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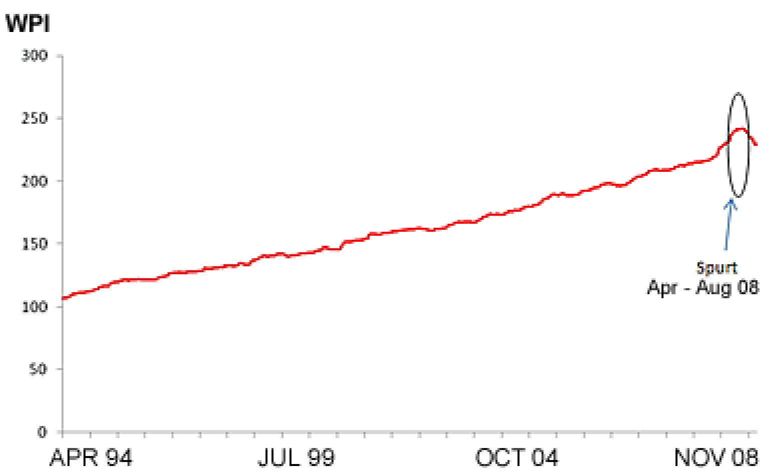
No cheer in India's low inflation

By Kunal Kumar Kundu

BANGALORE - India's efforts to combat inflation, as high as 7.85% a year ago as measured by the benchmark wholesale price index (WPI), have proved so successful, in tandem with falling global food and fuel prices, that zero increases may soon be registered.

The WPI inflation rate rose marginally to 0.31% for the week ended March 21, compared with 0.27% a week earlier. At the rate the inflation number has been moving, zero inflation (if not slightly negative index changes) could show up soon. If in the next two weeks the index increases (rather than falls, as has been happening of late) by even 0.5, inflation will be recorded as zero.

Even so, deflation does not seem to be a concern - it may be termed as disinflation, rather than a deflation. This is more of a statistical phenomenon, as the base effect kicks in big time rather than a situation of a drastic fall in prices due to a sustained decline in demand.



As can be seen from the chart above, there was a major spurt in the index value during early to mid-2008, led mainly by rising commodity prices, including oil. This was a period that saw the Reserve Bank of India going for major monetary tightening to cool off the inflationary effect.

Subsequently, as the global recession became evident, commodity prices started cooling off. The lagged effect of monetary tightening also entered into the equation, resulting in a slowing down of demand. As a result, post-August 2008, the index value started to fall and subsequently inflation, which is calculated year-on-year.

Going forward, inflation will remain low or be in the negative zone until the lower base effect starts kicking in again. After this, inflation will move back to positive territory. My hunch is that inflation might remain in negative territory for the next three to four months, after which a reversal might be visible. Only if real economic data takes a turn for the worse will the specter of deflation loom. As of now, the indications do not point to such a worsening scenario.

The other important question that needs to be answered is whether the WPI is indeed a real indicator of inflation in India? This does not seem to be the case, as Indian consumers are hardly, if at all, cheering this fall. The fall in wholesale prices is not percolating down to the retail level. The various consumer price index indicators that currently publish are at high single-digit levels. Clearly, there is a dichotomy here. There is a lagged transmission (from wholesale to retail) effect and I expect the CPI to start trending down soon, though it is highly unlikely that it will fall as low as the WPI has.

Clearly, the fall is not all-pervasive, and it is surely not because of a sustained fall in demand. A large part of this decline can be explained by the falling global prices of commodities (as virtually all the large economies are already well into recession or just about entering the recessionary zone) and by the various indirect tax reductions announced by the Indian government as part of its stimulus package to spur domestic demand.

Hence, deflation is not a realistic scenario at this point and it will likely kick in only if we see a big and sustained contraction in output, maybe 5% plus. Hence, the real economic data for the next few months will turn out to be crucial.

On the policy front, this calls for further rate cuts. However, whether these will translate into lower interest rates in the economy is not clear. Late last month, the interest rate on 10-year government bonds crossed the 7% mark, which is already 2% more than what it was in January. As a result, banks prefer to park their surplus liquidity in safer government securities.

What will also muddy the water is the humungous borrowing needed by the government to meet the requirements of the various stimulus packages it has announced. Not only will this lead to downward rigidity of interest rates, it will eventually crowd out private investment.

Looking ahead, it is quite likely that the focus will be back on inflation some time next year, although we will not see runaway inflation as we saw last year since global growth will be extremely benign. Purely domestic factors will drive prices higher in India.

Inflation will start rising not only because of a lower base effect but also because of a likely surge in the fiscal deficit. One need not look much beyond the recently announced interim budget. The deficit numbers announced in this are ample testimony to the government's failure to rein in wasteful expenditures, which could have ensured a capping of the deficit.

The so-called movement toward fiscal responsibility (announced with much fanfare by P Chidambaram when finance minister before his move to the Home Affairs Ministry late last year) was mostly an eyewash, as the government resorted to creative accounting practices. This involved reduction of direct payment of subsidies (which go straight into the calculation of deficit) and replacing that with various bonds (oil bonds, fertilizer bonds and so on). By reducing the direct payment of subsidies, the government did manage to show a lower deficit. In the bargain though, they transferred the deficit burden to the future generation, which will have to pay the maturing bonds.

Coming back to the recent budget, the officially announced fiscal deficit at the central government level has shot up to 6%. To this, if we add the state government deficits and if we bring the below-the-line items (such as the issuance of various bonds as mentioned earlier) we are staring at a fiscal deficit of over 10%, and in fact, closer to 12%.

In the current situation, with countries trying to spend their way out of recession by increasing their fiscal deficit, India has very little headroom to do so, given its already high level.

After the forthcoming general election that starts this month, things will deteriorate further if one considers populist measures announced recently by the various parties aspiring to rule the country. Ranging from rice at two rupees per kilogram, to free electricity for farmers, to farm-loan wavers, and on and on, the actual fiscal deficit will end up being much higher and without any doubt the high level of deficit will be inflationary.

That apart, we have seen investment drying up. Whatever capital investments are taking place are mostly for those projects on which substantial amounts of investment have already taken place and it would not make economic sense to abandon those projects midway.

In addition, many factories have either closed down or are on the verge of closing. This is more pronounced in the sector of small- and medium-sized businesses (SMEs). Demand for these has not only dried up, but getting working capital is a big challenge, given a clear reduction in the willingness of banks to lend.

What that means is that not only is no new capacity coming up, existing capacity is closing down. So, once the recovery happens, it is quite possible that rising demand will not be matched by increased supply, thereby adding to inflationary pressure.

That leaves one conclusion: while lower inflation numbers do not imply a deflationary tendency, they are no cause to cheer for India and its consumers. Given the problems enumerated above, inflation will soon start rearing its head.

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