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Dip in the rate of inflation

There has been a noticeable drop in the rate of inflation on a year-to-year basis. The national Consumer Price Index (CPI) increased by 14.6 percent in January 2020. It has fallen by 2.2 percentage points to 12.4 percent in February 2020. However, it is perhaps surprising that the 'core' rate of inflation has not fallen simultaneously but has increased marginally from 7.9 percent to 8 percent.

The divergence between the headline and the core rate of inflation is a clear indication of the fact that much of the fall in prices is in food and energy items. In fact, there has been a big drop in the rise in food prices from 23.6 percent in January 20 to 18.4 percent in February 20.

The fall in food prices is mostly in perishable items. These had been rising at a phenomenally rapid rate of as high as 78.4 percent in January 20. This has come down but still remains high at 32.2 percent. The fall, however, more than fully explains the decline of 2.2 percentage points in the overall rate of inflation. In particular, the much touted tomato price has fallen by as much as 61 percent in February 20. It now stands at Rs 45.48 per kg as compared to Rs 104.88 per kg in February 2019.

However, a surprising revelation is the significant fall in inflation in the housing rent and tariffs of utilities group. This has apparently contributed almost 30 percent to the drop in the year-to-year rate of inflation in February 20. Beyond this, all other product and service groups ranging from clothing and footwear to education have witnessed some increase in the rate of inflation, albeit of a small magnitude.

The mystery relates to the drop in housing and utilities rate of inflation from 9.6 percent in January 20 to 6.8 percent in February 20. It turns that this is mostly due to the fall in the rate of inflation in electricity charges. According to the PBS, electricity charges increased on a year-to-year basis in January 20 by almost 14 percent but there was apparently a decline of 4 percent in February 20. This alone contributes 37 percent to the fall in the rate of inflation between the two months. The Annexure to the monthly price statements by the PBS actually indicates that the electricity charge has increased from Rs 3.88 per kwh in February 19 to Rs 4.06 per kwh in February 20, a rise, not fall, of 4 percent. This inconsistency needs to be resolved.

There are other issues as well. First, the average price per kg of wheat flour in the 17 cities of Pakistan is reported at Rs 45 in February 20. The general perception is that the price of fair quality 'atta' ranges from Rs 55 to 60 per kg, with even higher prices in cities like Karachi. This likely understatement of the price of atta alone understates the rate of inflation by 1.2 percentage points.

The other problem is with the measurement of the rate of inflation in housing rents. This has been shown as unchanged at 5.6 percent in January and February. Given the double-digit rate of inflation, it is extremely unlikely that there has only been low single-digit inflation in housing rents. In fact, the rate of increase in rents has generally outpaced the rate of headline inflation in recent years. This has been the consequence of a growing housing shortage in the country. Over the last two years with less inflation, housing rents soared by more than 7 percent annually with much less increase in construction costs. The cost of construction inputs has now gone up much faster by almost 18 percent. Given the fact that over three-fourths of housing is owner-occupied in Pakistan, the appropriate proxy for inflation in rents is the rise in construction costs.

Adjustment for higher price of atta and more inflation in housing rents leads to an estimate of the rise in the CPI in February 20 to over 15 percent. This is more than 2.6 percentage points higher than the inflation rate reported by the PBS for February 20. However, the same two factors implied an inflation rate of 17 percent in January 20.

Turning to the month-to-month change in the price level, this has shown a drop of 1 percent only between January and February 20.This is a true indicator of the impact of recent efforts by the Government at providing relief by bringing down prices of basic necessities through interventions like the subsidy on sales by the Utility Stores Corporation. There has been some success in reducing the price of atta by 5 percent, but the price of sugar has gone up by as much as 8 percent between January and February 2020.

What is the outlook for inflation in coming months? There is one favourable outcome that is likely to emerge from the unfortunate global spread of the coronavirus. International commodity prices are likely to fall sharply. Already, the price of Brent crude has declined to below $49 per barrel. The recent reduction in the domestic retail prices of HSD and Motor Spirit will alone bring down the price level in March 20 by almost 0.5 percentage points in relation to that in February 20. In addition, the international price of palm oil, tea, cotton, pulses, etc., are falling on a, more or less, weekly basis. Therefore, the short-term outlook for inflation in Pakistan is favourable. Over the next three months, the headline rate of inflation could fall to a single-digit rate. This will provide significant relief to the currently over burdened consumers. However, the real test of the management of inflationary pressures in the economy will come after May 2020.

The first inflationary shock will come when the government is compelled to increase power and gas tariffs close to the presentation of the budget for 2020-21. Also, OPEC and other oil price producers may come to some agreement on supply cuts to stabilise the price of crude oil. Further, the government is expected to announce a budget in June 2020 which will include substantial additional taxation. The government has agreed with the IMF to come up with new taxation proposals to effectively raise almost Rs 900 billion. This will inevitably involve higher indirect taxation and the consequential jump in prices.

Therefore, any forthcoming decline in the rate of inflation to single-digit could be temporary in character. The year, 2020-21, may start with an upsurge once again in prices. The task of the Government will be to limit this to the extent possible and minimize the impact on the cost of living of the people in a period of, more or less, stagnant real per capita incomes.

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