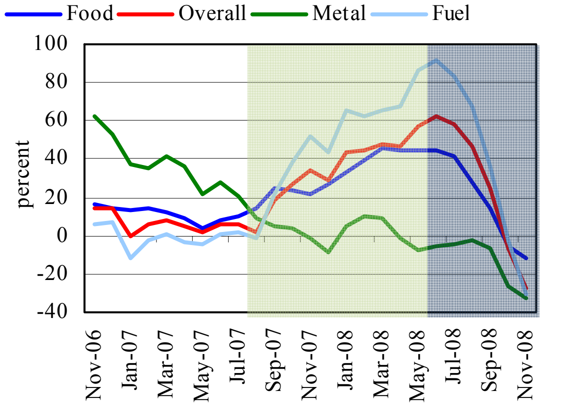
3 Prices

3.1 Global Inflation Scenario

After touching record highs, international commodity prices have retreated sharply since June 2008[1] (see **Figure 3.1** and **Box 3.1**) primarily due to global recession. Other factors that have led to the easing of commodity prices in international markets include: (a) appreciation of US dollar against almost all major currencies, (b) improved outlook for food commodity supplies, (c) significant reduction in shipment costs, as well as, (d) removal of trade barriers by some countries imposed earlier to shield their domestic economies from rising commodity prices.

Figure 3.1: Change in World Commodity Prices (YoY)



The impact of declining food prices is likely to be more pronounced for developing countries, where food expenditure accounts for a greater proportion of incomes. Moreover countries that are net importers of food and energy are likely to see improved current account and fiscal positions due to fall in commodity prices in general and sharp slide in fuel prices in particular.

The price of crude oil[2] has plummeted from a monthly peak of US$ 132.5 per barrel in July 2008 to US$ 54 per barrel in November 2008. Similarly, the prices of other major food items and metals have witnessed a significant fall from their recent peak levels (see **Table 3.1**). If the current trend in commodty prices continues, the YoY change in retail prices for a number of commodities will become negative. This risk has altered the future direction of policy responses in many economies as they are slashing interest rates due to the fear of possible deflation that will make debt more expensive by raising real interest rates. This may inflict another blow on the already depressed global economy.

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[1] According to IMF commodity price index

[2] Simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh.

Table 3.1: Global Commodity Prices

Item	Unit	Nov-07	Nov-08	Peak Value	Peak Month	Decline since current peak (%)
Crude oil	US$/barrel	91.3	54.0	132.5	Jul 08	-59.23
Rice	US$/MT	356.5	563.3	1015.2	Apr 08	-44.52
Wheat	US$/MT	321.2	226.8	439.7	Mar 08	-48.41
Sugar	US cents/Pound	9.9	11.8	14.0	Sep 08	-15.63
Palm oil	US$/MT	877.3	433.1	1146.9	Mar08	-62.24
Soybean oil	US$/MT	988.0	728.5	1414.4	Jun 08	-48.49
Corn	US$/MT	171.1	164.3	287.1	Jun 08	-42.79
Copper	US$/MT	6957.4	3729.2	8714.2	Apr 08	-57.21
Aluminum	US$/MT	2507.2	1857.1	3067.5	Jul 08	-39.46
Gold	US$/Ounce	806.2	760.9	968.4	Mar08	-21.43
Lead	US$/MT	3319.9	1286.4	3722.6	Oct 07	-65.44

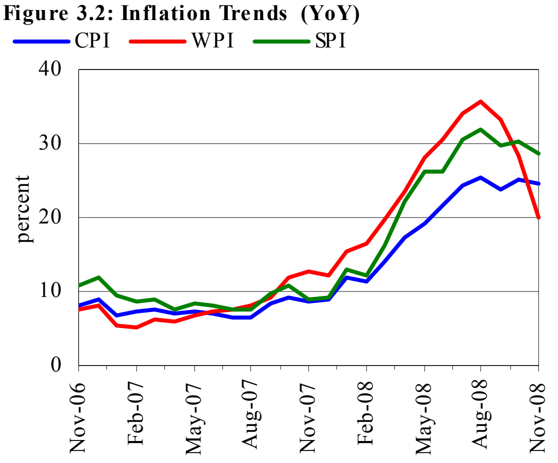
Source: IMF and www.gold.org

The reversal in commodity prices alongwith the possibility of sluggish growth prospects, have led many central banks around the world to reduce policy interest rates. However, countries,such as Pakistan and Sri Lanka, continue to suffer from high inflation emanating from countervailing domestic factors, forcing the retention of a tight monetary stance.

3.2 Domestic Scenario

In contrast to the decline in global inflationary pressures, these remain strong in the domestic economy (see **Table 3.2**). In particular, consumer price index (CPI) and the sensitive price indicator (SPI) have seen strong YoY increases in FY09 in Pakistan so far (see **Figure 3.2**).

Figure 3.2: Inflation Trends (YoY)



The strength of domestic inflation reflects the cumulative impact of strong aggregate demand, weakness of the rupee[3] as well as other factors[4] that limited the

[3] Pak Rupee depreciated by 13.3 percent during Jul-Nov FY09 (for details see **Chapter 6**) which offset a large part of the gains of falling international commodity prices.

pass-through of lower international prices to domestic consumers. The latter is suggested by the fact that CPI inflation has not, as yet, followed the abrupt slide in WPI inflation (see **Figure 3.3**).

Encouragingly, after recording strong growth (YoY) during the first two months of FY09, a significant decline in WPI inflation was seen during the later months. WPI inflation dropped to 19.9 percent in November 2008 from its peak of 35.7 percent in August 2008, mainly due to a decline in international fuel and commodity prices. This also suggests that the pass through of declining fuel and commodity prices to the wholesale prices has been quicker as compared to the retail prices.

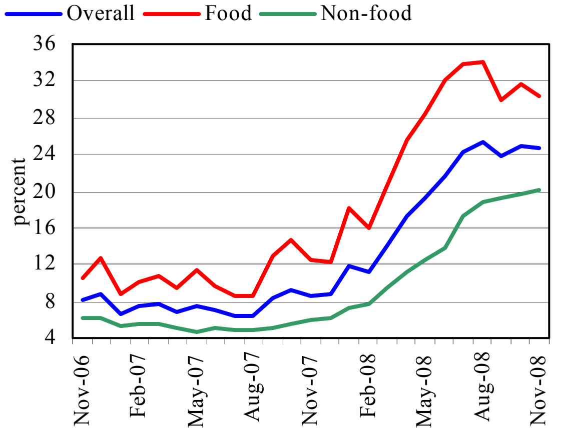
This is principally due to the very composition of the WPI basket. Prices of most of the items included in this basket are determined on the basis of international prices, for

Table 3.2: Inflation Trends
percent

	Year-on-Year[1]		12-month moving average[2]	
	Nov-07	Nov-08	Nov-07	Nov-08
CPI	8.7	24.7	7.6	19.1
Food	12.5	30.4	10.8	26.3
Non-food	5.9	20.2	5.3	13.7
WPI	12.6	19.9	7.9	25.0
Food	15.3	29.2	11.2	26.6
Non-food	10.7	12.8	5.5	23.7
SPI	9.0	28.8	9.0	23.3
Core				
NFNE[3]	6.9	18.9	5.9	12.9
Trimmed mean	8.6	21.3	7.1	16.1

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

Figure 3.3: Consumer Price Inflation (YoY)



[4] The weak pass through of falling international commodity prices by domestic manufacturers and transporters are also probably due to firms taking the opportunity to bolster margins, and/or dispute of levy of import duty as per L/C prices. For example, importers of metal and edible oil are particularly complaining about higher import duties, which hinder them from fully passing - on the impact of decline in international prices of these commodities.

example, furnace oil, mobil oil, pig iron, iron bars & sheets, coke, cotton, wires & cables etc. If the declining trend in wholesale prices continues, it may also help bring down retail prices in coming months.

Similar to CPI inflation, core inflation measured by both indicators, Non-food Non-energy (NFNE) and 20% trimmed mean, continued to accelerate during the first five months of FY09. Core inflation (YoY) measured by NFNE increased to 18.9 percent during November 2008 compared to only 6.9 percent in November 2007. Similarly, 20 percent trimmed mean core inflation (YoY) also remained strong as it increased to 21.3 percent in November 2008 from 8.6 percent in the same month last year (see **Table 3.2**). Strength in core inflation is indicating the persistence of inflationary pressures. Keeping in view stubbornly high inflation, uncomfortably high government borrowings from the central bank and almost about 100 percent increase in the current account deficit during Jul-Oct FY09, SBP tightened monetary policy during November 2008.

It is important to mention that while SBP raised policy rates by 500 basis points during CY2008 in four episodes of monetary tightening,[5] other measures were also taken to support appropriate liquidity in the banking sector and availability of credit to priority sector (for details see **Chapter 4**). Nevertheless, it should be kept in mind that the desired macroeconomic stability cannot be achieved solely by monetary policy measures. Coordination of fiscal policy is also needed. In this background, recent fiscal constraint, under IMF program, is likely to supplement monetary policy actions. Thus, inflationary pressures are expected to steadily ease going forward.

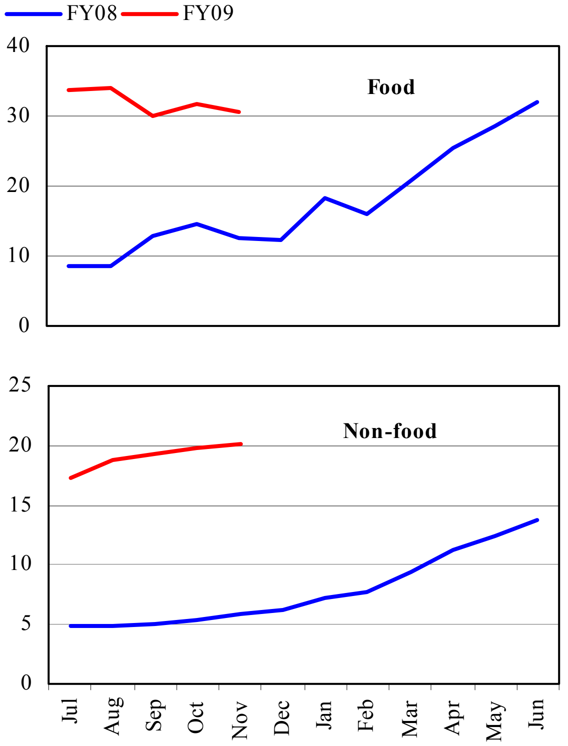
Despite easing of inflationary pressures, average CPI inflation for FY09 is likely to be in the range of 20 – 22 percent, compared with 12 percent in FY08. The persistence of inflationary pressures requires sustained macroeconomic discipline. In particular, reduction in fiscal and external deficits is necessary to achieve conducive macroeconomic environment.

[5] Two increases were announced as per usual issuance of MPS (i.e. January and July), while interim measures were also taken twice in May and November.

3.3 Consumer Price Index (CPI)

CPI inflation (YoY), which remained in single digits until Q2-FY08, started to accelerate from Q3-FY08 onwards. This rising trend continued during the first five months of FY09, and CPI inflation (YoY) reached 24.7 percent in November 2008 as against 8.7 percent in November 2007.

Figure 3.4: CPI Inflation (YoY) (percent)



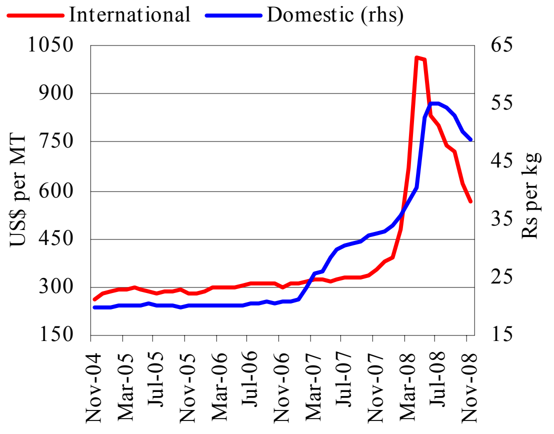
It is important to note that CPI food inflation is showing a modest downtrend in FY09 relative to a sharp upward path during FY08 (see **Figure 3.4**). In contrast, CPI non-food inflation has continued its rising trend in FY09 as a result of lagged impacts of fiscal stimulus, pass through of rising international commodity prices of key fuels to domestic consumer prices as well as second-round effects of persistently high food inflation. The recent downward adjustment in domestic prices of key fuels in response to declines in international oil prices is likely to ease non food inflation in months ahead.

This pass through of the substantial ease in international commodity prices is however likely to be considerably slow in the domestic economy as businesses seek to improve margins, as well as due to market structure issues. Acceleration of the anticipated downtrend may therefore require increased consumer awareness; the role of media in reporting wholesale and retail prices as well as support from effective monitoring by the government of the prices of essential items will be important here.

Economic literature clearly indicates that nominal prices can be downward sticky as downward adjustment in wages, profit margins and rents can be painful for businesses. For example, while the fixation of wheat support price at Rs 950 per

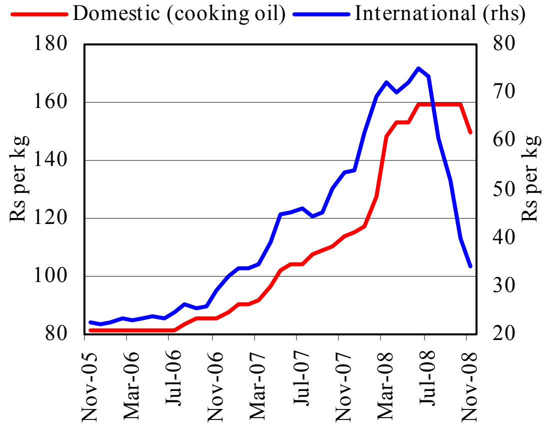
40 kg was encouraging for the farmers when international prices were high, the latter have since declined sharply, with the risk of substantial negative consequences. However, a downward adjustment in domestic wheat prices will be challenging. Similarly, while transport costs rose with the rise in fuel prices, there is little evidence of a corresponding downward revision when fuel prices declined.

Figure 3.5: Rice Prices



In the case of rice, similar disconnect was witnessed between local and international price levels. It may be noted that domestic rice prices started to increase sharply earlier than surge in international prices, however, ease in domestic prices was delayed and weaker than international prices (see **Figure 3.5**). Specifically, international rice prices came down by 44.5 percent in November 2008 relative to their peak levels. Whereas domestic prices of different varieties fell by only 11.4 – 21.7 percent from their peak levels, despite a bumper harvest of 6.5 million tonnes in FY09.

Figure 3.6: Edible Oil Prices



Similarly, domestic prices of ghee and cooking oil rose in tandem with international prices of edible oil (see **Figure 3.6**). However, downtrend in domestic ghee/cooking oil prices is relatively weaker relative to a sharp fall in international prices of key inputs, this is a source of disquiet.

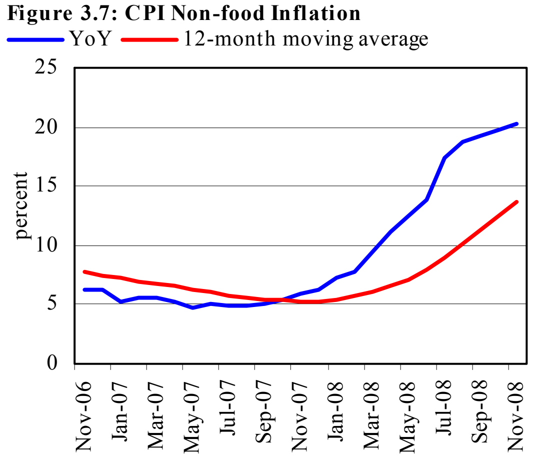
There is a need to ensure a corresponding decline in domestic *rice* prices with the fall in international prices. This requires administrative actions focusing on reduction in excessive profit margins of middlemen/wholesalers. Though imposition of minimum export price is not a recommended measure at the moment, however, if market mechanism fails to determine consumer price as per demand-supply forces, administrative measures are inevitable.

3.3.1 CPI Food Inflation

CPI food inflation remained high throughout the initial five months of FY09 and was recorded at 30.4 percent (YoY) during November 2008 as compared to 12.5 percent in the corresponding month last year. However, it seems that CPI food inflation (YoY) peaked out in August, 2008 and is likely to ease in H2-FY09.

Amongst major food commodities negative growth in sugar prices witnessed a reversal from June 2008 onwards and rose by 23.4 percent YoY in November 2008. This was mainly due to speculation supported by a 16 percent decline in sugarcane harvest, and consequent anticipated increase in domestic prices in months ahead. Wheat prices also remained strong during the first five months of FY09, showing a gradual adjustment towards a higher support price set by the government for FY09 crop. Given prospects of a bumper crop, substantial wheat imports in recent months, as well as ease in international prices, the domestic price of the commodity is likely to drop in coming months.

Figure 3.7: CPI Non-food Inflation

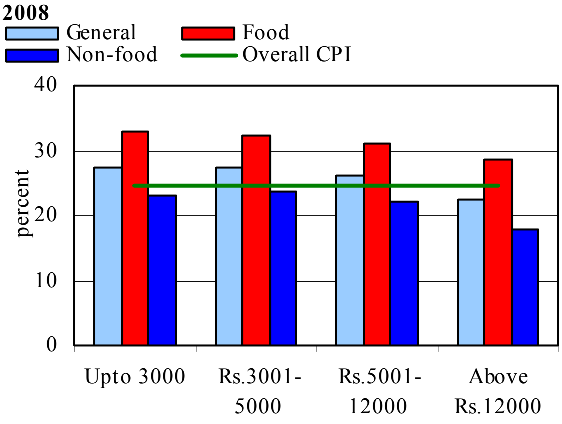


3.3.2 CPI Non-food Inflation

CPI non-food inflation (YoY) maintained a rising trend throughout the first five months of FY09 and was recorded at 20.2 percent during November 2008 which was 14.3 percentage points higher than the corresponding month last year (see **Figure 3.7**).

The acceleration in CPI non-food inflation was contributed by all sub-indices in the non-food group. The most significant increase, however, was registered in *fuel & lighting* and *transport & communication* sub-indices in November 2008. The increase in these sub-groups was due to an upward price adjustment of key fuels and subsequent rise in transportation charges. However, recent downward adjustment in fuel and transportation prices, in response to a decline in international fuel prices, would possibly help ease inflationary pressures in these sub-groups in coming months.

Figure 3.8: Incidence of Inflation (YoY) November 2008



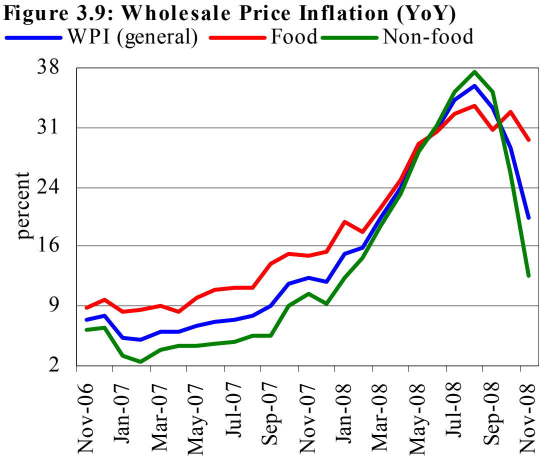
3.3.3 Income Group-wise Inflation

Income group wise data for the first five months of FY09 reveals that incidence of inflation remained high for lower income groups. Thus, in November 2008, all income groups, except the highest income group (having income above Rs 12000 per month), recorded higher inflation relative to the overall CPI inflation (see **Figure 3.8**). The high inflation for the low income earners is an evidence of strong food inflation, as food component constitutes a significant portion of lower income group expenditure.

3.4 Wholesale Price Index (WPI)

Wholesale price index (WPI) showed mixed trends during FY09. The first two months of FY09 witnessed high WPI inflation as it reached 35.7 percent (YoY) in August 2008 compared to 8.0 percent during the same month last year. However, since August 2008 a significant deceleration in WPI inflation has been witnessed (see **Figure 3.9**). The recent downtrend in WPI inflation was mainly contributed by the WPI non-food group that has registered a sharp decline since

Figure 3.9: Wholesale Price Inflation (YoY)



September 2008. On the other hand, WPI food group inflation remained hovering around 30 percent (YoY) so far. The downtrend in WPI non-food group inflation in the recent months is also reflected by the change in its weighted contribution in overall WPI inflation.

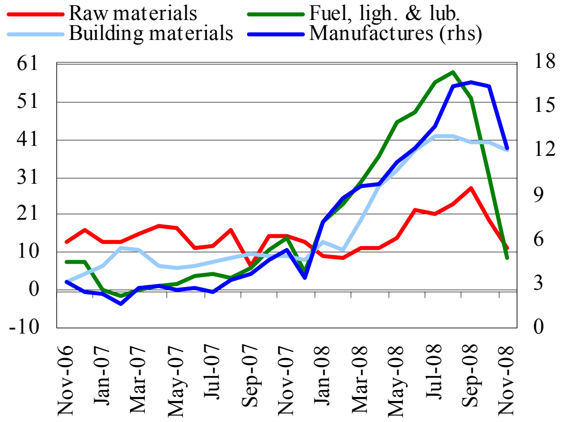
Table 3.4: Percent Contribution of Sub-indices to WPI Non-food Inflation

percent

	Nov-07	Jun-08	Oct-08	Nov-08
Raw materials	17.9	9.5	9.9	12.1
Fuel, lighting & lubricants	57.1	65.8	53.8	30.6
Manufactures	17.8	14.2	23.0	32.8
Building materials	7.2	10.5	13.4	24.5

Within non-food group, the weighted contribution of various sub-groups exhibited mixed trends. The weighted contribution of raw material, manufactures and building material sub-groups increased in November 2008 as compared to the same month of FY08. On the other hand, the weighted contribution of fuel, lighting & lubricant sub-group decreased (see **Table 3.4**). This relatively lower weighted contribution of the fuel, lighting & lubricant sub-group reflects the impact of downward revision of domestic oil prices followed by the ease in international crude oil prices.

Figure 3.10: WPI Non-food Inflation (YoY) (percent)



An analysis of YoY inflation of various WPI non-food group shows that all sub-groups registered a surge in inflation during the initial months of FY09. However, since September 2008, all sub-groups have experienced relative ease in inflation and this disinflation process is quite broad-based (see **Figure 3.10**).

Box 3.1: Major Developments in Global Commodity Markets

Crude oil prices have plummeted more than US$ 100 per barrel and reached as low as US$ 40 per barrel since hitting record heights five months ago. Global recession, tighter credit, rising non-OPEC supplies and reduced demand for crude oil particularly in US and Europe due to high oil prices helped drive oil prices down. The strengthening dollar against other currencies coupled with the decreased tension between Iran and the west also played the role in bringing down oil prices.

Wheat prices followed a downward course in the second half of 2008 as commodity demand softened amid global economic recession. Adequate rainfall and temperatures in wheat exporting countries boosted production of the crop and helped the wheat prices to end lower. As corn competes with wheat as a livestock feed, the declining corn prices further added to the downward pressure on wheat prices. Corn prices were brought lower after the demand for grains used as alternative fuel collapsed amid slumping energy prices.

Sugar prices remained under pressure in last five months of 2008 mainly on account of reduced demand amid global recession. The drop in crude oil prices also contributed to the downward trend of sugar prices by crimping demand for ethanol. Global sugar output in the year ending September 30, 2009 is expected to drop for the first time since 2005, led by cuts in India and the European Union. This implies that sugar prices may remain strong next year.

Edible oil: The second half of 2008 saw edible oil prices tumbling. The decline in demand amid global recession and increased supplies of palm oil remained responsible for pushing the prices lower. The supplies of edible oil found a boost owing to increased output in Malaysia and Indonesia and bumper crops in China and India. Fall in crude oil prices signaled lower demand for fuel substitutes and contributed to the downward pressure on palm oil prices.

Rice prices started to ease after reaching record highs in the second week of May 2008 and stayed weak until recently. The decline was helped by the globally increased supply of rice coupled with the removal of ban on its export. Farmers in the rice exporting countries started to plant more of the crop to take advantage of the high prices after prices touched the highest in May 2008. A report published by FAO expects rice prices to remain under pressure in international market in the near future mainly on account of weakening wheat prices (a substitute to rice). Prices, however, will also be strongly affected by the pattern of the monsoon in the Northern Hemisphere and Asian countries.

Metals prices remained on a downward track during the period July-December 2008. Demand for the metals significantly reduced after industrial growth slowed down due to global recession and the US dollar gained strength against other currencies. As the car sales plunged in Europe and America demand for aluminum, lead and platinum collapsed to bring down the prices of these metals. The price of nickel stayed under pressure owing to the falling demand from stainless steel makers. Copper prices came under pressure due to decreased demand from China, collapse of the housing market in US and rise in global stock piles of copper. The strong dollar remained as the main reason for causing the decline in gold prices during the last five month of 2008.