

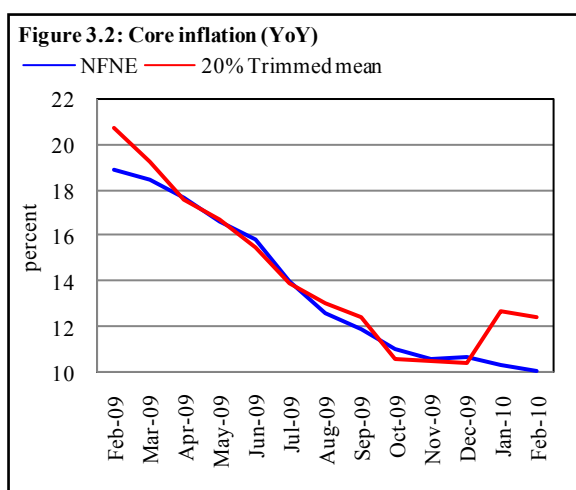
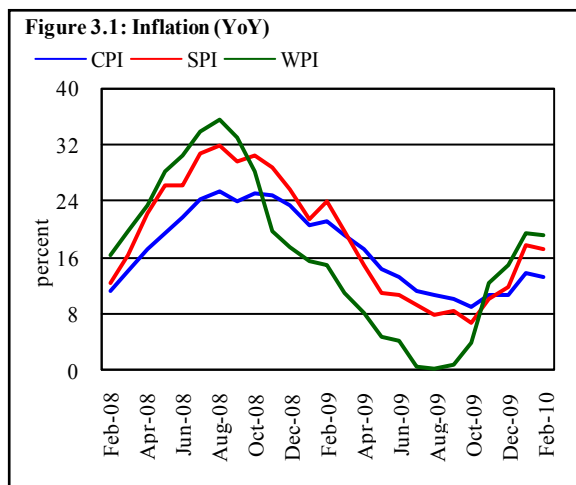
3 Prices

3.1 Overview

As anticipated, inflationary pressures strengthened in the economy in recent months. All price indices exhibited sharp rise since October 2009 (see **Figure 3.1**). Increase in domestic inflation is mainly attributed to: (a) rise in the administered prices of energy¹ and key fuels by the government; (b) exchange rate pass-through; and, (c) a temporary supply shock in January 2010 due to bad weather (fog) in the Punjab. Moreover, relatively higher international commodity prices of sugar, tea, pulses, rice, and crude oil also fueled inflationary pressures in the economy.²

Headline CPI inflation bottomed out at 8.9 percent in October 2009 before rising to 13.0 percent in February 2010. However, this remains lower than the 21.1 percent in February 2009, and 13.7 percent in the preceding month.

A divergent trend of core inflation measured by 20% trimmed mean and core inflation measured by non-food non-energy (NFNE) indicates that



¹ An upward adjustment in electricity and gas tariff is part of the efforts to reduce subsidy, thus help reduce burden on fiscal budget.

² The impact of this is more evident in sharp surge in wholesale price index (WPI) during recent months.

inflationary pressures were more concentrated in food and energy sub-groups in recent months (see **Figure 3.2**). A higher 20% trimmed mean measure also implies that within food and energy sub-groups, inflationary pressures were substantially broad based. It also points towards the possibility of strong second-round effects on prices of other goods and services due to increased cost of production and rise in cost of living (see **Table 3.1**).

The fear of these renewed inflationary expectations, due to an inevitable reduction in subsidies on power and indications of strength in aggregate demand³, contributed to the central bank's monetary policy committee decision to keep the policy interest rate unchanged in January 2010. The decision was supported by the risk posed by continued expansionary fiscal stance due to war against terrorism, etc. However, it is also important to mention that as inflationary pressures eased earlier in 2009, SBP cut policy rate by a total of 250 basis points in CY2009. This probably helped the recovery in the growth during FY10. In particular, LSM growth witnessed strong recovery and registered 2.3 percent production growth during Jul-Jan FY10 as against a decline of 5.4 percent in the same period last year.

Table 3.1: Different Dimensions of Inflation (YoY)
percent

	Feb-09	Jan-10	Feb-10
Overall CPI	21.1	13.7	13.0
Food group	22.9	15.5	14.9
Non-food group	19.6	12.2	11.5
HRI	18.5	13.4	12.7
WPI	15.0	19.6	19.3
Food group	22.0	15.6	15.4
Non-food group	9.8	23.0	22.6
SPI	23.9	17.8	17.2
Core Inflation			
NFNE	18.9	12.6	10.1
NFNE excl. HRI	19.4	7.5	7.6
Trimmed	20.8	12.7	12.4
Trimmed excl. HRI	22.4	12.7	12.4

SBP forecasts indicate that inflationary pressures are likely to persist going forward. This view is endorsed by most commodity analysts, who believe that crude oil prices would average above US\$ 80 for the remaining 9 months of 2010. This would also impact domestic inflation in the months ahead. In view of these factors, SBP forecasts remain unchanged, indicating that annual CPI inflation would fall in the range of 11-12 percent in FY10.

³ A strong growth in sale of consumer durables, reduced but continued current account deficit and consensus on a moderate acceleration in real GDP growth, all these factors indicate continued strength in aggregate demand.

3.2 Consumer Price Index (CPI)

Although CPI inflation during recent months was still lower than the levels seen in the preceding fiscal year, upward pressures on inflation are evident (see **Figure 3.1**). Specifically, headline CPI inflation rose to 13.0 percent YoY in February 2010 compared to a local trough of 8.9 percent recorded in October 2009. The surge in CPI inflation during February 2010 is principally attributed to rise in the prices of food commodities, upward adjustment in administered prices of key fuels and electricity tariff relative to the corresponding period last year. Nonetheless, CPI inflation marginally declined during February 2010 relative to the preceding month as supply restored after improvement in weather as well as a slight downward revision in the prices of key fuels (see **Table 3.2**).

Acceleration in inflationary pressures in recent months is also evident from the significant increase in the number of items recording double digit price increases in CPI basket (see **Figure 3.3**). It is important to note that a large part of the current strength in inflationary pressures is stemming from imported inflation (see **Figure 3.4**). In particular, a rise in the international prices of sugar, cotton (thus apparel & textiles), rice, pulses, and tea coupled with weakness in rupee parity led to substantial rise in domestic prices of these commodities. In contrast, a decline in international wheat prices did not lead to lower local prices due to higher minimum procurement prices. Anecdotal evidence suggests that part of domestic wheat consumption is met by inward smuggling from some

Figure 3.3: Distribution of Price Changes (YoY)

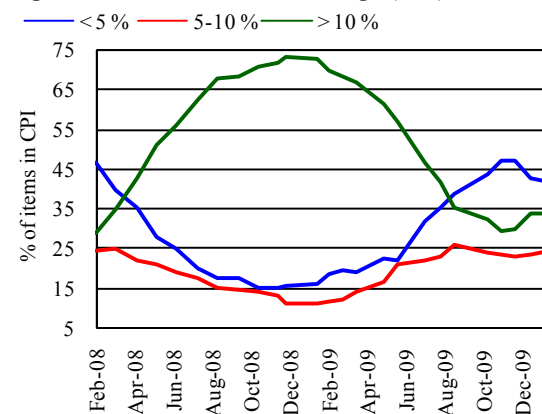
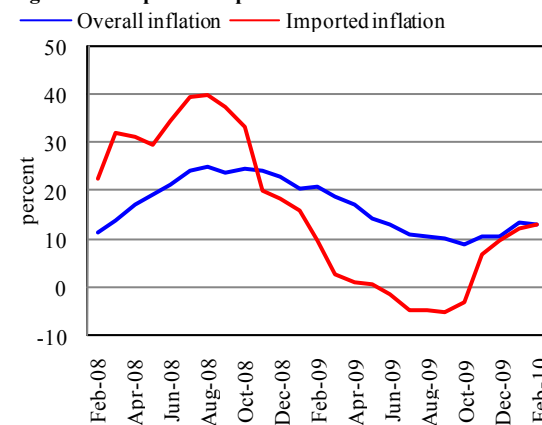


Figure 3.4: Impact of Imported Inflation



neighboring countries (Central Asian Republics, etc.). Though rise in wheat prices is subdued in FY10, its impact on overall inflation is strong since it is the key staple and a wage commodity in rural areas.

Table 3.2: Weighted Contribution to CPI Inflation (YoY)
percent

		Weights	Feb-08	Feb-09	Jul-09	Jan-10	Feb-10
1	House rent index	20.7	20.3	34.9	22.0	22.1	20.7
2	Milk fresh	11.2	13.2	7.9	7.3	9.6	11.2
3	Wheat flour	8.3	7.7	10.4	7.8	8.1	8.3
4	Sugar	-2.2	3.5	4.9	7.0	7.4	-2.2
5	Meat	2.1	2.8	4.9	4.8	5.5	2.1
6	Electricity	0.0	5.2	7.0	5.1	5.3	0.0
7	Vegetables	6.5	-1.5	4.0	3.6	4.5	6.5
8	Readymade food	2.6	3.6	0.8	5.2	4.0	2.6
9	Fresh fruits	1.8	-0.1	-7.2	3.0	2.9	1.8
10	Chicken farm	13.1	-1.1	-6.1	2.3	2.8	13.1

It is important to note that higher inflation in Pakistan relative to other regional countries has often been quoted as an anomaly. However, overall macroeconomic situation including large external and fiscal account imbalances, frequent changes in administered prices of fuel, energy⁴ and key food commodities, weak market structure, and frequent supply shocks are some reasons of higher inflation in Pakistan. In particular, a continued slide in Rs/US\$, which is in fact reflecting the position of Pakistan's external accounts, is also a major cause of higher inflation in the country. To have price stability in medium to long run, structural reforms, investment in agri sector focusing on enhancement of yields and productivity, sustained rise in exports, as well as, improvement in law & order situation (to attract forex inflows) are unavoidable.

3.2.1 CPI Food Inflation

CPI food inflation (YoY) resurged after bottoming out in October 2009. It rose from 7.5 percent in October 2009 to 14.9 percent in February 2010, though remained lower than the 22.9 percent recorded in February 2009 (see **Figure 3.5**). While overall domestic supply of essential food items is largely adequate in FY10, rise in the prices of imported commodities such as sugar, pulses and tea are the main source of acceleration in food commodity prices in recent months.

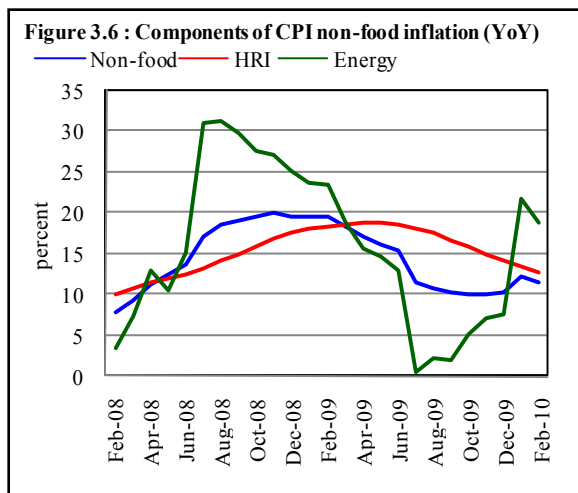
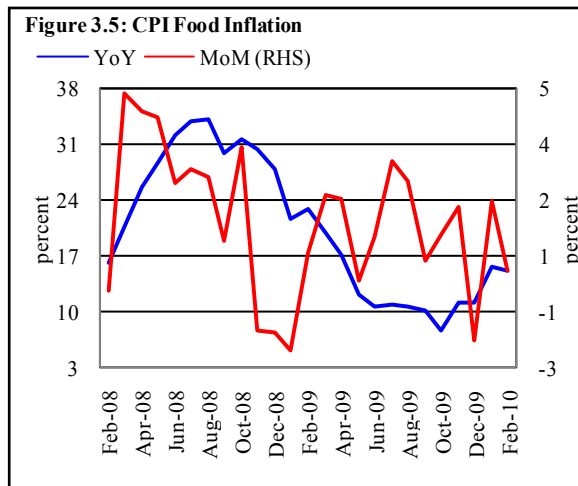
⁴ Government is reducing subsidies on these items. However, the impact on prices is disproportionate. A direct impact since these are part of the CPI basket. Also, these are key input in manufacturing process and transportation, therefore, carries a substantial indirect impact on prices of a large number of items.

Moreover, seasonal decline in the prices of food commodities in February was absent this year, probably reflecting increased transportation cost of these items.

In particular, domestic sugar prices witnessed an increase of 62.0 percent YoY during February 2010 on top of 63.6 percent in February 2009. Domestic sugar prices showed declining trend in recent weeks on the back of improved supply in the market and falling international sugar prices.⁵ However, decline in international prices is mainly a function of weak demand as major importers such as India, Pakistan, Egypt, Philippines, etc. deferred their purchases in response to very high prices in February 2010. In addition, an above 21.0 percent rise in Brazilian sugar output also improved supply. Nonetheless, there is a risk that whenever these countries will enter in the market, prices will resurge again. In this backdrop, it is important to timely import sugar to stabilize its prices in the country, as around 0.5 million tons of sugar is needed to import to meet the domestic consumption. A delay in imports may lead to shortages before the holy month of Ramadan, which may push up prices.

3.2.2 CPI Non-food Inflation

The impact of a continued moderation in HRI inflation coupled with a slight decline in key fuel prices in February 2010 relative to January 2010



⁵ FY10 sugar production dropped to around 3.0 million tons (due to sharp fall in sugarcane output), which is significantly lower than the domestic consumption requirements of about 4.2 million tons. Cost of imported sugar at Karachi port is estimated to be around Rs 48/kg on the basis of international prices as on March 18, 2010.

halted the rising trend in CPI non-food inflation; dropping to 11.5 percent YoY during February 2010 from 12.2 percent in the preceding month (see **Figure 3.6**).

Table 3.3: CPI Non-food Inflation (YoY) by Groups
percent

	Weights	MoM			YoY		
		Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10
Non-Food Group	59.7	1.2	2.8	0.6	19.6	12.2	11.5
Apparel, textile, etc.	6.1	0.3	0.5	0.7	15.4	5.2	5.6
House rent	23.4	1.3	0.8	0.8	18.5	13.4	12.7
Fuel & lighting	7.3	2.5	13.4	-0.1	29.8	20.2	17.2
Household furniture & equipment	3.3	0.7	0.6	0.7	14.7	5.6	5.5
Transport & communication	7.3	0.2	3.0	1.1	21.5	9.4	10.4
Recreation & entertainment	0.8	1.3	-0.3	3.5	14.0	2.1	4.3
Education	3.5	0.8	0.2	0.2	18.0	13.7	12.9
Cleaning, laundry, etc.	5.9	2.1	0.9	0.5	18.3	11.5	9.8
Medicare	2.1	0.4	2.7	0.4	14.2	5.9	5.9

Analysis of sub-groups of non- food reveals that out of nine sub-groups, five sub-groups showed a decline, three sub-groups an increase, and one saw no change, during February 2010 compared to the preceding month (see **Table 3.3**).

In particular inflation (YoY) in *transport & communication* sub-group has accelerated from 9.4 percent during January 2010 to 10.4 percent in February 2010 mainly due to indirect effect of increase in domestic fuel prices as transportation fares moved up. The acceleration in this sub-group is also attributed to upward rise in the prices of different vehicles and tyres and tubes amid strong domestic demand.

In contrast, a moderate deceleration in HRI is likely to continue during next few months of FY10 due to fall in the prices of cement and iron & bars. This would help contain CPI non-food inflation since HRI has about 45.9 percent weight in CPI non-food basket.

3.2.3 Incidence of Inflation

The incidence of inflation again shifted to low income groups with a sharp jump in food inflation (see **Table 3.4**). It is consistent with economic theory and the fact that a large part of income of this group is spent on food staples. However, it is notable that the incidence of non-food inflation is also higher for low income groups. This shows that a rise in power tariff and increase in the prices of key fuels – the major drivers of February 2010 inflation – also hurt low income groups. In fact, rise in administered prices of fuel leads to increase in transport

Table 3.4: Income Group-wise CPI Inflation (YoY)
percent

	Upto 3000			Rs. 3001-5000			Rs. 5000-12000			Above Rs. 12000		
	Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10
General	21.7	14.2	14.3	22.2	14.0	14.0	22.0	13.8	13.3	19.8	13.5	12.5
CPI Food	23.7	16.4	16.8	23.6	16.1	16.3	23.3	15.7	15.4	22.1	14.9	13.8
CPI Non-food	19.2	11.5	11.2	20.5	11.6	11.4	20.8	12.0	11.3	18.5	12.6	11.8

fares, which usually show downward rigidity. Similarly, consumption of electricity by low income groups is probably inelastic (at the lowest possible level), thus a rise in tariff severely hit their budget.

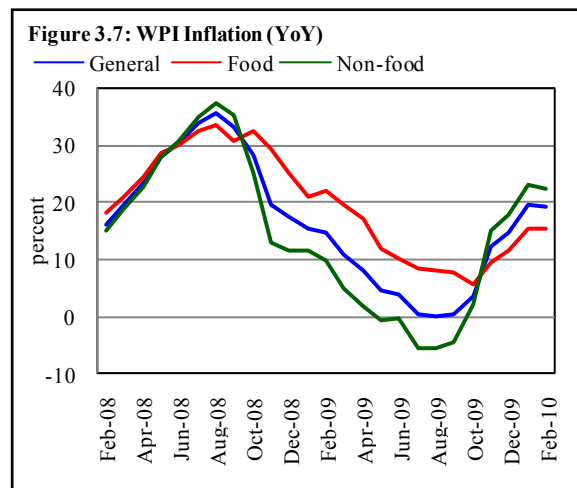
City- wise inflation data of the federal and provincial capitals shows that CPI inflation remained lower in all cities except Lahore compared to overall inflation in February 2010. Inflation in Lahore was slightly higher than overall inflation (see **Table 3.5**). This suggests that temporary supply disturbances did not severely hit major urban centers, rather inflationary pressures stemmed from smaller urban towns during February 2010.

Table 3.5: City-wise Inflation (YoY) of Selected Cities
percent

	Feb-09	Dec-09	Jan-10	Feb-10
Overall CPI	21.1	10.5	13.7	13.0
Islamabad	18.4	9.2	12.1	11.0
Lahore	18.1	9.9	13.4	13.1
Karachi	22.2	9.7	13.0	12.2
Quetta	25.1	7.9	10.6	11.0
Peshawar	23.9	7.8	12.9	12.3

3.3 Wholesale Price Index

WPI inflation rose to 19.3 percent YoY during February 2010 compared with 15.0 in February 2009 and a low of 0.3 percent in August 2009 (see **Figure 3.7** and **Figure 3.8**). Acceleration in WPI inflation came from September 2009 due to supply side pressures in some of agriculture commodities led by sugar and pulses (mash, moong), weakening of rupee, and rise in international commodity prices (see **Table 3.6**).



In particular, the impact of international commodity prices as well as exchange

rate pass-through was relatively strong on WPI basket because most of these are imported items. Even the prices of a large number of POL items in this basket are not administered and determined on the basis of international prices and prevailing rupee exchange rate. While the rise in WPI food inflation is also equally shared by CPI food inflation, dynamics of non-food inflation

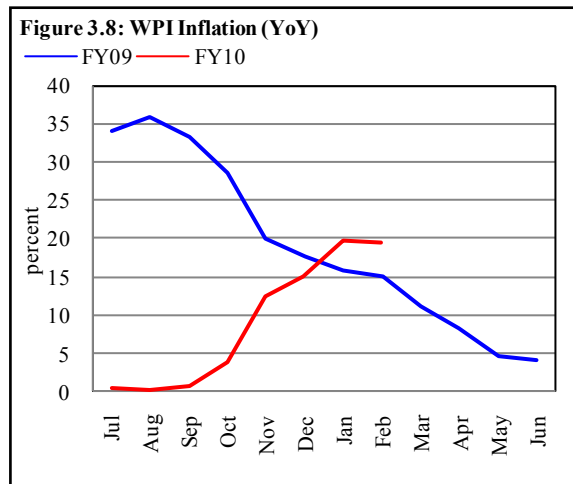


Table 3.6: Percentage Change in WPI Commodity Groups (YoY)

	General	Food	Raw materials	Fuel, lighting & lubricants	Manufactures	Building materials
Dec-08	17.6	25.3	10.2	10.2	9.7	30.6
Jan-09	15.7	21.0	16.4	11.7	7.5	20.3
Feb-09	15.0	22.0	19.9	7.1	6.9	20.1
Dec-09	15.0	11.5	33.7	25.5	11.0	-12.4
Jan-10	19.6	15.6	30.3	33.2	14.3	-3.7
Feb-10	19.3	15.4	34.7	30.8	15.1	-4.2

are largely different. For example, FY10 cotton harvest improved in Pakistan, however, its international prices rose to record levels due to global supply shortages. Impact of higher cotton prices is evident in both raw material as well as *manufactures* sub-groups due to rising prices of all types of yarn.

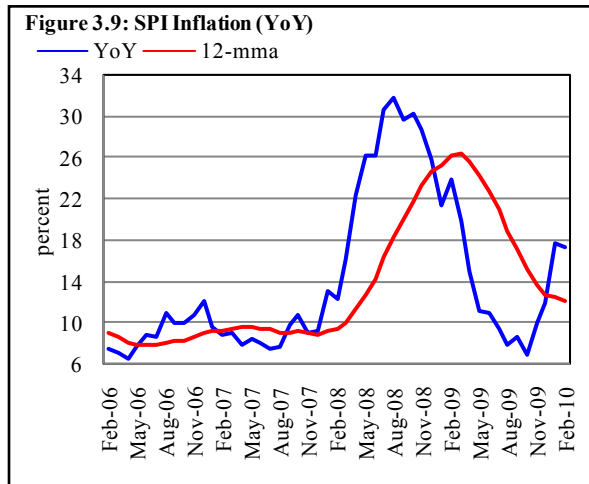
However, steep YoY rise in *fuel lighting and lubricants* is the combined impact of relatively higher administered prices of energy and fuel amid rising international prices and weakening of rupee. It is also important to note that the offsetting impact of building material sub-group on WPI inflation is reducing and likely to turn in positive in coming months. It is notable that while prices of cement and iron are declining, prices of almost all other construction material are trending upward.

3.4 Sensitive Price Indicator

Similar to CPI and WPI, inflation measured by sensitive price indicator (SPI) has also shown sharp increase in recent months after dipping to the lowest level since

April 2006 during October 2009 (see **Figure 3.9**). Weekly SPI inflation (YoY) also depicts a rising trend after reaching its 5-year low level in the second week of October 2009.

An analysis of SPI items on weekly basis suggests that SPI inflation was driven principally by rising prices of food commodities. Second large contribution came from the prices of petroleum products.



3.5 Global Inflation Scenario

There are mixed sentiments regarding the recovery in advanced economies. While the risk of deflation in advanced economies is low, a firm recovery remain elusive. Large fiscal stimulus provided some support to growth in advanced economies. At the same time, managing sustained economic growth with high unemployment will be challenging.

Table 3.7 : Inflation (YoY) and Key Policy Rates in Major Economies

Country	Inflation			Policy Rate		
	Feb-09	Sep-09	Feb-10	Current	Previous	Changed on
United States	0.2	-1.3	2.6*	0.25	1.00	Dec 16 2008
Japan	-0.1	-2.2	-1.3*	0.10	0.30	Dec 20 2008
Europe	1.2	-0.3	1.0*	1.00	1.25	May 07 2009
United Kingdom	3.2	1.1	3.5*	0.50	1.00	Mar 05 2009
China	-1.6	-0.8	2.7	5.31	5.58	Dec 22 2008
Sri Lanka	7.6	0.7	6.9	7.50	8.00	Nov 18 2009
Indonesia	8.6	2.8	3.8	6.50	6.75	Aug 05 2009
India	9.6	11.6	16.2*	4.75	5.00	Apr 21 2009
Pakistan	21.1	10.1	13.7*	12.50	13.00	Nov 24 2009
Thailand	-0.1	-1.0	3.7	1.25	1.50	Apr 08 2009
Philippines	7.3	0.7	4.2	4.00	4.25	Jul 09 2009
Vietnam	14.8	2.4	8.5	5.00	6.00	Apr 10 2009
Malaysia	3.7	-2.0	1.3*	2.00	2.50	Feb 24 2009

Sources: Bloomberg, IMF, World Bank, OECD, The Economist and Central Banks websites.

*data pertain to January 2010

Support from counter-cyclical monetary and fiscal policies also resulted in rising inflationary pressures particularly in advanced economies (see **Table 3.7**). Interest rates are at historically low levels in most of these economies, but maintaining policy rates at these levels with potential threat of inflationary pressures would be another challenge.

International commodity prices also recovered from their lows in mid 2009 mainly due to: (a) renewed interests of hedge funds in commodity markets; (b) OPEC cuts in oil production coupled with high cost of oil extraction in other parts of the world made low prices unsustainable; (c) bad harvests of sugarcane, cotton, rice, pulses, and tea in key producing countries; as well as (d) relative weakening of dollar and risks of inflation also boosted investors interest in commodities.

3.5.1 International Commodity Prices

International commodity prices have started increasing since August 2009 and trend has become more steep during the last three months (see **Figure 3.10**). Prices of all commodity groups rose during recent months. Strong demand from emerging economies and prospects of recovery in the developed economies dragged the metal and energy prices

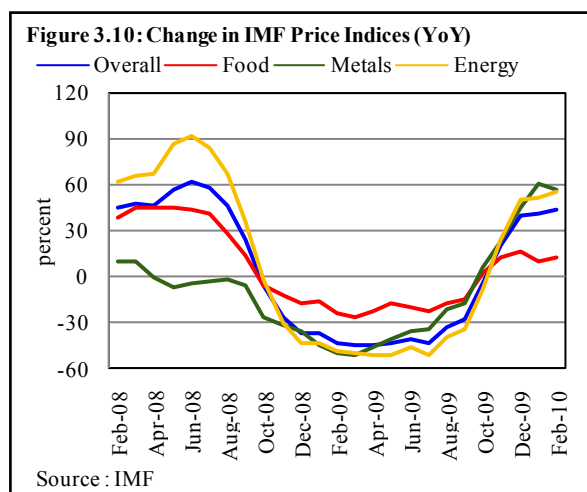


Table 3.8 : Prices Changes in Major Commodity Groups

Commodity group	Month on Month change				Year on Year change			
	Feb-09	Dec-09	Jan-10	Feb-10	Feb-09	Dec-09	Jan-10	Feb-10
Overall	-4.5	-0.5	4.2	-2.3	-43.7	40.5	41.1	44.4
Food	-2.6	1.8	1.1	-0.6	-24.7	16.6	10.2	12.5
Metals	-3.3	5.3	3.5	-5.6	-50.9	44.5	59.7	55.8
Energy	-5.8	-2.2	4.3	-2.9	-49.5	49.9	51.2	56.0

Source: IMF

higher despite higher inventories. However, recent credit tightening measures by China had downward pressures on commodity prices. In addition, bright prospects of wheat, corn and edible oil would help ease international prices in the months ahead (see **Table 3.8**).