Inflation | Decoding the dynamics

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In India, we have multiple price gauges—six consumer price indices (CPIs) and a Wholesale Price Index (WPI). While the Reserve Bank of India (RBI) examines all the price indices, both at aggregate and disaggregated levels, changes in WPI are taken as the headline inflation for policy articulation. Within WPI, non-food manufactured products inflation is considered the core inflation—an indicator of demand condition.

Going by any measure of inflation, India comes out as a moderate inflation country, though occasionally inflation crossed into the double-digit territory. The historical average long term inflation rate was around 7.5%.

But, significantly, inflation moderated sharply in the last decade. The annual average inflation rate was around 5.5% in the 2000s, irrespective of the inflation indices taken, whether WPI or CPI.

However, WPI inflation rose to an average of 9.6% in 2010-11 and continues to be over 9% in the current fiscal so far. The various measures of CPIs are also currently around 9%.

The persistence of inflation over a year-and-a-half raises three key questions:

How did the inflation dynamics change? How will inflation evolve in future? Why do we need to contain inflation?

Inflation dynamics

While a number of domestic and international supply shocks, coupled with firm demand conditions, exacerbated inflationary pressures over the past 18 months, structural changes in the inflation process were evident earlier.

Monthly WPI inflation data suggested there was a structural break around the mid-2000s, with the inflation rate during the latter half of the 2000s being higher. Higher levels of food prices seemed to have caused this break.

Food inflation, being subject to supply shocks, tends to be volatile. For example, the performance of monsoon has a significant bearing on the trend of domestic foodgrain prices. Spikes in food prices normally subside as they are transitory.

However, empirical analysis indicates that within the food group, inflation in protein items has become persistent. This suggests that protein inflation has assumed a structural character, adding rigidity to the overall level of food inflation.

The increase in protein prices is supported by the changes in consumer preference. For example, the 66th round of National Sample Survey Organisation survey shows that while the share of per capita expenditure on food has gone down—both in rural and urban centres—the dietary pattern has shifted in favour of protein items, whose share has gone up.

As the supply response has not been adequate, prices have increased and remained elevated. The rural consumption of protein is sustained by increase in wage rates.

There was another structural break in the core non-food manufactured products inflation towards the middle of 2009-10, around the time global commodity prices rebounded. The pass-through from non-food international commodity prices to domestic raw material prices has increased, particularly in recent years, reflecting growing interconnectedness of domestic and global commodity markets.

A sharp increase in non-food manufactured products inflation suggests producers are able to pass on the cost increases, given higher demand. In addition, reflecting the sharp rise in international crude oil prices, domestic fuel prices have also increased, as over 70% of our requirement for petroleum is met through imports.

To the extent the government has tried to cushion the impact of high international prices of oil by not passing on the increase fully to the consumers, it has increased the subsidy burden. Higher subsidy translates into higher fiscal deficit, which has inflationary implications.

On the demand side, there has been a significant increase in wages—both in the formal and informal sectors—in recent years. Even after accounting for high inflation, the increase in real wages has been positive both in urban and rural areas.

In addition, there has also been a significant demand stimulus from the crisis-driven fiscal and monetary policies. The current inflation process, therefore, is an amalgam of both supply constraints and demand pressures.

Shaping inflation’s path

Five factors will shape the inflation trajectory. The first is the trend in domestic food prices. Given the current stage of our economic development, the demand for food items, particularly animal protein, will increase with economic growth and a rise in income levels.

The demographic dividend, which has been contributing to our growth and productivity, has also raised consumption demand, particularly food.

As per a United Nations projection, a high consumption cohort in India’s total population will continue to dominate demand till 2040.

On the other hand, current per capita availability of cereals and pulses has been lower than that in the previous five decades. Oilseed production falls far short of demand.

Food prices in India are primarily determined by domestic demand and supply factors, and domestic price policy. With India’s domestic food prices being higher, import is not an option for reducing the prices. Hence, increasing agricultural productivity and expanding livestock production will be important for moderation of food inflation.

Second, global commodity prices and, particularly, crude oil prices will have an impact on overall inflation. This requires policy initiatives towards energy conservation, efficiency in energy usage, recourse to alternative sources of energy, and step up in domestic exploration of oil and gas. For a fast growing economy such as ours, energy supplies will tend to lag demand.

It is, therefore, important to contain demand by letting the pricing mechanism play its allocative role. For this, it will be desirable to make further progress towards deregulation of petroleum prices, particularly diesel. This will not only allow the price signals to operate, but also balance the demand for petroleum products.

Third, on the demand side, there is a need to shift aggregate demand away from consumption towards investment, to augment the potential output of the economy. The demographic dividend that we have in terms of addition of younger people to the labour force could be better harnessed when combined with increasing capital accumulation.

If the potential output does not expand, and the economy tends to grow faster than potential, it will result in overheating. The resultant inflationary pressures, by itself, will impact growth adversely. It is, therefore, important to enhance the potential output to dampen the inflationary impulses.

Fourth, the level of the fiscal deficit and the quality of government expenditure have significant influence on inflation. Under normal circumstances, when private demand is buoyant, expansion in the fiscal deficit could be inflationary. Since private borrowing competes with government borrowing, it could exert upward pressure on interest rates. This could crowd out private investment, which would have an adverse impact on the overall economic growth.

Further, it also matters whether the government borrowing is for financing consumption or investment. The fiscal multiplier works better with investment, but a rise in government consumption expenditure could be potentially inflationary. There is, therefore, a need to move towards credible fiscal consolidation to contain demand-side pressures on inflation.

Fifth, the stance of monetary policy and its ability to anchor inflationary expectations will affect how inflation evolves in future. The level of the policy interest rate should be such that it is neither too stimulative nor too tight.

This requires active liquidity management by RBI so that the systemic liquidity mostly remains in deficit in order to strengthen monetary transmission.

For an economy such as ours, with a large informal sector, there is also a need to foster financial deepening through financial inclusion to enhance our potential output.

Containing inflation

Prolonged high inflation, even if originating from the supply side, could give rise to increased inflation expectations and cause general prices to rise. Poorly anchored inflation expectations make long-term financial planning more complex, with potential adverse effects on investment and growth.

High inflation deters financial saving and increases lending rates, which discourage investment.

Moreover, high inflation is the most regressive form of taxation, particularly on the poor. It is, therefore, important to contain inflation and keep inflation expectations anchored so that consumers do not mark up their long-run inflation expectations by reacting to short periods of higher-than-expected inflation.

Keeping in view the costs of inflation and the fact that high inflation is inimical to sustained growth, the medium-term objective of RBI is to bring down inflation to 3%, consistent with India's broader integration with the global economy.

In this direction, monetary policy aims to contain perceptions of inflation in the range of 4-4.5% with a particular focus on the behaviour of the non-food manufacturing component, which is considered as core inflation given its high degree of persistence.

This objective is consistent with the estimated threshold level of inflation of 4-6%, suggesting the absence of a so-called new normal for inflation in India.

Both global and domestic factors will shape the inflation outlook in the future. RBI signalled the reversal from its crisis-driven expansionary monetary policy stance in October 2009. Since then, the cash reserve ratio has been raised by 100 basis points (bps).

One basis point is one-hundredth of a percentage point.

The policy repo rate has been raised by a cumulative 325 bps. As the liquidity in the system went from surplus to deficit, the effective policy rate tightening has been of the order of 475 bps. Thus, the cumulative monetary policy action would have the desired impact on inflation going forward.

Conclusion

While inflation is expected to moderate towards the later part of the year, reflecting monetary tightening and likely softening of global commodity prices, fiscal policy needs to be supportive in containing aggregate demand.

In addition, there is an urgent need to address the issue of structural supply constraints, particularly in agriculture, so that these do not become binding constraints in the long run, hampering the task of inflation management.