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Is there a structural twist in India's runaway inflation story?

India's inflation is on a decline, giving grateful policymakers wiggle room to relax tight monetary policy conditions. While the immediate danger has passed, the bigger worry is that structural factors, such as rising income and entitlement schemes, may have been behind the increase.

India's tastes in food differ from state to state. The North loves its *rotis* (wheat bread) while the South swears by rice. Some products have widespread appeal though, milk and its derivatives being one of them. It's no surprise that milk production rose by 4% annually in the decade till 2010-11 (India follows the April-March financial year), higher than the population growth of 1.6% per annum.

When retail milk prices rose by 40% in just three years (till January 2012), the impact was widespread. Food products also have a relatively high weightage in the inflation index, of 24.3%, but the rise in core inflation indicates a spill-over effect to other sectors of the economy too.

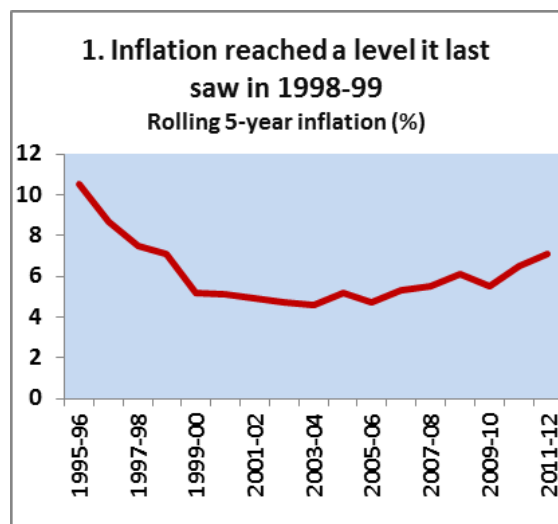
The sharp and sustained increase in inflation—in both food and non-food

products—is a key concern for India's policymakers. That it may not be just a cyclical phenomenon but have structural reasons behind it is a bigger worry. Inflation has eased substantially in recent months, from its high levels, chiefly due to falling food prices, though core inflation continues to remain relatively high.

The abating of headline numbers has emboldened the Reserve Bank of India (RBI), India's central bank, to halt its monetary policy tightening. In January, it marked this shift by cutting the cash reserve ratio to release more liquidity, but disappointed optimists by stopping short of an interest rate cut. Duvvuri Subbarao, the RBI governor, understandably wants to be cautious.

In the past five years (2007-2011), India's wholesale price index—which is more widely tracked than consumer inflation, presumably because it is considered more reliable—has averaged over 7%. That is the highest average for all five-year rolling periods since the late-nineties (see chart 1). Inflation had dropped to the 4%-5% levels in 2002-2004.

Inflation has ranged over 9% in two out of every five months in the past five years. That is over twice the long term inflation level of 4%-4.5% that the RBI is comfortable with. The last reading for inflation was 7.5% (December), 250 basis points lower than its September-level, which is still higher than the central bank's comfort zone.



What explains the persistence of inflation?

The spurt in inflation and its stubbornness suggest it may not merely be a cyclical phenomenon. When one looks at the rolling five-year average GDP growth, it shows that long term inflation scaled up when growth reached the 9% mark in 2007-08, just before the global financial crisis. Economic growth slowed since then, but inflation has accelerated (see Chart 2).

The other viewpoint is that inflation itself may have hurt growth in some measure. Various studies, including the ones done by the RBI, show that India's inflation threshold lies in the range of 4%-6%. Beyond this level, it begins to affect consumption. Inflation has also affected Indian industry's competitiveness, especially because the rupee (barring recent events) has not weakened in line with the inflation differential.

There is a real possibility that there are structural changes afoot which are causing inflation to slip outside of its normal limits. Here are some reasons we think which may have played a role.

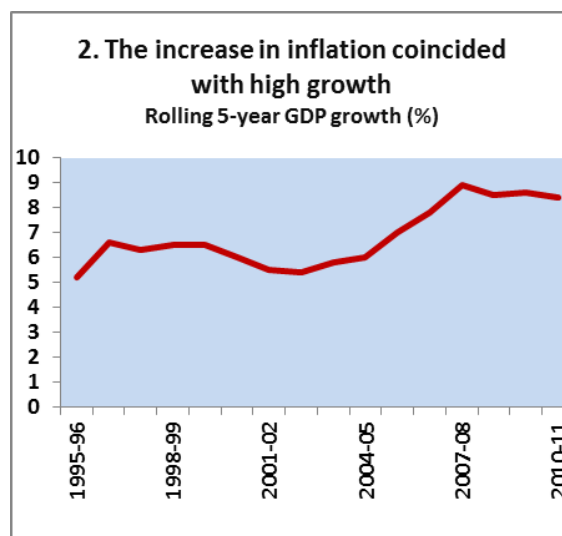
Rising income levels could be a key reason. The steady increase in income levels over the years has led to a spurt in demand for many items, which may have been previously unaffordable or were unavailable.

This is visible in the growing number and penetration of consumer goods and companies which sell them. Rising incomes are also influencing a change in food consumption patterns. Indians are climbing the food value chain—demanding more fruits, vegetables, and protein-rich foods.

Between 2006 and 2011, the combined inflation rate for fruits, vegetables, milk, eggs, fish and meat has been 12% per annum, as compared to 9.5% for the rest of the food basket (see Chart 3). This is not unusual. Other Asian economies had seen a similar trend during their take-off phase.

Another reason is the impact of price decontrols. The Indian government controls the prices of some key commodities such as

fuel in the inflation index. In the past, prices would remain low irrespective of what happened to international prices. But progressive reforms have given companies more freedom in fixing prices. Tariffs have moved up but there is still room for catch-up as they still do not reflect market rates.



The pricing of retail petroleum products, such as petrol and diesel, is governed more by politics than by economics. Prices do not increase proportionate to the hike in costs, but do not fall proportionately when global prices fall either. The net result is that they increase, even if gradually, and then remain there. That creates a floor under fuel prices.

In other administered items such as coal and electricity, prices have risen sharply, but have still not finished catching up either with import-parity prices, or to levels which are remunerative for the producers.

The state-owned coal monopoly, Coal India, has been in the news for increasing coal prices to bring them on par with global prices. In the past one year, it has hiked prices twice—for non-core sectors by as much as 80%-100%. It has proposed a shift to a new method of coal pricing, which will see coal prices increasing across the board. Protests by buyers have forced it to roll back some of these hikes.

What does all this do to the inflation index?

The fuels and power sub-index of India's wholesale price index rose by a compound annual growth rate (CAGR) of 6.3% in the past

five years, but has risen by an annual 12.5% in the past two years.

Another reason could be the government's socialist leanings, increasingly visible in the past five to six years. Its actions have boosted rural incomes, which also contributed to an increase in demand, though the methods are questionable, and may have distorted the labour market by artificially boosting wages.

Just before the 2009 elections, the government had announced a nation-wide farm loan waiver. The minimum support prices—assured prices at which the government will buy major farm produce—have been hiked fairly aggressively every year. Food inflation may affect the common man, but it has shifted the terms of trade in favour of farmers.

Another scheme that has attracted praise and criticism in equal measure is a large-scale social intervention scheme—The National

As incomes of many formerly subsistence-level families increase, the demand for food items increases sharply since income elasticity is high, at these relatively low income levels. While the scheme may have brought relief to poor families, it has had some unforeseen side-effects. The scheme is set to continue with the outlay increasing every year.

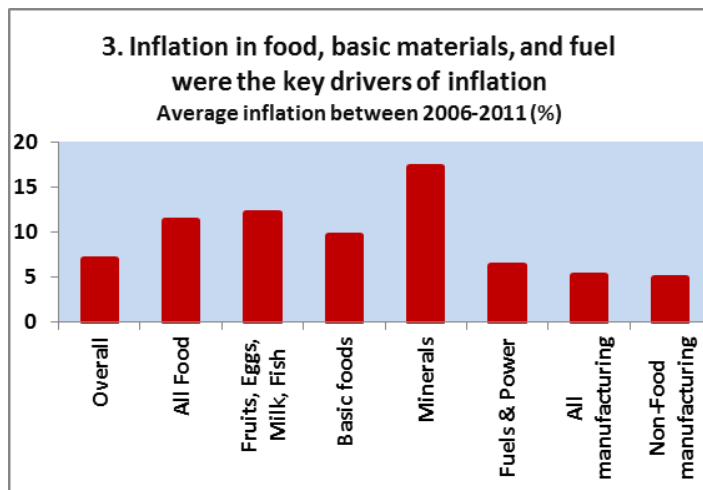
The politics of inflation too seem to have changed. Governments in India were known to lose elections in the past on their failure to defeat inflation. In the run-up to the elections in five states, inflation does not appear to be a very prominent poll issue. The jury is still out on whether inflation will affect the election results, which are due in March.

Rising incomes may have dented the effect of inflation on individuals, which could explain why inflation is not a burning issue, despite visibly eating into household budgets. Sections of the population—farmers, rural wage earners, and organized sector urban employees—have seen incomes rise rapidly since 2005-06. Anecdotal evidence suggests that casual workers, especially in urban areas, may have been losers.

Is high inflation here to stay? The rate of inflation has slid in recent months, though it remains higher than RBI's comfort level (see chart 4). Economic growth has slackened too. Commodity prices may soften due to a subdued global growth outlook. Energy prices may play spoilsport as they are vulnerable to geo-political developments in Iran and elsewhere in the Middle East. In this backdrop, India's inflation rate is set to moderate further in the coming months; a trajectory that the RBI is also betting on.

But the key concern is whether India's long-term inflation, and inflationary expectations, have both moved into a higher plane? Many of the structural factors that were listed earlier are very much present even now.

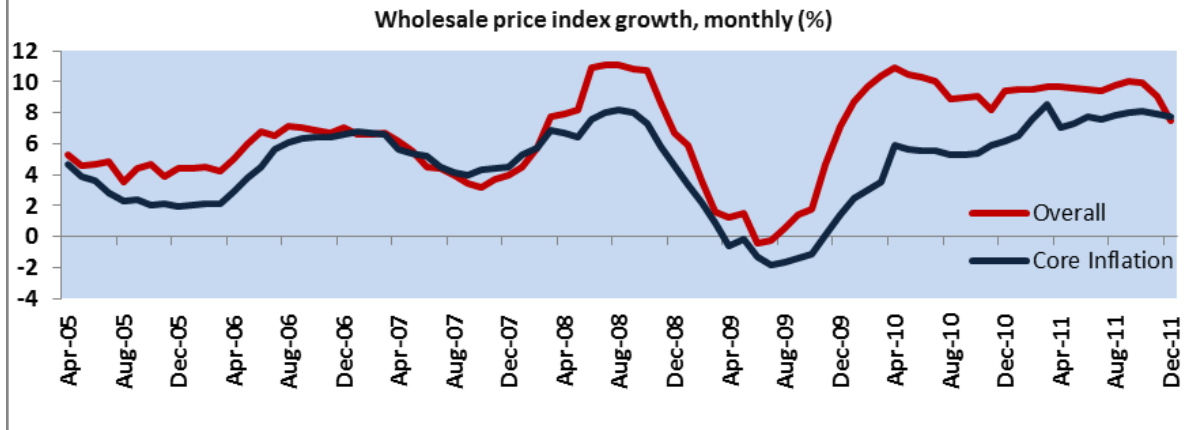
The catch-up by administered prices to their market prices is yet to be completed. Prices of basic foods suffered 9%-plus annual inflation over the past five years, also contributed by



Rural Employment Guarantee Scheme (NREGS). The government guarantees 100 days of employment for every rural family, with an annual outlay of \$10 billion. The amount is not very large, about 0.5% of GDP, but it has reduced labour availability and increased wage expectations.

Rural wages have been rising at between 15%-20% annually since 2009, while rural consumer inflation has been close to 10%. Industries that depend on farming, farmers who need farm labour, or even companies setting up projects in rural or semi-urban areas are facing an increase in wage costs.

4. The Central Bank will remain cautious till core inflation falls in sync with overall inflation



two consecutive poor monsoons in 2008 and 2009. They are likely to keep increasing at a minimum 5-6% over the coming years, as more families cross subsistence-levels, and agricultural production will find it hard to keep up with demand.

Per capita availability of cereals and pulses has marginally declined over the years. The consumption shift towards protein-rich foods is still not complete. The government's social welfare transfers (entitlement schemes), and hence, its fiscal deficits will also continue under the present regime.

Some macroeconomists worry that India's high inflation erupts when the economy speeds up beyond its long-term growth potential and is a sign that the economy overheats around that level.

When one looks at the past ten years of data, the overheating phenomenon is not consistently visible, though it does show up in certain years.

In the past three quarters, growth in India has been slowing down, yet inflation had held up at high levels.

Structural factors do appear to have contributed to keeping inflation high. While headline inflation may slide in the coming months, based on macro-economic dynamics such as tight monetary policy and slowing growth, not forgetting a high base effect, these structural factors will still lurk in the shadows.

When the dynamics change again, inflation could flare up again unless the supply-side situation improves; that's a prospect that should worry investors.

In the first two issues of *The View from Mumbai*, we looked at growth and inflation. A common thread that runs through both issues is how government policy—or at times the lack of it—is a key contributor. In the next issue, we will look at the contours of Indian politics from the viewpoint of an investor.

***The View from Mumbai** will cut out the hype or pessimism that prevails about India's future, laying out an unbiased and analytical view on the important issues that should be engaging the attention of global investors seeking to make sense of this market. **The View from Mumbai** is brought out by **IBV Research Insights**, an initiative to provide cutting edge business and economic research. It is led by a group of journalists who have been tracking the Indian economy, business, and capital markets for about two decades.*