# 3 Prices

## 3.1 Global Inflation Scenario

Inflationary pressures in the global economy remained strong during second quarter of FY08. Inflation in the US, UK, Euro area, Japan and China remained at a significantly higher level in January 2008 compared to January 2007. Inflationary pressures have also remained strong in the developing economies during the second quarter of FY08 (see **Table 3.1**).

**Table 3.1: Headline Inflation YoY**

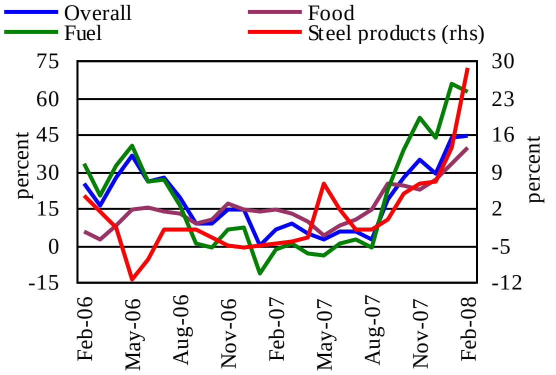
percent

| | Jun-07 | Sep-07 | Jan-08 |
|---|---|---|---|
| United States | 2.7 | 2.8 | 4.3 |
| Euro zone | 1.9 | 2.1 | 3.2 |
| UK | 2.4 | 1.8 | 2.2 |
| Japan | -0.2 | -0.2 | 0.7 |
| India | 6.1 | 5.7 | 5.5 |
| Bangladesh | 9.2 | 9.6 | 11.4 |
| Sri Lanka | 13 | 17.3 | 21.6 |
| China | 2.9 | 4.6 | 7.1 |
| Malaysia | 1.4 | 1.8 | 2.3 |
| Indonesia | 5.8 | 7.0 | 7.4 |
| Pakistan | 7.0 | 8.4 | 11.9 |

**Source:** IFS and statistical agencies of various countries

This was driven by reasonably strong growth in the global economy, which fueled a broad commodity market boom, particularly from emerging markets (see **Figure 3.1**). However, the most significant impetus to global inflation arguably came from the rise in energy prices, amid strong demand and supply concerns. Crude oil prices showed strong upward movements.

**Figure 3.1: World Commodity Price Indices Inflation (YoY)**




Source: IMF and World Bank

High energy prices also contributed indirectly to the rise in food prices, by spurring interest in bio-fuels, with attendant increase in the prices of key cereals. The impact of the latter was then compounded by production shocks to key crops, particularly for wheat and rice. Global inflationary pressures are likely to continue in months ahead. It is apparent from the rising core inflation (CPI excluding food and energy) in most of the economies (see **Table 3.2**).

**Table 3.2: CPI excluding Food and Energy* (YoY change)**

percent

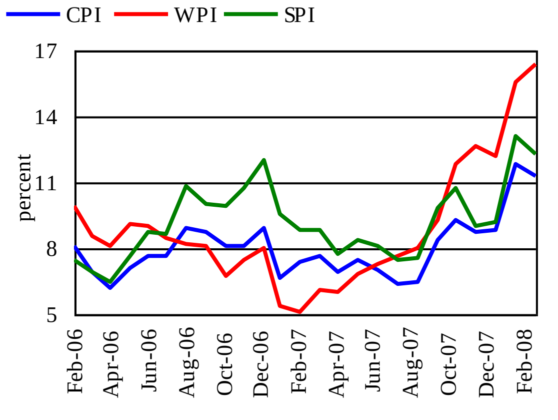
| | Jun 06 | Dec 06 | Jun 07 | Dec 07 |
|---|---|---|---|---|
| Australia | 1.8 | 2.3 | 2.5 | 2.8 |
| Korea | 2.0 | 2.2 | 2.5 | 2.6 |
| United States | 2.6 | 2.6 | 2.2 | 2.4 |
| Czech Republic | 1.8 | 1.6 | 2.7 | 4.1 |
| United Kingdom | 1.2 | 1.8 | 2.0 | 1.4 |
| Philippines | 5.8 | 4.6 | 2.5 | 2.6 |
| Thailand | 2.7 | 1.5 | 0.7 | 1.2 |
| South Africa | n.a | 3.8 | 5.7 | 7.8 |
| Pakistan | 6.5 | 5.7 | 5.7 | 7.2 |

* end month values
Source: OECD, statistical agencies & websites of various countries and FBS.

## 3.2 Domestic Scenario

Inflationary pressures in domestic economy have continued to mount throughout Jul-Feb FY08, with particularly sharp increases in the later months of the period (see **Figure 3.2**). Increasing inflationary pressures have persisted despite the central bank's efforts to contain the growth in aggregate demand. This reflects not only the stimulus from the expansionary fiscal policy but also the unanticipated strength of international commodity prices. The impact of high international food commodity prices was probably also aggravated by anti-competitive market structures and practices in the domestic market, as well as supply disruptions (see **Figure 3.2**).

**Figure 3.2 Inflation Trends (YoY)**




The dominant contribution of food prices is evident in all three inflation indices; the consumer price index (CPI), the wholesale price index (WPI), and the sensitive price indicator (SPI) (see **Table 3.3**). Indeed, the CPI food inflation (YoY) at 16.0 percent in February 2008 is significantly higher than the 10.0 percent seen in February 2007, though it came down from a peak of 18.2 percent in January 2008. The rise in the food inflation is now increasingly being supplemented by an acceleration in non-food prices. The latter is driven partly by high energy prices, but there is also evidence that the sustained rise in food and energy prices is engendering broad second round effects.

This view is supported by the sustained increase in both measures of core inflation since June 2007. On a YoY basis, NFNE (non-food non-energy) core inflation increased to 8.1 percent in February 2008 (the highest since November 2005) from 6.0 percent in February 2007. This uptrend in core inflation is supported by a rising house rent index (HRI) inflation during the past few months. Similarly, core inflation based on 20 percent trimmed-mean also recorded a rise and gained 3.1 percentage points during FY08 (see **Figure 3.3**).

The strength of inflationary pressures is largely due to rising international commodity prices (both food & fuel); as well as supply disruptions and market inefficiencies which can clearly be tackled through fiscal and administrative measures. However, given the evidence that these cost push inflationary pressures could generate second round inflationary cycle, continued monetary tightening was essential and guided the SBP decision to accentuate its monetary tightening.[1]

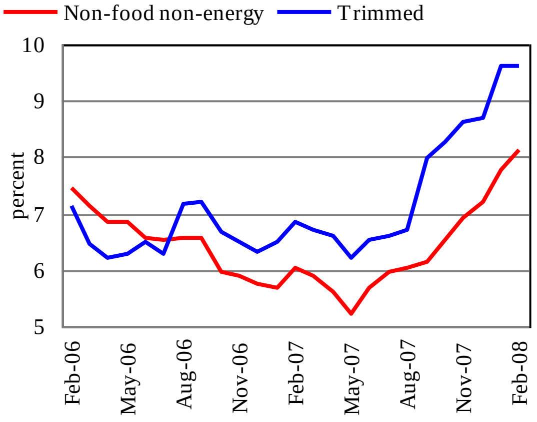
**Table 3.3: Inflation Trends**

percent

| | Year-on-Year[1] | | 12-month moving average[2] | |
|---|---|---|---|---|
| | Feb-07 | Feb-08 | Feb-07 | Feb-08 |
| **CPI** | 7.4 | 11.3 | 7.7 | 8.4 |
| *Food* | 10.0 | 16.0 | 8.7 | 12.1 |
| *Non-food* | 5.6 | 7.8 | 6.9 | 5.7 |
| **WPI** | 5.1 | 16.4 | 7.6 | 10.0 |
| *Food* | 8.7 | 18.3 | 7.5 | 13.5 |
| *Non-food* | 2.6 | 15.0 | 7.7 | 7.6 |
| **SPI** | 8.8 | 12.3 | 9.2 | 9.4 |
| **Core** | | | | |
| *NFNE*[3] | 6.0 | 8.1 | 6.4 | 6.4 |
| *Trimmed mean* | 6.8 | 9.6 | 6.6 | 8.2 |

[1]e.g., change in February 2008 over February 2007
[2]e.g., change in 12-month average of February 2008 over February 2007
[3]Non-food non-energy
Source: Federal Bureau of Statistics

**Figure 3.3: Core Inflation (YoY)**




[1] For details see Monetary Policy Statement for January to June 2008 at http://www.sbp.org.pk/m_policy/MPS-JAN-JUNE-FY08-EN.pdf

However, the monetary measures aimed at siphoning out the excess demand in the economy need to be supplemented by greater fiscal discipline, as well as administrative and policy measures to correct market distortions.

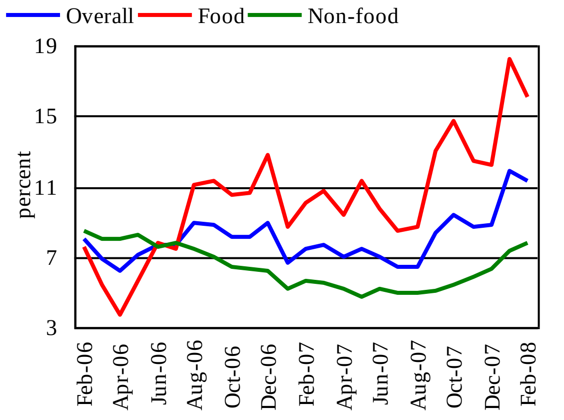
Ironically, the government has limited options to mitigate inflationary pressures through fiscal measures, given its shrinking fiscal space. Thus any subsidies need to be carefully targeted and should be limited in scope. Moreover, policy actions should not distort price signals, as these are essential to ensure investment and productivity increases needed to remove the shortages in future.

However, substantial gains can also be achieved through reforms aimed at reducing or eliminating anti-competitive practices and supporting investment in agricultural production, storage and transportation. The on-going boom in food commodity prices provides an incentive for investment on sustainable basis in the sector.

### 3.3 Consumer Price Index (CPI)

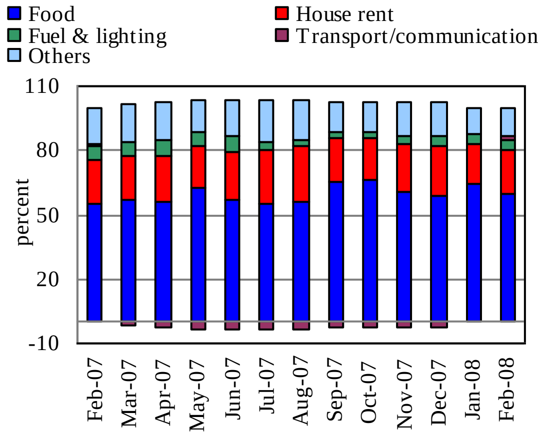
CPI inflation remained strong in the first eight months of FY08. CPI inflation (YoY) rose to 11.3 percent in February 2008 from 7.0 percent in June 2007. This upsurge was mainly due to a stubbornly high food inflation that has remained in double digits since September 2007. The pace of increase in non-food inflation has also accelerated in the past few months (see **Figure 3.4**).

**Figure 3.4: Consumer Price Inflation**




Due to persistent high food inflation, the contribution of food group in overall inflation has increased from 55.4 percent in February 2007 to 59.9 percent in February 2008 (see **Figure 3.5**). The high food inflation implies that it is hurting low income groups disproportionately. Although government is providing essential food items at subsidized prices through utility stores, a large segment of deserving population cannot avail this subsidy due to limited outreach of utility stores. Since food prices are likely to remain high in the medium to long-term, the targeted food subsidy program for low income groups needs to be revamped to be more effective. In addition, private sector's involvement is also necessary as it would be difficult for utility stores to cater all needy people. Moreover, there is an urgent need to increase the productivity of key food staples to ensure smooth domestic supply. It can be achieved through offering appropriate incentives to farming community, increase usage of fertilizer and certified seeds, as well as research and development to develop new high yield varieties.

**Figure 3.5: Weighted Contribution to CPI Inflation**




It is also important to note that frequency distribution of YoY change in the prices of items included in the CPI basket exhibits that number of items on extreme ends, i.e., showing YoY decline or no change and double digit rise, has increased in February 2008 compared to February 2007 (see **Table 3.4**). This phenomenon is more pronounced in CPI food group compared to the non -food group.

**Table 3.4: Distribution of Price Changes of CPI Basket (YoY)**

number of items

| Change in percent | Food group Feb-07 | Food group Feb-08 | Non-food group Feb-07 | Non-food group Feb-08 |
|---|---|---|---|---|
| 0 or less | 13 (5.2) | 20 (8.8) | 65 (8.2) | 71 (10.9) |
| 0 to 5 | 18 (8.0) | 8 (1.6) | 104 (12.6) | 69 (8.4) |
| 5 to 10 | 28 (4.1) | 12 (4.8) | 52 (28.8) | 75 (35.1) |
| 10 or above | 49 (22.9) | 68 (25.2) | 29 (10.1) | 35 (5.2) |
| **Total** | **108** | **108** | **250** | **250** |

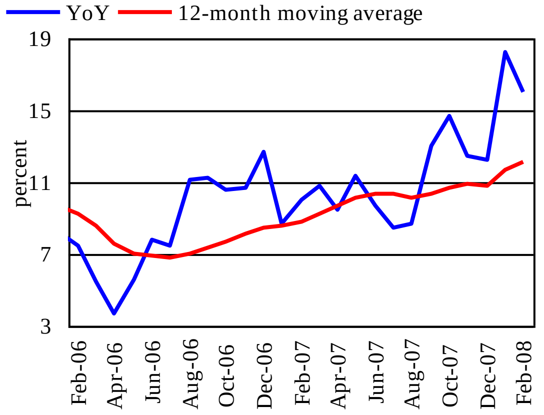
Note: Prices of 16 seasonal items were not reported during the months.

Values in parenthesis are weights.

### 3.3.1 CPI Food Inflation

CPI food inflation (YoY) started to strengthen since September 2007 and recorded at 16.0 percent in February 2008 after reaching to a local peak of 18.2 percent during January 2008; the highest level seen since April 1995 (see **Figure 3.6**). This persistence in CPI food inflation reflects the dynamics of international markets as well as factors specific to the domestic economy.

**Figure 3.6: CPI Food Inflation**




In the domestic markets, the prices of key staples including wheat, rice and edible oil have seen an uptrend throughout FY08. The rise in domestic wheat prices is mainly attributed to speculative hoarding done on the insufficient stocks position of the government. The low level of stocks impaired government's ability to intervene in the market to stabilize the prices. Moreover, since replenishment of government stocks needed import at substantially higher international prices, hoarders took advantage of the situation. As a result of supply shortages, domestic prices rose to record highs. It is also important to note that continued export of wheat flour to Afghanistan and illegal cross border movement of wheat further aggravated the supply shortages.

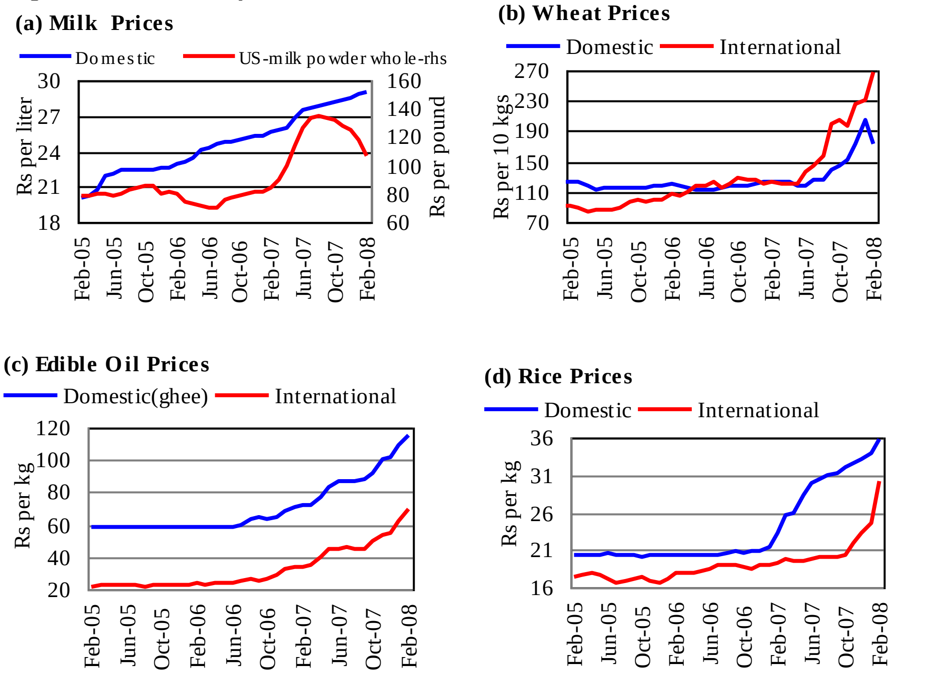
Also, a below-target FY08 rice harvest in Pakistan coupled with strong demand for Pakistani rice in the international market, has resulted in persistent pressure on domestic rice prices. Similarly, high international prices of edible oil has led to an increase in domestic vegetable ghee and oil prices as its production is based on imports from international market (see **Figure 3.7**). It is also important to note that while prices of wheat, edible oil and rice are following the trends of international prices, domestic milk prices are showing a secular uptrend despite a recent downtrend in international prices. This is

**Table 3.5: Top Ten Contribution to YoY CPI Inflation in February 2008 (Ranked by Weighted Contribution in percent)**

| | | YoY change | | Weighted |
|---|---|---|---|---|
| | **Items** | **Feb-07** | **Feb-08** | **Contribution** |
| 1 | House rent index | 6.3 | 10.0 | 20.7 |
| 2 | Vegetable ghee | 17.1 | 51.6 | 13.1 |
| 3 | Wheat flour | 3.3 | 25.3 | 11.2 |
| 4 | Milk fresh | 12.3 | 13.0 | 8.3 |
| 5 | Rice | 14.8 | 56.2 | 6.7 |
| 6 | Vegetables | -12.3 | 40.5 | 6.5 |
| 7 | Tomatoes | -45.8 | 190.9 | 4.5 |
| 8 | Readymade food | 9.4 | 17.2 | 2.8 |
| 9 | Natural gas | 1.7 | 9.7 | 2.6 |
| 10 | Cooking oil | 11.1 | 40.9 | 2.5 |
| | **Total** | | | **78.8** |

Note: Weighted contribution is estimated by multiplying the weights by the price change of an item; this is then reported as a share in YoY change in CPI, which is 11.3 percent in February 2008.

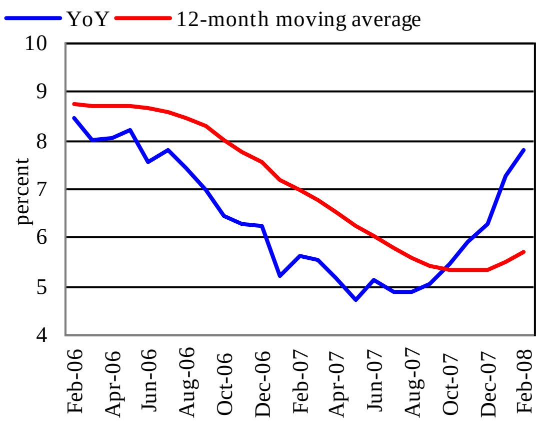
**Figure: 3.7:Commodity Prices**




mainly a reflection of (1) strong domestic demand, (2) an imperfect market structure, (3) lack of storage capacity, as well as (4) limited marketing network due to transportation problems.

It is important to note that the contribution of individual food items in the overall CPI inflation (YoY) has been significant as four out of top five items contributing in overall inflation during February 2008 were from the food group (see **Table 3.5**).

**Figure 3.8: CPI Non-food Inflation**




These items which have a cumulative weight of 15.8 percent include wheat flour, vegetable ghee, fresh milk and rice. These food items contributed half of the overall CPI inflation during February 2008.

### 3.3.2 CPI Non-Food Inflation

In comparison to CPI food inflation (YoY), CPI non-food inflation exhibited a relatively moderate increase in the first eight months of FY08. The YoY CPI non-food inflation rose to 7.8 percent in February 2008, bouncing back from 4.7 percent in May 2007 (see **Figure 3.8** and **Table 3.6**). The recent upsurge in non-food inflation is mainly due to an increase in non-food sub-groups including *house rent, fuel & lighting* and *household furniture & equipment*.

**Table 3.6: CPI Non-food Inflation by Groups** (YoY in percent)

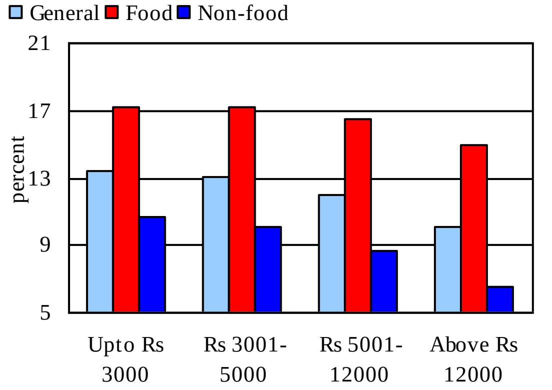
| | Weights | Feb-07 | Jul-07 | Sep-07 | Nov-07 | Dec-07 | Jan-08 | Feb-08 |
|---|---|---|---|---|---|---|---|---|
| **Non-food group** | **59.7** | **5.6** | **4.9** | **5.0** | **5.9** | **6.3** | **7.3** | **7.8** |
| Apparel, textile & footwear | 6.1 | 6.2 | 7.4 | 7.6 | 8.7 | 8.7 | 8.6 | 6.7 |
| House rent | 23.4 | 6.3 | 6.9 | 7.5 | 8.3 | 8.8 | 9.5 | 10.0 |
| Fuel & lighting | 7.3 | 6.5 | 2.6 | 2.7 | 4.8 | 5.5 | 7.4 | 6.2 |
| Household furniture | 3.3 | 7.5 | 6.2 | 6.3 | 5.9 | 6.5 | 6.1 | 6.3 |
| Transport & communication | 7.3 | 0.9 | -3.1 | -3.1 | -3.1 | -3.0 | -0.3 | 3.0 |
| Recreation & entertainment. | 0.8 | -0.1 | 0.0 | 0.0 | 0.3 | 0.4 | 0.5 | 0.7 |
| Education | 3.5 | 8.3 | 6.2 | 4.8 | 4.3 | 4.4 | 4.3 | 3.4 |
| Cleaning, laundry and others | 5.9 | 4.5 | 5.0 | 6.5 | 8.8 | 8.9 | 10.1 | 13.0 |
| Medicare | 2.1 | 9.3 | 14.0 | 7.8 | 7.9 | 7.6 | 7.5 | 7.9 |
| **Headline** | **100** | **7.4** | **6.4** | **8.4** | **8.7** | **8.8** | **11.9** | **11.3** |

It is important to note that inflation recorded by the *house rent index* sub-group has maintained a rising trend throughout FY08 and reached 10.0 percent (YoY) in February 2008 compared to 6.3 percent in the same month last year. This is mainly because of higher prices of bricks (reflecting higher input costs and wage pressures), iron bars & sheets and wires & cables (a consequence of high global metal prices). Despite a substantial upsurge in international oil prices, the government had imposed a freeze on the prices of key POL products during the period under review. Nevertheless, the impact of high international prices has been witnessed in rising prices of furnace oil and various petroleum products, as their prices are directly linked with international prices. The recent upward adjustment in the prices of key fuels during March 2008 would also likely to strengthen the inflationary pressures in the economy.

### 3.3.3 Incidence of Inflation

The contribution of food inflation in overall CPI remained high in the first eight months of FY08, which resulted in a larger incidence of inflation on the low-income groups where food staples typically account for a greater proportion of total expenditure (see **Figure 3.9**). Thus in February 2008, the lowest income group (income up to Rs 3000 per month) and middle income group (income Rs 3001 – 5000 per month) witnessed highest inflation of 13.4 and 13.0 percent respectively, followed by 12.0 percent in upper-middle income group (Rs 5001 – 12000) and 10.1 percent for the highest income group (with income above Rs 12000 per month). Food inflation for the lower-middle income group (Rs 3001 – 5000 per month) was the highest, showing that this group is more vulnerable given constraints to avail targeted subsidy through utility stores compared to low income group. This suggests that the government food subsidy program should also consider a part of this group with the lowest incomes with the people eligible under *bachat* card scheme (zakat recipients). Similarly, non-food inflation was higher than overall non-food inflation in lower and two middle income groups in February 2008.

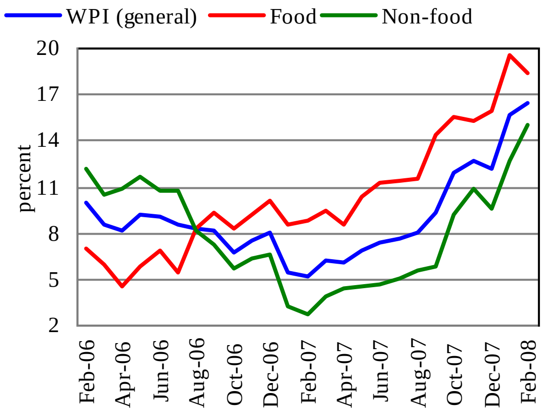
**Figure 3.9 : Incidence of CPI Inflation (YoY) February 2008**




## 3.4 Wholesale Price Index (WPI)

WPI inflation has remained in double digits since October 2007 principally driven by rising international commodity prices. Both, food and non food groups contributed to the rise in WPI inflation. In February 2008, WPI inflation (YoY) exhibited a steep rise and was recorded at 16.4 percent – the highest since February 1995. In particular, WPI food inflation exhibited a sharp rise and was recorded at 18.3 percent in February 2008 mainly due to a continuous

**Figure 3.10: Wholesale Price Inflation (YoY)**



increase in the prices of food items like rice, maize, vegetable ghee, wheat, fresh milk and cooking oil. Non-food WPI inflation also accelerated to 15.0 percent in February 2008 compared to only 2.6 percent during the same month last year (see **Figure 3.10**).

However, the contribution of food inflation came down to 47.3 percent in February 2008 as compared to 69.9 percent in the same month last year. Accordingly, the contribution of non-food group was recorded at 52.7 percent in February 2008 compared to 30.1 percent in the same month last year. The reason behind the decline in contribution of food group in WPI inflation is a relatively steeper rise in non-food inflation as well as higher weight of non-food in WPI basket (i.e., 57.9 percent). Therefore the impact of non-food WPI inflation is more pronounced in terms of weighted contribution. Within non-food group the weighted contribution of various sub-groups exhibited mixed trends. The weighted contributions of raw material, manufactures and building material sub-groups came down whereas the contribution of fuel, lighting and lubricant sub-group moved up in February 2008 (see **Table 3.7**).

**Figure 3.11: WPI Non-Food Group Inflation-YoY**

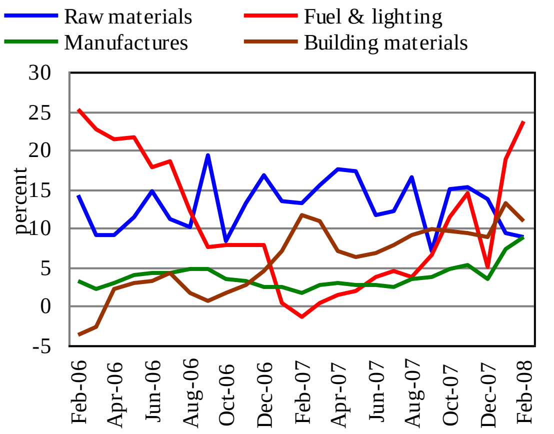



**Table 3.7: Contribution of Sub-indices to WPI Non-food Inflation** (in percent)

| | Feb-07 | Jun-07 | Jan-08 | Feb-08 |
|---|---|---|---|---|
| Raw materials | 62.3 | 31.4 | 10.0 | 8.1 |
| Fuel, lighting & lubricants | -22.0 | 34.9 | 60.4 | 64.0 |
| Manufactures | 22.9 | 21.4 | 20.9 | 21.9 |
| Building materials | 36.5 | 12.1 | 8.7 | 6.4 |

In case of WPI non-food group, components of all sub groups showed uptrend during the first eight months of FY08 except *raw material* sub group (see **Figure 3.11**). The WPI inflation for *fuel, lighting & lubricants* sub-group witnessed a sharp increase and witnessed a rise of 23.5 percent in February 2008. Within this group, coke, mobil oil, furnace oil, fire wood and coal witnessed double digit (YoY) growth.

The wholesale prices of *manufactures* sub-group also displayed significant YoY growth during FY08 and reached at 8.8 percent in February 2008 compared to 1.6 percent during the same month last year. Fertilizers, chemicals, footwear, soaps, plastic products and sole leather experienced double digit YoY growth in their wholesale prices. The *building material* also reflected uptrend during the first eight months of FY08 and reached 10.9 percent in February 2008 mainly due to the historic high metal prices coupled with an increase in the labor wages and bricks prices. The average YoY WPI inflation under *raw material* sub-group decelerated and depicted a lower growth of 8.9 percent during February 2008 compared to 13.1 percent inflation during the same month of 2007.

**Figure 3.12a: Fertilizer Prices (YoY change)**

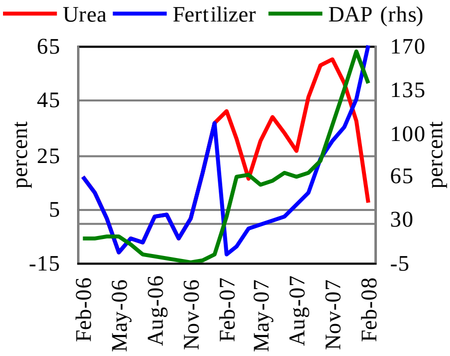
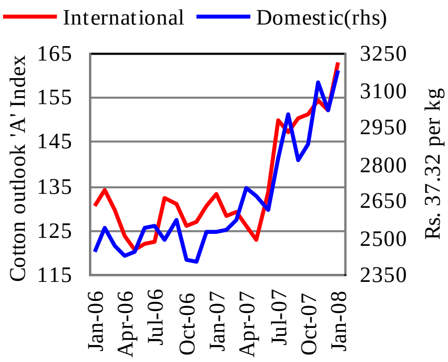



**Figure 3.12b: Cotton Prices**




Source: FBS, IMF and World Bank

In non-food group, the upward movement in international prices of DAP, urea and cotton were also reflected in the domestic wholesale prices of these commodities (see **Figure 3.12)**. During the past few months, DAP and urea prices have continuously been rising due to a strong demand and sharp increase in the cost of phosphate rock in the international market. Phosphate rock is a dominant raw material input for the production of phosphate fertilizers. Therefore, an increase in its price has led to high domestic fertilizer prices. Similarly, both domestic as well international cotton prices have also been on a rising trend mainly due to decline in FY08 harvest in major cotton producing countries.

### 3.5 Sensitive Price Indicator

The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items, e.g., petrol and diesel). The SPI inflation (YoY) accelerated to 12.3 percent in February 2008 as compared to 8.8 percent in February 2007. Similarly, the weekly SPI showed acceleration and was recorded at 15.7 percent in the second week of March 2008 compared to 12.5 percent in the last week of January 2008. Increase in weekly SPI inflation is mainly due to an increase in the prices of essential items like wheat, rice, LPG, vegetable ghee.

**Figure 3.13: Weekly SPI Inflation**