

Waqar Masood Khan

### **CPI and the policy rate**

The base of an index plays a critical role in its measurement. The longer a base is retained, the more distant it becomes from the start. This is all the more true when the index is based on weights used in measuring the relative importance of various components in the index.

The price index, which measures the prices of hundreds of commodities, is particularly sensitive to the base as not just the relative significance of commodities in the budget is changing but new ones are introduced leading to relative changes in the commodities significance in consumer budgets.

Until recently, the consumer price index (CPI) was using 2007-08 as the base year, nearly a 10-year old base. Work on the new base had started some four years ago and was completed in close collaboration with international agencies. A large number of surveys and studies were undertaken to formulate the recommendations for changes which were presented for approval to the Governing Council of the Pakistan Statistics Bureau (PBS). The final publication of the CPI based on the new base was unveiled this month together with a comparison with the CPI on the old base to allow a comparison of the impact of change.

The major reasons why a change in base is warranted include: (i) changes in tastes of consumers across the goods and services selected for inclusion; (ii) entry of new goods and services and exclusion of existing ones; (iii) refinements in the measurement methodology of some of the key items such as electricity and gas prices; and (iv) impact of geographical developments, warranting a closer assessment of their representative character.

The new CPI is based on 356 items which include 94 commodities as opposed to 487 items, and 84 commodities included in the previous CPI. Some 130 items have been discarded whose consumption was either terminated or became negligible. On the other hand, 10 more commodities have been added because of significant allocation in consumer budget. The income quintiles have been updated by a margin of Rs10,000 across the board.

The most significant and novel development is the division of consumers between urban and rural areas, and computing indices for them independently. This takes into account major differences in consumption patterns in two types of populations. The number of cities and markets in the urban areas has been increased from 35 cities and 68 markets to 40 cities and 76 markets. On the other hand, 27 markets in rural areas have been selected for 244 items that play a key role in rural household budgets.

Some notable changes in the relative importance of different groups of items are housing whose weight declined from 29.4 percent to 23.6 percent, transport from 7.2 percent to 5.9 percent and communication from 3.2 percent to 2.2 percent. Food, education and health were more or less the same; the major gainers were restaurant and hotels, which rose from 1.2 percent to 6.9 percent, and miscellaneous 2.8 percent to 4.9 percent.

The new CPI, from its outset, has been consistently below the old CPI. The year-on-year inflation for July and August under the new CPI is 8.39 percent and 10.49 percent, with an average of 9.44 percent, as compared to 10.34 percent and 11.63 percent, with an average of 10.98 percent under the old index. Clearly, inflation has come down by at least 1.5 percent, which is a remarkable development. The 12-month moving average of core-inflation was 7.5 percent, the main index that is used by central banks in inflation targeting.

The new numbers, together with some developments in the money and bond markets, have given rise to expectations that room has been created for the central bank to reduce its policy rate which is considered prohibitively high by the investors. The yield curve in the market was recently inverted. The yield on the 10-year Pakistan Investment Bonds (PIBs) declined to 12.7 percent from 13.5 percent just two weeks ago. This is a sharp reduction in yield of 80 basis points (bps) and a clear indication of market sentiments. Remarkably, the cut-off yields as well as current trading yields are significantly higher for PIBs of three-year and five-year maturities, being 13.75 percent and 13.12 percent, respectively. Clearly, the inversion of the yield curve within PIBs is evident.

The most recent treasury bills' (TBs) auction held in the last week of August has accentuated the trend. Against a target of Rs710 billion (110 in maturity and 600 additional), the bids were received for Rs953 billion while the accepted amount was Rs755 billion. In an incredible development, 79 percent of the amount was taken in 12-month TBs (which for years had not received any bids) and 21 percent in three-month and virtually nothing in six-month. The yields of 13.75 percent for three-month, 13.94 percent for six-month and 14.24 percent for twelve-month were not only signalling yield-curve inversion but also a clear signal that the market now expects a downward adjustment in the interest rate. Until recently, and for years, TBs were only sold in three-month maturity.

Not surprisingly, these developments have led to a strong rally in the stock market which has regained some of the lost points it had gained after the news of extension in term of office of the COAS. Market pundits are now sure that this revival was based on a fundamental improvement and is therefore likely to be sustained provided the building expectations of a rate cut are materialized.

In fact, the expectation of a rate cut holds the promise of a possible turnaround in country's economic fortunes. Regarding the inversion, one hopes that it is a temporary phenomenon and not a signal in support of brewing recession that otherwise is visible in some other indicators, such as a massive slow-down in imports, early reports of continued slow-down in production and consumption of such key industrial products like automobiles, cement and petroleum products. There are reports that cotton supplies have been affected both due to heat and rains while experts believe the target of 15 million bales for the current crops looks ambitious. Under the circumstances, the real impetus could come from an interest rate cut from an unduly and unsustainable present level of 13.5 percent. The new inflation numbers have made it completely untenable to maintain this high level of interest. There is near impossibility to realize an average inflation of 13 percent, which is the basis of the current policy rate.

The writer is a former finance secretary. Email: waqarmkn@gmail.com