

3 Prices

All major inflation measures continued to record a weakening in inflationary pressures through most of Jul-Feb FY06, suggesting that the tight monetary posture, administrative measures and favorable movements in key international commodity prices are reducing inflationary pressures in the domestic economy.

Particularly notable is the gradual reduction in CPI inflation despite sustained high oil prices and the supply shocks; CPI inflation has dropped from 9.3 percent YoY in June 2005 to 8.0 percent in February 2006 (see **Figure 3.1**). Moreover, while CPI inflation remained in high single-digits throughout the period, the volatility in the inflation rate is significantly lower than in the corresponding period last year. Also, core inflation, after clinging stubbornly in the range of 7.0 - 8.0 percent during the Jun FY04-Oct FY05 period is finally trending downwards, dropping to the 6.4 percent by February 2006 (see **Table 3.1**) for the first time in the last 20 months.

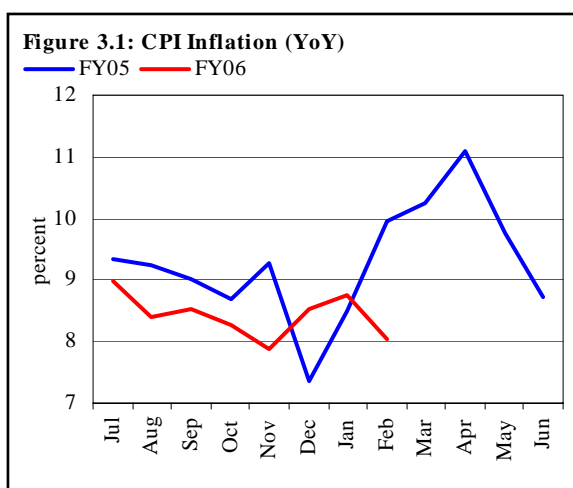


Table 3.1: Inflation Trends (end February)

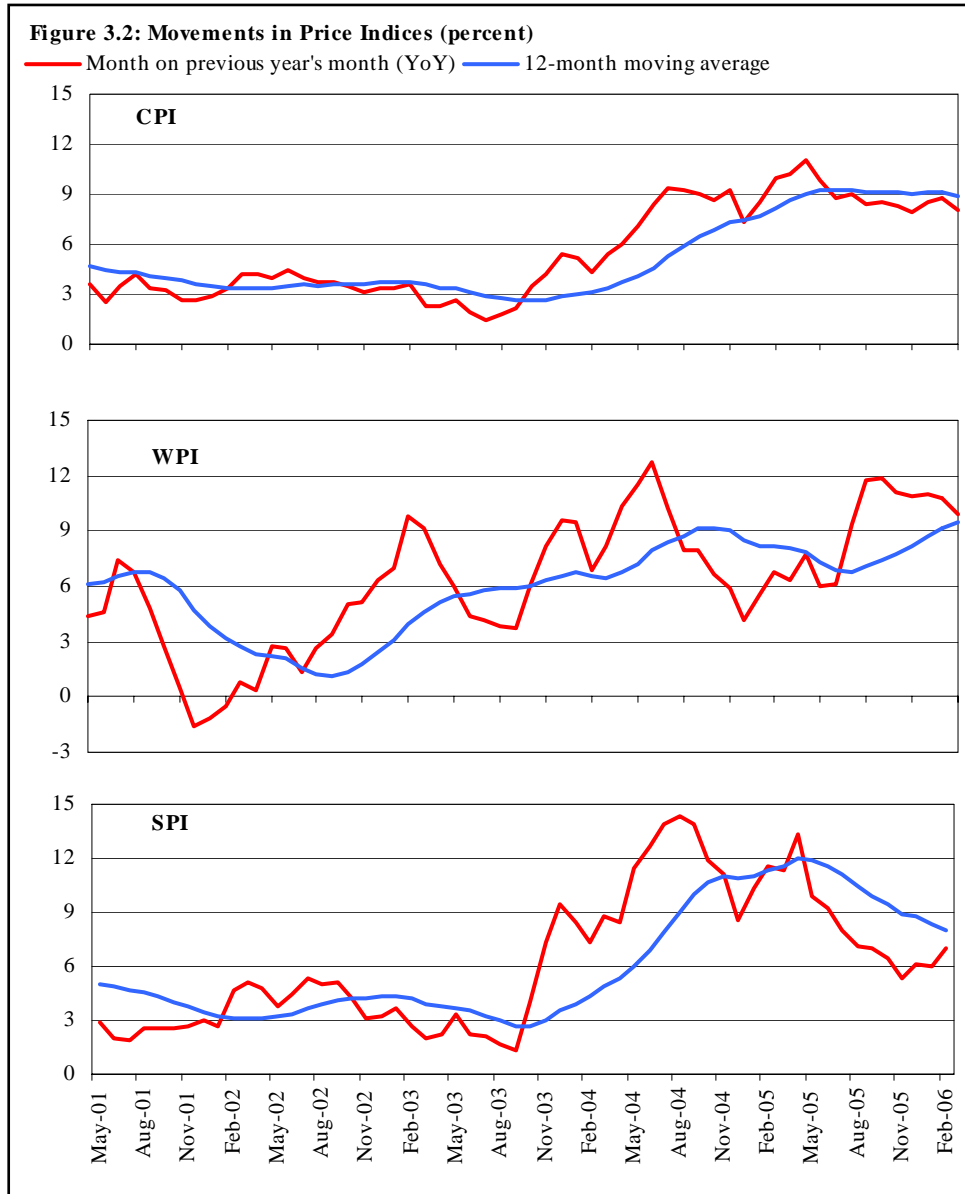
percent	Year on Year (YoY) ¹		12-m moving avg	
	FY05	FY06	FY05	FY06
CPI	10.0	8.0	8.2	8.9
Food	12.9	7.5	11.5	9.2
Non-food	8.0	8.4	6.0	8.7
H.Rent	12.3	9.4	9.7	11.2
WPI	6.7	9.9	8.1	9.4
Food	11.9	6.9	10.5	8.7
Non-food	3.3	12.5	6.4	10.0
SPI	11.6	7.0	11.4	8.0
Core inflation:				
• NFNE ³	7.4	7.0	6.1	7.5
• Trimmed mean ⁴	8.6	6.4	7.7	7.6

¹ Change in Feb 2006 over Feb 2005.

² Change in average of Mar 2005-Feb 2006 over the average of Mar 2004-Feb 2005.

³ Non-food, Non-energy inflation

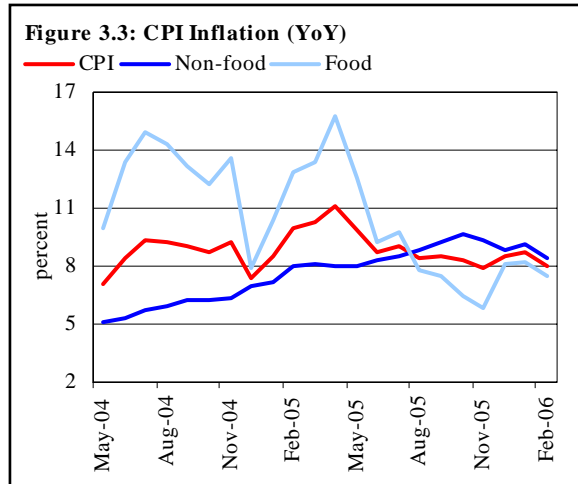
⁴ By trimming 20 percent of CPI items showing extreme changes
Source: Federal Bureau of Statistics



Similarly, the WPI inflation has decelerated, falling to 9.9 percent YoY in February 2006 after maintaining an average of more than 11 percent during the first half of the fiscal year (see **Figure 3.2**). As with the CPI, the contribution to

the decline in WPI inflation is quite broad-based, with all the sub-groups of the index recording a deceleration in price rises.

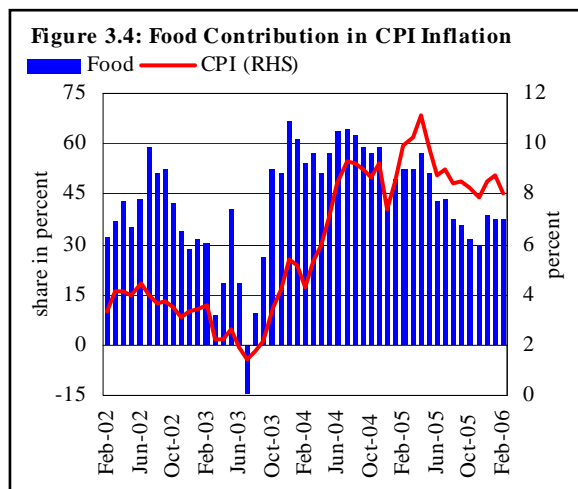
While there exists a possibility of a small rebound in food inflation¹, the impact of this should be mitigated by the impact on aggregate demand (and particularly non-food, non-oil demand), and lower volatility in energy prices. As a result, barring unforeseen supply shocks, SBP forecasts suggest that the average annual inflation for FY06 is likely to be in the neighborhood of the 8 percent annual target.



3.1 Consumer Price Index

As evident from **Figure 3.3**, and **Figure 3.4** it was the sharp decline in food price inflation² that contributed most to the deceleration in aggregate CPI inflation during Jul-Feb FY06.

Indeed, a larger deceleration in the CPI inflation was prevented only by the persistently high non-food inflation through most of this period. High energy prices, in particular, not only contributed directly to non-food inflation, but also forced a small resurgence in food

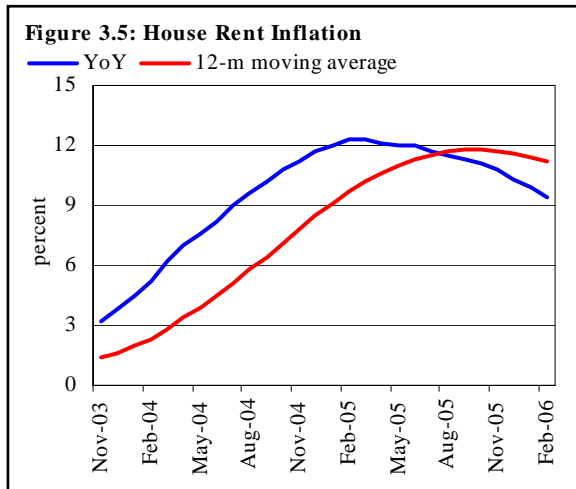


¹ As further increase in meat prices, as a substitution impact on the back of rising fears of bird flue; and in the milk prices due to high transportation cost is expected in the days ahead.

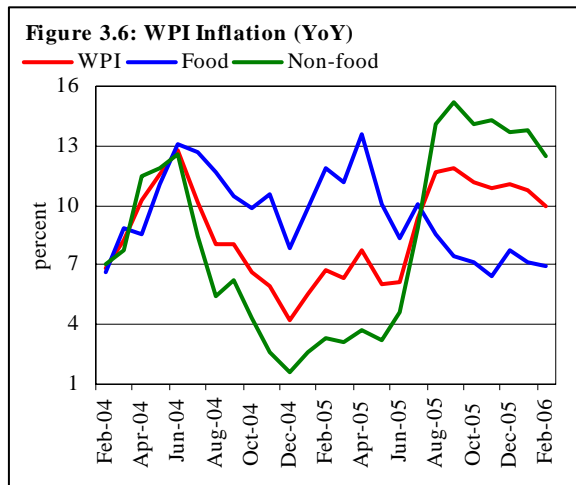
² Although the prices of some important commodities, such as sugar, fresh milk, pulses, etc. have increased sharply, their impact on aggregate food inflation has been offset by the deceleration in prices of some other key commodities, and a fall in wheat prices. For a more detailed analysis please see the SBP "Inflation Monitor" for February 2006.

inflation (through higher transportation costs and a general rise in inflationary expectations).

This trend is expected to change in the remaining months of FY06. On the one hand, the deceleration in food inflation is expected to taper off on the back of rising prices of pulses, sugar, meat and some vegetables, but on the other, the impact of this is expected to be offset by decline in poultry prices and a significant softening in non-food inflation. The latter is already evident in a disaggregation of the CPI inflation figure for February 2006 where: (1) the *fuel & lighting* and *transport & communication* sub-groups saw a sharp fall in their joint contribution to overall CPI inflation, and; (2) the house rent index (HRI) also decelerated substantially (see **Figure 3.5**).



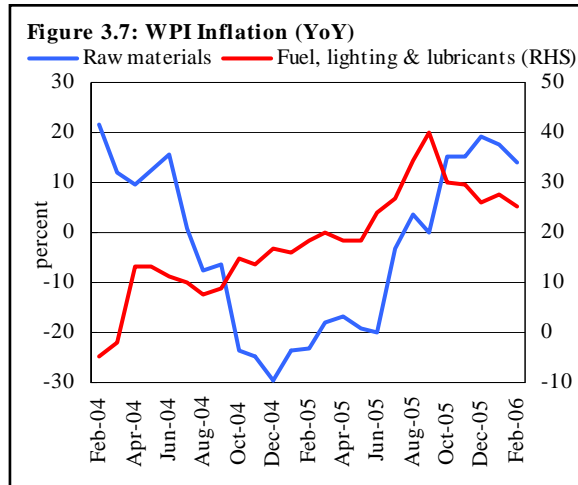
3.2 Wholesale Price Index
After being peaking off at 11.9 percent YoY in September 2005, wholesale price index (WPI) inflation decelerated to 9.9 percent YoY in February 2006. This deceleration was evident in both *food* and *non-food* group inflation (see **Figure 3.6**).



WPI *food* group inflation continued to decelerate through most of FY06, as the impact of significant rises in the prices of key commodities such as pulses, meat and sugar, were partially offset by a fall in the prices of wheat and its products, as well as weakness in the prices

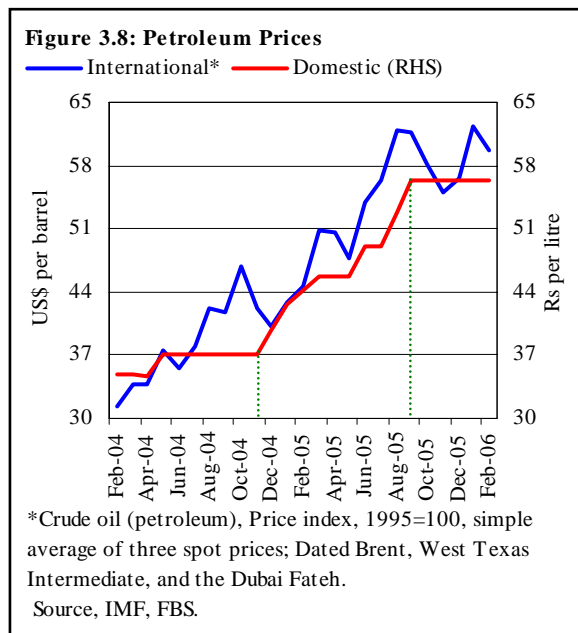
of some minor crops. As a result, WPI *food* inflation dropped to the 7 percent levels by Feb FY06.

Within the WPI *non-food* sub-group, inflation recorded by the *raw material* sub-index rose sizably, but the impact of this on overall WPI inflation was partially offset by the deflation in the *building material* index as well as a sharp deceleration in the WPI *fuel, lighting & lubricant* inflation.



The raw material sub-index of the WPI recorded an average inflation of 16.5 percent YoY during the second quarter of FY06 after witnessing average deflation of 17.6 percent YoY during FY05 (see **Figure 3.7**). The upsurge was primarily due to rising sugarcane and cotton prices; prices of both commodities rose sharply Oct FY06 onward when it became clear that the kharif FY06 harvest would be substantially below expectation.

By contrast, WPI inflation component of *fuel, lighting & lubricant* (19.3 percent weight in WPI) fell from 40.1 percent YoY in September 2005 to 25.2 percent YoY in February 2006. The deceleration in energy prices captured by the sub-index primarily reflects the relative stability in domestic oil prices despite some fluctuations in international oil prices (see **Figure 3.8**).

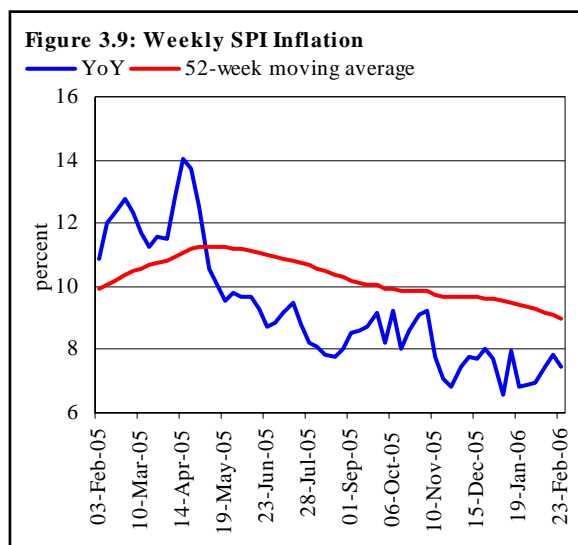


The *building material* is the only group of WPI items that has been recording a deflation since December 2005. This was mainly due to a decline in prices of iron and steel, primarily as a consequence of a reduction in the prices by Pakistan Steel, a reduction in the import duty, as well as declining steel prices in the international market. The impact of this would have been greater if not for the rising cement prices, which continued to move up despite the government's efforts to reduce prices by liberalizing the cement import policy.

3.3 Sensitive Price Indicator³

The Sensitive price indicator (SPI) exhibited, on average, a decelerating inflation trend during the first eight months of FY06 (see **Figure 3.9**).

Despite some volatility in some weeks of October (Ramadan effect), December (natural gas price effect) and February (sugar price effect), SPI continues to record a steady downward trend.



³ SPI is a sub-index of the CPI, constituting principally of key food staples and some important non-food items (including some fuels). Conceptually this indicator tracks the inflation in basic consumption items common to all income groups. The data for the SPI is provided by the FBS on a weekly basis, and higher frequency of the SPI makes it a useful leading indicator of inflationary trends.