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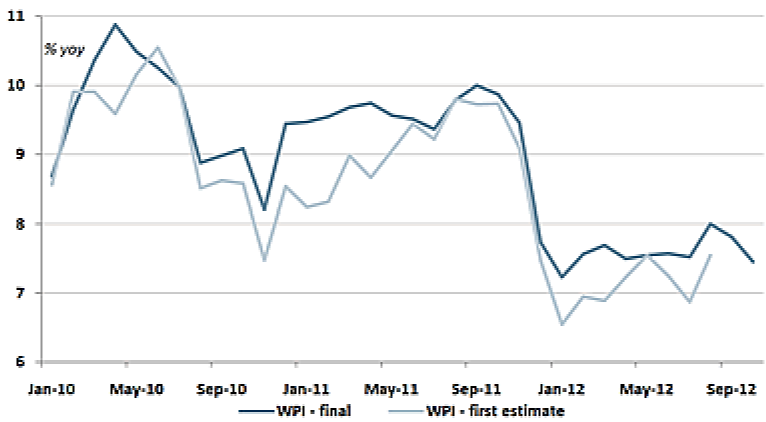
India's inflation pressures stay high

By Kunal Kumar Kundu

India's latest inflation figures, as shown in October Wholesale Price Index (WPI) data released on Wednesday, came in at 7.45% year-on-year (y-o-y), lower than the 7.81% increase recorded during September.

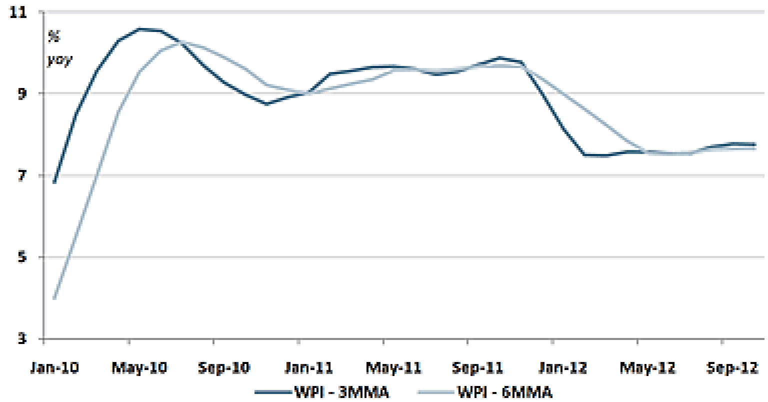
What is disconcerting is that the August inflation number was again revised upward, this time by 0.46 percentage points to 8.01%, the highest since September 2011. Between January 2010 and August this year - 32 months - the inflation number was unchanged only once; thrice it was revised lower while it was revised upward 28 times.



Note: Revisions up to August 2012. Source: Office of Economic Advisor

This continuous upward revision brings to question the credibility of the inflation data and, given its clear upward bias, makes it that much more difficult for the Reserve Bank of India to make an appropriate monetary policy call. There is every likelihood that the September and October data will be revised upward, perhaps again beyond 8%.

Still, inflation may be close to peaking out as suggested in the movement of both the three- and six-month moving average (MMA) data.



Source: Office of Economic Advisor, author's calculations

October inflation data, though it came in according to this author's expectations, was lower than the market forecast, possibly due to analysts' under-estimation of the base effect of food inflation, which recorded a year-on-year 6.6%. Food inflation in the same month last year crossed double digits at 10.2%.

Going forward, food inflation is likely to inch up (again due to the base effect), especially during December and January, though there's no immediate trigger for runaway food-price gains.

The biggest contributor to the upward revision of the August data was caused by adjustment of crude oil prices, which were initially grossly under-estimated. The Indian basket of crude oil peaked that month and, at the same time, the rupee also remained weak. When the full effect of these factors was considered, the index for crude petroleum was revised up more than 10% to 330.1 from 291.7. With the oil prices softening of late and the rupee showing some signs of strengthening, inflationary pressure on that front will ease.

What is also important to note is that, weak demand (both international and domestic) will likely help inflation to remain steady. A weak external environment is clearly taking its toll and India's exports (is US dollar terms) shrank during seven out of the last eight months.

Also, with domestic demand showing signs of weakness with high inflation and a high interest rate impacting consumer spending, it was not a surprise to see India's industrial production (IP) faltering, shrinking 0.37% in September.

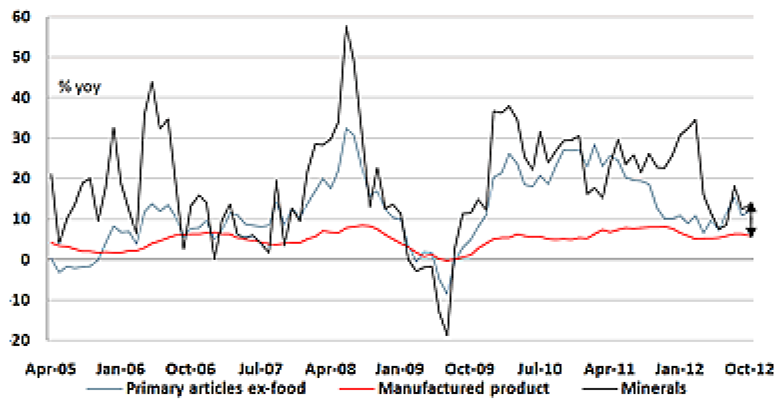
What is worse is that the August growth rate was also revised downward, by 0.47%. This data comes in as a big jolt since India's festival period has been in full swing now and this generally tends to spike up production aided by some build up in inventory.

Even more worrying is that the index value itself has been falling since March (with the exception of May), indicating that worse may be in store for the economy. Thus, for the first six months (April-September) of the present financial year, India's industrial production virtually remained stagnant (having growth by a mere 0.1%) compared with the same period in the previous year, when it grew 5.1%.

An analysis done by rediff.com shows that during quarter ending September 2012, while the Indian corporate sector recorded its highest net profit growth (with profit margins on the up), the core revenue grew a mere 9.2% on an annual basis, the lowest in three years.

If one adjusts for inflation, it would be safe to conclude that there's hardly any volume growth, indicating both poor demand and that the anaemic September industrial production data is a result of manufacturers being weary of faltering demand and hence preferring not to build up inventory, despite the approaching festival period.

The better margins for September are, therefore, a result of lower input costs. But now that the input costs are rising again, margins will shrink as companies prefer not to pass on higher costs to end users, thereby moderating the upward pressure on prices.



Source: Office of Economic Advisor, author's calculations

Hence the belief that the headline inflation may be close to peaking.

Having said that, inflation is not expected to ease soon enough to make the Reserve Bank of India walk down the monetary easing path now, as the overall inflation is still way above the bank's comfort zone and the government is yet to showcase its determination to ensure fiscal consolidation.

The only way the central bank can cut interest rates even in an-above comfort-zone inflation environment would be when inflation expectations are tamed. The problem is that with India's investment to gross domestic product (GDP) ratio falling over the past few years, the potential GDP growth rate has shrunk to less than 7%.

Thus, any improvement in demand will lead to shrinkage in the output gap, thereby resulting in a spike in inflation. Under this scenario, the RBI is unlikely to make its first rate cut move before the last quarter of the current financial year, that is in January to March 2013, though any form of aggressive rate cut is ruled out.

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