3 Prices

3.1 Global Inflation Scenario

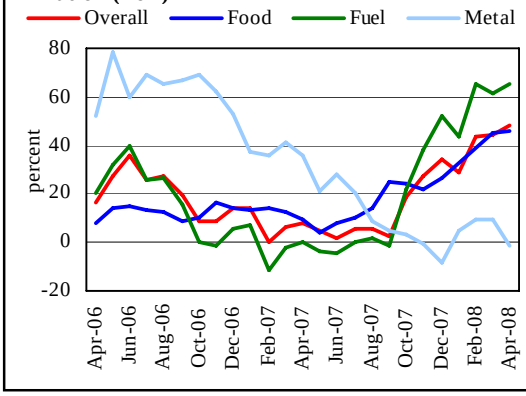
A number of factors are continuing to stoke up global inflationary pressures. Notably, these factors are: (1) sustained increase in global commodity demand, (2) supply issues, and (3) growing interest of investors in commodity markets on the back of a weak dollar[1] and falling interest rates. Prices of all key commodities have witnessed significant growth since July 2007 (see **Table 3.1**). The surge in commodity prices has been particularly strong in the last six months, with significant increase in global food and energy prices (see **Figure 3.1**).

Table 3.1: International Commodity Prices

Item	Unit	April 08	Percent change since July 2007
Crude oil	US$/barrel	109.0	48.0
Wheat	US$/MT	362.2	51.9
Rice	US$/MT	1015.2	205.3
Maize	US$/MT	246.6	67.9
Soybean	US$/MT	1292.1	57.7
Palm	US$/MT	1083.5	41.7
Iron ore	US cents/dmtu	140.6	66.0
Tin	US$/MT	2166	47.0
Dap	US$/MT	1200.6	175.2
Urea	US$/MT	471.3	75.9

Source: IMF and World Bank.

Figure 3.1: World Commodity Price Indices Inflation (YoY)



While increase in the prices of many key food commodities such as rice, wheat, and edible oil is mainly due to relatively disappointing harvests (which could improve in succeeding years), a significant contribution is also by factors that may not change. The

[1] The steady decline in the value of US dollar has been a key driver behind recent commodity price strength. Since July 2007, the US dollar has depreciated significantly against euro, yen and pound sterling that made dollar less attractive for investment and investors shifted their investments towards commodity markets.

latter include the increased demand from emerging economies (as income levels improve) and increased use of bio-fuel as an alternative energy source. The link of food prices with energy cost, is particularly troubling, given that energy prices are likely to remain significantly above historical norms in the foreseeable future.

The surge in global inflation has affected developing economies more than the developed economies. This is because the share of food in the consumption baskets of developing economies is significantly higher than developed countries. Moreover, the greater use of processed food in developed economies means that the impact of a rise in commodity prices is muted in food inflation for these economies, as (1) commodity prices account for only a small share of the prices of processed foods, and (2) many processed food industries either have long-term supply contracts, or hedge their price risk.

Not surprisingly, therefore, fiscal measures (tariff cuts and subsidies) aiming at, to partially protect the populace from rising food and energy commodity prices are more evident in developing economies. However, in countries where the fiscal deficit is already large, the fiscal measures to contain the impact of rising international food prices on domestic inflation are likely to prove unsustainable. The efforts to support poor by deterioration in fiscal balances, result in limiting sustainability of these measures. The latter concern is underlined by forecasts that the high food and energy prices are likely to remain.

A number of developing economies have introduced additional measures to rein in the rising food prices (see **Box 3.1**). For example, some major rice exporters have introduced export bans on rice (staple food of half of the world population) seeking to ensure availability (and low prices) in their domestic markets. Such measures have created supply disruptions in the world commodity market, and thus ultimately pushed up the food prices even higher across the globe.

The limitations of fiscal and administrative policies to contain inflationary pressures imply that the burden on monetary policy to contain inflationary pressures increases. Thus, monetary policy is tight in most of the emerging economies in the current spell of price hike. However, given that food inflation has taken less of a toll in developed economies, and that aggregate demand in these is already feared to be hit by the on-going financial crisis (which would help reduce inflation), monetary authorities in these economies have largely either loosened their monetary posture or are holding to a neutral stance.

Box: 3.1: Major Developments in International Food Commodity Markets
Following are the major developments that have led to a surge in food commodity prices in the international markets:

Wheat

- Rapid growth in emerging economies, importantly China and India, has resulted in increased demand for wheat, thus pushing its prices up.
- The number of wheat farmers switching to other crops such as maize and corn is growing due to increase in the preference for bio-fuel.
- Two years of drought in Australia has cut the global wheat stock to a level not seen since 1970s.
- Continued larger exports of wheat from USA led to depletion of wheat stocks to 60 years low level, creating panic.

Rice

- A ban from major rice exporters Vietnam, India, Egypt and Cambodia to ensure domestic availability aggravated supply concerns.
- Increase in rice demand as its consumption in Asia, Middle East and West Africa is rising due to higher per capita income.
- Short supplies due to reduction in acreage, rising cost of fuel and poor crop due to water shortages. As a result global current rice stocks are at the lowest levels since 1976.

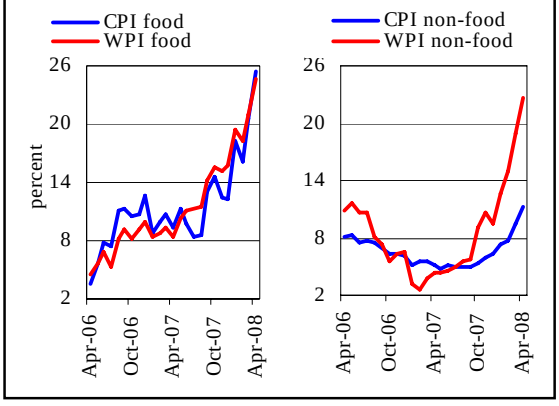
Edible Oil

- Expected lower rapeseed production in China because of bad weather and lowering of input tariff by Indian government has put pressure on vegetable oil prices in global market.
- US, EU and Russia have been showing high consumption of soybean oil for industrial use pushing its price in the international market.
- Increasing palm oil prices are also being supported by protectionist policies in major exporting countries like Indonesia where palm oil is politically sensitive as it is staple product.

3.2 Domestic Scenario

The impact of strong global inflationary pressures on domestic inflation has also compounded by the adjustments of administered prices of key fuels and wheat. All price indices have moved up significantly so far in FY08 and are significantly higher than the annual averages of the preceding five years (see **Table 3.2**).

Figure 3.2: Trends in CPI and WPI inflation YoY



It is important to note that trends of food inflation are similar in both CPI and WPI (see **Figure 3.2**). In contrast, there is a clear diversion in

non-food inflation in these indices[2].

Table 3.2: Inflation Trends
percent

	Year-on-Year[1]		12-month moving average		Avg. FY03-FY07 (YoY)
	April				
	2007	2008	2007	2008	
CPI	6.9	17.2	7.8	9.8	6.5
Food	9.4	25.5	9.7	14.3	7.5
Non-food	5.2	11.2	6.5	6.5	5.8
WPI	6.0	23.5	7.3	12.6	7.9
Food	8.4	24.6	8.1	15.8	7.7
Non-food	4.3	22.7	6.6	10.4	8.0
SPI	7.7	22.3	9.4	11.2	7.4
Core					
NFNE[3]	5.6	10.8	6.1	7.2	5.6
Trimmed mean	6.6	14.1	6.8	8.9	6.0

[1]e.g. change in April 2008 over April 2007
[2]e.g. change in 12-month average of April 2008 over April 2007
[3]Non-food non-energy

Source: Federal Bureau of Statistics

The initial diversion in non-food inflation in the two indices was primarily attributed to the fact that: (1) pass through of rising international oil prices was negligible in non-food CPI since the prices of key fuels remained unchanged in CPI basket. In contrast, pass through in WPI was significantly high as the prices of most of the POL items included in WPI are market based. (2) A large part of increased cost was probably absorbed by the producers to remain competitive in the market. Persistent rise in the commodity prices, however, forced producers to pass on some impact to consumers recently, which resulted in a sharp jump in CPI non-food inflation in April 2008, and (3) the impact of increase in the prices of various manufacturing inputs such as cotton and metals is only partially reflected in CPI non-food, while WPI non-food shows their full impact.

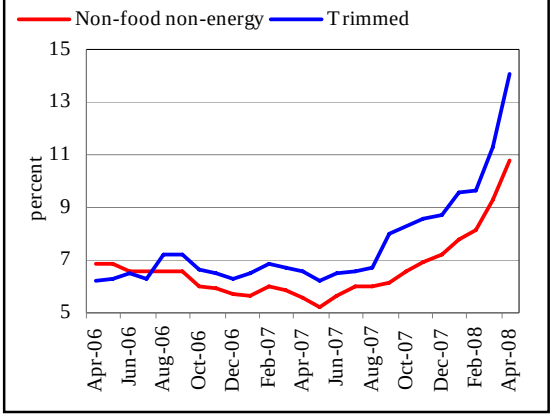
If inflationary pressures are, principally driven by rising food prices, a tight monetary posture may help contain second-round effects of high food inflation on CPI non-food inflation. But heavy government borrowing from SBP undermines its efforts to mitigate second-round effects of sustained high food inflation, which further fueled the inflationary pressures. As a result of large fiscal deficit, money growth remained well above the desired level and more than required growth in liquidity complicates monetary management.

The muted impact of monetary policy is also evident in rising core inflation

[2] CPI non-food inflation was only 6.3 percent YoY in December 2007, rose to 11.2 percent YoY by April 2008.

throughout FY08. Core inflation, measured by 20 percent trimmed mean, accelerated to double digits (14.1 percent -historic high level) in April 2008. Persistence of inflationary pressures is also evident from non-food non-energy (NFNE) based core inflation that increased to 10.8 percent in April 2008 (see **Figure 3.3**).

Figure 3.3: Core Inflation (YoY)



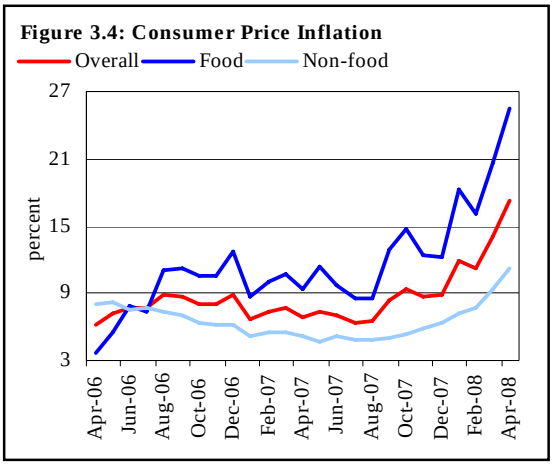
It should be kept in mind that the historic high food, energy, fertilizer and metal prices in international markets are the major causes of the strength in domestic inflation. Wheat, rice, edible oil, readymade food and milk prices have surged since July 2007. In perspective, a relatively lower domestic wheat flour prices encouraged smuggling to neighboring countries. Increase in wheat support price stimulated speculative hoarding. Low inventory stocks with the government, as well as, substantially higher input cost particularly fertilizers are the main reasons of the rising wheat prices. Procurement and import of sufficient quantity of wheat in order to stabilize flour prices will be a challenge for the government in coming months. Similarly, while Pakistan had sufficient surplus rice for export, rising international prices amid supply shortages attract Pakistani rice exporters, which resulted in increasing domestic prices of rice as well. Recently, in order to ensure domestic availability of rice, government has fixed a minimum export price for rice. Moreover, a tax on rice export would also help improve fiscal balance as well as ease domestic supply.

The unanticipated strength of food and energy prices is likely to continue in the medium-term. Such high inflation is not good for long-term growth and competitiveness. This suggests the need for a continuously tight monetary stance aiming at minimizing the second-round impact and pass through of administered prices. This is not easy task and requires effective support of fiscal authorities to reduce their borrowings from SBP. Further, depreciation of Pak rupee in recent months is also likely to generate inflationary pressures. Given the present inflationary pressures in the economy, SBP forecasts were revised upward with

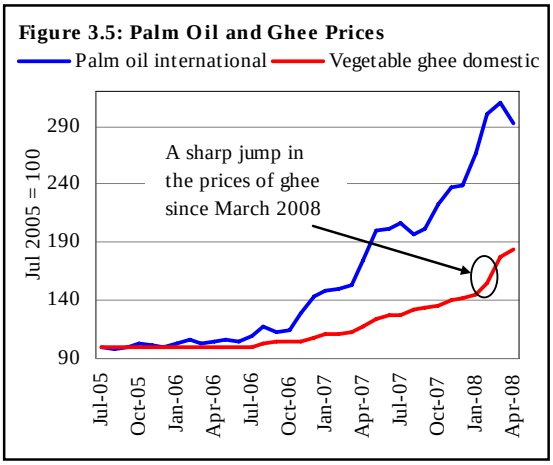
CPI inflation likely to fall between 10 to 11 percent during FY08, significantly higher than the 6.5 percent target for the year.

3.3 Consumer Price Index (CPI)

CPI inflation (YoY) remained in double digits during the third quarter of FY08. The acceleration in CPI inflation is contributed by both food and non-food components (see **Figure 3.4**).



Rising prices of key food staples (wheat, rice, edible oil and milk) continued to provide impetus to food inflation in recent months. It is also important to note that the pass through of rising international prices of palm oil has accelerated (see **Figure 3.5**).



The inflation outlook appears to be unfavorable given a sharp surge in wheat flour prices amid acute supply shortages in recent months, as well as, likely realization of upward revision in key fuel prices on food inflation[3]. Moreover, impact of depreciation of rupee is likely to fuel inflationary expectations in the times ahead.

Since the incidence of significantly high food inflation on the poor is disproportionately high, therefore, there is a need to take necessary administrative measures to protect low-income households by providing targeted subsidy to them

[3] In terms of higher transportation cost.

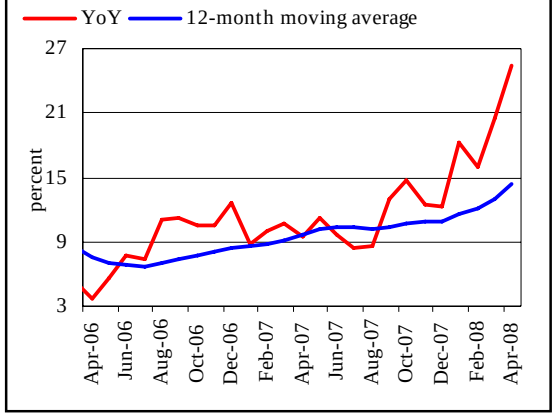
through ration cards, utility stores or through students of public schools[4]. Providing subsidy is, however, a short-term measure. In long-term, investment in agriculture sector to raise productivity is essential. This may be done by providing certified seeds, access to institutional credit, subsidy on fertilizer, reducing wastages, water reservoirs and investment in value addition chains. In addition, appropriate price signals to farmers and improve market structures are required to convince them that they will get a reasonable return for their labor. At the same time, strict check on illegal cross boarder movement of grains and a vigilant monitoring of domestic availability and timely imports in case of need to avoid crisis like situation will be crucial for domestic price stability.

It is important to note that non-food inflation is also likely to reach close to double digit levels by the end of current fiscal year. While, non-food group offsetting some of the impact of rising food inflation in FY07, it is contributing in strengthening inflationary pressures during FY08.

3.3.1 CPI Food Inflation

CPI food inflation increased significantly during the first nine months of FY08. CPI food inflation was 25.5 percent during April 2008, as compared to 9.4 percent in the corresponding month last year (see **Figure 3.6)**.

Figure 3.6: CPI Food Inflation



While the prices of most of the food items are rising, the dominant contribution to the sharp rise in CPI food inflation is from only a few items (see **Table 3.3**). Only seven food items with a total weight of 19.9 percent in CPI basket, contributed 47.1 percent in overall inflation during April 2008. Moreover, within the food group, only three items (wheat, vegetable ghee and fresh milk) contributed 56.1 percent of the food inflation during April 2008.

[4] It has been observed that drop out ratio from schools increases with rising incidence of poverty. Therefore, provision of basic food staple to public school students may probably help avoid increase in the drop out ratio as well as help the needy households.

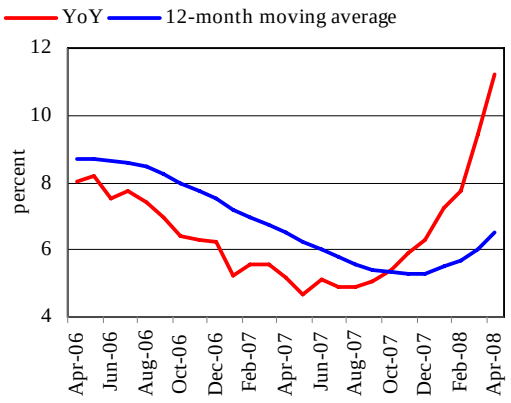
3.3.2 CPI Non-food Inflation

CPI non-food inflation (YoY) showed a sharp acceleration in FY08, though the pace of increase is slower than the food inflation. CPI non-food inflation rose to 11.2 percent in April 2008 compared with 5.2 percent in the same month last year (see **Figure 3.7**).

Table 3.3: Top Ten Contribution to YoY CPI Inflation in April 2008

	Items	Weights	YoY Change		Weighted contribution
			Apr-07	Apr-08	
1	Wheat flour	5.1	4.4	54.1	15.8
2	House rent index	23.4	6.2	11.4	15.4
3	Vegetable ghee	2.7	25.3	59.9	10.5
4	Milk fresh	6.7	11.2	21.0	8.7
5	Rice	1.3	28.4	60.2	5.2
6	Petrol	1.7	-6.9	28.2	3.5
7	Transport fare/charges	2.1	2.5	19.6	2.9
8	Cooking oil	0.7	18.2	59.1	2.5
9	Vegetables	1.8	7.9	18.6	2.2
10	Readymade food	1.7	6.4	20.7	2.2
	Total	**47.2**			**68.9**

Figure 3.7: CPI Non-food Inflation



The recent increase in non-food inflation is mainly attributed to jump in inflation in house rent index (HRI) and cleaning, laundry & personal appearance sub-groups during April 2008. Moreover, a trend reversal in sub-groups of transport & communication, as well as, fuel & lighting also put upward pressures on non-food inflation.

The rise in HRI is principally owed to increasing international metal prices and continued uptrend in domestic wages of construction workers. In contrast, increase in fuel & lighting and transport & communication sub-group is mainly a result of an upward revision in the domestic prices of key fuels amid record high international oil prices (see **Table 3.4**).

3.3.3 Income Group-wise Inflation

The contribution of food inflation in overall CPI remained high in the first nine months of FY08. This resulted in a larger incidence of inflation for the low-income groups, where food staples typically account for a greater proportion of total expenditure.

Table 3.4: CPI Non-food Inflation (YoY) by Groups

	Weights	Apr-07	Jun-07	Dec-07	Feb-08	Mar-08	Apr-08
Non-food group	59.7	5.2	5.1	6.3	7.8	9.4	11.2
Apparel, textile and footwear	6.1	7.3	7.2	8.7	6.7	6.9	8.4
House rent	23.4	6.2	6.7	8.8	10.0	10.6	11.4
Fuel & lighting	7.3	7.0	6.1	5.5	6.2	8.5	8.6
Household furniture & equip.	3.3	7.0	5.8	6.5	6.3	7.0	8.4
Transport & communication	7.3	-2.4	-3.1	-3.0	3.0	8.7	17.9
Recreation & entertainment	0.8	-0.2	0.1	0.4	0.7	0.9	1.0
Education	3.5	6.6	6.4	4.4	3.4	3.5	4.7
Cleaning, laundry & personal appearance	5.9	4.5	4.7	8.9	13.0	15.9	15.8
Medicare	2.1	10.1	9.9	7.6	7.9	6.5	7.4
Headline	**100**	**6.9**	**7.0**	**8.8**	**11.3**	**14.1**	**17.2**

Thus in April 2008, the lowest income group (income up to Rs. 3000 per month), middle income groups (income Rs. 3001 – 5000 per month) and upper middle income group (Rs. 5001 – 12000) witnessed highest inflation of 20.2, 19.9 and 18.1 percent, followed by 15.7 percent for the highest income group (with income above Rs. 12000 per month) (see **Figure 3.8**).

Figure 3.8: Incidence of CPI Inflation (YoY) Apr-08

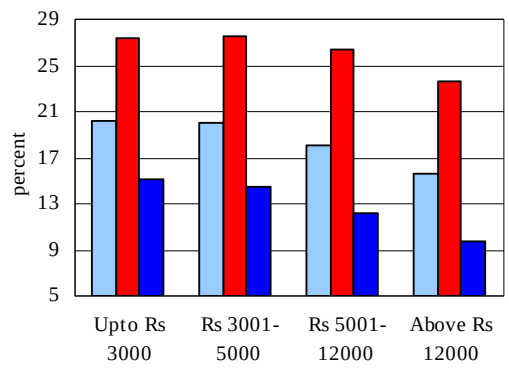
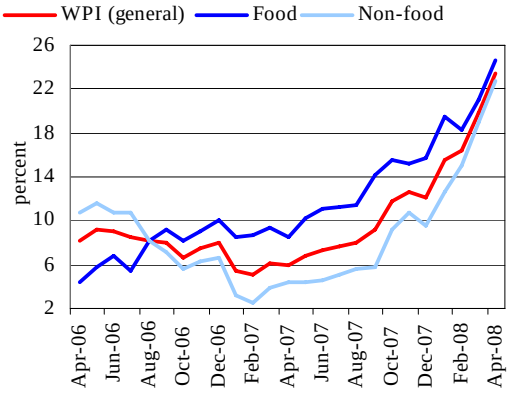


Figure 3.9: Wholesale Price Inflation (YoY)



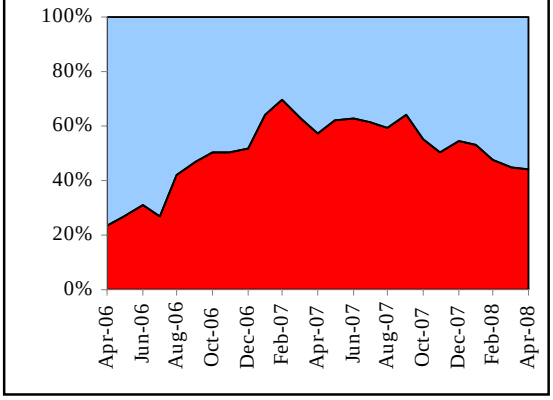
3.4 Wholesale Price Index (WPI)

Inflation measured by Wholesale Price Index continued its uptrend throughout the first nine months of FY08 and recorded 23.5 percent growth during April 2008, which is significantly higher than the 6.0 percent recorded in April 2007. Both, food and non

food groups of WPI contributed to the rise in WPI inflation (see **Figure 3.9**).

WPI food inflation reached 24.6 percent in April 2008 compared with 8.4 percent in the same month last year. Factors which drove CPI food inflation are also responsible for substantially high WPI food in recent months. WPI non-food inflation also rose to 22.7 percent in April 2008 compared to a subdued 4.3 percent during the same month last year. The strength of the rising pace of WPI non-food inflation is also evident from its rising weighted contribution (see **Figure 3.10**) in overall WPI inflation in recent months, despite continued double digit WPI food inflation in the current fiscal year.

Figure 3.10: Weighted Contributions in WPI

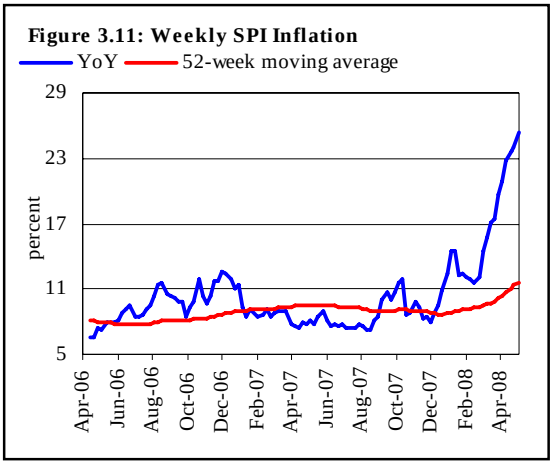


Within the non-food group of WPI, the fuel, lighting & lubricant sub-group showed a significant rise in its contribution during Q3-FY08 and has contributed more than 60 percent to non-food inflation in recent months, reflecting the impact of continuously rising international crude oil prices.

3.5 Sensitive Price Indicator (SPI)

Weekly inflation measured by SPI also increased considerably from 7.7 percent in the last week of FY07 to 25.4 percent in the first week of May 2008 (see **Figure 3.11**). Similarly the monthly SPI inflation reached to 22.3 percent (YoY) in April 2008 compared to 7.7 percent in the same month last year. This is mainly because almost 60 percent of the items included

Figure 3.11: Weekly SPI Inflation



in the SPI basket are from the food group, thus it largely exhibited the up trend of the CPI food component.

More than 60 percent of the items included in the SPI basket recorded double-digit YoY inflation during April 2008, with some of the items like rice, wheat, vegetable ghee, cooking oil, mustard oil, pulse masoor and tomatoes witnessing inflation of more than 50 percent.