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Indian inflation waiting to strike

By Kunal Kumar Kundu

The Reserve Bank of India (RBI) during its monetary policy review this month kept its key interest rate unchanged, much to the relief of market participants. While the expectation was for a rate increase, the softening of the inflation number (as shown by the wholesale price index, or WPI) just prior to the policy review, raised hopes of the status quo being maintained. The RBI obliged.

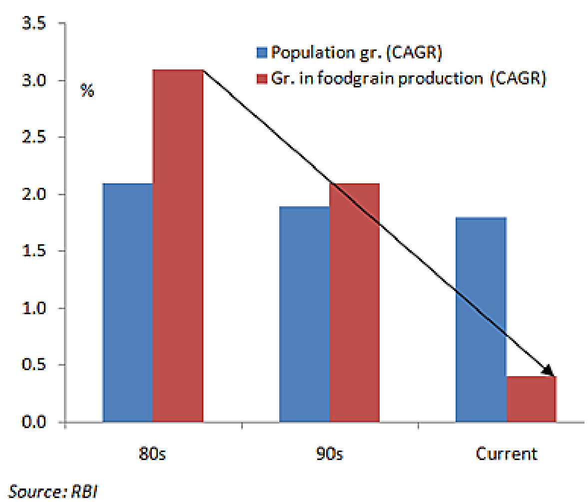
The relief was palpable, given that the RBI remains one of the most hawkish central banks in Asia with six successive rate increases from March this year. This pause comes after the RBI increased the lending (or repo) rate by 1.5 percentage points to 6.25% and the reverse repo by 2 percentage points to 5.25%.

While growth concerns took precedence over inflationary risk, aided by the drop in year-on-year inflation to 7.48% in November from 8.58% in October, the RBI kept its tone quite hawkish and has left the door open for further rate increases next time round. Clearly, the RBI is not very comfortable with the inflation outlook, and rightly so. I believe inflation is likely to be a bigger worry next year than is the general perception.

To understand this, consider three important factors - agriculture production, commodity prices and capital inflows.

Agriculture

The Indian agriculture sector has historically remained one of the most under-invested sectors and this is coming back to haunt the country. Not surprisingly, for the past two decades, India's foodgrain production has lagged behind the population growth rate.



In the decade of the 1980s, the population grew at a compounded annual growth rate (CAGR) of 2.1%, while foodgrain production rose by 3.1% CAGR. Thereafter, the growth rate of foodgrain production slowed down considerably, so much so that during the current decade (till financial year 2009-2010), the growth rate of foodgrain production was way below that of population increase.

Monsoon failures were a contributing factor this decade, helping to lead to a 19.2% shortfall in rainfall (compared with normal years) in 2002-03, a 13.8% shortfall in 2004-05 and a 29.2% shortfall during 2009-10. This not only indicates India's inability to reduce dependence on the monsoon (mainly because of a lack of adequate investment in irrigational infrastructure) but also an inability to increase productivity of foodgrain (again because of inadequate investment).

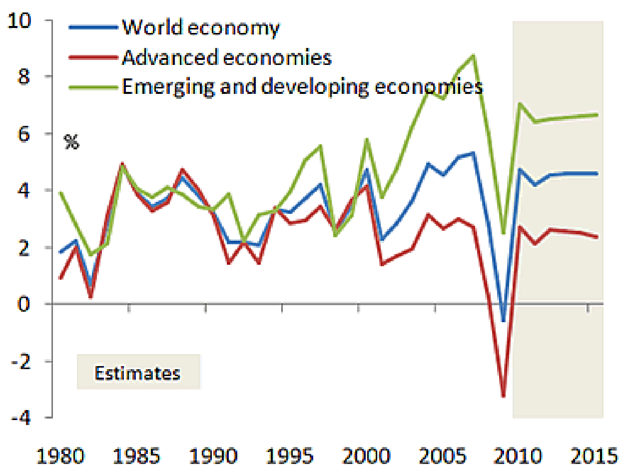
According to RBI data, while CAGR of foodgrain (kg/hectare) productivity peaked at 4.41% in the 1980s, it started to slide ominously thereafter. The growth rate fell to 2.36% in the 1990s, and to 1.06% during the first eight years of the current decade.

Not surprisingly, food inflation in India continues to remain inordinately high. After briefly flirting with a single digit rate (a high one at that), it is inching back toward the double digits (rising to 9.46% year-on-year in the week ended December 4 from 8.60% the previous week. Available indications are that food inflation will comfortably cross the double digit mark sooner rather than later.

Commodity prices

To my understanding, the biggest inflation risk is in high commodity prices, which are expected to remain at an elevated level going forward. There are two important drivers for these - economic activity and investment activity.

Although the developed world is floundering, the onus of keeping global activity at a decent level lies squarely on the shoulders of emerging economies.

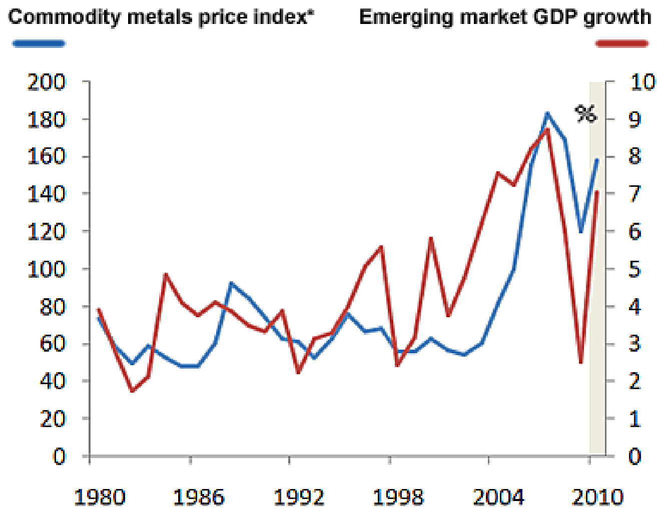


Source: IMF, WEO

With the emerging economies being much more commodity intensive, the demand for commodities is expected to remain strong.

Another important driver of commodity prices is the increasing importance of commodities as an asset class. Against the background of the financial turmoil in 2008, commodity prices have corrected sharply. One of the biggest corrections has been observed in the oil price. After reaching a record high in July 2008 at US$147, it plummeted nearly 80% to touch US$32 within just five months. On a broader basis, the CRB Commodity Index, one of the most recognized indices to track commodity prices, has also experienced a significant loss since peaking in July 2008.

The main reasons for the sharp correction were global recession, a stronger dollar and rising risk aversion among financial investors. However, commodities have come back strongly on the back of strong growth, shown by the emerging market economies as well as increased flows of investment into commodities.



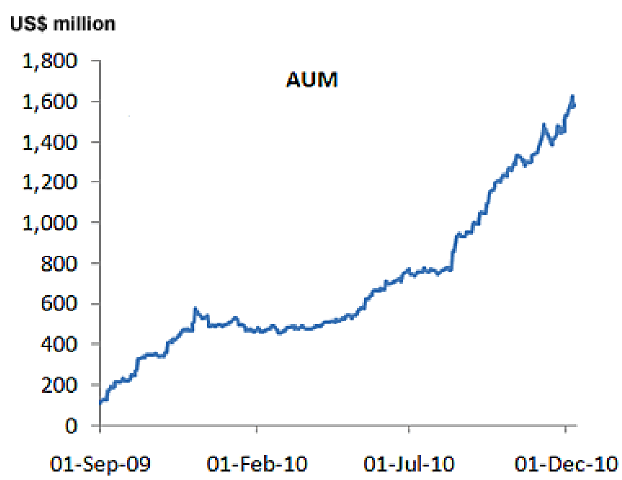
Source: IMF, WEO

** - Includes Copper, Aluminum, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices*

Among the various asset classes, currency is losing its sheen since there is a real threat of currency debasement, what with the developed economies experiencing high deficits and hoping to devalue their way out of their debt problems. Even the debt issuances of the developed economies, especially in Europe, are now looked at with suspicion as fears of default loom large.

The recent increase in the yield of US Treasuries reflects that investors' concerns are leading to lower demand. Real estate, as an asset class, is now hardly, if at all, attractive. Not surprisingly, therefore, commodities are back in favor.

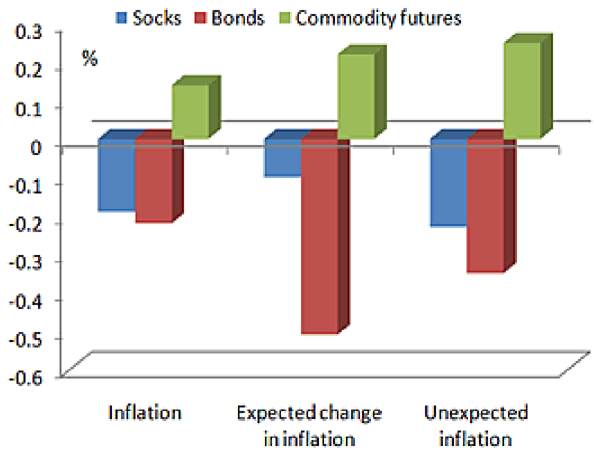
While earlier investors could only take part in the commodity play either by owning shares of commodity companies or through physically owning some assets, the emergence of commodity index products and exchange traded funds (ETFs) including exchange traded commodities over the past few years has increased the popularity of commodities among investors. ETF Securities Ltd, a pioneer in exchange traded commodities has, for example, seen its assets under management (AUM) in only their physical gold and silver shares jump in a little more than a year to more than US$1.6 billion currently, from a mere $100 million in September 09.



Source: ETF Securities Ltd

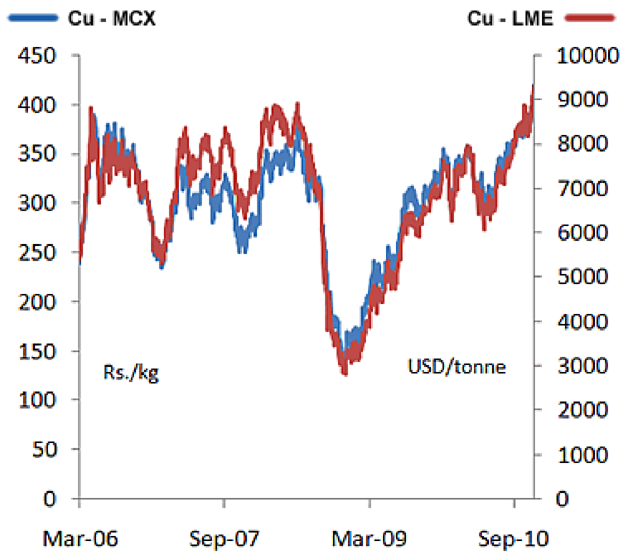
ETF Securities recently launched similar funds holding copper, nickel and tin. Other exchange traded products (ETPs) backed by aluminum, lead and zinc will be introduced next year. ETF Securities, JPMorgan Chase &

Co and BlackRock Inc have all announced plans to start such funds. According to available information, gold-backed ETPs accumulated 2,099 tonnes of bullion since they started in 2003, equal to nine years of US mine output. According to Barclays Capital, commodity assets under management rose $19 billion to a record $340 billion in October. It is also important to note here that commodities are an important hedge against inflation.

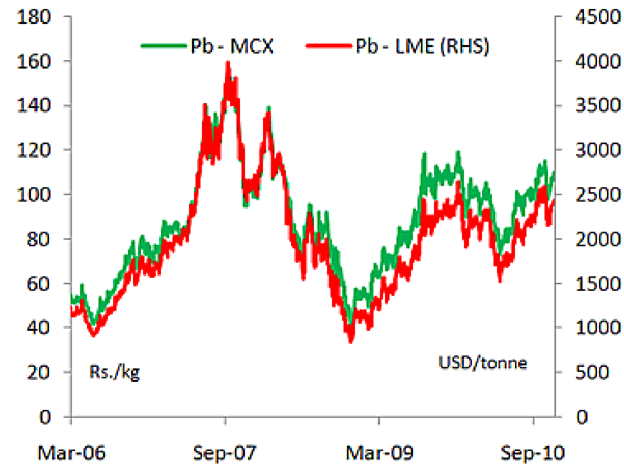


Source: Facts and Fantasies About Commodity Futures, Yale ICF working Paper No. 04-20

Indian prices of such industrial metals have also risen in sync with the global prices.



Source: Multi Commodity Exchange and Bloomberg
Note: Cu - Copper



Source: Multi Commodity Exchange and Bloomberg
Note: Pb - Lead

This is creeping into domestic inflation. India's automakers have already announced price increases, as has been the case with prices of many fast-moving consumer goods. Domestic prices of petrol and diesel have been raised again as global oil prices threaten to breach the $100 mark. This will again feed into inflation.

It is also important to note in this connection that the days of cheap oil are over. Oil exploration has now become a much more costly affair as more prospecting takes place further offshore. As a result, oil prices are unlikely to return to former lows even if economic activity weakens.

With such cost pressures building up, inflation in India will continue to remain at an elevated level. Unlike in the US, which is threatened by weak domestic demand, such demand in India is very strong. This, along with capacity constraints, means that the pricing power in India currently resides with producers. While capital investments have been taking place, new capacity will only come up after some gestation period. Until that time, producers will be able to pass on price increases as domestic demand stays firm.

Capital inflows
This is the third important source of inflation. As the Indian growth story remains strong, capital inflows will continue to be a major source of headaches for the RBI, particularly with the developed world economies continuing with their own brands of stimulus programs. Increased inflows of capital are forcing the RBI to intervene to prevent abrupt appreciation of the currency. As this increases, the money supply, inflation jacks up.

On the other hand, a rate increase to ward off inflation has the potential to increase capital inflows, adding to the dilemma. Although a high current account deficit (thanks mainly to India's over-dependence on imported oil) can help absorb the increasing inflows, given India's growth story, capital inflows will continue to be an important factor.

Overall, I am expecting inflation to be a major concern for India in 2011.

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