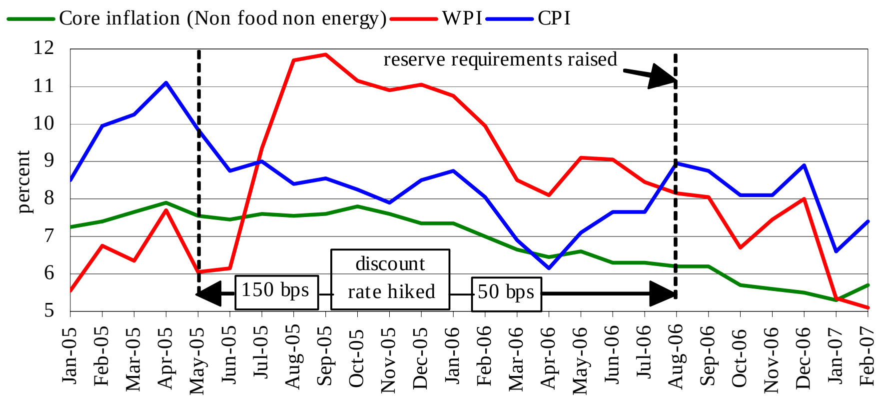
3 Prices

3.1 Overview

The underlying inflationary pressures in the economy continued to ease in FY07, with Consumer Price Index (CPI) inflation finally dipping below 7 percent YoY in January 2007 for the first time in 7 months;[1] and WPI inflation continuing its trend decline to fall to a 25-month low of 5.1 percent YoY by February 2007 (see **Figure 3.1**). Even more significant, from a policy perspective, is the stability of the downtrend in core inflation (as measured by the non-food non-energy component of the CPI), which has declined steadily since April 2005 to 5.7 percent YoY by February 2007. While the other important measure of core inflation (i.e., the 20 percent trimmed mean) witnessed a relatively smaller decrease in October-February FY07, in each month it remained same or below that in the corresponding months of FY06.

Figure 3.1: Monetary Tightening Paying Dividends

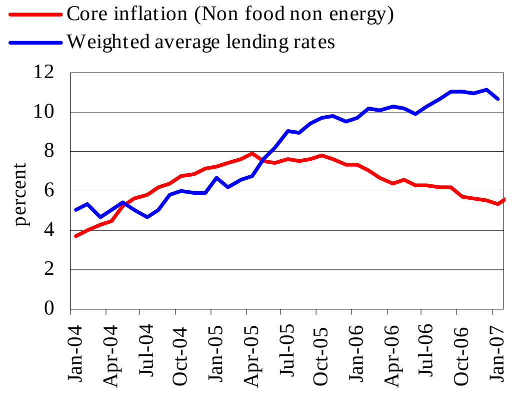


The broad reduction in underlying inflationary pressures in FY07 appears to be significantly driven by the tight monetary posture of the central bank (see **Figure 3.2**), suggesting that aggregate demand pressures in the economy are being reined-in by the continued tight monetary policy. However, the sharp slowdown in the overall CPI inflation in January 2007 mainly incorporates the impact of an exceptionally strong deceleration in food inflation as prices of many key staples

[1] CPI inflation decelerated to 7.4 percent YoY during February 2007 compared with 8.0 percent YoY in February 2006.

fell to more normal levels, after staying at exceptionally high peaks in the preceding months. Similarly, a reversal in CPI food inflation back into double digits level in February 2007 is mainly attributed to rise in the prices of rice, flour, some vegetables and fruits. In fact, it was mainly due to this abnormally high food price inflation that headline CPI inflation had remained stubbornly above the 8 percent levels through most of FY07.

Figure 3.2: Monetary Policy Stance & Inflation



In contrast, non-food inflation decelerated to 5.6 percent in February 2007 compared with 8.4 percent in February 2006, mainly on the back of continued monetary tightening and reduction in domestic prices of key fuels. As a result, the headline CPI inflation fell to 7.4 percent in February 2007 relative to 8.0 percent in the same month of 2006.

Table 3.1: Inflation Trends (February)

percent

	Year on Year[1]		12 month moving average[2]	
	FY06	**FY07**	**FY06**	**FY07**
CPI	**8.0**	**7.4**	**8.9**	**7.7**
Food	7.5	10.0	9.2	8.7
Non-food	8.4	5.6	8.7	6.9
House rent	9.4	6.3	11.2	7.3
WPI	**9.9**	**5.1**	**9.4**	**7.6**
Food	6.9	8.7	8.7	7.5
Non-food	12.2	2.6	10.0	7.7
SPI	**7.4**	**8.8**	**9.0**	**9.2**
Core[3]	**7.0**	**5.7**	**7.5**	**6.0**

[1] Change in Feb 2007 over Feb 2006

[2] Change in 12-month moving average of Feb 2007 over Feb 2006

[3] Non-food non-energy

Source: Federal Bureau of Statistics

However, despite the welcome decline in year-on-year inflation, it should be kept in mind that average annualized (12-month moving average) CPI inflation at 7.7 percent in February 2007 is still substantially higher relative to 6.5 percent annual target for FY07 (see **Table 3.1**). In fact, SBP projections remained unchanged, indicating that average CPI inflation for FY07 is likely to be in the range of 6.7 – 7.5 percent.

Given the still-high CPI inflation and the risk of a resurgence in food inflation,[2] SBP needs to retain its low inflation bias to raise real interest rates for savers, improve competitiveness of exports and sustain long-term growth in the economy.

3.2 Consumer Price Index

CPI inflation exhibited a volatile trend during the last few months principally driven from fluctuations in food inflation. Non-food inflation on the other hand witnessed a relatively stable downtrend since September 2005 (see **Figure 3.3**). Consequently, the contribution of food group to overall CPI inflation has increased from 38.3 percent in February 2006 to 55.4 percent in February 2007 (see **Figure 3.4**).

Figure 3.3: CPI Inflation - YoY

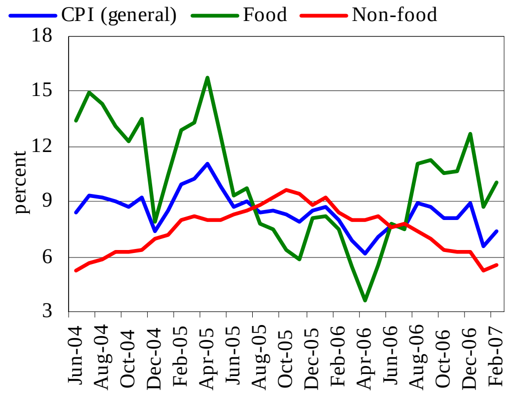
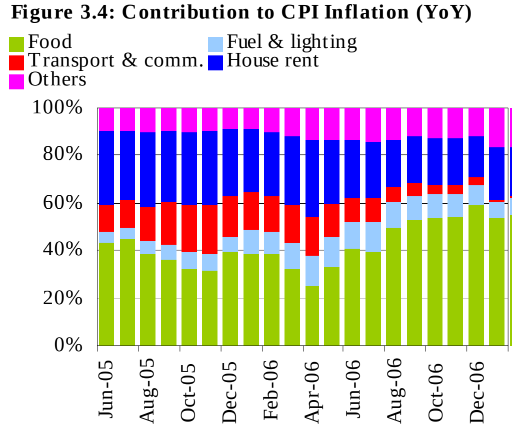


Figure 3.4: Contribution to CPI Inflation (YoY)



CPI Food Inflation

CPI food inflation hovered in double digits during most of the initial eight months of FY07. After witnessing a sharp decline in January 2007 to 8.7 percent, food inflation bounced back to 10.0 percent level in February 2007 compared with 7.5 percent in the corresponding month of FY06.

The rise principally represented an increase in the prices of some key food staples – wheat flour, milk, ghee as well as some fresh vegetables and fruits. For example, despite a negligible weight of 0.58 percent in overall CPI basket, the extraordinary rise in

[2] In contrast to the trend of the CPI and the WPI, Sensitive Price Indicator (SPI) inflation is still in double digits, principally reflecting continued upward pressures on essential items.

the prices of onions had contributed 13.2 percent to aggregate CPI inflation in February 2007 (see **Figure 3.5**).

It may be noted that the February 2007 reversal in CPI food inflation relative to January 2007 was mainly due to the fact that five items which were registering disinflation earlier, joined the groups of items which are contributing in persisting high CPI food inflation (see **Table 3.2**).

In particular, two commodities that are likely to contribute significantly to sustaining high food inflation in months ahead include milk and edible oil the prices of both of which are likely to be driven up following international trends.

For example, while domestic prices of cooking oil and vegetable ghee had remained quite stable until June 2006 despite significant declines in the international prices of soybean and palm oil, they are now headed up as international prices are rising (see **Figure 3.6**). Similarly, domestic milk prices are also expected to be driven upwards more by the influence of rising

Table 3.2: Change in the Prices of Food Items

number of items

Inflation range	Jul-06	Sep-06	Jan-07	Feb-07
Decline in prices	24	9	16	11
0% to 5%	30	29	20	20
5% to 10%	26	25	26	29
10% to 15%	10	22	27	24
15% to 20%	6	7	10	11
20% and above	15	20	10	13
Total items reported	**111**	**112**	**109**	**108**

Figure 3.5: Contribution to CPI Inflation

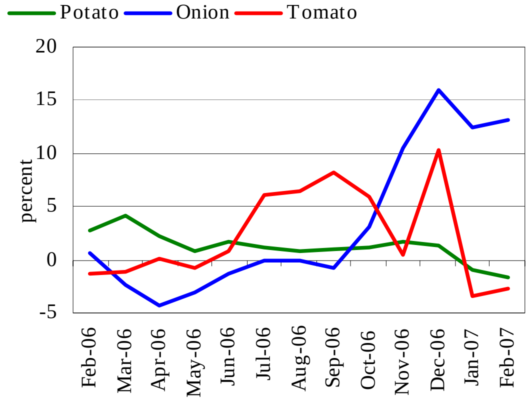
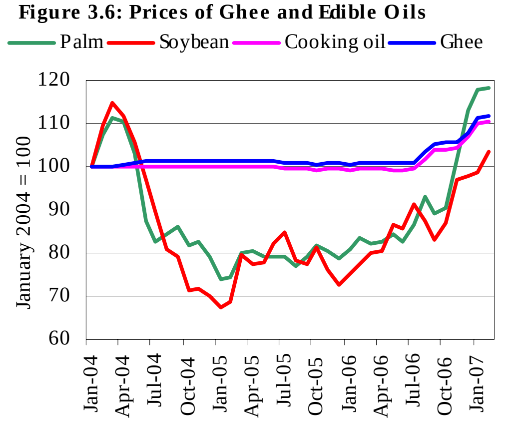


Figure 3.6: Prices of Ghee and Edible Oils

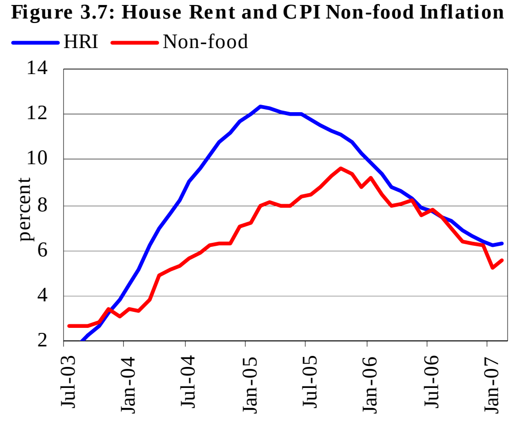


international prices rather than domestic cost-push factors.

CPI Non-food Inflation

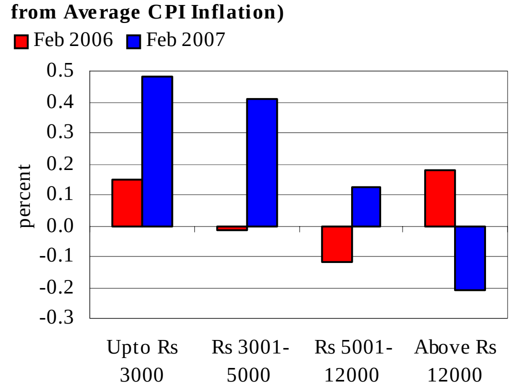
CPI non-food inflation continued to decelerate, falling to 5.6 percent YoY in February 2007 as against 8.4 percent in February 2006. Nonetheless, it remained higher than the 5.2 percent seen in January 2007. While the deceleration in CPI non-food inflation was mainly due to a sharp decrease in the *transport & communication, fuel & lighting* and *house rent* sub-indices, the relative month over month (MoM) rise is largely attributed to a MoM up tick in *house rent index* (HRI) in February 2007 (see **Figure 3.7**).

Figure 3.7: House Rent and CPI Non-food Inflation



The sharp deceleration in the CPI non-food YoY inflation is largely attributed to downward adjustment in the prices of key fuels by OCAC[3] as well as a decline in the prices of some automobiles (e.g. cars and motorcycle) due to a relative weakening in demand.

Figure 3.8: Income Group-wise Inflation (Difference from Average CPI Inflation)



Some of the sub-indices of non-food group, nevertheless, showed higher growth in recent months of FY07 as compared with FY06. These include a*pparel, textile & footwear, household furniture & equipment, education*, and *medicare*. The most significant of these was *medicare* inflation, which jumped from 3.0 percent in February 2006 to 9.3 percent in February 2007.

[3] Oil Companies Advisory Committee.

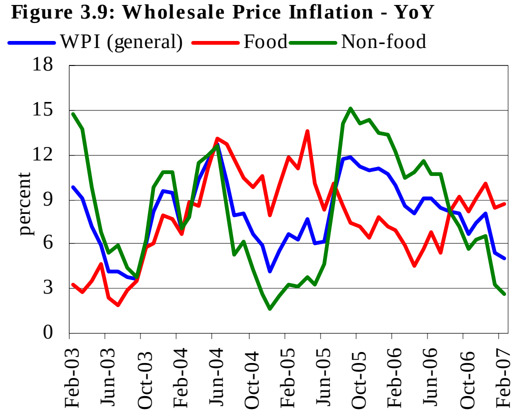
Income Group-wise Inflation

As mentioned earlier, the contribution of food inflation in overall CPI remained high in the first eight 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 February 2007, the lowest income group (income up to Rs 3000 per household per month) witnessed higher inflation of 7.9 percent than the average CPI inflation of 7.4 percent, followed by 7.8 percent and 7.5 percent for the two middle-income groups (see **Figure 3.8**). In contrast, only the highest income group (with income above Rs 12,000 per month) witnessed lower than average inflation in February 2007.

3.3 Wholesale Price Index

Inflation measured by Wholesale Price Index (WPI) generally maintained its downward trend throughout FY07 reaching 5.1 percent in February 2007, its lowest level in the preceding 25 months. Inflationary pressures appear to have eased in overall WPI inflation entirely due to a deceleration in WPI non-food inflation. While WPI non-food inflation witnessed a continued deceleration since July 2006, a part of this gain was offset by WPI food inflation, which is registering acceleration since August 2006 (see **Figure 3.9**). The major contribution to deceleration in non-food inflation stemmed from a disinflation by *fuel, lighting & lubricants* sub-index, principally reflecting downtrend in the international prices of POL.

Figure 3.9: Wholesale Price Inflation - YoY

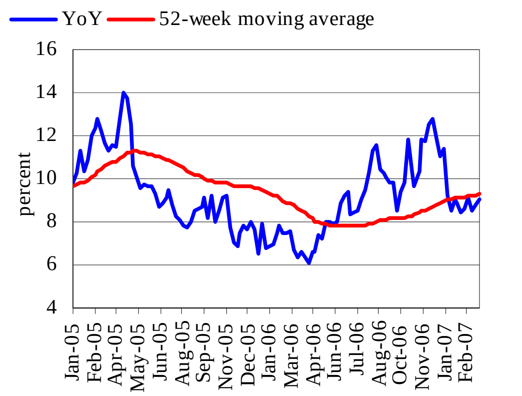


As a result, the contribution of *fuel, lighting & lubricants* sub-index dropped significantly from a positive 55.7 percent in February 2006 to a negative 6.6 percent by February 2007. Consequently, the weighted contribution of non-food inflation in WPI fell from 70.8 percent during February 2006 to 30.1 percent in February 2007 (see **Figure 3.9**).

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). Like CPI food inflation, the SPI also rose sharply in February 2007. 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 in the double digits (see **Figure 3.10**).

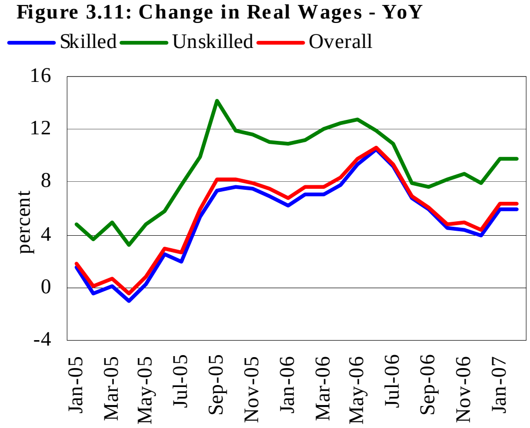
Figure 3.10: Weekly SPI Inflation



3.5 Wage Inflation in Construction Sector

Real wages in the construction sector continued to exhibit a rise through FY07, however the pace of rise marginally slowed. Specifically, real wages in construction sector witnessed a rise of 6.3 percent (YoY) in February 2007 compared with 7.6 percent increase seen in the same month of FY06 (see **Figure 3.11**).

Figure 3.11: Change in Real Wages - YoY



This slower growth stemmed from a deceleration in real wages for both skilled and unskilled workers but is more pronounced in the case of unskilled workers. Despite a sharper slowdown, real wages for unskilled workers rose by a strong 9.7 percent in February 2007 relative to 11.2 percent increase in February 2006. The rise in real wages for skilled workers was recorded at 5.9 percent YoY in February 2007 compared with 7.0 percent in the corresponding month of 2006. It may be noted that the real wages for construction workers witnessed a month over month acceleration in January and February 2007 compared with the first six months of FY07. The significant increase in real wages implies that (1) demand for construction labor is strong, as well as (2) domestic consumption demand would accelerate further. In particular, strong labor demand appears to reflect in increased construction activities in private sector as well as the focus on improving infrastructure by the government.