

7 Prices

Annualized inflation remained weak throughout Q1-FY04, with the CPI and SPI inflation both continuing the downtrend visible since February 2003. While the annualized WPI witnessed a rise, even here, the quarterly contribution was relatively subdued during Q1-FY04.¹ Significantly, the *marginal* (YoY) inflation at end-Q1-FY04 for all three indices also remained below the corresponding 12-month annualized rate, suggesting that annualized inflation could remain weak in coming months (see **Table 7.1**).

Table 7.1: Inflation Trends (End-September)

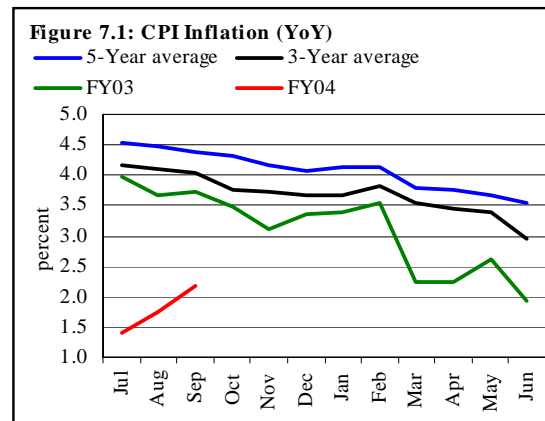
	percent			
	Marginal inflation		Annualized inflation 12-month average	
	FY03	FY04	FY03	FY04
CPI	3.7	2.2	3.6	2.6
Food	4.9	1.4	3.4	1.7
Non-food	3.0	2.7	3.7	3.2
WPI	3.9	2.9	1.5	5.9
Food	3.6	2.8	2.4	2.9
Non-food	4.2	3.0	2.0	8.5
SPI	5.1	1.4	4.1	2.6

Source: Federal Bureau of Statistics

However, the steep rising *trend* in marginal CPI inflation during Q1-FY04 (see **Figure 7.1**), a spike in the October 2003 CPI, as well as the relative strength of non-food prices has clouded this benign picture, suggesting that inflationary pressures in the economy, which still weak, are probably strengthening. In light of the above developments, the SBP

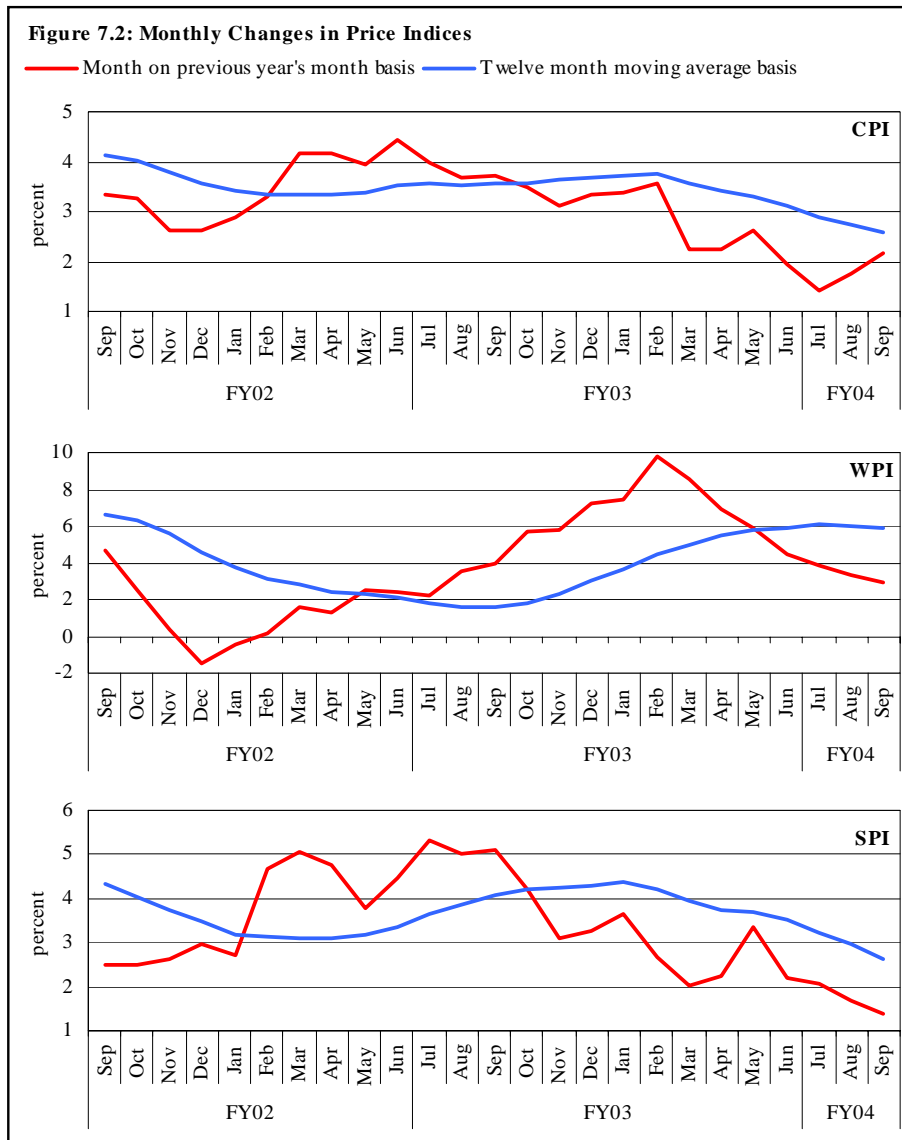
quarterly forecast has been revised upward, placing the annualized FY04 inflation within the range of 3.6 to 4.2 percent compared to the 2.4 to 2.8 percent range earlier. This is still lower than the targeted 3.9 percent for the period.

Non-food prices continued to make the greater contribution to inflationary pressures during Q1-FY04. Although both food and non-food components of CPI



¹ The annualized quarterly Q1-FY04 WPI inflation was 3.4 percent.

recorded lower increases relative to Q1-FY03, the deceleration was more pronounced in food inflation. Similarly, the acceleration in WPI stemmed largely from non-food components.



7.1 Consumer Price Index

As can be seen from **Table 7.1**, the annualized CPI inflation was 2.6 percent at end-September 2003. This is significantly lower than the 3.6 percent figure recorded in the corresponding period of FY03 and is the lowest level for over three decades. However, since the marginal (YoY) CPI inflation has bounced back strongly to reach 2.2 percent in September 2003 after bottoming out at 1.4 percent in July 2003, the sustainability of the very low annualized inflation is unclear.²

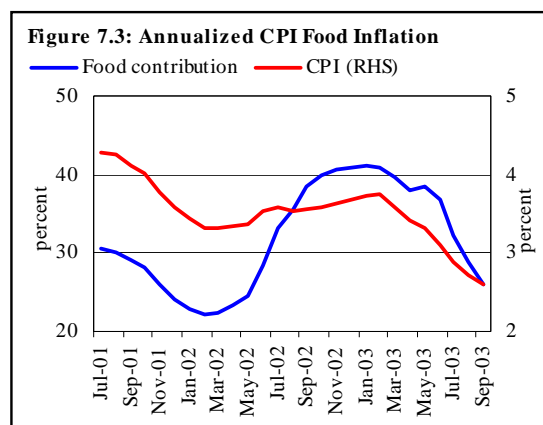
During this period, *recreation & entertainment, food & beverages, fuel & lightening, house rent, household, furniture & equipment* and *medicare* recorded a deceleration in price increase compared with the corresponding period of FY03. The impact of this was partially offset by higher increase in the prices of 'transport & communication', 'education', 'cleaning, laundry & personal appearance' and 'apparel, textile & footwear' sub-groups during the same period.

7.1.1 Food & Beverages

This CPI sub-index recorded a smaller annualized increase of 1.7 percent at end-Q1-FY04 compared with a 3.4 percent rise in the same period of FY03. The contribution of food in CPI inflation continued trending downwards due to a significant deceleration witnessed in the prices of most of the food items (see **Figure 7.3**).

In addition, out of 124 food items in the CPI basket, 47 items (having 22 percent share in food sub-group) recorded a decline in prices (these included onion, gram, garlic, potatoes, tomatoes, sugar, pulse mash, eggs and milk *tetra pack*) which helped to partially offset the increase in the prices of other essential items, i.e., wheat, flour, rice, meat, cooking oil, ghee etc. (see **Figure 7.4**).

The higher prices for wheat and rice could be attributed to higher international prices and strong domestic and external demand. In a bid to soften the domestic prices for ghee & cooking oil, Government lowered the custom duty on crude



²The October 2003 marginal (month-on-month) CPI inflation stands at 3.5 percent.

palm oil from Rs 9,500 per tonne to Rs 9,000 per tonne,³ however, the increase in import unit value seems to have mitigated the impact of this measure.

The subdued contribution of the food group to CPI inflation during Q1-FY04 may not be sustained into the succeeding quarter as the prices of some key staples (wheat, rice, milk, meat, etc.) have recently witnessed strong increases.

7.1.2 Non-food

By end-September 2003, the *non-food* component of annualized CPI increased by 3.2 percent compared with 3.7 percent in the corresponding period last year. The deceleration was entirely due to the lower increases in the prices of ‘recreation & entertainment’, ‘medicare’, ‘fuel & lightening’, ‘household, furniture & equipment’ and ‘house rent’ sub-groups (see **Table 7.2**).

The impact of this deceleration was partially

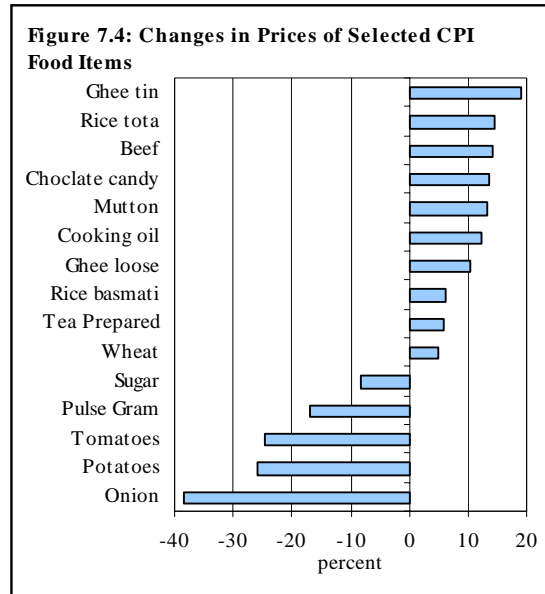


Table 7.2: Annualized CPI Inflation (End-period)

	Q1-FY03	Q4-FY03	Q1-FY04
Food & Beverages	3.4	2.8	1.7
Non-food group	3.7	3.3	3.2
Apparel, textiles, footwear	3.0	3.4	3.9
House rent	2.1	0.7	1.0
Fuel & lightening	8.3	7.6	6.6
Household furniture & equip.	3.4	2.9	3.0
Transport & communication	4.2	5.3	4.9
Recreation entertainment	4.2	0.9	0.7
Education	4.8	4.7	4.9
Cleaning, laundry & per. appearance	2.8	4.8	4.9
Medicare	3.4	3.1	1.6
CPI general	3.6	3.1	2.6

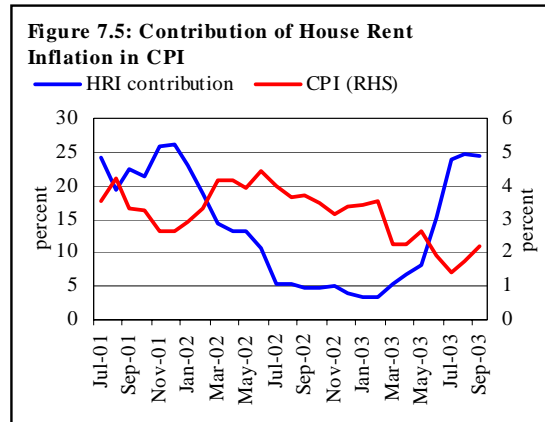
Source: Federal Bureau of Statistics

³ Announced in Federal Budget for FY04.

offset by stronger increases in the sub-indices for 'apparel, textile & footwear' (3.9 percent), 'cleaning, laundry, & personal appearance', 'education' and 'transport & communication' (each one rose by 4.9 percent).

Despite a lower increase in house rent index (HRI) on annualized basis, the quarterly and monthly movements of the HRI show notable increase in its contribution to CPI inflation. The sub-group has the largest weight in the CPI basket (at 23.43 percent) other than food. Not surprisingly, the stronger contribution of the HRI to CPI inflation coincides with the CPI

inflation up trend (see **Figure 7.5**). Moreover, the computation methodology of HRI suggests that HRI inflation would increase further in months ahead (see **Box 7.1**).



The weak growth in *medicare* group prices is possibly a reflection of a high-base effect stemming from the levy of GST on medicines in Q1-FY03 (which was subsequently withdrawn). This decline, therefore, may not be visible in subsequent periods.

In *fuel & lightening*, the prices for petrol during Q1-FY04 remained relatively low compared with Q1-FY03 (see

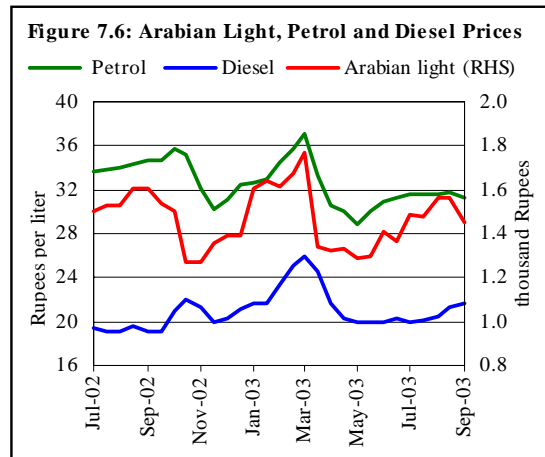


Figure 7.6). Since the domestic POL prices are linked with the price developments in world oil market, the decrease in POL prices should therefore be viewed in the context of a fall in global oil prices, coupled with the persistent strength of the Rupee against the dollar, during the period under review.

7.2 Wholesale Price Index (WPI)

Contrary to the CPI picture, annualized WPI inflation witnessed a sharp acceleration from 1.5 percent at end-September 2002 to 5.9 percent at end-September 2003. However, it should be noted that: (1) quarterly WPI inflation is a much weaker 3.4 percent in Q1-FY04, and (2) marginal WPI inflation was 2.9 percent for September 2003; both factors indicate that WPI inflation is now trending to levels consistent with (the lower) CPI inflation.

Non-food inflation continued to play a dominant role in WPI inflation, although its influence has weakened in recent months. Stronger contributions to non-food inflation were from the *raw materials* and *building material*.

7.2.1 Food

Food group inflation accelerated to 2.9 percent in end-Q1-FY04, up from 2.4 percent in the corresponding period of FY03. The acceleration was on account of the steep rise in the prices of 18 out of 39 items having a dominating share of 73.1 percent within the WPI food group. Significant increases were recorded in the prices of wheat flour (4.8 percent), rice (6.7 percent), fresh fruits (8.7 percent), cooking oil (12.6 percent), cottonseed oil (9.9 percent), meat (11.3 percent), fresh milk (1.8 percent), and chicken (2.2 percent).

The larger wheat purchases by the private sector last year and subsequent rise in exports together with the seasonal demand, seem to have spearheaded the increase in the prices of wheat and wheat based items. Moreover, ghee and cooking oil prices continued to be influenced by the lower domestic production, rise in Malaysian palm oil prices and subsequent increase in import unit value. The Malaysian palm oil prices soared to a record level during last many years in response to the high demand (China, India) as well the surging soybean price amid tight supplies. Meat prices also rose due to higher demand from Middle East.

However, the impact of these increases was partially offset by declines in the prices of onion (43.3 percent), gram (22.0 percent), potatoes (30.6 percent), spices (26.1 percent), sugar (8.8 percent) and dry fruits (6.7 percent). The abundant supply of potatoes and onion, largely because of the better crop, put downward pressure on their prices, while the decline in the prices of spices and dry fruits could be partly attributed to the decline in the unit value of competing imports during the period under review.

7.2.2 Non-food

Non-food group annualized inflation witnessed a sharp increase of 8.5 percent at end-Q1-FY04, mainly due to a 12.4 percent and 11.7 percent rise in the prices of

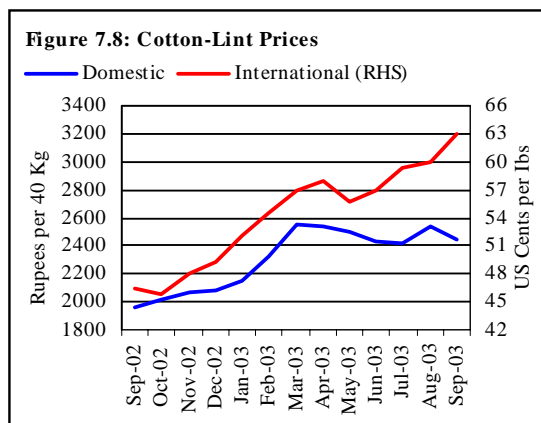
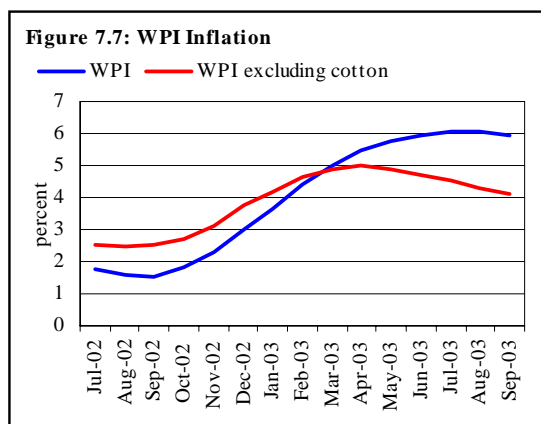
fuel, lightening & lubricants and *raw material* respectively. The sub-index of *fuel, lightening & lubricants* however, depicted a significant deceleration in prices since April 2003.

The increase in *raw material* index was mainly due to the hike seen in domestic cotton prices that continued to rally and reached a two-year high in August 2003 (see **Figure 7.7**).

Annualized WPI inflation excluding cotton is showing a clear downtrend since May 2003 (see **Figure 7.7**), implying that the current WPI inflation is significantly attributed to higher cotton prices (see **Figure 7.8**).

The sharp rise in domestic cotton prices during the 2004 season owes largely to lower world production, as well as strong export-based domestic demand.⁴

Similarly, the *building materials* sub-index continuing to rise mainly due to soaring prices of bricks/blocks, iron bar & sheets, paints & varnishes, and pipefitting, etc. Clearly, the increased momentum of construction activities across the country (demand pull) as well as an increase in the import unit value of iron and steel products (cost push) is translating into higher construction costs.



⁴ The higher demand vis-à-vis short supply in world market seems to have spearheaded New York Cotton Exchange futures contracts thus pushing Cotlook "A" & "B" Index to a 33-month high; the Cotlook A index, which was about 49 cents per pound in September 2002, moved up to 64.2 cent per pound in September 2003. The shortfall in world market was mainly due to decline in production of cotton vis-a vis rising demand from countries such as China and India.

The *fuel, lightening & lubricants* sub-group witnessed a substantial annualized increase of 12.4 percent by end-September 2003 over end-September 2002 due to higher oil prices amidst continued instability in Iraq. However, their prices are witnessing a deceleration after recording an annualized increase of 14.2 percent in May 2003. This slowdown is probably a result of a high-base effect following record high prices in FY03.

The combined impact of higher increases under *fuel, lightening & lubricant*, and *raw material* resulted into a sharp rise in the *manufactures* sub-group. This sub-group recorded an annualized increase of 3.8 percent at end-Q1-FY04 compared with a 0.9 percent rise in the corresponding period of FY03.

7.3 Sensitive Price Indicator (SPI)

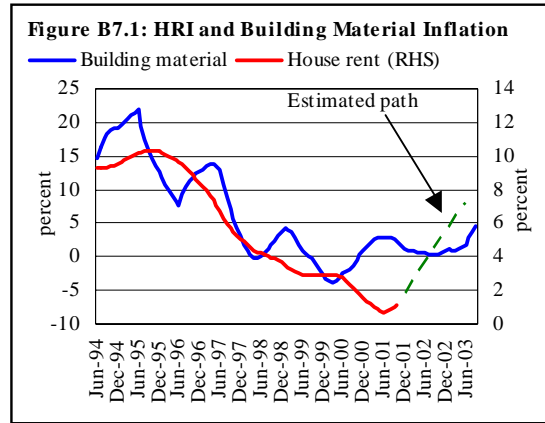
SPI covers prices of 53 essential items of daily use, mostly from the basket of the low-income group having monthly income upto Rs 3000. In line with CPI, the annualized average SPI inflation remained subdued; during Q1-FY04, annualized SPI increased only by 2.6 percent as against 4.1 percent in the corresponding period of FY03.

Items which recorded notable declines in prices during this period were included pulses, sugar, gur, and tea. Other important items that registered a larger decline in prices included potatoes, onion and tomatoes. In contrast, prices of wheat, wheat flour, rice basmati (broken) vegetable ghee, milk fresh, beef, mutton and chicken farm continued to increase during the period under review. Similarly, kerosene, gas and electric charges also were higher compared with the corresponding period last year.

Box 7.1: Computation of House Rent Index in CPI:

House Rent Index (HRI) carries a 23.43 percent weight in CPI, the second largest after food. The Federal Bureau of Statistics compiles this index using an indirect method by incorporating construction costs prevailing in 35-urban centers of the country. Both labor and material costs are taken into consideration; labor costs constitute 40 percent and remaining is accounted for by the material cost. The construction index is then compiled for individual urban centers by taking a 24-month moving geometric mean of the labor and material costs. Then the weights for house rent of individual cities (obtained through family budget survey) are applied to compute the overall HRI. Building material sub-group in WPI, therefore, has a direct relationship with the HRI sub-group in CPI through incorporating lags of upto 24-months.

Figure B7.1 confirms this close relationship. It is interesting to note that the ups and downs in WPI *building material prices* were not immediately captured by the HRI, which is consistent with the fact that the house rents are typically contractual and take time to incorporate price changes. A source of this deviation may be the broader coverage of HRI in CPI (based on 35-urban centers) compared to the building material sub-index in WPI (based on 16-urban centers).



The recent surge in the building material sub-index is a source of concern for CPI inflation in coming months. The dashed red line is showing an estimated increase in HRI during remaining part of FY04. On the basis of this estimation, it is concluded that about 0.5 percentage point increase in CPI during FY04 would solely come from HRI.