3 Prices

3.1 Overview

Inflationary pressures strengthened significantly in the economy during recent months. All price indices showed the rising inflation (see **Figure 3.1**). Specifically, headline consumer price index (CPI) inflation (YoY) rose to a 17-month high of 15.7 percent in September 2010 before falling to 15.5 percent during November 2010. Similarly, inflation measured by wholesale price index (WPI) and sensitive price index (SPI) also surged during the first four months of FY11. The rising pace of WPI inflation is a source of concern, since it is likely to push up the otherwise stable CPI non-food inflation (see **Figure 3.2**).

Figure 3.1: Inflation (YoY) Trends

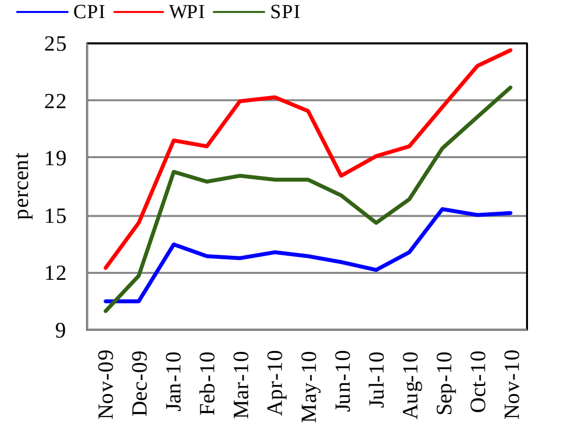
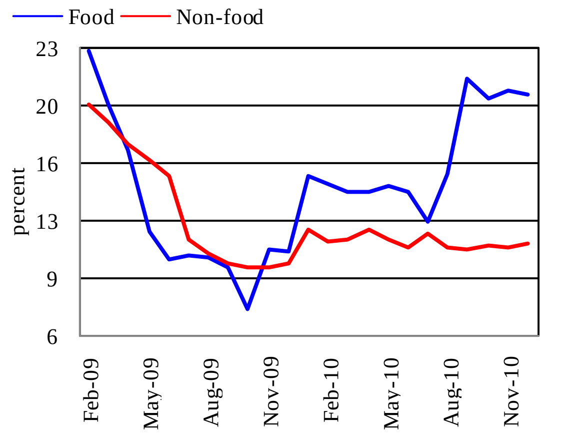
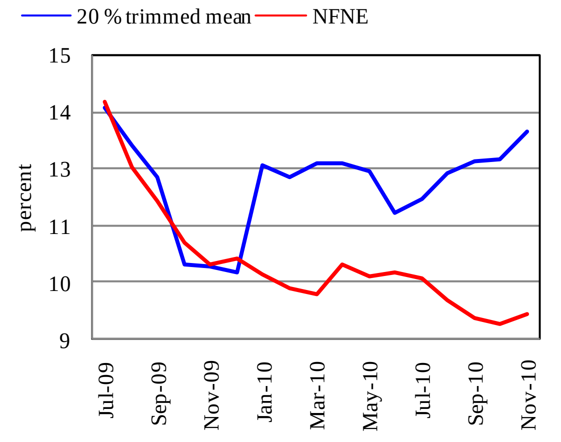


Figure 3.2: CPI Inflation-YoY



The major contributors to rising inflationary pressures in recent months include: (a) supply shortages of many perishable food commodities due to floods and rains, (b) direct impact of passing on of the higher global commodity prices, (c) indirect impact of increased fuel prices on the transportation cost, (d) upward adjustment in electricity tariff, as well as, (e) strong external demand for some key food staples. At the same time, excessive government budgetary borrowing, particularly from the central bank, is not only supporting strength in aggregate demand, it is also diluting the impact of monetary measures to contain inflation.

Figure 3.3: Core Inflation (YoY) Trend



Core inflation measured by 20% trimmed mean (20%TM) also indicates a gradual build up of inflationary pressures in the economy. Core inflation (20%TM) rose from 11.7 percent YoY in June 2010 to 13.4 percent YoY in November 2010. In contrast, core inflation measured by excluding food and energy from the CPI basket non food non energy (NFNE) hit a 31-month low of 9.3 percent YoY in October 2010. However, the latter should not be taken in complacency, as it only reflects that the current inflation is principally driven by food and energy (see **Figure 3.3**). Prima facie inflation from both food and energy appears to be transitory shock, but unfortunately, both of these components strengthen inflationary expectations and have strong second-round effects through pressures on wages and increases in the cost of production.

It is also important to note that a large part of the transitory shock on the prices of perishable food commodities due to floods, already shown some ease[1] in October 2010, is likely to be over by mid December 2010. However, as a consequence of this temporary price shock coupled with jump in sugar prices, a sense of pricing power was instituted amongst the traders, which leads to abnormal profiteering, particularly at retail level. This tendency is an important hurdle in containing inflation, despite substantial improvement in supply of minor crops. Moreover, continued monetization of fiscal deficit is also contributing in fueling inflationary pressures in the economy.

In this background, SBP raised policy rates by 50 basis points effective from 30th November 2010; this was third consecutive rise of the same magnitude in the first five months of FY11.[2] While the policy stance helped stabilizing non-food inflation during CY2010, the imposition of reformed general sales tax (RGST), a gradual weakening of rupee and continuation of upward adjustment in electricity

[1] Prices of perishable food commodities rose by 53.9 percent in September 2010, this pace slowed to 42.1 percent in November 2010.

[2] Earlier, SBP increased policy rate twice by 50 basis points each effective from 2nd August, 2010 and 30th September 2010.

tariff would augment inflationary expectations in months ahead. Thus the SBP has to be vigilant to counter the impacts of these developments to mitigate the second round effects.

On positive side, imposition of proposed RGST will increase the possibility of fiscal consolidation during FY11. However, continuation of budgetary borrowings from the central bank will offset any gains from improvements in fiscal indicators. It should also be remembered that an expected deterioration in external balances would also build inflationary pressures from the weakening of rupee parity. Therefore, while monetary tightening can only attempt to maintain macroeconomic stability, fiscal prudence is a pre-requisite for price stability.

3.2 Consumer Price Index (CPI)

The headline CPI inflation resumed its uptrend in the first four months of FY11, after witnessing resilience in H2-FY10 (see **Figure 3.4**). Headline CPI inflation (YoY) stood at 15.5 percent in November 2010, though slightly lower than the 15.7 percent registered in September 2010, was uncomfortably high. The recent surge in CPI inflation was largely due to rising food inflation. In addition, upward adjustment in the prices of key fuels amid rising international prices and gradual reduction in subsidy on electricity are also important contributors in the significantly high inflation in recent months (see **Figure 3.5**). Further, domestic prices of a number of commodities also pushed up as international commodity

Figure 3.4: CPI Inflation-YoY

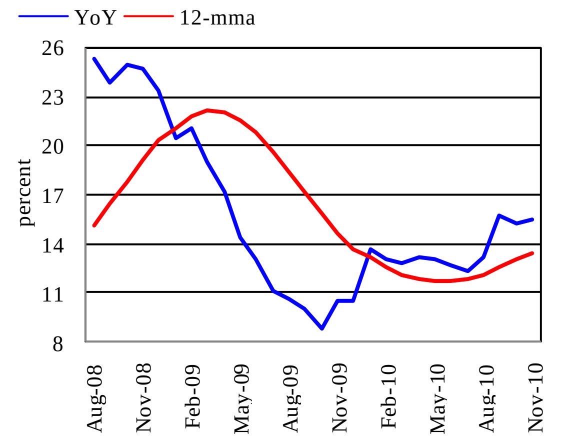
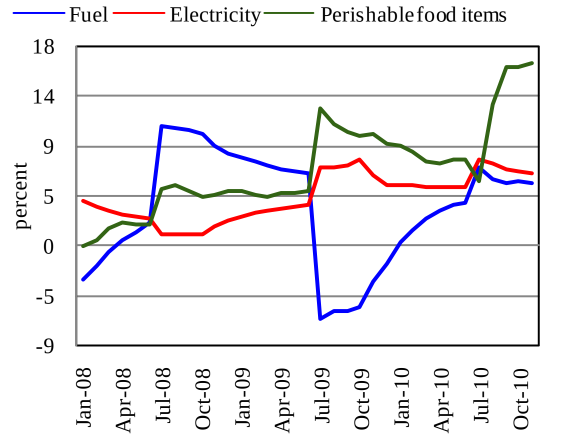


Figure 3.5: Direct Contribution in Inflation



prices resurged on supply concerns, strong demand from emerging economies and weakening of US dollar.

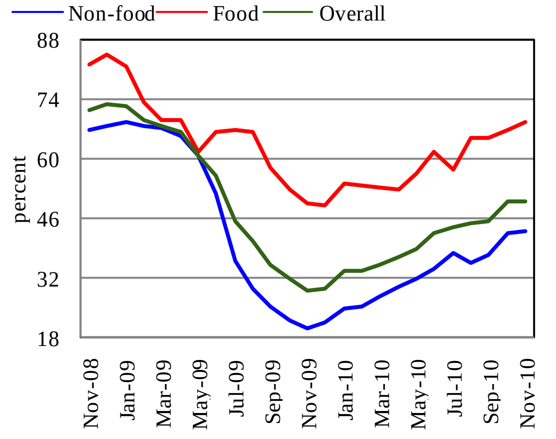
Table 3.1: Weighted Contribution to Food Inflation

percent

	Weights	CPI YoY Nov-09	CPI YoY Oct-10	CPI YoY Nov-10	Contribution
Vegetables	4.7507	20.2	47.7	26.2	7.8
Sugar	4.8255	50.1	81.2	56.2	10.8
Milk fresh	16.5127	14.0	15.3	18.1	14.3
Meat	6.6881	17.6	27.9	28.4	11.5
Vegetable ghee	6.6115	1.1	18.6	27.1	8.4
Onions	1.4806	14.2	65.1	167.7	12.4
Fresh fruits	4.0058	19.3	21.3	19.9	3.4
Pulse moong	0.5528	39.0	160.8	103.3	2.7
Readymade food	4.1726	11.7	15.7	17.5	3.6
Wheat flour	12.6723	6.3	3.2	4.5	3.4
Total	**62.2727**				**78.1**

A disaggregated analysis suggests that over 40 percent of food inflation is contributed by vegetables, sugar and dairy products (see **Table 3.1**). In particular, contribution of perishable food commodities in overall CPI inflation rose to 16.5 percent YoY in November 2010 – the highest since September 2004.[3] While, increased transportation cost is a common factor for all these items, a large part of rise in the prices of these items is associated with market structure problems and absence of effective consumer associations. A collective move on reduction of consumption of at least perishable commodities may force traders to rationalize their margins. In the case of vegetables and fruits, media can play an important role by increasing the coverage of wholesale prices of these commodities at prime time that would create awareness amongst consumers and improve their bargaining at retail outlets.

Figure 3.6: Number of Items Above 10-percent Price Rise



Another significant development is that inflationary pressures are now more broad-based. This is evident from the rising number of items registering double

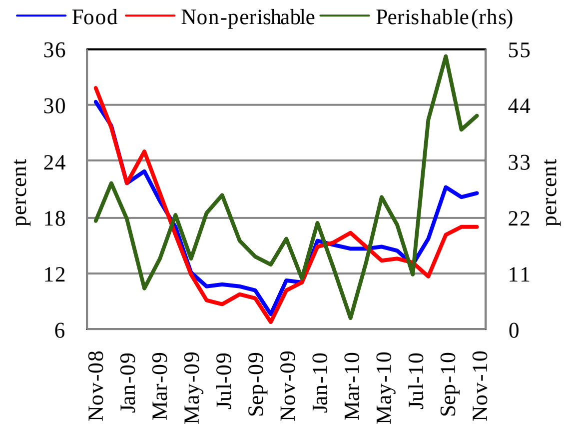
[3] The sharp surge in the prices of perishable food items in FY05 was largely due to low base effect as prices of these commodities plummeted during FY04 due to ample supply.

digit increases in both food and non-food groups in recent months (see **Figure 3.6**).

3.2.1 CPI Food Inflation

CPI food inflation rose to a 19 month high of 21.2 percent YoY in September 2010 before falling to 20.5 percent during November 2010. Recent surge in food inflation is mainly attributed to: (a) damages to minor crops and some major crops by floods and rains, (b) speculative hoarding of sugar, (c) higher transportation costs, (d) strong external demand for some commodities, and (e) rising international commodity prices.

Figure 3.7: CPI Food Inflation (YoY)



Segregated analysis of food group into perishable items and non-perishable items shows that generally food inflation is moving closely with the inflation in non-perishable commodities (see **Figure 3.7**). However, in the aftermath of the floods, a sharp jump in the prices of perishable commodities led to a departure of food inflation from the inflation in non-perishable items. Going forward, a rising trend in the prices of non-perishable commodities, albeit at lower pace, and a moderation in the prices of perishable items is likely to restore the earlier trend, i.e., convergence between food inflation and non-perishable items.

Inadequate imports, due to defaults by three international suppliers for import tenders of various quanta of sugar, resulted in domestic supply shortages. At the same time, hike in international sugar prices, gloomy outlook for domestic sugarcane harvest for FY11 and limited stocks with the government agencies drove domestic sugar prices to record high level. The contribution of only sugar in CPI food inflation was 10.1 percent in November 2010. These developments indicate weaknesses in the market structure and could be tackled through regulations and administrative measures. Above all, it appears that if private sector would have participated actively in sugar imports, sugar prices may not have soared to this level due to competitive pressures and sufficient supplies.

3.2.2 CPI Non-food Inflation

CPI non-food inflation has moved within narrow range during the recent months (see **Figure 3.8**). Moderation in house rent index (HRI) offset the impact of significant increases in *fuel & lighting* and *transport & communication* sub-indices in recent months (see **Figure 3.9**).

Figure 3.8: CPI Non-food Inflation

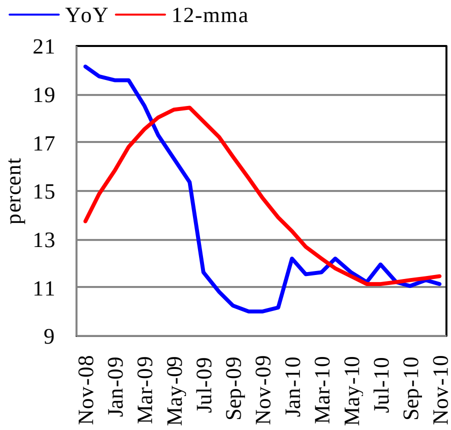
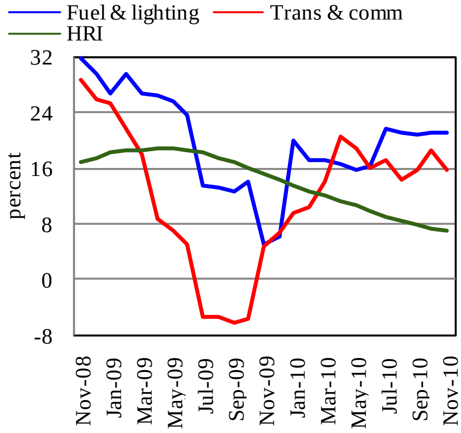
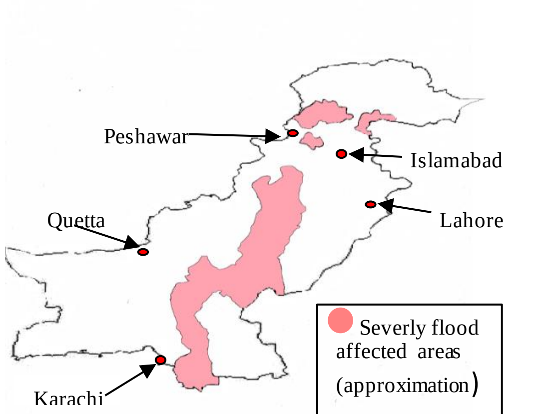


Figure 3.9: Non Food Inflation (YoY)



House rent index, which has the highest weight in CPI commodity basket as a single item, dropped to 6.9 percent in November 2010 – the lowest figure since July 2007. Continued decline in HRI can be attributed to lower domestic demand, decline in cement prices amid fall in export demand of cement due to stiff competition and slowdown in construction activity in United Arab Emirates (UAE).

Figure 3.10: Flood Affected Areas and Pakistan Major Cities



Source: NDMA and Google

On the other hand, rise in administered prices of fuels and electricity resulted in higher inflation within transportation and fuel & lighting sub-groups. Impact of higher prices of crude oil in international market was seen by a corresponding rise in domestic prices of petrol, diesel, and kerosene oil.

Similarly, government's efforts to eliminate subsidies resulted in higher electricity tariffs. At the same time, prices of electrical appliances also increased due to imposition of excise duty on these products in federal budget FY11, which is reflected in rising trend in household equipment sub-group. These factors combined to put energy inflation to the highest levels since February 2009 to 21.8 percent in October 2010, before it eased to 19.5 percent in November 2010.[4]

Table 3.2: City-wise Inflation (YoY) of Selected Cities
percent

	Nov-09	Oct-10	Nov-10
Overall CPI	**10.5**	**15.3**	**15.5**
Islamabad	9.5	12.4	12.4
Lahore	9.7	14.9	13.7
Karachi	9.7	13.9	14.5
Quetta	8.7	15.0	15.8
Peshawar	8.3	16.3	16.6

3.2.3 City-wise Inflation

City- wise inflation data of the federal and provincial capitals shows that CPI inflation in Peshawar remained higher than overall inflation; whereas inflation in other capital cities was lower than the overall CPI inflation (see **Table 3.2**). This shows that smaller cities were hit hard in the current episode of inflation, probably reflecting that supply to major urban centres is better than smaller towns. In addition, supply of perishable food products to major urban centres was not disrupted due to floods. Since, supply of these items in most major urban cities is from nearby rural areas, which were not severely hit by the floods (see **Figure 3.10**).

Table 3.3: Income Group-wise CPI Inflation – YoY
percent

	Upto 3000			Rs 3001-5000			Rs 5000-12000			Above Rs 12000		
	Sep-10	Oct-10	Nov-10	Sep-10	Oct-10	Nov-10	Sep-10	Oct-10	Nov-10	Sep-10	Oct-10	Nov-10
General	17.0	16.5	17.4	17.0	16.3	17.0	16.3	15.7	16.1	14.8	14.8	14.5
CPI food	21.9	21.0	22.2	21.8	20.7	21.7	21.4	20.1	20.8	20.7	19.7	19.6
CPI non-food	10.6	10.6	11.0	11.1	10.8	11.1	11.1	11.0	11.2	11.1	11.8	11.3

3.3.4 Incidence of inflation

The incidence of inflation remained higher on lower income groups (see **Table 3.3**) since present inflation is principally driven by food prices and a large part of income of low income groups is spent on food staples. However, even the lowest food inflation of 19.6 percent YoY for highest income group is uncomfortably

[4] Pakistan's energy index for October 2010 was higher than international energy index measured by IMF's Energy Index which was 17.7 percent during October 2010.

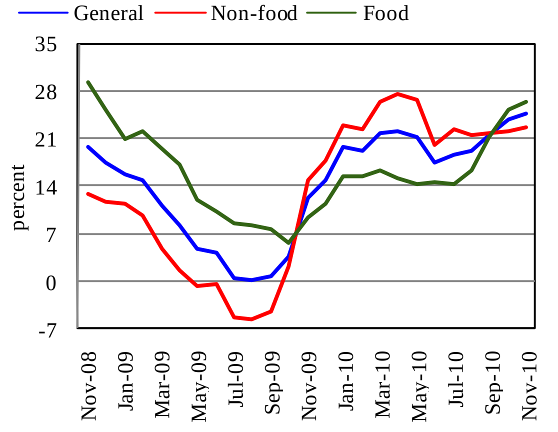
high.

Similarly, incidence of non-food inflation is higher for the higher income groups since a dominating share of their budget was spent on non-food items. Rise in prices of energy including fuels, electricity and gas hit the high income groups the most (see **Table 3.3**).

3.3 Wholesale Price Index (WPI)

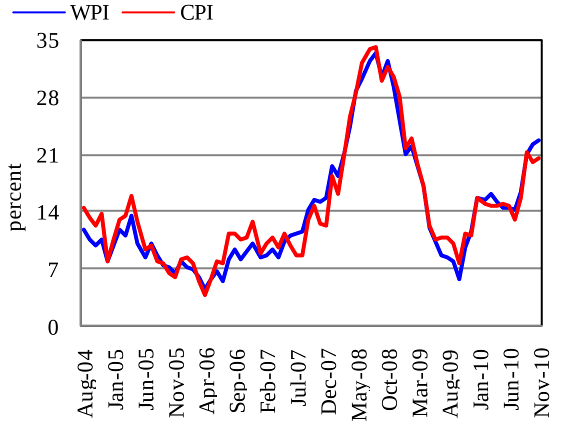
Unlike CPI inflation, WPI inflation has exhibited a continued up trend in recent months. WPI inflation rose to 24.7 percent YoY in November 2010 – the highest level since October 2008 (see **Figure 3.11**). Although both food and non- food groups of WPI contributed to this increase, the rise in non-food group was more pronounced. Rise in WPI inflation is attributed to supply side pressures in some agriculture commodities led by sugar and vegetables and rise in international commodity prices.

Figure 3.11: WPI Inflation-YoY



In food group, sharp increases were registered in the prices of onions, potatoes, tomatoes and vegetables due to domestic supply disruptions amid flood. Whereas, sugar prices surged by 60.0 percent YoY in November 2010 due to supply shortages. At the same time, firm international prices of palm oils, sugar, wheat, pulses and other food commodities also pushed up WPI inflation. It is important

Figure 3.12: Trends in Food Inflation



to note that food inflation in CPI and WPI baskets generally moves in tandem (see **Figure 3.12**), thus an ease in CPI food inflation and a rise in WPI food inflation is showing that at least a part of the increase in the prices of food items is absorbed by the retailers. A historical view also suggests that both CPI and WPI inflation will move in the same direction in months ahead.

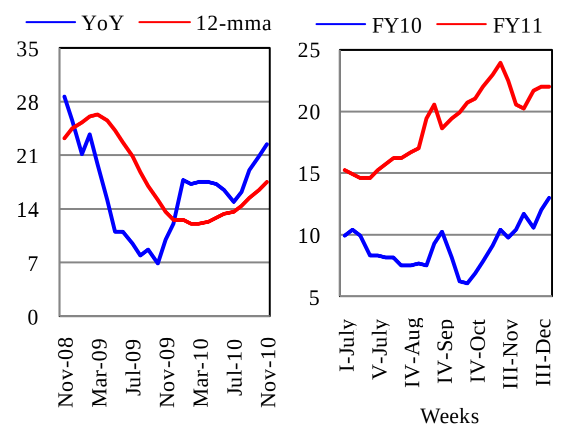
Table 3.4: WPI Non-food Groups

	Raw materials	Fuel, lighting & lubricants	Manufactures	Building materials
Jun-10	50.5	12.6	19.5	13.2
Jul-10	54.6	15.7	22.2	7.5
Aug-10	52.8	15.4	20.6	8.0
Sep-10	58.3	13.3	21.5	10.5
Oct-10	65.8	14.7	25.7	15.5
Nov-10	70.7	12.8	28.4	18.9

Within the WPI non-food group, all sub-groups witnessed acceleration in inflation during November 2010, except fuel & lighting sub-group (see **Table 3.4**). Specifically, inflation (YoY) in *raw materials* sub-group registered the highest growth of 70.7 percent. This surge in the prices of raw materials is mainly attributed to cotton, cotton seeds and sugarcane prices amid increasing international prices and domestic shortages due to crop damages amid flood.

Similarly, inflation in building materials sub-group is rising since July 2010. Prices of cement which had been declining since October 2009 resurged during November 2010 by 8.6 percent which was compounded by increases in the prices of other building materials, especially iron bars & sheets, paints & varnishes and wire & cables. This rising trend in building material sub-group also suggests that the declining trend of HRI (the single largest sub-group of CPI basket) will reverse in the third quarter of FY11.

Figure 3.13: SPI Inflation - YoY (in percent)



Inflation in fuel lighting and lubricants sub-group which remained higher during October 2010 due to upward adjustment in fuel prices, increase in electricity tariffs, as well as, rising international prices of petroleum products somewhat eased during November 2010. The surge in raw materials, as well as, increased transportation and energy costs also pushed up manufactures sub-group, which rose by 28.4 percent in November 2010 compared to 7.4 percent in same month of last year.

3.4 Sensitive Price Indicator (SPI)

Unlike CPI inflation which slightly eased during October 2010, SPI inflation has shown a continued uptrend in recent months. This is due to a disproportionately higher weight of perishable food items in SPI basket. SPI inflation (YoY) was recorded 22.5 percent during November 2010 compared to 20.9 percent in October 2010 and 10.0 percent in November 2009 (see **Figure 3.13**). Similarly, weekly SPI (YoY) remained very strong since the start of FY11 and reached 90 weeks high level at 24.0 percent in the second week of November 2010 before settling at 22.0 percent in the third week of December 2010.