee by 1.1 percent during October 2009, as well as, (b) increase in international prices (see **Table 3.3**).⁷ Thus, a part of the strength in food inflation may be explained by imported inflation.

Table 3.2: Inflation Trends -YoY

	CPI			Core inflation	
	General	Food	Non-food	NFNE	Trimmed
Jun-09	13.1	10.5	15.4	15.9	15.5
Jul-09	11.2	10.7	11.6	14	13.9
Aug-09	10.7	10.6	10.8	12.6	13.1
Sep-09	10.1	10	10.2	11.9	12.4
Oct-09	8.9	7.5	10	11	10.6
Nov-09	10.5	11.1	10	10.6	10.5
Dec-09	10.5	10.9	10.2	10.7	10.4
Jan-10	13.7	15.5	12.2	10.3	12.7
Feb-10	13	14.9	11.5	10.1	12.4
Mar-10	12.9	14.5	11.6	9.9	12.7
Apr-10	13.3	14.5	12.2	10.6	12.7
May-10	13.1	14.8	11.7	10.3	12.5
Jun-10	12.7	14.5	11.2	10.4	11.7



⁶ Standard deviation for FY10 was only 1.6 percent, compared with 4.2 percent and 5.0 percent for FY09 and FY08 respectively.

⁷ In open market rupee was traded at Rs 83.10/US\$ (mid-rate) by end September 2009, depreciated to Rs.84.00/US\$ by end-October 2009.

Prices of some of the food items were on rising trend despite substantially higher production than domestic consumption. These include: onion, moong pulse, meat, rice, fresh fruits. The rise in prices of these items is attributed to strong external demand. Particularly, poor harvests of onions and moong in India provided an opportunity to Pakistani exporters to export moong pulse to India and onion to other countries of the region replacing India as a major supplier during FY10.

A major contribution to CPI food inflation during Nov-Mar FY10 came from non-perishable items. However, despite some ease in contribution of non-perishable items April 2010 onwards, a sharp surge in the prices of perishable food commodities did not allow food inflation to ease. Interestingly, administered fuel prices were adjusted upward both in March and April, which raised the cost of transportation that was the major reason for rising prices of vegetables and fruits during Q4-FY10. It is also important to note that prices of perishable items are more volatile in nature mainly due to supply shocks (see **Figure 3.6**).

In contrast, rise in the prices of some non-perishable items was due to market imperfections. For instance, international sugar prices witnessed significant fluctuations during FY10; however, domestic sugar prices were generally trending upward (see **Figure 3.7**). A major reason was higher cost of domestic sugar production and slow pace of imports, which raised concerns over adequate availability. On one hand, private sector did not participate in sugar imports and on the other hand, TCP faced repeated defaults from suppliers. The experience of public sector sugar trade in FY10 reinforces the view that the government should have a limited role in commodity trade. Private sector should be encouraged and ensured non-intervention but with effective regulations. The role of Competition Commission is important to enforce regulation, making markets to yield efficient outcomes.

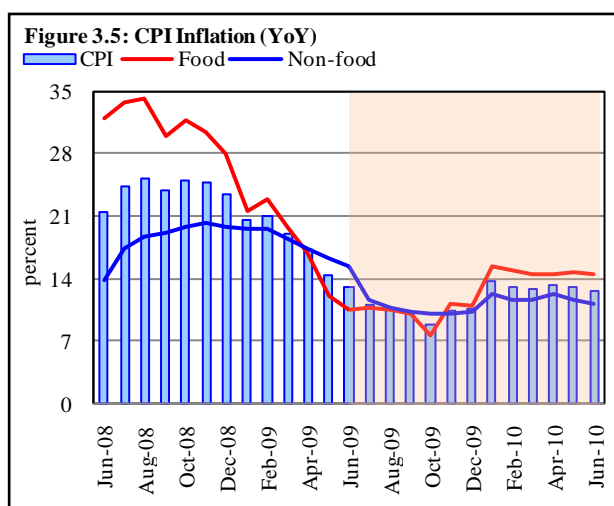
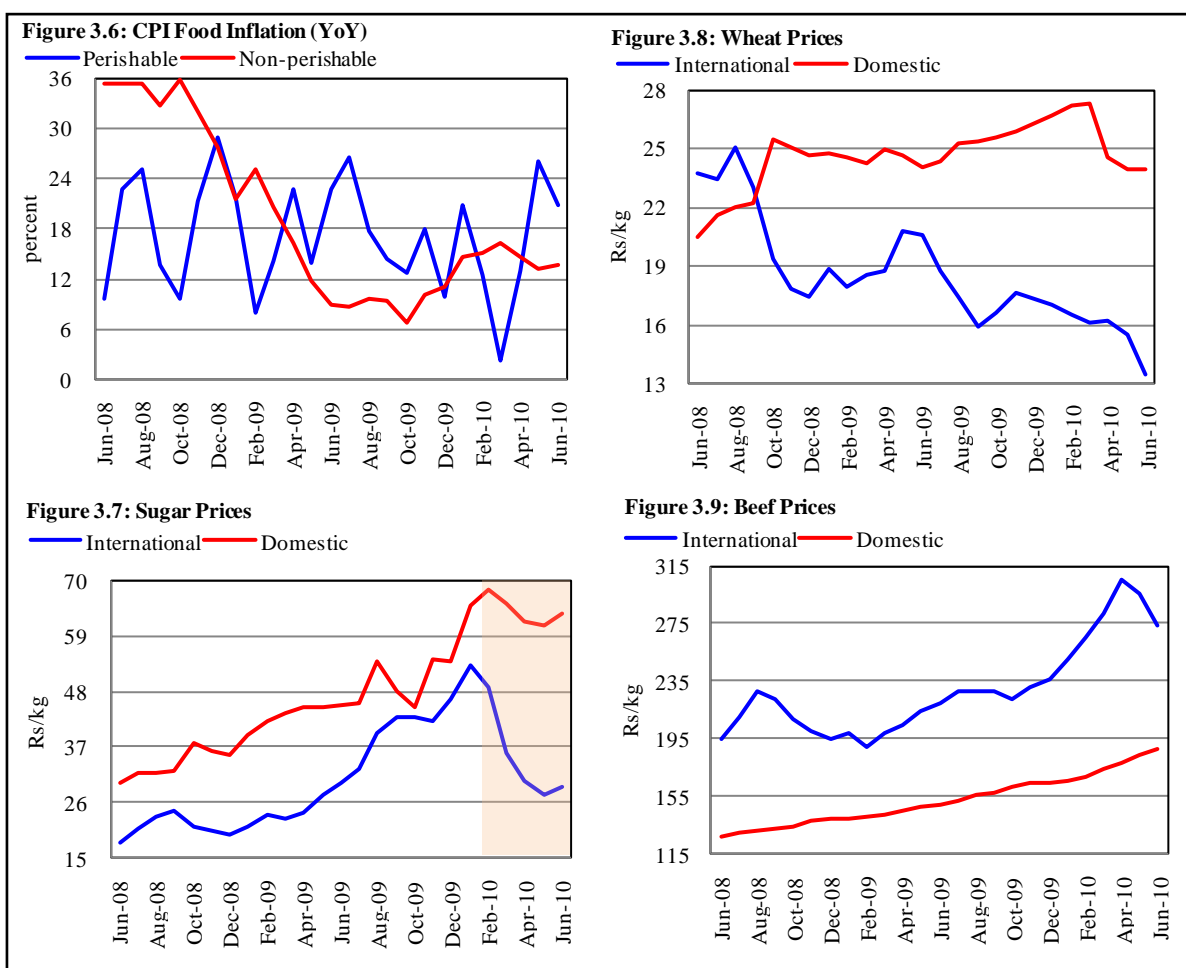


Table 3.3: Inflation in Selected Food-items

Items	Weights	YoY change				
		Oct-2009	Nov-2009	Dec-2009	Jan-2010	Jun-2010
Wheat	0.4830	0.5	3.2	6.3	7.8	-0.5
Wheat flour	5.1122	5.2	6.3	8.0	13.8	1.4
Besan	0.1320	-17.7	-15.4	-12.7	-11.1	12.0
Rice	1.3369	-13.5	-13.7	-10.6	-5.7	1.7
Pulse masoor	0.2214	-1.3	-6.8	-4.9	-3.6	4.0
Pulse moong	0.2230	7.3	39.0	54.1	62.2	134.3
Pulse mash	0.2017	47.4	58.4	66.3	72.5	92.4
Pulse gram	0.4272	-20.7	-16.8	-14.4	-13.7	16.4
Gram whole	0.1491	7.5	9.2	10.5	13.9	14.6
Cooking oil	0.6858	-11.3	-5.9	-5.9	0.4	3.3
Vegetable ghee	2.6672	-11.8	1.1	11.2	10.3	6.1
Sugar	0.1491	19.0	50.1	52.2	65.8	40.3
Fresh fruits	1.6156	8.7	19.3	18.8	20.0	17.5
Chicken farm	0.9158	13.7	37.7	15.3	22.9	20.0
Potatoes	0.5806	1.2	12.3	-3.4	24.2	16.4
Onions	0.6237	-6.1	14.2	-9.1	25.3	5.6
Tea lipton	0.3367	13.8	17.2	18.4	28.1	28.0
Tea loose	0.5674	20.7	20.6	23.2	24.5	25.3
Mutton	1.0883	13.8	15.4	15.3	15.9	27.9
Garlic	0.1949	166.6	215.3	247.2	243.8	288.8



The distortions created by excessive government intervention in setting domestic wheat prices also support this argument. International wheat prices plummeted during FY10 (see **Figure 3.8**). However, domestic wheat prices increased after government announced maintaining procurement price of Rs 950/40kg for 2010 wheat season. This suggests that consumers have to pay higher prices when international prices are higher, but in case of a decline in international prices, the benefit is not passed on to consumers. Government's intention was to ensure domestic food security by maintaining higher support prices; however, both the government and consumers paid the cost for this unwise decision. The government outstanding commodity financing from the commercial banks is at record levels, which entails a substantial financing cost. In addition, government is also facing significant storage costs as well as wastages. Indeed, consumers paid higher prices. The solution of this problem lies in the establishment of futures market, with all necessary infrastructure including contract enforcement and crop insurance.

3.2.2 CPI Non-food Inflation

CPI non-food inflation remained persistent throughout FY10. Annual average non-food inflation at 11.1 percent was significantly lower than the 18.4 percent recorded in FY09. A major reason for a decline in CPI non-food inflation was consistent decline in house rent index, which forms about 40.0 percent of CPI non-food component. HRI peaked out in May 2009 and has been gradually declining since then. It was 9.7 percent in June 2010 compared to 18.6 percent during June 2009. Fall in HRI is attributed to fall in the prices of cement, which has the highest weight in building materials sub-group of WPI basket. However, prices of other construction materials are now on the rise as indicated by trend reversal in changes in building materials sub-group of WPI from October 2009 onwards. As prices of commodities in WPI basket are more in consonance with international prices, rising

international prices of metals are exhibiting their impact on domestic market as well. It may, therefore, be expected that the growth in the HRI, subcomponent of CPI has bottomed out and will rise in coming months (see **Figure 3.10**).

CPI non-food inflation dropped to 11.2 percent (YoY) in June 2010 compared with 15.4 percent in June 2009 (see **Table 3.4**). Despite this moderation, CPI non-food inflation remained persistent and strong. The major impetus to this persistence came from significantly higher *fuel & lighting* and *transport & communication* sub-groups. It is interesting to note that prices of administered fuels (petrol and diesel) are moving in both directions over the years, however, transportation cost and fares are mostly trending upward. This indicates nominal stickiness of the prices in domestic economy.

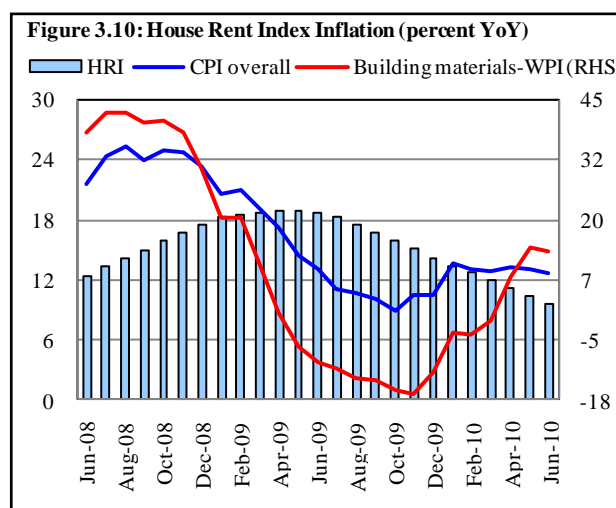


Table 3.4: CPI Non-food Inflation-YoY
percent

	Non-food	Apparel, textile & footwear	House rent	Fuel & lighting	Household furniture & equipment	Transport & communication	Recreation & entertainment	Education	Cleaning, laundry & personal appearance	Medicare
Jun-09	15.4	10.9	18.6	23.8	10.8	5.0	4.5	19.2	14.3	6.3
Jul-09	11.6	6.9	18.3	13.5	9.1	-5.5	3.1	17.8	12.9	6.1
Aug-09	10.8	6.1	17.6	13.2	7.8	-5.6	2.9	13.5	11.9	6.0
Sep-09	10.2	5.6	16.8	12.7	7.2	-6.4	2.4	13.4	11.7	5.2
Oct-09	10.0	5.1	16.0	14.1	6.2	-5.9	2.1	13.7	10.7	5.4
Nov-09	10.0	4.7	15.1	5.1	5.7	4.7	2.6	13.4	11.1	5.3
Dec-09	10.2	4.8	14.2	6.2	5.7	6.6	2.5	13.5	11.8	5.1
Jan-10	12.2	5.2	13.4	20.2	5.6	9.4	2.1	13.7	11.5	5.9
Feb-10	11.5	5.6	12.7	17.2	5.5	10.4	4.3	12.9	9.8	5.9
Mar-10	11.6	6.1	12.0	17.1	5.3	14.0	4.3	12.5	8.6	6.0
Apr-10	12.2	7.7	11.2	16.7	5.9	20.5	14.7	8.8	9.1	8.6
May-10	11.7	8.8	10.5	15.8	6.2	18.7	14.5	8.4	9.2	9.2
Jun-10	11.2	9.3	9.7	16.4	6.7	15.8	14.4	8.4	10.0	10.6

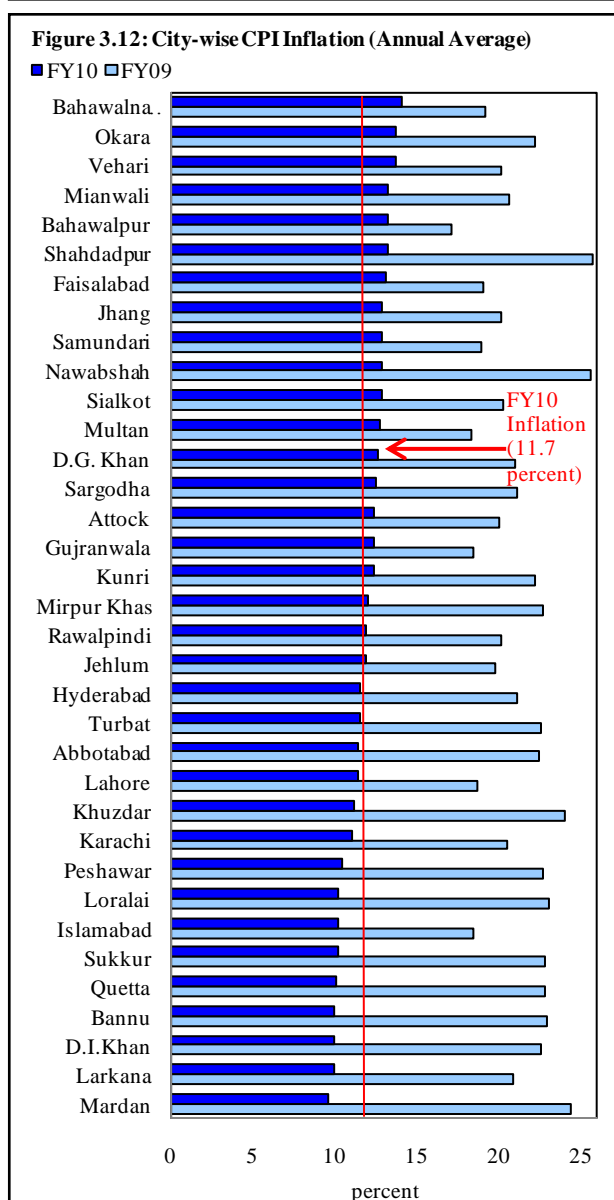
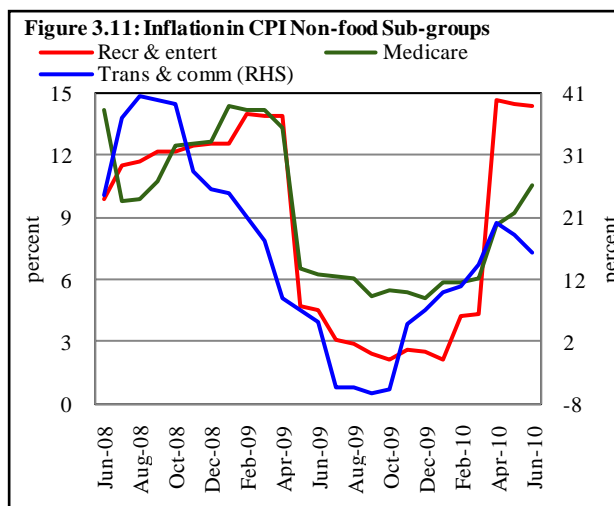
The rise in the contribution by *transport & communication* sub-group was due to upward adjustments in fuel prices following the rise in crude oil prices in international market. Similarly, prices of different drugs and medicines mainly contributed towards rise in inflation in the medicare sub-group (see **Figure 3.11**). A change in the prices of medicines needs approval of the government. Pharmaceutical companies were allowed to increase prices of their products during FY10 as prices of most of the raw material increased in the preceding years. Moreover, cost of production was also increased due to higher international prices of imported raw materials, as well as, depreciation of Pakistani rupee. The rise in inflation in *recreation & entertainment* sub-group during FY10 was mainly driven by a rise in TV license fee.⁸

Moreover, inflation in fuel & lighting sub-group also remained higher during FY10 due to upward adjustment in fuel prices and increase in electricity tariffs. As a part of government's agreement with IMF, it had to curtail its fiscal deficit by reducing subsidies in different sectors. Subsidies not only create market inefficiencies but are burden on national exchequer as well. Fuel and electricity tariff adjustment has shifted this burden to consumer which is likely to result in relatively more efficient use of these resources.

3.2.3 City-Wise Inflation

City-wise inflation data reveals that the highest CPI inflation was registered in Bahawalnagar during FY10 and the lowest in Mardan (see **Figure 3.12**). A break-up of the cities in terms of inflation during FY10 suggests that only a few big cities witnessed higher than average inflation during FY10 and most of the small urban centers of the country witnessed above average inflation. Interestingly, large urban centers including federal and provincial capitals experienced below average inflation. This pattern is probably because:

- a. FY10 inflation was mainly driven by food prices and bulk supplies to major



⁸ Pakistan Television has increased the TV license fee from Rs 300 to Rs 420 in April 2010.

urban centers help contain price hikes. But large supplies is a function of relatively higher prices in large cities due to profit margins of traders and transportation costs, which dampens the impact of change.

- b. Due to relatively higher income levels, weight of food sub-group for major urban centers is lower than the low-income small urban centers.
- c. A below average inflation in some far flung areas shows that a rise in food prices was less evident as most of these cities are largely self sufficient and generally supply vegetables and fruits to other cities.

3.2.4 Incidence of inflation

Since contribution of food inflation was dominant during recent years, the incidence of inflation fell disproportionately on low income groups (see **Table 3.5**). This is important to note that not only food inflation was higher in recent years, it was also more variable. Therefore, low income group is not only hit by higher inflation (see **Box 3.1**), incidence of inflation is more uncertain for this group compared with other income groups. It also implies that high and middle income groups experience relatively low and stable inflation. This situation suggests that targeted subsidy programs for the provision of key staples at low prices through Utility Stores Corporation should be introduced for the low income groups. This can be done with the help of NADRA and would help improve the national database of CNIC holders.

Table: 3.5: Incidence and Variability in Inflation

	CPI inflation (percent)		Standard deviation*	
	FY09	FY10	FY09	FY10
All income groups	20.8	11.7	4.24	1.57
Food	23.7	12.5	8.23	2.6
Non-food	18.4	11.1	1.55	0.83
Up to Rs.3000.	22.1	12.1	5.45	1.8
Rs.3001 - 5000.	22.1	12	5.26	1.67
Rs.5001 - 12000.	21.6	11.9	4.44	1.54
Above Rs.12000.	19.5	11.5	3.84	1.68

(*): Standard deviation computed by using monthly YoY CPI inflation for the respective fiscal years.

Box 3.1: Stylized Facts of Inflation⁹

Analysis of price statistics reveals some interesting facts. Some of them are given below:

Fact-1: Food inflation is generally higher in Pakistan than non-food inflation.

In recent years, it has been observed that food inflation remained higher than non-food inflation, irrespective of the levels of inflation (see **Table 3.1.1**).

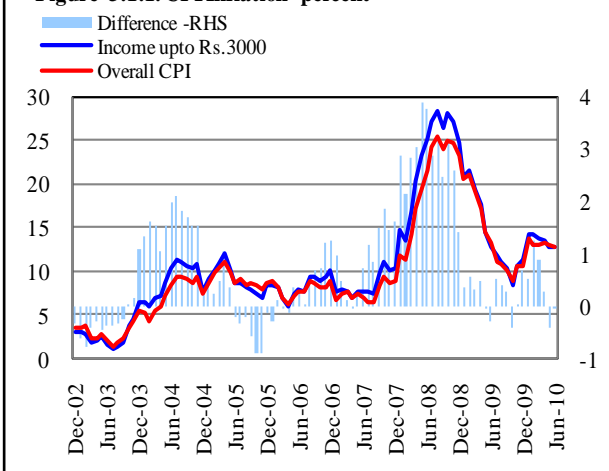
Fact 2: Headline CPI inflation was higher for low-income groups than the overall inflation.

Year-on-year (YoY) inflation on monthly basis from July 2002 to June 2010 reveals that out of 96 observations, CPI inflation for low-income group was higher than the overall CPI inflation for 67 times (about 70%). Inflation for low income group dropped below overall inflation only for 29 months during the sample period. It implies that low income group faced disproportionately higher inflation during most of this period. **Figure-3.1.1** also reveals that low income group witnessed a disproportionately lower inflation when inflation was decelerating. However, this was observed more when inflation was below 10% and declining

Table 3.1.1: CPI Inflation percent

Averages	Overall	Food	Non-food
FY03-FY10	9.67	11.62	8.26
FY03-FY07	6.55	7.73	5.73
FY08-FY10	14.88	18.10	12.48

Figure 3.1.1: CPI Inflation -percent



⁹ This note is an extract from a work in progress for the SBP Working Paper Series. The views expressed in this Box are those of the author and do not necessarily reflect those of the State Bank of Pakistan.

further. Therefore, it is important to maintain inflation in single digit to protect the low income group.

Fact 3: CPI inflation was higher for low-income than the higher income group.

A comparison of consumer price inflation for low income and high income groups reveals that out of sample period of 96-months, low income groups faced higher inflation for 70 months. More importantly, low income groups were relatively better off when inflation was low and declining. For example, inflation was lower for low income groups than high income group (for 11 months in a row) when inflation declined from 3.3% in Oct-2002 to 2.2% in Sep-2003 (see **Figure 3.1.2**). Similar episode was repeated for another 11 months when inflation fell from 9.7% in May-2005 to 6.2% in April-2006. This was not a coincidence. It shows that when inflation is low and falling, it is advantageous for the low income groups. In simple words, disinflationary process at low levels is more beneficial for the low income groups than the disinflationary process at high inflation rates as observed during FY10.

Fact 4: Middle income groups are more vulnerable to all types of inflationary shocks.

The above discussion establishes that low-income group is more exposed to food inflation and high income group to non-food inflation. However, data shows that middle income groups are vulnerable to both food and non-food inflation due to their consumption pattern. This peculiar situation exposes this group to all types of inflationary shocks and most of the time they face average CPI inflation (**Figure 3.1.3**).

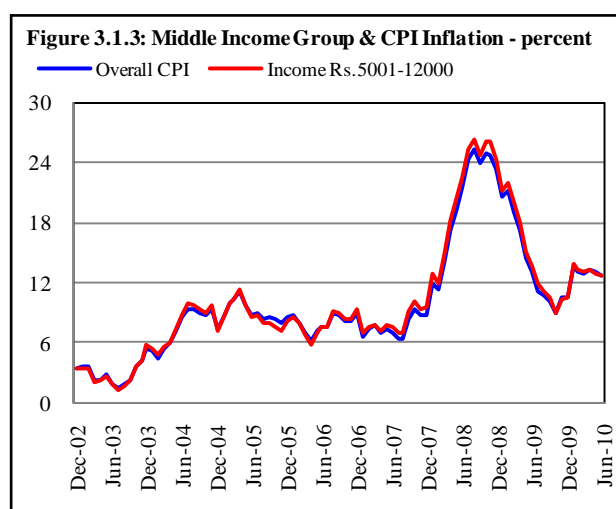
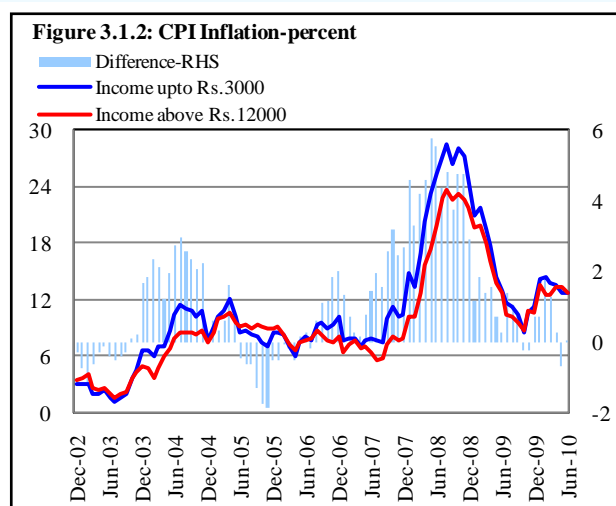
Conclusion and Implications

The above stylized facts are presenting a clear picture that high inflation is harmful for low income groups than high income group. It is a fact that inflationary pressures were mostly ignited from food inflation in Pakistan. Since low income groups spend most of their income on food commodities, they are more vulnerable to high inflation.

These findings suggest formulation of pro-poor policies to protect low income groups from the adversaries of inflation. These can be:

- Targeted subsidy: instead of providing general subsidies, only targeted subsidies should be extended to low income groups. At least key staples should be provided at discounted prices through Utility Stores Corporation by using NADRA database. It would also help improve documentation in the country.
- In case of surge in the prices of key staples (due to domestic or international factors), the scope of above mentioned targeted subsidy programs should be extended from low to middle-income groups.
- A part of this subsidy may be recovered by imposition of high tariff on imported luxury food items such as cheese, olive oil, canned food, confectionary, chocolates, etc.
- More important are the concrete efforts to increase domestic production of key staples and perishable food items (vegetables and fruits). Experience of other countries shows that enormous potential is available to raise yields of almost all crops and dairy farms. Improvement in supply at lower cost would help control volatility in food prices.
- There is a need for formulation and effective implementation of regulations to discourage antitrust activities such as cartelization, monopolies, hoarding, etc.

Finally, active associations of consumers can also play an important role to control profiting behavior of the traders.



3.3 Wholesale Price Index (WPI)

Inflation measured by Wholesale Price Index (WPI) dropped to the lowest level since May 2002 during the first quarter of FY10. However, inflationary pressures resurfaced Q2-FY10 onwards due to: (a) impact of rising international commodity prices; (b) gradual weakening of domestic currency; (c) upward adjustment in administered prices of key fuels; and (d) increase in electricity tariff to agriculture and industry. These factors led WPI inflation to 22.0 percent YoY in April 2010 – 18 months’ high (see **Figure 3.13** and **Table 3.6**). However, WPI inflation (YoY) slightly moderated during the final two months of FY10 amid a relative ease in international oil prices as well as improvement in domestic supply of some food commodities.

In contrast to CPI inflation, rise in non-food inflation principally drove WPI inflation during FY10. WPI non-food inflation reached 27.7 percent in April 2010 from a deflation of 5.6 percent in August 2009. Whereas, WPI food inflation rose from a bottom of 5.8 percent in August 2009 to its local peak of 16.3 percent in March 2010.

Within WPI non-food, all sub-groups except *building materials* witnessed rising trend in inflation during the year. Inflation in *fuel & lighting* sub-group remained strong due to rise in international crude oil prices and reduction in government subsidy on electricity tariff. Whereas, *raw materials* sub-group inflation was fueled by rise in international sugarcane and cotton prices amid weaker harvests in key producing countries. While domestic sugarcane harvest declined during FY10, cotton output increased. However, massive export of raw cotton and yarn resulted in domestic shortages.

Whereas, *building materials* sub-group remained in deflation during the first three quarters of FY10 mainly due to decline in cement prices amid weaker external demand that led to increased domestic competition. Similarly, a moderation in the prices of wires & cables amid relatively lower copper prices also contributed to contain inflation in this sub-group. However, *building materials* sub-index posted a positive rise in the final quarter of FY10 largely due to rise in the prices of iron bars & sheets. This rise in iron bars & sheet prices was attributed to higher international prices of iron ore during Q4-FY10 on the back of strong demand from China (see **Figure**

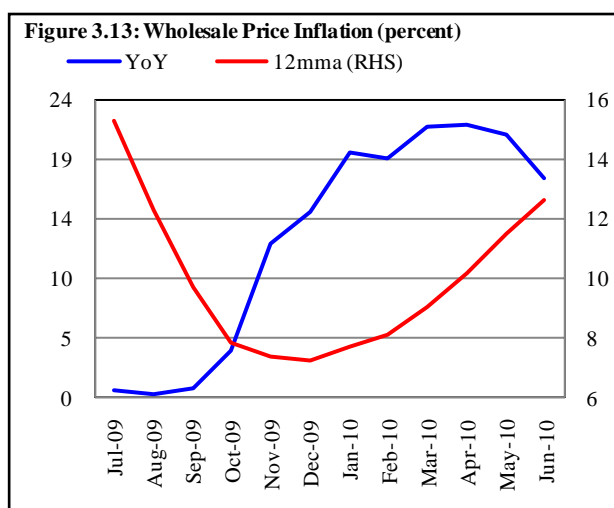
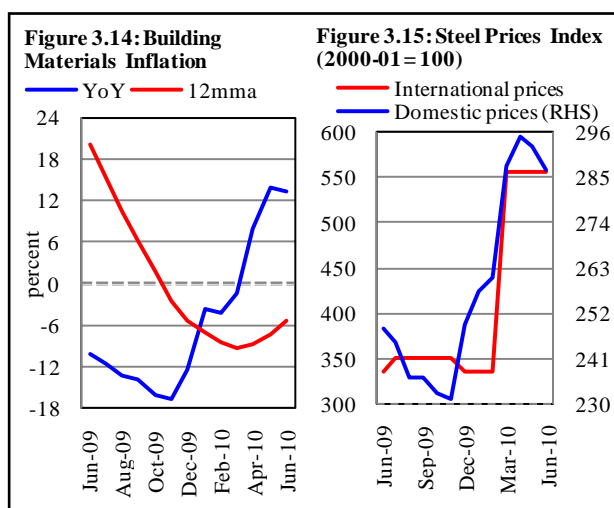


Table 3.6: WPI Inflation Trends

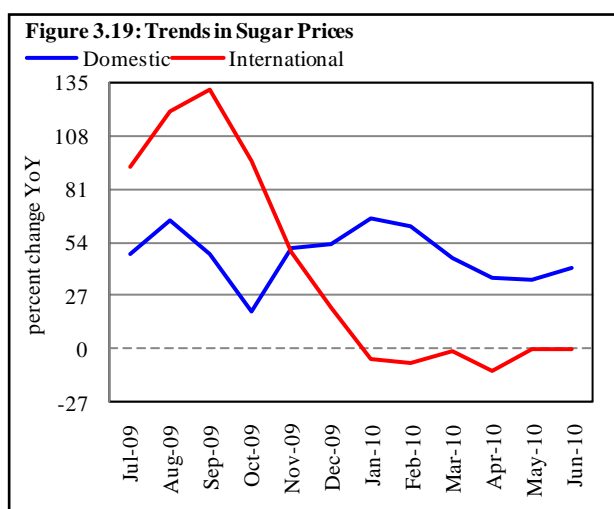
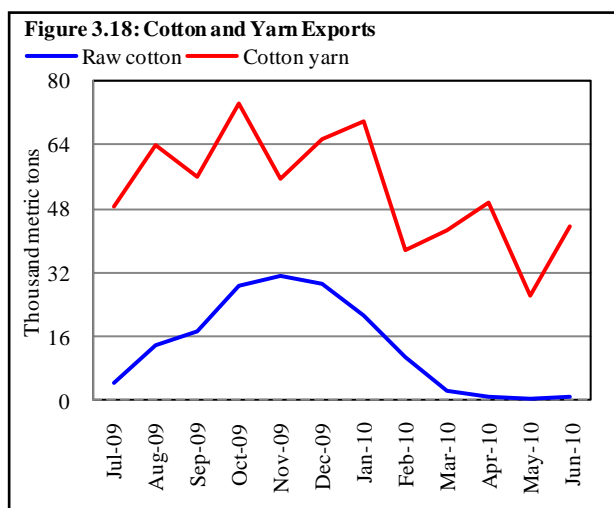
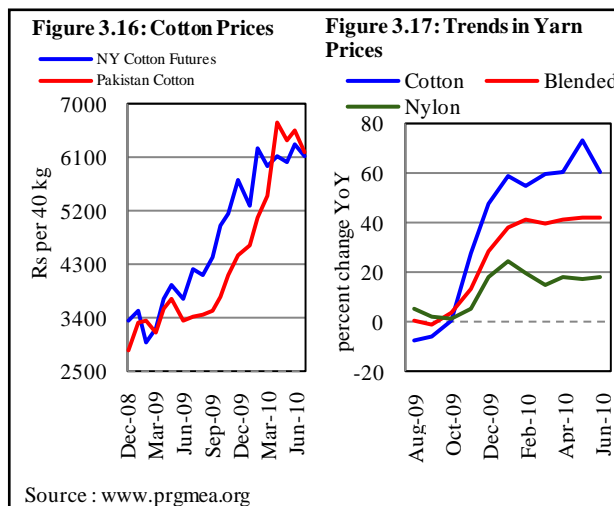
	FY09	FY10	FY09	FY10
	YoY-June		Annual Average	
Overall	4.15	17.62	18.19	12.63
Food	10.24	14.52	23.24	11.92
Non-food group	-0.34	20.14	14.39	13.20
Raw materials	11.94	50.48	17.81	29.09
Fuel, lighting & lubricants	-3.99	12.62	15.95	14.52
Manufactures	3.16	19.53	9.62	10.15
Building materials	-10.14	13.18	20.21	-5.44



3.14). Figure 3.15 shows that as the steel prices increased in the international market in H2-FY10, prices of iron bars & sheet in the domestic market also increased which were declining during H1-FY10. In addition, some other factors such as domestic demand and inventory levels also affect domestic prices of iron bars & sheets.

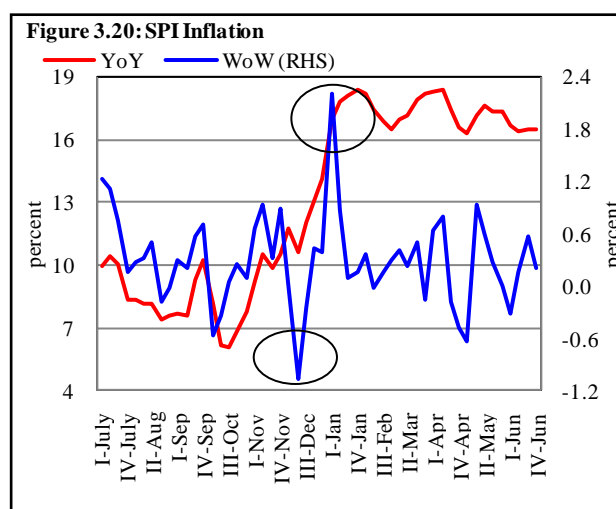
Inflation in *raw materials* and *manufacturers* sub groups is attributed to a number of factors including cotton price hike. Cotton prices in the local market registered significant increase during FY10 and generally followed trends in international prices (see Figure 3.16). However, domestic cotton prices remained well above the international prices. This was probably due to strong domestic and external demand because of higher export of Pakistan yarn and raw cotton (see Figure 3.18), which raised concerns over availability of yarn in the country. This factor compelled the government to ban cotton yarn exports by restricting monthly export quantum to 50 million kg in January 2010, which was then reduced to 35 million kg in March 2010. However, rapid depletion of cotton stocks and demands from value-added textile sector pushed the government to impose 15 percent regulatory duty on exports of all types of yarn in mid-May 2010. The impact of surge in cotton prices is also reflected in the increases in the prices of different types of manufactured yarn and clothing in CPI basket (see Figure 3.17).

Tobacco and sugarcane were the two other important items that contributed to strong inflation in *raw material*, and also led to increase in the prices of manufactured items such as refined sugar, gur, beverages, and cigarettes. Domestic sugarcane production declined in FY09 and FY10. However, it also coincided with crop failure in India, a major producer and consumer. Therefore, international sugar prices rose to 30-year high levels. Domestic sugar prices also reached record high levels in recent months, despite some ease in international prices (see Figure 3.19).



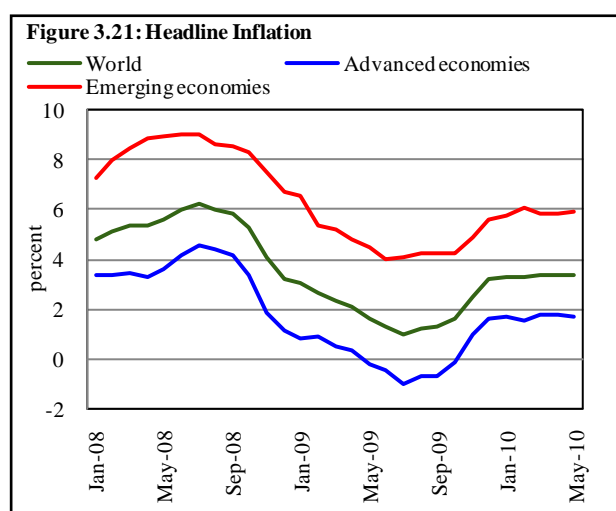
3.4 Sensitive Price Indicator (SPI)

Weekly inflation measured by SPI (based mainly on food items)¹⁰, remained strong during FY10 due to persistence in food inflation. Weekly SPI inflation (YoY) rose to 16.5 percent in the last week of FY10 compared to 9.9 percent in the first week of the fiscal year (see Figure 3.20). A greater fluctuation was observed during mid-FY10. Weekly SPI witnessed a deflation of 1.1 percent in the second week of December 2009 due to improved supply of rice and gur on account of arrival of new crops in the market. However, in the first week of January 2010, weekly SPI inflation reached 2.2 percent due to: (a) upward adjustment in electricity and gas tariff; as well as, (b) domestic shortages of onion and egg.



3.5 Global Inflation Scenario

The inflationary pressures strengthened globally as a result of fiscal stimulus and better than expected recovery in major economies,¹¹ particularly in emerging Asian economies (see Figure 3.21). Higher industrial production, double digit growth in trade, improvement in consumer confidence, and growth in employment opportunities were the main reasons for better performance of the world economy. Overall, macroeconomic developments confirmed expectations of a modest but steady recovery in most of the advanced economies and strong growth in many emerging and developing economies.



Inflation remained high in emerging economies¹² during FY10, especially in the first five months of 2010 with 5.9 percent monthly average rate. The surge in inflation in emerging economies was probably due to: (a) revival of asset price inflation on account of rise in capital inflow; (b) a very strong recovery following the financial crisis; and (c) operating much closer to full capacity level, reflecting higher domestic demand. It is expected that inflation will be up to 6.3 percent in 2010. In emerging economies, central banks have adopted contractionary policies to control the inflationary pressures. In recent months, India, Australia, Malaysia, South Korea, Pakistan, and Thailand have raised their policy rates (see Table 3.7).

In contrast to emerging economies, advanced countries came out from the phase of deflation from May 2009 to October 2009. Since November 2009, prices started to rise but with slower pace;

¹⁰ 41 items out of total 53 belongs to food group while only 12 items are from non-food group.

¹¹ IMF's latest projections show that the world economy would grow by 4.6 percent in 2010, up from 4.2 percent earlier growth forecast. IMF has maintained the growth forecast at 4.3 percent for 2011.

¹² Argentina, Brazil, Bulgaria, Chile, China, Colombia, Estonia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, and Venezuela.

consequently inflation remained low in advanced economies on the back of weak domestic demand, excess production capacity, and continued high unemployment rate. Inflation in advanced countries remained stable or flat at a low level of about 1.5 percent during recent months. Core inflation in the advanced economies dropped to very low levels reaching 0.9 percent (YoY) in May 2010, the lowest core inflation rate since January 2002 (see **Figure 3.22**). In most of the advanced economies, monetary authorities have kept the policy rates at low levels to stimulate the economic activities.

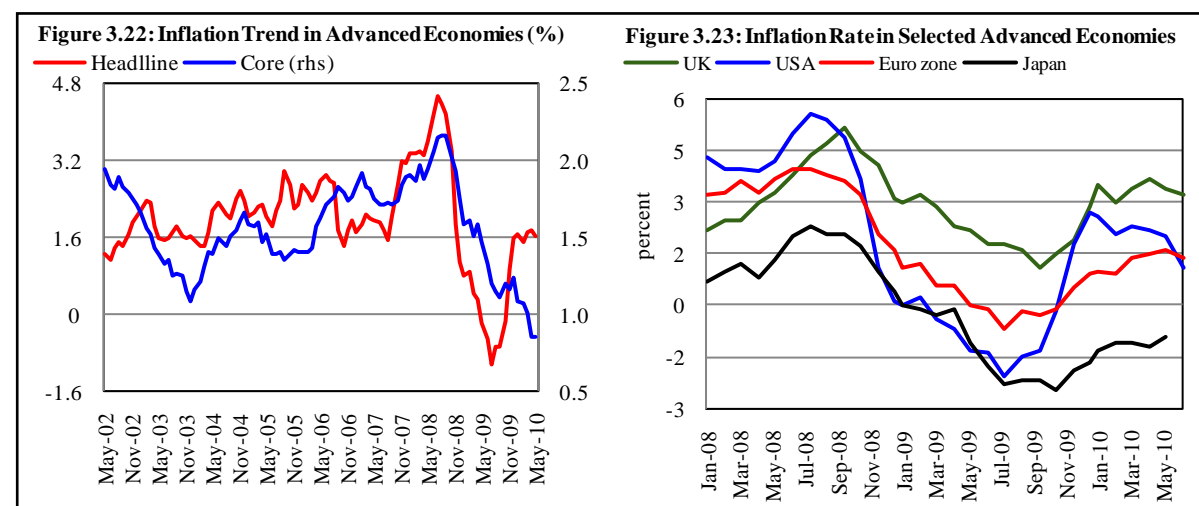
Within the advanced economies, further decline was observed in inflation in USA and UK during June 2010 (see **Figure 3.23**) due to lower gasoline cost and increase in unemployment.

And a continuous deflation is observed in Japanese economy since January 2009. Weak exports growth of many items such as consumers electronics, automobiles, optic fiber to main trading partners (USA, China and European Union) are the main factors responsible for deflation in Japan. It

Table 3.7: Policy Rate of Selected Economies

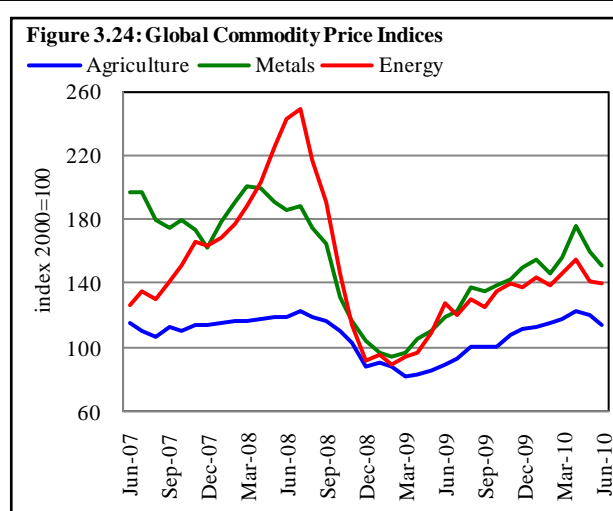
	Current rate	Previous rate	Date of change
United States	0.25%	1.00%	Dec 16 2008
United Kingdom	0.50%	1.00%	Mar 05 2009
Euro Area	1.00%	1.25%	May 07 2009
Australia	4.50%	4.25%	May 05 2010
Japan	0.10%	0.30%	Dec 20 2008
New Zealand	3.00%	2.75%	Jul 29 2010
South Africa	8.50%	9.50%	Apr 30 2009
China	5.31%	5.58%	Dec 22 2008
India	5.75%	5.50%	Jul 27 2010
Korea, South	2.25%	2.00%	Jul 09 2010
Philippines	4.00%	4.25%	Jul 09 2009
Malaysia	2.75%	2.50%	Jul 08 2010
Indonesia	6.50%	6.75%	Aug 05 2009
Canada	0.75%	0.50%	Jul 19 2010
Thailand	1.75%	1.50%	Aug 25, 2010

Source: Central Bank Websites, forexstreet.com, Bloomberg



is expected that inflationary pressures will remain subdued in advanced economies largely due to low capacity utilization, and gloomy growth outlook for advanced countries.

The impact of more than expected global recovery, particularly in China and India, was reflected in notable increase in international commodity prices of energy, metals and agriculture commodities (see **Figure 3.24**). During FY10, prices of energy, metals and agriculture commodities increased by 17.9 percent, 20.5 percent, and 11.3 percent respectively. Therefore, IMF commodity



price index (measuring overall international commodity prices) was up by 44.2 percent in June 2010 from its lowest levels since February 2009.

The rising trend in commodity prices during FY10 is due to a number of factors such as: (a) strong global economic recovery; (b) growth in world industrial production-particularly in emerging economies; (c) increase in manufacturing manager's index; (d) encouraging signs of growth in private demand; (e) depreciation of US dollar¹³ that encouraged investors to move into commodity markets; and (e) ease in real spillovers of the financial turbulence. Moreover, supply shortages of sugar and cotton also pushed up international commodity prices during FY10.

¹³US dollar has depreciated significantly against a basket of six major currencies (Euro, Yen, Pound, Canadian Dollar, Swiss Franc and Swedish Krona) during the year.