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MACROECONOMICS UPDATE

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Dr Rajiv Kumar
Senior Fellow, CPR
rkumar@cprindia.org

Geetima Das Krishna
Senior Researcher, CPR
geetima.krishna@cprindia.org

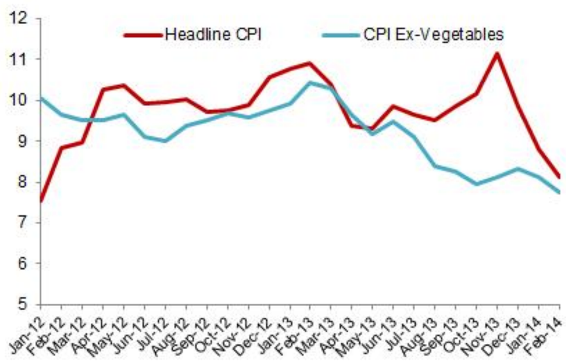
CPI inflation eased to 8.1% in February'14 - within reach of RBI's target of 8% by January'15

CPI inflation eased 300 basis points since November 2013 driven by lower vegetable prices

India's retail price inflation, indicated by Consumer Price Index (CPI), softened again in February and came in at 8.1% yoy (year-over-year) from 8.8% in January'14 and 9.9% in December'13. It was lower than the consensus expectation of 8.3%. CPI inflation came down by a whopping 3% points in three months from 11.2% in November 2013 driven entirely by lower food prices, particularly vegetable prices.

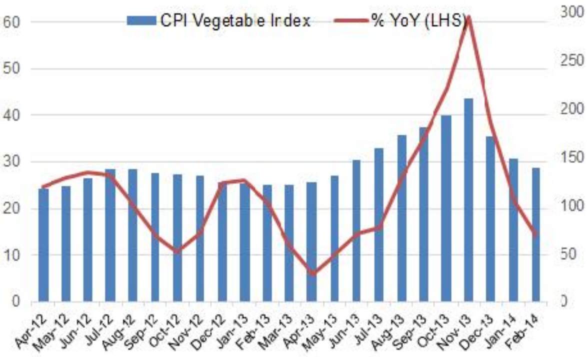
Vegetable prices usually soften in winter and as expected, their rate of increase which was 61% yoy in November 2013, softened to 14% in February 2014. In addition to vegetables, prices of sugar and edible oil also fell on monthly basis and that helped lower overall food price inflation to 8.6% in February from 14.5% in November 2013.

Chart 1: Trend of Headline CPI and CPI excluding Vegetables (% YoY)



Source; CMIE database, CPR Research

Chart 2: Vegetable inflation Index and annual change

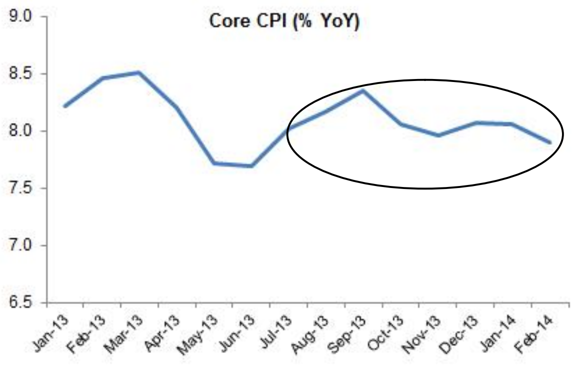


Source; CMIE database, CPR Research

…but core CPI, which had been sticky, eased only marginally….

The core CPI (excluding food and fuel), as opposed to headline retail inflation, that indicates actual broad-based imbalance between demand and supply in the economy, eased only marginally to 7.9% in February 14, demonstrating a stickiness around 8% since July 2013. Core inflation, in some sense the real measure of inflationary pressures in the economy has not declined in line with headline inflation reflecting the continuing supply-demand imbalance in the economy.

Chart 3: Core inflation was sticky



Source; CMIE database, CPR Research

It is generally assumed that a slowing economy, normally develops a negative output gap, where declining demand results in actual output being smaller than the supply potential of the economy. With the emergence of the negative output gap, prices and core inflation are expected to ease as producers try to increase demand by reducing prices and utilise excess capacity.

The stickiness of the core retail inflation for last eight months shows that this effect has not come about in India and so the question is why the core CPI inflation so high and sticky when growth is at sub-5% for last eight quarters? Should not core inflation collapse with lower growth?

…due to various reasons

First, as already argued by some economists that due to poor governance and sharp deterioration in investment sentiments, India's potential GDP growth might have actually come down in the last two years from around 7%. As the output gap is not as large as assumed, the decline in inflation did not materialise. The lower potential growth rate is also substantiated by rising ICOR (Incremental Capital Output Ratio) which implies that more capital is necessary to generate an incremental unit of output. In order to increase efficiency or productivity, we need to implement structural reforms to remove supply-side bottlenecks.

Second, the household inflation expectation survey of RBI shows that inflationary expectations have been running in double digits for past several years. According to Urjit Patel report, high food prices had kept inflationary expectations elevated. Higher government expenditure in rural areas and significant increase in procurement prices (MSP – Minimum Support Prices) had pushed up food prices. Even though actual inflation had been lower than expected, high inflationary expectations for such a long period, have resulted in deeply entrenched inflationary expectations. Therefore, a small dip in output gap might not be enough to bring down these expectations, which drive both wage negotiations and price setting. This is reflected in both continued rise in rural wages (15%) and hike in MSPs (average about 10%) that then drive other prices upward, setting up an inflationary spiral. This is best reflected in sticky prices for services which constitute nearly 64% of Core CPI.

Third, a significant number of prices in the economy are administratively controlled. These include prices of inputs like food, diesel, petrol, electricity, railway tariffs (which then impact prices of other transport services). Prices of major intermediate goods like steel, cement, fertilizers etc are also determined by public sector and hence are dependent on administrative decisions. These follow retail inflation with a lag and hence create a drag on the decline in prices, delaying the decline of the core inflation.

Fourth, a bottom-up approach at other components of Core CPI reveals that

- The 'Clothing and Footware' component has softened gradually over the year along with other income elastic components like 'Household requisite' and 'Personal Care'.
- 'Recreation and amusement' services inflation has moved up since the start of the fiscal year most probably due to inclusion of such services under service tax net.
- 'Transport' services inflation remained high as suppressed inflation in fuel component got released after government slowly deregulated various fuel products. Railway fares went up last year and air fares also moved up substantially over the last two years.
- 'Education' and 'Medical care' service inflations have been rising continuously over the year as those are more income inelastic and demand remained high. Moreover, these sectors are partly government controlled which puts a floor to the prices.
- Housing Index within Core CPI with about 24% weightage has been extremely sticky around 10% since June 2012. Housing is a different asset class where investors have more staying power and hold on to assets for a longer time to achieve anticipated returns. Even during Japan's asset price bubble in 1990s, house or land prices fell only after a lag after the fall in stock market.

All these four factors explain, though not exhaustively, the stickiness in core inflation. It will take a combination of demand repression through sustained monetary tightening and addressing supply side constraints through structural reforms to move the Indian economy from the current phase of 'medium term slowflation.' Any expectations that this can be achieved simply as a result of a favourable electoral outcome or a one sided monetary tightening are surely misplaced.

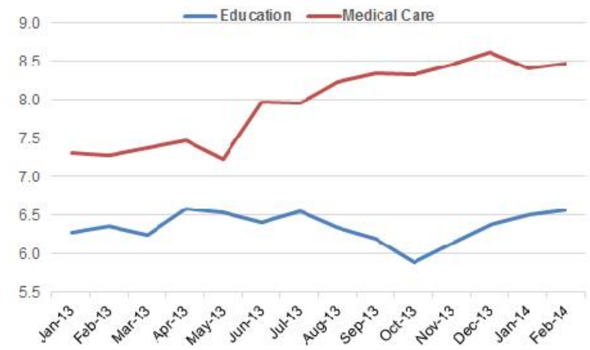
RBI is expected to remain on hold on April 1st, 2014 despite the softening of inflation

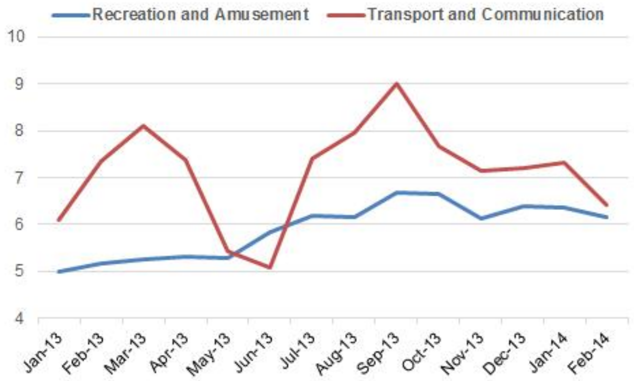
It is necessary to anchor inflation expectation to achieve sustainable growth in the medium term. However, RBI action might not be enough to put the inflation genie back into the bottle. Government will have to continue with supply side reforms - increase investment in agriculture sector, relook at Agriculture produce market committee act, remain on the path of fiscal consolidation, deregulate input prices etc. Therefore, we expect RBI to remain on hold in the next policy meet. We do not expect an easing of rate any time soon with future rate action dependent on inflation trajectory.

A final note of caution. Food products comprises 49.7% of CPI basket. The recent trend of softening of food prices may not last. Unseasonal winter rains and hailstorms have damaged wheat, sugarcane, potato and some horticulture crops that will put a floor to further softening of both cereal and non-cereal food prices. This will be followed by the seasonal rise in vegetable prices over the summer months. The risks of higher food prices may have gone up with the higher probability of El Nino that will result in a sub-normal monsoon in India. This will put pressure on food prices resulting in the reversal of the declining trend in headline CPI. So, by adopting inflation targeting as its policy driver and focusing on headline CPI inflation, and given the weight of food products in the consumption basket and CPI, RBI has exposed itself to weather uncertainties. This might well introduce new uncertainties and risks in the execution of monetary policy.

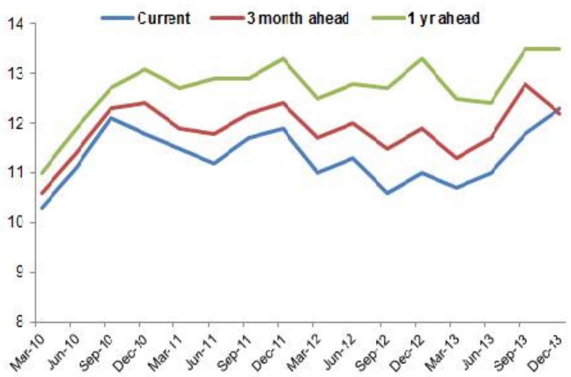
APPENDIX

Trend of annual change in Core CPI components (all remain sticky)

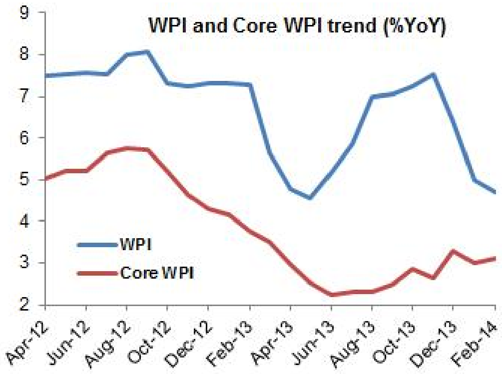




Household inflation expectation (% YoY)



WPI inflation eased to 4.7% yoy in Feb'14 as vegetable prices crashed from 98% in Nov'13 to 4% in Feb'14. Core inflation inched up



Source: CMIE database, CPR Research
Note: WPI – Wholesale Price Index inflation