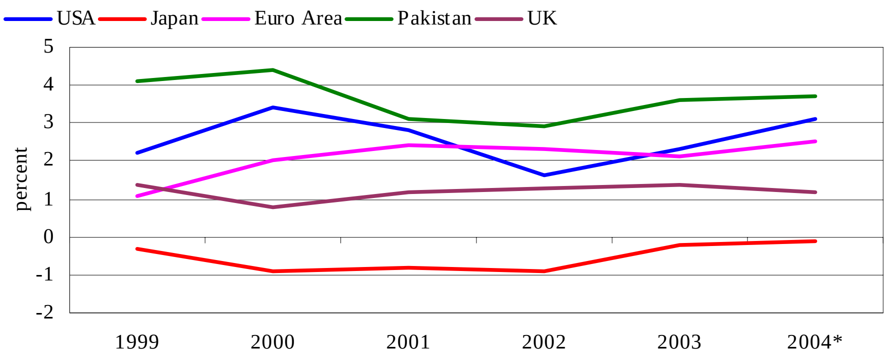
7 Prices

7.1 International Scenario

Inflationary pressures appear to be gathering pace in the global economy, in tandem with a visible improvement in most major economies, and with aggregate demand giving a significant boost to international commodity prices. In fact, even the Japanese economy, which till now had been struggling with deflationary pressures, finally recorded a pause in the YoY decline in consumer prices in February 2004, as a result of which the annualized deflation in the country *fell* to 0.1 percent by March 2004 (see **Figure 7.1**).

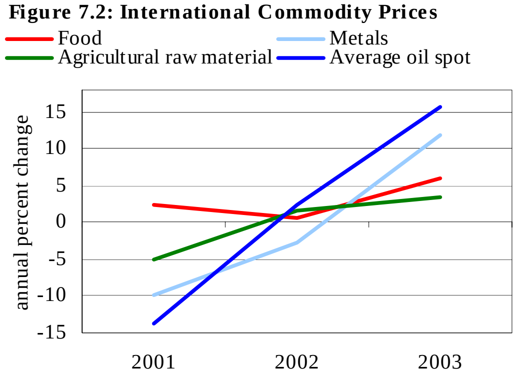
Figure 7.1: Annualized Inflationary Trends in Major Economies



Source: World Economic Outlook, IMF, April 2004.
(*) Latest from The Economist

The rise in international commodity prices is most strongly evident in "oil" and "metal" group prices since 2002 (see **Figure 7.2**). Interestingly, a strong impetus to the broad rise in non-food commodity prices appears to be emanating from the continuing strength of demand from China.

Figure 7.2: International Commodity Prices



Source: World Economic Outlook

Another important contribution to global inflationary pressures is from rising oil prices.[1] This is due to both, rising demand (especially from the rapidly expanding Far Eastern and Chinese economies), and supply-side considerations (the international markets continue to price-in the risk of a disruption in supply due to the conflict in the Middle East). The risk premium on oil price is conjectured by some analysts to be in the range of US$ 10 –15 per barrel.

Ironically, the exceptionally high oil prices now appear to be threatening the recovery of the global economy. If these high prices persist, the resulting weakness in the global economy could significantly derail global economic growth.

Table 7.1: Trends in Inflation - May

percent

	Marginal inflation[1]		Annualized inflation[2]	
	FY03	**FY04**	**FY03**	**FY04**
CPI	**2.6**	**7.1**	**3.3**	**4.0**
Food	2.6	10.2	3.2	5.0
Non-food	2.6	5.1	3.4	3.4
Non-food, non-oil	2.1	5.7	2.7	3.4
Non-food excl. HRI	5.6	1.0	8.1	2.5
WPI	**6.0**	**11.5**	**5.5**	**7.2**
Food	4.7	11.0	3.8	6.0
Non-food	6.8	11.8	6.6	8.0
SPI	**3.4**	**11.4**	**3.7**	**6.0**

[1]: Change in May 2004 over May 2003.
[2]: Change in 12-month average in May 2004 over corresponding average of 2003.
Source: Federal Bureau of Statistics

7.2 Domestic Scenario

The rising global inflationary trend is clearly impacting prospects for domestic inflation. However, the influence of the higher international prices of key products such as crude oil, edible oil, and cotton, on the domestic economy, although gradually growing, is still limited. Thus, the strengthening domestic inflation rate during FY04 remains largely explainable by domestic factors, particularly food prices (see **Table 7.1**).

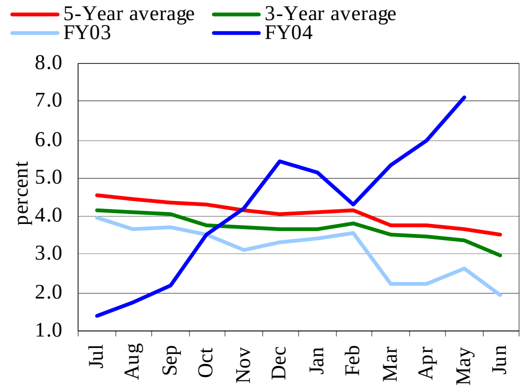
The influence of *food* inflation in the overall price pressures on the economy is particularly evident in the movements of the most broad-based inflation index, the Consumer Price Index (CPI). The deceleration in the marginal CPI inflation during the initial months of Q3-FY04 was owed principally due to a slowdown in food inflation, as was the subsequent acceleration (see **Figure 7.3**).

It had been anticipated that *food* inflation would witness some deceleration in H2-FY04 as the impact of the October 2003 food-price shocks was dissipated by seasonal factors. However, this expectation did not materialize due to a number of factors, which included the continued supply shortages of wheat despite the arrival

[1] Oil prices have shot up to record levels by end-May 2004 following a terrorist attack in Saudi Arabia.

of grain from the new crop. The shortage was compounded by the inexplicable delay in the build-up of the government wheat stocks through imports to buffer possible supply constraints and counter speculative hoarding. Another factor was the higher prices of other important staples (milk and meat).

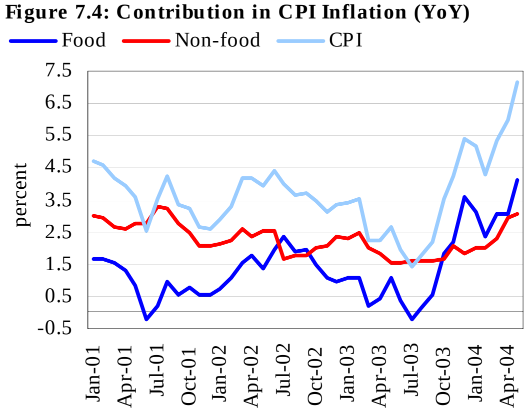
Figure 7.3: CPI Inflation (YoY)



Moreover, the unexpected strength of *food* inflation was complemented by the rise in *non-food* CPI inflation due to the continued (and un-seasonal) rise of international oil prices as well as robust increase in the prices of construction material[2] on the back of strong demand in addition to stronger than expected growth in the economy and, continued easy monetary posture of the SBP.

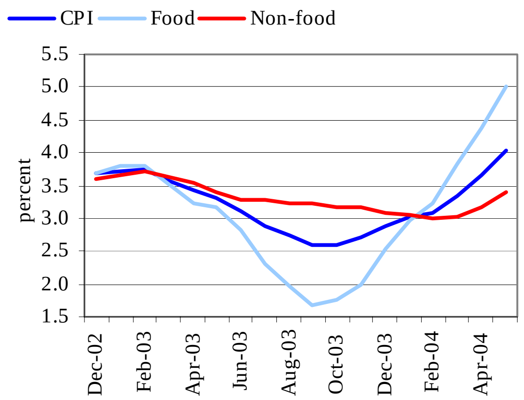
As a result of the impetus by both food and non-food components, CPI inflation rebounded to record a year-on-year increase of 7.1 percent during May 2004 - the highest YoY CPI inflation for any month during the preceding six years (see **Figure 7.4**). In annualized terms, CPI inflation swiftly reached to 4.0 percent in May 2004 after bottoming out at 2.6 percent in October 2003 (see **Figure 7.5**).

Figure 7.4: Contribution in CPI Inflation (YoY)



[2] Sub-index of House Rent in CPI is mainly based on sub-index of Building Material in WPI (see *First Quarterly Report for FY04* for details).

Figure 7.5: Annualized CPI Inflation



In view of the above developments, the SBP forecast for FY04 CPI inflation was revised upward to the 4.5-4.6 percent range. More importantly, it seems that inflationary pressures are likely to persist for some months to come. While food inflation is expected to taper off some months into the next fiscal year, even this relief may be offset by an expected escalation in non-food inflation stemming largely from international commodity prices (unless oil prices, particular, decline substantially in coming months) and, the continuing upward movement of the *house rent index* (HRI). In the face of the continuing upward movement in domestic inflation, the SBP opted to gradually raise interest rates. However, this rise in interest rates is constrained by a number of factors, notably the unclear linkage between interest rates and inflation amidst the structural changes in the credit cycle.

7.3 Consumer Price Index

Both marginal and annualized CPI inflation witnessed acceleration in May 2004 compared to the corresponding rates in May 2003 (see **Table 7.2**). Importantly, with marginal CPI inflation substantially above the annualized rate, the latter seems set to rise further, at least during the current calendar year.

CPI *food* inflation witnessed a particularly sharp 10.2 percent YoY rise in May 2004, the first double digit CPI food

Table 7.2: CPI Inflation in May

percent

	Marginal (YoY)[1]		Annualized[2]	
	2003	**2004**	**2003**	**2004**
Food & beverages	2.6	10.2	3.2	5.0
Non-food group	2.6	5.1	3.4	3.4
Apparel, textiles, footwear	4.3	0.7	3.4	3.0
House rent index	0.9	7.6	0.8	3.9
Fuel & lightening	5.7	1.7	7.8	3.2
Household furniture & equip.	3.2	5.0	2.9	3.3
Transport & communication	1.0	8.1	5.4	3.0
Recreation entertainment	0.5	-1.1	1.3	-1.0
Education	5.1	2.7	4.7	4.1
Cleaning, laundry & personal appearance	4.9	4.6	4.7	3.7
Medicare	0.4	1.7	3.6	1.0
CPI (general)	**2.6**	**7.1**	**3.3**	**4.0**

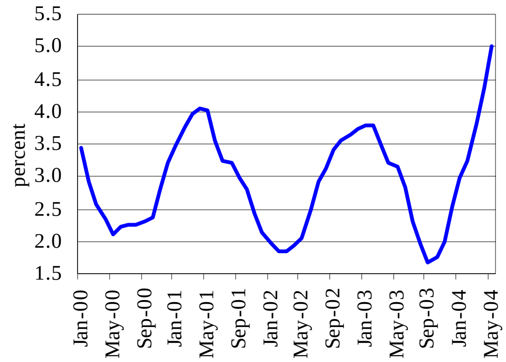
[1]: Change in May 2004 over May 2003.
[2]: Change in 12-month average in May 2004 over corresponding average of 2003.

inflation since September 1997.

7.3.1 Food Inflation

The CPI *food* inflation has risen sharply since October 2003 (see **Figure 7.6**), mainly due to supply shortages of wheat as discussed earlier. Although, supply shortages of some vegetables e.g., onion and tomatoes, have also contributed in the rise, their prices declined quickly as supply situation improved. In contrast, prices of wheat and its products did not see an appreciable fall, despite the arrival of the new crop. This appeared due to the continued availability of credit at low interest rates (which facilitated hoarding by the private sector) and government's inability to intervene in the market due to low wheat stocks (see **Section 2** for further details).

Figure 7.6: Annualized Food Inflation



The sharp acceleration in *food* inflation has serious negative consequences for the low-income group, where the purchases of food staples accounts for a substantial share of expenditures. In other words, for this income group, the benefits of high economic growth in terms of higher per capita income would be substantially eroded due to high *food* inflation.

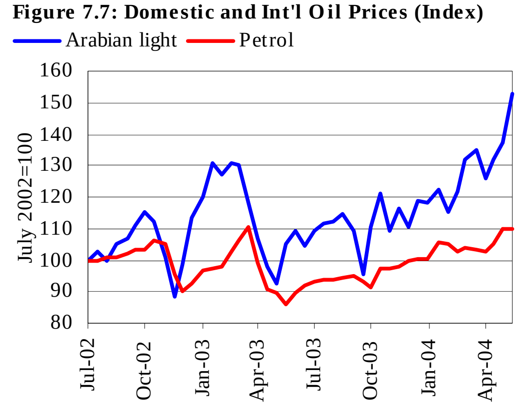
7.3.2 Non Food Inflation

The annualized *non-foo*d inflation had been stable relative to food inflation (in the range of 3.0 to 3.7 percent during last 20 months) and trending downward during most of the FY03 and FY04. However, in March 2004 it witnessed a trend reversal (see **Figure 7.5**). The recent up turn in annualized CPI *non-food* inflation is largely attributed to sharp increase in the sub-index of *house rent*,[3] record high international oil prices and a continued surge in the prices of palm oil.

[3] While, increase in *house rent* index was expected as mentioned in the *First Quarterly Report for FY04*, an unexpected sharp rise in the building material pushed HRI more robustly than earlier forecast.

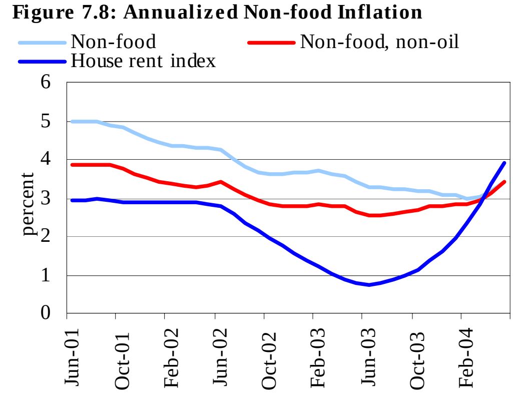
Similarly, contrary to expectations, international prices of oil and iron are moving upwards. Strong demand from China is an important factor that is likely to keep the prices of these items at significantly high levels in the near future. The impact of rising international oil prices is also visible on the domestic fuel prices. However, it is also evident that the domestic petrol prices, though widely criticized, were less volatile and did not rise at the same pace as international prices (see **Figure 7.7**). This was due to the government's creditable policy of largely buffering the impact of domestic prices by reducing the petroleum development surcharge. Nonetheless, even the resulting modest increase in local petroleum product prices pushed up the sub-indices of *transport & communication* and *fuel & lighting*. This cumulative impact more than offset the effect, on the respective sub-indices, of the recent downward adjustments in the electricity tariff and reduction in line rent for telephone.

Figure 7.7: Domestic and Int'l Oil Prices (Index)



An analysis of '*non-food non-oil'* inflation is important from the policy perspective. **Figure 7.8** shows that both *non-food* and '*non-food non-oil'* inflation rates have inched up since Q2-FY04. However, another important factor in *non-food* inflation is the role of *house rent* index (HRI) that has 23.43 percent weight in total CPI (or 39.3 percent in *non-food* group). A sharp rise in HRI is the major cause in pushing up the '*non-food non-oil'* component upward. This, in turn, implies that there is a need for measures to aid a decline in prices of *building material* (which basically drove

Figure 7.8: Annualized Non-food Inflation



up the HRI). In particular, the prices of cement are alleged to be artificially high due to the presence of a cartel (and strong demand from the construction activities in Afghanistan), while import restrictions on steel & iron to protect domestic industry are also a major reason for higher domestic prices of these commodities. If artificial price barriers are removed, then it is likely that the construction cost would come down substantially.

Moreover, the presence of a cartel for cement and regulatory arrangements for iron industries also imply that though monetary policy has a role in boosting housing and construction demand in the economy (through easy monetary stance), a large part of the current *non-food* inflation is still exogenously determined and subject to regulatory arrangements.

7.4 Wholesale Price Index (WPI)

WPI witnessed an increase of 11.5 percent (YoY) in May 2004 (see **Table 7.3**), the major factors contributing to this double-digit growth were the impressive increase in the sub-index of *building material*. *Food* inflation is stronger in WPI than in headline CPI, but its contribution to WPI inflation was overshadowed by even stronger *non-food* inflation.

The major sources of WPI inflation are: (1) higher prices of wheat, milk and related items; (2) the rise in the prices of cement; (3) a substantial increase in the prices of steel & iron; (4) the rising tendency in the crude oil and edible oil prices; and finally (5) significantly higher cotton prices.

Table 7.3: WPI Inflation in May

percent

	Marginal (YoY)[1]		Annualized[2]	
	2003	**2004**	**2003**	**2004**
Food	4.7	11.0	3.8	6.0
Non-food	6.8	11.8	6.6	8.0
Raw material	26.6	12.5	13.7	17.5
Fuel, lighting & lubricants	2.1	13.2	12.0	1.9
Manufactures	4.3	8.0	1.6	7.1
Building material	4.8	27.3	1.9	21.1
WPI general	**6.0**	**11.5**	**5.5**	**7.2**

[1]: Change in May 2004 over May 2003.
[2]: Change in 12-month average in May 2004 over corresponding average of 2003.
Source: Federal Bureau of Statistics.

The first three factors heavily influenced by the strong domestic demand on the back of remittances and easier access to housing credit at reasonably soft terms amid a rising trend in the international prices of steel and iron. The latter two sources of WPI inflation are merely a reflection of external developments.

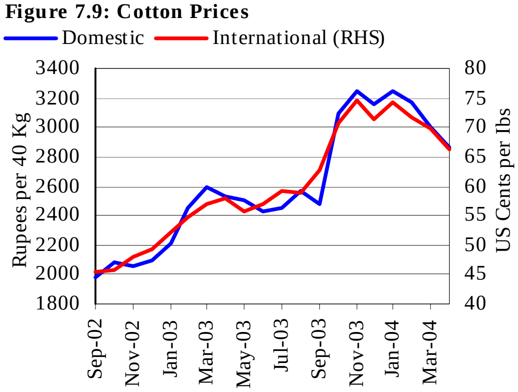
7.4.1 Non-food

Sub-index of *non-food* witnessed an increase of 11.8 percent in May 2004 over the corresponding month of 2003, mainly due to a 27.3 percent rise in the sub-index of *building material*.

The increase in *building material* sub-index is attributable to strong domestic demand from the construction industry, which was compounded by a rise in international prices of iron. However, international scrap prices have recently showed some decline in the international prices due to low buying from Far Eastern countries. This also implies that the prices of steel and iron would also see some correction in months ahead.

The sub-index of *raw materials* saw a slowdown on YoY basis since March 2004 and registered an increase of 12.5 percent in May 2004 compared with a substantial rise of 26.6 percent in May 2003. This is largely attributed to a marginal decline in the domestic and international cotton prices from January 2004 onwards, amidst expectations of a stronger rise in output relative to demand, during FY05 (see **Figure 7.9**).

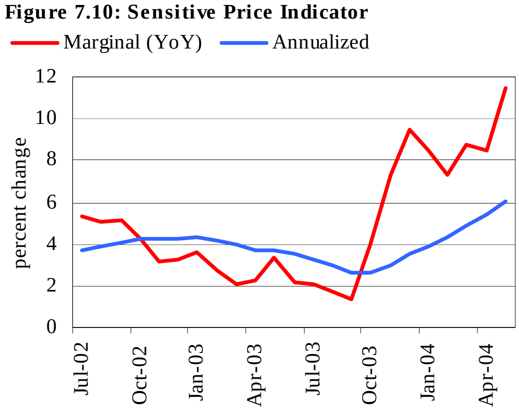
Figure 7.9: Cotton Prices



7.5 Sensitive Price Indicator (SPI)

A substantial rise in the important food items that are part of the SPI pushed YoY SPI inflation as high as 11.9 percent by June 17, 2004 over the corresponding period of 2003 (see **Figure 7.10**). The movements in SPI also show the incidence of inflation on the low-income

Figure 7.10: Sensitive Price Indicator



groups as the SPI basket consists on 53 items of daily use, mostly food. Most of the income of the lower income group is spent on the consumption of these food items.

There is no question that the market-based system is a very efficient way to maximize the social gains. However, this holds true largely in markets, where a large number of suppliers ensure market discipline in pricing, and where oligopolies and cartels are tightly regulated. In the absence of these, there is a pressing need for government regulation and/or interventions to counter anti-competitive behavior.

It is in this context that there appears to be a clear role for government intervention in Pakistan to ensure smooth supply of at least the key staples in order to protect the low-income group.

The recent announcement of the Government to import of 1 million tons of wheat is a very welcome (though overdue) measure, as the aggressive build up of buffer stocks by the Government (and the implicit threat of liberal supply in the market) would act to discourage speculative hoarding. In fact, initial reports suggest that the announcement of the planned imports has already influenced domestic wheat prices in recent weeks.