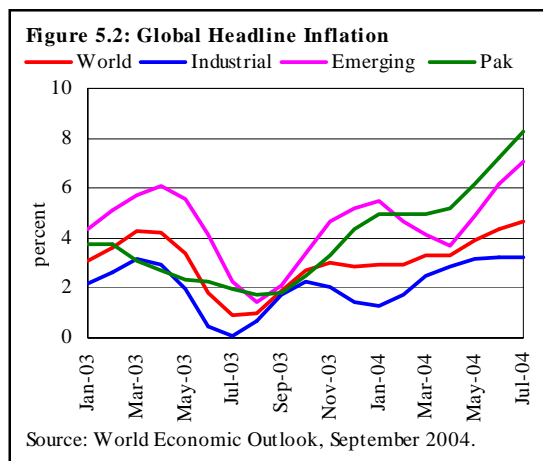
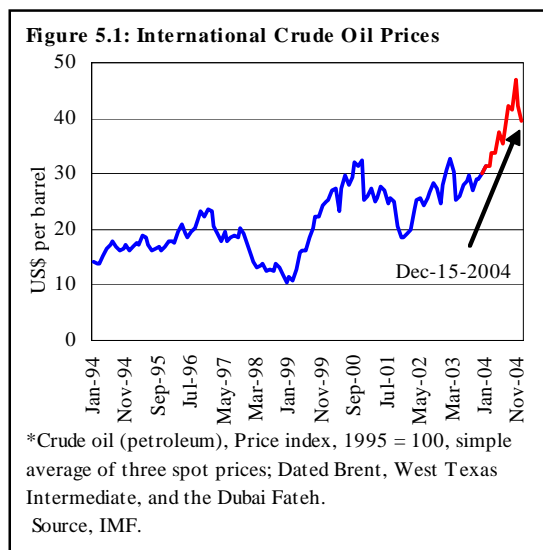


5 Prices

5.1 International Developments

An exceptional increase in crude oil prices was the most significant development for the global economy during the initial months of FY05, raising concerns over prospects for price stability and growth (see **Figure 5.1**). Oil prices rose as much as 31.9 percent between July and October 2004 alone to reach all-time highs before weakening demand finally allowed some respite (even then, however, average crude oil prices were still at US\$ 40.14 per barrel in mid-December 2004, up 34.0 percent YoY).

As with oil prices, price corrections were visible for other key commodities as well. For example, metal prices also witnessed a moderate fall during Q2-FY05 December 2004, after a sharp increase of 27.9 percent YoY during Q1-FY05, and cotton prices fell sharply due to a large jump in production. However, despite some moderate downward corrections, prices of most key commodities in December 2004 are still significantly higher than in the corresponding period of the preceding year. As a result, inflationary pressures strengthened globally in second half of 2004.



Earlier data show that the impact of rising oil and metal prices appeared to be much stronger in emerging market economies than the industrial countries (see **Figure 5.2**). This was probably a consequence of the sharper rise in demand for raw material from fast-growing Asian economies, particularly China. This suggests that efforts to cool down the Chinese economy (which dominates the growth in demand in international commodity markets) would likely to play an important role in easing pressures on international commodity prices going forward.

5.2 Domestic Developments

The impact of high international commodity prices on domestic inflation during July-November 2004 was contained to an extent by the Government's fiscal measures.¹ As a result, the inflation during the period owed principally to some supply-side shocks² as well as a continuing increase in aggregate demand. In particular, *food* inflation made a dominant contribution to the relatively high annualized inflation recorded by all three price indices during the initial months of FY05 (see **Table 5.1**).

Interestingly enough, while still strong, inflationary pressures from *food* prices are clearly weakening; it is this deceleration in food inflation that is mainly responsible

Table 5.1: Inflation Trends (end-November)

percent	YoY ¹		Average annualized ²	
	FY04	FY05	FY04	FY05
	CPI	4.2	9.3	2.7
<i>Food</i>	5.4	13.6	2.0	10.8
<i>Non-food</i>	3.5	6.3	3.2	5.0
<i>House rent</i>	3.2	11.2	1.4	7.8
WPI	8.2	5.9	6.3	8.9
<i>Food</i>	6.0	10.6	3.6	9.9
<i>Non-food</i>	9.8	2.6	8.1	8.2
SPI	7.3	11.1	3.0	11.0
Core³	3.8	8.3	1.9	6.1

¹ Change in November 2004 over November 2003.

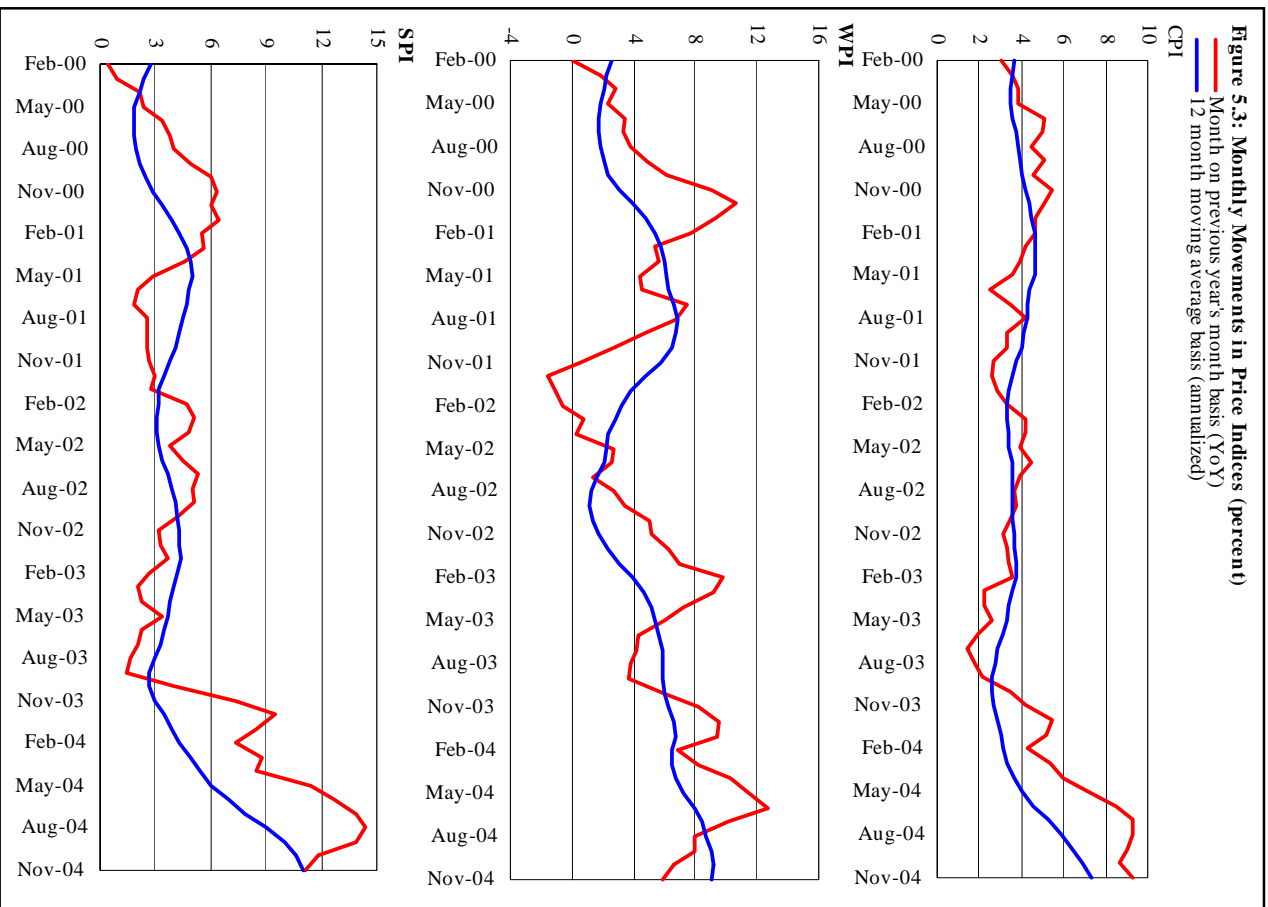
² Change in 12-month moving average during December 2003-November 2004 over the corresponding period last year.

³ By taking 10 percent weighted trim.

Source: Federal Bureau of Statistics.

¹ The government reduced tariffs and taxes on commodities such as petroleum, iron and steel and edible oil. A freeze on oil prices insulated the economy from oil price shock during September-November 2004 period; it does not imply that the higher oil prices did not impact the domestic economy. Since the prices of most of the petroleum products and petro-based chemicals for industrial purpose are not regulated, higher oil prices also raised the cost of these inputs. Moreover, increase in domestic oil prices before mid-May 2004 has its impact on current inflation. Similarly, a rise in building material and HRI sub-indices in WPI and CPI respectively is a reflection of increased metal prices.

² One of the (arguably) more significant factors was the speculative hoarding of key food items. Other than wheat, the prices of onion and potato rose also mainly due to speculative hoarding of these two important vegetables due to the possibility of their easy storage. It is evident from the fact that both of these vegetables recorded substantial production during FY04 crop, well above the domestic consumption.



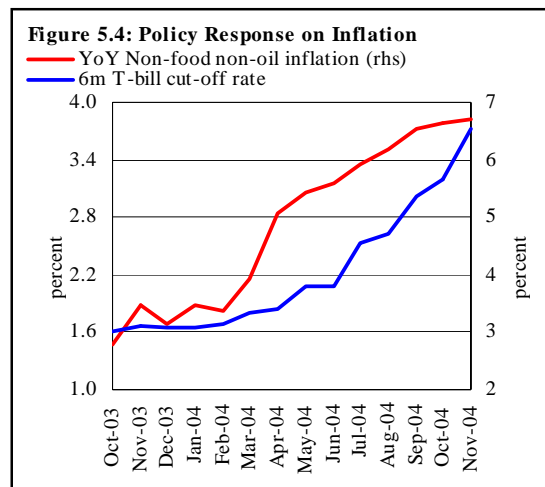
for the weakening marginal (YoY) inflation for WPI and the stagnation in marginal (YoY) CPI inflation rates.

As evident in **Figure 5.3**, marginal WPI inflation dropped from 12.8 percent in June 2004 to 5.9 percent in November 2004, while marginal CPI inflation has continued to hover around the 9 percent range for first 5 months of FY05.³ The variance between the YoY movements of the two indices simply reflects the fact that WPI is more sensitive to *food* prices; not only does the *food* group have a relatively lower weight in CPI, the downward pressures on YoY CPI due to declining *food* inflation were also offset by a sharp jump in the *house rent index* (HRI) inflation.

In fact, within CPI, both *food* and HRI (with leading weights of 40.34 percent and 23.43 percent respectively) are the only sub-indices witnessed double-digit inflation during November 2004. While, acceleration in HRI is likely to continue (it may be noted that there are serious questions raised by the IMF Mission on the methodology of computing HRI), *food* inflation would probably see a sharp decline in December 2004 onwards.

The fact that the weakness in inflationary pressures derive principally from a deceleration in *food* inflation means that the implications for monetary policy are limited. In fact, core inflation as proxied by *non-food non-oil* (NFNO) inflation is still on an uptrend up to end-November 2004. As detailed in **Section 4**, while headline CPI inflation cannot be ignored in the formulation of monetary policy given its impact on forming inflationary expectations, trends in core inflation are relatively much more important.

Not surprisingly, the monetary policy stance of the SBP also tracks movements in core inflation (see **Figure**



³ An up tick in *food* inflation during November 2004 is probably temporary as the survey timings coincided with the Eid-festival, when food items often witness a temporary rise.

5.4); as core inflation gathered pace, the SBP also gradually tightened its monetary posture, with a measured increase in benchmark interest rates. The SBP has also moved to support the Government's policy to discourage wheat hoarding.⁴ Significantly, while core inflation has continued its uptrend until November 2004, the *pace* of the rise in core inflation is clearly slackening, suggesting that the sustained (though gradual) increase in interest rates is taking effect.

All in all, there is some evidence that inflationary pressures may finally be easing. However, the negative real lending rates and high core inflation both suggest the desirability of a continuation of the SBP's measured monetary tightening.

Furthermore, it is important to note two major issues that could significantly alter the inflation momentum:

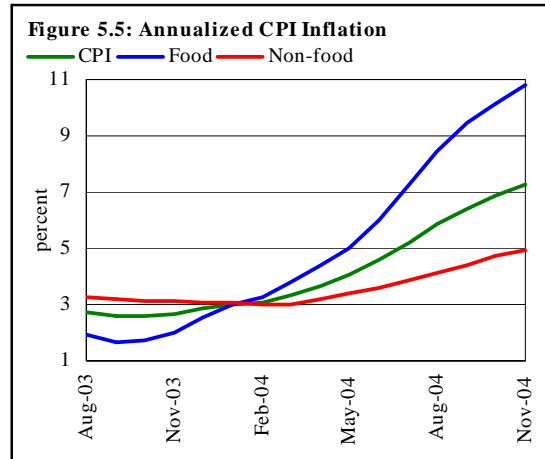
1. *Wheat supply*: Realization of the anticipated water shortage during rabi-FY05 could result in a substantially below target production of wheat. This is foreseeable, and in such an eventuality it will be crucial for the Government to head off a potentially destabilizing wheat shortage (and attendant rise in inflationary expectations throughout the economy, as seen in FY04) by ensuring adequate and timely imports. Fortunately, the Government appears to be well aware of these risks as evident from the already approved imports of wheat. It may be desirable to expedite the imports to ensure availability when required.
2. *Oil prices*: Government had significantly insulated the economy from the surge in international oil prices. However, this was changed in December with announcement of price hikes on key petroleum products ranging from 6-7 percent. Not only is this likely to spark a mini-surge in inflationary pressures, the resumption of the linkage of domestic prices could add to inflationary expectations if international oil prices remain volatile.

The current SBP forecasts suggest that FY05 annual CPI inflation will probably fall in the range of 7.6 – 8.2 percent, barring exceptional domestic and external shocks, and under the assumption that Government would contain speculation in wheat prices.

⁴ BPD, SBP Circular No. 12 dated May 10, 2004.

5.3 Consumer Price Index

Average annualized CPI inflation, continued the uptrend seen since the second quarter of FY04; the average annualized CPI inflation accelerated to 7.3 percent in November 2004 as against 2.7 percent in November 2003.⁵ Given that marginal (YoY) inflation still remains higher than the average annualized change in prices throughout FY05 so far, it is certain that average annualized inflation will rise further in months ahead.

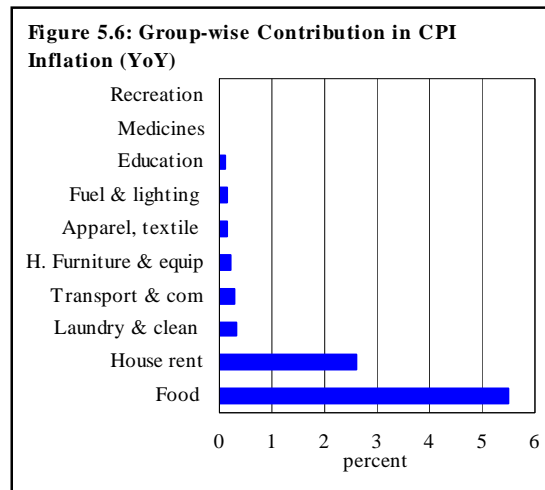


As in FY04, inflation in the first five months of FY05 was mainly driven by the *food* component of the CPI basket. Though, *non-food* inflation is steadily rising, this is almost entirely due to the increase in *house rent index*, which contributed 28.2 percent in the aggregate YoY CPI inflation during November 2004 (see **Figure 5.5** and **Figure 5.6**).

5.3.1 CPI Food Group

CPI *food* inflation (YoY) reached as high as 14.9 percent in July 2004, the highest increase in *food* prices since April 1997. Thereafter, this component of CPI decelerated until October 2004 before bouncing back to 13.6 percent in November 2004.

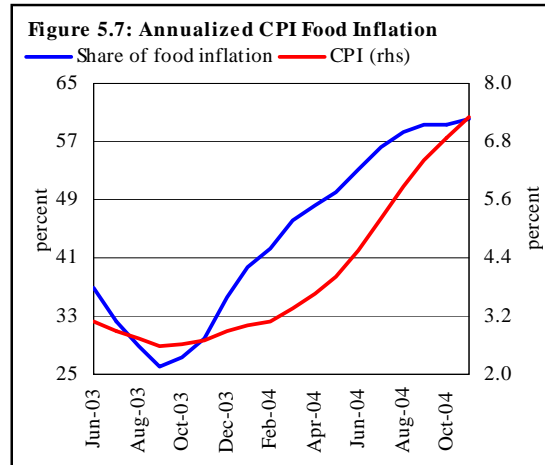
As a result of sustained YoY rise in CPI *food* component since October 2003, its average annualized inflation



⁵ Based on twelve month moving average change in CPI.

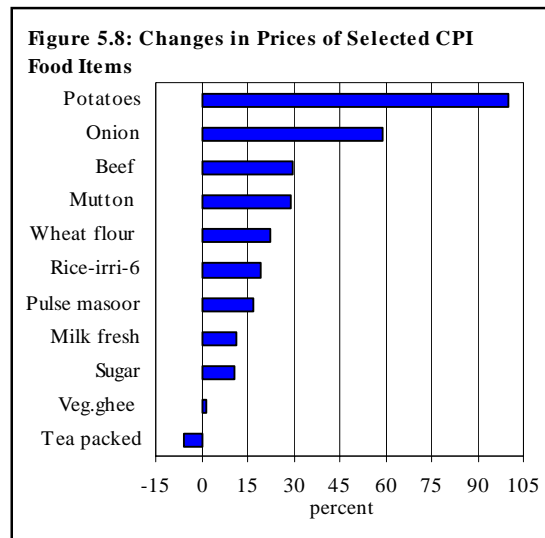
also entered into double digits (10.8 percent) by November 2004 and likely to rise steadily for months ahead. Consequently, the contribution of *food* inflation in overall headline inflation rose to over 60.0 percent in November 2004, more than twice that in November 2003 (see **Figure 5.7**).

This sharp increase in the CPI *food* sub-index was mainly driven by a few important items, such as wheat and wheat based products, milk, meat, and some vegetables and fruits (see **Figure 5.8**). The impact of wheat prices was particularly important due to both: (1) its greater weightage in the aggregate CPI as well as, (2) the impact of wheat price on inflationary expectations (given wheat is a key food staple). The direct impact of wheat and its products is about 14 percent in the aggregate YoY CPI inflation during November 2004.

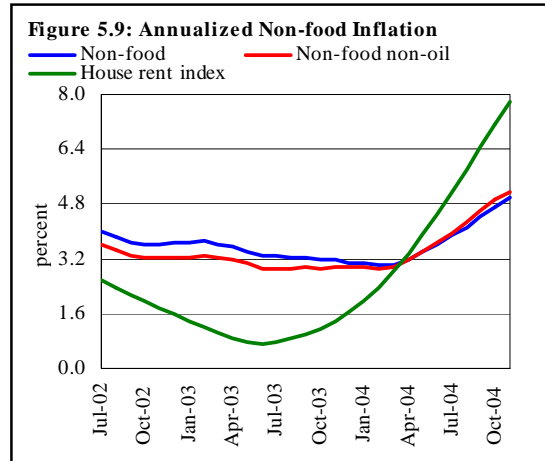


5.3.2 CPI Non-food Group

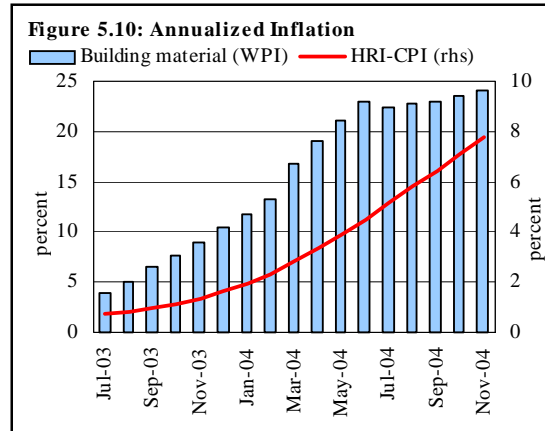
Non-food inflation was quite subdued until Q3-FY04, but it too, started to accelerate Q4-FY04 onwards. *Non-food* sub-group witnessed a rise of 6.3 percent YoY in November 2004 as against 3.5 percent in November 2003. Similarly, average annualized *non-food* inflation stood at 5.0 percent in November 2004 compared with 3.2 percent during the corresponding month of 2003.



In initial five months of FY05, *non-food* inflation was mainly driven by the rise in HRI, which recorded an average annualized increase of 7.8 percent in November 2004 as compared to a subdued 1.2 percent rise during November 2003 (see **Figure 5.9**). Since the computation of HRI in CPI is based on the sub-index of *building material* in WPI, the rising trend in HRI is closely following the movements in *building material* prices (see **Figure 5.10**).



Other sub-groups of non-food components witnessed a mixed trend. *Household furniture & equipment, transport & communication, cleaning, laundry & personal appearance* and *recreation & entertainment* exhibited a rising trend during November 2004 compared with *apparel, textile & footwear, fuel & lighting, education and medicare* which saw a



slowdown in inflation during the same period. While 38.9 percent of *food* items registered an above 10 percent rises in their prices during November 2004, only 10.4 percent of *non-food* items witnessed over 10 percent increases in prices during this period (see **Table 5.2**). This tendency shows that most of the *non-food* items helped contain inflation during November 2004.

In particular, despite a surge in international oil prices during last few months, a slowdown in rising pace of inflation under *fuel & lighting* sub-group is largely attributed to Government’s policy of keeping fuel prices unchanged until mid-December 2004.

Table 5.2: Distribution of Price Changes of CPI Basket. Nov-2004 over Nov-2003

Groups	Weights	% Changes	Total number of items	No. of items in each inflation range				
				Decrease or no change	Subdued increase	Moderate increase	Double digit increase	Not reported
				(0 % or less)	(0 to 5%)	(5 to 10%)	(over 10%)	
I. Food group	40.34	13.6	124	18	24	27	44	11
Food, Bev.	40.34	13.6	124	18	24	27	44	11
II. Non-food group	59.66	6.3	250	81	76	67	26	
Apparel, text.	6.1	2.6	42	7	11	19	5	0
House rent	23.43	11.2	1	0	0	0	1	0
Fuel & lighting	7.29	1.9	15	8	0	5	2	0
H/h. furn. & equip.	3.29	6.2	44	2	22	15	5	0
Transport & com.	7.32	4.1	43	14	10	11	8	0
Recreation, enter.	0.83	0.2	16	11	4	1	0	0
Education	3.45	2.6	24	14	8	2	0	0
Clean, ld. & per.	5.88	5.2	36	9	10	14	3	0
Medicines	2.07	1.0	29	16	11	0	2	0
Overall	100.00	9.3	374	99	100	94	70	11

5.4 Wholesale Price Index (WPI)

In contrast to the CPI, the slowdown in WPI inflation continued throughout the initial months of FY05, with marginal (YoY) WPI inflation falling from 12.8 percent in June 2004 to 5.9 percent by November 2004. This downtrend in WPI inflation is visible in both *food* and *non-food* components (see **Table 5.3**).

Specifically, WPI *food* sub-group, (with a weight of 45.8 percent in WPI basket), recorded a 10.6 percent (YoY) inflation during November 2004 as compared to the 6.0 percent rise in the same month of 2003.

Similarly, despite a continued substantial rise of 23.3 percent during November 2004 in sub-group of *building material*, WPI *non-food* inflation saw a deceleration. WPI *non-food* inflation (YoY) was recorded at 2.6

Table 5.3: Contribution in YoY WPI Inflation

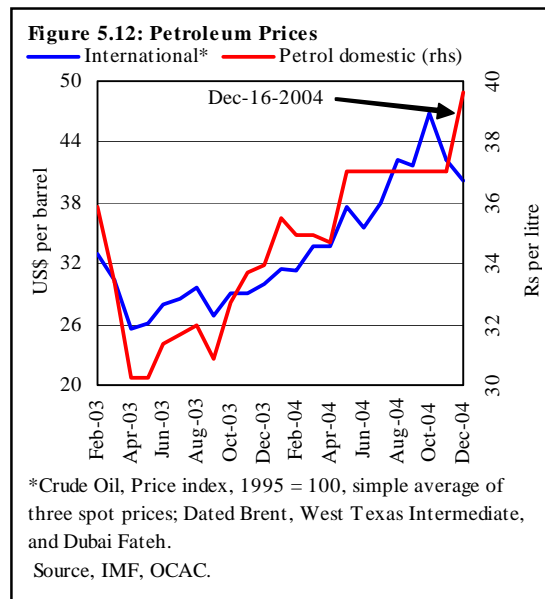
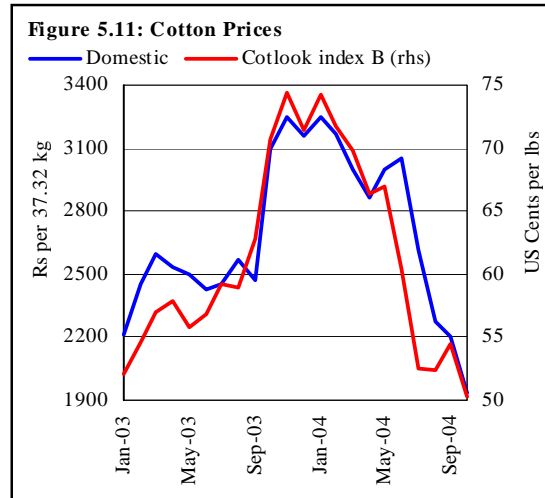
Group	Weighted inflation	
	Weight	(%)
Food	45.79	4.9
Non-food group	54.21	1.4
Raw mat.	8.76	-2.2
Fuel & lt.	15.28	2.1
Manufactures.	25.53	0.1
Build. material.	4.64	1.1
Overall	100.00	5.9

percent in November 2004 as against 9.8 percent in November last year. However, average annualized *non-food* inflation, which has slowed since September 2004, was recorded at 8.2 percent in November 2004, still marginally high (by 0.1 percentage point) that in November 2003.

The major contribution to the deceleration in *non-food* WPI stemmed from a disinflation observed in the sub-group of *raw material* and a sharp deceleration in the sub-group of *manufactures* during the initial five months of FY05.

In particular, prices of *raw material* sub-group have recorded a significant decline since the beginning of FY05, thus recorded a YoY *deflation* of 24.8 percent in November 2004 compared with a *rise* of 23.6 percent during the same month of 2003. This decline is largely attributed to a sharp fall (of over 45 percent) in the price of cotton during this period (see **Figure 5.11**).

International prices of crude oil saw a sharp rise since Q1-FY04, and domestic prices were also following this trend until mid-May 2004 when the Government froze prices of many key petroleum products. This freeze remained until mid-December 2004 (see **Figure 5.12**). However, despite this freeze,



fuel lighting & lubricants sub-group witnessed acceleration during November 2004 reflecting both, the increases in domestic oil prices prior to the freeze and the continuing rise in unregulated petroleum products (e.g. lubricants) and derivatives.

Similarly, although partially subdued due to the Government's fiscal measures, domestic prices of metals nonetheless increased, pushing up inflation in the *building materials* sub-group.

5.5 Sensitive Price Indicator

The SPI which reflects changes in the prices of basic essentials (largely food staples) decelerated by December 2004, to 7.6 percent YoY, well below the 9.5 percent YoY witnessed in December 2003.

In fact, SPI inflation has been steadily decelerating in recent months as evident in **Figure 5.13**. The only exception to this trend was during the Ramadan season.

5.6 Incidence of Inflation

The greater contribution of *food* inflation in overall CPI July-November 2004 inflation figures, suggests a larger incidence of inflation on low-income groups, where food staples typically account for a greater proportion of total expenditure.

In specific terms, YoY CPI inflation eroded the purchasing power of the lowest income group (income upto Rs: 3000/=) by 10.8

percent, followed by 10.2 percent and 9.7 percent for the two middle-income groups (1. income Rs: 3001/= to Rs: 5000/= & 2. income Rs: 5001/= to Rs 12000/=) as against the average CPI inflation of 9.3 percent during November 2004. On the contrary, the impact of this inflation lessened somewhat for the higher income group (income above Rs: 12000/=). This group witnessed an inflation of 8.6 percent (YoY) in November 2004.

