3 Prices

3.1 Global Inflation Scenario

The turmoil in international credit markets, that hit consumer demand around the world, resulted in low inflation in developing economies and created deflationary threats for developed countries. In the USA, YoY inflation turned negative in March 2009 – the first annual decline in consumer prices since 1955. The CPI inflation is falling in Japan and is close to zero in the Euro area. In the UK, though consumer price inflation was 2.9 percent in March 2009, prices measured by Retail Price Index (RPI) have declined (-0.4 percent) for the first time in nearly five decades (see **Table 3.1**). The state of deflation might turn precarious as consumers expect further fall in prices and defer purchases. This would cause further fall in profits, job losses, and weaker demand.

This situation has created challenges for central banks as deflation makes monetary policy less effective. In this scenario, central banks can inject money into the economy by purchasing long term assets to stimulate the economy.

Table 3.1: Inflation and Policy Rates in Major Economies

percent

	YoY inflation			Policy rates		
	Jul-08	**Dec-08**	**Apr-09**	**Current**	**Previous**	**Changed on**
United States*	5.6	0.1	-0.4	zero to 0.25	1.0	Dec 16 2008
United Kingdom *	4.4	3.0	2.9	0.5	1.0	Mar 05 2009
Euro Area	3.8	1.6	0.6	1.0	1.3	May 07 2009
Japan*	2.3	0.4	-0.3	0.1	0.3	Dec 20 2008
Australia@	5	3.7	2.5	3.0	3.3	Apr 08 2009
China*	6.3	1.2	-1.2	5.3	5.6	Dec 22 2008
India #	8.3	9.7	9.6	4.8	5.0	Apr 21 2009
Malaysia*	8.5	4.4	3.5	2.0	2.5	Feb 24 2009
Indonesia	11.9	11.1	7.3	7.5	7.8	Apr 03 2009
Sri Lanka	26.6	14.4	2.9	10.3	10.5	Feb 11 2009
Pakistan	24.3	23.3	17.2	14.0	15.0	Apr 21 2009

Sources: Bloomberg, IMF, World Bank, OECD, The Economist, and Central Banks' websites.

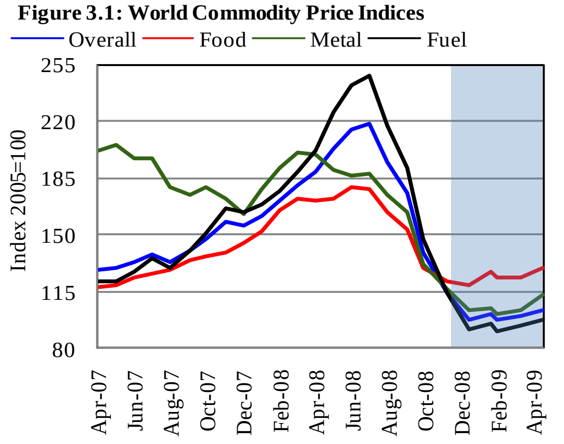
Inflation data pertains to February 2009.

* Inflation data pertains to March 2009.

@ Quarter 1, 2009.

Impact of weak global demand on the back of ongoing economic recession continued to affect commodity prices in the international markets. Commodity prices have declined from their peak levels in international markets (see **Figure 3.1** and **Table 3.2**). Though prices of all major commodities have slumped from all time highs, the impact of global economic slowdown is more pronounced in the case of oil.

Figure 3.1: World Commodity Price Indices



Source: IMF

On the one hand, food prices witnessed relatively lesser decline due to their less elastic demand, while on the other hand, prices of manufacturing goods, durables and construction were affected the most, alongwith a decline in fuel and metals prices.

Upto April 2009, the IMF food, fuel and metal price indices had declined sharply, by 26.7 percent, 61.1 percent and 40 percent respectively, since July 2008. The fall in commodity prices can be attributed to a number of factors, including a decline in global oil demand, particularly for power and steel production, on the back of sufficient avaiable stocks in the world. [1]

Table 3.2: Global Commodity Prices

Items	Unit	Jul-08	Dec-08	Apr-09
Crude oil	US$/barrel	132.5	41.5	50.3
Rice	US$/MT	799.0	550.8	577.3
Wheat	US$/MT	328.2	220.1	233.5
Sugar	US cents/pound	13.2	11.3	13.5
Palm oil	US$/MT	1,026.2	440.4	693.2
Soybean oil	US$/MT	1,372.3	681.0	787.3
Corn	US$/MT	266.9	158.2	168.7
Copper	US$/MT	8,407.0	3,105.1	4,436.9
Zinc	US$/MT	1,856.4	1,112.9	1,388.1
Gold	US$/Ounce	939.8	822.0	889.5
Lead	US$/MT	1,960.0	968.2	1,393.9

Source: IMF and www.gold.org

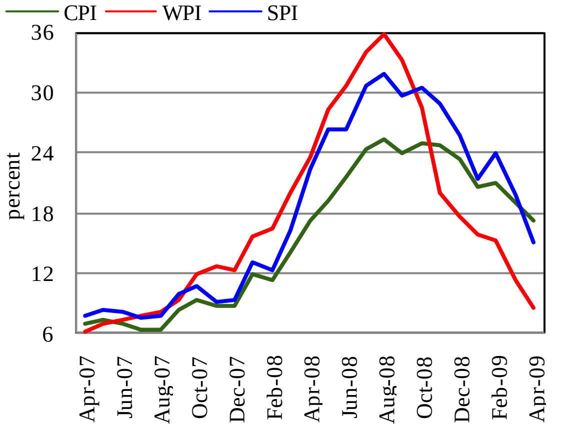
Among non-fuel commodities, prices of major grains eased as a result of improved supply conditions as farmers around the world increased area under cultivation as compared to the previous year in response to earlier high commodity prices. In addition, demand for food

[1] According to IMF's World Economic Outlook, April 2009, global oil demand fell by 0.4 million barrel per day in 2008.

commodities also eased since their use becomes less attractive as a substitute of oil (bio-fuel) due to decline in oil prices amid global recession.

Going forward, in the wake of sluggish global economic recovery, commodity prices are expected to remain subdued in coming months. However there are risks to this assertion, in particular, food prices may experience upward pressure as any disruption in the supply of key staples may force countries to adopt protectionist food policies due to their expreience of food crisis in past years.[2]

Figure 3.2: Inflation Trends (YoY)

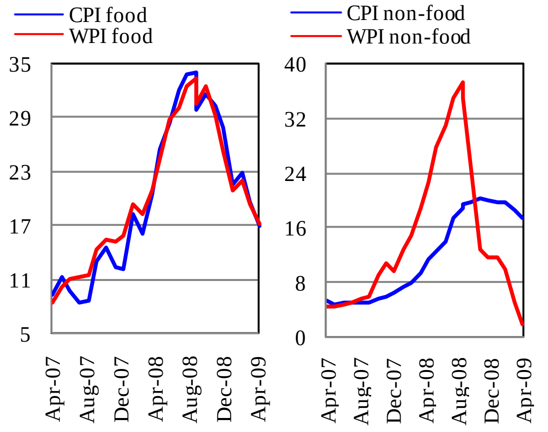


3.2 Domestic Scenario

The relative ease in inflationary pressures that began in Q2-FY09 has continued into Q3-FY09 with all price indices exhibiting a declining trend (see **Figure 3.2**).

While both food and non-food inflation show deceleration, the impact of the former was more pronounced in CPI. However, the impact of latter dominated in a sharp deceleration in WPI inflation (see **Figure 3.3**).[3] The sharper downtrend in WPI non-

Figure 3.3: Trends in CPI and WPI Inflation (percent YoY)



[2] Recently, Vietnam – world's second largest rice exporter – announced a four-month ban on overseas rice sales. Egypt extended the ban on rice exports upto October 2009, (this ban was originally planned to be lifted by April 2009). Similarly, India has also announced a ban on export of non-basmati rice. In Argentina, speculation has mounted that the government could set up a Grains and Oilseeds Trading Board and grant it greater control over a key revenue-earning sector of the economy.

[3] For detailed analysis of reasons behind the difference in the trends of the two inflation indices see *Second Quarterly Report* for FY09 on the State of Pakistan's Economy.

Table 3.3: Inflation Trends

percent

	Year-on-Year[1]				12-month moving average[2]	
	Apr-08	Peak value	Peak month	Apr-09	Apr-08	Apr-09
CPI	17.2	25.3	Aug-08	17.2	9.8	22.0
Food	25.5	34.1	Aug-08	17.0	14.3	27.2
Non-food	11.2	20.2	Nov-08	17.3	6.5	18.1
WPI	23.5	35.7	Aug-08	8.3	12.6	22.7
Food	24.6	33.5	Aug-08	17.2	15.8	26.6
Non-food	22.7	37.4	Aug-08	1.8	10.4	19.7
SPI	22.3	31.8	Aug-08	15.0	11.2	25.6
Core						
NFNE[3]	10.8	18.9	Feb-09	17.7	7.2	17.0
Trimmed mean	14.1	21.7	Oct-08	17.6	8.9	19.4

[1]e.g. change in Apr 2009 over Apr 2008

[2]e.g. change in 12-month average of Apr 2009 over Apr 2008

[3]Non-food non-energy

Source: Federal Bureau of Statistics

food inflation probably indicates the immediate impact of lower import unit values of key manufacturing inputs including oil, metal, lubricants etc. Also as a leading indicator, this points toward a sharp fall in CPI non-food inflation in next few months.

Signs of easing inflationary pressures are also evident in the decline in persistent component of inflation, which is measured by core inflation. The Non-Food Non-Energy (NFNE), and 20 percent trimmed mean, core inflation measures have both shown signs of relative ease since March 2009 (see **Table 3.3**).

A major contributory factor to this was the tight monetary posture of the central bank throughout 2008. SBP raised its policy discount rate four times during 2008, for a cumulative increase of 500 basis points, taking the discount rate to 15 percent. Indeed the need to tighten monetary policy was accentuated by expansionary fiscal policy. The subsequent improvement in fiscal discipline, and plunge in international commodity prices paved the way for containing excess demand and inflationary expectations. Accordingly, SBP reduced its policy discount rate by 100 basis points to 14 percent on April 20, 2009.

In case of month-on-month (MoM) inflation, all inflation measures have also declined from their peak levels. The MoM inflation peaked out in July 2008 except for CPI food and core inflation, measured by trimmed mean. For example, CPI inflation (MoM) was recorded at 1.4 percent in April 2009 compared to 3.0 percent in April 2008 (see **Table 3.4**).

Table 3.4: Inflation Trends (MoM)[1]

percent

	Apr-08	Jul-08	Apr-09
CPI	3.0	3.3	1.4
Food	4.3	2.8	2.0
Non-food	2.0	3.8	0.9
WPI	4.3	4.4	1.7
Food	3.7	3.5	1.7
Non-food	4.8	5.0	1.7
SPI	5.4	4.6	1.2
Core			
NFNE[2]	1.8	2.3	1.1
Trimmed mean	2.0	1.8	1.2

[1]Change in Apr-09 over Mar-09

[2]Non-food non-energy

Source: Federal Bureau of Statistics

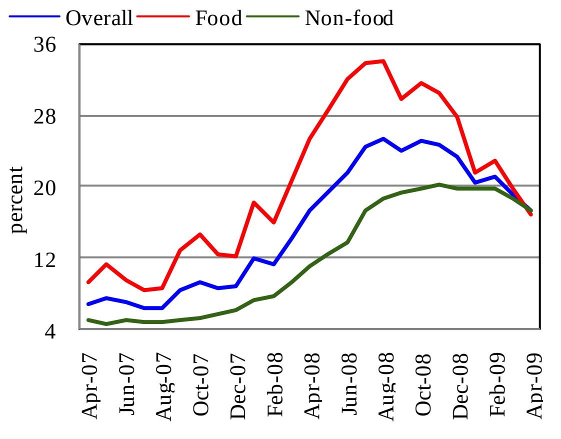
While, inflation is still high, SBP projection firmly indicates that the downtrend in inflation will gather pace in the next few months. The expectation, together with evident decline in domestic demand, led the SBP to initiate a loosening monetary policy.

Inflationary pressures are likely to continue easing in Q4-FY09. While the annual inflation for FY09 is expected to be well above its annual target of 11 percent, given that inflation measured by 12 month moving average for April 2009 is still 22 percent.

3.3 Consumer Price Index (CPI)

After peaking in August 2008, headline inflation (YoY) declined to 17.2 percent in April 2009. The recent downtrend in CPI inflation (YoY) was mainly attributed to declining domestic food inflation, principally a reflection of fall in international prices, and smooth domestic supply of key staples.

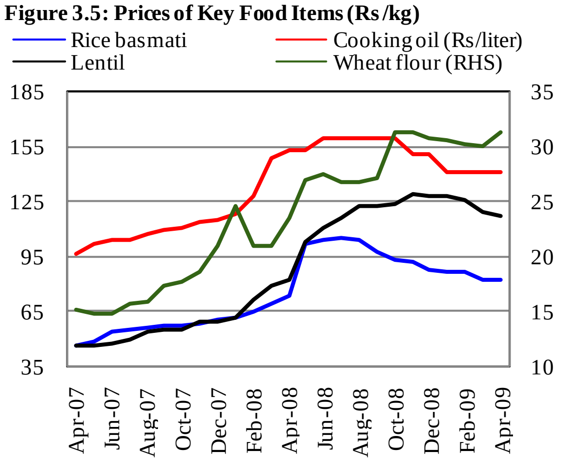
Figure 3.4: Consumer Price Inflation - YoY



The extent of the ease in CPI food inflation can be gauged from the fact that it has come down by 17.1 percentage points by April 2009 from its peak level in August 2008 (see **Figure 3.4**).

Encouragingly, CPI non-food group has also shown signs of relative easing during H2-FY09; however, this decline is not as prominent as in CPI food group. Going forward, CPI non-food inflation is expected to ease further as lagged impact of tight monetary stance, declining international commodity prices, subdued inflationary expectations amidst weaker domestic demand, and the absence of second-round effects due to a relative slowdown in food inflation.

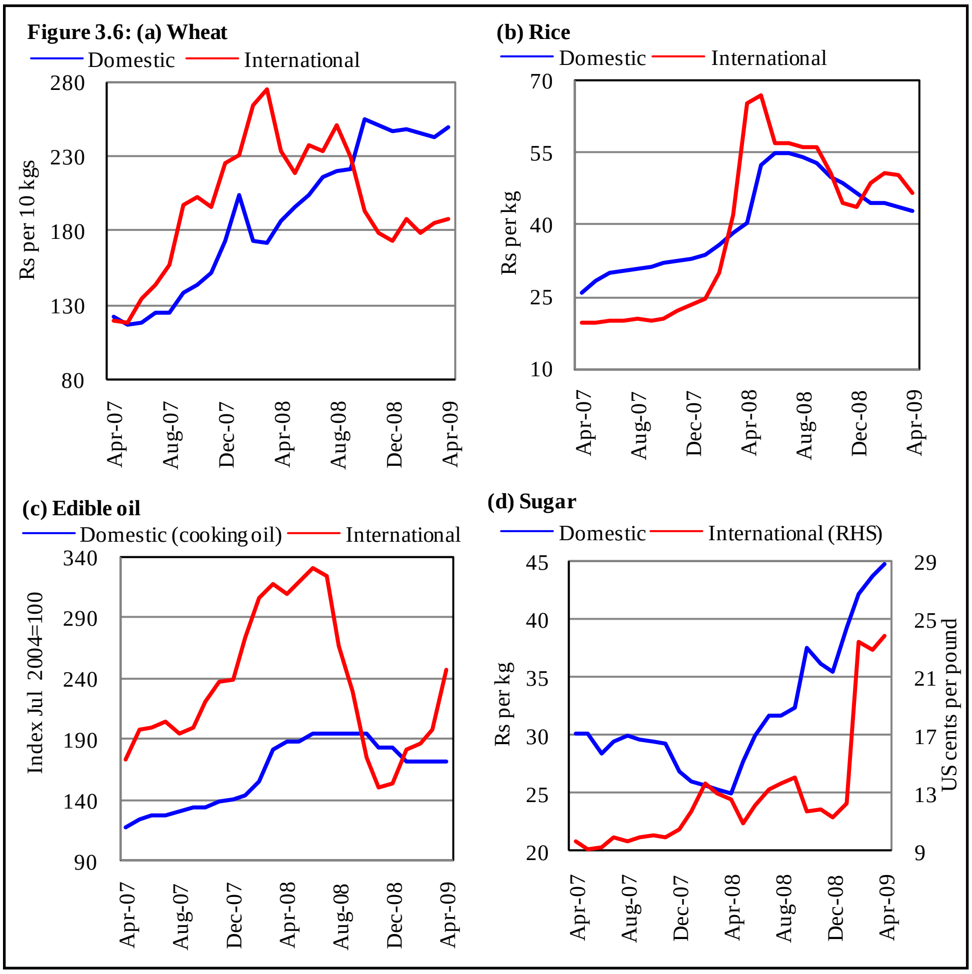
Figure 3.5: Prices of Key Food Items (Rs/kg)



3.3.1 CPI Food Inflation

After peaking at 34.1 percent in August 2008, CPI food inflation has retreated to reach 17.0 percent YoY in April 2009. This was mainly due to better supply management, as well as a gloomy global scenario for growth and commodity prices. In particular, substantial and timely import of wheat eroded the possibilities for speculative hoarding. Similarly, a bumper rice crop and lower international rice prices helped contain the domestic prices of the grain (see **Figure 3.5 and 3.6**).

Also, international wheat prices, which were above the domestic prices during its upward rally, dropped below domestic prices in recent months. In fact, if domestic wheat prices declined in tandem with international prices, domestic food inflation would have come down much earlier. The main reason of the current divergence between domestic and international prices was the government's decision to increase wheat procurement prices by 52 percent to Rs 950/40kg for FY09 crop. This decision resulted in a bumper wheat crop, despite water and urea shortages and some losses due to rains before harvesting in Punjab. Moreover, not only incentives for illegal cross border movement of the grain have been eroded, it also helped improve food security albeit at a higher cost. In recent months, domestic wheat prices have declined mainly due to expectations of a bumper wheat crop and lower demand from neighboring countries. However, wheat prices are expected to slightly move upward in May 2009 mainly due to an alignment of issue price with the government support price of Rs. 950 per 40 kg in Punjab province.



It is imperative to note that rice prices in the domestic economy witnessed a downtrend in Q3-FY09. The prices of domestic basmati declined mainly due to shrinking export of basmati rice from November 2008 onwards, amidst competition from India. However, price of rice irri-6 is expected to rise in the near future due to mismatch between demand and supply as recently many countries, including India, Egypt and Vietnam, have reintroduced restrictions on exports of irri-6 and similar varieties.

On the other hand, domestic price of sugar remained on an uptrend throughout FY09, mainly due to lower domestic production.[4] While the government's

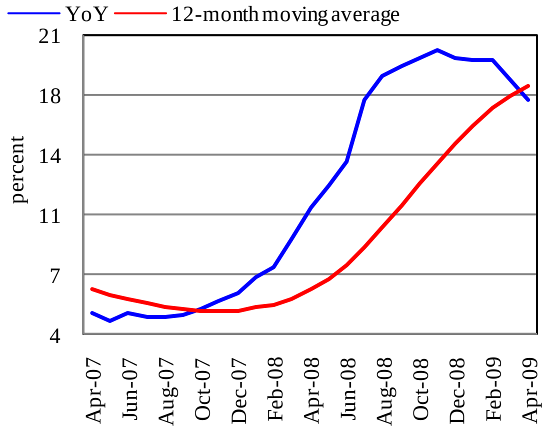
[4] Total sugar production remained at 3.2 million tonnes against last year's record production of 4.35 million tonnes according to Pakistan Sugar Mills Association (PSMA).

decision to allow import of sugar is likely to improve domestic supply, sugar prices are expected to remain high as international prices are also strong, principally reflecting high demand from India.

3.3.2 CPI Non-food Inflation

The uptrend in CPI non-food inflation that started during H1-FY08 witnessed a reversal during FY09 as YoY inflation of the sub-group reached 17.3 percent during April 2009 against a local peak of 20.2 percent reached during November 2008 (see **Figure 3.7**).

Figure 3.7: CPI Non-food Inflation



All sub-indices in the non- food group, except *house rent index*, have witnessed relative ease in YoY inflation during Q3-FY09 (see **Table 3.5**). In particular, the *transport & communication* sub-index has declined at a higher pace as compared to other sub-indices mainly reflecting the impact of downward adjustment in fuel prices and transportation charges, partially responding to the larger decline in international fuel prices. A slower pace of decline in *fuel & lighting* sub-group is

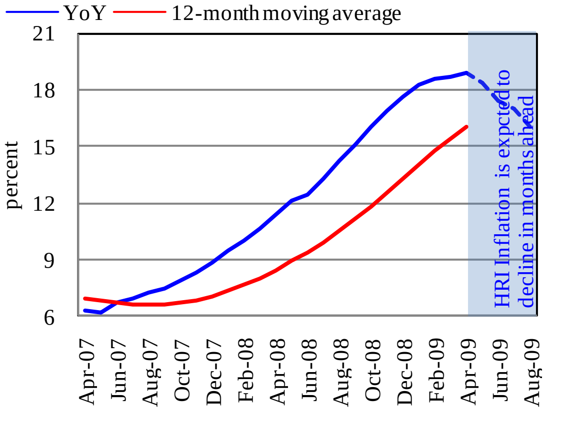
Table 3.5: CPI Inflation (YoY) by Groups

	Weight	Aug-08	Dec-08	Mar-09	Apr-09
Non-Food Group	**59.7**	**18.7**	**19.8**	**18.5**	**17.3**
Apparel, textile & footwear	6.1	14.9	15.7	13.6	12.3
House rent	23.4	14.2	17.6	18.7	18.9
Fuel & lighting	7.3	21.0	29.5	26.7	26.7
Household furniture	3.3	12.0	14.6	14.2	12.6
Transport & communication	7.3	40.5	25.7	17.8	8.6
Recreation & entertainment	0.8	11.7	12.6	13.9	13.9
Education	3.5	15.4	17.0	18.4	23.0
Cleaning, laundry	5.9	19.6	19.8	16.4	16.0
Medicare	2.1	9.9	12.7	14.2	13.4
Overall CPI	**100**	**25.3**	**23.3**	**19.1**	**17.2**

attributed to sharp upward adjustment in gas and electricity charges during the year.

Visible resilience in *education, cleaning & laundry, medicare* and *HRI* sub-groups of CPI represents the second-round effects of persistent high food inflation in the economy as all these sub-groups have a substantial component of wages and salaries. However, while tight monetary policy restricted the possible increase in these sub-indices in response to a surge in food inflation, an expected sharp slowdown in food inflation months ahead is likely to help contain rise in service oriented sub-indices of non-food group as well. And the combined impact of a slowdown in food and non-food inflation would be a sharp deceleration in overall CPI inflation.

Figure 3.8: House Rent Inflation



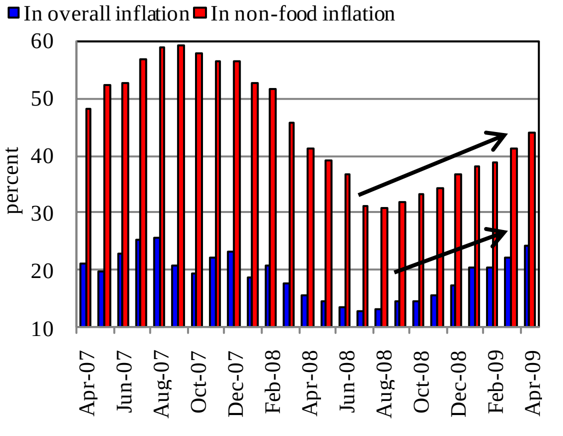
Moreover, in case of *house rent index*, YoY inflation seems peaking off and is expected to witness a reversal in coming months, given a significant decline in metal and other construction material prices (see **Figure 3.8**). Expected decline in HRI inflation will lead to ease-off overall CPI and CPI non-food inflation given that HRI has 23.4 percent weight in overall CPI basket and 39.3 percent weight in non-food group (see **Box 3.1**).

Box 3.1: Role of HRI in CPI Inflation

House Rent Index is the highest individual item in terms of weight in the CPI basket, having a 23.4 percent weight in overall CPI basket and 39.3 percent weight in non-food group.

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 while remaining is accounted for the material

Figure 3.1.1: Contribution of HRI Inflation (YoY)



cost. The construction index is then compiled for individual urban centers by taking a 24-month moving geometric mean of labor and material costs. After this the weights for house rent of individual cities (obtained through family budget survey) are applied to compute the overall HRI.

Overall CPI inflation (YoY) has witnessed a clear downtrend since September 2008. However, CPI non-food group has not witnessed a similar downtrend. This is primarily due to the persistence shown by HRI which has continued to rise. Due to the high weight of HRI in non-food group (39.3 percent) CPI non-food inflation has remained stubbornly high. This can clearly be observed as non-food inflation excluding HRI has decelerated more rapidly (see **Table 3.1.1**).

The persistence in non-food inflation due to HRI is also evident from its weighted contribution.

Table 3.1.1 Trends (YoY: Inflation in percent)

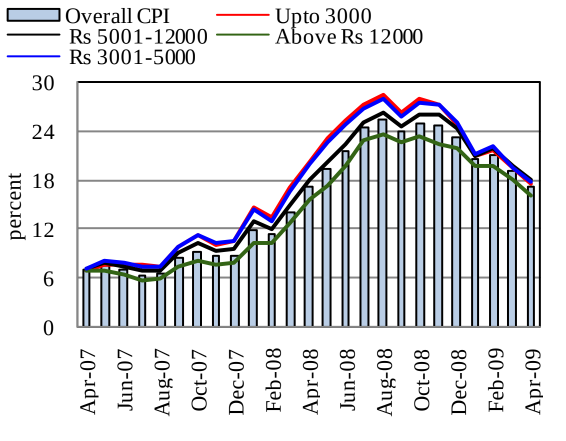
	General	Non-Food Group	House Rent	NFNE	NFNE excl HRI	Overall excl HRI	Non-food excl HRI
Apr-08	17.2	11.2	11.4	10.8	10.4	19.0	11.1
May-08	19.3	12.5	12.0	12.3	12.6	21.5	12.7
Jun-08	21.5	13.8	12.4	13.0	13.6	24.3	14.8
Jul-08	24.3	17.3	13.3	14.7	16.1	27.7	20.1
Aug-08	25.3	18.7	14.2	16.4	18.4	28.7	21.9
Sep-08	23.9	19.2	15.0	17.3	19.4	26.6	22.2
Oct-08	25.0	19.7	16.0	18.3	20.5	27.7	22.4
Nov-08	24.7	20.2	16.8	18.9	20.8	27.1	22.6
Dec-08	23.3	19.8	17.6	18.8	19.9	25.1	21.3
Jan-09	20.5	19.7	18.2	18.9	19.6	21.2	20.7
Feb-09	21.1	19.6	18.5	18.9	19.4	21.8	20.4
Mar-09	19.1	18.5	18.7	18.5	18.3	19.2	18.4
Apr-09	17.2	17.3	18.9	17.7	16.6	16.7	16.3

Figure 3.1.1 shows that the contribution of HRI in non-food inflation has consistently increased since September 2008 resulting in continuously high non-food inflation. Moreover core inflation measured by non-food non-energy (NFNE) has also remained persistently high mainly due to HRI, as HRI has 46 percent weight in NFNE group. However, going forward HRI inflation is expected to witness a reversal in its trend given a significant decline in metal and other construction material prices and the fall in HRI is expected to bring a sharp downtrend in CPI non-food and core inflation measured by NFNE.

3.3.3 Incidence of Inflation

Income group-wise inflation during FY09 shows that the highest incidence of inflation has shifted from lower income groups to the middle income groups since November 2008. The relative ease in inflationary pressures for the lowest income group can be attributed to declining food inflation, given that staple food accounts for a greater proportion of their total expenditure. Income group-wise inflation data further reveals that all income groups, except the highest income group (with earnings above Rs 12,000), recorded higher inflation incidence than the overall CPI inflation throughout FY09 (see **Figure 3.9**).

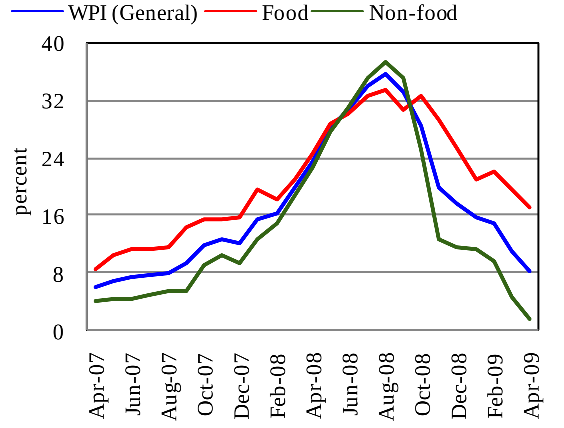
Figure 3.9: Income Group-wise Inflation (YoY)



3.4 Wholesale Price Index

Wholesale Price Index (WPI) inflation, that started declining in September 2008, continued its downtrend in FY09. The WPI inflation was recorded at 8.3 percent in April 2009 compared to 23.5 percent during the same month last year. The deceleration in non-food group inflation was more pronounced compare to food group (see **Figure 3.10)**.

Figure 3.10: Wholesale Price Inflation (YoY)



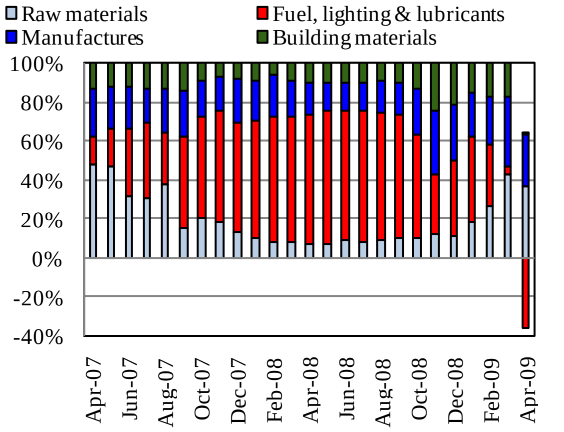
Within non-food group all sub-indices except raw material sub-index saw inflation decrease significantly during FY09. The weighted contribution of non-food group to overall WPI inflation also declined significantly from 56.1 percent in April 2008 to 12.3 percent in April 2009. Within WPI non-food group, fuel lighting & lubricant sub-index contribution dropped most significantly, from 37.5 percent in April 2008 to (-) 15.1 percent during April

Table 3.6: Percentage Change (YoY) of Selected WPI Non-food Commodities

	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Apr-09
Iron bars & sheets	34.2	53.9	53.9	28.8	-0.1	-9.8
Chemicals	36.6	44.9	31.6	8.9	-18.7	-21.1
Mustard/rapeseeds	48.3	64.1	70.9	32.0	7.2	5.8
Furnace oil	68.2	93.0	55.5	-41.2	-41.7	-40.0
Fertilizers	84.6	93.8	87.2	74.7	14.4	11.8
Coke	111.1	118.2	81.8	50.0	18.4	7.1

2009 (see **Figure 3.11)**.

Figure 3.11: Contribution in WPI Non-food Inflation



WPI food inflation (YoY) was 17.2 percent during April 2009 compared to 24.6 percent in the same month last year. The relatively low pace of decline in WPI food group inflation as compared to non-food group was primarily due to an increase in the prices of some food commodities such as onion (211.1 percent), sugar (85.7 percent), gur (84.6 percent), condiments (53.6 percent), pulse masoor (41.7 percent) and wheat flour (41.9 percent). Out of the 43 commodities in WPI food group, 28 registered price change above 10 percent during April 2009 (25 items in April 2009).

The sharp deceleration in WPI non-food inflation (YoY) was due to the impact of ongoing global economic recession on commodity prices. This can be seen from the decline of selected WPI non-food commodities (see **Table 3.6**).

However, given strong demand for cotton in the country and expected lower global production in FY10, domestic cotton prices are likely to increase in months ahead. Going forward, high cotton prices might weaken the pace of deceleration in WPI non-food group inflation.

3.5 Sensitive Price Indicator (SPI)

Inflation (YoY) measured by the sensitive price indicator (SPI) was 15.0 percent during April 2009, compared to 22.3 percent in the same month last year. The long run trend, measured by 12-month moving average, showed that an upward trend peaked out during March 2009 and decelerated to 25.6 percent during April 2009 (see **Figure 3.12**).

The decline in weekly SPI, which started from the first week of March 2009, continued till the first week of May 2009. Weekly SPI inflation (YoY) in first week of March 2009 was recorded at 21.4 percent and during the first week of May 2009 was at 11.8 percent. The long run trend in weekly SPI, measured by 52-week moving average, began to decline from first week of March 2009 (see **Figure 3.13**). A sharp downtrend in weekly SPI inflation reflects that CPI food inflation is likely to exhibit substantial deceleration in the months ahead.[5]

Figure 3.12: SPI Inflation

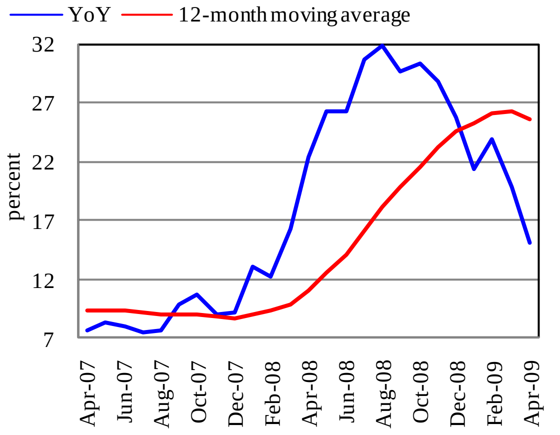
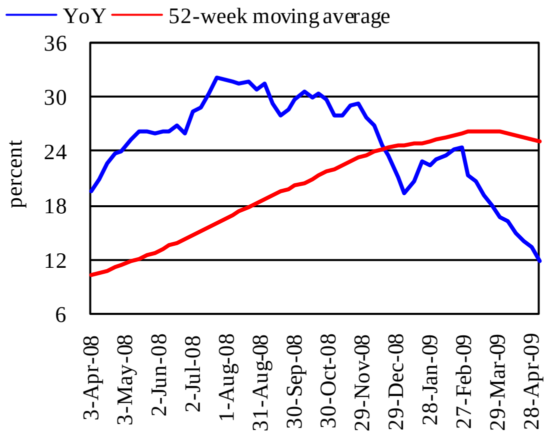


Figure 3.13: Weekly SPI Inflation



[5] 64 percent items included in the SPI basket are also included in *CPI food basket*. As discussed in *Second Quarterly Report* for FY09 on the State of the Pakistan's Economy, both CPI and SPI generally move in the same direction.