

South Asia

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Rajan holds firm on battle against inflation

By Kunal Kumar Kundu

Reserve Bank of India governor Raghuram Rajan has proved to be his own man and so far he has been doing an excellent job since taking over as the man at the top of the bank in early September.

While the previous governor, Duvvuri Subbarao, was also an inflation hawk towards the later part of his tenure, he failed to carry the government along with him and hence one was exposed to contradictory statements coming out from the two quarters, which does not necessarily make for conducive policy environment.

Rajan, however, has been able to stamp his authority and set appropriate expectations about his inflation fighting without much protest from the government. Of course, times change, and the government can only flex its muscles when dealing with an international heavyweight such as Rajan to its own peril.

Added to that is the fact that the government has tied itself into knots as far as fiscal discipline is concerned, especially given the forthcoming general election, due early next year.

The possibility of rolling over subsidy worth US\$15 billion to the next budget to officially keep the fiscal deficit within target shows that the government finds itself in a tight spot. This is officializing a practice that was started last year - that is, borrowing from next year's budget to meet the current year's expenses.

Rajan is fighting a lone battle, with his partner already having fled the battle field. In India, inflation has assumed major structural characteristics and, with the government unable to play its part, Rajan is left with no other option but to focus solely on inflation unless growth collapses. As of now, although the growth slowdown is palpable, it is not stark enough for Rajan to change the bias towards growth while weighing the growth-inflation trade off.

Not only does inflation in India continue to be inordinately high, it is showing signs of firming up after indications of some easing bias a few months back. A major contributor to the worrying level of headline inflation is high food inflation, which has averaged 12% annualized rate over the past 60 months.

High food inflation keeps headline Wholesale Price Index elevated



Source: EA Industry

Added to that, the rupee remains weak. Although it has appreciated by about 10% against the US dollar from its recent low and is showing signs of stability, it is still down by 13% from its end March close. Hence import inflation remains persistent.

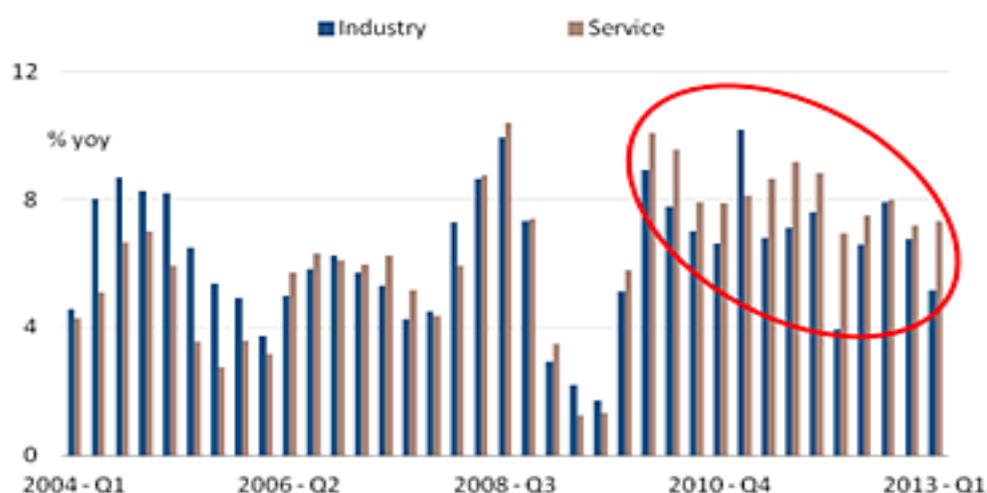
Rupee remains weak



Source: RBI

What is worrying is that the wage price spiral is feeding into core inflation from non-core (mostly food and fuel) inflation. While given the extent of demand destruction that the Indian economy has witnessed, manufacturing inflation remains benign as the corporations have weak pricing power, although service inflation has been high. A good way to gauge the service sector inflation is to calculate the same by using the sectoral gross domestic product deflator.

Service sector inflation remains high



Source: RBI, author's calculation

Not surprisingly, while the increases in the core Wholesale Price Index (WPI), which mostly represents manufactured goods inflation, remains relatively benign, core inflation in the Consumer Price Index, which has a much larger share of the service sector, remains at worrying levels.

Core CPI inflation much higher than core WPI



Source: Datastream, RBI, SG Cross Asset Research/Economics

Given this, it is not surprising that the Reserve Bank of India is moving away from looking only at core WPI inflation as a guide to monetary policy making and is keeping an equally hawkish eye on core CPI inflation.

This also explains why the central bank opted for a 0.25% increase in the policy rate during its meeting on October 29. With inflationary pressure showing no signs of abating, the RBI has clearly laid out its preference for being an inflation crusader under the circumstances. Hence one can expect at least one more round of rate increases by the RBI before it decides to take a pause.

Kunal Kumar Kundu is Vice President and India Economist at Societe Generale. The views are those of the author.

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