3 Prices

3.1 Global Inflation Scenario

Since the beginning of FY10, a sluggish recovery has been witnessed in the global economy. The Organisation for Economic Cooperation and Development (OECD) expects moderate recovery in 2010.[1] Importantly, deflation has started decelerating in most of the developed countires amid improved consumer confidence (see **Table 3.1**).

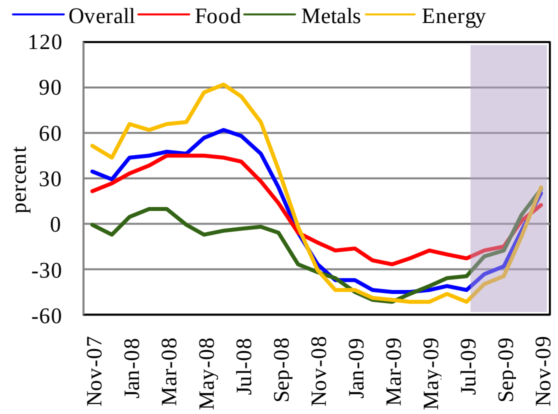
Table 3.1: Inflation (YoY) in Major Economies

Country	Nov-08	Jul-09	Nov-09
United States	1.1	-2.1	1.8
Japan*	1.0	-2.2	-2.5
Europe	2.1	-0.7	0.5
United Kingdom	4.1	1.8	1.9
China	2.4	-1.8	0.6
Sri Lanka	16.3	1.1	2.8
Indonesia	11.7	2.7	2.4
India*	10.4	11.9	11.5
Pakistan	**24.7**	**11.2**	**10.5**
Thailand	2.2	-4.4	1.9
Philippines	9.9	0.2	2.8
Vietnam	24.2	3.3	4.3
Malaysia*	5.7	-2.4	-1.6

Sources: Bloomberg, IMF, World Bank, OECD,The Economist and Central Banks websites. * Data pertains to October 2009
*Data pertains to October 2009

Signs of recovery in global economy are also evident from increasing international commodity prices since the beginning of the current fiscal year (see **Figure 3.1**). Commodity hedging has also supported the upward trend in prices.

Figure 3.1: IMF Price Indices (YoY)



Source : IMF

Rise in prices has been witnessed in all commodity groups, but is more pronounced in industrial metals. This is possibly because a substantial part of the fiscal stimulus, announced by various countries, has been allocated to infrasturcure projects, which may have resulted in increased demand for metals. A weakness of dollar also

[1] OECD Economic Outlook No. 86, November 2009.

supported increase in metal prices in recent months amid near zero interest rate in US. Metal prices registered a 22.2 percent YoY and 2.6 percent MoM growth during November 2009 (see **Table 3.2**). It is interesting to note that industrial metals prices started recovering after the monthly industrial production output figures turned positive in many of the industrial countries, e.g., Japan, China, Germany and United Kingdom.[2] Among the precious metals, gold prices in international market reached record levels during the quarter under review as demand for the commodity increased as a safe haven due to weaker dollar. Moreover, recently, some central banks have resorted to buying gold to diversify the composition of their reserves.

Table 3.2: Major Commodity Indices

	MoM change			YoY change			
Group	**Nov-08**	**Jul-09**	**Nov-09**	**Jul-09**	**Sep-09**	**Oct-09**	**Nov-09**
Overall	-17.5	-4.2	4.3	-44.6	-28.6	-4.7	20.4
Food	-5.7	-3.5	3.1	-21.8	-12.9	4.4	14.1
Metals	-11.7	3.1	2.6	-35.0	-17.8	5.2	22.3
Energy	-22.4	-6.4	4.5	-51.9	-34.9	-8.3	23.5

Source: IMF

Among other commodity groups, energy prices have also started recovering since the start of current fiscal year, mainly due to: a) increased concerns over sustainability of supply at lower prices, b) cut in production by OPEC, as well as, c) a moderate recovery in oil demand. Weakness of US dollar has also resulted in an increase in crude oil prices, as weak dollar affects the profitability of the producers. According to International Energy Agency, global oil demand is expected to rise further in the coming months. The expected rise in demand is likely to push oil prices upwards.

Food commodity prices also recovered during FY10. However, due to significant increase in their supplies, the pace of increase in prices remains slow. Wheat production in US, Ukraine, Argentina, Australia and Canada remained higher than expected. Similarly corn output remained better than expected. Soybean and palm oil production is also expected to remain higher. Keeping this in view, prices of these commodities in international market are expected to remain lower in near future. However, if winter wheat sowing in the US is delayed due to adverse weather conditions, prices may witness upward pressure.

It is important to note that International Grain Council has forecasted a 14 percent increase in use of cereals for the production of ethanol during 2009-10. This

[2] Source: Eurostat News Release 12th November, 2009.

increase in demand is likely to put upward pressure on edibile oil prices.[3]

On the other side, due to bad weather conditions in India and Philippines, rice crop for this season is lower than earlier estimates. Consequently, India is likely to become a net importer of rice this year putting upward pressure on prices of the grain.

It is also important to note that strong demand from China has forced freight costs for dry bulk commodities such as iron ore, coal and grains to reach peak levels during November 2009. Rising freight costs are likley to push commodity prices higher.

3.2 Domestic Scenario

Domestic inflationary pressures eased significantly during the first five months of FY10 relative to the corresponding period of FY09. Inflation measured by consumer price index (CPI) and sensitive price indicator (SPI) continued to decline, with CPI inflation YoY finally dropping to single digit (8.9 percent) during October 2009, for the first time in the preceding 21 months. However, CPI inflation YoY bounced back to 10.5 percent YoY during November 2009. It is important to note that variability in monthly inflation rates and trends in WPI inflation (YoY) raised concerns over the sustainability of the downtrend in headline inflation, particularly in the second half of FY10. WPI inflation has again started to increase since September 2009 and rose to 12.5 percent in

Figure 3.2: Inflation (YoY) Trends (in percent)

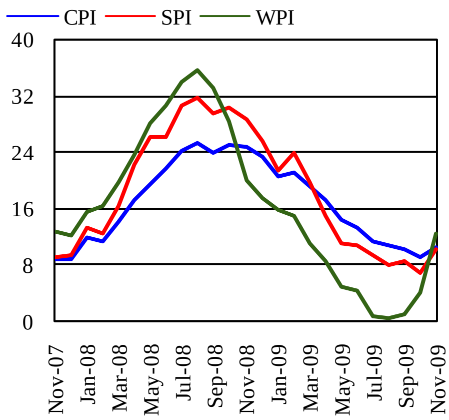
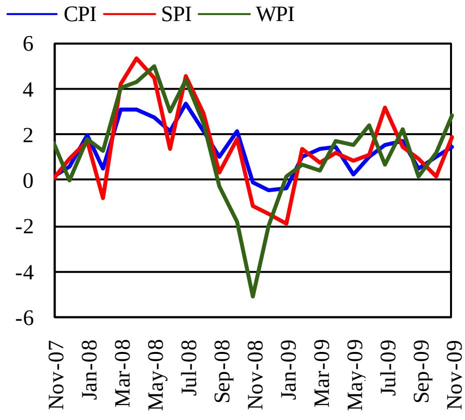


Figure 3.3: Inflation (MoM) Trends (in percent)



[3] Crop Prospects and Food Situation, United Nations' Food and Agriculture Organization (November 2009).

November 2009 after troughing at 0.3 percent YoY in August 2009. More importantly, WPI inflation is expected to remain strong in coming months. Similarly, all price indices exhibit positive growth on month-on-month (MoM) basis since February 2009, which shows considerable risks to the present disinflationary process (see **Figure 3.2** & **3.3**).

Table 3.3: Different Dimensions of Inflation (percent)

	Nov-08		Jul-09		Nov-09	
	MoM	**YoY**	**MoM**	**YoY**	**MoM**	**YoY**
Overall CPI	**-0.1**	**24.7**	**1.5**	**11.2**	**1.4**	**10.5**
Food group	-1.5	30.4	3.0	10.7	**1.8**	**11.1**
Non-food group	1.1	20.2	0.3	11.6	**1.0**	**10.0**
HRI	1.6	16.8	1.2	18.3	0.8	15.1
WPI	**-5.1**	**19.9**	**0.7**	**0.5**	**2.8**	**12.5**
Food group	-1.6	29.2	2.0	8.7	1.9	9.6
Non-food group	-7.9	12.8	-0.4	-5.4	3.5	14.9
SPI	**-1.1**	**28.8**	**3.2**	**9.4**	**1.9**	**10.0**
Core inflation						
NFNE	1.2	18.9	0.7	14	0.8	10.6
NFNE excluding HRI	0.9	20.8	0.1	10.1	0.8	6.4
Trimmed	0.7	21.3	0.8	13.9	0.7	10.5
Trimmed excluding HRI	0.3	24	0.7	12.1	0.9	9.0

The risk of resurgence in inflationary pressures is also evident from strong core inflation. Both indicators, non-food non-energy (NFNE) and 20 percent trimmed mean, although declining since H2-FY09, remain high. One of the main factors for the persistence in both measures of core inflation is the double digit increase in house rent index (HRI); even after the gradual moderation seen since June 2009. HRI has around 46 percent weight in NFNE and 29 percent weight in trimmed mean, hence the pace of decline in core inflation is slow relative to headline inflation. The high contribution of HRI to core inflation measures can also be observed from the fact that exclusion of HRI from the relative baskets of both measures of core inflation provide single digit inflation levels compared to their current double digit levels (see **Table 3.3**).

The recent disinflationary process is a function of: a) improvement in supply of most of the key staples (except sugar), b) constraint on government's monetization of the fiscal deficit, c) lagged impact of tight monetary stance, and d) a decline in imported inflation. The ease in inflationary pressures is encouragingly accompanied with a modest recovery in manufacturing sector as well as significant improvement in external account balances; build-up of reserves and stability in rupee parity. All these factors allowed SBP to cut the policy rate by 50 bps to 12.5 percent effective from November 25, 2009.

Figure 3.4: Distribution of Price Changes (YoY)

However, in the constrained monetization of the fiscal deficit and below expectation growth in external inflows, financing of fiscal deficit is becoming increasingly challenging. The government's reliance on borrowings from the domestic banking system coupled with quasi-fiscal activities such as the issuance of TFCs to resolve the energy sector circular debt raises the risk of crowding out private sector demand. Moreover, rising trend in international commodity prices, particularly crude oil, metals and some food items (rice, sugar) would likely to fuel inflationary pressures in the economy. Thus, the central bank will need to monitor overall macroeconomic and exogenous developments vigilantly.

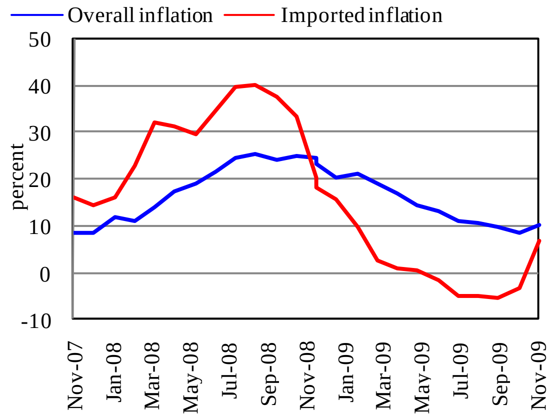
The risk of higher inflation in food commodities also stems from the weak monsoon in neighboring countries that would likely have negative spillovers on domestic prices. The recent increase in potato prices may be a harbinger of increases in other such commodities.

Given the declining trend in headline CPI inflation during recent months and risks of a reversal in this trend, SBP forecasts suggest that average inflation during FY10 would be in the range of 10.0 - 12.0 percent against the target of 9.0 percent.

3.3 Consumer Price Index (CPI)

Despite showing a slight uptick during November 2009, CPI inflation YoY has generally maintained a downtrend since H2-FY09. A relative ease in inflationary pressures is also evident from the declining number of items recording double digit price increases in CPI basket from Q3-FY09 onwards (see **Figure 3.4**). It is important to note that relatively lower contribution by imported inflation helped achieve the current disinflation despite an uptrend in international commodity prices. The major source of relative ease in imported inflation is a relative stability in rupee parity (see **Figure 3.5**). This suggests that stability in exchange

Figure 3.5: Impact of Imported Inflation



rate may now be an important source of inflationary expectations in Pakistan.

Although both food and non-food groups of CPI contributed to the downtrend in inflation, the impact of food group was more pronounced. Consequently the weighted contribution of food group to overall CPI inflation after remaining above 50 percent during H1-FY09, has been contributing less than 50 percent since January 2009 (see **Figure 3.6** & **3.7**).

Figure 3.6: Consumer Price Inflation (YoY)

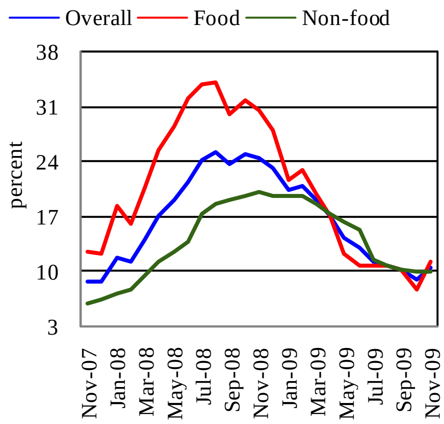
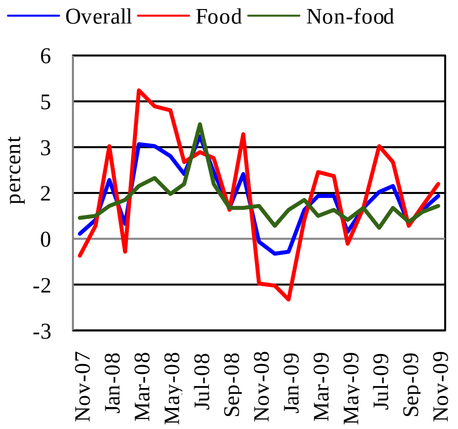


Figure 3.7: Consumer Price Inflation (MoM)



An analysis of the weighted contribution of individual items to overall CPI inflation (YoY) shows that despite a slowdown in HRI inflation, the contribution of HRI to overall inflation has increased persistently, compared to the last year, from 15.7 percent during November 2008 to 31.0 percent in November 2009 (see **Table 3.4**). Similarly, electricity and sugar have also shown an increase in their contribution to overall CPI inflation. An expected increase in electricity charges during H2-FY10 is likely to further increase its contribution to non-food and headline inflation.

Table 3.4: Weighted Contribution to CPI Inflation (YoY)

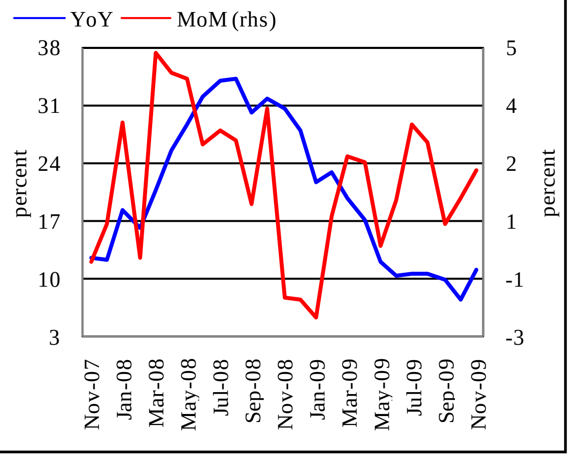
percent

		Weights	Nov-08	Dec-08	Jun-09	Jul-09	Oct-09	Nov-09
1	House rent index	23.43	15.7	17.5	30.8	35.0	38.3	31.0
2	Milk fresh	6.66	7.1	7.4	8.8	10.4	11.6	9.6
3	Wheat flour	5.11	14.9	12.1	7.1	7.9	4.4	4.4
4	Electricity	4.37	4.6	4.8	6.1	7.0	9.3	0.9
5	Meat	2.70	2.4	2.5	4.3	4.9	7.0	6.0
6	Vegetable ghee	2.67	1.9	0.7	-4.9	-6.1	-4.9	0.3
7	Sugar	1.95	1.3	1.7	4.7	4.9	3.0	6.4
8	Vegetables	1.92	3.0	2.2	4.7	4.3	5.4	5.0
9	Petrol	1.73	0.6	0.7	-3.2	-7.2	-4.9	2.4
10	Rice	1.34	3.9	3.4	-4.8	-5.3	-3.4	-2.8

3.3.1 CPI Food Inflation

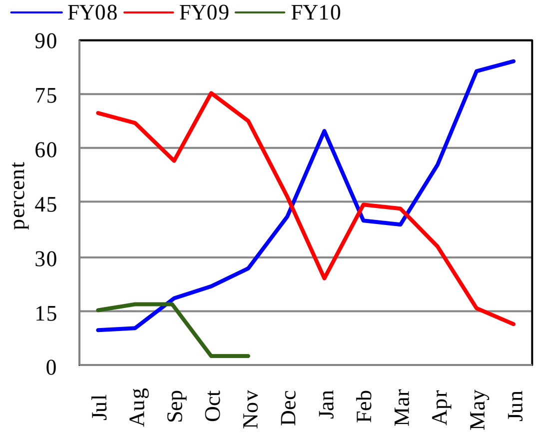
CPI food inflation (YoY) continued its declining trend since H2-FY09 and recorded single digit inflation for the first time in 25 months during October 2009. While, an uptick in CPI food inflation was witnessed during November 2009 as it increased to 11.1 percent, this level is still considerably lower than 30.4 percent recorded in the same month last year (see **Figure 3.8**).

Figure 3.8: CPI Food Inflation



A substantial decline in food inflation is mainly attributed to slowdown in the pace of rise in domestic wheat prices. It is important to note that wheat prices generally rise in October (before sowing season) because of limited supply. However this year, the increase was negligible due to ample stocks in the country (see **Figure 3.9**). In light of the government's decision to maintain support price at Rs 950 per 40 kg for FY10 wheat crop, it is likely that given favorable weather, wheat harvest could set a new record, as lower fertilizer prices would provide support to increase yields. This bodes well for the price stability of wheat, which is not only the key staple but also a wage commodity in rural area, and thus has significant impact on inflation. In contrast, despite significant fall, domestic sugar prices witnessed a

Figure 3.9: Changes in Wheat Prices



substantial increase of 50.1 percent during November 2009. However, variance in retail sugar prices increased across the markets and cities due to acute supply shortages and active administrative role. Given a drop in sugarcane output in FY10, there is a need to import at least 1 million tons of sugar to meet the domestic demand. This is an appropriate time to allow free trade of sugar by the private sector. The role of TCP may be redefined to procure adequate sugar to ensure supply to Utility Stores Corporation to support the government's targeted subsidy program.

Rice prices are declining in the domestic markets since April 2009. However, this trend is likely to be reversed in the second half of FY10 due to a rise in international rice prices amid lower rice output in India and damage to the rice crop in the Philippines. Farmers and traders may therefore see better prices in international rice market towards the middle of Q3-FY10.

Among other commodities, milk and meat continue to remain among the stronger contributors to overall inflation during the current fiscal year. Given that milk has the highest weight within food group, persistent rise in milk prices is a source of concern. Pakistan is one of the major milk producing countries, but a large quantum of milk could not be marketed. There is a need to expand the outreach of milk collection centers in rural areas with investment in storage at these centers. This would help improve supply and reduce wastages, and likely to help stabilize milk prices.

3.3.2 CPI Non-food Inflation

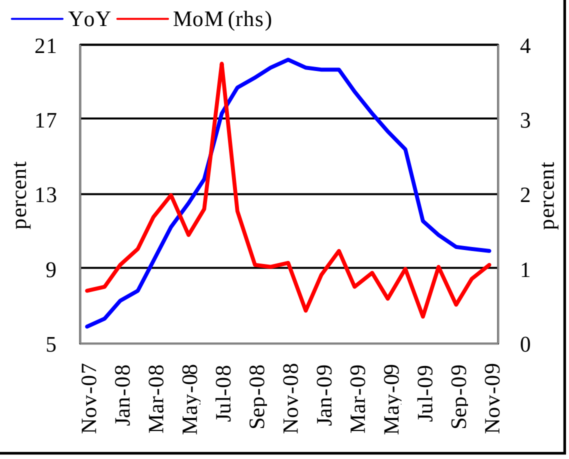
The downward trend in CPI non-food inflation (YoY), that started from December 2008 has continued into CY2009, though the pace of decline is not as pronounced as in food group. CPI non-food inflation was recorded at 10.0 percent during November 2009 as compared to 20.2 percent in November 2008 (see **Figure 3.10**).

Group-wise analysis of non-food group reveals that all sub-indices have generally depicted a downtrend in the last 12 months, though the pace of decline has varied across the sub-groups (see **Table 3.5**). In particular inflation in *transport & communication* has declined sharply to 4.7 percent in November 2009 from 28.6 percent in November 2008 mainly due to relatively lower domestic fuel prices compared to a year ago. However, deflation in this sub-group is likely to reduce significantly November 2009 onwards due to increasing prices of key fuels. Similarly *fuel & lighting* sub-group is likely to experience an increase in inflationary trends in coming months on the back of expected increase in electricity charges in H2-FY10.

Table 3.5: CPI Non-food Inflation by Groups

		MoM change			YoY change		
	Weights	**Nov-08**	**Oct-09**	**Nov-09**	**Nov-08**	**Oct-09**	**Nov-09**
Non-food group	**59.7**	**1.1**	**0.8**	**1.0**	**20.2**	**10**	**10**
Apparel, textile, etc.	6.1	0.7	0.2	0.4	15.9	5.1	4.7
House rent	23.4	1.6	0.9	0.8	16.8	16	15.1
Fuel & lighting	7.3	9.5	1.4	0.9	31.9	14.1	5.1
Household furniture & equipment	3.3	1.3	0.4	0.8	15	6.2	5.7
Transport & communication	7.3	-7.6	0.1	2.7	28.6	-5.9	4.7
Recreation & entertainment	0.8	0.3	0.0	0.8	12.5	2.1	2.6
Education	3.5	0.7	0.5	0.5	16.3	13.7	13.4
Cleaning, laundry, etc.	5.9	1.2	1.5	1.6	20.4	10.7	11.1
Medicare	2.1	0.1	2.0	0.0	12.5	5.4	5.3

Figure 3.10: CPI Non-food Inflation



House rent index, having the largest weight in CPI basket, although on a declining trend, has remained in double digits. It is significant to note that a disproportionately higher contribution by HRI is a major factor for a slow pace of disinflation in recent months. Given an ease in cement prices and a relative stability in other construction material costs, HRI is likely to decline for another year, barring an extraordinary surge in international prices.

Table 3.6: Income Group-wise CPI Inflation
percent

	Upto 3000		Rs 3001-5000		Rs 5000-12000		Above Rs 12000	
	Nov-08	**Nov-09**	**Nov-08**	**Nov-09**	**Nov-08**	**Nov-09**	**Nov-08**	**Nov-09**
Year on Year (November over November)								
General	27.3	10.5	27.4	10.3	26.1	10.3	22.5	10.8
CPI food	33	11.2	32.4	11	31.2	11	28.5	11.3
CPI non-food	22.9	10	23.7	9.7	22.2	9.7	17.7	10.3
Month on Month (November over October)								
General	-0.4	1.5	0.1	1.5	0.1	1.4	-0.5	1.4
CPI food	-1.5	2	-1.7	1.9	-1.5	1.8	-1.4	1.7
CPI non-food	0.6	1.2	1.6	1.1	1.6	0.9	0.3	1.2

3.3.3 Incidence of inflation

Income group-wise inflation during Q1-FY10 shows that the highest incidence of inflation on YoY basis was recorded for the highest income groups (with earnings above Rs 12,000 - see **Table 3.6**). The relatively lower inflation (YoY) in the lowest income group was primarily due to significant decline in food inflation.

Table 3.7: City-wise Inflation of Selected Cities (in percent)

	Nov-08		Oct-09		Nov-09	
	MoM	YoY	MoM	YoY	MoM	YoY
Overall CPI	**-0.1**	**24.7**	**1.0**	**8.9**	**1.4**	**10.5**
Islamabad	-0.6	21.0	0.4	8.1	0.6	9.5
Lahore	-0.1	22.5	0.4	8.4	1.0	9.7
Karachi	-0.5	24.2	0.7	7.5	1.5	9.7
Quetta	-0.6	26.9	0.9	6.5	1.5	8.7
Peshawar	-1.1	27.8	0.7	5.2	1.8	8.3

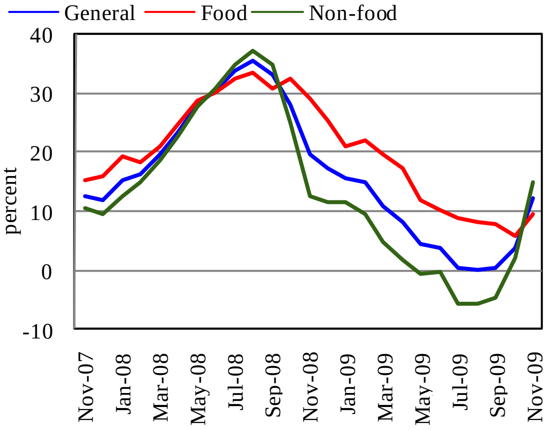
City-wise inflation data of the federal and provincial capitals shows that inflation on both YoY as well as MoM basis generally remained lower in these cities compared to overall CPI inflation (see **Table 3.7**).

3.4 Wholesale Price Index

After showing a declining trend since September 2008, WPI inflation showed an uptrend from September 2009 and rose to 12.5 percent YoY during November 2009. However, current inflation level is still less than 19.9 percent witnessed in November 2008.

This trend reversal in WPI YoY inflation is mainly due to WPI non-food group, which after registering negative growth since May 2009 is showing positive growth since October 2009. Similarly, WPI food inflation, after maintaining a continous downtrend during the first four months of FY10, also registered an increase in inflation during November 2009 (see **Figure 3.11**).

Figure 3.11: WPI Inflation YoY



Within non-food group, all sub-groups excluding *building materials* have started to rise since September 2009. In particular, *fuel, lighting & lubricants* sub-group, after registering negative growth during early part of FY10, has also shown positive growth since October 2009. Inflation in this sub-group was 26.9 percent during November 2009 compared to 9.0 percent during November 2008 (see **Table 3.8**). This uptrend in *fuel, lighting & lubricants* sub-group inflation reflects the impact of rising electricity charges and furnace oil prices. The rise in domestic furnace oil prices was mainly due to increasing international crude oil prices. If global crude oil prices remain strong, and the expected increases in domestic electricity charges implemented, inflation under this sub-group will rise further.

Table 3.8: Percentage Change in WPI (YoY)

	Nov-08	Jan-09	Jun-09	Jul-09	Sep-09	Oct-09	Nov-09
General	19.9	15.7	4.1	0.5	0.7	3.8	12.5
Food	29.2	21.0	10.2	8.7	7.8	5.8	9.6
Non-food group	12.8	11.6	-0.3	-5.4	-4.6	2.2	14.9
Raw materials	11.7	16.4	11.9	8.3	4.7	12.1	20.2
Fuel, lighting & lubricants	9.0	11.7	-4.0	-11.8	-7.9	4.7	26.9
Manufactures	12.2	7.5	3.2	1.2	-0.5	0.2	7.4
Building materials	38.3	20.3	-10.1	-11.5	-13.9	-16.1	-16.7

Similarly inflation in the *raw materials* sub-group has remained in double digits since October 2009. This uptrend was contributed by items like sugarcane and cotton. The prices of both of these items increased due to strong domestic demand and rise in their international prices in recent months.

Manufactures sub-group also registered a trend reversal in inflation (YoY) since October 2009. It is important to note that if *manufactures* sub-group's inflation will increase further in months ahead, it would push up WPI non-food inflation as it has the highest weight (45 percent) within non-food group of WPI.

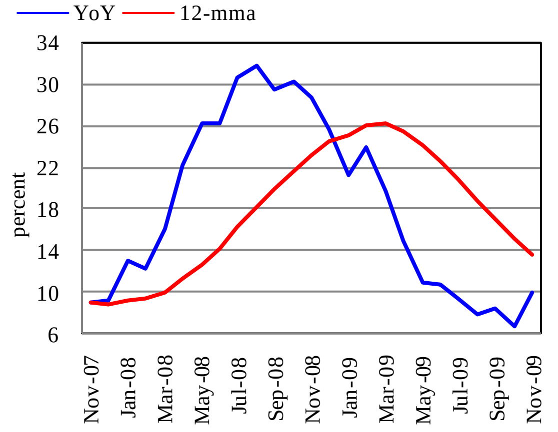
The only sub-group of WPI that has not yet registered positive YoY growth during FY10 is the *building materials* sub-group. The downtrend in this sub-group is entirely due to declining prices of two items, i.e., iron bars & sheets and cement, as prices of all other commodities in this, sub-group, have been recording increases. The downtrend in domestic cement prices is mainly due to: a) Competition Commission of Pakistan (CCP) measures against the alleged formation of a cartel by the cement industries, and b) increase in domestic supply following declining cement export volumes since June 2009 amid stiff competition as well as gloomy construction activities in Middle East. It is important to note that although the iron bars & sheets are still showing around 20 percent deflation, there are risks of future inflation. The pick up in global demand for iron ore will eventually be reflected in the domestic prices of the commodity.

Going forward, if global commodity prices continue to show strength, they are likely to be reflected in higher WPI inflation levels in months ahead as prices of important commodities in the WPI basket such as furnace oil, motor spirit, mobil oil, etc., are directly linked to prices in international markets.

3.5 Sensitive Price Indicator (SPI)

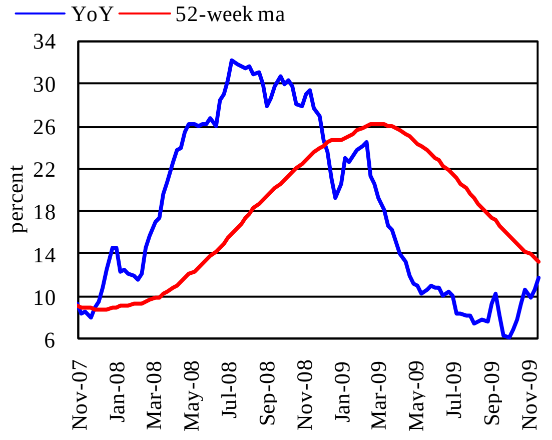
Inflation (YoY) measured by sensitive price indicator (SPI) generally maintained a declining trend during the first four months of FY10 and reached 6.7 percent during October 2009, compared to 30.3 percent in the same month last year. Although SPI inflation showed an increase during November 2009 to reach 10.0 percent, this level is still lower compared to 28.8 percent in November 2008. The long-run trend, measured by 12-month moving average, after peaking out in March 2009 (26.3 percent),

Figure 3.12: SPI Inflation



has remained on a declining path to reach 13.6 percent during November 2009 (see **Figure 3.12**). This downtrend is mainly due to relative ease in food inflation, as food commodities comprise more than 60 percent of items in the SPI basket.

Figure 3.13: Weekly SPI Inflation



In line with the trend in monthly SPI inflation, weekly SPI inflation (YoY) has also maintained a downtrend during Q1-FY10 (see **Figure 3.13**). However, it is pertinent to note that since the third week of October 2009, weekly SPI inflation has again started to rise due to rising prices of dairy products, pulses and poultry items. If this uptrend in weekly SPI inflation continues, then it is likely to be reflected in CPI food inflation in the months ahead.