7 Prices

The emerging inflationary pressures seen in Q1-FY04 strengthened in Q2-FY04 as all three price indices recorded an acceleration on a year-on-year (YoY) basis. In contrast to the downtrend visible in the corresponding periods in recent years[1] (see **Figure 7.1**), the end-December 2004 *marginal* inflation rates rose higher than the corresponding figures for December 2003 (**see Table 7.1**). This in turn, pushed up the annualized inflation rates.[2]

That fact that marginal inflation rates for all three indices have remained higher than the corresponding annualized rates throughout Q2-FY04 (i.e., annualized rates would rise going forward), and that these rates were *trending higher* throughout the quarter, fueled market expectations of a tightening of monetary policy.

However, from the central bank's perspective there is clearly a need to retain its relatively easy monetary posture, while closely monitoring for any surge in inflationary pressures to troubling levels. This perspective is based on the fact that: (1) domestic inflation is projected to remain relatively low, at

Figure 7.1: CPI Inflation

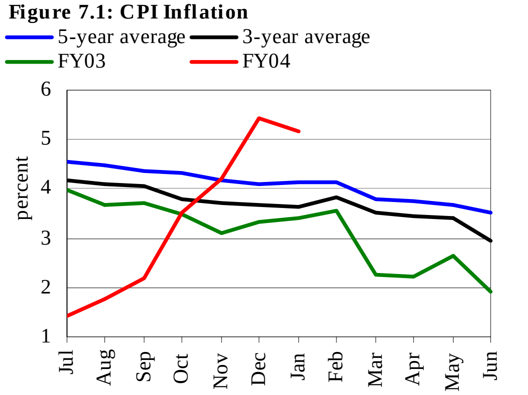


Table 7.1: Inflation Trends in December

percent

	Marginal [1]		Annualized [2]	
	FY03	**FY04**	**FY03**	**FY04**
CPI	3.3	5.4	3.7	2.9
Food	2.4	9.0	3.7	2.5
Non-food	4.0	3.1	3.7	3.1
Non-food, non-oil	2.9	3.2	2.8	2.8
WPI	6.3	9.6	2.4	6.6
Food	3.4	7.9	3.0	3.8
Non-food	8.4	11.0	2.7	8.6
SPI	3.3	9.5	4.3	3.5

[1]: Change in December 2003 over December 2002.
[2]: Change in 12-month moving averages.
Source: Federal Bureau of Statistics

[1] Marginal inflation was trending downward throughout FY03, while it is increasing sharply during FY04.
[2] While annualized CPI inflation for H1-FY04 is less than that for H1-FY03, this is simply because it dipped to 2.6 percent in September 2003 before pushing back up to 2.9 percent by December 2003.

around the 4 percent levels, during FY04; (2) a small increase in inflation is not unexpected and is tolerable in an economic recovery, as rising employment (and purchasing power) raises aggregate demand; and, (3) a pre-mature tightening of monetary policy could seriously jeopardize the medium term growth trajectory.

Despite the current rising price tends, overall inflation in FY04 is not likely to accelerate sharply because the prices of many important food items (particularly wheat) are expected to weaken in coming months. Moreover, non-food inflation remains subdued with the exception of *house rent* sub-index; almost all sub-groups in the *non-food* sub-group depict a visible deceleration in most recent data.

In light of the above developments, the SBP inflation forecast for FY04 has seen some revision. The revised forecasts places the lower bound of the likely inflation rate for the year higher, but keep upper limit intact, bring the most likely estimate for FY04 inflation between the 3.8 to 4.2 percent range.

7.1 Consumer Price Index

The sustained acceleration in marginal CPI inflation during H1-FY04 forced an up tick in the annualized CPI inflation during Q2-FY04. Almost all sub-groups in CPI witnessed increases except *recreation & entertainment*, which saw a marginal fall during December 2003. However present acceleration in CPI inflation is mainly a result of a sharp increase in the sub-index of *food & beverages* (see **Figure 7.2**).

It may be recalled that *non-food* inflation had been rising until March 2003 and it was a sharp deceleration in *food* inflation that forced overall CPI to move downward throughout FY03. By contrast, *food* inflation is the major factor behind the up tick in overall CPI inflation during Q2-FY04, and it is subdued *non-food* inflation that is likely to offset much of the current (*food*) inflationary pressures in coming months (see **Figure 7.3**).

Figure 7.3: Annualized CPI Inflation

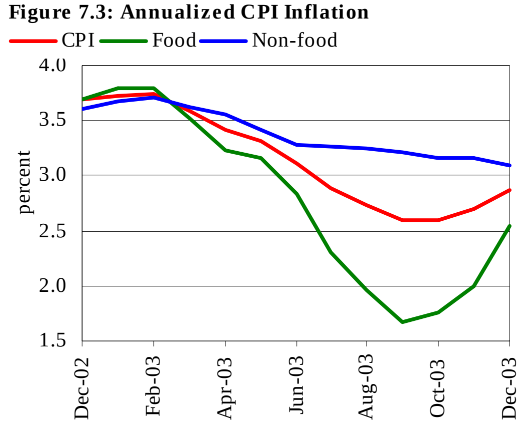
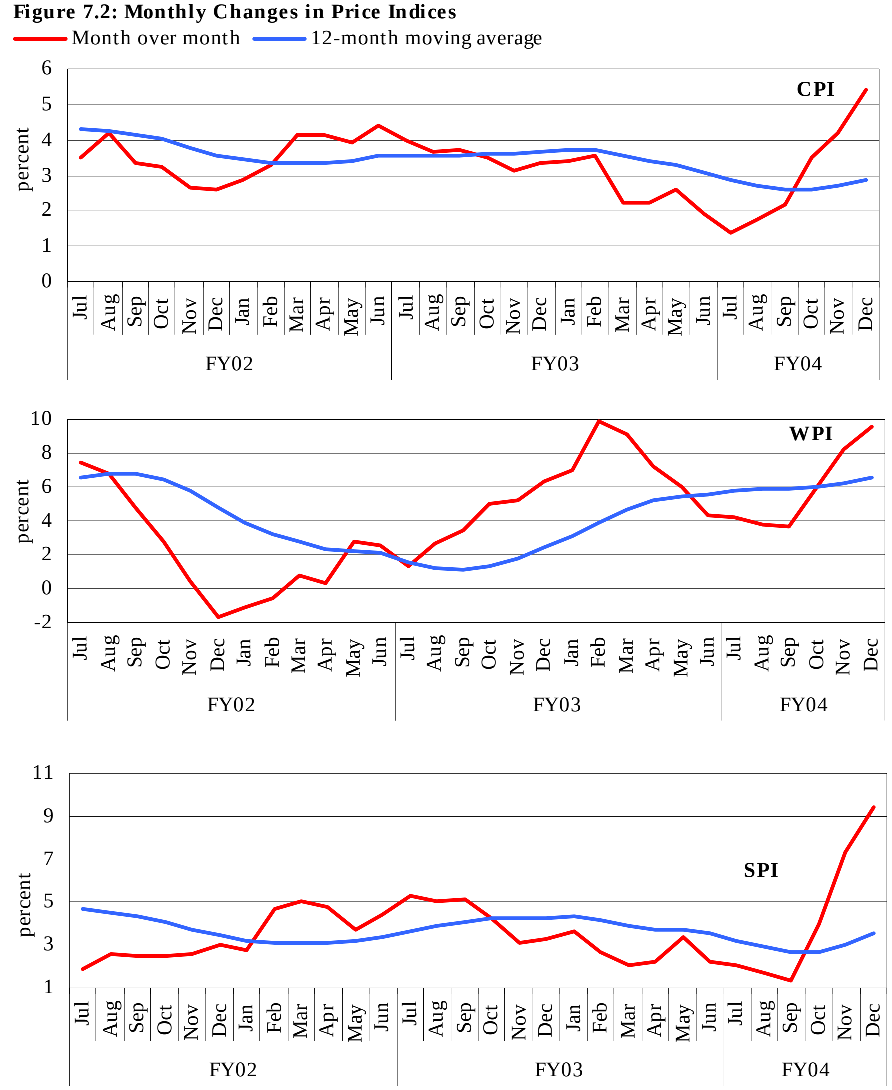


Figure 7.2: Monthly Changes in Price Indices



7.1.1 Food & Beverages

This sub-component of the CPI index depicted a sharp rise during Q2-FY04, pushing food inflation to its highest level for six years. As a result, the contribution of food inflation to annualized CPI inflation jumped back to the

August 2002 level of 35.7 percent by December 2003, after dipping sharply in Q1-FY04 (see **Figure 7.4**).

A glance at **Table 7.2** illustrates that much of the 9.0 percent food inflation in December 2003 was contributed by 24 items carrying a heavy weight in the food sub-index of the CPI, which easily offset even the price *deflation* in approximately 15 percent of the CPI food basket.

Key contributions to the sharp acceleration in *food inflation* stemmed from: (1) supply shortages (2) higher international prices; and (3) probably higher transportation cost in the case of rising prices of milk.

Figure 7.4: Annualized CPI Food Inflation

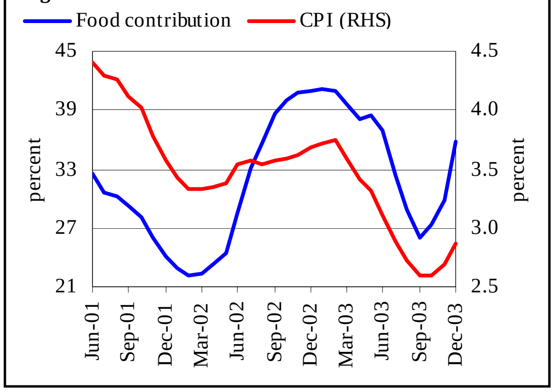


Table 7.2: Marginal (YoY) Food Inflation

percent

Range	Weights	No. of Items
Below 0%	5.855	26
0% - 2%	5.281	25
2% - 5%	8.775	16
5% - 9%	5.518	17
Above 9%	13.428	24
Total	38.856	108

Specifically, the supply shortages were observed in the case of wheat and some vegetables. Wheat and wheat products witnessed sharp surge mainly due to: (1) a 16.7 percent increase in support price of wheat for FY04 crop; (2) below target production in FY03; (3) depletion of stocks due to exports in the preceding two years; (4) withholding wheat supply by hoarders and speculators (helped by cheap credit availability); and (5) delay in import of wheat.

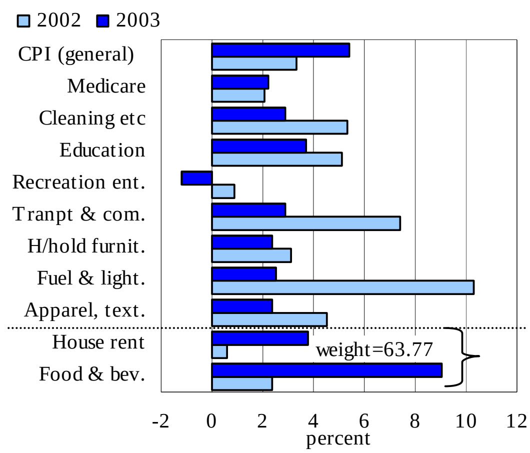
Another factor that contributed in the present *food* inflation is the price of meat. The external demand of beef and mutton is partly explained the rise in the prices of these items, while partly it is a function of the attitude of the domestic traders. The pricing policy of the traders is based on historical inflationary trend without considering that the rise in general price level is now moderated. There is a need to have some mechanism in place to address these inflationary expectations.[3] It may be noted that the present *food* inflation is largely due to supply shocks, rather than by easy monetary policy. Particularly, prices of minor crops are subject to large fluctuations while less volatile price structure assures maximization of utility and profits to both producers and consumers.[4]

7.1.2 Non-food

Although marginal (YoY) *non-food inflation* has been gradually moving up since July 2003, the December 2003 marginal *non-food* inflation remained significantly below the 3.9 percent recorded in December 2002 (see **Table 7.1**).

A disaggregated analysis of the December 2003 CPI inflation reveals that all sub-indices of *non-food* group witnessed YoY *deceleration* except *house rent* and *medicare* sub-indices, which saw an increase of 3.8 percent and 2.2 percent respectively (see **Figure 7.5**).

Figure 7.5: CPI Marginal Inflation (YoY) in December



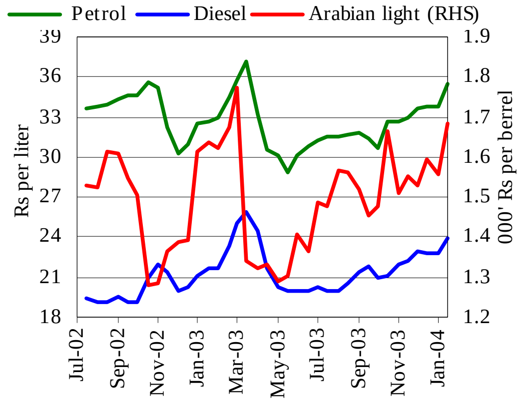
Sub-indices *fuel & lighting* and *transport & communication* recorded increases mainly due to (unanticipated) rising international oil prices (see

[3] It is important to note here that despite of low inflation rates, the higher SPI and CPI *food* inflation depicts that the incidence of present surge in inflation would be disproportionately more on low-income groups. Since this part of inflation is not mainly a result of easy monetary policy, government may take appropriate actions to halt the creation of inflationary spirals by not permitting imprudent rises in the prices of the essentials. For example, appropriate policy regarding wheat import, commodity operations; checks on hoarders and assurance of bulk supply may easily brought down the prices of wheat. Moreover, simply government cannot do micro management in a market-based system. People should come forward and establish Consumer Associations in line with other countries. In this way, no one can generate the artificial inflationary spirals.

[4] To minimize such volatility in the prices of minor crops some policy decisions are desirable. One option could be the establishment of future markets for crops may also help to smooth the prices by incorporating all information available with different economic agents. Indeed, here *too*, government has a role in facilitating the development of market structure, improvement in contract enforcement, etc.

Figure 7.6). *Fuel & lighting* sub-index is expected to show a deceleration in coming months mainly due to recently announced cut in the electricity charges, (the third in less than a year).

Figure 7.6: Arabian Light, Petrol and Diesel Prices



7.1.3 Incidence of Inflation

It is important to note that inflation erodes the purchasing power of different income groups disproportionately. Current surge in inflation has affected low-income group the most because of higher *food* inflation as this segment spends a larger proportion of their income on essential food items.

Table 7.3: Incidence of Marginal Inflation in December 2003
Percent

	Income groups (per month)				
	Up to Rs 3,000	Rs 3,001 to Rs 5,000	Rs 5,001 to Rs 12,000	Above Rs 12,000	CPI general
Food & beverages.	9.6	9.6	9.2	8.4	**9.0**
House rent	2.6	2.4	2.4	2.4	**2.4**
Apparel, text.	3.8	3.8	3.8	3.8	**3.8**
Fuel & light.	5.0	4.2	2.6	1.8	**2.5**
H/hold furniture.	3.0	2.4	2.2	2.5	**2.4**
Transport & communication	2.6	3.2	2.6	2.9	**2.9**
Recreation & entertainment	-0.5	-1.1	-1.1	-1.2	**-1.2**
Education	4.0	4.1	3.9	3.5	**3.7**
Cleaning etc	1.6	1.7	2.3	4.0	**2.9**
Medicare	2.3	2.3	2.2	2.1	**2.2**
CPI (general)	**6.5**	**6.3**	**5.7**	**4.9**	**5.4**

As evident in **Table 7.3** the various income groups experienced *food* and *overall* inflation in hierarchical order (from the lowest to the highest) during December 2003 over December 2002. Specifically, lower income group (upto Rs 3000) saw an inflation rate of 6.5 percent as against 5.4 percent average inflation for all income groups and the 4.9 percent inflation recorded for the highest income group (above Rs 12,000) in this period.

7.2 Wholesale Price Index (WPI)

Unlike the CPI profile, both *food* and *non-food* components of the WPI inflation witnessed acceleration during Q2-FY04 (see **Table 7.4**). Not only is marginal inflation accelerating, annualized WPI inflation also saw a sharp increase from 2.4 percent in December 2002 to 6.6 percent during December 2003.

Table 7.4: WPI Inflation in December
percent

	Marginal (YoY)		Annualized	
	2002	**2003**	**2002**	**2003**
Food	3.4	7.9	3.0	3.8
Non-food	8.4	11.0	2.7	8.6
Raw material	9.3	28.5	1.7	16.2
Fuel, lighting & lubricants	20.9	1.4	6.4	8.0
Manufactures	-0.2	11.3	0.4	5.7
Building material	1.3	18.5	0.9	8.7
WPI general	6.3	9.6	2.4	6.6

Source: Federal Bureau of Statistics.

While WPI *food* inflation is consistent with its CPI counterpart, WPI *non-food* component is higher as compared to CPI *non-food* inflation. This difference is an outcome of an upward movement in all WPI sub-indices during the current period, particularly sub-indices of *raw material* and *building material* witnessed a very strong surge in December 2003 both on marginal and annualized basis. The rise in the former was due to sharp increase in the cotton prices and hike in the latter sub-index is a reflection of higher international prices of iron & steel and strong domestic demand (largely on the back of increased construction activities, and high production of consumer durables).

7.2.1 Food

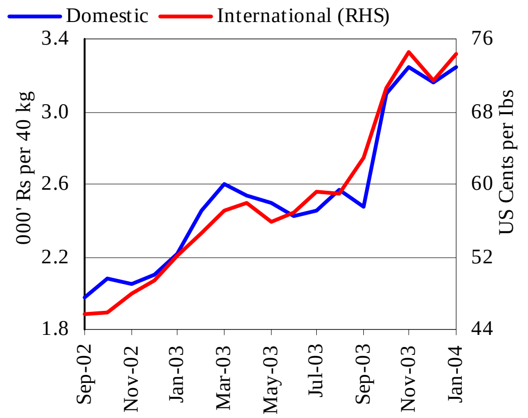
Marginal (YoY) *food* group inflation accelerated to 7.9 percent in December 2003, up from 3.4 percent in the corresponding period of 2002. The acceleration was on account of the steep rise in the prices of 24 out of 39 items in the WPI *food* basket. Significant increases during December 2003 over December 2002 were recorded in the prices of wheat, wheat flour, rice, jowar etc. However, the impact of these increases was partially offset by declines in the prices of gram split, potatoes, gur, sugar and spices.

7.2.2 Non-food

Non-food group annualized inflation witnessed a sharp increase of 8.6 percent in December 2003, mainly due to a 16.2 percent rise in the sub-index of *raw material*.

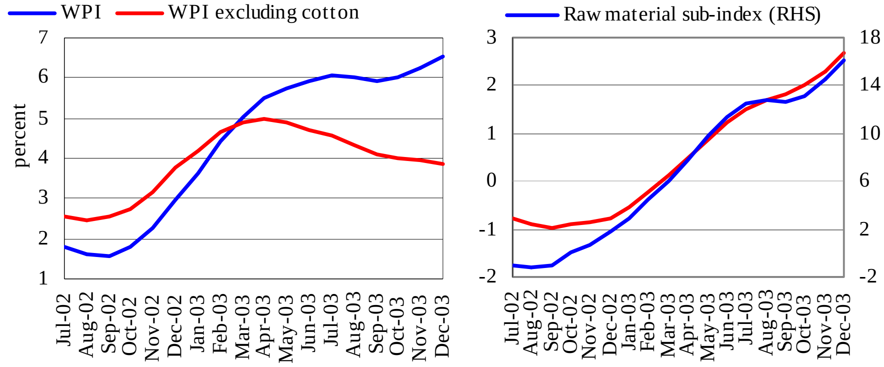
The increase in *raw material* index was mainly due to the rise seen in domestic cotton prices that continued to rally and reached over Rs 3000 per maund in October 2003 (the highest level in last two years) and remained above this level until January 2004 (see **Figure 7.7**).

Figure 7.7: Cotton-Lint Prices



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

Figure 7.8: Annualized WPI Inflation



The sharp rise in domestic cotton prices during the 2004 season owes largely to: (1) the fears of domestic production falling far below target (due to heavy rain in 2-cotton districts in early cropping period and viral attack later on in other districts); (2) higher international prices, as well as (3) strong export-based domestic demand.

The *building materials* sub-index continuing to rise in December 2003 over December 2002 mainly due to soaring prices of bricks (25.2 percent), iron bar &

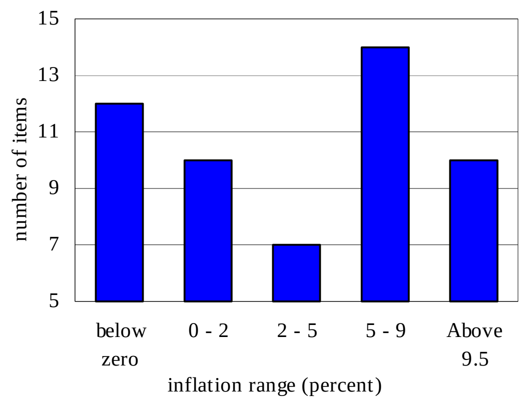
sheets (37.8 percent), timber (26.5 percent), and sanitary wares (4.5 percent). Clearly, the increased momentum of construction activities across the country (demand pull) as well as an increase in the import unit value of iron and steel products (cost push) is translating into higher construction costs. At the same time, banks' housing finance schemes are probably also contributing to higher construction demand as almost all major banks are offering loans for buying, construction and renovation of houses.

7.3 Sensitive Price Indicator (SPI)

Although SPI is compiled for four income groups, SPI inflation broadly shows the incidence of inflation on lower income group due to its specific coverage of 53 essential items of daily usage. Similar to CPI *food* inflation, SPI also witnessed acceleration in December 2003 over December 2002 and reached to 9.5 percent (see **Table 7.1**). On annualized basis, SPI inflation witnessed an increase of 3.5 percent in December 2003 compared with 4.4 percent in the corresponding period of 2002.

An item-wise analysis shows that only 10 items recorded increases above the average 9.5 percent YoY SPI inflation during December 2003 (see **Figure 7.9**). However these items account for about 25 percent weight in the SPI basket due to their importance in daily consumption. Similarly, only 7-items recorded increases between 2 – 5 percent in December 2003, however, due to inclusion of fresh milk and petrol in this range, their share in SPI inflation was registered at 31.9 percent.

Figure 7.9: SPI Inflation in Dec-03 (YoY)



This inflationary pressure was partially offset by a decline in the prices of 12 items with a smaller share of 13.8 percent in the basket.