

3. Price and Supply Situation

Framework of Inflation

3.01 Nepalese inflation has been affected more by the structural and external factors. However, increase in aggregate demand through the expansion of monetary aggregates as a factor affecting inflation can not be disregarded. Overall supply of goods and services such as agricultural produces and industrial products, and supply constraints due to closures and strikes come under structural factors. Factors such as price hike of petroleum products in the global market and direct impact of Indian inflation come under external factors that affect inflation in Nepal. The world currently is facing challenges to contain inflation due to food and petroleum products' price hike. India has also adopted anti-inflationary measures including smoothening the internal supply of goods and services. This has affected the overall supply in the Nepalese market, too. In this way, the steps that India took to ease supply situation internally, the effect of increasing Indian inflation, and the increasing prices of petroleum and food products in the international market have exerted pressure on price situation in Nepal. In this regard, there is a need to ensure economic stability by attaining price stability through effective monetary management, supply management and fiscal management so that people's livelihood will not get adversely affected.

Overall Consumer Price Situation

3.02 The year-on-year consumer price inflation increased to 7.2 percent in mid-March 2008 from 6.2 percent a year ago. The average consumer price inflation remained at 6.4 percent in the first eight months of FY 2007/08. While announcing monetary policy for FY 2007/08 Nepal Rastra Bank (NRB) had estimated that price situation would remain under control at 5.5 percent. However, through the mid-term review of the monetary policy, the NRB had stated that there was an upward pressure on price mainly due to international inflationary pressure as a result of increased prices of petroleum and food products, and rise in domestic food prices due to supply constraints after India imposed export restrictions on some of the food products to Nepal.

**Table 3(a) : Annual Inflation based on Consumer Price Index (Y-o-Y Percent)
(1994/95=100)**

(Percent)

	2003/04	2004/05	2005/06	2006/07	2007/08
Mid-July	5.4	2.4	7.3	7.3	6.3
Mid-August	5.2	2.6	8.2	6.6	7.0
Mid-September	5.6	2.6	7.8	7.5	6.3
Mid-October	5.8	2.7	8.5	7.1	6.3
Mid-November	4.9	3.1	8.8	7.3	5.7
Mid-December	5.0	4.6	7.0	7.6	5.8
Mid-January	4.7	5.7	5.8	8.0	6.4
Mid-February	4.4	5.7	7.7	6.2	7.2
Mid-March	1.7	5.8	7.9	5.6	
Mid-April	1.3	6.4	9.1	4.6	
Mid-May	1.8	6.2	9.1	4.5	
Mid-June	2.0	6.6	8.3	5.1	
Annual Average	4.0	4.5	8.0	6.4	6.4*

Source: Nepal Rastra Bank,

* Eight months average

Box 3 : Inflationary Pressures due to Food Price Increase

A study carried out by the International Food Policy Research Institute, entitled The World Food Situation, has stated that world food demand has increased by 8.0 percent and the world food price has increased by around 50 percent within the six-year period from 2000 through 2006. In recent years, food items are being used for the production of bio-fuel. Almost 25 percent of the foodgrains in the world was used to produce bio-fuel within 2003 through 2007. The United States of America increased the use of maize by two and half times to produce ethanol. The attraction towards bio-fuel is increasing, especially because of the increasing petroleum prices since 2003. As the price of crude oil has crossed over US\$ 135 per barrel, the demand for bio-fuel is likely to increase further, pressing more on prices of the food products.

In the poor countries, 50 percent of the total income is used in the purchase of food items. If the price of food products goes on increasing in the same way, it will create huge difficulty for the low-income people. In India, the government has been controlling the trade of food items for

the last 15 years. Just to note, India is the second largest paddy producing country after China, and Indian farmers and traders lead the world in rice trading. As they export foodgrains at higher prices, it has also exerted pressure on the domestic price. For instance, after the Indian government banned the export of rice (except Basmati rice) at the end of 2007, the price of rice increased from US\$ 650 per MT to US\$ 1,000 per MT. Since Nepal has an open border with India, and world food prices are increasing significantly, it is more likely that the price of food items will increase further and hence it is urgent for Nepal to strengthen the supply system.

Source: Nepal Rastra Bank

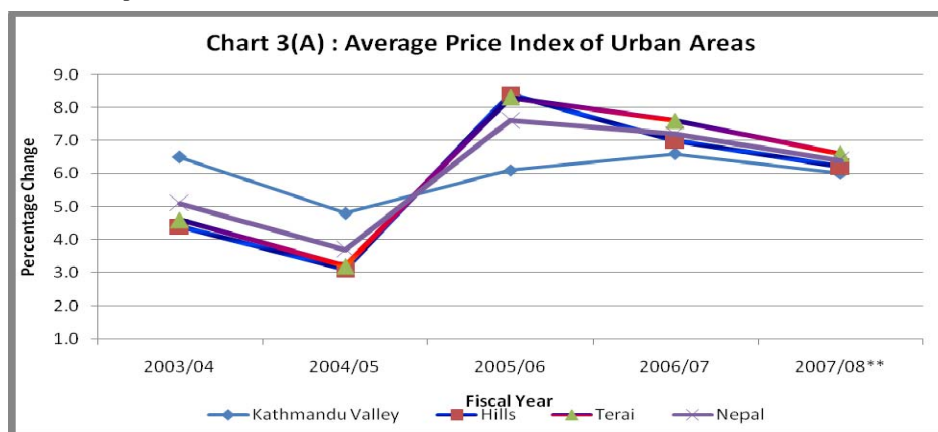
- 3.03 The urban consumer price inflation reached 7.2 percent in mid-March 2008 compared to the level of 6.2 percent in mid-March 2007. Region-wise, consumer price inflation in the Kathmandu Valley, hills and Terai remained at 7.0 percent, 7.5 percent and 7.1 percent respectively compared the to rate of 6.4 percent, 5.2 percent and 6.5 percent respectively a year ago.

Table 3(b) : Urban Consumer Price Index (Y-o-Y)
(1994/95 = 100)

Region	Weight (percent)	Fiscal Year				
		2003/04	2004/05	2005/06	2006/07	2007/08**
Kathmandu Valley	30.8	2.3	6.1	5.5	6.4	7.0
Hills	18.8	-1.0	6.6	7.6	5.2	7.5
Terai	50.4	-1.1	5.2	9.0	6.5	7.1
Nepal	100	-0.1	5.7	7.7	6.2	7.2

* Mid-March, ** Provisional

Source: Nepal Rastra Bank



3.04 The eight-month average consumer price index for the first eight months of FY 2007/08 remained at 6.4 percent from 7.2 percent a year ago. Region-wise, average inflation in Kathmandu was 6.0 percent, hills 6.2 percent and Terai 6.6 percent in 2007/08 compared to the rates of 6.6 percent, 7.0 percent and 7.6 percent respectively a year ago.

Table 3(c) : Average Consumer Price Index in Urban Areas

(1994/95 = 100)

Percentage Change*

Region	Weight (percent)	Fiscal Year				
		2003/04	2004/05	2005/06	2006/07	2007/08**
Kathmandu Valley	30.8	6.5	4.8	6.1	6.6	6.0
Hills	18.8	4.4	3.1	8.4	7.0	6.2
Terai	50.4	4.6	3.2	8.3	7.6	6.6
Nepal	100	5.1	3.7	7.6	7.2	6.4

* First eight months average growth, ** provisional

Source: Nepal Rastra Bank

Food and Beverages Group

3.05 Group-wise, the general price level of food and beverages group that has a weight of 53.2 percent in the overall consumer price index rose by 9.4 percent on year-on-year basis in mid-March 2008. The price inflation of this group was 9.2 percent a year ago. The higher increment in the price index of this group was on account of substantial increase in prices of rice and rice-products, pulses, milk and milk-products, oil and ghee. The prices of meat, fish and eggs, beverages, and restaurant meals also increased in the review period.

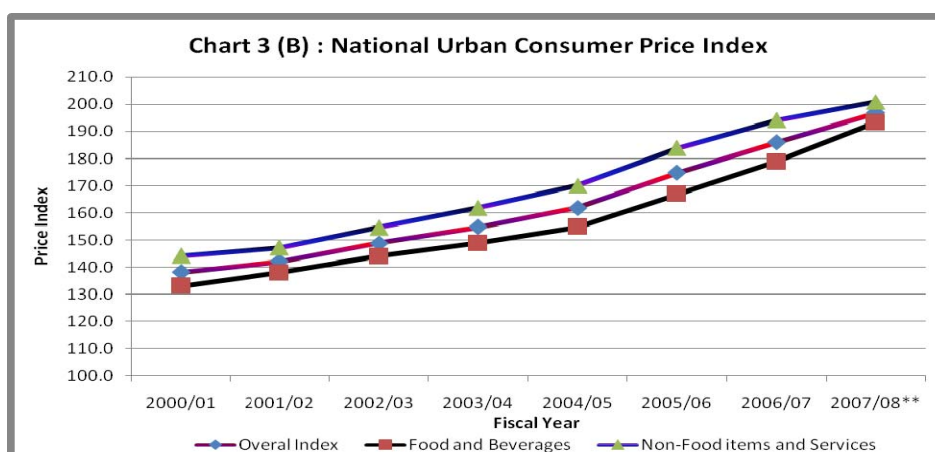


Table 3(d) : National Consumer Price Index (Y-o-Y)

1994/95 = 100)

Percentage Change*

Consumption Goods	Weight in Percentage	Fiscal Year				
		2003/04	2004/05	2005/06	2006/07	2007/08**
Total A + B	100.0	4.4	5.7	7.7	6.2	7.2
A Food and Beverage	53.2	3.1	4.7	6.2	9.2	9.4
Foodgrains and products	18.0	-0.8	5.8	13.2	7.8	14.9
Rice	(14.16)	0.8	5.5	14.8	3.4	19.4
Pulses	2.7	3.7	3.6	12.4	17.9	13.7
Vegetables and Fruits	7.9	1.2	4.0	1.5	18.4	-1.8
Spices	1.9	7.9	-4.9	2.4	26.8	-0.7
Meat, Fish and Eggs	5.2	5.6	9.1	-1.2	12.0	5.3
Milk and Milk Products	4.0	1.6	0.0	5.1	6.9	7.6
Oil and Ghee	3.1	19.7	-7.5	-3.0	10.9	27.3
Sugar and Sugar Products	1.2	6.5	25.5	5.3	-12.2	-8.4
Beverages	2.3	-0.7	3.2	10.4	3.1	2.2
Restaurant Meal	6.9	6.1	7.4	3.3	2.9	7.8
B. Non-Food and Services	46.8	5.7	6.8	9.1	3.2	4.9
Clothings	8.9	1.5	2.5	2.9	2.4	2.4
Cloths	(2.28)	1.9	2.7	2.2	1.2	0.5
Readymade Garments	(5.75)	0.4	2.1	3.0	2.5	2.6
Shoes	2.2	-0.1	1.3	2.8	6.1	4.6
Household Goods	14.9	8.8	12.3	14.1	3.1	6.1
Housing Furnishing and Household Goods	(3.5)	1.8	4.8	3.7	5.9	4.2
House Rent	(4.2)	3.9	4.5	4.5	4.1	5.0
Cleaning	(1.3)	2.0	1.8	2.5	9.5	7.9
Energy, Fuel and Water	(5.9)	15.6	20.4	22.8	1.4	6.9
Transport and Communication	4.0	11.1	14.1	21.2	0.5	1.1
Medicine and Personal Care	8.0	4.1	1.1	3.0	2.4	5.8
Education, Educational Materials and Entertainment	7.1	4.7	4.6	4.8	6.1	5.5
Tobacco and Tobacco Products	1.7	1.5	2.5	3.8	6.4	8.3

*Mid-march Y-o-Y, ** Provisional

Source: Nepal Rastra bank

Non-Food and Services Group

3.06 The price of non-food and services group that has a weight of 46.8 percent in the overall consumer price index increased by 4.9 percent on year-on-year basis in mid-March 2008. The index of this group had increased by 3.2 percent a year ago. This is attributed to increased prices of household goods, medicines, personal services, education, educational materials and recreation, tobacco and tobacco products.

Regional Consumer Price Situation

3.07 Region-wise, the price index of the Kathmandu Valley rose by 7 percent on year-on-year basis in mid-March 2008. The index had increased by 6.4 percent a year ago. In Kathmandu Valley, the prices of food and beverages increased by 9.8 percent and that of the non-food and services by 4.3 percent. In the food and beverages group, there was a significant increase in the prices of rice and rice-products, milk and milk products, oil and ghee, restaurant meals, and meat, fish and eggs. While the price of oil and ghee increased by 30.5 percent, the price of rice and rice-related products increased by 16.6 percent. In the non-food and services group, the prices of fuel, light and water, household goods and tobacco and tobacco-related products increased at a relatively higher rate.

3.08 The price index of the Terai region that is regarded as food basket of Nepal and border links with Nepal's major trading partner India, rose by 7.1 percent on year-on-year basis in mid-March 2008. Such index had increased by 6.5 percent a year ago. The increase in the prices of rice and rice-products, pulses, oil and ghee, and restaurant meals contributed to higher inflation of 7.1 percent in the Terai region. In non-food and services group, the prices of fuel, light and water, medicine and personal care, education, educational materials and recreation, and tobacco and tobacco products increased at a relatively higher rate.

3.09 In the hills, the price index increased by 7.5 percent in mid-March 2008 compared to the rate of 5.2 percent a year ago. In the hills, too, the prices of rice and rice product, pulses, and oil and ghee increased significantly. In the non-food and services group, the prices of medicine and personal care, education, educational materials and recreation, and tobacco and tobacco-related products rose relatively higher.

Core Inflation

3.10 NRB calculates core inflation by applying exclusion method under which the prices of rice, vegetables and fruits, fuel, light and water, and transport are excluded from the overall consumer price index. The year-on-year core inflation stood at 6.1 percent in mid-March 2008 from the level of 6.8 percent in mid-March 2007. Group-wise, the index of food and beverages group increased by 7.4 percent in mid-March 2008 compared to the rise of 9.6 percent a year ago. The prices of non-food and services group increased by 4.9 percent in mid-March 2008 compared to the 4.3 percent rise a year ago.

Wholesale Price Index

3.11 National wholesale price index on year-on-year basis increased by 6.6 percent in mid-March 2008. Group-wise, the price indices of agricultural products, domestically produced industrial goods, and imported goods increased by 4.9 percent, 9.0 percent, and 7.8 percent respectively.

3.12 In the agricultural products group, the prices of food products, cash crops and pulses increased significantly. In the domestically produced industrial goods group, prices of food products and construction materials increased at higher rates. In the imported goods group, the prices of petroleum products, coal, chemical fertilizers and chemical products increased at rapid rates.

3.13 It is more likely that the increasing prices of food products and petroleum products would exert pressure on the entire price inflation. As the pressure in the wholesale prices would ultimately affect the consumer price index, stabilizing the wholesale prices would remain an additional challenge in the pursuit of maintaining economic stability.

Table 3(e) : National Wholesale Price Index

(1999/00 = 100)

Percentage Change*

Group	Weight in percent	Fiscal Year				
		2003/04	2004/05	2005/06	2006/07	2007/08**
National	100.0	3.6	8.5	6.2	12.2	6.6
Agricultural Commodities	49.6	-1.2	7.6	4.7	19.9	4.9
Domestic Manufactured Goods	20.4	7.8	4.3	3.5	8.7	9.0
Imported Commodities	30.0	8.6	12.4	10.1	3.7	7.8

*Mid-March Y-o-Y, ** Provisional

Source: Nepal Rastra bank

National Salary and Wage Index

3.14 The year-on-year national salary and wage index increased by 9 percent in mid-March 2008 compared to the rise of 10.1 percent a year ago. Under the national salary and wage index, the salary index increased by 10.9 percent and the wage index increased by 8.4 percent. In the previous year, the salary index had increased by 6.2 percent while the wage index had increased by 11.4 percent. The increase in the salary index reflected mainly the salary increment of government officials in mid-July 2007. The increase in the wage index was on account of the wage increment in the industrial and construction sector.

Table 3 (f): National Salary and Wage Rate Index
(2004/05 = 100)

Percentage Change *

Groups/ Sub-groups	Weight in Percent	Fiscal Year			
		2004/05	2005/06	2006/07	2007/08**
Overall Index	100.0	9.8	4.3	10.1	9.0
1. Salary Index	27.0	8.6	0.4	6.2	10.9
1.1 Civil Service	2.8	20.0	0.0	10.0	23.5
1.2 Public Enterprises	1.1	11.4	4.4	6.7	8.8
1.3 Banks and Financial Institutions	0.6	0.2	10.0	3.0	50.5
1.4 Army and Police	4.0	19.7	0.0	11.4	9.3
1.5 Education	10.6	9.3	0.0	7.0	14.8
1.6 Private Organizations	7.9	0.0	0.0	1.3	-1.5
2. Wage Rate Index	73.0	10.03	5.7	11.4	8.4
2.1 Agricultural Laborers	39.5	10.5	7.3	10.9	6.0
2.2 Industrial Laborers	25.2	10.5	5.1	13.3	11.6
2.3 Construction Laborers	8.3	8.7	0.3	7.5	10.9

*Mid-march Y-o-Y, ** Provisional

Source: Nepal Rastra bank

Retail Prices of Some Major Goods

3.15 Among the retail prices of 10 agricultural products of daily consumption, the prices of all products except for the refined ghee and dry onion rose. In the food items, the price rise of the mustard oil was the highest. The price of mustard oil in the review period

increased by 32 percent, followed by rice, pigeon pea pulse and mutton. Region-wise, the price increment was highest in the hills, where the price hike of mustard oil was 28 percent. Besides, the pigeon pea pulse and mutton were the other items with the price hikes. In the Terai region, the price of mustard oil increased by 36 percent. Other major products with high prices included pigeon pea pulse and rice. Of the 10 major agricultural products, the prices of rice, pigeon pea pulse, mustard oil, potato and dry onion increased by 14.7 percent, 20.9 percent, 18.7 percent, 20.7 percent and 38.5 percent respectively in the first eight months of the current fiscal year compared to the same period last year.

Supply Situation

- 3.16 The supply of diesel increased by 9.3 percent to 198,420 kilolitres and the supply of kerosene decreased by 15.5 percent to 102,410 kilolitres in the first eight months of FY 2007/08. The supply of diesel and kerosene in the same period last year was 181,494 kilolitres and 121,191 kilolitres respectively. Similarly, the supply of petrol in the first eight months of FY 2007/08 increased by 9.0 percent to 67,768 kilolitres. In the same period last year, the supply of petrol was 62,180 kilolitres. The supply of LP gas increased by 6.7 percent to 67,768 MT in the first eight months of FY 2007/08 from the level of 62,180 MT a year ago. Similarly, the supply of furnace oil decreased by 12 percent to 2,320 kilolitres from the supply of 2,636 kilolitres a year ago. In the review period, the supply of aviation fuel increased by 11.9 percent to 46,243 kilolitres from 41,326 kilolitres a year ago.
- 3.17 The GON has started to fix the wholesale price (including VAT) for the petroleum products on the basis of the site of the Nepal Oil Corporation's storage point or the customs point since FY 2006/07. Arrangements have been made for the wholesale distribution of the petroleum products from Biratnagar, Birgunj, Amlekhgunj, Kathmandu, Pokhara, Bhairahawa, Nepalgunj, Surkhet, Dhangadi, Dipayal, Mahendranagar and Janakpur. In this system, the wholesale price and the retail price could differ from place to place. For example, the wholesale price of petrol per kilolitre is Rs 94,987.80 in Birgunj and Rs 99,100.63 in Dipayal. Average retail prices of petrol, diesel, kerosene, and LP gas in Kathmandu are Rs. 100 per liter, Rs. 70 per liter, Rs. 65 per liter and Rs. 1,200 per cylinder respectively.

- 3.18 As per the government policy to provide subsidy in the transportation of foods to the people of remote hilly districts, subsidy was provided on the air and land transportation of foods for 30 remote districts. In FY 2006/07, a total of 7,770 MT food was supplied to 30 remote hilly districts through transport subsidies, against the target of 7,838 MT. In the first eight months of FY 2007/08, a total of 6,987 MT of food has been supplied to 30 remote hilly districts against the target of supplying 4,700 MT. The annual supply target in FY 2007/08 is 8,930 MT.

Challenges

- 3.19 The price of petroleum product in the international market is increasing continuously. In this context, there is a need to implement concrete policy to ensure regular supply of petroleum products. The Nepal Oil Corporation, an authorized institution responsible for importing and distributing petroleum products, needs to be strengthened by curbing the leakages. Besides, a policy should be introduced encouraging private sector to import and distribute petroleum products. Also, a mechanism to automatically adjust petroleum prices with the international prices must be introduced. People must be encouraged to change their petroleum consumption habit so as to reduce its unnecessary use. Furthermore, there must be a distinction between the petroleum products used for the luxurious and personal uses and those used by general public as a bare necessity, and the necessary tax adjustments made by introducing the progressive tax on the basis of the uses of the product. There must be a management of mass transportation in the urban areas, especially under the concept of public-private partnership. However, for the medium and long-term, Nepal has no alternative of developing hydropower and alternative energy to reduce the increasing dependence on the petroleum products.
- 3.20 Currently, the world food price is increasing rapidly. According to the World Bank, the price of wheat increased by 181 percent in the last three years. Similarly the overall price of food items increased by 82 percent. Further, the stock of food products has remained at the lowest level since 1980. In the context that the food prices are increasing in Nepal too, it is likely that there will be huge pressure on future prices, especially; looking at the current level of storage capacity of Nepal. Also, as farmers store their produces in the Indian cities due to open border, there is double pressure on prices in Nepal.

To resolve this problem, there is a need to maintain a buffer stock of goods such as salt, oil, sugar, pulses and food items at different buffer zones developed under the involvement of government and private sector. Private sector has to be encouraged to establish at least one storage centre in each zone and sub-storage centre in the districts as per the need to store imported as well as domestic products. In addition, the government has to develop a mechanism to monitor the buffer stock in an effective manner.

- 3.21 Local products such as fruits, food products and cash crops lack proper market access. This has resulted in negative net output gain on the one hand and adversely affected the productivity due to dissatisfaction amongst the producers on the other. In this context, the cooperatives need to be mobilized in the collection and distribution of such items so as to increase their production and to productivity. Proper management and involvement of cooperatives could help in the supply management and help contain the price of the commodities in the market.
- 3.22 The effect of monetary expansion on inflation needs to be watched carefully. Since price stability is the major objective of monetary policy, there should no dichotomy towards the effective role of monetary management for this purpose. Therefore, it is necessary to show the result-oriented action to achieve price stability through monetary management. For this, the need is to further enhance the effectiveness of open market operations.