Rajan holds firm on battle against inflation
By Kunal Kumar Kundu

India: An economy undone
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Statistically speaking, the Indian economy may have bottomed out, but that's no cause for rejoicing. The impacts of a multitude of wrong policy choices will act as a drag and continue to pull back the economy. As John Maynard Keynes once famously said, "The boom, not the slump, is the right time for austerity."

Unfortunately for India, the country's policy makers do not care much what happens during the boom periods (as even their worst policy mistakes may not get exposed), while during a bust they have no choice. Not that I am hinting at austerity here in India. The problem is that during bust all necessary policies get shelved while wasteful expenditure continues in earnest.

India will pay the price for this, until probable salvation comes in the form of a new government after next year's general election.

The biggest price that the country is paying for all the policy mistakes manifests itself in the form of stubbornly high inflation. Inflation in India has remained elevated for an unprecedentedly long period of time. The official gauge of inflation, the Wholesale Price Index (WPI) averaged an annualized 8.3% over the past 45 months, starting from January 2010.

Source: Economic Advisor, author's calculation

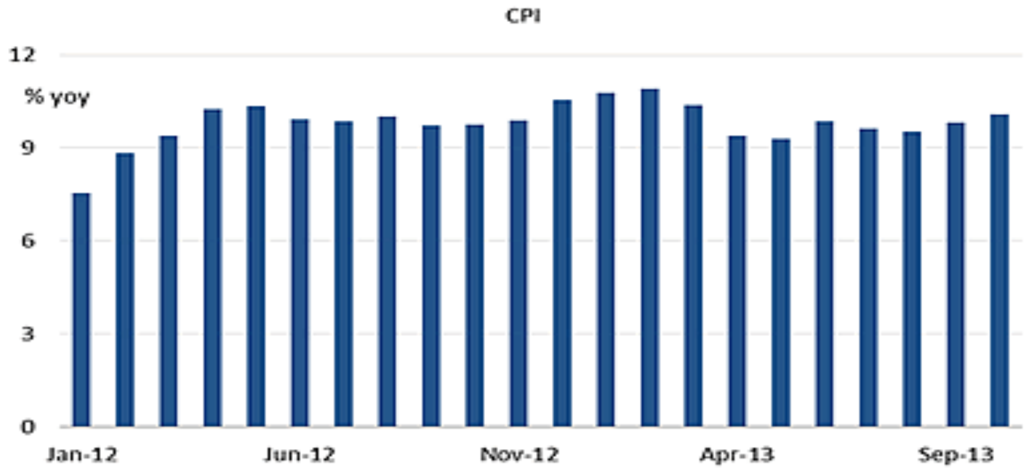
Although inflation was showing some signs of easing (albeit at a rather slow pace) from September 2012, of late the trend seems to have gone into reverse. The recently released WPI data for October 2013, shows that headline inflation is back at 7%.

More importantly, the data for August 2013 has been revised significantly upward from 6.1% annualized rate to 7%. Over the past 44 months, the WPI data has been revised upward as many as 35 times, with the average upward revision being to the tune of 0.5% per month.

Available indications suggest that by December, when it's time to release the final inflation data for September, it will again spike up, from 6.5% to 7% if not more. This will mean the third straight month of 7% inflation, much beyond Reserve Bank of India's targeted level of 5 to 5.5%.

The most important driver of headline inflation has again been food inflation, which clocked in at an 18.2% annualized rate during October. Over the past 60 months, food inflation averaged an annualized rate of 12.1%. With base effects failing to play any role, clearly food inflation has become more structural than cyclical.

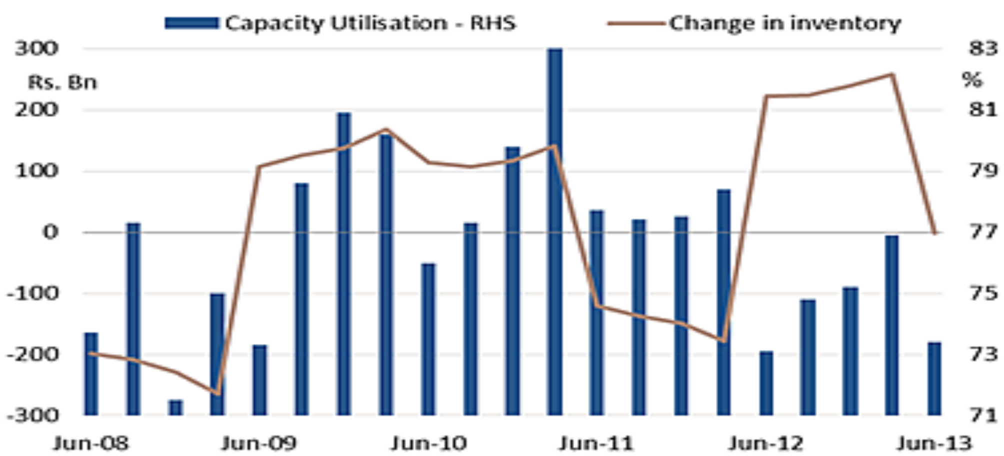
Even the other measure of inflation, the Consumer Price Index (CPI), crossed the 10% mark once more in October. Over the past 20 months, headline CPI inflation averaged an extremely high 9.8%.



Source: MOSPI

Given that inflation is the worst form of taxation on the poor, the government has not been covering itself in glory, despite an unwavering focus on social sector spending even at the cost of real economic progress.

The pain in the real economy is far from being over, though the downside may have bottomed out with 4.4% gross domestic product growth for the June 2013 quarter. Recently released industrial production data seems to have surprised the market, but on the downside. To me that in itself is a surprise. It seems that the analysts are not factoring in the effect on production of substantial build-up of inventory during the financial year that ended in March 2013.



Source: RBI, author's calculation

Most analysts were expecting a strong September number, given the likely impact of the forthcoming festive season in India. However, while their expectation was of a 3.5% growth in the Index of Industrial Production (IIP) during September, the final number came in at less than 2%, at 1.96%.

A closer look at the data reveals that festival-driven production was conspicuous by its absence - a clear manifestation of continued weak demand. What growth existed was driven mainly by a much improved performance by eight core industries, which did not have much going for them thus far.

However, despite the encouraging growth numbers, the problems of the core industries are from being over. As of June, about 50% of central sector projects (of 1.5 billion rupees, or US$24 million, and above) were delayed, up from 44% in June 2008, for which the cost overruns rose from 12% to 20% in the past five years.

Given the available information, the roads sector leads the list of delayed projects, followed by power, petroleum and railway. Not a surprising development given the vitiated policy development.

For the short term, therefore, the Indian economy will muddle through and anemic growth will be par for the course.

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