

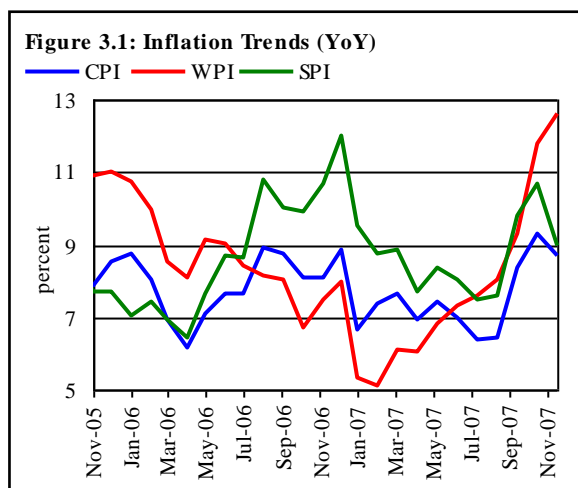
## 3 Prices

### 3.1 Overview

Inflationary pressures remained strong in the economy principally due to high international commodity prices (both food and energy) and continued strength of domestic demand. This is clearly captured in the uptrend visible in all price indices in recent months (see **Figure 3.1**).

The uptrend in the headline Consumer Price Inflation (CPI) during the past few months (see **Table 3.1**) is largely a result of continued rising prices of key food staples - the inflation in CPI food components hit a 30-month high of 14.7 percent in October 2007 before it slowed down in November to 12.5 percent. While CPI non-food has also been trending up, in November 2007 it was still lower than in November 2006.

In contrast with CPI, the WPI non-food group inflation saw accelerated growth in November 2007. This divergence between the trends in CPI and WPI non-food



**Table 3.1: Inflation Trends**

	Year-on Year <sup>1</sup>		12-month moving average <sup>2</sup>	
	Nov 06	Nov 07	Nov 06	Nov 07
<b>CPI</b>	8.1	8.7	7.9	7.6
Food	10.6	12.5	8.1	10.8
Non-food	6.3	5.9	7.7	5.3
<b>WPI</b>	7.5	12.6	8.7	7.9
Food	9.1	15.3	7.1	11.2
Non-food	6.3	10.7	9.9	5.5
<b>SPI</b>	10.7	9.0	8.5	9.0
<b>Core</b>				
NFNE <sup>3</sup>	5.9	6.9	6.8	5.9
Trimmed Mean	6.5	8.6	6.7	7.1

<sup>1</sup> e.g. change in November 2007 over November 2006

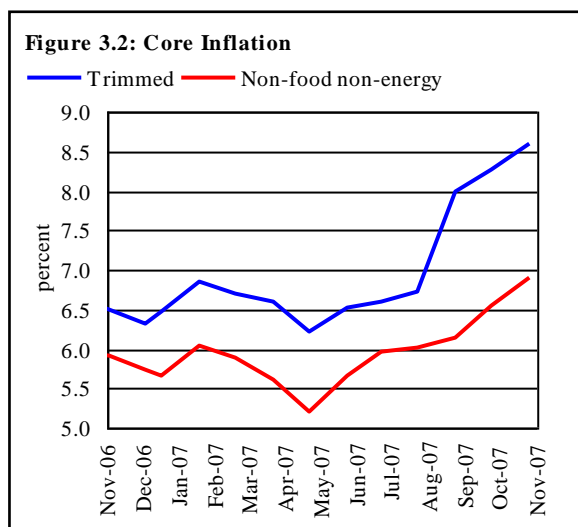
<sup>2</sup> e.g. change in 12-month moving average of November 2007 over November 2006

<sup>3</sup> Non-food non-energy

Source: Federal Bureau of Statistics

components simply reflects differences in the composition of the two indices and does not signal divergence in the underlying inflationary pressures.<sup>1</sup>

The impact of persistent strong increases in the prices of food and energy is now increasingly evident in the core inflation as well. Since June 2007 both measures of core inflation (i.e. *non-food non-energy* and 20% *trimmed mean*) have been trending up (see **Figure 3.2**). In other words, after resisting throughout FY07, the prices of a broader range of CPI basket is now being impacted by the cost push of high commodity prices, as suppliers of goods and services increased prices to protect margins. The risk of such a “second round” inflationary spiral was highlighted in the Monetary Policy Statement issued in July 2007.



The fact that inflation in recent months had been driven by supply-side factors such as food and energy prices has given rise to a debate over the need for monetary tightening. However, the emergence of a broader inflationary spiral in Pakistan as a result of the high commodity prices suggests that a tight monetary stance remains appropriate in order to contain further spread of inflationary pressures into the broader economy.

At the same time, a moderation in food inflation is desirable, as increases in food prices can have substantial adverse impacts on low-income groups. While government is providing some relief by the provision of key staples at subsidized rates through utility stores, its options for broader relief are, in the short-term, limited and involve challenging trade-offs.

<sup>1</sup> The difference is because a freeze on the prices of some fuels, that form part of the CPI basket, has helped contain CPI non-food inflation so far. On the other hand, the prices of some other fuels (e.g., furnace oil) and a number of petroleum products (e.g., lubricants), in the WPI basket are not regulated, and are therefore sensitive to international prices of POL. Moreover, the *raw material* sub-index of WPI also reflects the impact of rising international prices of commodities such as cotton, edible oil and metals that are not in the CPI basket.

- (1) Any substantial subsidies involve fiscal costs as well as problems in ensuring that it goes only to the vulnerable. For example, traders have the incentive to purchase goods at subsidized rates for re-sale at market prices.
- (2) Subsidies can also raise allocation inefficiencies. Inappropriate subsidies may destroy the economic incentives for producers ensuring that shortages persist for years.

More sustainable and effective medium term policies are needed. These include measures to enhance productivity, encouraging market competition, and increasing investment in food processing and storage, etc.

It should also be remembered that the domestic economy is now more open and prone to external shocks than ever before. This has important policy implications going forward. First, domestic prices will be more sensitive to the changes in international prices, despite the domestic availability. For example, Pakistan has sufficient exportable surplus of rice, however following a rise in the international prices of rice, domestic prices also increased. Second and more importantly, the difference between farm gate and import prices have to be narrowed in order to provide incentives to farmers. This is probably the only way to ensure sustainable productivity gains and smooth supply of agri-produce in medium to long-run.

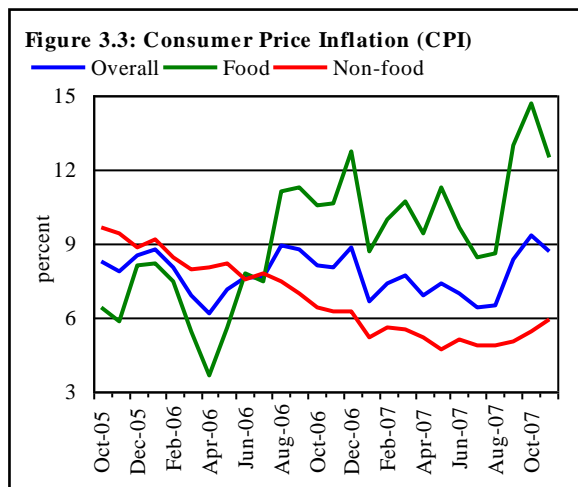
The emphasis on such medium-to-long term policies is particularly needed in light of the estimates given by Food and Agriculture Organization (FAO) and OECD. According to their estimates food prices will continue to increase between 20 to 50 percent over the next decade, from the average levels of the last ten years.

### **3.2 Consumer Price Index**

Despite evident volatility during the preceding two fiscal years, CPI inflation was largely trending downward and remained in the range of 6-9 percent. In contrast, headline CPI inflation resurged sharply in FY08 to reach 9.3 percent in October, the highest level in the preceding 29 months. The CPI inflation then dropped a little in November 2007 to 8.7 percent (YoY), but even this is quite high. Non-food inflation exhibited a more stable trend, but it too has begun to rise in recent months. In fact, CPI inflation (YoY) moved up by 2.3 percentage points during July-November 2007 principally driven by a rise of 4.0 percentage points in food inflation during July-November 2007 (see **Figure 3.3**).

As a result of significantly high food inflation, the contribution of the food group to overall CPI inflation increased from 54.5 percent in November 2006 to 60.9 percent in November 2007. However, it is important to note that the current

inflationary episode is not broad based. The concentration of inflation in fewer items can also be judged from **Table 3.2** that reveals that about two-thirds of overall CPI inflation is contributed by the top 5 items, representing around 40 percent of the CPI basket. Similarly, about 75 percent of food inflation during November 2007 is contributed by only four items; wheat flour, ghee, milk and rice (see **Figure 3.4**).



It is also important to note that the rise in the domestic prices of wheat, oil, rice and vegetables is likely to dissipate after recovery in global output and domestic supply. However, pressures on the prices of edible oil and dairy products are likely to be sustained going forward. Therefore, policy responses are needed to increase the levels of domestic production and productivity of these items.

**Table 3.2: Top Ten Items Contributing to YoY CPI Inflation in November 2007**  
percent

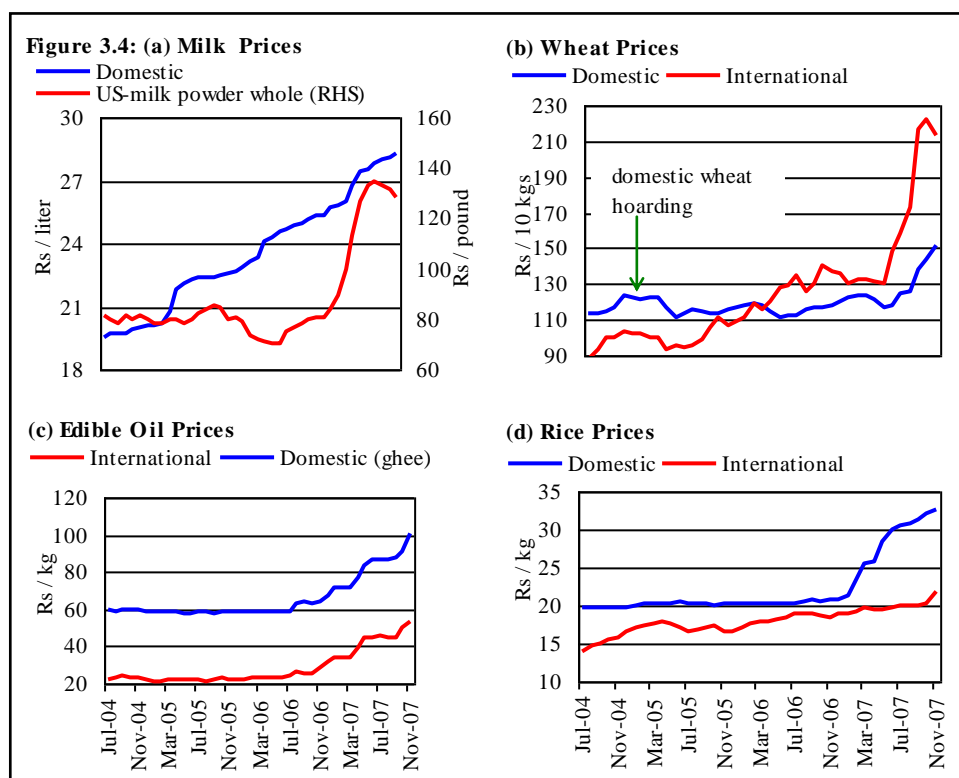
Items	YoY change		Weighted Contribution
	Nov 06	Nov 07	
1 House rent index	6.6	8.3	22.2
2 Wheat flour	1.9	24.7	14.1
3 Vegetable ghee	7.4	46.1	14.1
4 Milk fresh	11.9	12.6	10.2
5 Rice	2.8	56.6	7.9
6 Electricity	0.0	10.1	3.9
7 Fresh fruits	-3.1	17.0	3.1
8 Vegetables	13.7	9.4	2.5
9 Footwear	2.8	18.6	2.5
10 Cooking oil	4.9	33.1	2.5
<b>Total</b>			<b>83.2</b>

In contrast to food inflation, the CPI non-food group witnessed a lower YoY increase of 5.9 percent during November 2007 compared with 6.3 percent in the corresponding month of 2006. However, non-food inflation also bottomed out in May 2007 and saw an uptrend in recent months. This reversal in trend is mainly a result of a significant rise in the prices of a few items (such as house rent index, gas cylinder, toilet soap etc) in November 2007 relative to August 2007. However, the second round impacts of persistent rise in food and fuel prices are gradually emerging. In addition, a rise in utility charges (electricity and gas) from January 2008 would mount pressures on non-food inflation in months ahead.

Table 3.3: Distribution of Price Changes of CPI Basket, November 2007 (YoY)

Groups	% Changes	No. of Items				
		Total	(0 % or less)	(0 - 5%)	(5 - 10%)	(over 10%)
<b>I. Food Group</b>	<b>12.5</b>	<b>112</b>	<b>22</b>	<b>9</b>	<b>25</b>	<b>56</b>
<b>II. Non-Food Group</b>	<b>5.9</b>	<b>250</b>	<b>70</b>	<b>83</b>	<b>70</b>	<b>27</b>
Apparel, textile & footwear	8.7	42	2	17	19	4
House rent	8.3	1			1	
Fuel & lighting	4.8	15	7		2	6
Household furniture	5.9	44	2	15	25	2
Transport & com.	-3.1	43	22	13	6	2
Recreation & entertainment	0.3	16	10	3	1	2
Education	4.3	24	8	8	6	2
Cleaning, laundry	8.8	36	1	19	9	7
Medicines	7.9	29	18	8	1	2
<b>Overall</b>	<b>8.7</b>	<b>362</b>	<b>92</b>	<b>92</b>	<b>95</b>	<b>83</b>

Note: Prices of 12 seasonal food items were not reported during the month.



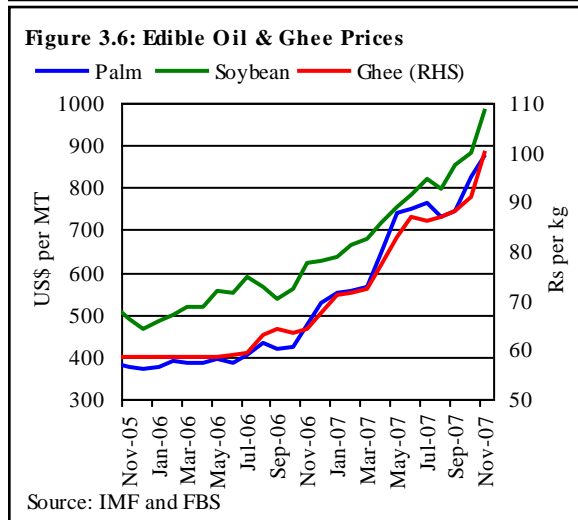
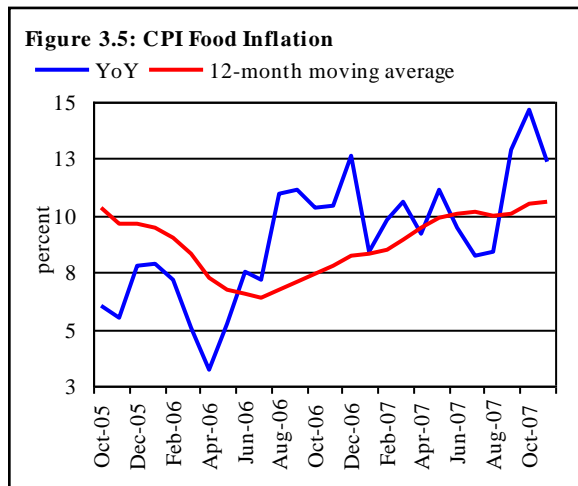
The data presented in **Table 3.3** reinforces the view that non-food inflation is quite narrow based. Only about 11 percent of items in this sub-group registered double digit rise in their prices compared with 50 percent of commodities in food group during November 2007.

### CPI Food Inflation

The growth in CPI food inflation slowed to 12.5 percent in November 2007 but still it is significantly higher than the 10.6 percent for the same month last year. The recent surge in CPI food inflation started from April 2006 and reached to 14.7 percent YoY during October 2007 (see **Figure 3.5**) the highest level seen since April 2005. This acceleration in food inflation is primarily due to rising international food commodity prices.

International food prices remained firm and showed an average inflation of 11.1 percent in FY07 mainly on account of shortage of supply and strong demand in the global commodity markets. Developments in the bio-fuel sector are partly responsible for the transformation of the global agricultural market.

Large quantities of traditional food/feed crops have been diverted for producing renewable energy in the form of bio-ethanol to be blended with petrol, and bio-fuel. As a result, international commodity prices of edible oil in particular are steadily increasing. Since Pakistan is dependent on imported edible oil, the rise in the prices is clearly reflected in the domestic prices of edible oil products (see **Figure 3.6**).



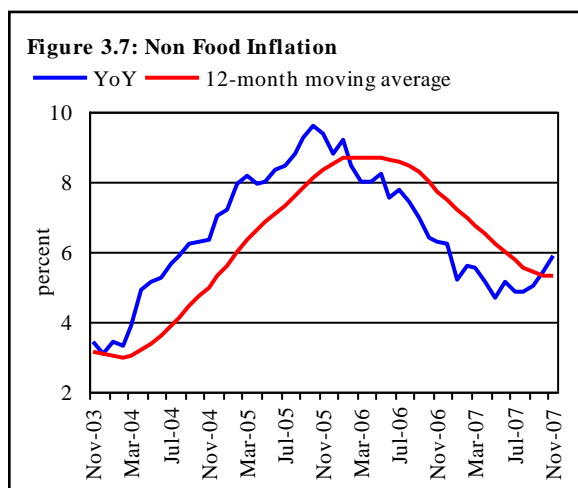
Wheat prices are also rising due to declining inventories as a result of poor crop in some major wheat exporting countries, e.g. Australia and Canada. There is also an upward pressure on rice prices due to increased demand of Pakistani rice as Indian rice has become costlier.

### ***CPI Non-food inflation***

Non-food inflation though bottomed out in May 2007 and reached to 5.9 percent in November 2007 from 5.4 percent in the preceding month. Nonetheless, despite the recent uptrend, the November 2007 figure is still lower than the 6.3 percent registered in November 2006 (see **Figure 3.7** and **Table 3.4**). The recent acceleration in non-food inflation was mainly due to the increases in *apparel & textile, house rent index, fuel & lightening and cleaning & laundry* sub-groups. However, increase in the contribution of latter sub-group was more pronounced (see **Figure 3.8**).

It is important to note that a freeze on the prices of key fuels by the government (despite a substantial rise in international oil prices) helped contain significant part of inflationary pressures in the economy. At the same time, prices of a number of other petroleum products<sup>2</sup> are increasing in tandem with international oil prices, which are indirectly impacting prices of a number of commodities.

<sup>2</sup> e.g., furnace oil, tar from coal, petroleum jelly & wax, lubricants, machine/engine oil etc.



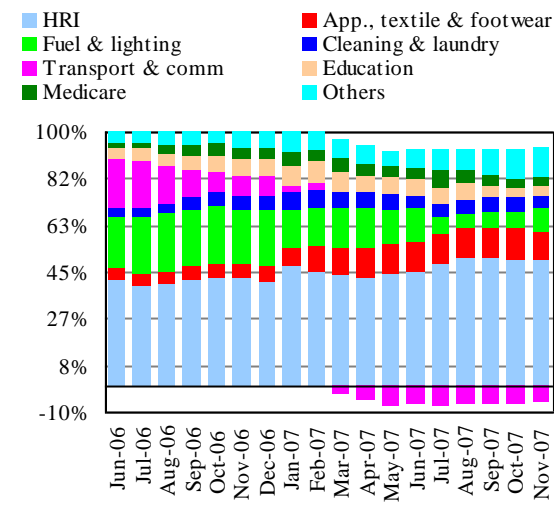
**Table 3.4: CPI Non-food Inflation (YoY) by Groups FY08**

	Weights	Aug	Sep	Oct	Nov
<b>Non-Food Group</b>	<b>59.7</b>	<b>4.9</b>	<b>5</b>	<b>5.4</b>	<b>5.9</b>
Apparel, textile	6.1	7.5	7.6	8.2	8.7
House rent	23.4	7.2	7.5	7.8	8.3
Fuel & lighting	7.3	2.2	2.7	3.1	4.8
Household furniture	3.3	6.6	6.3	6.3	5.9
Transport & com.	7.3	-3	-3.1	-3.1	-3.1
Recreation & entert.	0.8	0	0	0.3	0.3
Education	3.5	6.2	4.8	4.2	4.3
Cleaning, laundry	5.9	5.1	6.5	8.3	8.8
Medicare	2.1	9.8	7.8	7.9	7.9
<b>Overall CPI</b>	<b>100</b>	<b>6.5</b>	<b>8.4</b>	<b>9.3</b>	<b>8.7</b>

### 3.3 Income Group-wise Inflation

The low income groups suffered due to stubbornly high food inflation in recent months since a dominant share of their income is allocated to essential food items. In November 2007, the lowest income group (income up to Rs 3000 per household per month) witnessed higher inflation of 10.1 percent compared to average CPI inflation, followed by 10.2 percent and 9.4 percent for the two middle income groups (see **Figure 3.9**). The highest income group (with income above Rs 12,000 per month) witnessed lower than average inflation in November 2007. This mainly represents a rise in the cost of cotton textiles, footwear and cleaning and laundry in November 2007.

**Figure 3.8: Contribution in Non-food Inflation**

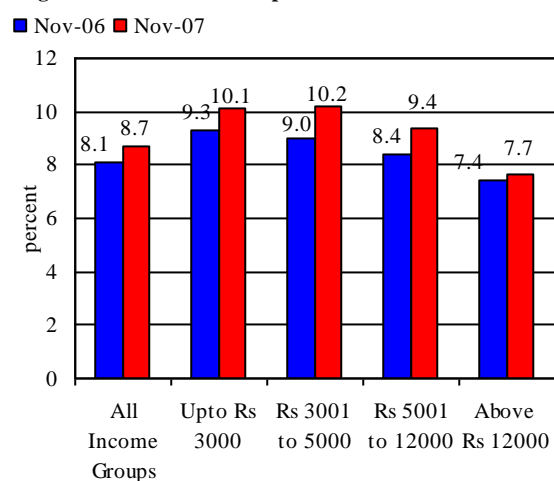


### 3.4 Wholesale Price Inflation

Wholesale Price (WPI) inflation continued an upward trend through the first five months of FY08, reaching 12.6 percent YoY in November 2007, the highest since July 2004. This acceleration was attributed to both the food and non-food components of WPI inflation (see **Figure 3.10**).

WPI food inflation accelerated to 15.3 percent in November 2007 compared with 9.1 percent of the same month last year. The WPI non-food sub-

**Figure 3.9: Income Groupwise CPI Inflation**



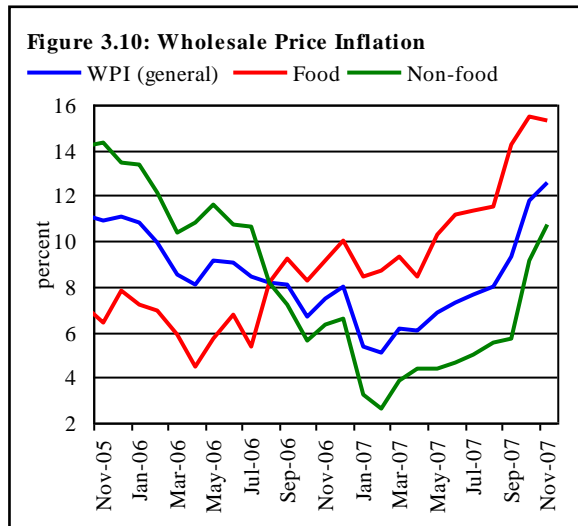


group also increased sharply and jumped to 10.7 percent in November 2007 from 6.3 percent in November 2006.

The opposite trend of non-food inflation in CPI and WPI is principally attributed to (1) increases in the cost of raw material pushed up WPI non-food inflation in recent months. Its impact on CPI non-food will be transmitted gradually. The major increases in the raw material sub-index were recorded by cotton, metal, edible oil and hides; and (2) Increase in fuel and lighting sub-index of WPI is more pronounced than CPI.

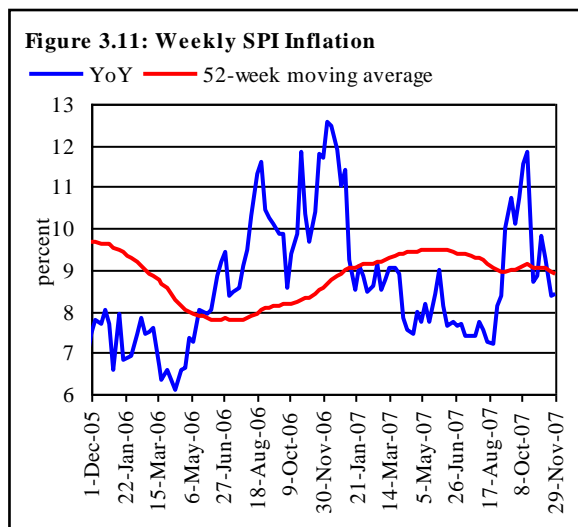
On the one hand, the

Government is sheltering consumers by providing substantial subsidy in the wake of rising international oil prices and on the other, prices of a number of items in WPI fuel & lighting are increasing with international prices of oil. Therefore, WPI fuel & lighting sub-group is showing a higher increase of 11.3 percent in October 2007.



### 3.5 Sensitive Price Indicator

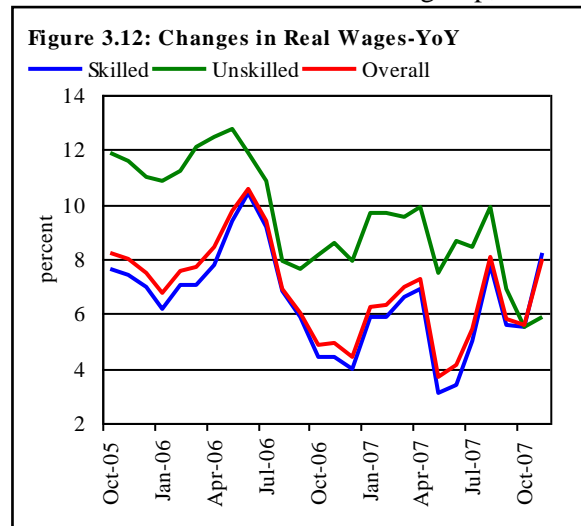
The weekly Sensitive Price Indicator (SPI) inflation (YoY) on average, increased considerably from 7.7 percent in the last week of FY07 to 8.4 percent by the end of November 2007. Similarly, the long-run trend in weekly SPI inflation, indicated by the 52 week moving average, also remained high, around the 9 percent mark, throughout the first four months of the current fiscal year (see **Figure 3.11**). This is mainly because almost



60 percent of the items included in the SPI basket are from the food group, and food inflation remained generally high in FY08.

### 3.6 Wage Inflation<sup>3</sup>

The growth in real wages accelerated during the initial months of FY08 after decelerating during the final months of FY07. However the acceleration is more pronounced in case of real wages of skilled workers and recorded an increase of 8.2 percent YoY in November 2007 compared to 4.4 percent in the same month last year (see **Figure 3.12**).



The city-wise wage inflation data reveals that in general Bahawalnagar, Khuzdar, Abbottabad, Mianwali and Faisalabad remained amongst the high nominal wage-inflation cities and these cities recorded between 10 to 21 percent YoY inflation in November 2007. On the other hand Okara, Sargodha, Larkana, Nawabshah and Jehlum remained amongst the cities with low YoY wage inflation during the period under review.

<sup>3</sup> This section is based on the wages for the skilled and unskilled *construction* workers only.