3 Prices

3.1 Overview

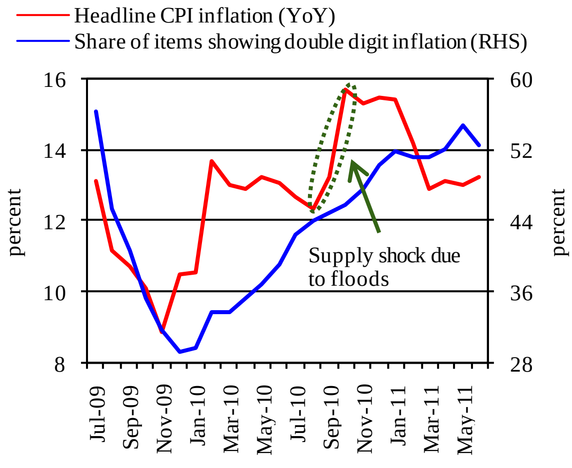
Recent trends in CPI inflation suggest that the impact of floods on prices has clearly worn-off, but in overall terms, inflationary pressures remain quite strong: Jul-May FY11 CPI inflation of 14.0 percent is considerably higher than 11.7 percent in the corresponding period of FY10. Nevertheless, we expect CPI inflation for FY11 to remain close to 14.0 percent – an improvement over SBP's earlier projections.[1]

Although high inflation is always a major source of concern for the central bank, some recent trends are disconcerting. Firstly, inflation remains stubborn. Secondly, inflationary pressures are broad-based, suggesting that inflation has permeated to most sectors and will therefore be difficult to curtail in the short run. Finally, although food inflation may decline in the coming months, overall inflation may not subside in the near future.

3.2 Inflation Trends

Year-on-year CPI inflation came down from a peak of around 15.5 percent in December 2010 to 13.23 percent in May 2011. Notably, this level of inflation was very close to its pre-flood level, indicating that the impact of the August 2010 floods on inflation has played out (see **Figure 3.1**). As the effects of the floods wore off, shortages of perishable food items were contained. The consequent decline in prices of perishable food items was the main reason behind deceleration in food inflation (see **Figure 3.2**). This, in turn, helped overall inflation ease till February 2011.

Figure 3.1: Inflation and Its Diffusion



[1] SBP projected FY11 inflation in the range of 14.5-15.5 percent (see **Second Quarterly Report on *State of Pakistan's Economy* for FY11**).

Disappointingly, this downtrend could not be sustained beyond February due to increases in the prices of non-perishable food items (e.g. cooking oil; dairy products; tea; and gram whole). Furthermore, rising prices of the apparel & textile and cleaning & laundry subgroups, as well as the increase in house rent index added to inflationary pressures. Hence, CPI inflation continued to hover around 13 percent February 2011 onwards – a reflection of inflation persistence.

Figure 3.2: Food Inflation (YoY)

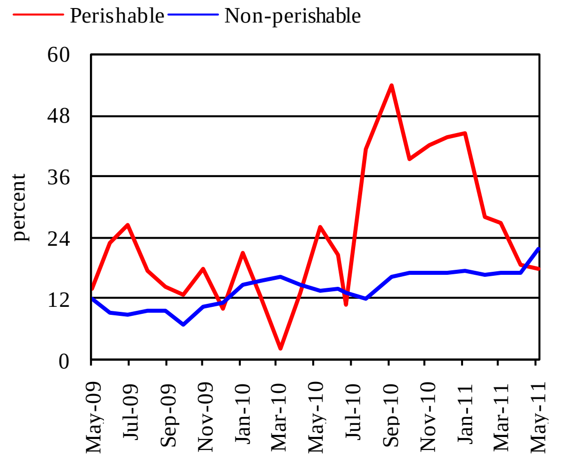
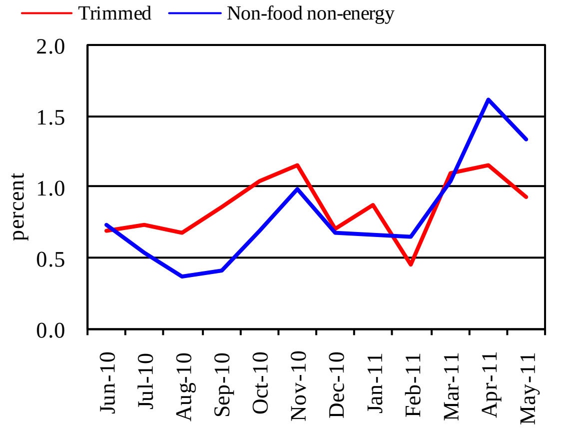


Figure 3.3: Core Inflation (MoM)



A key concern for SBP is the extent to which inflationary pressures have spread across the economy. Specifically, the share of items in the CPI basket displaying double digit inflation has remained over 50 percent in May 2011. To put this in perspective, in May 2010, only around 39 percent of commodities in the CPI basket were showing double digit inflation (see **Figure 3.1**). Paradoxically, this has not had a substantial effect on overall inflation. The reason is the items displaying double digit inflation have increased, but since they do not have significant weights in the CPI index, the overall inflation has not followed suit.

However, measures of core inflation do reflect the broad-based nature of inflationary pressures (see **Figure 3.3**). Month-on-month changes in core inflation (trimmed as well as non-food non-energy – NFNE) have been more pronounced lately due to the pass through of higher commodity prices in international markets. This implies that inflation has spread across a plethora of goods. The pressure on

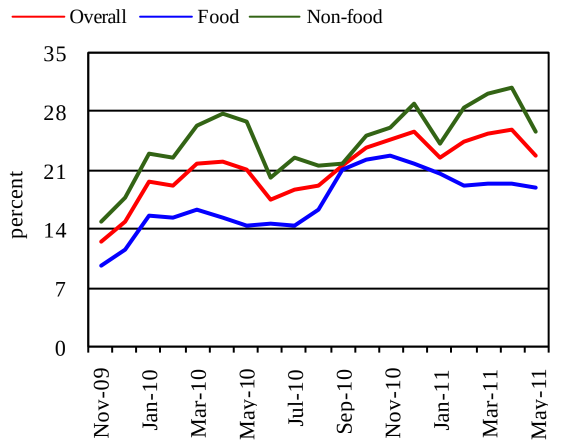
NFNE in particular implies that the economy will be much more vulnerable to food and energy shocks, which means that inflation cannot be mitigated entirely by orthodox policy measures such as monetary tightening.

3.3 Inflation Outlook

Following a good *rabi* season, wheat and sugar prices have come down which should contain, and perhaps ease, food inflation in the coming months.

Wholesale prices increased sharply, reaching 25.9 percent in April – the highest level in 30 months – before slowing down to 22.9 percent in May (see **Figure 3.4**). Non-food items (e.g., POL products and cotton) have largely accounted for the uptrend in wholesale prices.

Figure 3.4: WPI Inflation (YoY)



While cotton prices have dropped after March 2011, POL prices have not. Since POL prices pressure tend to spill-over to other items in the CPI basket, overall inflation seems unlikely to recede too sharply in the coming months. More generally, expectations of a global recovery, an earthquake in Japan and political unrest in MENA were the major factors responsible for the upward movement in global commodity prices in early 2011. However, commodity prices decreased sharply in the first week of May after a disappointing outlook on the US recovery. This drove the WPI inflation down in the month of May. Commodity prices have since rebounded and wholesale price inflation is expected to follow suit.

Unfortunately, the rebound in global commodity prices may fuel expectations that inflation in the country will remain stubbornly high in the near future. The perception that SBP monetizes the government's deficits adds to such expectations. Moreover, the general public has also come to expect increases in fuel prices, electricity tariffs and the imposition of the general sales tax, thus reinforcing inflationary expectations. Finally, the expected removal of various subsidies under the auspices of the IMF could also add to the problem.

Thus, the outlook for overall inflation, even in the absence of food or energy shocks, is not very encouraging. Although we expect food prices to provide some room for comfort, self-fulfilling inflationary expectations have ingrained themselves in the economy and consequently, inflation is not expected to ease substantially in the near future. On the external front, oil prices are expected to increase in the summer with increased demand from China, US and a recovering Japan. Higher, persistent core inflation has left the economy more vulnerable to such external pressures.