

Price

The overall inflation rate rose to 4.5 per cent at the end of December 2005, higher than the previous month's 4.3 per cent (Fig P.1). The persistent high oil prices, and somewhat liberal monetary policy, suggest that the up-trend in inflation rate will continue.

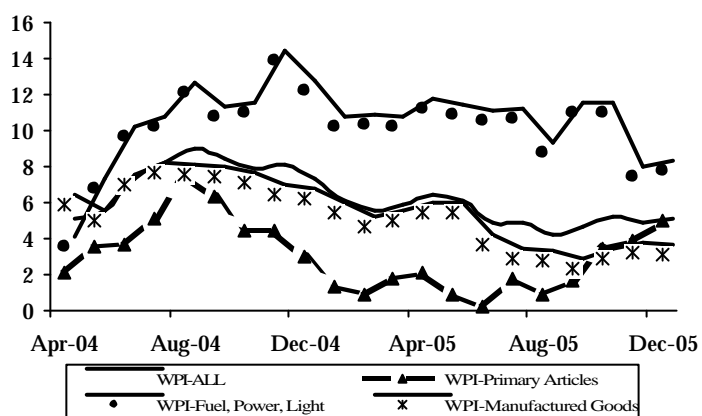
On a disaggregated basis, the group price index of primary articles has been on the rise since August 2005. However, the rise was especially sharp in December 2005 when the WPI-primary based index touched 5 per cent. This was mainly due to costlier food articles, amongst which pulses and eggs, meat and fish registered the highest rise. Within this group, there was some respite with the fall in the prices of condiments and spices.

The real problem however is the price of oil. After crossing US \$70 per barrel mark, it has come down to around US \$ 65 per barrel. This is the main factor responsible for the persistent 9 per cent or more inflation in the energy component of the WPI.

However, in recent months, inflation on account of energy related WPI has fallen marginally and stood at 7.8 percentage points at the end of December. But this was more due to waning of the impact of the price revision of petrol, diesel, etc.

The twin factors — tightness across the supply chain and the tightness in the refining capacity — for high global oil prices still exist. So far, the government has not yet passed on the complete burden of increased crude prices.

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



Inflation on account of manufactured goods has been hovering around the 3 per cent mark since October 2005 (Fig P.1). Except textiles, all other constituents within this group are on the rise. However, the principal factors (in the decreasing order of importance) for the upswings in prices of WPI-manufactured are chemicals and chemicals products, basic metal alloys and metal products, and food products. Increasing prices of non-ferrous metals like aluminium, copper etc. are reflected in the rising trend of metal prices. Among the chemical products, the prices have firmed up in case of basic heavy inorganic chemicals, fertiliser and pesticides, paint varnishes and lacquers, drugs and medicines.

Fig P.2 shows the use-based component of inflation rates and it is clear that the inflation rates on account of basic and intermediate were higher in end-December

The price index of primary articles, especially food, has been on the rise since August 2005

ber 2005. The tight supply situation, both on the domestic as well as international fronts, is the principal reason for this. The absence of this factor in the case of capital goods is reflected in more benign inflation (4.1 percentage point).

Consumer goods inflation, both non-durable as well as durable, has been low. The high inventory, increased competition and the wide spectrum of suppliers, both from within and outside India, has prevented producers from raising consumer prices.

Core inflation has declined below 5 per cent and stood at 4.9 per cent at the end of December (Fig P.3).

This indicates that inflation has been high in the categories of non-administered items. This may be a point of worry in the coming months.

Trends in CPI

Retail prices as indicated by the Consumer Price Index of Industrial Workers (CPI-IW) and Consumer Price Index of Agricultural Labourers (CPI-AL) are shown in Fig P.4. The inflation rate on account of CPI-IW has been on the rise for the last three months. It has crossed the 5 per cent mark at the end of November 2005. The increase was due to the rise in the prices of rice, wheat, wheat atta, pulses, onion, and vegetable and fruits items. The CPI-AL based inflation also shows similar rising trend, moving closer to 5 per cent mark at the end of November 2005.

The political ramifications of a rising CPI suggest that in the upcoming budget the finance minister could take steps by way of duty restructuring or by other means to reduce the increase.

International Trends

There is every indication that the commodity rally of late 2005 will continue into the first quarter of the 2006, if not beyond; and may flatten in the second half

Fig. P.2: WPI based Inflation rate of use-based classification (Percentage Change Y-o-Y)

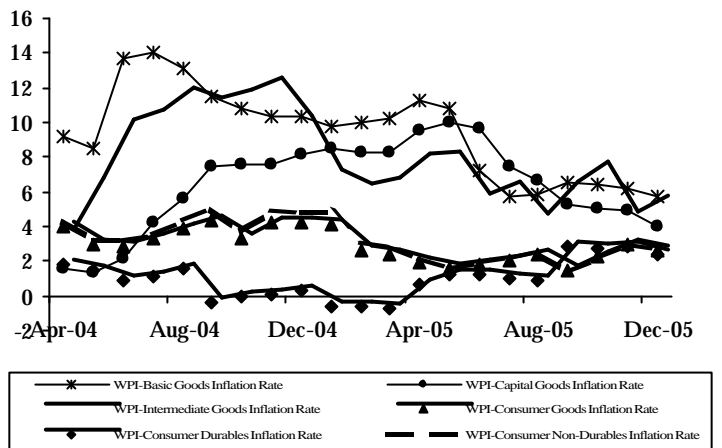


Fig. P.3 Monthly Inflation Rates (Percentage Change Y-o-Y)

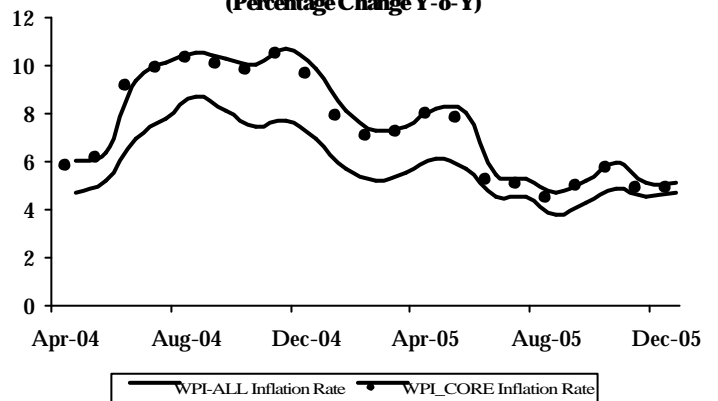
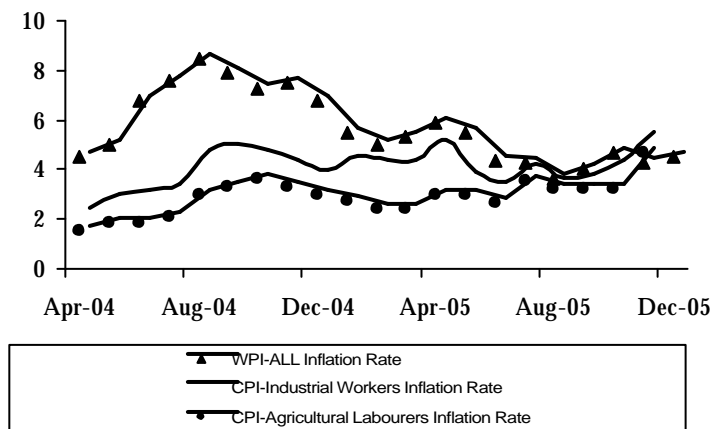


Fig. P.4: Wholesale & Retail Price Inflation (Percentage Change Y-o-Y)



of 2006. Population growth and rapid industrialisation by the developing and CIS countries have ushered in a huge and growing middle class, which is competing for every additional barrel of crude oil sold in the international markets, and for every kilogram of wheat, sugar, rubber or gold. Expectedly, the rapid industrialisation is itself spurring a parallel demand for commodities, such as copper for the burgeoning telecom industry, silver for electronics, gas and oil for running factories, electricity for heating, and iron and steel for cars and buses

In a general sense, given the demand-supply fundamentals, global economic growth, inflation and interest rates commodity and energy prices are expected to remain high and are likely to peak in the first quarter.

The crude market is likely to find strong support in the first quarter. Although the sedate nature of crude market in the last few weeks of 2005 caught many by surprise, there is unlikely to be a slowdown in demand anytime soon. Nor can there be a surprise increase in supplies.

Supply constraints remain severe across the base metals sector due to cost pressures from high raw material prices (including high-energy prices) and critically low level of inventories. Demand, on the other hand, continues to be robust. Among base metals, copper looks dis-

tinctly bullish and seems poised to top early in 2006. Silver (and gold as well), too, have a strong potential to move upwards.

The iron ore market is looking tight in 2006. China's demand for imported iron ore is expected to grow strongly again this year resulting in spike in iron ore prices. A similar trend is expected in the case of global steel prices.

The case for grains and commodity is expected to be no different. In effect, commodity prices are expected to firm up from the current year and the international commodity futures markets are likely to become far more active and buoyant.

Prognosis

Inflation remained around 4.5 per cent in the first eight months of 2005-06. The RBI and the government have kept the inflation forecast unchanged at 5-5.5 per cent. The direction will become clearer in the coming months as the higher base effect would be eliminated.

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 forecast for the coming months suggests that the WPI inflation rate will lie between 4.50-4.75 per cent.

WPI based inflation in coming months is expected to lie between 4.50-4.75 per cent