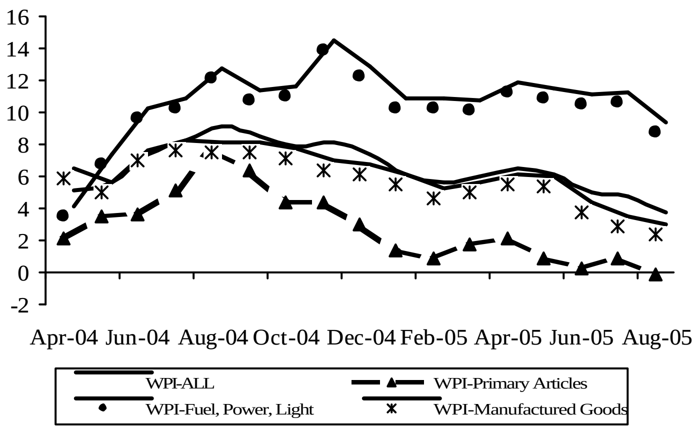
Prices

The first quarter of the 2005-06 began with a high overall inflation rate of 5.9 per cent in April, followed by 5.5 per cent in May (Fig. P 1). It began coming down then and stood at 3.1 per cent at the end of August 2005. But now it has gone up to more than 3.5 percentage points, if one considers the weekly indices of WPI-all commodity in the month of September 2005. The rise was expected due to the recent hike in domestic fuel prices. Moreover, the rise in the prices of fruits and vegetables, sugar group, cement and iron and steel prices (all above eight per cent) has contributed to the upward movement in the overall WPI. The persistent high oil prices, and somewhat liberal monetary policy, suggest that the up-trend in inflation rate will continue.

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



The unusually high and volatile oil price has been the focal point of discussion in recent times. After crossing US $ 70 per barrel mark, it has come down to around US $ 65 per barrel. This high price is the main factor responsible for persistent nine per cent or more inflation in the energy component of WPI. It now looks certain that there will be no improvement on the price front before 2007 at the earliest. There are two main factors for this up-trend: first and foremost is the tightness across the supply chain on account of strong economic growth and the consequent unanticipated surge in oil demand. Secondly, with the tightness in the refining capacity, production increases by OPEC or other suppliers may not lead to corresponding increases in the supply of refined petroleum products. OPEC has already committed to big production increases and has taken up investment in capacity expansion programmes. But the effect will be felt only at the beginning of 2007. Economic theory predicts that a permanent increase in oil or any other product price in an administered price regime should be absorbed by the domestic economy. By that logic, the hiking of diesel and petroleum prices by Rs 2 and Rs 3 per litre on 6 September 2005 seems to be a correct economic decision.

High crude prices are the main factor responsible for persistent nine per cent or more inflation in the energy component of WPI

Inflation on account of manufactured goods has declined since May 2005. A decline in the prices of textiles and a sharp deceleration in the inflation rate in respect of food products and basic metals, alloys and metal products are responsible for the lower rise in WPI-manufactured goods. However, following a firm trend in the international market, all major non-ferrous metal producers have increased the prices of their metal products since September 2005. This may put pressure on manufactured good prices.

Fig P.2 shows the use-based component of inflation rates. As this graph shows, after a spike, the inflation rates in all the categories are on a declining trend since May 2005. The high oil prices seem to have little effect on the intermediate components during this period. The high base effect seems to be the dominating factor. However, we may expect the intermediate component of inflation to go up in the coming months. The basic goods component is also expected to go up due to the continued spike in metal and steel prices.

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

Comparing the core and the WPI inflation levels, we see that the spread between the core and WPI-based inflation has reduced from two percentage points to one percentage point during June to August 2005 (Fig P.3). The core index is calculated by excluding primary food and non-food articles, and administered items such as coal, electricity and fertilisers. The RBI Governor's remarks in this regard that "barring the effects of oil prices, the core inflation has remained fairly stable", are indeed accurate.

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 exhibits benign growth in recent months, lying within the

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

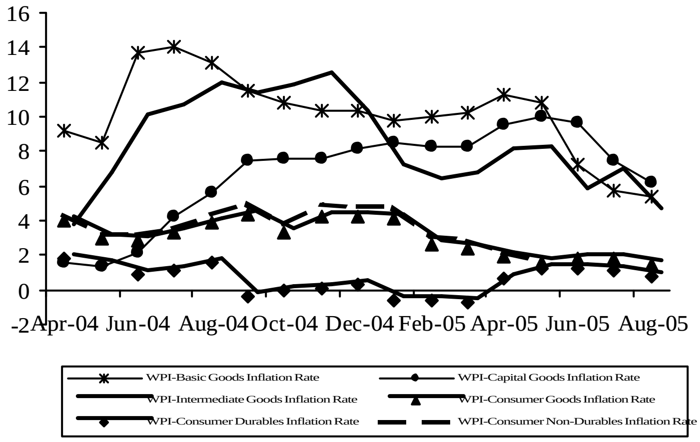


Fig. P.3 Monthly Inflation Rates (%,y-o-y)

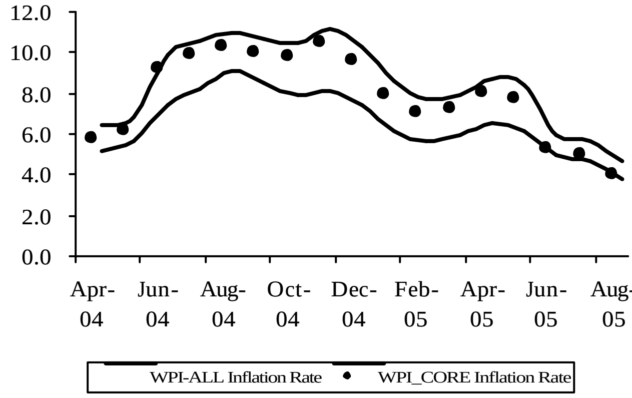
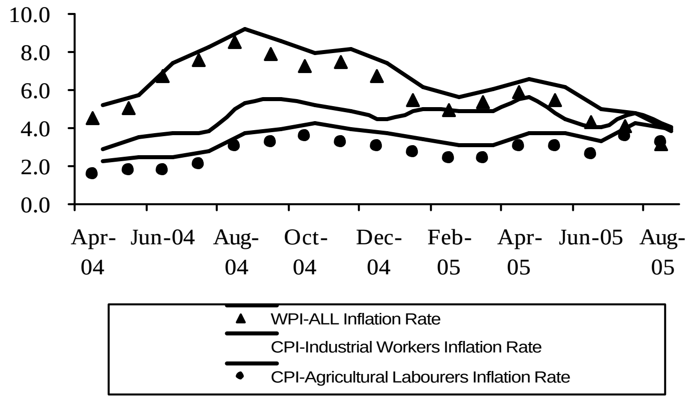


Fig. P.4: Wholesale & Retail Price Inflation (% Change Y-oY)



range of three to four percentage points. The CPI-IW based inflation rate has decreased from 4.1 per cent in July 2005 to 3.3 per cent in August. 2005. On the other hand, CPI-AL based inflation rates has moved closer to three percentage points after crossing the 3.5 percentage point mark. But the impact of the rising WPI is expected to push up retail prices, but with a lag.

International Trends

During January-August 2005, the overall index of primary commodity prices increased by 29 per cent in US dollar terms. Energy prices remained the main driver of the index, reflecting a strong growth in crude oil consumption and expectations of tight crude oil products markets and tightness in refining capacity going forward.

By contrast, average non-energy prises rose by five per cent in US dollars terms during the period January to August 2005. The key drivers of the surge in this index are metal and food prices. While most metals markets reacted to further reductions in inventory positions and specific labour issues of mining companies, strong Chinese demand for soybeans pushed the food index higher. According to IMF projections, the non-energy commodity price index for 2005 is projected to register an overall gain of nine per cent.

The robust demand for construction and manufacturing products in both USA and China is the primer for surge in metal prices. Robust demand for construction and manufacturing products has caused a sharp increase in iron ore prices. Copper prices rose by 20 per cent to an all-time high as copper inventory levels fell drastically and recent strikes by mining workers threatened world supplies. Uranium prices rose 44 per cent following demand push due to newly constructed (and planned) nuclear reactors.

Turning to specific food markets, overall beverage prices have remained unchanged since January 2005. The large global harvest of many items is expected to ease food prices, which went up by four per cent during the first eight months of the current calendar year. Hurricane Katrina, which devastated ports and cities in the southern parts of USA, logistics hubs for grain exports, appears to have had only a temporary impact on specific non-fuel commodity markets.

The robust demand for construction and manufacturing products in the US and China is driving the surge in metal prices

Prognosis

The RBI is continuing with monetary measures to absorb liquidity from the system, to rein in inflation. In the mid-term review of annual policy statement for the year 2005-06, reverse repo rate increased by 25 basis points to 5.25 per cent and the spread between reverse repo rate and repo rate under LAF maintained at 100 basis points. However, money supply growth has started rising. Currently M3 is growing at 15.7 per cent, mostly due to growing non-food credit to commercial sector.

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 hover between 4.0 to 4.5 per cent.

Inflation in the coming months is expected to be in 4.0 to 4.5 per cent range