Prices

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The first quarter of the financial year (FY) 2005-06 began with a high overall inflation rate of 5.8 per cent in April, followed by 5.5 per cent in May (Fig P.1). The year- on-year (Y-o-Y) inflation rate for primary articles remained at a low of two per cent and 0.9 per cent in April and May 2005 respectively, compared to 2.2 per cent and 3.5 per cent last year. In contrast, the maximum growth was observed in the fuel group — a high of 11.2 per cent in April 2005 up from 10.2 per cent in March 2005. The surge in prices of aviation turbine fuel (ATF), naphtha and furnace oil, which are market-driven, pulled up inflation in the fuel group during April 2005. During this period, the petroleum, diesel and LPG prices that require government approval did not see any hike. Furthermore, manufactured goods' prices too registered a growth of 5.3 per cent, thereby contributing to the overall rise in WPI.

While dollar prices of Indian crude moved up from US$ 40 to US$ 54, domestic prices were kept unchanged since mid-November 2004. To ease the inflationary expectations petrol and diesel prices were hiked by Rs. 2.5 per litre and two rupees per litre respectively on June 20, 2005. The government has opted to keep kerosene and cooking gas prices static. This hike in petroleum product prices is expected to have a direct impact on the wholesale price index. It would also have an indirect impact because of higher transport cost for various commodities and higher costs for commodities that use petroleum products as input. However, the pricing power of manufacturers will also determine the course of its transmission into the economy.

A look at use-based inflation rates (Fig P.2) reveals that basic goods and intermediate goods mainly led inflation in 2004. Basic

Fig P.1:WPI based Monthly Inflation Rate (% Change, Y-o-Y)

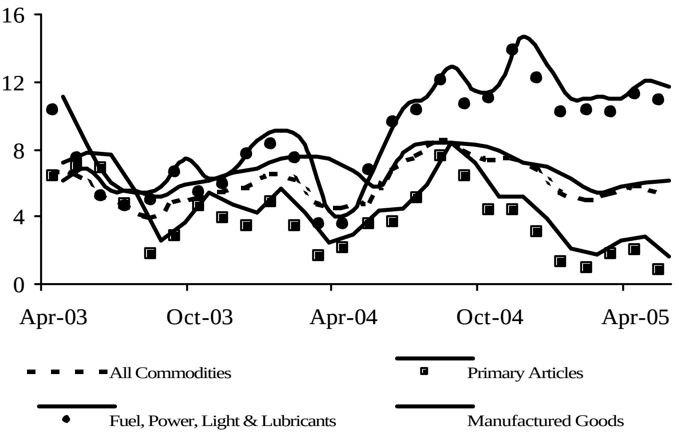
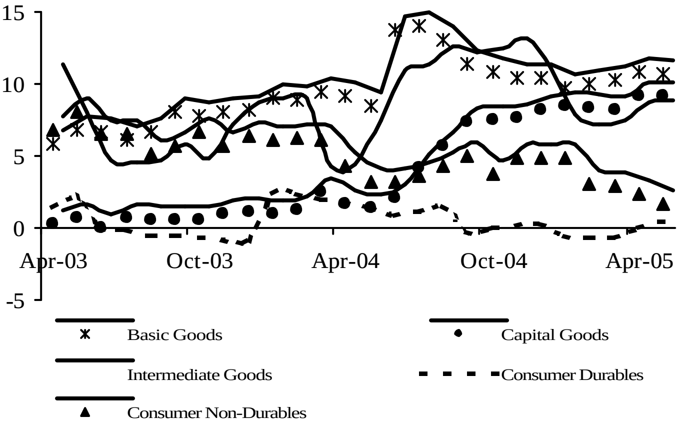


Fig P.2:WPI based Inflation Rate of Use-based Classification (% Change, Y-o-Y)



goods have been experiencing a steady rise in inflation. Intermediate goods too have seen 7.8 per cent inflation in April 2005 compared to 3.5 per cent during the same month last year. This category always undergoes volatile fluctuations, and though the petroleum price hike is likely to play a prominent role, the base year effect will run counter to it. At its peak last year, it hovered between 10-12.3 per cent from June-December 2004. The capital goods inflation rate has seen a massive increase from 1.8 per cent to 8.2 per cent in March 2005, as compared to the previous fiscal where it mainly moved in the range of zero to two per cent. Yet, its impact remains limited due to its low weightage on WPI basket. Focussing now on consumer goods, we observe the following. Although the inflation rate for consumer durables was able to recover from -0.7 per cent in March to zero per cent in April and subsequently to 0.4 per cent in May, the inflation for non-durables was on its way down from 2.9 per cent to 2.4 per cent and 1.6 per cent respectively, during the same time. This indicates that intense competition has prevented producers from raising prices.

Figure P.3 indicates that core inflation has been ruling about two per cent above the wholesale price index (WPI) based inflation rate during the first quarter, in keeping with the earlier trend. The core index is calculated by excluding primary food and non-food articles, and administered items such as coal, electricity and fertilisers. This indicates that inflation has been high in the categories of primary minerals, mineral oils in the fuel category and manufactures. Last year itself, crude and mineral oil prices contributed to 30 per cent of the overall price rise, despite the two-phased reduction of excise duties on petrol, diesel, LPG and kerosene. The Reserve Bank of India (RBI) Governor's remarks in this regard that -"barring the effects of oil prices, the core inflation has remained fairly stable…" are indeed accurate.

Fig P.3:Monthly Inflation Rates (% Change, Y-o-Y)

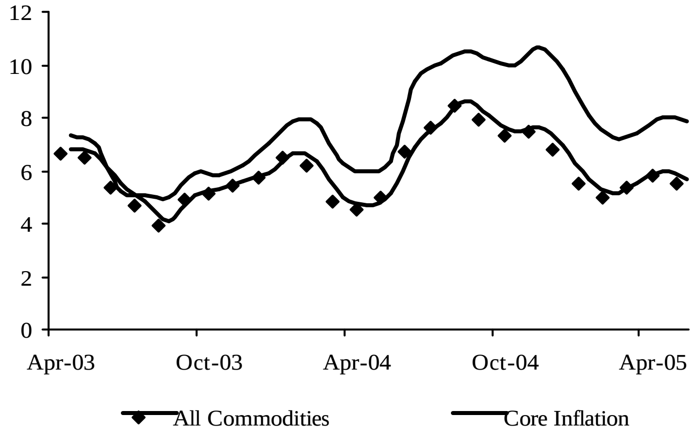
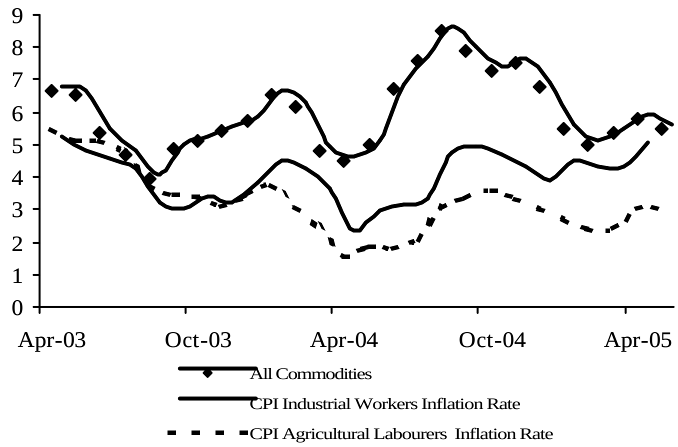


Fig P.4:Wholesale and Retail Price Inflation (% Change,Y-o-Y)



Trends in CPI

The Consumer Price Index (CPI) for industrial workers (IW) and agricultural labourers (AL) are generally considered to be the indicators of retail prices. The CPI-IW - last fiscal stayed much below the WPI (Fig P.4). This essentially was due to the differences in the commodity baskets. Key drivers of WPI such as fuels and metals have a negligible weight in CPI. The CPI-IW went up to 4.96 per cent in April after it had stayed put at the March level of 4.16 per cent. Again, it was food articles, with a huge weightage of 57 per cent in the index, which contributed to this. The increase was mostly due to the prices of rice, moong dal, urad dal, milk, vegetables & fruits, gur etc. On the other hand, inflation rate on account of CPI-AL has remained in the two to three per cent range in recent months.

International trends

After a frenzied start in 2005, there is now a sudden cooling in the global prices. Steel and other metals are all down between seven and 16 per cent. One obvious reason is lower Chinese demand because of sufficient stocks in its warehouses. The other is that the demand-supply mismatch is easing, especially in non-ferrous metals, as new capacities gradually start coming on-stream. Industrial metal prices began rising sharply in late 2003, and in many cases made new long-term highs by early 2005. Since then, however, they have cooled off. Most now appear either to have broken, or to be in the process of breaking. Iron ore contract prices, up by a remarkable 72 per cent this year, will not be lifted again next year because demand is moderating and more supplies will become available gradually.

What lies ahead

In the coming months inflation is expected to benefit by the base year effect. Both industry and agriculture are expected to maintain robust growth, and together with India Meteorological Department (IMD)'s forecast of a normal south-west monsoon, inflation is anticipated to be under control. The RBI, in its Annual Policy Statement has placed the inflation rate in the range of five to 5.5 per cent for 2005-06. Nevertheless, global oil prices will lend an element of uncertainty, since India imports 75 per cent of its domestically used crude oil.

At the outset, the RBI Governor raised the reverse repo rate (at which the banks lend their excess short term funds to RBI) by 25 basis points from 4.75 per cent to five per cent on April 28, 2005 in its pursuit to strive for an interest rate environment that is conducive to macroeconomic and price stability in the presence of oil uncertainties. This may be interpreted as a subtle indication of what is to come in case the economy is faced with further inflationary pressures. Liquidity is an important concern with the central bank, as this year huge government borrowing accompanies fierce loan growth.

To forecast composite WPI inflation in the coming months, we have used a multiplicative model consisting of four components of time series - trend, seasonal, cyclical and random. Our source of data is the official weekly price indices for the period 2000-05. The series was first deseasonalized and detrended. Whatever cyclical and random components were left after detrending the deseasonalized series, were computed as a residual index. Our forecast for the coming months (June-August) suggests that the inflation rate will lie between 4.21 to 4.26 per cent (Table P.1). Although estimates (actual as well as provisional) up to the week ending May 28 suggest that the inflation rate has been between five to six per cent, the inflation rate from June onwards is on its way down. It is likely to stay so for the coming three months too, in spite of the uncertainties on the oil front.

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Table P.1:Forecasted Inflation Rate

Week Ending	Forecasted Inflation Rate
04.06.05	4.26(4.22*)
11.06.05	4.25(4.33*)
18.06.05	4.25(4.10*)
25.06.05	4.25 (4.14*)
02.07.05	4.25 (4.09*)
09.07.05	4.24
16.07.05	4.24
23.07.05	4.23
30.07.05	4.23
06.08.05	4.23
13.08.05	4.22
20.08.05	4.22
27.08.05	4.22
03.09.05	4.21

* Provisional Inflation Rate