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India's inflation dip rouses false hopes

By Kunal Kumar Kundu

NEW DELHI - India's latest inflation figures, released last week, show the first sub-6% rise in the Wholesale Price Index (WPI) since November 2009. This was achieved mainly due to relatively low food inflation and retracing of global commodity prices.

The preliminary estimate for the WPI for March came in at 5.96%, down from 6.84% in February 2013. With core inflation (headline inflation stripped off the volatile food and energy component) falling to 3.48%, its turns out to be the first piece of good news on the economic front for many moons.

It prompted analysts and even some noted economists to believe that the genie of inflation has finally been bottled and from here onwards the economy will slowly start to trend up, aided by monetary policy support (an interest rate cut, if you may). The domestic stock markets also reacted positively in anticipation of a rate cut at the next Reserve Bank of India monetary policy meeting scheduled for May 3.

That is something of an overreaction to what is not, in fact, particularly optimistic data.

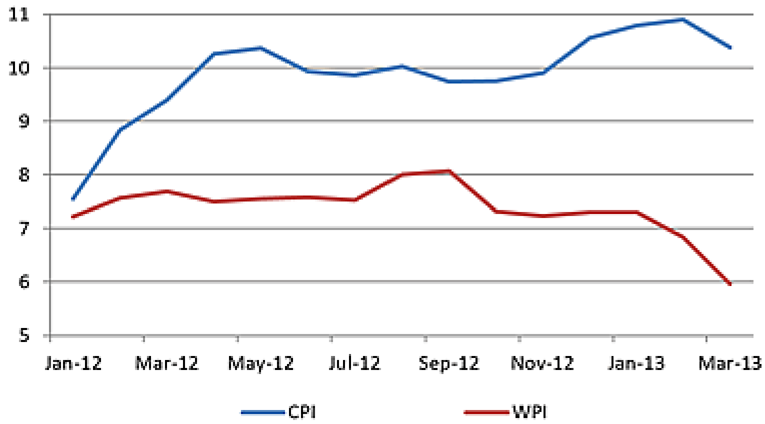
First, the lower inflation number itself is suspect. A nearly 0.9 percentage point decline in monthly inflation is not a regular occurrence. More importantly, the January inflation number was revised up by 0.68 percentage point from 6.62% to 7.31%. It is more than likely, therefore, that March inflation will be bumped up above 6% when the revised and final data is released in June.

Also, while the falling global commodity prices is a good news, the prudent decision to gradually raise the prices of regulated oil products like kerosene, diesel and cooking gas will likely negate the disinflation effect of lower commodity price.

What is also important to note is that, while overall food inflation has slowed down to 8.7%, food grain prices continue to remain elevated. Food grain inflation for March was as high as 16.8%, the ninth continuous month of double digit inflation.

In this light, it is worth recalling that the Food Security Act, the vehicle through which the ruling United Progressive Alliance is hoping to come back to power in a general election later this year, essentially deals with the supply of cheap food grains by the government to vulnerable sections of society. As the procurement frenzy goes up, the government will corner a large chunk of food grain, thereby pushing up prices in the market.

More importantly, the inflation that affects domestic consumers is measured by the Consumer Price Index, and its gains are still at the double digit level. Although it eased to 10.4% in March from 10.9% in February, the difference between the WPI and the CPI is high and rising.



Source: CEIC Data

Under this circumstance, how should monetary policy evolve? It is still probable that the central bank, as previously forecast here, will make a further 0.25% cut in the policy rate in May before taking a breather. There is not a case against too much easing of lending rates. While everybody and their friends are insisting that a cut in policy rate will rejuvenate the comatose animal spirit of entrepreneurs, the reality is quite different.

If increased investment were going to triggered by a 0.25% or a 0.50% cut in policy rate, it should have anyway taken off by now, especially when real rates (the difference between the nominal rate and the inflation rate) are very low in India and much lower than the real rates that were applicable when the country was going through an investment boom.

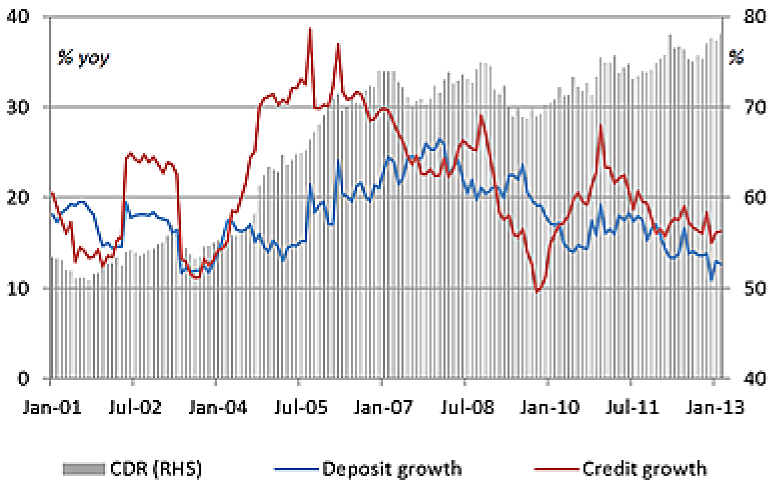
Investment is stuck, not because of high interest rates but due to the poor overall business environment. In a situation of unstable economic and political environment domestically, Indian businesses are investing more abroad than in their home country.

At this point in time, there is an argument against too much easing. For a start, while inflation may be easing (and even that may partly be chimerical given potential data issues) inflationary expectations have not yet been properly grounded.

Faster easing may lead to pick-up in consumption much ahead of investment, thereby reigniting inflationary pressure. Also, when inflationary expectations are high, domestic savings will take an even bigger hit. The saving rate is India is falling and may well be below 30% of gross domestic product during the year to March 2013. Last year, it was 30.81%, substantially lower than the peak savings rate of 36.82% recorded during year ending March 2008.

Of late, due to persistently high inflation, household savings have been the worst hit, declining from a peak of 25.18% to 22.33% and likely below 22% by March 2013. For generally risk-averse Indian households, the biggest chunk of financial savings flow to fixed income assets. If interest rates are reduced further in a period of high retail inflation, overall savings will be adversely affected.

In fact, bank deposit growth rates have slowed down much faster than the growth of bank credit, leading to the outstanding credit deposit ratio (CDR) rising to historically high levels (78.13% as of February 2013), thereby making it difficult for the banks to reduce the lending rates further.



Source: CEIC Data, author's calculation

More importantly, a further lowering of interest rates in an inflationary environment will potentially lead to a lowering of the already low savings rate. This can worsen the current account balance, thereby increasing the vulnerability of the economy.

The focus, therefore, should be on ensuring the right steps are taken to restart the investment cycle, including reducing the fiscal deficit (thereby freeing up resources that can be spent on infrastructure) and ensuring a fast and pragmatic resolution to investment roadblocks, such as land acquisition, environmental and other concerns (including fuel linkage for power projects), so that the country's numerous stalled projects can get back a lease of life.

Projects worth 7 trillion rupees (US$130 billion) are currently stuck because of these concerns, according to the available date. These projects have been hanging fire for a long time now. This is not only pushing up their cost but also putting at risk the huge amount of capital that has already been invested. If the government finally manages to get these projects going, India can hope to move out of the low level equilibrium that it presently finds itself in.

***Kunal Kumar Kundu** is a New Delhi-based economist. His website kunalsthoughts.weebly.com*