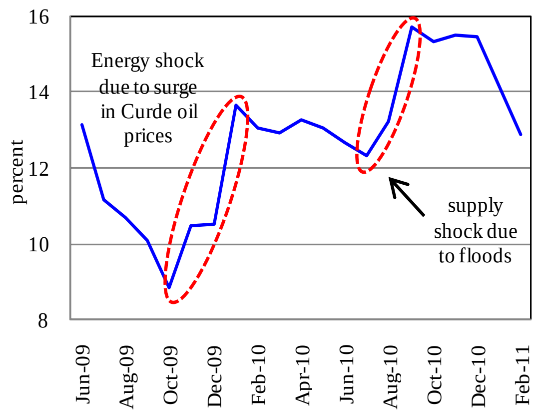
3 Prices

3.1 Overview

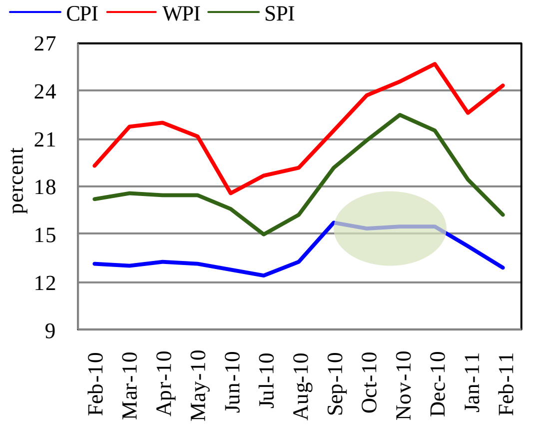
Inflationary pressures remained strong during H1-FY11, driven by the combined impact of flood-related supply shock, monetization of the fiscal deficit and rising global commodity prices (see **Figure 3.1**).

Figure 3.1: Inflation Scenario and Shocks to the Economy



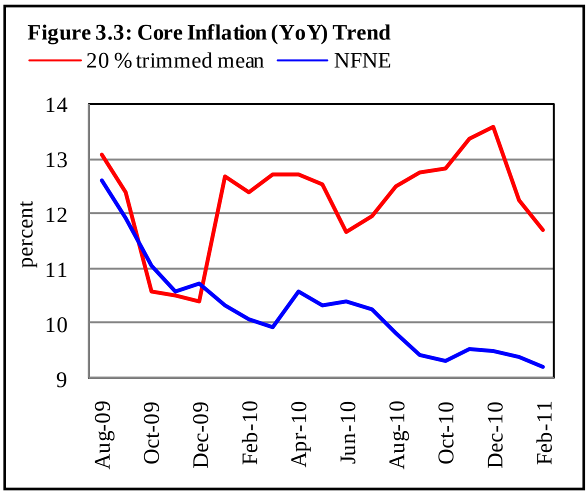
Although YoY inflation moderated somewhat during the initial two months of H2-FY11 (see **Figure 3.2**), this was largely due to wearingout of flood related rise in food inflation and delays in increasing domesitic retail fuel prices in line with the international oil prices. This trend is therefore unlikely to be sustained in the months ahead.

Figure 3.2: Inflation (YoY) Trends

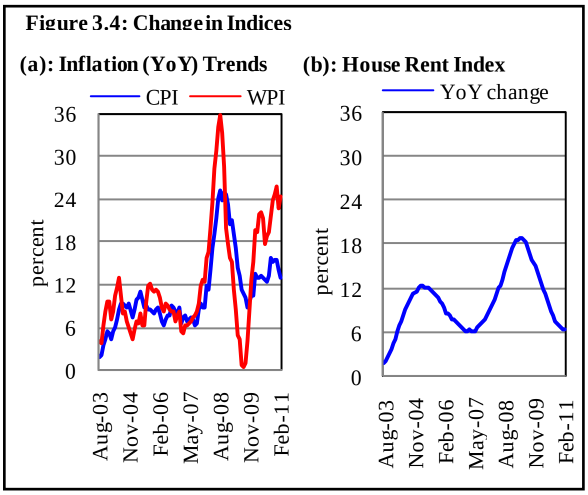


Moreover, the need to resume the IMF program would require additional revenue measures, and upward adjustment in power tariffs. These measures would initally add to infationary pressures. As such, despite moderation in inflation during Jan-Feb 2011, SBP's inflation forecast is in the range of 14.5-15.5 percent.

What this essentially means, is that while the period average CPI inflation for Jul-Feb FY11 is 14.3 percent, SBP expects inflationary pressures to edge up in the months ahead. Credence to this assessment is lent by the following observations:



- Although core inflation (excluding food and energy components from the headline CPI or non-food non-energy –(NFNE) is in single digit for the last seven months, this shows that inflationary pressures are principally coming from food and energy. Unfortunately, the surge in these prices have strong second-round effects. At the same time, core inflation measured by the trimmed method remains in double digit, reflecting strong inflationary pressures (see **Figure 3.3**). However, the downward trend is heartneing.



- The impact of rising international commodity prices is evident in the WPI (which reflects production costs) (see **Figure 3.4-a**). As this impact seeps into the CPI inflation with a lag, CPI non-food inflation is likely rise in the coming months.

- Global commodity prices are likely to remain firm due to: (a) unrest in North Africa and the Middle East; (b) supply shortages due to adverse weather in a number of important commodity producing/consuming countries; (c) depletion of inventories of key agricultural commodities (cotton, wheat etc.)

and metals (copper, iron ore) to multiyear lows; and (d) depreciation in the value of the dollar against major currencies.

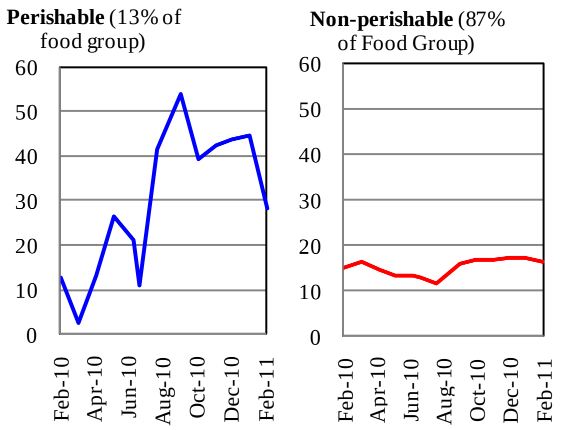
- As mentioned above, pass-through of rising international oil prices is inevitable. Upward adjustments in POL prices will hit transportation costs which in turn will impact most food prices.

- The expected reversal of the delcining trend in the house rent index (HRI)[1] in coming months because of an increase in the prices of construction materials (see **Figure 3.4-b**).[2]

- Any fiscal policy slippages that manifest in central bank financing, will also fuel inflationay pressures.

- It is important to note that while the surge in perishable food prices due to the floods eased somewhat in November 2010, external demand for vegetables and fruits[3] will keep upward pressure on food prices.

Figure 3.5: Food Inflation (YoY-percent)



- Non-perishable food inflation is also an issue (see **Figure 3.5**). Since non-perishable food items have 87.5 percent weightage in the food group, even a small rise in this group could overshadow any decline in the prices of perishable food commodities.

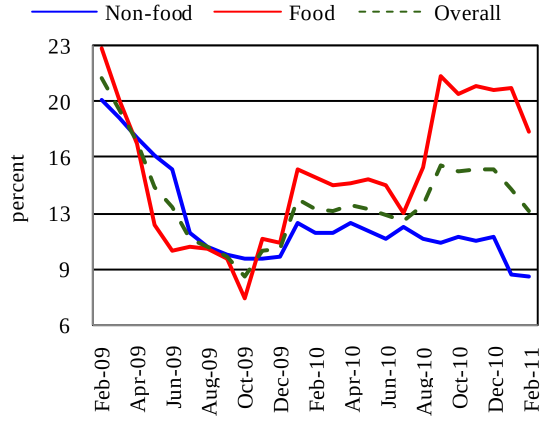
[1] A reversal in HRI would have significant impact due to its 23.43 percent weight in CPI basket.
[2] Anecdotal evidence suggests that wages have generally risen in informal markets, particularly for construction workers.
[3] Exports of fruits & vegetables saw 9.2 percent YoY growth in January 2011.

3.2 Consumer Price Index (CPI)

Headline CPI inflation eased somewhat to 12.9 percent YoY in Feb 2011 from 14.2 percent in the preceding month. This improvement was primarily attributed to a slowdown in food inflation, which was also supported by a marginal fall in non-food inflation.

The decline in non-food inflation was principally driven by the fall in HRI, which was further supported by the postponement of fuel price increases. This led to fall in the *fuel & lightening* and *transport & communication* sub-groups inflation. *Fuel & lightening* inflation dropped to 9.1 percent while *transport & communication* declined to a 12-month low of 12.3 percent. Consequently, non-food inflation fell to 8.9 percent, which is the lowest non-food inflation since Feb 2008 (see **Figure 3.6**).

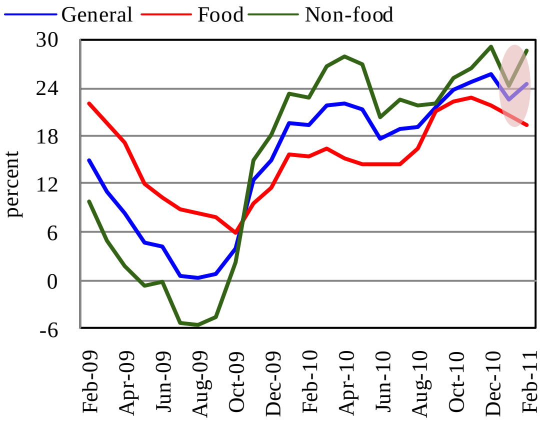
Figure 3.6: CPI Inflation-YoY



3.3 Wholesale Price Index (WPI)

In contrast with CPI, WPI bounced back to 24.4 percent YoY in Feb 2011, after showing a decrease in Jan 2011 (see **Figure 3.7**). Although WPI food inflation declined for the third consecutive month in a row, surge in non-food groups of WPI contributed to this rise.

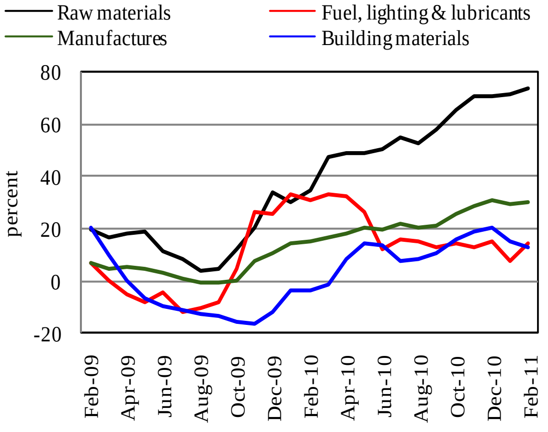
Figure 3.7: WPI Inflation -YoY



WPI non-food inflation rose to 28.0 percent YoY in Feb 2011 from 24.2 percent in Jan 2011. All sub-groups of WPI non-food witnessed acceleration in inflation, except, *building materials*. In particular, a rising trend in *raw materials* is still unabated; this sub-group registered a record inflation of 73.6

percent YoY during Feb 2011 compared with 71.1 percent in the preceding month (see **Figure 3.8**). This sharp rise was mainly a function of surge in international prices of cotton and sugarcane. While, impact of higher sugarcane prices is already been passed on to the consumers, the impact of record cotton prices would gradually push-up retail prices of all types of textile products

Figure 3.8: WPI Non-food Inflation -YoY



3.4 Sensitive Price Indicator (SPI)

SPI inflation declined for the second consecutive month, from 21.5 percent in Jan 2011 to 16.2 percent YoY in Feb 2011. This easing is mainly due to seasonal improvement in the supply of perishable food items, which have a significant weight in SPI basket.