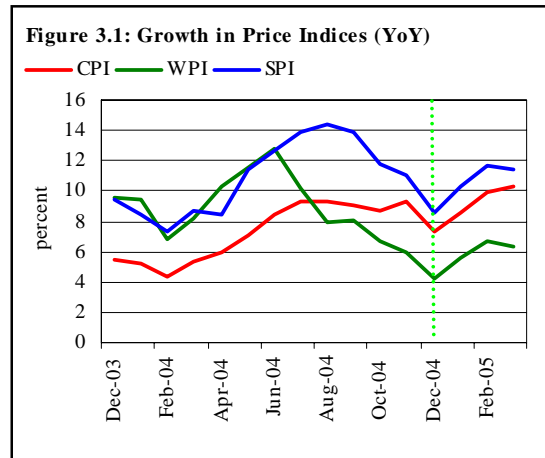


# 3 Prices

## 3.1 Overview

Concerns over inflationary pressures in the economy deepened by March 2005 as all three price indices bounced back from their near term troughs in December 2004 (see **Figure 3.1**). This was particularly evident in CPI inflation, which after dropping to 7.4 percent YoY in December 2004, climbed back to 10.3 percent YoY by March 2005<sup>1</sup> – a 90 month high, and the first time that CPI inflation has reached double-digits in more than seven years. Similarly, while marginal WPI inflation seems to be lower in March 2005 compared to that an year ago (see **Table 3.1**), this is simply because it had dropped as low as 4.2 percent YoY in December 2004 before it began rising again.

The key factors behind the resurgence in inflationary pressures appear to be the unexpected strength of petroleum product prices and subsequently, higher food prices. Indeed, earlier SBP projections had assumed a



**Table 3.1: Inflation Trends - (March)**

	Marginal inflation (YoY) <sup>1</sup>		Annualized inflation <sup>2</sup>	
	FY04	FY05	FY04	FY05
<b>CPI</b>	<b>5.3</b>	<b>10.3</b>	<b>3.4</b>	<b>8.6</b>
Food	7.6	13.3	3.8	12.0
Non-food	3.9	8.2	3.0	6.4
H.Rent	6.2	12.3	2.8	10.2
<b>WPI</b>	<b>8.2</b>	<b>6.7</b>	<b>6.5</b>	<b>8.0</b>
Food	8.9	11.1	5.1	10.7
Non-food	7.8	3.8	7.5	6.1
<b>SPI</b>	<b>8.7</b>	<b>11.4</b>	<b>4.9</b>	<b>11.6</b>
<b>Core<sup>3</sup></b>	<b>4.7</b>	<b>8.2</b>	<b>3.1</b>	<b>8.3</b>

<sup>1</sup> Change in March 2005 over March 2004.

<sup>2</sup> Change in 12-month moving averages of April 2004-March 2005 over April 2003-March 2004.

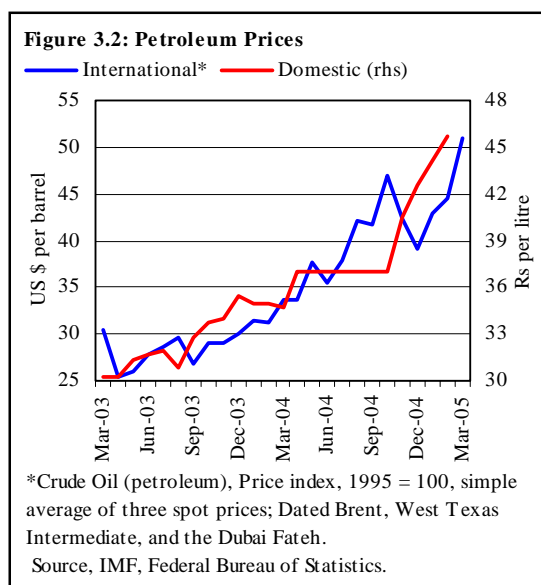
<sup>3</sup> By trimming both extremes by 10 percent each.

Source: Federal Bureau of Statistics

<sup>1</sup> The April 2005 CPI data released on May 18, 2005 shows CPI inflation at 11.1 percent YoY.

weakening in both food prices (particularly in wheat and wheat product prices following the harvest) and international oil prices (as the winter season ended). In the event, both assumptions proved optimistic.

While wheat prices have indeed stabilized somewhat, the impact of this on domestic food inflation was more than offset by a number of factors. The most important of these was the government's decision to end the freeze on domestic prices of key fuels in mid-December 2004 (see **Figure 3.2**). The resulting successive increases in local fuel costs in the following months probably contributed to rising prices in the economy directly (e.g. by pushing transportation costs that, amongst others, form an important part of food



prices), as well as indirectly (by igniting inflationary expectations). The impact on food inflation, in particular, was further exacerbated by other factors such as (1) a fall in the production of sugar and subsequent supply shortages, (2) rain damage to some key minor crops e.g., potatoes and onion; and possibly (3) speculative hoarding of some non-perishable food commodities.

Unfortunately, with international oil prices also showing unexpected resilience, there seems little hope of a sharp reversal of the recent hikes in transportation costs and thus food prices. All in all therefore, it now seems clear that the average inflation for FY05 is likely to exceed earlier projections; the revised SBP forecasts indicates that the annualized CPI inflation for FY05 will probably fall in the 9.0 to 9.4 percent range, up from the earlier (revised) estimated range of 8.2 to 8.8 percent.

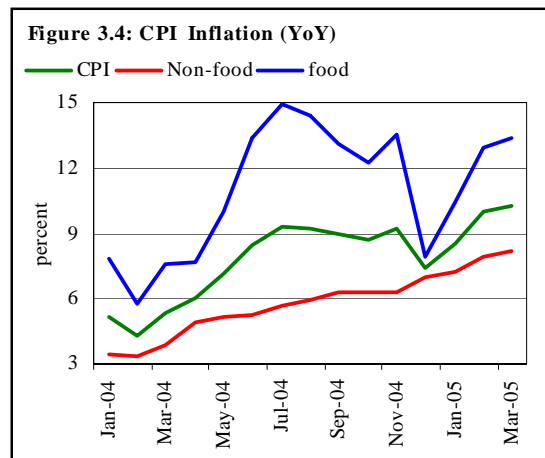
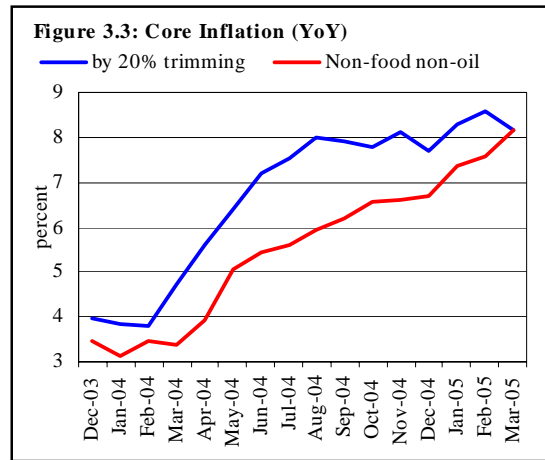
While the rise in the price indices was disquieting, the fact that the increase was driven principally by POL and food product prices meant that SBP policy had a relatively small role in containing these supply-side pressures. In fact, the composition of the CPI inflation pressures suggests that anti-inflationary policies

will need to focus more on administrative and fiscal measures (see **Box 3.1**). At the same time, acceleration in the tightening of monetary policy is likely to slow credit growth as well to discourage the use of banking funds for speculative purposes. Though, the full impact of this policy tightening will emerge with some time lags, some slowdown in core inflation is already visible during March 2005 (see **Figure 3.3**).

### 3.2 Consumer Price Index

In contrast to the downtrend in H1-FY05, the third quarter of the fiscal years witnessed a resurgence in inflationary pressures, with the marginal (year-on-year) CPI inflation recovering from a near-term low of 7.4 percent in December 2004, to reach 10.3 percent by end-March 2005.

A look at **Figure 3.4** clearly shows that while non-food inflation has been rising steadily throughout FY05, the dominant contribution to CPI inflation during this period was from food prices. It was the sharp fall in the latter that led the decline in overall CPI inflation during Q2-FY05, and in the subsequent quarter. While food inflation did not reach the highs seen in Q2-FY05, its rise was complemented by a continued increase in non-food inflation (principally due the sustained acceleration in the HRI and the impact of fuel price hikes). As a result, CPI inflation reached to double-digits for the first time in 7 years during March 2005.



### 3.2.1 CPI Food Group

Earlier in FY05, it was anticipated that CPI *food* group inflation would begin to weaken by mid-year. These expectations initially proved correct, with the share of food inflation in overall CPI gradually declining through the year from 64.6 percent in July 2004 to 41 percent by December 2005. Specifically, reasonably good *kharif* crops and later, hopes of a better than expected wheat crop led to a relative decline in prices. Unfortunately, these gains proved short-lived.

The rise in fuel prices and consequent increase in transportation costs led directly to a corresponding increase in food prices. More importantly, it probably hardened inflationary expectations. The expectations were subsequently exacerbated further by the rise in prices of some of the minor crops either due to hoarding or due to rain damage to some minor crops (see **Table 3.2**).

The inflationary expectations created incentives for speculative hoarding of commodities. In fact, there is already some evidence to this; price rises are evident even for crops that witnessed good harvests. Wheat prices are a case in point. After weakening initially amidst reports of an above target harvest, the prices have stabilized (in contrast to earlier seasons when prices dropped post-harvest). Similarly, some minor crops (e.g. *moong*, *mash*, etc.), which reportedly saw production rise by about a third, have also seen prices rise.

In hindsight, therefore, it is not surprising that food inflation bounced back from 7.5 percent in December 2004 to 13.3 percent by end-March 2005. Given that food inflation is not likely to respond significantly to monetary tightening, and that food prices threaten to permanently raise inflationary expectations, fiscal and administrative measures are clearly desirable to contain food prices. A good example of this was the government's decision to allow sugar imports. Similarly,

**Table 3.2: Contribution of Food Inflation (YoY) - March**  
percent share in overall CPI inflation

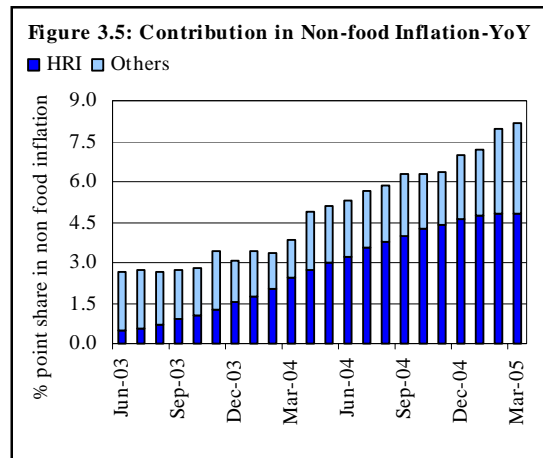
Food Staples	weights	FY04	FY05
Major crops	7.4787	28.6	3.9
Wheat & wheat products		27.9	3.1
Rice		0.7	0.8
Minor crops	6.3629	7.3	22.2
Pulses		-2.0	3.6
Vegetables		9.5	16.4
Fruits		-0.2	2.1
Processed food	13.727	11.1	10.4
Sugar refined		-4.1	9.0
Others		15.2	1.5
Milk products		6.5	6.2
Meat & chicken		11.4	8.7
Others		0.1	3.7
Overall	40.33	65.0	55.1

Source: Federal Bureau of Statistics

free movement of wheat, and maintenance of buffer stocks would allow wheat prices to stabilize at lower (market determined) levels.

### 3.2.2 CPI Non-food

CPI *non-food* sub index registered a growth of 8.2 percent YoY in March 2005 as compared to the subdued 3.9 percent YoY rise recorded in March 2004. Initially, during July-November FY05, the rise in non-food inflation had been relatively subdued and was driven principally by the acceleration in the *house rent index* (HRI). Thus, as the rise of the HRI began flattening out in November 2004, non-food inflation also appears to be stabilizing. However, subsequently, the acceleration in non-food inflation clearly owes significantly to factors other than the HRI (see **Figure 3.5**).

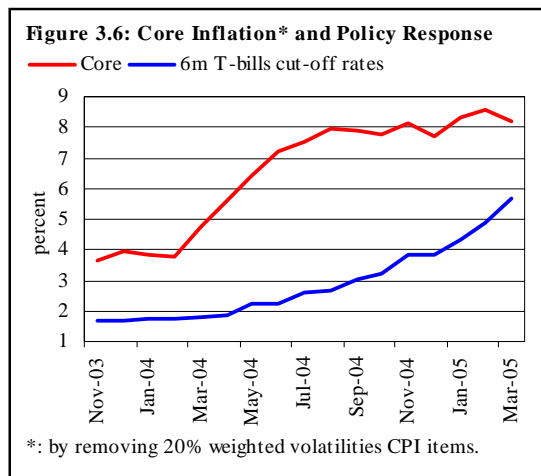


In fact, the break-up of CPI *non food* inflation reveals that while HRI remained the largest component of *non-food* inflation, the *acceleration* in *non-food* inflation December 2004 onward was driven principally by the sharp rises in the *transport & communication* and the *fuel, lighting & lubricant* sub-indices. The rise of these indices was, in turn, pushed up by the rising domestic fuel prices.

Specifically, Q3-FY05 saw significant increases in the prices of natural gas as well as petroleum products, which subsequently also forced the power utilities to raise tariffs<sup>2</sup>. Gas prices, that are linked to international fuel prices, increased by more than 15 percent in Q3-FY05. while, price of petroleum increased by more than 30 percent by the end of Q3-FY05 as compared to the same period last year. The rising fuel costs also led to increases in the air and train fares during Q3-FY05, which are reflected in the rising *transport & communication* sub-index.

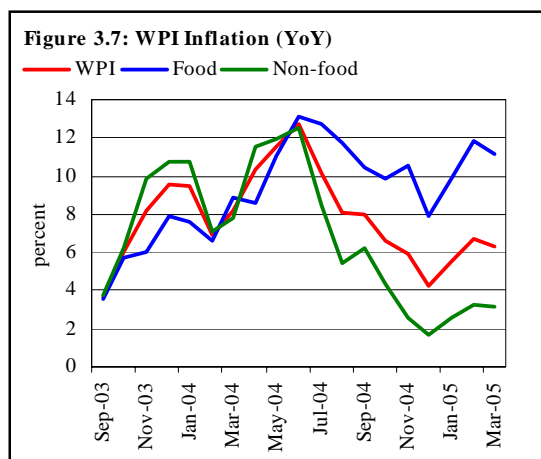
<sup>2</sup> The National Electric Power Regulatory Authority (NEPRA) allowed increase in power tariff for residential consumers of WAPDA companies on February 7, /2005 by an average 2.5 percent or 10-15 paise per unit because of high fuel cost (source: Website NEPRA: <http://www.nepa.org.pk>).

The persistent and sharp rise in *HRI* inflation was instrumental in the sharp acceleration in core inflation (*non-food non-oil*) from 5.6 percent YoY in July 2004 to 8.2 percent by March 2005. However, following the sustained (though gradual) increases in interest rates since July 2004 (see **Figure 3.6**), it seems likely that the upward pressure on core inflation will begin easing in the months ahead.



### 3.3 Wholesale Price Index

The movements of the WPI parallel that of the CPI during Q3-FY05, and for much the same reasons (see **Figure 3.7**). Not only did WPI reverse part of the losses witnessed in H1-FY05, the rise was driven by both food and non-food inflation, following the rise in fuel prices.

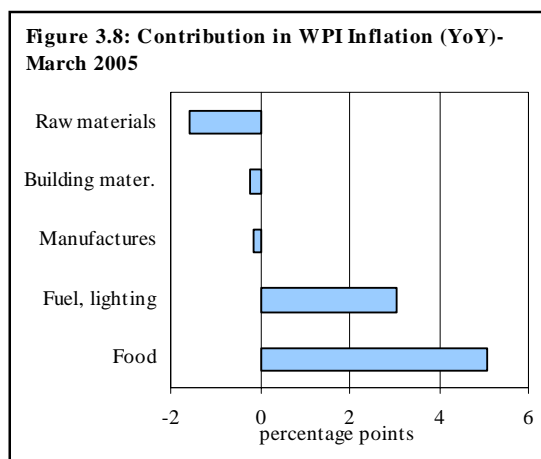


However, unlike the CPI, all of the inflationary pressure captured by the WPI during Q3-FY05 emanates from just two components – the double-digit *food* group inflation and the exceptional rise in *fuel & lighting* prices (see **Figure 3.8**).

It is important to note however, that the softening of WPI inflation in March 2005 is essentially due to a high-base effect. In fact, the rise of WPI sub-indices was exceptionally strong between March-July 2004, and thus, unlike CPI inflation, *ceteris paribus*, WPI inflation is likely to remain relatively subdued in the months ahead.

### 3.3.1 WPI Food Group

*Food* group, with a weight of almost 46 percent in the overall WPI basket, displayed the highest (over 80 percent) contribution in WPI (YoY) inflation during March 2005. On average *WPI food* inflation showed double digit (YoY) inflation in Q3-FY05 over the same period last year, due to a sharp rise in the prices of important food staples (see **Table 3.3**).



**Table 3.3: Distribution of Price Changes in WPI Basket -Mar-2005 (YoY)**

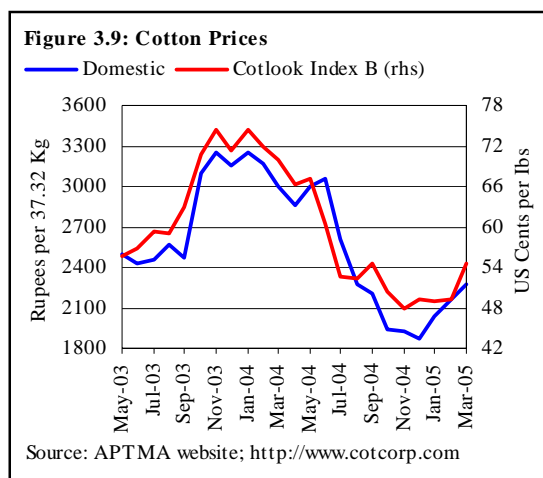
Groups	Weights	% Change	Total number of Items	No. of items in each inflation range			
				Decrease or no change (0% or less)	Subdued increase (0 to 5%)	Moderate increase (5 to 10%)	Double digit increase (Over 10%)
I. Food group	45.79	11.1	43	10	5	4	24
II. Non-food group	54.21	3.1	63	24	14	7	18
Raw materials	8.76	-17.9	9	5	2	0	2
Fuel/light & lubric.	15.28	20.0	11	4	0	1	6
Manufactures	25.53	-0.5	32	12	8	4	8
Building materials	4.64	-4.6	11	3	4	2	2
Overall	100	6.33	106	34	19	11	42

### 3.3.2 WPI Non-food Inflation

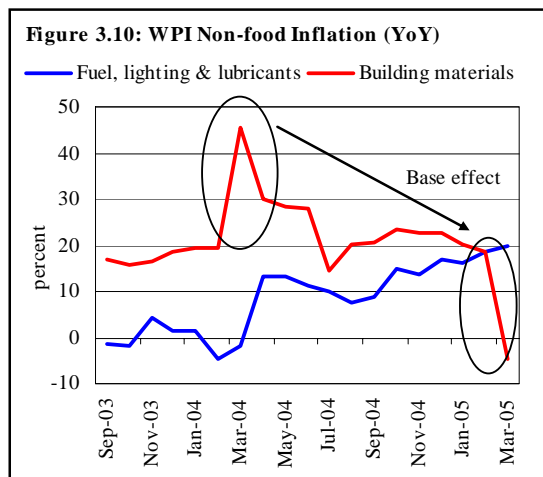
While *non-food* WPI inflation did rise from its near-term low in December 2004, it is still subdued at 3.1 percent YoY by end- March 2005 as compared to 7.8 percent YoY recorded in the corresponding month of FY04.

Interestingly, this low WPI *non-food* inflation was despite a 20 percent YoY inflation recorded in the *fuel & lighting* sub index of WPI in March 2005 as a result of the governments decision to pass on to consumers the impact of high international oil prices.

However, the impact of this on aggregate WPI inflation overshadowed by the deflation recorded in the other sub indices of WPI *non food* group (that have a collective weight of 72 percent in the WPI *non food* group). Specifically, the *raw material* sub index has been showing a deflation since August 2004, due to the decreasing price of cotton, following Pakistan's record cotton harvest as well as strong crops in other major cotton producing countries. However, despite the levels seen in recent years, price of cotton has been accelerating after being bottomed off in December 2004 in both domestic and international market (see **Figure 3.9**). Thus, as a consequence, raw material sub-index is likely to witness a trend reversal soon.



The relatively low cotton prices also contributed to a fall in the prices of textile products. This, together with downward pressures on prices of electronics<sup>3</sup> (due to competition from imports), underpinned the deflation in the prices of *manufactures* sub-index. Inflation in the commodities of this sub-group is therefore likely to remain subdued.



The deflation in the sub index of *building material* in March 2005 seems less sustainable (see **Figure 3.10**). This WPI sub-index has been recording double-digit inflation since July 2003 on the back of an unusual jump in international

<sup>3</sup> Audio visual prices have been on decrease due to the overall decreasing prices of electronics.



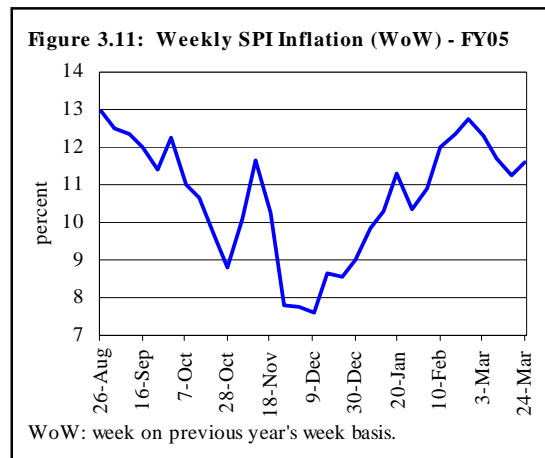
prices of iron & steel coupled with increased domestic construction activity, and the deflation recorded in March 2005 is likely to prove temporary, as it was caused by a high-base effect due to a price spike in March 2004 rather than a sustained slowdown in *building material* prices.

### 3.4 Sensitive Price Indicator

SPI inflation (YoY) that has been decelerating until December 2004, reversed direction in Q3-FY05 due to rising fuel and food prices. Since SPI data is compiled on a weekly basis, the added granularity clearly shows the linkage between the need of the freeze on prices of key fuels and inflationary expectations.

**Figure 3.11** clearly shows a sharp jump in SPI inflation on December 16, 2004, the date on which the government announced the end of the freeze on fuel prices. The end of this freeze was driven principally by the government's desire to resume collection of taxes on POL products.

It may be recalled that the SPI basket consists of some essential kitchen items, food staples, etc. Price hikes in these items typically have a greater impact on the budget of low income group. A redesign of taxes and surcharges on PoL products is necessary to moderate the regressive nature of its incidence, ultimately it may be desirable for the government to substitute these with alternative (less regressive) sources e.g. through broadening the tax base and imposition of an income tax on services and the agriculture sector.



**Box 3.1: Anti-Inflationary Administrative and Fiscal Measures**

In the case of acceleration in inflation due to exogenous factors, such as surge in international prices, supply shortages (genuine or artificial) and or increase in the administered prices, monetary policy is particularly ineffective in the short term. In this background, the present surge in inflation is a result of easy monetary stance as well as various exogenous factors outside the purview of the monetary policy, for example, rise in the procurement prices of wheat for FY04 crop, record hike in international oil and metal prices, which was further compounded due to hoarding activities with respect to some essential food items.

The impact of rise in aggregate demand due to easy monetary policy would be effectively curtailed through tightening of monetary policy, however, following fiscal and administrative measures are required to ease the inflationary pressures emerged due to supply shocks:

- (1) A quicker adjustment in the customs duty and sales tax on imports of important items, if their international prices increase sharply.
- (2) Reduction (and preferably elimination) of petroleum development levy (PDL) on key fuels.
- (3) Reductions in sales tax on POL due to strong trickle down impact of their prices on inflation because POL products are a major input in transportation and industry.
- (4) Since information relating to aggregate domestic production and consumption of essential food items is available, therefore, timely imports of such items in right quantity could taper off price pressures, as government did in the case of onion and to some extent for sugar.
- (5) Prices of some items (e.g., cement) are on higher side mainly due to cartelization. The government should discourage the formation of such cartels. Effective implementation of the existing regulations is required.
- (6) Intra-group cartels are also exploiting consumers, e.g. an individual is unable to book a car with a dealer directly (he/she directed towards banks/leasing company to do so). Thus individual buyer has no option but to pay either premium on cash purchase or avail some auto financing.
- (7) Organized trade associations (milk, meat, bread, transporters etc.) are also responsible for fueling inflationary pressures. These pressure groups determine their own prices and most of the time raise their profit margins. Strict regulations and monitoring at retail and wholesale level is required to discourage this tendency.
- (8) Speculative hoarding, of grains (wheat, sugar, pulses) and non-perishable vegetables (potatoes, onion), is also evident during last few years. Government may initiate anti-hoarding campaign and arrangements of direct sale (through utility stores, or stalls in weekly bazaars etc.) of the commodity under attack may probably discourage the hoarding. The hoarders should be dealt according to the regulations.

It has been observed that the abnormal profit margins at retail levels are prevailing in the case of vegetables and fruits. Formation of effective consumer associations may monitor these margins and advice the consumers about the appropriate prices of these items, or to avoid consumption of some item, if price is unreasonably high. Alternatively, responsibilities of the existing price control committees may be extended.

Conclusively, consumers have to play an important role in the stability of prices of essential food items. Since price setting is all about the price elasticity of demand, consumer may show resistance through collective actions. If they reduce the consumption of some perishable good, its prices cannot sustain at higher level. Similarly, even in the case of non-perishable items (e.g. potatoes) a substantial reduction in consumption would force the hoarders to restore the supply to avoid losses and storage cost. This can be done by creating awareness and guidance to the consumers through media and stalls in weekly bazaars.