

South Asia

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Inflation darkens Indian outlook

By Kunal Kumar Kundu

BANGALORE - India stands out among the emerging market growth stories as a country with an uncomfortably low (read negative) rate of real interest, meaning the inflation rate is substantially above the policy rate, despite the central [bank](#) raising key rates eight times in the past 13 months.

Last December, I emphasized that inflation would be India's biggest concern in 2011 (see [Indian inflation waiting to strike](#), Asia Times Online, December 23, 2010). In subsequent articles I have also talked about how the Reserve Bank of India (RBI), the central bank, continues to be behind the curve.

The bank itself has conceded that it has under-estimated the level of inflation - a month after forecasting 7% inflation for March it raised the figure to 8%. For a long time, the RBI has been in denial mode and has kept on hoping that inflation would remain under control. Clearly, it missed out on the bigger picture.

To the central bank's chagrin, India's inflation rate for February 2011 stood at 8.31%, still above the expected rate. Although the final inflation figure may yet come down for March, there's no gainsaying the fact that inflation is now the biggest bugbear and is occupying the minds and research space of economists of various hues.

How then is this rising inflation going to affect the economy going forward? In the current financial year, it has the potential to slow it down and by more than anticipated. While I do expect inflation to moderate next year, it is important to realize that the global economy has got to recalibrate the overall inflationary expectation going forward.

The average inflation rate is likely to be higher than what would have been considered tolerable even a few months back. In simple terms, the world has to accept the fact that relatively high inflation will be a way of life.

In the case of India, it very clear now that headline inflation has surely but steadily percolated down to core inflation. The fact that inflation is worrying India's central bank can be understood from a recent statement by deputy governor Subir Gokarn. He admitted, "The current rate of inflation does raise concerns about the risks of spiraling, as high inflation becomes increasingly entrenched into the wage and price-setting behavior of workers and producers."

The uncomfortably high rate of inflation will bite through several channels. Continuously elevated levels of oil prices will mean rising costs of oil imports. Despite the government's stated objective of freeing up of oil prices, only petrol prices are relatively deregulated (though not fully), while diesel prices are artificially controlled for fear of a further spike in inflation.

The ruling Congress government is also in a bind because of forthcoming state-level elections, especially given that way too many skeletons (read corruption scandals) have stumbled out of their cupboard for their comfort. They are not in a position to take decisive measures for fear of antagonizing their vote bank. Hence raising oil prices is out of question before the elections are over and results declared. Quite naturally, the oil subsidy cost will spiral.

Additionally, with various political parties vying with each other in terms of populist measures, things are likely to go from bad to worse. The state of Tamil Nadu best exemplifies competitive populism in politics. With the image of the ruling Dravida Munnetra Kazhagam (DMK) party in the state being badly bruised by the scandal over allocation of telecom spectrum (one of the party's own heavyweight ministers is languishing in jail), the DMK is banking on utterly populist schemes to regain the faith of the electorate.

Not to be left behind, the opposition All India Anna Dravida Munnetra Kazhagam is giving them a run for their money with its own set of schemes. Whoever comes to power will more than exhaust the state coffers by even trying to partially meet promises made. The natural consequence is a further increase in deficit.

While the government in its recent union budget projected a fiscal deficit of 4.8% of gross domestic product (GDP), the final deficit figure will be beyond 5%, most likely in the region of 5.3-5.5% of GDP. The rising deficit has its own inflationary consequence. Recently, the RBI indicated that managing inflation through monetary policy becomes more of a challenge if the fiscal deficit goes unguarded, which is quite likely to be the case in India in 2011.

After the elections, when the subsidy burden swells, oil prices will need to be raised, adding further to inflationary pressures.

Rising inflation and interest rates will squeeze corporate profit margins. Also, high interest rates will not only lead to a slowdown in leveraged consumption - it will lead to increased preference for saving over consumption. Even domestic investment is likely to face a slowdown because of inflation.

To conclude, with inflation conjuring up the fiercest headwind being faced by India this year, the country needs to brace for slower economic growth.

Kunal Kumar Kundu is Senior Practice Lead, Knowledge Services Division, Infosys Technologies Ltd. The views are those of the author, whose website is <http://kunalsthoughts.weebly.com>