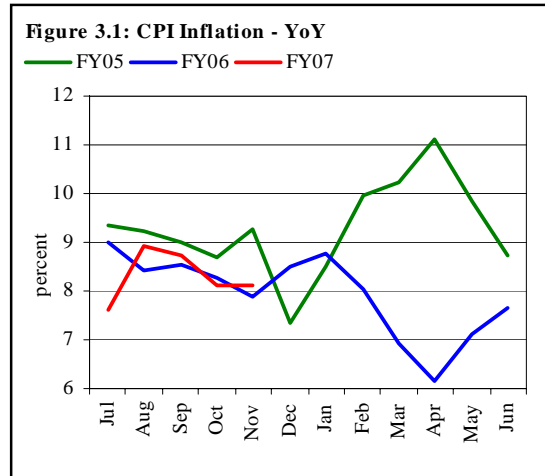


3 Prices

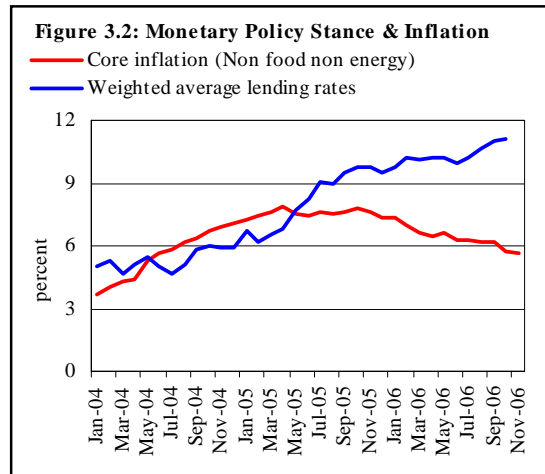
3.1 Overview

Although, on average, inflationary pressures appear to be weakening in the economy, the downtrend is unstable. This is evident in the benchmark Consumer Price Index (CPI) inflation, which jumped to 8.9 percent YoY in August 2006 before dipping to 8.1 percent YoY during October 2006 and remained at the same level in November 2006, slightly higher than the 7.9 percent YoY in November 2005 (see **Figure 3.1**). The



instability emerged essentially due to the volatility in food prices,¹ particularly stemming from (1) supply side disturbances on account of rains and floods, and (2) the impact of increases in international prices of some key food items.

A welcome development, from the monetary policy perspective, however, is that non-food inflation now appears to be trending downwards. This deceleration in non-food inflation is clearly mirrored in the easing of core inflation. The non-food non-energy (NFNE) measure of core inflation dipped to 5.6 percent YoY in November 2006 compared with 7.6 percent YoY for the



¹ It is also evident from significantly higher standard deviation for food inflation at 3.2 during the last 28 months compared with 1.2 for non-food inflation in the same period.

corresponding month of 2005, suggesting that demand pressures in the economy are being reined-in by the continued tight monetary policy (see **Figure 3.2**). While the other important measure of core inflation, (i.e., 20 percent trimmed mean) witnessed a small rise in Q1-FY07, in each month it remained below that in the corresponding month of FY06. Further, it too also has dipped in November 2006 to 6.1 percent compared with 6.6 and 6.4 percent in the preceding months. The initial rise in this core inflation measure is explained mainly by the impact of energy charges (that are excluded in the NFNE measure).

In contrast to the volatility in CPI inflation, the WPI inflation exhibited a steady downtrend, with the overall WPI inflation coming down to 7.5 percent YoY in November 2006 compared with 10.9 percent in November 2005. The major contribution to the decline in WPI is from the non-food group, which outweighed the acceleration in the food group prices (see **Table 3.1**).

Unfortunately, despite the moderation in inflationary pressures, CPI inflation is still close to the 8 percent levels by November 2006, which is significantly higher than the annual average inflation target of 6.5 percent for FY07.

Given that core inflation is likely to remain contained through the remaining months of FY07 as a result of a tight monetary policy, it is important that its impact is supplemented by measures to address food inflation and high energy prices. Volatile, double-digit food inflation is particularly undesirable in view of its greater adverse impact on low-income groups. Moreover, it is a source of disquiet for monetary policy as well since inflationary expectations are based on overall inflationary trend. There is a need for effective administrative measures (as exercised in the month of Ramadan) to discourage profiteering on food items.

Table 3.1: Inflation Trends (November)
percent

	Year on Year ¹		12-month moving average ²	
	FY06	FY07	FY06	FY07
	CPI	7.9	8.1	9.0
Food	5.8	10.6	9.9	7.9
Non-food	9.4	6.3	8.4	7.3
House rent	10.8	6.6	11.7	7.6
WPI	10.9	7.5	8.2	8.7
Food	6.4	9.1	9.3	7.1
Non-food	14.3	6.3	7.3	9.9
SPI	5.4	13.4	8.9	8.9
Core³	7.6	5.6	7.4	6.4

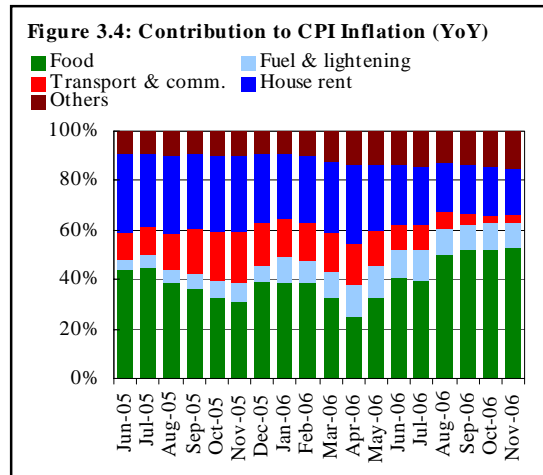
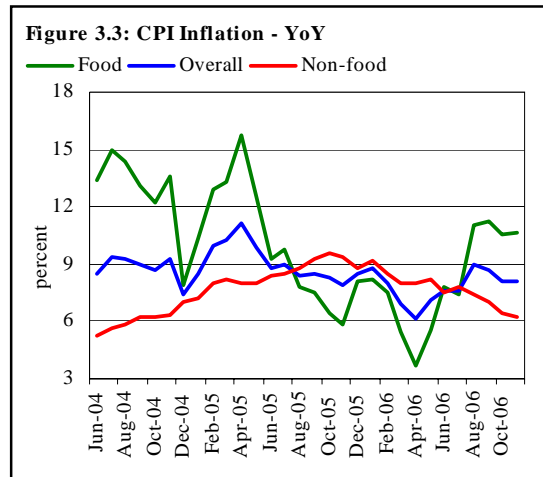
¹ Change in Nov 2006 over Nov 2005
² Change in 12-month moving average of Nov 2006 over Nov 2005
³ Non-food non-energy
Source: Federal Bureau of Statistics

In view of the above, SBP projections remained unchanged that CPI inflation is likely to remain slightly above than the 6.5 percent target for FY07 in the range of 6.7 – 7.5 percent during FY07.

3.2 Consumer Price Index

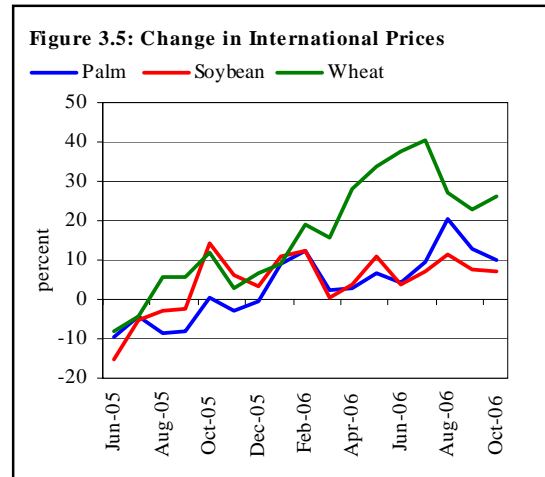
The CPI inflation exhibited a volatile trend during the last few months; this greater variability is mainly a result of fluctuations in food inflation. Non-food inflation however witnessed a relatively stable trend during the last two years (see **Figure 3.3**).

In contrast to FY06, inflation in the first five months of FY07 was mainly driven by food component of the CPI basket. Consequently, the contribution of food group to overall CPI inflation has increased from 31.2 percent in November 2005 to 53.1 percent in November 2006. On the other hand, the contribution of major non-food item, i.e., *house rent index* (having a weight of 23.4 percent in CPI) has declined significantly to 19.2 percent in November 2006 from 31.2 percent in the corresponding month of 2005. Moreover some reduction in the contribution of other sub-indices of non-food group to overall inflation has also been observed; e.g., contribution of *transport and communication* to overall inflation fell to 3.3 percent in November 2006 from its peak level of 20.7 percent in November 2005 (see **Figure 3.4**).



3.2.1 CPI Food Inflation

CPI food inflation, after declining to as low as 3.6 percent in April 2006 (despite pressures on the prices of sugar, milk and pulses), started rising in the subsequent months and increased significantly to 10.6 percent (YoY) in November 2006. The sharp acceleration is mainly attributed to supply disturbances for minor crops as well as sustained strong demand. Another important source of food inflation is the rising international prices of edible oil (see **Figure 3.5**); as a result, prices of ghee, cooking oil, prepared meal and bakery items registered increases.



The resurgence in food inflation since April 2006 is explained principally by reversal of the downtrend in wheat prices, which complemented the significant hike in the prices of some minor crops (vegetables, fruits) and meat, in the same period.

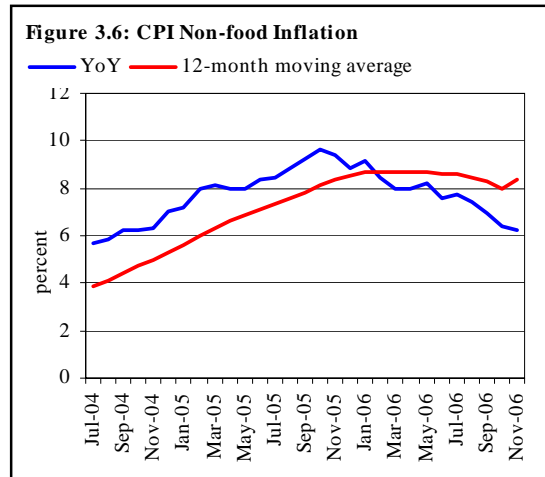
Table 3.2 shows that while a large number of food items witnessed a fall in the prices in April 2006, fewer food items showed a decline in prices during November 2006. In contrast, a larger number of food items exhibited a sharp rise of above 20 percent in November 2006 than the April 2006. Importantly, the number of items witnessed a rise in the range of 0 – 10 percent are almost unchanged during the both period. This analysis reflects that (1) food inflation is broad-based in November 2006 relative to April 2006; and (2) the impact of increase in the prices of a key staple (such as wheat or edible oil) influences the prices of a number of food items.

Table 3.2: Change in the Prices of Food Items

number of items		
Inflation range	Apr-06	Nov-06
Decline in prices	36	11
0% to 5%	25	26
5% to 10%	23	24
10% to 15%	16	25
15% to 20%	1	10
20% and above	8	16
Total items reported	109	112

3.2.2 CPI Non-food inflation

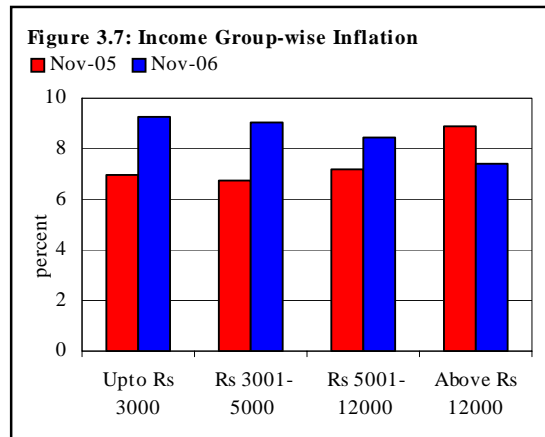
CPI non-food inflation continued to decelerate, falling to 6.3 percent YoY in November 2006 as against 9.4 percent in November 2005. As a result, 12-month moving average of non-food inflation also decelerated to below 8 percent in November 2006 for the first time since October 2005 (see **Figure 3.6**). The deceleration was mainly due to lower increase in the *transport & communication* sub-index and persistent decline in HRI.



Some of the sub-indices of non-food group, nevertheless, showed higher growth in recent months of FY07 as compared with FY06. These include *fuel & lighting, household, furniture & equipment, recreation & entertainment, education, and medicare*. The most significant of these was in *medicare* inflation, which jumped from 1.6 percent in November 2005 to 9.8 percent in November 2006. The rise in *fuel & lighting* sub-index though eased somewhat since July 2006, it is higher in November 2006 relative to the same month of 2005. It may be noted that in the case of any downward adjustment in the domestic oil prices following an ease in international prices, the sub-index is likely to show a sharper decline in months ahead.

3.2.3 Income Group-wise Inflation

As mentioned earlier, the contribution of food inflation in overall CPI remained high in the first five months of FY07, which resulted into a larger incidence of inflation on the low-income groups where food staples typically account for a greater proportion of total expenditure. Thus, in November 2006, the lowest

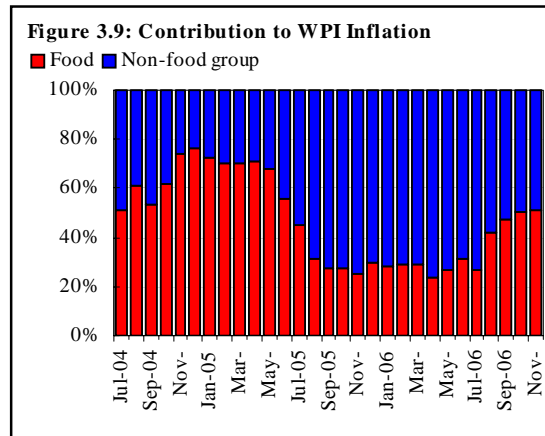
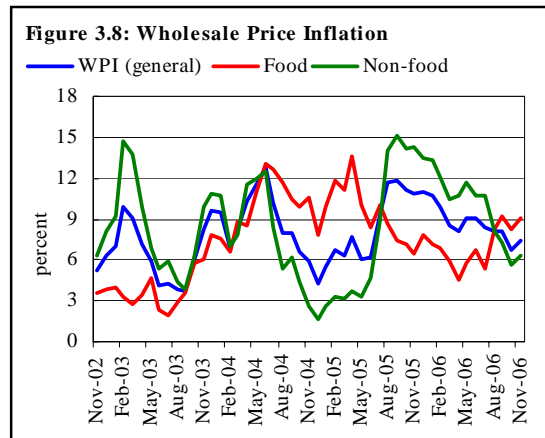


income group (income up to Rs 3000 per household per month) witnessed significantly higher than average inflation of 9.3 percent, followed by 9.0 percent and 8.4 percent for the two middle income groups (see **Figure 3.7**). As against the current pattern of inflationary incidence, all these income groups (lower income and middle income) witnessed below average inflation in November 2005. On the other hand, only the highest income group (with income above Rs 12,000 per month) witnessed lower than average inflation in November 2006, contrary to above average inflation in November 2005. This is because the driving force of inflation had been non-food prices in the FY06, while in FY07 the source of inflation has been food inflation.

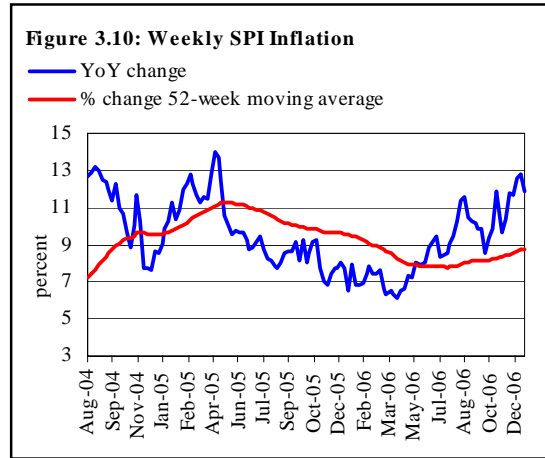
3.3 Wholesale Price Index

The Wholesale Price Index (WPI) maintained a downward trend throughout the first four months of FY07, reaching 7.5 percent YoY in November 2006, the lowest since April 2005. This slowdown is mainly attributed to a sharper deceleration in non-food component of WPI inflation (see **Figure 3.8**) on the back of weaker increase in *fuel, lighting & lubricants* sub-index.

However, WPI food sub-group inflation accelerated to 9.1 percent in November 2006 compared with 6.4 percent in the same month of 2005. The rise in WPI food sub-index partially offset the lower inflation recorded by non-food sub-group. As a result, the weighted contribution of non-food inflation in WPI fell from 74.6 percent during November 2005 to 48.8 percent in November 2006 (see **Figure 3.9**).

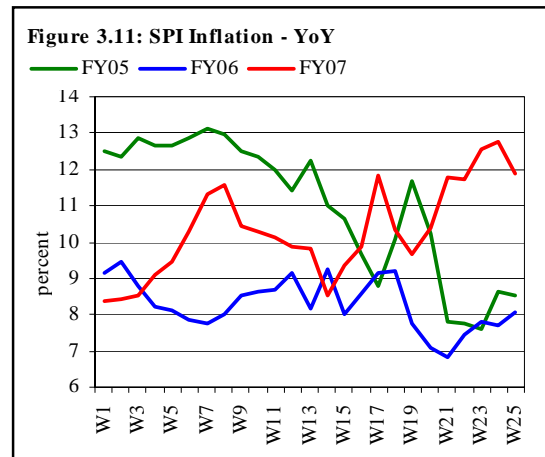


Interestingly, the food component is common in both CPI and WPI, however food inflation during November 2006 is relatively higher in CPI (10.6 percent YoY) than in WPI (9.1 percent YoY). The reason for the different pace of increase in the food sub indices in CPI and WPI is that some of the grains (bajra, maize and jowar) which recorded a decline in the prices are included in WPI but are not part of the CPI. Moreover, increases in the prices of wheat and its derivatives, pulses, milk and some other important food items are relatively higher in the case of CPI than the WPI. The latter fact is a reflection of increased profit margins at the retail level. This also reinforces the view that an effective price regulating system is required to discourage abnormal profit margins. Within the WPI non-food group, the sub-indices showed mixed trends in the first five months of FY07.



3.4 Sensitive Price Indicator

The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items e.g., petrol and diesel). In line with CPI food inflation, the SPI has followed increasing trends in the first five months of FY07. This is because more than 60 percent of the items included in the SPI basket are from the food group. During the period under review weekly SPI inflation YoY was generally high and remained around the 10 percent (see **Figure 3.10**).

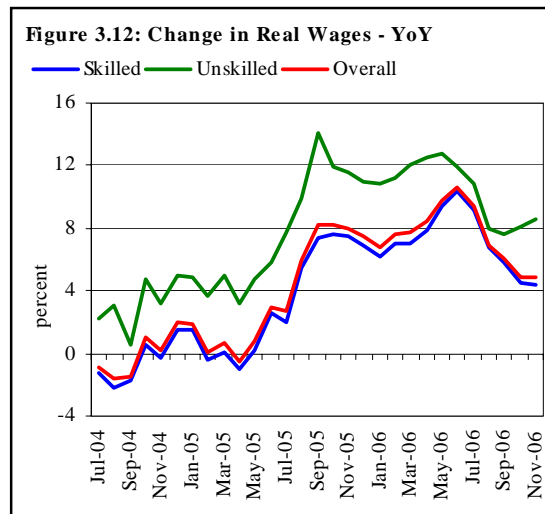


It may be noted that the inflationary pressures on food prices are persisting even by the second week of December 2006, when supply of fruits and vegetables usually improves (see **Figure 3.11**). This is

mainly attributed to supply shortages of vegetables due to unusual heavy winter rains.

3.5 Wage Inflation

The pace of increase in real wages eased during the initial months of FY07 after rising during the final months of FY06. However, the slowdown is more pronounced in the case of real wages for skilled workers (see **Figure 3.12**). It may be noted that despite the slowdown, the increase in average real wages during November 2006 remained strong at 4.9 percent YoY. Moreover, the rise in real wages for unskilled workers (which rose in recent months) is 8.6 percent YoY in this period. The significant increase in real wages implies that (1) demand for labor is strong, (2) a slower rise in real wages could potentially help reduce unemployment as well as (3) domestic consumption demand would accelerate further.



In particular, strong labor demand appears to reflect increased construction activities in private sector as well as building infrastructure by the government.