

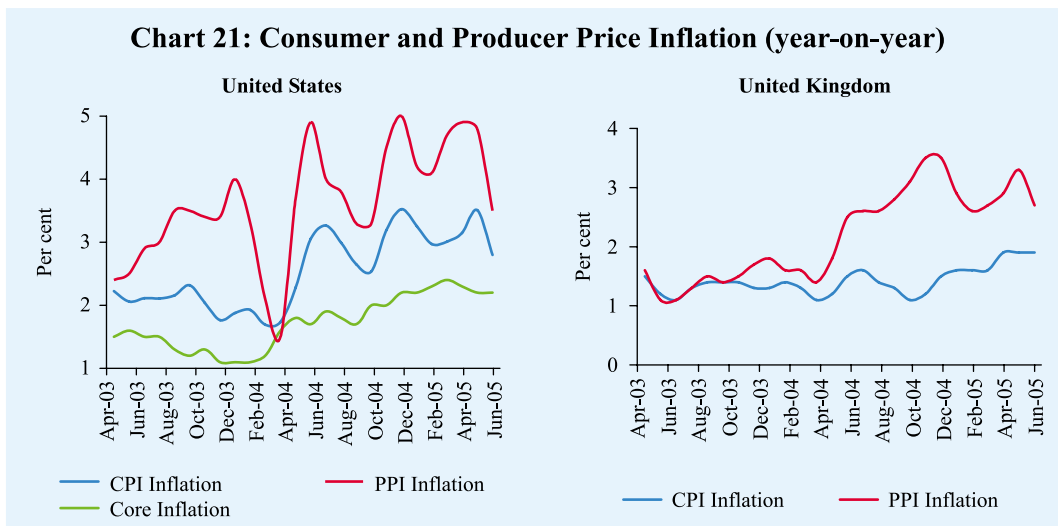
IV. PRICE SITUATION

Inflation remained firm in a number of economies in Q₁ of 2005-06, driven up by high and volatile international crude oil prices. In India, inflation conditions continued to be dominated by supply-side pressures, particularly in April 2005. In May and June, however, inflation eased, pulled down by the base effect of higher prices last year as well as various monetary and fiscal measures to stabilise inflation expectations.

Global Inflation

According to the International Monetary Fund's World Economic Outlook (April, 2005), consumer price inflation in developed countries is projected at 2.0 per cent in 2005 - the same level as in 2004. In developing Asia, inflation is expected to moderate to 3.9 per cent in 2005 from 4.2 per cent in the previous year, despite higher economic activity and the hardening of oil prices. This plateauing of inflation reflects, to some extent, the measured pace of pre-emptive monetary tightening by a number of central banks from 2004 onwards and, in case of emerging economies, less-than-full pass-through of higher international prices to domestic oil prices. On the other hand, inflation pressures are seen easing in some countries due to a weakening of economic activity. Sweden and Poland have lowered their policy interest rates during June 2005.

Producer prices continue to lead consumer prices in most economies, reflective of the supply-side character of inflation (Chart 21). With commodity costs representing only a small share of the overall costs and wages to earnings



ratios stable, high commodity prices have been partly absorbed in firms' profit margins. Although non-fuel commodity prices remain at elevated levels, there are indications of some leveling off as supply catches up with demand. This is also expected to have a soothing influence on headline inflation.

In the US, consumer price inflation, which had accelerated to 3.5 per cent in April 2005, decreased to 2.5 per cent by June 2005 reflecting some decline in energy costs. Core inflation (*i.e.*, excluding food and energy prices) which had started to edge up in early 2004 appears to be stabilising at around 2.0 per cent. The US Federal Reserve persevered with its measured pace of monetary tightening and raised its target Federal Funds Rate by a further 50 basis points during the quarter (April-June 2005) (Table 18). The US Federal Open Market Committee (FOMC) believes that the stance of monetary policy remains accommodative and although pricing power is more evident in recent months, longer-term inflation expectations in the US remain well contained.

Table 18: Inflation Indicators - Developed Economies

Country/ Region	Key Policy Rate/Bank Reserve Target	Policy Rates (Latest)	Changes in Policy Rates in basis points (January 2004 - June 2005)	2004		2005 (Latest)	
				Inflation	Growth (y-o-y)	Inflation (June)	Growth (y-o-y) (Q ₁)
1	2	3	4	5	6	7	8
Australia	Cash Rate	5.50	25	2.3	3.2	2.4 (Q ₁)	1.9
Euro Area	Interest Rate on Main Refinancing Operations	2.00	Unchanged	2.2	2.0	2.1	1.3
Japan	Target Balance of Current Account (Trillion Yen)	30-35 trillion yen	Raised by 3 trillion yen	0.0	2.6	0.2 *	1.3
New Zealand	Official Cash Rate	6.75	175	2.3	5.0	2.8 (Q ₁)	1.9
UK	Repo Rate	4.75	100	1.3	3.1	2.0	2.1
US	Federal Funds Rate	3.25	225	2.7	4.4	2.5	3.7

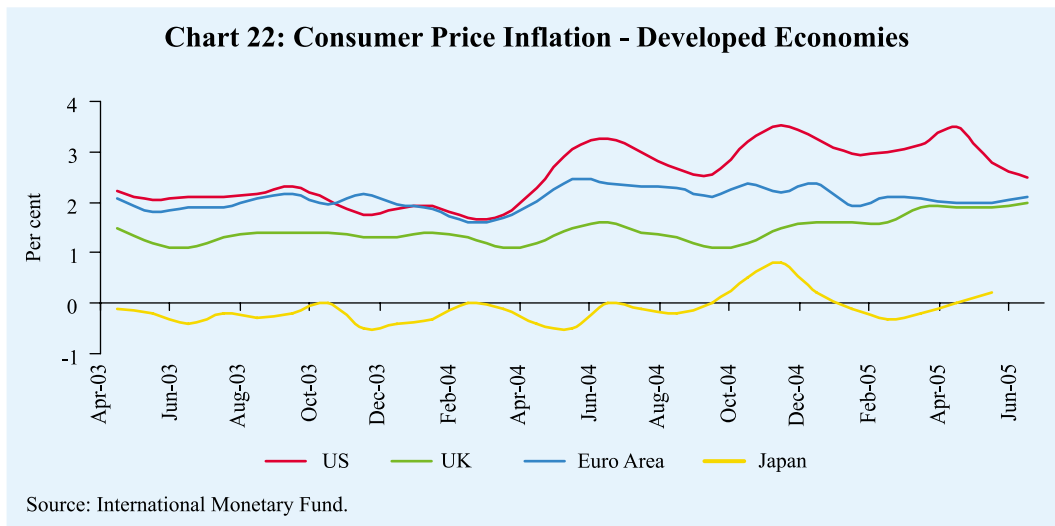
* May 2005.

Source : IMF and Official Websites of respective Central Banks.

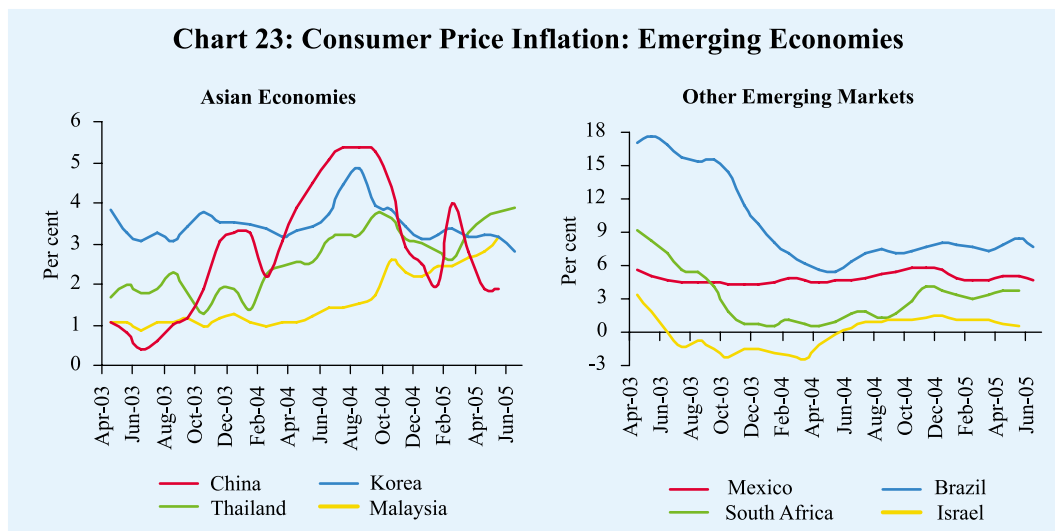
In the Euro area, inflation, measured by the Harmonised Index of Consumer Prices (HICP), moved in a narrow range of 2.0-2.1 per cent during April-June, 2005. The upward pressures on account of higher oil prices (which pushed the PPI inflation up to 3.5 per cent in May 2005) were counterbalanced by weak domestic demand, given the high unemployment. With consumer price inflation expected to fluctuate around current levels, the European Central Bank (ECB) chose to maintain its monetary policy stance (unchanged since June 2003).

In the UK, CPI inflation was driven up by higher oil prices to 2.0 per cent in June 2005 - the highest since May 1998. With risks to growth shifting to the downside with the deceleration of growth in Q1 of 2005, the market expects the policy repo rate - unchanged at 4.75 per cent since August 2004 - to be cut in the second half of this year.

In Japan, consumer prices, on a year-on-year basis, increased marginally by 0.2 per cent in May 2005 as against a decline of 0.5 per cent a year ago (Chart 22). Consumer prices are, however, projected to continue falling slightly on a year-on-year basis. While persisting with the target range for bank reserves at 30-35 trillion yen set since January 2004, the Bank of Japan (BoJ) has decided that the balance of banks' current accounts with it could be allowed to fall short of the target in case of weak liquidity demand.



In China, consumer price inflation was 1.8 per cent during April-May 2005, much lower than the level of above 5.0 per cent recorded during June-September 2004 (Chart 23). The easing of inflation since November 2004 reflects a decline in foodgrain prices and incomplete pass through of higher oil prices. Measures to tighten monetary policy by the People's Bank of China through a mix of higher reserve requirements and a hike in the benchmark deposit and lending interest rates also helped to rein in inflation.



Amongst other Asian economies, inflation in Indonesia remained high at 7.4 per cent in June 2005, driven up by higher input demand as well as oil prices. The State Bank of Indonesia raised the policy rate by 25 basis points in March 2005. In the Philippines, inflation accelerated to 7.6 per cent in June 2005 driven up by higher domestic fuel and food prices even as growth began to weaken. With inflation ruling above the target of 4-5 per cent, the Bank of Philippines raised the policy reverse repo rate by 25 basis points in April 2005. In Thailand, inflation climbed to 3.8 per cent in June 2005 due to higher oil prices. Economic activity has slowed partly on account of a deceleration of export demand, higher oil prices and the impact of the *tsunami* on the tourist traffic. With consumer price inflation above the target of 0-3.5 per cent and core inflation accelerating to 1.3 per cent in June 2005 (0.8 per cent in April), the Bank of Thailand raised interest rates by 25 basis points in June 2005 (Table 19). In Korea, inflation at 2.7 per cent in June 2005 was within the target as the large appreciation in the Won - about 11 per cent *vis-à-vis* the US dollar in June 2005 over the previous year - partly cushioned the impact of higher oil prices. With real GDP growth slowing down partly on account of a weakening of domestic demand, monetary policy continues to be accommodative - the policy rate was last cut by 25 basis points to 3.25 per cent on November 11, 2004.

Price Situation

Table 19: Inflation Indicators - Developing Economies

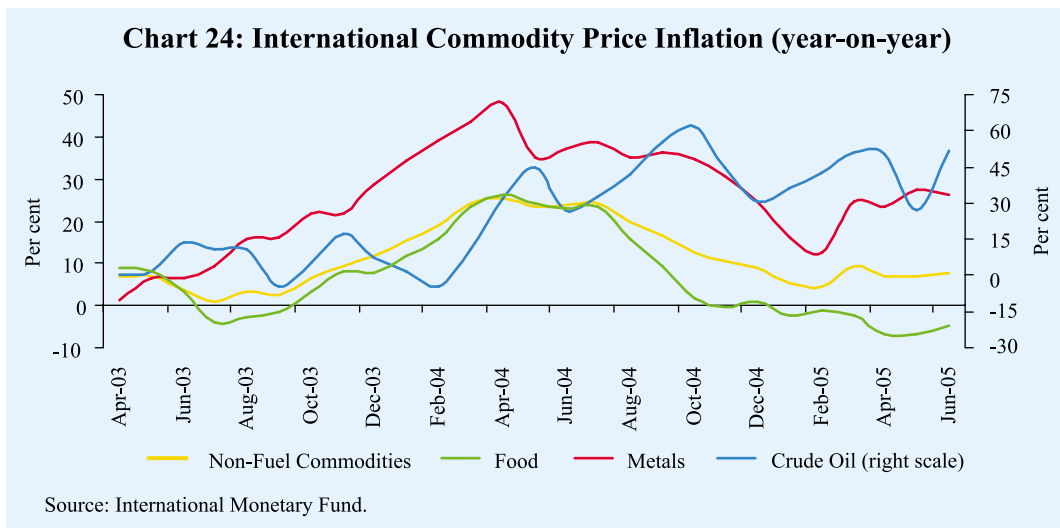
Country/ Region	Key Policy Rate/Bank Reserve Target	Policy Rates (Latest)	Changes in Policy Rates in basis points (January 2004 - June 2005)	2004		2005 (Latest)	
				Inflation	Growth (y-o-y)	Inflation (June)	Growth (y-o-y) (Q1)
1	2	3	4	5	6	7	8
Brazil	Selic Rate	19.75	3.25	6.6	5.2	7.3	2.9
China	M2			3.9	9.5	1.8 *	9.4
Israel	Key Rate	3.50	(-) 40	-0.4	4.3	0.2 *	4.1
Korea	Overnight Call Rate	3.25	(-) 50	3.6	4.6	2.7	2.7
Mexico	Reserve Requirement (Peso Short Position)	79 million	54 million (tightened)	4.7	4.4	4.3	2.4
Philippines	Reverse Repo Rate	7.00	25	5.5	6.1	7.6	4.6
South Africa	Repo Rate	7.00	(-) 100	1.4	3.7	3.3 *	4.2
Thailand	14-day Repo Rate	2.50	125	2.7	6.1	3.8	3.3

* May 2005.
Source : IMF and Official Websites of respective Central Banks.

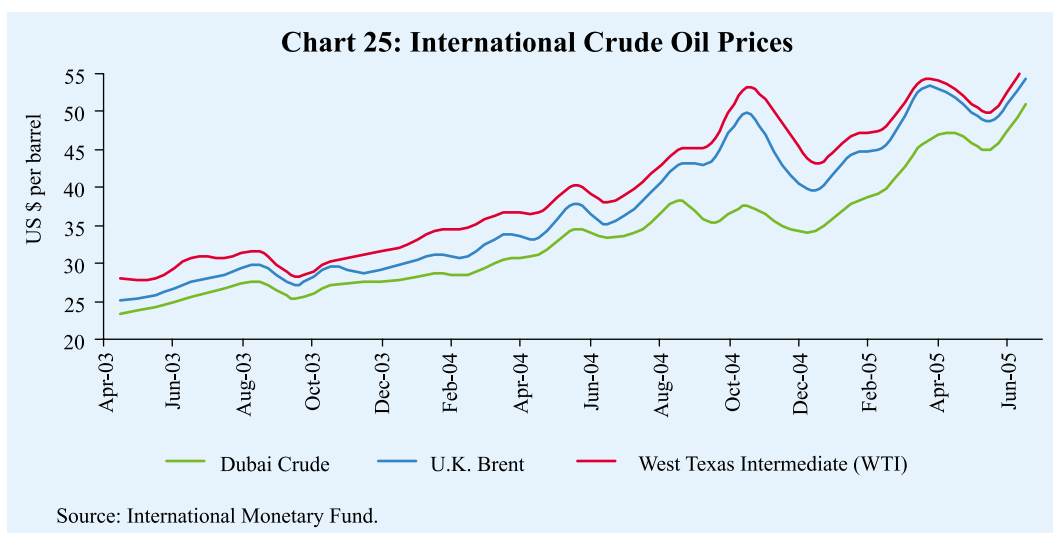
Global Commodity Prices

Global non-fuel commodity prices, which had risen sharply in the first half of 2004, appear to be stabilising at elevated levels. As a result, the base effect is now beginning to pull down commodity price inflation (Chart 24). The IMF's non-fuel commodity price index declined by 2.6 per cent between June 2005 and March 2005 and year-on-year (y-o-y) growth in the index slowed down to 7.6 per cent in June 2005 from 23.9 per cent a year ago.

Chart 24: International Commodity Price Inflation (year-on-year)

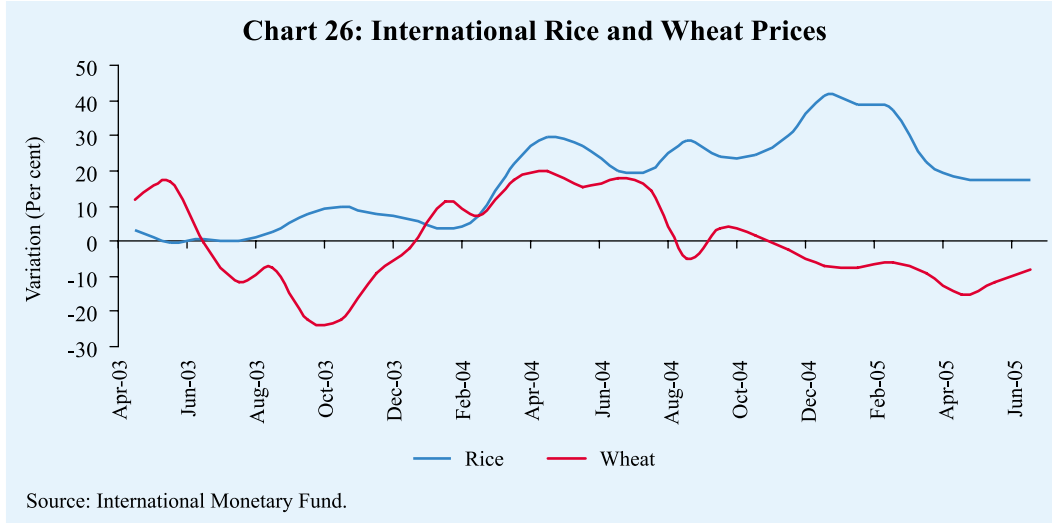


International oil prices were volatile during April-June 2005 and reached new highs, crossing US \$ 62 per barrel on July 7, 2005. Low inventories and low spare output capacity in the face of robust demand sustained high oil prices, despite increases in supply by the Organisation of the Petroleum Exporting Countries (OPEC) by 0.5 million barrels a day in their meetings in March 2005 and again on June 15, 2005. Average crude prices increased by about 6 per cent between June 2005 and March 2005 on top of an increase of 41.8 per cent in 2004-05. Dubai crude prices, which were subdued during June-October 2004 relative to the increase in the prices of US West Texas Intermediate (WTI), have risen faster since January 2005, narrowing the gap in pricing between markets (Chart 25). This poses significant risks to inflation in India as the basket of crude oil imported by India is weighted in favour of the Dubai crude variety.



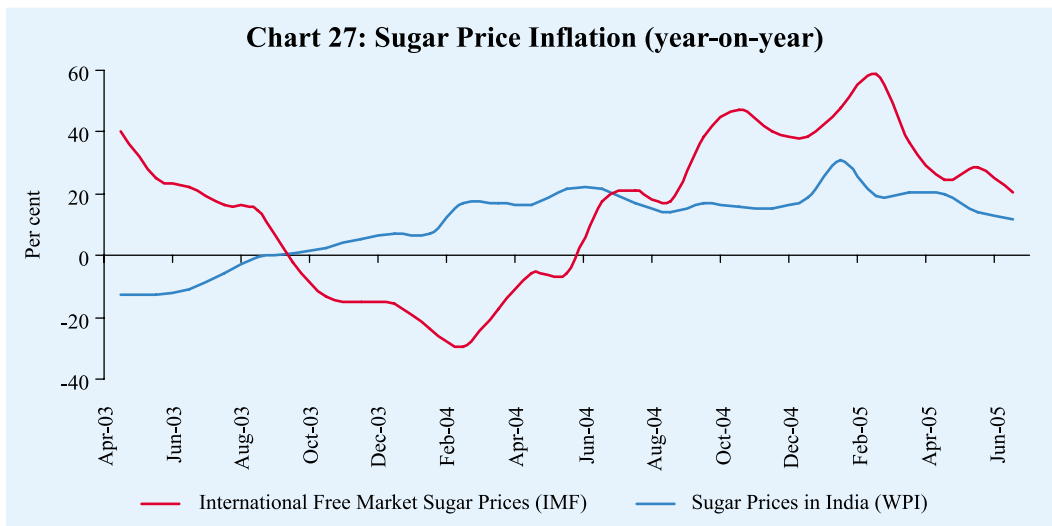
Agricultural commodity prices eased during April-June 2005 on improved crop prospects (Chart 26). Although the Food and Agricultural Organisation (FAO) estimates that global cereal output is likely to decline due to setbacks in production of wheat and coarse grains, the stocks held by major exporting countries are forecast to increase for the second consecutive year. Reduced export supplies in Thailand, China and Australia and resulting tightness in international markets for the third consecutive year are expected to keep rice prices firm.

Prices of oilseeds and oilseed-based products have edged up since March 2005 in reaction to sudden deterioration of production prospects in South America, but a soft outlook persists as excess supplies continue to dominate



market conditions. On the other hand, prices of edible oils and fats are expected to remain firm due to strong consumption demand and below average stock levels.

Sugar prices eased somewhat in April-May 2005 on the back of upward revision in estimates for global production during the 2004-05 season (October-September) reflecting better crops in Latin America (Chart 27). However, given the substantial shortfall in production, and strong consumption demand, prices edged up again during June 2005 and are likely to stay around the current elevated levels in the coming months.



Global cotton prices declined by about four per cent during June 2005 over March 2005 on top of a decline of 15.6 per cent during 2004-05 (April-March), reflecting a rebound in production. As the decline in cotton prices in 2004-05 had curtailed plantings and stimulated mill use, world production is projected to decline during 2005-06. The International Cotton Advisory Committee (ICAC), therefore, expects prices to harden in 2005-06 in view of the tight balance between demand and supply conditions.

Metal prices remained at elevated levels till March 2005 on the back of Chinese demand. With global supply led by a strong increase in Chinese production catching up with demand, the IMF's metal price index fell by 1.5 per cent between June 2005 and March 2005 (Table 20). Leading steel producers are cutting back on production in order to hold on to prices. Copper prices, however, remained firm as inventories hit a 33-year low in April 2005.

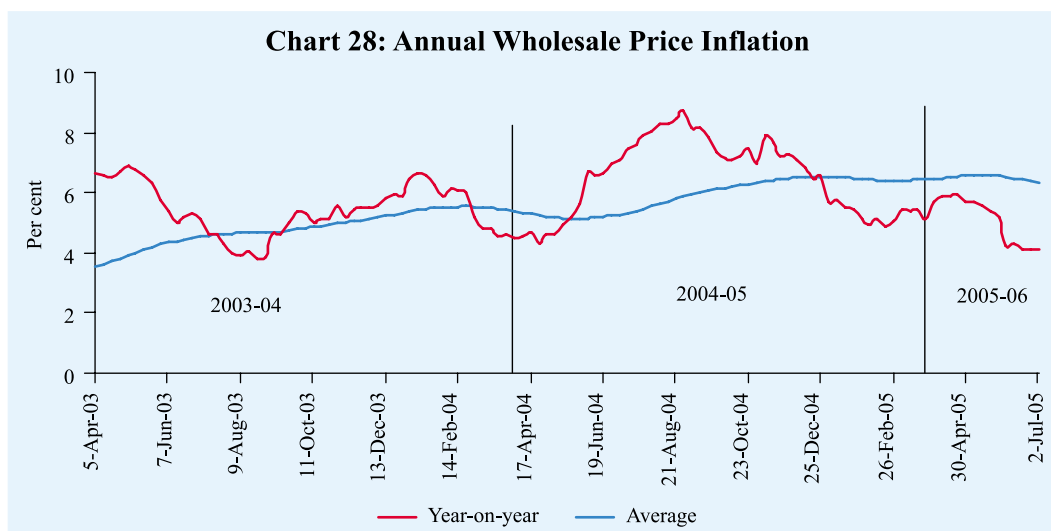
Table 20: World Commodity Prices

(Index 1995=100)							
Commodity/ Group	2002-03	2003-04	2004-05	March 2005	April 2005	May 2005	June 2005
1	2	3	4	5	6	7	8
All Commodities	113.5	122.6	161.0	189.2	188.1	180.7	195.5
A. Fuel	151.4	162.3	228.7	276.8	277.2	262.9	293.1
Crude Oil	160.2	169.1	239.8	296.0	294.4	277.9	313.2
Average Crude Spot Price (US \$ / barrel)	27.6	29.1	41.3	50.9	50.6	47.8	53.9
Coal (US \$ / tonne)	26.2	32.3	56.8	52.7	53.0	53.1	52.8
B. Non-fuel Commodities	78.8	86.1	98.9	108.9	106.4	105.4	106.0
Metals	73.0	88.1	114.5	136.8	134.8	132.3	134.7
Steel Products #	70.4	85.2	129.6	136.9	141.4	141.4	142.2
Agricultural Raw Materials	80.6	82.1	85.7	87.8	85.9	84.4	85.1
Cotton (Cotlook A Index) (US cents per Pound)	50.3	67.3	56.8	56.2	57.0	55.8	54.0
Food Products	83.8	89.6	97.8	101.7	98.7	99.0	98.0
Rice (US \$/tonne)	193.5	204.9	263.7	295.0	299.1	295.3	287.0
Wheat (US \$/tonne)	154.5	150.5	153.7	151.0	140.9	144.3	141.9
Sugar (Free Market) (US cents per pound)	6.7	6.5	8.3	8.9	8.5	8.5	9.0
Palm Oil (US \$/tonne)	384.5	430.9	399.7	374.8	375.8	370.2	369.6
Soybean Oil (US \$/tonne)	436.8	560.4	532.5	513.1	498.6	501.4	529.7

World Bank's composite price index for eight steel products (Base 1990=100).
Sources : International Monetary Fund and the World Bank.

Inflation Conditions in India

Headline inflation, measured by year-on-year (y-o-y) changes in the wholesale price index (WPI), hardened during April, 2005 driven up by prices of fruits and vegetables and some upward revision in the prices of petroleum products such as naphtha, aviation turbine fuel and furnace oil as well as iron and steel. Despite a 5.1 per cent increase in electricity prices in early June 2005 and 7-8 per cent increase in petrol and diesel prices effective June 21, 2005 base effects of rising prices in the previous year enabled headline inflation to ease to 4.1 per cent by July 2, 2005. Annual WPI inflation excluding the administered and partially decontrolled items (electricity, coal mining, mineral oils and urea-N-content) was significantly lower at 2.4 per cent, on a point-to-point basis. Inflationary pressures, however, continue to persist as reflected in the average inflation rate at 6.3 per cent on July 2, 2005 as compared with 5.3 per cent a year ago (Chart 28).



Supply Side Factors

Inflation was dominated by supply side factors in Q₁ of 2005-06 (Table 21). Prices of iron and steel, petroleum products, vegetables, eggs, fish and meat and electricity, which have a weight of about 20 per cent in the WPI basket, together contributed most of the overall increase in WPI of 2.2 per cent between end-March 2005 and July 2, 2005.

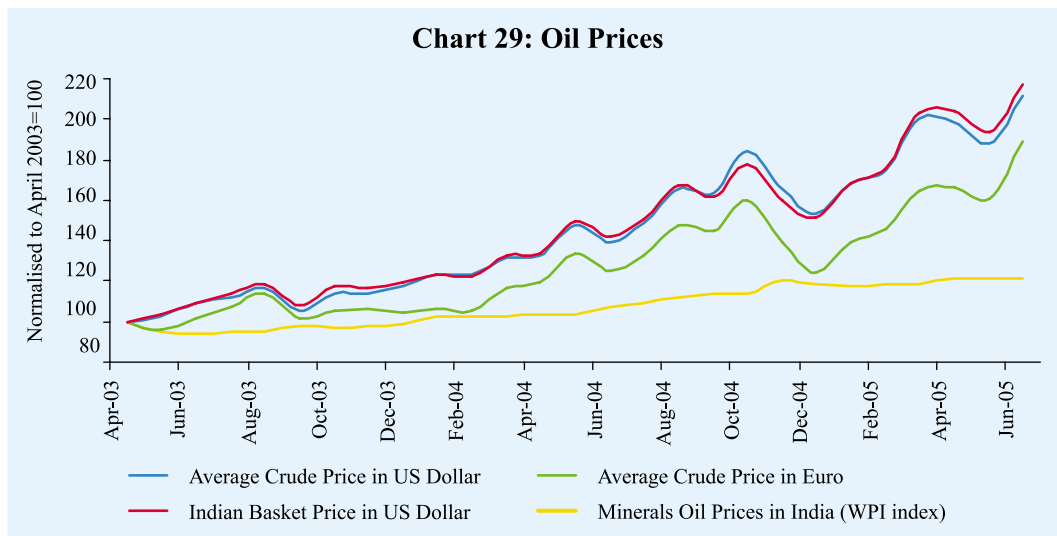
Table 21: Wholesale Price Inflation in India (year-on-year)

(Per cent)							
Commodity	Weight	2004-05		2004-05 (July 3)		2005-06 P (July 2)	
		Inflation	WCs	Inflation	WCs	Inflation	WCs
1	2	3	4	5	6	7	8
All Commodities	100.0	5.1	100.0	7.1	100.0	4.1	100.0
1. Primary Articles	22.03	1.3	5.5	3.9	12.5	0.1	0.3
<i>Food Articles</i>	15.40	3.0	8.9	1.2	2.8	3.6	13.4
i. Rice	2.45	2.9	1.3	-2.6	-0.9	4.4	2.4
ii. Wheat	1.38	-1.1	-0.3	1.4	0.3	2.8	0.9
iii. Pulses	0.60	-2.6	-0.3	-4.0	-0.3	6.6	0.9
iv. Vegetables	1.46	11.9	2.3	0.7	0.2	7.3	2.7
v. Fruits	1.46	11.5	4.1	-2.9	-0.7	11.5	4.2
vi. Milk	4.37	-1.7	-1.5	6.7	4.1	0.3	0.3
vii. Eggs, Fish and Meat	2.21	7.3	3.1	2.8	1.0	4.0	2.3
<i>Non-Food Articles</i>	6.14	-6.9	-8.8	3.8	3.5	-7.0	-11.0
i. Raw Cotton	1.36	-23.8	-6.5	3.3	0.7	-21.8	-7.2
ii. Oil Seeds	2.67	-6.5	-3.4	1.1	0.5	-6.9	-4.5
iii. Sugarcane	1.30	-0.7	-0.2	6.5	1.5	-0.7	-0.3
<i>Minerals</i>	0.48	68.0	5.3	134.9	6.4	-11.5	-2.1
i. Iron Ore	0.21	119.1	5.2	300.5	6.6	-16.3	-2.3
2. Fuel, Power, Light and Lubricants	14.23	10.5	42.7	10.3	29.8	10.5	53.9
i. Mineral Oils	6.99	16.0	34.9	14.8	22.2	15.2	42.6
ii. Electricity	5.48	0.8	1.2	2.6	2.9	6.2	11.3
iii. Coal Mining	1.75	17.1	6.4	16.8	4.7	0.4	0.2
3. Manufactured Products	63.75	4.6	52.0	7.2	57.5	3.3	45.3
i. Food Products	11.54	0.4	0.9	4.3	6.8	0.8	2.1
<i>Of which: Sugar</i>	3.62	19.7	10.3	19.9	6.9	13.0	8.8
Edible Oils	2.76	-8.4	-4.0	-0.8	-0.3	-5.8	-3.3
Oil Cakes	1.42	-17.4	-6.4	-5.5	-1.6	-12.0	-5.2
ii. Cotton Textiles	4.22	-12.7	-10.4	9.7	5.3	-11.6	-11.3
iii. Man Made Fibre	4.41	0.6	0.3	7.2	2.3	-2.7	-1.5
iv. Chemicals and Chemical Products	11.93	3.9	9.1	1.5	2.6	4.3	12.1
<i>Of which: Fertilisers</i>	3.69	3.3	2.2	0.1	0.1	3.0	2.5
v. Basic Metals, Alloys and Metal Products	8.34	17.1	28.4	28.8	31.0	8.3	18.5
<i>Of which: Iron and Steel</i>	3.64	21.3	17.0	44.4	21.8	7.0	8.1
vi. Non-Metallic Mineral Products	2.52	11.4	4.7	6.1	1.8	7.0	3.6
<i>Of which: Cement</i>	1.73	10.2	2.9	3.6	0.7	7.1	2.4
vii. Machinery and Machine Tools	8.36	7.1	8.6	3.1	2.8	7.3	10.9
viii. Transport Equipment and Parts	4.29	6.2	4.3	3.7	1.9	4.9	4.2
Food Items (Composite)	26.9	1.9	9.8	2.5	9.5	2.4	15.5
WPI Excluding Food	73.1	6.3	90.2	8.8	90.5	4.7	84.5
WPI Excluding Fuel	85.8	3.7	57.3	6.2	70.2	2.4	46.1

P : Provisional. WCs : Weighted Contributions.

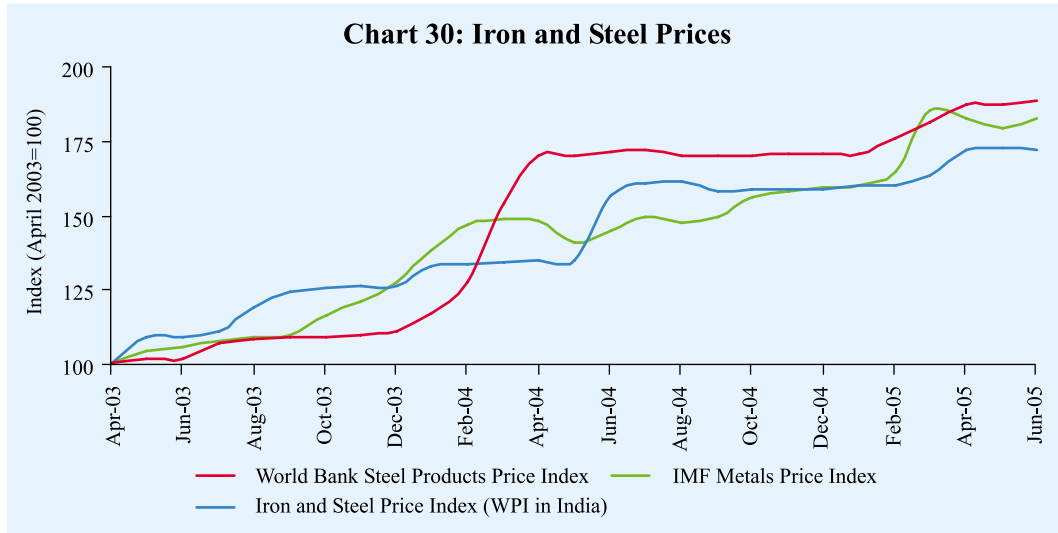
Prices of petrol and diesel were revised upwards by about 7-8 per cent effective June 21, 2005 after a gap of almost seven months (the last hike was on November 5, 2004 with some moderation effective November 15, 2004). Even after this increase, domestic PoL prices have been lagging the increase in

international oil prices (Chart 29). International crude prices (the Indian basket) increased by about 64 per cent between March 2004 and June 2005 from US \$ 31.9 a barrel to US \$ 52.4 a barrel. Over the same period, domestic mineral oil prices increased by 22.1 per cent - petrol by 19.7 per cent and high-speed diesel by 30.9 per cent.

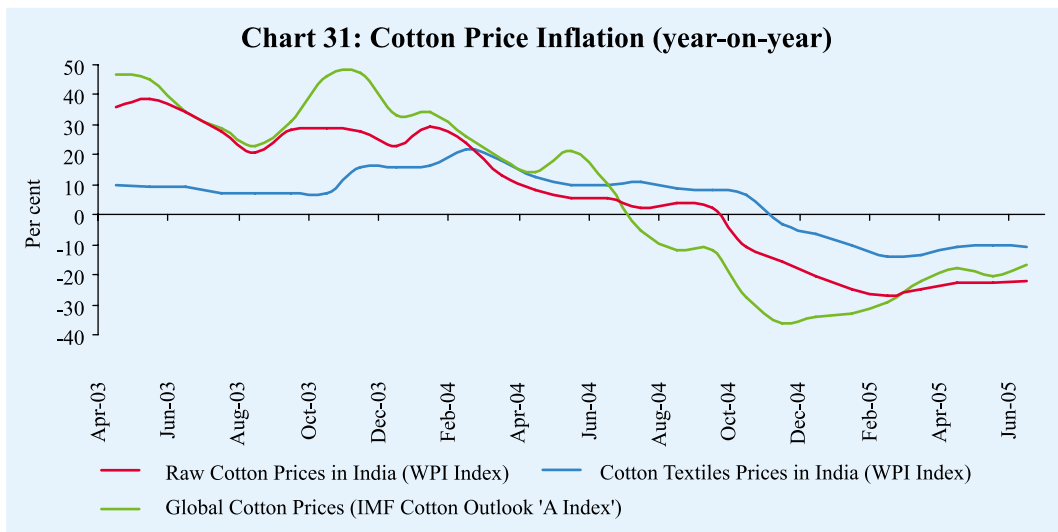


A change in prices of petroleum products impacts the WPI instantaneously to the extent of their weighted contribution in the index. Besides, prices of all other commodities using petroleum products as inputs would also change and indirectly impact inflation. The total impact (both direct and indirect) of the recent hike in prices of petroleum products on the headline inflation rate would be about 70-90 basis points.

Domestic iron and steel prices increased by 4.7 per cent between end-March 2005 and July 2, 2005 following the hikes in steel prices announced by various companies in April 2005 (Chart 30). In line with international trends, domestic companies announced price cuts/rebates of about 7-8 per cent on July 1, 2005.

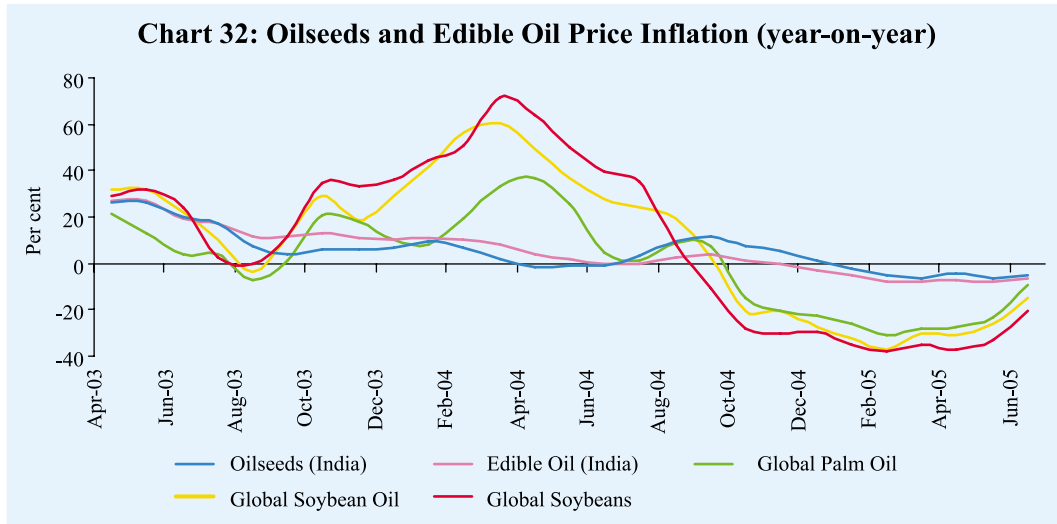


Raw cotton prices increased marginally up to July 2, 2005 reflecting worries about the monsoon on the eve of the sowing season and expectations of a reduction in cotton acreage due to lower prices of the previous year. However, year-on-year increase in cotton prices remained negative in line with international trends (Chart 31).

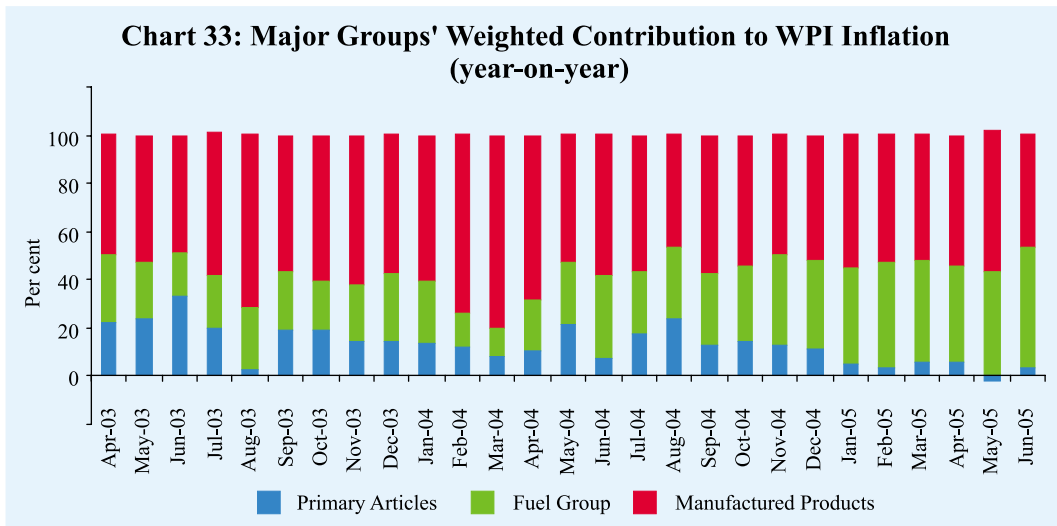


Price Situation

Oilseed prices hardened marginally reflecting a shortfall in domestic production during the 2004-05 season and the unsatisfactory progress of the South-West monsoon during June 2005. Edible oil prices declined further in line with international trends (Chart 32).

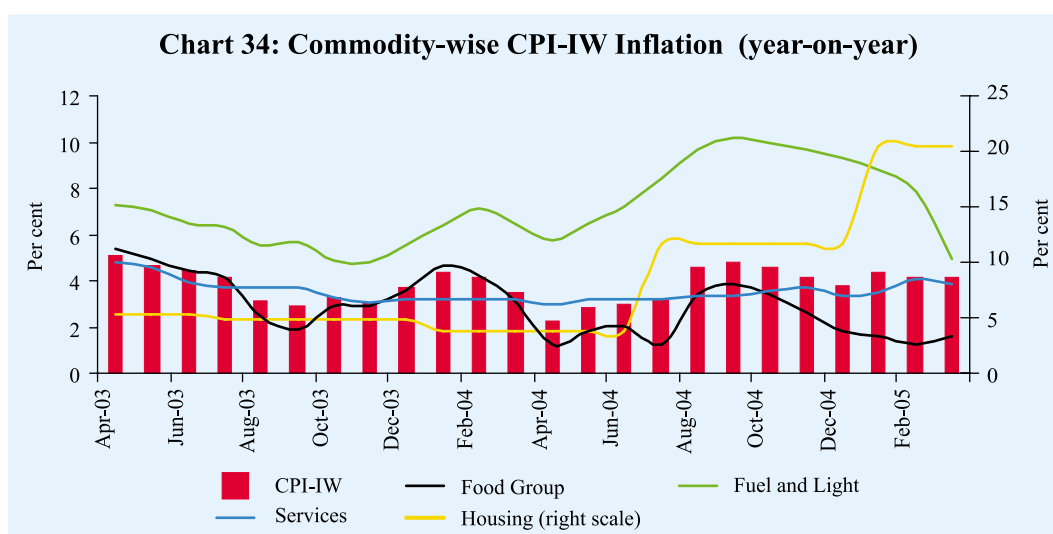


The fuel group contributed the maximum (49.7 per cent) to the year-on-year inflation at end-June 2005 followed by manufactured products (47.2 per cent) (Chart 33).



Consumer Price Inflation

Consumer price inflation (measured by the CPI for Industrial Workers) accelerated to 5.0 per cent in April 2005 from 4.2 per cent in March 2005 due to an increase in the prices of fruits and vegetables, rice and *dal*. It, however, fell to 3.7 per cent in May 2005 reflecting lower prices of food items such as wheat, wheat *atta*, onion, dry chillies and kerosene oil (Chart 34).



Other measures of CPI inflation also indicated marginal increases during April 2005, but remained steady thereafter (Table 22).

Table 22: Consumer Price Inflation (CPI) in India (year-on-year)

Inflation Measure	(Per cent)				
	March 2003	March 2004	March 2005	April 2005	May 2005
1	2	3	4	5	6
CPI-IW	4.1	3.5	4.2	5.0	3.7
CPI- UNME	3.8	3.4	4.0	4.2	4.2
CPI-AL	4.9	2.5	2.4	3.0	3.0
CPI-RL	4.8	2.5	2.4	3.0	3.0
<i>Memo:</i>					
WPI Inflation	6.5	4.6	5.1	5.7	5.2
IW : Industrial Workers. UNME : Urban Non-manual Employees. AL : Agricultural Labourers. RL : Rural Labourers.					

Asset Prices and Inflation

An upturn in asset prices characterised Q₁ of 2005-06, reflecting strong fundamentals (Chart 35). Equity markets continued their rally reaching new highs in June-July 2005. Gold prices remained firm in line with international trends on the back of sustained demand.

