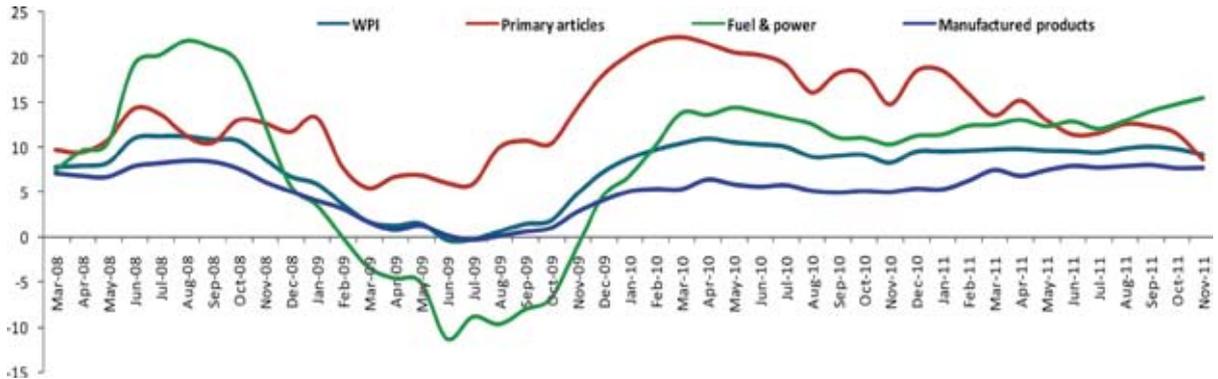


Inflation – Macro View

Inflation refers to persistent increase in prices. Wholesale Price Index (WPI) based Inflation – refers to increase in the prices of a representative basket of wholesale goods. India uses WPI changes as a central measure of inflation. It has three broad components – Primary articles, Fuel & power, and manufactured products.

Inflation – Wholesale Price Index (WPI) & its Components



Primary articles consist of food Inflation

May 2008 – July 2009

Genesis of Inflation – The Current Inflation episode began in May 2008 with Fuel and Food Inflation picking up. Reasons for the same are given below:

- **Higher crude prices** – Due to rapid growth of global economy in 2007 and early 2008 there was a huge demand for crude. Also, when stock market started showing weakness across the globe, investors started parking their money in commodities such as Crude.
- **Supply constraint** – Unprecedented drought in Australia and some part of Americas caused shortage of food grains in the global market. India too had a very bad production year and we had to import grains from the global market. This led to increase in general increase in food grains prices.
- **Excess liquidity** – High growth in emerging economies like India attracted huge amount of foreign capital, causing too much money to chase too few goods, leading to inflation.

Sub prime Crisis and Impact on Inflation in India – With Sub-Prime Crisis hitting the United States (biggest consumer of Crude), the demand for Crude declined significantly leading to a sharp decline in the crude prices by December 2008.

Crude oil (Dubai Fateh 32), \$/barrel (Monthly average)



RBI used monetary policy measures to tame the Initial round of Inflation. RBI had hiked Repo Rate to 9% in July 2008. Due to dropping crude prices and lagged im-

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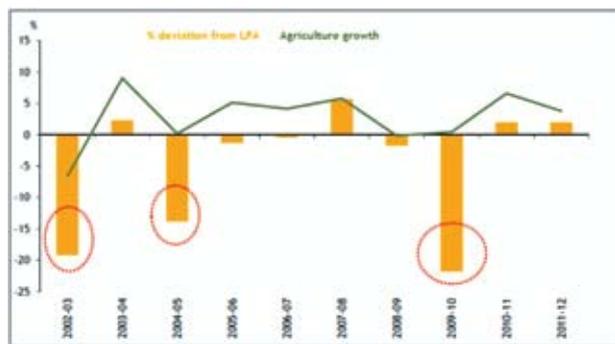
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part of monetary policy, Inflation declined to a low of -0.4% in June 2009.

August 2009 – March 2010

Sharp reversal in inflation from negative to positive territory – Food Inflation dragging inflation to 9% range:

- **Drought in 2009-2010:** India is significantly dependant on monsoons for agricultural production. Food price inflation was triggered by a short supply of essentials owing to lower farm production following drought and floods in different parts of the country during 2009-10.



*LPA - Long Period Average

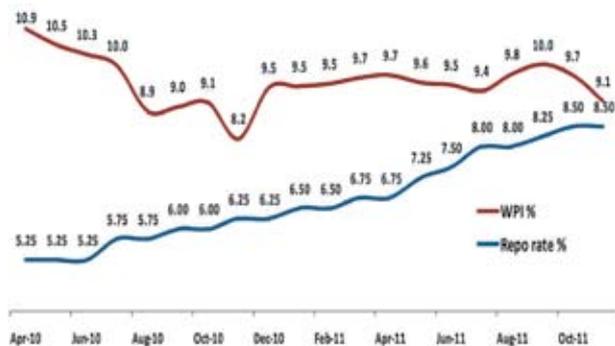
- **Global Commodities Price Rise:** All major global commodities including Crude, Base metals, Agricultural Commodities rose sharply pushing prices upwards to all time high.

April 2010 – March 2012

Inflation becomes broad based and Sticky – Spreading to manufacturing sector: Inflation remained high due to continuing high Commodity prices, structural food price inflation along with supply-side pressures resulting from increases in the cost of production (Rate hike by RBI pushing costs higher), poor governance and an unattractive business climate.

Inflation became broad based i.e. spreading from Fuel and food to Manufacturing sector.

Inflation has been persistently high and the Reserve Bank has hiked key policy rates 13 times since March 2010 to tame inflation.



Although the RBI cut policy rates by 50 basis points recently, the government data showed that the retail price inflation shot up to 9.47% in March 2012, compared with 8.83% in the previous month, primarily due to soaring vegetable prices. While urban areas saw a steep rise in inflation, 10.3% from 9.45% in February 2012, in rural regions, consumer price index (CPI)-based

inflation rose to 8.79% from 8.36% in the previous month. Wholesale price index (WPI)-based inflation fell to 6.89% in March from 6.95% in February, though according to this index, food inflation rose to a five-month high of 9.94%, compared with 6.07% in February and deflation in January 2012. Since the food basket has more weight in the CPI than in the WPI, overall inflation numbers showed a rise in the case of the retail price index.



Meanwhile, according to a recent Reuters' poll, India's economy will pick up this year, though more gradually than previously thought, while average inflation will be slower. Recently, the International Monetary Fund has suggested controlling of inflation as one of the crucial aims to bring India's growth back to potential and ensure its inclusiveness.

Drivers of Food Inflation

Shift in Dietary Patterns: There has been a shift in the dietary habits towards protein foods and a distinct feature of recent food price inflation has been the sustained price pressure in protein rich items (pulses, milk, fish, meat and eggs). Inflation in protein rich items has generally exceeded both headline (WPI) inflation and inflation in primary food articles.

The reason structural changes have triggered inflation in India is that the supply response in respect of most protein items has not been adequate.

With the exception of pulses, other protein rich items are not crop products. This is an important point since it explains the growing disconnect between the performance of agriculture and the trajectory of food inflation.

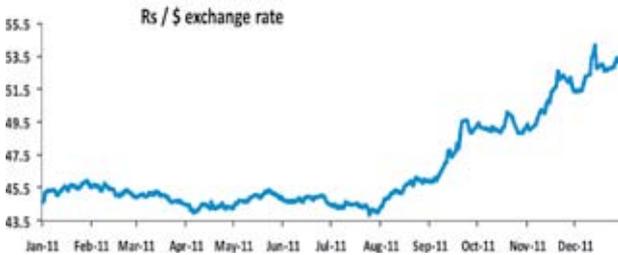
Structural High Primary Product Inflation/Supply Constraints:

Over the last decade, per-capita income levels have gone up nearly four times, while agriculture output has remained stagnant – largely due to a poor investment in agriculture, and fragmentation of land holdings. With rising per capita incomes, per capita consumption of food has also been on an up tick, thus putting pressure on food prices.

High Interest Rates/buoyant demand: have caused manufacturing Inflation to rise and become sticky. Tight Monetary policy has also led to transmission of costs into the economy through increased wages and higher input costs.

Depreciation of Rupee: Rupee Depreciation has further added to woes of Inflation as India is a net importer of commodities. For e.g. every ₹ 1

depreciation against the \$ adds ~\$3.0 bn to India's Oil Import bill.



Recent Trends: Weekly inflation data shows signs of softening commodity prices. Softening global commodity prices along with high base effect in food inflation is pushing the Inflation in to the negative territory. Normal monsoons have produced a bumper crop this year, which is further expected to push down the prices.

Trend of Rate of Inflation	YoY% *							
	12-Nov-11	19-Nov-11	26-Nov-11	03-Dec-11	10-Dec-11	17-Dec-11	24-Dec-11	Average
I. Primary Articles	9.1	7.7	6.9	5.5	3.8	2.7	0.1	5.1
(A) Food Articles	9.0	8.0	6.6	4.4	1.8	0.4	-3.4	3.8
(B) Non-Food Articles	4.1	2.1	1.4	2.1	1.4	0.3	0.8	1.7
(C) Minerals (Iron ore)	18.5	16.3	19.1	19.1	21.4	23.0	23.0	20.0
II. Fuel Index	15.5	15.5	15.5	15.2	15.2	14.4	14.6	15.1

Reversal of food inflation seems to be more of base effect rather than a permanent respite from Inflation.

Conclusion

Inflation being sticky and averaging 9.7%+ for nearly two years, despite effective monetary tightening to the tune of 525bps, is a clear indication that addressing supply-side issues is the key. An acknowledged fact is that this stickiness in inflation is partly a consequence of structural changes, since agricultural production has failed to keep up with rising per capita incomes and dietary changes.

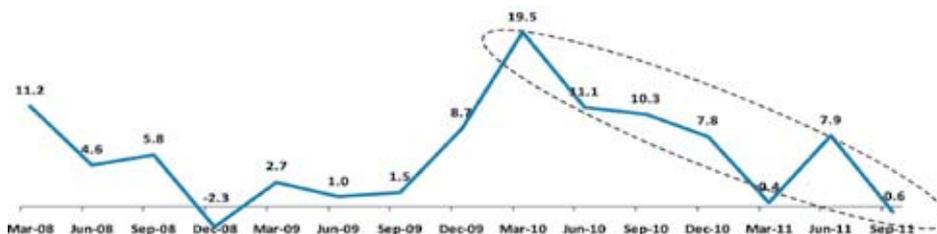
Steps to tackle inflation could include:

- (a) **Improving the logistics chain** – transportation, warehousing and cold chain facilities, as almost a third of agricultural produce is wasted due to poor logistical infrastructure;
- (b) **Raising productivity by emphasising seed/irrigation and fertiliser related reforms;**
- (c) **Unifying markets for agricultural products** within the country

Need to boost Investment Cycle

Policy uncertainty, coupled with restrictively high interest rates, has stifled fixed capital formation.

Gross fixed capital formation trends (Indicator of Investments)



To this end, key to reviving investments would be reforms in:

Power- Two key issues are (a) Addressing the losses of State Electricity Boards either through restructuring or fresh equity infusion by the government. To ensure that this does not become a recurring problem, necessary steps would be to ensure timely tariff revisions and improve operational efficiency. (b) Mechanisms for the passing through of prices of imported fuel. Given the current energy situation, there is a need to use more imported fuel (coal/gas/LNG). However, given the costs of imported fuel, power generated using imported fuel cannot be profitably sold in market on standalone basis currently. Thus, India needs to devise a mechanism which ensures that either cost of imported fuel becomes pass-through in tariff so higher cost imported fuel and cheap domestic fuel is pooled, so that average price of power is reasonable for new projects.

Mining- Thermal coal production has grown at abysmal rates, trailing underlying demand due to (a) delays in environmental/land clearance and (b) Shortages of rakes. Given India's energy requirements, coal production growth should be increased to 5%-10% levels. The coal shortage unfortunately cannot be fully met by imports, given low power tariffs relative to seaborne coal prices and SEB losses. Coal availability issues need to be resolved indigenously by - (i) expediting clearances: environment, forest, land acquisition; (ii) improving rake availability and (iii) allocation of coal blocks through competitive bidding.

Land Acquisition- Although India comprises 2.4% of the world's total area. However, it is also among the most densely populated countries in the world. Rising industrialisation has resulted in a growing struggle for land. A key step towards resolving issues related to compensation and rehabilitation would be the Land Acquisition Bill.

Labor Reforms – Key to avoid a Demographic Nightmare - Several instances of worker unrest seen in 2011, particularly in the autos and mining sectors, have been due to higher wage demands, consequently impacting production and taking a toll on growth. Moreover, due to rigid labor laws (i.e. high severance costs, difficulties in hiring and firing workers), many firms are now opting for contract laborers who fall outside the purview of regulation. However, this in turn is resulting in industrial unrest, as seen with Maruti's Gurgaon plant and other instances. Given that only 6% of India's total workforce of 506m is within the organised sector, calls upon the need to increase the number of formal jobs and a restructuring of the current labor policy.

National Manufacturing Policy aims to create National Investment and Manufacturing Zones (NIMZ) that would function as large autonomous industrial townships. This is estimated to create 100m new jobs and boost the share of manufacturing from 16% of GDP to 25% by 2022. ■