

3 Prices

Overview

Strong increases in food prices continued to underpin inflationary pressures in the economy, offsetting much of the gains from the abatement of non-food inflation through a tight monetary policy. Thus, principally due to rising food prices, the CPI and the SPI measures of inflation both recorded year-on-year increases in April 2007 (see **Figure 3.1**). The influence of food inflation is also evident in the WPI; although the WPI inflation has seen a year-on-year drop, this is simply because a surge in its food component was largely offset by a sharper decline in its non-food elements.

Inflationary pressures are particularly evident in headline CPI inflation which accelerated to 6.9 percent YoY in April 2007 compared with 6.2 percent YoY in April 2006, despite an ease in non-food inflation (see **Table 3.1**). The deceleration in non-food inflation is mainly attributed to deceleration in the sub-indices for *fuel & lighting*, *transport & communication* and *house rent*. The relative improvement in non-food component also helped bring

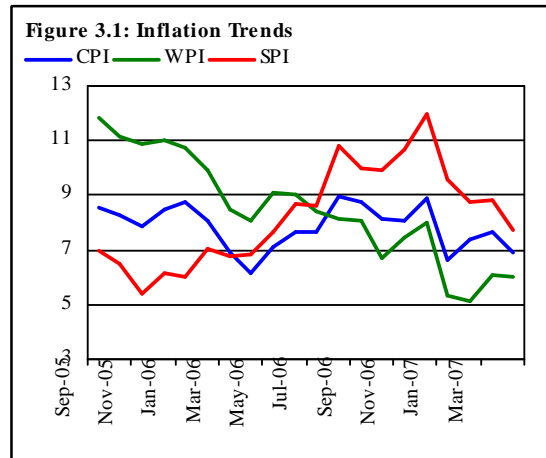


Table 3.1: Inflation Trends (End-April)

	YoY		12-m moving ave ²	
	FY06	FY07	FY06	FY07
CPI	6.2	6.9	8.2	7.8
Food	3.6	9.4	7.6	9.7
Non-food	8.0	5.2	8.7	6.5
<i>House Rent</i>	8.6	6.2	10.6	7.0
WPI	8.1	6.0	9.6	7.3
Food	4.5	8.4	7.5	8.1
Non-food	10.8	4.3	11.2	6.6
SPI³	6.4	7.7	8.1	9.4
Core- NFNE⁴	6.4	5.2	7.3	5.8
Core -trimmed⁵	6.0	6.1	6.9	6.7

¹ Change in Apr-2007 over Apr-2006

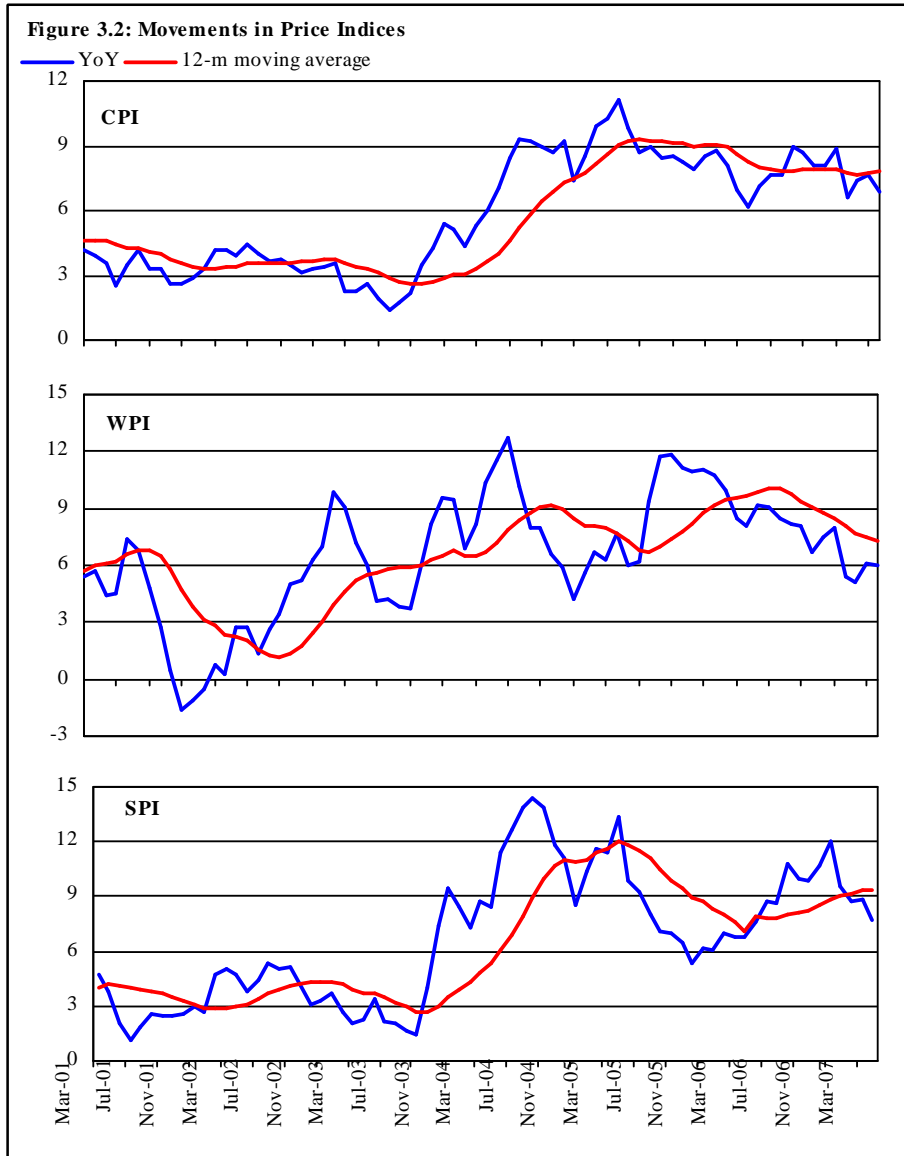
² Change in 12-m moving ave of Apr-2007 over Apr-2006

³ Pertains to all income groups indices compiled by FBS.

⁴ Non-food non-energy

⁵ 20 percent trimmed CPI inflation.

Source: Federal Bureau of Statistics



down annualized CPI and WPI inflation (12 month moving average – see **Figure 3.2**).

The impact of the unexpected resilience of food inflation and the likelihood of the continued upward pressures in near term due to increases in the prices of key staples such as milk and edible oil etc., SBP forecast for FY07 have been revised upwards from 6.7 – 7.5 percent to 7.5 – 7.8 percent.

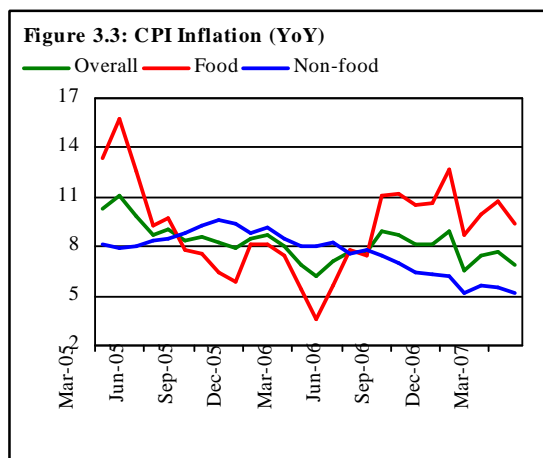
In this backdrop, the instability and resilience in headline CPI inflation (particularly in food component) needs to be addressed more effectively. It is true that a part of the rise in food inflation is a reflection of rising seems international prices of key food items; however the dominant part of the increase seems attributable to domestic factors, including market failure and weak anti-trust practices.

The resilience in food inflation raises a policy dilemma. On the one hand, food inflation is relatively less responsive to monetary tightening and therefore it is generally (but not always) a less desirable policy option, particularly when non-food inflation is low and declining. On the other hand, a persistent increase in food inflation could lead to a rise in inflationary expectations.

It may also be noted that SBP also provided support to priority sectors by providing subsidized financing to keep the current growth momentum intact, which partially muted the impact of monetary tightening. These developments imply that SBP at least has to review its policy of subsidized financing so that the higher interest rates can impact aggregate demand more effectively. In addition, the fact that real GDP growth remains strong (and may be above target in FY07) suggests that the strength of aggregate demand is still unabated. Another factor, which may fuel inflationary pressures going forward, is a significant rise in reserve money growth during FY07 mainly on account of massive forex inflows. In the light of the above, at the very least, the central bank will need to retain an anti-inflation bias in its policies while carefully evaluating the second round impact of rising food prices on broader inflation in the country.

3.2 Consumer Price Index

CPI inflation accelerated in April 2007 after registering a



deceleration during the preceding two months. The CPI inflation (YoY) stood at 6.9 percent for April 2007, higher than the 6.2 percent inflation during the same month of FY06. The movement in CPI inflation was mainly driven by food inflation during the first ten months of FY07. The food inflation exhibited higher variability compared to non-food inflation which has shown relatively stable downtrend since September 2005 (see **Figure 3.3**). As a result, the contribution of food group in overall inflation increased significantly from 24.9 percent during April 2006 to 56.1 percent in April 2007; the non-food group's contribution declined accordingly in the month. Within the non-food group, the contribution of house rent index in overall CPI inflation also declined from 32.3 percent during the last fiscal year to 21.2 percent.

Food Inflation

CPI food inflation accelerated significantly to 9.4 percent in April 2007, driven mainly by sharp increases in the prices of a few key staples. As a consequence, food inflation remained in double-digits, maintaining the trend since August 2006 (except for January and April 2007). The rise in food prices is not just a domestic phenomenon; the prices of major food items in international markets are also on the rise, contributing to high cost-push pressures.

A closer look at price movements of individual items included in the CPI food group reveals that prices of some important items such as wheat flour, milk rice and meat registered significant increases during April 2007 year on year. It is important to

note that the combined weight of commodities with 10 percent or higher inflation is about 56 percent of the food group. On the other hand, prices of 12 commodities declined during the month of April 2007 as compared to fall in the prices of 36 items in April 2006, i.e., the normal seasonal deceleration in prices of many commodities was not strongly evident in FY07.

As regards the contribution of individual items in overall CPI inflation, fresh fruits, milk fresh and vegetable ghee were the top three contributors in the over CPI inflation in April 2007 (see **Table 3.2**).

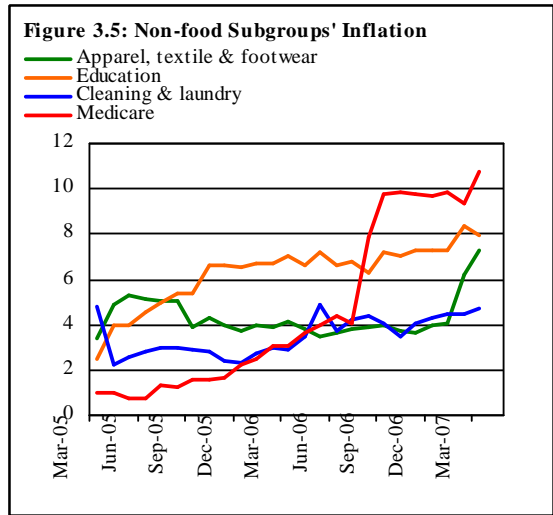
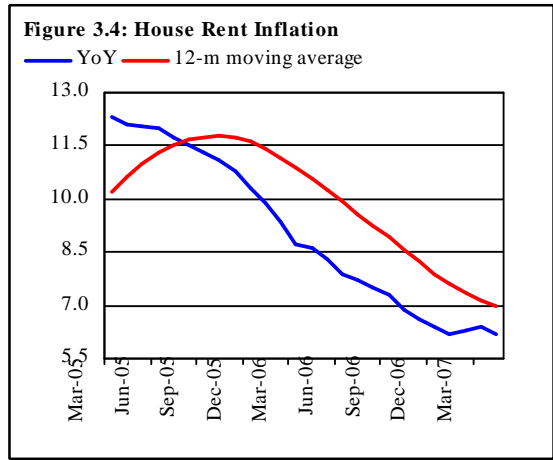
Table 3.2: Top 10 Food Items Contribution in CPI Inflation

Items	Weighted contributions			
	Jul-06	Dec-06	Feb-07	Mar-07
Fresh fruits	0.58	1.53	9.28	12.16
Milk fresh	8.87	9.12	11.39	10.22
Onions	-0.06	13.50	11.26	6.25
Vegetable ghee	0.29	3.50	6.05	6.17
Meat	6.73	5.06	5.84	4.49
Chicken farm	1.88	-1.38	1.85	4.46
Rice	0.18	0.58	2.51	4.43
Eggs	-2.65	-0.06	1.52	3.20
Wheat flour	-1.05	0.98	2.35	1.95
Readymade food	2.14	2.25	2.27	1.91

Non-food Inflation

In contrast to food inflation, non-food inflation decelerated to 5.2 percent in April 2007 from 8 percent in the same month of FY06. The deceleration was primarily contributed by a decline in inflation recorded by the *fuel & lighting* and *transport & communication* sub-indices while supported the impact of the continued deceleration in the *house rent index*. In fact, the *transport & communication* sub-group actually showed deflation¹ mainly due to a decline in the market prices of automobiles (cars and motorcycle) on the back of softening demand. The long run trend (measured by the 12 month moving average) in non-food inflation also witnessed a continued deceleration.

The inflation measured by the *fuel & lightening* sub-index decelerated to 7 percent in April 2007 compared to 10.7 percent in April 2006. The fall in *fuel & lighting* inflation was mainly due to the impact of a downward revision in the domestic prices of key fuels in December 2006. Similarly, House rent index (HRI) maintained its declining trend which started after February 2005; it recorded a moderate increase of 6.2 percent in April 2007 which is lower than the 8.6 percent rise during the corresponding month last year. The long run trend of house rent



¹ In contrast to 2.4 percent deflation in April 2007, the transport & communication subgroup recorded 13.4 percent inflation during April 2006.

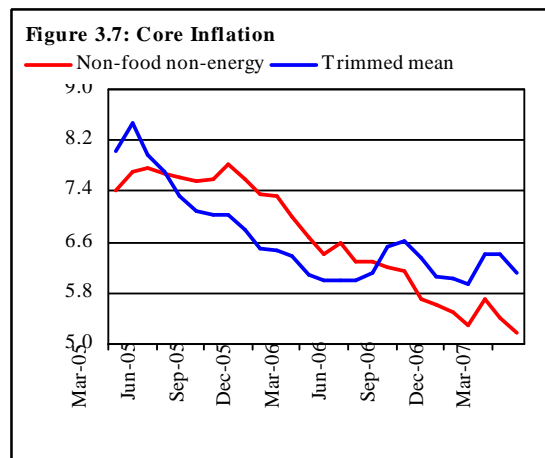
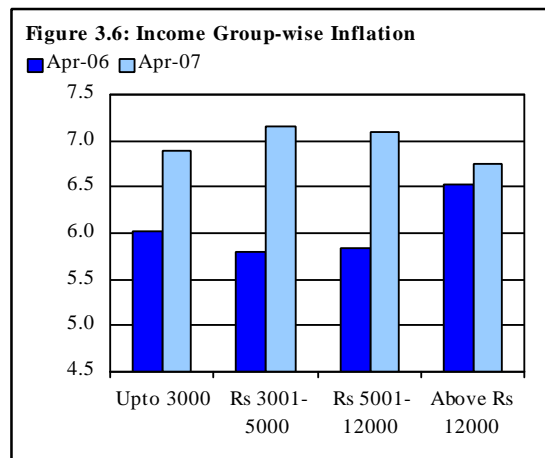
inflation also continued to decelerate (see **Figure 3.4**).

Other indices of non-food group that exhibited an increase in inflation during the month, included *apparel, textile & footwear, cleaning, laundry & personal appearance, household furniture & equipment and medicare*. The medicare sub index registered a significant double-digit increase of 10.1 percent in April 2007 compared to 3.7 percent growth in the same month last year (see **Figure 3.5**).

The latest published data reveals that the incidence of CPI inflation was the highest for the middle income groups during April 2007, in contrast to the April 2006 picture when the incidence of inflation was greatest for in the highest income bracket (of above Rs 12,000 - see **Figure 3.6**).

3.3 Core Inflation

Encouragingly, core inflation measured by excluding food and energy components from headline CPI inflation, witnessed a visible downtrend during FY07 (see **Figure 3.7**), indicating the impact of tight monetary stance of the central bank on underline inflationary pressures. However, this trend should not endanger complacency as core inflation has shown a little resilience in recent months. More importantly, central bank has to monitor the second round impacts on inflation due to sustained high food inflation, and be ready to act aggressively and pro-actively to minimize these impacts going forward.



The caution is also warranted by the behavior of the other core inflation measure (core inflation measured by trimming method by excluding 20 percent most volatile changes, which are generally temporary) stagnated in a narrow range of 5.9 – 6.5 percent during the last 17 months. This resilience in core inflation measure suggests that inflationary pressures are persisting in the economy.

3.4 Wholesale Price Index (WPI)

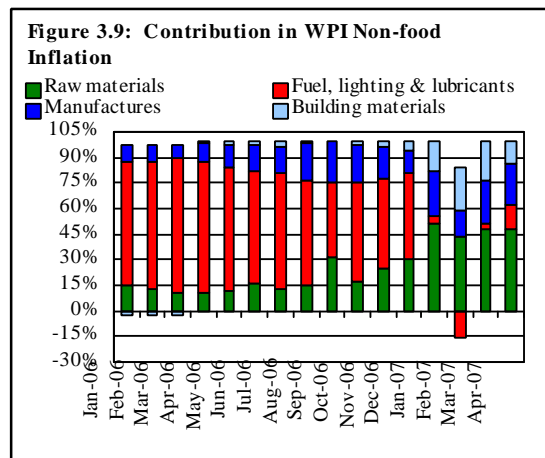
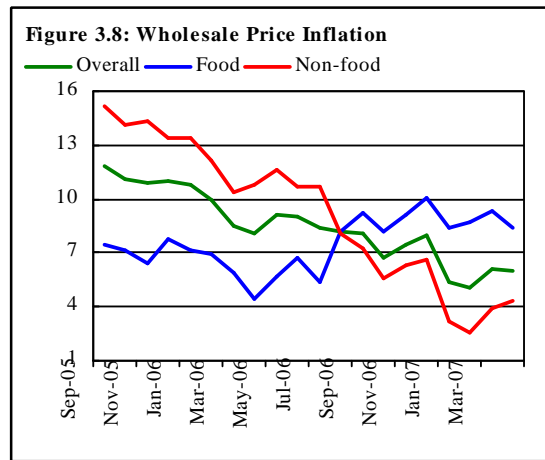
WPI inflation, that started declining in October 2005, continued its downtrend in FY07. The WPI registered 6.0 percent increase in April 2007 compared to 8.1 percent during the same

month last year (see **Figure 3.8**), as the strong deceleration in non-food component mitigated the inflationary pressures due to food component (see **Figure 3.9**). The *Fuel, lighting & lubricants* sub-index contributed in the deceleration of WPI non-food inflation during the first ten months of FY07. As a result, the contribution of *fuel, lighting & lubricants* sub-index dropped significantly from a positive 59.2 percent in April 2006 to a negative 6.1 percent by April 2007.

The increase in WPI inflation was attributed to rise in wholesale prices of onions, fruits, poultry items, cotton seeds, wires & cables etc., which showed increases of varying magnitudes.

3.5 Sensitive Price Indicator

Like CPI inflation, the sensitive price indicator (SPI) remained high during the first



ten months of FY07 due to rising inflation in food items.² The inflation under sensitive price indicator (SPI) accelerated to 7.7 percent in April 2007 compared to 6.4 percent seen in the same month last year. The long run trend indicated by 12-month moving average showed a slight increase due to continuously high SPI inflation during the current fiscal year.

² The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items, e.g., petrol and diesel). As mentioned in the second quarterly report FY07 that the fluctuations in the prices food items therefore affect the SPI directly due to the fact that it consists of more than 60 percent food items.